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CONCLUSION: INTERNATIONAL COOPERATION BY INFORMAL AGREEMENT

The varied uses of informal agreements illuminate the possibilities of international cooperation and some recurrent limitations. They underscore the fact that cooperation is often circumscribed and that its very limits may be fundamental to the participants. Their aim is often to restrict the scope and duration of agreements and to avoid any generalization of their implications. The ends are often particularistic, the means ad hoc. Informal bargains are delimited from the outset. More often than not, there is no intention (and no realistic possibility) of extending them to wider issues, other actors, longer time periods, or more formal obligations. They are simply not the beginning of a more inclusive process of cooperation or a more durable one.

These constraints shape the form that agreements can take. Interstate bargains are frequently designed to be hidden from domestic constituencies, to avoid legislative ratification, to escape the attention of other states, or to be renegotiated. They may well be conceived with no view and no aspirations about the longer term. They are simply transitory arrangements, valuable now but ready to be abandoned or reordered as circumstances change. The diplomatic consequences and reputational effects are minimized by using informal agreements rather than treaties. Informal agreements may also be chosen because of time pressures. To resolve a crisis, the agreement may have to be struck quickly and definitively, with no time for elaborate documents.

Because informal agreements can accommodate these restrictions, they are common tools for international cooperation. States use them, and use them frequently, to pursue national goals by international agreement. They are flexible, and they are commonplace. They constitute, as Judge Richard Baxter once remarked, a "vast substructure of intergovernmental paper."[84] Their presence testifies to the perennial efforts to achieve international cooperation and to its institutional variety. Their form testifies silently to its limits.

[84] Baxter, "International Law in 'Her Infinite Variety,'" p. 549.

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The Politics of Dispute Settlement Design: Explaining Legalism in Regional Trade Pacts

James McCall Smith

In recent years two parallel trends have emerged in the organization of international trade. The first development is the rise of regionalism, with a host of new integration initiatives drawn along geographical lines. *** The second is a distinct but less widespread move toward legalism in the enforcement of trade agreements. To an unusual extent trading states have delegated to impartial third parties the authority to review and issue binding rulings on alleged treaty violations, at times based on complaints filed by nonstate or supranational actors. Separately, the two trends have garnered scholarly attention ***. The intersection of these two trends, however, remains little examined.

Few comparative studies of institutional form, across different trade accords, have been undertaken. This is curious, for regional trade pacts exhibit considerable variation in governance structures. Moreover, questions of institutional design – which constitute a dimension of bargaining distinct from the substantive terms of liberalization – have proven contentious in recent trade negotiations, underscoring their political salience.[1] The creation of supranational institutions in regional trade accords has direct implications for academic debates regarding sovereignty,

[1] Mexico threatened to walk away from the North American Free Trade Agreement (NAFTA) over the inclusion of sanctions in the side accords. See *International Trade Reporter,* 18 August 1993, 1352. Canada risked its 1988 pact with the United States through its insistence on "binding" dispute settlement. See Hart 1994, 260–63, 301–302.

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globalization, and interdependence. Nevertheless, research on this particular issue remains scarce. ***

Addressing this gap, I focus on a specific aspect of governance in international trade: the design of dispute settlement procedures. In particular, I investigate the conditions under which member states adopt legalistic mechanisms for resolving disputes and enforcing compliance in regional trade accords. Some pacts are diplomatic, requiring only consultations between disputing states, but others invest standing judicial tribunals with the authority to issue prompt, impartial, and enforceable third-party rulings on any and all alleged treaty violations. To account for these variable levels of legalism, I offer a theory of trade dispute settlement design based on the domestic political trade-off between treaty compliance and policy discretion. The chief implication of this theory highlights the importance of economic asymmetry, in interaction with the proposed depth of integration, as a robust predictor of dispute settlement design. This framework helps explain otherwise puzzling delegations of authority by sovereign states to supranational judiciaries, linking variation in institutional design to domestic political factors conventionally ignored by traditional systemic theories of international relations. ***

At issue in this study is the nature of *ex ante* institutional design, not the record of *ex post* state behavior. During trade negotiations, governments stand, in part, behind a veil of ignorance with regard to future implementation of the treaty and future disputes. The question I investigate involves the type of dispute settlement mechanism, given this uncertainty, the signatory states agree to establish. In advance of actual integration, it is difficult to distinguish sincere commitments from symbolic ones. Even the most successful regional initiative, the European Union, has weathered crises of confidence in its uneven movement toward a single market.[2] Without evaluating the extent to which integration has proceeded, I seek to explain the design of the institutions within which that process unfolds. I examine the institutional structure of the general game, not the outcome of specific disputes, which depend on strategic interactions and highly contextual international and domestic political variables. ***

Nevertheless, I do assert that legalism tends to improve compliance by increasing the costs of opportunism. Legalistic mechanisms alter the cost-benefit calculus of cheating by increasing the probability of detection, resolving conflicts of interpretation, and endorsing commensurate

[2] Tsoukalis 1993, 14–45.

sanctions or making rulings directly applicable in domestic law. [Even] the most legalistic of mechanisms may not guarantee treaty compliance by sovereign states willing to defy its rulings. * Likewise, the least legalistic of pacts may give rise to highly successful integration. * Legalism is thus neither a necessary nor a sufficient condition for full compliance, but it does influence compliance by providing rulings of violation that are viewed as credible and legitimate by the community of member states. This information at a minimum increases the reputational costs of noncompliance, potentially jeopardizing opportunities for future international cooperation on issues of relevance to the domestic economy.[3]

In the first section I introduce the dependent variable, levels of legalism, by identifying specific institutional features that render one dispute settlement mechanism more or less legalistic than another. Next I sketch the elements of a theory of dispute settlement design, defining the basic trade-off and how it varies. Subsequent sections delimit the data set of regional trade agreements, summarize the principal characteristics of their dispute settlement mechanisms, and evaluate the explanatory leverage of my analytical framework ***.

DEFINING THE SPECTRUM: FROM DIPLOMACY TO LEGALISM

Discussions of dispute settlement in international and comparative law texts present the universe of institutional options as a standard set that ranges from direct negotiation at one extreme to third-party adjudication at the other.[4] Which features of institutional design determine the level of legalism along this spectrum? The first question is whether there is an explicit right to third-party review of complaints regarding treaty application and interpretation. A handful of agreements provide only for consultations and perhaps mediation or conciliation, which implies a very low level of legalism in that the disputing parties retain the right to reject any proposed settlement lawfully – the hallmark of a diplomatic system.[5] These pacts are identical in effect to treaties that offer an arbitral process but require explicit consent from all parties to the dispute, including the defendant, before the arbitration proceeds [– and to treaties where member countries that are not directly involved in the dispute control access to the arbitration process.] ***

[3] Maggi 1996.

[4] See Malanczuk 1997, 273–305; Merrills 1991; and Shapiro 1981.

[5] Diverse examples include the 1969 Southern African Customs Union; the 1983 ANZCERTA; and the 1992 Central European Free Trade Agreement.

Where there is an automatic right to third-party review, the second issue concerns the status in international law of rulings that result from the dispute settlement process. The question is whether arbitral or judicial rulings and reports are formally binding in international legal terms. *** If the disputants can lawfully ignore panel recommendations or sabotage panel reports by lobbying political allies, the system is less legalistic than mechanisms whose third-party rulings directly and irreversibly create an international legal obligation.

The next question concerns third parties – in particular, the number, term, and method of selecting arbitrators or judges in each treaty. At the diplomatic end of the spectrum are mechanisms that call for the appointment of ad hoc arbitrators to address a particular dispute. *** At the legalistic end are treaties that create a standing tribunal of justices who rule collectively on any and all disputes during extended terms of service. Even in the absence of explicit stare decisis, decisions made by a standing tribunal are likely to be more consistent over time – and thus more legalistic – than rulings by ad hoc panels whose membership changes with each dispute. [Most] agreements lie between these two poles. What varies is the extent to which disputants are able to angle strategically for sympathetic or biased judges. With a standing tribunal, the parties have little if any influence over the composition of the court after its initial establishment. With arbitrators selected ad hoc by the disputants, however, each party may be free to name nearly half the panel. Some arbitration mechanisms include innovative procedures that help enhance the impartiality of the panel ***.

A fourth question is which actors have standing to file complaints and obtain rulings. The tradition in international law has long been that only sovereign states have full international legal personality, according states an almost exclusive right to conclude international agreements and to bring claims regarding treaty violations. Most trade accords reflect this tradition by allowing only member states to initiate disputes. In some instances, however, standing is defined more expansively to allow treaty organizations – such as a secretariat or commission, which may have a bureaucratic interest in the treaty's effective implementation – to file official complaints against member countries for some failure to comply.[6] In other agreements even private individuals or firms, whose economic interests are most directly at stake in the context of trade policy, have

[6] In the Andean Pact, the Junta – a panel of three technocrats who administer the treaty – has standing to file complaints of noncompliance against member states. The European Union Commission enjoys similar powers.

standing to file complaints and require a ruling. *** Where individuals have standing, they can bring cases in one of two ways: directly, by filing a complaint with the tribunal; or indirectly, by requesting a domestic court to seek a preliminary ruling from the tribunal on any issue of relevance to the treaty. *** In general, the more expansive the definition of standing, the more legalistic the dispute settlement mechanism. When treaty organizations and private parties can file complaints, alleged violations are likely to be more frequent than if standing is accorded only to states, whose multiple diplomatic considerations make them reluctant to pursue certain cases.

Finally, there is the question of remedies in cases of treaty violation. The most legalistic alternative is to give direct effect in domestic law to dispute settlement rulings made at the international level.[7] Where rulings are directly applicable, government agencies and courts have a binding obligation under national law to abide by and enforce their terms. In most instances direct effect creates a right of action in national courts, allowing individuals or independent agencies to invoke the treaty and file suit against the government for disregarding its international commitments.[8]

*** [Another] remedy is the authorization of retaliatory trade sanctions. Permission to impose sanctions is granted only to the complaining state, not to the community of member states for collective action. This type of decentralized enforcement system has deep roots in international law ***. For several reasons, sanctions are not always viewed as an effective remedy in international trade,[9] but other things being equal treaties that provide for sanctions are more legalistic than those with no remedy at all ***. The specific way in which sanctions are authorized is relevant. Some accords *** require approval from a political body ***. Agreements that empower the arbitral panel or tribunal to authorize or prescribe sanctions directly are less subject to political interference and thus more legalistic.

[7] The question of direct effect may depend as much on domestic constitutional norms as on the terms of the treaty. *** I confine my analysis to explicit treaty provisions, assuming that reciprocal treaties should not provide for direct effect where domestic constitutional norms preclude it. ***

[8] The existence of a private right of action may also depend as much on domestic law as on specific treaty provisions. Again I restrict my analysis to the terms of the treaty. Some agreements ignore or confuse the issue, but others are clear.

[9] Even if carefully designed, sanctions impose costs on the sanctioning country as well as on the defendant. Moreover, a system of sanctions systematically favors larger, less trade-dependent states, which are able to implement and withstand retaliatory measures with less economic dislocation than smaller, more open countries. For a general critique of sanctions, see Chayes and Chayes 1995.

TABLE 14.1. *Institutional Options in Dispute Settlement Design*

Treaty provision	More diplomatic	<————>	More legalistic
Third-party review	None	Access controlled by political body	Automatic right to review
Third-party ruling	Recommendation	Binding if approved by political body	Directly binding obligation
Judges	Ad hoc arbitrators	Ad hoc panelists drawn from roster	Standing tribunal of justices
Standing	States only	States and treaty organs	States, treaty organs, and individuals
Remedy	None	Retaliatory sanctions	Direct effect in domestic law

Also relevant is whether the treaty provides any guidelines or potential limits on the level of sanctions that is approved. Mechanisms that offer a blanket authorization are less legalistic than those that apply certain norms regarding the appropriate level and sectoral composition of sanctions. ***

Table 14.1 summarizes the key features of institutional design that make a dispute settlement system more or less legalistic. This list is not comprehensive, since other issues – such as the presence or absence of deadlines or the extent to which arbitrators and judges have relevant legal expertise – can push an agreement toward one end of the spectrum or the other. * With these basic indicators, however, it is possible to categorize individual pacts. Even though the features in Table 14.1 are in theory independent of one another, they tend to cluster in practice, suggesting a hierarchical ordering of four dimensions: third-party review, third-party ruling, judges, and standing. The first question is whether the treaty provides for independent third-party review. Among pacts with some system of review, the next issue is whether rulings are directly binding in international law. Among pacts with binding rulings, those with standing tribunals are more legalistic than those with ad hoc arbitrators. Finally, tribunals with jurisdiction over claims by individuals, treaty organs, and states alike are more legalistic than those accessible only by states. In terms of remedy, the most legalistic pacts provide rulings with direct effect in national law, but the presence or absence of sanctions – though still significant – is a less meaningful indicator of legalism, with unilateral measures always available to states seeking to enforce third-party rulings in the decentralized international system. The basic issue is how effectively a given dispute settlement mechanism is able to produce impartial,

consistent, and legally binding third-party rulings on any and all alleged treaty violations.

THE ARGUMENT

When negotiating a trade pact, governments must decide how legalistic its dispute settlement mechanism will be. In making this choice, political leaders confront a trade-off between mutually exclusive goals. On the one hand, they care about compliance with the agreement, the value of which depends on the extent to which other parties honor their commitments. The more legalistic the dispute settlement mechanism they design, the higher the likely level of compliance. On the other hand, they also care about their own policy discretion – and the less legalistic the mechanism, the greater their discretion to craft policies that solidify domestic support.[10] ***

Policy Discretion

International trade agreements pose a familiar dilemma for national political leaders motivated to remain in power.[11] Among the principal determinants of any executive's or ruling party's popularity is the state of the economy.[12] One way political leaders seek to increase growth and create jobs is to negotiate reciprocal trade agreements, which almost as a rule produce net welfare benefits.[13] The political dilemma lies in the distribution of costs and benefits. Although benefits outweigh costs in the aggregate, for consumers and producers they are diffuse, or shared in small amounts by numerous individuals, whereas costs are concentrated. In political terms, concentrated costs imply organized opposition from adversely affected groups in import-competing sectors.

* * *

This generic problem of trade liberalization – diffuse net benefits, concentrated costs – is a factor in the political calculus of dispute settlement design. Political leaders cannot perfectly anticipate which groups will bear the heaviest costs of adjustment. During the negotiations, they

[10] Yarbrough and Yarbrough pose a trade-off between rigor and the opportunity for derogations that parallels the one I have drawn between treaty value and policy discretion; See Yarbrough and Yarbrough 1997, 148–49; and Smith 1995.

[11] On the political economy of trade, see Schattschneider 1935; Pastor 1980; and Magee, Brock, and Young 1989.

[12] See Kieweit and Rivers 1984; and Alesina and Rosenthal 1995.

[13] Wolf 1987.

propose specific exemptions or side payments for sectors that are clearly vulnerable to import competition.[14] The substantive terms of a treaty, which establish the depth and pace of liberalization, usually reflect such concerns. But political leaders realize that liberalization will impose concentrated costs they cannot foresee. As a result, they want to retain the discretion to respond in the future to uncertain demands for relief from injured groups.[15] Under a legalistic dispute settlement system, political leaders who provide import protection *ex post* run the risk of provoking complaints from foreign trade partners that could lead to rulings of violation, with attendant reputational costs and perhaps sanctions.

In disputes over nontariff barriers, legalistic dispute settlement also threatens to compromise the autonomy of domestic officials across a range of general regulations, from health and safety standards to environmental, antitrust, and procurement policies. *** In recent decades, *** the principal obstacles to open trade have been nontariff barriers, domestic regulations that discriminate against foreign producers, [which dominate the agendas of contemporary trade negotiations.] The politics of regulation is not unlike the political economy of trade: the marginal impact of regulatory policy on small, organized groups is often disproportionately large compared to its impact on the general, unorganized public. This characteristic increases its salience to officials seeking to remain in power, *** who may now face unprecedented complaints from foreign governments alleging unfair regulatory barriers to trade. If the merits of these complaints are judged in legalistic dispute settlement procedures, the policy discretion of political leaders may be constrained – and in areas where the domestic political stakes, given mobilized interest groups, are high.

* * *

Treaty Compliance

If legalistic trade dispute settlement poses such a clear domestic political threat, why would trade negotiators ever consider, much less adopt, any binding procedures? The answer lies in the benefits generated by dispute settlement mechanisms that improve government compliance and instill business confidence. The very procedures that constrain the policy autonomy of public officials, giving rise to political risks, also improve the economic value of the treaty, yielding domestic political benefits. If those

[14] See Destler 1986; Destler and Odell 1987; Goldstein 1993; and Pastor 1980.
[15] Downs and Rocke 1995, 77.

benefits are sufficiently large, they may offset the potential costs of policy constraints, making legalistic dispute settlement an attractive institutional option.

There are several ways in which legalistic dispute settlement is likely to enhance the level of compliance with international trade agreements. When implementing reciprocal liberalization, trading states confront problems of motivation and information.[16] Each state knows its partners may be motivated at times to violate their treaty commitments in order to provide protection to domestic groups. Each state also knows that with the prevalence and complexity of nontariff barriers, it may be difficult to generate information about every instance of defection by its partners. These transaction costs may prevent states from achieving mutually beneficial gains from exchange. [International] institutions arise in part to mitigate such costs by providing information about violations and in some instances by enforcing commitments.[17]

Formal dispute settlement procedures serve these very functions. As official forums where complaints are filed and judged, dispute settlement mechanisms play an important role in monitoring treaty violations, helping to offset problems of information. As independent bodies with the authority to endorse sanctions against offenders, dispute settlement mechanisms also help enforce treaty commitments, mitigating problems of motivation. Trading states realize that agreements are valuable only if compliance with their terms is high. *** The more legalistic the mechanism – in other words, the more effectively and impartially it identifies violations and enforces third-party rulings – the higher the likely level of government compliance.[18]

In addition to monitoring and enforcing compliance, dispute settlement procedures also serve to define compliance, clarifying the meaning of the treaty in disputes over how to interpret its terms. [Dispute] settlement operates in this respect as a type of relational contract.[19] Because the parties to a trade agreement cannot foresee all possible contingencies, they find it very difficult *ex ante* to define compliance. The accord they negotiate is inevitably incomplete; it does not specify how the parties are to behave under all possible circumstances. As circumstances change, conflicts of interpretation may arise. To avoid such conflicts, parties agree in

[16] See Yarbrough and Yarbrough 1990; and Milgrom and Roberts 1992.
[17] Keohane 1984.
[18] Economists have sought to demonstrate the benefits of third-party trade dispute settlement with formal models. See Maggi 1996; and Kovenock and Thursby 1994.
[19] Milgrom and Roberts 1992, chap. 5.

relational contracts to assign rights and responsibilities to define compliance, a role that trade accords often confer on impartial third parties.[20]

Finally, legalistic dispute settlement also improves the expected value of reciprocal trade pacts through its impact on the behavior of private traders and investors. For political leaders to realize fully the benefits of liberalization, private sector actors must believe that having committed specific assets to production for (or sales in) foreign markets, they will not be denied access to that market. Traders and investors are risk-averse with respect to decisions about investment, production, and distribution involving assets that are highly specific – in other words, assets that are costly to convert to other uses.[21] Other things being equal, they prefer minimum uncertainty, prizing a stable policy environment in which to assess alternative business strategies.[22] Legalistic dispute settlement serves as an institutional commitment to trade liberalization that bolsters the confidence of the private sector, reducing one source of risk. The private sector thus increases the volume of trade and investment among the parties, amplifying the macroeconomic – and, in turn, political – benefits of liberalization.

* * *

Assessing the Trade-off

Political leaders negotiating the design of dispute settlement always confront this tension between policy discretion and treaty compliance. The trade-off between these objectives is universal, but not uniform. Different governments assess it in dissimilar ways. And the weight a specific government assigns to each objective changes in different settings, as does the probability that its preferred mechanism will be adopted. In specifying the dimensions of variance, it is helpful to distinguish two stages in the process of dispute settlement design. The first is national preference formation; the second, international bargaining.[23]

[20] See Garrett and Weingast 1993; and Weingast 1995.

[21] Not all assets, obviously, are specific. For a discussion, see Frieden 1991, 434–40, who builds on the pioneering work of Oliver Williamson. Williamson 1985.

[22] Not all firms prefer stable, liberal trade policy to the prospect of future protection. Firms close to insolvency or in sectors with low productivity are likely to prefer trade policy discretion – and the increased probability of protection – to legalistic dispute settlement.

[23] This distinction follows Moravcsik 1993, 480–82.