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## Sovereignty and International Trade Regulation

Gary N. Horlick\*

**I have to add** an historical note. I note that our materials start with the Treaty of Westphalia in 1648. Certainly from the very beginning of U.S. history, with the treaty that in effect, created us, the Jay Treaty, people were bargaining away sovereign economic rights. We gave away fishing rights to Canada, or as it was then called, Nova Scotia in return for other English concessions. And no one blinked an eye that somehow we were sacrificing our sovereignty as part of a deal. So there has always been a long tradition on the economic sphere of people just going off and making deals because they made sense, and not bothering themselves too much with the sovereignty issue. It comes up all the time, but it has not been a major issue.

One of the interesting aspects is the political heat this issue is now starting to generate. Just to take a report from April 19, from *The Financial Times*, police in India have organized special patrols for 30 U.S. companies in India, including Cargill, Motorola, Hewlett-Packard and Texas Instruments, because of riots in India over the claim that the World Trade Organization (WTO) agreement infringes Indian sovereignty. So, certainly this is generating some heat as well as light.

The problem as a whole I think is best summarized by Lord Wilberforce's rather pithy observation in the English *Westinghouse* case in 1978, in connection with the traditional (since 1945 in *Alcoa*) U.S. attempts to extend its sovereignty in antitrust areas, that frequently the policies being attacked are precisely the ones the host country is determined to defend. It cannot be put better.

What you get down to frequently — and I will take NAFTA as an example — are attempts to negotiate those policies. There is a long tradition of sitting down in the economic sphere and negotiating away sovereign rights quite freely in both directions, so that everyone is better off. It was, for example, perfectly legitimate for the United States to want in NAFTA to add labor, environment, whatever else it wanted. This was not being forced on Mexico or Canada, it was part of a bargaining proposition. If someone wants to bargain for something, well then there is a price. It would be quite different if you were trying to impose it. And obviously there is international legal doctrine on when negotiation becomes coercion, but I doubt anyone could seriously claim

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that NAFTA reached that point.

Before I get into NAFTA directly, I will have to take head on Jon's assertion that the difference between the European Union (EU) and NAFTA is a difference of form over substance, or, as he put it in another context, a difference of degree rather than kind. If that is true, the difference of degree is so huge as to become a difference in kind, and a rather major one. I will pick on some of his examples which will show that NAFTA in essence comes half way in doing what the EU does. Take rules of origin, the laudable fact that you can get a binding ruling under NAFTA from any of the customs agencies in the three countries. What he did not tell you is that it is not binding on the other two agencies, and there is no guarantee of the binding ruling you get.

With luck, NAFTA will be more cooperative than the U.S./Canada FTA was, but the 49th parallel is littered with the bodies (or trucks) of innocent merchants who thought that a binding ruling from Canada on the rule of origin would be effective with U.S. Customs, or *vice versa*. There is progress, and I want to focus on the positive side, because you *can* negotiate progress.

We now in NAFTA have a single customs origin form for NAFTA, whereas in the U.S./Canada FTA, each country had a different form. But you are a long way from Europe. What is the rule of origin within Europe? In practical terms, there is no one at the border checking. So this is a difference of degree, I will concede, but a difference of degree that if you happen to be driving a truck, is so great as to be a difference in kind.

Jon correctly quoted Canadian law on the subject of deference to NAFTA. He did not quote U.S. law, which in typical U.S. fashion says that the U.S. law takes precedence over the international rules. The U.S. statute does not mention the traditional U.S. rule from the *Charming Betsy* in 1804, a John Marshall opinion that the U.S. shall always try to interpret its laws to the maximum extent possible to be in conformity with its international obligation. This is a black letter rule which is usually ignored now by U.S. courts, and which the Justice Department no longer appears in court to advocate very often.

Turning to NAFTA, as I said, NAFTA is in my view "half-way" for good reason. Fortunately, among the U.S., Canada and Mexico, we have not gone out and killed 60 million of each other in this century. Consequently you do not have the same political drive that you had in Europe, certainly in the '60's and later, to have a more integrated unit. That difference in the politics obviously lies behind the difference in the structures. That said, NAFTA is an attempt to manage economic interdependence without a great deal of concern for sovereignty. I am not going to recite the article which I put in the materials, which you can all read at your leisure. The core of it, as Jon pointed out, is the Chapter 20 dispute resolution system.

## I. CHAPTER 20 OF NAFTA AND VOTING RIGHTS

What I want to focus on here is the issue of voting rights. In the end you have to focus on who decides and in political science terms what you are talking about is legitimacy.

A Spanish fisherman is perfectly accustomed to a bureaucrat in Brussels, probably Greek, telling him what kind of net he can use. I do not want to pick on France, but if he is French, he might even block the entry of fish. The fisherman is not happy about it, but it is considered legitimate. And one of the reasons it is considered legitimate is that Spain has X votes in the EU out of the total of Y votes on the EU regulation that tells you what size net you can use. By contrast, New England fishermen, or some Canadian fishermen, do not recognize the legitimacy of someone in Washington, in the U.S. case, or Ottawa, in the Canadian case, telling them what size net to use. Compliance with fishing laws, especially in the U.S., has been more noted for its absence than its presence, leading to a noted absence of fish. So, what you are dealing with in essence is some sort of perceived legitimacy.

The closest we come in NAFTA — and that is why I focus on it as interesting — is precisely the reverse selection that Jon mentioned.

Let us assume for the moment that you tried to form a European Community out of Germany, Belgium and the Netherlands. You could not. Germany would never accept one-country, one-vote. Belgium and the Netherlands would never accept weighted voting. You have to have France.

Well, put in a NAFTA context, you cannot have one-country, one-vote on issues that really matter, and you cannot have weighted voting. In fact if you look into the future, you have to include Brazil in order to get anywhere near the kind of proportions of population, without even getting into size of the economies. So the problem in Chapter 20 becomes how you vote.

The U.S. has a nearly paranoid fear, understandable in political terms, that Jon and Chris Thomas lived through, of being ganged up on. So you could not have a situation in NAFTA, for example, of a panel of seven, where everyone gets two members, and you flip for the chairman. The U.S. fantasy is that even if the U.S. chooses the chairman, we would always be ganged up on, four to three.

The reverse selection Jon describes is done not for its elegance and as a neat solution, for which I credit the negotiators, but rather because it means that for the U.S. to lose a Chapter 20 decision in NAFTA, it has to lose either on the basis of votes by U.S. citizens the other countries chose, or votes by other countries' citizens the U.S. chose; therefore, the U.S. is not ganged up on by the other countries.

It is a beautiful solution, until NAFTA gets beyond three or four countries. Indeed if there is an extension of NAFTA, you start talking about weighted voting, at which point Mexico and Canada weigh in

and say they get the right in any such extension to the same number of votes as the U.S. has, because they had it in the beginning.

Now, contrast that with the European Union, which just went through a major battle over the exact same issue. The expansion to include the three Scandinavian countries plus Austria meant an expansion in the number of votes — you obviously do not take votes away from existing members — and a big fight over what is a blocking minority in the EU terms ensued.

To me the contrast with Europe is that there, one had an open attempt to negotiate sovereignty and voting, and here, for political reasons we cannot do that. Neither the U.S., Canada nor Mexico is even willing to talk publicly about yielding sovereignty and voting rights and all of that.

So the Chapter 20 solution is a neat solution to managing interdependence, i.e. to giving up something in economic and increasingly other fields, without having to confront the voting issue head on. What I just said is hardly a criticism of the NAFTA negotiators; it is reality. You would not have a NAFTA if you started talking about weighted voting.

## II. LABOR AND ENVIRONMENTAL AGREEMENTS

The main debate about NAFTA in terms of sovereignty was over the labor and environmental side agreements. Now this is interesting, because the agreements by their terms make no change at all in the labor and environmental laws of any of the three countries. The discussion was explicitly limited to ensuring that each country enforces its own laws. Obviously you have a sovereign right to decide if you are enforcing your own laws, and what was being talked about was “giving that up.” But you were not talking about changes in either who enforces the laws or what the laws were. Again, contrast this with the European Union, where international bureaucrats in Brussels make the rules, and often ensure enforcement. The interesting part of the labor and environmental agreement in Canada is that the issue was whether you impose trade sanctions or not. The U.S. and Mexico accepted trade sanctions.

Trade sanctions fit Jon’s formula, which is that you are not giving up your sovereignty; what you are doing is in effect saying “I can reject what this international process decides, if I am willing to pay a price in trade sanctions by retaliation against my own goods.” So the acceptance of trade sanctions is a maintenance of sovereignty; it is “I am willing to pay a price to stay sovereign.”

Canada’s solution shows how “snake bit” Canada feels about U.S. trade measures. Canada agreed that Canadian courts can enforce the decisions. In effect Canada gives up its sovereignty. They give it up to Canadian courts, but they are saying a Canadian court will implement

the decisions of this three nation body, whereas U.S. and Mexico say “no, we will decide whether we accept it or not, and if we do not, we are willing to pay for it.”

Buried within the side agreements, very strikingly — and it is a tribute to what politicians will do when negotiations are almost finished and they have to close the deal — at several points in the labor and environmental panel process, decisions are made based on the majority vote, and the U.S. has only one vote, which I consider amazing, and no one in Congress batted an eye because we were viewed as pushing the Mexicans into these side agreements.

Now obviously, as I mentioned, we cannot keep agreeing to one-country, one-vote. If you get into a western hemisphere free trade area, we are one country out of — depending on how you count them — 30 or more countries. So it is called the OAS and it is not traditionally the favorite model of the United States. So keep an eye on that issue, because the extension of NAFTA forces you to go back to the voting mechanism, because of the U.S. fear of being outvoted.

### III. CHAPTER 11 PRIVATE INVESTOR REMEDIES

The most interesting part of NAFTA as a concession of sovereignty, in my view, is the Chapter 11 investor-state dispute resolution system to which Jon alluded. This also to me is the biggest invitation to lawyers' creativity. One purpose of Chapter 11 is Mexico giving up what many of you are familiar with, its Calvo Clause. Under the Calvo Clause, to grossly over generalize, an investor has to sue in the courts of the host country. It cannot go outside. In effect the investor is waiving its rights to sue outside of the country.

NAFTA gets rid of the Calvo Clause. Instead of going to Mexican courts, if Mexico (or the U.S.) discriminates against a NAFTA investor, the investor can go to arbitration. Bear in mind, for anyone who has any complaints against any of the three countries, you do not have to be a U.S. or Canadian national. A NAFTA investor is someone with a significant business presence, more than just a shell in the U.S., Canada or Mexico. So Sony U.S. can complain that some Mexican government unit is discriminating against Sony, and Sony U.S. can use this procedure.

Now there are some safeguards, but they are weak, in my view, though maybe the three governments have “nods and winks” about them. In essence, you can take a sovereign country to arbitration, the arbitrators give you a money award, and you can go collect it. This applies to state and local governments as well as the national governments.

So if Lake County, Ohio denies you, Sony U.S., your zoning variance and you claim that there is some discrimination — that Lake County would grant the variance for an “American company,” Sony

Mexicana or Sony Canada can trigger one of these panels. And God knows what will happen when the Lake County Board of Supervisors, or whatever local governing body, gets an order from a U.S. District Court, under the New York Convention, ordering it to pay. That is the process to which the U.S. has agreed.

Now, of course the U.S. only agreed to this because it “knew” perfectly well, as trade negotiators always “know,” that in practice, Chapter 11 would apply only to Mexico. Actually, I think this stands more for the proposition, which is a scary one, that trade negotiators almost invariably know more about the foreign country than their own domestic arrangements. Thus, the U.S. negotiators could tell you, in considerable detail, how bad the Mexican judicial system is. But if you ask them, as I once asked one of them, what the average time to get to a jury in a civil action in the District of Columbia is, the reply is “huh?” Four years was the answer, by the way. And this is when they were complaining about Mexican courts taking too long.

Trade negotiators typically do not know their own domestic arrangement. It is not because they are ignorant, rather it is because they spend all of their time studying the foreign countries. For the corporate people here, that is probably the most important lesson to bear in mind, in view of the prospect of international negotiations on labor law or environmental law. Your own country’s negotiators will be perfectly willing to advocate things that would be a nightmare back home, not because they are trying to change their law, but because they do not know it. By “do not know it,” I do not mean that they cannot look it up and they are not smart people, but as all of you know, if there are any labor lawyers here, you have to know the entire culture, the ethos, how the rules fit together, what the real meaning of the precedents are, etc. . . . Well, you know you are not going to have many labor lawyers doing that negotiation; certainly not private ones, and certainly not management ones under this Administration. So hold on to your wallets.

What lies ahead for the future? To me the most interesting indicator is the one Jon highlighted, which is the new WTO Subsidies Agreement. It is as he described, a stealth version. It was not a controversial negotiation. It was probably, as I think about it, the best of the negotiations, or one of the best. It was essentially negotiated by the U.S., Europe, Canada and the GATT secretariat, with Mexico later joining in, all on a very cooperative basis. There were grave disagreements, but everyone was trying to find “the right answer.” And the result is a significant possibility of international discipline on subsidies at every level of government, all the way down to — I will pick on Lake County again — Lake County.

Let me change the tune. You just saw that Mercedes Benz went to Alabama a few months ago. It was going to go to North Carolina, and

overnight switched to Alabama. As the deal started dribbling out, the total came to \$253 million in state aid. And the plant only cost \$300 million. And then the final shoe fell. To show you how inventive people can get in subsidizing, it turned out the subsidy was \$300 million; the difference was made up by an agreement by the state of Alabama to buy 7,500 Mercedes Benz vehicles for state officials. So, you are going to see a lot of Mercedes driving around in Alabama with government tags.

Imagine someone telling Alabama, when it was in the process of stealing this plant from North Carolina, or Ontario or wherever, "you cannot do that." Well, what you are looking at is some fantasy of world government. A bunch of pointy headed international bureaucrats in Geneva — to use the pejorative term that is frequently used — will be sitting there deciding what Lake County, Ohio, or Manitoba, or Jalisco, can do. And no one is even aware of that. At the same time, in the same building, according to the paranoid fantasy, a similar group of bureaucrats will be pointing out how to subvert our environmental laws or our labor laws. The reality, as any of you who has been to Geneva knows, is considerably less colorful, not to mention slower.

But if you look at these new WTO agreements — Subsidies, TRIPS, Agriculture, Phytosanitary, Technical Standards — these are not dealing with border measures. They are dealing with uniform rules applied domestically; uniform domestic rules. They are not about tariffs, anti-dumping, customs valuation; they are about normal domestic law.

The environmental push on NAFTA and GATT, if you will recall, did not begin under President Clinton. It began when you had a Republican President viewed as being anti-environment. The U.S. environmental groups and labor groups were well aware that what they were trying to do was get leverage on their *own* government.

Let me go back to the NAFTA labor process. The side agreement is limited, as I said, to enforcement of each country's own laws, and only certain of them. The labor rights, again to over generalize, cover worker safety and treatment of workers, but not the right to organize.

The first two complaints have already been filed and initiated two days ago against Honeywell and General Electric. You have read the complaints. The people drafting them, being lawyers, knew enough to put in that they are complaining about worker safety, but 90% of the complaints are about the right to organize, which is explicitly excluded by the agreement. Once you start pushing the right to organize in Mexico, what about the U.S. right to work laws? That is clearly where this is headed. So right now everyone with an axe to grind domestically is starting to figure out, "how can I ride on the next trade agreement?"

Where does that leave us? You have in the WTO and in NAFTA something that formally meets Jon's definition, in the sense that, one,



they both have clauses that you terminate; and secondly, probably more importantly, you can ignore the rules. With the exception of Canada on the labor and environmental side agreements, you can ignore the rules and nothing happens domestically. You suffer retaliation in the trade sense, but there is no domestic effect at all. Now, realistically, does anyone think the U.S. can pull out of WTO or NAFTA?

So, what you are left with is — and this is what U.S. Trade Representation is telling Congress as we speak — that we can always ignore the decisions. Well, that is easy to say, but what if the WTO or NAFTA panel decides that our subsidy is illegal, that you could not give the money to Mercedes Benz? Well, we will just stiff them, because we do not have to listen to them, because all you are talking about is Alabama.

The other side of the equation, however, in reality becomes that if we stiff them we will have to allow them to shut out exports from North Dakota. North Dakota has just as many senators as Alabama. So when it really happens, you are going to have two senators from North Dakota saying “Oh, no, you are going to pay attention to that panel.”

Finally, let me turn to the most interesting frontier for “loss of sovereignty in the trade area” and this is what is being done informally, and Jon referred to some of it. Let me direct your attention to two examples. In the one Jon mentioned about having rules of origin, the NAFTA countries agreed formally to have the same rules of origin. They then sat down, each of them, and they negotiated the rules together. Each of them went off and promulgated technically three separate rules. There is a U.S. rule of origin, which by coincidence is identical to the Mexican and the Canadian rules of origin. But this is happening in much less formal ways all over the world.

There is an excellent study by the Administrative Conference of the United States of regulation of safety of large aircraft. Well, intuitively you know that you better have the same safety rules applying to aircraft at both ends of the flight if it is international. The people at the FAA who do aircraft safety go and meet with the joint European regulators, which is not a formal body; it is an informal body in Europe. And they all sit down and hash out the issues and they all go home and write regulations, which are not identical, but are pretty identical, and, more importantly, do not conflict. So the airplane can fly between both places. Aircraft safety, or fundamental domestic government responsibility, is now being done internationally, with no one looking at it.

Let me take the more extreme example, to which Jon adverted: the Basel Agreement on capital requirements. All of a sudden people all over New England were finding out that they could not get loans. Why? Because banks had to have a minimum capital requirement agreed at Basel. Who said that? Not some locally elected group, or

even the Federal Reserve. But the Federal Reserve, a completely unelected body, had gone off and met with the other central bankers, none of whom were elected, in Basel — it is always in Switzerland for some reason — and agreed on what the capital requirements should be.

The result, arguably, was a credit crunch all over the world. Now you cannot get much more fundamentally “domestic” than the availability of credit in an economic system. Here it is being decided internationally by a group of people, none of whom faced a vote and certainly with no fast track authority, no debate, in fact, no public access.

So, when you look into the future, the question is not whether there will be more of this international “cessation of sovereignty,” rather the question is “how.”

