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## PREFACE

We are proud to publish the fifth edition of the *Journal of International Business and Law* (JIBL), a joint effort by the students of Hofstra University School of Law and the Frank G. Zarb School of Business of Hofstra University. As in the past years, the student editors and staff worked tirelessly on this edition to successfully publish yet another issue of JIBL.

JIBL continues to serve as a vehicle to disseminate the research findings of students, faculty and alumni in the areas of international business, international trade, transactional law, and other related interdisciplinary fields. As globalization and its effects on business and law continues, there is a need for wide ranging scholarly debate and critical thinking on a broad range of topics that are crucial to both practitioners and academicians. This thinking is reflected in the articles that are published in this issue. By combining research in these fields, JIBL hopes to bridge the gap between law and business in international corporate and entrepreneurial activities.

This edition contains eight articles including four written by students of the Frank G. Zarb School of Business and the Hofstra University School of Law. Reflecting the broad scope of the Journal, the fifth edition features an eclectic collection of articles on topics including China's dominance in the garment industry, Cuban sanctions, deregulation and competition in underwriting, and UNESCO's efforts to promote cultural diversity.

For future issues, JIBL welcomes manuscripts on various international topics including the legal aspects of international business, effects of outsourcing, regional integration, roles of international agencies in regional economic development, issues in international trade, exchange rate fluctuations and their impact on financial performance, the economic crisis that confronts emerging nations of the world, and the cross-border issues that global companies need to address.

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James P. Neelankavil Ph.D.,  
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**“CHINA CASTS A GIANT SHADOW”**  
**THE DEVELOPING WORLD CONFRONTS TRADE**  
**LIBERALIZATION AND THE END OF QUOTAS IN THE**  
**GARMENT INDUSTRY**

*Dr. John A. Hall<sup>1</sup>*

The US\$500 billion international trade in textiles and garments – what I will refer to in this paper generally as the garment industry - and in particular the recent elimination of a protectionist system of quotas and its replacement with a more liberalized trade environment, offers the opportunity for a case-study of the nature, direction and implications of globalization in the Twenty-first century. This paper will examine how the special treatment of garment and textiles in international trade law – particularly the thirty-year system of quotas - fostered the spread of apparel manufacturing throughout the developing world. The apparel factories, located in all regions of Asia, Africa and Latin America, have come to provide employment for millions of women who are frequently the sole wage earners for their families. Though criticized as “sweatshops” and sources of worker exploitation, in many instances the apparel factories offer the only viable alternative to extreme poverty for their workers. Currently there are an estimated 40 million people around the world working in the garment and textile industries, accounting for 14 percent of global employment.<sup>2</sup> In addition, the export apparel sector has grown to become a vital cornerstone of many national economies. Through the system of quotas, even those nations which were less efficient and less competitive could flourish and build a successful export trade, as importing nations selectively chose which producing nations would be offered preferential access to their restricted markets. In this way, the economies of many poorer nations could develop in an environment largely protected from the harsh realities of truly unfettered global competition.

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<sup>2</sup> NATIONAL LABOR COMMITTEE, ELIMINATION OF TEXTILE AND APPAREL QUOTAS IN 2005 WILL SHOCK THE DEVELOPING WORLD, 1 (Sept. 2004), *at* [http://www.nlnet.org/news/public/files\\_upload/quotas2005\\_en.pdf](http://www.nlnet.org/news/public/files_upload/quotas2005_en.pdf) (last visited March 26, 2006).

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By 2004, global textile and apparel exports were just short of US\$500 billion a year, in spite of the artificial restraints resulting from the quota-system.<sup>3</sup> Some estimates are that the ending of quotas will result in an expansion of total garment exports to US\$1,200 billion by 2010.<sup>4</sup> Despite this projected expansion in the size of the global market, there is reason to believe that there may be a fundamental shift in the pattern of international production.<sup>5</sup> Indeed, the very notion of a truly global system of garment production may be in doubt.<sup>6</sup> With the eradication of the quota system on January 1, 2005, which ushered-in a new era of trade liberalization, there is reason to believe that China – and to a lesser extent India – will come to dominate worldwide apparel and textile manufacturing.<sup>7</sup> The result of a rapid global shift in production could be catastrophic for developing nations overwhelmed by Chinese competition. Much of the manufacturing capacity encouraged throughout the developing world during the last three decades – and with it the crucial employment and state revenues in dozens of countries - may simply evaporate.<sup>8</sup>

**GLOBALIZATION:**

For some, the prospect of apparel and textile manufacturing spreading throughout the world offered a panacea for the host of problems facing poorer nations. They pointed, for example, to the encouragement and creation of a textile and apparel industry in developing countries as a key element in the “trade not aid” reorientation of the relationship between the developed and emerging nations.<sup>9</sup> Importing companies in the developed world came to see the developing nations as a new source for low-cost textile and clothing

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<sup>3</sup> Kaushik Basu, *Winners and Losers in Textile Shake-up*, BBC News, 2 March 2005. [http://news.bbc.co.uk/2/hi/south\\_asia/4294679.stm](http://news.bbc.co.uk/2/hi/south_asia/4294679.stm) (last visited March 26, 2006).

<sup>4</sup> *Id.*

<sup>5</sup> See Ellen Israel Rosen, *The Wal-Mart Effect: The World Trade Organization and the Race to the Bottom*, 8 CHAP. L. REV. 261, 265 (2005) (“It is likely that the inevitable efforts by retailers, including Wal-Mart, to take advantage of the new no-quota rule, means that clothing production will move to countries that can produce the largest volume of apparel for the lowest cost.”)

<sup>6</sup> See NATIONAL LABOR COMMITTEE, *supra* note 2 (The U.S. Association of Importers of Textile and Apparel has predicted that its members will “react to the WTO’s lifting of quotas . . . by slashing the number countries they source production in from 50 today to just five or six countries by 2007.”)

<sup>7</sup> Jenny Strasburg, *American Shoppers Could Find Wider Selections; Flood of China-made Garments Means Job Losses for Millions in Other Countries*, S.F. CHRON, Jan. 18, 2005, at A7.

<sup>8</sup> See Rosen *The Wal-Mart Effect: The World Trade Organization and the Race to the Bottom*, *supra* note 5 at 265; See also, NATIONAL LABOR COMMITTEE, *supra* note 2 at 6.

<sup>9</sup> Stephen E. Lamar, *The Apparel Industry and African Economic Development*, 30 LAW & POL’Y INT’L BUS. 601 (1999).

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imports, and the process of outsourcing apparel production to cheaper overseas facilities gathered speed in the final decades of the Twentieth Century.<sup>10</sup> The apparel sector was seen by policymakers in both the developed and developing nations as an easily reached low rung on the ladder of economic development for the world's poorest countries, the key that would enable even the smallest countries to participate in the global economy, and as a quick and comparatively cheap way to generate steady industrial employment in countries with a plentiful but largely unskilled workforce. The spread of an export-oriented textile and garment industry to developing nations would act as a catalyst to growth by stimulating direct foreign investment in poorer countries, fostering a climate favorable to entrepreneurial enterprise, and creating the infrastructure which would encourage future industrial expansion.

This positive vision of the beneficial role of the worldwide spread of the garment and textile industries met with approval amongst those "Globalists" who actively lauded the potential of globalization. Participation in the global marketplace, they argued, would foster competitiveness and specialization; would encourage development, generate wealth, and raise millions in the developing world from poverty. The Economist, for example, has argued that: "[A]ll countries can raise their living standards through specialization and trade . . . [Countries] gain[] from focusing on the goods in which [their] relative advantage is greatest."<sup>11</sup> The benefit from the winning sectors should, it was believed, more than compensate for any losses associated with those sectors in which a country was less competitive.<sup>12</sup> In this way, developing countries could take advantage of their abundant supply of cheap labor to become specialized manufacturing centers for goods demanded by consumers in developed economies. Indeed, it was argued, "menial manufacturing labor is the historical first step in developing economy's first steps toward prosperity."<sup>13</sup> Manufacturing would offer developing countries employment opportunities for an often unemployed or underemployed unskilled workforce at wages

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<sup>10</sup> In 1950, 1.2 million Americans were employed in apparel manufacturing. By 2001, that number had declined to 566,000 despite a doubling in the U.S. population. In 1989 the U.S. imported \$24.5 billion in apparel; in 2001 that had risen to \$63.8 billion. By the end of 2001, 83 percent of all apparel sold in the U.S. was imported. Fred Dickey, *Workers hang on by a thread*, L.A. TIMES, Jan. 12, 2003.

<sup>11</sup> *Nagging Doubts About the Benefits of Globalization, and a Look at the Evidence*, THE ECONOMIST, Sept. 18, 2004 quoted in Juan Vega, *China's Economic And Political Clout Grows in Latin America at the Expense of U.S. Interests*, 14 MINN. J. GLOBAL TRADE 377, fn. 177 (2005).

<sup>12</sup> *Id.*

<sup>13</sup> Radley Balko, *Sweatshops and Globalization*, A WORLD CONNECTED, at [www.worldconnected.org/article.php/525.html](http://www.worldconnected.org/article.php/525.html) (last visited March 26, 2006)

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potentially far above what would otherwise be available in the local economy.<sup>14</sup> The garment industry promised eager developing nations a crucial first step – a so-called “starter industry” - towards participation in a broader international economy, attracting foreign investment and foreign currency and stimulating wealth creation.<sup>15</sup> Foreign consumers would in turn benefit from cheaper and more plentiful manufactured goods.

Critics of globalization, however, were more likely to stress the negative impact of the garment and textile industry on the workers of the developing nations. For much of the 1990’s, the term “sweatshop” was synonymous with the worst abuses of garment and textile workers in the developing world.<sup>16</sup> Critics warned that the developing world would become little more than an easily exploited source of cheap labor producing consumer goods for the wealthy nations; that wages would be forced ever lower in a “race to the bottom,” as manufacturers seek advantage over other low-cost producers; that developed countries would experience a loss of unskilled jobs, exacerbating the divide between the wealthy and the poor in those nations; and that in an unprotected environment, smaller nations would ultimately be unable to compete with the economies of scale of the large super producers, and the list of nations that would ultimately benefit from global trade will inexorably shrink.<sup>17</sup>

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<sup>14</sup> Nicholas D. Kristof and Sheryl Wudunn, *Two Cheers for Sweatshops*, N.Y. TIMES MAGAZINE, Sept. 24, 2000, available at <http://www.nytimes.com/library/magazine/home/20000924mag-sweatshops.html>. (last visited April 23, 2006).

<sup>15</sup> Gary Gereffi, *Outsourcing and Changing Patterns of International Competition in the Apparel Commodity Chain*, 1 (Paper presented at the conference “Responding to Globalization: Societies, Groups, and Individuals,” Boulder Colorado, 4-7 April 2002) available at [www.colorado.edu/IBS/PEC/gradconf/papers.gereffi.html](http://www.colorado.edu/IBS/PEC/gradconf/papers.gereffi.html) (last visited March 26, 2006) See generally, TOMAS LARSSON, *THE RACE TO THE TOP: THE REAL STORY OF GLOBALIZATION*, (Cato Institute 2001); See also JOHAN NORBERG, *IN DEFENCE OF GLOBAL CAPITALISM*, (Cato Institute 2003).

<sup>16</sup> See for example, The Workers Rights Consortium, at <http://www.workersrights.org/> (last visited March 26, 2006); Scholars Against Sweatshop Labor, at <http://www.umass.edu/peri/sasl/> (last visited March 26, 2006); Anti-sweatshop labor (ASSL) League, at <http://www.geocities.com/whydoyoukeepdeletingme/ASSLLeague.html?20069> (last visited March 26, 2006).

<sup>17</sup> See, for example, Press Release GA/SHC/3778, U.N. Fifty-Ninth General Assembly, Third Committee, *Delegates express Concern Over Negative Impact of Globalization As Third Committee Continues Debate on Social Issues*, (May 10, 2004) available at <http://www.un.org/News/Press/docs/2004/gashc3778.doc.thm> (last visited March 26, 2006); Press Release, TUC Online, *Why globalization is bad news for millions of female workers*, June 26, 2003, at <http://www.hartford-hwp.com/archives/26/216.html>; (last visited March 26, 2006); Balko, *supra* note 13.

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**THE HISTORY OF APPAREL QUOTAS:**

For several decades the global trade in textiles and garments received special treatment under international trade law. As early as the 1950's, cotton textiles were accorded special treatment, primarily because of concern in the United States about the potential impact on domestic manufacturers of low-cost textile imports from post-war Japan.<sup>18</sup> The rather narrow protectionist concerns voiced by the U.S. which initially prompted such special treatment, subsequently broadened into generalized U.S. and European fears about the potential threat posed to the domestic garment and textile industry from low-cost competition from the developing world. Despite subsequent attempts by the U.S. and Europe to protect their domestic manufacturers, however, the last twenty years have seen a dramatic decline in the U.S. and European manufacturing base in the face of an increasingly globalized and highly competitive textile industry.<sup>19</sup>

**GENERAL AGREEMENT ON TARIFFS AND TRADE (GATT):**

The quota regime for the apparel industry was initially intended as a way to protect domestic producers in developed countries from cheap textile and apparel imports from developing countries.<sup>20</sup> Following on the heels of independently negotiated agreements between various member and non-member countries, contracting parties to the General Agreement on Tariffs and Trade (GATT) agreed that Article XIX (which provides measures to safeguard local industries) would be significantly expanded for textiles.<sup>21</sup> Under GATT,

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<sup>18</sup> Ellen Israel Rosen, *MAKING SWEATSHOPS: THE GLOBALIZATION OF THE U.S. APPAREL INDUSTRY* 37-43 (University of California Press (2002).

<sup>19</sup> American Textile Manufacturers Institute, *The China Threat to the Textile Apparel Trade Report*, July 2, 2003, available at <http://www.ncto.org/textilecrisis/china.pdf> (last visited March 26, 2006); Vanessa Hua, *Elimination of Import Quotas Decimate Garment Industry*, S. F. CHRON., Jan. 18, 2005; Mike Davis, *Corporate Globalization: Overseas Sweatshops Destroy U.S. Garment Industry*, Organic Consumers Association (August 25, 2004) at <http://www.organicconsumers.org/corp/sweatshops8272004.cfm>. (last visited March 26, 2006)

<sup>20</sup> Ira Kalish, *Quotas End, Uncertainty Continues; Understanding the impact of the Agreement on Textiles and Clothing*, Deloitte Research Study (2005), at 3 available at [http://www.deloitte.com/dtt/cda/doc/content/ DTT\\_DR\\_Quotas\\_Feb05\(1\).pdf](http://www.deloitte.com/dtt/cda/doc/content/ DTT_DR_Quotas_Feb05(1).pdf) (last visited March 26, 2005).

<sup>21</sup> Kevin Kolben, *Trade, Monitoring, and the ILO: Working to Improve Conditions in Cambodia's*

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all countries are required to treat their trading partners equally.<sup>22</sup> GATT also placed a preference on customs tariffs over quotas.<sup>23</sup>

**THE MULTI-FIBER ARRANGEMENT (MFA):**

A series of expansions in the permitted safeguards for textiles were negotiated over the next thirty years, culminating in the adoption of the Multifiber Arrangement (“MFA”) in 1974,<sup>24</sup> which permitted importing countries to place quotas on textile imports when surges in imports of particular products threatened domestic industry.<sup>25</sup> In as much as the MFA permitted importing nations to treat trading partners differently, and to adopt quotas in preference to import duties, it contradicted basic GATT principles.<sup>26</sup> The final extension of the MFA, in 1991-1993, permitted importing countries to impose quotas to punish exporting countries that engaged in “trans-shipment” (shipping textiles through a third country to take advantage of that nation’s unused quota allocation and conceal the country of origin).<sup>27</sup>

The system of quotas permitted under the MFA benefited many developing nations in two specific ways: first, the quotas limited the growth of those nations threatening to become “mega-producer,” most notably China and India, by permitting importing nations to place a cap on imports from specific countries<sup>28</sup>; and second, the quotas guaranteed a clearly quantified access to

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*Garment Factories*, 7 YALE HUM. RTS. & DEV. L.J. 79, 88; Kitty G. Dickerson, *Textile Trade: The GATT Exception*, 11 ST. JOHN’S J.L. COMM. 393, 404 (1996); Rosen, *MAKING SWEATSHOPS*, *supra* note 18 at 37-43.

<sup>22</sup> See General Agreement on Tariffs and Trade, Oct. 30, 1947, art.1, 55 U.N.T.S. 188 (entered into force on Jan. 12, 1948. [hereinafter GATT])

<sup>23</sup> GATT, art. XI.

<sup>24</sup> Agreement Regarding International Trade in Textiles (Multifibre Agreement), Dec. 20, 1973, 25 U.S.T. 1001 (entered into force on Apr. 1, 1974); Kolben, *supra* note 21 at 88-9.

<sup>25</sup> Kolben, *supra* note 21, at 89.

<sup>26</sup> *Id.*

<sup>27</sup> *Id.* at 89 fn 61.

<sup>28</sup> Lamar, *supra* note 9, at 615. The quota system permitted under the MFA was discretionary in nature. Importing nations could choose to impose highly restrictive quotas, somewhat restrictive quotas, or indeed no quotas whatsoever, on each individual product line from each exporting country. In the U.S., it was the Executive Branch which had the responsibility and flexibility to impose quotas. Although the Executive Branch may be subject to pressure from Congress or pressure groups, it could refrain from imposing quotas if it desired. This provided enormous economic incentives for exporting nations to curry favor from the governments of importing nations. *Id.* It was possible, therefore, for the allocation of quotas by the U.S. to have reflected larger U.S. foreign policy and strategic objectives, enabling Washington to use quotas to reward some nations (such as Cambodia) who were moving towards greater democratization, and those (like the Philippines) deemed allies.



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U.S. and E.U. markets for small producers. In the case of the Philippines, for example, a largely cottage-based textile industry in the late 1950's, which began expanding in the 1960's, ballooned after the MFA was adopted in 1974.<sup>29</sup> The quotas allocated to the Philippines guaranteed access to the U.S. market for Philippine textiles and garments, and propelled the growth of its garment manufacturing sector. The value of garment exports grew rapidly from US\$36 million in 1970, to US\$2.4 billion in 2003.<sup>30</sup> Similarly, Macao's garment industry flourished under the MFA-regime, coming to represent 70 percent of all Macao's exports, as Hong Kong manufacturers shifted production to Macao to better access the restricted U.S. and EU markets.<sup>31</sup>

**THE AGREEMENT ON TEXTILES AND CLOTHING AND  
THE PHASE-OUT OF THE MFA QUOTAS:**

Under the so-called "Uruguay Round" of WTO negotiations, concluded in 1995, the contracting parties concluded the Agreement on Textiles and Clothing ("ATC").<sup>32</sup> Under the ATC, the WTO contracting parties agreed to phase out the MFA, thereby bringing textiles back under traditional GATT rules.

Under the ATC, MFA quotas were to be phased out progressively over a non-extendable ten-year period. In the first stage, which began on January 1, 1995, WTO Members were required to integrate not less than 16 percent of their 1990 imports of textiles and garments; in the second stage, beginning in January 1998, not less than a further 17 percent was to be integrated; and in the third stage, starting in January 2002, WTO Members were required to integrate a further 18 percent.<sup>33</sup> All remaining products (amounting to a maximum of 49

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<sup>29</sup> Laurent Duvillier, International Confederation of Free Trade Unions (ICTFU), *Surviving Without Quotas*, 1 (June 26, 2006) available at [http://www.icftu.org/www/PDF/RP\\_Garment\\_Report\\_170605edited\\_260605EN.pdf](http://www.icftu.org/www/PDF/RP_Garment_Report_170605edited_260605EN.pdf) (last visited March 26, 2006)

<sup>30</sup> Duvillier, *supra* note 29 at 1 citing Philippine Economic Indicators, National Economic & Development Authority (NEDA) at <http://localweb.neda.gov.ph>.

<sup>31</sup> See Macao Development Strategy Study Center and Academy of Hong Kong and Macao Economy of Guangzhou, Jinan University, *The Social and Economic Impact on Macao and Countermeasures for the Phasing Out of Textile and Garment Quota System in 2005*, (2004) at [http://www.ipim.gov.mo/en/publication/macauimage/cover/no36\\_03.htm](http://www.ipim.gov.mo/en/publication/macauimage/cover/no36_03.htm) (last visited March 26, 2006). citing Philippine Economic Indicators, National Economic & Development Authority (NEDA) at <http://localweb.neda.gov.ph>.

<sup>32</sup> Agreement on Textiles and Clothing, April 15, 1994, 1868 U.N.T.S. 14 (entered into force on Jan. 1, 1995).

<sup>33</sup> Montfort Mlachila and Yongzheng Yang, *The End of Textiles Quotas: A Case Study of the Impact on Bangladesh*, IMF Working Paper, WP/04/108 (2004), at 6 available at

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percent) were to be automatically integrated with the final elimination of all quotas on January 1, 2005.<sup>34</sup> Products not yet integrated were subject to a special transitional safeguard mechanism, whereby an importing country could apply quantitative restrictions for up to three years on imports from a particular source of supply that causes or threatens to cause serious injury to domestic industry. After integration, regular GATT safeguards would apply.<sup>35</sup>

In addition to this integration process, The ATC accelerated the annual growth rates for remaining quotas: 16 percent for the first stage of the agreement; 25 percent for the second stage; and 27 percent for the final stage<sup>36</sup> Further, Least Developed Countries (LDC's) could enjoy a one-stage advancement in the acceleration of quota growth.<sup>37</sup> Thus, while quotas were being removed on a certain number of product lines, the remaining quotas could be increased in the years leading up to the final elimination of the quotas. Some exporting countries, therefore, could experience a rapid expansion in their access to quota-restricted markets while enjoying protection from competitors who were less successful in obtaining quota allocations.

**PHASE-OUT AND THE RUN-UP TO ELIMINATION, 1994-2005:**

The phase-out of quotas during the three stages of the ATC prior to 2005, had far less impact than the final elimination. This was primarily due to importing nations "backloading" the quota phase-out, and retaining the most restrictive quotas on the most valuable products until the final elimination.<sup>38</sup> Initially, many developing nations, who felt that their access to markets in the U.S. and E.U. had been artificially restricted, believed that the move to a more liberalized trading environment would benefit them.<sup>39</sup> This optimism, however, began to evaporate as they watched with concern as China rapidly assumed global dominance in manufacturing many non-textile items which were either not governed by quotas or whose quotas were phased out.<sup>40</sup>

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<http://www.imf.org/external/pubs/ft/wp/2004/wp04108.pdf>. (last visited March 26, 2006).

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

<sup>37</sup> *Id.*

<sup>38</sup> Mlachila and Yang, *supra* note 33, at 4.

<sup>39</sup> Duvillier, *supra* note 29, at 1.

<sup>40</sup> Press Release, National Statistics Office, Merchandise Export Performance – March 2005, available at <http://www.census.gov.ph/data/pressrelease/2005/ex0503tx.html> (last visited March 26, 2006); Duvillier, *supra* note 29, at 2 fn. 4.

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In March 2004, the Istanbul Declaration was issued by the American Textile Manufacturers' Institute (ATMI), the American Manufacturing Trade Action Coalition (AMTAC), and the Istanbul Textile and Apparel Exporters' Association (ITKIB - Istanbul Tekstil Ve Konfeksiyon Ihracatci Birlikleri).<sup>41</sup> The declaration requested that a WTO emergency conference be called on July 1, 2005, in order to discuss the possibility of extending the textile quotas until the end of 2007.<sup>42</sup> The Declaration was signed by textile and trade associations from Mexico, Italy, Belgium and Austria, and was supported by trade associations from more than ten African countries.<sup>43</sup> "All this has indicated," the China Daily reported, "that the besiegement against Chinese textile exports may probably be intensified."<sup>44</sup>

On July 20, 2004, Mauritius became the first nation to make a formal request for an emergency meeting of the WTO to discuss the ending of quotas.<sup>45</sup> Within the U.S., domestic lobbies urged the Bush administration to support the call for a continuance of the system of apparel quotas.<sup>46</sup> Members of both the House of Representatives and the Senate drafted a letter to President Bush urging him to reexamine whether textile integration should be postponed until 2008 or later.<sup>47</sup> Among the signatories was John Kerry, Democratic Party nominee for President, and perhaps as a result, the domestic U.S. debate over apparel quotas became somewhat limited by the nature of the U.S. election.<sup>48</sup> In response to Democratic pressure, the Bush administration maintained that it would not support calls for an extension of the quota system.<sup>49</sup>

### JAN. 1, 2005: THE FINAL END OF THE QUOTAS

On January 1, 2005, the garment industry changed forever, as a new era of trade liberalization ushered in more direct and open competition between producing nations. Did it, however, herald the profound, dramatic and sudden collapse of the textile industry in much of the developing world that some had

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<sup>41</sup> *US Unwilling to Remove Textile Quotas*, CHINA DAILY, April 4, 2004, available at [http://www2.chinadaily.com.cn/english/doc/2004-04/04/content\\_320441.htm](http://www2.chinadaily.com.cn/english/doc/2004-04/04/content_320441.htm) (last visited March 26, 2005)

<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

<sup>44</sup> *Id.*

<sup>45</sup> Jane Li, *MFA Phase Out- Impact on Chinese Workers*, 52 ASIAN LABOUR UPDATE, (July -Sept. 2004) at <http://www.amrc.org.hk/5203.htm> (last visited March 26, 2006).

<sup>46</sup> *Id.*

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

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feared? Certainly the predictions were dire, and not merely amongst traditionally alarmist organizations. The World Trade Organization (WTO), for example, made a series of well-publicized predictions that China would gain significantly after January 1, 2005, at the expense of most other countries.<sup>50</sup> It anticipated that, in the absence any new protectionist measures or currency movement, China's share of E.U. apparel imports would rise from 18% to 29%.<sup>51</sup> The WTO projected an even more dramatic increase in China's share of U.S. apparel imports from 16% to 50%.<sup>52</sup> The smaller increase in China's share of the E.U. market reflects the fact that the U.S. waited until January 1, 2005, to eliminate many of its key quotas, while the EU had done so somewhat earlier.<sup>53</sup> The International Monetary Fund (IMF) has estimated that China could in fact gain an even greater share of the global market than that suggested by the WTO.<sup>54</sup> The IMF has suggested that, given China's attractiveness to foreign buyers, China's apparel exports could double by January, 2008.<sup>55</sup>

The early months of 2005 offered few hopes for many developing nations, as the worst-case scenario predictions of the IMF and the WTO appeared to be coming to pass. Indeed, the initial surge of Chinese exports to the U.S. and EU has been described as "explosive" by the U.S. Agency for International Development (USAID).<sup>56</sup> Between April 2004 and April 2005, for example, the volume of U.S. imports from China of cotton nightwear (quota code 351) increased 660%; of manmade fiber nightwear (651) by 248%; of cotton slacks (348) by 1,584%; of cotton knit blouses (339) by 1,639%; of cotton trousers (347) by 1,420%; of manmade fiber knit blouses (639) by 324%; and manmade fiber skirts (642) by 257%. As the USAID concluded in June 2005: "China, with its vast supply of labor, significant upstream capacity in textiles and manufacturing, efficient garment factories, and well-developed logistics infrastructure, has achieved breathtaking gains in exports in just the first few months of quota-free trade."<sup>57</sup>

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<sup>50</sup> Kalish, *supra* note 20, at 3.

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

<sup>54</sup> *Id.*

<sup>55</sup> Kalish, *supra* note 20, at 4.

<sup>56</sup> Lynn Salinger et al., Report prepared for United States Agency for International Development, *Measuring Competitiveness and Labor Productivity in Cambodia's Garment Industry* (June 2005), available at [http://www.usaid.gov/kh/democracy\\_and\\_governance/documents/703\\_Cambodia\\_Garment\\_Sector\\_Main\\_Report\\_\\_Nathan.pdf](http://www.usaid.gov/kh/democracy_and_governance/documents/703_Cambodia_Garment_Sector_Main_Report__Nathan.pdf) (last visited March 26, 2006)(hereinafter USAID Report).

<sup>57</sup> *Id.* at v.

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The tidal wave of Chinese imports, however, was of such a scale that it created a serious political backlash in both Europe and the U.S. The terms of China's 2001 accession to the WTO allow WTO members to restrain market-disrupting imports for 12 years after China's accession. The so-called textiles safeguard clause in the accession agreement, covering all products in the WTO Agreement on Textiles and Clothing, permits 90-day safeguard measures on a revolving basis, but is available only until December 31, 2008.<sup>58</sup> Following the extraordinary increase in China's apparel exports after January 1, 2005, governments in the U.S. and the EU were inundated with safeguard petitions from domestic manufacturers demanding the reinstatement of protectionist barriers to ward off the potentially crippling flow of cheap Chinese products.<sup>59</sup> The U.S. Committee for the Implementation of Textile Agreements (CITA), reviewed safeguard petitions in a number of product categories, and in May 2005 announced its intention to impose new quotas in several categories.<sup>60</sup> In late April 2005, the European Union also decided to investigate imports of nine product lines from China.<sup>61</sup>

The uncertainty as to whether importing countries may act to limit apparel and textile imports – in particular whether the U.S. and E.U. will attempt to limit the tide of imports from China – has created uncertainty and has undoubtedly impacted decisions made by importers. Fearing the potential that their orders from China may be trapped on boats or otherwise made unavailable as a result of government protectionism, buyers have shown a reluctance to entirely switch their production to China.<sup>62</sup> As Deloitte Research has predicted: “Apparel and textile producers will seek to diversify risk. As such, they will not put all their eggs in the China basket.”<sup>63</sup> In June 2005, USAID similarly concluded that U.S. and EU buyers were “retaining multiple sources of supply while waiting to see how safeguard actions (new quotas) against China

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<sup>58</sup> *Id.* at 7 fn 6.

<sup>59</sup> *Id.* at 7-8.

<sup>60</sup> *Id.* at 7. The committee confirmed market disruption for the following categories: cotton knit shirts and blouses (quota code 338/339); cotton trousers (347/348); cotton and manmade fiber underwear (352/652); men's and boy's woven cotton and manmade fiber shirts (340/640); manmade fiber trousers (647/648); manmade fiber knit shirts and blouses (638/639); and combed cotton yarn (301). *Id.* at 7; *See also* CITA news releases available at [www.otexa.ita.doc.gov](http://www.otexa.ita.doc.gov) (last visited March 26, 2006).

<sup>61</sup> *Id.* at 7-8. T-shirts, pullovers, blouses, stockings and socks, men's trousers, women's overcoats, brassieres, flax or ramie yarn, and woven-fabric yarn. *Id.* at 8. *See also* <http://trade-info.cec.eu.int/textiles/index.cfm> (last visited March 26, 2006).

<sup>62</sup> Kalish, *supra* note 20, at 4.

<sup>63</sup> *Id.* at 1.

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undertaken by the United States and European Union in early 2005 will play out.”<sup>64</sup>

The lingering possibility of future restrictions being imposed by importing countries probably explains why the dire predictions of the WTO and IMF have not yet come to pass. Ira Kalish, the Global Director of Consumer Business at Deloitte Research, has noted that the trade is “freer trade but not completely free trade. How free depends on decisions yet to be made by importing country governments.”<sup>65</sup> This is an important observation. The elimination of quotas did not eliminate all potential barriers to the free global trade in garments and textiles. Tariffs and import duties are, with certain restrictions, still permitted. A number of countries, including the U.S., maintain duty reduction programs to favor one region over another.<sup>66</sup> In addition, restrictive rules of origin, the rules that govern how a product is labeled and whether it can be imported, still operate.<sup>67</sup> Thus, the garment and textile industry continues to face a number of regulatory schemes that may continue to distort trade and investment patterns.<sup>68</sup> In addition, governments in importing countries face strong domestic pressure to counter the perceived “tidal wave” of cheap Chinese imports. As Ira Kalish noted:

Apparel producers and distributors would like to be able to plan on the basis of precise knowledge of the future trading regime. Yet that has not been possible. Importing governments may or may not act to limit apparel and textile imports depending on the future flow of goods, the political consequences, and the political power of competing interests. Consequently, risk exists and market participants must plan accordingly.<sup>69</sup>

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<sup>64</sup> USAID Report, *supra* note 55, at v.

<sup>65</sup> Kalish, *supra* note 20, at 1.

<sup>66</sup> Lamar, *supra* note 9, at 609.

<sup>67</sup> For example, in order to qualify for duty-free importation of textiles and garments into Europe, manufacturers must meet strict rules of origin – demonstrating that the garments and certain of their constituent parts (such as yarn), have originated in Lome or Generalized System of Preferences-qualifying countries. For many producers, such as those in Africa, which rely heavily on imported constituent parts, it is frequently impossible to meet such requirements. Lamar, *supra* note 9, at 609.

<sup>68</sup> *Id.*

<sup>69</sup> Kalish, *supra* note 20, at 1.

## CHINA CASTS A GIANT SHADOW

**COUNTRY-SPECIFIC ANALYSIS OF THE IMPACT OF  
TRADE LIBERALIZATION AND THE PHASE-OUT THE  
QUOTA SYSTEM:**

The ending of quotas has predictably impacted some countries far more seriously than others. Several nations have experienced a rapid loss of a significant portion of their manufacturing capacity, while others have – at least in the short term – benefited at the expense of their less competitive neighbors. Even in those countries that have witnessed an increase in textiles exports since January 2005, however, this increase is partly explained by the continuation of certain artificial restraints placed upon Chinese textile imports by the E.U., and by current uncertainty amongst Western buyers as to whether Washington will bow to political pressure and reassert trade restrictions on Chinese textiles.<sup>70</sup> If these artificial restraints on Chinese textile exports are resolved, the worst-case scenarios of a massive manufacturing shift from developing nations to China may materialize.

The consequences of shifts in global production of the garment industry are likely to impact all those developing countries currently active in the production of garments. Ellen Israel Rosen, for example, has predicted that amongst the “[h]uge losers in this race to the bottom” will be countries such as Costa Rica, Haiti, Jamaica, South Africa, Mauritius, Malaysia, Indonesia, Kenya, Lesotho, Madagascar and Mexico.<sup>71</sup> This paper will briefly outline the anticipated impact on just eight nations: five generally expected to suffer as a result of the new trade liberalization: Fiji, Bangladesh, the Philippines, Macao, and Mongolia; one country, Cambodia, which, in a closely-watched gambit, is attempting to maintain its attractiveness to Western buyers by eschewing the inevitability of the “race to the bottom” and emphasizing instead its comparatively progressive labor standards; India, the country which is aggressively – but perhaps belatedly - attempting to position itself to reap significant rewards from the end of quotas; and, finally, China, the country universally acknowledged as the huge winner in the newly liberalized trade regime.<sup>72</sup>

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<sup>70</sup> USAID Report, *supra* note 56, at v.

<sup>71</sup> See Rosen *The Wal-Mart Effect: The World Trade Organization and the Race to the Bottom*, *supra* note 5, at 265.

<sup>72</sup> For a discussion of the garment industry in Mauritius, South Africa, Lesotho, Kenya, Zimbabwe, Swaziland, Madagascar, Botswana and Tanzania, see Lamar, *supra* note 9; U.S. INT’L TRADE

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**Fiji:**

Fiji is an example of how changes in the world trade in garments can impact even the smallest economy. The Fijian garment industry has had a short history, but is now a critical part of the economic structure of the country. Indeed, the garment industry surpassed sugar as the number one export sector in 1997.<sup>73</sup> Fiji's two largest industries, garments and sugar, are both currently in what has been described as "terminal crisis."<sup>74</sup> Epeli Ganilau, the former head of the Great Council of Chiefs, has estimated that Fiji stands to lose US\$120 million of its national revenue, with upwards of 5,000 jobs expected to be lost in the garment industry.<sup>75</sup> These predictions appear well-founded, with the April 2005 closure of the Ghim Li Apparel factory, Fiji's largest manufacturer.

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COMMISSION, PUB. No. 3056, *Likely Impact Of Providing Quota-Free And Duty-Free Entry To Textiles And Apparel From Sub-Saharan Africa*, 2-13 (1997); Dorte Verner, *Are Wages and productivity in Zimbabwe affected by human capital investment and international trade?* World Bank Policy Research Working Paper 2101, Washington: World Bank (1999). For Egypt, see Salah El-Amrousi, *Qiz Mythology*, AL-AHRAM WEEKLY, <http://weekly.ahram.org.eg/print/2005/743/ec4.htm> (last visited March 26, 2006). In anticipation of the end of quotas, apparel quotas from El Salvador declined by 30 percent in November 2004, and it is expected that the apparel sector of the Dominican Republic will lose up to 40 percent of its jobs as a result of the end of quotas, see Basu, *supra* note 3; BUREAU OF INTERNATIONAL LABOR AFFAIRS, U.S. DEPT OF LABOR, WAGES, BENEFITS, POVERTY LINE, AND MEETING WORKERS NEEDS IN THE APPAREL AND FOOTWARE INDUSTRIES OF SELECTED COUNTRIES (2000), available at [www.dol.gov/ilab/media/reports/oiea/wagestudy](http://www.dol.gov/ilab/media/reports/oiea/wagestudy) (last visited March 26, 2006); U.S. INT'L TRADE COMMISSION, TEXTILES AND APPAREL: ASSESSMENT OF THE COMPETITIVENESS OF CERTAIN FOREIGN SUPPLIERS TO THE U.S. MARKET, Pub. No. 3056, Inv. 332-379(2004), available at <http://hotdocs.usitc.gov/pub3671/main.html> (last visited March 26, 2006); *Sweating for Fashion: Labour Comes Cheap, and Will Get Cheaper Still*, THE ECONOMIST, Mar. 4, 2004, available at [www.economist.com](http://www.economist.com); Richard P. Applebaum, Institute for Social, Behavioral, and Economic Research, *Assessing the Impact of the Phasing Out of the Agreement on Textile and Clothing and Apparel Exports on the Least Developed and Developing Countries* (2004). Turkey, Morocco, and Central Europe jointly accounted for over one quarter of the E.U.'s apparel imports in 2002. As Ira Kalish has concluded: "It is expected that the end of quotas will create turmoil for each of these countries." Kalish, *supra* note 20, at 2; for Mexico, see Rosen *The Wal-Mart Effect: The World Trade Organization and the Race to the Bottom*, *supra* note 5, at 265.; NATIONAL LABOR COMMITTEE, *supra* note 2, at 6. For a discussion of the insecurity of the Mexican maquiladora industry, see Elisabeth Malkin, *Manufacturing Jobs Are Exiting Mexico*, N.Y. TIMES, Nov. 5, 2002, at W1.

<sup>73</sup> DONOVAN STOREY, OXFAM INTERNATIONAL, *The Fiji Garment Industry*, 4 (Aug. 2004), at <http://www.oxfam.org.nz/resources/oxfam%20Fiji%20Garment%20Study.pdf>. (last visited March 26, 2006)

<sup>74</sup> Frank Gaglioti, *Textile Factor Closure devastates Fijian Economy*, World Socialist Web Site (May 19, 2005) at <http://www.wsws.org/articles/2005/may2005/fiji-m19.shtml>. (last visited March 26, 2006)

<sup>75</sup> *Id.*



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Singaporean firm Ghim Li was set up in Fiji to exploit the U.S. quota system, and manufactured apparel for Sears Roebuck, Wal-Mart and Kmart. With the end of the garment quotas in January 2005, however, the decision was made by Ghim Li to relocate production to China.<sup>76</sup>

The Fijian garment industry grew rapidly following the 1987 coup by General Sitiveni Rabuka.<sup>77</sup> In an attempt to attract foreign investors, the government suppressed trade unions<sup>78</sup>, set a minimum wage below the poverty level, and offered a 13-year tax “holiday” for garment firms which exported at least 70 percent of their product.<sup>79</sup> Australian apparel firms invested heavily in Fiji following 1991 when the Australian Labor Government created the Import Credit Scheme, which provided subsidies to Australian exporters of textiles, clothing and footwear.<sup>80</sup> The result was that Australian manufacturers began the apparel manufacturing process in Australia, before exporting the components to Fiji for assembly. The finished garments were then re-exported to Australia to take advantage of the South Pacific Area Regional Trade and Economic Cooperation Agreement (SPARTECA), which provided Fiji with tariff-free exports to Australia.<sup>81</sup> At its peak in 2000, the garment industry was responsible for 31 percent of Fiji’s total exports and 11 percent of its GDP.<sup>82</sup> Profit margins for the overseas firms were estimated to be around 30 percent.<sup>83</sup> However the industry went into decline following a May 2000 coup and subsequent political instability and Australian trade sanctions.<sup>84</sup> Foreign manufacturers began pulling out of Fiji at that time, with 14 factories closing in the months after the coup.<sup>85</sup> The decision by Australia to drop its sanctions in December 2000 did not encourage the foreign firms to return.<sup>86</sup> With the end of quotas on the horizon, Fiji was simply no longer considered a necessary part of international manufacturing nor a worthwhile risk, and any advantage it had once offered for its access to quota-restricted markets was soon to disappear in January 2005.<sup>87</sup>

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<sup>76</sup> *Id.*

<sup>77</sup> *Id.*

<sup>78</sup> Gaglioti, *supra* note 74.

<sup>79</sup> *Id.* See also STOREY, *supra* note 73, at 9.

<sup>80</sup> Gaglioti, *supra* note 74.

<sup>81</sup> *Id.*

<sup>82</sup> *Id.*

<sup>83</sup> *Id.*

<sup>84</sup> Gaglioti, *supra* note 74.

<sup>85</sup> *Id.*

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*

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Oxfam research indicates that Fijian garment workers earn as little as \$1.08 an hour, with some garment factory wages declining since 2000.<sup>88</sup> For a majority of the workers, the wages, however meager, are critical for meeting basic needs, and are the central component of family income. A high proportion of garment workers live in peri-urban squatter settlements in order to avoid the costs of formal housing, and to minimize travel to the factory.<sup>89</sup> Nevertheless, the collapse of the garment industry remove the only source of income for thousands of Fijian families, and is likely to exacerbate the problems of poverty, unemployment, social inequality, and prostitution. The Fijian Garment Industry report concluded that: “[A]ny collapse [of the garment industry] would create a crisis which would be both human and economic. Though low even by local standards, garment wages are a critical factor in supporting the urban poor.”<sup>90</sup> Fiji Textile Clothing and Footwear president, Ramesh Solanki, has warned that job losses in the garment industry will have serious social implications because the industry provides employment for females from poor education backgrounds who will struggle to find alternative work.<sup>91</sup>

**Bangladesh:**

Between 1984 and 2002, the apparel industry in Bangladesh saw an increase in the number of manufacturing facilities from 180 to over 3,600 facilities, 90 percent of which are located in and around Dhaka, and the port of Chittagong.<sup>92</sup> The value of Bangladesh apparel exports rose from US\$131 million in 1985-1986, to US\$4,583 million in 2001-2002.<sup>93</sup> The United Nations Development Programme concluded that Bangladesh’s “economy has improved significantly during the last decade, driven primarily by the garment sector, which brought in US\$6 billion in export earnings in 2001-2002.”<sup>94</sup> The apparel

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<sup>88</sup> Storey, *supra* note 73, at 31. Oxfam International is a confederation of non-governmental organizations working together to fight global poverty and injustice by focusing on development, advocacy and relief. See [www.oxfam.org](http://www.oxfam.org).

<sup>89</sup> Storey, *supra* note 73 at 32-33.

<sup>90</sup> Gaglioti, *supra* note 74.

<sup>91</sup> Pacific Islands Development Program, *Trade Pact Called Threat to Fiji Garment Industry*, FIJI TIMES ONLINE, Feb. 7, 2006, at <http://pidp.eastwestcenter.org/pireport/2006/February/02-07-13.htm> (last visited March 26, 2006).

<sup>92</sup> Mlachila and Yang, *supra* note 33 at 7.

<sup>93</sup> *Id.*

<sup>94</sup> UNITED NATIONS DEVELOPMENT PROGRAMME, LOOMING TRADE CURBS PUT BANGLADESH JOBS AT RISK, (June 2003) at <http://www.un-bd.org/undp/feature/2003/0203/0603/index.html> (last visited Feb. 16, 2006).

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export sector was initially jump-started by Foreign Direct Investment (FDI) from foreign investors primarily from the Republic of Korea and Hong Kong SAR, who were taking advantage of Bangladesh's export quotas to restricted markets, and who established factories in the export promotion zone (EPZ).<sup>95</sup> However, subsequent government restrictions intended to reserve the most valuable quotas for Bangladeshi manufacturers, have resulted in a decline in the role of FDI in the Bangladesh apparel industry.<sup>96</sup>

By 2004, the apparel industry in Bangladesh employed approximately 1.8 million people, which represented some 40 percent of all manufacturing employment.<sup>97</sup> 90 percent of those employed in the garment industry were women, and it is estimated that the industry supports about 10-15 million people indirectly.<sup>98</sup> Though the apparel industry contributes only 5 percent to Bangladesh's GDP, it has a vital role in providing employment to a large segment of that nation's poorest and most vulnerable families.<sup>99</sup> The United Nations estimates that upward of one million garment workers in Bangladesh will lose their jobs as a direct result of the elimination of the MFA quotas.<sup>100</sup>

There was widespread concern in Bangladesh that the end of quotas would hit the Bangladesh economy hard. The Bangladesh economy relies heavily on the exports of garments and textiles. In 2002, for example, these exports accounted for over 77 percent of Bangladesh's total manufacturing exports.<sup>101</sup> Only one exporter (Macau SAR) had a higher percentage of textiles and garments as a percentage of total manufacturing exports. In addition, 94 percent of Bangladesh's textile and garment exports in 2002 were to quota-restricted markets, again amongst the highest in the world.<sup>102</sup> With such an overwhelming reliance upon exports to the U.S. and the E.U., in particular, Bangladesh was particularly vulnerable to American buyers switching to cheaper produces following the ending of quotas. As the authors of an IMF Working Paper noted in June 2004: "Bangladesh . . . is potentially vulnerable to the large shock of the final stage of the quotas phase-out . . . Bangladeshi exporters will likely find it difficult to compete in the short to medium term."<sup>103</sup> They noted that while Bangladesh's wages are low compared with most of its

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<sup>95</sup> Mlachila and Yang, *supra* note 33 at 7-8.

<sup>96</sup> *Id.* at 8. The UNDP provides slightly different figures: two million people, eighty percent of whom are women. UNITED NATIONS DEVELOPMENT PROGRAMME, *supra* note 94.

<sup>97</sup> Mlachila and Yang, *supra* note 33 at 6.

<sup>98</sup> *Id.* at 6-7.

<sup>99</sup> *Id.* at 6.

<sup>100</sup> UNITED NATIONS DEVELOPMENT PROGRAMME, *supra* note 94.

<sup>101</sup> Mlachila and Yang, *supra* note 33 at 4.

<sup>102</sup> *Id.*

<sup>103</sup> *Id.*

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competitors, it is hampered by low productivity, inadequate infrastructure requiring public or private sector investment, and fragmented governmental policies.<sup>104</sup> Despite the fact that Bangladesh labor costs are lower than China's, the associated transportation, logistical and materials result in Bangladesh being a more expensive place to manufacture garments.<sup>105</sup>

Bangladesh's position is further complicated by its lack of an adequate textile industry to supply cloth to the apparel factories. Bangladesh has a small textile industry, which is unable to fully meet the demand of the garment industry. In 2002, for example, Bangladesh imported US 1.8 billion of textiles and related items.<sup>106</sup> In addition, Bangladesh's textile industry itself relies heavily on imported cotton and other raw materials.<sup>107</sup> This reliance on imported textiles and imported raw materials for the domestic textile industry, makes Bangladesh particularly vulnerable to the uncertainty of the world market. As Chinese apparel manufacturing increasingly outstrips the available Chinese domestic textile supply, Chinese apparel producers are themselves increasingly turning to the international market, increasing competition for the available textile products and driving up prices that Bangladesh garment manufacturers have to pay for imported materials.<sup>108</sup>

**The Philippines:**

The garment industry in the Philippines reached its peak under the MFA in 1991, when it represented as much as 35% of that nation's total exports and accounted for an estimated total workforce of one million employees.<sup>109</sup> Starting in the mid-1990's, however, the local garment industry witnessed a steady decline as it faced increasing competition from developing nations such as Cambodia. Under the MFA, roughly 92% of the Philippine's garment and textile exports were to the quota-regulated markets of the U.S. and the E.U.<sup>110</sup> While the Philippine exporters were largely shielded from the most dramatic impact of direct international competition with other producing nations, it became clear in the course of the 1990's that the local industry was unable to

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<sup>104</sup> *Id.*

<sup>105</sup> George Wehrfritz and Alexandra A. Seno, *Succeeding at Sewing*, NEWSWEEK, Jan. 10, 2005, at 38. ("[L]abor for a shirt made in Bangladesh runs just \$1.52, compared with \$2.28 in China, but after factoring in materials and transportation, the total cost of the Chinese shirt is \$11.15 – almost a dollar cheaper [than that produced in Bangladesh]").

<sup>106</sup> Mlachila and Yang, *supra* note 33 at 7.

<sup>107</sup> *Id.*

<sup>108</sup> *Id.*

<sup>109</sup> Duvillier, *supra* note 29 at 1.

<sup>110</sup> *Id.* at 3.

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compete with leading Asian exporters when forced to do so. While new producers, such as Cambodia, began gaining access to the U.S. and E.U. markets, and thereby offering a production alternative to foreign buyers, the Philippines saw its slice of the export pie gradually shrink. Between 1994 and 2004, its share of the U.S. clothing market shrunk from 4.3% to 2.8%.<sup>111</sup> Though this decline of market share was somewhat off-set by a growth in U.S. demand, nevertheless it was evident that it was not the Philippines that was benefiting from any market expansion. In the course of the same decade (1994-2004), the number of formal textile and garment workers in the Philippines declined from around 900,000 to approximately 311,000.<sup>112</sup> In 2003, for example, an estimated 90 textile or apparel factories closed or retrenched, eliminating 9,443 workers.<sup>113</sup>

Countries like the Philippines, which struggled with an aging manufacturing capacity and infrastructure, inefficient economic incentives from corrupt political agencies, and high-profile industrial conflict in many of its unionized factories, saw a dramatic but predictable loss of orders immediately prior to and following January 2005.<sup>114</sup> There had been a general decline of the Philippines' textile manufacturing base since the mid-1990's, as foreign buyers began shifting their orders to more cost-effective nations elsewhere in Asia, but the end of quotas nevertheless had a noticeable impact.<sup>115</sup> As of March 2005, the value of apparel and clothing exports from the Philippines decreased by 16.6% (US\$149.23 million) compared to the same period in 2004 (US\$179.01 million).<sup>116</sup>

In 2000 and 2001, in what many believed was an indicator of things to come, the Philippine manufacturing industry was hit by a US\$198 million export loss when existing global quotas on several items (notably baby clothing and luggage products) were phased out.<sup>117</sup> The rapidity with which production shifted following the phase-out of quotas on those items, confirmed for many a growing fear that a similar shift from the Philippines would occur following the elimination of the remaining textile and garment quotas by January 2005. Some

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<sup>111</sup> *Id.* at 2 *citing* United States International Trade Commission (USITC) *US Imports of Clothing from Top 30 Exporters (1990-2004)*, available at <http://datawebusitc.gov>.

<sup>112</sup> Duvillier, *supra* note 29 at 3-4.

<sup>113</sup> Duvillier, *supra* note 29 at 4 *citing* Key Labor Statistics, Bureau of Labor and Employment Statistics (DOLE), April 2005 available at [http://www.manila\\_online.net/bles/](http://www.manila_online.net/bles/).

<sup>114</sup> Duvillier, *supra* note 29 at 1-2.

<sup>115</sup> Duvillier, *supra* note 29 at 1-2 *citing* Press Release, Philippines National Statistics Office, Merchandise Export Performance March 2005 (May 10, 2005) available at <http://www.census.gov/ph/data/pressrelease/2005/ex0503tx.html>.

<sup>116</sup> *Id.*

<sup>117</sup> *Id.* at 2.

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observers warned that half of all jobs in the textile and garment industry in the Philippines would be in jeopardy with the end of the quota system.<sup>118</sup>

While the Philippine garment industry has undoubtedly been hurt by the rise of Chinese manufacturing, some in the Philippines see China as a possible savior of Philippine manufacturing. With the traditional economic relationship between U.S. buyers and Philippine manufacturers in jeopardy, the Philippine government is looking to China to become a key future trading partner. In November 2005, the visiting member of the Central Committee of the Communist Party of China, Zhang Dejiang, was asked by Speaker Jose de Venecia to help rebuild the Philippine garment and textile industry.<sup>119</sup> In particular, de Venecia noted, the Philippines “required fresh working capital, new technology, and joint ventures, [particularly] with Guangdong industrialists.”<sup>120</sup> The initial Chinese response was positive.<sup>121</sup>

**Macao:**

Located in Eastern Asia, bordering the South China Sea and mainland China, the two islands that make up Macao have an estimated population of less than half a million people. Since its reversion to China as a special administrative region in 1999, Macao’s economy has remained one of the most open in the world.<sup>122</sup> Macao’s garment industry began following World War Two, and flourished in the 1960’s, when Hong Kong manufacturers moved facilities there to avoid quotas imposed by the UK on Hong Kong garment exports.<sup>123</sup> Macao further prospered under the MFA-regime during the 1970’s and 1980’s, as it continued to be an attractive manufacturing base for Hong

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<sup>118</sup> Emilio R. Gonzales, *Behind The Seams*, 11 PHILIPPINE BUSINESS MAGAZINE 8 (November 2004) at <http://www.philippinebusiness.com.ph/archives/magazine/vol11-2004/11-8/forecast.htm>. (last visited Feb. 26, 2006).

<sup>119</sup> *Philippines: Chinese Aid Sought for Textile, Garments Industry*, Fibre2Fashion Web Site, (Nov. 12, 2005), at [http://www.fibre2fashion.com/news/apparel-newsdetails.aspx?news\\_id=8517](http://www.fibre2fashion.com/news/apparel-newsdetails.aspx?news_id=8517) (last visited April 1, 2006).

<sup>120</sup> *Id.*

<sup>121</sup> *Id.*

<sup>122</sup> CIA, THE WORLD FACT BOOK-MACAO, at <http://www.cia.gov/cia/publications/factbook/geos/mc.html> (last visited April 1, 2006) (Colonized by the Portuguese in the 16<sup>th</sup> century, Macao was the first European settlement in the Far East. Pursuant to an agreement signed by China and Portugal on 13 April 1987, Macao became the Macau Special Administrative Region (SAR) of China on 20 Dec. 1999. China has promised that, under its “one country, two systems” formula, China’s socialist economic system will not be practiced in Macao, and that Macao will enjoy a high degree of autonomy in all matters except foreign and defense affairs for the next 50 years.)

<sup>123</sup> MACAO DEVELOPMENT STRATEGY STUDY CENTER, *supra* note 31.

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Kong producers.<sup>124</sup> By the 1980's, the textile and garment industry accounted for more than 70 percent of all Macao's exports, with over 80 percent going to the U.S. and EU.<sup>125</sup> Though Macao's economy is heavily dependent on gaming and tourism, the number of workers in the garment industry now surpasses those working in hotels and restaurants.<sup>126</sup> Macao's garment industry is characterized by "small and medium-sized enterprises, with scattered distribution and relatively [out-dated] production technology."<sup>127</sup> The average manufacturing factory in Macao has just 33 employees, with 70 percent of the 1,232 factories employing between 1-19 employees, and only 42 factories having more than 200 employees.<sup>128</sup> Since the early 1990's, higher labor costs in Macao, combined with the increasing attractiveness of doing business in mainland China, have resulted in a significant shift of Hong Kong-financed garment manufacturing from Macao to China, particularly to the area around Zhuhai and Zhongshan in Guangdong Province.<sup>129</sup> According to the Macao SAR Government, between 1995 and 1999 the number of textile factories declined by 30 percent, and the number of garment factories by 7 percent.<sup>130</sup> Between 1990 and 1999, the number of garment factories declined from 745 to 394, or 47 percent, with employees falling from 35,917 to 26,429, or 27 percent.<sup>131</sup> With the end of the MFA-regime, the shift to China is expected to become even more dramatic. The small size of the Macao factories, the low technological level, low added value and labor-intensive production, the heavy reliance on outside Hong Kong investors, and the role of Macao as almost entirely a manufacturing platform geared for exports to quota-restricted markets, makes Macao particularly vulnerable to trade liberalization and the end of the MFA regime. In response to a questionnaire from the Macao Development Strategy Study Centre, only 53 of the 99 enterprises in the textile industry employing more than 100 people indicated that they planned to stay in

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<sup>124</sup> *Id.*

<sup>125</sup> *Id.*

<sup>126</sup> Figures from Macao's Statistics and Census Service show that around 10 percent of Macao's labor force was employed in garment factories in 2005, or 24,673 out of a total workforce of 240,000. In contrast, 21,368 workers were employed in hotels and restaurants. *Garment Industry Employs 10 Pct. Of Macao's Labor Force*, PEOPLES DAILY ONLINE, June 20, 2005 at [http://english.people.com.cn/200506/20/eng20050620\\_191250.html](http://english.people.com.cn/200506/20/eng20050620_191250.html) (last visited Apr. 18, 2006).

<sup>127</sup> MACAO DEVELOPMENT STRATEGY STUDY CENTER, *supra* note 31. See Macao Data, <http://www.macaodata.com/macau/draw/e05.html> (last visited Apr. 18, 2006).

<sup>128</sup> MACAO DEVELOPMENT STRATEGY STUDY CENTER, *supra* note 31.

<sup>129</sup> *Id.*

<sup>130</sup> *Id.*

<sup>131</sup> *Id.*

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Macao.<sup>132</sup> It is anticipated that the total value of textile and garment exports from Macao will decline by 40-50 percent as a result of the end of quotas.<sup>133</sup> It is hoped that some manufacturers who shift manufacturing to China will continue to keep offices in Macao, in order to avoid the currency controls in the mainland and to conduct foreign-currency payment and market operations. Smaller-scale manufacturing enterprises in Macao are, with few exceptions, not expected to survive.<sup>134</sup>

**Mongolia:**

Mongolia, a land-locked country bordering China, is an example of a country with no history of garment production, which became the focus of Chinese garment manufacturers purely to provide access to quota-restricted markets. By 2000, over 30,000 people were employed in primarily foreign-owned factories making clothes for export to the U.S.<sup>135</sup> By late 2004, as foreign manufacturers began shifting production to China, the number had declined to around 20,000.<sup>136</sup> These workers were the breadwinners for an estimated 80-100,000 people.<sup>137</sup> By 2004, the garment and textile industry represented 29.2 percent of the country's exports.<sup>138</sup> In 2003, the total value of sewn and knitted articles had risen to US\$97 million, or over 37 million items.<sup>139</sup> 97 percent of all sewn articles and 98 percent of knitted articles were exported to the U.S.<sup>140</sup> By late 2004, however, it was clear that the predominantly Chinese companies that had set up production in Mongolia, were

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<sup>132</sup> MACAO DEVELOPMENT STRATEGY STUDY CENTER, *supra* note 31.

<sup>133</sup> *Id.*

<sup>134</sup> *Id.* See *WTC Macau Holds Seminar On The New Regime of Textile and Clothing Exports to the EU Beyond 2005*, WORLD TRADE CENTER MACAU NEWSLETTER, Issue No. 26 (Oct. 2003) at <http://www.wtc-macau.com/news/n26/n26-index.htm> (last visited Apr. 18, 2006); *Managing the Transition to a Responsible Post-MFA Global Garment Industry*, Research Briefing for the BSR Conference 2004 (Nov. 2004) at [http://www.bsr.org/BSRConferences/2004/session\\_notes/2004\\_post-mfa\\_garment\\_industry.pdf](http://www.bsr.org/BSRConferences/2004/session_notes/2004_post-mfa_garment_industry.pdf) (last visited Apr. 18, 2006).

<sup>135</sup> John Smith, *Mongolian Garment Industry: Likely Effects of Abolition of Quotas and Actions That Are Urgently Required*, MONGOLIAN ECONOMIC POLICY REFORM AND COMPETITIVENESS PROJECT (2004) at introduction, International Trade at [http://www.eprchemonics.biz/documents/tech\\_reports/nov15\\_2004\\_abolition\\_quotas\\_en.pdf](http://www.eprchemonics.biz/documents/tech_reports/nov15_2004_abolition_quotas_en.pdf) (last visited April 1, 2006).

<sup>136</sup> *Id.*

<sup>137</sup> *Id.*

<sup>138</sup> *Id.*

<sup>139</sup> *Id.* at § 1.

<sup>140</sup> Smith, *supra* note 135, at Executive Summary.



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highly unlikely to remain once the MFA quota-regime was lifted.<sup>141</sup> Indeed, many of the factories had been planned to operate only until January 2005.<sup>142</sup> Mongolia faces many significant problems in attempting to retain a competitive garment industry, not least of which is that it is landlocked, and relies upon China and Russia for access to raw materials and markets.<sup>143</sup> Internally, logistical networks are poor, the workforce unskilled, managerial expertise lacking, and governmental bureaucracy burdensome.<sup>144</sup> The Mongolian Government was aggressive in providing encouragement to foreign businesses, but failed to adequately support domestic manufacturers, resulting in an industry dominated by foreign investors with no real or long-term ties to Mongolia.<sup>145</sup> Moreover, Mongolian factories produce few items with a high unit value, relying instead on basic commodity items with less value added.<sup>146</sup> These basic items are particularly vulnerable to cheap competition from China.<sup>147</sup> A report published by the Mongolian Economic Policy Reform and Competitiveness Project, concluded that “The Mongolian Government alone will not be able to prevent wholesale closure of the Industry, but it can set the climate to encourage industry not only to stay but also to develop for the future.”<sup>148</sup> The future, however, looks desperate for the Mongolian garment industry, as its factories are closed and the manufacturing machines physically removed by their owners to facilities in neighboring China.

**Cambodia:**

As in many developing nations, Cambodia’s garment and textile industry flourished under the MFA as primarily Chinese investors saw an opportunity to access the U.S. and EU markets free from the need to obtain the more limited quotas available in their home countries. Throughout the 1990’s, foreign investment flowed into Cambodia, factories were constructed in and around Phnom Penh, and tens of thousands of young women poured from the countryside into the city to work in textile industry.<sup>149</sup> By early 2005, the

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<sup>141</sup> *Id.*

<sup>142</sup> *Id.* at Executive Summary.

<sup>143</sup> *Id.* at §2.

<sup>144</sup> *Id.*

<sup>145</sup> Smith, *supra* note 135 at §2.

<sup>146</sup> *Id.* at §1.

<sup>147</sup> *Id.*

<sup>148</sup> *Id.* at Executive Summary.

<sup>149</sup> John Hall, *Human Rights and the Garment Industry in Contemporary Cambodia*, 36 STAN. J. INT’L L. 119, 128 (Winter 2000).

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membership of the Garment Manufacturers Association in Cambodia (GMAC) included 238 companies.<sup>150</sup> Only five percent of garment factories are owned by Cambodians.<sup>151</sup> The rows of factories are clustered around Phnom Penh, from which trucks transport filled shipping containers to the port city of Sihanoukville located 230 kilometers away. The value of garment exports grew from US\$26 million in 1995, to US\$2 billion in 2004.<sup>152</sup> Garment exports constitute nearly 80 percent of Cambodia's merchandise exports.<sup>153</sup> The U.S. and the EU represent 64 percent and 29 percent respectively, of Cambodia's total garment exports in 2004.<sup>154</sup> The USAID reports that clothing manufactured for the Gap represent one-third of all Cambodian garment exports.<sup>155</sup>

The sudden dependence of Cambodia on a single industry controlled by foreigners has created particular vulnerability. The influx of garment factories occurred in what had been up until that time a largely pre-industrialized rural society suffering the lingering effects of decades of war, genocidal oppression, and societal turmoil. For the government of Hun Sen, the foreign factory owners have reportedly provided a steady source of foreign currency in the form of taxes, duties, pay-offs and bribes that has helped secure his authoritarian control over the country.<sup>156</sup> For the people of Cambodia, the value of the factory jobs is even more essential. By October 2004, an estimated 230,000 Cambodians worked in garment factories, of whom 85-90 percent were women.<sup>157</sup> With rising poverty levels in the Cambodian countryside associated with failed government policies, illegal logging, crop failure and lowered prices resulting from cheap imported foodstuffs, the salaries of the factory workers have become a vital component of the floundering rural economy.<sup>158</sup> USAID

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<sup>150</sup> USAID Report, *supra* note 56, at 3.

<sup>151</sup> *Id.*

<sup>152</sup> *Id.*

<sup>153</sup> See USAID Report, *supra* note 56, at 3; International Monetary Fund (IMF), *Cambodia; Statistical Appendix*, IMF Country Report No. 04.330, Washington DC (2004), available at <http://www.imf.org/external/pubs/ft/scr/2004/cr04330.pdf> (last visited April 1, 2006).

<sup>154</sup> USAID Report, *supra* note 56, at 4.

<sup>155</sup> *Id.*

<sup>156</sup> Factory owners have reportedly funded organizations friendly to Hun Sen's ruling CPP party, while pro-CPP groups have attempted to suppress a free trade union movement and promote unions with strong links to the government. See George McLeod, *Union riot tragedy for labor rights*, PHNOM PENH POST, Issue 12/13 (June 20-July 3, 2003) available at <http://www.phnompenhpost.com/TXT/comments/c1213-1.htm> (last visited April 1, 2006).

<sup>157</sup> Kingdom of Cambodia Ministry of Commerce, *Cambodia's Garment Industry: Meeting the Challenges of the Post-Quota Environment*, Phase 1 Report for the Asian Development Bank, (Oct. 2004) at iv.

<sup>158</sup> See Eric Kenefick, *Report On The Cambodian 1998 Joint UNICEF-WFP Baseline Survey Of*

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estimates that the remittances sent home by the young female factory workers now sustains 20 percent of the entire country's population of 13 million people.<sup>159</sup> As USAID concluded: "These workers' incomes are critical to their families, the country, and even the region."<sup>160</sup> The stakes for Cambodia's continued success in the global economy are, therefore, extraordinarily high.

Interestingly, since 1999 Cambodia has attempted to create a niche as a socially responsible manufacturing platform. There are some hopes that this niche may continue to make Cambodia attractive to buyers even if Cambodia lacks the ability to be competitive in terms of cost-efficiency with China.<sup>161</sup> By the late 1990's, labor rights activists and researchers in the U.S. came to focus on the labor abuses and poor working conditions evident in many of the new garment factories in Cambodia.<sup>162</sup> Trade representatives for the Clinton administration, headed by Ambassador C. Donald Johnson, saw an opportunity to pressure the Cambodian manufacturers and government to abide by international norms and local labor laws.<sup>163</sup> On January 20, 1999, the U.S. and Cambodian governments signed the U.S./Cambodia Bilateral Textile Trade Agreement ("U.S./Cambodia Bilateral Agreement").<sup>164</sup> This agreement was remarkable for including a labor standards provision creating incentives for the Cambodian garment industry to bring itself substantially into compliance with international labor standards and Cambodian labor law.<sup>165</sup> This was the first time that a labor standards provision had been included in a bilateral, U.S.-negotiated trade agreement.

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*CASD Project And WFP Target Areas*, 21-27 (Tulane University 1998) available at [http://www.wfp.org/operations/vam/country\\_experience/cambodia\\_vam/inex.asp](http://www.wfp.org/operations/vam/country_experience/cambodia_vam/inex.asp) (last visited April 1, 2006). Noah Davies, Acting Country Director of the U.N. World Food Program, has noted that "the poverty is getting worse right now and the situation of malnutrition of children is a crisis' with over twenty percent suffering from "acute malnutrition ... The situation is much worse than people recognize." *Malnutrition Reaching Crisis Level, WFP Says*, CAMBODIA DAILY, Nov. 25, 1998, at 7.

<sup>159</sup> USAID Report, *supra* note 56 at 1.

<sup>160</sup> *Id.*

<sup>161</sup> *Id.* at 3.

<sup>162</sup> See generally Hall, *supra* note 149.

<sup>163</sup> Timothy A. Canova, *International Law Confronts the Global Economy: Labor Rights, Human Rights, and Democracy in Distress*, 8 CHAPMAN L. R. 1, 14 (2005).

<sup>164</sup> Agreement Relating to Trade in Cotton, Wool, Man-made Fiber, Non-Cotton Vegetable Fiber and Silk Blend Textiles and Textile Products Between the Government of the United States of America and the Royal Government of Cambodia (1999).

<sup>165</sup> For the most authoritative analysis of the U.S./Cambodian Bilateral Textile Trade Agreement, see Kolben, *supra* note 21; see also Andrew Wells-Dang, *Linking Textiles to Labor Standards: Prospects for Cambodia and Vietnam*, Foreign Policy in Focus Policy Report, (June 2002) at <http://www.fpif.org/pdf/reports/PRtxt-labor.pdf> (last visited April 1, 2006).

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Under the U.S./Cambodia Bilateral Agreement, which was renewed in December 2001, the International Labor Organization (ILO) designed and implemented a system of factory monitoring intended to ensure compliance with applicable labor law and improving working conditions.<sup>166</sup> Though flawed in terms of scope, reluctance of the ILO to engage with unions, lack of responsiveness to workers' complaints, and hampered by problems in implementation, the U.S./Cambodia Bilateral Agreement has been described as representing "an important and momentous experiment in transparent monitoring."<sup>167</sup> With the accession of Cambodia into the WTO in 2005, and the phasing out of the system of quotas permitted under the MFI, the ability of the U.S. to directly link access to its market with ILO-monitored compliance with local labor laws, has ended. Nevertheless, linking trade privileges to the respect of labor rights was a creative experiment which marked a significant move forward for international labor standards.<sup>168</sup>

A June 2005 Phnom Penh workshop of garment industry, government, and labor representatives, concluded that while the end of MFA quotas undoubtedly threatened the future of the garment industry in Cambodia, the situation was not as desperate as some had predicted one year previously.<sup>169</sup> It was noted that Cambodia had – at least temporarily – been able to hold its own in the first half of 2005.<sup>170</sup> By May 2005, for example, it was reported that sixteen large garment factories had been scheduled to begin production by the end of 2005, more than replacing the production capacity of the dozen factories that have failed.<sup>171</sup>

One explanation for Cambodia's apparent success in the post-quota world, is its ability to offer to buyers a guarantee of compliance with basic labor rights.<sup>172</sup> To certain western buyers, who have been stung by allegations of

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<sup>166</sup> Kolben, *supra* note 21, at 106-107.

<sup>167</sup> *Id.* at 107.

<sup>168</sup> WORLD BANK, *CAMBODIA: SEIZING THE GLOBAL OPPORTUNITY – INVESTMENT CLIMATE ASSESSMENT AND REFORM STRATEGY FOR CAMBODIA*, REPORT NO. 27925-KH (2004).

<sup>169</sup> Associates for International Resources and Development (AIRD), *Phnom Penh Workshop Highlights Strategies to Increase Labor Products in Cambodia* (June 2005), at <http://www.aird.com/news.php?id=14> (last visited April 1, 2006).

<sup>170</sup> AIRD, *supra* note 169. David Van, *Textiles and Clothing Case Study – Cambodia*, Asia Pacific Regional Initiative on Trade, Economic Governance, and Human Development, United Nations Development Program (2003).

<sup>171</sup> Elizabeth Becker, *Low Cost and Sweatshop-Free*, N.Y. TIMES, May 12, 2005 at C1. But see Eric Wasson, *Cambodian Jean Exports to US Drop After Quotas Lifted*, THE CAMBODIA DAILY, March 23, 2005 at 14.

<sup>172</sup> For a discussion of Cambodian labor law, see Hall, *supra* note 149, at 134-136 (freedom of association, the right to organize, and collective bargaining, guaranteed by Articles 36, 41 and 42 of the Cambodian Constitution; Articles 20(1) and 23(4) of the Universal Declaration of Human

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sweatshop abuses within their supply chain, this is a valuable guarantee. Brad Figel, Director of Government Affairs at Nike, for example, has indicated that Nike and other companies are willing to pay a premium for labor compliance.<sup>173</sup> Nike . . . lost confidence in Cambodia's compliance in 2000 and began the process of pulling out of the country. . . but re-entered Cambodia in 2002 after the ILO began the labor monitoring program and government and contractors promised greater labor compliance.<sup>174</sup>

The Cambodian government has decided to continue with the policy of ILO factory monitoring. Undoubtedly, it concluded that for Cambodia to keep its reputation for good labor standards, "it needs to continue letting the ILO issue independent reports on factory working conditions."<sup>175</sup> Cham Prasith, the Cambodian Minister of Commerce who reached the deal with Washington in 1999, has indicated that the benefits of the labor enforcement program have exceeded expectations: "We are extending our labor standards beyond the end of the quotas because we know that is why we continue to have buyers. . . If we didn't respect the unions and labor standards, we would be killing the goose that lays the golden eggs."<sup>176</sup> Dan Henkle, a vice president for GAP, which is by far the biggest buyer of Cambodian garments, has indicated that indeed the promise of labor law compliance is key to GAP's decision to remain in Cambodia.<sup>177</sup> During an economic and trade meeting under World Bank auspices in Phnom

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Rights; Article 8(1)(a) of the ICESCR; Chapter XI of the 1997 Labor Code; Article 7 of the ILO Convention 87); 150-152 (dispute resolution, mediation and arbitration, protected by the 1997 Labor Code Ch. XII); 152-153 (pre-employment fees, covered by Article 7(1) of ILO Convention 181, and ILO Convention 29, ratified by Cambodia on 24 Feb. 1969; and Article 44 of the 1997 Labor Code); 154-158 (factory conditions, guaranteed by Article 7 of the ICESCR, Chapter VIII of the 1997 Labor Code); 158-159 (equality of treatment, guaranteed by Article 2 of the Universal Declaration of human Rights, Article 3 of the ICESCR, and Articles 45 and 46 of the Cambodian Constitution); 159-162 (hours worked, guaranteed by Article 7(d) of the ICESCR, Article 1 of the ILO Convention 29, Articles 137, 147, 161, 165 of the 1997 Labor Code); 162-166 (wage issues, guaranteed by Article 23(3) of the Universal Declaration of Human Rights; Article 7(a)(ii) of the ICESCR, Articles 104, 107(2) and 117 of the 1997 Labor Code).

<sup>173</sup> JENNIFER MAUL, CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE, PROMOTING CAMBODIA'S COMPETITIVENESS IN A POST-MFA WORLD (Jul. 21, 2005) at <http://www.carnegieendowment.org/events/index.cfm?fa=eventDetail&id=810&&prog=z> (last visited April 1, 2006).

<sup>174</sup> MAUL, *supra* note 173; CAMBODIAN LABOR ORGANIZATION, WORKING CONDITION 2003 REPORT FOR IMPROVEMENT OF GARMENT, TEXTILES AND FOOTWEAR INDUSTRY (2004).

<sup>175</sup> Daniel Ten Kate, *New World Order; Can Cambodia's Garment Industry Survive?* THE CAMBODIA DAILY, Sept. 6, 2003 available at [http://www.camnet.com.kh/cambodia.daily/selected\\_features/new\\_world\\_order.htm](http://www.camnet.com.kh/cambodia.daily/selected_features/new_world_order.htm) (last visited April 1, 2006).

<sup>176</sup> Becker, *supra* note 171.

<sup>177</sup> *Id.*

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Penh in February 2005, he assured Cambodian officials that GAP would remain, but only so long as Cambodia continued to follow its special labor program.<sup>178</sup>

The Cambodian Government's "respect" for trade unions is somewhat less perfect than Mr. Cham's comments would suggest, and several leading union officials not affiliated with Hun Sen's ruling CPP party have been murdered in recent years.<sup>179</sup> Nevertheless, there appears to have been a genuine improvement in factory conditions as a result of the program of ILO monitoring. Ros Harvey, the ILO's Chief Technical Advisor in Cambodia, has noted that while factory conditions in Cambodia are still not perfect, there has been a tremendous amount of improvement.<sup>180</sup> Nevertheless, labor standards alone will not save the garment industry in Cambodia. USAID has concluded that serious internal problems still hamper the Cambodian garment industry, including a combination of significant governmental corruption, complex business regulations, and difficult import-export procedures.<sup>181</sup> Harvey of the ILO has warned that the country must strengthen its rule of law, reduce corruption, and improve trade facilitation for the apparel industry to remain competitive.<sup>182</sup> It would appear that there has been some improvement in this regard. With the apparel industry now accounting for ninety-percent of Cambodia's export earnings, and with the factory owners able to shift production to China or elsewhere with comparative ease, the factory owners are reported to have begun wielding their considerable political power to encourage the government to tackle the corruption which has been driving up production costs.<sup>183</sup> In response, the Government has begun to reduce levels of bureaucratic rules which had required widespread "palm greasing" by business owners. One estimate is that this has reduced production costs of each dozen t-shirts from \$2 to \$1.10.<sup>184</sup>

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<sup>178</sup> Becker, *supra* note 171. *See also* Gap, Inc., *Social Responsibility Report* (2003), at [http://www.gapinc.com/public/documents/CSR\\_Report\\_03.pdf](http://www.gapinc.com/public/documents/CSR_Report_03.pdf). (last visited April 1, 2006)

<sup>179</sup> Chea Vichea, president of a garment workers' union was shot to death in January 2004. Four months later one of his top assistants was killed. Becker, *supra* note 171. *See also* George McLeod, *supra* note 156 (discussing the violent suppression of a strike at Terratex when two workers were killed on 13 June, 2003; the beating of pro-union demonstrators outside Trinunggal Komsara factory in March 2003; and the activities of so-called "Brown Shirts" – gangs like the pro-CPP Pagoda Boys, hired by factory owners to assault and intimidate independent union officials.)

<sup>180</sup> Maul, *supra* note 173.

<sup>181</sup> USAID Report, *supra* note 56.

<sup>182</sup> Maul, *supra* note 173.

<sup>183</sup> Becker, *supra* note 171.

<sup>184</sup> *Id.*

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Most observers recognize that lowered production costs alone will not secure Cambodia's future success. Sok Siphana, secretary of state at the Ministry of Commerce and Cambodia's lead WTO negotiator, has summarized the position Cambodia is adopting: "Companies will always go to China for their profit. Yet profit alone is not always the basis for business. Image-conscious multinationals will continue using Cambodia because of our high labor standards."<sup>185</sup> Cambodia is banking on the idea that Western buyers will be willing to pay higher prices for garments produced in factories with better labor standards. The President of the Garment Manufacturers' Association of Cambodia, Van Sou Ieng, has complained that some western companies have shown reluctance to follow their vocal support for Cambodia's position with actual orders:

Instead of encouraging us with words, buyers should do it with actions. In countries that don't care about child labor, environmental protection or social justice, of course their prices will be cheaper. We believe the trend must change – if not, it will be a sad story for some factories.<sup>186</sup>

**India:**

Along with China, India is hoping to be a big winner as a result of the end of the quota system. Some early estimates were that India's share of the U.S. market would quadruple, from 4 percent to 15 percent, and that its share of the EU garments sector would increase 50 percent, from 6 percent to 9 percent.<sup>187</sup> The WTO has estimated that India's share of the global trade in textiles will increase from 3 percent in 2004 to 15 percent by 2010.<sup>188</sup> There were optimistic projections of a 50 percent increase in exports in just the first quarter of 2005.<sup>189</sup> Sears and Marks & Spencer have set up operations in India,

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<sup>185</sup> Kate, *supra* note 175.

<sup>186</sup> *Id.*

<sup>187</sup> PHD Chamber of Commerce and Industry, *End of Multi-Fibre Agreement to Make Indian Textile and Garment Industry Grab 8% of World Market by 2010*, (Oct. 16, 2004) at <http://www.phdccimail.com/pressrel.phd?sid=77> (last visited April 20, 2006)(Founded in 1905 as the Punjab Chamber of Commerce, the PHD Chamber of Commerce currently has a wide-ranging membership of more than 1500 corporate entities and hundreds of trade organizations spread throughout Northern Region India.)

<sup>188</sup> Geeta Pandey, *India awaits Textiles Boom*, BBC NEWS, December 22, 2004 available at [http://news.bbc.co.uk/1/hi/world/south\\_asia/4105973.stm](http://news.bbc.co.uk/1/hi/world/south_asia/4105973.stm) (last visited April 1, 2006).

<sup>189</sup> Basu, *supra* note 3.

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and the Gap is expected to expand its sourcing from India.<sup>190</sup> Observers expect Indian exports to jump from US\$14 billion in 2004, to between US\$40-80 billion by 2010.<sup>191</sup> India's economy has been expanding at a rapid pace, driven by its success as a manufacturer for the global market and protected from currency contagion by capital and currency control. Total trade grew by more than 20% over the last two years and at an annual rate of 25.6% during the first ten months of the fiscal year ending April 2005.<sup>192</sup> In comparison, U.S. trade grew at less than half that rate.<sup>193</sup> By 2004, the textile industry in India employed 35 million people and accounted for nearly one-quarter of India's exports.<sup>194</sup>

By the end of 2005, however, it was becoming clearer that, as the Wall Street Journal noted, "the anticipated boom has been more of a muted bang" for India.<sup>195</sup> The end of quotas was seen as a "once-in-a-lifetime" opportunity for Indian manufacturing, but it appears that local companies have failed to fully exploit the situation.<sup>196</sup> In the first quarter of 2005, for example, Indian exports to the EU actually grew by just 5 percent to US\$2 billion, rather than the 50 percent projected.<sup>197</sup> In contrast, Chinese exports to the EU jumped 59 percent to US\$7.5 billion during the same period.<sup>198</sup>

India's textile industry has several natural advantages. India is the third largest producer of cotton in the world.<sup>199</sup> It has a cheap skilled workforce and a huge domestic market.<sup>200</sup> Nevertheless, the MFA quota-regime is believed by some to have fostered and protected production inefficiencies in India. Rahul Mehta, managing director of Creative Outwear Ltd, one of India's biggest garment producers, has noted that: "Quotas afforded the comfort of assured business to manufacturers and to those who held a quota, and this imparted a sense of stability. . . Even inefficient manufacturers got quotas, which assured them business, and flab crept in."<sup>201</sup> In 2004, 75 percent of

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<sup>190</sup> *Id.*

<sup>191</sup> *Id.*

<sup>192</sup> Tyler Marshall, *The Price of Asia's Growth*, L.A. TIMES, Nov. 6, 2005, at A1.

<sup>193</sup> *Id.* at A18.

<sup>194</sup> Pandey, *supra* note 188.

<sup>195</sup> Cris Prystay, *India Plays Catch-Up in Textile; Labor Rules Hinder Country From Benefiting From End of Quotas*, WALL ST. J., Dec. 1, 2005, at A15.

<sup>196</sup> *Id.*

<sup>197</sup> *Id.*

<sup>198</sup> *Id.*

<sup>199</sup> Shuba Madhukar, *Indian Garments in a Brave New World*, (December 29, 2004) available at [http://www.domain-b.com/industry/textiles/20041229\\_new\\_world.html](http://www.domain-b.com/industry/textiles/20041229_new_world.html) (last visited April 1, 2006).

<sup>200</sup> *Id.*

<sup>201</sup> *Id.*



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India's apparel exports were to quota countries.<sup>202</sup>

Until recently, Indian law required that garment manufacturing should be primarily a small-scale activity.<sup>203</sup> In 2004, over 80 percent of India's apparel manufacturers operated with less than 20 machines.<sup>204</sup> The quotas were distributed by the Indian Government on the basis of "past performance entitlement" (PPE), which did not encourage manufacturers to expand facilities or invest in modern equipment.<sup>205</sup> The result was that the Indian apparel industry remained dominated by small-scale producers, with little to encourage the efficiencies of scale, industrial consolidation, equipment modernization, and infrastructure investment which has transformed the apparel industry in China.

In response to the anticipated ending of the MFA quota-system, the Indian Government began reversing some of its earlier policies in order to facilitate Indian competitiveness in the newly competitive global apparel trade. For example, the machinery import duty has been reduced to a nominal 5 percent; excise duties have been significantly reduced; and a "textile upgradation" fund has been established to encourage loans to support manufacturing modernization.<sup>206</sup> Most significantly, however, four years ago the government removed garments from the list of industries reserved for small-scale manufacturers, ending a four decades-old government approach to the garment industry as primarily a vehicle for providing stable employment for India's poor.<sup>207</sup> For decades, Indian garment companies were kept small by laws passed shortly after Indian independence; large companies were required to break up into small units, and while this encouraged geographically widespread employment throughout the country, it destroyed economies of scale and hampered India's international competitiveness.<sup>208</sup> Though this was less a problem under the quota regime, industry and government observers recognized that it would be impossible to maintain such a system in a more competitive post-quota global environment. Further, to encourage foreign investment in India's garment industry and help generate the capital necessary for facility modernization, the Indian Government has changed the law to permit textile factories entirely owned and operated by foreigners with 100 percent Foreign Direct Investment (FDI).<sup>209</sup> The shift from small-scale manufacturing to large-

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<sup>202</sup> *Id.*

<sup>203</sup> *Id.*

<sup>204</sup> Madhukar, *supra* note 199.

<sup>205</sup> *Id.*

<sup>206</sup> *Id.*

<sup>207</sup> Prystay, *supra* note 195.

<sup>208</sup> *Id.*

<sup>209</sup> Shankar, *Post-MFA Regime: Textile Restructuring and the Impending Turbulence*, LIBERATION,

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scale producers is far from complete, and most of India's garment manufacturers still remain small by international standards. By December 2005, fewer than 10 manufacturers had yearly revenue above US\$100 million, and only one of US\$200 million.<sup>210</sup>

It appears that a degree of expansion and modernization of capacity began in several of India's key manufacturing centers in the months prior to the ending of quotas, as some suppliers anticipated the requirements of the post-quota world. For example, in Tirupur – the self-styled “Manchester of India” – manufacturers invested heavily in state-of-the-art machinery from Taiwan, Germany, Japan, Italy, the UK and the U.S., as well as in processing and production facilities.<sup>211</sup> In addition, a number of the apparel manufacturers in Tirupur have established vertically integrated manufacturing facilities. The Royal Classic Group, for example, which has been operating in Tirupur since 1991, has established contract farms for growing the cotton it will use in its apparel factories, and anticipates expanding cotton production from 2,000 to 8,000 acres.<sup>212</sup> Additionally, Royal Classic has established its own spinning plant.<sup>213</sup> The Tirupur Exporters Association opened the Netaji Apparel Park, India's first dedicated apparel park, spread over 180 acres off highway 47, where it was hoped that over 50 companies would build facilities.<sup>214</sup> In Bangalore, big textile companies like the Ahmedabad-based Arvind Mills and the Mumbai-based Raymond, have set up new factories to make and export clothing.<sup>215</sup>

Nevertheless, Indian manufacturers were on the whole extremely cautious to add capacity in anticipation of the end of quotas, and were therefore

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Jan. 2005, available at [http://www.cpiml.org/liberation/year\\_2005/january/mfa\\_regime.htm](http://www.cpiml.org/liberation/year_2005/january/mfa_regime.htm) (last visited April 1, 2006).

<sup>210</sup> Prystay, *supra* note 195.

<sup>211</sup> V. Sridhar, *Towards New Frontiers*, FRONTLINE, Nov. 6-19, 2004, available at <http://www.hinduonnet.com/fline/fl2123/stories/20041119003710500.htm> (last visited April 1, 2006). (The recent reliance on more expensive but more efficient and versatile foreign machinery has been a severe blow to domestic Indian manufacturers of apparel machinery. Though Indian machines cost only a fraction of the foreign brands, the imported machines offer productivity levels that are six or seven times greater than the Indian machines. In addition, the foreign machines permit more complicated designs, including computerized jacquards. It is estimated that Indian apparel producers have imported close to 10,000 machines in the past decade. Some observers have stated that Indian machine producers from Ludhiana, which used to dominate the Indian market, are now “finished.”)

<sup>212</sup> *Id.*

<sup>213</sup> *Id.*

<sup>214</sup> T. Surendar, *Textiles: The Big Factories Are Coming*, BUSINESSWORLD, Nov. 15, 2004, available at <http://www.businessworldindia.com/nov1504/index.asp> (last visited April 1, 2006).

<sup>215</sup> *Id.*

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not in a position to take full advantage of the ending of the MFA quota-regime in early 2005. Manufacturers point to restrictive labor laws to explain their initially overly-cautious reluctance to add capacity.<sup>216</sup> In particular, they complain, they are forbidden under Indian labor law from hiring contract labor, and once employees are hired it is “almost impossible to fire” them.<sup>217</sup> Additionally, laws designed to guarantee stable employment to India’s workers, make the closure of unwanted factories extraordinarily difficult.<sup>218</sup> Many manufacturers, like Chennai-based Harbinger Singh, managing director of Roverco Apparel Ltd., delayed expanding his facilities and hiring more workers, out of concern that if he added capacity and the quota-system was extended or the anticipated boom did not materialize, he would have been left with unwanted factories he could not close and workers he could not fire.<sup>219</sup> When the MFA quota system did indeed expire, and the increase in orders materialized, Singh and others scrambled to “play catch-up” and add capacity. Singh, for example, built two new factories, which opened in June 2005.<sup>220</sup> Arvind Singhar, a textile industry consultant for KSA Technopak, a New Delhi textile-consulting firm, has estimated that Indian companies will invest upwards of US\$5 billion in capacity in 2006-2007.<sup>221</sup> In the meantime, EU and U.S. buyers have been told to wait months to place and receive their orders.<sup>222</sup> Undoubtedly, many simply turned to China. As Indian manufacturers gradually ramped-up production by mid to late 2005, exports to the U.S. and EU improved markedly. In the first seven months of 2005, Indian exports to those markets increased 29 percent compared to the same period in 2004, to US\$4.9 billion.<sup>223</sup> Nevertheless, there is a sense that India, unlike China, missed a golden opportunity because of its failure to position itself properly to take full advantage of the end of quotas.

Aside from inflexible labor laws and a conservative and cautious investment profile amongst its manufacturers, several other hurdles remain for India to become and remain competitive with China. The size of India’s new factories, though much larger than the traditional facilities, are still much smaller than those in China.<sup>224</sup> Even the biggest companies like Raymond and

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<sup>216</sup> Prystay, *supra* note 195.

<sup>217</sup> *Id.*

<sup>218</sup> Prystay, *supra* note 195. See also George Iype, *Boom Time For Indian Textiles*, at <http://in.rediff.com/money/2005/feb/10spec.htm> (last visited Feb. 10, 2006).

<sup>219</sup> Prystay, *supra* note 195.

<sup>220</sup> *Id.*

<sup>221</sup> *Id.*

<sup>222</sup> *Id.*

<sup>223</sup> Prystay, *supra* note 195.

<sup>224</sup> Surendar, *supra* note 214.

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Arvind Mills, for example, are building factories that are just a tenth the size of the newest facilities in China.<sup>225</sup> Gokuldas Images, India's largest exporter, has 1,000 sewing machines in its largest factory.<sup>226</sup> In comparison, medium-sized factories in China have 2,000 machines, with large factories having 10,000 machines in one location.<sup>227</sup> Productivity is lower in India than in China, whose labor productivity in the garment industry leads the industry.<sup>228</sup>

Indian infrastructure, in sharp contrast with China, is inefficient, poorly maintained, and frequently inadequate. As one observer has noted:

Overseas buyers and domestic suppliers all have their own horror tales of delayed shipments due to the deplorable congestion at Indian ports, the sordid conditions of roads from the manufacturing centres to the shipment points leading to consignments stranded in broken-down vehicles, traffic choke-ups at the numerous collection centres.<sup>229</sup>

India lacks a deep-water port, meaning that the largest container ships are unable to dock directly.<sup>230</sup> Instead, "feeder vessels" carry Indian products to be transferred to a "mother ship" in some other port.<sup>231</sup> Loading ships in Indian ports can take from eight days to several weeks.<sup>232</sup> Moreover, goods are required to be at Indian ports seven days prior to shipment.<sup>233</sup> As Kaushik Basu has noted, "In most East Asian ports the cut-off is [only] one day."<sup>234</sup> Indian ports are small and hampered by bureaucratic and logistical delays. Typically, for a product to travel from factory in India to retail outlet in New York takes around 30 days.<sup>235</sup> Most East Asian countries take half that time.<sup>236</sup> In

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<sup>225</sup> *Id.*

<sup>226</sup> *Id.*

<sup>227</sup> *Id.*

<sup>228</sup> It has been estimated, for example, that it takes 22.2 minutes to produce a cotton shirt in India, compared with just 12.5 minutes to produce the identical shirt in China. Edward Luce and Richard McGregor, *A Share of the Spoils: Beijing and New Delhi Get Mutual Benefits From Growing Trade*, FIN. TIMES, Feb. 24, 2005, at 17.

<sup>229</sup> Prystay, *supra* note 195; *Indian Garments in a Brave New World*, domain-b.com (The Information Company) Dec. 24, 2005, [http://www.domainb.com/industry/textiles/20041229\\_new\\_world.html](http://www.domainb.com/industry/textiles/20041229_new_world.html) (last visited Mar. 23, 2006).

<sup>230</sup> Basu, *supra* note 3.

<sup>231</sup> *Id.*

<sup>232</sup> Madhukar, *supra* note 199.

<sup>233</sup> Basu, *supra* note 3.

<sup>234</sup> *Id.*

<sup>235</sup> *Id.*

<sup>236</sup> *Id.*

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December 2004, Ratna Rao, a Delhi-based buying agent for the garment industry in the U.S. and the EU, expressed frustration with the failure of the Indian Government to anticipated necessary logistical improvements:

The government hasn't done any clear planning. Have we increased our facilities to take extra cargo? . . . Currently, there's always a backlog. We need to up-grade port facilities, we need to up-grade our airports. This entire logistics position has not been looked into. China has had the foresight to look at these issues, but not India.<sup>237</sup>

Nevertheless, India has several advantages that may help it to remain competitive. First, as a major producer of cotton, it can offer reduced shipment costs to buyers; second, Indian exporters are finally expanding and up-grading their manufacturing capacities in order to avail itself of economies of scale; third, India offers plentiful and cheap labor; and fourth, India offers a stable second source of supply to those foreign buyers who are concerned about over-relying on China (so-called "geographical derisking" or diversification).<sup>238</sup> India, it has been noted, offers the advantage of a stable democratic government and a highly developed fashion industry.<sup>239</sup> Moreover, the agreements between China and the EU and the U.S. at the end of 2005 to cap export growth may buy Indian companies time to build capacity. Indeed, the new caps on Chinese exports are, to some observers, "a godsend for India."<sup>240</sup>

Indian labor activists remain profoundly concerned about the consequences of the changing face of the Indian apparel and textile industries, and in particular the decline of small-scale producers.<sup>241</sup> There is a belief that employer demands for increased global competitiveness will be used as an excuse to drive down wages, undermine job security, and repeal laws

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<sup>237</sup> Pandey, *supra* note 188.

<sup>238</sup> In 2002, foreign buyers shifted orders from China to India as a result of the slow-down of production in China as a result of the SARS epidemic. The SARS epidemic highlighted for buyers the value of "de-risking" their sourcing strategy. Surendar, *supra* note 214. "The SARS outbreak in China in 2004 affected the apparel industry severely, sending buyers to build linkages with India and nations less affected by the outbreak." Madhukar, *supra* note 199.

<sup>239</sup> Madhukar, *supra* note 199.

<sup>240</sup> Prystay, *supra* note 195 (quoting Jal Irani, a textile analyst at Macquarie Securities in Mumbai).

<sup>241</sup> For a discussion of the potential negative impacts of global economic integration on the Indian garment industry, see Jayati Ghosh, *Waiting for the Boom*, *Frontline*, Jan. 29-Feb. 11, 2005, available at <http://www.hinduonnet.com/fline/fl2203/stories/20050211002309500.htm> (last visited April 1, 2006); Sujana Krishnamoorthy et al., *Structure of the Garments Industry and Labor Rights in India: The Post MFA Context*, Study for the Centre for Education and Communication in New Delhi (2004).

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guaranteeing worker and union rights.<sup>242</sup> There have been demands by employers, for example, that work stoppages and strikes be banned and that 12-hour workdays without overtime should be permitted.<sup>243</sup> The CPIML, an Indian trade union, has warned that:

The future of independent fabricators is at the mercy of the people who control the assembly line production . . . A new breed of monopoly traders come to control the entire industry with their large capital and the rest of us are at their mercy. This new breed cares for nothing but super profits. There are also demands to keep the role of state intervention at its minimum so that the market that is under the complete command of the monopoly capital can call the shots.<sup>244</sup>

**China:**

Ira Kalish has noted that “China casts a giant shadow.”<sup>245</sup> It is very much the 800-pound gorilla of the global trade in textiles and garments. In 1990, China accounted for 9% of global apparel exports; by 2002, this share had risen to 20.6%.<sup>246</sup> Similarly, in 1990, China accounted for 6.9% of the global exports in textiles; but by 2002 its share had increased to 13.5%.<sup>247</sup> No other country accounted for more than 5% of the global trade in 2002.<sup>248</sup> In contrast to the rise of China, between 1990 and 2002, the global share of textile and

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<sup>242</sup> Shankar, *supra* note 209.

<sup>243</sup> *Id.*

<sup>244</sup> *Id.*

<sup>245</sup> Kalish, *supra* note 20, at 2. Since beginning the reforms started in the late 1970's, which have included the restructuring of the economy and resulting efficiency gains, China has averaged 9.4 percent annual GDP growth. In 1978, China accounted for less than one percent of the world economy, and its foreign trade amounted to US\$20.6 billion. By 2005, China accounted for four percent of the world economy, with foreign trade worth US\$851 billion, the third-largest national total. Zheng Bijian, *China's "Peaceful Rise" to Great-Power Status*, Foreign Affairs (Sept./Oct. 2005) at <http://foreignaffairs.org.20050901faessay84502/zheng-bijian/china-s-peaceful-rise-to-great-power-status.html>. (last visited April 26, 2006) China's industrial growth rate was estimated at 27.7 percent in 2005. Measured on a purchasing power parity (PPP) basis, China in 2005 was the second-largest economy in the world after the U.S. CIA, THE WORLD FACT BOOK, CHINA at <http://www.odci.gov/cia/publications/factbook/geos/ch.html> (last visited April 25, 2006).

<sup>246</sup> *Id.* at 1.

<sup>247</sup> Kalish, *supra* note 20, at 1.

<sup>248</sup> *Id.*

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apparel exports from the EU had declined by more than 10%.<sup>249</sup>

This increase of China's role in the global trade of textiles and garments has come as the result of massive investment in modern manufacturing capacity which has resulted in very high labor productivity. Combined with relatively low labor costs, the high Chinese productivity has resulted in low unit labor costs.<sup>250</sup> In the space of fifteen years, China has achieved extraordinary efficiency as a result of a campaign of capital investment in capacity, the creation of a highly efficient transportation and utility infrastructure, economies of scale, and favorable government regulations including avoiding currency contagion with capital currency controls.<sup>251</sup> Even under the more restrictive quota regime, China had become the biggest apparel and textile exporter in the world.<sup>252</sup>

The Chinese Government has opened large areas near the coast for industrial development, forming giant industrial parks, offering tax benefits, and building infrastructure and transportation networks.<sup>253</sup> The degree of vertical integration (fibre-to-yarn-to-fabric-to-garment manufacturing in easy geographic proximity) and economic specialization of these "lump economy" cities is remarkable. Entire cities have been constructed on land which was, until recently, rice fields whose factories produce nothing except one specific type of clothing for export.<sup>254</sup> The city of Datang, in the Yangtze River Delta of coastal China, for example, had been a small town of barely 1,000 people in the late 1970's.<sup>255</sup> Today, it is known to buyers around the world as "Sock City," whose factories produce an astonishing nine billion pairs of socks a year.<sup>256</sup> Over 100,000 buyers from around the world place sock orders in Datang annually.<sup>257</sup> The Yangtze River Delta has several giant specialty cities, such

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<sup>249</sup> *Id.*

<sup>250</sup> *Id.*

<sup>251</sup> *Id.*

<sup>252</sup> Kalish, *supra* note 20, at 2. Despite China's rapid expansion of productivity and manufacturing capacity during the 1990's, its exports were limited by the system of quotas. China's share of the U.S. apparel market, for example, remained steady, with its share increasing only from 15% of U.S. apparel imports in 1995, to 16% in 2002. China's share of E.U. apparel imports rose somewhat more rapidly, from 14% in 1995 to 20% in 2002. The growth in China's share of the global trade occurred in exports to other important markets. From 1995-2002, for example, China's share of Japan's apparel imports rose from 59.1% to 77.5%, in part as Japanese retailers showed willingness to purchase apparel from China. Kalish, *supra* note 20 at 2-3.

<sup>253</sup> David Barboza, *In Roaring China, Sweaters are West of Socks City*, N.Y. TIMES, Dec. 24, 2004, at A1.

<sup>254</sup> *Id.*

<sup>255</sup> *Id.*

<sup>256</sup> *Id.*

<sup>257</sup> *Id.*

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“International Necktie City,” “Sweater City,” “Knit Clothing City,” and “Underwear City,” whose factories can accommodate even the largest of orders.<sup>258</sup> Quite simply, with such vast economies of scale, and with billions of dollars invested in new facilities, modern manufacturing equipment, infrastructure, transportation, port facilities, and supporting industries, China has become the world’s “garment behemoth.”<sup>259</sup>

China has benefited from a vast untapped labor force and low wages – “averaging from 15 to 86 cents an hour in the garment industry, by various estimates.”<sup>260</sup> Chinese manufacturers have also undoubtedly benefited from the governmental suppression of independent trade unions and the system of internal passports that deprives migrant workers, who form the majority of the export-manufacturing labor force, of many basic rights.<sup>261</sup> An AFL-CIO trade petition, prepared by Mark Barenberg of Columbia University Law School, argues that “repression of workers’ rights lowers Chinese wages by 47 to 86 percent.”<sup>262</sup> The China Business Review has noted that

[i]n practice. . .the rights of Chinese workers are routinely violated. Workers are often required to work far more than 40 hours a week, have few days off, are paid below the minimum wage, and are not paid required overtime. Improper deductions from wages are common . . . Physical abuse of workers, and dangerous working conditions, are also common.<sup>263</sup>

China’s regime suppresses any attempt at collective bargaining by free trade unions, while subjecting migrant workers to a system in which they have no bargaining power as individuals. It has been estimated that if labor rights

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<sup>258</sup> Barboza, *supra* note 253.

<sup>259</sup> *Id.*

<sup>260</sup> David Moberg, *Trading Down*, THE NATION, Jan. 10, 2005, available at <http://www.thenation.com/doc/20050110/moberg> (last visited April 1, 2006). The current labor force in China is estimated to be 791 million, with approximately half employed in agriculture and the rest largely divided between the industrial and service sectors. The CIA has estimated that from 100 to 150 million surplus rural workers are adrift between the villages and the cities, many subsisting through part-time, low-paying jobs. CIA, THE WORLD FACT BOOK, CHINA at <http://www.odci.gov/cia/publications/factbook/geos/ch.html> (last visited April 26, 2006). China’s population, currently believed to be 1.3 billion, is anticipated to rise to 1.5 billion by 2030. Bijian, *supra* note 245.

<sup>261</sup> *Id.*

<sup>262</sup> *Id.*

<sup>263</sup> Robert J. Rosoff, *Beyond Codes of Conduct: Addressing Labor Rights Problems in China*, 44 CHINA BUSINESS REVIEW, (March 2004).



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were enforced in China, manufacturing costs would rise between ten and seventy-seven percent.<sup>264</sup> In contrast, the official position of the Chinese Government has been to stress the positive economic benefits of the rise of Chinese manufacturing. Zhang Dejiang, a member of the Central Committee of the Communist Party of China, for example, has noted that in the province of Guangdong alone, 400 million Chinese have been raised to middle-class status in the last two decades, ushering in the biggest social and economic transformation in modern times.<sup>265</sup>

China offers manufacturers the significant advantage of being able to offer all stages of production (harvesting raw materials, weaving, textile manufacture, dyeing, processing, cutting, sewing and knitting, packaging, and distribution), combined with staggering economies of scale, high productivity and low unit cost.<sup>266</sup> Given the all too obvious competitive advantage held by China over most other producing nations, it is not surprising that prior to January 1, 2005, many textile and garment companies were actively building new production capacity in anticipation of the post MFA quota era. In 2003, for example, foreign direct investment in China's textile and garment industry was US\$4.4 billion.<sup>267</sup> Taiwanese investment in China's garment and textile sector rose 261% from 2000 to 2002.<sup>268</sup> It is generally expected that the freer trade system promised with the elimination of the MFA quotas and the integration of textiles and garments into the regular GATT system, will facilitate a substantial increase in the importance of China.<sup>269</sup>

Niall Ferguson, the Laurence A. Tisch professor of history at Harvard University, has urged Western nations to "wake up and smell the green tea." "China has," he suggests, "the most dynamic economy in the world and quite possibly in all history."<sup>270</sup> European Union finance leaders, Ferguson suggests, complacently assume that the E.U.'s economic strength relative to China is not in question.<sup>271</sup> In fact, he argues, Europe is threatened with becoming the "sick man" of the developed world, whose world influence is further hindered by a weak military capacity and a lack of significant energy reserves.<sup>272</sup>

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<sup>264</sup> Jonathan P. Hiatt and Deborah Greenfield, *The Importance of Core Labor Rights in World Development*, 26 MICH. J. INT'L L. 39, 50 (2004).

<sup>265</sup> Fibre2Fashion Web site, *supra* note 119.

<sup>266</sup> Kalish, *supra* note 20, at 4.

<sup>267</sup> *Id.*

<sup>268</sup> *Id.*

<sup>269</sup> *Id.*

<sup>270</sup> Niall Ferguson, *Wake Up and Smell the Green Tea*, L.A. TIMES, Oct. 17, 2005 at B11, available at <http://www.telegraph.co.uk/> (last visited Apr. 1, 2006).

<sup>271</sup> *Id.*

<sup>272</sup> *Id.*

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Though Ferguson's premise of the complacent decline of the EU may be premature, his comments about the formidable growth of the Chinese economy have merit. Frank Verrastro, an energy specialist at the Center for Strategic and International Studies in Washington and a former White House advisor, has argued that, taking into account Asia's economic expansion, population growth, and increased diplomatic influence, "I don't see how you can get away from the theory that the center of the world is moving east."<sup>273</sup> Singaporean Foreign Minister George Yeo Yong Boon has echoed this sentiment: "If we don't go mad and start to fight each other, then I believe the center of gravity of world civilization will shift to Asia during this century."<sup>274</sup>

In September 2005, the U.S. trade deficit swelled to US\$66.1 billion, representing an 11.4% increase from the previous month, in part driven by an oil price hike after Hurricane Katrina, and a labor dispute at Boeing Co.<sup>275</sup> Nevertheless, the politically-sensitive trade deficit with China continued its upward movement, and reached an all-time high of US\$20.1 billion in September 2005.<sup>276</sup> In October 2005, China reported a trade surplus of US\$12 billion.<sup>277</sup> In February 2006, the U.S. Department of Commerce reported that the U.S. trade deficit in goods and services reached a record level of US\$726 billion in 2005, an 18 percent increase over 2004, while the U.S. merchandise deficit alone, which excludes services, was US\$782 billion in 2005, also an 18 percent increase.<sup>278</sup> China's trade surplus with the U.S. increased 24.5% to a record US\$202 billion.<sup>279</sup> U.S. politicians and business lobby groups have accused China of gaining a trade advantage by keeping its currency artificially weak.<sup>280</sup> Despite calls from Washington for greater currency flexibility, Beijing

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<sup>273</sup> Marshall, *supra* note 192, at A18.

<sup>274</sup> *Id.*

<sup>275</sup> Reuters, *Trade Gap Grows to \$66 Billion as Exports Fall, Oil Prices Rise*, L.A. TIMES, Nov. 11, 2005 at C3.

<sup>276</sup> *Id.*

<sup>277</sup> *Id.*

<sup>278</sup> Robert E. Scott, *Economic Policy Institute, Rapid Growth in Oil Prices, Chinese Imports Pump Up Trade Deficit to New Record*, TRADE PICTURE, Feb. 10, 2006, [http://www.epinet.org/content.cfm/webfeatures\\_econindicators\\_tradepict20060210](http://www.epinet.org/content.cfm/webfeatures_econindicators_tradepict20060210) (last visited April 1, 2006).

<sup>279</sup> *Id.*

<sup>280</sup> "Sen. Charles Schumer, D-N.Y., and Sen. Lindsey Graham, R-S.C. have threatened legislation that would impose tariffs of 27.5 percent on Chinese exports unless Beijing agrees to dramatically raise the value of its currency....[and] Sen. Max Baucus, D-Mont., a top ranking Democrat on the Senate Finance Committee, warned ...that Congress would pass legislation to punish Beijing unless China worked to end the trade imbalance and further revalue its currency." Donna Borak, *China's Reserves Rise, Cause of U.S. Worry*, UNITED PRESS INT'L, Jan. 16, 2006, at <http://www.upi.com/InternationalIntelligence/view.php?StoryID=20060116-041130-4588r>. (last

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has affirmed its policy of keeping the yuan steady.<sup>281</sup> China currently holds more than \$260 billion in U.S. Treasury bonds, and its heavy investment in the U.S. national debt is an important component of America's ability to fund a record trade deficit during a period of virtually non-existent U.S. domestic savings.<sup>282</sup> China now has an estimated US\$818.9 billion in currency reserves, and added \$50 billion in reserves in just the last quarter of 2005.<sup>283</sup> Indeed, China is expected to accumulate more than \$1,000 billion in currency reserves by the end of 2006, becoming the world's largest holder of foreign currency.<sup>284</sup> China's world trade surplus reached US\$102 billion last year, capping an average growth rate of 9.9 percent between 1993 and 2004.<sup>285</sup>

How the government in Beijing is choosing to spend its new-found wealth is also causing concern in the West. Beijing is, for example, currently investing heavily in a controversial program of military modernization presumably intended to buttress China's ability to assert itself in international diplomacy and project China's power and prestige regionally. During an October 2005 visit to Beijing, U.S. Defense Secretary Rumsfeld bluntly warned that Beijing's decision to quickly modernize its military arsenal is cause for concern: "As you know, it raises some questions about whether China will make the right choices – choices that will serve the world's interests in regional peace and stability."<sup>286</sup>

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visited April 1, 2006); *See also US Could Get Tougher on China Trade Issues in 2006*, TDCTRADE.COM, Jan. 26, 2005, at [http://www.tdctrade.com/alert/us0602.htm?wt\\_source=tdc&wt\\_type=textlink&wt\\_placem](http://www.tdctrade.com/alert/us0602.htm?wt_source=tdc&wt_type=textlink&wt_placem). (last visited April 1, 2006).

<sup>281</sup> Reuters, *supra* note 275.

<sup>282</sup> *From T-shirts to T-Bonds-China and the World Economy*, THE ECONOMIST, July 30, 2005, at 61.

<sup>283</sup> Donna Borak, *China's Reserves Rise, Cause of U.S. Worry*, UNITED PRESS INTERNATIONAL, Jan. 16, 2006, at <http://www.upi.com/InternationalIntelligence/view.php?StoryID=20060116-041130-4588r>. (last visited Feb. 16, 2006).

<sup>284</sup> *Id.*

<sup>285</sup> *Id.*

<sup>286</sup> Mark Mazzetti, *Rumsfeld Urges New Political Direction for China*, L.A. TIMES, Oct. 19, 2005, at A3. (The enormous investment made by Beijing in China's military capacity – the scale of which has been made possible by the success of China's participation in the global economy - has provoked particular concern in Washington. In a July 2005 report, the Pentagon suggested that China may be spending \$90 billion a year on its military budget, three times the amount officially acknowledged by Beijing. This estimate is disputed by Beijing. Nevertheless, China's military spending could have profound regional consequences. The Pentagon report concluded that China may pose "a credible threat to modern militaries operating in the region ... [and that Beijing] may be tempted to resort to force or coercion more quickly to press diplomatic advantage, advance security interests, or resolve disputes.") While the dispute between mainland China and Taiwan provides one deeply troubling scenario for a potential U.S.-China military confrontation, the greatly

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During his October 2005 Beijing trip, Secretary Rumsfeld echoed themes previously articulated by the Bush administration: that China must become more democratic and politically open; it must abide by accepted norms of the largely free-market, democratic international economic system that has facilitated its growth; and it must play a bigger role in combating international terrorism, nuclear proliferation, disease and other threats to global stability.<sup>287</sup> Rumsfeld specifically warned that China's long-term economic growth could depend on that nation's willingness to accept greater democracy: "China's future prosperity, and to some degree the future of other nations' attitudes [about China], may well depend on internal events [within China]."<sup>288</sup> What is clear is that the United States is no longer the sole power that many nations look to for trade and protection.<sup>289</sup>

**CONCLUSIONS:**

Clearly, as USAID has concluded, "the garment sourcing wars are in full swing and will remain unsettled for some time."<sup>290</sup> What perhaps is most surprising is that what is occurring globally can indeed properly be described as a war rather than merely a rout. Developing countries have not been swept from the field (at least not yet), and indeed have secured some victories. It remains to be seen, however, whether they can win the war, or whether their successes will be no more than temporary holding actions during an inevitable retreat in the face of overwhelming odds. With current uncertainties associated with China's supply because of the potential reintroduction of safeguards by the U.S. and the EU, buyers will likely continue to hedge their bets by continuing to diversify their sourcing. This has undoubtedly created breathing space for developing countries, and has somewhat tempered the potentially devastating impact of the end of MFA quotas on those countries. However, the safeguards are temporary and cannot last indefinitely. The question for producers throughout the developing world is whether they can be cost-competitive when the safeguards are finally lifted.

Cambodia offers one possible model for producing nations searching for ways to protect their fledgling apparel industries from Chinese competition.

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expanded military capacity of China patently challenges the automatic assumption of American military supremacy in the Pacific that has survived largely unquestioned since the end of the Second World War.

<sup>287</sup> Mazzetti, *supra* note 286.

<sup>288</sup> *Id.*

<sup>289</sup> Marshall, *supra* note 192 at A1.

<sup>290</sup> USAID Report, *supra* note 56, at 7.

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Cambodia, though undoubtedly a cheap place to produce apparel, has chosen to foster an image as a “sweatshop-free” producer rather than simply drive down wages and costs in an attempt to remain cost-competitive with China. The Cambodian Government has decided instead to continue a program of independent factory monitoring carried out by the ILO, which appears to have genuinely improved factory conditions and labor compliance. Though Cambodia still faces enormous problems associated with corruption and bureaucratic inefficiency, foreign buyers appear to have responded well to Cambodia’s attempts to improve labor and factory conditions. The higher labor standards offered by Cambodian producers, it appears, is attractive to Western buyers sensitive to accusations that their products are manufactured in sweatshop conditions. Indeed, Cambodia appears to have directly benefited from media reports of poor labor standards elsewhere, and its reputation as a safe-haven for fair labor standards has attracted international retailers concerned about consumer backlash. Whether the Cambodian model will remain merely a niche for a tiny portion of producing countries, however, remains to be seen.

In today’s global economy, international corporate mega-buyers like Wal-Mart are largely turning to those manufacturing nations able to undercut their competitors.<sup>291</sup> The vulnerability of developing nations to decisions made by corporate boards tens of thousands of miles away, and the very real possibility that production will shortly concentrate in a tiny handful of producing nations, suggests that global free trade alone may not offer the path to widespread global development once anticipated, and that, rather, free trade leads to growth but maldistribution. The international marketplace is increasingly dominated by companies seeking little beyond lowering production

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<sup>291</sup> See Ted C. Fishman, *How China Will Change Your Business*, INC. MAGAZINE, March 2005, available at <http://www.inc.com/magazine/20050301/china.html> (last visited April 1, 2006) (“[N]o company has been a bigger catalyst in pushing manufacturers to China,” or to embracing the potential of large-scale manufacturing in China than Wal-Mart. “In 2003, Wal-Mart purchased \$15 billion worth of goods from Chinese suppliers.” Wal-Mart accounts for 10-13 percent of all Chinese exports to the U.S. More than 80 percent of Wal-Mart’s worldwide suppliers are in China.); See Rosen *The Wal-Mart Effect: The World Trade Organization and the Race to the Bottom*, *supra* note 5, at 273. (“Over the past decade, the symbiotic relationship between Wal-Mart and China has become one of the most significant in the retail industry . . . The company uses its power to drive down prices among American suppliers, which are often encouraged to relocate to China as a method of reducing wages and pricing.”); See also, Pete Engardio and Dexter Roberts, *The China Price*, BUSINESSWEEK, Dec. 6, 2004, at 102 available at [http://businessweek.com/magazine/content/04\\_49/b3911401.htm](http://businessweek.com/magazine/content/04_49/b3911401.htm) (last visited April 1, 2006) (Stating it is China’s willingness to please big retailers, and they are “better suppliers” is the reason many big retailers like Wal-Mart have deals with Chinese manufacturing); and Jian Jingjing, *Wal-Mart’s China Inventory to Hit US \$18b This Year*, CHINA DAILY, Nov. 29 2004, available at [http://www.chinadaily.com.cn/english/doc/2004-11/29/content\\_395728.htm](http://www.chinadaily.com.cn/english/doc/2004-11/29/content_395728.htm) (last visited April 1, 2006).

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costs and with little interest in the social and political consequences of their corporate decisions. Though nation states and international bodies may have reason to address issues of global poverty and economic dislocation, most corporate boards have little reason to do so. And yet it is these corporate boards – who have little stake in the societies or cultures from where they purchase their products – who are making the decisions that directly effect the lives of millions of the world’s poorest workers.

The vulnerability of developing nations to large-scale and rapid market-driven shifts in global production is clear. Yet there may also be a cost to the West. While the shift of production may be interpreted by some observers merely as a natural reward for efficiency, cost-effectiveness, and competitiveness in a liberalized global trade regime, it is not without potentially catastrophic and unanticipated consequences for Western consuming nations. First, and most obviously, the end of quotas seems likely to result in the systematic rise of a handful of super producers: nations able through economies of scale to dominate the global marketplace. It should not be assumed that the United States or EU countries will be among these nations. In the case of China, in particular, there is reason to be concerned that the unprecedented expansion of wealth and manufacturing capacity in that nation will result in the rise of an economic global superpower, with political, fiscal and military implications both regionally and internationally that are hard to predict and which are not necessarily beneficial to the West.<sup>292</sup>

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<sup>292</sup> As China becomes an increasingly important and influential participant in the global economy, it has sought to secure access to the raw materials needed to support its continued expansion. China’s oil needs, for example, are expected to double in the next two decades to over 14 million barrels a day. Marshall, *supra* note 192, at A18. The China National Petroleum Corporation is now involved in forty projects in thirty-two countries. See Vega, *supra* note 11, at 387 fn. 79. China is actively attempting to expand its diplomatic and political influence over nations which can provide the raw materials upon which China is dependent, and is increasingly following a policy of direct investment in infrastructure and energy projects in those nations. Inevitably, this is placing Beijing in competition with Washington for political and economic influence in many regions around the globe, from Central Asia to Africa. China’s influence is even increasingly surfacing in the produce and oil-rich nations of Latin America – long considered America’s “Backyard.” In a late 2004 trip to Argentina, Chile, Cuba and Brazil, Chinese President Hu Jintao promised tens of billions of dollars to improve the region’s infrastructure. Mark Magnier, *U.S. Is Watching China’s Latin American Moves*” LA TIMES, April 15, 2006, at A14. See also Vega, *supra* note 11, at 377-378. It has been suggested that the closer political and economic ties between China and Latin America may undermine U.S. ability to secure regional cooperation in initiatives in trade, human rights, antinarcotics, and environmental safeguards – interests simply not shared by Beijing – as Latin American countries feel less need to cooperate with Washington. See Vega, *supra* note 11, at 377-378. U.S. efforts to promote democratic reform in Central Asia have similarly been undermined by the rising influence of China, including the building of an oil pipeline running thousands of miles from the Kazakh oil fields in the northern Caspian to China. Marshall, *supra* note 192, at A1.

## CHINA CASTS A GIANT SHADOW

Beijing's direct economic influence is extending around the globe, from the Sudan, to Iran, to Latin America, and is often matched by diplomatic campaigns aimed at extending China's political influence over energy- and raw product-rich nations. These include countries ambivalent - or even actively hostile - towards the Bush administration and content not to be pressed on such issues as human rights, democracy, civil society, and governmental transparency. China has, for example, taken advantage of anti-American hostility in Latin America to further its own influence in the region. China's economic and political ties with Latin America have increased enormously since 2000. Nearly half of all China's foreign direct investment goes to Latin America, a figure Chinese officials estimate will reach \$100 billion by 2010, while Latin American trade with China grew to \$50 billion- a fourfold increase from 2000 to 2005. Magnier at A14. In 2004, Latin America had one of its better economic performances, with much of that growth coming not from trade with the United States but from rapidly expanding sales of raw materials to China, rather than trade with the United States. See Larry Rohter, *Bush Faces Tough Times in South America*, N.Y. TIMES, Nov. 2, 2005 at A12. Beijing is not just purchasing oil and raw commodities from Latin America, it is becoming actively and directly involved in oil extraction, transportation and infrastructure construction. Brazil is China's largest trading partner in Latin America, and bilateral trade between them tripled between 2000 and 2004. Vega, *supra* note 11, at 388. Brazilian exports (primarily oil and soy beans) to China reached US\$1.1 billion in the first quarter of 2004, with expectations that the trade could reach US\$10 billion in 2005. Vega, *supra* note 11, at 388 fns. 81-82. Chinese businesses are actively seeking Brazilian partners in economic sectors such as oil and agriculture, and Beijing has discussed directly investing between US\$3 billion to US\$4 billion in Brazilian transportation, refineries and other infrastructure, including a railway project connecting Brazil to the Pacific ports of Chile. Vega, *supra* note 11, at 388. In Argentina, China is also seeking to become investment partners in the infrastructure and transportation sector. Vega, *supra* note 11, at 388. Argentine President, Nestor Kirchner, and Chinese President, Hu Jintao, signed an agreement on June 28, 2004, under which China will begin investing in joint projects in Argentina, including a railway construction project, and Argentina will begin exporting citrus crops to China. Vega, *supra* note 11, at 388. China and Chile have entered into trade agreements permitting export to China of Chile's citrus harvest. *Chile, China Review Joint FTA Economic Study Progress*, LATIN AM. NEWS DIG., June 4, 2004. Even in Mexico, whose factories have been hit hard by Chinese manufacturing competition, the government has decided to increase its production of oil specifically to satisfy China's demand. Vega, *supra* note 11, at 388. "China has also indicated interest in [direct investment of US] \$3 billion in Ecuador, primarily in its oil sector." Vega, *supra* note 11, at 388. In Nicaragua, with the construction of a canal; and in Guyana, which now enjoys bilateral economic and technical cooperation with China. Vega, *supra* note 11, at 389. Venezuela poses a particular headache for the U.S., as its leftist president, Hugo Chavez, has actively pursued policies built upon a foundation of popular anti-Americanism and a deep-seated distrust of Washington. Venezuela's Foreign Minister, met with managers of China National Petroleum Corporation...in order to establish a strategic alliance over the exploration, transformation and transportation of crude oil, including modernizing and upgrading necessary infrastructure. Vega, *supra* note 11, at 389. The growing influence of China in Latin America is of significance. The failure of the U.S. to maintain its hegemony in the region, combined with growing links between Latin American governments and Beijing, might suggest that the U.S. is losing influence even within the region long known as "America's back-yard." See Richard E. Friedman, *Letter From the Publisher*, NAT'L STRATEGY F. REV., Fall 2004, at 4, available at <http://www.nationalstrategy.com/Fall%202004.pdf> (last visited April 1, 2006). The rise of China in Latin America may ultimately threaten the ability of the U.S. to guarantee its future access to Latin American oil reserves, a matter of national security and of profound economic consequence. Vega, *supra* note 11 at 391. Washington is described as

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As Tyler Marshall of the Los Angeles Times has noted:

As the Bush administration struggles to combat the threat of international terrorism, a far quieter force is challenging America's global influence: the growing economic clout of Asia. Increasingly, other nations have become captivated by the reality, and the potential, of fast developing commercial ties with the East. Suddenly, America is no longer the only guarantor of their economic viability or their political protector of choice.<sup>293</sup>

The shift of production may have other largely unanticipated consequences. The Western search for ever-cheaper sources of production may suggest to many that Westerners view the developing world as little more than a readily exploitable source of cheap labor. At this moment in history, when Western political, economic and democratic values are confronted by an increasingly violent anti-Western and Anti-American world view, a perception that Westerners have no interest in the often appalling consequences of their search for ever-cheaper consumer products, cannot best serve Western security or political interests. Put simply, anti-Western resentment, coupled with extreme poverty and social injustice, will fuel instability, anger and violence. At the very least, consuming nations should act to ameliorate the worst consequences of sudden shifts in global production. Given the vital importance of international economic stability, Western states should pursue trade agreements intended to limit extreme national or regional shifts in production of the sort we may currently be witnessing in garment and textile manufacturing, and to set a floor for the market with reference to international labor standards. In that way, Western nations can transform their image from one of self-centered consumer-driven indifference, to one of concerned partner with the world's poorest and most vulnerable nations.

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increasingly "attentive" to China's military-related activities in Latin America which, as Army Gen. Bantz J. Craddock told a Senate Armed Services Committee, involve "more and more Chinese non-lethal equipment," Chinese military missions in nearly 20 Latin American countries, and an increasing number of Latin American military offices receiving training in China. Magnier at A14.

<sup>293</sup> Marshall, *supra* note 192 at A1.



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**DEREGULATION AND COMPETITION IN  
UNDERWRITING:  
REVIEW OF THE EVIDENCE AND NEW FINDINGS**

*George J. Papaioannou and Adrian Gauci\**

**1. INTRODUCTION**

Starting in 1987 the underwriting business underwent a gradual deregulation that eventually culminated in the passage of the Financial Services Modernization Act in 1999, which repealed the Glass-Steagall Act of 1933 that had separated commercial and investment banking operations. In this paper we provide a review of the literature and report findings that seek to answer three important questions. First: What is the market's assessment concerning the benefits from the integration of commercial and investment banking activities? We answer this by reviewing the evidence on the market's reaction to news related to the relaxation of restrictions for commercial bank involvement in the underwriting business. Second: What is the impact of bank entry into underwriting on issuance costs? We answer this by reviewing the evidence on underwriting fees and the pricing of new issues. Third: How has deregulation affected the ownership and market structure in the underwriting of securities? We answer this by reviewing the evidence and present findings from our research on this issue.

The rest of the paper is organized as follows: Section 2 gives a brief historical background on the original regulation and subsequent deregulation of investment banking. Section 3 reviews the evidence on the market's reaction to various developments related to deregulation. Section 4 reviews the evidence

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on the impact that the entry of commercial banks had on underwriting fees and the underpricing of new issues. In section 5, we review previous evidence on market structure and competition and in section 6 we present our findings. Finally we conclude the paper with section 7.

## 2. HISTORICAL BACKGROUND

Prior to the passage of the Glass-Steagall Banking Act of 1933, securities firms as well as commercial banks were permitted to organize underwriting activities with the purpose to assist corporations and other entities to raise capital in the public markets through the issuance of securities. Along with trading in securities and advising on mergers and acquisitions (M&As), underwriting is part of what we call investment banking. By prohibiting commercial banks from engaging in the trading and underwriting of corporate securities, the 1933 Act effectively separated investment and commercial banking. Whereas the separation benefited the securities industry by shielding it from outside competition, it deprived commercial banks of vital business as well as the opportunity to integrate lending with securities issuance. Along with unfavorable developments related to declining profitability and increasing concentration risk, the restrictions on commercial banks came to be thought as unreasonable and unsustainable. For example, commercial banks could underwrite general obligation municipal bonds but not revenue municipal bonds. Or, they were not allowed to underwrite securities backed by mortgage and other paper originated and held by the banks themselves. No less important for the push toward deregulation was the emergence of new research which showed that the evidence on the alleged excesses that had given cause for the separation of the two industries was circumstantial and less compelling than originally perceived (Benson, 1990).

An early landmark in the comeback of commercial banks into the securities business was the Bank of America acquisition of the discount brokerage house of Charles Schwab in 1981. This led to granting Bank Holding Companies (BHC) the power to run brokerage business in 1983. However, the major breakthrough came in 1987 when the Federal Reserve Board (FRB) allowed Section 20 subsidiaries of commercial banks to underwrite securities, restricted first to municipal revenue bonds, mortgage and asset backed debt and commercial paper (Tier I powers). This expansion of commercial bank powers was based on section 20 of the Banking Act of 1933, which gave banks permission to organize non-permissible activities as long as they were not the principal business of the bank affiliated entity. To comply with this requirement, the FRB initially restricted the revenues generated by the newly permitted activities of Section 20 subsidiaries to no more than 5% of total

## DEREGULATION AND COMPETITION IN UNDERWRITING

revenue. Consequently, only the very big banks - those with large operations in originally permissible activities, like government and municipal general obligation bonds - were able to expand into securities underwriting and generate enough revenue to cover the costs of the new activities. Indeed, J. P. Morgan, Chase, and Bankers Trust were the first to apply and receive Section 20 powers. Over the ensuing decade, the FRB gradually relaxed its requirements, thus making it easier for more banks to enter the underwriting business. Thus, in 1989, Section 20 subsidiaries were allowed to underwrite debt and equity (Tier II powers). That same year the 5% revenue limit was raised to 10%, and then again to 25% in 1996. Also in 1996, the FRB significantly reduced the strict firewalls that were supposed to keep investment and commercial banking staff of the same banking corporation from working together by recommending clients across divisions and sharing information about client business. The higher fraction of revenues enabled more and relatively smaller banks to enter the field of underwriting and investment banking in general. The removal of the firewalls increased efficiency in networking and lowered the information costs incurred as part of the price discovery in the issuance process.

Eventually, after a series of forward movements and setbacks, the Congress passed the Financial Services Modernization Act (FSMA), signed by President Clinton on November 14, 1999. The Act ended over sixty years of separation of commercial banks from investment banking activities.<sup>1</sup> The new law set up a new corporate entity: the Financial Holding Company (FHC). Further, national banks and state chartered banks that elect not to obtain the FHC status are permitted to engage in securities business through subsidiaries.

### **3. THE MARKET'S REACTION TO COMMERCIAL BANK ENTRY INTO UNDERWRITING**

Since the changes in regulation and law that allowed commercial banks to enter the corporate underwriting field also expanded their powers in the securities business in general, it is difficult to isolate the specific effects of commercial bank entry into underwriting. This is so because intermediation in the issuance of securities through underwriting is inextricably linked to the conduct of other operations in the securities business. To understand this we need to look at the nature of the underwriting process.

There are five distinct services an underwriter offers the issuer: origination, issuance risk underwriting, price discovery, placement and aftermarket support. Origination starts with the issuer giving an investment bank the mandate to arrange the issuance of a type of security. This requires

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<sup>1</sup> For a detailed account of the deregulation process, see Czynnik and Klein (2004).

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extensive networking with top firm executives developed over many years through repeated deals or other professional contacts. Underwriting as a risk intermediation service exposes the investment banker to the possibility of having to inventory an unsold issue if it turns out to be overpriced (i.e., to carry an offer price above what the market is willing to bear at the time of the offer). To minimize this risk, underwriters engage in price discovery through costly information gathering and analysis and solicit information from groups of investors through roadshow presentations. Market intelligence skills and close relationships with informed and regular (mostly institutional) investors are extremely valuable for successful price discovery and marketing of new issues. To generate and maintain these skills and relationships investment banks engage in secondary market operations, like trading and market making, and order execution for institutional clients. Placing the new issue requires extensive relationships with retail and institutional investors, usually established through brokerage, trading and asset management operations. Finally, aftermarket support of the new issue entails the provision of liquidity services (i.e., serving as a market maker) and research analysis so that investors can acquire an interest in the new security at a lower information cost to them.

The multiplicity of services and their corresponding operations required for the underwriting business explain why the *de novo* entry into underwriting is extremely costly and difficult. Besides significant capital allocation, these services require specialized resources in human capital and a record of reputation, neither of which can be acquired at low cost or in a short period of time. Therefore, it is not surprising that successful entry into underwriting by commercial banks has been accomplished through acquisitions of established securities firms.

### **3.1. Commercial Bank Benefits**

The co-mingling of commercial and investment banking activities can create value if the benefits from positive synergies and complementarities exceed the costs of negative synergies. The trend towards the integrated investment bank that purports to combine strength in origination with placement capabilities seems to favor commercial banks. Their lending relationships can generate opportunities for underwriting mandates, whereas their extensive depositor networks can support their placement efforts. In addition, commercial banks are favored from the access they have to private information about loan clients. This gives commercial banks an information production cost advantage when they engage in price discovery for new issues. Large banks can also be better capitalized than investment banks and, thus, have greater risk bearing capacity in the execution of underwriting and related securities deals. From a

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financial standpoint, expanding into new business can also help banks diversify their revenue stream and benefit from risk diversification. Finally, moving into the securities business enables banks to operate as a “one-stop shop” and capture additional business from existing or new clients through cross-selling. However, as we discuss below, these benefits do not come without disadvantages. Mixing different operations can generate negative synergies. Most critical in this case are conflicts of interest and other agency problems that can complicate the banks’ role as underwriters. Banks could also engage in unprofitable acquisitions by paying premiums exceeding the net value created from the purchase and operation of securities business.

Notwithstanding the perceived benefits and risks, their ultimate impact on value needs to be assessed by examining the market’s reaction. Therefore, the following sub-section reviews the pertinent literature.

### **3.2. Evidence on Market Reaction: Commercial Banks**

Studies on the financial consequences of corporate conglomeration have revealed that (a) the market discounts the value of conglomerates in the order of 15% compared to the value of single-activity firms, and (b) the conglomerate discount declines or even disappears as the degree of relatedness of the combined business lines increases (see for example, Berger and Ofec, 1995). More specifically, DeLong (2000) shows that in the case of commercial bank mergers, those that increase focus in geography and activity increase value, whereas those that do not destroy value. Therefore, the market reaction to the potential or actual combination of commercial and investment banking depends on whether investors expect such undertakings to derive the benefits from combining related and complementary businesses or to suffer the costs of decreased corporate focus.

Saunders and Smirlock (1987) present early evidence on the market’s reaction to the acquisition of a discount broker (Charles Schwab) by Bank of America in 1981 and the subsequent FRB approval of commercial bank entry into discount brokerage in 1983. They find no evidence that commercial banks experienced abnormal stock returns or shifts in their risk. This is corroborated by Davidson, Hatfield and Glascock (1994) who find no significant market reaction to announcements of Bank Holding Company (BHC) acquisitions of securities firms in the 1981-87 period. These findings must be interpreted with caution because the potential for commercial bank entry into the core activities of investment banking, (i.e., underwriting), did not fully materialize before the approval of Section 20 affiliates in 1987.

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The next several studies cast light directly on the question of value creation by combining commercial banking with underwriting activities. Commercial bank stock prices reacted favorably to the establishment of Section 20 subsidiaries in 1987 (Apilado, Gallo, and Lockwood, 1993). However, the market's reaction was mixed when the FRB expanded the underwriting powers of banks by raising the revenue limit to 10% and permitting the underwriting of debt and equity issues. Banks with Section 20 operations realized negative value adjustment but large banks and those with applications for Section 20 powers realized value gains (Bhargava and Fraser, 1998). The increase of the revenue limit to 25% and the reduction of the firewalls between security subsidiaries and parent banks in 1996-1997 had a further beneficial effect on the valuation of banks. Both Cyree (2000) and Czyrnik and Klein (2004) find evidence of positive and significant market reaction to these developments. Czyrnik and Klein (2004) also find evidence of significant value gains for banks when in 1997 Bankers Trust (a commercial bank with Section 20 operations) acquired Alex Brown (a fairly large investment bank). The prospect of increased takeover activity in the underwriting industry as well as heightened expectations about deregulation of that industry produced additional positive market reaction upon announcement of the Travelers-Citicorp merger on April 6, 1998 (Johnston and Madura, 2000). The combination of Travelers (a financial conglomerate controlling an insurance firm and the securities powerhouse Salomon Brothers) with Citicorp (a commercial bank with global operations) formed Citigroup, the first universal bank in the United States since the Glass-Steagall Act of 1933.

Commercial banks were found to gain positive abnormal returns again when in 1999 the FSMA removed the walls between the two industries. Akhigbe and Whyte (2001) find evidence of positive market reaction around several dates preceding and including the passage of the 1999 Act. The price gains for commercial banks are also found to increase with size and capital, implying that bigger better capitalized firms will be able to undertake more profitable combinations of traditional banking with investment banking activities. Hendershott, Lee and Tompkins (2002) also evaluate the market reaction of commercial bank stock prices around various dates related to the passage of the 1999 Act. They find that commercial banks experience small, positive, but statistically insignificant gains in price. However, excess returns on commercial bank stocks vary directly with size and profitability. They interpret this as evidence that positive synergies will accrue primarily to the bigger and more profitable banks. Czyrnik and Klein (2004) also report significant value gains for commercial banks at the passage of FSMA by Congress on November 5, 1999.

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**3.3. Evidence on Market Reaction: Investment Banks**

The gradual and eventual removal of the barriers to entry into securities business should also impact the performance of the investment banking industry. Competition should increase as new institutions could now enter the market for underwriting and other securities business. This should then affect both the revenue and the risk of securities firms. On the benefit side, securities firms stood to gain in two ways. First, the pool of potential acquirers would expand to include commercial banks; hence, securities firms could capture takeover premiums. Increased competition in the market for corporate control could also exert discipline on securities firms to pursue value maximizing strategies with greater consistency. Second, deregulation of the financial services meant that securities firms could enter the field of commercial banking and, thus, match their rival banks in whatever area the latter might have an advantage over securities firms. If this new environment implied a potential for value creation, then market response to these developments should be reflected in positive price changes for the stocks of investment banks.

Several of the above reviewed studies provide evidence on this issue. Saunders and Smirlock (1987) report that especially small securities firms experienced value losses (i.e., negative stock price reaction) at the time of the Bank of America acquisition of Charles Schwab in 1981. This was early evidence of the pro-competitive effects of deregulation of the securities industry.

Studies examining the market's assessment to commercial bank entry into underwriting suggest that the Fed's approval of limited underwriting business for banks did not cause any appreciable value effects for investment banks (Bhargava and Fraser, 1998). However, these authors show that raising the revenue limit to 10% in 1989 caused a negative market reaction for investment banks. This implies that under the 5% limit, Section 20 subsidiaries were sufficiently constrained from expanding at the expense of securities firms, but this would no longer be the case after the 10% limit was allowed along with the power to underwrite debt and equity. The proposition that investment banks stood to benefit from the prospect of takeovers by commercial banks was empirically validated by the positive stock price reaction realized by security firms to the news of the Bankers Trust's acquisition of Alex Brown (Czyrnik and Klein, 2004) and the Travelers-Citicorp merger in 1998 (Johnston and Madura, 2000). Additionally, these studies find that the value gains are directly related to the size and leverage of the securities firms in their sample, consistent with the takeover hypothesis that larger, better established security firms and

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those more financially constrained would be the prime candidates for acquisition.

The passage of FSMA in 1999 also caused a positive re-evaluation of securities firms (Akhigbe and Whyte (2001), Hendershott, Lee and Tompkins (2002), and Czyrnik and Klein (2004)). The relationship of the value gains by securities firms to various firm characteristics led to various interpretations of the sources of these gains. Thus, Akhigbe and Whyte (2001) interpret the negative relationship of the abnormal stock returns to capital as evidence that better capitalized securities firms could fend off the acquisition attempts of commercial banks. Alternatively, it could imply that investment banks with more own capital at stake had more to lose from commercial bank competition. Hendershott, Lee and Tompkins (2002) find that larger investment banks realized greater return gains consistent with their hypothesis that large securities firms have greater potential to expand into banking activities and reap synergistic benefits. However, they find that abnormal returns varied negatively with profitability ratios. They interpret this as evidence against their hypothesis that increased business and takeover competition would force less profitable securities firms to improve their performance and create value.

### **3.4 Interpretation of the Overall Evidence**

A review of the overall evidence of the market's assessment of bank entry into investment banking reveals three distinct patterns. The establishment of Section 20 powers generated value gains for commercial banks but had no value effect for securities firms. Apparently, the initial underwriting powers and the low revenue limit were not perceived to go far enough to either threaten the securities industry or to generate appreciable gains through the takeover mechanism. The mergers of commercial banks with investment banks in 1997 and 1998 (coming at the heels of material broadening of Section 20 powers) signaled a strong potential for synergistic gains and takeover benefits for banks and investment banks, respectively. Thus, both industries enjoyed positive value gains. Finally, the passage of FSMA in 1999 solidified the market's expectation that commercial and investment banks stood to benefit from expanded scope of synergies and takeover gains. These expected gains more than offset any negative gains that the pro-competitive purpose of the act might imply for commercial and investment banks.

### **4. EFFECTS ON ISSUANCE COSTS**

If the entry of commercial banks in the underwriting business had pro-competitive effects, we should observe supportive evidence from its effects on



## DEREGULATION AND COMPETITION IN UNDERWRITING

issuance costs. For example, we should observe that commercial bank underwriting was less costly for issuers compared to investment bank underwriting. Or we should observe that underwriting costs declined, in general, after banks were permitted to act as underwriters.

Underwriting costs have two major components. The first is the underwriter fees paid in the form of a gross spread, that is, the difference between the gross proceeds from the sale of the issue to investors and the net proceeds paid to the issuer. The second is the possible underpricing of the issue, or the so called “money left on the table.” This cost arises if the fixed offer price of the issue turns out to be lower than the market price investors pay in the immediate aftermarket to purchase securities from the initial buyers. This difference, known as the implicit spread, is measured by the percentage change from the offer price to the first day market price and is called the initial return. If underwriters set the offer price to match their fair estimate of the expected market price of the issue, then the long-run average underpricing should be zero. Any underpricing or overpricing would be the result of random error. However, the evidence shows that the majority of new issues are underpriced and average underpricing is positive (see, for example, Ritter and Welch, 2002). The main theoretical explanation for underpricing is the asymmetry of information that exists about the quality of an issue.<sup>2</sup> As the intermediary between the issuer and the investors, the underwriter acts as certifier of the issue’s value. Underwriters do this by committing resources to learn about the firm and by interacting with informed investors who invest regularly in new issues. Certification power is bestowed upon underwriters because they have reputational capital they need to protect over the long-run in order to make deals repeatedly (Booth and Smith (1986) and Beatty and Ritter (1986)).

The ability to provide competitive prices in underwriting depends on the cost efficiencies and certification power brought to bear in the issuance process. Because the inherent underwriting risk and the placement effort are affected by how accurately the offer price is set (with respect to the unknown actual market price), greater underpricing can significantly lower the expected underwriting cost, but it can inflate the cost from underpricing. Therefore, the

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<sup>2</sup> In Rock (1986), informed (usually institutional) investors learn more about the issue than uninformed (retail) investors. Thus, they can discriminate between good (hot) and bad (cold) issues. Consequently they manage to get greater allocations of good issues whereas uninformed investors end up with more of the bad issues, on which they incur losses. To avoid the withdrawal of these investors from the market, underwriters underprice all issues sufficiently so that uninformed investors make a fair rate of return. In Benveniste and Spindt (1989), underwriters solicit private information from informed investors in order to improve on the offer price and avoid losses. In order to convince informed investors to share positive information, underwriters underprice new issues and give these investors greater allocations of good issues.

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major determinant for efficient pricing of underwriting services and proper choice of the offer price is the quality and cost of price discovery.

As lenders, commercial banks maintain close and on going relationships with corporate clients. Therefore, they should be able to assess the fair value of their loan clients' new issues with greater accuracy and by incurring less cost. This advantage should enable commercial banks to execute underwriting deals at a lower cost and provide better certification services than their rival investment banks. This has led to the formulation of the certification hypothesis that predicts lower underpricing for commercial bank underwritten issues (Puri, 1999).

However, commercial banks which bring loan client issues to the market face conflicts of interest. For example, a bank may recommend a new issue with the purpose to direct the proceeds toward the repayment of an outstanding loan. The incentive of the bank to do so increases with the probability of default of the bank's loan to the client. Therefore, the bank may conceal the true condition of the issuer and also set the offer price at a level that fails to reflect the true quality of the issue. However, this conflict of interest becomes apparent to rational investors who will be reluctant to buy new issues from the commercial bank's underwriting affiliate unless the issue is sufficiently underpriced. The conflict of interest hypothesis then predicts that new issues underwritten by commercial bank affiliates are more underpriced than those underwritten by investment banks (Puri, 1999).

### **4.1. Evidence on the Underwriter Fees and Underpricing of Debt Offerings**

The certification and conflict of interest hypotheses have been empirically tested in several studies. Puri (1994) examines the default performance of debt issues underwritten by commercial banks<sup>3</sup> and non-banks in the pre-Glass-Steagall Act, and finds that the default rate was lower for debt underwritten by banks. This supports the certification hypothesis. Evidence from the recent engagement of commercial banks in underwriting business supports this hypothesis as well. Thus, Gande, Puri, Saunders and Walter (1997) report that bonds underwritten by commercial banks were less underpriced than issues underwritten by investment banks. This finding holds especially for bonds of lower credit rating and when the proceeds are not used to repay bank related debt owed by the issuer. There is no evidence of difference in underpricing for bond issues whose proceeds were used to repay

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<sup>3</sup> We use the term commercial bank to mean a commercial bank subsidiary or affiliated securities firm through which the bank engages in investment banking activities.

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bank loans. The Gande, Puri and Saunders (1999) study finds evidence for the pro-competitive consequences of deregulation. Specifically, the authors report that underpricing of bond issues had declined in general following the banks' entry into underwriting, and that the yield savings increased with bank market share. These savings are also found to accrue mostly to the smaller debt issues. However, the above findings pertain to bond issues underwritten before the removal of the firewalls and the increase of the revenue limit to 25%. Rotten and Mullineaux (2002) analyze debt issues in the period 1995-1998 and find new evidence that contradicts previous findings. They find no significant difference in the yield spreads (and, hence, underpricing) for debt issues underwritten by Section 20 subsidiaries. This holds even for the non-investment grade bonds. More important is their finding that bank market share in debt underwriting is positively related to yields, and that increases in bank market share does not have a decreasing effect on offer yields, in general. This is evidence of an anti-competitive effect. Prior lending relationships and use of proceeds do not appear to have any bearing on yield spreads. This is further evidence in favor of the certification hypothesis.

Equally mixed is the evidence on underwriter fees. The earlier study of Gande, Puri and Saunders (1999) finds that the banks' entry into underwriting has caused underwriter fees (gross spread) to decline for nonconvertible debt issues whether underwritten by commercial or investment banks. The underwriter spread reduction was more pronounced among smaller and lower rated issues. The decline in gross spreads was also directly related to the market share captured by banks. There is no evidence, however, that commercial banks charged lower gross spreads than the investment banks. The analysis shows that the latter reduced their fees as banks gained market share. The findings provide evidence for the pro-competitive effect of the deregulation. Rotten and Mullineaux (2002) find, however, that Section 20 underwritten bond issues carry lower gross spreads than issues underwritten by investment banks, but this holds only for issues of non-investment grade bonds consistent with the notion that issues with greater information asymmetry benefit the most from the more efficient price discovery of bank-related underwriters. Using the issue proceeds to refinance bank-related debt had insignificant impact on these spreads. Yasuda (2005) examines whether the bank-issuer relationship affects the underwriter compensation of debt issues. He reports that banks offer fee discounts to issuers who are their loan clients. Since banks also provide better offer prices for the bond issues of such clients, the implication is that banks share the savings due to these relationships with their clients.

#### **4.2. Evidence on the Underwriter Fees and Underpricing of Equity Offerings**

In their study of bond issues, Gande, Puri and Saunders (1999) also report findings about the impact of bank entry into underwriting on the gross spreads charged for equity offerings. They find no evidence of lower underwriter fees for equity issues (IPOs) underwritten by commercial banks. This is corroborated by Chaplinsky and Erwin (2001) who find that gross spreads for IPOs and seasoned equity offerings (SEOs) have no impact on the choice of a commercial versus an investment bank as underwriter. Fields, Fraser and Bhargava (2003) also report insignificant differences in the gross spreads of IPOs underwritten by Section 20 and pure investment banks.

The evidence on the underpricing of equity issues (limited to IPOs) is rather mixed. Chaplinsky and Erwin (2001) find that initial returns (the underpricing metric) are indistinguishable for IPOs underwritten by commercial banks and investment banks, respectively. Utilizing a sample of IPOs underwritten by commercial bank affiliates and investment banks in the period 1995-1998, Hebb (2002) finds that underpricing is lower for bank underwritten IPOs only if there is a prior lending relationship that helps mitigate the price discovery costs and increases certification power. Consistent with this notion, the commercial bank advantage in producing lower underpricing is most pronounced in the post-1997 period when the firewalls had been relaxed. However, underpricing increases if the underwriter is a commercial bank and the issue proceeds are used to retire existing debt. This is evidence that commercial banks mitigate the market's perception of a conflict of interest by relatively underpricing these issues more. Schenone (2004) also finds that when bank affiliates underwrite IPOs of issuers with whom the parent bank has prior lending relationships underpricing is reduced by 17%. Prior underwriting relationships are much less important in reducing underpricing.

Fields, Fraser and Bhargava (2003) analyze a sample of IPOs underwritten by commercial and investment banks in the period 1991-1997. Their findings suggest that IPOs underwritten by commercial banks have significantly lower total issuance cost (i.e., the sum of gross spread and underpricing), but the cost savings come from the significantly lower underpricing. Moreover, firms whose IPOs were brought to the market by commercial bank affiliates realize superior long-term stock return performance than firms with IPOs underwritten by investment banks. The lower underpricing and the better long-term stock performance of commercial bank

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underwritten IPOs imply that banks use their superior inside information to market higher quality IPOs.

### 4.3. Interpretation of the Overall Evidence

The above evidence suggests that deregulation of underwriting lowered the underwriting fees on debt issues, especially those of lower quality, but had no impact on the gross spreads for equity issues. Thus, banks were not able or willing to translate their information superiority into lower spreads except for debt issues of low quality. Equity issues, especially IPOs, have sticky gross spreads, as the preponderance of the 7% fee indicates (see Chen and Ritter, 2000), which commercial bank competition did not affect. It is worth noting that bank entry put pressure on the relatively low gross spreads of debt issues, but did not impact the considerably higher IPO gross spreads. This may be due to the fact that debt underwriting is a more commodity type service whereas IPO underwriting requires more specialized resources. More important is the evidence that underwriting did not compel bank affiliates to underprice more due to conflicts of interest. Instead, the evidence suggests that commercial bank affiliates were able to exploit their superior information about loan clients' business to produce more efficient price discovery and, thus, reduce the underpricing of the new issues they underwrote, consistent with the certification hypothesis. Nonetheless, this advantage dissipates when proceeds are used to repay bank-related loans in line with the conflict of interest hypothesis.

## 5. OWNERSHIP STRUCTURE, COMPETITION AND CONCENTRATION

Commercial banks can enter the underwriting market either through internal expansion or through acquisitions. The banks' success and penetration rate would depend, however, on whether banks find or perceive the combination of banking and underwriting operations to be value creating. Therefore, the record on ownership structure, market profile and overall competition can shed light on this question. An additional question of importance is whether deregulation has decreased concentration or whether banks, through *de novo* expansion or acquisitions, have supplanted themselves as the new dominant players of the market. There has been limited evidence on the effects of deregulation on the ownership structure and competition of the underwriting industry. Smith's (2004) overview of recent developments in investment banking, including industry structure, is informative but incomplete. Some

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evidence on industry competition and concentration, usually fragmentary and focusing mostly on IPOs, can be found in several papers that examine the record of commercial bank affiliates in the underwriting of securities.

Gande, Puri and Saunders (1999) show banks had increased their market share of debt from 4.40% in 1991 to 16.28% in 1996, and their equity market share from (0.37%) in 1992 to 2.15%. Chaplinsky and Erwin (2001) conduct a more detailed analysis of market share data for equity IPOs and seasoned equity offerings (SEOs). They find that the Section 20 subsidiaries' market share increased from 0.5% in 1992 for IPOs and 0.1% in 1991 for SEOs to 20.6% for IPOs and 28.5% for SEOs in 2000. Despite these gains in equity underwriting market share, Chaplinsky and Erwin find that commercial bank acquisitions of other underwriting firms leads to a significant decline of the combined market share. Furthermore, considering Section 20 and securities firms that had been acquired in the 1990-2000 period together, Chaplinsky and Erwin find that their market share of equity offerings had declined from 32.3% in 1991 to 25.4% in 2000. On the contrary, independent investment banks had increased their market share from 67.7% in 1991 to 74.6% in 2000. Chaplinsky and Erwin also find that commercial bank affiliates underwrite, in general, IPOs and SEOs of smaller issuers, with fewer issues being listed on the New York Stock Exchange (a sign of quality).

Hansen (2001) investigates competition and ease of entry into the IPO market in the context of the pervasiveness of the 7% gross spread for IPOs. He finds that there is an increase of 62% in the number of different firms that enter the IPO underwriting market in the 1990's as compared to the 1980's. Further, he finds that seven of the 1998 top 15 underwriters are not in the 1985 top 15. Also, more than 15 different firms had been a top five underwriter at least once since 1985. In the post-1992 period, five large commercial banks have joined the league table's top 15 positions. Moreover, 27 different firms ranked in the top 15, and 11 different banks occupied a top five spot.

An interesting question is whether bank entry into underwriting has lowered the concentration of this industry. Gande, Puri and Saunders (1999) report that the five-firm concentration ratio and Herfindahl index for debt issues had declined, respectively, from 75.62% and 1506.38 in 1985 to 61.72% and 1175.43 in 1996. The drop in concentration was even more dramatic for lower quality debt (Caa-Ba3 rating): from 86.40% to 47.88% for the five-firm concentration ratio and from 3786.98 to 754.71 for the Herfindahl index over the same period. The decline for high quality debt was much smaller. Their findings corroborate the evidence that commercial banks have a comparative advantage in price discovery over pure investment banks in the case of issues with higher information production costs. Hansen (2001) estimates the Herfindahl index for IPOs and finds that it peaked in the 1988-1991 period

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(values ranged between 1200 and 1400) but subsided to just below 1000 in the 1992-2000 period.<sup>4</sup> A similar pattern was noted for the values of the four-firm concentration ratio. However, both the Herfindahl index and the four-firm concentration ratio were higher, on average, in the late 1990's than in the mid-1980's. Dovlin (2005) finds similar evidence for IPOs. The four-firm concentration ratio had increased from 38.6% in the 1980-1984 period to 55.9% in the 1995-2000 period. Similarly, the Herfindahl index had risen from 605.5 to 980.0 over the same periods. In his study of the determinants of IPO market share, Dunbar (2000) reports that the Herfindahl index peaked between 1091 and 1478 (signifying moderate concentration) in the years 1989-1990, but it returned to its lower previous range of 500-900 (signifying lack of concentration) in the 1991-1994 period. Corwin and Schultz (2005) calculate the Herfindahl index (in percentage form) for IPOs in the 1997-2002 period and find it to be stable at around 29.80%.

The overall evidence suggests that more firms were able to enter the top (at least 15) rankings of the league tables, and entry into the underwriting industry had increased in the 1990's. Although commercial banks captured and expanded their market share (most often through acquisitions of established investment banks) they did not appear to gain additional share as a result of the alleged synergies. Finally, industry concentration appeared to decrease mostly for debt offerings but not for equity issues.

### **6. EVIDENCE ON OWNERSHIP STRUCTURE, COMPETITION AND CONCENTRATION**

In this section we present data that show (a) changes in the ownership and organizational form of investment banks; (b) the entry and placement rates of pure investment banks and commercial bank affiliates in the underwriting league tables; and (c) changes in market concentration in the underwriting of securities. We analyze these data from 1985 to 2000, a period that starts before the approval of Section 20 subsidiaries and ends after the passage of the FSMA of 1999.

#### **6.1. Evidence on Ownership Structure**

We focus our analysis on the top ranked underwriters as shown in the league tables published by the *Investment Dealers' Digest* (IDD). These tables

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<sup>4</sup> According to the Department of Justice, a Herfindahl index value greater than 1800 indicate high concentration; a value between 1000 and 1800 indicates moderate concentration; and a value of less than 1000 signifies no concentration.

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rank by dollar volume of underwriting the top 15 book-running managers for various categories and subcategories of securities (i.e., equity, debt, IPOs, etc.). We choose the all-encompassing category of “all domestic issues” and identify the ranked underwriters in the years: 1985, 1990, 1995 and 2000. We classify these underwriters into several groups. “Independent investment banks” are those securities firms which are not majority-owned by another firm. “Affiliated investment banks” are securities firms operated as separate entities, but are majority-owned by another firm like a commercial bank, a non-bank financial firm (including insurance companies) or an industrial firm. “Public” are publicly held securities firms or affiliates whose parent firm is a publicly held firm. “Private” are privately held securities firms or affiliates whose parent firm is a privately owned firm. The annual issues of the *Yearbook* published by the Securities Industry Association are the source for the ownership status of our sample of underwriters.

Table 1 shows that of the top 14 investment banks in 1985, 11 were independent securities firms and 3 were affiliated with other firms, none of which were commercial banks. The number of independent securities firms (among the top 15) had declined to 5 by 2000. Nine of the remaining securities firms were owned by banks and one was owned by a non-bank financial firm. This is clear evidence of the consolidation that took place as a result of the deregulation. In most cases, the ascendancy of commercial banks (via subsidiaries) to the top ranks had been accomplished through external acquisition of major and sub-major pure investment banks rather than *de novo*. This trend corroborates the evidence that the value gains accrued to pure investment banks, reported in the previously cited studies, emanated from the expectation of takeovers. Table 1 also shows that by 2000 none of the underwriting firms were privately held (6 of the top 14 were private in 1985). The last holdout was Goldman Sachs which went public in 1999. The drive to public ownership was due to the need for more capital in order to cope with the costs of technology, participation in shelf registration offerings and large secondary market sales through bought deals and increased risks from trading and other investment type activities (for example, private equity and hedge funds). Finally, it is interesting to note that whereas none of the top 14 underwriters in 1985 were owned by a foreign firm, five of the top 15 underwriters were affiliated with foreign firms in 2000. This signifies both the rapid pace of globalization and the need foreign institutions had to enter the U.S. new issues market in order to establish their world-class credentials.



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**Table 1**  
Ownership Structure and Organizational Form of Underwriting Firms  
Period: 1985-2000

Status	1985	1990	1995	2000
<b>Independent</b>	11	6	7	5
Public	5	5	5	5
Private	6	1	1	0
<b>Affiliated</b>	3	9	8	10
With				
Commercial Banks	0	3	5	9
Financial Cos. / Insurance	2	4	3	1
Industria Firms	1	2	0	0
Public	3	9	8	10
Private	0	0	0	0

## 6.2. Evidence on Competition for Rankings

Conventionally, reputation in underwriting is based on the investment bank's place in the tombstone advertisements announcing new issues. This has led to a stratification of underwriters into "bulge bracket," "major," "sub-major," and other levels of lesser importance. The more underwriting deals an investment bank originates as a lead manager the higher its ranking in the league tables and, hence, the higher its status in the above hierarchical groupings. Academic studies have found that the reputation of an underwriter has important implications for the types of securities they underwrite, the degree of underpricing, and the spreads they charge (see Carter and Manaster, 1999). If indeed underwriting by commercial bank affiliates enjoys comparative advantages over underwriting done by pure investment banks, this should be reflected in the relative rankings of these two groups of underwriters.

We analyze the rankings in the league tables for various categories of securities in the period 1985-2000. We divide this period into two sub-periods: 1985-1990 and 1991-2000. The first period starts before the introduction of Section 20 subsidiaries and ends in 1990, a period during which Section 20 subsidiaries had not started yet to underwrite equity offerings. The second period from 1991 to 2000 encompasses all the major deregulation stages, including the passage of the FSMA in 1999. The categories of underwritten securities we select are such that they represent underwriting activity in the

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most important and comprehensive areas of domestic and international underwriting. The source of these data is the *Investment Dealers' Digest*.

We examine first how deregulation affected the rankings of the bulge bracket investment banks. Since the late 1970's the investment banks considered as bulge bracket firms have been: CS First Boston, Goldman Sachs, Lehman Brothers, Merrill Lynch, Morgan Stanley and Salomon Brothers (subsequently folded into Citigroup). Table 2 shows the percentage of times a bulge bracket firm occupied the top fifteen and top six positions, respectively, in the IDD league tables according to their underwriting volume for selected categories of securities. With very few exceptions, the tables give the top 15 underwriters in each type of security. Therefore, if all six bulge bracket firms occupied one of the top 15 rankings in each year, their maximum placement rate would be 40% (i.e., 6 divided by 15). Correspondingly, if all bulge bracket firms occupied the top six rankings, their maximum placement rate would be 100%.

The data of Table 2 show that the six bulge bracket firms achieved the maximum top 15 placement rate of 40% in five of the ten categories in the 1985-1990 period. They were even more successful in the period of Section 20 operations, 1991-2000, when they captured the maximum placement rate of 40% in seven of the categories. Bulge bracket firms managed to increase their average top 15 placement rate from 38.27% in the 1985-1990 period to 38.67% in the 1991-2000 period. Similarly, bulge bracket firms increased their average top six placement rate from 72.23% in 1985-1990 to 75.16% in 1991-2000. The findings imply that bulge bracket firms responded resiliently and successfully to the increased competition following the gradual and eventual deregulation of the underwriting industry. It is interesting to note that bulge bracket firms had also managed to increase their profile in the area of international underwriting during the 1991-2000 period. However, the success of the bulge bracket firms does not necessarily reflect the staying power of pure investment banks. Two of the bulge bracket firms, CS First Boston and Salomon Brothers (along with Shearson and Smith Barney) had become part of Credit Suisse and Travelers (Citigroup), respectively.

Table 3 presents data that show the placement rates of commercial bank affiliates. The ranking-based profile of these underwriters posts dramatic improvement both with respect to placing in the top 15 as well as the top six positions of the league tables. This is, of course, the natural result of deregulation that allowed banks to pursue underwriting business with much greater latitude. Thus, the average top 15 placement rate of commercial bank affiliates rose from 12.32% in the 1985-1990 period to 36.67% in the 1991-2000 period. The top six placement rate increased from 8.21% in the 1985-1990 period to 23.18% in the 1991-2000 period. Importantly, commercial bank

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affiliates were able to raise their ranking-based profile in all ten categories of securities in the domestic and the global market.

**Table 2**  
Percentage of Times Bulge Bracket Investment Banks Ranked in the Top 15 and Top 6 Positions in Underwriting

Category Name	Initial & Final Yr.	1985 - 2000 Top 15	1985 - 2000 Top 6	1985 - 1990 Top 15	1985 - 1990 Top 6	1991 - 2000 Top 15	1991 - 2000 Top 6
All Domestic Issues	1985 - 2000	0.400	0.885	0.400	0.889	0.400	0.883
Non-Convertible / Investment-Grade Debt	1985 - 2000	0.388	0.760	0.367	0.750	0.400	0.767
Non-Investment-Grade Debt / Junk Bonds	1985 - 2000	0.400	0.917	0.400	0.917	0.400	0.917
Mortgage-Related Debt	1985 - 2000	0.400	0.667	0.400	0.778	0.400	0.600
Common Stock	1985 - 2000	0.400	0.729	0.400	0.694	0.400	0.750
IPO	1985 - 2000	0.396	0.625	0.389	0.528	0.400	0.683
All Municipal Bonds	1985 - 2000	0.333	0.677	0.356	0.667	0.320	0.683
Global Debt and Equity	1987 - 2000	0.400	0.893	0.400	0.875	0.400	0.900
Eurobonds	1985 - 2000	0.325	0.365	0.325	0.167	0.360	0.483
Yankee Bonds	1987 - 2000	0.390	0.881	0.390	0.958	0.387	0.850
Average		0.383	0.74	0.383	0.722	0.387	0.752

The columns "Initial Year" and "Final Year" indicate the first and last year data was reported for this category in the period. Bulge bracket firms: Merrill Lynch, Morgan Stanley, Salomon Smith Barney (Citigroup), CS First Boston (CSFB), Goldman Sachs, and Lemman Brothers.

**Table 3**  
Percentage of Times Commercial Banks and Affiliates Ranked in the Top 15 and Top 6 Positions in Underwriting

Category Name	Initial & Final Yr.	1985 - 2000 Top 15	1985 - 2000 Top 6	1985 - 1990 Top 15	1985 - 1990 Top 6	1991 - 2000 Top 15	1991 - 2000 Top 6
All Domestic Issues	1985 - 2000	0.238	0.135	0.067	0.000	0.340	0.217
Non-Convertible / Investment-Grade Debt	1985 - 2000	0.267	0.115	0.022	0.028	0.413	0.167
Non-Investment-Grade Debt / Junk Bonds	1985 - 2000	0.292	0.156	0.078	0.056	0.420	0.217
Mortgage-Related Debt	1985 - 2000	0.246	0.104	0.122	0.056	0.320	0.133
Common Stock	1985 - 2000	0.163	0.135	0.022	0.000	0.247	0.217
IPO	1985 - 2000	0.167	0.115	0.022	0.000	0.253	0.183
All Municipal Bonds	1985 - 2000	0.204	0.125	0.144	0.056	0.240	0.167
Global Debt and Equity	1987 - 2000	0.343	0.179	0.183	0.083	0.407	0.217
Eurobonds	1985 - 2000	0.558	0.510	0.489	0.417	0.600	0.567
Yankee Bonds	1987 - 2000	0.329	0.238	0.083	0.125	0.427	0.283
Average		0.28	0.181	0.123	0.082	0.367	0.237

The columns "Initial Year" and "Final Year" indicate the first and last year data was reported for this category in the period. Firms have been included in the sample of commercial banks and affiliates if they were part of, or controlled by, a commercial bank. This also applies to CS First Boston and Salomon Smith Barney for the years they were affiliated with a commercial bank.

### 6.3. Ease of Entry into the Top Rankings

Persistent occupation of the top ranks by the same firms can signify either the existence of institutional barriers to entry (e.g., regulation) or firm-specific efficiencies. Both of these reasons are relevant in the case of the

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underwriting industry. Prior to the approval of Section 20 powers for commercial banks, securities firms were shielded from outside competition. Underwriting also requires human capital and intangible assets (like reputation and relationships) which take time to develop. For our purposes, we want to investigate the impact of regulation. If allowing commercial banks to enter underwriting business increased competition, then we should observe a greater number of different firms entering the top rankings of various classes of security offerings.

Table 4 presents the number of all firms that served as lead managers in the underwriting of various categories of securities and ranked in the top 15 positions of the league tables in the periods 1985-2000, 1985-1990 and 1991-2000. A greater number of firms signifies easier entry into the top rankings of the underwriting business, an indication of increased competition. We observe that in all ten categories the number of firms that managed to rank in the top 15 spots had increased, on average, by 50% in the 1991-2000 period compared to the 1985-1990 period. Interestingly, this happened as the consolidation of the industry intensified and, hence, the number of underwriters shrank during the later period. The highest number of underwriters placed in the top 15 was in the categories of IPOs, common stock and Yankee bonds. The two categories where there was a drop in the number of firms placed in the top six spots were "non-investment grade and junk bonds" and "mortgage-related debt." These are exactly the types of securities where banks had a distinct advantage. We can infer that once certain banks achieved top status, it was difficult to dislodge them, or that consolidation was more extensive within the underwriting industry segment that served those securities.

A related piece of evidence comes from the number of *new* underwriting firms that enter the top ranks of the league tables. Table 5 presents the pertinent data for two periods: 1991-1995 and 1996-2000. We count the new (different) firms that ranked in the top 15 or top six spots, respectively, in these two periods using 1985-1990 as the base period. With the exception of the international offerings, the number of new firms ranked in the top 15 spots was greater in the 1996-2000 period than in the 1990-1995 period. This is evidence that the U.S. domestic underwriting market became more competitive as deregulation accelerated and finally freed banks to enter the underwriting business. Mobility is very low, however, with respect to entry into the top six positions. Only a few firms succeed in entering the top six spots in the 1996- 2000 period. The only exceptions are Eurobonds and Yankee bonds.

The above evidence suggests that whereas entry into the league tables (i.e., the top 15 spots) has become easier as a result of deregulation, there are significant barriers to entry into the top six spots. This corroborates the evidence, reported in Table 2, that the traditional bulge bracket firms have

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defended successfully their market share in the face of new entrants into the underwriting industry.

**Table 4**  
Number of Investment Banks Ranked in the Top 15 and Top 6  
Positions in Underwriting

Category Name	Initial & Final Yr.	1985-2000 Top 15	1985-2000 Top 6	1985-1990 Top 15	1985-1990 Top 6	1991-2000 Top15	1991-2000 Top 6
All Domestic Issues	1985 - 2000	33	10	22	8	28	9
Non-Convertible / Investment-Grade Debt	1985 - 2000	33	9	21	7	28	8
Non-Investment-Grade Debt / Junk Bonds	1985 - 2000	44	17	27	14	29	10
Mortgage-Related Debt	1985 - 2000	34	13	23	11	27	10
Common Stock	1985 - 2000	40	15	21	11	35	12
IPO	1985 - 2000	44	18	22	13	37	14
All Municipal Bonds	1985 - 2000	34	13	24	9	30	11
Global Debt and Equity	1987 - 2000	30	9	17	8	28	8
Eurobonds	1985 - 2000	32	18	25	12	29	15
Yankee Bonds	1987 - 2000	42	12	11	7	41	11
Average		36.6	13.4	21.3	10	31.2	10.8

The columns "Initial Year" and "Final Year" indicate the first and last year data was reported for the category in each period. The sum of the second and third period does not equal the number in the first period because the same investment bank is counted each time it appears in a sub-period. In some years and security categories, the count of investment banks may be less than 15 because of non-reported data or because there were no other banks.

**Table 5**  
Number of New Investment Banks Ranked in the Top 15 and Top 6  
Positions in Underwriting

Category Name	Initial & Final Yr.	1991-1995 Top 15	1991-1995 Top 6	1996-2000 Top 15	1996-2000 Top 6
All Domestic Issues	1985 - 2000	4	1	7	1
Non-Convertible / Investment-Grade Debt	1985 - 2000	4	0	8	2
Non-Investment-Grade Debt / Junk Bonds	1985 - 2000	8	1	9	2
Mortgage-Related Debt	1985 - 2000	5	2	6	0
Common Stock	1985 - 2000	6	2	13	2
IPO	1985 - 2000	7	3	15	2
All Municipal Bonds	1985 - 2000	5	2	5	2
Global Debt and Equity	1987 - 2000	7	0	6	1
Eurobonds	1985 - 2000	4	5	3	1
Yankee Bonds	1987 - 2000	17	0	14	5
Average		6.7	1.6	8.6	1.8

The columns "Initial Year" and "Final Year" indicate the first and last year data was reported for this category in the period.

#### 6.4. Evidence on Market Concentration

We use the four-firm concentration ratio (FCR4) to investigate the impact of the banks' entry on the competitive structure of the new offerings

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markets.<sup>5</sup> Table 6 presents the average FCR4 for each category of securities in the three periods: 1985-2000, 1985-1990, and 1991-2000. There are some interesting patterns in the data. The concentration ratio declined for the “all domestic issues” as well as the “global debt and equity” category. However, the trend was not in the same direction for sub-categories of issues. For example, the domestic debt issues (excluding municipal debt) experienced a decline in concentration, hence an increase in competition. This is consistent with the evidence of increased competition by banks in the market of corporate debt underwriting. On the contrary, the concentration increased in the underwriting of IPOs and SEOs. Concentration also rose in the underwriting market for Eurobonds and Yankee bonds. These findings suggest that commercial bank entry into the underwriting of equity and other specialized issues did not have the same pro-competitive effect as their entry into debt underwriting. The average concentration ratio for all ten categories declined only slightly from 51.7% in 1985-1990 to 48.6% in 1991-2000.

**Table 6**  
Average Four-Firm Concentration Ratios for Categories of  
Underwritten Securities

Category Name	Initial & Final Yr.	1985-2000	1985-1990	1991-2000
All Domestic Issues	1985 - 2000	0.495	0.530	0.490
Non-Convertible / Investment-Grade Debt	1985 - 2000	0.572	0.617	0.564
Non-Investment-Grade Debt / Junk Bonds	1985 - 2000	0.546	0.739	0.506
Mortgage-Related Debt	1985 - 2000	0.502	0.533	0.495
Common Stock	1985 - 2000	0.518	0.447	0.530
IPO	1985 - 2000	0.524	0.482	0.533
All Municipal Bonds	1985 - 2000	0.375	0.339	0.388
Global Debt and Equity	1987 - 2000	0.400	0.360	0.404
Eurobonds	1985 - 2000	0.276	0.316	0.268
Yankee Bonds	1987 - 2000	0.687	0.804	0.683
Average		0.489	0.517	0.486

The columns “Initial Year” and “Final Year” indicate the first and last year data was reported for this category in the period.

<sup>5</sup> The four-firm concentration ratio is computed as the ratio of the sum of the gross proceeds of the issues managed by the top four underwriters within a year to the total gross proceeds raised from all issues for that category of securities.

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**7. SUMMARY AND CONCLUSIONS**

The gradual deregulation of investment banking services starting in 1987 and culminating in the repeal of the Glass-Steagall Act in 1999 should have serious implications for the structure and performance of the industry. Commercial banks and securities firms would be free to deploy their resources over a greater scope of operations and achieve potential synergies. The entry of additional underwriters should put pressure on underwriter fees and lower underpricing costs. As a result of these effects, we should observe changes in ownership and market structure.

Our review of the academic evidence reveals that the market reacted positively to the deregulation and as a result both commercial and investment banks realized value gains. Apparently, the market's assessment was that the benefits from synergies exceeded the negative impact of increased competition. The weight of the evidence also points toward a downward pressure on underwriter fees for debt offerings but not for equities. The impact of deregulation was found to be more pronounced on the pricing of new issues. Overall underpricing has declined for debt issues, and especially so for low quality debt. Commercial banks are able to price debt and equity issues better than pure investment banks when they have prior lending relationships with the issuers and proceeds are not used to repay bank loans. These findings are consistent with both the certification and the conflict of interest hypotheses. However, there is also evidence that finds no appreciable differences in the underpricing of debt issues between commercial and investment banks or an improvement in overall underpricing as a result of the banks' entry. The evidence will become more robust as more time will allow assessing the lasting effects of deregulation on issuance costs.

Previous studies show that commercial banks made significant gains in market share, especially in debt underwriting, but in most cases this was accomplished by acquiring established securities firms. However, these acquisitions have not generated additional synergistic market share gains in equity underwriting. Deregulation has increased the number of players, and mobility in and out of the top ranks has intensified - both signs of heightened competition. Although concentration has increased in the debt market, it has decreased in the IPO market.

Our own findings reveal that the impact of deregulation is rather mixed. As expected, U.S. and foreign commercial banks moved in quickly to acquire securities firms as a way to enter the underwriting business. Thus, by 2000, only a third of the top 15 underwriters were independent, pure investment banks. None of these underwriters were a private firm anymore.

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We find the new competition has not reduced the profile of the six bulge bracket firms. The degree with which they persist to occupy the top 15 and six positions in the league tables signifies that the climb to the top is still extraordinarily difficult. This is testimony to the power of reputation and the unusual skills brought to bear in retaining and managing complex networks of issuers and investors that give top underwriters an unrivaled strength in originating and placing new issues. Consistent with past studies, we find that the number of firms that appear in the league tables has increased in the 1990's; hence, deregulation has brought in new players in the industry. Mobility with respect to the top six positions has been extremely low nonetheless.

Finally, we find that whereas concentration has decreased in debt underwriting, it has increased in equity offerings and some international securities, like Eurobonds and Yankee bonds. This suggests that the skills needed for debt underwriting are more diffused than the skills needed to execute deals in more complex types of securities.

As the overall evidence shows, commercial banks have made significant inroads in investment banking by taking over securities firms and capturing a good fraction of the market share. The question, then, is whether this trend will last resulting in an organizational form that combines commercial and investment banking activities under the same roof. It is rather too early to tell. As the recent history of scandals has shown, there are too many conflicts of interest in running joint capital market operations. If also the evidence on the conglomerate discount is any guide, financial institutions may find the cost of managing conflicts of interest and diverse services to exceed profits.



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## RESPONSIBILITY TO PROTECT, HUMANITARIAN INTERVENTION AND NORTH KOREA

*Young Sok KIM\**

### I. INTRODUCTION

In the aftermath of the collapse of the Warsaw Pact and the disintegration of the Soviet Union, there has been a great deal of discussions promoting “humanitarian intervention” and its corollary “responsibility to protect.” The purpose of this article is to examine the so-called doctrine of “humanitarian intervention” and “responsibility to protect” in accordance with the changing character of state sovereignty and the requirements of international law.

Recently, the doctrine of humanitarian intervention has been increasingly used by the United States and the NATO member states including the United Kingdom in justification of their intervention into countries such as the former Yugoslavia, Kosovo, Afghanistan and Iraq. “For example, once it became clear that the [George W. Bush] administration could not produce any weapons of mass destruction in Iraq, the administration fell back upon the retroactive application of the doctrine of “humanitarian intervention” in order to somehow justify its war of aggression against Iraq on an ex post facto basis.”<sup>1</sup>

Then, what is the definition of humanitarian intervention? Even though the term is filled with ambiguity and subject to endless debate,

a working definition of “humanitarian intervention” is best limited to the threat or use of force by a state, group of states, or international organization primarily for the purpose of

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<sup>1</sup> FRANCIS A. BOYLE, DESTROYING WORLD ORDER: U.S. IMPERIALISM IN THE MIDDLE EAST BEFORE AND AFTER SEPTEMBER 11<sup>TH</sup> 106 (Clarity Press, 2004).

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protecting the nationals of the target state from widespread deprivations of internationally recognized human rights, whether or not the intervention is authorized by the target state or the international community.<sup>2</sup>

Therefore, the rescue by states of their own nationals or transboundary action by non-governmental organizations (NGOs) such as the International Committee of the Red Cross (ICRC) are not included within this scope. The focus here is on state action, not NGO's, and on the protection of the target state's nationals, not their own nationals.

Further, the humanitarian intervention may be subdivided as "UN-authorized humanitarian intervention" and "unilateral humanitarian intervention." The former is defined as a state or states acting under the express authority of the United Nations (UN or United Nations) Security Council pursuant to Chapter VII of the UN Charter while the latter is when humanitarian intervention is undertaken by a state or states acting without the authority of either the United Nations or a regional organization.

In this article, I briefly examine the changing character of the norms of sovereignty and the notion of responsibility to protect, and show that "unilateral humanitarian intervention" is still in violation of international law while "UN-authorized humanitarian intervention" may be permitted and used under the strict scrutiny of international law requirements.

## II. THE CHANGING CHARACTER OF SOVEREIGNTY

The principle of state sovereignty was the traditional legal order of international relations. Sovereignty is the central notion of international law.<sup>3</sup> Sovereignty is described as "independence from any outside authority".<sup>4</sup> The purpose of international law was formerly described as creating legal safeguards for the preservation of the sovereign power vested in a territorial nation state.<sup>5</sup>

In the past centuries, sovereignty considered the nation state as the only legitimate international actor entitled to the protection of international

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<sup>2</sup> SEAN D. MURPHY, HUMANITARIAN INTERVENTION: THE UNITED NATIONS IN AN EVOLVING WORLD ORDER 3-4, vol. 21 (University of Pennsylvania Press, 1996).

<sup>3</sup> IAN BROWNLIE, PRINCIPLES OF PUBLIC INTERNATIONAL LAW 289-290 (Oxford University Press 5<sup>th</sup> ed. 1998).

<sup>4</sup> STANLEY HOFFMANN, THE ETHICS AND POLITICS OF HUMANITARIAN INTERVENTION 12 (University of Notre Dame Press 1996).

<sup>5</sup> David J. Scheffer, *Toward a Modern Doctrine of Humanitarian Intervention*, 23 U. TOL. L. REV. 253, 259-260 (1992).

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law.<sup>6</sup> The reigning international legal positivist doctrine said that “only states could properly be considered the subjects of public international law endowed with international legal personality, and therefore individuals were merely objects of international law.”<sup>7</sup>

However, this exclusive premise of sovereignty no longer prevails. Nations are not the only actors in international affairs. There are many regional and international organizations exercising jurisdiction across national borders such as the UN and the Organization of American States (OAS). Further, the international human rights treaties for protecting individual human rights can challenge the sovereign power of a nation state by permitting individuals to claim their own human rights independently before international forums such as the Human Rights Committee under the International Covenant on Civil and Political Rights (ICCPR).<sup>8</sup> Moreover, the International Criminal Court (ICC), which was established in 1998 and has 100 state parties, pursues “individual criminal responsibility” of the violators of international law, not the state responsibility of the violators’ state of nationality.<sup>9</sup>

Therefore, the notion of sovereignty is changing and, “within the system of international relation[s,] the principle of sovereign consent has proven to be increasingly unworkable.”<sup>10</sup> “Today the nations of the world are [trying] to cope with the progressive evolution of a system of international relations that needs to move away from the notion of sovereign consent. . .and toward its replacement by the principle of consensus founded on reciprocal expectations of state behavior.”<sup>11</sup>

Professor Oscar Schachter also wrote that “[t]he fact that increasingly treaties in the economic and social fields as well as in the area of the law of war recognize the well-being of individuals as their *raison d’être* is further evidence that international law is moving away from its State-centered orientation.”<sup>12</sup>

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<sup>6</sup> *Id.*

<sup>7</sup> FRANCIS A. BOYLE, FOUNDATIONS OF WORLD ORDER: THE LEGALIST APPROACH TO INTERNATIONAL RELATIONS (1898-1922) 61 (Duke University Press 1999).

<sup>8</sup> THOMAS BUERGENTHAL ET AL. INTERNATIONAL HUMAN RIGHTS IN A NUTSHELL 59 (West Group, 3<sup>rd</sup> ed., 2002).

<sup>9</sup> Rome Statute of the International Criminal Court, art. 25, July 17, 1998, 37 ILM 999; Young Sok, Kim, The International Criminal Court: A Commentary of the Rome Statute, 337-344 (2000) (unpublished JSD dissertation University of Illinois Urbana-Champaign, UMI Dissertation Services) (on file with author).

<sup>10</sup> Boyle, *supra* note 7, at 15.

<sup>11</sup> *Id.*

<sup>12</sup> OSCAR SCHACHTER, INTERNATIONAL LAW IN THEORY AND PRACTICE 81 (Martinus Nijhoff Publishers 1991).

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**III. STATE SOVEREIGNTY AND NON-INTERVENTION IN DOMESTIC AFFAIRS**

The corollaries of the principle of state sovereignty “are the norm of the equality of rights of states and the norm of nonintervention in a state’s domestic affairs.”<sup>13</sup> Then, what is the implication of this changing character of sovereignty to the principle of nonintervention in domestic affairs? The principle is provided in Article 2(7) of the UN Charter as follows:

Nothing contained in the present Charter shall authorize the United Nations to intervene in matters which are essentially within the domestic jurisdiction of any state or shall require the Members to submit such matters to settlement under the present Charter; but this principle shall not prejudice the application of enforcement measures under Chapter VII.<sup>14</sup>

Even though the words “domestic jurisdiction” seems definite, it has been interpreted as having evolving meanings. “In the past, the United Nations found that “domestic jurisdiction” was [not an obstacle] to de-colonization or anti-apartheid measures.”<sup>15</sup> Further, if a state has a treaty obligation or an obligation under customary international law, the state is bound to the obligation. For example, Article 27 of the Vienna Convention on the Law of Treaties provides “A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty.”<sup>16</sup> Thus, as more nations commit to international treaties and customary international law expands its reach, the concept of “domestic jurisdiction” shrinks.<sup>17</sup>

In his annual report in 1991, UN Secretary-General Javier Perez de Cuellar stressed the importance of striking a balance between the rights of states and the rights of the individual by writing as follows:

I believe that the protection of human rights has now become one of the keystones in the arch of peace. I am also convinced that it now involves more a concerted exertion of international influence and pressure through timely appeal, admonition, remonstrance or condemnation and, in the last resort, an

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<sup>13</sup> HOFFMANN, *supra* note 4, at 12.

<sup>14</sup> U.N. CHARTER art. 2, para. 7.

<sup>15</sup> SCHEFFER, *supra* note 5, at 261.

<sup>16</sup> Vienna Convention on the Law of Treaties, art 27, May 23, 1969, 1155 U.N.T.S. 331.

<sup>17</sup> SCHEFFER, *supra* note 5, at 262.

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appropriate United Nations presence, than what was regarded as permissible under traditional international law.<sup>18</sup>

However, Perez de Cuellar did not argue for “humanitarian intervention”, but for “a higher degree of cooperation and a combination of common sense and compassion.”<sup>19</sup> He wrote that

We need not impale ourselves on the horns of a dilemma between respect for sovereignty and the protection of human rights. . . . What is involved is not right of intervention but the collective obligation of States to bring relief and redress in human rights emergencies.<sup>20</sup>

#### IV. SCHOLARS’ OPINIONS ON UNILATERAL HUMANITARIAN INTERVENTION

##### 1.The Opinion of Antoine Rougier

“The first comprehensive study of humanitarian intervention was published by Antoine Rougier in 1910.”<sup>21</sup> He concluded that humanitarian intervention looks like “an ingenious juridical technique to encroach little by little upon the independence of a State” as the following:

The conclusion which emerges from this study is that it is neither possible to separate the humanitarian from the political grounds for intervention nor to assure the complete disinterestedness for the intervening States. . . . Whenever one power intervenes in the name of humanity in the domain of another power, it cannot but impose its concept of justice and public policy on the other State, by force if necessary. Its intervention tends definitely to draw the [other] State into its moral and social sphere of influence. It will control the other State while preparing to dominate it. Humanitarian intervention consequently looks like an ingenious juridical

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<sup>18</sup> *Id.*

<sup>19</sup> *Id.* at 263.

<sup>20</sup> *Id.* at 263.

<sup>21</sup> BOYLE, *supra* note 1, at 107 *citing* A. Rougier, La théorie de l’intervention d’humanité, 17 *Revue général de droit international public* 468.



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technique to encroach little by little upon the independence of a State in order to reduce it progressively to the status of semi-sovereignty.<sup>22</sup>

### 2. The Opinion of Francis A. Boyle

Francis A. Boyle, Professor of International law at the University of Illinois, “examined the entire history of United States military intervention into the Western Hemisphere and the Pacific Basin from shortly before the Spanish-American War of 1898 up to the . . . Good Neighbor Policy of President Franklin Roosevelt’s administration starting in 1932.”<sup>23</sup> Even though “almost all of these military interventions were publicly justified on some type of humanitarian grounds by the United States government[, he wrote, according to] actual historical records[.]. . . that this specious rationale was nothing more than mere propaganda disseminated for the purpose of building public support for military intervention.”<sup>24</sup> Professor Boyle concluded that “under international law, ‘humanitarian intervention’ is a joke and a fraud that has been repeatedly manipulated and abused by a small number of very powerful countries in the North in order to justify wanton military aggression against and prolonged military occupation of weak countries of the South.”<sup>25</sup>

### 3. The Opinion of Ian Brownlie

Professor Ian Brownlie of Oxford said that operation of the doctrine of humanitarian intervention was “open to abuse since only powerful states could undertake police measures of this sort.”<sup>26</sup> He concluded that “no genuine case of humanitarian intervention has occurred, with the possible exception of the occupation of Syria in 1860 and 1861. With the embarrassing exception provided by Nazi Germany, the institution has disappeared from modern state practice”<sup>27</sup>

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<sup>22</sup> BOYLE, *supra* note 1, at 107.

<sup>23</sup> BOYLE, *supra* note 1, at 107.

<sup>24</sup> BOYLE, *supra* note 1, at 107. *See also* BOYLE, *supra* note 7.

<sup>25</sup> BOYLE, *supra* note 1, at 106.

<sup>26</sup> IAN BROWNLIE, *INTERNATIONAL LAW AND THE USE OF FORCE BY STATES* 338 (7<sup>th</sup> ed. 1991).

<sup>27</sup> *Id.* at 340.

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**4. The Opinion of Michael Akehurst**

In an article, Professor Michael Akehurst reviewed state practice regarding humanitarian intervention since 1945 including Vietnamese intervention against Cambodia.<sup>28</sup>

At the beginning of 1979 Vietnam overthrew the Pol Pot regime in Cambodia. But, instead of claiming to have exercised a right of humanitarian intervention, Vietnam denied that its forces had entered Cambodia and said that Pol Pot had been overthrown by the Cambodian people.<sup>29</sup>

In the Security Council debate in January 1979, many states said that “Vietnam had acted illegally by intervening in Cambodia’s internal affairs.”<sup>30</sup> Professor Akehurst observed that “Several of these states mentioned the Pol Pot regime’s appalling violations of human rights, but nevertheless said that those violations did not entitle Vietnam to overthrow that regime. Not a single state spoke in [favor] of the existence of a right of humanitarian intervention.”<sup>31</sup>

He concluded as follows:

From this brief survey of state practice, it will be seen that the concept of humanitarian intervention has been invoked by states on a surprisingly small number of occasions since 1945, and on each occasion humanitarian intervention has been condemned as illegal by other states. Moreover, the United Nations debates on Cambodia in 1979 provide some evidence that there is now a consensus among states in [favor] of treating humanitarian intervention as illegal.<sup>32</sup>

**5. The Opinion of Hedley Bull**

Hedley Bull, former Professor of International Relations at Oxford University, recognized that the “developments in international law in recent decades, especially in the field of human rights[, might]. . . provide a wide

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<sup>28</sup> Michael Akehurst, *Humanitarian Intervention*, in INTERVENTION IN WORLD POLITICS 95 (Hedley Bull ed., 1984).

<sup>29</sup> *Id.* at 97.

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> *Id.* at 99.

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mandate for legitimate forms of outside involvement in what was previously considered the sphere of jurisdiction of states.”<sup>33</sup> However, he opposed unilateral humanitarian intervention as follows:

[W]e have a rule of non-intervention because unilateral intervention threatens the harmony and concord of the society of sovereign states. If, however, an intervention itself expresses the collective will of the society of states, it may be carried out without bringing that harmony and concord into jeopardy.<sup>34</sup>

### 6. The Opinion of Sean D. Murphy

Professor Murphy wrote a book entitled “Humanitarian Intervention” while he was a lawyer working for the United States Department of State. He concluded against humanitarian intervention in his book: “In conclusion, unilateral humanitarian intervention finds little support in the rules of the UN Charter and in state practice in the post Charter era. . .”<sup>35</sup> After reviewing incidents of military intervention after the Cold War such as Liberia, Iraq, Bosnia and Herzegovina, Somalia, Rwanda, and Haiti, Professor Murphy summed up: “Recent events show a striking willingness of states to forego unilateral humanitarian intervention in favor of Security Council authorization, thereby reinforcing the views of those that regard unilateral humanitarian intervention as unlawful.”<sup>36</sup>

### 7. Conclusion

Most of the renowned scholars noted above opine that unilateral humanitarian intervention should not be permitted under current international law. Further, other eminent scholars such as Philip C. Jessup,<sup>37</sup> Louis Henkin,<sup>38</sup>

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<sup>33</sup> INTERVENTION IN WORLD POLITICS 189 (Hedley Bull, ed., 1984).

<sup>34</sup> *Id.* at 195.

<sup>35</sup> MURPHY, *supra* note 2, at 387; BOYLE, *supra* note 1, at 108.

<sup>36</sup> MURPHY, *supra* note 2, at 393.

<sup>37</sup> PHILIP C. JESSUP, A MODERN LAW OF NATIONS-AN INTRODUCTION 172-174 (Archon Books 1956).

<sup>38</sup> LOUIS HENKIN, HOW NATIONS BEHAVE: LAW AND FOREIGN POLICY 164 (Frederick A. Praeger, Publishers, 2nd ed. 1979).

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Noam Chomsky,<sup>39</sup> and Oscar Schachter<sup>40</sup> are of the view that unilateral humanitarian intervention is in violation of international law.

## V. LEGITIMATE MILITARY INTERVENTION UNDER INTERNATIONAL LAW

### 1. The UN Charter Rules on the Use of Force

The UN Charter contains the “only legitimate justifications and procedures for the perpetration of violence and coercion by one state against another state.”<sup>41</sup>

[T]hese rules include the UN Charter’s Article 2(3) and Article 33(1) obligations for the peaceful settlement of international disputes; the Article 2(4) prohibition on the threat or use of force; and the Article 51 restriction of the right of individual or collective self-defense to repel an actual “armed attack” or “*aggression armée*,” according to the French-language version of the U.N. Charter.<sup>42</sup>

Concerning the right of self-defense, there are “two fundamental requirements for the “necessity” and “proportionality” of a state’s forceful response to the foreign armed attack or armed aggression.”<sup>43</sup>

### 2. International Judicial Cases against Humanitarian Intervention

#### (i) The Corfu Channel Case

The International Court of Justice (ICJ) unanimously rejected doctrines of “intervention”, “protection” and “self-help” in the *Corfu Channel Case* ((U.K. v. Alb.), 1949 ICJ 4(Apr. 9)) of 1949 as “being totally incompatible with

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<sup>39</sup> NOAM CHOMSKY, *ROGUE STATES: THE RULE OF FORCE IN WORLD AFFAIRS* 49-50 (South End Press 2000).

<sup>40</sup> SCHACHTER, *supra* note 12, at 125-126.

<sup>41</sup> BOYLE, *supra* note 1, at 109.

<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

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the proper conduct of international relations in the post World War II era.”<sup>44</sup> Rejecting the British arguments in support of these three doctrines in order to justify its military intervention into Albanian territorial waters, the ICJ ruled:

The Court cannot accept such a line of defence. The Court can only regard the alleged right of intervention as the manifestation of a policy of force, such as has, in the past, given rise to most serious abuses and such as cannot, whatever be the present defects in international organization, find a place in international law. Intervention is perhaps still less admissible in the particular form it would take here; for, from the nature of things, it would be reserved for the most powerful States, and might easily lead to perverting the administration of international justice itself.

The United Kingdom Agent, . . . has further classified “Operation Retail” among methods of self-protection or self-help. The Court cannot accept this defence either. Between independent States, respect for territorial sovereignty is an essential foundation of international relations. The Court recognizes that the Albanian Government’s complete failure to carry out its duties after the explosions, and the dilatory nature of its diplomatic notes, are extenuating circumstances for the action of the United Kingdom Government. But to ensure respect for international law, of which it is the organ, the Court must declare that the action of the British Navy constituted a violation of Albanian sovereignty.<sup>45</sup>

This ICJ decision rejecting doctrines of intervention, protection and self-help constituted an authoritative declaration of the requirements of customary international law binding upon all members of the international community.<sup>46</sup> Moreover,

when all states parties to an international dispute are members of the United Nations, [UN] Charter articles 2(3), 2(4), and 33 absolutely prohibit any unilateral or multilateral threat or use of force that is not specially justified by the article 51 right

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<sup>44</sup> *Id.*

<sup>45</sup> BOYLE, *supra* note 1, at 110-111.; Corfu Channel (U.K. v. Alb.), 1949 I.C.J. 3, 35 (Apr. 9).

<sup>46</sup> BOYLE, *supra* note 1, at 111.

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of....self-defense, or else authorized by the United Nations Security Council.<sup>47</sup>

**(ii) The Nicaragua Case**

In the decision of *Nicaragua v. United States of America* (1986), the ICJ condemned the United States Reagan administration's contra/terror war against Nicaragua.<sup>48</sup> In the *Nicaragua* Case, the ICJ "expressly rejected the assertion by the United States that it had. . .[a] right of military intervention against Nicaragua on the grounds of alleged human rights violations."<sup>49</sup>

"The *Corfu Channel* case and the *Nicaragua* case are the two leading and most conclusive. . .international law [cases] that soundly condemn in no uncertain terms the so-called doctrine of humanitarian intervention."<sup>50</sup>

**3. Conclusion**

From the discussions above, one may conclude that the

transnational threat or use of military force and military intervention by one state against another state is only permissible in [two cases: (1) the case] of individual or collective self-defense where the victim state of an armed attack has expressly requested such assistance from another state or states; (2) the case when the conduct is] lawfully authorized by the U.N. Security Council acting within the proper scope of the powers delegated to it by the U.N. member states under the terms of the United Nations Charter.<sup>51</sup>

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<sup>47</sup> *Id.*

<sup>48</sup> BOYLE, *supra* note 7, at 165-167.

<sup>49</sup> BOYLE, *supra* note 1, at 113. Military and Paramilitary Activities (Nicar. v. U.S.), 1986 I.C.J. 14, 134 (June 27). Especially, paragraph 268 of the decision provides "In any event, while the United States might form its own appraisal of the situation as to respect for human rights in Nicaragua, the use of force could not be the appropriate method to monitor or ensure such respect. . . The Court concludes that the argument derived from the preservation of human rights in Nicaragua cannot afford a legal justification for the conduct of the United States." *Id.*

<sup>50</sup> BOYLE, *supra* note 1, at 113.

<sup>51</sup> *Id.*

## RESPONSIBILITY TO PROTECT

**VI. HUMAN SECURITY AND RESPONSIBILITY TO PROTECT****1. The Advent of the Concept of Human Security**

In the 1990s, the concept of human security appeared. It means “freedom from fear - freedom from pervasive threats to people’s rights, safety, or lives”.<sup>52</sup> The concept of human security is derived from

the transformation of International Human Rights Law in general and International Humanitarian Law and Criminal Law in particular. [International law is being transformed] from a state-oriented [dimension] to a people-oriented dimension, having regard to both the struggle against impunity in respect of the perpetrators and the responsibility to protect in respect of the victims.<sup>53</sup>

This revolution in international law includes (1) “the internationalization of human rights and the humanization of international law[, (2)] the protection of civilians in armed conflict and the criminalization of atrocities against civilians; [and (3)] the emergence of the individual as the subject – and not just the object- of international law.”<sup>54</sup>

**2. Recent Developments concerning the Responsibility To Protect****(i) Canada’s ICISS report**

In 2000, inspired by the UN “Secretary General’s call to action- and the demonstrable consequences of inaction in Bosnia and Rwanda,. . . Canada . . . establish[ed] the International Commission on Intervention and the State Sovereignty (ICISS)”.<sup>55</sup> The Commission’s report “argues that, where states are

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<sup>52</sup> Irwin Cotler, Minister of Justice and Attorney General of Canada, *Building a New International Law: What Have We Learned, What Must We Do?*, Address to the Magna Carta Foundation (January 12, 2005), available at <http://www.news.gc.ca/cfmx/view/en/index.jsp?articleid=120399> (last visited Jan. 20, 2006).

<sup>53</sup> *Id.*

<sup>54</sup> *Id.*

<sup>55</sup> *Id.*

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unable or unwilling to protect their populations from mass atrocities- or where the state is itself the perpetrator- the international community has the responsibility to act.”<sup>56</sup> However, the ICISS Report makes it clear that military intervention needs authorization of the UN Security Council in stating

There is no better or more appropriate body than the United Nations Security Council to authorize military intervention for human protection purposes. The task is not to find alternatives to the Security Council, but to make the Security Council work better than it has.<sup>57</sup>

**(ii) UN High Level Panel Report**

Further, in December 2004, the United Nations High Level Panel on Threats, Challenges and Change issued a report, entitled “A More Secure World: Our Shared Responsibility.” Paragraph 203 of the Report endorsed a collective international responsibility to protect when sovereign governments have proved powerless or unwilling to prevent as follows:

We endorse the emerging norm that there is a collective international responsibility to protect, exercisable by the Security Council authorizing military intervention as a last resort, in the event of genocide and other large scale killing, ethnic cleansing or serious violations of international humanitarian law which sovereign Governments have proved powerless or unwilling to prevent.<sup>58</sup>

However, the UN Panel Report also summarized the threshold criteria and precautionary principles which restrain the responsibility to protect and forcible humanitarian intervention. These five precautionary principles are:

1) The Principle of the Seriousness of the Threat: Is the threat in question serious enough to justify the use of military force?

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<sup>56</sup> *Id.*

<sup>57</sup> International Commission on Intervention and State Sovereignty (ICISS), ICSS Report, *The Responsibility to Protect* xii (December 2001).

<sup>58</sup> The Secretary-General, *A More Secure World: Report of the Secretary General's High-level Panel on Threats, Challenges and Change*, ¶ 203, delivered to the General Assembly, U.N. Doc. A/59/565 (Dec. 2, 2004).[hereinafter *UN Panel Report*]



## RESPONSIBILITY TO PROTECT

2) The Proper Purpose Principle: Is it clear that the primary purpose of the proposed military action is to stop or avoid the humanitarian catastrophe in question?

3) The Principle of Last Resort: Has every non-military option been explored?

4) The Proportionality Principle: Is the use of force proportionate to the objectives sought to be secured?

5) The Balance of Consequences Principle: Is the intervention likely to be successful, and the consequences of action not likely to be worse than the consequences of inaction?<sup>59</sup>

### (iii) 2005 World Summit Outcome Report Concerning Responsibility to Protect

Heads of state and government gathered at United Nations Headquarters in New York from September 14-16, 2005. The World Summit Outcome Report has three paragraphs on responsibility to protect.<sup>60</sup>

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<sup>59</sup> *Id.* at ¶ 207.

<sup>60</sup> The text of three paragraphs are as follows:

**Responsibility to protect populations from genocide, war crimes, ethnic cleansing and crimes against humanity**

138. Each individual State has the responsibility to protect its populations from genocide, war crimes, ethnic cleansing and crimes against humanity. This responsibility entails the prevention of such crimes, including their incitement, through appropriate and necessary means. We accept that responsibility and will act in accordance with it. The international community should, as appropriate, encourage and help States to exercise this responsibility and support the United Nations in establishing an early warning capability.

139. The international community, through the United Nations, also has the responsibility to use appropriate diplomatic, humanitarian and other peaceful means, in accordance with Chapters VI and VIII of the Charter of the United Nations, to help protect populations from genocide, war crimes, ethnic cleansing and crimes against humanity. In this context, we are prepared to take collective action, in a timely and decisive manner, through the Security Council, in accordance with the Charter, including Chapter VII, on a case-by-case basis and in cooperation with relevant regional organizations as appropriate, should peaceful means be inadequate and national authorities are manifestly failing to protect their populations from genocide, war crimes, ethnic cleansing and crimes against humanity. We stress the need for the General Assembly to continue consideration of the responsibility to protect populations from genocide, war crimes, ethnic cleansing and crimes against humanity and its implications, bearing in mind the principles of the Charter and international law. We also intend to commit ourselves, as necessary and

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The World Summit Outcome Report emphasizes responsibility to protect through “peaceful means” by saying “the international community, through the United Nations, . . . has the responsibility to use appropriate diplomatic, humanitarian and other peaceful means, in accordance with Chapters VI and VIII of the Charter [of the United Nations], to help to protect populations from genocide, war crimes, ethnic cleansing and crimes against humanity.”<sup>61</sup> Further, the World Summit Outcome Report is in favor of “collective action. . . through the security council,” not unilateral action by providing

we are prepared to take collective action, in a timely and decisive manner, through the Security Council, in accordance with the Charter, including Chapter VII, on a case-by case basis and in cooperation with relevant regional organizations as appropriate, should peaceful means be inadequate and national authorities are manifestly failing to protect their populations from genocide, war crimes, ethnic cleansing and crimes against humanity.<sup>62</sup>

### 3. An Evaluation

These recent developments of human security and responsibility to protect are responses to the UN’s failure to protect human lives in Srebrenica and Rwanda. “In July of 1995 approximately 10,000 Bosnian Muslim men and boys staying at a UN “safe haven” in Srebrenica were killed by the Bosnian Serb Army acting at the behest of the Milosevic regime and Serbia.”<sup>63</sup> The “UN Security Council, the United States, the NATO states, the European Union. . . allowed this shameful event to happen.”<sup>64</sup> In 1994, “the world witnessed

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appropriate, to helping States build capacity to protect their populations from genocide, war crimes, ethnic cleansing and crimes against humanity and to assisting those which are under stress before crises and conflicts break out.

140. We fully support the mission of the Special Adviser of the Secretary-General on the Prevention of Genocide. 2005 World Summit, Sept. 14-16, 2005, 205 WORLD SUMMIT OUTCOME, ¶¶138-140, U.N. A/RES/60/1 (Oct. 24, 2005)[hereinafter *World Summit Outcome Report*]

<sup>61</sup> World Summit Outcome Report, *supra* note 60 at para. 139.

<sup>62</sup> *Id.*

<sup>63</sup> BOYLE, *supra* note 1, at 115.

<sup>64</sup> *Id.*

## RESPONSIBILITY TO PROTECT

outright genocide inflicted by the Hutu government against the Tutsis in Rwanda. . . while the U.N. Security Council stood by and did nothing.”<sup>65</sup>

It is an important step for the United Nations to respond to its former failure by making the UN Panel Report and the World Summit Outcome Report. The UN Panel report has merits in that it applies a broad definition of the UN Charter’s peace and security mandate, declares precautionary principles, and sets much higher and effective standards than previously set by the UN in Srebrenica and Rwanda.

Nevertheless, it should be pointed out that the UN Panel Report does not recognize unilateral humanitarian intervention as lawful. It clearly states unilateral humanitarian intervention violates articles 2(3), 2(4) and 51 of the UN Charter as follows:

185. The Charter of the United Nations, in Article 2.4, expressly prohibits Member States from using or threatening force against each other, allowing only two exceptions: self-defence under Article 51, and military measures authorized by the Security Council under Chapter VII (and by extension for regional organizations under Chapter VIII) in response to “any threat to the peace, breach of the peace or act of aggression”.

186. For the first 44 years of the United Nations, Member States often violated these rules and used military force literally hundreds of times, with a paralysed Security Council passing very few Chapter VII resolutions and Article 51 only rarely providing credible cover. Since the end of the cold war, however, the yearning for an international system governed by the rule of law has grown. There is little evident international acceptance of the idea of security being best preserved by a balance of power, or by any single — even benignly motivated — superpower.<sup>66</sup>

To conclude, it is fair to argue, first, as of today unilateral humanitarian intervention without the express authorization of the UN Security Council is a violation of international law and the possibility of collective humanitarian intervention authorized by the UN Security Council becomes greater than before.

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<sup>65</sup> *Id.*

<sup>66</sup> The UN Panel Report, *supra* note 58 paras. 185-186.

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**VII. THE CONCEPT OF RESPONSIBILITY TO PROTECT  
AND ITS IMPLICATIONS FOR NORTH KOREA****1. Introduction**

Since the announcement by the United States on October 16, 2002 that North Korea (North Korea or DPRK) had acknowledged that it had a “program...to enrich uranium for nuclear weapons,”<sup>67</sup> tensions in the Korean Peninsula have increased.

In confirmation hearings before the U.S. Senate on January 18, 2005, the nominee for the U.S. Secretary of State and current Secretary of State, Condoleezza Rice, said that international unity was necessary to apply pressure on North Korea to abandon its nuclear arms program.<sup>68</sup> She also mentioned North Korea as one of the six “outposts of tyranny that should be dismantled.”<sup>69</sup>

Therefore, there are two major international concerns regarding North Korea: its nuclear weapons program and human rights violations.

**2. North Korea’s Nuclear Weapon Problem and Six Party Talks**

After North Korea’s announcement in October 2002, the United States together with Japan and the Republic of Korea (ROK or South Korea) on October 28, 2002 and Korea Energy Development Organization (KEDO) on November 14, 2002 respectively issued statements “that the DPRK’s program was a violation of the Agreed Framework [between the US and DPRK signed on October 21, 1994,] the Non-Proliferation Treaty,<sup>70</sup> the DPRK-IAEA Safeguards Agreement and the North-South Joint Declaration on the Denuclearization of the Korean Peninsula.”<sup>71</sup> “[Because] of those violations the KEDO Board decided to suspend heavy oil deliveries as of the December

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<sup>67</sup> International Atomic Energy Agency (IAEA), IAEA FACT SHEET, 05-24291/FS Series 1/01 Rev. 1/E, *available at* <http://www.iaea.org/Publications/Factsheets/English/iaea-e.pdf> (last visited January 30, 2006).

<sup>68</sup> Brian Lee, *U.S. can deter threats from North, Rice says*, JOONGANG DAILY, January 20, 2005.

<sup>69</sup> Kim Young-hie, *Bush’s freedom policy is no joke*, JOONGANG DAILY, February 6, 2005.

<sup>70</sup> Treaty on the Non-Proliferation of Nuclear Weapons, July 1, 1968, 21 U.S.T. 483, 729 U.N.T.S. 161.

<sup>71</sup> IAEA, Fact Sheet, *supra* note 67.

## RESPONSIBILITY TO PROTECT

[2002] shipment.”<sup>72</sup> In November and December 2002, the IAEA requested that the DPRK reply and cooperate with the Agency, but on “December [22, 2002] the DPRK started to cut seals and disable surveillance cameras.”<sup>73</sup> In January 2003, the “IAEA Board of Governors adopted a resolution January [6,] 2003 that called upon North Korea to cooperate fully and urgently with the Agency. . . [affirming] that unless the DPRK takes all required safeguards measures, it would be in further non-compliance with its safeguards agreement.”<sup>74</sup> However, “North Korea announced its withdrawal from the [Non-Proliferation Treaty] effective as of January [11,] 2003.”<sup>75</sup> In February 2003, the IAEA referred this issue to the UN Security Council, and the UN Security Council expressed its “concern” over the situation in North Korea in April 2003.<sup>76</sup> Additionally, “UN Secretary-General Annan. . . has appointed a Special Advisor on the North Korea issue.”<sup>77</sup>

Still, the tensions from the North Korea’s nuclear weapons program have not been defused. After three rounds of negotiations, six nations, including South Korea, North Korea, China, the United States, Russia and Japan, met in Beijing, China and held talks in July 2005. However, after nearly two weeks of the six party talks, the parties deadlocked over the issue of “peaceful use” of nuclear programs.<sup>78</sup> But, North Korea and the United States said an agreement remained possible.<sup>79</sup> Negotiators from the six countries announced the six-party Joint Statement on September 19, 2005 which “was intended to set the for the negotiation of a specific process through which North Korea would abandon a nuclear weapons program in return for economic and political steps by the other parties (in particular the United States), to promote mutual trust, stability and peace on the Korean Peninsula and in Northeast Asia.”<sup>80</sup>

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<sup>72</sup> *Id.*

<sup>73</sup> *Id.*

<sup>74</sup> *Id.*

<sup>75</sup> *Id.*

<sup>76</sup> IAEA, Fact Sheet, *supra* note 67.

<sup>77</sup> *Id.*

<sup>78</sup> Jim Yardley, *U.S. and North Korea Blame Each Other for Stalemate in Talks*, N.Y. TIMES, August 8, 2005 at A4.

<sup>79</sup> *Id.*

<sup>80</sup> Scott Snyder, *Redouble Efforts on Six-Party Talks*, JOONGANG DAILY, December 21, 2005, available at <http://joongangdaily.joins.com/200512/21/200512212156019109900090109012.html>.

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### 3. Human Rights Situation in North Korea and UN Commission on Human Rights

On April 15, 2004, the UN Commission on Human Rights adopted a resolution entitled “Situation of Human Rights in the Democratic People’s Republic of Korea”.<sup>81</sup> The resolution by the Commission expressed “its deep concern about continuing reports of systemic, widespread and grave violations of human rights in the Democratic People’s Republic of Korea” and requested the “Special Rapporteur to report his/her findings and recommendations to the General Assembly at its fifty-ninth session and to the Commission at its sixty-first session.”<sup>82</sup>

On April 14, 2005, the UN Commission on Human Rights again expressed

its deep concern about continuing reports of systemic, widespread and grave violations of human rights in the Democratic People’s Republic of Korea, including: (a) Torture and other cruel, inhuman or degrading treatment or punishment, public executions, extrajudicial and arbitrary detention, the absence of due process and the rule of law, imposition of the death penalty for political reasons, the existence of a large number of prison camps and the extensive use of forced labour;<sup>83</sup>

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<sup>81</sup> Office of the High Commissioner on Human Rights Resolution, *Situation of Human Rights in the Democratic People’s Republic of Korea*, 2004/13, UN Doc. E/CN.4/2004/127 (Apr. 15, 2004).

<sup>82</sup> *Id.*

<sup>83</sup> Office of the High Commissioner for Human Rights, *Situation of Human Rights in the Democratic People’s Republic of Korea*, 2005/11, 1 U.N. Doc E/CN.4/RES/2005/11 (Apr. 14, 2005).

## RESPONSIBILITY TO PROTECT

**4. The Possibility of Humanitarian Intervention Against North Korea**

If the UN Commission on Human Rights continues to raise the situation of human rights in North Korea, there may be some suggestions for humanitarian intervention against North Korea. However, any suggestions are very dangerous to the peace and security of the Korean Peninsula and in East Asia. The United States President George W. Bush has already decided it was too risky to take military action against North Korea in early 2003.<sup>84</sup>

If military action is taken against North Korea, it could ignite a new war on the Korean Peninsula and possibly bring a North Korean nuclear attack on Japan.<sup>85</sup> If a full-scale war resumed on the Peninsula, it was estimated in 1993 that there would be as many as one million casualties including 80,000 to 100,000 Americans.<sup>86</sup> Furthermore, “the destruction of propert[ies] and interruption of business activit[ies] [will] cost more than US \$1 trillion.”<sup>87</sup>

The only way to prevent this tragic disaster is through diplomacy based on international law.<sup>88</sup> International law prohibits unilateral humanitarian intervention without any exceptions. International law permits UN authorized humanitarian intervention under very strict conditions. Further, international law gives a mechanism for peaceful settlement of disputes and has precedent to settle disputes peacefully and to prevent wars.

**VIII. CONCLUSION**

In conclusion, principles of international law, UN Charter obligations, ICJ decisions and the opinions of the most respected scholars presume that humanitarian intervention is unlawful. Therefore, there is a heavy burden of proof to meet in undertaking the threat or use of force in the name of humanitarian intervention. With regard to unilateral humanitarian intervention, I think it is a flagrant violation of international law and has no justification. With regard to UN-authorized humanitarian intervention, there are five requirements to be met as specified in the report of the UN High Level Panel on Threats, Challenges and Change: (1) the Seriousness of the Threat; (2) Proper Purpose;

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<sup>84</sup> David E. Sanger, *North Korea Says It Has Made Fuel for Atom Bombs*, N.Y. TIMES, July 15, 2003 at A1.

<sup>85</sup> David E. Sanger, *No Time to Lose on North Korea*, N.Y. Times, July 18, 2003 at A16.

<sup>86</sup> Kelly J. Malone, *Preemptive Strikes and the Korean Nuclear Crisis: Legal and Political Limitations on the Use of Force*, 12 PAC. RIM L. & POL'Y J. 807, 831 (2003).

<sup>87</sup> *Id.*

<sup>88</sup> Sanger, *supra* note 85; but see David Sloss, *Forcible Arms Control: Preemptive Attacks on Nuclear Facilities*, 4 CHI. J. INT'L L. 39, 55-57 (2003).

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(3) Last Resort; (4) Proportionality and (5) Balances of Consequences. Those who invoke UN authorized humanitarian intervention and the Security Council must meet the five requirements cumulatively.

Of course, the principles of international law, UN Charter and ICJ decisions are not the panacea for all contemporary problems in the world. Further, the right of “humanitarian intervention” and the “responsibility to protect” are likely to be more frequently invoked in coming years because Cold War justifications have lost their efficacy.<sup>89</sup> Nevertheless, we should bear in mind that, in Canada’s ICISS Report, UN High Panel Report and UN World Summit Outcome Report of 2005, there are no references permitting unilateral military intervention without right authority such as authorization of the Security Council, authorization of the UN General Assembly under the “Uniting for Peace Resolution” or authorization of regional organization under Chapter VIII of the UN Charter.

In this regard, it may be worthwhile to pay attention to the views of Noam Chomsky:

A standard argument is that we had to do something: we could not simply stand by as atrocities continued. The argument is so absurd that it is rather surprising to hear it voiced. Suppose you see a crime in the streets, and feel that you can’t just stand by silently, so you pick up an assault rifle and kill everyone involved: criminal, victim, bystanders. Are we to understand that to be the rational and moral response?<sup>90</sup>

Military intervention in the name of responsibility to protect, which does not have any right authority, seems to be similar to the above-mentioned situation. Thus, unilateral humanitarian intervention against North Korea does not seem to be desirable nor permissible under the current conditions. It will do more harm than good to the Korean people as well as the people of the world. As a Korean, I hope this article makes a contribution to prevent war, ensure peace and human security in the Korean Peninsula and East Asia.

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<sup>89</sup> CHOMSKY, *supra* note 39, at 49-50.

<sup>90</sup> CHOMSKY, *supra* note 39, at 48.



## **DEVELOPMENT OF A WORLDWIDE CURRENCY: IS IT FEASIBLE?**

*Dominick Kerr\**

### **ABSTRACT:**

Transactions are the key to success in any economy. Whether it is buying or selling, transactions have been occurring since the beginning of human existence and an entity needs to transact in order to thrive. What once was a localized event between two individuals has now grown to include many parties across a global environment. This global evolution however does not come without its complications. Multiple monetary systems exist between nations that make transacting difficult. There have; however, been recent developments in unifying countries under one currency as seen in the European Union with the Euro. In order to better understand the future of international business it is necessary to explore the origins of transactions, the development of money and monetary exchange, the problems with multiple currencies, and developments of unified currencies. By examining these issues the question of global currency feasibility can be answered.

### **INTRODUCTION:**

Transactions, in one form or another, have been occurring for thousands of years. The idea of exchanging something you have for something

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you need holds its roots in the ancient barter system, in which one person would trade a good or service for another. This was a primitive, but effective way of getting the goods or services one needed and still is practiced in many parts of the world today. Through bartering however, there is no assurance that the values of the goods or services that are given up equal the values of the goods and services received. In addition there is no guarantee that those goods or services will be desired by the other party, which would cause the transaction to not occur at all.

Monetary exchange, however, has usurped the ancient bartering method and provided the people of the world with a convenient and efficient system of trading. Prior research has shown that having a convenient method of transacting provides an easy way to obtain a good or service that is needed. The transfer of money ensures that these goods or services can be obtained through a universally accepted medium that can then be used to satisfy a debt, purchase additional goods or services, or be saved and used for some other future purpose. This system has proven to be very effective and is the primary means of transacting in today's worldwide economy. There is one major flaw in this scenario. Different countries of the world, have, and use their own systems of monetary exchange and own form of money. This represents a barrier for the international economy making purchases of goods from other countries difficult because the value of each country's money is unequal and changes with relation to one another constantly. If there are difficulties with international transactions a question to obviously ask is, "Why not create a universal worldwide currency?"

Having a worldwide currency will save much time, money, and frustration for organizations and governments. It will also increase the ease in which individuals can buy goods or services. No longer will there be concerns over fluctuating exchange rates, transferring currency when traveling, or the other host of problems that international transactions bear. In fact a worldwide currency can be the beginning of attaining a truly global economy in which people can freely buy things from anywhere at anytime. Before a worldwide currency can be put in place however, it is wise to first examine the current monetary exchange system; the way it came about, how it currently works, the problems associated with it, the underlying governments and economies, and the degree of technological development. There is no argument that the world is shrinking, figuratively of course, and that the economies of the globe are more interconnected now than they have ever been. But with all of these factors to consider the appropriate question may not be, "How do we create a worldwide currency," but, "Is a worldwide currency feasible?"

## DEVELOPMENT OF A WORLDWIDE CURRENCY

### HISTORY OF TRANSACTIONS:

In order to properly address the concept of monetary exchange, one must look at the history of transactions over time. As mentioned earlier, bartering was the earliest method to exchange goods or services. In this system a person would trade what he had for something he needed<sup>1</sup>. For example, if a sheep herder needed clothes, he could go to a tailor and trade some sheep for clothes. This system is inherently simple and convenient for the parties involved yet is not very efficient. If in the previous example the tailor did not have a need or want for the herders sheep, then the transaction would not take place and both parties would be left where they started. The herder would then have to find another tailor who needed sheep, or find something else that would be suitable for barter. Another flaw of this system is that there was no standard denomination or value for an item. Sticking with our herder example, a single sheep may be worth two shirts and a pair of pants one day, but only one shirt another. The sheep is not constantly equivalent to anything but one sheep so the value was never determined until the point of sale. These wrinkles make it difficult to have uniform exchange and make obtaining the goods or services needed a challenge. But did monetary exchange come about as a result of the limitations of bartering?

The answer to that question is actually no. It is true that through the bartering system it was found that certain items (mostly commodities such as grains, or cattle) were preferred for trade over others for a number of different reasons. Some commodities lasted a long time, were durable, or were portable and these characteristics made them highly desired. Others were items that were a necessity for life and those in which could be obtained from many different vendors. Being that commodities have such demand, they were easy to trade and eventually became the earliest form of what we would consider money<sup>2</sup>. But for many years exchange was conducted quite successfully without the use of money at all and is reminiscent of the current way many transactions are undertaken; on credit.

Tallies were devices used to keep track of a person's debt and to whom it would be paid to. The basic concept of the tally was that it would be created once one person owed a debt to another person and would then be eliminated once that debt was repaid in a satisfactory way. Tallies were made out of a variety of materials such as clay or wood but were by no means money. They

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<sup>1</sup> "Barter - Relevance and Relation to Money." 2004. Retrieved from The University of Exeter website on 11/15/04 at <http://www.ex.ac.uk/~RDavies/arian/barter.html>

<sup>2</sup> "Barter - Relevance and Relation to Money." 2004. Retrieved from The University of Exeter website on 11/15/04 at <http://www.ex.ac.uk/~RDavies/arian/origins.html>

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were simply record keeping devices that made trading easy because there was no longer a need to provide a desired good or service at the point of sale. If a sheep herder needed clothes, he could go to the tailor and get them even though the tailor did not need sheep at that time. A tally would be created and once the tailor needed sheep, the herder would supply the sheep and the debt would then be fulfilled. This avoided the concept of money completely because debt could be held outstanding until a later date when the debt would then be repaid by the purchaser. Tallies could also be traded to satisfy other debts. Going back to the herder again, if the tailor had a tally from the herder he supplied clothes to, and also owed money to a merchant he purchased material from previously, the tally from the herder could be traded to the merchant to satisfy that debt, provided of course that the merchant needed sheep. This system worked very well and lasted thousands of years. So where did the physical form of money come in? Like one might expect it was a result of the government<sup>3</sup>.

The first form of money came about during the 7th century B.C. when governments used coins to pay their debts to mercenaries for service. The coins had high denominations and were a convenient way for the government to satisfy large obligations. These coins however were basically a symbol of the government's debt to soldiers and not an actual payment. If they were not payments however, why were they accepted? Like today's governments, ancient governments levied taxes on the people living under their domain. The tax automatically created a forced debt that had to be paid by the people living under the ruling power. The value of coins came into play because they could be used to fulfill this tax debt to the government. This in turn provided the government with the coins they originally issued which could now be used again to pay for additional services. Citizens that did not receive these coins from the government for goods or services provided obtained them through transacting with parties that did. They would accept the coins as payment for a product and then would use the coins themselves to pay the tax<sup>3</sup>. The coins therefore became highly desirable and sought after in trade. This became the preferred medium merchants wished to transact in and out of this stemmed money.

By getting an understanding of the history of transactions it is clear that monetary exchange was not some brilliant idea that a genius concocted in a moment of supreme clarity, but actually came about by accident. Yes, the entire way that we conduct business and purchase goods and services was stumbled upon because of a government's idea of paying their soldiers with a

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<sup>3</sup> Wray, L. Randall. "An irreverent overview of the history of money from the beginning of the beginning through to the present." *Journal of Post Keynesian Economics*; Summer 99, Vol. 21 Issue 4, p679, 9p.

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coin that they expected to be returned come tax time. As we have seen throughout history, the best ideas are often a result of accidents and the formation of money as the preferred way to do business was no different. The convenience and efficiency of trading money for items or services was undeniable and out of these early roots, evolved our current monetary system.

### **PROBLEMS ASSOCIATED WITH MONETARY EXCHANGE:**

Now it would be simple to just close the book and call the story of monetary exchange complete with everyone living happily ever after trading money for goods and services but unfortunately things are never that simple. In theory governments issuing coins for a convenient way to pay taxes is a great idea, but what happens when multiple governments issue their own coins to pay for taxes? Additionally what happens when the coins issued by these multiple governments are used at the same time for exchange of goods and services? Before going further we can already see a problem arising. When there are multiple forms of money, transactions become increasingly difficult. In essence we are back to a barter system. If a buyer has a coin that is desired by the seller, the transaction will commence. This is almost exactly like a person bartering some item he has for something that he needs. Transactions are now limited as to where they can take place and in many cases, are limited to a specific group of people. Taking this further, if a transaction in which two people are using two different sets of money does occur, and the seller receives a coin in which he cannot use to pay taxes to his government, he must exchange this coin for one that he can use. He has to however locate someone who can use the coin he had received in the transaction, and make sure that the person that was found has a coin that can be used by him. If that wasn't complicated enough, it also must be determined at what value each coin is worth for exchange at that particular moment. One coin can equal 10 sheep and the other coin could equal 8 goats. Are 10 sheep equal to 8 goats? This is difficult to determine.

The background laid out above brings us into our modern day conundrum. In today's times we still have many governments issuing a multitude of currencies in all denominations and of all different values. Monetary exchange has now become the standard form of transacting but issues constantly arise as to the purchasing power of that money with respect to many factors such as time, location and demand. A dollar in 1920 is worth substantially more than a dollar in 2000. Likewise on the same day a bottle of soda can cost \$1.25 in a deli on Long Island and will cost you \$0.75 at a general store in upstate New York.

International trade and multinational corporations provide the global economy with an entirely new set of circumstances and tribulations including

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foreign exchange rates, functional currencies, financial accounting and reporting, etc. Businesses have to worry not only about transacting across borders, but also must negotiate the currency used in international transactions and determine if it will appreciate or depreciate before payment is due. What makes the situation even more complex are the unique political, economic, and technological forces that have a significant influence on currency. It is absolutely fair to say that we are better off now than we were 2000 years ago but there are clearly issues that need to be addressed and many questions that need to be asked and answered. Addressing them though is the easy part. Actual solutions and implementation procedures are a whole different story.

### **U.S. DOLLAR AND THE EURO:**

So what is the total number of different currencies that we are talking about? Ten? Twenty? Thirty? According to xe.com's ISO 4217 Type Currency Code List, as of 2004 there are 172 different currencies in the world<sup>4</sup>. Each of these currencies, as one might expect has their own exchange rates, denominations, consumer confidence, and stability. Now to talk about the interaction of 172 different currencies would be long, confusing and unnecessary. Because it is evident that there are many currencies that are actively used in the global economy, the focus can shift to two major currencies, the U.S Dollar, and the Euro. Since the question of developing a worldwide currency is being addressed, looking at two currencies whose purpose was to unify multiple currencies within a region will help to determine if this task can be duplicated on a global scale. In the United States it was the individual currencies of the states themselves that were eliminated in favor of a common currency. In Europe it was to unify the currencies of most of the member countries in the European Union. It is undeniable that both of these currencies have played an integral role in shaping (or in the case of the Euro, beginning to shape) the history of these regions. The Dollar and Euro have also played significant roles in international trade and transactions. By looking at how these major currencies developed, a picture can be drawn to see if the climate is right to develop a worldwide means of exchange.

During the American Colonial period and before the standard issue of the U.S. Dollar, there were many different forms of currency. Some of these forms included natural commodities such as wheat, rice and tobacco, as well as foreign coins such as British coins and state issued paper money. The fact that there was no single form of currency was one of the catalysts that sparked the

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<sup>4</sup> "ISO 4217 Type Currency Code List." 2004. Retrieved from XE.com website on 11/17/04 at <http://www.xe.com/iso4217.htm>

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American Revolution. The British Parliament would not allow the colonies to issue their own money and this impeded the progress of development in the Americas. Post Revolution America in the 1790's saw the first issue of a unified American currency between the states. Gold and silver were however in short supply so foreign currency, such as the Spanish dollar, was still used for many years. Over the next century or so, the dollar was gaining acceptance by the states but remained extremely volatile. It wasn't until after the Great Depression, World War I and Roosevelt's "New Deal" in the 1930's that the American financial system finally came together. Confidence in America as a nation grew, and the economy was headed in a strong and positive direction<sup>5</sup>. This was the beginning of the supremacy of the U.S. dollar and in turn the United States as a superpower.

The United States Dollar has been (until fairly recently) the most dominant, powerful, steady, and desired currency in the entire world. Much financial data is available to indicate that the dollar is a very stable and trusted currency. Yearly average inflation rates have been about 2.75% over the past decade<sup>6</sup>. This is very low considering some other countries, like Haiti, have had an average inflation of about 21.25%<sup>7</sup>. The strong U.S. economy and political stability has been a basis for keeping the dollar strong against many other currencies of the world. The smaller the probability for a political uprising or rapid decline in economic prowess, the better the currency will hold up versus others. The monetary and fiscal policies of the United States also promote sustained growth and stable prices<sup>8</sup>. With policies in place that emphasize growth and stability the dollar is better apt to do well in the global marketplace, and investors will feel confident using it as a means for conducting transactions. Although the dollar is used as the basis for many international business transactions, it is losing some prestige to the unified currency of the European Union, the Euro.

The Euro was developed to standardize the way that the countries of Europe conducted transactions. As each state of the United States currently conducts business using the same currency, so now do the 12 participating countries in the European Union (Belgium Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, The Netherlands, Austria, Portugal, and Finland).

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<sup>5</sup> "Money in North American History." 2004. Retrieved from The University of Exeter website on 11/15/04 <http://www.ex.ac.uk/~RDavies/arian/northamerica.html>

<sup>6</sup> "Historical US Inflation Data Table" 2004. Retrieved from the InflationData.com website on 11/17/04 at [http://inflationdata.com/inflation/inflation\\_rate/HistoricalInflation.aspx](http://inflationdata.com/inflation/inflation_rate/HistoricalInflation.aspx)

<sup>7</sup> Data Retrieved from the Country Watch website on 11/17/04 at <http://www.countrywatch.com.ezproxy.hofstra.edu/cv/BuildOrynew.asp>

<sup>8</sup> "Monetary and Fiscal Policy". Retrieved from the International Information Programs website at <http://usinfo.state.gov/products/pubs/oecon/chap7.htm>

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The idea of the Euro and the issuance of the currency did not come about all at one time. It actually came about from a three stage series of events.

The first stage occurred in 1957 with the Treaty of Rome. This treaty declared a common European market in which the goal was to increase the prosperity and bring the people of Europe closer together. This treaty first put the idea of a closer knit Europe down on paper as a goal to strive for. The second stage was the creation of the European Monetary Union. The EMU laid the foundation for the creation of the Euro because the monetary policy of all of Europe was no longer determined by the individual countries but was unified under a single decision making body like that of the United States' Federal Reserve. The final stage was setting the irrevocable exchange rates for the different currencies and actual issuing of the Euro as the legal currency. Before this time, each country had its own currency, policies, and different exchange rates much as the rest of the world still does today. Unifying the currency promotes a more closely knit Europe both socially and economically (which was desired as mentioned above) and fosters easier trade and commerce between the member nations<sup>9</sup>.

So what does it take to become a member country and use the unified currency? According to an article written by J. Orlin Grabbe, a country is required to accomplish four things. The first is that a country "must have kept its currency within the normal margins around its fixed value in terms of the European Currency Unit and not devalued it against any other member country for two years." This is important because this ensures that the currency is strong with relation to other member countries. The second criterion is that there has to be price stability. The inflation of the consumer price index cannot be more than 1.5 percentage points above the three member countries with the lowest inflation rates. So inflation has to be low and the prices have to be relatively stable with regards to one another. This would ensure that the economies of the countries are comparable. Thirdly, the government deficit cannot be excessive, which is defined as "a) a government deficit that doesn't exceed 3 percent of yearly gross domestic product; and b) the value of outstanding government debt doesn't exceed 60 percent of yearly gross domestic product." This portion ensures that the government does not owe a large amount of money to other nations or creditors and that it is financially sound. The final criterion was that "long-term interest rates (ten-year government bond rates) cannot be more than two percent above the three member countries with the lowest rates of inflation<sup>10</sup>."

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<sup>9</sup> "The Euro...banknotes, coins, and more." Retrieved from the Euro website on 11/04/04 at <http://www.euro.ecb.int/en.html>

<sup>10</sup> Grabbe, J. Orlin. "The History of the Euro" 1997. Retrieved on 11/08/04 at



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All of these conditions focused on making sure the countries in the member nations are similar on many different fronts. Are all of these steps necessary though? Should a country be able to join if they didn't meet the criteria? The European Monetary Union did not set up these steps for the pure enjoyment of coming up with rigorous standards. There is obviously a method, and importance to making sure those entities that are using the same currency are similar in these factors, but why? It is a combination of political, economic, and technological forces that contribute to the success or failure of the monetary system that is being undertaken. If countries are not comparable it is not necessarily a recipe for failure but there is a much greater chance of success if those forces between countries are somewhat the same.

### **POLITICAL FACTORS:**

Political factors have some of the largest affects on monetary policy. Whether it is the government enacting policies that influence interest rates or the threat of a political takeover, success or failure often falls on the hands of the government. Thinking logically for a moment it is clear why the government would affect the currency of a nation. The first obvious reason is that government is responsible for monetary policies, fiscal policies, spending, global relations, law making, acts of war, etc. Reactions to government decisions have a huge impact on the perception of the governing nation as well as the currency it uses to conduct transactions. It is evident by this surface examination that a stable government, who makes sound decisions, would have the least impact on the volatility of its currency. Those currencies have less risk of changing values quickly and investors are more willing to conduct transactions in a currency whose behavior can be predicted.

If we shift the focus to one aspect of currency, exchange rates, we can see how political factors have a significant influence on this aspect of money. A study was performed that looked at some of the biggest exchange rate shifts between the U.S. Dollar and some of the other major worldwide currencies ( Japanese Yen, Deutsche Mark, British Pound, and Canadian Dollar) over an eight year period between January 1, 1990 and March 31, 1998. The goal of the study was to determine if the large shift in exchange rates were do to political, economic or technical forces. It is likely that each factor would contribute to changes in the exchange rate but this study determined that the largest changes in the rates were due to, at least in part, political reasons.

The five largest exchange rate shifts in the 90's for the Japanese Yen, all were results of political factors. The largest shift, a 3.37% decline in the

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<http://www.aci.net/kalliste/euro.htm>

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spot rate which occurred on February 12, 1994, was a result of the collapse of trade talks between Japan and the United States. The Deutsche Mark showed a similar shift, although upward, as a result of political factors. The largest shift in the exchange rate (3.12% increase on November 5, 1995) was a result of the U.S. House Budget Committee's approval of a balanced budget plan and a trade sanction imposed on Japan for failure to open its auto market. These two events caused the Dollar to have an increased rate of exchange based almost solely on political factors. The Mark shift also demonstrates the affect that currencies have on one another. The exchange rate of the Mark was altered due to Japanese sanctions as well as the decrease in the exchange rate of the Yen<sup>11</sup>. The United States imposed a sanction on Japan which in turn increased the exchange rate of the Mark, and decreased the exchange rate of the Yen.

The largest rate shifts for the British Pound and Canadian Dollar during the 1990's were also largely results of the political environment at the time. On September 16, 1992, the exchange rate rose 3.29% as a result of the Pound being suspended from the European Exchange Rate Mechanism because of interest rate increases. Political factors relating to the exchange rate of the Canadian Dollar showed changes that were not as drastic as the Japanese Yen, the Deutsche Mark or the British Pound, but still caused fluctuations. On October 31, 1995 the rate between the U.S. and Canadian dollar fell 1.64% because of news that Canadian voters rejected a referendum on Quebec's independence<sup>11</sup>.

The exchange rate changes of these magnitudes happened on only one day demonstrating the influence that a political decision or set of political events can have on the currency at any point in time. This study just examined exchange rates and individual events that spurred rapid change but there are many other effects that government decisions have on currency. The study also showed the variety of political conditions that influenced the exchange rates. These events ranged from talks about trade, deciding on secession possibilities, and even sanctions. Many different political factors influence currency and for good reason. It is the governments of different countries that cooperate with each other and set laws for organizations to conduct businesses and transact. Therefore there is some logic behind the fact that government decisions would not only influence currencies of the world, but influence them to a great extent. Beyond government decisions, the perceived stability of governments also has an influence on currency. Many currencies have gained and lost value simply based on the stability of the governments at that time.

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<sup>11</sup> Lobo, B. J. "*Large changes in major exchange rates: a chronicle of the 1990s.*" *Applied Financial Economics*, Nov2002, Vol. 12 Issue 11, p805, 7p

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Why would the stability influence a currency? Well a weak government can be an indication of weak nation which can than in turn indicate a risky currency. Investors do not like risk, and the riskier a currency the less it will be desired to be used in international transactions. Looking at Poland's currency, the zloty, we can see the effect that a risky political environment has on a currency. As of March 2004, the zloty had been trading at record lows versus the Euro for two reasons. One was the rising debt levels of the country and the second was because of political instability. The Democratic Left Alliance had been in power in Poland and over time they lost their control over the parliamentary majority. The political group changed party leaders and there was fear that the prime minister could possibly be leaving office forcing an early election. Now these political events do not have any direct relationship to the Polish currency but the indirect effect is that the events had caused the zloty to depreciate against the Euro. The government has to re-stabilize before there is a chance of the currency gaining any ground<sup>12</sup>.

The Polish zloty example is fairly common throughout the history of currency stability. There have been many instances in which the political environment of a country has dramatically influenced the way the currency has performed. The United States dollar is in a current state of depreciation with regards to international currencies for political reasons as well. Interest rates are still at a very low rate and this is due in large part to political pressure. Since the United States are in what some experts agree as a jobless recovery, Congress as well as the president's office would not be happy if interest rates rose while Americans were still out of work<sup>13</sup>. Over the past year the United States has seen interest rates rising consistently. There has also been data showing that job recovery is beginning although there is still much work to be done. Also one has to look at political decisions regarding tax cuts and acts of war. Reducing taxes in a time where the dollar is shaky and deficits will hurt the economy may not be the wisest idea. The ongoing war effort is not viewed as a sound decision by many in the world. Both of these issues factor in to the state of the United States perception to the rest of the world, which is carried forward at least in part to the stance of the currency.

### ECONOMIC FACTORS:

Political factors are not the only thing that influence currency or can impact the formation of a unified monetary system. Economic factors play an extremely large role. If we examine the economies of the world, we can see

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<sup>12</sup> *"The Big Slide."* Business Eastern Europe, 3/29/2004, Vol. 33 Issue 14, p3, 1p

<sup>13</sup> Coxe, Donald. *"Act Now, or Risk a Crash."* Maclean's; 3/1/2004, Vol. 117 Issue 9, p40, 1p, 1c

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right off the bat that many of them are not even remotely similar. The value of total goods and services produced by a nation (gross domestic product) can give a good surface view into a country's economy. Looking at the 2004 figures produced by the World Bank, the United States has the highest GDP of any nation with just about \$11.6 trillion. Compare that to the country with the second highest GDP, Japan, who has a little over \$4.6 trillion. The United States has just less than three times the GDP of the second nation. Making the gap even broader is that the 61st country, Slovenia, has a GDP of a little over \$32 billion. That is just over one quarter of 1% of the United States GDP! Slovenia is ranked 61st on the list which means that there are still 130 countries *below* Slovenia's level. This extremely large differential just gives a brief glimpse into the disparity of many of the global economies<sup>14</sup>.

There is really no question as to why economic forces would impact the development of a worldwide currency. One might find it rather simple to just leave economic forces out of the equation and to adopt a global currency on faith that these forces have no bearing on reality but as Argentina found out in the three plus year recession that they faced in the early 1990's, it is not so easy to just adopt a currency, or in their case peg their Argentinean peso against another currency. The other currency in this example was the United States dollar and what had happened was that Argentina decided it would be a good idea to link its currency to that of the United States, which at first was very successful. Inflation went down, foreign direct investment increased and things were looking up for the economy. The problem was that Argentina wasn't the United States and thought that they could run their economy in a similar fashion (or did not realize the potential impact of what they were doing). The government issued a lot of debt that they couldn't afford to pay back. This debt was not so astronomical if you were comparing it to that of the U.S., but the Argentinean government did not do a great job of collecting taxes so there was no money to finance the debt. What made matters worse is as the dollar appreciated against foreign currencies, the peso also appreciated which meant that Argentinean exports were priced too high and out of the market. The government was left with a real dilemma of having little tax dollars coming in, little dollars coming in from exports, and a high debt that needed to be funded. All of this together led to an economic collapse<sup>15</sup>.

So if the Argentinean peso was tied to the United States dollar why didn't the U.S. economy suffer a similar economic downturn? The United

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<sup>14</sup> "Total GDP 2004" 2004. Retrieved from the World Bank website on 3/26/05 at <http://siteresources.worldbank.org/DATASTATISTICS/Resources/GDP.pdf>

<sup>15</sup> Allen, Jodie T. "Euros, pesos...and globos?" *U.S. News & World Report*; 1/14/2002, Vol. 132 Issue 1, p39, 1p.

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States even had, and still has trillions of dollars in outstanding foreign debt. This should make the country's economy even more prime for a recession just as Argentina suffered. Well the United States is interesting because they don't necessarily follow normal economic convention. Because the world has faith in the stability of the U.S. government and economy, they are willing to overlook the massive debt that the country has with regards to the value of the dollar. The U.S. plays by its own set of rules and what on paper perhaps looks like an incomprehensible scenario (the amount of debt the country owes versus the relative stability of the dollar) is actually reality. These circumstances can obviously not be replicated by every country and this is one of the inherent problems with creating a worldwide currency. Everyone has to play by the same set of rules, follow the same standards, and most of all have economies that are stable and reliable enough for other countries to want to do business in. I do not think many countries would agree to have a common currency with a country whose economy is risky at best and in reality we saw in the Argentina example that this cannot happen. Even looking at the Euro, the four criteria that a country had to meet were all based on the premise of comparability. The goal is to make sure that the economies were on par with each other so unifying the currency would be feasible. The less comparable, the less likely the currency will succeed.

### **TECHNOLOGICAL FACTORS:**

We have seen how political and economic factors play a large role in the value of currencies as well as role in developing a new currency. Another very important factor in the quest for a worldwide currency is the level of technology within a nation. Once again this aspect falls back to the idea of comparability. Technologies in countries that would have the same currency must be on the same level for any hope of success. Given the times we live in and the wide variety of electronic transactions that are accomplished on a daily basis it is clear to see why technologies must be equivalent. If a worldwide currency was developed and over 50% of the countries did not have access to computers, how would electronic commerce, money transfers, and general information exchange take place? This would be very hard to do and is an area of concern that would need to be addressed before thoughts of a worldwide currency should enter into the picture.

Technology has an influence on the status of a currency for more reasons than just a means of making transactions. Technology has a direct affect on the economy of nations as well as production. In general the higher the level of technological advancement, the more productive and better off the economy is as a whole. This can be seen when looking at the level of labor

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productivity. The more productive the labor force in an economy, the more goods and services that can be produced and the higher the gross domestic product. A study was performed in 2001 by research analyst Michael Feroli for the United States Congress's, Joint Economic Committee Study which examined the revival of information technology during the 1990's and its role in productivity for the United States. His findings indicate that,

“(1) Information technology contributed significantly to the productivity revival. At least half of the one-percentage point increase in labor productivity growth is attributable to IT. In all likelihood the contribution from IT is even greater than this conservative estimate. (2) Both the production and use of IT has had an impact on the productivity revival.<sup>16</sup>

It is evident that technology plays a large role in shaping the economy of a nation and that it is also playing a role in shaping how currency is transferred. The speed and ease of communication has increased dramatically and the level of technology is constantly advancing. It is therefore imperative that technology must also be comparable between nations from both an economic standpoint and logistical standpoint when attempting to use a global currency.

### CONCLUSION:

The development of a worldwide currency in theory seems like a perfect idea. Instead of having to worry about exchange rates or transaction and translation gains and losses there could be one worldwide currency that would save time, effort, and money for all parties involved. This theoretically harmonious world however is not the world in which businesses and governments operate. The real world is filled with endless variables and factors that affect the environment of each country separately. What is successful for one country may not be applicable in another country. The political, economic, and technological issues that were discussed earlier are only some of the barriers that must be considered and overcome before a worldwide currency can even be a thought.

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<sup>16</sup> “*Information Technology and the New Economy.*” *Joint Economic Committee Study*, July 2001. Retrieved from the United States House of Representatives website at <http://www.house.gov/jec/growth/it.htm>

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The world however is moving in the direction of a more unified environment. The introduction of the Euro as a common currency for the 12 member nations of the European Union is a positive step in the direction of simplified and convenient transacting. The strength of the Euro against many currencies, especially the U.S. dollar, indicates that this movement has been an initial success. The involvement of specific nations however was not an accident and it was carefully planned out for a reason. All of the nations are comparable on many fronts and it is essential they stay that way in order for continued success over the future. If a worldwide currency was to be issued, a similar level of comparability must be reached between all nations, which is unfortunately highly unlikely to happen for a long time. Nations are still so far apart on many grounds and this gap does not appear to be closing quickly. Perhaps that is the goal that should be focused on. Close the gap between the developed and developing countries in the world and there may just be a true global environment. Will that happen in the coming decades? We'll have to wait and see.

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**CULTURAL IMPERIALISM**  
**VS.**  
**CULTURAL PROTECTIONISM:**  
**HOLLYWOOD'S RESPONSE TO UNESCO EFFORTS TO**  
**PROMOTE CULTURAL DIVERSITY**

*Eireann Brooks\**

**I. SUMMARY**

The adoption of the Convention on the Protection and Promotion of the Diversity of Cultural Expressions (“Convention on Cultural Diversity” or “the Treaty”) by the United Nations Educational, Scientific & Cultural Organization (“UNESCO”) in October 2005 was opposed only by the United States and its sole ally, Israel.<sup>1</sup> U.S. concerns may be directly linked to the lucrative, long-standing tradition of deriving great profit from international film distribution. The Convention on Cultural Diversity threatens to curtail Hollywood’s ability to generate revenue from overseas markets at its current rate, in the interest of preventing the spread of cultural homogeneity.<sup>2</sup> The U.S. government has identified some potential adverse effects of the treaty relating to trade, the free flow of information, and human rights.<sup>3</sup>

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\* J.D. Candidate, 2007, Hofstra University School of Law. I would like to thank my parents, LaRae Halsey-Brooks and James Brooks, for proofreading, editorial advice, and moral support. I would also like to thank the staff of the Journal of International Business & Law, particularly Andrew Extract, Dina Colon, and Sally Sancimino, for their editorial advice and assistance throughout the writing and editing process. I would like to express my gratitude to Professor Leon Friedman for serving as my advisor during the development of this Note. Finally, I would like to thank my first editor, Dennis Anderson.

<sup>1</sup> Alan Riding, *Unesco Adopts New Plan Against Cultural Invasion*, N.Y. TIMES, Oct. 21, 2005, at E3.

<sup>2</sup> Charles Masters, *Hollywood Lobbyist Concerned About Protectionism*, THE HOLLYWOOD REPORTER, Oct. 23, 2005, available at <http://www.entertainment-news.org/breaking/37574/hollywood-lobbyist-concerned-about-protectionism.html> (accessed Mar. 29, 2006).

<sup>3</sup> Jeffrey Thomas, *U.S. Disappointed by Vote on UNESCO Cultural Diversity Convention*, U.S. Dept. of State, Oct. 21, 2005, at <http://usinfo.state.gov/eur/Archive/2005/Oct/21-478266.html?chanlid=eur> (accessed Mar. 29, 2006).

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The exploitation of international film distribution has long been regarded as a substantial source of additional profit for Hollywood studios. The possibility exists that the cultural damage done by the pervasive importation of American cultural products into economically weaker cultures may outweigh the relative benefits associated with the unfettered domination of foreign markets. In that respect, the Convention on Cultural Diversity could have a greater impact on the preservation of culture than the potential inhibition of trade. The free flow of information is unlikely to be stifled by the largely symbolic Treaty. Once ratified by the requisite number of governments, the Convention on Cultural Diversity will simply become a factor to be considered during international trade negotiations.<sup>4</sup> Finally, the definition of “human rights” favored by the U.S. Department of State focuses primarily on the ability of individuals to freely “express themselves.”<sup>5</sup> UNESCO, however, takes a broader view of human rights as the concept relates to the interest held by those within a culture in its artistic traditions and the continued development and dissemination of its cultural products.<sup>6</sup>

## II. INTRODUCTION

In October 2005, UNESCO took a controversial step toward achieving one of its long-term objectives by adopting the Convention on Cultural Diversity.<sup>7</sup> The objective of the Treaty is to safeguard cultures from the threat of homogenization that accompanies the pervasive importation of cultural products, such as films and television programs, from economically dominant countries.<sup>8</sup> The United States strenuously objected to the terms of the Convention on Cultural Diversity, but its dissenting voice was no match for the 148 countries which supported the adoption of the Treaty.<sup>9</sup>

The Convention on Cultural Diversity has been perceived by the United States as a threat to the consistently lucrative international distribution of Hollywood films.<sup>10</sup> U.N. Ambassador Louise Oliver articulated three potential ramifications about which the U.S. government was specifically concerned prior

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<sup>4</sup> Riding, *supra* note 1.

<sup>5</sup> Thomas, *supra* note 3.

<sup>6</sup> S. James Anaya. *International Human Rights and Indigenous Peoples: The Move Toward the Multicultural State*, 21 ARIZ. J. INT'L & COMP. LAW 13, 15 (2004).

<sup>7</sup> Riding, *supra* note 1.

<sup>8</sup> Convention on the Protection and Promotion of the Diversity of Cultural Expressions, *available at* <http://unesdoc.unesco.org/images/0014/001429/142919e.pdf>.

<sup>9</sup> Riding, *supra* note 1.

<sup>10</sup> Masters, *supra* note 2.

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to the adoption of the Treaty: (1) an adverse impact on trade; (2) an adverse impact on the free flow of information between cultures; and (3) an adverse impact on human rights.<sup>11</sup>

The Convention on Cultural Diversity is the latest in a series of efforts by UNESCO to ward off the spread of cultural homogeneity through the excessive exportation of cultural products generated by economically dominant countries into cultures which are at a relative economic disadvantage. One of UNESCO's first steps toward protecting the folklore of African cultures was its co-development with the World Intellectual Property Organization of the Tunis Model Law, "intended to be used as a guideline [for Africa] in drafting national copyright legislation."<sup>12</sup> The Tunis Model Law protected "folklore and works derived therefrom as original works for an indefinite period," regardless of whether the expression of such folklore was fixed in a tangible form.<sup>13</sup> That law is believed to have exercised a significant influence upon the development of copyright laws in African countries "including Burundi, Cameroon, Ghana, Guinea, the Ivory Coast, Mali, and Congo."<sup>14</sup>

Since then, UNESCO has attempted to address various facets of the preservation of folklore and other culture-specific artistic traditions through initiatives such as the Recommendation on the Safeguarding of Traditional Culture and Folklore (1989)<sup>15</sup>; Guidelines on Living Human Treasures (1994)<sup>16</sup>; the Proclamation of Masterpieces of Oral and Intangible Heritage (1997)<sup>17</sup>; the Universal Declaration on Cultural Diversity (2001)<sup>18</sup>; and the Convention for the Safeguarding of the Intangible Cultural Heritage (2003).<sup>19</sup>

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<sup>11</sup> Thomas, *supra* note 3.

<sup>12</sup> Paul Kuruk, *Protecting Folklore Under Modern Intellectual Property Regimes: A Reappraisal of the Tensions Between Individual and Communal Rights in Africa and the United States*, 48 AM. U.L. REV. 769, 813 (1999).

<sup>13</sup> *Id.* at 814.

<sup>14</sup> *Id.*

<sup>15</sup> Recommendation on the Safeguarding of Traditional Culture and Folklore, *available at* [http://portal.unesco.org/en/ev.php-URL\\_ID=13141&URL\\_DO=DO\\_TOPIC&URL\\_SECTION=201.html](http://portal.unesco.org/en/ev.php-URL_ID=13141&URL_DO=DO_TOPIC&URL_SECTION=201.html) (accessed Mar. 29, 2006).

<sup>16</sup> Preserving and Revitalizing Our Intangible Heritage, *available at* [http://www.unesco.org/culture/heritage/intangible/treasures/html\\_eng/index\\_en.shtml](http://www.unesco.org/culture/heritage/intangible/treasures/html_eng/index_en.shtml) (accessed Mar. 29, 2006).

<sup>17</sup> Proclamation of Masterpieces: UNESCO Culture Sector, *available at* [http://portal.unesco.org/culture/en/ev.php-URL\\_ID=2226&URL\\_DO=DO\\_TOPIC&URL\\_SECTION=201.html](http://portal.unesco.org/culture/en/ev.php-URL_ID=2226&URL_DO=DO_TOPIC&URL_SECTION=201.html) (accessed Mar. 29, 2006).

<sup>18</sup> Universal Declaration on Cultural Diversity, *adopted* Nov. 9, 2001, art. 10, *available at* <http://unesdoc.unesco.org/images/0012/001271/127161e.pdf#page=9> (accessed Mar. 29, 2006).

<sup>19</sup> Convention for the Safeguarding of the Intangible Cultural Heritage, *available at* <http://unesdoc.unesco.org/images/0013/001325/132540e.pdf> (accessed Mar. 29, 2006).

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Folklore is an essential cultural element designed to preserve and ensure the future development of cultural beliefs, norms, and traditions.<sup>20</sup> Creative presentations of these cultural foundations are generated in a diverse array of artistic forms in order to provide a historical context for the development of future generations.<sup>21</sup> This topic was addressed by UNESCO in its Universal Declaration on Cultural Diversity (2001): “[Heritage] must be preserved, enhanced and handed on to future generations as a record of human experience and aspirations, so as to foster creativity in all its diversity.”<sup>22</sup> Understanding films and television programs as contemporary means for the transmission of folklore—at least within societies capable of supporting such industries—requires that “cultural consumption [should] be understood not only as a leisure activity but also as a consequential social practice.”<sup>23</sup>

A broad definition of the “cultural diversity” that UNESCO seeks to protect through the Treaty relates to ensuring that cultures are able to independently develop while simultaneously remaining receptive to valuable input from other cultures.<sup>24</sup> Culture is recognized as “an outgrowth of a collectivity”; therefore, “affirmation of a cultural practice is an affirmation of the particular cultural group.”<sup>25</sup> The continued development of products that contribute to or comprise a society’s cultural heritage may serve two purposes integral to a culture’s ability to generate and preserve its folklore. First, such products provide “aesthetic experience” for the members of a culture, which is “arguably an experience of the human spirit in isolation.”<sup>26</sup> Additionally, cultural products provide a common “cultural experience[, which] stresses our interdependence both across time and space.”<sup>27</sup> During the initial drafting process for the Treaty, UNESCO was charged with addressing “the unique and

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<sup>20</sup> See Sharon Black, Thomas Wright, & Lynnette Erickson, *Polynesian Folklore: An Alternative to Plastic Toys*, CHILDREN'S LITERATURE IN EDUCATION, June 2001, at 125, available at EBSCOHost, Accession No. 11305783.

<sup>21</sup> Sarah Harding, *Value, Obligation, and Cultural Heritage*, 31 ARIZ. ST. L.J. 291 (1999).

<sup>22</sup> Universal Declaration on Cultural Diversity, *supra* note 18.

<sup>23</sup> Hernan Galperin, *Cultural Industries in the Age of Free-Trade Agreements*, Canadian Journal of Communications, available at <http://www.cjc-online.ca/viewarticle.php?id=505&layout=html> (accessed Mar. 29, 2006).

<sup>24</sup> Ivan Bernier, *A UNESCO International Convention on Cultural Diversity*, MEDIA TRADE MONITOR, Mar. 7, 2003, available at <http://mediatrademonitor.org/node/134> (accessed Apr. 13, 2006).

<sup>25</sup> Anaya, *supra* note 6, at 22.

<sup>26</sup> Harding, *supra* note 21.

<sup>27</sup> Harding, *supra* note 21.

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exclusive problem of preserving and promoting cultural diversity in a context of economic globalization and trade liberalization.”<sup>28</sup>

The overriding purpose of the Convention on Cultural Diversity is to protect native film and television industries by creating a binding legal document that will ensure their continued government funding.<sup>29</sup> The potential effect has been summarized as follows: “[Adoption] could mean that countries will be able to [subsidize] domestic film industries and restrict foreign music and content on their radio and television stations in the name of preserving and promoting cultural diversity.”<sup>30</sup>

### III. CONVENTION ON THE SAFEGUARDING OF THE INTANGIBLE CULTURAL HERITAGE

“Intangible cultural heritage,” as defined by UNESCO, encompasses methods of recording and transmitting traditional expressions within a culture, including “oral traditions and expressions, performing arts, social practices, rituals and festive events, traditional craftsmanship, as well as knowledge and practices concerning nature and the universe that [are recognized] as part of [a culture’s] heritage.”<sup>31</sup> The advent of motion pictures has served as a modern method for the expression of folklore, enabling cultures to create films that either overtly or subtextually represent the beliefs and traditions prominent within a society during a specific period of time.<sup>32</sup>

In October 2003, UNESCO introduced the Convention for the Safeguarding of the Intangible Cultural Heritage (“Convention on Intangible Cultural Heritage”), which was unanimously adopted by the UNESCO General Conference.<sup>33</sup> The Convention on Intangible Cultural Heritage has been ratified by 47 countries, enabling it to enter into force on April 20, 2006.<sup>34</sup> Interviewed

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<sup>28</sup> Bernier, *supra* note 24.

<sup>29</sup> Convention on the Protection and Promotion of the Diversity of Cultural Expressions, *supra* note 8.

<sup>30</sup> Jon Henley, *Global Plan to Protect Film Culture*, THE GUARDIAN, Oct. 19, 2005, available at <http://www.guardian.co.uk/arts/news/story/0,11711,1595445,00.html> (accessed Mar. 29, 2006).

<sup>31</sup> Convention for the Safeguarding of the Intangible Cultural Heritage, *supra* note 19.

<sup>32</sup> See Rich Collins, *Disappearing Act*, WEEKLY WIRE, Nov. 17, 2005, [http://weeklywire.com/ww/11-10-97/gambit\\_swell.html](http://weeklywire.com/ww/11-10-97/gambit_swell.html) (last accessed Mar. 29, 2006) (positing that motion pictures function as cultural documents which provide “a wealth of information about the times that shaped them.”)

<sup>33</sup> UN News Centre, *UNESCO Treaty on Protecting Oral Traditions Could Come Into Force Next Year*, Feb. 16, 2003, <http://www.un.org/apps/news/story.asp?NewsID=13362&Cr=culture&Cr1=heritage> (accessed Mar. 29, 2006).

<sup>34</sup> See UNESCO, Convention for the Safeguarding of the Intangible Cultural Heritage. Paris, 17

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in 2003, UNESCO Director-General Koïchiro Matsuura expressed optimism about the potential impact of widespread ratification: “We could expect the Convention to enter into force [in 2006, which] is very good news for those who [are] justly concerned about the threats weighing against this particularly vulnerable heritage[.]”<sup>35</sup>

**A. Objectives**

The Convention on Intangible Cultural Heritage reflects a shift from the original definition of cultural property. Cultural property was initially defined as “objects of artistic, archaeological, ethnological, or historical interest.”<sup>36</sup> The current definition of the term has broadened significantly to encompass “the tangible and intangible effects of an individual or group of people that define their existence, and place them temporally and geographically in relation to their belief systems and their familial and political groups, providing meaning to their lives.”<sup>37</sup> The Convention on Intangible Cultural Heritage requires the creation of a central inventory of traditions classified as “intangible cultural heritage,” which could present a number of obstacles to the achievement of the Treaty’s objectives.<sup>38</sup>

The Convention on Intangible Cultural Heritage may provide a useful method for protecting intangible cultural heritage from misappropriation for profit, and thereby avoid the pitfalls presented by the application of traditional intellectual property law.<sup>39</sup> Copyright law, for example, does not provide an adequate forum for the resolution of a situation like that presented by the band OutKast’s performance of their hit single “Hey Ya” during the nationally-telecast 2004 Grammy Awards. The band utilized “an ethereal, Indian-sounding melody” to introduce their performance, then segued into a dance routine with backup dancers clad in skimpy “buckskin bikinis, [with] long braids and feathers in their hair.”<sup>40</sup> At a later point during the performance, the dancers “hit their open mouths with flat palms, imitating a traditional Plains-

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October 2003, at <http://portal.unesco.org/la/convention.asp?language=E&KO=17116> (listing the 47 countries that ratified the Convention on Intangible Cultural Heritage, and the dates of ratification.)

<sup>35</sup> *Id.*

<sup>36</sup> Angela R. Riley, “*Straight Stealing*”: Towards an Indigenous System of Cultural Property Protection, 80 WASH. L. REV. 69, 77 (2005).

<sup>37</sup> *Id.*

<sup>38</sup> Michael F. Brown, *Safeguarding the Intangible*, CULTURAL COMMENT, Nov. 2003, available at <http://www.culturalcommons.org/comment-print.cfm?ID=12>.

<sup>39</sup> Riley, *supra* note 36, at 72.

<sup>40</sup> Riley, *supra* note 36, at 70.

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tribe war cry.”<sup>41</sup> In addition, OutKast was joined onstage by the acclaimed University of Southern California marching band, whose hats were decorated with feathers to contribute to the theme.<sup>42</sup>

Native American leaders were outraged by the perpetuation of “tomahawk-and-tipi stereotypes,” likening OutKast’s performance to a crude blackface routine.<sup>43</sup> Not only were the Indian symbols used of a type traditionally reserved for ceremonial purposes, but the song used as a prelude to “Hey Ya” was also a sacred Navajo song wrongly appropriated for entertainment purposes.<sup>44</sup> Here, copyright law provided little recourse for those whose cultural heritage was exploited without regard for either the propriety of such use of long-standing cultural traditions or compensation, because “no law currently exists to protect against OutKast’s appropriation of Native culture, Native symbols, Native dance, or Native music,” which are not protected by copyright.<sup>45</sup> Moreover, copyright law extends only to “original works of authorship that are fixed in a tangible medium of expression.”<sup>46</sup> Therefore, that area of the law provides little assistance when ephemeral cultural traditions which are passed down through generations are the type of intellectual property sought to be protected.

### B. Obstacles

Several obstacles may prevent the fulfillment of UNESCO’s cultural-preservation objectives concerning the collection and documentation of intangible cultural heritage in the form of creative or artistic traditions required by the Convention on Intangible Cultural Heritage.<sup>47</sup> One potential pitfall relates to the possible wariness of some indigenous peoples regarding the misappropriation of their cultural traditions by outsiders for profit.<sup>48</sup> Another danger inadvertently created by UNESCO’s efforts may be the facilitation of intellectual property theft by “anyone positioned to take advantage of an intellectual property system that favors individual or corporate creativity over the collective inventiveness of folk traditions.”<sup>49</sup> Those problems could result from the creation of an inventory of cultural traditions as required by the

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<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> Riley, *supra* note 36, at 71.

<sup>44</sup> *Id.*

<sup>45</sup> *Id.* at 72.

<sup>46</sup> 17 U.S.C. § 102(a).

<sup>47</sup> Brown, *supra* note 38.

<sup>48</sup> Brown, *supra* note 38.

<sup>49</sup> *Id.*



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Convention on Intangible Cultural Heritage, which places particular emphasis upon artistic expressions.<sup>50</sup>

The difficult process of creating a complex inventory of cultural elements for every culture within a multiethnic nation may also prove to be an insurmountable obstacle for cultures seeking to comply with the convention's terms.<sup>51</sup> In addition, "cultural heritage that is inventoried, declared an official treasure, sustained by self-conscious instruction, and surveilled by government oversight committees" could become more likely to lose "the spontaneous creativity that gave it meaning in the first place."<sup>52</sup> Conflicts might also arise within or without the society regarding control of a tradition which has been recognized as a valuable aspect of intangible cultural heritage.<sup>53</sup>

#### C. Significance

The significance of the Convention on Intangible Cultural Heritage is illustrated by its position as a link between UNESCO's past efforts (which were primarily directed toward the issuance of suggested guidelines and government-issued declarations) and the more aggressive Convention on Cultural Diversity. The Convention on Cultural Diversity is UNESCO's most decisive step to date toward its ultimate objective: the preservation of cultural heritage. The Convention on Intangible Cultural Heritage describes UNESCO's mission of cultural preservation as an attempt to "bolster the idea that all cultures give purpose and meaning to lives and thus deserve to be safeguarded."<sup>54</sup>

The Convention on Intangible Cultural Heritage, when it enters into force, may be hindered by its focus on rationally cataloguing cultural traditions.<sup>55</sup> Such cataloguing could ultimately prove insufficient to protect economically weaker cultures from the erosion that is likely to accompany the pervasive importation of cultural products from dominant countries.<sup>56</sup> The static nature of required information-gathering neither encourages nor promotes participation in perpetuating and developing cultural traditions, which is

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<sup>50</sup> *Id.*

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

<sup>53</sup> Richard Kurin, *Tangible Progress*, CULTURAL COMMENT (2003), available at <http://www.culturalcommons.org/kurin.htm> (accessed Mar. 29, 2006).

<sup>54</sup> *Id.*

<sup>55</sup> Brown, *supra* note 38.

<sup>56</sup> *Id.*

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necessary to cultural survival.<sup>57</sup> The Convention on Cultural Diversity takes a more active approach to the prevention of widespread cultural homogeneity.<sup>58</sup>

#### IV. CONVENTION ON CULTURAL DIVERSITY

The Convention on Cultural Diversity is intended to function as a vehicle for the achievement of UNESCO's ultimate objective, which was articulated at a 2002 symposium held in Warsaw: to "develop a 'global framework' for the promotion of cultural diversity."<sup>59</sup>

European countries have attempted to curb the excessive exportation of American films from the time "screen quotas" were first implemented in Europe after World War I.<sup>60</sup> These quotas were intended to ensure that local films would continue to be exhibited.<sup>61</sup> A modern approach to erecting barriers against the American cultural invasion has been crafted by France and Canada, the driving forces behind the Convention on Cultural Diversity. Both countries have already taken steps toward protecting their native film industries through the creation of exemptions for cultural industries in agreements such as the North American Free Trade Agreement; the Mercado Común del Sur; the General Agreement on Tariffs and Trade; the General Agreement of Trade in Services; and the Agreement on Trade-Related Intellectual Property Rights.<sup>62</sup>

France and Canada believe that "culture—as expressed through film, TV, music and other forms—is essential to national identities and therefore must be treated separately from other goods in international trade negotiations."<sup>63</sup> France established the practice of providing governmental subsidies to its film, music, theatre, and opera industries in the interest of protecting its cultural heritage from erosion.<sup>64</sup> In addition, "strict quotas [are imposed] on the level [of] non-French material broadcast on radio and

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<sup>57</sup> Bernier, *supra* note 24.

<sup>58</sup> See Peter Ford, *Treaty Targets Hollywood Homogenization of Culture*, SEATTLE TIMES, Oct. 20, 2003, available at <http://archives.seattletimes.nwsource.com/cgi-bin/texis.cgi/web/vortex/search?skip=0&maxReturn=20&period=archive&searchType=date&sectionID=&query=treaty+targets+hollywood&prevQuery=peter+ford&type=new> (accessed Mar. 29, 2006).

<sup>59</sup> *Id.*

<sup>60</sup> Bernier, *supra* note 24.

<sup>61</sup> *Id.*

<sup>62</sup> Galperin, *supra* note 23.

<sup>63</sup> Masters, *supra* note 2.

<sup>64</sup> *Countries Turn Backs on Hollywood*, BBC NEWS, Oct. 20, 2005, available at <http://news.bbc.co.uk/1/hi/entertainment/arts/4360496.stm> (accessed Mar. 29, 2006).

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television.”<sup>65</sup> The first draft of the Convention on Cultural Diversity was viewed by those who disagreed with its objectives as an effort to make the types of cultural exemptions successfully established by France and Canada the “global norm.”<sup>66</sup>

Other countries without strong native industries have been more vulnerable to the Hollywood invasion, and have witnessed a downturn in the production of local films as a result.<sup>67</sup> In Russia, for example, theaters largely fell into disrepair and were either closed or converted following the collapse of the Soviet Union in 1991.<sup>68</sup> During the 1990s, American films dominated the market in the absence of a domestic film industry; on average, 80 American releases were exhibited per year in the Russian theaters that remained.<sup>69</sup> Russia has recently taken steps to reclaim its local industry, such as the development of a Federal Agency on Culture and Cinematography<sup>70</sup>, and increased production of local films. One Russian film, *Turkish Gambit*, outgrossed the latest installment of *Star Wars* during its run in Russia.<sup>71</sup> The internationally-acclaimed *Night Watch* was exhibited “on an unprecedented 325 screens” across Russia, and outgrossed American films including *The Lord of The Rings: Return of the King* and *The Day After Tomorrow*.<sup>72</sup>

*Night Watch* was released in three theaters in New York and Los Angeles on February 22, 2006, “[featuring] innovative digitalized subtitles that move around the screen.”<sup>73</sup> Over the three-day President’s Day weekend, the film “had the highest three-day per-screen average [\$28,995] of any film so far this year[,]” setting the stage for Fox Searchlight to expand its release into other major American markets.<sup>74</sup> This year’s Russian-produced *Night Watch* sequel, *Day Watch*, “debuted to record-setting business in Russia,” and Fox Searchlight may release that film in the United States later this year.<sup>75</sup>

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<sup>65</sup> *Id.*

<sup>66</sup> Nick Spicer, *UNESCO Battles over Culture Commerce*, NPR MORNING EDITION (radio transcript), Nov. 10, 2003, available at EBSCOHost, Accession No. 6XN200311101007.

<sup>67</sup> Kim Murphy, *Russia Steals the Scene*, L.A. TIMES, Aug. 3, 2005, at A1, available at [http://www.russiaprofile.org/cdi/article.wbp?article-id=72245173-AB7F-4087-ADD4-95A15C315545&content\\_type=print](http://www.russiaprofile.org/cdi/article.wbp?article-id=72245173-AB7F-4087-ADD4-95A15C315545&content_type=print) (accessed Mar. 29, 2006).

<sup>68</sup> *Id.*

<sup>69</sup> *Id.*

<sup>70</sup> Decision of the Government of the Russian Federation No. 291 of June 17, 2004 on the Federal Agency on Culture and Cinematography, Economic Law of Russia, *GARANT 87124* (2004).

<sup>71</sup> Murphy, *supra* note 67.

<sup>72</sup> *Id.*

<sup>73</sup> Steven Rosen, “*Night Watch*” Freaks the BOT; “CSA” Scores Well in New York, INDIEWIRE, Feb. 22, 2006, at [http://www.indiewire.com/biz/2006/02/night\\_watch\\_fre.html](http://www.indiewire.com/biz/2006/02/night_watch_fre.html).

<sup>74</sup> *Id.*

<sup>75</sup> *Id.*

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Film industries in other countries have also exhibited gains in recent years. In 2004, locally-produced films accounted for 24% of box office admissions in the Czech Republic; in 2005, locally-produced films accounted for 60% of the box office in Turkey.<sup>76</sup> However, even the existence of a thriving local film industry is sometimes insufficient to counteract the effects of the pervasive international distribution of American films.<sup>77</sup> In 2005, locally-produced films accounted for only 25% of ticket sales in Germany, a country with a film industry that is considered relatively strong.<sup>78</sup> In Russia, where the domestic film industry is ostensibly on the rebound, admissions for American films jumped from \$10 million in 1999 to \$215 million in 2004 (out of \$268 million total).<sup>79</sup> Therefore, the success of individual domestic films has not prevented American films from dominating Russian theatres and the box office revenue generated therefrom.

France and Canada, despite their efforts, have also suffered the effects of cultural erosion due to the pervasive international distribution of American cultural products.<sup>80</sup> Ratings data published by the Canadian Bureau of Broadcast Measurement, which is similar to the U.S. Nielsen ratings system, recently indicated that 19 of the top 20 most-watched television programs in primetime for a given week were American, not Canadian.<sup>81</sup> This trend seems to bode ill for a recent attempt by the Canadian Radio-television and Telecommunications Commission to increase the presence of native programming by rewarding domestic broadcasters who devoted more airtime to Canadian programs with more advertising minutes per primetime hour.<sup>82</sup> Steve Waddell, the national executive director of the Alliance of Canadian Cinema, Television and Radio Artists (ACTRA), urged further governmental intervention.<sup>83</sup> Waddell proposed that these advertising incentives were inadequate to stimulate broader support for native programming: “[T]he only way in which Canadian broadcasters will actually produce Canadian material to any significant extent is if they’re obligated to do so through regulation.”<sup>84</sup>

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<sup>76</sup> *Id.*

<sup>77</sup> Reuters, *European Box Office Slumps As Local Films Wither*, Dec. 27, 2005, available at [http://www.backstage.com/bsa/news\\_reviews/film/article\\_display.jsp?vnu\\_content\\_id=1001738085](http://www.backstage.com/bsa/news_reviews/film/article_display.jsp?vnu_content_id=1001738085) (accessed Mar. 29, 2006).

<sup>78</sup> *Id.*

<sup>79</sup> Murphy, *supra* note 67.

<sup>80</sup> Etan Vlessing, *Canadians Prefer U.S. Shows Over Local Fare*, THE HOLLYWOOD REPORTER, Sept. 28, 2005, available at <http://www.cbcwatch.ca/?q=node/view/1418> (accessed Mar. 29, 2006).

<sup>81</sup> Vlessing, *supra* note 81.

<sup>82</sup> *Id.*

<sup>83</sup> *Id.*

<sup>84</sup> *Id.*

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Canada became the first Member State to ratify the Convention on Cultural Diversity in December 2005.<sup>85</sup>

**A. Impact on Trade**

Foremost among the concerns expressed by the United States regarding the Convention on Cultural Diversity is the potential inhibition of long-standing trade practices. During the four months prior to UNESCO's general meeting in October 2005, the U.S. proposed 28 amendments that purported to address its concerns about textual ambiguities and contradictions.<sup>86</sup> All of the U.S. government's proposed amendments were rejected.<sup>87</sup> The U.S. was supported only by Israel in its opposition to the Treaty's adoption; Australia, Honduras, Liberia, and Nicaragua abstained.<sup>88</sup>

During the early stages of the drafting process, France and Canada counted on "the support of China and African countries as well as much of Latin America," with the exception of Mexico, Brazil, and Venezuela, who were concerned about their continued freedom to export television soap operas.<sup>89</sup> The United States was initially aligned with "other countries with commercial interests to defend," most notably Japan, due to its desire to continue exporting its widely popular animated movies, and India, due to its thriving Bollywood film industry.<sup>90</sup> India explained its defection following the adoption of the Convention on Cultural Diversity by "insisting that the convention relates to culture, not trade."<sup>91</sup>

The U.S. has more at stake than even its former fellow holdouts, because the American film industry has traditionally derived approximately half of its profits from overseas distribution.<sup>92</sup> Even before the signing of the General Agreement on Trade and Tariffs in 1947, foreign markets produced

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<sup>85</sup> UN News Centre, *Canada First To Ratify the U.N. Cultural Agency's Diversity Convention*, Dec. 23, 2005, available at <http://www.un.org/apps/news/storyAr.asp?NewsID=17030&Cr=UNESCO&Cr1=&Kw1=cultural+expressions&Kw2=diversity&Kw3=> (accessed Mar. 29, 2006).

<sup>86</sup> Thomas, *supra* note 3.

<sup>87</sup> *Id.*

<sup>88</sup> Riding, *supra* note 1.

<sup>89</sup> Alan Riding, *A Global Culture War Pits Protectionists Against Free Traders*, N.Y. TIMES, Feb. 5, 2005, at B9, available at <http://lists.essential.org/pipermail/e-commerce/2005q1/001586.html> (accessed Mar. 29, 2006).

<sup>90</sup> *Id.*

<sup>91</sup> Riding, *supra* note 1.

<sup>92</sup> Galperin, *supra* note 23.

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approximately half the revenue for Hollywood films.<sup>93</sup> Today, 85% of worldwide ticket sales are directed toward Hollywood movies.<sup>94</sup> James Gianopoulos, the co-chairman of 20th Century Fox Filmed Entertainment, pointed out that “[t]he U.S. [population] is roughly 300 million people and the [population of] rest of the world is 6 billion people, so when you think of the opportunity of international markets, that’s the best example[.]”<sup>95</sup>

Ratification of the Convention on Cultural Diversity could potentially curtail the ability of the United States to export Hollywood films at its current rate.<sup>96</sup> Exploitation of foreign markets is a practice that has been utilized by the American film industry to maximize profits for over eighty years.<sup>97</sup> In 2003, during early stages of the drafting process for the Convention on Cultural Diversity, the position taken by the U.S. was characterized derisively as a desire to secure its unfettered domination of foreign markets by “[insisting] on access to [such] markets in the name of free trade.”<sup>98</sup> Indeed, the trade agenda favored by the U.S. government has been described as follows: the elimination of “all barriers to the flow of trade and investments in the audiovisual sector.”<sup>99</sup>

Dan Glickman, chairman of the Motion Picture Association of America (“MPAA”), registered strenuous objections immediately following the adoption of the Treaty: “No one should use this convention to close their borders to a whole host of products . . . The World Trade Organization is the place for [trade].”<sup>100</sup> Glickman offered an illustration of the type of trade restrictions about which the American film industry is concerned: “What’s to stop a country saying that it’ll only take 20% of U.S. films, or taxing our films but not its own?”<sup>101</sup> Prior to the Treaty’s adoption, the U.S. government warned that “[m]ounting trade barriers, including efforts to prevent the free flow of investment and knowledge, [was] not a valid way to promote cultural liberty or diversity since such measures reduce choices.”<sup>102</sup> In France, American films account for “about 65 percent” of the box office, “compared with 90 percent elsewhere in Europe.”<sup>103</sup>

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<sup>93</sup> Galperin, *supra* note 23.

<sup>94</sup> Riding, *supra* note 1.

<sup>95</sup> Reuters, *supra* note 78.

<sup>96</sup> Masters, *supra* note 2.

<sup>97</sup> Bernier, *supra* note 24.

<sup>98</sup> Spicer, *supra* note 66.

<sup>99</sup> Galperin, *supra* note 23.

<sup>100</sup> Masters, *supra* note 2.

<sup>101</sup> *Id.*

<sup>102</sup> Riding, *supra* note 90.

<sup>103</sup> *Id.*

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The Motion Picture Association of America has balked at the cultural exemptions to trade agreements that France has established. However, those efforts have ensured that the French film industry continues to thrive at a higher level than those in other European countries.<sup>104</sup> The relative success enjoyed by the French film industry is attributable to the “trade barrier[s]” erected by the government to reduce the degree to which Hollywood films are permitted to dominate the market.<sup>105</sup>

In the beginning, the drafters of the Convention on Cultural Diversity sought to “take movies and TV programs off the agenda of the World Trade Organization [and] put them on UNESCO’s agenda[.]”<sup>106</sup> The drafters intended to create “a binding international legal document” cementing the ability of countries to financially support their local cultural industries by “[shielding] culture from the free-trade rules of the Geneva-based [WTO].”<sup>107</sup> UNESCO has described its goal as the creation of “a platform for international cooperation.”<sup>108</sup> If the Treaty, as adopted, is formally ratified by 30 member states, it will simply become a factor to be considered during WTO negotiations concerning cultural products.<sup>109</sup> The Treaty, despite changes made to its terms during the drafting process, would function as “a frame of reference, a code of conduct, and a discussion forum for all countries that consider the preservation of . . . cultural diversity [to be an essential aspect] of globalization.”<sup>110</sup>

French Culture Minister Renaud Donnedieu de Vabres claimed that the Convention on Cultural Diversity, as adopted in October 2005, was simply “a clear recognition” that cultural goods such as film, TV [programs], and music are not “merchandise like any other” and should be treated separately in world trade talks.<sup>111</sup> The effects of globalization and trade liberalization on cultures might be best approached from a sociological and anthropological standpoint.<sup>112</sup> For example, “trade in cultural goods brings to light different conceptions about . . . economic development, cultural artifacts, and issues of collective identity.”<sup>113</sup>

The rationale for the position supported by France and Canada is that although trends toward globalization and free trade “lead to closer ties and

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<sup>104</sup> Riding, *supra* note 90.

<sup>105</sup> *Id.*

<sup>106</sup> Spicer, *supra* note 66.

<sup>107</sup> *Id.*

<sup>108</sup> UN News Centre, *supra* note 86.

<sup>109</sup> Riding, *supra* note 1.

<sup>110</sup> Bernier, *supra* note 24.

<sup>111</sup> Riding, *supra* note 1.

<sup>112</sup> Bernier, *supra* note 24.

<sup>113</sup> Galperin, *supra* note 23.

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greater interaction between cultures, [such trends] may also harm the preservation of cultural identities[.]”<sup>114</sup> The “unrelenting flow” of American cultural products into Canada (and the preference developed by its citizens for American programs) motivates that government’s support of a cultural protectionism agenda in trade negotiations.<sup>115</sup> However, the effects of trade liberalization and globalization have alternately been proposed as catalysts for the development of a society’s own cultural expressions.<sup>116</sup> Such effects could serve as “a key element in the adaptation of various cultures to the transformations imposed on them by globalization and trade liberalization[.]”<sup>117</sup> Creators of cultural products, therefore, also “create a critical forum for confrontation between domestic and foreign values.”<sup>118</sup>

If the principal importance of the Convention on Cultural Diversity is symbolic, as some experts have proposed, the three-pronged threat perceived by the U.S. government may not come to fruition.<sup>119</sup> This theory may be supported by an examination of UNESCO’s past efforts to encourage and protect cultural diversity.<sup>120</sup> In the Universal Declaration on Cultural Diversity, UNESCO acknowledged that encouraging the unrestrained exchange of cultural products on a global scale may be desirable and potentially beneficial.<sup>121</sup> UNESCO seeks to strike a balance between a “free flow” of ideas and information and oppressive inequality borne from disparate economic conditions.<sup>122</sup>

Also lending support to this perspective is the fact that despite the disparity between the population of the U.S. and that of “the rest of the world,” James Gianopulos attributed only half of the revenue generated by 20<sup>th</sup> Century Fox in 2005 to international film distribution.<sup>123</sup> Although 20<sup>th</sup> Century Fox is only one of several major Hollywood studios, this figure indicates that the cultural damage done by the pervasive distribution of American films into foreign markets could outweigh the financial benefits of that practice, regardless of the MPAA’s trade-related concerns. Ticket sales for local and Hollywood-produced films declined precipitously in countries with formerly-thriving

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<sup>114</sup> Bernier, *supra* note 24.

<sup>115</sup> Galperin, *supra* note 23.

<sup>116</sup> Bernier, *supra* note 24.

<sup>117</sup> Bernier, *supra* note 24.

<sup>118</sup> Bernier, *supra* note 24.

<sup>119</sup> Riding, *supra* note 1.

<sup>120</sup> Riding, *supra* note 1.

<sup>121</sup> Spicer, *supra* note 66.

<sup>122</sup> Spicer, *supra* note 66.

<sup>123</sup> Reuters, *supra* note 78.



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cultural industries—including France, Germany, Spain, and Italy—during 2005.<sup>124</sup>

**B. Impact on the Free Flow of Information**

The U.S. government feared that the terms of the Treaty could have an adverse impact upon the free flow of information between cultures.<sup>125</sup> U.N. Ambassador Louise Oliver explained this concept as follows: “We support ‘protect’ as in nurture, not ‘protect’ as in barriers. . . . If the convention promotes cultural diversity, we are in favor. We’re not in favor of anything that prevents the free and open exchange of cultures.”<sup>126</sup> The adopted version of the Treaty addresses this concern, noting that “cultural diversity is strengthened by the free flow of ideas, and . . . is nurtured by constant exchanges and interaction between cultures.”<sup>127</sup>

The Convention on Cultural Diversity is intended to assist cultures in the protection and promotion of their native cultural industries; the U.S. government, however, believes the Treaty presents a threat to the free flow of ideas between cultures.<sup>128</sup> This perceived threat may be analogous to the potentially inhibitive effect that the expansion of intellectual property laws could have on the “free circulation of ideas and our common cultural heritage” within and without indigenous societies.<sup>129</sup> Classifying intangible cultural traditions as “property” protected under the law, however, may have the beneficial effect of putting the indigenous peoples whose property is the subject of this controversy “on the same footing as other citizens.”<sup>130</sup> Similarly, the Treaty could contribute to the revitalization of foreign film and television industries that have suffered from being overshadowed by the U.S.-produced cultural products that pervade their airwaves and fill their theaters.<sup>131</sup>

Proponents of trade liberalization, with the objective of avoiding what is derisively termed “cultural protectionism,” have not demonstrated that the

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<sup>124</sup> *Id.*

<sup>125</sup> Thomas, *supra* note 3.

<sup>126</sup> Riding, *supra* note 90.

<sup>127</sup> Convention on the Protection and Promotion of the Diversity of Cultural Expressions, *supra* note 8.

<sup>128</sup> *Id.*

<sup>129</sup> Riley, *supra* note 36, at 76.

<sup>130</sup> *Id.*

<sup>131</sup> See Spicer, *supra* note 66 (French film industry lobbyist Pierre Jolevan explained that “the Convention on Cultural Diversity is not about stopping Hollywood, which . . . would be impossible. [Rather,] the convention’s purpose is to simply ensure that non-American film industries can survive.”).

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pervasive importation of cultural products from one dominant source into economically weaker societies is beneficial for the maintenance or development of local cultural industries.<sup>132</sup> For example, although a unified European market might rival the American market in volume, “the idea that the free flow of cultural products would bring to the fore the ‘common European identity,’ creating a pan-European audience, has proven overly simplistic.”<sup>133</sup>

The exportation of American films to countries without film industries could potentially have effects that are ultimately classifiable as beneficial. This subject is explored in the 2005 film *Reel Paradise*, a documentary about the establishment of a free cinema on the remote Fijian island of Tavenui by John Pierson, an author who became a prominent figure in the American independent film scene during the 1990s. As noted by *New York Times* film critic Stephen Holden, “[m]ost of the Fijians who live on Tavenui are either native islanders or Indo-Fijians descended from indentured servants who immigrated to the islands in the late 19<sup>th</sup> century [who now] earn a subsistence living as farmers, fishermen, and merchants.”<sup>134</sup> Pierson exhibited films for free because otherwise, “hardly anyone on the island could afford to go.”<sup>135</sup>

Opponents of the excessive exportation of American cultural products might regard the exclusive flow of Hollywood films into an economically weak culture through an outlet such as Pierson’s theater as a particularly oppressive form of “cultural imperialism”—an attempt to impose American values on other cultures.<sup>136</sup> However, the Fijians responded appreciatively to Pierson’s efforts; his 288-seat theater was regularly packed for free exhibitions of films ranging from features starring the Three Stooges and Buster Keaton to more modern manifestations of gross-out comedy.<sup>137</sup>

The degree to which a culture is receptive toward the importation of American cultural products is not the only factor to be considered. Concerns regarding cultural erosion or the potentially stunted development of local cultural industries should not be dismissed as mere “cultural protectionism,” as

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<sup>132</sup> Galperin, *supra* note 23.

<sup>133</sup> Galperin, *supra* note 23.

<sup>134</sup> Stephen Holden, *Creating a Free Cinema Off Beaten Track in Fiji*, N.Y. TIMES, Aug. 17, 2005, available at <http://www.reelparadise.com/press/nytimes2.html> (accessed Mar. 29, 2006).

<sup>135</sup> *Id.*

<sup>136</sup> See Philippe Legrain, *Cultural Globalization Is Not Americanization*, THE CHRONICLE OF HIGHER EDUCATION, May 9, 2003, available at <http://chronicle.com/free/v49/i35/35b00701.htm> (explaining that “[c]ultural imperialism is said to impose American values as well as products, promote the commercial at the expense of the authentic, and substitute shallow gratification for deeper satisfaction.”).

<sup>137</sup> Holden, *supra* note 135.

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the U.S. Department of State has recently done.<sup>138</sup> Rather, “[globalization] poses a serious challenge to ethnic minorities whose languages, customs, and ideas are easily drowned out by the din of mass media catering to the interests of majority communities.”<sup>139</sup> During the early stages of drafting the Convention on Cultural Diversity, Louise Oliver characterized the U.S. government’s objective in this area as “the free and open exchange of cultures.”<sup>140</sup> The U.S. government remained ardently opposed to the Treaty’s terms throughout the drafting process. At the October 2005 meeting, the U.S. Department of State urged UNESCO to consider redrafting the Treaty in order to prevent governments from using its terms as the basis for imposing “protectionist trade measures in the guise of protecting culture.”<sup>141</sup>

An initial draft of the Convention on Cultural Diversity endorsed “the free flow of ideas by word and image,” and noted the distinction the drafters believed should be drawn between cultural products and other types of merchandise in trade negotiations.<sup>142</sup> In response to that early draft, the U.S. government offered a preview of the vague objections it would later launch regarding the adopted version: “[C]ontrolling cultural or artistic expressions is not consistent with respect for human rights or the free flow of information.”<sup>143</sup>

UNESCO had previously explored the idea of promoting the exchange of ideas between cultures in the Universal Declaration on Cultural Diversity.<sup>144</sup> The Universal Declaration explained that “creation draws on the roots of cultural tradition, but flourishes in contact with other cultures.”<sup>145</sup> UNESCO noted the importance of ensuring compatibility between a free flow of ideas and “the production and dissemination of diversified cultural goods and services through cultural industries that have the means to assert themselves at the local and global level.”<sup>146</sup>

“France and Canada view cultural independence as an essential part of their political identity[,]”<sup>147</sup> but the protectionist efforts of the European Union and Canada could have detrimentally affected the exchange of information

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<sup>138</sup> Thomas, *supra* note 3.

<sup>139</sup> Brown, *supra* note 38.

<sup>140</sup> Riding, *supra* note 90.

<sup>141</sup> *Id.*

<sup>142</sup> Riding, *supra* note 90.

<sup>143</sup> *Id.*

<sup>144</sup> Francesco Francioni, *Beyond State Sovereignty: The Protection of Cultural Heritage as a Shared Interest of Humanity*, 25 MICH. J. INT’L L. 1209, 1227 (2004).

<sup>145</sup> *Id.*

<sup>146</sup> *Id.*

<sup>147</sup> Riding, *supra* note 90.

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between cultures.<sup>148</sup> In particular, it has been contended that “protectionism and subsidies [for local cultural industries] have successfully nurtured an industry without necessarily providing Canadians access to a more diverse cultural sphere.”<sup>149</sup> Evidence of intracultural rejection of domestic films and television programs may support this contention.<sup>150</sup> However, the identification of a protectionist agenda is insufficient to condemn the effort of these nations to protect their cultural heritage from erosion. It is likely that other factors have played an integral role in their active support of UNESCO’s objectives, such as “attempts to conserve cultural traditions in the face of modernization, and the need to buttress standing in the world by garnering international recognition, prestige and even legitimization for one’s own cultural heritage.”<sup>151</sup>

### C. Impact on Human Rights

The U.S. government articulated concern regarding the potentially adverse effect of the Convention on Cultural Diversity on “human rights[.]”<sup>152</sup> This concern seems to be an unnecessarily hyperbolic way of expressing the benign concept of the freedom of individuals to “choose how to express themselves and how to interact with others.”<sup>153</sup> The U.S. Department of State has declared its position as a “vigorous proponent of cultural diversity[.]”<sup>154</sup> The Department of State also explained that its objective is to prevent “[g]overnments [from] deciding what citizens can read, hear, or see[, which] denies individuals the opportunity to make independent choices about what they value.”<sup>155</sup> Again, it should be noted that the adoption of this Convention only creates an additional factor to be considered during trade negotiations. The Treaty does not empower governments to summarily restrict importation of cultural products from the United States.<sup>156</sup>

The Convention on Cultural Diversity does not take the position that individuals should be prevented from expressing themselves freely. Rather, UNESCO has issued a statement to the effect that “cultural diversity must be considered as a ‘common heritage of humanity,’ and its ‘[defense] as an ethical

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<sup>148</sup> Galperin, *supra* note 23.

<sup>149</sup> *Id.*

<sup>150</sup> Vlessing, *supra* note 81.

<sup>151</sup> Kurin, *supra* note 51.

<sup>152</sup> Thomas, *supra* note 3.

<sup>153</sup> Thomas, *supra* note 3.

<sup>154</sup> *Id.*

<sup>155</sup> *Id.*

<sup>156</sup> Riding, *supra* note 1.

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imperative, inseparable from respect for human dignity.”<sup>157</sup> UNESCO’s efforts to preserve and promote cultural diversity could replace the myopic U.S. concept of individual freedom to trade without regard for cultural consequences with that of “. . . ‘humanity’ as the new ‘non-state actor[.]’”<sup>158</sup> By adopting this broader perspective, the Treaty may seek to preserve diversity as “a common patrimony to be preserved in the public interest.”<sup>159</sup>

The preservation of culture is inextricably intertwined with the protection of human rights. An analogy may be drawn to language preservation efforts such as those undertaken by the Republic of Ireland to ensure the survival of the native language, Irish Gaelic.<sup>160</sup> The Penal Laws, enacted in that country by the English in the 18<sup>th</sup> century, prohibited “any expression of Irish national identity, especially the use of the Gaelic language.”<sup>161</sup> By the end of the 18<sup>th</sup> century, no one “who had attained, or hoped to attain, a high position in life” still spoke the Irish language.<sup>162</sup> In addition, the use of Irish Gaelic in schools became a punishable offense.<sup>163</sup>

Language preservation efforts undertaken since then by Irish citizens in an attempt to salvage the native Irish culture have succeeded, to some extent. Although use of the language is still relatively low, the Republic of Ireland recently enacted a law recognizing Irish Gaelic as the official language to be used on ordnance survey maps and government documents concerning the Gaeltacht, a western area of the country where only the Irish language is spoken.<sup>164</sup> Perhaps of greater consequence is the recent addition of Irish Gaelic as an official working language of the European Union.<sup>165</sup>

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<sup>157</sup> Press Release, U.N. Educ. Scientific & Cultural Org. [UNESCO], General Conference Adopts Convention on the Protection and Promotion of the Diversity of Cultural Expressions, Press Release No. 2005-128 (Oct. 20, 2005), available at [http://portal.unesco.org/en/ev.php-URL\\_ID=30298&URL\\_DO=DO\\_TOPIC&URL\\_SECTION=201.html](http://portal.unesco.org/en/ev.php-URL_ID=30298&URL_DO=DO_TOPIC&URL_SECTION=201.html).

<sup>158</sup> Francioni, *supra* note 144, at 1226.

<sup>159</sup> *Id.*

<sup>160</sup> The use of Irish Gaelic in the Republic of Ireland was prohibited by law in the 18<sup>th</sup> century. Similar prohibitions or legal restrictions have not been imposed upon cultures whose domestic film industries have been weakened by a steady flow of films from the U.S. However, the effects may be similar in terms of the cultural damage resulting from the diminished ability to successfully create and disseminate cultural expressions.

<sup>161</sup> Anna Asián and James McCullough, *Hiberno-English and the Teaching of Modern and Contemporary Irish Literature in an EFL Context*, 5 *LINKS & LETTERS* 37, 40 (1998), available at <http://www.bib.uab.es/pub/linksandletters/11337397n5p37.pdf>.

<sup>162</sup> *Id.*

<sup>163</sup> *Id.*

<sup>164</sup> BBC News, *Irish Language Law Takes Effect*, Mar. 28, 2005, at <http://news.bbc.co.uk/1/hi/world/europe/4388061.stm> (accessed Mar. 29, 2006).

<sup>165</sup> *Id.*

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The use of one's native language is a crucial aspect of cultural expression, and the deprivation of that ability can only be classified as a deprivation of a basic human right. UNESCO has referred to language preservation as a goal intrinsically related to the protection of cultural diversity, noting that half of the languages spoken in the world are on the brink of extinction[.]<sup>166</sup> By the same token, the ability to produce and distribute native films and television programs is arguably a basic form of cultural expression as well. The maintenance of cultural integrity is said to be found in "the continuation of a range of cultural patterns."<sup>167</sup> This principle has been recognized "as a norm within the framework of human rights[.]"<sup>168</sup> The U.S. is hardly proposing that governmental support for native film industries be criminalized. However, the continued insistence of the U.S. government that its unfettered domination of foreign markets must be allowed to continue as an exercise of its own "human rights," notwithstanding the financial impact on local cultural industries, may deprive members of those cultures of the ability to express their cultural identities through artistic endeavors and the mass media.<sup>169</sup>

**V. CONCLUSION**

UNESCO has undertaken a laudable series of efforts to protect, preserve, and promote cultural traditions classifiable as intangible cultural heritage as well as the continued expression of cultural identities through folklore in the form of artistic media such as film and television. The work of this organization could play an important role in an eventual turning of the tide against the misappropriation of cultural traditions for profit and, more concretely, the U.S. domination of foreign markets through pervasive international distribution of its own cultural products. Efforts preceding the adoption of the Convention on Cultural Diversity sought to protect more ephemeral aspects of cultural expression, such as oral traditions and transmissions of folklore. The Convention on Intangible Cultural Heritage, in particular, took an approach to cultural preservation that relied primarily upon excessively rational techniques for ensuring the survival of cultural traditions, including extensive documentation.

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<sup>166</sup> UN News Centre, *supra* note 86.

<sup>167</sup> Anaya, *supra* note 6, at 25.

<sup>168</sup> Anaya, *supra* note 6, at 25.

<sup>169</sup> See Spicer, *supra* note 66 (French film industry lobbyist Pierre Jolevan described the purpose of the convention as it relates to ensuring the survival of international film industries: "Do we want a world which is under the power of a few people [creating films] or do we want to keep [in] each country a way of thinking, a way of seeing the world? That [is] the point.").

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The Convention on Intangible Cultural Heritage places an emphasis on creating inventories of cultural traditions, turning cultural preservation into an exercise in gathering information. This practice could potentially benefit societies by preventing intellectual property theft through the creation of a master list of traditional artistic practices historically associated with a certain culture. The actual information-gathering endeavor might prove less successful than anticipated, because cultural traditions are spontaneous and undocumented. Therefore, “intangible cultural heritage” may ultimately prove too ephemeral to protect in this manner. The Convention on Intangible Cultural Heritage recognized that a culture’s heritage is preserved through intangible methods of transmitting folklore, and in so doing paved the way for the Convention on Cultural Diversity.

The Convention on Cultural Diversity serves as a more explicit manifestation of UNESCO’s desire to ensure the survival of cultural traditions by supplying a means for governments to provide funding and other types of support to native film industries. Those efforts may serve to protect a society’s cultural industries from erosion due to the excessive importation of cultural products such as films and television programs from economically dominant sources, foremost among which is the U.S. The American film industry derives almost half of its box office revenue from overseas markets. This is an impressive figure, in terms of the degree to which the continued exportation of American films is important to the survival of our own native film industry. However, when the population of the United States is contrasted with the collective population of the foreign markets into which its films are imported, the figure becomes less worthy of reverence.

America may attract more moviegoers within its own borders than do other countries. If the presence of American films in foreign theaters were to decrease, the benefits to cultures whose film industries were given the opportunity to rebound from years of suppression due to overwhelming importation of American films could potentially outweigh the relative revenue generated abroad for Hollywood films—in terms of social policy, if not finance. Russian citizens, for example, embraced the renewed exhibition of locally-produced films, as evidenced by the success of *Night Watch* and its sequel.<sup>170</sup> The Convention on Cultural Diversity might not ultimately achieve this balancing effect, but if it is ratified, the Treaty will likely serve as an important step toward permitting foreign markets to overcome U.S. domination.

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<sup>170</sup> It should be noted that Canadian citizens, conversely, expressed an overwhelming preference for television programs imported from the U.S., despite the protection Canada has ensured that its cultural industries must receive during trade negotiations.

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If the Treaty's effects are largely symbolic, the position of the U.S. as the sole dissenter will have done little more than expose the government's fervent desire to maintain the advantage American films have traditionally enjoyed in foreign markets. This profit-maximizing perspective may violate a principle upon which the government has vehemently insisted that the Convention on Cultural Diversity would inflict irreparable damage: the connection between freedom of cultural expression and human rights. The U.S. domination of foreign markets, such as Canada—where viewers have developed an overwhelming preference for American programming—has a stifling effect on the cultural industries within those markets. In Canada, the government resorted to offering financial incentives to those who would broadcast local programs or continue to produce local films.

Some cultures, such as Russia, have successfully helped their cultural industries rise from the dead after years of U.S. domination. However, there is virtually no reciprocity where the pervasive international distribution of Hollywood films is concerned. Only 1% of films exhibited in American theaters are from foreign sources.<sup>171</sup> In contrast, 85% of the tickets sold in theaters around the world are for American films.<sup>172</sup>

In light of those figures, it is difficult to comprehend the basis for the position of the U.S. government, as expressed by the U.S. Department of State as well as U.N. Ambassador Louise Oliver. They contend that the Convention on Cultural Diversity is likely to have an adverse effect on the free flow of information and ideas between cultures, as well as the more nebulous concept of "human rights." Motion Picture Association of America chairman Dan Glickman's vow to fight the potentially detrimental effects of the Treaty, if ratified, is similarly baffling. The American film industry may rationally seek to protect its financial interests. However, the adverse impact on trade for the U.S. could be balanced by the beneficial impact on cultures who are freed, even slightly, from the oppressive importation of American films at the expense of their own native film industries.

The disparity between the rate at which American films are exported to the rest of the world and the rate at which they are imported into American theaters from foreign sources provides little support for the government's contention that the Convention on Cultural Diversity might have an undesirably stifling effect on the free and open exchange of ideas between cultures. It is difficult to conceive that any such effect could be of greater detriment to intercultural communication than the current arrangement. Existing practices may benefit the American film industry by generating additional profits but

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<sup>171</sup> Riding, *supra* note 1.

<sup>172</sup> Riding, *supra* note 1.



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cannot be said to benefit the native film industries—and, by extension, the unique cultural identities—of societies affected by the long-standing arrangements perceived to be endangered by the Treaty.

If cultural preservation can be classified as the protection of the ability to create expressions of cultural identity, surely that qualifies as a basic human right in the same sense that efforts to preserve the native language of Ireland in the face of a long history of suppression by the dominant English regime are classifiable as an exercise of the basic human right to use one's native language. The use of Irish Gaelic as an expression of cultural identity is analogous to the ability to create and disseminate films and television programs which serve a similar purpose. Therefore, the suppression of native film and television industries in foreign markets could qualify as a method of depriving a culture of the ability to use artistic endeavors and the mass media to express its long-standing traditions, beliefs, norms, and values. It should be noted that no similar restriction is imposed upon the production, exhibition, and exportation of Hollywood films.

Despite the apparent need for such a limitation, the significance of the Convention on Cultural Diversity is likely to be primarily symbolic. French Culture Minister Renaud Donnedieu de Vabres declared that the adoption of the Treaty was “a victory for consciousness-raising.”<sup>173</sup> Even if that is the sole effect of the Treaty, it may be sufficient to bring these concerns to the attention of the World Trade Organization. The Convention on Cultural Diversity will become a factor to be considered during trade negotiations if it ultimately enters into force. That does not seem to conflict with MPAA Chairman Dan Glickman's insistence that the WTO is the proper place for debate regarding the methods UNESCO seeks to impose for preserving cultural diversity, nor does this consequence seem to merit the alarm with which the adoption of the Treaty was originally received by representatives of the U.S.

The distinct possibility exists that the Convention on Cultural Diversity will ultimately have little practical effect immediately upon its ratification or rejection by member countries. For example, the rejection of domestic cultural products by Canadian consumers illustrates that consumers abroad have become accustomed to the dominant importation of American films and television programs. However, the value of the Treaty lies primarily in the buttressing effect it could have for UNESCO's ultimate goal—even if it is not ratified by the requisite number of countries. The mere existence of the Convention on Cultural Diversity may shed new light upon the need to prevent techniques of preserving traditional (and evolving) beliefs, values, and norms through the production of domestic cultural products from being entirely subsumed by the

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<sup>173</sup> Riding, *supra* note 1.

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utter dominance of Hollywood films in overseas markets. Therefore, the Treaty's greatest utility might be as a step toward worldwide recognition of these detrimental exportation practices, as it may illustrate the necessity for increased regulation in order to preserve cultural identity within those dormant or struggling markets.

One of the motivating factors often suggested for the worldwide box office slump in 2005 was the declining quality of Hollywood films. The position of the U.S. as the drastically more economically invested of the two dissenting members of UNESCO may support the international perception of the U.S. film industry as primarily interested in individual rather than collective cultural creativity, and motivated solely by mercenary factors. This perception could contribute to a continued backlash against its cultural products.

The Treaty is said to have "given voice to widespread concern about the perils of excessive domination by American popular culture"; as such, it could prove to be the most decisive step yet toward the objective UNESCO has been working to achieve for thirty years. The Convention on Cultural Diversity may help ensure the survival of cultures through the protection of expressions of traditional beliefs, values, and norms within a society, and the prevention of the misappropriation or stagnation which results from the excessive importation of cultural products from economically dominant sources.

**NOTHING BUT THE FACTS:  
AN IN-DEPTH ANALYSIS OF THE EFFECTS  
OF ECONOMIC SANCTIONS AGAINST CUBA**

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**Introduction: Importance of the Issue**

With the current uncertain state of the United States' economy, any measure to improve the economy would be welcomed. If the U.S. were to sell more goods, either at home or abroad, the increase in demand might strengthen the U.S. economy enough to foster a turn around. The question arises, how to sell more goods. One obvious answer would be for the U.S. economy to enter into a new market. In this globalized world economy, it may be difficult to find such a market for U.S. goods or services. By looking no further than 90 miles off the southern coast of Florida, however, one finds such an untapped economy: Cuba.

Although opening trade with Cuba may help alleviate some of the United States' economic woes, the U.S. has refused to lift its 46 year embargo. Why? Policy makers find it politically difficult to lift the sanctions because of the authoritarian nature of the Cuban government. The economic sanctions are seen as a way for the U. S. to display its disapproval of communism and uphold the American ideals of freedom and democracy. Policy makers are concerned that lifting the sanctions may give off the appearance of weakness in U.S. foreign policy. There is debate, however, over whether the sanctions actually accomplish their objectives. Even if they do, there is further debate as to whether the sanctions cause serious harm to the U.S. economy. The costs and benefits of the situation, from both economic and political perspectives, must be analyzed properly to ensure the correct policy is being instituted. The current state of the economy thus makes the topic of sanctions against Cuba an

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important issue because the U.S. is in need of measures that will help the economy recover.

This article will seek to analyze the state of affairs in detail, in order to provide an increased understanding of this situation. The article will begin by giving a general overview of the country of Cuba, by providing basic facts on its government, demographics, government, and economy. The article will next explore a theoretical analysis of economic sanctions. A clear definition of economic sanctions will then be presented along with a discussion on the types, purposes, and effects of economic sanctions. Then a historical overview of general economic sanctions will be presented. The article next turns to the history of the Cuban embargo, followed by a brief overview of the current situation.

Theories of international trade that may be helpful to explain sanctions are addressed in the next section. This discussion includes models in both a general and partial equilibrium framework. Next, an assessment of the Cuban embargo will be presented where the sanctions against Cuba, as well as its specific objectives are defined and explained. An assessment of these goals will then be presented, followed by an overview of U.S.-Cuban relations before the implementation of the embargo. Then economic effects of the embargo are discussed using the models presented earlier and various trade statistics. Also in this section, the actual effects of the embargo on both Cuba and the U.S. are addressed.

The article will then present a policy debate focusing on arguments for lifting and keeping the embargo. Following the policy debate, outlooks for the future, as well as recommendations to policy makers are discussed. Finally a conclusion will follow summarizing the main points of the article.

### **Cuba: Geography and Demographics**

The Republic of Cuba, or simply Cuba, is an island located 90 miles south of Key West, Florida. The island is slightly smaller than Pennsylvania, yet is the largest Caribbean island.

Climate is classified as tropical, however, there is a separate dry and rainy season from November to April, and May to October, respectively. Plains make up most of Cuba's terrain, but some hills and mountains are found in the south east. Several natural resources are found in the country, including cobalt, nickel, copper, iron ore, salt, timber, manganese, petroleum, silica, and arable land.

Over eleven million people live in Cuba, most of which, sixty nine percent, are aged 15 to 64. (World Fact Book, 2002, pg. 3) There is a negative net migration rate out of Cuba at -1.21 migrants/1000 population (World Fact

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Book, 2002, pg. 3) which is most likely caused by the large amount of Cubans that flee the country in order to enter the U.S. This illegal migration into the U.S. is quite significant each year. It was estimated that 5,400 Cubans attempted to enter the U.S. illegally in 2000, and only 750 were prevented by the U.S. Coast Guard. (World Fact Book, 2002, pg.4)

Most, fifty one percent, Cubans are mulatto; however, thirty seven percent of the citizens are white. Spanish is spoken in this country, like most of Central and South America. Roman Catholic is the predominate religion, comprising eighty five percent of the population. (World Fact Book, 2002, pg. 4)

According to social development standards, Cuba is doing quite well. The country has a very low population growth rate at only .35 percent. (World Fact Book, 2002, pg. 3) Life expectancy in Cuba is also good, at 79 for females and 74 for males. (World Fact Book, 2002, pg. 4) In addition, there is a high literacy rate, at ninety six and ninety five percent for males and females, respectively. (World Fact Book, 2002, pg. 4)

### **Cuba: Government and Economy**

Cuba, one of the last communist nations in the world, is headed by Fidel Castro Ruz. The government is located in the capital city of Havana. Its legal system is based on Spanish and American Law; however, elements of communist legal theory are present. Along with an executive branch, there is also a unicameral legislative branch called the "National Assembly of People's Power," and a judicial branch known as the "People's Supreme Court."

Economically speaking, Cuba is a command economy, meaning the government controls the economy. Like other command economies, Cuba faces problems with efficiency, and thus has seen its Gross Domestic Product (GDP) stall at \$25.9 billion. (World Fact Book, 2002, pg. 6) The major component, fifty eight percent, of GDP is services, followed by industry at thirty five percent of GDP. (World Fact Book 2002, pg. 6) If one looks at the sector composition of GDP, it appears that Cuba should be fairly prosperous; however, the GDP per capita remains low at \$2300. (World Fact Book, 2002, pg. 6) This is due in part to the composition of the labor force, of which twenty five percent is in agriculture. (World Fact Book, 2002, pg. 7) Much of the low per capita can be explained simply by the nature of the economy.

There are a large number of industrial and agricultural goods produced in Cuba. The industrial goods that are produced include petroleum, tobacco, chemicals, construction, services, nickel, steel, cement, agricultural machinery, and biotechnology. The main agricultural products are livestock, beans, potatoes, rice, coffee, citrus, tobacco, and sugar. Of the goods produced, sugar,

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nickel, and tobacco are the main exports. Fish, citrus, coffee and medical products are also exported by Cuba. The main imports of the country are petroleum, food, chemicals, machinery, and equipment.

### **Definition of Economic Sanctions**

Economic sanctions are the most common tool in international politics. Sanctions serve as an important aspect of foreign policy, because of the frequency with which they are used. In order to understand why sanctions are so important, one must first know the definition of a sanction. An economic sanction can be defined as a restriction imposed on one country, the target, by another country, the sender. This restriction is meant to persuade the target country to change a policy by affecting international commerce engaged in by the target. In other words, sanctions are policy tools imposed by a country to influence another country in order to achieve some political goal.

### **Types of Economic Sanctions**

There are many types of sanctions which a country can choose to implement. Many of the sanctions are various restrictions on trade, including arms embargoes, export and import tariffs (Haass, 1998, pg. 2) or even full trade embargoes. Countries may also prohibit financial involvement in another country, which prevents financial transactions between citizens. (O'Quinn, 1997, pg. 3) Countries may even just place an overall restriction on credit, financing, and investment. (Haass, 1998, pg. 2) This will cause the economic growth of the target country to decline due to a decrease in foreign direct investment (FDI), which is a type of capital flow between countries. This type of investment "gives the lender operating ownership and control over the borrower." (Yarbrough and Yarbrough, 2000, pg. 383) The country which capital flows out of is the lender, while the receiving country is the borrower.

Political maneuvers may also act as economic sanctions. Such maneuvers include visa denials, cancellation of air links, as well as foreign assistance reductions and cutoffs. Revocation of most-favored-nation trade status, votes in international organizations or a complete withdrawal of diplomatic relations can also be used as economic sanctions.

As described by Randy Newnham, there are two broad categories of sanctions: specific economic linkage and general economic linkage. Specific economic linkage is a "state directly linking economic actions to a political demand on a target state." (Newnham, 2002, pg. 1) General economic linkage can be defined as "using economic aid or penalties to influence a country in a general way." (Newnham, 2002, pg. 1)

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Newnham goes on to distinguish between two other types of sanctions: positive and negative sanctions. A positive sanction is one often overlooked by many analysts but as Corthright and Lopen said, they are “more useful than many believe.” (Newnham, 2002, pg. 8) An example of a positive sanction would be granting most-favored-nation status to a country for making a change the sender country wanted. When most people think of sanctions; however, they think of negative ones, which often occurs when one country seeks to punish another for some action.

Sanctions may be applied in one of two ways: unilaterally, or multilaterally. When one country imposes a sanction against another, it is an example of a unilateral sanction. The important element here is that only one nation imposes the sanction. Because there are many other potential trade partners, when sanctions are unilateral, the target country simply finds another supplier/buyer. For this reason, unilateral sanctions rarely produce the desired effect. If sanctions are implied multilaterally, it is much easier for the desired result to occur. A multilateral sanction is imposed by a group of countries on another country or countries. For this reason, the sender country often needs to find international support of the sanction. This method of application is preferred because the chance of success is greater. At times international organizations, such as the United Nations or World Trade Organization, initiate sanctions in order to control our global society. One recent example of such sanctions is those imposed by the United Nations against Iraq.

### **Purpose of Economic Sanctions**

The exact purpose of economic sanctions varies by situation. According to Richard N. Haass, director of the Foreign Policy Study of the Brookings Institute in Washington, D.C., there are four basic purposes of economic sanctions. These purposes are deterrence, punishment, coercion, and signaling. Deterrence is the goal of trying to prevent something from occurring, while coercion is trying to convince a country to act in a certain way. Punishment and signaling are similar goals in that they both express a dislike of another country’s actions. Punishment is done after the action has occurred, while signaling is done prior to the action. Sanctions may be implemented in order to achieve any one or a combination of these goals. Although there are only four main purposes of sanctions, there are many more specific goals which fall under one of the general categories.

One common reason for imposing economic sanctions is to achieve a national security objective. The basic goal may be “to deter military aggression or to force an aggressor to withdraw its armed forces from a disputed territory.” (O’Quinn, 1997, pg. 4) Another goal may be to “discourage the proliferation of

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weapons of mass destruction and ballistic missiles, end support for terrorism or discourage armed aggression.” (Haass, 1998, pg. 1) In this case, the sanctions will serve as a signal for a country to discontinue its threat to the sender country’s security or else face military action. The goal of a sanction may even be the replacement of a government if the threat from that regime is very high.

There are other political or humanitarian objectives that sanctions may seek to fulfill. Sanctions can be implemented for a variety of purposes, from protecting the environment to preventing illegal drug trafficking. When imposed against non-democratic states, the sanctions typically seek to aid in democratization. Often in such states, sanctions are also used to promote the rights of workers. Between democratic states, sanctions are used to resolve international trade and investment disagreements. When imposed in such a way, sanctions are used to “ensure market access or compliance with trade agreements.” (Haass, 1998, pg. 1)

The mere threat of sanctions also serves a purpose. A threat of a sanction can increase the bargaining power of the sender country. The threat will serve as a way to protect the country in all negotiations with other countries. A very common reason for applying sanctions is to appease the public. Here sanctions serve as an important political maneuver where one country can take action against another without using military force.

Even though sanctions are imposed frequently, they do not always achieve their objectives. Sometimes only part of the original goal is achieved, while in other cases a completely different outcome is realized.

### **Economic Effects of Economic Sanctions**

The concept of economic sanctions is simply to put pressure on the economy of the target country. This strain is brought about by affecting trade patterns of the target nation by imposing one of the various types of sanctions. One effect of sanctions is a reduction in income of the target country due to a decrease in exports. The import sector of a country is affected, thus sanctions may force a country to buy necessary goods from other suppliers who are often higher priced. This in turn causes the cost of imports to rise. If sanctions are imposed multilaterally, however, a nation’s ability to use alternative suppliers may be greatly reduced, forcing the country into an autarky state. This would drive the cost of imports even higher or may even completely cut off a country from a certain good. This could force the country to have to produce the good domestically or no longer use the good.

Even though economic sanctions are intended to have negative effects on the economy of the target country, they also affect the economy of the country or countries imposing them. In addition to having a general negative



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effect on the economy, sanctions can also affect individual companies and employees. There are many negative consequences of imposing sanctions, such as lower exports, less foreign investments, fewer jobs in the export sector, and loss of market share in the global economy. (O'Quinn, 1997, pg. 9)

A decrease in the direct foreign investment a country receives can have severe effects on its economy. When this reduction occurs, companies that rely on those funds may be forced to cut back production. In turn this will reduce the number of jobs available in that sector. The subsequent drop in employment may cause a decrease in consumer spending and trigger a downward spiral in the economy. Most jobs are not completely destroyed by a sanction because over time many of the workers will be absorbed into other sectors of the economy. Although the employment rate will return to near normal, the value of the workers in the new sectors is lower than the original value of production.

Lost market share of businesses in the imposing country can also be a consequence of economic sanctions. In such a case, because of the lost market share, those companies will sell fewer goods. This decrease in demand will thus cause jobs to be cut in the economy. It is clear that the negative consequences of economic sanctions in the imposing country can be quite severe. To put this into perspective, the Council on Competitiveness found that "eight specific sanctions cost the U.S. economy \$6 billion in annual export sales and 120,000 export related jobs." (O'Quinn, 1997, pg. 9) Even though the U.S. economy is very large, with a GDP over \$10 trillion, (Work Fact Book 2002) a loss of that magnitude can not be written off as totally insignificant.

It is tempting to believe that the easy way to solve the problem of the negative consequences would be to lift the sanctions. The solution, however, is not always that simple. Even after sanctions have been lifted there may be continuing negative effects. In order to regain lost market share in the target country, U.S. companies may be forced to transfer technology, cut prices, or make unusual concessions. Another long term consequence may be strained international relationships. These relationships may be harmed between the sender and the target country as well as between other countries not directly involved. Sometimes after sanctions have been lifted, the target country remains hostile toward the sender country. Relationships with potential trade partners can also be affected by sanctions. Here, the threat of sanctions being imposed causes unnecessary fear in these nations, harms those relationships.

### **History of Economic Sanctions**

Economic sanctions in some form have been part of international trade from the beginning of time. Ever since countries have traded with each other, one country has always tried to manipulate, or gain an advantage over the other.

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The first modern example of sanctions occurred in the 1930's when Germany used the "manipulation of trade to gain security advantages." (Newnham, 2002, pg. 5) Here, trade manipulation was used by Germany in order for the country to pave the way for its military conquests in World War II.

In political science, there are two competing views on what is the most important issue for a country. The realist view, which emphasizes national security, dominated the world of political thought from the 1930's to 1950's. According to this view, everything, including the economy, was of secondary importance. Since the 1950's however, the liberal view has gained momentum. This view puts less emphasis on issues of power in regards to national security. Instead, the liberal view focuses "on the use of economic power to solve economic problems." (Newnham, 2000, pg. 8)

Since the beginning of the liberal movement the importance of sanctions has increased. Since World War II, economic sanctions have played a major part in international relations. Between World War II and 1984, there were ninety one cases of economic sanctions. (Carter, 1988, pg. 10) The U.S. took part in imposing sanctions in sixty two of those cases, which is the most of any country. (Carter, 1988, pg. 11) Today, sanctions serve as the most important political tool a country possesses because they are widely used and preferred to military action.

Sanctions are regarded as successful if the overall objective was reached. The success rate however has greatly varied. Overall, U.S. sanctions were only successful thirty seven percent of the time. (Carter, 1988, pg. 14) The success rate also varies according to the type of goal sought. The two most successful kinds of sanctions are those with the goal of destabilization or modest policy goals. Examples of such goals include creating tension against the current government, and encouraging minor policy changes, respectively. Destabilization goals have been reached in sixty seven percent of the cases, while modest policy goals have been achieved forty percent of the time. (Carter, 1988, pg. 23) Sanctions that are typically unsuccessful include those that seek to disrupt military adventures, to impair the military potential of the target country and to induce major policy changes.

There are several specific cases of successful sanctions since World War II. In World War II, a trade embargo imposed by the Allies kept strategic materials from being bought from neutral countries. The embargo was placed into effect by the Allies, including the U.S. and Great Britain, on the Axis countries of Germany and Japan. It can be said this embargo "played at least a modest role in the defeat of the Axis countries." (Carter, 1988, pg. 10) Sanctions were also at least partially successful during the Cold War. In the mid 1970's, the mere threat of financial and export sanctions by the U.S. and

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Canada helped prevent the spread of nuclear weapons. This threat persuaded South Korea not to purchase a plant that could produce nuclear weapons.

Sanctions in the form of reductions in military and economic assistance were successful against Brazil from 1977 to 1984. The sanctions helped to increase respect for human rights in the country, by helping to remove the threat of political repression and torture. Sanctions were also successful against Haiti. Here a suspension of foreign assistance also helped to overthrow their government in 1986.

There are also many examples of the failure of sanctions. The two most famous examples, other than Cuba, concern sanctions against Pakistan and Iraq. During the Cold War, sanctions could not persuade Pakistan to fully accept multilateral safeguards. The sanctions imposed multilaterally by the U.N. against Iraq have been unsuccessful for a number of years. Originally, the sanctions were imposed to punish Iraq for its invasion of Kuwait. However, once the Gulf War was won, the sanctions were not lifted. The U.N. did not lift the sanctions in hopes of gaining leverage that could be used to encourage Iraqi disarmament. It is obvious that the leverage the U.N. hoped to gain did not actually happen. Saddam Hussein showed great disrespect for the U.N. and was often cited as saying their inspections were a joke.

When Hussein was still in power, disarmament did not take place to its full extent. If the sanctions would have been successful in persuading the country to disarm, when the U.N. inspectors searched Iraq at the end of the Gulf War they would not have found anything in violation of the peace agreement. It is puzzling that Hussein was found in violation of the agreement, yet the U.N. did nothing.

Recent events involving the war with Iraq have shown that the sanctions did not achieve their desired goal. If the sanctions had been effective, the war would have been unnecessary and full disarmament would have occurred. This however was not the case. When the sanctions were the only measure taken against Iraq, Hussein acted without regard to the consequences. Because the sanctions alone did not force any political change, nor did they achieve disarmament, the sanctions must be considered a failure.

### **History of the Cuban Embargo**

In the midst of the Cold War, the U.S. took a strong stance against communism when it applied economic sanctions against Cuba. Although the sanctions began many years ago, it still is a subject of great controversy, and has been dealt with by every President since 1960. The U.S. government imposed the sanction because it was concerned about Cuba forming an alliance with the Soviet Union that would establish a totalitarian regime in Cuba. The

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U.S. was greatly concerned about this possibility because of the extensive trade with Cuba. In addition, the possibility of a nation so close to the U.S. being aligned with the Soviet Union alarmed many in the U.S. government.

The U.S. policies towards Cuba have changed over the years. According to Donna Kaplowitz the embargo can be divided into five different stages. These periods are: 1) 1960-1962, 2) 1962-1970, 3) 1971-1980, 4) 1981-1989, and 5) 1989-1996. (Kaplowitz, 1998, pg. 2) We are currently in a transition period that began in 1996. In general, the history of the sanctions is characterized by alternating periods of strengthening and weakening of the sanction's terms.

In 1960, Dwight D. Eisenhower was the first US President to impose sanctions against Cuba. This was a mere year after Fidel Castro led a rebel army into power. At this time, the U.S. developed and imposed a unilateral sanction against Cuba. It was then that all exports to Cuba were prohibited. In 1961, the U.S. fears of an alliance between Cuba and the Soviet Union were strengthened when the two nations signed a trade agreement. This reaffirmed the basic reason for imposing the sanction.

The second period of the sanctions began on February 3, 1962 when a full trade embargo was imposed against Cuba, meaning that both exports and imports were completely restricted. By 1964, all imports, exports, and finance between the U.S. and Cuba were banned. This action was taken because the Kennedy Administration was "convinced that Castro was moving rapidly toward the establishment of a totalitarian regime in alliance with the Soviet Union." (Varona, 1994, pg. 7)

This period is defined by efforts on behalf of the U.S. to include other countries in the embargo. The embargo was tightened further in July of 1964 when the Organization of American States (O.A.S.) expanded the embargo to the entire continent of South America. The O.A.S. made this decision to support the U.S. embargo because Cuba was repeatedly involved in aggressive acts against its member countries. The O.A.S. governments' were angered by Cuba's support of many violent revolutions occurring throughout the Americas.

The embargo was first loosened during the 1970's. During this decade, several countries resumed trade with Cuba. Castro sought to resume trade relationships with the O.A.S. countries because of the failure of Cuba's economic policies. Imports from Latin America in 1958 before the implementation of the embargo was at \$84 million. Just over ten years later, during the heart of the O.A.S. ban, trade with Latin America hit an all time low, with both exports and imports valued only at \$1 million each. Eventually, many O.A.S. countries resumed trade with Cuba, because of the mutual economic benefit.

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In 1974, President Gerald Ford looked into improving the overall relations between the U.S. and Cuba. Products made by U.S. subsidiaries in Latin America were allowed to be exported to Cuba in 1975; however, there was a limit on which products could be exported. Only products that had less than twenty percent U.S. made content could be exported. In this same year, the O.A.S. ban was completely lifted. Once the sanctions of the O.A.S. were lifted, trade with between Cuba and Latin America quickly increased. By the end of 1975, imports from other Latin American countries to the island nation reached \$230 million.

President Jimmy Carter continued loosening the sanctions during his term. He relaxed the travel restrictions during the late 1970's, and established two interests sections in various embassies. In 1977, a U.S. interests section was set up in the Swiss embassy in Havana and a Cuban interests section was set up in the Czech embassy in Washington.

This trend was reversed in the 1980's, however, when Ronald Reagan was elected President. Reagan "entered office intent on reversing the tide of Soviet-Cuban advancements throughout the Third World." (Varona, 1994, pg. 9) The period from 1981-1989 is characterized by a tightening of the embargo. A partial ban on travel was re-imposed in 1982, and subsidiaries were strongly warned not to exceed limits established on trade content.

The tightening continued during the next period from 1989 to 1996. During this period efforts were once again made to globalize the embargo. This created animosity among the U.S. allies who expressed strong anti-embargo sentiment. It was during this period that the U.S. lost the support of regional and international organizations. This is shown by the many votes in the United Nations that condemn the U.S. policy towards Cuba. In fact, for ten years the General Assembly has called for the end of the embargo. (Reuters, 2001, pg. 1)

In October of 1992, President George Bush signed the Cuban Democracy Act into law. It was enacted because of "Castro's refusal to introduce democratic reforms and the increasing incidence of human rights violations on the island." (Kaplowitz, 1998, pg. 9) This act tried to make the embargo world-wide by closing the subsidiary loophole for trade. This act also "encouraged U.S. foreign aid recipient nations to avoid providing assistance to Cuban regime." (Kaplowitz, 1998, pg. 10)

The Helms-Burton Act of 1996 signed by President Bill Clinton expanded the embargo extraterritorially. This act "seeks to discourage investment in Cuba by imposing sanctions on foreign companies profiting from property confiscated by the Castro regime." (Vasquez and Rodriguez, 1996, pg. 1) The act tries to discourage third parties from being involved in business activities that use or profit from the use of property that was confiscated in 1959 by the Cuban government. A major provision of the act allows U.S. nationals

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who had property confiscated to file law suits in U.S. district courts to recover damages. It also states anyone who participates in activities involving confiscated property may be banned from visiting the U.S. Another provision limits the ability of the U.S. President to cease the sanctions against Cuba. The last main provision called for the U.S. executive branch to improve enforcement of current laws relating to Cuba, such as tightening the existing sanctions.

### **Current Situation**

The most current period, from 1996 to the present, is one filled with confusion. Although both President Clinton and President George W. Bush have been against the relaxation of the sanction, there has been increased disapproval of the embargo among the American people. "A growing coalition of U.S. critics – liberal Democrats, Catholic bishops, agribusiness giants, libertarian free-traders – argues that the embargo is an antiquated relic." (Jacoby, 2002, pg. 2) The concerns of the critics have led to lobbying of members of the U.S. Congress, several of whom now support easing the sanctions. In fact, the House of Representatives passed legislation in July 2002 that would "ease restrictions on trade and travel to Cuba." (Boston Globe, 2002, pg. 1) Even former President Carter has been getting in on the debate. The Carter Center and Carter himself have been pushing the idea that the best way to promote change in Cuba is "through maximum contacts between our two countries." (Keen, 2002, pg. 2)

Thus far President Bush seems unfazed by the growing dissent, and has vowed to continue with a hard-line stance against Cuba. Bush has taken such a stance in response to the demands of the Cubans in Florida who typically vote Republican. In order to be elected Bush needed their support, and thus appeared to be committed to following their demands. For this same reason, humanitarian efforts, such as allowing trade for food have been allowed in Cuba.

### **Economic Models**

The basic theory behind an embargo is simple: one country harms another by forcing it into an autarky state. This is accomplished by cutting off a country's trading partners in order to force a country to be self-sufficient. In reality, the target country never becomes a true autarky because of the presence of other potential trading partners throughout the world. The effects of moving from free trade to autarky can be analyzed in a general equilibrium framework or a partial equilibrium model.

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In order to understand the models, one must have an understanding of various economic concepts, including a production possibilities frontier and indifference curves. A production possibilities frontier (PPF) graphically shows the different combinations of two goods that can be produced using a set amount of resources. Indifference curves represent a combination of two goods which yield the same utility, or welfare. The indifference curves closest to the origin have the lowest utility, while those farther from the origin yield higher utility.

### General Equilibrium

The neoclassical model of trade provides a general equilibrium framework, which analyzes the effects of sanctions on the country as a whole. Under free trade, the neoclassical model would appear as figure 1, Neoclassical Free Trade. In this model, the production capabilities of two countries for two goods are graphed using a production possibilities frontier. The world price ratio ( $P_X/P_Y$ ) of the two goods in a country is graphed as well, in order to determine the optimal production point. This optimal production point is where the PPF is tangent to the price line, at point  $P^F$  in the graph. This point shows the highest level of production that can be reached by using only the resources available, and given the current prices.

According to this model, under free trade a country can consume beyond its production capability by trading. As seen in the figure, under free trade a country will produce at point  $P^F$ , but will consume different amounts of both goods, represented by point  $C^F$ . The country will face a situation where it produces more of one good than it consumes and thus exports this good to other countries. It will then import the other good, which it consumes more of than it produces from another country. This graph shows that this country will export good X in the amount of DF. The country will then import good Y in the amount of AB. Remember, the actual consumption point after trade must lie on the price line,  $P_X^F/P_Y^F$ . The corresponding indifference curve of the consumption bundle is also graphed to show the welfare associated with this bundle. The welfare achieved by this bundle of consumption is represented by indifference curve  $IC^F$ .

By forcing a country to move to autarky, the sender country is trying to reduce the target country's welfare. The receiving country's welfare will be reduced because it can only consume what it produces. Consider figure 2: Neoclassical Autarky. By adding to the graph for Neoclassical Free Trade, one can see the consequences of a move to autarky. When enforcing the embargo, the consumption and production points will move to point  $P^A$ , because the relative prices change to  $P_X^A/P_Y^A$ , reflecting the prices that occur in the

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domestic market. At this point, production in the economy is equal to consumption, because all that is consumed must be produced domestically since trade is no longer a valid option. In this situation both imports and exports equal zero. This moves society down to a new different indifference curve,  $IC^A$ . Since the new indifference curve is closer to the origin than the free trade one,  $IC^F$ , then by definition the welfare of the country has decreased.

This analysis assumes that the sanctions are imposed multilaterally by all countries against the target. In reality, the sanctions are rarely imposed by every country in the world. In order to be more realistic, the neoclassical model must be expanded to include three countries. Consider figure 3, Neoclassical Embargo Reality. In this model, one country would be the sender, one would be the target and the other can represent the rest of the world. The third country will continue to trade with both countries without regard to the sanction. When doing this analysis the true effects of the sanction cannot be determined without knowing the relative prices of all three countries.

In general, the effects of trade will still be present as described above; however, they will now be less dramatic. Production in this scenario moves to  $P^E$ , and consumption moves to  $C^E$ . The country now imports less goods in the amount IK, and exports less goods in the amount of LJ, as compared to AB and DF respectively, under free trade. Instead of pushing the country back to autarky, if effective, the embargo will push consumption back to  $IC^E$ , resulting in lower utility than the free trade scenario, but higher than autarky.

### **Import Sector Partial Equilibrium**

The neoclassical model argues that there are two goods in the economy, one which is imported, and one which is exported. As a result, if the target is small and the sender country is large, the effect of the embargo for the sender country in a general equilibrium sense would be small. However, the impact on specific sectors of the economy could be large, even when the target is a small country. In order to understand the effects of the embargo on a specific sector, one must use a partial equilibrium analysis.

When considering the effects of an embargo in partial equilibrium, one can view the embargo as a quota. When one country imposes an embargo against another it is like the former's government restricting imports from a free trade level to the level of zero. An embargo prohibits all imports; therefore, the imports would be at a level of zero. Another sanction, a quota may also limit the amount of imports to zero. One can then draw a parallel between the two, and view an embargo as a quota of zero.

Under partial equilibrium free trade, the graph would look like figure 4, Import Sector Partial Equilibrium Free Trade. On a graph, the supply and



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demand curves, S and D respectively, are drawn for the imported good. The world price of the good is then graphed as a horizontal line below the intersection of the supply and demand. Supply and demand quantities are determined by the intersection of each line with the price line. At the world price, the country will produce at point A, but demands a level of goods at point B. The amount of imports is shown as the difference between the supply and demand at the world price level. In this graph, the level of a good supplied will be different than at equilibrium. To meet the excess demand of the people, the country must import the difference between its production and consumption points, the amount of AB.

The welfare of a section of the economy can be seen using a partial equilibrium framework. In such a framework, one can distinguish between the welfare gained by consumers and the welfare gained by producers. The welfare of consumers is referred to as consumer surplus, while producers' welfare is called producer surplus. The producer surplus is the area above the supply curve up to the price level. Under free trade, it would be the area HEA. The consumer surplus is given by the area above the price line and below the demand curve. Before the quota of zero was imposed, this area was GEB.

The graph would be different under an import quota of zero, as shown in figure 5, Import Sector Partial Equilibrium Zero Quota. The quota of zero would decrease the level of imports to where supply equals demand at point C if the target country is the only source of imports for the sender. The point C is the equilibrium where the supply curve intersects the demand curve. This will raise the domestic price of the good up to the level  $DP^Q$ , because the country must now produce all of the good domestically.

The change in the welfare of the country can be seen by comparing the consumer and producer surplus in each graph. Following the imposition of the quota, the producer surplus would increase to FCH because of the increase in price. This means that domestic producers would gain from a zero quota. After the imposition of the quota, the consumer surplus is reduced to FGC because of the price increase. Consumers would thus be hurt by a zero quota. The net change in welfare is seen by the area ABC, which is a dead weight loss. The total effect of the embargo, or a zero quota, would be a net loss. Since one can consider the effects of a zero quota to be similar to the effects of an embargo, an embargo would also create a dead weight loss.

Because there are other countries of the world to consider, the actual effect of the embargo would not be a quota of zero. Most likely however, the country would be forced to pay at some level above the world price but below the domestic price, at possibly  $WP^E$ . This scenario can be seen in figure 6, "Import Sector Partial Equilibrium Embargo Reality" in the appendix. The effect of the embargo would be the same as a quota; however, the net loss

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would not be as great. Consumers lose out in this scenario as their surplus decreases to GLK. Producers gain however, because their surplus increases to HLJ. The losses from this scenario would most likely be felt by the sender country, however, if the target's trade constitutes a small fraction of the sender's trade, then the net loss will be small. The effects could also occur in the target country's import sector. This would occur because the target would be forced to purchase goods it originally bought from the sender from a higher priced supplier. The new net loss would fall to JABK as seen in the graph.

**Export Sector Partial Equilibrium**

Effects of the embargo can be seen in the export sector as shown in figure 7, Export Sector Partial Equilibrium Free Trade. The basic ideas are the same for imports as for exports. In the export sector, the production and consumption points are determined the same way as in the import sector, by the intersection of the price line with the supply and demand curves. The difference is that now the world price under trade is above the intersection of supply and demand. In the graph, point A is the consumption and point B is the production. The country would therefore export the difference between the two points, represented by the distance AB. Consumer and producer surplus is determined the same way as in the import sector. In this graph the producer surplus would be the area EBH, under free trade. The consumer surplus is GEA. As one can see the producers are much better off under free trade.

The graph for a quota of zero in the export sector is figure 8, Export Reality Partial Equilibrium Zero Quota. The effects of the quota would be to decrease the level of exports to the intersection of supply and demand. Point C would then be the equilibrium for the target country, assuming the sender was the only buyer of the good. This will reduce price to  $DP^Q$  because the country can no longer export its excess supply of goods, and therefore must consume all it produces domestically.

The change in the welfare can be seen in this graph by comparing the consumer and producer surplus. Following the imposition of the quota, the producer surplus would decrease to FCH because of the decrease in price. This means that domestic producers would lose from a zero quota. After the quota is imposed, the consumer surplus is increased to FGC because of the price decrease. Consumers would thus win from the imposition of a zero quota. The total effect of the embargo, or a zero quota, would be a net loss, as seen by area ABC. Since one can consider the effects of a zero quota to be similar to the effects of an embargo, an embargo would also create a dead weight loss.

Because there are more than two countries in the world, the actual effect of the embargo would be different than an export quota of zero. Consider

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figure 9, Export Sector Partial Equilibrium Embargo Reality. In most cases, the country will have to pay a price between  $WP$  and  $DP^Q$ , such as  $WP^E$ . The effects again would be similar to a zero quota, except on a smaller scale. The producer surplus would be the area LKH, which is smaller than with a zero quota, but larger than under free trade. The consumer surplus in this graph is GLJ, which is slightly smaller than under free trade, but larger than under a zero quota. In this instance, the net loss would only be JABK, as compared to ABC.

### Assessment of the Cuban Embargo

Applying the information presented previously, one can now clearly define the sanctions against Cuba. Specifically, the U.S. has imposed a full trade embargo against Cuba. This is an example of a specific economic linkage, because the action is taken directly by the U.S. Because of the restrictive nature, it is also an example of a negative sanction.

### Specific Objectives

The sanction was first initiated in order for the U.S. to express its disapproval of communism. The sanction's original goal sought to cause Cuba economic hardship in hopes of forcing Castro's communist regime to be removed.

Over the past four decades, the objectives of the embargo have evolved. While these objectives have not always been clearly defined, there were six main goals. These objectives are 1) overthrow Castro, 2) retaliation, 3) containment, 4) break Soviet Cuban ties, 5) demonstrate opposition, and 6) change the internal situation. (Kaplowitz, 1998, pg. 3)

In a very general sense, applying only the definition of an embargo, the embargo against Cuba has been implemented successfully. Because the embargo has prevented nearly all direct and indirect commercial relations between those subject to U.S. jurisdiction and Cuba or its nationals, in theory, the embargo has been successful. When you look at specific goals, however, the successfulness has varied.

The original goal discussed was to overthrow Castro. It was hoped that the strain of the sanctions would anger the population and encourage them to overthrow Castro. Once it was realized that Castro would not be removed from office, the objective changed to one of retaliation for the confiscation of U.S. property in Cuba. In total, there was \$1.8 billion in claims from the U.S. against Cuba. In 1960, the State Department said that the purpose of the embargo was to "defend the legitimate economic interests of [U.S] citizens . . .

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against the aggressive, injurious and discriminatory policy of Castro's regime." (Kaplowitz, 1998, pg. 4)

As time evolved, the goal was changed to containment, because it was clear Castro would not be overthrown, and U.S. citizens would not have their property returned. Under this new goal, the Cuban revolution was meant to be deprived by decreasing money available to the Cuban government. In theory, it was meant to make sure the communist movement did not gain further momentum and spread to other countries.

Another goal of the economic sanctions was to break the ties between the Soviet Union and Cuba. It was believed that the increased cost of this relationship would cause it to break down. Another goal of the U.S. embargo was symbolic in nature, seeking to express U.S. opposition to the policies of the Cuban regime. Symbolism itself had two parts to it. The embargo was supposed to show Cubans that Castro did not have their best interests in mind, because his policies were the reason the Cubans were cut off from many goods. It was also supposed to show the rest of the Western Hemisphere that communism did not belong.

The most recent objective of the economic embargo against Cuba was to change the internal situation in the country. This was seen as the primary objective in the 1990's, because of the failure of the original goals. Although similar to other goals, it is different because it sought to actually change Cuban policies, instead of just expressing distaste for them. The goal was no longer to remove Castro rather it now sought any measure that would make the country more democratic. For example, the Cuban Democracy Act stated a goal was to "further isolate the Castro regime in order to weaken its repressive apparatus and to increase pressure for democratic change on the island." (Varona, 1994, pg. 5) One can see the new goal expressed well in a statement by Assistant Secretary of State, Bernard Aronson. In March of 1990, Aronson said that "if Cuba holds fully free and fair elections under international supervision, respects human rights and stops subverting its neighbors, we can expect relations between our two countries to improve significantly." (Kaplowitz, 1998, pg. 8)

In 1996 via the Helms-Burton Act, twelve criteria were laid out for lifting the embargo. Currently, this appears to be the aim of President George W. Bush, who has made statements such as "If Cuba's government takes all the necessary steps to ensure that the 2003 elections are certifiably free and fair and if Cuba also begins to adopt meaningful market-based reforms, then and only then, I will work with the United States Congress to ease the ban on trade and travel between the two countries." (Shadid, 2002, pg. 2) Clearly the goal has now evolved into one less extreme, which is more likely to be realized.

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### Assessment of Objectives

The first goal of overthrowing Castro's regime has failed in practice because of propaganda exposed by Castro. Castro made the Cuban people feel loyalty to him by blaming the U.S. for the economic problems the country faced. "Castro blames Cuba's shambles of an economy and endless shortages on the embargo." (Jacoby, 2002, pg. 2) Although not entirely wrong, Castro's position is not completely right. It is true that the Cuban people face hardships because of the embargo; however, Castro does not admit that his economic policies are to blame for most of the hardships. In general, the U.S. can be partially blamed for the economic problems, but it is too strong to say the hardships are entirely the U.S.'s fault. Castro was successful in convincing his people of this position because he is a very charismatic and persuasive person. It is important to note that the command economy of Cuba failed like all other command economies in the past. In general, command economies fail because they create chronic shortages, as was evident in the former Soviet Union. Cuba too faces shortages, especially of food, caused by the command economy, which hinders development.

The goal of retaliation was also not reached. The actual consequence of the embargo was that it was ensured that the U.S. would not be paid for the property which was confiscated by the Cuban government.

The goal of containment was partially successful. According to Donna Kaplowitz in Anatomy of a Failed Embargo, (1998) this objective failed because the goal was "nebulous, changing, and difficult to obtain." (Kaplowitz, 1998, pg. 6) The main reason this goal was so hard to achieve is because Cubans turned to another source to finance their revolutions. This other source was the Soviet Union, which provided a great deal of aid to Cuba during most of the embargo's life. The embargo did not prevent Cuba from exercising its influence in other parts of the world, particularly in other South American countries, and Africa. Remember, Cuba's involvement in other Latin American countries is what sparked the O.A.S. sanction in the 1960's. Cuba also supported revolutions in such African countries as Ethiopia and Angola. The goal was partially successful, however, because communism did not spread around the globe.

The goal of the embargo in breaking ties with Cuba and the Soviet Union also failed. Even though the cost of the relationship did increase, the relationship did not disintegrate, rather it was strengthened. The embargo caused Cuba to move much closer to the Soviet Union because it was tied to

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Soviet trade and assistance more than ever. When the Soviet Union broke up, Cuba was greatly harmed because of its reliance on the Soviets.

Some believe that the symbolic goal was achieved (at least originally) because the U.S. public demanded action. This is no longer the case, as is evident from a 1998 Gallup poll in which many people stated to re-establish economic and diplomatic relations with Cuba. (Kaplowitz, 1998, pg. 8) To many, the objective to change the internal situation in Cuba is no longer valid because Cuba no longer poses a threat. The reasoning behind this statement is that without Soviet support Cuba does not have the resources to harm the U.S.

When looking thus far, one can see that the goal to induce change in Cuba also has not been achieved. Castro's policies are the same as they have always been, very controlling in nature. Although on the surface it may appear some policies have changed, upon close examination the policies are empty promises.

In general, sanctions against Cuba are a tricky matter. The sanctions were originally imposed unilaterally; however, they were not very effective. Several other democratic nations later joined in the imposition of sanctions; however, Cuba was able to find a trade partner—the Soviet Union—to fill the trade void. In the last few decades though, with the collapse of the Soviet Union, Cuba has lost its main trading partner. Thus the economic effects are more prominent in recent history than ever before. This has forced Castro to make some changes in policy such as dollarization. Dollarization occurred in Cuba when the dollar was legalized as a currency. Although on the surface it appears that changes have indeed been made, upon closer inspection one can see the changes are merely a facade. The dollar is not available to all people, rather only the elite use this denomination of currency.

There are various reasons offered as to why the embargo has failed. The basic reason is that the Cuban government has learned to get around the embargo by trading with other countries. As was seen, this is often a problem. This was especially true when Cuba turned to trading with the Soviet Union during much of the embargo's life. Others feel the embargo failed because of the ingenuity of Fidel Castro. Castro has smartly shifted the blame for Cuban economic problems onto the U.S. Some also feel the embargo failed because its goals were too difficult. This is particularly true of the goal to oust Castro. Here the U.S. tried to exercise too much power.

When looking at the various objectives set forth for the embargo, it is clear to see why many feel it has been a failure. Many scholars and people in general feel the embargo has been a failure for good reasons. Scholars such as Jorge Dominguez have said "In a broad strategic sense, U.S. policies toward Cuba have failed." (Kaplowitz, 1998, pg. 9) Sanctions expert Margaret Doxey also agrees, stating that "the general ineffectiveness of the [Cuba] embargoes

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has long been apparent.” (Kaplowitz, 1998, pg. 9) Many of the facts seem to support these scholars’ views.

### **U.S.-Cuban Relations before the Embargo**

In order to better understand the effects of the Cuban embargo, one must be aware of the situation prior to the embargo’s implementation. Following Cuba’s independence from Spain in December 1898, Cuba was administered by the U.S. for four years from 1898 to 1902. From that time until the 1950’s, Cuba and the U.S. had substantial trade. During this time, Cuba benefited greatly from its close economic ties to the U.S. In fact, in 1959 just before the implementation of the embargo “Cuba’s economic and social indicators ranked among the highest in the world.” (Cubafacts.com, 2002, pg.1)

In 1958, the U.S. was Cuba’s leading trade partner, accounting for three-quarters of Cuban imports (Kaplowitz, 1994, pg. 11) and eighty five percent of Cuban exports. (Enterprise Florida Inc., 1999, pg. 1) The U.S. was also a large investor in Cuba, lending \$11 million to the country for developmental projects in 1958. (Cubafacts.com, 2002, pg 1) In addition, many people, approximately 300,000 people, from the U.S. would visit Cuba each year during the 1950’s.

### **Economic Effects of the Embargo**

Although in the big picture, Cuban trade made up only a small part of the total U.S. trade, some industries were hurt extensively. Cuba was an important source of several goods for the U.S. Cuba supplied the U.S. with a substantial amount of sugar, cigars, citrus fruits, nickel, and unprocessed minerals. Several export industries suffered losses due to the embargo including, agriculture, tourism, port, cruise, and medical supply industries. Several Cuban sectors were initially harmed a great deal by the embargo, including the livestock, nickel, and sugar industries. As was shown earlier, the Soviet Union soon replaced the U.S. as Cuba’s leading trade partner and helped to offset much of the economic effects of the embargo.

By analyzing the trade pattern before the embargo and applying the trade models, one can get a better idea of the losses created by the embargo. Using the neoclassical model for three countries, assume the U.S. is the capital abundant country, while Cuba is labor abundant. This assumption is based on current export patterns of Cuba, which indicate the economy’s reliance on agriculture.

Let “X” be the capital intensive good and “Y” be the labor intensive good. Because the U.S. is the most developed country, it is safe to assume the

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U.S.'s relative price of good "X" and "Y" is the lowest. Cuba's relative price could then fall in the middle or be the highest. If Cuba's relative prices are such that they are in the middle, the embargo would be ineffective. This is because based on relative prices prior to the embargo, the U.S. and Cuba would not have traded extensively.

Due to the extensive amount of U.S.-Cuban trade before the embargo, it can be assumed that Cuba has the highest relative price. This places the rest of the world in the middle. This pattern of relative prices would have to be true in order for trade between the U.S. and Cuba to occur. If the relative prices were not as such, trade would not have occurred between the countries, because each would have bought from a lower priced supplier. This means that if Cuba's relative price was in the middle both the U.S. and Cuba would have traded more with the rest of the world than with each other. Since there was substantial trade between the U.S. and Cuba before the implementation of the embargo, one can assume that Cuba's relative price was in fact the highest.

Such a situation is shown in figure 3, Neoclassical Model Embargo Reality. The embargo in this case would be harmful to both economics because each would be forced to buy from a higher price supplier. The country would thus reduce its imports to IK, as compared to AB. Exports would also decrease as well moving from a level of DF to LJ. This would push each country back to an indifference curve below free trade, but above autarky, shown as IC<sup>E</sup>. For the U.S. such a move to a new indifference curve would create small losses, however, the percentage lost in Cuba would be much bigger simply due to the size of each economy.

Partial equilibrium analysis can be used to determine the losses caused by the embargo, because it is known that several sectors were affected more than others. Because Cuba supplied the U.S. with a great deal of sugar, consider the sugar market in both Cuba and the U.S.

In Cuba, under free trade the world price for sugar would be above the autarky price. After the embargo, however, the price level Cuba faced would fall similar to what would happen if an export quota was imposed. This means that the world price Cuba faces would lower than the free trade world price, yet it would remain above autarky price, as shown in figure 9, Export Sector Partial Equilibrium Embargo Reality. The lowering of world price would decrease the producer surplus to LKH and increase the consumer surplus to GLJ, relative to the free trade amounts of EBH and GEA, respectively. The total effect would be a net loss, as shown by the area AJKB. Note this area is smaller than the loss created by a zero quota, shown as ABC.

In the U.S. there would be a similar net loss; however, the embargo would act as a quota on imports. Here the world price would begin below the equilibrium price, as seen in figure 6, Import Sector Partial Equilibrium



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Embargo Reality. Once the embargo was in place, the world price would rise to  $WP^E$ , but not as high as the autarky price. This measure would decrease consumer surplus to GLK, but increase producer surplus to HLJ. The total net effect would again be negative, as shown by area JKBA.

The trade losses that occurred are in line with the predictions of the model. The embargo has cost the U.S. an extra \$35 million for purchasing nickel from other suppliers. (Kaplowitz, 1994, pg. 12) Citrus importers also lost a great deal, totaling \$34 million per year. (Kaplowitz, 1994, pg. 12) Seafood, tobacco, coffee and rum import industries were also harmed. In total it is estimated that the U.S. has lost \$15 to 30 billion due to the embargo. (Kaplowitz, 1994, pg. 12) Currently the U.S. GDP is over \$10 trillion, meaning the total losses from the embargo accounts for .15 to .03 percent of GDP. Annually this means the U.S. losses are less than 1 millionth percent of GDP.

The losses incurred by Cuba are not as clear cut, because of their extensive trade with the Soviet Union. By 1961, the Soviet Union replaced the U.S. as Cuba's main trading partner. The basic trade agreement called for Cuba to exchange sugar and nickel for Soviet oil and petroleum products. In fact, nearly eighty percent of Cuban sugar exports went to the Soviet Union, China, or other Soviet bloc countries. This measure ensured that the Cuba sugar market was not greatly harmed by the U.S. sanction.

Although the Soviet Union almost completely replaced the U.S. demand in the sugar market, it could not do so in every sector of the Cuban economy. Tourism was especially harmed. Tourists from the Soviet bloc countries never exceeded 30,000 per year, while approximately 300,000 U.S. tourists used to visit the island.

Foreign investment in Cuba was basically non-existent until the middle 1980's. At this time, the Cuban government realized Soviet economic assistance was becoming unsure. Soviet assistance was four to six billion dollars annually in 1990, which was a forty five percent decline from the assistance in the previous year. Luckily by 1990, foreign investment from other countries reached a level of \$800 million. Most of the investment has been in the tourism industry, which caused the industry to perform well in recent years. It is important to note that the growth of this industry is what led to Cuba's eventually dollarization.

Since the collapse of the Soviet Union, the effects of the sanction have been apparent in Cuba. Since the early 1990's, Cuba has faced hard financial times. The country has faced a vicious cycle of economic hardships caused by limited capital inflows, and reduced exports which led to lower domestic production. In fact Cuba is now considered one of the least developed countries in the Western Hemisphere with a GDP per capita at only \$1560. This is a huge

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decrease in the standard of living considering that Cuba was one of the most developed countries in the 1950's.

It has been hard for Cuba to find alternative suppliers, and markets for its goods which has reduced production and hindered development. Agricultural production was especially hurt by the collapse of the Soviet Union. In fact from 1989 to 1994, agricultural production fell fifty four percent because of shortages of fuel and equipment.

Currently, Cuba's trade value is much lower than it could have been if things would have continued as well as they did in the 1950's. Today Cuba's exports are only valued at \$1.8 billion according the CIA World Fact Book. (World Fact Book 2002) Their primary export trading partners are the Netherlands (22.4%), Russia (13.3%), Canada (13.3%), Spain (7.3%), and China (6.2%). (World Fact Book, 2002) The goods exported from Cuba have remained the same since the 1950's, which has caused the economy to stagnate. The main exports are sugar, nickel, tobacco, fish, medical products, citrus and coffee. Goods which are imported have remained similar as well. Imports in Cuba are primarily petroleum, food, chemicals, machinery and equipment, which are valued at \$4.8 billion. (World Fact Book, 2002) The main import trading partners are Spain (12.7%), France (6.5%), Canada (5.7%), China (5.3%), and Italy (5.0%). (World Fact Book, 2002) As one can see from examining the trade statistics, no trading partner comes close to replacing the volume of U.S. trade.

### **The Policy Debate**

There are basically eleven reasons for lifting the embargo against Cuba as defined by Adolfo Leyva De Varona in Propaganda and Reality: A Look at the U.S. Failed Embargo Against Castro's Cuba (1994). In this section, a brief discussion on each of the reasons is set forth.

### **Does the Embargo Cause Suffering?**

Some believe the embargo should be lifted because it causes the Cuban people unnecessary suffering and deprivation. Others go a step further, and claim the embargo is nothing but harassment of the Cuban people. Because the U.S. was Cuba's largest trading partner before the sanction, accounting for over seventy five percent of both Cuban imports and exports, it is believed that Cubans are cut off from various goods, which only the U.S. could bring to them. This is of great concern to many because the goods that cause suffering are the U.S.'s medical advancements. Due to the embargo, medicines that are only made in the U.S. are denied to people who need them in Cuba.

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Others believe this viewpoint is false. In reality, the suffering of the Cuban people is caused by Castro's inability to admit that communism has failed. One must realize the suffering of the Cuban people is not caused completely by the U.S.; instead the Cuban government is the culprit. In addition, it is false to believe the embargo encourages suffering, because the U.S. does allow trade for food and medicine so that the people of Cuba are not deprived. The U.S. is not the cruel heartless country that Castro portrays.

### **Will Lifting the Embargo Lead to Change?**

Many feel lifting the embargo would bolster economic reform which would eventually lead to political reform and liberalization. Some feel that the economic reforms such as joint and private enterprise and dollarization that has already taken place in Cuba, are a good indication that more reforms would accompany the lifting of the sanction. These measures are seen as important steps in the progress toward economic reform that would continue faster if the embargo was lifted.

Other people agree the embargo should be lifted in order for change to occur. Some believe that if the embargo is lifted, Castro would become more confident and take measures to help his country. It is argued that this liberalization would have to happen because Castro would not be able to blame the U.S. for every problem the country faces. In this instance, some believe the embargo simply strengthens Castro. The embargo makes Castro appear to be a fearless fighter against capitalism, which bolsters his support. This is further exemplified by anti-Castro Cubans going back and supporting Castro because they are fearful of the returning exiles coming into power.

Other critics of the embargo feel that a free flow of tourism and trade to the U.S. would inspire change in Cuba. It is believed that lifting the embargo would allow more information into the country which the public would use to encourage change. The increased pressure on the government by the people would then ensure change.

Those in favor of the embargo believe that such claims are unrealistic. Even though it appears that several reforms have been made in Cuba, they are a facade. These beliefs are false because of strict limitations on the reforms. One of these reforms is the allowance of joint enterprises with foreign investors. This may seem good on the surface, but upon closer inspection one sees that Cuban citizens are not allowed to establish their own businesses or join in with foreigners on investments.

Another reform is the emergence of private enterprises. This is also hollow because the businesses are extremely regulated. These businesses are not allowed to have brokers or to hire employees. They are also required to sell

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any food they produce to the government so that a free market does not prevail. Dollarization is also an empty step taken by the Cuban government. Normal citizens are not allowed to have dollars, unless they work in Cuba's tourism industry. This scarcity of the dollar created a powerful black market in Cuba. In order to combat some of this illegal market, Castro forced some people with dollars to convert back to the peso. Obviously then, the dollar is not free to circulate throughout the country.

As it is seen in any interview with Castro, he is already a confident leader. Lifting the embargo would not increase his confidence further. Even if it did happen, there is no reason to believe he would suddenly open up to democracy and liberalization.

It is also false to believe that full tourism and trade will raise expectations and encourage change in Cuba. People in Cuba already have high expectations. They hear from their exiled relatives and hope for a better life. They are not affected by the embargo in this regard. One cannot believe tourism will be the magic cure to inspire change. It must be remembered that tourists from the rest of the world go to Cuba and that has not sparked change. The main reason for this is that most Cubans have nothing to do with the tourism industry. This fact would not change as long as Castro is in office no matter if American tourists are on the island.

### **Have the Objectives been Successful?**

Another argument for lifting the embargo is that it has failed. Since one of the original goals of inspiring change in the country has failed, the embargo should be done away with. After 30 years, the country is still communist and is run the same way as it was before. The embargo is clearly ineffective.

Those in favor of the sanction feel it is unfair to say the embargo has failed for years. These people point out that only recently, since the collapse of the Soviet Union, has the embargo begun to work. Prior to that time, it was ineffective because of the massive amount of aid the Soviets gave to Cuba. After 1991, when the Soviet subsidies were cut off, is when the economic effects began to take place in Cuba. It is only since then that we can judge the effectiveness of the embargo.

Others state the embargo should be lifted because Cuba is no longer a threat to U.S. security. The reasoning is that since the Cold War is over and the Soviet Union no longer exists, Cuba does not have the support it once had. Critics here believe that the embargo is a relic and is outdated because the circumstances have changed.

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Some people do not believe that Cuba is no longer a threat. Even though Castro is getting old, there is no reason to believe his attitude has changed. He still has a lust for international prominence and he still harbors ill feelings towards the U.S. Both of these characteristics were easily seen in Barbara Walter's interview with Castro which appeared on ABC's 20/20. We should not discount Castro as a threat for another reason. He has openly supported terrorism in the past and there is no reason to believe he does not now. In the wake of September 11<sup>th</sup>, this point is of special importance because of the U.S.'s strong stance against terrorism. The U.S. can no longer give people the benefit of the doubt that they are docile. Each threat or potential threat must be taken seriously and the U.S. can no longer ease up on suspected terrorist supporters, like Castro and the country of Cuba.

Other people believe the embargo is harmful to U.S. businesses. The idea here is that U.S. businesses are losing out to other investors around the world in Cuba. Foreign current investors are reaping profits from their enterprises in Cuba while U.S. businesses miss out on this opportunity for gain.

Those in favor of the sanction feel the reality here is that foreign investment is not as great as everyone expected. One must also consider the fact that the Cuban economy is small. Even if opened to U.S. investments there would not be a great amount, therefore, the U.S. businesses are not missing out on much.

### **Is the Embargo Representative?**

Another reason the embargo should be lifted, is that U.S. foreign policy towards Cuba does not reflect the opinions of most Cubans. It is believed that U.S. policy is controlled by a small conservative group of Cuban exiles that do not represent the general sentiment of the Cuban people. It is believed that these exiles only represent the opinions of a small minority.

An additional objection to the embargo stems from this idea. Some critics believe "Cuban exiles are insensitive to the suffering caused by the embargo because they have little in common with those that are left behind in Cuba." (Varona, 1994, pg. 41) The concept here is that the exiles do not know what conditions are like now, they only know of the previous ones. The conditions and opinions of people in Cuba may have changed and they (the exiles) will have no idea of the current situation.

People in favor of the embargo believe that most Cuban exiles are represented by the U.S. policy towards Cuba. The fact is that eighty three percent of exiles from Cuba approve of the embargo. (Varona, 1994, pg. 38) It is false to say that the exiles do not know what the people in Cuba are currently going through. What some fail to realize, is that exiles are truly representative

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of the Cuban people, because they come from all walks of life, so every class is represented. One must also realize that exiles still have contact with those left behind, so they are aware of the current situation.

The final reason offered why the embargo should be lifted is because the Cuban people have done nothing to suggest they want change. Proponents of this view say that the population of Cuba has shown no willingness to fight for change. Since the people of Cuba do not want change, then the U.S. has no business forcing it upon them. Critics of this argument suggest that the people of Cuba do want change, but they are afraid to take measures against the government. According to those exiled, the people of Cuba do not agree with Castro and would like to see change. The people, however, know they do not have the power to force any change in the country.

### **Outlook for the Future: Recommendation to Policy Makers**

My recommendation to policy makers is simple. Lift the embargo. It is proven that free trade is advantageous to an economy; therefore, this is the situation we should strive for. Although opening trade with Cuba would not be a big boost to the U.S. economy, it would help. Even though Cuba is a small market, it is still one which is unsaturated with U.S. goods. Opening the embargo would only help the U.S. economy at this point. It would also greatly help the Cuban economy, which has been suffering since the collapse of the Soviet Union. As was stated in the Boston Globe in August 2002, "U.S. sanctions against Cuba have done little but deny Cubans goods made in the United States while denying Americans potential business in Cuba." (Jacoby, 2002, pg. 2)

Economically speaking, the embargo should be lifted, but we also have to consider the political issues. The biggest objection to lifting the embargo is that the U.S. will be giving into communism. This is not a valid objection. The U.S. has begun to trade with China, and they are still communist, so why should Cuba not be traded with? Sheer common sense will tell anyone that Cuba is much less of a threat to the U.S. than China.

The main reason the U.S. should lift the embargo is because it has failed to reach its most basic objective of forcing political change in Cuba. Representative Jeff Flake of Arizona said that the embargo has "Failed to produce any meaningful political or economic change in Cuba." (Lawrence, 2002, pg. 2) All the embargo has done is given Castro a tool for making the U.S. appear evil to the Cuban people. As stated by Jeff Jacoby in the Boston Globe, the U.S. is blamed for all the problems of the Cuban economy. Removing the embargo may help the Cuban people to stop seeing Americans as the bad guys because they would have access to more goods. In my opinion,

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only by opening trade can we really hope for any change to take place. This is the same opinion expressed by former President Jimmy Carter, who has said that “the best way to promote peaceful change in Cuba is through the maximum contacts between our two countries.” (Keen, 2002, pg. 2)

### **Predictions for the Future**

Although trade with Cuba seems insignificant on a large scale, the embargo has caused great losses. Once it is lifted both economies will receive a boost. According to Rosson and Adcock, (2001) it is expected all fifty states would receive increases in economic output, income, value added and employment caused by opening trade. For the Cuban Policy Foundation, Rosson and Adcock conducted extensive research involving the “economic impacts of expanded U.S. agricultural exports to Cuba” (Rosson and Adcock, 2001. pg. i) using an input-output model. Rosson and Adcock analyzed the effects in three separate scenarios. The first scenario allowed trade, but on a very restricted scale. The second allowed for more moderate trade between Cuba and the U.S. The final scenario anticipated a large volume of trade between the U.S. and Cuba once the embargo was lifted.

It has been predicted that the U.S. would gain \$1 to 2 billion in exports via trade with Cuba. (Kaplowitz, 1994, pg. 5) This increase would lead to an increase of \$47 million to 1.6 billion in GDP as well as create 1,000 to 31,262 jobs in the agricultural industry. (Rosson and Adcock, 2001, pg. i) The increase in jobs would help raise household income between \$25 million and \$818 million. (Rosson and Adcock, 2001. pg. i) The moderate export growth scenario calls for large increases on average. Under this scenario, agricultural exports are expected to increase GDP by \$517 million. (Rosson and Adcock, 2001. pg. i) Also, 10,656 jobs are expected to be created, and household income is expected to rise to \$273 million. (Rosson and Adcock, 2001. pg. i) These large increases are seen because of the expected market share regain by U.S. companies. U.S. companies are expected to regain 33 to 50 percent of Cuban trade. (Kaplowitz, 1994, pg. 5)

Opening trade would help specific industries. In particular it is expected to affect at least 22 commodity sectors in the U.S. One area that would receive a boost would be the U.S. agricultural industry. This is based on current trade patterns of Cuba which show that agricultural imports are the greatest. Here it is expected that ending the embargo would lead to a \$37.5 million to 1.24 billion increase in agricultural exports, as well as \$84 million to 3.6 billion increase in business sales. (Rosson and Adcock, 2001, pg. i)

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As we have seen, U.S.-Cuban trade would definitely help the U.S. economy. Even though it may be a small percentage in total, the increases can not be ignored or written off as completely insignificant.

### **Conclusion**

By moving from a general understanding of what sanctions are to a more specific look at the Cuban embargo, it is my hope that a reader has gained a greater understanding of economic sanctions against Cuba. Sanctions have been a part of international politics for many years. Recently, they have become more popular as policy makers have begun to favor the liberal over the realist approach to foreign policy. Although there are only a few basic types of sanctions, there are many potential purposes, which vary according to each situation. In general the purpose of sanctions is to harm the economy of the target country. The effects of these sanctions can be analyzed using either a general or partial equilibrium approach.

It has been shown that the U.S. imposed one type of embargo, a trade embargo, against Cuba beginning over forty years ago. This embargo was originally initiated during the Cold War, in hopes of ridding the Western Hemisphere of communism. The goals of the Cuban embargo have changed over the years, but one fact remains, nearly all of these objectives have failed. Even though the goals of the embargo have failed there is still a policy debate over what should be done. Although some policy makers feel that we should keep the embargo in place, public sentiment, has become increasingly unsupportive.

Various economic models show that lifting the embargo would be beneficial to both Cuba and the United States. The benefits would be greater for Cuba, however, because of the relative size of the two economies. This is based on a basic economic fact that free trade is beneficial. Because of the economic benefits that will be achieved, and the fact that many of the embargo's objectives have failed, it was recommended that the embargo be lifted. Both economically and politically this is the better solution. It is obvious that a future without the embargo looks brighter. One hopes that policy makers will consider all these facts when considering this matter in the future.



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Figure 1: Neoclassical Free Trade

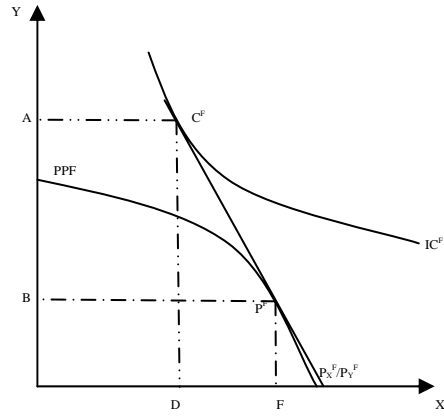
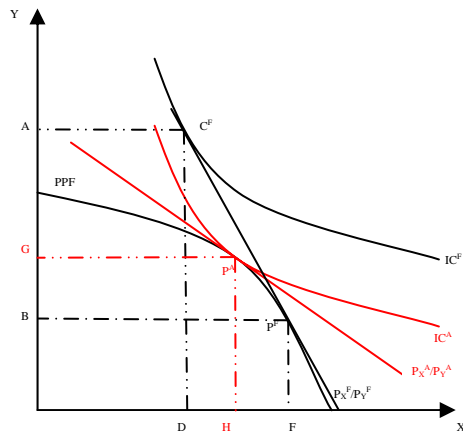
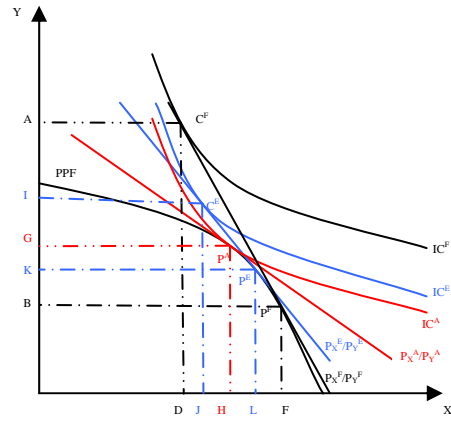


Figure 2: Neoclassical Autarky

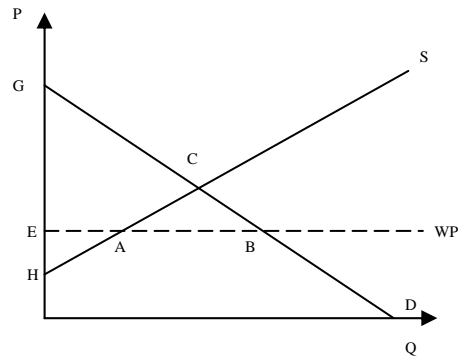


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**Figure 3: Neoclassical Embargo Reality**

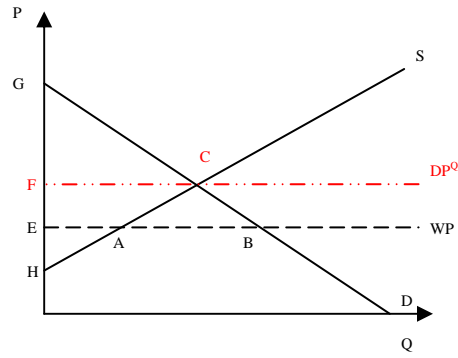


**Figure 4: Import Sector Partial Equilibrium - Free Trade**

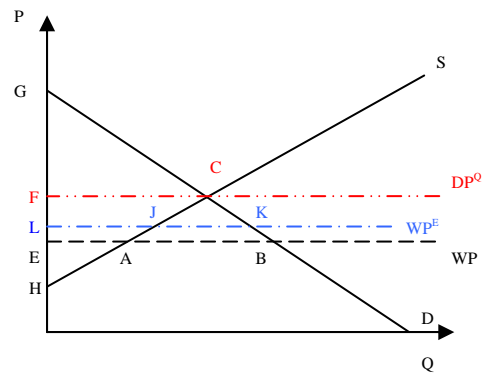


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**Figure 5: Import Sector Partial Equilibrium - Zero Quota**

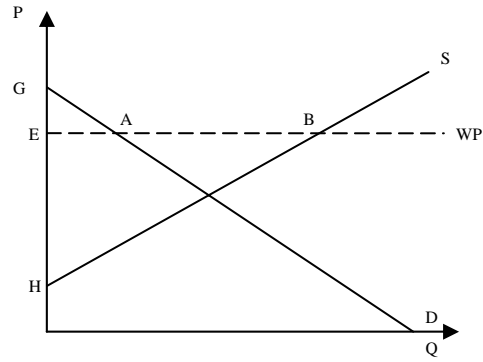


**Figure 6: Import Sector Partial Equilibrium - Embargo Reality**

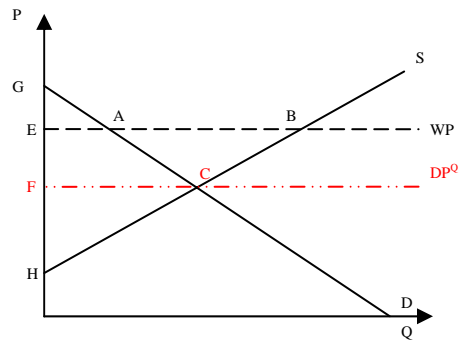


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**Figure 7: Export Sector Partial Equilibrium - Free Trade**

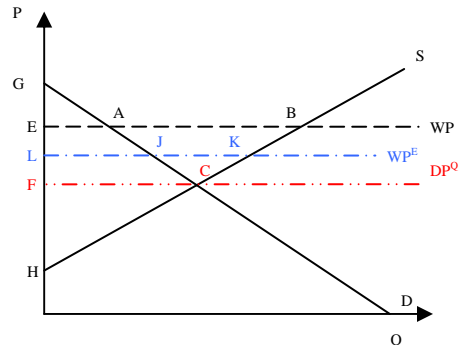


**Figure 8: Export Sector Partial Equilibrium - Zero Quota**



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**Figure 9: Export Sector Partial Equilibrium - Embargo Reality**



**THE FUTURE OF SPECIAL ECONOMIC ZONES  
IN THE AFTERMATH OF  
POLAND'S ACCESSION TO THE EUROPEAN UNION**

*Monika G. Kisłowska\**

**INTRODUCTION**

Poland, which became a Member State of the European Union ("EU") on May 1, 2004, came a long way to accomplish its goal of membership in the organization. The especially difficult accession process can be attributed to the fact that during the last fifteen years, Poland was going through a challenging transformation of its economic and political systems. During the early 1990s, Poland moved from a centrally planned economy and communist government to a market oriented economy and democratic government. This transformation influenced the speed and effectiveness of the country's adjustment to the EU, and drew attention to several areas in the Polish economy and political sphere that needed to undergo extensive reform.

For purposes of accession to the EU, a number of areas in Poland's economy underwent changes tailored to the specific EU requirements; among them, State aid proved to be one of the most interesting and complicated to adjust. State aid reform became especially important in light of the fact that this discipline bears directly on competition policy. Competition constitutes an integral part of the EU working mechanism because it ensures the proper functioning of the EU Common Market.<sup>1</sup> In Poland, an extensive network of Special Economic Zones ("SEZs") that constitute a key component of the country's State aid policy added to the difficulty of adjusting this area of Polish economy to the EU requirements. The SEZs were troubling because they were based on legislation that in many aspects directly contradicted the EU State aid guiding principles. The forms of State aid (preferential income and property tax

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<sup>1</sup> See Europa: Gateway to the European Union, [http://www.europa.eu.int/pol/comp/overview\\_en.html](http://www.europa.eu.int/pol/comp/overview_en.html) (last visited Jan. 17, 2006).



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breaks) offered in the SEZs were perceived by the EU as a serious barrier to the maintenance of the regime of fair competition in the integrated EU market. Consequently, during the years preceding Poland's accession to the EU, the original SEZs legislation was substantially reformed to meet the EU requirements.

Currently, the Special Economic Zones are prospering very well after their legislation was successfully adjusted to the EU norms; however, new complications are on the horizon. The major problem that the SEZs will soon face is that they are scheduled to cease to exist within the next ten to eleven years. Given how dynamic and beneficial the most recent activity in the SEZs has been to Poland's economy, the transition to a Poland without SEZs has the potential of causing a serious crisis. Poland still remains well behind its EU western counterparts in terms of standards of living and economic development, and this situation may be seriously worsened by the liquidation of the SEZs. One solution to the problem may be to allow for an extension of the lifetime of the SEZs, or a creation of SEZs in the new regions of Poland. Since SEZs legislation is no longer incompatible with the EU State aid principles, the fears of SEZs becoming a barrier to the maintenance of fair competition in the Common Market are no longer warranted. Moreover, given the most recent disputes regarding the EU budget, SEZs may just become a key to resolving those problems because they can help boost the development and bring standards of living in Poland closer to those within the western EU Member States.

This Note will attempt to analyze the impact of the EU accession conditionality on State aid and SEZs structure in Poland. Section II of this Note will briefly discuss the premises of the EU State aid policy, the changes that occurred within this field in the last fifteen years, and its most current trends. Section III will concentrate on the case study of Poland and will provide some background information on the system of State aid as it existed in the country prior to the EU accession negotiations. Section IV will discuss the SEZs, how they came into existence and the specific changes that the SEZs legislation underwent in order to become compatible with EU law. Finally, Section V will discuss the future of the SEZs and propose solutions that the EU and Poland could consider in order to make the transition from the SEZs less detrimental on Poland's economy but at the same time satisfactory to the EU.

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## THE BACKGROUND OF STATE AID IN THE EU.

In the EU, State aid is one of the five areas<sup>2</sup> that comprise the organization's competition policy<sup>3</sup>. Behind this simple phrase lies an elaborate mechanism that the EU put in place to control a form of state intervention that its individual Member States use to "promote a certain economic activity."<sup>4</sup> The intervention occurs when some economic sectors or activities are treated more favorably than others. In such situations less efficient firms, which receive State aid, are enabled to prosper at the expense of more efficient firms which do not receive aid.<sup>5</sup> This is in sharp contrast to the scenario where general economic measures are "equally applicable throughout the Member State and are intended to favor the whole of the economy."<sup>6</sup> The EU accepts these general measures and public subsidies because they have no affect on trade and do not distort or threaten to distort competition.<sup>7</sup> State aid measures, on the other hand, are perceived by the EU as destructive to the proper functioning of the Common Market<sup>8</sup> and to the maintenance of fairness in the competitive process among all the Member States,<sup>9</sup> hence, the EU's commitment to their strict control.

Articles 87 to 89 of the Treaty Establishing the European Community ("EC Treaty") provide the constitutional basis of State aid in the EU and set up its institutional framework.<sup>10</sup> Article 87(1) spells out the main premise of the law, which is the prohibition of State aid which "distorts or threatens to distort competition by favouring certain undertakings or the production of certain

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<sup>2</sup> The remaining four areas are Antitrust, Mergers, Liberalization and International. Europa: Gateway to the European Union, Competition: Policy Areas, [http://www.europa.eu.int/comm/competition/index\\_en.html](http://www.europa.eu.int/comm/competition/index_en.html) (last visited Jan. 17, 2006).

<sup>3</sup> Since effective competition is the key to a proper functioning of an open market economy, the EU devised a number of rules and regulations designed to ensure fair trade in goods and services by businesses and government of Member States. See Europa: Gateway to the European Union, [http://www.europa.eu.int/pol/comp/overview\\_en.html](http://www.europa.eu.int/pol/comp/overview_en.html) (last visited Jan. 17, 2006).

<sup>4</sup> Report: State Aid Scoreboard 2005: Spring 2005 update, COM(05)147 final at 11, available at [http://europa.eu.int/comm/competition/state\\_aid/scoreboard/2005/spring\\_en.pdf](http://europa.eu.int/comm/competition/state_aid/scoreboard/2005/spring_en.pdf) [hereinafter Scoreboard 2005].

<sup>5</sup> See Stephen Martin & Paola Valbonesi, *State aid in Context*, in REGULATORY REFORM AND COMPETITIVENESS IN EUROPE 176 (Giampado Galli & Jacques Pelkmans eds., 2000), available at <http://www.ks.dk/publikationer/statsstoette/2000/workshop/smartinpaper1.pdf>.

<sup>6</sup> See Scoreboard 2005, *supra* note 4, at 11.

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> Martin & Valbonesi, *supra* note 5, at 177.

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goods.”<sup>11</sup> The principle in this Article is a rather strict and broad prohibition. Thus, to offset its potentially all encompassing reach, the EC Treaty created mandatory and discretionary exceptions to the rule in Articles 87(2) and 87(3).<sup>12</sup> These mandatory exceptions concern aid of a social character; aid designed to combat damages caused by natural disasters and aid granted to certain areas of the Federal Republic of Germany.<sup>13</sup> The discretionary exceptions encompass such forms of assistance as aid to promote development of poor regions, the execution of projects important to common European interests, culture and heritage conservation, as well as, all aid that may be determined necessary by the Council.<sup>14</sup> The main goal of the EU is to work for the good of its Member States so the general ban on State aid is lifted when “the proposed aid schemes may have a beneficial impact in overall Union terms.”<sup>15</sup>

The European Commission (“Commission”), the only politically independent body in the EU, plays the main role in monitoring and controlling grants of State aid.<sup>16</sup> Its main job is “to uphold the interests of the EU as a whole.”<sup>17</sup> So to effectively ensure its integrity in this field, the Commission does not take instructions from any Member States’ government. Additionally, as the EU’s executive arm and the “Guardian of its Treaties,” the Commission ensures that regulations and directives adopted by the organization’s legislative bodies are executed.<sup>18</sup> In the realm of State aid, it has the exclusive authority to review the various aid schemes proposed by the Member States’ governments and to determine whether they are compatible with the Common Market. The Member States are obliged to give the Commission an advance notification of their aid projects (“ex ante notification”) and none of those projects can be implemented until approved by the Commission (the so-called “standstill principle”).<sup>19</sup> Consequently, any aid that is granted without the Commission’s

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<sup>11</sup> TREATY ESTABLISHING THE EUROPEAN COMMUNITY, Dec. 24, 2002, 2002 O.J. (C 325) 33, 67 available at [http://europa.eu.int/eur-lex/lex/en/treaties/dat/12002E/pdf/12002E\\_EN.pdf](http://europa.eu.int/eur-lex/lex/en/treaties/dat/12002E/pdf/12002E_EN.pdf) [hereinafter EC TREATY].

<sup>12</sup> See Martin & Valbonesi, *supra* note 5, at 177.

<sup>13</sup> EC TREATY, *supra* note 11, at 33.

<sup>14</sup> *Id.*

<sup>15</sup> Europa: Gateway to the European Union, Competition: State aid Overview, [http://www.europa.eu.int/comm/competition/state\\_aid/overview](http://www.europa.eu.int/comm/competition/state_aid/overview) (last visited Jan. 17, 2006).

<sup>16</sup> See *id.*

<sup>17</sup> Europa: Gateway to the European Union, Europe in 12 Lessons, [http://europa.eu.int/abc/12lessons/index4\\_en.htm](http://europa.eu.int/abc/12lessons/index4_en.htm) (last visited Jan. 17, 2006).

<sup>18</sup> *Id.*

<sup>19</sup> Vademecum – Community Rules on State aid (last updated Sept. 1, 2003), at 7 found at [http://www.europa.eu.int/comm/competition/state\\_aid/others/vademecum/vademecumen2003\\_en.pdf](http://www.europa.eu.int/comm/competition/state_aid/others/vademecum/vademecumen2003_en.pdf) [hereinafter Vademecum].

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approval is illegal, and the Commission has a duty to order recovery of such aid which requires the public authorities in the Member State, responsible for granting of the aid, to seek a refund from the aid recipients.<sup>20</sup>

The EU recognizes three broad types of State aid measures: horizontal, regional and sectoral.<sup>21</sup> Horizontal aid deals with market failures which usually entail some sort of externality (i.e. the social cost created by the business activity but not reflected in business cost or revenue), and which affect firms without regard to location or sector.<sup>22</sup> The main objectives of this type of aid are research and development, rescue and restructuring, employment, environment and small and medium size enterprises.<sup>23</sup> Regional aid is designed to assist with the development of disadvantaged regions.<sup>24</sup> Its main objectives encompass aid to regions where the standard of living is abnormally low or where there is serious unemployment as well as aid to regions which do not meet the requirements of the first type of aid but which are still disadvantaged in comparison to other regions of the EU.<sup>25</sup> Finally, sectoral aid deals with aid to the declining sectors, specifically coal, steel, shipbuilding and synthetic fibers sectors, and to the sectors that may suffer because of difficulty adjusting to the full forces of market competition, i.e. banking, air transport, shipping and motor vehicle sectors.<sup>26</sup> Planning, restructuring, minimizing harm to competitors and reducing capacity are the key objectives of this last type of aid.<sup>27</sup>

In the years preceding the 1990s, few reports or analyses discussing the trends in EU State aid levels were available. The situation began to change

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<sup>20</sup> *Id.* In 1998, the Commission decided to somewhat modernize and loosen its rules by designating certain categories of State aid which would be automatically, without the need for notification and approval, declared compatible with the Common Market if they meet a number of specific requirements (so called “block exemption notifications”).

<sup>21</sup> *See id.* at 5-6.

<sup>22</sup> Martin & Valbonesi, *supra* note 5, at 179.

<sup>23</sup> *Id.* at 180.

<sup>24</sup> *Id.* at 179. Regional aid is covered by the Articles 87(3)(a) and 87(3)(c) of the EC treaty. Article 87(3)(a) applies to State aid to promote the development of *areas where the standard of living is abnormally low or where there*

*is serious underemployment.* Article 87(3)(a) targets regions that are disadvantaged *compared to the EU average.* Article 87(3)(c) covers aid to other types of (national) problem regions “*aid to facilitate the development of certain economic areas.*” This Article gives Member States the possibility to assist regions which are disadvantaged *compared to the national average.* *See* Ewa Kaliszuk, *Polityka Wspólnoty Europejskiej w Zakresie Pomocy Publicznej*, 2 (125) *Wspólnoty Europejskiej*, 49, 50 (2002).

<sup>25</sup> Kaliszuk, *supra* note 24, at 50.

<sup>26</sup> Martin & Valbonesi, *supra* note 5, at 181.

<sup>27</sup> *See id.*

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in 1993 when the EU experienced a peak in State aid grants by its Members.<sup>28</sup> A serious effort aimed at the lowering of State aid marked the following decade. This was mainly realized through the tightening of State aid control, and ensuring that only the aid that served the Common Market was granted.<sup>29</sup> Various European Councils were convened that made the regulation of State aid a priority on their agenda. Initially, at the Dublin European Council in 1996, the EU Member States committed to the improvement of the effectiveness of State aid control and to the reinforcement of the control mechanisms.<sup>30</sup> Later, at the Cardiff European Council in 1998, the EU government concluded that strategies needed “to be developed for an overall reduction in State aid.”<sup>31</sup> Next, at the Lisbon European Council in 2000, a commitment “to promote competition” was reiterated and the Member States were called upon “to reduce the general level of State aid and shift the emphasis from supporting individual companies or sectors towards tackling horizontal objectives of common interest, such as employment, regional development, environment and training or research.”<sup>32</sup> Finally, at the Stockholm European Council in 2001, the Member States were asked to “demonstrate a downward trend in State aid in relation to the Gross Domestic Product (“GDP”) by 2003, taking into account the need to redirect aid towards horizontal objectives of common interest, including cohesion objectives.”<sup>33</sup> The Commission, also aware of the need for the reduction in the volume of State aid, asked the EU governments to “make additional efforts to avoid sector specific and especially ad hoc State aid.”<sup>34</sup>

The effectiveness of the European Councils' recommendations and of the Commission's measures designed to increase the transparency of the aid granting process is best illustrated by the downward trend in the overall EU State aid granted in the end of the 1990s. Initially, sectoral aid constituted the most prevalent type of aid in the EU with the aid to the manufacturing sector amounting to 4% of the value added of the twelve Member States in 1990.<sup>35</sup> But by the end of the 1990s, the Member States had already shifted a significant percentage of the aid that was earlier assigned to the specific manufacturing,

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<sup>28</sup> Commission of the European Communities Report: State aid Scoreboard 2001, COM(01)412 final at 12, available at [http://europa.eu.int/dur-lex/en/com/cnc/2001/com2001\\_0412en01.pdf](http://europa.eu.int/dur-lex/en/com/cnc/2001/com2001_0412en01.pdf) [hereinafter Scoreboard 2001].

<sup>29</sup> See *id.* at 6.

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> Martin & Valbonesi, *supra* note 5, at 182.

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coal and service sectors to assist with horizontal objectives.<sup>36</sup> As a result, in 1997, State aid to the manufacturing sector in the EU amounted to only 2.5% of the value added of the fifteen Member States.<sup>37</sup> These changes, although at first seemingly nominal, soon became the starting point for the fulfillment of the Lisbon Agenda of 2000 which was implemented to help shift the EU State's aid emphasis from supporting individual companies or sectors to assisting with the horizontal objectives of the Community.<sup>38</sup> This transformation was important because although these horizontal objectives still counted as State aid, they were substantially more in accordance with the common interests of the EU than the previously offered forms of aid. This was mainly because they had "the potential to create benefits that were greater than their cost measured in terms of aid amounts alone."<sup>39</sup>

The most recent findings show that the percentage of State aid granted to specific sectors has steadily decreased in favor of State aid committed to achieve horizontal objectives. The share of horizontal aid had risen to 79% of total aid<sup>40</sup> as compared to 50% in the mid-1990s.<sup>41</sup> Sectoral aid, which includes aid to rescue and restructure failing firms, now contributes 21% of all aid.<sup>42</sup> Table One shows a detailed breakdown of each type of aid by its subcomponents and by the individual Member States.

Some skeptics of the EU might argue that other economic reasons, other than EU policy, led to these structural changes in State aid. All the available data, however, seems to suggest that these changes were mainly the result of the reforms undertaken by the EU. The data seems to be even more credible when one considers the fact that it not only discusses the resolutions that were met, but also those that were not fully realized. For example, the situation in EU Member States regarding the level of State aid in relation to the GDP seemed much less encouraging. The trend in this area remained steady rather than downward, although the idea of lowering the ratio of State aid to the GDP was one of the main commitments of the most recent Stockholm European Council.<sup>43</sup> The overall volume of aid decreased from the high levels that

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<sup>36</sup> See Scoreboard 2001, *supra* note 28, at 13.

<sup>37</sup> Martin & Valbonesi, *supra* note 5, at 182.

<sup>38</sup> Scoreboard 2005, *supra* note 4, at 4.

<sup>39</sup> Scoreboard 2001, *supra* note 28, at 13.

<sup>40</sup> Total State aid as defined by the Article 87(1) of the EC Treaty covers manufacturing, services, coal,

agriculture, fisheries and transport sectors, but not the railway sector.

<sup>41</sup> Scoreboard 2005, *supra* note 4, at 5.

<sup>42</sup> See *id.*

<sup>43</sup> *Id.* at 14.

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existed in the early and mid-1990s; however, from 1999-2003, it remained the same, amounting to 0.57% of the EU GDP in 2003, compared to 0.63% in 1999 and 1.09% in 1992.<sup>44</sup> Expressed in absolute terms, the total aid granted by the fifteen EU Member States was estimated at €53 billion in 2003, compared to €74 billion in 1996 and €55 billion in 1999.<sup>45</sup>

Since State aid can take different forms, the EU Member States have a number of different instruments at their disposal when assigning aid, including grants, tax exemptions, soft loans, tax deferrals and guarantees.<sup>46</sup> During 2001-2003, the share of each aid instrument in the EU Member States' aid to the manufacturing and service sectors was as follows: grants accounted for 67% of the total State aid, tax exemptions for 22.7%, soft loans for 4.8%, tax deferrals for 2.6%, guarantees for 2.2% and equity participation for 0.7%.<sup>47</sup> Most recently, the use of tax exemptions as a form of aid decreased in favor of grants. For example, the grant aid rose from 48% in the years 1992-94, to 57% in the years 1995-97 and 67% in 2003. At the same time, tax exemptions decreased in those periods from 26% in the years 1992-94 and 24% in the years 1995-97 to 22.7% in 2003.<sup>48</sup> These changes were attributed to the fact that grants are more easily adopted by governments than tax exemptions because they do not require as many changes in the law.<sup>49</sup>

In sum, since the late 1990s the EU perceived the control and monitoring of State aid as extremely important to the proper functioning of the Common Market, with all Member States fairly participating in the exchange and competitive process occurring within the organization. In light of these conclusions, it is clear why this area of EU policy has become especially controversial during the organization's enlargement process and why the organization strived so hard to ensure that there existed uniformity in the legislation of each new Member State and the EU body of law called the "acquis communautaire." Allowing any country to become an EU Member State without first making sure that its laws were compatible with those of the EU could seriously undermine all of the efforts the EU had put into administering State aid among the existing Member States and preventing distortions that threatened to take over the Common Market. Since, in the past, Poland implemented State aid regulations that differed greatly from that of the

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<sup>44</sup> *See id.*

<sup>45</sup> *Id.* at 4.

<sup>46</sup> *See* Martin & Valbonesi, *supra* note 5, at 185, 187.

<sup>47</sup> *See* Scoreboard 2005, *supra* note 4, at 27.

<sup>48</sup> Martin & Valbonesi, *supra* note 5, at 185.

<sup>49</sup> *Id.*

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EU, it is understandable why the adjustment of this area of the economy became crucial to the success of the accession negotiations between Poland and the EU.

### **THE DEVELOPMENT OF THE CONCEPT OF STATE AID IN POLAND.**

In light of the information provided in the preceding section, it becomes clear that a background introduction to the structure of State aid in Poland is essential to better understand the nature of the problems that State aid and the SEZs posed during the EU accession process. Accordingly, this section of the Note will discuss State aid as it existed in Poland in the beginning of the 1990s and the changes that this area of the Polish economy underwent to become compatible with the EU legal norms.

#### **i. State Aid in Poland in the early 1990s.**

Prior to the 1990s, Poland was a communist country with a centrally planned economy, and as a result, the concept of State aid did not exist there during that time.<sup>50</sup> Instead, under the centrally planned economy, the government played a major role in controlling all aspects of economic organization through the direct intervention in the affairs of the enterprise sector.<sup>51</sup> The government used subsidies to link the state budget and the quantitative plans.<sup>52</sup> These plans were the main tool for controlling enterprises because they dictated “what kind of goods and services, how much, and when and where to produce.”<sup>53</sup> The government was responsible for setting the “socially desirable” prices, which were basically prices that created an illusion of serving society but that in no realistic way corresponded to the true cost of goods and services.<sup>54</sup> When the time for transformation came, the government was forced to abandon its control system and allow for the establishment of appropriate institutions that would help in the development of the private

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<sup>50</sup> Marcin Sowa, *State aid and government policy in Poland, 1994-2002*, at 3, CASE, Nov. 15, 2003, <http://www.case.com.pl/dyn/pplik--2100442.pdf>.

<sup>51</sup> Iraj Hashi, Ewa Balcerowicz, Marcin Sowa, Mikolos Szanyi & Marie Bohata, *The Comparative Analysis of State aid and Government Policy in Poland, Hungary and the Czech Republic*, Int'l J. Econ. Research (forthcoming) Center for Social and Economic Research, at 2.

<sup>52</sup> Report: State aid Scoreboard, Autumn 2004 update, COM (04)750 final at 11, *available at* [http://europa.eu.int/comm/competition/state\\_aid/scoreboard/2004/autumn\\_en.pdf](http://europa.eu.int/comm/competition/state_aid/scoreboard/2004/autumn_en.pdf) [hereinafter Scoreboard 2004].

<sup>53</sup> *Id.*

<sup>54</sup> *Id.*



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sector.<sup>55</sup> This was mainly done through the reduction of subsidies and a movement towards liberalization of prices which finally began to reflect real market levels.<sup>56</sup>

These changes were of an unprecedented scale and, not surprisingly, they quickly led to disturbance in the economy. Many enterprises, unable to withstand the new conditions, fell into financial trouble. To help businesses survive, the government intervened by providing firms with financial support.<sup>57</sup> In 1991, in an effort to save some of the hardest hit industries, the government established the Industry Development Agency ("IDA"), which became responsible for promoting industrial efficiency and assisting in restructuring.<sup>58</sup> From 1991-1996, the IDA played the main role in restructuring Ursus, Poland's largest tractor manufacturer, and the Polish National Railways.<sup>59</sup>

In the initial stages of this economic transformation, the government and its agencies set up State aid programs as they wished. Such freedom in structuring led to a situation where the majority of State aid granted in Poland in the early 1990s was not connected to any long-term policy but was ad hoc and unfocused.<sup>60</sup> Aid programs turned out to be direct support payments to the failing state-owned enterprises, which in many cases collapsed before they could even have a chance to restructure and become more efficient.

Poland's decision to apply for membership in the EU curtailed, to a certain degree, this process of uncontrolled governmental assistance. In fact, in 1994, a new era began for the country when it signed the European Agreement ("EA").<sup>61</sup> The EA provided a framework for trade and related matters between the EU and Poland,<sup>62</sup> and called for Poland to respect the boundaries set by the EU State aid rules. "The existence of a functioning market economy and the capacity to cope with competitive pressure and market forces within the EU,"<sup>63</sup> were among the most important requirements for joining of the EU. The fulfillment of those requirements was largely dependent upon the tight control of each Member State's State aid policy. Accordingly, because large

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<sup>55</sup> Hashi, *supra* note 51, at 2.

<sup>56</sup> Scoreboard 2004, *supra* note 48, at 11.

<sup>57</sup> *Id.*

<sup>58</sup> Sowa, *supra* note 50, at 4.

<sup>59</sup> *Id.* at 5.

<sup>60</sup> *Id.*

<sup>61</sup> Poland became a signatory to the EA in 1991 and the Agreement went into effect in early 1994. See *Strefy Kompromisu*, GAZETA WYBORCZA, Apr. 5, 2002, at 24.

<sup>62</sup> Scoreboard 2004, *supra* note 48, at 13.

<sup>63</sup> *Id.*

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discrepancies existed between the EU and the Polish structure of State aid, from the very beginning, the EU stressed the need for adjustment in this area.<sup>64</sup>

Thus, beginning with the EA, the organization began to specify which forms of Polish State aid it considered incompatible with the well functioning market economy. The policy outlined in Article 63.1 of the EA states, in relevant part: “The following are incompatible with the proper functioning of the Agreement, insofar as they may affect trade between the Community and Poland: . . . (iii) any public aid which distorts and threatens to distort competition by favouring certain undertakings or the production of certain goods.”<sup>65</sup> The EU argued that successful closure of negotiations in this area depended on the fulfillment of the following three requirements: (1) the alignment of Polish competition law with that of the *acquis communautaire*, (2) the creation of state monitoring agencies responsible for controlling the compatibility of State aid measures with the EU law, and (3) the practical application of the adopted EU regulations.<sup>66</sup>

Poland had considerably little trouble with a timely fulfillment of the second requirement. Starting in 1998, it had a functioning state monitoring agency, the Office for Competition and Consumer Protection (“UOKIK”)<sup>67</sup>, responsible for reviewing State aid granting measures. The situation was much more troublesome with respect to the timely achievement of the first and third requirements. Although, theoretically, it made a lot of sense for the EU to request from all its future candidate countries to start implementing the necessary reforms early; in practice, because the EU had not prescribed specific legal rules that would enable Poland to implement the guiding principles of the *acquis communautaire*, the real progress in this area was initially very slow.<sup>68</sup> In fact, the country did not begin to implement significant textual and practical changes to its State aid laws until the year 2000.<sup>69</sup> Some experts had explained this situation by pointing to the fact that the EA, while prescribing certain rules

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<sup>64</sup> Hashi, *supra* note 51, at 10.

<sup>65</sup> 1993 O. J. (L 348) 2, available at [http://europa.eu.int/smartapi/cgi/sga\\_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=en&numdoc=21993A1231\(18\)&model=guichett](http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=en&numdoc=21993A1231(18)&model=guichett).

<sup>66</sup> Kaliszuk, *supra* note 24, at 53.

<sup>67</sup> “UOKIK” is the Polish acronym for “Urząd Ochrony Konkurencji i Konsumentów” which translates to “Office for Competition and Consumer Protection.”

<sup>68</sup> See Adam A. Ambroziak, *Rozwiązanie Kwestii Udzielania Pomocy Publicznej w Specjalnych Strefach Ekonomicznych w Polsce (I)*, 2 (137) *Wspólnoty Europejskie* 2003 16, 25 (2003) [hereinafter Ambroziak I].

<sup>69</sup> See Sowa, *supra* note 50, at 7-10; Adam Szymaniak, *Problem Specjalnych Stref Ekonomicznych w Negocjacji Polski o Członkostwo w Unii Europejskiej*, 9 (132) *Wspólnoty Europejskie* 15, 17 (2002).

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to follow, did not have an implementing mechanism.<sup>70</sup> As a result, Poland did not feel as if it was truly obliged to follow the EU law. This phenomenon, as well as the fact that the EA was new legislation, provide a good explanation for why the SEZs created in Poland by the legislative act of December 24, 1994 have since proved to be so incompatible with the EU State aid law.

### **ii. Changes in the State Aid structure in Poland resulting from the country's negotiations for membership in the EU.**

State aid reforms took on a different character when the full-fledged accession negotiations opened in 1998 and the EU accession authorities more closely evaluated the level of Poland's compliance with the EU State aid norms.<sup>71</sup> At that time it was discovered, contrary to the Commission's expectations, that Poland had not been very effective in adapting the EU regulations. Poland had specifically failed to do away with certain fiscal measures, such as various tax preferences offered to investors in the SEZs,<sup>72</sup> which were most in conflict with the EU State aid and regional policy. Consequently, because the EU was not satisfied with the situation in Poland, it began to condition Poland's accession to the organization on a successful implementation of all required State aid reforms.<sup>73</sup>

In order to fulfill the EU's accession requirements outlined above and become eligible for accession to the EU, starting with the year 2000, Poland finally began to make some long awaited changes to its State aid policy. First, on June 30, 2000, the Polish legislature adopted the Act on the admissibility and supervision of State aid for entrepreneurs, called the State Aid Act of 2000 ("SAA").<sup>74</sup> The SAA, encompassing twelve ordinances and regulations, provided for a general prohibition on the grants of State aid, with exceptions for a few, limited circumstances of so called admissible types of aid. Those admissible types of aid consisted of aid for horizontal, regional and sectoral objectives.<sup>75</sup> The SAA also introduced the "de minimis" rule which allowed for all aid cases below €100,000 over three consecutive years to be exempted from all but reporting obligations.<sup>76</sup> In the fall of 2000, Poland also passed revised

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<sup>70</sup> See Ambroziak I, *supra* note 68, at 24; see *Strefy Kompromisu*, GAZETA WYBORCZA, Apr. 5, 2002, at 24.

<sup>71</sup> Scoreboard 2004, *supra* note 48, at 13.

<sup>72</sup> Kaliszuk, *supra* note 24, at 53.

<sup>73</sup> *Id.* at 50.

<sup>74</sup> Sowa, *supra* note 50, at 7.

<sup>75</sup> *Id.* at 8.

<sup>76</sup> *Id.* at 9.

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legislation regarding the SEZs, which was aimed at adopting the EU State aid norms into Polish law.<sup>77</sup>

Accordingly, where identified State aid measures were deemed to be incompatible with the EU *acquis*, Poland was required either to abolish them or align them with the EU norms. In some rare cases, consultations between Poland and the EU resulted in special transitory arrangements, which were strictly limited in scope and duration.<sup>78</sup> In the end, the negotiations regarding the adjustment of the competition policy were eventually concluded at the Copenhagen European Council in December 2002 and the Treaty of Accession was signed in Athens in April 2003.<sup>79</sup> Poland entered into transitory agreements regarding the restructuring of the steel industry, the grants of State aid for environmental protection and the grants of fiscal aid in the SEZs. The final review and adjustment of State aid schemes is still underway in the framework of the existing aid procedures.<sup>80</sup>

### iii. 1995-2003 State Aid trends in Poland.

During the period 1996-2002, the volume of State aid in Poland viewed as the share of GDP decreased significantly from 2.6% in 1996 to 1.3% in 2002.<sup>81</sup> With respect to the types of State aid granted, subsidies and fiscal operations, followed by soft credits became the most prevalent forms of aid offered.<sup>82</sup> Operations in equity were very minimal and so were credit warranties, although the latter showed a tendency to increase by 2000.<sup>83</sup> For the most part, State aid during those years was financed through the reduction in budgetary revenues.<sup>84</sup> The year 2000 was an exception when the direct expenditures and reductions in budgetary revenues equally contributed to the financing of State aid.<sup>85</sup> This pattern of aid structure differs significantly from the EU pattern where subsidies prevail. In the EU, more than 60% of aid is transferred to enterprises in the form of subsidies, and tax exemptions account for about 25% of aid, while soft credit for about 6%.<sup>86</sup>

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<sup>77</sup> *Id.*

<sup>78</sup> Kaliszuk, *supra* note 24, at 53.

<sup>79</sup> Scoreboard 2004, *supra* note 48, at 14.

<sup>80</sup> *Id.* at 16.

<sup>81</sup> *See* Sowa, *supra* note 50, at 14.

<sup>82</sup> *Id.*

<sup>83</sup> *See id.* at 15.

<sup>84</sup> *Id.*

<sup>85</sup> *Id.*

<sup>86</sup> *Id.*

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With respect to Polish State aid objectives, 33% of the aid in 2002 went to horizontal objectives, 18% to sensitive sectors and about 5% was appropriated to regional aid.<sup>87</sup> Table Two provides a more detailed description of State aid in Poland categorized by aid objectives. The structure of Polish State aid by aid objective is different from that of the EU where almost half of State aid is put toward horizontal objectives and about one quarter of aid is regional.<sup>88</sup> The post-transition character of the Polish economy, with more support directed at the sensitive sectors, as well as the pressure from the sensitive sector groups are the two factors responsible for this difference.<sup>89</sup> In the years after Poland's entrance into the EU, this dynamic has begun to change noticeably and Poland's State aid structure has gradually begun to look more like that of the EU. This state of affairs is mainly due to the successful alignment of Polish law with that of the EU, especially in the area of SEZs legislation, and to the Commission taking a more direct and active role in controlling and monitoring of the grants of State aid in Poland.<sup>90</sup>

### THE SEZs: ONE OF THE MOST CONTROVERSIAL ISSUES IN THE ACCESSION NEGOTIATIONS.

#### i. The creation of the SEZs.

The SEZs were first created in Poland pursuant to legislation passed on October 20, 1994, which was subsequently amended by the statutes adopted on November 16, 2000 and October 3, 2003.<sup>91</sup> They served as an important tool in the government's struggle for the successful adaptation of the country's economy to the stringent requirements of the free market system. Accordingly, some viewed the SEZs as special, privileged economic enclaves within which the government decided to either limit its rights or grant special preferences in order to achieve some specified economic or social goals.<sup>92</sup> In general, the

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<sup>87</sup> *Id.* at 17.

<sup>88</sup> *Id.*

<sup>89</sup> *Id.* at 18.

<sup>90</sup> Ministerstwo Gospodarki i Pracy [Ministry of Economy and Labor], *Raport: Specjalne Strefy Ekonomiczne stan na dzien 31 grudnia 2004 r.* [Report regarding the condition of the Special Economic Zones as of Dec. 31, 2004] Warsaw, March 2005, at 29-31, <http://www.mgip.gov.pl/NR/rdonlyres/F4B564A9-97C7-49D9-9FC3-66FA65F9E7B0/10311/RaportSSE2032005.doc> [hereinafter Ministry Report].

<sup>91</sup> Szymaniak, *supra* note 69, at 15.

<sup>92</sup> *Id.*

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SEZs were designed to help revive the economy by attracting new foreign capital to the country.<sup>93</sup> The main idea behind their creation was the desire to fight structural unemployment in selected regions of Poland.<sup>94</sup> This goal was accomplished by directing new investment into the SEZs. The SEZs appeared to be especially attractive to investors because they offered a number of fiscal advantages that other regions of the country did not possess.<sup>95</sup>

In accordance with the terms of the 1994 statute, the SEZs were created for a period of twenty years in isolated, uninhabited parts of the country's selected regions.<sup>96</sup> The aspect of the zones most responsible for encouraging investors to locate their firms there was the unique system of fiscal incentives. Pursuant to Article 12 of the 1994 statute, investors in the SEZs could choose among the following fiscal incentives: (1) a complete exemption from the income tax for the first 10 years of the investor's activity in the zones, (2) a 50% exemption from the income tax payment for the remaining years of investor's economic activity, until the zones cease to exist, (3) a possibility of including expenses that are not related to the purchase of permanent means of the business development in the costs of the investment and (4) a possibility of increase in the amortization rates of the permanent means used in the business pursued in the zones.<sup>97</sup> The last two incentives constituted tax preferences available for those investors that did not qualify for exemptions specified in the first two incentives. They allowed investors to lower their tax base in a preferential way and consequently to pay lower income taxes.<sup>98</sup>

The Board of Ministers was responsible for setting the conditions under which an investor in the SEZs was entitled to either a 100% or a 50% exemption from the income tax.<sup>99</sup> They included the following: (1) the creation and maintenance, for a specified period of time, of a certain number of new employment positions linked to the investor's activity in a zone, (2) the creation of a permanent production investment in a zone with a value exceeding a certain specified amount, (3) the achievement and maintenance, for a specified period of time, of a certain minimal level of income from the goods produced or services offered in a zone, and (4) the achievement and maintenance, for a

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<sup>93</sup> *Id.*

<sup>94</sup> See Ministry Report, *supra* note 90, at 2.

<sup>95</sup> *Id.*

<sup>96</sup> *Id.*

<sup>97</sup> Dz.U. z 1994 r. Nr 123, poz. 600, available at [http://ks.sejm.gov.pl/proc2/ustawy/582\\_u.htm](http://ks.sejm.gov.pl/proc2/ustawy/582_u.htm).

<sup>98</sup> See Adam. A. Ambroziak, *Funkcjonowanie Specjalnych Stref Ekonomicznych po Akcesji Polski to UE*, 4/5 (150) *Wspolnoty Europejskie* 43, 43 (2004) [hereinafter Ambroziak].

<sup>99</sup> See Article 12 § 5. Dz.U. z 1994 r. Nr 123, poz. 600, available at [http://ks.sejm.gov.pl/proc2/ustawy/582\\_u.htm](http://ks.sejm.gov.pl/proc2/ustawy/582_u.htm).

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specified period of time, of a certain minimal level of income from export of the goods produced or services offered in a zone.<sup>100</sup> It is worth noting that because at that time the tax rates in the country were quite high, such complete exemptions presented a valuable advantage to those who decided to invest in the SEZs.<sup>101</sup> In addition to the above outlined income tax incentives, investors in the SEZs could also take advantage of various exemptions and preferential treatments offered by local governments; the most important was a complete exemption from property taxes.<sup>102</sup>

Besides the quite advantageous specific tax incentives, the SEZs 1994 statute also included two other points that made investment in the SEZs even more attractive. First, as indicated in Article 13 of the 1994 statute, all exemptions and preferences outlined above could not have been taken away or deteriorated during the period for which the SEZs were created.<sup>103</sup> Second, the 1994 statute did not specify any limits on these preferential treatments.<sup>104</sup> These regulations were extremely advantageous to the SEZs investors because they provided them with an additional layer of assurance regarding the tax breaks that they were to obtain once they fulfilled the requirements for investment in the SEZs. At the same time, because these provisions were clearly in conflict with the EU's guiding principles on State aid, they soon became the main obstacles to the EU's acceptance of SEZs legislation.<sup>105</sup>

### **ii. Difficulties with SEZs in the face of Poland's negotiations for EU admission.**

The initial results following the creation of the SEZs were very optimistic. From 1994-1998, seventeen SEZs were created in Poland and the investors that were active in them already declared their willingness to invest over 3.9 billion zloty (approx. \$1.3 billion)<sup>106</sup> and create about 12,000 new jobs.<sup>107</sup> However, the problems began in March 1998 when Poland began to negotiate with the EU regarding its membership in the organization.<sup>108</sup>

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<sup>100</sup> See Article 12, § 6. *Id.*

<sup>101</sup> Ambroziak, *supra* note 98, at 44.

<sup>102</sup> *Id.*

<sup>103</sup> *Id.*

<sup>104</sup> Konrad Niklewicz, *Wyjscie ze specjalnej strefy*, GAZETA WYBORCZA, Feb. 8, 2002, at 26.

<sup>105</sup> *Id.*

<sup>106</sup> Zloty is the Polish currency. One dollar equals approximately three zloty.

<sup>107</sup> Niklewicz, *supra* note 104, at 26.

<sup>108</sup> *Id.*

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The alignment of a candidate country's legal norms with that of the EU has always been one of the main requirements of EU membership. Since, it was clear early on in the negotiation process that the rules governing the establishment and working of the SEZs in Poland were in conflict with the EU competition norms, Poland knew that they needed revision. The lack of limits on State aid offered in the SEZs was especially problematic since the EU law clearly states that State aid cannot exceed 50% of the cost of the investment for large firms and 65% of the cost of investment for small and medium enterprises.<sup>109</sup> At the time, the firms that were investing in Polish SEZs had already or would have in the near future exceeded these limits. Based on the EU's objection to SEZs legislation, in February 1999 Poland agreed to amend the SEZs law and those modifications went into effect on January 1, 2001.<sup>110</sup>

The revised SEZs statute harmonized Polish SEZs law with the *acquis communautaire*, although it applied only to those investing in the SEZs after December 31, 2000.<sup>111</sup> The new law did not apply to business that became active in the SEZs before the year 2001, because Article 13 of the SEZs founding statute protected against deterioration in the acquired rights of all those who started their business activity under the old SEZs rules.<sup>112</sup> The 2001 modification was mainly concerned with setting caps on the aid which before was virtually limitless. Accordingly, the businesses investing in the SEZs after December 31, 2000, needed to comply with a number of factors, set separately for each zone, in order to qualify for any type of exemption.<sup>113</sup> This meant that they were no longer automatically relieved of the 100% income tax for the first ten years of operations and 50% for the following ten years. The exemptions were now calculated separately for each SEZ but, in any case, they were not to exceed 50% of the cost of investment for a large company, and 65% for a small or medium enterprise.<sup>114</sup>

The EU accepted this new SEZ law as being compatible with the *acquis communautaire*; however, the organization was still unsatisfied with the solutions Poland proposed regarding the firms that had invested in the SEZs before 2001.<sup>115</sup> The pre-2001 investors were allowed to keep all of their tax

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<sup>109</sup> *Id.*

<sup>110</sup> *Id.*

<sup>111</sup> See Ambroziak, *supra* note 98, at 44.

<sup>112</sup> *Id.*

<sup>113</sup> P. Pogodzinski, *Od Nowego Roku Specjalne Strefy Ekonomiczne Przestaja Byc Rajami Podatkowymi*, Lex-Press, Oct. 15, 2000,

<http://www.lexpress.pl/modules.php?name=News&file=article&sid=40> (April 6, 2006).

<sup>114</sup> *Id.*

<sup>115</sup> Niklewicz, *supra* note 104, at 26.



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breaks and this was unacceptable to the EU. In search of a compromise, Poland asked for a thirteen-year long transition period for the pre-2001 investors that would allow them to keep the rights that they had been granted by virtue of the 1994 SEZs legislation.<sup>116</sup> The EU did not agree, arguing that Poland should have known from the time when the SEZs were first created that the original law establishing them was in violation of the EU rules spelled out in the 1994 EA.<sup>117</sup> The EU was referring to Article 63 of the EA which states, in relevant part, that “any public aid which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods” is incompatible with the agreement.<sup>118</sup> According to the EU’s interpretation of this Article, the rights that investors obtained as result of the 1994 SEZs legislation was prohibited because the law was originally enacted in violation of the EU rules. Poland did not agree with that interpretation of this EA provision. The country viewed the Article 63 clause as inapplicable to the 1994 SEZs legislation because at the time the EA lacked implementing rules.<sup>119</sup> In other words, there were no substantive and procedural rules that allowed incorporation of Article 63 into the Polish competition law as it existed at the time. There was clearly a disagreement as to the interpretation of the EA and no side was willing to accept its opponent’s view of the situation.<sup>120</sup>

In the end, Poland was faced with several options for resolving this controversial issue: (1) it could arbitrarily take away the rights of investors; (2) it could negotiate with investors and ask them to give up their rights in exchange for reimbursements from the government; (3) the government and the Parliament could decide to radically lower the income tax and get away with SEZs all together (this is what Ireland did in 1970s when it also had a SEZs problem, or (4) the government could initiate strict fiscal controls of all the investors in the SEZs.<sup>121</sup> The Polish government was quite reluctant to proceed with any of these solutions because each of them offered some negative consequences.<sup>122</sup> The first option, if adopted, could lead to a flood of lawsuits

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<sup>116</sup> *Id.*

<sup>117</sup> *Strefy Kompromisu*, GAZETA WYBORCZA, Apr. 5, 2002, at 24.

<sup>118</sup> 1993 O. J. (L 348) 2, available at [http://europa.eu.int/smartapi/cgi/sga\\_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=en&numdoc=21993A1231\(18\)&model=guichett](http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=en&numdoc=21993A1231(18)&model=guichett).

<sup>119</sup> *Strefy Kompromisu*, GAZETA WYBORCZA, Apr. 5, 2002, at 24.

<sup>120</sup> *Id.*

<sup>121</sup> See Niklewicz, *supra* note 104, at 26. All the SEZs laws implemented before 2001 had a provision that stated that a firm investing in a zone would lose all of its privileges if it was found that it had its fiscal obligation in any amount exceeding 3% of total obligation. Most likely all the firms in SEZs would have been found to break the law.

<sup>122</sup> *Id.*

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against the government and could undermine the country's credibility vis-à-vis the future foreign investors.<sup>123</sup> The second option could also turn out to be quite problematic because it presented the SEZs firms with difficulty calculating the reduction they were to possibly receive had they not accepted the new law.<sup>124</sup> With respect to the third option, it was doubtful that the country could afford such a maneuver.<sup>125</sup> Finally, the fourth solution could potentially have the most negative, long-run consequences because initiating stricter fiscal controls could send a signal to prospective SEZs firms that the country was doing so to destroy all private business.<sup>126</sup>

Eventually, Poland and the EU found a compromise which led to the official closing of accession negotiations in the competition policy chapter in December of 2002.<sup>127</sup> In general, the new legislation divides the pre-2001 investors into three separate groups and assigns them different rights. First, small and medium enterprises are allowed to keep the rights gained under the 1994 legislation until the end of 2011 and 2010.<sup>128</sup> Second, large investors are allowed to receive State aid in the amount of 75% of the cost of investment for those who entered the SEZs in 1999 and 50% for those who entered the SEZs in 2000.<sup>129</sup> Finally, investors from the motor vehicle sector are allowed to receive State aid amounting to no more than 30% of the cost of their investment.<sup>130</sup>

**iv. Current trends in the SEZs as reported at the end of Year 2004.**

Currently, there are fourteen SEZs operating in Poland: Kamieniogorska, Katowicka, Kostrzynsko-Slubicka, Krakowska, Legnicka, Lodzka, Mielecka, Pomorska, Slupska, Starachowiecka, Suwalska, Tarnobrzaska, Walbrzyska and Warminsko-Mazurska.<sup>131</sup> They encompass 429 enterprises, which have so far invested almost 20 billion zloty (approx. \$6.6 billion) and employed 77,600 people.<sup>132</sup> The SEZs differ based on area,

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<sup>123</sup> *Id.*

<sup>124</sup> *Id.*

<sup>125</sup> *Id.*

<sup>126</sup> *Id.*

<sup>127</sup> A. Ambroziak, *Rozwiazanie Kwestii Udzielania Pomocy Publicznej w Specjalnych Strefach Economicznych w Polsce (II)*, 3 (138) Wspolnoty Europejskie 37, 38-42 (2003) [hereinafter Ambroziak II].

<sup>128</sup> Ministry Report, *supra* note 90, at 4.

<sup>129</sup> *Id.*

<sup>130</sup> *Id.*

<sup>131</sup> See Ministry Report, *supra* note 90, at 8.

<sup>132</sup> See *id.*

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location, investment character and infrastructure. The Katowicka zone is the largest, covering 1120 hectares, whereas the Cracow Technological Park is the smallest with an area of roughly 122 hectares.<sup>133</sup> Originally, the total SEZs area was not to be increased beyond the territory that it covered as of December 31, 2000. However, due to the increased interest in the possibility of investment in the SEZs, as of May 31, 2004, a new provision was added to the SEZs legislation that now allows for increases in the SEZs area by approximately 1675 hectares, provided that the new area is used for investment of at least €40 million or one that creates 500 and more new job posts.<sup>134</sup>

The first permit allowing investment in the SEZs was issued in the Mielecka Zone in 1996.<sup>135</sup> Applications for permits increased each year for the following four years, reaching a climax in 2000. The year 2000 witnessed the most drastic increase in applications filed, mainly due to the anticipated changes in the SEZs law that were to limit the tax incentives offered.<sup>136</sup> Following the implementation of the 2000 reform in the SEZs legislation, which was unfavorable for most investors<sup>137</sup> the number of new permits issued fell in the years 2001-2003. There were 250 valid permits in the SEZs by December 31, 1999, 725 by December 31, 2000, 703 by December 31, 2001, 690 by December 31, 2002, and 670 by December 2003.<sup>138</sup> Then, in 2004, as the SEZs law stabilized, the situation began to improve. Many new firms began to invest in the SEZs, and by December 31, 2004 valid permits increased to 679.<sup>139</sup>

The number of new job posts created in the SEZs increased in the years 2001-2003 by about 20% a year.<sup>140</sup> The business activity in the Katowicka and Milecka zones added the highest number of new job posts, whereas the Slupska zone witnessed the smallest change in its employment level.<sup>141</sup> With respect to the investment dynamic, there has been a visible increase in investment activity in 2004. Based on a two year analysis, the Kostrzynsko-Slubicka zone experienced an increase of over 600% in investment development in the year 2003 as compared to 2002.<sup>142</sup> There were also

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<sup>133</sup> *See id.* at 9-10.

<sup>134</sup> *Id.* at 9.

<sup>135</sup> *Id.* at 13.

<sup>136</sup> *Id.*

<sup>137</sup> *Id.* at 9. In its negotiations with the EU, Poland was unable to keep the acquired rights of investors unchanged, and as a result many new investors which applied for permits in 2000 never began their investments and consequently their permits were taken back.

<sup>138</sup> *See id.* at 13.

<sup>139</sup> *See id.*

<sup>140</sup> *Id.* at 16.

<sup>141</sup> *Id.*

<sup>142</sup> *See id.* at 15.

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relatively high increases in investment in the Kammiennogorska zone– 208%, the Warminsko-Mazurska zone – 171%, and the Lodzka zone – 167%.<sup>143</sup> It is important, however, to keep in mind that it is quite difficult to expect the same level of development in all SEZs because the inflow of investors into each zone is different. It is enough to have one big new investment for the investment dynamic to immediately increase.

The business activity in SEZs not only has a positive effect on the economy of the country as a whole but also plays an important role on the local level by benefiting the areas directly surrounding each SEZ. The increase in investment in SEZs is often accompanied by a considerable increase in employment in construction firms, as well as in firms providing other types of services such as transport, education, finance and culture.<sup>144</sup> Generally, it is estimated that 100 new job posts created in the SEZs generate 50-100 new job posts in the regions surrounding the SEZs.<sup>145</sup>

In sum, SEZs are very beneficial to the country because most of all they are a great tool for attracting new investments. Although the EU does not look favorably on State aid granted in the forms of fiscal relief; this type of aid makes the most sense from the point of view of the country's budget, especially when taking under consideration the certainty of effects that SEZs bring with them.<sup>146</sup> In the case of direct subsidies, there is no assurance that the investment will be realized; in SEZs, on the other hand, an investor only gets exemptions if he actually goes through with his investment, begins production and earns income.<sup>147</sup>

### THE FUTURE OF SEZS IN POLAND.

As illustrated by the preceding discussion and analysis, the legal structure of SEZs in Poland has undergone many significant changes due to the country's accession to the EU and the accompanying alignment of the country's law with the *acquis communautaire*. The negotiation process which lasted for over four years and was characterized by many heated debates and strenuous compromises attests to the degree of difficulty these reforms presented for both Poland and the EU.<sup>148</sup> The Polish government feared that the country as a whole would be seriously undermined in the eyes of foreign investors if it was

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<sup>143</sup> *Id.*

<sup>144</sup> *Id.* at 23.

<sup>145</sup> *Id.*

<sup>146</sup> *Id.* at 30.

<sup>147</sup> *Id.* at 31.

<sup>148</sup> Ambroziak II, *supra* note 127, at 38-42.

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to retrospectively change the law under which investors came to participate in the SEZs. As a result, Poland tried to negotiate transition periods for those investing in the SEZs before 2001 and in defense of its position, it argued that the old State aid regime would not have a negative impact on the competition in the Common Market and the trade between Poland and other EU Member States.<sup>149</sup> On the other hand, the EU did not believe that State aid offered in the SEZs under the 1994 legislation was that harmless, especially in the context of large investors and insisted on an immediate modification of the Polish law to reflect the *acquis communautaire*.<sup>150</sup> Eventually a compromise was reached and Poland moved one step closer in its goal of accession to the EU.

Although the negotiations regarding the SEZs reform were successfully finalized, the early phases of the implementation of the new SEZs legislation brought a great deal of fear and doubt regarding the future success of the SEZs. The investor activity in the SEZs experienced a significant slow down in the years 2002-2003 when almost no new investors came into the SEZs and when a number of investors who were previously awarded permits to develop in the SEZs decided not to proceed because their rights acquired under the old law had changed.<sup>151</sup> Eventually the new SEZs legislation had not proven to be as destructive to the development of the SEZs as was initially thought. In fact, the past couple of years have shown that the fears and pessimism regarding the future effectiveness of the SEZs have not been realized. New investors entering into the SEZs have come to terms with the new SEZs legislation. The best proof of such attitude is the fact that investors still find the SEZs attractive, although the privileges offered in the SEZs for those investing there after January 1, 2002 are considerably lesser than before. What is most important is that the new rules are compatible with the *acquis communautaire* and certainly that they will not be taken away by the EU based on their unlawfulness. As a result, the SEZs system is more transparent and stable allowing those who would like to invest to work out their business plans and stay assured that no negative surprises will occur in the future.

After the initial slow down period in the SEZs, there was a considerable awakening in 2004 and 2005. Starting with the year 2004, many new firms invested in the SEZs and the year 2005 experienced a record number of new investors.<sup>152</sup> In 2004, two SEZs issued more than ten new permits, and starting with 2005 more than five SEZs have done so, with the Katowicka zone

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<sup>149</sup> *Id.* at 41.

<sup>150</sup> *Id.* at 43.

<sup>151</sup> Ministry Report, *supra* note 90, at 13-14.

<sup>152</sup> Małgorzata Grzegorzcyk, *Wszystko rośnie jak na drożdżach*, Puls Biznesu, Feb. 1, 2006.

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issuing more than thirty permits.<sup>153</sup> The investors in the Walbrzyska zone and Warminsko-Mazurska zone have already promised to expend capital investments worth more than one billion zloty (approx. \$333 million) and in the Kostrzynsk-Slubicka zone the investors foresee creating up to 5800 new job posts.<sup>154</sup> In the Lodzka zone, a record number of entrepreneurs began their investment activity by opening fourteen new factories.<sup>155</sup> Nine out of the fourteen SEZs have enlarged their area: the Krakowska zone nearly doubled its area to 260 hectares, the Kostrzynsko-Slubicka zone grew from 540 to 804 hectares and the Tamobrzaska zone expanded from 810 to 1105 hectares. These latest statistics are the best indicators of the beneficial effects that the SEZs exert on several regions in the country. The activity in the SEZs has lessened unemployment in Poland and the SEZs have also played a crucial role in making use of foreign investment which is the key to gaining new technological advances, which in turn help to ensure the competitiveness of the country's firms and economy.<sup>156</sup>

In sum, in the past two years, many positive changes occurred in the Special Economic Zones which have contributed to the increased activity. There is, however, a serious problem concerning SEZs in the future. This problem concerns the SEZs running out of room to accommodate new investors. Although some of the SEZs have increased their areas, the limit on such territorial expansion, which is determined by the legislation, has been almost exhausted.<sup>157</sup> Moreover, in accordance with the 1994 legislation, the SEZs are scheduled to cease existing by the end of 2017.<sup>158</sup> So the important question to consider now is what will happen after the year 2017? Will Poland be ready to phase out the SEZs so soon? Is another decade enough time for Poland to bring its standards of living and economic development to levels comparable with that of its EU western counterparts? Or maybe the EU should reconsider and allow Poland to extend the existence of SEZs for another decade? After all, Poland still remains behind the western Member States in terms of standards of living and economic development and it is quite unlikely that it will be able to catch up with them within only ten or eleven years left of the SEZs.

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<sup>153</sup> *Id.*

<sup>154</sup> *Id.*

<sup>155</sup> *Id.*

<sup>156</sup> *Inwestycje zagraniczne i transfer technologii: Co dalej ze specjalnymi strefami ekonomicznymi*, 34-35 *Dziennik Gospodarczy – Rynki Zagraniczne*, March 22-23, 2005, available at [http://ryнки.sm.pl/archiwum05/nr34\\_35.htm](http://ryнки.sm.pl/archiwum05/nr34_35.htm).

<sup>157</sup> Ministry Report, *supra* note 90, at 8.

<sup>158</sup> *Id.*

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As noted by a number of commentators in this area, the EU never really criticized the idea of SEZs themselves.<sup>159</sup> It simply did not approve of the preferential treatment offered to investors in the SEZs because it considered them to be incompatible with the *acquis communautaire*. After all, special economic areas, similar to the SEZs in Poland, have, for some time now, functioned in the territories of other EU Member States (i.e. Ireland and the Portugal Island of Madera) and they were allowed because they were compatible with the *acquis communautaire*.<sup>160</sup> Since the Polish SEZs legislation has now been aligned with EU norms, nothing should stand in the EU's way to allow Poland to create new SEZs after 2017 or extend the lifetime of those already in existence.

The problem is that the SEZs legislation as it is now contains a clause that permanently fixes the total allowable area of the SEZs. The 1994 SEZs legislation did not contain a provision limiting the allowable coverage area of the SEZs.<sup>161</sup> The provision came about in 2000 when certain changes were being worked into the SEZs legislation as a result of Poland's application for EU membership. The changes implemented in the SEZs legislation in 2000 allowed for: (1) the pre-mature closing down of the SEZs (meaning closing of the SEZs before the end of the period for which they were originally created), (2) the changing in the total area of the SEZs, and (3) the combining of two or more SEZs under the condition that the total combined area of all SEZs did not exceed the total area of the SEZs originally allowed.<sup>162</sup> The reason why, during that time, Poland agreed not to create any new SEZs is that the country was hoping that the EU would approve the maintenance of the acquired rights for the pre-2001 SEZs investors.<sup>163</sup> Poland did not succeed in sustaining the acquired rights; however, the limit on the area of the SEZs to be created in the future remained in effect.<sup>164</sup>

This declaration, fixing the total area of the SEZs, also resulted from the negative evaluation of the SEZs conducted by the Commission during the years 1999-2000.<sup>165</sup> This made sense because at that time the SEZs were still governed by the 1994 legislation which was in conflict with the Community rules regarding State aid.<sup>166</sup> However, the SEZs rules were modified as of

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<sup>159</sup> Szymaniak, *supra* note 69, at 18. See also Ambroziak I, *supra* note 68, at 20.

<sup>160</sup> Szymaniak, *supra* note 69, at 18.

<sup>161</sup> Ambroziak I, *supra* note 68, at 19.

<sup>162</sup> *Id.*

<sup>163</sup> Ministry Report, *supra* note 90, at 9.

<sup>164</sup> *Id.*

<sup>165</sup> Ambroziak I, *supra* note 68, at 20.

<sup>166</sup> *Id.*

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January 1, 2001 and from that date they were approved by the EU as compatible with the *acquis communautaire*.<sup>167</sup> Any new concessions gained by the investors would be governed by this new law and thus would be perfectly in line with what the EU regarded as lawful. In light of such conclusions, it seems that it would be more sensible for Poland to be able to create new SEZs. This is one possible and feasible solution to the important problem of the country catching up to its western member states in the EU.

After all, one main reason why the EU would like to do away with SEZs is that the organization is trying to lower the levels of State aid offered by individual Member States because it perceives such aid as destructive to the unity of Common Market. However, we have to remember that not all types of State aid threaten fair competition among the Member States. The EU has been most critical of the sectoral aid but this type has proven to be declining in all Member States. The aid offered in SEZs is not structural but rather regional aid and this type is not so destructive to the maintenance of fair competition among the EU Member States.

There is also another factor that speaks in favor of extending the lifetime of the existing SEZs or the creation of new SEZs in Poland. It is the idea that activity in the SEZs may in the long run assist with solving the important dispute regarding the EU budget. Most recently the EU Member States have shown to be in conflict regarding the budget funds that should be granted to each Member States. This conflict is especially true in the newly admitted Central and Eastern European Member due to their low GDP as compared to their western counterparts. By helping to attract more investment to countries like Poland through creation of SEZs, the EU will help Poland repair its budget and by doing so will eventually decrease the amount of aid that Poland may qualify for from the EU budget.

At first sight, the SEZs might seem to deprive Poland's budget of a significant amount of revenue by granting the preferential tax breaks. However, in the long run they will prove to be extremely beneficial to the country. Since 2001, any new investors in the SEZs are governed by the new SEZ legislation that is compatible with EU law. This law imposes limits on the amount of tax breaks that the government is allowed to grant to investors.<sup>168</sup> Therefore, as the businesses in the SEZs get stronger, they will eventually exceed those limits and will no long be eligible for the tax breaks. When that happens, the investors' tax rates will increase leading to an effective decrease in the amount of revenue to the country's budget; this is exactly what is happening with the American

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<sup>167</sup> *Id.*

<sup>168</sup> Ministry Report, *supra* note 90, at 4.



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investor, Delphi. Delphi is the world's largest producer of automotive parts.<sup>169</sup> It first appeared in Poland in 1998 when it decided to invest in the building of the center of research and development in the Katowicka zone.<sup>170</sup> Currently the center employs 560 Polish engineers who work on the development of the most technologically advanced solutions for the world's biggest car producers.<sup>171</sup> At the beginning of October 2005, the company signed a contract with the Ministry of Economy which granted it one million zloty (approx. \$333,000) to assist with the employment of an additional 260 workers.<sup>172</sup> At the same time, the further development of the Delphi research center will bring, in the next two years, almost five million zloty (approx. \$1.6 million) to the country's budget.<sup>173</sup>

### CONCLUSION

During the past decade, the Special Economic Zones constituted one of the most important and controversial aspects of Poland's State aid structure. Most recently the SEZs have been booming and the dynamic activity of investors in the SEZs has been a crucial factor in the country's economic development. The problem is that the Special Economic Zones have already almost entirely run out of areas for new investors and most troubling they are scheduled to cease to exist by the year 2017. At this point in time, it is hard to imagine that ten years will be enough time for Poland to catch up with its EU western counterparts in terms of standards of living and employment levels. For that reason, it is crucial that the EU allows Poland to create new SEZs.

Extending the existence of Special Economic Zones will help not only Poland but also the EU as a whole. If Poland's economic development stagnates, it is likely that the economic gap existing between Poland and other EU Member States will widen. As a result, Poland may qualify for more help from the EU budget which is already overburdened. On the other hand, if Poland is allowed to keep the SEZs or create new ones, it may further awaken the economic activity in the country and accelerate its adjustment to EU levels.

Finally, it is important to point out that the future of Special Economic Zones is not only dependant on the willingness of the EU to extend them because Poland also has to work to ensure that the SEZs remain compatible with EU goals. Most importantly, Poland has to ensure that, if allowed, new

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<sup>169</sup> Krzysztof Fijalek, *Rozbudowa Osrodka Badawczo-rozwojowego Delphi w Krakowie*, GAZETA WYBORCZA, Dec. 12, 2005.

<sup>170</sup> *Id.*

<sup>171</sup> *Id.*

<sup>172</sup> *Id.*

<sup>173</sup> *Id.*

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SEZs are created in those regions of the country that are truly the undeveloped and poor regions. There has been some criticism emerging that the Special Economic Zones are not really functioning in those parts of the country that most need them but rather in those regions where the local governments have the most political leverage. Accordingly, the Polish government has to ensure that SEZs are created in those regions that need them the most and this can be done by working on improving infrastructure and accessibility to those undeveloped regions so that they can become more attractive to investors.

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**TABLE 1** – State aid in EU by objective in 2003<sup>174</sup>

	EU-15	BE	DK	DE	EL	ES	FR	IE	IT	LU	NL	AT	PG	FI	SE	UK
<b>Horizontal Objectives</b>	79	100	94	73	97	63	76	64	96	100	91	99	19	99	100	99
Research and Development	14	30	4	10	1	5	21	12	16	21	45	37	2	32	7	24
Environment and energy saving	23	1	49	38	4	4	5	2	6	0	27	24	0	38	75	22
SME	13	32	0	4	1	15	24	3	33	3	2	10	10	6	2	12
Commerce	1	1	-	0	-	0	3	-	0	-	4	0	0	3	-	0
Culture and heritage conservation	2	4	4	1	1	2	5	6	-	-	-	-	0	4	11	0
Employment aid	3	5	33	0	2	4	1	16	8	-	0	4	2	6	-	0
Training aid	3	3	4	0	-	14	1	4	7	-	-	6	3	0	-	5
Regional development	21	24	0	20	84	19	17	22	27	76	14	17	2	9	5	35
<b>Sectoral Aid</b>	21	-	6	27	3	37	24	36	4	-	9	1	81	1	-	1
Coal	14	-	-	23	-	35	19	-	-	0	-	-	-	-	-	1
Manufacturing	3	-	6	3	3	2	5	27	1	0	9	1	1	-	-	0
Services	4	-	-	1	0	0	-	9	3	0	0	1	80	1	-	-
<b>Total aid less agriculture, fisheries and transport in million</b>	<b>37,334</b>	<b>655</b>	<b>921</b>	<b>14.4</b>	<b>333</b>	<b>3,174</b>	<b>4,806</b>	<b>417</b>	<b>5.7</b>	<b>36</b>	<b>497</b>	<b>590</b>	<b>1,254</b>	<b>519</b>	<b>1.04</b>	<b>3.01</b>

<sup>174</sup> Scoreboard 2005, *supra* note 4, at 22.

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**TABLE 2 – State aid in Poland by objectives in 2001 and 2002**<sup>175</sup>

Aid Title	2001		2002	
	In PLN million	In %	In PLN Million	In %
<b>1. Horizontal aid, of which:</b>	<b>3569.40</b>	<b>32.02%</b>	<b>3450.7</b>	<b>33.74%</b>
1.1. Research and development	95.0	0.85%	136.7	1.34%
1.2. Environmental protection	80.4	0.72%	142.2	1.39%
1.3. Small and medium size enterprises	61.9	0.56%	136.6	1.34%
1.4. Energy savings	7.7	0.07%	7.8	0.08%
1.5. Employment	106.9	0.96%	228.2	2.23%
1.6. Training	466.7	4.19%	368.5	3.60%
1.7. Restructuring	2123.5	19.05%	2091.3	20.45%
1.8. Rescue aid	128.4	1.15%	300.6	2.94%
1.9. Employment of handicapped and rehabilitation	198.0	1.78%	-	-
1.10. Infrastructure development	233.6	2.10%	10.4	0.10%
1.11. Other	67.3	0.60%	28.4	0.28%
<b>2. Sectoral aid, of which:</b>	<b>2700.3</b>	<b>24.22%</b>	<b>1835.4</b>	<b>17.94%</b>
2.1. Steel sector	26.7		5.3	0.00%
2.2. Ship building	9.3	0.24%	101.8	0.05%
2.3. Coal mining	2649.2	0.08%	1712.9	1.00%
2.4. Synthetic fibers	0.2	23.76%	0.1	16.75%
2.5. Automotive industry	6.6	0.00%	15.2	0.00%
2.6. Marine transport	8.3	0.06%	0.1	0.15%
<b>3. Regional aid</b>	<b>382.4</b>	<b>0.07%</b>	<b>469.6</b>	<b>0.00%</b>
<b>4. Agriculture</b>	<b>2383.9</b>	<b>3.43%</b>	<b>1766.9</b>	<b>4.59%</b>
<b>5. Other titles of aid</b>	<b>2112.0</b>	<b>21.38%</b>	<b>2706.0</b>	<b>17.27%</b>

<sup>175</sup> Sowa, *supra* note 50, at 19.

## GENERATING EXTRA WIND IN THE SAILS OF THE EU ANTITRUST ENFORCEMENT BOAT

*Corinne Bergen\**

### INTRODUCTION

With 90% of its antitrust law enforcement generated by private rights of action, the United States provides a great opportunity for aggrieved consumers to right the wrongs that have been done to them, while concurrently, maximizing its avenues of antitrust enforcement.<sup>1</sup> Consumers assist the Department of Justice (DOJ) and the Federal Trade Commission (FTC) with the enforcement of the U.S. antitrust law by asserting the right granted to them under the Clayton Act<sup>2</sup> to bring private actions.<sup>3</sup> Unlike the U.S. system for antitrust enforcement, the European Union (“EU”) does not expressly provide its citizens with a private right of action with which to secure compensation for violations. Currently however, the EU is working on creating an environment where the private right of action can thrive and succeed in compensating consumers, as well as, increasing the enforcement of its antitrust law.<sup>4</sup>

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<sup>1</sup> Katherine Holmes, *Public Enforcement or Private Enforcement? Enforcement of Competition Law in the EC and UK*, E.C.L.R., 25(1), 25-36 (2004).

<sup>2</sup> 15 U.S.C. § 12-27 (2000).

<sup>3</sup> Clifford A. Jones, *Exporting Antitrust Courtrooms to the World: Private Enforcement in a Global Market*, 16 LOY. CONSUMER L. REV. 409, 411 (2004) [herein after Jones] (countering the argument that the lack of treble damages is the cause of the deficiency in private antitrust enforcement actions in foreign nations by arguing that prejudgment interest sufficiently compensates consumers outside the US); 15 U.S.C. § 15 (2000) (containing the statutory grant of a private right of action).

<sup>4</sup> Commission Green Paper on Damages actions for breach of the EC antitrust rules: (December 19, 2005), available at [http://europa.eu.int/comm/competition/antitrust/others/actions\\_for\\_damages/gp\\_en.pdf](http://europa.eu.int/comm/competition/antitrust/others/actions_for_damages/gp_en.pdf) (last visited

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With the growth of transnational business dealings comes the responsibility of the EU to consider adopting a system for private enforcement that will not only work productively throughout Europe, as well as, with the U.S. system, but also work to promote competition while maintaining consumer protection. There are key features of the U.S. private enforcement system that work collectively to provide an incentive for individuals to take on the roles of “private attorneys general”<sup>5</sup> and the adoption of these key features, or a variation thereof, is necessary to a successful application of the private right of action in the EU.<sup>6</sup>

The recent actions taken by the EU with regard to private enforcement lay the first bricks on a path to effective and protective competition law enforcement in the EU, however, in order for the EU to establish a valuable private right of action it is necessary to look to the US system and examine how its different aspects work to provide a private right of action. This Note studies the current state of antitrust regulation in the U.S. and EU and examines the possible structures for a successful private right of action in the EU.

Part I contains a discussion of the state of antitrust law as it exists in the U.S. Part II discusses the current state of antitrust or competition law in the EU and the recent actions taken by the EU that will open the doors to the inception of a successful private right of action for its citizens. Part III provides an overview of how the encouragement in the U.S. to pursue a private right of action, not only stems from the ability of the plaintiff to recover treble damages, as well as attorneys’ fees, but also from broad discovery which makes it feasible for plaintiffs to obtain a significant amount of evidence, thereby increasing their chances of proving a violation of the law.<sup>7</sup> Also discussed in this section is how the availability of contingency fee arrangements and class actions in the US system allow those with minor claims to come together and bring suit against those violators who may have otherwise gone unpunished for their offences.<sup>8</sup> While incorporating a version of the aspects of the U.S. antitrust law into the EU system may encourage individuals to assert their private right of action,

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Jan. 14, 2006) (“Green papers are discussion papers published by the [European] Commission on a specific policy area. Primarily they are documents addressed to interested parties - organizations and individuals - who are invited to participate in a process of consultation and debate. In some cases they provide an impetus for subsequent legislation”).

<sup>5</sup> Hannah L. Buxbaum, *The Private Attorney General in a Global Age: Public Interests in Private International Antitrust Litigation*, 26 YALE J. INT’L L. 219, 224 (2001) (“examin[ing] the growing inconsistencies in judicial evaluation of the public interest at stake in regulatory disputes”).

<sup>6</sup> Donnadh Woods, *Private Enforcement of Antitrust Rules – Modernization of the EU Rules ad the Road Ahead*, 16 LOY. CONSUMER L. REV. 431, 433 (2004) [hereinafter Woods].

<sup>7</sup> Janet L. McDavid & Howard Weber, *E.U. Private Actions*, NAT’L L.J., Apr. 25, 2005, available at <http://www.nlj.com> (last visited Sept. 14, 2005).

<sup>8</sup> *Id.*

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there are other aspects of the U.S. construct, such as standing and the indirect purchaser exclusion, that are relevant to the issue of private antitrust litigation<sup>9</sup>. And finally, part IV points to the EU's recently published Green Paper on "Damages actions for breach of the EC antitrust rules,"<sup>10</sup> and addresses the issues raised by the structural suggestions for EU competition law contained therein.

### UNITED STATES ANTITRUST LAW

#### A. U.S. Statutory Antitrust Law and Its Enforcers

In the U.S., consumer protection against "business practices that unreasonably deprive customers of the benefits of competition, resulting in higher prices for inferior products and services,"<sup>11</sup> is set forth in two basic antitrust laws, the Sherman Act<sup>12</sup> and the Clayton Act.<sup>13</sup> In addition to these two laws, the Federal Trade Commission Act (FTCA) is also utilized to prevent the deprivation of the benefits of competition for the benefit of the consumer.<sup>14</sup>

##### i. The Sherman Act of 1890

In 1890, Congress utilized the authority granted to it under the U.S. Constitution, to "regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes,"<sup>15</sup> to ratify the Sherman Act.<sup>16</sup> The

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<sup>9</sup> *Id.*

<sup>10</sup> See Commission Green Paper, *supra* note 4.

<sup>11</sup> U.S. Department of Justice, Washington, D.C. 20530: Antitrust Enforcement and the Consumer (1996), available at [http://www.pueblo.gsa.gov/cic\\_text/misc/antitrust/antitrust.htm](http://www.pueblo.gsa.gov/cic_text/misc/antitrust/antitrust.htm) (last visited April 16, 2006).

<sup>12</sup> 15 U.S.C. § 1-7 (2000).

<sup>13</sup> 15 U.S.C. § 12-27 (2000).

<sup>14</sup> See CRS Report for Congress, 95-116: General Overview of United States Antitrust Law (1995) [hereinafter CRS Report] (Stating that these laws do not constitute the entirety of antitrust law in the United States, but rather they are those which are most often utilized. "There are also some statutes directed to specific industries or types of transactions which indicate the likely antitrust consequences for economic conduct in those areas," such as the Export Trading Company Act, 15 U.S.C. §§ 4001-21, and the Soft Drink Interbrand Competition Act, 15 U.S.C. §§ 3591-03.), available at <http://www.cnie.org/nle/crsreports/risk/rsk-63.cfm> (last visited April 16, 2006).

<sup>15</sup> U.S. CONST. art. I, § 8, cl. 3.

<sup>16</sup> Jaafar A. Riazi, *Finding Subject Matter Jurisdiction Over Antitrust Claims of Extraterritorial Origin: Whether the Seventh Circuit's Approach Properly Balances Policies of International Comity and Deterrence*, 54 DEPAUL L. REV. 1277, 1280 (2005).

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Sherman Act consists of seven sections laying out the foundations of illegality with regard to business practices.<sup>17</sup> Of these seven sections, Sections 1 and 2 are of the greatest importance. Section 1 declares felonious, “every contract, combination in the form of a trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations.”<sup>18</sup> Under Section 2 felony status is granted for “every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations.”<sup>19</sup> Violations under the Sherman Act are punishable civilly, as well as, criminally.<sup>20</sup>

The mission of the Antitrust Division of the United States Department of Justice is to “promote and protect the competitive process – and the American economy – through the enforcement of the antitrust laws.”<sup>21</sup> The DOJ is the only source of antitrust enforcement that is able to bring both civil and criminal enforcement actions pertaining to the antitrust laws.<sup>22</sup> The DOJ may “prosecute serious and willful violations of the antitrust laws by filing criminal suits that can lead to large fines and jail sentences.”<sup>23</sup> Where criminal enforcement actions are not suitable, the DOJ will bring civil actions “seeking court orders forbidding future violation of the law and requiring steps to remedy the anti-competitive effects of past violations.”<sup>24</sup> Punishment for violations can reach up to \$100,000,000 for corporations, \$1,000,000 for any person, or imprisonment up to 10 years, or a combination of fines and imprisonment.<sup>25</sup>

**ii. The Clayton Act of 1914**

The Clayton Act, enacted in 1914, is comprised of Sections 12 to 27 of Title 15, which seek to fill in the gaps left open by the Sherman Act.<sup>26</sup> These

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<sup>17</sup> 15 U.S.C. § 1-7 (2000).

<sup>18</sup> 15 U.S.C. § 1 (2000).

<sup>19</sup> 15 U.S.C. § 2 (2000).

<sup>20</sup> 15 U.S.C. §§ 1-2 (2000).

<sup>21</sup> U.S. Department of Justice, Overview Antitrust Division, *available at* <http://www.usdoj.gov/atr/overview.html> (last visited March 21, 2006) [hereinafter DOJ:Overview].

<sup>22</sup> U.S. Department of Justice, Washington, D.C. 20530: Antitrust Enforcement and the Consumer, *available at* [http://www.usdoj.gov/atr/public/div\\_stats/211491.htm](http://www.usdoj.gov/atr/public/div_stats/211491.htm) (last visited March 21, 2006).

<sup>23</sup> See DOJ: Overview, *supra* note 21.

<sup>24</sup> *Id.*

<sup>25</sup> Antitrust Criminal Penalty Enforcement Act 2004 (raising the statutory maximum fines from \$10,000,000 to \$100,000,000 for corporations, and from \$350,000 to \$1,000,000 for individuals, and the maximum prison sentence from three years to ten years).

<sup>26</sup> 15 U.S.C. § 12-27 (2000).



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sections punish such illegal practices as price-fixing<sup>27</sup>, bid rigging, and tying arrangements.<sup>28</sup> The importance of this act cannot be underestimated because, not only does it add to the reach of the Sherman Act by establishing the right to prevent activity “in its incipiency which may tend to restrain trade,”<sup>29</sup> but it also grants the right of “any person who shall be injured in his business or property by reason of anything forbidden in the antitrust laws [to] sue therefore in any district court of the United States in the district in which the defendant resides or is found or has an agent, without respect to the amount in controversy.”<sup>30</sup> In addition to providing the much needed private right of action the Clayton Act allows those seeking a private right of action to collect treble damages<sup>31</sup>, court costs and attorney’s fees.<sup>32</sup>

### iii. The Federal Trade Commission Act

The Federal Trade Commission Act, along with the Clayton Act, was enacted in 1914, supplements the Sherman and Clayton Acts and provides for the Federal Trade Commission. The FTC is “empowered and directed to prevent persons, partnerships, or corporations. . .from using unfair methods of competition in or affecting commerce,<sup>33</sup> and unfair or deceptive acts or practices

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<sup>27</sup> See 15 U.S.C. § 13 (2000) (Stating that it is illegal for any person to “discriminate in price between different purchasers of commodities of like grade and quality...where the effects of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce, or to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them”).

<sup>28</sup> Tying arrangements exist where entities conspire to sell their product in connection with another product so that if the consumer wants “X” he must also purchase “Y”.

<sup>29</sup> See Congressional Research Service Report for Congress, *supra* note 14. The Sherman act provides protection against concerted activity which actually restrains trade, while the Clayton Act allows for protection against concerted activity which may tend to restrain trade, but which has not yet done so. An example of the use of these laws would be the prevention of a merger between two entities which if permitted to go forth would restrain trade.

<sup>30</sup> 15 U.S.C. § 15 (2000).

<sup>31</sup> Treble damages consist of three times the actual damages sustained.

<sup>32</sup> See Congressional Research Service Report for Congress, *supra* note 14. (In 1982 the provision for damages was amended to restrict foreign states from recovering more than actual damages, court costs, and reasonable attorney’s fees. (15 U.S.C. § 15(b)). In addition, until 1990 the United States was unable to collect treble damages in the event that it sustained monetary injury, but fortunately this limitation was removed by Congress after “hearing testimony to the effect that the damage limitation made the federal government the ‘antitrust victim of choice’”).

<sup>33</sup> See Federal Trade Commission Act [hereinafter FTCA], 15 U.S. C. § 44. (Defining “commerce” as “commerce among the several States or with foreign nations, or in any Territory of the United States or District of Columbia, or between any such Territory and another, or between any such Territory and any State or Territory or foreign nation”).

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in or affecting commerce”.<sup>34</sup> The Bureau of Competition, the antitrust arm of the FTC, carries out its mission to “allow for unfettered competition in the marketplace” by investigating alleged antitrust violations and alerting the FTC to when it is necessary to take formal action against such violators.<sup>35</sup>

As both the DOJ and the FTC are given the responsibility of enforcing the antitrust laws, it is necessary for these two entities to work in concert so that they may aid one another in the continued protection of the competitive process of the American economy, while preventing a duplication of effort on their parts.<sup>36</sup> These entities engage in frequent consultation with one another by following a “clearance procedure” as each case arises, so that it may be determined “which agency would be the more appropriate one to handle the matter.”<sup>37</sup> While the DOJ and the FTC play essential roles in the enforcement of the U.S. antitrust law, it is the private enforcement granted under the Clayton Act which plays a pivotal role consisting of about 90% of the total U.S. antitrust enforcement.<sup>38</sup>

### B. The United States Private Right of Action

When private individuals assert the right granted to them under the Clayton Act they may do so in one of two forms.<sup>39</sup> The first is the pure statutory form, and the second is the contract form.<sup>40</sup> In the pure statutory form, the private litigant assumes the role of “private attorney general” by seeking compensation for a wrong that may have been done to him, while at the same time acting in a capacity that defends the public interest.<sup>41</sup> Under this form, the litigant alleges that he or she has suffered damages, generally, not as a result of some contractual relationship between the parties, but rather, as a result of another’s violation(s) of the U.S. antitrust law.<sup>42</sup>

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<sup>34</sup> FTCA, 15 U.S.C. § 45.

<sup>35</sup> Federal Trade Commission: Bureau of Competition. <http://www.ftc.gov/ftc/antitrust.htm> (last visited September 14, 2005).

<sup>36</sup> *Id.*

<sup>37</sup> Department of Justice, Division Manual, Antitrust Division with Other Agencies and with the Public. <http://www.usdoj.gov/atr/foia/divisionmanual/ch7.htm> (last visited October 8, 2005).

<sup>38</sup> See Holmes, *supra* note 1.

<sup>39</sup> See Buxbaum, *supra* note 5, at 224 (“examin[ing] the growing inconsistencies in judicial evaluation of the public interest at stake in regulatory disputes”).

<sup>40</sup> *Id.*

<sup>41</sup> *Id.* at 222.

<sup>42</sup> *Id.* at 224. (In such instances a contracting party may claim that the forum selection clause should be vacated because violations of United States antitrust laws are present, so that the private litigant may have the advantage of litigating in a more favorable forum).

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Unlike the pure statutory form, under the contract form the individual's claims are most often raised in situations where some type of contractual relationship<sup>43</sup> exists between the two parties. A plaintiff may seek the protection of the U.S. antitrust law in an offensive way, for example, in a situation where there is "a licensee who believes that a breach of contract by its licensor involves violations of U.S. antitrust law."<sup>44</sup> However, more commonly, the U.S. antitrust law is utilized under the contract form in a defensive way, where a defendant seeks to avoid contract terms which may include forum selection clauses and the like.<sup>45</sup> Differing from cases brought in the pure statutory form, cases of the contractual nature "reveal a focus on private-law values rather than on the strength or character of the public interest asserted."<sup>46</sup>

Of the two forms, it is the pure statutory form in which enforcement of the antitrust law or compensation for the violation of antitrust law is the main objective, while under the contractual form the claimant is most likely utilizing the antitrust law as leverage to further their own private interests. These actions may be brought by individuals, but they are most often brought by a class consisting of consumers who have been aggrieved by another's violation of the law or by states<sup>47</sup> acting on behalf of their citizens.<sup>48</sup>

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<sup>43</sup> *Id.* at 237. (These contractual relationships are generally international relationships as the conflict arises as a result of the enforcement of forum-selection and choice-of-law clauses in international agreements).

<sup>44</sup> *Id.* at 226.

<sup>45</sup> *Id.*

<sup>46</sup> *Id.* at 236. (As there is a "judicial unwillingness to insist on the application of domestic regulatory law in the face of private contractual arrangements...contract cases have marginalized the private attorney general by sharply restricting the circumstances in which private attorneys general can assert U.S. laws abroad").

<sup>47</sup> See 15 U.S.C. 15(c) (2000) (granting "any attorney general of a State" the right to "bring a civil action in the name of such State, as *parens patriae* on behalf of natural persons residing in such State...for injury sustained by such natural persons to their property by reason of any violation" of the Sherman Act).

<sup>48</sup> See Charles W. Smitherman III, *The Future of Global Competition Governance: Lessons from the Transatlantic*, 19 Am. U. Int'l Rev. 769, 806 (2004) (discussing long-term convergence through continued strong extraterritoriality and cooperation by the United States and the European Community as a model for future competition law).

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**PRESENT STATE OF EU ANTITRUST LAW****A. EU Antitrust Law and Its Enforcers**

Presently in the EU, antitrust enforcement generally lies in the public sector, as there is an absence of a guaranteed right to its citizens to bring private actions against violators of its antitrust law. The EU's antitrust law, or competition law as termed from the European perspective, is set forth in Articles 81 and 82 of the Treaty Establishing a European Community ("EEC Treaty").<sup>49</sup>

Article 81 (1) of the treaty prohibits "all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the common market."<sup>50</sup> More or less analogous to Section 1 of the Sherman Act, it can be said that a violation of Article 81 calls for "at least two companies. . .involved in restraining trade, as opposed to unilateral action by one business."<sup>51</sup> In addition to listing particular "undertakings," which are prohibited, such as price-fixing and bid-rigging, Article 81 (3) declares Article 81 (1) to be inapplicable if any such undertaking "contributes to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit".<sup>52</sup>

Congruent to Section 2 of the U.S. Sherman Act, which prohibits monopolization or attempted monopolization,<sup>53</sup> Article 82 prohibits "any abuse by one or more undertakings of a dominant position with the common market or

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<sup>49</sup> EC Treaty art. 81-82.

<sup>50</sup> EC Treaty art. 81 (1).

<sup>51</sup> Larry Bumgardner, JD, *Antitrust Law in the European Union: The Law is Changing – But to What Effect?*, 8 GRAZIADIO BUS. REP. (2005), available at <http://gbr.pepperdine.edu/053/euantitrust.html> (last visited, April 16, 2006).

<sup>52</sup> EC Treaty art. 81 (3); 15 U.S.C. § 1-7 (2000) (While the Sherman Act does not specifically provide for an exception such as is present in Art 81(3) of the EU antitrust law, it does state that when presiding over antitrust claims the court has discretion when it comes to punishment for such violations. As this is the case, it may be possible that a court would be less likely to harshly punish those violators whose acts have contributed to the production of goods or promote technology, while creating a benefit for the consumer).

<sup>53</sup> See Congressional Research Service Report for Congress, *supra* note 14.

## EU ANTITRUST ENFORCEMENT

in a substantial part of it. . .insofar as it may affect trade between Member States.”<sup>54</sup> Though similar in context, it has been argued that the U.S. antitrust scheme is geared more toward consumer protection, while the EU scheme is primarily focused on protecting competition.<sup>55</sup>

Unlike the U.S. antitrust laws which are enforced by public as well as private entities, Article 85 of the EEC Treaty, entrusts the duty of enforcing the competition laws to the European Commission (“the Commission”), stating that it shall “ensure the application of the principles laid down in Articles 81 and 82.”<sup>56</sup> Also, under Article 82, the Commission is ordered to work “on its own initiative, and in cooperation with the competent authorities in the Member States” when investigating possible violations of the competition law.<sup>57</sup> In the event that such a violation is present, the Commission has the duty of proposing appropriate measures to bring it to an end or alternatively to record such violations and authorize the Member States to remedy the situation according to its orders.<sup>58</sup> In assigning punishment, the Commission and respective Member States subject companies to heavy monetary fines, “which may be as large as 10 percent of the companies’ worldwide annual revenue,” however the EU does not issue criminal penalties for competition law violations.<sup>59</sup>

### **i. Member States**

As the states in the U.S. each have their own set of local antitrust laws, the Member States in the EU each have their own diverse governments and versions of competition law. Some Member States provide for the private enforcement of their competition laws,<sup>60</sup> however the lack of a set rule governing private enforcement under the EU competition law leaves plaintiffs “with little or no legal guidance in many jurisdictions.”<sup>61</sup> As a result of the variation that exists from one Member State to the next in terms of substantive as well as procedural aspects of their competition law, there is the “possibility of inconsistent verdicts and forum shopping.”<sup>62</sup>

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<sup>54</sup> EC Treaty art. 82.

<sup>55</sup> See Bumgardner, *supra* note 51.

<sup>56</sup> EC Treaty art. 85.

<sup>57</sup> EC Treaty art. 82.

<sup>58</sup> EC Treaty art. 85.

<sup>59</sup> See Bumgardner, *supra* note 51.

<sup>60</sup> See McDavid, *supra* note 7 (stating that only 12 out of the 25 member states appear to expressly provide for a private right of action to seek damages resulting from violations of their competition laws).

<sup>61</sup> *Id.*

<sup>62</sup> *Id.*

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**B. Paving the Way for a Private Right of Action**

The private right of action is neither explicitly forbidden by EU competition law, nor specifically granted.<sup>63</sup> As a result, it was unclear whether such a right existed until the 1999 European Court of Justice (“ECJ”)<sup>64</sup> decision of *Courage v. Crehan*.<sup>65</sup> In that case the ECJ held that the usefulness of the competition law and “the practical effect of the prohibition laid down in Article 81(1)<sup>66</sup> would be put at risk if it were not open to an individual to claim damages for loss caused by conduct liable to restrict or distort competition.”<sup>67</sup> As a result of this notion and the explicit grant of power over enforcement of the competition law laying solely in the hands of the Commission under the EEC Treaty, the ECJ went on to conclude that “actions for damages before the national courts can make a significant contribution to the maintenance of effective competition in the Community.”<sup>68</sup>

**i. The Birth of National Enforcement of Community Competition Law**

Following the ECJ decision in *Courage v Crehan*, the EU adopted Regulation 1/2003 (the “Regulation”), in December of 2002, which established the foundation for a new and more productive enforcement of Articles 81 and 82.<sup>69</sup> Taking effect in May 2004 an important part of the Regulation called for bringing together national competition authorities with the Commission to form a network termed the European Competition Network (“ECN”).<sup>70</sup> According to

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<sup>63</sup> John H. Beisner and Charles E. Borden, *Expanding Private Causes of Action: Lessons From the U.S. Litigation Experience*, 9-10, available at <http://www.omm.com/webdata/content/newsevents/beisnerpdf2.pdf> (last visited, April 16, 2006).

<sup>64</sup> EC Treaty art. 83.

<sup>65</sup> *Courage v. Crehan*, C-453/99, [2001] ECR I-6297, available at <http://curia.eu.int/jurisp/cgi-bin/form.pl?lang=en&Submit=Rechercher&alldocs=alldocs&docj=docj&docop=docop&docor=docor&docjo=docjo&numaff=C-453/99&datefs=&datefe=&nomusuel=&domaine=&mots=&resmax=100> (last visited, April 16, 2006).

<sup>66</sup> EC Treaty art. 81.

<sup>67</sup> *Id.*

<sup>68</sup> *Id.*

<sup>69</sup> See Woods, *supra* note 6 (expanding the author’s presentation given at the Institute for Consumer Antitrust Studies, Loyola University Chicago examining the issues raised with regard to incorporating a private right of action into EU competition law), available at, <http://www.luc.edu/law/academics/special/center/antitrust/symposium/woods.pdf> (last visited April 16, 2006).

<sup>70</sup> *Id.*

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the Regulation the new system of enforcement will ensure that EU competition law provides a base standard for the evaluation of possible violations across the entire EU “thereby establishing a level playing field for companies active in the international market.”<sup>71</sup>

The most critical part of the Regulation that may facilitate the opening of the door to private rights of action in the EU is that which allows national courts to “fully adjudicate” antitrust matters.<sup>72</sup> Prior to this Regulation the Commission’s notification and exemption system<sup>73</sup> was an obstacle to private enforcement in Member States. Under this system the Commission would receive a notification of a possible antitrust law violation and then analyze the suspect action to determine whether it should be exempt from penalty under Article 81 (3).<sup>74</sup> While the Commission was in the process of making a determination on the issue any ongoing private action on that matter would be forced to come to a halt, as the Commission would now be the sole law enforcer.<sup>75</sup> However, now that the Regulation has eliminated the Commission’s monopoly on the applicability of Article 81(3)<sup>76</sup> national judges will be able to take a greater role in the enforcement of Articles 81 and 82 and there will be less interruption of ongoing private rights of action taking place in the national courts.<sup>77</sup>

As the Commission does not have the power to award damages to those who have been injured by a violation of the competition law, the ability of national courts to apply competition law along with their own national law creates a number of advantages for private parties seeking action.<sup>78</sup> Not only may private parties assert EU competition law claims in the same action as national law claims, but these parties will now have the benefit of a faster litigation process now that there is more than one entity involved in the

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<sup>71</sup> *Id.*

<sup>72</sup> *Id.* at 433 (stating that before this Regulation courts in member states were inhibited in their action because the law called for notification to the Commission of possibly violations, who would then assume the responsibility of determining whether there was in fact a violation).

<sup>73</sup> The notification and exemption system is the process by which the Commission investigates and determines whether or not an agreement that has been notified to the Commission meets the criteria for exemption under Article 81(3).

<sup>74</sup> EC Treaty art. 81 (3).

<sup>75</sup> See Woods, *supra* note 6, at 433.

<sup>76</sup> EC Treaty art 81(3) (Setting forth the situations in which the Commission has the sole right to find section 81(1) to be deemed inapplicable).

<sup>77</sup> See Woods, *supra* note 6, at 433.

<sup>78</sup> Notice on cooperation between national courts and the Commission in applying Articles 81 and 82 of the EEC Treaty, *available at* [http://europa.eu.int/smartapi/cgi/sga\\_doc?smartapi!celexplus!prod!CELEXnumdoc&lg=EN&numdoc=31993Y0213\(01\)](http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexplus!prod!CELEXnumdoc&lg=EN&numdoc=31993Y0213(01)) (last visited April 16, 2006).

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enforcement of the law.<sup>79</sup> In addition, national courts have the ability, in those Member States that permit it, to award legal costs to successful parties.<sup>80</sup> While the Commission is not granted the power to award such legal costs, the private parties in certain member states will now be able to reap this benefit.<sup>81</sup>

**ii. Member States Applying Community Competition Law in Their National Courts**

When presiding over actions for damages<sup>82</sup> the application of Articles 81 and 82 by the national courts is necessary to determine the illegality of the conduct giving rise to such actions.<sup>83</sup> When the national judges engage in such community law application they must “take account of the Commission’s powers in order to avoid decisions which could conflict with those taken or envisioned by the Commission.”<sup>84</sup> Though the national courts are not bound by the rulings of the Court of Justice<sup>85</sup> in the same sense that U.S. courts are bound by the precedent of higher courts, the “Court of Justice has established a number of principles which make it possible for such contradictory decision to be avoided,” and the Commission encourages national courts to follow these principles.<sup>86</sup>

The first step that a national court must take in determining the illegality of the “agreement, decision or concerted practice”<sup>87</sup> is to look to whether it is an action covered by the reach of Articles 81 and/or 82.<sup>88</sup> Making such a determination may prove to be simple if such action has previously been the “subject of a decision, opinion or other official statement issued by an administrative authority and in particular by the Commission.”<sup>89</sup> Again, though the national courts would not be bound by such entities’ determinations, their

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<sup>79</sup> *Id.*

<sup>80</sup> *Id.*

<sup>81</sup> *Id.*

<sup>82</sup> *Id.* (“The national courts may have to reach a decision on the application of Articles 81 and 82 in several procedural situations. In the case of civil law proceedings, two types of action are particularly frequent: actions relating to contracts and actions for damages. In the former, the defendant usually relies on Article 81(2) to dispute the contractual obligations invoked by the plaintiff”).

<sup>83</sup> *Id.*

<sup>84</sup> *Id.*

<sup>85</sup> *Id.*

<sup>86</sup> Case 48/72, *Brasserie de Haecht v. Wilkin-Janssen*, [1973] ECR 77; Case 127/73, *BRT v. Sabam*, [1974] ECR 51; Case C-234/89, *Delimitis v. Henninger Brau*, [1991] ECR I-935.

<sup>87</sup> See Notice, *supra* note 78.

<sup>88</sup> *Id.*

<sup>89</sup> *Id.*



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holdings or statements can provide useful information to the national courts which can aide them in making their determinations.<sup>90</sup> In the event the matter before the national court is one which the Commission has not ruled on, the national court can still be “guided in interpreting the Community law in question, by the case-law of the Court of Justice and the existing decisions of the Commission.”<sup>91</sup>

In order to further aide the national courts in their determinations of community antitrust law, the Commission has created several notices<sup>92</sup> in which they specify “categories of agreements that are not caught by the ban laid down in Article 81.”<sup>93</sup> Through the help of these aides the national courts should be able to make an informed and accurate finding of whether the actions of an alleged violator are in fact illegal under the community law.<sup>94</sup> Should it be the case that the Commission is in the process of investigating or making a judgment in a case relating to the same action being questioned in the national court, then the court may, “if they consider it necessary for reasons of legal certainty, stay the proceedings while awaiting the outcome of the Commission’s action.”<sup>95</sup>

### **iii. National Courts Determining Exemptions Under Article 81(3)**

As was stated earlier, Article 81(3) provides the Commission with the power to make exemptions for those engaging in activities that otherwise would be illegal under competition law, in a situation where such practice “contributes to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting

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<sup>90</sup> *Id.* (“It should be noted in this respect that not all procedures before the Commission lead to an official decision, but that cases can also be closed by comfort letters. Whilst it is true that the Court of Justice has ruled that this type of letter does not bind national courts, it has nevertheless stated that the opinion expressed by the Commission constitutes a factor which the national courts may take into account in examining whether the agreements or conduct in question are in accordance with the provisions of Article [81] (12)”).

<sup>91</sup> *Id.*

<sup>92</sup> See Notice on Exclusive Dealing Contracts with Commercial Agent (OJ no 139, 24. 12. 1962, p. 2921/62; and Notice on Agreements, Decision and Concerted Practices In the Field of Cooperation Between enterprises (OJ No C 75, 29. 7. 1968, p. 3, as corrected in OJ No C 84, 28. 8. 1968, p. 14).

<sup>93</sup> See Notice, *supra* note 78.

<sup>94</sup> *Id.*

<sup>95</sup> *Id.* (Stating that if it is the case that the national courts have remaining doubts about how to interpret/apply the community law in a certain instance, “they may stay proceedings in order to bring the matter before the Court of Justice.”).

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benefit”<sup>96</sup> If it is the case that the Commission has ruled a certain action exempt under the power granted to it in Article 81(3) then the national courts are obligated to honor this determination.<sup>97</sup> “Agreements, decisions and concerted practices which fall within the scope of application of a block exemption regulation are automatically exempted from the prohibition laid down in Article 81(1) without the need for a Commission decision or comfort letter,” and as such national courts must honor this as well.<sup>98</sup>

If an agreement comes before a national court, which does not constitute a block exemption and which has not been deemed exempt by the Commission under Article 81(3), the Commission calls for the national courts to adhere the following procedure: First, the national court must determine whether the procedural requirement needed for an exemption has been complied with.<sup>99</sup> In the event that the requirement was not fulfilled, then an exemption is not applicable and the national court is permitted to decide the issue in question pursuant to Article 81(2).<sup>100</sup> If the requirement has been complied with, then the national court must “assess the likelihood of an exemption being granted in the case in question in light of the relevant criteria developed by the case law. . . and by previous regulations and decisions of the Commission.”<sup>101</sup> If it is the case that the national court has determined that the questioned action cannot be granted exemption status, then the court must then work to resolve the conflict in compliance with Article 81(1) and (2).<sup>102</sup> However, if the national court determines that exemption status is achievable, then it has the duty to suspend the case until the Commission has been able to make their own determination on the matter.<sup>103</sup>

The Commission recognizes that the principles it has given the national courts are difficult to implement and at times may be lacking in sufficient guidance to enable the courts to work through the process

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<sup>96</sup> EC Treaty art. 81 (3).

<sup>97</sup> See Notice, *supra* note 78. (If the Commission has not made an official ruling on the applicability of Article 81(3), but has issued comfort letters in which it states that Article 81(3) shall apply, the “Commission considers that national courts may take account of these letters as factual elements” and follow them as well).

<sup>98</sup> See Notice *supra* note 78.

<sup>99</sup> *Id.* (This procedural requirement calls for proper notification of the agreement or concerted practice to the Commission).

<sup>100</sup> *Id.*

<sup>101</sup> *Id.* (Case law for this purpose is referring to the decisions or guidelines set forth by the Court of Justice and the Court of First Instance).

<sup>102</sup> *Id.*

<sup>103</sup> *Id.* (During the time in which the case is suspended in the national court, that court is permitted, so long as in compliance with the law of its nation, to implement any temporary measures it deems warranted).

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straightforwardly and apply the appropriate law without a hitch.<sup>104</sup> As a result of this conflict, the national courts are permitted to bring cases which may cause them difficulty, before the Court of Justice for a preliminary ruling, or they may request the Commission's assistance.<sup>105</sup> The EEC Treaty calls for the "constant and sincere cooperation between the Community and the Member States."<sup>106</sup> Moreover, with the *Courage v. Crehan* decision and the implementation of Regulation 1/2003, EU antitrust enforcement has increased from merely the Commission alone, to the Commission and the Member States bonded together as a unified force ensuring the protection of competition in the common market.<sup>107</sup>

However, even with this unified public force the amount of antitrust infringement protection available is still not being fully realized because of the lack of a strong private sector acting as a deterrent to potential antitrust violators.<sup>108</sup> In order to establish an effective private right of action in the EU it is necessary to look to the antitrust system of the U.S. for guidance.<sup>109</sup>

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<sup>104</sup> *Id.* (Difficulties may arise in instances where the "...practical application of Art 81 (1) and Article 82 gives rise to legal or economic difficulties, where the Commission has initiated a procedure in the same case or where the agreement, decision or concerted practice concerned may become the subject of an individual exemption.").

<sup>105</sup> *Id.* (When a national court asks the Commission for assistance this assistance may come in the form of: "information of a procedural nature to enable them to discover whether a certain case is pending before the Commission, whether a case has been the subject of notification, whether the Commission has officially initiated a procedure or whether it has already taken a position through an official decision or through a comfort letter sent by its services," clarification on points of law and the Commission's "customary practice in relation to the Community law at issue," information regarding the likelihood that the Commission would grant an exemption in the case at hand, and finally, information "regarding factual data: statistics, market studies and economic analyses.").

<sup>106</sup> *Id.*

<sup>107</sup> *Id.*

<sup>108</sup> Julian Joshua, *Competition Law: Antitrust law and policy in a global market*. Competition Law Insight (Oct. 12, 2004) available at [http://www.howrey.com/docs/JulianJoshua\\_competitionlawenforcement.pdf](http://www.howrey.com/docs/JulianJoshua_competitionlawenforcement.pdf) (last visited Feb. 24, 2006). (Stating that former Commissioner Mario Monti viewed private rights of action as valuable claiming that 'the threat of such litigation can have a strong deterrent effect and result in a high level of compliance with the competition rules'.).

<sup>109</sup> See McDavid, *supra* note 7.

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**FEATURES OF UNITED STATES PRIVATE ENFORCEMENT  
RELEVANT TO SUCCESSFUL EUROPEAN UNION  
PRIVATE ENFORCEMENT****A. Class Actions**

The attractiveness of the class action suit in the United States is that it enables one or more individuals with minimal, yet nonetheless important, claims to bond together and litigate their claims as a strong unified force.<sup>110</sup> Creating a greater likelihood that wronged consumers will assert their claims, the availability of the class action suit also acts as a powerful deterrent against violations of antitrust law.<sup>111</sup> Unlike antitrust violators in the U.S., those in the EU are comforted by the idea that a consumer with a minute monetary claim will not go through the ordeals of litigation to seek such insignificant redress because of the lack of such a legal tool like that of the class action.

Those who are critical of the class action suit argue that it tends to shift the focus from client to lawyer, from damages to attorneys' fees and from litigation to settlement. This notion stems from the fact that often "the plaintiff's lawyers receive high fees, while the class action members are awarded coupons of limited value."<sup>112</sup> There are additional negative aspects of class action settlements, such as the pressure upon defendants into settling for large damage awards in situations where a court may have awarded much less or found a lack of liability altogether. This comes about because of the threat of having to endure long litigation processes which could potentially cost them astonishing sums in legal fees.<sup>113</sup>

European unwillingness to provide for collective litigation has eased with the enactment of the 1998 European Directive on Injunctions for the Protection of Consumers' Interests (the "Directive").<sup>114</sup> This Directive required

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<sup>110</sup> See Beisner, *supra* note 63 ("In other words, the critical feature of the American class action is that it permits the aggregation and simultaneous determination of numerous claims...some certified classes have contained millions or tens of millions of class members").

<sup>111</sup> See Jones, *supra* note 3 (stating that though class actions amount to approximately 20 percent of all private actions in the United States, they have a deterrent effect because of the potential size of the damage awards).

<sup>112</sup> See Woods, *supra* note 6, at 436.

<sup>113</sup> *Id.*

<sup>114</sup> Directive 98/27/EC on Injunctions for the Protection of Consumers' Interests (May 19, 1998), available at [http://europa.eu.int/comm/consumers/policy/developments/acce\\_just/acce\\_just09\\_en.pdf](http://europa.eu.int/comm/consumers/policy/developments/acce_just/acce_just09_en.pdf) (last visited Sept. 19, 2005).

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all Member States to implement laws for collective litigation by the year 2000, however the collective actions called for were not akin to class actions in the U.S.<sup>115</sup> Member States are now obligated to allow some consumer organizations or independent public entities<sup>116</sup> to bring actions on behalf of a group of wronged individuals.<sup>117</sup> In addition, the collective actions called for under the Directive generally demand no more than injunctive or declaratory relief and in the event that damages are sought, they usually accrue to the consumer organization and not the individual members of the group.<sup>118</sup> Though this collective tool exists in the EU, the inability of private individuals to come together and bring a private class action, under which they are personally reimbursed for a wrong done to them, hinders the incentive for consumers to engage in collective actions and, therefore, hinders the potential for a strong deterrent effect like that of U.S. class actions.

### **B. Contingency Fee Arrangements/Fee Shifting**

When an individual asserts a cause of action there are great transaction costs, such as money, time and energy.<sup>119</sup> For many, a great obstacle to bringing a cause of action is the lack of capital necessary to fund such endeavors.<sup>120</sup> In a contingency-fee system, like that of the U.S., this obstacle is surmounted with ease; a prospective litigant's monetary worries are alleviated because law firms assume the costs with hopes of sharing<sup>121</sup> in a potentially large damage award.<sup>122</sup> Therefore, U.S. plaintiffs risk relatively little when deciding to pursue a cause of action; either the litigant wins and is awarded damages minus one third<sup>123</sup> for his/her lawyers' fees, or the litigant is unsuccessful and incurs no monetary cost for his/her representation. Although it is infrequent that litigants in the U.S. are also awarded their attorneys fees, under the Clayton Act the U.S. grants a private litigant who asserts an antitrust claim the right to recover three times the amount of damages he has sustained,

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<sup>115</sup> See Beisner, *supra* note 63, at 5.

<sup>116</sup> *Id.* (stating that public bodies in this sense means some sort of administrative agency).

<sup>117</sup> See Jones, *supra* note 3, at 428.

<sup>118</sup> See Beisner, *supra* note 63, at 6.

<sup>119</sup> See Woods, *supra* note 6, at 436.

<sup>120</sup> *Id.*

<sup>121</sup> The typical percentage gained by the law firms under a contingency-fee arrangement in the United States is 30 percent of the final damages awarded.

<sup>122</sup> See Woods, *supra* note 6, at 463.

<sup>123</sup> While the standard contingency fee arrangement in the United States calls for approximately one third of the plaintiff's award to be turned over to his/her attorney, this amount does not include other expenses that may be deducted by the attorney as long as they are reasonable.

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in addition to, the cost of suit, including a reasonable attorney's fee. Under the U.S. system however, a defendant in such an action does not receive a similar benefit.<sup>124</sup>

Unlike the contingency system practiced in the U.S., "every European legal system employs a fee-shifting standard of some type that requires the losing party to pay the prevailing party's legal fees"<sup>125</sup> This standard heavily discourages a plaintiff from bringing any cause of action, let alone a competition violation claim against a powerful entity who is likely to rack up a great deal of legal fees, unless he/she is likely to succeed.<sup>126</sup> Without the abolition of this fee-shifting standard and the incorporation of a contingency-fee system it may be that the private right of action in the EU will not flourish with these monetary obstacles remaining lingering overhead.

### C. Damages

Under Section 15 of the Clayton Act an individual seeking a private right of action in the U.S. is permitted to sue for and recover "threefold the damages by him sustained."<sup>127</sup> This concept is referred to as treble damages and it was initiated not only to punish the violating party for their current violation of the antitrust laws, but also to deter them from engaging in violations in the future.<sup>128</sup>

While at first glance this notion of triple the injury sustained may look like a windfall for the plaintiff, it has been argued that the amounts awarded are not actually trebled but rather are closer to the actual amount of injury sustained.<sup>129</sup> The root of this notion is that the lack of "prejudgment interest" awarded in the U.S. causes the plaintiff's award to be closer to actual damages or even less than the actual damages sustained after their transaction costs and attorney's fees have been paid. Though the Clayton Act does state that a court presiding over an antitrust claim may award interest on actual damages calculated from the date of service of such person's claim to the date of judgment, or for a period less than that,<sup>130</sup> courts in the U.S. usually do not award prejudgment interest unless a litigant has acted in bad faith to

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<sup>124</sup> See Clayton Act, *supra* note 12.

<sup>125</sup> See Beisner, *supra* note 63, at 14.

<sup>126</sup> *Id.*

<sup>127</sup> 15 U.S.C. § 15 (2000).

<sup>128</sup> See Woods, *supra* note 6.

<sup>129</sup> See Jones, *supra* note 3.

<sup>130</sup> 15 U.S.C. § 15 (2000).

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deliberately delay the proceedings.<sup>131</sup>

In addition to treble damages, it has been argued that another reason why damages awarded in the U.S. are often quite large is because juries, rather than judges are usually the parties who award such damages.<sup>132</sup> Recently, there have been a number of studies that have concluded that juries are more likely to award greater damages than judges.<sup>133</sup> As a result of likely high damage awards, in addition to the defendant's increased liability as a result of joint and several liability of co-defendants, a U.S. defendant in such an action is likely to choose to settle the claim.<sup>134</sup> The increased likelihood of settlement proves to be an additional incentive for plaintiffs and plaintiffs' firms in the U.S. to initiate antitrust lawsuits as it increases their chances of coming away with some form of redress.<sup>135</sup>

As stated previously, there is no explicit grant of a private right of action to the citizens of the EU in Articles 81 and 82 and, as such, discussion of the types of damages one may be awarded in such an action is absent.<sup>136</sup> Though *Courage v. Crehan* stated that damages should be awarded to support the practical effect of the competition law, this case did not dictate just what process should be used to reach a suitable damage award.<sup>137</sup> And while national courts now have the power to award damages to a plaintiff seeking an antitrust action under the community laws because of Regulation 1/2003, these awards do not prove to be as large as those in the U.S. For the most part the national courts follow the process of damage calculation that is used in their normal civil proceedings<sup>138</sup> where a claimant's damages are "limited to restitution; treble, exemplary or punitive damages are generally not available."<sup>139</sup> "In European case law it does not seem that the courts of any jurisdiction have developed a coherent approach to the subject, let alone a standardized approach across the

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<sup>131</sup> See Woods, *supra* note 6.

<sup>132</sup> See Beisner, *supra* note 63, at 18.

<sup>133</sup> *Id.*

<sup>134</sup> *Id.* at 24. ("Cases that, based on the compensatory damages at stake, would have been relatively minor litigation are transformed by the potential of punitive damages into litigation that poses a threat to the defendants' fiscal health").

<sup>135</sup> *Id.*

<sup>136</sup> See Woods, *supra* note 6, at 450.

<sup>137</sup> *Courage v. Crehan*, C-453/99, [2001] ECR I-6297, available at <http://curia.eu.int/jurisp/cgi-bin/form.pl?lang=en&Submit=Rechercher&alldocs=alldocs&docj=docj&docop=docop&docor=docor&docjo=docjo&numaff=C-453/99&datefs=&datefe=&nomusuel=&domaine=&mots=&resmax=100> (last visited, April 16, 2006).

<sup>138</sup> *Id.* "In some jurisdictions these methods appear capable of generating delays that are aggravated by the complex nature of such calculations in competition cases".

<sup>139</sup> See McDavid, *supra* note 7.

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different jurisdictions.”<sup>140</sup> Again because each Member State has its own procedural law, the differences that vary from one to another certainly do not aide in providing for a “level playing field. . .for bringing actions for breach of Community competition law before the national courts.”<sup>141</sup>

#### D. Discovery

Yet another obstacle facing a potential claimant in an antitrust action is access to the requisite evidence to prove his/her case. In the U.S., those seeking a private cause of action are fortunate because of the broad discovery permitted under the law.<sup>142</sup> Plaintiffs’ firms are much more likely to go forward with bringing an action because of the security of knowing they have such enormous power when it comes to what they may request the defendant to produce.<sup>143</sup> A plaintiff’s counsel may even proceed with initiating an action despite lack of knowledge of the details of the case based on his or her confidence in their ability to garner sufficient evidence from the defendant.<sup>144</sup> Along with the grand requests that a plaintiff may make to a defendant may come exorbitant production costs.<sup>145</sup> The ability of a plaintiff to cause a defendant to incur large discovery costs adds to the pressure put on a defendant to agree to a settlement early on in the proceedings despite the likelihood that the plaintiff’s claims may be without merit.<sup>146</sup> In addition to their power to persuade plaintiffs to bring an action, the U.S. discovery rules also persuade defendants to comply with such demands because they carry a threat of a maximum jail sentence of five years for the destruction or failure to produce relevant documents.<sup>147</sup>

Similar to the law regarding damages in the EU, there is no discussion of the rules governing discovery for a private right of action with regard to antitrust claims. Because private rights of action are dealt with in the national courts rather than in the EJC again the possibility for inconsistencies within the system are great.<sup>148</sup> While each national court does have certain rules

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<sup>140</sup> See, Woods, *supra* note 6, at 456.

<sup>141</sup> See Woods, *supra* note 6, at 456.

<sup>142</sup> *Id.* at 438.

<sup>143</sup> See Beisner, *supra* note 63, at 16.

<sup>144</sup> *Id.*

<sup>145</sup> *Id.* Stating that costs to a defendant to comply with discovery requests may reach sums “running in the tens of millions of dollars”.

<sup>146</sup> *Id.*

<sup>147</sup> FED. R. CIV. P. 37.

<sup>148</sup> *Id.* “To the extent that there are no procedural rules at the European level – and as a matter of EC law procedural rules are limited in scope for the moment – the national courts operate in the context of their national procedural rules”.



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governing discovery, the depth of permissible discovery does not reach that which is permitted in the courts of the U.S., and therefore, plaintiffs will be less likely to initiate a suit without knowing exactly what violation the defendant committed or how he or she will go about proving it in a court of law.<sup>149</sup>

**E. Standing and Exclusion of the Indirect Purchaser**

In order to bring a private right of action in the U.S. the claimant must have “standing” to bring suit. “The gist of standing is whether there is a justiciable controversy being litigated among adverse parties with substantial interest affected so as to bring forth a clear articulation of the issues before the court.”<sup>150</sup> The Supreme Court has held, in *Illinois Brick Co. v. Illinois*, that “indirect purchasers do not have standing to sue for violations of the antitrust laws under section 4 of the Clayton Act.”<sup>151</sup> In that case the defendants, a number of concrete manufacturers being sued for their collusive practices, had sold their product to contractors who then submitted bids to general contractors, who in turn submitted bids to the plaintiffs, the indirect purchasers.<sup>152</sup> Had the contractors themselves sued the concrete manufacturers, then they would have been able to recover damages for the inflated costs, despite the defendant’s claim that the contractors suffered no injury because they “passed on” such costs to their customers, the general contractors.<sup>153</sup> This is the case because the Supreme Court, in *Hanover Shoe Co. v. United Shoe Machinery Corp.*, rejected the “passing on” defense to a suit initiated by a direct purchaser.<sup>154</sup> However in *Illinois Brick*, the defendant was permitted to use the “passing on” defense because it was being sued by the customers of the contractors, the “indirect purchasers”.<sup>155</sup> In allowing this defense, the Supreme Court reasoned that if you allow the use of the defense in this situation, then you would also have to allow its use in a case where the plaintiff is a direct purchaser,<sup>156</sup> however there would

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<sup>149</sup> See Beisner, *supra* note 63, at 17. (Stating that “the scope of available discovery in European courts is usually circumscribed, and a European plaintiff is often unable to obtain discovery from a defendant unless he or she can identify the documents he or she seeks with substantial specificity”).

<sup>150</sup> *Street v. Smart Corp.*, S.E.2d 695, 698 (quoting *Texfi Industries v. City of Fayetteville*, 261 S.E.2d 21, 23 (N.C. 1980), *aff’d*, 269 S.E.2d 142 (N.C. Ct. App. 1980)).

<sup>151</sup> *Crouch v. Crompton Corp.*, No. 02 CVS 4375. 2004 WL 2414027, at \*5 (N.C. Super. Oct. 28, 2004).

<sup>152</sup> *Id.*

<sup>153</sup> *Id.*

<sup>154</sup> *Id.*; see also *Hanover Shoe Co. v. United Shoe Machinery Corp.*, 392 U.S. 481 (1968).

<sup>155</sup> *Id.*

<sup>156</sup> *Id.* (Stating that “the predicate of the *Illinois Brick* suit was the passing on of all or part of the overcharge by the direct purchaser; without passing on, there could be no injury to the indirect

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be a great problem of multiple liability if this were the case.<sup>157</sup> In reaction to this problem, the court found that the only ways to avoid creating multiple liability would be to “(1) allow indirect purchasers to sue but overrule *Hanover Shoe* or (2) retain *Hanover Shoe* and preclude indirect purchasers from suing.”<sup>158</sup> Eventually the court found that “the direct purchaser suit is on balance a more effective instrument for enforcement of the antitrust rule[s]. . . than the indirect purchaser suit,”<sup>159</sup> and so it chose to exclude indirect purchasers from bringing private antitrust damage actions.<sup>160</sup>

Some view this indirect purchaser exclusion to be destructive of the “fundamental character of the private antitrust action” and against Congress’ intent in providing for the private right of action.<sup>161</sup> Those who take this view believe that to allow the direct purchaser to recover while denying the indirect purchaser the right to recover is inadequate because it allows a party who may not have actually been injured to collect, while leaving those actually injured without a remedy.<sup>162</sup> This notion is dismissed however, by the concept that “even if indirect purchasers were given the nominal right to sue, they would often fail to receive significant compensation” because of the fact that “in a class action<sup>163</sup>, much of even the compensatory portion of the judgment may end up in the pockets of lawyers or in states’ treasuries.”<sup>164</sup> Until a new system is developed under which the windfall to the direct purchasers could be eliminated while the recovery of indirect purchasers reaches sufficient compensatory amounts, it is in the best interest of U.S. antitrust enforcement to allow the exclusion of indirect purchaser suits to continue.<sup>165</sup>

The decision by the Supreme Court in *Illinois Brick* excluded indirect purchasers from suing.<sup>166</sup> Some states alleviated the problems created by indirect purchasers either through the implementation of *Illinois Brick* repealer statutes or by interpreting their existing statutes to permit indirect purchaser standing based on language difference between the state and federal statutes.<sup>167</sup>

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purchaser”).

<sup>157</sup> *Id.*

<sup>158</sup> *Id.*

<sup>159</sup> *Id.* at 6.

<sup>160</sup> *Id.*

<sup>161</sup> *Id.*

<sup>162</sup> *Id.*

<sup>163</sup> (Indirect purchasers are more likely to come together in a class action because their injury taken alone may not be great enough to assert a cause of action).

<sup>164</sup> *Id.*

<sup>165</sup> *Id.*

<sup>166</sup> *See Crouch v. Crompton, supra* note 151, at 5.

<sup>167</sup> *Id.*

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Repealer statutes were then challenged in *California v. ARC America Corp.*<sup>168</sup> In this case the Supreme Court held that states were permitted to allow indirect purchasers to recover damages under state antitrust laws, even though “(1) the result may and almost assuredly will be a double recovery and (2) a preferable deterrent exists under federal law.”<sup>169</sup>

While the Supreme Court had made its decision with regard to the standing of indirect purchasers in price fixing cases, it “specifically noted that its decision was not directed to standing” in general.<sup>170</sup> After analyzing Congress’ intent with regard to section 4 of the Clayton Act, the Supreme Court concluded that “Congress did not intend the antitrust laws to provide a remedy in damages for all injuries that might conceivably be traced to an antitrust violation.”<sup>171</sup> The United States Supreme Court responded and set forth minimum requirements in order for an individual to have standing to bring an action. These requirements however, do not take the form of a “single bright line test”,<sup>172</sup> rather they require judges to assess the plaintiff’s harm, the supposed violation by the defendant, and the causal relationship between the two based on a series of factors: (1) whether the plaintiff is a consumer or competitor in the allegedly restrained market, (2) whether the injury alleged is direct and a first hand product of the restraint alleged, (3) whether there exist more directly injured parties with motivation to sue, (4) whether the damage claims are speculative and (5) whether the claims (a) risk duplicative recovery and (b) would require a complex apportionment of damages.<sup>173</sup>

In some member states of the EU, such as Germany and Italy, the laws regarding standing are much narrower in that they call for the injured party to be directly targeted by an antitrust violator in order to seek compensation.<sup>174</sup> While in other European jurisdictions, such as England, an individual may have standing where (1) a violator did not have any knowledge of his violation but merely engaged in it by charging a price created under an illegal cartel scheme by its parent corporation,<sup>175</sup> and (2) there was no actual purchase by the plaintiff from this violator.<sup>176</sup> Such differences in standing requirements are liable to

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<sup>168</sup> *California v. ARC America Corp.*, 490 U.S. 93 (1989).

<sup>169</sup> See Crouch, *supra* note 151, at 8.

<sup>170</sup> *Id.*

<sup>171</sup> *Hawaii v. Standard Oil Co.*, 405 U.S. 251, 263 (1972).

<sup>172</sup> *Id.*

<sup>173</sup> *Associated Gen. Contractors of California, Inc. v. California State Council of Carpenters*, 459 U.S. 519 (1983).

<sup>174</sup> See Woods, *supra* note 6, at 441.

<sup>175</sup> *Id.*

<sup>176</sup> *Id.*

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breed “forum shopping” among the member states; a trait quite uncharacteristic of an efficient legal arena.<sup>177</sup>

The procedural rules of some Member States in the EU, such as Italy, Sweden and France, call for a plaintiff to meet a strict causation requirement with regard to the defendant’s actions and the injury sustained in a competition law case.<sup>178</sup> For an indirect purchaser, meeting this requirement is likely to be unattainable, and so it seems that the “procedural laws of these member states could be said to resemble the U.S. indirect purchaser rule,” in that they both prevent consumers from seeking a remedy for an injury caused by an antitrust violator.<sup>179</sup>

Again, as a result of the lack of the private right of action under the EU competition law, there is a lack of discussion of the “passing on” defense which has created such debate in the U.S. Supreme Court and within the states themselves.<sup>180</sup> “There does not appear to be any case law directly on point from any jurisdiction in relation to actions for breach of EC competition laws,” however the issue has been considered in some national courts, such as Italy, where the court declined to award damages to a plaintiff because the court found that the plaintiff had “passed on” the effects of the defendant’s violation to its customers.<sup>181</sup> Therefore, it seems that under at least one member states’ law, defendants in suits by direct purchasers are permitted to utilize the “passing on” defense, though it remains unclear how other national courts would confront the matter.<sup>182</sup>

### GREEN PAPER: PRIVATE RIGHT OF ACTION FOR VIOLATIONS OF EU ANTITRUST LAWS

On December 19, 2005 the Commission presented a Green Paper<sup>183</sup> focusing on damages actions for the breach of the EU antitrust rules, or in other words private rights of action.<sup>184</sup> The purpose of the Green Paper and its attached Commission Staff Working Paper (the “Working Paper”)<sup>185</sup> is to

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<sup>177</sup> *Id.*

<sup>178</sup> *Id.*

<sup>179</sup> *Id.* at 449.

<sup>180</sup> *Id.*

<sup>181</sup> *Id.* at 459.

<sup>182</sup> *Id.* at 458.

<sup>183</sup> See *European Union Documents: Documents of Individual Institution*, available at [http://europa.eu.int/documents/comm/index\\_en.htm](http://europa.eu.int/documents/comm/index_en.htm) (last visited Feb. 23, 2006).

<sup>184</sup> See Green Paper, *supra* note 4.

<sup>185</sup> *Commission Staff Working Paper: Annex to the Green Paper: Damages Actions for Breach of the EC Antitrust Rules*, Dec. 19, 2005, available at

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“identify the main obstacles to a more efficient system of damages claims and to set out different options for further reflection and possible action to improve damages actions.”<sup>186</sup> Among other things,<sup>187</sup> the Green Paper and the Working Paper discuss the obstacles facing an efficient system for a private right of action with regard to such areas as discovery, damages, costs of actions, collective actions, and indirect purchaser standing.<sup>188</sup> The Commission hopes that by putting forth these documents they will encourage “interested parties to comment on the issues discussed and on the options formulated with regard to these issues.”<sup>189</sup> Hopefully, with these comments the Commission will be aided in its efforts to establish an efficient and effective system for private antitrust damages claims.<sup>190</sup>

**A. Green Paper: Discovery**

As was previously mentioned, because the depth of permissible discovery not only varies from Member State to Member State, but also on the whole is much less than that which is provided for under the U.S. system, it is not as simple for a potential claimant in the EU to initiate private antitrust actions, as well as, garner enough information to be able to prove his/her case, as it is for a claimant in the U.S.<sup>191</sup> In its Green Paper the Commission asks “whether there should be special rules on disclosure of documentary evidence in civil proceedings for damages under Articles 81 and 82 of the EC Treaty?”<sup>192</sup>

The Green Paper proposes that once a claimant has “set out in detail the relevant facts of the case and has presented reasonably available evidence in support of its allegations (fact pleading),” then that party would be able to go forward with the disclosure process.<sup>193</sup> The Green Paper list three possible options for disclosure once the fact pleading has been set forth.<sup>194</sup> Under “Option 1”, disclosure would be court ordered and limited to relevant and

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[http://europa.eu.int/comm/competition/antitrust/others/actions\\_for\\_damages/sp\\_en.pdf](http://europa.eu.int/comm/competition/antitrust/others/actions_for_damages/sp_en.pdf) (last visited Feb. 23, 2006).

<sup>186</sup> See Green Paper, *supra* note 4.

<sup>187</sup> *Id.* (Other aspects commented on consist of jurisdiction, the fault requirement, the introduction of experts, statute of limitation, etc.)

<sup>188</sup> *Id.*

<sup>189</sup> *Id.* at 5.

<sup>190</sup> *Id.*

<sup>191</sup> See Beisner, *supra* note 63, at 16-17.

<sup>192</sup> Commission Green Paper, *supra* note 4, at 5.

<sup>193</sup> *Id.*

<sup>194</sup> *Id.*

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reasonably identified individual documents.<sup>195</sup> Under “Option 2”, mandatory disclosure of classes of documents between the parties would be ordered by the court, and under “Option 3” “there would be an obligation on each party to provide the other parties to the litigation with a list of relevant documents in its possession, which are accessible to them.”<sup>196</sup>

In requiring the claimant to set forth a fact pleading rather than a notice pleading<sup>197</sup> like that in the U.S. the proposed EU discovery system will not allow a potential claimant to set forth a claim without knowing the substance of his/her claim. This is important because it will deter potential claimants from overloading the courts with unmeritorious claims.<sup>198</sup> With such a burden on the claimant to begin with, adopting Option 3 would persuade claimants to bring an action because it would allow the claimants to choose from a complete list of relevant documents which they may not have had knowledge of when initiating the case.<sup>199</sup>

### B. Green Paper: Damages

The Green Paper sets forth 4 possible ways in which damages could be defined.<sup>200</sup> Under “Option 14” damages would be awarded “with reference to the loss suffered by the claimant as a result of the infringing behavior of the defendant (compensatory damages).”<sup>201</sup> “Option 15” calls for damages to include the recovery of illegal gain, while “Option 16” calls for double damages.<sup>202</sup> And finally, “Option 17” discusses the possibility of awarding prejudgment interest.<sup>203</sup>

As discussed previously, in the U.S. a claimant may sue for and recover treble damages for violations of the antitrust law.<sup>204</sup> The Commission

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<sup>195</sup> *Id.*

<sup>196</sup> *Id.*

<sup>197</sup> See Commission Staff Working Paper, *supra* note 185. (“Under notice pleading it is not necessary to make a prima facie case for a party to require discovery of evidence by another party”).

<sup>198</sup> Notion that because it is so easy to initiate a case in the U.S. a claimant can start discovery proceedings without actually knowing the complete substance or facts regarding his/her claim, or whether such claim is legitimate or not. In doing so that claimant could potentially cost the defendant large sums in production costs, thereby putting pressure on such defendant to settle a claim that may not have merit, just to avoid the cost.

<sup>199</sup> See Commission Green Paper, *supra* note 4, at 5.

<sup>200</sup> *Id.* at 7.

<sup>201</sup> *Id.*

<sup>202</sup> *Id.*

<sup>203</sup> *Id.*

<sup>204</sup> 15 U.S.C. § 15 (2000).

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recognizes that “pure compensation of the loss does not always constitute a sufficient incentive for antitrust claimants to bring a case before the court,” however, it does not seem that they are prepared to initiate treble damages as it does not appear in the list of possible options.<sup>205</sup> That which would be most persuasive in causing an individual to seek out a claim, while at the same time creating a deterrent to future violations, would be to allow potential claimants to collect double their damages calculated to include prejudgment interest. Unlike the U.S. system a claimant in the E.U. probably would not have to make a claim for attorneys’ fees as most of Europe follows a system by which the losing party pays the winning party’s fees.<sup>206</sup>

### C. Green Paper: Costs of Actions

Availability of litigation capital is an essential factor when deciding whether or not to bring a claim for damages, especially when the claimant is in a legal system which calls for them to pay the defendant’s costs in the event that they lose their claim.<sup>207</sup> Under “Option 27” the Green Paper proposes “establish[ing] a rule that unsuccessful claimants will have to pay costs only if they act in a manifestly unreasonable manner by bringing the case.” By adopting this proposal the Commission will alleviate a great burden for claimants who wish to bring an antitrust claim.

The Green Paper, does however, fail to discuss a proposal for adopting a contingency fee type system, like that of the U.S., whereby claimants will not be discouraged from pursuing an action because of lack of litigation capital.<sup>208</sup> Should the Commission provide for such a system, the amount of private actions would certainly increase, and in turn enforcement of the antitrust laws would increase as well.

### D. Green Paper: Collective Actions

The Commission realizes that it is “unlikely for practical reason, if not impossible, that consumers and purchasers with small claims will bring an action for damages for breach of antitrust law.”<sup>209</sup> In addition to providing a way for individuals to bring their small claims against antitrust violators, collective actions, or class actions as they are termed in the U.S., would also

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<sup>205</sup> See Commission Staff Working Paper, *supra* note 185, at 34.

<sup>206</sup> See Beisner, *supra* note 63, at 14.

<sup>207</sup> *Id.* at 61.

<sup>208</sup> See Commission Green Paper, *supra* note 4, at 7.

<sup>209</sup> *Id.* at 8.

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create more efficiency in the private antitrust enforcement arena because they would allow a large number of claims to be grouped together into one claim thereby saving valuable time and money.<sup>210</sup> The Green Paper proposes under “Option 25” to create a system that would allow consumer associations to bring actions on behalf of a group of injured parties whereby damages would be awarded such that the illegal gain of the defendant would be awarded to the consumer organization, while each injured party would recover the amount of individual damage suffered.<sup>211</sup> Initiating collective actions of this type would not only increase the incentive for individuals with small claims to seek damages action against antitrust violators, but it will also increase deterrence of antitrust violation.

**E. Green Paper: Indirect Purchaser Exclusion and the “Passing On” Defense**

As the Commission well recognizes, “the ‘passing-on defense’ substantially increases the complexity of damages claims as the exact distribution of damages along the supply chain could be exceedingly difficult to prove.”<sup>212</sup> “Option 23,” set forth in the Green Paper, calls for the complete exclusion of the passing-on defense.<sup>213</sup> While this would serve to bolster a great deterrent for parties to engage in antitrust violations because of the extreme amount of liability they would be facing, it does seem to be quite unjust. “Option 24” on the other hand, seems to be an ideal solution to the indirect purchaser problem, because it calls for “a two-step procedure, in which. . .the infringer can be sued by any victim, and in a second step, the overcharge is distributed between all the parties.”<sup>214</sup> However, the problem of damage calculation would remain and this process could cost valuable time and money.<sup>215</sup> If anything can be learned from the U.S. experience on the issue of the passing-on defense, it may be that in the interest of efficient antitrust enforcement it may be necessary to allow only direct purchasers to sue and reap a windfall while indirect purchasers remain excluded.

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<sup>210</sup> *Id.*

<sup>211</sup> *Id.* at 9.

<sup>212</sup> *Id.* at 8.

<sup>213</sup> *Id.*

<sup>214</sup> *Id.*

<sup>215</sup> *Id.*



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### CONCLUSION

As the European Union embarks on its journey toward a system that could efficiently provide for a guaranteed private right of action for its citizens it has many things to consider: Whether to (1) broaden discovery to enable claimants to easily get the information needed to prove their case; (2) provide for greater damages to compensate injury while creating a great deterrent to illegal antitrust actions; (3) depart from the “loser-pays” rule so that claimants won’t be discouraged from bringing legitimate actions; (4) create a collective action system by which small claimants can bond together, and (5) block some claimants from bringing suit in the best interest of efficient antitrust enforcement. While it may not be ideal for the EU to adopt a system identical to that of the U.S. private antitrust enforcement, there is certainly a great deal that can be learned by looking at the U.S. system and how its framework works to create an arena that fosters private rights of action. Through the use of this example, as well as the comments that should emerge in response to the Commission’s Green Paper, the EU will soon be well on its way to establishing a private right of action and a marked increase in its antitrust enforcement for the benefit of competition and consumers alike.