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THE COST OF CREDIBILITY:
EXPLAINING RESISTANCE TO INTER-STATE
DISPUTE RESOLUTION MECHANISMS

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ABSTRACT

When states enter into an agreement the credibility of their commitment is undermined by the weakness of the international enforcement system. Including a mandatory dispute resolution provision in the agreement is one of the available strategies to improve the binding nature of an agreement and, therefore, increase the credibility and value of the agreement. As a matter of practice, however, states typically do not include mandatory dispute resolution provisions in their treaties and other agreements. International law scholars have long known this fact, but have not offered an explanation for this behavior that is consistent with what we know about contract and bargaining theory.

This paper explains why the use of mandatory dispute resolution provisions is the exception rather than the rule in inter-state agreements. When states violate an international commitment, they face a loss in the form of direct sanctions or a reputational loss. These sanctions can be increased through the use of a dispute resolution clause. Both direct and reputational sanctions represent a joint loss for the parties to an agreement. In the event of a breach, therefore, the parties are better off without a dispute resolution provision. On the other hand, by increasing the sanction for a violation of international law, a dispute resolution clause increases the likelihood of compliance. States, therefore, must balance the credibility and compliance benefits of a mandatory dispute resolution provision against the joint costs imposed by those provisions in the event of a violation.

The analysis generates a series of results. It is shown that dispute resolution clauses are more likely when rates of compliance are high even in the absence of such clauses, when the marginal impact of the clause on compliance is large, and when the parties to the agreement face similar ex ante probabilities of breach. Dispute resolution clauses are also more likely in low stakes agreements than in high stakes ones, and in multilateral agreements rather than bilateral ones. On the normative side, the paper demonstrates that increasing the accuracy of tribunals will increase the use of dispute resolution clauses, even if the parties are risk neutral. It also offers support for the view that money damages (or other damages that take the form of transfers between the parties) should be encouraged.

THE COST OF CREDIBILITY: EXPLAINING RESISTANCE TO INTER-STATE DISPUTE RESOLUTION MECHANISMS

Andrew T. Guzman

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I. INTRODUCTION

Within domestic legal systems courts stand ready to resolve legal disputes. In the international realm, there have been attempts to create analogous institutions to resolve disputes between states. These attempts include the establishment of the International Court of Justice (ICJ), the dispute resolution procedures of the World Trade Organization, the United Nations Convention on the Law of the Sea (UNCLOS) dispute settlement provisions,¹ and a wide range of dispute resolution procedures contained in bilateral and regional agreements including, for example, NAFTA.

Despite the above efforts to establish international courts, it remains that case that when sovereign states enter into international agreements, they typically do not provide for the mandatory resolution of disputes.² For example, the United Nations Charter lacks such provisions, as do most military agreements, environmental agreements, and many other international agreements. Although this fact is well known and, indeed, considered unremarkable among international law scholars, it should be puzzling for contract scholars. An international agreement is, after all, a contract that seeks to influence the behavior of states. The parties to such a contract have a greater incentive to comply if the sanction for non-compliance is increased. If one assumes that states entering into international agreements hope for compliance, and that dispute resolution provisions

¹ The ICJ, WTO Disputes Settlement Understanding, and UNCLOS Tribunal represent the primary multilateral organs that adjudicate disputes subject to mandatory dispute resolution provisions.

² I am unaware of any comprehensive examination of the use of such clauses in treaties. A 1976 writing claimed that of some 17,000 treaties registered with the League of Nations or United Nations less than 4,000 contained any clause providing for the peaceful settlement of disputes. Among those with such a clause, a large percentage simply called for negotiation. Others required the ex post consent of all parties before the dispute was sent before an arbitral tribunal such as the International Court of Justice (ICJ). See Sohn (1976). See also Madeline Morris, High Crimes and Misconceptions: The ICC and Non-Party States,

provide some increase in the penalty for the violation of an agreement, then one might expect the parties to adopt such provisions.³ Put another way, one might expect dispute resolution provisions to be common because they increase the credibility of a commitment by providing a compulsory mechanism through which alleged violations are investigated and the party at fault is publicly identified. Being identified as having violated international law is costly for a state because it leads to a loss of reputation in the eyes of both its counterparty and other states and because it might give the offended state the right to impose sanctions of some kind.⁴ A loss of reputation harms a state because it makes it more difficult to enter into future agreements.⁵ For example, the WTO dispute settlement mechanism is intended to increase the cost of violating one's trade obligations by calling for the end of violative measures and by identifying guilty states.⁶

The parties to a contract might resist increasing the sanction for breach if the existing sanction is already optimal. This is almost certainly not the case in the inter-state context because the enforcement mechanisms available to states are weaker than would be the case under an optimal regime.⁷ If one accepts that the existing enforcement system

*4, mimeo (2001) ("States are particularly unwilling to enter into broad commitments to adjudicate future disputes, the content and contours of which cannot be foreseen.").

³ The dispute resolution provisions that are considered by this article are mandatory terms that are agreed upon prior to the development of a dispute. In addition, only terms that provide for the resolution of disputes by a disinterested third party are included. Thus, provisions for conciliation and negotiation are not included, nor are post-dispute commitments to arbitrate.

⁴ See Guzman (2001) for a discussion of how reputation affects international law.

⁵ Without a dispute settlement provision, a state can unilaterally publicize a dispute, but uninvolved states may not be able to verify which party is at fault.

⁶ "By serving as a vehicle for transmitting information about violations throughout the trading system, central dispute resolution enhances the reputational cost of cheating." Schwartz & Sykes (2002).

⁷ It is true that even in the absence of a dispute resolution mechanism, reputational mechanisms may reduce the incentive to violate an international commitment, but there is no reason to think that reputation is sufficient to allow contracting between states at the optimal level. This is so because reputational sanctions are limited in magnitude and can be unpredictable. Even a total loss of reputational capital may not be enough to deter a violation of international law. Reputational sanctions are also likely to under-deter breach because the actions of the parties may not be observable to third parties. In the absence

among states is weaker than is optimal, and if dispute settlement provisions represent a way to increase the commitment level of states, one would expect states to adopt dispute settlement procedures in virtually all agreements.⁸ Yet state behavior is just the opposite. States often avoid the use of dispute resolution clauses that offer a low cost way of increasing the sanction for wrongdoing and the credibility of their promises.

The question of why states resist dispute settlement clauses, then, presents a puzzle.⁹ The existing literature offers some suggestions to explain this behavior, but, as shown in Part II, these explanations are incomplete and difficult to reconcile with what we know about contracting, litigation, and settlement.¹⁰

This paper offers an explanation of why states include dispute resolution clauses in some agreements but not others. Key to the explanation is recognition of the fact that the sanction for the violation of an international agreement is reputational, and this

of a disinterested adjudicator, the breached against party cannot credibly demonstrate that the other party was at fault. See Guzman (2001).

⁸ In some unusual instances one state may be better off if it cannot commit. For example, if commitment is possible, a state may have to choose between a commitment to assist an ally in the event of war and losing the goodwill of that ally. If commitment is not possible, the state can promise to provide military assistance and therefore maintain the friendship of its ally without committing itself to military support. In general, however, states are better off with the ability to make binding promises. Even in those circumstances where a state is better off without the ability to commit, its would-be contract partner is worse off and, taken together, the two are worse off in the absence of a commitment mechanism.

⁹ One possible explanation for the absence of dispute resolution clauses in some international agreements is that they are designed to resolve coordination problems. Once established, treaties of this sort have no need for dispute resolution procedures because neither party has an incentive to cheat. The theory advanced in this paper explains the absence of dispute resolution agreements when states seek to overcome a prisoner's dilemma. Some scholars have suggested that all or virtually all treaties address coordination games. Goldsmith & Posner (1999). If this is the case, of course, dispute resolution clauses are unnecessary because nobody has an incentive to violate the agreement. The puzzle would then be the fact that dispute resolution clauses are as common as they are. That all agreements represent the resolution of a coordination game is not a commonly held view, however, and in any case, this paper is not the forum in which to address the question. For the purposes of this paper, it is simply assumed that some agreements represent attempts to resolve prisoners' dilemmas, and it is these agreements that are the subject of this paper.

¹⁰ This paper concerns only the ex ante commitment of states to use dispute settlement procedures. Whether states choose to submit themselves to some form of formal dispute settlement by a third party ex post is a different issue that is not addressed here.

reputational loss represents a net loss to the parties in the sense that one party suffers a loss while the other enjoys no offsetting gain.¹¹ This is in contrast to the typical domestic case in which sanctions take the form of money damages. The use of a dispute resolution clause, therefore, increases the total costs of breach, which has two effects. First, it provides a benefit to the states because it increases compliance in much the same way as do money damages in the domestic context. Second, it imposes a cost on the states because it increases the joint cost of breach. Thus, for those cases in which a breach occurs despite the presence of a dispute resolution clause, the parties are worse off with a tribunal than they would be without one.¹²

The analysis generates a series of results. It is shown that dispute resolution clauses are more likely when rates of compliance are high even in the absence of such clauses, when the marginal impact of the clause on compliance is large, and when the parties to the agreement face similar ex ante probabilities of breach. Dispute resolution clauses are also more likely in low stakes agreements than in high stakes ones, and in multilateral agreements rather than bilateral ones. On the normative side, the paper demonstrates that increasing the accuracy of tribunals will increase the use of dispute resolution clauses, even if the parties are risk neutral. It also offers support for the view that money damages (or other damages that take the form of transfers between the parties) should be encouraged.

¹¹ The sanction may also take the form of retaliation by another state through, for example, trade restrictions. As discussed in Part V.E, the argument presented in the paper applies at least as well to sanctions of this sort as it does to reputational sanctions.

¹² Some readers may object that the parties could renegotiate before the tribunal renders a decision. This point is addressed in Part V.F.

As is the case with any positive theory of state behavior, the model presented in this paper makes assumptions about how states make decisions. First, it is assumed that states act rationally and in their own self-interest. Second, it is assumed that states act as unitary actors. Although not specifically discussed, the model allows for the possibility that state preferences are the product of an interaction of domestic interests. What is really assumed, then, is that the outcome of the domestic political process generates a policy that the state pursues. An alternative approach with which to analyze state decision making looks to domestic interest groups in an attempt to understand how domestic interactions lead to international behavior.¹³ This paper treats states as unitary actors because that assumption is sufficient for the present purposes and because it provides stronger predictive results.¹⁴

Part II of the paper outlines some of the existing explanations for state resistance to dispute resolution mechanisms and explains why they are incomplete. Part III provides a simple example which conveys the intuition behind the results. Part IV presents the model itself and Part V explores possible extensions of the model as well as its implications.

II. EXISTING EXPLANATIONS

The reluctance of states to enter into binding dispute resolution has received limited attention from international law scholars. One reason for the lack of interest may be the fact that this behavior is so common as to be considered the norm – it is simply

¹³ Schwartz & Sykes (1996); Sykes (1991); Slaughter (1998).

¹⁴ See Guzman (2002) for a discussion of the public choice assumptions and their use in international law scholarship.

accepted that states rarely provide for dispute resolution.¹⁵ The literature that exists offers several explanations for the behavior of states. Two of the most common of these explanations are discussed below. In general, such explanations are neither satisfactorily developed in the literature, nor the product of a theory of negotiation. As a result, although existing explanations provide some useful insights, they are often inconsistent with what we know about negotiation and contract theory and sometimes difficult to reconcile with the way in which states behave.¹⁶

A. Maintenance of Control Over Negotiations

One of the most commonly advanced explanations for the absence of dispute resolution clauses in international agreements is that states prefer to retain control over disputes rather than turn to a third party.¹⁷ It is argued that resolution of a dispute through interstate bargaining and diplomacy is more constructive than the use of third party adjudication.¹⁸ In support of this claim it is stated that diplomacy is less likely than arbitration to harm the prestige of states and that it allows states to simply ignore or walk away from the dispute if non-resolution is the preferred outcome. In addition, a diplomatic solution does not create an international precedent in the same way that a published opinion does.

¹⁵ Not only do states rarely include dispute resolution procedures, but when they include some form of procedure, it is rarely mandatory. It is common, for example, for a “dispute resolution” clause to call for no more than conciliation and negotiation in the event of a dispute.

¹⁶ I should add that existing discussions of dispute resolution often do not distinguish between ex ante commitments to dispute resolution and ex post agreement on its use. This paper only considers that ex ante aspect of the issue. The explanations discussed in this Part may provide a better explanation for why states fail to enter into dispute resolution ex post than why they do not do so ex ante.

¹⁷ See Morris, at *7, Rovine, Fitzmaurice, at 462-73.

¹⁸ “It is one thing to show that resort to the [International Court of Justice] is preferable to armed conflict; it is quite another matter to demonstrate that judicial processes are as valuable as ordinary out-of-court bargaining and discussion.” Rovine, at 314. “[T]here is a more fundamental reluctance to submit to

This argument misses the mark. There is no doubt that states value the opportunity to resolve disputes through diplomatic means, but the presence of mandatory dispute resolution does not prevent negotiation between the states involved in a dispute. Dispute settlement procedures are triggered only if one of the states prefers to abandon negotiation in favor of a formal process with a third party adjudicator. Prior to the case's arrival before a tribunal, therefore, the parties have an opportunity to settle the case through diplomatic means. The domestic system of litigation and settlement offers an obvious analogy here. The court system stands ready to adjudicate disputes, but the vast majority are resolved through pre-trial negotiation. The WTO dispute resolution represents an international example of negotiation in the presence of a mandatory dispute resolution process. Between 35 and 40% of all cases filed at the WTO are settled at the pre-panel stage.¹⁹ The notion that a dispute settlement system prevents diplomatic bargaining is simply wrong.²⁰

State preferences for negotiation may be part of the explanation of why states do not submit their disputes to arbitration *ex post*, but even that is doubtful. Once the dispute is present, the parties' interests diverge. Whatever the merits of bargaining and diplomacy, states are unlikely to submit a dispute to a tribunal *ex post* if one of the states expects to lose.

third-party adjudication that rests on the perceived advantages to States in some circumstances of retaining control over the resolution of disputes." Morris at *6-7 (citing Rovine, Fitzmaurice at 462-73).

¹⁹ Guzman & Simmons (2002). Busch & Reinhart (2001) report that panels are established in only 43% of WTO cases. This figure, however, includes all cases that are have been filed and for which a panel has not yet been established. For many of those cases there has simply not been enough time to determine if there will ultimately be a panel or not. The Guzman & Simmons figure includes only cases that have been settled, gone to a panel, or have been "inactive" for at least three years.

²⁰ Compulsory dispute resolution does, of course, affect the outcome of negotiations. In particular, it leads to a less favorable outcome for the breaching party.

An ex ante approach to the problem reveals why states are unlikely to object to a dispute resolution clause despite the loss of control. The argument that states wish to retain control of their disputes is convincing enough if one imagines a state that is in the midst of a dispute because of its own verifiable failure to live up to its international obligations. If another state has violated international law, however, the offended state may wish to have a tribunal identify the guilty party. When considering a dispute resolution clause ex ante, however, the states do not know which of them might be at fault in the event of a dispute. Assuming that the states are risk neutral,²¹ there is no reason for them to avoid a dispute resolution clause. Although giving up control over the dispute will hurt a state in some cases, the ability to force its counterparty to submit to dispute resolution will help the state in other cases. Furthermore, one would expect a dispute resolution clause to increase the cost of breaching the agreement, thereby increasing compliance and the value of the agreement and making the clause attractive to the parties.

Among the supposed benefits of retaining control over a dispute is the avoidance of an all-or-nothing result. The above discussion suggests that even if dispute resolution led to an all-or-nothing outcome, it is not clear why states would seek to avoid it. In any event, it is misleading to think of dispute resolution procedures as being all-or-nothing decisions while imagining that the alternative features greater flexibility. In the absence of a dispute resolution procedure, either party can choose to refuse negotiations, in which case there is no settlement and the dispute ends. If there is a dispute settlement

²¹ Risk neutrality is discussed in the next section.

procedure, either party can refuse to negotiate and invoke that procedure.²² Similarly, in both cases the parties are able to engage in negotiation and diplomacy as long as both parties are willing. Thus, whether there is a dispute settlement clause or not, one party can prevent a negotiated settlement. Without such a clause it is the defendant that can do so. With such a clause it is the complainant. The case without a dispute settlement provision is, in fact, less flexible because the defendant can not only end the negotiations, but can achieve victory by doing so. Faced with a dispute settlement provision, the most the complainant can do is refuse to settle and proceed to a tribunal – where it faces the risk of losing.

A related explanation for why states are reluctant to provide for dispute resolution relies on an appeal to sovereignty. The argument here is that states refuse to surrender control over their disputes to a third party because they are unwilling to compromise their sovereignty. This justification suffers from several problems. First, it fails to distinguish between cases in which dispute resolution clauses are included and cases in which they are not. If states are unwilling to surrender control over a dispute in some contexts, why are they willing to do so in others?

A second problem with this explanation is that the term “sovereignty” is too malleable to provide a useful explanation. States are constantly giving up sovereignty in order to get some benefit. For example, European countries surrendered enormous amounts of sovereignty in order to build the EU, NAFTA states surrendered sovereignty over regional trade restrictions and dispute resolution, and developing countries have

²² Some agreements call for a mandatory period of consultation before a formal tribunal gets involved, but a party that prefers a tribunal can simply refuse to agree to any negotiated outcome short of what it expects to receive from that tribunal.

surrendered their sovereign control over the treatment of investors through bilateral investment treaties. Appeals to sovereignty must address the fact that states are often eager to compromise their sovereignty in order to achieve other objectives. Such claims must, therefore, be accompanied by an explanation of why states will not engage in a similar compromise in exchange for improved international cooperation.

Third, it is difficult to know why a state would be willing to surrender sovereign control over the substantive provisions of an agreement but refuse to surrender control over the handling of disputes. States entering into an agreement presumably wish to bind their counterparties, a goal that can be advanced with a dispute resolution clause. Failing to include such a clause, therefore, undermines the very exchange of sovereignty that is intended by the agreement. If a state does not want to compromise its sovereignty in this context, why wouldn't it simply refuse to enter into the agreement in the first place?

B. Risk of Losing

Another oft-cited reason for the reluctance of states to enter into dispute resolution agreements is their fear of losing the case.²³ To the extent dispute resolution identifies the winners and losers in a dispute, of course, a state benefits from a dispute resolution provision when it wins a case. The claim, therefore, is that states prefer to avoid the dispute altogether rather than risk losing – even if they also stand a chance of winning. In other words, states are risk averse.²⁴

²³ “Most obviously, but most fundamentally, states resist judicial settlement because they fear losing.” Rovine, at 317.

²⁴ “[T]he more uncertain the adjudicated outcome of a particular dispute would be, the less willing a State will be to seek binding third-party adjudication.” Morris at *8. See Merrills at 293-94 (“when the result is all important, adjudication is unlikely to be used because it is simply too risky.”)

Risk aversion is an unsatisfactory reason for states to avoid dispute resolution for at least two reasons. First, recognizing that states enter into many international agreements and have frequent and repeated interactions with other states, it is hard to see why a state would be risk averse. Each individual commitment and each individual compliance decision represents just a small fraction of the states' behavior. With many such interactions, one would expect states to seek to maximize the total value of their commitments rather than to avoid risk. In essence, states are well diversified in their international interactions, allowing them to reduce the overall risk to which they are exposed.²⁵ Second, and perhaps more importantly, the use of a dispute resolution procedure may actually reduce the risk faced in any given case if one views the case from an ex ante perspective. Ex ante, a dispute resolution clause increases the likelihood of compliance, which can cause a reduction in the overall risk of the agreement.

III. A SIMPLE EXAMPLE

The basic intuition of the model can be developed through a simple example, which is presented in this Part. Part IV develops a more general model with more general assumptions.

Assume that there are two countries, labeled A and B. They face a prisoner's dilemma in which cooperation yields a payoff of 5 to each of them.²⁶ If one party cooperates while the other party defects, the defecting party receives $N > 5$ and the other

²⁵ It would be incorrect to respond that some disputes involve such a large loss that the existence of other agreements represents inadequate diversification. No individual dispute can impose losses on a state that exceed the cost of simply ignoring the dispute resolution clause. The damage that a state can suffer, therefore, is capped by the fact that there is no coercive enforcement mechanism in place.

²⁶ The game as presented should be thought of as the presented discounted value of a repeated game rather than a one shot game. This is important because the game must be repeated for cooperation to emerge as a possibility in the absence of an enforcement mechanism.

party suffers a loss of 5. If both parties defect, they each receive a payoff of 0. N is a random variable. The states can attempt to solve their problem by establishing a treaty, but in the absence of a dispute resolution mechanism, we assume that the treaty does not change the payoffs. Therefore, if there is no dispute resolution mechanism, the game can be represented as follows:

		Country B	
		Cooperate	Defect
Country A	Cooperate	(5, 5)	(-5, N)
	Defect	(N , -5)	(0, 0)

In some states of the world, however, the parties can achieve the cooperative outcome through the inclusion of a mandatory dispute resolution clause in the agreement. In the event of a dispute, such a clause allows the breached against party to bring the breaching party before a neutral tribunal. When a tribunal declares that one state has violated its international obligation, that state suffers a reputational loss of R . The loss comes about because the state that loses before a tribunal finds it more difficult to establish international agreements in later periods with either its counter party in this agreement or third parties.²⁷ If the parties adopt a dispute resolution clause, the game can be represented as follows:

		Country B	
		Cooperate	Defect
Country A	Cooperate	(5, 5)	(-5, $N-R$)
	Defect	($N-R$, -5)	(- R , - R)

²⁷ Without a dispute resolution clause, it is assumed that third parties have difficulty identifying the breaching party, which reduces the reputational sanction for a breach.

If there is no dispute settlement mechanism in place, the probability that the states choose to comply with the agreement is given by ρ . If there is a dispute resolution mechanism in place, the probability of compliance is increased because the expected reputational sanction of a failure to comply is higher. The probability of compliance in the presence of a dispute settlement mechanism is denoted $\rho+q$, where $q < 1-\rho$.

Assuming that the states are identical, when a state enters into the agreement without a dispute resolution clause, its expected payoff is:

$$5\rho + (1-\rho)(0) = 5\rho$$

If there is a dispute resolution clause, the expected payoff to a state is:

$$5(\rho+q) + (1-\rho-q)(-R)$$

Comparing the above expressions, the state's expected payoff is greater with a dispute settlement procedure if and only if

$$5(\rho+q) + (1-\rho-q)(-R) > 5\rho$$

Simplifying yields:

$$5 > R(1-\rho-q)/q$$

This expression makes it clear that a dispute resolution clause is desirable in some agreements, but not others. Specifically, a dispute resolution clause is more attractive as q , the marginal impact of dispute resolution on compliance, increases; and as R , the marginal impact of dispute resolution on the sanction for breach, falls.²⁸

The intuition behind this result is straightforward. A dispute settlement clause is attractive because it increases the likelihood of compliance and, therefore, the probability

of the cooperative outcome. As the impact of dispute resolution on compliance increases, so does the use of dispute resolution clauses. On the other hand, even in the presence of a dispute resolution clause, breach will sometimes occur. Because the reputational loss is a net loss to the parties rather than a transfer between them, increasing that loss reduces the payoff to the parties in those states of the world in which there is a breach. An increase in R , therefore, has two effects. First, it increases the loss in the event of a breach, making a dispute resolution clause less desirable. Second, it causes an increase in q , a function of R , which makes dispute resolution more desirable.

When negotiating an agreement, therefore, the parties must take into account both the increase in compliance that is generated by the dispute resolution clause and the resulting joint loss that occurs when there is a breach. These offsetting effects will lead them to include dispute resolution provisions in some agreements but not in others. The following Part develops a more general model of state behavior that yields similar results.

IV. THE MODEL

Suppose that two countries, labeled A and B, seek to achieve cooperation through the use of a treaty. If both countries comply with the terms of the treaty, they each receive a payoff of P , $P > 0$.²⁸ A country that violates the treaty enjoys a positive payoff, N_i , $i=A,B$. N_i is a random variable whose distribution is known to the parties. N_A and N_B need not be drawn from the same distribution. The gain of N_i can be thought of as an increase in a state's payoff as a result of an outside option that becomes available, but that can be pursued only by breaching the treaty. If a country complies with the treaty

²⁸ Of course changes in R also have an impact on q which must be taken into account.

²⁹ For convenience, Appendix A provides a list of variables and their definitions.

while its partner breaches, the breached against party suffers a loss of L . This loss might reflect, for example, the loss of investments made in reliance on the treaty. If both states violate the agreement, they both receive 0. The payoffs if there are no dispute resolution procedures can be represented as follows:³⁰

		Country B	
		Cooperate	Defect
Country A	Cooperate	(P, P)	(-L, N_B)
	Defect	(N_A , -L)	(0,0)

Notice that under these assumptions, there will be compliance with the treaty in some states of the world, but the treaty itself provides no compliance pull – meaning that the behavior of the parties is unchanged by the treaty.³¹

Compliance can be improved through the use of a dispute resolution clause. If the parties have included such a clause in the treaty, either party can call for the use of the dispute resolution procedures. For the moment, it is assumed that the arbitral body is able to identify the party that is responsible for a violation.³² This impartial determination of culpability imposes a cost on the breaching party in the form of a loss, R . This loss can take the form of a reputational loss that inhibits the state's ability to make credible commitments in the future, or it can take the form of a sanction imposed by the injured state. For now the paper will proceed on the assumption that the loss is a

³⁰ It is assumed that $2P$ is larger than that expected value of $N_i - L$.

³¹ One could carry out the same analysis under an assumption that a failure to honor a treaty imposes some reputational harm even in the absence of a dispute resolution mechanism. As long as the dispute resolution procedures increase that reputational harm, one would get result analogous to those developed here.

³² This assumption is relaxed in Part V.A.

reputational one.³³ Part V.E demonstrates that the same results would hold for sanctions. It is assumed that a party refusing to appear before the tribunal, or otherwise disputing the authority of the tribunal suffers the full reputational loss of R . One can think of this loss as the lost value due to the reduced credibility of the country's future promises. The payoffs if there are dispute resolution procedures are as follows:

		Country B	
		Cooperate	Defect
Country A	Cooperate	(P, P)	(-L, $N_B - R$)
	Defect	($N_A - R$, -L)	(0, 0)

When the parties enter into their agreement they know the distributions of both N_A and N_B , so they know the probability of compliance with the treaty. We denote the probability of compliance in the absence of a dispute resolution provision ρ . The term compliance is used here to describe the situation in which both parties honor the agreement. If the parties include a dispute resolution provision, breach becomes less attractive because a party that loses before a tribunal suffers the reputational loss of R . Let q denote the marginal impact of a dispute settlement clause on the probability of compliance.³⁴ Thus, in the presence of a dispute settlement clause, the probability of

³³ By assuming that a reputational loss exists, I am assuming that international law can have at least some binding effect. I recognize that some are skeptical of this claim, but if international law has no effect, the mystery is not why states fail to establish dispute resolution procedures, but rather why they enter into international agreements at all. In any event, this debate continues in the international relations literature, and I put it to one side for present purposes. For a discussion of this debate, including my own views, see Guzman (2001).

³⁴ q is a function of R , as discussed below.

breach is $1-\rho-q$. Finally, assume that country A is responsible for any given breach with probability ϕ , and country B is at fault with probability $1-\phi$.³⁵

Consider first the case in which there is no dispute resolution procedure. The expected payoff to Country A from the establishment of the treaty is given by:³⁶

$$\rho P + (1-\rho)[\phi N - (1-\phi)L] \quad (1)$$

It is true that a state can publicize a breach unilaterally in an attempt to impose the reputational loss, R , on the breaching state. In this case, however, other states have no way of knowing which party is actually at fault and each country will suffer half of the reputational loss. Rather than suffer this loss, the breached against state will simply remain silent.

Now consider the payoff if the parties establish a dispute resolution procedure. Country A's payoff from an agreement with a dispute resolution clause is given by:

$$(\rho+q)P + (1-\rho-q)[\phi(N-R) - (1-\phi)L] \quad (2)$$

Comparing expression (2) and expression (1), a country prefers to include a dispute resolution clause if and only if:

$$(\rho+q)P + (1-\rho-q)[\phi(N-R) - (1-\phi)L] > \rho P + (1-\rho)[\phi N - (1-\phi)L]$$

Simplifying yields:

$$qP > \phi [(1-\rho-q)R + q(N+L)] + qL \quad (3)$$

If the inequality in (3) is not satisfied, the parties prefer to establish the agreement without a dispute resolution clause. It is clear from expression (3) that there are some

³⁵ For convenience it is assumed that in every instance of breach only one of the countries is "at fault," ruling out the case in which both states breach. This is done to simplify the notation.

values for which this is the case. This range is smaller for large values of P , as we would expect. If the gains from cooperation are large, there are greater benefits from increasing compliance, which is one of the consequences of adopting a dispute settlement clause.

It is also straightforward to see that an increase in ϕ , the probability that Country A breaches, reduces the appeal of a dispute resolution clause. This reflects the fact that when Country A breaches it is better off if there is no dispute resolution clause. An increase in ϕ , therefore, reduces the likelihood that Country A will accept a dispute resolution clause. A reduction in ϕ increases that appeal of such a clause for A, but it reduces the appeal for Country B. As ϕ deviates from $\frac{1}{2}$ therefore, one country likes dispute resolution more while the other likes it less. Recognizing that both parties must consent to such a clause, deviations of ϕ in either direction from $\frac{1}{2}$ reduce the likelihood that the clause will be adopted.³⁷

An increase in N – the expected value of breaching one's obligation – reduces the appeal of dispute resolution procedures. This is so because an increase in N makes violation of the agreement more attractive at the margin. This causes a reduction in the probability of compliance, ρ . A reduction in ρ increases the cost of dispute resolution because it increases the probability of breach and, therefore, the probability that one of the parties will suffer a loss of R .

The magnitude of the reputational loss also affects the appeal of a dispute resolution clause. The impact of R on the use of dispute resolution clauses, however, is

³⁶ Without loss of generality, from this point on the paper considers only the payoffs to country A. To simplify the notation, we also drop the subscript on N_A and recognize that we are using N to indicate the expected value of N_A .

uncertain in the model. On the one hand an increase in R reduces the appeal of such clauses because it increases the cost suffered by the breaching party. On the other hand, q is a function of R such that increased sanctions improve compliance, yielding a joint gain. From equation (3) it is clear that we cannot predict, a priori, how an increase in R will affect the attractiveness of dispute resolution mechanisms. In order to make such a prediction we would have to know the size of $\delta q/\delta R$, the marginal impact of a change in R on q . If changes in R lead to sufficiently large changes in q , dispute resolution clauses become more attractive as R increases. It is also the case that the impact of a change in R depends in part ϕ , on the probability that country A is responsible for a breach. Specifically, changes in R have a larger impact when ϕ is larger. This is so because A only suffers a reputational loss when it is at fault.

That changes in R have an ambiguous impact on the use of dispute resolution is important for the design of dispute resolution procedures. It shows that one cannot simply claim that states resist dispute resolution procedures because the cost of losing is too high. Under certain circumstances, an increase in the cost of losing a dispute settlement proceeding will increase the use of dispute settlement clauses. On the other hand, the claim that strengthening the international enforcement system will increase the use of these mechanisms is also overstated. In some cases an increase in the reputational penalty for a violation of international law will reduce the use of dispute resolution clauses.³⁸

³⁷ ϕ might deviate from $1/2$ if, for example, the distribution from which N_i is drawn differs for countries A and B.

³⁸ The same can be said about an increase in other sanctions that do not take the form of transfers between the parties, as discussed in Part V.E.

Finally, the appeal of a dispute resolution clause is influenced by q , the marginal impact of such a clause on compliance. An increase in q means that a dispute resolution clause generates a larger increase in the probability of compliance. This makes a dispute resolution clause more attractive as it increases the likelihood of cooperation and a gain of P .³⁹

V. EXTENSIONS & IMPLICATIONS

A. Mistakes by the Tribunal

Up to this point it has been assumed that a tribunal is always able to identify the breaching party accurately. Therefore, when parties are deciding whether or not to adopt a dispute resolution clause, their decision turns on the probability that they will violate the agreement, but not on the court's ability to identify the breaching party. It is, of course, more realistic to assume that tribunals, like all courts, will sometimes make mistakes. This section explains how the potential for mistakes by a tribunal affects the behavior of states and the likelihood that a dispute resolution clause will be included in an international agreement.⁴⁰

It is assumed that a tribunal only handles a case if one of the parties has violated the agreement. Although it is possible for one party to pursue a dispute resolution claim that is frivolous, this assumption is not problematic as long as the pursuit of a frivolous claim is itself a violation of the agreement.⁴¹

³⁹ This can be seen most clearly in (3) by dividing both sides of the expression by q .

⁴⁰ For a discussion of the value of court accuracy in the domestic context, see Louis Kaplow, *The Value of Accuracy in Adjudication*, 23 *Journal of Legal Studies* 307 (1994).

⁴¹ In the interests of simplicity we exclude the possibility that both parties have violated the agreement.

Assume that when a case is before a tribunal there is a probability γ that the court assigns blame to the wrong party. When the tribunal makes a mistake of this sort, a blameless state is labeled as the breaching party. Because the court's accuracy is common knowledge, states that lose before a tribunal suffer a less severe reputational loss than they would if tribunals never made mistakes. Third parties, recognizing that a losing state may nevertheless be innocent, will only impose a fraction of the full reputational sanction. Specifically, we assume that the sanction imposed will be a fraction, $1-\gamma$, of the full sanction, R . Similarly, the party that wins before the dispute resolution body suffers a reputational loss of γR because third parties realize that in a fraction γ of cases it is the winning party that has actually breached its obligation.⁴²

The second effect of mistakes by the tribunal is to reduce the "compliance pull" of the dispute resolution process. For example, if the tribunal only identifies the culpable party correctly 75% of the time, there is a smaller incentive to comply than would be the case if the tribunal never made mistakes. Put differently, an increase in the frequency of mistakes reduces the magnitude of q , the marginal impact of dispute resolution on the likelihood of compliance. This obviously reduces the payoffs to the parties of adopting a dispute resolution provision.

To identify the impact of tribunal error on the decision to adopt dispute resolution clauses, we calculate the expected payoff to A at the time the agreement is reached:⁴³

$$\rho P + qP - (1-\rho-q)[\phi(1-\gamma)(N-(1-\gamma)R) + (1-\phi)(\gamma)((1-\gamma)(-R)-L) + \phi\gamma(N-\gamma R) + (1-\phi)(1-\gamma)(-\gamma R-L)]$$

⁴² See *infra* page 24 for a discussion of why parties might bring cases even when they stand to suffer a loss by doing so.

⁴³ The expression in square brackets accounts for A's payoff when A breaches the agreement and loses before the tribunal, when B breaches and A loses, when A breaches and B loses, and when B breaches and B loses.

This expression can be restated as follows:

$$\rho P + qP_A - (1-\rho-q)[\phi(N-R+2\gamma R-2\gamma^2 R) - (1-\phi)(2\gamma R-2\gamma^2 R+L)] \quad (4)$$

Comparing this expression to (2), one can see that to determine the effect of the tribunal's mistakes on the country's payoff, we must determine whether the expression in square brackets is greater or less than $\phi(N-R) - (1-\phi)L$. This turns out to depend on the magnitude of ϕ .⁴⁴

Consider first the case in which $\phi=1/2$, meaning that each party is equally likely to violate the agreement. Under this assumption, expression (4) is easily simplified and is identical to expression (2). Thus, if the parties are equally likely to violate the agreement, the fact that the tribunal makes mistakes does not affect the payoffs in the event of breach.⁴⁵ Although A is harmed by the fact that it may be blamed for a breach by B, that harm is exactly offset by the fact that when A breaches there is a chance that B will be found to be the guilty party. Although the payoffs are the same in the event of a breach, mistakes nevertheless reduce the attractiveness of dispute resolution relative to the case in which the tribunal never makes mistakes because they reduce the likelihood of compliance. The marginal impact of dispute resolution on compliance, q , is reduced

⁴⁴ If the tribunal is completely ineffective, meaning that $\gamma=1/2$, it must be the case that $q=0$ because the tribunal provides no compliance benefit. Substituting these values into (4) shows that expression (4) is then identical to expression (1), the payoff that exists in the absence of mandatory dispute resolution mechanism. Thus, if dispute resolution is ineffective, there is no reason to adopt a mandatory dispute resolution clause. This raises an alternative explanation for the use of such clauses. If dispute resolution tribunals are often unable to identify the breaching party, but able to do so in other cases, this could explain why states adopt such provisions only occasionally. Even under this view, however, the theory advanced in this paper would still apply. Where dispute resolution is effective, it is presumably only be adopted when it increases the payoff to the parties. In addition, it is not certain that the parties to an agreement are able to anticipate the effectiveness of the tribunal at the time they decide whether or not to include a dispute resolution clause.

⁴⁵ This result contrasts with the claim that parties resist dispute resolution clauses because they are risk averse. See Part II.B.

because a portion of the reputational loss associated with a breach is borne by the non-breaching party.

Now consider the case in which $\phi < 1/2$. Under this assumption, expression (4) is smaller than expression (2).⁴⁶ This means that A receives a lower expected payoff from a dispute resolution clause when the tribunal makes mistakes than when the tribunal is perfect. When the probability that A will be the state violating its obligation is less than one half, therefore, mistakes by the tribunal reduce the value of dispute resolution to A. This is so because, in expectation, mistakes by the tribunal impose costs on A when B violates its commitment and reduce the costs A faces when it breaches. If A is responsible for fewer than half the breaches, therefore, mistakes reduce its expected benefit from a dispute resolution clause. Since A must consent to the inclusion of a dispute resolution clause, mistakes by the tribunal make it less likely that such a clause will be part of the agreement.

The remaining case is the one in which $\phi > 1/2$. Under this assumption, dispute resolution will have greater value for A than is the case when the tribunal makes no mistakes.⁴⁷ The impact on the likelihood of a dispute resolution clause, however, remains

⁴⁶ Let $X = 2\gamma R - 2\gamma^2 R$. Because $\gamma < 1$, we know that $X > 0$.
The contents of the square bracket in expression (4) are:

$$\begin{aligned} & \phi(N-R+2\gamma R-2\gamma^2 R) - (1-\phi)(2\gamma R-2\gamma^2 R+L) \\ &= \phi(N-R+X) - (1-\phi)(X+L) \\ &= \phi(N-R) + X(2\phi-1) - (1-\phi)L \end{aligned}$$

Since $\phi < 1/2$, we know that $2\phi-1 < 0$.

Therefore, $\phi(N-R) + X(2\phi-1) - (1-\phi)L < \phi(N-R) - (1-\phi)L$, meaning that (4) < (2).

⁴⁷ This ignores the impact of the mistakes on the q , the increased likelihood of compliance, which at least partially offsets the increased payoff to A discussed in the text.

negative because country B will face a smaller payoff as a result of the mistakes, making B less likely to agree to a dispute resolution clause.⁴⁸

If $\phi \neq 1/2$, then, dispute resolution clauses are more likely if the tribunal can be expected to interpret the agreement and the facts consistently with the intent of the parties. Thus, for example, one might expect dispute settlement procedures to be present in highly specialized contexts where tribunals are made up of individuals with technical expertise in the relevant area because specialized tribunals are more likely to share the parties' understanding. In addition to this positive claim, the analysis supports proposals aimed at improving the accuracy of tribunal decisions, including increasing the specialization of tribunals. For example, it may be worth considering changes in the composition of the WTO appellate body to reflect the subject matter of the case.⁴⁹ An appeal relating to the TRIPs agreement would have a panel made up of individuals with expertise in intellectual property while one relating to an anti-dumping case would be staffed by individuals with a background in international trade.

There remains the question of why a state would ever use the dispute resolution provisions when there is a chance that the tribunal will make a mistake. By bringing the case the state exposes itself to a loss because third party states assign a portion of the reputational loss to each of the parties to the dispute. At least two reasons exist that could explain why a state would bring a case despite the fact that doing so might expose it to a

⁴⁸ Because the impact of mistakes is a matter of shifting the reputational loss between the parties, an assumption of zero transaction costs would eliminate the impact of mistakes on the appeal of dispute resolution. Any change in payoffs as a result of mistakes could be compensated for at the time the contract is signed. Even with such an assumption, however, there would remain a lower compliance incentive which would reduce the incentive to include a dispute resolution clause.

⁴⁹ Currently, WTO panels are chosen with an eye to the subject matter of the dispute, but the appellate panel for a case is made up of three people drawn from a fairly permanent roster of seven.

loss. First, a state might nevertheless choose to bring a case in order to develop a reputation as a state that files suit against treaty violators. A state that is known to pursue dispute settlement when its counter parties violate an agreement enjoys higher compliance from its treaty partners. Second, in addition to the reputational impact of dispute resolution, the offended party may receive permission to impose economic sanctions, as is sometimes done in the WTO. Although these sanctions typically reduce the overall welfare of the sanctioning country, certain groups within the country will benefit. If these groups are politically powerful relative to those that stand to lose due to the sanctions, they may be able to persuade the government to pursue the case. Thus, for example, if the economic sanction takes the form of reduced imports from the violating state, import competing sectors within the offended country may lobby to have the case pursued through the dispute resolution process. If it is dispersed consumers that stand to suffer a loss due to the sanctions, they will be less able to organize and influence the decision to pursue the case.⁵⁰

Notice that although this section considers mistakes by a tribunal, it applies equally well to tribunal decisions that go beyond the intent of the parties. Thus a tribunal that interprets an agreement in such a way as to include requirements that the states did not intend makes a “mistake.” This may explain why states are often unwilling to include dispute resolution clauses in agreements that are open ended and whose scope is uncertain. Even if the parties have agreed on the obligations imposed by the agreement, a

⁵⁰ Schwartz and Sykes advance a similar argument regarding the use of unilateral sanctions within the trading system. Schwartz & Sykes (2002), at 23.

tribunal may have a different understanding of the agreement.⁵¹ For example, the International Court of Justice (ICJ) allows a state to confer jurisdiction upon the court for all disputes concerning international law between itself and any other state that has similarly consented to the court's jurisdiction.⁵² In practice, this "Optional Clause" has seen only limited use by states, despite the fact that it only binds them when both parties to the dispute have consented to jurisdiction. One possible explanation is the open-ended nature of the agreement.⁵³

B. The Multilateral Case

Until now the paper has focused on agreements between two countries, A and B. The implicit assumption has been that there are many other countries in the world, and that these countries interact with countries A and B. This assumption is necessary for the reputational loss suffered by a party as a result of their violation of international law to be a net loss for the parties to the transaction. Although it is true that a reputational loss is a loss for the affected party, it represents useful information for other states. When it is learned that a state has violated an international obligation, other states benefit from the knowledge. They may, for example, conclude that they should not enter into an agreement that previously appeared worthwhile.

It is reasonable to ignore the value of this reputational information for many bilateral agreements because it provides a benefit to every country, so the breached

⁵¹ Of course vagueness in the agreement may also represent a failure of the parties to agree on a more precise set of obligations, in which case they may avoid dispute resolution provisions because the probability of breach is higher.

⁵² See Article 36(2) of the Statute of the International Court of Justice.

⁵³ Another possible explanation is that states gain very little from a blanket acceptance of the ICJ's jurisdiction. They are better off adopting dispute resolution clauses only in those agreements where doing so makes them better off.

against party gets only a tiny fraction of the total benefit. When one considers a multilateral agreement that includes a large share of relevant states, however, the value of this reputational information must be taken into account. For example, an agreement entered into by every state would be more likely to include a dispute resolution clause because the reputational loss felt by a breaching party would be offset by an informational gain enjoyed by all other parties.

Modeling the multilateral case is complicated by the fact that it is hard to know the relationship between the reputational loss felt by a breaching party and the informational gain enjoyed by other states. It seems reasonable to assume that the latter, when aggregated over all states, is at least as large as the former because the ultimate effect of dispute resolution is to provide information to all states. Given that the global community is receiving better information as a result of the dispute resolution clause, it follows that it is in a better position to evaluate opportunities. With better information, states are better able to anticipate the behavior of their potential treaty partners and, therefore, their efforts to distinguish welfare increasing agreements from welfare reducing ones will be more successful. It is true that the reputational loss felt by a state may prevent a future agreement from being reached, but if this is so it is because one of the parties to that would-be agreement has decided that the agreement is not worthwhile.

Despite the general assumption that information gains are at least as large as reputational losses, it is hard to make general statements about overall welfare as long as one retains the assumption that transaction costs are substantial. Although it is likely that the provision of more information will increase overall welfare, it is easy to imagine cases in which the information gleaned from a dispute resolution decision prevents an

agreement from going forward despite the fact that the agreement is welfare increasing from a global perspective. The problem is that agreements require the consent of every participating state, and it may be that a tribunal's decision causes one state to conclude (accurately) that the agreement will generate losses for itself despite the fact that the agreement has a positive impact on worldwide welfare. To put it another way, the unanimity required for international agreement leads to too few agreements if transaction costs are significant. Only agreements that represent a pareto improvement are completed, despite the fact that many additional agreements may offer increases in worldwide welfare. In this environment, the use of a dispute resolution clause that leads to a reduction in a state's reputation may prevent individual states from entering into some agreements that would reduce their welfare, but no general statement can be made about the impact those deals would have on global welfare.

The ambiguous effect of dispute resolution may, however, be an artifact of the particular fashion in which reputation is modeled here. The model assumes that reputation can only be influenced in a negative fashion. As a modeling matter, this is not problematic as it simply represents a normalization of the reputational impact of compliance at zero. As a description of reality, however, it is probably more accurate to think of reputation as being a variable that increases over time as a state complies with its obligations. Under this assumption, dispute resolution would not only reduce reputations when a state is declared to have violated its obligation, it would also increase the reputation of states that prevail in litigation or that never find themselves before a tribunal at all. If reputation can increase as well as decrease, reputational concerns may give states an incentive to enter into agreements with dispute resolution clauses.

Up to this point the discussion has distinguished between bilateral agreements and universal multilateral ones. Obviously there are agreements that lie between these two poles and that produce incentives regarding dispute resolution that lie between those of the extreme cases. The key question in such cases is the extent to which the parties to an agreement capture the informational impact of a tribunal's decision. When all states are part of an agreement, it is clear that the informational gains are fully internalized by the parties to the agreement. On the other hand, in a bilateral agreement between parties with infrequent interactions with one another, the informational benefits of a dispute resolution procedure are captured almost exclusively by third party states.

Although identifying agreements as bilateral and multilateral provides a useful proxy for the inclusion of the informational externalities generated by dispute resolution, it is more accurate to consider the degree of interaction among the parties to an agreement and between those states and third parties. Thus, for example, a bilateral agreement might generate relatively few informational externalities if the two countries interact more often and more closely with one another than either does with other states. On the other hand, a regional agreement with many states may fail to capture such externalities if all of the states have frequent and important relationships with countries that are not party to that agreement.

What can ultimately be said about dispute resolution, therefore, is that agreements between states with a high degree of mutual dependence are more likely to have dispute resolution clauses. This is so because most of the informational benefit from a breach is captured by the breached against party or other parties to the agreement. Put differently, the parties to the agreement behave in a fashion similar to a closed system because they

have relatively minor interactions with non-party states. This may explain the use of dispute resolution clauses in some regional organizations such as NAFTA – regional interactions between the NAFTA countries represents a large percentage of the important relationships of the member states.⁵⁴

C. High Stakes Issues

International law scholars are in agreement that high stakes cases are poor candidates for dispute resolution. The conventional reason is that “nations will not adjudicate matters which, they feel, they could not afford to lose or where, if they lost, they could not afford to obey the judgment.”⁵⁵ The problem with this explanation is that the costs of losing before a tribunal are limited. With high stakes issues, one would expect the losing party to simply ignore the judgment rather than compromise on an issue that is perceived to be of great national importance.⁵⁶ The loss, then, would be limited to whatever direct sanctions are applied plus the loss of reputation. Even accepting that these sanctions may be significant, they seem inadequate to explain state aversion to dispute resolution in high stakes agreements.

The theory advanced in this Article suggests a different explanation. Notice first that the compliance decision of states is unlikely to be influenced by reputational considerations when the stakes are high. This is so because the costs and benefits involved are sufficiently large in magnitude that the reputational loss as a result of a

⁵⁴ This is obviously less true of the United States than it is for Canada or Mexico. Nevertheless, Canada and Mexico combined represent a very large share of U.S. interactions with foreign states. For example, the two countries combined account for approximately one-third of U.S. trade.

⁵⁵ Henkin at 187. Morris at *8 (“[T]he more important and sensitive the subject of a dispute is to a State, the less willing the State is to submit the dispute for third-party adjudication.”).

⁵⁶ See Guzman (2001).

breach is unlikely to alter a state's compliance decision. In the context of a high stakes agreement, therefore, increasing the reputational cost of a violation through the use of a dispute resolution clause will generate only a small increase in the ex ante probability of compliance. In the language of the model, q is small for high stakes issues. As shown in expression (3) and the accompanying discussion, a small q reduces the appeal of a dispute resolution clause. Thus, the explanation provided by this model is that dispute resolution clauses are rare in high stakes agreements because the inclusion of such a clause increases the loss to the parties in the event of a breach without significantly increasing the probability of compliance.

Notice that in a discussion of high stakes obligations one must look carefully at the precise obligation in question and not only the subject matter. The mere fact that an agreement deals with, say, nuclear weapons, does not imply that it is necessarily a high stakes agreement. For example, a promise to allow inspections of nuclear facilities may not be considered a high stakes issue because the relevant obligation is to permit inspections rather than to engage in any particular conduct with respect to the nuclear weapons themselves.

D. The Role of Damages and Injunctions

The model presented in this paper assumes that sanctions in international law take the form of reputational sanctions. As long as these sanctions represent a net loss to the parties, there exists at least some incentive to avoid the use of dispute resolution provisions. If one could eliminate the loss to the parties as a result of the dispute resolution process and replace it with a transfer between the parties, dispute resolution clauses would be much more desirable.

Where possible, therefore, one would like to encourage damages that take the form of transfers between the parties. The obvious candidate for damages is money, although the rarity with which states transfer money either as compensation for past acts or in order to obtain future benefits suggests that there are significant hurdles to the use of money as a form of damages.⁵⁷ One exception to the general resistance to money damages appears to be those contexts in which a state interacts with private parties. In this situation, the use of money damages is sometimes acceptable to states. For example, bilateral investment treaties provide that a state that has expropriated the assets of a foreign firm must pay compensation.⁵⁸ In at least these circumstances, therefore, money damages should be encouraged in order to increase the use of dispute resolution. Even some disputes between states might be amenable to money damages, though it is difficult to find examples of this practice. If the use of money damages as the exclusive remedy is problematic, using such damages as a supplement to other sanctions, including injunctions and reputational sanctions would nevertheless be a step in the right direction. One can imagine, for instance, that violations of economic obligations, which typically cause financial damage to the injured party, could be at least partially remedied through the use of money damages. WTO panels, for example, could call for the payment of money damages in cases involving economic injury.⁵⁹

Another form of remedy that represents a transfer rather than a loss is the use of injunctions. This is a form of damages that is commonly used in international dispute

⁵⁷ See Bhagwati (2001).

⁵⁸ Guzman (1997); Vandeveld.

⁵⁹ This suggestion is not intended to minimize the significant problems that would accompany a decision to use money damages. One such problem is the measurement of the damages. A second is the fact that the international community does not generally have access to the use of coercive force to compel

resolution, including in the WTO. Where the violation is likely to be ongoing the use of an injunction may increase the attraction of a dispute resolution mechanism, and one would expect dispute resolution clauses to be more common in such cases.

E. Public Choice and Sanctions

The previous section explains that financial payments would be a desirable form of damages because they represent transfers between the parties and, therefore, do not provide a disincentive for the use of dispute resolution clauses. If money damages are unavailable, however, alternatives should be considered. One potential strategy, used by the WTO, permits the use of sanctions by the offended party to penalize the breaching party. Sanctions increase the cost of violating an agreement but like a reputational loss, they almost always represent a net loss for the parties. The most typical form of sanction, for instance, is the imposition of trade restrictions – which leads to a welfare loss for all affected states, including the sanctioning party.

Despite the fact that the state imposing sanctions suffers a welfare loss, it may nonetheless choose to proceed with such measures. There are two reasons for this. First, a state may want a reputation for penalizing those that violate their agreements, and a failure to impose sanctions may harm that reputation. Second, there may be political reasons to impose sanctions. If, for example, the use of sanctions allows the government to satisfy the demands of a powerful local interest group, they may be used even if they are welfare reducing for the state.

compliance with judgments. Thus, even if money damages were adopted, it may be impossible to compel the payment of the judgment in every case.

If there are political reasons for a government to use sanctions when it has the opportunity to do so legally, the impact of sanctions on the use of dispute resolution changes. If sanctions, despite their negative impact on domestic welfare, generate positive returns to decision makers, then they affect the use of dispute resolution clauses much like transfers. That is, if sanctions represent a gain to the decision makers of one state and a loss to those of another, they do not reduce the appeal of a dispute resolution clause in the same way as a reputational loss.⁶⁰ Thus, a dispute resolution process that permits the implementation of sanctions may lead to more frequent adoption of dispute resolution clauses than is the case when the only sanction is a reputational loss.

Even if dispute resolution clauses are adopted more often, however, the fact that they are adopted for political reasons means that their impact on welfare is uncertain. Using sanctions as a penalty may be desirable if the impact on compliance is sufficient to increase the expected payoff to the states despite the pure loss imposed in the event of a breach. On the other hand, if the impact on compliance is small, giving states the ability to use sanctions reduces the expected benefit of a dispute resolution clause.

F. Renegotiation

This paper presents a model in which states sometimes choose not to include a dispute resolution clause in their agreements because when such clauses are triggered a loss is imposed on the one of the parties that does not represent a gain to the other party. In a world without transaction costs, however, a dispute resolution system that is costly would not lead to fewer dispute resolution clauses. Rather it would lead to fewer

⁶⁰ We assume here that the gains to the leaders of one state are equal in magnitude to the losses felt by the leaders of the other state. This need not be true, in which case we must assess whether there is a net

appearances before tribunals. When faced with a dispute, the states involved would seek a negotiated solution in order to avoid the joint loss. In this context, the dispute settlement clause serves to alter the terms of the negotiated settlement because it changes the parties' threat points. In the absence of transaction costs, however, the parties would never actually proceed to litigation before the tribunal, so the loss would never be suffered. There would be, therefore, no reason for the parties to avoid dispute settlement clauses.

In the international arena, however, it is clear that transaction costs are substantial. One can imagine several reasons why states might find it difficult to make the sort of transfers that are necessary to avoid the use of dispute resolution. First, states are reluctant to engage in inter-state cash transfers to resolve differences. This may be because the amounts needed to compensate an injured party are too large and states face fiscal constraints, or because it is costly, as a political matter, for policy makers to be seen as either buying the goodwill of a neighbor or selling the interests of their country. There may also be additional political constraints on efforts to settle disputes through negotiation. The voters of a state may perceive the settlement of a dispute as capitulation by their government, and this may be more costly to policy makers, in political terms, than a loss before a tribunal. When faced with a tribunal ruling, political leaders can change national policy and claim that they have no choice. They are able, in other words, to shift the blame for the policy change from themselves to the tribunal. In addition, if the subject of the dispute affects powerful lobby interest within one or both states,

gain or loss.

compromise may be difficult because a negotiated solution that harms any one of those interests may be politically unacceptable.

Finally, pursuing the case may have some value to the plaintiff because it may help its reputation as one that pursues dispute resolution when wronged. This need not violate the assumption that dispute resolution represents a joint loss because the breached against state may be seen as weak and suffer a loss if it is learned that the agreement was violated and the state did not pursue it. That is, building a reputation for forcing breaching parties into the dispute resolution process may help a state to avoid a reputational loss of its own.

The lesson from a consideration of renegotiation is that a reduction in transaction costs at the dispute stage is desirable. If these transaction costs can be brought down, states are less likely to find themselves before a tribunal – even when a violation occurs – because negotiated solutions are more likely. This will increase the appeal of a dispute resolution clause in the original agreement and the likelihood of compliance. One example of current efforts to reduce transactions costs is the mandatory consultation period provided for within the WTO dispute settlement procedure.⁶¹

VI. CONCLUSION

International legal scholarship and indeed, international law, is built on the premise that the international legal obligations of states alter the incentives of those states. One of the important research challenges facing the field is the development of an understanding of how commitments and behavior are related. This paper represents an

attempt to further such understanding with respect to the use of dispute resolution procedures. International law scholars are familiar with the reluctance of states to include mandatory dispute settlement clauses in their agreements but have not, until now, developed a theory to explain this behavior. There is, on the other hand, a well developed contract law literature that can be applied to the behavior of states. Though such an approach promises many benefits, the lack of a coercive enforcement structure in the international arena makes the analogy to contract imperfect, and forces us to use the lessons of contract law with caution.

The use of dispute resolution clauses is one of the areas in which analogy to contract is difficult. This paper has developed a theory of state behavior with respect to dispute resolution clauses that takes into account the unique features of the international arena. State reluctance to adopt mandatory dispute settlement clauses is explained by the fact that these clauses, when triggered, impose a joint loss upon the parties. States, therefore, will only accept such a clause if the benefits, in the form of increased compliance, outweigh the costs that must be borne in the event of breach.

The theory yields both positive and normative results. One such result is the counter-intuitive conclusion that dispute resolution clauses are most likely when rates of compliance are expected to be high even without such clauses. This is so because the expected cost of a dispute resolution clause is reduced as the probability of compliance increases. A related result is that parties are less likely to adopt dispute resolution clauses when the marginal impact of those clauses on compliance is small. This implies that high

⁶¹ The complaining party cannot demand a panel until 60 days after a request for consultation. WTO DSU art. 4(7). Whether the mere requirement of consultation reduces transaction costs is open to question, but the waiting period is intended to encourage settlement.

stakes commitments – where the reputational loss caused by a violation of international law is unlikely to change compliance decisions – are less likely to include dispute settlement provisions than are commitments involving smaller stakes.

The theory also suggests that bilateral agreements are less likely to include dispute resolution provisions than are multilateral ones. More precisely, dispute resolution is more likely as the level of integration among the parties increases relative to the integration between the parties and other states. The level of integration matters because the more the informational externality generated by a dispute resolution procedure is captured by the parties to an agreement, the more likely they are to include a dispute resolution provision. This offers a possible explanation of why some multilateral and regional agreements such as the WTO, the EU, and NAFTA have dispute settlement procedures.

The paper also shows that dispute resolution clauses are most attractive if the parties are equally likely to violate their commitments. If one party has a higher probability of breaching its commitment, that party is less likely to accept a dispute resolution clause.

One of the normative lessons of the paper is that dispute resolution procedures should be structured to increase the likelihood that a tribunal will share the parties' understanding of an agreement. This is true even if the parties are risk neutral because mistakes by the tribunal make dispute resolution less appealing to at least one of the states. This provides one possible explanation for why states have rarely been willing to grant jurisdiction to international adjudicatory bodies whose role goes beyond the narrow interpretation of a treaty.

In addition, dispute resolution is more likely to be used if the sanction represents a transfer between the parties to a dispute. Recognizing the difficulty of establishing a regime with this form of damages, it is nonetheless worthwhile to try to increase the use of money damages or other transfers whenever possible.

The weakness of the international enforcement regime is a constant issue for international law scholars. This is so whether they are thinking about how to increase compliance with international commitments or defending their entire discipline from skeptics. One of the tools that promises to increase compliance is mandatory dispute resolution. If states can commit, *ex ante*, to the resolution of their disputes before an impartial tribunal, they increase the sanction associated with a violation – even if that sanction is only reputational – and they therefore increase compliance. One of the shortcomings of mandatory dispute resolution has proven to be the reluctance of states to include it in their agreements. The standard response of international lawyers that states resist such clauses in order to keep their options open is inconsistent with what we know about contracting, credibility and commitment. This paper offers an alternative explanation. Coupled with a recognition of the fact that transaction costs are substantial in the context of an inter-state dispute, it is possible to explain the behavior of states by focusing on the fact that mandatory dispute resolution imposes a net loss on the parties to an agreement.

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APPENDIX A: VARIABLE LIST

- P Payoff to each party if both parties comply with the agreement.
- N_i Payoff to Country i if it breaches while Country j , $j \neq i$, complies.
- L Loss suffered by a party if it complies while the other state breaches.
- R Reputational loss following the breach of an international agreement.
- ρ Probability of compliance in the absence of a dispute resolution procedure.
- q Marginal impact of dispute resolution procedures on probability of compliance.
- ϕ Probability that country A is at fault in the event of a breach.
- γ Probability that the court assigns blame to the wrong party.