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International Regulatory Competition, Externalization, and Jurisdiction

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I. INTRODUCTION

The increasing realization that the United States economy does not operate in isolation from the rest of the world is transforming discourse regarding regulatory policy. This transformation is

evident in discourse regarding the appropriate level of regulation, often framed as the debate between regulation and deregulation (as though the quality of regulation were immaterial). The appropriate quantity and type of regulation n1 can no longer be determined without casting a wary eye at the quantity and type of regulation imposed by competing states -- lobbyists for regulated industries will argue that a greater quantity of regulation will hamper national competitiveness. This transformation is also relevant, in an indirect but important sense, in debates regarding increasing free trade, as increased free trade -- diminished tariff and non-tariff barriers to trade -- increases the pressure of competition from foreign enterprises subject to less costly foreign regulatory regimes. n2

Concerns raised by the proposed North American Free Trade Agreement (NAFTA) regarding a race to the bottom in environmental regulation, or concerns about Japan's allegedly inappropriate failure to enforce antitrust laws, give rise to questions about the ability or right of international society to intercede in domestic regulatory affairs. At the same time, the European Community is riven by the question of how to implement the doctrine of subsidiarity n3 to protect local prerogatives from inappropriate central meddling. This Article will examine the relationship between horizontal competition among states, and vertical competition between states and other institutions n4 representing different levels of economic organization.

Vertical competition in regulation should determine whether horizontal competition in regulation should be maintained. Horizontal cooperation is the antithesis of horizontal competition. This cooperation constrains horizontal competition and is equivalent to a move up the scale of social organization to institutionalization (or regulation) at a higher level of social organization. Assuming rational states, n5 such a move may be justified by comparing the utility of horizontal competition and diversity with the utility of centralization in regulation. The epithet "subsidiarity" n6 is often used to mean that horizontal competition and diversity in regulation should be maintained, unless the balance of efficiency clearly favors centralization. n7

Part II of this Article considers the theoretical dynamics of horizontal competition in regulation, n8 referring to analyses in the area of regulatory competition in corporation law among U.S. states (the "Delaware phenomenon") and in the area of tax or fiscal competition. Certain insights of these studies may be applied, *mutatis mutandis*, to international competition in other types of regulation.

Part III of this Article considers the multilateral General Agreement on Tariffs and Trade (GATT), n9 and the unilateral U.S. disciplines on subsidies, which, if applicable, could suppress competition in "regulatory subsidies." We conclude that these disciplines would not generally be applicable. This is an appropriate outcome, as these antisubsidies regimes are structurally unable to apply all of the complex policy factors necessary to be considered to determine whether regulatory competition should be suppressed or fostered. Presently, there is no central discipline on regulatory subsidies. This is because there is currently no political agreement on how to differentiate between deregulation which amounts to a naked regulatory subsidy and deregulation which constitutes a legitimate exercise of regulatory sovereignty.

Finally, in Part IV, we evaluate the principle of subsidiarity as a type of vertical regulatory competition applied to determine when horizontal regulatory competition should be suppressed or fostered. n10 This Article concludes that the principle of subsidiarity may be expanded and refined beyond its use in European Community discourse and used as a guiding principle for

determining which types of regulatory competition are acceptable to be left unregulated at the international level, and which should be subjected to international disciplines. Subsidiarity indicates that neither comprehensive international discipline nor unbridled inter-governmental competition is appropriate. Rather, unceasing policy analysis and political discourse remain necessary, to define those areas that are appropriate for international discipline, and those areas that should be left to competition. The European Community provides a model of an institutional infrastructure that facilitates such continued analysis and political discourse. n11 The new approach to harmonization in the European Community -- essential harmonization combined with mutual recognition -- amounts to a forum for negotiation of subsidiarity: the level of harmonization is determined by negotiation in which each participant seeks to maximize its own social preferences. These preferences include competitiveness, the achievement of regulatory goals, and the continued progress of the European Community. As a result, the European Community provides certain competitive advantages for its members against non-members. n12

A. Horizontal Competition

In horizontal competition, economic institutions at the same horizontal level of social organization compete for economic power and welfare. This term describes the competition among states within the federal United States, among member states of the European Community, or among states in the international community at large.

In an increasingly global and mobile economy marked by brutal competition in trade, states increasingly compete with one another to provide their firms with the advantage of reduced regulatory costs or increased regulatory subsidies. States compete, like firms, for capital and other economic factors. n13 Governments have several tools available by which to engage in horizontal economic competition. They may subsidize production by payments or provision of capital, goods, or services at artificially low rates. Direct subsidies on exports or on domestic production are regulated, with varying effectiveness, under GATT, n14 the Subsidies Code, n15 the Treaty of Rome n16 (as among European Community members), and unilaterally under the national trade laws of various countries, such as the United States. A more subtle tool available to a government engaged in horizontal economic competition is to decrease its level of regulation, in order to make compliance less costly to regulated firms. Use of this tool might be expected to give rise to a "race of laxity" n17 or a "race for the bottom" n18 among competing states. As described in Part III below, regulatory competition between states appears generally unconstrained by such international regimes as GATT, the Subsidies Code, and U.S. trade law. n19 Therefore, regulatory competition n20 may be a more easily available tool than more overt subsidies and may be the decisive weapon in the international economic warfare of the coming years. n21

B. Vertical Competition

By vertical competition, we describe the dynamic by which regulatory authority should be allocated among institutions at different levels. n22 Vertical competition determines whether the state as regulator is a more effective social institution for organizing the relevant economic activities than the market and competition among firms. n23 The debate regarding subsidiarity

in the European Community is essentially a debate about whether the Community is a more effective social institution for the relevant purposes than Member States. Here we view the market and its constituent firms merely as different types or levels of economic organization. n24 Further, states (to the extent that they operate as economic institutions) and transnational economic institutions exist for the same economic reasons as firms: to freeze politics and negotiations in a set of fixed insitutions or rules that reduce the costs of transacting. These debates in the Community illustrate some of the complexities of "vertical" competition.

Below are two brief examples, in the areas of antitrust law and environmental regulation, which illustrate the potential conflicts and disorder that may arise from our failure to understand, structure, and accept regulatory competition.

C. Examples of Regulatory Competition

1. Antitrust Enforcement

Antitrust provides two important examples of how states can engage in horizontal competition: through weak enforcement of antitrust regulation and by explicit statutory exceptions to antitrust regulation. Either approach may be used to provide competitive advantages to local firms. As in many facets of horizontal regulatory competition, the issue of extraterritoriality n25 plays an extremely significant role in antitrust law.

Probably the best-known example of alleged competitive failure to regulate constituting a domestic subsidy in this connection is the charge made by the United States in connection with its Structural Impediments Initiative n26 regarding Japan. The United States has accused Japan of lax domestic enforcement of its antitrust laws, which permits Japanese competitors collusively to fix artificially high prices in the Japanese domestic market. n27 The United States charges that this practice has the collateral effect of generating oligopolistic profits that are used to finance the dumping of subsidized low-priced products in foreign markets. n28 Japan has responded with stricter antitrust enforcement. n29

To further combat lax Japanese antitrust enforcement, the United States has threatened to apply U.S. antitrust laws extraterritorially to anticompetitive practices in Japan that have adverse effects on U.S. exporters. n30 When the United States applies its antitrust laws extraterritorially pursuant to the effects doctrine, n31 it is in essence targeting externalities -- the domestic effects of foreign conduct. The externalities are produced by Japan's relatively weak antitrust enforcement. To the extent that Japan is able to externalize some or all of the adverse effects, it has diminished internal incentives to strengthen its domestic antitrust enforcement. n32 Thus, as will be discussed below, n33 conflict of laws or prescriptive jurisdiction rules make a critical difference, insofar as they affect the ability of a state to externalize. In addition, the effects doctrine, which has been so severely criticized outside the United States, n34 provides a basis for prescriptive jurisdiction that is exactly congruent with the economic consequences of the conduct, and thus prevents externalization.

Another example of regulatory competition in the antitrust field, and perhaps the obverse of the circumstance described above, is the permissive approach taken by the United States to anticompetitive activity by U.S. persons that only affects export markets. Under the Webb-Pomerene Act, n35 the Export Trading Company Act, n36 and the Foreign Trade Antitrust

Improvements Act, n37 foreign plaintiffs injured by United States conduct with no U.S. effects have no right to recover under U.S. antitrust laws. n38 This approach may be viewed as regulatory competition that assists U.S. exporters by unburdening them from domestic antitrust regulation. n39 Again, the United States, like the Japanese in the example described above, is able to externalize the effects of its relaxed antitrust enforcement through the manipulation of prescriptive jurisdiction.

At least one leading policy-maker, Sir Leon Brittan, has called for greater cooperation in antitrust policy, administration, and enforcement, perhaps through the GATT because of the trade and competitiveness implications of antitrust policy. n40 How should we think about this appeal? Is it too great an intrusion on domestic policy prerogatives, or is it an appropriate subject for international cooperation?

2. Environmental Regulation

A second illustrative example of horizontal regulatory competition is the field of environmental regulation. Weak environmental protection regimes are increasingly viewed by some as subsidies to polluting producers. n41 According to this perspective, the failure to maintain environmental protection at an appropriately high level provides an illicit subsidy to local business. n42 By absorbing the environmental costs of production, in a context where the environmental costs of production might otherwise be charged to the producer, a particular society can assist its producers by lowering their costs of competing on either domestic or foreign markets. But who bears the cost of the reduced environmental regulation? There are a few possibilities:

* The environmental degradation may be generalized but limited to the territory of the state that maintains weak environmental regulation. In that case, the costs are borne by the populace of this state and, assuming no transaction costs and full democracy, the populace will have articulated its collective preferences in trading environmental protection for reduced costs of production. This phenomenon is referred to herein as "*broad-based domestic externalization*." A generalized version of the "polluter pays principle" is followed: the collective person who pollutes bears the cost (in terms of environmental degradation) of the pollution. n43 We include here circumstances in which the state pays the cost of cleaning up the environmental degradation from its general funds.

* The environmental degradation may have effects on specific groups within the territory of the state that maintain weak environmental regulation. Here the polluting industry is able to externalize costs to these affected groups, and presumably the affected groups are not sufficiently enfranchised in the domestic political process to seek appropriate regulation or redress. This phenomenon is referred to herein as "*selective domestic externalization*."

* Finally, and most relevant to our discussion, is the circumstance of spillover: where the environmental degradation has effects outside the territory of the state that maintains

weak environmental regulation. In this case, the "regulating" state is able to reduce local regulatory costs at the expense of foreign persons. Thus, unless the foreign affected persons are able to obtain appropriate regulation or redress through the diplomatic process or through the "extraterritorial" application of their home country law, the polluter and the regulating state will successfully externalize the costs of environmental degradation. This phenomenon is referred to herein as "*international externalization*." n44

There have been calls for an environmental round of GATT negotiations in order to address some of the perceived problems of reconciling free trade policy with international environmental policy. n45 Is environmental policy a proper subject for international cooperation, or is it an issue that should be considered part of internal affairs or domestic prerogatives? Some have argued that developing countries, in particular, should not be restricted in their freedom to accept environmental degradation in order to advance economic development. n46

We use the environmental regulation and antitrust regulation examples because they are vivid and historically apt; virtually any area of economic regulation could provide examples. Regulation of services such as banking and insurance provide many examples of regulatory protectionism, as well as relaxation of regulation to enhance the competitiveness of foreign operations of local persons. n47 Institutional regulation of providers of financial services raises special spillover problems, and therefore calls for different approaches to cooperation among regulators. n48 The point here is not to create a catalog of regulatory competition, but to provide examples for purposes of illustration. Such examples illustrate how different societies may have varying attitudes toward economic competition and acceptable levels of environmental degradation.

The areas of antitrust and environmental protection illustrate the dilemmas that policy-makers confront in an era marked by both vigorous economic competition and renewed aspirations for international cooperation. In order to address these dilemmas, policy-makers must first consider some fundamental questions. What regulatory questions are best addressed at the state level (and left to the arena of regulatory competition)? Which substantive issues should be regulated by supranational bodies because they are not appropriate areas for horizontal regulatory competition? A first step to understanding the nature of these questions is to examine what we currently understand about regulatory competition.

II. REGULATORY COMPETITION: LESSONS FROM THE DELAWARE PHENOMENON AND FISCAL COMPETITION LITERATURE

When a state self-consciously engages in regulatory competition, it recognizes that it is an economic institution that must compete in an open economic setting -- that it must sacrifice or compromise domestic policy in order to achieve international economic policy goals. n49 It is important to note that these goals are not necessarily inconsistent, although in some respects they will be.

Regulation is a "factor endowment" (a created one) that can affect, positively or negatively, a state's competitiveness in international trade. n50 Deregulation may shift a regulatory system from being neutral to subsidy-providing; more saliently, it can shift the trade status quo. In addition, deregulation, as opposed to subsidization, implies (but does not require) a shift in risk

and cost to private transactors (selective domestic externalization), rather than to the state (broad-based domestic externalization).

Regulatory competition implies, but does not require, n51 that private firms have some choice as to what regulatory law will govern their activities, either on the territorial principle of prescriptive jurisdiction where the private firm has a choice of where to locate its activities, or on another basis for prescriptive jurisdiction, n52 for example where the private firm can choose its nationality. Different states' corporate law and tax law, as discussed below, as well as other regulations, apply varying bases for prescriptive jurisdiction, and accord varying degrees of choice to private firms. n53

A. A Conflict of Laws Analysis of the Delaware Phenomenon

The "market" among sub-national states within the United States for incorporation, and Delaware's ascendance as the leading state of incorporation, provides an example of regulatory competition. The competition is partly driven by the United States conflict of laws principle that incorporators are free to choose the state of incorporation, and thereby choose the law applicable to the corporation's internal affairs, without regard to where the corporation will actually engage in business. n54 This principle is not shared in most civil law jurisdictions. n55 This private law principle of party autonomy in choice of governing law is inapplicable in many commonly understood areas of regulatory law, such as antitrust n56 or environmental regulation, but is still partially applicable in tax regulation n57 and financial regulation. n58 There is a significant literature describing and analyzing the Delaware competition. n59

1. Three Perspectives on the Delaware Competition

One group of scholars argues that centralized or harmonized national discipline is necessary to limit the adverse effects on regulatory effectiveness of competition among states. n60 This group perceives the competition among states as a scramble for franchise tax revenues and for revenues of the local bar and others who service locally incorporated corporations. n61 The concern reflected in this perspective is that of the earnest regulator, concerned about a race to the bottom. This view finds that shareholders are abused by managers who can independently make decisions about jurisdiction of incorporation, and that the market for shares is an inadequately effective discipline on managers in this regard. The market is perceived to be inadequately effective due to limitations on the ability of shareholders to obtain and utilize information about the corporate law rules of the various states. n62 The state is viewed unidimensionally, interested in its own income and that of a narrow spectrum of lobbyists.

Another group of scholars rejects the race to the bottom theory and argues from a law and economics perspective that competition in corporation law is a useful discipline on state corporation laws, producing efficient corporation laws. n63 These scholars argue for a policy of fostering competition among states, rather than imposing national discipline on such competition. This view finds that the market for investment by shareholders will discipline managers in their choice of jurisdiction, so that the jurisdiction that provides the most efficient corporate law "contract" between management and shareholders will be selected. n64

The "race for the top" model is dependent on the ability of at least one class of potential injured parties -- the shareholders -- to identify the costs being allocated to them by virtue of applicable state corporation law, and to coalesce into effective action to avoid these costs or discount for them. Shareholders may lobby state legislatures against "lax" corporate laws, or they may seek to influence corporations not to incorporate or reincorporate in states with lax corporate laws. n65 Whether shareholders have the requisite interest, information, and ability to take these various types of actions depends on many factors. n66 This view concentrates on shareholders as a force countervailing management interest in laxity; one of its limitations, as discussed below, is a failure to consider other constituencies. n67

A third school expands upon the "race for the top" approach by recognizing the sophistication and efficiency that Delaware corporation law has gained, perhaps as a "first mover," through attention and experience. This sophistication and efficiency gives Delaware advantages that should answer the concerns of both "race for the top" and "race for the bottom" scholars. First, its regulatory regime, apart from its laxness or strictness, is more complete and easier to use, as well as more stable. Second, the Delaware regime is better known, and is now the standard. Thus, according to this perspective, the competition is not a zero-sum game between pro-managerial laxity and pro-shareholder rigor, but has a qualitative element that may enhance values for both sides. n68

2. A Cost-Benefit Analysis of the Competition

As has been observed before, n69 all three of the schools described above seem to agree that regulatory competition does indeed occur, and we will assume here that this is correct. n70 Whether the competition is good or bad depends on the benefits that it brings and the costs that it imposes. Here, we must be cautious to include all societal costs and benefits. n71 Law and economics theory argues that unless there is a market failure -- unless transaction costs or externalities prevent the market from operating to allocate social resources accurately -- the market is the most accurate allocator of social resources. n72 Subsidiarity may be viewed as a corollary of this theory, insofar as it argues that centralization of authority -- suppression of competition among states -- is only appropriate where decentralized authority operates less efficiently than centralized authority. n73 Thus, both law and economics and subsidiarity would argue that the presumption is in favor of deregulation and decentralization, respectively, until a market failure is identified.

In connection with his consideration of the Delaware phenomenon as a model for the European Community, Professor Charny compares different types of corporate rules in order to determine how each type of rule implicates the comparative advantages of centralization and decentralization. n74 Professor Bebchuk performs a similar rule-specific analysis, finding that competition is good in some areas of corporate law and bad in others. n75 Such an approach is obviously quite complex. The practical application of such an approach can likely be undertaken best by sophisticated institutions. Nonetheless, as a starting point, it is useful to develop a matrix of costs and benefits, recognizing that they are implicated differently, if at all, for each rule, and for each person or society. Given this high degree of particularity and relativism, all we can do is develop a catalog of costs and benefits, leaving it to further analysis and political discourse to weigh the costs and benefits individually for any type of rule or group of people. n76 The

following is a list and discussion of the benefits that result from decentralization and centralization:

Benefits of decentralization

* Competition in regulation.

* Diversity and cultural specificity.

Benefits of centralization

* Economies of scale and reduction of learning costs.

* Reduction of costs of undesirable regulatory arbitrage: evasion, externalization, and extraterritoriality.

* Reduction of costs of double compliance due to overlapping and differing regulation.

a. Benefits of Decentralization

i. Competition in Regulation

In a market economy, competition provides a discipline that results in more efficient and innovative production of goods and services. In the context of regulation, one major advantage of decentralization is the possibility that regulatory competition will result in discipline, causing governments to produce public goods efficiently and innovatively. n77

Where the state engages in the competitive reduction or suppression of regulation, we would assume that it is obtaining a benefit larger or more visible than the detriment being conferred on it or on its empowered constituents by the lower level of regulation. Thus, assuming for the moment that all constituents are empowered, competition in regulation can be worthwhile from the state's standpoint for one of two reasons. First, competition makes it possible to regulate more efficiently, achieving regulatory goals at reduced regulatory costs. n78 Second, the regulating state is able to externalize the detriment associated with its reduced level of regulation. n79 If we further assume the unavailability of regulatory innovation leading to greater regulatory efficiency, the race to the bottom is fueled by the ability, from the standpoint of the regulating state and the regulated person, to externalize costs. n80 The costs may be externalized to foreign governments or to foreign residents. In a state where our assumption that all constituents are empowered is not correct, costs may also be externalized to unempowered domestic residents.

ii. Diversity and Cultural Specificity

It is obviously necessary to recognize the diversity and the commonality of human aspirations, both individually and socially. The diversity of human conditions and aspirations argues for maximum decentralization, in order to allow the greatest possible matching of aspirations to rules. It is also necessary to recognize the commonality of human aspirations, which has two ramifications relevant here. First, different people may choose the same rule, simply because it works best. Second, it is necessary to enter into social contracts in order to achieve both common and unshared aspirations. This contracting must be entered into at every horizontal level of society from the individual up. n81 If there were no commonality, and no efficiencies to be gained from taking action in larger units, the logical result is anarchy. The remaining question is how shall the tradeoff between diversity and centralization be struck? A cost-benefit analysis is appropriate, but the costs and benefits of a particular social rule will differ for each participant. Therefore, the appropriate tradeoff cannot be determined deductively, but must be determined inductively through negotiation. n82

Diversity, like biodiversity, may also be viewed as having an intrinsic value beyond accommodation of cultural specificity, representing a source of comparative regulatory data to assist regulatory reform. In this sense, decentralization provides laboratories of regulation, in the sense that Justice Brandeis referred to the states as laboratories of democracy. n83

b. Benefits of Centralization

i. Economies of Scale

Economies of scale may be created by establishing a single set of rules to govern a broad class of transactions since transactors need not learn to deal with multiple sets of rules. n84 This is really the same reason for having institutions and firms as opposed to competition and contract: the reduction of transaction costs that would otherwise be incurred in order to establish or to learn about different relationships for each transaction. n85 This factor may be large or small depending on the global nature of a particular business, the degree of difference among types of regulation and the cost of compliance. This advantage is in terms of the private transactor's costs of compliance.

ii. Reduction of Costs of Undesirable Regulatory Arbitrage

The centralization of regulatory authority enables the regulator to reduce the costs that stem from the undesirable evisceration of regulation through regulatory arbitrage. In the corporation law context, Professor Charny views regulatory arbitrage as a problem where the protected party -- assumed to be shareholders alone -- cannot police the arbitrage. n86 However, if one assumes that the protected parties are sophisticated enough to police regulatory arbitrage, it would seem a small next step to expect them to protect themselves without any regulation. n87 Thus, the problem of regulatory arbitrage is that the protected parties can police neither the activities of management, nor the choice of jurisdiction of incorporation by management. n88 Regulatory arbitrage is likewise a transaction costs problem, from the standpoint of both the protected party and the regulator. But where regulatory arbitrage does not involve the externalization of costs, it

ought not to be viewed as a problem. Instead, the arbitrage should be viewed as yielding advantages of invigorated regulatory competition.

These two advantages of centralization -- economies of scale and reduction of regulatory arbitrage -- are both techniques of reducing transaction costs. The question then is what type or level of regulation reduces transaction costs the most? n89 The protection of regulatory effectiveness through limitation of regulatory arbitrage could be viewed as no more than one type of cost of implementing regulation. However, in international society as it stands today, it probably should be viewed as a special type of regulatory cost -- perhaps as an interjurisdictional transaction cost. n90 This is because the special requirements involved in constraining regulatory arbitrage affect the substance of regulation. First, in order to limit regulatory arbitrage, especially where it involves international externalization, it may be necessary, in the absence of coordination, to apply regulation "extraterritorially" or, beyond the generally recognized scope of regulatory jurisdiction. n91 This may be unacceptable to other states that may feel their sovereignty diminished by extraterritorial regulation. Second, it may be necessary to harmonize regulation and to coordinate surveillance and enforcement activities with other jurisdictions. n92 These two requirements indicate that the state must leave the comfortable world of intra-state management and enter the market of international relations: it must contract with other states in order to obtain the goods -- regulatory assistance or acquiescence -- that it needs.

Centralization makes evasion through regulatory arbitrage more difficult, if not impossible, to the extent that it establishes uniform rules and centralized surveillance and enforcement. It thus reduces the possibility of regulatory underlap. n93 However, to the extent that the problem is not innocent regulatory underlap, but international externalization through intentional failure to regulate, centralization may be more difficult for the government benefiting from international externalization to accept.

Professor Bebchuk argues that, in addition to rules that externalize, rules that result in significant redistribution to managers from shareholders (selective domestic externalization) are also susceptible to regulatory arbitrage. n94 This is because the detriment imposed by the market on managers is insufficient to deter them from seeking to be governed by rules that allow them to engage in the redistributive abuse. n95 He provides the examples of the following issues: self-dealing, taking of corporate opportunities, and insider trading. It is worth noting that these issues are not governed by state corporate law alone. First, self-dealing and taking of corporate opportunities, in addition to being addressed by corporate laws, are addressed by state blue sky laws, n96 which limit public offerings into the state and thus protect the in-state potential shareholders. In contrast to state corporation law, states use a different basis for laws governing self-dealing and corporate opportunities: state blue sky laws operate to protect potential in-state shareholders, thus preventing externalization by other states. Second, self-dealing, corporate opportunities and insider trading are all addressed by federal law, through either direct prohibitions n97 or disclosure requirements. n98 Thus, blue sky laws provide different bases for regulatory jurisdiction, and federal law centralizes rules and enforcement as they relate to public corporations, to limit regulatory arbitrage in these areas.

iii. Reduction of Duplicative Costs of Compliance

The most obvious example of overlapping compliance costs is double taxation, where the same economic activity is taxed by two different sovereigns at the same vertical level. n99 Similarly, the same economic activity may be regulated by two different sovereigns, for example where U.S. antitrust law is applied to a merger between two European Community companies that are subject to European Community antitrust law. n100 Any attempt to reduce regulatory overlap also requires states to contract with other states to allocate jurisdiction. n101

To the extent that states agree, explicitly or implicitly, on rules of deference, they create rules of prescriptive jurisdiction on a centralized basis in order to ameliorate the costs of overlapping regulation. The other technique that may be used is to harmonize rules, which results in any jurisdictional overlap or conflict of laws becoming a false conflict n102 because the competing substantive rules are the same.

B. Fiscal Competition

Taxation has two important similarities to corporate law. First, one significant motivation of the state is to generate revenue. However, the tax system often has other purposes besides revenue collection, such as redistributional goals. n103 Second, United States international tax law, like the internal affairs rule in conflict of laws relating to corporations, places a significant emphasis on nationality of corporations, as defined by place of incorporation, for jurisdictional purposes. n104

1. The Tiebout Model

The archetypal work in the area of fiscal competition is that of Charles Tiebout, whose work considers both government revenues and government expenditures. n105 Tiebout's insight was that there is, in connection with United States local government (as opposed to national government), an institutional framework for intergovernmental competition. This competition provides a source of market-like discipline on the operations of government.

Tiebout postulates a city resident about to move to the suburbs; this person would choose the community "which best satisfies his preference pattern for public goods." n106 For his pure theory, Tiebout assumes, among other things: (i) full mobility, (ii) wide choice of communities, (iii) full knowledge of each community's revenue and expenditure patterns, and (iv) resource constraints and economies of scale that result in an optimal size for any community. n107 The purpose of assuming resource constraints is to obtain a determinate number of communities; this is already true of international society. The purpose of assuming economies of scale is to provide a reason to seek newcomers; states in international society have other reasons to seek new sitings of business, including tax revenues, export earnings, jobs, technology, and other externalities. n108 Tiebout's other assumption is that the public goods supplied by any particular community provide no externalities that affect other communities. Tiebout points out that where such externalities are of sufficient importance, "some form of integration may be indicated." n109

Tiebout considers the expenditure and revenue sides of the equation together. He imagines decision-makers considering the public goods that the local government provides, and comparing them with the tax rates that would be required to be paid. He then compares the discipline

provided by this system with that of the private market. Taxes are prices and public goods are goods. n110 Consumers similarly indicate their preferences through their choices of goods. n111

This model has policy implications. First, Tiebout postulates that integration -- centralization -- is justified if it provides more of the relevant public good at less cost. n112 Second, policies that enhance mobility and information available to the consumer improve allocation. n113 One policy ramification implicit in the model is that "consumer" choices may be influenced as much by the composition of the basket of public goods provided by a particular community as by absolute efficiency in providing public goods.

2. Application of the Tiebout Model to International Fiscal Competition

The Tiebout model can provide a means of analyzing the structure of competition, and of understanding the limits of cooperation. As the international economy has become more open, the mobility of business has increased. Not only is capital more mobile, but labor and commodity mobility among states has increased as well. This provides some, but not all, of the conditions of applicability of the Tiebout model. n114

Examining the Tiebout model, Peggy and Richard Musgrave have found that fiscal competition as an ordering device "largely disappears in a more realistic view of the international case." n115 They argue that mobility of factors not only establishes the preconditions for competition, but also establishes the need for fiscal coordination in order to ensure that the market signals are accurate. Coordination is required in order to ameliorate the inefficiencies that they suggest otherwise arise: (i) inefficient use of resources due to differential tax burdens depending on the jurisdiction of economic activity, n116 and (ii) failure to preserve inter-nation equity to ensure that the country of economic activity is entitled to take a "fair" tax share. n117

It is not clear, however, that the first suggested inefficiency is truly inefficient: differential tax burdens are a necessary part of the "market" for public goods that Tiebout describes. These differential tax burdens may result in suboptimal allocation in the private sector, but are necessary to provide a market allocation in the governmental sector. n118 Thus, from a policy standpoint, the suboptimal allocations at the private sector level that come with diversity must be compared with the enhanced allocations at the state level that come with competition born of diversity, in order to determine whether, as the Musgraves suggest, the suboptimal allocations at the private sector level should be effected through tax harmonization. As to the second suggested inefficiency, partial coordination could preserve inter-nation equity without eliminating fiscal competition. Through agreed rules of tax jurisdiction, inter-nation equity could be preserved without requiring full coordination of tax rates. This technique would preserve the benefits of fiscal competition.

The second main criticism the Musgraves level at the Tiebout model is that differential mobility of factors results in problems of tax avoidance -- regulatory arbitrage. n119 "Differential mobility" refers to the idea that, for example, capital is more mobile than labor, which is more mobile than plant. It is important to note, however, that mobility must be defined in terms of jurisdictional rules: something is mobile if jurisdictional outcomes can be manipulated through changes of location or changes of legal home; something is immobile if

jurisdictional rules do not allow for such manipulation. On this basis, regulatory competition is "the competition of the immobile factors for the mobile factor." n120

This observation leads to the possibility that states will seek to tax relatively immobile factors more harshly in response to regulatory arbitrage effected through the manipulation of mobile factors. n121 Thus, as we have determined with respect to the Delaware phenomenon, it is not a race to the bottom, but a race to externalize (either domestic or international externalization). If differential mobility can be reduced or addressed through cooperation, states will have less incentive to engage in this race.

The Musgraves' conclusion is that fiscal competition cannot foreclose free riding, preserve inter-nation equity, and avoid distorting market outcomes: "Most basically, and *in the absence of coordinating measures*, there is no initial set of entitlements established within an international legal framework on the basis of which fair competition can proceed." n122

These problems require a complex pattern of coordination. n123 The Musgraves' criticism outlined above is not necessarily inconsistent with the Tiebout model, but may best be interpreted as an international supplement to the Tiebout model. Competition and coordination are not mutually exclusive: fiscal competition needs rules of the game that can only be established through cooperation. Cooperation in the form of market facilitating regulation at an international level is necessary to achieve the benefits of competition. In order to have socially useful competition, it is necessary to ensure that governments do not free ride on one another by taxing inappropriately, and that individuals and firms cannot avoid taxes through regulatory arbitrage. Of course, the word "inappropriately" begs the very question being asked: what is the appropriate scope of tax and other regulatory jurisdiction? This question cannot be answered on an *a priori* basis. n124

C. Application of Delaware Analysis and Fiscal Competition Analysis to International Competition in Other Forms of Regulation

Two issues are worth considering before trying to draw lessons from the Delaware phenomenon and fiscal competition. First, how much does a firm's mobility vary between these two different regulatory areas, and between these and other areas? Second, how broad is the range of public policy interests implicated? If only the public fisc is involved, and if no prudential regulatory purpose is implicated, do the Delaware phenomenon and fiscal competition analyses provide a skewed model of regulatory competition?

1. Mobility in Corporate Regulation and Tax Versus Mobility in Other Regulatory Areas

In regulatory systems where there is necessarily a greater nexus between the circumstances that give rise to regulatory jurisdiction n125 and the substantive activities of the regulated firm, it becomes less appropriate to depict the state's choice as a prisoner's dilemma than it may be under the model drawn by the Delaware corporate law literature.

Where regulatory jurisdiction is based on more substantive criteria than mere incorporation-based nationality, the activities of the regulated firm will, by definition, have a greater effect on

the interests of the regulating state. The inability to externalize costs will provide an incentive for the state to regulate efficiently. Recall that one of the relatively unconventional features of U.S. conflict of laws is the application of the laws of the jurisdiction of incorporation to issues relating to the internal affairs of the corporation. n126 Also, one of the less conventional features of U.S. tax law is that it purports to tax corporations formed under U.S. law on their worldwide income. n127

Using jurisdiction of incorporation as a basis for prescriptive jurisdiction allows both firms and governments to be free riders, allowing form to outwit substance. Thus, jurisdiction of incorporation is arguably an unsatisfactory basis for regulatory and tax jurisdiction over corporations, if it is manipulable as in the U.S. system.

2. Policy Interests of State in Corporate and Fiscal Fields Versus Policy Interests in Other Regulatory Areas

Non-substantive bases for prescriptive jurisdiction provide mobility to the regulated party. This resultant mobility is only a problem to the extent that substantive adverse effects impact a society that lacks prescriptive jurisdiction. n128 Substantive adverse effects can only occur (or will only be recognized) if the state has substantive policy interests that are harmed.

None of the schools of thought regarding the Delaware phenomenon mentioned above appears to consider systematically the ability of other constituencies -- debt-holders, employees, customers, governments, and potential tort claimants -- to affect the choice of state of incorporation, much less the impact of the involvement of these constituencies on regulatory efficiency. n129 In addition, none of these schools of thought considers systematically the effect of state policies other than revenue-raising through franchise taxes. In fact, to take the Delaware phenomenon model to its logical conclusion, a state might establish a system of regulation purely in order to attract the most franchise taxes. A state could offer incorporation and the benefit of limited liability with no other regulation whatsoever and garner the greatest possible market share. n130

One reason this disregard of other state policies (if not other firm constituencies) may be correct in the context of corporate law is the very fact that there is no necessary substantive connection in U.S. law between the state of incorporation and the principal place of business n131 of the corporation. n132 Accordingly, the state of incorporation may have no interest in the corporation other than with respect to its franchise tax payments. On the other hand, the circumstance of the state of incorporation may be comparable to that of the prisoner in the prisoner's dilemma: it can act to increase the aggregate welfare, but will only find it useful to do so if the other states do the same. n133 If they do not all cooperate, each individual state is better off providing a system of corporate law that attracts those who decide a corporation's state of incorporation. In this sense, the competition in corporate law may provide a model for analysis that differs significantly from other areas of regulation, as it involves a heightened prisoner's dilemma, unmoderated by the countervailing effects of local adverse effects of insufficient regulation. Corporation law is comparable to our traditional notions of private law, as it supplies details for the corporation contract between private parties, but may not implicate traditional public interests as powerfully as antitrust, environmental regulations or taxes, or even securities law. n134

Another important feature of the Delaware and fiscal policy models is that they are relatively one-sided and unbundled: the state gives little in *direct* exchange for its tax revenues. Many public goods are available regardless of whether one pays taxes or is locally incorporated. We discuss above the possibly restrictive view of state interests assumed in connection with the Delaware corporate law competition literature, which may be characterized as collapsing corporate law policy into fiscal policy. n135 In this sense, it is similar to fiscal competition. It is useful to draw a distinction here between "pure" taxation, where the state merely seeks to collect money from the citizen, and regulation that implements more specific and independent social policies (such as tax law to the extent it comprises tax expenditures). n136 The state's interests with respect to pure taxation are relatively simple and do not involve any specific social policies or the protection of any particular constituencies within society.

If, on the other hand, the motivations of the state are less purely oriented toward the fisc, the process of regulatory competition grows more complex. Rather than merely collecting tax revenues, a state will have multiple policies to integrate. These policies include traditional domestic regulatory goals like fair and competitive markets, protection of the environment, and maintenance of a stable financial system. Each policy will be substantively related to the bases for jurisdiction applied in a different way. Differential mobility will operate differently with respect to each policy. On this basis, regulatory competition is an extremely complex game.

In addition, we must recognize that in carrying out regulatory arbitrage, a firm will have multiple goals, including minimizing the incidence of taxes and the net cost of regulation. n137 Moreover, the firm has multiple constituencies that may affect its ability to engage in regulatory arbitrage.

If two sets of conditions were met, the competition in regulatory laxity would become a competition in regulatory efficiency. The first condition is the reduction to zero of transaction costs limiting the ability of the affected persons including not only managers and shareholders but also, *inter alia*, employees, customers, creditors, competitors, neighbors, and potential tort claimants, to evaluate regulation and to assert their interests (complete enfranchisement, information, and mobility). The second condition is zero transaction costs limiting the ability of the state to apply its regulation appropriately, including international agreement on rules of regulatory jurisdiction (completely efficient allocation of regulatory jurisdiction). The second condition may be satisfied through selective regulatory cooperation.

3. Application to Other Forms of Regulation

Despite the problems of comparability described above, we can draw several points from the Delaware corporation law and fiscal competition literatures.

First, it is important to consider regulation as a qualitative product, not just as a quantitative burden for firms to bear. This approach to Delaware corporation law examines the quality of the regulation: its utility as a social institution to establish relationships. n138 Corporation law under the U.S. system differs from other types of regulation insofar as it is relatively, although not completely, facultative: it is available to be used to define relationships if the parties wish. n139 The freedom of choice of jurisdiction of incorporation is an extension of this facultative

nature of U.S. corporation law. Corporation law is a product that is less tied to other regulatory products than might be the case with say, environmental regulation.

Second, both the firm and the state have multiple interests and multiple constituents. There are many customers for law as a product, each with a role in any "purchase" decision. In order to analyze the firm's mobility and the extent to which the market will limit mobility to jurisdictions with lax regulation, it is necessary to consider the influence of all of the constituents and factors important to the firm. In order to analyze the state's conduct, it is necessary to consider all of its constituents.

Private factors that we have referred to as selective domestic externalization implicate the concept of law as a product. It is necessary to broaden the class of consumers of law as a product to include not just taxpayers, managers, and shareholders, but also the full range of persons protected by regulation. These consumers of law may not pay through taxes, and need not be consumers of real products; n140 they may be workers, financiers, or residents. Each will vote with her feet to the extent that, as Tiebout assumes, she is informed and mobile. n141 An important complexity is that the analysis must take account of many factors. Many different costs and benefits attend each decision. Greater accuracy in taxation and in regulation may in theory be attained by applying taxation and regulation only where a direct nexus exists with the public good provided or regulatory harm prevented. Such greater accuracy may be perceived as diminishing the complexity of the taxation and regulatory decision. However, the search itself for this direct nexus may introduce its own, although perhaps more benevolent, complexities. n142

Third, it is worth analyzing a given type of regulation into its component parts. Some components may be more susceptible to free riding or evasion than others due to differential mobility. For example, in the field of fiscal competition, cooperation among states to establish agreed rules of tax jurisdiction and enforcement cooperation does not require that fiscal competition in rates be relinquished. *Cooperation among regulators is always useful if it can provide an orderly market in the product, enhancing the benefits of competition: if it can enhance the ability of the state to apply its regulation to activities substantively related to the state.* n143 It is worth facilitating this competition by ensuring that it is not (i) distorted through inappropriate extraterritoriality, (ii) artificially "bundled," n144 or (iii) artificially made opaque.

The main difference between consumers of law as a product and consumers of real products is that law is, but perhaps need not be, to a very great extent a tied and tying, or a "bundled" product. We accept legal structures as part of the fabric of a complex social system. It is not yet generally acceptable, other than in the context of commercial contracts with persons from other states, to choose one law to govern one relationship and another law to govern others. n145

If it were, states might compete in the "legal services" market by offering regulatory systems at the lowest possible transaction costs in the same manner that financial services law firms compete by offering the most innovative transaction structures at the lowest cost. n146 This is, of course, the way that Coase indicates commercial firms must compete: as institutions for the organization of transactions to reduce transaction costs. n147 The competition would be enlivened if the bundles were broken through greater application of user fees or greater imposition of transactional regulation as opposed to institutional regulation. Regulatory reforms that enhance specificity in jurisdiction, which ensures the congruence between jurisdiction and effects, facilitate the operation of the competition in regulation.

If we assume that the firm and the state -- as economic institutions -- exist to reduce transaction costs, then the best firms and the best states are those that reduce transaction costs the most. Thus, the states that provide the most efficient institutional economic structures are the best. While this may appear a call for unmitigated competition among states to provide the most efficient structures, the competition need not be unmitigated. Consider three qualifications. First, the competition is not merely horizontal among states. According to the principal of subsidiarity, it is also vertical among states and subnational and supranational units. Second, different groups of people populating states will have varying preferences. Third, the most successful states will recognize that the first qualification means that they cannot provide the most efficient structures without transferring sovereignty to subnational and supranational units in some fields. n148 Selective cooperation among states is necessary to provide the best product -- the most efficient regulation. n149

III. REGULATORY SUBSIDIES UNDER TRADE LAW

Assuming that a particular theoretical level and type of regulation is appropriate to address domestic social goals, regulatory competition that reduces regulation below such level will obviously be sub-optimal from a domestic policy perspective. Deregulation below this optimum level is a means of providing advantages to particular firms at the expense of either society at large (broad based domestic externalization), or a particular segment of society (selective domestic externalization). Such deregulation amounts to a regulatory subsidy. n150

We have argued above that regulatory competition requires selective moderation by regulatory cooperation. However, regulatory competition is today subject to few explicit international disciplines, except in certain specific subject areas and under the special regional enterprise of the European Community. n151 However, GATT, the principal multilateral trade regime, addresses subsidies. To the extent that regulatory subsidies are similar to "real" subsidies, the motives for international discipline should be the same. We explore below to what extent regulatory subsidies may be considered subject to the discipline of GATT. Finally, we consider whether regulatory subsidies are addressed under the unilateral regime established by the United States to supplement GATT. Is there already a multilateral or unilateral discipline that would limit the race to the bottom?

We may distinguish regulatory subsidies from other subsidies on the basis that regulatory subsidies are embedded and intertwined in a system of regulation which as a whole has purposes other than financial support of the industry or firm being subsidized, or deviates from other principles of regulation. n152 We will not consider in this Article, except as a point of reference, other types of subsidies, such as cash subsidies or indirect financial subsidies. These more direct types of subsidies are easier to discipline than regulatory subsidies because they are more susceptible to identification and measurement, and because they are more difficult to legitimize in international discourse. n153

The separation of regulatory subsidies from regulatory measures designed to implement independently legitimized social values may be impossible, except by examining the intent of the legislators or regulators. Regulatory subsidies may be unintentional, or may have begun unintentionally. Intentional regulatory subsidies, however, are based on a naked desire to promote the beneficiary industry or firm. n154

A. Regulatory Subsidies Under GATT

The GATT regime seeks to enhance the freedom of trade. Its first vocation, at which it has had reasonable success in many sectors, at least in the developed world, was to reduce tariffs on most goods and to eliminate quotas. Its second vocation is to reduce or hold down non-tariff barriers or distortions to trade, including subsidies and countervailing duties imposedin response to subsidies, which may have increased in response to the reduction of tariff barriers and the rise of the regulatory state. n155 Under the Uruguay Round, this second vocation has been extended to include not just trade in goods, but also trade in services, as well as other fields. n156 GATT has not been particularly concerned with non-trade values, like regulatory effectiveness. However, there are increasing demands for GATT to confront the effectiveness of such non-trade areas as environmental regulation, in order to counteract the argument that trade liberalization leads to harmful deregulatory pressures. n157

This subsection describes the approach of GATT to subsidies generally and considers the possible extension of this approach to regulatory subsidies, with a view toward assessing the utility of GATT as a discipline on regulatory competition. There can be little doubt that mere differences in economic regulation, regardless of intent to subsidize, result in differences in competitiveness among the industries of different states, thereby distorting trade. On the other hand, there also can be little doubt that the GATT system today lacks the institutional machinery and political legitimacy to eliminate these differences in any significant way. n158 The question left is which of these regulatory differences that distort trade should GATT discipline, and how should it do so, given its institutional limits and other prudential factors. This question is fundamental, as it asks what business regulation issues should be addressed at the national level, and what business regulation issues should be subjected to multilateral discipline. It is the same question asked by our discussion of the Delaware phenomenon and fiscal competition: where should the balance be struck between competition and cooperation?

It is appropriate to consider initially why states are willing to cooperate in this context. Why would a state restrict its freedom to grant subsidies -- the freedom to exercise national economic, industrial, and social policy -- in the multilateral GATT process? Gary Clyde Hufbauer and Joanna Shelton Erb find the answer simple: "unbridled and competing national subsidies can undermine world prosperity." n159 They further argue that the protectionist contagion that led to the Great Depression has taught the "international community to fashion guidelines that distinguish between acceptable and unacceptable national subsidy measures." n160 From this perspective, subsidies are similar to other mercantilist (export subsidies or facilitation of exports) or protectionist (domestic subsidies or exclusion of imports) measures. For this reason, they stimulate international cooperation in order to avoid the adverse consequences of a prisoner's dilemma, in which each participant, unsure of whether the others will cooperate, engages in behavior that is less optimal than cooperative behavior. n161 This seems to be an accurate analysis of the reasons why international cooperation provides discipline on subsidies, regardless of whether one is persuaded that subsidies are intrinsically dangerous or that they can be disciplined. n162 The issues grow more difficult with respect to regulatory subsidies, as they are more difficult to identify and, more importantly, require more complex cooperation in order to provide discipline.

It is useful to summarize the basic terms of the applicable GATT provisions, in order to assess how GATT might restrict the "grant" of regulatory subsidies, or the competition in regulatory subsidies. n163

1. Article XVI

Section A of GATT article XVI provides loosely that any contracting party must notify the other contracting parties of any subsidies that operate directly or indirectly to increase exports or reduce imports. n164 Article XVI(1) refers to any subsidy that directly or indirectly distorts trade. If this subsidy causes or threatens serious prejudice to the interests of another contracting party, the subsidizing party must consult with such affected party with respect to the possibility of limiting the subsidies.

Section B of GATT article XVI, adopted in 1955, provides stronger disciplines which only apply to export subsidies. n165 Because only seventeen countries have accepted section B, n166 most members of GATT are not required to avoid using export subsidies. Section B prohibits direct and indirect export subsidies for manufactured products that result in export prices lower than comparable domestic market prices. n167

2. Article VI

GATT article VI does not prohibit or limit the ability of states to maintain subsidies per se, but authorizes the unilateral imposition of countervailing duties to respond to subsidies, including those permitted under article XVI. Thus, it allows contracting parties to respond unilaterally to subsidies. n168 Article VI(3) of GATT contains a broad reference to subsidies granted, directly or indirectly, on the manufacture, production, or export of products.

3. The Subsidies Code

The GATT Subsidies Code, signed in 1979, elaborates and extends these concepts. n169 However, the Subsidies Code only applies among the twenty-five states that are parties, including the United States. The Subsidies Code recognizes that subsidies are used by governments to promote important objectives of national policy, n170 and thus does not impose a blanket prohibition on all subsidies. Reflecting GATT itself, the Subsidies Code instead provides two means of relief for subsidies: unilateral imposition of countervailing duties, n171 or international prohibitive discipline through mediation, conciliation, and dispute resolution. n172

The Subsidies Code prohibits export subsidies on products other than certain primary products. n173 Like the primary GATT agreement, n174 it does not specifically define export subsidies, but instead sets forth a list of eleven types of practices that are "illustrative of export subsidies." n175 The practices listed include direct subsidies, internal transport charges for export shipments that are lower than those for domestic shipments, exemption of direct taxes, indirect taxes or social welfare charges in respect of exports, export credits, and "any other

charge on the public account constituting an export subsidy in the sense of Article XVI" n176 of GATT. None of the illustrations relates to or could be compared directly to regulatory subsidies. None of these definitions were drafted with regulatory subsidies in mind.

The Subsidies Code imposes a non-restrictive regime on subsidies other than export subsidies. Most regulatory subsidies are likely to fall into this non-restrictive category. According to the Subsidies Code, these other subsidies (referred to herein as "domestic subsidies") may have legitimate social and economic policy objectives, such as (i) assisting disadvantaged regions, (ii) restructuring certain sectors as may become necessary, for example, due to trade liberalization, (iii) sustaining employment and encouraging re-training, (iv) encouraging research and development, and (v) promoting development of developing countries. n177 Illustrative examples of domestic subsidies include such general categories of assistance as "government provision or government financed provision of utility, supply distribution and other operational or support services or facilities" with the "aim of giving an advantage to certain enterprises." n178

The Subsidies Code stipulates that it creates no basis for action against domestic subsidies under GATT, leaving open the possibility that article XVI may do so, and that the Subsidies Code's interpretations of article XVI may serve as a basis for actions under article XXIII. n179 The signatories to the Subsidies Code, recognizing that these domestic subsidies may cause or threaten injury or may nullify or impair GATT benefits, thereby distorting normal competition, agreed to seek to avoid doing so. n180 In addition, the Subsidies Code permits national authorization of countervailing duties against even domestic subsidies that result in material injury. n181

4. Application to Regulatory Subsidies Generally

While the references to subsidies in article VI, article XVI, and the Subsidies Code have never been interpreted definitively to include regulatory subsidies, it appears possible that they could be so interpreted. n182

First, all of the export subsidy illustrations provided in the Annex to the Subsidies Code call for some differential treatment between production for export and production for domestic consumption. Regulatory subsidies could be applied differentially in this way, as in our examples of relaxation of application of antitrust laws or environmental laws. n183

Second, the differential delivery of government services or other inputs from the government may constitute an export subsidy. Thus, where the regulatory subsidy amounts to the provision of some government benefit on more favorable terms or conditions than would be available for domestic production, an export subsidy may exist.

Third, the final paragraph of the Annex to the Subsidies Code refers to "any other charge on the public account constituting an export subsidy in the sense of Article XVI of the General Agreement." n184 This provision may be interpreted as excluding regulatory subsidies that do not constitute a charge on the public account, as where the regulation shifts the costs to other private persons, rather than to the public account. n185 If this were so, perhaps no subsidy would exist where the cost can be externalized from government; this would provide government with the best of both worlds, and strong incentives for externalizing costs of subsidy policies.

This interpretation would exclude from discipline narrow domestic externalization, or international externalization. This language might discipline broadbased domestic externalization: externalization of costs to domestic society at large, to the extent that it can be viewed as a charge on the public account. However, this type of externalization is the most benevolent of the three types identified above, as it places the costs of subsidization on the collective entity that formulates regulation.

Finally, several of the illustrations of export subsidies contained in the Annex to the Subsidies Code involve remissions, exemptions, or deductions from taxation: circumstances in which the government gives up something to which it is otherwise entitled. n186 To the extent that regulation imposes costs on enterprise, and those costs can be considered a sort of "regulatory tax," the relaxation of regulation or other forms of regulatory subsidy may be considered a remission of this tax.

As noted above, GATT and the Subsidies Code provide no specific definition for subsidies. Rather, their draftsmen seem to have been unable to agree, n187 and willing to accept a common law process to define prohibited subsidies. In any event, they have not specifically addressed regulatory subsidies. Nor has GATT common law yet spoken directly to the question of regulatory subsidies per se. However, by considering how the GATT process has addressed other related or unanticipated types of subsidies, we may assess how it might deal with regulatory subsidies.

In 1976 a GATT panel reported pursuant to article XXIII of GATT on the consistency of the U.S. tax laws establishing a special regime of taxation for "domestic international sales corporations" (DISCs) with the export subsidy provisions of GATT. n188 In the DISC case, the GATT panel examined the DISC system as a derogation from basic U.S. tax principles, intended to make manufacturing for export more beneficial from a tax standpoint than manufacturing for domestic sales. n189 Briefly, the DISC system allowed U.S. businesses to set aside a portion of their export income, and defer for an indefinite period of time income taxes that would otherwise be payable on such income. Deferral provides a significant benefit, due to the time value of money. This program was successful, accounting in 1975 for approximately 70% of total U.S. exports. n190

The DISC system was criticized by both the European Community and Canada as an explicit export subsidy. They argued that the DISC system was a system for the "remission of direct taxes," prohibited under item (c) of the illustrative list of export subsidies adopted with Section B of Article XVI of GATT. n191 The United States argued that the DISC system did not constitute an export subsidy within the meaning of Article XVI(4), because tax deferral, as opposed to tax remission, was not specifically mentioned.

Using a competition in regulation rationale (a "two wrongs make a right" argument), the United States further argued that its DISC system "removed an existing distortion rather than created a new distortion in international trade." n192 The United States pointed out that other parties to GATT, including several members of the complaining European Community, n193 provided deferral and exempted foreign earned income to a greater extent than the United States under the DISC system. The panel rejected this argument, declining to accept competition in subsidization as a justification for subsidization otherwise in violation of GATT: two wrongs do not make a right. To do otherwise would establish a basis for subsidization and for competition

in subsidization: each member would examine closely the system of each other member to find implicit subsidies to redress. n194

The panel concluded that the DISC system violated GATT:

The Panel considered that if the corporation income tax was reduced with respect to export-related activities and was unchanged with respect to domestic activities for the internal market this would tend to lead to an expansion of export activity. Therefore the DISC legislation would result in more resources being attracted to export activities than would have occurred in the absence of such benefits for exports. n195

The GATT panel found that the DISC system constituted a program for remission of taxes not by virtue of the deferral of taxes itself, but by virtue of remission of (or failure to charge) interest on the taxes deferred. This was a violation of article XVI(4) of GATT. As an export subsidy, the DISC system was also subject to notification under article XVI(a), which the United States had not done.

The DISC decision provides two principles relevant to our inquiry. The first principle is that a subsidy cannot be justified on the basis of subsidies provided by the complaining states. The GATT panel was unwilling to allow the possibility that GATT would take on the administrative and substantive nightmare of attempting to compare whole governmental systems in order to compare and net out subsidies. n196 The second is that the failure to charge taxes on an equivalent basis can be an export subsidy, even if not specifically described in the examples provided. Therefore, it would be open to a subsequent panel to find that the absorption by the state of costs related to exported goods that, in connection with goods manufactured for the domestic market, are absorbed by the manufacturer, is also an export subsidy. Because there is no policy basis for distinguishing tax remission from remission of regulatory requirements, there are no GATT principles that would prevent a GATT panel from arriving at this view.

Two other GATT dispute resolution reports and a third complaint brought under GATT are instructive. In the 1952 Belgian Family Allowances matter, n197 the GATT Panel on Complaints examined the question of whether a Belgian charge on Danish goods, which did not apply to goods originating in certain other countries, violated the most favored nation (MFN) principle of GATT. The MFN principle ordinarily prevents discrimination among goods originating in various GATT members. The Belgian charge was designed to level the playing field in connection with public procurement by the Belgian government. It did so by levying a charge equivalent to Belgium's family allowance charge, unless the country of origin already had an equivalent charge.

The panel determined that Belgium was not entitled to discriminate in the levying of the charge. Thus, if one regards the failure of other states to impose a family allowance charge as a type of regulatory subsidy, Belgium was not permitted to "countervail" this regulatory subsidy. It should be emphasized that the panel did not evaluate this matter as a subsidies case.

In 1991 a GATT dispute resolution panel determined that the U.S. Mammals Protection Act (MMPA) violated, *inter alia*, article XI(1) of GATT. n198 One motivation of the MMPA appears to have been to level the playing field between U.S. tuna fishermen, who were subject to restrictions on killing dolphins, and foreign fishermen, who might not otherwise be so restricted. The MMPA did so by blocking imports of tuna from countries without dolphin protection rules comparable to those of the United States. The panel in this case found that the U.S. assertion of

"extraterritorial" jurisdiction to regulate the production processes used by Mexican fishermen was an illegal embargo under GATT.

In both of these cases (neither of which addressed these issues in the subsidies context), GATT was hostile to attempts by importing states to level the regulatory playing field through departures from general GATT free trade principles.

In 1983 the European Community initiated GATT proceedings against Japan arguing that Japanese failure to prevent anticompetitive practices in its internal market "nullified and impaired" n199 the concessions that Japan had made under GATT to the Community. n200 The Community argued that Japan was indirectly protecting its domestic markets by tolerating anticompetitive practices among private parties. Although the European Community did not press this complaint to a conclusion, one wonders how a GATT panel would consider this argument.

To summarize our discussion of the application of GATT to regulatory subsidies, we may conclude that regulatory subsidies theoretically could be considered to be subsidies. As subsidies, they could be the subject of nullification and impairment or other claims, and may be countervailed once they are identified. n201 However, this does not end our discussion of GATT with respect to regulatory subsidies, as there are remaining difficult questions regarding the determination of their magnitude and available remedies. The international community has not agreed on standards and centralized procedures for the examination of each contracting party's system of economic regulation in order to determine the magnitude of such subsidies. Where subsidization is not intended, it is especially difficult to legitimize an effort to compare systems, assess the degree of subsidy, and either forbid the subsidy or permit it to be countervailed. n202 This endeavor is left to the discretion of each contracting party. If this delegation does not legitimize subsidies and countervailing duties, it at least empowers each contracting party to act in its own interests.

Professor Cass points out that the emphasis on unilateral discretion in GATT subsidies law was based on a desire of many countries other than the United States to preserve substantial freedom for domestic subsidies in order to shield *dirigiste* internal economic policies. n203 The core focus of the Subsidies Code was therefore to provide "a mechanism to protect firms in export markets against the extraterritorial effects of subsidies that might serve domestic political purposes." n204 Thus, in a world of interdependent economies, it is considered appropriate to limit the extraterritorial effects of domestic economic or industrial policy measures.

We may now examine how the United States, the most active user of countervailing duties, n205 has unilaterally defined subsidies for purposes of determining whether to countervail them, and whether the establishment of a level playing field is appropriate and feasible. n206 This discussion will highlight the fundamental tensions in U.S. law between the desire for a level playing field, the desire to subsidize or to regulate differently on a case-by-case basis, and the desire to avoid destructive competition in subsidies.

B. Regulatory Subsidies Under U.S. Trade Law

This subsection supplements the description above of potential discipline on regulatory subsidies under GATT with a description of potential unilateral discipline on regulatory

subsidies under U.S. law. n207 First enacted in 1897, Title 19, section 1303 of the U.S. Code requires the Secretary of the Treasury to assess countervailing duties on imported goods benefitting from any "bounty or grant." n208 In 1979, the Trade Agreements Act incorporated the GATT Subsidies Code into U.S. law with section 1671 of Title 19, n209 which added a requirement for a finding of the existence or threat of material injury not required under section 1303. The Subsidies Code requirements imposed under section 1671 are only applicable to imports from certain other signatories of the Subsidies Code, and certain other specially designated countries.

The most difficult issue in U.S. countervailing duty law is defining countervailable subsidies. n210 While some difficult decisions have been made, U.S. subsidies law has not squarely addressed the issue of whether regulatory subsidies are countervailable subsidies. Section 1303 and section 1671 use essentially the same definition of subsidy. n211 In addition, section 1677(5) provides a non-exclusive list of examples of subsidies:

> (i) Any export subsidy described in Annex A to the Agreement (relating to illustrative list of export subsidies). n212
>
> (ii) The following *domestic subsidies, if provided or required by government action to a specific enterprise or industry, or group of enterprises or industries, whether publicly or privately owned, and whether paid or bestowed directly or indirectly* on the manufacture, production, or export of any class or kind of merchandise:
>
> (I) The provision of capital, loans, or loan guarantees on terms inconsistent with commercial considerations.
>
> (II) The provision of goods or services at preferential rates.
>
> (III) The grant of funds or forgiveness of debt to cover operating losses sustained by a specific industry.
>
> (IV) The assumption of any costs or expenses of manufacture, production, or distribution. n213

The fourth example -- the assumption of costs of manufacture, production, or distribution *if provided or required* by government action -- may on its face encompass most regulatory subsidies. Because of the reference to subsidies "provided or required" it may encompass regulatory subsidies that allocate costs to other private persons, instead of just to government. n214 While no court has so held, the broad language of the statute could conceivably support a finding that a regulatory subsidy is countervailable under U.S. law, regardless of who bears the cost.

In the recent Canada Softwoods Lumber decision, n215 the International Trade Administration (ITA) found that restrictions imposed by the Canadian province of British Columbia on the export of logs constituted countervailable subsidies conferred on local log processors. The ITA focused on the program's effect of reducing the costs of logs purchased by local processors from what the costs might otherwise be. Such export restrictions may be

analogized to regulatory subsidies, insofar as they are marked by governmental intervention that does not provide a direct subsidy and provides little direct governmental financial contribution, but results in advantages for the domestic industry. The restrictions may be distinguished from our examples of regulatory subsidies insofar as they may be viewed as less clearly embedded in a separately justified regulatory system.

1. The Specificity Test

The main battleground for defining countervailable subsidies under U.S. law is the issue of "specificity." n216 Section 1677 establishes a requirement that countervailable domestic subsidies be "provided *or required* by government action to a specific enterprise or industry, or group of enterprises or industries." n217 In 1988, the Omnibus Trade and Competitiveness Act added to this definition a "special rule" specifying that in applying the definition of subsidy,

> the administering authority, in each investigation, shall determine whether the bounty, grant, or subsidy in law or in fact is provided to a specific enterprise or industry, or group of enterprises or industries. Nominal general availability, under the terms of the law, regulation, program or rule establishing a bounty, grant, or subsidy, of the benefits thereunder is not a basis for determining that the bounty, grant, or subsidy is not, or has not been, in fact provided to a specific enterprise or industry, or group thereof. n218

The Court of Appeals for the Federal Circuit has recently upheld the specificity test applied by the International Trade Administration in *PPG Industries v. United States*. n219 In this case, the court recognized that not all domestic subsidies that may distort trade in a way adverse to U.S. producers were intended to be countervailed under the relevant statutes, and deferred to the ITA's discretion to distinguish between those that are countervailable and those that are not on the basis of the specificity test. While the specificity test has met with wide acceptance, its content has been debated at length. n220

The specificity test applied by the ITA and upheld in *PPG Industries* is not very specific. A subsidy provided by its terms to a particular enterprise or industry, or group of enterprises or industries, clearly has the requisite specificity. Subsidies of nominal general availability present more difficulty. The ITA considers three factors in an imprecise balancing test: the extent to which the foreign government limits the availability of the subsidy; the extent of actual use of the subsidy; and, the extent of government discretion in making the subsidy available. n221

What does specificity have to do with the countervailable nature of subsidies? Let us consider the basis for the specificity test, before we review its application to regulatory domestic subsidies. Probably the best justification for the specificity test is a practical one as opposed to a theoretical one: the practical need to moderate the theoretical overbreadth of anti-subsidy law.

If not for the specificity test, it would be legitimate -- and necessary in order fully to redress "subsidization" -- to examine every public expenditure of an exporting country in order to determine to what extent it enhances the competitive capability of that country's firms. n222 If one intends to provide a level playing field, n223 the next step would be to begin to address regulation that allocates costs from trading firms to other private parties, as opposed to the government. It may be further necessary to address other differences in factor endowments, perhaps examining cultural traits of thrift, diligence, and innovation. Finally, in order to truly

provide a level playing field, is it not necessary to compare subsidies and to countervail only to the extent the subsidy provided by the exporting country *exceeds* the subsidy provided by the importing country? n224

If on the other hand, the intent is to do something less than create a completely level playing field, then it must be to redress distortions that vary from hypothetical market allocations. This is the "benchmark" the ITA uses in its proposed rules. The proposed rules are intended to codify the ITA's methodology for determining the existence and value of countervailable subsidies. n225 The problem, of course, with this standard, is that it is too demanding; every government in a market economy finds it necessary to intercede in various ways, distorting market allocations. n226 This goal of redressing particular departures from hypothetical allocations made by a hypothetical market economy is not much different, when carried to its logical extension, from the goal of establishing a level playing field. Both require a complete evaluation of each government's role in the economy.

In order to moderate the theoretical overbreadth of either rationale, the specificity test appears necessary. However, the specificity test is difficult to administer consistently, partly because it is not congruent with the real concerns raised by subsidies. The real problem with subsidies and countervailing duties arises from the fact that both subsidies and countervailing duties may interfere with the ability of other states to establish the type of economic system they desire. Subsidies granted by an exporting country interfere with the importing country's goal of undistorted trade. The importing country's countervailing duty interferes with the exporting country's ability to realize its goal of subsidizing its industry. This problem could easily be solved by ending international trade, but so long as international trade exists, it is not clear how these conflicting desires can be reconciled.

In other areas, problems of overlapping power -- allocation of jurisdiction -- are addressed in two possible ways: (i) conflict of laws rules (rules of prescriptive jurisdiction) to determine which government's rules will apply to a particular transaction or person, and (ii) harmonization of rules, so that it is immaterial (or at least relatively unimportant) which government's rules apply.

The specificity test is insufficient to deal with the problem of jurisdictional overlap for at least two reasons. First, the specificity test is underinclusive, as it would exclude areas that require discipline. The jurisdictional overlap and consequent disruption of trade may be quite real and problematic despite its lack of specificity. Specificity is in effect a proxy for intent, and subsidies may exist and cause damage without intent. n227 Second, the specificity test is overbroad, as it may allow the imposition of countervailing duties against activities of foreign states that may be viewed as legitimate. "Specific" subsidies in some circumstances may be appropriate.

2. Application of the Specificity Test to Domestic Regulatory Subsidies

How would the specificity test address the issue of domestic regulatory subsidies in our earlier examples of antitrust law and environmental regulation? The failure of Japan to apply antitrust regulation to domestic competitors n228 would probably lack the requisite specificity, assuming that it is not done strategically. n229 This conclusion is based on the assumption that

the "subsidy" of lax antitrust enforcement occurs across the range of Japanese industry, and is not granted to only particular firms or industries. Similarly, weak environmental regulation, n230 unless it consists of derogations from broadly applicable rules or can be related to a specific industry or group of industries, would lack specificity. This raises a temporal "chicken and egg" problem: if no regulation has been introduced regulating mercury discharge by the mining industry, but scientists recommend it and other countries have it, is the lack of regulation a sufficiently specific subsidy? Again, respect for differences in national preferences frustrates comparison. For example, a developing country might prioritize economic development values ahead of concerns regarding mercury discharge, and tolerate mercury levels that would be unacceptable in Denmark. n231

IV. SUBSIDIARITY AND COMPETITION IN REGULATION

The discussion above of GATT and U.S. rules regarding subsidies and countervailing duties has shown that these bodies of law lack legitimate or administrable principles for distinguishing acceptable exercises of domestic regulatory sovereignty from unacceptable methods of unfair trade. Indeed, it is difficult to imagine a principle that would provide a discrete decision for every case. As noted earlier, the task is to distinguish those rules in which local autonomy and competition in regulation are to be preferred over centralization and harmonization in regulation. This same central issue -- competition versus cooperation -- informed and guided our earlier discussion of the lessons of the Delaware phenomenon and fiscal competition.

Subsidiarity has been established in the European Community, on a political level if not yet on a legal level, as a central principle for determining, as between Member State and Community, the level at which regulation should be effected. The principle of subsidiarity is invoked to delimit the boundary between issues that must be regulated at the Community level, and issues properly left to the Member States. n232

A. A Working Definition of Subsidiarity

The principle of subsidiarity is often invoked in opposition to federalism, n233 although it is a central principle of federalism. n234 Subsidiarity is premised on the unassailable proposition that no single level of organization is appropriate for all social functions. The principle of subsidiarity is a guide for determining what functions should be allocated to the state. n235 We shall consider subsidiarity both as a means of dividing regulatory functions between states and inter-state organizations and of moderating between competition and cooperation, with a view toward addressing the concerns raised by the Delaware corporate law and fiscal competition literatures, and the inadequacies of GATT and U.S. subsidies law to address these concerns.

B. Application of the Principle of Subsidiarity

The principle of subsidiarity indicates that particular social issues should be addressed at the level of society where they can be addressed most effectively. n236 It thus requires continuous vertical competition for regulatory effectiveness among levels of government. n237 It is important to consider how effectiveness is to be measured.

Effectiveness must be measured not only in terms of economic efficiency, but also in terms of a broader range of values that may be described as effectiveness in implementing social policy. n238 Clearly, different individuals and social groups -- families, villages, cities, subnational regions, states, and supra-national regions -- will have varying social policy preference sets. These preference sets will converge and diverge in varying measures. Convergence of preference sets will require agreement on how values are to be compromised or assimilated.

Given subsidiarity measured in terms of effectiveness in satisfying a given common preference set, there will always be some benefit in regulating at varying levels, to take advantage of varying combinations of preference sets. While there may be unacceptable transaction costs and excessive complexity associated with a great multiplicity of levels of social organization, it would appear useful to have at least several levels of social organization to capture the benefits of varying combinations of preference sets. This would indicate greater flexibility in allocating functions to varying levels of sub-state units, as well as varying levels of supra-state units, such as regional and functional organizations.

In addition to identifying common preferences, it is useful to identify tradeoffs of unshared preferences that can enhance aggregate welfare. Perhaps a "horse-trading" approach to subsidiarity is necessary. Such an approach might be comparable to the approach taken in the negotiation of harmonizing directives in the European Community. A horse-trading approach would allow negotiators or legislators to apply subsidiarity in particular regulatory areas *to the extent of shared values* based on those shared values. To the extent values are not shared, or priorities differ, the value of promoting the international system and of receiving concessions in other regulatory areas, would induce societies to make concessions in the regulatory area at hand. This approach requires a forum for continued negotiation over a broad range of issues, in order to allow the intergrated multi-issue decisionmaking and repeat play that makes this "horse trading" possible.

V. CONCLUSION: COMPETITION AND COOPERATION IN REGULATION

How does subsidiarity respond to the problem of determining the balance between competition and cooperation among states in regulation, and in defining and disciplining regulatory subsidies? This problem demonstrates the accuracy of Anderson's law: "I have yet to see any problem, however complicated, which when you looked at it in the right way, did not become still more complicated." n239

A. Horizontal Competition

Horizontal diversity of regulation confers two main benefits: congruence with differing cultures and regulatory Darwinism -- competition for survival of the most efficient regulation.

n240 These benefits have costs which must be first minimized and then measured and compared to their benefits. Horizontal diversity also provides opportunities for firms and states to engage in bad conduct. It allows states to externalize costs to foreign parties through lax regulation. Regulatory arbitrage has redeeming qualities (in terms of disciplining states and creating other efficiencies) only when not associated with externalization by states. Regulatory arbitrage is acceptable only when firms are required to bear the regulatory costs properly allocable to their activities and states are required to bear the social costs associated with their regulation or lack thereof.

U.S. law responds to the problem of domestic subsidies with the principle of specificity to determine which domestic subsidies are countervailable. n241 Assuming that regulatory subsidies are considered subsidies, the specificity test is not a coherent approach to determining which domestic regulatory subsidies should be countervailable. Even if some regulatory subsidies are included in the definition of subsidies under GATT and the Subsidies Code, GATT provides little discipline on subsidies that cannot be characterized as export subsidies, instead merely permitting countervailing duties that may further distort trade. n242 It would take a significant degree of political will and legal legitimation to broaden the discipline of GATT on domestic regulatory subsidies. Moreover, it would require detailed and arduous negotiation of standards for regulation, departures from which could constitute subsidies subject to discipline. We may assume that international society is unprepared for such an effort toward "essential harmonization" on any comprehensive basis.

Thus, in order to secure the full benefits of competition in regulation, without externalization and without the threat of inappropriate retaliation, it is necessary to develop rules of regulatory jurisdiction. In order for these rules of regulatory jurisdiction to be effective to protect competition, they must be agreed upon among states. Thus, horizontal cooperation is always required, not necessarily in regulation, but in allocating regulatory jurisdiction. We can compare agreed rules of regulatory jurisdiction on the international level with agreed rules of property and torts on the domestic level: both facilitate the operation of the market by clarifying the distributive consequences of action.

An effects-based test n243 for jurisdiction would be appropriate to provide congruence between regulatory jurisdiction and regulatory cost. The deficiency of the effects test in this regard, of course, is that a single person's activities, carried out within a single state's territory, may have effects in a number of jurisdictions. This deficiency may be addressed in part by regulation designed to deal with issues on as specific a basis as possible -- regulation that is the least restrictive alternative to address local effects. n244 The goal is to craft rules of regulatory jurisdiction that are analog rather than digital in nature -- rules that allow the exercise of jurisdiction to the extent of the local adverse effect.

The development of rules of regulatory jurisdiction could have collateral benefits beyond the rectification of regulatory competition. By clarifying the distributive consequences of action and by limiting excesses of regulatory jurisdiction and externalization, such rules would clarify whether Brazil has the right to cut down its forests, whether Mexico must protect dolphins in the same manner the the United States does, and whether Japan must apply antitrust regulation in a manner comparable to the United States. This clarification would facilitate horse trading among different values, and payoffs by one government to another to affect the other's substantive regulatory policy.

B. Horizontal Cooperation Linked to Vertical Competition

Our discussion of horizontal competition indicates that jurisdictional rules regarding regulation should be coordinated. This conclusion does not address the question of cooperation in substantive regulation. A complex and continuous political process -- a process of subsidiarity in action -- is necessary to determine where harmonization of substantive regulation makes sense. Where it does, rules of regulatory jurisdiction become far less important.

Subsidiarity, as outlined above, requires negotiation and assimilation of varying social preferences and priorities. Once these are negotiated and assimilated, it is necessary to produce an assimilated and prioritized preference set for a number of vertical levels. What are the family, municipality, state, federal, regional, global, or other preference sets? These preference sets must be arrayed against the effectiveness with which they can be achieved at each level. Subsidiarity in this sense requires governmental functions to be distributed vertically in such a way as to maximize achievement of each individual's preference set. It thus responds to the question of the appropriate degree and level of horizontal cooperation by establishing vertical competition in effectiveness.

C. Vertical Cooperation

Vertical cooperation among varying levels of government is necessary in order to allow governmental functions to be allocated in as precise a way as possible. First, vertical cooperation is necessary in order to undertake the process of allocation of responsibility among vertical levels -- in order to establish the rules by which the vertical competition in regulation described above operates. Second, it may be necessary to divide responsibility for a regulatory area among various vertical levels in order to achieve optimum regulation. In order for this division to work, there must be possibilities for cooperation among vertical levels. To commence this vertical cooperation requires no more than a recognition that the international legal order is not defined solely by the state, and that certain responsibilities are best allocated at levels beyond or below that of the state. n245 To continue, vertical cooperation requires complex institutions for the negotiation of allocation of responsibility among vertical levels.

FOOTNOTES:

n1 The term "regulation" is used herein in a very broad sense, including all public law. Public law includes both obvious regulatory areas such as antitrust, environmental regulation, food and drug regulation, and securities regulation, and less obvious areas such as taxation and international trade regulation. Insofar as the distinction between public law and private law is porous, private law areas such as contracts, property, and torts may also be implicated, although they are often viewed as less malleable than traditional public law rules.

n2 For example, the strongest argument levelled by environmentalists against the North American Free Trade Agreement (NAFTA) in recent debates is not an argument that it is important for the well-being of either Mexican or U.S. citizens that Mexican environmental regulation and its enforcement be enhanced. Rather, the argument is more indirect. It is that if U.S. industry is subjected to the brisk wind of competition from Mexican firms subject to a lower level of environmental regulation, U.S. industry will soon suffer in competitive terms. The environmentalists' concern is that U.S. industry will then call for a reduction in the level of environmental regulation in the U.S., or perhaps will successfully block any increase.

n3 Subsidiarity is a principle of federalist government which holds (in the formulation that makes the most sense) that regulation should be effected at the level of government able to implement the social goal most efficiently. For a cogent review of varying definitions of subsidiarity, and of the origins of the principle, see MARC WILKE & HELEN WALLACE, SUBSIDIARITY: APPROACHES TO POWER-SHARING IN THE EUROPEAN COMMUNITY (1990).

n4 By "institutions," I mean any structure that provides predictability or regularity to human relations, from contracts to firms to governments to treaties to international organizations. The opposite of institutions in this sense is politics, the otherwise unconstrained exercise of market or other power. Contracts reflect elements of institutions as well as elements of the market.

n5 This Article assumes throughout that states are rational actors. This assumption obviously does not comport with the real world. However, states are at least partially rational actors, and perhaps the competition described here diminishes the ability of states to act irrationally, by exposing to the brisk wind of competition the eccentricities of irrational states.

n6 For a description of subsidiarity in the context of economic integration, see Joel P. Trachtman, *L'Etat, C'est Nous: Sovereignty, Economic Integration and Subsidiarity, 33 HARV. INT'L L.J. 459 (1992).*

n7 In a speech at The hague on May 16, 1992, Margaret Thatcher argued for unmitigated regulatory competition: "Instead of a centralized bureaucracy, the model should be a market -- not only a market of individuals and companies, but also a market in which the players are governments." Ronald Van de Krol & Philip Stephens, *Thatcher Attacks Pace of European Integration*, FIN. TIMES, May 17, 1992, at 1. Consistent with her views on regulation of business, Thatcher would appear to be unwilling to accept regulation of regulatory competition among states. While Thatcher concludes that no central (European Community-level) government is appropriate, she would accept the allocation of some responsibilities to supranational units on a strictly delegated basis.

n8 While this Article provides some examples of competition in regulation, it does not quantify the effects of this competition. On an international level, there is little documented quantitative evidence that a competition occurs; however, there is much evidence to indicate that countries consider the regimes of others, and their competitive effects, as they reform their regulation.

n9 The General Agreement on Tariffs and Trade, *opened for signature*, Oct. 30, 1947, 61 Stat. A3, 55 U.N.T.S. 187 [hereinafter GATT].

n10 It should be understood that the suppression of regulatory competition will often be intended to foster inter-firm competition. For example, in the European Community, regulatory harmonization is aimed at creating a single market, in order to provide the benefits of Community-wide competition. In addition to the internal benefits of this competition, one goal of this program is to create a bloc that can foster world class competitors with the United States and Japan. Thus, there are many possible levels of competition and cooperation, including the firm, the industry, the state, the region and the world. One of the questions posed is how can we determine at what level to compete and at what level to cooperate? This question is related to the idea expressed by strategic trade theorists that the United States should direct and muster its industries more actively, should have more inter-firm cooperation -- in order to be more effective as a competitor at the inter-state level. *See* Paul R. Krugman, *Is Free Trade Passe?*, J. ECON. PERSP., Fall 1987, at 135.

n11 *See* Jacques Pelkmans, *The New Approach to Technical Harmonization and Standardization*, 25 J. COMM. MKT. STUD. 249 (1987).

n12 *See* Trachtman, *supra* note 6, at 463-67, 470.

n13 There is an increasingly wide popular and scholarly literature on competitiveness. *See, e.g.*, MICHAEL PORTER, THE COMPETITIVE ADVANTAGE OF NATIONS (1991); ROBERT B. REICH, THE WORK OF NATIONS (1991); LESTER THUROW, HEAD TO HEAD (1992).

n14 GATT, *supra* note 9, art. XVI. The Director General of the GATT has written of subsidies generally:

A principal difficulty is to draw a distinction between subsidies granted by governments in pursuit of valid economic and social policies and those which, directly or indirectly, intentionally or unintentionally, have the effect of distorting world trade and depriving other countries of legitimate trade opportunities.

Another problem is to define "subsidy." Support given to an industry may go well beyond the simple grant of an export or a domestic subsidy. It could be argued that free State education, providing as it does the skills for industry, is a form of government subsidy.

REPORT BY THE DIRECTOR-GENERAL, THE TOKYO ROUND OF MULTILATERAL TRADE NEGOTIATIONS 54 (1979). The tasks identified above suffer from two difficulties: first, they are impossible, and second, they are insufficient, for, even if they were achieved, they would not solve the underlying problem. Merely to distinguish and define those subsidies that are not legitimately immanent in the separately justified regulatory system does not address the fact that those subsidies that are immanent may distort trade as well.

n15 Agreement on Interpretation and Application of Articles VI, XVI and XXIII of the General Agreement on Tariffs and Trade, *done* April 12, 1979, *31 U.S.T. 513*, 1186 U.N.T.S.

204 [hereinafter Subsidies Code]. For the background of the Subsidies Code, see Richard D. Rivers & John D. Greenwald, *The Negotiation of a Code on Subsidies and Countervailing Measures: Bridging Fundamental Policy Differences, 11 LAW & POL'Y INT'L BUS. 1447 (1979).*

n16 Treaty Establishing the European Economic Community (Treaty of Rome), Mar. 25, 1957, arts. 92-94, 298 U.N.T.S. 11 [hereinafter Treaty of Rome].

n17 This term was apparently introduced by *Justice Brandeis. Liggett Co. v. Lee, 288 U.S. 517, 559 (1933)* (Brandeis, J., dissenting).

n18 This term was apparently introduced by William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware, 83 YALE L.J. 663, 666 (1974).*

n19 *See infra* part III.

n20 Competitive deregulation, competitive failure to regulate, and regulatory subsidies will be referred to collectively herein as "regulatory competition."

n21 Former Vice President Quayle, as chairman of the White House Council on Competitiveness, led the Bush Administration's war on allegedly inefficient regulation. Former President Bush announced a 90-day moratorium on new regulations in his State of the Union address on January 28, 1992, and extended this moratorium for 120 additional days on April 29, 1992. This attack on regulation was justified by the need to increase the international competitiveness of the United States. *See* David Warner, *Regulation's Staggering Costs; Federal Regulation of Business*, NATION'S BUS., June 1992, at 50.

n22 For an elucidation of some of the economic and political science concepts involved in the topic of vertical competition, see ALBERT BRETON, CENTRALIZATION, DECENTRALIZATION AND INTERGOVERNMENTAL COMPETITION (1990). Professor Bebchuk has made the point that, at least in the area of corporate law, arguments for regulation may be equivalent to arguments for centralization of regulation. As discussed below, it is better to say that arguments for regulation are of the same type as arguments for centralization of regulation. Otherwise an absurd reduction of Professor Bebchuk's point would be that anything worth regulating is worth regulating under a worldwide centralized regime. *See* Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law, 105 HARV. L. REV. 1435 (1992).*

n23 In this sense, we can consider the economic basis for the state and for transnational organization as informed by the social contractarian problem of determining whether the state or some other type of organization -- firm, sub-state, or inter-state -- provides the greatest social goods for the lowest social costs.

n24 See DOUGLASS NORTH, STRUCTURE AND CHANGE IN ECONOMIC HISTORY (1981) for a discussion of the state as an economic institution.

n25 "Extraterritoriality" is commonly understood to mean the extension of jurisdiction to prescribe to conduct taking place abroad. As this term has many faults, including the pejorative connotations that many attach to it, it is used here merely as a shorthand for the problem of prescriptive jurisdiction. For a useful description of the problem of extraterritoriality, and references to some of the voluminous literature, see Lea H. Brilmayer, *The Extraterritorial*

Application of American Law: A Methodological and Constitutional Appraisal, 50 LAW & CONTEMP. PROBS. 11 (1987).

n26 JOINT REPORT OF THE U.S.-JAPAN WORKING GROUP ON THE STRUCTURAL IMPEDIMENTS INITIATIVE (1990). *See* Gary R. Saxonhouse, *Japan, SII and the International Harmonization of Domestic Economic Practices*, 12 MICH. J. INT'L L. 450, 465 (1991).

n27 *See Hills Urges Japan to Step Up Antitrust Enforcement and Increase Maximum Fines*, 9 Int'l Trade Rep. (BNA) No. 18, at 761 (Apr. 29, 1992).

n28 This claim was earlier made by a U.S. consumer electronics firm, unsuccessfully, in the celebrated *Matsushita case. Matsushita Electric Industrial Co. v. Zenith Radio Corp., 475 U.S. 574 (1986), rev'g In re Japanese Elec. Prod. Antitrust Litig., 723 F.2d 238 (3d Cir. 1983), rev'g Zenith Radio Corp. v. Matsushita Electric Industrial Co., 513 F. Supp. 1100 (E.D. Pa. 1981).*

n29 *Japanese Fair Trade Commission Orders Firms to Stop Bid-Rigging*, 9 Int'l Trade Rep. (BNA) No. 27, at 1135 (July 1, 1992) (Japanese Fair Trade Commission taking an aggressive enforcement posture with respect to the practice of *dango* (bid-rigging)).

n30 *See U.S. Broadens Enforcement Posture on Foreign Application of Sherman Act*, 9 Int'l Trade Rep. (BNA) No. 15, at 622 (Apr. 8, 1992); Joseph P. Griffin, *The Impact of Reconsideration of U.S. Antitrust Policy Intended to Protect U.S. Exporters*, 19 WORLD COMPETITION 5 (1992) (including as an annex the Apr. 3, 1992U.S. Department of Justice Policy Regarding Anticompetitive Conduct that Restricts U.S. Exports). In addition, legislation has been introduced in the U.S. Congress by Senator Metzenbaum to provide specific statutory causes of action in these types of cases. S. 2610, 102d Cong., 2d Sess. (1992). *See also Antitrust Enforcement Officials Discuss Problems of Acting Against Foreign Firms*, 9 Int'l Trade Rep. (BNA) No. 19, at 798 (May 6, 1992).

n31 *See United States v. Aluminum Co. of America, 148 F.2d 416 (2d Cir. 1945).* The literature on the effects test is voluminous. *See, e.g.*, Harold G. Maier, *Resolving Extraterritorial Conflicts or "There and Back Again," 25 VA. J. INT'L L. 7 (1984);* Karl Meessen, *Antitrust Jurisdiction Under Customary International Law*, *78 AM. J. INT'L L. 783 (1984);* Andreas Lowenfeld, *Public Law in the International Arena: Conflict of Laws, International Law, and Some Suggestions for Their Interaction*, 163 RECUEIL DES COURS 310 (1979).

n32 On the other hand, empowered Japanese consumers might complain about the requirements to pay higher prices due to anticompetitive practices. It might be appropriate to compare and net the amount of domestic externalization from the amount of international externalization.

n33 *See infra* part III.

n34 *See, e.g.*, HOMER MOYER, JR. & LINDA MABRY, EXPORT CONTROLS AS INSTRUMENTS OF FOREIGN POLICY, app. at 8, 9, 10 and 11 (1985) (discussing letters of protest regarding United States application of its export controls to European subsidiaries of U.S. companies and to technologies licensed to Europeans).

n35 *15 U.S.C. § § 61*-65 (1988).

n36 *15 U.S.C. § § 4001*-4021 (1988).

n37 *15 U.S.C. § § 6a*, 45(a)(3) (1988).

n38 *See* Spencer W. Waller, *The Ambivalence of United States Antitrust Policy Towards Single-Country Export Cartels*, 10 NW. J. INT'L L. & BUS. 98 (1989). The U.S. government and the Commission of the European Communities have recently signed an agreement on cooperation in antitrust enforcement that includes the concept of "positive comity." *See* Charles F. Rule, *European Communities-United States: Agreement on the Application of Their Competition Laws, 30 I.L.M. 1487 (1991).* Positive comity involves cooperation in enforcement in order to limit the ability of firms to engage in regulatory arbitrage, and represents a small but significant change in the beggarthy-neighbor approach to antitrust jurisdiction. *See* Joseph P. Griffin & Joel P. Trachtman, *U.S./EC Will Coordinate Investigations, Trade Info*, EUR. 1992 L. & STRATEGY, Jan. 1992, at 1.

n39 *See* S. REP. NO. 27, 97th Cong., 1st Sess. (1982); H.R. REP. NO. 686, 97th Cong., 2d Sess. (1982); H.R. REP. NO. 924, 97th Cong., 2d Sess. (1982) (conference report).

n40 Sir Leon Brittan, Competition Law: Its Importance to the European Community and to International Trade, Address at the University of Chicago Law School (Apr. 24, 1992) (transcript on file with author).

n41 There is significant concern that NAFTA could lead to a race to the bottom, by virtue of the reduction of tariff and non-tariff barriers. *See Environmental Group Coalition Proposes Stronger NAFTA Safeguards*, 9 Int'l Trade Rep. (BNA) No. 26, at 1097 (June 24, 1992). Former U.S. Trade Representative Carla Hills made assurances that this would not happen. *See USTR Hills Says There Will Be No "Downward Harmonization" Under NAFTA*, 9 Int'l Trade Rep. (BNA) No. 26, at 1096 (June 24, 1992).

n42 On October 25, 1991, Senator Max Baucus proposed that an environmental code and dispute settlement mechanism be negotiated under the auspices of GATT. It would be modelled on the Subsidies Code, *supra* note 15. Baucus suggested that while each state would be free to establish its own standard of environmental regulation, importing states would be able to use countervailing duties to balance the competitive effect of low levels of regulation. Three criteria would be applied. First, the importing state's standards would be required to have a sound scientific basis. Second, they must be applied to domestic production. Finally, only imported goods causing domestic injury would be countervailable. *Baucus Calls for Environmental Code in GATT Modeled After Subsidies Code*, 8 Int'l Trade Rep. (BNA) No. 43, at 1568 (Oct. 30, 1991); *Baucus Urges New GATT "Green" Round to Consider Proposed Environmental Code*, 8 Int'l Trade Rep. (BNA) No. 44, at 1620 (Nov. 6, 1991).

n43 The "polluter-pays" principle is both a statement of environmental policy that calls for states to require that their firms internalize the cost of pollution, and an anti-subsidy rule that strictly limits governments providing subsidies for environmental compliance. *See* OECD COUNCIL RECOMMENDATION ON THE IMPLEMENTATION OF THE POLLUTER-PAYS PRINCIPLE, Nov. 14, 1974, *reprinted in 14 I.L.M. 234 (1975).*

n44 Of course, life is not as simple as these categories of externalization might suggest; most regulatory regimes will have varying aspects of each of the three types of externalization.

n45 See Joel P. Trachtman, *United States -- Restriction on Imports of Tuna, 86 AM. J. INT'L L. 142 (1992)*, for a discussion of a recent GATT dispute resolution panel report which both raises these issues, and is the genesis of a renewed GATT interest in environmental affairs.

n46 Lawrence H. Summers, the chief economist of the International Bank for Reconstruction and Development (World Bank), has suggested that developing countries should, from an economic standpoint, engage in regulatory competition by accepting dirty industries from the developed world. This sad, but perhaps true, suggestion is premised on different preferences in the developing world, placing greater emphasis on industrial development and lesser emphasis on the environment. *See The Freedom to be Dirtier than the Rest; Why Differing Environmental Priorities Cause Problems for Trade*, ECONOMIST, May 30, 1992, at 7.

n47 *See* Joel P. Trachtman, *Recent Initiatives in International Financial Regulation and Goals of Competitiveness, Effectiveness, Consistency and Cooperation*, 12 NW. J. INT'L L. & BUS. 241 (1991). Trade in services, as opposed to trade in goods, has in the past been excluded from the operation of GATT. GATT itself presently deals almost exclusively with trade in goods. *See, e.g.*, JOHN H. JACKSON, LEGAL PROBLEMS OF INTERNATIONAL ECONOMIC RELATIONS 993-94 (1986). The current Uruguay Round negotiations include discussion of GATS: a "General Agreement on Trade in Services" that would operate parallel to GATT under the umbrella of a Multilateral Trade Organization. *See* Draft Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Annex II, GATT Trade Negotiations Committee Document MTN. TNC/W/FA (Dec. 20, 1991) [hereinafter Dunkel Draft].

n48 The regulatory problem is illustrated by the Bank of Credit and Commerce International (BCCI) scandal. *See* Daniel M. Laifer, Note, *Putting the Super Back in the Supervision of International Banking, Post-BCCI, 60 FORDHAM L. REV. 467, 479-89 (1992).* In response to the BCCI scandal, the Basle Committee on Banking Regulations and Supervisory Practices, under the leadership of Gerald Corrigan of the New York Federal Reserve Bank, has reinforced the Basle Concordat, which allocated authority and established principles regarding foreign bank supervision. Basle Committee on Banking Supervision, Minimum Standards for the Supervision of International Banking Groups and their Cross-Border Establishments (June 1992), *reprinted in* 55 INT'L PRACTITIONER'S NOTEBOOK 18-22 (Oct. 1992). *See also* Rod McNeil, *Basel Group's Bank Supervision Plan to Step Up International Coordination*, AM. BANKER, July 13, 1992, at 1.

n49 *See* Robert D. Putnam, *Diplomacy and Domestic Politics: The Logic of Two-Level Games*, 42 INT'L ORG. 427 (1988).

n50 Institutional change can move the "Pareto frontier" of efficiency, in the same way that technological innovation can. *See* Guido Calabresi, *The Pointlessness of Pareto: Carrying Coase Further, 100 YALE L.J. 1211 (1991).*

n51 Regulatory competition does not require the possibility of regulatory arbitrage, simply because the goal of states may not be to attract or retain the presence of firms, but to make their own firms more competitive.

n52 *See* RESTATEMENT (THIRD) OF THE LAW OF FOREIGN RELATIONS OF THE UNITED STATES § § 402-403 (1987) [hereinafter RESTATEMENT] for an elaboration of a system of bases for jurisdiction, as well as a reasonableness test for determining when, in the event of overlaps, jurisdiction should not be exercised.

n53 It is critical to recognize that competition in regulation is a derivative of, and is based upon, competition among firms: it assumes that firms are subject to competitive disciplines and are seeking the lowest-cost means to produce. One way in which a firm seeks the lowest-cost

means to produce is by arranging its operations and affairs so as to incur the lowest regulatory costs possible. Accordingly, if it has the requisite mobility and information, and if the costs of obtaining necessary information and moving do not outweigh the benefits, a firm will move to the jurisdiction with lower regulatory costs, *ceteris paribus*.

n54 The general United States conflict of laws rule regarding the internal affairs of corporations is that the law of the state of incorporation governs its internal affairs. *See* Deborah A. DeMott, *Perspectives on Choice of Law for Corporate Internal Affairs*, 48 LAW & CONTEMP. PROBS. 161 (1985); Richard M. Buxbaum, *The Origins of the American "Internal Affairs" Rule in the Corporate Conflict of Laws in* FESTSCHRIFT FUR GERHARD KEGEL ZUM 75. GEBURTSTAG 75, 86 (H.-J. Musiak & K. Schurig eds., 1987). On the other hand, states may determine not to apply this rule where it contravenes a strong public policy, or pursuant to a "pseudo-foreign" corporation statute such as that of California or New York. *See* CA. CORP. CODE § 2115 (1988); N.Y. BUS. CORP. LAW § 1306 (McKinney 1989).

n55 Civil law states generally refer not necessarily to the law of the state of incorporation, but, for example, to the law of the state of the *siege social* under French law or the *Geschaftssitz* or *Sitz* under German law. These concepts, sometimes referred to as the "seat" rule, are less formalistic than the U.S. rule, and depend on a number of factors. See David Charny, *Competition Among Jurisdictions in Formulating Corporate Law Rules: An American Perspective on the "Race to the Bottom" in the European Communities, 32 HARV. INT'L L.J. 423, 428-30 & nn. 15-20 (1991),* for a description of the European systems. *See also* Andreas Reindl, *Companies in the European Community: Are the Conflict of Law Rules Ready for 1992?*, 11 MICH. J. INT'L L. 1270 (1990); Dimitris Tzouganatos, *Private International Law as a Means to Control the Multinational Enterprise*, 19 VAND. J. TRANSNAT'L L. 477 (1986). The "seat" rule generally mandates that the internal affairs of a corporation shall be subject to the laws of the state in which the corporation's principal seat is located. This rule was recently found to be consistent with the European Community's right of establishment. Case 81/87, The Queen and H.M. Treasury and Commissioners of Inland Revenue *ex parte* Daily Mail and General Trust PLC, 1988 E.C.R. 5483, Common Mkt. Rep. (CCH) P14,510 (1988).

n56 Party autonomy in choice of governing law may be viewed as applicable to the extent that the "effects doctrine" -- providing prescriptive jurisdiction to the sovereign in whose territory adverse effects occur -- is not applied. *See supra* notes 30 and 31. Limiting prescriptive jurisdiction in antitrust to the sovereign in whose territory conduct occurs allows enterprises to plan the governing law of their actions and avoid the jurisdiction of the country in which the adverse effects are felt. See the discussion of "positive comity" *supra* note 38.

n57 Nationality of the taxpayer is an important, but not necessarily determinative, criterion in determining tax jurisdiction.

n58 To the extent that mutual recognition of foreign financial regulation is provided, as, for example, under the European Community's Second Banking Directive or under the U.S.-Canada Multijurisdictional Disclosure System, the choice of initial jurisdiction of establishment or licensing may determine the governing law. See the discussion of the revised Basle Concordat in McNeil, *supra* note 48.

n59 For some examples and references, see, e.g., Bebchuk, *supra* note 22; Alfred F. Conard, *The European Alternative to Uniformity in Corporation Laws, 89 MICH. L. REV. 2150 (1991);* Charny, *supra* note 55, at 423-56; David Schaffer, *Delaware's Limit on Director Liability: How*

the Market for Incorporation Shapes Corporate Law, 10 HARV. J.L. & PUB. POL'Y 665 (1987); Barry D. Baysinger & Henry N. Butler, *Race for the Bottom Versus Climb to the Top: The ALI Project and Uniformity in Corporate Law, 10 J. CORP. L. 431 (1985);* Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle,* 1 J.L. ECON. ORG. 225 (1985) [hereinafter *Law as a Product*].

n60 *See, e.g.*, Cary, *supra* note 18, at 696-703; Joel Seligman, *The Case for a Federal Corporate Charter, 49 MD. L. REV. 947 (1990).* This view has been widely criticized, *inter alia,* on the grounds that it fails to recognize that centralized or harmonized regulation may be subject to similar interest group politics and that it fails to recognize the countervailing effect of shareholders' ability to discipline corporations.

n61 *See* Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporation Law, 65 TEX. L. REV. 469 (1987).*

n62 Roberta Romano, *The State Competition Debate in Corporate Law, 8 CARDOZO L. REV. 709, 712 (1987)* [hereinafter *State Competition Debate*]. This position is borne out to some extent by the fact that disclosure required of public corporations does not specifically include disclosure regarding the general corporation law of the jurisdiction of incorporation: either potential shareholders are independently charged with knowledge of such law, or variations are deemed relatively immaterial (at least by the Securities and Exchange Commission), or, most likely, both explanations are operative. *See* Regulation S-K, 17 C.F.R. § 229.202 (1991) (requiring disclosure regarding the registrant's securities, but not specifically calling for disclosure regarding the shareholder's rights as a shareholder under the law of incorporation).

n63 This is the "race for the top" school. *See, e.g.*, RALPH K. WINTER, GOVERNMENT AND THE CORPORATION (1978); Peter Dodd & Richard Leftwich, *The Market for Corporate Charters; "Unhealthy Competition" Versus Federal Regulation,* 53 J. BUS. 259 (1980); Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law, 26 J.L. & ECON. 395 (1983). See also* Romano, *Law as a Product, supra* note 59. The top generally refers to corporate law rules that maximize shareholder value, not necessarily social interests as a whole. For a recent review of the literature, and revised law and economics approach analyzing certain failures of the market to maximize shareholder value, which includes an expanded view of the goalsof corporation law, see Bebchuk, *supra* note 22.

n64 *See, e.g.*, Dodd & Leftwich, *supra* note 63; Easterbrook & Fischel, *supra* note 63, at 398, 401-03.

n65 They may do so either through exercising a voice in a proxy contest, or by voting with their feet by investing in other corporations. In the latter regard, shareholders may use the market mechanism to vote with their dollars and discount the value of shares of companies incorporated in states with lax corporate laws, declining to buy, or selling, unless they are adequately compensated for the costs allocated to them by virtue of lax corporate law. *See* ALBERT HIRSCHMAN, EXIT, VOICE, AND LOYALTY -- RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES (1970).

n66 One important factor is the concentration of share ownership, and its institutional, as opposed to individual, character. Institutional investors are very active in monitoring and disciplining the terms of corporate debt, and in discounting for terms that are adverse to them. The impact of corporate law rules on shareholders may be analogized to the terms of corporate

debt for creditors or bondholders. The terms of debt are determined by contract to a greater extent than are the terms of a corporate charter, although the terms of debt are affected by both state corporate and commercial law, on the one hand, and federal securities law, on the other hand.

n67 This concern regarding the role of shareholders to affect corporate decisions is most important with respect to those issues in which there are conflicts of interest between management and shareholders; these conflicts of interest distinguish corporate law from other areas of regulation, in which we generally assume a unitary corporate actor.

n68 Professor Romano's work is at the core of this third school. *See Law as a Product, supra* note 59, at 225-83; *State Competition Debate, supra* note 62, at 709-57.

n69 *See* Bebchuk, *supra* note 22, at 1456 n.80 (citing Romano, *Law as a Product*).

n70 The empirical evidence, even in the Delaware phenomenon literature, is meager, weak, and of questionable relevance. Most of it centers around the question of whether stock prices decline in conjunction with reincorporations (apparently they do not). *See* Dodd & Leftwich, *supra* note 63, at 281-86; Romano, *Law as a Product, supra* note 59, at 279. See also Professor Bebchuk's criticism of the utility of this evidence, Bebchuk, *supra* note 22, at 1448-51. It would be more useful, in any event, to assess the behavior of legislatures -- to know under what circumstances concerns regarding regulatory competition result in the adoption or non-adoption by legislatures of a specific rule.

n71 Benefits may be measured as increments to the welfare of society as a whole, assessing all of the benefits and detriments to society. One question that might be asked is, which society is our reference: local, state, national, or transnational? In our discussion of subsidiarity below, we argue that the reference should be not societies but individuals: that welfare must be measured from the individual on up, accepting a "greatest good for the greatest number" calculus (hopefully incorporating a definition of "good" broad enough to encompass a long-term perspective and empathy for others). For other perspectives on the measurement of benefits, see *Symposium on Efficiency as a Legal Concern, 8 HOFSTRA L. REV. 485 (1980).*

n72 *See, e.g.*, RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 343-46 (1986). Posner points out, however, that the failure is best looked at as a failure of both the market and the legal rules.

n73 Bebchuk makes a related point: "these benefits of state competition are simply a special case of the familiar point that, as long as competition operates to reward producers of the best product, competition is socially desirable." Bebchuk, *supra* note 22, at 1457.

n74 Charny, *supra* note 55, at 435-56.

n75 Bebchuk, *supra* note 22, at 1440.

n76 This discussion is informed by David Charny's careful analysis. *See* Charny, *supra* note 55, at 441-56. We follow Charny's approach of distinguishing among different types of rules in order to assess the dynamics of potential regulatory competition, recognizing that the costs and benefits of centralization described below are implicated differently for each rule.

n77 An economic theory of federalism would argue that competition among regulators should lead to efficient regulation. Richard Posner, *The Constitution as an Economic Document, 56 GEO. WASH. L. REV. 4, 13-15 (1987).*

n78 Institutional or regulatory reform may reduce regulatory costs without sacrificing social goals. *See* Calabresi, *supra* note 50, at 1211-37.

n79 Interestingly, as noted above, the arguments for decentralization among governments are also the arguments for deregulation -- decentralization from government to firms. This point is made by Bebchuk, *supra* note 22, at 1497-98. The firm believes that it can achieve the regulatory goal more effectively when left alone, or that it can externalize the cost that the regulation is seeking to contain. Society has an interest in fostering enhanced effectiveness and limiting externalization. Regulatory architecture that allows maximum effectiveness (through competition or otherwise) with minimum externalization is to be desired. Bebchuk argues that the justifications for regulation support limiting competition among states. It is true that the points are related, but there are still significant reasons to have regulation where one might not want centralization.

n80 The concept of differential mobility discussed in the fiscal competition literature, *infra* part II, describes the same phenomenon.

n81 *See* discussion of subsidiarity *infra* part IV.

n82 We may consider the European Community's essential harmonization approach to standards as an example of negotiation among (at least) twelve social structures, aimed at determining the correct level of regulation of various standards. *See supra* notes 3 and 6 and accompanying text for discussion of subsidiarity.

n83 *New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932)* (Brandeis, J., dissenting).

n84 While this is obvious in theory, Professor Bebchuk believes that the size of any benefits from standardization is likely to be small, especially in comparison to the benefits of competition. He also argues, based on standardization among states around Delaware corporation law, that standardization can arise from competition, and need not be imposed. Bebchuk, *supra* note 22, at 1494.

n85 *See* RONALD COASE, THE FIRM, THE MARKET AND THE LAW 37-47 (1988).

n86 Charny, *supra* note 55, at 437-38.

n87 In other words, if they have the ability to compare regulatory systems and address regulatory arbitrage, *a fortiori*, they should have the ability to evaluate and address the risks the regulation addresses.

n88 It is unlikely, although not impossible, that the protected party would be able to police one activity of management but not the other.

n89 Subsidiarity responds to the question of what is the most efficient level at which to regulate. *See infra* part IV.

n90 It is an interjurisdictional transaction cost, in the same sense that the cost of contracting is an inter-firm transaction cost.

n91 Professor Bebchuk argues in favor of extraterritoriality on the basis of a "substantial fraction" of U.S. shareholders, in order to prevent evasion of federal law, although he also recognizes the problems with and alternatives to extraterritoriality. Bebchuk, *supra* note 22, at 1508-09 n.213.

n92 Thus, we see the inclusion of mutual assistance provisions in bilateral tax treaties, the conclusion of memoranda of understanding regarding mutual assistance in the securities regulation realm, and the development of the notion of positive comity in the antitrust sphere. *See* Griffin & Trachtman, *supra* note 38.

n93 *See supra* note 48 and accompanying text.

n94 Bebchuk, *supra* note 22, at 1484.

n95 *Id.*

n96 "Blue sky" laws are state securities laws that coexist with federal securities laws but often adopt a different or additional regulatory approach: merit regulation. Merit regulation imposes substantive requirements for access to the capital market in addition to the federally-mandated disclosure. *See, e.g.*, Mark A. Sargent, *State Disclosure Regulation and the Allocation of Regulatory Responsibilities, 46 MD. L. REV. 1027 (1987).* Merit regulation might restrict access by companies that had been subjected to self-dealing or taking of corporate opportunities by management.

n97 *See* § 16(b) of the Securities Exchange Act of 1934, *15 U.S.C. § 78p*(b) and Rule 10b-5 under the Securities Exchange Act of 1934, 17 C.F.R. § 240.10b-5 (1991) (prohibiting insider trading).

n98 *See* Item 404 of Regulation S-K under the securities laws, 17 C.F.R. § 224.404 (1991). The disclosure requirements cover self-dealing directly, but do not directly cover taking of corporate opportunities. However, general disclosure standards would indicate that any such taking that is material must be disclosed.

n99 Most countries ameliorate double taxation through unilateral deference by virtue of a credit for foreign taxes on foreign source income or an exclusion for foreign source income. The effectiveness of these mechanisms depends, *inter alia*, on the definition of foreign source income. *See, e.g.*, SOL PICCIOTTO, INTERNATIONAL BUSINESS TAXATION 58-63 (1992).

n100 *See* Barry Hawk, *European Economic Community Merger Regulation, 59 ANTITRUST L.J. 457 (1991).*

n101 Of course, states may also defer on a unilateral basis, as the United States and other states do in the tax area, with foreign tax credits and exemptions for foreign income. However, their actions are not purely unilateral, as they expect at least a generalized level of reciprocity.

n102 "False conflict" generally refers to any circumstance where, despite the fact that some nexus exists between the subject matter of adjudication and more than one state, only one state has any real interest. *See* ARTHUR VON MEHREN & DONALD TRAUTMAN, THE LAW OF MULTISTATE PROBLEMS 120-21 (1965). Harmonization would result in a different type of false conflict: one where the interests of both states involved are the same.

n103 *See* STANLEY S. SURREY & PAUL R. McDANIEL, TAX EXPENDITURES (1985). *See also* Victor Thuronyi, *Tax Expenditures: A Reassessment, 1988 DUKE L.J. 1155 (1988).*

n104 I.R.C. § 7701(a)(4) (1988) (defining domestic corporations as corporations organized in the United States or under the laws of the United States or any state thereof). Domestic

corporations are taxed on their worldwide income, subject to a foreign tax credit. On the other hand, most U.S. income of foreign corporations is subject to taxation.

n105 Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956).

n106 *Id.* at 418.

n107 This set of assumptions is probably adaptable to firms choosing their site of operations. Professor Shaviro questions the presence of the facts underlying these assumptions, especially with respect to the choices of individuals. Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation, 90 MICH. L. REV. 895, 963 (1992)* (citing David Lowery & William E. Lyons, The *Impact of Jurisdictional Boundaries: An Individual-Level Test of the Tiebout Model*, 51 J. POL. 73 (1989)).

n108 Jeffrey Atik, *Investment Contests and Subsidy Limits in the European Community*, 32 VA. J. INT'L L. (forthcoming 1992).

n109 Tiebout, *supra* note 105, at 423. Two forms of public good and two forms of externality are involved. First, there are public goods that firms want, like education, police protection, or infrastructure. These may be difficult to restrict to a given community. Second, there are regulatory public goods to which firms would rather not be subjected, but which they are able to avoid. Here the externality arises because unregulated firms impose a cost on the community, precisely because they are not regulated by the community. Both types of externality would appear to call for cooperation, if not integration. Professor Bebchuk reaches a similar conclusion in his analysis of state corporation law: "the fundamental difference between federal and state [corporation] law is this: if the former provides protection to parties other than shareholders, shareholders cannot easily avoid its reach, whereas if the latter does so, they can." Bebchuk, *supra* note 22, at 1486.

n110 By analyzing each item of regulation in terms of its costs and benefits to the relevant person, one might easily extend the Tiebout model to include regulation more generally,. This would require a much more complex calculation.

n111 Tiebout, *supra* note 105, at 422. *See also* HIRSCHMAN, *supra* note 65, at 15-20 (concerning the market emphasis on exit, versus the political emphasis on voice).

n112 Tiebout, *supra* note 105, at 423.

n113 *Id.*

n114 The main limitations would appear to remain in the areas of mobility and information.

n115 Peggy Musgrave & Richard Musgrave, *Fiscal Coordination and Competition in an International Setting, in* INFLUENCE OF TAX DIFFERENTIALS ON INTERNATIONAL COMPETITIVENESS: PROCEEDINGS OF THE VIIITH MUNICH SYMPOSIUM ON INTERNATIONAL TAXATION 61, 64 (Munich Symposium on International Taxation ed., 1990).

n116 The neutrality of fiscal systems that can ameliorate this problem is often referred to, with some variations, as capital import neutrality and capital export neutrality. Capital import neutrality is a territoriality-based neutrality and calls for all investors -- foreign and domestic -- to be taxed the same on their activities in the local economy. Capital export neutrality is a

nationality-based neutrality and calls for local persons to be taxed the same on domestic and foreign investment. *See, e.g.*, Peter E. Gumpel, *The Taxation of American Business Abroad -- Is Further Reform Needed?*, 15 J. INT'L L. & ECON. 389, 396-401, 405-07, 411-15, 427-29 (1981), and sources cited therein. These aspects of neutrality are often inconsistent with one another. *Capital export neutrality is completely inconsistent with fiscal competition*.

n117 This type of neutrality is often referred to as national neutrality. *Id.* The Tiebout model demands national neutrality, as otherwise the discipline on governments would be skewed by less than neutral allocation of tax revenues.

n118 The Musgraves' criticism is based on the assumption that higher tax rates should not be factored into the determination of the optimal allocation. However, higher tax rates and higher regulatory costs are an element of institutional economic competition, and should be factored into the determination of optimal allocation.

n119 Musgrave & Musgrave, *supra* note 115, at 66.

n120 HORST SIEBERT, THE SINGLE EUROPEAN MARKET -- A SCHUMPETERIAN EVENT 6 (Kiel Discussion Paper No. 157) (1989). Siebert goes on to state that "the arbitrage of consumers and firms will clearly reveal which national regulatory system is best in the eyes of the consumer or the producer: national regulation has to pass a litmus test of private agents voting with their purses and with their feet. Accordingly, there will be pressure on national regulations to adjust over time." *Id.*

n121 In this sense, this point is the same as the second inefficiency described by the Musgraves, as mentioned above: failure of inter-nation equity due to inaccurate rules of fiscal jurisdiction.

n122 Musgrave & Musgrave, *supra* note 115, at 70 (emphasis added).

n123 Like Charny in the context of corporate law, the Musgraves recognize the need for a typology of taxes, with different taxes treated differently along the continuum of competition and cooperation. Musgrave & Musgrave, *supra* note 115, at 71.

n124 In part IV, we explore how the principle of subsidiarity provides a methodology and a set of principles for use in answering this question.

n125 Here I assume that one of the following generally recognized bases for jurisdiction is used: territoriality of conduct, nationality of actors, territoriality of effects, or nationality of affected persons. These are bases for jurisdiction because they implicate a state's interests. *See* RESTATEMENT § § 402 and 403 (1987).

n126 *See supra* note 55 and accompanying text.

n127 *See* PICCIOTTO, *supra* note 99, at 4-14. *See also* Yitzhak Hadari, *The Choice of National Law Applicable to the Multinational Enterprise and the Nationality of Such Enterprises, 1974 DUKE L.J. 1, 25-31 (1974).*

n128 By prescriptive jurisdiction, we mean here less the formal bases for prescriptive jurisdiction as described in § 402 of the RESTATEMENT, than the bases of prescriptive jurisdiction based on "reasonableness" articulated in § 403 of the RESTATEMENT.

n129 Charny recognizes the possibility that, particularly in Germany, stakeholders such as employees and bank creditors may have more influence over incorporation decisions than in the U.S. Charny, *supra* note 55, at 439.

n130 This perspective is striking in comparison to the perspective of international trade, where the state's direct tax revenues are of minimal concern. Indeed, the entire topic of state subsidization entails the perceived need to discipline expenditures from public funds that enrich foreign consumers, but may damage foreign competitors. *See infra* part IV.

n131 I use principal place of business as the most common reference, but *siege social*, head office or other bases for substantive corporate connection would work just as well.

n132 *See supra* note 54.

n133 *See* sources cited *infra* note 161.

n134 In fact, one might argue that U.S. securities law deals with the public policy issues -- corporate law as it affects the integrity and efficiency of the capital market -- while leaving the private law issues to state corporation law. Of course, this public/private distinction is relatively porous.

n135 *See supra* text accompanying notes 130-134.

n136 *See* SURREY & McDANIEL, *supra* note 103, 1-6.

n137 Thus, the firm will bundle the various regulatory attributes and business attributes of each jurisdiction and choose among the various packages. *See*David W. Leebron, *A Game Theoretic Approach to the Regulation of Foreign Direct Investment and the Multinational Corporation, 60 U. CIN. L. REV. 305 (1991).*

n138 *See* Romano, *Law as a Product, supra* note 59, at 233; Romano, *The State Competition Debate, supra* note 62, at 720-25.

n139 All jurisdictions prescribe at least some mandatory rules, but they are generally only applicable to corporations formed under local corporation law. For a discussion of the role of mandatory rules, see, e.g., Roberta Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws, 89 COLUM. L. REV. 1599 (1989);* Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments, 102 HARV. L. REV. 1820 (1989).*

n140 In fact, they may be sellers of real products, as a seller of pesticides will consider the potential regulatory costs and tort liability that would apply if it sells its product in a particular jurisdiction.

n141 *See* HIRSCHMAN, *supra* note 65, at 21-29.

n142 *See* the discussion of user fees in Shaviro, *supra* note 107, at 903-07.

n143 This is an extension of Tiebout's point that integration may be necessitated by externalities. Tiebout, *supra* note 105, at 423.

n144 We may compare bundling of public goods with tying of private goods, which may be prohibited under antitrust or competition laws, for similar reasons.

n145 Choice of law is of course permitted with respect to the governing law of contracts, andso, in this sense, private persons can use law facultatively. They can select the bodies of

applicable law, the way a lawyer might select a boilerplate contract. They may even use *depecage* to provide for split choice of law. Choice of law clauses, however, are not particularly effective in choosing the applicable public or regulatory law (mandatory law), except in marginal ways. For example, U.S. securities laws contain anti-waiver provisions. *See, e.g.*, § 14 of the Securities Act of 1933, *15 U.S.C. § 77n* (1988). However, this inflexible approach is not necessarily the best where all affected persons exercise an informed choice. It may be acceptable to allow a U.S. investor in securities to waive the protections of the Securities Act of 1933. The Securities and Exchange Commission has changed its international rules to do just that in more and more circumstances. *See* Trachtman, *supra* note 47, at 295-96. In addition, the U.S. Supreme Court has shown growing solicitude to choice of law and forum clauses. *See Scherk v. Alberto-Culver, 417 U.S. 506 (1974)* (upholding an arbitration clause in an international contract, despite § 14 of the Securities Act); *Mitsubishi Motors v. Soler Chrysler-Plymouth, 473 U.S. 614 (1985)* (similar in antitrust context); *Carnival Cruise Lines, Inc. v. Shute, 111 S. Ct. 1522 (1991)* (upholding choice of forum clause contained in boilerplate included with ticket, between two U.S. parties, despite serious inconvenience).

n146 *See, e.g.*, N.Y. GEN. OBLIGATIONS LAW § 5-1401 (McKinney 1989), providing for the enforcement of choice of law clauses in connection with certain types of contracts, regardless of connection with the state of New York. *See also Committee Report by the Committee on Foreign and Comparative Law of The Association of the Bar of the City of New York* (Gruson, Subcommittee Chair), *Proposal for the Mandatory Enforcement of Governing-Law Clauses and Related Clauses in Significant Commercial Agreements*, 38 REC. A.B. CITY N.Y. 537 (1983).

n147 COASE, *supra* note 85, at 7, 33-55 (reprinting Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937)).

n148 This process occurs through institutions such as the European Community and GATT. Reductions of sovereignty need not be large, dramatic, or substantive. Numerous small, pedestrian, or procedural -- and especially jurisdictional -- instances of cooperation may suffice.

n149 A remaining question is what incentives the state has to maximize citizen welfare at the expense of the state's autonomy. Perfect democracy would presumably make this question unnecessary. However, even without perfect democracy, the incentives include the discipline of imperfect democracy, fortified by greater dissemination of information regarding the relative success of other states, as well as greater international trade.

n150 Of course, international externalization is not directly a subsidy, but could be considered worse than a subsidy as it transfers the cost of the assistance to foreign persons.

n151 This is done with relative effectiveness by the Basle Committee on Banking Regulations and Supervisory Practices, in connection with supervisory responsibility and capital requirements in the commercial banking area. The International Organization of Securities Commissioners (IOSCO) seeks to emulate the Basle Committee. The European Community centralizes regulation as part of its harmonization process. Harmonization is negotiated in order to form the predicate for mutual recognition and free trade. As a necessary part of this process, the member states consider the extent to which mutual recognition and free trade will impair the competitiveness of their local enterprises and negotiate harmonization at a level that compromises among three considerations: (i) the substantive domestic regulatory goal, (ii) competitiveness of local enterprises, and (iii) the international political and economic need to continue the process of harmonization and free trade.

n152 *See supra* note 14.

n153 As we will discuss below, this does not mean that "real" subsidies have been effectively addressed. In fact, they have not been.

n154 Another way to attempt to determine the extent of regulatory subsidy is by measuring the extent to which the regulation applied is the least subsidizing means of accomplishing the independent regulatory goal. However, this test would require a highly intrusive inquiry into the regulatory goal and scrutiny of the means of implementation selected.

n155 *See, e.g.*, JAGDISH BHAGWATI, THE WORLD TRADING SYSTEM AT RISK (1991).

n156 *See* Dunkel Draft, *supra* note 47. Besides discussing the above mentioned "General Agreement on Trade in Services," the Uruguay Round negotiations also include proposals on trade-related investment measures (TRIMS) and trade-related intellectual property measures (TRIPS).

n157 Environmentalists have criticized the outcome of a recent GATT panel decision finding inconsistent with GATT rules the U.S. Marine Mammals Protection Act, Pub. L. No. 92-522, § 2, 86 Stat. 1027 (1972), *16 U.S.C. § § 1361*-1362, 1371-1384, 1401-1407 (1988), *as amended by* Fishery Conservation Amendments of 1990, Pub. L. No. 101-627, 104 Stat. 4436, 4467 (1990) [hereinafter MMPA]. *See* United States -- Restrictions on Imports of Tuna, No. DS21/R, *reprinted in 30 I.L.M. 1598 (1991). See also* Joel P. Trachtman, *International Decisions: GATT Dispute Settlement Panel, 86 AM. J. INT'L. L. 142 (1992).*

n158 *See* Dunkel Draft, *supra* note 47. *See also* JOHN H. JACKSON, RESTRUCTURING THE GATT SYSTEM. (1990).

n159 GARY C. HUFBAUER & JOANNA SHELTON ERB, SUBSIDIES IN INTERNATIONAL TRADE 8 (1984). Interestingly, the authors reject economic theory in favor of historical experience as a basis of policy. They argue that the Great Depression experience demonstrates that competing protectionism and mercantilism undermine world prosperity.

n160 *Id.* John Jackson makes a similar argument. John H. Jackson, *Perspectives on Countervailing Duties, 21 LAW & POL'Y INT'L BUS. 739, 742 (1990):* "The unfettered use of subsidies in international trade can lead to counter-subsidies, and counter-counter-subsidies in an escalating progression, all of which can seriously damage world welfare." These arguments are used to counter the arguments from an economic welfare perspective that the target of subsidies should "send a thank you note" to the subsidizing government. *See* Alan O. Sykes, *Countervailing Duty Law; An Economic Perspective, 89 COLUM. L. REV. 199 (1989).*

n161 For an explanation of the prisoner's dilemma, see R. DUNCAN LUCE & HOWARD RAIFFA, GAMES AND DECISIONS (1957). *See also* ROBERT M. AXELROD, THE EVOLUTION OF COOPERATION 27 (1984). Essentially, the prisoner's dilemma is a game theoretic illustration of a circumstance in which each player's individual choices are less attractive in an aggregate sense than cooperation; if the players fail to cooperate, their aggregate welfare is diminished. The prisoner's dilemma assumes the inability of the players to communicate with one another or to enter into binding agreements to control future behavior; neither of these assumptions is strictly applicable to international society. To the extent that international economic relations is not a prisoner's dilemma, cooperative behavior, where it is

optimal may prevail. In this sense, the expansion of institutions to foster communications and enforcement of agreements may provide benefits.

n162 For an argument that countervailing duty law serves little purpose and may damage the country imposing them,see Sykes, *supra* note 160.

n163 *See generally* Kenneth S. Komoroski, *The Failure of Governments to Regulate Industry: A Subsidy Under the GATT?*, 10 HOUSTON J. INT'L L. 189 (1988) (arguing that minimum environmental regulation standards exist and that government failure to enforce these standards confers an unfair benefit on industry, giving rise to permissible countervailing duties under GATT).

n164 GATT, *supra* note 9, art. XVI.

n165 Section A, labelled "Subsidies in General," applies to any subsidy that operates directly or indirectly to increase exports or to reduce imports. On the other hand, section B, labelled "Additional Provisions on Export Subsidies," purports to cover a narrower group of subsidies: direct or indirect subsidies "on the export of" any product.

n166 These were Austria, Belgium, Canada, Denmark, France, Federal Republic of Germany, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Federation of Rhodesia and Nyasaland, Sweden, Switzerland, the United Kingdom, and the United States.

n167 *See* HUFBAUER & SHELTON ERB, *supra* note 159, at 46-48.

n168 This approach was carried forward in article 4(1) of the Subsidies Code: "it is desirable that the imposition [of countervailing duties] be permissive in the territory of all signatories." Subsidies Code, *supra* note 15.

n169 Subsidies Code, *supra* note 15.

n170 Subsidies Code, *supra* note 15, second recital, art. 11(1) (signatories "do not intend to restrict the right of signatories to use such [domestic] subsidies to achieve" important social, economic policy, and other objectives).

n171 Subsidies Code, *supra* note 15, arts. 1-6.

n172 Subsidies Code, *supra* note 15, arts. 11(2), 17-18.

n173 Subsidies Code, *supra* note 15, art. 9(1).

n174 *See infra* note 187.

n175 Subsidies Code, *supra* note 15, art. 9(2), Annex points (a)-(k).

n176 Subsidies Code, *supra* note 15, Annex point (l).

n177 Subsidies Code, *supra* note 15, art. 11(1).

n178 Subsidies Code, *supra* note 15, art. 11(3).

n179 Subsidies Code, *supra* note 15, art. 11(4).

n180 Article 11(2) of the Subsidies Code, *supra* note 15, establishes the basis for action against nonprohibited domestic subsidies, stating that they may "cause or threaten to cause injury to a domestic industry of another signatory . . . or may nullify or impair benefits accruing to another signatory under the General Agreement, *in particular where such subsidies would*

adversely affect the conditions of normal competition" (emphasis added). For a discussion of possible causes of action, see Robert Hudec, *Regulation of Domestic Subsidies Under the MTN Subsidies Code, in* INTERFACE THREE: LEGAL TREATMENT OF DOMESTIC SUBSIDIES 1-18 (Don Wallace, Jr. et al. eds., 1984).

n181 *See Second Report of the Group of Experts on Anti-Dumping and Countervailing Duties, reprinted in* 9th Supp. BISD 200 (1961) (permission of subsidies under article XVI does not debar the imposition of countervailing duties under article VI). For a discussion of the use of countervailing duties in combination with nullification and impairment and other actions, see Hudec, *supra* note 180, at 16-17.

n182 For a detailed discussion of the definition of "subsidy," see HUFBAUER & SHELTON ERB, *supra* note 159, at 45-110. It is not clear that the illustrative list of export subsidies included in the Annex to the Subsidies Code may be used to assist in determining what are domestic subsidies, or for that matter other countervailable subsidies. Jackson notes that "some signatory countries believe that the definition of 'subsidy' for Track II purposes, does not necessarily apply to Track I." Jackson, *supra* note 160, at 747. Track I relates to the procedures for implementation of countervailing duties under Part I of the Subsidies Code. Track II relates to the procedures for dispute resolution regarding export subsidies, injury-causing subsidies, and subsidies causing nullification and impairment. *See* Konstantinos Adamantopoulos, *Subsidies in External Trade Law of the EEC: Towards a Stricter Legal Discipline*, 1990 EUR. L. REV. 427 (1990).

n183 *See supra* text accompanying notes 25-48.

n184 Subsidies Code, *supra* note 15, Annex point (1).

n185 It is not clear whether this language may be read as limiting the other provisions of the Annex to those activities constituting a charge on the public account. In a 1962 report, a GATT Panel of Experts indicated that a charge on the general public account is not required to constitute a subsidy. *Review Pursuant to Article XVI:5*, GATT doc. L/1160 of 24 May 1960, *reprinted in* 9th Supp. BISD 188 (1961). The Dunkel Draft would reverse this proposition, requiring "a financial contribution by a government or any public body." Dunkel Draft, *supra* note 47, at I. 1.

n186 Subsidies Code, *supra* note 15, Annex points (e), (f), (g), (h), and (i).

n187 See *Report of the Panel on Subsidies on the Operation of the Provisions of Article XVI*, GATT doc. L/1442 & Add. 1-2 of 21 Nov. 1961, *reprinted in* 10th Supp. BISD 201, 208 (1962), in which the Panel noted the absence of a general definition of the term "subsidy" in the GATT and
considered that it was neither necessary nor feasible to seek an agreed interpretation of what constituted a subsidy. It would probably be impossible to arrive at a definition which would at the same time include all measures that fall within the intended meaning of the term in Article XVI without including others not so intended . . . .

n188 *Report on United States Tax Legislation (DISC)*, GATT doc. L/4422 of 12 Nov. 1976, *reprinted in* 23d Supp. BISD 98 (1977) [hereinafter the DISC Case].

n189 For a discussion of the basis for this dispute, and its GATT dispute resolution ramifications, see John H. Jackson, *The Jurisprudence of International Trade: The DISC Case in GATT, 72 AM. J. INT'L L. 747 (1978).*

n190 DISC Case, *supra* note 188, para. 17.

n191 *See Provisions of Article XVI:4*, GATT doc. L/1381 of 19 Nov. 1960, *reprinted in* 9th Supp. BISD 32, 185-87 (1961).

n192 DISC Case, *supra* note 188, para. 39.

n193 Referring to France, Belgium, and the Netherlands. The United States brought "counterclaims" against these countries, arguing that their failure to tax their nationals on income earned abroad, combined with a liberal approach to defining income earned abroad (failure to address transfer pricing effectively) constituted an export subsidy. The panels in these cases, comprised of the same members, found the U.S. claims well founded.

n194 HUFBAUER & SHELTON ERB, *supra* note 159, at 61-62.

n195 DISC Case, *supra* note 188, para. 67.

n196 Of course, this would be the only way to create a truly level playing field.

n197 *Report of the Panel on Complaints on Belgian Family Allowances*, GATT doc. G/32 of 7 Nov. 1952, *reprinted in* 1st Supp. BISD 59-60 (1953).

n198 *Dispute Settlement Panel Report on United States Restrictions on Imports of Tuna*, No. DS21/1, *reprinted in 30 I.L.M. 1598 (1991).*

n199 "Nullification and impairment" are grounds for bringing a dispute resolution proceeding under article XXIII of GATT.

n200 *See* Anthony McDermott, *EEC Backs Away from Confrontation with Tokyo*, FIN. TIMES, Apr. 21, 1983, at 7.

n201 Unlike U.S. countervailing duty law, GATT does not explicitly include a specificity requirement. *See infra* text accompanying notes 217-220. The Dunkel Draft would add a specificity requirement. Dunkel Draft, *supra* note 47, at I.2-I.3.

n202 The Structural Impediments Initiative involves attempts to do just this, at least in some areas. *See* sources cited *supra* note 26.

n203 Ronald A. Cass et al., *Subsidy Law: Can a Foolish Inconsistency Be Good Enough for Government Work?, 21 LAW & POL'Y INT'L BUS. 609, 634 (1990)* (citing Richard R. Rivers & John D. Greenwald, *The Negotiation of a Code on Subsidies and Countervailing Measures: Bridging Fundamental Policy Differences, 11 LAW & POL'Y INT'L BUS. 1447 (1979)).*

n204 Cass, *supra* note 203, at 634.

n205 MARGARET KELLY ET AL., ISSUES AND DEVELOPMENTS IN INTERNATIONAL TRADE POLICY 121 (International Monetary Fund, Occasional Paper No. 63, 1988).

n206 *See* text accompanying notes 207-231, *infra*.

n207 GATT became binding on the U.S. on January 1, 1948, pursuant to a Protocol of Provisional Application to which the U.S. agreed by executive agreement. *See* John H. Jackson, *The General Agreement on Tariffs and Trade in United States Domestic Law, 66 MICH. L. REV. 249 (1967).*

n208 *19 U.S.C. § 1303* (1988).

n209 *19 U.S.C. § 1671* (1988).

n210 *See, e.g.*, Christoph Lehmann, *The Definition of "Domestic Subsidy" Under United States Countervailing Duty Law*, 22 TEX. INT'L L.J. 53 (1987); William Lay, Note, *Redefining Actionable "Subsidies" Under U.S. Countervailing Duty Law, 91 COLUM. L. REV. 1495 (1991).*

n211 Section 1671 refers to subsidies, which are defined in section 1677(5) as meaning the same thing as "bounty or grant" as provided in section 1303. *See Bethlehem Steel Corp. v. United States, 590 F. Supp. 1237, 1242* (Ct. Int'l Trade 1984).

n212 This refers to the Annex to the Subsidies Code, *supra* note 15.

n213 *19 U.S.C. § 1677*(5)(A)-(B) (1988) (emphasis added).

n214 The Court of International Trade has stated in dictum that at least direct private subsidies may be included in this term to the extent that private persons are required to provide them. *Bethlehem Steel Corp. v. United States, 590 F. Supp. 1237, 1242* (Ct. Int'l Trade 1984). In addition, the International Trade Administration (ITA) of the Department of Commerce recently stated that because neither GATT nor the Subsidies Code requires a financial contribution from the allegedly subsidizing state, U.S. law does not require such a showing. Certain Softwood Lumber Products from Canada, *57 Fed. Reg. 22,570* (Dep't Comm. 1992) (final affirm. countervailing duty determination).

n215 Certain Softwood Lumber Products from Canada, *57 Fed. Reg. 22,570* (Dep't Comm. 1992) (final affirm. countervailing duty determination).

n216 U.S. law does not require that export subsidies be specific in order to be countervailable. *19 U.S.C. § 1677*(5)(A)(i) (1988). This provision excludes the specificity language contained in § 1677(5)(B).

n217 *19 U.S.C. § 1677*(5)(B) (1988) (emphasis added).

n218 *19 U.S.C. § 1677*(5)(B)(1988). This provision was added in 1988 by Pub. L. No. 100-418, Title I, Subtitle C, part 2 § 1312, 102 Stat. 1184. This provision adopted the holding of *Cabot v. United States, 620 F. Supp. 722* (Ct. Int'l Trade 1985), *appeal dismissed, 788 F.2d 1539 (Fed. Cir. 1986)* (declining to accept nominal general availability as incompatible with requisite specificity for countervailability).

n219 *928 F.2d 1568 (Fed. Cir. 1991).* This case involved an ITA determination that Mexican government natural gas price controls and the FICORCA foreign exchange deposit program were not bounties or grants under § 1303. At trial, Judge Carman (who decided the Cabot case) upheld this determination. The court of appeals affirmed by a divided panel, with no majority opinion. *See* James Toupin, *United States Court of Appeals for the Federal Circuit Tenth Anniversary Commemorative Issue: International Trade Decisions of the United States Court of Appeals for the Federal Circuit During 1991, 41 AM. U. L. REV. 983, 1002-04 (1992).*

n220 *See Cabot Corp. v. United States, 620 F. Supp. 722* (Ct. Int'l Trade 1985); *Bethlehem Steel Corp. v. United States, 590 F. Supp. 1237, 1241-46* (Ct. Int'l Trade 1984).

n221 Certain Softwood Lumber Products from Canada, *51 Fed. Reg. 37,453* (Dep't Comm. 1986), *cited with approval in PPG Industries, Inc. v. United States, 928 F.2d 1568, 1576-77 (Fed. Cir. 1991). See also* Countervailing Duties: Notice of Proposed Rulemaking and Request for Public Comments, *54 Fed. Reg. 23,366* (Dep't Comm. 1989) (to be codified at 19 C.F.R. §

355). For a critique of these proposed rules, see Richard Diamond, *Countervailing Duty Law for the 1990's: A New Look at the Law and Economics of Subsidies, 21 LAW & POL'Y INT'L BUS. 507, 518 (1990).*

n222 Professor Diamond observes that "if such governmental actions were countervailable, virtually every product in international trade could be subject to a levy, a result which contrasts with accomplishments under the GATT." Diamond, *supra* note 221, at 518. He further argues for an "entitlement" model as a basis for determining which subsidies to countervail. This model means United States producers are "entitled" to compete without the risk of being defeated by subsidies provided by the governments of their competitors' home countries. *See also* Daniel K. Tarullo, *Beyond Normalcy in the Regulation of International Trade, 100 HARV. L. REV. 546 (1987).*

n223 The Supreme Court seems to have adopted this level playing field rationale. *Zenith Radio Corp. v. United States, 437 U.S. 443, 455-56 (1978)* (stating countervailing duties are intended "to offset the unfair competitive advantage that foreign producers would otherwise enjoy from export subsidies"). *Accord Georgetown Steel Corp. v. United States, 801 F.2d 1308, 1315 (Fed. Cir. 1986).* Diamond refers to this approach as the "entitlement" model. Diamond, *supra* note 221, at 518.

n224 *See Canada Makes First Uruguay Round Proposal for New Subsidies, Countervailing Duty Code*, 6 Int'l Trade Rep. (BNA) No. 27, at 863 (July 5, 1989) (stating that Canada's proposal would require private parties seeking the imposition of countervailing duties to declare the level of subsidies they receive from their own government, which would then be netted out).

n225 Countervailing Duties: Notice of Proposed Rulemaking and Request for Public Comments, *54 Fed. Reg. 23,366* (Dep't Comm. 1989) (to be codified at 19 C.F.R. § 355).

n226 Diamond, *supra* note 221, at 523. On the other hand, it might be argued that good regulation enhances the market nature of allocations, and that where this is the case, no countervail is appropriate.

n227 See John Barcelo III, *An "Injury-Only" Regime (For Imports) and Actionable Subsidies, in* INTERFACE THREE: LEGAL TREATMENT OF DOMESTIC SUBSIDIES 19 (Don Wallace Jr. et al. eds., 1984), for an argument that the escape clause, *19 U.S.C. § § 2251*-2253 (1988), should be used to address subsidies, because the real concern is injury and adjustment, not the identification of subsidization itself.

n228 *See supra* text accompanying notes 25-30.

n229 Regardless of whether it were effected strategically, it might give rise to a discretionary action by the U.S. Trade Representative under the Trade Act of 1974 § 301(d)(3)(B)(i)(III), *19 U.S.C. § 2411*(d)(3)(B)(i)(III) (1988), which refers to acts which deny fair and equitable "market opportunities, including the toleration by a foreign government of systematic anticompetitive activities by private firms."

n230 *See supra* text accompanying notes 42-46.

n231 *See supra* note 46 and accompanying text.

n232 *See supra* note 3.

n233 See the description of the "necessity test" in Andrew Adonis & Andrew Tyrie, *What Kind of European Union? Some Community Reforms for the 1990's*, NAT'L WESTMINSTER BANK Q. REV., May 1991, at 47, 49. The necessity test would permit the Community to act only where the Member States are incapable of achieving the relevant purpose. This is not unlike the idea of taking action at the lowest possible level, which is literally a recipe for anarchy.

n234 *See* WILKE & WALLACE, *supra* note 3, at 15 (citing ALEXANDRE MARC & ROBERT ARON, PRINCIPES DU FEDERALISME (1948)).

n235 The principle of subsidiarity may be considered an overarching guiding principle for determining at what level decisions should be made. It may be considered by legislators as a prudent principle of legislation without any legal obligation to apply it, or it may be imposed as a legal obligation, with jurisdiction allocated to a court to determine whether its dictates have been followed. The latter structure would make calls for application of the principle of subsidiarity in legislative debates more compelling, and would enlist the court as a guardian and arbiter of the principle. Of course, a court would need a working definition of subsidiarity that would allow it to decide concrete cases.

n236 Article 130R of the Treaty of Rome, added by the Single European Act, provides for Community action in connection with the environment to the extent that specified objectives "can be attained better at the Community level than at the level of the individual Member States." Treaty of Rome, *supra* note 16. The formulation contained in the Draft Treaty of European Union of February 14, 1984 would entrust the European Community "only with those powers required to complete successfully the tasks they may carry out more satisfactorily than the States acting independently." Draft Treaty Of European Union, Feb. 14, 1984, 17 BULL. OF THE EUR. COMMUNITIES, COMMISSION OF THE EUR. COMMUNITIES No. 2, at 9 (1984). Other formulae have been proposed, such as one holding that the Community should act only when the member states are incapable of achieving the relevant purpose. Is efficiency a part of the purpose? In a 1990 report on the principle of subsidiarity on behalf of the European Community's Committee on Institutional Affairs, rapporteur Valery Giscard d'Estaing defined subsidiarity as follows:

> 'The principle of subsidiarity' implies that the Union will be required to perform those tasks which can be carried out more effectively by the institutions of the Union than by the Member States acting independently, because of their importance or effects or for reasons of more effective implementation.

Thus, the Member State must retain all the powers which it is able to wield more efficiently itself and must transfer to the Community those powers which it is unable to use effectively. The Community therefore intervenes only in a subsidiary capacity and in accordance with a principle of exact appropriateness whereby each level is granted powers only because these cannot, given their nature and scope, be exercised efficiently and effectively at any other level.
Interim Report Drawn Up on Behalf on Insitutional Affairs on the Principle of Subsidiarity (June 22, 1990), EUR. PARL. SESSION DOC. (A3-163/90/Part B) 2 (1990). This definition, like many others, raises at least as many questions as it answers. In Maastricht at the European Council meetings of Dec. 9-10, 1991, the Heads of State and Government adopted the Treaty on Political Union. Article 3b of the "Provisions Amending the Treaty Establishing the European

Economic Community with a View to Establishing the European Community" provides as follows:

> The Community shall act within the limits of the powers conferred upon it by this Treaty and of the objectives assigned to it therein. In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community.

Any action by the Community shall not go beyond what is necessary to achieve the objectives of this Treaty.
Treaty on Political Union, *reprinted in 31 I.L.M. 247, 257-58 (1992).*

n237 *See* BRETON, *supra* note 22, at 8, 14-15. Breton states that
the generally accepted proposition is that the variance in the distribution of preferences is smaller, the extent of bundling less, and the strength of intergovernmental competition greater at more junior levels of government. As a consequence, the welfare costs of public supply rise as the degree of expenditure concentration increases. To put it differently, the more junior governments have a comparative advantage when it comes to reducing welfare costs.
Id. at 15.

n238 *See supra* note 71.

n239 DICTIONARY OF CONTEMPORARY QUOTATIONS 10 (Deborah D. Eisel & Jill S. Reddig eds., 1981) (quoting Paul Anderson).

n240 *See supra* text accompanying notes 69-102; *see also* Norbert Reich, *Competition Between Legal Orders: A New Paradigm of EC Law?, 29 COMMON MKT. L. REV. 861 (1992).*

n241 *See supra* text accompanying notes 216-231.

n242 *See supra* text accompanying notes 155-181.

n243 *See* sources cited *supra* note 31.

n244 The obverse of this requirement for regulation to be specific is a requirement that states unbundle the public goods that they provide. One of the requirements for effective competition among governments in providing public goods is that public goods are unbundled or untied, in order for consumers of these public goods to be able to make choices more accurately.

n245 *See* Trachtman, *supra* note 6, at 460-63.