The Emerging Global Constitution: Why Local Governments Could Be Left Out

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Unrecognized by most state and local policymakers and managers, there are changes looming in the global legal environment that could profoundly limit the autonomy and policy discretion of subnational governments in the United States. The most far-reaching of these changes would make it more difficult for state and local governments to serve as "laboratories for democracy," places where future national policies are explored and tested in virtually every sector of governance before they are replicated on a national scale. Areas possibly threatened include banking regulation, economic development, government purchasing, consumer protection, working conditions, health and medical insurance, and environmental law.

The agreements, in fact, empower such multilateral bodies as the World Trade Organization and a new set of international courts and dispute resolution systems to rule on the legality of state and local laws concerning expenditures, procurement, regulation, taxation, licensing, and ownership. Policies found in conflict with these agreements must then be terminated, or trade sanctions and monetary compensations will be imposed.

Critics and proponents have described these changes in a variety of ways, including an "undebated amendment to the U.S. Constitution," "a bill of rights for investors," "a threat to sovereignty," "a level playing field for free trade and foreign investment," "a slow-motion coup d'etat," "an evolution in governmental sovereignty," and "a corporate-rule treaty." Whether the agreements are largely good or bad for state and local governments and their citizens, two facts are certain:

- To date, state and local officials have had little to say about these changes and little input into the negotiations.
- In the year 2000, the pace of negotiations will quicken on a variety of fronts that will reach further into the local domain.

Thus, the stakes are high in crafting this new global legal framework. These agreements change the balance among federal, state, and local governments; private and public sectors; and social and economic values. They force those who create or manage government programs in a variety of areas to worry about whether their activities conflict with international law. And they demand that state and local officials become parties to writing the fine print in these trade and investment liberalization agreements.

This article seeks to provide local government managers with an overview of these issues and to answer these questions: What are the most important current and looming negotiations, and what are they about? What is causing this movement toward a global economic constitution? How large a change in our federalist system of government is this likely to be?

Also, what government functions are likely to be most affected? Are any real, live programs being challenged by international bodies like the World Trade Organization? How is the U.S. government trying to protect these activities? Is there a flaw in this approach? How might city and county managers and other state and local officials get involved in this policy making and better shape the looming global agreements?

What Is the Shape of Things to Come?

The past director of the World Trade Organization (WTO) describes the new framework as an economic constitution, while trade scholars say the framework is designed to limit the powers of subnational government in countries with a federal system.

In fact, several existing WTO agreements already limit state and local purchasing power and economic development practices. In addition, NAFTA includes a chapter that empowers foreign investors to sue national governments if federal, state, or local policies nullify investors' expectations of future profits. All of these agreements could be dramatically expanded by international negotiations now in progress. Figure 1 gives an overview of how the negotiations could affect the powers of state and local government, and the following remarks expand on individual entries in the chart.

Figure 1. Negotiations That Affect State and Local Powers

International Negotiations	State and Local Powers Influenced
WTO Agreement on Subsidies • "The sunset" in 1999 of "green light" subsidy protection.	**Economic Development Incentives** • Screening mechanisms. • Export-related targeting. • Small-business targeting.
WTO Agreement on Procurement • Expanded coverage of local government under negotiations with the European Union. • Greater disclosure requirements under WTO transparency negotiations.	**Government Purchasing Criteria** • Minority business preferences. • Domestic business preferences. • Recycled-content preferences. • Labor or human rights criteria.

Various Investment Agreements	Government Powers Generally
• NAFTA Chapter 11 "interpretation." • FTAA: Free Trade Area of the Americas. • MAI: Multilateral Agreement on Investment. • BITs: Bilateral Investment Treaties.	• Use of punitive damages by courts. • Residency requirements for landownership and casino permits. • Performance requirements such as community reinvestment acts or "first-source" agreements linked to permits. • Takings law: interpretation of whether a taking has occurred and what should be the basis for compensation.

WTO Agreement on Subsidies and Countervailing Measures (SCM). The SCM regulates subsidies that could affect international competition. It prohibits "red light" subsidies that provide direct financial assistance to a company or sector in a way that is linked with export promotion, domestic content provisions, or import substitution. "Yellow light" subsidies can be challenged if the complaining country can prove that the subsidy places one of its businesses at a competitive disadvantage.

Exceptions to these rules are contained in a set of "green light" subsidies, which protect a large number of state and local programs (for distressed areas, environmental compliance, and research and development) from being challenged under the SCM. Countries that do not comply can be hit with stiff, countervailing duties on their products. These exceptions are scheduled to "sunset" at the end of 1999; the Office of the U.S. Trade Representative (USTR) is involved in developing the American policy position on renewal, reform, or termination of the SCM and negotiates on behalf of the United States with the WTO Subsidy Committee.

WTO Agreement on Government Procurement (GPA). The GPA requires countries to purchase goods and services based only upon price and performance criteria. It has 26 member nations, including the European Union, Japan, Canada, and the United States, which also lists 37 states as covered by the agreement. Many state and local purchasing policies could be challenged as violations of GPA's performance-only rule.

To name just a few, these policies include minority and small-business preferences, buy America/buy-local preferences (47 states), recycled-content preferences (47 states), the "MacBride principles" for avoiding and condemning discriminatory practices in Northern Ireland (19 cities and states), and the "Burma laws" that avoid doing business with companies that provide foreign exchange to the military government of Burma (24 cities and states).

Two negotiations could affect local procurement. First, a process between the United States and the European Union seeks to expand the GPA to include cities and the remaining states. Second, the next round of WTO negotiations is likely to require all levels of governments to disclose their purchasing power. This "transparency" requirement, although laudable, could constitute a significant unfunded mandate imposed on state and local governments across the country. The ultimate goal would be to bring all policies into compliance with the GPA.

Various Investment Agreements. The negotiations on foreign investor protection involve the most far-reaching limits on state and local authority. This is because the agreements provide more protection for investors than exists under constitutional law and because they privatize the enforcement process by enabling investors to seek monetary damages from national governments.

Several NAFTA cases are already in the works on matters of regulation of gasoline additives, land use, fresh water exports, transportation of hazardous waste, and punitive damages. Investment agreements are being negotiated in several forums. The NAFTA cases have stimulated the creation of a high-level working group on "interpretation" of the basic investor rights that have spawned these cases.

Other negotiators are working on the investment chapter of the Free Trade Area of the Americas (FTAA), which is supposed to replace NAFTA by the year 2005. This group will complete a detailed outline of the chapter by the end of 1999.

The Multilateral Agreement on Investment (MAI), which expanded upon the NAFTA models, has been under negotiation within the Organization of Economic Cooperation and Development (OECD). After these negotiations broke down in late 1998, the European nations proposed moving the process into the next round of WTO negotiations, beginning in November 1999. The NAFTA and MAI model also is being used to draft bilateral investment treaties (BITs) with emerging-market countries.

Why Is All This Happening?

Free traders have been successful in negotiating a number of worldwide and regional trade agreements that restrict traditional tariffs, quotas, custom duties, and other instruments of protectionism. As these barriers to commerce have fallen, traditional policymakers have turned their attention to other "structural impediments," including restrictions of foreign investor rights, subsidies, regulations, and procurement practices.

Multinational corporations also have an interest in these reforms for a number of reasons. First, as the effects of such impediments as duties and tariffs

decline, the impacts of other programs on company bottom lines become more visible. As a result, global companies are increasingly concerned about competitor subsidies in such forms as tax policies, permit and licensing systems, property ownership restrictions, on- and off-budget government expenditures, regulatory practices, buy-local purchasing programs, and so forth.

Second, fairer treatment of foreign investors will lower certain protectionist barriers for all global corporations and will improve market access for their transnational business affairs.

Third, seeking reform on the international level enables business communities to accomplish their domestic political agendas. For example, NAFTA's Chapter 11 and the MAI doctrine on expropriation create a potential international "takings" law that U.S. corporate lobbyists have not been able to enact through Congress. The Fifth Amendment of the U.S. Constitution provides that "private property [shall not] be taken for public use without just compensation." Such "takings" law in the United States is limited to physical occupation of property and a few extreme situations of "regulatory takings." NAFTA Chapter 11 goes beyond U.S. law and would increase the number of cases in which foreign investors could seek compensation from the U.S. government for the loss of their property values and profits.

Similarly, the new dispute systems will generally look more favorably on business concerns than do current domestic courts. Consequently, businesses will be in a position to "shop around" for the best venue in which to air their complaints.

Basically, reform and negotiation efforts are motivated by a vision of (1) deeper integration of national economies and legal systems, (2) deregulation under the existing constitutional frameworks, and (3) a fairer playing field for all parties.

How Big a Change Is This?

These agreements are a big deal. In many respects, they could fundamentally alter our federal system of government. To start with, the new global "constitution" conflicts with existing constitutional policies. For example, in the United States it would upset the historic balance among the federal government and the states; alter the separation of powers among legislatures, courts, and the executive branch; and change the balance between the rights of private businesses and the broader public interest, as represented by government.

The fast-track processes that have been instituted to negotiate trade and investment agreements preclude the kind of debate, analysis, and evaluation that are required to amend the U.S. Constitution in an accountable manner. A

Cornell International Law Journal article by Robert Stumberg ("Sovereignty by Subtraction," 1998) has a good discussion of these issues and the alternatives. An introductory treatment of the pros and cons of additional congressional debate and oversight also can be found in Bruce Stokes, Future Visions for U.S. Trade Policy (Washington, D.C.: Council on Foreign Relations, 1998) and in (editor) Jeffrey Schott's Restarting Fast Track (Washington, D.C.: Institute for International Economics, April 1998).

Next, a deeper integration of national economies and legal frameworks upsets historic political compromises and breaks with deeply held policy traditions. For example, investors could use the international agreements to challenge previously enacted laws regarding the retraining of displaced workers in a targeted industry, approaches for financing employee health insurance, and many other issues.

Last, governments tend only to see their competitors' unfair practices and not to recognize their own. A global constitution may turn out to be a double-edged sword, one that can be wielded against those who are proposing it. This is not to say that all these traditions are cast in stone and should not be changed. But it is to argue that a deeper analysis of and more broad-based discussion of the issues is a "must."

What Government Functions Are Most Affected?

For the first time, multilateral bodies like the WTO are focusing on bread-and-butter government functions, not just the narrower policy world of custom duties and tariffs. This is a vast, largely unrecognized change. In addition, states, counties, and municipalities are not true "parties" to many of these agreements, although they are subject to the full extent of their obligations. Now, let's look at the specifics.

Many of the existing and proposed agreements do not allow governments to discriminate against foreign investors for any purpose. This is called "National Treatment" or "Most-Favored Nation Treatment." In the authors' view, the National Treatment language in NAFTA and in the proposed MAI is a significant break with U.S. law under the commerce clause of the Constitution. American law weighs the burden of a policy on foreign commerce, for example, along with the legitimacy and importance of the statute and its benefits. NAFTA and the MAI only consider the economic burden on companies. Under U.S. law, state and local governments are free to discriminate in favor of their own residents with respect to exceptions for subsidies and government purchasing.

In addition to protecting foreign investors from explicit discrimination, these "relative" standards also protect investors from "de facto" discrimination, which means being placed at a competitive disadvantage by a law, even though the

law is not discriminatory on the face of it. Examples of laws that would violate National Treatment include:

- Laws that restrict the ownership of private assets to residents or U.S. citizens.
- Residency requirements for casino licenses.
- Buy-America/buy-local procurement practices.
- Minority or small-business procurement preferences or subsidies.
- Preferences for traditional and resident fishing rights.
- Government procurement that encourages recycled-content markets.
- Living-wage ordinances.
- Indian-preference guidelines for hiring and joint ventures.
- The use of social and human rights criteria for governmental purchasing of goods and services.
- Laws that protect local business ownership by restricting foreign or out-of-state ownership.

Certain agreements go beyond these nondiscrimination standards and set out "absolute" investor protections that shield foreign investors, even if domestic investors are treated in exactly the same way. These protections would include a limit on "performance requirements" (such as export performance or the use of domestic firms or domestic content) and a mandate to compensate foreign investors if the government "expropriates" their property, which is like compensation for "taking" property in the United States but without the U.S. requirement that all the property must be taken before compensation is due.

As proposed in the MAI, the broadest investor protection is called "General Treatment," which requires government to treat foreign investors "no less favorably" than under the principles of international law, which are less well defined than the comparable principles of U.S. constitutional law. General Treatment also enables a foreign investor to seek damages if a government impairs the use, management, operation, enjoyment, or disposition of an investment.

Here are examples of current laws or practices that investors could challenge under these absolute investor protections:

- Environmental regulations, such as wetland or coastal-zone restrictions, could be challenged as partial expropriations of assets without compensation. U.S. law on compensation for taking private property usually requires proof that the government has taken all, not merely part, of a property or its value. In addition, an investor could easily argue that the same environmental regulations also "impair" the enjoyment or operation of an investment, although the award of damages might be less under expropriation.

- Community reinvestment acts and “first-source” hiring agreements linked to permits could be challenged as “performance requirements” because they mandate use of local content, workers, or business relationships. Some agreements do permit a number of other performance requirements, such as building a factory or hiring local workers, but only if the government provides a subsidy to the investor. Hence, regulatory approaches are not looked upon fondly.

Furthermore, these doctrines and agreements really run against the grain of the entire field of state and local economic development, whose purpose is to identify, nurture, and sustain a competitive advantage for one’s own country, region, town, or citizenry. Economic development practice abounds with the use of tax, government spending, procurement, and regulatory powers in a multitude of ways.

The ultimate problem is the inherent conflict in values between the equally legitimate goals of protecting foreign investors and exercising the sovereignty necessary to design and run appropriate and accountable, place-based economic development strategies.

Additional scrutiny of these existing and proposed agreements, as well as further input from state and local officials and the economic development community, are needed if these treaties are to strike a better balance between the goals of investor protection and economic development. Indeed, can state and local policymakers and economic development professionals turn this threat into an opportunity to generate more effective, equitable, accountable, and sustainable economic development activity?

Given how far-reaching these agreements potentially are, they could affect an exceedingly wide spectrum of law-making authority, covering, for example, laws dealing with environmental protection, government purchasing, economic development, land controls, work hours, participation in labor unions, business licensing, antitrust enforcement, and health regulations.

Have Any of These Programs Been Challenged?

Yes. Although the agreements are just starting to be enforced, we already can point to a few real, live examples. The early NAFTA claims brought by private investors make it abundantly clear that new international investment rules have a major effect on national sovereignty and on state and local powers.

In federal systems, like those of Canada, Mexico, and the United States, states and provinces have traditional regulatory power over judicial systems, resource management, and economic sovereignty. Each of these powers has been challenged in a series of NAFTA cases brought by disgruntled investors. Figure

2 illustrates the national and state powers jeopardized by a few of the 12 current NAFTA cases.

Figure 2. Selected NAFTA Cases		
	Immediate Issue(s)	**Broad Concerns**
Loewen v. United States	May a state jury punish fraud with high, punitive damages? Does fair and equitable treatment extend to a jury's state of mind?	International reexamination of domestic judicial proceedings. Local control over legal remedies. Preservation of national principles of justice (public disclosure). Corporate accountability for illegal actions.
Ethyl v. Canada	May Canada ban the import and transport of a chemical?	Federal power to protect the environment and citizens' welfare. Disclosure concerning the disbursement of public funds. The validity of laws with a legitimate purpose but discriminatory effects.
Sun Belt Water v. Canada	May a province ban the export of its water?	Provincial power over resource protection. Autonomy over nation/state division of power.
S.D. Myers v. Canada	May Canada ban the export of toxic waste?	Federal power to protect the environment and citizens' health.
Metalclad v.Mexico	If an investor unknowingly purchases environmentally protected land, must a state	Allocation of investment risk between governments and investors.

	compensate the investor when it expropriates the land?	
Time Warner v. Canada (potential claim)	May Canada ban a type of magazine (split runs) in order to protect national publishers?	National control over the choice to pursue trade violations by other nations (national control over "legalized" trade wars).

For instance, large punitive damage awards are being challenged in the first NAFTA case against the United States. A Canadian corporation is arguing that NAFTA's standard of "fair and equitable treatment" under international law does not permit local juries to impose punitive damages based on the size of the company (rather than on a small multiplier of actual damages) in order to deter fraudulent practices. This case has large implications for the future of tort law as applied to foreign companies.

A close study of these cases suggests that many of their concerns have merit. Many might prevail in domestic courts. But the real issue with these cases is that NAFTA changes both the standard for review and the court in which the case is heard. This raises issues of democracy, as these changes alter the law-making process. And lastly, the changes enable companies to win in a global venue (e.g., tort reform, takings legislation, etc.) what they have failed to achieve in the U.S. Congress.

The first big subsidy case for the United States under the SCM agreement also has just arisen. The WTO recently ruled that U.S. tax laws on foreign sales corporations (FSCs) violate WTO rules against export subsidies. FSCs are subsidiaries of U.S. firms that export U.S.-made goods into overseas markets. Qualified FSC income is not subject to current U.S. taxation—a protection that exempts up to 15 percent of earnings. This program saves American firms about $1.8 billion annually. Boeing is the biggest beneficiary—to the tune of $130 million per year. The FSC is criticized as corporate welfare by some; others, like the National Trade Council, defend it as a means of obtaining tax parity with European nations.

If the United States loses its appeal, it must terminate the law or face $2 billion in trade sanctions. This level of countervailing duties would dwarf America's recent victories in the WTO against the European Union, when the WTO allowed sanctions against European/Caribbean banana-trade support practices and the EU's ban on hormone-fed beef ($308 million in total).

The WTO ruling against the United States is important for three reasons:

- More challenges are on the way, and the reasoning that led to this ruling could apply to a number of state and local development programs.
- A failure for the United States to win its appeal and to terminate the program would lead to costly countervailing measures applied to U.S. goods.
- This case is a wake-up call for state and local officials and for the American economic development community to become informed about these issues and to contribute to the conversation on what sorts of economic development programs should remain legal in the new millennium.

How Might State and Local Sovereignty Be Better Protected?

U.S. negotiators are aware of these conflicts. They propose to protect existing laws and future law-making authority by invoking unilateral (or "country-specific") exceptions. In the MAI negotiations, U.S. negotiators proposed to list (or "grandfather") approximately five laws per state, and for the remaining conflicts, they advocate a number of open-ended exceptions for categories like procurement, subsidies, social services, and minority affairs.

There are three basic problems with this U.S. strategy for sovereignty protection. First, the grandfathered lists of laws do not preserve future law-making authority. State and local governments would have to freeze grandfathered laws as they are at the time that a far-reaching agreement, such as the proposed MAI, is adopted. They could neither renew nor adapt the laws to changing conditions, except to come into compliance with the agreement's terms.

Second, many of the exceptions are opposed by European nations and thus may be bargained away in future negotiations. And third, the open-ended exceptions are not likely to be recognized in practice by the global dispute panels.

The United States has unsuccessfully tried to use general exceptions, which are applicable to all nations, to preserve laws that have been challenged under WTO agreements. But country-specific exceptions are even less likely to be recognized by a multilateral dispute panel than are general exceptions that apply to all countries. Furthermore, there are several principles of international law that require dispute panels to construe exceptions narrowly, even to the point of ignoring them if the exception contravenes the objectives of the agreement.

The authors' conclusion, thus, is that if the United States wants certain policies and practices allowed, then it must push for having them "carved out" of the actual agreement—just as the proposed Multilateral Agreement on Investment was written so as not to apply to U.S. tax policy.

What Should State and Local Officials Do?

Not all of these changes are bad. Some of the current and proposed agreements could curb the use of wasteful subsidies for large, mobile business-attraction projects. Also, foreign governments use their government powers to keep American business out or to subsidize some of our competition deeply. These efforts should be better policed.

Yet, because global trade and investment negotiators are moving beyond their own domain of tariffs and duties and quotas and reaching into the workings of "Main Street" governments, a broader and deeper debate is required. Old ways of negotiating, monitoring, and evaluating these agreements are not democratic or accountable. Bigger policy issues are at stake. Thus, we need to:

- Start a leadership network that can (1) enable state and local officials and managers to communicate with each other across state lines, levels of government (e.g., city, county, and state), and divisions of power (e.g., legislatures, governors, attorneys general); and (2) serve as a much-needed state and local voice before Congress and federal agencies.
- Establish a resource bank for analysis and technical support that looks at these agreements and their doctrines from the state and local points of view.
- Develop a mutual education network to enable state and local actors to share critical intelligence on what is happening in global policy making on a regular and timely basis.
- And, most of all, involve state and local officials in setting the agenda for future negotiations.

With these foundations in place, America's state and local governments can be players in the creation of the new global economic constitution.

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Resources

This article draws from a number of detailed research products funded by the Ford Foundation. Additional detailed support for the article's theses and arguments are available in the publications listed here, most of which can be found at www.cfed.org.

Corporation for Enterprise Development and Harrison Institute, *International Investor Rights and Local Economic Development* (July 1999).

Harrison Institute and Corporation for Enterprise Development, *Federalism and Foreign Investors: The Emerging Conflict Between International Investment Agreements and Traditional State/Local Authority* (April 1999).

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Robert Stumberg, "Sovereignty by Subtraction: The Multilateral Agreement on Investment," *Cornell International Law Journal*, Volume 32, Number 3 (1998).