Privatization, Public Goods and the Ironic Challenge of Free Trade Agreements

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Abstract

Use of quasi-markets for provision of public goods requires clear property rights, a predictable adjudication process and low transaction costs. These may be undermined by new restrictions on government action found in the new generation of free trade agreements. These trade agreements privilege foreign over domestic investors, replace public courts with private arbitration, supplant traditional standards for legislation by requirements to be "least trade restrictive," and forward a new definition of "takings" that requires governmental compensation for lost potential profits from regulatory action. These features undermine the governance structure necessary to reduce transaction costs of delivering complex public services.

Key words: local government, privatization, free trade, partial takings, property rights, transaction costs

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Introduction

In the last few decades both theoretical and practical developments in public administration have increasingly emphasized the positive power of market based models of government service delivery to promote efficiency, flexibility and responsiveness (Henig 1989-90, Osborne and Gaebler 1992, Savas 2000). Basic governmental services are being conceptualized as toll goods capable of being provided via markets to consumer voters (Savas 2000, Tiebout 1956). These new market-oriented approaches are proposed as an option to provide government services through private delivery, promote economic development (by expanding the scope for private markets), and may enhance the efficiency of public services and citizen choice (Eggers and O'Leary 1995, Savas 2000). These are the goals of free trade agreements as well.

There is substantial debate (both pro and con) about the effectiveness of market approaches in reaching these efficiency and democracy goals (Boyne 1998, Eggers and O'Leary 1995, Savas 2000, Sclar 2000, Starr 1987, Warner and Hefetz 2002a, 2002b, 2003, 2007, Warner and Hebdon 2001). Our purpose here is *not* to argue the merits of privatization but rather to examine the role of government in creating the institutional context for effective quasi-markets for public goods. When Coase (1960) first argued the case for voluntary market solutions for public goods, he acknowledged the importance of:

- a clear system of property rights,
- an open and fair bargaining framework based on complete information shared by all parties, and
- an adjudication process.

Together these elements lower the otherwise high transaction costs of such market arrangements by eliminating uncertainty and therefore risk. Trade rules and obligations may create a more stable environment for business in protected sectors, but a less predictable environment for regulators, legislators and planners.

Recent international trade agreements, the North American Free Trade Agreement (NAFTA), the US-Central American and Dominican Republic FTA (CAFTA), the Free Trade Area of the Americas (FTAA), various bilateral agreements, and the General Agreement on Trade in Services (GATS), are designed to liberalize markets, including those for public goods, and limit governmental intrusions on market independence (Appleton 1994). See Table 1. Traditional governmental powers are being reinterpreted as "nontariff barriers" to trade (Gordon 2001, Greider 2001b, Longworth 2001). This system is in conflict with Coase's theory of providing public goods and the broad body of transaction cost economics that recognizes the importance of governance for market functioning (Coase 1952, 1960, Williamson 1996, Nelson 1997, Lowery 1998, Sclar 2000, Hefetz and Warner 2004, 2007). Table 1 provides an outline of the key governance features of selected agreements.

Table 1 about here

Trade agreements, negotiated by the U.S. Trade Representative (USTR) bilaterally, regionally, and at the 148 country World Trade Organization (WTO), are creating a new template for trade governance which has implications for more general government practice. Trade agreements do not regulate industry; rather they create restrictions on government activity to relieve industry of tariffs and other government measures. Government measures are defined broadly to include any law, administrative ruling or guideline from the government or anyone acting with government authority by contract or devolution. The goal is to expand trade by lowering transaction costs for multinational companies by streamlining or eliminating government interference with markets. However, these provisions may raise transaction costs for state and local governments who attempt to contract for public service delivery.

This paper describes the key governance changes created by these new free trade agreements and shows how they alter government's bargaining position by enhancing foreign investor property rights over domestic interests, supplanting the domestic courts system with private arbitration tribunals, and restricting government regulatory authority. While our focus is primarily on the United States, we use case examples from NAFTA in Mexico, Canada and the United States to show how these new governance provisions are being interpreted in practice. Mexico, Canada and the U.S. are all federal states where division of power and authority between national and sub-national units of government is important. We also discuss the implications these provisions will have on a broader array of government services if they are added to the GATS schedule of commitments.

Creating a Framework for Market Solutions

Use of quasi-markets for public service delivery requires low transactions costs and competition to ensure choice and efficiency. Thus market solutions need a governance framework to be effective: 1) the capacity to regulate private action; clear property rights and an open process for contract bargaining and adjudication, 2) diversity which gives choice, and 3) citizen voice. Coase's (1960) suggestion that voluntary markets could provide solutions to public goods rests critically on the assumption of zero transactions costs. Coase recognized that transaction costs and bounded rationality may restrict choice in a voluntary market-based model. This is why he identified clear property rights and a process for bargaining as so important. However, as Table 2 illustrates, the mechanisms in the trade agreements create an environment that is in conflict with the elements that are the foundations of Coase's theory.

Insert table two about here.

The capacity to regulate private action: Recognizing that contracts are a challenge and costly to enforce, transaction cost economics focuses on the mechanisms of governance. Williamson (1996) has shown theoretically that for transactions that are complex, contracts will be unavoidably incomplete, and hierarchy, as opposed to markets, will be the preferred governance solution. When applying private markets to public goods, contracts are almost always incomplete due to complexity of public service delivery and lack of competition (Hefetz and Warner 2004, 2007, Sclar 2000, Lowery 1998).

Salamon, in his discussion of the 'tools of government', has emphasized the managerial challenges of ensuring efficiency, transparency and effectiveness when public goods are produced through an inter-dependent network of market actors. The effectiveness, legitimacy and accountability of these networks depend on adequate governance systems (Rhodes 1996, Salamon 2002). The broad mix of public and private actors involved in free trade makes the challenge of network governance especially difficult (Longworth 2001).

Diversity between levels of government: Tiebout (1956), in his model of a competitive public market between governments, emphasized the importance of diversity in local government provision to ensure choice. In federalist states, such as the U.S., state and local authority helps ensure diversity and choice. Although in Dillon's Rule states, local governments have more limited authority, diversity at the state and local level is a key hallmark of the U.S. Constitution. State power vis a vis the federal government, protections of private property from seizure without remuneration, and the autonomy of legislative and court systems are key U.S. constitutional protections. This new generation of free trade agreements is changing the structure for government action and undermining core aspects of state and local government authority. Ironically, this may limit the potential for effective use of market based service delivery for the provision of public goods.

Citizen voice, choice and protection: The protections for citizen participation and access to the legislative and judicial processes are not preserved in the trade agreements. The Freedom of Information Act, Open Meetings Acts, the transparency of court transcripts, and protected speech for dissent all provide citizen protections that help ensure both democratic behavior by governments and public accountability of private contractors (Dannin 2004). Legal examination shows citizen protection when public services are provided by private providers is not guaranteed (Dannin 2004, Moe 1987, Sullivan 1987). This has raised questions about the limits of market approaches to public goods especially when government managers must balance heterogeneous citizen desires with cost and quality constraints and the need for accountability and public involvement (Hefetz and Warner 2004, 2007, Warner and Hefetz 2007, Feldman and Khademian 2001, Svara 1998).

This paper describes the key governance changes created by these new free trade agreements and shows how they raise transaction costs for state and local governments in an effort to lower the transaction costs of private action. We argue there is a governance deficit in these agreements that should be addressed. If private markets present an alternative to direct public delivery, state and local governments need the authority to structure markets to ensure efficiency, competition and to safeguard the public good.

The New Generation of Trade Agreements

Since the 1990's, the United States has pursued an ambitious trade agenda beginning with the NAFTA and the GATS. These have served as a template for a new generation of multi- and binational trade agreements that reach beyond the traditional treaties of the past that limited excessive tariffs, import limitations, or customs practices. Modern trade agreements include government procurement of goods and services, and government regulation of services, investments and financial transactions.

This generation of free trade agreements creates a framework for member country governance and affects areas traditionally reserved to state governments by the U.S. Constitution. The NAFTA was the first agreement that shifted the balance toward investor and economic concerns by granting individual foreign investors rights to challenge domestic government measures in international arbitration and receive cash awards for government activity that would have been upheld in domestic courts (Warner and Gerbasi 2004a).[i] This is in conflict with the traditional role of government as the arbiter between private rights and the public interest and of the domestic courts to ensure that burdens are legitimate. Rather than operating within the domestic legal arena of predictable liabilities and obligations, government officials are expected to comply with trade obligations that prefer private rights to the public interest. In addition to being heard in an international court, international challenges are decided under different laws, and hold government action to a higher standard. State and local officials are not involved in the negotiations and are not informed of the results in a manner that makes the new obligations and liabilities clear. Trade rules shift the legal norms and traditional flexibility of state and local government to tailor laws to benefit and suit local conditions in three ways:

1. Increased government liability for regulations through a redefinition of takings and property,
2. A new standard for regulatory review, and
3. Substitution of private adjudication procedures for the public courts (Appleton 1994).

These elements introduce instability into the legislative and judicial processes that constitute the framework for federal, state and local governance. We believe these provisions will raise transaction costs both for state and local governments and domestic private contractors.

Redefinition of Property and Takings

Beginning with NAFTA, most U.S. trade agreements include investor protections that redefine property and government liability for regulatory action. Approved by Congress, this is a preemption of legislative authority and conflicts with seminal court and legislative decisions that value the balancing role of the state over the private right to contract (Bernstein 2004). Traditionally the role of the state has been as an umpire between private interests, and an advocate for the public problem of market failure (John Roberts quoted in Appleton 1994 p. 206). This is rarely more evident than in “takings” litigation – the balance between the use of property for private gain and the interest of the public in that property. Epstein (1985) first proposed that government actions such as zoning, environmental and labor regulations constitute takings. Epstein argues that most regulations since the New Deal are intrusions of government on private property and should be compensated as a loss. However Epstein’s radical view of takings has been rejected by U.S. courts. After decades of judicial and legislative debate, the concept of *takings* in the U.S. domestic context awards compensation under limited circumstances to citizens whose property is used for the public good. In the United States, loss of use of the property in its *entirety* gets compensation, but partial losses in property value are insufficient to qualify (Eagle 2001). In 1993 the Supreme Court reasserted this stance holding that "diminution in a property's value, however serious, is insufficient to demonstrate a taking" (Concrete Pipe 1993). The fair market value of the property (in its current use) is awarded in the case of a full taking.

Under the trade agreements, both the definition of property and the instances that would require government compensation have been expanded. *Property* includes future profits, market share, and market access (NAFTA Chapter 11). *Partial losses* of profit or use of land due to government taking (in physical form or via regulations) may require government compensation (Mann and von Moltke 1999). This is a greater right than U.S. citizens have under the takings clause (Greider 2001a). This expansion in property rights is restricted to foreign private investors only; partial regulatory takings are considered non-compensable, reasonable losses for the privilege of citizenship in the domestic context (Dalton 1999). While this concept has benefited U.S. business interests abroad, it could also increase government liability for traditional regulations domestically.

- Case Example: Metalclad is a U.S. company that purchased land in Mexico with the intent of building a processing plant for toxic wastes. The Mexican regional and federal governments approved the venture. The local government refused to issue a building permit due to an environmental impact report from a government engineer that found the project would have exacerbated ground water pollution. When building didn't stop, the local government rezoned the area as an environmental refuge. Metalclad claimed the rezoning was an expropriation of their investment, took the claim to a NAFTA tribunal, and was awarded $16.8 million. Judge Tysoe (2001) of British Columbia, one of the judges who reviewed the decision, voiced concern that this broad interpretation of the treaty could interfere with customary and legitimate local zoning laws.

It is unlikely that this would have been the result in a Mexican or United States court. There were other uses of the property, the project endangered groundwater resources, and the company didn't get proper local permits to build. Making government pay private investors for the losses incurred as a result of government regulations will substantially undermine government action. In the Metalclad case, the federal government is withholding federal funding from the town until it indemnifies the federal treasury, significantly raising costs of government action for the state and local governments.

Government-supported market solutions are a compromise between the private provider and the public interest. The promise of market based solutions for public goods is that governments can craft bargaining frameworks that encourage private bargaining to reduce externalities and free riders. Pollution trading schemes, for example, show the potential for market solutions to traditional externalities (Tietenberg 1992). Clear property rights, full information and the power to negotiate are critical if such private bargaining solutions are to be successful (Hefetz and Warner 2004, 2007, Warner and Hefetz 2007, Webster 1998, Staley and Scarlet 1997). Current domestic U.S. takings legislation clearly shapes property owners' expectations of compensation for limits on private property use in favor of the public good (Callies 1996, Trelease 1971).

In most instances, restrictions on property that affect all owners in the same fashion are not compensable under U.S. legal standards (Eagle 2001). If the agreements require foreign investors be paid for restrictions of general applicability, the costs may prohibit the action or develop a dual standard for domestic and foreign property owners (Stokes 2001). U.S. officials would have to determine liability by separately analyzing domestic and foreign property holders' rights before passing legislation or administrative rules. Foreign investors would have an avenue to seek reimbursement for ordinary regulations that limit externalities, while domestic investors would bear the full cost of their actions. This will raise the costs for domestic providers. Furthermore, international court-enforced compensation for regulatory takings due to trade obligations may undermine foreign investors' incentives to participate in voluntary market solutions, one of the key promises of privatization.

A New Standard of Review for Regulatory Action

The changes in the definition of government liability are only the first intrusive element of the new agreements. In addition to the potential for greater takings liability, trade agreements apply a stricter standard for deciding if laws are "necessary" or "legitimate." Under the *domestic regulation* trade rule, foreign service suppliers have the right to be governed by the least restrictive/burdensome legislative option (NAFTA Art. 1201, GATS Art. VI: 4). Therefore, laws related to licensing of services or technical standards must stand up to *strict scrutiny* that they are the least burdensome law rather than the deferential *rational relation* basis typically used in the United States. The U.S. standard of review reflects the deference the federal government affords subnational government. If the laws passed are rationally related to a legitimate government objective, they are generally upheld unless free speech or other special circumstances are at issue. Trade rules open the door for international tribunals to second guess state and local laws and court interpretations. This undermines the legislative diversity allowed by the federalist system.

Trade Rules:

- The *domestic regulation* trade rule requires that technical standards governing a particular industry regarding qualifications, licensing requirements and procedures must be: (a) "based on *objective and transparent* criteria," and (b) "no more *burdensome* than *necessary* to ensure *the quality of the service*" (GATS Article VI:4).
- The national treatment rule requires that governments treat foreign service providers at least as well as domestic providers.
- Market access rules restrict government's ability to limit the number of service suppliers, number of outlets, foreign ownership, or the value or volume of product or service output.

These rules can be applied against any government measure that directly or inadvertently causes economic harm to a foreign business venture. State and local legislation regarding zoning, utility rate-setting or economic development could be in conflict with trade rules (Schweke and Stumberg 2000, Warner and Gerbasi 2004b). Examples cited by Schweke and Stumberg include residency requirements, procurement rules privileging local, minority or small business owners, or requiring recycled content, and living wage ordinances. Any subsidies must be extended to the foreign investor. For example, United Parcel Service is challenging the Canada Post in a NAFTA tribunal for using its existing letter facilities to deliver parcels. UPS claims this violates national treatment by providing an impermissible latent subsidy that gives the Canada Post a competitive advantage (UPS v. Canada 2001).

The domestic regulation criteria raise several weaknesses of domestic law when interpreted through a trade lens. Whether a rule is *necessary* in the United States depends on whether the restriction on the private individual advanced a legitimate government objective. In trade parlance, *necessary* means there is no less restrictive way to achieve the goal. The fact that one state or community may have a less restrictive law could be evidence that the law in question is overly burdensome. This was one of the original objections leveled by a Canadian firm, Methanex, against the State of California for its law restricting use of MTBE due to groundwater contamination.

- Case Example: Methanex, a Canadian firm, challenged California's right to ban MTBE (a groundwater pollutant) on the grounds that it violates NAFTA Chapter 11 obligations (Methanex Statement of Claim 1999). Methanex claims California could have pushed for strict compliance with existing environmental inspection regulations of underground gasoline storage tanks rather than banning MTBE (Lazar 2000). To choose the more expeditious route of eliminating the chemical from gasoline allegedly conflicts with Methanex's right to be governed by the least trade restrictive methods available. Methanex also asserted a national treatment violation because a U.S. domestic product would replace the market lost by MTBE. The damage claim was nearly a billion dollars including good will, reputation and future profits.
- Case Example: Canada is taking these criteria seriously as it considers how to structure a new $5 billion federal subsidy for child day care. Government objectives extend beyond quality to include access for disabled and minority children and human development and citizenship development goals. Legal advice suggests NAFTA rules may consider these criteria "not objective" and "burdensome." As a result, policy debate is centered around restricting private access to subsidies altogether (Shrybman 2004). This undermines the very potential for market provision that trade agreements are trying to achieve.

The definitions of "burdensome", "necessary" and "legitimate" under GATS are still being negotiated by the WTO Working Group on Domestic Regulation that generally meets in Geneva. At present, the only legitimate objectives for government are to protect the consumer of a service and to ensure the quality of the service. Considerations such as assessing the likelihood and costs of a potential contract failure have been considered and rejected in the initial domestic regulation negotiations (WTO Working Party 1998). A failure of public benefit may not be sufficient cause for a government agency to reclaim primary provision of the good or service. This will increase the risk of state and local governments in the contracting process.

<u>Substitution of Private International Arbitration for Public Courts</u>

When governments use contract markets they need the security of a standard adjudication procedure should the contract fail or measure be challenged on constitutional or other grounds. Open contracting requires the standards be similar for all regulated entities. The domestic court system, developed to create an environment that is predictable and stable for both business and government activity in the domestic arena, is irrelevant to the trade arena. The international arbitration system is modeled after a private adjudication tribunal for commercial disputes. Two different sets of laws (one for domestic contractors, and another – unknown one – for foreign firms) will make it difficult for governments to construct fair bidding processes or monitor and enforce contracts or regulations. Key differences between these tribunals and the public U.S. courts system include:

- Lack of public access to witnesses, testimony, and possibly any notice of the existence of a challenge to domestic law;
- Legitimacy determined by trade rules and international standards;
- No deference to law of host nation or subnational government;
- No precedence - Panels are not required to decide similar facts like prior courts did;
- A very narrow appeals process.

The federal government defends challenges to government measures in an international tribunal panel. The federal government may not share the same interests as the state and local governments. Difference in the rules of engagement for international dispute resolution may create confusion and a lack of finality raising uncertainty and transaction costs for state and local governments.

Equally important is the possibility that foreign complainants could either circumvent domestic courts, or appeal each negative decision in an international venue. If a domestic court decision is made, an unfavorable outcome for the foreign investor might encourage the investor to avoid state law by going into arbitration. This has already taken place on several occasions.

- Case Example: *Loewen Group, Inc. v. United States:* Loewen was found guilty of illegal competitive tactics and was fined $400 million in a punitive damages award in the Mississippi Supreme Court. Loewen settled the case for $175 million. Still dissatisfied with the outcome, in 1998 Loewen turned to the NAFTA process for relief. The tribunal decided early on that a court case was a *government measure* and therefore could be interpreted by an international tribunal. Loewen since was sold to a U.S. firm, and thus lost its foreign investor standing, so the panel dismissed the claim.
- Case Example: *Glamis v. United States:* Michael Steeves, the vice president for investor relations of a gold mining company challenging a California mining reclamation law, told reporters that he filed a NAFTA investor-state claim under Chapter 11 specifically because the chances of success were better than using the U.S. courts and law. "You use whatever means is at your disposal, where ever you think you have the greatest chance of success." (quoted in Thompson 2005).

These cases illustrate the challenge NAFTA's adjudication procedures present to the stability of the domestic courts system. No civil dispute with a foreign investor can be considered settled until a tribunal also has considered it. Arbitration panels are not required to follow the precedent set by previous panels, so each time an issue arises, it may be decided differently. The arbitration panels are under no requirement to give the court or the state laws deference or access to the process. The courts would lose their ability to interpret the law for foreign cases, and U.S. domestic laws could become irrelevant where foreign investors are concerned. There would be two standards for disputes, one for foreigners set by an international tribunal and the traditional U.S. law for domestic investors. This disrupts the finality of the court system. In this regard, the Conference of Chief Justices, has asked the U.S. Congress "to preserve the integrity of the courts … and their ability to adjudicate fairly and finally the rights of all parties who seek justice in them" (AIADA 2004).

For example, while the Canadian company, Methanex, challenged California law in international arbitration, the U.S. court system has supported California cities that have sued refiners for MTBE ground water well pollution and is making gasoline refiners pay (Gullo 2002, Kay 2002). Courts have awarded cities close to $40 million for remediation (Mehta 2002). The Methanex dispute stands in stark contrast to current domestic legal practice (Lazar 2000). Although the Canadian case recently failed (U.S. Dept of State 2005), neither the State of California nor its affected municipalities were allowed to be the party to arbitration proceedings about their own laws.

<u>What are the public goods and services in question?</u>

Each of these agreements, to varying degrees, liberalizes markets to provide public goods and services traditionally supplied by governments. The examples above illustrate the underlying purpose of the agreements, which is to eliminate "unnecessary" regulation (Bottari and Wallach 2001). The NAFTA, the CAFTA and the GATS change the governmental role from market participant through contracting and regulation to direct competitor. In the NAFTA, services are included unless specifically carved out; but under the GATS, each country selects the services where public providers can not be preferred over private companies or restricted in violation of trade rules. Services provided by government agencies are exempt, but the caveat is that the service must not be for a fee nor available in the marketplace. Read more closely, GATS covers all services "except services supplied in the exercise of governmental authority," which are defined as services "supplied neither on a commercial basis, nor in competition with one or more service suppliers" (GATS Article I §3). Given the goal to encourage private investment, the exemption for government services will be interpreted narrowly (Dobbin 2001). Some services currently committed under the GATS include business services; financial services; construction; engineering; services incidental to energy, mining and agriculture; higher education; and sewage services contracted by private industry. Public services such as health care, education, water distribution, and waste disposal are already available as commercial alternatives and therefore may not be within the government exclusion. Elements of these services are already committed. This is why Canadian child care advocates recommend restricting public support to public and non-profit child care centers. They believe if Canada allows private Canadian firms access, it would have to open its subsidies to U.S. private child care firms as well (McCain and Coffey 2004).

Free Trade Agreements Create a Democratic Deficit

Under these free trade agreements, foreign investors have the right to participate in domestic lawmaking, and if they are not satisfied with that process, take their complaints to an international arbitration tribunal not available to similarly situated domestic investors (Wallach and Sforza 1999). The success of the U.S. system is based on the transparency of the process, and the ability of citizens to participate in debates regarding laws, policies and actions. Public hearings are an opportunity for all stakeholders to be heard, and ideally come to a balance of interests. The U.S. system is built on the notion of checks and balances. If a lawmaking body exceeds its authority, the court or the executive can keep the legislature in check. International trade agreements lack such checks and balances.

These new free trade agreements create a quandary for state and local governments. U.S. state and local governments recognize the need to be competitive and thus typically support free trade as a source of economic development. They have only recently begun to comment on the reduction in government authority in the trade agreements (Warner and Gerbasi 2004b). This is partly due to the fact that the early cases (under NAFTA) primarily involved Mexico and Canada and were thus less visible to U.S. officials. Recent losses at the WTO under GATS have prompted some academics to comment on the loss of control by U.S. state governments (AIADA 2004). The Canadian Union of Public Employees and the Council of Canadian municipalities have been very critical of these agreements and have requested major revisions or repeal (CUPE 2001). Some litigators suggest the partial takings liability would bankrupt many local governments or divert financial resources from critical public works (Kendall et al. 2000).

Public Leadership

States have a lack of access to the trade negotiation process and a lesser role in dispute resolution. The executive branch of the federal government has the exclusive right to negotiate treaties, trade agreements and trade rules (Article I of the United States Constitution). When the breadth of trade agreements was limited to tariffs and other border issues, independent federal action may have been sufficient. New agreements target government regulation of areas traditionally reserved to states including the protection of health, morals and economic development within state borders. Lack of involvement of states in the negotiation of these rules can undermine their traditional areas of authority (Warner and Gerbasi 2004a).

The Intergovernmental Government Policy Advisory Committee (IGPAC) is the single representative committee for dialog between state and local government and the USTR. Recently expanded to 35 members, IGPAC gives the USTR comments on trade agreement drafts and proposes changes to both agreements and negotiating objectives (IGPAC 2004). This committee, however, is only one of 30 advisory committees (USTR 2002). There is a committee for civil society submissions, an environmental issues committee, and the balance represent various industry sectors. IGPAC and various government associations have been active in representing the broad authority of state and local officials if not industry specific regulations.

- IGPAC has requested adjustments to the arbitration system, that deference be given to state and local legislation, and greater communication occur between states and the USTR (IGPAC 2004).
- The National Conference of State Legislatures has asked that reservations be made to avoid unnecessary preemption and preserve traditional state authority (NCSL 2002).
- The National Association of Counties (NACo 1999) requested clearer communication of all impacts federal legislation may have on state and local operations.
- The National League of Cities requested transparency, disclosure, legal standards (including traditional definitions of takings) and the need to protect local governments' rights to subsidies and procurement preferences (NLC 2002).
- Washington, California, Maine and North Carolina have formed trade oversight committees to analyze the impact of trade on state laws, authority, and prerogatives.
- Over a dozen counties and municipalities have passed resolutions requesting protection from the trade agreements or declaring they will not participate in the trade agreements and do not consider themselves bound.

States also may get information from the State Point of Contact (SPOC) system required by the World Trade Organization implementing legislation (Statement of Administrative Action 1994). The governor has the privilege of appointing the SPOC, and the USTR communicates with the states through the SPOC network or governors' offices nearly exclusively. It is up to the states to develop a functional network that relates state and local concerns to the USTR.

Though networks exist, communication between states and the USTR could be improved. Requests for state participation from the USTR are often one-sided and directed to the governors rather than the legislature. Updates on liability and court proceedings are normally only shared with the state in question if a state law is at issue as required by the implementing legislation (Statement of Administrative Action p. 673). In the event of a challenge, the federal government defends the state's interests in cooperation with the state attorney general. The legislature is not consulted. There is little effort to analyze the impact of trade obligations on state and local practices. As an example, when NAFTA was presented to Congress, the novel addition of investor-state dispute resolution and targeted monetary awards was not raised or discussed (Meyerson 2002). Abner Mikva, a former federal court judge and NAFTA arbitration panelist remarked that "[i]f Congress had known there was anything like this in NAFTA, they never would have voted for it" (Liptak 2004). As corroborated by independent review of the 2004 Congressional hearings on NAFTA, Senator John Kerry admitted that "when we debated NAFTA, not a single word was uttered in discussing Chapter 11" (Ambrogi

2002). This extreme example is one illustration of the lack of transparency and information about liabilities and obligations in trade agreements. Few state and local officials are aware of the challenges that have been brought against U.S. regulations (typically state environmental laws) or under what circumstances they might be challenged.

Conclusion

Public goods arise from market failures over externalities and free riders. This creates the need for government solutions in the first place. It follows naturally that government concerns with public goods could be in conflict with private interests in profit. The potential for market based provision of public goods lies precisely in the ability of government to regulate property rights and create a Coasian bargaining framework (Webster 1998). Research and practical experience with privatization has shown that for efficiency to be achieved governments must have flexibility to play a market structuring role (Starr 1987, Sclar 2000, Warner and Hefetz 2001, 2007). Thus it is no surprise that government concerns with choice, stability and social provision could be in conflict with the narrow economic goals of free trade.

The goals of free trade are to create a level playing field to promote the free movement of capital and goods so the benefits of comparative advantage can be pursued. State and local governments are fundamentally about democracy, voice and choice (Warner and Hefetz 2002a, Briffault 2000). At the core of privatization is the potential for market-based solutions to enhance choice and efficiency in public goods provision. However, if this market potential is to be realized, greater attention must be given to governmental authority and democratic voice. The authority of state and local government to make regulations to protect public well being is being reinterpreted as a barrier to free trade. Citizen voice and state and local government authority are being restricted in order to enhance the voice of private foreign investors. The democratic and governance deficits in these free trade agreements make it difficult to balance citizen and foreign investor interests. Ironically, this singular focus on reducing trade barriers may undermine the very potential for state and local governments to manage markets for public service delivery.

Although some scholars argue that increasing dependence on the market implies a shrinking role for government (Savas 2000, Bennett 1990), others argue it creates a new dimension for government action--in structuring the market of service providers (Osborne and Gaebler 1992, Schamis 2002, Warner and Hefetz 2001, 2007, Hefetz and Warner 2004, 2007). Lack of competition, problems with information, contract specification and monitoring raise the transaction costs associated with market solutions (Ferris 1986; Hirsch 1995; Pack 1989; Prager 1994; Salamon 2002). All aspects of the service–quality, timing, access, cost and procedures for monitoring and exiting a contract and opportunity for public deliberation must be included in the contract. Effective use of market provision may require an expansion of governmental administrative oversight into private service delivery in order to ensure accountability and public objectives are maintained (Blanchard et al. 1998). The challenge is to create a governance system that balances governmental authority and market interaction (Amin and Hauser 1997).

Transaction cost economics makes clear that for complex contracts some level of hierarchical control is required. In public services, this not only ensures citizen voice and a democratically controlled process to balance competing interests, but also a market governance structure that reduces transaction costs for both government and private contractors alike. The standard economic view of the trade negotiators ignores the fundamental requirements of a successful market governance system. Ironically, by undermining state and local government control, they raise the costs and undermine the viability of market solutions for public goods.

Table 1. Selected Impacts of Trade Agreements on State and Local Governments

New Generation Trade Agreements		
Name	**Signatories**	**Highlighted Impacts on Government**
North American Free Trade Agreement (NAFTA) 1994.	United States Canada Mexico	▪ Individual foreign investors can sue nations. ▪ Dispute resolution in secret international tribunals. ▪ Removes domestic court jurisdiction over cases ▪ Property redefined for foreign investors. ▪ All services open to foreign investment unless on short list of excluded sectors.
The General Agreement on Trade in Services (GATS) 1995 - Service commitment and administratively negotiated discipline offers submitted in 2005.	The World Trade Organization Countries148 countries including the European Union and China	▪ Liberalizes services scheduled by the parties. ▪ Trade-legal test for government action. ▪ Government provision exception limited to those services not offered privately or in competition. ▪ Water delivery and treatment, schools, and prisons may be open to competition. ▪ Renegotiate to add or expand services every five years.
The Free Trade Area of the Americas (FTAA) In draft form.	34 North, Central and South American countries and the Caribbean but not Cuba.	▪ Liberalizes all service sectors not specifically excluded ▪ Draft includes NAFTA investor rights chapter ▪ May extend foreign investor protection from performance requirements to domestic investors
The Central American Free Trade Agreement (CAFTA) 2005.	Includes Costa Rica, Guatemala, El Salvador, Honduras, Nicaragua, and the Dominican Republic.	▪ Links by reference to the GATS service schedule of commitments. ▪ Extends the investor protections to U.S. subsidiaries as well as third country investors with "substantial business interests" in the CAFTA country. ▪ Includes "licenses, authorizations, permits, and similar rights" to define investment property.[ii]

Table 2. Coasian Requirements and Trade Rule Features

Coase's Elements	Trade Rule Features
• A clear system of property rights,	• Different property rights for domestic and foreign investors
• An open and fair bargaining environment,	• Limit government tools to balance private profit with public interests
• A predictable adjudication process.	• International courts hear cases, are closed to the public, use international standards to review legitimacy and "necessity," and are not held to precedent.

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[i] Under investment agreements like NAFTA that include investor to state arbitration, private foreign investors challenge U.S. laws before international arbitration panels. These issues historically have been resolved through diplomatic negotiations between countries, and GATS claims are still brought by countries, not individuals.

[ii] US-CAFTA Final Text Article 10.28(g). Retrieved August 4, 2005. Web site: www.ustr.gov/assets/Trade_Agreements/Bilateral/CAFTA/CAFTA_DR_Final_Texts/asset_upload_file328_4718.pdf.