

Preliminary and Incomplete  
(References to be added)

Regulating Multinational Corporations: Towards Principles of Cross-border Legal Frameworks  
in a Globalized World Balancing Rights with Responsibilities

Joseph E. Stiglitz

Grotius Lecture<sup>1</sup>

Presented at the 101<sup>st</sup> Annual Meeting of the American Society for International Law  
Washington, D.C., March 28, 2007

1. The importance of corporations and the problems they present

An increasing fraction of commerce within each country is conducted by corporations which are owned and controlled from outside its borders, corporations which often conduct business in dozens of countries. These corporations have brought enormous benefits—indeed, many of the benefits attributed to globalization, such as the closing of the knowledge gap, the gap between developing and developed countries which is even more important than the gap in resources, are due in no small measure to multinational corporations. More important than the capital which they bring<sup>2</sup> is the transfer of technology, the training of human resources, and the access to international markets.

In recent years, especially following the collapse of the initiative to create a Multilateral Agreement on Investment within the OECD<sup>3</sup>, there has been a proliferation of bilateral investment treaties (B.I.T.s) and investment provisions within bilateral free trade agreements.<sup>4 5</sup> These agreements are purportedly designed to provide greater protection for investors, thereby encouraging cross-border investment. There is, to date, little evidence that they have done so.

---

<sup>1</sup> This lecture draws heavily from Chapter 7 of J. E. Stiglitz, *Making Globalization Work*, New York: W.W. Norton, 2006.

<sup>2</sup> Indeed, in a country with China, sitting on 1 trillion dollars of reserves, there is little value to the capital itself.

<sup>3</sup> The initiative to create an MAI collapsed in October 1998 when the French Prime Minister Lionel Jospin announced his government was withdrawing from the talks. The developing countries were worried that new obligations would be imposed on them, and that the agreement would bring them little benefit. For additional details see Guy de Jonquieres. "Retreat over OECD pact on investment." *The Financial Times*, Oct 21, 1998, Sec. World Trade, p 4. There is an interesting parallel with the failure of the multilateral trade talks: each was followed by a proliferation of bilateral agreements, which were in general even more disadvantageous to the developing countries.

<sup>4</sup> It is important to recognize that these so-called free trade agreements are not really free trade agreements, but managed trade agreements. A free trade agreement (FTA) would eliminate not only tariffs, but non-tariff barriers and subsidies. None of the FTA's do that. For a further discussion, see, e.g. J. E. Stiglitz and Andrew Charlton, *Fair Trade for All*, Oxford University Press, 2005 and J. E. Stiglitz, *Making Globalization Work*, op. cit.

<sup>5</sup> The number of such agreements has been increasing so rapidly that it is hard to keep track. According to UNCTAD, which tries to monitor them, the numbers almost doubled between 1995 and 2005, going from 1,322 to 2,495. These figures only include BITs which make up slightly less than half of all International Investment Agreements (IIA) according to "Developments in international investment agreements in 2005." IIA Monitor No. 2 (2006). United Nations: New York and Geneva.

One World Bank study, based on standard cross-country regressions, has questioned whether they do so.<sup>6</sup>

This paper is concerned with a set of more fundamental issues. Even if it could be established that B.I.T.'s led to increased investment, and even if that investment could be shown to lead to higher growth<sup>7</sup>, it does not mean that societal welfare has been increased, especially once account is taken of resource depletion and environmental degradation. These agreements are designed to impose restraints on what governments can do—or at least impose a high cost to their undertaking certain actions.

These agreements are, of course, not all identical; and what exactly they do is itself a subject of some controversy. Like any agreement, it depends on the interpretations of particular words, and the judicial processes through which these words are given meaning is one of the sources of dissatisfaction with the agreements. Different arbitration panels have interpreted even the same words differently, creating a high level of uncertainty (both among governments and investors) about exactly what these agreements do. This article is focused not on any specific agreement, but on the general thrust of these agreements, which goes substantially beyond protection against expropriation.

They (The agreements?) are concerned with the far broader issue of what happens when changes in regulations or taxes adversely affect the value of a foreign owned asset.<sup>8</sup> They do not, of course, stop governments from changing regulations or taxes; but they do require that the government compensate those that are adversely affected. In doing so, they increase the costs of governments changing regulations and taxes. (It should be clear that they are not symmetric: they do not allow the government to capture the increase in value that results from government actions that might positively impact the value of the assets, unless such recapture is guaranteed in the treaty itself.)

Governments, of course, are constantly changing regulations and taxes and making investment which have a variety of impacts on firms. The general stance in all sovereigns, especially in democracies, is that it should be the right of each government to make these changes, without paying compensation. In the United States, the debate has centered on regulatory takings, with anti-environmentalists arguing for compensation. They know that by increasing the cost of environmental regulations, they will reduce the scope.<sup>9</sup> They have argued that the Constitution

---

<sup>6</sup> See Hallward-Driemeier, Mary. "Do Bilateral Investment Treaties Affect FDI? Only a bit ... and they could bite." June 2003, World Bank, DECRG. UNCTAD found similar results in "Bilateral Investment Treaties in the Mid-1990s." 1998. United Nations, New York and Geneva.

<sup>7</sup> An increase in foreign investment might not lead to higher growth if, for instance, foreign investment displaced domestic investment. It is important, of course, to measure growth appropriately, taking account the depletion of natural resources and the degradation of the environment. Moreover, countries should focus not on GDP (which most of the empirical studies do), but on NNP. The former looks at output produced within a country, the latter at the (net) income of the citizens of the country. If output goes up, but all of the resulting increased income goes to foreigners, it obviously is of little benefit to the citizens of the country. Using these concepts, it is even easier for foreign investment to go up, but the well being of the citizens to decrease. Some of the mines in Papua New Guinea, for instance, caused enormous environmental degradation; the low royalties they received almost surely were not enough to compensate them for this damage.

<sup>8</sup> There are important questions even of what that means, on which I shall comment briefly below.

<sup>9</sup> To be fair, some of the advocates of regulatory takings provisions see it as not just instrumental (i.e. reducing the scope for regulation) but believe that such provisions are necessary for a just society (if it is *unfair*, in some fundamental sense, to deprive people of their property; partial deprivation through

protects against the arbitrary taking of property without full compensation; and they have argued that such takings should even then be highly restricted, e.g. to the construction of roads. Courts have consistently rejected that view.<sup>10</sup> Indeed, in a highly controversial case, the Supreme Court sustained the right of eminent domain to takings of land for developmental purposes, in which the land taken would subsequently be used by private parties.<sup>11</sup> Disappointed with these Court rulings, conservatives and anti-environmentalists have turned elsewhere. In some states, they have successfully passed initiatives<sup>12</sup>, though such initiatives have not yet been fully tested in the courts???? Tkck. They have introduced legislation into Congress, but so far, such legislation has failed to pass.<sup>13</sup> I was in the Clinton Administration during a period of particularly intensive efforts by some in Congress to have such legislation adopted. There was remarkable agreement among all the offices of the White House—the Council of Economic Advisers (CEA), the Office of Science and Technology (OSTP), the Office of Information and Regulatory Affairs (of the Office of Management and Budget) and the Council on Environmental Quality. We all believed that such legislation would unduly circumscribe the ability to legislate needed regulations for protecting the environment, workers, consumers, and investors; and we were supported in this by President Clinton and Vice-President Gore.

My interest in the subject at hand arose partly because at the same time that we were fighting back—successfully—these regulatory takings initiatives, we were also working hard for the passage of NAFTA (the North American Free Trade Agreement), which, in its Chapter 11, continued language which has subsequently been interpreted (at least in some cases) as a

---

regulation is also fundamentally unfair) regulatory takings will enhance economic efficiency. **We shall discuss these issues briefly below (cf. discussion of endangered species)**

<sup>10</sup> The Supreme Court has utilized a three-prong test, developed in *Penn Central Transportation Co. v. City of New York*, 438 U.S. 104 (1978), to analyze when regulation has gone “too far,” constituting a taking and therefore requiring compensation from the Government. These factors are the character of the government action, the economic impact of the regulation on the landowner, and the distinct investment-backed expectations of the landowner. Laws and regulations that focus on restricting public nuisance, and protecting the health and safety of the community, have not required compensation. See, e.g., *Hadacheck v. Sebastian*, 239 U.S. 394, 410--12 (1915) (barring brick manufacturers from residential areas).

<sup>11</sup> See *Kelo v. Conn.*, 545 U.S. 469 (2005). This much discussed case focused on the interpretation of “public use” in the 5<sup>th</sup> Amendment of the U.S. Constitution., in the context of eminent domain The Court’s decision that the taking of private property to transfer to private companies (primarily Pfizer) in order to boost economic development in the City was constitutional, continues to generate great opposition.

<sup>12</sup> These regulatory takings initiatives have found success in Oregon in 2004, with the passing of Measure 37, requiring just compensation for any land use regulation passed after the statute was implemented; and also in Arizona in 2006, when voters overwhelmingly supported Proposition 207 (cited as the “Private Property Rights Protection Act”), which merged eminent domain and regulatory takings clauses into one amendment. However, initiatives failed to garner sufficient voter support in Washington (Initiative 933), California (Proposition 90), and Idaho (Proposition 2).

The initiative in Oregon has faced legal challenge in Oregon Courts. Although plaintiffs attempting to overturn Measure 37 gained success in the lower courts, the Oregon Supreme Court found the measure constitutional, and reversed this decision, therefore clearing the way for the initiative to continue functioning. See *MacPherson v. Dept. of Administrative Purposes*, 340 Or. 117, 130 P.3d 308 (Or. 2006).

<sup>13</sup> Congress passed the Treasury, Postal Services and General Government Appropriations Act, 1997 (Pub. L. No. 104-208, §645, 110 Stat. 3009 (1997)) in 1997, requiring the Office of Management and Budget to prepare a detailed analysis of the costs and benefits of each regulatory action of the Federal Government. There have been a series of House bills in the 109<sup>th</sup> Congress attempting to implement greater limits on eminent domain and regulation by Federal government: however, these proposals have all died in the Senate. See Private Property Rights Protection Act 2005, H.R. 4128, 109th Cong. (2005); Threatened and Endangered Species Recovery Act, H.R. 3824, 109th Cong. (2005); Private Property Rights Implementation Act, H.R. 4772, 109th Cong. (2006).

regulatory takings provisions. Had President Clinton known about this, I feel confident that he would, at a minimum, have demanded a side-letter providing an interpretation of Chapter 11 that precluded such an interpretation. But we never had a discussion on the topic in the White House, and I am convinced that President Clinton was not apprised of the risk of such an interpretation.<sup>14</sup> In the subsequent fast track discussions in Congress, the issue too did not get raised. **Ck** This highlights one of the main criticisms of these agreements—that they are, in their nature, not democratic. That, indeed, may be their main rationale: to circumvent normal democratic processes, to get protections for investors that they would never have obtained had there been an open and public discussion. If the U.S., in adopting such an agreement, was not fully aware of its import, this is even more likely to be the case in developing countries.

The consequences are just becoming apparent, as the number of suits brought under these agreements has soared. One recent count has the number of NAFTA suits alone at , entailing claims of billion.<sup>15</sup>

In this lecture, I want to focus on some foundational issues:

- a) Is there a need for international economic agreements concerning the regulation of multinational corporations?
- b) If there is, what should be the scope for such multinational agreements, and what global institutional arrangements might be most effective?
- c) In particular, should governments have the right to restrict entry of corporations (as opposed to people or capital) from abroad, or should they have the right to insist on incorporation inside their own country?
- d) What should be the extent of protection of property against changes in regulation or taxation?
- e) Are there legitimate reasons that a country might wish to discriminate between foreign and domestic firms? Should investment treaties be limited to prohibiting such discrimination? What are the costs and benefits of such a restriction?
- f) If these global institutional arrangements cannot be created (at least in the short run), what can individual countries do?

The entire discussion is informed by modern economic theory, which has helped clarify the role of markets and of government, including the importance, and limitations, of property rights. In this sense, this paper is a contribution to the general theory of law and economics; but it lies on foundations that are markedly different from the predominant Chicago “Law and Economics”

---

<sup>14</sup> The Council of Economic Advisers played a central role in the passage of NAFTA. At the time, there was considerable debate within the White House about whether to pursue its passage, with higher priority being assigned to domestic issues (reducing the deficit, health care reform, welfare reform). It was partly at the urging of the Council that the adoption of NAFTA was added to the list. And the CEA was involved in all of the important decisions that led up to the passage. I had an occasion subsequently to ask Mickey Kantor, who at the time was the U.S. Trade Representative, and thus the person directly responsible for trade agreements like NAFTA, whether he was aware *at the time* of the full import of Chapter 11. He pointed out, rightly, that the Clinton Administration had inherited the text from the Bush Administration, so besides the concerns about labor and environment that got reflected in side-letters of agreement, little attention was paid to the details of what was inside the agreement.

<sup>15</sup> For a discussion of the exponentially increasing role of litigation in addressing trade disputes, specifically at the WTO, see Alan Beattie, “From a trickle to a flood - how lawsuits are coming to dictate the terms of trade,” *Financial Times*, Mar. 20 2007.

school<sup>16</sup>, which sees legal institutions as part of a system designed to ensure efficiency, promoted most effectively through free market competition combined with secure property rights.<sup>17</sup> The last quarter century has seen a re-examination, and a rejection, of the economic foundations on which this theory rests, and the creation of a new paradigm, based on imperfect information and incomplete markets. In this new paradigm<sup>18</sup>, markets by themselves are not, in general, efficient, and government intervention (sometimes even quite limited interventions, such as circumscribing conflicts of interests, as in the case of auditing<sup>19</sup>) can lead to welfare improvements.<sup>20</sup> Laws and regulation are, however, not only directed at improving efficiency, but also at promoting social justice more broadly defined, including protecting those who otherwise might not fare so well in the market economy if left to themselves. This helps explain legislation and regulation designed to protect consumers, workers, and investors. In addition, there are some areas in which rules are essential: every game, including the market game, requires rules and referees. There may be more than one set of “efficient” rules; but different rules have different distributional consequences. Society, in selecting a set of rules to regulate economic behavior, has to be mindful of these distributional consequences.

---

<sup>16</sup> This set of theories has been most forcefully articulated in the works of Richard Posner. See Posner, Richard A. *Economic Analysis of Law*, 7th Edition., 2007, Wolters Kluwer Law & Business, and Posner, Richard A. *Antitrust Law*, 2<sup>nd</sup> Edition, 2001, University of Chicago Press.)

<sup>17</sup> This school typically also sees the forces in the economy to maintain competition as being strong. For instance, even when there is a natural monopoly (a single firm dominates the market, because of increasing returns to scale), competition *for* the market—to be that single firm—is so strong that efficiency is ensured. See Baumol, William; Panzar, John; Willig, Robert. *Contestable Markets & the Theory of Industry Structure*. 1988, Academic Press. Like much of the rest of this theory, it rests on weak foundations: if there are even arbitrarily small sunk costs, then markets are not contestable; potential competition does not suffice to ensure economic efficiency. See, e.g. Farrell, Joseph. “Cheap talk, coordination, and entry.” *Rand Journal of Economics*, Vol. 18, No. 1, Spring 1987, p 34-39.; J. E. Stiglitz, “Technological Change, Sunk Costs, and Competition,” *Brookings Papers on Economic Activity*, 3, 1987. Also in special issue of *Microeconomics*, M.N. Baily and C. Winston (eds.), 1988, pp. 883-947; and P. Dasgupta and J. E. Stiglitz, “Potential Competition, Actual Competition and Economic Welfare,” *European Economic Review*, 32, May 1988, pp. 569-577.

<sup>18</sup> For an exposition, see J. E. Stiglitz “Information and the Change in the Paradigm in Economics,” in *Les Prix Nobel; The Nobel Prizes 2001*, Tore Frangmyr (ed.), The Nobel Foundation, 2002, pp. 472-540. Abbreviated version in *American Economic Review*, 92(3), June 2002, pp. 460-501.

<sup>19</sup> See Sarbanes-Oxley Act of 2002, [Pub. L. No. 107-204, 116 Stat. 745](#) (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

<sup>20</sup> This revisionist view has also changed perspectives on other non-market institutions. Previously, some had argued that non-market institutions arose to address market failures (see, e.g. North, Douglass. *Structure and Change in Economic History*. New York: WW Norton, 1981); for instance, because of moral hazard, markets provide only limited insurance, and gaps in market insurance are filled, in part, by non-market institutions, like families. Putting aside the functionalist fallacy, a closer analysis of the interactions between these non-market institutions and markets shows that they may, in fact, be dysfunctional; that is, while they may arise to fill in holes left by the market, the market responds to these non-market institutions, with the net result that the overall level of insurance may be decreased: the non-market institutions, which are less efficient in risk sharing than the market institutions, crowd out the market institutions. See R. Arnott and J. E. Stiglitz, Moral Hazard and Non-Market Institutions: Dysfunctional Crowding Out or Peer Monitoring,” *American Economic Review*, 81(1), March 1991, pp. 179-190. North’s more recent work (for instance, *Institutions, Institutional Change and Economic Performance*. Cambridge University Press, 1990 and *Understanding the Process of Economic Change*. Princeton University Press, 2005) seems to reflect a recognition of the limitations in the earlier view. For a broader discussion of these issues, see J. E. Stiglitz, “Challenges in the Analysis of the Role of Institutions in Economic Development,” in *Villa Borsig Workshop Series 2000: The Institutional Foundations of a Market Economy*, Gudrun Kochendorfer-Lucius and Boris Pleskovic (eds.), German Foundation for (DSE), 2001, pp. 15-28.

We look at the laws relating to corporate governance and bankruptcy through this perspective. We argue that even a narrow focus on efficiency requires going beyond frameworks that ensure shareholder value maximization; but when a broader perspective incorporating equity as well as efficiency is taken, the case for alternative frameworks becomes even more compelling. We argue that B.I.T.'s may interfere with a country's ability to develop a legal framework maximizing society's social welfare.

We view B.I.T.'s through two different lens—as imposing restrictions on the ability of governments to impose certain regulations, and as providing insurance to those establishing businesses within a jurisdiction. Imposing restrictions on governments' behavior may reduce regulatory uncertainty (although at a high cost), but it may not be the best way to reduce risk. As an alternative, should the market provide insurance? Normally, free market advocates think of markets as more efficient than government in providing insurance. Is there a rationale, in this case, to rely on publicly provided insurance?

### **1.1. Basic Perspectives**

The basic perspective I take in this paper is the following: It is hard to think of a successful American economy with only state laws, with no way of dealing with cross-border disputes. Accordingly there is a need for some international agreements—indeed I argue later that we should create an International Commercial Court to adjudicate disputes, a court based on clear principles of jurisprudence and high standards of transparency, with full time judges not subject to the kinds of conflicts of interest for which the arbitration processes under the B.I.T's have been so roundly criticized. But more is required than just a Court: there needs to be some way of adapting the law, to ensure that the Courts' interpretations are consistent with prevailing mores and with changing conditions. Federal law should be subjected to strong democratic political processes; if Courts' interpretations are sufficiently out of line with the intent of the legislation, then there is a democratic process by which such “misinterpretations” can be corrected.

BIT's and the investment provisions of FTA's have attempted to fill in the gap, but they have done so in a way which is not totally satisfactory. One of the major failings of the Treaty approach is that there is no easy means of correction and adaptation; correcting a treaty is far harder than correcting a piece of legislation.

But the critique of the BITs provided here is more fundamental: they are based on an incoherent set of economic principles, which leads to a failed understanding of the appropriate role of national regulation. We argue that there is a fundamental difference between the rights of labor and capital to move across borders and the rights of a corporation incorporated in one jurisdiction to operate in another, and that it is a legitimate prerogative of governments to require that those wishing to engage in material business within their borders to be incorporated (e.g. through the establishment of a subsidiary) within the country.

One of the problems of the B.I.T.'s is that they are one-sided and unbalanced: they give corporations rights without responsibilities, compensation for adverse treatment, but not recovery of capital gains from positive treatment; they have given foreign firms protections not afforded to domestic firms, thereby creating an unlevel playing field, with perverse incentives. There are good reasons that governments have not provided these guarantees to domestic firms—and there are good reasons that they should not be provided to international firms.

I approach these issues from the perspective of an economist, an economist that sees institutions like “corporations” and “property rights” as social constructions, to be evaluated on how well

they serve broader public interests. Individuals have rights—the kinds inscribed in the Bill of Rights. Individuals may have certain rights to act together collectively; but there is no inherent right, for instance, to limited liability, which defines corporations. Limited liability is a social construction which has proven very useful; indeed, without it, it would be hard to imagine modern capitalism.<sup>21</sup> But the circumstances in which the corporate veil can be pierced, the “rights” which ought to be granted to these limited liability institutions (including the right to enter a country), or the extent to which the officers of these institutions should be held liable for the actions which these institutions take, is a matter of economic and social policy. To repeat, corporations have no inherent rights.

Thus, an analysis of the desirability of extending to them certain rights is quintessentially a matter of economic and social analysis—to ascertain what the consequences are of one set of provisions or another. The intent of this paper is to provide this analysis.

Readers will see a close parallel between the approach taken here and that taken by Adolf A. Berle and Gardiner C. Means in their classic work, *The Modern Corporation and Private Property*.<sup>22</sup> They called attention to the separation of ownership and control, and explored the implications for property rights. My 1985 paper<sup>23</sup> helped put Berle and Means on solid footings; it provided information theoretic foundations for the separation of ownership and control, and helped explain why effective control is not exercised by shareholders. It helped begin the modern discussion of corporate governance.<sup>24</sup>

## 1.2. Outline of the Paper

Section 2 provides a brief reprise of the problems posed by multinationals; it describes the benefits they have brought, but also explains why they have been subject to such criticism. It then explains why foreign corporations may present problems that are somewhat different from those posed by domestic firms. Section 3 provides the core of the economic analysis. It articulates the market fundamentalism position, underlying many of the arguments of free market advocates, including those stressing the importance of property rights protection (sometimes referred to as the Chicago school). It describes (a) why under those perspectives there would be no need for bilateral trade agreements; but (b) why these ideas have been rejected by modern economic analysis. On the basis of this, it shows why government regulation is required, and applies that analysis to explain the need for government rules governing corporate governance and bankruptcy. On the basis of this analysis, we argue against an unfettered right to

---

<sup>21</sup> See Bruce Greenwald and J. E. Stiglitz, “Information, Finance and Markets: The Architecture of Allocative Mechanisms,” *Industrial and Corporate Change*, 1(1), 1992, pp. 37-63.

<sup>22</sup> The 1932 edition was published by Macmillan; the revised edition (1967) was published by Harcourt Brace.

<sup>23</sup> “Credit Markets and the Control of Capital,” *Journal of Money, Banking, and Credit*, 17(2), May 1985, pp. 133-152.

<sup>24</sup> Earlier, I had explored limitations on alternative mechanisms for corporate control, such as takeovers. See, e.g. “Some Aspects of the Pure Theory of Corporate Finance: Bankruptcies and Take-Overs,” *Bell Journal of Economist*, 3(2), Autumn 1972, pp. 458-482.; “Ownership, Control and Efficient Markets: Some Paradoxes in the Theory of Capital Markets,” in *Economic Regulation: Essays in Honor of James R. Nelson*, Kenneth D. Boyer and William G. Shepherd (eds.), Michigan State University Press, 1982, pp. 311-341. For a more recent contribution showing how managers can ensconce themselves, and act in ways that are not in the interests of their shareholders, see A. Edlin and J. E. Stiglitz “Discouraging Rivals: Managerial Rent-Seeking and Economic Inefficiencies,” *American Economic Review*, 85(5), December 1995, pp. 1301-1312

establishment. Sections 4 to 8 then take up a series of issues that have been the subject of investment treaties. Section 5 takes a brief look at the investment treaties and some of the objections that have been raised against them in light of this analysis. Section 6 proposes an international framework to govern cross border economic activities, emphasizing two core principles: (a) the minimizing of the scope of such agreements to standards that are viewed as absolutely essential for the conduct of cross border business; and (b) discrimination.

Section 7 highlights what countries can do to restore balance to the governance of cross border economic relations short of the achievement of such an international agreement. It argues for strong caution in signing bilateral investment treaties (especially agreements that are more expansive than recommended in section 6).

Finally, section 8 explains why the adverse consequences of the Investment Treaties are so great that there needs to be a serious roll back in the agreements already signed.

## **2. Problems posed by multinationals**

For all the reasons given earlier, multinationals have brought enormous benefits. Today, countries around the world compete to attract multinationals; they boast of having a business-friendly environment. And foreign capital has poured into developing countries, increasing six fold between 1990 and 1997, before it slowed (and reversed) as a result of the East Asian and global financial crisis.<sup>25</sup>

But for all the benefits they bring, multinationals have been vilified—and often for good reason.

In some cases they take a country's natural resources, paying but a pittance and leaving behind an environmental disaster.<sup>26</sup> When called upon by the government to clean up the mess, they announce that they are bankrupt: all the revenues have already been paid out to shareholders. They have taken advantage of limited liability.

In some cases, when the adverse consequences of their actions are criticized, the MNC pleads that they are simply following the law; but such defenses are disingenuous, for they often work hard to make sure that the law is the law that suits them well and maximizes their profits.

Consider, for instance, the regulation of cigarettes. We—and I include in the “we” the cigarette companies—have known for decades that cigarettes are bad for one's health, but the cigarette companies have deliberately tried to create confusion about the scientific evidence. While they have worked hard to stop regulation, they have also worked hard to make sure that they do not bear any liability for the enormous costs that result from their dangerous products. (More recently, Exxon has engaged in a similar attempt to discredit the science of global warming.<sup>27</sup>

---

<sup>25</sup>UNCTAD provides data on FDI flows to developing countries. In 1990 they received \$21.23 billion. This rose to \$128.8 in 1997, and increase of just over 6 times. Between 1997 and 2000 FDI was stagnant. It hit \$130.69 billion in 2000.

<sup>26</sup> See, for instance, the discussions in Jared Diamond, *Collapse*, 2005, Penguin. and in Chapter 5 of J. E. Stiglitz, *Making Globalization Work*, *op cit*

<sup>27</sup> See Ball, Jeffrey. “Exxon Softens Climate Change Stance.” *The Wall Street Journal*, January 11, 2007, A2. (Or “Smoke, Mirrors, and Hot Air: How ExxonMobil Uses Big Tobacco's Tactics to ‘Manufacture Uncertainty’ on Climate Change,” Union of Concerned Scientists, Cambridge, MA, July 2007.



When BP owned up to the costs, it was castigated by the other members of the oil club, for a while almost treated as a pariah.)

In developing countries, there are widespread allegations of corruption—and many contracts that only make sense when seen in that context. For years, many countries provided tax deductions for bribes; in effect, Western governments were subsidizing them, even though they undermined democratic governance abroad (and even as they lectured developing countries about the importance of governance). I was the U.S. representative to the OECD ministerial meeting in the mid-90s, when the U.S. was pushing for the anti-bribery Convention. I was shocked by the resistance.

The problem is more pervasive. Companies, like BP and Hydro, that have made an effort to make their transactions more transparent, have not met with support from their colleagues.<sup>28</sup> This puts the “good” guys at a competitive disadvantage.

## **2.1 Why foreign multinationals may present a worse problem than domestic corporations**

Problems of corporations taking advantage of limited liability and using their enormous financial powers to frame legislation to their advantage arise with domestic as well as multinational corporations. What then is distinctive about multinationals?

First, their economic powers are huge—often far larger than that of the countries with which they are dealing. The revenues of GM are greater than the GDP of more than 148 countries, while Walmart’s revenues exceed the combined GDP of sub-Saharan Africa. It is an unfair playing field. Not surprisingly, they often try to use their economic power to create a playing field that is even more unlevel, trying to obtain special tax or regulatory treatment.

Sometimes, they do this in ways that are above board, such as with campaign contributions (which have proven so corrosive of democratic processes even in strongly established democracies, such as the United States, but whose adverse effects are likely even greater in the nascent democracies of much of the developing world).

Sometimes, they exert their influence simply through the threat of leaving: if environmental or worker safety regulations are enforced, or if they are asked to pay their fair share of taxes, they will go elsewhere, where governments are more compliant with their wishes. (The asymmetries in liberalization—with capital markets being far more liberalized than labor markets—have enhanced opportunities for such threats).

But sometimes, they engage in corruption (bribery): the developing countries with which they deal are often weak, and salaries of government officials are low, very low, making these countries particularly susceptible to corruption.

Secondly, these companies often leverage their own economic power with the power of their governments, to get even better terms. A drug company in the U.S. will successfully pressure the U.S. government to put pressure on a foreign country that considers issuing a compulsory license,

---

<sup>28</sup> In Angola, BP announced that they would “publish what they paid” to the government; the government responded by threatening to demand that they leave—and the other oil companies quickly went along with the demands of the government. See Shaxson, Nicholas. “BP to give details of Angola operations.” *The Financial Times*, February 12, 2001, p 29 and Transparency International. “Global Corruption Report 2003.”

even when the issuance of that license is totally within the framework of the WTO. Poor aid-dependent countries are particularly susceptible to such political pressures, for there is always a (veiled or unveiled) threat to reduce the assistance which is necessary for their survival.<sup>29</sup>

Companies will get their governments to force a renegotiation of a contract, when it becomes unfavorable to their companies, e.g. as a result of underbidding (as was the case of many of Argentina's water concessions), but, not surprisingly, they will put pressure on the country not to renegotiate when it turns vastly unfavorable to the country, e.g. as a result of overbidding.<sup>30</sup>

This is even true when there is evidence that the unfavorable provisions were the result of corruption (as in the case of Suharto's Indonesian contracts).<sup>31</sup> Unhappiness in these countries is enhanced when it turns out that the Western ambassadors who put pressure on the countries not to renegotiate wind up on the Boards of Directors of the Western companies. Corruption (at least in appearances) does not seem to be limited to the developing countries.

Thirdly, sometimes multinational corporations take advantage of the lack of administrative capacities and technical expertise in developing countries to get away with things that they could not get away with in developed countries. Of course, even in developed countries, they try. Several oil companies systematically cheated on their contracts with Alaska, hoping that their shaving off just a few pennies on every barrel would not get detected: a few pennies a barrel multiplied by billions of barrels adds up. Through sophisticated detection techniques, costing millions of dollars, they were caught and prosecuted; the oil firms eventually agreed to pay more than a billion dollars to Alaska.<sup>32</sup> But this was not the only such case: Exxon similarly cheated on its contract with Alabama, assuming again that they could just get away with it.<sup>33 34</sup> But if the oil companies attempt to get away with such practices in the U.S., what must be the case in developing countries?

Fourthly, multinationals sometimes take advantage of their cross border activities to insulate themselves from accountability. In old cowboy movies, the sheriff chases the bandits to the state border—the bandit knows that once he crosses the border he is safe. So too for the modern

---

<sup>29</sup> This is also a concern with "voluntary" trade preferences granted by developed countries to developing countries, that can be withdrawn almost at will (e.g. under the system of GSP).

<sup>30</sup> Pressure for renegotiation is often done behind closed doors and is therefore hard to document. As Chief Economist of the World Bank, however, I saw ample evidence that this was occurring.

<sup>31</sup> In some cases, the terms of the contracts are so unfavorable to the developing country that the only plausible explanation is that of corruption. See, for instance, the extensive discussion of Enron's electricity contracts in India (discussed, e.g. in Chapter 10, of J.E. Stiglitz, *Roaring Nineties*, New York: W.W. Norton, 2003), or the Bolivian gas contracts.

<sup>32</sup> I was an expert witness in the case. For a discussion, see p 140 of *Making Globalization Work (op cit)*. Details are provided in the case Nos. 86-1115, 86-1427, UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT, 265 U.S. App. D.C. 390; 832 F.2d 158; 1987 U.S. App. LEXIS 16285

<sup>33</sup> See p 319 of *Making Globalization Work (op cit)* or *State of Alabama v Exxon Mobil Corp.*, No. cv-99-2368.

<sup>34</sup> More recently, when it was observed that U.S. government royalties from oil and gas did not seem to increase commensurately with gas and oil prices in the post-Iraq years, it appeared that the contracts were not only secret, but also had provisions that they could not be disclosed even by the U.S. government. It subsequently turned out that an "error" had been made in the signing of the contract, that allowed the oil companies to increase a larger fraction of the increase in prices than they would normally have been allowed. Not surprisingly, some suspected foul play. See Andrews, Edmund L. "US Royalty Plan to Give Windfall to Oil Companies." *The New York Times*, February 14, 2005, p A1 and Andrews, Edmund L. "Interior Dept. Near 2 Pacts on Leases for Oil Drilling." *The New York Times*, Sept 15, 2006, p C2.

corporation: the U.S. has refused (without explanation) to extradite the Union Carbide officials, so that they could be held responsible for the mass loss of life at Bhopal. Even when economic judgments are reached against corporations in one jurisdiction, it may be difficult to enforce it in another. Smart multinationals know this and move assets out of jurisdictions where claims might be brought against them.

Finally, and perhaps most importantly, companies often act differently abroad than they do at home, a result perhaps of differences in moral sensibilities to foreigners (rationalized with arguments like, “they are lucky to have a job”; moreover, individuals are always more sensitive to peer pressure from those they view as their peers), or, perhaps because of beliefs of difference in public sensitivities.

## **2.2. Conflicting demands for legal frameworks**

The perceptions (and reality) that multinationals bring problems as well as benefits has put them in the center of enormous controversy. Demands for more regulation have been met with demands for stronger protection. Multinationals have put forth a list of demands that they want from countries where they operate—for instance, low taxes and regulation, rights to move employees and capital in and out—but citizen groups have also put forth a list of demands of foreign companies that operate within their boundaries (making contributions to national development efforts, in ways consistent with domestic laws and regulations, accepting the absence of special treatment). Worried about these demands, in recent years, multinational corporations have sought to achieve a greater degree of protection for their investments abroad through international treaties.

Corporations have, in addition, sought uniformity—but the uniform terms which they have sought are those that are favorable to their interests. The desire for greater protection of property and greater uniformity is understandable—uniformity may lead to lower costs, and greater protection may lead to lower risk premia. In a competitive world, both may lead to lower prices and higher output.

The failed attempt at a multilateral investment treaty described earlier—and the many successful bilateral agreements—can be seen as a response to these concerns. Before turning to an analysis of what is wrong with these agreements, we need to put the broad issue of corporate regulation in perspective.

## **3. Economic Theory and the Regulation of Investment**

### **3.1. Free Market Ideology**

Free market ideologies, which have provided much of what passes as the intellectual foundations of much of the recent global economic legislation, would suggest that no global agreements are in fact needed. Countries, competing with each other, pursuing their own self-interest, would presumably arrive at a set of policies (regulations) which are globally efficient. These policies would provide the optimal degree of property rights protection. If there are advantages in standards, standardization—around the right practices—would emerge on its own. The most that would be required is some mechanism for contract enforcement; but modern theories of reputation would suggest that even this may not be required: countries that did not live up to their commitments would lose their reputation and would be unable to recruit capital.

There is a curious—but hardly surprising—inconsistency on the part of the advocates of strong international economic agreements (e.g. the investor protections): they often seem to believe in free market ideologies but yet want strong government intervention in setting standards (often, however, only in some directions, not in others), including standards for property protection (as in the multilateral investment agreements). I say hardly surprising, because when I served as Chairman of the Council of Economic Advisers, I was continually beset by pleas from business interests for protection and subsidies: everybody believed competition was good in general—but in their industry, they would complain about unfair or destructive competition; everybody believed that subsidies were bad (especially hand-outs for the poor)—but that their industry needed help, often in the form of tax breaks or loan guarantees, for one of a myriad of reasons.

There is a second curious—but again hardly surprising—inconsistency on the part of the advocates of those who want strong “rights of establishment,” the rights of foreign companies to open up business in any country. This position is typically taken by those who believe that free markets and full competition is necessary (and almost sufficient) to attain economic efficiency. But in the perfect markets view which underlies such presuppositions, ownership and control simply do not matter. Any owner would do exactly the same thing; indeed, it would make no difference whether the firm were controlled by workers, maximizing their wage income and subject to the constraint of being able to raise capital, or shareholders, maximizing their profit and subject to the constraint of being able to get workers.<sup>35</sup>

To be sure, few people (on either sides of these debates) believe that to be the case; but that simply means that few people—including strong advocates of market based solutions—believe in the assumptions that must be satisfied if markets, by themselves, are to yield efficient outcomes.

### 3.1.1 Central **ideas of free-market economics underpinning the theory of regulation**

Two key ideas underlay much of current thinking about free-market economics, and much of the law and economics literature is predicated on these ideas:

- (a) Myth 1: *Adam Smith’s invisible hand*. Adam Smith’s notion that individuals and firms in the pursuit of their self-interest, guided only by competitively determined prices, lead the economy, as if by an invisible hand, to economic efficiency.<sup>36</sup> There is only limited need for government intervention, e.g. dealing with externalities.
- (b) Myth 2. *Coasian bargaining*. But Ronald Coase<sup>37</sup> suggested that even when there were externalities, one shouldn’t worry: all we need to do is assign clear property rights, and market participants will, through a process of bargaining, lead to an efficient outcome.

---

<sup>35</sup> This perspective is often attributed to J. B. Clark, *Distribution of Wealth*, 1899.. To be fair, many advocates of free market economics have in mind a quite different model of the market economy, one in which entrepreneurship plays a central role, a perspective associated with Knight, Frank H., *Risk, Uncertainty, and Profit*. Boston, MA: Hart, Schaffner & Marx; Houghton Mifflin Company, 1921 and Hayek, Friedrich A. "The Use of Knowledge in Society." *American Economic Review* 35 (September 1945), p 519-30.. But while these ideas have been highly influential, modern economic analysis rests more heavily on the neoclassical ideas growing out of the work of Clark and Walras.

<sup>36</sup> *Wealth of Nations*, originally published in 1776.

<sup>37</sup> Coase, R. H. "The Problem of Social Cost." *Journal of Law and Economics*, Vol. 3 (October 1960), p 1-44.

Of course, even if markets were efficient, efficiency is not everything: In particular, the market may result in a distribution of income which does not comport with any system of social justice, and accordingly governments might want to intervene in the market allocation. But such an argument does not necessarily mean that there is any need for government regulatory intervention, only that government might need to intervene in the distribution of resources (endowments).

Here, however, I want to address the above propositions, which are directed at the notion that markets are efficient.

There is a grain of truth in each of these ideas, but unfortunately, only a grain. Research over the past 30 years has shown that these propositions hold only under highly restrictive conditions—conditions not satisfied by any modern economy.<sup>38</sup> Economists had long recognized that markets are not efficient when there are externalities and public goods (though, as noted, Coase had suggested that even then government intervention was not required). But the major shift in the economic paradigm<sup>39</sup> resulting from the Economics of Information established that markets do not lead to efficient outcomes whenever information is imperfect (asymmetric) and when risk and capital markets are incomplete—that is, always; more precisely, it can be shown that the market allocation is not, in general, constrained Pareto efficient.<sup>40</sup> In short, there is no longer a presumption that markets, by themselves, will lead to efficient outcomes.

When information is imperfect, markets are rife with externalities. For instance, if some individuals smoke more, it will drive up health insurance premiums. Even insurance companies cannot observe whether individuals smoke or not, so part of the costs of individuals who smoke is borne by non-smokers. There is an economic inefficiency, a market failure, which judicious government intervention (taxes on cigarettes, or regulations) can help ameliorate.

Unfortunately, Coasian bargaining simply cannot deal with these market imperfections, because the underlying problem is the lack of information: non-smokers cannot tell who the smokers are in order to force them to compensate them for smoking. But even in simpler contexts of ordinary externalities, Coase was, in general, wrong: so long as there are transactions costs and information asymmetries, Coasian bargaining does not, in general, lead to efficient outcomes.<sup>41</sup>

---

<sup>38</sup> It was not until the 1950's, 175 years after Smith's "conjecture" about the efficiency of competitive markets, that Arrow and Debreu succeeded in establishing the conditions under which markets yield efficient outcomes. There are a host of "market failures," situations in which markets by themselves do not lead to Pareto efficiency, and in which appropriate government intervention can, in principle at least, make everyone better off. See Arrow, Kenneth J.; Debreu, Gerard. "Existence of an Equilibrium for a Competitive Economy." *Econometrica*, Vol. 22, No. 3 (Jul., 1954), p 265-290.

<sup>39</sup> See Stiglitz, "Information and the Change in the Paradigm in Economics," *op cit*

<sup>40</sup> J.E. Stiglitz, "Externalities in Economies with Imperfect Information and Incomplete Markets," *Quarterly Journal of Economics*, May 1986, pp. 229-264. For a more detailed analysis focusing on the problems posed by moral hazard and insurance, see R. Arnott and J. E. Stiglitz, "The Welfare Economics of Moral Hazard," in *Risk, Information and Insurance: Essays in the Memory of Karl H. Borch*, H. Louberge (ed.), Norwell: Kluwer Academic Publishers, 1990, pp. 91-122. For a more accessible exposition, see J. E. Stiglitz, "The Invisible Hand and Modern Welfare Economics," In *Information Strategy and Public Policy*, D. Vines and A. Stevenson (eds.), Oxford: Basil Blackwell, 1991, pp. 12-50. For a more diagrammatic exposition, see R. Arnott, B. Greenwald, and J.E. Stiglitz, "Information and Economic Efficiency," *Information Economics and Policy*, 6(1), March 1994, pp. 77-88.

<sup>41</sup> See Farrell, Joseph. "Cheap talk, coordination, and entry." *Rand Journal of Economics*, Vol. 18, No. 1, Spring 1987, p 34-39.

The externalities associated with imperfect information (and incomplete markets) are so diffuse and pervasive that it is inconceivable that they could be addressed through Coasian bargaining; but the information imperfections themselves mean that the kind of compensation envisioned in Coasian bargaining (where, in a world with well-defined property rights, those imposing external costs on others compensate them for the damage they suffer) is impossible.<sup>42</sup>

### 3.2. The need for international regulation

Even if there is a need for government regulation, it does not mean that there is a need for international regulation or agreements that bind what a government can do. Indeed, standard beliefs in the efficacy of competition among communities would argue the opposite.

- (c) Myth 3. *Tiebout competition*. Communities competing against each other would ensure that the legal environment which ensured economic efficiency would be established. People would migrate to communities (countries) with strong property rights, and away from those without it.<sup>43</sup>

In a sense, Tiebout's argument is more robust than that of Smith and Coase; in Tiebout's world, there might be imperfections in markets that necessitated government intervention. But each country would have an incentive to adopt the optimal regulatory system. Not surprisingly, given the restrictive conditions under which market competition ensures economic efficiency within a country, it is not surprising that competition among communities does not in general result in efficiency globally.<sup>44</sup>

It should be clear, however, that much of the demand for international regulation is not related to failures of Tiebout competition, and virtually none of the argumentation for such regulation is based on this analytic framework. Rather, the argument seems to be that the business community in the advanced industrial countries believes that developing countries have not provided as strong property rights protection as they would like, and they use their political leverage to get in developing countries protections that they have not been able to get themselves. In short, it is a distributive motive, though cloaked in an efficiency rationale: it is argued that it would be good for the developing countries. But if it were good for developing countries, presumably they would have adopted such regulations on their own.

[When I say "good" for developing countries, in the language of economics, this means a Pareto Improvement, one which benefits all citizens, and which accordingly would be supported by all,

---

<sup>42</sup> Sometimes, one can devise costly sorting mechanisms to identify the injured and the injurers, but the costs of running such a system may be markedly greater than those associated with an efficient regulatory system.

<sup>43</sup> In Tiebout, Charles M. "A Pure Theory of Local Expenditures." *The Journal of Political Economy*, Vol. 64, No. 5 (Oct., 1956), p 416-424, Tiebout himself only focused on competition in the supply of public goods and taxation.

<sup>44</sup> See JE Stiglitz, "Theory of Local Public Goods," In *The Economics of Public Services*, M.S. Feldstein and R.P. Inman (eds.), MacMillan Publishing Company, 1977, pp. 274-333. (Paper presented to IEA Conference, Turin, 1974.); JE Stiglitz, "The Theory of Local Public Goods Twenty-Five Years After Tiebout: A Perspective," In *Local Provision of Public Services: The Tiebout Model After Twenty-Five Years*, G.R. Zodrow (ed.), Academic Press, 1983, pp. 17-53; and JE Stiglitz, "Public Goods in Open Economies with Heterogeneous Individuals," In *Locational Analysis of Public Facilities*, J.F. Thisse and H.G. Zoller (eds.), North-Holland Publishing Company, 1983, pp. 55-78.

regardless of the political process. There is an alternative: good for developing countries could mean good on average, or good for some groups. Of course, if there were good redistributive mechanisms, good on average could be translated into good for all—the winners could compensate the losers. But in practice, the losers know that such compensation is often not paid, and therefore they exert what political influence they can to stop such “reforms.” (Similar reasoning holds for reforms that benefit some groups at the expense of others.)]

There is one argument for why a developing country might want to sign a bilateral investment treaty: governments might want to commit themselves not to engage in certain actions which might disadvantage investors, but they have difficulties in making credible commitments. International agreements increase the cost of abrogating such promises, thereby making the commitment more credible. But if this (an example of what is sometimes called “public failure,” a limitation on the ability of governments that lead to potentially inefficient outcomes) were what motivated such agreements, presumably developing countries would be asking for such agreements; they would be perceived as mutually beneficial. In practice, they are part of the demands developed countries impose on developing countries as part of trade agreements, acceded to by developing countries because the cost to the developing country is less than the surplus they believe they get out of the trade deal.

### 3.3 Corporate Governance and Bankruptcy regulation

One of the arenas in which governments often do impose regulations is corporate governance and bankruptcy. Again, market based economics forces one to ask, why is there a need for such legislation? Can market participants not voluntarily make arrangements without government intervention? The role of the government is to enforce property rights—in this case, enforce contracts—so that private parties live up to their agreements. From this perspective, firms could raise capital under any agreement that they wanted and with any corporate governance they desired; the firm’s charter would spell out all the rights, both control rights and rights to income. For instance, the firm might borrow money from lenders, with a loan covenant stipulating that if the borrowers could not repay the amount lent, the only assets that could be attached would be those of the corporation (just as in collateralized borrowing, the only asset that can be attached in the event of a default is the asset that has been put up as collateral.)

Interestingly, this position has relatively few advocates; there is widespread support for the idea that governments should have laws regulating corporate governance and bankruptcy. But the laws that exist reflect two further myths.

- (d) Myth 4: *Shareholder value maximization leads to economic efficiency.* Simplistic Marshallian economics<sup>45</sup> was based on the notion that firms maximize the well-being of their owners; but modern corporations have many owners, with different preferences. In this more complicated setting, the dictum is that firms should maximize stockholder value; policies which do so will be unanimously desired by all shareholders and will ensure economic efficiency.
- (e) Myth 5: *Takeovers ensure shareholder value maximization.* When worries were raised that managers’ interests might deviate from that of shareholders, there was again an easy

---

<sup>45</sup> Alfred Marshall was one of the great economists of the last part of the 19<sup>th</sup> century and early part of the 20<sup>th</sup>. At the turn of the century, he was asked to describe both the achievements of economics up to that point and the limitations. He noted its failure to deal with modern corporations. See A. Marshall (1897) REFERENCE??

answer: any firm that did not maximize its value would be taken over; the person taking over the firm would change the policy and reap the gain in going to a value maximizing strategy.

Myth 4 provides the normative basis of legislation (common in the Anglo-American tradition) dictating that corporations should undertake actions which maximize shareholder value. Myth 4 also provides the basis of legislation restricting actions which might impede the take-over process, because it is the takeover process which provides the most important mechanism of ensuring shareholder value maximization. Myth 4 and 5 provide the basis of providing deference to management: after all, any management team that did not maximize shareholder value would presumably be quickly replaced.

Interestingly, the conditions under which these myths are true—assumptions of perfect information and complete contracting—are conditions under which there is no need for government regulation (government would simply enforce contracts). The conditions which lead to a need for government regulation are the conditions under which shareholder value maximization is not in general welfare maximizing. Many governments outside the Anglo-American sphere (cf. the Rheine model, sometimes referred to as stakeholder capitalism<sup>46</sup>) argue for a broader stakeholder view: companies should pay attention to the well being of other stakeholders (workers, the community); but this view has been roundly criticized by the advocates of shareholder maximization. Economic theory, I shall argue, is, however, more supportive of the latter view.

Indeed, the very reason that corporate governance is an issue is related to imperfect information—shareholders have to delegate responsibility for making decisions to managers. With costless information, presumably the shareholders themselves could “order” the managers to engage in activities which maximize their well being.

Even without imperfect information, so long as there are not a “full set of state-contingent markets” (called Arrow-Debreu securities markets) value maximization does not in general lead to (Pareto) efficiency.<sup>47</sup> Thus, the widespread view that firms should maximize shareholder value has no normative basis in economic theory.

When there is not a complete set of futures markets, it even may be difficult to determine what a long-run value maximizing market strategy might look like—different individuals may differ in their judgments about the prices that are likely to prevail in the future or on the probabilities of different states.<sup>48</sup> There will not be general consensus on what is required to maximize today’s

---

<sup>46</sup> For an overview see Kelly, Gavin; Kelly, Dominic; Gamble, Andrew, eds. *Stakeholder Capitalism*. 1997, New York: St. Martin's Press; London: Macmillan Press in association with the Political Economy Research Centre. For an early description of the differences between different forms of capitalism see Aoki, Masahiko. “Toward an Economic Model of the Japanese Firm.” *Journal of Economic Literature*, Vol. 28, No. 1. (Mar., 1990), p 1-27.

<sup>47</sup> See J. E. Stiglitz, “On the Optimality of the Stock Market Allocation of Investment,” *Quarterly Journal of Economics*, 86(1), February 1972, pp. 25-60 and JE Stiglitz, “The Inefficiency of the Stock Market Equilibrium,” *Review of Economic Studies*, XLIX, April 1982, pp. 241-2611.

<sup>48</sup> For an early exposition of the ensuing problems, see J. E. Stiglitz, “Some Aspects of the Pure Theory of Corporate Finance: Bankruptcies and Take-Overs,” *Bell Journal of Economist*, 3(2), Autumn 1972, pp. 458-482.



stock market value. But even when there is, that will not in general lead to a constrained Pareto efficient outcome.<sup>49</sup>

Moreover, shareholders will not, in general, all agree that the firm should maximize *today's* shareholder value. Many shareholders may be interested in the long-run value of the firm and may argue that the markets are simply “uninformed.” These shareholders will argue for taking actions which the market thinks are “wrong,” even if they decrease the value of shares today. This is especially true of those shareholders who plan to hold the company's shares for a long time: why should they worry about whether the company meets its quarterly earnings estimate?

Disagreements about what is in the interests of shareholders arise frequently, and Courts have often given deference to managers. But managers' interests often diverge from that of shareholders or other stakeholders. Indeed, Berle and Means emphasized the separation between ownership and control in their classic work<sup>50</sup>. My own work provided theoretical foundations for this division—imperfections of information and costs of information necessitated delegating decision making (from owners to managers), but it is impossible to align perfectly the interests of managers with shareholders. (This has come to be called the Principal agent problem.<sup>51</sup>) Understanding the roots of the separation between ownership and control is necessary, in turn, for designing an appropriate legal framework for corporate governance.

Highlighting the disparity of interests are the actions deliberately undertaken by managers to enhance asymmetries of information between them and shareholders—and other potential buyers—and otherwise to entrench themselves. These actions may enable management to extract a larger share of the firm's value, even if they simultaneously decrease the firm's market value. They impede the efficacy of the take-over mechanism. But even without these distortions, the take-over mechanism may not ensure that firm will engage in value maximizing strategies—the only instances where take-overs may be easy is where shareholders are worried that a raider will destroy the value of the firm.<sup>52</sup>

---

<sup>49</sup> See S. Grossman and J. E. Stiglitz, “Stockholder Unanimity in the Making of Production and Financial Decisions,” with S. Grossman, *Quarterly Journal of Economics*, 94(3), May 1980, pp. 543-566 and “On Value Maximization and Alternative Objectives of the Firm,” *Journal of Finance*, 32(2), May 1977, pp. 389-402.

<sup>50</sup> *Op cit*

<sup>51</sup> The language is due to Ross, Stephan A. “The Economic Theory of Agency: The Principal's Problem.” *The American Economic Review*, Vol. 63, No. 2, May 1973, p 134-139. Among the earliest analysis of the principal agent problem was that of Stiglitz, “Incentives and Risk Sharing in Sharecropping,” *Review of Economic Studies*, 41(2), April 1974, pp. 219-255.[originally written in 1969]. While the setting of the problem was that of the landlord trying to ensure that his tenant farmer maximized the return he received, I pointed out that the problem was essentially that of the owners of the firm trying to ensure that the manager acted in ways consonant with their interests.

<sup>52</sup> It is interesting that in spite of the importance (at least in theory) of the takeover mechanism, particularly in ensuring discipline for managers, there was little formal literature in this area, until my 1972 paper, “Some Aspects of the Pure Theory of Corporate Finance: Bankruptcies and Take-Overs.” *Bell Journal of Economist*, 3(2), Autumn 1972, p 458-482. There is by now a large literature showing empirically that the take-over mechanism does not work well, e.g. suggesting that take-overs often lead to a decrease in the value of the taking over firm (even if the firm taken over benefits.) See Agrawal, Anup; Jaffe, Jeffrey F.; Mandelker, Gershon N. “The Post-Merger Performance of Acquiring Firms: A Re-Examination of an Anomaly.” *The Journal of Finance*, Vol. 47, No. 4. (Sep., 1992), p 1605-1621, and Ravenscraft, D. and F. M. Scherer, 1987, *Mergers, Selloffs and Economic Efficiency* (The Brookings Institution, Washington, DC). There are a number of reasons for the failure of the take-over mechanism. Grossman and Hart in “Takeover Bids, The Free-Rider Problem, and the Theory of the Corporation.” *The Bell Journal of*

More generally, the management of a public company is a public good, and consequently, there will be systematic market failure. All shareholders benefit if other shareholders monitor management, in ways which lead to increased returns. The same is true for all creditors, with one critical difference: because of the lower level of risks, there may be less risk diversification. A single lender may have a sufficiently large stake that it pays him to monitor closely the firm. Shareholders benefit, to the extent that by avoiding excessively risky activities, or activities which benefit the manager at the expense of the corporation as a whole, the probability of bankruptcy is reduced. But to the extent that creditors focus on minimizing the risk of default, the overall expected returns of the firm—and hence of equity owners—may be reduced.

While it is often difficult to test whether firms are maximizing their shareholder value, there are many instances of corporate behavior which seem hard to reconcile with such a view. Ex post it is easy to make judgments: a firm that invests \$100 billion—and winds up with a market capitalization of \$20 billion—clearly did not use shareholder money well. But perhaps, given the information which was available or which could reasonably have been obtained, it might have been ex ante the right decision. It is difficult for outsiders to judge the ex ante information (including all the relevant probabilities). However, there are a large number of instances where outsiders can make judgments—we can ascertain whether firms maximize shareholder value with respect to the management of their tax liabilities. The fact is that both corporate financial policies and employee compensation programs are designed such that billions of dollars are paid unnecessarily in taxes; there are simple changes which would have no real consequences other than the tax liabilities. These are called tax paradoxes, and they strongly support the view that firms often do not maximize shareholder value.<sup>53 54</sup>

In contrast to the standard paradigm which sees managers faithfully carrying out the mandate of shareholders in maximizing shareholder value—with any manager who does not do so, either out of incompetence or because he has his own agenda, being quickly replaced by one who does—a more accurate paradigm sees enterprises as being controlled by managers, maximizing their own welfare and subject to a set of constraints and oversights. They operate in such a way as to expand their span of control and their market power vis à vis those who might take them over, e.g. by creating asymmetries of information.<sup>55</sup> These constraints are such as to create effectively

---

*Economics*, Vol. 11, No. 1. (Spring, 1980), p 42-64. point out that if a small shareholder believes that the takeover will be successful and will increase the value of the firm, it would not pay him to sell, but it would pay to free ride on the successes, sharing in the capital gains.

<sup>53</sup> The earliest of these is called the dividend paradox, which I described in 1973, in “Taxation, Corporate Financial Policy and the Cost of Capital,” *Journal of Public Economics*, 2, February 1973, pp. 1-34. Other paradoxes related to inventory accounting (the choice of FIFO vs. LIFO) and the use of accelerated depreciation. Since I wrote my paper, a much larger fraction of the revenue of corporations is distributed to households in a tax preferred way.

<sup>54</sup> While tax paradoxes are the most obvious deviation from shareholder value maximization, there are others: many closed end mutual funds sell for a market value less than the value of their shares. There is a simple action—dissolving the firm—which would lead to an increase in shareholder value. Since this paradox was first discussed in the 70s, the magnitude of the discount in closed end mutual funds in some parts of the world has actually increased and a number of funds have been created to take-over these mutual funds, to realize shareholder potential. The difficulties that they have encountered illustrate the problems of corporate governance and take-over mechanisms more generally. Other paradoxes relate to forms of compensation, i.e. that there are forms of compensation which provide as good incentives, with less total (corporate plus individual) taxes and better risk sharing properties than those commonly employed by firms. See, e.g. J. E. Stiglitz, *Roaring Nineties*, New York: W.W. Norton, 2003

<sup>55</sup> See A. Edlin and J. E. Stiglitz “Discouraging Rivals: Managerial Rent-Seeking and Economic Inefficiencies,” *American Economic Review*, 85(5), December 1995, pp. 1301-1312 .

an (imperfect) hierarchy of “control.” Banks provide the most direct set of controls by closely monitoring the regular activities of the firm. Shareholder discontent must be kept low enough that there is not a battle of control, either from dissident shareholders or from take-over agents. Securities markets enter periodically, in assessing firm performance when additional capital is required—though the potential need for such additional capital exerts a more continuing influence on firm behavior.<sup>56</sup>

### **3.3.1 Bankruptcy law**

Corporate governance laws provide rights (and responsibilities) for various parties engaged in decision making by on-going corporations. Corporate bankruptcy laws define what happens when corporations cannot meet their debt obligations. They specify rights to claims on different assets, as well as control rights (rights to decision making), e.g. who gets to propose an alternative organization (the disposition of certain assets), and who must give their approval.

In a world of perfect contracting, there would be no need for bankruptcy laws (just as there would presumably be no need for corporate governance laws). All governments would need to do would be enforce the contracts, which would specify what would happen if the party fails to fulfill the contract. In fact, however, all governments do far more than just enforce contracts. Developing countries have been encouraged to adopt good bankruptcy laws. Some of the problems faced by many of the East Asian countries in the midst of the 1997 crisis were blamed on inadequate bankruptcy laws; the IMF and the U.S. Treasury did not chastise the banks for having signed loan contracts that did not adequately specify what happened if the borrowers could not meet their obligations. Why this is so is a question to which we turn in the next subsection.

### **3.3.2. Meaning of ownership and control**

Ownership matters for two reasons: rights to control (make decisions) and rights to income.

Ownership defines residual rights to control. It is actually very difficult to specify fully what one might mean by control rights; governments, at all levels, have some control rights, in the sense that they restrict the kinds of actions that firms can undertake, and they can affect those actions more broadly through tax policy and a variety of incentives; banks can insist that the firm take certain actions, if they are to extend or not withdraw credit—the firm may have little choice but to accept these demands, especially if has debt obligations that could force it into bankruptcy. I use the term residual rights to control to reflect that, given all of these other constraints, there may still be some scope of choice, and presumably the “owner” has the right to make a choice among this set.

In the simple neoclassical paradigm, workers and the suppliers of other factors have a horizontal supply curve at the competitive market price, so that the actions of the firm have no effect on them. The actions of the firm only affect the residual returns. Thus, the controller of residual rights, in exercising those rights, only affects his own well being, this is why allowing him to do so freely naturally results in economic efficiency.

---

<sup>56</sup> Firms would, of course, prefer to raise more of their capital long term, rather than to be kept on a short leash by banks; and there would be certain efficiency gains from doing so, such as insulating firms from the risk of volatility in short term capital markets. But the monitoring benefits associated with short term (bank) credit are such as to lead to the optimal contract being shorter term than the investment projects which they finance.

But in the real world, that is not the case. There are many stakeholders who are affected by the firm's actions. That this is so can be said to reflect a "market failure," but it is worthwhile digging deeper to ask, more specifically, why this is the case. Part of the reason is that there is incomplete contracting and incomplete insurance. A worker who goes to work for a firm does not know fully the jobs that will be assigned to him, how difficult or unpleasant the tasks, or the hours that he might have to work. The firm might not know either (i.e. there may or may not be asymmetries of information). There are contingencies which cannot be perfectly anticipated, but different actions by the firm can affect the likelihood of more or less pleasant contingencies occurring—and therefore affect the well-being of the worker. They might, for instance, increase the likelihood that he will be redundant. The worker may have invested in (firm specific) human capital. But there is no insurance against the destruction of the value of that capital should he be fired.

Bondholders are aware that the firm may take actions which adversely affect their claims on the firm, and that is why there are typically bond covenants. But it is well recognized that these covenants only constrain a fraction of the possible actions which the firm might undertake.

In short, actions of firms—including subsequent contracts with third parties—affect the well being of those who have previously signed (implicit or explicit) contracts. Different governments may take different positions on how these externalities might best be dealt with, e.g. through voice on the boards of directors, restrictions on the kinds of contractual arrangements that can be undertaken, etc. To date, economic theory has not provided a simple set of prescriptions which defines the best set of ways by which these externalities may be handled in all situations.

As an example, some governments mandate that there be collective action clauses in bonds, which allow a qualified majority (say 85% of the bondholders) to restructure. It is recognized that there may be circumstances in which renegotiation (a new bond) is desirable, but that in such circumstances, a small minority can hold up what might otherwise be a Pareto superior renegotiation, demanding a ransom. On the other hand, the ability of a (qualified) majority to restructure the debt contract means that they can, in principle, redesign the contract in ways that work markedly to the disadvantage of the minority: the minority may not simply be holding up the majority, but may have legitimate differences in interests and perspectives. Regrettably, it is difficult to write a simple legal framework that protects against one abuse without opening up the window to another abuse.

There is another set of "externalities" that may arise, which relate to signaling. Bankruptcy provisions may be used to signal one's likelihood of going bankrupt. Firms that have a low probability of going bankrupt may signal this by imposing heavy penalties on themselves should they go bankrupt. But it is easy to see that the resulting signaling equilibrium is not Pareto efficient. Signals are costly, and in general, signaling equilibria are inefficient. Governments may enforce a better equilibrium by eliminating the scope for signaling, e.g. by imposing a standardized bankruptcy regime.<sup>57</sup>

---

<sup>57</sup> In technical terms, this is referred to as imposing a pooling equilibrium. A competitive market equilibrium cannot be characterized by pooling (one of the central results of Rothschild-Stiglitz [See, "Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information," *Quarterly Journal of Economics*, 90(4), November 1976, pp. 629-649.] The inefficiencies in contractual equilibria are, however, not limited to problems of signaling. In moral hazard models, contracts by one party affect reservation levels and behavior within other contracts. See, e.g. P. Rey and J. E. Stiglitz, "Moral Hazard and Unemployment in Competitive Equilibrium," October 1993, and R. Arnott and J. E.

Finally, it is impossible (prohibitively costly) to have contracts that anticipate every contingency. All contracts are incomplete, and there is an important role for government to specify what happens in those contingencies which have not been anticipated—a set of “defaults” which greatly simplify the writing of contracts.<sup>58</sup>

In addition to these externalities, there are a host of more widely discussed macro economic externalities, where decisions by firms have social costs which they do not appropriately take into account (just as firms do not appropriately take into account environmental externalities.) For instance, even without unemployment insurance benefits, firm decisions concerning lay-offs do not, in just, lead to Pareto efficiency<sup>59</sup>; with unemployment benefits in unemployment systems that are not fully experienced, it is obvious that when firms lay off an individual, it imposes a social cost on others.

### 3.3.3. Implications for the Role of Government

The implications of these views for corporate governance laws are clear and strong.

- (a) The presumption in many jurisdictions of deference to management ought to be rethought. Management has both the ability and the incentives to pursue their own interests, which may conflict with those of other stakeholders, including shareholders. There are enough instances of the abuses of that discretion—and a clear enough theoretical basis suggesting that management’s interests may conflict with other stakeholders—that the presumption should be that they are acting in their own interests.

---

Stiglitz “Labor Turnover, Wage Structure & Moral Hazard: The Inefficiency of Competitive Markets,” *Journal of Labor Economics*, 3(4), October 1985, pp. 434-462.

<sup>58</sup> Asymmetric information can also explain why the economy may get stuck at an inefficient contractual equilibria. See J.E. Stiglitz, “Contract Theory and Macroeconomic Fluctuations,” in *Contract Economics*, L. Werin and H. Wijkander (eds.), Basil Blackwell, 1992, pp. 292-322.

<sup>59</sup> This is seen most obviously in efficiency wage models, where wages affect productivity either because of effects on incentives, selection, morale, or labor turnover. For instance, in the Shapiro-Stiglitz “shirking” model, firms must pay a high enough wage to induce individuals not to shirk. The requisite wage depends on the unemployment rate and the rate of time that individuals remain in the unemployment pool. Firms that have a policy of letting go of labor more easily lead to higher labor turnover, and, at any unemployment rate, a shorter duration in the unemployment pool. This means that the equilibrium unemployment rate will be higher. More generally, it is optimal to throw “sands in the wheels,” some friction, e.g. associated with mandatory severance pay. See C. Shapiro and J. E. Stiglitz, “Equilibrium Unemployment as a Worker Discipline Device,” *American Economic Review*, 74(3), June 1984, pp. 433-444; Richard Arnott and J. E. Stiglitz, “Labor Turnover, Wage Structure & Moral Hazard: The Inefficiency of Competitive Markets,” *Journal of Labor Economics*, 3(4), October 1985, pp. 434-462; Patrick Rey and J. E. Stiglitz. “Moral Hazard and Unemployment in Competitive Equilibrium,” October 1993; J. E. Stiglitz, “Alternative Theories of Wage Determination and Unemployment in L.D.C.’s: The Labor Turnover Model,” *Quarterly Journal of Economics*, 88(2), May 1974, pp. 194-227; J. E. Stiglitz, “Alternative Theories of Wage Determination and Unemployment: The Efficiency Wage Model,” In *The Theory and Experience of Economic Development: Essays in Honor of Sir Arthur W. Lewis*, M. Gersovitz, et al. (eds.), London: George Allen & Unwin, 1982, pp. 78-106; and J. E. Stiglitz, “Prices and Queues as Screening Devices in Competitive Markets,” in *Economic Analysis of Markets and Games: Essays in Honor of Frank Hahn*, D. Gale and O. Hart (eds.), Cambridge: MIT Press, 1992, pp. 128-166

For instance, in my book *The Roaring Nineties*, I explained how unfettered markets (or more accurately, markets with poorly designed regulatory and tax regimes) led to perverse incentives, whereby executives had incentives to disclose misleading and incomplete information, and information in forms that were not easily analyzed by the market. Bad information led to bad resource allocations. But the system did allow some people (CEO's of certain companies) to do very well.

It is understandable that Courts would want to defer to the “business judgment” of managers. Ex post, decisions often turn out wrong, and Courts are seldom called upon to question management when they go right. “Monday morning quarterbacking” provides ample opportunity for raising questions about motives when the decisions appear flawed. Yet, current practice often gives management an easy pass; they can pursue their own interests, cloaked in language suggesting that it is, in their judgment, in the best interests of the firm or shareholders.

There is thus a case that can be made for a change in presumption. Management should be placed in the position of a fiduciary, one which is entrusted to make certain risk decisions. Courts can be asked to make judgments about whether a reasonable person, given the information that managers had or reasonably could have obtained at the time, had adequately balanced the risks and rewards facing other stakeholders, and when management failed to do so, whether the balance of risks and rewards facing management was such as to likely distort its decision.

(b) There is a strong rationale for corporate governance laws which give voice to other stakeholders, who are affected by managerial decisions in ways which are not fully reflected in the price system, so that there are meaningful and real externalities. Some increases in job security might, for instance lead to Pareto improving investments in human capital by workers or reductions in unemployment; and even if these changes are not Pareto improving, they could improve the well being of workers.

#### 3.3.4. Differences among countries

As we look across countries, we see marked differences in laws governing corporate governance and bankruptcy and in the kinds of contracts commonly found. One could draw three alternative conclusions:

(i) Each is efficient, but reflects the distinctive circumstances of the country; (ii) the differences show the existence of multiple equilibria, one of which Pareto dominates the other, implying an important role for government to ensure that the Pareto superior equilibrium is chosen; or (iii) they could all be Pareto efficient, with different distributional consequences.

##### *Implications for Bilateral trade agreements*

All three interpretations provide a strong cautionary note against the current wave of bilateral investment treaties. The first case suggests that standardization would have a cost—in reducing efficiency within at least one of the two countries; and since it is more likely that the standard that will be accepted will be that of the advanced industrial countries, the brunt of the loss is more likely to be borne by the developing country

The second provides compelling evidence against the market fundamentalist perspective that has provided the intellectual foundations for these agreements, that all that is required for economic efficiency is for the government to enforce property right. I have referred to the kind of

inefficiency exhibited by Pareto dominated multiple equilibria as a structural inefficiency;<sup>60</sup> but even when there are not these structural inefficiencies, there are myriad marginal inefficiencies, where government interventions could lead to Pareto improvements.

In the third interpretation, there are likely to be large distributional consequences within countries. It may be difficult to compensate for the changes in distribution that result from standardization; and even if it is possible, there may be large (deadweight) losses associated with such compensation.

For instance, the design of bankruptcy laws is hotly contested. America has recently adopted a bankruptcy law which is decidedly pro-creditors. Other countries should have the right to decide, for instance, on whether to have a more pro-debtor bankruptcy law.

The point of this discussion is not so much to advocate reform of the laws on corporate governance or bankruptcy (though the analysis should make it clear that at least many of the arguments put forward for some legal structures do not have solid economic foundations) as to argue that (a) in general, there is more than one set of rules and regulations (laws) which are consistent with Pareto-efficiency; (b) different rules and regulations may have distributive consequences; accordingly, one cannot see legal frameworks as simply ensuring economic efficiency; and (c) competition among communities is sufficiently limited that countries do have choices among alternatives and the competition is sufficiently imperfect so that it does not necessarily result in efficient outcomes. Issues of efficiency and equity are inextricably linked—and indeed, there is a long legal tradition which sees the rule of law as protecting individuals from what might emerge in unfettered markets.<sup>61</sup> Any restriction on the choice a country makes with respect to these laws may thus be welfare reducing.

This is important because rights of establishment—rights of corporations from abroad to enter a country—are different from rights concerning movement of labor or capital. When labor or capital moves into a country, it knows that in doing so, it must respect the laws of the country. But corporations are neither people nor capital, but legal entities, with particular governance structures. Of course, companies entering a country must obey laws relating to the treatment of the environment or workers. But governments care about corporate governance because they believe that the well being of their citizens may depend on how these legal fictions, corporations, behave, and in particular how they are governed. Countries have created these legal fictions, which are so important for the conduct of business and the functioning of capitalism, granting limited liability<sup>62</sup>; but in doing so, they have every right to impose restrictions on how these entities are governed. Those governance structures affect the functioning of the economy, including the rights and well-being of various groups. Allowing corporations from another country to produce within a country allows entities governed by different laws to engage in business in ways and according to rules which its own citizens, operating within the country, are not allowed to operate. Worse still, with free mobility of capital, those within the country can

---

<sup>60</sup> See, for instance, J. E. Stiglitz, “On the Optimality of the Stock Market Allocation of Investment,” *Quarterly Journal of Economics*, 86(1), February 1972, pp. 25-60.

<sup>61</sup> As we have noted earlier, one of the central criticisms of the Chicago law and economics school is that it focuses on efficiency.

<sup>62</sup> For a discussion of the importance of limited liability for the functioning of capitalism, see B. Greenwald and J. E. Stiglitz, “Information, Finance and Markets: The Architecture of Allocative Mechanisms,” *Industrial and Corporate Change*, 1(1), 1992, pp. 37-63. Also in *Finance and the Enterprise*, V. Zamagni (ed.), Academic Press, 1992, pp. 11-36.

choose to establish corporations outside the country, then enter the country operating under rules that are different from those which the country deemed best for itself.

In short, unfettered rights of establishment combined with free mobility vitiate the ability of government to establish rules governing corporate governance and corporate bankruptcy. If there were a single set of rules which were efficient, then this would make little difference: all countries could agree on the desirable set of rules, and that would be the end of the matter. But we have argued that these rules do matter, and that there is no single set of Pareto efficient rules.

To see how it makes a difference, consider what happens if a firm goes bankrupt. The priority of claims may be different from that which would have prevailed under domestic law.

Free international commerce can easily be reconciled with restrictions on the rights of establishment. Firms entering a country would simply be required to establish subsidiaries inside the country. The subsidiaries would be governed by the laws within the country. Capital (“ownership”) moves freely, but the rights of the owners (relative to those of others) and their obligations would be governed by the laws of the host country.

#### **4. Regulatory takings**

The most noxious provision of bilateral trade agreements—and the most obvious intrusion on the rights of a country to self-governance—concern regulatory takings. The provisions require compensation of foreign businesses for regulations<sup>63</sup> which decrease the value of an asset (of an on going business, or, in some cases, even of a potential business). All countries pass a myriad of regulations to improve the efficiency of the economy and to affect the distribution of income. While such regulations may not always be based on sound economic theory or evidence, and may be designed and implemented in ways which do not fully achieve their objectives, or which, in achieving their objectives, may encounter significant adverse ancillary costs, every country has reserved for itself the right to adopt such regulations, and to do so without compensating those that are adversely affected. There are sound theoretical reasons why they should have the right to do so.

The underlying justification for such regulations is that without such them, the economy is often not Pareto efficient, and even if it is Pareto efficient, the distribution of income which emerges in market equilibrium may not be consistent with any principles of social justice.

The underlying justification for restrictions on the ability of government to impose regulations is that without such restrictions, returns on investments will be exposed to political risks—the risk of a change in regulations; and the exposure to such risks will reduce the level of investment and lower standards of living. The argument against imposing such restrictions is that it restricts the freedom of sovereigns to adapt to changing circumstances and changing preferences. This is especially important in democracies, and even more important as societies change from imperfect democracies controlled by small elites to more contestable democracies. In such cases, the elites can pass legislation empowering themselves, even when these regulations result in economic inefficiencies. Restrictions on changes in taxation and regulation serve to make it more difficult to change the distribution of wealth and power in society.

---

<sup>63</sup> Sometimes, the provisions extend to taxes, and for good reason: It is often possible to achieve any regulatory outcome through the imposition of an appropriate set of taxes.



More generally, requiring compensation for changes in societal regulations makes it more difficult to restore social justice and to correct market inefficiencies because such changes are made more expensive.

Domestic courts have repeatedly faced the challenge of balancing the costs and benefits of such restrictions, and repeatedly drawn a distinction between explicit expropriations (where compensation is required) and these other instances of possible diminution in asset values. Indeed, when applied to the area of taxation, the demand for compensation yields the absurd result that governments could never increase taxes; for if the value of the asset is its (expected present discounted value of) future income, any increase in taxes would have to be fully offset by a compensatory payment.

There is a further argument against providing compensation for changes in regulation: the impacts on values are highly speculative. Consider the consequences of changing a regulation allowing a toxic dump site in a village in a country in which common law actions can be taken against environmental damages, and in which punitive damages can be imposed. Should appropriate compensation for the new regulation take account of the likelihood that a tort action would follow if the firm actually used the site as a toxic waste dump? What kinds of punitive damages might be imposed? With what probabilities? Would the assessor of compensation have to judge which pollutants the firm might likely use or the value of the damage to the groundwater system? One of the reasons for ex ante regulation rather than ex post compensation is that it is often difficult to determine the appropriate levels of ex post compensation, and litigation costs are high.

Consider, moreover, the case of a country debating passage of a law regulating toxic waste dumps. With foreigners (but not domestic firms) protected with a regulatory takings provision, prices of toxic waste dump sites would all be depressed as a result of the expectation of the passage of the law. A foreigner could then buy the land, and when the law is passed, demand compensation, though, in effect, the price was already discounted to reflect the expectation of the regulation.

In principle, one could argue that at the time of purchase, there was a reasonable expectation that such legislation be passed, so that he should not be compensated. But different individuals will differ in their expectations, and whose “reasonable” expectations should be used? For marketed assets, one could use changes in market values. In the case at hand, there might be little change in market values (since the market already reflected the expectation of the passage of regulations). But there are other factors affecting market value. If the demand for toxic waste dumps in general falls (say as a result of a tax on polluting chemicals), would the assessor of the damage caused by the regulation have to parse out what fraction of the loss in market value is due to the regulation, and what due to other factors?

What happens if the firm argues that the market underestimated the expected returns? After all, most people who enter a business are more optimistic about the returns than those who decide not to enter the business. The firm may even be able to produce numbers backing its claims. But the fact that others chose not to enter the business may reflect that others who looked at the prospects are more pessimistic.

The speculative nature of the requisite compensation is even clearer in the case of compensation for “pre-establishment” investments, e.g. when a foreign firm enters a country with the idea of potentially setting up a business. Engaging in this kind of exploration requires, of course, investment. But if, in the interim between his initial exploration and undertaking investment, a

regulation is passed which makes investment unattractive, what should be the basis of the compensation? The loss of potential income, had the investment been undertaken and proven successful? Or only the direct loss of exploratory investment? Some of the B.I.T. panels seem to have taken the former view.<sup>64</sup> But clearly, such potential returns are entirely speculative. There are a myriad of circumstances that might have interfered with achieving the “anticipated” returns, e.g. a recession, new products, new sources of competition, etc. Indeed, part of pre-establishment exploratory research should entail ascertaining the likelihood of a change in the regulatory environment. In a sense, a firm that is taken by surprise by a change in the regulation is a firm whose pre-investment research was clearly deficient. Why then should the government compensate it?

Consider a country contemplating passing tort legislation, which would make corporations liable for environmental damages. Clearly, a firm that had been planning to engage in unsound environmental practices may find the value of its project markedly decreased. Could the firm sue, demanding compensation for the *expected* decrease in the value of the “project”? Or can it only sue after it has been sued, and then only for the damages which it has to pay? But if it can recover the cost of any damage it imposes on others, the incentives provided not to engage in activities which damage others are totally undermined.

The adoption of regulatory provisions within B.I.T.’s applicable to foreign corporations when countries have themselves rejected such regulatory taking provisions completely eviscerates the country’s policies. Any domestic firm could establish a foreign subsidiary, and the foreign subsidiary could then undertake business in the country—with all the protections afforded by the B.I.T. It is only small businesses and individuals, unable to pay the legal and other transactions costs, which are then left unprotected.

#### **4.1. Market insurance**

Regulatory takings provisions are designed to reduce the risks facing enterprises in doing business. There are other ways in which risks can be dealt with. Insurance markets are designed to assess risk, and transfer risks from those less able or willing to bear it to those more able or willing. For the most part, there are not markets for insurance against these risks; and the absence of such markets can be viewed as a market failure. The existence of such a market would, at the same time, provide a benchmark against which the “takings” could be judged. If the premium was very high, it would reflect a general understanding that such regulations were anticipated, and would accordingly have already been reflected in market prices so that when such regulations are in fact passed, little compensation is required.

Governments have stepped in to fill the void in expropriation insurance; arguably, countries negotiating bilateral investment agreements could set up an insurance fund for regulatory takings. Firms could be asked to pay premiums into the insurance fund, which would compensate them if specific regulations were enacted. Governments might set the premiums to reflect the likelihood of the passage of various kinds of regulations, e.g. a 20% premium for the passage of a regulation that would restrict the ability of a toxic waste dump to be created on a particular site.

---

<sup>64</sup> This is **NOT** true. See any of the following ICSID cases: PSEG v Republic of Turkey (ICSID Case No. ARB/02/5), *Occidental Exploration and Production Company v. The Republic of Ecuador*, LCIA Case No. UN 3467, Award of July 1, 2004; *Metalclad Corporation v. The United Mexican States* (ICSID Case No. ARB(AF)/97/1), Award of August 6, 2004; *Wena Hotels v. Arab Republic of Egypt*, (ICSID Case No. ARB/98/4), Decision on Jurisdiction of May, 25, 1994. reference

Note that compensating firms for not polluting creates a market distortion—for it encourages the entry of potential polluters. The provision of insurance against regulation could be designed in such a way as to assess the adverse environmental (or other) impacts of the firm, forcing the firm to pay at least part of those costs (through the premiums), thereby increasing economic efficiency.<sup>65</sup>

## 5. Rights and responsibilities

One of the criticisms of the bilateral trade agreements is that they have focused on rights, not on the responsibilities of corporations. For instance, corporations have, on a number of occasions, contributed enormously to environmental degradation, without repairing the damage. When the host country demands something be done, the firm (a subsidiary which has paid out all revenues in the form of dividends) declares bankruptcy, leaving the government to clean up the mess.

Limited liability was never intended to allow corporations escape their liability for such behavior. In these cases, the corporate veil should be pierced, and the mother company should be responsible for clean-up. (Any firm with a controlling share, e.g. 20% or more interest, should be viewed as fully liable. This will provide strong incentives for them to exercise oversight over the actions of the enterprise.<sup>66</sup>)

Enforcing responsibilities across borders is often difficult. Even when a judgment is collected, it may be difficult to collect when the multinational corporation has removed all assets from the jurisdiction in which the damage or tort occurred. Bilateral investment treaties should contain provisions for the enforcement of judgments in the host country against multinationals in the home country.

We noted earlier that foreign firms may have less of an incentive to behave “responsibly” abroad than they do at home, where social pressures may be brought to bear. Worse still, they may use their disproportionate economic power to ensure that they get protective legislation. One country even passed a law making it illegal to sue international mining companies. This makes it all the more important that there be legal standards that demand that firms operating abroad behave in accordance with the same standards that they do at home, enforceable with tort actions in the home country (an expanded aliens tort provision), and this too should be part of any bilateral investment treaty.

One of the problems in modern corporations is that management’s incentives are distorted.<sup>67</sup> Management is seldom held personally responsible; management can gain (through implicit or explicit stock options or other incentive schemes) from engaging in environmentally destructive activities would paying the clean-up costs. The firm has an incentive to engage in using limited liability to shift the burden of clean up to the government. And even if the firm is caught and

---

<sup>65</sup> Not all regulations, however, should be viewed as attempts to control externalities. Some can be viewed as part of the provision of a public good. The endangered species act imposes costs on those unlucky enough to have a spotted owl nest in their tree.

<sup>66</sup> Obviously, legal frameworks would need to be more complex, to avoid the risk that all “owners” wishing to avoid responsibility by keeping shares under the 20% threshold.

<sup>67</sup> I have discussed the broader issue of the distorted incentives facing management in *The Roaring Nineties* (W.W. Norton, 2003). Stock options have, for instance, led to distortions in the information provided to the market. Sarbanes Oxley recognized the distorted incentives confronting accounting firms (a problem to which Arthur Levitt, then head of the SEC, had previously called attention) but did nothing about the problems of stock options.

forced to clean up, the management is unlikely to pay the price. The management in place when the time for clean up occurs may not be the management in place at the time the environmental degradation occurred. In short, the compensation schemes confronting most CEO's and their management teams are not designed to lead to the maximization of shareholder value; but even if they were so designed, the maximization of shareholder value does not coincide with the maximization of societal welfare in the presence of limited liability. It is appropriate that the legal frameworks that govern incorporation—including the rights of foreign companies doing business within a country—try to correct these “market failures.”

But governments need to go beyond this: they must make officers of companies criminally liable for the violation by their companies of a nation's laws, including those that govern the environment and worker safety and health. Corporations do not take actions: it is individuals within the corporations who take actions. But it is all too easy for no one to take responsibility. CEO's get paid handsomely; they are quick to take responsibility for increases in share values, even when those increases are largely accounted for by events beyond their control (e.g. the rise in oil prices giving rise to record profits by firms in the oil industry), but slow to take responsibility for the mistakes.

To implement this in a world of multinational corporations requires a willingness of countries to extradite those accused of such crimes; this should be an essential part of any multilateral investment treaty.<sup>68</sup> The fact that it is never so reflects the unbalanced nature of these agreements.

So too should be provisions which allow the enforcement of judgments against individuals and corporations in their home jurisdiction—including corporations that are deemed to have controlling interest (say 20% share).

## **6. Towards regulating multinational corporations globally**

We noted in the beginning that one of the problems facing many small poor countries in their attempt to regulate large multinational corporations is that the economic power of the latter may be much larger. There is another compounding problem: when problems are global in nature, it is inefficient to address them piecemeal, in a fragmented way. Of course, multinationals may prefer that; while it may increase their legal costs, it also may increase the likelihood that they will prevail or that actions will not be brought against them. Maintaining the public good is a public good; and maintaining the global public good is a global public good. There will, accordingly, be an undersupply of such services.

For instance, the maintenance of competition is essential for the well-functioning of a market economy. The benefits that accrue to a firm like Microsoft in engaging in its anti-competitive practices accrue globally. Yet any national prosecution typically looks only at the damages

---

<sup>68</sup> For instance, the U.S. refused to extradite (without explanation) the officials of Union Carbide, so that they could stand trial in India for the Bhopal disaster, in which thousands were killed and hundreds of thousands injured. No one from Union Carbide has been held accountable, and the compensation paid to the innocent victims is widely viewed as grossly inadequate. “Clouds of Injustice.” 2004, Amnesty International Publications. See *In re Union Carbide Corp. Gas Plant Disaster at Bhopal, India* 809 F.2d 195, 197-201 (2nd Cir. 1987) (dismissing the case to India on *forum non conveniens* grounds, and not requiring extradition of individuals). The \$470 million settlement paid by Union Carbide has been challenged, so far unsuccessfully, on various grounds in U.S. Federal Courts. For the most recent ruling, see *Bano v. Union Carbide Corporation*, 198 Fed.Appx. 32, 2006 WL 2336428 (2nd Cir. 2006) (dismissing the appeal from District Court rulings under the Alien Tort Claims Act).

incurred within its borders. Small countries may find it unprofitable to bring a case to recover damages that have occurred within their borders. Just as there is an argument for the consolidation of cases in class action suites, there is an argument for the consolidation of cases globally. In some cases, countries have tried to reach out beyond their borders, but in most cases Courts have expressed a reluctance to do so. Thus in the *Empagran Case*<sup>69</sup>, the Supreme Court did not allow foreign litigants to proceed in an anti-trust civil action, after the defendants reached an agreement with the American plaintiffs. I wrote an *Amicus Curiae*<sup>70</sup> explaining that without global anti-trust action, market participants, as they weighted the expected costs and benefits of engaging in illegal anti-competitive behavior, would have an incentive to engage in such behavior on a global scale, knowing that at most they risked significant punishment in the United States and a few other jurisdictions. (In a modern economy, in fact, such behavior can only be effective if it is conducted on a global scale.) The *Empagran* case raises the possibility that any consolidation of cases in any single jurisdiction could be easily vitiated, simply by the defendants settling with the plaintiffs within that jurisdiction.

In many of these areas, there is a need for International Commercial Courts, a subject to which I turn in the next section.

## **7 Other dissatisfactions with Bilateral Trade Agreements and related agreements**

There are a number of aspects of recent Bilateral Investment Agreements and Treaties which are disturbing:

- a) Because the legal frameworks are put into treaties, it is hard to make changes—even minor “corrections” of the kind that are standard in legislation. Economic legislation (regulation) is particularly subject to fads and fashions; and the neo-liberal doctrines that underlie much of the thinking of the past quarter century quite likely will go out of fashion, but it will not be easy to make the necessary changes in the agreements.
- b) The political processes by which such treaties are made short-circuit much of the political discourse, in which various interests are balanced. The negotiations are often conducted in secret; in the United States, a fast track process means the treaty must be voted up or down—no amendments are allowed. Corporate interests are actively engaged in the secret negotiations; the secrecy only serves to keep out active participation from others, whose viewpoints might differ. The result is agreements that are far different—reflecting particular corporate interests—than would likely have emerged in a more democratic debate.

I saw this so clearly in the years I served on the Council of Economic Advisers, years which saw the passage of NAFTA and the conclusion of the Uruguay Round negotiations. As I have already suggested, had there been a sense that there was a provision within NAFTA that might have possibly been interpreted as a regulatory takings measure, at the very least, there would have been a side-letter making clear that that was not the case. But not only was there no discussion of the full import of Chapter 11, it is not even clear the extent to which senior people in the U.S. Trade Representative’s office were aware of the provision.<sup>71</sup>

---

<sup>69</sup> *F. HOFFMANN-La ROCHE LTD, et al., Petitioners* *Hoffmann-La Roche Ltd. v. EMPAGRAN S.A. et al.* No. 03-724 SUPREME COURT OF THE UNITED STATES *Empagran S.A.*, 542 U.S. 155 (2004).

<sup>70</sup> See Brief of Amici Curiae Economists Joseph E. Stiglitz and Peter R. Orszag in Support of Respondents, 2004 WL 533934 (U.S.). 2003 U.S. Briefs 724; 2004 U.S. S. Ct. Briefs LEXIS 238

<sup>71</sup> The agreement had been largely negotiated and agreed upon during President Bush’s Administration.

The same could be said for TRIPS, the intellectual property provision of the Uruguay Round, which was opposed both by the Council of Economic Advisers and the Office of Science and Technology; we believed that it was bad for American science, bad for global science, and bad for developing countries. But there was little public debate, little awareness of the nature of the agreement, which was largely shaped by the entertainment and pharmaceutical industries, with virtually no consultation, say, from America's academic scientific community, or the user communities that might be affected. The agreement was designed to reduce access to generic versions of medicines, including life saving medicines. The implications were not fully realized until developing countries, like South Africa, pressed the case on access to generic AIDS medicines; the resulting hue and cry eventually led to a modification of the agreement.

c) The processes for adjudicating disputes have been of particular concern. Western democracies have developed a set of standards concerning due process (and including standards of evidence, procedures, etc) designed to increase the likelihood of a fair outcome: trials are held in open Court; in cases presenting novel issues, extensive written decisions weigh the arguments; there are appellate procedures to review the deliberations: an participants may, under certain circumstances, call for a jury trial. All of this is costly and time consuming, but there is a consensus that such procedures, in enhancing the likelihood of a just and fair decision, are worth the cost.

There is a concern that the dispute adjudication processes in B.I.T.s often fall far short of these "best practices." Arbitration often occurs behind closed doors, with arbitrators who are not full time and often are representing parties in other cases where related issues are in dispute. In some cases, even the occurrence of a dispute is kept secret, let alone its resolution. Appeals may be limited, and, not surprisingly, since the decision in some cases may not be open, other cases cannot build on what has been decided. This adds an extra layer of uncertainty and capriciousness to the decisions. While the B.I.T.s were designed to reduce uncertainty, in some ways they have had just the opposite effect.

This is particularly important because in some cases, the interpretation of the language of the treaty seems to have gone well beyond what at least many of those who voted for the treaty (or Administration officials who supported the Treaty) thought at the time of passage. But because of the difficulties of correcting Treaty language, the "law" made by such interpretations can have long lasting effects.

It is understandable why corporations like such processes: they have a record of providing more protections than judges in the Courts of either the host country or the country of the investors. But that reflects the fact that such arbitrators are often less sensitive to the social context in which "fair" decisions ought to be reached.

This is evident, for instance, in cases involving countries passing legislation intended to provide greater equality of opportunity (affirmative action legislation, such as South Africa's Broad-Based Black Economic Empowerment Act<sup>72</sup>). Such legislation has played an important role in housing, labor, and credit markets in the U.S. Yet, arguably, they also have adverse effects on profits in the short run (otherwise firms would have presumably hired more of the disadvantaged individuals). In judging the legality of such legislation, Courts have had to carefully balance a variety of rights, and different Courts have sometimes come to different views. But these are complex and divisive issues that in the end will have to be

---

<sup>72</sup> Broad-Based Black Economic Empowerment Act 53 of 2003.

resolved by the Supreme Courts of each country. But each country should have the right to come to a view on these issues within its own judicial procedures; they should not be short-circuited by a commercial arbitration panel that is likely not to be sufficiently attentive to the broader societal issues raised by such restrictions.<sup>73</sup>

Similarly, Courts on occasion have to decide whether contracts should not be enforced as a result of force majeure, as in the Westinghouse case.<sup>74</sup> Argentina's crisis of 2001 highlights the issues. In the crisis, contracts had to be broken, and it was clear from the interest rate charged that debt contracts had some expectation that they would be broken. It is not clear whether the arbitrators have the ability to judge the full societal consequences of what would have happened had, say, all utility contracts been honored, or whether they have the broader societal sensitivities to make the appropriate judgments, even if they had analyzed the consequences appropriately.

This discussion illustrates the complex trade-offs between the rights of different individuals and groups in society. Honoring the rights of the owners of utilities would have decreased the ability of government to honor its implicit or explicit obligations to other societal claimants, such as retirees.

In U.S. bankruptcy law, Chapter 9 deals with the bankruptcy of public authorities, and it is in some ways markedly different from other chapters (like 7 and 11) that deal with private bankruptcies. In particular, it provides priority to the continuation of the public functions of the public authority, explicitly recognizing public claimants, even if they have no formal "contract." Again, it is not clear that the arbitrators have approached their decisions within this frame; but it is clear that the language is such as to give them latitude to ignore these broader public policy concerns.

### 7.1. Better processes for dispute resolution

It is understandable that investors will be skeptical about relying on host country courts; such courts may be viewed as excessively sensitive to domestic considerations and may treat foreign corporations unfairly. Even in the U.S., litigants spend considerable energy looking for a favorable venue. Venue shopping is important because litigants believe that the outcome will be affected by the jurisdiction in which the case is tried (home court advantage) and the laws under which it is tried.

That is why there is a need for an International Commercial Court, consisting of full time international judges, of the highest qualifications and without any commercial attachments, to adjudicate cross boundary disputes and enforce cross boundary contracts and regulations. Such courts should be governed by the highest standards of due process, including transparency. There should also be appellate processes.

---

<sup>73</sup> This proposition will be played out soon, as several Italian investors in South Africa's mining industry have commenced proceedings at the International Centre for Settlement of Investment Dispute (ICSID), claiming that the BEEA violates the terms of bilateral investment treaties between Italy (and Luxembourg) and South Africa. One such example would be Piero Foresti, Laura De Carli and others v. Republic of South Africa (Case No. ARB(AF)/07/1), though this has yet to be decided, so it is uncertain how the courts will weigh societal justifications.

<sup>74</sup> For an overview see Joskow, Paul L. "Commercial Impossibility, the Uranium Market and the Westinghouse Case." *The Journal of Legal Studies*, Vol. 6, No. 1. (Jan., 1977), pp. 119-176. Also, see *In re Uranium Antitrust Litigation*, 480 F.Supp. 1138 (D.C. Ill. 1979).

The Courts should interpret disputes within the laws of the host country, giving deference to decisions made in the public interest, e.g. concerning the environment, labor, and social regulations and force majeure, recognizing the conflicts of formal and informal claimants and the primacy of public claimants—as the United States itself has done in Chapter 9 of its Bankruptcy code.<sup>75</sup>

As commerce becomes increasingly globalized, the need for such courts will necessarily increase. I noted earlier that with global markets, there is a need for global anti-trust actions. In the short run, one can do with cases from around the world consolidated into one master case; but it would be far better to have a global Competition Court, with competition standards corresponding to the strongest prevailing in the world.

Until such international commercial courts are created, and until investors can gain confidence in the judiciaries in the host countries, there needs to be a third alternative, to which I referred earlier: plaintiffs from developing countries should have the right to sue in the home country, using the higher of the standards of the host and home country, for damages resulting from torts, anti-competitive behavior, etc.; and if defendants from the home country claim as a defense against the enforcement of an action against them that the courts of the host country are biased, then they should be willing to be sued in the home country, again using the higher of the standards of the host and home country.

## **8. Non-discrimination**

Companies entering a foreign country worry most about discrimination—both explicit discrimination (not being allowed to do business) and implicit discrimination (passing laws that differentially affect the kinds of businesses foreigners are engaged in). All countries engage in some discrimination. U.S. government officials are required to fly with American carriers. The U.S. Jones Act restricts the ability of foreign ships to transport people and goods between American ports. Such discrimination is not surprising: politicians are more sensitive to voters and campaign contributors, and most countries do not allow foreign firms to make campaign contributions. But the possibility of such discrimination adds risk to cross border investment and thereby adversely affects global efficiency.

Bilateral investment treaties should focus on proscribing direct discrimination. Inevitably, however, legislation affects different people differently; the fact that foreign investors may be hurt disproportionately should only be relevant if it can be shown that was the purpose of the legislation, i.e. that there were not legitimate public purposes.<sup>76</sup>

Such non-discrimination provisions will provide much of the security that investors need, without compromising the ability of democratic governments to conduct their business. Few governments will raise taxes to a confiscatory level, because they know that in doing so, they will

---

<sup>75</sup> See 11 U.S.C. §901 *et seq.* (2000).

<sup>76</sup> Similarly, during financial crises where domestic and foreign creditors both have claims over assets of domestic firms, the principles which guide such resolutions will inevitably have differential effects on domestic and foreign claimants. For instance, in the 1997-1998 Korean crisis, domestic creditors had lent against collateralized assets, while the foreign creditors had lent, unsecured, to the “mother” company. The result was that Korean claimants recouped a larger fraction of what was owed. But this was not discrimination. Pressure was put on Korea to change the prioritization of claims to ensure a “fair” outcome between domestic and foreign creditors. In my judgment, that was wrong.



kill the economy; but they might raise taxes on foreign businesses to a confiscatory level, knowing that domestic businesses might willingly enter in their stead.

## **9. Concluding Remarks**

Corporations are legal entities, created by governments to enhance the well-being of their citizens, by creating certain conditions that are conducive to investment and the conduct of business. Governments grant certain rights—limited liability—but we have argued that these are not “natural rights” or “human rights” but only instrumental rights, shaped to further societal goals. Thus, the corporate veil can and should be pierced under certain circumstances; limited liability is not intended to make corporations or their officers immune from responsibility for their actions, including environmental damage. Governments have the right and responsibility to pass corporate governance laws, bankruptcy laws, and health, safety, and environmental regulations to further the well-being of their citizens. Foreign individuals and corporations wishing to conduct business within a country should be subjected to the rules and regulations of the host country, including the rules and regulations that govern incorporation and bankruptcy. Hence, it is not unreasonable for governments to require foreign corporations operating within their borders to establish subsidiaries, whose governance and dissolution would be governed by national laws.

Bilateral investment treaties and the investment provisions of many bilateral trade agreements have provided protections for foreign firms that go well beyond those provided to domestic firms, have paid more attention to rights than to responsibilities of corporations, and have included dispute resolution mechanisms that fall far short of the standards that we have come to expect of judicial processes in modern democracies. The result is that they have actually increased the degree of regulatory uncertainty—when one of the main arguments for these agreements was a reduction in regulatory uncertainty.

While they have not eliminated the uncertainty facing firms, they have heightened the uncertainty facing governments—the magnitudes of some of the settlements can have significant budgetary consequences for developing countries. It is not clear that these governments are the best provider of risk mitigation services. The problems are aggravated by the standards of compensation sometimes employed, which provide compensation not just for past investment, but for future business prospects.

These agreements have undermined democratic processes, circumscribing what democratic governments can and should do to enhance the well-being of their citizens. There is no coherent economic theory underlying these agreements; on the contrary, modern economic theory calls for more active intervention in the economy than these agreements call for. Indeed, these agreements are, to a large extent, reflective of deficiencies in current democratic processes; they risk preserving existing inefficiencies and inequalities by making it more difficult for democratically elected governments to correct past market failures and social injustices. This is especially so for the regulatory takings provisions which inhibit legitimate government efforts in environmental, health, and employment regulation, or in taking actions in the context of crises, where force majeure may necessitate the abrogation of existing contractual arrangements.

They are unbalanced in paying more attention to the rights of corporations than to their responsibilities.

There is a need for international laws concerning the conduct of cross border businesses. But given the imperfections in the political processes by which they are arrived at, and given the

important role that national regulations play in promoting societal welfare, the scope of such laws should be restricted. The agreements should focus on the minimal safeguards required for the conduct of cross border investments.

We have suggested that the following principles might guide the future evolution of such international laws and regulations:

- (a) Bilateral and multilateral agreements should focus on non-discrimination
- (b) Such agreements should not presume a right of establishment and should not go beyond domestic laws with respect to the protection of property rights; they should be particularly respectful of domestic legislation concerning the environment, labor, or affirmative actions.
- (c) There should be an International Commercial Court to adjudicate international disputes, governed by the laws of the host country.
- (d) In the absence of such an ICC, adjudication should occur in existing Courts; if foreign corporations do not “trust” host country courts, then the adjudication should occur in the home country, but at the higher of the prevailing standards of the host or home country.
- (e) Those injured by corporations should be allowed to sue in host country courts, under the higher of the standards of the two countries.
- (f) Corporate officials should be made criminally liable for the violation of domestic laws, and any B.I.T. should provide for expedited extradition for corporate offenses.

Multinational corporations have played a mixed role in our global economy: they have been responsible for many of the achievements of globalization, but also for some of the key problems. With the reforms described here, there is a greater chance that the positive benefits will be preserved, and the adverse effects ameliorated.