

REDEFINING  
SOVEREIGNTY IN  
INTERNATIONAL  
ECONOMIC LAW

EDITED BY  
WENHUA SHAN, PENELOPE SIMONS AND DALVINDER SINGH

STUDIES IN INTERNATIONAL TRADE LAW

## REDEFINING SOVEREIGNTY IN INTERNATIONAL ECONOMIC LAW

The concept of state sovereignty is increasingly challenged by a proliferation of international economic instruments and major international economic institutions. States from both the south and north are re-examining and debating the extent to which they should cede control over their economic and social policies to achieve global economic efficiency in an interdependent world. International lawyers are seriously rethinking the subject of state sovereignty, in relation to the operation of the main international economic institutions, namely the WTO, the World Bank and the International Monetary Fund (IMF).

The contributions in this volume, bringing together leading scholars from the developed and developing worlds, take up the challenge of debating the meaning of sovereignty and the impact of international economic law on state sovereignty. The first part looks at the issues from the perspectives of general international law, international economic law and legal theory. Part two discusses the impact of trade liberalisation on the sovereignty of both industrialised and developing states and Part three concentrates on the challenge to state sovereignty created by the proliferation of investment treaties and the significant recent growth of investment treaty based arbitration cases. Part four focuses on the domestic and international effects of international financial intermediaries and markets. Part five explores the tensions and intersections between the international regulation of trade and investment, international human rights and state sovereignty.

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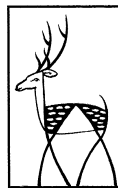
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Wenhua Shan  
Penelope Simons  
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## *List of Abbreviations*

AFSS	Assessment of Financial Sector Standards
AGOA	Africa Growth and Opportunity Act
AIM	Alternative Investment Market
AMS	Aggregate Measure of Support
ANC	African National Congress
ANCOM	Andeans Community
AoA	Agreement on Agriculture
APEC	Asia Pacific Economic Cooperation
ASEAN	Association of South Eastern Asian Nations
Bafin	Bundesanstalt für Finanzdienstleistungsaufsicht
BEE	Black Economic Empowerment
BIS	Bank for International Settlements
BITs	Bilateral investment treaties
CESCR	United Nations Committee on Economic, Social and Cultural Rights
CESR	Committee on European Securities Regulators
CFTC	Commodities and Futures Trading Commission
CNBV	National Banking and Securities Commission
CODESA	Convention for a Democratic South Africa
COSO	Committee of Sponsoring Organizations of the Treadway Commission
DSU	WTO Dispute Settlement Understanding
EC	European Community
ECB	European Central Bank
ECHR	European Convention for the Protection of Human Rights and Fundamental Freedoms
ECJ	European Court of Justice
ECJ	European Court of Justice
ECtHR	European Court of Human Rights
ESC Rights	Economic, Social and Cultural Rights
EU	European Union
FAO	Food and Agriculture Organization of the United Nations
FDI	Foreign Direct Investment
FRRP	Financial Reporting Review Panel
FSA	Financial Services Authority
FSAP	Financial Sector Assessment Program
FSSA	Financial System Stability Assessment
FTA	Free Trade Agreement

FTAA	Free Trade Agreement of the Americas
GAAP	Generally Accepted Accounting Principles
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	Gross domestic product
GPA	Agreement on Government Procurement
IATP	Institute for Agriculture and Trade Policy
ICC	International Chamber of Commerce
ICC	International Criminal Court
ICANN	Internet Corporation for Assigned Names and Numbers
ICCPR	International Covenant on Civil and Political Rights
ICESCR	International Covenant on Economic, Social and Cultural Rights
ICSID	International Centre for the Settlement of Investment Disputes
IFRS	International Financial Reporting Standards
IAs	international investment agreements
IISD	International Institute for Sustainable Development
ILM	International Legal Materials
ILO	International Labour Organization
IMF	International Monetary Fund
IOSCO	International Organisation of Securities Commissioners
MAI	Multilateral Agreement on Investment
MERCOSUR	Common Market of the South
MFN	most favoured nation (treatment)
MIGA	Multilateral Investment Guarantee Agency
MTN	Medium Term Note
NAFTA	North America Free Trade Agreement
NFIDCs	Net Food-Importing Developing Countries
NGOs	non-governmental organisations
NIEO	New International Economic Order
NP	(South African) National Party
NYSE	New York Stock Exchange
OECD	Organisation for Economic Cooperation and Development
OHCHR	Office of the High Commissioner for Human Rights
PPPs	public-private partnerships
PTIAs	preferential trade and investment agreements
QIS	Quantitative Impact studies
ROSC	Report on Observance of Standards and Codes
RTAs	Regional Trade Agreements
SACU	South African Customs Union
SAPs	Structural Adjustment Programmes
SCC	Stockholm Chamber of Commerce
SDT	Special and Differential Treatment
SEC	Securities and Exchange Commission

SPS	Sanitary and Phytosanitary Measures
SPs	Special Products
SPS	Agreement on the Application of Sanitary and Phytosanitary Measures
SOG	Special Safeguard Mechanism
SSM	Special Safeguard Mechanism (for Developing Countries)
TBT	Technical Barriers to Trade
TCE	Treaty Establishing a Constitution for Europe
TNCs	Transnational Corporations
TRIPs	Trade-Related Aspects of Intellectual Property Rights
TRQ	Tariff Rate Quota
UDHR	Universal Declaration of Human Rights
UN	United Nations
UNCITRAL	United Nations Commission on International Trade Law
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNESCO	United Nations Scientific and Cultural Organization
UNGA	United Nations General Assembly
US	United States
USTR	United States Trade Representative
VCLT	Vienna Convention on the Law of Treaties
WHO	World Health Organization
WIPO	World Intellectual Property Organization
WTO	World Trade Organization



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# Introduction

W SHAN, P SIMONS AND D SINGH

*There exists perhaps no conception, the meaning of which is more controversial than that of sovereignty. It is an indisputable fact that this conception, from the moment when it was introduced into political science until the present day, has never had a meaning which was universally agreed upon.*

Lassa Oppenheim, *International Law* 137  
(AD McNair (ed), 4th edn 1928).

SOVEREIGNTY HAS ALWAYS been a controversial concept, but perhaps has never attracted as much discussion and debate as it does today. Rapid advancements in transport and communication technologies, together with a proliferation of international treaties and institutions, have led to an increasingly globalised world. The sovereign independence of states seems to have given way to interdependence, particularly in economic spheres. Has the concept of sovereignty lost its relevance in the current international legal system, as has been argued by some?<sup>1</sup> Or does it continue to play a key role in defining relations between states?<sup>2</sup> International lawyers have thus been debating and rethinking the meaning and significance of state sovereignty.

This same debate is taking place within international economic law in relation to the operation of the major international economic institutions, such as the World Trade Organisation, the World Bank and the International Monetary Fund. This book compiles the papers presented at the Society of Legal Scholars (SLS) Symposium 2006 entitled 'Redefining Sovereignty: An International Debate on Sovereignty and International Economic Law', which was held on 30–31 May 2006 at Oxford Brookes University, Oxford. It is the first collection of writings on this topic by leading scholars from both developed and developing country backgrounds.

The structure of book resembles that of the conference. Thus the book is divided into five parts, with Part One focusing on the general theme and

<sup>1</sup> L Henkin, for instance, has argued for a complete abandonment of the concept of 'sovereignty'. He writes, '[F]or legal purposes at least, we might do well to relegate the term sovereignty to the shelf of history as a relic from an earlier era'. L Henkin, *International Law: Politics and Values* (Dordrecht, Martinus Nijhoff Publishers, 1995) at 10.

<sup>2</sup> R Jennings, for example, has observed that, '[L]ooking even briefly at such international constitutional law as we have, one can only conclude that the suggested demise of national State sovereignty has been much exaggerated'. R Jennings, 'Sovereignty and International Law', in G Kreijen *et al* (eds), *State, Sovereignty, and International Governance* (Oxford, OUP, 2002), at 35.

the other four Parts devoted to trade, investment, banking and human rights respectively. The first Part of the book looks at the impact on state sovereignty of international economic law and institutions from general and theoretical perspectives. Drawing on his extensive research on this topic, *John Jackson* argues that the traditional, Westphalian concept of sovereignty no longer represents an adequate understanding of sovereignty in today's globalised world and he identifies a new notion of sovereignty which he refers to as 'Sovereignty-Modern'. The essence of this new approach is that the concept of sovereignty should not be completely discarded or eliminated without establishing a valid substitute, but should be disaggregated and redefined by employing analytical tools such as 'power allocation analysis'. *Ernst-Ulrich Petersmann*, in his chapter, contends that the effective protection of human rights and market rights requires the constitutionalisation of international law. He develops a case for the extension of rights-based multilevel constitutionalism, which characterises German and EU law, to international economic law and its institutions. For Petersmann, this would entail the strengthening of democratic processes and legal remedies at the global, transnational level to ensure a proper balancing of rights and obligations. *Robert Howse* questions two commonly held assumptions about state sovereignty: first that states have in fact relinquished sovereign power of control to global markets; and second that economic globalisation and the globalisation of common social values, such as human rights, has led to the shift of sovereign power from the state to international organisations or other international governance mechanisms. Providing poignant examples, Howse suggests that in many cases state sovereignty has not in fact been ceded, but rather strengthened. *Vaughan Lowe's* contribution provides an excellent conclusion to this Part. For Lowe, the term 'sovereignty' in public international law is a 'signifier', rather than a legal norm, principle or institution, and he argues that, for lawyers, the debate over the term is, strictly speaking, unnecessary.

Part Two of the collection discusses the impact of the WTO's regime on sovereignty of both industrialised and developing states with specific reference to the dispute settlement system and proposals for reforming the organisation. It attempts to address the issue of a law-based system of trade liberalisation and the pressures exerted by state sovereignty. *An Chen* reviews the outcomes of the last three rounds of trade cases to critique the US unilateralist approach to the multilateralist model adopted by the international community represented by the WTO. Utilising this analysis Chen highlights the threat this unilateralist approach poses to general international peace and security and state sovereignty. *Philip Nichols* provides a broad survey of international law and sovereignty both from an historical and contemporary perspective. He suggests the WTO should adopt a new criterion for membership to better represent the more modern interpretation of sovereignty in international law and international relations. *Asif Qureshi* explores the relationship between the WTO and state sovereignty by briefly analysing state sovereignty from the perspective of self determination and the right to development. He uses this perspective to analyse

the WTO's dispute settlement system and the reform agenda associated with it, to discuss how best to improve the way these matters can be dealt with when trade disputes arise. He illustrates the extent to which the WTO has accommodated state sovereignty and what it can do further to include the development objectives of developing states. *Mads Andenas* and *Stefan Zleptnig*, on the other hand, provide a detailed examination of how better to take into account 'non-trade' concerns. They provide a comparative analysis of the principle of 'proportionality' and its possible utility in the constitutional make up of the WTO to enhance the efficiency with which it can take into account the competing interests in world trade in its judicial decision making. The components of the proportionality principle and tests associated with it are considered.

Part Three discusses the challenges to state sovereignty created by the proliferation of investment treaties and the dramatic increase of investment treaty based arbitration cases in recent years. In his contribution, *M Sornarajah* looks at the issue from a political economic theory perspective and explores the neo-liberal agenda underlying international investment treaties and arbitration. In particular, he identifies some worrying trends of expansionary treaty interpretation adopted by some arbitrators, and warns that certain arbitrators have raised questions as to the 'legitimacy of the system itself', which may break down unless 'there is self-correction effected'. *Joachim Karl* provides an evaluation of the impact of investment treaties and arbitration on state sovereignty. He explores the main limitations of investment treaties on state sovereignty, and discusses concerns with regard to dispute settlement procedures. More importantly, he also highlights potential areas of reform—such as clarifying substantive treaty provisions, limiting access to investment arbitration, and improving consistency and predictability of awards—which states may take in order to reassert state sovereignty in investment arbitration. *Wenhua Shan* looks at issues of state sovereignty and international investment law from a more specific angle, namely the 'death' and 'revival' phenomenon of the Calvo Doctrine. After examining the domestic laws and international treaty practices of Latin American states, he concludes that the doctrine was merely deactivated, but not completely dead in the 1990s, and that there is now a new trend of revival of the Calvo Doctrine within and beyond Latin America. He argues that the revival of Calvo signals a shift of tension in international investment law, from a 'north-south divide' towards a 'private-public debate', and that a 'double-layered approach' should be taken in understanding the concept of state sovereignty.

Part Four examines the challenges faced by sovereign states from international financial intermediaries and markets at a domestic and international level. *Charles Chatterjee* and *Anna Lefcovitch* explore the work developing countries need to do to improve access to banking finance to assist with economic growth and sustainable development. With this broad agenda in mind, they argue that there is a need for effective oversight of the banking system to improve depositor confidence. The problem associated with compliance

is however inextricably linked to the countries' stage of development. *Dalvinder Singh* provides an analysis of the role of the IMF and World Bank in financial sector reform and the emerging compliance with the Basel Core Principles for Effective Bank Supervision. He explores the necessity for regulation and supervision to oversee banks' domestic and transnational activities. *Jorge Guira* investigates the opportunity and risks exposed to sovereign states by the actions of international financial intermediaries. The idea of regulatory arbitrage is used to illustrate how the UK and US have through regulation directly and indirectly influenced the shape of corporate governance, optimal levels of bank risk and capital, and the hedge fund industry.

Part Five of this collection examines tensions and intersections between state sovereignty, the international regulation of trade and investment and the promotion and protection of human rights. *Andrew Lang* examines the trade and human rights literature and questions the necessity of using human rights language to critique mainstream trade policy. He critically assesses the impact of the trade and human rights literature in terms of moving forward debates about appropriate trade policy. *Penelope Simons* investigates the link between the structure of the WTO Agreement on Agriculture, corporate concentration in agricultural markets and food insecurity in developing countries. She analyses the current agricultural trade rules, state and corporate practice under those rules, as well as current proposals for reform under the Doha Round negotiations, and assesses the impact of such rules, practices and proposals on the capacity of developing states to comply with their obligations to respect, protect and fulfil the right to adequate food. *David Schneiderman*, in his chapter, examines the tension between national constitutional priorities and the transnational or international protection of economic interests under the international investment rules promoted by industrialised states. Suggesting that states are entitled to develop constitutionally supported human rights protections, he examines the South African policy of Black Economic Empowerment and the extent to which these types of policies may contravene or clash with the key tenets of current bilateral free trade and investment agreements.

International economic law is relatively new, but it is the fastest developing area of international law. The papers in this edited collection present a richness and diversity of perspectives and raise important concerns in relation to the expansion of international economic law and its institutions, and the implications of this expansion for state sovereignty. We hope this collection will initiate and stimulate further debate on this topic.

*(March 2008, Oxford)*

Part One

**Sovereignty and International  
Economic Law**





## *Sovereignty: Outdated Concept or New Approaches*

JOHN H JACKSON

THIS CONFERENCE SO ably organized by the Oxford Brookes University, and particularly Professor Wenhua Shan has been titled ‘Sovereignty’ and focuses on one of the most important but problematic concepts of International Law. With a number of papers on different economic and regulatory contexts, the variety of puzzles posed by the concept ‘Sovereignty’ has been excellently demonstrated. The organizers have mentioned that one particular stimulus for this conference and its topic was an article by this author published in the *American Journal of International Law*.<sup>1</sup> Subsequent to that publication, a book by this author has been published by Cambridge University Press in April 2006 (also slightly before the conference was held.) My contribution to this conference therefore is appropriately related to those works, and builds upon them. Readers who are interested in a fuller exposition of my thinking in this context may wish to address directly those two works (as well as several other works by this author).<sup>2</sup>

Although much criticized, the concept of ‘sovereignty’ is still central to much thinking about international relations and particularly international law. The

<sup>1</sup> JH Jackson, ‘Sovereignty Modern: A New Approach to an Outdated Concept’, 97 *Am J Int’l L* 782 (2003).

<sup>2</sup> JH Jackson, *Sovereignty, the WTO, and Changing Fundamentals of International Law* (CUP, 2006). Other related published works by this author includes: JH Jackson, ‘The Great 1994 Sovereignty Debate: United States Acceptance and Implementation of the Uruguay Round Results’, in *Politics, Values, and Functions: International Law in the 21st Century—Essays in Honor of Professor Louis Henkin* 149 (JI Charney *et al* (eds) 1998) [hereinafter Jackson, *The Great Sovereignty Debate*]; JH Jackson, ‘Sovereignty, Subsidiarity, and Separation of Powers: The High-Wire Balancing Act of Globalization’, in *The Political Economy of International Trade Law: Essays in Honour of Robert E. Hudec* 13 (DLM Kennedy and JD Southwick (eds), 2002); see also Jackson, below n 5; JH Jackson, ‘The WTO Dispute Settlement Understanding—Misunderstandings on the Nature of Legal Obligation’, 91 *AJIL* 60 (1997) (Editorial Comment); JH Jackson, WJ Davey, and AO Sykes, *Legal Problems Of International Economic Relations: Cases, Materials And Text On The National And International Regulation Of Transnational Economic Relations* (4th edn 2002); see Jackson, above n 1.

old 'Westphalian' concept in the context of a nation-state's 'right' to monopolize certain exercises of power with respect to its territory and citizens has been discredited in many ways, but it is still prized and harbored by those who maintain certain 'realist' views or who otherwise wish to prevent (sometimes with justification) foreign or international powers and authorities from interfering in a national government's decisions and activities. Furthermore, when one begins to analyze and disaggregate the concept of sovereignty, it quickly becomes apparent that it has many dimensions. Often, however, the term 'sovereignty' is invoked in a context or manner designed to avoid and prevent analysis, sometimes with an advocate's intent to fend off criticism or justifications for international 'infringements' on the activities of a nation-state or its internal stakeholders and power operators.

In addition to the 'power monopoly' function, sovereignty also plays other important roles. For example, the concept is central to the idea of 'equality of nations,' which can be abused and, at times, is dysfunctional and unrealistic. This often leads to various techniques to avoid the 'one nation, one vote' approach to decision making in international institutions. The concept of equality of nations is linked to sovereignty concepts because sovereignty has fostered the idea that there is no higher power than the nation-state, so its 'sovereignty' negates the idea that there is a higher power, whether foreign or international (unless consented to by the nation-state). This approach can sometimes seriously misdirect actions of those institutions, but substitutes such as consensus, in turn, can often lead to paralysis, damaging appropriate coordination and other decision making at the international level.

'Sovereignty' also plays a role in defining the status and rights of nation-states and their officials. Thus, we recognize 'sovereign immunity' and the consequential immunity for various purposes of the officials of a nation-state.<sup>3</sup> Similarly, 'sovereignty' implies a right against interference or intervention by any foreign (or international) power. It can also play an antidemocratic role in enforcing extravagant concepts of special privilege of government officials.

In addition, one can easily see the logical connection between the sovereignty concepts and the very foundations and sources of international law. If sovereignty implies that there is 'no higher power' than the nation-state, then it is argued that no international law norm is valid unless the state has somehow 'consented' to it. Of course, treaties (or 'conventions') almost always imply, in a broader sense, the 'legitimate' consent of the nation-states that accepted them. However, important questions arise in connection with many treaty details, such as when a treaty-based international institution sees its practice and 'jurisprudence' evolve over time and purports to obligate its members even

<sup>3</sup> See Arrest Warrant of 11 Apr 2000 (Dem Rep Congo *v* Belg), 41 *ILM* 536 (2002) (*Int'l Ct Justice*, Feb 14, 2002) (especially separate opinion of Judge ad hoc Bula-Bula, *ibid* at 597 (in French)).

though they opposed that evolution.<sup>4</sup> Likewise, treaty making by various ‘sovereign’ entities can be seriously antidemocratic and otherwise flawed.<sup>5</sup>

Like treaties, the other major source of international law norms, ‘customary international law,’ is theoretically based on the notion of consent, through the ‘practice of states’ and ‘*opinio juris*.’ For centuries, practitioners and scholars have debated the impact of customary international law on ‘holdout’ states, and what constitutes a ‘holdout,’ but often in the context of rationalizing the notion that consent exists. The ambiguities of these notions are obvious, and form part of a broader mosaic of criticism against the very existence of ‘customary international law norms.’<sup>6</sup>

The above remarks do not exhaust the complexity of the ‘sovereignty’ concept. This article, however, does not purport to cover all possible dimensions of sovereignty but, instead, focuses on what might be thought of as the core of sovereignty—the ‘monopoly of power’ dimension—although it will be clear that even this focus inevitably entails certain linkages and ‘slop-over penumbra’ of the other sovereignty dimensions. This ‘core’ dimension is examined in the context of its roles with respect to international law and institutions generally, and international relations and related disciplines such as economics.

National government leaders and politicians, as well as special interest representatives, too often invoke the term ‘sovereignty’ to forestall needed debate. Likewise, international elites often assume that ‘international is better’ (thus downplaying the importance of sovereignty) and this is not always the better approach. What is needed is a close analysis of the policy framework that gets us away from these preconceived ‘mantras.’ The objective is to shed some light on these policy debates or, in some cases, policy dilemmas, and to describe some of the policy framework that needs to be addressed.

The subject of this article has been extensively addressed in different kinds of frameworks or academic disciplines, many contained in books by political science and international relations scholars with important insights,<sup>7</sup> in addition

<sup>4</sup> An example of an ‘evolutionary approach’ can be seen in some of Professor Thomas Franck’s writings, particularly, TM Franck, *Recourse to Force: State Action against Threats and Armed Attacks* 8 (2002) (noting the evolution of practice regarding the veto power under the UN Charter). See also *United States—Import Prohibition of Certain Shrimp and Shrimp Products, Report of the Appellate Body*, WTO Doc WT/DS58/AB/R, para 130 (adopted Nov 6, 1998).

<sup>5</sup> See, eg, JH Jackson, ‘Status of Treaties in Domestic Legal Systems: A Policy Analysis’, 86 *AJIL* 310 (1992).

<sup>6</sup> See CA Bradley and JL Goldsmith, ‘Customary International Law as Federal Common Law: A Critique of the Modern Position’, 110 *Harv L Rev* 816 (1997); JL Goldsmith and EA Posner, ‘Understanding the Resemblance Between Modern and Traditional Customary International Law’, 40 *Va J Int’l L* 369 (2000); JP Kelly, ‘The Twilight of Customary International Law’, 40 *Va J Int’l L* 449 (2000).

<sup>7</sup> See, eg, MR Fowler and JM Bunck, *Law, Power, and The Sovereign State* (1995); TL Friedman, *The Lexus And The Olive Tree: Understanding Globalization* (1999); *The Greening Of Sovereignty In World Politics* (KT Liftin (ed), 1998); SD Krasner, *Sovereignty: Organized Hypocrisy* (1999); *State, Sovereignty, And International Governance* (Gerald Kreijen et al (eds), 2002); *State Sovereignty As Social Construct* (TJ Biersteker and CW (eds), 1996); *Subsidiarity And Shared Responsibility: New Challenges For Eu Environmental Policy* (Ute Collier, J Golub, and A Kreher (eds), 1997); Centre For Economic Policy Research [CEPR], ‘Making Sense of Subsidiarity’,

to the many works by legal professionals.<sup>8</sup> However, many of those works focus on how to describe the concept of ‘sovereignty,’ how it has operated in the past and present in international relations, and how it can be criticized. This article addresses a somewhat different question; namely, what, if any, are the valid issues raised in the so-called sovereignty debates, and how can we analyze those issues for their future impact on policy?

The importance and need for this type of analytic activity should be obvious, but still merits mention. Much has been said and written about ‘globalization’. Despite being an ambiguous term of controversial connotation, it is reasonably well understood to apply to the exogenous world circumstances of economic and other forces that have developed in recent decades owing, in major part, to the sharply reduced costs and time required for the transport of goods (and services), and similar reductions in costs and time requirements for communication.<sup>9</sup> These circumstances have led to new structures of production; they, in turn, have resulted in greatly enhanced (and sometimes dangerous) interdependence, which we can do little to remedy and which often renders the older concepts of ‘sovereignty’ or ‘independence’ fictional. Indeed, these circumstances, particularly those of communication techniques heretofore unknown, are seen as having dramatic effect on the way governments act internally. In addition, these circumstances often demand action that no single nation-state can satisfactorily carry out, and thus require some type of institutional ‘coordination’ mechanism. In some of these circumstances, therefore, a powerful tension is generated between traditional core ‘sovereignty,’ on the one hand, and the international institution, on the other hand. This tension is constantly apparent, and addressed in numerous situations, some of which are poignantly and elaborately verbalized in the work of international juridical institutions such as the dispute settlement system of the World Trade Organization (WTO).<sup>10</sup> In fact, the now extraordinarily elaborate jurisprudence

in *Annual Report: Monitoring European Integration* 4 (1993) [hereinafter CEPR, Subsidiarity]; see also A Chayes and AH Chayes, *The New Sovereignty* (1995).

<sup>8</sup> See, eg, L Henkin, *International Law: Politics and Values* (1995); Marcel Brus, ‘Bridging the Cap Between State Sovereignty and International Governance: The Authority of Law’, in *State, Sovereignty, And International Governance*, above n 7, at 3.

<sup>9</sup> Some historical literature claims that at the turn of the previous century (late 1800s, early 1900s), the world was very integrated and, arguably, more freely permitted transactions to cross borders than at present. See, eg, J Frankel, ‘Globalization of the Economy’, in *Governance in a Globalizing World* 45 (JS Nye Jr and JD Donahue (eds), 2000). However, the circumstances are vastly different today, particularly in view of the factors mentioned in the text, which have an astonishingly different impact on globalization of world society than the factors involved one hundred years ago.

<sup>10</sup> See, eg, JH Jackson, *The Jurisprudence Of The GATT and the WTO: Insights on Treaty Law and Economic Relations* (2000) [hereinafter Jackson, *The GATT and the WTO*]; JH Jackson, *The World Trading System: Law And Policy Of International Economic Relations* (2nd edn 1997); Jackson, Davey, and Sykes, above n 2, ch 7; JH Jackson, ‘Dispute Settlement and the WTO: Emerging Problems’, 1 *J Int’l Econ L* 329 (1998) [hereinafter Jackson, *Dispute Settlement*].

of the WTO<sup>11</sup> exemplifies the tension between internationalism and national governments' desires to govern and deliver to their democratic constituencies, a tension that is also manifested in a large number of international law and international relations contexts.

These considerations suggest the need for further rethinking (or reshaping) of the core concept and roles of sovereignty, and for a new phrase to differentiate these directions from the old and, some argue, outmoded 'Westphalian' model.

Consequently, this article will approach the subject of 'sovereignty-modern' in several further parts. These parts involve a connected logic; after noting the setting and 'landscape' of the subject and the ambitions of the article, they proceed (part I) to outline, and remind the reader about the older sovereignty concepts and to survey a small portion of a vast literature of criticisms of these older concepts. Part II then presents this author's views about what elements of the traditional sovereignty concepts may remain important in current global circumstances and how these 'real policy values' need to be recognized and separated from the outmoded baggage of older Westphalian sovereignty concepts. Principally (but not exclusively), this article focuses on the 'policy values' of allocating power to the decision-making mechanism that operates with authority and legitimacy.

Part III then fleshes out some of the policy detail of the 'allocation' issues, in the modern and global context, with reference to policies that might suggest the need for a higher- or lower-level allocation of power.

Part IV briefly presents a few examples to illustrate the approach suggested by parts II and III. Examples could be drawn from widely different subjects (economic matters, human rights, the environment, federal entities, etc) to suggest the potential generality of the discussion in parts II and III. However the emphasis in part IV on economic subjects reflects the stronger expertise of this author, but other subject areas easily could suggest potential relevance of the analysis in parts II and III.

Finally, part V draws some conclusions, including an important underlying theme of the article, first articulated in this introduction. This theme not only shows how the rethinking of 'sovereignty' is necessary to escape the traps of use or misuse of older sovereignty thinking, but also challenges certain other key 'fundamentals' of 'general' international law thinking, such as the 'nation-state consent' requirement of norm innovation and the notion of 'equality of nations'.

<sup>11</sup> In less than 11 years of existence (since Jan 1, 1995), as of Dec 6, 2007 the WTO dispute settlement system has received 369 complaints, see [http://www.wto.org/english/tratop\\_e/dispu\\_e/dispu\\_status\\_e.htm](http://www.wto.org/english/tratop_e/dispu_e/dispu_status_e.htm) and see also Update of WTO Dispute Settlement Cases, WTO Doc WT/DS/OV/27 (Jun 9, 2006), and has completed 142 adopted panel reports and 84 appellate body reports. The total number of pages of the jurisprudence exceeds fifty thousand, and all informed observers seem to recognize that this is indeed a remarkable achievement, particularly when one examines the intricacy and complexity of the cases, and the importance of the analysis and reasoning.

I. TRADITIONAL WESTPHALIAN SOVEREIGNTY CONCEPTS:  
OUTMODED AND DISCREDITED?

The general perception is that the concept of sovereignty as it is thought of today, particularly as to its 'core' of a monopoly of power for the highest authority of what evolved as the 'nation-state,' began with the 1648 Treaty of Westphalia. As time passed, this developed into notions of the absolute right of the sovereign, and what we call 'Westphalian sovereignty.'<sup>12</sup>

One United States government official has succinctly defined the concept and its problems:

Historically, sovereignty has been associated with four main characteristics: First, a sovereign state is one that enjoys supreme political authority and monopoly over the legitimate use of force within its territory. Second, it is capable of regulating movements across its borders. Third, it can make its foreign policy choices freely. Finally, it is recognized by other governments as an independent entity entitled to freedom from external intervention. These components of sovereignty were never absolute, but together they offered a predictable foundation for world order. What is significant today is that each of these components—internal authority, border control, policy autonomy, and non-intervention—is being challenged in unprecedented ways.<sup>13</sup>

As noted above, a considerable amount of literature deals with the issue of 'sovereignty' and the various concepts to which it might refer. Most of this literature is very critical of the idea of 'sovereignty' as it has generally been known. One eminent scholar has described the sovereignty concept as 'organized hypocrisy.'<sup>14</sup> Some other authors have referred to it as being 'of more value for purposes of oratory and persuasion than of science and law.'<sup>15</sup>

World leaders and diplomats have added their critical appraisals of older sovereignty ideas, while still recognizing the importance of some attributes of

<sup>12</sup> The 'Treaty of Westphalia' is the Peace Treaty Between the Holy Roman Emperor and the King of France and Their Respective Allies, Oct 24, 1648, available at <<http://fletcher.tufts.edu/multi/texts/historical/westphalia.txt>> (visited Oct 6, 2006).

<sup>13</sup> RN Haass, former ambassador and director of Policy Planning Staff, US Department of State, 'Sovereignty: Existing Rights, Evolving Responsibilities', Remarks at the School of Foreign Service and the Mortara Center for International Studies, Georgetown University, at 2 (Jan 14, 2003), transcript available at <http://www.state.gov/s/p/rem/2003/16648.htm> (visited Oct 6, 2006). Ambassador Haass is currently president of the Council on Foreign Relations.

<sup>14</sup> Krasner, above n 7, at 9, where he describes four ways that the term 'sovereignty' has been used:

domestic sovereignty, referring to the organization of public authority within a state and to the level of effective control exercised by those holding authority; interdependence sovereignty, referring to the ability of public authorities to control transborder movements; international legal sovereignty, referring to the mutual recognition of states or other entities; and Westphalian sovereignty, referring to the exclusion of external actors from domestic authority configuration.

<sup>15</sup> Fowler and Bunck, above n 7, at 21 (quoting Quincy Wright, *Mandates under the League of Nations* 277–8 (1968)).

the concept. In 1992 the then United Nations secretary-general Boutros Boutros-Ghali said in his report to the Security Council, 'Respect for [the state's] fundamental sovereignty and integrity [is] crucial to any common international progress. The time of absolute and exclusive sovereignty, however, has passed; its theory was never matched by reality'.<sup>16</sup>

Almost a decade later, after some abject failures by the United Nations to meet apparent needs for action and intervention in Bosnia, Somalia, Rwanda, and Kosovo, the new secretary-general Kofi Annan introduced his 1999 annual report to the General Assembly by noting that '[o]ur post-war institutions were built for an inter-national world, but we now live in a global world.'<sup>17</sup> Secretary-General Annan then expressed impatience with traditional notions of sovereignty:

If the collective conscience of humanity—a conscience which abhors cruelty, renounces injustice and seeks peace for all peoples—cannot find in the United Nations its greatest tribunal, there is a grave danger that it will look elsewhere for peace and for justice.

Any such evolution in our understanding of State sovereignty and individual sovereignty will, in some quarters, be met with distrust, scepticism, even hostility. But it is an evolution that we should welcome.

Weapons of mass destruction, genocide, failed states, and rogue states all pose extreme conceptual problems for doctrines of sovereignty. But, of course, an important dilemma develops when international institutions do not have the capacity or the will to act to prevent or redress such extreme dangers to world peace and security or to particular regions and populations. In what circumstances, then, should other entities, including powerful sovereign states, have the right or duty to step into the breach? And to what degree is there a requirement to exhaust recourse to international institutions before such action? Has the practice of nations already begun to develop new norms condoning such a practice?

Some of the discussion and practice about the role of 'sovereignty' also focuses on the principle of 'subsidiarity,' which is variously defined, but roughly stands for the proposition that governmental functions should be allocated, among hierarchical governmental institutions, to those as near as possible to the most concerned constituents, usually downward on the hierarchical scale. Therefore, some believe that an allocation to a higher level of government would require special justification as to why that higher institutional power was necessary to achieve the desired goals.<sup>18</sup>

In addition, most authors discussing 'sovereignty' cite a very large number of 'anomaly examples'; mainly situations of governmental entities that do not fit

<sup>16</sup> *An Agenda for Peace—Preventive Diplomacy, Peacemaking, and Peace-Keeping, Report of The Secretary-General*, UN Doc A/47/277-S/24111, para 17 (1992), UN Sales No E.95.1.15 (1995).

<sup>17</sup> UN Secretary-General Kofi Annan, quoted in Brus, above, n 8 at 19.

<sup>18</sup> See text at n 32–5 below in Part II cited references.



into the normal concepts of sovereignty.<sup>19</sup> Thus, sovereignty is sometimes divided up or ‘fractionated,’ sometimes temporarily, sometimes nominally, for example, to facilitate a diplomatic compromise.

Overall, the concept of sovereignty seems quite often to be extremely, and perhaps purposefully, misleading, and may act as a crutch for politicians and the media to avoid the tough and very complex thinking that should be undertaken about the real policy issues involved.<sup>20</sup>

In the area of trade policy, one finds many specific instances of avoidance of ‘sovereignty concepts.’ A striking example is the General Agreement on Tariffs and Trade (GATT) and now, the WTO, whose membership is not limited to a ‘sovereign entity’ but, instead, to a ‘State or separate customs territory possessing full autonomy in the conduct of its external commercial relations.’<sup>21</sup>

Sometimes the principle of noninterference on the nation-state level is closely linked to sovereignty, yet today’s globalized world abounds in instances in which the actions of one nation (particularly an economically powerful nation) constrain and influence the internal affairs of other nations. For example, powerful nations have been known to influence the domestic elections of other nations and to link certain policies or advantages (such as aid) to domestic policies relating to subjects such as human rights. International organizations also partake in some of these linkages, as evidenced by the so-called conditionality of the International Monetary Fund (IMF).<sup>22</sup>

For these and other reasons, some scholars would like to do away with sovereignty entirely. Professor Henkin writes, ‘For legal purposes at least, we might do well to relegate the term sovereignty to the shelf of history as a relic from an earlier era.’ But he continues his thought by saying, ‘To this end, it is necessary to analyse, ‘decompose’ the concept . . .’<sup>23</sup>

This article expresses the view that the complete elimination of the word or concepts associated with ‘sovereignty’ would lose some important principles. This observation leads me to part II, discussing affirmative attributes of

<sup>19</sup> RH Jackson, *Quasi-States: Sovereignty, International Relations, and the Third World* (1990). Krasner, in his book, above n 7, elaborately describes many such anomalies, which led him to the title *Sovereignty: Organized Hypocrisy*.

<sup>20</sup> See works cited in n 7 above.

<sup>21</sup> General Agreement on Tariffs and Trade, Oct 30, 1947, Art XXXIII, TIAS No 1700, 55 UNTS 194 [hereinafter GATT]; Marrakesh Agreement Establishing the World Trade Organization, Apr 15, 1994, Art XII, in World Trade Organization, *The Legal Texts: The Results of the Uruguay Round of Multilateral Trade Negotiations* (1999) [hereinafter WTO Agreement].

<sup>22</sup> Many examples of linkages exist, such as pressures by the European Union for human rights protection in the Cotonou Agreement, the Association Agreement with African, Caribbean, and Pacific States. See E de Vos, ‘The Cotonou Agreement: A Case of Forced Regional Integration?’ in *State, Sovereignty, and International Governance*, above n 10, at 497; see also *Krasner*, above n 10, at 105 (for other human rights linkages); GC Hufbauer, JJ Schott, and Kimberly Ann Elliott, *Economic Sanctions Reconsidered* (3rd edn forthcoming 2004) (for economic sanctions to promote human rights). On IMF conditionality, see, for example, DE Siegel, ‘Legal Aspects of the IMF/WTO Relationship: The Fund’s Articles of Agreement and the WTO Agreements’, 96 *AJIL* 561, 572–5 (2002).

<sup>23</sup> Henkin, above n 8, at 10, quoted in Jackson, *The GATT and the WTO*, above n 10, at 367.

sovereign concepts, and to part III, which develops the concept of ‘sovereignty-modern’.

## II. POTENTIALLY VALID POLICY OBJECTIVES OF SOVEREIGNTY CONCEPTS

### 1. Sovereignty and the Allocation of Power

Recognizing that almost no perceptive observer or practitioner is prepared to sign on to the full import of the traditional Westphalian notion of sovereignty, what can be said in favor of modified or ‘evolving’ sovereignty concepts?<sup>24</sup> Many, if not most, of the critics of the older sovereignty notions recognize, with varying degrees of support, some of the important and continuing contributions that the sovereignty concepts have made toward international discourse, stability, and peace.

As indicated at the outset of this article, sovereignty is deeply interwoven into the fabric of international law, and to abandon, wholesale, the concept of ‘sovereignty’ requires very serious thought about a substitute that could efficiently fill the gaps left by its absence.

Broadly, one could see the ‘antiquated’ definition of ‘sovereignty’ that should be ‘relegated’ as something like the notion of a nation-state’s supreme absolute power and authority over its subjects and territory, unfettered by any higher law or rule (except perhaps ethical or religious standards) unless the nation-state consents in an individual and meaningful way. It could be characterized as the nation-state’s power to violate virgins, chop off heads, arbitrarily confiscate property, torture citizens, and engage in all sorts of other excessive and inappropriate actions.

Today, no sensible person would agree that this antiquated version of sovereignty exists. A multitude of treaties and customary international law norms impose international legal constraints (at the least) that circumscribe extreme forms of arbitrary actions even against a sovereign’s own citizens.

So what does ‘sovereignty,’ as practically used today, signify? I offer a hypothesis: most (but not all) of the time that ‘sovereignty’ is used in current policy debates, it actually refers to questions about the allocation of power; normally ‘government legal decision-making power.’ That is, when someone argues that the United States should not accept a treaty because that treaty infringes upon US sovereignty, what the person most often means is that he or she believes a certain set of decisions should be made, as a matter of good governmental policy, at the nation-state (US) level, and not at the international level.<sup>25</sup>

<sup>24</sup> See *State, Sovereignty, and International Governance*, above n 7, at 282–3.

<sup>25</sup> The author previously articulated these concepts in Jackson, *The GATT and the WTO*, above n 10, at 369. ‘Power’ is used here similarly to the phrase ‘effective’ or ‘legitimate authority,’ although these terms could be subject to considerable additional discussion.

Another way to articulate this idea is to ask whether a certain governmental decision should be made in Geneva, Washington, DC, Sacramento, Berkeley, or even a smaller subnational or subfederal unit of government. Or, when focusing on Europe, should a decision be taken in Geneva, Brussels, Berlin, Bavaria, Munich, or a smaller unit?

There are various other dimensions to the ‘power allocation’ analysis. Those mentioned above could be designated as ‘vertical,’ whereas there are also ‘horizontal’ allocations to consider, such as the separation of powers within a government entity (eg, legislative, executive, judicial) and division of powers among various international organizations (eg, the WTO, the International Labour Organization, the IMF, the World Bank). Indeed, one can go even further and note that power allocation could refer to the types of participants involved: governmental, nongovernmental (which can embrace issues of government versus private enterprises), and so forth. This is obviously a subject that could have widespread relevance, but this article will focus on the vertical governmental choices of allocation of power.

In all those dimensions one can ask a number of questions that would affect the allocation issues. Questions of legitimacy loom large; today there is often a focus on ‘democratic legitimization,’ which is frequently meant to challenge more traditional concepts of sovereignty (illustrated by views noted in the previous section and related to notions that sovereignty is gravitating away from ideas of ‘sovereignty for the benefit of the nation-state’ and toward ideas of ‘sovereignty of the people’).<sup>26</sup>

Other major topics relevant to vertical allocation issues include the capacity of the institution at each level to perform the tasks needed to pursue the fundamental policy goals motivating the choices (eg, market economic efficiency principles, cultural identities, preserving peace, subsidiarity concepts, environmental and externalities questions, environmental and global commons issues).

Clearly, the answer to the question of where decisions should be made will differ for different subjects. One approach may be appropriate for fixing potholes in streets or requiring sidewalks, another for educational standards and budgets, yet another for food safety standards, and still another for the rules necessary for an integrated global market to work efficiently in a way that creates more wealth for the whole world. Questions of culture and religion pose further decisional challenges.

When one reflects on these questions of allocation of power, this issue is easily identified as arising in dozens of questions at various government levels. News reports recount activities related to these questions almost daily.

<sup>26</sup> TM Franck, ‘The Emerging Right to Democratic Governance’, 86 *AJIL* 46, 90 (1992); see also International Commission On Intervention And State Sovereignty [ICISS], *The Responsibility To Protect* 11 (International Development Research Centre, 2001); Henry Schermers, ‘Different Aspects of Sovereignty’, in *State, Sovereignty, and International Governance*, above n 7 at 185, 192.

## 2. Values Involved in Power Allocation Analysis

Clearly, many values or policy objectives could influence consideration of the appropriate level or other (horizontal) distribution of power within a landscape of governmental and nongovernmental institutions. A small, illustrative group of these policies is outlined below.

Reasons for preferring governmental action at an international level. Many reasons could be given for preferring an international-level power allocation, including what economists call 'coordination benefits,'<sup>27</sup> sometimes analyzed in game theory as the 'Prisoners' Dilemma.'<sup>28</sup> In this situation, if governments each act in their own interest without any coordination, the result will be damaging to everyone; whereas matters would improve if states assumed certain, presumably minimal, constraints so as to avoid the dangers of separate action. Likewise, much has been said about the 'race to the bottom' in relation to necessary government regulation<sup>29</sup> and the worry that competition between nation-states could lead to a degradation of socially important economic regulation.

Economists sometimes suggest that the upward placement of government decision making is particularly needed where there is so-called factor mobility, such as investment funds or personal migration. This is partly because governments find it more difficult to tax or regulate in an effective way in the face of factor mobility.<sup>30</sup>

The subject area of the environment directly engages these issues of power allocation. Issues involving the so-called global commons, where actions that degrade the environment have 'spill-over effects,' illustrate the need for higher supervision.<sup>31</sup>

Many other subject matters are very controversial and remain unresolved in this regard. For example, at what level should competition policy (monopoly policy) be handled? What about human rights, or democratic values and democratic institutions? Questions of local corruption or cronyism might seem to call for a higher level of supervision.

<sup>27</sup> C Coglianese, 'Globalization and the Design of International Institutions', in *Governance in a Globalizing World*, above n 9, at 297, 298–300.

<sup>28</sup> RO Keohane, 'International Relations, Old and New', in *A New Handbook of Political Science* 462, 469 (RE Goodin and H-D Klingemann (eds), 1996).

<sup>29</sup> John H. Jackson, 'International Economic Law in Times That Are Interesting', 3 *J Int'l Econ L* 3 (2000). See also *Regulatory Competition and Economic Integration: Comparative Perspectives* (DC Esty and D Geradin (eds), 2001); and articles in 3 *J Int'l Econ L* 215–385 (2000).

<sup>30</sup> RW Jones, *Globalization and the Theory of Input Trade* 135 (2000).

<sup>31</sup> WC Clark, 'Environmental Globalization', in *Governance in a Globalizing World*, above n 9, at 86.

### 3. Allocating Power More Locally: The Principle of ‘Subsidiarity’

Advocates of subsidiarity (a concept much discussed in Europe) note the value of having government decisions made as far down the ‘power ladder’ as possible. Historically, subsidiarity derives partly from Catholic philosophy of the nineteenth and early twentieth centuries.<sup>32</sup> Among the various policy values that it involves,<sup>33</sup> one of the basic ideas is that a government closer to the constituents can better reflect the subtleties, necessary complexity, and detail embodied in its decisions in a way that most benefits those constituents.

Likewise, it is often said that the decision making that is furthest down the ladder and closest to the constituent will be policed by a greater sense of accountability. Indeed, many illustrations of the dangers of distant power come to mind, including, of course, the origins of the United States in its rebellion against England in the eighteenth century. Similarly, colonialism, particularly twentieth-century, post-Second World War colonialism<sup>34</sup> and the move to decolonize, raised a number of these issues. Decisions made remotely from constituents often become distorted to accommodate the decision makers’ goals, which are local to their own situation and institution, and are not made to accommodate the targeted ‘beneficiaries.’<sup>35</sup>

As a counterpart to European subsidiarity, an enormous amount of discussion about ‘federalism,’ which really engages these same issues, takes place in the United States. There is a worry that decisions taken ‘inside the beltway’ often neglect the facts and details ‘on the ground’ in local areas, partly to accommodate the particular, relatively selfish goals of some senators or other members of the US Congress.

At times, the controversy over the level on which to place a government decision is truly a controversy over the substance of an issue. Thus, national leaders will use international norms to further policy that they feel is important to implement at their own level but is difficult to do because of the structure of their national constitution or political landscape. Likewise, other leaders may want to retain power over certain issues at the national or even the subnational level, because they feel they have more control at those levels in pursuing the

<sup>32</sup> For a succinct overview of the history of the concept of subsidiarity, with mention of sources that go back as far as Aristotle and a sixteenth-century book by the political philosopher Johannes Althusius, leading to nineteenth- and twentieth-century Catholic social thought, including the papal encyclical *Quadragesimo Anno* (fortieth year) in 1931, see T Stauffer, ‘Subsidiarity as Legitimacy?’ in World Bank Institute, *Intergovernmental Fiscal Relations and Local Financial Management Program*, topic 3 (Jul 26–Aug 6, 1999), at <[http://www1.worldbank.org/wbiep/decentralization/Topic03\\_Printer.htm](http://www1.worldbank.org/wbiep/decentralization/Topic03_Printer.htm)>; see also PG Carozza, ‘Subsidiarity as a Structural Principle of International Human Rights Law’, 97 *AJIL* 38 (2003).

<sup>33</sup> CEPR, Subsidiarity, above n 6; see also Carozza, above n 32 (a remarkably full account and history of the concept of subsidiarity, which elaborates an argument for its importance in the context of applying international human rights obligations, somewhat counter to the approach of many human rights advocates who argue that human rights norms are ‘universal’).

<sup>34</sup> G Kreijen, ‘The Transformation of Sovereignty and African Independence: No Shortcuts to Statehood’, in *State, Sovereignty, and International Governance*, above n 7, at 45.

<sup>35</sup> See T O’Neill and G Hymel, *All Politics Is Local* (1994).

policies that they favor. These issues do raise the question of attempts by power elites to bypass democratic procedures that annoy them.

Another policy that can urge allocation both up and down the ladder is the policy of preventing a governmental institution from misusing power. Thus, those who wish to have governmental decisions made at a higher level, such as at the international level, must also consider the potential misuse of power that could occur in international institutions. The often inferior effectiveness of the constraints on international institutions to those on national institutions (eg, lack of elections) may be the core of an argument against placing power at the higher level. On the other hand, power clearly can also be misused at lower levels of government. Likewise, there is generally a 'separation of powers' principle that could apply. The US Constitution has, as its centerpiece, the separation-of-powers principles to avoid monopolies of power, which then lead to misuse. Such separation can be as between various relatively 'equal' levels of governmental action, or as between higher and lower levels of governmental action. For example, in considering how governments should make decisions, it may be determined that only a portion of a certain power should be allocated to the higher level, reserving to a lower level some powers that would be used to check the higher level. To some extent, the implementation of treaties, without having direct application in domestic legal systems, is potentially such a check against power at the higher level. But allocation of greater power to the higher-level treaty may also check lower-level misuse of power.<sup>36</sup> This could be called 'sovereignty in slices'.

Another aspect of the decision involving the allocation of power is the policy goal of 'rule orientation' regarding the matter concerned. Particularly for economic purposes, a rule system that provides additional clarity, security, and predictability can be very significant, particularly when the subject matter involves millions of entrepreneurs ('decentralized decision making' as part of the market system). Thus, part of the consideration regarding on what level to place governmental power might deal with whether different levels have different abilities to make an effective rule-oriented program. Of course, this question raises a risk inherent in internationalism in the minds of some, who may view with suspicion a rule system's method of interpreting treaty text.

### III. THE POWER ALLOCATION POLICY ANALYSIS: A CORE APPROACH?

#### 1. A Fuzzy Road Map of the Policy Landscape

On the basis of the analysis in the previous sections, we can now see that a key question is how to allocate power among different human institutions. It is probably not surprising that this question is very complex. Many factors must

<sup>36</sup> EC Karmarck, 'Globalization and Public Administration Reform', in *Governance in a Globalizing World*, above n 10.

be considered, some of which are discussed below. To some extent, they center on a common question of ‘power,’ and therefore, in some ways, this question relates to virtually all of government and political science studies, as well as, eg, international relations, economics, and law.<sup>37</sup> When one has to develop the landscape of this policy analysis, one recognizes that a huge number of specific substantive policies play a part, as well as what we might call ‘procedural’ or ‘institutional’ policies (how to design the appropriate institutions).<sup>38</sup> Some of these policies typically do not converge in the directions they would suggest that allocation of power should take. That is, differing policies often pose dilemmas for policymakers, where they must engage in a certain amount of balancing.

Indeed, the policy landscape is so complex that one may question whether it is possible to arrive at any worthwhile generalizations. It could be argued that because of this complexity each case has to be decided *sui generis*, or on a ‘case by case’ basis (to use a phrase often indulged in by juridical institutions). Nevertheless, this article will attempt some restrained and constrained generalizations, more in the manner of a road map or inventory/checklist of the type of subjects and factors that are to be considered.

## 2. Outlines of the Landscape and Its Dimensions

As mentioned above, over time there developed a number of so-called sovereignty fictions, which have never really represented what goes on in the real world. One of these fictions is the notion that absolute power is concentrated at the head of a nation-state, and we have seen extensive literature criticizing the myths and anomalies regarding that. In analyzing how to allocate power, we have mentioned different dimensions such as vertical versus horizontal allocations. With respect to the horizontal allocation, we would look at important concepts such as the separation of powers in the US Constitution, whereby power is allocated among legislative, executive, and judicial branches.<sup>39</sup> Similar

<sup>37</sup> As an exercise verifying this proposition, the author, with very able student research assistance, formulated a chart of the many news and other reports that touch on these allocation-of-power questions at various levels of government. This report involves too many instances to include in this article, but we could make it available to interested persons. As an example, one can examine the *Financial Times* (London) for May 12, 2003, which in this single issue touches on seven or more topics of ‘allocating power or authority’; they include the United Kingdom’s consideration of joining the euro single currency, the role of international law in cases of unilateral use of armed force, European Union measures relating to carbon emissions, testing requirements for chemicals, the control of Iraqi oil exports, WTO rulings related to steel tariffs, and ideas for a European common defense fund.

<sup>38</sup> Coglianesi, above n 27.

<sup>39</sup> Another aspect of opposing categories comes into play here, although I will not develop that very much in this article; that is, the allocation of power as between government institutions (at all levels and among different horizontally equal institutions), on the one hand, and nongovernment institutions (private enterprises, nongovernmental organizations, pro bono institutions, etc), on the other hand. This portion of the analysis would push one into questions of market-oriented economic structures and their value, as well as their limitations.

considerations apply at the international level, between functional divisions within an international organization and between different international organizations.

The characteristics of institutions are very important to handling the issues of allocation, and must be examined carefully. The nature of the issues involved must also be examined. What types of information and expertise are needed for certain kinds of substantive issues? Is the institution to which power will be allocated, regarding those issues, capable of finding and processing that information? Does it have adequate means at its disposal to carry out its mission? And if not, what roles will other levels of institutions play?

The capacity of a treaty-based international institution to implement activities designed to achieve internationally agreed-upon goals will clearly also be part of an analysis as to where to allocate power. If an allocation to the international institution is not accompanied by adequate means to operate effectively, this deficiency could suggest reasons for not allocating power. But the reverse could also be true (as mentioned in the introductory pages above): nation-states may find that economic or other exogenous circumstances render nation-states that act unilaterally ineffective, thus manifesting a greater need for international approaches.

In addition, many of the issues about democratic legitimacy come into play when one is allocating power at different levels and to different horizontally equal institutions. Issues that may call for different kinds of allocations include, eg, taxes, expenditures for public goods and services, and regulation of private sector agents.

### **3. Comparing International Institutions with National and Subnational Institutions: The Devil in the Details**

There are a series of factors that policymakers trying to develop an appropriate allocation of power must consider about international institutions. The following is just a beginning checklist:

- (1) Treaty rigidity, namely, the problem of amending treaties and the tendency of treaties to be unchangeable, although actual circumstances (particularly in economics) are changing very rapidly.
- (2) International organization governance questions, particularly with respect to choosing officials of the international organization. Governments tend to push favored candidates, to claim 'slots,' and to disregard the actual quality of the individuals concerned or the nature of the tasks they are to assume.
- (3) International organization governance in the decision-making processes. What should the voting structure be? Should consensus be required? What are the dangers of paralysis because of the decision-making procedures? What are the dangers of decision-making procedures that are likely to be



considered illegitimate or out of touch with reality? This factor relates to the fiction of ‘sovereign equality of nations’ and the problems of a one-nation, one-vote system. It can be argued that these two concepts, or fictions, are very antidemocratic, as compared to a system that would recognize the populations or other weights concerned in the representation and the organization. Is it fair that a ministate of less than fifty thousand inhabitants should carry the same weight in a voting structure as giant governments of societies that have more than one hundred million constituents each? Does giving the ministate such weight accentuate possibilities of ‘holdout’ bargaining, what some call ‘a ransom’? Is it fair that a voting majority of United Nations members today could theoretically encompass less than 5 per cent of the world’s population?<sup>40</sup>

- (4) International diplomacy techniques. To what extent is it appropriate or necessary that there be special privileges for diplomats, such as tax freedom and other immunities? Do such privileges in the context of international organizations’ decisions tend to result in actions that are out of touch with citizen beneficiaries?
- (5) International diplomacy as it operates substantively, sometimes in contrast to or in diminishing a rule-oriented structure, through power-oriented bargaining.
- (6) International governmental issues that relate to the allocation of an international organization’s resources, such as a ‘headquarters mentality,’ devoting large amounts of the budget to the perquisites and comfort of the headquarters personnel.
- (7) The impact of a dispute settlement system and its jurisprudential techniques such as those used to ‘interpret’ international agreements.
- (8) The constitutional ‘treaty-making’ authorities of different levels of government. One can also examine the effect of the ‘direct application’ or ‘self-executing nature’ of treaties, and ask whether the treaties were made with a legitimate amount of democratic input, such that they should be allowed to trump nation-state-level democratic and parliamentary institutions.<sup>41</sup>
- (9) Comparison with governance questions at the nation-state or local level, such as how officials are chosen, the amount of transparency and participation allowed, and the resources available to undertake tasks.

Finally, it must be mentioned that, in many cases, individually insignificant details are involved in how institutions perform their tasks, which, however,

<sup>40</sup> When my assistant and I examined a list of all the United Nations nation-states and ranked them from those with the smallest population to those with the largest population, and then counted from small upward until we passed the midpoint, so that we had a majority of the UN nation-states, we learned that the total population of that majority (ranked from the smallest upward) amounted to less than 5% of the total population of all of the nation-states that are UN members. Likewise, when we do this with a slightly larger list of all nation-states and include some that are not UN members, we get the same result. I wish to acknowledge the able assistance of Ms Woojung Kim, JD, Georgetown University Law Center, for the study relating to this footnote.

<sup>41</sup> See, eg, Jackson, above n 5.

when added up, or utilized by a large number of participants, can have a degrading effect on the efficiency or fairness of operations.

#### 4. Legitimization in the Power Allocation Analysis

By now the reader may have an inkling that some important fundamental principles of legal and normative legitimization are relevant to the power allocation analysis. Arguably, almost the entire analysis of power allocation outlined in this part so far could be based on traditional sovereignty and nation-state-consent principles. The detailed questions on power allocation leave open perhaps the most important question, who (what entity) should decide the power allocation? It is possible (and probable) that today many will say that the nation-state will decide in each case, for itself, whether it is willing to allocate 'its own sovereign power' either up the scale or downward. (In the latter case certain checks are likely to be retained in the hands of the sovereign.) After all, for any treaty-based rule, it is plausible to say that each nation will decide, and if it decides to accept the treaty obligations, its consent has legitimized its obligation.

The issue of customary international law is more ambiguous, of course, and thus, often more controversial.<sup>42</sup> Certainly, rather extravagant claims are frequently made about what new customary norms have come into being, as compared with the traditional international rules of such norm formation (eg, practice plus *opinio juris*), which more strongly emphasize state consent. Questions arise in either case. Is the ultimate decision about allocation put in the hands of an international juridical or diplomatic institution? Does such an institution have certain biases or conflicts of interest? To pursue this line of analysis as a basis for a new allocation of power, however, may stretch some of the traditional international law concepts of state consent. Some examples of the outer limits of consent include:

- (1) A nation finds that its trade or financial welfare requires it to accept a major complex treaty because most of the rest of the world has done so (eg, via the WTO or IMF).
- (2) The UN or other major charter is deemed so fundamental that its interpretation of obligations (considering treaty rigidity constraints against amendment) 'evolves' or is influenced by developing 'practice under the agreement' in unexpected (or impossible to expect) ways. Specific decisions of the institution may 'validate' this evolution, either explicitly or impliedly, although the decisions may not always be broadly accepted (or acceptable), or could in fact be 'bad policy' by relatively objective standards. Elites may weigh heavily in certain of these processes, as may certain special interest groups (business or nonbusiness, sometimes with single-issue objectives).

<sup>42</sup> See, for example, the powerful criticisms of customary international law by Bradley and Goldsmith, above n 6; Goldsmith and Posner, above n 6; Kelly, above n 6.

- (3) Voting rules and procedures may result in anomalies that lead to decisions that do not reflect a membership as a whole. Various pressures may be placed upon voting nations through favors or ‘vote buying.’ An individual nation-state may have no particular interest in the vote on an issue, and thus be willing to ‘hold out’ (ransom its vote) or swap its vote on this issue for one on some completely different and irrelevant issue. The votes of many small nations may control in a situation of little interest to them. Votes of nations belonging to certain groups may be controlled or guided by single institutional mechanisms, which thereby have great weight. The European Union, for example, has twenty-five votes in the WTO, and many more that it can influence through pressures related to its association agreements.

In reflecting on the experience of many national or international human institutions, one finds there is nothing new in the examples mentioned above. What is new, however, is the degree to which these international institutional circumstances have an impact on nation-state governments trying to deliver the fruits of their important achievements to their constituents. The other side of these considerations is that they may be outweighed by the ‘coordination’ benefits realized through the cooperative action of international institutions. Indeed, in this context scholars and other observers have argued that the nation-states participating in such institutions have enhanced their sovereignty by leveraging it through joint action.<sup>43</sup>

Clearly, in some cases, however, the ‘state consent’ theory extended in the above paragraphs will not carry the legitimization far enough to be broadly persuasive. This limitation could apply in particular to issues of humanitarian intervention (especially in cases of inaction by relevant international institutions), and potentially to some issues regarding terrorism and weapons of mass destruction. A core of cases is being recognized by world leaders and scholars as not satisfactorily solved by ‘consent doctrines.’ This is where the sovereignty revisionist theories have teeth, and where, in this author’s opinion, confusion and uncertainty reign, and possible ‘auto-determination’ by overreaching unilateral nation-state decisions poses a serious risk to some traditional concepts of sovereignty, as well as to ‘rule-based’ objectives for international relations.

#### IV. EXAMPLES OF DIFFERENT POWER ALLOCATION PROBLEMS

The analysis outlined in the previous parts can also be applied to various subjects and endeavors (including many subjects discussed in this conference), keeping in mind, however, the caveats that were also mentioned above.

<sup>43</sup> Brus, above n 8, at 18; see also ICISS, above n 26, *Supplementary Volume*, at 129.

## 1. Economics and Markets

As a ‘thought experiment,’ consider the following.<sup>44</sup>

Advocates of market economics argue that the most efficient process of decision making in an economy is reliance on the private sector to handle most of the choices, and to keep the government out. However, there is the well-recognized exception of ‘market failure,’<sup>45</sup> and thus it becomes necessary to analyze what such failure entails.

Often, categories of market failures include monopolies and competition problems, lack or asymmetries of information, public goods and free rider problems, and externalities. In each of those cases, one can see how the economics of a globalized, economically interdependent world operates. It is quite likely that in some cases, an analyst could make one kind of judgment about the existence of market failure by looking only at the nation-state level, but come to a different conclusion when appraising the global or international level. Monopoly judgments will depend somewhat on how one defines the ‘relevant market.’ Are borders truly open, and thus does a single producer within a nation-state really have to face competition? Does that producer not have monopoly power? Asymmetries of information are found across national borders, particularly where the cultures and languages are different.

Even if a judgment is made as to the existence of market failure, leading to a government response, the kinds of government responses possible at the nation-state level differ dramatically from those at the international level. Most often, the international-level institutions do not have powers that can effectively tax, subsidize, or materially alter market mechanisms (such as by setting up tradable permits). Another governmental response is to maintain rules and prohibitions. This is virtually the only available government response at the international level, and it raises an important practical question as to whether a particular rule or prohibition will in fact be effective (i.e., followed), and therefore operate efficiently to correct the market failure. There has been much bitter fighting, at least in discourse, about whether an international competition policy or set of rules—an international competition policy for things like monopoly and antitrust—should be put in place.

## 2. The WTO and Its ‘Constitution’: Impact of Institutional Detail

The World Trade Organization can become a major illustration of principles outlined in this article.<sup>46</sup> Certainly, one of the more intricate and elaborate (and

<sup>44</sup> For a previous article on the economic analysis of power allocation, see JH Jackson, ‘Global Economics and International Economic Law’, 1 *J Int’l Econ L* 1 (1998).

<sup>45</sup> See, eg, R Lipsey, P Courant, D Purvis and P Steiner, *Microeconomics*, pt 4, at 207 (12th edn 1998).

<sup>46</sup> See WTO Agreement, above n 21. See also the following works by this author: *The GATT and the WTO*, above n 10; *The World Trading System*, above n 10; *Dispute Settlement*, above n 10;

some say controversial) examples of power allocation principles can be witnessed in relation to the WTO. Globalization and the problems that accompany it are forcing institutions to adapt or the creation of institutions that can cope. Clearly, many of these problems relate to treaty clauses that penetrate deeply into a nation-state's 'sovereignty' decisions about economic regulation. Thus, any international cooperative mechanism will, of necessity, clash with national 'sovereignty,' and with special national interests whose own economic well-being will be affected by the international decisions. Not surprisingly, therefore, the WTO not only is a candidate for filling institutional needs to solve current international-level problems, but also is a target currently under attack.

Nevertheless, as noted in previous parts of this article, increasingly often nation-states cannot regulate effectively in the globalized economy, and this inability is particularly relevant to economic factors that are global and mobile (investment, monetary payments, and monetary policy, and even free movement of persons). As outlined by very eminent economists in recent decades (such as Douglass North and Ronald Coase),<sup>47</sup> markets will not work unless there are effective human institutions to provide the framework that protects the market function. Therefore, the core problem is the globalization-caused need to develop appropriate international institutions. If a thorough analysis led to the conclusion that the WTO is a good place in which to concentrate some of these cooperation activities, one could see the WTO becoming essentially an international economic regulatory level of government. This prospect, of course, is scary to many people.

The WTO plays two major, and somewhat conflicting, parts with respect to the power allocated to it. On the one hand, it moderately enhances the institutional structure for negotiating and formulating rules, and changing them as needed for the conduct of international trade and certain other economic activities at the international level. On the other hand, the WTO operates an extraordinarily powerful dispute settlement system, which is basically unique in international law history. This system has rare characteristics for an international institution: mandatory jurisdiction and submittal to its procedures, as well as an appellate process that was established to try to achieve a higher degree of coherence and rationality in the rules of the massive treaty clauses applying to the WTO's subject competence. One can immediately see a series of power allocation issues, not only as between nation-states and the WTO, with regard to its two different parts, but also as allocation between those parts. In addition, intricate details<sup>48</sup> can have very substantial effects on the real power allocation impacts that occur.

JH Jackson, 'The WTO 'Constitution' and Proposed Reforms: Seven 'Mantras' Revisited', *4 J Int'l Econ L* 67 (2001) (addressing 'mantras' related to the WTO).

<sup>47</sup> RH Coase, *The Firm, the Market and the Law*, ch 5 (1988) (reprint of 1960 article); DC North, *Institutions, Institutional Change, and Economic Performance* (1990).

<sup>48</sup> See, eg, B Lindsey and D Ikenson, *Antidumping Exposed: the Devilish Details of Unfair Trade Law* (2003).

## V. PERCEPTIONS AND REFLECTIONS: CHANGING FUNDAMENTALS OF INTERNATIONAL LAW

The proposition tentatively put forth in this article is that for the ‘core sovereignty’ concepts, which mostly involve the nation-state’s monopoly of power and its logical derivative of state-consent requirements for new norms, the power allocation analysis, when explored more profoundly, can help overcome some of the ‘hypocrisy’ and ‘thought-destructive mantras’ surrounding these concepts so that policymakers can focus on real problems rather than myths. This analysis can thus help policymakers weigh and balance the various factors to reach better decisions on questions such as accepting treaty norms, dispute settlement mechanisms and results, necessary interpretive evolution of otherwise rigid treaty norms, and even in some cases new customary norms of international law.

Such an analysis recognizes that there are desiderata in sovereignty concepts other than the ‘core’ power allocation issues, and that even as regards the core issues there are clearly cases that the world must resolve by explicit (or well-recognized implicit) departures from traditional sovereignty concepts. Taken together, these considerations can be labeled ‘sovereignty-modern’ and suggest that further analysis and discussion would help build some new ‘handholds on the slippery slopes’ looming just ahead of certain issues not resolved by traditional sovereignty, as the world faces major risks of uncertainty, miscalculations in diplomacy, and over-reaching by certain nation-states.

The follow-up question becomes: What are some theories or principles that could reach beyond the traditional sovereignty parameters but offer some principled constraints to avoid the risks just listed? Several can be mentioned.

One possibility would be to recognize certain international institutions as the legitimate entities to decide on some of these parameters. This approach would require that such an institution seriously discuss these limits and modes of activity (without a tilt toward that institution’s ‘turf’), and that it develop these limits with enough precision to be useful to national and international decision makers. This seems to be more carefully done in juridical institutions, which might well be an argument for more reliance on such institutions. However, ‘checks and balances’ are needed regarding those institutions, lest they go wrong through faulty analysis, lack of adequate empirical information, or their frequent remoteness from the real world activities that are relevant to reasoned and just opinions.

Another possibility is to follow a chain of reasoning, developed by some scholarly analysis, that traditional ‘sovereignty’ concepts themselves must evolve and be redefined. This avenue might also be pursued by juridical institutions, with the same caveats as mentioned above and throughout this article. ‘Sovereignty of people,’ rather than governments, is sometimes mentioned in this context.

Another, and probably more heroic, possibility is to develop a general theory of sources of international law based on what some authors have called the ‘international community.’<sup>49</sup> To some this implies a sort of ‘*acquis communautaire*.’<sup>50</sup> It could well imply participation by nongovernmental persons and entities, and it could embellish the more traditional concepts of ‘practice’ under agreements or *opinio juris*, to stretch those frontiers. The risk and problem is the imprecision, and thus the controversy, that can develop about the use of this approach in specific instances. It has been invoked in some situations, such as the Kosovo crisis,<sup>51</sup> with the phrase ‘overwhelming humanitarian catastrophe.’

Yet another approach is to use the concept of ‘interdependence,’ often most associated with economic policy and activity, to justify certain new norms. In many of these cases, this concept can probably be used in tandem with more traditional sovereignty and nation-state-consent approaches to persuade nations to give such consent. Frequently, a key question, however, is the holdout state, which in some economic circumstances is given added incentives to hold out when other states are constraining their reach for policy and economic advantages.

The approach of this article has been to respond to the many extensive challenges and criticisms of the concept of ‘sovereignty’ by urging a pause for reflection about the consequences of discarding that concept in broad measure. Since sovereignty is a concept fundamental to the logical foundations of traditional international law, discarding it risks undermining international law and certain other principles of the international relations system. Doing so could challenge the legitimacy and moral force of international law, in the sense of what Professor Franck terms the ‘compliance pull’<sup>52</sup> of norms backed by characteristics of legitimization. It seems clear that the international relations system (including, but not limited to, the international legal system) is being forced to reconsider certain sovereignty concepts. But this must be done carefully, because to bury these concepts without adequate replacements could lead to a situation in which pure power prevails; that, in turn, could foster chaos, misunderstanding, and conflict, like Hobbes’s state of nature, where life is ‘nasty, brutish, and short.’<sup>53</sup> In the alternative, this vacuum of legitimization principles could lead to greater aggregations of hegemonic or monopolistic power, which might not always be handled with appropriate principles of good governance.<sup>54</sup>

Thus, one of the recommendations of this article is to disaggregate and to analyze: break down the complex array of ‘sovereignty’ concepts and examine particular aspects in detail and with precision to understand what is actually at

<sup>49</sup> D Greig, ‘“International Community”, “Interdependence” and All That . . . Rhetorical Correctness?’ in *State, Sovereignty and International Governance*, above n 7, at 521, 563–6.

<sup>50</sup> Greig, above n 49, at 563–6.

<sup>51</sup> *Ibid.*

<sup>52</sup> Franck, above n 26, at 51.

<sup>53</sup> T Hobbes, *Leviathan* 100 (M Oakeshott (ed), Collier Books 1962) (1651) ([‘In a state of nature there are] no arts; no letters; no society; and which is worst of all, continual fear, and danger of violent death; and the life of man, solitary, poor, nasty, brutish, and short’).

<sup>54</sup> RO Keohane, ‘Governance in a Partially Globalized World’, 95 *Am Pol Sci Rev* 1 (2001).

play. A major part of this approach is to understand the pragmatic functionalism of the allocation of power as between different levels of governance entities in the world. To the extent feasible, this should be done in a manner not biased either in favor of or against international approaches. Indeed, as time moves on and the world continues to experience trends toward interdependence and the need for cooperative institutions that can also enhance peace and security, the substitute for portions of nation-state sovereignty will probably be international institutions that embrace a series of legitimizing 'good governance' characteristics, such as some of those recommended by Robert Keohane<sup>55</sup> and other thinkers and philosophers. Among those characteristics one can expect a broader set of participants than just nation-states, but also nonstate and non-governmental bodies and individuals, including economic (business) actors; moral, religious, and scholarly entities; and international organizations. Those characteristics will likely include elements of 'democratic legitimization' and some notions of 'democratic entitlement', not only for nation-states, but also for international institutions. Validating characteristics will also likely include elements of efficiency and the capacity to carry out appropriately developed institutional goals and to build in techniques for overcoming 'treaty rigidity' so that the institutions can evolve to keep up with the changing world. It is more and more probable that a juridical institutional structure of some kind will be seen as a necessary part of any such international institution, and that the use of force or other concrete actions impinging on local societies will be constrained by the institutional and juridical structures. This is, in essence, a 'constitutional' approach to international law. Thus, international lawyers must 'morph' into constitutional lawyers.

To cope with the challenges of instant communication, and faster and cheaper transportation, combined with weapons of vast and/or mass destruction, the world will have to develop something considerably better than either the historical and discredited Westphalian concept of sovereignty, or the current, but highly criticized, versions of sovereignty still often articulated. That something is not yet well defined, but it can be called 'sovereignty-modern', which is more an analytic and dynamic process of disaggregation and redefinition than a 'frozen-in-time' concept or technique. Even then, a 'sovereignty-modern' power allocation analysis may not always be the only appropriate approach to analysis of the many problems listed in this article. It needs to be considered a valuable analytic tool, but not one that can always lead to an appropriate resolution to such problems. When used in tandem with other policy tools, including realistic appraisals of the political and legal feasibility of various policy options, it can be a valuable means to sort through elaborate and complex policy 'landscapes'. There is much thinking yet to do, and no one ever said it was going to be easy.

<sup>55</sup> *Ibid.*





*State Sovereignty, Popular Sovereignty  
and Individual Sovereignty:  
From Constitutional Nationalism to  
Multilevel Constitutionalism in  
International Economic Law?*

ERNST-ULRICH PETERSMANN

I. INTRODUCTION AND SUMMARY: NEED FOR REDESIGNING  
SOVEREIGNTY FOR THE BENEFIT OF CITIZENS AND THEIR  
CONSTITUTIONAL RIGHTS

OVER THE PAST centuries, claims to supreme political and legal power over people (sovereignty) by rulers (eg the pope, emperors, monarchs, colonial powers), states and international organisations have become increasingly contested. The Westphalian system of international law among sovereign states—based on internal sovereignty (as defined by constitutional law) and external sovereignty (as defined by state-centered international law)—was power-oriented and lacked democratic legitimacy, as illustrated by colonialism and imperial wars. Also the UN Charter (eg, Chapter V regulating the Security Council) remains based on power-oriented structures lacking input-legitimacy (eg, in terms of respect for human rights and democracy) as well as output-legitimacy (eg, in terms of protection of ‘democratic peace’). Even though proclaimed on behalf of ‘We the peoples of the United Nations determined . . . to reaffirm faith in fundamental human rights’ (Preamble of the UN Charter), the intergovernmental structures of UN law have proven to be incapable of realising the human rights objectives of UN law. The

ineffectiveness of so many UN guarantees of human rights in so many countries undermine also the democratic legitimacy and effectiveness of UN law.<sup>1</sup>

The claims by rulers to supreme ordering power ('political sovereignty') must be distinguished from democratic constitutional law as the legal source of sovereign powers ('constitutional sovereignty'), as well as from 'democratic sovereignty' and 'individual sovereignty' in the sense of the actual capacity of a democratic polity and of individual citizens to self-government. Modern globalisation is characterised by increasing economic, political, legal and other limitations of political sovereignty and by the re-allocation of government powers to democratic people, indigenous people, international organisations and individual human beings as legal subjects of inalienable human rights. This dynamic transformation of international relations and of international law entails tensions between the 'sovereign equality' of UN member states as one of the constitutional principles of the UN Charter (Art.2), the 'right to self-determination of all peoples' as universally recognised in the Article 1 of both the International Covenant on Civil and Political Rights (ICCPR) and the International Covenant on Economic, Social and Cultural Rights (ICESCR), and the universal recognition, in numerous UN human rights instruments, of 'the inherent dignity and of the equal and inalienable rights of all members of the human family [as] the foundation of freedom, justice and peace in the world' (for example, the Preamble of the ICESCR). Human rights law, like most democratic constitutions, proceeds from the two premises that (1) human rights are not granted, but only recognised by governments; and (2) citizens constitute governments with limited powers that must be exercised for the protection of the human rights and public interests of their citizens.<sup>2</sup> The UN Human Rights Committee has rightly emphasised (eg in its General Comments 24 and 26 on the UN Covenant on Civil and Political Rights) that—even if human rights treaties are concluded among states—unilateral reservations and denunciations may be legally invalid and cannot take away 'inalienable' human rights of citizens,<sup>3</sup> just as democratic governments may lack powers to unilaterally abrogate constitutional rights of their citizens. This contribution argues for a 'constitutional approach' to international law based on the following principles:

- (1) **Equal individual freedom as first principle of justice:** The universal recognition of inalienable human rights requires construing state sovereignty, popular sovereignty and 'individual sovereignty' in a mutually coherent

<sup>1</sup> See E-U Petersmann, Constitutionalism, International Law and 'We the Peoples of the United Nations', in HJ Cremer *et al* (eds), *Tradition und Weltoffenheit des Rechts. Festschrift für H Steinberger* (Berlin, Springer Publishers, 2002) 291 ff.

<sup>2</sup> These constitutional premises prompted me to argue (eg in E-U Petersmann, *Constitutional Functions and Constitutional Problems of International Economic Law*, (Fribourg, University Press Fribourg, 1991) that precise and unconditional, intergovernmental guarantees of freedom, non-discrimination and rule of law (eg in GATT Articles II, III, XI:1) can serve 'constitutional functions' enlarging corresponding, constitutional freedoms and other rights of citizens.

<sup>3</sup> Cf *Compilation of General Comments and General Recommendations by Human Rights Treaty Bodies*, UN doc. HRI/GEN/1, Rev.7 (2004).

- manner so as to protect more effectively equal freedoms of individuals and other ‘principles of justice’ across frontiers (below Sections II and V).
- (2) **Human rights require multilevel constitutional protection:** Historical experience confirms the constitutional claim that legal guarantees of equal freedoms among individuals and among republican states cannot remain effective over time without multilevel constitutionalism constituting, limiting and legitimising governance powers and protecting human rights at national, international and transnational levels of human interactions in a mutually coherent manner (below Section III).
  - (3) **Human rights require the ‘constitutionalisation’ of international law:** Constitutional approaches to international law have practical consequences for the interpretation and progressive development also of international economic law. For instance, respect for individual and democratic freedom entails diversity and regulatory competition—among individuals as well as among private and public, national, regional and worldwide organisations (eg, competing worldwide and regional trade liberalisation and trade regulation)—which must be respected and promoted by ‘cosmopolitan principles’, including human rights, ‘participatory’ and ‘deliberative democracy’ so as to promote inclusive decision-making, as well as other ‘legitimising principles’ (such as subsidiarity) and ‘prioritising commitments’ (such as avoidance of serious harm, satisfaction of urgent needs, *cf* Section IV).
  - (4) **The needed international ‘social market economy’ must be based on ‘cosmopolitan democracy’:** The more remote regional and worldwide governance institutions operate from their citizens, the less effective *procedural* citizen rights for democratic participation, representation and parliamentary control risk becoming; and the more important are *substantive*, constitutional rights and their judicial protection through interrelated networks of national and international rule-making, administration and courts. Rights-based multilevel constitutionalism requires more comprehensive processes of weighing and balancing rights and obligations of governments and of individuals in the interpretation and application of international economic law by governments and courts (Section V).
  - (5) **The ‘transformation power’ of economic constitutionalism depends on ‘struggles for human rights’:** The increasing complexity of globalisation makes decentralised rules and adjustments protecting individual freedom, democracy and state sovereignty ever more important. Constitutional democracies have strong economic, political and legal reasons for extending rights-based constitutionalism to multilevel economic governance so as to safeguard constitutional democracy and set incentives for the peaceful transformation of non-democratic and less-developed countries. The difference between American and European approaches lies *not* in the European recourse to ‘normative’, ‘soft’ and ‘civilian power’ (which are also used in US foreign policies), but in the European preference for *multilevel constitutional*

*restraints* on multilevel economic governance rather than for the focus by the US, as well as by other continental nation states, on constitutional nationalism (Section VI).

## II. INTERNATIONAL LAW AMONG STATES, AMONG PEOPLES AND AMONG INDIVIDUALS? LIMITATION OF STATE SOVEREIGNTY BY CONSTITUTIONAL, POPULAR AND INDIVIDUAL SOVEREIGNTY

The Westphalian system of international law among sovereign states conceived international law as reciprocal limitations on state power aimed at protecting international order rather than human rights and justice.<sup>4</sup> Also the state-centred UN legal system protects neither human rights nor democratic peace effectively. Even constitutional democracies (like the US) view compliance with international law often as a national policy choice depending more on the respective costs and benefits than on rule of international law and its culture of legal formalism. The universal recognition of human rights and of supranational organisations entails a progressive broadening of the international community to individuals and other non-state actors.<sup>5</sup> Traditional principles of international law (such as sovereign equality of states, non-intervention into domestic affairs, consensus-based rule-making) are increasingly qualified in the law of worldwide and regional organisations. Also civil societies, parliaments and democracies increasingly challenge the legitimacy of power-oriented rules of international law (eg the sovereignty of failed states that tolerate genocide and international terrorism); democratic governments insist on their constitutional powers to adopt policy measures even if they are inconsistent with power-oriented international law rules.<sup>6</sup> If law is perceived as a struggle for individual constitutional rights and human rights, such challenges to power politics disguised as international law are to be welcomed. Without stronger constitutional safeguards for individual freedom as a ‘first principle of justice’ as well as of constitutional protection of other human rights and democratic peace, UN human rights law is bound to remain ineffective in many areas.<sup>7</sup>

<sup>4</sup> On the pursuit of ‘order’ rather than ‘justice’ in international relations see: R Foot, JL Gaddis and A Hurrell (eds), *Order and Justice in International Relations*, (Oxford, OUP, 2003); J Thomson, *Justice and World Order*, (Tokyo, United Nations Press, 1992).

<sup>5</sup> Cf J Goldsmith and EA Posner, *The Limits of International Law* (Oxford, OUP, 2005). On the ‘formalism’ of the general international law rules coordinating the fragmented bilateral, regional and worldwide treaty systems see M Koskeniemi, *Fragmentation of International Law: Difficulties Arising from the Diversification and Expansion of International Law* (4 Apr 2006) UN doc A/CN.4/L.682.

<sup>6</sup> See M Ignatieff, *American Exceptionalism and Human Rights*, (Cambridge MA, Harvard UP, 2005); J Rubinfeld, ‘The Two World Orders’ in G Nolte (ed), *European and US Constitutionalism*, (Cambridge, CUP, 2005) at 280–96.

<sup>7</sup> On the different conceptions and principles of universal justice (e.g human rights), and of corrective and distributive justice in particular cases (eg preferential treatment of poor countries), see: E-U Petersmann, ‘Theories of Justice, Human Rights and the Constitution of International Markets, in Symposium: The Emerging Transnational Constitution’ (2003) 37 *Loyola Law Review* 407–60.

The more the human rights obligations of every UN member state evolve into *ius cogens*, the more it becomes necessary to construe the ‘sovereign equality’ of states, the limited powers of intergovernmental organisations and the ‘right to self-determination of all peoples’ in conformity with the human rights of their citizens.<sup>8</sup> The European Court of Justice (ECJ) and the European Court of Human Rights (ECtHR) emphasise that human rights constitutionally restrain also the limited powers of *intergovernmental* organisations; they interpret and enforce the fundamental rights guarantees of the European Convention on Human Rights (ECHR) as a ‘constitutional instrument of European public order’.<sup>9</sup> The emerging ‘multilevel human rights constitution’, based on national, regional and worldwide guarantees of human rights and of democratic self-determination of peoples, calls for construing state sovereignty, popular sovereignty and ‘individual sovereignty’ in a mutually coherent manner so as to protect maximum human liberty and other human rights as basic principles of justice.

From such a human rights perspective, the international legal system—including international economic law—must serve human rights and democratic self-government as the proper basis of sovereignty.<sup>10</sup> Citizens and democratic people must be recognised and legally protected as subjects of international law. Just as decolonisation and democracy resulted from struggles for the liberation of suppressed people, so will the needed democratisation of the power-oriented international legal system not come about without bottom-up struggles for the defense of cosmopolitan human rights against power politics, including border discrimination reducing domestic consumer welfare and impeding a mutually beneficial division of labor among citizens across frontiers. The UN High Commissioner for Human Rights has, in a number of reports on the human rights dimensions of the law of the World Trade Organisation (WTO),

<sup>8</sup> See the broad interpretation of UN human rights as international *ius cogens* and constitutional limitation of intergovernmental powers by the European Court of First Instance in Cases T-315/01 *Kadi v Council and Commission* and T-306/01 *Yusuf v Council and Commission* [2005] CMLR 1334.

<sup>9</sup> On the ECJ jurisprudence that respect for fundamental rights is a ‘condition of the legality of Community acts’, see *Accession of the Community to the European Human Rights Convention: Opinion 2/94*, [1996] ECR I-1759; Case C-84/95 *Bosphorus Hava Yollari Turizm Ticaret AS v Minister for Transport, Energy and Communications, Ireland* [1996] ECR I-3953. On the constitutional functions of the ECHR see the judgment of the ECtHR in *Bosphorus v Ireland* (App No 45036/98) ECHR 30 Jun 2005 which confirmed, *inter alia*, ‘that a Contracting Party is responsible under Article 1 of the Convention for all acts and omissions of its organs regardless of whether the act or omission in question was a consequence of domestic law or of the necessity to comply with international legal obligations’ (para 153).

<sup>10</sup> See E-U Petersmann, ‘Constitutionalism and WTO Law—From a State-Centred Approach towards a Human Rights Approach in International Economic Law’ in DLM Kennedy and JD Southwick (eds), *The Political Economy of International Trade Law* (Cambridge, CUP, 2002) at 32–67; *idem*, E-U Petersmann, ‘Human Rights, Markets and Economic Welfare: Constitutional Functions of the Emerging UN Human Rights Constitution’ in FM Abbott, C Breining-Kaufmann and T Cottier (eds), *International Trade and Human Rights: Foundations and Conceptual Issues* (Ann Arbor, Michigan UP, 2006) 29–68. More generally see: Allen Buchanan, *Justice, Legitimacy and Self-Determination: Moral Foundations for International Law* (Oxford, OUP, 2004).

endorsed a human rights approach to international trade law.<sup>11</sup> Similarly, WTO Director-General P Lamy has called for ‘cosmopolitics’ and ‘cosmopolitan constituencies’ in support of global public goods such as a liberal trading system.<sup>12</sup> Yet, UN human rights law does not protect freedom of profession, private property, open markets, freedom of trade and other legal preconditions for a mutually welfare-enhancing, international division of labor.<sup>13</sup> Nor has the UN Conference on Trade and Development (UNCTAD) acted as a leader for a liberal (ie liberty-based) international trade order committed to the protection of human rights.

The worldwide liberalisation and regulation of welfare-reducing trade barriers continues to be based on the General Agreement on Tariffs and Trade (GATT) and WTO law. The 150 WTO Members emphasise that the WTO rules and policies must remain ‘member-driven’ and outside the UN system. WTO Members have not responded to the UN proposals for a ‘human rights approach to international trade’; they continue to leave the clarification of the interrelationships between UN law, WTO law and human rights to the WTO dispute settlement system. The ‘member-driven’ character of the WTO entails that WTO rules and policies tend to be ‘producer-driven’ for the benefit of powerful ‘rent-seeking interest groups’ (such as textiles, agricultural and steel lobbies, periodically elected trade politicians) to the detriment of general consumer welfare and citizen rights. As WTO law does not refer to human rights, democratic self-government and social justice, WTO rules remain contested inside constitutional democracies and by civil society.

### III. MULTILEVEL ECONOMIC GOVERNANCE REQUIRES MULTILEVEL CONSTITUTIONALISM PROTECTING INDIVIDUAL RIGHTS AND DEMOCRATIC GOVERNANCE

Modern globalisation and the universal recognition of human rights are transforming the intergovernmental ‘society of states’ into a cosmopolitan community of citizens with complex layers and networks of private and public, national and international governance and legal regulation.

<sup>11</sup> See E-U Petersmann, ‘The Human Rights Approach to International Trade Advocated by the UN High Commissioner for Human Rights: Is it Relevant for WTO Law and Policy?’ (2004) 7 *Journal of International Economic Law* 605–28.

<sup>12</sup> Cf S Charnovitz, ‘The WTO and Cosmopolitics’ in E-U Petersmann (ed), *Reforming the World Trading System. Legitimacy, Efficiency and Democratic Governance* (Oxford, OUP, 2005) 437–46; P Lamy, *Towards World Democracy* (London, Policy Network, 2005). According to David Held, ‘cosmopolitanism can be taken as the moral and political outlook that offers the best prospects of overcoming the problems and limits of classic and liberal sovereignty’, D Held, ‘Law of States, Law of Peoples: Three Models of Sovereignty’ (2002) 8 *Legal Theory* 1 at 24.

<sup>13</sup> See the criticism of UN human rights law and policies by E-U Petersmann, ‘Human Rights and International Trade Law—Defining and Connecting the Two Fields’ in T Cottier, J Pauwelyn and E Bürgi (eds), *Human Rights and International Trade*, (Oxford, OUP, 2005) at 29–94.

## 1. Diverse Forms of Multilevel Economic Governance

Five basic types of international economic regulation (eg of exchange rates, investments, production, trade, competition, consumption, goods, services, social and environmental standards, transnational movements of capital, persons and communications) can be distinguished<sup>14</sup> and interact in manifold ways that often lack transparency:

- (1) international treaties and intergovernmental organisations at worldwide or regional levels (such as the WTO and the more than 250 regional trade agreements), which increasingly protect also private rights (eg in the EC) and private judicial remedies (eg in the World Bank's International Center for the Settlement of Investment Disputes);
- (2) informal intergovernmental networks among domestic regulatory agencies (such as the Basel Committee of national bank regulators, the International Competition Network among national competition authorities);
- (3) national authorities implementing international economic rules and policies subject to international regulation and constitutional restraints;
- (4) hybrid public-private 'regulatory partnerships', such as the worldwide administration of website addresses by the private Internet Corporation for Assigned Names and Numbers (ICANN), which is subject to the regulatory supervision by the United States and closely cooperates with the World Intellectual Property Organisation (WIPO) (eg concerning the peaceful settlement of domain name disputes by the WIPO arbitration procedures); and
- (5) private regulatory bodies such as the International Standardisation Organisation (ISO) for the international harmonisation of standards that are also used as a legal basis for intergovernmental trade regulation (eg in the WTO Agreement on Technical Barriers to Trade), or the International Chamber of Commerce (ICC) whose private rules and commercial arbitration are closely connected with national and intergovernmental regulatory systems (see, for instance, the private 'Independent Review Procedures' administered jointly by the ICC and the WTO in order to determine the compliance by public and private parties with the WTO Agreement on Preshipment Inspection).

<sup>14</sup> Cf B Kingsbury, N Krisch and R Stewart, 'The Emergence of Global Administrative Law' (2005) 68 *Law and Contemporary Problems* 15ff; C Joerges and E-U Petersmann (eds), *Constitutionalism, Multilevel Trade Governance and Social Regulation* (Oxford, Hart Publishing, 2006).



## 2. Synergies of National and International Constitutionalism in the Control of Multilevel Governance

Most states have adopted constitutions that constitute polities and government powers, subject governments to constitutional restraints, and commit government policies to the promotion of human rights and other constitutional objectives. Globalisation demonstrates that national constitutions alone can neither protect human rights across frontiers nor secure the collective supply of global public goods (like international peace, rule of law and a healthy environment). National constitutions turn out to be ‘incomplete constitutional safeguards’; in a globally interdependent world where ever more citizens pursue their happiness by consuming foreign goods and services or travelling abroad, national constitutions can no longer realise many of their objectives without complementary ‘international constitutional safeguards’ protecting constitutional rights, and limiting abuses of power, in transnational and international relations.<sup>15</sup>

The more governments cooperate internationally for the collective supply of ‘international public goods’, the more multilevel governance in international organisations is leading to multilevel legal restraints on national policy powers. Since the Constitution (*sic*) Establishing the ILO of 1919, also many other constituent agreements of international organisations—such as the World Health Organisation (WHO) and the UN Educational, Scientific and Cultural Organisation (UNESCO)—are named ‘constitutions’ in view of the fact that, *eg*, they:

- (1) constitute a new legal order with legal primacy over that of the member states;
- (2) create new legal subjects and hierarchically structured institutions with limited governance powers;
- (3) provide for institutional checks and balances (*eg* among rule-making, administrative and dispute settlement bodies in the WTO);
- (4) legally limit the rights of member states (*eg* regarding withdrawal, amendment procedures, dispute settlement procedures);
- (5) provide for the collective supply of ‘public goods’ that—as in the case of the above-mentioned treaty constitutions (of the ILO, WHO and UNESCO)—are partly defined in terms of human rights (such as core labour rights, the human rights to health and education); and often

<sup>15</sup> See, for example, E-U Petersmann, ‘Multilevel Trade Governance Requires Multilevel Constitutionalism’, in C Joerges and E-U Petersmann, n 14 above, ch 1; DM Johnston, ‘World Constitutionalism in the Theory of International Law’, in RSJ Macdonald and DM Johnston (eds), *Towards World Constitutionalism. Issues in the Legal Ordering of the World Community* (Leiden, Nijhoff Publishers, 2005) 3–30; R Uerpman-Witzack, ‘The Constitutional Role of Multilateral Treaty Systems’ in A von Bogdandy and J Bast (eds), *Principles of European Constitutional Law* (Oxford, Hart Publishers, 2006) 147–81.

- (6) operate as ‘living constitutions’ whose functions—albeit limited in scope and membership—increasingly evolve in response to changing needs for international cooperation.

The worldwide ‘treaty constitutions’ differ fundamentally from national constitutions by their limited policy functions and less effective constitutional restraints (eg on intergovernmental and national policy powers). State-centered international lawyers therefore prefer to speak of ‘international institutional law’<sup>16</sup> or of an intergovernmental ‘constitutionalism lite’.<sup>17</sup> From citizen-oriented economic and constitutional perspectives, however, international organisations are becoming no less necessary for the collective supply of public goods than national organisations. Human rights and their moral value premises (normative individualism) require designing national and international governance as an integrated, multilevel constitutional framework for the protection of citizen rights, democratic self-government and cooperation among free citizens across frontiers.<sup>18</sup> *International constitutionalism* is a functionally limited, but necessary complement to *national constitutionalism* which, only together, can protect human rights and democratic self-government more effectively across frontiers in a globally integrating world.

### 3. Constitutional Functions of WTO Law

None of the supporters of ‘international constitutionalism’ claims that international ‘treaty constitutions’ constituting and limiting international rule-making, executive and judicial powers for the collective supply of international public goods are, or should become, constitutions in the same sense as national constitutions. In line with the diverse national constitutional traditions, constitutional approaches to multilevel governance differ inevitably. For instance, the notion of a ‘WTO constitution’ is increasingly being used in view of

- 1) the comprehensive rule-making, executive and (quasi-) judicial powers of WTO institutions;<sup>19</sup>
- 2) the ‘constitutionalisation’ of WTO law resulting from the jurisprudence of the WTO dispute settlement bodies;<sup>20</sup>

<sup>16</sup> Cf N Blokker and HG Schermers, *International Institutional Law* (4th edn) (Boston MA, Martinus Nijhoff, 2003).

<sup>17</sup> Cf J Klabbbers, ‘Constitutionalism Lite’ (2004) 1 IOLR 31 at 45. On the general recognition of multilevel constitutionalism in Europe see C Joerges and E-U Petersmann (eds), *Constitutionalism, Multilevel Trade Governance and Social Regulation* (Oxford, Hart, 2006).

<sup>18</sup> On the ‘constitutional functions’ of international organisations as a ‘fourth branch of government’ see E-U Petersmann, ‘Constitutionalism and International Organizations’ (1996) 17 *Northwestern Journal of International Law & Business* at 398, 415ff.

<sup>19</sup> See JH Jackson, *The World Trade Organisation: Constitution and Jurisprudence* (London, Royal Institute of International Affairs, 1998).

<sup>20</sup> See DZ Cass, ‘The Constitutionalization of International Trade Law: Judicial Norm-Generation as the Engine of Constitutionalization,’ (2001) 12 *EJIL* 39.

- 3) the *domestic* ‘constitutional functions’ of GATT/WTO rules, for example for protecting constitutional principles (like freedom, non-discrimination, rule of law, proportionality of government restrictions) and domestic democracy (for instance, by limiting the power of protectionist interest groups) for the benefit of transnational cooperation among free citizens;<sup>21</sup>
- 4) the *international* ‘constitutional functions’ of WTO rules, for example, for the promotion of ‘international participatory democracy’ (eg, by holding governments internationally accountable for the ‘external effects’ of their national trade policies, by enabling countries to participate in the policy-making of other countries)<sup>22</sup> and of the enhancement of ‘jurisdictional competition among nation states’<sup>23</sup> and ‘the allocation of authority between constitutions’;<sup>24</sup>
- 5) in view of the necessity of ‘constitutional approaches’ for a proper understanding of the law of comprehensive international organisations that use constitutional terms, methods and principles for more than 50 years (see, eg, the ‘Constitutions’ of the ILO, WHO, FAO, EU);<sup>25</sup> or
- 6) in view of the need to interface and coordinate different levels of governance on the national and international level.<sup>26</sup>

All these constitutional approaches agree that the WTO should not be simply viewed in narrow *economic* terms (for example, as an institution promoting economic welfare through trade liberalisation). WTO rules and policies also pursue *political* as well as *legal* objectives that are no less important than the economic benefits from liberal trade; a recent illustration of this are the guarantees of private rights to trade and intellectual property rights, including ‘rights to import and export’, of private access to independent courts and rule of law in the 2001 WTO Protocol on the accession of China.<sup>27</sup> The introduction of open markets and rule of law in China, including a system of independent trade courts (supervised by a chamber of the Chinese Supreme Court specialised in

<sup>21</sup> See E-U Petersmann (n 2 above); JO McGinnis and ML Movsesian, ‘The World Trade Constitution’ (2000) 114 *Harvard Law Review* 511–605; PM Gerhart, ‘The Two Constitutional Visions of the World Trade Organisation’ (2003) 24 *University of Pennsylvania Journal of International Economic Law* 1–75, contrasts the ‘inward-looking, economic vision of the WTO’ in helping member countries addressing internal political failures with the ‘external, participatory vision of the WTO’ helping WTO members to address concerns raised by policy decisions in other countries.

<sup>22</sup> See, for example, PM Gerhart, ‘The WTO and Participatory Democracy: The Historical Evidence’ (2004) 37 *Vanderbilt Journal of Transnational Law* 897–934.

<sup>23</sup> See JO McGinnis, ‘The WTO as a Structure of Liberty’ (2004) 28 *Harvard Journal of Law and Public Policy* 81–8.

<sup>24</sup> J Trachtman, ‘The WTO Constitution: Toward Tertiary Rules’ (2006) 16 *EJIL* 646.

<sup>25</sup> See, for example, E-U Petersmann, n 13 above; N Walker, ‘The EU and the WTO: Constitutionalism in a New Key’ in G de Búrca and J Scott (eds), *The EU and the WTO: Legal and Constitutional Issues*, (Oxford, Hart, 2001).

<sup>26</sup> T Cottier and M Hertig, ‘The Prospects of 21st Century Constitutionalism’ (2003) 7 *Max Planck Yearbook of United Nations Law*, at 261.

<sup>27</sup> See Accession of the People’s Republic of China (23 Nov 2001) WTO doc WT/L/432 pt 1, s 2.

WTO law), illustrates that the WTO Agreement is one of the most revolutionary ‘transformation agreements’ in the history of international law.

#### 4. Constitutional Nationalism vs Multilevel Constitutionalism

The progressive transformation of the intergovernmental EC Treaty rules into constitutional and judicial guarantees of individual rights was largely the result of the struggle of citizens and courts (including the ECJ and the ECtHR) against welfare-reducing abuses of foreign policy powers. In Europe, this struggle for individual freedom and democratic self-government across frontiers has led to the legal and judicial protection of ever more ‘new’ fundamental rights (as codified in the 2000 EU Charter of Fundamental Rights) and ‘constitutional principles’ of EU law (as codified in Part I of the 2004 Treaty Establishing a Constitution for Europe (TCE)).<sup>28</sup> Their underlying value premises of *normative individualism* and rule of international law (*cf* Article I–2 TCE on the ‘Union’s values’) remain, however, contested by many politicians and their legal advocates—not only outside Europe in treaty regimes dominated by hegemonic countries (like the North American Free Trade Area) but also in the EU’s external relations.<sup>29</sup> Most Europeans agree with the US view that popular sovereignty inside democratic nation states remains a precondition for legitimate transnational governance.<sup>30</sup> Yet, the rights-based, cosmopolitan European constitutionalism differs fundamentally from the constitutional nationalism in most democracies outside Europe,<sup>31</sup> especially from the current US focus on

<sup>28</sup> See Bogdandy and Bast n 15 above). Even though the process of ratification of the TCE ((2004) 47 Official Journal of the EU C 310) has been blocked by two negative *referenda* in France and the Netherlands, it appears realistic to assume that the basic constitutional principles codified in the TCE will continue to prevail in EU constitutional law.

<sup>29</sup> See the power-oriented justifications by members of the EU legal services of the frequent EU violations of WTO law (eg, PJ Kuijper, ‘WTO Law in the European Court of Justice’ (2005) 42 CML Rev 1313–41, who criticises the rule-oriented ‘Kupferberg jurisprudence’ of the ECJ as politically ‘naïve’, at 1320); Kuijper claims, at 1334, that ‘it is difficult to point out one specific moment at which it can be established beyond doubt that WTO rules have been breached, even after a decision of a panel or report of the Appellate Body’, and ‘that it is rarely or never possible to speak of a sufficiently serious breach of WTO law’ by the political EU institutions justifying the EU’s non-contractual liability for damages pursuant to Article 288 EC Treaty.

<sup>30</sup> *Cf* JA Rabkin, *Law without Nations? Why Constitutional Government Requires Sovereign States* (Princeton NJ, Princeton University Press, 2005).

<sup>31</sup> For some Anglo-Saxon communitarian lawyers, even Europe cannot be properly described as ‘constitutionalised’ until it embodies a European polity and *demos* legitimising its community (*Cf* J Weiler, *The Constitution of Europe* (Cambridge, CUP, 1999)). Other Anglo-Saxon lawyers challenge the recognition of ‘market freedoms’ in European constitutional law on the ground that neither individual economic freedom nor other individual rights are ‘a matter considered essential to constitutionalisation in the received tradition’ of ‘mature constitutional systems, for example in the United States, Canada and Australia’ (DZ Cass, *The Constitutionalization of the WTO* (Oxford, OUP, 2005) at 168, 176, 191). For a criticism of ‘constitutional nationalism’ see my review of the book by Cass in (2006) 43 CMLR at 890–2, and E-U Petersmann, ‘Introduction and Summary’ in Joerges and Petersmann (n 14 above).

*national constitutionalism and hegemonic, power-oriented foreign policies.*<sup>32</sup> Even though the US Constitution confirms the federal insight that sovereignty is divisible, many North-American lawyers remain reluctant to conceive international legal constraints on legislative and executive powers as constitutional rules, for instance because such international rules ‘do not establish the power they restrain and cannot be understood as emanations of a *pouvoir constituant*’.<sup>33</sup>

## 5. Constitutional Limits of Judicial Governance

WTO Members tend to construe the limitation of the jurisdiction of WTO dispute settlement bodies to ‘the covered agreements’ (Article 7 WTO Dispute Settlement Understanding (DSU)) narrowly as permitting only legal claims and defences based on WTO rules. International lawyers and WTO dispute settlement bodies, however, emphasise that the customary methods of treaty interpretation require interpreting WTO rules as part of the international legal system in conformity with general international law rules unless WTO law has excluded recourse to other rules of international law.<sup>34</sup> WTO dispute settlement practice continues to identify an increasing number of general principles of law (for example, on burden of proof, good faith, abuse of rights, due process of law, legal security) and more specific treaty principles for the mutual balancing of rights and obligations under WTO law (for example, principles of legal security, transparency, non-discrimination, necessity, and proportionality).<sup>35</sup> Some

<sup>32</sup> On the US penchant for imperial, unilateral foreign policies, notwithstanding US-leadership in promoting multilateral legal disciplines for other countries after World Wars I and II, see: I Daalder and J Lindsay, *America Unbound: The Bush Revolution in Foreign Policy* (Washington DC, Brookings Institution, 2004). On the often skeptical US attitude *vis-à-vis* international law see: JF Murphy, *The United States and the Rule of Law in International Affairs* (Cambridge, CUP, 2004).

<sup>33</sup> Cf A von Bogdandy, ‘Constitutionalism in International Law: Comment on a Proposal from Germany’ (2006) 47 *Harvard International Law Journal* 223 at 240.

<sup>34</sup> See J Pauwelyn, *Conflict of Norms in Public International Law: How WTO Law Relates to Other Rules of International Law* (Cambridge, CUP, 2003) at 37–8. According to Pauwelyn, ‘it is for the party claiming that a treaty has “contracted out” of general international law to prove it’ (at 213). Many WTO members and WTO lawyers proceed from the contrary presumption that the limitation of the jurisdiction of WTO dispute settlement bodies to ‘the covered agreements’ entail an agreed presumption in favor of exhaustive WTO regulation and confirms that ‘(i)n international law, every tribunal is a self-contained system (unless otherwise provided)’, as stated by the International Criminal Tribunal for Yugoslavia in *Prosecutor v Tadic*, (Jurisdiction) (1996) 35 ILM 32 at para.11. For an explanation of this narrow perception of the WTO as—in principle—a self-contained legal regime see, for example, J Neumann, *Die Koordination des WTO-Rechts mit anderen völkerrechtlichen Ordnungen: Konflikte des materiellen Rechts und Konkurrenzen der Streibeilegung*, (Berlin, Duncker & Humblot, 2002).

<sup>35</sup> On general principles of international law as part of the WTO legal system, and the need for a principle-oriented WTO jurisprudence balancing WTO rights, WTO obligations as well as the numerous WTO exceptions protecting policy autonomy for non-economic regulation, see E-U Petersmann, WTO dispute settlement practice 1995–2005: Lessons from the past and future problems, in: Y Taniguchi *et al* (eds), *The WTO at Ten: Dispute Settlement, Multilateral Negotiations, Regional Integration* (Cambridge, CUP 2006).

of these principles (for example, the burden of proof) are applied as general principles of law, whereas others (such as the non-discrimination and necessity principles of WTO law) appear to be construed as WTO-specific ‘principles underlying this multilateral trading system’, as they have been explicitly acknowledged in the Preamble and in other provisions of the WTO Agreement.

The perspective of *international* judges focusing on the customary methods of international treaty interpretation may differ fundamentally from the perspective of domestic judges confronted with WTO law arguments (focusing, for example, on national and EU constitutional law rather than on WTO obligations of the EC). In the EC and in some other WTO members, the domestic constitutional perspective has occasionally prompted national judges and EC judges to interpret domestic trade rules (for example, the customs union rules in the EC Treaty) as protecting private rights even if the respective trade rules were drafted as intergovernmental rights and obligations and implemented GATT/WTO obligations of the EC (for example, the EC customs union rules implementing GATT Article XXIV). From the European perspective of a common market without a common state, such ‘empowering functions’ of liberal trade rules for the benefit of the private market participants, and their incorporation as an ‘integral part of the Community legal system’ in order to limit governmental trade policy discretion, have prompted me to support such ‘constitutional interpretations’ by EU judges of intergovernmental trade rules for the benefit of EU citizens, and to suggest that EU judges should interpret national and international trade rules as a functional unity inside the EU for the benefit of citizens.<sup>36</sup>

Yet, such ‘constitutional interpretations’ are not permissible for the international WTO judge who must interpret the intergovernmental WTO rules ‘in accordance with customary rules of interpretation of public international law’, as prescribed in Article 3.2 of the DSU.<sup>37</sup> The WTO panel report, *United States: Sections 301–310 of the Trade Act 1974*, emphasised, for example, that ‘[n]either the GATT nor the WTO has so far been interpreted by GATT/WTO institutions as a legal order producing direct effect’, that is, creating rights and obligations not only for WTO member states but also direct individual rights for traders, producers and consumers.<sup>38</sup> International law and WTO rules limit, however, also the *legislative discretion* of national legislatures. The WTO panel report on

<sup>36</sup> See E-U Petersmann, ‘Application of GATT by the Court of Justice of the EC’ (1983) 20 *CML Rev* 409.

<sup>37</sup> On the ‘constitutional limits’ of WTO jurisprudence see the various contributions (eg, by R Howse, W Davey and E-U Petersmann) in T Cottier and P Mavroidis (eds), *The Role of the Judge in International Trade Regulation. Experience and Lessons for the WTO* (Ann Arbor, Michigan University Press, 2003) at 43–90.

<sup>38</sup> See WTO, *United States: Sections 301–310 of the Trade Act of 1974—Panel Report* (22 Dec 1999) WT/DS152/R [7.72]. The Panel makes the following important reservation: ‘The fact that WTO institutions have not to date construed any obligations as producing direct effect does not necessarily preclude that, in the legal system of any given member state, following internal constitutional principles, some obligations will be found to give rights to individuals. Our statement of fact does not prejudice any decisions by national courts on this issue’.

Mexico's measures affecting telecommunications services, for instance, concluded that private price-fixing practices remained 'anti-competitive practices' prohibited under Mexico's obligations under the General Agreement on Trade in Services (GATS) even if Mexican legislation required such uniform pricing practices.<sup>39</sup> Due to the different jurisdiction, applicable laws and judicial competences of national and international courts, their 'constitutional interpretations' may differ at national and international levels. 'Constitutionalisation' by means of jurisprudence must respect constitutional limits which may not apply to 'constitutionalisation' by national and intergovernmental rule-making. Yet, as the WTO guarantees of freedom, non-discrimination and rule of international law go far beyond the autonomous guarantees in the domestic laws of most states, the legitimacy of WTO jurisprudence derives not only from 'legal formalism'<sup>40</sup> but also from protecting individual freedom, non-discriminatory conditions of competition and rule of law across national frontiers for the benefit of welfare-increasing cooperation among citizens.

#### IV. PRACTICAL POLICY RELEVANCE OF CONSTITUTIONAL APPROACHES

Compared with traditionally power-oriented foreign policy approaches (eg in the context of GATT 1947), multilevel constitutionalism may require different policy approaches and judicial approaches, for example in the following areas of multilevel trade governance.

##### 1. Constitutional Interpretation

The interpretation of the constituent agreements of international organisations, and of international guarantees of private freedoms and rule of law (such as the 'market freedoms' guaranteed in the EC Treaty), may justify 'constitutional' and 'dynamic-evolutionary interpretations' different from those of the more 'static interpretations' of other contractual elements of international treaties.<sup>41</sup> For instance, the customary rules of international treaty interpretation and WTO jurisprudence admit that the 'contractual' dimensions of WTO law may require different interpretative approaches (for example in, interpreting GATT and GATS schedules of commitments, WTO 'non-violation complaints' aimed at maintaining the 'balance' of reciprocal tariff commitments) than their

<sup>39</sup> WTO, *Mexico: Measures Affecting Telecommunications Services—Panel Report* (2 Apr 2004) WT/DS204/R [7.244]–[7.245].

<sup>40</sup> S Picciotto, 'The WTO's Appellate Body: Legal Formalism as a Legitimation of Global Governance' (2005) 18 *Governance: An International Journal of Policy, Administration and Institutions* at 477 ff.

<sup>41</sup> On the problems of 'constitutional interpretation' see JE Alvarez, *International Organizations as Law-Makers* (Oxford, OUP, 2005) ch 2.

‘constitutional’ dimensions (eg in cases of judicial clarification of the inherent powers of WTO dispute settlement bodies, or of the powers of WTO Members under the WTO exceptions protecting ‘public morals’ and ‘public order’). The universal recognition of human rights entails ‘constitutional principles’ and *ius cogens* rules that may require rights-based interpretations going beyond the original meaning of treaty terms at the time of the conclusion of intergovernmental treaties (such as GATT 1947).

## 2. Constitutional Rules for Conflict Resolution

The fragmented, decentralised nature of international relations among 200 sovereign states makes normative conflicts between national, bilateral, regional and worldwide rules inevitable. The Vienna Convention on the Law of Treaties (VCLT) and other general international law rules offer formal legal principles for preventing and resolving such conflicts (for example, on the basis of *lex specialis*, *lex posterior*, rules on *inter-se* agreements, *ius cogens*, *erga omnes* obligations). Constitutionalism requires respecting individual and democratic diversity and viewing regulatory diversity, regulatory competition and regulatory conflicts positively.<sup>42</sup> For instance, the WTO negotiations on stricter substantive WTO disciplines for regional trade agreements (RTAs) are bound to fail as long as RTAs (such as the more than 60 RTAs concluded after the failure on the 2003 WTO Ministerial Conference to advance the Doha Round negotiations in the WTO) are favored not only as ‘competing trade liberalisation’, but also as competing *fora* for regional trade regulation that does not appear acceptable in the consensus-based, worldwide WTO negotiations.<sup>43</sup>

## 3. Constitutional Functions of WTO Rules

Liberal international trade rules differ from most other areas of international law insofar as their international guarantees of freedom, non-discrimination and rule of law tend to go beyond the autonomous guarantees of freedom and non-discrimination in national and regional laws. International treaties constituting and limiting multilevel governance are a necessary precondition for the collective supply of global public goods (like a liberal, rules-based world trading system) which cannot be secured through power-oriented foreign policies focusing only on *national* interests. The inherent tendencies of freedom and

<sup>42</sup> Cf E-U Petersmann, ‘Justice as Conflict Resolution: Proliferation, Fragmentation and Decentralization of Dispute Settlement in International Trade’ (2006) 27 *University of Pennsylvania Journal of International Economic Law* 273–367.

<sup>43</sup> Cf E-U Petersmann, ‘The WTO and Regional Trade Agreements as Competing Fora for Constitutional Reforms’ in L Bartels and F Ortino (eds), *Regional Trade Agreements and the WTO Legal System* (Oxford, Oxford University Press, 2006) 281–312.



competition to destroy themselves ('paradox of freedom') require internationally agreed 'constitutional restraints' on abuses of foreign policy powers in order to secure the rule of law in international relations (eg by means of the WTO dispute settlement system), open markets (eg by means of WTO guarantees of non-discriminatory conditions of competition), respect for human rights and social justice (as reflected and protected in the numerous 'exceptions' from WTO rules). Constitutionalism offers criteria for designing the law of international organisations (eg the necessary 'checks and balances' between rule-making, executive and adjudicative powers).

#### 4. Human Rights Approaches to International Economic Law

From a rights-based constitutional perspective (as, eg, in EU constitutional law), national and international constitutionalism should be perceived as complementary instruments for the protection of the constitutional rights and human rights of citizens. Just as economists (from Adam Smith to Amartya Sen) perceive market economies and economic growth as instruments for enabling and promoting individual freedom as the ultimate goal of economic life and the most efficient means of realising human welfare, so should national and international law (eg the WTO objective of 'sustainable development') be seen as instruments for the protection of human rights and democratic self-government of peoples.<sup>44</sup> The rights-based premises of constitutionalism require empowering individuals and civil society (eg non-governmental organisations) as legal subjects of international economic law. Multilevel constitutionalism can promote welfare-enhancing synergies between national and international constitutionalism; power-oriented foreign policies and border discrimination tend to undermine such synergies (eg by preventing EU and US courts from applying and enforcing self-imposed WTO guarantees of freedom and rule of law in domestic courts).

#### 5. Individual Empowerment and Responsibility

Human rights call for promoting individual rights and accountability in the transnational division of labour among producers, investors, traders and consumers. According to Article 1 of the Universal Declaration of Human Rights (UDHR), '(a)ll human beings are born free and equal in dignity and rights. They

<sup>44</sup> On 'development as freedom' and substantive 'opportunity to achieve', see A Sen, *Rationality and Freedom* (Cambridge MA, HUP, 2002) ch 17 on 'markets and freedoms'; E-U Petersmann (ed), *Developing Countries in the Doha Round* (Florence, EUI, 2005) 3–18. See also, FA Hayek, *The Constitution of Liberty* (Chicago, IL, University of Chicago Press, 1960) 35: 'Economic considerations are merely those by which we reconcile and adjust our different purposes, none of which, in the last resort, are economic (except those of the miser or the man for whom making money has become an end in itself)'.

are endowed with reason and conscience and should act towards one another in a spirit of brotherhood'. UN human rights conventions recognise in their Preambles 'that these rights derive from the inherent dignity of the human person'. Respect for human dignity and human rights, that is, *normative individualism*—and not just state sovereignty, 'the will of the people' (Article 21 of the UDHR) and their 'right of self-determination' (Article 1 of the ICCPR and the ICESCR)—are of particular importance for empowering individuals in the international division of labour. The references, in Article 1 UDHR, to 'reason and conscience' lend support to the view that the protection of human dignity as the basic objective of all human rights requires respect for 'individual sovereignty' (for example, in the sense of moral, rational, personal, and legal autonomy), responsibility and a real capacity for personal self-development.<sup>45</sup> Human dignity as a moral 'right to have rights' requires individuals to be treated as legal subjects rather than as the mere objects of authoritarian government policies, especially in the regulation of transnational economic activities of private citizens. The authoritarian state-centred practices of treating citizens as mere objects even in those fields of international law which regulate mutually beneficial private co-operation across frontiers (such as WTO law), need to be challenged in the light of the human rights objective of empowering citizens and protecting human rights across national borders. From a human rights perspective, the legitimacy of intergovernmental organisations (such as the WTO) depends less on 'output legitimacy' (for example, in terms of the promotion of economic growth) than on 'input legitimacy' in terms of respect for human rights, fundamental freedoms, democratic procedures and rule of law for the benefit of citizens, even if the statutory law of the organisation does not explicitly refer to the universal human rights obligations of all states today. Just as democratic polities must be legally constituted by human rights and a political constitution, so must a social world economy be based on and protected by human rights and a citizen-based 'economic constitution'.

## 6. Deliberative Cosmopolitan Democracy

Whereas national democracies are constitutionally defined by, and on behalf of, 'the people', the influence of popular and parliamentary democracy on the law and policies of intergovernmental organisations remains inevitably limited. Respect for human rights, private and democratic self-government and social

<sup>45</sup> See the contributions by K Dicke and J Frowein in D Kretzmer and E Klein (eds), *The Concept of Human Dignity in Human Rights Discourse* (The Hague, Kluwer, 2002) at 111 ff; E-U Petersmann, Human Rights, Markets and Economic Welfare, n 10 above, at 30 ff. On 'individual sovereignty' see also UN Secretary-General Kofi Annan, 'Two Concepts of Sovereignty', *The Economist*, 18 Sept 1999, and E-U Petersmann, 'From State Sovereignty to the Sovereignty of Citizens' in the International Relations Law of the EU?' in N Walker (ed), *Sovereignty in Transition*, (Oxford, Hart, 2003) at 145–66.

justice require more transparent, participatory and deliberative forms of transnational ‘cosmopolitan democracy’ so that citizens can better comprehend, influence and scrutinise multilevel governance for their mutual benefit.<sup>46</sup> The purely intergovernmental structures of the WTO and of many other international organisations do not adequately empower, inform and include citizens and their representative institutions in their collective decision-making procedures so as to ensure ‘cosmopolitics’ for the benefit of all citizens and their individual and democratic self-determination. Cosmopolitanism requires decentralising decision-making and promoting mutually beneficial cooperation across frontiers based on

- (1) equal individual rights (subject to democratic diversity) so as to enhance the real capacity of informed, individual and democratic self-determination;
- (2) stronger, institutionalised accountability mechanisms for the consequences of individual and social actions;
- (3) inclusive decision-making taking account of each person’s equal rights, arguments and interests as closely as possible to the citizens concerned;
- (4) protection of ‘exit’ and alternative choices at subsidiary levels of decision-making (eg RTAs as alternatives to consensus-based WTO agreements); and
- (5) avoidance of serious harm and prioritising of scarce resources on the amelioration of urgent need.<sup>47</sup>

## 7. Social Market Economy and Social Justice

Contrary to the views of the American legal philosopher John Rawls and to the prevailing ‘Washington consensus’, individual rights to distributive and social justice and corresponding government obligations should be recognised not only *inside* constitutional democracies but also in international law and transnational relations, albeit subject to limitations and conditionality.<sup>48</sup> For instance, the emerging ‘Geneva consensus’ (Pascal Lamy) in the Doha Development Round negotiations acknowledges that market access commitments by less-developed countries may need to be complemented by international adjustment and capacity-building assistance in order to avoid serious harm, promote the social

<sup>46</sup> See J Habermas, *Between Facts and Norms—Contributions to a Discourse Theory of Law and Democracy* (Cambridge MA, MIT Press, 1996) at 315–28, arguing that democratic self-government requires that only those rules may claim democratic legitimacy that can meet with the assent of all rational citizens in a discursive process equally open to all possibly affected persons. Public discourse and collaborative reasoning will enhance problem-solving and mutual learning. On the relationships between democracy and rule of law, see also E-U Petersmann, ‘European and International Constitutional Law: Time for Promoting Cosmopolitan Democracy in the WTO’ in G de Búrca and J Scott (eds), *The EU and the WTO*, (Oxford, Hart Publishing, 2001) at 81–110.

<sup>47</sup> For a similar list of ‘constitutive’, ‘legitimizing’ and ‘prioritising cosmopolitan principles’ see Held, n 12 above, at 24 ff.

<sup>48</sup> Cf Petersmann, *Theories of Justice*, n 7 above.

acceptability of trade competition and help to meet the adjustment costs and human rights obligations in less-developed countries.

#### V. COSMOPOLITAN DEMOCRACY DEPENDS ON MULTILEVEL CONSTITUTIONAL AND JUDICIAL SAFEGUARDS OF HUMAN RIGHTS

In a globally interdependent world, constitutional democracy cannot remain effective unless local and national constitutional rights and institutions are supplemented by international constitutional guarantees protecting the diversity of democratic polities and mutually beneficial cooperation of free citizens across frontiers. Proposals for stronger, multilevel constitutional restraints on *foreign policies* for the protection of equal citizen rights aim at *strengthening* constitutional democracies by enabling citizens, civil society, parliaments and governments to cooperate more effectively in the collective supply of international public goods. In Europe, such international guarantees of human rights and of liberal trade have proven of crucial importance for peaceful economic and legal integration of all 47 member states of the Council of Europe based on common constitutional rules.

Inside constitutional democracies and regional integration law, the legal protection of human rights—including economic, social and cultural (ESC) rights—legitimately differs depending on the diverse constitutional traditions, development experiences and priorities of the countries concerned. At the global level, the ratification of the ICESCR by 156 countries has—in the words of the chairperson of the UN Committee on ESC Rights—so far failed to change the widely held perception of violations of ESC rights . . . as inevitabilities, as a ‘normal’ state of affairs in an unfair world where goods, resources and power are divided in a grossly inequitable manner.<sup>49</sup> Also UN Secretary-General Kofi Annan, in his final address to world leaders assembled in the UN General Assembly on 19 September 2006, admitted that the intergovernmental structures of UN law do not effectively empower individuals to protect themselves against abuses of government powers and to create the economic resources needed for the enjoyment of human rights; the power-oriented international legal system is widely perceived as ‘unjust, discriminatory and irresponsible’ and has failed to effectively respond to the three global challenges to the United Nations—‘an unjust world economy, world disorder and widespread contempt for human rights and the rule of law’—resulting in divisions that ‘threaten the very notion of an international community, upon which the UN stands’.<sup>50</sup>

European law remains unique in granting effective legal and judicial remedies empowering individuals against national rulers and intergovernmental

<sup>49</sup> VB Dandan, Foreword to S Leckie and A Gallagher (eds), *Economic, Social and Cultural Rights: A Legal Resource Guide* (Philadelphia, University of Pennsylvania Press, 2006) at ix.

<sup>50</sup> Kofi Annan, ‘10 Years After—A Farewell Statement to the General Assembly’ in UNGA, Sixty-first Session, 10th Plenary Meeting (19 Sept 2006) UN doc A/61/PV.10.

organisations. The ICESCR, for instance, does not protect freedom of profession, private property, open markets, freedom of trade and other legal preconditions for empowering individuals to create the economic welfare—including a mutually beneficial, international division of labour—needed for the enjoyment of human rights. UN human rights bodies have no powers to prevent or effectively sanction the widespread violations of human rights by UN member states. Most UN agencies and the WTO do *not* pursue effective rights-based development strategies. Empowerment of individuals to use law for securing their ESC rights must be anchored in *national* constitutional laws in order to offer effective remedies at the local levels where people work and live. Liberal (ie liberty-based) constitutional theory offers the most important moral and legal foundation for empowering people across frontiers.

A clarification of the constitutional foundation of human rights is the necessary first step in challenging the persistent neglect of ESC rights by many governments and most international organisations. Even inside Europe, the interaction between constitutional law and human rights legitimately differs among countries and among the regional organisations in Europe (such as the EU, the European Free Trade Area, the Council of Europe). The elaboration of the *Charter of Fundamental Rights of the European Union* and of the TCE confirms that social and intergovernmental agreement on multilevel constitutional safeguards of human rights depends on clarifying the underlying value premises, such as the need to reconcile state sovereignty, popular sovereignty and individual sovereignty through multilevel constitutionalism (discussed above in Sections II to IV). The following section addresses three propositions for extending rights-based, multilevel constitutionalism to an international ‘social market economy’ and ‘cosmopolitan democracy’. *First*, the synergies between constitutional rights and human rights need to be strengthened by grounding both on respect for human dignity and human liberty rights in conformity with modern theories of justice. *Second*, the more distant regional and worldwide governance institutions operate from their citizens, the less effective *procedural* citizen rights for democratic participation, representation and control risk becoming in multilevel economic governance. A social international market economy, and a complementary cosmopolitan democracy, must be founded on stronger *substantive*, constitutional rights empowering citizens to engage in mutually beneficial private cooperation across frontiers and regulating the international division of labour through integrated networks of national and international rule-making, administration and courts. *Third*, rights-based multilevel constitutionalism must be progressively extended bottom-up and requires more comprehensive processes of weighing and balancing rights and obligations of governments and of individuals in the interpretation and application of international economic law by governments and courts at national and international levels.

## 1. Rights-Based Constitutionalism: The *ius cogens* Core of Human Rights

Human rights and other constitutional rights serve complementary functions: they empower individuals by actionable rights and serve as ‘balancing principles’ for ‘optimising’ rights and obligations depending on the particular circumstances.<sup>51</sup> Rights-based constitutionalism, and the human rights guarantees in democratic constitutions, differ from republicanism (for example, in ancient Greece, classical Rome, the Italian Renaissance republics) by their *contractual* justification (rather than eg Aristotelian justifications) of democratic polities and of constitutional constraints on government powers in order to secure man’s freedom. Modern theories of justice from Kant to Rawls recognise maximum equal legal freedom of all human beings as the ‘first principle of justice’.<sup>52</sup> Human rights theories and rights-based, modern constitutional theories—notably since the American and French revolutions in the 18th century and the post-war, rights-based constitutional law in Europe—are rooted much more in *normative individualism* than it is the case in many other countries, whose constitutional traditions remain influenced by historical power struggles for ‘mixed constitutions’ and by constitutional privileges of monarchs, Houses of Lords, churches or of other previous rulers (for instance, communist parties) limiting equal individual rights.

My own publications have construed the recognition—in German and European constitutional law and UN human rights instruments—of human dignity as the source of inalienable human rights in accordance with the Kantian concept of human dignity (eg as the moral and rational capacity of human beings of exercising one’s freedom of choice in a ‘just’ manner respecting the equal autonomy and maximum equal freedom of all others).<sup>53</sup> According to

<sup>51</sup> On these dual functions of human rights and other constitutional rights as *rules*, as well as *principles* for optimising rules depending on what is factually and legally possible in the particular circumstances, see R Alexy, *A Theory of Constitutional Rights* (Oxford, OUP, 2002) ch 3. Article I-9, para 3 of the TCE acknowledges these dual functions in the following terms: ‘Fundamental rights, as guaranteed by the European Convention for the Protection of Human Rights and Fundamental Freedoms and as they result from the constitutional traditions common to the Member States, shall constitute general principles of the Union’s law’.

<sup>52</sup> On differences between Kantian and Rawlsian principles of justice see Petersmann, n 7 above.

<sup>53</sup> According to Immanuel Kant, ‘freedom constitutes man’s worth’, and ‘freedom (independence from the constraints of another’s will) insofar as it is compatible with the freedom of everyone else in accordance with a universal law, is the sole and original right that belongs to each human being by virtue of his humanity’ (Cf I Kant, ‘The Metaphysics of Morals’ in H Reiss (ed) and HB Nisbet (tr), *Kant: Political Writings* (2nd edn) (Cambridge, CUP, 1991) at 136). According to Kant, equality and all other human rights derive from this universal birthright of freedom. Justice requires, according to Kant, exercising one’s freedom in accordance with the moral ‘categorical imperative’ that individuals and a just constitution must allow the ‘greatest freedom’ for each individual along with ‘the most precise specification and preservation of the limits of this freedom so that it can coexist with the freedom of others’. Kant defines law (‘Recht’) as ‘the sum total of those conditions within which the will of one person can be reconciled with the will of another in accordance with a universal law of freedom’; Kant follows from his moral ‘categorical imperative’ that ‘every action which by itself or by its maxim enables the freedom of each individual’s will to co-exist with the freedom of everyone else in accordance with a universal law is *right*’ (at 133).

Kant, respect for human dignity and justice require treating human beings as ends in themselves, respecting their moral choices, and protecting maximum equal freedom of individuals through ever more precise, national, international and cosmopolitan constitutional rules.<sup>54</sup> As everybody ‘may seek his happiness in whatever way he sees fit, so long as he does not infringe upon the freedom of others to pursue a similar end which can be reconciled with the freedom of everyone else within a workable general law’,<sup>55</sup> treating a person as an end-in-herself and respecting her freely chosen objectives require legal protection of a human right to maximum equal freedom in the economic area no less than in other areas of human cooperation. For only the individual himself can know, and decide on, his own ends and personal self-development. Hence, human dignity and human liberty are indivisible, as recognised in the 1993 Vienna Declaration and Programme of Action adopted by the World Conference on Human Rights: ‘All human rights are universal, indivisible and interdependent and interrelated’.<sup>56</sup> The ECJ has acknowledged that respect for human rights is a condition of the lawfulness of EC acts.<sup>57</sup> The ECtHR has likewise recognised in a series of judgments that the human rights guarantees of the ECHR also apply whenever states implement intergovernmental rules adopted in international organisations.<sup>58</sup> National and international human rights increasingly

<sup>54</sup> On Kant’s moral ‘categorical imperatives’ for acting in accordance with universal laws (‘Act only in accordance with that maxim through which you can at the same time will that it become a universal law’), for respecting human dignity by treating individuals and humanity as ends in themselves (‘So act that you use humanity, whether in your own person or that of another, always at the same time as an end, never merely as a means’), and for respecting individual autonomy (‘the idea of the will of every rational being as a will giving universal law’) and individual right (‘Any action is right if it can coexist with everyone’s freedom according to a universal law’), see also AW Wood, *Kant’s Ethical Thought*, (Cambridge, CUP, 1999). On Kant’s social and historical theories of the antagonistic human nature promoting market competition and constitutional ‘rules of justice’, and on Kant’s moral imperative of transforming the ‘lawless freedom’ in the state of nature into lawful freedom through ever more precise national, international and cosmopolitan constitutional rules see also: E-U Petersmann, ‘How to Constitutionalize International Law and Foreign Policy for the Benefit of Civil Society?’ (1999) 20 *Michigan Journal of International Law* 1–30.

<sup>55</sup> Kant, ‘On the Common Saying: This May be True in Theory, but it does not Apply in Practice’, n 53, at 74).

<sup>56</sup> UNGA, ‘Vienna Declaration and Programme of Action’ World Conference on Human Rights (12 Jul 1993) UN doc A/CONF.157/23 [5], reproduced in: *The UN and Human Rights 1945–1995* (New York, UN, 1995) at 450.

<sup>57</sup> See n 9 above.

<sup>58</sup> See *Bosphorus v Ireland*, n 9 above: ‘a Contracting Party is responsible under Article 1 of the Convention for all acts and omissions of its organs regardless of whether the act or omission in question was a consequence of domestic law or of the necessity to comply with international legal obligations’ . . . (para 153). ‘In . . . establishing the extent to which State action can be justified by its compliance with obligations flowing from its membership of an international organisation to which it has transferred part of its sovereignty, the Court has recognised that absolving Contracting States completely from their Convention responsibility in the areas covered by such transfer would be incompatible with the purpose and object of the Convention’ . . . (para 154). ‘State action taken in compliance with such legal obligations is justified as long as the relevant organisation is considered to protect fundamental rights, as regards both the substantive guarantees offered and the mechanisms controlling their observance, in a manner which can be considered at least equivalent to that for which the Convention provides’ (para 155).

limit foreign policy powers even if they are being exercised collectively in inter-governmental organisations. Yet, contrary to the reasoning of the EU Court of First Instance in the *Kadi* and *Yusuf* judgments which declined jurisdiction to review UN Security Council resolutions in the light of European human rights, judicial protection of the broader constitutional and human rights guarantees in European constitutional law should not be abandoned in favour of the more limited *ius cogens* core of UN human rights limiting the powers of the UN Security Council.<sup>59</sup>

## 2. Constitutional Protection against Arbitrary Interference in Individual Freedom: A General Right to Liberty?

A general constitutional right to liberty (as recognised in Article 2:1 of the German Basic Law) protects the legal autonomy of citizens by means of individual rights and legal protection against arbitrary interference in ‘negative liberties’ (ie legal freedom of action), including against restriction of individual freedom resulting from *multilevel* governance and from *international* rules adopted in distant intergovernmental organisations.<sup>60</sup> The constitutional commitment to respect for human dignity (such as that recognised in the German Basic Law, the EU Charter of Fundamental Rights, UN human rights instruments), and the constitutional guarantees of civil, political, economic, social and cultural human rights, recognise that negative liberty is a necessary but insufficient condition of human dignity; it must be complemented by specific ‘positive liberties’ in order to effectively empower individuals and their personal

<sup>59</sup> Article 53 of the VCLT defines a ‘peremptory norm of general international law’ as ‘a norm accepted and recognized by the international community of States as a whole as a norm from which no derogation is permitted and which can be modified only by a subsequent norm of general international law having the same character’. The *ius cogens* core of UN human rights is smaller than that of European human rights and constitutional law. In the *Kadi* and *Yusuf* cases (n 8 above), the Court of First Instance examined the consistency of sanctions imposed by the UN Security Council and EU implementing regulations only with regard to the *ius cogens* core of UN human rights to make use of one’s property, the right to a fair hearing and the right to an effective judicial remedy; the Court claimed that it had no jurisdiction to examine whether the EU implementation of the UN sanctions was also consistent with the broader guarantees of fundamental rights in EU law. The legal consistency of the listing of alleged terrorist groups with European human rights law was also challenged in the ECtHR which elaborated a concept of presumed compliance of the EU with the ECHR: ‘the Court finds that the protection of fundamental rights by EU law can be considered to be . . . ‘equivalent’ . . . to that of the Convention system’ (*Bosphorus v Ireland*, n 9 above, para 165); Judge Ress rightly emphasised in his concurring opinion (para 2) that the ‘concept of a presumption of convention compliance should not be interpreted as excluding a case-by-case review by this Court of whether there was really a breach of the Convention’.

<sup>60</sup> On the constitutional protection in Germany of a general right to liberty, complemented by specific constitutional liberty rights and other civil, political, economic, social and cultural rights, see Alexy, n 51 above, notably ch 7. On the constitutional protection of human rights against multilevel governance interferences in the EC see, eg, the *Yusuf case* (n 8 above) concerning decisions of the UN Security Council freezing the bank accounts of alleged terrorists.



self-development.<sup>61</sup> Comprehensive constitutional guarantees of individual access to courts (as eg in German law) protect individual liberty against arbitrary legislative and administrative restrictions by offering judicial review based on principles of proportionality and balancing of all constitutional rights and principles.<sup>62</sup>

Of course, constitutional guarantees of a general right to liberty and of fundamental ‘market freedoms’ (as protected in EU law) are not recognised in many constitutional democracies which never suffered from dictatorship (as in Germany) and never secured international democratic peace by multilevel constitutional law (as among the 27 EU member states), including legal and judicial guarantees of international ‘free movement of persons, services, goods and capital, and freedom of establishment’ as ‘fundamental freedoms’ (Article I-4 of the 2004 TCE). It has been argued, for example, that the common law, while protecting specific liberties, does not give any weight to liberty in general;<sup>63</sup> and that in ‘mature constitutional systems, for example in the United States, Canada and Australia’, neither individual economic freedom nor other individual rights are ‘a matter considered essential to constitutionalization in the received tradition of constitutionalization’.<sup>64</sup> US constitutional law protects individual economic freedom and a common market, *inter alia*, by constitutional requirements of a legal basis for governmental restrictions of individual liberty, rather than by a general individual right to liberty.<sup>65</sup> As US constitutional, antitrust and economic law effectively protect a common market inside the US, most US lawyers see no need for the kind of judicial review by US courts of national governmental restrictions of economic freedom as it is practiced, for example, by the German Constitutional Court, the EC Court and by the WTO Appellate Body.

From the perspective of citizens, constitutional protection of a general right to liberty may offer more effective legal and judicial remedies vis-à-vis multi-level governance in distant international organisations. For instance, it extends

<sup>61</sup> The German Constitutional Court recognises a human right to respect and protection of human dignity and focuses ‘on an understanding of the human being as an intellectual and moral creature capable of freely determining and developing itself. The Basic Law conceives of this freedom not as that of an isolated and autonomous individual, but as that of an individual related and bound to society’ (Bundesverfassungsgericht Entscheidungen vol 45, 187, at 227). This reconciliation of the principle of negative liberty with the social interdependence of the individual is explained by the Court in the following terms: ‘the individual must submit himself to those limits on his freedom of action which the legislature sets in order to maintain and support social co-existence within the limits of what is generally acceptable according to the relevant subject-matter, and so long as the independence of the person remains guaranteed’ (Bundesverfassungsgericht Entscheidungen vol 4, 7, at 16).

<sup>62</sup> See Alexy, n 51 above, ch 7.

<sup>63</sup> Cf TTS Allan, *Law, Liberty and Justice* (Oxford, Clarendon Press, 1993) at 135–43.

<sup>64</sup> DZ Cass, n 31 above, at 168, 176, 191.

<sup>65</sup> Cf FL Morrison and RE Hudec, ‘Judicial Protection of Individual Rights under the Foreign Trade Laws of the United States’ in M Hilf and E-U Petersmann (eds), *National Constitutions and International Economic Law* (Deventer, Kluwer 1993) at 92 ff.

the substantive scope of constitutional rights protection and requires the justification of all governmental restrictions of individual liberty. As human and constitutional rights also express objective, constitutional principles that must be taken into account in the whole legal order, a general right to liberty may influence the burden of proof in the balancing of competing constitutional rights, obligations and principles.<sup>66</sup> Even though national constitutional traditions may legitimately differ from country to country, there are important arguments for basing legal and judicial remedies against abuses of multilevel governance powers on the principle that multilevel governance restrictions of individual freedom require constitutional justification and judicial remedies.

The WTO dispute settlement rules and practices—such as that WTO Members have a right to complain under the WTO dispute settlement system without proving a ‘legal interest’,<sup>67</sup> and that violations of WTO rules are presumed to ‘nullify’ treaty benefits (eg reasonable expectations of non-discriminatory conditions of trade competition)<sup>68</sup>—are based on principles similar to those of constitutional protection of a right to liberty. The progressive evolution of the core of inalienable human rights into *ius cogens*, and the increasing recognition of the dual nature of human rights—that is, as *individual constitutional rights* as well as *objective constitutional principles* for the mutual balancing and ‘optimising’ of other constitutional rights and obligations (for example, by means of proportionality requirements)—support the claim that intergovernmental guarantees of private freedom might constitute not only *intergovernmental rights*, but may also justify legal and judicial protection of *private freedoms* based on domestic constitutional rights to liberty and constitutional requirements to exercise governance powers in ‘strict observance of international law’ (Article I-3, para 4 TCE). Such interpretations of constitutional rights to freedom (such as those in German and EC constitutional law) in conformity with self-imposed *international* guarantees of freedom (such as

<sup>66</sup> For a discussion of the German Constitutional Court case-law on the general right to liberty as protecting ‘human freedom of action in the widest sense’, subject to the broad constitutional limitation clause, see Alexy, n 51 above, ch 7. In view of Article 93:1 German Basic Law on ‘constitutional complaints, which can be raised by anyone on the grounds that their constitutional rights . . . have been infringed by a public authority’, the German Constitutional Court has held: ‘Everyone can allege by way of constitutional complaint that a law limiting his freedom of action does not belong to the constitutional order because it infringes (either procedurally or substantively) individual provisions of the Constitution or general constitutional principles and thus that it infringes his constitutional right under Article 2:1 Basic Law’ (Bundesverfassungsgericht Entscheidungen vol 6, 32, at 41).

<sup>67</sup> In the WTO dispute over the European Communities import restrictions on bananas, the European Communities claimed that the United States had no ‘legal right or interest’ to sue as it did not export any bananas (WTO, *EC:Bananas III (USA)—Panel Report* (22 May 1997) WTO doc WT/DS27/R/USA [II.21]). The Appellate Body confirmed the finding by the Panel that the DSU did not require a ‘legal interest to sue’ (WTO, *EC: Bananas III—Appellate Body Report* (9 Sept 1997) WTO doc WT/DS27/AB/R, [132]).

<sup>68</sup> Cf E-U Petersmann, *The GATT/WTO Dispute Settlement System* (Deventer, Kluwer 1997) 142 ff.

GATT's customs union rules and their incorporation into the EC Treaty) have nothing to do with the proposition of a human right to free trade.<sup>69</sup>

### 3. Procedural and Participatory Citizen Rights vis-à-vis Multilevel Governance

From a human rights perspective, individuals and their elected representatives constitute not only 'peoples' and democratic states, but—through the intermediary of their state agents—also intergovernmental organisations as a necessary 'fourth branch of governance'.<sup>70</sup> None of these various forms of collective governance institutions has a constitutional mandate to disregard or violate human rights. The legitimacy of international organisations (such as the UN, the WTO and the EU) depends on respect for, and promotion of human rights. Yet, at international levels—far away from the local communities in which citizens live and co-operate, and far away also from national parliaments—intergovernmental rules and procedures inevitably suffer from 'democratic deficits' compared to local and national democratic processes and parliamentary decision-making. It remains an important task to strengthen the democratic accountability of multilevel governance as well as legal and judicial remedies against abuses of foreign policy powers.

UN human rights instruments recognise that human rights need to be protected and mutually balanced through democratic legislation, and that 'everyone has the right to take part in the government of his country, directly or through freely chosen representatives' (Article 21(1) UDHR); '(t)he will of the people shall be the basis of the authority of governments; this will shall be expressed in periodic and genuine elections which shall be by universal and equal suffrage and shall be held by secret vote or by equivalent free voting procedures' (Article 21(3) UDHR). These core guarantees of a human right to democratic governance<sup>71</sup> focus on national rather than international gover-

<sup>69</sup> P Alston and DZ Cass have imputed to me the absurd views 'that the WTO agreements consist of a series of human rights' (Cass, n 31 above, at 146); 'that the WTO has direct effect' (at 147); that 'any state attempts to deny that possibility are not legally binding' (at 148); and that my support for a 'human rights approach to international trade' is 'fixated on only one category of human rights, namely individual economic rights' (at 172). Alston and Cass overlook that my arguments for protecting freedom of trade are based on constitutional rights to liberty (eg in German and EU law) and on the EC legal obligations to respect the GATT and WTO guarantees of freedom of trade. My proposal to interpret—inside the EU—the 'human right to liberty' (eg in Article II-66 EU Charter of Fundamental Rights, Article 3 UDHR) more broadly than it is done in common law countries follows from my Kantian definition of the 'first principle of justice' (*cf* Petersmann, n 7); it aims at avoiding gaps in human rights law (eg the lack of UN human rights provisions protecting freedom of profession and freedom of contract). I have opposed a 'human right to free trade' as running counter to the 'indivisibility' of human rights and to the necessary balancing of liberty rights with all other human rights and constitutional rights.

<sup>70</sup> See Petersmann, n 18 above.

<sup>71</sup> On the emerging 'human right to democratic governance', see, for example, TM Franck, 'The Emerging Right to Democratic Governance' (1992) 86 *AJIL*, 46–91; GH Fox and BR Roth (eds), *Democratic Governance and International Law* (Oxford, OUP, 2000); E Stein, 'International Integration and Democracy: No Love at First Sight', (2001) 95 *AJIL* 489–532. On the recognition

nance; but UN human rights instruments also recognise a human right ‘to a social and international order in which the rights and freedoms set forth in this Declaration can be fully realised’ (Article 28 UDHR). Just as European constitutional law requires EU member states to respect ‘representative democracy’ (Article I-46 TCE) and ‘participatory democracy’ (Article I-47 TCE) at national and European levels, so does the realisation of UN human rights require stronger safeguards for participatory, representative and deliberative democracy in multilevel trade governance.

Democratic control by citizens and by national parliaments of international bureaucratic bargaining in distant, intergovernmental organisations is—for numerous reasons—far more difficult than in domestic political processes.<sup>72</sup> For example, national parliaments and civil society groups often complain of the ‘information asymmetries’ which result from intergovernmental rule-making by bureaucratic networks in non-transparent, intergovernmental organisations without effective parliamentary participation and effective democratic control by public opinion and civil society (for example, insufficiently ‘inclusive’ decision-making without participatory and/or consultative rights of non-governmental groups that may be affected by intergovernmental decisions). Such democratic concerns increase if intergovernmental negotiations (for example, in the WTO) are strongly influenced by powerful interest groups (for example, agricultural, textile and steel lobbies); take place behind closed doors without adequate ‘deliberative democracy’; do not refer to human rights in the international negotiations and balancing processes; and may lead to comprehensive ‘package deals’ (like the 1994 WTO Agreement) which can hardly be reopened at the request of a single national parliament, or at the request of a few WTO members in the consensus-based WTO decision-making processes, once the international negotiations have been closed.

#### 4. Substantive Citizen Rights in Multilevel Economic Governance

Human rights and democratic procedures can be combined in many ways which legitimately differ among countries. Yet, the more remote governance institutions operate far away from the citizens affected by intergovernmental regulation (for example, in the EU, UN and the WTO), the less effective procedural citizen rights for democratic participation and representation risk becoming, and the more important are the legal and judicial protection of substantive

and promotion of human rights by international organisations, see: ‘Interdependence between democracy and human rights’, Report of the Office of the High Commissioner for Human Rights, E/CN.4/2004/54 of 17 Feb 2004.

<sup>72</sup> See the comparative study of the control of trade policies by 11 parliaments in European Parliament (Directorate-General for External Policies for the Union), *The Role of Parliaments in Scrutinising and Influencing Trade Policy* (Dec 2005) PE 370-166v01-00 (the study suggests that, with the exception of the Swiss Parliament and US Congress, most parliaments do not appear to control trade policy and WTO rule-making effectively).

rights (like the ‘market freedoms’ and other fundamental rights protected by the EC Court). It is therefore to be welcomed that, even though the EC and EU Treaties continue to be drafted primarily in terms of rights and obligations of governments, the Union is explicitly ‘founded on the values of respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights’, without reference to sovereignty;<sup>73</sup> and the EU Charter of Fundamental Rights protects general and specific dignity rights (Title I), liberty rights (Title II), equality rights (Title III), solidarity rights (Title IV), citizen rights (Title V) and ‘rights to justice’ (Title VI) that go beyond those in national constitutions and in UN law.<sup>74</sup>

As it was to be expected from the perspective of rights-based constitutional theory, European integration law and multilevel governance in the EU have proven to be most successful in those areas (like European competition law and common market law) where individual citizens and national courts were empowered to act as self-interested guardians of the rule of law and could directly enforce the legal obligations of EU institutions and national governments through domestic courts. *Vice versa*, those areas of Community law where EU citizens and national courts were prevented from directly enforcing the international obligations of the EU and of EU governments (like multilevel trade governance in the WTO) have remained characterised by frequent violations of the rule of law to the detriment of consumer welfare and the individual rights of EU citizens. Due to the pressures by the political EU organs and the judicial self-restraint by the ECJ, there has been only one single judgment by the ECJ establishing a violation by the EU of its international legal obligations since 1958,<sup>75</sup> compared with more than 35 GATT and WTO dispute settlement findings of violations of GATT and WTO obligations by the EU and EU member states. The legal advocates of the EU Commission justify the frequent violations of the EU’s WTO guarantees of freedom—even if EC violations of WTO rules had been formally established in legally binding WTO dispute settlement rulings and the ‘reasonable period of time’ for implementing such rulings had long expired—by power-oriented, Machiavellian arguments that judicial protection by the ECJ of the EU citizens’ reliance on respect for the rule of international law would be ‘naïve’.<sup>76</sup>

<sup>73</sup> Article I-2 Treaty TCE, n 27 above, which corresponds to the *Treaty on European Union (Maastricht Treaty)* Art 2.

<sup>74</sup> The text of this Charter, first proclaimed by the European Parliament, the EU Commission and the EU Council in Dec 2000 (Official Journal of the EC, C 364/1-22 of 18 Dec 2000), has become Part II of the TCE, n 28 above.

<sup>75</sup> Case T-115/94, *Opel Austria GmbH v EU Council*, (*Austria and EC Commission intervening*) [1997] 1 CMLR 733.

<sup>76</sup> See Kuijper, n 29 above. At the request of the political EU institutions, the EU Court has refrained from reviewing the legality of EU acts in the light of GATT law for more than 30 years, even if the EU violations had been formally established in legally binding GATT and WTO dispute settlement rulings. Notwithstanding the longstanding EU jurisprudence that GATT and WTO obligations form an ‘integral part of the Community legal system’ binding on all EC institutions and judicially enforceable *vis-à-vis* EU member states, the Court consistently denies ‘direct effects’ of

In the field of the EU's common foreign and security policy, legal and judicial remedies are even more limited in the EU (*cf* Article 46 EU Treaty) as well as in worldwide governance institutions. The more trade and foreign policies operate by 'internal' restrictions of EU citizens (such as their freedom to buy foreign bananas, beef, genetically modified food), and the more European courts exercise judicial deference and—as in the recent *Kadi* and *Yusuf* cases—abdicate their judicial task of reviewing EU restrictions of individual freedom for their compliance with all EC obligations,<sup>77</sup> the less rule of law can be maintained inside the EU. Without rule of law, also democracy becomes illusionary in the EU's multilevel governance.<sup>78</sup> The legally incoherent UN and WTO jurisprudence of the ECJ amounts to a 'political question doctrine' which arbitrarily disregards the EU's WTO obligations and WTO dispute settlement rulings but gives legal primacy to UN resolutions as 'supreme law, a supreme law offering virtually no guarantees of judicial review, at any level',<sup>79</sup> without subjecting the domestic implementation of such UN resolutions and WTO obligations to effective judicial review inside the EU.

## 5. Conclusion: Need for More Comprehensive 'Balancing' and Judicial Protection of Public and Private Rights and Obligations

As more and more countries adopt democratic constitutions and (inter)national legal and judicial guarantees limiting the powers of the rulers, the need for

GATT and WTO rules as well as judicial protection of EU citizens and EU member states against violations of WTO rules by EU institutions. The ECJ's arguments against 'direct applicability' rely on obvious misinterpretations of WTO rules (*cf Fiamm and Another v Council of the European Communities and Another (Spain, intervening)* [2006] 2 CMLR. 9: 'applicants are wrong in inferring from Articles 21 and 22 of the DSU an obligation on the WTO Member to comply, within a specified period, with the recommendations and rulings of the WTO bodies' as well as on political arguments (like lack of international reciprocity, need to protect the 'scope of manoeuvre' of the political EC bodies) that had been rejected as legally irrelevant by the EC Court in its *Kupferberg* judgment (Case 104/81 *Hauptzollamt Mainz v CA Kupferberg & Cie KG a.A.* [1982] ECR 3641). The EU legal services support this judicial self-restraint *vis-à-vis* WTO law and welcome that also 'the *Nakajima* doctrine has never really been applied . . . because this doctrine . . . (is) untenable on grounds of legal logic' (Kuijper, n 29 above, at 1340). In the *Kadi* and *Yusuf* judgments, the Court of First Instance claimed that UN Charter obligations prevail not only over other international legal obligations (*cf* Article 103 UN Charter) but also over EU human rights law; this submission to UN law has been rightly criticised as amounting to 'judicial abdication', *cf P* Eeckhout, 'Does Europe's Constitution Stop at the Water's Edge?' in W Devroe, D Droshout and M Faure (eds), *Law and Policy in the EU's External Relations* (Leuven, Europa Law Publishing, 2005): 'The judicial abdication by the CFI means that, insofar as the resolutions are implemented by EC regulations, there can be no review by either the EU Courts or national courts' . . . 'Community law . . . becomes an instrument for turning UN resolutions into supreme law, a supreme law offering virtually no guarantees of judicial review, at any level'.

<sup>77</sup> *Cf* Kuijper, n 29 above, who claims that the ECJ should focus on the political 'law in action' rather than the WTO 'law in the books' (eg at 1332–4). In the *Kadi* and *Yusuf* judgments, the Court of First Instance held that it had no jurisdiction to review the legal consistency of UN Security Council decisions freezing the bank accounts of alleged terrorists with EU fundamental rights guarantees, (*cf* n 8 above, para 272).

<sup>78</sup> *Cf P* Eeckhout, n 76 above, at 20: 'In CFSP matters there is both a democratic and judicial deficit'.

<sup>79</sup> Eeckhout, n 76 above, at 26.

legislative, administrative and judicial ‘balancing’ of rights and obligations, as well as of public and private interests, on the basis of ‘fair procedures’ and ‘constitutional principles’ (such as non-discrimination, necessity, proportionality) is increasingly recognised. This is particularly so in constitutional systems (like German and EU law) with broad liberty rights and constitutional requirements that restrictions of liberty must be constitutionally justifiable. National constitutional courts as well as international human rights courts acknowledge that human rights and other ‘fundamental rights’ constitute *rules* as well as *principles* for reconciling (‘optimising’) competing principles and rules relative to what is legally and factually possible in particular circumstances. Similarly, international economic courts (like the ECJ and the WTO Appellate Body) emphasise the need for ‘holistic’ treaty interpretation balancing intergovernmental rights and obligations with broader constitutional principles; the requirement, in Article 31 of the VCLT, that ‘a Treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose’, constitutes ‘one holistic rule’,<sup>80</sup> whose different elements (text, context, object and purpose) may be difficult to separate. The comprehensive UN reports analysing interrelationships and potential conflicts between human rights and international trade law suggest that human rights law and international and European trade law appear to be flexible enough in order to be interpreted and applied in mutually coherent ways.<sup>81</sup>

## VI. STRUGGLES FOR HUMAN RIGHTS: AMERICAN CONSTITUTIONAL NATIONALISM VERSUS EUROPEAN MULTILEVEL CONSTITUTIONALISM

The moral and democratic importance of complementing constitutional nationalism by multilevel constitutionalism for limiting abuses of foreign policy powers and protecting human rights more effectively in international law can be appreciated best by recalling the Kantian origins of multilevel constitutionalism. According to Kantian legal philosophy, the moral ‘categorical imperative’ of protecting human dignity and maximum equal freedoms of individuals through a ‘universal law of freedom’ requires *national*, *international* as well as *cosmopolitan* constitutional rights protecting individual freedom against abuses of power in all human relations (ie inside states, in intergovernmental relations, as well as in cosmopolitan relations among individuals and foreign govern-

<sup>80</sup> This term was used already in the Panel report on *United States: Sections 301–310 of the Trade Act 1974*, n 38 above, para 7.22. The Appellate Body has recently confirmed in *EC Chicken Cuts: Interpretation pursuant to the customary rules codified in Article 31 of the Vienna Convention is ultimately a holistic exercise that should not be mechanically subdivided into rigid components* (WTO, *EC Chicken Cuts—Appellate Body Report* (12 Sept 2005) WTO docs WT/DS269/AB/R and WT/DS286/AB/R [176]).

<sup>81</sup> See n 8–11 and 13 and related text.

ments).<sup>82</sup> The inevitable struggles for progressively extending such constitutional liberty rights also depend on democratic discourse in a communicating public that must transcend intergovernmental diplomacy and may eventually turn into a ‘cosmopolitan constituency’ for the collective supply of global public goods (including multilevel constitutional guarantees of human rights).<sup>83</sup> From a Kantian and European perspective, international law must be evaluated from the standpoint of human rights and must be transformed into an instrument for the constitutional protection of broadly defined human rights. The perspective of non-European countries, however, is often very different.

### 1. American Constitutional Nationalism Distrusts International Law

The post-war US leadership for a liberal international economic order was based on hegemonic US leadership and national constitutionalism (exemplified by the strong distrust of the US Congress and US courts vis-à-vis international law, congressional insistence on powers to adopt measures in violation of international law). Many Anglo-Saxon lawyers and ‘realist’ politicians argue ‘against constitutionalisation’ of international relations and claim, for example, ‘that the WTO is not constitutionalized, and nor, according to any current meanings of the term, should it be’.<sup>84</sup> The European openness to international law is criticised as a democratic deficiency by some US lawyers who praise the US’ unilateralism and resistance against international influences as living up to the ideal of democratic self-determination; the post-war US support for internationalism and multilateralism was ‘for the rest of the world, not for us’, even though America’s commitment to internationalism in economic affairs is recognised as serving US interests.<sup>85</sup> The widespread criticism by American, Australian and Canadian lawyers (like P Alston, DZ Cass and R Howse) of multilevel constitutionalism often reflects process-based (rather than rights-based) conceptions of parliamentary democracy and communitarian (rather than cosmopolitan) traditions. Many

<sup>82</sup> For a discussion of Kant’s constitutional and cosmopolitan legal theories, and for a criticism of the lack of constitutional theory in public international law doctrine, see Petersmann, n 54 above).

<sup>83</sup> Such struggles inevitably entail social antagonism (which Kant described as the ‘unsocial sociability’ of rational individuals) and ‘an uncomfortable condition of permanent revolution’ (*cf* AW Wood, n 54 above, at 333) for the progressive extension of rights-based constitutionalism.

<sup>84</sup> Cass, n 31 above, at x; see notably Part III of her book (‘Against Constitutionalization’) which agrees with the ‘anti-constitutionalisation critique’, for instance that the ‘WTO undermines decisions of democratically authorized national constituencies’ (at 212). Notwithstanding seven chapters favoring *national* over *multilevel* constitutionalism, her Chapter 8 concludes that ‘trading democracy, not merely trading constitutionalization, should be the key to WTO constitutionalization in this century’ (at 242). For Europeans familiar with the reality of European constitutional law and other ‘international treaty constitutions’, it appears anachronistic to deny the emerging international constitutional law. The most important insight of Cass’ book remains, as admitted at the end, that her ‘received account’ of Anglo-Saxon constitutionalism has, indeed, ‘been revealed as neither descriptively adequate nor normatively appealing’ (at 240).

<sup>85</sup> *Cf* Rubinfeld, n 6 above, at 283, 293.



developing countries, even if they criticise the North-American focus on civil and political rather than ESC human rights and argue in favour of development-oriented reforms of international law, likewise emphasise the classical international law principle of state sovereignty rather than the need for multilevel constitutional restraints of national policy powers.

## 2. Multilevel European Constitutionalism is Committed to ‘Strict Observance of International Law’ (Article I-3 TCE)

Europeans are more inclined to infer from the European integration experience that multilevel governance requires rights-based, multilevel constitutionalism for adjusting and preserving individual and democratic self-government in an interdependent world. Just as the EU remains democratically legitimate only as a legal community with limited powers committed to ‘strict observance of international law’ (Art I-3 TCE), so must international law overcome its obvious ‘constitutional deficits’ by constitutional reforms. Whereas Americans tend to view international courts as a potential threat to national democracy, such ‘counter-majoritarian difficulties’ are less perceived in the European context where ‘judicial governance’ by the ECJ and the European Court of Human Rights inevitably affects European democracies and their changing, democratic majorities. This contribution has defended the European views that:

- 1) Globalisation demonstrates that ever more constitutional objectives can no longer be achieved without multilevel governance and multilevel constitutionalism promoting the collective supply of international public goods.
- 2) In order to remain legitimate and effective, multilevel governance—such as intergovernmental rule-making, administration and judicial governance in worldwide institutions (such as the WTO and UN agencies) and in regional regimes—must respect and protect human rights and remain democratically accountable; this cannot be achieved without stronger multilevel constitutional restraints. European integration illustrates that international law and international organisations for the collective supply of international public goods can also *enlarge* citizen rights, *enhance* the legitimacy of multi-level governance, *limit* abuses of multi-level governance, and *facilitate* parliamentary accountability of foreign policies beyond what is possible through national constitutionalism.
- 3) Human rights and democratic self-government require redesigning ‘constitutional sovereignty’ in a manner reconciling state sovereignty, popular sovereignty and individual sovereignty based on respect for human dignity and human rights. The existing forms of worldwide governance and constitutional nationalism remain highly ineffective in terms of protection and promotion of universal human rights, international rule of law, democratic peace and a healthy environment.

### 3. Multilevel Constitutionalism as a 'Transformation Policy' and 'Struggle for Human Rights'

The more than 2,400 years of historical experiences with republicanism confirm that rights-based constitutionalism offers the most effective safeguards for protecting the public interests of citizens. The differences between American and European approaches to multilevel governance lie *not* in the European recourse to 'normative', 'soft' and 'civilian power' (which are also used in US foreign policies), but in the European preference for *multilevel constitutional restraints* on multilevel economic governance rather than for state-centred approaches to international law and constitutional nationalism. The American and European approaches compete in worldwide treaty negotiations (eg US rejection of the Rome Statute of the International Criminal Court, the UNESCO Convention on the Protection and Promotion of the Diversity of Cultural Expressions, the UN Convention on Biological Diversity) as well as in the competing recourse to regionalism, bilateralism and unilateralism as policy alternatives whenever international public goods cannot be supplied effectively at worldwide levels (such as, for example, in the Doha Round negotiations in the WTO).

At the regional level, the EU has succeeded in using its normative and economic 'power of attraction' for extending its multilevel constitutionalism to 27 EU member states; the rights-based free trade rules and basic human rights commitments of EU law have been further extended to more than 20 additional countries in Europe and the Mediterranean. This peaceful transformation of ever more countries in Europe—based on EU accession, association and cooperation agreements—was made possible by the constitutional and economic benefits of EU law rather than by unilateral 'power' of the EU to make other countries do what they would not otherwise do.<sup>86</sup> With regard to countries outside Europe, the EU's cooperation agreements (eg with Russia and the African, Caribbean and Pacific countries) and 'human rights conditionality'<sup>87</sup> have been much less successful in promoting multilevel constitutionalism. The more than 200 regional trade agreements concluded in the Americas, Africa and Asia were often more influenced by the national interests of 'regional hegemonies' (such as the US in North America, Argentina and Brazil in MERCOSUR, South Africa in the Southern African integration agreements, China in Asia) and tend to avoid multilevel constitutionalism (such as supranational regulatory agencies and courts).<sup>88</sup> 'Continental hegemonies' (like Brazil, China, India, Russia, South

<sup>86</sup> Cf H Sjursen, 'What Kind of Power?' (2006) 13 *Journal of European Public Policy* 169–81.

<sup>87</sup> Since the 1990s, it became official EU policy to include 'human rights clauses' in all new trade and cooperation agreements with third countries, cf L Bartels, *Human Rights Conditionality in the European Union's International Agreements* (Oxford, OUP, 2005).

<sup>88</sup> Yet, also in Africa and in the Americas, an increasing number of RTAs explicitly refer to human rights as an objective or fundamental principle of economic integration, or implicitly limit membership to countries committed to protection of human rights; cf FJ Garcia, *Integrating Trade and Human Rights in the Americas*, in FM Abbott, C Breining-Kaufmann and T Cottier (eds), n 10 above, chs 16 and 16.

Africa) are likely to follow more the state-centred foreign policy approaches of the US than Europe's multilevel constitutionalism. The future legal and constitutional structures of international economic law remain uncertain. The history of constitutionalism suggests that the needed 'constitutionalisation' of international economic law depends on 'struggles for human rights' by citizens, civil society, parliaments and courts against the never-ending abuses of private and public power by self-interested rulers.

## *Sovereignty, Lost and Found*

ROBERT HOWSE\*

### I. INTRODUCTION

IN THIS BRIEF essay, I want to challenge two very common, and inter-related, stories about ‘globalisation’ and sovereignty. The first is that globalisation entails the ceding of sovereignty understood as the actual capacity of public authorities to control or determine behavior and outcomes on their territory to global markets or market actors. This story is as common to those who embrace globalisation as to those who fear it. The second story associates globalization—including both the globalisation of markets and the globalisation of values and opinion (human rights)—with the transfer or allocation of sovereignty or sovereign powers to international institutions or governance mechanisms. The second story has, evidently, both normative and positive dimensions. Not only is it often presented as a description of an unfolding reality, but as a prescription—an answer to globalisation’s challenges and opportunities in the broadest sense.<sup>1</sup> For example, if mobile capital in the global marketplace makes it difficult for governments to maintain environmental standards, one should create a world environmental organisation. Global governance may be seen as an effort of governments to take back control they have apparently lost at the national level to global markets. (Thus the interrelatedness of the two stories). Or, in a different way, the notion of crimes against the world community—against humanity—may be thought to imply logically that accountability for those crimes be addressed before a tribunal of the world community (the International Criminal Court (ICC)).

\* Thanks to Ruti Teitel for enormously helpful comments on an earlier version; I had the opportunity to present some of these thoughts at a panel at Oxford Brookes University, Oxford, UK, May 30, 2006. The reactions of my fellow panelists and others present were also very helpful in developing this draft. In particular, I am grateful to John Jackson and Dan Sarooshi. I also had the opportunity to present an earlier version of the paper at the Conference in Honor of Ruth Lapidoth, Hebrew University of Jerusalem, Jun 2006, and benefited from the comments of various participants, especially Michael Reisman and Kalypso Nicolaidis.

<sup>1</sup> See for example, JH Jackson, *Sovereignty, the WTO and Changing Fundamentals of International Law* (Cambridge, CUP, 2006).

The second story engages many of the multiple facets of sovereignty as a concept—its meaning as actual control or power to affect outcomes, its attributes as a positive legal principle or doctrine of the international legal order, and its many normative resonances, deeply connected to conceptions of legitimacy.<sup>2</sup>

In challenging these stories, I can hardly claim originality. They have already been put in question by studies such as those by Saskia Sassen and Anne-Marie Slaughter, which address the real world complexities of the relationship between globalisation and national sovereignty; there are international law scholars who have introduced subtlety and caution to the debate over the ‘loss’ of national sovereignty, for example Ruti Teitel. Nevertheless, the stories in question continue to influence—consciously or unconsciously—discussions about sovereignty and globalisation among international lawyers as a professional community. We would like to think that globalisation is about *us*—that as the functionaries or guardians of global *law* we possess the tools to realise globalisation’s opportunities and constrain its dark sides. To paraphrase Carly Simon, we’re so vain we think this song is about us. But it is about us only to a modest extent. Moreover, there is an increasing tendency among international lawyers, a tendency that however has existed throughout the post World War II period, to see international law or order not as a mechanism to achieve the objectives of governments and citizens within states where interstate cooperation is needed to attain those objectives, but as a constitutional or constitutionalist project on behalf of humanity or a world community. In this vision, the nation-state and national sovereignty are viewed as the sites of resistance and reaction.

This tendency has been influenced by a development that is very positive: an increasing recognition of human rights as a normative constraint on national sovereignty,<sup>3</sup> as a universal morality, the normative force of which does not depend entirely or perhaps even largely on state consent. But the leap from such a recognition to the idea of global constitutionalism, which seems intuitively obvious or almost instinctive for many international lawyers, is a huge—and I shall attempt to show—unwarranted one.

## II. STORY NUMBER 1

In its most crude and unalloyed form the story of a loss of sovereignty—as control—to global ‘markets’ is well expressed by Thomas Friedman, who sees

<sup>2</sup> On these multiple facets, see for example, R Teitel, ‘National Sovereignty: A Cornerstone of International Law—and an Obstacle to Protecting Citizens’, (2002) Sept/Oct *Legal Affairs* at 27–9; D Sarooshi, *International Organizations and Their Exercise of Sovereign Powers* (Oxford, Oxford University Press, 2005) ch 1; N McCormick, *Questioning Sovereignty: Law, State, and Nation in the European Commonwealth* (Oxford: Oxford University Press, 1999); B Kingsbury, ‘Sovereignty and Inequality’ (1998) 9 *EJIL* 599.

<sup>3</sup> Teitel, *ibid.*

globalisation as an inevitable force, a system the laws of which are as immutable or as little subject to alteration by conscious human will, as the laws of geophysics:

I feel about globalization a lot like I feel about the dawn. Generally speaking, I think it is a good thing that the sun comes up every morning. It does more good than harm. But even if I didn't start globalization, I can't stop it—except at a huge cost to human development—and I'm not going to waste time trying.<sup>4</sup>

One does not, like Friedman, have to believe in the basic goodness of globalisation to view it as an inevitable force; much the same logic underlies Susan Strange's claims concerning the 'erosion' or 'retreat' of the state, which under conditions of globalisation, cedes power to multinational firms.<sup>5</sup>

For the story of a loss of control to global markets to be true, it must be the case that global market operators are able effectively to punish or frustrate efforts of governments to direct the economy and society that are at odds with the free operation of global markets. The common story is that capital is mobile under globalisation and market operators will vote with their feet; if a government's policies are not favorable to the operation of global markets, investment will go elsewhere, speculators will sell its currency and its economy will suffer. There is always some jurisdiction to which capital can go that has lower environmental or labor standards, or policies less constraining of private enterprise in other ways. Thus, from one point of view there is a race to the bottom. Whether such races to the bottom actually happen has been contested.<sup>6</sup> What is clear is that many governments have blamed 'globalisation' for policy choices that have involved preferring regulation that is somehow non-intrusive with respect to market outcomes, or deregulation or underregulation. In some cases, governments or decision makers within governments, more precisely, may actually believe that as Valmont says in *Dangerous Liaisons*, 'it's beyond my control'. In other instances, they may be using globalisation as a pretext for making choices informed by other objectives, including the conferral of rents on powerful domestic constituencies.

An increasing body of evidence and scholarly research is, however, bringing to prominence a most extraordinary phenomenon: some of the most dramatic economic success stories have occurred in states with governments that have pursued dirigiste economic policies, opposing and distorting global market forces where their objectives suggested such a course of action, 'opening up' to global markets only to the extent, again, that such opening up served their

<sup>4</sup> TL Friedman, *The Lexus and the Olive Tree* (New York, FSG, 1999) at xviii.

<sup>5</sup> S Strange, 'The Erosion of the State' (1997) *Current History* (Nov) at 365–9; S Strange, *The Retreat of the State: The Diffusion of Power in The World Economy* (Cambridge and New York, CUP, 1996).

<sup>6</sup> D Vogel, *Trading Up: Consumer and Environmental Regulation in a Global Economy* (Cambridge MA, Harvard University Press, 1997). And see in the context of UN federalism, Richard Revesz, 'Rehabilitating Interstate Competition: Rethinking the Race to the Bottom' (1992) 67 *NYUL Rev* 1210.

objectives. Here, one thinks of Brazil, India and China. High levels of dependence on trade and foreign investment and developing country status have not deterred countries such as these from attempting to control markets to achieve their economic and social objectives, with some considerable success.<sup>7</sup> At the same time, pro-globalisation ‘liberalising’ reforms in a number of Latin American countries produced economic failure and social disaster.

Brazil is a particularly interesting case. While highly dependent on foreign investment, and especially American investment, Brazil has refused to enter into Bilateral Investment Treaties with its main economic partners—treaties that typically give investors protection against, *inter alia*, ‘regulatory takings’. Contrary to the economic liberal dogma that it is impossible or at least prohibitively costly to try and create national ‘winner’ industries in an era of global markets, Brazil has become a world leader in ethanol as an alternative fuel in that very era, through the pursuit of a set of conscious, market-transforming government policies. The failure of liberal economic dogma to explain these kinds of outcomes has led economists to be increasingly interested in domestic institutions as a factor in economic policy, suggesting that ‘good governance’ not merely pro-market policies are needed for success. But this compounds the mystery for China is a non-transparent totalitarian state and Brazil’s public institutions are often said to be rife with corruption and often susceptible to paralysis, while India’s dense federalism and rigid public administration are hardly consonant either with trendy notions of ‘good governance’.

What *has* arguably happened with globalisation is that sovereignty has shifted within the state, as Saskia Sassen has most effectively argued.<sup>8</sup> Increased dependence or interdependence with respect to global markets increases the power and authority of those actors within the state who are able to bargain with global market actors, or set the terms for participation in the global economy. On balance, the globalisation of markets has reinforced a trend—which has a number of causes—towards weaker legislatures and stronger executives in many liberal democracies, for instance.

<sup>7</sup> D Rodrik, ‘Rethinking Growth Policies in the Developing World’, Luca d’Agliano Lecture in Development Economics, Torino, Italy, 8 Oct 2004. On China, see M Gallagher, ‘Reform and Openness: Why China’s Economic Reforms have Delayed Democracy’, (2002) 54 *World Politics* 338.

<sup>8</sup> S Sassen, *Territory, Authority, Rights: From Medieval to Global Assemblages* (Princeton NJ, Princeton University Press, 2006).

### III. STORY NUMBER 2

#### 1. Legal Form and the Transfer or Allocation of Sovereignty to International Institutions

Whether as a matter of legal form sovereignty is being transferred or allocated increasingly to international institutions, is often not clearly separated from the question of what actual power or control these institutions wield in relation to states, individuals and other actors. Part of the project of demystifying the notion of ‘sovereignty lost’ is to address these questions separately.

The characterisation of international institutions as constituted by transfers or allocations of sovereignty from nation-states as a matter of positive law or legal formality has been addressed in depth by Sarooshi.<sup>9</sup> Sarooshi uses three factors to ‘measure’ the extent to which sovereign powers have been allocated or conferred in some way on international institutions: whether the powers are revocable; whether the institution can exercise powers either over states or other actors without further acts of state consent being required, and whether the powers are exercised exclusively or concurrently with states. Accepting these criteria for the sake of argument, it is quite clear that, as a matter of legal formality, there are very few international organisations that have had significant grants of sovereign powers. The United Nations Security Council is a rare instance of an international body that can take binding and effective decisions without the further consent of all the Members of the organisation. The voting rules in the IMF make it another such rare example. In the case of the WTO, contrary to what is widely believed and regardless of what kind of power or influence it actually wields (the question of real-world control), as a matter of legal form, only the dispute settlement organs have been granted effective authority, through compulsory jurisdiction and effective automaticity in the legally binding character of final dispute settlement rulings, with countermeasures authorised in response to continuing non-compliance. No *regulatory* powers have been delegated or conferred on the WTO. Even Jeremy Rabkin, a strident opponent of the transfer of sovereignty to international organisations, concedes:

the WTO remains international in the true and traditional sense: it is an arrangement for coordinating policies between governments about goods and services that cross national borders. The commitments made in GATT rounds are implemented by domestic legislation. Domestic courts enforce only such domestic implementing legislation. The international dispute-settlement machinery is available only for government-to-government disputes. If American firms are dissatisfied with American trade policy, they must take their complaints to the American government. They have no direct recourse to the WTO, nor do foreign firms, which can reach the WTO only by persuading their own governments to raise objections against an American policy.

<sup>9</sup> Jackson, n 1 above.



In no case can the WTO reach directly into US domestic law or impose a change in American law that American political authorities do not approve.<sup>10</sup>

If the formal legal powers of the post-war international institutions and their successors (in the case of the WTO) rarely correspond to the internationalist vision or fantasy of regulating the world,<sup>11</sup> and remain with very few exceptions within the paradigm of state sovereignty, dependent upon consent through treaty making or consensus decision procedures for all important exercises of power, this is the case with the newer institutions as well. The ICC, which is often cited as an example of loss of sovereignty by critics of international institutions, does, admittedly, point on its face to a newer ‘constitutionalist’ paradigm of direct exercise of power over individuals; but, as Teitel as emphasised, ‘. . . the ICC is predicated upon an alternative jurisdictional principle to primacy, stated under the reconciling principle of “complementarity” [footnote omitted]. . . the ICC’s jurisdiction is triggered if, and only if, the national legal system is “either unwilling or unable” to exercise jurisdiction’.<sup>12</sup>

Another relatively new international institution—or rather an old institution that has developed a major new role under conditions of globalisation—is the Bank of International Settlements (BIS). The BIS responds to one of the classic risks of globalised financial markets the failure of a bank or broader instability of the banking system in one country can have spillover effects on the banks or banking systems of other countries. Therefore the soundness of banks’ deposit and lending practices is a matter of international concern. But the way the BIS operates is far away from the conceptual model of ‘global regulator’ or a constitutionalist model of global governance—even farther away than some of the Bretton Woods institutions. In the BIS, *national* regulators negotiate guidelines for sound banking practices, including reserve ratios. These guidelines are not binding rules of international law. Translating the guidelines into mandatory norms is a matter mostly for national regulators in the domestic setting.<sup>13</sup>

## 2. Sovereignty as Control on the Ground: *Qui regit, rex est*

As suggested in the introduction, it is characteristic of international lawyers and internationalists generally to view the loss or weakening of ‘traditional’ nation-state sovereignty as a major effect of economic globalisation and the culture of human rights, and to view the implications of this in terms of a greatly expanded or heightened role for international law and institutions—even in some cases, to

<sup>10</sup> J Rabkin, *Why Sovereignty Matters* (Washington DC, American Enterprise Institute, 1998).

<sup>11</sup> AM Slaughter, ‘Regulating the World’, in JG Ruggie (ed), *Multilateralism Matters: The Theory and Praxis of an Institutional* (New York, Columbia University Press, 1993).

<sup>12</sup> R Teitel, ‘The Law and Politics of Contemporary Transitional Justice’ (2005) 38 *Cornell Int L J* 837 at 852.

<sup>13</sup> M Barr and J Miller, ‘Global Administrative Law: The View from Basel’ (2006) 17 *EJIL* 15.

imagine the law and institutions in question as an emergent global constitutional order. But are the effects real or any more real than possible counter-effects? And even if 'traditional' nation-state sovereignty has indeed been weakened, lost, or perhaps more accurately still, displaced, has it really been transferred or reallocated to global laws and institutions?

Globalisation, broadly understood, including both the domestic regulatory changes, business behavior changes and technological changes that have merged domestic markets into international ones, has resulted in a weakening of many international institutions, at least for some period of time. Specialised UN agencies such as World Intellectual Property Organisation and the International Telecommunication Union, with their traditional bureaucratic instincts and incapacity to respond rapidly to technological and business developments, had to wield effective power and influence to lobby groups, particular governments (above all the United States), and epistemic communities seeking to expand the possibilities of global markets, including networks of domestic regulators.

Perhaps one of the most stunning losses of effective power of an international organisation to nation-state sovereignty is the case of the IMF. This will seem counterintuitive to many observers, since the IMF is often denounced as an international institution that has been very intrusive into domestic sovereignty through its lending 'conditionality'. But in fact 'conditionality' represented an extraordinary gambit by the IMF's bureaucracy to regain lost power and influence.

The IMF Articles supposed that the Fund would play the role of oversight of exchange rates and macroeconomic policy adjustment, therefore; a crucial limitation on state sovereignty, since exchange rates and interrelated fiscal and monetary policy choices are crucial to domestic economic outcomes generally, including distributive or redistributive outcomes. With the Nixon-Administration-inspired collapse of the gold standard at the beginning of the 1970s, the shift to floating, 'market'-determined exchange rates essentially stripped the IMF of its policing or regulatory role with respect to the developed world at least. There was an enormous sovereignty gain for the US treasury when the dollar replaced gold as the 'reserve' value of the system.

The demise of the IMF as a global financial regulator is nowhere better illustrated than in its marginality to management or resolution of two of the most important challenges in international monetary relations in recent times—the Mexican Peso crisis and the resulting bailout and the dispute between the United States Congress and China concerning the RMB exchange rate. In both instances, resolution or management was largely undertaken through bargaining among national 'sovereigns' and market actors. International institutions and, even less so, international legal rules were barely in the shadow.

It is clear from Robert Rubin's insider account of the Mexican bailout that, despite Rubin's words of praise for the 'leadership' of the IMF Director at the time Michel Camdessus, that the decision to bail out the Mexican currency was taken in Washington DC, that the amount of money required was such that only

strong US support could allow it to happen, and that the key terms of the program were determined by the US and Mexico. The IMF did come up with a very substantial amount of money but the whole project was largely outside its control and direction. Consider the following episode between Bob Rubin and Michel Camdessus:

[O]ur G-7 allies were still protesting Camdessus's decision to add another \$10 billion from the IMF. On the morning of February 21, the day for signing our agreement with Mexico, Camdessus told me that the IMF could provide only 7.8 billion, plus contributions from elsewhere. That was inconsistent with his original commitment; now he only wanted to go ahead with the extra \$10 billion only if it came as bilateral loans from other countries, . . . That was a problem for us, since Mexico needed to have the entire \$17.8 billion, and I had always told Congress that the total IMF contribution would be \$17.8 billion . . . I called back and said, 'Michel, this is not what we agreed to. And if you insist, I am going to go out and make a public statement. We are going to hold a press conference and announce that you have changed the deal. And I'm not going to go ahead with the Mexican program'.

Michel said, 'You can't do that'.

I replied that, in fact we could . The moment was dramatic, but in the end, Camdessus came around, . . .<sup>14</sup>

This little exchange, over the mere matter of \$2.2 billion, says much about who is sovereign—as Grotius apparently quipped, 'qui regit, rex est'.<sup>15</sup>

In the case of the dispute as to whether the pegging of the Renminbi to the dollar is a currency 'manipulation' giving Chinese exports an 'unfair' competitive advantage, both the IMF and the WTO legal framework contain rules and institutional mechanisms for addressing disputes concerning whether a currency is being manipulated to secure an 'unfair' advantage in trade.

The GATT rules concerning exchange measures and convertibility are contained in Article XV of the General Agreement.<sup>16</sup> Art XV:4 states that 'Contracting parties shall not, by exchange action, frustrate the intent of the provisions of this Agreement, nor by trade action, the intent of the provisions of the Articles of Agreement of the International Monetary Fund'. According to the Interpretative Note Ad Article XV:

The word 'frustrate' is intended to indicate, for example, that infringements of the letter of any Article of this Agreement by exchange action shall not be regarded as a violation of that Article if, in practice, there is no appreciable departure from the intent of the Article. Thus, a contracting party which, as part of its exchange control operated in accordance with the Articles of Agreement of the International Monetary

<sup>14</sup> R Rubin and J Weisberg, *In an Uncertain World: Tough Choices from Wall Street to Washington* (New York, Random House, 2003) at 30–31.

<sup>15</sup> Quote from J-J Rousseau, 'Polysynody' in C Kelly (ed) *Jean-Jacques Rosseau: The Plan for Perpetual Peace: On the Government of Poland, and Other Writings on History and Politics* (Lebanon, NH, Dartmouth Press, 2003) at 98.

<sup>16</sup> General Agreement on Tariffs and Trade 1994 (adopted 15 Apr 1994, entered into force 1 Jan 1995 1867 UNTS 187 (GATT 1994).

Fund, required payment to be received for its exports in its own currency or in the currency of one or more members of the International Monetary Fund will not thereby be deemed to contravene Article XI or Article XIII [of the GATT on quantitative restrictions]. Another example would be that of a contracting party which specifies on an import license the country from which the goods may be imported, for the purpose not of introducing any additional element of discrimination in its import licensing system but of enforcing permissible exchange controls.

The IMF Articles of Agreement provide that an IMF Member shall not ‘manipulate exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members’.<sup>17</sup> Currency manipulation as such is defined in the surveillance provisions of the IMF Articles as ‘protracted large-scale intervention in one direction in the exchange market’

Despite this legal framework in the WTO and the IMF, the dispute concerning the value of the Renminbi has largely<sup>18</sup> played itself out in other sites—the US Congress, Treasury, and the Chinese Government have been engaged in a complex triangulated negotiation, with Congress representing US domestic producer interests and their concern with ‘fair trade’, while Treasury and the Chinese government have a strong shared interest in China moving to an exchange rate that is responsive to market forces but in a manner that does not jeopardise financial stability and also in tandem with the strengthening and reform of China’s banking and financial system. While it is true that the IMF has suggested that it may have a larger role in the future in exchange rate surveillance (this is part of the medium term strategy announced by the Director), this development may be largely reactive to US concerns about China.

The Mexican bailout and the China exchange rate dispute are just two events in the recent history of globalisation, but they are events that have affected the fates of millions of people, with huge amounts of money at stake, and indeed the stability and prosperity of entire economies. That these events have been managed largely outside of the formal governance or decision-making mechanisms of intergovernmental multilateral institutions, suggests that the pressures of globalisation even at their most intense and critical, do not necessarily point towards a major role for international law or institutions.

What of the day-to-day management of interdependence? As Anne Marie Slaughter has shown in depth,<sup>19</sup> much of this happens through on-going cooperation, negotiation and adjustment between regulators, administrators, judges, and other officials of different sovereign states. Such cooperation is, in some cases, facilitated by classic treaty law or some kind of institutional framework,

<sup>17</sup> Articles of Agreement of the International Monetary Fund (adopted 27 Dec 1945, entered into force 27 Dec 1945) 2 UNTS 390 (IMF Agreement) Art IV, s 1(iii).

<sup>18</sup> I do not mean to suggest that the IMF has not made comments or pronouncements on the issue of China’s exchange rate; but that the IMF has not played a ‘sovereign’ or governing role in determining the course of reform.

<sup>19</sup> AM Slaughter, *A New World Order* (Princeton NJ, Princeton University Press, 2004).

but in many cases it does not even require even the classic forms of international law in order to work. The allocation of power or control or ‘sovereignty’ to international institutions is simply not a major part of the story.

What about the counterexample of IMF conditionality? We must first of all ask who was the exercising the underlying power to impose conditionality. Rarely was IMF lending itself sufficient to provide adequate leverage to impose conditionality. In the case of the reschedulings of the 1980s, the provision of IMF standby credits was understood to be a necessary condition for the Paris and London Club rescheduling developing country and Eastern European debt. It was governments—in collusion with commercial banks—who thus in effect provided the IMF with the leverage to impose conditionality. Had governments not been persuaded that conditional IMF standby credits were in their interests, they would have rescheduled Paris Club debt without requiring the grant of such credits. In other words, the IMF could not have imposed effectively conditionality on the basis of its delegated powers as an international institution.

In terms of the first story addressed in this essay, that of a ceding of sovereignty to the market, it should be observed as well that the London Club (commercial bank creditors) has typically taken its cues in rescheduling from official creditors in the Paris Club. In other words, governments have in many respects maintained control over the terms of repayment not only of official debt but commercial or private bank debt as well, ultimately. A dramatic example of how public power, not market power, determined the legal baseline against which debtor countries bargained for rescheduling is the *Allied Bank* litigation. The New York courts would have been prepared to apply the Act of State doctrine to bar enforcement of official debt obligations of Costa Rica to private banks in the face of a national financial crisis in the debtor nation, had the State Department not intervened to tell the court that the actual policy of the United States was that the debt should be legally enforceable even in these circumstances.<sup>20</sup>

As governments as well as private capital market actors have distanced themselves from IMF conditionality (in part because IMF programs have typically not worked and in some cases disastrously misfired),<sup>21</sup> developing country governments in some cases, most dramatically that of Malaysia, have thumbed their nose at the IMF, taking an alternative approach to the management of financial crises.<sup>22</sup> This is a dramatic example that the IMF itself as an institution has not really attained sovereignty or genuine control over such matters. Finally, there is a wide agreement now suggesting that in fact in those countries where there has not been local buy in or ownership of IMF-dictated reforms, the reforms actually have not really happened or been sustainable; on the other hand, IMF conditionality can be a pretext for governments to impose reforms they

<sup>20</sup> R Howse, ‘The Courts, the International Debt Crisis, and the Dilemma of Rescheduling: Rethinking the Allied Bank Decision’ (1988) 46 *U T Fac L Rev* 578.

<sup>21</sup> See J Stiglitz, *Making Globalization Work* (New York, WW Norton, 2006) at 34–9.

<sup>22</sup> E Kaplan and D Rodrik, ‘Did the Malaysian Capital Controls Work?’, NBER Working Paper 8142/2001 at 27 < <http://www.nber.org/papers/W8142> > (last visited Jun 7, 2007).

wanted for other reasons, and can even change the balance of domestic interests in economic policy change,<sup>23</sup> helping to in other words, once again the internal sovereignty of the state has been enhanced, not reduced, by the apparent exercise of power by the international institution.

Kal Raustiala has explored the ways in which what appears like a 'loss' of sovereignty to international economic institutions may in fact be a way of enhancing or strengthen national sovereignty understood as real control over outcomes.<sup>24</sup>

One of the most dramatic examples of such enhancement is reflected in the WTO TRIPs Agreement: effectively, the United States was able to have entrenched as an obligation of WTO Membership the adoption of the US system of intellectual property protection in most respects, thereby acquiring a powerful means of assuring that the interests of US intellectual property holders are protected worldwide. At the same time, the US did not give up its power to use political leverage and the threat of trade sanctions to induce countries to move to even higher standards of intellectual property protection than those entrenched in TRIPs.<sup>25</sup> The attempt by mostly developing countries to use the institutional framework of the WTO to take back some of their lost (to the US) sovereignty in respect of intellectual property resulted in two weak agreements, the Doha Declaration on TRIPs and Public Health and the pre-Cancun agreement on the implementation of the Doha Declaration. While symbolically important as an acknowledgement that WTO norms are revisable and not rigidly constitutional, these agreements have largely unaffected the real world ability of the US and its major industrial interests to determine outcomes with respect to intellectual property protection globally.<sup>26</sup>

The WTO has been used extensively by governments as a means of strengthening internal sovereignty—altering the domestic social contract, rebalancing the relative power of different internal constituencies (business, labor, the public sector), or legitimating specific strategies for domestic economic reform. Alejandro Ferrer, currently trade minister of Panama, explains that the Panamanian government of the day, in joining the WTO and binding itself to the WTO treaties, was seeking to undertake a profound restructuring of the way in which the Panamanian economy and society operated, thereby consolidating Panama's democratic revolution. The government saw WTO membership and the ensuing obligations to open up the economy to trade based on principles of non-discrimination and transparency as a means of breaking down a system

<sup>23</sup> A Drazen, 'Conditionality and Ownership in IMF Lending: A Political Economy Approach', (2002) 49 IMF Staff Papers 36.

<sup>24</sup> K Raustiala, 'Rethinking the Sovereignty Debate in International Economic Law', (2003) 6 *JIEL* 841.

<sup>25</sup> See P Drahos and J Braithwaite, *Information Feudalism: Who Owns the Knowledge Economy?* (New York, New Press, 2002).

<sup>26</sup> F Abbott, 'The Doha Declaration on the TRIPs Agreement on Public Health and the Contradictory Trend in Bilateral and Regional Agreements', Occasional Paper No 14 (Quaker United Nations Office, 2004).

based on cronyism, entrenched privilege, and large amounts of corruption.<sup>27</sup> An intense struggle and debate about internal change in Panama was conducted almost entirely in terms of the case for or against WTO accession.

China represents a dramatic case where WTO accession has been a vehicle by which the regime has consolidated its internal political and economic program, reasserting, through state responsibility for implementing WTO rules, control over many local practices and authorities.<sup>28</sup> In a path-breaking set of case studies about how participation in the WTO system has affected economic, political and social outcomes in a wide variety of countries, most of them developing, the editors concluded that the effects, positive or negative, depended on governance at the domestic or local level; what really mattered to outcomes were domestic institutions and political and economic structures. In only a few cases, was the outcome determined by the WTO (where there was dispute settlement) or through governments being constrained in their actions by WTO rules.<sup>29</sup>

The WTO, the World Bank and the IMF have been sites for the construction and dissemination of neo-liberal 'Washington consensus' ideology by elites claiming to possess technical expertise and an enlightened notion of global welfare.<sup>30</sup> This is indeed an important way in which these institutions have affected the exercise of sovereignty by nation-states. But it is difficult to conceive of the ability of international organisations to provide sites or for the construction of social meanings by epistemic communities as itself an example of delegated or allocated sovereignty. By and large, the epistemic communities claim to be communicating truth and expertise rather than asserting sovereignty. Of course, they are projecting power; but if one thinks of the effects of international institutions in terms of their use of delegated sovereignty, then these kinds of projected power tend not to be visible, or to be underestimated. The 'authority' on the basis of which this power is projected is not really delegated competences, or sovereignty but knowledge and dedication to some vision of the global good.

While states and their governments continue to control and to use international institutions as means of expressing and enhancing sovereign power, both internal and external sovereignty, an area where it might seem more obvious that the state is yielding sovereignty to non-governmental actors is that of investment agreements (either bilateral investment treaties or investment provisions within regional trade agreements such as NAFTA), which confer rights on investors to sue governments for damages where they violate investor enti-

<sup>27</sup> A Ferrer, *Accession of Panama to the WTO: Implications for Developing Countries Joining the World Trade System* (Panama, Circulo Editorial y de lectura, 2001) see especially 182–5.

<sup>28</sup> M Gallagher, Oral Presentation, 'China's Accession to the WTO: The Legal Perspective', Symposium organised by the Chinese Law Society, University of Michigan School of Law, Apr 11 2001.

<sup>29</sup> P Gallagher, P Low and AL Stoler, *Managing the Challenges of WTO Participation: 45 Case Studies* (Cambridge, CUP, 2005) at 21–2.

<sup>30</sup> On the WTO in this respect see R Howse, 'From Politics to Technocracy and Back Again: The Fate of the Multilateral Trade Regime' (2002) 96 *AJIL* 94.

lements under these treaties. Under such agreements governments cannot typically engage in nationalisation even for public interested reasons and in a non-discriminatory manner without providing foreign investors with full market value compensation, where nationalisation entails expropriation. Moreover, in many instances, investment treaties—as interpreted in investor/state arbitration—appear to allow compensation for regulatory actions that affect the economic value of the investor’s property in a manner that is similar to the effects of formal expropriation. Clearly, such treaties allow private enterprises to impose significant costs on governments for adopting certain kinds of public policies, and in that sense they may be seen as constraining sovereignty. Such costs have been imposed through arbitral awards even in the context of crucial public interests, such as the measures taken by Argentina<sup>31</sup> to deal with its monetary crisis, and measures taken in the context of failed privatisations of water services to ensure adequate provision of water to the public (the Suez/Vivendi arbitrations).<sup>32</sup>

But this returns us to the complex effects of precommitment or hands-tying through international obligations on sovereignty. Clearly, investment treaties have imposed costs on governments seeking to make regulatory changes *ex post* these commitments, reflecting *inter alia* changes in the democratic will. Thus, as with the WTO as well (mitigated by the fact that private actors have no standing to sue and there are no damages awards) the normative ideal of sovereignty as democratic self-determination is threatened by this kind of pre-commitment that raises the costs of changing course in public policy in response to the changing will of the people. At the same time, as already discussed to some extent above in relation to the WTO, the capacity to tie the hands of a subsequent regime or government increases the sovereignty (in terms of actual control on the ground) of the government making the precommitment by allowing it lock in preferred policies against ‘fickle’ public opinion. These may have included denationalisation, privatisation and deregulation of public services. While these policies on their surface appear as if they diminish the state—the terminology suggests a transfer of power from state to market—in fact they usually entail a rearrangement of public and private power that does not reduce the control of the state over people’s lives, but shifts the way in which private and public actors collide and collude to produce those effects, and the effects themselves.<sup>33</sup>

While the investment treaty example suggests the anti-democratic potential of hands tying through international legal commitment, there may<sup>34</sup> be some

<sup>31</sup> See, eg, *CMS Gas Transmission Co v Argentina* ICSID Case No ARB/01/08 (United States/Argentina BIT).

<sup>32</sup> *Suez, Sociedad General de Aguas de Barcelona S.A. and Vivendi Universal S.A. v Argentina* ICSID Case No ARB/03/19.

<sup>33</sup> See R Howse, JRS Prichard and MJ Trebilcock, ‘Smaller or Smarter Government?’ (1990) 40 *U Toronto L J* 498; R Howse, ‘Reform, Retrenchment or Revolution?: The Shift to Incentives and the Future of the Regulatory State’ (1993) 31 *Alberta L Rev* 455.

<sup>34</sup> Beth Simmons, ‘International Law Compliance and Human Rights’, 45th Annual ISA Convention, Mar 17–20, 2004.



contexts where such hands-tying may actually serve democratic ideals and values. Beth Simmons has attempted to show, for example, that commitment to human rights treaties in the context of transitions from authoritarian rule to democracy may serve to counter backsliding towards practices such as torture associated with authoritarianism and which clearly can undermine the new order by creating an atmosphere of fear and intimidation in public life.

### 3. The Normativity of Sovereignty and the Universality of Human Rights

There is no question that an increasing recognition of human rights as a universal morality has significance for some of the traditional normative meanings of sovereignty—particularly the notion that there is no higher normative authority than the state, as well the conception of sovereignty as including the right of a state to non-interference in its internal affairs by other states. On the other hand, it is a complicated question whether the overall import of these developments is the transfer or allocation of sovereignty through constitutionalised international law or to international institutions. While the normativity of human rights is universal and resides in an ideal conception of humanity itself that transcends the legitimating power of the state, as Teitel notes, when it comes to acting, there are only a few standards of international law that can be issued as directives to a state, and those are prohibitions against the most egregious crimes like slavery and genocide'.<sup>35</sup> Moreover, Oona Hathaway's study of the relationship between adherence to human rights treaties and actual human rights performance suggests that states' being formally bound to international human rights norms may have little actual impact;<sup>36</sup> on the other hand the notion that human rights have a universal *normative* force (as opposed to positive legal force) that constrains states regardless of whether they have consented to be so constrained is a profoundly affecting political, economic and social struggles in many countries and communities.

These effects are by no means necessarily resulting in diminished sovereignty. The idea of human rights is generally today thought to imply a commitment to democracy, and democracy tends to imply popular sovereignty within a closed political community, the nation-state. And the right to 'national' self-determination has been a powerful ideological basis for struggle for and acquisition of sovereignty by 'peoples' who did not previously have their own sovereign state. Even where human rights are the mandate of international institutions this mandate need not be interpreted as at odds with national

<sup>35</sup> Teitel, n 2 above.

<sup>36</sup> O Hathaway, 'Do Human Rights Treaties Make A Difference?' (2002) 111 *Yale L J* 1935. Hathaway's results are however not uncontroversial; see R Goodman and D Jinks, 'Measuring the Effects of Human Rights Treaties', (2003) 14 *EJIL* 171. My concern here is the conceptual point that the normative effect of international human rights law cannot simply be measured by formal treaty adherence by states.

sovereignty rather than enhancing of it. For example, the Office of the High Commissioner for Human Rights has published a number of studies or papers on globalisation where it has shown how some human rights, such as the right to health, imply the need to protect national sovereignty *against* rules on economic globalisation, such as those concerning intellectual property in the WTO (and as argued above these rules are not really a surrender of sovereignty to the WTO as an institution but a transfer of sovereignty from some countries to others).

## VI. CONCLUSION

In understanding the significance of globalisation and the human rights revolution for sovereignty we must always bear in mind the fundamentally dual or ambiguous nature of the concept—that it remains both a statement of a normative ideal (connected to self-determination, cultural and national autonomy, democracy, and related concepts) and a judgment about the actual capacity of states and/or their governments to affect or determine outcomes. As the discussion of human rights immediately above illustrates, challenges to sovereignty as a normative ideal need not result in the diminishment of sovereignty as capacity to determine outcomes; the weakening of sovereignty as a normative ideal is reflected, for instance, in the rise of humanitarian intervention, the notion that it is legitimate to intervene forcibly on the territory of a ‘sovereign’ state for humanitarian and/or human rights aims (eg Kosovo) but humanitarian intervention also gives (some) states new possibilities to project their sovereign power and interests globally.<sup>37</sup>

The way in which sovereignty continues to structure and restructure global order cannot be properly appreciated or explained through attempts to simplify the idea into a purely normative or purely positive concept. The formalism with which many international lawyers continue to treat sovereignty is perhaps a way of trying to avoid this difficulty but at the cost of not being true to the phenomena, and in many respects (as have attempted to illustrate in this paper) distorting them, especially with respect to international institutions. The way forward on this issue is instead closer intellectual engagement between sophisticated social scientists with an openness to the way in which norms shape and reshape reality (Sassen, Ruggie, Sabel, Simmons, Hafner-Burton are some examples) and sophisticated international legal thinkers whose philosophical and/or social scientific interdisciplinary orientation has liberated them in varying degrees—from the blinkers of formalism (Hathaway, Kennedy, Weiter, Kingbury, Slaughter, Teitel, von Bogdandy, to name a few).

<sup>37</sup> As is brilliantly remarked and explored by Teitel, ‘Humanity’s Law: Rule of Law for the New Global Politics’, (2002) 35 *Cornell Int L J* 355.



# *Sovereignty and International Economic Law*

VAUGHAN LOWE

## I. INTRODUCTION

ONE OF THE best-known passages in international jurisprudence is the paragraph in the award of Professor Max Huber in the *Island of Palmas* case which begins with the words:

Sovereignty in the relations between States signifies independence. Independence in regard to a portion of the globe is the right to exercise therein, to the exclusion of any other State, the functions of a State.<sup>1</sup>

The papers delivered at this conference have focused upon some of the areas of greatest practical importance in which the functions of States are exercised in the sphere of economic relations. In this paper I want to step back from the immediacy of those concerns and to reflect on a curiosity in Huber's choice of language—the distinction between his references to what sovereignty *signifies* and what independence *is*.

My central point is that the role of sovereignty within the international legal system is subtle and elusive: that the term is indeed, as Huber indicated, a signifier rather than a legal norm or principle or institution. From that, it follows that appeals to sovereignty in order to resolve legal disputes must be accompanied by careful examinations of what precisely it is that sovereignty signifies; and in my view what sovereignty signifies is not a defined, static body of rights and duties but a changing frame of reference in international relations, whose content is partly—perhaps largely—determined by factors and processes outside the law.

First, let me say something about the ways in which the term 'sovereignty' is used.

<sup>1</sup> *Netherlands v USA, Island of Palmas case (1928)*, 2 UNRIAA 829.

## II. USES OF 'SOVEREIGNTY'

Outside the particular contexts of the EU and WTO, the concept of sovereignty is, in fact, used remarkably rarely in the formal conduct of international law. The cases are, it is true, sprinkled with references to sovereignty as the 'basis' of international law. The International Court's Advisory Opinion in the *Nuclear Weapons* case referred to 'the very basis of international law, which rests upon the principles of sovereignty and consent';<sup>2</sup> and in its *Nicaragua (Merits)* judgment the Court referred to 'the fundamental principle of State sovereignty, on which the whole of international law rests'.<sup>3</sup> Such statements are, however, of limited significance. They illustrate the acknowledgment by the Court of the acceptance of sovereignty as an ordering concept, an explanation or identification of the principles upon which the international legal system rests, but not a necessary element in the chain of reasoning that connects the facts in a case with the rules of international law that are applied to those facts so as to lead to a determination of the legal rights and duties of the parties concerned. Rather like the concept of God, the concept of sovereignty may underpin the normative structure to which it relates; but rules of conduct can be identified and applied without any reference to the underpinning concept. Humanist morality, atheistic cosmology, and international law without sovereignty, are all possible positions.

Two examples may illustrate the point. First, the *Salem* case, in which the arbitral tribunal, dealing with claims that Egypt was responsible for the denials of justice allegedly committed by the Mixed Courts in Egypt, held that:

The responsibility of a State can only go as far as its sovereignty: in the same measure as the latter is restricted, that is to say as the State cannot act in a free and independent manner, the liability of the State must also be restricted.<sup>4</sup>

The reference in that passage to sovereignty is not necessary. The Court could quite easily have said that a State can only be responsible for the acts of a body that is exercising power on behalf of the State, or whose acts are imputable to the State. Indeed, such a formulation would have been more accurate than that actually employed.

A second example is the decision of the Permanent Court of International Justice in case of the *Customs Regime between Germany and Austria*.<sup>5</sup> In that case the Court had to decide whether the 1931 Austrian-Germany customs regime was compatible with the terms of a Protocol implementing the provisions of Article 88 of the Treaty of St Germain, 1919, which had stipulated that:

<sup>2</sup> *Legality of Threat or Use of Nuclear Weapons*, Advisory Opinion of 8 Jul 1996, *ICJ Reports* 1996, p 226 at para 21.

<sup>3</sup> *Military and Paramilitary Activities in and against Nicaragua (Nicaragua v United States of America)*, Judgment of 27 Jun 1986, *ICJ Reports* 1986, p 14 at para 263.

<sup>4</sup> *Salem Case 1932 (United States v Egypt)*, *RIAA*, vol II, p 1161, at para 151.

<sup>5</sup> *Customs Régime between Germany and Austria (Protocol of March 19th, 1931)*, Advisory Opinion No 20 of 5 Sept, *PCIJ Reports*, Ser. A/B. No 41 (1931), p 37.

The independence of Austria is inalienable otherwise than with the consent of the Council of the League of Nations.

If ever there were a case that invited a discussion of the sovereignty of a State, this was surely it: but the Court did not approach the matter in terms of sovereignty.<sup>6</sup> The Court referred only to the loss of 'independence' by Austria, and to acts that 'would modify its independence in that its sovereign will would be subordinated to the will of another Power or particular group of powers'.<sup>7</sup> The adjective 'sovereign' in that phrase seems to me to be entirely superfluous.

These examples are typical of the uses to which the concept of sovereignty is put in legal reasoning by international tribunals. It affirms, as an article of faith, one of the theoretical foundations of international law; and it serves as a rhetorical flourish in discussions of constraints upon the freedom of States to act. But it does little else.

### III. INTERNAL AND EXTERNAL SOVEREIGNTY

Why is the use in international law of the concept of sovereignty so limited? Two reasons might be put forward. The first is that the concept of sovereignty as it has developed in modern western legal and political thought, derived from writers such as Jean Bodin,<sup>8</sup> has its origins in concerns about the internal constitutional structure of States—in what is often called the 'inward' aspect of sovereignty. As Hinsley put it:

at the beginning, at any rate, the idea of sovereignty was the idea that there is a final and absolute political authority in the political community; and everything that needs to be added to complete the definition is added if this statement is continued in the following words: 'and no final and absolute authority exists elsewhere'.<sup>9</sup>

That 'inward' aspect is a robust, absolute idea. But this concept is detached from the reality of the principle as it operates in the practice of international law, and has little to do with it even in theory. The 'outward' aspect of sovereignty, that which concerns its significance in the context of relations between sovereign entities and which yields, for example, the principle of sovereign equality, appears to have grown parasitically upon the concept of internal sovereignty, in response to what was thought to be the need to explain the paradox of the coexistence of many absolute sovereigns in different States.

<sup>6</sup> Though the separate opinions of Judge Anzilotti and the joint dissenting opinion of seven other judges did refer to sovereignty.

<sup>7</sup> *Customs Régime between Germany and Austria (Protocol of March 19th, 1931)*, above, n 4, at p 47.

<sup>8</sup> See FH Hinsley, *Sovereignty* (2nd edn) (Cambridge, CUP, 1986). See also JHW Verzijl, *International law in Historical Perspective*, vol I (Springer, 1968), ch VI, O Gierke, (trans FW Maitland) *Political Theories of the Middle Age* (Cambridge, CUP, 1900).

<sup>9</sup> FH Hinsley, *Sovereignty* (2nd edn 1986), pp 25–6.

‘Outward’, ‘external’, ‘international’ sovereignty has always been a more subtle and qualified concept. The qualifications flow from recognition that the coexistence of many sovereign States means that as a matter of fact no one can act entirely free of constraints resulting from the existence and actions of others. Many lawyers accordingly accept (and, despite what some international relations scholars seem to think lawyers believe, have long accepted) that even as a matter of legal principle sovereignty is not an absolute value, but rather one that may give way to others, such as the right of intervention in the case of massive human rights violations.<sup>10</sup> Sovereignty is, as it was, bounded.

The operation of factual constraints upon a State’s freedom of action lies at the root of recent arguments that the practical value of ‘sovereignty’ is so deeply compromised on the factual level that international institutions, far from undermining the sovereignty of individual States, are in truth the only, and the best, mechanisms available for preserving and maximising the enjoyment of national sovereignty.<sup>11</sup> This alone may provide one powerful reason for sovereignty’s modest role in international law. Far from being the unshakeable foundation of the system, it is a rather dilapidated cloak carried over from the arguments of an earlier age.

The factual constraints on the exercise of sovereignty are complemented by legal constraints; and the legal limitations upon sovereignty are manifold. The Permanent Court of International Justice, in the first case to come before it, pointed out the paradox of external sovereignty when it said:

The Court declines to see in the conclusion of any Treaty by which a State undertakes to perform or refrain from performing a particular act an abandonment of its sovereignty. No doubt any convention creating an obligation of this kind places a restriction upon the exercise of the sovereign rights of the State, in the sense that it requires them to be exercised in a certain way. But the right of entering into international engagements is an attribute of State sovereignty.<sup>12</sup>

The combined effect of the factual and legal constraints is such that in most cases there will be little point in asking if a State is sovereign, or if a particular act or situation is compatible with the sovereignty of the State. The question will be, is this action or situation compatible with the specific rights of the State? Does this action or situation deprive the State of any practical freedom of action to which it was legally entitled? These questions can be asked, and answered, without using the term ‘sovereignty’.

<sup>10</sup> The latter notion has a long history. See, eg E de Vattel, *Le Droit des Gens* (1978) (Classics of International Law edition, 1916), Liv. II, ch IV, s.56).

<sup>11</sup> See, eg K Raustiala, ‘Rethinking the Sovereignty Debate in International Economic Law’, 6 *J Int Econ Law* 841–78 (2003), and references therein.

<sup>12</sup> *Case of the SS ‘Wimbledon’*, *Case of the SS ‘Wimbledon’*, Judgment No 1 of 17 Aug 1923, *PCIJ Reports*, Ser A, No 1, 1923, at p 25).

## IV. THE RADICAL UNCERTAINTY OF SOVEREIGNTY

A second reason why the concept of sovereignty is of limited value is that the meaning of the concept is radically unclear. Dan Sarooshi and others<sup>13</sup> have argued that sovereignty is, in Gallie's terms,<sup>14</sup> an essentially contested concept—that is, a concept whose precise meaning is inherently capable of being settled by argument, but about the meaning of which disputes can be sustained by rational argument and evidence. Whether or not sovereignty satisfies the formal criteria that define Gallie's notion of contestable concepts,<sup>15</sup> I think that contests over the *content* of the concept are not the main problem.

Earlier, I quoted Hinsley's prototypical definitions of sovereignty—that there is a final and absolute political authority in the political community, and no final and absolute authority exists elsewhere. That is a serviceable 'adjectival' use of the term, functioning as a description of a quality of a political entity. There may be many components of the notion of political authority, each of which is one characteristic of sovereignty, one thread in the tapestry—powers to set and raise taxes, to establish criminal laws, to determine legal status and so on. Indeed, as has been observed, into the nineteenth century it remained common in treaties of cession to refer to transfers of '*tous les droits de souveraineté*', as if sovereignty really were the bundle of separate public rights that it had been considered to be in feudal times.<sup>16</sup> Viewed in this way it is evident that there is room for debate over which rights in the bundle—powers of taxation, legislation, and the like—are truly essential to sovereignty and which are not. But such debates do not seem to me to be the essential difficulty with the use of sovereignty as a concept in legal reasoning.

'Sovereignty', as a concept, might be used in two main ways. It might be used adjectivally, to describe a sovereign State or sovereign right, for example. But in so far as the question is whether an entity is or is not a sovereign State, international law cuts the Gordian Knot of the political theorists' debate by invoking the doctrine of recognition. A State is a sovereign State if it *is* recognized as such, whether or not it *should* have been recognized according to whatever view of the necessary components of the bundle of rights included in the concept of sovereignty one might have. Some may think, for instance, that the provisions in the Compact of Free Agreement between the Marshall Islands and Micronesia and the United States which give the Government of the United States:

<sup>13</sup> See D Sarooshi, 'The Essentially Contested Nature of the Concept of Sovereignty: Implications for the Exercise of International Organizations of Delegated Powers of Government', 25 *Michigan J Int. Law* 1107–39 (2004).

<sup>14</sup> WB Gallie, 'Essentially Contested Concepts', in WB Gallie, *Philosophy and the Historical Understanding* (New York: Schocken Books, 1964), pp 157–91.

<sup>15</sup> See N Albertsen, 'Concepts Reasonably Contested: Rereading Gallie', [http://ruc.dk/sscforskning/Konferencer/Political\\_Theory/papers/albertsen/](http://ruc.dk/sscforskning/Konferencer/Political_Theory/papers/albertsen/) (visited May 2006).

<sup>16</sup> JHW Verzijl, *International Law in Historical Perspective*, vol I (1968), p 259.



full authority and responsibility for security and defence matters in or relating to the Marshall Islands and the Federated States of Micronesia

and which stipulate that in recognition of that authority and responsibility:

the Governments of the Marshall Islands and the Federated States of Micronesia shall consult, in the conduct of their foreign affairs, with the Government of the United States,

sit awkwardly with the idea of independent sovereign Statehood. But no matter: the Marshall Islands and Micronesia are recognized as sovereign States; and for the purposes of international law, that is the end of the matter.

In so far as the question is whether some act or situation is compatible with the sovereignty of a State or is an infringement of that sovereignty, the issue is, at least in most cases, not one that can be resolved definitively by the examination of the *content* of sovereignty. It could be resolved only by considering the *implications* of sovereignty.<sup>17</sup>

Take for example, a case where State A permits or even mandates the formation and operation of a cartel among shipping companies engaged in international transportation from State A ports. State B forbids the cartelization of transport, and some of the State A cartel ships serve State B ports. Each of the two States may claim that the right to choose the economic structure of the State is an integral part of the sovereignty of every State. Each may claim the right to impose its policy on that ground. Clearly, it is not possible to have shipping trades between State A and State B both cartelized and non-cartelized. One or other policy must yield. But I think that it would be artificial and misleading to pretend that an examination of the content of the concept of sovereignty is all that is needed to decide which must yield. At the least, one would need to consider related legal principles concerning jurisdiction, non-intervention and self-determination; and I think that even then a solution could only be found by the development of a reasonable policy; and not by the identification of the precise meaning of the principle.

That appears to be true even in some of the circumstances in which sovereignty is most frequently said to entail legal consequences. Take the territorial sea, for instance: the sovereignty of a coastal State over its territorial sea is often said to ‘mean’ that if a question arises as to whether or not that State may legislate in a certain way for foreign ships in the territorial sea, the legal presumption is that it may do so—in contradistinction to the position in respect of foreign ships on the high seas, where the presumption is that in the absence of some specific rule of law, coastal States may not exercise jurisdiction over foreign ships. Those presumptions may work well enough when asking if, for example, a State has the right to enact laws on the protection of the marine archaeological heritage: but what if the question is whether the coastal State can enact and enforce laws forbidding gambling, or the consumption of alcohol, or the performance of abortions, on passing ships? In those circumstances we do not fall

<sup>17</sup> And for this reason sovereignty may in this context fall outside Gallie’s strict definition of an essentially contested concept.

back on presumptions, and we do not always accept the consequences of their application. We discuss policies, and the implications of adopting particular positions on the legal questions.

## V. WHAT SOVEREIGNTY CAN DO

So what, then, is the use of sovereignty? It seems to me that sovereignty, as a concept, identifies a framework for inquiry.<sup>18</sup> It does so in much the same way that maritime boundary delimitations are based upon 'equitable principles' or the need to achieve an 'equitable result'. The references to 'equity' there compel no particular outcomes in specific cases. The precise content of equity is extremely unclear. But the concept of equity serves to frame the inquiry. The relative wealth, or the population sizes, or the political systems or the histories of neighbouring States are (broadly speaking) irrelevant to delimitation. Coastal configurations and relative coastal lengths are considerations that can and should be taken into account. In relation to the continental shelf beyond the 200-mile limit, geomorphology may be taken into account.

Similarly, in the contexts of discussions within the framework of sovereignty—my shipping cartel for example—the principles of self-determination, of permanent sovereignty over natural resources, of non-intervention and sovereign equality are relevant: considerations of the relative wealth, coastal configuration, or economic plans of the States concerned are not.

Two objections—at least—might be made to this view. One is that the components of 'sovereignty' are normative, not descriptive as they are in my 'equity' example, and that in consequence 'sovereignty' must have *some* normative content; the other is that the components of sovereignty are neither clear nor fixed.

As to the first, I do not think that the fact that some of the components of the concept of sovereignty themselves have a normative quality means that sovereignty itself necessarily has that quality. One response, rather bland and obvious, is that to the extent that any of sovereignty's component norms is applied, in the sense of being adopted as a reason for deciding to act or resolve a dispute in a certain way, it is the component norm and not the broader concept of sovereignty itself that is being given normative force. And it might also be said that it is by no means the case that giving consideration to the implications of an act or situation for, say, the principle of non-intervention or self-determination is the same as giving effect to a norm of non-intervention or self-determination. And, furthermore, it might be said that the references to factual circumstances—coastal

<sup>18</sup> The idea of such a framework is close to John Bell's idea of a canon by which the acceptability of legal arguments is to be judged: see J Bell, 'The Acceptability of Legal Arguments', in N MacCormick and P Birks, *The Legal Mind*, (Oxford: Oxford University Press, 1986), pp 45–65. It differs from that idea in that a canon is related to the acceptability of arguments to a specifically legally-literate audience, whereas the idea of a framework as I use it here is specifically not so limited but draws upon articulated contributions from a much wider range of participants in the debate over the underlying values.

configuration, geomorphology and so on, in my delimitation example—are not so very different, because the reference to each of those factors is in truth a shorthand for some kind of proposition that could be framed in normative terms. For example, States ought to keep the natural prolongation of their land mass, and the concepts of geomorphology must be taken into account in making a determination of what is a natural prolongation. But in none of these cases does consideration of the factors dictate what the outcome must be. The discipline is imposed by the concept on the *process* of making the decision, not on its outcome. A supposedly ‘equitable’ decision might be criticised for ignoring coastal configuration: it cannot be criticised simply because the line is ‘wrong’.

As to the second criticism, that the content of sovereignty is uncertain and changing: that is my point. There is no fixed concept of sovereignty. Decisions taken by reference to the concept of sovereignty determine its implications, rather than its content; and a decision made at a given time and in a given context will not necessarily be followed in what some may consider to be similar circumstances in future.

One consequence of this openness of the concept is that whatever content it does have it will not change according to the rules that govern changes in customary international law. We do not need consistent practice and *opinio juris*, although changes in practice may contribute to the development of the concept of sovereignty. Rather, the concept changes with our understanding of what it means to be sovereign; and that is as much—even more—a matter of political debate than it is of legal debate. Popular debates over federalism and the distribution of powers in the EU are at least as important as decisions of the European Court of Justice or the WTO Appellate Body. And whatever content is given to the concept of sovereignty at any given time, it forms no more than the framework within which more specific debates, about rights and duties and rules that are truly part of the international legal order, must take place.

## VI. CONCLUSION

It is in relation to that process that I think Huber’s words have a peculiar accuracy. It is not the precise *meaning* of sovereignty, its *denotation* that is important. It is what sovereignty signifies, what it connotes. That connotation includes principles such as self-determination, non-intervention and so on; and reference to sovereignty brings these principles to bear upon the factors to be taken into account. Thus, sovereignty signifies, connotes, independence; and independence has precise meaning; it denotes, ‘in regard to a portion of the globe, the right to exercise therein, to the exclusion of any other State, the functions of a State’.

Which leads me to my final conclusion; that debates over sovereignty may be convenient vehicles for debates over policies and political principles, but may be debates into which, strictly speaking, lawyers have no need ever to enter.

Part Two

## **Trade Liberalisation and WTO Reform**



# *Trade as the Guarantor of Peace, Liberty and Security?*

AN CHEN

## I. INTRODUCTION

**I**S INTERNATIONAL TRADE the Guarantor of Peace, Liberty and Security? In my view, the answer to this question can be in either way: Yes! or No! To be brief, if international trade is conducted on the basis of equity and mutual-benefit, it can be the guarantor of global peace, liberty and security. However, if international trade is based on inequity and unilateral selfishness, it can otherwise be the destroyer of peace, liberty and security, and even the motivation of war—not only trade war, but real war with fire, cannons and bombs!

History has already provided us with many such examples. Both the Independence War between the American people and the British Empire (1775–1783), and the Opium War between the Chinese people and the British Empire (1840–1842), convincingly demonstrates the answers to this question from a negative perspective.

If we cast our eyesight to the contemporary world at large, it is easy to find that this globe is still full of fights between multilateralism and unilateralism. In the field of international trade nowadays, multilateralism is mainly represented by the WTO mechanism, while unilateralism is largely reflected by the unilateral actions of the states driven by their own interests. As the saying goes, forgetting history means losing future. Considering the current situation and drawing lessons from the history, it is sound to say, if all states act in line with multilateralism, it is definitely helpful to peace liberty and security, and thus will guarantee a lasting global peace. However, if a state, particularly a super power, stubbornly clings to unilateralistic selfishness, it is surely harmful to peace, liberty and security, and will very likely to put the global peace at risk.

It is important for us to trace back to some major fights between multilateralism and unilateralism happened in WTO mechanism during last decade.

At the turn of the twenty-first century, the development of economic globalization is accelerating and the interdependent relationship between nations is

deepening. The World Trade Organization (WTO), the so-called Economic United Nations, has been in operation for more than ten years. In this context, the world trading system of global multilateralism is further strengthening. However, strong unilateralism, the adversary of global multilateralism, originating from the contemporary sole superpower, the United States, has not been ready to concede to the WTO multilateralism voluntarily. During the latest decade, this superpower has been persistently, and by hook or crook, imposing obstacles to impede the solidifying and strengthening of global multilateralism in hopes of maintaining its economic hegemonic status of unilateralism. Usually those unilateral behaviors are conducted under the camouflage of defending US sovereignty, safeguarding US interest, and enforcing US law. New evidence of this is the mighty disturbance of the US Trade Act's Section 201<sup>1</sup> and the chain of disputes ignited by the United States in March of 2002 within the WTO, specifically in the area of the international steel trade. These disputes were collectively decided by the WTO Panel in the case of *United States—Definitive Safeguard Measures on Imports of Certain Steel Products*.<sup>2</sup>

In a macro view, the recent disputes concerning the US Trade Act's Section 201 (Section 201 Disputes) are nothing but the third big round of confrontations between US unilateralism and WTO multilateralism during the last decade. Its occurrence is never occasional or isolated. It has been closely connected with,

<sup>1</sup> See s 201 of the Trade Act of 1974, 19 USC §2251.

<sup>2</sup> WTO Final Panel Report, WT/DS248/R-WT/DS259/R (Jul 11, 2003), available at [http://www.wto.org/english/tratop\\_e/dispu\\_e/distabase\\_e.htm](http://www.wto.org/english/tratop_e/dispu_e/distabase_e.htm) [hereinafter US—Certain Steel Products]. The Secretariat noted at the beginning of the Report that:

In the disputes, WT/DS248, WT/DS249, WT/DS251, WT/DS252, WT/DS253, WT/DS254, WT/DS258, and WT/DS259, as explained in paragraph 10.725 of the Panel's Findings, the Panel decided to issue its Reports in the form of a single document constituting eight Panel Reports, each of the Reports relating to each one of the eight complainants in this dispute. The document comprises of a common cover page, a common Descriptive Part, and a common set of Findings in relation to the complainants' claims that the Panel decided to address. This document also contains Conclusions and Recommendations that, unlike the Descriptive Part and the Findings, are particularized for each of the complainants. Specifically, in the Conclusions and Recommendations, separate document numbers/symbols have been used for each of the complainants (WT/DS248 for the European Communities, WT/DS249 for Japan, WT/DS251 for Korea, WT/DS252 for China, WT/DS253 for Switzerland, WT/DS254 for Norway, WT/DS258 for New Zealand and WT/DS259 for Brazil).

The background for such an approach is: Although all complaints made by the eight co-complainants were considered in a single panel process, the United States requested the issuance of eight separate panel reports, claiming that to do otherwise would prejudice its WTO rights, including its right to settle the matter with individual complainants. The complainants vigorously opposed to this request, stating that to grant it would only delay the panel process. The Panel decided to issue its decisions in the said form of 'one document constituting eight Panel Reports'. Thus, for WTO purposes, this document is deemed to be eight separate reports, relating to each of the eight complainants in this dispute. In the Panel's view, this approach respected the rights of all parties while ensuring the prompt and effective settlement of the disputes. See *United States—Definitive Safeguard Measures on Imports of Certain Steel Products—Final Reports of the Panel* (circulated 11/07/2003), WT/DS248/R, WT/DS249/R, WT/DS251/R, WT/DS252/R, WT/DS253/R, WT/DS254/R, WT/DS258/R, WT/DS259/R.

and continues from, the first and second big rounds of the same confrontation: ‘*The Great 1994 Sovereignty Debate*’ in the United States, and the disputes over the US Trade Act’s Section 301 (Section 301 Disputes) that occurred in the WTO during 1998–2000.

The core of all the three rounds of confrontation focuses on the restriction and anti-restriction between the US economic hegemony and the economic sovereignty of other states. These confrontations deeply root in the policy that has been firmly established by the US since 1994 when it just acceded to WTO: continuing to enforce its unilateralism, so as to maintain and extend its owned economic hegemony.

This article is written in the manner of a flashback. First, a brief introduction is given to the recent development of the Section 201 Disputes, ie, the third round of the aforementioned confrontation. Second, a general origin of the confrontation is traced back to the conflict between the national unilateralism of each sovereign state and the multilateralism of the WTO system during the formation stage of the WTO. Third, an objective and logical analysis is conducted to show that the third round confrontation has been closely connected with, and continues from, the first and second round confrontations, and that the common motive and trigger of the three rounds of confrontation have manifestly been the traditional US unilateralism, which has grown deep as a result of the longstanding economic hegemony of the United States, often under the camouflage of US sovereignty. Fourth, more attention is paid to the WTO/DSB Panel Report in the case of the Section 301 Disputes, with the idea that the law-enforcing image of the Panel was not as good as reasonably expected, and that the Panel Report itself entails some legal flaws and suspicions, as well as some latent perils to WTO multilateralism.

Finally, this article probes into the significant implications and lessons from the sovereignty debate and the aforementioned disputes that might be worthy of notice by developing countries.

## II. IGNITION OF THE SECTION 201 DISPUTES: US UNILATERALISM AND SOVEREIGNTY

On June 22, 2001, on the grounds that the US steel industry was seriously injured by imported steel products, the US government authorized the US International Trade Commission to invoke Sections 201–204 of the US Trade Act of 1974, generally referred to as Section 201, to carry out investigations on more than twenty countries that exported steel to the United States.<sup>3</sup> Based upon the Commission’s preliminary conclusion, on March 5, 2002, US President

<sup>3</sup> Letter from RB Zoellick, US Trade Representative, Executive Office of the President, to the Honorable Stephen Koplan, Chairman, United States International Trade Commission (Jun 22, 2001), available at <http://www.usitc.gov/steel/ER0622Y1.pdf>.



George W Bush declared the employment of safeguard measures that implemented three-year long quota restrictions on major imported steel, or otherwise levied additional tariffs ranging from eight to thirty per cent, which were to come into effect after March 20, 2002.<sup>4</sup> The United States' behavior was met with violent condemnation from the injured states, and a large-scale trade war was triggered as a consequence.

Prior to March 22, 2002, the European Commission (EC) had drafted a list of those commodities that it might use to retaliate against the United States.<sup>5</sup> The list included 325 categories of commodities—such as steel, textiles, citrus, fruits, paper, rice, motorcycles, and firearms.<sup>6</sup> This list, aside from being submitted to the fifteen member nations of the EC for approval, was also delivered to the WTO.<sup>7</sup> The EC intended to levy additional tariffs ranging from ten to thirty per cent of the total value of 2.5 billion Euros, which was equivalent to the damages incurred from the United States' unilaterally enhanced steel import tariff.<sup>8</sup> If by June 18, 2002, the United States continued to adhere to its unilateral measures of arbitrarily increasing tariffs, and refused to compensate the EC for damages incurred from its additionally levied steel tariff, the EC retaliatory measures would enter into force on the same day.<sup>9</sup>

Other states, including Japan, the Republic of Korea, China, Switzerland, Norway, New Zealand, and Brazil, also incurred damages from the United States' unilateral measures. From March 14, 2002, to May 21, 2002, all of the states that had incurred damages jointly participated in the EU-US consultations or engaged in separate consultations.<sup>10</sup> However, none of the dispute settlement

<sup>4</sup> Proclamation No 7529, 67 Fed Reg 10553 (Mar 5, 2002); Memorandum of Mar 5, 2002, 67 Fed Reg 10593.

<sup>5</sup> *EU Draws up Steel Sanctions List*, CNN.COM (Mar 23, 2002), at <http://edition.cnn.com/2002/WORLD/europe/03/23/steel/?related>.

<sup>6</sup> P Lannin, *EU Draws up US Sanctions List in Steel Row*, PNLTV (Mar 22, 2002), at <http://www.pnlvtv.com/NewsStories/Mar%2022%20EU%20draws%20up%20US%sanctions%20list%20in%20steel%20row.htm>.

<sup>7</sup> *EU Draws up Steel Sanctions List*, above n 5.

<sup>8</sup> Lannin, above n 6; *see also* 2002 JO (L 85) 1.

<sup>9</sup> 2002 JO (L 85) 1.

<sup>10</sup> United States—Definitive Safeguard Measures on Imports of Certain Steel Products—Request to Join Consultations—Communications from Korea, WTO Doc WT/DS258/4 (Jun 4, 2002); United States—Definitive Safeguard Measures on Imports of Certain Steel Products—Request to Join Consultations—Communications from Norway, WTO Doc WT/DS258/5 (Jun 4, 2002); United States—Definitive Safeguard Measures on Imports of Certain Steel Products—Request to Join Consultations—Communications from China, WTO Doc WT/DS258/6 (Jun 4, 2002); United States—Definitive Safeguard Measures on Imports of Certain Steel Products—Request to Join Consultations—Communication from the European Communities WTO Doc WT/DS258/2 (May 29, 2002); United States—Definitive Safeguard Measures on Imports of Certain Steel Products—Request to Join Consultations—Communication from Japan, WTO Doc WT/DS258/3 (May 29, 2002); United States—Definitive Safeguard Measures on Imports of Certain Steel Products—Request for Consultations by New Zealand, WTO Doc. WT/DS258/1 (May 21, 2002); United States—Definitive Safeguard Measures on Imports of Certain Steel products—Request for Consultations by Chinese Taipei, WTO Doc WT/DS274/1 (Nov 11, 2002); United States—Definitive Safeguard Measures on Imports of Certain Steel Products—Request for Consultations by Brazil, WTO Doc. WT/DS259/1 (May 23, 2002); United States—Definitive Safeguard Measures on Imports of Certain Steel Products—Request for Consultations by Switzerland, WTO Doc

consultations succeeded in resolving the dispute. The parties then proceeded separately to request the establishment of a panel to examine the issues arising from the consultations.<sup>11</sup> On July 25, 2002, in accordance with Articles 6 and 9.1 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* (DSU), the Dispute Settlement Body (DSB) eventually established a single panel to examine similar matters raised by all the complainants.<sup>12</sup>

On July 11, 2003, the final reports of the Panel on *United States-Definitive Safeguard Measures on Imports of Certain Steel Products* were issued and circulated to all Members, pursuant to the DSU.<sup>13</sup> The Panel concluded that the safeguard measures imposed by the United States on the imports of certain steel products were inconsistent with the *Agreement on Safeguards and the General Agreement on Tariffs and Trade* (GATT).<sup>14</sup> Therefore, the Panel recommended that the DSB request that the United States bring the safeguard measures into conformity with its obligations under the GATT.<sup>15</sup>

On the same day that the Reports were issued for circulation, the eight co-complainants jointly declared that they ‘welcome[d] the Panel’s decision which upheld their main arguments and call[ed] upon the United States to terminate its WTO incompatible safeguard measures without delay’.<sup>16</sup> The co-complainants further stated that ‘should the United States appeal this Panel’s decision, the

WT/DS253/1 (Apr 8, 2002). Canada, Chinese Taipei, Cuba, Mexico, Thailand, Turkey, and Venezuela participated in the Panel proceedings as third parties. US—Certain Steel Products, above n 2.

<sup>11</sup> United States—Definitive Safeguard Measures on Imports of Certain Steel Products—Request for the Establishment of a Panel by Brazil, WTO Doc WT/DS259/10 (Jul 22, 2002); United States—Definitive Safeguard Measures on Imports of Certain Steel Products—Request for the Establishment of a Panel by New Zealand, WTO Doc. WT/DS258/9 (Jun 28, 2002); United States—Definitive Safeguard Measures on Imports of Certain Steel Products—Request for the Establishment of a Panel by Norway, WTO Doc. WT/DS254/5 (Jun 4, 2002); United States—Definitive Safeguard Measures on Imports of Certain Steel Products—Request for the Establishment of a Panel by Switzerland, WTO Doc WT/DS253/5 (Jun 4, 2002); United States—Definitive Safeguard Measures on Imports of Certain Steel Products—Request for the Establishment of a Panel by China, WTO Doc WT/DS252/5 (May 27, 2002); United States—Definitive Safeguard Measures on Imports of Certain Steel Products—Request for the Establishment of a Panel by Korea, WTO Doc. WT/DS251/7 (May 24, 2002); United States—Definitive Safeguard Measures on Imports of Certain Steel Products—Request for the Establishment of a Panel by Japan, WTO Doc. WT/DS249/5 (May 24, 2002); United States—Definitive Safeguard Measures on Imports of Certain Steel Products—Request for the Establishment of a Panel by European Communities, WTO Doc. WT/DS248/12 (May 8, 2002).

<sup>12</sup> US—Certain Steel Products, above n 2.

<sup>13</sup> *Ibid.*

<sup>14</sup> *Ibid.*

<sup>15</sup> *Ibid.* These Panel Reports must be adopted by the DSB within sixty days after the date of its circulation unless a party to the dispute decides to appeal, or the DSB decides by consensus not to adopt the report. See *Understanding on Rules and Procedures Governing the Settlement of Disputes*, Apr 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 2, Art 16(4), *Legal Instruments—Results of the Uruguay Round* vol 31, 33 ILM 81 (1994) [hereinafter DSU]. If the Panel Reports are appealed to the Appellate Body, they cannot be considered for adoption by the DSB until after the completion of the appeal. *Ibid.*

<sup>16</sup> *USA—Steel: Full Victory for the Co-Complainants in the WTO Panel against the US Steel Safeguards* (Jul 11, 2003), [http://europa.eu.int/comm/trade/issues/sectoral/industry/steel/legis/pr\\_110703\\_en.htm](http://europa.eu.int/comm/trade/issues/sectoral/industry/steel/legis/pr_110703_en.htm).

co-complainants [would] continue to work together to ensure that the WTO Appellate Body confirm[ed] that the United States' steel safeguard measures violate[d] WTO rules'.<sup>17</sup> The co-complainants requested that the Panel Report be adopted at the 'earliest opportunity to allow a prompt termination of the United States' safeguard measures'.<sup>18</sup> However, the co-complainants stated that they would 'keep working in close coordination if the United States decide[d] to appeal'.<sup>19</sup>

Thereafter, it was reported that the United States, 'instead of complying with the Panel's ruling, announced its intention to lodge an appeal with the WTO against the Panel's decision'.<sup>20</sup> With regards to China, a spokesman for the People's Republic of China's Ministry of Commerce told reporters on July 15, 2003, that '[w]e have noted the United States is to take such action [appeal]'.<sup>21</sup> 'We will continue to collaborate with the seven other plaintiffs to ensure that the WTO appellate body retains the Panel's present decision'.<sup>22</sup> It was further reported:

[T]he Ministry had also taken note of the EU's announcement that it was ready to retaliate if the United States refuse[d] to accept the WTO decision within five days of the final judgment. An EU spokesman recently announced that the body had prepared a list of US products against which it would implement sanction measures. If the United States failed to comply with the WTO decision. As one of the plaintiffs, China is closely watching the development of the issue, studying counteractive measures to protect the rightful interests of the domestic iron and steel sector.<sup>23</sup>

On August 11, 2003, the United States officially notified the WTO of its decision to appeal to the Appellate Body certain issues of law covered in the Panel Reports, as well as certain legal interpretations the Panel developed.<sup>24</sup> The United States sought review of the Panel's legal conclusion that the application of safeguard measures on imports of certain major steel products was separately and/or jointly inconsistent with Articles XIX:I of the GATF and Articles 2.1, 3.1, 4.2, and 4.2 (b) of the Safeguards Agreement.<sup>25</sup> The United States argued that the Panel's findings were in error and based on erroneous findings on issues

<sup>17</sup> *USA-Steel: Full Victory for the Co-Complainants in the WTO Panel against the US Steel Safeguards* (Jul 11, 2003), [http://europa.eu.int/comm/trade/issues/sectoral/industry/steel/legis/pr\\_110703\\_en.htm](http://europa.eu.int/comm/trade/issues/sectoral/industry/steel/legis/pr_110703_en.htm).

<sup>18</sup> *Ibid.*

<sup>19</sup> *Ibid.*

<sup>20</sup> M Yan, *US Faces Stand Over Measures*, CHINA DAILY (Jul 16, 2003), available at [http://www1.chinadaily.com.cn/en/doc/2003-07/16/content\\_245580.htm](http://www1.chinadaily.com.cn/en/doc/2003-07/16/content_245580.htm).

<sup>21</sup> *Ibid.*

<sup>22</sup> *Ibid.*

<sup>23</sup> *Ibid.*

<sup>24</sup> United States-Definitive Safeguard Measures on Imports of Certain Steel Products—Notification of an Appeal by the United States under para 4 of Article 16 of the Understanding on Rules and Procedures Governing the Settlement of Disputes, WTO Doc, WT/DS248/17, WT/DS249/11, WT/DS251/12, WT/DS252/10, WT/DS253/10, WT/DS254/10, WT/DS258/14, WT/DS259/13 (Aug 14, 2003) [hereinafter Safeguards Agreement], available at [http://www.wto.org/english/tratop\\_e/dispu\\_e/apellate\\_body\\_e.htm](http://www.wto.org/english/tratop_e/dispu_e/apellate_body_e.htm).

<sup>25</sup> *Ibid.*

of law and related legal interpretations.<sup>26</sup> The United States further sought review on the grounds that the Panel had acted inconsistently with Article 11 of the DSU, in that it failed to make an objective assessment of the matter before it, including an objective assessment of the facts of the case and the applicability of and conformity with both the GATT and the Safeguards Agreement.<sup>27</sup> The United States also sought review of the Panel's findings on the grounds that the Panel acted inconsistently with Article 12.7 of the DSU, in that its report did not set out the basic rationale behind its findings and recommendations.<sup>28</sup>

On 10 November 2003, the Appellate Body Report<sup>29</sup> was circulated to Members. The Appellate Body upheld the Panel's ultimate conclusions that each of the ten safeguard measures at issue in this dispute was inconsistent with the United States' obligations under Article XIX: 1(a) of the *GATT 1994* and the *Agreement on Safeguards*. The Appellate Body reversed the Panel's findings that the US failed to provide a reasoned and adequate explanation on 'increased imports' and on the existence of a 'causal link' between increased imports and serious injury for two of the ten safeguard measures. Ultimately, however, even these measures were found to be inconsistent with the *WTO Agreement* on other grounds.

At its meeting on 10 December 2003, ie, just one month after the Appellate Body Report had been circulated to Members, the DSB adopted the Appellate Body report and the Panel report, as modified by the Appellate Body report.<sup>30</sup>

At that same DSB meeting of 10 December 2003, the US informed Members that, on 4 December 2003, the President of the United States had issued a proclamation that terminated all of the safeguard measures subject to this dispute, pursuant to section 204 of the US Trade Act of 1974.<sup>31</sup>

However, it is necessary to remind and note that at the same time and in the same proclamation, the US President, after obtaining a great deal of both economic and political benefits during the past period of 21 months, satisfactorily announced, 'These [US] safeguard measures have now achieved their purpose'. He emphasized, 'We will continue to pursue [our] economic policies', as well as 'our commitment to enforcing our trade laws'.<sup>32</sup> As to the serious damages that had been incurred by abusing these US safeguard measures to foreign steel-related trade partners during the same period of 21 months, the eloquent President pretending to be deaf and dumb, kept absolutely silent without saying even one word of regret, sorriness or apology.

<sup>26</sup> *Ibid.*

<sup>27</sup> *Ibid.*

<sup>28</sup> *Ibid.*

<sup>29</sup> United States—Definitive Safeguard Measures on Imports of Certain Steel Products—AB-2003-3—Report of the Appellate Body (circulated 10/11/2003), WT/DS248/AB/R, WT/DS249/AB/R, WT/DS251/AB/R, WT/DS252/AB/R, WT/DS253/AB/R, WT/DS254/AB/R, WT/DS258/AB/R, WT/DS259/AB/R.

<sup>30</sup> Minutes of Meeting, DSB, WTO, 10 Dec, WT/DSB/M/160, 27 Jan 2004, (04-0286)

<sup>31</sup> *Ibid.*

<sup>32</sup> [US] President's Statement on Steel, at <http://www.whitehouse.gov/news/release/2003/12/20031204-5.html>.

The Section 201 Disputes, first ignited by the United States in March 2002, and eventually settled down under the WTO/DSU/DSB mechanism in December, 2003, had once become the focus of worldwide attention. The specific Disputes have now been over, and turned into history. However, as is known to all, Mr History has always been the best teacher. Should people of the contemporary world learn something from the 'new history' and its related precedents?

As mentioned above, with regard to the United States, the ignition of these disputes has never been isolated or occasional. It is deeply rooted in the United States' longstanding unilateralism and its new conception of sovereignty that evolved in 1994.

For a better understanding on the origin and essence of the current US unilateralism and its related disputes, it would be necessary to trace back to the history upon '*The Great 1994 Sovereignty Debate*'<sup>33</sup> and its history happened in the United States. The debates of 1994 focused on whether or not the United States should accept the WTO system and strictly observe its multilateralism.<sup>34</sup> Specifically, it centered upon whether the acceptance of the WTO system and the observance of its multilateral rules, inter alia, the WTO/DSU/DSB system and its rules, would impair, infringe, destroy, or deprive the United States of its sovereignty as it effected its economic policy decision-making.<sup>35</sup>

### III. CONFLICTS OF SOVEREIGNTIES IN THE FORMATION OF THE WTO SYSTEM

In light of the worldwide scope and the accelerated advancement of economic globalization, is the sovereignty hedge of nations being demolished too quickly? Should it be demolished at all? Are the principles and notions of economic sovereignty obsolete and in the process of being abated and diluted, and should it be weakened and diluted? This is not only a realistic problem arising out of the contemporary international community, but also a significant, controversial, and theoretical question often confronted in international forums.

Manifestly, the WTO is the product of the accelerated development of economic globalization. The necessary premise and procedure to establish the worldwide organization is the conclusion of a multilateral international treaty. To be a member of the WTO, each sovereign country or separate customs territory must, on the basis of equity, willingness, and reciprocity, conclude an international treaty establishing and/or acceding the multilateral organization,

<sup>33</sup> This phrase was first coined by JH Jackson in his article, *The Great 1994 Sovereignty Debate: United States Acceptance and Implementation of the Uruguay Round Results*, 36 *Colum J Transnat'l L* 157, 160, 162, 174, 179, 182, 188 (1997), available at <http://www.worldtradelaw.net/articles/jacksonsovereignty.pdf>.

<sup>34</sup> *Ibid.*

<sup>35</sup> *Ibid.*

in which the international codes and rules of conduct, with legally binding effect, are stipulated for joint observance.<sup>36</sup>

For every sovereign country, entering into such a treaty allows the country to acquire certain economic rights and interests. In accordance with the principle of reciprocity and equilibrium in rights and obligations, a nation, while acquiring economic rights and benefits, must also assume some corresponding economic obligations and restraints. This means that each sovereign country promises to self-restrict its inherent economic sovereign power to some extent as a concession. However, due to the differences or even contradictions among interests of each sovereign state, the core focus of the discussion and dispute in the consultation process is: what is the scope and degree of restrictions that should be imposed on another nation's economic sovereignty, and what scope and degree of self-restriction is acceptable to impose on its own economic sovereignty.

In the process of establishing the WTO, there existed numerous differences in national situations and requirements among the 125 prospective contracting parties. Furthermore, the international trade issues involved were of an unprecedented and vast range. Therefore, to accomplish harmony and consensus on so vast a scope of topics, obstacles and hardships had to be overcome in every state. During the eight-year-long Uruguay Round (UR) negotiations, the diplomats of every country bargained with each other. Though forms varied, in essence, the negotiations consistently focused on the same core, ie, the conflicts and compromises around the restriction and anti-restriction on national sovereignty, or around the conflicts and compromises between national unilateralism and international multilateralism. As known to all, the UR ultimately succeeded, concluding an agreement in 1994. However, during the last decade, the core of such conflicts has not only appeared in international negotiations, but has also been reflected in internal fora.

The domestic debate on national sovereignty that arose in the United States during the later negotiation stage of the WTO, and the period around its signing and ratification, was a typical reflection and refraction of the international restriction versus anti-restriction struggle on national economic sovereignty.

#### IV. THE REFRACTION OF SUCH CONFLICTS IN THE UNITED STATES: 'THE GREAT 1994 SOVEREIGNTY DEBATE'

The reason that a ten-year old domestic debate is worthy of great attention is not only due to the fact that it involved the major weighty issue of national sovereignty; but also due to the fact that such a debate of 1994 firstly broke out within the sole superpower, ie, the *First World*. Then, it had a broad effect on

<sup>36</sup> *Ibid* at 166; see also *World Trade Organization, Accession: Technical Note, Completion of the Working Party Mandate*, [http://www.wto.org/english/thewto\\_e/acc\\_e/tn\\_4accprocess\\_e.htm](http://www.wto.org/english/thewto_e/acc_e/tn_4accprocess_e.htm).

the combat between the First World and the *Second World*, and profoundly influenced the vast *Third World*. Therefore, it has a strikingly universal and global importance.

In the comparatively long period of time before the WTO Agreement and its multilateral system came into operation on January 1, 1995, some US authoritative legal scholars repeatedly advocated the theories of ‘sovereignty *obsolete*’,<sup>37</sup> ‘sovereignty *dilution*’, and even ‘sovereignty *discarding*’,<sup>38</sup> all of which developed into original and fashionable theories and were continuously invoked and testified to in US foreign political and economic affairs.

In 1989, an US international law professor, Louis Henkin, delivered a series of lectures before The Hague Academy of International Law. In his lectures, Henkin re-examined the principal themes of traditional international law and elaborated on the latest developments in the current era.<sup>39</sup> In particular, Henkin addressed the fact that international law had experienced long-term conflicts between two superpowers armed with nuclear weapons, and had also experienced the emergence and proliferation of many Third World countries during the Cold War.<sup>40</sup> However, Henkin argued that the misconceived invocation of sovereignty had impeded the modernization and development of international law.<sup>41</sup> In his opinion, the perversion of the term ‘sovereignty’ was rooted in an unfortunate mistake.<sup>42</sup> Henkin declared that ‘[s]overeignty is a bad word’, not only because it has served terrible national mythologies in international relations, and even in international law, but also because it is often a catchword, or a substitute for thinking and precision.<sup>43</sup> Henkin emphasized that ‘[f]or international relations, surely for international law, [sovereignty] is a term largely unnecessary and better avoided’.<sup>44</sup> Henkin even advocated that ‘we might do well to relegate the term sovereignty to the *shelf of history as a relic from an earlier era*’.<sup>45</sup>

In the early 1990s, the disintegration of the Soviet Union and the end of the Cold War pushed the United States to the throne as the sole superpower. Professor Henkin stated that ‘international law will have to respond to the

<sup>37</sup> P Jessup, *A Modern Law of Nations* 1–3, 12–13, 40–42 (Macmillan 1948). Jessup was a professor at Columbia University from 1949 to 1953. He was appointed as the Ambassador-at-Large, playing an active role in foreign affairs. In 1970, he was chosen as a Judge of the International Court of Justice.

<sup>38</sup> L Henkin, *The Mythology of Sovereignty*, Asil Newsletter, Mar–May 1993, 1–2, available at <http://www.asil.org/pres.htm>; L Henkin, *International Law: Politics and Values*, xi, 1–2 (Martinus Nijhoff 1995). ‘This volume derives from a series of lectures delivered as the ‘general course’ at The Hague Academy of International Law in Jul 1989’. *Ibid* Mr Henkin served as President of the American Society of International Law and was a long-time professor at the Columbia Law School.

<sup>39</sup> See Henkin, above n 38.

<sup>40</sup> *Ibid* at 1.

<sup>41</sup> *Ibid* at 2.

<sup>42</sup> *Ibid* at 8.

<sup>43</sup> *Ibid* (emphasis added).

<sup>44</sup> See Henkin, above n 38, at 10 (emphasis added).

<sup>45</sup> *Ibid* (emphasis added).

changed world order at the turn of the twenty-first century'.<sup>46</sup> Henkin further warned that 'the world community ought to be alert to new opportunities to overcome old-order obstacles to a better international law'.<sup>47</sup>

The implication of Henkin's opinions, in its context, is that the sharp change in power contrast and balance greatly favors the United States. Thus the United States should take this opportunity to relegate the traditional sovereignty concepts in international law that reflected the 'old-order', so that the ideology of 'the obsolete of sovereignty', advocated by hegemonists, may pervade and prevail in the world without fetter.

### 1. Away with the 'S' word—[sovereignty of other states]!

In May of 1993, when the negotiations of the UR were in tense debate and the struggle for economic sovereignty among every category of nation was spreading like a wildfire, Professor Henkin issued a paper, *The Mythology of Sovereignty*.<sup>48</sup> Henkin's main viewpoints are as follows:

Talk of 'sovereignty' is heavy in the political air, often polluting it. . . . 'Sovereignty' is used to describe the autonomy of states and the need for state consent to make law and build institutions. 'Sovereignty' is used to justify and define the 'privacy' of states, their political independence, and territorial integrity; their right and the rights of their peoples to be let alone and to go their own way.

But sovereignty has also grown a mythology of state grandeur and aggrandizement that misconceives the concept and clouds what is authentic and worthy in it, a mythology that is often *empty* and sometimes destructive of human values.

For example . . . [o]ften we still hear that a sovereign state cannot agree to be bound by particular international norms—eg, on human rights, or on economic integration (as in Europe). Even more often, sovereignty has been invoked to resist 'intrusive' measures to monitor compliance with international obligations—human rights commitments or arms control agreements . . .

It is time to bring sovereignty down to earth; to examine, analyze, reconceive the concept, cut it down to size, break out its normative content, repackaging it, perhaps even rename it . . .

. . .

*Away with the 'S' word!*<sup>49</sup>

The enlightening remarks of Professor Henkin assuredly are not '*empty* words' without target. The realistic purport of his reasoning is obviously to boost the

<sup>46</sup> *Ibid* at 2.

<sup>47</sup> *Ibid*.

<sup>48</sup> L Henkin, *The Mythology of Sovereignty*, *Am Soc'y Int'l L Newsl*, Mar–May 1993, 1–2, available at <http://www.asil.org/pres.htm>.

<sup>49</sup> *Ibid* (emphasis added). 'S' is the first letter of the word sovereignty. This sentence means that sovereignty should be relegated *away to the shelf of history as a relic*. If 'S' and 'word' are read together, the sentence reads, 'Away with the *sword*', thus implying that sovereignty is an old but 'terrible' *sword* that needs to be done away with.



'big stick' policy that the United States is practicing in the international community, and to facilitate the United States in pursuing its neo-interventionism, neo-gunboatism, and neo-colonialism disguised under the flag that human rights is superior to sovereignty, that preventing and controlling the proliferation of weapons of mass destruction is superior to sovereignty, or that economic integration is superior to sovereignty. The targeted countries definitely include all the small and weak nations who were not willing to succumb to the political and economic hegemony of the United States during the 1980s and 1990s. The theory was then met with applause within the United States. As a newsletter, the American Society of International Law diffused and propagated Professor Henkin's enlightening remarks to a large audience.

However, history is apt to mock people. Only one year later, in the United States, there broke out the Great Debate concerning *whether the United States could relinquish its own sovereignty*. Many American scholars and politicians, one after another, stressed that the United States should never accept wholesale the legal system embodying the UR negotiation results or the WTO Agreement, especially its dispute settlement mechanism.<sup>50</sup> Otherwise, the scholars argued, the United States' own economic decision-making sovereignty would be diminished, detracted, or taken away.<sup>51</sup> Thus, the notion of sovereignty that Professor Henkin had vigorously advocated to *do 'away with'*, was *re-adopted* and *re-expounded on* by many American scholars.

## 2. Never away with the US 'S' word—'sovereignty' (hegemony) of United States!

One such scholar, Professor John H Jackson, subsequently wrote a commentary intended to explore the issue of sovereignty as it related to the Great Debate.<sup>52</sup> As one of the major counsels on the foreign trade policy of the United States, Professor Jackson had the experience of participating in the nation-wide Great Debate. He twice testified and attended hearings held separately by the Senate Finance Committee and the Senate Committee on Foreign Relations.<sup>53</sup> In his paper, Jackson discusses the causes and major points of the Great Debate. Some of his discussion is outlined below.

<sup>50</sup> M Schaefer, *Sovereignty, Influence, Realpolitik and the World Trade Organization*, 25 *Hastings Int'l & Comp L Rev* 341 (2002); PJ Buchanan, *The Great Betrayal: How American Sovereignty and Social Justice are Being Sacrificed to the Gods of the Global Economy* (Little Brown 1998); PJ Buchanan, *Showdown at the GATT Corral*, *Denver Post*, Oct 9, 1994, at E4.

<sup>51</sup> Schaefer, above 46, at 341; PJ Buchanan, *Fritz Hollings Derails the GATT Express*, *Denver Post*, Oct 2, 1994, at F4 (arguing that '[i]n the World Trade Organization, established by GATT, America surrenders her national sovereignty, her freedom of action to defend her own economic vital interests from the job pillagers of Tokyo and Beijing. We give up our freedom—to foreign bureaucrats who will assume authority over America's commerce that the Founding Fathers gave exclusively to the Congress of the United States. And, if we are outraged by WTO's decisions, we have just one vote, out of 123, to challenge those decisions. . . . And in [the] WTO, the US has no veto power').

<sup>52</sup> Jackson, above n 33.

<sup>53</sup> *Ibid* at 188 n 3.

The eight-year long UR negotiation was launched in 1986, and ultimately concluded on April 15, 1994, when the representatives of the contracting members signed the *Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations* and the *Marrakesh Agreement*, establishing the WTO.<sup>54</sup> As a continuation of, and supplement to, the 1947 GATT, one of the major innovations of the WTO was its establishment of a new set of dispute settlement mechanisms correcting some of the birth-defects that existed in the original 1947 GATT.<sup>55</sup>

One such birth defect that the UR attempted to correct ‘concerned the dispute settlement procedures of the 1947 GATT’.<sup>56</sup> According to Article 22 of the GATT, international trade disputes arising between contracting members’ governments should be resolved through mutual consultations.<sup>57</sup> If no satisfactory settlement is reached between the disputing parties within a reasonable time, the dispute may be referred to all of the contracting parties for resolution.<sup>58</sup> ‘As practice developed, disputes were considered by a panel of experts (usually three but sometimes five individuals) not to be guided by any government’.<sup>59</sup> The Panel would then submit a report to a council made up of contracting parties, that if adopted was considered binding on the parties.<sup>60</sup> However, ‘the decision to adopt the report had to be by “consensus.”’<sup>61</sup> According to this procedure, a Panel report can only be passed with the unanimous agreement of those present at the meeting, which allows the parties in the dispute to block the consensus of the council—in fact resulting in a *de facto* phenomenon where ‘one objection means veto’ and results in a low efficiency and weakness of the GATT dispute settlement mechanism.<sup>62</sup>

In light of this, the DSU eliminated the ability of a party to block the adoption of the report.<sup>63</sup> The DSU provides that the Dispute Settlement Body (DSB), the name under which the General Council held its meetings, is fully competent to deal with the disputes.<sup>64</sup> ‘Accordingly, the DSB shall have the authority to establish panels, adopt panel and Appellate Body reports, maintain surveillance of implementation of rulings and recommendations, and authorize suspension of concessions and other obligations under the covered agreements’.<sup>65</sup> What is

<sup>54</sup> Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Apr 15, 1994, *Legal Instruments—Results of the Uruguay Round* vol 1 (1994), 33 ILM 81 (1994) [hereinafter Final Act].

<sup>55</sup> Jackson, above n 33, at 166.

<sup>56</sup> *Ibid* at 165.

<sup>57</sup> General Agreement on Tariffs and Trade, Oct 30, 1947, Art XXII, 61 Stat. A- 11, TIAS 1700, 55 UNTS 194, available at [http://www.wto.org/english/docs\\_e/legal\\_e/ gatt47\\_02\\_e.htm# articleXXII](http://www.wto.org/english/docs_e/legal_e/ gatt47_02_e.htm# articleXXII) [hereinafter GATT].

<sup>58</sup> *Ibid*. Art XXIII.

<sup>59</sup> Jackson, above n 33, at 165.

<sup>60</sup> *Ibid*.

<sup>61</sup> *Ibid*.

<sup>62</sup> *Ibid* at 189 n 16.

<sup>63</sup> *Ibid* at 176.

<sup>64</sup> DSU, above n 15, Art 2(1).

<sup>65</sup> *Ibid*.

more important, the DSB completely transformed from the consensus procedure practiced during the 1947 GATT to the decision-making procedure of reverse consensus, whereby '[t]he report is deemed adopted unless there is a consensus against adoption'.<sup>66</sup> In essence, if any complaining party so requests, a panel must be established unless the DSB decides by consensus not to establish a panel.<sup>67</sup> After the panel (similar to 'the first instance adjudicating organization') or the Appellate Body (similar to 'the second instance adjudicating organization') submits its report to the DSB, unless the DSB decides by consensus not to adopt the report, the DSB must adopt the report, requiring the concerned parties to unconditionally accept the recommendations or to implement related rulings.<sup>68</sup> Otherwise, a party who breaches the DSB's ruling (usually the losing party) will incur various sanctions and retaliations.<sup>69</sup> In short, the actual effect of the new decision-making principle that the DSB adopted in its dispute settlement proceedings is that if the injured claimant or the winning party insists on the legitimate demands determined by the panel or the Appellate Body in the DSB meeting, the final decision and recommendations will be implemented by a 'pass with one vote'.

From this it can be perceived that the dispute settlement mechanism of the WTO is tougher and more efficient than that of the GATT. If this dispute settlement mechanism operates normally, it can have a binding effect on the economically powerful contracting members, especially on the superpower. In international trade, the powers are invariably in dominance because of their national wealth. Meanwhile, they act on a principle of national egoism and hegemonism, thus materially impairing the trade interests of the economically weak nations. If such dispute settlement mechanisms are effectively implemented, once the injured party complains, a superpower, like the United States, cannot block the decision or escape from sanctions at will by relying upon its economic dominance and recourse to the formerly applied principle of consensus.

The perfected new dispute settlement mechanism of the DSU is an indispensable element of the integral WTO Agreement system. After the US negotiation representatives signed onto the single package treaty, the responsible governmental department sent it to the US Congress for consideration and ratification.<sup>70</sup> Subsequently, the two houses of Congress held a series of congressional hearings and plenary sessions on the UR results, during which many congressmen sharply criticized the UR results, arguing that the ratification and acceptance of the WTO Agreement was unconstitutional because it would infringe on the United States'

<sup>66</sup> Jackson, above n 33, at 176; DSU, above n 15, Art 16(4).

<sup>67</sup> DSU, above n 15, Art 16(4).

<sup>68</sup> *Ibid* arts 6(1), 16(4), 17(14).

<sup>69</sup> *Ibid* arts 3(7). The other party may suspend the application of the concessions or other obligations under the covered agreements on a discriminatory basis to those Members who neither abide by the WTO rule nor accept the rulings of the DSB. *Ibid*.

<sup>70</sup> Jackson, above n 33, at 168–9.

sovereignty.<sup>71</sup> One of the arguments they posed was that the sovereignty of the United States would definitely be eroded should the United States accept the new WTO dispute settlement mechanism.<sup>72</sup> The congressmen who held this opinion can be categorized as the ‘Sovereignty Anxiety Group;’ while other congressmen, the ‘Sovereignty Confidence Group’, refuted the above viewpoints, deeming that the acceptance of the WTO system, together with its indispensable dispute settlement mechanism, would not impair the sovereignty of the United States at all.<sup>73</sup>

Those who ‘argued against the WTO did so partly because the dispute settlement procedure was tougher, and no longer permitted a single nation [trade superpower] to *block* acceptance of a panel report’ *at will*.<sup>74</sup> Members of Congress who opposed the WTO were concerned with the issue of ‘whether the allocation of power regarding WTO decision-making was an inappropriate infringement on the United States’ sovereign decisionmaking’.<sup>75</sup> Politicians most often addressed the issue of whether ‘this nation [should] accept the obligation to allow certain decisions affecting it (or its view of international economic relations) to be made by an international institution rather than retaining that power in the national government?’<sup>76</sup> ‘Various opponents to the treaty argued that the WTO posed risks to US sovereignty because decisions could be made in the WTO that would override US law’.<sup>77</sup>

In addressing these viewpoints, Professor Jackson acknowledged that ‘acceptance of any treaty, in some sense reduces the *freedom and scope* of national government actions’.<sup>78</sup> ‘At the very least, certain types of actions inconsistent with the treaty norms would give rise to an international law violation’.<sup>79</sup> However, Professor Jackson repeatedly argued that the majority of objections to joining an international treaty, which result in a loss of US sovereignty, are arguments about the allocation of power.<sup>80</sup> ‘That is, when a party argues that the US should not accept a treaty because it takes away US sovereignty to do so, what that party most often really means is that he or she believes a certain set of

<sup>71</sup> *Ibid* at 169; *The World Trade Organization and US Sovereignty: Hearings before the Senate Committee on Foreign Relations*, 103rd Cong. (1994) (testimony of R Nader, Center for Responsive Law), available at 1994 WL 4188790 [hereinafter R Nader Testimony]. The heated argument between the two factions of Congress, ‘combined with a general public debate in all the various media, as well as many academic, business, and other public forums’, created a great debate that swept across the nation. Jackson, above n 33, at 169–70. Professor Jackson named it ‘The Great 1994 Sovereignty Debate’, and proclaimed 1994 a year of ‘historic importance’ in US history. *Ibid*.

<sup>72</sup> See R Nader Testimony, above n 71; R Perot, *Appeal to Trade Body Carries Risks for US*, *Houston Chron* 2, Jun 14, 1996.

<sup>73</sup> See, eg, 140 *Cong Rec* H11492 (Nov 29, 1994) (statements of Rep Archer, Rep Coble, Rep Richardson, and Rep Bunning); 140 *Cong Rec* S15,342 (Dec 1, 1994) (statements of Sen Domenici, Sen Cochran, Sen Hutchison, Sen Roth, Sen Gramm, and Sen Grassley).

<sup>74</sup> Jackson, above n 33, at 177 (emphasis added).

<sup>75</sup> *Ibid* at 174.

<sup>76</sup> *Ibid* at 179.

<sup>77</sup> *Ibid* at 173.

<sup>78</sup> *Ibid* at 172 (emphasis added).

<sup>79</sup> Jackson, above n 33, at 172.

<sup>80</sup> *Ibid* at 160, 179, 182, 187–8.

decisions should, as a matter of good government policy, be made at the nation-state [US] level and not at an international level'.<sup>81</sup> Professor Jackson suggested that 'nervousness about international dispute settlement procedures reflects a government's desire to have some flexibility to resist future strict conformity to norms in certain special circumstances, particularly circumstances that could pose great danger to essential national objectives'.<sup>82</sup> In response to those opposing the WTO on the basis that the WTO would damage US sovereignty, Professor Jackson provided the following explanations and clarifications:

There is some confusion about the effect of a WTO and its actions on US law. It is almost certain to be the case (as Congress has provided in recent trade agreements) that the WTO and the Uruguay Round treaties will not be self-executing in US law. Thus, they do not automatically become part of US law. Nor do the results of panel dispute settlement procedures automatically become part of US law. Instead, the United States must implement the international obligations or the result of a panel report, often through legislation adopted by the Congress. In a case where the United States feels it is so important to deviate from the international norms that it is willing to do so knowing that it may be acting inconsistently with its international obligations, the US government still has that power under its constitutional system. This can be an important constraint if matters go seriously wrong. It should not be lightly used of course. In addition, it should also be noted that governments as members of the WTO have the right to withdraw from the WTO with six month notice (Art XV:1 of the WTO Agreement). Again, this is a drastic action which would not likely to be taken, but it does provide some checks and balances to the overall system.<sup>83</sup>

Hereby Professor Jackson actually presented US Congress and other wide audiences with the following 'US creeds':

- (1) When entering into or concluding any international treaty, the United States consistently put into primary consideration the national interests, the US sovereignty safeguarding its national interest and the US law.
- (2) The international norms and code of conduct stipulated in the international treaties concluded by the United States, and the international obligations undertaken by the United States therein, must generally be reviewed, ratified and enacted by the US Congress, the main branch embodying the US sovereignty, before they became a part of the US domestic law to be implemented.
- (3) Once the United States deemed it necessary to take certain measures or actions to safeguard its significant national interests, it's *empowered* to escape from the binding of international rules and norms, to breach its international obligation undertaken in the light of international treaties, and to

<sup>81</sup> Jackson, above n 33, at 160.

<sup>82</sup> *Ibid* at 175.

<sup>83</sup> Results of the Uruguay Round Trade Negotiations: Hearings Before the Senate Finance Committee, 103d Cong. 114 (1994) (Mar 23, 1994, testimony of JH Jackson); JH Jackson *et al*, *Legal Problems of International Economic Relations: Cases, Materials and Text* 305 (3rd edn 1995) [hereinafter *Legal Problems of International Economic Relations*].

go in its own way. When necessary, the United States even does not hesitate to withdraw from the international treaties that it deems would restrain it from free action. Such power is the US sovereignty, the sovereignty that the United States persistently retains in hand in the process of the international 'allocation of power'.<sup>84</sup>

The above creeds on US sovereignty expounded by Professor Jackson represent the typical opinion among WTO proponents at that time.<sup>85</sup> After months of nationwide debate, the sovereignty creeds of the proponents gradually prevailed throughout the whole nation, especially in Congress.<sup>86</sup> The majority of congressmen were thus relieved from the anxiety of sovereignty and further convinced that US sovereignty was firmly in its own hands, even after it joined the WTO.<sup>87</sup> Ultimately, the WTO Agreement was successively approved by the House of Representatives on November 29, 1994, by a vote of 288 to 140, and by the Senate on December 1, 1994, by a vote of 76 to 24.<sup>88</sup>

What is interesting is that, as a compromise between the WTO opponents and proponents and a deal between President Bill Clinton (Democratic Party) and the Senate Majority Leader Robert Dole (Republican Party), a statutory ad hoc commission was to be established pursuant to special legislation proposed by Mr Dole a few days before the congressional votes were cast.<sup>89</sup> The ad hoc commission was to be 'composed of five US federal judges who would review the adopted WTO Panel reports adverse to the United States'.<sup>90</sup> The Commission would evaluate and judge whether the reports violated four particular criteria. The specific criteria for evaluating WTO dispute reports were 'whether the panel had: 1) exceeded its authority or terms of reference; 2) added to the obligations of or diminished the rights of the United States; 3) acted arbitrarily or capriciously or engaged in misconduct, etc; or 4) deviated from the applicable standard of review including that in article 17.6 of the antidumping text'.<sup>91</sup>

After careful review and evaluation, the Commission would report the results of its review to Congress.<sup>92</sup> If the Commission determined that the WTO/DSB Panel's report was contrary to any of the above criteria, and if the number of

<sup>84</sup> *Legal Problems of International Economic Relations*, above n 79.

<sup>85</sup> 140 *Cong Rec* S15, 342 (Dec 1, 1994) (statements of Sen. Domenici, Sen. Cochran, Sen. Hutchinson, Sen. Roth, Sen. Gramm, and Sen. Grassley).

<sup>86</sup> *Ibid.*

<sup>87</sup> *Ibid.*

<sup>88</sup> 140 *Cong Rec* H11493 (Nov 29, 1994); *S Vote Rpt* 329 (Dec 1, 1994).

<sup>89</sup> Jackson, above n 33, at 186; A Bill to Establish a Commission to Review the Dispute Settlement Reports of the World Trade Organization and for Other Purposes, s 16, 104th Cong (1995) [hereinafter A Bill to Establish a Commission]. 'This proposal has not become law, although a series of attempts were made to enact it in 1995 and 1996'. Jackson, above n 33, at 186.

<sup>90</sup> Jackson, above n 33, at 186; A Bill to Establish a Commission, above n 89.

<sup>91</sup> A Bill to Establish a Commission, above n 89.

<sup>92</sup> *Ibid.*

such reports amounted to three within five years, Congress would then consider withdrawing from the WTO and act at its will.<sup>93</sup>

While the proposal has never become law, it has been vigorously advocated by members of Congress at various times and remains a possibility that would provide the United States with the ability to attack and shoot at the proper time. Professor Jackson opined that the proposal *per se*, its obvious proposition and the review criteria set up by it, clearly shows the ‘anxious concerns’ of the WTO opponents.<sup>94</sup>

More interesting, there seems to be some ‘contradictions’ or ‘conflicts’ between the aforesaid theories of Prof Henkin’ and Prof Jackson. In fact, these theories actually constitute a pair of well-coordinating weapons, spear and shield, both of which have been firmly grasped in US hands.

### 3. The ‘contradiction’ and coordination between ‘spear’ and ‘shield’

When Prof Jackson summarized his article concerning ‘*The Great 1994 Sovereignty Debate*’, he mildly expressed his dissent to the above quoted arguments of Prof Henkin, the senior authority.<sup>95</sup> He acclaimed that:

In some sort of nominal sense, my views may appear to be somewhat contrary to parts of Professor Henkin’s views, especially in those instances when he speaks of relegating ‘the term sovereignty to the shelf of history as a relic from an earlier era’ or doing away with the ‘“S” word’. . . . [T]he observable fact is that the word ‘sovereignty’ is still being used widely, often in different settings which imply different ‘sub-meanings’.<sup>96</sup>

Therefore, Prof Jackson contends that the word sovereignty should be decomposed to use appropriately in different situations.

These remarks seem obscure upon the first reading, but after due consideration, one can comprehend without difficulty that the words of the two professors refer to sovereignty *in different circumstances*.

The sovereignty that Prof Henkin advocated to relegate specifically refers to the *sovereignty of those small and weak nations that* (1) are unwilling to succumb to the superpower, (2) constantly raise the justice flag of sovereignty, and (3) boycott the interventionism and hegemonism of the superpower.

While, the sovereignty that Prof Jackson seeks to preserve refers specifically to the ‘*sovereignty of the United States itself*’. Behind the camouflage of ‘*sovereignty*’, the United States can cover its *vested hegemony*, and thus resist being bound by its international treaty obligations and the international rule and code of conduct. Therefore, even the viewpoints of the two professors seem contra-

<sup>93</sup> A Bill to Establish a Commission, above n 89; G Horlick, WTO Dispute Settlement and the Dole Commission, 29(6) *J World Trade*, 45–8 (1995).

<sup>94</sup> Jackson, above n 33, at 187.

<sup>95</sup> See Jackson, above n 33, at 158–9.

<sup>96</sup> *Ibid.*

dictory each other at first sight, they actually constitute a pair of well-coordinating weapons: Prof Henkin's relegation theory is the *spear* to attack the small and weak nation's sovereignty, while Prof Jackson's preservation theory provides the *shield* to defend the United States' 'sovereignty', the vested hegemony. The two theories differ in function, while serving the same purpose (maintain US hegemonic interests) perfectly. This is another perfect example for the philosophy of pragmatism and double standards acted upon by the United States in the international community.

Now, faced with the attacking spear and the defending shield, of hegemonist, shouldn't the developing countries, especially the weak and small nations, intensify their sense of crises / risks so as to avoid unconsciously accepting the theory of the abolishment, relegation, weakening, or dilution of economic sovereignty?

For the third world, it seems necessary to advocate: **Never away with the 'S' word in current time!** They must firmly cling to the **'S' word**, so as to use their sovereignty, separately and/or jointly, to fight against the political and economic hegemony, when the political and economic hegemony have still existed in contemporary world.

#### 4. Some discussions on 'Double Standards' etc

There have been some different opinions<sup>97</sup> in regard to my above-mentioned comments on the viewpoints of Prof Henkin and Prof Jackson. To summarize, these opinions can be roughly categorized into the following several types:

- (1) Both Prof Henkin and Prof Jackson are respectful scholars, and they don't serve as the 'instrument' or the so-called 'spear and shield' of the US government. Their ideas did not necessarily represent those of the US government and therefore do not function as self-serving excuses to be used by the US government.
- (2) Somebody also raise their suspicion on the understanding of the academic works of Prof Henkin and Prof Jackson. They doubt whether there exist 'partial quotations' of the works of the two professors.
- (3) It is strongly proposed among some scholars that the US is a state always actively advocates multilateralism in the international arena. For example, the US was one of the firmest propeller of the GATT (and later the WTO) and the UN, the most important international organizations in this world. Therefore, it seems lack of evidence to say that the US adopts a unilateralistic approach in dealing with international affairs.
- (4) Starting from a practical perspective, some scholars argue that, ever since the US joined the WTO, it has been the state that has lost the most cases, and therefore suffered the most in the WTO system.

<sup>97</sup> See Video Record, 'the Conference on International Economic Law and China in Its Economic Transition', held in Xiamen, China, Nov 4-5, 2004.



- (5) Finally, it has been proposed by some scholars that all politics are local and/or national. To be more specific, given that the US has adopted double standards in dealing with international affairs by resorting to either unilateralism or multilateralism out of its own interest, it is no denying that China and, in the large, all other states have acted in the similar way, too, because the decision-making of all states are driven by their respective state interests. Hence it is unfair to only reproach the US for its double standards while ignoring that similar situation for the rest of the world.

Admittedly, the above opinions are thought provoking. However, despite of the benefit I draw from them, I also think it is of paramount importance to clarify my ideas in discussion with the above opinions.

First, I would be happy to admit that both Prof Henkin and Prof Jackson have received worldwide acknowledgement for their outstanding academic achievements. Nevertheless, this does not prevent others from disagreeing with them at some academic points. A successful scholar receives social respect is one thing, while his proposition as to one specific matter is challenged is another thing. Social respect cannot conceal doubt and challenge. Besides, it should be stressed that the quotations from the works of the two professors were not 'partial' or 'out of context', but direct and accurate, ie the quotations were taken from the academic works written down in black and white by the two professors.

Second, it is true that US has been an active proponent of some international organizations, but this fact should be differentiated from being multilateralistic. I would propose to conduct a further exploration to the actual adoption of multilateralism by the US and its motives for so doing. Facts have shown that whether the US would strictly enforce multilateralism actually depends on whether the US could benefit from so doing. This is a result of a complicated process of assessing and comparing gains and losses of adopting multilateralism. When the US could benefit from multilateralism, it is willing to be a good player. On the contrary, when US could not benefit from doing so, it will stand on the opposite side by insisting on unilateralism. In recent years, the Section 201 Disputes, Section 301 Disputes and the US' withdrawal from the Kyoto Protocol to the United Nations Framework Convention on Climate Change are typical examples of its such stance.

Third, it might be as well argued that, by reviewing the WTO cases in general, the US is the one that has lost the most cases. But I would say, just like every coin has two sides, the US is no exception in joining WTO. So, when we are talking about who has lost the most, let us in the same time do not forget who has gained the most. In this sense, as everyone knows, the US is undoubtedly the biggest winner in the WTO mechanism in total.

Fourth, in light of the double standards issue, I would propose that even if the adoption of double standards in dealing international affairs actually constitute a global phenomenon to some extent, this does not serve to justify the US' stance in maintaining double standards and clinging to unilateralism. In my mind,

whether a state can, and to what extent, be justified by adopting double standards towards certain issues, should be tested depending on the actual and specific situation of that state. Admittedly, the adoption of double standards does harm to the international economic order. However, when we explore further as to the actual harm and impact this may create, we must differentiate from state to state according to the actual situation of the specific state in question. As the sole super power in this world, the injustice and harm incurred by the US' double standards and unilateralism is far more than that caused by a weak and small state. When the poor states are sometimes coerced to adopting unilateralism as their final resort merely for survival and existence, the US is always trying the same suit with a strong aim to become an even mightier super power. This, in turn, actually and significantly harms the global welfare and widens the already wide gap between the poor and the strong states. The final result will be a more imbalanced international community and a more unjustified world order.

Finally we must further differentiate upright scholars from the 'pragmatic', speculating politicians. It could be 'common' for those 'pragmatic' politicians to arbitrarily employ double standards in one same matter, but for any upright scholars, never should they take the double standards position when they comment on one same matter.

As a common sense of international law, (1) each state, strong or weak, big or small, has the sovereignty based on independence and equality; (2) each state shall fully respect the independent sovereignty of any other state; (3) each state has equal right to share benefits from the international community; (4) each state, in return for the benefit it shares, shall undertake the obligation to conduct appropriate self-restraint on its own sovereignty, so as to promote world prosperity on the basis of mutual benefit, equality, equity and multilateralism; (5) under the multilateral mechanism, such as UN and WTO, no state has the privilege of requiring any other state to do 'away with' its sovereignty in any excuse; also, no state has the privilege of stubbornly insisting on its vested hegemony under the camouflage of 'sovereignty'. Therefore, as an upright scholar and/or commentator, he/she should follow a *unified and unitary criterion rather than 'double standard', in treating the solemn sovereignty problem of all states*. It therefore seems hard to advocate that Prof Henkin's 'sovereignty discarding' theory is right but inapplicable to the US sovereignty, while Prof Jackson's 'sovereignty preserving' theory is also right, but also inapplicable to other states.

However, if Prof Jackson's theory get popular, ie each state insists on its unilateral selfishness while disregarding its international obligations, even after its concluding multilateral treaty and acceding related multilateral mechanism, how can the global multilateralism continue to exist and develop?

## V. 'THE GREAT 1994 SOVEREIGNTY DEBATE' AND SECTION 301

In fact and in essence, what WTO opponents and proponents argue over is *not* the economic sovereignty of the United States, but the economic hegemony of the United States. An obvious example of this aspect is the implementing practice of Section 301 of the US Trade Act<sup>98</sup> and the decision made by the US Congress after the Great Debate that Section 301 should continue to be implemented.

Section 301, familiar to everyone and appearing ubiquitously in Chinese and foreign newspapers, is the 'big stick' that the Office of the US Trade Representative (USTR)<sup>99</sup> frequently waves to threaten and make submissive its trade adversaries, and fully reflects the United States' economic hegemony in the area of international trade.<sup>100</sup> Though wordy, the core content of Section 301 is never ambiguous. Section 301 provides, in part:

<sup>98</sup> 19 USC. §§ 2411–20 (2003). Section 301 refers to § 301 of the US Trade Act of 1974, whose contents have been expanded through several amendments, and incorporated into the Omnibus Trade and Competitiveness Act of 1988, as s 301–310. These ten sections, as a whole, are habitually referred to as s 301.

<sup>99</sup> The USTR is appointed by the US President and approved by the Senate, with the rank of Ambassador Plenipotentiary and Extraordinary. Formerly, the USTR conducted US foreign trade negotiations. Since 1974, its office has been located in Washington, DC, and has become a permanent institution of the US government. Its authority has been extended constantly, participating in the US government's foreign trade decision-making, issuing policy guidance on foreign trade to other branches and departments of the US federal government, representing the US government in presiding or presenting various foreign trade negotiations, accepting the 'petition' of the US commercial actors and defending their rights and interests in foreign trade, implementing s 301 to initiate 'tort and contract breach' investigations on its trading partners of foreign governments, and determining whether or not to take retaliatory actions or impose sanction measures.

<sup>100</sup> For example, take the three retaliatory measures and economic sanctions that China encountered. In November of 1991, the USTR, under the pretext that China had failed to provide 'sufficient' and 'effective' protection for the intellectual property rights of US businesses, and failed to provide 'equitable' market access opportunity to those American businessmen, listed China as a 'Priority Foreign Country' to which s 301 should apply. PK Yu, *From Pirates to Partners: Protecting Intellectual Property in China in the Twenty-First Century*, 50 *Am Univ LR* 131, 141 (2001). Meanwhile, it unilaterally published a 'retaliatory list' against China with a resulting cost of \$1.5 billion. *Ibid* at 142. Through repeated consultations between the two sides, the dispute was ultimately resolved. *Memorandum of understanding Between China (PRC) and the United States on the Protection of Intellectual Property*, Jun 17, 1993, PRC-US, TIAS No 12036 (1995). However, on June 30, 1994, the United States played the old trick again, listing China once more as a Priority Foreign Country. UTSR, 1995 *Annual Rpt*, available at [http://www.ustr.gov/html/1996\\_tpa\\_monitor\\_3.html](http://www.ustr.gov/html/1996_tpa_monitor_3.html). Simultaneously, the USTR put forward many harsh requirements that directly contravened and interfered with China's legislation, jurisdiction, and internal affairs. For example, the United States required the amendment of Chinese civil law, shortening the time limit for judicial hearings, revising the provisions on the charge for civil litigation with the purpose of lowering the charge, engaging in a large-scale attack on torts committed against US intellectual property rights in China, reporting the results of such actions to the United States until it was satisfied, and quarterly reporting to the US government the 'situation of China's investigation and disposal of the torts on US intellectual property rights.' As the US requirements were too harsh, after seven rounds of consultations the dispute remained unsolved. DE Sanger, *US Threatens \$2.8 Billion on Tariffs on China Exports*, *NY Times*, Jan 1, 1995, at A14. Then, on December 31, 1994, the United States unilaterally announced its retaliatory list against China would increase in cost, to approximately \$2.8 billion, in

If the United States Trade Representative determines under section 304(a)(1) that: the rights of the United States under any trade agreement are being denied; or an act, policy, or practice of a foreign country—violates, or is inconsistent with, the provisions of, or otherwise denies benefits to the United States under, any trade agreement, or is unjustifiable and burdens or restricts United States commerce; the Trade Representative shall take action authorized in subsection (c), subject to the specific direction, if any, of the President regarding any such action, and shall take all other appropriate and feasible action within the power of the President that the President may direct the Trade Representative to take under this subsection, to enforce such rights or to obtain the elimination of such act, policy, or practice.<sup>101</sup>

an attempt to compel China to succumb. *Ibid* In response, China carried out direct, justified, favorable, and dignified counterattacks. MM Hamilton, *US to Hit China with Stiff Tariffs; Sanctions are Largest Ever Imposed*, *Wash Post*, Feb 5, 1995, at A1; Yu, above, at 144. On the one hand, China pointed out that the United States' use of unilateral retaliatory measures to cope with its trading partners was obviously in breach of the principle that disputes should be resolved through multilateral consultations, which is required by many international treaties and conventions, and thus should receive general condemnation in the international community. On the other hand, in accordance with Article 7 of the Foreign Trade Law of the People's Republic of China—which provides that if any country or region takes discriminatory, restrictive, or other similar measures of trade against China—China can take corresponding measures on the basis of factual circumstances. The Ministry of Foreign Trade and Economic Cooperation of the PRC (MOFTEC) published an 'intended anti-retaliatory list on the US', which provided that double tariffs would be levied on some large quantity goods imported from the United States, suspension of the import of other large quantity goods from the United States, suspension of the negotiations of some large-scale joint venture projects with US partners, and suspension of the applications of American businessmen to establish investment corporations in China. Yu, above, at 144. Meanwhile, it was clearly announced that 'the above measures would come into effect when the United States officially implemented its retaliation on Chinese exported goods'. *Ibid* at 144. Considering that its 'retaliation' and 'sanctions' on China could not be fulfilled, along with the possibility of losing the big market in China, the United States had to restrain itself from its former attitude and abolish some of its formerly adhered to harsh requirements. See Julia Chang Bloch, *Commercial Diplomacy*, in *Living with China: US-China Relations in the Twenty-First Century* 185, 197–98 (Ezra F Vogel (ed) 1997). On February 26, 1995, China and the United States reached a 'win-win' compromise in the form of 'exchange of notes;' thus an on-the-trigger 'trade war', evoked by the United States, was avoided. See Agreement Regarding Intellectual Property Rights, Feb 26, 1995, PRC-US, 34 ILM 881 (1995). Between the spring and summer of 1996, a trade dispute between China and the United States rose again. RW Stevenson, *US Cites China for Failing to Curb Piracy in Trade*, *NY Times*, May 1, 1996, at D4; Yu, above, at 148. The United States unilaterally listed China as the Priority Foreign Country under s 301, and announced a retaliatory list on China to the value of \$2 billion. *Ibid*, at D4; Yu, above, at 148. Correspondingly, the department of Chinese government solemnly declared again that '[t]o safeguard our national sovereignty and dignity, . . . we are forced to take corresponding anti-retaliation measures'. *The Announcement of the MOFTEC: The PRC's Anti-retaliation List on the US*, *People's Daily*, May 16, 1996 (on file with author); Sanger, above, at A1. The anti-retaliation list contained eight items and provided that '[t]he above measures would come into effect once the United States implemented its retaliatory measures on Chinese exported goods'. *Ibid*; Sanger, above, at A1. On June 17, 1996, through arduous negotiations, the two sides reached an acceptable agreement. China Implementation of the 1995 Intellectual Property Rights Agreement, Jun 17, 1996, PRC-US, available at <http://www.mac.doc.gov/China/Agreements.htm>. This new 'contest' demonstrated once again that the trade disputes between states, especially between large, powerful ones, should and could only be resolved justifiably and reasonably through equitable consultations. An action such as unilateral retaliation, which is merely bullying the weak by relying on one's power, is destined to end fruitlessly, and what is left is an arbitrary image.

<sup>101</sup> 19 USC § 2411(a).

Relying on both the authority and procedure provided by Section 301 and the economic dominance of the United States, subsection C authorizes the USTR to take various unilateral and compulsory retaliatory actions to compel its adversaries to eliminate the policy, act, or practice; to phase out their injury or restriction on US commerce; or to provide the United States with compensation that is satisfactory to the US government and its related economic sectors while disregarding other domestic law and international treaties.<sup>102</sup>

The purpose and practical function of Section 301 lie in its unilaterally set-up US criteria, justified or not, which compels other nations to open their domestic market by means of retaliatory threat and sanctions. Such hegemonic legislation and its implementation once gave rise to a wide range of reproaches and criticism in the international community, as this domestic act of the United States obviously deviated from the provisions of the GATT, a treaty both concluded and ratified by the United States. The United States adopted *unilaterally set-up criteria, unilateral judgment, and unilateral implementation* of retaliatory sanctions to replace the principle of multilateralism, where any dispute should be investigated and dealt with by a neutral panel and then reported to the GATT counsel for review which is reflected by the original GATT dispute settlement mechanism. Such an action is in breach of the international obligations that the United States committed itself to. However, the supremacy of US interests and national egoism is the constant reflection of US pragmatism in the area of international trade, which results in improper harassment of the normal international trade order in the international community. In view of this, during the UR, a majority of GATT contracting members, especially those who had experienced the attack of Section 301, were determined to strengthen the binding effect of the original dispute settlement mechanism of the GATT to stop the United States from its aggressive unilateralism and arbitrariness.<sup>103</sup>

During the period that the US representative signed the WTO Agreement and sent it to the US Congress for review and ratification, many congressmen made it clear that no changes in Section 301 would be tolerated.<sup>104</sup> Consequently, 'except for some minor procedural amendments, Section 301 remains intact'.<sup>105</sup> It was pointed out by some US experts that '[t]his statute . . . was perhaps *the most important political bellwether* of the sovereignty considerations in the Congress during the 1994 Debate'.<sup>106</sup>

Conspicuously, even though an US executive representative signed the WTO Agreement, the US legislature continues to enforce Section 301, in contravention of the WTO Agreement. The actual effect of this device inevitably leaves the

<sup>102</sup> 19 USC § 2411(a) § 2411; Y Zhang and Y Guan, *Section 301 of the US Trade Act, Int'l Trade* 6–9 (1992); G Yang, *Study on the Section 301 of the US Trade Act* 36–57 (1998); see generally United States—ss 301–10 of the Trade Act of 1974, WTO Panel Report WT/DS/152/R (Dec 22, 1999).

<sup>103</sup> Jackson, above n 33, at 183.

<sup>104</sup> *Ibid.*

<sup>105</sup> *Ibid.*

<sup>106</sup> *Ibid* at 183–4 (emphasis added).

United States *sitting on the fence with an ability to gain advantages from both sides*. In international trade disputes between the United States and its trading partners, particularly in cases where the United States is the defendant, if the conclusion and award made through the WTO dispute settlement procedure is in favor of the United States, the United States, as the winning party, will agree and accept the conclusion or award in a high-sounding manner to show that it strictly abides by the international treaty. On the other hand, if the conclusion or award is against the United States, making it the losing party, the United States—no longer able to play the old trick of blocking the enforcement of the Panel report or DSB decision—but can still cast away the DSB decisions like worn-out shoes and boycott, even retaliate against the winning party under the rhetoric of *safeguarding the United States' economic sovereignty and defending the United States' constitutional institutions*. In addition, the United States can abandon the DSB procedures of the WTO, unilaterally invoke Section 301, and impose accusations of engaging in unjustified trade on the defendant and adjudicate the case in accordance with its statute, in the dual capacities of both plaintiff and judge, all pursuant to its self-established statutory criteria! Furthermore, it is demonstrated that in the circumstance of power politics and hegemonic action, '[t]he international public law is nothing but on defaulted basis, while the powerful are able to tie others in accordance with their own law!'<sup>107</sup>

What the United States preciously cherished was the vigorously aggrandized sovereignty, the vested hegemony in the camouflage of 'sovereignty'. The US Congress, after its ratification of the WTO Agreement, still retains and enforces Section 301, and passionately continues to promote the adoption of the above-proposed legislation that 'the United States can't lose more than three times'.<sup>108</sup> Thus, the vested hegemony was doubly armored to resist sword and spear, and to keep itself immortal.

## VI. THE EU-US ECONOMIC SOVEREIGNTY DISPUTES CAUSED BY SECTION 301: ORIGIN AND PRELUDE

The US practice since the WTO Agreement's entry into force in January of 1995 demonstrates that the United States in fact acts upon the conclusion it came to during '*The Great 1994 Sovereignty Debate*': that although it entered into the multilateral system of the WTO, it was able to retain and pursue unilateralism under Section 301. In some circumstances, the United States indeed achieved the

<sup>107</sup> G Zhen, *Frightening Words in the Flourishing Age: Law of Justice* 42 (1898). It is amazing that since human society has stepped into the twenty-first century, the sigh of regret uttered by a thinker from a weak nation in the late nineteenth century is still of realistic importance, and is a sharp satire to the history and hegemony who do not change their mode of operation.

<sup>108</sup> Referring to A Bill to Establish a Commission to Review the Dispute Settlement Reports of the World Trade Organization and for Other Purposes, s 16, 104th Cong. (1995).

anticipatory aim of ‘sitting on the fence in order to gain advantages from both sides’, but in other situations new trade wars and disputes were triggered, making the United States a targeted country. The following are cases involving typical disputes.

### 1. US–Japan Auto Disputes

During the period before and after the WTO Agreement came into effect, the United States conducted a series of bilateral negotiations with Japan regarding Japan’s opening its market for automobiles and automobile parts. However, neither the United States nor Japan would budge from their viewpoints and the dispute remained unsolved.<sup>109</sup> The United States, as a member of the WTO, totally disregarded the multilateral dispute settlement mechanism of the DSU, instead relying directly on Section 301 and unilaterally declaring, on May 16, 1995, that it would levy 100 per cent ad valorem duties on thirteen different types of imported Japanese luxury-model automobiles.<sup>110</sup> Additionally, the United States withheld the liquidation of customs entries with respect to the automobiles, causing a detention of goods.<sup>111</sup>

Clearly, these were retaliatory measures and punitive sanctions. Faced with US unilateral retaliation, the Japanese government filed a request for consultation with the WTO/DSB on May 22, 1995, claiming that the measures taken by the United States constituted serious discriminatory treatment to Japanese commodities and was in breach of Articles 1 and 2 of the GATT and Article 23 of the DSU.<sup>112</sup> Japan further charged that the unilateral decision of the US

<sup>109</sup> Letter from Michael Kantor to Renato Ruggiero (May 9, 1995), in 141 *Cong Rec* S6433; James Gerstenzang, *US, Japan Still on Collision Course over Trade Diplomacy: Clinton and Murayama Meet at Summit, but Neither Budge on Sanction Threat*, *LA Times*, Jun 16, 1995, at 18.

<sup>110</sup> Statement by Ambassador Michael Kantor, Office of the USTR, Executive Office of the President (May 16, 1995), available at <http://www.ustr.gov/releases/1995/05/95-36.html> [hereinafter Kantor Statement]; WE Scanlan, *A Test Case for the New World Trade Organization’s Dispute Settlement Understanding: The Japan–United States Auto Parts Dispute*, 45 *Kan L Rev* 591, 605 (Mar 1997). This rate of duty is much higher than the binding tariff of 2.5% that the United States committed to on the tariff concession schedule. Calculated on the basis of the total value of the same category of imported goods in 1994, the total amount of the newly imposed tariff is \$590 million.

<sup>111</sup> Kantor Statement, above n 107.

<sup>112</sup> United State–Imposition of Import Duties on Automobiles from Japan under ss 301 and 304 of the Trade Act of 1974, WTO Doc. WT/DS6/1 (May 22, 1995) [hereinafter US–Japan Auto Disputes]; GATT, above n 57, Art 1 (providing that each contracting member must accord mutually with ‘general Most-Favored-Nation Treatment, [w]ith respect to customs duties and charges of any kind imposed on or in connection with importation or exportation or imposed on the international transfer of payments for imports or exports, and with respect to the method of levying such duties and charges, and with respect to all rules and formalities in connection with importation and exportation’, and that no discriminatory measures may be taken at will); GATT, above n 57, Art 2 (providing that each contracting member pledge to each other to levy tariffs subject to the listed preferential tariff in the annexed ‘tariff concession schedule’ of each member, and not to increase tariffs arbitrarily); DSU, above n 15, Art 23 (providing that the trade disputes arising between contracting members should be resolved in accordance with the DSU multilateral procedures and rules, and unilateral measures must not be taken willfully).

government had a significant adverse impact on the Japanese export industry in that goods with a value of over 108 million dollars that were scheduled to be exported to the United States were forced to stop being transported or had to be transported to other countries—the scheduled production plan with a value of 93 million dollars would have to be reduced.<sup>113</sup> Thereafter, through two rounds of negotiation, the United States and Japan reached an understanding on June 28, 1995.<sup>114</sup> The Japanese government accepted the United States' specific proposal for Japan to open its market for automobile and automobile parts, and promised to adopt specific measures to implement the proposal.<sup>115</sup> The US government, as a compromise, phased out its decision to levy an 100 per cent duty on automobiles imported from Japan and withholding the liquidation of customs.<sup>116</sup>

## 2. US–EC Banana Disputes

In February of 1996, and August of 1998, respectively, the United States and countries in the 'Dollar Banana District', including Ecuador, Guatemala, Honduras, and Mexico, jointly requested consultation with the EC pursuant to the WTO system, claiming that the various regulatory measures implemented by the EC in the importation and distribution of bananas from the above five countries made them enjoy less favorable treatment than that the EC conferred upon Contracting Members of the Lomé Convention, thus breaching the primary rule of the WTO, and constituting trade discrimination.<sup>117</sup> While the concerned negotiations were still in progress, the United States—on November 10, 1998, under the pretext that the proposed concession by the EC concerning the new banana importation regime was not consistent with the WTO, and on the basis of Section 301—unilaterally declared that it would issue a list of retaliation measures on the EC and a timetable to enforce the sanctions, threatening that unless the EC made further concessions the United States would impose trade sanctions at the beginning of 1999.<sup>118</sup>

The next day, November 11, 1998, EC President Jacques Santer responded by writing a letter to US President Clinton, warning that the United States' proposals would breach its international obligations under the WTO

<sup>113</sup> US–Japan Auto Disputes, above n 107.

<sup>114</sup> US–Japan Automotive Agreement, Aug 23, 1995, *reprinted in* 34 ILM 1482 (1995) [hereinafter Auto Agreement]; USTR Fact Sheet on US–Japan Auto and Auto Parts Agreement Released Jun 28, 1995, 12 *Int'l Trade Rep* (BNA) 1163, 1163–4 (Jul 5, 1995).

<sup>115</sup> Auto Agreement, above n 111.

<sup>116</sup> *Ibid.*

<sup>117</sup> European Communities–Regime for the Importation, Sale and Distribution of Bananas—Recourse to Article 21.5 by Ecuador, WTO Panel Report, WT/DS27/RW/ECU (Apr 12, 1999) [hereinafter Ecuador Panel Report].

<sup>118</sup> James Cooper, *Spirits in the Material World: A Post Modern Approach to United States Trade Policy*, 14 *Am U Int'l L Rev* 957, 972 (1999); S Fidler and N Bucklar, *US Threatens 100% Tax on European Union Exports in Banana Trade War*, *Fin Times*, Nov 11, 1998, at 1 (including cheese, clothing, cosmetics, electronic goods, paper and wine among the products threatened with tariffs).



Agreement.<sup>119</sup> EU Trade Commissioner Sir Leon Brittan further pointed out that although the United States was authorized to raise queries and disagreements on the new banana importation regime implemented by the EC on January 1, 1999, it was not empowered to threaten the EU with unilateral sanctions.<sup>120</sup> Director General of the WTO Renato Ruggiero argued that both sides should resolve the dispute within the DSU multilateral system established by the WTO Agreement.<sup>121</sup> After continual failed negotiations, the EC, in accordance with Article 22.6 of the DSU, submitted a request for arbitration.<sup>122</sup> On January 29, 1999, the DSB decided to establish an arbitral tribunal.<sup>123</sup> After the establishment of the arbitral tribunal, the United States, under the pretext that the arbitral proceeding was not prompt enough, initiated lightning-like retaliation on March 3, 1999, and announced that it would unilaterally levy 100 per cent retaliatory ad valorem duties as punishment on twenty categories of popular goods exported to the United States from such EC members as Britain, Italy, Germany, and France, totaling \$520 million.<sup>124</sup>

The arbitrary action taken by the United States sharply escalated the 'Banana War', and the multilateral system established by the WTO was confronted with a serious threat.<sup>125</sup> The United States' action was condemned by many representatives who attended a WTO emergency conference.<sup>126</sup> On April 9, 1999, the

<sup>119</sup> *EU Attacks Clinton over Bananas*, BBC News, Nov 11, 1998, available at [http://news.bbc.co.uk/1/hi/business/the\\_economy/212262.stm](http://news.bbc.co.uk/1/hi/business/the_economy/212262.stm); S Bates and L Elliott, *Banana War Puts Global Economy at Risk*, *The Guardian*, Nov 12, 1998, available at <http://www.guardian.co.uk/banana/Story/0,2763,208538,00.html> [hereinafter *Banana Wars*]. In his letter to President Clinton, Jacques Santer stated that '[n]o WTO member had the right unilaterally to determine whether another member is in compliance with WTO rules'. *Ibid.*

<sup>120</sup> Press Release No 97/98, European Union, Statement by Sir Leon Brittan: EU/US Banana Dispute (Nov 10, 1998), available at <http://www.eurunion.org/news/press/1998-4/pr97-98.htm>. Nigel Gardner, spokesman for European Trade Commissioner Sir Leon Brittan, was also quoted as saying, 'What we will not do is negotiate with the gun of unilateralism illegally at our heads'. *Fight Over Banana Trade Escalates*, *Natl LJ* (Nov 30, 1998), at A14.

<sup>121</sup> *Banana Wars*, above n 116.

<sup>122</sup> European Communities—Regime for the Importation, Sale and Distribution of Bananas—Recourse to Arbitration by the European Communities under Article 22.6 of the DSU, WTO Arbitrator Dec, WT/DS27/ARB (Apr 9, 1999) [hereinafter European Communities Arbitration].

<sup>123</sup> *Ibid.* ¶ 1.1.

<sup>124</sup> JR Schmertz, Jr and M Meier, *US–EU Banana Dispute Continues Despite WTO Arbitration: EU Issues Regulation to Increase Support to its ACP Banana Suppliers*, *Int'l L Update*, May 1999, at 5; Implementation of WTO Recommendations Concerning the European Communities' Regime for the Importations, Sale, and Distribution of Bananas, 64 Fed. Reg. 19209 (Apr 19, 1999); Eliza Patterson, *The US–EU Banana Dispute*, ASIL INSIGHTS, Feb 2001, <http://www.asil.org/insights/insigh63.htm> [hereinafter *The US–EU Banana Dispute*].

<sup>125</sup> John Lloyd, *Yanks Go Home . . . But Not Just Yet: US Sanctions*, *NEW STATESMAN*, Mar 12, 1999, at 14.

<sup>126</sup> *Banana Deal Frittered Away*, BBC NEWS, Dec 19, 1999, available at <http://news.bbc.co.uk/1/hi/business/238370.stm>; C Denny and S Bates, *Bananas: It's a Trade War*, *The Guardian*, Mar 5, 1999, available at <http://www.guardian.co.uk/banana/Story/0,2763,208540,00.html>; *Crisis Talks Over Bananas*, BBC NEWS, Mar 8, 1999, available at [http://news.bbc.co.uk/1/hi/business/the\\_economy/292041.stm](http://news.bbc.co.uk/1/hi/business/the_economy/292041.stm); *US Declaring War Over Bananas*, BBC NEWS, Mar 8, 1999, available at <http://news.bbc.co.uk/1/hi/world/292654.stm>; Mark Milner, *WTO Talks up Banana Peace*, *THE GUARDIAN*, Mar 8, 1999, available at <http://www.guardian.co.uk/banana/Story/0,2763,209337,00.html>.

DSB Panel Report was issued and the arbitral award was made.<sup>127</sup> The Panel Report concluded that the EC's new banana importation regime was inconsistent with the Most-Favored-Nation treatment and the National Treatment stipulated in the GATT and GATS, and recommended that the DSB require the EC to make further revisions on the new regime.<sup>128</sup> The arbitration panel decided that the EC's new regime had constituted injury to the US interest, but that the actual loss was \$191.4 million instead of the \$520 million that was originally claimed by the United States.<sup>129</sup> In other words, the actual loss only accounted for 36.8 per cent of what the United States claimed, ie, the original us claim of \$520 million was with 63.2 per cent inflation and extortion! On April 9, 1999, the United States requested authorization from the DSB to retaliate on the basis of the amount determined by the arbitral award, and the authorization was given to the United States on April 19, 1999.<sup>130</sup>

The international dispute ended with a partial financial win for the United States. The United States, however, has paid the great price of its international credit and image for its reckless waving of the 'big stick', otherwise known as Section 301, to implement a unilateral threat after it has undertaken its international obligations under the multilateral system of WTO/DSB.

### 3. EC-US Section 301 Dispute

Due to the United States' continuous use of Section 301 during the Banana Dispute, on November 25, 1998, the EC requested consultations with the United States in accordance with Article 22.1 of the GATT and Article 4 of the DSU, with the intent of addressing the US use of Section 301 after the WTO and its multilateral dispute settlement mechanism, the DSU, came into effect.<sup>131</sup> Clearly, the intention of the EC was to open up a second battlefield so as to transform its position as the defendant in the Banana Dispute into the plaintiff in the Section 301 Dispute. Thus, the United States, truculent in the Banana Dispute, was forced to play defense in the new proceeding.

<sup>127</sup> *The US-EU Banana Dispute*, above n 121.

<sup>128</sup> European Communities—Regime for the Importation, Sale and Distribution of Bananas—Recourse to Article 21.5 by the European Communities, WTO Panel Report, WT/DS27/RW/EEC (Apr 12, 1999), 7.1–7.2 [hereinafter European Communities Panel Report].

<sup>129</sup> European Communities Arbitration, above n 119, 1.1, 8.1. On April 11, 2001, the United States and the EU reached an understanding in their long running dispute over bananas that called for the EU to adopt a new licensing system for bananas by Jul 1, 2001. In return, the United States lifted retaliatory duties on \$191 million worth of EU products. See *US Trade Representative Announces the Lifting of Sanctions on European Products as EU Opens Market to US Banana Distributors*, Office of the United States Trade Representative, Executive Office of the President, Jul 1, 2001, <http://www.useu.be/Categories/Bananas/BananaUSSanctionsEUJuly1.html>.

<sup>130</sup> *The Week in Review*, *Natl LJ*, Apr 19, 1999, at A8.

<sup>131</sup> United States—ss 301–10 of the Trade Act of 1974, WTO Panel Report, WT/DS152/R (Dec 22, 1999), ¶ 1.2 [hereinafter ss 301–10 Panel Report]; L Zhu (ed), *Analysis of WTO Dispute Settlement Cases*, 563–71, 2000.

From the date of the official operation of the WTO/DSU multilateral dispute settlement mechanism until July 13, 2001, the total number of disputes requiring consultations or determinations under the DSU amounted to 234. Compared with other disputes, the EC's claims in this dispute were peculiar. First, normally the objects of the dispute concern the treatment of a certain category of commodity or certain specific commodities; however, in the present case the complaint focused on the United States' hegemonic Section 301 legislation. Second, generally the disputes do not directly or clearly involve the struggle of economic sovereignty between the concerned states, although they may involve the concrete economic interests of the states. However, the present dispute between the EU and the United States reflected, rather directly and conspicuously, the restricting and anti-restricting practice of economic sovereignty between the two big powers. As for the United States, it consistently regarded the hegemonic Section 301 as its lifeblood to safeguard its economic sovereignty. Although the United States entered into the WTO multilateral system, the United States believed that the Act could not be crippled, let alone be abolished. Otherwise, the United States would not hesitate to withdraw from the WTO, which was discussed earlier in this paper.<sup>132</sup> On the other hand, the EC persistently regarded the Lomé Convention, concluded with 70 odd developing countries in Africa, the Caribbean, and the Pacific region—and the 'generalized non-reciprocal and non-discriminatory [tariff] preferences' conferred to the latter—as its significant measure of exercising economic sovereignty and promoting the cooperation between the North and the South.<sup>133</sup> Once the WTO Agreement had officially come into effect, the original mechanisms implemented by the EC in accordance with the Lomé Convention were gradually transformed to be consistent with the new WTO system.

However, during the Banana Dispute, the United States, without waiting for a determination to be made by the WTO/DSU multilateral rules, frequently threatened sanctions in accordance with its unilateral, hegemonic Section 301 legislation. Confronted with such hegemonic actions, which impaired the EC's economic sovereignty, the EC refused to submit willingly and targeted Section 301 in hopes of *catching the ring leader, cutting the weed, and digging out the roots*.

As it is well known, a number of countries have suffered to varying degrees from the United States' invocation of Section 301. When the EC first initiated the Section 301 Dispute, many WTO members—including the Dominican Republic, Columbia, Panama, Guatemala, Mexico, Jamaica, Honduras, Japan, and Ecuador—quickly echoed a request to participate in the consultations as interested third parties in accordance with Article 4.11 of the DSU.<sup>134</sup> All the

<sup>132</sup> See above Part V.

<sup>133</sup> ss 301–10 Panel Report, above n 128, ¶ 5.150.

<sup>134</sup> See United States—ss 301–10 of the Trade Act of 1974, Request to Join Consultations, WTO Doc WT/DS152/9 (Dec 14, 1998) (Communication from Columbia), WT/DS152/2 (Dec 9, 1998) (Communication from Dominican Republic), WT/DS152/3 (Dec 9, 1998) (Communication from

requests were granted. On December 17, 1998, the disputing parties held consultations but were unable to settle the dispute.<sup>135</sup> Upon the request of the EC, the DSB decided on March 2, 1999, to establish a panel to deal with this dispute.<sup>136</sup> David Hawes, Terje Johannesen, and Joseph Weiler were selected for the panel, with David Hawes acting as Chairman.<sup>137</sup> The terms of reference were:

To examine, in the light of the relevant provisions of the covered agreements cited by the European Communities in document WT/DS 152/11, the matters submitted to the DSB by the EC in that document and to make such findings as will assist the DSB in making its recommendations or in giving its rulings according to the above mentioned agreements.<sup>138</sup>

In the mean time, other countries that suffered from Section 301 declared, one after another, that they reserved their rights to participate in the panel proceedings as third parties.<sup>139</sup> Those WTO members include Brazil, Cameroon, Canada, Columbia, Costa Rica, Cuba, Dominican Republic, Ecuador, Hong Kong (China), India, Israel, Korea, St. Lucia, and Thailand.<sup>140</sup> An unprecedented situation developed in which thirty-six WTO members, including the fifteen EC member states and twenty-one state or regional members of the WTO, requested participation in the panel proceeding as third parties so that they could jointly condemn Section 301. The United States was more isolated than ever!

During the panel proceeding, the EC, the United States, and the third parties engaged in fierce ‘sword-like’ verbal debates. In essence, the hostility and debate among many WTO members, ignited by Section 301 of the US Trade Act, fully reflected a new battle on the restriction and antirestriction of economic sovereignty among nations under the new accelerated economic globalization. The process not only reflected the fight between the global economic hegemon and other economic powers on economic sovereignty, but also indicated new contests between many economically weak countries and the global economic hegemon on economic sovereignty. Accordingly, the dispute attracted the world’s attention.

Pursuant to Articles 12.8 and 12.9 of the DSU, the period in which the panel must conduct its examination, from the date that the composition and the terms

Panama), WT/DS152/4 (Dec 9, 1998) (Communication from Guatemala), WT/DS152/5 (Dec 14, 1998) (Communication from Mexico), WT/DS152/6 (Dec 14, 1998) (Communication from Jamaica), WT/DS152/7 (Dec 14, 1998) (Communication from Honduras), WT/DS152/8 (Dec 14, 1998) (Communication from Japan), WT/DS152/10 (Dec 14, 1998) (Communication from Ecuador); DSU, above n 15, Art 4.11.

<sup>135</sup> s 301–10 Panel Report, above n 128, ¶ 1.2.

<sup>136</sup> *Ibid* ¶ 1.5.

<sup>137</sup> *Ibid* ¶ 1.7.

<sup>138</sup> *Ibid* ¶ 1.5.

<sup>139</sup> United States—ss 301–10 of the Trade Act of 1974, Constitution of the Panel Established at the Request of the European Communities, WTO Panel Report, WT/DS152/12 (Apr 6, 1999).

<sup>140</sup> *Ibid*.

of reference of the panel have been agreed upon until the date the final report is issued to the parties to the dispute, must not exceed six months.<sup>141</sup> If it is impossible to conclude the proceedings in time, upon approval of DSB, the time limit can properly be prolonged, but in no case should the period from the establishment of the panel to the circulation of the report to the Members exceed nine months.<sup>142</sup> The deadline for this case was December 31, 1999.<sup>143</sup> On December 22, 1999, the panel issued a lengthy, 351-page concluding report.<sup>144</sup> Neither the EC nor the United States requested an appeal, and the DSB formally passed the Panel Report on January 27, 2000.<sup>145</sup>

Although the Panel Report was issued in time and no appeal was submitted, a series of latent perils were left behind, which deserved further discussion. In the following text, the arguments of the EC and United States, the main contents of the Panel Report, and the latent perils left behind are introduced and analyzed.

## VII. THE EU-US ECONOMIC SOVEREIGNTY DISPUTES CAUSED BY SECTION 301: CLAIMS AND REBUTTALS

### 1. The Claims of the EC Representatives

The EC representatives claimed that the United States, after the WTO Agreement established the multilateral system, still retained and enforced the unilateral retaliation and sanctions laid down in Sections 301–310 of the US Trade Act, which was in derogation of the international obligations the United States undertook when it signed the WTO Agreement.<sup>146</sup> The EC particularly emphasized that what the United States stipulated in its Trade Act was inconsistent with the provisions that concerned the ‘*strengthening of the multilateral system*’ as laid down in Article 23 of the DSU.<sup>147</sup>

Article 23.2(a) of the DSU provides that in case of a trade dispute, WTO members must settle the dispute in accordance with the rules and procedures established by the DSU.<sup>148</sup> No member may unilaterally make a determination to the effect that its ‘[trade] benefits have been nullified and impaired’.<sup>149</sup> In determining whether its benefits have been impaired, members ‘shall make any such determination consistent with the findings contained in the panel or Appellate Body report adopted by the DSB or an arbitration award rendered

<sup>141</sup> DSU, above n 15, Art 12.8.

<sup>142</sup> *Ibid* Art 12.9.

<sup>143</sup> ss 301–10 Panel Report, above n 128.

<sup>144</sup> *Ibid*.

<sup>145</sup> United States—ss 301–10 of the Trade Act of 1974, WTO Panel Report, WT/DS152/14 (Feb 28, 2000).

<sup>146</sup> ss 301–310 Panel Report, above n 124, ¶¶ 3.1, 4.1–4.18, 4.26–4.48, 4.100–4.199, 4.126, 4.146–4.153.

<sup>147</sup> *Ibid* ¶¶ 4.1, 4.3; DSU, above n 15, Art 23 (emphasis added).

<sup>148</sup> DSU, above n 15, Art 23.2(a).

<sup>149</sup> *Ibid*.

under this Understanding'.<sup>150</sup> However, Section 304(a)(1)(A) of the US Trade Act requires the USTR to determine whether another member denies the United States rights or benefits under the WTO Agreement, irrespective of whether the DSB adopted the findings on the matter contained in the panel or Appellate Body report.<sup>151</sup> Meanwhile, Section 306(b) requires the USTR to unilaterally determine whether a recommendation of the DSB has been implemented, irrespective of whether the multilateral proceedings on this issue under the DSU have been completed.<sup>152</sup> Therefore, the above provisions of the US Trade Act have obviously breached what is set forth in the DSU.

Article 23.2(c) provides that if a WTO member fails 'to implement the recommendations and rulings within [a] reasonable period of time' the winning party must follow the multilateral procedures of the DSU 'to determine the level of suspension of concessions or other obligations and obtain DSB authorization in accordance with those procedures before suspending concessions or other obligations under the covered agreements'.<sup>153</sup> However, Section 306(b) requires the USTR to determine and carry out sanctions under Section 301 and Section 305(a) in cases where the opposing party fails to implement the DSB recommendations, irrespective of the scope and level that the DSU multilateral system determines, and without the DSB's authorization.<sup>154</sup> It is obvious that the stipulations in the US Trade Act directly breach what is in the DSU.

Articles I, II, III, VIII, and XI of the GATT stipulate that mutual favored treatment and common obligations—such as the Most-Favored-Nation Treatment, Schedules of Concessions, the National Treatment, Reducing Fees and Simplifying Formalities connected with Importation and Exportation, and Elimination of Quantitative Restriction—should be adhered to by all WTO members.<sup>155</sup> In other words, all disputes must be solved in accordance with the multilateral system. Section 306(a), however, requires the USTR to unilaterally make determinations on whether to impose high duties, fees, or restrictions on imported goods from foreign countries involved in trade disputes.<sup>156</sup> It is obvious that the provisions of the US Trade Act violate one or more of the above GATT provisions.

Additionally, even if Section 301–310 could be interpreted to permit the USTR to have options in implementing the law to avoid WTO-inconsistent unilateral determinations and retaliatory actions, it could also be interpreted to permit the USTR to have discretion to unilaterally make determinations inconsistent with the WTO multilateral system and to invoke retaliatory sanction measures. Therefore, it is obvious that the provisions of Sections 301–310 cannot be regarded as a sound legal basis for the implementation of the United

<sup>150</sup> *Ibid.*

<sup>151</sup> 19 USC § 2414(a)(1)(A) (2003).

<sup>152</sup> 19 USC § 2416(b) (2003).

<sup>153</sup> DSU, above n 15, Art 23.2(c).

<sup>154</sup> 19 USC § 2416.

<sup>155</sup> GATT, above n 57, arts. I, II, III, VIII, XI.

<sup>156</sup> 19 USC § 2416.

States' obligations under the WTO. The lack of this sound legal basis is sure to produce a situation of threat and legal uncertainty against other WTO members and their economic operators.<sup>157</sup> This will fundamentally undermine the 'security and predictability' of the multilateral trading system.<sup>158</sup>

What is more, the apparent confusion in Sections 301–310 is nothing more than a deliberate policy, providing a particular mode for the United States to invoke administrative measures and deviate from the WTO multilateral system at any time. In fact, the United States—by maintaining legislation such as Sections 301–310, which on its face and by its intent mandates unilateral determinations and actions in breach of the United States' obligations under the DSU and the WTO—implements a deliberate policy pursuing double objectives: the USTR may make a unilateral determination or evoke unilateral sanctions so that the rival may be directly 'killed' or may surrender at the threat of being 'killed'. Such a scheme could be called the 'Damocles sword effect'.<sup>159</sup>

In its argument to the Panel, the EC maintained that in particular, United States' Section 301 was deployed to create a constant threat, 'the Damocles sword effect', using it 'as a "bargaining" tool in order to extract extra trade concessions' and preferential interests.<sup>160</sup> Even after the entry into force of the WTO Agreement, the conduct of the United States remained unchanged, disregarding its international obligations under the WTO legal system. The United States acted unilaterally in the Banana Dispute, impairing the interests of the EC Other members of the WTO, such as Canada, Korea, Hong Kong (China), India, Japan, and Brazil, however, had identical experiences and suffered greatly both before and after the conclusion of the WTO Agreement. Accordingly, they all condemned the unilateral practice of Section 301, and supported and concurred with the EC's charges against the United States.<sup>161</sup> Ultimately, the EC argued that in consideration of all of the above factors, Sections 301–310 of the US Trade Act, may *in no case*, be regarded as consistent with what is laid down in Article 16.4 of the WTO Agreement and with the WTO legal system.<sup>162</sup> Article 16.4 of the WTO Agreement expressly provides that '[e]ach Member shall ensure the conformity of its laws, regulations and administrative procedures with its obligations as provided in the annexed Agreements'.<sup>163</sup> Sections 301–310 of the US Trade Act, the EC argued, breached several of the above-cited provisions of the WTO legal system and its international obligations, and the EC requested the panel to clearly rule that:

<sup>157</sup> ss 301–10 Panel Report, above n 124.

<sup>158</sup> *Ibid* ¶ 4.35.

<sup>159</sup> *Ibid* ¶¶ 4.43–4.44, 7.5–7.6. The term 'Damocles sword effect' originates from Greek mythology in which the tyrant Dionysius ordered his official Damocles to be seated. A sword was hung by a horse's mane over Damocles' head, indicating that Damocles was in jeopardy.

<sup>160</sup> *Ibid* ¶ 4.46.

<sup>161</sup> *Ibid* ¶¶ 4.45–4.48.

<sup>162</sup> ss 301–10 Panel Report, above n 128, ¶ 4.59

<sup>163</sup> *Ibid* (quoting WTO Agreement Article XVI:4).

the United States, by failing to bring the Trade Act of 1974 into conformity with the requirements of Article 23 of the DSU and of Articles I, II, III, VIII, and XI of the GATT 1994, acted inconsistently with its obligations under those provisions and under Article XVI.4 of the WTO Agreement and thereby nullifies or impairs benefits accruing to European Communities under [those Agreements]; and to recommend that the DSB request the United States to bring its Trade Act of 1974 into conformity with its obligations under the DSU, the GATT 1994, and the WTO Agreement.<sup>164</sup>

## 2. The Rebuttals of the United States

In view of the claims and requests of the EC, the United States responded with the following arguments:

Sections 301–310 do not prevent the United States from following to the letter the requirements of the DSU. This legislation provides ample discretion to the United States Trade Representative to pursue and comply with multilateral dispute settlement procedures in every instance . . . . The European Communities may not assume that the USTR will exercise this discretion in a WTO-inconsistent manner. . . .<sup>165</sup>

Nevertheless, the reason this case has been filed is because European Communities found itself in the position of having failed to comply with DSB rulings and recommendations in [the Banana Dispute].<sup>166</sup>

Sections 301–310 provide more than adequate discretion to the USTR [to pursue] and comply with DSU Article 23 and other WTO obligations in every case. Section 304 permits the USTR to base her determinations [whether the trade interests of the United States are impaired] on adopted panel and Appellate Body findings in every case. And Section 306 permits, in every case, the USTR to request and receive DSB authorization to suspend concessions in accordance with DSU Article 22 . . . Sections 301–310 are thus consistent with DSU Article 23, Article XVI:4, and GATT Articles I, II, III, VIII, and XI.<sup>167</sup>

The law is the protector of both the weak and the strong, equally. It protects the small and the large, equally. It protects the popular and the unpopular, equally. . . . The United States knows that Sections 301–310 are not popular. But the WTO and the DSU are not a clubs to be used in a popularity contest against any one Member. If they are to protect the weak credibly, they must also protect the strong against attacks not on what they have done, but on who they are.<sup>168</sup>

Sections 301–310 allow the USTR to comply fully with United States' obligations under the WTO Agreement and its annexes. This law by its mere existence violates none of [the United States' obligations under the WTO system]. The EC's transparent efforts to turn this proceeding into a forum for making political attacks on United States' trade policy only highlight the absolute void at the center of its legal case.<sup>169</sup>

<sup>164</sup> *Ibid* ¶ 3.1.

<sup>165</sup> *Ibid* ¶ 4.51.

<sup>166</sup> *Ibid* ¶ 4.52.

<sup>167</sup> ss 301–10 Panel Report, above n 128, ¶ 4.58.

<sup>168</sup> *Ibid* ¶ 4.62.

<sup>169</sup> ss 301–10 Panel Report, above n 128, ¶ 4.65.



The United States indicate[d] that its Administration has, in the Statement of Administrative Action approved by Congress, provided its ‘authoritative expression . . . concerning its views regarding the interpretation and application of the Uruguay Round agreements . . . for the purposes of domestic law’ . . . the USTR will:

- invoke DSU dispute settlement procedures, as required under current law;
- base any Section 301 determination that there has been a violation or denial of US rights under the relevant agreement on the panel or Appellate Body findings adopted by the DSB;
- following adoption of a favorable panel or Appellate Body report, allow the defending party a reasonable period of time to implement the report’s recommendations; and
- if the matter can not be resolved during that period, seek authority from the DSB to retaliate.<sup>170</sup>

The Statement of Administrative Action (SAA) provides:

This statement describes significant administrative actions proposed to implement the Uruguay Round agreements . . . this statement represents an authoritative expression by the Administration concerning its view regarding the interpretation and application of the Uruguay Round agreements, both for purposes of US international obligations and domestic law. Furthermore, the Administration understands that it is the expectation of the Congress that the future Administrations *will observe and apply* the interpretations and commitments set out in this Statement. Moreover, since this statement will be approved by the Congress at the time it implements the Uruguay Round agreements, the interpretations of those agreements included in this Statement carry particular authority.<sup>171</sup>

The US explicitly, officially, repeatedly, and unconditionally confirmed the commitments expressed in the SAA namely that the USTR would . . . ‘base any Section 301 determination that there has been a violation or denial of US rights under the relevant agreement on the panel or Appellate Body findings adopted by the DSB’.<sup>172</sup>

That is to say, US law precludes [the USTR’s] affirmative determination not based on adopted panel or Appellate Body findings.<sup>173</sup>

Based on the above reasons, the United States requested that the panel rule explicitly:

That [the] European Communities has [sic] failed to meet its burden of establishing that Sections 301–310 of the Trade Act of 1974 are inconsistent with DSU Article 23, WTO Agreement Article XVI:4, and GATT 1994 Articles I, II, III, VIII, and XI, and that Sections 301–310 are therefore not inconsistent with these obligations,<sup>174</sup> . . .

<sup>170</sup> *Ibid* ¶ 4.121.

<sup>171</sup> ss 301–10 Panel Report, above n 128, ¶ 7.110 (emphasis added).

<sup>172</sup> *Ibid* ¶ 7.115.

<sup>173</sup> *Ibid* n 683; The Uruguay Round Agreements Act: Statement of Administrative Action at 366, reprinted in HR Doc. No 103–316 [hereinafter SAA].

<sup>174</sup> ss 301–10 Panel Report, above n 128, ¶ 4.65.

[that] Sections 301–310 . . . do not mandate action in violation of any provision of the DSU or GATT 1994, nor do they preclude any action consistent with those [WTO] obligations,<sup>175</sup> . . . [and must] reject the EC’s speculative arguments in their entirety.<sup>176</sup>

#### VIII. THE WTO/DSB PANEL REPORT ON THE SECTION 301 CASE

The Panel for the dispute was initiated on March 31, 1999. The whole proceeding lasted about nine months, during which the EC’s charges and claims, and the responses of the United States, together with the condemnations against Section 301 by the twelve countries and regions participating in the proceeding as third parties, were fully heard by the Panel. On December 22, 1999, the Panel issued its final report to the concerned parties and submitted it for DSB approval.<sup>177</sup> As the report was not appealed, the DSB formally passed the final Panel Report on January 27, 2000.<sup>178</sup>

In the lengthy 351-page report, the Panel initially concluded that:

Our function in this case is *judicial*. In accordance with Article 11 of the DSU, it is our duty to ‘make an objective assessment of the facts of the case and the applicability of and conformity with the relevant covered agreements, and make such other findings as will assist the DSB in making recommendations or in giving the rulings provided for in the covered agreements’.<sup>179</sup>

The mandate we have been given in this dispute is limited to the specific EC claims. . . . We are *not* asked to make an *overall assessment* of the compatibility of Sections 301–310 with the WTO Agreements. . . . We are, in particular, not called upon to examine the WTO compatibility of *US actions taken in individual cases* in which Sections 301–310 have been applied.<sup>180</sup>

In determining whether Section 304 constituted a violation of DSU 23.2(a), the Panel found that:

Section 304(a) requires the USTR to determine *whether* US rights are being denied within 18 months. It does not require the USTR to determine *that* US rights are being denied at the 18 months deadline.<sup>181</sup>

[W]e find that even though the USTR is not *obligated*, under any circumstance, to make a Section 304 determination . . . it is not *precluded* by the statutory language of Section 304 itself from making such a determination.<sup>182</sup>

Therefore, pursuant to examination of text, context and object-and-purpose of [DSU] Article 23.2(a) we find, at least *prima facie*, that the statutory language of Section

<sup>175</sup> *Ibid* ¶ 3.2.

<sup>176</sup> *Ibid* ¶ 4.145.

<sup>177</sup> United States—ss 301–10 of the Trade Act of 1974, WTO Panel Report, WT/DS152/14 (Feb 28, 2000).

<sup>178</sup> *Ibid*.

<sup>179</sup> ss 301–10 Panel Report, above n 128, ¶ 7.12 (emphasis added).

<sup>180</sup> *Ibid* ¶ 7.13 (emphasis added).

<sup>181</sup> *Ibid* ¶ 7.31(c) (emphasis added).

<sup>182</sup> *Ibid* ¶ 7.31(d) (emphasis added).

304 precludes compliance with Article 23.2(a). . . . Under Article 23 the US promised to have recourse to and abide by the DSU rules and procedures, specifically not to take unilateral measures referred to in Article 23.2(a). In Section 304, in contrast, the US statutorily reserves the right to do so. In our view, because of that, the statutory language of Section 304 constitutes a *prima facie* violation of Article 23.2(a).<sup>183</sup>

We [do] not conclude that a violation has been confirmed. This is so because of the special nature of the Measure in question. The Measure in question includes statutory language as well as other institutional and administrative elements. To evaluate its overall WTO conformity we have to access all of these elements together.<sup>184</sup>

One of the institutional and administrative elements the Panel refers to concerns the SAA, which was submitted by the US President for congressional approval. With regards to the SAA, the Panel determined that:

[T]he US Administration has carved out WTO covered situations from the general application of the Trade Act. It did this in a most authoritative way, *inter alia*, through a Statement of Administrative Action (SAA) submitted by the President to, and approved by, Congress. Under the SAA so approved ‘. . . it is the expectation of the Congress that future administrations would observe and apply the [undertakings given in the SAA]’. This limitation of discretion would effectively preclude a determination of inconsistency prior to exhaustion of DSU proceedings.<sup>185</sup>

The SAA thus contains the view of the Administration . . . concerning both interpretation and application and containing commitments, to be followed also by future Administrations, *on which domestic as well as international actors can rely*.<sup>186</sup>

On this point, the Panel totally supports and accepts the arguments of the United States on Section 301, and repudiates and rejects the claims of the EC. However, during the proceedings, the EC called the Panel’s attention to another paragraph, which contained ambivalent statements in the SAA, and which is cited repeatedly by the United States as the authoritative administrative statement.

There is *no basis for concern* that the Uruguay Round agreements in general, or the DSU in particular, will make future Administrations *more reluctant* to apply section 301 sanctions that may be *inconsistent* with US trade obligations because such sanctions could engender DSU-authorized counter-retaliation . . . Just as the United States may now choose to take section 301 actions that *are not GATT authorised*, governments that are the subject of such actions may choose to respond in kind. That situation *will not change* under the Uruguay Round agreements. The risk of counter-retaliation under the GATT *has not prevented* the United States from taking action in connection with such matters as semi-conductors, pharmaceuticals, beer, and hormonetreated beef.<sup>187</sup>

<sup>183</sup> ss 301–10 Panel Report, above n 128, ¶ 7.97 (emphasis added).

<sup>184</sup> *Ibid* ¶ 7.98.

<sup>185</sup> *Ibid* ¶ 7.109 (emphasis added).

<sup>186</sup> *Ibid* ¶ 7.111 (emphasis added).

<sup>187</sup> *Ibid* ¶ 4.108 (emphasis added) (quoting SAA, above n 164). The word ‘now’, as used in this para refers to Sept of 1994, when the SAA was sent to Congress for approval. The WTO Agreement had not come into effect at that time, so international trade was conducted in accordance with the 1947 GATT.

The EC contends that this portion of the SAA, providing for an authoritative interpretation of the URAA, the implementing statute, announces in very clear and unambiguous terms that the United States will not feel impeded by its international obligations to continue having recourse to retaliatory action of unilateralism.

The Panel, not persuaded to accept the EC's analysis, admitted, however, that 'some of the language in the SAA appears ambivalent'.<sup>188</sup> They noted 'however that, following US constitutional law, cases of ambiguity in the construction of legal instruments should, where possible, always be resolved in a manner consistent with US international obligations'.<sup>189</sup> The Panel concluded 'that it [was] possible to do so in this case'.<sup>190</sup>

In consideration of the above reasons, the Panel to this dispute comes to the following conclusions:

(a) Section 304(a)(2)(A) of the US Trade Act of 1974, is not inconsistent with Article 23.2(a) of the DSU; (b) Section 306(b) of the US Trade Act of 1974, . . . is not inconsistent with either Article 23.2(a) of the DSU; or 23.2(c) of the DSU; (c) Section 305 (a) of the US Trade Act of 1974, is not inconsistent with Article 23.2(c) of the DSU; (d) Section 306 (b) of the US Trade Act of 1974, is not in consistent with Articles I, II, III, VIII, and XI of GATT 1994. . . [A]ll these conclusions are based in full or in part on the US Administration's undertakings mentioned above. It thus follows that should they be repudiated or in any other way removed by the US Administration or another branch of the US Government, the findings of conformity contained in these conclusions would no longer be warranted.<sup>191</sup>

#### IX. THE EQUIVOCAL LAW-ENFORCING IMAGE CONCLUDED FROM THE PANEL REPORT

The Section 301 Dispute Panel findings are rather impressive when we take a comprehensive look at the above Panel findings and conclusions. The Panel's decision can be characterized with four observations. *First*, the Panel creates a limit for its own duty, being overly cautious, dares not to transgress the 'mine bounds', and is irresponsible for its duties. *Second*, the Panel is *shilly-shalling* towards the two powers, and is smooth and slick in ingratiating itself with both sides. *Third*, the Panel leaves the offender at large, criticizing the offender pettily while doing it great favor. *Fourth*, the Panel is partial to and pleads for hegemony, and thus, leaves a lot of suspicions and hidden risks. Therefore, it is not surprising that international scholars make a general valuation on the final report of the Panel, commenting that '[w]hile the United States—Section 301 Panel Report is politically *astute*, its legal underpinnings are *flawed* in some

<sup>188</sup> ss 301–10 Panel Report, above n 128, ¶7.113.

<sup>189</sup> *Ibid.*

<sup>190</sup> *Ibid.*

<sup>191</sup> *Ibid* ¶8.1.

respects and its policy implications for the future of the WTO Dispute Settlement Body generate serious concerns'.<sup>192</sup> The above observations concluded from the Panel's report are further analyzed below.

### 1. The Panel Creates a Limit for Its Own Duty, Is Overly Cautious, Dares Not Transgress the 'Mine Bounds', and Is Irresponsible for Its Duties

Since the enactment of Section 301 of the US Trade Act of 1974, the USTR has frequently waved this 'big stick' to threaten and force its trading partners into submission, and to extract extra hegemonic economic interests. The record of the United States' practice in the last twenty years sufficiently shows that it met ample condemnation in the world public opinion. The US government is aware of this opinion, admitting that '[t]he United States knows that Sections 301–310 are not popular'.<sup>193</sup>

During the proceeding, '[i]n addition to the EC, twelve of the sixteen third parties expressed highly critical views of this legislation'.<sup>194</sup> This situation clearly indicates that Section 301 and the US related practices have aroused public indignation among many WTO members. Faced with this reality, the Panel felt compelled to note this US confession in its final report, stating that '[i]n its submissions, the US itself volunteered that Sections 301–310 are an unpopular piece of legislation'.<sup>195</sup>

Subsequently, however, the Panel limits its terms of reference with a 'three-not' mandate. The Panel determines that its purpose is: 1) not 'to make an overall assessment of the compatibility of Sections 301–310 with the WTO Agreements;' 2) not to examine other aspects beyond the specific EC claims; and 3) not 'to examine the WTO compatibility of US actions taken in individual cases in which Sections 301–310 have been applied'.<sup>196</sup> The Panel claims that its function is *judicial*, yet when encountered with the offending indignation aroused by the hegemonic legislation and the related practices of the United States in the international community, the panel chooses to impose on itself the 'three-not' limit, fails to strictly enforce the law, and fails to investigate and examine the hegemonic legislation in order to determine the cardinal question of right or wrong. This review style strikingly reflects the Panel's image that they act too cautiously so as to avoid transgressing the bounds of mines, as if they were faced with the abyss or treading on thin ice. In other words, they lack the courage and boldness to act upright, without flattery, and to enforce the law strictly.

<sup>192</sup> SW Chang, *Taming Unilateralism Under the Trading System: Unfinished Job in the WTO Panel Ruling on United States Sections 301–310 of the Trade Act of 1974*, 31 *Law & Pol'y Int'l Bus* 1151, 1156 (2000) (emphasis added).

<sup>193</sup> ss 301–10 Panel Report, above n 128, ¶ 4.62.

<sup>194</sup> *Ibid* ¶ 7.11.

<sup>195</sup> *Ibid*.

<sup>196</sup> *Ibid* ¶ 7.13.

In fact, the function, authority, and terms of reference of the Panel are generally provided for in DSU Article 11, that is, in addition to making an objective assessment of the facts of the case and the applicability of and conformity with the relevant covered agreements, the panel should ‘*make such other findings as will assist the DSB in making the recommendations or the rulings provided for in the covered agreements*’.<sup>197</sup> This can be taken as the legitimate power and terms of reference rendered by the WTO/DSU system to the DSB panel. When necessary, the panel *should* enlarge its scope and depth of review according to the related issues to make such other findings.

As far as this case is concerned, the concrete claims of the EC involve some critical articles of Sections 304–306 of the US Trade Act. These articles are closely related with other articles of Section 301 and constitute an indispensable part of Section 301 as an organic whole. If the Panel is the one that strictly abides by its function and terms of reference provided for in DSU Article 11, how could it consciously neglect and evade such an integral part of Section 301? How could it avoid making an overall assessment on the illegitimacy of the hegemonic legislation and its consistency with the WTO system in its entirety? How could it turn a deaf ear to and ignore the *specific practices* of legislation that have aroused the indignation of the world? How could it fail to thoroughly investigate, but indeed pardon the specific hegemonic practices of Section 301 complained of by over thirty WTO members? Indeed, the Panel failed to judge right from wrong, and failed to assist the DSB in making a correct determination in accordance with the related provisions. Is not such a short-sighted judicial examination of the Panel a violation of the law? Is it not irresponsible for the panel’s duties?

Such adjudication, however, brings to mind a popular fable. *A* was hurt by an arrow and went for treatment from doctor *B*. *B* took out a small saw, sawed the arrow shaft outside *A*’s body off, then announced the completion of the operation and requested compensation. *A* was perplexed, pointing out that the metal arrowhead remained in his body. *B* responded, ‘I’m a physician who is only responsible for the portion outside your body; as for the metal arrowhead within your body, you should go to a surgeon!’

## 2. The Panel Hovers between the ‘Two Powers’ in Its Attempt to Ingratiate Itself with Both Sides

Among the concerned parties in the dispute, the claimants consist of the fifteen countries of the EC, including Germany, United Kingdom, France, and Italy, which are four economically powerful countries; and the respondent is the superpower of global economic hegemony—the United States. Also concerned parties in the dispute are the participating third parties, sixteen of which are

<sup>197</sup> *Ibid* ¶7.119 (emphasis in original); DSU, above n 15, Art 11.

WTO members, including Japan and Canada. The latter two are also economically powerful nations. The third parties concurred completely with the EC in its arguments before the Panel. Therefore, this can be characterized as a dispute between two powers, one that is opposing Section 301, and the other defending it. The leading actors in the dispute are the most economically developed ‘Seven’,<sup>198</sup> which are divided into two sides. Between the two sides, a great war broke out that centered on the restriction and anti-restriction of its own economic sovereignty. This circumstance in the history of world trade development is rare, if not unprecedented. Although the superpower is very formidable, it stands alone; and particularly when opposed by six powerful nations, who have substantial WTO members’ support, it faces considerable power and opposition. The Panel judging the dispute is thereby caught between the two bigs.

After the final Panel Report was circulated among the members of the WTO on December 22, 1999, both parties to the case announced they would not seek an appeal. However, in their related statements, they both report a positive outcome, illustrating each sides’ mental victory. The USTR issued a press release on December 22, 1999, announcing that the dispute settlement Panel of the WTO ‘has rejected a complaint by the European Union, upholding the WTO-consistency of Section 301 of the Trade Act of 1974’.<sup>199</sup>

US Trade Representative Charlene Barshefsky triumphantly and arrogantly stated that ‘[s]ection 301 has served, and will continue to serve, as a cornerstone of our efforts to enforce our international trade rights’.<sup>200</sup>

To be sure, the US statement of *victory* is not totally without basis, as the final Panel Report determined that Section 301 is not inconsistent with the WTO/DSU system.<sup>201</sup> However, the United States avoids mentioning the precondition and reservation on which the determination is based—ie, it was alleged and asserted that the US Administration, in the SAA, has promised to preclude the USTR’s discretion to make unilateral determinations or retaliatory sanctions prior to the exhaustion of DSU proceedings or without the DSB’s authorization. Should the US Administration repudiate the preconditions, the above findings would not be justified and the United States would incur state responsibility because the existence of Section 301 would then be rendered inconsistent with its obligations under the WTO system. Thus, the United States’ statement of *victory*, which avoids mentioning the preconditions and reservations, should be considered ‘*emasculated*’, and could be rendered meaningless at any time.

<sup>198</sup> The G7, they are Germany, United Kingdom, France, Italy, Japan, Canada, and the United States.

<sup>199</sup> Press Release No 99-102, Office of the US Trade Representative, WTO Panel Upholds s 301 (Dec 22, 1999), available at <http://www.ustr.gov/releases/1999/12/99-102.html>.

<sup>200</sup> *Ibid.*

<sup>201</sup> ss 301–10 Panel Report, above n 128, ¶ 7.115.

On December 23, 1999, just after the issuance of the United States' press release, the EU Trade Commissioner, Pascal Lamy, also issued a press release, in which he stated that:

[t]he EU notes *with satisfaction* the WTO Panel's now published report on the Section 301 case. This is a fair result, a balanced outcome to a difficult case, but overall, it is *a victory for the multilateral system*. Neither side can claim a triumph, because while the Section 301 legislation can stay on the books, the Panel has clarified that it can be used against other WTO members only as long as it strictly follows WTO rules. I am glad the United States has given the necessary commitments to these effects.<sup>202</sup>

The EC's statement of *victory* is also not totally without basis. Through this *new-case*-igniting, the EC effectively curbed the \$520 million claim of the United States in the banana case, compelling the WTO/DSU to reduce the US compensation to \$191.4 million, thereby eliminating the 63.2 per cent inflation and extortion claimed by the United States in the banana *old-case*.<sup>203</sup> Furthermore, it prompted the United States, during the proceedings, to state repeatedly that in the future it would implement Section 301 strictly under the WTO multilateral system. However, the main goals of the EC, namely, to deny and abolish the unilateral and hegemonic legislation of Section 301 through the recommendation or determination of the DSB, were far from satisfied. Therefore, the so-called '*victory* of the multilateral system' is rather very limited and very unstable, for the *bane* remains and the chronic disease of Section 301 may recur at any time in the future.

The final Panel Report, having not been appealed by either party, was formally adopted by the DSB on January 27, 2000. The international public has levied both praise and criticism for the Panel Report. One international author commented that '[t]he Panel decision seem[ed] to be a fair "political" decision that pleased both parties, or at least enabled them to save face. However, this panel decision is *legally weak*, even though it is not entirely wrong'.<sup>204</sup> This overall assessment seems not to be without basis. In light of the fact that both sides claimed *victory* and the Panel's way of ingratiating itself with both parties, the Panel displays an undeniable '*astute*' skill at avoiding the core issues.

### 3. The Panel Leaves the Offender at Large, Criticizing Pettily While Doing it Great Favor

In the final Panel Report, quoting copiously from various sources, the Panelists expounded in great length on the general rules and principles guiding the

<sup>202</sup> Press Release No 86/89, Delegation of the European Commission to the United States, WTO Report on US s 301 Law: A Good Result for the European Union and the Multilateral System (Dec 23, 1999), available at <http://www.eurunion.org/news/press/1999/1999086.htm>.

<sup>203</sup> See above s VI.B.

<sup>204</sup> Chang, above n 189, at 1185.



interpretation of international treaties provided for in Article 31 of the Vienna Convention on the Law of Treaties, and proved that the statutory language of Section 301 is inconsistent with the WTO/DSU multilateral system and that the United States actually did breach its international obligations.<sup>205</sup> However, the Panel's opinion swerved suddenly and concluded, in even greater length and energy, that the plain words and the definite meaning in the statutory provisions only constituted *prima facie* evidence,<sup>206</sup> and thus could not be relied upon to determine that the hegemonic legislation was inconsistent with the WTO and the United States' international obligations.<sup>207</sup> Subsequently, the Panel again invoked Article 11 of the DSU as the basis of its competence, casting away the self-imposed 'three-not' limits that had confined it to analysis of the claims themselves.<sup>208</sup> The Panel exceeded Section 301 *per se* by distracting peoples' attention *beyond* Section 301 to the United States' institutional and administrative elements.<sup>209</sup> Quoting laboriously and rationalizing the SAA and the solemn pledge and obtuse statements of the US representative,<sup>210</sup> the Panel concluded that the SAA can revise and abolish the formal legislation of the US Congress, that the SAA had curtailed the USTR's *discretion* to make unilateral determinations according to Section 301, and consequently confirmed that the unilateral hegemonic legislation of the United States was not inconsistent with the WTO multilateral system. However, as for the ambivalent sections of the SAA, the Panel, under the pretext of US constitutional principles, endeavored to persuade the world to rely on the United States', the economic hegemon's assurances that it would make interpretations of its own hegemonic law strictly in conformity with its international obligations.<sup>211</sup>

A general survey of the integral reasoning process and the method employed by the Panel manifests that its trick was appallingly identical to the behavior of some politicians in the political arena—for example, saying East for the purpose of saying West; just producing clouds with the hand upper-turned, while promptly producing rain with the same hand over-turned; negating in the abstract but confirming in the specific; and criticizing a bit while conferring great favor!

#### 4. The Panel Is Partial to and Pleading for Hegemony and Thus Leaves a lot of Suspicions and Hidden Perils

In brief, the Panel's attitudes and approaches toward the Section 301 Disputes aforesaid could be objectively summarized as *partial to* and *pleading for* the

<sup>205</sup> ss 301–10 Panel Report, above n 124, ¶¶ 7.58–7.79.

<sup>206</sup> *Ibid* ¶ 7.98.

<sup>207</sup> *Ibid* ¶¶ 7.104–7.113.

<sup>208</sup> *Ibid* ¶¶ 7.119, 7.13.

<sup>209</sup> *Ibid* ¶ 7.98.

<sup>210</sup> ss 301–10 Panel Report, above n 124, ¶ 7.109.

<sup>211</sup> *Ibid* n 681.

contemporary *hegemony*. A lot of Remaining Suspicions and Hidden Perils, which have been left, are the inevitable destination of the three adjudicating ways and dispute-settling styles as mentioned above in points 1, 2 and 3. In essence, the Remaining Suspicions and Hidden Perils are the inevitable results of the panel's lacking of the courage and boldness to act uprights without flattery, and to enforce the related international laws and WTO rules righteously. The following Part X of this paper will conduct a concise analysis of these inevitable destination and results.

## X. THE REMAINING SUSPICIONS AND LATENT PERILS ENTAILED BY THE PANEL REPORT

Scrutinizing the content and the final conclusions of the Panel Report, one can perceive the legal suspicions and latent perils embodied therein.

### 1. The First Suspicion and Latent Peril

*Is the SAA that was submitted by the US President and approved by the US Congress indeed a mandatory binding statute?*

As stated above, the Panel approved and affirmed the arguments of the United States, confirming that the SAA had lawfully and effectively curtailed the discretion vested with the USTR by Section 301, so that the latter could not make unilateral determinations or resort to unilateral retaliatory measures prior to the exhaustion of the DSU proceedings.<sup>212</sup>

Manifestly, the affirmation and determination of the Panel is premised on the fact that the related statements in the SAA have a mandatory binding effect on the USTR. However, after a careful check of the key words in the key paragraphs in the SAA, it can be concluded that the premise of a mandatory binding effect does not exist at all.

The original text of the SAA reads as follows:

Although it will enhance the effectiveness of Section 301, the DSU does not require any significant change in Section 301 for investigations that involve an alleged violation of a Uruguay Round agreement or the impairment of US benefits under such an agreement. In such cases, the Trade Representative *will*:

- invoke DSU dispute settlement procedures, as required under current law;
- base any Section 301 determination that there has been a violation or denial of US rights under the relevant agreement *on* the panel or Appellate Body findings adopted by the DSB;
- allow the defending party a reasonable period of time to implement the report's recommendations; and

<sup>212</sup> *Ibid* ¶7.112.

- if the matter cannot be resolved during that period, *seek* authority from the DSB to retaliate.<sup>213</sup>

In the above paragraph, the word ‘*will*’ is the key word. As far as the original meaning of ‘*will*’ is concerned, it is a *soft, discretionary, optional, and ambiguous* auxiliary verb. In the legal vocabulary, it differs totally from ‘*shall*’, a rigid, compulsory, resolute, non-negotiable, and execution-force auxiliary verb. In the above listed actions, the SAA doesn’t direct that the USTR ‘*shall invoke*’, ‘*shall base*’, ‘*shall allow*’, or ‘*shall seek*’ when carrying out the investigations. In short, the four actions listed in the SAA are not compulsory executive directions; thus the SAA is not a compulsory statute with a binding legal effect.

The preamble of the SAA provides that ‘[f]uture Administrations *will* observe and apply the interpretations and commitments set out in this Statement’.<sup>214</sup> These words reveal again that the US Administration *has no intention at all* of treating the SAA statements, interpretations, and commitments on the relationship between Section 301 and the WTO system as an administrative order so as to *direct* future US Administrations to strictly *abide* by them.

Furthermore, as the EC brought to light during the proceeding, the SAA contains clearly ambivalent statements that state publicly that there is no basis for concern that the WTO/DSU will make future Administrations more reluctant to apply Section 301 unilateral sanctions.<sup>215</sup> Until the SAA was submitted to the US Congress for approval in September of 1994, the USTR could willingly and dauntlessly apply Section 301 unilateral sanctions without the DSB’s authorization. The situation remains unchanged. The United States can *continue* to dauntlessly persist in its *old way*.<sup>216</sup> In this context, recalling the historic ‘Great Sovereignty Debate’ that took place in the US Congress between the ‘Sovereignty Confidence Group’ and the ‘Sovereignty Anxiety Group’, it seems obvious that this paragraph of the SAA is the proclamation, statement, and appeasement made by the ‘Sovereignty Confidence Group’ with the aim of eliminating the ‘Sovereignty Anxiety Group’s’ apprehension and anxiety toward the new WTO/DSU multilateral system.

This would explain why the US Administration repeatedly adopted the word ‘*will*’ in the SAA and made ambivalent statements and declarations in the same document. It further indicates that the US Administration is never willing to be absolute, but rather leaves an adequate margin for itself to persist in the implementation of Section 301. It also accurately reflects the United States’ mentality and reluctance to part with hegemonic actions. The US Congress approved both the SAA and the Uruguay Round Agreement Act, indicating that the ‘egoism,

<sup>213</sup> SAA, above n 164, at 365–6 (emphasis added); *see also* ss 301–10 Panel Report, above n 124, ¶ 7.112 (quoting the SAA at 365–6).

<sup>214</sup> SAA, above n 210, at 1; *see also* ss 301–10 Panel Report, above n 128, ¶ 7.110.

<sup>215</sup> SAA, above n 210, at 366.

<sup>216</sup> The Panel ‘recognize[d] of course that an undertaking given by one Administration can be repealed by that Administration or by another Administration’. ss 301–10 Panel Report, above n 124, ¶ 7.109.

unilateralism, pragmatism, and fence-sitting' philosophy and codes of conduct of the United States' ruling class were once again 'effectively applied' and vividly manifested.

Those sitting on the Panel are inevitably those learned scholars who are well-versed in legal science and English. However, they consciously evaded the twice-used key word '*will*' and its legal meaning. In response to the ambivalent statements in the SAA, the Panel pleads for the United States to 'follow the interpretation principle' of the US Constitution. However, by making controversial conclusions based on the interpretation principle of the US Constitution, they negated the irrefutable conclusions of the worldwide-accepted interpretative principles provided for in Article 31 of Vienna Convention on the Law of Treaties. Furthermore, the Panel arbitrarily transformed the weak, ambiguous, and ambivalent statement in the SAA into an US '*guarantee*' that would preclude it from making unilateral determinations in the international community, thereafter asking the international communities to *rely* on it. How can this way of pleading and examination not be suspected of being partial to hegemony?

## 2. The Second Suspicion and Latent Peril

*Does the USTR, after the entry into force of the WTO Agreement, truly abide by the commitments and 'guarantees' made in the SAA?*

During the proceedings, the United States flatly denied that the USTR had ever taken any unilateral retaliatory action. The relevant statement reads as follows:

The record shows that the [US] Trade Representative has never once made a Section 304(a)(1) determination that US GATT or WTO agreement rights have been denied which was not based on the results of GATT and WTO dispute settlement proceedings. Not once.<sup>217</sup>

In responding to this overall denial by the United States, the EC pointed out that the USTR had published the retaliatory list in the banana case before the exhaustion of DSU proceedings.<sup>218</sup> Japan, as an interested third party to the dispute, further pointed to the USTR's publishing of the retaliatory list in the Automobile Parts Dispute.<sup>219</sup> Jointly, they refuted and exposed the United States' unjustified denial.

Both of these unilateral acts took place after the SAA and WTO/DSU had come into effect. The lists were not only conspicuously registered in the US Federal Register, but also appeared in the Section 301 Tables of Cases compiled

<sup>217</sup> ss 301–10 Panel Report, above n 128, ¶ 7.128.

<sup>218</sup> On Apr 19, 1999, the WTO/DSU proceedings were exhausted and the United States was given permission to publish the retaliatory list by the DSB. However, on Dec 21, 1998, the United States unilaterally published its retaliatory list of sanctions on the EC, *four months* prior to the exhaustion of the DSU proceedings.

<sup>219</sup> In the Automobile Parts Dispute, the United States unilaterally published its retaliatory list on May 16, 1995, without recourse to the DSB in accordance with the DSU.

by the USTR Bureau themselves.<sup>220</sup> These irrefutable facts strongly demonstrate that the statement in the SAA made by the US Administration to the USTR is *devoid* of legally binding effect. The actions of the USTR to date show that it does not abide by the commitments and ‘*guarantees*’ made in the SAA, but rather casts them away like worn-out shoes. It is also a sufficient indication that the SAA statements are, in essence, nothing more than crafty maneuverings and double-faced tactics to deceive the public.

However, even in the face of such irrefutable facts, the Panel unexpectedly pardoned the United States, stating that ‘[w]e are, in particular, not called upon to examine the WTO compatibility of US actions taken in individual cases’.<sup>221</sup> ‘We do not consider the evidence before us sufficient to overturn our conclusions regarding Section 304 itself’.<sup>222</sup>

In conducting a comprehensive survey of the proceedings in the above two cases, one can perceive that the United States, after its anticipated goals were accomplished by waving the ‘big stick’ to threaten its opposition, ceased at the proper time and did not formally carry out its original unilateral retaliatory sanctions. According to the United States’ self-defending logic—that because the USTR did not actually execute its original unilateral retaliatory sanctions in the above two cases—the United States does not breach its international obligations under the WTO system. According to this logic, the Charter of the United Nations should not ban the using of military threats in international relations, and the criminal law of every nation should not stipulate that blackmail is a criminal offense; in other words, under this logic, threatening other nations ‘does not breach international law’, and blackmail ‘is not a violation of criminal law’. Is this not ridiculous?

Nevertheless, it is this kind of ridiculous logic that the Panel adopted in its final report. What is worse, it is no different from encouraging the United States to wreak havoc in international trade by relying on its unilateral hegemonic ‘big stick’ in subsequent practice. Consequently, its influence would definitely bring about additional weakening and devastation to the WTO/DSU multilateral system. The critical issue then becomes whether the action of carrying out threats and relying on Section 301 is *per se* inconsistent with the WTO, whether it repudiates the United States’ international obligations, and whether the United States should incur state responsibility.

<sup>220</sup> Notice of Determination and Request for Public Comment Concerning Proposed Determination of Action Pursuant to s 301: Barriers to Access to the Auto Parts Replacement Market in Japan, 60 Fed Reg 26745 (May 18, 1995); Press Release No 98-113, Office of the US Trade Representative, Executive Office of the President, USTR Announcing List of European Products Subject to Increased Tariffs, (Dec 21, 1998) (on file with author); Implementation of WTO Recommendations Concerning the European Communities’ Regime for the Importation, Sale and Distribution of Bananas, 63 Fed Reg 71, 665–6 (Dec 29, 1998); Press Release No 99-17, *United States Takes Customs Action on European Imports* (Mar 3, 1999) (on file with author); s 301 Table of Cases, Japan Auto Parts No 301–93, The EC and the Importation, Sale, and Distribution of Bananas No 301-100 (Aug 9, 1999), available at <http://www.ustr.gov/reports/301report/act301.htm>.

<sup>221</sup> ss 301–10 Panel Report, above n 128, ¶ 7.13.

<sup>222</sup> *Ibid* ¶ 7.130.

### 3. The Third Suspicion and Latent Peril

*Is the 'Damocles sword effect' of Section 301 really consistent with the WTO/DSU multilateral system? Does it not repudiate the United States' international obligations?*

As stated above, the formal implementation of Section 301 of the US Trade Act of 1974 is a frequently waved 'big stick', utilized by the USTR to threaten its trading partners. Relying on the formidable 'Damocles sword effect' created by the 'big stick', the United States repeatedly fulfilled its anticipated goals and enjoyed incredible benefits. According to the Section 301 Table of Cases compiled by the USTR Bureau, from July 1, 1975 to August 5, 1999, 119 cases were investigated over the course of twenty-four years. In only fifteen of these cases were trade sanctions actually imposed. In the remaining 104 cases, almost 87.4 per cent of all the trading partners were compelled to succumb to the enormous pressure of the 'big stick'. This shows that the mere publishing of possible retaliatory measures is sufficient to create a formidable and threatening influence, forcing the United States' trading partners, especially those economically small and weak countries, to accede to open their markets or to reach agreements that favor the United States. Experience has shown that the might of Section 301 lies in the threat of a trade sanction, rather than the sanction itself.<sup>223</sup>

Whenever the USTR invokes Section 301, it follows a certain procedure.<sup>224</sup> First, upon receiving the petition and allegations from the interested person, the USTR determines to initiate an investigation after review and then publishes the summary of the case in the Federal Register; meanwhile, it requests consultations with the concerned foreign country regarding the issue involved in the investigation.<sup>225</sup> Second, the interested persons of the United States are invited to bring forth verbal comments, including new petitions and allegations.<sup>226</sup> Third, public hearings are held to seek advice from the petitioners.<sup>227</sup> Fourth, a preliminary retaliatory list is announced, the list is presented to the foreign countries concerned, and necessary revisions and supplements are made to the retaliatory list with the development of the case.<sup>228</sup> Finally, the retaliatory sanctions are actually implemented.<sup>229</sup>

In this law enforcing process, the powerful US media actively helps disseminate the news and create a great sensation. The media sensation not only

<sup>223</sup> Chang, above n 189, at 1157; JL Eizenstat, *The Impact of the World Trade Organization on Unilateral United States Trade Sanctions under Section 301 of the Trade Act of 1974: A Case Study of the Japanese Auto Dispute and the Fuji-Kodak Dispute*, 11 *Emory Int'l L Rev* 137, 153–4 (arguing that the Congressional intent underlying s 301 is to open foreign markets by creating 'credible threats of retaliation').

<sup>224</sup> See 19 USC § 2411.

<sup>225</sup> *Ibid.*

<sup>226</sup> *Ibid.*

<sup>227</sup> *Ibid.*

<sup>228</sup> *Ibid.*

<sup>229</sup> 19 USC § 2411.

constitutes a great mental threat to the United States' trading partners in the negotiation process, but actually compels the concerned enterprises confronted with the occasional retaliatory risks such as high tariff rates, high regulatory fees, customs suspension and other deliberate difficulties, to carry out risk avoiding measures in advance to eliminate their inner apprehensions. Such measures include: reducing or stopping goods being transported to the United States; shifting the goods originally transported to the United States to other countries; or increasing the insurance premiums, etc—which all result in a sharp increase in price of the concerned goods, greatly weakening or even utterly depriving the concerned commercial undertaking, and thus denying the chance of fair competition in the international market.

In light of this, it is the United States' reliance upon its economic dominance that led it to implement its hegemonic, Section 301. Ever since the formal publishing of the case in the Federal Register and the initiation of investigation, the increasingly consolidated 'Damocles sword effect' has *substantively* caused continuously significant discriminatory treatment of relevant trading partners, economic actors and goods, and, consequently, has *substantively* violated the most fundamental principles in the WTO/GATT international trade system: the principles of the Most-Favored-Nation Treatment and the National Treatment.<sup>230</sup> Concerning *procedure*, the 'Damocles sword effect' violates and tramples the fundamental principles of the WTO/DSU system: multilateral adjudication and examination to solve disputes. In other words, this 'Damocles sword effect' has breached and infringed upon relevant trading partners' both *substantive* and *procedural* privileges and interests under the WTO multilateral system, far before retaliatory sanctions are formally implemented. As to this action, the United States continues acting at will and refuses to deviate from its pre-WTO old track. In doing so, the United States totally repudiates the international obligations it has under the WTO system.

Countering with the startlingly conspicuous 'Damocles sword effect' and its destructive consequence on the WTO system, the Panel, in its lengthy final report, only casually mentioned it and never penetrated it deeper. However, on the same pretexts of the statements in the SAA and interpretation of US constitutional principles, it determined not to investigate further.<sup>231</sup> The objective effect of this method of examination actually confuses the significant falsehood and truth, mixes up black and white, wrong and right, and thus consequently connives and encourages the economic hegemony.

#### 4. The Fourth Suspicion and Latent Peril

*Does the exemplary effect and its consequent influence of partiality and connivance in the Panel Report on US Section 301 not affect the general situation?*

<sup>230</sup> DSU, above n 15, Art 2.

<sup>231</sup> See ss 301–10 Panel Report, above n 128, ¶¶ 7.89–7.92.

*Should we therefore see no harm in letting it go, or is this a matter of significance which should not be ignored?*

As stated earlier, the struggles and debates launched on the hegemonic act of Section 301 reflected the new conflicts between WTO members on the restriction and anti-restriction of economic sovereignty during the new acceleration of global economic integration. In the contesting process, the United States, on one side, under the big flag of safeguarding its economic sovereignty by asserting execution of Section 301 as its offending weapons and defending magic weapons, has striven to maintain and enlarge its in-hand economic hegemony and to retain its global economic hegemony. This purport, as early as 1994, had floated onto the surface during ‘*The Great 1994 Sovereignty Debate*’. It was widely spread and advocated and thus became the ‘most political bellwether’ in the Congress’ review.<sup>232</sup> The EC and numerous other WTO members, on the other hand, in having recourse to the WTO multilateral system, requested that the United States revise and relegate Section 301 in the hope of restricting and weakening US economic hegemony and defending their constantly impaired economic sovereignty. Facing such a globally important dispute, the Panelists, to be responsible and impartial, should take the basic provisions in the WTO/DSU system as their codes and rules of conduct.

The WTO Agreement, in its preamble and Article 16.4, explicitly provides that its objectives are to establish ‘an integrated, more viable, and durable multilateral trading system’ through the joint efforts of the contracting members.<sup>233</sup> It additionally provides that each Member must ensure the conformity of its laws, regulations, and administrative procedures with its obligations as provided in the annexed agreements.<sup>234</sup>

The DSU, an accessory to the WTO Agreement and a forcible guarantee of its objectives, explicitly provides in its General Provisions: ‘The dispute settlement system of *the WTO is a central element in providing security and predictability to the multilateral trading system*’.<sup>235</sup> Its first objective is usually to secure the withdrawal of the measures concerned if these are found to be inconsistent with the provisions of any of the covered agreements.<sup>236</sup> Correspondingly, the function of panels established under the DSU is to make an objective assessment of the facts of the case and the applicability of and conformity with the relevant covered agreements, and make such other findings as will assist the DSB in giving rulings provided for in the covered agreements.<sup>237</sup> These provisions expressly stipulate specific functions and codes of conduct for the Panel in adjudicating each dispute.

<sup>232</sup> See above Part V of this paper.

<sup>233</sup> DSU, above n 15, at pmb1.

<sup>234</sup> *Ibid* Art 16.4.

<sup>235</sup> *Ibid* Art 3.2 (emphasis added).

<sup>236</sup> *Ibid* Art 3.7.

<sup>237</sup> *Ibid* Art 11.



Reviewing Section 301, which aroused the indignation of the international community and is sternly condemned by thirty-plus WTO members, the Panel did not investigate or make such findings in assisting the DSB to make recommendations and rulings for the United States to revise and relegate the notorious hegemonic statute, even though it was fully aware that the specific provisions and practices of Section 301 actually breached many agreements in the WTO multilateral system. The Panel, by the above means of ‘criticizing pettily while doing great favor’, deceived the public and affirmed Section 301 flatly, allowing Section 301 to be preserved and remain intact. The final Panel Report is obviously partial to hegemony, which has aroused controversy and criticism from the learned persons in the international academic field and in the public opinion arena.<sup>238</sup>

If the report were left alone and not further criticized or boycotted with the passing of time, it may gradually result in the four types of chain reactions?

First, using the conclusions of the Panel’s report to fashion a protective umbrella and bulletproof clothes, the United States will proceed unbridled in implementing its hegemonic Section 301 while safeguarding, consolidating, and extending its state global economic hegemony. It will continue to open up the markets of its trading partners through recourse of unilateral threat and blackmail, with the purpose of extracting more presumptuous and inequitable rights without being bound by the WTO/DSU multilateral system and totally evading the risks of incurring claims and anti-retaliations in the WTO/DSU system. Its rationale is that the only reservation that the Panel made in its final report is that once the United States repudiates its commitments and ‘guarantees’ as established by the SAA, the United States would incur state responsibility. This is only an utterance of void and forged ‘Trammel Incantation’ that *cannot tame* the contemporary intractable *Monkey King!*<sup>239</sup>

<sup>238</sup> Chang, above n 189, at 1224–6. The Seoul scholar, Seung Wha Chang, pointed out in the article that the Panel’s ruling stands on shaky legal ground, because the Panel did not sufficiently focus on the ambivalent position of the United States, which is expressed in the SAA as well as in other congressional records for the passage of the URAA in 1994. *Ibid.* The Panel did not make a formal ruling on the WTO consistency of specific US actions. *Ibid.* Instead, it directly supports the US denials. *Ibid.* It heavily relies on the assurances made by the United States before it during the proceeding. *Ibid.* All these pose a risk for the WTO/DSU dispute settlement mechanism. *Ibid.* These comments are of deep insight. However, at the end of the Chang’s paper, the author declared in particular that the goal of his article was not to unilaterally blame s 301 on behalf of US trading partners, but to persuade the United States not to abuse s 301 in the future. *See ibid.* The author claimed that s 301 can co-exist with the WTO multilateral system, that the WTO needs the United States to be a leader in maintaining its multilateral trading system, and so forth. *Ibid.* Those ‘good will’s’, to a certain degree, demonstrate the bewilderment and naivety of the author: the hope to advise the tiger; that a tiger could change its diet from meat to vegetables; the hope to cure the chronic disease of hegemony by simply applying some light, herbal medicine.

<sup>239</sup> *Monkey King*, a mythical hero a the Chinese classic novel, *The Pilgrim to the West*, is the apprentice to Saint Xuanzang, an elite monk who contributed to the spread of Buddhism in China. St Xuanzhang resolved to acquire the original Buddhist Classics from India, a country far from China, then in Tang Dynasty. *Monkey King* was an escort to St Xuanzhang, but because he was intractable and sometimes disobedient, St Xuanzhang had to utter the ‘splitting-headache incantation’ to control him when he did not behave rightly.

**Second**, other economic powers may follow US practice in shielding their various unilateral legislations and measures by adopting an ambiguous and publicly deceiving ‘Statement of Administrative Act’. They can then bully weak trading partners and prevent the interest-impaired, economically weak countries from invoking the WTO multilateral system to charge and sanction them.

**Third**, for those economically weak nations, they, in self-defense, will be compelled to each craft an ambiguous domestic ‘Statement of Administrative Act’ to escape from the binding provisions of the WTO multilateral trade system and consequent international obligations.

**Finally**, the various unilateral domestic legislations are sure to gradually collide with each other, thoroughly shaking and destroying the foundation of the WTO integral multilateral system, which was established through the joint efforts of all of its members. In the end, the WTO system will exist no more and a big historic retrogression will occur. Even a thousand-mile dike can collapse due to the existence of one ant-hole. The danger posed by the false conclusions of the Section 301 case, acting as the one ant-hole, may make the WTO system similarly vulnerable to collapse. In consideration of all these chain reactions, the adverse influence of the Panel Report cannot be neglected.

#### XI. THE IMPLICATIONS FOR DEVELOPING COUNTRIES OF ‘THE GREAT 1994 SOVEREIGNTY DEBATE’ AND THE EC–US ECONOMIC SOVEREIGNTY DISPUTES

Conspicuously, ‘*The Great 1994 Sovereignty Debate*’ in the United States took place in an accelerated economic globalization on the eve of the birth of the WTO system. Against this background, the causes of the debate, which broke out regarding the abolition or preservation of Section 301, were not confined to the United States itself and its follow-up influence was far reaching and exceeding US territory.

As expected, soon after the WTO came into effect, the Japan-US Automobile Parts Dispute, the US–EC Banana Dispute, the EC–US Section 301 Disputes, and the EC–US Section 201 Disputes occurred one after the other. Although the proceedings and results of these cases may differ, they shared significant commonalities. First, the United States was targeted as the formidable adversary in the contests. Additionally, each was closely related to the hegemonic legislation of Sections 301 and 201, or directly aimed at the theme of the abolition or preservation of Section 301. Moreover, the essence of the cases was based upon restriction and antirestriction conflicts between the United States’ economic hegemony and the economic sovereignty of other nations.

The fierce rise, fall, and re-emergence of the debates, which revolved around the restriction and anti-restriction on economic sovereignty from 1994 to 2003, provide significant information worthy of serious research by the international

community, especially small and weak nations. Such nations should analyze and inquire about these debates so as to draw some enlightenment.

The implications of the debates for developing countries, which have occurred over the span of ten years, are several as follows:

*First*, as economic globalization accelerates, the offensive and defensive war of economic sovereignty has not calmed down; rather, it continues and sometimes becomes rather fierce. Therefore, the developing countries must strengthen their sense of crises/risks to avoid unconscious acceptance of the theories of *obsolescence, relegation, weakening, or dilution of economic sovereignty*.

The main characteristic of this offensive and defensive war is that the most powerful nation is striving to defend its vested economic hegemony, to weaken further the economic sovereignty of those less powerful nations, and to damage the hard-earned economic sovereignty of weak nations. The international hegemonist has been consistently applying a double standard to the issue of economic sovereignty, ie, regarding its own economic sovereignty and actually economic hegemony as a *holy god* while it treats that of weak and small nations as a *small straw*.

Under such international circumstances, the third world should **never away with the 'S' word in current time**. They must consciously insist their independent sovereignty, so as to separately and/or jointly fight against the political and economic hegemony, when the political and economic hegemony still exist.

*Second*, the international allocation of decision-making power in global economic affairs is an important part of the offensive and defensive wars on economic sovereignty. Therefore, the developing countries should strive to acquire an equitable portion of decision-making power in the international arena.

The equity and rationality of the international allocation of decision-making power in world economic affairs is decisive as to whether a weak nation's economic sovereignty can obtain the protection it deserves. Further, it determines whether the international allocation of world wealth is reasonable. To change the severe inequity in the international allocation of global wealth, the protection of the weak nations' sovereignty should be strengthened. For this purpose, reformations should be conducted on the source of the severe inequity malpractice in the international allocation of decision-making power in world economic affairs.

As noted above, Professor Jackson, when reviewing and concluding '*The Great 1994 Sovereignty Debate*', emphasized repeatedly that the core and essence of the debate was about the allocation of power, the appropriate allocation of the decision-making power in international affairs between the US government, and international institutions.<sup>240</sup> This insight touched the essence of the issue and was on point. Perhaps confined by his social status and position, Professor Jackson was unable or did not dare to further expose the gigantic

<sup>240</sup> See Jackson, above n 33.

inequity of the current allocation of the decision-making power in international affairs between the superpower and the majority of developing countries.

The facts attest that, in the allocation system of decision-making power in international economic affairs, the United States has acquired a portion far in excess of what it deserves. During ‘*The Great 1994 Sovereignty Debate*’, the arguments of the ‘Sovereignty Confidence Group’ and the ‘Sovereignty Anxiety Group’ seem contradictory, even though, in essence, they share a common fundamental starting point—ie, grasping tightly a *super-portion* of decision-making power in international affairs without making any concessions, while endeavoring to seize the *small portion* of the decision-making power that rests on other’s plates to satisfy its own voracious appetite.

As is well known, the two worldwide economic organizations, the World Bank and the International Monetary Funds, established in accordance with the Bretton Wood System approximately fifty years ago, implemented a weighted voting mechanism based upon the amount of capital subscription advocated by the United States. It enables the United States to enjoy a super-portion of decision-making power in relevant international economic affairs.<sup>241</sup> During the Uruguay Round negotiations, the United States intended to play the old trick again to implant the weighted voting mechanism into the WTO; however, its efforts failed due to constant resistance from the majority of developing countries.<sup>242</sup>

The practice of the various decision-making mechanisms in some international economic organizations, in many years, has repeatedly proven that the weighted voting mechanism on the basis of economic power and upon the ‘size of the purse’ will inevitably lead the wealthy to bully the poor, the bigger to oppress the smaller, and the strong to over-shadow the weak. Conversely, to implement the ‘one nation, one vote’ equitable voting mechanism will contribute to the realization of equality between nations, distributing the wealth to the poor, and provide mutual complementation and benefits. It will particularly help to support the weak and restrain the strong. During the United State’s ‘*Great 1994 Sovereignty Debate*’, what most worried the ‘Sovereignty Anxiety Group’ was the organic combination of the voting system of ‘one nation, one vote’ in the WTO with the voting system of reverse consensus in the DSB, which made the United States impossible to dash around due to its economic dominance. However, what the strong and hegemonic dread is always what the weak yearn for. To safeguard their deserved interests and rights in the contemporary offensive and defensive wars of economic sovereignty, obviously developing countries, weak nations, and small nations must strengthen their cohesive force

<sup>241</sup> For example, in the ‘International Monetary Fund’, the voting rights of the United States account for twenty per cent of the overall voting rights for a long time, while the voting rights of many weak and poor countries only account for 0.1% or 0.01%. The differences of voting rights between them reach several hundred, even several thousand, times. Later, the percentage of the voting rights was ‘slightly tuned’, while the great differences have not been fundamentally changed.

<sup>242</sup> See Jackson, above n 33, at 161, 174–5.

to strive for deserved equitable portions in the international allocation of decision-making power in global economic affairs.

*Third*, the economic sovereignty of a country lies in its autonomy, power in all its domestic and foreign economic affairs. In the new circumstance of economic globalization, the developing countries should particularly dare to insist on and be good at maneuvering their economic sovereignty.

In the tide of accelerated economic globalization, what the developing countries face is a situation in which chances and crises coexist. To make use of the chances, the developing countries must grasp tightly their economic sovereignty. Only by using it as major leverage can developing countries conduct necessary guidance, organization, and management on various internal and foreign economic affairs. To prevent and defend crises, the developing countries should rely on their tightly grasped economic sovereignty, apply it as the main defense, and take all necessary and effective measures to disintegrate and eliminate any crisis possible.

There is no such thing as a free lunch in the world. Sacrifice must be paid to take advantage of the chances and to make use of foreign economic resources to serve a nation's own economic construction. But the sacrifice is limited to an appropriate degree of self-restraint on certain economic power and economic interests, and on the basis of complete independence and autonomy. The appropriate degree of self-restraint may be found by: 1) persisting on the balance between obligation and right, and resisting harsh foreign requirements. We should flatly reject those extra requirements that would generate a severe negative impact or deteriorate a nation's security and social stability, without making any concession;<sup>243</sup> 2) making an overall assessment of the advantages and disadvantages, gains and losses, on the autonomy basis, then striving for more advantages than disadvantages, more gains than losses; 3) being vigilant in peace time and strengthening our sense of anxiety in assessing, anticipating, and taking precautions earlier due to the possible risks accompanying such chances, such as the *re-manipulation* of the national economy vein by foreign countries, the loss of control and confusion of the finance and monetary order, the drain of national property, and the taxation source of national treasury; 4) being prudent enough and taking deep consideration without making promises too rashly as to those concessions and prices with too high a risk with less benefits; and, finally, 5) making arrangements before and after making

<sup>243</sup> For example, in the 'single package' negotiation on China's accession to the WTO at the beginning of 2001, some developed country members put forward harsh requirements on China's adjustment on its agricultural policy, which were denied by the Chinese delegation. The head of the Chinese delegation and its chief negotiation representative, Yongtu Long, emphasized: 'with regard to the agriculture, China has a population of 900 million engaging in agriculture industry, so keeping the stability of agriculture is of great importance to the social stability and economic development of China . . . After its accession to the WTO, the Chinese government needs to reserve those measures in support of agriculture which are consistent with the WTO. The interest of the 900 million agricultural population will forever be the first consideration of us'. Fifteenth Session of WTO Chinese Working Group Finished, PEOPLE'S DAILY (Jan 19, 2001).

promises to enhance the ability to defend and eliminate crisis. Only then can nations, as steadfast as a mid-stream rock, retain their autonomy in their economy under the lash of the economic globalization tide.

*Fourth*, any mistake in **theory** is sure to lead to blindness in **practice** and paying a great price. After an overall survey of the current contradiction between the South and the North, it is obviously *inadvisable* for the weak and small nations of developing countries to recognize or to adopt the theories of *sovereignty weakening* or *sovereignty dilution*.

With accelerated economic globalization, various theories of diluting or weakening the concept of sovereignty will appear quietly on some occasions, which seem to be novel and fashionable ideas. Some less-worldly people with a kind heart, who have not tasted the bitterness of a small or weak nation, may be perplexed by certain specious arguments, evidence, or false impressions, and thus become unconsciously the echoers of the fashionable theories. However, considering the reality that contemporary economic hegemony is performing arbitrariness from time to time, and combining with the fact that those theories of the obsolete and relegation of sovereignty were created *right from* the hegemonic country and have been advocated as a strong theoretical support of economic hegemony, it should be a sudden wake-up for many people: the development direction of the sovereignty dilution and weakening theories is destined to the sovereignty obsolete and relegation theories. This destination is never the welfare of the small and weak nations, rather it is a *theoretical trap* and people with good intention can not foresee its results.

If people can keep calm and strengthen their observation and comparison of the current international reality they will naturally accept the right judgment in conformity with reality. In the situation of accelerated economic globalization, hegemonism and power politics still exist, thus the tasks of the developing countries to safeguard their national sovereignty, security, and interests are still arduous.<sup>244</sup>

Consider for a moment China's place in this discussion. In the offensive and defensive wars in the field of political and economic sovereignty during the period of twentieth century, China, being the biggest developing country, had suffered severe historic tortures of national oppression, exploitation and humiliation, been trampled by powers; and then, it experienced great historic exultation when eventually achieving autonomy on politics and economy after 100 odd years of striving to restore its national dignity. Now, at the beginning of the twenty-first century, in the new situation of accelerated economic globalization, China is, as well as a great deal of other developing countries, once again confronted with the offensive and defensive wars of economic sovereignty in the new century. It is necessary at this moment to revive the eager exhortation left by Mr Deng Xiao Ping that Chinese people cherish their friendship and cooperation with other countries and their people, but they cherish more their rights of

<sup>244</sup> See Z Jiang, *China-Africa Cooperated Hand in Hand, Creating a New Century*, *People's Daily* (Oct 11, 2000).

autonomy acquired through long periods of striving. Any country should not count on China to be their dependency, should not expect China to swallow the bitter fruits that may impair their country's interests.<sup>245</sup>

## XII. CONCLUSION

In a macro view, the conflicts and confrontations between US unilateralism and WTO multilateralism during the last decade have produced at least three big rounds attracting worldwide attention. The first round was embodied in '*The Great 1994 Sovereignty Debate*'. The second was reflected in the Section 301 Dispute. The third round was incarnated in the Section 201 Disputes. Notwithstanding the fact that the expression of each round has varied, each have the same core: the restriction and anti-restriction on US economic hegemony, coming under the high-flown flag and camouflage of defending the United States' 'sovereignty', safeguarding US interests, and implementing US laws.

In the first round, the United States reluctantly accepted WTO multilateralism with the pre-condition that US unilateralism co-exist with it. Moreover, the Dole Commission is set to be activated at anytime necessary, to guarantee that US unilateralism may always defeat WTO multilateralism.

In the second round, WTO multilateralism was only on the surface respected and observed by using the twist-explained SAA of the United States, while US unilateralism was insisted upon by USTR's declaration that 'Section 301' has served, and *will continue to serve*, as a cornerstone of US efforts to enforce US international trade 'rights'.<sup>246</sup> Additionally, owing to the fact that US unilateralism was, to some extent, *actually* protected and encouraged by the Panel Report, the US unilateralism, also to the same extent, *actually* won in the 'suit'. Thus, the 'Damocles sword' is still hanging over the weak's heads! And therefore, the Judgment on this round has been criticized for its being politically astute but legally flawed, and *particularly* for its serious policy implications on the WTO/DSB system and on multilateralism.

The third round resulted in a small win for WTO multilateralism after the multilateralism had *actually* lost twice during the previous two big rounds. It had been so hard to achieve by so many WTO members with collective and cooperative struggles for such a long period of 21 months. Undoubtedly, this win, even if small, has been worth congratulating for the wide supporters of WTO multilateralism. However, the real meanings of the small win had better not to be unduly and excessively appraised. People seem need to keep in their

<sup>245</sup> See X Deng, *The Opening Ceremony Remarks on the Twelfth Plenary Session of the CCP, The Selected Works of Xiaoping Deng*, 372 ((People's Publ House 1983).

<sup>246</sup> USTR Press Release, WTO Panel Upholds 301 (Dec 22, 1999), available at <http://www.ustr.gov/releases/1999/12/99-102.pdf>.

mind that the longstanding and traditional US unilateralism has far from willingly retreated since then.

In this respect, one of the strongest evidences is that, as cited and mentioned in Part II of this paper, the US President emphasized and vowed, 'We will *continue to pursue* [our] economic policies', as well as 'our commitment to enforcing our trade laws',<sup>247</sup> right after US had lost in the 'Section 201' Disputes and was forced to temporarily terminate the abused US 'safeguard measures' of unilateralism. Similar to the USTR's declaration right after the end of 'Section 301' Disputes in December 1999, the US President's proclamation right after the end of 'Section 201' Disputes in December 2003 *actually* announced to the world: We, USA, *will continue to pursue* our policies of *economic hegemony*, and *continue to conduct* such activities *still under the camouflage of defending US 'sovereignty', safeguarding US interests, and enforcing US laws*. Therefore, even though US lost in the recent 'Section 201' Disputes, its hegemony chronic malady of unilateralism may *continue to recur* at any time.

Of course, nobody can nowadays precisely predict what, when, where and how it will happen in the future. However, in light of the conflicts over the last decade and their related lessons, it is certain that traditional US unilateralism will not exit from the international trade arena voluntarily, or get out of its old rut automatically. Consequently, WTO multilateralism cannot proceed forward smoothly in the foreseeable future. There will inevitably occur more rounds, big or small, of new conflicts and confrontations between US unilateralism and WTO multilateralism, and/or between US economic hegemony and economic sovereignties of other states, if the United States, the unique super-power in the contemporary world, continues to persist in its established unilateralist and arbitrary behavior.

Under such circumstances, should the weak in the contemporary world, *inter alia*, the wide developing countries, sum up the experiences from the even small win in the third round aforesaid? How to enhance their united and cooperative struggles against contemporary economic hegemony and its unilateralism, so as to protect their own economic sovereignties and related equitable rights? Could they achieve some new and bigger success? Could international trade really play the role of guarantor of global peace, liberty and security?

Let us wait and see!

<sup>247</sup> See above n 32.





## 6

# *Sovereignty and Reform of the World Trade Organisation*

PHILIP M NICHOLS\*

Sovereignty: The supreme, absolute, and uncontrollable power by which any independent state is governed; supreme political authority; the supreme will; paramount control of the constitution and frame of government and its administration; the self-sufficient source of political power, from which all specific political powers are derived; the international independence of a state, combined with the right and power of regulating its internal affairs without foreign dictation; also a political society, or state, which is sovereign and independent.

—Black's Law Dictionary

**B**LACK'S LAW DICTIONARY describes a sovereignty that never was and probably never could be. David Kennedy noted years ago the inherent contradiction in such an absolutist definition of sovereignty: states 'cannot be both internally absolute and externally social'.<sup>1</sup> In the real world, no sovereign has absolutely unconstrained power; sovereigns are better thought of as entities that have power and control over something rather than power and control over everything. A corollary of the absolutist conception of sovereignty is that since all sovereigns are absolutely powerful all sovereigns are absolutely equal and absolutely independent. A corollary of the real condition of sovereignty, however, is that sovereignty appears in a multitude of forms and can be arranged in a multitude of hierarchies and relationships.

The World Trade Organisation is an organisation comprised of sovereigns. These sovereigns have come together to achieve a number of tasks generally outlined in the preamble to the agreement creating their organisation: 'raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, and expanding the production of and trade in goods and services, while allowing for the optimal use of the

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<sup>1</sup> D Kennedy, 'Theses About International Law Discourse' (1980) 23 *German Yearbook of International Law* 353, 361.

world's resources in accordance with the objective of sustainable development'.<sup>2</sup> The organisation and its members utilise numerous tools and resources in pursuit of these goals; one overlooked tool, however, is the composition of the organisation itself. The World Trade Organisation operates in part by forging agreement on how sovereigns will exert their control, and then holding those sovereigns responsible for exercising that control.<sup>3</sup> By coordinating the way that sovereigns exercise control, the World Trade Organisation indirectly reaches trade behaviours throughout the world.

The composition of an organisation inevitably affects its effectiveness. In the case of an organisation that works by coordinating the way its members use their control, the composition of its membership is particularly important. It is fair from the outset, therefore, to ask whether the World Trade Organisation incorporates the appropriate sovereigns as members. This question will become even more pertinent as the World Trade Organisation matures and takes on a deeper and more sophisticated commitment to the tasks outlined in its preamble.

Traditional international law's absolutist conception of sovereignty is rooted, perhaps mistakenly, in the Treaty of Westphalia and interpretations of the writings of Grotius and Leibniz.<sup>4</sup> There is nothing inherently universal about these concepts; rather, they were forced on much of the world during the European period of occupation and colonisation.<sup>5</sup> More recent theories of international law based on other intellectual paradigms, such as critical legal studies,<sup>6</sup> have had nowhere near the influence of the dominant theory of international law.<sup>7</sup>

The complexity of any school of thought defies simple explanation; nonetheless, put simply traditional international law positions itself as a set of rules whereby nations interact with one another.<sup>8</sup> Nations are the principal international actors, with some recognition of international organisations created by those nations.<sup>9</sup> A fundamental principle of traditional international law is that international law concerns itself only with the relations among the nations and not with the internal processes within those nations.<sup>10</sup>

<sup>2</sup> Marrakesh Agreement Establishing the World Trade Agreement (15 Apr 1994) LT/UR/A/2 preamble <<http://docsonline.wto.org>>.

<sup>3</sup> P Nichols, 'Realism, Liberalism, Values, and The World Trade Organization' (1996) 17 *University of Pennsylvania Journal of International Economic Law* 851.

<sup>4</sup> JG Starke, *Introduction to International Law* (9th edn London, Butterworths, 1984) 7–14.

<sup>5</sup> CL Blakesley, EB Firmage, RF Scott and SA Williams, *The International Legal System* (5th edn New York, Foundation Press, 2001) 1432.

<sup>6</sup> See Nigel Purvis, 'Critical Legal Studies in Public International Law' (1991) 32 *Harvard International Law Journal* 81 (suggesting a theory of international law that rejects states as primary international actors, rejects the possibility of objective consensus, and rejects the idea of determinate international legal obligations and rules).

<sup>7</sup> CL Blakesley, (2001) above n 5 at p 1432.

<sup>8</sup> G von Glahn and JL Taulbee, *Law Among Nations: An Introduction to Public International Law* (8th edn New York, Pearson Longman, 2007).

<sup>9</sup> K Raustiala, 'Sovereignty and Multilateralism' (2000) 1 *Chicago Journal of International Law* 401, 415.

<sup>10</sup> H Lauterpacht, 'Spinoza and International Law' (1927) 8 *British Year Book of International Law* 89, 106–7; see S Picciotto, 'Networks in International Economic Integration: Fragmented States and the Dilemma of Neo-Liberalism' (1996) 17 *Journal of International Law and Business*

International law's preoccupation with the character of international actors—sovereign nations—is a product of the times from whence it sprang. Grotius did not concern himself with the nature the international actor.<sup>11</sup> That task was undertaken by Grotius's intellectual descendant Gottfried Wilhelm Leibniz. The *Codex Juris Gentium Diplomaticus* contains the first reference in European scholarship to the international person. As a diplomat for and advisor to various rulers of German principalities, Leibniz found almost of necessity that sovereigns and the polities they ruled were legitimate international actors. Leibniz did not, however, suggest that those whom he labelled as sovereign were the only legitimate international actors.

Leibniz's international plurality lost ground from the outset with the work of Samuel Pufendorf, who held the first chair of international law in a European University.<sup>12</sup> Pufendorf too was concerned with the weakened Holy Roman Empire and with legitimising the independent states. He posited that independent states 'and supreme sovereignty come from God as the author of natural law'.<sup>13</sup> Pufendorf's argument provided a foundation upon which the independent states could place themselves on equal footing with the empire; that argument was based on their divine right to international personhood. Pufendorf's writings contain the seeds of an absolutist conception of sovereignty.

The treaty that finally brought some measure of peace to the Thirty Year War, often called the Treaty of Westphalia,<sup>14</sup> is often blamed for the modern concept of sovereignty carried throughout the world by the European nations during their period of conquest and occupation. The treaty does discuss in broad terms the nature of sovereignty. Much of the treaty, however, is concerned more closely with who qualifies a legitimate international actor. Interestingly, the treaty seems to recognise a multitude of actors in an almost hierarchical architecture. This complexity was simplified by the exigencies of Pufendorf and by the centuries of scholars who followed. These scholars sharpened Pufendorf's absolutist definition and granted a monopoly in international law to sovereign states.

The highly stylized conception of sovereignty described in Black's Dictionary does not exist. In the real world, polities are subject to laws. This may occur voluntarily, as when a polity joins an international body or binds itself to a treaty, or it may occur involuntarily, for example through the imposition of rules of universal jurisdiction or through the working of a tribunal that claims jurisdiction.

1014, 1018 (discussing the relationship between traditional international law and the realist school of international relations and noting that both are state centred).

<sup>11</sup> H Lauterpacht, 'The Grotian Tradition in International Law' (1946) 23 *British Year Book of International Law* 1, 21–2.

<sup>12</sup> Created at Heidelberg as the Chair of The Law of Nature and Nations in 1661.

<sup>13</sup> S Pufendorf, *On the Law of Nature and Nations* Book VII.III 1 and 2, p 1000–1 (New York, Classics of International Law, 1934).

<sup>14</sup> Peace Treaty between the Holy Roman Emperor and the King of France and Their Respective Allies, Oct 24, 1648, 1 *Major Peace Treaties of Modern History* 7 (1967), also available at <<http://www.yale.edu/lawweb/avalon/westphal.htm>>.

Sovereignty is not a sacred condition of statehood: sovereignty is simply a tool for making order of relationships, including relationships among polities.

As is true of any useful tool, many iterations of sovereignty exist. There is no reason to belabour this point with the hundreds of examples that can be found throughout the world: the United States serves as a brief but illustrative example. The United States as a federal polity claims sovereignty. Within that polity, fifty component States claim and are given sovereignty, of a different sort.<sup>15</sup> Within these fifty-one polities exist also fifty-three Native American tribal governments that claim and are recognised by the other polities to have sovereignty.<sup>16</sup> The Kingdom of Hawaii recently appeared as a party at a proceeding before the Permanent Court of Arbitration at The Hague,<sup>17</sup> and the United Nations continues to consider the status of that once recognised Pacific nation within the United States.<sup>18</sup> Elsewhere in the Pacific, residents of American Samoa and Swains Island are considered US nationals but not US citizens.<sup>19</sup> For almost forty years after the second world war, the United States administered four other regions of the Pacific as a trustee authorised by the United Nations and exercised full authority over these regions that were not part of the United States.<sup>20</sup> Three of those regions have become ‘independent’ nations whose actions with respect to the United States (as are those of the United States with respect to those nations) are bounded by a Compact of Free Association between each and the United States.<sup>21</sup> One region, the Northern Mariana

<sup>15</sup> EH Caminker, ‘State Sovereignty and Subordination: May Congress Commandeer State Officers to Implement Federal Law’ (1995) 95 *Columbia Law Review* 1001; L Brilmayer and RD Lee, ‘State Sovereignty and the Two Faces of Federalism: A Comparative Study of Federal Jurisdiction and the Conflict of Law’ (1985) 60 *Notre Dame Law Review* 833.

<sup>16</sup> H Hannum, ‘Sovereignty and Its Relevance to Native Americans in the Twenty-First Century’ (1998/1999) 23 *American Indian L Rev* 487; Patrick Macklem, ‘Distributing Sovereignty: Indian Nations and Equality of Peoples’ (1993) 45 *Stanford Law Review* 1311; WW Mankiller, ‘“Tribal Sovereignty is a Sacred Trust”: An Open Letter to the Conference’ (1998/1999) 23 *American Indian L Rev* 479; Judith Resnik, ‘Dependent Sovereigns: Indian Tribes, States, and the Federal Courts’ (1989) 56 *University of Chicago Law Review* 671.

<sup>17</sup> *Lance Paul Larsen v Kingdom of Hawaii* (Perm. Ct. Arb. 2001) <<http://www.pca-cpa.org/ENGLISH/RPC/LAHK/lahkaward.htm>>. The case is discussed briefly in LM Kanehe, ‘The Akaka Bill: The Native Hawaiians’ Race For Federal Recognition’ (2001) 23 *Hawaii Law Review* 857, 898–9.

<sup>18</sup> UNCHR ‘Consideration of Reports Submitted by States Parties Under Article 40 of the Covenant: United States’ ¶ 37 (2006) UN Doc. CCPR/C/USA/Q/3/CRP.4. <<http://www.ohchr.org/english/bodies/hrc/docs/AdvanceDocs/CCPR.C.USA.CO.pdf>>.

The Kingdom of Hawaii has filed a complaint within the United Nations suggesting a breach of international law during the ‘prolonged and illegal occupation of the entire territory of the Hawaiian Kingdom by the United States of America since the Spanish-American War of 1898’ because of ‘the failure on the part of the United States of America to establish a direct system of administering the laws of the Hawaiian Kingdom’. Complaint Against the United States of America ¶ 1.1 (filed Jul 5, 2001) <[http://www.hawaiiankingdom.org/pdf/Hawaiian\\_UN\\_Complaint.pdf](http://www.hawaiiankingdom.org/pdf/Hawaiian_UN_Complaint.pdf)>.

<sup>19</sup> CL Eisgruber, ‘Birthright Citizenship and the Constitution’ (1997) 72 *New York University Law Review* 54, 56.

<sup>20</sup> Trusteeship Agreement for the Former Japanese Mandated Islands, Jul 18, 1947, 61 Stat. 3301.

<sup>21</sup> *Compact of Free Association between the Government of the United States and the Governments of the Marshall Islands and the Federated States of Micronesia*, Pub L No 99-239, § 201, 99 Stat. 1773 (1986) (codified as amended at 48 USC § 1901 (1994)); Compact of Free

Islands, became a Commonwealth that has the right of self-governance within the sovereignty of the United States and that can override most federal laws if it chooses.<sup>22</sup> Another island polity in another ocean, Puerto Rico, also has become a Commonwealth with some rights of self governance and a claim that the federal government cannot alter its organic laws.<sup>23</sup> Elsewhere in that region, the US Virgin Islands has less autonomy than Puerto Rico, but unlike Puerto Rico it maintains its own customs territory distinct from that of the United States.<sup>24</sup> And again, in the past in that region the United States once exercised authority over the lands surrounding the Panama Canal; courts treated the area as an unincorporated territory of the United States even while recognising that the land was not actually part of the United States and remained part of Panama.<sup>25</sup>

A cynic could argue that the only polity in this group with sovereignty is the federal United States because it could, probably, violently force all of the other polities to do what it wishes while none of them, probably, could violently force the federal government to their will. This very crude conceptualisation of sovereignty ignores the fact that sovereignty is a legal construct; in forcing other polities to its will the United States would abrogate treaties, violate international law, and transgress its own constitution. A sophist, on the other hand, might suggest that the only polity in this group with sovereignty is the United States because it has the most of whatever sovereignty is. Such an attenuated conceptualisation of sovereignty would not change the fact, however, that the other polities have a great deal of whatever sovereignty is. Sovereignty is not a magical status nor is it uniform throughout the world; it is a tool for organising relationships and exists in many forms and iterations.

Different ‘international’—the word connotes something between sovereign nations—organisations use different iterations of sovereignty as a criteria for membership, depending on their needs and goals. The International Olympic Committee extends membership to Puerto Rico, for example, while the United Nations does not. The Cherokee Nation does not belong to the International

Association between the United States and the Government of Palau, *Pub L No 99–658*, § 101, 100 Stat. 3673 (1986) (codified as amended at 48 USC § 1931 (1994)).

<sup>22</sup> *Covenant to Establish a Commonwealth of the Northern Mariana Islands*, 48 USC § 1801 Art 1 (2006). Joseph Horey notes the contradiction between this arrangement and the current notion of sovereignty: ‘has not the power of government been vested in two different places at once?’ Joseph Horey notes the contradiction between this arrangement and the current notion of sovereignty: ‘has not the power of government been vested in two different places at once?’ JE Horey, ‘The Right of Self-Government in the Commonwealth of the Northern Mariana Islands’ (2003) 4 *Asia-Pacific Law and Policy Journal* 180, 183.

<sup>23</sup> TA Aleinikoff, ‘Sovereignty Studies in Constitutional Law: A Comment’ (2000) 17 *Constitutional Commentary* 197, 200.

<sup>24</sup> *US v Hyde*, 37 F.3d 116, 117 (3rd Cir 1994); see GT Arnold, ‘Bordering on Unreasonableness?: The Third Circuit Again Expands the Border Search Exception in *United States v Hyde*’ (1995) 40 *Villanova Law Review* 835. The Virgin Islands belong to the United States but have the power of self-governance, although probably not the power to overrule federal legislation. See Organic Act of the Virgin Islands, s 4524, 74th Cong, 49 Stat 1807 (1936); Revised Organic Act of Jul 22, 1954, ch 558, 68 Stat. 497.

<sup>25</sup> *Canal Zone v Scott*, 502 F.2d 566, 568 (5th Cir 1974).

Olympic Committee but does belong to the International Indian Treaty Council. The Commonwealth of the Northern Mariana Islands belongs to both the International Olympic Committee and the Secretariat of the Pacific Communities.

The World Trade Organisation uses a particular iteration of sovereignty as its criteria for membership. Those polities that maintain and control a customs territory can become members of the World Trade Organisation.<sup>26</sup> To continue using the example of the many sovereigns contained within the United States, this means that Puerto Rico, which is part of the customs territory maintained by the federal polity, could not join. In theory, however, the Virgin Islands and the Commonwealth of the Northern Mariana Islands could, because each of those polities is specifically outside of the customs territory of the federal polity and each maintains its own customs territory.

Neither the Virgin Islands nor the Commonwealth of the Northern Mariana Islands does belong to the World Trade Organisation, but similar polities do enjoy membership. Hong Kong, Macau and Taipei do not qualify to membership in the United Nations but are full voting members of the World Trade Organisation. On the other hand, Andorra, Monaco and San Marino are full voting members of the United Nations but do not qualify for membership in the World Trade Organisation.<sup>27</sup> Membership in these international organisations is not coincident because each organisation uses as a criteria for membership different iterations of sovereignty.

The iteration of sovereignty used by the World Trade Organisation—maintenance and control of a customs territory—made sense when the international trade regime was formed. The World Trade Organisation is the direct descendent of the international regime that was formed after the end of the second world war. As the second world war came to a close, allied nations discussed the need to recover from the economic devastation that preceded and was caused by the war. The three international organisations discussed by the allies as stewards of economic recovery were the Bank for Recovery and Development (later the World Bank), the International Monetary Fund, and the International Trade Organisation. The International Trade Organisation was to serve as a forum for negotiating standards in a number of arenas including investment, labor and competition. While the other two bodies became real, the creation of the International Trade Organisation stalled due to the failure of the United States Congress to ratify its charter documents. This left only the General Agreement on Tariffs and Trade (the General Agreement), which had been intended as a temporary agreement pending creation of the International Trade Organisation.<sup>28</sup>

<sup>26</sup> Marrakesh Agreement Establishing the World Trade Agreement (15 Apr 1994) LT/UR/A/2 Art XII <<http://docsonline.wto.org>>.

<sup>27</sup> The membership of the World Trade Organisation can be found at <[http://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/org6\\_e.htm](http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm)>. The membership of the United Nations can be found at <<http://www.un.org/Overview/unmember.html>>.

<sup>28</sup> RE Hudec, *The GATT Legal System and World Trade Diplomacy* (2nd edn New York, Praeger Publishers, 1990); JH Jackson, *The World Trading System: Law and Policy of International Economic Relations* (Cambridge, MIT Press, 1997); JH Jackson, *Restructuring the GATT System*

The General Agreement propounded a number of principles, two of which were central to its mission. The first of these was the accordance of most-favoured-nation treatment among all parties: at the point at which goods enter a customs territory, goods from all parties to the agreement must be treated the same.<sup>29</sup> The second fundamental principle of the General Agreement was national treatment: once goods enter a customs territory they must be accorded the same treatment as domestically produced goods.<sup>30</sup> In tandem, the most-favoured-nation principle and national treatment principle allowed goods from all parties to the General agreement to compete on roughly the same footing.

In addition to operationalising these two principles, the General Agreement required countries to engage in a long-term program of trade liberalization through tariff action.<sup>31</sup> Conceptually, this program was both simple and elegant: all barriers to trade other than tariffs were to be eliminated, and tariffs were to be 'bound' so that a country could not impose a tariff higher than that to which it had agreed.<sup>32</sup> Over a period of years, the bindings were to be negotiated down so that eventually trade among nations would be virtually unfettered.<sup>33</sup>

To a great extent, the goal of decreasing barriers and increasing trade worked. Claus-Dieter Ehlermann notes that '[t]he various rounds of multilateral trade negotiations have reduced tariffs to overall levels at which they no longer create a serious obstacle to trade'.<sup>34</sup> As the significance of tariffs and quotas diminished, the intractability of other barriers to trade became more obvious. Myriad issues—government procurement, product standards, environmental regulations, safety rules, advertising limitations, for example—affect trade in goods and services, and many of these rules and policies exist for good reasons independent of trade.<sup>35</sup> Moreover, the General Agreement itself was

(London, Printer, 1990); TJ Dillon, Jr, 'The World Trade Organization: A New Legal Order for World Trade?' (1995) 16 *Michigan Journal of International Law* 349, 351–2; W Diebold, 'Reflections on the International Trade Organization' (1994) 14 *Northern Illinois University Law Review* 335, 336.

<sup>29</sup> SJ Rubin, 'Most-Favoured-Nation Treatment and the Multilateral Trade Negotiations: A Quiet Revolution' (1980–1981) 6 *International Trade Law Journal* 221. The most-favoured-nation requirement was and is, of course, encumbered with many exceptions.

<sup>30</sup> DA Farber and RE Hudec, 'Free Trade and the Regulatory State: A GATT's-Eye View of the Dormant Commerce Clause' (1994) 47 *Vanderbilt Law Review* 1401, 1418.

<sup>31</sup> JH Jackson, *The World Trading System: Law and Policy of International Economic Relations* (Cambridge, MIT Press, 1989) 115, 118–19.

<sup>32</sup> *Ibid*; This process is called 'tariffication'. DR Purnell, '1993 International Trade Update: The GATT and NAFTA' (1994) 73 *Nebraska Law Review* 211, 217.

<sup>33</sup> JH Jackson, (1989) above at n 31 at 115–16.

<sup>34</sup> C Ehlermann, 'The International Dimension of Competition Policy' (1994) 17 *Fordham International Law Journal* 833, 840.

<sup>35</sup> D Kennedy, 'The International Style in Postwar Law and Policy: John Jackson and the Field of International Economic Law' (1995) 10 *American U J of Int'l L and Policy* 671, 698; PR Trimble, 'Book Review' (1985) 83 *Michigan Law Review* 1016, 1020–1. There is some evidence that as tariff levels decreased, the use of nontariff barriers increased. EJ Ray, 'Changing Patterns of Protectionism: The Fall in Tariffs and the Rise in Non-Tariff Barriers' (1987) 8 *Northwestern Journal of International Law and Business* 285, 305–6.



encumbered by numerous exceptions.<sup>36</sup> Many of these exceptions reflected the fact that trade exists in the context of human society, and must be fitted into and balanced against a host of other activities, goals and necessities.<sup>37</sup>

The history of multilateral trade negotiations under the international trade regime highlights the difficulty in accommodating societal interests, and also reflects the relative ascendancy of non-tariff issues as a matter of concern. The parties to the General Agreement conducted eight multilateral negotiating rounds. The first five involved reductions of the tariff bindings.<sup>38</sup> The next two substantially increased the reach of the General Agreement and the GATT (as the quasi-institution is known) to include discussions on non-tariff barriers.<sup>39</sup> The last of the multilateral negotiations, the Uruguay Round, resulted in the creation of the World Trade Organisation. The World Trade Organisation's portfolio extends beyond trade in goods and includes services and intellectual property; the Organisation's structure includes committees that deal with environmental issues, economic development, investment, balance of payments and debt, government 'transparency', and sanitary and phytosanitary measures.<sup>40</sup> The current round of multilateral trade negotiations, the Doha Round, includes discussion of the relationship between trade and investment, competition policy, government procurement, the environment, electronic commerce, trade finance, technology transfer, capacity building, and the conditions of least-developed countries.<sup>41</sup> Clearly, the realities of fitting a trade regime into the complexities of the modern world have forced the international trade regime to become more sophisticated and to consider a much broader array of issues.

Given the evolution in the focus of the international trade regime over the past sixty years, it is fair to ask whether it is appropriate to continue using the same criteria for membership as was used at the close of the second world war. Put differently, a legitimate question regarding possible reform of the World Trade Organisation is whether that organisation uses the best iteration of sovereignty as its criteria for membership. This is a different question than whether

<sup>36</sup> PD Ehrenhaft, 'Book Review' (1990) 84 *American J Int'l L* 334, 335 (1990).

<sup>37</sup> See S Charnovitz, 'The Influence of International Labour Standards on the World Trading Regime: A Historical Overview', (1987) 126 *International Labour Review* 565; C Fox, 'The UNIDROIT Convention on Stolen or Illegally Exported Cultural Objects: An Answer to the World Problem of Illicit Trade in Cultural Property' (1993) 9 *American University Journal of International Law and Policy* 225; JI Garvey, 'Trade Law and Quality of Life—Dispute Resolution Under the NAFTA Side Accords on Labor and the Environment' (1995) 89 *American Journal of International Law* 439, 439 (1995); PM Nichols, 'Trade Without Values' (1996) 90 *Northwestern University Law Review* 658.

<sup>38</sup> These are known as the Geneva Round (1947), the Ancey Round (1949), the Torquay Round (1950), the Geneva Round (1956) and the Dillon Round (1960–1961). JR Arnold, 'The Oilseeds Dispute and the Validity of Unilateralism in a Multilateral Context' (1994) 30 *Stanford Journal of International Law* 187, 193.

<sup>39</sup> These are known as the Kennedy Round (1962–1967) and the Tokyo Round (1973–1979). See JH Jackson (1989) above n 31.

<sup>40</sup> Information on the World Trade Organisation can be found at <[http://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/org2\\_e.htm](http://www.wto.org/english/thewto_e/whatis_e/tif_e/org2_e.htm)>.

<sup>41</sup> Ministerial Declaration (14 Nov 2001) WT/MIN(01)/DEC/1 <<http://docsonline.wto.org>>.

the World Trade Organisation should extend participatory membership to entities other than sovereigns.<sup>42</sup> Rather, the question is whether the World Trade Organisation would be better at achieving its goals if a wider variety or different set of sovereigns participated as members.

California illustrates the vitality of this question. California is a sovereign state within the United States, but it does not qualify for membership in the World Trade Organisation because it does not control a customs territory. California does, however, play a significant role in many of the issues within the World Trade Organisation's mandate. California's economy, measured by gross domestic product, is larger than all but seven members of the World Trade Organisation; indeed, the economy of just the five county area of Los Angeles is larger than those of all but nine members of the World Trade Organisation and the economy of Los Angeles county alone is larger than all but sixteen. California transacts more than four hundred billion US dollars worth of trade, again dwarfing that of most World Trade Organisation members. California's global presence is not limited to trade in goods. California also has significant activity in services, in the production of intellectual property, and in cross border employment. California is the world's twelfth greatest emitter of carbon dioxide pollutants. California attracts more foreign investment than do most members of the World Trade Organisation.<sup>43</sup>

California is not passive about its role in the world. California maintains Foreign Trade Offices in most major cities of the world. California has its own Infrastructure and Economic Development Bank and an Export Loan Office. California sends active trade missions throughout the world and concludes agreements with businesses and companies. California's Office of California—Mexico Affairs orchestrates a broad array of international issues; the California Office of Binational Border Health deals with more specific international issues.<sup>44</sup> California enacts tens of thousands of laws and regulations that touch on virtually every issue within the World Organisation's mandate, and many of

<sup>42</sup> For a debate on the question of non-sovereign participation, see S Charnovitz, 'Participation of Nongovernmental Organizations in the World Trade Organization' (1996) 17 *U of Pennsylvania J of Int'l Economic Law* 331; P Nichols, 'Extension of Standing in World Trade Organization Disputes to Non-government Parties' (1996) 17 *U of Pennsylvania J of Int'l Economic Law* 295; P Nichols, 'Realism, Liberalism, Values and the World Trade Organization' (1996) 17 *U of Pennsylvania J of Int'l Economic Law* 851; GR Shell, 'The Trade Stakeholders Model and Participation by Non-state Parties in the World Trade Organization' (1996) 17 *U of Pennsylvania J of Int'l Economic Law* 359.

<sup>43</sup> J Kyser and G Huang, *International Trade Trends and Impacts: The Southern California Region* (Los Angeles, Los Angeles Economic Development Corporation, 2006) <<http://www.laedc.org/reports/Trade-2006.pdf>>; J Kyser, ND Sidhu, G Huang and C Flor, *2006–2007 Economic Forecast & Industry Outlook for California and Southern California Including The National and International Setting* (Los Angeles, Los Angeles Economic Development Corporation, 2006) <<http://www.laedc.org/reports/Forecast.pdf>>; US Department of Energy, *Energy Information Administration, Emissions of Greenhouse Gases in the United States 2004* (Washington, Government Printing Press, 2005) Table 1 at 2.

<sup>44</sup> Information regarding these and other programs in California can be found at <[http://www.ca.gov/state/portal/myca\\_homepage.jsp](http://www.ca.gov/state/portal/myca_homepage.jsp)>.

these laws and regulations are beyond the review of or control by the federal United States government because California is a sovereign polity.<sup>45</sup>

The point is not that California is big, nor is the point that California is active. The point is that California is big and active *and* that California makes sovereign decisions that affect the global economy and international trade, and that also affect related social and cultural issues. The existence of California sharpens the question: does the World Trade Organisation use the correct iteration of sovereignty? As the World Trade Organisation's mandate continues to evolve, that question will become more and more pertinent.

At present, the answer to the question is probably a qualified 'yes'; the membership of the World Trade Organisation is well suited to a body whose primary goal is the reduction of barriers at the customs border. The repeated collapses of the Doha Round of multilateral trade negotiations supports an inference that the World Trade Organisation will probably continue to focus on customs borders at least in the short term.<sup>46</sup> The history of the international trade regime, however, indicates that the multiple intersections between issues other than tariffs and international trade cannot long be ignored.<sup>47</sup> At some point, the question will come to the forefront of reform of the international trade regime.

Sovereignty has not undergone a significant transformation. The understanding of sovereignty, however, has become more sophisticated and less dogmatic, and with a more accurate understanding of sovereignty has come improvement in the ability to discuss and describe sovereignty. A natural consequence is the

<sup>45</sup> L Batchelder, 'The Costs of Uniformity: Federal Foreign Policymaking, State Sovereignty, and the Massachusetts Burma Law' (2000) 18 *Yale Law and Policy Review* 485.

<sup>46</sup> At the time of the writing of this chapter, the final outcome of the Doha Round of Multilateral Trade Negotiations remains unclear. One barrier to agreement has been the resistance of emerging economies and developing countries to the introduction of nontariff issues while in their opinion tariffs on the goods that they produce remain unacceptably high in industrialized countries. In an effort to salvage the negotiations, the scope of the Round has been reduced; the history of the Round as well as its current status can be found at <[http://www.wto.org/english/tratop\\_e/dda\\_e/dda\\_e.htm](http://www.wto.org/english/tratop_e/dda_e/dda_e.htm)>. At the outset of the Doha Round, many scholars suggested that it could initiate a breakthrough in the incorporation of issues outside of tariffs and quotas. See LA DiMatteo, K Dosanjh, PL Frantz, P Bowal and C Stoltenberg, 'The Doha Declaration and Beyond: Giving Voice to Non-Trade Concerns Within the WTO Trade Regime' (2003) 36 *Vanderbilt Journal of Transnational Law* 95; PM Gerhart, 'Slow Transformation: The WTO as a Distributive Organization' (2002) 17 *American U Int'l L Rev* 1045.

<sup>47</sup> See A Afilalo and Dennis Patterson, 'Statecraft, Trade and the Order of States' (2006) 6 *Chicago J of Int'l Law* 725; A Alvarez-Jimenez, 'Emerging WTO Competition Jurisprudence and its Possibilities for Future Development' (2004) 24 *Northwestern University Journal of International Law and Business* 441; S Cho, 'Linkage of Free Trade and Social Regulation: Moving beyond the Entropic Dilemma' (2005) 5 *Chicago J of Int'l Law* 625; R Howse, 'The Appellate Body Rulings in the Shrimp/Turtle Case: A New Legal Baseline for the Trade and Environment Debate' (2002) 27 *Columbia J of Environmental Law* 491; S Dillon, 'A Farewell to "Linkage": International Trade Law and Global Sustainability Indicators' (2002) 55 *Rutgers Law Review* 87; JH Knox, 'The Judicial Resolution of Conflicts between Trade and the Environment' (2004) 28 *Harvard Environmental Law Review* 1; OL Reed, 'Nation-building 101: Reductionism in Property, Liberty, and Corporate Governance' (2003) 36 *Vanderbilt Journal of Transnational Law* 673; T Weiler, 'NAFTA Article 1105 and the Principles of International Economic Law' (2003) 42 *Columbia J Transnat'l L* 35.

ability to ask better questions about sovereignty. One question that should be asked is whether an organisation that extends membership to sovereigns has in fact selected the optimal set of sovereigns.

To be sovereign is to control something. The criteria for membership in the World Trade Organisation, a criteria established sixty years ago, is control over a customs border and territory. To the extent that the World Trade Organisation concerns itself primarily with tariffs and quotas, then that is probably the most appropriate criteria for membership. The evaluation of its criteria for membership, however, may be allowed to lie dormant but should not be extinguished. As the international trade regime continues to mature and as the World Trade Organisation turns its attention to trade issues other than tariffs and quotas, those concerned with reforming and improving the effectiveness of the organisation should continue to ask whether membership extends to the most appropriate set of the wide variety of sovereigns.



*Sovereignty Issues in the  
WTO Dispute Settlement—  
A ‘Development Sovereignty’  
Perspective*

ASIF H QURESHI

I. INTRODUCTION

**T**HIS CHAPTER FOCUSES on the configuration of sovereignty, development and the dispute settlement process, in the framework of the WTO. Sovereignty far from being contested is a reality in the WTO dispute settlement system. It is a human condition that is embellished in the racial diversity of mankind. On the whole it needs to be denigrated. Indeed, the challenge in legal analysis is to rein it rather than acknowledge the competition in international relations for it. However, sovereignty has also spurred nations to compete and in that manner pushed the limits of mankind’s progress. Equally, sovereignty can facilitate development, self-help and self-determination amongst developing nations. Such sovereignty may be coined as ‘development sovereignty’. The development dimension in the dispute settlement process of the WTO calls for both sensitivity to ‘development sovereignty’, and the need for a certain degree of relinquishment of sovereignty on the part of developed nations. The ‘development sovereignty’ matrix is a function of the relationship of sovereignty and development, and can indeed be traced in the seeming detail of the WTO dispute settlement system.

In this spirit this chapter touches upon some aspects of the relationship of sovereignty and development in the context of the dispute settlement system of the WTO, and the contemporary discourse on its reform.

## I. SOVEREIGNTY AND DEVELOPMENT

## 1. Selected Observations on Sovereignty

Perspectives on sovereignty can fall under various categories:

- Theoretical
- Philosophical/Doctrinal
- Realistic
- State centred
- Human Rights centred
- Internationalist
- Developed/Euro-centric
- Developing/Third World

What is critical however is to understand that each of these differing perspectives are not the definitive statements in the analysis of the place of sovereignty in international relations and International Law, although they do individually contribute to the subject. I think also from the standpoint of legal analysis these differing perspectives need to be distinguished from mere opinion, and opinion founded in scholarship, particularly in terms of the sources of International Law they draw from, and the practice of States.

In relation to developing/third world perspectives on sovereignty in international economic relations—the emotive and sometimes perfunctory manner in which the relationship between development and sovereignty and the developing country perspective is dealt with is to be noted. The painting of the origins of the developing country perspective on sovereignty, in the framework of the historical and quite legitimate call for a New International Economic Order (NIEO), as a psychological condition stemming from insecurity ‘which no one in their right mind would now advocate’, is akin to the Soviet era when political dissidents were considered as being mentally disturbed by the ruling elite. Rigorous scholarship invites a more rational response to opposing points of view, if response is indeed what is needed. For example, calls for a weighted voting system in the WTO on the basis of a questionable legitimacy to such equal votes by developing Members of the WTO, and the unsatisfactory pace of progress in decision-making in the WTO, partake of such emotive responses. First, there is a failure in candour—in revealing from whose perspective the pace of progress in decision-making is unsatisfactory. Second, it is quite tendentious to assert as Professor John Jackson did in this conference<sup>1</sup> publicly that there is a broad and significant consensus for the reform of the voting system in the WTO. This can hardly be the case given that the majority of the Members of

<sup>1</sup> ‘Redefining Sovereignty in International Economic Law’, Oxford Brookes University, 30–31 May 2006.

the WTO are developing Members whose voting status would change upon the introduction of a weighted voting system to their detriment. Third, it is intuitively and impressionistically persuasive to juxtapose, for example, the voting rights of the US along with that of a developing Island State in the Pacific, to substantiate the case of voting reform in the WTO, as Dr Dan Sarooshi did at the conference.<sup>2</sup> However, this juxtaposition appeals essentially to one's sense of emotion. It is lacking in logic because voting rights are not about the origins or status of a voter member State, they are essentially about the future normative framework for all the voters. It is contrary to human rights thinking in that at a stroke the rights of US residents are placed at a premium to the rights of individuals from a developing Island State in the Pacific. It goes against the very idea of liberal trade as it has the potential to distort trade and investment in favour of those Members of the WTO who can have a greater say in protecting trading rights in the WTO. It is contrary to notions of justice in that having induced trade liberalisation amongst Members, against the background of one member one vote, it seeks to take away the foundations upon which that understanding for liberalisation was constructed. Finally, it is to be noted that critics who rely on this kind of juxtaposition when it comes to voting are remarkably silent when it comes to the Appellate Body decision<sup>3</sup> which accorded *locus standi* to a Member in the WTO dispute settlement process on the basis of potential rather than actual interest in the goods the subject of trade protection.

Contemporary efforts at the de-politicisation of sovereignty, by for example reformulating its focus in terms of the challenge to determine appropriate allocative decisions between the State and non-State<sup>4</sup>—represent commendable efforts in the shaping of the sovereignty discourse. However, it should be noted that this is set against a denial of the human race and its condition, which is primed in terms of sovereignty. To analogise—is it really seriously being advocated that football fans attending World Football matches, focus on the team that is the most skilled. There is something in the nature of the human condition and football fans that partakes of the possessive. This 'possessive' is grounded in the competitive spirit, along with the need to focus on fair play and equal opportunities in the playing field. The competitive spirit is innate; and the concern for fair play cannot be addressed until there is an assurance that rational allocation of decision making processes will be arrived at objectively and through effective representative mechanisms. In the absence of an international neutral rational allocator of functions and decisions we are reduced to a focus on the decision making processes that engage the allocative decisions in international organisations. Herein, to reiterate, American and European mantra on reform of the decision making processes in the WTO so as to undermine the

<sup>2</sup> *Ibid.*

<sup>3</sup> See *European Communities—Regime for the Importation, Sale and Distribution of Bananas* Appellate Body Report, (WT/DS27/AB/R), Adopted Sept 1997.

<sup>4</sup> JH Jackson, *Sovereignty, the WTO, and Changing Fundamentals of International Law* (Cambridge, CUP, 2006).



system of one Member one vote does not assist in the sanitising of the sovereignty debate. Decision-making processes in international organisations are best formulated against the background of Rawls's veil of ignorance.<sup>5</sup> Set in that context this mantra may well be better directed at the question of how best to truly represent effectively all interest groups.

## 2. Relationship of Development and Sovereignty

That there is a relationship between sovereignty and development is undoubted. Development it is recognised involves policy space, differential responsibility, and a certain degree of protection from encroachments on sovereignty. It is the case also that a significant part of the developing world inherits a cultural and religious setting that is diverse, and that itself raises questions of its protection. The nature of the relationship between development and sovereignty is thus constructive. The responsibility that accompanies sovereignty is differential and as such sovereignty nurturing. Moreover, sovereignty provides for a defence against the encroachment of State competence, and therefore specifically calls for its guarding. This interpretation of sovereignty in terms of development can be termed as 'development sovereignty'. However, it may be noted that sovereignty and development need not necessarily correlate, as it can be the case that from a development perspective a course of action may be desirable but that from a self determination/sovereignty perspective a different approach may be dictated.<sup>6</sup>

In contrast sovereignty in the developed world is at its core assured, and informed by the need to preserve its offensive capabilities and the replication of its development paradigm consistent with its further development. The nature of the relationship of sovereignty with the developed status is thus essentially expansive. This expansive tendency can be couched as an internationalist approach to sovereignty.

<sup>5</sup> See J Rawls', *A Theory of Justice* (Cambridge Mass, Belknap Press, 1971).

<sup>6</sup> See *Turkey-Consultation Under Article XXII:2* Report of GATT Working Party Adopted on 28th Mar 1966 (L/2465) Paragraph 16. The representative of Turkey pointed out that the increase of the Turkish tariff could not be appreciated out of the context in which this measure had been taken. The tariff increase was only one feature of the long-term development plan which, as appeared from the Turkish submission for the waiver, was intended to accelerate economic growth, raise levels of employment and ensure economic stability, and the maintenance of balance-of-payments equilibrium, thus enabling Turkey to reduce reliance on direct import controls. He did not share the view that a contracting party which was in balance-of-payments difficulties and needed protection for its economy could not grant preferential tariff treatment; indeed there were many such instances among contracting parties in GATT. Moreover, the representative of Turkey said that Turkey was quite conscious of its own interest and would naturally act in accordance with the requirements of its economic development, but as sovereign State, Turkey strongly felt that no further guidance was required in this context.

### 3. Sovereignty and Dispute Settlement

The relationship of sovereignty and the WTO dispute settlement system does not need to be spelt out. It arises in the context of the jurisdiction of the dispute settlement organs, in the kind of representation and participatory rights accorded in the dispute settlement process, in the processes of interpretation and adjudication, and in the remedies afforded. In some measure the architecture of the WTO dispute settlement system is the result of the ‘contest’, to borrow a phrase,<sup>7</sup> between member sovereignty and the WTO, and is therefore already cast.

However, the process of the demarcation of sovereignty, as much as its impact, is nevertheless to be found in the on going operations of the dispute settlement system. The processes involve:

- Interpretations of the substantive aspects of a Member’s sovereignty;
- Determinations of the participatory rights of Members;
- Techniques of interpretation; and
- Compliance related issues.

The WTO Panel and Appellate Body proceedings are replete with pleadings based on sovereign rights, including on occasions both opposing parties basing their claims *inter alia*, on sovereignty.<sup>8</sup> Such claims involve the assertion that the WTO provisions should not be interpreted in such a manner as to undermine a Member’s sovereignty;<sup>9</sup> or independently in terms of the principle of sovereignty

<sup>7</sup> D Sarooshi, *International Organizations and Their Exercise of Sovereign Powers* (Oxford, Oxford University Press, 2005).

<sup>8</sup> See for example *United States—Import Prohibition of Certain Shrimp & Shrimp Products*, Panel Report, (WT/DS58/R) Adopted Nov 1998 para 7.24 ‘Malaysia contends that, since s 609 allows the United States to take actions unilaterally to conserve a shared natural resource, it is therefore in breach of the sovereignty principle under international law. The United States responds that Article XX(b) and (g) contain no jurisdictional limitations, nor limitations on the location of the animals or natural resources to be protected and conserved and that, under general principles of international law relating to sovereignty, States have the right to regulate imports within their jurisdiction.’

<sup>9</sup> See for example *United States—Restrictions on Imports of Tuna* Report of the Panel (DS29/R) 1994 para 3.64 ‘The United States argued that the import prohibitions taken under the intermediary nation embargo were “necessary” in terms of Article XX(b) to ensure the life and health of dolphins. In this regard, the term “necessary” in Article XX(b) had to be interpreted in accordance with its normal meaning. “Necessary to protect human, animal or plant life or health” would normally be construed to mean that the measure was *needed* to protect such life or health. Any interpretation of this word as meaning “least inconsistent” with the General Agreement was needlessly complex and unpredictable, and had not basis in the text or drafting history of the General Agreement. Under that interpretation, the contracting party invoking Article XX(b) had first to prove a negative, that is, the non-existence of other measures. The contracting party then had to establish the range of alternatives available and rank them according to “least inconsistency” with the provisions of the General Agreement. 3.65 The United States further argued that a “least inconsistent” test would impinge on the sovereignty of each contracting party. Panels would dictate the specific measures to be adopted by the contracting party, since presumably there was only one measure among all the alternatives that was the “least inconsistent” with the General Agreement’.

under International Law.<sup>10</sup> In this context it is to be noted that there are essentially two grounds which give the sovereignty principle legitimacy in WTO adjudication. First, as has been stated, the WTO does not function in isolation but is set against the background of International Law.<sup>11</sup> Secondly, and more specifically the principle of sovereignty is a ‘relevant rule of International Law’,<sup>12</sup> and therefore is material in the interpretation of WTO Agreements.

Panel and Appellate deliberations acknowledge that the WTO Agreements were negotiated against the background of State sovereignty, and that the WTO is set within the framework of sovereign Members.<sup>13</sup> Indeed, it has even been claimed that ‘a Member’s regulatory sovereignty is an essential pillar of the progressive liberalization of trade in services’.<sup>14</sup> Thus, the principle of sovereignty is acknowledged as an ‘additional argument’.<sup>15</sup> The judicial organs of the WTO have acknowledged that they have no business to determine the scope and content of sovereignty outside their function of interpreting and applying the WTO

<sup>10</sup> See *United States—Restrictions on Imports of Tuna* Report of the Panel (DS29/R) 1994 para 4.2 ‘Australia further stated . . . In other instances, GATT exceptions provisions might be invoked in line with sovereignty principles. The text of the General Agreement clearly respected the sovereign right of contracting parties to maintain their own standards. However, sovereignty was a two-way street in the GATT. A contracting party which claimed the right to take trade restrictions based on unilaterally-determined standards must expect other contracting parties to claim the right to justify trade restrictions against that contracting party on the same grounds. The United States intermediary nation embargo effectively denied other contracting parties subject to the embargo the sovereignty to set their own standards for the like product. 4.38 . . . The prescription of another country’s policies through the withholding of access, based not on multilaterally-agreed rules but on that country’s unilateral action, could not be justified under recognized principles of international law. These principles held that extra jurisdictional acts could only lawfully be the object of jurisdiction if the principle of nonintervention in a domestic or territorial jurisdiction of other states was observed. This followed from the nature of the sovereignty of States and the fact that a state was supreme internally. Article II, paragraph 7, of the United Nations Charter reflected this principle in providing that the United Nations could not intervene in matters which were essentially within the domestic jurisdiction of a state. A related principle was that states could not normally exercise jurisdiction in areas beyond national jurisdiction. There were some situations in international law where such a jurisdiction was conferred, for example in relation to certain types of activities carried out by a state’s nationals in areas beyond its territorial jurisdiction. But there was no established general basis in international law for the exercise of such a jurisdiction, particularly in relation to the activities of nationals of another state’.

<sup>11</sup> *United States—Standards for Reformulated and Conventional Gasoline*, Appellate Body Report (WT/DS2/AB/R) Adopted May 1996.

<sup>12</sup> See Arts 31–32 of the VC on the Law of Treaties.

<sup>13</sup> *Japan—Taxes on Alcoholic Beverages* Appellate Body Report (WT/DS8,10,11/AB/R), Adopted Nov 1996, para F ‘It is self-evident that in an exercise of their sovereignty, and in pursuit of their own respective national interests, the Members of the WTO have made a bargain. In exchange for the benefits they expect to derive as Members of the WTO, they have agreed to exercise their sovereignty according to the commitments they have made in the *WTO Agreement*’.

<sup>14</sup> *United States—Measures Affecting the Cross-Border Supply of Gambling and Betting Services* Report of the Panel (WT/DS285/R) Adopted Apr 2005, para 16.316.

<sup>15</sup> *United States—Import Prohibition of Certain Shrimp and Shrimp Products*. Recourse to Article 21.5 of the DSU by Malaysia, Report of the Panel, (WT/DS58/RW) Adopted Nov 2001: ‘we nonetheless consider that the “sovereignty” question raised by Malaysia is an additional argument in favour of the conclusion of an international agreement to protect and conserve sea turtles which would take into account the situation of all interested parties’.

Agreements.<sup>16</sup> In relation to some vital aspects of a member's sovereignty there is express acknowledgement of a Member's sovereignty, in the regulatory sphere, in the fiscal sphere,<sup>17</sup> and in relation to internal national decision making processes.<sup>18</sup> With respect to the application of national measures extra-territorially, in relation to environmental matters for instance, the exercise of jurisdiction is restricted by the requirement of the existence of some nexus between the measure and the object of regulation.<sup>19</sup>

Indeed, the principle of sovereignty has also permeated the very process of adjudication and compliance. Thus, the process of interpretation is informed by the principle of *in dubio mitus*.<sup>20</sup> Deference is accorded to national interpretation of domestic law.<sup>21</sup> Premium is placed on the textual approach to interpretation in deference to member sovereignty.<sup>22</sup> With respect to some agreements the deferential standard of review is applied even though not expressly authorised.<sup>23</sup> The manner in which a government forms its delegation,

<sup>16</sup> *United States—Import Prohibition of Certain Shrimp and Shrimp Products*, Appellate Body (WT/DS58/AB/R) Adopted Nov 1998 para 185. In reaching these conclusions, we wish to underscore what we have *not* decided in this appeal. We have *not* decided that the protection and preservation of the environment is of no significance to the Members of the WTO. Clearly, it is. We have *not* decided that the sovereign nations that are Members of the WTO cannot adopt effective measures to protect endangered species, such as sea turtles. Clearly, they can and should. And we have *not* decided that sovereign states should not act together bilaterally, plurilaterally or multilaterally, either within the WTO or in other international fora, to protect endangered species or to otherwise protect the environment. Clearly, they should and do.

<sup>17</sup> *United States—Tax Treatment For 'Foreign Sales Corporations'* Panel Report, (WT/DS108/R) Adopted 2000, para 7.122 and Appellate Body Report (WT/DS108 AB/R) Mar, 2000 para 139 and 148.

<sup>18</sup> *United States—Definitive Safeguard Measures on Imports of Certain Steel Products*, Appellate Body Report, WT/DS 248, 249, 251, 252, 253, 254, 258, 259/AB/R), Adopted Dec 2003, para 158: 'We note also that we are not concerned with how the competent authorities of WTO Members reach their determinations in applying safeguard measures. The *Agreement on Safeguards* does not prescribe the internal decision-making process for making such a determination. That is entirely up to WTO Members in the exercise of their sovereignty. We are concerned only with the determination itself, which is a singular act for which a WTO Member may be accountable in WTO dispute settlement'.

<sup>19</sup> US—Shrimps (AB) above n 15.

<sup>20</sup> *EC Measures Concerning Meat and Meat Products (Hormones)*, Appeal Body, (WT/DS26,48/AB/R), Adopted 1998, para 65: 'We cannot lightly assume that sovereign states intended to impose upon themselves the more onerous, rather than the less burdensome, obligation by mandating *conformity* or *compliance* with such standards, guidelines and recommendations. To sustain such an assumption and to warrant such a far-reaching interpretation, treaty language far more specific and compelling than that found in Article 3 of the *SPS Agreement* would be necessary. The interpretative principle of *in dubio mitius*, widely recognized in international law as a "supplementary means of interpretation"', has been expressed in the following terms: 'The principle of *in dubio mitius* applies in interpreting treaties, in deference to the sovereignty of states. If the meaning of a term is ambiguous, that meaning is to be preferred which is less onerous to the party assuming an obligation, or which interferes less with the territorial and personal supremacy of a party, or involves less general restrictions upon the parties'. R. Jennings and A. Watts (eds), *Oppenheim's International Law*, 9th edn, vol I (Longman, 1992), p 1278.

<sup>21</sup> *United States—Sections 301–310 of the Trade Act of 1974* (WT/DS152/R), Panel Report, Adopted 2000.

<sup>22</sup> See for example JH Jackson (2006) above n 4.

<sup>23</sup> See the Appellate Body decision involving the ASCM and SA.

and consequently its participation and representation in dispute settlement proceedings, is a matter for the Member government concerned.<sup>24</sup> The treatment of the statements of a Member's representatives, in dispute settlement proceedings, because they can have far reaching effects on a sovereign Member's commitments, is a matter of special judicial sensitivity.<sup>25</sup> The determination of compliance by a Member is informed by a presumption of compliance.<sup>26</sup> And Members need to respect the sovereignty of another member where verification of matters is required.<sup>27</sup>

In conclusion, judicial pronouncements and practice have revolved not merely on the task of clarifying the tensions between Member sovereignty and WTO commitments, but that there is evidence of deference to the principle of sovereignty both in terms of the substantive sovereignty of a Member and its external sovereignty in the WTO. Indeed on occasions judicial pronouncements have engaged in the clarification of the scope of sovereignty independent of the question of WTO commitments.

#### 4. Development /Sovereignty and the Dispute Settlement System

Special and differential (S&D) provisions in the DSU intended for developing Members reflects an effort at substantive equality. It is an indulgence in sovereignty accorded to developing Members—according a greater degree of sovereignty in the dispute settlement process to developing countries—through for example facilitating their greater participation in the dispute settlement system; and some insulation from the full rigours of its operation. The need for this indulgence to be made more effective is generally recognised, and is an aspect of the Doha Round negotiations.

<sup>24</sup> EC—Bananas (AB) above n 3 para 5. 'By letter of 9 Jul 1997, the Government of Saint Lucia submitted reasons justifying the participation of two specialist legal advisers, who are not full-time government employees of Saint Lucia, in the Appellate Body oral hearing. Saint Lucia argued that there are two separate issues concerning rights of representation in WTO dispute settlement proceedings. The first issue is whether a state may have its case presented before a panel or the Appellate Body by private lawyers. The second issue deals with the sovereign right of a state to decide who constitutes its official government representatives or delegation. On the second, and more fundamental issue, Saint Lucia submitted that as a matter of customary international law, no international organization has the right to interfere with a government's sovereign right to decide whom it may accredit as officials and members of its delegation'.

<sup>25</sup> US—s 301 (Panel) above n 21 para 7.118 'A sovereign State should normally not find itself legally affected on the international plane by the casual statement of any of the numerous representatives speaking on its behalf in today's highly interactive and inter-dependant world'.

<sup>26</sup> *United States—Import Measures on Certain Products from the European Communities* (WT/DS165/R), Panel Report, Adopted 2001 quoting the following conclusion of the *Hormones* Arbitration Report: '9. WTO Members, as sovereign entities, can be *presumed* to act in conformity with their WTO obligations. A party claiming that a Member has acted *inconsistently* with WTO rules bears the burden of proving that inconsistency'. (emphasis in original) .

<sup>27</sup> *European Communities—Protection of Trademarks and Geographical Indications for Agricultural Products and Foodstuffs*, Panel Report (WT/DS174/R, WT/DS290/R) Adopted Apr 2005, para 7.248 'Verification in a third country calls for respect for its sovereignty'.

Generally, in the WTO dispute settlement practice, the exceptional special margin of sovereignty needed by developing Members has been recognised. Thus, the use of outside counsel has been justified, in particular so as to enable developing Members to effectively represent themselves in WTO dispute settlement proceedings.<sup>28</sup> To some degree the development condition of a Member has been taken into account in the assessment of its trade practices<sup>29</sup>—in terms of the degree of latitude in their trade practices needed for their development, and dictated by their development condition.

One aspect of dispute settlement that may be highlighted here is the interpretative process. The development of the interpretative process in the WTO has been influenced by how Member's perceive their sovereignty being affected by it. Thus, the emphasis on 'objects and purposes' of the WTO that might impact positively on the development objective, is resisted on the basis that such a development will impact on national sovereignty. By the same token it may be possible to analyse the emphasis on strict interpretation as responding to the preservation of negotiated sovereignty. Whereas the identification of the 'common intentions'<sup>30</sup> of the parties to an agreement as the purpose of interpretation, places a premium on the original negotiators, in particular the shapers of that intention.

Equally, the process of interpreting Articles 31–32 of the VC, which set out the customary rules of treaty interpretation, needs to be sensitive to the fact of the differing capacities of the Members of the WTO. Differing interpretation of the rules of treaty interpretation may impact differently on different categories of Members. Thus, the Appellate Body has ruled that in the determination of 'subsequent practice' under Article 31 of the VC there is no need for universal practice; and that silence in terms of the practice can be construed as acceptance of the practice. Such an interpretation potentially puts a premium on the practice of trend setters in international trade, and can penalise passive participation in international trade relations. Herein the sovereignty of Members is impacted—in particular developing Members.

By the same token the meaning of 'parties' in the context of Article 31 (3) (c) of the VC raises questions of sovereignty if non-parties to certain 'relevant rules of International Law' end up being subjected to commitments that are informed by such agreements.<sup>30a</sup> It remains to be seen if the Appellate Body will be sensitive to the fact that relatively the developing Members of the WTO have made

<sup>28</sup> See *Indonesia-Certain Measures Affecting the Automobile Industry*, Report of the Panel, (WT/DS54,55,59,64,R) Adopted Jul 1998.

<sup>29</sup> A Qureshi, 'Interpreting WTO Agreements for the Development Objective', (2001) 37 *Journal of World Trade* 847.

<sup>30</sup> See *European Communities—Customs Classification of Frozen Boneless Chicken Cuts* Report of the Appellate Body, (WT/DS269,286/AB/R), Adopted Sept 2005.

<sup>30a</sup> See however the *EC-Measures Affecting the Approval and Marketing of Biotech Products*, Report of the Panel, (WT/DS 291/R) September 2006, para 7.75, in which the Panel concluded that all the parties to the WTO had to be parties to the multilateral agreement which formed the 'relevant rules of International Law'.

a lesser impact generally on rules of International Law, and therefore on ‘relevant rules of International Law’.

The principle of ‘good faith’ in Article 31 of the VC is a principle that has much to commend for the developing Membership. Good faith embraces fair play—which is something developing Members are in particular need of. However, the interpretation placed in the WTO thus far on this as not involving an investigation into the ‘bad faith’ of a Member, or that it involves only the identification of the better faith,<sup>31</sup> has somewhat dented the potential value of this principle in the process of interpretation and adjudication.

### 5. Sovereignty and Reform of the DSU

The sovereignty perspective has two dimensions in the context of the reform of the DSU. First, it is reflected in the kind of judgement involved with respect to the state of the current dispute settlement system and its operation. Thus, generally the picture of the state of play in dispute settlement is painted relatively more optimistically on the part of developed States, and indeed analysts from developed countries.<sup>32</sup> On the other hand, from the perspective of developing countries, the need for reform appears to be greater. This assessment of the state of play is to a certain extent attributable to sovereignty—the current system being perceived by developed Members as being broadly consonant with the degree to which they can accommodate the surrender of State sovereignty that accompanies participation in the WTO dispute settlement system. Thus, strengthening the enforcement system has been more a concern of developing Members. Second, the treatment of some of the proposals for reform can be attributable to sovereignty concerns, for example the proposal for collective retaliation does not seem to have commanded a ‘high level of support’.<sup>33</sup>

## III. CONCLUSION

Sovereignty is a feature of the dispute settlement system; and ‘development sovereignty’ an aspect of it. There is room however for greater consciousness and scope for ‘development sovereignty’ in the framework of the WTO dispute settlement system.

In particular, the interface between ‘development sovereignty’ and the dispute settlement system can be augmented through for example:

- Expansive sovereignty being accorded for the development objective in substantive interpretations of WTO commitments;

<sup>31</sup> See US—s 301 (Panel) above n 21.

<sup>32</sup> See for example TN/DS/14 (Nov 2005).

<sup>33</sup> *Ibid* para 6.

- Flexible approaches to procedural and participatory rights in dispute settlement processes for developing Members;
- Sensitivity in the assessment of trade obligations so as to take into account the impact of development in the capacity of a Member to discharge WTO obligations;
- Creativity in operationalising S&D provisions; and
- Sharpening and facilitating the capacity of developing members to enforce their WTO rights against other Members.





# *The Rule of Law and Proportionality in WTO Law*

MADS ANDENAS AND STEFAN ZLEPTNIG

## I. INTRODUCTION

**P**ROPORTIONALITY, NECESSITY AND balancing are discussed in the context of the World Trade Organization (WTO). The WTO treaty framework contains several necessity tests. They are prominently placed in the General Agreement on Trade in Services (GATS) and the General Agreement on Tariffs and Trade (GATT), and also in the Agreement on Sanitary and Phytosanitary Measures (SPS) and Technical Barriers to Trade (TBT).

The liberalisation of trade in goods and services requires that the meaning of and the relationship between these tests are clarified. In this chapter we set out a comparative approach for doing so at a general WTO level. This is now particularly relevant in the context of the GATS and the liberalisation of trade in services.

The role of the principle of proportionality in the WTO legal order has been a matter of discussion for some time. In 2001, Axel Desmedt concluded that there is ‘not one single overarching (unwritten) proportionality principle in WTO law’.<sup>1</sup> (Desmedt 2001, 441). The main argument advanced against proportionality is that the WTO is institutionally not ready for such a fundamental balancing of values and interests (mainly economic versus non-economic), and that such balancing is at the core of the proportionality analysis (Neumann and Türk 2003, 231–3).

In contrast, Meinhard Hilf has argued in a series of publications that ‘the principle of proportionality is one of the more basic principles underlying the multilateral trading system’. (Hilf 2001, 120). The author emphasises that ‘[a]

<sup>1</sup> On page 478 he also argues that ‘it seems there is no basis yet for the recognition in WTO law of an unwritten and overarching proportionality principle as known in EC law’.

sensitive balancing process, guided by the principle of proportionality . . . , is needed in which no rule or principle involved should be left to redundancy or inutility. The principle of proportionality should rule any process of interpretation and application of WTO law with a view to obtaining a due relation between the different interests at stake'. (Hilf 2001, 130)

Our main conclusion in this chapter is that there is no crude balancing of trade and non-trade values and interests in the WTO. The tests written into the WTO Agreements provide for a more sophisticated way of balancing, taking account of the individual circumstances at stake and the competing rights and interests involved. We argue that comparative legal thinking based on insights gained from the principle of proportionality in other legal orders, and the role of principles generally, may help structure and rationalise this process.

## II. THE PRINCIPLE OF PROPORTIONALITY

### 1. Function and Scope

We first turn to the *function* and *scope* of the principle of proportionality and similar balancing tests. Proportionality is not only a *judicial* doctrine but also *legislative* doctrine for the political institutions to follow. Proportionality is a 'trade-off device' which helps resolve conflicts between different norms, principles and values. It is also a determining factor for the role of courts in reviewing administrative or legislative measures. Proportionality provides a legal standard against which individual or state measures can be reviewed. Proportionality is closely related to the issues of intensity of review (the level of scrutiny exercised by judges) and whether there should be a full review on the merits or a more deferential notion of judicial review (de Búrca 1993; Emiliou 1996; Ross 1998).

Proportionality has developed as a test of review. It is used in different contexts. First, it is recognised in some systems as the test for the exercise of competences. Secondly, it is used to review justifications for interference with or restrictions on rights. Thirdly, it is also used to determine the extension of rights. Other limiting mechanisms, such as leaving national authorities a 'margin of appreciation' in European Human Rights law,<sup>2</sup> or having a rule of reason in US federal anti trust law, may in fact involve or incorporate similar balancing exercises.

In European Human Rights law, for instance, proportionality is applied in at least three different contexts. First, as a benchmark to establish the legality of derogations. Second, with the aim to establish the legality of interferences by states with Convention rights. And, third, to determine scope of application of some of the rights established by the Convention.

<sup>2</sup> Which is based on the European Convention of Human Rights 1950 (ECHR).

On a more general level, a first use of proportionality is as a general test for the exercise of competences. This aspect features in domestic legal systems (eg control of discretion in German administrative law),<sup>3</sup> as well as European Union (EU) law. In the latter case, the Community courts control the exercise of discretion conferred on the Community institutions and, in particular, the European Commission. There are differences in the intensity of review depending on the area and subject matter of the decision. A second use relates to justifications for interference with, or restrictions on, rights. This is typically the case in areas such as EU free movement law, national constitutional law, the European Human Rights law (of the ECHR) and human rights in English law. In addition to the differences in the intensity of review depending on the area and subject matter of the decision, the kinds of rights involved provide another variable.

The areas of application of the principle of proportionality overlap with the functions it is intended to fulfil. This may be illustrated by the following typology of functions.

(i) *Control and Limitation of Discretion.* The basic idea underlying proportionality is that citizens of liberal states should only have their freedom of action limited insofar as this is necessary in the public interest. Public authorities should, in the choice of their measures, choose the least onerous. The principle of proportionality guides this process and thereby imposes restrictions on the regulatory freedom of governments.

(ii) *Balancing of Conflicting Rights and Interests.* Such conflicts will often need to be resolved through a judicial balancing act. If this process is guided by the principle of proportionality, the conflicting objectives will be reconciled through the application of the three-step proportionality test.

For instance, these considerations reflect the role of proportionality in EC law. Proportionality is applied to review domestic measures restricting the free movement within the EC Internal Market. In this context, proportionality guides the balancing process between free trade objectives and other legitimate public policy objectives. This reasoning generally also applies to WTO law (Desmedt 2001, 445), even though proportionality and balancing is not used as openly as in EC law. The balancing aspect is also part of the proportionality and necessity tests in public international law.

(iii) *Standard for Judicial Review.* Proportionality as a general principle of law underlies legislative and administrative actions. At the same time it also used as a standard for judicial review of such actions. The proportionality test is usually associated with a full review on the merits, going beyond the more traditional

<sup>3</sup> Different conceptual approaches towards administrative law exist in the European legal systems. Traditionally, the French system emphasised the discretion or freedom of the administration to take decisions, whereas the German system focused on the protection of individual rights of citizens. Changes and convergences have occurred in the recent past. (Schwarze 1996).

and narrower concept of a reasonableness review of the initial decision. Judges applying the principle of proportionality also define a particular (active) role for the judiciary within the legal system: the review of administrative or legislative measures *on the merits*. The fact that courts apply the proportionality test as an independent ground of review has raised concerns about undue judicial interference with administrative and legislative decision-making, the separation of powers, and balancing undertaken by the judiciary (Craig 2003, 38).

(iv) *Scope of Legal Norms*. Proportionality is also a tool to determine the scope and limitations of legal norms. Examples are the inherent limitations of the free movement provisions, such as the ‘rule of reason’ in Article 28 EC (‘mandatory requirements’ doctrine). Another example are the provisions on unlawful discrimination in ECHR and EC law. Despite the usually general wording of equality provisions, differences in treatment are allowed under certain circumstances. Proportionality serves the purpose to determine whether discrimination can be objectively and reasonably justified and thus does not fall foul of the equality principle. The non-discrimination provisions, in fact, include a kind of ‘rule of reason’.

(v) *Limit and Rationalisation of the Power of Judges*. The proportionality test, and its three-step structure, also provides an important tool to confine the legal authority conferred on judges. Counterbalancing far-reaching powers wielded by the judiciary, proportionality introduces rational legal arguments in the decision-making process. Those arguments need to be presented and justified by the parties to a dispute and the judiciary in a public deliberative process. The requirement is that interests at stake, the weight attributed to conflicting norms and other reasoning be made transparent through the three-step analysis (Craig 1999a, 99–100).

## 2. The Elements of the Proportionality Test

The principle of proportionality, in its most elaborate form, consists of three different requirements: suitability, necessity and proportionality *stricto sensu* (proportionality in the narrow sense). These are cumulative requirements, and they are ascending in terms of intensity with which the measure is reviewed (Jans 2000, 241).

There is no single coherent principle of proportionality. Its constituent elements vary, as well as the degree and intensity of review imposed. Tests given different names, such as necessity, reasonableness,<sup>4</sup> cost-benefit-analysis<sup>5</sup> or

<sup>4</sup> For the use of the concept of *reasonableness* in the sense of proportionality, see Ortino (2005). He distinguishes between *substantive* and *procedural* reasonableness.

<sup>5</sup> See Trachtman (1998) who points out the similarities and differences between proportionality, balancing and the cost-benefit-analysis.

rationality review, often contain normative requirements that may be very similar to a proportionality test (or, in our argument, constitute a proportionality test).

*a) Suitability*

Suitability is the first step of assessment. It requires that the adopted measure is suitable or appropriate to achieve the objective it pursues (Snell 2002, 196). In other words, suitability requires a *causal relationship* between the objective and the measure (Jans 2000, 240). One function of this stage of assessment is to single out measures that claim to protect the general interest while, in fact, they have a protectionist purpose. It can easily be argued that measures which are not suitable at all to pursue the stated objective should not be imposed on that basis.<sup>6</sup>

Courts need to determine for themselves the moment at which the suitability of a measure as an objective standard is assessed. In a given case it may make a difference whether the measure is evaluated from an *ex ante* perspective (the moment when the measure was enacted) or an *ex post* perspective (the moment when the measure is analysed by the court). In domestic law, the legislator is often granted a certain ‘right to err’ in making his appraisals about future developments, operation, and effectiveness of the measure adopted. The scope of discretion thus granted to the initial decision maker will also affect the intensity of review, ranging from mere review of evidence to intense substantive review of the decision.

*b) Necessity*

The necessity test requires that the objective, upon which a measure is based, cannot be achieved by alternative means which are less restrictive than the measure adopted. If there is a choice between several appropriate measures, the least onerous and equally effective measure needs to be selected (Snell 2002, 198). This is often called the ‘least restrictive alternative’ (Jans 2000, 240). The test, in fact, combines two questions. The first question is whether there are less restrictive, or milder, measures. Secondly, one needs to ask whether the alternative measures are equally effective in achieving the pursued objective (Ortino, 2004, 471).

The underlying objective of this test is that the measure adopted by the state should do minimum harm to citizens or the community. In a trade context, the necessity requirement obliges the states to impose the least trade-restrictive measure in pursuing non-trade-related domestic policy objectives.

<sup>6</sup> Prominent cases in EC law include Joined Cases 62 and 63/81 *Seco* [1982] ECR 223 paragraph 14; Case C-240/95 *Schmitt* [1996] ECR I-3179, paras 10–22. In German law, see BVerwGE 27, 181, 187–88 (parking prohibition).

The European Court of Justice (ECJ) in *de Pijper* ruled out the necessity of domestic legislation which the Dutch authorities tried to justify on public health grounds. The ECJ held that the measure was not necessary since the domestic authorities could have pursued the same objective as effectively by adopting other means which were less-restrictive to intra-Community trade.<sup>7</sup> In *Familiapress*, another free movement case, the ECJ ruled that it was for the national court to assess whether the national prohibition was ‘proportionate to the aim of maintaining press diversity and whether that objective might not be attained by measures less restrictive of both intra-Community trade and freedom of expression’.<sup>8</sup>

Looking at some recent English cases, such as the central *Shayler* judgment,<sup>9</sup> necessity is interpreted differently compared to the classical three-step test outlined in this section. The English courts tend to align ‘necessity’ with the principle of proportionality *stricto sensu*.

### c) *Proportionality Stricto Sensu*

The third step is to analyse whether effects of a measure are not disproportionate or excessive in relation to the interests affected. This final stage of assessment comes into play once a measure has been found suitable and necessary to achieve a particular objective. It is at this stage that a true weighing and balancing of competing objectives takes place. The more intense the restriction of a particular interest, the more important the justification for the countervailing needs to be.

This third step will often not be reached. In EU law, necessity dominates most cases where the ECJ has applied the proportionality test. In some other cases, the ECJ has tended to disguise proportionality *stricto sensu* as a normal necessity analysis, and it did not explicitly address the third step of analysis (Ortino 2004, 471). Within the necessity test, the Court has conducted a marginal review of proportionality, as some cases on consumer protection and product labelling illustrate.<sup>10</sup> The Court has implicitly questioned the level of protection adopted by the Member States, in addition to a traditional review of suitability and necessity of the domestic measures.

In those rather rare cases where the ECJ has applied proportionality *stricto sensu*, it has usually reviewed the objectives submitted by the Member States to justify their domestic measures. In *Stoke-on-Trent*, the Court outlined proportionality *stricto sensu* in the most unambiguous way:

<sup>7</sup> Case 104/75 *de Peijper* [1976] ECR 613, paras 16–29.

<sup>8</sup> Case C-368/95 *Familiapress* [1997] I-3689, para 27. See also Case C-275/92 *Schindler* [1994] ECR I-1039. In this case, the Court granted the domestic authorities a wide margin of discretion to restrict or prohibit certain types of lotteries on public policy grounds.

<sup>9</sup> *Shayler v R* [2002] 2 WLR 754 (House of Lords), relating to the compatibility of Official Secrets Act 1989 with Human Rights Act 1998.

<sup>10</sup> See Case 120/78 *Rewe (Cassis de Dijon)* [1979] ECR 649; and Case 178/84 *Commission v Germany (German Beer)* [1987] ECR 1227.

Appraising the proportionality of national rules which pursue a legitimate aim under Community law involves weighing the national interest in attaining that aim against the Community interest in ensuring the free movement of goods.<sup>11</sup>

This was a rather exceptional statement in the jurisprudence of the ECJ (Jans 2000, 248). It highlights what balancing in the trade context usually is about. It involves the value and importance of the national objective upon which the measure is based and the overall interest in ensuring free trade. The relative costs and benefits of the domestic measure and the restrictions imposed on free trade will be assessed.

*Danish Bottles* is a classical case where the ECJ applied the full proportionality test in the area of domestic environmental protection. It found that:

[T]he system for returning non-approved containers is capable of protecting the environment and . . . affects only limited quantities of beverages compared with the quantity of beverages consumed in Denmark. . . . *In those circumstances, a restriction of the quantity of products which may be marketed by importers is disproportionate to the objective pursued.*<sup>12</sup>

Equally, in another case concerning the review of a Community legal act, the ECJ explained the full proportionality test as follows:

[T]he principle of proportionality . . . requires that measures adopted by Community institutions should not exceed the limits of what is appropriate and necessary in order to attain the legitimate objectives pursued by the legislation in question, and where there is a choice between several appropriate measures, recourse must be had to the least onerous, *and the disadvantages caused must not be disproportionate to the aims pursued . . .*.<sup>13</sup>

The application of the principle of proportionality in the area of fundamental rights is also illustrative. Whenever fundamental rights are restricted or interfered with by public authorities, the legislative or administrative measures will be assessed against the background of the principle of proportionality. This assessment is particularly relevant in areas covered by the European Convention of Human Rights (ECHR) and domestic constitutional law. Usually, the first stage of assessment is to identify the protected right or interest. One then moves on to identify the extent to which the right is interfered with or restricted. The next stage is to identify the reasons for that restriction. Finally, the last stage is to assess whether the interference was excessive or not. Restrictions have to be suitable, necessary, and proportionate. In this context, proportionality *stricto sensu*, involves a 'fair balance' between the disadvantages for the person whose rights are restricted and the weight of the legitimate aims pursued by the state.

<sup>11</sup> Case C-169/91 *Stoke-on-Trent* [1992] ECR I-6625, para 15.

<sup>12</sup> Case 302/86 *Commission v Denmark* [1988] ECR 4607 para 21. See also Case 44/79 *Hauer* [1979] ECR 3727 para 30.

<sup>13</sup> Case T-13/99, *Pfizer* [2002] ECR II-3305, paras 411–13. In many instances, the ECJ delegates the decision whether domestic measure is disproportionate to the national courts. See, in this respect, Case C-67/98 *Zenatti* [1999] ECR I-07289, para 37.



Interferences with fundamental rights need to be ‘proportionate to the policy aims that underlie them’. (Sales and Hooper 2003, 426).

In the area of fundamental rights, state measures that are necessary may still be disproportionate because the disadvantages caused to an individual are excessive, compared to the aims pursued by the state. A necessary measure may be proportionate when it just marginally impacts on fundamental rights. On the other hand, even a severe impact on fundamental rights, such as the shooting of a criminal, may, in individual circumstances, be the only possible way to achieve a specific objective. It is only after a finding of necessity that a careful balancing and weighing will come into play.

### III. BALANCING IN THE WTO

The concept of proportionality, while its core remains the same, has different constitutive elements and objectives which very much depend on the area of application of this principle. The different elements of the proportionality test may be applied with an ascending degree of scrutiny. In WTO law, we can conceptually distinguish between two different areas of application. First, the public policy *exceptions* which limit the scope of legal rules and provide for derogations from main treaty obligations (eg Art XX GATT). Second, the *positive obligations* imposed on Members by the SPS and TBT Agreements. These positive obligations lay down substantive criteria for domestic regulation to ensure that domestic regulation does not impose too burdensome constraints on international trade (Howse 2000, 154).

Within either of these two categories, one may further distinguish between the *substantive* and *procedural* aspects of the different tests. The substantive aspects lay down normative requirements to assess the compliance of domestic measures with WTO law. Related to substantive obligations are procedural obligations incumbent on the Members, which we refer to as the procedural aspect. Procedural obligations need to be taken into account at the national level (in administrative proceedings or the legislative process) and will subsequently be reviewed by the WTO judicial bodies. In so far as these procedural requirements relate to the quality of the domestic processes, they impose ‘procedural checks’ on domestic decision-making (Scott 2004).

A few authors have forcefully argued that the principle of proportionality is not explicitly (or even implicitly) recognised in the law of the WTO. Our own approach in this section is to address this argument and attempt to move the existing debate further and to outline some structural features inherent in the different tests laid down in the WTO Agreements.

## 1. Objective justifications: public policy Exceptions in the GATT

### *a) Introduction*

Article XX GATT provides for a list of general exceptions from the GATT obligations. The scope and application of this provision is crucial for WTO Members which want to justify their domestic policies as GATT-consistent and invoke one of the public policy exceptions in Article XX. This provision has already touched upon some of the most sensitive issues of WTO law and is likely, in the future, 'to raise some of the most difficult questions that the WTO will face'. (McRae 2000, 233).

Any domestic measure, in order to qualify as a lawful exception under Art XX GATT, needs to comply with the conditions laid down in this provision.<sup>14</sup> The Appellate Body (AB) in *US–Gasoline* set out the appropriate method and sequence of steps for applying Article XX (WTO 1996, 22). This consists of two different steps, which, taken together, make the full assessment of a measure under Article XX. The first step is to assess whether the *general design* of a measure falls within the scope of one of the exceptions in Article XX (a)–(j). Subsequently, the *application* of a measure is assessed against the criteria in the introductory clauses (Chapeau) of Article XX.

### *b) General Design*

The first step is to determine whether the domestic measure can be justified in accordance with one of the public policy exceptions. So far, the main focus of the case law has been on health measures (paragraph b), enforcement measures (paragraph d) and conservation measures (paragraph g). The choice of WTO Members to adopt a specific public policy objective and to choose the desired level of protection or enforcement has not been questioned by the panels and the AB (WTO 2002c, paragraph 16). In *Asbestos*, for instance, the AB held that 'it is undisputed that WTO Members have the right to determine the level of protection of health that they consider appropriate in a given situation'. (WTO 2001, paragraph 168). In *US–Gasoline*, the AB previously stated that 'WTO Members were free to set their own environmental objectives, but they were bound to implement these objectives through measures consistent with . . . [GATT] provisions . . .'. As far as the assessment of the appropriateness of the aim pursued is concerned, Members will have a wide margin of discretion. This discretion is subject to the condition that the chosen objective falls within the scope of the exceptions mentioned in Article XX GATT.

<sup>14</sup> In this paper we will not specifically deal with Art XIV GATS which is equivalent to Art XX GATT. The recent *USGambling* dispute confirmed that jurisprudence developed under Art XX GATT is also relevant for the interpretation of Art XIV GATS.

The next step will be to determine the relationship, or connection, between the aim pursued and the measure adopted. This is a sensitive issue, for it impacts on the intensity with which judges review (second-guess) domestic policy choices. The relationship between the aim and measure is typically at the core of any proportionality inquiry (both in the domestic and international context).

In Article XX there is a textual difference in the individual paragraphs between the requirement that a measure be ‘necessary to’ protect a specific public policy objective (eg public morals; human, animal or plant life or health) or, alternatively, ‘relates to’ such an objective (conservation of exhaustible natural resources; products of prison labour). We now explore the scope and application of these two tests.

(i) *Necessary to . . .*

The necessity test in Articles XX (b) and (d) has been subject to considerable academic interest and also featured prominently in the WTO jurisprudence. In the *Thai—Cigarettes* case, the panel elaborated on the necessity criterion and stated that trade restrictions were necessary ‘only if there were no alternative measures consistent with the [GATT], or less inconsistent with it, which Thailand could reasonably be expected to employ to achieve its health policy objectives’. (GATT 1990, paragraph 75). In *US—Gasoline*, the Panel’s standard was whether ‘there were measures consistent or less inconsistent with the General Agreement that were reasonably available . . .’. The focus on the least trade-restrictive and least GATT-inconsistent measure has led to considerable criticism in the academic literature, in particular for imposing too many constraints on legitimate domestic policy choices.

Subsequent reports by the Appellate Body refined the necessity test. *Korea—Beef* is particularly relevant in this respect. According to the AB, in order to evaluate the necessity of a measure one needs to take into account, first, ‘the extent to which the measure contributes to the realization of the end pursued’ (WTO 2001a, paragraph 163) and, second, ‘the extent to which the compliance measure produces restrictive effects on international commerce’. As a consequence, measures with a lesser impact on international commerce ‘might more easily be considered as “necessary” than a measure with intense or broader restrictive effects’. The AB stressed that a ‘weighing and balancing’ approach contributes to determine whether a Member could ‘reasonably be expected to employ’ an alternative measure or whether a less WTO-inconsistent measure is ‘reasonably available’.

One interpretation of this judicial development is that the necessity test evolved from a ‘least-trade restrictive approach to a less-trade restrictive one, supplemented with a proportionality test (‘a process of weighing and balancing of a series of factors’). (WTO 2002c, paragraph 42). Within this balancing test, the AB will assess the relative importance of domestic interests or values pursued. This approach implies a significant shift towards a greater role of the panels and the AB in evaluating the legitimacy and necessity of domestic measures.

On the other hand, some have argued that the approach in *Korea–Beef* introduces a more ‘relaxed’ necessity test, a kind of *de minimis rule*, which leaves more discretion and an additional margin of appreciation to the Members. (Neumann and Türk 2003, 211; Howse and Türk 2001, 325).

The AB further elaborated on the necessity requirement of Article XX in the *Asbestos* case. The report concludes that ‘in determining whether a suggested alternative measure is “reasonably available”, several factors must be taken into account, besides the difficulty of implementation’. (WTO 2001, paragraph 170). That determination will be influenced by the ‘the weighing and balancing’ of various factors, as outlined in *Korea Beef*. The main factors that need to be taken into account in this assessment are (a) the extent to which the alternative measure contributes to the realization of the end pursued and (b) the importance of the interests and values pursued by the Member.<sup>15</sup> It is then necessary to assess whether there ‘is an alternative measure that would achieve the same end and that is less restrictive of trade than a prohibition’. (WTO 2001, paragraph 172) This approach does not put into question the objective pursued by the Member, but is intended to provide a standard to evaluate the necessity of a domestic measure.

In recent disputes the AB confirmed and applied the concept of necessity as previously developed in *Korea–Beef* and *EC–Asbestos*. The AB report in *US–Gambling* elaborated on the necessity standard under Art XIV(a) GATS (WTO 2005, paras 304–27) and the AB report in *Dominican Republic–Cigarettes* dealt with the necessity standard under Art XX(d) GATT (WTO 2005a, paras 57–74).

The necessity test seems to imply the following. A measure is necessary if it is either indispensable or alternative measures are not reasonably available to achieve the same legitimate public policy objective.<sup>16</sup> This determination will be made upon a weighing and balancing of different factors, including the trade-restrictive effects of the measure, the importance of the aim pursued, and the contribution made by possible alternative measures to achieve that aim pursued. This test certainly introduces a flexible balancing approach into Article XX GATT and a certain degree of subjectivity on the part of the judiciary. At the same time, it requires both the judiciary and the parties to the dispute to structure and justify their arguments along the lines defined by the AB in its jurisprudence and to present the arguments in such a way that they fit with the requirements imposed by the necessity analysis.

(ii) *Relating to . . .*

Other exceptions in Article XX are subject to the condition that the measure is ‘related to’ a legitimate public policy objective (eg conservation of exhaustible

<sup>15</sup> For instance, the more important the interest or value pursued, the easier it will be to justify the domestic measure enacted to achieve that objective as ‘necessary’.

<sup>16</sup> In *Korea–Beef*, (WTO 2001a, paragraph 161), the AB referred to ‘a range of degrees of necessity’, whereby indispensable, absolutely necessary and inevitable measures ‘certainly fulfil the requirements of Article XX (d)’.

natural resources in Article XX(g)). The term ‘related to’ indicates that this standard requires a looser degree connection between the measure and the aim than the stricter necessity test. The AB in *Korea Beef* stressed that the term ‘relating to’ is ‘more flexible textually than the “necessity requirement” found in Article XX (g)’. (WTO 2001a, paragraph 104). Initially, the GATT panel in the *Canada–Salmon and Herring* case argued that ‘relating to’ included not only measures that are necessary or essential to achieve the conservation of exhaustible natural resources but are ‘primarily aimed at’ the chosen objective (GATT 1988, paragraph 4.6). Subsequently, the AB in *US–Gasoline* clarified that the term ‘relating to’ requires at least a ‘substantial relationship’ between the means and end which ‘cannot be regarded as merely ancillary or inadvertently aimed at the conservation of clean air . . .’. (WTO 1996, 19).

In *US–Shrimp*, the AB assessed whether the domestic measure was ‘reasonably related’ to the ends, arguing that ‘the means and ends relationship [between the measure and the policy pursued in that case] . . . is observably a close and real one . . .’. (WTO 1998a, paragraph 141). This was also the AB’s interpretation of the test as applied in the previous *Gasoline* case. The AB reaffirmed that the requirement of ‘relating to’ is about a ‘close and genuine relationship of end and means’. (paragraph 136). The AB further held that the *design* of the domestic measure was ‘not disproportionately wide in its scope and reach in relation to the policy objective of protection and conservation of sea turtle species’. (paragraph 141).

While the scope of the ‘relating to’ test is still somewhat unclear (McRae 2000, 226), the AB has at least outlined some general criteria for that test. The main requirements are a ‘close and genuine relationship’ between the measure and the aim pursued, which, in, other words, need to be reasonably related. The test is less strict than the necessity test. This may lead to the result that—in so far as the specific tests are concerned—a measure relating to environmental objectives can justified more easily under Art XX(g) GATT (conservation of exhaustible natural resources) than under Article XX(b) GATT (protection of human, animal or plant life or health). In both cases, WTO Members can define and chose without judicial interference the level of protection which they consider appropriate. The assessment of the measures adopted pursuant to that policy choice, however, will be more intrusive. First, the necessity test requires an assessment whether a WTO Member could reasonably have been expected to employ a less trade-restrictive alternative. This determination will be governed by a balancing and weighing of different factors. Conversely, the ‘related to’ test seems to be a more deferential reasonableness standard which also includes some elements of a proportionality inquiry. (Desmedt 2001, 476).

### *c) Application of the Measure: The Chapeau*

We move from the tests set out in individual paragraphs of Article XX GATT to the next step. If a national measure is found to comply with these require-

ments, it will be ‘provisionally justified’ (WTO 1998a, paragraph 147). The next step is then to turn to the introductory clause of Article XX GATT, also known as the Chapeau, to determine whether a measure, in its *concrete application*, is lawful under Article XX as a whole. The chapeau requires that measures should 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*’.

In *US–Gasoline* the AB has begun to develop a coherent theory regarding both the function of the chapeau and its relationship with the general exceptions. The AB stressed that the ‘purpose and object of the introductory clauses of Article XX is generally the prevention of abuse’ of the exceptions in Article XX (WTO 1996, 22). While those exceptions ‘may be invoked as a matter of legal right, they should not be applied so as to frustrate or defeat the legal obligations of the holder of the right under the substantive rules of the [GATT]’.

In *US–Shrimp* the AB focuses on the balancing of competing rights, interests and obligations as the predominant feature within the chapeau analysis. This expresses the concern of the AB to prevent abuse of the general exceptions which are only available upon a careful balancing of different factors.

The wording of the chapeau provides for three different standards for domestic measures (WTO 1998a, paragraph 150). These must neither constitute ‘arbitrary discrimination’ or ‘unjustifiable discrimination’ between countries where the same conditions prevail, nor must they constitute ‘a disguised restriction on international trade’. *US–Shrimp* demonstrates that the interpretation and application of these three requirements will be influenced and governed by the overarching balancing approach.<sup>17</sup>

In *US–Shrimp*, the AB found that a measure constituted unjustifiable and arbitrary discrimination since that discrimination could reasonably have been avoided. That aspect of the analysis, in particular the assessment whether discrimination is *unjustifiable* or *arbitrary*, requires a typical balancing of competing rights and interests protected by the GATT. Part of the assessment in *US–Shrimp* turned on factors inherent in the regulatory process, such as transparency, due process or elements of basic fairness in domestic administrative proceedings (WTO 1998a, 181–2; Scott 2004, 350–1). This can be seen as the procedural side of the balancing test or proportionality inquiry, recognising that rights and interests can only be realised through fair and equitable domestic procedures. Additionally, such a proceduralist approach in the assessment of trade restrictions might lead to greater deference towards domestic regulatory choices while it includes, at the same time, a close scrutiny of the regulatory processes underlying the decision-making process.

<sup>17</sup> Similarly, McRae (2000, 231).

*d) Conclusion: How the Tests in Article XX GATT Operate*

One function of Article XX is to define the scope of the legal obligations under this provision (McRae 2000, 232). This is done through a two-step analysis which includes different standards and tests such as necessity or reasonableness. It will also involve the due balancing of the right of a WTO Member to invoke the exception and the substantive rights of other WTO Members.

It has been argued that ‘in no case will the proportionality requirements contained in Article XX of the GATT allow for a “balancing test” of advantages resulting from overall trade objectives underlying the WTO agreements with the advantages resulting from national policy objectives as mentioned in the individual clauses of Article XX’. (Desmedt 2001, 476). Our approach is slightly different. One aspect of proportionality is to govern the scope and application of exceptions such as Article XX and, as a consequence, to evaluate and balance the different interests at stake. As outlined above, balancing within Article XX needs to be undertaken several times in order to determine the necessity, reasonableness or proportionality of a particular measure. The question in those cases is to determine which rights or interests need to be balanced against each other, and it would be misleading to reduce this balancing act solely to general trade versus non-trade concerns.

## 2. Positive Obligations for Domestic Regulation

The SPS and TBT Agreements set out detailed positive obligations for domestic regulation. The most prominent standards are necessity, reasonableness and proportionality. They apply as independent positive requirements for domestic regulation and not just as justification provisions for a *prima facie* violation of other provisions. The positive obligations set out in the SPS and TBT Agreements are intended to mitigate the trade-restrictive effects of domestic regulation, while leaving sufficient discretion to Members to pursue their domestic public policy objectives.

*a) The SPS Agreement*

The SPS Agreement applies to ‘all sanitary or phytosanitary measures which may, directly or indirectly, affect international trade’ (Art 1.1). SPS measures are a very sensitive area of WTO law and policy. They often significantly impact on core areas of public policy, for instance national health and safety policies. According to the SPS Agreement, each WTO Member is free to determine its own appropriate level of sanitary or phytosanitary protection. The determination of the appropriate level of protection is considered by the AB as ‘a prerogative of the Member concerned and not of the panel or of the Appellate Body’. (WTO 1998b, paragraph 199). The chosen level of protection is generally not

questioned by the panels, and WTO Members could well pursue a zero risk approach (if the other conditions of the SPS Agreement are complied with). However, the *instrument* chosen to attain that level of protection will be assessed whether it is adequate and complies with the necessity requirements laid down in the SPS Agreement. Within the scope of the SPS Agreement it is important to outline this distinction between the *objective* pursued by state and the *instrument* to attain that objective (WTO 1998b, paragraph 200).

Article 5.4 SPS requires that Members, determining their level of protection, ‘take into account the objective of minimizing negative trade effects’. This provision could allow a full balancing of competing objectives, along the lines of proportionality *stricto sensu* (that is no excessive impact on trade). Yet, the more limited nature and legal effect of this provision was clearly outlined by the panel in the *Hormones* case. (WTO 1997a, paragraph 8.169).

One possible reading of Article 5.4 SPS is that Members should avoid measures with excessive trade-restrictive effects. This means that the determination of the appropriate level of protection by a Member is subject to the condition that it ‘should’ take into account the effects on trade. Article 5.4 does not seem to allow for a true balancing and trade-off of possible negative effects on trade against the desired level of protection. It does not require any cost-benefit analysis of the intended level of protection either. These restrictions would run counter to the AB’s repeated findings that the appropriate level of protection is a prerogative of the Members.

Panels may face the difficulty that Members do not explicitly and with sufficient precision determine their appropriate level of protection. The AB stated that, in such circumstances, panels may establish the Member’s level of protection on the basis of the actual SPS measure applied (WTO 2003, paragraph 207). Such initial determination is necessary to assess whether the measure adopted complies with the relevant provisions of the SPS Agreement.

Subsequently, WTO Members need to undertake a risk assessment, upon which the national measures shall be based.<sup>18</sup> The AB has clarified that the criterion that the measure be ‘based on’ risk assessment requires ‘a *rational relationship* between the measure and the risk assessment’. (WTO 1998, paragraph 193). In other words, Members can only lawfully enact an SPS measure in those cases where the risk assessment ‘reasonably support[s]’ the measure at stake. Note that the rational relationship requirement (risk at stake—measure) is a separate obligation from the traditional necessity or proportionality analysis (objective—measure) in other provisions of the SPS Agreement.

Article 2.2 SPS lays down the requirements to domestic measures: they cannot not be maintained without ‘*sufficient* scientific evidence’. Clarifying this provision, the AB in *Japan–Apples* followed the panel’s conclusions and held that the sufficient scientific evidence criterion requires a ‘rational and objective relationship’ between the measure and the relevant scientific evidence (WTO

<sup>18</sup> See SPS Agreement, Articles 2.2 and 5.1. These two articles should be read together.



2003, paragraph 147). The panel in this case, noting the lack of sufficient scientific evidence to support the Japanese measure, had found that the measure at issue was ‘clearly *disproportionate* to the risk identified on the basis of the scientific evidence available’.

The next step of analysis is to turn to the necessity of the measure. This relates to the relationship between the aim pursued and the measure at issue. Article 2.2 SPS requires that any SPS measure is ‘applied only to the extent *necessary* to protect human, animal or plant life or health . . .’. Article 5.6 SPS refines this obligation, requiring WTO Members to ensure that SPS measures are not ‘more trade-restrictive than required to achieve their appropriate level of . . . protection, taking into account technical and economic feasibility’. Footnote 3, which is attached to Article 5.6 SPS, further delineates the concept of necessity:

[A] measure is not more trade-restrictive than required unless there is another measure, *reasonably available* taking into account technical and economic feasibility, that achieves the *appropriate level* of sanitary or phytosanitary protection and is *significantly less restrictive* to trade.

The AB in *Australia–Salmon* elaborated on the necessity test and mainly referred to the requirements grounded in Footnote 3. It held that the three elements are cumulative, in the sense that all three elements have to be met for a finding of inconsistency with Article 5.6 SPS (WTO 1998b, paragraph 194). A measure will therefore be consistent with Article 5.6 SPS if there is no alternative measure available, or if the alternative measure does not achieve the appropriate level of protection, or if it is not significantly less trade-restrictive.

Member states are further required to comply with an additional discipline laid down in Article 5.5 SPS. The objective of this provision, which needs to be read in the context of Article 2.3 SPS,<sup>19</sup> is to achieve ‘consistency in the application of the concept of appropriate level of . . . protection’ within the state. The underlying rationale is to avoid situations where different situations or products which are similarly dangerous are given a different treatment, for instance through a very high level of protection in one case and a very lenient treatment in another (Pauwelyn 1999, 653). The AB in *EC–Hormones* and *Australia–Salmon* specified the three elements which are part of the test under Article 5.5 SPS. First, the WTO Member adopts different appropriate levels of protection in different situations. Second, the different levels of protection are arbitrary or unjustifiable. Finally, the arbitrary or unjustifiable distinctions in the level of protection result in either discrimination or a disguised restriction of international trade. (WTO 1998, paragraph 214).

<sup>19</sup> Article 2.3 SPS reads as follows: ‘Members shall ensure that their sanitary and phytosanitary measures do not arbitrarily or unjustifiably discriminate between Members where identical or similar conditions prevail, including between their own territory and that of other Members. Sanitary and phytosanitary measures shall not be applied in a manner which would constitute a disguised restriction on international trade’.

The third element ('discrimination' or 'disguised restriction') seems conceptually the most controversial (Pauwelyn 1999, 654). The AB in *EC–Hormones* ruled that arbitrary or unjustifiable differences in the levels of protection may act as a 'warning signal' that the measure in its application leads to discrimination between Members or to a disguised restriction on international trade. What therefore needs to be proven to find a violation of the third element of Article 5.5 SPS is that the Member in fact applies the SPS measure in a way which either discriminates between WTO Members or constitutes a disguised restriction, ie it provides protection for the domestic producers. In the subsequent *Australia–Salmon* case the AB made an interesting finding concerning what constitutes a disguised restriction on international trade. It held that a measure which is not based on risk assessment strongly indicates a 'trade restrictive measure in the guise of an SPS measure, ie a "disguised restriction on international trade"' (WTO 1998b, paragraph 166).

The wording of Article 5.5 is clearly modelled upon the chapeau of Article XX GATT. Despite this similarity, the AB ruled out that the interpretation and reasoning of the chapeau may be imported into the analysis of Article 5.5 SPS. The justification provided by the AB is that there are 'structural differences' between those two provisions and the standards they impose (WTO 1998, paragraph 239). The chapeau of Art XX GATT is generally more concerned with preventing the abuse of rights in the application of a measure, whereas Article 5.5 primarily aims for consistency in the levels of protection with the aim to reduce unnecessary regulation (Neumann 2002, 479).

The SPS Agreement attempts to bridge the gap between national regulatory autonomy and protectionist trade restrictions enacted as sanitary and phytosanitary measures. The task of the panels and the AB to strike the delicate balance between necessary, legitimate and protectionist measures is guided by the individual provisions of the SPS Agreement. On the one hand, the agreement does not authorise a broad balancing of the costs and benefits of a regulatory measure in the sense of proportionality *stricto sensu*. Most importantly, Members are free to determine their level of protection without judicial interference, except for the requirement that differences in levels of protection shall be consistent. The Agreement's detailed provisions, however, provide strict normative standards for the instruments chosen and applied by a WTO Member to achieve its level of protection. The necessity requirement aims to ensure that the chosen measure is no more trade restrictive than necessary. Proportionality elements also govern the determination whether different levels of protection are reasonably consistent and do not result in discrimination or a disguised restriction on trade. As outlined above, this consistency requirement is subject to different conditions whose normative content remains somewhat elusive. For instance, there is some leeway in determining which distinctions in the levels of protection will be considered arbitrary or unjustifiable and those that will be acceptable. A further question is how far the consistency requirement imposes constraints on WTO Members to autonomously determine their level of

protection and whether this does not lead to a true balancing of competing factors (chosen level of protection versus discrimination; trade restriction versus arbitrariness and justifiability) by means of judicial review.

*b) TBT Agreement*

The substantive obligation in Article 2.2 TBT requires that

Members shall ensure that technical regulations are not prepared, adopted or applied with a view to or with the effect of creating unnecessary obstacles to international trade. For this purpose, *technical regulations shall not be more trade-restrictive than necessary to fulfil a legitimate objective, taking account the risks non-fulfilment would create*<sup>20</sup>.

The last sentence refers to ‘legitimate objectives’ that domestic measures (ie ‘technical regulations’) aims to achieve. Article 2.2 TBT defines those objectives in a non-exhaustive list. The objectives include, amongst others, national security requirements, the prevention of deceptive practices or protection of the environment. Both the panel and the AB in *EC–Sardines* stated that this list is only illustrative and other objectives may also be considered ‘legitimate’. It is for the Member to determine those objectives.

While the chosen level of protection may not be called into question, the subsequent assessment of a domestic measure under Article 2.2 TBT takes place in different steps. Technical regulations must first be capable of contributing to a ‘legitimate objective’. In contrast to the SPS Agreement, this term indicates that the object and purpose of a measure may be questioned by the panels with regard to their legitimacy. The AB in *EC–Sardines* clearly stated that it was prepared to examine and determine the legitimacy of a TBT measure’s objective, and the panel equally ruled that it was required to do so (WTO 2002b, paragraph 286). Interestingly, the panel in *EC–Sardines* referred to a finding of the panel in *Canada–Pharmaceuticals Patents* which defined with the notion of ‘legitimate interests’ in the context of Article 30 of the TRIPS Agreement.<sup>20</sup> The panel in *Canada–Pharmaceutical Patents* stated that a legitimate interest is ‘a normative claim calling for protection of interests that are “justifiable” in the sense that they are supported by relevant public policies or other social norms’ (WTO 2000, paragraph 7.69).

Some authors are sceptical about the possibility that panels and the AB question the legitimacy of objectives pursued by WTO Members. Neumann and Türk, for instance, argued that ‘Article 2.2 TBT should not equip WTO tribunals with the ability to *a priori* rule out the legitimacy of measures, since this

<sup>20</sup> Article 30 provides for an exception to exclusive rights conferred by a patent. The provision reads as follows: ‘Members may provide limited exceptions to the exclusive rights conferred by a patent, provided that such exceptions do not unreasonably conflict with a normal exploitation of the patent and do not unreasonably prejudice the *legitimate interests of the patent owner*, taking account of the *legitimate interests of the patent owner*, taking account of the *legitimate interests of third parties*’.

could interfere with domestic policy choices. In addition to such political considerations, recital 6 of the TBT-Preamble clearly establishes that WTO Members remain free to adopt their level of protection. If the level of protection remains a national *domaine réservé*, it is not evident that the decision which value is legitimate should be centralized at the WTO level'. (Neumann and Türk 2003, 219). We believe that there are also some valid arguments against this interpretation. Textually, Article 2.2 incorporates the notion of *legitimate* objectives, which implies that there are illegitimate objectives as well. The question then is 'Who shall ultimately determine whether a measure is legitimate or illegitimate with regard to Article 2.2 TBT?' It would be unduly deferential towards WTO Members to let them decide on the legitimacy of the objectives pursued, without subjecting them to *any* subsequent oversight by the WTO judicial bodies. Finally, the issue of legitimate objectives should not necessarily be discussed together with the appropriate level of protection. As was stated by the *Sardines* panel, 'it is up to the Members to decide which policy objectives they wish to pursue and the levels at which they wish to pursue them'. These two issues closely interrelate, but they should be assessed independently of each other.

If a measure has a legitimate objective, it shall be no 'more trade-restrictive than necessary'. It is one of the key objectives of the TBT Agreement that Members avoid unnecessary obstacles to international trade. This requirement imposes constraints on the WTO Members which are similar to the least trade-restrictiveness requirement under the SPS Agreement. Referring to the preamble, the panel in *EC-Sardines* ruled that 'Members cannot create obstacles to trade which are unnecessary or which, in their application, amount to arbitrary or unjustifiable discrimination or a disguised restriction on international trade'. (WTO 2002a, paragraph 7.120).

The question arises whether the necessity analysis in Article 2.2 TBT should be the same as the three-step test under the SPS Agreement. According to this test, national measures will be consistent with Article 5.6 SPS if there is no alternative measure available, or if the alternative measure does not achieve the appropriate level of protection, or if it is not significantly less trade-restrictive. Due to the similar wording of the relevant provisions in the SPS and TBT Agreements, one may argue that the core necessity standards should be the same.

Finally, technical regulations shall not be more trade-restrictive than necessary to fulfil a legitimate objective, '*taking account of the risks non-fulfilment would create*'. There is some uncertainty about the meaning of this requirement. On the one hand, it seems like a balancing or cost-benefit-analysis test, similar to the tests adopted in *Korea-Beef* and *EC-Asbestos* (balancing of the importance of the values and policies and the extent to which the measure contributes to the aim pursued). Assessing the risks of non-fulfilment of a particular objective will be part of the necessity analysis. It may actually make the necessity requirement more relaxed and less rigid (Ortino 2004, 486). On the other hand, the term could also point towards a full proportionality test. That would allow

the panel to determine whether the costs of a measure (ie the negative effects on international trade) are excessive or disproportionate to the risks of not fulfilling the pursued objective. A measure could therefore be disproportionate even though it is the least trade-restrictive measure. This question has not been fully clarified yet.

*c) Conclusion: how the tests in the SPS and TBT Agreements operate*

The TBT Agreement is deferential towards the policy objectives that WTO Members want to achieve, but it shows less deference to the means employed to achieve those objectives. This is not unusual and reflects similar normative standards in the GATT and the SPS Agreement. It can be argued that there is a broader scope for a balancing test in the TBT Agreement. Additional criteria, which are not included as such in the SPS Agreement, relate to the legitimacy of the objectives pursued and the risk of non-fulfilment of those objectives. This entails some more subjectivity, or discretionary elements, permitted in a panel decision (Desmedt 2001, 459).

It remains to be seen whether the jurisprudence interpreting the TBT Agreement will move more towards a necessity and balancing test which structurally resembles the traditional proportionality test (for instance, as applied in public international law). Weighing and balancing of protected rights and interests may take place with regard to both the legitimacy of the objectives pursued and the weight attributed to the risk of non-fulfilment of that objective.

Generally, the SPS and TBT Agreements lay down positive normative standards for trade restrictive measures which go beyond the principle of non-discrimination and also apply to non-discriminatory domestic regulation. These standards provide for detailed obligations which are more sophisticated and structured than for the tests applied in the GATT, and for instance in EC free movement law or in the Interstate Commerce Clause. One difference is that the tests applied in the context of EC law and the Interstate Commerce Clause have been developed and elaborated through the jurisprudence, while the tests in the SPS and TBT Agreements were explicitly written into these more modern trade agreements. The main standards in the SPS and TBT Agreements are that the domestic measures pursue an accepted public policy objective and that they are no more trade-restrictive than necessary. This determination is governed and influenced by a balancing and weighing process aiming to ensure that the obstacles to international trade are not disproportionate or excessive to the objectives pursued by the Members.

#### IV. CONCLUSION

One of the most important challenges for WTO law is the balancing of competing rights, principles, values, or interests. The perceived juxtaposition of free

trade and non-trade interests is one fundamental expression of this concern. Another concern is whether the WTO judicial bodies should do balancing *at all* or better leave that to national institutions. Legally, balancing in the WTO requires constant (re-)interpretation of specific provisions of the WTO Agreements which lay down the criteria to be taken into account by the WTO Members.

The increasing demand for authoritative and sensitive balancing is a major challenge for judicial bodies that have to cope with concrete disputes. Some dispute that there is, or that there should be, adjudication of competing values in the WTO. Others may want to cloud the issue for a variety of reasons. Judges, for instance, may favour tests which could avoid 'the impression that there is any need to adjudicate competing values at all'. (Howse 2000, 140). In analysing the jurisprudence and disputes which appear rather technical at first glance, one finds many instances where such a balancing of rights, principles, values, and interests is actually taking place and can hardly be avoided. The increasing maturity of the WTO legal system has been analysed against the background of its 'constitutionalization'. One particular aspect of this process is the so-called 'judicial norm-generation' whereby constitutional-type principles and techniques are generated through the WTO jurisprudence (Cass 2001). Deborah Cass explicitly mentions the principle of proportionality, rational relationship testing and less restrictive means.

Balancing within the WTO legal system can take place at two different levels. First, at the national level. Domestic authorities are in many instances required by WTO law to take into account and weigh competing interests as part of their domestic decision-making process. Additionally, the domestic decision-making process must be transparent, open and unbiased. This can be considered as the procedural aspect of substantive tests imposed by WTO law. Second, also balancing takes place at the WTO level, in particular in the dispute settlement proceedings. Whenever a dispute arises, the judicial bodies, applying the specific provisions of the WTO Agreements, will have to balance competing factors.

Balancing is incorporated in many specific WTO provisions. Article XX GATT, for instance, consists of different steps of analysis, relating both to the design and application of domestic measures. While there is no overall balancing of competing values, the different steps of analysis within Article XX GATT each require a concrete evaluation and balancing of specific rights and interests at issue. One important function of the tests in Article XX GATT is to structure and rationalise the assessment of domestic measures. The same holds true for the SPS and TBT Agreements.

We can identify at least two possible ways how the principle of proportionality could apply in WTO law. First, proportionality as a principle of general international law may *inform* the interpretation of specific provisions of the WTO Agreements. Second, proportionality may be a specific *obligation* within the WTO Agreements, having been laid down in provisions such as Article XX GATT and similar provisions in the SPS and TBT Agreements. Those

provisions often require balancing and the reliance on some sort of proportionality theory to define the specific obligations incumbent on the WTO Members.

Tests like necessity, reasonableness or proportionality are not standardised and may well lead to confusion, given that they are applied in many different legal regimes. For instance, the concept of necessity is often mentioned in the WTO Agreements as well as in other legal systems. In the traditional reading of the principle of proportionality, necessity is the second step of analysis. It does not (explicitly) include a weighing and balancing of the advantages and negative impacts of a measure. Alternatively, the use of the concept of necessity in the context of UK human rights law stands for, and includes, a fuller proportionality analysis. Public international law also includes some balancing of rights and interests to refine the concept of necessity. Within the scope of Article XX GATT, necessity is equally not restricted to a simple assessment of the least trade-restrictiveness of a domestic measure. The determination whether a trade-restrictive measure is necessary to pursue a legitimate public policy objective will be made upon a balancing of different factors as elaborated in the jurisprudence.

A more coherent proportionality theory applied by the WTO judiciary can have several consequences. First, it imposes an obligation on Members to justify their measures according to a relatively structured legal criterion. It further makes the judicial process more rational, coherent and predictable. One effect is to limit the discretion of judges by requiring them to follow a sequence of steps in analysing domestic measures. Through the three-step analysis, a structured deliberative process may take place, within which judges play a predominant role. The procedural aspect of proportionality, both in its application by domestic authorities and by the WTO judiciary, involves a 'structured weighing of interests' (de Burca 1993, 146). This includes the fact that all interested parties may articulate their views which subsequently need to be taken into account in the balancing process. In that sense, the principle of proportionality may pose less of a danger to WTO Members pursuing legitimate policy choices than some other, vaguely defined tests.

One counterargument against proportionality (and balancing) in the WTO context is that it often provides judges with too great a power to examine legitimate domestic measure and to interfere with sovereign policy choices. Balancing by the judiciary may promote vagueness and leave the courts a 'permanent loophole', maximising their freedom of action (Regan 1986). Our argument is different. The more structured and rational a test, the more the courts will have to engage in a transparent judicial discourse with regard to trade-offs they are constantly required to make. Such discourse needs to take the arguments advanced by the parties more seriously. As the experience in other legal systems shows, this is no guarantee for elaborate and sophisticated judgments. Yet it may contribute to reducing the vagueness and unpredictability of judicial reasoning in the WTO. It may limit discretion and that is one central purpose of the rule of law.

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Part Three

**Investment Treaties and  
Investment Arbitration**



# *The Neo-Liberal Agenda in Investment Arbitration: Its Rise, Retreat and Impact on State Sovereignty*

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## I. THE RISE AND DECLINE OF NEO-LIBERALISM

THE ‘ROARING NINETIES’ has been described as the peak of the neo-liberal thinking in international economic relations.<sup>1</sup> Neo-liberalism and its larger political counterpart neo-conservatism have been variously defined.<sup>2</sup> Essentially, neo-liberalism includes a range of economic views the fundamental basis of which is the thinking that the market will arrange economic affairs efficiently and that state intervention in the working of the market is unnecessary or if necessary, should be kept to a minimum. This view, associated with the thinking of the leaders of the capitalist world, principally, Reagan, Thatcher and Kohl, dominated the course of events in the 1990s and the early years of the new millennium not only on the domestic front but also in the shaping of international economic affairs. The zenith of the trend was in the formation of the World Trade Organization (WTO) with a commitment to the liberalization of movement of assets and investments in a rapidly globalizing world.

The WTO’s competence was sought to be extended, besides international trade, into other areas such as services and intellectual property. Both areas

<sup>1</sup> The words appear in the title of a book by the economist, Joseph Stiglitz. J Stiglitz, *The Roaring Nineties* (Penguin, 2003). Other economists also state that the 1990s was an unusual period of euphoria. It was regarded by economic historians as a belle époque which was compared with the period of euphoria in the decade prior to the First World War. See PW Rhode and G Toniolo (eds), *The Global Economy in the 1990s* (Cambridge, CUP, 2005).

<sup>2</sup> The popular statement of the free market as a panacea for economic ills is contained in Milton and Rose Friedman, *Free to Choose: A Personal Statement* (Harcourt Brace, New York, 1980). An author who has made a volte face from neo-liberalism to a position against it is Francis Fukuyama. See his recent book, Francis Fukuyama, *After the Neo-Cons: America at the Crossroads* (Profile Books, New York, 2006).

impinge on investments.<sup>3</sup> Such extension was possible during the time of the ascendancy of neo-liberal solutions. But, the subsequent efforts to expand its competence further into the fields of competition and investment showed that there was a waning of the fervour. There were indications that such expansionist trends which would further erode the sovereign regulatory controls of the host state would be resisted, particularly by developing countries. The constant demonstrations whenever the institutions associated with neo-liberalism met and the failure of the Doha Round of negotiations regarding the WTO must be seen as signaling the impending decline of neo-liberalism. Yet, the trend towards neo-liberalism entrenched certain attitudes in the law. These attitudes are yet to be dismantled. But, there is increasing evidence that there is a backlash against the trends of the period in which neo-liberalism was dominant. The law that was made during this period will be slowly dismantled as disenchantment with the policies adopted hardens. Groups which profited during this period include large multinational corporations, large law firms which jumped into the lucrative practice of investment arbitration as well as a few professors who made a few fast bucks as arbitrators. They will resent the decline of the period which ensured their economic development often to the detriment of the developing countries, which were misguided into thinking that investment arbitration would lead to greater flows of foreign investment and hence generate new prosperity.<sup>4</sup>

There will be assiduous effort made to preserve the gains made in this period. The bandwagon of foreign investment arbitration was something onto which many jumped onto sensing profits to be made as in a gold rush. Persons came to it from several areas and often without an adequate grounding in international law which had hitherto been the genesis of the law on the area. Many were commercial arbitrators who sought to introduce ideas of private law into an area in which sovereign considerations were important. A recent study looks into the question as to the relevance of private law techniques in resolving public law disputes. It points out that essentially public law issues of concern to the state are being decided by men versed in the settling of commercial disputes through the use of techniques of commercial law and questions the legitimacy of the process, especially because it lacks review.<sup>5</sup> Others barged into the subject from peripheral areas of international law without having a base in the general

<sup>3</sup> Service, delivered through commercial presence within the host state, is a form of investment and is covered by the General Agreement on Services. Intellectual property, covered by the instrument on Trade Related Intellectual Property (TRIPS) is also a form of investment and is included within the definition of investment in investment treaties. But, the singular difference was that in investment law, unlike in trade, the multinational corporation had standing to bring an arbitration under investment treaties.

<sup>4</sup> The claims made against some developing countries often exceeded the national reserves held by them. Thus, the claims in *Salineri*, *Hubco* and the *SGS* cases which ran together exceeded the reserves of Pakistan. The fact that the awards made did not amount to the claims is not material as the state was put in peril of the possibility of the claims succeeding.

<sup>5</sup> G Van Harten, *Investment Treaty Arbitration and Public Law* (Oxford, OUP, 2007).

principles of international law or any demonstrated competence in the subject. Law firms also saw in the explosion of investment arbitration the easy opportunity for spoils. They rushed in with fancy theories of litigation seeking to expand the field even further. The ‘lost lawyer’<sup>6</sup> was beginning a march onto an area of the law which was intended to further economic development of the poor. Instead, what was furthered was the economic development of large law firms and individual arbitrators who saw endless possibilities for easy profits in the developing field. Some international lawyers also descended on this lucrative field lending their authority as publicists, highly qualified or otherwise, to give directions to the law that would ensure that what guided it was not the economic development of the poor, an often reiterated formula that hid misconduct but entirely non-altruistic and self-promoting objectives. The law that was constructed ensured the dominance of the economies of the developing world by multinational corporations ensuring their ability to enter states by neutralizing the regulatory controls that could be devised and protecting assets of these corporations from measures that would erode their profitability. The justification that was often advanced was that market discipline and disciplines of governance were necessary to ensure economic development of the developing countries, a Kipling-type justification reminiscent of the white man’s burden that justified colonialism and plunder.

In the process of these trends, impact of the emergence of the dominant neo-liberal thinking in economic affairs was felt in the area of foreign investment as well. An impetus was given in this period to the making of investment treaties that gave protection to foreign investment and ensured the compulsory arbitration of disputes that arose from alleged violations of the standards of treaty protection. The rapid proliferation of these treaties in the 1990s has been recorded. Many of the treaties of the 1990s emphasized the right of entry of foreign investment, the conferment of national treatment after entry to foreign investors and the right to invoke arbitration unilaterally. The treaties were made on the assumption that they promote investment flows into developing countries. This assumption has been heavily contested in recent literature.<sup>7</sup> Despite the existence of such a large number of these bilateral and regional treaties, the efforts to bring about a multilateral regime on investment protection, attempted in the belief that the prevailing neo-liberal climate was opportune for the making of such global rules, have met with significant and repeated failure.

The failure of these efforts has not resulted in any diminution of the efforts at the creation of a regime of investment protection through other means. Investment protection in the past had been created through the exercise largely of private power and the employment of the low order sources of public international law. It is not a phenomenon that is commented on in the traditional

<sup>6</sup> The ‘lost lawyer’ features in the book by the former Dean of the Yale Law School, Arthur Kronman, *The Lost Lawyer* (Harvard University Press, Cambridge MA, 1989).

<sup>7</sup> The list of this literature is increasing. The writers are largely economists. The lawyers who have written in combination with economists include Salacuse and Rose Ackerman.



works on the subject but is a hidden process that has generated a significant movement for the creation of transnational rules intended to protect foreign investment. Thus, the idea that foreign investment contracts are internationalized contracts protected by rules of transnational, if not international, law was built up entirely through the exercise of private power and the employment of the low order sources of international law, like the decisions of often uncontested arbitral awards and the writings of the so-called highly qualified publicists, who were often hired hands providing mercenary services for the large multinational corporations.<sup>8</sup> This trend towards the creation of a private system of foreign investment protection, which remained dormant during the 1970s and the 1980s when the New International Economic Order was articulated in opposition, was revived in the 1990s when the new wisdom demanded the revival of the neo-liberal tenets.

Three parallel systems of investment protection met and revived in this period. The first was the system of diplomatic protection and state responsibility for injuries to aliens which allegedly existed as a part of customary international law. Its codification was attempted without any reference to alien protection but there was no acceptance of that effort. The second was the private system of protection through the theory of internationalization of foreign investment contracts. This was a system that depended on the existence of appropriate clauses in the contract, enabling it to be lifted out of the control of the host state's laws and subjected to a system of transnational law for its protection. Arbitration was the mechanism through which such protection operated.<sup>9</sup> A series of arbitral awards as well as commentary enabled the entrenchment of this strategy of protection. The third was the system of protection through investment treaties. These treaties had been in existence from 1959. But, during the ascendancy of neo-liberal thinking, there was a new spurt in such treaty making. The treaties also contained devices which enabled unilateral recourse to arbitration by the foreign investor to protect treaty rights. This privatization of the treaty mechanism enabled a fusion of ideas that had been constructed in the area of internationalization of foreign investment contracts to seep into the area of treaty based arbitration. As the misnamed notion of 'arbitration without privity' took hold,<sup>10</sup> the number of treaty based arbitra-

<sup>8</sup> These were usually pompous persons teaching at the older universities of Europe or working with large multinational law firms. They had a vested interest in promoting a certain type of international law which advanced both their interests and those of their clients.

<sup>9</sup> The continuing existence of this older system of self-created investment protection is often ignored because of the extensive commentaries that treaty based investment arbitration is receiving. The three Indonesian arbitrations (*Karaha Bodas*, *Himpurna* and *the Phaiton Energy*) indicate their continuing importance.

<sup>10</sup> Misnamed because privity is not absent in such arbitrations. The technique employed is that the state holds out an offer to all investors of the other state that is party to the treaty and the offer is accepted when a dispute arises by the foreign investor, thus creating privity. The term is a flamboyant expression without sense. The theoretical basis of such a situation in which a state becomes committed to an unlimited number of persons who cannot be clearly identified has not been sufficiently explained.

tions, particularly before tribunals of the International Centre for the Settlement of Investment Disputes increased, enabling arbitrators to outdo each other in their ability to recognize new expansionary doctrines favouring neo-liberal trends.

The period provided an opportune setting for the revival. The fall of communism and the resulting triumph of capitalism, the sovereign debt crisis which dried up funds for development, and the withdrawal of aid left the developing countries reliant on foreign investment as the source for development capital. The neo-conservative drive towards market democracy even by force if necessary also enabled the neo-liberal notions to thrive. There was an implicit assumption that free markets and political democracy were connected and that the United States, the single hegemonic power will use force to make its vision of a new world order based on market democracy a reality. The announcement of the war on terror after the events of 11 September, 2001, the invasion of Iraq, the subsequent introduction of new investment laws in that country and the continued threats of similar invasion elsewhere indicated how force will be utilized to enhance political and economic interests.

The time was opportune for striking anew. Third World cohesion that had existed in the days of the New International Economic Order had diminished. Each developing state was competing for foreign investment, after announcing open door policies. The newly emergent states of East Europe also sought such investment, enhancing competition for the foreign investment that was available. The Latin American states ditched the Calvo doctrine and joined in the chase for foreign investment. Argentina, the home of Calvo, signed investment treaties with the United States and other states. It embarked on a programme of liberalisation which was later to end in an economic crisis, triggering off a spate of arbitrations against it.<sup>11</sup> In this climate, it was easy to press home the neo-liberal message and ensure that a sound foundation for it was laid through quickly made investment treaties. This accounts for the sudden spurt in investment treaties in the 1990s. During the period, two global investment instruments were attempted. The World Bank brought about Guidelines in 1992, the Expert Group deciding that the time was not ripe for binding rules. But, in 1995, the OECD thought the time was ripe and attempted a binding global instrument on investment. Disagreement among the member states as well as open opposition by non-governmental groups led to the abandonment of the project. The effort itself indicates that there was a clear agenda to bring about rules on investment protection to the exclusion of other areas of concern such as the environment, human rights and labour standards that could be affected as a result of the flows of such foreign investment. The effort to draft the OECD's Multilateral Agreement on Investment (MAI) indicated the highpoint of the neo-liberal

<sup>11</sup> The economic crisis, the causes for it and the consequences are discussed in the several arbitral awards. For a more recent discussion, see the award in *LG&E v Argentina*, ICSID Case No ARB/02/1, Decision on Liability of 3 Oct 2006.

agenda. Its discontinuance was as a result of the emergence of opposition to the agenda. The discontinuance of the MAI was an indication that the neo-liberal way was on the decline.

## II. THE NEO-LIBERAL AGENDA IN INVESTMENT ARBITRATION

The attempt at the creation of a regime for foreign investment depended to a large extent on the provision of enforcement machinery to ensure that the machinery had sufficient compliance mechanisms. Arbitration became the means for establishing such a compliance mechanism. It was an already existing device. Tacking it onto the regime brought about by investment treaties was an obvious strategy. The strategy was enhanced by the fact that in *AAPL v Sri Lanka*,<sup>12</sup> the view was stated that particular formulation of the dispute settlement provision of the investment treaty gave rise to a right in the foreign investor to invoke arbitration against the host state unilaterally. This view was to result in the hitherto dormant arbitral institution, the International Centre for the Settlement of Investment Disputes as well as other arbitral institutions, attracting a large number of investment arbitrations.<sup>13</sup> The number of the disputes that were brought under the treaty provisions sky rocketed, making large law firms take a definite interest in the area and keep the area active through exorbitant litigation strategies.

But, a fillip was given to the neo-liberal agenda because institutional mechanisms committed to the agenda already existed. The theory on which ICSID was established itself contained the neo-liberal proposition that the provision of neutral arbitration would ensure the flow of foreign investment into developing countries and thereby lead to economic development. The first line of the preamble to the ICSID Convention ties economic development and foreign investment with investment arbitration: 'Considering the need for international cooperation for economic development, and the role of private international investment therein' The arbitration mechanism as well as the investment treaties operated on the basis of the neo-liberal theory that flows of foreign investment were facilitated through the investment treaties as they gave protec-

<sup>12</sup> This brought about what was termed infelicitously, as 'arbitration without privity'. *AAPL v Sri Lanka (Asian Agricultural Products Ltd v Sri Lanka*, ICSID Case No ARB/87/3, Final Award of 27 Jun 1990) did not dispense with privity. Rather, the idea was based on the existence of privity, an agreement to arbitrate being created through the unilateral offer of the state in the dispute settlement provision and the acceptance of it after the dispute by the foreign investor by bringing the claim to arbitration.

<sup>13</sup> Treaties such as the UK-Sri Lanka treaty had existed without the technique used in *AAPL v Sri Lanka* being attempted. Whether there was a unilateral offer held out to an undeterminable class of persons—a novelty by the standards of any legal system— or whether it was only an invitation to treat which required a further agreement based on a good faith commitment to negotiate may be too late now to be taken up. It is, however, relevant to note that some agreements show a rethinking on the issue. Thus, the US-Australia FTA does not contain an investor-state arbitration provision. Likewise, too, the Japan-Philippines FTA (2006) does not contain such a provision.

tion to the foreign investment through the recognition of treatment standards, the provision of compensation upon expropriation, the right of repatriation of profits and compulsory arbitration at the instance of the foreign investor. There is much economics oriented literature which debates the issue as to whether investment treaties do in fact lead to greater investment flows. The large majority of the papers seem to suggest that there is little or no linkage between investment treaties and investment flows. If this is so, developing states are giving up sovereign control over foreign investment on a whim that investment flows will occur through the signing of these treaties. Some institutions, including UNCTAD, which was created to help developing states, are committed to these treaties and are unlikely to advise reconsideration of the treaties.

Once a network of investment treaties was put in place, it became possible for arbitrators whom the system required to show fidelity to investment protection, to build up an edifice of rules that facilitated the entrenchment of the neo-liberal agenda. Some arbitrators consciously facilitated the model. Others did so, as the very business of arbitration required that they bring about results that would keep the arbitrator in the business.<sup>14</sup> The arbitrator was required to show the necessary loyalty to the system of arbitration if he were to remain in business. He would not only seek to remain in business but promote expansionist views so that both he and his fellow arbitrators would continue in lucrative business resulting from the widening of the bases on which claims could be made. Multinational corporations and transnational law firms will gleefully fund such a project as one gets increasing protection while the other is assured of greater business. The stage had been set for the working out of the neo-liberal agenda through investment arbitration.

As in the past, when private power was able to construct seemingly valid principles of international law and develop the theory of the internationalization of foreign investment contract through the employment of low order sources of international law, such as general principles of law, the decisions of international tribunals and the writings of 'highly qualified publicists',<sup>15</sup> so, too, in the period of neo-liberalism a similar exercise was engaged in. Employing these familiar techniques, arbitrators now fashioned a system that enhanced foreign investment to the detriment of the sovereignty of the host state and its regulatory powers over and beyond the principles agreed to in the treaties. In the course of the assertion of the principles of neo-liberalism, arbitrators made exorbitant statements which have triggered off reactions against the neo-liberal trends in recent times. Both these expansionary views as well as the reaction by

<sup>14</sup> The behaviour of arbitrators as promoters of pro-business models has been studied by Yves Dezaley and Bruce Grant, *Dealing in Virtue: International Commercial Arbitration and the Construction of Transnational Legal Order* (1996). On the role of private power in the construction of rules of international commercial law, see Claire Cutler, *Private Power and Global Authority: Transnational Merchant Law in the Global Political Economy* (Cambridge, CUP, 2003).

<sup>15</sup> The building up of the theory of an internationalized contract is dealt with in M Sornarajah, *The International Law on Foreign Investment* (2nd edn) (Cambridge, CUP, 2004), at 404, 420.

states to them need to be recounted in order that the present course of the law can be identified.

It is best to detail what is meant by the tenets of neo-liberalism as far as foreign investment is concerned and then detail the manner in which these tenets have been entrenched through investment arbitration. It would then be possible to identify the reaction to these efforts and the dismantling of the propositions that were sought to be established by those who pursued the neo-liberal agenda.

Neo-liberalism, as indicated earlier, is based on the belief that the free market, unregulated by the state, will be a more efficient mechanism to ensure economic efficiencies and distribution of assets within the community. The counterpart of this thesis at the global level is that liberalization of flows of assets within the global market will ensure the achievement of similar efficiencies and bring about economic development in the poorer nations of the world. The idea became enmeshed with a wider global view when it came to be coupled with the spread of democracy and the rule of law. The World Bank spoke of investment arbitration and similar disciplines in foreign investment as bringing about a rule of law. In the same vein as others spoke of international trade as coming to be based on law rather than power. The idea was that the relationships that came about would be based on rules of law but the fact is that the rules were determined by those with power and the rule of law became a subterfuge for the hiding of such power.

When the simple difficulty that the determination of the law that was to rule was in itself based on power and that the World Bank had no mandate to impose its view on the rule of law on states, a change in the vowel was made and the World Bank announced that it was merely concerned with the role of law in investment matters. But, what came to be known in the literature as the 'Washington Consensus' had a component that involved the bringing about of strong rules on investment protection and the promotion of the belief that flows of foreign investment are uniformly beneficial. The agenda involved the building up of strong legal institutions of contract and property, concepts of the variety favoured in capitalist and not socialist legal systems.<sup>16</sup> It also involved the privatization of state owned utilities. It is to be noted that many of the recent arbitrations arise out of the efforts at dismantling the privatizations which had taken place earlier. They also arose in the context of liberalization programmes that had been initiated during the heydays of the neo-liberal philosophy, the plight of Argentina providing the classic example.

Neo-liberalism came to be coupled with democracy and was taken over by the neo-conservatives whose vision embraced more than the construction of an economic order. It involved the idea that democracy should be brought about even if it required the use of force so that a world based on democracy and its

<sup>16</sup> Institution building was part of the agenda. Though institutionalists are sometimes regarded as distinct from the neo-liberals, market notions cannot be regarded as apart from notions of contract and property. A principal work is by H De Soto who identified the absence of strong rules on property as a reason for underdevelopment.

economic counterpart the free market could come into existence. Kantian notions were borrowed to construct the vision that perpetual peace would be assured as states bent on making economic progress or a people making political decisions collectively will not go to war. The neo-conservative vision was guided by the vision in which the hegemonic state would lead the world towards the realization of such perfect peace. Since this was the objective of the law, the law must be geared to the promotion of this vision and should not act as an impediment in the way of the realization of the vision. Thus, investment arbitration was given a distinct philosophical base that required promotion of the free market visions.

In the field of foreign investment, this vision would translate into firm rules on investment protection and the promotion of the belief that such rules are necessary for flows of foreign investment into developing states whose internal systems are deficient in providing adequate protection. The achievement of this vision would depend on a network of bilateral and regional investment treaties in the absence of a multilateral agreement on investment. Compliance with the rules so brought about would be ensured by an effective arbitration system, which will interpret the investment treaties in such a manner as to make the vision a reality. The rise in the number of treaties in the 1990s is a recorded fact and attests to the vigour of the neo-liberal views during this decade.<sup>17</sup>

There were identifiable trends that were put in motion once the explosion of investment treaties had taken place. There was an emergence of a trend towards the expansionary interpretation of the principles agreed upon in the investment treaties to ensure that investment protection was enhanced. These trends are identified in this paper and the reaction to them after the euphoria for neo-liberalism had diminished is also identified. It is best to provide a short summary of these trends before expanding upon them in the paper.

The first was the so called arbitration without privity. This is the central basis of expansion as it created a jurisdictional basis for the expansionary views by providing a larger base of cases from which the agenda could be fully blown up. The second was the creation of firm notions of contract and property which were capable to supporting the free market philosophy to the exclusion of ideas of contract and property that may be subversive of such a philosophy. The third was to exclude regulatory control over foreign investment so that the space for the host state to take action to prevent environmental pollution or protect the interests of its citizens was destroyed so that the interests of property protection could trump all other interests. The fourth was to forestall the possibility of the remedies based on expropriation diminishing in vigour by establishing treatment standards as a strong alternative claim and expanding the scope for such claims by fleshing out the international minimum standard and the fair and

<sup>17</sup> Developing states were not forced into the making of these treaties. They did believe in the force of the neo-liberal vision in the 1990s. Some coercion has usually been alleged in the making of these treaties.

equitable standard. The fifth was to diminish the scope of the local remedies rule and the efforts to exclude international jurisdiction through making of a distinction between contractual claims and treaty based claims. Finally, the boost given to the so called umbrella clause ensured that in certain treaties the contract obtained inflexible protection. These different assertions made through investment arbitration are expanded upon in the rest of the paper. The reaction to them is also assessed.

These assertions limit the sovereignty of states above and beyond what is agreed to in investment treaties. Treaties by definition are restraints on sovereignty but they are voluntarily assumed restrictions, undertaken by states in order to achieve some mutually advantageous objectives. But, when they come to be interpreted by tribunals which do not have democratic legitimacy and with a hidden agenda to advance the cause of one of the parties or a particular objective on the basis of a particular economic or political philosophy, the erosion of sovereignty is well beyond what was agreed to by one of the parties. A reaction naturally has to set in and disenchantment with the system must result. The reaction is clearly visible as states have begun to retract from their commitments by seeking renegotiations,<sup>18</sup> resisting the enforcement of awards, issuing anti-suit injunctions against arbitrations, making treaties with defences based on public welfare, health, morals and environmental grounds and bringing about mechanisms that would make bilateral binding interpretations of treaties possible. There have also been instances of states pulling out of the ICSID system.<sup>19</sup>

There is a view among international lawyers that the increase in the number of international judicial tribunals has secured a situation that is akin to a Kantian peace. One does not know what the extent of the Kantian peace embraced for it was known that Kant did not embrace the whole of humanity, thinking that some of humanity belonged to inferior groups.<sup>20</sup> It would appear that the exercise that is being performed suggesting the constitutionalization of the law through these exercises is of the same variety, enhancing a constitutionalism that favours the interests of the strong to the detriment of the weak. That charge has already been made in the case of the so-called constitutionalization thesis as regards other international tribunals.<sup>21</sup>

At least these tribunals are international tribunals in the proper sense of the term with roots in international instruments made by states agreeing to their

<sup>18</sup> The European Union required member states to revise their treaties regarding the obligation to repatriate profits and other funds. The recent UK treaty with Mexico indicates the adoption of a restrictive obligation on transfer of funds making it subject to currency controls imposed under European laws. The Czech Republic announced revision of its treaties following inconsistent awards against it. Argentina has also announced similar plans.

<sup>19</sup> Three states, Venezuela, Nicaragua and Bolivia have recently withdrawn from the ICSID system.

<sup>20</sup> This theme is explored more fully in the writings of my colleague, Professor Chen Liu Ten who is Professor of Philosophy at the National University of Singapore.

<sup>21</sup> See eg, Jose Alvarez, 'The New Dispute Settlers: Half Truths and Consequences' (2003) 38 *Texas ILJ* 405; Nico Kirsch, 'International Law in Times of Hegemony: Unequal Power and the Shaping of the International Legal Order' (2005) 16 *European JIL* 369.

exercise in specific areas with specific rules. In the case of investment arbitration that is simply not the case. The frequently invoked tribunal, the ICSID, came into existence well before the invocation of its jurisdiction in reliance of investment treaties. Though the tribunals work within the framework of the ICSID Convention, they are no more than ad hoc tribunals constituted to deal with the specific case. They lack legitimacy of a proper international court set up through a choice in which the international community participates, as is the case with the other tribunals that have come into existence in recent times. The authority of these tribunals to legislate for the area of foreign investment protection on the basis of spurious theories relating to standards of governance and efficiency must be doubted. The International Court of Justice stated that 'it is clear that the Court cannot legislate'.<sup>22</sup> If the Court, convoked by the international community as a whole cannot legislate, it is unthinkable that an arbitral tribunal created ad hoc to deal with a dispute between the parties can purport to make pronouncements that are binding in international law or be treated as binding by successive tribunals. As indicated, states are realizing that the situation has got out of hand. Developed states which are massive receivers of foreign investment stand at the butt end of receiving the same kicks that they have now administered to developed states. These developed states are retreating from these excesses even faster than developing states by creating exceptions and defences to liability in the investment treaties they sign. The law that has been created is being dismantled to some extent so that there could be greater sovereign regulatory space. The effort to recapture lost sovereignty seems to be accelerating. The future danger is that the tables will be turned on the developed states all of which are becoming massive recipients of foreign investments from India and China. They will begin to fear that investors from these states will start to behave like their own investors and bring claims against them.

The disenchantment with investment arbitration will also accelerate simply because basic tenets of decision making seem to be thwarted by the system that is now operating. Decision making within any legal system must be perceived to be impartial and just. It derives normative content only because it adheres to certain principles such as fairness and neutrality. When arbitrators are intent on creating law on the basis of an agenda that promotes the interests of international business and their own careers as arbitrators by demonstrating fidelity to the emerging agenda, the trust in the system evaporates. If the existence of such an agenda that promotes investment protection can be demonstrated to exist in a system that is based on sovereignty, the whole process of investment arbitration becomes tainted with suspicion.

<sup>22</sup> *The Nuclear Weapons Case* [1996] ICJ 226 at p 237.



## 1. The Expansion of 'Arbitration without Privity'

'Arbitration without privity' is a term that sacrifices accuracy to flamboyance. Even a neophyte in the field knows that there can be no arbitration without privity. All that happened in *AAPL v Sri Lanka*, which is credited with being the first case in which the technique was used, was that an arbitration agreement was constructed by the tribunal from the existence of a unilateral offer made to all foreign investors in the investment treaty by the host state and its acceptance by the foreign investor by bringing the claim. Through construction of different instruments, an arbitration agreement is created between the parties on which the jurisdiction of the tribunal is founded. The technique has been resorted to so often that it may be too late to question its soundness.<sup>23</sup> But, it is necessary to examine whether it has a sound theoretical basis.

The dispute settlement provision in the investment treaty creates, according to this technique of founding jurisdiction, a *stipulatio alteri*. The Roman law on the point was that such a stipulation could not be made (*nemo potest stipulare alteri*) except in the case of a *donatio mortis causa* or possibly, in the case of a *fideicommissum*.<sup>24</sup> It took a while for European legal systems to move out of this principle making it possible by contract to confer benefits on third parties. Because of the doctrine of consideration, the common law took a considerable time to move out of the law that contractual benefits could not be conferred on third parties. It would be a novel proposition in domestic law that a stipulation could be made in favour of unknown third parties. That being the case in domestic legal systems, the so called technique of 'arbitration without privity' requires belief in the idea that international law has advanced to the stage where it can confer benefits on third parties, and that too on entities that traditionalists say do not have personality in international law. It is also strange that the draftsmen and commentators on the investment treaties did not claim that the dispute settlement clauses in the treaties had the unique effect of creating unilateral rights in foreign investors, often unknowable to the parties.<sup>25</sup> The notion that the treaties create a unilateral right in foreign investors, though supported by the language of the treaties, may not have been the intention of the parties. Such a major step would not have passed without comment in academic journals. The UK formulation that was interpreted in *AAPL v Sri Lanka* had been in

<sup>23</sup> *American Manufacturing and Trading, Inc v Zaire*, ICSID Case No ARB/93/1, Award, 21 Feb 1997, (1997) ICSID Rpts 14.

<sup>24</sup> Both were testamentary devices not contracts; a *donatio inter vivos* was a contract.

<sup>25</sup> The description of British treaties by Denza and Brooks, 'Investment Protection Treaties: The British Experience' (1987) 36 ICLQ 1069 written three years before *AAPL v Sri Lanka* (1990) does not contain any reference to this possibility. Both writers were Foreign Office legal officers with experience in drafting British investment treaties. Dr Mann, who commented on the UK-Philippines treaty makes no reference to the possibility. FA Mann, 'British Treaties for the Promotion and Protection of Investment' (1981) 52 BYIL 241. The conclusion that the technique was an afterthought is not a far-fetched one. The UK-Sri Lanka treaty was the one on which *AAPL v Sri Lanka* was based.

use for a considerable period of time without being invoked in the way it was in that arbitration.

One would of course say that much water has flown over the bridge and that it is futile to rake up this matter now. But, what is happening now is that notions of corporate nationality are being used to expand the scope of jurisdiction without any seeming limit. In *Tokios Tokelés v Ukraine*,<sup>26</sup> the tribunal enabled Ukrainians to engage in a ‘round tripping’ exercise by simply re-investing their money through a company incorporated in Lithuania with which Ukraine had an investment treaty. In *Aguas del Tunari v Bolivia*,<sup>27</sup> the notion of ‘company migration’ was used so that a company though established in a country which had no investment treaty, could still obtain investment protection by ‘migrating’ to a country with which there was a treaty relationship. Earlier in *Fedax v Venezuela*,<sup>28</sup> a tribunal held that nationals holding Venezuelan bonds could transfer the bonds to Dutch nationals with whom Venezuela had an investment treaty and that the new Dutch bondholders could secure protection of the investment treaties.

These exorbitant techniques of obtaining jurisdiction clearly exceed the original intent of the parties and if unchecked will soon bring arbitration into contempt. These arbitration tribunals have acted in furthering a particular philosophy of investment arbitration to which the affected host state party, usually the developing state, had not given its consent. Let alone the fact that the notion of the so called ‘arbitration without privity’ itself is a suspicious device, when it is extended well beyond what could have been the intention of the parties, the exercise of jurisdiction and the resultant awards become unsupportable. These trends are counterproductive in that they will cast such doubts on the system of investment arbitration that states will be reluctant to engage in the system. Consent being the basis of arbitration, any extension of an already dubious method of constructing consent will undermine the effectiveness of the system and pose an affront to the sovereignty of the state which is assumed to have given consent.

## 2. Protection of Contract and Property

The major feature of the internationalization theory was that it emphasized the sanctity of contract as the basic principle of foreign investment protection. It elevated the investment contract into an instrument akin to a treaty and gave it protection through the doctrine of *pactum sunt servanda*. Contract theory

<sup>26</sup> *Tokios Tokelés v Ukraine*, ICSID Case No ARB/02/18, Decision on Jurisdiction of 29 Apr 2004.

<sup>27</sup> *Aguas del Tunari et al v Bolivia*, ICSID Case No ARB/02/3, Jurisdictional Award (English), 21 Oct 2005.

<sup>28</sup> *Fedax NV v Venezuela (Bolivarian Republic of)*, ICSID Case No ARB/96/3, Decision on Jurisdiction, 11 Jul 1997.

involves the clash of several competing interests. Contractual stability competes with the need to take factors such as changed circumstances and the doing of justice to weaker parties into account. Some have argued that the progress in the law of contract has been characterized by a movement away from contractual sanctity to the realization of just outcomes through taking into account the relative bargaining strengths of the parties, changes in surrounding circumstances and fluctuations in economic trends in the market relating to the price of commodities and labour. In the internationalization theory as well as in investment arbitration, despite these trends that have emerged in national systems, the overwhelming view has been that contractual sanctity must be protected even in situations where there is environmental harm that may result or where public interests may require that the contract be rearranged.

The same view is taken as to property. It would appear that there is an absolutist view on property that animates investment arbitration. Some American scholars have argued that the concept of property that is used in NAFTA arbitration seems to be more absolutist than that used in American constitutional law.<sup>29</sup> These trends are clearly evidenced in cases which involve takings effected for environmental reasons. The tribunals have uniformly held that environmental grounds do not provide justification for takings effected by states. Thus, in *Santa Helena v Costa Rica*, the arbitration tribunal stated:<sup>30</sup>

Expropriatory environmental measures—no matter how laudable and beneficial to society on the whole—are, in this respect, similar to any other expropriatory measures that a state may take in order to implement its policies; where property is expropriated even for environmental purposes, whether domestic or international, a state's obligation to pay compensation remains.

Similar views have been expressed by other tribunals.<sup>31</sup> In *Techmed v Mexico*,<sup>32</sup> the tribunal stated: 'we find no principle stating that regulatory administrative action are *per se* excluded from the scope of the treaty, even if they are beneficial to society as a whole—such as environmental protection'.<sup>33</sup> A reaction has set in against such reasoning. Since the *Methanex Award*<sup>34</sup> and its ruling that takings that have an environmental reason may not be regarded as expropriatory takings, these earlier awards must now be regarded as suspect.

<sup>29</sup> V Bean, 'The Global Fifth Amendment: NAFTA's Investment Protection and the Misguided Quest for an International Regulatory Takings Doctrine' (2003) 78 *NYULR* 30.

<sup>30</sup> *Compañía del Desarrollo de Santa Elena SA v Republic of Costa Rica* ICSID Case No ARB/96/1, Award of Feb 17, 2000 (and Rectification of Award of Jun 8, 2000), 15 *ICSID Rev—FILJ* 169 (2000).

<sup>31</sup> *Technica Medioambientales Techmed SA v Mexico*, ICSID Case No ARB (AF)/00/2, Award of 29 May 2003 (2004), 43 *ILM* 133; also *Metalclad Corporation v The United Mexican States*, ICSID Case No ARB (AF)/97/1, Award of 30 Aug 2000.

<sup>32</sup> *Technica Medioambientales Techmed SA v Mexico*, ICSID Case No ARB (AF)/00/2, Award of 29 May 2003 (2004), 43 *ILM* 133.

<sup>33</sup> *Ibid*, para 121.

<sup>34</sup> *Methanex v United States of America*, UNCITRAL (NAFTA), Award of 3 Aug 2005, (2005) 44 *ILM* 1345.

Increasingly, investment treaties are recognizing that regulatory expropriations are non-compensable and that takings induced by sound environmental reasons may be regarded as regulatory takings. Separate provisions also appear in investment treaties on environmental protection. It would appear that a tussle is now taking place between the neo-liberal vision of an absolute property protection and the need for regulatory space so that a state may achieve some of its fundamental objectives. The statement of the exception relating to state conduct to protect health, safety and morals of the public in investment treaties is again evidence of this change taking place. There is every indication that the neo-liberal efforts will be beaten back in this area. States will intervene increasingly in order to ensure that recalcitrant arbitrators are beaten back to sense. The view that sovereignty is in abeyance is hardly accepted by states. The arguments presented by the United States in the *Methanex case* are redolent of the heavy sovereignty rhetoric that developing states relied on in the 1970s. The developed states, which are now becoming the largest host to third world capital, understand the extent to which their regulatory space has been infringed by investment treaties they have made to advantage their multinationals. The prospect that these treaties may soon be made use against them stares them in the face and they are beginning to feel uncomfortable. Rapid changes will take place, as a result, in the area. It could well be that sovereignty will provide the refuge for developed states when they have to face up to arbitrations under investment treaties. Birds may well come home to roost. Devices, that developed countries made, will come to be used against them. It will be interesting to watch what their response would be. It is perhaps in anticipation of such eventualities that model treaties of the United States and Canada now contain exceptions relating to several areas and conserve considerable regulatory space.

### 3. Preservation of Regulatory Space

As indicated, the neo-liberal model emphasized investment protection. It destroyed the scope for regulation of foreign investment, an entirely internal process that takes place within the territory of the host state by submitting it to distinct treatment standards, some of them, like the fair and equitable treatment, capable of indefinite expansion by arbitral tribunals, and the curtailment of expropriation through the devising of new and expansionary theories of expropriation. A further phenomenon was the potential use to which the most favoured nation treatment was put which enabled the idea that one could secure protection on the basis of the best possible treatment that had been promised in other treaties.<sup>35</sup> This again was an illustration of the initiation of an expansionary trend

<sup>35</sup> This technique was initiated in *Maffezini v Spain* (ICSID Case No ARB/97/, Award on Jurisdiction, 25 Jan 2000, 124 ILR 9), and was followed in *Siemens v Argentina* (*Siemens v Argentina*, ICSID Case No ARB/02/8, Decision on Jurisdiction of 3 Aug 2004, 44 ILM 138).

but fortunately this trend was nipped in the bud quite early. Arbitration tribunals clearly evinced a desire to ensure that the regulatory space for the host state was curtailed as much as possible.

The theories of expropriation that were the basis of litigation within NAFTA were so expansive that the regulatory space for the host state diminished to a vanishing point. The un-packaging of the concept of property had been performed by the Iran–US Claims Tribunal so that interference with the right to management or the other incidental rights of property was regarded as expropriation. This unpackaging was done in the context of the language used in the specific treaty which created the Iran–US Claims Tribunal which was expansive enough to deal with all measures that affected the investment of American nationals in Iran. The expansive notions articulated by the Iran–US Claims Tribunals could perhaps, have been accommodated within the treaty provisions creating the tribunal. Arbitrators, especially those who sat on the Iran–US Tribunal, took these ideas into investment treaty arbitration despite the fact that these treaties did not provide the same expansive jurisdiction to the tribunals on which they sat. These ideas were taken even further in NAFTA litigation. In the *Ethyl Case*,<sup>36</sup> the announcement made by a Canadian minister for the environment that she was considering a ban on a petroleum additive which was suspected to be carcinogenic was alleged to be an expropriation as the announcement resulted in the shares of the American company manufacturing the additive to drop. The Canadian government settled the claim. Obviously, there was some belief that such conduct fell within the language of the NAFTA provision on expropriation.<sup>37</sup> The *Methanex Case*<sup>38</sup> was fought on the basis of a similar theory. The award in that case indicated that states will now seek to contest litigation on the basis of such exorbitant theories with vigour. In any event, the more recent investment treaties create sufficient grounds for justifying the conduct of states which interfere on the basis of the health, morals or welfare of the public.

Taxation, export and exchange controls are another issue which concern the regulatory space of the host state. Many recent arbitrations have involved taxation of windfall profits. The issue again is whether the interests of investment protection should be considered so overwhelming that the host state cannot adjust taxation measures according to the extent of the profits that had been made. The recent treaties again seek to scotch the possibility of expansionary views in this area by specifically dealing with taxation and whether taxation

<sup>36</sup> *Ethyl Corporation v The Government of Canada*, UNCITRAL, Award on Jurisdiction of 24 Jun 1998, (1998) 38 ILM 1378.

<sup>37</sup> Though differently explained by some Canadian circles, there was also the abandonment around the time of legislation banning cigarette advertisement partly on the basis that the effort could be construed as expropriation. The reason generally given for the abandonment is that it violated free speech.

<sup>38</sup> *Methanex v United States of America*, UNCITRAL (NAFTA), Award of 3 Aug 2005, (2005) 44 ILM 1345.

could amount to expropriation. Once more there is a retreat from the neo-liberal positions of the past.

#### 4. Expansion of Treatment Standards

There are three possible bases for causes of action in investment treaties: expropriation, the violation of treatment standards and violation of the right to transfer funds.<sup>39</sup> Developments in the area of expropriation show that the expansionary trends that were initiated have now come to be effectively stymied. Not only are direct expropriations infrequent, but the scope for indirect expropriations and the nebulous phrase, conduct ‘tantamount to an expropriation’ being defined broadly have been considerably curtailed by the rediscovery of the rule that regulatory expropriation is non-compensable. There will be an increasing tendency in investment treaties to leave out the phrase ‘tantamount to an expropriation’ altogether. Though the scope of regulatory takings has yet to be worked out, it does cut inroads into the earlier trends to expand the scope of the concept of taking. The right to transfer funds is also being curtailed. The newer treaties recognize this right subject to exigencies which may require the imposition of exchange controls. The European Union’s demand that existing treaties be renegotiated to provide for such an exception to the right to transfer funds is an example. After the Asian and Argentinian economic crisis, it is unlikely that investment treaties will not contain such restrictions. It could well be that in times of stringent economic crisis, the plea of necessity will come to be recognized.<sup>40</sup> The possibility of expansion of two of the three possible causes of action has been plugged by states exercising their sovereignty. The argument that sovereignty is in abeyance made by some writers is far-fetched.

This leaves standards of treatment as the area in which further expansion is possible. Of the different standards of treatment, (international minimum standard, fair and equitable standard, full protection and security and the most favoured nation standard), the obvious candidate for initiating an expansionary trend would be through the fair and equitable treatment which, along with the international minimum standard, are nebulous terms waiting to be fleshed out.

It has already been pointed out that arbitral tribunals had attempted to expand the most favoured nation treatment but that this effort has now been somewhat stunted. The candidate that has been picked out for expansion is the fair and equitable standard. The effort to build up the fair and equitable standard as an independent standard is usually begins with a note written by the distinguished international lawyer, Dr Francis Mann on the UK-Philippines

<sup>39</sup> The third cause of action has not been frequently used. *Gruslin (Philippe) v Malaysia* (ICSID Case No ARB/99/3, Final Award, 27 November 2000, 5 ICSID Rpts 484) may be an example.

<sup>40</sup> As indicated in *LG&E v Argentina*, ICSID Case No ARB/02/1, Decision on Liability of 3 Oct 2006.

investment treaty. He wrote in the note that in his view, the fair and equitable standard was an independent standard that was higher than the traditional international minimum standard. This may offer an explanation for the use of the two distinct standards in investment treaties. But, it is forgotten that Dr Mann wrote ten years later that ‘the standard provision that “investments” shall at all times “be accorded fair and equitable treatment and shall enjoy full protection and security” is hardly sufficient to cover the real risk’.<sup>41</sup> Such a result would not eventuate if there was a comprehensive standard that was higher than the international minimum standard. It is now history that the view of Dr Mann had been relied on in the *Pope and Talbot Award*<sup>42</sup> and that the view has had to be abandoned as a result of the Interpretative Note of the NAFTA Commission that the fair and equitable standard was not different from the existing customary international law principles. At least in the NAFTA context and in the context of new American and Canadian treaties, it is clear that the fair and equitable standard has no significance other than confirming the international minimum standard.

The accommodation of a fair and equitable standard in a treaty which provides for an international minimum standard would be theoretically a difficult task. The precise extent of the content of an international minimum standard has yet to be worked out. It is a project that has engaged the minds of the best of American international lawyers from Borchard, Eagleton Ralston, Roth, Whiteman, Baxter, Sohn, Lillich and others. It is a project which has lasted over a century. Yet, the international minimum standard, the existence of which is denied collectively by the developing states, has not been fleshed out. Outside the standards applicable to expropriation and to state responsibility for denying protection and security to aliens which are separately provided for in investment treaties, international minimum standard captures the category which involves a denial of justice. Denial of justice which engages responsibility of a host state because of the failure of the host state to provide a standard of relief by the judicial organs of a host state to an injured alien is extremely difficult to establish. The United States in *Loewen v United States*<sup>43</sup> took a classic stance that required strict proof of denial of justice when this is made the basis of a claim to liability.

That being the fate of the international minimum standard, the case for the emergence of a seemingly more imprecise standard such as the fair and equitable standard in the law would be extremely difficult. It would be a bold claim to make that in the last five years or so, the fair and equitable standard has in fact been fleshed out by international arbitrators.<sup>44</sup>

<sup>41</sup> FA Mann, ‘Foreign Investment in the International Court of Justice: The ELSI Case’ (1992) 86 *AJIL* 92 at p 100.

<sup>42</sup> *Pope & Talbot Inc v Canada*, UNCITRAL (NAFTA), Award of 10 Apr 2001 13, *World Trade & Arb Mat'l* 61 (Apr 10, 2001).

<sup>43</sup> *Loewen Group, Inc and Raymond L Loewen v United States of America*, ICSID Case No ARB (AF)/98/3 (NAFTA), Award of 26 Jun 2003, 42 *ILM* 811.

<sup>44</sup> The claim is made in Christoph Schreuer, ‘Fair and Equitable Treatment in Arbitral Practice’ (2005) 6 *Journal of World Investment and Trade* 357.

There are theoretical difficulties with such a view. The legitimacy of the arbitration tribunals to attribute meanings to phrases used by the states in treaties on the ground that they have a mandate to expand the content of the terms would be suspect particularly in view of the fact that investment tribunals are not judicial institutions representative of the international community but appointed by the parties to the dispute, one of which is not a state.<sup>45</sup> The institutions which administer these arbitrations do so on the basis of a particular objective that the strengthening of investment protection should be the goal of such arbitration. Unlike courts of a democratic state which can breathe meaning into statutes and can be put right by the legislature if necessary, investment tribunals do not have control mechanisms that would exercise a corrective function. Some treaties, like NAFTA and the new US Model Agreement, include provisions for such control. As indicated, the first occasion for the use of the machinery is the reversal of the view of the tribunal in *Pope and Talbot v Canada* that the fair and equitable standard is a higher standard than the international minimum standard. Unless there is such a control mechanism, the legitimacy of the idea that idiosyncratic views of arbitrators prone to take views favourable to investment protection should constitute the content of a standard is unlikely to find acceptance. It is an increasing feature of investment treaties to include such control mechanisms which call for joint consultations in the event of the need for reinterpretation of terms used in the treaty and for other purposes. Given the precedent in NAFTA, it is unlikely that fair and equitable provision would be interpreted differently in other treaties or that such an interpretation would be accepted by respondent states.

The proof of a violation of an international minimum standard itself is difficult. The guiding case in the area has always been regarded as the *Neer Claim*.<sup>46</sup> It required a high standard of violation of alien rights to be shown before state responsibility could arise. It was necessary to destroy the basis of responsibility articulated in the *Neer Claim* which has provided the guiding principles on the subject so far. There was a strict standard articulated in the *Neer Claim* in that the orthodoxy was that state responsibility should not be lightly imputed to a state, particularly when that imputation flows from conduct that takes place within the state in pursuance of its civil authority. The standard in the *Neer Claim* was a hindrance to the development of looser standards such as the ones based on the fair and equitable standard. So, a demolition job had to be done on the *Neer Claim*. This was done in awards such as the *Mondev Award*<sup>47</sup> which refer to the fact that the *Neer Claim* is an old one and may not be reflective of modern developments without identifying what those developments are. The existence of an imprecise standard such as the fair and equitable standard in

<sup>45</sup> This theme is elaborated on in the recent book, G Van Harten, *Investment Treaty Arbitration and Public Law* (Oxford, OUP, 2007).

<sup>46</sup> *Neer claim* (United States v Mexico), (1926) 4 RIIA 60.

<sup>47</sup> *Mondev International Ltd v United States of America*, ICSID Case No ARB (AF)/99/2 (NAFTA), Award of 11 Oct 2002, (2002) ICSID Rpts 192.



bilateral investment treaties which do not articulate any precise criteria for the identification of such a standard can hardly be regarded as a modern development requiring the displacement of a staid and solid case that has provided guidance in this area for decision makers for a long time. Scholars also seek to do a hatchet job on the Neer Claim despite the fact that it has provided that standards for determining state responsibility for a long time. Age cuts both ways. Here it is used as an argument against a principle so that the law could be delinked from the existing principle and be cast on an uncharted sea so that there could be a fresh charting by a new set of arbitrators. It is also suggested that the formulation by the International Court, in *ELSI*, of the standard required is more lax. But, the base for these views has been cut from under the feet of these scholars as states are increasingly reinterpreting the fair and equitable standard into insignificance or leaving it out in their new treaties.

The view that is sometimes taken that the imprecision of the fair and equitable standard is beneficial in that it allows a tribunal to manoeuvre its way to a just solution in the precise situation of each case is also one that is open to the same objection. Such an open-ended mandate has not been given to tribunals by the state parties. Investment tribunals are not like the International Court of Justice to which such a task could possibly be entrusted. Even in institutional systems, tribunals come together as *ad hoc* tribunals for a specific case. It is unlikely that states contemplated that such a comprehensive mandate should be entrusted to such tribunals, many of whose members do not have any competence in international law. A view that such a mandate has been given would be subversive of the system of investment arbitration particularly at a time when it becomes evident that arbitration tribunals consist of arbitrators having particular visions of their own as to what the law is or should be. Their conception of what is fair may not accord with the conception of fairness others may have. Arbitrators indicate evident biases in their awards. Some are commercial arbitrators clearly unconscious of the international law background of the treaties. They seek to maximize the interests of international commerce to the detriment of public interests of states.<sup>48</sup> They are committed to securing the interests of investment protection as self-interest in continuing in the profession requires such a course. Many are both practitioners in leading law firms as well as arbitrators. There is a self-interest in formulating propositions that would increase the base for litigation. For this and other reasons, they are prone to take expansive views which favour investment protection over other interests that may exist. The effort to flesh out the nebulous fair and equitable standard is an instance of such an inclination. The persons who operate in this field are distinctly identifiable as a small group of persons who fulfill a multitude of roles, acting as counsel, arbitrators and as academics who write up their briefs as articles. They are indeed in their own eyes, 'highly qualified publicists' with

<sup>48</sup> The fact that new treaties now contain wide exceptions relating to public health, morals and safety and national security are reactions to this overemphasis on commercial doctrines of contractual sanctity and investment protection.

a divine mandate to shape the law for lesser beings. But, it is unlikely that those who assume such mantles are likely to be accepted as such by others against whom decisions are made in the absence of power structures as existed in the past when Kipling was able to exhort the carrying of such self-imposed burdens.

As a result of the rise of a lucrative practice in investment arbitration by leading multinational law firms, there is a febrile effort to slant the development of the law in directions which are favourable to the interests of certain groups that are interested in promoting investment protection at the expense of other interests of the international community. Fairness would require that interests such as environmental protection, the protection of water rights as human rights of a people and other rights associated with development are weighed against investment protection in deciding issues of fairness and equity. Unfortunately, these competing considerations do not enter the picture at all.

It is best to look at the attempt at expansion through a report of the OECD on fair and equitable standard.<sup>49</sup> The Report candidly acknowledges that 'no case can be found which applies the fair and equitable standard of a bilateral investment treaty as an autonomous standard'.<sup>50</sup> But, the third part of the Report seeks to canvass the possibility that arbitral tribunals have given a definite content to this amorphous standard.

The third part of the report is the more ambitious one in that it seeks to suggest that in modern arbitral awards, it is possible to establish the existence of the fair and equitable standard as a distinct category. Now here, of course, the report seeks to identify four categories for which the Report argues there is support in the arbitral awards. The first of course is the obligation of vigilance and protection. It is difficult to see how this category could go under fair and equitable treatment simply because of the fact that all treaties do refer to the obligation to provide full protection and security. In terms of customary law, there seems to be good basis for the suggestion that the failure to provide protection and security to aliens involves the responsibility of the state. Since such a duty would be subsumed under human rights propositions in modern times, the principle would be binding on all states, irrespective of whether there was an investment treaty or not. Quite apart from that, one would think that the international minimum standard found in investment treaties already incorporates the notion of full protection and security. Besides, full protection and security are spelt out as requirements in most investment treaties in the provisions on treatment standards. There is no reason why it should be included in the fair and equitable standard.

<sup>49</sup> OECD, *Report on Fair and Equitable Standard in International Investment Law* (Sept, 2004). The title page acknowledges that the document was prepared by C Yannacca-Small, Legal Adviser, Investment Division, Directorate for Financial and Enterprise Affairs. A later publication of the OECD, contains a chapter on fair and equitable treatment written by the same author. OECD, *International Investment Law: A Changing Landscape* (Paris, 2005).

<sup>50</sup> OECD, *Report on Fair and Equitable Standard in International Investment Law* (Sept, 2004), at 23.

The second of the four categories identified in the Report is due process and other acts of arbitrariness including denial of justice. Lumped together under this category are a whole list of ideas that emanate from modern administrative law systems of the United States and the UK. In the past efforts had already been made to lump these administrative standards under the heading of international minimum standards. Thus, due process makes its appearance in *Amco v Indonesia*,<sup>51</sup> which is not a treaty case. There, compensation was held due to the foreign investor as the cancellation of his investment license, however just it may have been in fact, was accomplished without due process. In the *Amco Case*, due process was converted into a principle of international law very much in the mode of the fairy god-mother converting a pumpkin into a horse carriage. The terminology of due process comes from American law. The circumstances in which natural justice has to be provided in the common law jurisdictions of the Commonwealth vary so widely that it would be difficult to extract clear propositions. Notions of arbitrariness vary in administrative systems. In the *Amco Case* itself, there was no prospect of proof of the condition regarding capitalisation even if a hearing had been held as under Indonesian law the only method of capitalisation was through certificates issued by the Bank of Indonesia. There were no such certificates issued. Doctrine was created in that case to favour the foreign investor on the basis of due process being a general principle when the acceptance of such a principle in systems of administrative law in a uniform manner would be highly contestable.

The same reasoning is now being attempted with the notion of legitimate expectations. It is a principle of administrative law created by the English courts and accepted widely by the courts of the Commonwealth. Initially, it was created to protect the weak litigant against the power of administrative authorities. The courts provided relief to women jockeys denied the right to ride in races, taxi drivers denied their licenses, market stall holders denied the right to trade in markets by local councils and immigrants denied the right to remain in the country despite earlier promises. The rule was not conceived to protect investments made by multinational corporations. It was intended to protect the small man and woman against institutional might. The later course of development of the doctrine has been to find its limits, particularly through reconciling with the rule that estoppel cannot arise from misrepresentations made by government officials. Clearly, a limit had to be found for otherwise necessary policy changes that governments have to make in the public interest would be attended by a flood of litigation. But, it would appear that the notion of legitimate expectation has been received into investment arbitration through the English law without the anxieties felt by the English courts about the limitless application of the doctrine and the need to reconcile it with competing public interests. It is received as an aspect of the fair and equitable standard doctrine. How such arbitral law making can be condoned baffles developing country international lawyers. But,

<sup>51</sup> *Amco v Indonesia*, Decision on Jurisdiction, 25 Sept 1983, (1983) 1 ICSID Rpts 389.

it would appear that the process has been lauded as imposing necessary discipline in matters relating to foreign investment in some quarters which assume that such discipline could be imposed at the caprice of a few arbitrators. Such exorbitant law-making by individuals will have counterproductive effects on investment arbitration.

This is not to say that the notion of legitimate expectations of a foreign investor has no scope but its scope is not as a part of the fair and equitable standard of treatment. The notion obviously has application in common law systems as it constitutes part of the host state's law which necessarily applies to foreign investment. It also constitutes international law as part of the concept of appropriate compensation which developing countries accept must be paid in the event of an expropriation. So, where a state inveigles a foreign investor by holding out promises and does not fulfill those promises through the creation or recognition of rights entailed in the expectations created by those promises, it is accepted by developing countries which articulated the notion of appropriate compensation that the foreign investor must be paid full compensation for the denial of the rights which are created by the promises. It is through such notions of appropriateness of compensation that developing country international lawyers would seek to accommodate notions such as legitimate expectations and not through amorphous notions such as fair and equitable standards.

The fourth aspect of the fair and equitable standard that the Report refers to is the notion of good faith. Again, the notion has no fixed content. Though it forms part of the contract law of civilian legal systems its acceptability to common law systems is coming to be explored only in recent times. Again, it would be difficult to accept the notion as constituting a general principle. Neither can one amorphous principle, good faith, give content to another equally amorphous principle, the fair and equitable standard sufficient form or content.

The episode of building up a system of protection through the existence of the fair and equitable treatment notion in investment treaties is an indication of the neo-liberal agenda in operation. The cycle probably will end when states become conscious of what is being done and rectify matters. But, more importantly, there would arise divisions among arbitrators on the employment of such devices. Those with fidelity to the system of arbitration will oppose these tendencies which bring the system into disrepute. As a result, there would be a systemic failure which would require new structures to be built so that the faults resulting in the failure could be remedied.

## **5. Diminishing the Relevance of the Local Remedies Rule**

The local remedies rule is an integral part of international law. In the *ELSI Case*,<sup>52</sup> the International Court of Justice was prepared to read the rule into the

<sup>52</sup> *Elettronica Sicula SpA (ELSI) v Italy*, Award (Merits), ICJ (20 Jul 1989).

freedom, commerce and navigation treaty that it was concerned with in that case. It is axiomatic that this should be the case with every investment treaty. The local remedies rule is a rule protective of territorial sovereignty which requires that disputes which take place within the territory of a state should first be dealt with by the local tribunals. An opportunity must be given to the local state to redress the injury that may have been done to the alien before the matter could be dealt with by a foreign tribunal. There are also practical reasons given for the rule. The dispute is clearly defined where the local tribunals have dealt with it. An opportunity is given to the host state to avoid international responsibility.<sup>53</sup> When the local tribunals deal with the issue of an injury to the alien, the liability ensues only when there is a denial of justice by the tribunals.

In a sense, the requirement of due process for liability to arise from an expropriation is an affirmation of the local remedies rule. When the rule of due process was first stated, the failure to provide due process was regarded as a method of establishing liability in the host state. So, in *Amco v Indonesia*, liability proceeded not on the basis of the substantive wrongfulness of the state interference but on the procedural wrongfulness of not providing a hearing to the foreign investor prior to the hearing. The earlier tribunals in *Amco* had concentrated on the manner of the taking, which involved the army of the host state marching in and taking possession of the foreign investment property. By emphasizing the procedural wrongfulness as the basis for the liability, the tribunal in *Amco* was in effect affirming the rule that local remedies in the way of a hearing prior to the taking should have been provided. Expropriation, in the circumstances of foreign investment, is the classic way in which a contract is broken through state interference. Whether the claim is dressed up as a violation of a treatment standard or as an expropriation, the fundamental proposition encapsulated in the local remedies rule is that a prior procedure before the local courts is required. Absence of due process is a requirement for expropriation in most investment treaties.

When a foreign investment contract itself contains a clause that requires disputes arising from it to be litigated before the prescribed courts of the host state, the issue arises whether the foreign investor could by-pass the provisions of the contract which he had agreed to and bring a claim before an external arbitral tribunal on the basis of the treaty provisions in the investment treaty between his home state and the host state. If party autonomy is the prized concept, then such an agreement should be possible and the foreign investor should be deemed to have waived his rights under other instruments. There are deviations from these traditional positions in modern investment arbitration which also do not presage well for the present system.

<sup>53</sup> CF Amerasingh, *The Local Remedies Rule*, 2nd edn (Cambridge, CUP, 2004).

### III. CONCLUSION

The capricious manner in which some arbitrators have assumed the mantle of arranging the international system for investment protection will lead to a systemic failure in treaty-based investment arbitration. Signs of this are already beginning to emerge. There are instances of states withdrawing from arbitration systems. There are treaties made without reference to investor-state arbitration. Most importantly, the inclusion of the concept of regulatory takings and the reinterpretation of the fair and equitable standard as nothing more than the old and equally uncertain international minimum standard makes inroads into the bases on which actions are maintainable under investment treaties. There have been announcements also of reconsiderations by states as to whether they will continue to stay with the treaties once their termination dates pass. These problems have resulted largely because of the espousal of neo-conservative perspectives by some arbitrators who have been more intent on the instrumental use of the treaty principles to bring about preferred systems than act within the scope of the treaties. These arbitrators have raised questions as to the legitimacy of the system itself. Unless there is self-correction effected, the system of investment arbitration will attract criticism from states and may, as a result, break down.



# *International Investment Arbitration: A Threat to State Sovereignty?*

JOACHIM KARL\*

## I. INTRODUCTION

**T**HIS ARTICLE EXAMINES what impact the huge increase in investor-state disputes in recent years might have on state sovereignty and how it might influence the future negotiations of international investment agreements (IIAs). It starts with some background information on the number of disputes, and the countries and issues involved. The paper then analyses the main reasons that might explain the steep surge in disputes, namely the continuing increase in foreign investment, the rising number of IIAs and their increasing complexity, the often broad and ambiguous treaty language, the emergence of multilayered investment rules, and the important domino effect triggered by NAFTA investment disputes. The next section asks to what extent the rise in arbitration cases may affect state sovereignty. It identifies sensitive areas such as the broad access to arbitration, the existence of sweeping treaty obligations and the increase in regulatory content, the fact that awards may have substantial implications for the domestic policy agenda, and the granting of rights not only to other states, but also to private parties. The paper then discusses the concerns that have been voiced lately with regard to dispute settlement procedures themselves, in particular in respect of the sheer number of cases, the possibility of multiple proceedings and forum shopping, the quality of awards, and the perceived lack of consistency and predictability of awards. The final section identifies a number of potential reform areas *in case* countries see a need to amend existing IIA provisions in order to reassert state sovereignty in investment arbitration.

\* The views expressed in this paper are those of the author and do not necessarily reflect the views of UNCTAD or its members. The author thanks Mr Hamed El-Kady, UNCTAD, for his research contribution.



## II. THE RISE IN INVESTOR-STATE ARBITRATION

### 1. Some Facts

Since the 1960s, bilateral investment treaties (BITs) have been containing provisions on investor-state dispute settlement, which grant foreign investors the right to initiate international arbitration against their host countries in case of an alleged violation of the agreement.<sup>1</sup> In the 1990s, the same right was incorporated into regional and sectoral IIAs such as NAFTA, MERCOSUR and the Energy Charter Treaty. More recently, it has been included in free trade agreements (FTAs), which increasingly contain investment provisions.<sup>2</sup>

While investor-state arbitration has been dormant for a long time,<sup>3</sup> the last couple of years have witnessed an enormous increase in such disputes. In 2006, at least 29 new cases were filed, bringing the total number of known treaty-based arbitration to 259.<sup>4</sup> As compared to the year 2000, the number of known disputes has more than tripled, although the 2006 figures constitute a slowdown compared to the previous rise (see figure 1). Approximately 60 per cent of the total of 259 cases were filed with the International Centre for Settlement of Investment Disputes (ICSID)—a World Bank affiliate based in Washington, DC (see figure 2).

By far the most cases (43) have been brought against Argentina as a result of that country's financial crisis in the early 2000s.<sup>5</sup> The two other main defendants are Mexico (18) and the United States (11), which have both faced numerous arbitration cases under the NAFTA (figure 3). Among the 'top ten defendants' are only four OECD countries (Czech Republic, Mexico, Poland, US). All others are either developing countries or transition economies.

Given the high number of disputes brought against Argentina, it is no surprise that four out of the ten most frequently invoked bilateral investment treaties (BITs) in arbitration involve this country. Three agreements concern the US (figure 4).

A survey of the disputes reveals that most deal with one or the other of the following IIA provisions: Scope and definition, fair and equitable treatment, non-discrimination, expropriation, and the so-called 'respect' or 'umbrella' clause. The main types of host country measures challenged in these disputes have been emergency laws adopted during financial crisis, value added taxes, rezoning of land, the regulation of hazardous waste facilities, privatisation, and treatment by media regulators.<sup>6</sup>

<sup>1</sup> UNCTAD, *Investor-State Disputes Arising from Investment Treaties: A Review* (New York and Geneva, 2005).

<sup>2</sup> See, eg, the FTA between the Republic of Korea and Singapore of 2005.

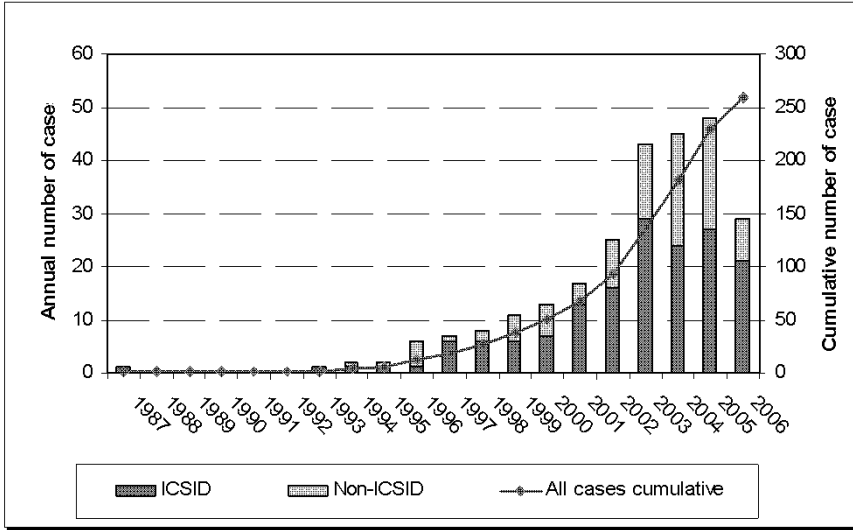
<sup>3</sup> The last wave of arbitration cases dates back to the early 1980s when the US–Iran Claims Tribunal had to decide over the numerous nationalisations of US companies in the aftermath of the Iranian Revolution. Before, investment arbitration mainly occurred in the context of decolonisation and accompanying nationalisations.

<sup>4</sup> As not all cases are made publicly known, the actual number of disputes may be considerably higher.

<sup>5</sup> Investor-State Dispute Settlement database, available at [www.unctad.org/iia](http://www.unctad.org/iia).

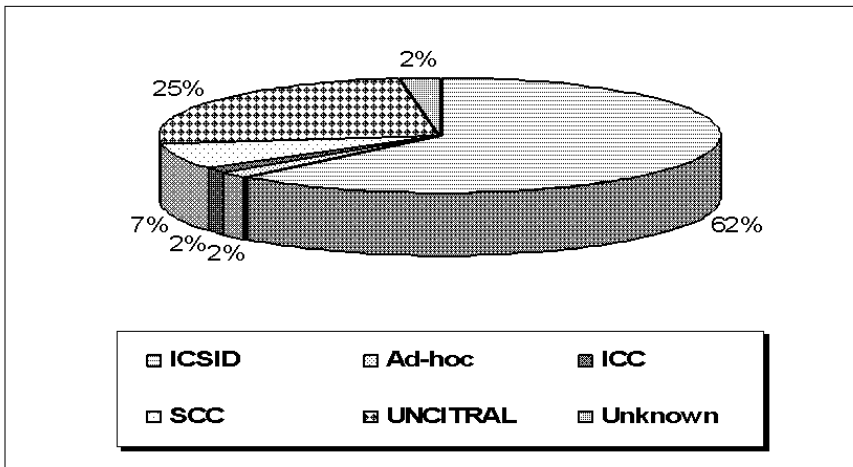
<sup>6</sup> For a more detailed analysis of these cases, see UNCTAD, *Investor-State Disputes Arising from Investment Treaties: A Review* (New York and Geneva, 2005).

Figure 1. Known Investment Treaty Arbitrations (cumulative and newly instituted cases, 1987–end 2006)



Source: UNCTAD ([www.unctad.org/ia](http://www.unctad.org/ia)).

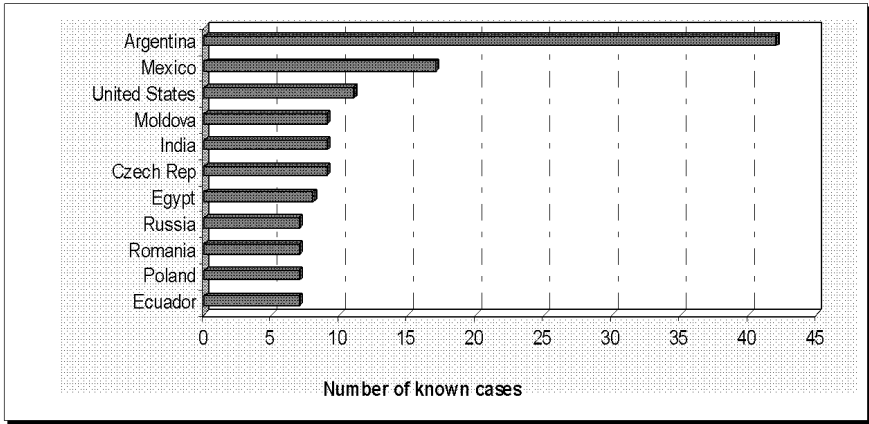
Figure 2. Disputes by forum of arbitration, cumulative as of end 2006 (Percentage)



Source: UNCTAD.

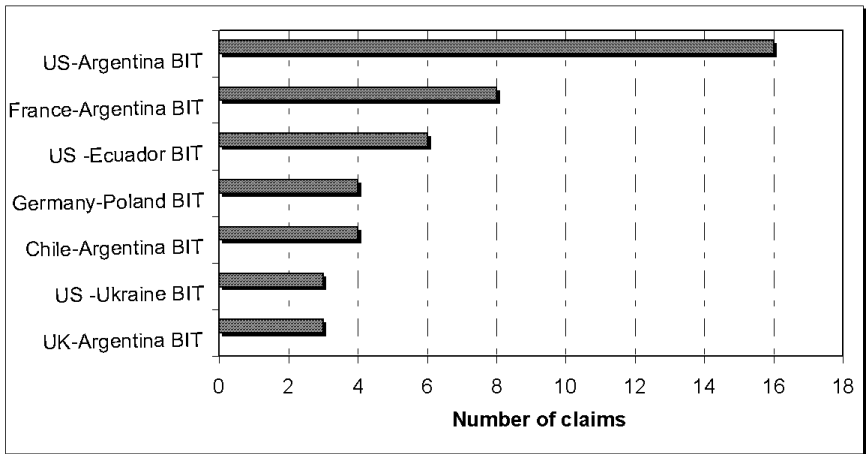
Note: SCC = Stockholm Chamber of Commerce; ICC = International Chamber of Commerce.

**Figure 3: Main Defendants in State-Investor Cases (as of end 2005)**



Source: UNCTAD

**Figure 4: BITs Most Frequently Invoked in Investment Arbitration (as of end 2005)**



Source: UNCTAD

## 2. Main Reasons for Increase in Investment Arbitration

The continuing move towards investment liberalisation in many countries has considerably reduced the potential for conflicts between foreign investors and host countries. What could then explain the stunning increase in investor-state disputes?<sup>7</sup>

<sup>7</sup> See with regard to this section also UNCTAD, *International Investment Agreements: Trends and Emerging Issues* (New York and Geneva, 2006).

First, FDI annual outflows continue to rise and so does the global FDI outward stock. In 2006, global FDI outflows amounted to \$ 1.2 trillion, bringing the total FDI outward stock to more than \$ 12.4 trillion as compared to \$ 2.6 trillion in 1994—an increase of almost 500 per cent. While in 1994, there were 40,000 transnational corporations with 250,000 foreign affiliates worldwide, the numbers stood at 78,000 and 780,000 respectively in 2006.<sup>8</sup> With more investors and investments, there are also more occasions for an investment dispute to arise.

Second, the increase in FDI is accompanied by a substantial surge in international investment agreements. In 2006, 73 BITs and 18 other IIAs<sup>9</sup> were concluded. The total number of BITs exceeded 2550 and the total number of other IIAs was above 240 at the end of 2006.<sup>10</sup> As compared to 1995, the number of BITs more than doubled, and the number of other IIAs became almost 5 times as high.<sup>11</sup> The strong increase in investment agreements means that foreign investors have more legal ‘weapons’ in their hands that they can use against their host states in case of a dispute.

Third, IIAs are increasingly perceived as instruments accompanying the process of globalisation. As a result, they have become more complex in content. They are no longer limited to establishing a few basic rights of protection for foreign investors, but also reflect public concerns, for instance with regard to the protection of health, safety, the environment and core labour rights. In addition, comprehensive economic cooperation agreements have been concluded more recently that combine investment issues with related matters, such as trade, services, intellectual property, competition, or industrial policies.<sup>12</sup> The interpretation, application, and implementation of these multifaceted IIAs and the assessment of their full legal and economic implications may be a considerable challenge, and may thus give rise to disputes.

Fourth, most IIAs contain broad and ambiguous language on key protection standards, such as the principle of fair and equitable treatment and the article on expropriation. Not surprisingly, foreign investors have started to test in arbitration cases where the ‘limits’ of these provisions are.<sup>13</sup> Awards are not yet so frequent as to constitute a well-established set of case law. Recently, the US and Canada have revised their model BITs with the objective of clarifying the meaning of the above-mentioned clauses and procedural rules relating to dispute settlement.<sup>14</sup> However, these efforts might also make the reading of the treaty more complicated.

<sup>8</sup> See UNCTAD, *World Investment Reports 1995 and 2007*.

<sup>9</sup> These are free trade agreements and other economic cooperation treaties including investment provisions.

<sup>10</sup> See UNCTAD, *Recent Trends in International Investment Agreements, IIA Monitor Nr 2 (2007)*—forthcoming.

<sup>11</sup> However, there is a remarkable difference in the development of BITs and other IIAs. While the number of BITs concluded annually has been decreasing constantly in the last six years, the situation is the opposite with regard to other IIAs.

<sup>12</sup> See, for example, the FTA between the US and Singapore of 2003.

<sup>13</sup> See below s III.

<sup>14</sup> See below s IV.

Fifth, the growing universe of IIAs means that foreign investors and governments have to operate within an increasingly complex framework not only of *multifaceted*, but also *multilayered* investment rules.<sup>15</sup> With the number of treaties containing overlapping obligations increasing it becomes more demanding to correctly assess their interaction and to identify differences between them. Furthermore, foreign investors may be more often in a position to claim a ‘more favourable’ treatment via the most favoured nation treatment (MFN) clause. However, the scope of application of this clause has become unclear in the light of some recent contradictory arbitral awards (see below).

Finally, the NAFTA disputes have triggered a domino effect. As can be seen from figure 1, the surge in international investment arbitration largely coincides with the entering into force of NAFTA. As of 1 January 2007, 34 NAFTA investment disputes had been launched.<sup>16</sup> The NAFTA is also the treaty in connection to which the potential risks of a broad and ambiguous treaty language for host countries became first apparent.

Without wishing to underestimate the importance of the rise in arbitration cases, it needs to be underlined that their total number is still very small compared to the global number of foreign investors and their subsidiaries, which might become parties to a dispute.<sup>17</sup> In addition, only a limited number of countries have been involved in such disputes, and only a relatively small portion of the total number of more than 2700 IIAs has been at stake.<sup>18</sup>

### III. INVESTMENT TREATIES—A STRAIGHTJACKET FOR SOVEREIGNTY?

#### 1. The Impact of Investment Treaties on State Sovereignty

Any treaty limits the sovereignty of the contracting parties, and IIAs are no exception to this rule. However, it is only now in connection with the wave of investment disputes that states actually *feel* this effect. Like through a burning glass, these disputes have brought to light the whole range of sovereignty concerns associated with IIAs as will be explained below.

Most IIAs apply to ‘every kind of asset’ of a foreign investor and therefore reach far beyond the protection of foreign direct investment. Whereas the latter is limited, in essence, to greenfield investments and the merger or acquisition of existing enterprises, ‘every kind of asset’—understood in its plain meaning—

<sup>15</sup> UNCTAD, Recent Developments in International Investment Agreements, IIA Monitor Nr 2 (2005).

<sup>16</sup> Investor-State Dispute Settlement database, available at [www.unctad.org/iaa](http://www.unctad.org/iaa).

<sup>17</sup> As indicated above, while there were 259 known investor-state arbitration cases at the end of 2006, the number of transnational corporations that could potentially invoke arbitration procedures stood at 78,000 in 2006.

<sup>18</sup> Even if each of the 259 known investment disputes involved a different IIA, these disputes would concern less than 10 per cent of the total number of more than 2700 IIAs existing at the end of 2006.

provides for a very broad, open-ended scope of protection. Accordingly, arbitration tribunals have, for instance, considered promissory notes and other banking instruments, as well as loan agreements and construction contracts as an ‘investment’.<sup>19</sup>

Likewise, most IIAs follow an extensive approach with regard to the investors protected by them. Coverage is not restricted to the natural person or parent company directly *owning* the foreign subsidiary. Rather, IIAs consider it to be sufficient if there is an *indirect* link between the foreign investors and their investment, eg through an intermediary company in a third country (or even several intermediaries in various countries). And most IIAs are already satisfied if the investor effectively *controls* the investment. Under this construct, determining whether a foreign investor is protected by an IIA can be a considerable challenge. For instance, in the recently decided *Aguas del Tunari v Bolivia* case,<sup>20</sup> there were two intermediary companies between the foreign investor (IWH, Netherlands) and the investment (AdT, Bolivia), and the former—being a joint venture—was not even the ultimate owner. The tribunal concluded that IWH indirectly controlled AdT.<sup>21</sup>

In addition to these broad definitions, most IIAs include far-reaching treaty obligations. Prominent examples are the commitments to ‘fair and equitable treatment’, to provide ‘full and constant protection and security’, or to refrain from any ‘unreasonable’ or ‘discriminatory’ treatment. Another IIA provision that has raised concern is the protection in case of expropriation, which extends to ‘indirect’ expropriation or ‘any measure having equivalent effect’. It has been argued that such broad and ambiguous treaty language would make the outcome of investment disputes unpredictable (see below).

These extensive obligations have to be seen in connection with the wide range of policy areas to which they may apply. Almost any field of the domestic policy agenda of host countries may in one way or another affect foreign investment, and therefore become relevant under an IIA. This is most obvious for, eg, corporate law issues, taxation, competition, intellectual property, auditing, labour, safety and environmental regulations, real estate, financial aids, consumer protection, immigration law, but does not stop there. Also more remote areas related to so-called ‘soft’ investment determinants as, for instance, the infrastructure, the functioning of state institutions, general administrative procedures or security issues may become important.

Furthermore, as said before, the IIA universe continues to become more dense and complex, both with regard to the amount of existing treaties and the scope and content of obligations. Obviously, the more IIAs a country concludes, the greater the number of states to which the sovereignty constraints apply.

<sup>19</sup> For further reference, see UNCTAD, *Investor-State Disputes Arising from Investment Treaties: A Review* (New York and Geneva, 2005).

<sup>20</sup> *Aguas del Tunari v Republic of Bolivia*, ICSID Case No ARB/02/3, Decision on Jurisdiction of 21 Oct 2005.

<sup>21</sup> See n 20.

Sovereignty is also limited by the broader obligations that countries have undertaken in more recent IIAs, for instance with regard to the right of establishment of foreign investment, the prohibition of certain trade-related *and* service-related investment measures (performance requirements), transparency obligations, or the foreign investors' right to employ senior management and board of directors of their choice.

A unique feature of IIAs is that they constrain sovereignty not only vis-à-vis other states, but also in respect of *private* parties—the foreign investors. Given the fact that these investors are often powerful transnational corporations, the effect of this restraint on IIA contracting parties may be considerable, in particular in the case of developing countries. Most IIAs also grant these private companies the right to international arbitration in case of an alleged treaty violation by the host country. This is in striking contrast to international trade rules, where only state parties have access to the WTO dispute settlement mechanism.

The cumulative impact of these issues on state sovereignty can be significant. Why then do countries continue to conclude IIAs at all? The more than 2700 IIAs concluded worldwide clearly suggest that, despite the above-mentioned constraints, a cost-benefit analysis speaks in favour of these agreements. It should not be forgotten that IIAs leave considerable regulatory freedom for contracting parties. The majority of them leave it up to the host countries to decide whether they want to admit foreign investment or not. With regard to the protection of established investment, the IIAs are confined to a relatively small—albeit important—number of core obligations. Countries concluding IIAs consider that these limitations on sovereignty are more than compensated by the positive impact, which these treaties may have on improving the investment climate and on making countries more attractive to foreign investors. Another explanation could be that many countries have not (yet) been involved in investment disputes, and have therefore not (yet) experienced the effects of the sovereignty restraints.

It also needs to be emphasized that even among those countries that have faced numerous arbitration cases, apparently none has explicitly given up the policy of concluding IIAs. Rather than abandoning these treaties altogether, these countries have started to tackle sovereignty issues in the IIAs themselves (see below). Reactions have been relatively modest and were limited to some modifications and clarifications of these agreements.

## 2. Recent Concerns about Investor-State Dispute Settlement<sup>22</sup>

In addition to the above-mentioned issues, a number of concerns have been voiced about international arbitration *procedures and awards*, namely that

<sup>22</sup> This paper only addresses those concerns that are related to state sovereignty. Besides, there are also other concerns such as those related to transparency, and the participation of the public at large.

there would be too many disputes, that the existing dispute settlement system would allow for parallel proceedings and treaty shopping, that awards would be too generous for foreign investors, thereby having huge financial implications for the defending host countries, and that the outcome of disputes would lack consistency and predictability. All these allegations require a closer look.

*a) Increase in Investment Disputes*

The substantial increase in arbitration cases is well documented.<sup>23</sup> However, the fact of more investment disputes is in itself nothing bad. It shows that IIAs are ‘alive’ and actually fulfil their purpose of providing foreign investors with legal protection in the host country. Also, it should not be surprising that foreign investors rely on these treaties, including the dispute settlement mechanism, to enforce their rights. Thus, it is not the current situation, which is unusual, but rather the past when arbitration cases were extremely rare.

An important novelty in investment disputes has to do with the fact that they no longer exclusively present a scenario, where an investor from a developed country sues a developing country. Starting with the NAFTA, where Canada and the US became defendants in investment disputes, a (slowly) growing number of industrialised countries see themselves in the same position. By the end of 2006, 52 of the 259 known treaty-based investor-State disputes (approximately 20 per cent) had been filed against a developed country. Other cases had been filed against advanced developing countries such as Argentina and Chile. The new phenomenon of industrialised countries as defendants has given the current reform debate considerable momentum.

*b) Parallel Proceedings and Treaty Shopping*

In close connection with the increase in investment disputes is the concern that foreign investors have too many fora at their disposal of where to conduct arbitration proceedings. This issue has various facets:

One case in point is a situation in which different shareholders having shares in the same subsidiary (the ‘investment’) and facing essentially the same dispute with the host country initiate arbitration procedures before different arbitration panels. This was the situation in the ‘Lauder/CME’ cases.<sup>24</sup>

Another issue has to do with subsequent procedures that one and the same investor might want to initiate with regard to the same subject matter. This could happen, for instance, if a foreign investor first sues the host country before its domestic courts, and, having not succeeded there, seeks a more favourable

<sup>23</sup> See above s II.

<sup>24</sup> See *Ronald S Lauder v Czech Republic*, UNCITRAL, Final Award of 3 Sept 2001; *CME Czech Republic v Czech Republic*, UNCITRAL, Partial Award of 13 Sept 2001 and *The Czech Republic v CME Czech Republic*, Court of Appeal, 42 *International Legal Materials* 919 (2003).



outcome before an international arbitration tribunal.<sup>25</sup> One special case in this connection are disputes arising from an investment contract between the foreign investor and the host country. According to numerous IIAs, the breach of such investment contracts amounts to a violation of the investment agreement.<sup>26</sup> As a result, the foreign investor may have access to the dispute settlement mechanisms available under both the investment contract and the IIA.

In practice, subsequent proceedings before domestic and international tribunals are rare. It appears that if foreign investors have the option of international arbitration, they seize this opportunity without prior recourse to the domestic courts. This makes sense given the extra costs and additional time involved in subsequent lawsuits, and the unclear legal situation that investors would face if they obtained contradictory awards (one in their favour and the other against them). The risk of ‘double proceedings’ is therefore only substantial if the foreign investor is *required* under the domestic law of the host country or the IIA to go first to the domestic courts. In this case, however, the host country cannot blame the foreign investor for going through a procedure that it itself has established.

A further concern relates to the so-called ‘treaty shopping’. It means that a foreign investor seeks the best IIA available to him under which to sue the host country. This possibility exists in the case of indirect investments involving several countries (eg an investor in country A makes an investment in country B, which makes an investment in country C and so on). If the final investment (eg in country D) suffers a damage, the parent company in country A can choose on which IIA to found the claim, since—in principle—three different enterprises (those in countries A, B and C) could be considered as ‘investors’ with regard to the investment in country D. Once again, cases of ‘treaty shopping’ are not frequent. Even if it occurs, it does not necessarily mean that the defendant host country has to face several proceedings. Keeping in mind that foreign investors will choose the forum, where they think their chances to succeed are the best, it is not very likely that, in case of a defeat at their tribunal of choice, they will pick another forum available under a different IIA. In addition, numerous IIA contain so-called ‘denial of benefits’ clauses that may prevent certain claims from proceeding (see below).

### *c) Too Generous Awards*

Another concern brought forward against international investment arbitration is that tribunals would interpret IIAs too generously, and thereby distort the delicate balance between investment protection, on the one hand, and state sovereignty (ie the right to regulate), on the other hand. Some cases relating to the

<sup>25</sup> It should be noted that the reverse situation cannot happen under most IIAs, since they consider the award of an international arbitration tribunal as being final.

<sup>26</sup> This outcome is achieved through the so-called ‘umbrella’ or ‘respect’ clause in IIAs.

MFN principle, the standard of fair and equitable treatment, and the protection against expropriation have been cited in support of this view. They will be discussed in the subsequent paragraphs.

The most prominent example is probably the ‘fair and equitable treatment’ standard. It is also the one most frequently reviewed by tribunals. A survey of the jurisprudence shows a trend towards a more favourable interpretation of this provision for foreign investors. While it was originally perceived as reflecting customary international law on the protection of aliens, thereby only prohibiting treatment of ‘such an unjust or arbitrary manner [. . .] unacceptable from the international perspective’,<sup>27</sup> it has developed into a more open and flexible protection standard. Its content derives now from a patchwork of interpretations in numerous arbitration awards. What counts is, for instance, whether there is a lack of due process,<sup>28</sup> a breach of the legitimate expectations of the investor,<sup>29</sup> or the absence of good faith conduct, which is consistent, totally transparent and free from ambiguity.<sup>30</sup> In another case, it was held that the standard ‘has to be interpreted in the manner *most conducive* [emphasis added] to fulfil the objective of the BIT to protect investment and create conditions favourable to investments’.<sup>31</sup>

It can hardly be argued that the aforementioned awards have interpreted the standard in a manner that would be inconsistent with the text of the clause. The real issue at stake is therefore not the existing jurisprudence, but the underlying treaty language.

The tendency towards an expansive treaty interpretation also exists with regard to the expropriation article. Whereas in the past, this provision had almost exclusively been invoked with regard to formal expropriations, the focus has shifted in recent years on regulatory takings, where the ownership rights of the foreign investors remain formally untouched, but where governmental measures indirectly have the effect of depriving them of the economic value of the investment.<sup>32</sup> Under many national laws, indirect takings are a familiar concept; in the context of IIAs, they are something relatively new for arbitration tribunals to deal with. Two well-known cases have caused some alarm in this respect: In the ‘Ethyl’ case,<sup>33</sup> an American investor claimed compensation from the Canadian government because of an import ban on a gasoline additive, MMT, arguing that the prohibition amounted to an indirect taking. The dispute

<sup>27</sup> *Metalclad Corporation v The United Mexican States*, ICSID Case No ARB (AF)/97/1, Award of 30 Aug 2000.

<sup>28</sup> *Loewen Group Inc. and Raymond Loewen v United States of America*, ICSID Case No ARB (AF)/98/3, Award on the Merits of 26 Jun 2003.

<sup>29</sup> *Tecnicas Medioambientales Tecmed v United Mexican States*, ICSID Case No ARB (AF)/00/2, Award of 29 May 2003.

<sup>30</sup> *Ibid.*

<sup>31</sup> *MTD Equity Sdn Bhd & MTD Chile SA v Chile*, ICSID Case ARB/01/7, Award of 25 May 2004.

<sup>32</sup> UNCTAD, *Taking of Property* (New York and Geneva, 2000).

<sup>33</sup> *Ethyl Corporation v The Government of Canada*, UNCITRAL, Award on Jurisdiction of 24 Jun 1998.

was settled out of court through a compensation payment by the Canadian government. In the ‘Metalclad’ case,<sup>34</sup> the tribunal concluded that a measure to prevent the use of land as an underground landfill and establish it as a State wildlife protected area was a measure tantamount to expropriation and required compensation. Subsequent awards, on the other hand, have stressed the exceptional character of regulatory takings.<sup>35</sup>

A final example is the interpretation of the MFN principle. In the ‘Maffezini’ award,<sup>36</sup> the tribunal interpreted the scope of application of this standard broadly and considered that it allows a foreign investor to benefit from a more favourable time requirement concerning the initiation of arbitration contained in an IIA concluded by the host state with a third country. Other tribunals, however, have taken a more restrictive view on this issue (see below).

#### *d) Lack of Consistency and Predictability*

It has been argued that awards in investment arbitration lack consistency because international tribunals have come to contradictory conclusions on the same subject matters.<sup>37</sup> Examples include the principle of national treatment, the MFN principle, the scope of dispute settlement, the so-called ‘umbrella clause’ and the issue of regulatory takings.

- *National treatment*: The applicability of this provision depends on whether foreign and domestic investors are ‘in like circumstances’. While one tribunal considered this condition to be met if the two businesses in question were in commercially competitive sectors,<sup>38</sup> another tribunal took a narrower approach by requiring that the activities of the foreign investor were comparable to economic activities in the domestic sphere.<sup>39</sup> The same issue may come up concerning the MFN principle.
- *MFN principle*: While some tribunals confirmed the applicability of the MFN standard in respect of dispute settlement provisions, other tribunals held the opposite view.<sup>40</sup>
- *Scope of investor-state dispute settlement*: While some tribunals are of the opinion that ‘disputes concerning an investment’ also cover purely contrac-

<sup>34</sup> See n 27 above.

<sup>35</sup> See, for instance, *SD Meyers v Canada*, UNCITRAL, First Partial Award of 13 Nov 2000; *Marvin Roy Feldman v The United Mexican States*, ICSID Case No ARB/(AF)99/1, Award on Merits of 16 Dec 2002.

<sup>36</sup> *Emilio Agustín Maffezini v. The Kingdom of Spain*, ICSID Case No ARB/97/7, Award of 13 Nov 2000; Rectification of Award of 31 Jan 2001.

<sup>37</sup> See Schreuer, *Diversity and Harmonization of Treaty Interpretation in Investment Arbitration*, in: *Transnational Dispute Management*, Vol 3, Issue Number 2, Apr 2006.

<sup>38</sup> See *SD Meyers v Canada*, n 35 above.

<sup>39</sup> See *Methanex v United States*, UNCITRAL, Final Award of 3 Aug 2005.

<sup>40</sup> See ‘Maffezini’ (n 36) and *Siemens v Argentina*, ICSID Case No ARB/02/8, Decision on Jurisdiction of 3 Aug 2004, on the one hand, and *Salini Costruttori SpA and Italstrade SpA v Jordan*, ICSID Case No ARB/02/13, Decision on Jurisdiction of 9 Nov 2004, *Plama Consortium Limited v Bulgaria*, ICSID Case No ARB/03/24, Decision on Jurisdiction of 8 Feb 2005, on the other hand.

tual disputes between an investor and the host country,<sup>41</sup> other tribunals have adopted a narrower approach by limiting the dispute settlement provisions to claims arising out of an alleged treaty violation.<sup>42</sup>

- *Umbrella clause*: Arbitral tribunals have come to different conclusions concerning the extent to which a treaty provision obliging contracting parties to respect any other commitment they have undertaken with regard to an investment transforms a breach of contract into a violation of the investment treaty.<sup>43</sup>
- *Regulatory takings*: While one tribunal considered an alleged improper governmental interference with an investment in the television business to be an indirect expropriation, another tribunal came to the opposite conclusion with regard to the same subject matter.<sup>44</sup>

A lack of consistency could make the outcome of arbitration proceedings unpredictable and thereby ultimately undermine the legitimacy of investor-state dispute settlement procedures.

However, it is not so unusual that different courts or tribunals decide the same legal questions differently. IIA provisions—like any law or contract—are open to interpretation, and so it is only natural that judges and arbitrators may have a different understanding of their meaning, especially when they are vaguely formulated. There is also no evidence that cases of inconsistency would be more frequent in investment disputes than in other areas. Further, as case law develops, future arbitration tribunals will have more precedents at hand, which should have a certain harmonising effect.<sup>45</sup> Nonetheless, one major reason for concern remains: Unlike in the WTO or in the EU, there is no ultimate judicial authority for the interpretation of IIAs (see below).

Amidst all the possible worries about investment arbitration, its important positive aspects should not be forgotten. It may increase investor confidence, thereby improving a host country's attractiveness for foreign investment. It contributes to the development of and respect for international law, and reduces political pressure. International arbitration also has many advantages in terms of the language used, speed, and assembled expertise.

<sup>41</sup> *SGS Société Générale de Surveillance SA v Republic of the Philippines*, ICSID Case No ARB/02/6, Decision on Jurisdiction of 29 Jan 2004.

<sup>42</sup> *SGS Société Générale de Surveillance SA v Islamic Republic of Pakistan*, ICSID Case No ARB/01/13, Decision of 6 Aug 2003. See also Gaillard, *Investment Treaty Arbitration and Jurisdiction Over Contract Claims—the SGS Cases Considered*, in: Weiler (ed), *International Investment Law and Arbitration* (London 2005), p 325–46.

<sup>43</sup> See, for instance, the cases cited in n 41 and 42.

<sup>44</sup> See the above-mentioned 'Lauder/CME' cases (n 24).

<sup>45</sup> Dolzer, *Fair and Equitable Treatment: A Key Standard in Investment Treaties*, in: *The International Lawyer*, Spring 2005 (39 *Int'l Law* 87); see also Schreuer, *Fair and Equitable Treatment in Arbitral Practice*, *J of World Investment & Trade*, Jun 2005.

#### IV. ADDRESSING SOVEREIGNTY CONCERNS IN IIAS— POTENTIAL AREAS OF REFORM

It follows from the above analysis that addressing sovereignty concerns in connection with international investment arbitration would entail two issues: a review of substantive IIA provisions and a possible reform of dispute settlement procedures. However, the case for reforms is not obvious. In general, the current arbitration mechanisms work satisfactorily. This does not mean that the current rules and procedures could not be further improved.

This section provides a brief overview of the various policy areas where one *could consider* taking reform steps.<sup>46</sup> This outline does not suggest that reforms should actually be carried out. To arrive at this conclusion would require a more profound analysis of the possible advantages and disadvantages of each individual reform measure. Rather, the objective is to show that IIA contracting parties have a broad range of options at hand to reassert state sovereignty with regard to investment arbitration *if they think that there is a need to do so*. What also becomes clear from the preceding section is that some possible reform areas are more important than others. This relates, in particular, to the issue of clarifying the content of the principle of fair and equitable treatment, and the idea of establishing an appeals mechanism.

##### 1. Clarifying Substantive Treaty Provisions

An obvious choice to strengthen state sovereignty would be to redraft substantive treaty provisions that have been a reason for concern (box 1). The primary objective would be to reduce ambiguity in treaty language, to ensure a fair balance between investment protection and the public interest, and thereby to improve the consistency and predictability of awards. The US and Canada have already moved in this direction by modifying their respective model BITs. For instance, the 2004 US model agreement clarifies that the concept of fair and equitable treatment does ‘not require treatment in addition to or beyond that which is required’ by the customary international law minimum standard of treatment of aliens, and that, ‘except in rare circumstances, non-discriminatory regulatory actions that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations’. The US model also spells out that in order to be covered by the agreement, an asset must have the characteristics of an ‘investment’, including the ‘commitment of capital or other resources, the expectation of gain or profit, or the assumption of risk’.

<sup>46</sup> See also the comprehensive discussion paper of the OECD ‘Improving The System Of Investor-State Dispute Settlement: An Overview’, presented at a symposium co-organised by ICSID, OECD and UNCTAD on ‘Making The Most Of International Investment Agreements: A Common Agenda’, held in Paris on 12 Dec 2005.

**Box 1: Addressing Sovereignty Concerns in IIAs—Substantive Provisions**

- Reducing/clarifying the scope of the agreement (eg narrower definitions of «investment» and «investor»);
- Clarifying individual treaty provisions (eg fair and equitable treatment, expropriation, non-discrimination);
- Reaffirming public interests vis-à-vis investment protection (eg through exceptions and exclusions);
- Interpretative statements of contracting parties.

Among the above-mentioned provisions, the principle of fair and equitable treatment might become a preferred candidate for clarification. Given its general character as basic protection clause and its broad scope of application, it is likely to remain the IIA provision most often invoked in investment disputes. Further, the differences in interpreting this provision are huge, ranging from a strict limitation to the international minimum standard to a much higher degree of protection. Also, despite that fact that recent arbitral awards have commonly interpreted the provision in a broad manner, they have circumscribed the content of the obligation in a variety of terms. While all expressions used point into the same direction, their alternative application might nevertheless lead to different results. For example, a lack of due process might constitute a narrower interpretation of a violation of the fair and equitable treatment principle than a requirement to respect the legitimate expectations of the investor. Tribunals might also come to different conclusions concerning the meaning of each of these protection standards.

The basic problem is that the principle of fair and equitable treatment inherently contains a strong subjective element. This was less of an issue as long as IIAs—although formally a legally binding instrument—had in practice more the role of a political statement expressing the goodwill of contracting parties to create and maintain a favourable investment climate. The standard of fair and equitable treatment is the declaration ‘par excellence’ to make this point. With IIAs increasingly used to enforce investor rights against host countries, it has become more important to explain (to potential arbitrators) what contracting parties actually mean with it.

On the other hand, clarifying the fair and equitable principle in an IIA is no easy task. As can be seen from the cited awards, each attempt to define ‘fair and equitable’ in other terms creates new questions about their meaning. The problem remains that a subjective standard cannot be described in objective terms unless one changes its content, eg by reducing it to an obligation not to discriminate. Such a transformation might derive the foreign investor from the ‘safety net’ that the standard is supposed to provide in addition to the more specific treaty provisions. What contracting parties can do, however, is to clarify

whether they understand the standard in the sense of the international minimum standard or as a wider-reaching provision. They also have the possibility to provide concrete examples in the IIA of standard situations in which they consider that the principle of fair and equitable treatment would be violated.

It should be mentioned that the approach of clarifying IIA provisions might also have its drawbacks. It makes an initially ‘simple’ treaty more complex. This might to some extent weaken the investment promotion objective of IIAs. Rather than establishing basic rights of protection in a straightforward manner, a more legalistic and sophisticated treaty language conveys the (correct) message that investment protection is a complicated matter requiring substantial governmental safeguards. This ‘Yes, but’ approach towards investment protection might particularly pose a problem for smaller investors that do not have enough legal expertise to properly analyse these new IIA provisions and assess their implications.

## 2. Limiting Access to International Arbitration

Countries considering that international arbitration is too easily accessible for foreign investors or that it should be restricted in respect of specific disputes have many possibilities at their disposal. Constraints could be established with regard to the types of investment disputes for which arbitration is available (box 2), or concerning the procedural preconditions for and rules of arbitration (box 3).

### **Box 2: Limiting Access to Arbitration—Scope and Standing**

- Exclusion of certain categories of investment disputes (eg pre-establishment disputes, disputes based on investment contracts, taxation matters, disputes unrelated to a violation of IIA provisions);
- Denial of benefits clause;
- Loss or damage as precondition.

### **Box 3: Limiting Access to Arbitration—Procedural Preconditions**

- Mediation and conciliation as alternatives to binding dispute resolution;
- Refusal of frivolous claims;
- “Cooling-off” periods;
- Time limits on claims;
- Internal administrative review prior to arbitration;
- “Fork in the Road”;
- Prior exhaustion of local remedies;
- Additional mechanisms to preclude the arbitration from proceeding.

Compared to the clarification of substantive treaty provisions, limitations on access to arbitration are more common in treaty practice. Indeed, some of the options listed above (denial of benefits clause,<sup>47</sup> ‘cooling off’ periods) can be found in many IIAs. Other limitations, such as the ‘fork in the road’ (ie the requirement that a foreign investor has to make an irrevocable choice between domestic court procedures and international arbitration) or the exclusion of IIA-based dispute settlement for investment contracts having their own dispute resolution mechanisms are also nothing new. Several other constraints have made its way into the new US model agreement. Among them are the conditions that the disputing investor must claim to have incurred loss or damage as a result of the alleged treaty violation, and the mandatory involvement of the financial authorities of both contracting parties in the resolution of disputes relating to taxation or financial services, including their right to terminate the dispute by consent.<sup>48</sup> Still other issues, such as the possibility for each contracting party to exclude dispute settlement with regard to pre-establishment disputes, have been considered in the past, namely during the OECD-based negotiations on the stillborn Multilateral Agreement on Investment (MAI), or are under discussion, for instance a stronger emphasis on mediation and conciliation as alternatives to binding arbitration.<sup>49</sup>

### 3. Consistency and Predictability of Awards

A consistent and predictable international jurisdiction on investment matters is not only important under sovereignty considerations. It is likewise fundamental for confidence building vis-à-vis foreign investors and for creating stable investment conditions in the host country.

One way of action in this respect would be to clarify substantive IIA provisions as has been described above. Another option is to modify dispute settlement procedures with a view to provide for more consistency and to increase the quality of awards. Although there are various options available (box 4), concrete reform steps have basically been limited to the US and Canadian model agreements.

<sup>47</sup> According to this clause, contracting parties usually have the right to deny the protection of the treaty to an investor who has no substantial business activity in the home country, and who is effectively controlled by persons of a non-contracting party. Benefits can also be denied in case that nationals of a country with whom the host country does not maintain diplomatic relations control the investor company.

<sup>48</sup> See Arts 20 and 24.

<sup>49</sup> UNCTAD, *Alternative Methods of Treaty-Based Investor-State Dispute Resolution* (forthcoming).



**Box 4: Arbitration Awards - Consistency and predictability**

- Composition of Tribunal – Establishment of a “Roster”;
- Possibility of consolidation of claims;
- Clarification of governing law;
- Parties’ comments on draft award;
- More scientific and technical expertise;
- Amicus curiae submissions;
- Specification of applicable law;
- Specification of different kinds of final awards;
- Preliminary rulings;
- Appeals mechanism.

For instance, the 2004 US model agreement expressly allows the consolidation of claims and foresees the eventual establishment of an appellate body in the future.<sup>50</sup> In addition, it provides for the possibility of amicus curiae submissions, pre-award comments of the parties involved on the proposed decision, and the involvement of experts on environmental, health, safety or other scientific measures.<sup>51</sup> The model treaty also specifies in some detail the law governing the dispute and the kind of awards that the tribunal may render.<sup>52</sup>

The establishment of an appellate body would be the most effective means to ensure consistency and predictability of awards. Appeals mechanisms are an integral part of all developed legal systems. Without such an institution, which has the right to review awards and to correct them if necessary, there is always a risk that different tribunals arrive at different conclusions on the same legal issue.

On the other hand, the fact that an arbitration award is generally not open to review has been considered as one of the major advantages of this kind of dispute settlement, because it allows the disputing parties to terminate the conflict relatively quickly at reasonable costs. However, it has also been argued that investment arbitration involves issues of public interest, which would make the acceptance of the risk of flawed or erroneous decisions less justifiable than it may be in traditional commercial arbitration.<sup>53</sup> Likewise, the undeniable additional time and costs involved in an appeals procedure would have to be seen against the gain in legal security and quality; also, there would be possibilities to reduce these inconveniences, for instance, by setting limits for the time and scope of appeals procedures.<sup>54</sup>

<sup>50</sup> See Art 33 and Annex D.

<sup>51</sup> See Arts 28 and 32.

<sup>52</sup> See Art 34.

<sup>53</sup> See the OECD discussion paper (n 46 above).

<sup>54</sup> See the OECD discussion paper (n 46 above).

It follows from the above that any attempt to introduce an appeals mechanism in investment arbitration would need to strike a balance between the interest of the appealing party to have broad access to judicial review and the need of not giving up entirely one of the main advantages of arbitration, namely the swiftness of the whole procedure. An appeals mechanism would therefore have to be composed in such a way as to go beyond the already available review means under the ICSID Convention and national laws, while at the same time avoiding full-blown appeals procedures known from national court proceedings. This means, on the one hand, that an appeals mechanism should not be limited to cases where (1) new facts have emerged that would have resulted in a different decision of the tribunal,<sup>55</sup> (2) there are reasons for an annulment of the decision (ie no proper constitution of the court, manifest excess of powers by the court, corruption of court members, serious departure from a fundamental rule of procedure, failure to state reasons in award),<sup>56</sup> or (3) the award violates the public policy of the country where the decision was rendered.<sup>57</sup> On the other hand, the scope of an appeals procedure should not be so broad as to include any questions of fact. In other words, an appeals body should, in addition to the already existing review grounds, allow contesting an initial award in case of an alleged (*serious*) *error of law*.

It would be relatively easy for contracting parties to agree on an appellate body with regard to their specific agreement (eg a BIT). However, since such a tribunal would be confined to ensure consistency with regard to the application and interpretation of *one single IIA*, it would not be in a position to tackle the global dimension of the problem, ie the fact that consistency is predominantly an issue with regard to the application of different IIAs involving different countries. For instance, if tribunal 1 has interpreted the ‘fair and equitable treatment’ principle contained in the agreement between countries A and B in one way, and tribunal 2 has come to a different interpretation of the same provision in the treaty between countries C and D, who else than a multilateral appellate body overlooking all IIAs involved could have the authority to make a final judgment on this question?

Setting up a multilateral appellate body would require a multilateral agreement, which ideally would cover all countries participating in the global IIA network. However, as the development of the WTO Doha Round shows, there is currently no consensus on the establishment of multilateral investment rules. The idea of a multilateral appellate body is therefore—at least for the time being—not a realistic option. Even integrating this appellate body into the framework of the already existing ICSID would be a major challenge because it would require consensus by all member countries.<sup>58</sup>

<sup>55</sup> Art 51 of the ICSID Convention.

<sup>56</sup> Art 52 of the ICSID Convention.

<sup>57</sup> Besides the already mentioned issue of an excess of court power, this is the requirement most frequently found in national laws to set aside an arbitral award.

<sup>58</sup> See also Schreuer, Diversity and Harmonization of Treaty Interpretation in Investment Arbitration, in: *Transnational Dispute Management (TDM)*, vol 3, issue 2, Apr 2006.

## V. CONCLUDING REMARKS

States are the ‘masters of the treaties’ they conclude. They can therefore take sovereignty concerns relating to investment arbitration into account when negotiating them.

Countries assess the need to take reform steps differently. While some countries have already modified their model agreements, the great majority continues to conclude IIAs unchanged. Whether this lenient approach will continue in the future depends to a great extent on the further development of investment disputes. If disputes keep on increasing considerably and involve an ever-growing number of countries, the voices in favour of a review of current arbitration mechanisms and the underlying treaty provisions giving rise to arbitration will probably become louder. It is also important how many developed countries will become defendants in investment disputes. Given their overall greater bargaining power in investment treaty negotiations, they will not have an interest in changing the existing rules until they consider it necessary as a means to strengthen their defence in investment arbitration. Since, with the remarkable exception of the NAFTA, most developed countries face treaty-based arbitration only vis-à-vis investors from *developing countries*,<sup>59</sup> a crucial question is whether the increasing number developing countries becoming capital exporters will result in more investment disputes in the future.

Many options exist to address arbitration-related sovereignty concerns in IIAs, including the clarification of substantive treaty provisions and the modification of procedural rules of arbitration. Important potential reform areas could be, in particular, the principle of fair and equitable treatment and the establishment of an appeals mechanism.

Modifications of the current rules may involve a trade-off between strengthening state sovereignty, on the one hand, and offering favourable conditions for foreign investors, on the other hand. Developing countries in particular need to assess carefully whether limitations of investment protection could have a substantial impact on their attractiveness as hosts to foreign investment.

As mentioned above, reform steps are more likely at the bilateral (or regional) level than at the multilateral plane. This may have important consequences: Modifications may take place at a relatively slow pace, since they would need to be incorporated through a multitude of individual negotiations rather than through a ‘one-shot’ multilateral deal. An additional complication may arise from the MFN clause contained in IIAs. It might undermine newly negotiated terms on dispute settlement between the parties if foreign investors of either party could claim the more favourable ‘old’ conditions retained in other IIAs. The most worrying likely development, however, is that the existing system of

<sup>59</sup> The reason is that most IIAs have been concluded between developed and developing countries.

investment arbitration becomes still more fragmented and complex. Against this background, it would be useful if countries sought some international coordination when they revise their IIAs, for instance in the various regional organisations to which they belong (eg OECD, NAFTA, EU, APEC, ASEAN). Countries can also benefit from technical assistance and policy research, such as the one provided by UNCTAD.



# *Calvo Doctrine, State Sovereignty and The Changing Landscape of International Investment Law*

WENHUA SHAN\*

HAVING DOMINATED Latin American States for over a century, Calvo Doctrine has been widely assumed<sup>1</sup> and predicted<sup>2</sup> ‘dead’, particularly in the 1990s, facing global waves of economic liberalisation. However, some recent moves in and beyond Latin America (LA)<sup>3</sup> suggest that this principle is still very much alive and relevant. Within Latin America, there is an increasing trend to limit and control international investment arbitration. Venezuela, for example, established in 2001 an internal mechanism to review public interest contracts with international arbitration clauses.<sup>4</sup> In March 2005, two Argentine Congressmen reportedly proposed a bill aimed at limiting and

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<sup>1</sup> Shea, for instance, pronounced Calvo’s death as early as 1950s in his most cited book on Calvo Clause, in light of the rejection it received from European and North American States. More recently, for example, Giesze wrote that, ‘[A]s a practical matter, the *Calvo doctrine is a dead letter* in the overwhelming majority of Latin American countries’. Shihata also considers Calvo Doctrine irrelevant in current world. See respectively Donald Shea, *The Calvo Clause: A Problem Of Inter-American And International Law and Diplomacy* (Mineapolis, University of Minnesota Press, 1955), at 20; CR Giesze, ‘Helms-Burton In Light Of The Common Law And Civil Law Legal Traditions: Is Legal Analysis Alone Sufficient To Settle Controversies Arising Under International Law On The Eve Of The Second Summit Of The Americas?’ 32 *International Lawyer* 51, 77 (1998), and IFI Shihata, ‘Towards a Greater Depoliticization of Investment Disputes: The Roles of ICSID and MIGA’, 1 *ICSID Review-Foreign Investment Law Journal* 1, at 3–4 (1986).

<sup>2</sup> In an article published in 1995, for example, Manning Cabrol pronounced the ‘imminent death’ of Calvo clause. See Denise Manning-Cabrol, ‘The Imminent Death of the Calvo Clause and the Rebirth of the Calvo Principle: Equality of Foreign and National Investors’ (1995), 26 *Law & Policy of International Business* 1169.

<sup>3</sup> See s III for further details.

<sup>4</sup> B Werninger and DM Lindsey, ‘Venezuela’, in N Blackaby, DM Lindsey and A Spinillo (eds), *International arbitration in Latin America* (Kluwer 2002), at 235.

controlling international arbitration on state-investor investment disputes.<sup>5</sup> Recently, Bolivia decided to withdraw from the ICSID Convention.<sup>6</sup> These events in Latin America, together with moves in the rest of the world such as the episode of ‘Calvo in the Congress’ in the US, suggest a ‘revival’ or ‘resurgence’ of the Calvo Doctrine, which have attracted wide attention.<sup>7</sup>

This article intends to explore and examine the alleged ‘death’ and ‘revival’ phenomena of the Calvo Doctrine and evaluate the implications of such phenomena on international investment law and the concept of state sovereignty. It is divided into four parts. Part I briefly looks into the essence and elements of the Doctrine, in order to establish the criteria of assessment. Part II examines whether and to what extent Calvo was dead in 1990s, by referring to the criteria established in Part I. Part III presents the case of the ‘revival of Calvo’ in and beyond Latin America. Parts IV and V analyses the implications of Calvo’s eventful life on the international investment regime and the concept of state sovereignty. It argues that a more precise definition of the Calvo Doctrine is ‘anti-super-national-treatment’, rather than ‘national treatment’ as commonly held; Calvo was merely deactivated, but not completely dead in the 1990s; The revival of Calvo goes well beyond Latin America and demonstrates a fundamental flaw in the current regime on international investment; and the key to remedy such flaw is to revisit the nature of international investment treaties and to strike a balance of rights and obligations between foreign investors and host states. Further, it argued that the fall and rise of Calvo in contemporary world demonstrates that the concept of state sovereignty is still very much alive and relevant in contemporary international law. What has been changed and is still changing is the ‘concrete sovereignty’, whilst the ‘abstract sovereignty’ stays intact.

## I. CALVO DOCTRINE: ESSENCE AND ELEMENTS

### 1. The Essence of Calvo Doctrine

It is often said that the essence of the Calvo Doctrine is ‘equal treatment/national treatment’ or ‘equality’. For example, Donald Shea, probably the most eminent researcher on this theory, has asserted that ‘these two

<sup>5</sup> Guido Santiago Tawil, ‘Is Calvo finally back?’ *Translational Dispute Management* (No 3, Jun 2005) partly posted at <C:\Documents and Settings\xjtu\Local Settings\Temporary Internet Files\Content.IE5\TWSN9501\tdm2-2005\_5[1].htm> (last visited on 6 Jun 2006).

<sup>6</sup> Damon Vis-Dunbar, Luke Eric Peterson and Fernando Cabrera Diaz, ‘Bolivia notifies World Bank of withdrawal from ICSID, pursues BIT revisions’, *Investment Treaty News* (8 May 2007).

<sup>7</sup> For instance, in Sept 2005, the Washington DC Bar organised a timely seminar entitled ‘*The Resurgence of the Calvo Doctrine?*’ Seminar programme can be found at: <[http://www.bg-consulting.com/docs/calvo\\_program.jpg](http://www.bg-consulting.com/docs/calvo_program.jpg)> (last visited on 6 Jun 2006). For details above events signalling the ‘revival’ of the Calvo Doctrine beyond Latin America, see s III.2 below.

concepts of non-intervention and absolute equality of foreigners with nationals are the essence of the Calvo Doctrine'.<sup>8</sup> Manning-Cabrol, a more recent writer on this principle, has also maintained that 'equality is the central tenet of the Calvo Doctrine'.<sup>9</sup> Yet while 'equality of states', in conjunction with state sovereignty, has provided the legal foundation of the Calvo Doctrine, it in itself does not fundamentally characterise Calvo. Instead of emphasizing 'absolute equality' between states or between nationals and foreigners, the Calvo Doctrine actually emphasizes rejection of superiority or imperial prerogatives of powerful states and their nationals. In other words, the Calvo Doctrine is essentially 'anti-super-state' or 'anti-super-national-treatment', focusing on the opposition and rejection of any discriminatory treatment by western powers against weak, developing host states and their nationals, as compared to the treatment those western power accord each other and demand for their citizens in these host states. Unlike 'equal/national treatment', 'anti-super-national-treatment' does not deny or reject the special privileges that host countries often grant or reserve to their own nationals. A close reading of Calvo's writing supports this distinction: though he did use equality of states and individuals as the legal basis of his arguments, what he specifically rejected was special privileges enjoyed by foreign states and their nationals, not the privileges that a national might enjoy in his or her home state based on citizenship. For instance, he wrote,

The rule that in more than one case it has been attempted to impose on American states is that foreigners merit *more regard and privileges more marked and extended* than those accorded even to the nationals of the country where they reside. This principle is intrinsically contrary to the law of equality of nations. . . . To admit that in the present case governmental responsibility, that is the principle of an indemnity, is to create *an exorbitant and fatal privilege, essentially favourable to the powerful states and injurious to the weaker nations*, establishing an unjustifiable inequality between nationals and foreigners.<sup>10</sup> (Emphases added)

He then concluded that 'the responsibility of governments towards foreigners cannot be *greater* than that which these governments have towards their own citizens'.<sup>11</sup>

Calvo's 'anti-super-state' or 'anti-super-national-treatment' approach is reified in the widely used 'Calvo Clauses' in domestic constitutions and laws, and in bilateral and regional treaties; such clauses often highlight that the treatment of foreigners and foreign investors should be 'no more favourable than' that accorded to national and national investors, as we will see below in Section I.3.

<sup>8</sup> Shea, above, n 1, at 19–20.

<sup>9</sup> It is noted that the doctrine embraced two levels of equality, namely 'equality of nation-states or the equal treatment of nationals and foreigners'. Manning-Cabrol, above, n 2, at 1172.

<sup>10</sup> Shea, above, n 1, at 18.

<sup>11</sup> *Ibid* at 19.



The ‘anti-super-national-treatment’ approach of Calvo can be explained by the specific background against which this theory was developed. As Shea pointed out, the Calvo Doctrine was born at a time when ‘strong logical, moral and legal defences’ were badly needed in Latin American countries, which then were facing ‘real or imagined abuses of either diplomatic protection of aliens living within their territories or armed intervention in behalf of their foreign creditors’ and which were unable to resist by force.<sup>12</sup>

Characterising the Calvo Doctrine as supportive of ‘anti-super-state’ and ‘anti-super-national-treatment’ rather than of ‘equality’ or ‘national treatment’ not only more accurately reveals the focus of this theory, but also distinguishes Calvo from the ‘national treatment’ standard frequently used in BITs. Indeed, although both standards highlight the value of ‘equality’ and therefore are often confused by commentators,<sup>13</sup> the ‘anti-super-national-treatment’ under the Calvo Doctrine and the ‘national treatment’ under BITs actually represent the two extremes of the spectrum of ‘equality’: while the former focuses on the elimination of discrimination against host states and their nationals, the latter emphasizes the abandonment of discrimination against foreigners.<sup>14</sup> The distinct character of the ‘national treatment’ principle in BITs is evidenced by the use of the expression ‘treatment *no less favourable than* that accorded to national investors’ in most BITs, provisions which might better be characterized as ‘anti-inferior-national-treatment’. Nevertheless, these two distinctive principles might converge and unite as one principle under the umbrella of the principle of ‘equality’ or ‘national treatment’. This is particularly the case when the phrase ‘the same treatment’ is used; as will be discussed below, this appears to be what happened in 1990s in Latin America.

## 2. Key Elements of Calvo Doctrine

The essence of the Calvo Doctrine may be broken down into two key elements: a substantive sense and a procedural sense.<sup>15</sup> In the substantive sense, the Calvo

<sup>12</sup> Shea, above, n 1, at 14.

<sup>13</sup> For example, Manning-Cabrol considers national treatment in international investment treaties to be the same as the ‘equal/national treatment’ principle enshrined in the Calvo Doctrine, and argues that Calvo found new life in such treaties (as well as in domestic legislation). See Manning-Cabrol, above, n 2, at 1195.

<sup>14</sup> Zamora also noted such a distinction between the two principles and has pointed out that, ‘[U]nlike concepts of national treatment, however, the Calvo Doctrine was created to address the perceived favouritism granted to foreigners, rather than discrimination against them. In other words, the purpose of the Calvo Doctrine is to bring foreigners down to the level of nationals, while the purpose of national treatment is to raise them up to the level of nationals’. See Stephen Zamora, ‘Allocating Legislative Competence in The Americas: The Early Experience under NAFTA and the Challenge of Hemispheric Integration’, (1997) 19 *Hous J Int'l L* 615, 622.

<sup>15</sup> KJ Vandeveld, ‘Sustainable Liberalism and the International Investment Regime’, (1998) 19 *Mich J Int'l L* 373, 379.

Doctrine emphasizes that host states shall not grant foreigners any rights or benefits greater than those they accord to their own nationals. This carries both specific and abstract implications: on a specific or practical level, it prohibits the provision of any special privileges or incentives to foreigners and foreign investors by a host state; on an abstract or theoretical level, it rejects the so-called 'international minimum standard' as a standard of law applicable to the treatment of foreigners including foreign investors. In the procedural sense, the Calvo Doctrine emphasizes that foreigners shall not be entitled to any remedies other than those available to nationals of a host state. It therefore implies a rejection of both non-local remedies (ie, foreign or international remedies including diplomatic protection or military intervention) and non-local laws (ie, foreign or international law) as applicable laws. As a procedural requirement, the rejection of non-local laws echoes and coincides with the substantive law requirement of rejection of an 'international minimum standard'. The two requirements may therefore be regarded as one element. It can thus be seen that the Calvo Doctrine indeed takes a very classic, state-centric view of international law, based on an absolutist view of state sovereignty and equality of states.

In short, the Calvo Doctrine effectively means, on the one hand, a rejection of special substantive privileges to foreigners and foreign investors ('no super-national treatment'), including specific incentives and benefits and in an abstract sense the 'international minimum standard' of treatment they allegedly may enjoy; and, on the other hand, a rejection of any special procedural privileges to foreigners, including recourse to non-local remedies and the applicability of non-local laws. More specifically, the rejection of special substantive and procedural privileges for foreigners may be described in three basic elements, namely the 'anti-super-national-treatment' standard, exclusive local jurisdiction, and exclusion of diplomatic protection,<sup>16</sup> with the first being the substantive requirement, and the latter two the procedural requirements. As the substantive standard for the doctrine, the 'anti-super-national-treatment' standard may thus be regarded as the body of the norm, while 'exclusive local jurisdiction' and 'exclusion of diplomatic protection' may be regarded as the legs on which the body stand, or the arms without which the body could not effectively operate. In a sense, the procedural aspects of the Calvo Doctrine,

<sup>16</sup> Such factors are also the three key elements of the Calvo Clause, see Manning-Cabrol, above, n 2, at 1173. However, according to Lipstein, the Calvo Clause has five elements: 'submission to local jurisdiction, free choice of law, sphere of application, waiver of protection by home state and surrender of rights under international law'. See K Lipstein, 'The Place of the Calvo Clause in International Law', 22 *Brit YB Int'l L* 130, 131-3 (1945). Wesley likewise observes that there are five common provisions in the clause: '(1) Submission to local jurisdiction; (2) application of local law; (3) assimilation of foreigners for purposes of local contractual arrangements; (4) waiver of diplomatic protection by the foreigner's home state; and (5) surrender of rights arising under international law'. RC Wesley, 'The Procedural Malaise of Foreign Investment Disputes in Latin America: From Local Tribunals to Fact-finding', (1975) 7 *Law And Policy Of international Business* 818.

namely 'exclusive local jurisdiction' and 'exclusion of diplomatic protection', are actually more important than the substantive aspect, the 'anti-super-national-treatment' standard.

### 3. The Calvo Doctrine and Calvo Clause

The Calvo Doctrine understandably did not win acceptance by European and US governments and lawyers, as it not only eliminates the possibility of abusing diplomatic protection, but also '[e]liminate[s] the institution itself, without substituting an acceptable alternative'.<sup>17</sup> Latin American states, on the other hand, 'enthusiastically received' this doctrine and, as a countermeasure to the rejection of the doctrine by western powers, they resorted to 'Calvo Clauses' to enforce it.<sup>18</sup> Calvo Clauses typically can be found in constitutions, domestic legislation, international treaties and contracts signed between foreign investors and Latin American governments.<sup>19</sup> The 1933 Constitution of Peru, for example, included the following article:

Article 31. Property, whoever maybe the owner, is governed exclusively by the laws of the Republic and is subject to the taxes, charges, and limitations established in the laws themselves.

The same provision regarding property applies to aliens as well as Peruvians, except that in no case may the said aliens make use of their exceptional position or resort to diplomatic appeals.<sup>20</sup>

A piece of Ecuadorian legislation from 1938 likewise stipulated that

[f]oreigners, by the act of coming to the country, subject themselves to the Ecuadorian laws without any exception. They are consequently subject to the Constitution, laws, jurisdiction and police of the Republic, and may in no case, nor for any reason, avail themselves of their status as foreigners against the said conditions, jurisdiction, and police.<sup>21</sup>

As an example of a 'Calvo Clause' implemented by contract, the contract between Mexico and the North American Dredging Company of Texas contained the following provision:

Article 18: The Contractor and all persons, who as employees or in any capacity may be engaged in the execution of the work under this contract either directly or indirectly, shall be considered as Mexicans in all matters, within the Republic of Mexico,

<sup>17</sup> Shea, above, n 1, at 20.

<sup>18</sup> *Ibid* at 21.

<sup>19</sup> *Ibid* at 21–32.

<sup>20</sup> *Constitution of 9 April 1933*, in *Constitutions of the Americas 670–1*, RH Fitzgibbon (ed), 1948, as cited in Shea, above, n 1, at 24.

<sup>21</sup> Shea, above, n 1, at 26 and n 56 (with sources for further examples of such constitutional provisions).

concerning the execution of such work and the fulfilment of this contract. *They shall not claim, nor shall they have, wither regard to the interests and the business connected with this contract, any other rights or means to enforce the same than those granted by the laws of the Republic of Mexicans, nor shall they enjoy any other rights than those established in favour of Mexicans. They are consequently deprived of any rights as aliens, and under no conditions shall the intervention of foreign diplomatic agents be permitted, in any matter related to this contract.*<sup>22</sup>

The Calvo Doctrine was also fully embodied in international treaties,<sup>23</sup> particularly in regional integration arrangements within Latin America. For example, Decision 24, the first foreign investment code of the Andean Pact countries, forbade Andean Community member countries from ‘granting to foreign investors any treatment more favorable than that granted to national investors’<sup>24</sup> and required that ‘in no instrument relating to investments or the transfer of technology shall there be clauses that remove possible conflicts or controversies from the national jurisdiction and competence of the recipient country or allow the subrogation by States to the rights and actions of their national investors’.<sup>25</sup>

The Calvo Doctrine was first embraced in Latin America, but its influence has gone well beyond that quarter of the world, particularly after World War II when a number of new states emerged in Asia and Africa as the result of the decolonisation process. These newly independent states, like Latin American states, were more than ready to embrace this state-centric or absolutist international law theory that they believed would help safeguard their state interest, particularly by taking back control over natural resources within their territories that were previously controlled by developed western powers. Meanwhile, communist governments that formed the Soviet block also found this theory appealing, as it would help them expel and exclude the presence and influence of Western capitalists. As a result, ‘Calvo Clauses’ have been embedded in the domestic laws of developing states beyond Latin America, especially in Asian and African states. For example, Chinese law dealing with foreign related contracts, since 1986 and as stands today, has a ‘Calvo Clause’, which provides that all Sino-foreign equity joint venture contracts, Sino-foreign cooperative joint venture contracts and Sino-foreign contracts for the joint exploration and development of natural resources, shall be governed by Chinese law and subject to the exclusive jurisdiction of Chinese courts.<sup>26</sup> Furthermore, a Calvo Clause was

<sup>22</sup> Shea, above, n 1, at 29 (emphasis added).

<sup>23</sup> For an extensive list of such treaties, see Shea, above, n 1, at 23 and n 44.

<sup>24</sup> Andean Commission: Decision 24, Common Regime of Treatment of Foreign Capital and of Trademarks, Patents, Licenses, and Royalties, Art 50, Nov 30, 1976, 16 ILM 138, at 153 (1977) [hereinafter ‘Decision 24’].

<sup>25</sup> *Ibid*, Art 51.

<sup>26</sup> See Art 126 of the Contract Law of the People’s Republic of China (stating that such contracts should be governed only by Chinese law) and Art 246 of the Civil Procedural Law of the People’s Republic of China (stating that any disputes arising out of such contracts should only be subject to the jurisdiction of Chinese courts).

also included in United Nations General Assembly (UNGA) resolutions when the New International Economic Order (NIEO) movement reached its summit, when the aforementioned two forces, namely the newly emerged states and the soviet block, formed a united front in the 1960s with a vast majority in the UN.<sup>27</sup> Article 2(2) of UNGA Resolution 3281 confirms, on the one hand, states' rights to regulate foreign investment in accordance with their respective laws and regulations and to reject the granting of preferential treatment to foreign investment. On the other hand, it stipulates that in case of expropriation, compensation should be paid by the state adopting such measures, 'taking into account its relevant laws'. Resolution 3281 might therefore be regarded as a global version of a 'Calvo Clause'.<sup>28</sup> The Calvo Doctrine thus reached its historical high in this Resolution.

However, the acceptance by an overwhelming majority of UN members in Resolution 3281 did seem to have secured a permanent international footing for this principle. Not long after the Resolution was adopted, the world was swept by the tides of economic liberalisation and globalisation. The Calvo Doctrine faced severe challenges ahead, which brought it to the brink of death.

## II. CALVO DOCTRINE IN THE 1990S: DEAD OR DEACTIVATED?

The 'death' of Calvo Doctrine is not at all a new topic. As a matter of fact, as early as 1955, Shea has pronounced its death because it 'has failed to receive recognition as a principle of international law', by which he meant recognition by western states.<sup>29</sup> Even by a not so Eurocentric standard, this doctrine had been again declared 'imminent death' a decade ago in mid 1990s.<sup>30</sup> But has it really been dead? This section will try to answer this question by first introducing the broader background of the attitude changes in Latin America towards foreign investment and arbitration since 1980s. It will then examine international treaty practices and domestic legislation respectively, with a view toward assessing whether and to what extent the Calvo Doctrine has been dead.

<sup>27</sup> Vandeveld, above, n 15, at 384.

<sup>28</sup> Lillich noted that Latin American efforts on the Charter were 'no more than a thinly-disguised attempt to endow the Calvo Doctrine'. R Lillich, 'The Diplomatic Protection of Nationals Abroad: An Elementary Principle of International Law Under Attack', (1975) 69 *Am J Int'l L* 359, 361. Schneiderman considers that the Calvo Doctrine was 'a central plank of the new International Economic Order (UNGA 3171 of the 1973) and the UN Charter of Economic Rights and Duties of States (1974)'; David Schneiderman, 'Investment Rules and The New Constitutionalism', (2000) 25 *Law & Soc Inquiry* 757, 766.

<sup>29</sup> Shea, above, n 1, at 20.

<sup>30</sup> Manning-Cabrol, above, n 2.

## 1. Investment Liberalisation and Latin American

Investment liberalization, as a manifestation of economic liberalization and globalization, started to sweep the developing world in the 1980s and reached its peak in 1990s. A number of factors contributed to this phenomenon, the most important among which were believed to be the debt crises of developing states since early 1980s (hence a further hunger for foreign direct investment, or 'FDI'), the collapse of the Soviet block in the 1990s (hence a further boost of market oriented economic reform in the former USSR and Eastern European countries), and the success stories of 'Asian Tigers' characterised by private investment and export trade.<sup>31</sup>

The essence of investment liberalization is the liberalization of regulatory regimes of foreign investment. According to the World Investment Report 2005, since 1991, an average of 64 states per year made changes to their FDI laws and regulations. Among the 2,156 changes during that period, 2,006 were changes for more liberal investment regimes, accounting for 93 per cent of the total changes.<sup>32</sup> (*Table 1*) In 2005, another 205 changes occurred, among which 164 were changes favourable to foreign investors.<sup>33</sup> Another element of investment liberalization has been the sharp rise of BITs. UNCTAD statistics show that by the end of 2004, the number of BITs worldwide had reached 2,392, of which 2,010 were concluded in 1990s, with 1996 being the peak year in terms of the number of new BITs.<sup>34</sup> (*Tables 2–3*) A further 70 BITs were signed in 2005, bringing the total number to 2495.<sup>35</sup> Meanwhile, states have been very active in entering into bilateral, regional and trans-regional preferential trade and investment agreements (PTIAs). By April 2005, 212 such agreements had also been concluded, of which about 87 per cent were signed in 1990s.<sup>36</sup> These PTIAs differ from BITs in their coverage, yet they resemble the latter in their content on investment protection and liberalization. They almost invariably guarantee national and most favored nation (MFN) treatment, free transfer of funds and profits, compensation for expropriation, and resort to international arbitration tribunals in case of disputes between a foreign investor and the host state. In other words, these bilateral, regional and multilateral treaties aim to set standards at the international level and to guarantee access to international dispute settlement platforms, both of which run in the opposite direction of the Calvo Doctrine.

<sup>31</sup> Vandeveldel, above, n 15, at 386–91.

<sup>32</sup> *Ibid*

<sup>33</sup> UNCTAD, *World Investment Report 2006*, UNCTAD/WIR/2006, at 24.

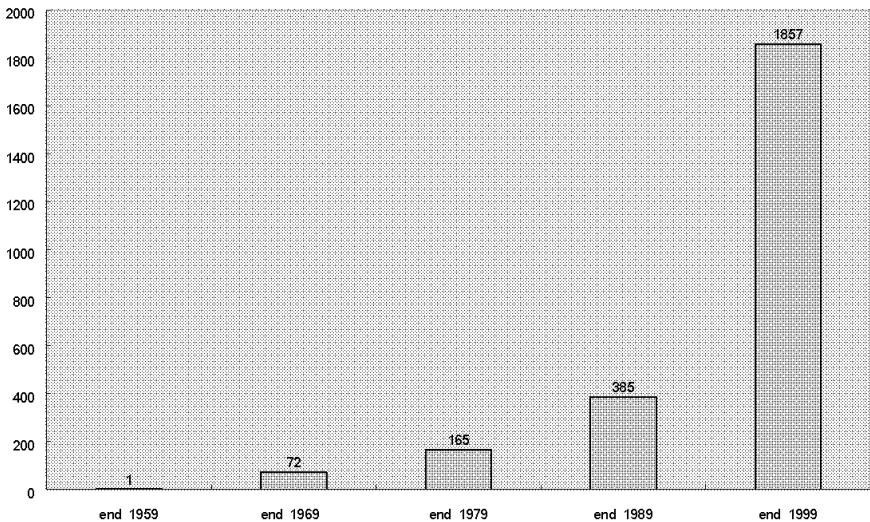
<sup>34</sup> UNCTAD, *World Investment Report 2005*, UNCTAD/WIR/2005, at 28.

<sup>35</sup> UNCTAD, *World Investment Report 2006*, UNCTAD/WIR/2006, at 26.

<sup>36</sup> *Ibid*

Table 1: Changes in Domestic Legislation (1991–2005)<sup>37</sup>

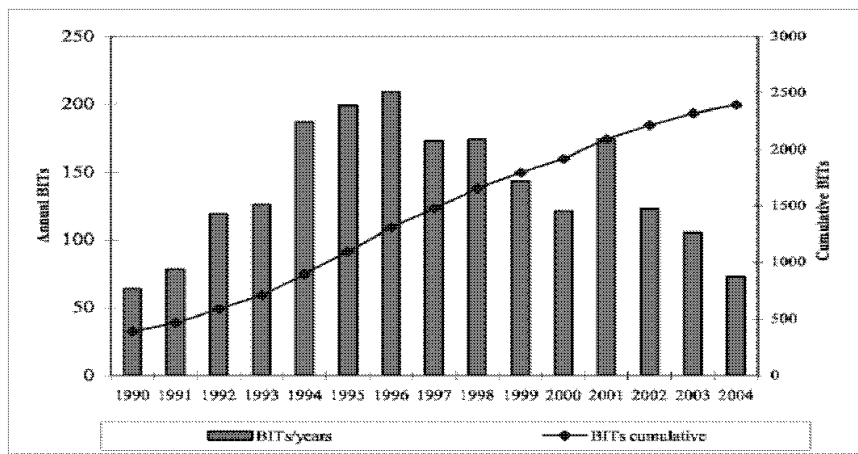
Year	Number of countries changed FDI laws	Number of changes made to FDI laws	Changes in favour of foreign investors	Changes detrimental to foreign investors
1991	35	82	80	2
1992	43	79	79	0
1993	57	102	101	1
1994	49	110	108	2
1995	64	112	106	6
1996	65	114	98	16
1997	76	151	135	16
1998	60	145	136	9
1999	63	140	131	9
2000	69	150	147	3
2001	71	208	194	14
2002	70	248	236	12
2003	82	244	220	24
2004	102	271	235	36
2005	93	205	164	41

Table 2: Increase in BITs by End 1990s (1959–1999)<sup>38</sup>

<sup>37</sup> UNCTAD, *World Investment Report 2005*, p 26; *World Investment Report 2006*, at 24.

<sup>38</sup> UNCTAD: *Bilateral Investment Treaties (1959–1999)*, UNCTAD/ITE/IIA/2 (2000), at 1.

Table 3: BITs (1990–2004)<sup>39</sup>



It is not a surprise that Latin American states had initially resisted investment liberalization and such treaties, given its Calvo tradition. However, economic events in the 1980s, principally the Latin American debt crisis, forced many Latin American countries to shift their attention from commercial loans back to FDI. The debt crisis caused ‘drastic reductions in net voluntary commercial bank lending to LDCs’,<sup>40, 41</sup> These reductions forced the LDCs to correct their external balances and seek alternative forms of external financing, most notably FDI.<sup>42</sup> Meanwhile, the worldwide trend of investment liberalization rendered the Latin American state no choice but to open up their markets and adopt higher standards of treatment for foreign investors to attract foreign investment.<sup>43</sup> Consequently, many Latin American countries began to conclude international investment treaties in the late 1980s, while modifying their domestic legislation to accommodate international arbitration and international standards of treatment for foreign investment. A close look follows in the next two Parts, examining these international treaties and domestic laws respectively.

<sup>39</sup> UNCTAD: *World Investment Report 2005*, at 27.

<sup>40</sup> LDC here stands for ‘Less Developed Countries’.

<sup>41</sup> See Stijn Claessens, ‘Alternative Forms of External Finance’, (1991) *World Bank Working Paper* No 812.

<sup>42</sup> The term ‘alternative finance’ refers to ‘all forms of external financing outside the public sector . . . [Alternative finance] thus includes FDI, project lending, portfolio investment, closed-end equity funds, private non-guaranteed debt, licensing, joint ventures, quasi-equity contracts, and other forms of private-to-private lending’. *Ibid*

<sup>43</sup> Some economists considered that such a change marked a rejection of the import substitution model of the 1950s, 1960s, and 1970s, and the emergence of a development model. See generally ‘The Macroeconomics Of Populism In Latin America’ in Rudiger Dornbusch & Sebastian Edwards (eds), 1991), and Victor Bulmer-Thomas, *The Economic History Of Latin America Since Independence* (1994).



## 2. International Treaties

The international treaty practice by Latin American States on the protection and promotion of foreign investment can be seen from three deferent levels: bilateral, regional and global. The following explores the three levels of practice in turn.

### a) BITs

UNCTAD Statistics show that Latin American states did not engage in BITs until late 1980s.<sup>44</sup> By the end of 1990s, Latin American states have entered into a total number of 300 BITs, among which 93 per cent were signed in the 1990s.<sup>45</sup> Most Latin American States have ratified some BITs. For instance, Argentina led the table with 43 ratified BITs, followed by Peru with 24 BITs, Chile 22, Cuba 19, Ecuador 18, Venezuela 17, Bolivia 15, Paraguay 15, Uruguay 13, El Salvador 10.<sup>46</sup> Other states have also ratified certain BITs, including Panama (9), Mexico (3), Honduras (3), Nicaragua (3), Belize (2), Costa Rica (3), Guiana (2) and Dominica Republic (1).<sup>47</sup> Like all other BITs, BITs by Latin American States contain two categories of provision: Substantively, they accept general standards of treatment such a fair and equitable treatment, national treatment and MFN treatment, free transfer of funds and guarantee of compensation in case of expropriation; procedurally, they accept jurisdiction of international arbitration tribunals.<sup>48</sup>

It is observed that earlier BITs by Latin American States still had certain elements influenced by Calvo, requiring certain conditions to be fulfilled before

<sup>44</sup> UNCTAD, *Bilateral Investment Treaties 1959–1999*, NCTAD/ITE/IIA/2 (2000), at 15. According to UNCTAD, however, the total number of BITs concluded by Latin American and Caribbean States have reached 451 by the end of 2004. See UNCTAD: *Recent Developments in International Investment Agreements*, IIA MONITOR No 2 (30 Aug 2005) UNCTAD/WEB/ITE/IIT/2005/1, at 2.

<sup>45</sup> *Ibid.*

<sup>46</sup> UNCTAD, *Bilateral Investment Treaties 1959–1999*, UNCTAD/ITE/IIA/2 (2000), at 7–14?

<sup>47</sup> Some countries, however, have signed some BITs without ratifying them. For example, Brazil has signed 14 BITs, but has ratified any of them. Colombia signed 6 bits but only ratified one (with Peru). UNCTAD, *Country-specific Lists of BITs*, available at: <<http://www.unctad.org/Templates/Page.asp?intItemID=2344&lang=1>> (visited on 6 Jun 2007). For analysis on the legal effects of such un-ratified BITs, see UNCTAD: *Recent Developments in International Investment Agreements*, IIA MONITOR No 2 (30 Aug 2005) UNCTAD/WEB/ITE/IIT/2005/1, at 8.

For more elaborate discussion on its implication on the consent to international arbitration, see *Ceskoslovenska Obchodni Banka, AS v The Slovak Republic* (ICSID Case No ARB/97/4), *Decision on the Further and Partial Objection to Jurisdiction* (Dec 1, 2000), paras 33–59. The text of the Decision on Objections to Jurisdiction of May 24, 1999 is published on-line as it appears as in (1999) 14 *ICSID Review—Foreign Investment Law Journal* (No 1). In this case, the relevant BIT was signed but not ratified, and the Arbitration tribunal held that state consent to submission to ICSID arbitration could not be established on the basis of the BIT. The Tribunal nevertheless found such consent was given by Czech Government by way of the Consolidation Agreement entered into between the parties expressing that the Agreement should be governed by domestic laws and the BIT.

<sup>48</sup> JW Salacuse, 'BIT by BIT: The Growth of Bilateral Investment Treaties and Their Impact on Foreign Investment in Developing Countries', (1990) 24 *International Lawyers* 655, 664–73.

recourse to international arbitration.<sup>49</sup> For example, earlier Argentine BITs required that submission to international arbitration might not be initiated until the following conditions: either the issue had been decided by a local court; or the issue had been submitted to a local court but did not receive a verdict after the lapse of certain period of time. In other words, resorting to local remedies was the prerequisite for the launch of an international arbitration.<sup>50</sup> Such local remedies requirements, however, were abandoned in later BIT practice. The Argentina–US BIT of 1991, for example, does not require exhaustion of local remedies as a prerequisite.<sup>51</sup> One commentator concluded, therefore, that this BIT signalled ‘the abandonment, by Argentina, of the Calvo Doctrine which has governed for more than a century investments from abroad’.<sup>52</sup>

In the other 11 BITs entered into between US and the Latin American States, including Bolivia, Ecuador, El Salvador, Grenada, Haiti, Honduras, Jamaica, Nicaragua, Panama, Trinidad and Tobago and Uruguay (See *Table 4*), submission to international arbitration is not conditioned on recourse to local remedies.<sup>53</sup> With regard to applicable law, although most of these BITs do not refer to specific applicable laws, they generally require the BITs not prejudicing legal effects of domestic laws of the host state, any investment agreement of investment licences, as well as any ‘international legal obligations’.<sup>54</sup> The Uruguay–USA BIT signed in 2004 (the first US BIT since its latest model was released) went further to stipulate that the current BIT and applicable rules of international law should be the applicable law in case of alleged violation of substantive obligations out of this BIT (Article 3 to Article 10); if the claim involves violation of an investment agreement or investment authorisation, then the ‘rules of law’ specified in the pertinent investment agreement or investment authorization, or as the disputing parties may otherwise agree apply; if such rules of law have not been specified or otherwise agreed, then the applicable law will be ‘(i) the law of the respondent, including its rules on the conflict of laws; and (ii) such rules of international law as may be applicable’.<sup>55</sup> In other words, applicable international law is one of the default rules of law to be applied, unless the dispute involves an investment agreement or investment authorisation in which the rules of law are otherwise specified or agreed.

<sup>49</sup> In a recent article, Scheurer called this as one of ‘Calvo’s grandchildren’. Christoph Scheurer, ‘Calvo’s Grandchildren: The Return of Local Remedies in Investment Arbitration?’, *The Law and Practice of International Courts and Tribunals* 4: 1–17, 2005, at 3–5.

<sup>50</sup> BM Cremades, ‘Disputes Arising out of Foreign Direct Investment in Latin America: A New Look at the Calvo Doctrine and Other Jurisdictional Issue’, (May–Jul, 2004) 59 *Dispute Resolution Journal* 80.

<sup>51</sup> Art 7, Argentina–US BIT.

<sup>52</sup> H Golsong, ‘Introduction’ (to Treaty Concerning the Reciprocal Encouragement and Protection of Investment between Argentina and the USA), Nov 14, 1991, 31 *ILM* 124, 124.

<sup>53</sup> See Art 9, Bolivia–US BIT; Art 6, Ecuador–US BIT; Art 9, El Salvador–US BIT; Art 6, Grenada–US BIT; Art 7, Haiti–US BIT; Art 9, Honduras–US BIT; Art 6, Jamaica–US BIT; Art 7, Nicaragua–US BIT; Art 1, 2000 Amending Protocol to Paraguay–US BIT; Art 9, Trinidad and Tobago–US BIT; and Art 24, Uruguay–US BIT.

<sup>54</sup> See, eg, Art 10, Argentina–US BIT.

<sup>55</sup> Art 30, Uruguay–US BIT.

Table 4: US Bits With Latin American States<sup>56</sup>

Partner	Date of Signature	Date of entry in to force
Argentina	14 Nov 91	28 Oct 94
Bolivia	17 Apr 98	6 Jun 01
Ecuador	27 Aug 93	11 May 97
El Salvador	10 Mar 99	
Grenada	2 May 86	3 Mar 89
Haiti	13 Dec 83	
Honduras	1 Jul 95	11 Jul 01
Jamaica	4 Feb 94	7 Mar 97
Nicaragua	1 Jul 95	
Panama	27 Oct 82	30 May 91
Trinidad and Tobago	26 Sep 94	26 Dec 96
Uruguay	4 Nov 05	

The previous survey of BITs concluded by Latin American States show that, whilst earlier BITs were somehow influenced by Calvo principle requiring resorting to local remedies as prerequisite, recent BITs have generally accepted non-local remedies and general international law as the governing norms, which departs significantly from the Calvo principle. Indeed, a 'silent revolution' has taken place, particularly in the sense of accepting international arbitration for state-investor disputes.<sup>57</sup>

#### *b) Regional Arrangements*

Regional integration in Latin America dates back to 1960s when some Latin American States entered into the Andean Pact.<sup>58</sup> However, the liberalisation movement in Latin American States has resulted in some changes to the Andean Pact since late 1980s. Decision 24, the original FDI code of the Andean Pact, as mentioned above, had two distinctive 'Calvo Clause' (Articles 50 and 51) prohibiting the provision of 'super-national treatment' to foreign investors and recourse to remedies non-national jurisdiction. However, these two clauses were gradually changed in late 1980s and early 1990s. In 1987, Andean Group modified its FDI code and replaced it with Decision 220, which maintained the 'anti-super-

<sup>56</sup> UNCTAD: 'Total number of Bilateral Investment Agreements concluded by United State, as of 1 Jun 2006', posted at: <<http://www.unctad.org/Templates/Page.asp?intItemID=2344&lang=1>> (last visited on 6 Jun 2007)

<sup>57</sup> N Blackaby, DM Lindsey and A Spinillo, 'Overview of Regional Developments', in *International arbitration in Latin America*, above n 4, at 10.

<sup>58</sup> The recent wave of regional integration within that region, however, demonstrated a marked difference from the original Andean Pact movement, in that it no longer sticks to the nationalistic approach and import substitution policies but place the emphases on market forces. Sebastian Edwards, 'Latin American Economic Integration: A New Perspective on an Old Dream', (1993) 16 *World Economy* 317.

national-treatment' provision<sup>59</sup> but loosed the strict national jurisdiction requirement. Article 34 of Decision 220 provided that, '[f]or the settlement of disputes or conflicts deriving from direct foreign investments or from the transfer of foreign technology, Member Countries shall apply the provisions established in their local legislation'.<sup>60</sup> It thus left member states the discretion to stick to or derogate from the Calvo Doctrine. This, nevertheless, leaves doubt as to whether investors in the Andean Pact countries are still limited to recourse provided by national law and tribunals, given that 'anti-super-national-treatment' provision survived.<sup>61</sup>

Andean Group's alleged shift of attitude toward foreign investment occurred in 1991 when Decision 291,<sup>62</sup> the latest and most liberal FDI code was adopted. In an attempt to stimulate foreign capital and technology flows into ANCOM's subregions, ANCOM relaxed the 'anti-super-national-treatment' provision in the previous FDI codes.<sup>63</sup> Article 2 of Decision 291 provides that 'foreign investors shall have the same rights and obligations as pertain to national investors, except as otherwise provided in the legislation of each Member Country'.<sup>64</sup> Apart from allowing member countries discretion in deciding the treatment of foreign investors, this provision also marked a subtle change of emphasis from 'anti-super-national-treatment' towards 'equal treatment' or 'national treatment', which is closer to what national treatment standard embedded in most BITs. Hence it might be an example of the said 'convergence' of the two original distinct standards.

Decision 220 and Decision 291 thus opened the possibility for ANCOM member countries to accept international standard of treatment and jurisdiction of international arbitration tribunals. It is therefore essential to look into the domestic legislation of member states to ascertain the extent of such change of attitude.

Another example of regional integration is Mercosur, the Common Market of the South created in 1991 by four countries in Latin America, namely

<sup>59</sup> Art 33 of Decision 220 provided that 'member countries could not grant foreign investors a more favorable treatment than that granted to national investors'. It is noted that although Art 33's text differed slightly from that of Art 50, the effects were identical: foreign investors were not to be granted rights greater than those granted to nationals. See EA Wiesner, 'ANCOM: A New Attitude Toward Foreign Investment?' (Spring-Summer, 1993) *University of Miami Inter-American Law Review* 435, at 447.

<sup>60</sup> Art 34, the Common Foreign Investment and Technology Licensing Code, Decision 220 of May 11, 1987, Commission of the Cartagena Agreement, reprinted in 27 *ILM* 974 (1988) [hereinafter 'Decision 220'].

<sup>61</sup> One commentator argued that, while Decision 220 did not completely rid Calvo principle, it nevertheless denied 'an ANCOM passport to roam the Andes at will'. However, another commentator argued that, '[I]f, as this Art argues, national laws only permit the settlement of disputes before local courts and under local laws, then Calvo's other principle that there is no right to diplomatic protection must also survives'. See EE Murphy, Jr, 'The Andean Decisions on Foreign Investment: An International Matrix of National Law', 24 *International Lawyer* 643 (1990), at 653; and Wiesner, above, n 59, at 448-9.

<sup>62</sup> Common Code for the Treatment of Foreign Capital and on Trademarks, Patents, Licenses, and Royalties, Decision 291 of Mar 21, 1991, Commission of the Cartagena Agreement, reprinted in 30 *ILM* 1283 (1991) [hereinafter Decision 291].

<sup>63</sup> Art 2, Decision 291.

<sup>64</sup> *Ibid.*

Argentina, Brazil, Paraguay and Uruguay.<sup>65</sup> Mercosur adopted a Protocol to regulate investments from non-member states (the Buenos Aires Protocol).<sup>66</sup> Article 2 (c) of the Protocol provides national treatment, MFN treatment and 'just and equitable treatment' for foreign investment. The wording for 'national treatment' and MFN treatment is typical BIT language, which means treatment 'no less favourable' than that granted to national investors or investors from other non-member states.<sup>67</sup> With regard to state-investor dispute resolution, Article 2 (h) of the Protocol provides a 'fork in the road' clause, which avails investors to choose between two options: either competent courts of the host state, or an international arbitration tribunal, which could be either an ad hoc or an institutional tribunal.<sup>68</sup> Since it uses local remedies only as a conclusive alternative to international arbitration, it differs significantly from Calvo principle of 'exclusive local remedies'. The Protocol goes on to stipulate that the governing law of such disputes include the terms of the present Protocol, the laws of the host state including its rules of conflicts, the terms of any agreements between the investor and the host state, and 'principles of international law'.<sup>69</sup> Clearly, this Protocol generally follows a liberal BIT approach rather than a Calvo approach.

Finally, although the negotiation of the Free Trade Agreement of the Americas (FTAA) has been suspended, the latest negotiation draft suggests acceptance of international standards of treatment and jurisdiction of international arbitration tribunals.<sup>70</sup> It therefore might be regarded as another attempted departure from the Calvo Doctrine embedded in regional integration instruments.

### *c) Global Conventions*

Although so far there is no comprehensive global agreement on investment protection, there are a few global conventions that bear significant implications to international investment. Two World Bank initiatives, the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID Convention)<sup>71</sup> and the Convention Establishing the Multilateral Investment Guarantee Agency (MIGA Convention)<sup>72</sup> are the most important among them. The New York Convention on the Recognition and Enforcement

<sup>65</sup> For the basic treaty of Mercosur, see Treaty Establishing a Common Market between the Argentine Republic, the Federal Republic of Brazil, the Republic of Paraguay and the Eastern Republic of Uruguay, posted at: <<http://64.233.183.104/search?q=cache:lrC6UFek7KAJ:www.sice.oas.org/trade/mrcsr/mrcsrtoe.asp+mercosur&hl=zh-CN&ct=clnk&cd=7>> (visited on 16 Jun 2006).

<sup>66</sup> Protocol on Promotion and Protection of Investment Proceeding from Non-Member Countries of the MERCOSUL, available at: <<http://www.cvm.gov.br/ingl/inter/mercosul/buenos-aires.asp>> (visited on 15 Jun 2006).

<sup>67</sup> *Ibid*, Art 2 (c).

<sup>68</sup> *Ibid*, Art 2 (h)

<sup>69</sup> *Ibid*, Art 2 (h)(4).

<sup>70</sup> Ss C. 2. b, Chapter XVII Investment, of the Free Trade Area of the Americas (Draft Agreement) (Derestricted, FTAA.TNC/w/133/Rev.3, Nov 21, 2003), particularly Arts 29 and 41.

<sup>71</sup> The Convention is available at: <<http://www.worldbank.org/icsid/basicdoc/basicdoc.htm>> (last visited on 15 Jun 2006).

of Foreign Awards<sup>73</sup> is also important in the context of investment dispute settlement.

As an important companion to BITs, the ICSID Convention aims at providing an international mechanism for the settlement of state-investor disputes, in particular, by facilitating international arbitration and conciliation. This mechanism goes apparently against the Calvo Doctrine, which advocate exclusive national jurisdiction and local remedies. It is therefore unsurprising that Latin American States boycotted this convention in 1964 even after the drafters made effort to revise some of the provisions to address Latin American States' concerns.<sup>74</sup> Before 1980, only few small Latin American States (Jamaica and Trinidad and Tobago) joined in the convention. But now most Latin American States have become members of the Convention (except notably Brazil and Mexico), among which most realised their membership in 1990s. (Table 5) This again affirms that the investment liberalisation did take place most dramatically in 1990s.

Table 5: Latin American Members of the ICSID Convention<sup>75</sup>

Contracting State	Date of Signature	Date of Ratification	Date of Entry into Force
Argentina	21/05/1991	19/10/1994	18/11/1994
Bahamas	19/10/1995	19/10/1995	18/11/1995
Bolivia	03/05/1991	23/06/1995	23/07/1995
Colombia	18/05/1993	15/07/1997	14/08/1997
Costa Rica	29/09/1981	27/04/1993	27/05/1993
Dominican Republic	20/05/2000		
Ecuador	15/01/1986	15/01/1986	14/02/1986
El Salvador	09/06/1982	06/03/1984	05/04/1984
Grenada	24/05/1991	24/05/1991	23/06/1991
Guatemala	09/11/1995	21/01/2003	20/02/2003
Haiti	30/01/1985		
Honduras	28/05/1986	14/02/1989	16/03/1989
Jamaica	23/06/1965	09/09/1966	14/10/1966
Nicaragua	04/02/1994	20/03/1995	19/04/1995
Panama	22/11/1995	08/04/1996	08/05/1996
Paraguay	27/07/1981	07/01/1983	06/02/1983
Peru	04/09/1991	09/08/1993	08/09/1993
Trinidad and Tobago	05/10/1966	03/01/1967	02/02/1967
Uruguay	28/05/1992	09/08/2000	08/09/2000
Venezuela	18/08/1993	02/05/1995	01/06/1995

<sup>72</sup> The Convention is available at: <<http://www.miga.org/sitelevel2/level2.cfm?id=1107>> (last visited on 15 Jun 2006).

<sup>73</sup> The full text of the Convention is available at: <<http://www.jus.uio.no/lm/un.arbitration.recognition.and.enforcement.convention.new.york.1958/doc>> (last visited on 16 Jun 2006).

<sup>74</sup> Gonzalo Biggs, 'The Latin American Treatment of International Arbitration and Foreign Investments and the Chile-US Free Trade Agreement', (2004) 19 *ICSID Review-Foreign Investment Law Journal* 68.

<sup>75</sup> ICSID: 'List of Contracting States and other Signatories of the Convention' (as of 9 May 2007), available at <<http://www.worldbank.org/icsid/constate/c-states-en.htm>> (last visited on 6 Jun 2007).

Meanwhile, Latin American States also dropped their rejection to the New York Convention facilitating the enforcement of arbitration awards made in other states.<sup>76</sup> Now almost all Latin American States, even including Brazil and Mexico, have become members of the Convention. This demonstrates that the general attitude towards international arbitration in Latin American States have had a U turn: from utter rejection towards general acceptance and recognition. Latin American states have, finally, also accepted the MIGA Convention aiming at providing guarantees for international investment.<sup>77</sup> Since the MIGA mechanism is based on host states' recognition of the subrogation of rights of investors by the MIGA, this acceptance again evidenced derogation from Calvo Doctrine by Latin American States.

#### *d) Observations*

The preceding survey suggest that since 1980s Latin American States have not, in general, adhered to Calvo Doctrine in their international investment treaty practice: Most of them have entered into BITs that guarantee certain international law standards and access to international arbitration. At regional level, Mercosur followed the BIT approach and the Andean Pack has been revised to accommodate member states' need of flexibility in deviation from Calvo clause. Most of them also accepted the ICSID Convention providing an international platform for arbitration of state-investor disputes, the MIGA convention recognition rights of subrogation and the New York Convention facilitating world wide enforcement of arbitration awards.

It would still, however, be a step too far to conclude that all Latin American states they have completely abandoned Calvo by their treaty practice. There are three main reasons. First of all, there are significant exceptions to such general treaty practice. Brazil, the largest state and FDI recipient<sup>78</sup> in the region, for instance, has not yet ratified any BITs (although has concluded a few of them) or the Mercosur Protocols,<sup>79</sup> nor has it accepted the ICSID regime. And it seems unlikely that Brazil will change it approach in near future as it is doing enormously well as a magnet for foreign investment.<sup>80</sup> Colombia has only ratified

<sup>76</sup> Latin American States had long been hostile to the New York Convention, and were, in general, among the last countries to accept it. For example, Brazil did not accept it until 2002. See Gonzalo Biggs, *ibid*, p 63.

<sup>77</sup> According to MIGA Website, MIGA members from Latin America and the Caribbean include: Antigua and Barbuda, Argentina, Bahamas, Barbados, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominica, Dominican Republic, Ecuador, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Nicaragua, Paraguay, Panama, Peru, St Kitts & Nevis, St Lucia, St Vincent, Suriname, Trinidad & Tobago, Uruguay, Venezuela. See MIGA: *MIGA Member Countries* (Last updated on 19 Jan 2007), posted at: <<http://www.miga.org/sitelevel2/level2.cfm?id=1152>> (last visited on 6 Jun 2007).

<sup>78</sup> UNCTAD Press release, UNCTAD Doc. UNCTAD/PRESS/EB/2004/007 (Mar 5, 2004).

<sup>79</sup> Inter-American Development Bank (IADB, 2006), *Legislation for Foreign Investment Statutes in Countries in the Americas, Comparative Study- Brazil*, available at: <<http://alca-ftaa.iadb.org/eng/invest/BRA~1.HTM>> (last visited 16 May 2006).

<sup>80</sup> Cremades, above, n 50, at 81.

one BITs (with Peru) despite that it has signed 6 of them.<sup>81</sup> Moreover, Mexico, another important state in the region also has not signed up to the ICSID Convention, although it joined the North America Free Trade Agreement (NAFTA) and concluded a number of BITs. Secondly, some investment treaties contain significant reservations to the acceptance of international standards and the international arbitration. Using Schreuer's language, some of the treaty provisions are actually 'Calvo's Grandchildren'.<sup>82</sup> Early Latin American BITs, for example often place local remedies as a prerequisite for international arbitration. Given the uncertainty in terms of the applicability of MFN in procedural aspects following recent arbitration cases such as *Salini v Jordan*<sup>83</sup> and *Plama v Bulgaria*<sup>84</sup> cases, such reservations should not be ignored. Also, the Andean FDI code still, as a general principle, requires 'equal treatment' between domestic and foreign investors and only leaves its member states the discretion to adopt higher standards of treatment or access to international arbitration. It is therefore essential to look into the domestic legislations in the region to establish whether Calvo Doctrine has actually been abandoned in the Andean Community. Thirdly, it has been argued and has increasingly been recognised that developing countries including Latin American countries enter into BITs and other investment treaties mainly for economic considerations,<sup>85</sup> rather than because of a true believe in the norms embedded therein. In other words, the departure from or even rejection to the Calvo Doctrine represents only a change in technique, not a change in principle. This seems to be supported by the following examination of the domestic constitutions and laws.

### 3. Domestic Legislations

Compared with international treaties, domestic legislation better reveals the real attitude of Latin American states towards the Calvo Doctrine, as domestic

<sup>81</sup> Among the six BITs, three are with Latin American States and three with developed states including UK, Spain and Italy, but none of the BITs with developed states have bettered into force. UNCTAD, *Country-specific Lists of BITs*, above, n 47.

<sup>82</sup> Christoph Schreuer, 'Calvo's Grandchildren: The Return of Local Remedies in Investment Arbitration', (2005) 4 *The Law and Practice of International Courts and Tribunals* 1.

<sup>83</sup> *Salini Costruttori SpA and Italstrade SpA v Hashemite Kingdom of Jordan* (Case No ARB/02/13), Decision of the Tribunal on Jurisdiction of Nov 29, 2004, 20 *ICSID Rev—FILJ* 148 (2005); 44 *ILM* 569 (2005). In both this and the *Plama v Bulgaria* cases, the tribunals rejected the idea that MFN clause in BIT has the general effect of multiplying jurisdictional or procedural benefits, a jurisprudence first developed in *Maffezini v Spain* and was followed in some later cases. See *Emilio Agustín Maffezini v Kingdom of Spain* (Case No ARB/97/7), Decision on Objections to Jurisdiction of Jan 25, 2000, 16 *ICSID Rev—FILJ* 212 (2001); 5 *ICSID Rep* 396 (2002); 124 *ILR* 9 (2003).

<sup>84</sup> *Plama Consortium Limited v Bulgaria*, ICSID Case No ARB/03/24, Decision on Jurisdiction, 8 Feb 2005, 20 *ICSID Rev—FILJ* 262 (2005); 44 *ILM* 721 (2005).

<sup>85</sup> See eg, Rudolf Dolzer, 'New Foundations of the Law of Expropriation of Alien Property', (1981) 75 *Am J Int'l L* 553, at 583–9; Oscar Schachter, 'Compensation for Expropriation, Editorial Comment', (1984) 78 *Am J Int'l L*, 121, at 127; AT Guzmán, *Explaining the Popularity of Bilateral Investment Treaties: Why LDCs Sign Treaties that Hurt Them?*, 1997, *Harvard Jean Monnet Working Paper* 12/97, at 72.



legislation more accurately reflects the unilateral wills of the host states, unlike international treaties, in which the host state must compromise with other states. Also, the Andean FDI code refers to domestic laws to determine the treatment and methods of dispute settlement for foreign investment. It is therefore crucial to look into domestic laws and regulations to ascertain whether Latin American states have shifted their attitudes towards foreign investment. This section intends to do so by exploring and comparing domestic legislation, particularly the rules on standards of treatment and the investment dispute settlement, in nine major Latin American states, namely Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Peru and Venezuela.

### *a) Argentina*

Argentina has been lauded as having ‘probably the most pro-business’ FDI legislation in the world.<sup>86</sup> The general standard of treatment of foreigners and foreign investors is laid down in the national constitution and laws.<sup>87</sup> Section 20 of the Argentine Constitution establishes the principle of ‘equal treatment’ of foreigners and nationals, stating that

[f]oreigners enjoy in the territory of the Nation all the civil rights of a citizen; they may engage in their industry, commerce or profession; own real property, purchase it and alienate it. . . .<sup>88</sup>

Accordingly, the Foreign Investment Law of 1993 (No 21,382) grants foreign investors rights equal to those of local investors in all fields, while liberalizing the entry and outflow of capital.<sup>89</sup> The legal and tax treatment is virtually the same for Argentine citizens and foreigners.<sup>90</sup> Decree 1853/93 of September 1993, which combines in one piece of legislation the liberalization measures contained

<sup>86</sup> One Argentine website highlights the main aspects of investment liberalization as follows: (1) Foreign investments are warmly welcomed and virtually unrestricted, with no sector restrictions—investments are allowed even in sensitive areas such as oil, mass media (broadcasting, cable, newspapers and magazines), nuclear power generation and nuclear mineral mining; (2) No approvals or paperwork of any kind are required to materialize foreign investments—there is absolutely no red tape; (3) No registration of investments is ever required: complete confidentiality assured; (4) Foreign investors are entitled, without approvals or formalities, to repatriate capital and remit profits abroad at any time—no waiting periods whatsoever; (5) Unrestricted access to foreign exchange markets—absolutely no approvals or formalities for making transfers abroad; (6) No discrimination against foreign investors: foreign and domestic companies are treated equally under the law, including access to domestic or foreign currency financing in the local market and full eligibility for economic development incentive programs; (7) No performance requirements to be met by foreign investors; (8) International law protection: most capital-exporting countries covered by a valid bilateral investment treaty. See Hacienda Virtual Realty Argentina—HVRA, Legal Reforms and the Foreign Investor, available at: <<http://www.hvra.com.ar/enforinv.htm>> (05/20/2006).

<sup>87</sup> IADB: *Legislation for Foreign Investment Statutes in Countries in the Americas, Comparative Study-Argentina* (2006) available at: <<http://alca-ftaa.iadb.org/eng/invest/ARG~1.HTM>> (105/16/06) [hereinafter IADB: *Argentina*], s 1.

<sup>88</sup> s 20, Constitution of the Argentine Nation (1994).

<sup>89</sup> IADB: *Argentina*, above, n 87, at s 1.2.

<sup>90</sup> *Ibid*

in the Economic Emergency and State Reform Acts of 1989 and the above mentioned Foreign Investment Law,<sup>91</sup> confirms in Article 2 that ‘foreign investors may invest in the country without any prior approval, on the same terms as investors domiciled in the country’. Thus it is clear that Argentina enshrines national treatment as the cardinal principle of treatment for foreign investors.

On the settlement of state-investor disputes, Argentina also insists on the equal treatment principle. Foreign investors are therefore entitled to ‘exactly the same recourse’ available to local investors.<sup>92</sup>

It can thus be concluded that, within its domestic legislation, Argentina loyally adheres to the cardinal Calvo principle of equal/national treatment for foreign investors. Such national treatment, however, seems to subtly differ from Calvo, as it emphasises absolute equality between foreigners and nationals, and does not have the classical ‘Calvo stress’ emphasizing the non-discrimination against nationals, ie, the prohibition of special favour to foreigners.

On the other hand, it must be noted that Argentina has been very active in entering into investment promotion and protection treaties. So far it has signed the ICSID Convention, the MIGA Convention,<sup>93</sup> the New York Convention, the Inter-American Convention on International Commercial Arbitration (the Panama Convention),<sup>94</sup> and at least 58 BITs, of which 53 have entered into force.<sup>95</sup> It has also signed on to some regional treaties, including the two MERCOSUR Protocols on investment protection (namely the Colonia Protocol<sup>96</sup> and the Buenos Aires Protocol) and a few arbitration conventions.<sup>97</sup>

Such treaties have effectively raised the standards of treatment for foreign investors well beyond the standards of treatment for national investors, most notably by allowing foreign investors to resort to international arbitration mechanisms such as the ICSID, and by accepting the applicability of general principles of international law. These treaties thus raise a question of constitutionality: Since international treaties are subordinate to the Constitution in Argentina,<sup>98</sup> does it constitute a breach of the constitutional requirement of absolute equality of treatment between national and foreign investors to grant foreign investors higher treatment than that given to domestic investors? Such an unconstitutionality challenge has already been raised by the Argentine

<sup>91</sup> HVRA, *Legal Reforms and the Foreign Investor*, above, n 86.

<sup>92</sup> IADB: *Argentina*, above, n 87, at s 5.1.

<sup>93</sup> A Spinillo and E Vogelius, *Argentina*, in *International arbitration in Latin America*, above, n 4, at 19.

<sup>94</sup> *Ibid* at 439.

<sup>95</sup> UNCTAD, *Country-specific Lists of BITs*, above, n 47.

<sup>96</sup> Protocol of Colonia for the Promotion and Reciprocal Protection of Investments in Mercosur (investment within member countries), unofficial English translation available at <<http://www.cvm.gov.br/ingl/inter/mercusul/coloni-e.asp>> (visited on 8 Jun 2007)

<sup>97</sup> For details of such regional arbitration conventions, see Spinillo and Vogelius, above, n 93, at 20, 25–6.

<sup>98</sup> IADB: *Argentina*, above, n 87, at s 5.4.

government in the proceedings of some of the investment arbitration cases against the country.<sup>99</sup>

The constitutionality of BITs and treaty-based investment arbitration, as we will see below, is an issue existing in many Latin American countries that has already been tested before local courts in these countries, notably in Colombia. Indeed, such anti-BIT and investment arbitration moves in Argentina, together with similar moves in other Latin American states in recent years, have been regarded as signals of the ‘resurgence of the Calvo Doctrine’.<sup>100</sup>

### *b) Bolivia*

The standard of treatment for foreign investors in Bolivia is governed by Bolivian Foreign Investment Law (Law No 1182).<sup>101</sup> Article 2 of the law expressly adopts the national treatment standard by providing that

[e]xcept where otherwise established by law, foreign investors and the entities or companies in which they take part, have the same rights, duties and guarantees that the laws and regulations give to national investors.<sup>102</sup>

With regard to investment dispute settlement, Article 24 of the Constitution of Bolivia expressly denies foreigners the right to diplomatic protection by stating:

[f]oreign subjects and enterprises are subject to Bolivian laws, and in no case may they invoke exceptional positions or have recourse to diplomatic claims.<sup>103</sup>

Article 10 of the Foreign Investment Law of Bolivia nevertheless permits investors to agree to settle their disputes in courts of arbitration.<sup>104</sup> Accordingly,

<sup>99</sup> The Argentine prosecutor, for example, argued in a hearing in the CMS Gas Transmission Company *v* Republica Argentina case that bilateral treaties do not supersede the National Constitution and that a company therefore cannot invoke such a treaty to avoid trying the case in Argentina before local courts. The Argentine judiciary has also recently echoed the government’s position by deciding in a landmark case (*Jose Cartellone Construcciones v Hidroelectrica Norpatagonica SA*) that, as far as matters of public policy are involved, the Argentine courts may review the reasonability, fairness and constitutionality (ie the merits) of an arbitration award. Further developments down this line include a new decree passed in 2003 to terminate a decision made in 1996 authorizing the submission of disputes between Argentine Government and a foreign investor, Bulgheroni Group, to international arbitration tribunals, and a reportedly proposed bill aimed at limiting the intervention of national or international arbitral tribunals in cases involving the State, State agencies or enterprises. Details of such developments are included in s III.1 (1) below.

<sup>100</sup> Similar recent events in other Latin American States include Brazil’s 2004 Private Public Partnership Act prohibiting international arbitration, and Venezuela’s constitutionality challenge against international arbitration. Details of such developments are included in s III.1 (2)–(3) below.

<sup>101</sup> *Ley de Sept 17, 1990, Inversiones No 1182, Gaceta Oficial de Bolivia, Sept 26, 1990*. See also IADB (2006): *Legislation for Foreign Investment Statutes in Countries in the Americas, Comparative Study-Bolivia*, available at: <<http://alca-ftaa.iadb.org/eng/invest/BOL~1.HTM>> (05/16/06) [hereinafter IADB: *Bolivia*], s 1.2.

<sup>102</sup> Art 2, *Ley de Sept 17, 1990, Inversiones No 1182, Gaceta Oficial de Bolivia, Sept 26, 1990*.

<sup>103</sup> Art 24, *The Constitution of Bolivia* (as amended by No 2410, Aug 8, 2002), in *Constitutions of the Countries of the World* (AP Blaustein and GH Flanz eds), [loose-leaf], (20 Volumes, Oceana Publications, 1971–) [hereinafter *World Constitutions*].

<sup>104</sup> IADB: *Bolivia*, above, n 101, s 5.

cases involving technical disputes may be referred to international arbitration panels governed by international arbitration rules.<sup>105</sup> In 1997, Bolivia passed Law No 1770, a legal framework for dispute settlement and arbitration to which the parties may resort before bringing their disputes before the courts.<sup>106</sup> In this context, it is noted that Bolivia has entered into 22 BITs<sup>107</sup> and is a member of the ICSID Convention, the MIGA Convention, the New York Convention and the Inter-American Convention on International Commercial Arbitration.<sup>108</sup>

Like Argentina, Bolivia enshrines equal/national treatment as the cardinal standard of treatment for foreign investors. Bolivia appears, however, to be more loyal to the Calvo Doctrine than Argentina, in that Bolivia's Constitution still explicitly renounces diplomatic protection. Nevertheless, technical disputes are allowed to be submitted to international arbitration.

*c) Brazil*

Brazilian laws also embrace equal/national treatment for foreign investors. Article 5 of Brazilian Constitution (as amended) states:

[A]ll persons are equal before the law, without any distinction whatsoever, Brazilians and foreigners residing in the country being ensured of inviolability of the right to life, to liberty, to equality, to security and to property. . . .<sup>109</sup>

This marks a significant change from the 1988 Constitution, which differentiated 'Brazilian Company of National Capital' and 'Brazilian Company of Foreign Capital' and treated them differently.<sup>110</sup> Law No 4131 stipulates in Article 2 that 'the same legal treatment dispensed to national capital shall, under the same circumstances, be dispensed to the foreign capital invested in the country, any and all forms of discrimination not foreseen in this present law being prohibited'.<sup>111</sup> This article is repeated in Article 2 of the Decree No 55762 that sets down implementing regulations with regard to Law No 4131 (as amended).<sup>112</sup>

<sup>105</sup> Wiesner, above, n 59, at 460.

<sup>106</sup> WTO, *Trade Policy Review-Bolivia: Secretariat's Report* 18, WT/TPR/154/Rev.1 (2005).

<sup>107</sup> UNCTAD, *Country-specific Lists of BITs*, above, n 47.

<sup>108</sup> IADB: *Bolivia*, above, n 101, s 5.2.

<sup>109</sup> The Constitution of Brazil (including amendments until Constitutional Amendment 52, enacted on Mar 8, 2006), available at: <<http://www.v-brazil.com/government/laws/constitution.html>> (last visited Jun 16, 2006).

<sup>110</sup> Pedro Da Motta Veiga, *Foreign Direct Investment in Brazil: Regulation, Flows and Contribution to Development* 3–4 (2004), available at: <[http://www.iisd.org/pdf/2004/investment\\_country\\_report\\_brazil.pdf](http://www.iisd.org/pdf/2004/investment_country_report_brazil.pdf)> (last visited May 20, 2006).

<sup>111</sup> Law No 4131, Sept 3, 1962, which regulates the investment of foreign capital and remittance of funds abroad, in ICSID: *Investment Laws of the World*, [loose-leaf] [hereinafter *Investment Laws of the World*]; See also IADB: *Legislation for Foreign Investment Statutes in Countries in the Americas, Comparative Study-Brazil*, available at: <<http://alca-ftaa.iadb.org/eng/invest/BRA~1.HTM>> (05/16/06) [hereinafter IADB: *Brazil*], s 3.1.b.

<sup>112</sup> Decree No 55,762 of Feb 17, 1965, which sets out regulations for implementation of Law No 4131, Sept 3, 1962, as amended, in *Investment Laws of the World*, above, n 111.

With regard to settlement of investment disputes, Brazil also adheres to the aforementioned national treatment principle. Foreign investors are therefore able to resort to the same procedures as the national investors do and there is no special form of recourse for foreign investors.<sup>113</sup> It is important to note, however, that Brazil did not accept arbitration until the Arbitration Act was passed in 1996. Yet the constitutionality of the Act was immediately challenged in the case *MBV v Resil* before the Brazilian Federal Supreme Court soon after it was promulgated.<sup>114</sup> In 30 December 2004, Brazil adopted Federal Law No 11079, establishing a legal framework for Brazilian public-private partnerships (the PPP Law),<sup>115</sup> which contains substantive limitation on arbitration as a means of settling any disputes arising from PPP contracts.<sup>116</sup> Such events thus demonstrate the reluctance of the Brazilian government to subject cases involving public entities, such as state-investor disputes, to international arbitration.<sup>117</sup>

This is confirmed by the fact that although Brazil has signed 14 BITs<sup>118</sup> and two MERCOSUR Protocols, it has ratified none of these agreements and protocols.<sup>119</sup> Indeed, the government decided to withdraw these agreements from the consideration of the Brazilian Parliament, because some elements of their texts were considered by members of Parliament to be incompatible with the Brazilian Constitution.<sup>120</sup>

Brazil can therefore be regarded as a country that unreservedly upholds the absolute 'national/equal treatment' principle in dealing with foreign investors. It does so not only through its domestic laws, but also by rejecting international treaties that would have the effect of granting more favourable treatment to foreign investors.

<sup>113</sup> IADB: *Brazil*, above, n 111, s 5.

<sup>114</sup> Although the Act was declared constitutional in the end, the lengthy deliberation on the case (more than five years) and the substantial portion of dissenting judges (four out of eleven including the reporting judge) has clearly demonstrated the country's hesitation and substantial resistance to arbitration, particularly to international arbitration. For details of the case, see s III.1(2) below.

<sup>115</sup> The law is posted at the Brazilian Ministry of Planning, Budget and Management website: <[https://www.planalto.gov.br/ccivil\\_03/\\_Ato2004-2006/2004/Lei/L11079.htm](https://www.planalto.gov.br/ccivil_03/_Ato2004-2006/2004/Lei/L11079.htm)> (last visited Jun 22, 2006). An English version is also available at: <[http://www.planejamento.gov.br/arquivos\\_down/ppp/legislacao/lei\\_11079\\_301204\\_eng.pdf](http://www.planejamento.gov.br/arquivos_down/ppp/legislacao/lei_11079_301204_eng.pdf)> (last visited Jun 22, 2006).

<sup>116</sup> It requires that, for example, the seat of the arbitration be in Brazil and the proceedings be conducted in the Portuguese language. Art 11 III, the PPP Law, *ibid*.

<sup>117</sup> As noted by Rubins, the only path towards international arbitration recognized in Brazil is the carefully drafted arbitration clause in contracts between a foreign investor and the Brazilian Government, as, 'Brazil lacks the legal infrastructure that [exists] in many other countries in Latin America give[ing] foreign investors explicit guarantees of equitable treatment and access to international arbitration'. See ND Rubins, *Investment Arbitration in Brazil*, in 4 *Journal of World Investment and Trade*, at 1080–1, 1091 (2003).

<sup>118</sup> Namely, BITs with Belgium, Chile, Cuba, Denmark, Finland, France, Germany, Italy, the Republic of Korea, the Netherlands, Portugal, Switzerland, the United Kingdom and Venezuela. See UNCTAD, *Country-specific Lists of BITs*, above, n 47. See also Rubins, above, n 117, at 1979, 1088–90.

<sup>119</sup> WTO: *Trade Policy Review-Brazil: Secretariat's Report* 24, WT/TPR/S/140 (Nov 1, 2004).

<sup>120</sup> *Ibid*.

d) Chile

The Chilean Constitution establishes national treatment for both national and foreign investors.<sup>121</sup> Article 9 of the Foreign Investment Statute establishes that foreign investment and the enterprises participating in it shall also be subject to the regular legal regime that applies to national investment, and may not be discriminated against either directly or indirectly.<sup>122</sup> The law further clarifies that any legal or regulatory provisions applicable to most of a particular productive activity and that exclude foreign investment shall be deemed discriminatory.<sup>123</sup> Similarly, rules that establish sectoral or zonal exception regimes are discriminatory if foreign investment does not have access to them.<sup>124</sup>

According to Chilean law, foreign investors have the same procedural recourse as local investors.<sup>125</sup> Article 10 of the Statute, furthermore, prescribes that in the event that legal provisions are issued which foreign investors or enterprises with foreign capital may consider to be discriminatory, the investors or enterprises may request the Foreign Investment Committee to eliminate the discrimination, provided that no more than one year has lapsed since the provision was issued.<sup>126</sup> Besides its purely domestic law, Chile is an ICSID signatory, as well as a signatory to the MIGA Convention, the New York Convention and the Panama Convention.<sup>127</sup> Chile has also signed at least 51 BITs, fifteen of which were yet to enter into force.<sup>128</sup>

It can thus be said that Chile seriously upholds the national treatment principle, with an emphasis on the elimination of discriminatory measures against foreign investors. Meanwhile, Chile is active in signing investment treaties that have the effect of upgrading the standard of treatment and protection afforded to foreign investors, well beyond those accorded to national investors; this may,

<sup>121</sup> IADB: *Legislation for Foreign Investment Statutes in Countries in the Americas, Comparative Study-Chile*, available at: <<http://alca-ftaa.iadb.org/eng/invest/CHI~1.HTM>> (05/16/06) [hereinafter IADB: *Chile*], sec 4.1. The constitution (La Constitución Política de Chile, 1980) may be found at: <<http://www.camara.cl/legis/masinfo/m6.htm>> (last visited on 8 Jun 2007).

<sup>122</sup> Art 9, Foreign Investment Statute, *in* Investment Laws of the World, above, n 111. See also IADB: *Chile*, above, n 121, s 4.1.

<sup>123</sup> *Ibid.*

<sup>124</sup> *Ibid.*

<sup>125</sup> IADB: *Chile*, above, n 121, s 5.1.

<sup>126</sup> Art 10, Foreign Investment Statute, *in* Investment Laws of the World, above, n 111. See also IADB: *Chile*, above, n 121, s 5.1.

<sup>127</sup> CE Jorquiera etc, *Chile*, *in* International Arbitration in Latin America, above, n 4, at 91–2.

<sup>128</sup> Chile has effective BITs with Argentina, Australia, Austria, Belgium, Bolivia, China, Costa Rica, Croatia, Cuba, the Czech Republic, Denmark, Ecuador, El Salvador, Finland, France, Germany, Greece, Guatemala, Honduras, Italy, Indonesia, Lebanon, Malaysia, Nicaragua, Norway, Panama, Paraguay, Peru, the Philippines, Poland, Portugal, Romania, Spain, Sweden, Switzerland, Ukraine, the United Kingdom, Uruguay and Venezuela. Further bilateral investment agreements have been, or are being negotiated, with Brazil, Colombia, the Dominican Republic, Egypt, Greece, Hungary, the Netherlands, New Zealand, South Africa, Tunisia, Turkey and Viet Nam; those were not yet in force in May 2003. WTO, *Trade Policy Review-Chile: Secretariat's Report 18*, WT/TPR/S/124 (2003). For more updated information, see UNCTAD, *Country-specific Lists of BITs*, above, n 47.

in turn, result in the ‘constitutionality’ issue elaborated above in Argentina’s case. The general attitude of the country seems to be moving away from the Calvo Doctrine towards a more liberal investment regime.

*e) Colombia*

The Colombian Constitution generally grants national treatment to foreigners in Colombia, subject to exceptions maintained by the Constitution and the laws.<sup>129</sup> Accordingly, Article 3 of Resolution 51 (issued by the National Economic and Social Policy Council of Colombia (CONPES) pursuant to Law No 9 of 1991 regulating foreign investment and foreign exchange in Colombia)<sup>130</sup> further elaborates the national treatment standard for foreign investment:

Subject to Article 100 of the Constitution of Columbia, and to Article 15 of Law 9 of 1991, and except for those matters relating to the transfer of funds abroad, the investment in Colombia of foreign capital will be treated, for all effects and purposes, *in the same way* as are the investments of residents in Colombia. Consequently, and without prejudice to the provisions set forth in special regulations or regimes, *no discriminatory conditions or treatments may be imposed on those who invest foreign capital vis-à-vis national private resident investors, nor may investors of foreign capital be given a more favourable treatment than that granted to national private resident investors.* (emphasis added)<sup>131</sup>

Thus, Colombian law unambiguously states its absolute equal/national treatment principle, which means a prohibition of any sort of discrimination between foreign and domestic investors, subject to express exceptions. Colombian law distinguishes itself from other Latin American legislation in that it still explicitly declares its prohibition of discrimination against domestic investors, ie, special privileges for foreign investors.

The most important provision related to investment dispute resolution is Article 23 of Resolution 51, which states:

Except as provided by in international treaties and conventions in force, the provisions set forth in Colombian law shall be applied to the resolution of controversies or conflicts derived from the application of the Regime of Investments of Foreign Capital [the Statute]. International arbitration will be subject to the provisions of Decree 2279 of 1989 as well as the norms and regulations that amend or supplement it.

<sup>129</sup> Art 100 of the Colombian Constitution stipulates that, ‘[F]oreigners in Colombia enjoy the same civil rights that are granted to the Colombians. Nevertheless, for reasons of public order, the law may subject foreigners to special conditions or deny their exercise of certain civil rights. Also, foreigners enjoy, in the territory of the Republic, the guarantees granted to the nationals, save the limitations established by the Constitution or the law’. See *Constitución de 1991 con reformas hasta 2005* [Political Constitution of 1991 through 2005 reforms], available at: <<http://pdba.georgetown.edu/Constitutions/Colombia/col91.html>> (Jun 16, 2006).

<sup>130</sup> IADB: *Legislation for Foreign Investment Statutes in Countries in the Americas, Comparative Study-Colombia*, available at: <<http://alca-ftaa.iadb.org/eng/invest/COL~1.HTM>> (05/16/06) [hereinafter IADB: *Colombia*], s 3.1 and 4.1.

<sup>131</sup> Art 3 of Statute of Foreign Investment (Resolution 51 as amended), *in* the Investment Laws of the World, above, n 111. See also IADB: *Colombia*, above, n 126, s 3.1 b.

With the same exception established in the preceding paragraph and without prejudice to actions that may be brought before foreign jurisdictions, all matters pertaining to the investment of capital from abroad will also be subject to the jurisdiction of Colombian courts as well as to Colombian arbitration rules.<sup>132</sup>

Article 23 thus establishes that, as a general principle, foreign investment disputes are subject to the jurisdiction of Colombian courts and tribunals applying local laws, including local arbitration rules. However, if an effective international treaty or convention to which Colombia is a party gives foreign investors the right to submit investment-related disputes to the jurisdiction of a non-Colombian court and/or to apply non-Colombian laws, then the above-quoted local jurisdiction and local law requirements may be waived. Paragraph 2 of Article 23 also suggests that in certain cases it is possible to bring a suit in a foreign jurisdiction, in which case the parties are not required to subject the dispute to Colombian jurisdiction and Colombian arbitration rules. Article 23 therefore opened the door for Colombia to enter into international treaties that accept international arbitration and international law. In this vein, it should be noted that, although Colombia has joined in the ICSID Convention, MIGA Convention and the New York Convention, it has so far only ratified one BITs (the BIT with Peru) even though it has signed six of them.<sup>133</sup>

Two constitutionality challenges might have contributed to such a conservative approach towards BIT ratification. The first was a 1995 case against the 1994 BIT with the UK. The 1994 Colombian–UK BIT contains such normal BIT provisions as national treatment, MFN treatment, and expropriations and their compensation. In particular, expropriation is prohibited unless it is for a public purpose, non-discriminatory, and accompanied by the payment of ‘prompt, adequate and effective’ compensation.<sup>134</sup> As required by the Constitution,<sup>135</sup> the BIT (as enacted by Law 246/95) was presented to the Colombian Constitutional Court for its certification. The Court ruled by a six to three majority that the BIT was contrary to the Colombian Constitution, particularly in two respects.<sup>136</sup> First, the BIT would effectively deactivate such provisions of the Colombian Constitution as the provision on expropriation without the payment of compensation in the interests of equity.<sup>137</sup> It was held that the government could not waive the exercise of a power delegated to it by the Constitution by conceding the payment of prompt, adequate, and effective compensation in case of all expropriation. Second, the investment treaty runs against the equal/national treatment provisions of the Constitution by granting British

<sup>132</sup> Art 23 of Statute of Foreign Investment (Resolution 51 as amended), *in* Investment Laws of the World, above, n 107. See also IADB: *Colombia*, above, n 130, s 5.1.

<sup>133</sup> UNCTAD, *Country-specific Lists of BITs*, above, n 47.

<sup>134</sup> David Schneiderman, *Constitutional Approaches To Privatization: An Inquiry Into The Magnitude Of Neo-Liberal Constitutionalism*, (2000) 63 *Law & Contemp Probs* 83, at 107.

<sup>135</sup> Art 241, Colombian Constitution.

<sup>136</sup> Colombian Constitutional Court Decision No C-358/96, as cited in David Schneiderman, above, n 134, at 107 and n 176.

<sup>137</sup> Art 58, Colombian Constitution as of 1994.



investors more favourable treatment with respect to expropriations than that available to Colombian nationals. The Constitutional Court rendered a similar decision in a later case with regard to a Cuba-Colombia BIT.<sup>138</sup> It is notable that despite the removal of the expropriation without compensation in case of equity provision after the 1999 amendment to the Constitution, the Colombian government still has only ratified one BITs.

It can thus be concluded that, on the one hand, Colombian laws uphold the Calvo Doctrine by adhering to the principle of equal/national treatment for foreign investment in an absolute sense, prohibiting discrimination against either foreign or domestic investors. On the other hand, Colombian laws deviate from the Doctrine in that they opened the door through domestic legislation to accept non-national jurisdiction and the application of non-national law based on international treaties. However, the constitutionality challenge to and the reluctance to ratify signed BITs suggest that strong resistance still exists in Columbia towards such deviation from Calvo principles.

#### *f) Ecuador*

Ecuador also sets forth national treatment as the cardinal standard for foreign investment. This stems from Article 13 of the Ecuadorian Constitution, which stipulates that, with the exception of limitations established in the Constitution and by law, foreigners generally enjoy the same rights as do Ecuadorians.<sup>139</sup> Under the Constitution, the Law on Investment Promotion and Guarantees and its implementing regulations and the Foreign Trade and Investment Law are the key instruments governing foreign investments in Ecuador.<sup>140</sup> Article 13 of the Law on Investment Promotion and Guarantees confirms that foreign investments enjoy the same conditions as those provided for investments by Ecuadorian natural and legal persons.<sup>141</sup> However, the Law on Investment Promotion and Guarantees allows discriminatory treatment between domestic and foreign investors in 'strategic' areas, including fisheries, mining and hydrocarbons.<sup>142</sup> The Constitution restricts the purchase, for economic purposes, of land or concessions in national security areas by foreigners.<sup>143</sup> Thus, the national treatment principle is provided to foreign investors but with important reservations.

With regard to settlement of disputes, the Ecuadorian Constitution used to reject diplomatic protection and foreign jurisdiction in foreign investment

<sup>138</sup> Colombian Constitutional Court Decision No C-379/96, as cited in David Schneiderman, above, n 134, at 107 and n 178.

<sup>139</sup> It was Art 14 in the 1979 Constitution. In the current Constitution, the Constitution of 1998, it is retained but renumbered as Art 13.

<sup>140</sup> WTO: *Trade Policy Review-Ecuador: Secretariat's Report* 18, WT/TPR/S/rev.1 (2005).

<sup>141</sup> *Ibid.*

<sup>142</sup> *Ibid.*

<sup>143</sup> Art 15, The Political Constitution of the Republic of Ecuador 1998.

contract disputes.<sup>144</sup> The current Constitution modifies this provision, establishing an exception to the exclusive local jurisdiction requirement in cases where foreign jurisdiction was established in accordance with an international treaty. Article 14 of the 1998 Constitution reads:

[C]ontracts executed between the Government, or between Public Entities and natural or legal foreign persons, will implicitly entail the waiver of any diplomatic protection; it is not allowed to agree to submit the aforementioned contracts to a foreign jurisdiction if they are executed in the territory of the Republic of Ecuador, unless it is provided for in an international agreement.<sup>145</sup>

Accordingly, the Law on Investment Promotion and Guarantees affirms, '[B]oth the State and foreign investors shall be able to submit any dispute arising from the application of this law to any Arbitration Court constituted under the terms of international treaties of which Ecuador is a member, as well as to the procedures specifically agreed upon or set forth in bilateral or multilateral agreement executed and ratified by Ecuador'.<sup>146</sup> In this context, Ecuador has signed 29 and ratified 22 BITs, mostly in 1990s.<sup>147</sup> Ecuador also accepted ICSID Convention, MIGA Convention and New York Convention.<sup>148</sup>

Ecuador thus serves as another example of a Latin American state that generally still insists on the Calvo Doctrine but has modified it so as to allow the flexibility provided for in international treaties.

#### *g) Mexico*

In general, Mexico grants national treatment to foreigners and foreign investors. This stems from Article 33 of the Mexican Constitution, which entitles them the guarantees granted by Chapter I Title I of the Constitution. In terms of property rights, Article 27 contains a well known Calvo provision:

Only Mexicans by birth or naturalization and Mexican companies have the right to acquire ownership of lands, waters, and their appurtenances or to obtain concessions for the exploitation of mines or waters. The State may grant the same right to foreigners, provided they agree before the Ministry of Foreign Affairs to consider themselves as nationals in respect to such property, and bind themselves not to invoke the protection of their governments in matters relating thereto; under penalty, in case of non-compliance with this agreement, of forfeiture of the acquired property to the Nation.<sup>149</sup>

<sup>144</sup> Art 16, The Political Constitution of the Republic of Ecuador 1979.

<sup>145</sup> Art 14, The Political Constitution of the Republic of Ecuador 1998.

<sup>146</sup> Art 32, The Law on Investment Promotion and Guarantees, *in* *Investment Laws of the World*, above, n 111.

<sup>147</sup> UNCTAD, *Country-specific Lists of BITs*, above, n 47. Recently, Ecuador has expressed its intention to terminate its BIT entered into with the US government. See s III.1(4) for further details.

<sup>148</sup> RS Cordero, *Ecuador, in* *International arbitration in Latin America*, above, n 4, at 135.

<sup>149</sup> Art 27, Mexican Constitution.

This provision clearly upholds the national treatment principle and at the same time denounces diplomatic protection. It was reiterated and implemented in Mexico's previous FDI law and regulations, namely the Foreign Investment Law of 1973<sup>150</sup> and Foreign Investment Regulations of 1989.<sup>151</sup> It was, however, deleted from the current FDI legal regime, which consisted mainly of the Foreign Investment Law of 1993 and the Foreign Investment Regulations 1998, a sign of a more liberal approach taken by the authorities. Despite such deletions, however, Mexico's general adherence to the Calvo principle elaborated above remains valid, as the constitutional provision remains unchanged.

With regard to dispute settlement, foreign investors generally have the same procedural recourse as national investors.<sup>152</sup> In this regard, it is notable that relevant local laws, such as the Federal Code of Civil Procedure and the Code of Civil Procedure of the Federal District, have established the exclusive competence of the national courts on certain matters, including matters relating to land and water, resources of exclusive economic zones, acts of authorities, criminal liability, most family matters, tax matters, employment matters and certain agricultural matters.<sup>153</sup>

Special recourse for foreign investors, however, is envisaged only in the dispute settlement sections of free trade treaties or BITs to which Mexico is a party.<sup>154</sup> In this context, it must be noted that in 1992 Mexico ratified the North America Free Trade Agreement (NAFTA), the Chapter 11 of which contains a very liberal investment regime. Since NAFTA, Mexico has concluded several BITs, of which twelve have entered into force.<sup>155</sup> Mexico is a member of the

<sup>150</sup> 1973 *Law to Promote Mexican Investment and to Regulate Foreign Investment*, Official Gazette, Mar 9, 1973. Art 3 of this law provided:

Foreigners who acquire properties of any kind in the Mexican Republic agree, because of such action, to consider themselves as Mexican nationals with regard to these properties and not to invoke the protection of their governments with respect to such properties, under penalty, in case of violations, of forfeiting to the Mexican Government the properties thus acquired.

<sup>151</sup> Regulations of the Law to Promote Mexican Investment and to Regulate Foreign Investment (as amendments), *Diario Oficial de la Federación (México)*, May 16, 1989. It stipulated in Art 31:

When the 'foreigners exclusion clause' is not in the company by-laws, the express agreement or covenant, which is an integral part of the company by-laws, whereby the present or future foreign partners of the companies in question shall be obligated to formally agree with the Secretary of Foreign Relations to be considered as nationals with respect to shares of said companies which they acquire or of which they are holders, as well as of the assets, rights, concessions, participation or interest which they hold in such companies, or else of the rights and obligations which they derive from the contracts in which the same companies are party to with the Mexican authorities, and to not invoke, for that purpose, the protection of their Governments, under the penalty, otherwise, of losing their equity interests in favour of the Nation.

<sup>152</sup> IADB: *Legislation for Foreign Investment Statutes in Countries in the Americas, Comparative Study-Mexico*, available at: <<http://alca-ftaa.iadb.org/eng/invest/MEX~1.HTM>> (05/16/06) [hereinafter IADB: *Mexico*], s 5.1.

<sup>153</sup> C von Wobeser, *Mexico*, in above, n 4, at 160–2.

<sup>154</sup> *Ibid.*

<sup>155</sup> UNCTAD, *Country-specific Lists of BITs*, above, n 47.

New York Contention and the Inter-America Convention for Commercial Arbitration, but notably has not joined with ICSID Convention or MIGA Convention.

Here again, it appears to be an issue of the constitutionality of these international treaties because Mexican nationals are not entitled to such standards and access to international remedies as are provided for in these treaties. In an effort to address this issue, the Mexican government passed the Law Regarding the Making of Treaties in 1992,<sup>156</sup> which authorizes the state to negotiate international treaties with enforceable dispute settlement mechanisms.<sup>157</sup> Some commentators believe that this law has cleared ‘any doubts about the scope of the Calvo Clause in the Constitution’.<sup>158</sup> However, given that the Law Regarding the Making of Treaties is law subordinate to the Constitution, one has to doubt whether such a statement is over-optimistic. Besides, the Law also requires such dispute settlement mechanisms to render equal treatment to Mexicans and foreigners.<sup>159</sup>

*b) Peru*

The Peruvian Constitution of 1993 (as amended) established the principle of equal treatment for foreign and national investment with an exception to ensure reciprocity.<sup>160</sup> Article 63 of the Constitution states:

Domestic and foreign investments are subject to the same conditions. . . . If another country or countries adopt protectionist or discriminatory measures that prejudice the national interest, the State may, in defence of the latter, adopt similar measure.<sup>161</sup>

This national treatment standard is reflected in Legislative Decree No 662 of 29 August 1991 on foreign investment promotion.<sup>162</sup> Decree 662 sets as its objective the removal of ‘[o]bstacles and restraints to foreign investors in order to guarantee the equality of rights and duties applicable to foreign and national investors . . .’.<sup>163</sup> and establishes in Article 2 the national treatment standard by providing that, except for constitutional and decree limitations, foreign investors and their companies have ‘the same rights and obligations as those of

<sup>156</sup> Law Regarding the Making of Treaties, Dec 21, 1991, Mex, 31 ILM 390 (1992). The official text of the law appears in CDLX *Diario Oficial de la Federación*, Jan 2, 1992 at 2.

<sup>157</sup> Antonio Garza Cánovas, Introductory Note to the Law Regarding the Making of Treaties, 31 ILM 390, 391 (1992).

<sup>158</sup> See *ibid* at 391. See also Justine Daly, *Has Mexico Crossed the Border on State Responsibility for Economic Injury to Aliens?—Foreign Investment and the Calvo Clause in Mexico after NAFTA*, 25 *St Mary's LJ* 1147, at 1189 (1994); Schneiderman, above, n 134.

<sup>159</sup> Garza Cánovas, above, n 157, at 391.

<sup>160</sup> WTO: *Trade Policy Review-Peru: Secretariat's Report* 17, WT/TPR/S/69 (2000).

<sup>161</sup> Art 63, paras 1–2, The Political Constitution of the Republic of Peru 1993 (as amended to 2005), in *World Constitutions*, above, n 103.

<sup>162</sup> Above n 150.

<sup>163</sup> Preamble and Art 2 respectively, Legislative Decree No 662 of 29 Aug 1991, as in *Investment Laws of the World*, above, n 111.

national investors and companies'. It goes further by requiring, in absolute terms, that 'the national laws shall, in no event, discriminate against investors or companies on the basis of national or foreign investors participating therein'.<sup>164</sup> In particular, Decree 662 announces that 'all laws limiting or restricting in any manner foreign investments in any economic activity are hereby revoked as from the effective date thereof'.<sup>165</sup> It is therefore clear that the national treatment standard established in Peruvian law emphasizes the prohibition of discrimination against foreign investors in an attempt to attract FDI.

With regard to dispute settlement, Peruvian Constitution contains the following provision:

In all State contracts and those of public officials with resident aliens, submission of latter to the laws and competent authorities of the Republic and their renunciation to all diplomatic claims are in order. Contracts of financial nature may be exempted from the national jurisdiction.

The State and other persona of public law may submit disagreements stemming from contractual relations to courts established by virtue of treaties in force. They may also submit to domestic or international arbitration in the form provided by law.<sup>166</sup>

This constitutional provision might be regarded as a moderated 'Calvo Clause'. It is essentially a Calvo Clause in that it absolutely denounces diplomatic protection and generally upholds the exclusive use of domestic law and domestic jurisdiction. It is moderated by allowing two exceptions: one is for contracts of a financial nature, which are allowed to resort to non-national jurisdiction; the other is for treaty-based arrangements on jurisdiction and applicable law. One commentator maintains that there is a presumption in favour of investment-dispute settlement before Peruvian courts and under Peruvian law, since although Article 16 of Decree 662 permits the State to submit disputes to arbitration tribunals based on international treaties, foreign investors can never be certain if the Peruvian government will actually agree to do so.<sup>167</sup> Nevertheless, this exception at least makes it constitutionally possible for the government to enter into international agreements on the solution of investment disputes. Indeed, Peru has signed 29 and ratified 26 BITs.<sup>168</sup> Peru is also a member of ICSID Convention, MIGA Convention, New York Convention and the Panama Arbitration.<sup>169</sup>

<sup>164</sup> *Ibid*, Legislative Decree No 662, Art 2.

<sup>165</sup> *Ibid* Art 31.

<sup>166</sup> Art 63, The Political Constitution of the Republic of Peru 1993 (as amended to 2005), in *World Constitutions*, above, n 103.

<sup>167</sup> Wiesner, above, n 59, at 463.

<sup>168</sup> UNCTAD, *Country-specific Lists of BITs*, above, n 47.

<sup>169</sup> PO Parodi, *Peru and Annex 1: Table of Adherence to the New York Convention, Panama Convention and Washington Convention*, in above, n 4, at 194 and 439.

i) *Venezuela*

In accordance with the 1999 Venezuelan Constitution, foreigners and foreign investors enjoy national/equal treatment. Article 301 of the Constitution states:

[B]usiness enterprises, organs or persons of foreign nationality shall not be granted with regimes more advantageous than those established for Venezuelan nationals. Foreign investment is subject to the same conditions as domestic investment.<sup>170</sup>

The Investment Protection and Promotion Law of 1999<sup>171</sup> affirms such a principle by stating in Article 7 that, in similar circumstances, foreign investors and their investments are subject to the same rights and obligation as national investors and their investments, except for measures provided for in special laws and the limitations contained in the present law.<sup>172</sup> The law also provides in Article 6 'fair and equitable treatment' for foreign investment in accordance with international law, and guarantees that foreign investors will not be subject to 'arbitrary or discriminatory measures affecting the maintaining, management, use, enjoyment, expansion, sale or liquidation' of their investment.<sup>173</sup> Article 9 goes further, allowing foreign investors to enjoy the more favorable of the two treatment standards established by Articles 6 and 7, ie, between national treatment and fair and equitable treatment.<sup>174</sup> Article 8 establishes MFN treatment for foreign investment.<sup>175</sup> While the preceding four articles seem to have, distinctively, adopted BIT language guaranteeing the best standards of treatment for foreign investors, Article 10 turns the attention to national investors and assures that, in similar circumstances, they will be not be treated in a way that is 'less favorable' than the treatment accorded to foreign investors.<sup>176</sup> Thus, the Investment Protection and Promotion Law establishes high standards of treatment for all investors and their investments.

On dispute settlement, the 1999 Venezuelan Constitution includes an unambiguous 'Calvo Clause' that says:

Article 151: In the public interest contracts, unless inapplicable by reason of the nature of such contracts, a clause shall be deemed included even if not expressed, whereby any doubts and controversies which may raise concerning such contracts and which cannot be resolved amicably by the contracting parties, shall be decided by the competent courts of the Republic, in accordance with its laws and shall not on any grounds or for any reason give rise to foreign claims.<sup>177</sup>

<sup>170</sup> Art 301, The Constitution of the Bolivian Republic of Venezuela (adopted at the referendum of Dec 15, 1999), *as in* World Constitutions, above, n 103.

<sup>171</sup> *Ley de Promoción y Protección de Inversiones* (Decreto N° 356, 3 de octubre de 1999), *Gaceta Oficial* N° 5.390 Extraordinario de fecha 22 de octubre de 1999 [hereinafter Investment Protection and Promotion Law].

<sup>172</sup> *Ibid* Art 7.

<sup>173</sup> *Ibid* Art 6.

<sup>174</sup> *Ibid* Art 9.

<sup>175</sup> *Ibid* Art 8.

<sup>176</sup> *Ibid* Art 10.

<sup>177</sup> Art 151, The Constitution of the Bolivian Republic of Venezuela (adopted at the referendum of Dec 15, 1999), *as in* World Constitutions, above, n 103.

The Constitution thus not only renounces diplomatic protection, but also unreservedly upholds the exclusive jurisdiction of national courts and national law on public interest contracts. In this regard, it appears that Article 155 of the Constitution would not be of relevance, as it seems to cover treaties between state parties, but not contracts made by the state as governed in Article 151. Article 155 essentially establishes that if there is any international agreement entered into by the Venezuelan government and a foreign party, any disputes arising between the parties in connection with the interpretation or implementation of the agreement should be resolved by ‘peaceful means recognised under international law or agreed upon between them in advance’.<sup>178</sup>

Such a Calvo position does not, however, seem to have been taken in the Investment Protection and Promotion Law, which effectively adopts a very liberal, BIT-style approach toward the settlement of international investment disputes.<sup>179</sup> Articles 21 through to 23 of the Law deal with such issues. Article 23 sets forth the rule for the resolution of disputes relating to the application of the present law. It provides that investors (presumably national or foreign) may choose to submit the dispute to a local court or a local arbitration tribunal after having exhausted all administrative remedies.<sup>180</sup> If a dispute involves an ‘international investor’, special channels will apply as provided for in Articles 21 and 22. Article 22 deals with situations where a dispute arises between Venezuela and an international investor whose home state has an investment treaty arrangement with Venezuela, or where provisions of the ICSID Convention or MIGA Convention are applicable to the dispute.<sup>181</sup> In such cases, arbitration under the terms of the relevant treaty or agreement would apply.<sup>182</sup> Alternatively, the international investor may opt to institute proceedings in Venezuela.<sup>183</sup> Related to these policies, Venezuela has signed 25 and ratified 21 BITs<sup>184</sup> and is a member of the ICSID Convention, MIGA Convention, New York Convention and the Panama Convention.<sup>185</sup>

In such disputes, where the disputant international investor is a national of a state with which Venezuela does not have an investment treaty and the dispute is related to ‘the interpretation and application of the rules provided for in the present Law’, then the international investor may assign the dispute to its home state, which may then submit the case to international arbitration once diplomatic channels are exhausted.<sup>186</sup> In that case, the composition, method of

<sup>178</sup> Art 155, The Constitution of the Bolivian Republic of Venezuela (adopted at the referendum of Dec 15, 1999).

<sup>179</sup> Art 21–3, Investment Promotion and Protection Law, above, n 171.

<sup>180</sup> *Ibid* Art 23.

<sup>181</sup> *Ibid* Art 22.

<sup>182</sup> *Ibid*.

<sup>183</sup> *Ibid*.

<sup>184</sup> UNCTAD, *Country-specific Lists of BITs*, above, n 47.

<sup>185</sup> B Weinger and DM Lindsey, *Venezuela and Annex 1: Table of Adherence to the New York Convention, Panama Convention and the Washington Convention*, in above, n 4, at 227 and 439.

<sup>186</sup> Art 21, Investment Promotion and Protection Law, above, n 171.

selection, procedure and treatment of costs of the arbitration are to be determined by mutual agreement of the investor's home state and Venezuela.<sup>187</sup> Alternatively, the international investor may opt to take the domestic remedies established in Article 23.<sup>188</sup>

Two major conflicts between the Constitution and the FDI Law may be observed here. First, the diplomatic protection envisaged in Article 21 conflicts with the denunciation of diplomatic claims stipulated in Article 151 of the Constitution, as it could well be the case that the dispute also involves a public interest contract. Secondly, for the same reason, the international remedies for disputes involving international investors provided for in Articles 21 and 22 also seem to breach the exclusive national jurisdiction requirement in the same constitutional provision.

In this regard, it would be useful to recall that the Venezuelan government had already been challenged by local citizens for violation of Article 151 on its agreement to submit disputes arising out of oil concession agreements to international arbitration.<sup>189</sup> In a more recent case, the *Minera Ias Cristinas, CA (MINCA) v Corporacion Venezolana de Guyana (CVG) case* (the *MINCA Case*),<sup>190</sup> the Supreme Court dismissed MINCA's petition on the ground that the subject matter concerned state assets and therefore could not be subject to arbitration.<sup>191</sup>

Venezuelan law is therefore characterized by, on the one hand, the rather traditional provisions in the Constitution that adopt a Calvo approach, and, on the other hand, the very liberal provisions in the FDI law that adopt BIT-style standards of treatment and dispute settlement methods. Venezuelan law thus displays significant disparities between the two levels of laws, particularly on dispute settlement. The constitutionality of governmental actions has already been challenged again and again before Venezuelan courts.

#### *j) Observations*

Despite differences in detail, four general observations might be extracted from the preceding survey on the domestic laws in the nine major Latin American states.

First of all, all the countries considered subscribe to the national/equal treatment standard. In most of the countries, the national/equal treatment standard is guaranteed in the national constitutions and reaffirmed in relevant FDI laws.

<sup>187</sup> *Ibid.*

<sup>188</sup> *Ibid.*

<sup>189</sup> Details of this cases and follow-up events follow in s III.1(3). See also EE Eljuri, *Oil Opening: A Constitutional Challenge*, available at: <<http://www.natlaw.com/pubs/spveen1.htm>> (last visited Feb 12, 2006).

<sup>190</sup> Decision No 0083 of the Political Administrative Chamber of the Supreme Court of Jul 15, 2004.

<sup>191</sup> For details see s III.1 (3) below.



Though this generally demonstrates the continued existence and validity of the Calvo principle, it must be noted that there has been a shift of emphasis, from non-discrimination against nationals and national investors, toward a general requirement of non-discrimination based on nationality. Thus, in the constitutions of most countries, foreigners and foreign investors are guaranteed the 'same rights and obligation' as nationals and national investors. In some countries, such as Colombia and Venezuela, emphasis has been explicitly placed on both ends of the national treatment standard: the non-discrimination against foreign investors on one end and non-discrimination against national investors on the other. Clearly such legislation reflects the influence of BITs; the recent Venezuelan FDI law effectively copies BIT standards. It might be said that Calvo and BIT approaches, the two traditionally distinct and opposing approaches towards national treatment, have both been transformed and have converged here to formulate a standard of national treatment that pursues genuine equality: equality of treatment regardless of nationality. Nevertheless, such transformation and convergence may still be regarded as changes within the Calvo paradigm of national treatment, a paradigm based on the equality of states and the equality of individuals.

Second, apart from Brazil (and, to a lesser degree, Colombia), all countries have accepted international investment treaty-based arbitration, by explicit domestic provisions and/or by actively entering into investment treaties. However, the degree of such acceptance varies. Thus in Bolivia only 'technical disputes' might be referred to international arbitration, while in Venezuela, foreign investment disputes can be submitted for international arbitration even though there is no treaty obligation specifically providing for such submissions. Needless to say, international investment treaty-based arbitration is simply inaccessible to foreign investors in Brazil. The access of different foreign investors to international arbitration varies, depending on whether there is a valid BIT between their home states and the host country, and on the specific provisions on dispute settlement contained in such BITs. Nonetheless, despite the potential issue of constitutionality in some countries and apart from Brazil, it is clear that Latin American states have generally moved away from absolute exclusive national jurisdiction and have accepted general international law as applicable law. In this sense, one may say that Calvo has been substantially eroded and generally discarded, albeit with certain important exceptions and reservations highlighted in the end of Section II.2(4).

Third, diplomatic protection is still expressly denounced in the constitutions of most countries, namely Bolivia, Colombia, Ecuador, Mexico, Peru and Venezuela, particularly in relation to public interest contracts. In this regard, it might be said that Calvo is still very much alive.

Finally, recent years seem to have seen a 'resurgence' of Calvo, witnessed most notably by constitutionality challenges in Argentina, Colombia and Venezuela against BITs and investment arbitration, and Brazil's PPP Law prohibiting international arbitration, details of which follow in Section III.1.

#### 4. General Observation: Calvo has been Deactivated but not Dead

The preceding survey of domestic laws and international treaties by Latin American States shows that Calvo is still alive with regard to diplomatic protection, alive but transformed and melded with BITs on the national treatment standard, and greatly eroded and largely discarded on the exclusive national jurisdiction and national law requirement. Admittedly, the last element, the exclusive national jurisdiction and national law requirement, constitutes the core of the whole doctrine. Even on this point, as discussed above, Calvo is not completely dead, as there are still important exceptions and reservations. It would therefore only be fair to conclude that Calvo has been significantly changed, or substantially 'disfigured', or generally 'deactivated', but not yet completely 'dead'. When political and economic climates are 'right', it could be re-activated again and 'resurge', as what seems to be happening.

### III. CALVO DOCTRINE IN THE 21ST CENTURY: REVIVED AND RESTORED?

#### 1. The Revival of the Calvo Doctrine: Within Latin America

The tide of investment liberalisation, however, seems to have reversed itself in recent years. As a result the Calvo Doctrine has returned to the world stage, particularly to Latin America. The chief indicator of the Calvo Doctrine's revival is the dramatic increase of investment treaty-based arbitration cases, which have forced states world-wide, particularly in Latin America, to re-think their approach towards investment liberalisation in general and the acceptance of international arbitration in particular. According to UNCTAD there were 219 investment treaty-based arbitration cases by November 2005, more than two-thirds initiated since 2002.<sup>192</sup> In other words, an average of more than 30 cases have been initiated in each of the last four years. Almost all of these cases have been brought by investors against states.<sup>193</sup> Most defendant states were developing states (47 out of 61), most frequently Latin American.<sup>194</sup> Argentina topped the list with 42 cases, which accounted for nearly 20 per cent of the total caseload.<sup>195</sup> Mexico followed with 17 cases.<sup>196</sup> Ninety-four per cent of the states

<sup>192</sup> UNCTAD, *Latest Developments in Investor-State Disputes Settlement*, 1–2, IIA Monitor No 4, (UNCTAD/WEB/ITE/IIT/2005/2). For more updated data and a comprehensive assessment of such arbitration cases, see Joachin Karl, 'International Investment Arbitration: A Threat to State Sovereignty?', in this book.

<sup>193</sup> *Ibid.*

<sup>194</sup> *Ibid* at 3.

<sup>195</sup> In UNCTAD statistics, there are 14 developed defendant states, 37 developing states and 10 Southeast European and the Commonwealth of Independent States (CIS). As Southeast European and CIS states are generally developing states, the number of developing states might be counted as 47. *Ibid* at 1–2.

<sup>196</sup> *Ibid.*

that had been sued two or more times were developing states, including three more Latin American states: Ecuador (7), Chile (4) and Venezuela (3). Statistics from the ICSID shows that of 72 cases pending before ICSID in April 2004, 41 were against Latin American states, nearly 60 per cent of the total number.<sup>197</sup>

The surge of investment treaty arbitration cases demonstrates the teeth of BITs and puts governments across the world on notice. Latin American states, the states with the strongest Calvo tradition, have naturally adopted, or are contemplating adopting, measures to limit investment treaty arbitrations and bring them under national control. This new trend is most perceptible in Argentina, Brazil, Bolivia, Ecuador and Venezuela.

#### *a) Argentina*

Argentina is the home country of Carlos Calvo, the father of the Calvo Doctrine. However, it was also among the most enthusiastic Latin American countries in departing from that Doctrine by entering into BITs. As said above, Argentina signed at least 58 BITs, leading the BIT league table in Latin America.<sup>198</sup> The recent dramatic rise of BIT-based arbitration cases against Argentina was triggered by Argentina's Emergency Law No 25561, adopted in January 2002. The law, responding to an economic crisis, declared a public emergency until December 10, 2003, froze local tariffs, and abolished the one-to-one US Dollar-Peso convertibility.<sup>199</sup> Such measures had a significant negative impact on foreign investors who had stakes in privatised state-owned enterprises. One commentator observed that the net consequence of these measure for the utility companies was 'a roughly two-thirds reduction in income'.<sup>200</sup>

Because of state-investor arbitration clauses, investors began to sue the Argentine government. Of the 85 cases pending before ICSID as of February 2004, 35 of the cases were brought against Argentina, accounting for nearly half of the total investment arbitration caseload worldwide,<sup>201</sup> a magnitude unheard

<sup>197</sup> Cremades, above, n 50, at 81 n 8.

<sup>198</sup> UNCTAD data show that Argentina signed 58 BITs by Jun 1, 2006, which is more than any other country in Latin America. See UNCTAD, Country Specific List of BITs, available at: <<http://www.unctad.org/Templates/Page.asp?intItemID=2344&lang=1>> (last accessed on Mar 27, 2007).

<sup>199</sup> Law No 25561, Jan. 6, 2002, BO Articles 2–5, and 8–9. For English sources see Cremades, above, n 50, at 81; PC Mastropierro, LB Pascal, ALERT: Argentine Devaluation Law, available at: <[http://www.haynesboone.com/knowledge/knowledge\\_detail.asp?groupid=all&page=pubs&pubid=380](http://www.haynesboone.com/knowledge/knowledge_detail.asp?groupid=all&page=pubs&pubid=380)> (last visit on Mar 27, 2007); M & M Bomchil ABogados, Public Emergency Regulations on Public Works and Utilities Contracts and Licenses, available at: <[http://www.ag-internet.com/bullet\\_iln\\_one\\_five/Bulletin-ContractsLicenses.doc](http://www.ag-internet.com/bullet_iln_one_five/Bulletin-ContractsLicenses.doc)> (last visit on Mar 27, 2007).

<sup>200</sup> Paolo Di Rosa, *The Recent Wave of Arbitrations against Argentina under Bilateral Investment Treaties: Background and Principal Legal Issues*, 36 *U Miami Inter-Am L Rev*, 41, 48 (2004).

<sup>201</sup> *Ibid* at 43.

of in the history of arbitration. Currently, Argentina still has 31 cases pending before the ICSID, amounting to twenty eight per cent of its total caseload.<sup>202</sup>

Such a large caseload for one country constitutes a significant burden, politically as well as financially. The average legal fee to defend a single investment treaty-based arbitration is estimated to be one to two million US dollars, in addition to which are costs for the arbitration tribunals amounting to roughly US \$400,000.<sup>203</sup> Therefore, Argentina will have to pay tens of millions of dollars annually in order to defend these cases. Should Argentina lose every case, it would owe compensation amounting to roughly 17 billion dollars,<sup>204</sup> which, as alleged by Argentina, exceeds its annual budget.<sup>205</sup> Facing such severe legal challenges, Argentina has tried to cope by using procedural tactics.<sup>206</sup> Meanwhile, it has challenged the constitutionality of investment treaties and treaty-based arbitration.<sup>207</sup> Finally, Argentina has taken legislative measure to tackle the problem, and is currently considering further legislative measures.<sup>208</sup>

a) Procedural Tactics In dealing with these cases, the Argentine government first makes every effort to reach a negotiated settlement with the disputant investors.<sup>209</sup> If this fails, the Government then almost always challenges the arbitrator's jurisdiction.<sup>210</sup> So far, the Government has failed to win a single jurisdictional challenge.<sup>211</sup>

These jurisdictional challenges have been launched on various grounds, some of which relate to 'Calvo clauses' in BITs and/or concession agreements. In *Lanco International Inc v Argentine Republic*, a US investor sued Argentina at the ICSID, based on a 'fork-in-the-road clause' in a 1991 US–Argentina BIT allowing a choice among local remedies, agreed channels and international arbitration.<sup>212</sup> The Argentine government challenged ICSID's jurisdiction,

<sup>202</sup> See List of Pending Cases, available at: <<http://www.worldbank.org/icsid/cases/pending.htm>>, last accessed Mar 27, 2007 (showing that 31 out of the 110 pending cases are against Argentina).

<sup>203</sup> The legal costs to claimants are approximately the same as for defendants. See UNCTAD, *Issues Related to Investment Arrangements: Investor-State Disputes and Policy Implication*, 7, TD/B/COM.2/62 (Jan 14, 2005), available at: <[http://www.unctad.org/en/docs/c2d62\\_en.pdf](http://www.unctad.org/en/docs/c2d62_en.pdf)>.

<sup>204</sup> Indeed, the CMS award, the first of the many Argentine cases, has required Argentina to pay the company \$1.33 billion. See UNCTAD, *Latest Developments in Investor-State Disputes Settlement*, 6, IIA Monitor No 4, UNCTAD/WEB/ITE/IIT/2005/2 (2005); see also Luke Peterson, *Argentina Moves to Annul Award in Dispute with CMS Company Over Financial Crisis*, Investment Treaty News (International Institute for Sustainable Development, Winnipeg, Canada), Oct 26, 2005, at 4–6, available at: <[http://www.iisd.org/pdf/2005/investment\\_investsd\\_oct26\\_2005.pdf](http://www.iisd.org/pdf/2005/investment_investsd_oct26_2005.pdf)> (accessed Mar 27, 2007).

<sup>205</sup> *Ibid.*

<sup>206</sup> See *infra* Part I.1.a.

<sup>207</sup> See *infra* Part I.1.b.

<sup>208</sup> See *infra* Part I.1.c.

<sup>209</sup> See Cremades, above, n 50, at 81.

<sup>210</sup> See Yanru Wei, *On the Impropriety of China's Recent Acceptance of Full ICSID Jurisdiction*, 13 *J Int'l Econ Law* (in Chinese) 108, at 139–40.

<sup>211</sup> *Ibid.*

<sup>212</sup> Argentina–US BIT, Article 7, as cited in *Lanco International, Inc. v Argentine Republic* (Case No ARB/97/6), Preliminary Decision on Jurisdiction of Dec 8, 1998, 40 ILM 457 (2001), § 20.

arguing that Argentina had not given the necessary written consent to grant the ICSID jurisdiction and that the dispute should be settled by the Federal Contentious Administrative Tribunal of Buenos Aires, as provided in the Concession agreement between the parties.<sup>213</sup> The tribunal held, however, that the BIT constituted an open offer by the government and ‘consent’ for the purposes of Article 25 (1) of the ICSID Convention.<sup>214</sup> The tribunal made the later much-debated distinction between the contract claim and the treaty claim, and ruled that the Argentine government’s consent to the BIT had not been withdrawn by its subsequent execution of the Concession Agreement with the investor concerned.<sup>215</sup>

Subsequently in *CMS Gas Transmission Co v Argentine Republic*,<sup>216</sup> the Argentine government again challenged ICSID’s jurisdiction. This time the government claimed, *inter alia*, that the license the Government granted to TNG<sup>217</sup> contained a separate dispute settlement mechanism vesting exclusive jurisdiction in the Federal Court of Buenos Aires. The Tribunal nevertheless upheld the investors’ right to ICSID arbitration, reasoning that CMS was not bound by the license as it was not a party to it. But the Tribunal went further and ruled out altogether the legal effect of such ‘Calvo clauses’ by saying ‘. . . referring certain kinds of disputes to the local courts . . . [is] not a bar to the assertion of jurisdiction by an ICSID tribunal under the treaty, as the functions of these various instrument are different’.<sup>218</sup>

While a full discussion of this issue could merit a doctoral dissertation, it is sufficient to note here that Argentina was unsuccessful in challenging the jurisdiction of the ICSID tribunal. The government then attempted a further procedural technique to tackle the problem: applying for annulment of the ICSID award once the award is made. Thus in September 2005, Argentina applied for annulment of the award on the merits of the CMS case.<sup>219</sup> As of this article’s submission, the annulment case is still pending before the ICSID.

b) The Unconstitutionality Argument The Argentine government has recently challenged the constitutionality of BITs and, consequently, the BIT-

<sup>213</sup> Clause 12, the Concession Agreement for the Port Terminal No 3, as cited in *Lanco International, Inc. v Argentine Republic*, *ibid*, § 6.

<sup>214</sup> *Lanco International, Inc v Argentine Republic*, *ibid*, §§ 32–3.

<sup>215</sup> *Lanco International, Inc v Argentine Republic*, *ibid*, §§ 34–40. For further analyses on the distinction and relationship between contractual claims and treaty claims, see Yuval Shany ‘Contract Claims vs. Treaty Claims: Mapping Conflicts Between ICSID Decisions on Multisourced Investment Claim’ 99 *Am J Int’l L* 835.

<sup>216</sup> *CMS Gas Transmission Co v Republic of Argentina*, Decision on Objections to Jurisdiction, ICSID ARB/01/8, 42 ILM 788 (2003).

<sup>217</sup> TNG is the company in which the claimant had 29.42 per cent of the shares.

<sup>218</sup> *CMS Gas Transmission Co v Republic of Argentina*, above, n 216, para 76.

<sup>219</sup> The annulment proceeding can at least provide some additional time for Argentina before the payment has to be made. See Peterson, above, n 204.

based arbitration process.<sup>220</sup> The Argentine prosecutor, for example, argued in a hearing in the *CMS Gas Transmission Co v Republica Argentina* case that:

- a) Bilateral treaties do not supersede the National Constitution and therefore a company can not invoke such treaty to avoid trying the case in Argentina before local courts and violate the right of defence in court of the Argentine State.
- b) A company that is engaged in the rendering of public services can not impose a limitation on the sovereign right of the government to change its economic policy or the tariffs.<sup>221</sup>

The Prosecutor also conducted a public campaign advocating the re-adoption of the Calvo and Drago<sup>222</sup> doctrines and attacking BITs and the ICSID by stating that Argentina should never again agree to submit a contractual dispute to a system with ICSID characteristics.<sup>223</sup>

The foundation of the constitutional argument is Sections 27 and 75 of the Constitution of Argentina. Section 75.22 set forth the legal status of international treaties as beneath the Constitution, but above the laws, excepting certain human rights treaties, as expressly stipulated in the Constitution, which

<sup>220</sup> There are two lines of argument for the unconstitutionality of the ICSID Convention and its awards. One is the position actually adopted by the Argentine Government. The other is a more recent and also more radical argument, which has not been adopted by the Argentine Government. It holds that both BITs and the ICSID regime are unconstitutional because they were approved in violation of the process established in the Argentine Constitution as reformed in 1994.

Since the ICSID Convention was ratified and hence entered into force after the constitutional reforms took effect, and the domestic implementation bill was also subsequently published, the new constitutional provisions should apply. Additionally, the new Constitution requires a special and very stringent procedure for 'treaties of integration which delegate powers and jurisdiction to supra-national organizations'. It is argued that since the acceptance of the arbitral jurisdiction of the ICSID requires transfer of sovereign power of domestic jurisdiction to be transferred to the ICSID, the ICSID Convention has 'integration' purposes and as such must be subjected to the special constitutional procedure. Because such a procedure has never been undertaken, the validity requirement under the new system has not been completed and consequently any arbitration carried out by the ICSID against Argentina can be declared null and void by a domestic court.

The argument goes further in that the special procedure required by the new Constitution is mandatory, and as a result, such treaties delegating powers and jurisdiction to international bodies as the ICSID Convention should be rendered null and void per se with the enactment of the reform.

For further details of the arguments, See CE Alfaro and PM Lorenti, *The Growing Opposition of Argentina to ICSID Arbitral Tribunals: A Conflict between International and Domestic Law?* 6 *J World Invest & Trade* 3, 417, 425–9 (2005). Alfaro and Lorenti consider that the ICSID Convention is merely a treaty of 'cooperation', not an 'integration treaty', and therefore does not require the fulfilment of the special procedure required by the new constitution. *Ibid*, at 429–30.

<sup>221</sup> CE Alfaro, 'The Battle of the Century: Argentina Against the ICSID Arbitration and the BITs', *World Law Group E-news Issue No 31* (Nov 2004), available at: <[http://www.imakenews.com/bcastro/e\\_66201\\_86528.pdf](http://www.imakenews.com/bcastro/e_66201_86528.pdf)>.

<sup>222</sup> The Drago Doctrine was announced in 1902 by the Argentinean Minister of Foreign Affairs Luis Maria Drago, arguing mainly that no foreign power, including the United States, could use force to collect debt. See Wikipedia, the Free Encyclopedia, *Drago Doctrine*, available at: <[http://en.wikipedia.org/wiki/Drago\\_Doctrine](http://en.wikipedia.org/wiki/Drago_Doctrine)> (last visited Jan 22, 2007).

<sup>223</sup> Alfaro, n 221 above.

enjoy constitutional status.<sup>224</sup> In short, most treaties, such as BITs and the ICSID Convention are subordinate to the Constitution. Section 27 further subjects such treaties to ‘the principles of public law laid down by this Constitution’.<sup>225</sup> As a result, two commentators argue, ‘the validity of the ICSID Convention in Argentina could be tested by ascertaining its compatibility with said ‘public law principles’ of the Constitution’.<sup>226</sup> The commentators continue by saying that the same ‘public law principles’ test could be applied to arbitration awards rendered by the ICSID tribunals because they are the ‘products’ of the ICSID.<sup>227</sup> Therefore, the Congress should not have ratified treaties such as the ICSID Convention that conflict with the Constitution’s ‘public law principles’ of the Constitution, nor should the President have negotiated the treaty in the first place.<sup>228</sup> The power to review treaties for unconstitutionality, however, lies in the hands of the Judiciary and, ultimately, the Federal Supreme Court of Argentina.<sup>229</sup>

In this connection, it is relevant to note that the Argentine judiciary recently echoed the Administration’s position in a landmark case that, in matters of public policy, the Argentine courts may review the reasonability, fairness and constitutionality, ie, the merits, of an arbitration award.<sup>230</sup> The case, *Jose*

<sup>224</sup> Chapter IV s 75.22 of the Constitution of the Argentine Nation reads,

[t]reaties and concordats have a higher hierarchy than laws.

The American Declaration of the Rights and Duties of Man; the Universal Declaration of Human Rights; the American Convention on Human Rights; the International Pact on Economic, Social and Cultural Rights; the International Pact on Civil and Political Rights and its empowering Protocol; the Convention on the Prevention and Punishment of Genocide; the International Convention on the Elimination of all Forms of Racial Discrimination; the Convention on the Elimination of all Forms of Discrimination against Woman; the Convention against Torture and other Cruel, Inhuman or Degrading Treatments or Punishments; the Convention on the Rights of the Child; in the full force of their provisions, they have constitutional hierarchy, do not repeal any section of the First Part of this Constitution and are to be understood as complementing the rights and guarantees recognized herein. They shall only be denounced, in such event, by the National Executive Power after the approval of two-thirds of all the members of each House.

In order to attain constitutional hierarchy, the other treaties and conventions on human rights shall require the vote of two-thirds of all the members of each House, after their approval by Congress.

Const Arg § 75.22, available at: <[http://www.argentina.gov.ar/argentina/portal/documentos/constitucion\\_ingles.pdf](http://www.argentina.gov.ar/argentina/portal/documentos/constitucion_ingles.pdf)>.

<sup>225</sup> s 27 of the Argentine Constitution reads, ‘[t]he Federal Government is under the obligation to strengthen its relationships of peace and trade with foreign powers, by means of treaties in accordance with the principles of public law laid down by this Constitution’. *Ibid* § 27.

<sup>226</sup> However, Alfaro and Lorenti seem to have entertained an expansive interpretation on the concept of ‘public law principles in the constitution’ by extending them to cover all ‘matters of public law’, with which the author of the present paper does not agree. See CE Alfaro and PM Lorenti, above, n 220, at 420, 423–5.

<sup>227</sup> *Ibid*.

<sup>228</sup> *Ibid* at 421.

<sup>229</sup> *Ibid*.

<sup>230</sup> Corte Suprema de Justicia [CSJN] (1 Jun 2004), *Jose Cartellone Construcciones Civiles SA v Hidroelectrica Norpatagonica SA / La Ley [LL] (Causa J-87, XXXVII RO) (Arg)*, the Decision in Spanish is available at the Court’s website: <[http://www.csjn.gov.ar/documentos/cfal3/toc\\_fallos.jsp](http://www.csjn.gov.ar/documentos/cfal3/toc_fallos.jsp)> (last visited on 17 Mar 2007).

*Cartellone Construcciones Civiles SA v Hidroelectrica Norpatagonica SA*, reportedly concerned a domestic arbitration involving a public services contract between a private Argentine company and a state-owned enterprise.<sup>231</sup> The contract had an arbitration provision excluding any appeal to courts.<sup>232</sup> The Federal Supreme Court of Argentina decided that the Court may 'review arbitral awards if 'unconstitutional', 'unreasonable' or 'illegal', even when the parties involved have specifically agreed to waive the right to appeal'.<sup>233</sup> This decision 'reaffirmed the Supreme Court's role of 'guardian' of the Constitution and of *public policy*, even in those cases that ha[d] been previously submitted to arbitrators and where judicial review ha[d] not been admitted by the parties'.<sup>234</sup> In supporting the decision, the Supreme Court invoked Article 872 of the Civil Code, which states that 'rights granted with aim at public policy cannot be waived'.<sup>235</sup> With this, the Court effectively rejected the possibility of any parties' agreement restricting review over matters of public policy.

This decision implies that an award rendered by an international arbitration tribunal may be challenged in Argentina as 'unreasonable' or 'unconstitutional'. This decision 'is already influencing Argentine lower courts in connection with international arbitrations'.<sup>236</sup>

From an international law point of view, the aforementioned constitutional-ity argument is hardly tenable. The Vienna Convention on the Law of Treaties establishes that a state may not invoke the provisions of its internal law as justification for its failure to perform according to treaty.<sup>237</sup> Likewise, a state may not assert that its consent to be bound was expressed in violation of a provision of the state's internal law requiring competence to conclude treaties, unless violation of the provision was manifest and concerned a rule of its internal law of fundamental importance.<sup>238</sup> In the case of Argentina, establishing that the consent given by the Argentine Congress in BIT practice has been in 'manifest' violation of a provision of Argentine internal law would be very difficult. Even if the 'violation' could be established, it could hardly be shown

<sup>231</sup> CE Alfaro, *Argentina: ICSID Arbitration and BITs Challenged by the Argentine Government*, Alfaro-Abogados, Dec 21, 2004, available at: <<http://www.alfarolaw.com/ima/tapa/alfaro3.htm>>.

<sup>232</sup> *Ibid.*

<sup>233</sup> *Ibid.*

<sup>234</sup> *Ibid.*

<sup>235</sup> *Ibid.* (reporting on Corte Suprema de Justicia [CSJN], (1 Jun 2004), *Jose Cartellone Construcciones Civiles SA v Hidroelectrica Norpatagonica SA l, La Ley* [LL] (Causa J-87, XXXVII RO) (Arg) (citing 11 Cód Civ 872 (Arg)).

<sup>236</sup> HA Grigera Naon, *Arbitration in Latin America: Progress and Setbacks*, 21 *Abr Int'l* 127, 165 (2005).

<sup>237</sup> Vienna Convention on the Law of Treaties Arts 27, Jan 27, 1980, 1155 UNTS 331, available at: <[http://untreaty.un.org/ilc/texts/instruments/english/conventions/1\\_1\\_1969.pdf](http://untreaty.un.org/ilc/texts/instruments/english/conventions/1_1_1969.pdf)>.

<sup>238</sup> Vienna Convention on the Law of Treaties Art 46, Jan. 27, 1980, 1155 UNTS 331, available at <[http://untreaty.un.org/ilc/texts/instruments/english/conventions/1\\_1\\_1969.pdf](http://untreaty.un.org/ilc/texts/instruments/english/conventions/1_1_1969.pdf)>. Some Argentine constitutional scholars have also noted such limitations imposed by international law. For example, Nestor Sagues has pointed out that the unconstitutionality of an international treaty could only be declared in the case where such a treaty violates the competence rule as set forth in the Article 46 of the Vienna Convention on the Law of Treaties. See Alfaro and Lorenti, above, n 220, at 422.



that the violation was ‘manifest’, as a violation is only ‘manifest’ if ‘objectively evident to any state conducting itself in the matter in accordance with normal practice and in good faith’.<sup>239</sup>

Judicial review for ICSID awards is more straightforward, as the ICSID Convention clearly requires member states to recognize ICSID awards as binding and enforce them as if they were final judgment of a court in that state.<sup>240</sup> Nevertheless, the issue may arise for investment arbitrations rendered by other arbitration tribunals such as International Chamber of Commerce (ICC) Court of Arbitration or *ad hoc* tribunals established in accordance with the rules of the United Nations Commission on International Trade Law (UNCITRAL). Thus Argentine courts could review the merits of such awards and set aside them on the ground that they were ‘unreasonable’ or ‘unconstitutional’.

c) Legislative Measures While using procedural tactics to suspend and delay the arbitration process and the unconstitutionality argument to defend its position, the Argentine government has also taken and is considering taking further legislative measures to limit and prevent further investment arbitration cases. To further this end, the government has canceled a 1996 decree<sup>241</sup> and is contemplating a new law to control international arbitration.

In 2003, the Argentine government passed a new decree terminating a 1996 Menen administration decision, which authorized the submission of disputes between Argentine government and certain foreign investors to international arbitration tribunals.<sup>242</sup> The new decree pointed out that referring such disputes to international arbitration ‘presented a series of difficulties from the legal, political and economic point of view’.<sup>243</sup>

This was not the end of the story, but rather the first step of the government’s attempt to ‘renationalise’ state-investor disputes.<sup>244</sup> Horacio Rosatti, then head of the office of the Attorney General in the Treasury, reportedly said that the

<sup>239</sup> Vienna Convention on the Law of Treaties Art 26(2), Jan. 27, 1980, 1155 UNTS 331, available at: <[http://untreaty.un.org/ilc/texts/instruments/english/conventions/1\\_1\\_1969.pdf](http://untreaty.un.org/ilc/texts/instruments/english/conventions/1_1_1969.pdf)>. The aforementioned *Ceskoslovenska Obchodni Banka, AS v The Slovak Republic* case also touched upon Article 46, but held it irrelevant as it is about ‘invalidity of treaties’, because the BIT at issue did not actually enter into force. *Case No ARB/97/4 Ceskoslovenska Obchodni Banka, AS v Slovak Republic Decision of the Tribunal on the Objections to Jurisdiction of May 24, 1999*, 14 ICSID Rev—Foreign Inv LJ 251, 265 (2000), available at: <<http://www.worldbank.org/icsid/cases/csob.pdf>>.

<sup>240</sup> ICSID Convention Art 54(1), available at: <[http://www.worldbank.org/icsid/basicdoc/CRR\\_English-final.pdf](http://www.worldbank.org/icsid/basicdoc/CRR_English-final.pdf)>.

<sup>241</sup> Decreto N° 1021/96 of 6 Sept 1996, available at: <<http://www.boletinoficial.gov.ar/bora.portal/PrimeraSecci%C3%B3n/BusquedaRapida/tabid/81/Default.aspx>> (last visit on 17 Mar 07).

<sup>242</sup> Decreto N° 966/2003 of 28 Oct 2003, available at: <<http://www.saij.jus.gov.ar/news/files/decreto966.html>> (last visit on 17 Mar 2007). See also Laurence Norman, *Government Reopens 7-Year-Old Case Vs Oil Group?* Dow Jones Int’l News, Oct 28, 2003 (reporting the 2003 decree annulling the 1996 executive order), available at: <[http://www.latinpetroleum.com/printer\\_2375.shtml](http://www.latinpetroleum.com/printer_2375.shtml)> (retrieved 27 Jan 2005); Cremades, above, n 50 (discussing the same event citing the same source as above), at 81.

<sup>243</sup> Decreto 966/2003, *ibid.*

<sup>244</sup> Norman, above, n 242.

aim of the government was to 'recover the jurisdiction of national courts'.<sup>245</sup> Further, he said that the government was considering measures to bring other state-investor disputes back within Argentina's ambit, including measures to ensure that, first, that the companies had 'exhausted all legal channels in Argentina' and second, 'that the final decisions of international tribunals should then undergo 'analysis' by the local courts'.<sup>246</sup>

Following a speech by President Kirchner on March 2005, which severely questioned eventual decisions of international or arbitration tribunals on state-investor claims,<sup>247</sup> two House Representatives of the ruling party reportedly promoted a bill aimed at limiting the intervention of national or international arbitral tribunals in cases involving the State, State agencies or enterprises.<sup>248</sup> The proposed bill prohibits access to international arbitration in such cases unless: a) an appeal of their decisions before Argentine federal courts is provided, b) the State's counterparty in the dispute is a foreign state (state-state disputes), or c) the Congress has exempted the case through a specific statute.<sup>249</sup> The bill also requests the Executive to inform the appropriate authorities of Argentina's repeal of any treaty accepting such jurisdiction; and, meanwhile, demands that the Executive, its agencies and enterprises issue necessary orders or decisions in order to annul prior agreements or decisions contrary to such provisions.<sup>250</sup> Since the bill generally requires all state-investor arbitration cases to be subject to the ultimate control of national courts, it would effectively abolish the finality and hence the autonomy of arbitration.

Other bills of similar nature have reportedly been introduced before the Argentine Congress since 2004.<sup>251</sup> For instance, a bill introduced in September 2004 in the House of Deputies would 'subject all disputes to which the State is a party to the exclusive jurisdiction of the Argentine courts and would prohibit any clause to the contrary'.<sup>252</sup> The bill would also require the denunciation of treaties in which the State had agreed to the jurisdiction of judicial or arbitral tribunals.<sup>253</sup> Another bill introduced in August 2005 would demand that matters relating to 'economic policy and determinations by Argentine courts concerning direct or indirect expropriation should not be subject to review by international courts or tribunals'.<sup>254</sup> The August 2005 bill would also require that a provision 'to that effect be included in each investment treaty as a condition for approval'.<sup>255</sup> If such bills are adopted, the Calvo Doctrine can be said to

<sup>245</sup> *Ibid.*

<sup>246</sup> *Ibid.*

<sup>247</sup> Tawil, above, n 5.

<sup>248</sup> *Ibid.*

<sup>249</sup> *Ibid.*

<sup>250</sup> *Ibid.*

<sup>251</sup> See OM Garibaldi, *Carlos Calvo Redivivus: The Rediscovery of the Calvo Doctrine in the Era of Investment Treaties*, *Transnat'l Dis. Mgmt*, Dec 2006, at 1.

<sup>252</sup> *Ibid.*

<sup>253</sup> *Ibid.*

<sup>254</sup> *Ibid* at 43–4.

<sup>255</sup> *Ibid* at 44.

have finally returned to its birthplace. It remains to be seen, however, whether the bills are mere rhetoric or will be ultimately adopted.

*b) Brazil*

Brazil, the Latin American giant, had long been resistant to arbitration until 1996 when the Arbitration Act was adopted to facilitate arbitration practice.<sup>256</sup> In 2002, Brazil ratified the New York Convention and paved the way for recognition and enforcement of foreign arbitration awards.<sup>257</sup> Yet Brazil remains suspicious of international arbitration on some level. This is witnessed first by a constitutionality challenge against the Arbitration Act and more recently by the restrictive approach taken in the 2004 Public-Private Partnership Law (the PPP Law).

a) The Constitutionality Challenge In October 1996, soon after the Arbitration Act was approved, an appeal (*MBV v Resil*) was brought before the Brazilian Federal Supreme Court challenging the validity of the Arbitration Act as a violation of the Constitution.<sup>258</sup> As the first case concerning the Arbitration Act, the case was brought to the attention of the eleven justices of the Court.<sup>259</sup> The case originated in a request of enforcement for a foreign arbitration award issued in Barcelona, Spain.<sup>260</sup> The Court, however, took the opportunity to review the constitutionality of the entire Act.<sup>261</sup>

Initially, the reporting justice (Min Sepúlveda Pertence) considered that certain articles (including Articles 6 and 7, admitting specific performance of the arbitration clause, Article 41, providing the exclusion of courts when faced with an arbitration clause, and Article 42, listing the circumstances under which an appeal might be made against a judgement given under Article 7) of the Arbitration Act were unconstitutional, mainly because they would represent a

<sup>256</sup> Before 1996, arbitration in Brazil were subject to a number of restrictions. For instance, pre-dispute submission to arbitration by contract were unenforceable unless both parties agreed to enter into another arbitration agreement after the dispute actually raised. Foreign arbitration awards would not be recognised or enforced until two court imprimaturs had been obtained, one from the court at the sea of arbitration and one from the Brazilian Federal Supreme Court. For further details, see ND Rubins, *Investment Arbitration in Brazil*, 4 *J World Investment & Trade* 1071, 1084–7 (2003).

<sup>257</sup> Brazil joined the New York Convention in 2002, by Decree No 4311 of 23 Jul 2002. *Ibid.*, at 1075 n 16.

<sup>258</sup> For details of the case, see Joao Bosco Lee, *Brazil, in International Arbitration in Latin America*, above, n 4, 63–6; see also Guido Santiago Tawil, *The Role of Arbitration and International, Regional, Subregional and Bilateral Treaties in Latin America*1, available at: <<http://www.bomchil.com/cas/articulos/The%20role%20of%20arbitration%20and%20international.pdf>> (last visited May 22, 2006).

<sup>259</sup> Tawil, *ibid.*, at 14.

<sup>260</sup> *Ibid.*

<sup>261</sup> In Brazil, the Supreme Court takes charge of the control of constitutionality, and has jurisdiction to examine the constitutionality of the entire law in case one of its provisions is called into question. Therefore, even though the matter of the validity of the arbitration clause was not argued in the enforcement procedure, the Court raised the issue in its own initiative. See Lee, above, n 258, at 64 n 15.

general denial of access to the judicial review provided for in Article 5, XXXV of the 1998 Constitution.<sup>262</sup> After more than five years of discussion, however, the position of the reporting judge was defeated in December 2001 by a seven to four decision, and the Arbitration Act was declared constitutional.<sup>263</sup>

Although the final decision was pro-arbitration, the position of the reporting judge and the other three dissenting judges, as well as the long deliberation, have demonstrated Brazil's persistent suspicion and hesitation towards international arbitration.

b) The PPP Law On December 30, 2004, Brazil adopted Federal Law No 11079, establishing a legal framework for Brazilian public-private partnerships (PPPs) and for bids and concession agreements within the scope of federal, state and local governments (the PPP Law).<sup>264</sup> The PPP Law permits parties to choose arbitration as a means to settle any dispute arising from PPP contracts.<sup>265</sup> It requires, however, that the seat of the arbitration be in Brazil and the proceedings be conducted in Portuguese.<sup>266</sup> Furthermore, the PPP Law only accepts domestic arbitration and prohibits the submission of any disputes in relation to a PPP contract to international arbitration. Foreign investors therefore can only seek redress before local courts or arbitration tribunals applying Brazilian law. This affirms the reluctance of the Brazilian Government to subject cases involving public entities, such as state-investor disputes, to international arbitration.<sup>267</sup>

c) *Bolivia*

In the last couple of years (and May Day in particular), Bolivia has taken dramatic steps to enhance control over foreign investments in that country. On May Day 2006, the Morales Government passed a decree to nationalise oil and gas industries. The decree stipulates that companies conducting activities in the gas and petroleum production industry have to turn over the entire production of hydrocarbons to 'Yacimientos Petroliferos Fiscales Bolivianos' (YPFB), which will control the distribution of these resources, and will also determine the amount and conditions at which gas and petroleum will be allocated to the

<sup>262</sup> Article 5, XXXV of the Constitution provides that 'the law shall not exclude from review by the Judiciary any violation of or threat to a right'. Constituição Federal [CF] [Constitution] Art 5, XXXV (Braz). For further details of the reporting justice's reasoning, see Lee, above, n 258, at 63–4. See also Tawil, above, n 258, at 14–15.

<sup>263</sup> See Tawil, above, n 258, at 15.

<sup>264</sup> Lei No 11.079, de 30 de dezembro de 2004, available at: <[https://www.planalto.gov.br/ccivil\\_03/\\_Ato2004-2006/2004/Lei/L11079.htm](https://www.planalto.gov.br/ccivil_03/_Ato2004-2006/2004/Lei/L11079.htm)>. An English version is available at: <[http://www.planejamento.gov.br/arquivos\\_down/ppp/legislacao/lei\\_11079\\_301204\\_eng.pdf](http://www.planejamento.gov.br/arquivos_down/ppp/legislacao/lei_11079_301204_eng.pdf)>.

<sup>265</sup> *Ibid.*, Art 11, III.

<sup>266</sup> *Ibid.*

<sup>267</sup> As noted by Rubins, the only path towards international arbitration recognised in Brazil is by carefully drafted arbitration clauses in contracts between a foreign investor and the Brazilian Government, as 'Brazil lacks the legal infrastructure that in many other countries of Latin America give foreign investors explicit guarantees of equitable treatment and access to international arbitration'. See ND Rubins, *Investment Arbitration in Brazil*, 4 *J World Investment & Trade* 1071, 1080–1, 1091 (2003).

domestic and foreign markets.<sup>268</sup> Bolivia's nationalization agenda has been described as 'another chapter in Latin America's turn to the left'.<sup>269</sup>

On 1 May 2007, Bolivia shocked foreign investors again by formally notifying the ICSID of its withdrawal from the ICSID convention.<sup>270</sup> According to Bolivian officials, there were several reasons for the withdrawal, including the ICSID's alleged bias towards corporations, the lack of a substantive appeals mechanism for arbitration rulings, and the confidentiality of arbitration hearings charged with resolving matters of public interest.<sup>271</sup>

Bolivia's withdrawal marked the first formal withdrawal from the ICSID system which has attracted 144 members.<sup>272</sup> A month earlier, it was reported that Bolivian President Evo Morales had called upon Latin American Governments to withdraw from the World Bank's investment dispute facility.<sup>273</sup>

Meanwhile, Bolivia is also reportedly pursuing revisions to its 24 bilateral investment treaties (BITs), seeking changes in the definition of investment, performance requirements, and dispute resolution.<sup>274</sup> Bolivia intends to limit the definition of an investment only to those that 'truly generate a value to the country'. For performance requirements, Bolivia demands greater scope to set requirements for the use of domestic inputs and set rules for the transfer of technology. Finally, on dispute resolution, Bolivia wants to limit investor-state arbitrations to domestic fora, rather than international venues such as ICSID. Bolivia has reported already notified several countries of its intention to renegotiate their bilateral investment treaties.<sup>275</sup>

<sup>268</sup> *Bolivia: Presidential Supreme Decree 28701 (Nationalization of Hydrocarbons Sector) (May 1, 2006)*, International Law In Brief (*Am Soc'y of Int'l L*, Wash, DC), May 25, 2006, available at: <<http://www.asil.org/ilib/2006/05/ilib060525.htm#11>>. See also Carin Zissis, 'Bolivia's Nationalization of Oil and Gas', posted at: <<http://www.cfr.org/publication/10682/>> (last visit on 4 Jun 2007).

<sup>269</sup> Carin Zissis, *ibid.*

<sup>270</sup> In an interview with Investment Treaty News, Pablo Solon, Bolivia's Charge D'affaires for Trade with the Ministry of Foreign Affairs in La Paz, says that a letter dated May 1st, 2007 was sent to the World Bank's president Paul Wolfowitz giving formal notice of Bolivia's departure from ICSID. See Vis-Dunbar, Peterson, and Diaz, above, n 6.

<sup>271</sup> Fernando Cabrera Diaz, 'Bolivia expounds on reasons for withdrawing from ICSID arbitration system', Investment Treaty News (27 May 2007).

<sup>272</sup> The legal implications of such withdrawal, however, remain unclear. Schreuer is of the view that access to ICSID arbitration may already be closed to some foreign investors from the moment a notice of withdrawal has been received by the World Bank, whilst Fernando Mantilla-Serrano contends that Bolivia's consent to ICSID arbitration is based on relevant BITs, and investors can continue to take advantage of such consent regardless Bolivia's withdrawal from the ICSID Convention. See Vis-Dunbar, Peterson and Diaz, above, n 6.

<sup>273</sup> As quoted by the Washington Post, President Morales said, '(We) emphatically reject the legal, media and diplomatic pressure of some multinationals that . . . resist the sovereign rulings of countries, making threats and initiating suits in international arbitration'. Reuters: 'Latin leftists mull quitting World Bank arbitrator', Washington Post (29 Apr 2007), posted at: <[http://www.bilaterals.org/article.php3?id\\_article=8099](http://www.bilaterals.org/article.php3?id_article=8099)> (last visited 4 Jun 2007).

<sup>274</sup> Vis-Dunbar, Peterson and Diaz, above, n 6

<sup>275</sup> It was said that Bolivia intended to make these changes one at a time, as these existing BITs became due to expire. It has been noted that, however, most of Bolivia's BITs also contain a so-called 'survival clause', enabling most of the protections offered in the BIT to continue to apply to investments made before the termination of the treaty concerned, for 10 to 20 years after that termination date, *ibid.*

These recent initiatives, including the nationalisation of oil and gas industries, the withdrawal from the ICSID and the revision of the BITs are clear indicators of a move toward Calvo's revival.

*d) Ecuador*

As noted above, Ecuador has attracted a number of investment treaty arbitration cases in recent years, among which most were brought on the basis of the Ecuador–US BIT.<sup>276</sup> In response, the Ecuadorian Government 'has publicly chafed at the obligations contained in such international treaties'.<sup>277</sup> For example, the Attorney General of Ecuador has reportedly said that he is studying whether Ecuador should terminate the BIT with the United States.<sup>278</sup>

A more concrete step, however, has been taken in May 2007, when the Republic of Ecuador announced its wish to terminate the Ecuador–US BIT.<sup>279</sup> The 1993 BIT that entered into force on 11 May 1997 stipulates that either party may give notice to terminate the agreement after its entry into force for ten years. It is therefore possible for the Ecuadorian or US Government to terminate the agreement unilaterally since 11 May 2007.<sup>280</sup>

According to Reuters, Ecuador's Foreign Affairs Minister Maria Espinosa has stated that her Government does not intend to keep the treaty with the United States, though it remains open to exploring other avenues for the mutual protection of US–Ecuador investment.<sup>281</sup> It thus provides another example of Latin America's return to the Calvo Doctrine.

*e) Venezuela*

Certain events which occurred in Venezuela in recent years have also been regarded as evidence of the resurgence of the Calvo Doctrine;<sup>282</sup> most notably, the Exploration Round Case and the MINCA Case.

a) The Exploration Round Case In December 1995 a group of Venezuelan nationals filed a petition with the Venezuelan Supreme Court asking for a ruling on the constitutionality of arbitration provisions in the Congressional

<sup>276</sup> Luke Eric Peterson, 'Ecuador announces that it wants out of US investment treaty', *Investment Treaty News* (8 May 2007).

<sup>277</sup> *Ibid.*

<sup>278</sup> Di Rosa, above, n 200, at 74 n 88.

<sup>279</sup> Luke Eric Peterson, 'Ecuador announces that it wants out of US investment treaty', *Investment Treaty News* (8 May 2007).

<sup>280</sup> Under the treaty, however, a party needs to provide one year's notice before the termination becomes effective. Also, the treaty protections will continue to be available for a further time-period of ten years, for 'investments made or acquired prior to the date of termination'. *Ibid.*

<sup>281</sup> See also Reuters: 'Trade benefits at risk as Ecuador scraps US Treaty' (7 May 2007), available at: <<http://www.reuters.com/article/bondsNews/idUSN0737429220070507>> (last visited on 4 Jun 2007).

<sup>282</sup> See Cremades, above, n 50, at 81.

Accord approving the 1995 Exploration Bidding Round.<sup>283</sup> One provision in the Congress Accord (Condition 17) stated that all disputes arising from Association Agreements (ie, oil exploration agreements with investors concluded following the bid) will be resolved by binding arbitration.<sup>284</sup> The Venezuelan citizens, however, challenged that this provision violated Article 127 of the Venezuelan Constitution, which, they believed, gave local courts exclusive jurisdiction over such contracts.<sup>285</sup> Article 127 of the 1961 Venezuelan Constitution states as follows:

in contracts of public interest, even when not expressly stated, there is considered to be incorporated, if not against the nature of the contract, a clause pursuant to which any doubt or dispute that may arise in connection with such contracts and which cannot be amicably resolved by the parties, shall be decided by the competent courts of the Republic, in accordance with its laws, and may not give cause or reason to foreign claims.<sup>286</sup>

Since the validity of arbitration had never been decided by the Supreme Court and there had been contradictory opinions from the Attorney General's office on this issue,<sup>287</sup> the case was rather controversial.

On 17 August 1999, the Venezuelan Supreme Court threw out a milestone ruling on the Case,<sup>288</sup> upholding the constitutionality of the arbitration clause in the Accord. The Supreme Court held that although the agreements were 'contracts of public interest', they fell within the exception in Article 127, which waived the application of the local court jurisdiction requirement in case such application would be 'against the nature of the contract'.<sup>289</sup> The Court held that this exception 'enabled the [g]overnment, subject to subsequent congressional approval, to decide—on a case-by-case basis—whether to include an arbitration clause in a contract of public interest'.<sup>290</sup> The Court justified its conclusion by stating that, in the present case, 'an eventual arbitral tribunal would not be confronted with issues concerning "the national interest."' <sup>291</sup>

Although the Exploration Round Case was resolved in favour of arbitration and foreign investors, the uncertainty of the constitutionality of arbitration has not been eradicated, given that the Venezuelan Supreme Court did little to clarify the ambiguity surrounding the 'nature of the contract' exception. The new Constitution, adopted in 1999, after the case was settled, did nothing to resolve the question. Contrary to what foreign investors have hoped for, the new

<sup>283</sup> EE Elijuri, *Oil Opening: A Constitutional Challenge* (1996), available at: <<http://www.natlaw.com/pubs/spveen1.htm>>.

<sup>284</sup> See, *ibid*

<sup>285</sup> See Cremades, above, n 50, at 81.

<sup>286</sup> *Ibid*.

<sup>287</sup> See Elijuri, above, n 283.

<sup>288</sup> Cremades, above, n 50, at 83 (citing Supreme Court Decision of Aug 17, 1999, File No 812–29).

<sup>289</sup> *Ibid*.

<sup>290</sup> *Ibid*.

<sup>291</sup> *Ibid*.

Constitution retains Article 127's existing language along with its exception, but renumbered it as Article 151.<sup>292</sup>

Further, the President of Venezuela issued, in March 2001, Instructive Order No 4 'to regulate the internal review mechanisms of public interest contracts to be executed by the Republic, particularly, in connection with the inclusion of international arbitration clauses'.<sup>293</sup> According to this Order, contracts concerning public interests must be submitted to the Attorney General of the Republic for an opinion with regard to the legality of the arbitration clause in light of Article 151 of the new Constitution.<sup>294</sup>

Additionally, as new members of a recently-established Supreme Tribunal of Justice have been appointed, the Supreme Court's previous favourable ruling upholding the constitutionality of an arbitration clause in a public contract might also be changed.<sup>295</sup> This perception seems to have been confirmed in the *Minera las Cristinas, CA (MINCA) v Corporación Venezolana de Guyana (CVG)* case ('MINCA Case'),<sup>296</sup> a discussion of which follows.

b) The MINCA Case The MINCA Case involved a 1992 mining agreement between CVG, an agency of Venezuelan Government, and MINCA, a Venezuelan company ninety-five per cent owned by a Canadian company, Vannessa Ventures Ltd. The agreement was for the exploration, development and exploitation of gold and copper in an area called 'Las Cristinas'.<sup>297</sup> The agreement contained a dispute resolution provision requiring 'that any dispute between parties would be referred to an arbitration seating in Venezuela, in accordance with the ICC Arbitration Rules and the Venezuelan Code of Civil Procedure'.<sup>298</sup> A dispute arising in 2001 between the two parties resulted in the CVG terminating the mining agreement and then taking physical control of the site.<sup>299</sup> Later the Ministry of Energy and Mines passed a resolution to terminate the mining agreement and the government 'issued a Presidential Decree declaring the area of Las Cristinas reserved to the National Government'.<sup>300</sup>

MINCA first challenged CVG's action, and then the ministerial resolution and the Presidential Decree before domestic courts, but all its requests for judicial review were dismissed.<sup>301</sup> In May 2002, MINCA filed a petition in front

<sup>292</sup> Constitution of the Bolivarian Republic of Venezuela, Article 151. An unofficial English translation of the Constitution can be found at the Australia Venezuela Solidarity Network Chavez website: <<http://www.venezuelasolidarity.org/?q=node/53>> (last visited on 17 Mar 2007).

<sup>293</sup> B Weininger and DM Lindsey, 'Venezuela', in *International Arbitration in Latin America*, above, n 4, 235.

<sup>294</sup> *Ibid* at 235–6.

<sup>295</sup> See Cremades, above, n 50, at 83.

<sup>296</sup> BM Cremades, *Resurgence of the Calvo Doctrine in Latin America*, (2006) 7 *Business Law International* 65 (citing Decision No 0083 of the Political Administrative Chamber of the Supreme Court, of 15 Jul 2004).

<sup>297</sup> *Ibid*.

<sup>298</sup> *Ibid* at 66.

<sup>299</sup> *Ibid*.

<sup>300</sup> *Ibid*.

<sup>301</sup> *Ibid*.



of the Supreme Court of Justice, ‘requesting the enforcement of the arbitration clause’.<sup>302</sup> The Supreme Court dismissed MINCA’s petition on the ground that the subject matter concerned state assets and therefore could not be subject to arbitration.<sup>303</sup> The Court founded its decisions on, *inter alia*, the aforementioned Article 151 of the Constitution, which generally subjects contracts of public interests to the exclusive jurisdiction of local courts.<sup>304</sup> It thus resurrected the uncertainty of Venezuela’s position towards international arbitration.

The aforementioned events in Latin American states, clearly suggest that the tide of investment policy seems to be turning. No longer are Latin American states as eager to embrace neo-liberalism. Rather, a more conservative or nationalistic approach seems to be gaining the upper hand in these states.<sup>305</sup> As a result, Calvo does not seem to be dead, as many assumed or predicted, but rather alive and well.

## 2. The Revival of Calvo Doctrine: Beyond Latin America

The resurgence of the Calvo Doctrine identified above does not seem to confine itself within Latin America. Rather, Latin American states’ recent Calvo moves coincided with a worldwide trend reflecting, revising and rejecting neo-liberalist investment instruments, while embracing a more conservative and balanced regime for international investment. Thus, firstly, to everyone’s surprise, the Calvo Doctrine ‘suddenly is in vogue again . . . in the US Congress’!<sup>306</sup> Mounting cases against the US government before international arbitration tribunals, particularly those under the NAFTA Chapter 11, has put the United States, a long-time unreserved advocate of investment liberalism, on defence, and forced it to re-examine investment treaties and treaty-based arbitration for the first time in history from a defendant’s perspective. It has been noted that, since the mid-1990s, there has been ‘a gradual, relatively moderate (but unmistakable) weakening’ in the US of the commitment to the traditional high standard of investment protection.<sup>307</sup> Thus in 1994 the Clinton administration dropped in its

<sup>302</sup> BM Cremades, *Resurgence of the Calvo Doctrine in Latin America*, (2006) 7 *Business Law International* 66.

<sup>303</sup> *Ibid.*

<sup>304</sup> *Ibid* at 67.

<sup>305</sup> The ‘revival’ or ‘resurgence’ of the Calvo Doctrine in Latin America has attracted wide attention. For instance, in Sept 2005, the Washington DC Bar organized a timely seminar entitled ‘The Resurgence of the Calvo Doctrine?’ District of Columbia Bar, ‘The Resurgence of the Calvo Doctrine?’ seminar program, available at: <[http://www.bg-consulting.com/docs/calvo\\_program.jpg](http://www.bg-consulting.com/docs/calvo_program.jpg)> (last visited Feb 15, 2007).

<sup>306</sup> David Schneiderman, *Calvo in Congress: The Migration of Constitution-Like Investment Rules*, available at: <<http://www.ualberta.ca/GLOBALISM/pdf/Aus%20pdfs/schneidermanab.pdf>> (last visited Feb 15, 2007).

<sup>307</sup> Garibaldi noted that such change might be the result of a political compromise between the country’s traditional position and the pressure from the circumstantial alliance of at least three political forces, namely the pro-regulation interests on the left, the legal defence interest and the anti-internationalist interests on the right. Garibaldi, above, n 251, s 1.03 [3] [c].

model BIT the ‘umbrella clause’, a provision requiring the state to observe obligations it had assumed in relation to the foreign investment.<sup>308</sup> In 2001, the three NAFTA member states, led by the US, adopted a binding interpretation declaring that ‘[t]he concept of ‘fair and equitable treatment’ and ‘full protection and security’ do not require treatment in addition to or beyond that which is required by the customary international law minimum standard of treatment of aliens’,<sup>309</sup> in an effort to eliminate the undesired influence of the *Pope & Talbot Inc. v Canada*<sup>310</sup> jurisprudence. A bill was enacted in 2002 regarding the Executive’s authority to negotiate trade and investment treaties, which requires that,

. . . the principal negotiating objectives of the United States regarding foreign investment are to reduce or eliminate artificial or trade-distorting barriers to foreign investment, *while ensuring that foreign investors in the United States are not accorded greater substantive rights with respect to investment protections than United States investors in the United States*, and to secure for investors important rights comparable to those that would be available under *United States legal principles and practice*.<sup>311</sup> (emphasis added)

This bill was regarded as ‘Calvo in the Congress’ because it adopted language very similar to the Calvo Doctrine as policy in international investment treaty-making practice. As a result, the US government recently revised its Model BIT<sup>312</sup> and adopted a more conservative approach in its BIT practice. A narrower definition of ‘investment’, for example, was adopted in the US–Uruguay BIT signed in December 2004, the very first after the 2004 Model BIT was adopted.<sup>313</sup> Indirect expropriation has been clarified and redefined so that mere adverse effect on the economic value of an investment does not constitute an indirect expropriation and that, except in rare circumstances, non-discriminatory regulatory actions by a party aimed at protecting legitimate public welfare objectives, such as public

<sup>308</sup> *Ibid.*

<sup>309</sup> *Ibid.*

<sup>310</sup> *Pope & Talbot Inc v Canada*, 13 *World Trade & Arb Mat'l* 61 (Apr 10, 2001), available at: <[http://www.dfait-maeci.gc.ca/tna-nac/documents/Award\\_Merits-e.pdf](http://www.dfait-maeci.gc.ca/tna-nac/documents/Award_Merits-e.pdf)>. The Award held that fair and equitable treatment and full protection and security standards imposed an additional obligation to the international minimum standard of treatment under general international law. *Ibid* at ¶ 111.

<sup>311</sup> Trade Act of 2002, *Pub L* No 107–210, § 2102 (b)(3), 116 Stat. 995.

<sup>312</sup> Treaty Between the Gov’t of the United States of Am. and the Gov’t of [Country] Concerning the Encouragement and Reciprocal Prot. of Inv. (2004 Model BIT) (United States Trade Representative), available at: <[http://www.ustr.gov/assets/Trade\\_Sectors/Investment/Model\\_BIT/asset\\_upload\\_file847\\_6897.pdf](http://www.ustr.gov/assets/Trade_Sectors/Investment/Model_BIT/asset_upload_file847_6897.pdf)> (last visited Jan 22, 2007).

<sup>313</sup> Instead of the previously used open asset-based definition of investment, the US–Uruguay BIT has opted to define the term ‘investment’ in economic terms, which in principle covers every asset that an investor owns and controls, but adds the qualification that such assets must have the ‘characteristics of an investment’, such as ‘the commitment of capital or other resources, the expectation of gain or profit, or the assumption of risk’. Treaty Between the United States of Am. and the Oriental Republic of Uruguay Concerning the Encouragement and Reciprocal Prot. of Inv, US–Uru, [Date of Treaty], available at: <[http://www.ustr.gov/assets/Trade\\_Agreements/BIT/Uruguay/asset\\_upload\\_file748\\_9005.pdf](http://www.ustr.gov/assets/Trade_Agreements/BIT/Uruguay/asset_upload_file748_9005.pdf)> (last visited Feb 15, 2007) at § A, Art 1 [hereinafter US–Uruguay BIT]. This is complemented by exclusions of several kinds of assets (eg certain debt instruments), *ibid.*

health, safety, and the environment, do not constitute indirect expropriations. A special procedure was devised in the US–Uruguay BIT at the early stages of the dispute settlement process, with a view to discarding ‘frivolous’ claims.<sup>314</sup> Moreover, the BIT envisions the possibility of setting up a mechanism for appellate review, in order to ensure greater consistency in arbitral awards.<sup>315</sup>

Secondly, many other states, like Canada, Japan and certain Latin American states, are following the steps of the US. Thus, it has been observed that Canada’s new model BIT is noteworthy ‘because it steps back from a current high water mark of private investor protection’<sup>316</sup> The EU also has taken legal actions against some of its member states requiring them to amend their BITs, so as to comply with the EU law reserving right to introduce restrictions on capital-movements in case serious financial or security difficulties arise, which are absent from current BITs.<sup>317</sup> An UNCTAD study has discovered that a ‘new generation of BITs’ has actually emerged, modelled after the new US and Canadian Model BITs.<sup>318</sup> These new BITs exhibit four main features, most of which have the effect of either narrowing down substantive obligations, or tightening-up access to the state-investor dispute settlement mechanism.<sup>319</sup>

Thirdly, world-wide efforts have failed time and again to create a global mechanism that protects and liberalizes investment flows. The debacle of the Multilateral Agreement on Investment (MAI)<sup>320</sup> within the OECD demonstrated that a liberal approach toward international investment was not viable even among developed countries, namely the OECD member states.<sup>321</sup> The

<sup>314</sup> UN Conference on Trade and Development [UNCTAD], *Recent Developments in International Investment Agreements*, UNCTAD/WEB/ITE/IIT/2005/1, IIA MONITOR No 2 (2005), at 5, available at: <<http://www.unctad.org/Templates/Download.asp?docid=6294&lang=1&intItemID=3784>>.

<sup>315</sup> *Ibid.*

<sup>316</sup> James McIlroy, *Canada’s New Foreign Investment Protection and Promotion Agreement: Two Steps Forward, One Step Back?*, 5 *J World Investment & Trade* 621, 646 (2004).

<sup>317</sup> In 2004, the European Commission had notified Denmark, Austria, Finland and Sweden that provisions in certain of their BITs guaranteeing the free movement of investment-related transfers were in conflict with EU rules. The EU rules maintains that restrictions on capital-movements can be introduced when serious financial or security difficulties arise, which are omitted from certain BITs concluded by the aforementioned EU member-governments. Consequently, the European Commission has pressured these governments to revise their BITs accordingly. Apart from Denmark which took a conciliatory position, Austria, Finland and Sweden have refused to revise or annul the treaties in question. In Oct 2005, the Commission took the three governments to the European Court of Justice. The case is pending at the moment. For further details, see Damon Vis-Dunbar, ‘European Governments defend BITs in lawsuit brought by EU Executive Branch’, *Investment Treaty News* (Mar 16, 2007); See also Luke Eric Peterson, ‘Euro Commission takes three states to Euro Court of Justice over BITs’, *Investment Treaty News* (Oct 26, 2005); Luke Eric Peterson, ‘EU Executive Branch Looking at Possible Incompatibilities of Some European BITs’, *INVEST-SD* (May 24, 2004). For an analysis on the EU’s competence on external investment treaty making, see Wenhua Shan, ‘Towards an Common European Community Policy on Investment Issues’, 2 *The Journal of World Investment* 603, Sept 2001.

<sup>318</sup> UNCTAD, above, n 314, at 4.

<sup>319</sup> *Ibid* at 4–6.

<sup>320</sup> Organisation for Economic Co-Operation and Development (OECD), *Multilateral Agreement on Investment: Documentation From the Negotiations*, available at: <<http://www1.oecd.org/daf/mai/>> (last visited Jan 22, 2007).

<sup>321</sup> *Ibid.*

Cancun ministerial conference, which led to the abandonment of the talks on a MAI within the WTO framework,<sup>322</sup> in turn, clearly refused another major effort to set forth a liberal investment regime on a global scale.

Finally, the change of governmental attitude towards investment liberalization is also reflected in domestic legal changes and BIT growth trends. As Table 6 shows, restrictive measures have been on the surge since 2000. In 2000, only 2 per cent of the legal changes were geared toward more restrictions—this increased to 7 per cent in 2001. In 2003 it reached 10 per cent, followed by a further three point increase in 2004 and another seven point increase in 2005 reaching 20 per cent of the total changes. The only drop during this period occurred in 2002, from 7 per cent to 5 per cent, and did not change the general conservative trend. (*Table 6: Restrictive Measures Adopted 2000–2005*) While there are still new BITs concluded each year, the general trend of newly-signed BITs has declined since 2001, as shown in Table 3.

**Table 6: Restrictive Measures Adopted 2000–2005<sup>323</sup>**

Year	Number of Legal Changes	Number of more restrictive measures adopted	Percentage of restrictive measures in total changes
2000	150	3	(2%)
2001	208	14	(7%)
2002	248	12	(5%)
2003	244	24	(10%)
2004	271	36	(13%)
2005	205	41	(20%)

To sum up, the international investment regime tide has been turning even beyond Latin America: neo-liberalism is no longer unreservedly favoured by all countries, developed and developing states alike.<sup>324</sup> On the contrary, now even developed states, including the strongest advocates of a liberal investment regime, such as the United States, have started to rethink the roles and functions of international investment treaties and to redesign their BIT programs in order to contain the threats posed by the previously unfettered liberal investment regimes.<sup>325</sup> Calvo is regaining ground in the battle of international investment law.

<sup>322</sup> Decision Adopted by the General Council, *Doha Work Programme*, § (1)(g), WT/L/579 (Aug 2 2004), available at: <[http://www.wto.org/english/tratop\\_e/dda\\_e/ddadraft\\_31jul04\\_e.pdf](http://www.wto.org/english/tratop_e/dda_e/ddadraft_31jul04_e.pdf)>.

<sup>323</sup> Source: *World Investment Report 2006*, p 24.

<sup>324</sup> The 1990s may be regarded as an era of ‘neo-liberalism’. In that period, investment and trade liberalisation had gain almost universal support in all states, developed or developing. For a good study on neo-liberalism and international investment law, see M Sornarajah, ‘The Neo-Liberal Agenda in Investment Arbitration: Its Rise, Retreat and Impact on State Sovereignty’, in this book.

<sup>325</sup> The aforementioned ‘Calvo in Congress’ episode is a best example of such change of attitude in developed states.

### 3. Restoration of the Calvo Doctrine?

The resurgence of the Calvo Doctrine demonstrates that the neo-liberalist ideology underpinning international investment instruments exemplified by existing BITs<sup>326</sup> is neither ideal nor sustainable. However, it is unclear whether the current trend is going to eventually lead to, and sustain, a complete restoration of the Calvo Doctrine in its original form, or whether it is only a transitory phenomenon, which will soon die off. In other words, it is uncertain whether the political economy of international investment law will be completely replaced by the Calvo Doctrine (as an example of ‘economic nationalism’), or will continue to be dominated by neo-liberalism (or ‘economic liberalism’).<sup>327</sup>

The current trend is likely to continue, but unlikely to restore Calvo in its original form. Rather, Calvo will be revived in a modified form, striking a balance between the rights and interests of the investors and those of the states. There are two reasons for the sustainability of this trend. First, as elaborated above, the resurgence of Calvo is not a single event happening in one country or one region. Rather, it has been echoed throughout the world. Such a global trend is unlikely to quickly disappear. Second and more fundamentally, the decline and resurgence of Calvo has exposed a fundamental flaw in both the previous classical Calvo regime and the current dominant neo-liberal regime: the imbalance of the rights and obligations between the host state and foreign investors.

<sup>326</sup> BITs present themselves as liberalist instruments, as evidenced by the goals typically referred to in their preambles, ie, to create favourable conditions for investment and to increase economic prosperity. The history of the birth and development of BITs also shows that, as observed by Kenneth Vandavelde, ‘a principal inducement for states to enter into a BIT has been precisely that it affirms liberalism’. KJ Vandavelde, *The Political Economy of a Bilateral Investment Treaty*, 92 *Am J Int’l L* 621, 627 (1998). This nature of BITs, as embodied in their preambles, has actually been acknowledged by arbitration tribunals and has had an impact in the interpretation of BIT provisions. Vandavelde, *ibid*, at 627–8.

<sup>327</sup> According to Vandavelde, who pioneered studies in the political economy of BITs, there are three dominant political economic theories relevant to BITs: economic nationalism, economic liberalism and Marxist economics. Among them, Marxist economics is generally hostile to foreign investment, considering it a tool of neo-colonialism that subjects local economies to foreign control and promotes underdevelopment. Following the collapse of the Soviet Bloc and the reforms in China and other formerly Communist states, this theory is no longer practised. ‘Economic nationalism’ holds that international investment should be regulated to ensure that it promotes national political policy. Economic nationalist developing states therefore have sought to control inward and outward investment flows through interventionist measures—such as protective tariffs, tax incentives, investment screening, and performance requirements. The goals are to attract those foreign investments that would further their development policy, to prevent establishment of those investments that would not, and to ensure that investment, once established, would continue to operate in accord with national policy. Calvo Doctrine is a typical reflection of this theory, particularly in developing states. Economic liberalism posits that free markets, unfettered by state regulation, would result in the greatest prosperity for all. Accordingly, liberalism also advocates the free movement of capital across borders, which in essence holds that the state should permit the market to determine the direction of international investment flows. This theory is generally favoured by developed capital exporting states, which have actively promoted BIT programmes, particularly since the 1970s, as an essential neo-liberalist tool. For a good analysis of the basic features of these theories, and BITs as quintessentially liberalist instruments, see Vandavelde, *ibid*, at 621–8. See also, Sornarajah, above, n 324.

Before the 1980s, when Calvo dominated Latin America and indeed international forums such as the United Nations General Assembly, states had every power and no substantial international law restraints,<sup>328</sup> while investors took great commercial and non-commercial risks without sufficient international legal protection. There was an imbalance in favor of the states. Since the 1980s, and particularly in the 1990s when states—including Latin American states—embraced the neo-liberalistic investment regime, foreign investors have enjoyed every ‘constitution-like’ guarantee and privilege derived from BITs and other investment instruments,<sup>329</sup> while governments were forced to retreat—there was too much of an imbalance favouring foreign investors. Neither regime is ideal, although both of them may have some merit.

Calvo is unlikely to be completely restored because no country can now afford to be entirely cut off from interactions with the world in this era of globalization. With intensified international interactions, there come more extensive international rules, setting forth international substantive standards and procedural remedies. To reject such standards and remedies altogether, as Calvo originally advocated, would be neither plausible nor desirable. The classical Calvo Doctrine no longer fits the world as it is now, if it ever fit the world before. On the other hand, the neo-liberal regime must be reformed to avoid repeating the ‘Catch-22’ situations that Argentina and many other Latin American states have faced in recent years.<sup>330</sup> An ideal FDI regime, therefore, might have to be found somewhere between the two previously existing regimes, perhaps a ‘Third Way’ in international investment law.

The new generation of BITs, exemplified by the new US and Canadian model BITs, may be regarded as a step in that direction.<sup>331</sup> They nevertheless demonstrate only small changes within the previous liberalist paradigm of BITs. These

<sup>328</sup> For details of the origin of Calvo Doctrine and its international influence before 1980s, see s I above.

<sup>329</sup> Some scholars have argued that BITs and other investment treaties display the characteristics of domestic constitutions in that they bind governments over long periods of time to constitution-like rules designed to protect the private property of individuals and firms against discriminatory treatment or takings of investment interests, and that they generate constitution-like entitlements legally enforceable before tribunals and courts. See David Schneiderman, *NAFTA’s Takings Rule: American Constitutionalism Comes to Canada*, 46 *U of Toronto LJ* 499 (1996). See also Stephen Clarkson, *Somewhat Less Than Meets the Eye: NAFTA as Constitution*, Address at the International Sociological Association Annual Meeting (Jul 27, 1998), available at: <<http://www.chass.utoronto.ca/~clarkson/manuscripts/ecconstitution98.html>>.

<sup>330</sup> In the annulment application, for example, Argentina argued that the judgment by the ICSID in the CMS case placed the country in a ‘Catch-22’ when facing an emergency economic situation: a state may either do nothing and let the economy collapse, or do something to rescue the economy but then go bankrupt paying huge compensation to investors affected by such rescuing efforts. See Luke Peterson, *Argentina Moves to Annul Award in Dispute with CMS Company over Financial Crisis*, Investment Treaty News (ITN) (Int’l Inst Sustainable Dev, Winnipeg, Manitoba, Canada), Oct 26, 2005, at § 4, para 14, available at: <[http://www.iisd.org/pdf/2005/investment\\_investstd\\_oct26\\_2005.pdf](http://www.iisd.org/pdf/2005/investment_investstd_oct26_2005.pdf)>.

<sup>331</sup> For instance, James McIlroy has noted that the new Canadian model BIT attempts to ‘strike a balance between private investors’ rights and the right of a sovereign State to regulate in public interest’. McIlroy, above, n 316, at 644–5.

changes do not alter the fundamental character of these investment treaties as quintessential liberalist instruments, which only protect and ‘empower’ investors without sufficient consideration of the rights of host states and the duties of the investors.<sup>332</sup>

To fully address the problem of the imbalance of rights and obligations between investors and states, a more radical and even revolutionary solution is needed. There are two alternative possibilities: one is to complement the current liberalist or capitalist BITs with binding instruments, in the form of bilateral, or preferably global, agreements on the rights of states and the obligations of foreign investors (a ‘complementary approach’). Efforts of this nature have been made at global and multilateral levels, but with only very limited success.<sup>333</sup> Hence, within the OECD, the Guidelines for Multinational Enterprises have been adopted to regulate the conduct of multinational corporations, but lack binding force.<sup>334</sup> Globally, the UN Code of Conduct on Transnational Corporations had been drafted and discussed intensively in the 1970s and 1980s, but was finally abandoned in the 1990s during the heatwave of global investment liberalization.<sup>335</sup> It may be easier to simply resume work on the UN Code of Conduct with a view to establishing a binding global treaty on the regulation of the duties and responsibilities of international investors.

The other possibility, which might be called a ‘consolidated approach’, is to add provisions on the responsibilities of foreign investors to the existing bilateral or multilateral investment instruments. This would effectively redefine the nature and ideology of BITs, moving from a one-sided liberalist instrument assuring and empowering foreign investors, toward a more rational instrument that balances the interests, rights and responsibilities of all parties concerned, particularly between host state and foreign investors. In this regard, one has to refer to the impressive work done by the International Institute for Sustainable Development (‘IISD’), which developed the IISD Model International Agreement on Investment for Sustainable Development (‘IISD Model Investment Agreement’).<sup>336</sup> The IISD

<sup>332</sup> Brewer and Young, for example, observed in the 1990s that the focus of investment law making had been shifted from an emphasis on ‘firms’ obligations and governments’ rights’ to an emphasis on ‘firms’ rights and governments’ obligations’. See TL Brewer and S Young, *Towards a Multilateral Framework for Foreign Direct Investment: Issues and Scenarios*, Transnational Corporations, vol 4, no 1 (Apr 1995), at 74–5.

<sup>333</sup> See Wenhua Shan, *The Legal Framework of EU-China Investment Relations* (Oxford, Hart, 2005), at 274.

<sup>334</sup> For the text and further information about the Guidelines, namely the OECD Declaration and Decisions on International Investment and Multinational Enterprises (Nov 2000) DAF/IME (2000) 20, see <[http://www.oecd.org/document/28/0,2340,en\\_2649\\_34889\\_2397532\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/28/0,2340,en_2649_34889_2397532_1_1_1_1,00.html)> (last visited on Mar 17, 2007).

<sup>335</sup> The last draft version was completed in 1988, but work on it was suspended in early 1990. For further details of the draft code, see M Sornarajah, *The International Law on Foreign Investment*, 275–83 (Cambridge, CUP, 2004).

<sup>336</sup> The Model Agreement, together with a negotiators’ handbook, is available on the International Institute for Sustainable Development (IISD) website: <[http://www.iisd.org/publications/publication\\_list.aspx?themeid=7](http://www.iisd.org/publications/publication_list.aspx?themeid=7)> (last visit on 17 Mar 2007). The Model Agreement was also published in 20 *ICSID Rev—Foreign Investment LJ* 91, (2005).

Model Investment Agreement marks the first major attempt to construct such a consolidated instrument on international investment. It aims to address the balance of interests among foreign investors, the host states and the home state. In a separate article entitled 'Objective', it sets out its objectives '[promoting] foreign investment that supports sustainable development, in particular in developing and least developed countries'.<sup>337</sup> The goal of promoting investment is no longer a singular objective, but one that is complemented and qualified by the goal of sustainable development. Also, the Preamble clearly states that it seeks 'an overall balance of rights and obligations in international investment between investors, host countries and home countries'.<sup>338</sup> To strike such a balance, the text of the IISD Model Investment Agreement provides for sets of substantive rights and obligation for each of the actors, as shown in Table 7 below. The Agreement also sets out three mechanisms to implement such rights and obligations. It encourages states to incorporate the rights and obligations in the agreement into domestic laws, which eventually enables domestic remedies to be brought to bear on investors.<sup>339</sup> It allows host states to raise the issues of compliance with the obligations in front of the international dispute settlement mechanism devised therein, either by a direct claim by a host state to annul rights of an investor under this agreement due to persistent failure to comply with the obligations, or a counterclaim to an investor-state claim based on the breach of an obligation by an investor.<sup>340</sup> Finally, it models the OECD Guidelines on Multinational Enterprises and provides for a national authority to thoroughly investigate civil society complaints of non-compliance in the host or home state.<sup>341</sup>

The IISD Model Investment Agreement notably contains some interesting innovations. For example, allowing a direct claim by host states against foreign investors for failing to comply with their investor obligations is a novel approach.<sup>342</sup> Although it is yet unknown whether and how it might work in practice, it is indeed a 'logical corollary' of the one-sided investor-state dispute settlement regime that exists for current international investment instruments.<sup>343</sup> Despite that it is still in an early stages of development and that there is certainly room for further improvement,<sup>344</sup> the IISD Model Agreement represents the first genuine effort to strike a balance between the rights and obligations of host states and foreign investors and therefore deserves serious consideration.

<sup>337</sup> IISD Model International Agreement on Investment for Sustainable Development (Int'l Inst Sustainable Dev (IISD) 2005), Art 1, 20 *ICSID Rev—Foreign Investment LJ* 91, (2005) [hereinafter IISD Model Agreement].

<sup>338</sup> *Ibid.*

<sup>339</sup> Howard Mann, *The IISD Model International Agreement on Investment for Sustainable Development: An Introductory Note*, 20 *ICSID Rev—Foreign Investment LJ* 84, 86 (2005).

<sup>340</sup> *Ibid.*, at 86.

<sup>341</sup> *Ibid.*, at 87.

<sup>342</sup> IISD Model Agreement, above, n 337, at Art 18(C).

<sup>343</sup> Mann, above, n 339, at 86.

<sup>344</sup> For example, Articles 11(A) and (B) might be improved by referring to the overriding effect of binding international law, particularly international treaty obligations, when asserting the applicability of local laws and local jurisdiction of the host state. See IISD Model Agreement, above, n 337, Art 11(A)–(B).



**Table 7: Summary of Key Rights and Obligations of Foreign Investors, Host States and Home States<sup>345</sup>**

Parties	Rights	Obligations
Foreign Investors	<ul style="list-style-type: none"> <li>• National treatment</li> <li>• Most favoured nation</li> <li>• Minimum international standards</li> <li>• No expropriation without compensation</li> <li>• Senior management</li> <li>• Transfer of assets</li> </ul>	<ul style="list-style-type: none"> <li>• Comply with local laws</li> <li>• Pre-establishment impact assessment</li> <li>• Anti corruption</li> <li>• Environmental management/ international environmental obligations</li> <li>• Human rights protection</li> <li>• Core labor standards</li> <li>• Provision and publication of information</li> </ul>
Host States	<ul style="list-style-type: none"> <li>• Inherent right of states to regulate, articulate development policy</li> <li>• Right to performance requirements (exception from national treatment)</li> <li>• Investment promotion</li> <li>• Access to investor information</li> </ul>	<ul style="list-style-type: none"> <li>• Investor civil liability</li> <li>• Procedural fairness</li> <li>• Maintenance of environmental standards, labour standards</li> <li>• Minimum standards for: environmental assessment, core labor, human rights</li> <li>• Anti-corruption</li> <li>• Publication of information</li> </ul>
Home States	<ul style="list-style-type: none"> <li>• Claim protection of investor rights in dispute settlement</li> </ul>	<ul style="list-style-type: none"> <li>• Assistance to facilitate foreign investment</li> <li>• Provide information on investors</li> <li>• Ensure procedural laws allow for hearing on investor liability</li> <li>• Anti-corruption</li> </ul>

## VI. THE CHANGING LANDSCAPE OF INTERNATIONAL INVESTMENT LAW: FROM NORTH-SOUTH DIVIDE TO PRIVATE-PUBLIC DEBATE

The revival of Calvo in and beyond Latin America not only signals a significant change of attitude and ideology toward the international investment regime, but also marks a noticeable shift of tension in international investment law, indicating progress. In previous debates on international investment instruments, such as UN General Assembly Resolutions<sup>346</sup> and BITs, the tension was pri-

<sup>345</sup> Mann, above, n 339, at 88.

<sup>346</sup> Resolutions 1803 and 3281 are the most important resolutions relating to the standard of treatment for international investment, particularly on the issue of expropriation and its compensation. The two instruments are traditionally read as taking contrasting stands and having different legal effects. The author is, however, of the view that the two resolutions should be read together as one emerging standard of two different development stages, carrying the same legal implications.

marily between developed states, with capital-exporting countries representing the interests of foreign investors, and developing states, and with capital-importing countries representing the interests of host states.<sup>347</sup> In other words, the previous international investment law-making process has been dominated and characterized by a North-South divide, with developed states trying to push for a neo-liberalist agenda, and developing states attempting to resist such an agenda and maintain their inherent rights to regulate and control foreign investment. The picture has recently changed and become much more complicated. The North-South divide has narrowed from what it was three or four decades ago. Currently, a more dominant issue seems to be the conflict between the private interests of foreign investors and the public interests of states, namely host states. In other words, the featured debate of international investment law-making seems to have shifted from a 'North-South Divide' to a 'Private-Public Debate'. The following four major factors might have contributed to this shift.

The first factor is the shift, or the realization, of the role of leading developed states with regard to international investment. Before 1990s, developed states such as the US and Canada had viewed themselves, and rightly so, as capital-exporting states and representatives of foreign investors, and therefore had fought hard to secure highest possible standard of protection for their investors abroad by pushing ahead BIT and multilateral investment treaty programmes. Since 1990s, particularly after a series of NAFTA Chapter 11 cases, these countries have woken up realising that they are also major capital-importing states and therefore also have every reason to defend their interest as host states, just like what the developing states had done in the 1960s and 1970s. According to Weiler, so far there have been 16 NAFTA cases against the US and 13 against Canada.<sup>348</sup> Such litigation has forced the two governments into the shoes of capital-importing states, a standing point that used to be exclusive to developing states. Consequently, as mentioned above, they have stepped back from

See Shan, above, n 333, at 181–7. See also Declaration on Permanent Sovereignty over Natural Resources, GA Res. 1803 (XVII), at 223, UN Doc A/RES/1803 (XVII) (Dec 14, 1962); Charter of Economic Rights and Duties of States, GA Res. 3281 (XXIX), at 251, UN Doc. A/RES/3281(XXIX) (Jan 15, 1975).

<sup>347</sup> The literature on this debate has been tremendous. See, eg, S Friedman, *Expropriation in International Law* (1953); Charles N Brower, *Current Developments in the Law of Expropriation and Compensation: a Preliminary Survey of Awards of the Iran-United States Claims Tribunal*, 21 *Int'l Law* 639 (1987); R Dolzer, *New Foundations of the Law of Expropriation of Alien Property*, 75 *Am J Int'l L* 553 (1981); Francesco Francioni, *Compensation for Nationalisation of Foreign Property: The Borderland Between Law and Equity*, 24 *Int'l and Comp LQ* 255 (1975); Rosalyn Higgins, *The Taking of Property by the State: Recent Developments in International Law*, 176 *Recueil des Cours* 263 (1982); Eduardo Jiménez de Aréchaga, *State Responsibility for the Nationalisation of Foreign Owned Property*, 11 *NYU J Int'l L & Pol* 179 (1978); DR Robinson, Notes and Comments, *Expropriation in the Restatement (Revised)*, 78 *Am J Int'l L* 176 (1984); Oscar Schachter, *Compensation for Expropriation*, *ibid* at 121; M Sornarajah, *State Responsibility and Bilateral Investment Treaties*, 20 *J World Trade L* 79 (1986); FA Mann, *British Treaties for the Promotion and Protection of Investments*, 52 *British Yearbook Int'l L* 241 (1981).

<sup>348</sup> See Todd Weiler, *Naftaclaims.com*, <[http://www.naftaclaims.com/disputes\\_canada.htm](http://www.naftaclaims.com/disputes_canada.htm)>; *ibid*, <[http://www.naftaclaims.com/disputes\\_us.htm](http://www.naftaclaims.com/disputes_us.htm)> (last visited Jul 31, 2006).

their previously unfettered liberal approach and have started to revise their BIT programs. Such a change by leading developed states helps to establish a shared understanding and a common interest between them and developing states: the need to effectively tame and regulate foreign investors and their investment in the international investment law-making process.

The second factor is that the role of developing countries in the international investment process has also been undergoing change. A number of developing countries have become more and more important foreign investment suppliers in the world. In its *World Investment Report 2004*, the United Nations Conference on Trade and Development (UNCTAD) highlighted that ‘outward FDI from developing countries is becoming important’.<sup>349</sup> The report noted that some developing economies such as Malaysia, South Korea, and Singapore had already developed an established track record in outward investment.<sup>350</sup> Others, such as Chile, Mexico and South Africa, have become players relatively recently.<sup>351</sup> Others, such as Brazil, China and India, are at the take-off stage.<sup>352</sup> Viewed in relation to gross fixed capital formation, a number of developing economies, such as Singapore, Hong Kong (China) and Taiwan rank higher than a number of developed countries (Germany, Japan, the United States) in FDI outflow. In other words, a number of developing countries, relatively speaking, are already among top investors.<sup>353</sup> Moreover, annual FDI outflows from developing countries have grown faster over the past 15 years than those from developed countries—from negligible up until the end of the 1980s, to over one-tenth of the world total stock and some 6 per cent of world total flows in 2003 (\$0.9 trillion and \$36 billion, respectively).<sup>354</sup> Some developing economies are now large investors by global standards.<sup>355</sup>

Such an increased role in outward investment in those developing states has already has an impact on their international investment law-making practices. China, for example, has, since the late 1990s, significantly upgraded its substantive protection for foreign investment and provided wider access for foreign investors to resort to international arbitration forums, partly owing to its growing outward investment.<sup>356</sup>

<sup>349</sup> UN Conference on Trade and Development [UNCTAD], *World Investment Report 2004: The Shift Towards Services*, at 19, UN Doc UNCTAD/WIR/2005, UN Sales No E.04.II.D.33 (2004). See also Chart 2.

<sup>350</sup> *Ibid.*

<sup>351</sup> *Ibid.*

<sup>352</sup> *Ibid.*

<sup>353</sup> *Ibid.*

<sup>354</sup> *Ibid.*

<sup>355</sup> In 2003, for instance, Hong Kong (China) had a larger outward FDI stock than Sweden, even if round tripping and indirect FDI is taken into account. Also, transnational corporations (TNCs) from Hong Kong figure prominently among the leading TNCs from the developing world, along with those from Singapore, Mexico and South Africa, *ibid.*

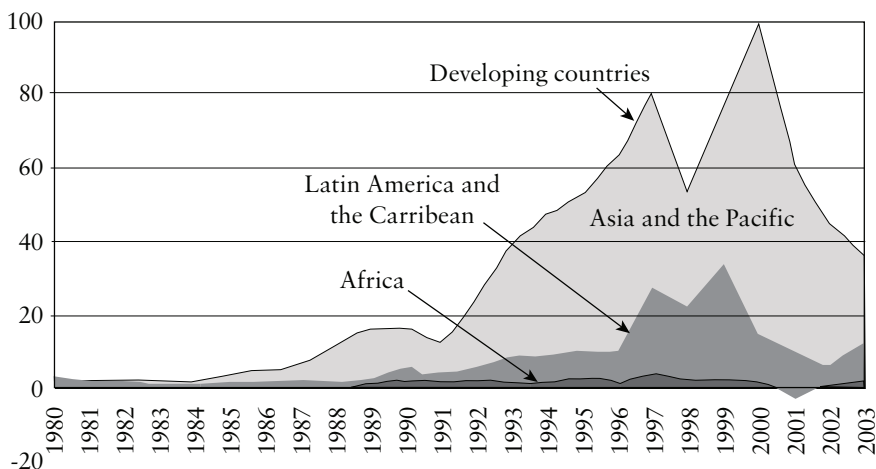
<sup>356</sup> Since 1998, China has widened its acceptance of international arbitration as a means of state-investor dispute settlement, by accepting all investment disputes to be automatically submitted to international arbitration including the ICSID. So far four BITs with such provisions have come into

The changing role of developing states is also witnessed by a notable increase of South-South BITs in recent years. The *World Investment Report 2005*, for example, noted that the largest number of the new BITs signed during 2004 were between developing states.<sup>357</sup> The change in the role of developing states thus echoes similar changes in the role of the developed states identified above, and further enhances the shared understanding and interest in international investment law-making between the two groups.

The third factor is that the domestic legal infrastructure in developing states for the protection and promotion of foreign investment has been significantly improved, as a result of the extensive legal changes that favoured foreign investment and the massive BIT networks established, particularly during the 1990s. As said above, *World Investment Report 2005* indicates that, since 1991, an average of 64 states in every single year have made some changes to their FDI laws and regulations. Among the 2,156 changes made during that period, 93 per cent were changes aimed toward a more liberal investment regime (*see*

**Chart 2: FDI outflows from developing countries by region 1980–2003**<sup>358</sup>

(Billions of dollars)



effect, another 16 are in the ratification process. One of the main reasons for China's opening-up in this area is that Chinese investment abroad has been increasing rapidly over the last few years and the government is actively encouraging domestic companies to do so.

<sup>357</sup> The Report noted that there were 28 BITs signed between developing states accounting for 38 per cent of the total, followed closely by the 27 BITs between developed and developing states. *See* UNCTAD, *World Investment Report 2005: Transnational Corporations and Internationalization of R&D*, at 24, UN Doc. UNCTAD/WIR/2005, UN Sales No E.05.II.D.10 (2005).

<sup>358</sup> Source: UNCTAD, FDI/TNC database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)).

Table 1).<sup>359</sup> Meanwhile, there has been an explosive expansion of the BIT network in the world. UNCTAD statistics show that 2,010 out of the 2,392 BITs concluded by the end of 2004 were signed in the 1990s (*see* Table 3)<sup>360</sup>. Also, states had been very active in entering into bilateral, regional and trans-regional PTIAs, most of which again were concluded in 1990s.<sup>361</sup> Such changes in domestic law, together with the extensive international investment treaty network, have significantly narrowed the gap between developed and developing countries in terms of the legal protection and promotion of international investment. Although the gap admittedly still exists, it is by far less significant than it was three decades ago. Consequently, the need for further legal protection of foreign investment has been greatly reduced, as has the tension between developed and developing states in intentional investment law making process. This obviously paved the way for a shift of attention to the more universal question, namely the conflict between public and private interests.

The fourth and final factor is that the increased participation of civil society in the international investment law-making process has significantly contributed to highlight the need for and importance of regulating international investment. Earlier NAFTA cases on investment arbitration, such as the *Metalclad*, *SD Myers and Pope & Talbot*,<sup>362</sup> have focused the attention of many non-governmental organisations (NGOs) on international investment treaties and related arbitration practice. The debate on the draft MAI within the OECD and the discussions on a multilateral agreement on investment within the WTO framework in the Doha Round have demonstrated the width and depth of NGO participation in the global investment law-making processes. Whilst different NGOs have different missions and therefore foci, they all share a main concern: that investment liberalisation cannot be achieved at the expense of important public interests, such as human rights, environmental, and labour standards. In other words, they have helped highlight the importance of regulating foreign investment for the public good. Such voices from NGOs, most of which are actually based in developed states, have over the years become more and more influential in domestic and international law and policy making. As a result, they have helped to raise the awareness of the general public, particularly in the developed world, of the need to regulate foreign investment, and thus contributed to the shift of tension in international investment law making.

To conclude, recent years have witnessed a shift of tension on international investment law-making, from ‘*strong states*’ versus ‘*weak states*’, ie, a ‘North-

<sup>359</sup> *Ibid* at 28.

<sup>360</sup> *Ibid*.

<sup>361</sup> *Ibid*.

<sup>362</sup> *Metalclad Corp v United Mexican States*, ICSID Case NoARB(AF)/97/1, *ICSID Rev—For Investment LJ* 168 (2001); *SD Myers Inc v Canada*, UNCITRAL (NAFTA), First Partial Award, 13 Nov 2000; *Pope & Talbot Inc v Canada*, above, n 310; and Interim Award, 26 Jun 2000.

South divide', towards 'state sovereignty' versus 'corporate sovereignty',<sup>363</sup> ie, a 'Private-Public debate'. If this is what is happening, there might be a better chance to strike a sensible global convention on the *protection as well as supervision, promotion as well as regulation* of international investment for the general good of the world.

## V. THE CALVO DOCTRINE AND THE CONCEPTION OF STATE SOVEREIGNTY

To certain extent, the lifecycle of Calvo reflects the life story of the traditional concept of state sovereignty, as the former founds itself on the latter. More precisely, Calvo's 'anti-super-national-treatment standard' (or the national/equal treatment standard) and national law requirement may be regarded as a reflections of 'prescriptive sovereignty' or 'legislative sovereignty', ie, a state's jurisdiction to lay down laws and apply them to 'the conduct, relations or status of persons, or in the interest of persons in things'.<sup>364</sup> Meanwhile, Calvo's national jurisdiction requirement and renunciation of diplomatic protection reflects 'adjudicative sovereignty', which refers to a state's jurisdiction to enforce laws, in particular, 'to subject persons or things to the process of the courts or administrative tribunals of a state'.<sup>365</sup>

The fact that the Calvo Doctrine has been deactivated and picked up again proves that, first of all, the concept of state sovereignty is not dead, but still very much alive and relevant. It is true that state sovereignty is frequently and increasingly subject to constraints from international treaties and international institutions, yet states still remain ultimate control over such constraints as state consent still remains the prerequisite of these treaties and there is always a possibility for them to 'stay out' or 'opt out'. Of course there will be costs for that and in some cases the costs might be so high that states would rather not to do so. But the point is that states still legally has the authority to decide, after weighing up the pros and cons: whether or not a state eventually decides to opt out is less important if relevant at all. Thus, as the present study has revealed, Brazil chose to 'stay out' of the BITs and consequently to stay clear of international investment treaty based arbitration institutions in 1990s, when most other Latin American states 'opted in' the neo-liberal investment regime by ratifying BITs and the ICSID Convention. And when the latter Latin American states found out in recent years that they were trapped in such investment regimes, they started making efforts to re-gain control over such international

<sup>363</sup> Given the size and strength of some transnational corporations and that they are now often equipped with the standing to directly bring lawsuit against host governments before international forums such as the ICSID under BITs and other investment instruments, it is not too much an exaggeration to say that they enjoy certain elements of 'sovereignty', which may be referred to as 'corporate sovereignty'.

<sup>364</sup> O Schachter, *International Law in Theory and Practice*, Martinus Nijhoff, 1991, at 254.

<sup>365</sup> Schachter, 255.

mechanisms. Although very unlikely, it would not be impossible for those states to abandon those BITs and the ICSID altogether, if they found such investment treaties unbearable even after revision or reform. Bolivia has recently withdrawn, for example, from the ICSID Convention. Ecuador has also been considering terminating its BIT with the US. Likewise, the proposed Argentine bill of 2005, if goes ahead, would lead to renegotiate or terminate all the BITs it has concluded.

Another observation that might be drawn from Calvo's life experience is that whilst 'abstract sovereignty' remains unchanged, 'concrete sovereignty' tends to change over time. As argued elsewhere, it is important to draw a distinction between the two sub-concepts of state sovereignty.<sup>366</sup> 'Abstract sovereignty', which may be regarded as the concept of sovereignty *per se* as originally conceived by political scientists such as Bodin, refers to the 'final source of authority'.<sup>367</sup> On the other hand, 'concrete sovereignty' refers to the actual powers which derive from and implement the 'abstract sovereignty'. Thus whilst 'concrete sovereignty' may be divided, horizontally, into legislative executive and adjudicative powers (or 'sovereignty' as often used or rather 'misused'), or into economic political social and cultural powers, 'abstract sovereignty' cannot.<sup>368</sup> A state may, moreover, delegates concrete sovereignty/powers vertically, to international or supranational institutions such as ICSID or EU, or sub-national bodies such as provinces or states. As indicated above, the elements of the Calvo Doctrine signifies elements of legislative and adjudicative sovereignty, ie aspects of concrete sovereignty, and as such, can be activated or deactivated over time, without necessarily demonising the 'abstract sovereignty' of the states concerned. In other words, states may remain sovereign, with or without Calvo.

<sup>366</sup> I have argued elsewhere for a 'Double-Layered Conception' of state sovereignty, which draws a distinction between the concept of sovereignty in the abstract ('abstract sovereignty') and the concept of sovereignty in the concrete (or 'concrete sovereignty'). For details see Wenhua Shan, 'Redefining the Chinese Concept of Sovereignty', in Gungwu Wang and Yongnian Zheng (eds) *China and the New International Order* (Routledge 2008) at 53–80.

<sup>367</sup> As observed by Brierly,

'Bodin was convinced that a confusion of uncoordinated independent authorities must be fatal to a State, and that there must be one final source and no more than one from which its laws proceeds. The essential manifestation of sovereignty, he thought, is the power to make the laws, and since the sovereign makes the law, he clearly cannot be bound by the laws that he makes.'

See JL Brierly, *The Law of Nations* (1955), at 7.

<sup>368</sup> Rousseau has actually drawn a similar distinction between sovereignty and powers, as the 'actual exercise of sovereignty'. J-J Rousseau, *The Social Contract and the Discourses* (Campell Publishers, 1993) at 192–207, particularly 200–1.

Part Four

**Banking Regulation and International  
Financial Institutions**





# *Banking, Economic Development and the Law*

CHARLES CHATTERJEE AND ANNA LEFCOVITCH\*

## INTRODUCTION

**T**HE IMPORTANCE OF developing a strong capital market, including an efficient banking system, for a sustainable economy can hardly be over-emphasised, and yet many countries, particularly in the developing world, do not seem to have paid much attention to this matter. Absence of a strong and reliable financial market contributes to sluggish economies and discourages foreign investors from investing in those economies; the benefits of interaction with other economies are hardly derived by these stagnant economies.

Heating-up of economies should be part of a government's domestic economic policy, and in this respect, governments should closely work with their central banks. Without relying on any theoretical approach advocated by many economists on this issue, from a realistic standpoint, it may be stated that all economies move around a cycle: high employment provides incomes, incomes should lead to savings, and savings should raise the prospects of investment in a country. In this process, expansion of the domestic economy proves to be essential as it provides the causal link between these essentials.

Commercial banks in a country under the supervision of their central bank may directly contribute to the economic development process in a country. Not only does the banking structure in a financial market need to be improved but also the banking habit of peoples must be developed.

It is the purpose of this chapter to examine how the two elements of: (a) banking structure; and (b) banking habit, may be developed in a developing country.

\* The views expressed in this article are those of the authors, and in no way may be attributed to the institutions with which they are affiliated.

## 1. How the Banking Structure in a Country may be Improved

Every country has banks, but the operational systems, particularly in developing countries, are not, in general, as advanced as those in many developed economies. There are a variety of reasons for operating less sophisticated banking systems in developing countries: restrictive banking whereby people of low income many not have any access to banking; the lack of financial assistance to small businesses; the lack of technology; or the lack of trained staff; conservative risk study; low returns on investments; high interest on loans.

'*Banking structure*' in this context would mean the banking network that the central bank of a country has adopted. Generally, in developing countries, banking facilities are available to middle-to-upper income groups of people; thus, the others who constitute the majority, are left out of the system. Most banks, whether commercial or rural, and particularly the latter, will have a limited type of mandate from the central bank concerned, and are government-controlled; thus, profit-maximisation may not necessarily be their motive; they, in most cases, operate as service providers to their people. There should exist a system of co-ordination between the private sector and the public sector whereby banking policies are formulated to cater for the private sector too. Banking system in developing countries, in general, remains in the exclusive domain of the government, in consequence of which the requirements of the private sector for economic development remain unsatisfied. Economic stagnation in a country is thus encouraged.

Competition between banks may offer better and cheaper services to customers. The more investment opportunities are created by commercial banks for investors, the more investment banks can make. Banking should not be kept confined to the rich only. Commercial banks should create banking habits by pointing out to people the benefits of banking, as well as the drawbacks of not using banks.

Of course, in developing countries, the lack of securities often present obstacles to bank lending. Security on goods coupled with periodic supervision of businesses, until they become financially viable, might not present much business risk; but it is accepted that this method might not be a risk-free one; nevertheless, a bank's lien on a business might make it a profit-driven business. In order to avoid losses lending should be gradual. Generally, wealth may be created in the domestic sectors, and people may feel encouraged to set up their own businesses which, in turn, should create employment.

Banks should be able to attract customers by being customer-friendly, and providing advice which would be in the best interests of customers. They should also clearly explain to customers the merits and disadvantages of each type of investment in which they may be interested, but never persuade to accept any kind of investment; customers should also be asked to seek independent legal advice on banking matters, including investments, from experts of customers'

choice. In England, the classic case on this issue is *Hedley Byrne & Co v Heller & Partners Limited*<sup>1</sup> in which case the House of Lords held, inter alia, that:

‘. . . a negligent, though honest misrepresentation, spoken or written, may give rise to an action for damages for financial loss caused thereby, apart from any contract or fiduciary relationship, since the law will imply a duty of care when a party seeking information from a party possessed of a skill trusts him to exercise due care, and that party knew or ought to have known that reliance was being placed on his skill and judgment . . .’.<sup>2</sup>

According to Lord Devlin:

‘The duty of care arises where the responsibility is voluntarily accepted or undertaken either generally, where a general relationship is created, or specifically in relation to a particular transaction’.<sup>3</sup>

His Lordship went on to state that:

‘Payment for information or advice is very good evidence that it is being relied upon and that the informer or adviser knows that it is. Where there is no consideration, it will be necessary to exercise greater care in distinguishing between social and professional relationships and between those which are of a contractual character and those which are not. It may often be material to consider whether the adviser is acting purely out of good nature or whether he is getting his reward in some indirect form’.<sup>4</sup>

Banks must inform their prospective customers honestly of their products, but must not persuade them to accept any product. Banks must make their best efforts to develop confidence in banking in prospective customers by explaining to them the advantages and disadvantages of banking and making banking accessible to them. Interests in banking must be created; this is particularly important for developing countries. Improved awareness of the public in banking may motivate the government concerned to offer more financial facilities to them.

The onus of improving the banking structure is primarily on the central bank of a country. In so doing, central banks should take into consideration the available resources, human or otherwise, the possibilities of expanding the domestic market, and the prospects of improving the export market for the country. Plans for improving the financial market, including, retail banking, loans facilities, insurance and opportunities for saving, form the foundation of a free market economy. Awareness of banking by making positive efforts in informing the people of the merits and risks in opening bank accounts and using banks not only for transactional purposes but also for investment should prove useful.

<sup>1</sup> *Hedley Byrne & Co v Heller & Partners Limited* [1964] AC 465.

<sup>2</sup> *Ibid.*, 466.

<sup>3</sup> *Ibid.*

<sup>4</sup> *Ibid.*, 529.

## 2. Banking and the Economy of a Country

As this work is addressed to non-specialists, it would be inappropriate to go into the technical aspects of the issues. The co-relationship between a less developed economy and a poor banking structure is co-extensive. An improved banking system which encourages people to deposit money with banks or to provide loans, particularly for setting up businesses can, if run effectively, not only create employment but also produces a spill-over effect whereby more deposits may be attracted by banks. Of course, in developing countries, the issue of security against loans may present difficulty as in most cases, borrowers might not offer security against loans, whether in the form of tangible or intangible property. This hurdle may be overcome by two means: (a) a thorough risk study; and (b) by taking the business as security with the right of supervision. The borrower must remain accountable to the lender.

Risks in lending money may be minimised by providing knowledge and skills required for running businesses, generally, and specific risks to particular businesses. Supervision-based loans to businesses may be less risky and can provide training to businessmen for calculating risks. All economies are usually sectorised into three sectors: closed, open and open-closed. Whereas the closed sector is exclusively meant for domestic industries and agriculture; private foreign investors are allowed participation in the open sector, but the sector is not closed to domestic enterprises. The open-closed sector is the sector in which private foreign investors are allowed to participate over a limited period of time, and thereafter it would be transferred into a closed sector; the primary purpose of having this sector is to allow the local enterprises to learn the skill from the foreign experts and to become self-sufficient in operating the industry concerned.

The importance of banking in any sector of an economy, be it agriculture or industry, can hardly be over-emphasised. Banking awareness and banking habits should receive priority in all economies, rich or poor alike. In developing countries, the nature of banking habits of people, particularly in rural areas, is not noteworthy. The primary causes of indifference to banking may be: (a) the mechanics of creating public awareness to banking is limited to publicity predominantly by advertisements, which would not cause curiosity about banking in the minds of the ordinary people; (b) a high degree of apprehension that a disclosure of savings would accrue tax liability; (c) apprehension of losing money in the event of a bank being closed down; and (d) that the lack of awareness of the advantages of banking. Pro-active action for dealing with these issues is extremely necessary particularly in developing countries.

Banking generates money for any economy. Central banks in developing countries are required to bring banking even to ordinary people. It is through an active banking system that a domestic economy may be expanded, which, in turn, would create employment, leading to savings and investment.

In short, the banking industry in a country should be inviting, customer-driven, and as risk-free as possible. The incidence of risks may be minimised by an effective supervision system effected by the central bank of a country. This issue has received attention in the following Section of this work.

### 3. The Supervisory Functions of a Central Bank

The supervisory functions of a central bank range from guiding and monitoring the activities of domestic commercial banks primarily for the purpose of protecting the interests of their customers; to develop confidence in the minds of the latter so that banking habit grows to operating an economic policy which would expand the domestic economy, in addition to implementing an effective monetary policy. The issue of what should be the precise scope of the supervisory functions of a central bank may provoke controversy among experts; furthermore, the supervisory functions that are usually performed by central banks in developed countries may not be performed equally competently by many of the central banks in developing countries.

Precisely a decade ago, the Basle Committee developed twenty-five core principles for an effective banking supervision, many of which, if not all, may also be implemented by the central banks in developing countries. These Principles stand for the ‘*minimum requirements*’ and in many cases may need to be supplemented by other measures in order to address particular conditions prevailing in individual countries. The term ‘*core principles*’ clearly suggests that these are the central and most important principles, and that the adoption and enforcement of additional principles is encouraged to deal with any particular risk to which a particular financial market may be subject.<sup>5</sup>

Twenty-five Core Principles were adopted under seven different headings:

#### Preconditions for Effective Banking

Supervision	Principle 1
Licensing and Structure	Principles 2–5
Prudential Regulations and Requirements	Principles 6–15
Methods of Ongoing Banking Supervision	Principles 16–20
Information Requirements	Principle 21
Formal Powers of Supervisors	Principle 22; and
Cross-border Banking	Principles 24 and 25

Two major pre-requisites must be satisfied to adopting an effective banking supervision: (a) an effective banking structure; and (b) an effective regulatory and supervisory structure. According to the Core Principles, an effective system of banking supervision:

<sup>5</sup> See further C Chatterjee, ‘The Basle Core Principles for Effective Banking Supervision: An Analysis’, (2001) 1 *European Financial Services Law* 78.

‘. . . will have clear responsibilities and objectives for each agency involved in the supervision of banking organisations. Each agency should possess operational independence and adequate resources’.

This objective can be satisfied only by a regulatory body. But the issue of an effective banking supervision becomes otiose if there does not exist an efficient banking structure, the important ingredients to which are: (a) a developed market structure; (b) sound macro-economic policies; (c) competition; and (d) good banking practice, all these need governmental support.<sup>6</sup>

The Core Principles also state that a suitable legal framework for banking supervision is necessary.

Most of the developing countries lack the ingredients to an efficient banking structure. These are to be achieved through the legislative process. Guidance from the International Monetary Fund and the International Bank for Reconstruction and Development (IBRD) may also be available. These ingredients, in general, are: (a) a developed market structure; (b) sound macro-economic policies; (c) competition; and (d) a good banking practice with governmental support. The requirements at (a), (b) and (c) cannot be satisfied unless the country has a good operational economic policy which would progressively strengthen the economy. In fact, these requirements can be cyclical in that, with a good banking system, the country can develop a sound macro-economic structure. The market must be founded on the *laissez-faire* doctrine so that consumers have the best deal. A banking system should provide the financial engine to an economy; this has been the case in all developed economies. The inter-relationship between a developed banking structure and governmental supports should be close; in fact, there exists a concomitant relationship between governmental support and a sound banking system in a country.

Banking must be attractive to investors; they must be provided protection from risks, including bank collapses, and inappropriate and inadequate advice by bank officials. In developed countries there exists a protection scheme but where supervision and surveillance are effective, the depositors’ protection scheme need not be activated. Central banks’ policies must be directed at confidence-building in the minds of customers and investors.

The first Principle of the Basel Core Principles is entitled ‘*Preconditions for Effective Banking Supervision*’. This Principle states that:

‘An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organisations. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking organisations and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal

<sup>6</sup> *Ibid*, 79.

protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place’.

According to this Principle, the requirements of an effective banking system are: (i) clear responsibilities and objectives for each agency involved in the supervision of banking organisations; (ii) operational independence of each agency combined with adequate resources; (iii) a suitable legal framework for banking supervision; (iv) clear and appropriate provisions relating to authorisation for banking operations; (v) non-vulnerability of supervisors by providing suitable legal protection; and (vi) arrangements for sharing information between supervisors and protecting the confidentiality of such information.

On a further analysis it would appear that each agency involved must have clear objectives in relation not only to the banking system concerned, but also in regard to the economic policy and programme for the country concerned. ‘*Adequate resources*’ in this context would include competent human resources. A suitable legal framework for banking supervision would entail appropriate legislation with the benefit of competent enforcement officers, and a clear and effective enforcement procedure. Here, central banks must require the commercial banks to rigidly follow the minimum criteria of good banking: (a) adequate solvency margin; (b) an honest accounting practice; (c) absence of high-risk exposure; and (d) honesty and integrity.

It is essential that supervisors are allowed to carry out their supervisory work without any fear of threats against them by the supervised entities or their officers or that they become subject to civil actions. Supervisors must carry out their functions without any bias in favour or against any authorised/licensed institution. A rigid banking supervision system is at the heart of a progressive capital market; it forms the basis for the protection of customers and investors. It must not be vitiated by corruption. The principles of corporate governance (democracy, transparency, accountability and fairness) must be applied to an ideal banking system. Connected with the supervision system is the licensing procedure. Licensing criteria must be strict and they must be rigidly followed. The ownership structure must be transparent<sup>7</sup> and no one owner should be allowed undue power of control by virtue of disproportionate share-holding. The organisational structure of a commercial bank should allow participation of experts, including experts in capital market issues. Any change in the organisational structure must be immediately reported to the central bank with justification. In relation to licensing and structure, the Basel Core Principles provided, inter alia, that:

‘Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties’. (Paragraph 4).

<sup>7</sup> Basle Core Principles for Effective Banking Supervision (1997), reproduced in (1998) 37, *International Legal Materials* 406.



The Core Principles further provided that:

‘Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision’.

This position is particularly important for those jurisdictions that lack effective legislation on acquisitions and mergers, and allow banks to be controlled by members of families. In other words, in order to avoid undue risks originated by virtue of major acquisitions or because of a pyramidal organisational structure, governments should adopt stringent legislation outlining the conditions of acquisitions and mergers.

It is for central banks to direct their commercial banks as to risk minimisation by evaluating the quality of assets over periods of time; by adopting prudential practices and procedures related to the granting of loans, investments; and by reviewing the management of loans and investment portfolios. Central banks must set limits to restrict bank exposures to single borrowers or groups of related borrowers (Paragraph 9). Central banks must also ensure that commercial banks have adequate policies and procedures for identifying and controlling country risk and transfer (risk) in their international lending and investment activities, and that they maintain appropriate resources against such risks (Paragraph 11).

Again, central banks must ensure that commercial banks adequately control market risks and, where appropriate, specific limits are imposed on them. All commercial banks should have a comprehensive risk management procedure in place. They must be subject to internal and external audit. The Core Principles further stated that:

‘Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict ‘know-your customer’ rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements’. (Paragraph 15)

In addition to implementing the ‘*know-your-customer*’ principle, which benefits both the bank and its customers, commercial banks must demonstrate that in dealing with their customers, they maintain a high ethical and professional standards, particularly about advising them on investments issues. They must advise them with due care and skill.

‘*Supervision*’ entails both monitoring and controlling the activities of those who are subject to supervision. In order to effect appropriate supervision, both the supervisor and the supervised must have appropriate knowledge and expertise. Thus, training for both the supervisor and the supervised is needed. The Basle Core Principles have been addressed to the Basle Committee members, but there is no reason why the supervision structure and the central banking structure needed for supervision may not be modelled over a period of time by developing countries. Indeed, in developing the Core Principles, in addition

to the Basle Committee (G-10 countries), representatives from the following countries also participated: Chile, China, the Czech Republic, Hong Kong, Mexico, Russia and Thailand; and the following countries were closely associated with the work: Argentina, Brazil, Hungary, India, Indonesia, Korea, Malaysia, Poland and Singapore.

## II. IS IT POSSIBLE FOR A DEVELOPING COUNTRY TO IMPROVE HER BANKING INFRASTRUCTURE?

It has been explained that attempts at improving the banking infrastructure in a country would entail dealing with a number of fundamental issues in addition to costs, but in can be achieved. In so far as supervision and control of commercial banks are concerned, there is no reason why, with the assistance of governments, the Basle Core Principles may not be implemented by developing countries over a period of time. An effective implementation of the Basle Core Principles predominantly requires training of personnel and direction from central banks, perhaps through manuals and code of conduct. There should, of course, be a reporting and audit system, both internal and external in place. At this point it would be apposite to justify the involvement of private sectors and the improvement thereof by means of case studies.

### 1. Angola

The lack of substantial economic activity outside of the oil and diamond sectors has left Angola as an undiversified economy in consequence of which most Angolans are without sustainable incomes. Angola joined the World Bank Group in 1989, and the first IDA credit for economic management building capacity was advanced to the Angolan government in 1991. Following the successful implementation of the Transitional Support Strategy in 2003–2004, IDA's current assistance strategy is set out in the Interim Strategy Note (ISN) which includes, inter alia, the plan for the preparation of potential future projects and areas of analytic and advisory support until June 2006. The ISN's support for the government's programme for 2005 and 2006 is based on the following:

- to enlarge transparency in governance, to intensify capacity development, and in particular, to lend support for public sector reform and empowerment of civil society;
- to rehabilitate emergency infrastructure; and
- to improve the environment for private sector growth, and to facilitate better infrastructure financing.<sup>8</sup>

<sup>8</sup> Angola—Country Brief, <http://www.worldbank.org> (Apr 2006) at p 2.

The ISN placed a strong emphasis on economic and sectoral work, including public expenditure and financial management reforms and improvement of the climate for private sector investment.

In its attempt to improve private sector investment and assistance to the private sector, the International Finance Corporation has been building its portfolio of investments in Angola in the following major investments:

- a 15 per cent shareholding in NovoBanzo Enterprise Bank of Angola SARM, a bank targeting medium and small enterprises. The bank has already disbursed more than 1000 loans worth US\$5.5 million to Luanda's small enterprises;
- a US\$ 1 million equity investment in Nova Societale de Seguzos de Angola SARM (Nossa) which represents 16.7 per cent of Nossa's share capital. This is the first private insurance company in Angola;
- a US\$ 10 million loan has been provided by the International Finance Corporation to Odebrecht Services no Exterior, a wholly-owned subsidiary of Construtora Norberto Odebrecht of Brazil. This financing will be utilised for infrastructure improvements in the Luanda suburban development project<sup>9</sup>

Between March 15 and 29, 2006 an IMF mission conducted discussion with the Angolan authorities for the 2006 Article IV consultations of the IMF Article of Agreement. Since that peace settlement in 2002, the rehabilitation of 4 million displaced persons, the output of agricultural smallholdings has been steadily growing. Although rising production and revenues from the oil sector have been the main driving forces behind the improvements in overall economic activity and the macroeconomic conditions, commercial activity outside the petroleum sector is extremely limited.

During 2005, however, GDP grew by about 18 per cent primarily owing to rising oil production, and during the same year, clear signs of buoyancy in the construction sector and sustained growth in agriculture became manifest. Inflation declined significantly. Nearly US\$ 600 million from outstanding commercial oil-backed loans was paid off.<sup>10</sup> The IMF concluded that economic prospects would be favourable if a focus was maintained on macroeconomic stabilisation and the development of the private sector.<sup>11</sup>

Despite the continued growth and strong public finances, Article IV Consultations pointed out however that the outlook was subject to significant risks which must be addressed by government actions. In its preliminary conclusions the IMF Mission pointed out, *inter alia*, that:

‘ . . . given limited administrative and absorption capacity, a careful assessment of rising public expenditure is needed to assess its value for money and yield and to minimise potentially adverse macroeconomic consequences. In addition, the authorities

<sup>9</sup> Angola—Country Brief, <http://www.worldbank.org> (Apr 2006) at p 3.

<sup>10</sup> Angola 2006 Article IV Consultations, Preliminary Conclusions of the IMF Mission, <http://www.imf.org/external/np/ms/2006/032906.htm>, at p 1.

<sup>11</sup> *Ibid*, 2.

should specify a clear monetary anchor, with responsibilities for executing monetary policy defined for the National Bank of Angola (BNA), to maintain the downward trend in inflation even in the face of external shocks'.<sup>12</sup>

The Mission rightly pointed out that economic development at the macro level may not be achieved if limited administrative and absorption capacity exist in a country. Furthermore, as has been explained, the central bank of a country has a major responsibility to adopt and implement a clear monetary policy and effectively supervise the activities of the commercial banks within its jurisdiction. Furthermore, the pace of structural reform must accelerate sharply, accompanied by improvements in transparency.<sup>13</sup>

The IMF Mission also concluded that the Angolan Government should aim to reduce Angola's public debt, while building up foreign exchange resources, but certain adjustments in economic policies should also be considered: capital expenditure must be decreased, while the absorptive capacity of the economy must be increased. The inefficiency and weak governance should be appropriately dealt with. The Mission also concluded that a better approach to deal with Angola's economic situation would be:

'. . . to mitigate the potentially adverse macroeconomic consequences on policies and the exchange rate through a transparent execution process and maintaining a high import content. At the same time, the further increase planned in the public payroll should be carefully monitored in the light of domestic capacity constraints and the need to prevent further unproductive spending . . .'.<sup>14</sup>

The Mission also pointed out that increased public spending was likely to exert additional pressure on the domestic price level. This is to be treated as a general advice to all developing countries. The economy witnesses rising foreign exchange resources from the export of certain commodities or natural resources, but the remedial process should entail both sale of foreign currencies and new issues for government securities to take excess liquidity away from the market.

The Mission rightly pointed out that transparent management of public resources and an improved business climate would be essential. This is another important issue which all countries, developed or developing, should implement. An '*improved business climate*' would imply a climate in which confidence in the private sector would be developed, and that economic development should be achieved through participatory means. Indeed, transparency is one of the conditions of corporate governance. Thus, timely publication of the audit reports of government-sponsored industries, particularly external debt statistics, with full details, would simply allow the people in the country concerned to place trust and confidence in the government.

<sup>12</sup> *Ibid*, 2.

<sup>13</sup> *Ibid*, 3.

<sup>14</sup> *Ibid*, 4.

## 2. Bangladesh

Recently (between 2003 and 2004) at the request of the Bangladesh Ministry of Finance, the World Bank dealt with their programme known as Enterprise Growth and Bank Modernisation, and provided recommendations,<sup>15</sup> which may, in general, be applied to many other countries with similar banking infrastructure.

Having studied the country profile, the Bank observed that not only did vulnerabilities exist in macroeconomic fundamentals, but also owing to high import prices, inflation rose. The IMF forecast that the country's trade balance would deteriorate from a negative US\$3.6 billion in 2004/05 to a negative US\$7.7 billion in 2006/07. The strengthening of the Bangladesh Bank was viewed as a pre-requisite for ensuring a sound, efficient and competitive banking sector. The World Bank noted that the nationalisation of the industrial and financial sectors had a negative impact on Bangladesh's economy. It further noted that the small and medium scale industries were not well covered by financial services and business development services; lack of access to finance was a major constraint encountered by this sector. Furthermore, the potential of this sector to create employment was not sufficiently appreciated. The pace of privatisation needed to be accelerated. Incidentally, these features are available in almost all developing countries.

In Bangladesh, banks also perceived small and medium enterprises risky; thus their access to finance and business development services were very restricted. In Bangladesh, like many other developing countries, commercial banks are nationalised institutions, and their negative impact on the financial sector has had a far-reaching effect even on the economy as a whole.

According to the World Bank, sector issues needed to be addressed, and that the government would be required to reduce its ownership of assets in the real and financial sectors of the economy; such a policy would ultimately reduce the fiscal deficit through reduction and elimination of losses and should foster private sector development and growth through more productive use of state controlled assets. In many cases, exclusively state controlled sectors consistently made losses for years. The Bank maintained that in order to sustain the reform programme in Bangladesh, it would be important to take steps that would help generate employment over the short to medium term, especially through seeking up growth in the small and medium enterprises sector.<sup>16</sup>

A competitive private banking system which is prevalent in most of the developed countries should be allowed to be established by governments in developing countries too. Divestment of shareholding in government-controlled banks should be the norm in developing countries. That is what the World Bank also recommended in respect of the government-controlled banks in Bangladesh.

<sup>15</sup> Report No AB 580—Project Information Document (PID) Negotiation Stage, World Bank.

<sup>16</sup> *Ibid*, 4.

Shareholding by private entities would encourage people to take interest in banks, and use them as engines of economic growth.

Countries may like to seek advice from experts, including the International Monetary Fund and the International Bank for Reconstruction and Development for restructuring the banking infrastructure in order to create public awareness as to the importance of the active participation of the people in the financial markets. Developing countries, in general, can improve their banking infrastructure by doing the following, in particular:

- privatisation of banks;
- creating public awareness;
- establishing a system of close supervision and surveillance;
- engagement of the private sector in the country whenever possible;
- training of bank personnel;
- legal reform for a successful implementation of these issues.

### **3. Bolivia**

Bolivia is one of the heavily indebted poor countries in the world, indeed, the Heavily Indebted Poor Countries (HIPC) initiative has recently reduced her debt payment obligations by US\$ 1.2 billion. The usual factors of a poor country are evident in Bolivia: poverty, high infant mortality rate, high illiteracy rate; and the lack of infrastructure. Her primary natural resources are minerals, and the country depends largely on exports of minerals and soya beans, the prices of which often fluctuate. Population dispersion represents another critical development issue in Bolivia. Over 35 per cent of the country's rural population has very limited access to health and education services.<sup>17</sup>

In 1998, the World Bank prepared a Comprehensive Development Framework (CDF),<sup>18</sup> which governs, inter alia, the national poverty-reduction strategies. The framework was based on four pillars:

- instead of focussing on short-term macro-economic stabilisation and balance of payments corrections, development strategies should be comprehensive and contain a long-term vision;
- development agenda for every country must be based on citizen participation;
- development strategies must be carried out in partnership with governments, donors, civil society, the private sector and other stakeholders. The principle of corporate governance should be operated in implementing development strategies; and
- development performance should be evolved on the basis of measurable results.<sup>19</sup>

<sup>17</sup> See further Bolivia Country Brief prepared by the World Bank in Feb 2004.

<sup>18</sup> CDF Proposals were first launched in Jan 1999.

<sup>19</sup> See further Comprehensive Development Framework, CDF Secretariat, The World Bank, 17 Sept, 2001 at 1 (CDF).

The Comprehensive Development Framework (CDF) is based on four inter-related principles: long-term holistic vision; country ownership; partnership, and a focus on measurable results.

In respect of CDF, the following questions receive closer attention:

- the comprehensiveness of the country's strategies;
- the extent to which national institutions would be involved in building ownership of the strategy and the expenditure priorities;
- whether the private sector played a significant role in country strategy formulation and consultation;
- whether the assistance of strategies and programmes of the external partners are in line with the country's strategy; and
- the challenges that the World Bank Group must accept to support effectively the implementation of the CDF principles.

In other words, CDF must be implemented with the participation of the indigenous people at all stages. According to the World Bank, country ownership is the linchpin of CDF.<sup>20</sup> National strategies should involve a participatory process.<sup>21</sup> However, country ownership is dependent on the capacity of the country concerned to absorb changes. Furthermore, even where participation of the people would be allowed, in certain cases, no institutional outlet through which the voice of poor and marginalised would be followed up may not exist. Accountability and access to development information are also two other extremely important factors for the success of CDF. Poverty reduction strategy should also be included in CDF. In low-income countries, the introduction of the poverty-reduction scheme has helped promote the formulation of comprehensive strategies addressing macro, social and structural issues. However, certain key economic sectors such as infrastructure, banking and finance which are so important for poverty reduction still remain weak. In fact, these sectors are not sufficiently prioritised by governments. However, recent legislation in Bolivia provides for enhanced accountability both in the public sector and in the financial sector which, in effect, will have the effect of strengthening the Country's banks' resilience.

Thus, an understanding of the macroeconomic / sectoral linkages that may become a direct contributory factor for poverty-reduction is needed; in other words, the need for integrating macroeconomic policy, with sector strategies is urgently needed.<sup>22</sup> This issue is closely linked with the issue of the lack of country capacity, but the latter can be developed by both indigenous and external means.

CDF places significant importance on country ownership and the involvement of the government and civil society, but in many countries no significant participation of the private sector in CDF has become manifest. CDF and coun-

<sup>20</sup> See further Comprehensive Development Framework, CDF Secretariat, The World Bank, 17 Sept, 2001, 3.

<sup>21</sup> *Ibid.*

<sup>22</sup> *Ibid.*, 70.

try ownership should be institutionalised. In its Report of 2001 on Bolivia, the CDF Secretariat stated, *inter alia*, that:

‘While capacity is central to progress on ownership, experience indicates that when countries take steps to strengthen ownership, latent or undeveloped capacity emerges. In addition, country ownership is greatly strengthened when there is strong commitment and leadership from the highest political levels. This is seen in countries such as Bolivia, Kyrgyz Republic, Mauritania, Romania and Vietnam’.<sup>23</sup>

CDF promotes an integrating approach which would involve the private sector and other stakeholders along with the government to achieve its objectives. This may be viewed as crucial for country ownership. Private sector involvement was noticeable in Bolivia particularly in relation to short-term issues. Without the participation of small and medium-size enterprises (SMEs) and micro enterprises, the private sector input in the CDF scheme would be meaningless.<sup>24</sup> These industries would not entail much costs to set up, but can create employment which would not require very many skilled workers. These industries can be most appropriate for rural areas too. Such industries also provide a springboard for attaining better skills and efficiency. The production process becomes cost-effective. A centralised system of public sector control makes people feel alien to their own affairs, and the private sector expertise remains unutilised. According to the World Bank, the Government of Uganda successfully engaged the private sector in the implementation of its agreed national agenda in the forms of research, surveys and joint meetings (between the private and public sectors). One of the objectives of the Private Sector Foundation (PSF) was to identify the constraints to which the private sector was subject; and this resulted in the formulation of a national private sector strategy. PSF also participated fully in poverty reduction strategy consultations.

### III. CONCLUSION

It has been explained that banking is at the heart of any economy and that every country should accord sufficient priority to this industry. Developing countries, in general, tend to fail to appreciate the importance of this instrument of economic development. State-controlled banking industry often lead to downturn stagnation. Customer confidence is an essential factor for a thriving banking industry. Risk minimisation and the protection of customers’ interest by making investment in high return projects are the two very essential factors to develop ‘*banking interest*’ in the minds of the people in a country.

Bank failures and often the lack of interest of banks, as providers of finance, often work as a disincentive to utilise services of banks. Banks are transactional institutions in that the more transactions they are involved in, the more profits

<sup>23</sup> *Ibid.*, 13.

<sup>24</sup> *Ibid.*, 17.



they make. Thus, they are also required to encourage people to utilise banking services in the interest of both banks and their customers. Thus, eventually, the 'banking habit' will be created.

The economic policy of a country cannot be formulated by disregarding of the functions that commercial banks may contribute to the implementation of the policy. The vast majority of people living in rural areas in developing countries must be informed of the advantages of banking. The culture of saving money at home needs to be changed by pointing out the advantages of banking. Assurances must be given of the security of their deposits. This can, of course, be achieved by a system of effective supervision and control by central banks. This is where the Basle Core Principles come into play, and central banks in developing countries should try to implement them as far as possible.

Efficient and alternative banking is also important for small economies. These economies cannot prosper for the lack of resources and appropriate banking facilities. With the introduction of an effective banking system, the economic strength of these countries may be improved.

On the basis of the case study it may be concluded that a country's macro-economic policies may be improved if participation of the indigenous people is allowed along with the direct involvement of the private sector. The close and concomitant relationship between the banking industry and small and medium-scale enterprises is not difficult to find. Private banks, small and medium-scale enterprises and public-private enterprises contribute to the economic capacity-building of a country. Poverty reduction strategy must be an integral aspect of the macro-economic policy of a government; indeed it has been an integral aspect of Country Assistance Strategy (CAS) devised by the World Bank, and it ensures that CAS provides an effective vehicle for integrating and rationalising World Bank operations.<sup>25</sup>

Many governments seem to fail to appreciate the macro-economic/sectoral linkages that contribute to poverty-reduction strategies.<sup>26</sup> The issue of capacity-building needs to be addressed by all developing countries, and provision for external assistance should be made to enhance the process of capacity-building. Participation by international players should not be imposed, it must be agreed to by the host country concerned.

National institutions, such as parliaments or assemblies and a broad spectrum of the population should be involved in national debates for attaining consumers on a long-term vision and a national strategy.<sup>27</sup> Finally, the role of local culture in the development process should be seriously considered. However, development with external assistance may not be achieved if host governments maintain a rigid view of sovereignty and treat any external participation as an encroachment upon their sovereignty.

<sup>25</sup> See further Comprehensive Development Framework, CDF Secretariat, The World Bank, 17 Sept, 2001, 22.

<sup>26</sup> *Ibid*, 10.

<sup>27</sup> *Ibid*, 11.

# *The Role of the IMF and World Bank in Financial Sector Reform and Compliance*

DALVINDER SINGH\*

## I. INTRODUCTION

THE INTERNATIONAL COMMUNITY has over the last few decades focused considerable attention on how best to regulate financial markets to reduce the likelihood of financial crisis occurring that could undermine wider objectives such as financial stability and economic development. Regulation and supervision of those operating in domestic financial markets is undertaken at a domestic level and ‘shadows’ their transnational business activities. The efforts of the international community have focused on devising standards and assisting in capacity building so countries can undertake this responsibility. These efforts can be divided in to two rather crude but broad categories: countries that pose risks to the stability of the financial system as a result of the complexity and riskiness of the business undertaken within their financial markets; and development issues that focus on improving the efficiency of the banking system and the capacity with which countries can undertake the task of regulation and supervision *per se*. While these issues are inextricably linked, and ineffective oversight of financial markets has resulted in crises, it is the efforts to improve banking supervision and compliance with international standards devised in this area that are the subject of this chapter.

The first section of this chapter explores the catalyst for this attention on improving the effectiveness of bank supervision, namely the financial crises that arose during the 1990s. These crises highlighted the important link between the performance of the wider economy and the decisions taken thereon—generally referred to as the macro-economic factors—and the oversight of the financial

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and banking systems and its efficiency—generally referred to as the micro-economic factors. This distinction is important, as it provides the context to examine the assistance the IMF and World Bank give to countries in equal measure, something that is neglected. The second section considers the necessity for bank regulation and supervision, and the role of the Basel Committee on Banking Supervision, exploring some of its work and the standards it has devised to improve domestic bank regulation and supervision, known as the Basel Core Principles.<sup>1</sup> These principles are used by the IMF and World Bank to measure the extent to which countries' systems of banking regulation and supervision meet international best practices. The 'exclusivity' of the membership of the Basel Committee will be explored, and the implications of this for the legitimacy of the standards as well as its influence on countries to adopt its standards. The third section explores the responsibilities of the IMF and World Bank and the impact of the financial crises in the 1990s on their respective roles. It first looks at their general purposes under their Articles of Agreement, with special reference to financial and technical assistance in the financial sector of their members. Their traditional remits, namely the IMF's macro-economic assistance and the World Bank's micro-economic assistance, will be considered, and where necessary the changes to them. These are examined by referring to examples illustrating how issues to do with financial sector law reform are integrated into the assistance sought by the member countries. The fourth section then looks at the joint efforts of the IMF and World Bank in this area with the establishment of the Financial Sector Assessment Program (FSAP) and the assessment of their member countries and the extent to which they comply with, for instance, the Basel Core Principles. It focuses on this assessment as being a remedial tool to ascertain the extent to which member countries pose a 'systemic risk' to international financial stability and the need for development assistance to improve their capacity to move towards compliance. It also explores, with reference to specific country examples, the extent to which countries are complying and the work needed to ensure compliance. This is relative to the stage of development of the country and the sophistication of the banking system and the risks it poses. The fifth section explores the work undertaken so far by the IMF and World Bank in this area by examining the findings of the Independent Evaluation Group [IEG] and the general literature on the subject. The final section provides some concluding observations.

### **1. The Financial Crises of the 1990s**

Financial crises have occurred over the centuries, and indeed in the last few decades they have arisen in developed, emerging-market and developing countries. No country has been immune from the effects, whether directly or

<sup>1</sup> Hereafter the Base Core Principles.

indirectly.<sup>2</sup> Financial crisis can arise from adverse changes or shocks in an economy at a macro- or micro-economic level, and at a structural or institutional level.<sup>3</sup> Examples are changes in economic policy such as deregulation of the financial markets or the adoption of a floating currency; but equally changes in exchange rates, interest rates, the valuation of a currency and rises in the rate of unemployment or inflation can affect the value of assets and liabilities held by financial firms. The main cause of the financial crises of the mid- to late 1990s was the loss of confidence in a number of countries arising from such changes. In the case of Mexico, the peso crisis in 1994–1995 followed the introduction of a number of new economic policy initiatives based on a free-market model.<sup>4</sup> The major catalyst of the Asian crisis was the collapse of confidence in the Thai financial markets. Indonesia and South Korea followed in a regional domino effect, toppling over one by one notwithstanding the fact that the region had experienced a number of years of economic growth.<sup>5</sup> The financial crisis in Thailand was caused by pressure on its exchange rate in the money markets, and the flotation of the Thai baht resulted in pressure in parts of the region to respond accordingly, undermining confidence in the region.<sup>6</sup>

The problems in the macro-economic part of the economy were exacerbated by problems at the micro-economic level: official regulators of the financial system did not have the capacity and resources to prevent or indeed manage the ensuing crises, and paid little attention to the regulation and supervision of banks by failing to focus on actually doing the job of monitoring and enforcing

<sup>2</sup> For example, the World Bank provides the following list of costs (in billions of US dollars) that were accrued when dealing with the various crises in the 1990s: Argentina 1995–1996: \$3.7; Argentina 1999 \$8.3; Argentina 2001, \$40; Ecuador 1999–2000, \$2.0; Indonesia 1997–1998, \$38; Jamaica 1996–1997 \$2.0; Korea, Rep of 1997–1998, \$58; Mexico, 1995 \$48.8; Russian Fed, 1998 \$22.5; Thailand, 1997–1999, \$17.2; Turkey 2001–2003, \$22.2; Uruguay, 2002, \$3.3 in ‘International Rescue Efforts and Bank Response to Crisis’, available at <http://www.worldbank.org>.

<sup>3</sup> CP Kindleberger, *Manias, Panics and Crashes: A history of Financial Crises* 4th edn, (Basingstoke, Palgrave Macmillan, 2001); B Eichengreen, *Financial Crises and what to do about them* (Oxford, Oxford University Press, 2002). For a legal perspective of the financial crises see, D Arner, M Yokoi-Arai and Z Zhou (eds), *Financial Crises in the 1990s* (London, BIICL (2001); See also GA Walker, ‘International Financial Stability—The Need for a Multilateral Response’, in JB Atanasio and JJ Norton (eds), *Multilateralism v Unilateralism: Policy Choices in a Global Society* (London, BIICL, 2005) at p 483; See also CJ Lindgren, TJT Balino, C Enoch, AM Gulde, M Quintyn and L Teo, ‘Financial Sector Crisis and Restructuring Lessons from Asia’, (1999) Occasional Paper 188, Washington DC, IMF.

<sup>4</sup> GAO Report. Mexico’s Financial Crisis: Origins, Assistance and Initial Efforts to Recover, Feb 1996, GAO/GGD-96-56 at p 110–14.

<sup>5</sup> As noted by GA Walker, ‘Some 370 million people were lifted out of poverty between 1975–1985. This meant that the proportion of East Asians living below the absolute poverty level of \$1 a day fallen from 60 per cent to 20 per cent’, World Bank, *East Asian Miracle: Economic Growth and Public Policy* (1993) at n 39 in GA Walker, above n 3 at p 494.

<sup>6</sup> AF Lowenfeld, *International Economic Law* (Oxford, Oxford University Press, 2003) at p 592; H Christensen, ‘International Financial Contagion’, (2000) No 76, *Financial Market Trends* 65 at p 70; H Christensen, ‘Moral Hazard and International Financial Crises in the 1990s’, (2001) No 78, *Financial Market Trends* 115. See also AK Lim, ‘The S&L Crisis Revisited: Exporting an American Model to resolve Thailand’s Banking Problems’ (1998) 9 *Duke Journal of Comparative and International Law* 343.

the rules.<sup>7</sup> In addition to this poor level of protection in terms of regulation and supervision to safeguard market confidence and integrity of the financial markets, poor protection of creditor interests in terms of legal preconditions resulted in claims not being efficiently processed within the legal system.<sup>8</sup> In the case of Indonesia, for example, the expansion of the banking sector without commensurate prudential regulation and supervision to oversee and control its growing complexity exposed the fragility of the whole banking system.<sup>9</sup> This is echoed in a study by Harris highlighting the importance of regulators keeping pace with rapid growth in the financial sector.<sup>10</sup> Eatwell also in support of the post-Asian financial crisis agenda links the macro/micro-economic issues together: 'Too often today, regulation is seen as an activity that involves the behaviour and interaction of firms, with little or no macroeconomic dimension. By the very nature of financial risk this is a serious error, and is likely to lead to serious policy mistakes'.<sup>11</sup> The Asian financial crisis, for instance, led to a number of bank closures in Indonesia, 86 financial institution closures in Korea and 58 closures in Thailand.<sup>12</sup> The individual countries entered into a process of formally screening individual banks to ascertain their viability according to international standards, in conjunction with the commitments they entered in to with the IMF and the World Bank as expressed in their individual Letters of Intent.<sup>13</sup> Finally, as a result of these and other crises the IMF and World Bank shifted their efforts and attention to assist members to reform their legal and regulatory infrastructures overseeing the financial sector to reduce the impact of a future financial crisis by addressing the issue in light of the Basel Core Principles and the capacity to ensure compliance.<sup>14</sup>

<sup>7</sup> M Yokoi-Arai, 'Regional Financial Institutionalization and the Creation of a Zone of Law: The Context of Financial Stability/Regulation in East Asia' (2001) 35 *International Lawyer* 1627 at p 1644. AD Roller, 'Thailand's Banking Crisis and Subsequent Reform: Could Thailand Benefit from an International Standard' (2001) 24 *Suffolk Transnational Law Review* 411; See generally A Crockett, 'Why is financial stability a goal of public policy?' (1997) 4 *Federal Reserve Bank of Kansas Economic Review* 5.

<sup>8</sup> A Gelpern, 'Systemic Corporate and Bank Restructuring in Financial Crisis', in JB Attanasio and JJ Norton (eds), *A New International Financial Architecture: A Viable Approach*, (London, BIICL, 2001) at p 225; M Reaz and T Arun, 'Corporate governance in developing economies: Perspective from the banking sector in Bangladesh' (2006) 7 *Journal of Banking Regulation* 94 at p 102.

<sup>9</sup> M Pangestu, 'The Indonesian Bank Crisis and Restructuring: Lessons and Implications for other Developing Countries', (2003) G-24 Discussion Paper No 23, UNCTAD at p 2.

<sup>10</sup> K Harris, 'Anticipatory Regulation for the Management of Banking Crises', 38, *Columbia Journal of Law and Social Problems*, (2005) 251 at p 257.

<sup>11</sup> J Eatwell, 'New Issues in International Regulation', in E Ferran and CAE Goodhart (eds) *Regulating Financial Services and Markets in the 21st Century* (Oxford, Hart Publishing 2001) at p 245.

<sup>12</sup> GAO Report. International Finance: Actions Taken to Reform Financial Sectors in Asian Emerging Markets, Sept 1999, GAO/GGD-99-57.

<sup>13</sup> AF Lowenfeld, above n 6 at p 594; Communiqué of the Interim Committee of the Board of Governors of the International Monetary Fund, Washington DC, Oct 4, 1998.

## 2. Bank Fragility and the Basel Core Principles for Effective Banking Supervision

The banking industry is one of the most regulated and supervised sectors in any economy, given the real likelihood of collapse if its associated risks are not regulated or managed efficiently.<sup>15</sup> The industry performs a number of services: it manages the distribution of savings and investments, which is essential for an economy to operate effectively; and banks are also a central vehicle for the exercise of a state's monetary policy due to their role in an economy's payment system.<sup>16</sup> The susceptibility of banks to collapse or failure arises as a result of the 'maturity mismatch' between their borrowing and lending: the former is usually short term and the latter is normally on a long-term basis. Banks function on a small asset reserve and hold a large proportion of illiquid assets in the form of loans, which makes them susceptible to failure. Their fragility is heightened by the fact that the inter-bank market is made up of a network of large unsecured creditor and debtor relationships, where the failure of one bank could lead to the collapse of others if confidence in this market was undermined in some way—like a bank not being able to meet its obligations on time.<sup>17</sup> In addition to these factors highlighting the need for bank supervision, the legal obligation a bank has to its customer depositors is also limited. The bank-customer relationship of debtor and creditor provides that a bank does not have a continuous obligation to account for its decisions as to how it uses depositors' money: the bank can place deposits at any risk.<sup>18</sup>

In an extreme scenario, the fallout from any failure may have wider systemic consequences, with a significant risk of contagion in the financial system where the collapse of a bank could spread to others in the sector.<sup>19</sup> A systemic failure such as this can have wider repercussions on the performance of an economy, especially where the banking system represents a major part of its financial system. The economic costs of such failures can be considerable, and require huge amounts of public funds to stabilise the financial system.<sup>20</sup> Failures can also

<sup>15</sup> CAE Goodhart, P Hartmann, D Llewellyn and L Rojas-Suarez (eds), *Financial Regulation: Why, How and Where Now?* (London, Routledge, 1998); P Molyneux 'Banking Crises in the Macro-economic Context' in RM Lastra and HN Schiffman (eds), *Bank Failures and Bank Insolvency Law in Economies in Transition*, (London, Kluwer Law International, 1999) at p 7.

<sup>16</sup> *Ibid*, CAE Goodhart (1998) at p 10.

<sup>17</sup> X Freixas, G Curzio, G Hoggarth, and F Soussa, 'Lender of last resort: A review of the literature', in CAE Goodhart, and G Illing (eds), *Financial Crises, Contagion, and the Lender of Last Resort: A Reader* (Oxford, Oxford University Press, 2002) at p 33.

<sup>18</sup> See A Campbell and D Singh, 'Legal Aspects of the Interests of Depositor Creditors: The Case for Depositor Protection Systems', in A Campbell, JR LaBrosse, DG Mayes and D Singh (eds), *Deposit Insurance* (Basingstoke, Palgrave Macmillan, 2007) p 40.

<sup>19</sup> G Wood, 'The lender of last resort reconsidered' (2000) 18 *Journal of Financial Services Research* 203; RM Lastra, 'Lender of last resort: An international perspective', (1999) 48 *International & Comparative Law Quarterly* 340; G Kaufman, 'Bank contagion: A review of the theory and evidence' (1994) 8 *Journal of Financial Services Research* 123; G Kaufman 'Bank failures, systemic risk, and bank regulation', 16, *Cato Journal*, (1996) 1; CAE Goodhart and G Illing, above n 17; CAE Goodhart, 'Some regulatory concerns', Special Paper No 79, Financial Markets Group, London School of Economics, Dec, 1995 at p 16.

<sup>20</sup> K Harris (2005) above n 10.

undermine efforts to achieve certain development objectives, such as the efficiency with which financial resources are allocated in a country to a larger proportion of the population,<sup>21</sup> or improving the system of regulation and supervision to ensure depositor and investor confidence by making sure those operating in the marketplace are judged to be well-managed institutions and do not pose a threat to the integrity and confidence of the market and threaten the savings of ordinary depositors.<sup>22</sup> This requires specific focus on putting in place adequate legal preconditions and regulatory infrastructure to ensure the objectives of financial stability and depositor protection are achieved. Where there are gaps in the system of regulation and supervision it is evident that the financial system is not overseen effectively to weather domestic and international risks from either bank failures or financial crises.

In light of the fragility of the banking system, a system of regulation and supervision is necessary.<sup>23</sup> In general terms, bank regulation refers to the rules banks are required to comply with and supervision refers to the monitoring process undertaken by a regulator when an institution seeks entry into the banking industry; supervision also controls the exit of banks from the industry, so that this is as orderly as possible and does not disrupt the banking system. The concept of prudence is integral to bank regulation and supervision, as it connotes the idea that regulation requires bank activities to be undertaken with some form of reasonable care. In order to ensure banking is undertaken with a degree of prudence, bank supervisors use a number of tools to regulate banks: capital adequacy, liquidity ratios, large exposure rules, consolidated supervision and deposit insurance. These tools need to extend over the domestic and international operations of a business and require a broader examination than simply focusing on capital adequacy standards, in light of the fact that most bank failures are ultimately caused by mismanagement and ineffective supervision. As Marauhn explains, ‘With the existence of such a supervisory system at the national level, states can still preserve a large degree of sovereignty within the process of internationalisation by, first, allowing foreign actors in and, second, supervising home actors also abroad. The notion of extraterritorial jurisdiction thus comes into play’.<sup>24</sup> This is for two reasons: firstly, to ensure the interests of depositors and market confidence are not threatened by the

<sup>21</sup> AH Bouab, ‘Financing for Development, The Monterrey Consensus: Achievements and Prospects’ (2004) 26 *Michigan Journal of International Law* 359; RP Buckley, ‘The Essential Flaw in the Globalisation of Capital Markets: Its Impact on Human Rights in Developing Countries’ (2001) 32 *California Western International Law Journal* 119 at pp 127–8.

<sup>22</sup> For instance, the World Bank explained the poverty and social impact objectives of financial sector reform in the following terms: ‘Strengthening financial infrastructures acts a steady promoter of growth and reduces the frequency and costs of financial crises’: Egypt, Program Document, Report No 36197—EG (2006) at p 32.

<sup>23</sup> Federal Reserve System (1994) Purposes and Functions, available at [www.federalreserve.gov/pf/pf.htm](http://www.federalreserve.gov/pf/pf.htm), at pp 59–60. For a wider examination of regulation and supervision see RM Lastra, *Central Banking and Banking Regulation* (London, LSE Financial Markets Group, 1996) at p 108.

<sup>24</sup> R Grote and T Marauhn (eds), *The Regulation of International Financial Markets* (Cambridge, CUP, 2006) at p 9.

activities of banks' overseas operations; secondly, as will be seen below, a risk of contagion through the international markets can mean a financial crisis in one jurisdiction spreads to others due to the interconnected nature of financial markets. As a result of this interdependency and interconnectedness, efforts have been made to improve the way countries regulate and supervise the operations of banks; this has mainly been through the work of the Basel Committee on Banking Supervision.<sup>25</sup>

The Basel Committee on Banking Regulation and Supervisory Practices was established after the collapse of Franklin National Bank and Bankhaus Herstatt in 1974, fatalities of foreign-currency dealings. These collapses illustrated at the time how risk can be transmitted from the 'home state' to 'host states' because of the interrelatedness of banks' wholesale dealings among themselves. The effect of the collapses was felt in a number of jurisdictions, which forced central banks to recognise that cooperation was needed to manage such disasters through formal *ex post* mechanisms of coordination and information sharing. In the light of the experience of the early 1970s, banking regulators focused on areas beyond their respective markets, paying attention to the transnational operations of banks in other countries and including these operations in what is called 'consolidated supervision'. The general principle, in the Basel rules, is that 'no banking institution should be allowed to avoid supervision'. The Basel Committee has highlighted three broad 'principles' that underpin its work: 'exchanging information on national supervisory arrangements; improving the effectiveness of techniques for supervising international banking business; and setting minimum supervisory standards in areas where they are considered desirable'.<sup>26</sup>

The rationale for the core principles was the fact that 'weak' systems of banking were exacerbating problems associated with financial instability domestically and internationally during the 1990s. The principles were devised with the assistance of a number of non-G10 supervisory authorities in order to enhance political acceptance of the standards.<sup>27</sup> This culminated in a set of 25 core principles deemed necessary for effective banking supervision. The Basel Committee's Core Principles for Effective Banking Supervision are considered

<sup>25</sup> Consolidated supervision has also been an important part of its standards building work to reduce the likelihood of banking failures that could have systemic consequences in either host or home markets. For an early examination see, A Hirsch, 'Supervising Multinational Banking Organizations: Responsibilities of the Home Country', (1981) 3 *Journal of Comparative Corporate Law and Securities Regulation* 40; NL Petersen, 'Supervising Multinational Banking Organizations: Responsibilities of the Host Country' (1981) 3 *Journal of Comparative Corporate Law and Securities Regulation* 27. For an indepth analysis of the role of the Basel Committee see GA Walker, *International Banking Regulation—Law, Policy and Practice* (The Hague, Kluwer Law 2001). See also D Wood, *Governing Global Banking: The Basel Committee and the Politics of Financial Globalisation* (Aldershot, Ashgate Publishing, 2005). WA Ryback, 'Work of Basle Committee', in RC Effros, (ed), *Current Legal Issues Affecting Banks, vol 3* (Washington DC, International Monetary Fund 1992); JJ Norton, 'Appendix—Background Note on the Basle Committee', in JJ Norton, (ed), *Bank Regulation and Supervision in the 1990s* (London, Lloyd's of London Press Ltd, 1991).

<sup>26</sup> <http://www.bis.org/bcbs/history.htm>.

<sup>27</sup> <http://www.bis.org/publ/bcbs30a.pdf>. at p 1.



the ‘blueprint for an effective system of banking supervision’, and are one of the key examples of the efforts made to improve domestic bank regulation and supervision.<sup>28</sup> The Core Principles provide a set of rules that need to be in place if a system of banking regulation and supervision is to be effective. However, what is considered effective is essentially relative to the country under consideration: while a developing country could be compliant with the Core Principles, it does not necessarily mean it is attaining the standards one may expect in a developed country where the risks associated with banking can be completely different and more complex. The Core Principles focus on the responsibilities of the home regulator to oversee the operations of a bank both domestically and internationally. They are not a set of rules for sharing responsibilities for regulating internationally active banks *per se* between the home and host states, like the initial Basel Concordats.<sup>29</sup> In addition to the Core Principles a methodology was devised to ensure that compliance could be assessed as consistently as possible.<sup>30</sup> As Norton explains, this was to ‘enable assessors to take into account not only the strict application of the Principles, but the comprehensive adoption of the mechanisms underlying the Principles by providing both the basic concepts and relevant interpretations’.<sup>31</sup> The adoption of broad principles and a flexible approach to their application is necessary so they can be equally applicable to banking systems at both ends of the spectrum, from developed to developing economies, and emerging markets in between—where, as will be seen, the issues and gaps are different. Failing this, a situation would soon arise where the findings and recommendations were not commensurate to the needs of the banking system. Indeed, the assessment methodology also reduces the gap between formal compliance and actual compliance.<sup>32</sup>

The Core Principles include a focus on the ‘preconditions for effective regulation and supervision’, such as a framework of regulation and supervision that is based on clear objectives; they also pay specific attention to both entry and exit requirements for an effective banking system. This entails licensing for banks to delineate the permissible activities they are able to undertake, and the power to confer such licences or deny them if a bank does not fulfil the appropriate criteria. Once a bank is licensed the regulator needs powers to supervise its business efficiently on a continuous basis, particularly its adherence to capital requirements. To ensure banks comply with the prudential measures, regulators need to have in place mechanisms to take ‘corrective action’, and in the extreme

<sup>28</sup> C Freeland, ‘The Basel Committee Process’, Paper prepared for the One World Trust Workshop ‘Increasing Accountability through External Stakeholder Engagement’, 23–24 Oct, London, UK at p 2.

<sup>29</sup> Basel Committee: Principles for the supervision of banks’ foreign establishments (Concordat) May 1983 at <http://www.bis.org/publ/bebsc312.pdf> (This replaced the 1975 Concordat)

<sup>30</sup> Basel Committee on Banking Supervision, ‘Core Principles Methodology’, Oct, 1999.

<sup>31</sup> JJ Norton, *Financial Sector Law Reform in Emerging Economies* (London, BIICL, 2000) at p 59.

<sup>32</sup> See also K Pistor, who asserts ‘[t]he signalling function of internationally agreed legal standards is likely to erode if too many countries practice formal compliance, rather than real compliance’. In K Pistor, ‘The Standisation of Law and its effect on Developing Economies’, No 4, G-24 Discussion Paper Series, UNCTAD, Jun 2000 p 15.

scenario powers to revoke a licence if depositor interests are threatened. Finally, the Core Principles also focus on the need for the international aspects of a bank's business to be supervised on a consolidated basis.

The Basel Committee is without doubt the central think-tank and deviser of standards, recommendations, policy and guidance in banking on an international level; it has no credible challenger, and the jewel in its crown is the 1988 Capital Adequacy Accord.<sup>33</sup> The importance given to its standards and recommendations has resulted in serious consideration as to what form of law it devises: whether it is 'hard' or 'soft' law standards.<sup>34</sup> The Bank for International Settlement [BIS] has attempted to clarify this by highlighting that the Basel Committee 'does not possess any formal supranational supervisory authority, and its conclusions do not, and were never intended to have legal force'.<sup>35</sup> For example, there is no formal international legal instrument that first articulates its function, secondly sets out the responsibility of its members, and thirdly outlines the way decisions will be agreed upon to provide it with the formal position of a 'law-making' institution. As Marauhn explains, the Basel Committee is not, from a public international law perspective, an international organisation as it lacks the necessary formal law-making powers and has a more informal, non-transparent approach.<sup>36</sup>

The Basel Committee has been described as an 'international club for banking regulators'.<sup>37</sup> It has a more exclusive membership than the BIS, which has a somewhat wider membership representing some emerging-market economies like India and Brazil.<sup>38</sup> The Basel membership is limited to a select group of central banks from industrialised countries rather than crossing the economic divide between developed and developing nations. Its widening consultation process adds further legitimacy with the international community, as it means a more diversified set of viewpoints contribute to devising its international

<sup>33</sup> Basle Committee on Banking Supervision, 'International Convergence of Capital Measurement and Capital Standards', Basel Jul (1988) available at <http://www.bis.org/publ/bcbs04a.pdf>.

<sup>34</sup> M Giovanoli, 'A New Architecture for the Global Financial Market: Legal Aspects of International Financial Standard Setting', in M Giovanoli, (ed), *International Monetary Law: Issues for the New Millennium* (Oxford, Oxford University Press 2001). DE Ho, 'Compliance and International Soft Law: Why do Countries Implement the Basel Accord' (2002) 5 *Journal of International Economic Law* 647; LC Lee, 'The Basle Accords as Soft Law: Strengthening International Banking Supervision' (1998) 39 *Virginia Journal of International Law* 1; GF Hundl, WM Reisman, B Simma, PM Dupuy, C Chinkin and RDL Vega, 'A Hard Look at Soft Law', (1998) 82 *American Soc Int'l L L Proceedings* 371.

<sup>35</sup> <http://www.bis.org/bcbs/history.htm>.

<sup>36</sup> See also R Grote and T Marauhn, (2006) above n 24 at p 10–11.

<sup>37</sup> See CD Hadjiemmanuil, 'Central Bankers 'Club' Law and Transitional Economies: Banking Reform and the Reception of the Basel Standards of Prudential Supervision in Eastern Europe and the Former Soviet Union' in JJ Norton and M Andenas *Emerging Financial Markets and the Role of International Organisations*, London, Kluwer Law International, (1996) at p 179; S Emmenegger, 'Basle Committee on Banking Supervision—a secretive club of giants?' in R Grote and T Marauhn (2006) above n 24 at p 224. See also D Zaring, 'International Law by Other Means: The Twilight Existence of International Financial Regulatory Organizations' (1998) 33 *Texas International Law Journal* 281 at pp 303.

<sup>38</sup> [http://www.bis.org/about/orggov.htm#P24\\_1838](http://www.bis.org/about/orggov.htm#P24_1838).

standards. But the lack of formal representation of the international community on its board has called into question whether it is sufficiently ‘democratic’ to establish rules that states are required to conform to through their central banks or regulators. Macey has described the work of the Basel Committee as a form of ‘regulatory imperialism’ as it ‘persuades’ or ‘enforces’ non-G7 countries to comply with its standards.<sup>39</sup> This has led to criticism in light of the fact that the rules promulgated by the Basel Committee are expected to be followed by others even though they have not formally been party to their development, albeit they have been invited to engage in the consultation process. But despite this central banks have in most instances put their names to the rules, highlighting the importance of being seen to be in compliance.<sup>40</sup> According to Alford, ‘the [Basel] Committee relied on regulators’ moral authority and informal pressure for enforcement’ to achieve this.<sup>41</sup> Indeed, the promulgation of its standards does lead many countries to adopt them as soon as possible, to avoid undermining the perception of the quality of their financial systems and placing their banks at a commercial disadvantage, or incurring international criticism for failing to comply.<sup>42</sup>

The Basel Committee is, as mentioned above, made up of central banks (and bank regulators) rather than their respective sovereign states or political agencies, and thus it operates at an administrative level—central bank to central bank rather than state to state, albeit it is ultimately individual states that delegate responsibility domestically to the central banks to make law, because of their technical expertise to deal with the international administration of bank regulation and oversee their internationally active banks on a transnational basis.<sup>43</sup> Barr and Miller caution against more state involvement by adopting a ‘treaty-making model’, suggesting the current level of dialogue between the various interested parties is sufficient to ensure the accountability of domestic regulators.

<sup>39</sup> JR Macey, ‘Regulatory Globalisation as a Response to Regulatory Competition’, (2003) 52 *Emory Law Journal* 1353; See also RP Delonis, ‘International Financial Standards and Codes: Mandatory Regulation with Representation’, (2004) 36 *New York University Journal of International Law and Politics* 563 at pp 616–29. Despite this some have called for the BIS, where the Basel Committee resides, to act as the international bank regulator see C Felsenfeld and G Bilali, ‘The Role of the Bank for International Settlements in Shaping the World Financial System’ (2004) 25 *University of Pennsylvania Journal of International Economic Law* 945.

<sup>40</sup> MS Barr and GP Miller, ‘Global Administrative Law: The View From Basel’, (2006) 17 *European Journal of International Law* 15.

<sup>41</sup> DE Alford, ‘Core Principles for Effective Banking Supervision: An Enforceable International Financial Standard’ (2005) 28 *Boston College International and Comparative Law Review* 237 at p 259 and also at p 263.

<sup>42</sup> A Crockett, ‘International Standard Setting in Financial Supervision’, Lecture at the Cass Business School, City University, UK Feb 5, 2003. Where he asserts how peer pressure ensures compliance in this area.

<sup>43</sup> See generally D Shelton, ‘Law, Non-Law and the Problem of Soft Law’, in D Shelton, *Commitment and Compliance: The Role of Non-Binding Norms in the International Legal System* (Oxford, Oxford University Press, 2003) at p 12; See D Zaring (1998) above n 37; See also D Zaring, ‘Informal Procedure, Hard and Soft, International Administration’ (2005) 5 *Chicago Journal of International Law* 547.

However, mechanisms to implement or simply commit to the Basel standards vary across the international community, giving rise to a whole host of different responses at a national level.<sup>44</sup> An overarching body would be required to ensure consistency on a transnational level. While formulating the standards and principles this way may be considered appropriate, their enforcement is a difficult issue to address given the lack of resources to ensure compliance and commitment; here reliance has to be placed on the domestic regulators. At the international level the functions and resources of state-centred institutions like the IMF and World Bank are needed to enhance the capacity of individual states to regulate and supervise their domestic financial services sector and oversee the transnational activities of banks that operate within other markets.

## II. IMF AND THE WORLD BANK: A COORDINATED APPROACH?

The IMF and the World Bank have responsibility respectively for exchange rate and currency stability, and reconstruction and development.<sup>45</sup> The post-war agenda of exchange rate stability and reconstruction has been broadened to assist members with their efforts to achieve monetary and financial stability, create sustainable economic growth to reduce poverty, and enhance development; focusing on their capacity to improve the domestic infrastructure that is necessary in most cases to deal with the prescribed assistance the institutions provide.<sup>46</sup> The responsibilities of the two are distinguishable by the period over which they assist their members. The IMF's assistance has tended to be on a short-term basis, focusing on macro-economic matters; whereas the World Bank has concentrated on long-term development projects that focus on the micro-economic side. In the pursuit of these interdependent goals a considerable level of cooperation between the two institutions has evolved, notwithstanding an inevitable degree of tension on occasion when their policies seem to conflict with one another; this occurred especially during the 1990s and the financial crises experienced by a number of countries.<sup>47</sup> This has resulted in more formal coordination over the years to deal with such matters, although both still

<sup>44</sup> E Colomatto and JR Macey, 'A Public Choice Model of International Economic Cooperation and the Decline of the Nation State' (1996) 18 *Cardozo Law Review* 925.

<sup>45</sup> The IMF and the World Bank see Article 1 of the Articles of Agreement available at <http://www.imf.org/external/pubs/ft/aa/aa.pdf> and Article 1 of the Articles of Agreement for IBRD available at <http://www.worldbank/>.

<sup>46</sup> For example, see D Vines and CL Gilbert, 'The IMF and international financial architecture', in D Vines and CL Gilbert, (eds), *The IMF and its Critics: Reform of Global Architecture*, (Cambridge, CUP, 2004); See also R M Lastra, *Legal Foundations of International Monetary Stability*, (Oxford, Oxford University Press 2006).

<sup>47</sup> For a critical analysis of the tensions that have ensued from the relationship between the IMF and World Bank see IFI Shihata, *The World Bank and the IMF relationship—Quo Vadis?* in JJ Norton and M Andenas (eds), *International Monetary and Financial Law upon Entering the New Millennium: A Tribute to Sir Joseph and Ruth Gold*, (London, BIICL, 2002) at pp 1–28.

concentrate on their ‘core tasks’.<sup>48</sup> Gilbert *et al* propose the core foci as ‘the Fund on macro-economic and crisis resolution and macro-policy advice; and the Bank on longer-term development—including micro-economics and trade and industry issues—and poverty reduction’.<sup>49</sup>

This move from the traditional remits of responsibility is evidence of a growing influence of the two in the arena of a country’s domestic policy;<sup>50</sup> this is achieved through the conditions attached to their financial and technical assistance when domestic policies and legal and regulatory infrastructure are not sufficient to prevent or manage a crisis.

### 1. The evolving role of the IMF and World Bank

The responsibilities and functions of the IMF centre on its key purpose: to deal with ‘international monetary problems’ by acting as the forum for its members to ‘consult’ and ‘collaborate’ with it so as to ‘facilitate’ and ‘promote’ ‘international monetary co-operation’, ‘growth of international trade’ and ‘exchange rate stability’ to achieve financial and economic stability.<sup>51</sup> The IMF seeks to achieve these broad purposes through its core functions: surveillance, financial assistance and technical assistance to ensure its members continuously adhere to its underlying purposes.<sup>52</sup> The traditional objective of surveillance is ensuring ‘orderly exchange arrangements’ among members. The IMF, in ‘consultation’ with its members by both bilateral and multilateral means, assesses individual members’ economic and monetary policies against its purposes to ascertain whether they pose a risk to the stability of the international monetary system. It seeks to provide financial assistance to members experiencing balance of payment problems, on the basis that the individual member complies with the conditions set for such assistance so the IMF can be assured the money will be repaid. This invariably requires the member country to adjust its economic and monetary policies, giving rise to a considerable level of coercive and unfettered leverage by the IMF to ensure changes are indeed made. The final function of the IMF is to provide technical assistance to its members, but without the same degree of compulsion as is attached to the other activities. Conditionality which

<sup>48</sup> Article 1 of the Articles of Agreement sets out the purpose of the IMF; for a critique of the relationship see also CL Gilbert, A Powell and D Vines, ‘The World Bank: an overview of some major issues’ in CL Gilbert and D Vines, *The World Bank: Structure and Policies* (Cambridge, CUP, 2000) at pp 70; See also M Goivanoli, in M Goivanoli (ed) (2001) above n 34 at pp 14–16.

<sup>49</sup> *Ibid*, CL Gilbert and D Vines (2000) at p 70.

<sup>50</sup> See R Hormats, ‘Reflections on the Asian Financial Crisis’, in JB Attanasio and JJ Norton (eds) (2001) above n 8 at pp 3; As GA Walker in JB Attanasio and Norton (2005) above n 3 highlights, ‘. . . few, if any, of the problems which have arisen in international financial markets can be considered or treated separately and certainly not resolved on an individual basis’, at p 489.

<sup>51</sup> IMF Articles of Agreement Article I: Purposes; For an overview of the methods used to achieve its purposes see F Gianviti, ‘Reform of the International Monetary Fund in JB Attanasio and JJ Norton, (2001) above n 8 at pp 80.

<sup>52</sup> See IMF Articles of Agreement Art IV and V above n 45.

generally refers to the designated policy and procedures attached to the assistance the IMF provides ensures to a certain extent the objectives of the assistance is achieved. It has, in many respects, generated a considerable level of controversy in light of the expansion of its policy remit to include matters at a micro level such as infrastructural reform. As Lastra notes the rationale for this expansion was the fact that the crisis stricken countries discussed above exposed considerable problems in this area thus exacerbating the financial problems they experienced.<sup>53</sup>

The traditional functions as noted above have expanded considerably over the years, both formally through amendments of the Articles of Agreement and informally through policy pronouncements, to encompass a broader set of issues that underpin the stability of the international monetary system. This has widened the IMF's role from macro-economic policy matters to include micro-economic policy, to achieve *inter alia* 'financial and economic stability in its broadest sense' by acting as a forum for 'international cooperation to monitor economic developments on a global scale' and specifically addressing weaknesses in the overseeing of domestic financial markets.<sup>54</sup> The key issue highlighted is the risks now posed by such weaknesses in the financial system, both internally and externally to others. The traditional role of surveillance has been broadened from what Lastra coins "macro-surveillance" to "micro-surveillance",<sup>55</sup> specifically focusing on financial system soundness by placing particular attention on 'weak financial institutions, inadequate bank regulation and supervision, and lack of transparency' as a result of its broad discretionary mandate articulated in the Articles of Agreement.

These issues form part of the broader agenda of bilateral and multilateral surveillance the IMF undertakes periodically with members to 'lessen the frequency and diminish the intensity of potential financial system problems'; members are required to cooperate with the IMF, outlining how they will attempt to deal with any issues by drawing up a programme of reform. For example, the Article IV staff report for Tunisia in 2002 illustrated the work the authorities were undertaking in the financial sector area and progress towards implementing the findings from a Financial Sector Assessment Program (FSAP) assessment.<sup>56</sup> Despite the perception that financial sector reform is a 'wholesale' part of Article IV consultation, in fact only two reports explicitly refer to financial

<sup>53</sup> RM Lastra, 'IMF Conditionality', 4 *Journal of International Banking Regulation*, (2002) 167 at p 177.

<sup>54</sup> R Hockett, 'From Macro to Micro to "Mission-Creep": Defending the IMF's Emerging Concern with the Infrastructural Prerequisites to Global Financial Stability', (2002) 41 *Columbia Journal of Transnational Law* 153; JJ Norton, 'A 'New International Financial Architecture?: Reflections on the Possible Law-Based Dimension', in JB Attanasio and JJ Norton, (2001) above n 8 at pp 167; JW Head, 'Seven Deadly Sins: An Assessment of Criticisms Directed at the International Monetary Fund' (2004) 52 *University of Kansas Law Review* 521.

<sup>55</sup> See RM Lastra, above n 46, pp 402–6.

<sup>56</sup> Tunisia, Preliminary Conclusions of the Article IV Consultation Mission for 2002 at para , 28.

sector matters, namely Tunisia and Iceland.<sup>57</sup> However, when a country is seeking financial support from the IMF the picture is very different: here the issue of financial sector reform features frequently, in addition to the traditional areas of IMF responsibility, in the Letters of Intent prepared by the member seeking support.<sup>58</sup> For example, the Letter of Intent of the government of Thailand dated 1997 contained numerous references to its intention of making changes in the financial sector, such as legal and regulatory reforms. To obtain financial support from the IMF these changes were of a short- and long-term nature, and designed ultimately to restore confidence in the financial system by closing insolvent banks, putting in place a deposit protection system and improving the approach to enforcement sanctions.<sup>59</sup> These issues form part of the adjustment policy the member seeking assistance must put in place and adhere to in order to give the IMF the assurance to provide such assistance.

The IMF's technical assistance function has also evolved in light of its broader agenda to include financial sector reform, which incorporates the FSAP, by providing technical assistance on a voluntary basis. In more recent Letters of Intent, such as Turkey in 2006, the letter not only referred to the measures put in place to effect financial sector reform, but also expressed the intention to 'use the findings of the FSAP for Turkey to guide our future reform efforts in the financial sector'.<sup>60</sup> This indicates the link between the compulsory and the voluntary parts of the IMF's role and the importance attached to financial sector reform, if necessary, in seeking financial support from the IMF. The voluntary aspect is important because not all members will require formal assistance but may nevertheless pose a threat to domestic or international stability, so some form of voluntary assessment programme was needed that specifically focused on bank regulation reform—especially given that weaknesses in this area were part of the reason for the Asian financial crisis.

The World Bank is primarily made up of two main agencies: the International Bank for Reconstruction and Development (IBRD), and the International Development Association (IDA) and affiliate agencies.<sup>61</sup> The role of the IBRD is aimed at reduction of poverty and sustainable development, although its initial responsibility was for assistance with the reconstruction of countries affected by war. The World Bank acts for its members as a facilitator for investment and technical assistance, broadly speaking to assist with the 'development of productive facilities and resources in less developed countries'.<sup>62</sup> The investment

<sup>57</sup> IMF News—Mission Concluding Statements. at [www.imf.org/](http://www.imf.org/).

<sup>58</sup> Country's Policy Intentions Documents, at [www.imf.org/](http://www.imf.org/).

<sup>59</sup> Thailand: Letter of Intent, (1997).

<sup>60</sup> Turkey: Letter of Intent, (2006) para , 19.

<sup>61</sup> The World Bank Group is actually made up of five agencies: International Bank for Reconstruction and Development (IBRD), International Development Association (IDA), International Finance Corporation (IFC), Multilateral Investment Guarantee Agency (MIGA), International Centre for the Settlement of Investment Disputes (ICSID).

<sup>62</sup> Article 1(i) IBRD Articles of Agreement (As amended effective 16, 1989); CL Gilbert and D Vines in CL Gilbert and D Vines (2000) above n 48 at p 14, highlight that the issue of development which the World Bank is now recognised for was not initially one of its primary objectives.

(or loans as the case may be) it provides comes from both private means and its own resources, but the principal objective is to give financial assistance to members on the most reasonable terms and conditions. The IBRD raises most of its funds by selling its AAA-rated bonds to financial intermediaries in the international markets. The traditional objectives it tries to 'promote' are of a long-term nature: the 'growth of international trade', 'equilibrium of balance of payments' and 'investment for the development of the productive resources of members, focusing on raising productivity, the standard of living and conditions of labor in their territories', but avoiding interfering in the political affairs of the country.<sup>63</sup> The purpose of the IBRD is relatively narrow in terms of its Articles of Agreement, but has obviously been interpreted broadly to cover the whole spectrum of development, from economics to health, education, environment, infrastructure and poverty alleviation:<sup>64</sup> 'The Articles must receive a great measure of purposive interpretation to reflect the Bank's changing role as a development institution'.<sup>65</sup> The objectives are continuously evolving rather than static and rigid, and need to be interpreted in the broad spirit rather than to the letter.

The primary functions of the World Bank as a whole are said to be to act as a financial intermediary, a development research institution and a development agency.<sup>66</sup> The IBRD and the IDA provide long-term finance for specific programmes over 15–20 years and 35–40 years respectively, depending on whether the individual country is classified as middle-income or low-income—the former do not have the financial need to seek assistance from the IBRD. The World Bank also assists members by providing what are termed 'knowledge services' through assessments and technical assistance on development matters; this is one of its most important roles. The loans provided by the World Bank fall into two broad categories: goods and services, and adjustment loans or 'structural adjustment loans'. The latter are for policy and institutional reforms: the 'programme of reforms . . . proposed by the country and negotiated with the World Bank to ensure the objective of the projects and the outcomes are achieved under the aegis of conditionality'.<sup>67</sup> Non-compliance can ultimately lead to the withdrawal of a loan, or in most cases the threat of it being withdrawn, notwithstanding the fact that a country is not obliged to fulfill the measures set out in

<sup>63</sup> IBRD, Article IV s. 10.

<sup>64</sup> World Bank, World Bank Group, Working For a World Free of Poverty MP?2M/1-2006 available at [www.worldbank.org/](http://www.worldbank.org/).

<sup>65</sup> World Bank, 'Legal Aspects of Conditionality' available at <http://www.worldbank.org/> at p 6.

<sup>66</sup> CL Gilbert, A Powell and D Vines in CL Gilbert and D Vines (2000) above n 48 at p 40.

<sup>67</sup> See for example IBRD Article III, s. (4) (vii); The essential requirements are set out in paragraph 13 Operational Policy 8.60: The Bank determines which of the agreed policy and institutional actions by the country are critical for the implementation and expected results of the program supported by the development policy loan. The Bank makes the loan funds available to the borrower upon maintenance of an adequate macroeconomic policy framework, implementation of the overall program in a manner satisfactory to the Bank, and compliance with these critical program conditions'. in paragraph 13 of Operational Policy 8.60. A similar provision also exists in the IDA's Articles of Agreement.



the programme; this is seen as its sovereign prerogative given the political, social and economic implications of the programme for the country.<sup>68</sup>

Financial sector reform has been on the World Bank's agenda for a considerable length of time (a lot longer than it has featured at the IMF), either through financial support for structural reform projects or technical assistance to a country's authorities to develop this area of the economy and improve the capacity to oversee the financial system through legislative changes and training.<sup>69</sup> Structural adjustment loans have focused on a broad range of areas, including reducing government ownership and strengthening bank supervision.<sup>70</sup> For example, in the period 1993–2003 the World Bank provided \$56 billion of assistance for financial sector reform projects, which equates to about 24 per cent of its budget,<sup>71</sup> to improve economic growth and reduce poverty by enhancing the mobility of savings and investment across as broad a sector of the economy as possible to make it more inclusive.<sup>72</sup> The size and complexity of the projects mean that the World Bank acts as the overall 'lead manager', with other donors, especially regional development banks, providing assistance such as technical and financial support. In these projects the state is at the centre and advocates the reforms, while the central bank and government departments are responsible for implementing the changes; this is in contrast to the general perception that changes in banking regulation and supervision are implemented by the central bank rather than being state led.

Support has focused on numerous projects relating to the infrastructure of the financial system; for instance, in the case of Egypt in 2006, which is no exception, the goal was to modernise bank regulation and its enforcement so as to comply with international standards.<sup>73</sup> The changes were aimed at improving the efficiency of the banking system by enhancing market confidence and accountability of individual banks. In Paraguay in 2002 the focus was on mechanisms to deal with efficient bank resolution and provide an effective safety net to avoid small depositors losing their money when a bank fails or is closed.<sup>74</sup> In Mexico in 1995<sup>75</sup> and the Philippines in 1998, technical assistance to strengthen financial sector oversight by improving their capabilities to deal with financial

<sup>68</sup> CL Gilbert, A Powell and D Vines above 48 at p 59–60. A critique of the implication of World Bank Structural Adjustment Loans is beyond the parameters of this chapter.

<sup>69</sup> Independent Evaluation Group, *World Bank Assistance to the Financial Sector: A Synthesis of IEG Evaluation*, The World Bank Group, Washington DC (2006) at p 1; CL Gilbert, A Powell and D Vines in CL Gilbert and D Vines (2000) above n 48 at pp 66.

<sup>70</sup> For a case study see JR Magnusen, 'Structural Adjustment Policies and the Evolution of the New Legal Framework for Economic Activity in Ghana' in JJ Norton and M Andenas, (1996) above n 37 at p 81.

<sup>71</sup> Independent Evaluation Group (2006) above n 69 at p 3.

<sup>72</sup> See for instance Jamaica-Bank Restructuring and Debt Management Program Adjustment Loan, Report. No PID 9540. p 3. This is iterated in one way or another in Program Information Documents (PID).

<sup>73</sup> Egypt: Program Information Document Report No AB2097 (2006).

<sup>74</sup> Republic of Paraguay-Financial Sector Adjustment Loan Report No PID11244 (2002).

<sup>75</sup> Mexico-Financial Sector Restructuring Adjustment Loan, Report No PIC2076 (2005).

crisis was one of the main features of the loan.<sup>76</sup> In the case of Pakistan where the reform efforts have been in place for a significant length of time compliance with the Basel Core Principles now stands at 22 out of the 25 Core Principles.<sup>77</sup>

## 2. The IMF and World Bank Financial Sector Assessment Program: A Diagnostic Tool

The FSAP diagnostic tool was introduced by the IMF and World Bank after the Asian financial crisis on a voluntary basis.<sup>78</sup> This prompted the international community to respond with a whole host of initiatives to mitigate the risk of such episodes occurring again.<sup>79</sup> The IMF and the World Bank set up the FSAP so their respective strengths and specialisms could be harnessed together to identify financial sector ‘vulnerabilities’ and deal with the ‘development needs’ of their members to reduce the likelihood of further financial crises and the disruption they cause to financial stability. Another objective of the FSAP is to determine the extent to which members comply with international standards of financial regulation and supervision in banking, securities and insurance business; this is either incorporated under the Assessment of Financial Sector Standards or in an individual Report on Observance of Standards and Codes (ROSC).<sup>80</sup> The joint programme aims, ‘to help countries to enhance their

<sup>76</sup> Philippines-Banking System Reform Loan Report No PID6477 (1998).

<sup>77</sup> IEG Report *IEG Review of World Bank Assistance for Financial Sector Reform*, Washington DC, World Bank (2006) at p 25.

<sup>78</sup> FSAP Briefing Note, ‘Program Objectives, Processes, and Output’, A joint initiative of the World Bank and IMF Financial Sector Assessment Program; M Conthe and S Ingves, Financial Sector Assessment Program: A Commentary’, *American Banker*, Mar 9, 2001. F Gianviti, ‘Legal Aspects of the Financial Sector Assessment Program (FSAP) May 9, 2002: available at <http://www.imf.org/external/np/leg/sem/2002/cdmfl/eng/gianv2.pdf>.

<sup>79</sup> For example, the earlier Communiqué of the Development Committee highlighted the importance of international collaboration to assist the East Asian Region to resolve the ongoing difficulties it experienced. It highlighted ‘a concerted strategy for restoring sustainable growth and reversing the dramatic increase in poverty in East Asia’ was needed to include: ‘1 maintaining and accelerating progress on structural reforms, including governance structures required for the efficient working of markets; 2 restructuring the banking system and corporate sectors and in the short term, restoring credit to viable businesses; 3 mobilizing necessary resources to finance growth; 4 regenerating demand; 5 protecting the environment. Communiqué of the Development Committee Oct 5th 1998.

<sup>80</sup> IMF, ‘Progress Report: Developing International Standards’, Mar 1999; The standards assessed are:

1. Regulatory and supervisory standards
    - Basel Core Principles for Effective Banking Supervision (BCP)
    - IAIS Insurance Core Principles (ICP)
    - IOSCO Objectives and Principles for Securities Regulation (SCP)
  2. Transparency and disclosure standards
    - IMF Code of Good Practices on Transparency in Monetary and Financial Policies (MFP)
  3. Institutional and market infrastructure standards
    - Core Principles for Systemically Important Payment Systems (CPSIPS)
- See FSAP Briefing Note, above n 78 at p 2.

resilience to crises and cross-border contagion, to foster growth, by promoting financial system soundness and financial sector diversity';<sup>81</sup> its synergy connects the macro/micro prudential aspects of financial stability by linking it with the regulatory infrastructural needs of a country. The diagnostic focus of the FSAP then forms a platform for remedial work under the direction of the assessed country.

*a) FSAP process and tools*

The FSAP process has focused on the needs of developing, emerging and industrialised countries.<sup>82</sup> It concentrates on what it terms 'systemically important countries', as well as countries at various stages of development that pose a systemic threat to international financial stability. For example, in the case of developed countries a 'vulnerability assessment' is undertaken to gauge the extent to which the banking system can withstand macro-economic shocks;<sup>83</sup> In the case of emerging economies the FSAP process has to pay particular attention to the quality of regulation after financial crises and the diversity of the financial system, to assess whether the non-bank sector, for instance, can pose a systemic risks to the overall well-being of the financial system. The priority set for developing countries is different, focusing on building the infrastructure of the financial system.<sup>84</sup> The response by those deemed systemically important differs from that of countries at other stages of development. For example, the former consider the FSAP as an external review from an international perspective to gauge whether they could weather episodes of international financial instability; the latter consider it as an opportunity for identifying gaps in existing regulation and supervision and initiating reforms with development objectives in mind. According to observations made after the pilot programme, most countries that participated wanted more attention to be paid to the 'implications of missing, incomplete, or informal markets for the stability and the development of a diversified financial sector'.<sup>85</sup> The most recent review highlights similar sentiments wanting improvements in the assessment to reflect the development issues that are integral to the reform process.<sup>86</sup>

<sup>81</sup> IMF Reviews Experience with the Financial Sector Assessment Program (FSAP) and Reaches Conclusions on Issues Going Forward', PIN No 01/11 Feb 5th 2001 p 1

<sup>82</sup> IMF and World Bank, Financial Sector assessment Program—Review, Lessons, and Issues Going Forward, Feb, (2003) at p 8.

<sup>83</sup> In respect to industrialised economies the main focus has been on the effectiveness of the regulation and supervision to oversee the growing number of international financial conglomerates concentrated in these economies which can give rise to concerns associated with 'too-big-too-fail' scenario and the potential risks of contagion. *Ibid*, at p 16.

<sup>84</sup> *Ibid*, p 8; See also IMF & World Bank, 'Development Issues in the FSAP', Feb 24, (2003).

<sup>85</sup> IMF & World Bank, 'FSAP—A Review: Lessons from the Pilot and Issues Going Forward', Nov (2000) at p 12.

<sup>86</sup> IMF & World Bank, 'FSAP—A Review, Lessons, and Issues Going Forward', Feb (2005), at p 25.

The process of assessing observance of codes and standards consists of a pre-mission, the mission and a post-mission assessment involving an international team of consultants and IMF and World Bank officials. The country first completes a questionnaire on its system of bank regulation in conformity with the Basel Core Principle methodology; this is then submitted to the 'mission chief'.<sup>87</sup> The mission involves an in-country Financial System Stability Assessment (FSSA) of the banking system and its regulation and supervision. The team hold discussions with institutions such as the central bank and the bank regulator and supervisor, and have meetings with figureheads in the banking industry.

The stress test forms a significant part of the FSAP process. It consists of assessing the extent to which a country's financial system can withstand instability arising from 'plausible shocks to key macroeconomic variables'.<sup>88</sup> The assessment focuses on macro-economic shocks to the financial system to judge its robustness to withstand them. Stress tests could examine the implications of changes to interest and exchange rates for financial services firms.<sup>89</sup> The stress test is not a single, uniform model that is simply applied to all countries, ignoring the level of development; each assessment is designed around the country relative to the 'complexity of the financial system, and data availability, while also being mindful of the resource burden imposed on the central bank and supervisory authorities'.<sup>90</sup> For example, in the case of Gabon the stress tests focused on issues such as a government default on domestic debt repayments as a result of changes to oil production in the country and their effect on commercial banks servicing their debts.<sup>91</sup> In Mexico the focus was on the resilience of the banking sector to withstand a slowdown to the US economy, which would have a significant effect on banking profitability.<sup>92</sup> The position in Sweden was assessed by testing the resilience of the banking sector to real estate, exchange and interest rate shocks; it was found that banks were resilient to such changes.<sup>93</sup>

The assessment of financial sector standards is the other significant part of the overall assessment of the financial system. The focus of the FSAP is on three areas: '(i) financial sector regulation and supervision; (ii) institutional and market infrastructure; (iii) policy transparency'.<sup>94</sup> It consists of assessing countries' financial systems in light of a variety of international standards in banking, securities and insurance business. The international banking standards devised by the Basel Committee are a significant part of the FSAP process, which adopts the Basel Committee methodology to evaluate compliance with the Core

<sup>87</sup> IMF & World Bank above n 86 at p 21.

<sup>88</sup> IMF & World Bank, *Analytical Tools of the FSAP*, Feb, (2003).

<sup>89</sup> *Ibid*, p 4.

<sup>90</sup> *Ibid*, p 17.

<sup>91</sup> *Ibid*, p 17.

<sup>92</sup> *Ibid*, p 17.

<sup>93</sup> *Ibid*, p 17.

<sup>94</sup> *Ibid*, p 22.

Principles. Through the assessments a number of issues have over time been identified which would call into question the effectiveness of the regulatory regime in a country:<sup>95</sup> examples are political interference in the authorisation process or lack of legal immunity from law suits; a lack of powers to deal with unauthorised activities; a lack of criteria to ascertain whether a bank, shareholders or individual director are fit and proper; capital adequacy rules which are not adhered to or monitored effectively on either an individual bank basis or a consolidated basis; large exposures which are not monitored or reported; insufficient on-site assessment of banks; limited consolidated supervision of cross-sector or cross-border activities; ineffective enforcement by the regulators of standards and rules that actually exist; and limited cooperation between respective regulators to oversee banks that operate across borders.

The degree of compliance with the Basel Core Principles makes interesting, yet unsurprising, reading. The level of compliance is in many respects commensurate with the stage of development the country is at. Indeed, the forms of 'non-compliance' are also associated with the stage of development.<sup>96</sup> Developing countries evidence a lower level of compliance than their transitional or advanced country counterparts. In the case of developing countries, the lack of a formal licensing system that clearly identifies which businesses are regulated could lead to a situation where banks gradually pursue business they are not authorised to undertake and expose themselves to risks the regulator is not readily able to monitor and examine. John Head, for instance, warns against the use of entry requirements 'to shelter poorly-run existing banks'; rather, they should provide 'important protection against a host of dangers, including incompetent or untrustworthy managers, inadequate capitalization, sloppy lending practices'.<sup>97</sup> Another significant concern is if the laws governing banking business are not effectively enforced.

The general findings in more advanced countries are 'minor' in comparison and show a high level of compliance; nevertheless, gaps raise concerns. For example, in some cases, surprisingly, regulators lack powers to request changes to the board of directors and senior management of banks, giving rise to quite serious oversight weaknesses. The lack of power to deal with issues of individual non-compliance is a very serious threat to prudent banking. Given that most bank failures arise from mismanagement, such findings are exacerbated when interlinked with the 'systemic' implications associated with advanced countries.<sup>98</sup> The position in emerging countries does differ as a result of their efforts

<sup>95</sup> World Bank & IMF, *Financial Sector Assessment: A Handbook*, Washington DC, The World Bank, (2005) at p 118–19. See also IMF & World Bank, 'Implementation of the Basel Core Principles for Effective Banking Supervision, Experiences, Influences, and Perspectives', Sept (2002) at pp 16.

<sup>96</sup> While the findings are relative to the countries assessed at the time of the review the findings are nevertheless interesting to note.

<sup>97</sup> JW Head, 'Getting Down to Basics: Strengthening Financial System in Developing Countries' (2005) 18 *Transnational Lawyer* 257 at p 272.

<sup>98</sup> A de Juan, 'From good bankers to bad bankers: Ineffective supervision and management deterioration as major elements in banking crises', (2003) 4 *Journal of International Banking Regulation* 237.

to rectify problems, but issues to do with the efficacy of legal infrastructure still exist.<sup>99</sup> As Arai notes, countries may simply wish to show the world that ‘on paper’ they tick the box for implementing the Core Principles, to make themselves an attractive marketplace for foreign investors, but the substance of the regulation and supervision may not be sufficient to oversee the risks within the marketplace.<sup>100</sup>

The next section explores more specific country findings at different economic positions and levels of economic development.

*b) Low/middle-income countries*

Algeria is a country that has attempted to transform itself into a market-based economy in which the state plays less of a role; it has a ‘fragile’ banking system which has received ‘pervasive state support and forbearance’.<sup>101</sup> Responsibility for banking supervision and regulation is divided between the Money and Credit Council, the Banking Commission and the Bank of Algeria (the central bank). Banks are predominantly publicly owned, but with a gradual rise in the number of privately owned institutions. However, the banking system is considered fragile in light of the level of non-performing loans and insolvent institutions that are simply financially propped up by the state. The position in Algeria, shows a picture of a country that is faced with a considerable task to overcome despite progress in some areas. The 2004 report is far more explicit about the changes required in the structure of banking, strongly suggesting a move away from public-owned banks to private ownership, because of the moral hazard that would ensue from the country’s ‘unconditional’ liquidity support to the public banks.<sup>102</sup> The main recommendation after the 2000 assessment was that ‘the authorities should develop their capacity to enforce efficiently the existing regulations’ and avoid regulatory forbearance. While the move towards privatisation was found to be necessary in ‘divesting the state from the banking system’, the recommendations focus, as a first priority, on the regulator having a better level of insight into the management of publicly owned banks and improving aspects of the authorisation, supervision, enforcement and accountability mechanisms.<sup>103</sup> The 2004 report reiterates the issues pertaining to the fragility of the banking system found in 2000, and noted ‘the authorities still need to make greater use of all supervisory tools and sanctions [and] expedite sanctions with respect to banks that fail to meet their obligations’.<sup>104</sup>

<sup>99</sup> IMF and World Bank above n 86 at p 14.

<sup>100</sup> M Yokai-Arai (2001) above 7 at p 1648.

<sup>101</sup> The Banking Law 90-10 of Apr 1990 cited in Report on the Observance of Standards and Codes (ROSC): Algeria, Jun 2000.

<sup>102</sup> Algeria: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Monetary and Financial Policy Transparency and Banking Supervision (2004) at p 5.

<sup>103</sup> *Ibid*, p 15.

<sup>104</sup> *Ibid*, p 18.

Uganda, despite being one of the poorest countries in the world,<sup>105</sup> has got a relatively 'sound' banking system according to the IMF FSSA report.<sup>106</sup> The economy is considered vulnerable to external shocks, however, particularly the agricultural sector, which plays a dominant part in its export earnings. Responsibility for the banking system and prudential bank regulation and supervision lies with the Bank of Uganda.<sup>107</sup> The position in Uganda is fairly typical of other developing countries, where compliance with the Core Principles is not consistent; nevertheless, inroads have been made to improve bank regulation and supervision by adopting a risk-based approach to the way they undertake their responsibilities. A move by the Bank of Uganda to close 'nonviable' banks is suggested, due to the opaque capital levels at some banks. The 2003 assessment describes the importance of dismantling the formal arrangement between the Minister of Finance and the Bank of Uganda for consultation about 'revoking a bank license' or 'rejecting an application for a banking license', in order to avoid political capture of day-to-day regulation and supervision.<sup>108</sup> The banking system consists of a number of banks engaged in a range of financial services, but consolidated supervision of those activities is limited and it is therefore difficult for the regulator to see how the non-banking activities could impact on the bank. A more pressing issue highlighted is the scope of deposit insurance cover: this has been extended on a number of occasions to cover all deposits rather than limited to the original amount indicated,<sup>109</sup> and there is a possibility of undermining market discipline by extending cover for prolonged periods of time. The use of 'lender of last resort' has also been challenged in light of the liquidity support given to insolvent banks without good security.<sup>110</sup> Another issue that is important to rectify, as it goes to the heart of effective bank supervision, is the point made by Justice James Ogoola: 'a strong, but secondary cause of bank failures was the consistently weak supervision by Bank of Uganda'.<sup>111</sup> For example, formal powers to remove management are rarely used. The assessment points out that 'effective supervision lies more with prompt and firm decisions by the supervisor than with the legal framework'.<sup>112</sup> The legal framework may not necessarily comply with the Basel Core Principles in its entirety, but the point highlighted is that regulators must ensure the rules they have are applied consistently.

<sup>105</sup> World Bank Country Brief, Sept 2006.

<sup>106</sup> Uganda: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Monetary and Financial Policy Transparency, Banking Supervision, Securities Regulation, Insurance Regulation, Corporate Governance, and Payments (2003) at p 7.

<sup>107</sup> <http://www.bou.or.ug>; see The Financial Institutions Act, 2004.

<sup>108</sup> Experimental IMF Report on Observance of Standards and Codes, 1999 at p 15; Uganda (2003) above n 106 at p 38.

<sup>109</sup> *Ibid*, p 17.

<sup>110</sup> *Ibid*, p 37.

<sup>111</sup> *Ibid*, p 39.

<sup>112</sup> *Ibid*, p 39.

*c) High-income countries*

The UK is a leading international financial centre, regulated and supervised by the Financial Services Authority (FSA).<sup>113</sup> The UK assessment in 1999 highlighted the effectiveness of the previous system, which at the time was being replaced with a new regime that attempts to reduce the degree of discretion supervisory authorities have when making decisions. The assessment emphasised the importance of having measures to ensure the new regulatory authority is effectively accountable for its decisions and appropriate mechanisms are in place to seek redress.<sup>114</sup> The 2003 assessment provides a review of the banking sector and the UK's compliance with the Basel Core Principles; the outcome is positive, and the recommendations suggest a different approach rather than gaps *per se* in the system of regulation and supervision. For example, the IMF report recommended the FSA enhance the level of expertise to monitor market risks and issues such as the way banks manage liquidity.<sup>115</sup> The UK response was to judge each recommendation individually to gauge the benefits it would bring. In most cases the recommendations were considered already addressed in various parts of the regulatory regime, and so did not provide a net benefit but simply exposed the industry to additional compliance costs if they were implemented.<sup>116</sup> The unique UK risk-based approach to regulation and supervision assesses risks rather differently to other standard risk-based systems of regulation, as it adopts a top-down approach of seeking to ascertain whether a firm violates the statutory objectives.

Germany is also a leading international financial centre. Bafin and the Bundesbank are responsible for the regulation and supervision of the financial system, which was considered effective in the 2003 assessment.<sup>117</sup> The German system has a very large banking network with a high proportion of public sector savings banks; preconditions for effective regulation and supervision are in place and function efficiently to ensure bank supervision operates in the appropriate macro-prudential environment. Nevertheless, the industry has experienced difficult periods of low profitability and required some consolidation to strengthen it overall. The 2003 assessment highlighted the importance of strengthening the reporting of banks' loan portfolios so these can be assessed more effectively to ascertain their 'quality'. The 'universal' structure of

<sup>113</sup> See <http://www.fsa.gov.uk/> Financial Services and Markets Act 2000; United Kingdom: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Banking Supervision, Insurance Supervision, Securities Supervision, Payments, Monetary and Financial Policy Transparency, Securities Settlement Systems, and Anti-Money Laundering and Countering Terrorist Financing (2003).

<sup>114</sup> Experimental Report on Transparency Practices: United Kingdom, (1999) at p 8.

<sup>115</sup> United Kingdom (2003) above n 113 at p 64.

<sup>116</sup> *Ibid*, at p 65.

<sup>117</sup> Bafin (Bundesanstalt für Finanzdienstleistungsaufsicht) Germany: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Banking Supervision, Securities Regulation, Insurance Regulation, Monetary and Financial Policy Transparency, Payment Systems, and Securities Settlement. (2003).



the financial system means more attention is needed on lending to related parties, as this practice can be exposed to abuse. The response to the assessment has been mixed, not least because of the conclusion that full compliance with the Core Principles was achieved. For example, regulatory oversight of acquisitions and investments in other commercial or financial firms was said to be inadequate. The authorities in their response challenged this point and explained that rules exist to monitor such activities; also, audit of bank accounts focuses on these activities if they fall below the threshold set for reporting such investments.<sup>118</sup> The IMF's conclusion about the controls to monitor lending to affiliated parties was also challenged, on the basis that controls do exist which the authorities consider sufficient to address such lending: a management board must vote on the matter in the absence of the beneficiary, and it also requires agreement from the bank's supervisory board. In the case of remedial actions the IMF considered it important to recommend that the authorities have clear rules on taking 'prompt corrective action'; the authorities considered this unnecessary 'prescription' of regulatory 'discretion', thus reducing the level of flexibility that presently exists.<sup>119</sup>

*d) Post-financial-crisis countries: A mixture of low/middle- and high-income countries*

The assessment of Korea in 2003 provides a picture of a country that has attempted to make changes after the Asian crisis.<sup>120</sup> Responsibilities for banking supervision are with the Ministry of Finance and Economy, Financial Supervisory Commission, Financial Supervisory Service, Bank of Korea and Korea Deposit Insurance Corporation, each with discrete areas to oversee or assist in providing an effective system of bank regulation and supervision. The significant number of overseers of the banking system was identified as an issue in the assessment, as it can result in problems of coordinating regulatory and supervisory efforts if need arises. The lack of an express immunity from legal suit, whether in criminal or civil law, is another matter that needs addressing.<sup>121</sup> The recommendations suggest that the authorities put in place a risk-focused approach to supervision.<sup>122</sup> Fundamental aspects of an effective system of banking supervision, such as a specific perimeter around the types of activities banks can undertake, do not exist in the present system of regulation; and there is a lack of fit and proper criteria for senior management and other employees, and thus no formal system of prior approval to gauge their competency to undertake

<sup>118</sup> *Ibid*, p 32.

<sup>119</sup> *Ibid*, p 33.

<sup>120</sup> Republic of Korea: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Monetary and Financial Policy Transparency, Banking Supervision, Securities Regulation, Insurance Regulation, Corporate Governance, and Payment Systems (2003).

<sup>121</sup> *Ibid*, p 36.

<sup>122</sup> *Ibid*, p 36.

their responsibilities. The recommendations were generally accepted by the Korean authorities: the ‘shortcomings’ found during the assessment are, in the eyes of the Koreans, on course to be resolved.<sup>123</sup>

The assessment of the Philippines in 2004 provides a mixed picture of compliance. Non-performing loans within the industry are highlighted as a problem the authorities need to deal with.<sup>124</sup> A considerable level of reliance is placed on the banking industry, and the very close links between a small number of bank-financial conglomerates expose the country to a significant degree of systemic risk occurring in the banking system. The assessment highlights that ‘compliance is overall quite high’, but the gaps that exist are considered ‘critical’. In particular, the enforcement regime gives rise to a significant degree of regulatory forbearance. The recommendations highlight the ‘excessive’ grace periods and suggest a policy of ‘prompt corrective action’ to minimise the risks of undermining or threatening banking stability. The assessment identifies other gaps: for example in the area of large exposure regime for the consolidated activities of banks, which is further exacerbated by the ‘high level of connectivity in the banking system’.<sup>125</sup> Because the financial services industry is to some extent transnational in nature, importance is attached to formal mechanisms of cooperation between the region’s regulatory authorities. The recommendations propose that the authorities improve the dissemination of information between the home and host state in order to effectuate better consolidated supervision.<sup>126</sup>

Mexico has experienced a number of financial crises over the last few decades. A considerable level of structural and legal reform in the financial sector was made after the crisis in the mid-1990s to try to ensure the country can cushion itself against internal and external shocks, such as from a downturn in the US economy.<sup>127</sup> It has also introduced reforms so that the financial sector can assist in its plans for ‘sustainable economic growth and development’.<sup>128</sup> The Secretariat of Finance and Public Credit, Banco Mexico, the Institute of the Protection of Savings and the National Banking and Securities Commission (CNBV) are conferred with responsibility for prudential supervision. The degree of compliance with the Basel Core Principles is ‘inconsistent’, even though considerable legal reform has taken place. The culture of compliance has been a cause for concern, particularly the regard the industry has for the authority of the CNBV, which was damaged by the way it dealt with the banking crisis; the recommendations are therefore not surprisingly focused on this. The IMF report suggests the ‘autonomy’ of the CNBV be improved by, for

<sup>123</sup> *Ibid*, p 38.

<sup>124</sup> Philippines: Report on the Observance of Standards and Codes—Banking Supervision (2004).

<sup>125</sup> *Ibid*, p 4.

<sup>126</sup> *Ibid*, p 6.

<sup>127</sup> Mexico: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Monetary and Financial Policy, Transparency; Payment Systems; Banking Supervision; Securities Regulation; and Insurance Supervision. Oct 2001, IMF Country Report No 01/192.

<sup>128</sup> *Ibid*, p 10.

instance, putting in place protection from legal suit for its staff in the discharge of their responsibilities and enhancing the accountability of external auditors in the supervisory process. The complex way in which regulation and supervision are exercised by the individual ‘regulatory’ bodies is itself a cause for concern, especially the lack of coordination between the bodies to enforce their responsibilities—which in various respects overlap with one another, thus creating a degree of confusion. Evidence of regulatory forbearance after the crises has been an issue for the authorities to address by improving the enforcement of prudential supervision and disclosure to enhance the regulators’ ‘credibility’ within the financial system.<sup>129</sup>

### 3. Observations on the Work of the IMF, the World Bank and the FSAP

The efforts of both the IMF and the World Bank since the financial crises of the 1990s have focused on a number of issues to mitigate the risk of further crises occurring. The impact of these crises and the growing interdependency of the international community have resulted in a broadening scope of their responsibilities. The IMF has begun to use financial sector reform as a way of reducing the incidence of financial crisis; the World Bank, on the other hand, has assisted its members with such reform since its establishment.

In both institutions this has resulted in some form of ‘mission creep’: the IMF is paying more attention to micro-economic matters; while the World Bank is now addresses macro-economic issues. This has taken place on two practical levels, to fulfil both their respective purposes under the Articles of Agreement and the FSAP agenda. This work can be split into their ‘compulsory’ and ‘voluntary’ jurisdictions, albeit it is the sovereign member country that initiates assistance in both instances. Assistance is used to achieve either the ‘monetary stability objective’ or ‘development and poverty reduction objectives’. For instance, the assistance provided to Nepal as part of its long-term strategic plan to reduce poverty has focused on both direct and indirect law reform, such as a new supervision manual and company legislation, and more structural reforms, such as the recapitalisation of its banks.<sup>130</sup> In more practical terms it has included training for supervisory staff and external auditors to improve supervision. It is also important to note that financial sector reform forms part of a number of other discrete set of assessments undertaken by the IMF and World Bank as well. For example, the World Bank’s ‘Investment Climate Assessments’ focuses on diagnosing matters that hinder economic growth by looking at the economy holistically to look at ways of improving economic productivity by improving the business environment.<sup>131</sup> The assessments focus on evaluating

<sup>129</sup> Mexico above n 127 at p 65.

<sup>130</sup> Nepal: An Assessment of the Implementation of the Tenth Plan/PRSP, Dec 2006, at pp 40–2.

<sup>131</sup> <http://web.worldbank.org/wbsite/external/countries/africaext/e...>

the existing economy and its infrastructure and reforms proposed in for instance the financial sector.<sup>132</sup>

The IMF and World Bank use surveillance, consultation and project supervision per se to ensure the policy conditions attached to financial assistance are complied with; they also have the right to withdraw assistance. This adds an enforcement element which is lacking with the existing standards-creating bodies, such as the Basel Committee.<sup>133</sup> Notwithstanding this, sovereign states are not always willing to adopt reforms. Cooperation varies to some extent depending on whether the policy changes come about through assistance, in line with the general purposes, or are initiated through the FSAP.<sup>134</sup> Evidence suggests that countries have been more inclined to accept policy changes through the FSAP than through formal assistance.<sup>135</sup>

The need for reform, whether for the purposes of monetary stability or development, must emanate from the state, as it will be ultimately responsible for initiating and putting in place the reforms. The issue of financial sector reform gives rise in practice to a considerable level of political controversy because of the importance and power held by those making up the financial system, regardless of whether it is predominantly in public or private hands.<sup>136</sup> It does not reside in a political vacuum, and resistance to change can therefore be considerable, even in times of crisis. Where countries' reforms efforts were relatively slow or met with resistance before a crisis, they were certainly more willing candidates for reform after the crisis.<sup>137</sup> On most occasions it came about from the political change that occurs after financial crises, or when those who want to improve the financial system to achieve a broad set of political and economic goals came into power. But even when laws and regulations are passed, substantive changes can be resisted; for instance, a process of restructuring or privatisation of the banking system is controversial albeit considered 'best practice', which was the position in Bangladesh.<sup>138</sup> In some cases resistance to reforms resulted in the World Bank postponing or reducing a loan to reflect the fact that the government was not ready to initiate the indicated changes. In practice, therefore, progress can be slow or not achieved to the fullest extent, leading to continuing exposure to systemic risks as a result of poor oversight of the banking and financial system from both a domestic and a transnational perspective.

<sup>132</sup> See for example, The World Bank Group, 'An Assessment of the Private Sector in Nigeria, Pilot Investment Climate Assessment' (2002) pp 92–105.

<sup>133</sup> DE Alford, (2005) above n 41 at p 293.

<sup>134</sup> IEG, *Financial Sector Assessment Program: IEG Review of the Joint World Bank and IMF Initiative*, Washington DC, World Bank (2006) at pp 26–31.

<sup>135</sup> *Ibid*, p 29

<sup>136</sup> JJ Norton, 'The Modern Genre of Infrastructural Law Reform: The Legal and Practical Realities—The Case of Banking Reform in Thailand', 55, *SMU Law Review*, (2002) 235 at pp 241–2.

<sup>137</sup> IEG Report, (2006) above n 134 at p 37.

<sup>138</sup> IEG Report, (2006) above n 134 at p 25.

The initiatives for financial sector reform have focused primarily on ownership, restructuring, improvement of the financial safety net and regulation and supervision to reduce the risk of systemic risks,<sup>139</sup> but these matters are not without associated problems if they are not implemented properly or lack the political will to ensure compliance.<sup>140</sup> It is difficult to ascertain the utility of some of the reforms put in place by the World Bank—like the capacity to exercise bank supervision, for instance—unless post-reform assessments are made once the changes are bedded in.<sup>141</sup> The IMF's continuous relationship with its members through surveillance and consultation possibly makes this less of an issue. An associated problem which may arise is that recommendations for reform are not feasible for a country because in practical terms it lacks the political will to ensure compliance, or the reforms are alien to the legal system and so lack enforcement. Indeed, such administrative law measures do not reside in a vacuum but require a clear legal context to ensure they are clearly operable and can be efficiently applied; this involves technical assistance with devising the rules and regulations and continuous training to build understanding of how to apply them, otherwise they become ineffective. Pistor highlights the problem of ineffective laws and the associated risks if they lack the appropriate substance to ensure their effectiveness: 'once a crisis hits, investors will pull out where they might have serious doubts about the effectiveness of legal institutions and their ability to protect their claims. At this point, they will not be misled by formal indicators, but take a closer look at the ability of countries to actually enforce these rules'.<sup>142</sup> This problem is also highlighted by the study by Reaz and Arun, of Bangladesh, they point out the lack of effective judicial oversight as well as regulation over the banking industry hinders to a considerable extent the efficiency of the banking system because of the lack of legal enforcement of resolutions when disputes arise.<sup>143</sup> In light of these problems Morais advocates an incremental rather than a 'big bang' approach to financial sector reform, so the relative stage of development, political will and costs can be taken in to account.<sup>144</sup>

The most controversial of changes concerns the issue of ownership and restructuring. A move away from a state-centred banking system to a private-oriented system is controversial, but is said by some to enhance the overall

<sup>139</sup> For a broad overview see for instance, SM Fries, 'Financial Reform and development in Transition Economies and the Role of IFI's', in Norton and Andenas (1996) above n 37 at p 57.

<sup>140</sup> In a paper by JJ Norton and M Yokoi-Arai, 'Discerning Future Financial Crises: The Law and Institutional Based Dimensions' (2001) 24 *Bank of Valletta Review* 20 at p 31, protests regarding the foreign take over of a large Indonesian bank is used to illustrate the problems associated with some forms of reform.

<sup>141</sup> IEG Report (2006) above n 134 at p 65.

<sup>142</sup> K Pistor, above n 32 at p 15.

<sup>143</sup> M Reaz and T Arun (2006) above n 8 at p 102. See also JJ Norton, 'Encouraging Capital Flows and Viable Dispute Settlement Frameworks under the Monterrey Consensus', 10, *Law and Business Review of the Americas*, (2004) 65.

<sup>144</sup> HV Morais, 'The Quest for International Standards: Global Governance vs. Sovereignty', (2002) 50 *University of Kansas Law Review* 779 at p 820.

efficiency of the system as well as bringing improved corporate governance.<sup>145</sup> This has resulted in it being a significant part of the reform packages initiated by the IMF and World Bank. But if the change in ownership is not managed properly, in most cases it has resulted in disaster.<sup>146</sup> As highlighted in the 2006 IEG report, banks that were privatised were subsequently closed or required recapitalisation with public funds, thus defeating the objective of privatisation. The issue of public or private ownership needs to be premised first and foremost on improving the governance of the institution, rather than based on the idea that private ownership will lead to efficiency improvements.<sup>147</sup> In such instances only some kind of due diligence process could reduce the risks, by ensuring those who seek to buy a bank are indeed fit and proper and have the appropriate experience and commitment to undertake banking business.

The FSAP initiative is really the only concerted attempt to determine the level of substantive compliance with the designated international financial standards. There are thus not only reasons of national interest to commit to an assessment, but also an international need in light of the direct and indirect effects of a crisis on other parts of the international community. Compliance with the international standards enhances the attractiveness of a country for foreign investors, especially to tap into external sources of borrowing.<sup>148</sup> However, as it is a voluntary assessment, some states—including some that pose a significant risk to international financial stability—have decided not to be assessed yet. This brings to the fore the question of whether FSAP assessment should be made compulsory rather than voluntary. The voluntary approach reinforces country ownership of the assessment, which is important given the responsibility it has to cooperate with the FSAP team and ensure it moves to towards substantive compliance—which can require a considerable level of resources. Even the IEG reports a pragmatic position, highlighting ‘the program resources should be directed at those countries that are willing to provide the data, access to key personnel and other support needed to make the assessment effective’.<sup>149</sup>

The utility of an assessment, as outlined above, varies from those countries considered to pose a systemic risk or vulnerability to those seeking to ascertain from an external source the gaps in their system regulation. It is also important to appreciate that any reform is going to take a considerable length of time to actually show its benefits.<sup>150</sup> The lack of a rating system and reliance on broad-brush observations about the level of country compliance is the most appropriate approach as is the case with other matters; namely lender of last resort,

<sup>145</sup> M Reaz and T Arun, above n 8 at p 94.

<sup>146</sup> IEG Report (2006) above n 134 at p 57.

<sup>147</sup> IEG Report (2006) above n 134 at p 37.

<sup>148</sup> See the general conclusions of C Christofides, C Mulder, and A Tiffin, ‘The Link Between Adherence to International Standards of Good Practice, Foreign Exchange Spreads, and Ratings’, WP/03/74, *IMF Working Paper*, (2003) at p 26.

<sup>149</sup> IEG Report (2006) above n 134 at p 7.

<sup>150</sup> IMF & World Bank Jul (2005) above n 95 at p 21.

where constructive ambiguity is deemed necessary, as the risk of triggering a panic if a report on a country was to disclose systemic misgivings outweighs the benefits of improved accountability. A certain level of protection is also built into the process to protect vulnerable states, because it is the right of the individual state to decide whether a report is made publicly available—again, this enhances country ownership of the assessment. Indeed, although the final report is completed by the FSAP team, negotiation between the team and the country influences the overall tone of the report and the findings it proposes. This approach is perfectly reasonable: the international community would not really want to discourage future assessments by taking a hard-faced position. The IEG notes that some of the assessment findings are communicated in other ways through the period of assessment. This is common practice in banking regulation, with its environment of confidentiality; but the caveat is that the duty of confidentiality is not absolute, and on occasions it may be necessary to disclose certain misgivings in the public interest. The IEG warns: ‘disguising problems, even in a few cases, defeats the purpose of the FSAP program’.<sup>151</sup> Nor is assessment one way: assessed countries have a right to challenge the recommendations and have on occasion strongly objected to the findings—as in the case of Jamaica, where issues of non-compliance were robustly challenged and gaps in the Core Principles identified, suggesting the standards are not complete themselves. For example, the provisions regarding consolidated supervision are not adequate to oversee the activities of financial conglomerates, and over the last decade or so specific regulatory measures have been adopted to assess their activities. In particular, specific information needs to be gathered from the respective regulators in a much more coordinated manner, rather than simply relying on the annual and interim consolidated returns produced by banks themselves to fulfil consolidated supervision requirements.<sup>152</sup>

The FSAP,<sup>153</sup> while considered to be prominent and far-reaching with ‘positive’ results, is nevertheless not deemed a panacea against future financial crises occurring. According to Conthe and Ingves, ‘Even a more developed FSAP would not be a vaccine that would inoculate all countries against financial crisis’.<sup>154</sup> Notwithstanding this Ingves has also rightly pointed the benefits of an external assessment in comparison to a countries self-assessment because the appropriate level of objectivity is more than likely to be missing.<sup>155</sup> So the

<sup>151</sup> IEG Report (2006) above n 134 at p 21.

<sup>152</sup> Jamaica: Financial System Assessment, including Reports on the Observance of Standards and Codes on the following topics: Basel Core Principles for Effective Banking Supervision, the CPSS Core Principles for Systemically Important Payment Systems, and IMF Monetary and Financial Policy Transparency Codes, (2006) pp 45–6.

<sup>153</sup> FSAP is no panacea against financial crisis, see M Conthe & S Ingves, Financial Sector Program C:\Documents and Settings\p0073917\Desktop\IMF Paper\Financial Sector Assessment... (19/01/2006)

<sup>154</sup> *Ibid*, p 2.

<sup>155</sup> S Ingves, ‘Can Regional financial sector assessments provide additional values to the EU countries’, 52, BIS Review, (2006) 1, at p 2.

programme is continuously evolving in light of the findings and recommendations made to improve it, through both the experience of undertaking an assessment and its external appraisal. The key factor is that the system is flexible enough to assess countries at both ends of the development spectrum, from the most advanced industrialised countries to the least developed. The assessment process is not about simply checking whether the Basel Core Principles have been formally implemented in domestic law by legislative means, appended to a Banking Act, but rather to ensure reform of the regulatory system takes place to achieve the spirit and substance of the principles. The process requires a considerable level of resources, both practically and financially. The issue that arises is how frequent should these assessments be: at the moment they occur approximately every ten years, but this is considered inadequate given the lapse of time in between and the likelihood of financial crisis during that period, so updates are suggested every four years. While it does take time for improvements to bed in and influence practice, additional problem areas will not be discovered in a timely fashion if the FSAP is the only form of oversight. Other means of formal assistance, like surveillance and help with financial and technical issues, could be used within the interim period. Issues could be addressed, but only if they rise up from the ground and are detectable through surveillance. But FSAP assessment findings have prompted some assessed countries to support the broader assistance provided by the World Bank.

### III. CONCLUSION

This chapter has focused on the importance of bank regulation and supervision from an international perspective, where issues of financial stability and development are central in the pursuit of substantive compliance with the Basel Core Principles. These principles are somewhat controversial, given the unrepresentative way they have been devised. Despite this, the international community has moved to adopt these and other international standards; but a level of substantive compliance is not forthcoming, which poses the greatest risk internationally. The IMF and World Bank have taken a central role here on a macro-economic and micro-economic level to reduce the risks of further financial crises. In light of the integrated nature of these two areas, some form of overlap was going to be evident in both institutions. What is clear here is the need for the two to work closer together, as shown above, in pursuit of their general purposes to ensure their country members have the capacity to improve both the efficiency of the banking system to meet the needs of the economy and the actual oversight of the banking system. It is evident that the IMF has a wider remit through its surveillance and consultation functions, giving it more of an influential role in this area with its membership of developed, emerging-market and developing countries as it provides a continuous basis for dialogue with them. The World Bank's influence *per se* is somewhat limited in this respect, as



its assistance is linked with its financial and technical support to those seeking help—traditionally emerging-market and developing countries.

Compliance with the Basel Core Principles is not comprehensive, to say the least, across the international community. The political will is not forthcoming in many quarters of the world, and in others it is driven by the reputational risk associated with not being seen to be non-compliant with the broad standards. Some remain reluctant to undergo a formal assessment, although a paper-based review has been undertaken—as in the case of the USA, for example, to show some level of support to the FSAP. Others probably consider the economic costs of an assessment exposing weaknesses outweigh the benefits of more inward investment in the financial sector. The risks associated with non-compliance in such circumstances are mitigated by the state's possible willingness to stand implicitly in support of the financial system if problems were to be experienced. However, those taking advantage of such 'lucrative' markets may not have the same commitment from the respective authorities in the home market hence the need for compliance. This also shows the importance of regional efforts, which need to be stepped up to ensure compliance as the interlinkages between the various intermediaries and markets are even more intertwined.

The role of the IMF and World Bank in this area needs to continue whether it is individually or jointly both in terms of their general purposes or through FSAP. What is clear from the above is the need for a more nuanced approach tailored to the needs of individual countries on a more periodical basis to ensure compliance. This requires consideration of the political and social climate of the country not just the economic and financial position. Therefore, highlighting the actual importance of taking a long term approach on a step by step basis towards building the capacity to supervise and comply with the international standards. The knowledge and experience of the two institutions adds the appropriate support in trying to work towards inter alia better compliance with the Basel Core Principles to mitigate the risks to financial stability, economic growth and the reduction of poverty.

*International Financial Law and the  
New Sovereignty: Legal Arbitrage  
as an Emerging Dimension of  
Global Governance*

JORGE GUIRA\*

I. INTRODUCTION

THE LAST FEW years have witnessed several significant trends affecting international capital markets, international banking, and investment funds regulation. Companies who understand the rules but fail to make the connection between the rules and the advantages that they can get in the marketplace by applying them skilfully limit their competitiveness. Sovereignty, essentially defined by Prof. Abraham Chayes and Antonia Handler Chayes, as the inclusion or participation of a State in a legally based framework of power, is not a static concept.<sup>1</sup> Indeed, as a logical corollary, to the extent that a State takes actions that will bring it greater wealth (economic power) and political power generally within such a legal framework, then it may ordinarily be expected to have greater sovereignty in the international legal system. Further, mutuality including mutual recognition between States is a second component of this new sovereignty.<sup>2</sup>

\* The author gratefully acknowledges the Cambridge Endowment for Research in Finance, especially Associate Prof Kern Alexander and Lord John Eatwell, which Cambridge University Basel II Conference participation allowed him to explore many of these ideas. All citations current and reviewed as of Feb 1, 2007.

<sup>1</sup> A Chayes and AH Chayes, *The New Sovereignty: Compliance with International Regulatory Agreements* (Cambridge, Mass, Harvard University Press, c1995).

<sup>2</sup> This concept may of course be critiqued for being teleological or self referent; one gets sovereignty 'points' for participating, and then for becoming a party to the system that agrees to some form of mutuality or reciprocity; sovereignty begets more sovereignty within this logic. Nonetheless, it shines a light on the important truth that global governance has many interstices, and is no longer accepted as being based upon formalistic dimensions of legality, but is broader in scope. See K Anderson, 'Squaring the Circle: Reconciling Sovereignty and Global Governance through Global Government Networks, Book review of A M Slaughter, *A New World Order*' (2005) 118 *Harvard Law Review* 1255.

Recent developments have highlighted important issues as to the development of the London markets vis-a-vis the US markets, Basel I and II, and hedge funds. I have therefore chosen to highlight three emerging developments in these areas of international finance and banking to explain how the rules and the markets interconnect to provide possibilities for States to creatively use their regulation of financial markets as a means of gaining greater sovereignty at the expense of others, through artful practice. This concept of legal arbitrage in an era of increasing regulatory competition presents some intriguing issues to consider.

To begin, it is important to understand that the concept of arbitrage in today's markets can help create value for firms by reducing the costs of capital and managing risk more creatively (if not more efficiently). Legal arbitrage, defined as using the rules to obtain benefits, reduce transaction costs, and lower risks in the financial markets can be employed as a tool of gamesmanship in a firm's global strategy.<sup>3</sup>

To illustrate the possibilities of legal arbitrage, three cases are presented. In the first case, the behaviour of three entities is examined. First, we look at the interests and behaviour of a public entity or state—such as the UK. Next, we look at the behaviour of a well capitalised, listed firms such as those on the 'FTSE 100 index', the television firm ITV, to take an example. And, finally we look at the interests and behaviour of emerging growth firms anywhere in the developing world that they may be listing.

The world, of course, is much more than a 'black box' where individual rational actors seek advantage, making purely series of decisions that lead to some inevitable market impact. This is wrong not only because it is too simplistic but also because it trivialises the randomness of certain behaviour, and the at least occasional irrationality of markets (eg, the 1990s 'new era' of productivity leading to the dotcom bubble and irrational exuberance).<sup>4</sup>

So, we must first ask this: Are there any clear markers that can help us predict human behaviour when it comes to markets?

The answer: yes and no.

It is pretty clear that large corporations, financial institutions, and indeed nations seek a *competitive advantage* over others, and this notion, particularly if *sustainable* is the basis for strategic decision making. Multinational companies will try to obtain a sustainable competitive advantage over their competitors

<sup>3</sup> H Jackson and E Pan 'Regulatory Competition in International Securities Markets: Evidence from Europe in 1999-Part I', (2005) 56 *Business Lawyer* 653 provides an interesting perspective on this issue. There is an extensive literature drawing upon law and economics literature that has compared various aspects of financial regulation as well as an extensive law and finance literature. See for example, L Bebchuck, O Bar-Gill, M Barzuza, 'The Market for Corporate Law', (2006) 162 *Journal of Institutional and Theoretical Economics* 134; R La Porta, F Lopez-de-Silanes, A Shleifer and RW Vishny, 'Law and Finance', (1998) 106 *Journal of Political Economy* 1.

<sup>4</sup> See H Shefrin, *Beyond Greed and Fear: Understanding behavioral finance and the psychology of investing*. (Oxford, Oxford University Press, 2002) discussing heuristics, framing, and anomalies.

and execute strategies consistent with these objectives whenever they can, although this is obviously subject to many forces and is difficult to optimise.<sup>5</sup>

Nation-states will seek to do the same.<sup>6</sup> Both may be seriously stymied toward their own rational ends of power and wealth maximization-with political interest group brokering that reduces benefits of the above strategy.

So far, it seems, we have assumed that as a business decision maker you can determine what it is that will give you that sustainable competitive advantage. Of course, no matter how well designed your model or strategic insight is, events sometimes will overtake events in unexpected ways; moreover, the law as an agent of change sometimes leads to unintended consequences. Further, behavioural economics teaches that most (Chief Executive Officer) CEO's, Chief Financial Officer (CFO's) and Chief Operating Officer (COO's) will adopt a strategic vision that does not take into account the whole picture but rather the unique skills and perspectives that helped them reach the top perch in their organisation. So, multinational corporations as non-state actors may be expected to likewise act in ways that fall short of perfectly maximizing utility for their entity because of these variables in decision making.

The three significant developments below illustrate three major themes of vital importance to today's decision makers that directly impact on the extent to which a nation state may exercise its sovereignty.

## II. INTERNATIONAL CORPORATE FINANCE LAW AND POLICY-THE OPTIMAL WAY TO GROW

### 1. Case I: London and the International Capital Markets

When the EU Prospectus Directive was announced on December 31, 2003, the conventional view was that it would cause confusion in the markets, and increased costs-to say the least.<sup>7</sup> In certain cases, it of course has raised costs.

Yet, for the UK, as we survey its implementation of the EU Prospectus Directive after the July 1, 2005 deadline it seems that this legislation is, on balance, not likely to limit the UK's competitiveness in global equity capital markets.<sup>8</sup> This is true notwithstanding the fact that greater documentation than

<sup>5</sup> Studies from Michael Porter of Harvard Business School, and many others have long focused on various factors that must be taken into account in determining international competitiveness. M Porter, *The Competitive Advantage of Nations*, (New York, Free Press, 1990) [hereinafter Porter I]; M Porter, *Competitive Advantage: Creating and Sustaining Superior Performance*, (New York, Free Press, 1985) [hereinafter Porter II].

<sup>6</sup> See *ibid* at Porter I.

<sup>7</sup> See [http://ec.europa.eu/internal\\_market/securities/prospectus/index\\_en.htm](http://ec.europa.eu/internal_market/securities/prospectus/index_en.htm) discussing Directive of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC.

<sup>8</sup> See The Prospectus Regulations 2005 implementing same in the UK available at [http://www.hm-treasury.gov.uk/documents/financial\\_services/eu\\_financial\\_services/fin\\_eufs\\_pd.cfm](http://www.hm-treasury.gov.uk/documents/financial_services/eu_financial_services/fin_eufs_pd.cfm).

was previously needed may be required in some cases.<sup>9</sup> Rather, in combination with UK developments in international corporate governance appears, the UK position in international capital markets seem strengthened. Why is it that the UK has benefited in this way?

Well, one way to visualise the issue is this: the UK has two windows to the world—one facing Europe and one facing America.

And that perspective, plus the experience of being the head of a 34 state ‘Commonwealth of nations’ (former British colonies) has helped British decision makers position London to attract and maintain greater financial services work in the international capital markets arena versus other competitors by exploiting changes in the legal rules. This is not to suggest that advances to UK’s competitive position in the market for offerings is all by virtue of intelligent policy design, but certainly, it is not all by historical accident either.

#### *a) UK: A Classic Case*

The most well-known example of UK legal and or regulatory arbitrage is when the US Federal Reserve promulgated Regulation Q in 1963.<sup>10</sup> This law limited the amount of interest that could be paid on dollar deposits in the United States, but not overseas. As Nobel Prize winning Chicago economist Milton Friedman notes, the effect was that non US banks based overseas (in this case primarily British) could pay higher rates to depositors.<sup>11</sup> This helped create the so-called ‘euro-dollar market’ whereby such foreign banks attracted more foreign circulating money, which in turn, could be used as the basis for large syndicated loans, in dollars, across the globe. Thus, the London international banking market flourished.<sup>12</sup>

The US restrictive practice—some might say over-restrictive practice—because it did not allow the markets to operate but rather set artificial ceilings—was the catalytic component that allowed the UK to position itself intelligently using its own competitive strengths.

#### *b) US: SOX Impact*

The cost of a US stock listing after the Enron scandals that rocked America went up dramatically. As Columbia Law Professor John Coffee has pointed out, corporate decision makers were accused of too close an emphasis on short term results, or on benefiting from gatekeepers such as auditors that were lax.<sup>13</sup> The

<sup>9</sup> Slaughter and May [www.slaughterandmay.pd-consultation.response.pdf](http://www.slaughterandmay.pd-consultation.response.pdf).

<sup>10</sup> <http://www.federalreserve.gov/regulations/default.htm> citing 12 CFR 217.

<sup>11</sup> [http://www.cato.org/pubs/policy\\_report/v21n2/friedman.html](http://www.cato.org/pubs/policy_report/v21n2/friedman.html).

<sup>12</sup> GG Kaufman, ‘Emerging Economies and International Financial centres’ at p 4, found at <http://sba.luc.edu/research/wpapers/001101.pdf>.

<sup>13</sup> Coffee, JC (2006) *Gatekeepers: The Professions and Corporate Governance* (Oxford, Oxford University Press).

cost of questionable situational morality on the part of corporate America was significantly pricier ‘enhanced disclosure’ in order to raise investor confidence and to protect investors therein.

The Sarbanes Oxley (SOX) legislation produced a set of rules, applicable to US as well as foreign private issuers (20F form reporting), including the great bulk of FTSE index firms.<sup>14</sup> These rules, especially Section 404 were quite expansive in their reach.<sup>15</sup> They mandate certifications by CEO’s and CFO’s including that Form 20F is not inaccurate and free from misleading statements, and that financial statements fairly present a view of the firm. There is direct liability for certification statements.<sup>16</sup> In addition, stringent requirements on auditing and auditing committees imposed by the SEC and also by the NYSE make compliance even more demanding.<sup>17</sup> Section 404 and other key provisions required all firms including foreign firms listed in the US, so-called ‘foreign private issuers’ to provide improved standards of financial information and internal controls.<sup>18</sup>

Section 404 and its companion provisions also raised the level of liability for making misleading statements or fraud.<sup>19</sup> If not exactly inducing shock, this did have the effect of causing a re-think among global firms as to where they might wish to raise capital next.<sup>20</sup>

From the vantage point of 2006, a tough, enforcement-oriented SEC, armed with a new set of rules may have achieved its intended effect of buttressing confidence among investors. It certainly raised standards of disclosure. However,

<sup>14</sup> PL 107–204, Jul 30, 2002. There is a wealth of information regarding Sarbanes Oxley, as implemented by the SEC from the Congressional Act. The law may be found at <http://www.sec.gov/about/laws.shtml#sox2002> Interpretative releases as to the numerous sections of the law may also be found at the SEC’s website at <http://www.sec.gov/spotlight/sarbanes-oxley.htm>.

<sup>15</sup> See <http://www.sec.gov/about/laws/soa/2003.pdf> at p 44 and *ibid* at n 14 for more detailed discussion of its implementation.

<sup>16</sup> Freshfields, ‘Securities offerings and listings in the US: an overview for non-US issuers’ (Euromoney, 2003) found at <http://www.iflr.com>.

<sup>17</sup> *Ibid.*

<sup>18</sup> *Ibid.*

<sup>19</sup> *Ibid.* See also n 14 above.

<sup>20</sup> At the time of the first draft of this paper, which was based upon a talk on the major developments impacting international banking and financial law in mid-2006, the US Secretary of the Treasury had not changed into the hands of Hank Paulsen such that the topic here was novel of capital markets arbitrage. Paulsen quickly led the charge with respect to the ‘London Challenge’, calling on the US SEC to seriously look at a principles-based approach, among other measures. H Paulsen, ‘Competitiveness of US Capital Markets’, Remarks Made to the Economic Club of New York, Keynote address on Competitiveness, New York, New York, Nov 20, 2006 <http://www.ustreas.gov/press/releases/hp174.htm> A special task force Committee on Capital Markets Regulation, was set up to review this and other key challenges, and New York City also got involved due to concerns about Wall Street’s reduced competitiveness. See H Scott’s piece on ‘The End of American Dominance In Capital Markets’ at [http://www.law.harvard.edu/news/2006/07/20\\_scott.php](http://www.law.harvard.edu/news/2006/07/20_scott.php) presaging the Paulsen backed Committee on Capital Markets Regulation, <http://www.capmktreg.org/index.html> Interestingly, Paulsen has reactivated an interagency group that focuses on crisis prevention and is now focussed on hedge funds and systemic risk, the issue addressed in s IV of this paper A Evans-Pritchard, ‘Paulson re-activates secretive support team to prevent markets meltdown’, Daily Telegraph, Oct 30, 2006 <http://www.telegraph.co.uk/money/main.jhtml?xml=/money/2006/10/30/cvview30.xml>.

the SEC's focus was the impact on the overwhelming US domestic market, including domestic issuers.

This, however, may have alienated many foreign firms listing on the US exchanges who found their cost of accessing US capital had just gone up.<sup>21</sup> The burdens of SOX compliance would also create significant administrative burdens that were, at least, somewhat unwelcome. Those would be candidates for a US listing who were thinking of it as their next logical move found this disconcerting.

Large UK firms, although they might have some 'wobble room' as to securities filings with respect to accounting harmonization of the US GAAP with the UK international accounting standards were, largely, stuck.<sup>22</sup> De listing from the US exchanges was quite difficult.<sup>23</sup> You have to reduce shareholder membership under Rules 12g-4 and 12h-2 under the 1934 SEC Act to less than 300 shareholders of record and this is quite difficult.<sup>24</sup>

UK firms were presented with three possible de-listing options: de-list first, terminate the depository rights facility available to foreign purchasers of securities in the USA, and hope for the numbers to go down; amend the articles to force the USA shareholders to sell out; or, enter into a Section 425 UK Companies Act scheme of arrangement whereby shares would be restructured to ensure equality of treatment of UK shareholders arguing the presence of US shareholders necessarily brings about unduly burdensome regulation.<sup>25</sup>

Compliance with the US standards did have some positive uses: those firms maintaining such new enhanced disclosure would be better positioned for mergers and acquisitions activity with their US counterparts. So far, delisting has been somewhat limited, although recent proposed SEC rules set the legal foundation to make it easier.<sup>26</sup> So, how does Europe and specifically London enter into this?

### *c) Enter London, and for that matter, Europe: Comply Or Explain*

The UK, as part of the European Union obeys certain Directives but it also has its own rules. These rules first as to disclosure are listed below.

To begin, the UK Combined Code sets out rules that require companies listing on the London Stock Exchange to either 'comply or explain' as to certain disclosure requirements.<sup>27</sup> This allows the firm to beg off the rules when it can

<sup>21</sup> See above n 20, especially Paulsen Remarks.

<sup>22</sup> *Ibid.*

<sup>23</sup> Proposed Rule 34-55005, Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Dec 22, 2006, found at <http://www.sec.gov/rules/proposed/proposedarchive/proposed2006.shtml>.

<sup>24</sup> *Ibid.*

<sup>25</sup> Although there may be others, these are the core options that the author is aware of.

<sup>26</sup> F Norris, 'SEC eases delisting for foreign companies', Dec 7 2006, IHT; <http://www.sec.gov/news/press/2006/2006-207.htm> summarises the re-proposed changes to the rules.

<sup>27</sup> <http://www.frc.org.uk/corporate/combinedcode.cfm>.

make a case that they are unduly burdensome, for example. So, in practice, if you can make a case for this, you have achieved a *de jure* exemption from the core rules.

These statements as to non-compliance must be made by qualified auditors as to objectively reliable information with greater monitoring from the Financial Reporting Review Panel (FRRP) monitoring group, who in turn has a memorandum of understanding as to the need to keep up standards.<sup>28</sup> Companies delaying bad news may have their directors fined or be disqualified. The Smith and Turnbull guidance provide principles for somewhat beefed up internal controls, but they are not mandated in the same way as they are in the US system.<sup>29</sup> These comply or explain provisions do not apply to the UK's junior market, the AIM, which requires a third party gatekeeper to vet the firm, prior to listing, as its means of signalling quality assurance as to the financial and other representations made.<sup>30</sup>

The UK via the Listing Rules requires continuous reporting of material developments, and this is a subject of related and great interest vis-a-vis the related EU Market Abuse Directive to curb insider trading and publish material information, and its UK implementation.<sup>31</sup> The US has adopted provisions for accelerated disclosure, in Section 409.<sup>32</sup> The UK therefore has a tiered approach, and a considerably more flexible one than the US.

All UK firms must comply with IFRS developed International Accounting Standards as of January 31, 2005.<sup>33</sup> The use of these Standards is mandated by the EU and is the subject of some concern among commentators as to its ambiguities of interpretation, especially.<sup>34</sup>

*d) The EU Prospectus Directive has a limited bite and may extend the number of investors interested across Europe*

The EU Prospectus Directive sets out a series of core rules which have as their goal ending the fragmentation of the European capital markets.<sup>35</sup> While eschewing a single super-regulator, the Lamfalussy report writers who devised the broad Financial Services Action Plan scheme whereby securities sold in one country in Europe could be sold in all countries via a 'single passport' sought to remove the impediments further to achieve a single market.<sup>36</sup>

<sup>28</sup> See <http://www.frc.org/frp/about>.

<sup>29</sup> See *ibid* at Smith Report and Turnbull guidance; *cf* with Sect. 404 at n 14.

<sup>30</sup> See <http://www.londonstockexchange.com> and 'AIM rules for companies'.

<sup>31</sup> See [fsahandbook.info/FSA/html/handbook/LR](http://fsahandbook.info/FSA/html/handbook/LR); See Commission Directive 2003/6/EC and 2004/72/EC; [www.hm-treasury.gov.uk/media/9DF/5B/market\\_abuse\\_parts1and2\\_180604.pdf](http://www.hm-treasury.gov.uk/media/9DF/5B/market_abuse_parts1and2_180604.pdf)

<sup>32</sup> See s 409 at n 14.

<sup>33</sup> [http://www.icaew.co.uk/library/index.cfm?AUB=TB2I\\_25594#eu](http://www.icaew.co.uk/library/index.cfm?AUB=TB2I_25594#eu) provides a complete and detailed set of primary documents as to this issue from both an EU and UK point of view.

<sup>34</sup> [http://ec.europa.eu/internal\\_market/accounting/ias\\_en.htm](http://ec.europa.eu/internal_market/accounting/ias_en.htm) (See Roundtable for the Consistent application of IFRS); See EC 1606/2002 and the legislation that follows as to specific dimensions.

<sup>35</sup> EU Prospectus Directive 2003/71/EC.

<sup>36</sup> See [ec.europa.eu/internal\\_market/securities/lamfalussy/index\\_en.htm](http://ec.europa.eu/internal_market/securities/lamfalussy/index_en.htm).



European securities may be issued by a firm's home state, defined as the place where its registered office is kept, for EU based issuers.<sup>37</sup> A non-EU issuer may choose where to place its equity or low denomination bonds, but once it makes such a selection it is largely stuck and cannot change.<sup>38</sup> (High denomination bond issuers can choose between the location of the registered office and of where trading is taking place as the *situs* of registration).<sup>39</sup>

This EU member state will be responsible for approving the prospectus, and it is subject to the EU *maximum harmonization* rule, so it cannot change the substance of the rules as to the content of the prospectus, but significantly, it may provide an individualised basis for exemptions.<sup>40</sup> And it is these exemptions that may provide a clue as to the attractiveness of one market versus another, especially as to non-EU issuers. All securities must be traded on a regulated market, which in turn can be defined in various ways.

The general framework, including exemptions, works as follows. First, the FSA will review any offer of securities to the public or request for admission to an exchange.<sup>41</sup> The EU has essentially defined an offer as a communication to persons in any form and any means that provides sufficient information on terms of securities offered to enable an investor to purchase or sell a security.<sup>42</sup> The UK treasury has proposed that re-sales on European markets will not be deemed an offer.<sup>43</sup>

Exemptions to the Directive include offers to qualified investors (ie, wealthy persons named on the FSA's Qualified Investor Register, Government, FSA authorised or regulated financial institutions), an offer of up to 100 persons *in each* EU state, offers of less than 2.5 million Euro, and offers where the securities are denominated in units of greater than 50,000 Euro.<sup>44</sup> (The impact of the Prospectus Directive on certain debt, specifically the Medium Term Note (MTN) programmes is beyond the scope of this summary). On a European wide level, it is estimated that these provisions will wipe out the need for about 75 per cent of prospectuses, due to the small size (2.5 million Euro exemption).<sup>45</sup> Civil and criminal liability attaches within each state to the provisions of the Directive.

A companion Directive, the Transparency Directive, requires non-EU firms issuing securities to present IFRS accounts or a true and fair view of their accounts with supplemental information. The Committee on European Securities Regulators (CESR) has said that US, Canadian, and Japanese GAAP should be deemed IFRS equivalent, subject to certain exemptions.<sup>46</sup> This

<sup>37</sup> See Prospectus Directive, above n 35.

<sup>38</sup> *Ibid.*

<sup>39</sup> *Ibid.*

<sup>40</sup> *Ibid.*

<sup>41</sup> [http://www.fsa.gov.uk/Pages/Library/Policy/CP/2004/04\\_16.shtml](http://www.fsa.gov.uk/Pages/Library/Policy/CP/2004/04_16.shtml).

<sup>42</sup> *Ibid.*

<sup>43</sup> *Ibid.*

<sup>44</sup> *Ibid.*

<sup>45</sup> See Prospectus Directive, above n 35.

<sup>46</sup> [http://ec.europa.eu/internal\\_market/securities/transparency/index\\_en.htm#adproposal](http://ec.europa.eu/internal_market/securities/transparency/index_en.htm#adproposal) especially Dec 2006 postponement of equivalence.

provision is designed to limit issuers delisting in Europe as the IFRS requirement could otherwise be deemed to be unduly burdensome, precipitating at the very least a restructuring of the securities offering.

Although figures are unavailable it appears that a certain number of investors may require a prospectus, but just how many is unclear. A significant number of non-EU securities sold in London and throughout Europe are so called privately placed securities. These are securities that are sold accredited investors only and are subject to US Sec Rule 144A and Regulation S, making them securities for investment only and subject to resale only after seasoning, for example, in Europe, to the US.<sup>47</sup> A separate filing document is presented with Regulation S/144A transactions, and to the extent the requirements including financial burdens of compliance with these regulations is lesser than that of the EU Prospectus Directive, the size of EU issuance may be more limited.

The UK Listing Authorities rules, as amended, exempt firms with issuance of securities of less than 2.5 Million Euro, or, that offer *all* securities to qualified investors, in which case no prospectus is needed.<sup>48</sup> Qualified investors, are roughly the functional equivalent of privately placed or accredited investors, in US parlance.<sup>49</sup> The AIM market brings to market issues of securities vetted by so-called Nominated advisors (NOMADS) who suffer reputation loss if the issue of securities does not work out. In that the investor base of nomads is likely to have substantial numbers of qualified investors, then a prospectus is not more likely, at least initially in this market as to such listed shares. However, for smaller issuers, a prospectus will be required and would seem appropriate to maintain liquidity levels of some size.

*e) What are the elements of the above rules that achieve the interests of the UK to further establish itself in global markets?*

The key point of these rules is that the UK's more flexible 'comply or explain' regime allows for easier mechanisms to sell securities from a UK base than from the USA, while still providing the superior market size advantage of the London markets for foreign firms.

Of course, the larger firms, the FTSE 100, for example, will already be listed in America, in the usual scheme of things and may not rely upon the Combined Code to provide less disclosure. That is true even if they are granted a limited waiver in the US as to certain disclosure requirements, an option which is available to foreign private issuers to a limited extent. Further, the UK firms have to

<sup>47</sup> [www.dorsey.com/files/tbl\\_s21Publications%5CPDFUplod141%5C1052%5CSummary\\_of\\_SEC\\_Regulation\\_S.pdf](http://www.dorsey.com/files/tbl_s21Publications%5CPDFUplod141%5C1052%5CSummary_of_SEC_Regulation_S.pdf).

<sup>48</sup> As part of UK Implementation of EU Prospectus Directive; See Explanatory Memorandum to the Prospectus Regulations 2005, No 1433 at p 6. found at [www.opsi.gov.uk/si/em2005/uksiem\\_20051433\\_en.pdf](http://www.opsi.gov.uk/si/em2005/uksiem_20051433_en.pdf).

<sup>49</sup> See <http://www.fsa.gov.uk/Pages/Doing/UKLA/qir/index.shtml>. See also <http://www.law.uc.edu/CCL/33ActRls/rule501.html>.

comply with IAS anyway, and no additional burden is placed upon them by the Prospectus Directive (although there may be some more reporting requirements vis-à-vis the UK implementation of the EU Market Abuse Directive).

Moreover, the UK listing requirements add no additional costs as is the case with the US, and its various rule based audit committee requirements, for example, that are essentially taken care of by the Smith and the Turnbull guidance in the UK.

There are also a significant number of US investors in the UK, and they are increasing. They will be able to participate quite extensively in the UK markets with the UK requirements promoting investor confidence, but at reduced cost. This is based upon the 'comply or explain' provisions and the UK provisions articulated above that allow for principles based flexibility as to high standards of corporate governance. And, so long as the UK implementation of the EU Prospectus Directive does not upset the status quo, the UK market will remain very attractive. In short, it will be cheaper to comply in the UK, and no more burdensome to list for most entities so the UK stays extremely attractive. Plus, it will be a bridge to European sales.

As to the AIM market, this is likely to also benefit by attracting firms that can benefit from the perception of more stringent requirements vis-à-vis their own jurisdictions, such as Russia and China, but much less than the USA. This means, for example, if you have an attractive mining company you will look to the AIM market as your likely first port, globally for an equity offering.

All of these developments serve to consolidate or at least not diminish the UK's competitive position in international capital markets. It is, for all but the biggest UK firms, a source of lower regulatory cost capital than the US but at the same time it provides stronger quality assurance than most emerging markets due to its perceived standards of high reputation and market integrity, as well as regulatory oversight.<sup>50</sup>

The new competitive position above is not expressly set out in the FSA's regulatory impact assessment, and perhaps it was not foreseen or more precisely is just not within the strict terms of reference.<sup>51</sup> In any event it would seem that, for now, London has successfully positioned itself as a very interesting situs for international capital markets activity, indeed.

<sup>50</sup> Of course, there are some issues. The UK's own FSA has said recently that over 29% of recent trades appear tainted by some form of insider trading. 'FSA begins Insider dealing Probe', BBC Dec 19, 2006, <http://news.bbc.co.uk/1/hi/business/6193459.stm>.

<sup>51</sup> However, would you want to tell the rest of Europe how your harmonization of the EU Directive with the rest of Europe is going to consolidate your position as the leading centre for capital markets activity in Europe, or would you take a more tactful, discreet, diplomatic role? Prudence suggests the latter is the sensible choice. Clifford Chance Global capital markets head Tim Plews has outlined for the City of London a report on some ways in which the US and EU could work together in the financial services area is there is plenty of room for collaboration as well as competition. See T Plews, 'EU-US Coalition on Financial Regulation, The Transatlantic Dialogue in Financial Services: The Case for Regulatory Priority Action 2005', [www.aba.com/aba/documents/abia/EUUSReport.pdf](http://www.aba.com/aba/documents/abia/EUUSReport.pdf).

Thus, London has achieved a global market position whereby it can use its primarily institutional investor base to achieve three commercial and financial objectives with greater ease. First, it can serve as a bridge to existing US capital for the largest firms, or those who otherwise see fit (because of a preference for US capital raising) to maintain an enhanced disclosure tier. Second, its more flexible rules allow it to be a situs for firms that do not wish to be listed in the US, at lower cost and with substantial access to a large capital market of investors. Third, it retains its position as a strong base for emerging market companies through the AIM or junior market process.

This multi-tiered approach results in win-win for the private exchanges of the City of London without, at least facially compromising standards of investor confidence vital to attracting and maintaining the flow of capital raising in London.

### III. INTERNATIONAL BANKING LAW AND POLICY AND THE OPTIMAL USE OF CAPITAL

#### 1. Case Two: Basel and the Rules of Banking—Should we be surprised at the Evolution of Basel II?

A fundamental issue for financial institutions is how much risk they can take on. Critical to the determination of how much risk can be undertaken is the issue of how much taking on that risk will cost the banks with bank supervisors, and/or the market. A small group in Switzerland, affiliated with the ‘Central bank’s’ central bank (The Bank of International Settlements or BIS) and made up of the G10 countries decided in the late 1980s to undertake such a ‘benchmarking’ exercise.<sup>52</sup> The group had initially developed out of efforts to contain and prevent cross-jurisdictional banking risks arising from the 1974 Bank Herstatt failure.<sup>53</sup>

##### *a) History and Evolution*

The principles set forth and guidelines submitted by the Basel Committee on Banking Supervision came to be known as the 1988 Basel Accord or Basel I.<sup>54</sup> It was intended that these provisions would become national law, as they were merely ‘soft law’ as proposed by the Committee without express legislative effect. However, implementation of the laws would vary. Basel was intended to ensure there was adequate supervision of banks, and that a level playing field among international banks could be developed.

<sup>52</sup> <http://www.bis.org/publ/bcbs28b.htm>.

<sup>53</sup> [http://www.bis.org/about/global\\_financial\\_stability.htm](http://www.bis.org/about/global_financial_stability.htm).

<sup>54</sup> <http://www.bis.org/publ/bcbs04a.htm>.

The major concept of capital adequacy was that banks should have a certain amount of capital which would be needed to keep on hand so that a safe and sound banking system would be ensured. The concept developed, SMU International Banking Law Professor Joseph Norton describes, with many different legal, accounting, and regulatory dimensions.<sup>55</sup> The crude figure of 8 per cent was arrived at, and banks had to keep this level of regulatory capital subject to the risk weight that was attached to the bank's assets.<sup>56</sup> The 8 per cent figure represented capital divided by the risk weight.

So, for example, an OECD country loans were theoretically very low in terms of default. They were assigned 0 per cent risk weight. Non OECD government borrowers might have a 1000 per cent risk weight classification, while developing country loans could be set at 250 per cent. This meant that a bank would not have to keep any capital against its portfolio of OECD loans because of the 0 per cent risk weight (0 multiplied by 8 per cent) whereas it would have to keep 8 per cent of capital for non-OECD loans (100 multiplied by 8 per cent equals 8 per cent). It is important to note that as Basle developed further and various Quantitative Impact Studies (QIS) were undertaken the relevant figures were changed for various types of risk, so that they would not be one size fits all, but would be recalibrated and further refined to more closely reflect actual risk.

The major type of risk that banks focussed on was credit risk.<sup>57</sup> This is the risk associated with the default of a financial product or technology, such as the repayment of a loan. Determining an appropriate measure of market risk was a core concern as valuing the exposure to a fluctuating portfolio was a difficult issue. (The US focus was commercial banks because the banks were fragmented into deposit-taking, loan-making institutions, commercial banks and those that engaged in capital markets activity such as trading debt and equity, otherwise known as investment banks, or when combined, universal banks).

This was a major concern of the Europeans who promulgated the Capital Adequacy Directive that was the predecessor to the current Capital Requirements Directive (CRD).<sup>58</sup> Because of the concern among certain groups that market risk would not be adequately covered with current Basel standards, it slowly evolved to provide further testing whereby market risk could be added to the capital base required if justified by quantitative analysis.<sup>59</sup> It was also to

<sup>55</sup> JJ Norton, *Devising International Bank Supervisory Standards* (The Hague, Kluwer, 1995) at p 3–20.

<sup>56</sup> *Ibid.*

<sup>57</sup> <http://www.bis.org/publ/bcbs54.htm>.

<sup>58</sup> The European Commission has adopted a proposal for the amendment of the Consolidated Banking Directive (2000/12/EC) and the Capital Adequacy Directive (93/6/EEC) to introduce a new capital requirements framework for banks and investment firms. The Capital Requirements Directive, comprising Directive 2006/48/EC and Directive 2006/49/EC, was published in the Official Journal on Jun 30, 2006.

<sup>59</sup> The treatment of market risk has evolved from the so called building block approach where it was expressly made an element of calculations to supposed refinements to the usage of bank's own value at risk models with certain back testing over time. Discussion of these developments is summarised at <http://riskinstitute.ch/00013409.htm> and can be found in the BIS website links on that page and in greater detail in the BIS website on market risk.

be made more transparent.<sup>60</sup> Whether the methodology used enhanced sound risk management by encouraging the use of more market sensitive risk management technology is the subject of some intensive debate.

If history comes in from the side-it is oblique, as economic historian William Woodruff was fond of saying, then two developments stimulated further market developments.<sup>61</sup>

One, was the sense that operational risk was an important issue. Operational risk is the risk associated with someone within the bank engaging in fraud or in some other processing disruption or an error.<sup>62</sup> The 1995 Barings failure highlighted the need to address issues of operational risk further.<sup>63</sup> The Barings event had grown in size and scope due to a lack of proper internal controls in the banks as well as fraudulent reporting.<sup>64</sup>

Second, it was clear that banks use of leverage was becoming more sophisticated by taking as much of the assets off the balance sheet as possible (either from a regulatory capital and/or accounting perspective), thus stimulating lawyers and bankers to package receivables in asset securitizations that would place the bank in a better position to lend more and therefore earn more money.<sup>65</sup>

Basel II added the element of operational risk to the above formula of capital subject to credit risk and market risk, so now all three elements were to be measured.

#### *b) Risk management competency: COSO and other developments*

As a general rule, banks felt that they were better at understanding the risk which they had to face than the supervisors. They argued that because of the superiority of the models that they would essentially develop better models, especially of credit risk, and over time, of operational risk. The banks therefore suggested that a methodology which would provide them incentives to capture such risk which would be aligned with the amount of regulatory capital they would have to keep would be a better solution to the correct calibration of risk. Naturally, not all banks would have the financial wherewithal to do such modelling. So, this option of developing individualised risk buckets was only offered to the largest banks, the so-called international banks, which hold the

<sup>60</sup> <http://riskinstitute.ch/136090.htm> which includes a copy of the Basel Committee's 'The Supervisory Treatment of Market Risk', Apr 1993.

<sup>61</sup> The author recalls this as one of Professor William Woodruff's sayings about events often overtaking day to day expectations of continuity. See *A Concise History of the World*, ((Altrincham, Abacus, 2005).

<sup>62</sup> See Secretariat, 'The New Basle Capital Accord: An Explanatory Note', Jan 2001 p 4 found at [www.bis.org/publ/bcbsca01.pdf](http://www.bis.org/publ/bcbsca01.pdf).

<sup>63</sup> JB Dial, Status report on Regulatory and Self Regulatory Responses to the Barings Bankruptcy, Oct 19, 1995, found at <http://www.cftc.gov/opa/speeches/opachic95s.htm>.

<sup>64</sup> *Ibid.*

<sup>65</sup> [http://goliath.ecnext.com/coms2/gi\\_0198-39674/Basel-I-and-the-law.html](http://goliath.ecnext.com/coms2/gi_0198-39674/Basel-I-and-the-law.html).

overwhelming majority of global banking assets. The others, who make up the greatest numbers of banks, if not banking assets, would continue to apply standardised formulas.

In the US especially, the COSO or Treadway Commission report had since the 1990s, championed stringent reporting requirements in order to improve risk management as Basel itself was evolving.<sup>66</sup> (These guidelines, first applied in banking became the Substantive basis for the above SOX corporate governance reforms focused on financial reporting and better internal controls).<sup>67</sup>

*c) The More Information, the Better*

Basel II was supposed to improve the process by permitting banks to be more refined in their taking up of risk. The process of Basel I can be seen to be refined through the ongoing risk survey process known as the Quantitative Impact Survey, which is now in its fifth incarnation (QIS 5) but has been completed and released fully through QIS 4.<sup>68</sup> Interestingly, the survey results, allowing for some dispersion of course across various banks, show that the banks have become so adept that they do not need capital kept at the previous levels of risk.<sup>69</sup>

Basel II consists of three pillars.<sup>70</sup> The first is the new minimum capital requirements, as adjusted by credit, operational and market risk parameters.<sup>71</sup> The second is the supervisory role whereby factors are taken into account to what extent the banks' own figures will be used and how they may be adjusted.<sup>72</sup> Third, is the concept of market discipline whereby firms are required to provide greater details of their risk management processes, and other risk control features.<sup>73</sup>

*d) Implementation of Basel in the US and likely implementation in Europe of the Capital Adequacy Directive*

The response of the banking supervisors as to this on a global basis appears likely to be cautious, rather than fully accepting. Nevertheless, the amount of economic capital (amount which banks actually keep on hand as liquidity)

<sup>66</sup> <http://www.coso.org>.

<sup>67</sup> See Discussion of Integrated Risk management framework and especially Sox s 404 internal controls found at [http://www.coso.org/Publications/ERM/COSO\\_ERM\\_ExecutiveSummary.pdf](http://www.coso.org/Publications/ERM/COSO_ERM_ExecutiveSummary.pdf)

<sup>68</sup> Goodwin Proctor Financial services Alert found at [www.goodwinprocter.com](http://www.goodwinprocter.com) citing bank regulators' concern regarding reduction of capital charge based upon dispersion profile of banks undertaking QIS4. Concern is IRB approach without prudential supervision would lead to a possibly unhealthy trade off between safety and soundness and leverage as most banks capital charges would be reduced. See G French, 'Basle II Implementation and Policy Issues', Mar 24, 2006 Cambridge Endowment for Finance, Basle II Seminar.

<sup>69</sup> *Ibid.*

<sup>70</sup> Basel II-Revised International Capital Framework, Jun 2006, found at <http://www.bis.org/publ/bcbsca.htm>.

<sup>71</sup> *Ibid* (See also <http://www.bis.org/publ/bcbs128.htm>).

<sup>72</sup> *Ibid.*

<sup>73</sup> *Ibid.*

seems to invariably be greater than that for regulatory capital anyway perhaps because of fluctuations in the maturity of different financial instruments.

Specifically, the challenge posed by significantly lower regulatory capital requirements based upon the IRB Foundation or Advanced approach has been met with the response that the rules have to be changed. Thus, to implement Basel II, the proposed rulemaking of Federal Reserve Rules suggest that banking supervisors should have the discretion to adjust the figures as to capital adequacy notwithstanding the results of the QIS 4 process that suggest lower amounts of regulatory capital are called for.<sup>74</sup>

In Europe, the Committee of European Bank Supervisors is in the process of discussing appropriate approaches in response. However, the European Capital Requirements Directive (CRD), which must be initially implemented by national regulators such as the FSA in the UK is harmonisation.<sup>75</sup> It is likely that the European approach will mirror the conservative US approach and not allow for dramatic reductions in regulatory capital.

The good news in this is that if regulatory gamesmanship has been undertaken by the bankers, then it does not appear that there at least has not been a response to this which may trump the modelling work done by the banks. In this sense, to the extent the process provides for banks to have strong incentives to have better quality information may be reduced, to the extent they do not obtain expected capital adequacy relief. Still, it seems likely that some reduction in capital adequacy will take place. If so, we should have a reduction on the cost of capital. In this sense, it is a good thing, because the global economy benefits. But then we have to assume that the risk element has been properly calibrated by the bank and properly overseen by the banking supervisor.

Finally, some authors criticise Basel II as not rationally incentivising firms to manage risk effectively, such as Intelligence Capital Founder and Professor Avinash Persaud.<sup>76</sup> Providing the type of incentives to really align the banks interest with good risk management is therefore the next frontier beyond Basel II. This is because the use of credit risk technology that provides innovations in the financial markets as to risk may not be taken into account even with the international banks use of their internal ratings based process, due to the prudential constraints which supervisors may impose in the application of the supervisory rules.

Ordinarily, we could expect this to be ‘another story’. But with hedge funds (and private equity funds for that matter) increasingly becoming important as the holders of global assets, the above developments take a somewhat darker side.

<sup>74</sup> French above n 68 at p 12–13

<sup>75</sup> J Vesala, ‘CEBS Role in Basel II Implementation and More Broadly’, Cambridge Endowment for Finance, Basle II Seminar, Mar 24, 2006.

<sup>76</sup> A Persaud and S Pratt, ‘Implementing Basel 2 in Developing Countries: Problems, Possibilities and an Alternative Solution’, Presented at Cambridge Endowment for Finance, Basle II Seminar, Mar 24, 2006.



IV. INTERNATIONAL SECURITIES REGULATION AND HEDGE FUNDS:  
A NEW AND EMERGING INVESTMENT FRONTIER

**1. Case Three: Hedge Funds and their Regulation: Getting the Balance Right**

*a) More information but not necessarily better direct controls on fund's risk appetite*

Hedge funds historically were connected with various short term strategies rather than longer term investing. Investors seek returns not correlated with the market itself, and are enticed by the fund manager's reputation.<sup>77</sup> The lack of transparent reporting may obviously be an issue to some investors and the paucity of detailed information about fund manager's performance can be an initial stumbling block in some cases, but this is usually not the case.

Firms such as Steve Feinberg's Cerberus have now entered the buyout game beating our venerable players such as KKR. And, ESL, Eddie Lampert's vehicle has bought out Kmart and is attempting, like Cerberus in many of its investments to become an operational company and not just a 'passive investor'.<sup>78</sup>

This phenomena of 'convergence' has led to hedge funds increasingly becoming involved not just as vulture funds in distressed debt, or macro bond funds, using sophisticated quantitative techniques to leverage anomalies in markets but in mainstream lending to corporate firms and the taking up of significant equity positions as would typically take place in a management buy out.<sup>79</sup> (In a management buy out, a private equity fund takes a position that will provide first payment usually plus other terms that will provide it with significant upside returns if the new management's profit maximizing execution strategy for realising value is successful).<sup>80</sup>

Hedge funds are concentrated (about 85 per cent or more) in the US or the UK, according to the most reliable estimates.<sup>81</sup> Former Federal Reserve Chief Alan Greenspan highlights their primary function as providing liquidity to the

<sup>77</sup> For example, funds that engage in short selling, go against the market. See 'FSA, Hedge Funds: A Discussion of Risk and Regulatory Engagement', Jun 2005 with a breakdown of the different fund types, p 14. It may be found at [http://www.fsa.gov.uk/pubs/discussion/dp05\\_04.pdf](http://www.fsa.gov.uk/pubs/discussion/dp05_04.pdf). Reputation is not necessarily a guide to optimal performance as LTCM with a distinguished team of investment professionals collapsed (as of course did Enron) PM Parkinson, Testimony before US House Committee on Banking, Housing, and Urban Affairs, 'Hedge Funds, leverage and the lessons of Long-Term Capital Management' May 9, 1999. <http://www.Federalreserve.gov/BoardDocs/testimony/1999/19990506.htm>.

<sup>78</sup> 'The Next Warren Buffett' Business Week, Nov 22, 2004. [http://www.businessweek.com/magazine/content/04\\_47/b3909001\\_mz001.htm](http://www.businessweek.com/magazine/content/04_47/b3909001_mz001.htm).

<sup>79</sup> P Ziobro, 'PE Hedge Fund Convergence Growing and Hurting Returns', Dow Jones Newswire, Oct 5, 2006.

<sup>80</sup> JS Levin and A Ginsberg, *Structuring, Drafting and Negotiating Venture Capital and Private Equity Transactions* (New York, Aspen 2006) is the leading work for practising fund lawyers.

<sup>81</sup> FSA above n 77 at discussion p 3–17.

markets, due to high levels of securities trading, and therefore being a source of flexibility in the international financial system.<sup>82</sup> The FSA has stated its view that between 33 to 50 per cent of all daily trading activity in both the London and New York markets is due to hedge funds.<sup>83</sup> (There are no less than US\$ 870 Billion in assets held in over 7000 funds). Notwithstanding the new registration guidelines below for a select group of funds, it is important to note that investment advisors are still subject to the antifraud provisions of the SEC rules.

*b) Growing Response to the Challenge: US and UK*

In response to the growth in hedge funds size and scope, US and UK regulators have taken a number of steps to require greater disclosure. US rules now require offshore funds to register with the SEC when more than 15 US persons are investors in the fund as determined by the 'look through' test (to determine the economic reality of who the investors really are), and investments are locked up for more than two years.<sup>84</sup> This is pursuant to the US Investment Advisors Act of 1940.<sup>85</sup> (Hedge funds may also be subject to certain reporting requirements pursuant to the Commodities and Futures Trading Commission (CFTC) Rules). What would happen next is that the SEC would then be able to determine if they have a compliance programme and are otherwise in compliance with SEC rules. At this point, the two major concerns are the lack of internal control and governance procedures. To remedy this in part, a firm would be required to designate a chief compliance officer. Second, the valuation of illiquid securities is a substantial concern.

More recently, in the wake of the Goldstein decision whereby hedge funds will be allowed to withdraw from registration and the above reporting, the SEC has renewed its call for more regulation.<sup>86</sup> The Chair of the New York Federal Reserve has stated his concern that the primary issue of concern is systemic financial risk.<sup>87</sup> Specifically, that lack of transparency as to the level of risk is a

<sup>82</sup> *Ibid.*

<sup>83</sup> *Ibid.*

<sup>84</sup> See <http://www.sec.gov/rules/final/ia-2333.htm>.

<sup>85</sup> *Ibid.*

<sup>86</sup> Testimony of SEC Chair C Cox Before the US Senate Committee on Banking, Housing and Urban Affairs, Jul 25, 2005 found at <http://www.sec.gov/news/testimony/2006/ts072506cc.htm>; Goldstein decision from US DC Court Of Appeals may be readily found at Goldstein V SEC, No 04-1434, (DC Cir 2006), or see <http://jurist.law.pitt.edu/paperchase/2006/06/federal-appeals-court-strikes-down-sec.php>; F Norris, 'Court Says SEC Lacks Authority on Hedge Funds', *NY Times*, Jun 26, 2006.

<sup>87</sup> This is especially so after the collapse of US Based Amaranth Advisors in Sept 2006. TF Geithner, 'Hedge Funds and Derivatives and Their Implications for the Financial System' Sept 16, 2006. See also TF Geithner, 'Risk Management Challenges in the US Financial System' <http://www.ny.frb.org/newsevents/speeches/2006/gei060914.html>; <http://www.newyorkfed.org/newsevents/speeches/2006/gei060228.html> In addition to other research suggesting credit risk is a major concern the SEC, FSA, and others are looking in a coordinated way at increased regulation of prime lending. See R Miller and J Westbrook, 'Hedge Fund Borrowing Looked at by Fed, SEC, and

subject of major concern. Add to that the rise in liquidity, and there is concern that risks may not be properly taken into account, especially as traders for funds are likely to undertake similar positions.

Interestingly, 90 per cent of hedge funds have decided to register, despite the Goldstein decision and its window of opportunity to opt out. The reason, some commentators suggest is that this makes the fund more attractive among institutional investors, for only a modest cost.<sup>88</sup>

*c) Response Posed as to Certain Risks Increasingly Specified*

UK rules focus most recently on valuation issues, following a similar perception of risk here as the US. Specifically, the concern, as articulated by the FSA's Dan Waters is that a large percentage of hard to value assets may be bundled together in such a way that valuation is extremely difficult, and therefore potentially troubling, for investors.<sup>89</sup> Given the potential illiquidity of positions especially when things go bad, it presents the possibility of market risk, and fraud related operational risk as positions become uncovered. The Basel Committee counterpart in international securities regulation, International Organisation of Securities Commissioners (IOSCO), may step into the lacunae, but it is still early days for a co-ordinated regulation of this field.<sup>90</sup> Issues such as conflicts of interest when representing levels of true risk due to tie-ins to bonus based compensation, and side deals represent two further potentially important areas of regulatory concern that are attracting attention.

So far, the response of funds to the call for US registration has been perceived as smaller than expected. Perhaps the reason for this is that hedge funds are avoiding the costs of compliance associated with this activity due to its burdensome nature. Indeed, some analysts perceive that it is when large institutional investors place demands on funds (especially funds of funds conducting due diligence) for greater disclosure as a condition of doing business that hedge funds will see registration as means of signally respectability, and not just merely burdensome.<sup>91</sup>

European Regulators' Jan 9, 2007, found at <http://www.bloomberg.com/apps/news?plbid=20601087&refer=home&slbid=aMFZqx2S1aWg>; See also B Bernanke, 'Hedge Funds and Systemic Risk', May 16, 2006 discussing major hedge fund issues from LTCM to present in <http://www.federalreserve.gov/Boarddocs/speeches/2006/200605162/default.htm>.

<sup>88</sup> See HH Glover, 'Most Hedge Funds Remain Registered' Jan 19, 2007 found at <http://www.financial-planning.com/pubs/fpi/20070119101.html>.

See SR Breslow *et al*, 'SEC issues Interpretative Guidance [Aug 11, 2006]' found at <http://www.srz.com/publications/publicationsDetail.aspx?publicationIbid=1559>.

<sup>89</sup> D Waters, 'FSA Regulation and Hedge Funds: An Effective and Proportionate Approach for a Dynamic, International Marketplace' Oct 19, 2006, found at [http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/1019\\_dw.shtml](http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/1019_dw.shtml).

<sup>90</sup> 'The Regulatory Environment for Hedge Funds- A Survey and Comparison', Mar 2006 found at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD213.pdf> ;See <http://www.iosco2006.org/html/EN/public.htm#panel2>.

<sup>91</sup> See above n 87 citing Miller and Westbrook for evidence of this starting to take place.

*d) A Review of Key Risks*

The European Central Bank (ECB) recently expressed its view that caution was required due to the strong possibility that hedge market fund positions were highly correlated, and therefore if one unanticipated movement took place in the market, then systemic calamity could follow.<sup>92</sup> Although stated with a different view this is not an altogether different type of observation that that made by Prof. Persaud. For banks for example, the homogeneity of models and classification of risk encourages certain specific risk taking behaviour, preferring certain types of loans to others for example. So, if the supervisors get it right, then the cost of capital is reduced. However, if they get it wrong, everyone suffers-in a big way.

Herd behaviour (if you prefer) of banks all contribute to risks being amplified and not minimised when measurement of risks is undertaken in the same way. That's to say that bank traders will tend to act in similar ways when chasing yields a certain percentage of the time. Further, when hedge funds act in similar ways, using similar models, their individual actions create a large wave effect. This is what is known as correlation risk, or as Prof Persaud calls it the 'liquidity black hole' whereby market risk is not well accounted for in that there are plenty of buyers when you place your trade-but not so many or even none when the market perception changes.<sup>93</sup>

How the US and the UK—the home of the major hedge fund operators—will play an increased role in monitoring and surveillance of these funds is an interesting story whose importance cannot be underestimated.

If the regulator's noose is tightened too hard (or costs raised too high), then it is likely that a series of legal manoeuvres would take place whereby the funds would move offshore-and then provide less information, less monitoring, less surveillance.

Separate and distinct from the monitoring of credit risks for prime brokering, and for vehicles such as leveraged loans, this makes a difficult market to oversee, even tougher. Given assets held by new groups of investors, large funds of funds, and pension funds, this is especially worrying. On the other hand if stronger disclosure is required and internal controls on operational risks are adjusted, and better devices for monitoring of market risks are undertaken, then we can feel more confident that the appropriate regulatory balance has been achieved.

<sup>92</sup> See L Papademos, 'ECB Financial Stability Review', Dec 11 2006, found at <http://www.bis.org/review/r01611212f.pdf>; See also for background N Chan, M Getmansky, SM Haas, AW Lo, 'Systemic Risk and Hedge Funds' Fourth Joint Central bank conference, Nov 8–9, 2005, Frankfurt, Germany. Scarily, this present danger is confirmed in T Adrian, 'Hedge Fund Risk and Correlation', Sep 7, 2006, found at <http://www.newyorkfed.org/research/economists/Adrian/hedgefundcorrelationsand risk.pdf>

<sup>93</sup> For a discussion of liquidity see A Persaud, 'Credit Derivatives, Insurance Companies and Liquidity Black Holes'. Geneva Papers on Risk and Insurance, vol 29, pp 300–12, Apr 2004. Complex structured financial transactions(csft's) which are offered by financial institutions have to undergo compliance tests. MA Gadziala, 'Regulation, Compliance, and Responsibility' May 4, 2006, found at <http://www.sec.gov/news/speech/2006/spch050406mag.htm>.

Moreover, the issue of the extent to which hedge funds may be engaging in illegal behaviour that is difficult to trace presents another difficult issue for domestic regulators and of international co-ordination. Specifically, the fact that hedge funds have access to information regarding companies before it is made public provides possible opportunities for insider trading. This most notably takes place when hedge funds acquire information on loans trading in the secondary market as a function of buying and selling certain credit derivatives.

*e) The International Financial Law System, Hedge Funds and Sovereignty*

So, the regulation of hedge funds poses some critical challenges for the international financial law system. The optimal solution is one whereby the incentives to stay within the US/UK regulatory framework are strong enough that they override the desire to exit and engage in regulatory/legal arbitrage.

Absent a hedge fund precipitated financial crisis it is unlikely that the current regulatory scheme will be dramatically overhauled although some additional step by step incremental changes are likely to be discussed and may be undertaken.

What will happen in the EU vis-à-vis hedge fund regulation is another interesting story yet to unfold.

Finding ways to make arbitrage work for regulators in their desire to improve the safety of the international financial system and provide for better risk management is a fundamental and ongoing challenge of our globalised age.<sup>94</sup> The response of states must take into account the dangers that have to do with managing private capital flows, but the risks which financial institutions will have within them in working with the funds and servicing their prime brokerage needs.

#### V. A CONCLUDING OBSERVATION: DEVELOPING A COMPETITIVE EDGE BY ALIGNING INTERESTS IN A GLOBAL ECONOMY FOR SOVEREIGN STATES

The ever changing battle of wits between gamekeeper and poacher in international banking and investment show no sign of abating, not that they, of course, ever will, with the stakes as high as they are.

For it is in the nature of international finance, that markets and rules will be in constant flux to respond to the challenges posed by developments. From the each of the above case study discussions, we can see how various parties may

<sup>94</sup> Interestingly, it is hedge funds (Atticus and TCI) owning over 20% of the French exchange Euronext stock who have pushed its merger with the NYSE, where they also hold about 6% each. The implications of this for competition between stock markets and the resulting rules that will be developed to facilitate competitiveness and/or constrain nationalistic market access reducing legislation as stock markets may be owned by the same entity will be interesting to watch unfold, especially as further tie-ups between exchanges seem likely.

either financially benefit or suffer from situations where they either are not placed to or cannot align their strategy with the rules of international banking, securities, and finance.

Corporate decision makers must continually seek out advisors who can assist them in taking advantage of the opportunities that such changing rules create and harness them as a basis for value creation. Likewise, they must be ever vigilant as to the risks which these developments may pose in order to allocate capital most wisely.

Legal arbitrage is pivotal in obtaining global, regional, or national financial advantage for the world's leading corporate and financial institutions. In the international capital markets, there is a cybernetic process whereby states who seek to impose rules that are more costly will suffer vis-à-vis other states whose regimes impose fewer regulatory burdens.<sup>95</sup> In international banking, states that impose higher costs in banking may see that their financial institutions are less competitive globally as well. Whether the trade off is worth it given the risk is another matter. States that seek to impose higher costs on hedge funds by requiring enhanced disclosure similarly face pressure, given likely capital flight. Whether and to what extent such disclosure of investors is relevant to the issue of sound risk management as banks assist hedge funds in their activities awaits reform arising from the inevitable crisis which, as a matter of probability, will likely occur.

States will intelligently seek to foster greater economic power by the use of financial regulation. Failure to understand that this game is global, rather than just domestic, may provide an impetus for a domestic overreaction, and possible over regulation. An overheated desire to attract international capital, however, may provide a basis for broader failure if the need for systemic risk management is not properly accounted for. Getting the balance right in an era of global capital flows presents one of the central legal challenges to sovereignty in our Age.

<sup>95</sup> There is an extensive 'law and finance' literature found at the <http://www.ssrn.com> website on issues such as investor protection, and listing, as well as papers by scholars such as Prof Larry Ribstein, Prof Roberta Romano and others on issues of regulatory competition and the phenomena of opt-out to various securities disclosure schemes. An interesting study is L Ribstein, Cross Listing and Regulatory Competition, Oct 5, 2004 found at the ssrn website.



Part Five

**Human Rights and International  
Economic Law**





*Re-Righting International Trade:  
Some Critical Thoughts on the  
Contemporary Trade and  
Human Rights Literature*

ANDREW TF LANG

I. INTRODUCTION

THE INTERNATIONAL HUMAN rights movement has been seriously engaged in public debates about the international trading system since at least the late 1990s. This was a time when public concerns about economic globalization were widespread, and when a consensus began to emerge among human rights communities that the international economic environment was one of the most significant determinants of people's quality of life (particularly those in developing countries), and therefore of their enjoyment of human rights. Although at first it was a struggle even to convince many of a link between international trade and human rights, the literature on 'trade and human rights' has by now taken hold, and has reached a critical mass in terms of its quantity, quality and mainstream acceptance. This chapter derives from my conviction that the trade and human rights literature has by now developed to a point that it is necessary to take stock, and cast a critical look over its achievements to date. How has the human rights movement helped to progress debates about trade policy? What questions have (and have not) been asked, and how well have those involved in the trade and human rights debate responded to them? My argument is divided into two parts. The first addresses the literature on the impact of the international trade regime on the enjoyment of human rights. The second analyses the impact of the human rights movement on the ongoing evolution of the trade regime, and of trade policy debates more generally.<sup>1</sup>

<sup>1</sup> For a fuller exposition of the arguments advanced in this chapter, see Lang, 'Rethinking trade and human rights' (2007) 15 *Tulane Journal of International and Comparative Law* 335, and 'The Role of the Human Rights Movement in Trade Policy-Making: Human Rights as a Trigger for Policy Learning' (2007) 5 *New Zealand Journal of Public and International Law* 147.

## II. THE IMPACT OF THE TRADE REGIME ON THE ENJOYMENT OF HUMAN RIGHTS

For those interested in the interface between the trade and human rights regimes, one of the first and most important tasks has been building a picture of impacts of the international trading system on standards of human rights protection for various groups across the world. A good deal of the research produced in the first decade of the trade and human rights debate has therefore concentrated on precisely this task. It can be divided roughly into two separate lines of enquiry. On the one hand, there is a relatively sophisticated and well-developed body of work on the impact of international trade flows themselves: analysis, for example, of the labour-market implications of trade liberalization, or of the various social transformations (and dislocations) caused both by rapid import liberalization and by the radical restructuring of economies towards export-oriented growth.<sup>2</sup> This body of work displays a profound awareness of the complexity of the task of mapping the impacts of international trade, and in particular of the multi-dimensionality, multi-directionality, unpredictability and context-dependence of the effects of trade liberalization.

On the other hand, there is a complementary body of work on the impact of the international trade *regime* on the trade policy decisions of its Members—and through that, on the character of the international trading system more generally. In contrast to the more sophisticated literature just described, this work is founded on a very simple—indeed, to my mind oversimplified—model of how the international trade regime affects the policy choices of its Members. In this model, the trade regime (which in this context is treated as the same as the WTO) acts primarily as an external constraint on its Members' behaviour, by imposing a set of powerful, binding and enforceable legal obligations which require them to adopt certain kinds of policies, and refrain from adopting others. Within this framework, we know the impact of the trade regime primarily by looking at the rules it establishes and at the ways these rules are interpreted and applied. More specifically, we know the impact of the trade regime on human rights by looking at the ways it constrains the ability of its Members to take measures to promote the enjoyment of human rights. Sometimes, for example, WTO rules may prohibit certain policy choices which, in some circumstances, are said to be a useful tool for promoting human rights.<sup>3</sup> Other times, WTO rules may require the adoption of policies which lead in practice to undermining human rights protections.<sup>4</sup>

<sup>2</sup> For some examples, see the chapters in Brysk (ed), *Globalization and Human Rights* (Berkeley, University of California Press, 2002).

<sup>3</sup> Examples which have received significant attention in the trade and human rights literature include rights-based trade sanctions, rights-based 'social labelling' initiatives, certain kinds of precautionary food safety regulation, subsidies (including favourable government procurement practices) in favour of marginalised and otherwise disadvantaged social groups, among many others.

<sup>4</sup> The classic example here is the TRIPs-mandated level of intellectual property protection, and its effect on the availability of certain kinds of pharmaceuticals.

Partly as a result of the pervasiveness of this model, the trade and human rights literature has been characterised by a great deal of formal analysis of what precisely it is that WTO rules do and do not require. Since some of the most important trade law disciplines remain ambiguous and underdeveloped, there is a great deal of room for this kind of analysis, and equal room for substantive disagreement on the issues. But, in the present context, I want to sidestep all of that discussion—or at least to take a step back from it—and instead make some arguments about the questions that it *fails* to address, and why those questions are important.

As part of a broader renewal of interest in the role of institutions in international politics, the last two decades or so have seen the development of a large literature in the field of international relations attempting to map and to theorise the particular functions performed by international institutions, and the various processes by which they influence social and political outcomes. One distinctive strand within this literature is represented by constructivist thinking on the role of institutions.<sup>5</sup> While this strand is of course itself highly diverse, it is fair to say that much constructivist thought—which in turn draws inspiration primarily from various traditions of organization theory within the discipline of sociology<sup>6</sup>—is concerned less with the way that institutions act as external constraints on the self-interested behaviour of states, and more with the way that they shape the processes by which states formulate their preferences and interests. That is to say, they tend to see institutions not primarily as a set of rules constraining behaviour, but rather as ‘social environments’<sup>7</sup> in which a variety of interactional and social processes work to transform participants’ belief systems and views of the world, and thus their action within it.

In my view, scholars of the trade regime, and more particularly those involved the trade and human rights debate, have much to learn from this scholarship. Most obviously, it alerts us to a variety of different modes through which the trade regime affects the enjoyment and protection of human rights, which are largely neglected in the present trade and human rights literature. For example, a number of scholars have argued that one of the most significant functions of international institutions is the production and dissemination of policy *norms*, that is, shared ideas about desirable, effective and legitimate policy choices. There is a sophisticated literature on the various microprocesses by which this

<sup>5</sup> A good early introduction to this literature can be found in JG Ruggie and F Kratochwil, ‘International Organization: A State of the Art on an Art of the State’ (1986) 40 *International Organization* 753; RO Keohane, ‘International Institutions: Two Approaches’ (1988) 32 *International Studies Quarterly* 379. See generally also the references cited below.

<sup>6</sup> Foundational texts in this literature include P DiMaggio and WW Powell, *The New Institutionalism in Organizational Analysis* (Chicago, University of Chicago Press, 1991); WR Scott and JW Meyer, *Institutional Environments and Organizations: Structural Complexity and Individualism* (Thousand Oaks California, Sage, 1994). See also M Finnemore, ‘Norms, culture, and world politics: insights from sociology’s institutionalism’ (1996) 50 *International Organization* 325.

<sup>7</sup> See AI Johnston, ‘Treating International Institutions as Social Environments’ (2001) 45 *International Studies Quarterly* 487.

kind of normative diffusion takes place. Some concentrate on the role of persuasion, argumentation and conscious deliberation within international institutions.<sup>8</sup> Others focus on acculturation—that is, the often tacit processes by which members of an organization come to share its normative commitments. Within international organizations, these commentators note, psycho-social pressures to conform arise from processes of identification, shaming, back-patting, status maximization, habituation, and so on.<sup>9</sup> And others still concentrate on discursive practices, showing how the distinctive conceptual frameworks, modes of speaking, and forms of argument characteristic of particular international regimes can construct particular policy orientations as appropriate, rational, modern, legitimate, and so on.<sup>10</sup> There are strong reasons to think that these processes play an important role within the international trade regime. Through many of its institutional practices, the WTO tends to teach states about the kinds of trade policies which are desirable and in their best interests. There are, for example, a number of venues within the current WTO system which we might expect to function as sites of normative socialization: accession negotiations teach new Members what it means to be a modern liberal trading nation; the Trade Policy Review Mechanism helps to produce and disseminate norms concerning the proper shape and objectives of domestic economic policy; while technical assistance programs are (or at least have the potential to be) the mechanism by which government leaders are taught norms of appropriate trade policy behaviour.

As well as their normative dimension, there is also a cognitive dimension to international institutions like the WTO. Scholars who focus on this aspect draw attention to the ways in which international institutions are involved in the production and dissemination of socially sanctioned knowledge about (certain aspects of) the world. As Barnett and Finnemore note, such institutions exercise the power of *classification* and the power to *fix meanings* to social phenomena.<sup>11</sup> They give the example of the World Bank, and the role it plays in producing and sustaining a particular meaning of ‘development’. This role is crucial, they argue, because it

<sup>8</sup> On the role of persuasion, see, eg T Risse, “‘Let’s Argue!’: Communicative Action in World Politics” (2000) 54 *International Organization* 1; AI Johnston, n 7 above, and references cited therein.

<sup>9</sup> See AI Johnston, n 7 above; R Goodman and D Jinks, ‘How to Influence States: Socialization and International Human Rights Law’ (2004) 54 *Duke Law Journal* 621, drawing heavily on a wide range of research into pressures on individuals to conform in social groups.

<sup>10</sup> For commentators who make this claim in relation to the trade regime, see DK Tarullo, ‘Logic, Myth, and the International Economic Order’ (1985) 26 *Harvard International Law Journal* 533; D Kennedy, ‘Turning to Market Democracy: A Tale of Two Architectures’ (1991) 32 *Harvard International Law Journal* 373; C Ochoa, ‘Advancing the Language of Human Rights in a Global Economic Order: An Analysis of a Discourse’, (2003) 23 *Boston College Third World Law Journal* 57; A Lang, ‘Beyond Formal Obligation: The Trade Regime and the Making of Political Priorities’ (2005) 18 *Leiden Journal of International Law* 403. See also, more generally AS Yee, ‘The Causal Effects of Ideas on Policies’ (1996) 50 *International Organization* 69.

<sup>11</sup> MN Barnett and M Finnemore, ‘The Politics, Power, and Pathologies of International Organizations’ (1999) 53 *International Organization* 699.

determines not only what constitutes the activity (what development is) but also who (or what) is considered powerful and privileged, that is, who gets to do the developing . . . and who is the object of development.<sup>12</sup>

The WTO arguably performs a very similar function in respect of the liberal trade project. It provides a venue for the social construction of the international trading order, for defining the categories through which actors interpret the trading system and their place within it.<sup>13</sup> It provides a key forum for defining the meaning of trade liberalization, for generating collective understandings about the social purpose of the liberal trade project, and who is to be involved in it. We commonly think of the purpose of the trade regime in stylized, functional terms, as the liberalization of trade. But the reality is that the regime is informed by a much thicker sense of purpose, which varies over time: at times the liberal trade project has been seen as part of a broader project of international peace, or of post-war reconstruction, or of the maintenance of both domestic and international stability, or as the driver of growth in the developing world.<sup>14</sup> This evolving sense of purpose plays a hidden but vital role in shaping trade policy decisions at all levels.

Another, somewhat more familiar, body of literature analyses the ways in which international institutions modify the dynamics of domestic policy debates, in particular by reconfiguring the constellations of actors involved in them. Thus, for example, it is commonly observed that the international trade regime helps to overcome public choice problems besetting domestic trade policy-making by mobilizing exporters in favour of a liberal trade agenda, and facilitating their regular input into domestic trade policy debates.<sup>15</sup> Similarly, as Swenarchuk has noted, one practical effect of the national treatment obligation in WTO law—by which foreign products are entitled to equivalent treatment to that granted to their domestic equivalents—is to give foreign producers an interest in the governmental regulation of domestic businesses.<sup>16</sup> In some circumstances, the result has been direct lobbying by foreign businesses in favour of

<sup>12</sup> *Ibid.*, at 711.

<sup>13</sup> For an interesting argument along these lines, in respect of regional institutions (NAFTA, Mercosur and the EU), see FG Duina, *The Social Construction of Free Trade: The European Union, NAFTA, and MERCOSUR* (Princeton, Princeton University Press, 2006).

<sup>14</sup> See generally, JG Ruggie, 'International Regimes, Transactions, and Change: Embedded Liberalism and the Post-war Economic Order' in SD Krasner (ed), *International Regimes* (Ithaca and London, Cornell University Press, 1983) 195; F Trentmann, 'Political Culture and Political Economy: Interest, Ideology and Free Trade' (1998) 5 *Review of International Political Economy* 217; F Trentmann, 'National Identity and Consumer Politics: Free Trade and Tariff Reform' in D Winch and PK O'Brien (eds), *The Political Economy of British Historical Experience, 1688–1914* (Oxford, Oxford University Press, 2002) 215.

<sup>15</sup> See, eg, JH Jackson, *The World Trading System: Law and Policy of International Economic Relations* (Cambridge Mass, MIT Press, 1997); IM Destler, *American Trade Politics* (Washington, IIE, 2005), among many others.

<sup>16</sup> M Swenarchuk, *From Global to Local: GATS Impacts on Canadian Municipalities* (Ottawa, Canadian Center for Policy Alternatives, 2002).

domestic liberalization.<sup>17</sup> In others, the input is more diffuse or indirect. Whatever the precise mechanism, the point is a general one: that institutions such as the WTO reconfigure the kinds of actors engaged in trade policy-making, mobilizing certain actors and demobilizing others, creating new spaces for political action and closing off others, making new arguments available and de-legitimizing others, and thus shaping the kinds of policy choices which are ultimately made.

What is the importance of these observations for the trade and human rights debate? The implications are at least twofold. First, it is possible that the critical energies of human rights actors are being partially misdirected. Since the debate at present largely proceeds on the basis of a view of the WTO as a set of constraining rules, by far the majority of critical attention is paid to the formal texts of WTO agreements. The focus is on ‘getting the rules right’, and in particular on ensuring that these texts provide sufficient ‘policy space’ for WTO Members to take measures to protect their populations from the vicissitudes of global markets. But if these rules represent only one of the many modalities through which the trade regime influences the character of the trading system—and in many circumstances only a relatively minor one—then there is a real danger that these kinds of critiques are missing the point. They fail to analyse and critique some of the more powerful ways in which the trade regime influences social outcomes in the pursuit of a purely formal, and in many ways illusory, ‘policy autonomy’. This suggests also that public concerns over the implications of the WTO for ‘sovereignty’ are potentially equally misguided, and ought to give way to more fine-grained analysis of the ways in which the WTO shapes and remakes domestic policy-making processes, rather than merely constrains or ‘trumps’ them.

Second, attending to the variety of modes of influence that the WTO yields can help us to imagine productive ways in which the trade regime and the trading system can be more positively involved in the pursuit of a range of desirable social projects such as the pursuit of human rights. When we think of the WTO as essentially a set of constraining rules, then the kinds of things it can offer these projects is relatively limited. As just noted, reformative projects tend to focus on the negative task of removing WTO constraints. But once we realise that, for example, the WTO plays a *teaching* function, this raises the possibility that it might be harnessed as a site of policy learning: a venue for the production and exchange of innovative policy knowledge.<sup>18</sup> Similarly, once we realise that it also plays a *normative* role—disseminating ideas of legitimate and desirable

<sup>17</sup> See, for an example related to debates about liberalization of the telecommunications industry, D Roseman, ‘Domestic Regulation and Trade in Telecommunications Services: Experience and Prospects under the GATS’ in A Mattoo and P Sauvé (eds), *Domestic Regulation and Service Trade Liberalization* (Washington, World Bank, 2003) 83.

<sup>18</sup> On the potential of the WTO as a site of learning, see, eg, B Hoekman, ‘Operationalizing the Concept of Policy Space in the WTO: Beyond Special and Differential Treatment’ (2005) 8 *JIEL* 405; Cooney and Lang, ‘Taking Uncertainty Seriously: Adaptive Governance and International Trade’ (2007) 18(3) *EJIL* 523.

trade policy, and constructing the values and purposes associated with the liberal trade project—then it becomes clear that the WTO may function as a valuable space for the deliberative and discursive renewal of the liberal trade project, providing tools and a venue for the collective re-imagining of that project. And finally, if it is true that the WTO acts in part to mobilize particular constituencies and to facilitate their insertion into trade policy-making processes, then it might be fruitful to ask how these spaces and mobilizing forces might be exploited to generate yet broader and more active public participation in respect of trade policy questions.<sup>19</sup> The point is that a fuller appreciation of the role of the WTO in social and political life can lead to a richer and more positive reformative and critical agenda.

### III. THE ROLE OF THE HUMAN RIGHTS MOVEMENT IN TRADE POLICY DEBATES

Let me pivot at this point onto what I see as the second of the two primary preoccupations of the trade and human rights literature. Rather than concentrating on the impact of the trade regime on the enjoyment of human rights, this section focusses, conversely, on the role of the human rights movement in influencing the evolution of the trading system. If the trade and human rights debate is at its heart about the trading system and what it ought to look like—and in my view it is—then it is relevant to ask what human rights actors and human rights language bring to trade policy debates. We are accustomed to thinking about trade policy as a self-contained and specialised policy sub-field, and trade policy debates as the proper domain of trained elites deploying specialised technical knowledge. In this context, the claims of human rights actors do not always make obvious sense. What can human rights actors tell trade policy experts about what trade policy ought to be which they don't already know? What is the 'value-added' of human rights in trade policy debates? How might attention to 'human rights' help us to determine or achieve better trade policy outcomes? One serious flaw of the present trade and human rights literature is that there have been few explicit attempts to answer these questions. Without a clear conception of what it is that the human rights movement offers, the possibilities of productive engagement between trade and human rights commentators is significantly reduced.

While explicit answers to the question of what human rights offer trade policy debates are rare, most interventions into the trade and human rights debate are informed at least by implicit models of what it is that human rights offer. There are a number of such models, but for present purposes I want to focus on the one which is perhaps the simplest and most prevalent. This is a model in which human rights are understood primarily as a set of rules to guide the

<sup>19</sup> This last possibility, it should be noted, is to some extent already happening within the broader literature connecting the WTO with principles of democratic governance.



decisions of trade policy-makers. In this framework, reference to human rights rules is seen as a way of defining the boundaries of socially acceptable trade policy choices. Human rights are seen to provide a legitimate way of arbitrating between competing trade policy choices—determining which is the more appropriate or normatively desirable. The logic is clear: governments must not implement certain trade policies where to do so would lead to a violation of their human rights obligations; and they must conversely pursue those trade policies which, in their circumstances, facilitate the progressive enjoyment of human rights. As applied to the WTO, human rights rules are seen as helping us determine the appropriate degree of constraint which those rules ought to impose. To simplify: if WTO law prohibits policy choices which may facilitate the enjoyment of human rights, then WTO law has gone too far. And if it requires policy choices which actively undermine the enjoyment of human rights, then again it has gone too far.

One can see the results of this model in the kinds of scholarship which the trade and human rights debate has tended to produce. A great deal of such scholarship is focussed on elaborating the relevant human rights norms, and applying them in particular trade policy contexts in an attempt to draw specific policy proposals from them. Recent work addressing agricultural trade liberalization and its relation to the rights to food and health (among others) provides an interesting illustration. Commentators often begin by setting out the content of (say) the right to food, focussing primarily on the relevant provisions of the ICESCR, as well as the elaborations of the Committee on Economic, Social and Cultural Rights in their General Comment No 12. It is typical then to attempt to apply this normative framework to agricultural trade. This involves a close analysis of particular trade policies, and their impact on the human rights of vulnerable populations. For example, many point to the economic and social costs imposed on the rural poor from programs of import liberalization in some developing countries. Others show how the pursuit of a development policy focussed on cash crops for export can displace certain communities from access to land and other resources. Many also engage, conversely, with arguments that some trade-restrictive measures, including temporary safeguards and tariffs, may in certain circumstances be the most appropriate for some developing country governments to implement. At the conclusion of this kind of analysis—and of course I am simplifying in order to set out most clearly what I perceive to be its logical structure—an attempt is often made to draw specific policy conclusions. A ‘human rights approach’ to agricultural trade, it is concluded, requires (say) the reduction of domestic subsidies in EU and US, or that the Agreement on Agriculture include greater flexibility for some developing countries to take special safeguard measures to protect their rural farmers.<sup>20</sup>

<sup>20</sup> A sophisticated example of this form of scholarship is provided in the chapter by Simons in this volume. See also generally, OHCHR, ‘Globalization and Its Impact on the Full Enjoyment of Human Rights’, E/CN.4/2002/54, 15 Jan 2002; M Ritchie and K Dawkins, ‘WTO Food and Agricultural Rules: Sustainable Agriculture and the Human Right to Food’ (2000) 9 *Minnesota*

The point I wish to make is not that this kind of intervention is somehow unproductive or simplistic—far from it. It has been clear for some time now that civil society actors, prominently including human rights actors, are among the most sophisticated and critical commentators in many aspects of trade policy debates. Nor do I wish to single out work on agricultural trade liberalization: I could have chosen examples from any number of different issue areas in which the same basic argumentative structure is deployed. But I do think that we need to be clear about what function human rights are performing in this kind of analysis, and what they are not. It is common to talk as if human rights are in some sense the source of the ultimate trade policy prescriptions—that human rights rules provide the criteria by which to arbitrate between alternative trade policy proposals. In fact, however, almost all of the intellectual heavy lifting in these analyses is not done by human rights norms at all. When it comes to the evaluation of concrete trade policies, the interventions of human rights commentators tend to rehearse and reproduce precisely the same kinds of arguments which trade policy experts have been having for some time—concerning the appropriateness of subsidies as a trade policy tool, the usefulness of tariffs in particular situations, the effects of liberalization, and so on. I am not suggesting that human rights commentators tend to reproduce orthodox opinion on these questions. In fact, the opposite is almost always the case: human rights have come to be seen largely as a language for articulating counter-orthodox critiques of prevailing trade policy consensus. But, regardless of the substantive positions taken, the point is that the discussion of trade policy matters engages with precisely the same set of arguments, in essentially the same way, as have characterised trade policy discussions for some time.

The result is that one can often be left wondering why it is necessary for these commentators to frame their arguments in human rights terms. Framing the argument in this way seems merely to confuse matters, and to add an extra, unnecessary, layer of analysis. Indeed, it comes to appear as if the implicit result (and perhaps purpose) of this kind of commentary is to *construct* the human rights regime in ways which support a particular trade policy agenda, that is, to construct a legal regime to support a counter-hegemonic international trade agenda. This may be an effective political strategy—its effectiveness is an empirical question—but it is important to be clear about what is happening, and in particular to be clear about the risks that it entails. These risks are real. It is not just that (like all political technologies) human rights are susceptible to misdeployment, or capture by powerful interests. Perhaps more importantly, it is that to speak as if particular trade policy choices were somehow mandated by human rights rules risks obscuring the contestability of these choices, lending them a falsely inflated legitimacy, and stifling ongoing debate about desirable

trade policy. After all, these proposals may be mistaken, superseded by better or different knowledge, and ought always to be open to question.

So far I have argued that human rights actors, institutions and language do not (in that capacity) offer substantive new knowledge or new normative insights into what trade policy ought to be. To speak as if they do, as if reference to human rights rules can resolve disputed trade policy questions, is in my view illusory and perhaps even counterproductive. But that does not mean that the human rights movement has nothing to offer trade policy debates. To my mind, some of the most important and potentially transformative impacts that the human rights movement has had on trade policy debates have been made in its role as a *trigger for policy learning*.<sup>21</sup> The body of specialised knowledge which trade policy experts deploy in formulating and debating policy dilemmas is of course neither fixed nor certain, but at the same time neither is its ongoing evolution unimpeded. When at any particular time certain narratives, problem formulations, and policy prescriptions come to be seen as orthodox and broadly accepted, it can be very difficult for these lessons and prescriptions to be *unlearned*, and for this body of knowledge to continue to evolve as needed. In my view, the human rights movement has helped to perform precisely this function—of providing an impetus for learning—in contemporary trade policy debates. It has helped to create the conditions in which profound policy learning is possible. It has helped in the evolution of trade policy knowledge by changing the social conditions in which that knowledge is produced. And it has acted as an impetus for the production of new forms of knowledge about the trading system, and therefore influenced the evolution of ideas about what is rational and desirable trade policy.

There are a variety of ways of conceptualising the ways in which the human rights movement is performing this function. At one level, it does so simply through the provision of feedback to the trade regime on the outcomes of trade liberalisation. Feedback mechanisms of this kind play an obvious role in triggering a rethink of policy consensus. But, at a deeper level, we can also understand the human rights regime as contributing to changing ideas about what constitutes relevant knowledge in trade policy debates, and modified the range of topics to which trade experts now turn their attention. To simplify somewhat, we have always had a very well developed body of knowledge about the impact of trade liberalization on (for example) growth rates, on aggregate national wealth, and even to some extent on employment and wage conditions. But human rights actors have prompted research into other questions: the impact of trade policy on levels of poverty, access to food, on the livelihoods of the rural poor, on the rights of women and other vulnerable groups, on the health of children, and so on. Not long ago, we did not even have a methodology for approaching these questions, and they hardly registered as relevant issues within orthodox trade policy debates. Now, however, they are all matters

<sup>21</sup> See Lang, 'The Role of the Human Rights Movement', n 1 above.

on which we have a considerable and growing body of knowledge. The general point is that human rights actors bring a unique set of concerns and preoccupations, which can drive the production of new forms of knowledge about the impacts of the trading system, and therefore in turn contribute to changing perceptions of appropriate trade policy.

The human rights movement has helped to facilitate learning not just about the most appropriate technical means of achieving the desired ends of trade policy, but also about what the overarching goals of trade policy ought to be. Precisely because the language of human rights is an ethical language, it has the ability to generate debate about the broader normative vision in which the liberal trade project is embedded. While it will be clear that I do not think 'human rights' themselves necessarily provide a vision of the most appropriate ends towards which the trade regime ought to be striving (these ends will always quite appropriately be contested and never finally resolved), human rights actors have nevertheless been instrumental in generating a renewed critical debate about the social purposes of the international trading system. They have done this in part by providing an institutional and discursive space in which such debate can occur, and in part specifically by putting such questions on the international agenda. By forcing trade actors to justify their activities and policies according to ethical criteria, they have helped over the last decade or so to prompt a reflexive questioning of both the means and ends of trade policy, thereby reshaping the framework within which rational trade policy knowledge is deployed.

Recognising and making explicit this conception of the function that the human rights movement is performing in trade policy debates has implications for the kind of activities that human rights actors engage in, as well as for the kind of scholarship which is produced in the context of the trade and human rights debate. In addition to elaborating more detailed human rights norms, spelling out their apparent implications for particular trade policy questions, and constructing an entire international legal system to complement and counteract WTO law on the international level, human rights actors may also focus on performing effectively as a knowledge network. Precisely what this looks like will naturally be worked out over time, but it may involve highlighting and paying closer attention to those questions to which trade policy experts traditionally do not address themselves, and providing an impetus for the production of knowledge on those questions, as well as a space in which such knowledge will be received. It may involve providing social and institutional mechanisms for the distribution and exchange of such information, helping to transform it from mere information into the kind of processed—and, crucially, shared—social knowledge about the trading system which informs policy-making on an ongoing basis. It may also involve more explicit and directed mechanisms for bringing such knowledge to the attention of relevant policy-makers. In other words, the human rights movement should recognise that it is not only in the game of norm production, but also that of knowledge production, and concentrate

further efforts on making its interventions into such realms still more effective and productive.

#### IV. CONCLUSION

I began this chapter by suggesting that the time had come for a critical appraisal of the shape and direction of the trade and human rights literature as it has emerged from its first decade. It will be clear that the purpose of this exercise is intended to be constructive. While there is no doubt that engagement between trade and human rights scholars is to be desired, and similarly no doubt that the trade and human rights literature has to date produced some important and highly productive work, there are in my view still some significant gaps and flaws in the assumptions and modes of argumentation characteristic of the contemporary debate. The comments I make in this chapter are intended to help put that literature on a surer conceptual footing going forward, so as to facilitate a more sustained, direct and productive engagement between trade and human rights institutions, languages, scholars and communities.

*Binding the Hand that Feeds Them:  
The Agreement on Agriculture,  
Transnational Corporations  
and the Right to Adequate Food in  
Developing Countries*

PENELOPE SIMONS\*

I. INTRODUCTION

In the 1920s, when the ‘market juggernaut’ was rolling at full steam, John Maynard Keynes called for a ‘new wisdom for a new age’ with ‘new policies and new instruments to adapt and control the workings of economic forces, so that they do not intolerably interfere with contemporary ideas as to what is fit and proper in the interests of social stability and social justice’.<sup>1</sup>

**K**EYNES’ CALL TO ‘adapt and control the working of economic forces’ is echoed in the current global concern over the human rights impacts of the World Trade Organisation (WTO) regime. One of the key social justice and human rights issues we face today is the problem of global hunger—a lack of access to adequate food by a large proportion of the world’s population. For many developing, and in particular low-income states, the development of the agriculture sector is crucial to reducing the numbers and prevalence of malnourished people. A fair and balanced agricultural trade regime that eliminates trade distorting subsidies and protectionist market access

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<sup>1</sup> UNCTAD, *Trade and Development Report, 2003: Capital Accumulation, Growth and Structural Change*, Doc UNCTAD/TDR/2003 at I.

policies, and allows states at the early stages of economic development sufficient policy space to protect their agriculture sector, can have an important role to play in the reduction of poverty levels and in addressing food security. On the other hand,

Opening national agricultural markets to international competition—especially from subsidized competitors—before basic market institutions and infrastructure are in place can undermine the agriculture sector, with long-term negative consequences for poverty and food security.<sup>2</sup>

This chapter seeks to clarify the impact of the WTO agricultural trade regime and the related unregulated activities of transnational corporate actors on food security in developing states. It investigates the link between the structure of the WTO Agreement on Agriculture, corporate concentration in agricultural markets and food insecurity in developing countries. It does this through an analysis of the right to adequate food, the key tenets of the current agricultural trade regime and related state practice and corporate activities. It concludes by considering proposals for reform in the current Doha Round of WTO negotiations, and the implications for the sovereignty of developing countries, in terms of national policy space to protect and develop their agriculture sector and the right to food.

## II. STATE OBLIGATIONS TO PROTECT THE RIGHT TO ADEQUATE FOOD AND FOOD SECURITY

There are an estimated 854 million undernourished<sup>3</sup> people in the world, 820 million of whom live in developing states.<sup>4</sup> The Food and Agriculture Organisation of the United Nations (FAO) notes that, ten years after the Rome Declaration of the World Food Summit, in which governments pledged to halve the number of malnourished people from 1990 levels by 2015, '[v]irtually no progress has been made towards [this] target'.<sup>5</sup> The highest prevalence of undernourishment exists in some of the least developed states, many of which fall into the category of least-developed countries (LDCs) under the WTO agreements and most of which are low-income states. In sub-Saharan Africa, for example, one in every three people does not have access to sufficient food.<sup>6</sup> FAO estimates that by 2015 'sub-Saharan Africa will be home to around 30 per cent of the

<sup>2</sup> Food and Agriculture Organisation of the United Nations (FAO), *State of Food and Agriculture 2005: Agricultural Trade and Poverty—Can Trade Work for the Poor?* (Rome, FAO, 2005) at 6 (hereinafter, FAO, *State of Food and Agriculture 2005*).

<sup>3</sup> 'Undernourishment or malnourishment', is a measure of dietary intake related to energy needs and is one of the key indicators of food insecurity and vulnerability: see FAO, *Focus on Food Insecurity and Vulnerability: A review of the UN System Common Country Assessments and World Bank Poverty Reduction Strategy Papers* (FAO, Rome, 2003) at 56.

<sup>4</sup> FAO, *The State of Food Insecurity in the World 2006: Eradicating World Hunger—Taking Stock Ten Years After the World Food Summit* (FAO, Rome, 2006) at 8 (hereinafter FAO, *SOFI 2006*).

<sup>5</sup> *Ibid.*, at 8.

<sup>6</sup> *Ibid.*, at 5.

undernourished people in the developing world, compared with 20 per cent in 1990–92.<sup>7</sup>

It is widely recognised that one of the main causes of malnourishment is the lack of access to adequate food caused by poverty, and not the global food supply.<sup>8</sup> Moreover, according to the FAO, ‘hunger is not only a consequence but also a cause of poverty, and . . . it compromises the productive potential of individuals, families and entire nations’.<sup>9</sup>

## 1. The Right to Adequate Food

The right to adequate food is a fundamental human right that is essential for the enjoyment of all other human rights.<sup>10</sup> It is recognised in the International Covenant on Economic and Social Rights 1966 (ICESCR), among other international instruments,<sup>11</sup> as a component of the right to an adequate standard of living. Article 11(2) of the ICESCR imposes binding legal obligations on states parties to take action to address the global problem of hunger:

The States Parties to the present Covenant, recognizing the fundamental right of everyone to be free from hunger, shall take, individually and through international co-operation, the measures, including specific programmes, which are needed:

- (a) To improve methods of production, conservation and distribution of food . . .
- (b) Taking into account the problems of both food-importing and food-exporting countries, to ensure an equitable distribution of world food supplies in relation to need.<sup>12</sup>

This right has been interpreted by the Committee on Economic, Social and Cultural Rights (CESCR) in its General Comment No 12, which notes that the

<sup>7</sup> *Ibid.*

<sup>8</sup> According to the Committee on Economic, Social and Cultural Rights, ‘the roots of the problem of hunger and malnutrition are not lack of food but lack of *access to* available food, *inter alia* because of poverty, by large segments of the world’s population’. CESCR, ‘Substantive Issues Arising in the Implementation of the International Covenant on Economic, Social and Cultural Rights: General Comment No 12’ in ‘Note by the Secretariat, Compilation of General Comments and General Recommendations Adopted by Human Rights Treaty Bodies’ (12 May 2004) UN Doc HRI/GEN/1/Rev.7 at [5]. See also UNGA, ‘The Right to Food: Report of the Special Rapporteur on the Right to Food’, (28 Aug 2003) UN Doc A/58/330, at [29]; and FAO, *SOFI 2006* n 4, at 4 where it states: ‘The knowledge and resources to reduce hunger are there. What is lacking is sufficient political will to mobilize those resources to the benefit of the hungry’.

<sup>9</sup> FAO, *SOFI 2006*, n 4 above at 13.

<sup>10</sup> CESCR, ‘General Comment No 12’, n 8 above, at [4].

<sup>11</sup> The right to adequate food is recognised in the Universal Declaration of Human Rights (adopted 10 Dec 1948) UNGA Res 217 A(111) (UDHR) Art 25. It is also protected under the Convention on the Rights of the Child (adopted 20 Nov 1989, entered into force 2 Sept 1990) 1577 UNTS 3 (CRC); Article 27 of the CRC recognises the ‘right of every child to a standard of living adequate for the child’s physical, mental, spiritual, moral and social development’. Article 27(3) imposes an obligation on states to assist parents, within their means, in providing for children’s needs, ‘particularly with regard to nutrition, clothing and housing’.

<sup>12</sup> International Covenant on Economic, Social and Cultural Rights (adopted 16 Dec 1966, entered into force 3 Jan 1976) 993 UNTS 3 (ICESCR) Art 11(2).



right to adequate food must be interpreted broadly and is realised when each individual ‘alone or in community with others, [has] physical and economic access at all times to adequate food or means for its procurement’.<sup>13</sup>

Article 2 of the ICESCR imposes an obligation on states parties ‘to take steps, individually and through international assistance and co-operation’, ‘to the maximum of [their] available resources’ and ‘by all appropriate means’ towards the progressive realisation of the rights protected under the Covenant. These steps must be ‘deliberate, concrete and targeted’ and states have an immediate ‘minimum core obligation to ensure the satisfaction of, at the very least, minimum essential levels of each of the rights’.<sup>14</sup> Thus although the right to food will be fully realised over time, states must ‘take the necessary action to mitigate and alleviate hunger’ and work expeditiously towards this goal.<sup>15</sup>

Article 11 imposes a three-part obligation, to respect, protect and fulfil the right to adequate food. States are prohibited from taking action that prevents the access to adequate food of persons within their territorial jurisdiction. States are further obliged ‘to ensure that enterprises or individuals do not deprive individuals [such] access’.<sup>16</sup> Finally, states are required both to take positive action ‘to strengthen people’s access to and utilization of resources and means to ensure their livelihood, including food security’, and to fulfil the right to adequate food in instances where individuals or groups ‘for reasons beyond their control’ do not have access to adequate food.<sup>17</sup>

While states are ultimately accountable under the ICESCR, the responsibility for the realisation of the right to adequate food also falls on all members of society including business entities. ‘The private business sector—national and transnational—should pursue its activities within the framework of a code of conduct conducive to respect of the right to adequate food’.<sup>18</sup> States are required to take action in the protection of the resource base for food, ‘to ensure that activities of the private business sector and civil society are in conformity’ with this right.<sup>19</sup> The CESCR notes that violations of the right to adequate food include the:

. . . adoption of legislation or policies which are manifestly incompatible with pre-existing legal obligations relating to the right to food; and failure to regulate activities of individuals or groups so as to prevent them from violating the right to food of others, or the failure of a State to take into account its international legal obligations regarding the right to food when entering into agreements with other States or with international organizations.<sup>20</sup>

<sup>13</sup> CESCR, ‘General Comment No 12’, n 8 above, at [6].

<sup>14</sup> CESCR, ‘General Comment No 3’ in ‘Note by the Secretariat, Compilation of General Comments and General Recommendations Adopted by Human Rights Treaty Bodies’ n 8 above, at [2] and [10].

<sup>15</sup> CESCR, ‘General Comment No 12, n 8 above, at [6] and [14].

<sup>16</sup> *Ibid.*, at [15].

<sup>17</sup> *Ibid.*

<sup>18</sup> *Ibid.*, at [20].

<sup>19</sup> *Ibid.*, at [27].

<sup>20</sup> *Ibid.*, at [19].

All states parties to the ICESCR have extraterritorial obligations in relation to the rights protected in the Covenant.<sup>21</sup> The right to adequate food imposes obligations of an extraterritorial nature on states to take action to respect, protect and fulfil the right to adequate food in other countries. This includes an obligation to 'ensure that the right to adequate food is given due attention' in international agreements where it is pertinent and to 'consider the development of further international legal instruments to that end'.<sup>22</sup>

This responsibility was underlined in the Rome Declaration of the World Food Summit in which participant governments agreed to 'strive to ensure that food, agricultural trade and overall trade policies are conducive to fostering food security for all through a fair and market-oriented world trade system'.<sup>23</sup> Among other things the World Food Summit Plan of Action calls on exporting countries to 'reduce subsidies on food exports in conformity with the Uruguay Round Agreement in the context of the ongoing process of reform in agriculture conducted in the WTO'.<sup>24</sup> It requests that exporting states: '[a]dminister all export-related trade policies and programmes responsibly, with a view to avoiding disruptions in world food and agriculture import and export markets, in order to improve the environment to enhance supplies, production and food security, especially in developing countries'.<sup>25</sup> Finally, states commit to '[s]upport the continuation of the reform process in conformity with the Uruguay Round Agreement and ensure that developing countries are well informed and equal partners in the process, working for effective solutions that improve their access to markets and are conducive to the achievement of sustainable food security'.<sup>26</sup>

States parties to the ICESCR also have extraterritorial obligations in some circumstances to regulate the activities of corporate nationals.<sup>27</sup> According to the Special Rapporteur on the Right to Food, the obligation to take action to respect, ensure respect for, and fulfil the right to food in other countries includes a responsibility to regulate and monitor the extraterritorial activities of corporate nationals that may violate or contribute to the violation of the right to adequate food. The Special Rapporteur notes that:

<sup>21</sup> Unlike Art 2 of the International Covenant on Civil and Political Rights (adopted 16 Dec 1966, entered into force 23 Mar 1976) 999 UNTS 171 (ICCPR), Article 2 of the ICESCR does not expressly limit the reach of state obligations. Under Art 2(1), states parties undertake 'to take steps, individually and through international assistance and co-operation . . . with a view to achieving progressively the full realization of the rights recognized in the present Covenant by all appropriate means . . . .'

<sup>22</sup> CESCR, 'General Comment No 12 n 8 above, at [36].

<sup>23</sup> World Food Summit, *Rome Declaration on World Food Security and World Food Summit Plan of Action*, (13–17 Nov 1996) <<http://www.fao.org/docrep/003/w3613e/w3613e00.htm>> (last visited Jun 10, 2007).

<sup>24</sup> *Ibid.*, at [40(c)].

<sup>25</sup> *Ibid.*, at [40(d)].

<sup>26</sup> *Ibid.*, at [41(b)].

<sup>27</sup> R McCorquodale and P Simons, 'Responsibility Beyond Borders: State Responsibility for Extraterritorial Violations by Corporations of International Human Rights Law' (2007) 70 MLR 599 at 619.

. . . it is becoming increasingly clear that monopoly control of the food system by transnational corporations can be directed towards seeking monopoly profits, benefiting the companies more than the consumer. The actions of transnational corporations can sometimes directly violate human rights standards, including the right to food.<sup>28</sup>

Therefore, home states of these corporations should establish regulatory and monitoring mechanisms, as well as effective remedies for violations of this right. One hundred and thirty-two of the one hundred and fifty WTO member states have ratified the ICESCR and therefore have obligations to respect, protect and fulfil the right to adequate food both within their own territory and in other states. This includes obligations to take the right to adequate food into account in international treaties where relevant and to take steps to ensure that the activities of corporate nationals do not violate this right in other states. It has also been argued that the right to adequate food is now part of customary international law and, therefore, that *all* states have obligations to respect, protect and fulfil this right.<sup>29</sup>

### III. THE TRADE IN AGRICULTURE AND FOOD SECURITY

#### 1. Agricultural Development and Food Security

Food security represents the realisation of the right to adequate food.<sup>30</sup> As noted above, poverty rather than world food supply is one of the primary causes of undernourishment or food insecurity. For a large number of developing states, development of their agricultural economy is essential for tackling food insecurity. As FAO notes:

Some 70 per cent of the poor in developing countries live in rural areas and depend on agriculture for their livelihoods, either directly or indirectly. In the poorest of countries, agricultural growth is the driving force of the rural economy. Particularly, in the most food-insecure countries, agriculture is crucial for income and employment generation.<sup>31</sup>

<sup>28</sup> UNGA 'Report of the Special Rapporteur on the Right to Food' n 8 above, at [31].

<sup>29</sup> See UNGA, 'Interim Report of the Special Rapporteur on the Right to Food' (12 Sept 2005) UN Doc A/60/350 [48]; but see also S Narula, 'The Right to Food: Holding Global Actors Accountable under International Law' (2006) 44 *Colum J Transnat'l L* 691 at 795–796, who distinguishes between the right to be free from hunger as a right under customary international law and the right to adequate food, for which 'additional steps must be taken to elevate the broader right to adequate food to this status'. The US, however, has constantly objected to the development of this right and therefore would not be bound by the rule of customary international law (see *ibid*).

<sup>30</sup> See CESCR, 'General Comment No 12', n 8 above at [6]ff. Cf the FAO definition of food security in World Food Summit, n 23 above at [1]: 'Food security exists when all people, at all times, have physical and economic access to sufficient, safe and nutritious food to meet their dietary needs and food preferences for an active and healthy life'.

<sup>31</sup> FAO, *SOFI 2006*, n 4 above, at 28. See also H Thomas and J Morrison, 'Trade Related Reforms and Food Security: A Synthesis of Case Study Findings' in H Thomas (ed), *Trade Reforms and Food Security: Country Case Studies and Synthesis* (Rome, FAO, 2006) at 56 and 64; and

Trade in agriculture can play an important role in the reduction of poverty levels and in addressing food security. However, FAO cautions that the 'gains from trade liberalization are neither automatic nor universal'.<sup>32</sup> Developing states, particularly those in the early stages of economic development and which have the highest incidence of hunger, such as sub-Saharan African states, need to retain the flexibility to implement policies to ensure they can pursue development of their agriculture sector in order to address food security issues and other development goals. The extent to which the current WTO regime for agricultural trade supports and facilitates these ends, and thus the fulfilment of state obligations with respect to the right to adequate food, will be examined below.

## 2. The WTO Agreement on Agriculture (AoA)

The AoA<sup>33</sup> creates binding legal obligations for WTO member states in relation to three areas of government intervention in agricultural markets, aimed at increasing market access and reducing domestic support and export subsidies for agricultural products. The commitments were to be implemented over a given period (which was longer for developing countries) beginning in 1995.

### *a) Market Access*

Articles 4 and 5 and Annex 5 set out the provisions relating to market access. Under these provisions all member states were required to convert all non-tariff barriers<sup>34</sup> to tariffs and to bind them according to the rates set in the base period between 1986 and 1988.<sup>35</sup> The reduction commitments are set out in the schedules of each member as specified in Article 4(1). Developed countries were required to reduce these tariffs by 36 per cent over 6 years, with a minimum reduction of 15 per cent per tariff. Developing countries were required to reduce their tariffs by 24 per cent over 10 years, with a minimum reduction per tariff of 10 per cent. LDCs were required to convert non-tariff barriers to tariffs and to bind the tariffs, but were exempted under Article 15(2) from reduction commitments.<sup>36</sup>

M Stockbridge, 'Agricultural Trade Policy in Developing Countries During Take-Off', Oxfam Research Report, Jul 2006, at 7 and 10.

<sup>32</sup> FAO, *SOFI 2006*, n 4 above, at 29.

<sup>33</sup> Agreement on Agriculture (15 Apr 1994) LT/UR/A-1A/2 <<http://docsonline.wto.org>> (last visited Jun 6, 2007).

<sup>34</sup> These are defined in Article 4(2) n 1 to include 'quantitative import restrictions, variable import levies, minimum import prices, discretionary import licensing, non-tariff measures maintained through state-trading enterprises, voluntary export restraints, and similar border measures other than ordinary customs duties, whether or not the measures are maintained under country-specific derogations from the provisions of GATT 1947'. They do not include 'measures maintained under balance-of-payments provisions or under other general, non-agriculture-specific provisions of GATT 1994 or of the other Multilateral Trade Agreements in Annex 1A of the WTO Agreement'.

<sup>35</sup> AoA, Attachment to Annex 5.

<sup>36</sup> S Murphy, *Trade and Food Security: An Assessment of the Uruguay Round Agreement on Agriculture* (London, Catholic Institute for International Relations, 1999) at 12.

In addition, a time-bound Tariff Rate Quota (TRQ) system was established to ensure minimum access of imports at a reduced tariff level from the high rates set during the tariffication process. Developed states were required to allow access of products 'equal to 3 per cent of domestic consumption [and] rising to 5 per cent' over 6 years and developing states were required to allow access equal to 1 per cent of domestic consumption, rising to 4 per cent over 10 years.<sup>37</sup>

Article 5 created a special safeguard mechanism (SSG) which allows parties that have applied tariffication to a product (conversion of non-tariff barriers) and marked it in their schedules as an SSG product, to apply an increase in duty to protect domestic production from surges in import volumes or a sudden fall in world prices.<sup>38</sup> The SSG can be triggered either when a predetermined price or volume of goods in relation to specified commodities is reached.<sup>39</sup>

### *b) Domestic Support*

Articles 3, 6 and 7, and Annexes 2, 3 and 4 deal with domestic support (farm subsidies). Under Article 3(1) and (2), members agreed not to provide domestic support above the levels set out in their respective schedules. Different types of domestic subsidies were accorded different treatment under the AoA and were classified in various 'boxes'.

'Amber box' subsidies were subject to reduction. Article 7(2) requires that all domestic subsidies that do not satisfy the criteria in Annex 2 or other exemption provisions be included in the calculation of members' Current Total Aggregate Measurement of Support (AMS). Article 6(1) provides for the reduction of domestic subsidies based on the total AMS, which is defined as the 'sum of all domestic support provided in favour of agricultural producers'<sup>40</sup> during the 1986–1988 base period.<sup>41</sup> Developed countries were required to reduce their total AMS by 20 per cent over 6 years and developing countries by 13.3 per cent over 10 years.<sup>42</sup> LDCs were again exempt from reduction commitments under Article 15(2).

Article 6(5), the 'blue box', allowed member states to exclude from the calculation of the current total AMS, the value of direct payment made under government production-limiting support programmes, where such payments

<sup>37</sup> *Ibid*, at 13.

<sup>38</sup> AoA, Article 5(1). See also CG Gonzalez, 'Institutionalizing Inequality: The WTO Agreement on Agriculture, Food Security, and Developing Countries' (2002) 27 Colum J Envtl L 433 at 454; and S Murphy, *CAFOD Policy Brief: Food Security and the WTO* (Sept 2001) at 12 <<http://www.ukfgo.org.uk/docs/CAFOD%20Trade%20Food%20security%20and%20the%20WTO.htm>> (last visited Jun 10, 2007).

<sup>39</sup> AoA, Article 5(1)(a) and (b).

<sup>40</sup> AoA, Article 1(h).

<sup>41</sup> AoA, Annex 3, [11].

<sup>42</sup> In the final year of the respective implementation periods, the Current Total AMS for developed countries will be the Total Base AMS minus 20 per cent, and, for developing countries, the Total Base AMS minus 13.3 per cent: see K Jackson, *Sectoral Uruguay Round Agreement: The Agricultural Sector* (26 Jul 1995) UN Doc UNCTAD.TD/B/WG8/2/Add.1, at 21.

satisfied one of three listed conditions.<sup>43</sup> Annex 2, the ‘green box’, allowed for listed support programmes that were designated as non-trade-distorting subsidies to be excluded from calculations of the current total AMS.<sup>44</sup> These included, among other things, certain government services, public stockholding for food security, food aid programmes, decoupled income support, income safety nets and disaster relief programmes.

Article 6(2), the ‘Special and Differential Treatment box (SDT)’, exempted developing countries from reduction requirements for investment subsidies for agriculture, input subsidies for low-income or resource-poor producers and subsidies ‘to encourage diversification from growing illicit narcotic crops’.<sup>45</sup> Article 6(4), also referred to as the *de minimis* exception, allowed developed countries to exclude from the calculation of their current total AMS both product-specific and non-product-specific subsidies that did not exceed five per cent of a state’s annual production. Developing countries could exclude such subsidies that did not exceed 10 per cent of annual production value.<sup>46</sup>

### *c) Export Subsidies*

The final area of government intervention that the AoA seeks to regulate is the subsidisation of exports. Article 1(e) defines ‘export subsidies’ as ‘subsidies contingent upon export performance’.<sup>47</sup> Article 3 makes export subsidy reduction commitments set out in members’ schedules binding under the AoA.<sup>48</sup> Under Article 8, members undertook not to subsidise exports except in conformity with the AoA and scheduled commitments.<sup>49</sup> Developed countries were required to reduce (but not eliminate) the value of export subsidies by 36 per cent and to reduce the quantity of subsidised exports by 21 per cent within six years. Developing countries were required to reduce the value of such subsidies by 24 per cent and the volume by 14 per cent over ten years.<sup>50</sup> As with tariff rates and domestic subsidies, LDCs were exempted from reductions under Article 15(2). All export subsidies that were not listed in country schedules are now prohibited and, except in a few cases, new subsidies, even for LDCs, may not be introduced.<sup>51</sup>

<sup>43</sup> Payments must be either based on fixed area yield, or made on a maximum of 85 per cent of the base level of production, or be payments for a fixed number of livestock head (Article 6(5)(a)(i–iii). Gonzalez (n 38 above, at 457) notes that this exemption includes certain US and EU subsidy programmes such as ‘U.S. deficiency payments and E.U. compensation payments, both of which pay farmers the difference between a government target price . . . and the corresponding market price’.

<sup>44</sup> AoA, Annex 2.

<sup>45</sup> AoA, Article 6(2).

<sup>46</sup> AoA, Article 6(4).

<sup>47</sup> AoA, Article 1(e).

<sup>48</sup> AoA, Article 3.

<sup>49</sup> AoA, Article 8.

<sup>50</sup> C Stevens, R Greenhill, J Kennan and S Devereux, *The WTO Agreement on Agriculture and Food Security, Economic Paper 42* (London, Commonwealth Secretariat, 2000) 38.

<sup>51</sup> See Murphy, n 36 above, at 14 who notes that: ‘However, certain subsidies related to marketing costs and internal and international transport charges for export producers are allowed for developing countries’.

Article 9(1) enumerates the type of export subsidies subject to reduction. These include, among other things, direct subsidies conditioned on export performance, below-cost sale of non-commercial agriculture stocks, subsidies for the reduction of export market costs and internal transport charges.

There are no specific reduction commitments for ‘export credits, export credit guarantees or insurance programmes’.<sup>52</sup> However, Article 10(2) requires members to work toward agreement on disciplines for these latter types of subsidies, and Article 10(1) prohibits the circumvention of the reduction commitments through recourse to non-listed export subsidies or through non-commercial transactions. These provisions have been interpreted as prohibiting export credit, export credit guarantees and insurance programmes where such programmes by their terms constitute export subsidies.<sup>53</sup> In addition, Article 10(4) prohibits members from tying food aid to commercial exports either directly or indirectly. It also requires, *inter alia*, that the provision of food aid be ‘carried out in accordance with the FAO “Principles of Surplus Disposal and Consultative Obligations”’.<sup>54</sup>

### 3. The Structural Inequality of the AoA

As some commentators predicted, the market access provisions have not effectively enhanced market access for agricultural products.<sup>55</sup> In the first place, states were allowed ‘considerable latitude in setting the level of these tariffs’.<sup>56</sup> Since reduction requirements referred to an average maximum reduction (subject to a minimum reduction per tariff), OECD states made strategic reductions and tended to reduce tariffs on products not produced domestically.<sup>57</sup> Some developed countries engaged in ‘dirty tariffication’, setting tariffs so high that they

nullified the benefits of tariff bindings and tariff reduction by creating tariff equivalents, to which subsequent reductions apply, that were at times more import-restrictive than the non-tariff barriers they replaced.<sup>58</sup>

In other words, where this took place, not only was market access not increased it was actually restricted.

<sup>52</sup> Jackson, n 42 above, at 26. See also Murphy, *ibid*.

<sup>53</sup> In *US–Subsidies on Upland Cotton*, it was held that export credits and export credit guarantees and insurance programmes could in certain circumstances constitute export subsidies and would contravene Article 10(1) where such programmes were used in a way so as to circumvent export subsidy commitments: see WTO, *US: Subsidies on Upland Cotton—Report of the Panel* (8 Sept 2004) WT/DS267/R [7.935]ff and WTO, *US: Subsidies on Upland Cotton—Report of the Appellate Body* (3 Mar 2005) WT/DS267/AB/R [623]–[626].

<sup>54</sup> AoA, Art 10(4). See Gonzalez, n 38 above, at 456.

<sup>55</sup> Stevens *et al*, n 50 above, at 38.

<sup>56</sup> *Ibid*.

<sup>57</sup> Gonzalez, n 38 above, at 461. See also FAO, *The State of Food and Agriculture 2005* n 2 above, at 40–41.

<sup>58</sup> Gonzalez *Ibid*, at 460.

In addition, the highest tariffs were imposed on the commodities most important to developing country exporters.<sup>59</sup> For example, UNCTAD reported that Canada set initial tariffs on certain dairy products at between 230 and 360 per cent. The EU set initial tariffs on beef at 213 per cent and on wheat at 167.7 per cent, while Japan set tariffs on wheat at 352.7 per cent, and the US set tariffs on sugar at 244.4 per cent.<sup>60</sup> According to the FAO, 38 WTO member states (few of whom were developing countries) 'established TRQ commitments for a total of 1379 quotas and claimed SSG privileges on 6072 individual tariffed items'. The combination of TRQs and SSG privileges has allowed these states greater flexibility in protecting sensitive products.<sup>61</sup>

Many developing countries had already liberalised their agricultural markets under the structural adjustment programmes (SAPs). Since most of these states opted to set tariff ceilings rather than using tariffication to convert non-tariff barriers,<sup>62</sup> only a small number of them (22) have access to the SSG.<sup>63</sup> This is in contrast to OECD countries, in which access to the SSG provisions is notified for almost 80 per cent of tariffed items.<sup>64</sup> It has also been alleged that the EU 'manipulated' the calculation of its trigger prices for safeguard protection under the AoA, allowing them more frequent access to the mechanism.<sup>65</sup> A 1999 FAO study found that a number of the developing countries surveyed reported difficulties for domestic producers in competing with cheaper imports. The FAO

<sup>59</sup> *Ibid.*

<sup>60</sup> Jackson, n 42 above, at 14. The FAO 2002 Synthesis of Case Studies notes that although there was a general growth in exports in the countries studied, 'few case studies were able to make a link to improved market access under the AoA'. Indeed, market access improvement tended 'to occur under regional trade agreements or as a result of preferential schemes . . . rather than resulting from the Uruguay Round'. A number of countries reported market access difficulties in particular in relation to 'dairy products, fruits and vegetables and their preparations, meat and processed foods'. However, Indonesia reported improved market access for its agricultural exports in the US, Japan and EU. See FAO, 'Developing Country Experience with the Implementation of the Uruguay Round Agreement on Agriculture: Synthesis of the Findings of 23 Country Case Studies' (Oct 2002), Paper No 3, FAO Geneva Symposium on The Experience with Implementing the WTO Agreement on Agriculture, and Special and Differential Treatment to Enable Developing Countries to Effectively Take Account of Their Development Needs, Including Food Security and Rural Development, at [62]–[63], [65] (hereinafter FAO, *Developing Country Experience*).

<sup>61</sup> See FAO, *State of Food and Agriculture 2005* n 2 above, at 40.

<sup>62</sup> Developing countries had the option in the conversion of non tariff barriers of whether to use the tariffication process or to set tariff ceilings and many chose the latter and set a single bound tariff rate for all agricultural products: see FAO, *State of Food and Agriculture 2005* *ibid.*, at 39–40.

<sup>63</sup> FAO, *Issues at Stake Relating to Agricultural Development, Trade and Food Security* (23–24 Sept 1999) Paper No 4, FAO Symposium on Agriculture, Trade and Food Security: Issues and Options in the Forthcoming WTO Negotiations from the Perspective of Developing Countries, at [34], n 22 (hereinafter FAO, *Issues at Stake*). See also Murphy, n 38 above, at 12, who states there are only 21 developing countries with access to the SSG; and C Dommen, 'Raising Human Rights Concerns in the World Trade Organisation: Actors, Processes and Possible Strategies' (2002) 24 HRQ 1 at 36.

<sup>64</sup> FAO, *ibid.*, at [34].

<sup>65</sup> A Kwa for Southeast Asian Food and Fair Trade Council, *Towards Food Security: A Position Paper for Developing Countries in the Review of the WTO Agreement on Agriculture* (1999) 2 <<http://www.focusweb.org/publications/1999/Towards%20Food%20Security.htm>> (last visited Jun 10, 2007). See also Gonzalez, n 38 above, at 463.



states that in many cases this problem related to ‘the very commodities that are vital for the economy of these countries—in terms of food supply, employment, economic growth and poverty reduction’.<sup>66</sup>

Developing countries now have lower tariffs for agricultural products than developed states<sup>67</sup> and those without access to the SSG for key agricultural products are exposed to highly subsidised products entering their markets at prices that undercut local producers. Thus, for example, the FAO reported that import surges have had a negative impact on Jamaican domestic production of poultry, beef, dairy products and rice.<sup>68</sup>

Developing countries have also encountered market access difficulties arising from the application of the Agreement on the Application of Sanitary and Phytosanitary Measures (SPS). The 1999 FAO report noted that ‘trade harassment’ with respect to the application of SPS standards ‘was considered a common problem’ where some large importing countries required “sameness” in the process rather than “equivalence”’.<sup>69</sup> Some of these concerns were reiterated in the 2002 FAO report.<sup>70</sup> Murphy notes that the imposition of these standards under the agreement ‘continues to pose problems for developing country exporters, as such rules can often change unexpectedly and devastate the exporting industry in the process’.<sup>71</sup>

In terms of farm subsidies, the ‘amber box’ reduction requirements (AMS) made little difference since developed-country domestic subsidies were already lower than those in the base period against which reductions were measured.<sup>72</sup> Many developed countries found ways around the reduction provisions to the effect that farm support programmes in developed countries were not included under the AMS quantifications<sup>73</sup> or were ‘recharacterised’ and included under ‘green box’ exemptions.<sup>74</sup> Developed country subsidies to agriculture actually

<sup>66</sup> FAO, *Synthesis of Country Case Studies*, Paper No 3 (23–24 Sept 1999), FAO Symposium on Agriculture, Trade and Food Security: Issues and Options in the Forthcoming WTO Negotiations from the Perspective of Developing Countries, at [19] (hereinafter FAO, *Synthesis of Country Case Studies*). SSG rights are more common for ‘meat, cereals, fruit and vegetables, oilseeds and oil products and dairy products’: see FAO, *Issues at Stake*, n 63 above, at [34].

<sup>67</sup> J Morrison and A Sarris, ‘Determining the Appropriate Level of Import Protection Consistent with Agriculture Led Development in the Advancement of Poverty Reduction and Improved Food Security’ in J Morrison and A Sarris (eds), *WTO Rules for Agriculture Compatible with Development* (Rome, FAO, 2007), 21.

<sup>68</sup> FAO, *Developing Country Experience*, n 60, at [33].

<sup>69</sup> FAO, *Synthesis of Country Case Studies*, n 66, at [13].

<sup>70</sup> FAO, *Developing Country Experience*, n 60, at [69]–[71].

<sup>71</sup> Murphy, n 36 above, at 15.

<sup>72</sup> Gonzalez, n 38 above, at 467–8.

<sup>73</sup> Murphy n 36 above, at 16. Gonzalez (*ibid*, at 466–7) argues that since ‘blue box’ compatible subsidies (such as US deficiency payments) were not required to be included in the Current Total AMS but were included in the calculation of Total AMS, the US, among others, was not required to reduce a large portion of its subsidies.

<sup>74</sup> Gonzalez notes (*ibid*, at 467) that the US 1996 Farm Bill ‘replaced deficiency payments with direct income payments to farmers decoupled from agricultural prices or current production’, and were claimed to be ‘fully compatible with the ‘green box’ exemptions’. See also Murphy, n 36 above, at 16; FAO, *State of Food and Agriculture 2005* n 2 above, at 31; and W Phillips, *Why Children Stay*

rose significantly during the 1995–2004 period.<sup>75</sup> Moreover, some of these highly subsidised products are of critical importance to developing country farmers, and the subsidies, which allow the products to be sold below production costs on the global market, have negated the latter's comparative advantage.<sup>76</sup>

Many developing countries claimed zero or below *de minimis* levels of total AMS (total domestic support for producers) and are now prevented from employing these forms of direct subsidy above *de minimis* levels allowed, or will have to rely on the limited Article 6(2) Special and Differential Treatment (SDT) exemptions.<sup>77</sup> The reality is, however, that many developing countries and LDCs do not have the financial resources, whether due to general budgetary constraints or the requirements of SAPs,<sup>78</sup> to invest in domestic agricultural support programmes even up to the permitted *de minimis* levels.<sup>79</sup> The FAO stated in its 2002 report that AMS for the sample countries was 'well below committed or permitted levels'. Moreover, in a number of countries studied, both AMS and 'green box' subsidies had declined because of lack of resources or policy changes.<sup>80</sup> In addition, because developing states were excluded from key negotiations on the 'green box' during the Uruguay Round, many of their subsidy programmes, where they existed, were not even included in the green box criteria and are therefore not exempt from reduction commitments.<sup>81</sup>

*Hungry: Agricultural Trade, Food Security and the WTO* (Nov 2001) 15 <<http://www.global-poverty.org>> (last visited, Jun 10, 2007) who argues that certain countries, including Canada, 'reworked some elements of their domestic support structures so they fit into the Green Box provisions'. However, certain cotton subsidies characterised by the US as green box subsidies have now been declared illegal by the Dispute Settlement Body: see WTO, *US: Subsidies on Upland Cotton* n 53 above.

<sup>75</sup> See Dommen, n 63 above, at 36 where she notes that subsidies of OECD states 'increased from US \$182 billion in 1995 to over \$300 billion in 1998'. See also FAO, *The State of Food Insecurity in the World 2005: Eradicating World Hunger—Key to Achieving the Millennium Development Goals* (Rome, FAO, 2005) n 4 at 27 which shows an increase in OECD state subsidies between 2002 and 2004 from US\$226 billion to US\$280 billion.

<sup>76</sup> See, for example, 'Kicking the Habit', editorial, *The Guardian Weekly*, 21–27 Aug 2003, at 14: US subsidies to its cotton farmers are equal to the total market output, creating unfair competition for cotton from West Africa that can be produced for two-thirds of US production costs. US subsidies undercut the world price for cotton by 40 per cent. This also means that developing countries earn less to pay for expensive food imports. See also WTO, *US: Subsidies on Upland Cotton—Report of the Panel*, n 53 above; and FAO, *The State of Food Insecurity in the World 2003: Monitoring Progress Towards the World Food Summit and Millennium Development Goals* (Rome, FAO, 2003), at 21 (hereinafter FAO, *SOFI 2003*), where it notes that in 2002, the EU provided US\$2.3 billion in subsidies for domestic sugar production where 'production costs are more than double those in many developing countries'.

<sup>77</sup> See Jackson, n 42 above, at 25. See also Dommen, n 63 above, at 35; and Phillips, n 74 above, at 15. The FAO states that of a selection of 100 developing countries, only 12 reported a base Total AMS above *de minimis* levels, 8 claimed positive base Total AMS but below *de minimis* levels and 80 claimed zero or negative base Total AMS. See FAO, *Issues at Stake*, n 63, at [14] and Table 2.

<sup>78</sup> For more on the relationship between SAPs and agricultural trade, see J Madeley, *Trade and Hunger: An Overview of Case Studies on the Impact of Trade Liberalization on Food Security* (Stockholm: Forum Syd, 2000) at 7.

<sup>79</sup> Murphy, n 36 above, at 16; FAO, *State of Food and Agriculture 2005* n 2 above, at 32.

<sup>80</sup> FAO, *Developing Country Experience*, n 60, at [40].

<sup>81</sup> Phillips, n 74 above, at 15.

As with the market access and domestic subsidy provisions, the articles requiring the reduction of export subsidies have not led to significant benefits for developing countries, including LDCs. In addition, many developing countries that did provide export subsidies eliminated them under SAPs.<sup>82</sup> Since the introduction of new subsidies is prohibited under the AoA provisions, ‘only 25 . . . WTO members have the right to subsidise exports [of agricultural products] and only two to three exporters account for most export subsidies’.<sup>83</sup> Where developed states, such as the US, the EU and Canada, have reduced these subsidies, they have found other ways, such as the use of export credits to promote exports and to give exporters an unfair competitive advantage.<sup>84</sup> The US, for example, uses export credits, which, along with export subsidies, facilitate undercutting by US exporters of global prices for key agricultural commodities.<sup>85</sup> However, since the Cotton Subsidies decision, it is clear that in some cases these programmes will fall foul of AoA rules.<sup>86</sup>

Export subsidy levels remain high, and many developing countries have been unable to compete against subsidised products released onto the global market by developed country corporations.<sup>87</sup> This can be particularly problematic where subsidised products compete with domestically produced commodities that are crucial to a developing country’s economy.<sup>88</sup>

<sup>82</sup> Phillips, n 74 above, at 16.

<sup>83</sup> Murphy, n 36 above, at 16. This number includes the EC 15 as one member: see *US: Subsidies on Upland Cotton—Panel Report* n 53 above, at n 843. Murphy (*ibid*) further states that ‘[t]hree exporters account for 93 per cent of subsidised wheat exports, two for 80 per cent of subsidised beef exports and two for 94 per cent of subsidised butter exports’. See also Gonzalez, n 38 above, at 464. The lack of recourse to export subsidies was raised as an issue by India and Indonesia in the FAO 2002 study. These countries use stock-holding schemes as mechanisms for price stabilisation. The FAO stated that for India,

. . . the inability to sell abroad at less than the domestic price has become a binding constraint in the light of its huge surplus stocks of cereals, which are currently much above the stipulated norms for buffer stocks. Holding such a high level of stocks is expensive, but the options are limited. Releasing these stocks in the open market will lead to a significant fall in prices, which may benefit consumers in the short run, but will have significant implications for future output growth and food security in the long run. Similarly, exporting at such low prices is also not feasible without resorting to direct subsidies which are not permissible. (FAO, *Developing Country Experience*, n 60, at [46]).

<sup>84</sup> Gonzalez, n 38 above, at 464–5. See also Murphy, n 36 above, at 16–17.

<sup>85</sup> See G Monbiot, ‘Africa’s Scar Gets Angrier’, *Guardian Weekly* (12–18 Jun 2003) at 13, where he states that export credits allow US exporters to undercut global prices for wheat and maize by 10 to 16 per cent, and for cotton by 40 per cent.

<sup>86</sup> The US GSM 102, GSM 103 and SCGP export credit guarantee programmes for cotton and other unscheduled commodities, as well as for rice where the subsidy exceeded US reduction commitments were found to have contravened Art 10(1): see *US: Subsidies on Upland Cotton* WT/DS267/R [7.943] and [7.949] WT/DS267/AB/R [623]–[627] n 53 above.

<sup>87</sup> Phillips, n 74 above, at 17.

<sup>88</sup> FAO, *Synthesis of Country Case Studies*, n 66, at [19].

#### 4. AoA Implementation and Food Security

It is widely argued that the AoA has been a bad bargain for developing states.<sup>89</sup> The AoA creates a legal regime for agricultural trade that effectively sanctions the developed states' subsidies and protectionist policies on market access and has done little to assist many developing states to gain an increased share of the global market for key agricultural products which compete with those from developed states. But whether this bad bargain translates into a food security issue is another question.<sup>90</sup>

Because of the many factors that contribute to food security,<sup>91</sup> and the relatively short period of implementation of the AoA, commentators suggest that it can be difficult to establish 'simple causal relationships' between the implementation of the AoA and an increase or decrease in food insecurity.<sup>92</sup> The impact of trade reform on poverty and food security depends on the circumstances of each country.<sup>93</sup> However, according to the US-based Institute for Agriculture and Trade Policy (IATP), while '[t]he direct causal chains in these scenarios are complex and specific to each country and commodity . . . a broad trend [of impacts on food security] is observable and documented by numerous institutions and organizations'.<sup>94</sup> In order to assess these impacts, it is necessary first to examine the role played in this story by transnational corporations (TNCs) active in global agricultural markets.

<sup>89</sup> See KH Cross, 'King Cotton, Developing Countries and the "Peace Clause": The WTO's US Cotton Subsidies Decision' (2006) 9 JIEL 149 at 150. See also the variety of commentaries on the AoA by Oxfam, ActionAid, and the Institute for Agricultural Trade Policy, for example.

<sup>90</sup> The FAO states that '[t]o date, both adherence to the AoA and its impact on food security have proven hard to measure': see FAO, *SOFI 2003*, n 76 above, at 20. In fact, of the sample of 23 countries studied, the number of undernourished declined and in only 4 did the number increase between 1990–1992 and 1997–1999. The FAO noted, however, that it was 'not possible to isolate the impact of the AoA in contributing to this improvement'. See FAO, *Developing Country Experience* n 60, at [83].

<sup>91</sup> There are a wide variety of factors that can influence the food security of different populations. These include: the commitments of a state under structural adjustment programmes; a country's debt; currency fluctuations; domestic policies on agriculture, consumers, health and nutrition; trade policy (both international and domestic); along with policies on supply, distribution and access to food: see Murphy, n 36 above, at 8–9.

<sup>92</sup> *Ibid.*, at 4 and 17. Murphy states that 'any qualitative, and even quantitative analysis must be tentative. Assessments are further complicated . . . by other policy pressures, ranging from structural adjustment programmes negotiated with the World Bank to economic and environmental shocks, such as the recent crises in some Asian countries or the drought caused by El Niño' (at 6)). See also Dommen, n 63 above, at 34.

<sup>93</sup> FAO, *State of Food and Agriculture 2005*, n 57 above, at 6.

<sup>94</sup> M Ritchie, S Murphy and MB Lake, *United States Dumping on World Agricultural Markets*, Institute for Agriculture and Trade Policy, Cancun Series Paper No 1 (2003), at 14–15. Despite the inconclusive finding in its 2002 report, this view is supported by the FAO. See FAO, *SOFI 2003*, n 76 above, at 20–1.

## IV. TNC ACTIVITY AND FOOD SECURITY

## 1. TNCs and the Negotiation of the AoA

The negative impact of liberalisation on certain developing countries was predicted. As Murphy states, '[t]he AoA was expected to hurt African countries' interests, while the wealthiest countries were expected to profit most from the new rules. This was openly acknowledged and accepted as the probable outcome of the agreement and is one of the few predictions that has been borne out by experience'.<sup>95</sup>

Securing the interests of big business was one of the goals of the negotiations on agriculture. Ritchie and Dawkins allege that the US and the EU used their political clout in the Uruguay Round negotiations to ensure that, among other things, the AoA rules would serve the interests of their major corporate actors by facilitating an increase in trade volume of agricultural products.<sup>96</sup> This was accomplished by requiring member states to reduce domestic prices to that of global prices, reducing subsidies to farmers to remove tariff and non-tariff barriers while protecting export subsidies.

The end result has been more or less as expected: increased volumes of production to try to make up in volume traded what was lost to lower prices and less government support—and thus increased export dumping.<sup>97</sup>

It is possible to surmise that transnational agribusinesses and integrated livestock companies played a significant role (albeit behind-the-scenes) in this outcome. In the domestic sphere, these business entities are able to exert significant influence on public policy and lawmaking both through political donations and well-financed lobby groups.<sup>98</sup> The UNDP maintains that the agricultural industry has been successful in influencing 'national positions in international trade negotiations'.<sup>99</sup> Some corporate executives in the agricultural industry have served in high-ranking government positions and subsequently returned to work in the private sector. For example, a former vice-president of Cargill acted as the US negotiator on agriculture in the initial stages of the Uruguay Round negotiations before returning to work in the grain industry.<sup>100</sup> Moreover, a study of the composition of US trade advisory committees found that of the 111 members of the three committees reviewed, 92 were from individual companies and 16 from trade associations, compared with only two from labour unions.<sup>101</sup>

<sup>95</sup> Murphy, n 38 above, at 13.

<sup>96</sup> M Ritchie and K Dawkins, 'WTO Food and Agricultural Rules: Sustainable Agricultural and the Human Right to Food' (2000) 9 *Minn J Global Trade* 9 at 16.

<sup>97</sup> *Ibid.*, at 16–18.

<sup>98</sup> UNDP, *Human Development Report 2002: Deepening Democracy in a Fragmented World* (New York, Oxford: Oxford University Press, 2002) 68.

<sup>99</sup> *Ibid.*

<sup>100</sup> Murphy, n 36 above, at 11.

<sup>101</sup> UNDP, *Human Development Report 2002*, n 98 above, at 68.

## 2. Concentration of Agricultural Markets

The activity of TNCs in agricultural markets is not regulated under the AoA or by any WTO agreement. There are no provisions to deal with market structure and concentration of corporate power.<sup>102</sup> This fact, and changes in domestic government policies towards freer markets appear to have facilitated the development of oligopolies in agricultural markets; much of the consolidation of market power in this area has taken place since the end of the Uruguay Round in 1994.<sup>103</sup> Statistics<sup>104</sup> show that small groups of TNCs control almost every sector of the agricultural industry—from farm inputs such as seeds, pesticides and fertilisers to exporting, shipping and processing, and food retailing. An UNCTAD study on market concentration in the agricultural input industry found that six major agrochemicals companies control approximately 77 per cent of the global market (with the top three companies controlling 50 per cent), and the top four seed companies control an estimated 30 per cent of the global market for seeds, while five corporate groups control a significant percentage of the agricultural technology market.<sup>105</sup>

This concentration of market share is also reflected in global agricultural trade. For example, global trade in cereal is controlled by five TNCs,<sup>106</sup> and it is estimated that the US company Cargill controls 60 per cent of that trade.<sup>107</sup> The US exports two-thirds of the world supply of corn<sup>108</sup> and Cargill's corn exports provide for approximately half of US exports or 30 per cent of the world market.<sup>109</sup> Similarly, six TNCs control 40 per cent of the world coffee trade,<sup>110</sup>

<sup>102</sup> S Murphy, *Market Power in Agricultural Markets: Some Issues for Developing Countries, Trade-Related Agenda, Development and Equity*, Working Paper 6, South Centre (1999) at 1 <[http://www.southcentre.org/publications/publist\\_category\\_WorkingPapers\\_index.htm](http://www.southcentre.org/publications/publist_category_WorkingPapers_index.htm)> (last visited Jun 9, 2007).

<sup>103</sup> Ritchie and Dawkins, n 96 above, at 19. Even if the AoA has not caused or contributed to the current market structure, the fact that it is oligopolistic and thus will affect competition means that it should be addressed within the WTO.

<sup>104</sup> These statistics have been taken from a variety of reports issued and studies conducted over the last 8 years and may not represent current figures. Rather, they should be seen as illustrative of a general picture of the global food system. For an excellent study of concentration of global markets for cash crops see B Vorley, *Food, Inc—Corporate Concentration from Farm to Consumer* (London, IIED, 2003). See also WD Heffernan, *Consolidation in the Food and Agriculture System*, Report to the National Farmers Union (5 Feb 1999).

<sup>105</sup> UNCTAD, 'Tracking the Trend Towards Market Concentration: The Case of the Agricultural Input Industry' (20 Apr 2006) UNCTAD/DITC/COM/2005/16 at 3, 8 and 25ff.

<sup>106</sup> B Chatterjee, *Trade Liberalisation and Food Security*, Briefing Paper No 6, CUTS Centre for International Trade, Economics & Environment (Jul 1998).

<sup>107</sup> Murphy, n 36 above, at 11.

<sup>108</sup> See DE Ray, DG De La Torre Ugarte and KJ Tiller, 'Rethinking US Agricultural Policy: Changing Course to Secure Farmer Livelihoods Worldwide', Agricultural Policy Analysis Centre, The University of Tennessee (2003) 25 <<http://www.agpolicy.org/blueprint.html>> (last visited Jun 10, 2007).

<sup>109</sup> See Murphy n 38 above, at 6.

<sup>110</sup> E Neuffer, 'The Coffee Connection Thousands of Miles from Boston's Breakfast Tables and Fast-Food Restaurants, at the End of a Global Trade Network, Guatemala's Farmers Are Barely Scraping By', *Boston Globe*, 29 Jul 2001, A1.

on which the livelihoods of an estimated 20 to 25 million small farmers and workers in developing countries depend.<sup>111</sup> Three companies control 85 per cent of the global trade in cotton.<sup>112</sup> Two US companies market 50 per cent of the world supply of bananas.<sup>113</sup> The FAO states that ‘the production, distribution and trade in oil seeds and oils’ is now controlled by a small group of TNCs.<sup>114</sup> In addition, Cargill and another company are the leading exporters of soybeans from Argentina, Brazil and the US, and supply a substantial amount of the global market.<sup>115</sup>

Corporate control of agricultural markets is also highly integrated. According to Heffernan, ‘[t]he emerging global food system is characterized by a few dominant firms that have developed a variety of different alliances with other firms in the system’.<sup>116</sup> These include mergers and acquisitions, joint ventures and other less formal strategic alliances, making this consolidation horizontal (ownership or control of an agricultural sector) and vertical (control over more than one stage in the food production chain, such as providing inputs, processing and/or exporting outputs), as well as global.<sup>117</sup> Through these relationships, a small number of corporate actors are able to influence every aspect of the food chain. For example, with respect to cereals, a TNC and its partners might develop the gene, sell the seeds, collect, process, export and import the grain. In terms of meat production they might produce animal feed, raise and slaughter the animal, and process the meat.<sup>118</sup>

<sup>111</sup> See G Dicum and N Luttinger, *The Coffee Book: Anatomy of an Industry from Crop to Last Drop* (New York, The New York Press, 1999) at 38. According to Oxfam, the livelihood of approximately 25 per cent of the population of Uganda depends on coffee sales. Oxfam International, *Mugged: Poverty in Your Cup* (2001) at 8 <<http://www.maketrade-fair.com/assets/english/mugged.pdf>> (last visited Jun 10, 2007).

<sup>112</sup> S Suppan, ‘The WTO’s Cotton Crisis and the Crisis in Commodities’, *IATP Trade and Global Governance Program*, Aug 2006, at 2 <<http://www.tradeobservatory.org/library.cfm?refID=88936>> (last visited Jun 7, 2007).

<sup>113</sup> MM McLaughlin, *World Food Security: A Catholic View of Food Policy in the New Millennium* (Washington DC: Center of Concern, 2002) at 86.

<sup>114</sup> FAO, *FAO Support to the WTO Negotiations: Major Constraints to Trade in Processed Agricultural Products Confronting Developing Countries* (2003), <<http://www.fao.org/docrep/005/y4852e/y4852e02.htm>> (last visited Jun 10, 2007).

<sup>115</sup> See Murphy, n 38 above, at 6.

<sup>116</sup> WD Heffernan, *The Influence of the Big Three—ADM, Cargill and ConAgra* (1999) 5, <<http://www.foodcircles.missouri.edu/coop.pdf>> (last visited Jun 10, 2007). UNCTAD also cites this report, see n 105 above at 41–2.

<sup>117</sup> Heffernan, *ibid.* Thus, for example, Cargill has corn export, import, milling and shipping operations in over 160 countries: see Murphy, n 38 above, at 6. A number of the leading corporate groups in the agricultural biotechnology industry are also the major players in the seed and agrochemical industries: see UNCTAD n 105 above; and ETC Group, *Globalization, Inc.—Concentration in Corporate Power: The Unmentioned Agenda*, Communiqué, Issue #71 (Jul/Aug 2001) at 6–9 <<http://www.etcgroup.org>> (last visited Jun 10, 2007).

<sup>118</sup> Heffernan refers to these alliances as food system clusters and identifies three such clusters of companies that are among the dominant actors in the global food system. See Heffernan, n 116 above, at 5. These include Novartis/Archer Daniels Midland (ADM), Cargill/Monsanto and ConAgra. For diagrams illustrating these clusters see <<http://www.foodcircles.missouri.edu/consol.htm>> (last visited Jun 10, 2007).

Ritchie and Dawkins argue that although it may be too soon to understand the full implications of this market concentration, 'it is evident that higher prices are being charged to farmers for inputs and lower prices paid to them for their production'.<sup>119</sup> A report on corporate concentration in the Canadian agricultural industry shows that despite the fact that farmers in Canada have upgraded their technology and have tripled their gross incomes over the last three decades, their net incomes have declined. The increase in gross revenues has been paralleled by an increase in costs of inputs. Companies that produced fertiliser, for example, increased their prices 75 per cent as grain prices rose, despite the fact that the cost of fertiliser production did not change.<sup>120</sup> Similarly, the report states that in 1998 when hog prices fell below the cost of production, pork packers earned huge profits (these were record profits in the case of Maple Leaf and double the annual average for the preceding three years for Fletchers).<sup>121</sup> Farmers have little negotiating power in a system where they have increasingly fewer choices among sellers of inputs and buyers of outputs (who may even be the same company or family of companies).

This concentration of market power in agricultural markets has a number of effects that can be linked to food security issues in developing countries.

### 3. Subsidies, Oversupply and Depressed Agricultural Commodity Prices

Many argue that overproduction in domestic agricultural markets, leading to increased supply in global markets, which in turn contributes to low world prices, is caused by domestic subsidies paid to farmers. This is the rationale behind the structure of the AoA, which purportedly aims to create a fair trade regime by, *inter alia*, removing trade-distorting production subsidies.<sup>122</sup> While production subsidies do play a role, a report from the Agricultural Policy Analysis Center at the University of Tennessee argues that subsidies themselves are not the cause of over-production, and therefore oversupply and depressed global commodity prices. Rather, it is low global farm gate prices (prices paid to farmers for their outputs) that trigger government subsidies. In markets such as Canada, Australia and Mexico, where domestic subsidies have been reduced, these reductions have not led to lower production levels. Farmers have continued 'to produce as much as they can—even in the face of declining prices and declining subsidies—as long as they can'.<sup>123</sup>

The drastic decline in global agricultural commodity prices can be partially attributed to changes in US policy, away from price support and supply

<sup>119</sup> Ritchie and Dawkins, n 96 above, at 19–20.

<sup>120</sup> D Qualman, *The Farm Crisis and Corporate Power* (Apr 2001) 23–4 <<http://policyalternatives.ca/index.cfm?act=news&call=469&do=article&pA=BB736455>> (last visited Jun 10, 2007).

<sup>121</sup> *Ibid.*, at 26–7.

<sup>122</sup> Although, as has been demonstrated, in practice the agreement actually institutionalises and protects both the EU and US domestic subsidy programmes.

<sup>123</sup> Ray, Ugarte and Tiller, n 108 above, at 41. See also Ritchie and Dawkins, n 96 above, at 13.



management programmes and towards a free-market approach, the goal of which is to drive down US commodity prices to make them more competitive on the global market.<sup>124</sup> It is this form of governmental intervention, along with the oligopolistic structure of the markets, that contributes to the distortion of global agricultural market prices.<sup>125</sup> Because US corporations are among a small group of dominant players in the global market, low US prices have the effect of driving down world commodity prices as these commodities enter the global market.<sup>126</sup> In US cereal markets, for example, prices are set by the dominant sellers, and these prices have a strong influence on global commodity prices, even in relation to commodities where the US is not a dominant exporter in terms of volume.<sup>127</sup> In the case of coffee, prices are set by big transnational roasting companies.<sup>128</sup>

Commentators argue that the real beneficiaries of low prices are big corporations such as integrated livestock producers, who are able to ‘purchase [animal] feed from the market at below production cost’ (while small farmers produce feed themselves and therefore bear production costs), and agribusinesses<sup>129</sup> who can purchase commodities at below production cost and be guaranteed ‘an unrestricted availability of commodities . . . [in] the absence of supply control mechanisms’.<sup>130</sup> For every pound of coffee sold in the US, the transnational roasting company receives (depending on quality) between US\$2.69 and \$8.49, while a Guatemalan farmer earns less than 35 cents and a farm worker less than 14 cents.<sup>131</sup>

Low prices and the lack of production control mechanisms are also beneficial for companies that supply farm inputs and machinery, since it ensures ‘an inflated demand for their products, since the government no longer removes any acreage from production through set-asides’.<sup>132</sup> In addition, these transnational

<sup>124</sup> Ray, Ugarte and Tiller, *ibid.*, at 9. The change in policy was partially influenced by the agribusiness lobby (at 18). Ray *et al* argue that deregulation in the agricultural sector does not work since agricultural markets have not historically been self-correcting: ‘. . . neither the quantity of crops demanded nor the quantity supplied is significantly responsive to changes in price, so timely market self-correction does not take place. Total annual output remains relatively constant irrespective of prices, the level of subsidies, or other sources of revenue’ (at 21).

<sup>125</sup> Ritchie, Murphy and Lake, n 94 above, at 8.

<sup>126</sup> Ray, Ugarte and Tiller (n 108 above, at 11) argue that while the ‘US does not hold a monopoly [in agricultural commodities]—it is one of a few major players in the oligopolistic world markets—low US prices consistently drive down world prices’.

<sup>127</sup> *Ibid.*, at 24–7.

<sup>128</sup> J Draeger ‘Perking Up the Coffee Industry through Fair Trade’ (2002) *Minn J Global Trade* 337 at 357.

<sup>129</sup> FAO notes that most farm subsidies in the US and EU are paid to large producers: See FAO, *SOFI 2005*, n 75 above, at 27. See also Oxfam International, ‘Finding the Moral Fiber: Why Reform is Urgently Needed for a Fair Cotton Trade’, Oxfam Briefing Paper 69 (Oct 2004) at 17–18, where it notes that 10 per cent of US farms receive 79 per cent of cotton subsidy payments and one per cent of those receive 25 per cent of such payments.

<sup>130</sup> Ray, Ugarte and Tiller, n 108 above, at 13.

<sup>131</sup> Neuffer, n 110 above.

<sup>132</sup> Ray, Ugarte and Tiller, n 108 above, at 13. Proponents of free trade argue that low prices benefit consumers. However, according to Ray *et. al*, even in developed countries it is not clear that consumers benefit from lower commodity prices, since consumer benefit ‘depends on the ability of the

actors benefit from export subsidies and export credits in the many different countries in which they operate, giving them an even greater competitive advantage over small producers in developing countries.<sup>133</sup>

#### 4. Dumping and Food Security

TNCs that are able to purchase at below the cost of production and benefit from an unlimited supply of commodities, as well as production and export subsidies, are then able to sell onto the world market at below production costs and thereby significantly undercut foreign competition. This practice of corporate dumping (the sale of goods at below production cost) is facilitated by the provisions and structure of the AoA.<sup>134</sup> Not only are US and EU production and export subsidy programmes protected under the agreement, dumping is not adequately disciplined under the AoA—even now that the Peace Clause has expired<sup>135</sup> and subsidies can be, and are being, challenged in the WTO Dispute Settlement Body.<sup>136</sup>

A background paper on the AoA, prepared by IATP for the Cancun Ministerial Meeting in September 2003, states that '[t]he impact of agricultural dumping from the US and EU on developing states has been well documented as the most harmful effect of current agriculture trade rules'.<sup>137</sup> While the impact of trade reforms and dumping will depend on the circumstances of each state,

marketing system to transfer the lower prices to them. In some cases, agribusinesses and middlemen are able to capture some or all of the benefits of low prices'. This observation is echoed by Qualman (n 120 above, at 26) who argues that despite the fact that hog prices in Canada have remained the same over a 23-year period, and are currently below the cost of production, consumer prices have risen by over 200 per cent.

<sup>133</sup> Murphy, n 102 above, at 10 and 21–2.

<sup>134</sup> As is dumping in the form of food aid (providing food aid when global prices are low to certain states in order to open future markets).

<sup>135</sup> Under Article 13 (the Peace Clause) which expired in Dec 2003, certain AoA subsidies could not be challenged. Thus, conforming 'green box' subsidies, a certain level of 'blue box' subsidies and conforming export subsidies were exempt from challenges normally allowed under Article XVI GATT 1994 and Part III of the WTO *Agreement on Subsidies and Countervailing Measures* (SCM). Conforming green box measures were also exempt from countervailing duty and non-violation nullification and impairment actions. Articles 13(b) and (c) allowed conforming 'blue box' and export subsidies to be subject to countervailing duties but required members to show a threat or injury in conformity with Article VI GATT 1994 and Part V of the SCM and to exercise due restraint in initiating any countervailing duty investigation.

<sup>136</sup> Cross (n 89 above, at 190) notes that the US Cotton Subsidies decision has laid the ground for further challenges of US, EU and other subsidy programmes. On Jun 8, 2007 Canada requested a panel in the case of *US: Subsidies and Other Domestic Support for Corn and Other Agricultural Products*: See Inside US Trade, 'Canada Brings WTO Panel Against US Farm Subsidies' Jun 8 2007 <<http://www.insidetrade.com/>> (last visited Jun 10, 2007). It should be noted that the Cotton Subsidies Decision has not yet been implemented and that the use of the DSB to challenge subsidies is not a viable means for most developing countries to address the inequalities of the agreement, given the complexity and cost (both financial and political) of such cases and the difficulties of enforcement: see Murphy, n 36 above, at 14; see also Cross at 192–3.

<sup>137</sup> S Murphy, 'WTO Agreement on Agriculture Basics', Institute for Agriculture and Trade Policy, WTO Cancun Series Paper No 2 (2003) at 14.

this practice of corporate dumping can be said to undermine the food security of vulnerable populations in two ways. First, for developing countries that have opened up their markets pursuant to SAP commitments and/or AoA market access commitments, these commodities enter the domestic market at prices well below the cost of production. As discussed above, only a few developing countries have access to the SSG provisions that would allow them to protect domestic markets from import surges by imposing higher tariffs on certain key agricultural commodities. These cheap imports compete with domestic producers and can prevent local producers of similar products in developing countries from being able to meet their production costs, let alone make a marginal profit.<sup>138</sup> This can lead to a loss of livelihood and a cycle of poverty, as dispossessed farmers and unemployed farm labourers cannot afford to buy less expensive imports. In its 1999 case study analysis of the impacts of trade, the FAO reported that liberalisation had contributed to ‘the concentration of farms, in a wide cross section of countries. While this led to increased productivity and competitiveness with positive results, in the virtual absence of social safety-nets, the process also marginalised small producers and added to unemployment and poverty’.<sup>139</sup>

Second, many developing countries depend on imports to satisfy part of their food supply and thus require foreign exchange revenues to purchase on the global market. For those countries that rely on agricultural exports to generate such exchange, highly subsidised commodities released onto the global market may undercut their earnings and thereby jeopardise food security.<sup>140</sup> Coffee exports, for example, constitute a substantial part of foreign exchange earnings for many countries. Thus, when the market is flooded with excess, low-cost coffee and global prices drop as a result, those countries that rely on such exports may be unable to finance their debt payments and/or purchase sufficient food to meet the needs of their populations. In addition, in countries whose economies rely on the production of a few commodities for export, the oversupply of the products on the global market can result in a loss of livelihood for many thousands of small farmers and farm labourers, and lower wages for those who are still able to find employment in the industry. The dramatic fall in coffee prices in 2001, for example, led to major losses of income in Guatemala, from lower

<sup>138</sup> See Ritchie, Murphy and Lake, n 94, above, at 2–3, where it is noted that the US undercuts world prices by 40 per cent for wheat, 25–30 per cent for maize and nearly 30 per cent for soybeans. The authors further argue that EU dumping of beef onto the market destroyed the cattle industries of Burkina Faso and Côte d’Ivoire (at 11). See also Oxfam International, ‘Stop the Dumping! How EU Agricultural Subsidies Are Damaging Livelihoods in the Developing World’, Oxfam Briefing Paper No 31 (Oct 2002).

<sup>139</sup> FAO, *Synthesis of Country Case Studies*, n 66 above, at [18]. The 2002 FAO study is much more tentative in its conclusion, stating that ‘[t]he most likely groups to benefit from the reduction of trade barriers in foreign markets and the expansion of exports are commercial producers. Small farmers may not be able to participate in growing export-oriented crops and may experience greater competition in accessing resources, including land, marginalizing their position even further’: see FAO, *Developing Country Experience*, n 60 above, at [92].

<sup>140</sup> Ritchie, Murphy and Lake, n 94 above, at 14.

wages and massive unemployment and thus increased food insecurity.<sup>141</sup> Equally, the falling prices in cotton have been linked with a substantial increase in poverty among cotton farmers in Benin and an increase in rural poverty generally.<sup>142</sup>

This situation may be compounded by market access barriers in developed states. As mentioned above, many OECD countries engaged in 'dirty tariffication', setting original tariff levels so high (sometimes exceeding 300 per cent) that reduction commitments under the AoA did not significantly improve market access.<sup>143</sup> In many cases, the highest tariffs were set in relation to commodities most important to developing country exporters. In addition, of OECD-member tariffed goods, almost 80 per cent are subject to the SSG provisions and therefore can be protected if import prices go below the set trigger price or if imports exceed the trigger volume.<sup>144</sup>

Food prices rose dramatically following the entry into force of the Uruguay Round agreements.<sup>145</sup> Although world prices subsequently subsided, many LDCs are becoming more dependent, and are spending an increasing percentage of their GDP, on food imports while their export revenues have stagnated, reducing their purchasing power. In addition, the volumes of food aid to LDCs and NFIDCs has dropped significantly.<sup>146</sup>

## 5. The AoA and the Right to Adequate Food (Food Security)

Andrew Lang has questioned the necessity of framing in human rights terms the type of critique of the trade regime presented in this paper, stating that it adds an 'extra unnecessary layer of analysis'.<sup>147</sup> However, to examine the issue of trade-related food security as a fundamental human right, is to treat it as a valid legal interest (rather than simply as a policy consideration) which imposes international legal obligations on states.

It would be hard to maintain that in negotiating, ratifying and implementing this treaty, states have taken into account their international legal obligations

<sup>141</sup> P Varangis, P Siegel, D Giovannucci and B Lewin, 'Dealing with the Coffee Crisis in Central America: Impacts and Strategies', World Bank Policy Research Working Paper 2993 (2003) at 49–51 <<http://www-wds.worldbank.org>> (last visited Jun 10, 2007)

<sup>142</sup> Oxfam, *Finding the Moral Fiber*, n 129 above at 13, citing a study prepared for the World Bank by the International Food Policy Research Institute.

<sup>143</sup> Gonzalez, n 38 above, at 460–1.

<sup>144</sup> FAO, *Issues at Stake*, n 63, at [34].

<sup>145</sup> Murphy, n 36 above, at 17–18.

<sup>146</sup> FAO, *FAO Support to the WTO Negotiations: Food Import Bills of Least Developed Countries (LDCs) and Net Food Importing Developing Countries (NFIDCs)* (2003) <<http://www.fao.org/docrep/005/y4852e/y4852e06.htm>> (last visited Jun 10, 2007). See also J Morrison and A Sarris, n 67 above, at 33. See also Monbiot, n 85 above, at 13 who argues that the US tends to increase its food aid (which it provides in the form of agricultural products rather than in funds to the World Food Programme) when global commodity prices are low.

<sup>147</sup> See Andrew Lang's contribution in this volume.

regarding the right to food.<sup>148</sup> Individual states do not appear to have taken any steps to regulate the domestic and global business practices of corporate nationals which may contribute to violations of the right to food. In addition, as discussed above, the structure of the AoA itself protects trade-distorting subsidy programmes and market access policies and does not address the issue of corporate concentration in global agricultural markets. As such, the treaty facilitates the dumping of agricultural commodities on global markets which can undermine the food security of vulnerable populations in developing countries.

However, the AoA does incorporate provisions relating to food security and thus arguably does recognise the right to adequate food. Food security is specified as a ‘non-trade’ concern that should be taken into account and there are a number of provisions that purport to address trade-related food security concerns.<sup>149</sup>

Article 16, the chief mechanism under the AoA to address food security issues, imposes an obligation on members to take action as agreed under the Decision on Measures Concerning the Possible Negative Effects of the Reform Programme on Least-Developed and Net Food-Importing Developing Countries (Marrakesh Decision).<sup>150</sup> As its title suggests, the decision acknowledges the potential for negative impacts following the implementation of the AoA on LDCs and Net Food-Importing Developing Countries (NFIDCs) that may not be able to finance sufficient food imports in the short term. It recognises that reductions in export subsidies will result in a decreased flow of food, and that liberalisation in general will result in greater price volatility for food imports.<sup>151</sup> Developed states agreed ‘to establish appropriate mechanisms’ to ensure the availability of food aid sufficient to meet developing country needs and particularly the needs of LDCs and NFIDCs.<sup>152</sup> Members further recognised that countries experiencing financial difficulties in paying for food imports were to be eligible for assistance from existing financial institutions or other institutions that might be established.<sup>153</sup>

<sup>148</sup> CESCR, ‘General Comment No 12’, n 8 above, at [19].

<sup>149</sup> The preamble of the AoA notes that commitments under the treaty ‘should be made in an equitable way . . . having regard to non-trade concerns, including food security . . . having regard to the agreement that special and differential treatment for developing nations is an integral element of the negotiations, and taking into account the possible negative effects of the implementation of the reform programme on least-developed and net food-importing developing countries’. Article 12 requires members that wish to institute export prohibitions or restrictions on agricultural products to ‘give due consideration to the effects’ such measures may have on the food security of importing members, and requires written notice of such measures to be provided to the Committee on Agriculture. Under Article 12(2), developing countries are exempt from this requirement except in cases where they are net-food exporters of the specified foodstuff.

<sup>150</sup> Decision on Measures Concerning the Possible Negative Effects of the Reform Programme on Least-Developed and Net Food-Importing Developing Countries in Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, reprinted in (1994) 33 ILM 392.

<sup>151</sup> *Ibid* at [2].

<sup>152</sup> *Ibid* at [3].

<sup>153</sup> *Ibid* at [5]. In addition, paragraph 4 requires that any agreement on agricultural export credits ‘makes appropriate provision for differential treatment in favour of’ LDCs and NFIDCs.

However, the Marrakesh Decision, as well as other provisions relating to food security, such as Article 6(2) (special and differential treatment) and certain green box exemptions,<sup>154</sup> do not appear to have provided developing countries with effective mechanisms to address the negative impact of the AoA and TNC concentration in global agricultural markets on food security. In the first place, the term food security is not defined in the AoA. Stevens *et al* note that, within the WTO system, food security 'is often taken to relate primarily to the adequate supply of imported food to member states'.<sup>155</sup> This narrow conception of food security does not conform with the FAO and UN CESCR definition of food security.<sup>156</sup> Nor does it acknowledge the complexity of the issue. As such, it negates the other ways that trade contributes to the problem of food insecurity, for example by the undercutting of domestic agricultural markets in developing countries and the consequent effects on small-scale farmers and farm labourers.<sup>157</sup>

Second, in terms of protecting domestic markets from surges in imports for certain products, as noted above, most developing countries do not have access to the SSG mechanism, and of those that do, few 'have the resources and capacity to apply general safeguard measures, including providing evidence for the obligatory proof of injury'.<sup>158</sup>

Third, trade rights are not conditioned in any way on compliance with the right to adequate food. The Marrakesh Decision, for example, applies only to LDCs and NFIDCs and does not create enforceable rights for these countries. Developed countries are not legally required 'to make food or other assistance available to countries adversely affected by the implementation of the Uruguay Round commitments on agriculture'.<sup>159</sup> In addition, the decision has not been sufficiently implemented.<sup>160</sup> Ritchie and Dawkins note that in 1996, the WTO Committee on Agriculture decided not to activate the decision following the release of an IMF report that questioned FAO's projections of negative impacts related to AoA implementation.<sup>161</sup> The FAO study had estimated that LDCs

<sup>154</sup> 'Public stockholding for food security purposes', 'domestic food aid' and various structural adjustment and regional assistance programmes are listed as exemptions in Annex 2, [3], [4], [9], [10], [11] and [13] (green box), and are not, therefore, considered trade-distorting subsidies subject to reduction or required to be included in calculations of AMS (total domestic support) Art 6(1). In addition, developing countries are permitted to reasonably subsidise the purchase of food for the public stockholding and domestic food aid programmes (Annex 2, [3] and [4] and notes 5 and 6). Annex 5 [1(d)] also allows countries to restrict market access for designated products in their schedules that are subject to special and differential treatment for food security purposes.

<sup>155</sup> Stevens *et al*, n 50 above, at 3.

<sup>156</sup> See n 30 above.

<sup>157</sup> Phillips, n 74 above, at 7.

<sup>158</sup> FAO, 'FAO Support to the WTO Negotiations: The Need for Special Safeguards for Developing Countries' (2003) <<http://www.fao.org/docrep/005/y4852e/y4852e05.htm>> (last visited Jun 10, 2007).

<sup>159</sup> MG Desta, 'Food Security and International Trade Law: An Appraisal of the World Trade Organization Approach' (2001) 35 *J of World Trade* 449 at 467.

<sup>160</sup> Dommen, n 63 above, at 33.

<sup>161</sup> Ritchie and Dawkins, n 96 above, at 25.

and NFIDCs would face huge increases in their food import bills, 14 per cent of which could be attributed to the implementation of the WTO agreements.<sup>162</sup> While some countries appear to have taken steps to fulfil their commitments under the decision in good faith,<sup>163</sup> FAO studies have reported that many eligible developing countries have not received the assistance that should be available.<sup>164</sup>

Thus, these provisions fall far short of the requirement that states give 'due attention' to the right to adequate food in international agreements 'whenever relevant'<sup>165</sup> and do not provide developing countries with the means to ensure that they can fulfil *their* obligations in relation to the right to food of individuals within their territories.

## V. CONCLUSION

As noted above, it is poverty rather than world food supply that is one of the main causes of food insecurity. It is widely accepted that growth in domestic agricultural production can have a significant impact in reducing poverty, and that improving agricultural production and particularly staple food production is more effective in addressing food security in developing countries<sup>166</sup> than the reliance on cheap imports.<sup>167</sup> As the FAO notes, 'chronic food insecurity can be addressed most effectively through policies that tap the huge agricultural potential of developing countries to increase agricultural productivity and food production'.<sup>168</sup>

State intervention in the agriculture sector is critical to ensuring agricultural growth in the early stages of a state's economic development.<sup>169</sup> Historically, states have protected their agriculture sectors as they move from the early to middle stages of economic development<sup>170</sup> using a wide range of policy mechanisms including state trading and export monopolies, a variety of non-tariff

<sup>162</sup> Ritchie and Dawkins, n 96 above, at 25.

<sup>163</sup> See eg WTO, Committee on Agriculture, Notification, Doc No G/AG/N/CAN/52, for a list of the actions taken by Canada, for example, pursuant to the Marrakesh Decision.

<sup>164</sup> See FAO, *Synthesis of Country Case Studies*, n 66, at [17], where it states that none of the eligible countries that were studied reported 'receiving any tangible assistance related to the Decision (eg changes in food aid volumes, compensatory financing or increased assistance to agricultural development programmes)'. This problem was also reported in the FAO 2002 study. See FAO, *Developing Country Experience*, n 60, above at [91].

<sup>165</sup> See n 22ff and accompanying text.

<sup>166</sup> Morrison and Sarris, n 67 at 34–6.

<sup>167</sup> Ritchie, Murphy and Lake, n 94 above, at 14. Ritchie *et al* argue that for countries with available fertile land 'a policy of dependence on cheap imports makes little economic sense'.

<sup>168</sup> FAO, *Some Issues Relating to Food Security in the Context of WTO Negotiations on Agriculture*, (20 Jul 2001) Discussion Paper No 1, FAO Geneva Roundtable on Food Security in the Context of WTO Negotiations on Agriculture, at 2.

<sup>169</sup> Morrison and Sarris, n 67 above at 41, who state that '[t]here is ample evidence to suggest that the state needs to play a significant role in stimulating the transformation of agriculture'.

<sup>170</sup> *Ibid*, at 22.

barriers, state marketing boards to ensure price stability for both producers and consumers, subsidies for producer inputs and credit and government investment in rural infrastructure and agricultural research.<sup>171</sup>

A trade regime that effectively undermines this potential will likely also undermine a country's potential to be food secure. The AoA liberalisation rules, the manner in which they have been implemented, domestic trade and agricultural policies of major developed countries, and the concentration of market power in agricultural markets appear to do just that. In this context, the reforms made by developing countries and LDCs pursuant to SAPs and the AoA have left them with few policy options to allow them stimulate agricultural, and hence, economic growth.

WTO members that have ratified the ICESCR,<sup>172</sup> and particularly those which were the major players in the Uruguay Round negotiations have violated their obligations to take the right to food into account in entering into and implementing the AoA. Moreover, to the extent that these states have duty under the ICESCR to regulate the domestic and extraterritorial activities of their corporate nationals which contribute to violations of the right to adequate food in other countries, these states are in breach of this obligation.

It remains to be seen whether any agreement reached in the revived Doha Round negotiations<sup>173</sup> will satisfy the obligations of states parties with respect to the right to adequate food and result in sufficient changes to the AoA to redress the inequalities, and will allow developing countries, in particular LDCs, more flexibility to protect their markets in order to pursue food security and other key development goals. To date, however, the proposals on the table do not look promising.

In the first place, the issue of market structure is not being addressed. There is language in the July Framework Agreement<sup>174</sup> and the Hong Kong Ministerial Declaration<sup>175</sup> to support the development of a Special Safeguard Mechanism (SSM) for developing countries. There is also language to allow for the designation of Special Products (SPs) 'based on criteria of food security, livelihood security and rural development needs' that would exempt designated agricultural products from tariff reduction commitments. However, there is disagreement as to whether the SSM should apply to all or some tariff lines, to

<sup>171</sup> Stockbridge, n 31 above, at 12.

<sup>172</sup> To the extent that the right to adequate food has entered customary international law, this applies to all states (except the US).

<sup>173</sup> The negotiations for reform of the agricultural trade regime are prescribed under Article 20 of the AoA. Members commit themselves to ongoing negotiations regarding the liberalisation of trade in agriculture, taking into account, among other things, 'non-trade concerns, special and differential treatment to developing country Members, and the objective to establish a fair and market-oriented agricultural trading system, and the other objectives and concerns mentioned in the preamble [such as food security]'.  
<sup>174</sup> WTO, Decision Adopted by the General Council on 1 Aug 2004 (2 Aug 2004) WTO doc WT/L/579 at [41]–[42].

<sup>175</sup> WTO, Ministerial Declaration (22 Dec 2005) WTO doc WT/MIN(05)/DEC at [7].



staple food products or products related to food security.<sup>176</sup> Ambassador Falconer, Chair of agricultural negotiations, has proposed that the SSM be limited to use in relation to SPs.<sup>177</sup> With regard to SPs, there is no agreement on the number of products that developing countries should be allowed to specify, with the EU and US calling for six per cent of tariff lines while developing countries have been insisting on allowing designation of up to 20 per cent.<sup>178</sup>

There are proposals on the table for developed country subsidy reduction.<sup>179</sup> The US, for example, is proposing to reduce its AMS by 60 per cent, but the effectiveness of such a cut will depend, among other things, on the base years agreed and whether the US is successful in gaining agreement for an expansion of the 'blue box' criteria that would allow it to shift some of its subsidies from the 'amber box'.<sup>180</sup> A recent report has suggested that the current draft US Farm Bill could actually significantly increase trade-distorting subsidies.<sup>181</sup> In addition, the EU and US have shown little willingness to make any changes to the current 'green box'.<sup>182</sup> The EU has agreed to eliminate export subsidies by 2013, but this proposal is contingent on US agreement to adopt disciplines on export credits, export credit guarantees and insurance programmes and food aid, as well as on agreement among WTO members on significant improvements in market access in other non-agricultural areas of negotiation.<sup>183</sup> Finally, the US is pushing for ambitious tariff cuts for developing countries on both agricultural and non-agricultural products.<sup>184</sup>

<sup>176</sup> A Matthews, 'Shallow Versus Deep Special and Differential Treatment (SDT) and the Issue of Differentiation in the WTO Among Groups of Developing Countries' in J Morrison and A Sarris (eds), n 67 above, 79 at 93–4.

<sup>177</sup> S Murphy, 'Still Not Confronting the Real Challenges: Part II of the Challenges Paper for the Doha Negotiations on Agriculture', Institute for Agricultural Trade Policy, Trade and Governance Program, (May 2007) at 2 <<http://www.iatp.org/iatp/publications.cfm?accountID=451&refID=98818>> (last visited Jun 10, 2007).

<sup>178</sup> There are indications that key negotiating states (the US, EU, India and Brazil) are considering the development of indicators for designating SPs rather than setting specific limits on numbers: see Inside US Trade, 'G4 Considers Dropping Specific Limits on Special Products in WTO', Jun 8 2007 <<http://www.insidetrade.com/>> (last visited Jun 10, 2007).

<sup>179</sup> See South Centre, 'State of Play in Agriculture Negotiations: Country Groupings' Positions—Domestic Support Pillar', Analytical Note SC/AN/TDP/AG/1–2 (Nov 2006).

<sup>180</sup> Institute for Agricultural Trade Policy, 'A Fair Farm Bill for the World', (Mar 2007), 4.

<sup>181</sup> Inside US Trade, 'Johanns Says Emerging Farm Bill Would Increase Subsidies', Jun 8 2007 <<http://www.insidetrade.com/>> (last visited Jun 10, 2007).

<sup>182</sup> See South Centre, n 179 above.

<sup>183</sup> See South Centre, 'State of Play in Agriculture Negotiations: Country Groupings' Positions—Export Competition Pillar', Analytical Note SC/AN/TDP/AG/1-3 (Nov 2006). See also Oxfam International, 'A Recipe for Disaster: Will the Doha Round Fail to Deliver for Development?', Oxfam Briefing Paper 87 (April 2006) at 10. Significant reductions in tariffs for non-agricultural products for many developing countries would also compromise their chances for development as it would open their industrial markets before they were competitive. Historically many developed countries and advanced developing countries have used tariffs as part of their industrial development strategy: see Oxfam, *ibid.*, at 14–16.

<sup>184</sup> See South Centre, 'State of Play in Agriculture Negotiations: Country Groupings' Positions—Market Access Pillar', Analytical Note SC/AN/TDP/AG/1-1 (Nov 2006).

It is clear, as Murphy states, that '[t]he pretence of a development agenda has long since been dropped'.<sup>185</sup> This is perhaps not surprising given the mercantilist basis of the WTO and the fact that there is no collective understanding of how this organisation and its members should pursue and support development.<sup>186</sup> States parties to the ICESCR have clearly not looked to their international human rights obligations as a basis for developing such an understanding. Unfortunately, this means that once again the human rights of the hungry will not be adequately addressed. Nor will trade in agriculture play its potentially important role in reducing poverty levels and addressing food security, but rather, it will likely contribute to the opposite.

<sup>185</sup> S Murphy, n 177 above at 3.

<sup>186</sup> JE Stiglitz and A Charlton, *Fair Trade for All: How Trade Can Promote Development* (Oxford, OUP, 2005) 67.



*Realising Rights in an Era of Economic Globalisation: Discourse Theory, Investor Rights, and Broad-Based Black Economic Empowerment*

DAVID SCHNEIDERMAN\*

I. RIGHTS AND UNIVERSALITY

THE REFRAIN BY now is familiar: we are in the midst of a rights revolution, we are told.<sup>1</sup> New and old nation states, emerging from the yoke of totalitarianism, apartheid, or state socialism have rearranged their constitutional orders to embrace modern systems of human rights and freedoms. Accompanying the refrain are some careful, and at other times extravagant, claims about movement toward a global consensus on questions around human rights.

Rights, of course, are paradoxical things. They aspire to universality, yet take on particularity once they undergo translation within national legal systems.<sup>2</sup> While purporting to limit state action, they also require state supports for their realization. Patterned on systems of practice embedded within particular constitutional cultures, citizens operating under these new constitutional orders will experience rights differently, at present, and over time. As with other sorts of legal borrowing,<sup>3</sup> the formation and interpretation of rights will be dependant upon extant legal and political cultures, levels of social and economic

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<sup>1</sup> See CR Epp, *The Rights Revolution: Lawyers, Activists, and Supreme Courts in Comparative Perspective* (Chicago, Chicago University Press, 1998) 23.

<sup>2</sup> See W Brown, *States of Injury: Power and Freedom in Late Modernity* (Princeton, NJ, Princeton University Press, 1995) 97–8.

<sup>3</sup> D Nelken, 'Towards a Sociology of Legal Adaptation' in D Nelken and J Fest (eds), *Adapting Legal Cultures* (Oxford, Hart Publishing, 2001).

development, and complementary institutional and civil society supports. We might say, following David Harvey, that the experience of rights will be geographically uneven.<sup>4</sup>

At the very same time as rights have taken on this universal register, there has occurred a corresponding push for the free movement of goods, services, and capital across national frontiers unimpeded by laws of national polities. These claims oftentimes are framed in the language of rights. With Baxi, we might label these ‘trade-related, market-friendly human rights’.<sup>5</sup> Consider in this light the range of rights directly available to investors for the promotion and protection of foreign investment: those prohibiting discriminatory treatment, regulatory takings, or unfair and inequitable treatment. Historically, these were collectively described as constituting the minimum standard of treatment required by international law.<sup>6</sup> Then and now, democratic self-government is viewed as untrustworthy according to the logic of this rights regime, and so limitations on government action are taken up as the preferred means to secure the gains made toward open global markets. Even if enforcement is done by investors through the aegis of *ad hoc* arbitral tribunals,<sup>7</sup> the expectation is that this regime of rules precommits states to a limited set of acceptable policy responses to social and economic problems, outlawing those considered extreme or beyond the threshold of normalcy.<sup>8</sup> These will be responses deemed acceptable to capital-exporting states—an assemblage that gives expression to the ‘minimum standard of treatment’ required by the rules of ‘civilised justice’. The experience of rights under this regime, then, is not meant to be geographically uneven.

What happens when these differing conceptions of rights conflict? The response readily at hand for many Anglo-American legalists is that national sovereign rights regimes naturally will take precedence. I am more interested in an account informed by critical approaches to international relations and international political economy:<sup>9</sup> how much divergence from generally-accepted investor protection principles will states which are home to foreign investment tolerate in the interests of advancing differing conceptions of human rights in host states? We might ask, then ‘what kinds and degrees of divergence remain

<sup>4</sup> D Harvey, *Spaces of Hope* (Berkeley, University of California Press, 2000) 81.

<sup>5</sup> U Baxi, *The Future of Human Rights* (2nd edn) (New Delhi, Oxford University Press, 2006), c 8.

<sup>6</sup> E Borchard, ‘The ‘Minimum Standard’ of the Treatment of Aliens’ (1939) 33 *American Society of International Law Proceedings* 51.

<sup>7</sup> CH Schreuer, *The ICSID Convention: A Commentary* (Cambridge, CUP, 2001) 1082. As Coe, Jr. observes in relation to the North American Free Trade Agreement’s Investment Chapter, tribunals have generated, if somewhat unpredictably, ‘strands of uniformity’. See JJ Coe, Jr, ‘Taking Stock of NAFTA Chapter 11 in Its Tenth Year: An Interim Sketch of Selected Themes, Issues, and Methods’ (2003) *Vanderbilt Journal of Transnational Law* 1381 at 1409.

<sup>8</sup> M Coward, ‘The Globalisation of Enclosure: Interrogating the Geopolitics of Empire’ (2005) 26 *Third World Quarterly* 855.

<sup>9</sup> R Cox, Social Forces, States, and World Orders: Beyond International Relations Theory’ in R Cox with T Sinclair, *Approaches to World Order* (Cambridge, CUP, 1996) 85 at 878–91 and S Gill, ‘Epistemology, Ontology and the Critique of Political Economy’ in S Gill, *Power and Resistance in the New World Order* (Houndmills, Palgrave Macmillan, 2003) 15 at 17–19.

possible and desirable?’<sup>10</sup> This is not to deny variation in the investment treaty regime.<sup>11</sup> Rather, it is to try to determine the outer limits of toleration in the articulation of human rights norms when they run up against the economic interests of powerful OECD states.

The more radical side of Jürgen Habermas’s discourse theory is helpful to understanding some of the unevenness in the articulation and interpretation of rights. A discourse-theoretic account provides, Habermas maintains, a way to think through this tension. There are few more unabashed human rights universalists than Habermas. The contemporary discourse of individual rights, he insists, cannot be resisted. Rights perform critical functions in ‘modern economic societies’, including generating the ‘necessary conditions’ for commerce and an ‘individualistic legal order’.<sup>12</sup> Normatively, systems of rights establish the necessary preconditions for the generation of legitimate law through democratic institutions. Yet rights, according to Habermas’ account, are not ‘transcendentally pure’.<sup>13</sup> Instead, they should be considered the ‘product of historical circumstance and . . . perceived social contexts’.<sup>14</sup> Habermas’ work importantly underscores the capacity for democratic publics to frame, interpret, and then apply constitutional fundamentals. Though economic power may be constituted by law, and even privileged in the form of constitutional rights, economic power also can be tamed by the production of law. In which case, core rights, including investor rights, are legitimate candidates for reframing under processes of democratic opinion- and will-formation. I draw on this aspect of Habermas’ discourse-theoretic account in the first part of the paper in order to better understand the linkages between national approaches to rights and transnational ones represented by investor rights.

Moving beyond theory, in the second half of the paper I take up the case of failed talks between the South African Customs Union (SACU) (including South Africa, Botswana, Lesotho, Namibia, and Swaziland) and the US toward a comprehensive free trade and investment agreement. Negotiations ended in failure because of what the Office of the United States Trade Representative (USTR), in its press release, described as ‘differences’ that ‘will require detailed examinations over the longer term’.<sup>15</sup> The talks are instructive, however, in so far as

<sup>10</sup> T McCarthy, ‘On Reconciling Cosmopolitan Unity and National Diversity’ in P De Greiff and C Cronin (eds), *Global Justice and Transnational Politics* (Cambridge, The MIT Press, 2002) 267.

<sup>11</sup> M Sornarajah, *The International Law on Foreign Investment* (2nd edn) (Cambridge, CUP, 2004) 206.

<sup>12</sup> J Habermas, ‘On Legitimation Through Human Rights’, trans. William Rehg in Pablo De Greiff and Ciaran Cronin (eds), *Global Justice and Transnational Politics* (Cambridge, The MIT Press, 2002) 207–8.

<sup>13</sup> J Habermas, *Between Facts and Norms: Contributions to a Discourse Theory of Law and Democracy*, W Rehg (trans) (Cambridge, The MIT Press, 1998) 129.

<sup>14</sup> Habermas, *ibid.*, 314.

<sup>15</sup> United States Trade Representative, ‘US–SACU Agree to Pursue Concrete Steps to Deepen Trade and Investment Relations’ (18 Apr 2006) at <[http://www.ustr.gov/Document\\_Library/Press\\_Releases/2006/April/US-SACU\\_Agree\\_to\\_Pursue\\_Concrete\\_Steps\\_to\\_Deepen\\_Trade\\_Investment\\_Relations.html](http://www.ustr.gov/Document_Library/Press_Releases/2006/April/US-SACU_Agree_to_Pursue_Concrete_Steps_to_Deepen_Trade_Investment_Relations.html)> (last visited, Jun 14, 2007).

one of the roadblocks (though certainly not the sole one) was South Africa's program of 'black economic empowerment' (BEE)<sup>16</sup> designed to build up a new black indigenous entrepreneurial class. To the extent that the program rubs up against the logic of international investment law, the case study elucidates some of the difficulties countries like South Africa and others in the global South have in living up both to their own national constitutional commitments and those undertaken at the transnational level. It shines a light on the capacity of South Africans to draw out the content of constitutional rights more radically in the face of a powerful transnational legal order.<sup>17</sup>

That experience also enables me to join issue with those, like Hardt and Negri, who argue that it is grave mistake to 'harbor nostalgia' for the sovereign state.<sup>18</sup> They describe the decline of the nation-state as a 'structural and irreversible process' in which juridico-economic structures at local levels are being overtaken by transnational strictures associated with economic globalization.<sup>19</sup> Though they are correct to underscore the multiplicity of transnational sites that have overtaken national juridical structures, of which the investment rules regime is but one, they overstate the capacity of these structures to obliterate state legal forms. Rather than being rendered obsolete, national states (even those on the periphery) continue to play critical, even if subsidiary, roles in the future direction rules and institutions of economic globalization will take. I turn, first, to a brief discussion of the discourse-theoretic account of rights.

## II. PROCEDURALISM AND RIGHTS

In a fit of triumphalism, Habermas purports to solve the tension between democracy and rights.<sup>20</sup> In Habermas' proceduralist account, popular sovereignty is predicated upon the establishment of minimum core rights to equal liberty that are exercised in the private sphere. These private liberties guarantee the conditions for the exercise of political autonomy in the public sphere.<sup>21</sup> A vibrant public sphere, then, is dependant upon the private autonomy secured by basic private rights and liberties.<sup>22</sup> For these reasons, Habermas maintains,

<sup>16</sup> See Inside US Trade, 'US-African Forum Unlikely to Tackle BIT in Short Term' (5 May 2006).

<sup>17</sup> Dennis Davis similarly has found Habermasian discourse theory an appropriate candidate for understanding South African constitutional developments than competing accounts offered by Rawls or Dworkin. See 'Democracy and Integrity' in D Davis, *Democracy and Deliberation: Transformation and the South African Legal Order* (Kenwyn, Juta & Co Ltd, 1999).

<sup>18</sup> M Hardt and A Negri, *Empire* (Cambridge, Harvard University Press, 2000) 218, 336.

<sup>19</sup> Hardt and Negri, *ibid.*, 336.

<sup>20</sup> This part draws on D Schneiderman, 'Habermas, Market-Friendly Human Rights and the Revisability of Economic Globalization' (2004) 8 *Citizenship Studies* 419.

<sup>21</sup> Habermas, n 13 above, at 129.

<sup>22</sup> Habermas, n 13 above, at 125.

private and public autonomy—secured by equal rights and democratic deliberation—are ‘equally original’ or ‘co-original’.<sup>23</sup> They ‘require each other’.<sup>24</sup>

Individuals are recruited from the private sphere, according to this account, to participate in public sphere deliberations and the enactment of laws that steer and balance systems of economic and administrative power.<sup>25</sup> Even the constitutional system of rights is a legitimate subject of democratic opinion and will formation. It is in the public sphere and via the operation of legitimate law-making structures that these abstract rights get worked out, enabling democratic reflection on the meaning and application of basic rights.<sup>26</sup> It is in these fora that the ‘unsaturated’ basic rights of the private sphere are ‘*interpreted and given concrete shape*’ through the medium of law.<sup>27</sup>

The modern constitutional state is legitimate, Habermas maintains, ‘only to the extent that it secures the co-original private and public autonomy of its citizens’.<sup>28</sup> Basic rights to equal liberties operate, then, as both a precondition for and a product of constitutional democracy. What is presupposed, Michelman notes, is a polity, already constituted, which has settled upon a body of core fundamental liberties.<sup>29</sup> Insofar as Habermas’ proceduralist account resists hypothetical contractualist moments,<sup>30</sup> this is described as a co-originalist ‘trap’. There can be no core set of basic rights that are pre-political, only those that get worked out by the authors of law in the public sphere. In which case, constitutional framers cannot be bound by any stable regime of autonomy rights that promote equality and political participation.

Habermas seeks to resolve this paradox between democracy and rights by invoking the dimension of historical time. He describes co-originality as a ‘two-stage reconstruction’. Unsaturated basic rights act as legal principles that guide framers in their work.<sup>31</sup> A democratic constitution, Habermas writes, is a ‘tradition building project with a clearly marked beginning of time’. Later generations have the ‘task of actualizing the still untapped normative substance of the system of rights laid down’ in the original instance of framing.<sup>32</sup> In this way, the modern

<sup>23</sup> Habermas, n 13 above, at 409.

<sup>24</sup> Habermas, n 13 above, at 417; J Habermas, ‘Constitutional Democracy—A Paradoxical Union of Contradictory Principles?’ in J Habermas, *Time of Transitions*, ed, and trans by C Cronin and M Penser (Cambridge, Polity Press, 2006) 114.

<sup>25</sup> Habermas, n 13 above, at 169.

<sup>26</sup> A Arato, ‘Procedural law and Civil Society: Interpreting the Radical Democratic Paradigm’ in Michel Rosenfeld and Andrew Arato, eds. *Habermas on Law and Democracy: Critical Exchanges* (Berkeley, University of California Press), 326–36.

<sup>27</sup> Habermas, n 13 above, at 125.

<sup>28</sup> Habermas, n 13 above, at 409.

<sup>29</sup> FL Michelman, *Brennan and Democracy* (Princeton, Princeton University Press, 1999) 50; FL Michelman, ‘Constitutional Authorship’ in L Alexander (ed), *Constitutionalism: Philosophical Foundations* (Cambridge, CUP, 1998) 64 at 88.

<sup>30</sup> J Habermas, ‘Reconciliation Through the Public Use of Reason: Remarks on John Rawls’ Political Liberalism’ (1995) 92 *Journal of Political Philosophy* 109.

<sup>31</sup> Habermas, n 13 above, at 126.

<sup>32</sup> Habermas, n 24 above, at 122.



constitutional state, Habermas writes, is not a ‘finished structure, but a delicate and sensitive—above all fallible and revisable—enterprise, whose purpose is to realise the system of rights anew in changing circumstances, that is, to interpret the system of rights better, to institutionalise it more appropriately, and to draw out its contents more radically’.<sup>33</sup> Habermas’ project of rights is universalisable precisely because the authors of law can redraw rights to suit particular contexts, improve on prior practice, and draw out their contents even more radically.

If originating in the murky foundations of the past, the story of rights can be expected to gain legitimacy via developed practices of deliberation and law making over time. Habermas thereby maintains his grip on the procedural underpinnings of his model of rights and democracy. Both founders and later generations, Cronin observes, must be expected to ‘share an intuitive understanding of what it means to engage in a democratic constitutional project’.<sup>34</sup> This is an account in which there cannot be expected to be unframed framers. They are, instead, only ‘finite’ constitutional actors ‘who are socialised in concrete forms of life’ pragmatically engaged in constitution making practices.<sup>35</sup>

Habermas’ two-stage reconstruction helps us to better understand the novel processes leading to the adoption in 1996 of the Constitution of the Republic of South Africa.<sup>36</sup> The framers of the final constitution (a constitutional assembly composed of the National Assembly and the Senate of South Africa’s first democratically-elected Parliament) were given the task of devising a final constitutional plan. This plan had to accord with 34 constitutional principles identified in the 1993 interim constitution (the product of the multi-party Convention for a Democratic South Africa [CODESA], though dominated by the African National Congress [ANC] and the incumbent National Party [NP]).<sup>37</sup> While the text of the interim constitution clearly influenced the final version, the constitutional principles were expected to guide the framing exercise by laying down a number of substantive commitments (thoroughly ‘saturated’ principles, one might say) that were to control the constitutional assembly. So while the final draft would be in the hands of a body with the requisite legitimacy—the product of the first democratic election in South Africa—it would have to accord with the substantive limits laid down in the heat of multiparty negotiations during the transition to democracy.<sup>38</sup> The South African Constitutional Court was party to this process having been asked to certify whether the final version was in conformity with these underlying commitments.<sup>39</sup> Indeed, the Court rejected

<sup>33</sup> Habermas, n 13 above, at 384.

<sup>34</sup> C Cronin, ‘On the Possibility of a Democratic Constitutional Founding: Habermas and Michelman in Dialogue’ (2006) 19 *Ratio Juris* 343 at 358.

<sup>35</sup> Habermas, n 13 above at 324.

<sup>36</sup> The Constitution of the Republic of South Africa Act 108 of 1996.

<sup>37</sup> The Constitution of the Republic of South Africa Act 200 of 1993.

<sup>38</sup> See R Spitz with M Chaskalson, *The Politics of Transition: A Hidden History of South Africa’s Negotiated Settlement* (Oxford, Hart Publishing, 2000) 78–80.

<sup>39</sup> H Klug, *Constituting Democracy: Law, Globalism and South Africa’s Political Reconstruction* (Cambridge, CUP, 2000) 50–2.

the first version of the final constitution on nine separate grounds in its first certification judgment, and approved a second draft a few months later.<sup>40</sup>

Despite the implication that this discussion concerning rights is to be one ‘without end’,<sup>41</sup> there are some suggested limits, as the South African case suggests. Constitutionalism appears to be privileged over democracy—constitutional projects, as laid down by constitutional forebears, are favored over alternative schemas. In which case, the authors of law are not also fully its addresses, as Habermas maintains.<sup>42</sup> ‘In what sense’, asks Honig, ‘can the people be said to have free authorship if they are required to approach the constitution as their forebears did, with the same standards and from the same perspective’.<sup>43</sup> There also is some ambivalence in Habermas’ scheme about the relationship between rights and markets.<sup>44</sup> Habermas is attuned to growing inequalities in the modern world and the distorting effects of money on democratic processes. Yet, he also insists that traditional civil rights, such as rights to property and to contract, are prerequisites to the legitimacy of the constitutional state. Habermas admits, however, that those rights will be interpreted and applied differently across space and time. They have the potential of being the subject of continual contemplation via deliberative democratic processes. We might understand paradigmatic shifts in the understanding of property rights, from its expansive classical nineteenth-century liberal version to its more modest twentieth-century functional version, in this way.<sup>45</sup>

In which case, we can expect the authors and addressees of law operating within national legal frames to draw out different implications from the global discourse of human rights. We might say that South Africans did just that in their 1993 interim and 1996 final constitution. Having no domestic human rights tradition to draw upon, they looked to the constitutional experience of other states, such as Germany, Canada, and the US, while drawing out the content of rights, we might say, more radically. Property rights, for instance, are relaxed in ways that permit their redistribution through land reform in order to redress past racial discrimination under apartheid.<sup>46</sup> Property can be taken with the provision of something less than fair market value where it is ‘just and equitable to do so’ having regard to a range of factors including the history of acquisition of the property and the extent of state investment and subsidy in the acquisition

<sup>40</sup> *In re Certification of the Constitution of the Republic of South Africa* 1996, (4) SA 744 (6 Sept); *In re Certification of the Amended Text of the Constitution of the Republic of South Africa* 1996 (2) SA 97 (4 Dec).

<sup>41</sup> Cronin, n 34 above, at 357.

<sup>42</sup> Habermas, n 13 above, at 104.

<sup>43</sup> B Honig, ‘Dead Rights, Live Futures: A Reply to Habermas’s ‘Constitutional Democracy’’ (2001) 29 *Political Theory* 792 at 795.

<sup>44</sup> See, eg, WE Scheuerman, ‘Between Radicalism and Resignation: Democratic Theory in Habermas’ Between ‘Facts and Norms’ in R Von Schomberg and K Baynes (eds), *Discourse and Democracy: Essays on Habermas’ Between Facts and Norms* (Albany, State University Press of New York, 2002).

<sup>45</sup> Habermas, n 13 above, 403. This is discussed further in Schneiderman, n 20 at 424–5.

<sup>46</sup> The Constitution of the Republic of South Africa Act 108 of 1996, s 25(8).

or improvement of the property.<sup>47</sup> These rules, as I have argued elsewhere, are at variance with norms promoted in contemporary investment treaty practice.<sup>48</sup>

The resulting constitutional text is a mélange of classically liberal freedoms, modern equality protections, and social rights. Drawing on these legal sources, the ANC government embraced a policy to bring a fraction of black South Africans out of poverty by generating a new black middle class. It is to a discussion of this policy that I turn next.

### III. BLACK ECONOMIC EMPOWERMENT

The rush of excitement associated with the constitutional and political transformation of South Africa in the mid-1990s has been replaced by residual stark inequalities.<sup>49</sup> By virtually any economic indicator, black South Africans remain at the bottom rungs of the economic ladder.<sup>50</sup> Unemployment in South Africa hovers over forty per cent; wealth and land ownership remains concentrated in the hands of the privileged few.

Policy options seemingly were few when the ANC took power in the first democratic elections in 1994.<sup>51</sup> Projects of nationalization<sup>52</sup> gave way to the embrace of a multi-pronged program of economic liberalism, including the generation of a new black entrepreneurial middle class. Enterprises were expected to part with minority control of their South African operations at discounted prices to black entrepreneurs.<sup>53</sup> Initially, ANC leadership believed that this could be achieved through the ordinary operation of market processes without the steering mechanism of the state.<sup>54</sup> Given the scarcity of capital among Black South Africans, financing of BEE deals was achieved via ‘special purpose

<sup>47</sup> The Constitution of the Republic of South Africa Act 108 of 1996, s 25(3).

<sup>48</sup> D Schneiderman, ‘Investment Rules and the New Constitutionalism’ (2000) 25 *Law & Social Inquiry* 757.

<sup>49</sup> Parts III and IV of the paper draw on D Schneiderman, *Constitutionalizing Economic Globalization: Investment Rules and Democracy’s Promise* (Cambridge, CUP, forthcoming), c 5.

<sup>50</sup> A Handley, ‘Business, Government and Economic Policymaking in the New South Africa, 199–2000’ (2005) 43 *J of Modern African Studies* 211; R Burgess and T Harjes, ‘South Africa: Unlocking the Door to Faster Growth’ (2005) 34 *IMF Survey* 360; D Rodrik, ‘Understanding South Africa’s Economic Puzzles’ (Sept 2006) <<http://ksghome.harvard.edu/~drodrik/Understanding%20South%20Africa.pdf>> (last visited, Jun 14, 2007); and B Stokes, ‘South Africa Surviving’ *National Journal* (3 Feb 2007) 28.

<sup>51</sup> N Mandela, ‘South Africa’s Future Foreign Policy’ (1993) 72 *Foreign Affairs* 86; H Marais, ‘The Logic of Expediency: Post-Apartheid Shifts in Macro-Economic Policy’ in S Jacobs and R Calland (eds), *Thabo Mbeki’s World: The Politics and Ideology of the South African President* (Pietermaritzburg and London, University of Natal Press and Zed Books, 2002) 83.

<sup>52</sup> H Marais, *South Africa: Limits to Change: The Political Economy of Transformation* (London and Cape Town, Zed Books and UCT Press, 1998) 146.

<sup>53</sup> See discussion in D Gqubule, ‘Black Participation in the Economy of South Africa After 1994’ in D Gqubule (ed), *Making Mistakes Righting Wrongs: Insights into Black Economic Empowerment* (Johannesburg and Cape Town: Jonathan Ball Publishers), 2006 at 117.

<sup>54</sup> S Gelb, ‘Creating a Black Business Class in South Africa’ (2004) *CNEM Newsletter* #7 (Summer).

vehicles', often resulting in little control and few dividends to BEE companies and their owners.<sup>55</sup> With a subsequent market downturn in the years following 1998, soaring interests rates frustrated debt repayment based solely on returns from dividends. Numbers of companies defaulted. Or, white-owned enterprise established BEE corporate 'fronts' with full operating control and ownership remaining in original hands. On those occasions where BEE-based divestiture was successful, it tended to benefit a small cadre of former ANC activists like Cyril Ramaphosa (former Secretary General and chief constitutional negotiator), Tokyo Sexwale (former Gauteng provincial premier and candidate to succeed Thabo Mbeki as ANC leader) and Patrice Motsepe (another former provincial premier).<sup>56</sup> These 'BEE-lionaires' were handpicked to buy equity shares in a variety of white-owned businesses.<sup>57</sup> The program was severely discredited for its cronyism and corruption, prompting Archbishop Desmond Tutu to pronounce that BEE benefited only a small 'recycled elite'.<sup>58</sup>

Under prodding from black business leadership,<sup>59</sup> President Thabo Mbeki changed tack and embraced 'broad-based' black economic empowerment. The broad-based version is measured not only by equity ownership, but by increasing the number of black-controlled enterprises, encouraging the hiring and promotion of blacks into executive and managerial ranks, and by measuring levels of procurement by private industry from black-owned enterprises. The strategy is intended to be inclusive so that economic empowerment benefits all black people, including women, workers, youth, people with disabilities, and people in rural areas.

The public and private sectors are expected to comply with 'codes of good practice', which refine BEE objectives and generate indicators for measuring progress using BEE 'scorecards'. Sectoral 'transformation Charters' have been developed by particular industries in cooperation with government, including those for the mining, construction, and financial services sectors.

There is a heavy emphasis on voluntarism in the documentation around BEE. Though a state-driven initiative, the process is described as 'inclusive'. All enterprises operating in South Africa are expected to 'participate' in the establishment of 'innovative partnerships'. After a badly received first draft of the mining charter, the government has acceded a great deal of authority to industry in the

<sup>55</sup> V Jack, 'Unpacking the Different Waves of BEE' (2006) 22 *New Agenda: The South African Journal of Social and Economic Policy* 19; A Hirsch, *Season of Hope: Economic Reform Under Mandela and Mbeki* (Scottsville and Ottawa, University of KwaZulu-Natal Press and International Development Research Centre, 2005) 122 <<http://www.idrc.ca/openbooks/215-5>> (last visited, Jun 14, 2007).

<sup>56</sup> OC Iheduru, 'Black Economic Power and Nation-Building in Post-Apartheid South Africa' (2004) 42 *J of Modern African Studies* 1 at 12.

<sup>57</sup> J Cronin, 'BEE-lionaires and Wanna-BEEs' (2004) *Mail & Guardian* (20 Oct).

<sup>58</sup> A Meldrum, 'Tutu Says Mbeki Enriching Few at the Expense of the Poor' *The Guardian* (24 Nov 2004) <<http://www.guardian.co.uk/international/story/0,,1358029,00.html>> (last visited, Jun 14, 2007).

<sup>59</sup> Black Economic Empowerment Commission, *Report* (Johannesburg, Skotaville Press, 2001).

drafting of sectoral charters.<sup>60</sup> Many companies have responded positively to the government's lead. Deutschebank, for instance, divested itself of 25 per cent control over its South African operation to black-owned enterprise. Merrill Lynch announced in 2006 the sale of an 8.5 per cent stake in its South African operations to its black employees and a consortium of black women professionals.<sup>61</sup> Others were slower to respond. The energy company Sasol included BEE among the 'risk factors' of doing business in South Africa in its 2003 US Securities and Exchange Commission filing. The company has since changed course and is reported to have 'embraced' BEE, hiring its first black executive director (with plans to hire two more) and selling a minority share of its liquid fuels operation to a black consortium.<sup>62</sup>

Although the discourse of voluntarism is predominant, government holds in reserve financial rewards for those companies that perform well on their scorecards. Enabling legislation mandates that 'every organ of the state and public entity' will take BEE measurements into account in granting procurement contracts, licenses, concessions, undertaking the sale of state-owned enterprise, and in entering into private sector partnerships. In the realm of mining rights, the new Act of 2002 requires owners of existing mining rights to convert to 'new order rights' and successful conversion is dependant upon compliance with BEE standards.<sup>63</sup> There is much, then, that government can do to promote BEE. The UK management group Proudfoot, for this reason, sold off a 51 per cent stake in its South African operation to empowerment companies in February 2005 because it feared 'the increased likelihood of exclusion from future government and public sector work without appropriate empowerment accreditation and broad-based ownership'.<sup>64</sup>

All of this is, unequivocally, in furtherance of constitutional rights and values.<sup>65</sup> The ANC government expressly connects the policy to the equality-promoting provisions of the 1996 constitution intended to erase the legacy of apartheid's racist past. Section 9 (2) of the constitution, in particular, enables the state to take 'measures designed to advance the condition of persons dis-

<sup>60</sup> Gelb, n 54 above at 2.

<sup>61</sup> S Gunnion, 'Merril Lynch Seals Empowerment Deal' *Business Day* (9 Feb 2006) <<http://www.businessday.co.za/articles/frontpage.aspx?ID=BD4A152279>> (last visited Jun 14, 2007).

<sup>62</sup> J Reed, 'Sasol Sells Stake in Unit to Black Investors' *Financial Times* (23 Sept 2005) 30; J Reed, 'A Race to Meet Black Empowerment Rules' *Financial Times* (26 Sept 2005) 16.

<sup>63</sup> E Maluleke, 'Finding a Balance between the Rights of the Few and the Many', *Business Day* (10 May 2004) at <<http://www.businessday.co.za>> (last visited, 14 June 2007).

<sup>64</sup> P Wadula, 'Stake in Proudfoot's Africa Arm Sold to Black Investors' *Business Day* (17 Feb 2005) 15

<sup>65</sup> This constitutional lineage is admitted in the preamble to the BEE Act, which expressly declares that the bill is intended to 'promote the achievement of the constitutional right to equality'. Also see South Africa, Department of Trade and Industry, 'South Africa's Transformation: A Strategy for Broad-based Black Economic Empowerment' [Mar 2003] 1.3 and A Sachs, 'The Constitutional Principles Underpinning Black Economic Empowerment' in X Mangcu, G Marcus, K Shubane, and A Hadland (eds), *Visions of Black Economic Empowerment* (Auckland Park: Jacana Media (Pty) Ltd, 2007) c 2.

advantaged by unfair discrimination'. Other provisions mandate not only equality of opportunity but of outcome (s 9[2]). The state is expected to perform a variety of redistributive functions, including taking measures to foster access to property (s 25[5]), land and water reform (s 25[8]), rights to adequate housing (s 26), rights to health care, sufficient food and water, social security (s 27), and to education (s 28). Procurement practices also are expected to advance these constitutional objectives: while procurement is required to be 'fair, equitable, transparent, competitive and cost-effective', any organ of the state may take measures to prefer categories and the advancement of persons 'disadvantaged by unfair discrimination' (s 217). The federal government is required, by the terms of this section of the constitution, to implement national framework legislation to achieve these procurement objectives.

#### IV. RIGHTS IN DIFFERENT REGISTERS

According to Vandevelde, US trade policy has been in the single-minded pursuit of developing a body of state practice establishing the highest protections for foreign investment that would rise to the level of international law.<sup>66</sup> South Africans and their SACU partners certainly must have been aware that negotiations toward a free trade and investment treaty would be tough.<sup>67</sup> They also were aware that good faith negotiations provided an opportunity to deepen access to US markets gained initially through the Africa Growth and Opportunity Act (AGOA).<sup>68</sup> AGOA unilaterally admits goods from Africa duty free into the US and is due to expire in 2015.<sup>69</sup>

Just how discordant were the constitutional values advanced by BEE and promoted by the South African negotiators with the high standards of protection for investors promoted by US negotiators? It might be claimed that there were no inconsistencies. Some commentators argue, for instance, that investor protections such as those found in NAFTA's Chapter Eleven do not overly constrain the regulatory space of national states. Instead, fears that this may be the case are characterised as 'highly speculative' and even 'exaggerated'.<sup>70</sup> The

<sup>66</sup> KJ Vandevelde, 'The BIT Program: A Fifteen-Year Appraisal' (1992) *American Society of International Law Proceedings* 53.

<sup>67</sup> N Bayne, 'Bilateral Economic Diplomacy: The United States' in N Bayne and S Woolcock (eds), *The New Economic Diplomacy: Decision-Making and Negotiation in International Economic Relations* (Aldershot, Ashgate, 2003) 163, 172.

<sup>68</sup> United States, The Trade and Development Act of 2000, Title 1, Public Law 106–200 106th Congress.

<sup>69</sup> The Africa Growth and Opportunity Act of 2000 removes import duties on goods such as apparel and footwear from 37 sub-Saharan countries. The Act was to expire in 2008, but was extended in time by President George W Bush until 2015. See AGOA Acceleration Act of 2004, PL 108–274 and The Library of Congress, Congressional Research Service, 'United States-Southern African Customs Union (SACU) Free Trade Agreement negotiations: Background and Potential Issues' (14 Jul 2006) at 5.

<sup>70</sup> AS Alexandroff, 'Introduction' in Alexandroff (ed), *Investor Protection in the NAFTA and Beyond: Private Interest and Public Purpose* (Toronto, CD Howe Institute, 2006) 196.

methodology used in these sorts of assessments often involve nothing more than the counting of investment tribunal cases and decoding a balance sheet of winners and losers.<sup>71</sup> Yet these commentators would not deny the functional and normative aims served by Chapter Eleven and the investment regime of which it forms a part. Canadian trade law experts Hart and Dymond, for instance, admit that the objective of investor rights is to impose the disciplines of the Fifth and Fourteenth amendments of the US constitution on all governments, making them ‘a critical part of the architecture of rules and procedures for governing the global economy’.<sup>72</sup> Congressional leaders in 2002 expressly admitted that they sought to promote US constitutional norms globally through their trade and investment treaty program.<sup>73</sup> It should attract little controversy to claim, as I have elsewhere, that the investment rules regime exhibits ‘constitution-like’ characteristics associated with limited government.<sup>74</sup> In which case, normative commitments made at the transnational level might well be dissonant with commitments made within national constitutional domains in so far as they do not merely replicate classical constitutional conceptions of limited government.<sup>75</sup> South Africans unquestionably turned this corner, moving beyond classical legal thinking in their 1993 interim and 1996 final constitutions.<sup>76</sup>

To return to the question posed at the beginning of this paper: how far will the leading authors of the investment rules regime tolerate the right to be different in the construction of rights? What scope is there for states, following Habermas, to codify and interpret investor rights differently over the course of constitutional time? The outcome of negotiations between SACU and the US suggests not a lot of variation will be tolerated. This is not to say that the BEE plan runs entirely afoul of typical investment disciplines. The Department of Trade and Industry wisely emphasises the stick of procurement in promotion of BEE (associated with the third wave of BEE).<sup>77</sup> Many states actively encourage the hiring of disadvantaged persons distinguished by race and class and many firms already will be complying with these sorts of requirements within their home states. South Africa is not a signatory to the Uruguay-round plurilateral

<sup>71</sup> I have taken issue with this sort of methodology elsewhere. See D Schneiderman, ‘Constitution or Model Treaty? Struggling Over the Interpretive Authority of NAFTA’ in S Choudhry (ed), *The Migration of Constitutional Ideas* (Cambridge, CUP, 2006) 294 at 312–13.

<sup>72</sup> M Hart and W Dymond, ‘NAFTA Chapter 11: Precedents, Principles, and Prospects’ in Laura Ritchie Dawson (ed), *Whose Rights? The NAFTA Chapter 11 Debate* (Ottawa, Centre for Trade Policy and Law, 2002) 168. The Fifth and Fourteenth Amendments to the US Constitution (the ‘takings’ clause) guarantee that property shall not be taken for a public purpose without the provision of just compensation. See DA Dana and TW Merrill, *Property: Takings* (New York, Foundation Press, 2002).

<sup>73</sup> See M Poirier, ‘The NAFTA Chapter 11 Expropriation Debate Through the Eyes of a Property Theorist’ (2003) 33 *Environmental Law* 851.

<sup>74</sup> See Schneiderman, n 48 above.

<sup>75</sup> The classical view is well represented in CH McIlwain, *Constitutionalism Ancient and Modern* (Ithaca, Cornell University Press, 1966).

<sup>76</sup> See K Klare, ‘Legal Culture and Transformative Constitutionalism’ (1998) 14 *South African Journal on Human Rights* 146.

<sup>77</sup> Jack, n 55 above, at 20.

Agreement on Government Procurement (GPA), and so need not comply with the strict requirements on government purchasing which likely would undermine the compliance mechanisms contemplated by the BEE plan.<sup>78</sup> Even the United States has exempted minority set-aside schemes from GPA disciplines.<sup>79</sup> Rewarding foreign investors with licenses, concessions, or the selling off of state-owned enterprise, by contrast, could run up against the principal of national treatment. The 1998 South Africa-UK bilateral investment treaty (BIT) (South Africa's model treaty until 2001), commits South Africa not to treat UK investors and their investments to 'treatment less favorable than that which it accords to its own nationals or companies'.<sup>80</sup> In so far as foreign nationals—including the sub-set of foreign black-owned companies—are structurally disadvantaged in applying for licenses or competing for the sale of state-owned enterprise compared to local competitors, namely black-owned enterprise, then such measures might be construed as discriminatory.<sup>81</sup> The program can be characterized as non-discriminatory on its face as its burdens fall on all large firms, foreign or national. The scheme is structured, however, in ways that benefit locals—by definition, it is intended to promote black indigenous entrepreneurs who are nationals of South Africa—disfavoring foreign nationals and so potentially triggering the obligation of national treatment. Much would turn on the appropriate comparator group for the purposes of determining whether there has been discrimination. In a suggestive paper, Peterson indicates that the proper comparator for the purposes of discrimination analysis would be 'local investments owned by South Africans who do not hail from historically-disadvantaged groups'.<sup>82</sup> Such a choice of comparator would signal a shift away from the more exacting equality analysis of investment rules disciplines, typically mandating strict egalitarianism and an emphasis on investor impact,<sup>83</sup> in favour of one that tolerates preferential treatment for the purpose of remedying historical discrimination.<sup>84</sup> This is a path that investment tribunals have not yet

<sup>78</sup> P Bolton, 'The Use of Government Procurement as an Instrument of Policy' (2004) *The South African Law Journal* 619 and C McCrudden, 'International Economic Law and the Pursuit of Human Rights: A Framework for Discussion of 'Selective Purchasing' Laws under the WTO Government Procurement Agreement' (1999) 3 *Journal of International Economic Law* 8.

<sup>79</sup> McCrudden, *ibid* at 20; Stefan Griller, 'Selective Purchasing Under the GPA' in Stefan Griller (ed), *International Economic Governance and Non-Economic Concerns: New Challenges for the International Legal Order* (New York, SpringerWien, 2003) at 272; and CF Corr and K Zissis, 'Convergence and Opportunity: The WTO Government Procurement Agreement and US Procurement Reform' (1999) 18 *NYL Sch J Int'l & Comp L* 303 at 346.

<sup>80</sup> Article 3.

<sup>81</sup> Sornarajah, n 11 above, at 321, 325.

<sup>82</sup> L Peterson, 'South Africa's Bilateral Investment Treaties: Implications for Development and Human Rights' *Dialogue on Globalization Occasional Paper No 26* (Nov) (Geneva, Friedrich-Ebert-Stiftung, 2006) at 31 <[http://www.fes-globalization.org/publications/FES\\_OCP26\\_Peterson\\_SA\\_BITS.pdf](http://www.fes-globalization.org/publications/FES_OCP26_Peterson_SA_BITS.pdf)> (last visited, Jun 14, 2007).

<sup>83</sup> See, for example, the tribunal decision in *SD Myers, Inc v Government of Canada* (2001) 40 *International Legal Materials* 1408.

<sup>84</sup> This is the sort of treatment endorsed by the Indian Supreme Court in *State of Kerala v NM Thomas* AIR 1976 SC 490 and the Constitutional Court of South Africa in *Minister of Finance v Van Heerden* 2004 (6) SA 121.



taken, but may be foreshadowed, perhaps, by the narrow comparator group chosen in the unsuccessful challenge to the state of California's ban on the use of a methanol-based gasoline additive in *Methanex*.<sup>85</sup>

It is with these concerns in mind that South Africa's Department of Trade and Industry has deviated from the standard language in recent bilateral investment treaties with China, Iran, Russia, and the Czech Republic, among others. The usual requirements of national treatment, most favored nation, and fair and equitable treatment are subject to the exception of laws or measures, 'taken pursuant to Article 9 of the Constitution . . . the purpose of which is to promote the achievement of equality in its territory, or designed to protect or advance persons, or categories of persons, disadvantaged by unfair discrimination'.<sup>86</sup> In which case, aspects of BEE should be immune to challenge from foreign investors from these countries. Investors based in numerous European countries that signed bilateral investment treaties with South Africa in the nineties based on a UK model will not be so restricted from pursuing claims as these do not contain a 'promotion of equality' exception.<sup>87</sup>

Perhaps the most problematic aspect of the BEE program from the perspective of investors concerns the issue of 'ownership'.<sup>88</sup> SACU-US negotiations were plagued, according to the online resource Inside US Trade, by questions on investment and how US companies would comply with BEE.<sup>89</sup> American negotiators would have been emboldened by reports that US-based companies 'indicated they could not meet empowerment criteria'.<sup>90</sup> Even the State Department reported that, though US companies 'support the broad goals' of BEE, they expressed concerns about the 'lack of clarity and consistency' in BEE rules and had a 'major concern' with the requirements of equity ownership.<sup>91</sup>

BEE Charters and 'codes of good practice' call for the divestiture of minority share ownership in the range of twenty five per cent in a variety of sectors (eg financial institutions, mining, information and communications technology). Firms not included within the scope of these charters are expected generally to

<sup>85</sup> *Methanex v USA* (2005) 44 *International Legal Materials* 1345 [Final Award of the Tribunal on Jurisdiction and Merits, 3 Aug]. The tribunal ruled that, for the purposes of the national treatment argument, the preferred comparator group was not merely a group of competitors at large, including those who produced a different product, but a group that was identical to the claimant in all respects but nationality and who produced precisely the same product (at IV.B.17). The case is discussed in detail in D Schneiderman, n 48 above, ch 3.

<sup>86</sup> 2000 South Africa–Iran BIT.

<sup>87</sup> Peterson n 82 above, 30. There are sketchy reports that a Swiss investor successfully sued for compensation under a 1997 South Africa–Switzerland BIT. See Peterson *ibid* at 35 and Trade Law Centre for Southern Africa, 'Investment Project: South African Case Study' (May 2004) at 10, 14.

<sup>88</sup> T Makgetla, 'Foreign Firms Fret over BEE', *Mail & Guardian* (25 Jan 2006) <[http://www.mg.co.za/printPage.aspx?area=/insight\\_economy\\_business/&articleId](http://www.mg.co.za/printPage.aspx?area=/insight_economy_business/&articleId)> (last visited, June 14, 2007).

<sup>89</sup> Inside US Trade, 'August Round of SACU Talks Delayed, USTR Says No New Date Set' (9 Jul 2004).

<sup>90</sup> Inside US Trade, 'Slow Pace of SACU FTA Negotiations Raises Doubts Among Supporters' (7 May 2004).

<sup>91</sup> United States Department of State, '2005 Investment Climate Statement—South Africa' <<http://www.state.gov/e/eb/ifa/2005/42112.htm>> (last visited, June 14, 2007).

perform well on BEE scorecards if they, too, hope to receive the benefits that flow from equality-promoting corporate practice. These government-induced expectations, it might be argued, are measures equivalent to expropriation in so far as government hopes to deprive investors indirectly of a significant part of their investment interest, though with the provision of compensation.<sup>92</sup> Foreign firms whose global practice is not to sell equity scored a pretty big victory in late 2006 when they secured exemptions from the divestiture components of cabinet-approved codes of good practice. Closely-held foreign companies are expected to develop a range of equity-equivalents that will perform similar functions as transfers of ownership.<sup>93</sup> This renders more tentative claims that such measures are tantamount to expropriation, at least for those firms that qualify for equity equivalents. Non-qualifying firms might claim that the ownership requirements are in the nature of a taking, in which case, these measures could not be shielded from attack by the ‘promotion of equality’ exception included in recent South African BITs. There are no exceptions to indirect or regulatory takings under either the old or new model of investment treaty used by South Africa.

It is even less likely that investor suits can be forestalled (though not necessarily won) in regard to state measures associated with BEE and enshrined in legislation, such as the Mineral and Petroleum Development Act of 2002. As mentioned, owners of existing mining rights are required to convert to ‘new order rights’ under the Act—successful conversion is dependant upon compliance with BEE standards.<sup>94</sup> This disturbance of acquired rights has prompted allegations of expropriation. The Executive Director of Anglo-American in 2002 alluded to the possibility of launching a claim under the South Africa-UK BIT for the alteration of mining rights but admitted that political considerations militated against it.<sup>95</sup> Instead, investors in a family-owned Luxembourg-based granite mining enterprise have launched an investment dispute claiming that their subsidiaries in South Africa have been stripped of mining rights, amounting to an expropriation, and that the ‘forced’ divestiture of 26 per cent of the enterprise to historically disadvantaged South Africans amounts to a denial of

<sup>92</sup> United Nations Conference on Trade and Development, *Investor-State Disputes Arising from Investment Treaties: A Review* (New York and Geneva, United Nations, 2005) 46. On measures that deprive an investor of a ‘significant part’ of an investment interest, see *Metalclad Corporation and the United Mexican States* (2001) 13 *World Trade and Arbitration Materials* 47 at para 103 and, on ‘partial takings’ that amount to indirect expropriation, see *SD Myers, Inc. v Government of Canada* (2001) 40 *International Legal Materials* 1408 at para 283.

<sup>93</sup> See South Africa, Department of Trade and Industry, ‘Guidelines: Equity Equivalent Programme for Multinationals’ at <<http://www.thedti.gov.za/bee/EquityEquivalentGuideline2007>> (last visited, June 14, 2007); C Southey, ‘South Africa exempts foreign groups on black empowerment’ *The Financial Times* (15 Dec 2007) 7; S Njobeni, ‘Multinationals Get Clarity on BEE Codes’ *Business Day* (15 Dec 2006) at <<http://www.businessday.co.za/articles/article.aspx?ID=BD4A342686>> (last visited, Jun 14, 2007).

<sup>94</sup> Maluleke, n 63 above.

<sup>95</sup> L Peterson, ‘South Africa’s Plans for Black Economic Empowerment Confronting Foreign Investor Rights: Investment Law and Policy News Bulletin (9 May 2003)’ <[http://www.iisd.org/pdf/2003/investment\\_investsd\\_May9\\_2003.pdf](http://www.iisd.org/pdf/2003/investment_investsd_May9_2003.pdf)> (last visited, Jun 14, 2007).

fair and equitable treatment.<sup>96</sup> Such investor disputes, together with the collapse of US–SACU talks and the concession to closely-held corporations in codes of good practice, makes clear that the actors and institutions comprising the investment rules regime are not likely to tolerate well this modest departure from the regime of investor rights. Rather than being fallible and revisable and subject to continual democratic reassessment, the contents of investor rights are intended, instead, to constrain and dominate those very processes.

## V. CONCLUSION

South African negotiators have convinced a small number of states to modify investment treaty practice to accommodate a promotion-of-equality exception. It likely is from within countries like South Africa, we might conclude, that divergent understandings of the relation between state and market of this sort will be articulated in investment rules. Emerging out of the ruins of apartheid, many people—from ordinary citizens to heads of state—wish the democratic and multiracial experiment of South Africa to succeed. South Africans might be able to trade on this moral authority, so to speak, so as to extract concessions from powerful economic actors, as social movement actors have for instance, in gaining access to lower cost drugs to combat HIV/AIDS (despite the AIDS denialism President Thabo Mbeki).<sup>97</sup> To the extent that South African negotiators can successfully engage other states on these terms, they might begin to generate a modest counter-narrative to the dominant model of investor protection. It is one that recognises the role of the state in fashioning solutions to economic inequality beyond the dominant paradigm offered by international investment law. It is a path that Habermas' discourse-theoretic account would recommend but a change of direction to which powerful OECD states are unlikely to follow.

This is not to say that broad-based BEE is also not without its problems—it so far has assisted a narrow class of economic entrepreneurs and likely will not resolve the deep and persistent economic inequalities that prevail in South Africa.<sup>98</sup> It is only to say that South Africans, in addition to the peoples of other states, should be entitled to experiment in these ways. It is to say that investment rules should not be available to hinder or frustrate transitions to a better future, even ones only slightly more tolerable than the present.

<sup>96</sup> B Ryan, 'Mining Law: Big Test of Rights' *Financial Mail* (23 Feb 2007) at [secure.financial-mail.co.za/07/0223/features/efeat.htm](http://secure.financial-mail.co.za/07/0223/features/efeat.htm); T Creamer, 'Italy Raises Concern About SA's Mine Law, But Takes Hands-Off Position in Granite Dispute' *Mining Weekly Online* (15 Mar 2007) at [http://www.miningweekly.co.za/article.php?a\\_id=105736](http://www.miningweekly.co.za/article.php?a_id=105736) (last visited, Jun 14, 2007).

<sup>97</sup> H Klug, 'Campaigning for Life: Building a New Transnational Solidarity in the Face of HIV/AIDS and TRIPS' in B Sousa Santos and Rodríguez-Garavito (eds), (Cambridge, CUP, 2005) 118.

<sup>98</sup> M MacDonald, 'The Political Economy of Identity Politics' (2004) 103 *The South Atlantic Quarterly* 629.

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