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Efficient Breach of International Agreements

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Efficient Breach of International Agreements

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Economic theory suggests that when the benefits of breaching an agreement exceed the costs of complying with an agreement, the system governing the agreement should allow a party to breach the agreement. On the other hand, when the costs of breach outweigh the benefits of breach, the governance mechanisms should create an incentive for a party to comply with the agreement. The theory of efficient breach predicts that parties will attempt to forge mechanisms that allow efficient breaches and deter inefficient breaches. In the domestic arena, the breaching party itself can determine if the breach is efficient: The breach is efficient if the party can afford to pay damages.

In the international arena, there is little chance that a state will be forced to pay damages for breaching an agreement. International law must provide specifically whether a breach is legal or illegal.

In bilateral agreements, parties attempt to achieve efficiency through the use of informal governance mechanisms such as economic hostages and collateral. In multilateral agreements such as the General Agreement on Trade and Tariffs (GATT), breach is allowed when compliance would be politically untenable. Other breaches are punished with retaliatory trade measures. In unilateral agreements such as the EEC, breaches are not countenanced. As unilateral agreements take on federal characteristics, states are expected to comply with all undertakings.

This article tests the theory of efficient breach in international agreements under three of the four governance structures outlined by Beth V. Yarbrough and Robert M. Yarbrough.

I. INTRODUCTION: EFFICIENT AND INEFFICIENT BREACHES OF DOMESTIC CONTRACTS

One of the central tenets of domestic contract law is the compensation principle: a party that breaches a contract should pay only the

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resulting damages caused by the breach. The compensation principle has been justified by the theory that some breaches of contracts are efficient; i.e. the aggregate benefits of breach outweigh the aggregate costs. The theory of efficient breach is rooted deeply in Anglo-American law. As Oliver Wendell Holmes said,

[t]he duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it — and nothing else. If you commit a tort, you are liable to pay a compensatory sum. If you [enter] a contract, you are liable to pay a compensatory sum unless the promised event comes to pass, and that is all the difference. But such a mode of looking at the matter stinks in the nostrils of those who think it advantageous to get as much ethics into the law as they can¹

In a domestic setting, an agreement that binds two parties is a contract.² In an apartment lease, for example, a landlord grants permission to a tenant to live in the apartment. In exchange, the tenant agrees to pay rent. If either party fails to perform its obligations under the lease, the non-breaching party may bring suit in a court of law. The court can order the breaching party to pay money damages to the non-breaching party in the amount equal to the loss to the non-breaching party.

With some exceptions, the law of contract damages adheres to the compensation principle. There are four major ways of awarding damages in Anglo-American law. Expectation damages represent the amount of money that would put the non-breaching party in the position in which it would have been if the contract had been performed, i.e. if the non-breaching party's expectations had been fulfilled. Reliance damages represent the amount of damages sufficient to place the non-breaching party in its pre-contract position. Courts order specific performance of a contract obligation if the subject matter of the contract is unique or the benefits of performance are idiosyncratic, such as where the seller of a home breaches his agreement to sell. Finally, courts order restitution of money that has been transferred to the breaching party. In this case, the non-breaching party may choose the measure of damages.³

Despite the threat of lawsuit, contracts are often broken. In determining whether a party will comply with a contract, a common as-

1. Oliver Wendell Holmes, *The Path of the Law*, 10 HARV. L. REV. 457 (1897). Other jurists believe that a contract is a moral obligation that should never be broken.

2. The party that breaches the contract, or that may potentially breach the contract, is called the "breaching party." The other party is the "non-breaching party."

3. Another method is to award damages or penalties specified in the contract (liquidated damages and penalty clauses). Some laws also allow criminal sanctions. Non-legal sanctions exist as well. See *infra* section III.

sumption is that the non-breaching party will act rationally. A party will break the contract if the cost of breaching the contract is less than the cost of compliance with the contract; conversely, a party will comply with the contract if the cost of breaching the contract exceeds the cost of compliance. The legal remedy for breach affects a party's decision to breach. If the penalty is high, few breaches will occur; if the penalty is low, breaches will occur more frequently. Thus, the legal system can achieve an optimal rate of contract breach by awarding the appropriate measure of damages.

There are two legal avenues that permit efficient breach. First, there are a number of domestic legal doctrines, such as impossibility, that completely forgive contractual performance. Second, a party can breach a contract if it is willing to pay the cost of breach, including paying a judgment or a settlement fee. In an efficient breach, the costs of breach will not exceed its benefits, and the party will choose to breach the contract.⁴

In addition to encouraging efficient breach, the domestic legal system also deters inefficient breach. First, damages are imposed on the breaching party in the amount of the harm that falls on the non-breaching party. Second, the non-breaching party may make a side payment to the potential breaching party to induce it not to breach the contract. A side payment will prevent a breach if the harm to the non-breaching party (and thus the amount of money it is willing to pay) exceeds the benefit to the potential breaching party.

In the domestic context, major debates have developed regarding the encouragement of efficient breaches. The first debate concerns whether courts should enforce penalty clauses and as to whether courts should impose specific performance. Courts generally refuse to enforce penalty clauses if the remedy specified in the contract exceeds the actual damage to the non-breaching party. An argument against enforcing penalty clauses is that awarding a penalty greater than the actual damages forces a party to comply with a contract even when breach would be efficient.⁵

4. For example, suppose that a manufacturer (the "seller") agrees to sell a machine for \$100. Assume that the machine costs \$80 to make. Suppose further that the seller finds another buyer who is willing to pay \$130 for the machine. If the seller breaks his contract with the original buyer and sells to the second buyer, the seller will earn a profit of \$50 instead of a profit of \$20. The benefit to the seller for breaching the contract is the incremental increase in profit of \$30. Assume that the original buyer could have earned \$110 from the machine. Breach will cause the original buyer to lose the \$110 benefit of owning the machine. But because the original buyer will not have to pay the \$100 purchase price, the original buyer's net loss resulting from the breach is \$10. Under contract law, the seller would pay \$10 to the original buyer in damages (assuming a replacement machine cannot be found at the contract price). Because the seller can gain \$30, the seller will breach the contract and pay the \$10 in damages and still be \$20 better off. No party is worse off.

5. See Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and*

An argument in favor of enforcing penalty clauses is that the amount of damages specified in a contract may indicate the idiosyncratic value of performance, which would otherwise be underestimated by a court. Under this argument, the parties themselves are better able to determine the value of the contract and the necessary damages than a court.⁶ Other commentators rely on the general idea that all clauses in a contract are efficient.⁷

In response, critics of penalty clauses claim that penalty clauses may result in attempts to induce breach.⁸ The party for whose benefit the penalty clause operates may induce the other party to breach in order to collect the penalty; for example, the party might withhold certain crucial information from the other party.⁹ If penalty clauses were enforced, parties would engage in a wasteful use of resources to detect and punish inducement of breach. In the domestic context, the induced breach argument is dubious because it presumes that parties would inject an overcompensatory penalty clause in the contract. The most recent attack on penalty clauses rests upon the argument that "penalties [may] induce social inefficiency by preventing potential actors from competing with the parties to the contract."¹⁰

Although courts are reluctant to enforce overcompensatory penalty clauses, they typically enforce penalty clauses that undercompensate the non-breaching party. In defense of this rule, Stole argues that it is often rational for parties to set undercompensatory penalty clauses. Such clauses, Stole contends, communicate valuable pre-bargain infor-

the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach, 77 COLUM. L. REV. 554, 567-68 (1977). Another argument against overcompensation is that the purpose of contract law is not to punish but to compensate. *Id.*

6. Lars A. Stole, *The Economics of Liquidated Damages Clauses in Contractual Environments with Private Information*, 8 J.L. ECON. & ORG. 582, 583 (1992).

7. *Id.* at 582 ("Economists have long recognized that agreements freely entered into by all affected parties with full information and cognizance of the terms of trade necessarily improve social welfare in the traditional Pareto sense."). For defenses of penalty clauses on efficiency grounds, see Goetz & Scott, *supra* note 5, at 558-77; John H. Barton, *The Economic Basis of Damages for Breach of Contract*, 1 J. LEG. STUD. 277, 286-87 (1972); Alvin C. Brightman, *Liquidated Damages*, 25 COLUM. L. REV. 277, 279-81, 302 (1925); Thomas S. Ulen, *The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies*, 83 MICH. L. REV. 341, 356 (1984); Richard A. Epstein, *Beyond Foreseeability: Consequential Damages in the Law of Contract*, 18 J. LEG. STUD. 105, 137 (1989).

8. Kenneth W. Clarkson, Roger L. Miller & Timothy J. Muris, *Liquidated Damages v. Penalties: Sense or Nonsense?*, 1978 WIS. L. REV. 351 (1978).

9. *Id.*

10. Tai-Yeong Chung, *On The Social Optimality of Liquidated Damage Clauses: An Economic Analysis*, 8 J.L. ECON. & ORG. 280, 281 (1992); see also Phillippe Aghion & Patrick Bolton, *Contracts as a Barrier to Entry*, 77 AM. ECON. REV. 338 (1987); Peter Diamond & Eric Maskin, *An Equilibrium Analysis of Search and Breach of Contract. I: Steady States*, 10 BELL J. ECON. 283 (1979).

mation and should be upheld by courts.¹¹

The second debate is whether courts should award monetary damage or specific performance.¹² For instance, if a seller fails to deliver a unique product, such as land, courts may award specific performance because money damages would not adequately compensate the injured party for its losses. If the product is not unique, however, courts award monetary damages.¹³

One major analytical insight recognizes that negotiation costs are higher if the breaching party can rely on specific performance rather than damages.¹⁴ Under a money damage system, the only information the parties need to negotiate a solution is the amount of damages suffered by the non-breaching party.¹⁵ Once this figure is determined, the breaching party pays the other the agreed upon amount and subsequently breaches the contract.

Under a specific performance regime, however, where the non-breaching party has the power to deny the breaching party the benefits of breaching the contract, both parties require more information during negotiation. For example, if the buyer can demand specific performance, but the seller wants to sell to a different buyer, the original buyer may attempt to force the seller to pay all the benefits of the breach. In order to extract the benefits of the breach, the original buyer must assess the exact amount of the potential benefits to the seller. The benefits of breach are typically the benefits arising under the contract with the second buyer, less the benefits the breaching party would have received had it complied with the terms of the original contract. Thus, the first buyer must seek two pieces of information: the benefits to the breaching party from the first agreement and from breaching the contract.

Specific performance also creates a bilateral monopoly cost. The greater the range of negotiation, the more likely the parties will resort

11. See Stole, *supra* note 6.

12. See Anthony T. Kronman, *Specific Performance*, 45 U. CHI. L. REV. 351 (1978) (favoring traditional distinction between unique and nonunique goods); Alan Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 271 (1979) (advocating specific performance); Steven Shavell, *The Design of Contracts and Remedies for Breach*, 99 Q.J. ECON. 121 (1984) (advocating specific performance for contracts "to give" and damages for contracts "to do"); William Bishop, *The Choice of Remedy for Breach of Contract*, 14 J. LEG. STUD. 299 (1985) (arguing against Schwartz and specific performance); Edward Yorio, *In Defense of Money Damages for Breach of Contract*, 82 COLUM. L. REV. 1365 (1982).

13. One author contends, however, that these two categories can be broken down into about twenty categories. See William Bishop, *The Choice of Remedy for Breach of Contract*, 14 J. LEG. STUD. 299 (1985).

14. See *id.* at 311-14. See also Timothy J. Muris, Comment, *The Costs of Freely Granting Specific Performance*, 1982 DUKE L.J. 1053 (1982).

15. Bishop, *supra* note 13, at 312.

to strategic bargaining techniques that can kill a mutually beneficial agreement. Specific performance widens the range of bargaining, and thus increases the probability of breakdown. In comparison, an optimal court system would penalize all breaches of contract by imposing a fine on the breaching party equal to the damage done. Such an ideal system would allow efficient breach and deter inefficient breach.

It should be noted that an optimal system of contract enforcement does not exist, even in domestic law. For example, it is not necessarily true that the domestic court system punishes a breach of contract by the amount of damage done. The costs of litigation, both time and money, may deter a plaintiff with a good chance of success from litigating to recover damages. Thus, potential plaintiffs have designed a number of self-help remedies to punish breaching parties without resorting to litigation. Returning to the earlier example, a landlord may avoid litigation costs by seizing a tenant's security deposit, evicting the tenant summarily, or damaging the tenant's reputation. Extra-legal sanctions such as these are sometimes more important than the legal sanctions.¹⁶

II. EXTENDING EFFICIENT BREACH TO INTERNATIONAL AGREEMENTS

The differences between domestic and international agreements are reflected in the normative and positive aspects of the theory of efficient breach. This section examines certain general properties of international agreements that affect efficient breach.

A. *Reasons for Breaching Treaties*

The assumption of rationalism is as valid in the international arena as in the domestic arena: it is reasonable to assume that nations weigh the costs and benefits before violating an agreement. Louis Henkin argues that "usually a nation deliberately violates a norm or agreement because it expects that the advantages of violation will outweigh its costs. Faced with the temptation to act in disregard of law or obligation, the government will know what it hopes to gain . . ."¹⁷

There are three broad reasons that nations break treaties, all of which mirror domestic contracts. The first is temporal opportunism. If the benefits of a treaty accrue early, a state may be tempted to violate the treaty to avoid obligations that it must perform later.¹⁸ Thus, despite the fact that *ex ante* the agreement would have been beneficial, a party may be tempted to breach it once the benefits have accrued in

16. See *infra* section III.

17. LOUIS HENKIN, *HOW NATIONS BEHAVE* 69 (2d ed. 1979).

18. THOMAS HOBBS, *LEVIATHAN* 68 (The Scholar Press Limited, 1969) (1651) ("For he that performeth first, has no assurance the other will performe after . . .").

favor of that party.¹⁹ A good example is a bilateral investment treaty.²⁰ The guest country performs first by, for instance, investing in the host country's copper mine. The host country performs its main obligation last by refraining from expropriating the investment. However, the temptation to expropriate in violation of the agreement often proves too strong. A common remedy for temporal opportunism rests in the design of a contract specifying that each party is to perform its obligations simultaneously.²¹

Second, a state might threaten to breach in order to extract concessions from the other side. This prospect underlies Yarbrough & Yarbrough's theory of strategic organization.²²

Third, the costs and benefits of adhering to a treaty may change during the course of performance, causing one state to breach even - though *ex ante* the state would have adhered to the treaty. For example, suppose that the gross benefit of a treaty was \$10 billion at the time a state signed it, but the benefit then falls to \$5 billion before the country has performed its obligations. If the cost of the obligation is \$7 billion, the country would breach the treaty (assuming it does not suffer any legal or extra-legal punishment).

B. *Uncompensated Injury*

One objection to the theory of efficient breach in the domestic sphere is that breach of a contract prejudices the interests of the non-breaching party. However, the non-breaching party can be fully compensated, at least in theory, if a court awards damages equal to the damage caused by the breach. Even if damages are not awarded, the non-breaching party will be compensated *ex ante* for the risk of breach if there are no transaction costs. Suppose, for example, that during

19. Many domestic agreements require a party to perform its duties at a different time than its counterpart. For example, a grocery store that sells on credit performs its part of the agreement first because it supplies the goods. The consumer pays later. The party that performs last is tempted to breach its obligation to perform.

20. See CHARLES LIPSON, *STANDING GUARD: PROTECTING FOREIGN CAPITAL IN THE NINETEENTH AND TWENTIETH CENTURIES* (1985).

21. Anthony T. Kronman, *Contract Law and the State of Nature*, 1 J.L. ECON. & ORG. 5, 10 (1985).

22. Yarbrough & Yarbrough write:

The strategic organizational perspective . . . would lead us to expect unilateral liberalization only by countries with good alternatives to their current trade arrangements, that is, by countries facing little or no threat of opportunism by trading partners. This is the case whenever the country has little investment in relation-specific assets for trade that can be held up by an opportunistic trading partner.

BETH V. YARBROUGH & ROBERT M. YARBROUGH, *COOPERATION AND GOVERNANCE IN INTERNATIONAL TRADE: THE STRATEGIC ORGANIZATIONAL APPROACH* 56 (1992) [hereinafter Yarbrough & Yarbrough (1992)].

negotiations both parties know that there is a fifty percent probability that, under a change of circumstances, the breaching party would benefit one hundred dollars by breaching the contract. Suppose further that the cost of breach to the non-breaching party would be forty dollars. Breach would be efficient because the benefits of breaching (one hundred dollars) exceed the costs to the other party (forty dollars). The non-breaching party will protect itself from the chance of breach by demanding compensation *ex ante*. It will be exposed to an expected loss of twenty dollars (fifty percent of forty dollars) if it signs the agreement. It can, therefore, demand compensation from the potential breaching party in the form of a higher price if the non-breaching party is the seller or in the form of a higher interest rate if the non-breaching party is a lender. As a result, even if there are no damages, the risk of efficient breach does not injure the non-breaching party in a world without cost.

Ex ante compensation does not usually occur in international agreements. Typically, international agreements involve transfers of legal obligations, not transfers of money. Such transfers are discrete rather than continuous. For example, it would be difficult for Germany to pay Russia \$25 billion to compensate Russia for the risk that Germany might breach a trade agreement. Thus, we are left with a situation in which even an efficient breach would result in an uncompensated risk to the non-breaching party.

Nonetheless, international relations succeed reasonably well in deterring inefficient breach through informal sanctions. The mere fact that injured parties are not compensated does not mean that nations decline to enter into international agreements in the future. The benefits of an agreement will often outweigh its costs, even if the costs include the risk of uncompensated breach. The failure to compensate injuries resulting from efficient acts does not make a system untenable. As an illustration, consider the common law of negligence. A plaintiff cannot recover for a defendant's action if the benefits of the action outweigh the risk to the plaintiff since such action is reasonable and, therefore, not actionable in a court of law.

As for *ex post* compensation, few examples can be found in international law. Among them are the measures authorized by the General Agreement on Tariffs and Trade (GATT) in response to subsidies or dumping. A domestic industry can lobby its government to raise tariffs on products imported from a country that engages in subsidies or dumping. The resulting increase in the domestic price level compensates the domestic producers.

C. *The Morality of Breaking a Treaty*

One objection to efficient breach is that a party has a moral obligation to keep an agreement. This objection has often been rejected in

domestic law on the grounds that the purpose of law is to increase aggregate welfare, not to enforce obedience to an agreement if such obedience has no practical utility.²³

D. Goals of Treaty Policy: Interest Groups and Relative Gains Maximization

A treaty does not necessarily improve a nation's welfare. In domestic law, theorists assume that any contract willingly entered into by an individual is in that person's best interest. As Hobbes wrote,

[w]hensoever a man Transferreth his Right, or Renounceth it; it is either in consideration of some Right reciprocally transferred to himselfe; or for some other good he hopeth for thereby. For it is a voluntary act: and of the voluntary acts of every man, the object is some Good to himselfe.²⁴

Nations, however, are controlled by interest groups that seek to maximize their own wealth rather than that of the country.²⁵ Thus, international agreements may increase the welfare of a particular interest group but not the citizenry as a whole. The negotiation of free trade agreements is an exception, at least as an initial matter, to the theory that treaties are instruments of wealth-seeking. Once a free trade agreement is in effect, however, interest groups exert a heavy influence on nations' compliance and sanctioning behavior.²⁶

Nations also may not maximize welfare because they sometimes pursue relative, rather than absolute, gains. In domestic situations, it is assumed that a party will attempt to maximize its absolute gains; furthermore, if there are no transaction costs, parties in a contractual relationship maximize their joint gains. In international relations, however, Joseph Grieco contends that states sometimes maximize relative gains, not absolute gains.²⁷ Thus, even if there were a net cost to the breach of an agreement, a party might nonetheless breach its treaty in order to impose costs on its treaty partners. As a result of relative gains maximization, states may not sign an agreement at all. Recently, the relative gains thesis has been challenged. Robert Keohane contends that relative gains are maximized only when states

23. See, e.g., Holmes, *supra* note 1.

24. HOBBS, *supra* note 18, at 65-66.

25. According to public choice theory, laws are enacted to increase the welfare of interest groups at the expense of the rest of society. See JAMES M. BUCHANAN & GORDON TULLOCK, *THE CALCULUS OF CONSENT* (1962); George Stigler, *The Theory of Economic Regulation*, 2 *BELL J. ECON. & MGMT. SCI.* 3 (1971).

26. See JAMES BOVARD, *FAIR TRADE FRAUD* (1991) (discussing U.S. trade behavior).

27. Joseph M. Grieco, *Anarchy and the Limits of Cooperation: A Realist Critique of the Newest Liberal Institutionalism*, 42 *INT'L ORG.* 485, 487 (1988) ("[A] state that is satisfied with a partner's compliance in a joint arrangement might nevertheless exit from it because the partner is achieving relatively greater gains.").

pursue "positional goods," such as status.²⁸ Charles Lipson contends that relative gains matter only in security relationships.²⁹ Furthermore, Duncan Snidal has shown that relative gains will bar cooperation only if few states are involved.³⁰

E. General Legal Differences

There are three major legal differences between domestic contracts and international agreements. First, the parties to international agreements are states, not individual actors; all the state's domestic actors — individuals, politicians, interest groups, and political parties — are compressed into one negotiating unit. Second, unlike domestic agreements, international agreements vary widely in formality and in enforceability. Some international agreements are meant to be non-binding.³¹ Some international agreements are subject to strict third party enforceability (e.g. by the European Union), while some international agreements are enforceable only through reputation and self-help. Enforceability is the most notorious difference between international law and domestic law: domestic law has a body with the power to enforce judgments against parties; international law does not.³² The methods for enforcing international agreements are considered in section III below.

28. ROBERT O. KEOHANE, AFTER HEGEMONY: COOPERATION AND DISCORD IN THE WORLD POLITICAL ECONOMY 54 (1984).

29. Charles Lipson, *International Cooperation in Economic and Security Affairs*, 37 WORLD POL. 1 (1984).

30. As Snidal summarizes,

[r]elative gains considerations are shown to matter only for issues involving small numbers of states. The impact of relative gains drops off quickly with more than two states and is virtually irrelevant for issues involving a large number of actors. In addition, the transition to cooperation is not appreciably more difficult under relative gains than under absolute gains.

Duncan Snidal, *International Cooperation Among Relative Gains Maximizers*, 35 INT'L STUD. Q. 387, 388 (1991).

31. Lipson identifies six reasons why nations choose informal agreements over treaties. First, informal agreements can be amended more easily than treaties. Second, informal agreements are less costly to negotiate because they do not require that parties foresee all types of contingencies. Third, informal agreements can be implemented quickly. Fourth, informal agreements escape oversight by democratic organs because they do not have to be ratified. Fifth, informal agreements made by one bureaucracy can escape oversight by other bureaucracies. Sixth, informal agreements do not constitute as much of a commitment as do treaties. The cost of using informal agreements rests in their lesser reliability. Charles Lipson, *Why Are Some International Agreements Informal?*, 45 INT'L ORG. 495, 500-501 (1991).

32. Within international law, I include the law governing what Yarbrough & Yarbrough call unilateralism, multilateralism, and bilateralism. See Yarbrough & Yarbrough (1992), *supra* note 22, at 17-19. Minilateral regimes, such as the EEC, have often been distinguished from international law.

F. Criticism of International Law as Unenforceable

The rule of *pacta sunt servanda* holds that states must honor their treaty obligations.³³ It has often been argued, however, that international law is “unenforceable” because it provides for no effective court-ordered remedy. The power of an international tribunal to assess monetary damages is limited. First, the parties must agree to place their disputes before the tribunal in the first place.³⁴ Second, international treaty law has no real central enforcement mechanism.³⁵ Under the U.N. Charter, a judgment by the International Court of Justice against a member of the United Nations can be enforced by the Security Council.³⁶ However, this enforcement power has never been used.

33. *Pacta sunt servanda* is a rule of customary international law and is also contained in the Vienna Convention on the Law of Treaties. Vienna Convention on the Law of Treaties, May 23, 1969, 1155 U.N.T.S. 331, art. 26 [hereinafter Vienna Convention]. (“Every treaty in force is binding upon the parties to it and must be performed by them in good faith.”). Thus, *pacta sunt servanda* is doubly binding on the signatories to the Vienna Convention: Argentina, Australia, Austria, Barbados, Canada, Central African Republic, Chile, Colombia, Congo, Cyprus, Denmark, Egypt, Finland, Greece, Haiti, Holy See, Honduras, Italy, Jamaica, Japan, Liberia, Republic of Korea, Kuwait, Lesotho, Liberia, Malawi, Mauritius, Mexico, Morocco, Nauru, Netherlands, New Zealand, Niger, Nigeria, Panama, Paraguay, Philippines, Rwanda, Spain, Sweden, Syria, Tanzania, Togo, Tunisia, United Kingdom, Uruguay, Yugoslavia, and Zaire. LOUIS HENKIN ET AL., INTERNATIONAL LAW: CASES AND MATERIALS 12 (2d ed. Supp. 1987).

34. Two parties can agree to submit their disputes to the International Court of Justice by *compromis*. Statute of the International Court of Justice, June 26, 1945, 59 Stat. 1055, T.S. 993 art. 36. There is an obligation to submit any disputes to arbitration if the dispute might threaten international security. Article 2, paragraph 3, of the U.N. Charter states that

[a]ll Members shall settle their international disputes by peaceful means in such a manner that international peace and security, and justice, are not endangered.

Article 33, paragraph 33, of the U.N. Charter states that

[t]he parties to any dispute, the continuance of which is likely to endanger the maintenance of international peace and security, shall, first of all, seek a solution by negotiation, inquiry, mediation, conciliation, arbitration, judicial settlement, resort to regional agencies or arrangements, or other peaceful means of their own choice.

Countries may submit their disputes to the tribunal at any time. Moreover, parties may sign a treaty in which they submit all future disputes to the compulsory jurisdiction of the arbitral body. However, parties are not required to make such submissions and only approximately 80 disputes have been submitted to the I.C.J.

35. An exception to the formal nonenforcement of international law is the European Union, which imposes effective sanctions for noncompliance. However, the EU may be exceptional. Many scholars characterize the EU as supranational law, not international law. For a discussion of the EU, see *infra* section IV(D).

36. U.N. Charter, art. 94, states as follows:

1. Each Member of the United Nations undertakes to comply with the decision of the International Court of Justice in any case to which it is a party.
2. If any party to a case fails to perform the obligations incumbent upon it under a judgment rendered by the Court, the other party may

The violations of the laws of war during World War I led to widespread cynicism about international law. Many scholars abandoned international law for new disciplines such as international relations.³⁷ Yet, the failure to prevent war and wartime atrocities is not convincing evidence of the breakdown of international law. War, with its high stakes and its short shadow of the future, is precisely where we would expect informal enforcement mechanisms to be least effective. Informal mechanisms remain effective in enforcing long-term commercial arrangements.

International lawyers would argue that it is a mistake to assume that international law is unenforceable merely because there is no central authority to punish violators.³⁸ For example, the United States Supreme Court does not have any enforcement mechanism to require the Congress and the President to abide by its decisions. The Court's decisions are obeyed because the other branches of government have a respect for its legal authority. The difference between international law and domestic law (or, at least, national constitutional law) is only in the degree of respect accorded to the law.

States find it in their interests to comply with treaties for a number of reasons, including future gains, reputation, and retaliation.³⁹ Recent scholarship suggests that these reasons for treaty compliance are also important in enforcing domestic contracts, thus undercutting those who criticize international law as unenforceable.

Several factors indicate that domestic economic relations are controlled not so much by legal sanctions as by non-legal sanctions. First, litigation costs often preclude litigation as an effective enforcement mechanism.⁴⁰ Second, a favorable judgment cannot be collected if the defendant cannot pay. Third, we observe that parties often use extra-legal sanctions: collateral for loans, security deposits in leases, and the threat of damage to one's reputation.⁴¹ As an empirical matter,

have recourse to the Security Council, which may, if it deems necessary, make recommendations or decide upon measures to be taken to give effect to the judgment.

While the Security Council's recommendations are nonbinding, its decisions may give rise to enforcement measures. The Security Council must vote unanimously to pass such an enforcement measure.

37. MARK W. JANIS, *AN INTRODUCTION TO INTERNATIONAL LAW* 134 (1988).

38. See HENKIN, *supra* note 17.

39. See e.g., L.G. Telsler, *A Theory of Self-Enforcing Agreements*, 53 J. BUS. 27 (1980) (discussing future gains). See *infra* section III.

40. In small lawsuits (say, for instance, a dispute between a dry cleaner and a customer), the cost of litigation may exceed the possible damages claimed by the plaintiff. David Charny argues that litigation costs mean that parties are undercompensated under domestic law. David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 HARV. L. REV. 373, 407 (1990) (litigation costs result in under-compensation). See also Stewart Macaulay, *An Empirical View of Contract*, 1985 WIS. L. REV. 465, 469-70 (1985).

41. Consumer loans are repaid largely because consumers wish to maintain a

Macauley notes that merchants rarely sue when sales contracts are breached.⁴²

III. INFORMAL ENFORCEMENT MECHANISMS AND THEIR IMPACT ON COMPLIANCE AND SANCTIONING BEHAVIOR

It is in the interests of parties to deter breaches of agreements by punishing breach. In addition to enforcement by the courts, there are also informal methods of punishing breach. Although private parties rely on both formal and informal sanctions, nations must rely exclusively on informal mechanisms. Court-enforced judgments for damages practically do not exist in the international arena.⁴³

Anthony Kronman has outlined the types of informal sanctions that are used to enforce agreements.⁴⁴ Although his explanation is oriented toward private arrangements, it can easily be extended to international agreements. For Kronman, informal sanctions would operate in "the state of nature," a situation characterized by two assumptions: first, where there is no third party enforcement;⁴⁵ second, where the parties cannot compel one another to perform an agreement or to pay damages.⁴⁶ The second assumption is particularly relevant

good credit rating. Charny, *supra* note 40, at 395. See also PATRICK ATIYAH, *THE RISE AND FALL OF FREEDOM OF CONTRACT* 715 (1979) ("Even between private commercial organizations, the fact that business relationships are so often continuous means that the desire to maintain the goodwill of other contracting parties is often more important than the letter of the contract.").

42. Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55, 60-62 (1963). Although parties engage in resolution without lawsuits, Lipson rightly points out that merely because domestic actors engage in pretrial settlement of disputes does not mean that domestic actors are engaging in actions without the need for formal adjudication. He argues that "[w]hen parties discuss compliance after agreements have been signed, they bargain in the shadow of law and judicial enforcement." Lipson, *supra* note 32, at 503.

43. Another major difference between private contracts and treaties is that some treaties, e.g. the EEC treaty, are enforced more like federal constitutions than agreements. Nations comply with these treaties out of respect for the federal institution behind the treaty. See *infra* Section Part IVD.

44. See Kronman, *supra* note 21, at 8. Kronman uses the term "state of nature" to refer to the absence of third party enforcement.

45. Kronman summarizes as follows:

[M]y concept of the state of nature is a broad one, broad enough to include any situation in which individuals and groups must arrange their transactions (if they are to transact at all) without the aid of an independent enforcement mechanism whose powers are significantly greater than their own.

Id. at 9. As Kronman points out, the lack of third party adjudication is a problem not only for enforcing transactions but also for preventing the imposition of externalities upon other parties. *Id.* at 6. Thus, without third party enforcement, we would expect to have more breaches of contract, as well as more thefts of property. Kronman considers the first problem of transactional insecurity a more difficult problem than the second problem of possessory insecurity. *Id.* at 7.

46. *Id.* at 7 ("When two individuals (or groups) exchange promises and neither

because it matches the standard assumption of "anarchy" in international relations. Although Kronman considers only one motivation for breach of an agreement, nonsimultaneous performance,⁴⁷ his analysis can be applied to other reasons for breach.⁴⁸ Kronman outlines four different ways of enforcing agreements through self-help: hostages, collateral, hand-tying, and union.

A. *Hostages: Discretionary Sanctions of No Value to the Non-breaching Party*

A discretionary sanction is the ability of one party to harm the other party.⁴⁹ Assets of the breaching party that can be destroyed by the non-breaching party are called "hostages."⁵⁰ The hostage must have value to the breaching party but need not have any value to the non-breaching party.⁵¹ If the non-breaching party convinces the breaching party that breach will result in the destruction of the asset, then the breaching party will not breach the agreement.

Hostages have two disadvantages. First, it may be difficult for the non-breaching party to convince the breaching party that it will indeed destroy the vulnerable asset.⁵² The non-breaching party is typically better off if it negotiates an agreement for a payment of even a small value than if it destroys the asset. Second, the sanction may be carried out by the non-breaching party, and the asset will be destroyed.⁵³ The

has the power to compel the other to perform, and there is also no third party powerful enough to enforce the agreement on their behalf, I shall speak of them as being in a state of nature vis-à-vis one another, even where both parties are able to protect whatever they presently possess from attack or expropriation by the other.").

47. *Id.* at 10.

48. For the sake of convention, I will refer to Kronman's "the earlier performing party" as the non-breaching party and the later performing party as the breaching party.

49. One example of a discretionary sanction is loss of reputation. Often, the non-breaching party has the discretion to destroy the reputation of a potential violator. For example, suppose that a developing nation has decided to default on its debts to banks in the United States. Faced with such a possibility, the United States could either refuse to negotiate, or it could forgive at least part of the debt. If the United States refuses to negotiate, the debtor country must unilaterally repudiate its debt, thus suffering a severe loss of reputation. If the debtor country negotiates with the United States, then the debt is not repudiated but renegotiated. A country that renegotiates its debt, e.g. Mexico, suffers less of a reputational loss than a country that repudiates its debt, e.g. Peru. Because some reputational effects are beyond the control of the non-breaching party, reputations can also be considered an example of "hand-tying."

50. Some later theorists use the term "hostage" to refer to sanctions that occur automatically in case of breach. I prefer Kronman's convention of referring to such situations as "hand-tying." See *infra* Part III(A)(3).

51. Daniel K. Benjamin, *The Use of Collateral to Enforce Debt Contracts*, 16 ECON. INQUIRY 333, 354 (1978). ("[E]ven assets that are worthless to a creditor in the event of default can be valuable as a form of collateral.").

52. See Kronman, *supra* note 21, at 14-15.

53. Yarbrough and Yarbrough contend that such retaliation only occurs if "under-

destruction of the asset is inefficient because it does not achieve anything.⁵⁴ Such a problem also exists with retaliatory trade practices, which may disintegrate into unproductive sanctioning behavior.⁵⁵

In general, discretionary sanctions have two disadvantages. First, the potential breaching party will understate the real value of the vulnerable asset.⁵⁶ If the breaching party can convince the non-breaching party that the value of the asset is very low, then the non-breaching party will not believe it has enough leverage to force the breaching party to perform the rest of the agreement.

Second, discretionary sanctions may discourage efficient breach if the value of the asset to the potential breaching party exceeds the benefit from treaty violation. Faced with the possibility of risking damage to the vulnerable asset, a party might choose to comply with an agreement even though the benefits of violating the agreement exceed the costs that would be imposed by violation.⁵⁷

B. Collateral: Discretionary Sanctions Available to the Non-breaching Party

The second method of self-enforcement of agreements is for one party to provide "collateral" to the other party. Collateral is an asset the non-breaching party can seize in case of breach.⁵⁸ Unlike hostages, collateral has value to the non-breaching party.⁵⁹

lying conditions change unexpectedly." Yarbrough & Yarbrough (1992), *supra* note 22, at 76.

54. Unless the asset in question is the breaching party's reputation, in which case destruction of the reputation represents information that is valuable to the breaching party's future trading partners.

55. Kronman, *supra* note 21, at 93.

56. *See id.* at 14.

57. The same problem may occur with collateral if the value of the collateral exceeds the benefit of violation.

58. Yarbrough and Yarbrough claim that an antidumping bond is an example of collateral. Beth V. Yarbrough & Robert M. Yarbrough, *Reciprocity, Bilateralism, and Economic 'Hostages': Self-Enforcing Agreements in International Trade*, 30 INT'L STUD. Q. 7, 17-18 (1986) [hereinafter Yarbrough & Yarbrough (1986)]. An antidumping bond is posted by a company about to face trade litigation in the United States before certain tribunals. If the company loses, the plaintiff can recover against the bond insurer rather than the company itself. The antidumping bond is posted by a company when an antidumping proceeding begins, too late to ensure compliance. Thus, an antidumping bond is really not a hostage, "a payment that changes hands contingent on compliance with the agreement." *Id.* at 17. The bond merely ensures that the antidumping duty will be collected if levied.

Benjamin Klein gives an example of collateral as the capital investments made by a franchisee. The franchisor typically owns the land on which the franchisee does business. Any capital investments made by the franchisee are worthless in the case of termination. Benjamin Klein & Keith Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615, 629 n. 14 (1981).

59. Kronman, *supra* note 21, at 30 n. 15.

The advantage of collateral is that the non-breaching party need not engage in negotiations with the breaching party to protect itself from breach.⁶⁰ Furthermore, a threat to foreclose on the collateral is more credible than a threat to destroy a hostage because the non-breaching party would acquire the value of the collateral. If the value of the collateral is greater than the value of performance, then the non-breaching party will be fully protected from breach. A disadvantage is that the non-breaching party may be tempted to seize the collateral without provocation and forego further contractual performance.⁶¹ Another problem is that if the value of the collateral is less than the value of continued performance, then the non-breaching party is undersecured. It must rely on its ability to threaten to deprive the non-breaching party of the value of the collateral.⁶²

An example of collateral in international relations is the ability of a GATT signatory to raise its tariffs in response to a violation of the GATT by another country. Such an action harms the offending country by hurting its export industry.⁶³ The action simultaneously benefits

60. *Id.* at 16.

61. *Id.* Kronman analyzes the problem of opportunistic seizure using three scenarios. In the first, the value of the collateral is worth more to the non-breaching party than the benefits of continued performance of the contract, so the non-breaching party is completely secured. Kronman uses the following example:

Suppose that you have now given me a golden goblet as collateral to secure your promise to deliver [a] calf once it is born. The goblet, let us assume, is worth as much to me as the calf — it is, therefore, a perfect form of collateral.

Id.

In the second scenario, the collateral is worth more to the breaching party than it is to the non-breaching party. This assumption is realistic because if the collateral was worth less to the breaching party, then the breaching party would have already sold the collateral to the non-breaching party: "We can also assume that the goblet is worth at least as much to you (it may be worth more), since otherwise you would already have sold or traded it to me." *Id.* at 16-17.

In the third, performance is worth more to the non-breaching party than the cost of performing. Otherwise, the non-breaching party would not have agreed to the contract:

[A]ssume that you value the goblet more than the calf. [This] assumption follows from two premises: first, that the goblet is worth as much to me as the calf (that it is a complete substitute for the calf and hence a perfect form of collateral), and second, that the calf is worth more to me than to you, as it must be, or we would not have agreed to our original exchange.

Id. at 17. Because the collateral is worth more to the non-breaching party than the benefits of continued performance of the contract (first scenario), and because performance is worth more to the non-breaching party than the cost of performing (third scenario), the collateral is worth more to the non-breaching party than the cost of performing is to the breaching party.

62. *Id.* at 16.

63. Some authors have claimed, however, that an increase in tariffs sometimes helps the exporting industry of the offending country by raising the price of its products.

the retaliating country by boosting the domestic price of imported products, thus increasing profits in those industries that compete with imports.⁶⁴ Another example of the use of collateral occurred when the United States froze Iranian assets in response to the Iranian capture of U.S. hostages in 1979. The United States could have converted the bank accounts to its own use.⁶⁵ Instead, the U.S. released the assets after Iran released the Americans held hostage in Iran.

C. *Hand-Tying: Mandatory Penalties*

Hand-tying is defined as "actions that make a promise more credible by putting it out of the promisor's power to breach without incurring costs he could otherwise have avoided."⁶⁶ According to Kronman, hand-tying occurs when the destruction of an asset would be automatic.⁶⁷

The literature on hand-tying falls into two categories. The first, encompassing the works of Kronman⁶⁸ and Telser,⁶⁹ holds that some agreements are self-enforcing because parties wish to retain the future benefits of performance by the other party.⁷⁰ The second set of theo-

64. This is a political benefit since it helps producers at the expense of consumers. Classical economic theory teaches that the costs to consumers of tariffs often outweigh the benefits to consumers.

65. For example, in 1963, the United States seized all Cuban assets in the United States. The United States sold the assets in order to pay for the expenses of determining the losses suffered by American companies during Cuba's nationalization decrees. See HENKIN, *supra* note 17, at 346. See also 28 Fed. Reg. 6974-85 (1963); 78 Stat. 1110, 22 U.S.C. § 1643(j) (1964), amended, 79 Stat. 988, 22 U.S.C. § 1643(j) (1976).

66. Kronman, *supra* note 21, at 18.

67. Kronman differs in terminology from Yarbrough & Yarbrough, who use the term "hostage" to refer to all losses to a breaching party automatically resulting from breach. For example, the future benefits of an agreement are a "hostage." Yarbrough & Yarbrough (1986), *supra* note 58, at 11 ("A more general form of hostage is the future benefits expected from the continuation of a trading relationship."). Since Yarbrough & Yarbrough assume that any future benefits are lost automatically upon breach, such future benefits would fall under Kronman's rubric of "hand-tying." But again, the difference is merely in terminology. Another difference in terminology results from the fact that if one party would incur costs from terminating the contract (ties its hands), the same costs could be imposed by the other party's termination. Thus, an asset that is a hand-tying commitment is also an economic hostage: The asset can be destroyed at the discretion of the other party. Because hand-tying and hostages are different sides of the same coin, one understands Yarbrough & Yarbrough's reference to both as "economic hostages."

68. See Kronman, *supra* note 21.

69. See Telser, *supra* note 39, at 1.

70. One may wonder why a breaching state would automatically lose the benefits of the treaty. Indeed, a non-breaching state might continue to comply with the treaty, thus continuing to confer benefits on the breaching state, even though the non-breaching state has the discretion to abrogate the treaty by invoking the doctrine of retaliatory breach. The answer lies in the behavioral assumption that all states unilaterally pursue policies that are in their best interest. If a state modifies its

ries, advanced by Klein & Leffler⁷¹ and Williamson,⁷² and applied to international agreements by Yarbrough & Yarbrough,⁷³ holds that parties will comply with agreements in order to avoid losing the value of assets that are not useful outside the agreement. Qualitatively, these two sets of theories are convergent because the benefit of preserving a transaction-specific asset is also a benefit of complying with the agreement.

Telser introduced the theory that an agreement might be self-enforcing if the threat of loss of future benefits of the treaty is a sufficient incentive for states to comply with a treaty.⁷⁴ In Yarbrough & Yarbrough's terminology, $E(c)$ is the discounted present value of the stream of benefits to the breaching part if both parties comply, $E(n)$ is the discounted present value of the stream of benefits to the breaching party if both parties do not comply, and $E(v)$ is the discounted present value of the amount that the breaching party expects to gain from the violation. Parties will comply with an agreement if $E(c) - E(n) > E(v)$.⁷⁵ A party would adhere to such an agreement even if there were no courts or third party enforcement mechanisms because if "one party violates the terms then the only recourse of the other is to terminate the agreement."⁷⁶

Klein & Leffler argue that the prospect of repeat business and future profits deters firms from breaching contracts.⁷⁷ In sales of

optimal unilateral policy through a treaty, such a concession was probably traded for some reciprocal concession by the other state. If the other state violates the treaty, then the *quid pro quo* is dissolved. There is no reason for the non-breaching state to continue complying with the agreement. The non-breaching state reverts back to its unilateral policies, which, by definition, are different from its treaty obligations.

71. See Klein & Leffler, *supra* note 58.

72. See OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* (1985).

73. See Yarbrough & Yarbrough (1992), *supra* note 22.

74. See Telser, *supra* note 39.

75. Kronman, *supra* note 21, at 20. More generally, hand-tying works only if the costs of breaching the agreement outweigh the benefits of the breach.

76. Telser, *supra* note 39, at 27.

77. In Klein & Leffler's model, there is no governmental mechanism to enforce a manufacturer's implied warranties. The only reason a manufacturer would produce high-quality goods is the prospect of repeat business:

Contracts are not enforceable by the government or any third party.

Transactors are assumed to rely solely on the threat of termination of the business relationship for the enforcement of contractual promises.

Klein & Leffler, *supra* note 58, at 616. Potential purchasers are assumed to be unable to determine the specific level of product quality before the purchase. *Id.* at 620. Klein & Leffler assume that if a seller loses its reputation as a result of selling a product of less-than-contracted-for quality, it will lose both the benefits under the immediate contract in question and the opportunity to make future contracts. *Id.* ("[I]f quality is less than contracted for, all consumers cease to purchase from the particular sampled "cheating firm."). Presumably, the seller will keep the profits it made from the low-quality products themselves.

goods, the seller will reduce quality only if "the one-time wealth increase obtained from low quality production" exceeds the "continual stream of rental income that will be lost if low quality output is deceptively produced."⁷⁸ Knowing this, consumers buy only from firms that charge a high price, or more specifically, a price above salvageable cost.⁷⁹

This "quality-assuring price" is the price at which firms produce high quality goods. Klein & Leffler point out that if the quality-assuring price were greater than total costs,⁸⁰ other firms would enter the market, causing the price to fall.⁸¹ However, consumers demand that price be at least equal to the quality-assuring price.⁸² The result is that firms make firm-specific capital investments in the form of either (1) brand name capital investments or (2) nonsalvageable productive assets.⁸³

While Klein & Leffler explain why parties invest in firm-specific capital, Oliver Williamson uses transactional economics to explain how the presence of firm-specific capital affects the type of governance structure controlling the relationship.⁸⁴ For Williamson, transactional economics makes two fundamental assumptions about human behavior: rationality and self-interest.⁸⁵

78. *Id.* at 620. One crucial, but reasonable, assumption in product markets is that consumers can identify the supplier of each product.

79. Price must be above salvageable costs. *Id.* at 618. Otherwise, the firm would have nothing to lose from producing lower quality goods. See ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 105 (Edwin Cannan, ed., 1937) (1776).

80. Klein & Leffler distinguish between sunk and salvageable costs. Klein & Leffler, *supra* note 58, at 619.

81. *Id.* at 625 ("Thus, if price assures quality, the firms producing quality greater than $q(\min)$ appear to earn positive economic profits. However, this cannot describe a full market equilibrium. When the price is high enough to assure a particular high level of quality, additional firms have an incentive to enter the industry.").

82. *Id.* ("Consumers know that any price below P^* for its associated quality results in the supply of $q(\min)$. They therefore will not purchase from a firm promising that quality at a lower than P^* .").

83. *Id.* at 626-29.

84. See Williamson, *supra* note 72. Transactional economics has been referred to alternatively as "transaction costs economics" or "neoinstitutional economics," although Williamson refers to transaction cost economics as a subset of, not a synonym of, new institutional economics. *Id.* at 16. See also Ronald Coase, *The Nature of the Firm*, 16 *ECONOMICA* 386 (1960); Ronald Coase, *The Problem of Social Cost*, *J.L. & ECON.* 1 (1960) (Coase is credited with founding transactional economics); Thráinn Eggertsson, *Economic Behavior and Institutions* (1990) (surveying neoinstitutional economics).

85. Regarding rationality, Williamson uses a semistrong form, called "bounded rationality," in which economic actors are assumed to be "intendedly rational, but only limitly so." Williamson, *supra* note 72, at 45 (citations omitted). Bounded rationality differs from "maximizing" rationality, the strong form assumption prevalent in microeconomics. Unlike maximizing rationality, bounded rationality assumes that there are limits on the human ability to plan for the future and anticipate contin-

Williamson identifies three important dimensions that affect, and may ultimately transform, the economic relationship between two parties. The first dimension is the degree of "asset specificity."⁸⁶ Asset specificity refers to the creation of an asset that has increased value only when used in a certain way. Williamson explains that

parties to a transaction commonly have a choice between special purpose and general purpose investment. Assuming that contracts go to completion as intended, the former will often permit cost savings to be realized. But such investments also are risky, in that specialized assets cannot be redeployed without sacrifice of productive value if contracts should be interrupted or prematurely terminated. General purpose investments do not pose the same difficulties. "Problems" that arise during contract execution can be solved in a general purpose asset regime by each party going his way⁸⁷

A transaction-specific asset is not the same as a fixed asset. Many

gencies. *Id.* at 46. Williamson argues that limits on people's competence is different than the neoclassical assumption of information costs:

There is . . . a fundamental difference between a situation in which a decision maker is uncertain about the state X and a situation in which the decision has not given any thought to whether X matters or not, between a situation in which a prethought event judged of low probability occurs and a situation in which something occurs that never has been thought about Most complex models of maximizing choice do not come to grips with the problem of bounded rationality. Only metaphorically can a limited information model be regarded as a model of decision with limited cognitive abilities.

RICHARD R. NELSON AND S.G. WINTER, AN EVOLUTIONARY THEORY OF ECONOMIC CHANGE 66-67 (1982), *quoted in* Williamson, *supra* note 72, at 46 n. 6. Bounded rationality is also distinguished from "organic rationality," the assumption that people maximize welfare indirectly through trial and error. *Id.* 46-47.

Secondly, Williamson assumes that people are "opportunistic." Opportunistic parties are willing to break the rules to increase their welfare. *Id.* at 47-49. They are also willing to lie, steal, cheat, and refuse to disclose information. The assumption that actors behave without regard to rules is appropriate in international affairs. It accommodates the realist critique that international law is unenforceable. By contrast, neoclassical economics employs the semistrong form of "simple self-interest seeking," which holds that individuals play within the rules. *Id.* at 49. It treats "individuals as playing a game with fixed rules that they obey. They do not buy more than they can pay for, they do not embezzle funds, they do not rob banks." Williamson rejects the weak form of self-interest that assumes that people obey all rules. *Id.* at 49. This "obedience" assumption has been summarized as follows:

One can imagine the limiting case of a monolithic collectivism in which the prescriptions of the central plan are carried out by functionaries who fully identify with the imposed macrogoals. In such a system the economically relevant processes reduce almost completely to technical manipulations.

ADOLPH LOWE, ON ECONOMIC KNOWLEDGE: TOWARD A SCIENCE OF POLITICAL ECONOMICS 142 (1965), *quoted in* Williamson, *supra* note 72, at 49.

86. Williamson, *supra* note 72, at 52-56.

87. *Id.* at 54.

assets that are regarded as fixed can be redeployed to another use, such as general purpose buildings.⁸⁸ One example of transaction-specific asset is where a tailor promises to make a suit of clothes for a buyer.⁸⁹ If the tailor initially cuts the fabric to fit the dimensions of the suit, the tailor has dedicated a certain amount of investment (the value of the cloth for the suit) towards performing the contract. If he does not make the suit for the buyer, the cloth becomes worthless.⁹⁰ Another example of an transaction-specific investment is the investment created when an importing country requires imported goods to meet peculiar standards.⁹¹ "Such standards are ideal for the provision of hostages because the standards involve investment in specialized capital equipment or production procedures which are non-salvageable if the market for which they are designed are lost."⁹² An electronics firm that builds a factory necessary to produce an electric plug meeting an importing country's regulations is providing a transaction-specific asset.⁹³

Williamson's second dimension is uncertainty, defined as the inability of parties to predict the behavior of others, either because opportunistic behavior is difficult to predict or because of communication failures.⁹⁴ Williamson's third dimension is frequency.

Williamson coined the term "fundamental transformation" to describe the change from a party's prebargain situation in which the company has many potential business partners to the post-bargain situation in which an agreement has been reached with one partner and asset-specificity has been developed. The presence of asset-specificity deters breach by the asset owner.⁹⁵ As a result, the other party is more likely to enter into the contract. Although asset-specificity encourages the asset holder to comply, it also encourages the other party to breach. The party who owns the specific asset is subject to the opportunistic behavior of the other party.⁹⁶ For example, a buyer may be willing to pay \$10 for a product that requires the manufacturer of the product to build a factory at the cost of \$5. Before the factory is built,

88. *Id.*

89. Kronman, *supra* note 21, at 19.

90. *Id.*

91. Yarbrough & Yarbrough (1986), *supra* note 58, at 10-11.

92. *Id.* at 10.

93. Yarbrough & Yarbrough (1992), *supra* note 22, at 92. Another example are the Canadian regulations that require that imports of canned goods meet container-size requirement. Yarbrough & Yarbrough (1986), *supra* note 58, at 11.

94. WILLIAMSON, *supra* note 72, at 54.

95. Yarbrough & Yarbrough (1986), *supra* note 58, at 11. ("The fact that the exporting country stands to lose the hostage (the value of . . . equipment) as punishment for any opportunistic behavior against the U.S. may serve as a mechanism for enforcing existing agreements.")

96. Paradoxically, the same factor that gives rise to the need for an enforcement mechanism provides the enforcement mechanism itself.

the parties would agree to any price between \$5 (the lowest price the manufacturer would pay) and \$10 (the highest price the buyer would accept). But after the factory is built, the manufacturer would be willing to accept any price, even \$1, because the alternative — non-production — would not result in any profit at all.⁹⁷ Although the buyer would be willing to pay \$10, it is likely that the buyer will negotiate a lower price *ex post* because of the seller's vulnerability.

One example of pre-commitment through hand-tying is reputation. If a person violates an agreement, that person's reputation is damaged automatically. On its face, reputation sounds like an ephemeral and non-economic idea, but reputation represents a useful asset. A business with a good reputation will receive future sales. Therefore, a court, when deciding the amount of damages to award to a business, would not award damages for lost reputation *and* lost sales. The two are synonymous. A problem with reputation as a commitment is that it is difficult to calibrate the value of the commitment to the seriousness of breach. Thus, the damage to a state's reputation may differ from the cost of breach. If the damage to reputation is greater than the cost of breach, then some efficient breaches may be overdeterred. If the damage to reputation is less than the benefit of breach, then some inefficient breaches may remain underdeterred.

E. *Union*

The fourth method of reducing opportunism is union. As Williamson states, "[t]ransactions that are supported by investments in durable, transaction-specific assets experience 'lock in' effects, on which account autonomous trading will commonly be supplanted by unified ownership (vertical integration)."⁹⁸ The interests of two parties become aligned. In domestic agreements, union is typified by a manufacturer who merges with its distributor. The European Union is a sophisticated governance structure that illustrates the principle of union.⁹⁹

Union concludes Kronman's taxonomy of non-legal sanctions. Charney proposes another taxonomy of nonlegal sanctions, divided into three major categories.¹⁰⁰ The first category is "relation-specific prospective advantage," which he explains as follows: "The committing party places a particular asset under the control of another party; that party will confiscate or destroy the asset if the promisor breaches."¹⁰¹

97. Note that, under the assumption that the manufacturer possesses specific assets, the manufacturer can sell to only one buyer.

98. Williamson, *supra* note 74, at 53.

99. Yarbrough & Yarbrough (1992), *supra* note 22. These governance structures are examined *infra* in section IV(D).

100. Charney, *supra* note 40, at 392-97.

101. *Id.* at 392.

Examples of "relation-specific prospective advantage" are the ability of a bank to destroy a small business by calling a note payable on demand and a franchisor's ability to revoke the right to use a trademark. Both of these examples are probably "hostages" in Kronman's terminology. Another example is the opportunity to deal again with the same party (the "repeat deal").¹⁰² By comparison, Kronman's terminology would treat the benefit of future dealings as a hand-tying arrangement.

Charney's second category of non-legal sanctions is reputation. His third category is the psychic and social costs of breach, including guilt and loss of self-esteem.¹⁰³

F. *Side Payments*

Under any scheme in which the sanctions for breach are over-effective — the sanctions for breach exceed the damage of the breach — efficient breach might still occur if the breaching party bribes the non-breaching party. Two problems arise in international relations that create a barrier to side payments. First, it is difficult to express many treaty obligations in monetary terms. If a state refuses to adhere to a security treaty, it would be difficult to determine the amount of money that would compensate the non-breaching state. However, some non-monetary favors, such as a vote in the U.N., can be exchanged. Second, even if the damage could be expressed in monetary terms, there may be a psychological barrier that prevents states from making cash payments to each other, with the exception of extreme cases, such as reparations extracted from the loser of a war.¹⁰⁴

The ineffectiveness of side payments also contributes to overcompliance. In domestic law, a hostage-taker can be paid off if the benefits of violation to the breaching part exceed the costs of violation

102. *Id.* at 393.

103. *Id.* at 447-48. Beyond mere taxonomy, Charney suggests some changes to domestic law in light of the presence of informal sanctions. He contends that an action for promissory estoppel should not be available in all instances where a party reasonably relies on a promise. If the reliance is based upon a belief that noncompliance will be punished by nonlegal sanctions, the plaintiff should not recover unless it was unfeasible to draft a contract incorporating the obligation in question. *See also id.* at 447-48, 450. A promisee should be able to recover under promissory estoppel only if "he can show that his transactional behavior would have been different had he correctly assessed the probability of breach." *Id.* at 455. Thus, it is not enough that the promisee take actions in purported reliance. Charney suggests that when parties take formal means of memorializing an agreement, but do not actually sign a contract, the courts should be reluctant to enforce the promise because the parties likely considered, but rejected, the alternative of legal enforcement. *Id.*

104. *See* JOHN MAYNARD KEYNES, *THE ECONOMIC CONSEQUENCES OF THE PEACE* (1919). In the Treaty of Versailles, the victorious allies extracted reparations from Germany. Keynes criticized these reparations. *Id.*

to the hostage-taker; then, the violation can occur. No retaliatory action will be taken because of the transfer payment. As noted above, however, transfer payments are difficult to make in the international arena.

IV. BEHAVIOR UNDER VARIOUS STRUCTURAL CONDITIONS

Armed with an array of non-legal sanctions, a few predictions about breach and compliance behavior are possible. We have seen how a court system imposing damages equal to damage done can achieve an efficient result. However, the penalty for breach is often greater or less than the actual amount of damage done, and sometimes there is no penalty at all. An efficient system must impose costs or benefits on the breaching party with the objective that the breaching party behaves efficiently (i.e. efficient breaches occur but no inefficient breaches occur). This section outlines the structural details that will result in efficient compliance behavior by parties to an agreement.

There are a number of elements that affect the compliance and sanctioning behavior of parties. First, the breaching party benefits from breaching the contract. Second, breach imposes losses on the non-breaching party. Third, the breaching party may suffer losses in form of penalty if it breaches the contract. Penalties can be either discretionary (collateral, or a hostage, using Kronman's terminology) or automatic (hand-tying).¹⁰⁵ A non-breaching party can choose to waive a discretionary penalty (for instance, a lawsuit). An automatic penalty (for instance, the loss of transaction-specific assets) automatically operates if a party breaches the contract. Fourth, there is the ability of the non-breaching party to make a side payment to the breaching party to induce the breaching party not to breach the contract. Fifth, there is the ability of the breaching party to make a side payment to the non-breaching party to induce the non-breaching party to forego retaliatory measures. These five factors determine whether a party may breach a contract. A few examples will suffice to explain how these factors would affect the decision to breach or not to breach.

Case 1: No penalties. Examining factors one and two alone, suppose that the non-breaching party cannot impose any type of penalty and cannot bribe the breaching party not to breach. In this case, the agreement will be breached if there is any benefit at all to breach, even if breach is inefficient. This is the simple case of

105. Furthermore, damages can be split along another dimension. Damages can be pictured as imposed by the judicial system, or as extra-legal damages (damages that occur from, say, retaliation). We could further distinguish between retaliatory acts that benefit the retaliating party. If a bank seized the collateral, the bank derives benefit at the same time the defaulting borrower is harmed. Other retaliatory acts are purely harmful, such as loss of reputation.

undercompliance, the *cause célèbre* of the realists' attack on international law. An example would be North Korea's refusal to turn over South Korean prisoners of war in compliance with the armistice ending the Korean War. South Korea had delivered its prisoners earlier than North Korea had, and, therefore, it possessed no bargaining power to hold North Korea to the agreement.¹⁰⁶

Case 2: Exact compensation. Considering the case in which the non-breaching party can enforce a discretionary penalty equal to the cost of breach (in effect, if the non-breaching party can sue for damages), breach will occur if the benefits to the breaching party will exceed the penalty. In the case of inefficient breach, breach will not occur. The benefits do not exceed the costs, so the benefits do not exceed the discretionary penalty. Thus, the ability to impose a discretionary penalty leads to efficient results. It has often been pointed out that the existence of a discretionary penalty equal to the cost of breach is an unrealistic assumption in the international sphere.

Case 3: Mandatory penalty. Considering the case of a mandatory penalty instead of a discretionary penalty, breach will occur if the benefits exceed the mandatory penalty. If the penalty is greater than the cost, an efficient breach will be deterred. If the penalty is less than cost, an inefficient breach will be allowed to occur. However, if the penalty is equal to cost, only efficient breach occurs.

Case 4: Opportunistic breach. The discretionary penalty can be used to extort the other party, even if it has not breached the agreement. For example, suppose a manufacturer of custom-made merchandise builds a plant to fulfill its production obligations under a single contract. Once the plant is established, the buyer has an incentive to threaten to breach the contract unless the manufacturer reduces his price. In *Alaska Packers' Ass'n v. Domenico*,¹⁰⁷ a boat owner agreed to hire seamen for a fishing voyage. During the voyage, the seamen refused to work unless the boat owner paid them wages at a rate higher than that originally agreed to.

Given opportunity for negotiations, side payments, and flexibility in the amount of the non-legal sanctions, an efficient result can be achieved. Because these factors are almost always absent to some extent, efficient behavior is obstructed.

V. BREACH UNDER VARIOUS INSTITUTIONAL FORMS

Yarbrough & Yarbrough have analyzed the factors that determine the type of institution that will be used to govern free trade agreements. Yarbrough & Yarbrough refer to their analysis as "the strategic

106. HENKIN, *supra* note 17, at 78.

107. 117 F. 99 (9th Cir. 1902).

organizational approach" to international trade policy. The analysis consists of identifying which of four possible institutional structures will be chosen by nations that wish to agree to reduce tariffs. Under each institutional form, parties attempt to create an incentive for efficient compliance behavior.

According to Yarbrough & Yarbrough, institutional forms are designed to prevent opportunism. Opportunism is only present when there is a relation-specific investment¹⁰⁸ (in Williamson's lexicon, "asset-specificity"). Yarbrough & Yarbrough supply some useful examples of asset-specificity in the area of free trade, including

1. Locationally specialized trade facilities (for example, the Soviet-European gas pipeline);
2. specialized vertical production linkages across national boundaries (for example, Canadian-U.S. links in the North American automobile industry);
3. dedicated assets in the form of export capacity (for example, Japanese automobile capacity designed to service the U.S. market).¹⁰⁹

An exporting country's economic hostage is its export industry. If the exporting country violates a free trade agreement, the country risks that it will lose the value of its specific assets if the other party withdraws from the agreement.

Generally, the type of institutional framework depends upon three factors: first, whether there is relation-specific investment; second, whether there is effective third party enforcement in the form of a hegemon; and third, whether there is effective third party enforcement in the form of a regional trade treaty. If there is no relation-specific investment, unilateral free trade develops. If there is relation-specific investment, the institutional form depends upon the type of enforcement structure available. Multilateralism prevails if there is a hegemon. "Minilateralism" prevails if there is the possibility of negotiating a regional treaty with third party enforcement. If there is no effective third party enforcement and no possibility of a regional treaty, bilateralism with self-help as a remedy prevails.

A. *Unilateralism*

The first institutional form is unilateral trade liberalization, defined as a single country's unilateral adoption of a trade policy without negotiations or agreements with others. For example, if a powerful country determines that its best policy is free trade, regardless of the reciprocal trade policies of other countries, the country is relatively invulnerable to the trade policies of other countries. The country pur-

108. Yarbrough & Yarbrough (1992), *supra* note 22, at 34-35.

109. *Id.* at 25.

sues open trade but does not attempt to persuade other countries to adopt liberal policies.¹¹⁰

Under the strict assumption that countries are not affected by each other's trade policies, there would be no need for cooperation. As Axelrod and Keohane note, cooperation is defined as "when actors adjust their behavior to the actual or anticipated preferences of others."¹¹¹ A party has no need to attempt to change another's actions through negotiations if it does not care about the other's actions.

With unilateralism, there is no need for any enforcement mechanism at all.¹¹² Yarbrough & Yarbrough argue that unilateral trade liberalism is pursued by countries that do not have relation-specific assets.¹¹³ A country without relation-specific assets cannot be a target for opportunism. Asset-specificity is a characteristic not only of the physical nature of an asset but of a nation's trading opportunities. Thus, if a country has only one trading partner, all its export industries are relation-specific. If a country has several trading partners, its export industry is no longer relation-specific.

The foremost example of unilateralism is Great Britain's trade liberalization in the 19th century. Britain did not face the threat of opportunism because its export markets were substitutable. As inter-firm manufacturing trade increased, there was an accompanying increase in asset-specificity and the resulting potential for opportunism, and unilateralism declined as an effective trade policy.

B. *Bilateral treaties*

The second institutional form is bilateral trade. Bilateralism occurs if there is no hegemon, there is a threat of opportunism, and there is no possibility of third party enforcement.

If a country violates international law, other countries often retaliate. The actions and reactions of states throughout history have developed a body of practice that has coalesced into international law. The international law that has developed relating to treaty breach is more lenient than the law governing breach of domestic agreements. A possible reason is that international law lacks a "compensation principle" that induces the parties themselves to determine what breaches are efficient and inefficient.

Bilateral parties often punish breach of international law for the

110. *Id.* at 55.

111. ROBERT AXELROD & ROBERT O. KEOHANE, COOPERATION UNDER ANARCHY 226 (1985).

112. Thus, it is confusing that Yarbrough & Yarbrough characterize unilateralism as having an enforcement mechanism of self-help. See Yarbrough & Yarbrough (1992), *supra* note 22, at 17, Fig. 1.3.

113. *Id.* at 56.

sake of deterrence. If a government arrests another government's diplomats, its own diplomats may be arrested. Confiscations of property by one nation will often be met by retaliatory confiscations by the other.¹¹⁴ Such retaliation gives teeth to international law.

The retaliatory actions of countries may eventually develop into rules of customary international law. In international law, state practice attains the status of customary international law if two requirements are met.¹¹⁵ The first requirement is that states follow the practice. The second requirement, *opinio juris*,¹¹⁶ holds that states engaging in the practice possess the belief that doing so is required by international law.¹¹⁷ Thus, the mere fact that a certain practice is prevalent among states is an insufficient basis for international law. Often a state will follow a rule merely out of fear of retaliation from other states. Such acquiescence out of fear does not create customary international law.

Customary rules that have developed through an informal sanctioning process are often efficient. A recent literature has developed on

114. HENKIN, *supra* note 17, at 54.

115. For general discussions of customary international law, see ANTHONY D'AMATO, *THE CONCEPT OF CUSTOM IN INTERNATIONAL LAW* (1971); Michael Akehurst, *Custom as a Source of International Law*, 47 BRIT. Y.B. INT'L L. 1 (1974-75); KAROL WOLFKE, *CUSTOM IN PRESENT INTERNATIONAL LAW* (1964); Myres S. McDougal, *The Hydrogen Bomb Tests and the International Law of the Sea*, 49 AM. J. INT'L L. 356 (1955); Oscar Schacter, *Towards a Theory of International Obligation*, 8 VA. J. INT'L L. 300 (1968); Sir Humphrey Waldock, *General Course on Public International Law*, 106 *Receuil des Cours d'Academie de Droit International [R.C.A.D.I.]* 1 (1962).

116. The full Latin phrase is *opinio juris sive necessitatis*.

117. The second source of international law listed in the Statute of the I.C.J. is "international custom, as evidence of a general practice accepted as law." Statute of the International Court of Justice, *supra* note 34, art. 38(1)(b). See also *S.S. Lotus* (Fr. v. Turk.), 1927 P.C.I.J. (ser. A) No. 10; *Asylum Case* (Colum. v. Peru), 1950 I.C.J. 266 (customary international law is not a practice adopted "merely for reasons of political expedience."); In the Case Concerning Right of Passage Over Indian Territory (Port. v. India), 1960 I.C.J. 6 (holding that a practice was customary international law because it "was accepted by law by the parties and [had] given rise to a right and correlative obligation."); *North Sea Continental Shelf Cases* (F.R.G. v. Neth.), 1969 I.C.J. 4 ("Not only must the acts concerned amount to a settled practice, but they must also be such, or be carried out in such a way, as to be evidence of a belief that this practice is rendered obligatory by the existence of a rule of law requiring it. The need for such a belief, i.e., the existence of a subjective element, is implicit in the very notion of the *opinio juris sive necessitatis*. The States concerned must therefore feel that they are conforming to what amounts to a legal obligation. The frequency, or even habitual character of the act, is not in itself enough. There are many international acts, e.g., in the field of ceremony and protocol, that are performed almost invariably, but which are motivated by considerations of courtesy, convenience or tradition, and not by any sense of legal duty."); *RESTATEMENT (THIRD) ON FOREIGN RELATIONS* (Revised) § 102(2) ("Customary international law results from a general and consistent practice of states followed by them from a sense of legal obligation.").

the effectiveness of informal sanctions. Professor Richard Epstein argues that, with respect to domestic tort law regarding negligence, an informal sanctioning process can create efficient rules.¹¹⁸ Epstein's conclusion recognizes that in consensual cases, in which negligence is the appropriate standard of liability, "custom should be regarded as conclusive evidence of due care."¹¹⁹

In Epstein's view, three factors determine whether legally useful customs develop. The first factor, "reciprocity," determines whether the parties occupy symmetrical roles.¹²⁰ If a party would be adversely affected by a custom in one transaction and benefitted by the custom in another transaction, the party is more likely to pick a custom that would maximize the joint benefits of each party. The concept that parties will attempt to adhere to a rule, rather than to spasmodic practice, is implicit. Presumably, parties wish to rely on a common history of analysis rather than recreate a cost-benefit analysis for each occurrence.

The second factor is frequency. Custom is more likely to develop out of frequent transactions, such as purchases or sales,¹²¹ than out of infrequent ones, such as employer liability, medical malpractice, and product liability cases.¹²² The third factor is severity. The more severe the harm, the more likely that parties will ignore long-term consequences in order to win the dispute.¹²³

Epstein contends that the last two factors, frequency and severity, predict when custom may develop. Thus, custom is most likely to develop in cases of high frequency and low severity.¹²⁴ It is less likely in cases of high frequency transactions with high severity.¹²⁵ No custom is likely to develop in low-frequency/low-severity transactions or low frequency/high-severity transactions.¹²⁶

As Epstein demonstrates, customary rules can be efficient in a world of informal sanctions among parties. Thus, it is reasonable to expect that customary international law related to treaty breach will tend to allow efficient breach and deter inefficient breach.

118. Richard A. Epstein, *The Path to the T.J. Hooper: The Theory and History of Custom in the Law of Tort*, 21 J. LEGAL STUD. 1 (1992).

119. *Id.* at 4.

120. *Id.* at 11-12.

121. *Id.* at 11.

122. *Id.*

123. *Id.* at 14. ("The immediate players may be so preoccupied by the size of the stakes in their own transactions (which in the limit could be a rule or ruin situation) that they will not possess the long time horizon that allows relational gains to soften the desire for immediate success.")

124. *Id.* at 13-14.

125. Epstein, *supra* note 118, at 14-15.

126. *Id.* at 15-16.

Most bilateral international agreements have no meaningful third party determination of when a treaty is broken.¹²⁷ Although international law requires that a state engage in negotiation before breaching a treaty,¹²⁸ many states in practice violate treaties without notice or negotiation. For example, the United States denounced the International Load-Line Convention in 1939;¹²⁹ France denounced the North Atlantic Treaty Organization in 1966; and Russia denounced the Treaty of London in 1856. Under international law, there are ample legal justifications for abrogating a treaty. Many of these doctrines are vague, however, and can be easily invoked. For instance, a state may withdraw from a treaty with the consent of all parties to the treaty.¹³⁰ A state may also withdraw from the terms of a treaty if the treaty provides for termination, denunciation, or withdrawal.¹³¹

If a treaty does not provide for termination, denunciation, or withdrawal, a party may withdraw from the treaty if either "it is established that the parties intended to admit the possibility of denunciation or withdrawal" or "a right of denunciation or withdrawal may be implied by the nature of the treaty."¹³² Brownlie notes that "[w]hen a treaty contains no provisions regarding its termination, the existence of a right to denunciation depends on the intention of the parties, which can be inferred from the terms of the treaty and its subject-matter."¹³³ Brierly,¹³⁴ Fitzmaurice,¹³⁵ and Hall¹³⁶ claim that com-

127. For example, multilateral treaties that have some sort of determination are the GATT, which authorizes a Panel to adjudicate disputes, and the European Union, which authorizes the European Court of Justice to adjudicate disputes.

128. The Vienna Convention on the Law of Treaties, which codified the customary international law relating to treaties, requires in most instances that a breaching state give 12 months notice of breach and that the breaching party negotiate before breaching a treaty. Vienna Convention, *supra* note 33, art. 56.

129. International Load-Line Convention, July 5, 1930, 47 Stat. 2228. The Convention outlaws the overloading of cargo ships.

130. I use the term "withdrawal" synonymously with "terminate" or "denounce."

131. Vienna Convention, *supra* note 33, art. 54. ("The termination of a treaty or the withdrawal of a party may take place: (a) [i]n conformity with the provisions of the treaty; or (b) [a]t any time by consent of all the parties after consultation with the other contracting States.")

132. *Id.* art 56(1)(b).

133. IAN BROWNLIE, *PRINCIPLES OF PUBLIC INTERNATIONAL LAW* 496-97 (1966).

134. Brierly notes that commercial treaties and treaties of alliance are probably subject to denunciation "even though they contain no express provision to that effect." J.L. BRIERLY, *THE LAW OF NATIONS* 331 (6th ed. 1963).

135. Fitzmaurice cites commercial or trading arrangements as examples of "certain sorts of treaties which, unless entered into for a fixed and stated period or expressed to be in perpetuity, are in their nature such that any of the parties to them have an implied right to bring them to an end or to withdraw from them." Gerald Fitzmaurice, *Second Report on the Law of Treaties* 72, U.N. Doc. A/CN.4/107 (1957).

136. Hall states that

[a] treaty becomes void . . . [b]y denunciation . . . when the treaty, as in the case of treaties of alliance or commerce, postal conventions and the like, is voidable at the will of one of the parties, the nature of its

mercial treaties imply this right. As a result, a party to a commercial treaty with no provision for termination may denounce it at any time. According to the Vienna Convention, however, the party must provide not less than one year's notice before terminating the treaty.¹³⁷

Under certain circumstances, a party may breach a treaty in retaliation for breach by another party. The provoking breach, however, must be material: it must consist of either a repudiation of the treaty not sanctioned by international law or "the violation of a provision essential to the accomplishment of the object or purpose of the treaty."¹³⁸

Once a material breach has been committed, the non-breaching parties to the treaty have three possible responses. First, the parties can by unanimous agreement suspend the treaty in whole or in part.¹³⁹ Second, "a party specially affected by the breach" may raise the breach "as a ground for suspending the operation of the treaty in whole or in part in the relations between itself and the defaulting [s]tate."¹⁴⁰ Third, a party may suspend "the treaty in whole or in part with respect to itself if the treaty is of such a character that a material breach of its provisions by one party radically changes the position of every party with respect to the further performance of its obligations under the treaty."¹⁴¹

A party may terminate a treaty if performance becomes impossible. Impossibility has been interpreted both broadly and narrowly. Under the broad view, a party may abrogate a treaty if it becomes physically or morally impossible for the party to perform its obligations under the treaty.¹⁴² Under the narrow view, exemplified by the Vienna Convention, "the impossibility [must result] from the permanent disappearance or destruction of an object indispensable for the execution of the treaty."¹⁴³ It is agreed that the impossibility cannot be caused by the party's breach of either the agreement or of some other international legal obligation "owed to any other party to the treat-

contents being such that it is evidently not intended to set up a permanent state of things

WILLIAM E. HALL, *A TREATISE ON INTERNATIONAL LAW* § 116, at 405 (A. Pearce Higgins, ed., 8th ed. 1924).

137. Vienna Convention, *supra* note 33, art. 56(2).

138. *Id.* art. 60(3)(b).

139. *Id.* art. 60(2)(a).

140. *Id.* art. 60(2)(b).

141. *Id.* art. 60(2)(c).

142. CHARLES G. FENWICK, *INTERNATIONAL LAW* 452 (3d ed. 1948) ("[T]he arising of conditions physically or morally incompatible with the fulfillment of the treaty would either render it void or at least suspend its operation until the conditions had changed."); IAN SINCLAIR, *THE VIENNA CONVENTION OF THE LAW OF TREATIES* 191 (2d ed. 1984) (referring to Capotorti's view that "impossibility of performance, as an objective fact, paralyzes the treaty in all cases, whatever the cause.").

143. Vienna Convention, *supra* note 33, art. 61(1).

ty."¹⁴⁴

A fundamental change of circumstances (the doctrine of *rebus sic stantibus*) may be used to excuse non-performance¹⁴⁵ but only if (1) the fundamental change of circumstances "occurred with regard to those existing at the time of the conclusion of the treaty,"¹⁴⁶ (2) the change of circumstances "was not foreseen by the parties,"¹⁴⁷ (3) "the existence of those circumstances constituted an essential basis of the consent of the parties to be bound by the treaty,"¹⁴⁸ and (4) the change in circumstances radically transformed "the extent of obligations still to be performed under the treaty."¹⁴⁹

Rebus sic stantibus was relied upon to terminate treaties of colonization after World War II. The colonial powers, faced with imminent loss of their territories, were forced to admit that the treaties supporting their empires were no longer valid.¹⁵⁰ These terminations illustrate the way in which the realities of international relations shaped international law.

Some observers argue that a state cannot be forced or be expected to "sacrifice its very existence to uphold its treaty obligations"¹⁵¹ and that no nation would consent to its own annihilation.¹⁵² Thus, there may be a self-defense, or national security defense, to treaty performance. As evinced by state practice¹⁵³ and enunciated by Derek Bowett,¹⁵⁴ a state has a right to act in self-defense if the aggressor poses an immediate danger to the security or independence of the defending state, if the aggrieved state has no alternate means of protection, and if the state responds proportionately to the danger.

Under the doctrine of reprisal, a state may commit an otherwise illegal act if the act is committed in retaliation for an international

144. *Id.* art. 61(2).

145. *Id.* art. 62 (assuming existence of doctrine by placing restrictions on it); see also *Free Zones (Fr. v. Switz.)* 1932 P.C.I.J. (Ser. A/B) No. 46, at 156-58 (June 7) (assuming that principle existed but not deciding exact scope of principle).

146. Vienna Convention, *supra* note 33, art. 62(1).

147. *Id.*

148. *Id.* art. 62(1)(a).

149. *Id.* art. 62(1)(b).

150. HENKIN, *supra* note 17, at 84.

151. HALL, *supra* note 136, at 415. ("A treaty therefore becomes voidable so soon as it is dangerous to the life or incompatible with the independence of a state, provided that its injurious effects were not intended by the two contracting parties at the time of its conclusion."); GYORGY HARSZTI, *SOME FUNDAMENTAL PROBLEMS OF THE LAW OF TREATIES* 378 (1973); FENWICK, *supra* note 142, at 454.

152. FENWICK, *supra* note 142, at 454.

153. See, e.g., SPANISH RED BOOK ON GIBRALTAR 133 (1965) (describing Spanish suspension of ferry service to Gibraltar); Derek W. Bowett, *Economic Coercion and Reprisals by States*, 13 VA. J. INT'L L. 1, 8 (1972) (describing Indonesian nationalization of Dutch private property in 1958).

154. Bowett, *supra* note 153, at 10.

delinquency.¹⁵⁵ States have traditionally used asset freezes and blockades — such as the blockade of Cuba by the United States in October 1962 — to achieve political goals.

Some other excuses for treaty non-performance are necessity and *force majeure*. One doctrine that deters opportunistic retaliation is the principle of economic coercion, which may prevent opportunistic renegotiation of treaties. United Nations General Assembly Resolution 2625 evinces what some claim to be a general principle of international law.¹⁵⁶ It states that “[n]o state may use or encourage the use of economic, political or any other type of measures to coerce another State in order to obtain from it the subordination of the exercise of its sovereign rights and to secure from it advantages of any kind.”¹⁵⁷ Thus, if a party threatens to breach a treaty, unless the other state makes a concession or renegotiates the treaty, such a threat might be deemed economic coercion.

If a party wishes to terminate, withdraw from, or suspend a treaty,¹⁵⁸ it must comply with the notice requirements of the Vienna Convention. The notice requirements presumably affect the exercise of rights under the doctrines of termination under a treaty’s provisions (Article 54(a)), termination by consent of the parties (Article 54(b)), unilateral withdrawal (Article 56), retaliatory breach (Article 60), impossibility of performance (Article 61), fundamental change of circumstances (Article 62) discussed above, as well as other provisions. The breaching party must notify the other parties to the treaty of its claim and must indicate the “the measure proposed to be taken with respect to the treaty and the reasons therefor.”¹⁵⁹ If no party objects after at least three months, or a lesser amount of time in cases of “special urgency,” the party may carry out such termination, withdrawal, or suspension.¹⁶⁰ Some authorities suggest that in cases of special urgency, the notification requirement can be waived altogether.¹⁶¹ For

155. *Id.* at 7. See also J.G. STARKE, *INTERNATIONAL LAW* 520 (1989).

156. Oscar Schachter, *International Law in Theory and Practice*, 178 R.C.A.D.I. 185-86 (1982-V). (“2625’s prohibition against coercion applies to a state discontinuing trade with an offending country and imposing as a condition for the resumption of trade a change in the internal or foreign policy of the offending state.”).

157. Declaration on Principles of International Law Concerning Friendly Relations and Co-Operation Among States in Accordance with the Charter of the United Nations, G.A. Res. 2625, U.N. GAOR, 25th Sess., Supp. No. 28, U.N. Doc A/8082 (1970).

158. Vienna Convention, *supra* note 34, art. 65(1) (If the party “invokes either a defect in its consent to be bound by a treaty or a ground for impeaching the validity of a treaty, terminating it, withdrawing from it or suspending its operation.”).

159. *Id.*

160. *Id.* art. 65(2).

161. Jimn ez de Ar echaga, *International Law in the Past Third Century*, 159 R.C.A.D.I. 80 (1978) (suggesting that breach enables the aggrieved party to provisionally suspend its own performance notwithstanding the Vienna Convention).

example, in 1940, the President of the U.S. suspended the operation of the International Load Line Convention of 1930¹⁶² on the grounds of changed shipping conditions brought about by the war in Europe.¹⁶³ The United States did not give prior notice; rather, it argued that the notice requirement was inoperable in the "swiftly changing conditions inherent in the world situation."¹⁶⁴ If a party objects to breach, the parties must seek a negotiated solution under Article 33 of the United Nations Charter.¹⁶⁵ If no solution has been reached within one year after the date on which the objection was raised, any one of the parties to the dispute may submit the dispute to the Conciliation Commission.¹⁶⁶ The Conciliation Commission reports to the parties its conclusions of facts and laws, but the report "shall not be binding upon the parties and it shall have no other character than that of recommendations submitted for the consideration of the parties in order to facilitate an amicable settlement of the dispute."¹⁶⁷

Thus, under the Vienna Convention, a party may prevent another party from withdrawing, terminating, or suspending a treaty by refraining to give consent. Although the rest of the Vienna Convention is generally accepted as declaratory of international law, the procedural provisions contained in Articles 65 and Articles 68 may not represent international law because they do not conform to the practice of states. For example, the United States, in withdrawing from the International Load-Line Convention on the basis of a fundamental change of circumstances, did not attempt to negotiate its withdrawal.

Despite the multiplicity of doctrines and treatises related to non-performance of treaties,¹⁶⁸ international relations theorists have expressed disappointment in the sophistication of the law of treaty non-

162. International Load-Line Convention, *supra* note 129.

163. Herbert W. Briggs, Editorial Comment, *The Attorney-General Invoked Rebus Sic Stantibus*, 36 AM. J. INT'L L. 89 (1942); see also *Letter from Acting Attorney General Francis Biddle to President Franklin D. Roosevelt of July 28, 1941*, 40 OFFICIAL OPINIONS OF THE ATTYS GEN. OF THE U.S. 119 (1949).

164. *Letter of Acting Attorney General Francis Biddle, supra* note 163, at 123.

165. The United Nations Charter, article 33, provides that

1. The parties to any dispute, the continuance of which is likely to endanger the maintenance of international peace and security, shall, first of all, seek a solution by negotiation, enquiry, mediation, conciliation, arbitration, judicial settlement, resort to regional agencies or arrangements, or other peaceful means of their own choice.
2. The Security Council shall, when it deems necessary, call upon the parties to settle their dispute by such means.

166. Vienna Convention, *supra* note 33, art. 66, Annex.

167. *Id.* Annex(6).

168. See, e.g. ARIE E. DAVID, *THE STRATEGY OF TREATY TERMINATION: LAWFUL BREACHES AND RETALIATIONS* (1975); Herbert W. Briggs, *Unilateral Denunciation of Treaties: The Vienna Convention and the International Court of Justice*, 68 AM. J. INT'L L. 51 (1974).

performance. Yet these doctrines, however undeveloped when compared with domestic law, seem to allow broad room for non-compliance with treaty obligations.

Excusing breach is conducive to efficient breach only if the legal doctrines that allow a state to abrogate a treaty are coextensive with efficient breach; i.e., non-performance is allowed only if breach would be efficient. One way to test this hypothesis might be to compare excuses for treaty performance with actual clauses in treaties that provide for repudiation. If a treaty specified the conditions for breach,¹⁶⁹ one would expect that the treaty allows efficient breach and forbids inefficient breaches. A treaty that did not allow for an efficient breach would unnecessarily impose costs upon the breaching party. Because parties to a contract will not impose an inefficient term upon a party, efficient breach will be allowed.¹⁷⁰

C. *Multilateralism and GATT*

Another institutional form is multilateralism. Multilateralism arises when a hegemon creates an entire governance system for free trade; the hegemon may do so in two different ways. First, it may bribe countries to sign a multilateral agreement. For example, the United States bribed other countries to join GATT by (1) allowing the preference system among commonwealth countries, (2) permitting discrimination against its imports during the early years of GATT, and (3) providing foreign aid to Europe.¹⁷¹ Second, the hegemon may punish those who breach the agreement. Both unilateralism and multilateralism involve a hegemon. In multilateralism, however, the hegemon actively punishes other countries for defecting (as well as offering them incentives to comply), whereas in unilateralism the hegemon does not care about, and is not affected by, the policies of other nations.

Countries abided by the GATT, according to Yarbrough & Yarbrough, because of the implicit threat that the United States would retaliate against defectors. In particular, the escape clause allowed the United States to retaliate legally.¹⁷² In recent years, the credibility of the U.S. threat of retaliation has declined because the position of the U.S. as a hegemon has eroded. The importance of the GATT has declined, too, as international trade outside the GATT has grown and as

169. A treaty might not specify conditions for breach, in which case the customary international law regarding breach applies.

170. The GATT signatories have freely adopted a broad excuse provision. For a discussion of GATT, see Alan O. Sykes, *Protectionism as a "Safeguard": A Positive Analysis of the GATT "Escape Clause" with Normative Speculations*, 58 U. CHI. L. REV. 255 (1991).

171. Yarbrough & Yarbrough (1992), *supra* note 22, at 62-63.

172. *Id.* at 64.

countries have erected non-tariff barriers to trade.¹⁷³ As a result, "[a]greements must become more self-contained and rely on internal mechanisms for enforcement instead of a third party in the form of a hegemon."¹⁷⁴ Because the United States is no longer a hegemon in the world trade community, the GATT today has perhaps moved closer to Yarbrough & Yarbrough's model of bilateralism.

One primary GATT enforcement mechanism is retaliation by injured countries in the form of anti-dumping and countervailing duties. By and large, this governance mechanism appears to conform with the efficient breach notion that an injured party should be awarded the amount of damage done. Import duties result in higher prices, which compensate producer groups. Although economic theory suggests that anti-dumping duties and countervailing duties are inefficient from an aggregative welfare standpoint, international actors are not motivated by aggregate efficiency but rather by the power of special interest groups.¹⁷⁵

Thus, Sykes argues that certain actions will be inefficient from the economic standpoint but efficient from the political standpoint. One interpretation is that the GATT escape clause, Article XIX, prevents countries from enacting more drastic protectionist measures.¹⁷⁶ Article XIX easily dispenses protectionism without the necessity of violating an international agreement.

The escape clause was included in GATT at the insistence of the U.S. negotiator.¹⁷⁷ U.S. policy, according to public choice theory, is driven primarily by producers, who have a more concentrated interest in trade policy than do consumers. As a result, although free trade is efficient, it may not always prevail. Sykes argues that the GATT escape clause reduces the possibility of adverse political consequences to the GATT negotiators by allowing them to escape their GATT obliga-

173. *Id.* at 67.

174. *Id.*

175. That interest groups control trade policy is perhaps an oversimplification. There are many theories that seek to explain free trade. See RONALD ROGOWSKI, *COMMERCE AND COALITIONS* (1989). One theory holds that the scarce factor of production will oppose free trade and the abundant factor will favor free trade. *Id.* See also James Cassing, Timothy J. McKeown & Jack Ochs, *The Political Economy of the Tariff Cycle*, 80 AM. POL. SCI. REV. 843-62 (1986). According to business cycle theory, free trade will occur during booms; protection will occur during busts. *Id.* See also MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION* (1971). According to hegemonic stability theory, free trade occurs when one nation has a large market share of international trade. The most relevant theory for these purposes is the public choice theory or "rent seeking" theory, which postulates that there will be free trade only if it is favored by the politically powerful economic groups in society. The most powerful group is the producer group, not the consumer group, because the benefits to the producer group are more concentrated than the costs to consumers. *Id.*

176. Sykes, *supra* note 170, at 273-74.

177. *Id.* at 274.

tions when there was domestic political pressure to protect certain industries.¹⁷⁸ Like Yarbrough & Yarbrough, Sykes views the GATT as a self-enforcing agreement.

Another breach provision in GATT is Article XXVIII, which allows a country to renegotiate a tariff binding. Sykes argues that such *ex post* negotiation is allowed in order to avoid deciding, *ex ante*, all types of contingencies that would allow breach.¹⁷⁹ If negotiations fail, then the GATT allows a country to breach, but only at the risk that other countries may withdraw "substantially equivalent concessions." This, too, is a way of punishing the offender for damage done. Interestingly, the enforcement measure is discretionary, not automatic.

D. *Minilateralism and the European Community*

The fourth institutional form is minilateralism, which crosses the boundary from anarchy to organized government. The conditions under which minilateralism arises are (1) the presence of specific trade-related investment and (2) the creation of effective third-party enforcement.¹⁸⁰

Yarbrough & Yarbrough's example of minilateralism is the European Community (and Union) from 1986 forward. Before 1986, Yarbrough & Yarbrough contend, the EEC was characterized by anarchic types of enforcement. Many countries actually refused to comply with Community directives:

The French defied an injunction of the Community Court by forbidding imports of British lamb. The British and West German governments threatened to withhold their legally required financial contributions to the Community in response to a budget increase. The British refused to comply with their Community obligations without a reduction in their budgetary contribution. French subsidies to turkey farmers, alleged by Britain to be illegal under Community policy, caused Britain to suspend vaccinating birds against pests — to justify a policy of keeping out French turkeys to protect the newly disease-vulnerable British birds.¹⁸¹

The turning point was the Single European Act in 1985, when voting by the Council of Ministers was changed from unanimous voting to qualified majority voting. Yarbrough & Yarbrough contend that before this turning point, enforcement of EEC law was impossible because the necessary unanimous vote could never be reached.

International institutions such as GATT and the European Union provide a middle ground between treaty law and federalism. One func-

178. *Id.* at 278-80.

179. *Id.* at 283.

180. Yarbrough & Yarbrough (1992), *supra* note 22, at 90, Fig. 5.1.

181. *Id.* at 94.

tion of such institutions is to lend precision to the circumstances under which a country should be punished by its trade partners. Axelrod and Keohane summarize this function as follows:

Regimes incorporating the norm of reciprocity delegitimize defection and thereby make it more costly. Insofar as they specify precisely what reciprocity means in the relevant issue-area, they make it easier to establish a reputation for practicing precisely because others will be more willing to make agreements with governments that can be expected to respond to cooperation with cooperation.¹⁸²

Axelrod and Keohane identify a theoretical gap that exists when discussing the effect of institutions.¹⁸³ "Upward looking" theories focus on the behavior of individual actors. "Downward-looking" theories examine the implications for actors of the way in which the entire institution is organized. Such downward-looking theories are public goods and market failure.

One theory, neo-functionalism, appears to have bridged the gap between actor-oriented theories and state-oriented theories. Neo-functionalism attempts to explain how national actors begin to shift their loyalties towards a regional government.¹⁸⁴ Actors are assumed to be self-interested groups and political parties that favor integration to accomplish their own goals. These groups influence the supra-state political actors, namely the European Council and the European Commission. Neo-functionalism postulates that there is an economic and political spillover effect whereby "any integrative action in one sector creates a situation in which the original goal can be assured only by taking further actions in related sectors."¹⁸⁵

For neo-functionalists, the processes of integration created "an integrated and enforceable body of community law."¹⁸⁶ The increased enforceability of this law can be traced through a series of landmark opinions of the European Court of Justice. In *van Gend & Loos*, the Court held that a private company could directly invoke certain provisions of the Treaty of Rome against the Dutch government.¹⁸⁷ In *Costa v. Enel*, the Court held that Community law was supreme above national law.¹⁸⁸ In other decisions, the Court has held that certain treaty provisions and community legislation have direct application with-

182. Axelrod & Keohane, *supra* note 111, at 252.

183. *Id.* at 252.

184. Anne-Marie Burley & Walter Mattli, *Europe Before the Court: A Political Theory of Legal Integration*, 47 INT'L ORG. 41, 53 (1993) (quoting Ernst Haas, *International Integration: The European and the Universal Process*, 15 INT'L ORG. 315, 366 (1961)).

185. Burley & Mattli, *supra* note 184, at 55.

186. *Id.* at 57.

187. Case 26/62, *N.V. Algemene Transport & Expeditie Onderneming van Gend & Loos v. Nederlandse administratie der belastingen*, 1963 E.C.R. 1.

188. Case 6/64, *Costa v. Enel*, 1964 E.C.R. 585.

out the necessity of national enabling legislation.

There is very little room in the European Union treaties for breach. The Treaty of Rome contains no escape clauses. Furthermore, there are no provisions for termination of the treaty. Although termination of the treaty might be allowed under the customary international law related to treaty termination, a country's withdrawal would result in its loss of the reciprocal benefits of Union membership, a cataclysmic fallout.¹⁸⁹

Minor violations of treaty provisions have been shut down by heightened enforcement since 1986; nations seeking to evade their treaty obligations find little solace in the text of the Treaty of Rome or in community legislation. There are no countervailing duties or anti-dumping duties to be used or abused.

We are left with a question of why unification reduces the opportunities for parties to breach the agreement. The answer is that greater unification leads to reciprocal recognition of the welfare of other countries' interest groups. Suppose, for instance, that low-cost Italian steel manufacturers begin to gain market share from British steel manufacturers. Ordinarily, British steel companies would put pressure on the legislature for protective tariffs on subsidies. Possibly, the steel companies would succeed in overrunning the diffused interests of the steel consumers.¹⁹⁰ But with integration, the Italian steel companies would register their political preferences for free trade, perhaps counterbalancing the British producer interests.

VI. CONCLUSION

Despite the fact that nations seek to maximize the welfare of interest groups, they also seek to generate efficient compliance behavior in the same way as private parties do. In anarchy, the sanctions available to punish non-compliance with agreements are often too clumsy to perfectly generate efficient behavior. Because informal sanctions are not as precise as court-ordered damages, parties to international agreements face high negotiating costs. If negotiations fail to reach the efficient result, there will be overcompliance and undercompliance with agreements. As institutions become more sophisticated, remedies for breach become more precise and the idea of efficient breach becomes correspondingly more robust. After a certain

189. The reduction in trade barriers has led European industries to make investments that hinge upon continued participation in the European Union. One such type of investment is the building of plants that capitalize on Union-wide economies of scale.

190. Under GATT, the British steel companies could convince the British government to levy anti-dumping duties and countervailing duties on Italian imports, assuming that the Italians engaged in dumping or subsidies. See Bovard, *supra* note 26 (collecting instances of American retaliatory action).

point, centralization requires the disposal of the domestic contract law analogy entirely.

In light of the infrequency of treaty breach, and given the decentralized nature of international law, international law contains a surprisingly complex set of rules governing termination. The explanation for this may be the lack of compensation in international relations. In domestic law, private actors are forced to compensate each other for breach, thereby determining for themselves when it is efficient to breach a contract. In international law, however, this selection must be done through a legal mechanism, through custom, or both.

International agreements are not motivated by a state's total economic welfare but by the welfare of powerful interest groups. As a result, we would expect that doctrines forgiving treaty termination would hinge upon variations on the welfare of the powerful political groups. This expectation is borne out in the GATT, which calibrates the escape clause and the ability to levy retaliatory duties on the misfortunes of producer groups. In the European Union, integrationist tendencies eliminate some barriers to trade and also eliminate most excuses for treaty breach. Changed circumstances that adversely affect one politically powerful producer group usually improve the lot of another producer group in the Union. As economic welfare is aggregated across economic groups, fewer breaches of treaty obligations are politically efficient from a Union perspective. It is perhaps more expeditious to eliminate any recourse to breach.