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Public versus Private Enforcement of International Economic Law: Standing and Remedy

Alan O. Sykes

ABSTRACT

This paper develops a theory of the rules regarding standing and remedy in international trade and investment agreements. Regarding investment agreements, the paper argues that a credible government-to-firm commitment (or signal) that the capital importer will not engage in expropriation or related practices is required and that a private right of action for money damages is the best way to make such a commitment. In trade agreements, by contrast, importing nations have commitments that are best viewed as government to government rather than government to firm. The parties to trade agreements can enhance their mutual political welfare by declining to enforce commitments that benefit politically inefficacious exporters and can most cheaply do so by reserving to themselves the standing to initiate dispute proceedings—a right to act as a political filter. The paper also suggests why governments may prefer to utilize trade sanctions rather than money damages as the penalty for breach of a trade agreement.

Like all bodies of law, the public international law of trade and investment requires an enforcement mechanism. The choices to be made in designing such a mechanism are many. Parties to trade and investment agreements must decide whether to create an adjudicative body to hear complaints about alleged breach of obligations or to rely on informal diplomacy. They must decide whether to create formal sanctions for

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breach of obligations or to rely on each party's concern for its reputation and perhaps unilateral retaliation or "self-help" to discourage breach. If they choose to create an adjudicative body, they must decide who has standing to bring complaints before that body. And if they choose to create a formal sanction for breach of obligations, they must select the type of penalty that they will use as well as some principle for calibrating its magnitude.

A fair amount has been written about some of these issues in international economic law, but little has been written from an analytical perspective about what the law and economics literature terms the choice between public and private enforcement of law (exceptions include Levy and Srinivasan 1996; Trachtman and Moremen 2003; and Nzelibe 2005). This choice becomes relevant once parties to an international agreement elect to allow an adjudicative body to hear complaints. They may then reserve to themselves the exclusive right to petition that body (public enforcement) or allow private actors with a stake in the dispute to petition it (private enforcement). Intertwined with that choice is the parties' choice of a sanction for breach of obligations—regardless of who has standing before the adjudicative body, the parties to the pertinent agreement may provide no formal sanctions for a finding of breach, they may provide for sanctions that only a governmental party to the agreement has the capacity to administer (such as trade sanctions), or they may provide for money damages that can be paid to the parties injured by violations.

A quick survey of international economic law reveals quite a mixed picture along these dimensions. Private rights of action for money damages have become routine in international investment agreements. In the trade area, by contrast, money damages are much more circumscribed, and provisions for the award of such damages are absent from important multilateral arrangements (although they are always an option for the settlement of disputes as a practical matter). Likewise, some trade agreements afford private actors standing to enforce the rules in a court, while others do not. The goal of this paper is to explain these features of current law from a political economy perspective.

In brief, I argue that in the investment arena, the function of international agreements is to reduce the perceived risk of expropriation and related events for private investors and thereby to reduce the cost of capital for capital-importing nations. The most effective mechanism to achieve such risk reduction is a private right of action for compensatory damages should an importing nation engage in proscribed behavior. In

the trade arena, by contrast, the function of international agreements is to make credible government-to-government commitments regarding market access and thereby to raise mutual political welfare relative to an environment without bilateral or multilateral cooperation. For the enforcement of such agreements, it can suffice to provide standing and remedy only to governments, and indeed a private right of action for damages may prove politically counterproductive for reasons that I will explain. Governments can then achieve mutual gains by reserving standing to themselves and becoming political filters for enforcement action, especially when *ex post* legislative action to reverse problematic adjudicative decisions is infeasible. Regarding the remedy available for breach of trade agreements, I offer several reasons why governments might prefer to employ trade sanctions rather than money damages and in the process rebut the suggestion by other commentators that trade sanctions are preferred because they are better at coercing compliance.

Section 1 sets out relevant characteristics of international trade and investment law and reviews existing commentary on private standing and remedies. Section 2 then offers a political economy explanation for why investment agreements have private rights of action. Section 3 considers the heterogeneity among trade agreements regarding the standing of private parties and addresses the choice between trade sanctions and monetary damages.

1. LEGAL AND ECONOMIC BACKGROUND

1.1. Current Law

1.1.1. Investment. The public international law of investment is largely a creation of bilateral agreements and, to a lesser extent, customary international law. The United States, for example, has relied on a network of bilateral Friendship, Commerce, and Navigation (FCN) Treaties to secure limited rights for investors (as well as certain trade and shipping rights) in foreign countries throughout much of its history (for illustrative examples, see United States 1853; Liberia, 54 Stat. 1739 [1938]). These treaties generally did not create any private rights of action. It was also long thought that customary international law provided foreign investors with protection against expropriation, requiring “prompt, adequate and effective compensation” in the event of any expropriation (see Sornarajah 2004). Customary law afforded a private

right of action to an investor if the host country allowed customary law to be enforced against it in its domestic or foreign courts.

During the middle of the twentieth century, however, various developing countries began to question whether customary law obliged them to provide “prompt, adequate and effective compensation” for expropriation. This movement culminated with the 1974 United Nations Charter of Economic Rights and Duties of States, adopted by the General Assembly, which provided that compensation for expropriation was to be measured by the law of the expropriating state. These developments created considerable unease among investors in developing countries and spawned an initiative that began in Europe to negotiate new Bilateral Investment Treaties (BITs). The United States began its own program to negotiate BITs in 1977 (for a thorough history, see Vandeveld 1993). Bilateral Investment Treaties typically provide various nondiscrimination commitments and expressly embrace the old customary law standard of “prompt, adequate and effective compensation” for expropriation. They provide investors with the right to take investment disputes to neutral international arbitration and commit each party to enforce arbitral awards (including an award of damages).¹

Many of the principles found in BITs were incorporated into the investor rights provisions of the North American Free Trade Agreement (NAFTA). Chapter 11 of NAFTA contains nondiscrimination obligations respecting investment and an obligation to provide prompt compensation for any “expropriation” (NAFTA, art. 1110). It also requires parties to accord investors of another party “treatment in accordance with international law, including fair and equitable treatment and full protection and security” (NAFTA, art. 1105[1]; see generally NAFTA, arts. 1102 [national treatment], 1103 [most-favored-nation treatment], 1110 [expropriation and compensation]). Any dispute under these provisions may be submitted by an investor to arbitration, and the arbitrators have the power to award money damages and restitution (NAFTA, art. 1135).

Chapter 11 of NAFTA has sparked a number of interesting cases in recent years that have led some public officials and academic commentators to question the wisdom of the investor rights provisions. I will say more about these controversies below.

Finally, the Organisation for Economic Co-operation and Develop-

1. The United Nations maintains a searchable database of Bilateral Investment Treaties (BITs) on the United Nations Conference on Trade and Development Web site (http://www.unctadxi.org/templates/DocSearch__779.aspx). When last visited, the Web site listed 44 BITs to which the United States is a party.

ment's proposed (and now abandoned) Multilateral Agreement on Investment also would have included private rights of action for investors (for the the negotiating text of the MAI, see 1998 BDIEL AD LEXIS 33). Its provisions in this regard closely resembled a typical BIT, with investors having the right to proceed to arbitration and to collect monetary compensation from violator states.

1.1.2. International Trade Law. International trade law is a vast area, encompassing numerous bilateral, regional, and multilateral agreements. It will suffice for my purposes to consider four of these arrangements: the World Trade Organization (WTO, incorporating the General Agreement on Tariffs and Trade [GATT]), NAFTA, the Treaty Establishing the European Community (the EC Treaty), and the U.S. Constitution. I recognize, of course, that the EC Treaty and the U.S. Constitution are much more than simply trade agreements, but it is their trade-related provisions, as interpreted by their high courts, that are of interest here.

Although these trading arrangements differ in many particulars, they are strikingly similar as to many core substantive obligations. All four arrangements expressly limit or eliminate tariffs on trade among their members (GATT, art. II; NAFTA, art. 302; EC Treaty, art. 25; U.S. Const., art. I, sec. 10). All four arrangements place severe limitations on quotas and other quantitative restrictions (GATT, arts. XI and XX; NAFTA, art. 309; EC Treaty, arts. 28 and 30).² And all four systems prohibit discriminatory taxation and regulation that disadvantages commerce from other member states for the purpose of protecting domestic firms against foreign competition (GATT, art. III; NAFTA, art. 301).³ Many other similarities might be noted.

The four systems differ importantly, however, regarding the standing of private parties to invoke the rules. Under the law of the WTO, only member governments may bring disputes into the dispute resolution process. Private parties may lobby their governments to do so, of course, but the ultimate decision to pursue a case is reserved to national governments.

2. Under the U.S. Constitution, protectionist quantitative restrictions are prohibited by judicial interpretation, the so-called Dormant Commerce Clause.

3. Under the EC Treaty, such discriminatory measures will be found to have "equivalent effect" to quantitative restrictions and thus be prohibited under article 28 unless they can be justified by certain "mandatory requirements" such as public health (art. 30). The leading case remains case 120/78, *Rewe-Zentral AG v. Bundesmonopolverwaltung Fur Branntwein (Cassis de Dijon)*, 1979 E.C.R. 649. Similar jurisprudence has evolved in the Dormant Commerce Clause cases in the United States. See Currie (2000, chap. 3).

Putting aside the NAFTA investor rights provisions noted above (as well as heretofore unused private rights of action under the largely meaningless NAFTA side agreements on labor and the environment), NAFTA also denies standing to private parties. Only the three member governments can initiate a case to enforce the core trade commitments regarding tariffs, quotas, nondiscrimination commitments, and the like.⁴

Within Europe, the situation is different. Private interests can resist the enforcement of laws that violate the EC Treaty in the courts of member states. Controversial issues may be referred to the European Court of Justice for a ruling, which the courts of member states treat as binding (*Cassis de Dijon*, 1979 E.C.R. 649). In an indirect way, therefore, private parties may be said to have standing to enforce the trade rules of the EC Treaty against member states.

The United States presents a similar picture. Private actors can challenge state laws that they believe to violate the trade-related principles of U.S. constitutional jurisprudence in state or federal court. A ruling to the effect that a state law is unconstitutional will ordinarily be accompanied by an order directing state enforcement authorities not to enforce it.

With regard to the remedy that is available when a party challenging the legality of a member state law obtains a favorable ruling, the four systems also exhibit some important differences. The WTO system requires member states adjudged to be in violation of WTO rules to conform their behavior within a "reasonable period of time" (WTO 1994, art. 21[3]). If the member state fails to do so (and the "reasonable period" will be fixed by arbitration if necessary), the complaining member and the violator must negotiate over the possibility of trade compensation (usually substitute trade concessions by the violator to compensate for the violation). If those negotiations fail, the complainant may withdraw trade concessions that it has made to the violator (that is, retaliate) in an amount equivalent to the harm done by the violation.⁵ The magnitude of retaliatory suspension of concessions is also subject to binding arbitration. In cases where the violator conforms its behavior

4. To be sure, private parties can appeal certain disputes arising in national administrative agencies to "binational panels" as an alternative to appellate review in national courts. But these cases merely afford an alternative mechanism for the enforcement of national law and do not confer standing on private parties to enforce principles of the North American Free Trade Agreement (NAFTA) per se.

5. Some commentators argue that the equivalence requirement can be understood, in a rough way, to implement a rule of expectation damages. See Sykes (2000).

within a reasonable time, however, the mainstream view⁶ is that the complainant has no rights to trade compensation or retaliation or to compensation of any other sort.⁷

Further, nothing in the structure of the system prevents WTO members from settling for monetary compensation. Such a settlement has occurred once to my knowledge, in a case involving a challenge to the U.S. Copyright Act brought by Europe under the WTO Trade-Related Aspects of Intellectual Property Rights (TRIPS) agreement. U.S. law did not require the collection of royalties for music played at certain smaller eating and drinking establishments and was adjudged to violate TRIPS. In lieu of amending the act, the United States ultimately agreed to pay approximately \$1 million per year in compensation to European artists (Bhala and Attard 2003). The *Copyright* case is discussed at length in Grossman and Mavroidis (2003).

The NAFTA dispute resolution system is quite similar to that of the WTO. Under Chapter 20, disputes that cannot be settled through consultations are referred to an arbitral panel. If the panel rules in favor of the complaining member, the losing party must comply with the ruling, offer compensation to the prevailing party, or else suffer retaliation in the form of the suspension of “benefits of equivalent effect.” There is no monetary remedy.

The situation is a bit muddled in Europe, but a damages remedy is available in some cases against a member state for a violation by that state of its EC treaty obligations. A leading case on monetary compensation is *Francovich v. Italy* (cases C-6 and 9/90 [1992], I.R.L.R. 84), in which the Court of Justice held that workers injured by the failure of the Italian government to implement a Commission Directive to pro-

6. Some commentators have questioned this proposition, however, finding precedent in international law for retrospective remedies and noting that a few dispute panels (mostly under the old GATT system) have recommended remedies that are retrospective (such as reimbursement of wrongfully collected antidumping duties). See Mavroidis (2000).

7. One might argue that such a system encourages cheating because there is no penalty for it unless the cheater is caught and still refuses to stop within a “reasonable time.” No fully satisfactory explanation for this aspect of the system exists, although Schwartz and Sykes (2002) offer a speculation. They argue that the bulk of disputes involve good-faith differences in interpretation of WTO law and that litigating such disputes to conclusion may create an important positive externality in the form of useful precedent for the hundred-plus other states bound by the same ambiguous “contract.” The rule denying a right of compensation or retaliation for violations unless cured within a reasonable time encourages parties to litigate to a final judgment. It may also assist developing countries, whose legal capacities are limited and who may inadvertently fail to comply with WTO law quite regularly.

tect workers in bankrupt firms might have an action for damages against the Italian government. Subsequently, in *Brasserie du Pecheur v. Germany* (joined with cases C-46, 48/93, *The Queen v. Secretary of State for Transport, Ex Parte Factortame Ltd.* 1996 E.C.R. I-1029), the Court of Justice ruled that Community Law afforded a right to damages under three conditions: “the rule of law infringed must be intended to confer rights on individuals; the breach must be sufficiently serious; and there must be a direct causal link between the breach . . . and the damage” (para. 51). The second factor is often the key issue, and the question whether a breach is “sufficiently serious” turns in significant part on courts’ assessments of whether the national government in question has committed a flagrant breach of EC law or has instead acted in good faith (albeit illegally) in an area where it has considerable discretion (see Bermann et al. 2002, chap. 10).⁸

The situation in the United States has changed somewhat in recent years. Until fairly recently, cases challenging state laws under the Dormant Commerce Clause sought only declaratory or injunctive relief. Sitting in the background since the Reconstruction Era, however, was 42 U.S.C. section 1983, which provides for private rights of action against any “person” who, under “color” of state law, deprives any individual of “any rights, privileges, or immunities secured by the Constitution and laws” of the United States. The remedy for a violation of section 1983 includes money damages and attorney fees (pursuant to 42 U.S.C. sec. 1988). Only in modern times did litigants begin to advance the theory that state laws, regulations, and administrative actions in violation of the Dormant Commerce Clause amounted to a violation of section 1983. The first decisions rejected this theory, holding that the Commerce Clause creates no “individual rights” and merely constrains the activities of states (see, for example, *Consolidated Freightways Corporation of Delaware v. Kassel*, 730 F.2d 1139 [8th Cir. 1984]; *J & J Anderson, Inc. v. Erie*, 767 F.2d 1469 [10th Cir. 1985]). But in *Dennis v. Higgins* (498 U.S. 439 [1991]), the Supreme Court held that a violation

8. An interesting recent case is case C-93/02, *Biret International S.A. v. Council of the European Union*, 2003 E.C.R. I-10497, which raised the question whether a European Union (EU) company could recover damages for the failure of the EU to implement the WTO Appellate Body decision in the beef hormones controversy. The case seemingly turned on whether the dispute finding had any direct effect within the EU. The European Court of Justice declined to rule clearly on that issue and found in favor of the council on the other grounds (the plaintiff was in liquidation by the time any cognizable damages could have arisen). For further discussion, see Egli (2005).

of the Commerce Clause by a state does give rise to a cause of action under section 1983 and to a claim for attorney fees under section 1988. Later decisions by lower courts have awarded monetary damages for the injuries suffered by private plaintiffs due to Commerce Clause violations (*Poor Richard's v. Ramsey County*, 922 F. Supp. 1387 [D. Minn. 1996], in which approximately \$60,000 plus provable attorney fees for wrongful revocation of a waste disposal license was awarded), although reported litigation in the area to date is sparse.⁹

In sum, trade agreements present a mixed landscape on the issues of both standing and remedy. The two entities considered here with the deepest degree of economic integration, Europe and the United States, afford some private rights of action to enjoin member states from enforcing laws and regulations that violate core trade commitments. Both systems also open the door to monetary remedies to a limited extent. The WTO and NAFTA do not provide private rights of action with respect to trade commitments, nor do they provide monetary remedies even for the member governments with standing to bring cases (although nothing precludes monetary settlements).

1.2. Prior Commentary on Standing and Remedy in International Economic Law

Recent writing on standing and remedy in the trade and investment areas has focused on three issues: the wisdom of recent developments in NAFTA investor rights litigation, the proper role of private parties as

9. Among the reasons for the paucity of litigation is the confusing body of precedent regarding what constitutes a "person" acting under color of law and what "immunities" such "persons" enjoy. Generally speaking, municipalities are considered "persons" and enjoy no immunity from suit, even when they act in good faith. However, municipal liability is limited to actions that represent the "policy or custom" of the municipality. State governments, by contrast, are completely immune from suits for damages unless they waive their immunity. Individual officials (state or municipal) may be sued in their individual capacity (as distinguished from suits against their government employers), but they enjoy various immunities as well, ranging from absolute immunity for some functions (like the actions of legislators) to qualified or good-faith immunity for other types of actions. The result of this hodgepodge is that for a plaintiff to recover money damages from a state, either the state must have waived immunity or the suit must be brought against a state official in his or her individual capacity and the plaintiff must overcome whatever immunity is afforded to the defendant. Then damages may be sought from the individual defendant and will be obtained from the state itself only if the state has a policy of indemnifying its employees against liability. Given all of these potential hurdles, it is no surprise that successful actions for damages appear to be quite rare. For an introduction to this confusing body of law, see Chemerinsky (2003, chap. 8).

amici curiae in the WTO, and the wisdom of trade sanctions for violations of WTO law.

Much of the commentary on NAFTA investor rights litigation has been highly critical of the decisions in cases brought by private parties. The greatest concern is that the concept of expropriation is being applied too elastically and that regulatory takings are imprudently found to constitute compensable expropriation.¹⁰ A case of particular concern in this context is *Metalclad Corp. v. United Mexican State* (40 I.L.M. 36 [2001]), which involved the denial of an environmental permit to a waste disposal site and resulted in a \$16 million award to the American complainant. Another notable case was *S. D. Myers, Inc. v. Canada* (NAFTA Arbitration Tribunal under the United Nations Commission on International Trade Law Rules [November 13, 2000]), which involved a claim by an American company producing a fuel additive in Canada that a Canadian ban on interprovincial trade in the additive was enacted for protectionist reasons rather than the stated health reasons. Canada settled the case for \$19 million rather than litigate to conclusion.¹¹

Commentators make the point that such decisions imply a far broader takings doctrine under NAFTA than under U.S. domestic law and generally argue against compensation for these regulatory takings. Among other things, they contend that the conventional cost internalization argument for compensation is flawed and that any benefits from compensation as "insurance" are available in the private insurance market (Been and Beauvais 2003). The same issues feature prominently in earlier literature on domestic takings (Epstein 1980; Blume and Rubinfeld 1984). Notwithstanding the critique of individual decisions, however, there has been little or no criticism of private rights of action in the investment area per se. All of the commentators seem to accept their wisdom, as long as they are governed by the proper substantive rules.

In the trade area, the absence of private rights of action in the WTO

10. Another concern was that arbitral panels would read NAFTA, art. 1105, broadly and that its requirement of "fair and equitable" treatment would become a license to award damages for any government action that the arbitrators viewed as unfair. Much of the concern here flowed from the arbitrators' reading of article 1105 in *Metalclad Corp. v. United Mexican States* (40 I.L.M. 36 [2001], see esp. para. 100-101). That issue was perhaps laid to rest by a recent "clarification" adopted by the NAFTA Free Trade Commission, which stipulates that article 1105 requires no more than observance of the customary international law standard regarding minimum treatment of aliens. See the discussion of the *Metalclad* case in Jackson, Davey, and Sykes (2002, pp. 1153-66).

11. Information on both cases may be found at <http://www.naftaclaims.com>. Much of the critical commentary is collected in Brower (2003).

and NAFTA also seems to be accepted by most of the commentators (Trachtman and Moremen 2003; but see Shell 1995). But the United States and many nongovernmental organizations favor a more limited opportunity for private actors to participate in the WTO dispute process as *amici curiae*. In two controversial decisions, the WTO Appellate Body ruled that dispute panels and the Appellate Body itself could accept such submissions at their discretion (Jackson, Davey, and Sykes 2002, pp. 315–17). These decisions received a chilly reception from the membership at large, however, and reportedly only the United States spoke in defense of them before the Dispute Settlement Body. Developing countries argued that their result was to shift the balance of power toward the well-funded nongovernmental organizations of the developed world, whose agendas were often at odds with the interests of developing countries (Statement by Uruguay at the General Council Regarding the Decision by the Appellate Body Concerning Amicus Curiae Briefs, WT/GC/38 [December 12, 2000], excerpted in Jackson, Davey, and Sykes 2002, pp. 303–5). One infers from these events that any proposal for creating private standing would be roundly rejected by the WTO membership as a whole.

If there has been little advocacy of private standing, there has been much discussion of changing the remedy for violations of WTO rules. Numerous commentators have observed that trade sanctions cause substantial welfare losses (Guzman 2002). It is considered a puzzle as to why international trade agreements do not use money damages as a sanction, which are said to constitute transfers without the deadweight costs of trade retaliation (Guzman 2004). Such observations lead various commentators to advocate changes in WTO sanctions, generally arguing for monetary penalties in some form, although stopping short of advocating a private right of action (Charnovitz 2001, 2002; Davey 2001; Bronckers and van den Broek 2005).

Another line of commentary pushes in the same direction. It has long been claimed that developing countries are at a disadvantage in the WTO dispute resolution process. The explanation usually includes the notion that developing countries have small markets and are thus unable to affect the prices received by exporters to their markets (in effect, they lack any “monopsony power” that can be exploited through tariffs). Consistent with this thesis, Bagwell, Mavroidis, and Staiger (2004) indicate that in not one instance has a developing country actually exer-

cised its retaliation rights in a WTO dispute.¹² This perceived imbalance of power has led a group of African nations to propose that monetary penalties be introduced into the system and has led Mexico to propose that retaliation rights be subject to auction (Bagwell, Mavroidis, and Staiger 2003).

A few scholars have weighed in on the other side of this debate, suggesting that trade retaliation is preferable to monetary remedies because it will be more effective at inducing compliance with trade commitments. The most thorough exposition of this argument is that of Nzelibe (2005; see also Goldstein and Martin 2000). I will return to these arguments below.

2. INVESTMENT

This section offers a rationale for the existence of private rights of action for money damages in investment agreements, a rationale that does not apply to trade agreements, as Section 3 will demonstrate. As noted earlier, the impetus for modern BITs (which provide the model for NAFTA, chap. 11) was a growing concern about the expropriation of foreign investments in developing countries during the mid-twentieth century. The concern reached its zenith when developing countries as a group took the position in the United Nations that customary law did not require compensation for expropriation. Investors with sunk investments in those countries faced greater risk and had an incentive to lobby their governments for international agreements to reduce it. This political pressure was the impetus for developed nations to seek to enter BITs with developing countries.

From the developing countries' perspective, BITs were a double-edged sword. They plainly limited the capacity of governments to expropriate existing foreign investments without compensation, a limitation that worked to their disadvantage, other things being equal. But they also yielded an important benefit. Investors in developing countries (as elsewhere) will require a risk premium on their investments to ensure themselves an expected competitive rate of return. A risk of uncompensated expropriation thus increases the price of imported capital to developing countries. A reduction in this risk likewise lowers the cost of foreign

12. Busch and Reinhardt (2003) look further at the experience of developing countries in WTO dispute settlement and contend that they are disadvantaged by their relative incapacity to pursue effective strategies in the early phases of disputes.

capital, which can create rents for domestic factors of production that work with foreign capital. Those factors will in turn offer political support for any policy that reduces expropriation risk (for a simple diagrammatic exposition of the benefits of capital inflow to the country that hosts new foreign investment, see Lindert 1991, pp. 547–49). This explanation of why many developing countries agreed to BITs is a conventional one in the literature (Guzman 1998; Elkins, Guzman, and Simmons 2004).¹³

Because a central objective of the investment agreements was to induce foreign investors to make new investments in developing countries at a lower interest rate, the utility of a private right of action for money damages is obvious. To see why, consider a world of BITs without the private action. In the event of an uncompensated expropriation or similar action, an investor would have to lobby its own government to take some sort of action against the violator state. The investor might be politically inefficacious in this process for any number of reasons. It might be unable to offer enough political benefits in return for the governments' assistance. Its government might have diplomatic reasons for declining to take any action or for declining to retaliate against the violator in any effective way. And even if some retaliation were forthcoming, the retaliation might do nothing to compensate the investor for its losses. Considerable risk for investors would remain, and the risk premium on new investments would reflect it. A credible promise of monetary compensation to investors, by contrast, in an amount set by neutral arbitrators, goes much further to reduce investment risk and to achieve the developing countries' goal of lowering the cost of foreign capital.

Moreover, for any developing country that does not plan to engage in significant expropriation or other prohibited activity, a credible prom-

13. Guzman (1998) argues that developing countries accepted BITs because they lowered the cost of foreign capital in this fashion and made direct foreign investment in the territory of the signatory more attractive than in the territories of other nations that had not executed BITs. Guzman further argues that the net effect on BITs on developing countries as a group may have been adverse—if they collectively possessed monopsony power in the capital market, a policy that permitted uncompensated expropriation might have allowed them to exploit it. He argues that proposed BITs induced the abandonment of this collectively valuable policy by forcing each developing nation into a sort of prisoner's dilemma. Each was tempted to defect from the collectively preferred regime by the prospect of obtaining a competitive advantage over others, and once they all defected they were collectively worse off than before. Whether or not Guzman is correct in this claim, it seems that on all accounts the developing countries accepted BITs because of their desire to lower the cost of foreign capital.

ise of monetary compensation to investors imposes few if any offsetting costs. If expropriation never occurs, compensation and the attendant litigation costs need never be paid. The possibility of socially excessive litigation because of a divergence between the private and social costs of suit—a concern explored in Section 3—is then minimal. A promise of monetary compensation to investors is thus a cheap commitment device for states with benign intentions toward investors and a cheap way for states with more benign intentions than others to signal their type. As long as the capital-importing nation is confident that it does not wish to engage in prohibited behavior, then the private right of action on behalf of foreign investors is not a burden on it but a clear benefit.

These observations have some clear implications for the current debate over the NAFTA investor rights decisions and offer some additional support to the argument of Been and Beauvais (2003) that a regulatory takings doctrine under NAFTA, chapter 11, is undesirable. The commitment by a developing country to a private right of action for investors is a low-cost commitment or signal that it will respect investors' property rights only to the extent that expropriation is defined to include acts that the national government is unlikely to want to undertake. An expansive regulatory takings doctrine, by contrast, can sweep in many acts of expropriation that arguably result from the resolution of regulatory uncertainty (such as the denial of the environmental operating permit in *Metalclad*) or the emergence of new information about the subject of regulation (such as the health issues associated with the gasoline additive in *S. D. Myers*).¹⁴

Been and Beauvais (2003) note that such regulatory policy changes typically do not confer private rights of action for damages under U.S. law, and it seems unlikely that developing countries would wish to provide broader insurance against regulatory policy changes. The extensive literature on legal transitions suggests that compensation for policy changes (or insurance against them) can encourage overreliance on policies that may change and may chill desirable change as well (Kaplow 1986b; Shaviro 2000). Further, the capacity of international dispute panels accurately to distinguish well-intentioned or desirable regulatory policies from those driven by protectionism or other forms of capture is limited. The tendency in international law is to restrict the scrutiny of

14. I stipulate that some commentators have a less benign view of the actions of the respective governments in those cases, and I take no position on the ultimate merits of either case.

domestic regulation by international dispute panels to fairly narrow issues such as the presence of clear discrimination or the violation of various procedural requirements and to foreclose open-ended inquiry into the wisdom or legitimacy of regulation through cost-benefit balancing and the like (Sykes 1999, 2003; Trebilcock and Soloway 2002). An open-ended expropriation doctrine that permits challenges to regulatory outcomes under investment agreements would thus stand in contrast to the treatment of national regulation in other areas of international economic law, a fact that casts additional doubt on the wisdom of compensation for regulatory takings under NAFTA.

3. INTERNATIONAL TRADE

The last section argues that the (capital-) importing nation that is party to an investment agreement wishes to commit or signal to private (capital) exporters that their investments are secure against government interference. The private right of action for compensatory damages facilitates this government-to-firm commitment in a way that a mere government-to-government commitment cannot. Trade agreements are different in an important way—nations importing goods and services have no direct interest in making exporters of goods and services more secure or confident so that market access commitments will be respected. An importing nation, call it A, will make commitments that benefit exporters in another nation, call it B, only to the degree that the government of B will make reciprocal commitments that benefit A's exporters. For this reason, trade agreements are better structured as government-to-government commitments, and a private right of action for damages may actually be counterproductive (indeed, private standing irrespective of the remedy may be counterproductive).¹⁵ Section 3.1 develops this argument.

Even if standing under trade agreements is best limited to governments, it remains to consider what remedy the agreement should select. Section 3.2 offers several new reasons why trade sanctions might be

15. The proposition that trade agreements arise to facilitate government-to-government market access commitments is a standard one in the modern economics literature. See, for example, Bagwell and Staiger (2002). A smaller strand of literature, however, explores whether trade agreements may also facilitate valuable commitments by governments to their domestic firms. Because such theories do not suggest any role for private rights of action by foreign firms, however, I do not address them here. Useful references include Maggi and Rodriguez-Clare (1998) and Staiger and Tabellini (1999).

preferred to money damages, despite what some commentators note as the apparent inefficiency of trade sanctions.

3.1. Standing

Unlike the situation with investment agreements, importing nations do not enter trade agreements out of a desire to lower the price of imports. They view any reduction in their own trade barriers, and the attendant price of their imports, as a concession that is attractive only in return for concessions by trading partners. This critical difference can lead to a denial of standing for private parties in the trade arena.

To understand the difference between the two contexts and why it matters, we must begin with the conventional account of the political economy of trade agreements. Imagine first a world without any international cooperation, in which nations set their trade policies unilaterally (Nash behavior). National trade policy will reflect the political equilibrium between the domestic interest groups opposed to imports (domestic import-competing industries) and the domestic interest groups that favor imports (domestic import-consuming industries and consumers). Export industries have a limited stake in policy, which is reflected in the degree to which a more restrictive import policy may result in some retaliation against them by foreign governments acting unilaterally. This risk is diffused across many export industries, and so they are unlikely to mobilize much to participate in the trade policymaking process. When international cooperation (and trade agreements) becomes possible, by contrast, nations can negotiate specific reductions in their trade barriers in exchange for reciprocal reductions by others in particular industries. Exporters thus gain a more direct stake in policy and will lobby their home governments to secure specific market access concessions in their favor abroad.¹⁶ Because exporter interests are better mobilized in this setting and because they invariably prefer a reduction in trade barriers, the new political equilibrium with international cooperation will result in a more open trading system. Indeed, we observe that international trade agreements systematically lower trade barriers, not raise them.

Even so, negotiated reductions in trade barriers by importing nations are still viewed as a cost by their governments—such concessions damage the interest groups (domestic import-competing industries) who lobbied

16. One might also say equivalently, following Bagwell and Staiger (2002), that in the Nash equilibrium when nations act unilaterally, they ignore the externalities that their trade policies impose on foreigners (exporters). Trade agreements afford an opportunity for that externality to be internalized.

for the trade barriers in the first instance. It follows that, holding constant the negotiated market access concessions by trading partners, importing nations will prefer that foreign exporters face greater risk regarding the security of market access commitments and thus charge higher prices. Indeed, importing nations would gladly reintroduce their dismantled barriers to imports if they could do so without suffering any retaliation or punishment by foreign governments. This is the exact opposite of the investment setting, where the *raison d'être* of the agreement from the importing nation's perspective is to lower the price of imports (capital) by eliminating certain risks otherwise faced by (capital) exporters.

Hence, in contrast to the investment setting, a private right of action for foreign exporters is of no direct utility to the importing nation in the trade setting. It may have some indirect utility, but only to the degree that the exporters who obtain such an action will lobby their home governments to make additional concessions in exchange for it. This observation leads to the essential point—in the investment setting, importing nations benefit directly by giving a remedy for breach of the agreement to all investors. In the trade setting, importing nations can benefit (indirectly) only by giving a remedy for breach of a trade agreement to foreign exporters who are politically efficacious in their home countries and will induce their governments to offer reciprocal trade benefits in return. This observation suggests the value of what I will term a political filter in the dispute resolution process.

3.1.1. The Concept of a Political Filter and Its Implications for Rules of Standing. A central tenet of public choice theory is that some interest groups are better organized than others and thus better able to influence the political process. Indeed, this observation affords the standard explanation for protectionist trade policies, which (perhaps with rare exception) lower the national economic welfare of nations that employ them—the harm from protectionist policy is often borne by a diffuse group of poorly organized consumers, while the benefits inure to well-organized import-competing industries.

But not all industries are equally well organized. Industries that are made up of a large number of small producers, for example, may have difficulty overcoming the transaction costs and free-rider problems associated with efforts to influence the political process. Industries with a few larger firms may be better able to overcome free-rider problems and transaction costs, by contrast, and individual firms in such industries may have high enough stakes in the outcome of policy decisions that

they are willing to incur the costs of acting alone to influence political representatives.

Thus, consider some generally applicable legal rule under a trade agreement, such as a requirement that forbids regulatory measures that discriminate against foreign commerce (the “national treatment” obligation in WTO parlance), and imagine that a governmental party to a trade agreement has violated that obligation. In the absence of any private standing to enforce the rule, political officials in the nation whose exporters are aggrieved by the violation must decide whether to bring a compliance action themselves. If the violation affects a well-organized export industry, officials may expect significant political rewards from such an action. If the violation affects a poorly organized industry, by contrast, they may expect few political rewards from bringing the enforcement action.

The violation of the national treatment rule will also have political consequences for officials in the violating state. An inadvertent violation that confers rents on a poorly organized import-competing industry, for example, will generate little political support for those officials. But if the violation confers substantial rents on a well-organized import-competing industry, it may be a source of considerable political benefits to the officials who can claim credit for it. These observations suggest that the political officials who become parties to trade agreements can enhance their mutual welfare by retaining the right to determine which enforcement actions are brought.

The basic idea can be formalized very simply as follows: consider two states, A and B (although the analysis readily generalizes to the multilateral case). Assume for simplicity that states are unitary actors, each with a political utility function—let $U()$ denote the utility function for A and $V()$ denote the utility function for B. Each function is additive, and its arguments will become clear shortly.

Industries in each state may be divided into two categories, exporting industries and import-competing industries. State A has comparative advantage in the set of industries that export to B, call them industries in the set AB, with its members denoted α_i , $i = 1 \dots n$. State B has comparative advantage in the industries that export to A, call them industries in the set BA, with its members denoted β_j , $j = 1 \dots m$.

States A and B have entered a trade agreement that contains some generally applicable legal rule (say, national treatment). Import-competing industries in each state do not like the national treatment rule (which forecloses a range of protectionist policies that could benefit

them), while exporting industries in each state benefit from the national treatment rule. Political officials in state A can thus gain political utility from a national treatment rule that is enforced for industries in AB but will suffer a loss of political utility from a national treatment rule that is enforced for industries in BA. Let $u(\alpha_i)$ denote the political benefit derived by officials in state A from the enforcement of the national treatment rule in (its exporting) industry α_i , and let $u(\beta_j)$ be the political detriment suffered by officials in state A from the enforcement of the national treatment rule in (its import-competing) industry β_j . Choose the utility scale so that $u(\alpha_i) \geq 0$ for all i and $u(\beta_j) \leq 0$ for all j .

The situation in state B is exactly the opposite. Let $v(\alpha_i)$ denote the political detriment suffered by officials in state B from the enforcement of a national treatment rule in (its import-competing) industry α_i , and let $v(\beta_j)$ be the political benefit derived by officials in state B from the enforcement of the national treatment rule in (its export) industry β_j . Choose the utility scale so that $v(\alpha_i) \leq 0$ for all i and $v(\beta_j) \geq 0$ for all j .

If the national treatment rule is enforced in all industries, officials in each state enjoy total utility equal to the sum of their own utilities from enforcement in each industry:

$$U = \sum_{i=1\dots n} u(\alpha_i) + \sum_{j=1\dots m} u(\beta_j) \quad \text{and} \quad V = \sum_{i=1\dots n} v(\alpha_i) + \sum_{j=1\dots m} v(\beta_j).$$

But the parties can almost certainly do better. Imagine that some exporters in state A are very poorly organized, say, those in industry α_2 . Suppose for simplicity that $u(\alpha_2) = 0$. But imagine that the import-competing firms in state B are better organized, so that $v(\alpha_2) < 0$. The parties to the trade agreement would then experience a (political) Pareto improvement if they agreed not to enforce the national treatment rule in industry α_2 —officials in state A would be no worse off, while officials in state B would enjoy utility gains.

The point is much more general and does not depend on the presence of export industries for which the political utility of enforcement is zero (indeed the utility scale is completely arbitrary). State A can agree to forego enforcement of the national treatment rule on behalf of its industries where the political gains to its officials are small and the political costs to officials abroad are large, while state B can make a reciprocal promise. The political costs in each state from foregone enforcement on behalf of export industries under such an arrangement can be far outweighed by the political gains from foregone enforcement in politically powerful import-competing industries.

One can take the analysis a step further and imagine that the parties write an elaborate contingent contract, specifying industry-by-industry where the national treatment rule applies and where it does not. Sykes (1991) considers a mathematically analogous problem. For present purposes, it is enough to note that the solution has the following properties: for any point on the parties' Pareto frontier (and thus associated with an optimal treaty), a shadow price exists that allows units of each party's utility to be converted into units of the other's utility. An optimal treaty will provide that the parties forego enforcement of the national treatment rule (or any other rule, for that matter) in any industry for which the political utility gain to officials in the violator state outweighs the political utility loss to officials in the state harmed by the violation, using the treaty's shadow price to convert utilities into the same units.

A detailed contingent contract of that sort would be extremely costly to write, however, especially given the wide array of rules found in modern trade agreements. The parties will thus prefer cruder and cheaper rules. A simple rule with considerable potential appeal is that parties will not bring enforcement actions on behalf of politically weak export industries. As long as the poorly organized export industries in state A are not as poorly organized on average on the import side in state B, and vice versa, an exchange of reciprocal promises to forego enforcement on behalf of poorly organized export industries can leave both sides at a considerably higher level of utility.

How might the parties implement such a rule? The obvious way is to omit any private rights of action from their agreement. Because it is costly for the parties to bring enforcement actions themselves, they will bring actions only on behalf of exporters who offer sufficient political rewards in exchange. It is precisely the group of politically weakest exporters whose cases will be ignored under this arrangement.

To be sure, the denial of standing to private parties under trade agreements can come at some political cost. Even politically efficacious exporters might prefer to retain control of their cases to ensure that appropriate resources are expended on them. Likewise, if the denial of standing is also accompanied by a remedial system that politically efficacious exporters find unsatisfactory, they might prefer to obtain private standing because of a perceived connection to a superior remedy. Thus, while the parties to a trade agreement can in principle benefit from political filters, one cannot show that they will always be preferred as a theoretical matter once all other pertinent considerations have been taken into account. A denial of standing to private parties has the "vir-

ture” of excluding politically inefficacious exporters from the dispute system but may also leave politically efficacious exporters less secure and less willing to reward political officials for securing trade concessions.

Hence, my argument is not that the implicit political filter that accompanies a denial of private standing is always preferable in trade agreements. Rather, the point is that it is potentially attractive in the trade area but not in the investment area. To minimize its cost of imported capital, the capital-importing nation prefers that all investors be secure against the expropriation of their sunk investments, not just those who are politically efficacious in their home countries.

3.1.2. Other Considerations Favoring Restrictions on Private Standing. Two further considerations may also help explain the denial of private standing in some trade agreements. First, in newer trade agreements such as NAFTA and much of the WTO, each member state confronts a number of transition issues. The task of ferreting out all national and subnational regulation that might run afoul of the WTO Technical Barriers Agreement, the Sanitary and Phytosanitary Measures Agreement, and so on, is not a trivial one. Thousands of regulatory measures are potentially in play (especially after the WTO agreement made clear that its obligations apply to state and local regulation as well as national regulation), and many nations may be constrained in their capacity to make conforming changes quickly (especially developing countries). In the face of many potential transition violations, therefore, the parties may well desire to limit enforcement actions to those of the greatest political importance to aggrieved exporters. Private rights of action, by contrast, might tax the resources of nations seeking to comply with their obligations and distort the timing of the compliance agenda (from the standpoint of maximizing joint political gains). This problem is likely to be far less acute in the investment area, where the basic rules have been established for a long time (although some NAFTA decisions have shaken them up, perhaps unwisely, as noted earlier).

Second, legal interpretations developed in one case inevitably have consequences for others. Officials concerned with their political welfare must worry that precedents established in an enforcement action brought on behalf of their exporters will come back to haunt them in an action brought against them by foreign exporters. Only by reserving standing to themselves and thereby retaining control over the arguments put forward in litigation can officials ensure that their export interests do not

advance legal theories that are lacking in net political value. The same issue can arise in the investment arena, to be sure, and one might interpret the uneasy reaction of NAFTA member governments to recent decisions as a manifestation of this problem. Trachtman and Moremen (2003) make a similar point. Levy and Srinivasan (1996) make the related point that private actors may bring actions when, for diplomatic reasons, their governments might prefer forbearance.

3.1.3. *Objections.* One possible objection to this line of reasoning is that it ignores the resources that political officials must expend to bring compliance actions. Perhaps the direct costs of briefing and arguing cases, and the related expenses of deciding which claims to bring, more than offset the benefits from the political filter mechanism outlined above.

Although this objection surely raises a logical possibility, it should not be exaggerated. As a practical matter, governments can (if they wish) push much of the cost of compliance actions back onto the private sector. Indeed, it is routine in WTO practice for the private interests who seek compliance actions on their behalf to supply legal assistance for the purpose of developing the legal analysis, writing briefs, and the like. Nations could also agree to allow privately funded counsel to argue the cases (although neither NAFTA nor WTO practice allows private parties to appear at present). It is simply not the case, therefore, that governments must bear high litigation costs when they choose to act as a political filter.

A second possible objection is that the analysis proves too much. If governments can gain by interposing themselves as political filters between private interests and the dispute resolution process under trade agreements, why do private rights of action emerge in some contexts nevertheless? As noted earlier, both the European Union and the U.S. constitutional system afford limited private rights of action to parties aggrieved by violations of trade rules.

A partial explanation for the disparity across systems is that private rights of action may not have been contemplated by the framers of either the U.S. Constitution or the EC Treaty. In the United States, the important free-trade principles associated with the Dormant Commerce Clause were developed by the Supreme Court years after the Constitution was written. Likewise, the modern powers of the European Court of Justice in the trade area may not have been anticipated during the founding period and decisions such as *Cassis de Dijon*, analogizing regulatory

trade barriers to measures having an “equivalent effect” to quantitative restrictions, may have come as a surprise. Private rights of action in each system may thus be an unanticipated creation of the courts rather than a mechanism desired by the political founders.

Even if this suggestion is correct, however, it is at best an incomplete answer to the puzzle. Had private rights of action been viewed as seriously problematic in either system, political actors could have changed the law to extinguish them. This observation suggests a second important consideration bearing on the wisdom of private rights of action.

3.1.4. *Ex Post* Political Oversight as an Alternative to a Political Filter. Both Europe and the United States have political bodies (the Congress and the EC Commission) with the capacity to address sensitive trade matters directly. The WTO and NAFTA do not have such bodies—only a costly process of amending the pertinent treaty text, which requires unanimous acceptance, can override judicial decisions that political actors find unpalatable.

The presence of a body like the Congress or the Commission reduces the value of interposing a political filter at the front end of the dispute resolution process. As long as the body has not lost too much flexibility to constitutional rules that it cannot change, it can handle the most politically charged matters directly and can correct judicial decisions that become politically unacceptable over time (decisions under the Dormant Commerce Clause in the United States, for example, can always be overridden by an affirmative exercise of the Commerce power). In such a system, the danger of politically objectionable judicial decisions surviving for any length of time is much less and the opportunity to shift the costs of bringing cases onto the private sector is more attractive. Put differently, bodies like the Congress and the Commission can serve as *ex post* political filters, undoing the undesirable decisions while avoiding the costs of sorting the larger number of cases that arise *ex ante*.

A possible objection to this line of reasoning, however, is that constitutional restrictions may preclude Congress and the Commission from discriminating among industries in a politically desirable fashion. The Equal Protection Clause of the U.S. Constitution, for example, likely precludes policies that treat industries differently solely in accordance with their political efficacy (some other rational basis is almost certainly required to justify disparate treatment). An *ex ante* political filter may have the advantage of circumventing such “bothersome” legal con-

straints. Still, the ex post mechanism has a potentially sizeable cost advantage that may on balance favor private standing.

3.2. Remedy: Trade Sanctions and Money Damages

Regardless of the rules governing the standing of private parties, some remedy must be made available to parties who have standing. We thus return to the puzzle of why trade agreements such as NAFTA and the WTO select the seemingly inefficient remedy of trade sanctions with their attendant deadweight costs, in preference to a remedy such as money damages.

As noted at the outset, nothing in the current law of NAFTA or the WTO precludes the use of monetary payments to resolve disputes. Compensation is allowable (and indeed preferred) to trade retaliation, and nothing restricts the form that compensation might take. Yet, with very rare exception, WTO and NAFTA cases are not settled in this fashion (putting aside NAFTA investor rights cases). Thus, by revealed preference of sorts, we must infer that trade retaliation is preferred in general by violator states to the alternative option of money compensation, at least given the implicit reservation prices of complainants. This section suggests a few considerations that may help explain this state of affairs. Before turning to those issues, however, I wish to rebut one argument that has appeared elsewhere.

3.2.1. Are Trade Sanctions Preferred Because They Better Induce Compliance? As noted earlier, some scholars, most notably Nzelibe (2005), have argued that trade agreements utilize trade sanctions rather than money damages because the sanctions mechanism is more effective at inducing parties to comply with their commitments. Trade retaliation can be targeted at powerful export groups in the violator country, the argument runs, which will motivate them to encourage their governments to cease the violation. Likewise, trade retaliation provides at least temporary benefits to import-competing firms that compete with the imports that are targeted. Their political support for retaliation makes the use of the retaliatory sanction a credible threat. Money damages, it is argued, are inferior in both respects. Their costs are borne by a diffuse group of taxpayers in the violator state, who will not organize to lobby their government to avoid monetary liability—money is too “cheap” from the perspective of the violator state for monetary penalties to be an effective deterrent to misconduct. Further, the beneficiary of a monetary sanction will be the national treasury of the complaining state,

and no interest group in that state will have much interest in pushing for its government to pursue the sanction.

I find this line of reasoning unconvincing for two reasons. First, to the degree that damages are a cheap penalty from the perspective of violators, they can always be increased. At some point, monetary penalties would become a sufficient burden on the treasury of even the wealthiest trading nations that a violator nation would prefer to comply with its commitments rather than to pay damages, and the prospect of collecting the money would be an appealing prospect for potential complainants. The claim that damages will not induce compliance, therefore, must be modified to something like the following: compensatory damages (perhaps measured by the loss of rents to foreign exporters injured by the violation) will not suffice to induce nations to comply with their commitments.

Even this modified claim is problematic, for it implies that parties to trade agreements should actually prefer to utilize a compensatory-damages remedy. To see why, assume, *arguendo*, that the claim is correct. Then, parties prefer a state of the world in which they violate the rules and pay compensatory damages to a state of the world in which they comply with their commitments and avoid damages. If this is true, however, then there is a clear opportunity for efficient breach (in a political sense), and the parties could enjoy Pareto gains by incorporating a compensatory-damages remedy into the agreement. Violators by hypothesis enjoy higher utility even when bearing the cost of damages, and injured exporters should be indifferent between compliance with the agreement and full compensation for violations. Under these circumstances, a trade retaliation remedy that sufficed to induced compliance would eliminate this source of joint gains, and it would not be in the mutual interest of the parties to employ it.

The suggestion that trade retaliation is preferred over damages in trade agreements because it is a more effective mechanism for inducing compliance thus suffers from two logical problems. It is not a convincing rationale for the widespread use of trade retaliation in my view. I now turn to some other considerations that weigh against monetary remedies.

3.2.2. Are Monetary Remedies a Mere Transfer? The claim that money damages are a simple transfer is misleading for one well-known reason and one perhaps not so well known. First, governments face budget constraints and must finance money damages through taxation. Putting aside lump-sum taxes, oft invoked by economists but hardly ever used

in practice, taxes create their own distortions. The choice between trade sanctions and money damages then is not a simple choice between a mechanism that creates welfare costs and one that does not. And although it may well be true that methods to raise the money for a damages award can be found that cause less distortion than the trade sanctions for which the award substitutes, the magnitude of the difference need not be dramatic. This may be especially true in developing countries, some of which still rely heavily on trade taxes to raise funds for their national treasuries—trade sanctions against them raise inefficient barriers to their exports, but monetary awards against them might well force an increase in inefficient tariffs on their imports (which might even hurt the exporters from the complaining nation).

Second, the claim that money damages are a simple transfer neglects the lessons of the economic literature on the private versus social value of litigation. Landes and Posner (1975) note that the Becker/Stigler prescription in the criminal law area for higher penalties and lower probabilities of sanction (to save on administrative costs) becomes problematic if private enforcers could collect the higher penalties—increases in the penalty may induce more expenditure on enforcement rather than less (see also Polinsky 1980). In the same spirit, Shavell (1982) explores the difference between the private incentive to file civil claims for damages and their social value in a tort setting. The social return to a prospective lawsuit is the value of the *ex ante* change in risky behavior, which can be measured by the reduction in the expected costs of accidents induced by prospective liability. The social cost of a lawsuit is its litigation cost—the damages payment from a defendant to a plaintiff is simply a transfer. Because there is no necessary relationship between the damages payment (and the attendant incentive to file suit) on the one hand and the social gains from prospective liability on the other, litigation may occur too often or too infrequently from an economic standpoint. The analysis is refined somewhat in Menell (1983) and Kaplow (1986a), but the essential point remains the same (Shavell 2004).

These insights have potentially important implications for the wisdom of damages actions in international trade agreements. The social gains from such actions and the private gains may be quite different. Consider a simple illustration. Figure 1 depicts a market for imported goods in some importing state. The curve I_s is the import supply curve, which reflects the quantity of imports available to the state in question at each price. The curve I_d is an import demand curve, which is constructed from the excess of domestic demand over domestic supply for the good in

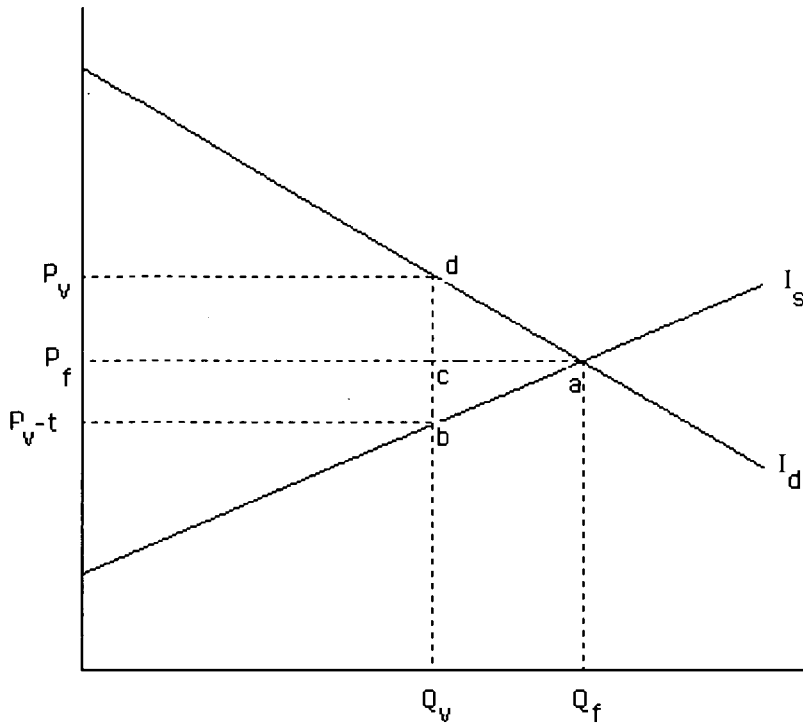


Figure 1. Deadweight costs and incentives to litigate

question at every price. Assume that a pertinent trade agreement requires “free” trade, which would produce an equilibrium price P_f and quantity of imports Q_f where I_s and I_d intersect. But the importing nation violates the agreement and imposes a tax of t on imported goods, yielding an equilibrium price to domestic consumers of P_v and net price to foreign sellers of $P_v - t$; import quantity drops to Q_v . The deadweight cost of the violation in this simple framework is equal to the area abd . The rectangle $P_v db(P_v - t)$ is tax revenue.

Consider the incentives to file a case under these assumptions. Foreign sellers lose surplus owing to the violation in the amount $P_f ab(P_v - t)$. Their potential gains from suit exceed the deadweight cost (triangle acd appears to be smaller than rectangle $P_f cb(P_v - t)$). This observation suggests the possibility that a case may be pursued for its private value, even when the costs of litigation may considerably exceed the social

gains from the case. If the foreign sellers were in charge of the decision to file a case (more about this issue in a moment), they would compare their private litigation costs to the private gains from suit, and we could easily imagine settings in which suit would be filed even if it is socially inefficient (litigation costs exceed the social gains).¹⁷

The situation depicted in Figure 1 is not at all contrived. Many violations of trade agreements result in large transfers—tax revenue for the government at the expense of foreign producers and domestic consumers, quota rents to domestic importers who hold importation rights at the expense of foreign producers and domestic consumers, producer surplus for favored trading partners at the expense of other trading partners who are discriminated against, and so on. Deadweight losses arise in most of these scenarios to be sure, but they may be much smaller than the transfers away from injured foreign exporters.

An extreme example of the problem is the recent *Bananas* case in the WTO, which began in the waning years of GATT. Europe maintained a scheme for restricting imports of bananas that favored banana producers and their affiliated importers located in some of its former colonies over those in other nations. The fight was not so much about the quantity of imports that would enter the European Union (EU) or their price, but over who would get what shares under the applicable quotas and which importers would get the requisite import licenses and the attendant quota rents. As a rough approximation, the social stakes were nil and the battle was simply over the allocation of the artificial profits created by the import restrictions (for a history of the case, see Salas and Jackson 2000).

To be sure, the lessons from the literature on private versus social incentives for litigation do not necessarily transfer to a setting in which there is no private standing. The reader may well have noted that a great deal was spent on the *Bananas* litigation by governments despite the absence of monetary remedies. Thus, if we consider the current situation in the WTO or NAFTA where only governments have standing and contemplate changing the remedy only, the questions become how would governments behave under a system with damages remedies? And how does that compare to behavior in the current system with trade sanc-

17. A dynamic perspective does not change the basic conclusion. Think of the amounts in Figure 1 as per-period amounts, sum them over time, and discount to present value—the same issues arise.

tions? Would the problem of socially excessive litigation become more or less acute under a monetary remedy system?

The answer surely depends in part on the precise nature of the monetary remedy, about which one could only speculate. Further, one cannot answer these questions without a more complete theory of how governments make litigation decisions under either system. If we imagine that governments would act as profit maximizers in a system of money damages, for example, we can apply more or less directly the lessons from the private-litigation literature to the monetary damages case. But that assumption about the governmental objective function is no doubt open to debate, and in any case it would remain to contrast that case with the behavior of governments in the current system with trade sanctions, where profit maximization in a conventional sense surely does not capture the decision-making calculus.

Finally, the danger of socially excessive litigation also turns on the degree to which a mere threat of litigation may deter violations in the first place. If violations never occur, and thus litigation never ensues, the danger of socially excessive litigation evaporates. This point is akin to the observation in Shavell (2004) that the danger of socially excessive tort litigation is diminished when injurers are subject to a negligence rule rather than a strict-liability rule and can avoid suit by exercising due care.

Thus, one must confront yet another difficult set of empirical issues in comparing the two systems, involving the degree to which a change in the remedy would encourage or dissuade violations and alter the amount of litigation. On this general set of issues, it is questionable whether trading nations can avoid litigation costs under any remedial regime by simply complying with the rules. Flagrant cheating occurs under trade agreements to be sure, but many disputes involve good-faith disputes over the interpretation of legal obligations or the application of legal principles to the facts. Many violations may simply be accidental, especially by developing countries with limited compliance capacity. In other cases, the law is unclear or its application under the circumstances is fairly debatable—trading nations can then comply with the rules only by abandoning potentially legitimate policies, and they may be unlikely to do so in many cases. But these observations do little to answer the question whether a switch to money damages would do more or less to encourage violations and thus to encourage or discourage litigation.

In the end, therefore, the issues here are complex and require much more theoretical and empirical work before they can be resolved. What

can be said with confidence, however, is that monetary remedies are not superior to trade sanctions because they are a mere transfer. Monetary remedies too will be accompanied by potentially significant deadweight costs, and the question whether those costs are higher or lower than those of trade sanctions admits of no easy answer.

3.2.3. Money Damages and Developing Countries. Developing countries might be quite uneasy about a system of monetary damages, at least if they were calibrated to compensate foreign exporters for the damages they suffer owing to illegal acts. Many developing countries regularly suffer severe shortages of hard currency and will be hard-pressed to pay significant damages in any currency that they cannot print. And because their legal infrastructure is often weak, their ability to avoid damages judgments by simply complying with the law is limited, as noted above—indeed, within the WTO, developing countries often complain that they do not fully understand how to implement their obligations and seek assistance for capacity building in this regard. Monetary damages might thus produce a significant chill on their domestic regulatory initiatives and expose them to considerable liability for inadvertent violations.

Although some developing countries have nevertheless suggested that a monetary remedy be introduced into WTO law as noted earlier, Davey (2001) explains the nature of the remedy that they have in mind. They do not advocate a system of compensatory damages but a sliding-scale system of fines set on the basis of factors such as gross domestic product and per capita income. Mexico's proposal for auctioned retaliation rights provides similar protection to the treasuries of developing countries in that no nation would be compelled to participate in any auction. Existing proposals for monetary remedies, therefore, are aimed at imposing substantial monetary costs on violations by wealthier states while imposing small costs on violations by developing countries. It is thus possible that no system of monetary damages lies at the core of the bargaining game between North and South, at least not as the game has been structured so far, and not on the scale of the WTO. The problem might be overcome in future bargaining by some sort of issue linkage, but the opportunity for such an arrangement perhaps has not yet arisen.

3.2.4. Is It Possible to Substitute Money Damages for Trade Sanctions? Finally, one must reflect on the practical challenges of designing a credible system of monetary penalties to replace trade sanctions. Imagine that monetary penalties were assessed against a violator state that

then declined to pay the judgment. What consequence would follow? Unless nations are confident that reputation or repeat-play concerns will alone ensure respect for monetary awards—and they plainly lack confidence in these forces to police the rest of their obligations—it seems that any system of monetary liability would have to be backed up with the threat of trade sanctions. At the end of a dispute, violator states would then have the opportunity to choose between paying the assessed damages or suffering the trade retaliation that follows from nonpayment. In many ways, such a system is the mirror image of the status quo—violator states today choose between retaliation under agreed standards for calibrating it and negotiated compensation, which can be monetary or anything else. It is not clear what advantage an alternative system of monetary penalties would really offer.

To be sure, part of the problem might be avoided if trading nations posted bonds *ex ante*. But this system too could quickly break down without a threat of sanctions to induce bonds to be posted in a timely fashion and to be replenished when needed.

The Mexican auction proposal, of course, does embody a blend of monetary payments and trade retaliation. The proposal is apparently making little headway in the WTO at large, however, perhaps because of the concern noted above—it would amount to a sizable transfer from North to South and may not yet lie at the core of any near-term global bargain.

I conclude this section with one last point about the contrast between trade and investment. If a threat of trade sanctions is necessary for monetary penalties to be enforceable in a trade setting, why not also in the investment context? The answer is that an alternative threat sits in the background of an investment agreement to induce governments to pay damages, wielded by the global capital market. Any capital-importing nation that defaults on its obligations under a BIT or similar instrument will face an increased cost of capital that lowers its welfare. Because the importing nation entered the BIT in the first place to avoid paying such risk premia, it will typically respect a judgment against it absent some substantial change in circumstances.

3.2.5. *Damages in Europe and the United States.* The remarks above perhaps prove too much in light of the difference between NAFTA and the WTO on the one hand and Europe and the United States on the other. Damages awards in the U.S. and European systems are sometimes available to successful plaintiffs and are collected without the need for

a trade sanctions regime in the background.¹⁸ The reason is likely multifaceted and relates to the existence of a political body that sits above the member states with various coercive options, the power of judges to order individual public officials to act and to punish those who do not, and perhaps a stronger pull of reputation in these more deeply integrated systems. Monetary penalties assuredly have more appeal, other things being equal, where the member states can be trusted to pay them without a fight.

4. CONCLUSION

The role of private actors in the enforcement of international economic law varies greatly between investment and trade agreements and considerably within the trade area as well. A private right of action for money damages is especially valuable in the investment arena, where a key objective of the parties is to lower the cost of capital for new, irreversible investments. Nations can cheaply achieve that objective by credibly promising to compensate for expropriation and related practices, so long as those practices are clearly and appropriately defined. This objective is absent in the trade area, where trading nations will often prefer to act as political filters by denying standing to private parties and thereby retaining the ability to block private enforcement actions that can reduce joint political welfare. The existence of a political body with the capacity to reverse politically unfortunate judicial decisions (an *ex post* political filter) is at least an imperfect substitute for the denial of private standing and will make private rights of action more attractive, other things being equal. Finally, it is by no means clear that private rights of action for damages would be superior to trade sanctions or that they could be substituted for trade sanctions as a practical matter in a system such as the WTO or NAFTA. These observations can begin to explain, in broad brush, the patchwork of rules regarding private standing and remedies under existing investment and trade agreements.

18. Recall *Dennis v. Higgins* (498 U.S. 439) in the United States and the *Francovich* (1991 E.C.R. I-5357) line of cases in Europe, discussed in Section 1.1.2.

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