Restriction and Rhetoric: A Critique of the Constitutional Prohibition Against Foreign Ownership in Philippine Mass Media

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“Critical Regulation”

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CALL FOR PAPERS

The field of applied economy lies at the nexus of theory and implementation, the practical and the philosophical. We must attempt to link the ivory tower of academia with the glass towers of the City and Wall Street. By understanding the theoretical foundations of global markets and economic decision making, applied economy can inform us about the role of market structures within larger analytical frameworks.

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Editorial: Critical Regulation

The way the economy is regulated and thus structured is an evidently imperative subject in an Age of such conflicting ideas and somewhat high levels of instability. Our third issue of, *The Journal of Applied Economy* will largely revolve around the concept of regulation in all its forms with a vast collection of ideas and nuances from a variety of constituents.

It has become globally evident that a lack of regulation has been largely responsible for the current macro-financial condition. In contrast, low levels of corporate transparency which was such an important topic in our previous issue; remains a fundamental area of inspection. Moreover, the analysis and exploration of risk minimization and the identification of such possible risk is an area that many of our current papers discuss, emphasizing its importance.

Subsequently, the wellbeing of consumer and producer interests remains a paramount issue. Pursing strategies to further align the goals of both parties in a social and financial sense continues to be an issue of the day. As such, I am happy that the majority of these articles center on this common theme.

Firstly, Thomas J. Pate of White & Case LLP critically analyses the credit rating agencies business model and its possible contribution to the current ongoing credit crises. Pate’s paper is a revelation, providing thorough insight into the transparency of credit rating agencies, a factor of disaster that has been largely overlooked by the general public. Concluding the article with proposals for regulatory reform; Pate makes a clear point that the lack of transparency credit rating agencies have instigated in the past continues to be a grave issue.

Through a lucid and succinct approach, Karl T. Muth of The University of Chicago Booth School of Business presents law and economics thought experiments grounded in contract law. Through his hypothetical scenarios he describes in eloquence the interests and possible behaviour of actors in the insurance markets. In his conception of simple counterparty relationship he offers substantial utility in understanding why breaches occur and where insurance products offer dubious incentives. Thus, his work offers a bright insight into the possible reforms that may be undertaken to reduce risk in the insurance industry.

Providing a general overview of public-private contracts in the water sector, Professor Guerra-Pujol of Barry University Dwayne O. Andreas School of Law elucidates the intricacies of this market in Jiangsu, China and Havana, Cuba. Following his presentation of a partnership-game model, he suggests it’s possible application in the instances of public-private contracts in the water sector. Globally, the occurrence of public-private water contracts is an
increasing phenomenon and I strongly believe this paper will serve as a voice of reason in an area of industry that can be often so poorly conducted.

Highlighting a clear path for regulation in an industry that controls more than two trillion USD, Mr Jean-Randolphe W. Fietcher of the New York University School of Law employs outstanding scholarship in his exploration of Sovereign Wealth Funds (SWFs) in France and abroad. As the financial crisis has caused a shift in global investments, it is evident that a clear framework of regulation will enable SWFs to accede to capital markets freely whilst protecting the interests of the citizens of donor countries. Fietcher continues his eloquence in his analysis of the French Strategic Investment Fund and the justifiability of its current mechanism whilst commending France on its position as a recipient and donor country as a result of the creation of its SWF.

Addressing a critical conundrum in many developing and emerging countries, Ms Diane A. Desierto of the Yale Law School precisely outlines the need for a greater enforcement of socio-economic rights. Trapped in the prison of poverty, the right to freedom is worthless without the means to execute its aspirations. Through a thorough exploration of the practices and legal boundaries of socio-economic rights in the Philippines and South Africa, Desierto makes a clear case for a greater need for their implementation and enforceability. Her article will surely serve as a bright light in the darkness of poverty and injustice.

In his comprehensive paper detailing one of the fastest growing financial systems on the globe, Alex Arakcheev of the University of Westminster School of Law, critiques the world of Islamic Finance whilst suggesting a need for transparent regulation and a clear legal framework. Islamic Finance extends worldwide and exploits highly sophisticated financial products and procedures based upon Shariah Law. As such, a regulatory framework for such transactions will help to reduce risks and align the needs of the borrowers and the sellers. I commend Mr Arakcheev for his dazzling work in such an exciting frontier.

Finally, I am pleased to acknowledge our continued partnership with the Elias Clark Group, our publishers, and, importantly, Cengage Learning. Cengage is one of the largest producers of specialized educational material in the world, as a result of this relationship The Journal of Applied Economy is now available in the Lexis catalogue. We appreciate all the support from readers and the continued excellence of our editorial staff.
We must not fear the critical regulation of the future; as Adam Smith commented, “virtue is more to be feared than vice, because its excesses are not subject to the regulation of conscience.”

H. Trent Moore
Melbourne, Australia
13 March 2010
TRIPLE A RATING STENCH: MAY THE CREDIT RATING AGENCIES BE HELD ACCOUNTABLE?

Thomas J. Pate
Professor of Law
Southern Methodist University

Many social policies require substantial sacrifices by existing persons in order to benefit the members of distant future generations. Particularly salient examples of this are the elaborate and expensive efforts now undertaken to prevent high-level radioactive wastes from polluting the biosphere, or the stringent restrictions that may be soon be imposed on burning fossil fuels in order to mitigate the long-term climate change consequences of global warming. However, this trade-off does not only exist in the environmental policy area. Many other social policies also call for substantial sacrifices to be made at least partly if not largely on behalf of distant future generations.

The existence of this trade-off presents a fundamental and difficult ethical question that is far too often overlooked by policy makers. Do we have any ethical obligations at all to the yet-unborn members of future generations? Are we under a moral obligation to consider their interests, as best we can anticipate what those interests will be, as well as our own concerns in making these policy decisions? Or are we morally free to choose among policies solely with regard to their consequences for existing persons, with no obligations to concern ourselves with their impacts on future generations? In this brief essay I will try to demonstrate that this is a far more difficult question to answer than is commonly realized.

If we do in fact have ethical obligations to take into account the impacts of our policies upon future generations, then this raises the derivative question of how then should we balance the interests of the members of those future generations with the rights and interests of existing persons? I will try to show that this is also a much tougher question to answer than is generally understood.

There is a fairly broad consensus among current policy makers that we do have ethical obligations to future generations to take their interests into account in choosing our actions. One rarely if ever hears arguments to the contrary. There is, of course, considerable controversy regarding the precise nature and scope of these obligations. But there does appear to be general agreement that we do have some such moral obligations that we need to respect. In addition,
at least in America if not elsewhere, there is also a broad consensus that the primary analytical framework that should be used for measuring and balancing the legitimate interests of future generations against the interests of existing persons is a cost-benefit analysis framework. In this framework the impacts of a policy on each affected generation are measured by the yardstick of the willingness-to-pay off its members to enjoy or to avoid the policy’s consequences, and then those future impacts of the policy are appropriately discounted to a smaller present value, prior to their aggregation with its current impacts, in making an overall assessment of the merits of the policy.¹

I have written several related articles over the past few years in which I have tried to broaden the conversations now taking place regarding these difficult ethical and policy assessment questions in the environmental policy context by arguing in some detail that they cannot be adequately addressed without also taking into account in some fashion what I have called “the problem of person-altering consequences.”² This important problem is unfortunately largely if not completely overlooked in current discussions. In this short essay I hope to generalize this analysis and communicate to a broader readership the nature of this problem, and make clear that the problem also comes up with regard to many other social policy decisions outside of the environmental context that also pose trade-offs between the impacts on existing persons and those affecting future generations.³

The central idea that I would like to communicate here is the simple yet momentous point that all social policies will inevitably have geometrically proliferating and eventually universal and eternal person-altering consequences. That fact has major implications for conceptualizing the nature of our ethical obligations to future generations, if there in fact are any such obligations, and for balancing the interests of future generations against those of existing persons when formulating policies.

Let me begin by briefly explaining exactly what I mean by the phrase “person-altering consequences,” and then I will try to make clear the dramatic and rather troubling implications such consequences present for determining our ethical obligations to future generations, and for the assessment of policies. This phrase is one that I myself have coined, but the underlying concept is not original to me but derives from work done in the late-1970’s and early-1980’s by the noted British philosopher Derek Parfit and some of his academic contemporaries.⁴ Parfit originally, and in my opinion somewhat inaptly, labeled his insight the “Non-Identity Problem,”⁵ and it has been later discussed by other philosophers under that moniker, but I have chosen to use what I think is the more descriptively accurate phrase “person-altering consequences” that better communicates its core meaning.

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Parfit’s insight is one of those simple yet profound insights that sometimes win people Nobel Prizes 30 or 40 years later after their significance becomes widely appreciated. It is an idea that is pretty obvious once it is explained to you. It then seems like something that you have already known all along, even if you have never fully articulated it to yourself or to anyone else, yet it is an insight with dramatic implications for many fields of law.

Parfit’s insight starts with the recognition of the indisputable fact that the particular sperm-egg fusion that results from a successful act of human reproduction is an event that is radically contingent. The outcome is highly sensitive to minor changes in any of a large number of factors. Which particular one of the hundreds of millions of sperm that are released in an ejaculation will unite with the female egg, if any, is a very uncertain event. Even the slightest change in the timing or any other aspect of a reproductively successful act of intercourse will almost surely lead to a different sperm-egg fusion, and therefore ultimately to the birth of a genetically different individual than would have otherwise been born. The person now conceived and born will be a different individual in the most fundamental genetic sense.

The consequences of this simple fact are momentous. Any social policy measure that is significant enough in its direct or indirect impact on human behaviour to lead to even a single different sperm-egg fusion taking place will create a genetically different individual than the person that would have been born absent the implementation of the policy. Even the most minor and locally-focused policy will surely have that much impact on someone’s behaviour. And over time, as that now genetically different individual is born and matures and over their life influences numerous other people in major or minor ways, this will result in an exponentially spreading cascade of individuals being conceived and born that are now genetically different from those persons that would otherwise have been conceived and born absent the policy’s initial impact. This cascade of genetic alterations will lead eventually (and probably sooner rather than later) to the creation of an entirely different population of human beings for all the rest of eternity than those persons that would have been conceived and born absent that initial and perhaps very minor policy impact.

In other words, even a quite small initial policy impact will ultimately lead, after a period of time probably on the order of no more than a few decades at the most, to the entire human population that would have been born and lived their lives throughout the rest of eternity from that point on now never even coming into existence. They will instead be replaced by a population consisting of genetically different individuals. Yet another way to put this is
that any social policy will have rapidly spreading and eventually universal person-altering consequences in that it will alter the fundamental genetic identities of all future persons. Moreover, those person-altering consequences can be seen to be necessary conditions of the existence of all future persons who come into existence, since those persons would never have been conceived and born absent the policy’s implementation. Those consequences make life possible for the members of future generations who are conceived and born, and will thus be far more significant to those persons than are all of the other impacts of the policy combined.

Most attempts to assess the ethical implications of policies that have long-term effects as well as immediate impacts, or to value in dollar terms the overall effects of such policies, have simply ignored these person-altering consequences. As a result, the conclusions that these efforts have reached are unfortunately irrelevant for assessing the relative merits of the actual choices that those policies present.

As an example, consider for a moment the seemingly rather radical approach of taking all of our existing high-level radioactive wastes, on which we now devote literally billions of dollars/year of resources to try to isolate from the biological environment, and simply putting those wastes into ordinary, inexpensive steel barrels with perhaps 150- to 200-year containment capabilities in a salt-water environment, and then dumping them by barge somewhere into the middle of the Pacific Ocean and just forgetting about them. The likely response by current world leaders to such a proposal would be that this would be an outrageous violation of our ethical obligations to consider the welfare of distant future generations. Moreover, a typical cost-benefit analysis of this waste-dumping policy would doubtless conclude that it would result in such massive burdens for all distant future generations, commencing perhaps 200 years or so from now and continuing on for eons untold, that even when the benefits to existing persons of freeing those billions of dollars/year of resources for other uses are considered the policy’s impacts would still be on balance massively negative. Such an ocean waste-dumping proposal would be a complete non-starter politically, I am sure.

The conventional framework of analysis that underlies this disparaging conclusion, however, implicitly involves an assessment of how future persons would likely feel about living in a world with a potentially very serious ocean radioactive waste problem, as compared to those same persons experiencing their lives without that radioactive waste problem. But this comparison is revealed to be totally inapt, and thus irrelevant to the real choices at hand, once one is aware of person-altering consequences. The proper comparison of
alternatives that should be made for ethical and policy valuation purposes is quite different.

Let me explain. If we were to continue to spend billions of dollars/year on high-level radioactive waste storage, as we do now, there will then be one particular population of future persons conceived and born over time in future years. If, however, we cheaply dump those radioactive wastes into the Pacific Ocean in simple steel barrels, and free those billions of dollars/year of resources for other uses, those new uses of those considerable resources will immediately trigger an exponentially spreading cascade of person-altering consequences. Well before the time perhaps a couple of centuries from now or so when those radioactive toxins begin to leak into the biosphere, the entire human population alive then and later coming into being for the rest of eternity will owe their very existence to that waste-dumping policy; it will have been a necessary condition of their conception and birth. They would simply never have been conceived and born had the ocean radioactive waste-dumping not taken place. In that event an entirely different group of persons would have come into being.

The proper hypothetical question to imagine posing to those future persons who live in the post-ocean waste dumping world, for either ethical assessment or policy valuation purposes, is therefore: “Do you prefer the world that you now live in, facing as you do a perhaps quite serious ocean pollution problem resulting from our prior radioactive waste-dumping policy, to a world which is without such a radioactive waste problem, but which is also a world in which neither you nor any of the people you have ever known have ever come into existence?”

In other words, the proper hypothetical question to ask is “Do you prefer living your life with the radioactive waste problem, or would you prefer non-existence?” That Hobson’s Choice is in fact the true choice of alternatives that would be presented to them! My surmise, from what I know of people (and supported by the statistically rather low suicide rates) is that virtually everyone asked this question would strongly prefer their existence, even with the particular and perhaps serious set of problems that their life posed for them, to non-existence. If this is the case, then we have not actually harmed any person by dumping those radioactive wastes into the Pacific Ocean.

If we do dump those wastes into the ocean, then those future persons, who are conceived and born with the radioactive waste problem to deal with, if they thought about it, would be grateful for what we have done, in a sense, because they would not otherwise exist. On the other hand, one can at least imagine the untold zillions of what one might loosely call “unrealised potential
persons,” that is, persons who might have been conceived and born under other circumstances, but who as a result of our choices will now never actually be conceived. But those wholly imaginary and non-existent unrealised potential persons of course have no standing to complain about the particular choices that we have made. My conclusion, admittedly troubling but seemingly impossible to avoid, is that since we probably will not harm any actual future person by our ocean radioactive waste-dumping actions, since they would likely all strongly approve of our actions so that they could come into existence, then under the conventional secular, consequentialist ethical premises that underlie most modern thinking we would simply not have violated any ethical obligations to anyone by dumping those radioactive wastes in the Pacific Ocean.

More broadly, and rather disturbingly, the pervasiveness of person-altering consequences means that any social policy that we undertake, no matter how radically present-oriented it is, and no matter how indifferent we are to its long-term consequences for future persons, is ethically self-validating under conventional ethical criteria in that one of its consequences will the person-altering consequence of bringing into being a future population that would not want us to have acted in any other way. So why not just dump those radioactive wastes into the Pacific Ocean and free lots of resources for the enjoyment of existing persons?

Where does this line of thinking lead, as a practical matter? Well, if one now recognizes the nature of the problem posed for conventional ethical assessment by person-altering consequences, but still feels at an intuitive level, as I do, that there must somehow be something morally wrong with pursuing such radically present-oriented policies as my ocean radioactive waste-dumping hypothetical, then I would like to suggest that what one is actually doing, probably implicitly rather than explicitly, is applying a non-consequentialist ethical criterion to condemn such policies. That is, one is likely applying an ethical criterion that is not grounded upon an assessment of the policy’s consequences for the specific individual persons who will later come into being, but one that assesses the ethical merits of a policy on some basis other than those consequences. In addition, one is also, again probably implicitly rather than explicitly, applying some valuations algorithm in order to translate this non-consequentialist policy assessment into a rather large number in dollar terms before aggregating it with the conventional, financial measure of the policies’ consequences for existing persons, in order to reach such an overall negative assessment of the merits of the policy.

It is indeed a major step for one to leave the safe moorings of conventional secular, consequential ethical premises for the murky and uncharted waters of
non-consequentialist ethical standards and policy valuation criteria. One is certainly free to reject the use of conventional ethical standards and proceed in this other fashion, if one chooses. But I would recommend that before one does so one first reflects carefully upon what alternative, non-consequentialist ethical premises they are explicitly or implicitly applying in making these assessments, and whether they really do accept those ethical premises as valid. In addition, I would recommend that one also try to be clear about the justifications for the particular valuation algorithm one is using to quantify the non-consequentialist assessment of a policy in dollar terms before aggregating that assessment with the policy’s consequences for existing persons to reach overall conclusions.

The problem of person-altering consequences not only dramatically undercuts conventional, secular ethical thinking, but also renders rather useless the widely-used framework of cost-benefit analysis that is based on the methodology of aggregating the willingness-to-pay of the persons affected by a policy to evaluate its merits. Let me briefly explain.

Conventional cost-benefit analysis assesses the impacts of policies on future generations by hypothetically positing the willingness-to-pay question to the same hypothetical future persons under two different scenarios, life with the policy impacts and life without the policy impacts, and then comparing the answers to evaluate the policy. The assumption is therefore made, usually implicitly rather than explicitly, that the same future persons will exist whether or not a policy is implemented. This “same persons will exist either way” assumption is, however, clearly revealed to be untenable once one recognizes the existence of person-altering consequences. When conducting cost-benefit analyses, future persons’ hypothetical willingness-to-pay valuations of a policy’s impacts should instead be made as compared to the actual, demonstrable alternative of those persons’ non-existence, should that policy not be implemented.

Unfortunately, if the hypothetical willingness-to-pay question was to be posed in this proper fashion that contrasts the actual achievable alternatives, any policy whatsoever would likely receive a massive (if not infinite) positive valuation from each of the specific future populations of individuals that the policy will bring into existence. Even if these valuations are then discounted quite heavily to reflect their futurity, one will still inevitably conclude that all policy alternatives whatsoever, including the null option of taking no action of any sort which would lead to the birth of a particular specific population of future individuals over time that would obviously favour that inaction, will generate massive future benefits. These massive future benefits extending for all eternity are obviously going to be impossible to meaningfully quantify and
compare across alternatives, and in any event the size of those future benefits will completely dominate and render trivial any adverse policy impacts upon existing persons, no matter how widespread and severe those current impacts might be.\textsuperscript{xii} This bizarre, blanket result that all policy options whatsoever will generate massive net benefits of indeterminate size that completely dominate any adverse impacts upon existing persons would render any cost-benefit analyses done in this fashion rather useless as a practical tool for helping policy makers to choose among policy alternatives.

One could perhaps attempt to try to salvage in part the cost-benefit framework of analysis by, again, instead first applying a non-consequentialist ethical criterion to assess the significance of a policy for future generations, rather than using the normal secular, consequentialist willingness-to-pay framework, and then attempt to quantify into dollar terms in some fashion this non-consequentialist assessment before aggregating it with the usual willingness-to-pay based assessment of the policy’s impacts on existing persons.\textsuperscript{xii} But I will be the first to admit that I have no idea what would be the appropriate non-consequentialist ethical criterion to apply.

Consider again my ocean radioactive waste dumping hypothetical. What, exactly, is morally wrong with doing something like this that as I have shown will benefit virtually all if not all existing and future persons, by their own assessments? Has God somewhere decreed that radically present-oriented policies are morally wrong, even if no existing or future person is thereby injured? What evidence exists supporting this claim?

Alternatively, should we retain a secular orientation, but now focus upon the nature of the intentions of the actors, rather than upon the inevitably beneficial consequences of their actions for future generations given their person-altering consequences? But are intentions rather than likely results the proper ethical touchstone? Or should we perhaps take the tact of ascribing existential reality and moral significance to some impersonal, collective generalization such as, for example, “the human race,” and then to try evaluate policies in terms of their beneficial or adverse impacts upon this collective generalization that stand apart from the policy’s impacts upon the specific individuals that together comprise that generalization? But does the “human race” really exist apart from the specific individuals that comprise it, and even if it does exist in some sense do we really owe ethical obligations to anyone or anything except specific individuals? Finally, even if we can somehow come up with a plausible non-consequentialist ethical criterion for policy analysis, I have no idea of how one would then meaningfully translate such a non-consequentialist assessment into dollar terms for aggregation with the policy’s consequences for existing persons, in order to reach a meaningful overall policy assessment.
Let me briefly summarize my conclusions. Once one recognizes the nature and ubiquity of person-altering consequences, one is unfortunately forced to concede that all policy alternatives whatsoever are ethically self-validating if one judges them by conventional secular, consequentialist ethical standards. Those ethical criteria thus can no longer provide meaningful moral guidance as to when sacrifices by existing persons on behalf of distant future generations are called for, if ever. This presents a real conundrum for policy makers, since there is little if any consensus regarding which if any of the many competing secular or theistic non-consequentialist ethical criteria should be applied to assess future policy impacts in making decisions, nor how such non-consequentialist assessments are to be quantified into dollar terms for aggregation with the policy consequences for existing persons.

Moreover, cost-benefit analysis is now shown to be an untenable analytical approach, since cost-benefit analyses that ignore person-altering consequences are clearly irrelevant to the real choices at hand, and such analyses that incorporate person-altering consequences in the usual willingness-to-pay manner will always unhelpfully conclude that all policy options whatsoever will generate massive net benefits of uncertain magnitude that will completely dominate any adverse impacts upon existing persons.

So the person-altering consequences of policies indeed pose a significant intellectual problem, and one that I am admittedly at somewhat of a loss as to how to resolve. I hope that I have made clear, however, that the current practice of simply ignoring person-altering consequences is untenable, and that we need to figure out a better way to address those consequences.

REFERENCES


This short essay is intended only to communicate the essential nature of the problem of person-altering consequences. For more detailed discussion of the numerous technical issues raised by person-altering consequences for ethical assessment and for cost-benefit analysis see generally id.


I have discussed elsewhere in some detail the issues presented by those “transitional” generations of persons conceived and born after the person-altering consequences of a policy have begun to spread but before they become universal. See Crespi (2007), supra n. 3, at 10885.

By the phrase “secular premises” I refer to ethical premises that are derived from reflections on the human condition that are agnostic with regard to the question of the existence of a supreme supernatural being. By the phrase “consequentialist premises” I refer to the ethical premise that actions have ethical relevance only to the extent that they have consequences for the rights or interests of specific persons.

Sunstein, supra n. 1.

Crespi (2008), supra n. 2, at 10705.

If the willingness-to-pay of those future persons were to be measured by their offer prices, the aggregate benefit measure would be very large but finite because of wealth constraints on offer prices. If, however, asking prices were used as the measure, those benefits would obviously be infinite. Id. at 10709-10. Whether offer prices or instead asking prices are the appropriate measure of willingness to pay is a difficult and unresolved question. For an extended discussion of this point, see generally Gregory Scott Crespi, “Valuation in Cost-Benefit Analysis: Choosing Between Offer Prices and Asking Prices as the Appropriate Measure of Willingness to Pay,” 39 J. Mar. L. Rev. 429 (2006).

Crespi (2008), supra n. 2, at 10711.

Id. at 10715-16
The consumer cannot buy insurance against the risk of becoming a bad risk in the future.

I. Introduction

This brief Article examines a law and economics thought experiment involving two types of insurance contracts not currently offered by any insurer in the United States. The purpose of this Article is to demonstrate that: 1) with careful planning, one can very closely align the interests of the insurer and the insured even when creating unconventional insurance products; 2) moral hazards can be minimized or avoided where it is extremely difficult to collect on the underlying policy prematurely or fraudulently; and 3) even very unusual insurance contracts can be based upon familiar contractual ideas that have evolved over the past several centuries. Many, including attorneys, judges, economists, and sociologists have suggested that complex insurance instruments tend to facilitate undesirable, risky behaviors simply by virtue of their complexity – because the effect of the contractual bargain itself is not well-understood. The Author suggests, instead, that complex insurance instruments – and other types of contracts – become dangerous not when they are overly complex, but rather when the interests of the insurer and the insured diverge beyond a mutually acceptable margin of error. Somewhat counterintuitively, but not coincidentally, more precisely aligned incentives tend to produce fairer contracts, as well.

From an econometric or financial modeling standpoint, one should picture the insurer as the party attempting to build a predictive model that fits the dataset generated by the insured’s actions. Where the interests and motives of the first party are well-understood by the second party, the model will tend to more closely fit the data. Well-aligned incentives do not always make the insured less risky (though they may), but will tend to make the insured’s risk-taking more predictable. Now, we turn to two hypothetical insurance instruments designed to demonstrate the considerations and effects when near-perfect alignment exists.
II. Incarceration Insurance

Imagine an incarceration insurance that offers periodic payments to a third-party designated beneficiary while the insured is in prison. Although it is a cross between a life insurance policy and a disability policy, it behaves similarly to workplace disability policies in the United States and is in effect for a term of years and renewable for additional terms.

To illustrate what the pertinent clauses from such a policy might contain:

§ 19.1 Prompt Performance. Upon the court-ordered incarceration of the Participant, the Company, with the cooperation of the Beneficiary or his agent or counsel, shall promptly commence payment of the Policy Proceeds to the Beneficiary. Payments shall occur on the first of each calendar month, in accordance with the table provided as Schedule A, so long as the Participant is incarcerated on the final calendar day of the preceding calendar month. Policy Proceeds shall be prorated on a per diem basis in accordance with Table 2 of Schedule F in any case where incarceration of the Participant begins with a fractional month of incarceration. The Company will not recognize or honor claims\(^\text{18}\) for fractional days of incarceration, nor for pretrial confinement.

\(^\text{18}\) For details on what circumstances involve the confinement of the Participant, but do not qualify as “incarceration” and will not create a payment of Policy Proceeds to the Beneficiary, please refer to Participant Rider 2.

§ 22.1 Disbursement and Enjoyment of Proceeds. An Incarceration Benefit equal to the amount of incarceration insurance coverage to which the Beneficiary is entitled under the terms of this Plan, subject to the payment scheme described in Schedules A and B, shall be disbursed promptly and in full from the Company to the Participant’s designated Beneficiary on the basis described in §§ 19, 20.

The incentives here, in coarse terms, are relatively well-aligned. The company would prefer that the participant in the plan not go to prison. It is
very likely that the insured, like the insurer, would prefer not to go to prison. There are two primary disruptions, however: 1) the participant in the policy may enjoy an information advantage relative to the company; and 2) the participant may want to protect himself from the insured risk but poorly estimate his ability to shield himself from this risk. The first concern can be combated by proper diligence on the part of the insurer and a waiting period preceding the policy’s effective period. This waiting period would prevent the payment of some number of claims from expected, imminent, or reasonably foreseeable incarceration. The second concern may be substantial due to underfunded criminal defense efforts, unexpected evidentiary rulings, or an unexpected lack of cooperation from an employer, co-conspirator, or other party.

The likely customers for incarceration insurance fall into two distinct, generally-mutually-exclusive categories: 1) wealthy businesspeople or corporations purchasing insurance on behalf of their executives, and 2) opportunistic insurance-seekers who believe they have an information advantage. In the former group, the corporation might take out an incarceration policy designed to compensate the corporation for loss of goodwill or to fund an executive search-and-hire process to replace the incarcerated executive. In the latter group, a person may believe he or she has an information advantage in that he suspects he is under investigation by prosecutors but has not yet been indicted. Alternatively, the person may seek incarceration insurance because she worries that ill-gotten assets may be frozen or confiscated, while insurance proceeds would flow freely to her designated beneficiaries.

III. Deportation Insurance

Imagine now, instead, an insurance product completely separate and apart from the incarceration insurance discussed above. This policy offers the insured a lump sum benefit if he or she is deported from the United States. Like the incarceration insurance product, it is effective for a fixed term and can be renewed for subsequent terms. Also similar to incarceration insurance, it is unlikely the participant will undertake any affirmative act he or she knows will cause (or substantially increase the likelihood of) deportation.

This is not to suggest that moral hazards are entirely avoided where the insured’s interests are well-aligned with the insurer’s interests. A moral hazard surely exists in both incarceration and deportation insurance, as it does in any contract architecture where the value of the policy is dramatically higher than the value of the premiums thus far remitted from the insured to the insurer. However, this peculiar flavor of incentive alignment offers a rare eclipse between policy-contemporary and post-policy effect: both incarceration and
deportation may not only be undesirable to the participant, but may substantially interfere with the participant’s ability to enjoy the proceeds of the policy.xxx

For obvious reasons, many deportation insurance policies would likely involve third-party beneficiary schemes (spouses, children, or business partners designated as beneficiaries). Some companies might buy deportation insurance on their employees, a key non-specialist consultant unable to obtain an H-1b visa,xxx for instance. Lastly, one might buy deportation insurance as a political bargaining chip – the insured unpopular person of interest might be more likely to be asked nicely to leave the country.xxxii

IV. Moral Hazard: An Efficient Breachxxxiii Parallel?

Note that, as discussed supra, parties likely to seek these types of insurance instruments are sophisticated parties.xxxiv Still, information disparityxxxv remains a risk, as with health insurance or life insurance.xxxvi However, risk of a willful act intended to create a policy windfallxxxvii benefitting the insured (the hallmark affirmative act associated with moral hazard)xxxviii is substantially reduced, as the vast majority of insured will do everything possible to avoid incarceration or deportation. Also, the insured’s ability to enjoy his or her insurance proceeds may be diminished when the insured becomes imprisoned or deported.xxxix Despite this natural sympathy between the interests of insurers and the interests of the insured, incentive syzygy may still not be achieved with regard to third parties. Just as suicide may be used to produce life insurance proceeds for the enjoyment of others, incarceration and deportation insurance policies might be exploited for the benefit of third parties. This leads one to the question of whether such strategic behavior should be prevented and, if so, how.

A moral hazard is not an efficient breach in the Chicagoan,xli Posnerianxlii sensexlii – in a contractual framework, it is not a breachxliii at all. It is, instead, an opportunistic exploitation of the terms of an insurance instrument.xliv One might ask why, then, should the two be compared. The comparison is useful because both behave as outside optionsxlv that compete with the anticipated mode of performance,xlvii offering a benefit to the acting party.

In essence, an efficient breach allows at least one party to reap the benefits of non-performance while, at the other end of the spectrum, exploitation of an insurance instrument allows one party to force the counterparty’s performance.
While the benefits of an efficient breach are shared by the parties (see right side of Figure a, supra), the effects of a windfall are negatively correlated between the counterparties, as the collection of the policy’s value harms the insurer in equal measure (see left side of Figure a, supra). Comparing the various outcomes illustrated by Figure a, modes ex contractu (center) and extra-contractu (right and left), yields an important conclusion: while negotiated (and even un-negotiated, in the case of efficient breaches) outcomes produce largely sympathetic behavior between the various parties, the risk to the insurer in the case of a claim is irreparably large. Insurers can do little to hedge this risk, aside from relying upon the law of large numbers, prudent investing cash reserves, and “pooling” risk into less risky bundles in order to calm investor fears.
V. A Word About Risk Pool Distortion

In any pool containing more than one insured individual, the “average” risk of the pool may be a useful figure, while changes in the average risk among pools may be deceptive. As an example, suppose that InsuranceCo is an insurance company insuring two pools of people insured against incarceration and that each pool includes one hundred people. Further, suppose the average risk of Pool Alpha is represented by the variable $\mathbf{s}$, while the average risk of Pool Beta is represented by the variable $\mathbf{z}$. Higher numerical values, on an arbitrary scale, represent lower risk (lower probability of a claim). Pool Alpha is less risky than Pool Beta. All risk values for people insured in Pool Alpha fall between 50,000 and 80,000, and $\mathbf{s} = 63,000$. Meanwhile, all people insured in Pool Beta fall between 10,000 and 40,000, and $\mathbf{z} = 26,000$. By simply moving the riskiest ten people from Pool Alpha to Pool Beta, the values $\Delta \mathbf{s}$ and $\Delta \mathbf{z}$ both become positive. In other words, the average risk value of each portfolio has decreased, even though InsuranceCo is taking exactly the same risks.

Particularly with more exotic flavors of insurance, it is important to not allow reallocation and statistical maneuvers to bias calculations of portfolio risk. From the example supra, it should be obvious that both instant risk (examining each policy separately) and contingent risk (examining scenarios involving a series of claims combinations) must be accounted for in ways other than a moving average of attributed risk value. Both types of risk can be reduced through counterparty incentive alignment. Quantifying alignment, however, proves challenging.

VI. Testing the Alignment of Parties’ Incentives

In Figure β, infra, a person must be in a quadrant other than quadrant D in order to buy either type of insurance (any person whose situation can be described by quadrant D’s parameters is already both deported and incarcerated). For the purposes of this discussion, all quadrants are mutually-exclusive as to each other and, taken as a whole, the figure is absolutely inclusive as to the sample.
This quadrant analysis is useful in that it can be visualized in terms of likelihood of A versus B or likelihood of A versus C, depending upon which insurance product is involved. Incentive alignment should be considered in the context of game theory assumptions about the parties’ interests and the overarching assumption that, all other things being equal, parties will tend to engage in decisions and actions consistent with their interests.

One could also envision a solution framework using non-parametric statistics. Perfect risk can also be expressed as the inverse of an insurer’s preference for a given contract. Similarly, the amount of risk an insured individual is willing to take can be expressed as the inverse of the person’s preference for freedom versus incarceration or residence versus deportation. With a large enough dataset describing these preferences across a population eligible for the insurance product in question, one could use maximum likelihood estimation to tailor the statistical model to the data relatively accurately.
VII. Creating New Species Within Extant Genera

While the two products discussed in this Article are surely unconventional, they are not unprecedented in their behavior as insurance instruments.

Because the type of incarceration insurance discussed here is structured to provide periodic payments to a beneficiary during the time of the incarceration, it can be modeled on the contractual language and actuarial considerations of a traditional worker disability policy. Meanwhile, the deportation insurance discussed here provides a lump sum to the insured or to a third-party beneficiary, and can be loosely modeled on life insurance products. Each, then, represents a theoretical contract scheme firmly tied to an analogous existing lineage of products. Hence, providers of incarceration insurance are asked to accept two types of risk (whether the insured becomes incarcerated and for how long), while deportation insurance providers are only asked to accept a binary risk (whether or not the insured is deported). Of course, this binary risk is spread across many procedural due process safeguards, which may prevent attempts to speedily deport an alien, but the result is still one of two outcomes. While deportation schemes are the modernized, “kinder, gentler” progeny of banishment, their procedural complexity invites substantial maneuvering by the insured. By waiving certain procedural rights, the deportation defendant could likely speed deportation and payment of the deportation insurance lump sum (and enjoyment of the windfall described by the left side of Figure 1, supra).

If an insurance company were concerned about this process, it would have few options. One cannot contractually compel another to exhaust his appeals or exercise constitutional rights. The insurance company could offer to provide or reimburse trial counsel, but could not force counsel upon the defendant at any stage of the proceedings.

How, then, can the interests of the insured and the insurer be well-aligned if it is so difficult for the same attorney to represent both parties’ interests, one might ask. In essence: is this representation puzzle a good metric for measuring the degree to which the parties’ interests are aligned? It is not. This is because the incentives one considers in crafting an insurance policy, from an actuarial standpoint, are centered on actions taken by the insured within the bounds of the policy, rather than the trial strategy pursued by the insured in subsequent proceedings. The question of whether interests are aligned, then, looks at the intersection of the parties’ interests when considering the purpose of the policy: “do both the insured and insurer favor non-incarceration over incarceration?” or “do both parties prefer non-
deportation to deportation?” At this level, the interests of most insurers and most insureds are relatively well-aligned.

Still, there are issues upon which the parties will never fully agree, as they’ve essentially wagered against one another. To write a policy is to suggest that the prospective insured has a less accurate picture of the likelihood of future events than the insurer.

**VIII. Irreconcilable Differences**

When are the interests of the insurer and the insured so divergent that the two cannot be reconciled as a matter of good faith counterparty performance? Figure γ describes the possible outcomes of an incarceration insurance policy:

Figure γ. 

While there may be parity at the first level (both insurer and insured prefer the insured to not become incarcerated), there is disparity at the second level (insurer would prefer to avoid paying a claim once insured becomes incarcerated). The question, then, is one not of parity, but of priority. Both the insurer and insured might prefer that the insured remain in Quadrant A of Figure β, supra, all else being equal. However, an insured individual may prefer to have his claim paid and be incarcerated — for instance, if debts are mounting and incarceration is seen as inevitable — rather than being not incarcerated with an unpaid claim. Hence, as soon as the insured assigns a higher priority to collecting payment than to avoiding peril, disparity at the first level occurs. It is important, also, to recognize that when a “moral hazard” tempts the insured actor, either X or Y in Figure γ may result.

The Author offers a “prioritization-synchronization theory” to explain the position of the parties in these scenarios: inefficiency and costs will follow
where two parties have conflicting prioritization of contractual duties, temporally or hierarchically. The law generally presumes that the interests (and, in turn, the priorities) of the insurer and the insured are reasonably well-aligned,\textsuperscript{lxxv} or a policy would not have been written. However, on occasion, insurers poorly appraise the intentions of the counterparty – for instance, where a person takes out a life insurance policy and commits suicide in order to cause payment of the policy.\textsuperscript{lxxvi}

Dissimilar prioritizations between insurer and insured also account, in part, for higher premiums. In other words, where the two parties’ incentives and expectations are congruent, uncertainty will be reduced and premiums will be lower. Even in the most exotic of insurance products, a comparison of not only the parties’ incentives, but also one party’s prioritization of the incentives compared to the other, is an important (and too often overlooked) exercise.

IX. Conclusion

The challenges facing a pair of insurance products where the interests of insurer and insured are relatively well-aligned illustrate the difficulty of managing other insurance contracts that present a more nuanced web of incentives. However, these simple, hypothetical instruments also illustrate the utility in re-tasking existing know-how and common sense about incentive alignment to predict behavior on both an individual and pool basis. The turning point at which the relationship between insurer and insured becomes more adversarial than sympathetic must also be considered, both in drafting the documents and in pricing the insurance. This is particularly true if the parties may have different interests when making decisions from which a claim might arise. For instance, in the case of deportation insurance, the two parties’ interests decouple once the insured decides he or she would rather assent to deportation and collect the lump sum than resist deportation.

The world spent much of Q109 writing down (or writing off) underperforming high-risk tranches of undesirable insurance instruments from credit default swaps to counterparty indemnity arrangements, and the valuation of insurance contracts remains, at the margin, more an art than a science. However, considering the evolution of insurance products is crucial to understanding sources of risk that may not be readily actuarially ascertainable. Aligned incentives make for better, more efficient, and more predictable insurance products, but will not by themselves insulate the insurer from risk.

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1 See Joseph P. Newhouse, Cream Skimming, Asymmetric Information, and a Competitive Insurance Market, 3 J. HEALTH ECON. 97, 97-100 (1984).

1 Though writing such insurance policies may be legal in some jurisdictions, the Author has been unable to locate any evidence of either policy explored in this Article having been written in the United States.

1 Any similarity to any insurance policy, marketed product, insurer business practice, or person in the United States or elsewhere is purely coincidental. This Article’s discussion is rooted in theory alone.

1 Aligned interests are important, as they make the nature of the arrangement clearer and decrease risk of litigation or settlement controversy between the insurer and the insured. Aligned interests may also decrease the risk that the insurer will be accused of acting in bad faith. See Bunge Corp. v. Recker, 519 F.2d 449, 452 (8th Cir. 1975); Marsu B.V. v. Walt Disney Co., 185 F.3d 932 (9th Cir. 1999).

1 Moral hazard, as used in this Article, refers to any scenario where an insured party acts or plans to act to produce a higher probability of a loss where the same party would not act in the same way if the risk of the same loss were uninsured. This definition is similar to, but broader than, the definition provided in Donald R. McMinn, Transactional Lawyers Under Fire: A Look at Coverage Questions Arising in the Context of Securities Class Action Suits Against Legal Professionals, 30 TORT TRIAL & INS. PRAC. L.J. 999, 1002 n.10 (2003).


1 One might think, at first glance, that more perfectly aligned incentives would tend to align in such a way as to dissuade efficient breach by the insured, typically benefiting the insurer.


1 Fair, in this context, is not used in an equitable sense. In economic terms, an insurance contract is “fair” when the anticipated “payout” from the policy is zero. This principle of “actuarial fairness” is commonly expressed in the econometric and actuarial scholarship as the condition where the following if/where term is satisfied: if (1 - ε)y1 + εy2 = 0 where ε = π(ω2) = 1 − π(ω1). See Klaus Ritzberger, FOUNDATIONS OF NON-COOPERATIVE GAME THEORY 72 (2002, Oxford Univ. Press). Notice this model of fairness forces
insurer’s super-premium profits to zero. This is a similar concept to that of perfect competition: in an environment of perfect competition, the long-run equilibrium will be a state in which prices are set equal to marginal cost— one’s costs are matched with revenue, but there are no free (excess) rents.

1 This is exactly the viewpoint embraced by traditional actuarial statistics approaches, which first examine the “p-value” (best visualized as the right tail of a Chi-square distribution) and then use standardized residuals analysis to examine each category where the model does not fit the existing data. Because this Article deals with hypothetical insurance products where no data exists, and because its focus is on the legal (rather than economic) implications of near-optimally and sub-optimally sympathetic counterparty interests, the Author avoids delving into these statistical analyses in any depth.

1 See Douglas G. Baird et al., Game Theory and the Law 154 (1998) (riskier insured parties tend to purchase expensive insurance); see also R. Duncan Luce & Howard Raiffa, Games and Decisions: Introduction and Critical Survey (7th ed. 1957) (covering comparative risk assumption from a technical standpoint); Morton D. Davis, Game Theory: A Non-Technical Introduction (1983) (providing comparatively less quantitative approaches to similar topics).

1 “Company” and “insurer” refer to the same party, while “participant” and “insured” refer to the same party.

1 This is modeled after “preexisting condition” provisions and stall windows in health insurance policies. See Elizabeth Leonard, Teaching Health Law, 37 J.L. Med. & Ethics 139, 141 (2009).

1 This could be likened to a car insurance policy. Though a car insurance policy does not pay to replace the brakes on a car, faulty brakes increase the risk of an accident in which the insured asset will be “totaled.” Though the incarceration insurance would not pay for the defense of the individual, it would bear some pecuniary risk if the defense offered is ineffective, incompetent, or nonsensical. Further, just as there is some risk a person will undertake to inspect and fix his own brakes and erroneously conclude they are in acceptable working condition, there is a risk the pro se criminal defendant will place himself in jeopardy.

1 For instance, a thirty-five-year-old executive with a young child potentially facing a twenty-year prison term might opt for incarceration insurance to provide regular income for the child should he be unable to do so. Life insurance would be a poor substitute because the triggering event the executive wants to insure against (incarceration) does not match the triggering event of the life insurance policy (death).
For the purposes of this discussion, assume the benefit is a paid-on-demand cash amount that can flow to the insured or to a third-party beneficiary assignee.

In most policies, the timeline of payments and benefits ends with either the expiration of the policy or the payment of the policy proceeds.

Ronald Gilson, Contracting For Innovation: Vertical Disintegration and Interfirm Collaboration, 109 Colum. L. Rev. 431, 452 (2009) (“Of particular importance are the information barriers that prevent parties from controlling moral hazard when the future states of the world depend on their own actions.”).


The savvy prosecutor might be more likely to attempt to “persuade” a person to leave, rather than using a strategy involving deportation, if success in deporting the individual would create a financial windfall. Surely creating million-dollar private payouts to deported foreigners through state action would prove unpopular.


For a discussion of exotic insurance instruments tailored to specific insured individuals’ risk, see Railway Officials & Employees Accident Ass’n v. Johnson, 109 Ky. 261 (1900) (Nineteenth Century life and limb instrument for railroad employee going into such detail as to list potential causes of death, including specifically providing for death by sunstroke).

For information on the principle of information disparity, see 1 JEFFREY W. STEMPHEL, STEMPHEL ON INSURANCE CONTRACTS § 4.08H (3d ed. 2006).

Participant may know more about his or her risk of health problems or death, or may face risk factors that are difficult, impracticable, or expensive for the insurer to ascertain or quantify.

Smith & King, *Contracts as Organizations*, 51 ARIZ. L. REV. 1, 14 (2009) ("[M]oral hazard is best addressed through ex post incentive alignment.").


See Lake River Corp. v. Carborundum Co., 769 F.2d 1284, 1289 (7th Cir. 1985) (Posner, J.) (discussing efficient breach in traditional contractual context).


The insured would have substantial difficulty, after all, collecting the proceeds of an insurance contract which he or she breached.

Matters are not helped by the fact that there is an “imprecise link between the legal definition of insurable interest and the actual presence of moral hazard.” Jacob Loshin, *Insurance Laws’s Hapless Busybody: A Case Against the Insurable Interest Requirement*, 117 YALE L.J. 474, 483 (2007).

Though both are outside options in an economic sense, it is important to note that the two are not similar in a legal sense. Opportunistic breach is not an area in which efficient breach theory should be applied, even according to efficient breach’s most enthusiastic proponents. See Walgreen Co. v. Sara Creek Prop. Co., 966 F.2d 273, 275 (7th Cir. 1992) (Posner, J.).


Less any premiums collected, or – for perfect symmetry – assume windfall occurs on a lump sum policy at \( t_0 \) where policy is in effect at \( t_1 \) but first premium is paid at \( t_1 \).

Outside the usual contract scheme lie unexpected breaches (efficient breaches not contemplated at the time of the contract’s drafting) and/or...
unexpected affirmative acts causing a present obligation to pay (insured collects value of policy via a “morally hazardous” claim). Note that some scholars argue the left (“moral hazard”) side of the figure is an outcome super-contract, ensnaring and obligating the counterparty via a strategic, affirmative act by the insured. This argument is primarily semantic and will not be discussed here.

1 See P. K. Sen & J. M. Singer, LARGE SAMPLE METHODS IN STATISTICS at Theorem 2.3.10 (1993).

1 Referred to as “putting the float to work” in the industry literature.

1 This is, in part, why advanced actuarial tools analyze the marginal risk increase of adding specific individuals to the pool rather than simply tracking a moving average.

1 In other words, a person who has been convicted but not sentenced does not lie on the negative X-axis between quadrants A and C, but rather in quadrant A. This simplified quadrant analysis assumes that all parties’ status is definite and discernible to other parties.

1 Put another way, no individual in the population, at any given time, is described by more or less than one quadrant.

1 Relative likelihood of the outcomes (continued non-imprisonment versus imprisonment during the term of the insurance policy, for example) is actuarially calculable as the likelihood one will exercise an option to protect against the risk in question. See “The Hi-Fi,” a game theory exercise created by J.D. Williams of the RAND Corporation, reprinted in Saul Stahl, AM. MATHEMATICAL SOC’Y, A GENTLE INTRODUCTION TO GAME THEORY 22-23 ¶14 (1999).

1 The Author contends that non-cooperative game theory is the appropriate framework for these comparative bias and self-interest analyses, but this is not a mathematical paper and this aspect will not be discussed in detail here. For further reading peculiar to this topic, see Roger B. Myerson, GAME THEORY: ANALYSIS OF CONFLICT (1997). See also Robert Gibbons, A Primer in Game Theory (1992).

1 Perfect risk refers to the factor representing risk if all known contributing factors are correctly weighted.

1 Given an infinite range of quantified risk to choose from, the lowest value being zero, the rational insurer will choose zero risk, all other factors being set equal. Similarly, an insurer’s preference for a given contract will increase in a manner highly correlated with decreases in assessed risk.

1 This is a common approach to increase a dataset’s utility in preparation for semiparametric regression or other semiparametric modeling work. See P.M. Robinson, Root-n Consistent Semiparametric Regression, 56 ECONOMETRICA 931, 931-954 (1998).
Competing game-theory-based analytical methods exist for determining the prevailing outcomes of nearly any insurance scheme. For insight into why the nature of the policy and the rules of the game can vastly change outcomes in problems involving insurance products, see KARL H. BORCH, RECIPROCAL REINSURANCE TREATIES SEEN AS A TWO-PERSON COOPERATIVE GAME 31-50 (1960). For a contemporary game theory approach, see J. LEMAIRE, COOPERATIVE GAME THEORY AND ITS INSURANCE APPLICATIONS 17-40 (1990), http://www.casact.org/library/astin/vol21no1/17.pdf.

For a detailed discussion of these safeguards, see 6 NOWAK & ROTUNDA, TREATISE ON CONSTITUTIONAL LAW § 22.7(b) (4th ed. 2009).

For a few cases where waiver of procedural rights would have sped deportation proceedings and caused prompt payment of a deportation policy, see Cody Harris, A Problem of Proof: How Routine Destruction of Court Records Routinely Destroys a Statutory Remedy, 59 STAN. L. REV. 1791, 1798, 1800-08 (2007).

No exercise of a trial right can be contractually compelled. Far less egregious contractual coercion has attracted the ire of the state courts, such as forcing a withdrawal from a bank account or the exercise of an option. See, e.g., Betterman v. Fleming Companies, Inc., 677 N.W.2d 673 (Wisc. App. Ct. 2004).
interest. See, e.g., CHI of Alaska, Inc. v. Employers Reinsurance Corp., 844 P.2d 1113 (Alaska 1993) (opposing party in case stipulated that counsel has “an absolute duty of fidelity to the insured over the interests of the insurer.”); Farmers Ins. Co. of Ariz. v. Vagnozzi, 675 P.2d 703, 708 (1983) (“We emphasize that the attorney who represents the insured owes him an undeviating allegiance whether compensated by the insurer or the insured and cannot act as an agent of the insurance company by supplying information detrimental to the insured.”).

1 See Twin City Fire Ins. Co. v. City of Madison, Miss., 309 F.3d 901 (5th Cir. 2002).

1 “Reconciled” is used colloquially here, rather than technically. For work on the technical reconciliation of negotiated counterparty risk, see numerous discussions of optimal insurance models and game theory tests, particularly the Kalai-Smorodinsky game theory solution framework and work on related Nash solutions, such as in J. Nash, The Bargaining Problem, 18 ECONOMETRICA 155, 155-162 (1950). But see E. Kalai & M. Smorodinsky, Other Solutions to the Nash Bargaining Problem, 43 ECONOMETRICA 513 (1975). For a modern interpretation of these solutions and a comprehensive discussion of competing methodologies, see KARL H. BORCH, ECONOMICS OF INSURANCE (Aase K.K. & Sandmo A. eds., 1990).

1 In this diagram, the insured has become incarcerated, and the insurance company will either pay under the policy or deny the claim.

1 Quadrant C, Figure $\beta$; left cell, Figure $\gamma$.

1 Quadrant A, Figure $\beta$; right cell, Figure $\gamma$.

1 This is also true in areas such as life insurance and home/fire insurance, where the insured may not take measures to insulate him- or herself from harm (regular medical check-ups, or a smoke detector). The game theory analysis of this question has taken many paths, including examining signaling and adverse selection. The central problem, of course, is that the contract cannot bar the insured’s carelessness or change the insured’s natural risk profile. “An insurer is not able to learn exactly how an individual behaves once the insurance contract is purchased. Hence, the contract cannot be written in a way that protects the insurance company from individuals taking actions that they would not take if they did not have insurance.” DOUGLAS G. BAIRD, ROBERT H. GERTNER & RANDAL C. PICKER, GAME THEORY AND THE LAW 153 (1994).

1 While the insured will act in his or her own best interest, the insured may not always correctly estimate whether the claim will then be paid. For additional research on this aspect of moral hazard, see CAROL A. HEIMER, REACTIVE RISK AND RATIONAL ACTION: MANAGING MORAL HAZARD IN INSURANCE CONTRACTS (1985). See also N. Reichman, Managing Crime Risks:
Towards an Insurance Based Model of Social Control, in Research in Law, Deviance and Social Control 155 (S. Spitzer & A. Scull eds., 1986).

This phenomenon of presumption is most obvious when courts wrestle with the question of life insurance policies and suspected suicides. “[I]n a contested evidentiary hearing such as the trial of an action to recover the proceeds of a life insurance policy, a finding of suicide is warranted only if ‘no conclusion other than suicide may reasonably be drawn[.]’” Infante v. Dignan, 55 A.D.3d 1258 (2008) (quoting Green v. William Penn Life Ins. Co. of N.Y., 48 A.D.3d 37, 40 (2007)).

For a vivid description of one such scheme, see Iseberg v. Gross, 879 N.E.2d 278, 282 (Ill. 2007) (discussion of plan to exploit lapse of suicide exemption clause in life insurance policy via well-timed suicide of insured party).
This paper first provides a general overview of the most common forms of contractual arrangements or public-private contracts in the water industry and reviews two recent examples of large-scale public-private contracts -- one in the municipality of Havana, Cuba, the other in the Jiangsu province of the People's Republic of China. The second half of the paper then presents a generalized partnership-game model and explains the possible application of this game-theoretic model to public-private contracts in the water sector.

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**KEYWORDS:** INTERNAL EXTERNALITY, PUBLIC-PRIVATE CONTRACTS, PARTNERSHIP-GAME MODEL, UNDERINVESTMENT.

**I. INTRODUCTION**

Game theory, a branch of mathematics, has been applied to a wide variety of fields and problems, including military strategy (Schelling, 1960), evolutionary biology (Axelrod & Hamilton, 1980), and the law (Baird, et al., 1994). In this paper, we shall apply a game-theoretic framework to a subset of contracts in the water industry. These contracts are part of a broader political-economic trend: the creation of hybrid “public—private partnerships,” not only in the

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1 In this paper, we define the terms “water industry” and “water sector” broadly to include fresh water supply, wastewater treatment, and sanitation and sewerage services.
water sector, but also in the fields of energy, telecommunications, transportation, and many other areas of the economy (see, e.g., Crosslin, 1991). Since a significant fraction of new infrastructure projects are now in the form of public-private joint ventures, and since this trend is likely to continue in the foreseeable future, the model presented in this paper may potentially have a wide application.

The paper is divided into five parts. Following this brief introduction, part two provides a general overview of the most common forms of contractual arrangements or public-private partnerships in the water industry. Part three then reviews two recent examples of large-scale public-private contracts -- one in the municipality of Havana, Cuba, the other in the Jiangsu province of the People’s Republic of China. Next, part four presents a generalized partnership-game model and explains the possible application of this game-theoretic model to public-private contracts in the water sector. Lastly, part five concludes by identifying areas for future research.

II. TAXONOMY OF CONTRACTUAL ARRANGEMENTS IN THE WATER INDUSTRY

In summary, the most common forms of “public-private partnerships” in the water industry include service contracts, management contracts, leases, concessions, and build-operate-transfer contracts as well as formal joint ventures (cf. Budds & McGarahan, 2003, p. 89, table 1). Although public-private partnerships thus come in a wide variety of shapes and sizes, all such contractual arrangements fall between the following two extremes or “ideal types.” At one extreme is the public goods model of water distribution or full public ownership and management of water and sanitation infrastructure. Under this model, a state-owned enterprise or public utility is exclusively responsible for the provision of water and sanitation services. At the other extreme, in contrast, is exclusive private ownership and management of water resources -- the private goods model in which the water and sanitation networks are privately owned and operated.

For clarity, then, one can think of public-private partnerships as consisting of a gradual continuum or sliding scale of contractual arrangements falling within the wide area between these two extremes (cf. Conca, 2006, pp. 231-232, Table 7.2). Service contracts, for example, are short-term agreements in which a private contractor agrees to perform a specific, well-defined task in return for a fixed or per-unit fee, such as installing water meters, repairing pipes, or collecting bills. Thus under a service contract, private-sector participation in the water utility is kept to a minimum.
Management contracts and lease agreements, in turn, expand private-sector participation in the provision of water and sanitation services. Under a management contract, a private firm is responsible for the day-to-day operations and maintenance of the water or sanitation network in return for a fixed or performance-based fee, but ownership of the network is still public. Under a lease contract, the assets of the water utility are transferred (leased) to a private firm in return for a lease fee. The firm is responsible not only for the day-to-day operations and maintenance of the water/sanitation network, but also for billing and revenue collections as well. Thus the firm must recoup its operation and lease-fee costs directly from end users.

Concession contracts further increase private-sector participation in the water industry. Under a concession, a private firm is responsible for the entire operation of the water utility. Moreover, the firm is required to invest its own funds in the upgrade and expansion of the network and bears the financial risk of these investments. As such, concessions tend to be long-term contracts, often with terms of 20 to 30 years, to allow the firm to recoup its investments.

Build-Operate-Transfer (BOT) contracts are similar to concession contracts in substance but are used to finance the construction of new infrastructure projects, such as water purification and sewage treatment plants, for example. Furthermore, under a BOT-type contract a private firm owns and operates the infrastructure project until the expiration of the contract; thus ownership is private during the term of the contract. An additional example of public-private partnerships in the water industry is the use of joint venture agreements in which a private firm forms a new company with the participation of the public sector. The new firm created under joint venture may then negotiate a management, lease, concession, or BOT contract, as the case may be.

Rather than focus on the differences among these myriad forms of contractual arrangements or public-private partnerships, we will consider the following salient similarity all such contracts share: the existence of cooperation and collaboration as well as the possibility of conflict due to potential underlying conflicting interests between the public and private sectors. In all the various contractual arrangements described above, the parties to the contract are, in effect, partners working towards a common goal. That is, the mere existence of these contractual arrangements indicates that there are possible gains from trade in the water sector -- that both sides are better off cooperating together rather than acting alone. This cooperative element is most explicit in the case of a joint venture. But at the same time, there also exists a potential for opportunistic behavior, shirking, and exploitation as well, especially in the case of long-term contracts involving asset-specific investments (see, e.g., Williamson, 1979; Klein, et al., 1978).
The central question, then, is an empirical one. What type of behavior will emerge on average from public-private partnerships, cooperation or opportunism? We will attempt to answer this question in the remainder of this paper.

III. THE JIANGSU AND HAVANA PUBLIC-PRIVATE WATER PROJECTS

The contractual arrangements described above do not emerge in a vacuum. Accordingly, in this section we shall provide a brief summary of water governance in two countries -- the Republic of Cuba and the People’s Republic of China, and we shall then compare and contrast two specific public-private water projects, one in Jiangsu, China, the other in Havana, Cuba.

First, we consider the case of Cuba. The main source of water governance in Cuba is the National Water Resources Institute (Instituto Nacional de Recursos Hidráulicos, or INRH), a governmental agency created under Law Decree No. 114 of 6 June 1989 and Law Decree No. 147 of 21 April 1994. In addition to the INRH, several Cabinet-level government ministries also play a supporting role in Cuba’s water governance, including the Ministry of Economy and Planning, the Ministry of Health, the Ministry of Finances and Prices, and the Ministry of Construction, but it is the INRH that exercises primary authority over Cuba’s water-supply and sanitation systems. Since 1989, for example, the INRH has promulgated 41 detailed resolutions or sets of regulations governing the day-to-day operations of Cuba’s water sector, such as collection and billings, inspection protocols, technical specifications, etc. (INRH, 2009a). In addition to its regulatory function, the INRH also operates 241 small dams (embalses) and 175 small-scale hydroelectric plants.

Prior to 2000, water supply and sanitation in Cuba were the responsibility of Cuba’s provinces and local municipalities. During the years 2000-2001, however, the INRH conducted a thorough administrative reorganization of Cuba’s water sector. In summary, the INRH created a number of quasi-independent state-owned enterprises for the provision of water supply and sanitation services to end-users (INRH, 2009b). Most importantly, one of these INRH-led state-owned enterprises consists of a mixed public-private joint venture or empresa mixta -- “Aguas de la Habana” -- between the INRH and a foreign firm, the Sociedad General de Aguas de Barcelona, S.A. (Agbar).

In summary, the INRH authorized this public-private joint venture to operate a large part of Havana’s water and sanitation infrastructure under a

---

2 For an extensive summary of water governance models generally, see Grover (2006), p. 225, Table 12.2.
long-term, 25-year concession contract. The INRH and Agbar established this joint venture or empresa mixta in the year 2000 under article 13 of Cuba’s foreign investment law, a law which permits the creation of public-private joint ventures in all sectors of Cuba’s national economy, except in the areas of education and health care (Dávalos Fernández, 1993).

Under the terms of the joint venture agreement, the partners INRH and Agbar each own a 50% interest in Aguas de la Habana. This mixed firm was granted a 25-year concession by the INRH to operate and upgrade the water and sanitation infrastructure in twelve of Havana’s fifteen municipal districts and is responsible for all aspects of Havana’s water and sanitation systems, including water supply, sewerage, water treatment, and pipeline and drainage maintenance (Rayon Martin, 2004, pp. 7-8). The water and sanitation infrastructure, however, will remain publicly-owned during the duration of the concession, and to date, Aguas de la Habana is the sole public-private partnership in Cuba’s water sector.

Next, we turn to China. The main source of water governance in China is the national Water Law of 2002 (see, e.g., Xie, 2009, pp. 67-69). Like the INRH in Cuba, the Ministry of Water Resources of the People’s Republic of China has played a key regulatory role in China’s water sector. In addition, a number of different government ministries and municipal entities exercise discrete and overlapping jurisdiction over China’s water sector (see, e.g., Yun, 2008, p. 13, Figures 1 and 2). At the municipal level, for example, the city government and the local water utility have primary authority over the municipality’s water infrastructure. At the national level, the Ministry of Water Resources regulates the management of recycled water and urban underground water resources; the Ministry of Environmental Protection regulates water quality; and the Ministry of Housing and Urban-Rural Development has authority over the construction of urban infrastructure projects.

Nevertheless, the government ministry that has played the most important role in China’s transition towards public-private projects is the Ministry of Construction (MOC). In December of 2002, China’s Ministry of Construction released its “Opinions on Accelerating the Marketization of Public Utilities” (Policy Paper No. 272, MOC, 2002). Then, after the Third Plenary Session of the Sixteenth Central Committee of the Chinese Communist Party in 2003 authorized state-owned utilities to create public-private partnerships in the water and power sectors, the Ministry of Construction established additional guidelines in 2004 for concessions and build-operate-transfer contracts in its “Measures on Public Utilities Concessions Management” (Policy Paper No. 126, MOC, 2004). Since 2004, China has openly embraced the use of public-private partnerships in all aspects of its water industry.
Unlike the more cautious INRH in Cuba, however, which has authorized but a single public-private partnership in the Cuban water sector since 2000, provincial and local authorities in China have approved a large number of public-private water infrastructure projects throughout China since 2004 (see, e.g., Budds & McGranahan, 2003, p. 107). A useful illustration of public-private partnerships in China is the joint venture in the Jiangsu province of China between Agbar, the same firm involved in the Havana project described above, and the Golden State Water Group Corporation (Golden).

In 2007, Golden and Agbar established a joint venture to manage three water infrastructure projects -- two drinking water treatment plants and one wastewater plant -- in the province of Jiangsu, China (Agbar, 2008, pp. 4-5). In particular, the joint venture entered into three separate 30-year contracts, one for the operation of an existing drinking water treatment plant and water distribution network in Xuyi (the Xuyi project), another for the construction and operation of a new drinking water treatment plant in Taizhou (the Taizhou project), and another for the operation of an existing wastewater treatment plant in Nanjing (the Nanjing project).

The private partners to the joint venture, Agbar and Golden, formed a Hong Kong company to conduct their business operations in Jiangsu. As part of the deal, the shares of two previously state-owned water utilities in Xuyi and Nanjing will be transferred directly to the Hong Kong joint venture firm, while the shares of the remaining state-owned utility in Taizhou will be transferred to an intermediary Hong Kong holding company. The joint venture firm will then raise funds for the construction of the Taizhou project through the sale of convertible notes that will then be convertible into shares of the intermediary holding company.

The structures of the Jiangsu and Havana contracts are thus very different from each other in their particulars. The Havana project consists of a joint venture between a public agency and a private firm, while the three Jiangsu projects will be undertaken by a joint venture consisting of two private firms. Nevertheless, the Havana and Jiangsu contracts share two important features: the need for cooperation among the partners for the venture to succeed and the possibility of strategic behavior undermining the success of the partnership.

This latter point, in turn, raises an important research question: which of the two possibilities will predominate, cooperation or opportunistic behavior? In the remainder of the paper, we present a simplified two-player partnership game and then apply this model to public-private contracts generally.
IV. SIMPLIFIED PARTNERSHIP-GAME MODEL

There is an increasing use of game theory in the water governance literature (see, e.g., Parrachino, et al., 2006; Wei & Gnauck, 2007). Here, we shall present an abstract and simplified game-theoretic model of public-private contracts generally. We recognize at the outset that no two public-private projects in the water sector are alike in all respects, as illustrated by the Havana and Jiangsu projects described above -- since the duration, financial requirements, and other contractual details of each joint venture are sensitive to local conditions and other endogenous factors (such as interest-group politics, public opinion, legal institutions, etc.). Nevertheless, just as game-theoretic models have been used to analyze mutualisms among competing microbes, which form transient partnerships to perform tasks that individual microbes are unable to perform on their own (see, e.g., Marx, 2009), following the lead of Watson (2006) and Levy (2007), we shall apply a game-theoretic framework to public-private contracts as well.

A. Basic assumptions

First, we identify the agents or players, describe their strategy spaces and payoffs, and stipulate the rules of the game. For simplicity, ours is a two-player model, Player A and Player B. For purposes of the model, the identity of the agents is irrelevant: the players could just as will consist of individuals, private firms, or state-owned-enterprises.

We will indicate the strategic investment or strategic effort level (S) of each player with the notation S_A for Player A and S_B for Player B. For simplicity, we limit the effort level of the players to the interval [0, 1], and we assume that each player chooses his or her strategic effort level independently of the other player. Thus: 0 ≤ S_A ≤ 1 and 0 ≤ S_B ≤ 1. That is, both players have available to them a continuum of effort-level strategies between zero and one. At one extreme, each player can choose to invest zero effort in the partnership (S = 0), and at the other extreme, he or she can choose to invest maximum effort (S = 1). Notice that the choice of effort level is a strategic one, since the best choice for each player (i.e., the choice that maximizes his or her individual payoff) will be in large part dependent on the effort level chosen by the other player.

The rules of this partnership game are likewise simple and straightforward. Each partner must decide independently how much time, money, and effort to invest in the joint project, and they agree to split the profits of the partnership equally. This additional assumption regarding 50-50 profit-sharing may not literally apply to all public-private projects, but it is a
close approximation to reality in many public-private partnerships. For example, in those cases requiring some form of competitive bidding prior to the formation of the joint venture, the bid paid by the private partner could represent a kind of ex ante profit-sharing by the state or “public partner.”

Of course, this is a highly stylized and simplified strategy set. In real life, it would be unrealistic to capture a partner’s effort level with a single variable, or to set a fixed upper limit on his or her effort level. Nevertheless, most partnership agreements do, in fact, spell out the inputs to be provided by the partners, and by abstracting from reality and focusing our attention on the underlying structure of the interaction between the partners, we hope to illuminate the tension between cooperation and conflict in real-world public-private partnerships.

B. Payoff functions and best-responses

The payoffs \( V \) of each player can be expressed as a function of their combined effort levels (that is, \( SA \) plus \( SB \)), divided by one-half owing to the 50-50 profit sharing rule, minus the private costs of participating in the partnership (cf. Watson, 2006, p. 81). We ignore social costs and social benefits for simplicity. Since the payoffs to each player are a function of the strategic effort levels \( SA \) and \( SB \) of both players, the payoffs to Player A \( (V_A) \) can be expressed as follows:

\[
V_A(SA, SB) = (1/2)[SA + SB + (SA)(SB)(\epsilon)] - SA^2
\]  

(1.1)

Similarly, since this is a symmetrical interaction, the payoffs to Player B \( (V_B) \) are as follows:

\[
V_B(SA, SB) = (1/2)[SA + SB + (SA)(SB)(\epsilon)] - SB^2
\]  

(1.2)

In other words, the payoffs of each player will be a function of that player’s effort level plus the other player’s effort level plus the product of both players’ efforts combined, multiplied by the constant \( \epsilon \), which represents positive-interaction effects or synergies resulting from the partnership (such as technological expertise, business know-how, access to financing, etc.), minus the private costs to the player of contributing his or her efforts to the joint venture. For simplicity, we will assume that the interaction constant can take on any value between the interval \([0, 1]\). Thus: \( 0 \leq \epsilon \leq 1 \). In addition, the costs corresponding with each player’s effort level are taken to be the square of each
player’s effort level because the cost of providing an extra unit of effort is increasing in the amount of effort already provided. This simplification also allows us to preserve a linear payoff function.

Before proceeding, notice the relation between the interaction constant $c$ in our model and the positive-interaction effects resulting from most public-private partnerships generally. One important rationale for public-private partnerships in the water sector, for example, is that such ventures produce positive synergies that would not exist under an alternative infrastructure model, such as pure public ownership or pure private ownership at the other extreme. The level of this synergy will vary depending on the type of contractual arrangement chosen in each specific case, but the general idea is that both parties -- the public utility and the private firm -- are better off cooperating rather than acting alone.

Having established the payoff functions of the players, the next step in our analysis is to find the “best response” (BR) of each player in this game. That is, what is Player A’s best response (BRA) to each possible strategy choice within Player B’s strategy set (SB), and similarly, what is Player B’s best response (BRB) to Player A’s strategy set $S_A$? At first glance, this may seem like a daunting if not impossible task since both players’ strategy sets are comprised of a continuum of strategies rather than a small number of discrete strategies. After all, there are an infinite number of points between the interval $[0,1]$. Nevertheless, since a best response implies that the player must be maximizing his payoff function, we can convert this analysis into a relatively simple maximization problem, using single-variable calculus to find the first- and second-order conditions of the payoff functions set forth above.

Notice that we assume the goal of the players is, in fact, to maximize their financial rewards or payoffs from the joint venture. While this may be a realistic assumption in the case of private partners, some may object to its application to the state actor or public partner. Nevertheless, to the extent the state actor also wishes the project to succeed, either for benevolent reasons (to provide quality public goods to the poor) or for purely selfish reasons (to stay in power and avoid social unrest), the maximization assumption here serves as a good proxy for the state’s interest for the project to succeed. In any case, it allows us find an explicit, mathematical solution to the best response question.

Beginning with Player A, we find Player A’s best response -- the point at which Player A maximizes his or her payoffs given the strategy set $SB$ of Player B -- by taking the first derivative of Player A’s payoff function ($dVA$) with respect to $S_A$ (the first order condition) and write the new expression as follows:

$$dVA/dS_A = (1/2)[1 + 0 + (1)(SB)(c)] - 2SA$$
Note that because the second derivative of Player A’s payoff function is a negative value \( d''V_A/dS_A = 0 + (1/2)\left[(0) + (0)(s)\right] = -2 = -2 \), we also know that the first order condition of the payoff function is, in fact, a maximum value.

Having maximized Player A’s payoff function in equation 1.3 above, we will next find Player A’s best response \((BRA = S'A)\) to Player B’s strategy set \(SB\). To do this, we set the first-order differential equation above equal to zero, substitute \(S'A\) in place of \(S_A\), and solve for \(S'A\) as follows:

\[
\begin{align*}
(1/2)[1 + (SB)(s)] - 2S'A &= 0 \\
(1/2)[1 + (SB)(s)] &= 2S'
\end{align*}
\]

\[
(1/2)(1/2)[1 + (SB)(s)] = (1/2)(2S'A)
\]

\[
(1/4)[1 + (SB)(s)] = S'A
\]

\[BRA(SB) = (1/4)[1 + (SB)(s)] = S'A \quad (1.4)\]

In other words, equation 1.4 above represents Player A’s best response to each possible choice of effort level within Player B’s strategy set \(SB\). Likewise, we derive Player B’s best response \((BRB)\) to Player A’s strategy set \(SA\). Because the mathematical operations are identical to the ones we have carried out thus far, we will not repeat them but simply write out Player B’s best response function to Player A’s strategy set as follows:

\[BRB(SA) = (1/4)[1 + (SA)(s)] = S'B \quad (1.5)\]

C. Equilibrium analysis

The resulting equilibrium in the effort levels of the partners will depend on the value of the interaction constant \((s)\). For the sake of simplicity, we will examine the following three cases: \(c = 0\), \(c = 1/2\), and \(c = 1\). That is, we will vary the interaction or synergy constant and compare the resulting equilibrium in each
When $c = 0$, there is no positive interaction effect or synergy resulting from the joint venture. This might occur when each partner works alone or separately from the other. Under this scenario, Player A’s best response is an effort level of $1/4$ or $0.25$, far below the maximum effort level of $1$, while Player B’s best response is also $1/4$.

Next, when $c = 1/2$ or $0.5$, the synergy resulting from the partnership is equal to one-half the product of both players’ effort levels, and the resulting best response equilibrium of both players comes to $0.285$. Notice that although the value of the synergy variable has increased one-half unit, the resulting increase in the effort level of the players has increased by a much smaller amount.

Lastly, when $c = 1$, the interaction effect is equal to the product of both players effort levels. The greater their effort levels, the greater the synergy resulting from their partnership. Under this scenario, however, the resulting equilibrium for both players is an effort level of only $3/8$ or $0.365$ the maximum effort, a small increase over the previous equilibrium effort levels. Thus, the effort level under this equilibrium increased by a smaller rate than the increase in the interaction constant.

We now begin to detect the emergence of a pattern. Although the interaction constant has increased by one-half unit (from $0$ to $1/2$ and from $1/2$ to $1$), the effort level at equilibrium has increased by a much smaller unit (from $0.25$ to $0.285$ and from $0.285$ to $0.365$). More significantly, as we shall discuss in subsection IV.D below, the best responses of the players are sub-optimal from the perspective of the partnership per se (as opposed to the perspective of the individual partners).

In addition, in all three cases set forth above ($c = 0, 1/2, \text{ and } 1$) the equilibrium point always occurred at the intersection of both players’ best response functions ($S^*A = S^*B$). Although the actual location of the intersection depended on the magnitude of the interaction constant, we are able to find the general equilibrium $S^*A = S^*B$ by substituting $S^*A$ for $S^*A$ and $S^*B$ in Player A’s best response function and solving for $S^*A$ as follows:

\[ S^*A = (1/4)[1 + (S^*A)(c)] \]

\[ 4S^*A = 1 + (S^*A)(c) \]

\[ 4S^*A - (S^*A)(c) = 1 \]

\[ S^*A(4 - c) = 1 \]
This general equilibrium equation tells us that the optimal effort levels of Player A and Player B at equilibrium will always be less than one, regardless of the value of c, the interaction variable (i.e., \( S^*A < 1; S^*B < 1 \)). This seems to imply that there is a significant divergence or conflict of interest between the individual partners on the one hand and the partnership entity itself on the other hand. We explain and discuss the significance of this finding in subsection IV.D below.

D. Discussion: the problem of “internal externalities”

The model presented in this paper shows that the best response of each individual player at equilibrium will be less than optimal from the perspective of the partnership. Although both players have an incentive to increase their respective effort levels as the value of interaction variable c increases, the resulting increase in \( S^*A \) and \( S^*B \) will be a fraction of the corresponding increase in the interaction constant c. To sum up, the total effort level of each player will remain far below its maximum value, and at the margin, the effort levels of the players will increase at a rate much smaller than the corresponding increase in the interaction variable.

In the context of a partnership or other cooperative venture, this model predicts that the partners will end up underinvesting in the joint venture, ultimately resulting in smaller joint gains. This underinvestment behavior thus produces an “internal-externality” within the joint venture: had the players chosen a higher effort level, the partnership would have generated higher joint payoffs for both players. But by choosing a lower effort level instead -- lower than optimal not from the individual player’s perspective but from the perspective of the partnership -- each player ends up externalizing or shifting the loss of this foregone gain on the other player and on the partnership as a whole.

The ultimate source of this problem is the distribution of costs and benefits within the partnership. Each player bears the full cost of his or her effort level -- the \( S^2 \)-squared and \( SB \)-squared terms that appear on the right-hand side of the initial payoff functions set forth in equations 1.1 and 1.2 above -- while the benefits generated by their joint efforts are spread out evenly between the players. At the margin, then, each player bears the full cost of any additional increase in his or her effort level but obtains only half the benefit resulting from the corresponding increase in the effort level (cf.
Hardin, 1968). This type of payoff structure in which benefits are spread out and costs are concentrated produces what we will call an “internal-externality problem.”

The size or magnitude of this internal-externality problem will depend on the difference between the individual payoffs at equilibrium and the higher joint payoffs that could have been generated by the partnership had the players chosen a higher effort level. For example, instead of maximizing the individual payoffs of the players, let us maximize the joint payoffs of the partnership ($VP$) (i.e., let us maximize the revenue of partnership net of total effort costs). From the perspective of the partnership (as opposed to the individual partners), its payoff function is now as follows:

$$VP(S_A, S_B) = S_A + S_B + [(S_A)(S_B)(\hat{\epsilon})] - S_A^2 - S_B^2$$

(1.7)

Now, let us assume that $S_A = S_B = S$ (that is, we assume that the partners are able to coordinate their strategic effort levels and choose to invest the same level of effort) and simplify the above expression as follows:

$$VP(S) = S + S + [(S)(S)(\hat{\epsilon})] - S^2 - S^2$$

$$VP(S) = 2S + [(\hat{\epsilon})(S)(\text{square})] - 2S^2$$

(1.8)

To maximize this function, we find the first derivative of $VP$ with respect to the effort level $S$ as follows:

$$dVP/dS = 2 + (2S)(\hat{\epsilon}) - 4S$$

(1.9)

Note that the above equation represents a maximum value when $\hat{\epsilon} < 2$ because the second derivative of this equation with respect to $S$ is two times $\hat{\epsilon}$ minus 4 (that is, $d''VP/dS = 0 + 2\hat{\epsilon} - 4 = 2\hat{\epsilon} - 4$). Since the maximum value of $\hat{\epsilon}$ in our model is 1, the first order condition is indeed a maximum value.

Next, we set equation (1.9) equal to zero, substitute $S'$ in place of $S$, and solve for $S'$ to find the optimal effort level of the partnership (that is, the optimal level not of the individual partners, but of the partnership):

$$2 + (2S')(\hat{\epsilon}) - 4S' = 0$$

$$2 = 4S' - (2S')(\hat{\epsilon})$$
Lastly, we consider the following three cases ($c = 0$, $c = 1/2$, and $c = 1$) and determine the optimal effort level ($S$) from the perspective of the partnership for each case. In summary, when $c = 0$, the optimal effort level of the partnership is $1/2$; when $c = 1/2$, the optimal effort level is $2/3$; and when $c = 1$, the optimal effort level is $1$. Notice that in each case, the corresponding optimal effort level from the partnership’s perspective is far greater than the best-response level from the players’ individual perspective as set forth in subsection IV.C above).

In other words, if the players aim to maximize the payoffs of the partnership per se, and if they could agree to provide the same amount of effort level as each other, the players would end up investing a significantly higher effort level than under the previous scenario (in which the players attempt to maximize their individual payoffs). This difference between individual and group payoffs is the amount of the “internal externality.”

Turning our attention back to the water sector, this analysis suggests that public-private partnerships might suffer from underinvestment and that the design of such partnerships must be sensitive to this problem.

V. CONCLUSION

Our game-theoretic model of public-private partnerships predicts that such ventures will suffer from underinvestment, but how serious is this underinvestment problem in the real world, and what are the most cost-effective solutions to this problem? These are no doubt complex and thorny empirical questions and thus require further research (see, e.g., Renzetti & Dupont, 2003; Sader, 1999). Yet, when underinvestment is seen as a kind of externality problem, we can immediately identify several broad categories or types of potential solutions, following the lead of Coase (1960).

One possible solution is, of course, single ownership, either private or public, of water infrastructure projects. Another possible solution might consist of the imposition of a “shirking tax” on underinvesting partners, although this type of solution would have to consider the administrative costs and distortion effects of Pigovian taxes generally. Yet another possible solution might be the creation of default rules or governance frameworks that reduce
transaction costs and encourage Coasian bargaining between the participants in public-private joint ventures. As an aside, this may explain why most public-private contractual arrangements have finite durations instead of being open-ended. Nevertheless, this type of solution would still have to overcome several potential obstacles, such as the possibility of stalemate (Schelling, 1960) and the hold-up problem resulting from asset-specific investments (Klein, et al., 1978).

Accordingly, in place of a top-down, one-size-fits-all solution, we conclude that water governance systems should continue to permit experimentation with alternative public-private contractual mechanisms to determine through trial-and-error which of these solutions best promote efficiency and equity in the water industry.

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THE FRENCH STRATEGIC INVESTMENT FUND:
A CREATIVE APPROACH TO COMPLEMENT SWF REGULATION
OR MERE PROTECTIONISM?

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INTRODUCTION

While oil-rich countries of the Persian Gulf or Asian countries with immense foreign exchange surpluses dominated the financial debates with their Sovereign Wealth Funds, France decided to launch its own, comparatively very small, Fonds Stratégique d’Investissement, in the middle of the crisis one year ago. Was it a protectionist reflex or is it rather part of a pro-active defence strategy, a way to participate in the global phenomenon of SWFs?

In a first part, I will describe and define the phenomenon of SWFs and the related concerns raised by the different involved parties, and then, in the main part, expose my favoured regulatory framework, i.e. a pragmatic approach based on current achievements by the international community on one hand and domestic regulations on the other hand. France will be particularly interesting, now that it is as well a donor country as a recipient country. Could it even be the much-sought ideal type of SWF-regulation? To conclude, I will look critically at how the French SWF was set up and how it has evolved since its inception.

*     *     *

DEFINITIONS AND CONCERNS RAISED BY SOVEREIGN WEALTH FUNDS

Sovereign Wealth Funds (SWF) are not a new phenomenon: They have been around since 1953, when the Kuwait Investment Authority, now the world’s fourth largest SWF, was founded3. But they eventually caught the attention of the West around 2005, when the United States and Europe became aware that oil-rich or exporting countries from the Middle East and Asia had set up large and rapidly growing SWFs and were launching more aggressive investment strategies towards their economies. They became a source of concern when the major geopolitical actors China and Russia set up their own funds. The visibility of the SWFs reached its paroxysm in 2008, during the financial crisis, when they invested massively to save financial institutions. Since then, as we

3 Ian Bremmer, State Capitalism Comes of Age - The End of the Free Market?, 88 Foreign Aff. 40 2009, p. 44
will see, there has been a shift in the strategies and in the perception of SWFs by host countries.

It is not easy to define SWFs, as there is no such thing as a typical SWF; they are all different. Nonetheless, they share certain characteristics and can be put into categories, for instance regarding the origin of their wealth (commodity exports or foreign exchange surpluses) or their purpose (stabilising funds, savings funds, reserve investment corporations). The International Working Group on Sovereign Wealth Funds (IWG) defines SWFs as “special purpose investment funds or arrangements, owned by the general government. Created by the general government for macroeconomic purposes, sovereign wealth funds hold, manage, or administer assets to achieve financial objectives, and employ a set of investment strategies which include investing in foreign financial assets.”

This definition excludes operations of state-owned enterprises (SOEs), government-employee pension-funds, or assets managed for the benefit of individuals. The IWG emphasises three key-elements: (1) SWFs are owned by the general government; (2) the investment strategies include investments in foreign financial assets, thereby explicitly excluding those funds that solely invest in domestic assets; (3) SWFs are created to achieve financial objectives. Being more precise, this definition is also narrower and the second point would exclude funds such as Malaysia’s Khazanah Nasional or, before they started investing abroad, Singapore’s Temasek Holding and Abu Dhabi’s Mubadala Development Company. Obviously, the IWG based its definition on the assumption that governmental funds do not raise particular concerns abroad if they invest only on the domestic market and, hence, do not need to be addressed by the international community.

Before the financial crisis, recipient countries evoked several concerns pertaining to the size and rapid growth of the funds, in relation with their potential macroeconomic effects and the political or geostrategic agendas of the donor countries.

As far as we can evaluate it based on published data or extrapolations, the amount of assets held by the SWFs is impressive: The aggregate portfolio managed by the SWFs is estimated between 2 and 3 trillion USD, which exceeds the assets held by all hedge funds, but is still inferior to the total assets under private management ($53 trillion). The largest fund, Abu Dhabi’s ADIA

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5 now renamed International Forum on Sovereign Wealth Funds
6 Sovereign Wealth Funds, Generally Accepted Principles and Practices, “Santiago Principles”, October 2008, p. 3 (and Appendix I, p. 27)
7 Ibidem
8 Trésor-Economics, No. 28, January 2008, p. 1
is deemed to manage between $500 and $900 billion\(^9\). Comparing the situation before and after the crisis, Beck and Fidora expose that SWFs “would surpass official foreign exchange reserves and reach USD 7,000 billion by 2014”\(^{10}\) and conclude that “there are no grounds to believe that sovereign wealth funds would become less important players in global financial markets in the future”\(^{11}\).

Despite recognised benefits, such as making the SWF’s donor country “a partner in the economic health of the host country” or potentially leading “to more open and better functioning markets within the investor nation” through encouraged reciprocity, or in particular the fostering of financial stability\(^{12}\), the size and growth of SWFs has raised concerns of economic nature, such as a potential distortion of asset prices in case of portfolio shifts or rumours. However, such an effect would be contrary to the theory of financial markets\(^{13}\), and experts agree that, overall, “the growing demand by SWFs for financial assets should be positive for the world economy”, given the fact that “SWFs typically have a high foreign currency exposure, no explicit liabilities that trigger leverage or funding liquidity pressures” and that they have “a greater capacity than many other large investors to take long-term views on investments, namely to follow buy-and-hold strategies”\(^{14}\). Doubtless, SWFs were very helpful in recapitalising affected financial institutes, thus participating in the stabilisation of the whole banking sector. It must be underlined that it was the banks themselves who asked the different SWFs to intervene, and further that the funds are not participating in the management of the concerned banks, although their financial participations would definitely legitimise them to do so\(^{15}\).

Concurrently with the nascent SWF phenomenon, the Western economies were challenged by the rise of the new economic order, which allegedly entailed, besides a change in the flow of capital, relocation of businesses to lower cost-destinations, loss of jobs, and reverse-privatisations\(^{16}\). While SWFs do not cause this change, they are definitely part of this bigger picture. Hassan sees the root of anxiety over SWFs “in the anxiousness about the unmooring

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\(^{9}\) CRS-Report, p. 6

\(^{10}\) Roland Beck and Michael Fidora, Sovereign Wealth Funds – Before and Since the Crisis, European Business Organizaiton Law Review 10 (2009), p. 359

\(^{11}\) Id., p. 360

\(^{12}\) Paul Rose, Sovereigns as Shareholders, 87 N.C. L. Rev. 83 2008-2009, p. 92 et seq.

\(^{13}\) although documented in empirical literature on price pressure in financial markets, see Beck and Fidora, p. 360 et seq.

\(^{14}\) Trésor-Economics, No. 28, January 2008, p. 5

\(^{15}\) Alain Demarolle, Rapport sur les Fonds souverains, p. 12

\(^{16}\) Gal Luft, Sovereign Wealth Funds, Oil and the New World Economic Order, in The Rise of Sovereign Wealth Funds: Impacts on U.S. Foreign Policy and Economic Interest, Washington DC, 21 May 2008, p. 35 et seq.
of the intellectual foundations of laissez-faire capitalism.” He correctly highlights the “struggle about the real role of private enterprise and where should the boundaries of the state end” and the “anxiety about the loss of sovereign power and its geopolitical consequences”.

The concerns of political nature are due to the fact that SWFs are an investment arm of sovereign entities. Hence, unlike other investors, they could possibly be used as means to advance the political or geostrategic agendas of their governments rather than as investment devices. Röller and Véron identify three categories of threats potentially posed by a foreign acquisition of a US or EU company: (i) dependency upon a foreign-controlled supplier for crucial goods or services (incl. defence industry); (ii) transfer of technology or other expertise; and (iii) infiltration, surveillance, or sabotage, harming crucial areas like defence.

Such threats are not unlikely. Indeed, China’s ambitions over Africa, for example, are evident. Moreover, Bremmer notes that the leadership of the Chinese Communist Party “dispatches China’s national oil corporations abroad to secure the long-term supplies of oil and gas that China needs to fuel its continued expansion.” Also Russia’s endeavours are taken seriously by its neighbours such as Ukraine. However, so far, these threats have supposedly materialised not through SWFs (with the exception of Temasek and Dubai Ports World, if we consider it as extended Arm of the Dubai World fund) but through SOEs:

- In August 2005, the Chinese CNOOC had to renounce to take control over UNOCAL because of pressure of the US authorities.
- In January 2006, Temasek had to reduce the stakeholding it aimed at in Shin Corp, a Thai media enterprise, to 42% after major uprisings had occurred in the host country.

17 Adnan Hassan, A Practical Guide to Sovereign Wealth Funds, p. 4
18 Ibidem. See also Rose, p. 95, regarding the rise of state capitalism.
19 Ibidem
20 Rose, p. 94-96, with obvious and subtle hypothetical examples
21 Lars-Hendrik Rölle and Nicolas Véron, Safe and Sound: An EU Approach to Sovereign Investment, Bruegel Policy Brief Issue 08/2008, p. 4
23 Bremmer, p. 44 et seq.
24 “Russia will use the economic factors to transform the internal politics of Ukraine”, said Hrigoriy Perepelitsa, director of Foreign Policy Research Institute, the academy of the Ukrainian Foreign Ministry, quoted in Claude Barfield, Beware of Investment Protectionism, The American (The Journal of the American Enterprise Institute), 17 December 2008
25 Demarolle, p. 12 et seq.
• In May 2006, the sale of six American ports to Dubai Ports World had to be abandoned after strong reactions by Congress (although the deal had been accepted after CFIUS review).

• In May 2006, the British Secretary of State for Trade and Industry, Alan Johnson, announced a “robust scrutiny” over the bid by Gazprom over the British Centrica. The deal has not (yet) been concluded.

• In September 2006, the public Russian Bank VTB acquired 5.02% of European Aeronautic Defence & Space Co. (“EADS”), which entailed doubts by France and Germany regarding the underlying intentions. “The Russian firm was more likely pursuing political goals as well as financial goals, evidenced by a comment from Sergei Prikhodko, an aide to Russian President Vladimir Putin.”

While there is little doubt that a SWF can exercise considerable influence over a company through a full takeover, Demarolle asks the right questions in relation with minority share stakes: (i) Is a minority stake – especially without representative on the board – really an efficient way to achieve the above mentioned goals (especially with regard to technological and strategic transfers)? (ii) Is a SWF truly the adequate instrument for a national government, to achieve these goals? SOEs, which have the necessary experience and know-how, are much more likely to exercise influence. Furthermore, there are other (more) adequate ways to achieve geopolitical and strategic goals. Thus, it would be wrong to focus solely on the phenomenon of sovereign wealth funds while leaving aside the broader threat of foreign governments (or private firms secretly acting for foreign governments). This being said, while the concerns were focussed on the efficient functioning of financial markets and on national security, there has been a certain shift since the financial crisis: Indeed, SWFs are now increasingly investing in developing countries. Today, according to the OCDE, 69% of their wealth is invested in Northern America and in Europe, but they are now investing 7 to 10% of their wealth in shares of emerging markets, i.e. an annual inflow of $100 billion. There is rather another concern: Western nations ask themselves

26 Rose, p. 128
27 Id. P. 13 et seq.
28 Beck and Fidora, p. 365
29 Lyons, p. 18
how to maintain and attract foreign investors and in particular SWFs. Therefore they understand that they have to avoid protectionism. Hence there is a tension between open markets and protection of national interests.

**THE NEED FOR REGULATION & THE PRAGMATIC APPROACH**

1. *Why regulate the SWF*

During the last two or three decades, there was a belief in predominantly neo-liberal countries that it is best to have as few regulations as possible. However, every society, every market needs basic rules to function. When we ask ourselves why to regulate, we must look beyond law to other disciplines. In the ambit of SWF, we must seek on one hand what is best for the recipient country and, on the other hand, what is best for the donor country. How to define “the best”? Even within a state, there are many contradicting positions, for example between public and private interests. This renders regulation particularly complicated when several states or a whole community of nations are concerned. From a public interest perspective, regulation can be deemed necessary in case of market failures. The financial crisis has shown us where deregulation or a laissez-faire policy can lead if nobody at all takes the initiative of regulating. Of course, a public response in the form of exaggerated regulation can have as bad consequences and, for instance, obstruct or even paralyse the economy. Public responses are requested in fields such as national security, in order to obtain diversity, for instance in broadcasting, or in case of irreversibility, i.e. when the market would likely fail and lead to irreparable consequences for future generations, such as loss of know-how or extinction of endangered species. In these cases, at least at domestic level, law has a facilitating role to achieve chosen public interest objectives. On the other hand, “private interest theories of regulation are premised on an assumption that regulation emerges from the actions of individuals or groups motivated to maximise their self-interest.” They are often linked with deregulation or self-regulation. As exposed in the regulatory space theory, “actions and intentions of regulatory actors are embedded in larger systems and institutional dynamics”. Cultural differences are reflected in the political and legal outcome.

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31 Ha-Joon Chang, Ha-Joon Chang, Globalisation, Economic Development and the Role of the State, p. 177
32 Bronwen Morgan and Karen Yeung, An Introduction to Law and Regulation, p. 16.
33 Id., p. 18
34 Id., p. 20
35 Id., p. 31
36 Id., p. 35
37 Id., p. 43
This explains why certain regulations “may involve very similar actors in different countries and yet different national political contexts would shape the preferences of those actors in different ways, leading to the emergence of different regulatory regimes.”

On these premises, let us examine how to best address the concerns exposed in the first chapter, beginning with the recipient countries of the West. These capital-importing countries desperately need to attract foreign investments and acutely compete for it. They all recognise that “the rule of law and an appropriate degree of stability and predictability of policies form the governmental framework for domestic economic growth and also for the willingness of foreign investors to enter the domestic market.” Economic liberalism, as defined by the Washington Consensus in the late 1980s, promising “more growth and innovation than economic protectionism within closed national or regional borders” is still the dominant theory amongst them, even though they recognise that “economic reforms need to be complemented by social and environmental policies.” However, in reality, their economies have never been completely open or completely closed. Furthermore, there are very different policies from one country to another. Even identical words, for instance ‘protectionism’, can have very different meanings from one order to another. On the other hand, as pointed out in the previous chapter, fears regarding strategic influences sought by foreign public investors must be taken seriously. Hence there must be a well-balanced mechanism to avoid unwanted intrusion without blocking foreign investments. Blocking foreign investments can be not only harmful to the domestic economy but also, as in the case of the EU, threaten a superior order, the single market. Sovereign wealth funds, for their part, want to access capital markets as freely as possible. Their money loses its value every day it is not invested. Therefore, they have to try to alleviate the fears of potential recipient countries, without divulging some strategies that are part of their competitive advantage over others. As an alternative, or if they are scrutinised too closely or hindered from entering a market in spite of their efforts, they can seek for more friendly jurisdictions or more interesting investments. Donor countries, respectively their citizens whose money is being invested, also have legitimate claims. They should expect increased revenues or at least preservation of their assets, but also sound investment strategies, a good management, access to information and accountability. If their claims are not

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38 Id., p. 59 and 65 regarding national particularities
40 Id., p. 79
heard, they can use their political weapons, mainly electoral powers, but if necessary also, like in Thailand, public protests.

2. Existing regulation

Different ways have been explored to achieve some of the regulation goals outlined above. Whereas some solutions have been elaborated at a national level\textsuperscript{41}, no hard-law mechanism has been set up at the international level. One solution would have been to regulate SWFs through a Multilateral Investment Agreement. In spite of long negotiations held under the auspices of the World Bank and the OECD and several drafts, and although there were large areas of consent, this endeavour had to be halted in 1998 because of several points of disagreement, such as the ‘exception culturelle’ claimed by France and Canada in support of the French culture\textsuperscript{42}. Possibly the OECD, regrouping mainly the (once) capital-exporting countries, was not the adequate forum for a question of world-importance. But then, the World Trade Organisation did not better, since its aim to include investment issues into its mandate failed as early as 1994\textsuperscript{43}. Its agenda on trade issues was already complex enough.

Since multilateral options were unsuccessful, bilateral options could be explored. Whereas foreign direct investments (FDI, i.e. concrete investments in a foreign country, such as building a factory, setting up a business or a joint venture) are protected by customary international law, this is not the case of portfolio investments (mere holding of shares possibly bought on the stock exchange). The latter are usually not covered by Bilateral Investment Treaties (BITs), although there is a trend towards including them\textsuperscript{44}. Hence, SOEs are more likely to be subsumed under existing treaties (which does not entail automatic approval of the investment/permission to enter the market) than funds that just buy and sell shares, even if they hold them for a certain period. BITs could be relatively easily adapted by a side-letter procedure (instead of redrafting the BIT), but this would nonetheless require distinct negotiations between donor and host states. Since every country has its specificities and given that every SWF is different, there would be endless negotiations and, in the end, no uniform practice, hence no favourable outcome for investors or investees.

Given these unfortunate non-results among states on the international level, recipient countries, acknowledging the “positive force for development and

\textsuperscript{41} see below under sub-chapter 3
\textsuperscript{43} Id., p. 27
\textsuperscript{44} Sornarajah, p. 7, 8 and 227
global financial stability” of SWFs, took the initiative to produce the “OECD Declaration on Sovereign Wealth Funds and Recipient Country Policies” at the OECD Ministerial Council Meeting on 4-5 June 2008 in Paris. They basically agreed, respectively repeated long-standing OECD commitments, on a voluntary, non-binding basis, that “(i) recipient countries should not erect protectionist barriers to foreign investment; (ii) recipient countries should not discriminate among investors in like circumstances. Any additional investment restrictions in recipient countries should only be considered when policies of general application to both foreign and domestic investors are inadequate to address legitimate national security concerns; and (iii) where such national security concerns do arise, investment safeguards by recipient countries should be: a) transparent and predictable, b) proportional to clearly-identified national security risks, and 3) subject to accountability in their application.” This has to be seen as a response of the recipient countries to the voluntary framework the donor countries were setting up, and to which procedure the OECD could openly contribute.

In effect, in October 2008, the donor countries, encouraged and supported by the IMF, regulating themselves within the IWG, adopted the Generally Accepted Principles and Practices (GAPP), the so-called “Santiago Principles”. “The IWG is of the view that the GAPP, together with the OECD’s guidance for recipient countries, will help achieve the shared goal of maintaining a stable and open investment environment.” These principles as well represent mere voluntary guidelines, thanks to which they are more than the lowest common denominator. If they had been obliged to agree on already achieved standards or on compulsory goals, SWFs or their home countries, would not have reached a productive consensus, if any at all. But this way, there is a horizon to which the SWFs can strive. There is hope that peer pressure, acculturation and positive feedback from the recipient countries will guide more reticent funds towards the goals agreed upon, in a similar way (but without the pretention of becoming customary law) like the Universal Declaration of Human Rights, now the basis for Human Rights all around the world. In order to share gained experiences and to discuss further developments, the funds established a rather informal International Forum on Sovereign Wealth Funds, which replaced the IWG on April 2009. Principles agreed upon include a sound legal framework to support the SWF’s effective operation and the achievement of its stated objectives (GAPP 1), clear definition and disclosure of the policy (GAPP 2), a sound and clear governance framework (GAPP 6), a clearly defined accountability framework (GAPP 10), an annual report and audited

45 OECD Declaration on Sovereign Wealth Funds and Recipient Country Policies, p. 2
46 GAPP, p. 4
financial statements (GAPP 11 and 12), respect of all applicable regulatory and disclosure requirements of the countries in which they operate (GAPP 15).

Finally, and importantly, pursuant to GAPP 19, the SWF’s investment decisions should aim to maximize risk-adjusted financial returns in a manner consistent with its investment policy, and based on economic and financial grounds. If investment decisions are subject to other than economic and financial considerations, GAPP 19.1 provides that these should be clearly set out in the investment policy and be publicly disclosed.

3. Pragmatic approach of SWF regulation

My approach of SWF regulation will be a pragmatic one; it relies on the diagnosis that the nations are too diverse to be able to agree, today, on a global and binding framework to regulate foreign investments, a fortiori SWFs. Conversely, SWFs are too multifaceted to be governed under a detailed and compulsory international framework. Under these circumstances, the voluntary instruments provided by the OECD and the IWG are adequate, if not ideal, to alleviate concerns of capital-importing countries as well as those of investing SWFs, but they have to be complemented by national regulations. Hence, countries not adhering to the OECD Principles, for instance too protectionist states, will forgo chances of investment in their domestic economies, whereas secretive and refractory SWFs will not be likely to operate any lucrative investment in developed countries.

The OECD Principles allow countries to set up investment safeguards in case of national security concerns, as long as they do not constitute protectionist barriers. I will compare two countries that have developed interesting systems to avoid potentially harmful foreign investments: the USA and France.

a) USA: CFIUS Review Process

The Foreign Investment and National Security Act of 2007 (FINSA) updated the framework established in 1975, when President Gerald Ford created the Committee on Foreign Investments in the United States (CFIUS), a body composed of different governmental agencies chaired by the Treasury. One of the goals of the reform was to address SWFs, given the growing frequency of important US assets acquisitions by these vehicles. Concerned about the disastrous precedent of Dubai Ports World, possible backlashes in other parts

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48 George Stephanov Georgiev, The Reformed CFIUS Regulatory Framework: Mediating Between Continued Openness to Foreign Investment and National Security, p. 126, citing the example of the Sarbanes-Oxley Act of 2002 which already showed such shifts from the US to Europe and Asia.

49 Georgiev, p. 131, notes that “foreign investments in the US originating from the UAE alone fell by over $1 billion in 2006”.

(2010) J. App. Econ. 68
of the world in case of perceived protectionism, and the competition for foreign investments pushed by other developed countries, the US had to take care to remain open to foreign investment.

The CFIUS review process starts either on recommendation from a CFIUS member agency or, most likely, with a voluntary notice from a party to a potential transaction that could harm national security. The process is fairly efficient, since the review potentially initiated by CFIUS lasts only 30 days. After this period, the committee either concludes that no threat exists and ends the review or commences a forty-five day investigation. It then sends its recommendations to the President, which may, within fifteen days, “suspend, prohibit, or order certain modifications to the transaction through a mitigation agreement, or [he] may permit the acquisition by not taking any action.

Regardless of the outcome, [he] must submit a report to Congress explaining [his] decision.” 50 A positive feature lies in the regulatory safe harbour provided to investors once their transaction has undergone review: it is then immunised against subsequent reviews. Further, a single process allows standard treatment nation-wide. The role of Congress is increased through reporting requirements, but it cannot block specific transactions; the whole process operates within the administration. All concerned agencies and departments participate in the operations, including intelligence agencies. More problematic is the fact that FINSA does not define “national security”. There is however a non-exhaustive list of factors to consider in determining the existence of a threat to national security, i.e. among others “domestic production needed for projected national defense requirements, the control of domestic industries and commercial activity by foreign citizens as it affects the capability and capacity of the US to meet national security requirements (…)” 51. The new list “adds the potential effects of a transaction on critical infrastructure including major energy assets; the potential effects on sales of military goods or technology to countries posing a regional military threat to the US.” 52 Some problems were not solved with this legislative update, such as higher transaction costs, the potential use of the process for political or own financial means 53, and the necessity to address “problems arising outside of a change of corporate ownership or control”, for which there still have to be additional mechanisms to detect and remedy national security issues 54. Hence, CFIUS alone cannot resolve all possible problems caused by potentially harmful foreign investments.

50 Georgiev, p. 127 et seq.
51 Georgiev, p. 127
52 Id., p. 133
53 Id., p. 129; Rose, p. 112 et seq.
54 Id., p. 129
b) France: Decree of 31 December 2005 and Economic Patriotism

France is part of the European Union (EU) that regards FDI flows as “a crucial element for the consolidation of the internal market, while investments to and from the rest of the world ensure that the EU is well positioned in world markets and well integrated in worldwide technology flows”\(^{55}\). Unfortunately, the EU has not (yet?) been able to set up a system like CFIUS governing foreign investments for its whole territory\(^{56}\). Therefore, EU member states remain solely responsible for the assessment of national security issues. There are, nonetheless, certain provisions in the European Community Treaty and case law that are relevant to foreign investments\(^{57}\): They require EU member states to allow the free movement of capital, not only of investors within the EU but also of foreign investors.

“France does not have any laws or policies that specifically restrict SOEs or SWFs from investing in France.”\(^{58}\) However, there is also an ex-ante review process, conducted by the Ministry of Economy, Finance, and Employment, in a timeframe of two months. Other agencies, such as the Ministry of Defence, are asked for their inputs. The Decree, akin to FINSA, provides for mitigation through the attachment of conditions to the eventual agreement. Unlike the US, France has established a list of eleven protected sectors requiring authorisation in its Decree No. 2005-1739. Given such a precise definition of national defence and public security, France claims that its system is clear and transparent to foreign investors. Among the sensitive sectors, there are (1) gambling and casinos\(^{59}\), (6) production of goods or supply of services to ensure the security of the information systems, and (9) activities carried out by firms entrusted with national defence contracts or of security clauses\(^{60}\). However,

\(^{56}\) For a sound analysis and a balanced solution for the EU, establishing a common framework and leaving the execution to the member states, see Röller and Véron, p. 7 and 8. See also Maaike Okano-Heijmans and Fans-Paul van der Putten, Europe needs to screen Chinese investment, Financial Times, 11 August 2009, available under <http://www.eastasiaforum.org/2009/08/18/europe-needs-to-screen-chinese-investment/>.
\(^{57}\) mainly article 56, implementing OECD principles in the EU. Pursuant to article 188C of the Lisbon Treaty, FDI will be included in the common commercial policy for which the EU will have exclusive competence.
\(^{59}\) The EC however formally asked France to amend its Decree in 2006; discussions are still ongoing.
there are several additional laws restricting foreign investments, for example in
audiovisual communications and media companies (cf. the French exception
culturelle), in the banking and insurance sector and in the aerospace sector.

“Finally, a number of public monopolies exist in France that are not open to
investment, including atomic energy, railway passenger transport, coal mines,
gunpowder and explosives, and certain postal services.”  

An important sector is missing from the lists: the energy infrastructure. Although there has been a
parliamentary motion in June 2007, there is still no relevant legal provision. In
spite of this, “while the use of government golden shares is not targeted at
foreign investors, the French government could use such a share to oppose
any measure that might jeopardize the security of energy supplies – potentially
including the purchase of French energy infrastructure by foreign state-owned
terprises, private hedge funds, or sovereign wealth funds.”  

The amount of restrictions just listed above hints beyond doubt a certain economic patriotism,
if not outright protectionism. But, to be fair, it must be underlined that out of
68 cases treated between 2006 and 2007, none has been refused by the
Ministry and all the investors accepted the mitigation agreements proposed in
slightly over 50% of the cases. Moreover, many SWFs have already
successfully invested in France.

In his article “Globalization à la Carte”, Sabatier marvellously illustrated the
French paradox: France constantly insists on the importance of foreign
investments in France, also by SWFs, and commits itself to free trade and
capital flow, but often only in one direction: French companies buy American
companies (Alcatel-Lucent) and operate railways throughout the world
(Connex, Veolia Transport), but when a foreign investor intends to enter the
French market, there is always a reason why it is not possible in the instant
case. I agree with the authors who recognise that economic liberalism is not
absolute, that nationalist policies such as those pertaining to culture protection
or industrial policy (namely with regard to the theory of irreversibility) may be

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61 Id., p. 58 et seq.
62 Id., p. 59.
63 Demarolle, p. 25
64 Demarolle, p. 21
65 Patrick Sabatier, Globalization à la Carte, International Herald Tribune, 8 May 2006,
available under <http://www.nytimes.com/2006/05/18/opinion/18iht-edssabat.html>; see
also Carlo Stagnaro and Alberto Mignardi, Protectionism Will Kill Europe, The Independent
66 Demarolle, p. 21 et seq.
67 PepsiCo-Danone; GDF merged with Suez to prevent the latter from becoming the prey of
the Italian Enel.
68 Robert Gilpin, Global Political Economy – Understanding the International Economic
Order, Princetown University Press, Princetown and Oxford, p. 14
justified under certain circumstances. “The question of purpose [of economic activity] is at the core of political economy, and the answer is a political matter that society must determine.”\textsuperscript{69} Sabatier\textsuperscript{70} quoted a poll according to which public opinion favours economic patriotism to 69%. It is hard thus, for the state, to ignore such a clear result. This explains why state capitalism has always been widely accepted in France, even by right wing politicians, as opposed to the US or other European countries that do not share France’s “protectionism”. This is also why Wintrebert\textsuperscript{71}, by trying to reformulate the conditions necessary for a European protectionism, insists that the antagonism between free trade and protectionism must be qualified.

Under these premises, is the sovereign wealth fund established by France one year ago a creative way of complementing the existing review mechanism or is it just another protectionist device?

\textbf{THE FONDS STRATÉGIQUE D’INVESTISSEMENT}

At the G7 meeting in 2007, President Nicolas Sarkozy attacked SWFs.\textsuperscript{72} One year later, he set up the French-style SWF\textsuperscript{73}: The Strategic Investment Fund (SIF).

The SIF was created in the middle of the global downturn in order to support the development of small and mid-cap enterprises with a strong potential for innovation and sector leadership, and to stabilise the capital companies deemed strategic to the French economy (i.e. those possessing specific know-how, key-technologies, jobs of national importance, and in general the automobile, aerospace, shipbuilding and railway industries). It was endowed with EUR 20 billion, i.e. 14 billion worth of stakes in French companies, previously held by the government and the Caisse des Dépôts et Consignations (CDC), and 6 billion of cash. The fund is owned by CDC (51%) and the French government (49%).

Although it is definitely sovereign, in the sense of government owned, and even strategic, the SIF is at odds with the definition of SWFs exposed at the very beginning of this paper. Firstly, France did not have any surpluses that it wanted to manage separately from the central bank; but at least the fund owns

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{69} Gilpin, p. 24
\item \textsuperscript{70} cf. FN 65
\item \textsuperscript{71} Raphaël Wintrebert, Free Trade vs. Protectionism: Extricating France form a False Dilemma, Working Paper
\item \textsuperscript{72} “We’ve decided not to let ourselves be sold down the river by speculative funds, by unscrupulous attitudes which do not meet the transparency criteria one is entitled to expect in a civilised world. It’s unacceptable and we have decided not to accept it.”, quoted in Larry Elliott, Darling backs G7 move on sovereign funds, The Guardian, 19 October 2007
\item \textsuperscript{73} Speech of 20 November 2008 at Montrichard. It contains the whole strategy and organisation.
\end{enumerate}
\end{footnotesize}
major French companies, the same way Temasek owns SingTel, Singapore Airlines or the banking group DBS. Secondly, and most importantly, contrary to the definition of the IWG expressly excluding funds not investing abroad, the SIF aims uniquely at investments on the domestic market. As such, and in consideration of its relatively meagre resources, it does not pose any (hypothetical) concerns to other recipient countries. This is not to say that the SIF does not raise any concerns at all on its domestic market: The main concern is certainly the one of protectionism; it can also affect competition, for instance if it acquires shares to a price exceeding market prices or if the SWF has some insider knowledge, e.g. through state intelligence; finally, if the management is deficient or investments are not planned carefully, the fund could face bankruptcy and would have to be held accountable to its constituents, the French citizens. Therefore, the SIF does after all combine both aspects: the one typical to donor countries and, through the fears of protectionist behaviour, the one typical to recipient countries. Thus, it is appropriate to call the SIF an SWF, as Sarkozy wished from the beginning. When he created it, Sarkozy insisted on the fact that it should be a model, exactly following the guidelines recipient countries would want to impose upon SWFs. Is this goal close to be achieved? The legal framework that established the fund is not to be questioned: The fund is constituted as a French public limited company (société anonyme, SA), and updated articles of incorporation are readily available. The global structure of the fund, as a subsidiary of CDC, a long-established service company of the French state, is clear, the governance model is exemplary and takes into account French specificities: There is a Board of Directors composed of 7 members (2 representatives of CDC, 2 of the state, 3 other qualified persons), chaired by a president (the director of CDC), including an investment committee (presided by the manager of the fund); it is directed by a Directeur général; and finally, to guarantee coherence and a balance in the fund’s strategy, there is a Comité d’orientation, comprising representatives of the economy, of labour unions (of utmost importance in France, to avoid strikes and public protests), and other qualified persons. Though being run by the state, the SIF is independent from the government; but since the government shares the citizens’s views on state capitalism, views enforced by the SIF, there is a factual link between these parties. Parliamentary oversight is guaranteed by the Commission de surveillance of CDC (composed of 5 Members of Parliament), which has been a grant of independence of this organism since 1816. Since the fund’s scope is not in the first line to maximise revenues but strategic, it had to be clearly set out in the investment policy and be publicly disclosed, pursuant to GAPP 19.1. This has been done: The fund’s

74 Fonds Stratégique d’investissement, Statuts, Mis à jour le 15 juillet 2009 (2010) J. App. Econ. 73
strategy was publicly announced by the President and has been refined later in a publicly available document.\textsuperscript{75,76}

This being said, everything is not yet perfect. Parliamentary interventions and a free press can and do help guiding the fund: At first, the SIF has been criticised for turning away from the stated strategy, namely in some “firemen’s actions”. It has also been criticised for not being socially responsible enough, i.e. investing in firms that would undergo restructurings in spite of the state’s help (in the case of Nexans). Heads of trade unions have complained that, in spite of their unions being members of the Comité d’orientation, they struggle to receive substantive information. Despite the published strategy, the regular press releases, the financial statements (to be published) and the oversight mechanism, Members of parliament wish even more transparency and a reinforced exterior supervision. The Norwegian fund is cited as a good example for parliamentary cooperation. The FSI, for its part, rejects these allegations as unsubstantiated, recalls the intense parliamentary supervision and the fact that it has merely minority shareholdings, but admits that it is still very young and that it can evolve and become even more respected.\textsuperscript{77}

Turning to the recipient side, we note that within a year of its inception, the SIF has directly invested EUR 450 million in 14 companies and further 650 million in different regional and sectoral partnerships. The economic choices have been embraced so far.\textsuperscript{78}

Finally, concerning the fear of protectionism, the fund does not seem to reinforce the existing barriers. Admittedly, its size does not allow it to compete with SWFs of the Middle East. But interestingly, since its foundation, the SIF appears to be very open to cooperations with foreign investors, notably SWFs. To this end, it had contacts to many SWFs and concluded a Memorandum of Understanding with Mubadala,\textsuperscript{79} deemed as complying with the international expectations, for future joint investments. France would remain in charge of the operations and make sure that its domestic strategic goals are achieved, whereas Mubadala would benefit from its investments and from a new level of legitimacy.

This kind of collaborations has been saluted by international observers who view them “as a sign that SWFs are maturing into more sophisticated investors; cognizant of their limitations and looking for the tools to overcome

\textsuperscript{75} Les orientations stratégiques du Fonds stratégique d’investissement, 20 April 2009
\textsuperscript{76} Sénat.fr, Le fonds stratégique d’investissement, un “fonds souverain à la française”? 16 January 2009; Fonds Stratégique d’Investissement, <http://www.fonds-fsi.fr/>\textsuperscript{77}
\textsuperscript{77} Marie Visot, Le fonds souverain français grandit dans l’ombre, Le Figaro, 21 Octobre 2009
\textsuperscript{78} Id.
them. This in turn (as Waki suggests\textsuperscript{80}) will contribute to SWF’s international acceptance.\textsuperscript{81}

**Conclusion**

France has a tradition of state capitalism, which is not totally compatible with the EU’s liberal view on the common market and foreign investment. However, the fund it created, while being an instrument of economic patriotism, cannot be accused of increasing France’s insulation from the globalised world. To the contrary, through the Fonds Stratégique d’Investissement, France participates in the “select club” of SWF donor countries and, through cooperations with other funds, can really be a player, even a trend setter. Together with a CFIUS-like foreign investment review mechanism, to be established on EU-level to achieve the greatest efficiency, smaller French-style SWFs can truly achieve the goal of good regulation.

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\textsuperscript{80} Natsuko Waki, Sovereign funds join forces for strategic investment, 18 August 2009, <http://uk.reuters.com/article/idUKTRE57H3C820090818>.

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“JUSTICIABILITY OF SOCIO-ECONOMIC RIGHTS: COMPARATIVE POWERS, ROLES, AND PRACTICES IN THE PHILIPPINES AND SOUTH AFRICA”

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Abstract

This paper proposes a theory of justiciability for socio-economic rights specified in Art. II, secs. 8-24 and Art. XIII – XV of the 1987 Philippine Constitution. While these provisions had been previously declared as the “heart of the new [1987] Charter” (ARIS (Phil) Inc. v. National Labor Relations Commission et al., G.R. No. 90501, August 5, 1991), subsequent jurisprudence of the Philippine Supreme Court has tended to treat these constitutional norms as little more than aspirational, non-self-executing, and ultimately mere hortatory guidelines for the Legislative and Executive Branches. (Basco et al. v. Philippine Amusements and Gaming Corporation, G.R. No. 91649, May 14, 1991)

A closer look at the formative history of the 1987 Philippine Constitution exposes structural considerations that militate against automatic non-justiciability of socio-economic rights. Article VIII, Section 1 of the postcolonial and post-dictatorship 1987 Constitution uniquely expanded the Philippine Supreme Court’s power of judicial review beyond the traditional justiciability threshold (“the duty of courts of justice to settle actual controversies which are legally demandable and enforceable”), towards wider review of government discretion (“to determine whether or not there has been a grave abuse of discretion amounting to lack or excess of jurisdiction on the part of any branch or instrumentality of the Government”). A corollary expansion of the Court’s rule-making powers accompanied the enlargement of the sphere of judicial review. Article VIII, Sec. 5(5) of the 1987 Constitution grants the Court the power to “promulgate rules concerning...the enforcement of constitutional rights”.

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From the standpoint of judicial power, the Philippine Supreme Court has clearly been vested with constitutional authority to determine its own parameters of justiciability with respect to constitutionally-textualized socio-economic rights. The Court’s own practice of relaxing justiciability constraints in cases of “threshold constitutional importance” affirms the malleability of justiciability doctrine beyond the frontiers of the six-pronged test in Baker v. Carr. This deliberate expansion of both the judicial review and rule-making powers of the Philippine Supreme Court typifies the active re-direction of the Court’s role, away from the passivity of the standard political question doctrine that had predominated earlier constitutional eras under the 1973 and 1935 Constitutions.

Moreover, the drafting history of the 1987 Constitution belies any intent to diminish the constitutional importance of socio-economic rights, as opposed to civil and political rights. The 1986 Constitutional Commission repeatedly referred to international legal standards on socio-economic rights (particularly the International Covenant on Economic, Social, and Cultural Rights) to introduce specific constitutional prescriptions, and not mere normative aspirations. This places greater responsibility on Philippine judges to carefully ascertain if justiciability is constitutionally-intended, or, conversely, if justiciability had been purposely ruled out by the framers of the 1987 Constitution.

Justiciability can be reconceptualised with sensitivity towards the Court’s use and understanding of its powers, roles, and practices under the 1987 Constitution. To this end, the jurisprudence of the South African Constitutional Court on socio-economic rights provides rich comparative insights into judicial methodology and interpretation. Cognizant of its historic and constitutional role, the South African Constitutional Court has long transcended the usual objections of ‘enforceability’ and ‘lack of government resources’ to adjudicate cases involving governmental distributive programs that impact on socio-economic rights. Exemplar cases such as Government of Republic of South Africa v. Grootboom, Minister of Health v. Treatment Action Campaign, and Thiagraj Soobramoney v. Minister of Health, among others, show that socio-economic rights and governmental duties can indeed be calibrated in modern constitutional adjudication.

Drawing from comparative South African scholarship, this paper proposes a triangulated theory (“Purpose-Role-Norm”) to assist the Philippine Supreme Court in determining the justiciability of socio-economic rights in the 1987 Constitution. First, the Court could look to the purpose of the justiciability constraint, and whether maintaining the traditionally high justiciability threshold set by Baker v. Carr is consistent with this purpose. This framework deliberately espouses Professor Jonathan A. Siegel’s methodology in his work, “A Theory of Justiciability”, 86 Tex. L. Rev. 73 [November 2007].
Second, the Court should also look to their constitutional role, and whether, under their expanded judicial review and rule-making powers, the Court can appropriately adjudicate the case or controversy involving socio-economic rights. This analytical prong should be examined along with the third aspect to this theory, which is to look at the norm as constitutionally-formulated. From a considered scrutiny of both constitutional text and its corresponding drafting history, the Court can also better determine whether the Constitutional provision contemplates an actionable right, as opposed to a non-self-executing norm requiring Congressional implementation.

The foregoing triangulated theory has not been absent or unattempted in jurisprudential methodology. However, much of the difficulty with determining the propriety of the Court’s adjudication of socio-economic provisions of the 1987 Constitution lies with eliciting methodological consistency, and how the Court could provide for the predictability and stability of constitutional outcomes. The documented experience of the South African Constitutional Court has much to impart on its consciousness of the Court’s role and powers under the South African Charter. The South African Constitutional Court also valuably demonstrates a decided predisposition to adjudicate socio-economic rights notwithstanding usual governmental resource constraints. At the very least, this proposed triangulated theory aspires to prevent offhand dismissals of Philippine constitutional cases on socio-economic rights, by inducing the Philippine Supreme Court to periodically and systematically revisit its constitutional powers, roles, and practices.

INTRODUCTION

We are living in a society in which there are great disparities involved. Millions of people are living in deplorable conditions and in great poverty. There is a high level of unemployment, inadequate social security, and many do not have access to clean water or to adequate health services. These conditions already existed when the Constitution was adopted and a commitment to address them, and to transform our society into one in which there will be human dignity, freedom and equality lies at the heart of our new constitutional order. For as long as these conditions continue to exist that aspiration will have a hollow ring.

Indeed, in countries where the task of maintaining body and soul and together is getting more and more to be a mission impossible, man’s efforts should be focused in enhancing the socio-economic rights of the vulnerable in our society. For what good is not being arrested if one is already incarcerated by the prison of poverty? What good is freedom of expression if the only idea you can mumble are words begging for food? What good is freedom to think on the part of the ignorant who is even ignorant of his ignorance? What good is the right to property to him who is shirtless, shoeless, and roofless? What good are political and civil rights to those whose problem is how to be human?

Let me conclude by saying that total human liberation requires not only the preservation of political and civil rights but demands the enjoyment by our people of their socio-economic rights. Only then can we translate the dream of Rizal into reality that in every person there is self-worth that the State should bring to life. In Rizal’s immortal words: “[Because] every being in creation has his spur, his mainspring; man’s is his self-respect; take it away from him and he becomes a corpse; and he who seeks activity in a corpse will only find worms.”

(Indolence of the Filipinos, La Solidaridad, Aug. 31, 1890, p. 194.)


On February 25, 1986, hundreds of thousands of Filipinos of diverse political affiliations, religious persuasions, and ideological proclivities assembled at Epifanio de los Santos Avenue (EDSA) in Metropolitan Manila, peaceably demanding the ouster of then-President Ferdinand Marcos. In his twenty-year dictatorship, Marcos had seized all governmental power and left all other political institutions in stasis under a sham democracy, where “[t]he Executive rules by decree. There is no legislature, no elections, and very little judicial review. The people are not allowed to choose their representatives. Citizens languish in jails without charge, many since Martial Law was declared. Military authority is supreme.”

During Marcos’ twenty-year dictatorship, the Philippine Supreme Court had been packed with a majority of loyal Marcos appointees. The Court became instrumental to legitimating the dictatorship regime when it upheld the constitutionality of various presidential decrees that steadily (and often surreptitiously) enlarged Marcos’ executive and legislative powers. In parallel with this practice, the Court also frequently invoked the political question doctrine to bar judicial review of many of Marcos’ acts

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during the dictatorship. A historical text authorized by the Philippine Supreme Court characterizes this strategy as one among several forms of judicial accommodation made with the authoritarian regime:

“...the courts gave their cooperation and support to the dictatorship and to its program for a New Society under a new constitutional order. That was their best choice. Supposing that, because of their attachment to constitutionalism, they had resisted the dictatorship, the courts would simply have been replaced by military tribunals. The judges of the period had the sagacity and the foresight to trust the political leadership, and despite their misgivings, follow its path toward a promised constitutional order. It was by such faith and hope that we can justify their collaboration in strategies and measures which, in the fateful months of late 1972 and early 1973, were antithetical and destructive of republicanism. Indeed, looking at the period as a whole, the Judiciary as an institution was basically preserved and functioning all throughout, without disruption or disturbance.”

In the face of Marcos’ overwhelming dominance of the Court, then-Chief Justice Roberto Concepcion (who was not a Marcos appointee, and frequently, would spearhead the dissenting minority in many of the cases broadening Marcos’ executive powers), was constrained to declare in Javellana v. Executive Secretary that “[t]his being the vote of the majority, there is no further

When the 1986 EDSA “People Power” Revolution successfully ousted Marcos, one of the first acts of the new government under Corazon Aquino (and facilitated by now Constitutional Commissioner Roberto Concepcion) was to strengthen the independence and judicial review powers of the Philippine Supreme Court. Under the 1987 Constitution, the Philippine Supreme Court was purposely entrusted with broader judicial review and rule-making powers. The framers of the 1987 Constitution envisaged the Court as the institution most critical to safeguarding democracy in the Philippines’ post-dictatorship constitutional order. Wary of the Court’s reputational decline in Javellana, the Philippine Supreme Court under the 1987 Constitution reiterated fidelity to the Constitution as the foremost mandate of judicial conduct: “...Justices and judges must ever realize that they have no constituency, serve no majority nor minority but serve only the public interest as they see it in accordance with their oath of office, guided only by the Constitution and their own conscience and honour.”

The recent decisions of the Court in this decade’s explosive constitutional controversies reveal that the Court remains highly conscious of its greater transformative and mediating role in Philippine democracy. Following the 2001 “EDSA II” demonstrations that ousted President Joseph Estrada, the unanimous Court in Estrada v. Desierto et al. held that Estrada had “constructively resigned” from office, paving the way for an orderly constitutional succession in favour of the then-Vice President, Gloria

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85 Otherwise known as the “Ratification Cases”, Javellana et al. v. Executive Secretary et al., G.R. No. L-36142, March 31, 1973, declared the effectivity of the 1973 Constitution, and in turn, paved the way for Marcos’ decade-long extension of his presidential term. The Ratification Cases ‘legalized’ the Marcos regime, and lent the pretense of legitimacy to Marcos’ arrogation of absolute power as President of the Philippines.


87 Saturnina Galman v. Sandiganbayan, G.R. No. 72670, September 12, 1986 (en banc).

Macapagal-Arroyo. Writing for the unanimous Court, Justice (later Chief Justice) Reynato Puno rejected the asserted non-justiciability of the dispute, emphasizing that judicial review power had been deliberately enlarged under the 1987 Constitution:

“To a great degree, the 1987 Constitution has narrowed the reach of the political question doctrine when it expanded the power of judicial review of this court not only to settle actual controversies involving rights which are legally demandable and enforceable but also to determine whether or not there has been a grave abuse of discretion amounting to lack or excess of jurisdiction on the part of any branch or instrumentality of government. Heretofore, the judiciary has focused on the "thou shalt not's" of the Constitution directed against the exercise of its jurisdiction. With the new provision, however, courts are given a greater prerogative to determine what it can do to prevent grave abuse of discretion amounting to lack or excess of jurisdiction on the part of any branch or instrumentality of government.”

Flowing from the expansion of its judicial review power under the 1987 Constitution, the Court has stood firm on its role to protect and defend the Constitution from unlawful “charter change” attempts. In Lambino v. Commission on Elections et al., the Court declared unlawful a “people’s initiative” to amend the 1987 Constitution for failure to comply with constitutional requirements, stressing the crucial role of the Court in the preservation of democracy and the rule of law:

“The Constitution, as the fundamental law of the land, deserves the utmost respect and obedience of all the citizens of this nation. No one can trivialize the Constitution by cavalierly amending or revising it in blatant violation of the clearly specified modes of amendment and revision laid down in the Constitution itself. To allow such change in the fundamental law is to set adrift the Constitution in unchartered waters, to be tossed and turned by every dominant political group of the day. If this Court allows today a cavalier change in the Constitution outside the constitutionally prescribed modes, tomorrow the new dominant political group that comes will demand its own set of changes in the same cavalier and unconstitutional fashion. A revolving-door constitution does not augur well for the rule of law in this country.

An overwhelming majority — 16,622,111 voters comprising 76.3 percent of the total votes cast — approved our Constitution in a national plebiscite held on 11 February 1987. That approval is the unmistakable voice of the people, the full expression of the people's sovereign will. That approval included the prescribed modes for amending or revising the Constitution.

No amount of signatures, not even the 6,327,952 million signatures gathered by the Lambino Group, can change our Constitution contrary to the specific modes that the people, in their sovereign capacity, prescribed when they ratified the Constitution. The alternative is an extra-constitutional change, which means subverting the people's sovereign will and discarding the Constitution. This is one act the Court cannot and should never do. As the ultimate guardian of the Constitution, this Court is sworn to perform its solemn duty to defend and protect the Constitution, which embodies the real sovereign will of the people. Incantations of "people's voice," "people's sovereign will," or "let the people decide" cannot override the specific modes of changing the Constitution as prescribed in the Constitution itself. Otherwise, the Constitution — the people's fundamental covenant that provides enduring stability to our society — becomes easily susceptible to manipulative changes by political groups.
gathering signatures through false promises. Then, the Constitution ceases to be the bedrock of the nation's stability.

The Lambino Group claims that their initiative is the "people's voice." However, the Lambino Group unabashedly states in ULAP Resolution No. 2006-02, in the verification of their petition with the COMELEC, that "ULAP maintains its unqualified support to the agenda of Her Excellency President Gloria Macapagal-Arroyo for constitutional reforms." The Lambino Group thus admits that their "people's" initiative is an "unqualified support to the agenda" of the incumbent President to change the Constitution. This forewarns the Court to be wary of incantations of "people's voice" or "sovereign will" in the present initiative.

This Court cannot betray its primordial duty to defend and protect the Constitution. The Constitution, which embodies the people's sovereign will, is the bible of this Court. This Court exists to defend and protect the Constitution. To allow this constitutionally infirm initiative, propelled by deceptively gathered signatures, to alter basic principles in the Constitution is to allow a desecration of the Constitution. To allow such alteration and desecration is to lose this Court's raison d'être.”

To date, the Philippine Supreme Court enjoys a greater level of public confidence and trust perception than most other institutions of the national government. 92 While the Court has not been immune from recent attacks on its impartiality (especially with its present composition dominated by a majority of appointees of the incumbent President Gloria Macapagal-Arroyo), 93 the

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Court remains salient to two (2) spheres of contestation --- the narrow concerns of private rights adjudication, as well as the broader issues of public policy legitimation. Rightly or wrongly, Filipinos under the postcolonial and post-dictatorship 1987 Constitution appear to look to the Philippine Supreme Court as the most definitive voice of public reason.\textsuperscript{94}

Not unlike the Philippine Supreme Court’s institutional evolution alongside political reform, the South African Constitutional Court’s path to establishment and entrenchment in South Africa’s constitutional culture should be read within the post-apartheid struggles to define a new politico-social order in South Africa. The South African Constitutional Court emerged in 1994 under South Africa’s 1993 Interim Constitution, and continues to exercise its mandate under the Final Constitution of 1996.\textsuperscript{95} The creation of the South African Constitutional Court “was enveloped in intense and highly political conflict, in part because all actors were able to foresee the power and importance of the Court in South African politics. Conflict over the Court’s structure was publicized widely, which probably undermined the initial legitimacy of the institution to at least some degree...the Constitutional Court was conceived in controversy, continues to be involved in the most contentious social issues, and has not been timid in offending various constituencies. Ironically, it suffers at once from an understandable identification with the ANC [African National Congress], which undoubtedly undermines its legitimacy among the whites, and from an image in some quarters as much too timid in its approach to constitutional development, too willing to protect the white minority, allied with the regular judiciary, and too slow to reflect the racial diversity of society at large.”\textsuperscript{96} Notwithstanding its politically-chequered history, the Court continues to enjoy relative institutional

\textsuperscript{94} RUSSELL HARDIN, DISTURST (2004, Russell Sage Foundation), at pp. 307-311.

\textsuperscript{95} Id. at note 7. See Stacia L. Haynie, “Resource Inequalities and Litigation Outcomes in the Philippine Supreme Court”, The Journal of Politics, Vol. 56, No.3 (August 1994), at pp. 752-772.


security. It has been able to issue principled judgments with high technical legal quality, even in the face of adverse public opinion or political criticism.  

Both the Philippine Supreme Court and the South African Constitutional Court occupy privileged positions in shaping public political-social discourses in their respective countries. The Philippine Supreme Court has demonstrated progressively liberal (and judicially activist) stances in recognizing the fullest protections of international standards on civil and political rights as “part of the law of the land.” Long before the adoption of the 1987 Constitution, Philippine jurisprudence had already progressively recognized the incorporation of various international human rights and humanitarian law instruments in the Philippine legal system. Over thirty (30) years before the promulgation of the 1987 Constitution, the Philippine Supreme Court applied the Universal Declaration of Human Rights as “generally accepted principles of international law [forming] part of the law of the Nation” to rule against the indefinite detention of foreign nationals or stateless aliens. Nearly two (2) decades since the adoption of the 1987 Constitution, a unanimous Philippine Supreme Court stressed the obligatory effect imposed by a postwar Supreme Court on the Universal Declaration of Human Rights (UDHR) in the Philippines. Relying on the incorporation of the UDHR as generally accepted principles of international law forming part of the law of the land, the unanimous Court in the 2007 case of Government of Hongkong Special Administrative Region v. Hon. Felisberto T. Olalia Jr. affirmed the correctness of a lower court order granting bail to a potential extraditee.
(departing from previous jurisprudence that limited the exercise of the right to bail to criminal proceedings). 

Despite its landmark recognition of the UDHR’s legal effect in the Philippines, however, the Philippine Supreme Court has proved reticent in


“xxx Thus, on December 10, 1948, the United Nations General Assembly adopted the Universal Declaration of Human Rights in which the right to life, liberty, and all the other fundamental rights of every person were proclaimed. While not a treaty, the principles contained in the said Declaration are now recognized as customarily binding upon the members of the international community. Thus, in Mejoff v. Director of Prisons, this Court, in granting bail to a prospective deportee, held that under the Constitution, the principles set forth in that Declaration are part of the law of the land. In 1966, the UN General Assembly also adopted the International Covenant on Civil and Political Rights which the Philippines signed and ratified. Fundamental among the rights enshrined therein are the rights of every person to life, liberty, and due process.

The Philippines, along with the other members of the family of nations, committed to uphold the fundamental human rights as well as value the worth and dignity of every person. This commitment is enshrined in Section II, Article II of our Constitution which provides: ‘The State values the dignity of every human person and guarantees full respect for human rights.’ The Philippines, therefore has the responsibility of protecting and promoting the right of every person to liberty and due process, ensuring that those detained or arrested can participate in the proceedings before a court, to enable it to decide without delay on the legality of the detention and order their release if justified. In other words, the Philippine authorities are under obligation to make available to every person under detention such remedies which safeguard their fundamental right to liberty. These remedies include the right to be admitted to bail. While this Court in Purganan limited the exercise of the right to bail to criminal proceedings, however, in light of the various international treaties giving recognition and protection to human rights, particularly the right to life and liberty, a reexamination of this Court’s ruling in Purganan is in order.”
providing similar recognition for socio-economic rights that are already textualized in Articles II, XIII, IV, and XV of the 1987 Constitution. In *Basco et al. v. Philippine Amusements and Gaming Corporation*, the Court expressly held that several provisions of Article XIII (Social Justice and Human Rights) and XIV (Education, Science and Technology, Arts, Culture and Sports) of the 1987 Constitution “are merely statements of principles and policies. As such, they are basically not self-executing, meaning a law should be passed by Congress to clearly defined and effectuate such principles.” Other than this bare declaration, however, the Court did not provide a methodology for differentiating between justiciable and non-justiciable socio-economic provisions in the 1987 Constitution.

Unlike the Philippine Supreme Court, the South African Constitutional Court appears more progressive in developing jurisprudence on socio-economic rights adjudication. It has produced a body of jurisprudence that not only recognizes the actionability of socio-economic rights, but also contains a consistent methodology for paring away the usual conceptual barriers underlying non-justiciability of socio-economic rights, such as resource constraints.

In this respect, the South African Constitutional Court’s methodology for determining justiciability of socio-economic rights has immense value for the Philippine Supreme Court. As a self-imposed institutional restraint that is not constitutionally-defined, the narrowness or width of justiciability is calibrated according to the nature and scope of a court’s institutional competence. As shown in its decisions on socio-economic rights, the South African Constitutional Court has, to a greater degree than the Philippine Supreme Court, more effectively deployed its institutional role and capacity towards a more nuanced use of justiciability. Beyond its traditional purpose as a self-limiting practice, the South African Constitutional Court has evidently looked at the justiciability of socio-economic rights in relation to the larger

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purposes of the judicial function in a democracy. The South African Constitutional Court’s socio-economic rights jurisprudence thus exemplifies “purposive interpretation” at its most concrete, where judges accept clear textual meanings but also considers the objective purposes of statutes --- or “the interests, values, objectives, policy, and functions that the law should realize in a democracy.”

Given their similar institutional powers and roles, the South African Constitutional Court could provide a significant comparative lens to the Philippine Supreme Court in constitutional socio-economic rights adjudication. Part I of this paper surveys the problem of justiciability of socio-economic rights in the Philippine constitutional system. Part II then examines the South African Constitutional Court’s adjudication of socio-economic rights, and the interpretive methodologies that the Court uses to override objections based on non-justiciability. Drawing from the South African Constitutional Court’s methodology, Part III proposes a triangulated theory, inspired by the “purposive interpretation” model, for Philippine judges to re-evaluate the justiciability of socio-economic rights in the 1987 Philippine Constitution. Not all socio-economic rights specified in the 1987 Philippine Constitution are automatically deemed justiciable, but under the triangulated theory (“Purpose-Role-Norm”) it is possible to ascertain which specific constitutional provisions could be deemed justiciable. In the Conclusion, the paper emphasizes that justiciability under the 1987 Philippine Constitution is less an institutional barrier as it is a self-regulating mechanism. The extent to which the Philippine Supreme Court can effectively self-regulate depends, in large measure, on its recognition and use of its institutional role and powers. If the Court consciously acts in full expression of its constitutional role and powers, there should be a much narrower gap between seemingly “aspirational” and “rights-discursive” norms in the 1987 Philippine Constitution.

I. THE PROBLEM OF JUSTICIABILITY AND SOCIO-ECONOMIC RIGHTS IN THE PHILIPPINE CONSTITUTIONAL SYSTEM

Justiciability: Pre- and Post- 1987

Before the promulgation of the 1987 Constitution, justiciability stood in sharp relief among Philippine constitutional doctrines as a wholesale adaptation of the six-pronged *Baker v. Carr* test.\(^{103}\) Justiciability doctrine filters political questions\(^ {104}\) from the actual cases and controversies which courts could adjudicate. According to the *Baker v. Carr* test, a case involves a non-justiciable political question if there is “a textually demonstrable constitutional commitment of the issue to a coordinate political department; or a lack of judicially discoverable and manageable standards for resolving it; or the impossibility of deciding without an initial policy determination of a kind clearly for non-judicial discretion; or the impossibility of a court’s undertaking independent resolution without expressing lack of respect due coordinate branches of the government; or an unusual need for unquestioning adherence to a political decision already made; or the potentiality of embarrassment from multifarious pronouncements by various departments on one question.”\(^ {105}\) The pre-1987 Philippine Supreme Court adopted the *Baker v. Carr* test to characterize various controversies during the Marcos dictatorship as involving political questions not properly subject of judicial review.\(^ {106}\)

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\(^{104}\) Pablo Sanidad et al. v. Commission on Elections et al., G.R. No. L-44640, October 12, 1976 (en banc): “Political questions are neatly associated with the wisdom, of the legality of a particular act. Where the vortex of the controversy refers to the legality or validity of the contested act, that matter is definitely justiciable or non-political.”


The 1987 Constitution revolutionized the scope of judicial review, and necessarily provoked constitutional rethinking on the traditional justiciability doctrine. Article VIII, Section 1 of the 1987 Constitution is a broader formulation of the power of judicial review than in previous Philippine Constitutions:

“Section 1. The judicial power shall be vested in one Supreme Court and in such lower courts as may be established by law.

Judicial power includes the duty of the courts of justice to settle actual controversies involving rights which are legally demandable and enforceable, and to determine whether or not there has been a grave abuse of discretion amounting to lack or excess of jurisdiction on the part of any branch or instrumentality of the Government.”

Unlike the United States Constitution which does not expressly textualize judicial review (first explained in the leading case of Marbury v. Madison which elicited the principle of judicial review from “particular phraseology” of the US Constitution that was “supposed to be essential to all written constitutions”), Article VIII, Section 1 of the 1987 Constitution expressly establishes judicial review in the Philippine constitutional system. The Philippine Supreme Court dates the initial exercise of judicial review (through invalidation of constitutionally infirm legislative acts) way back to 1902, stating that the executive and legislative branches effectively acknowledged the power of judicial review in provisions of the Civil Code that mandated consistency of legislative, administrative, and executive acts with the Constitution as a requirement for legality.107 This provision of the 1987


“Article 7. Laws are repealed only by subsequent ones, and their violation or non-observance shall not be excused by disuse, or custom or practice to the contrary.

When the courts declare a law to be inconsistent with the Constitution, the former shall be void and the latter shall govern.
Constitution expanded the *certiorari* jurisdiction of the Supreme Court to include cases of “grave abuse of discretion amounting to lack or excess of jurisdiction on the part of any branch or instrumentality of the Government.” As noted by the Court, the rationale for this expansion is attributable to the experience of martial law under the Marcos dictatorship. Former Chief Justice and 1986 Constitutional Commissioner Roberto Concepcion proposed the expansion to avoid repetition of the Court’s experience in failing to resolve crucial human rights cases due to the obstacle of the political question doctrine:

“Fellow Members of this Commission, this is actually a product of our experience during martial law. As a matter of fact, it has some antecedents in the past, but the role of the judiciary during the deposed regime was marred considerably by the circumstance that in a number of cases against the government, which then had no legal defense at all, the solicitor general set up the defense of political questions and got away with it. As a consequence, certain principles concerning particularly the writ of *habeas corpus*, that is, the authority of courts to order the release of political detainees, and other matters related to the operation and effect of martial law failed because the government set up the defense of political question. And the Supreme Court said: ‘Well, since it is political, we have no authority to pass upon it’. The Committee on the Judiciary feels that this was not a proper solution of the questions involved. It did not merely request an encroachment upon the rights of the people, but it, in effect, encouraged further violations thereof during the martial law regime…xxx xxx xxx

Briefly stated, courts of justice determine the limits of power of the agencies and offices of the government as well as those of its officers. In other words, the judiciary is the final arbiter on the question whether or not a branch of government or any of its officials has acted without jurisdiction or in excess of jurisdiction or so capriciously as to constitute an abuse of discretion amounting to excess of jurisdiction or lack of jurisdiction. This is not only a judicial power but a duty to pass judgment on matters of this nature.

Administrative or executive acts, orders, and regulations shall be valid only when they are not contrary to the laws or the Constitution.”

(2010) J. App. Econ. 95
This is the background of paragraph 2 of Section 1, which means that the courts cannot hereafter evade the duty to settle matters of this nature, by claiming that such matters constitute a political question.”

Dean Pacifico Agabin notes the counter-majoritarian objection against such an expansion of judicial review in light of the demonstrated history and ideological conservativism of the judiciary in the Philippines, stating that the “pendulum of judicial power [has swung] to the other extreme where the Supreme Court can now sit as ‘superlegislature’ and ‘superpresident’. If there is such a thing as judicial supremacy, this is it.” Article VIII, Section 1 is a constitutional policy to give a ‘heavier weighting of the judicial role in government’, according to former Supreme Court Justice Florentino Feliciano, as a reflection of the “strong expectations in [Philippine] society concerning the ability and willingness of our Court to function as part of the internal balance of power arrangements, and somehow to identify and check or contain the excesses of the political departments.” Former Supreme Court Justice Santiago Kapunan cautioned, however, against the ‘inherently antidemocratic’ nature of the expanded judicial review power:

“This brings me to one more important point: The idea that a norm of constitutional adjudication could be lightly brushed aside on the mere supposition that an issue before the Court is of paramount public concern does great harm to a democratic system which espouses a delicate balance between three separate but coequal branches of government. It is equally of paramount public concern, certainly paramount to the survival of our democracy, that acts of the other branches of government are accorded due respect by this Court. Such acts, done within their sphere of competence, have been --- and should always be --- accorded with a presumption of

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108 Id. at note 26, citing I Record of the Constitutional Commission 434-436 (1986).
regularity. When such acts are assailed as illegal or unconstitutional, the burden falls upon those who assail these acts to prove that they satisfy the essential norms of constitutional adjudication, because when we finally proceed to declare an act of the executive or legislative branch of our government unconstitutional or illegal, what we actually accomplish is the thwarting of the will of the elected representatives of the people in the executive or legislative branches of government. Notwithstanding Article VIII, Section 1 of the Constitution, since the exercise of the power of judicial review by this Court is inherently antidemocratic, this Court should exercise a becoming modesty in acting as a revisor of an act of the executive or legislative branch. The tendency of a frequent and easy resort to the function of judicial review, particularly in areas of economic policy has become lamentably too common as to dwarf the political capacity of the people expressed through their representatives in the policy making branches of the government and to deaden their sense of moral responsibility.”

Clearly, the expansion of judicial review is a constitutional policy that does not immunize Philippine courts from politics. Former Supreme Court Associate Justice Feliciano affirms that a court fulfills dual functions (‘deciding’ as opposed to ‘law-making’) in the three-pronged process of applying legal norms to any given controversy before it: 1) determination of the operative facts; 2) determination of the applicable legal or normative prescriptions; and 3) relating the applicable prescriptions to the operative facts.112 Inevitably, the elasticity of the Court’s use of its power of judicial review under the ‘grave abuse of discretion’ standard in Article VIII, Section 1 of the 1987 Constitution would depend to a significant extent on the rationality, predispositions, and value judgments of the majority of the members of the Court.113

112 Id. at note 29, at 34-36.
113 The Supreme Court admitted the elasticity of the ‘grave abuse of discretion’ standard, citing Justice Isagani A. Cruz, in the landmark anti-logging case of Oposa et al. v. Factoran et al., G.R. No. 101083, July 30, 1993, which involved a Petition hinged on the alleged existence of an ‘intergenerational’ right to a healthful and balanced ecology, which right
Since the promulgation of the 1987 Constitution, Filipino individuals and citizens’ groups have sought recourse to the expanded judicial review power of the Supreme Court to directly file petitions for writs to annul, enjoin, or prohibit governmental acts that violate fundamental human rights and civil liberties, and/or to compel governmental conduct towards observance of such rights and liberties. In the words of the Court, this expansion of judicial power “is an antidote to and a safety net against whimsical, despotic, and oppressive exercise of governmental power.”

As such, the expansion of the Court’s power of judicial review contemplates any governmental deprivation of rights within the penumbra of the individual’s constitutionally-guaranteed rights to life, liberty, and due process.

Over the last two decades since the promulgation the 1987 Constitution, the Court has issued writs and/or resolved cases on fundamental civil liberties and basic constitutional rights guarantees using its expanded judicial review power, including, among others: 1) nullifying administrative rules and regulations issued by the executive department that contravened the constitutionally-mandated agrarian reform program; 2) affirming the constitutional right to a fair and a speedy trial; 3) affirming a lower court judgment finding the government’s use of arrest, detention, and/or deportation orders to be illegal and arbitrary; 4) enjoining the military and police’s conduct of warrantless arrests and searches, ‘aerial target zonings’ or ‘saturation drives’ in areas where alleged subversives were supposedly hiding; 5) declaring search warrants defective and the ensuing seizure of private

the Court held was sufficient to vest standing on petitioners on behalf of minors and generations yet unborn.


116 Luz Farms v. Secretary of the Department of Agrarian Reform, G.R. No. 86889, December 4, 1990 (en banc).

117 Lisandro Abadia et al. v. Court of Appeals et al., G.R. No. 105597, September 23, 1994 (en banc).


properties to be illegal;\textsuperscript{120} 6) acquitting a person whose conviction for murder was based largely on an inadmissible extrajudicial confession (obtained without the presence of counsel);\textsuperscript{121} 7) upholding the dismissal of a criminal charge on the basis of the constitutional right against double jeopardy;\textsuperscript{122} 8) acquittal of a public officer due to a violation of the constitutional right of the accused to a speedy disposition of her case;\textsuperscript{123} 9) prohibiting the compelled donation of print media space to the Commission on Elections without payment of just compensation;\textsuperscript{124} and 10) prohibiting governmental restrictions on the publication of election survey results for unconstitutionally abridging the freedom of speech, expression, and the press.\textsuperscript{125}

Apart from the Court’s expanded power of judicial review, it has also been vested with considerable rule-making powers unheard of in previous constitutional eras. Article VIII, Section 5(5) of the 1987 Constitution vests the Supreme Court with the authority to promulgate rules ‘concerning the protection and enforcement of constitutional rights’:

“Sec. 5. The Supreme Court shall have the following powers:

xxx xxx xxx (5) Promulgate rules concerning the protection and enforcement of constitutional rights, pleading, practice, and procedure in all courts, the admission to the practice of law, the Integrated Bar, and legal assistance to the underprivileged. Such rules shall provide a simplified and inexpensive procedure for the speedy disposition of cases,


\textsuperscript{122} People v. Acelo Verra, G.R. No. 134732, May 29, 2002.

\textsuperscript{123} Imelda R. Marcos v. Sandiganbayan, et al., G.R. No. 126995, October 6, 1998 (en banc).

\textsuperscript{124} Philippine Press Institute Inc. v. Commission on Elections, G.R. No. 119694, May 22, 1995 (en banc).

\textsuperscript{125} Social Weather Stations Inc. et al. v. Commission on Elections, G.R. No. 147571, May 5, 2001 (en banc). See also In Re Emil (Emiliano) P. Jurado Ex Rel: Philippine Long Distance Telephone Company (PLDT) per its First Vice-President, Mr. Vicente R. Samson, A.M. No. 93-2-037 SC, April 6, 1995 (en banc).
shall be uniform for all courts of the same grade, and shall not diminish, increase, or modify substantive rights. Rules of procedure of special courts and quasi-judicial bodies shall remain effective unless disapproved by the Supreme Court.”

The Supreme Court’s authority to promulgate rules ‘concerning the protection and enforcement of constitutional rights’ is a formulation unique to the 1987 Constitution, nowhere found in the rule-making power of the Court as expressed in the 1973 Constitution and the 1935 Constitution.\(^{126}\) Philippine Supreme Court Chief Justice Reynato Puno has publicly declared that the framers of the 1987 Constitution purposely expanded the Court’s rule-making power in view of the fundamental importance of protecting individuals’ constitutionally-guaranteed rights:

“I respectfully submit further that the framers of the 1987 Constitution were gifted with a foresight that allowed them to see that the dark forces of human rights violators would revisit our country and wreak havoc on the rights of our people. With this all-seeing eye, they embedded in our 1987 Constitution a new power and vested it on our Supreme Court – the power to promulgate rules to protect the constitutional rights of our people. This is a radical departure from our 1935 and 1972 Constitutions, for the power to promulgate rules or laws to protect the constitutional rights of our people is essentially a legislative power, and yet it was given to the judiciary, more specifically to the Supreme Court. If this is disconcerting to foreign constitutional experts who embrace the tenet that separation of powers is the cornerstone of democracy, it is not so to Filipinos who survived the authoritarian years, 1971 to 1986. Those were the winter years of human rights in the Philippines. They taught us the lesson that in the fight for human rights, it is the judiciary that is our last bulwark of defense; hence, the people entrusted to the Supreme Court this right to promulgate rules protecting their constitutional rights.”\(^{127}\)

\(^{126}\) See 1973 CONST., art. X, sec. 5(5); 1935 CONST., art. VIII, sec. 13.

The foregoing interpretation of the Court’s expanded rule-making power under the 1987 Constitution appears to have been adopted by the Court itself outside of specific jurisprudential pronouncement. There is no case, to date, that interprets the Constitutional intent behind the expansion of the Court’s rule-making power under the 1987 Constitution. However, when the Court promulgated the Rule on the Writ of Amparo in October 2007, it also authorized the release of the Annotation to the Writ of Amparo. In this Annotation, the Committee on Revision of the Rules of Court stated in no uncertain terms that the Supreme Court was purposely vested with this ‘additional power’ to protect and enforce rights guaranteed by the 1987 Constitution:

“The 1987 Constitution enhanced the protection of human rights by giving the Supreme Court the power to ‘[p]romulgate rules concerning the protection and enforcement of constitutional rights…’ This rule-making power unique to the present Constitution, is the result of our experience under the dark years of the martial law regime. Heretofore, the protection of constitutional rights was principally lodged with Congress through the enactment of laws and their implementing rules and regulation. The 1987 Constitution, however, gave the Supreme Court the additional power to promulgate rules to protect and enforce rights guaranteed by the fundamental law of the land.

In light of the prevalence of extralegal killing and enforced disappearances, the Supreme Court resolved to exercise for the first time its power to promulgate rules to protect our people’s constitutional rights. Its Committee on Revision of the Rules of Court agreed that the writ of Amparo should not be as comprehensive and all-encompassing as the ones found in some American countries, especially Mexico. xxx The Committee decided that in our jurisdiction, this writ

128 The Writ of Amparo is a form of judicial relief “available to any person whose right to life, liberty and security is violated or threatened with violation by an unlawful act or omission of a public official or employee, or of a private individual or entity”, and applies to “extralegal killings and enforced disappearances or threats thereof”. See full text at http://www.supremecourt.gov.ph/RULE_AMPARO.pdf (last visited 15 March 2009).

of amparo should be allowed to evolve through time and jurisprudence and through substantive laws as they may be promulgated by Congress.”

Significantly, the Annotation does not refer to any portion of the Record of the 1986 Constitutional Commission that explains the expansion of the Court’s rule-making power. Given the Court’s pronouncement in this Annotation, however, it appears unlikely that the Court would countermand its own interpretation of the expansion of its rule-making power under the 1987 Constitution. This interpretation of the Court’s expanded rule-making power could similarly explain the Court’s promulgation of the Rule on the Writ of Habeas Data in January 2008. Noting the expansion of its powers of judicial review and rule-making, the Philippine Supreme Court nevertheless clarifies the hornbook tests of justiciability in the following manner:

“A justiciable controversy is defined as a definite and concrete dispute touching on the legal relations of parties having adverse legal interests which may be resolved by a court of law through the application of a law. Thus, courts have no judicial power to review cases involving political questions and as a rule, will desist from taking cognizance of speculative or hypothetical cases, advisory opinions and cases that have become moot. The Constitution is quite explicit on this matter. It provides that judicial power includes the duty of the courts of justice to settle actual controversies involving rights which are legally demandable and enforceable. Pursuant to this constitutional mandate, courts, through the power of judicial review, are to entertain only real disputes between conflicting parties through the application of law. For the courts to exercise the power of judicial review, the following must be extant (1) there must be an actual case calling for the exercise of judicial power; (2) the question must be ripe for adjudication; and (3) the person challenging must have the "standing."

130 Id., at pp. 2-3.
An actual case or controversy involves a conflict of legal rights, an assertion of opposite legal claims, susceptible of judicial resolution as distinguished from a hypothetical or abstract difference or dispute. There must be a contrariety of legal rights that can be interpreted and enforced on the basis of existing law and jurisprudence.

Closely related to the second requisite is that the question must be ripe for adjudication. A question is considered ripe for adjudication when the act being challenged has had a direct adverse effect on the individual challenging it.

The third requisite is legal standing or locus standi. It is defined as a personal or substantial interest in the case such that the party has sustained or will sustain direct injury as a result of the governmental act that is being challenged, alleging more than a generalized grievance. The gist of the question of standing is whether a party alleges "such personal stake in the outcome of the controversy as to assure that concrete adverseness which sharpens the presentation of issues upon which the court depends for illumination of difficult constitutional questions." Unless a person is injuriously affected in any of his constitutional rights by the operation of statute or ordinance, he has no standing.132

Notwithstanding the above hornbook tests, however, it should be noted that the Philippine Supreme Court has frequently exercised its institutional discretion to accept various reasons to relax requirements on aspects of justiciability doctrine, such as standing, mootness, and ripeness.133

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Socio-economic rights under the 1987 Constitution: Text, Structure, Ideology, and Justiciability

The 1987 Constitution contains multiple and specific provisions on socio-economic rights. Some are found in Article II (Declaration of Principles and State Policies), others in Articles XIII (Social Justice and Human Rights), XIV (Education, Science and Technology, Arts, Culture, and Sports), and XV (The Family). The particular categorization or grouping of a socio-economic right in any of these Articles seems immaterial to its justiciability. For example, Article II, Sections 15 (right to health) and 16 (right of the people to a balanced and healthful ecology) formed the constitutional basis for standing in a class suit seeking the cancellation of Timber License Agreements (TLAs) in the landmark case of Oposa et al. v. Factoran et al.\textsuperscript{134} The unanimous Supreme Court affirmed the constitutional importance of these rights in no uncertain terms:

“The complaint focuses on one specific fundamental legal right -- the right to a balanced and healthful ecology which, for the first time in our nation's constitutional history, is solemnly incorporated in the fundamental law. Section 16, Article II of the 1987 Constitution explicitly provides:

Sec. 16. The State shall protect and advance the right of the people to a balanced and healthful ecology in accord with the rhythm and harmony of nature.

This right unites with the right to health which is provided for in the preceding section of the same article:

Sec. 15. The State shall protect and promote the right to health of the people and instill health consciousness among them.

While the right to a balanced and healthful ecology is to be found under the Declaration of Principles and State Policies and not under the Bill of Rights, it does not

\textsuperscript{134} Minors Oposa et al. v. Hon. Fulgencio S. Factoran et al., G.R. No. 101083, July 30, 1993 (en banc). Emphasis supplied. This case has been repeatedly cited as a valuable municipal practice in international environmental law.
follow that it is less important than any of the civil and political rights enumerated in the latter. Such a right belongs to a different category of rights altogether for it concerns nothing less than self-preservation and self-perpetuation aptly and fittingly stressed by the petitioners the advancement of which may even be said to predate all governments and constitutions. As a matter of fact, these basic rights need not even be written in the Constitution for they are assumed to exist from the inception of humankind. If they are now explicitly mentioned in the fundamental charter, it is because of the well-founded fear of its framers that unless the rights to a balanced and healthful ecology and to health are mandated as state policies by the Constitution itself, thereby highlighting their continuing importance and imposing upon the state a solemn obligation to preserve the first and protect and advance the second, the day would not be too far when all else would be lost not only for the present generation, but also for those to come generations which stand to inherit nothing but parched earth incapable of sustaining life.”

Significantly, the Court in Manila Prince Hotel v. Government Service Insurance System et al. declared the presumption that a constitutional provision is self-executing, subject to textual examination:

“Admittedly, some constitutions are merely declarations of policies and principles. Their provisions command the legislature to enact laws and carry out the purposes of the framers who merely establish an outline of government providing for the different departments of the governmental machinery and securing certain fundamental and inalienable rights of citizens. A provision which lays down a general principle, such as those found in Art. II of the 1987 Constitution, is usually not self-executing. But a provision which is complete in itself and becomes operative without the aid of supplementary or enabling legislation, or that which supplies sufficient rule by means of which the right it grants may be enjoyed or protected, is self-executing. Thus a constitutional provision is self-executing if the nature and extent of the right conferred and the liability imposed are

fixed by the constitution itself, so that they can be determined by an examination and construction of its terms, and there is no language indicating that the subject is referred to the legislature for action.

As against constitutions of the past, modern constitutions have been generally drafted upon a different principle and have often become in effect extensive codes of laws intended to operate directly upon the people in a manner similar to that of statutory enactments, and the function of constitutional conventions has evolved into one more like that of a legislative body. **Hence, unless it is expressly provided that a legislative act is necessary to enforce a constitutional mandate, the presumption now is that all provisions of the constitution are self-executing.** If the constitutional provisions are treated as requiring legislation instead of self-executing, the legislature would have the power to ignore and practically nullify the mandate of the fundamental law. This can be cataclysmic. That is why the prevailing view is, as it has always been, that

... in case of doubt, the Constitution should be considered self-executing rather than non-self-executing ... Unless the contrary is clearly intended, the provisions of the Constitution should be considered self-executing, as a contrary rule would give the legislature discretion to determine when, or whether, they shall be effective. These provisions would be subordinated to the will of the lawmaking body, which could make them entirely meaningless by simply refusing to pass the needed implementing statute.”

Under the above presumption of the “self-executing” nature of constitutional provisions, it may be preliminarily argued that the socio-economic rights in Articles II, XIII, XIV, and XV of the 1987 Constitution are indeed actionable rights that could be subject of judicial review. Unless the text of the provision expressly provides for the need for implementing legislation, the socio-economic right cannot be characterized non-justiciable.
Applying this textual filter to Articles II, XIII, XIV, and XV, the following socio-economic rights appear actionable:

- **Article II**: right to health (Sec. 15); right to a balanced and healthful ecology (Sec. 16); rights of workers (Sec. 18); rights of indigenous cultural communities within the framework of national unity and development (Sec. 22); human rights (Sec. 11); parental rights (Sec. 12); fundamental equality before the law of women and men (Sec. 14); equal access to opportunities for public service (Sec. 26).

- **Article XIII**: full protection to labor; rights of all workers to self-organization, collective bargaining and negotiations, peaceful concerted activities, right to strike, security of tenure, humane conditions of work, living wage, workers’ rights to participate in policy and decision-making processes affecting their rights and benefits (Sec. 3); right of farmers, farmworkers, landowners, cooperatives, and other independent farmers’ organizations to participate in the planning, organization and management of the agrarian reform program (Sec. 5); homestead rights of small settlers and the rights of indigenous communities to their ancestral lands (Sec. 6); rights of subsistence fishermen to the preferential use of local marine and fishing resources, both inland and offshore (Sec. 7); urban and poor dwellers’ rights against arbitrary, unjust, and illegal eviction, and the right to adequate consultation before their relocation (Sec. 10); right of the people and their organizations to effective and reasonable participation at all levels of social, political, and economic decision-making, under consultation mechanisms provided by law (Sec. 16).

- **Article XIV**: right of all citizens to quality education at all levels (Sec. 1); compulsory elementary education [Sec. 2(2)]; academic freedom [Sec. 5(1)]; rights of indigenous cultural communities to preserve and develop their cultures, traditions, and institutions (Sec. 17).

- **Article XV**: right of spouses to found a family in accordance with their religious convictions and the demands of responsible parenthood [Sec. 3(1)]; right of children to assistance, including proper care and nutrition, and special protection from all forms of neglect, abuse, cruelty,
exploitation, and other conditions prejudicial to their development [Sec. 3(2)]; right of the family to a family living wage and income [Sec. 3(3)]; right of families or family associations to participate in the planning and implementation of policies and programs that affect them [Sec. 3(4)].

The Records of the 1986 Constitutional Commission affirm that the framers of the 1987 Constitution specifically intended the new provisions of Article XIII on Social Justice and Human Rights to form the centrepiece of the new Charter. In discussing their conceptions of socio-economic rights during the Charter deliberations, the 1986 Constitutional Commissioners repeatedly referred to the standards enshrined in the Universal Declaration of Human Rights and the International Covenant on Economic, Social, and Cultural Rights. Most importantly, it appeared that the 1986 Constitutional Commissioners either did not foreclose or expressly recognized the possibility of seeking judicial relief on the basis of some of these rights alone as textualized in the 1987 Constitution. Otherwise stated, socio-economic

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137 Id. at note 54. Records of the Constitutional Commission, Vol. IV, No. 69, 29 August 1986; Records of the Constitutional Commission, Vol. 4, No. 71, 1 September 1986. See also Brigido R. Simon Jr. v. Commission on Human Rights, G.R. No. 100150, January 5, 1994 (where the Court discussed that the framers of the 1987 Constitution were well-aware and cognizant of the ICESCR when they drafted the Social Justice and Human Rights provisions in the Constitution); Central Bank (now Bangko Sentral ng Pilipinas) Employees Association Inc. v. Bangko Sentral ng Pilipinas et al., G.R. No. 148208, December 15, 2004 (where the Court discussed the international law principle of equality and prohibition against discrimination as part of the Constitutional formulation and development of the Social Justice and Human Rights provisions in the Constitution). This interactive approach on international and domestic socio-economic rights standards coincides with the scholarly literature proposing a dissolution of the traditional, category-bound approach to socio-economic rights. See ISFAHAN MERALI and VALERIE OOSTERVELD, GIVING MEANING TO ECONOMIC, SOCIAL, AND CULTURAL RIGHTS (University of Pennsylvania Press, 2001).

138 Id. at note 55, see for example, the following exchange between Commissioners Suarez and Bernas on the right to education:

“MR. SUAREZ: I have been handling a number of cases in behalf of student demonstrators who were demanding quality education in the form of good teachers, good books, academic freedom, improved facilities. Will this statement "The State shall protect and promote the right of all citizens to quality education at all levels," be a license or permission for
rights as a whole were not intended to form a class of merely aspirational, and automatically non-justiciable, norms in the 1987 Constitution. Somewhat sporadically, the Philippine Supreme Court has recognized several socio-economic rights as legally demandable rights that could be subject of judicial review. What is still lacking in these cases, however, is a clear and consistent

them to go before our courts and demand the protection which is provided under this provision?

FR. BERNAS: The answer would have to be in the affirmative, with proper explanation. If the school involved is a state school, then I think the State can easily answer that. But if the school involved is a private school, which is precisely in such situation because the State is not allowing a private school to collect the tuition that is necessary to raise its quality, then the private school would have a proper defense. This will awaken the eyes of the State to the fact that, if the private schools are to deliver quality education, then there must be some reasonableness in the regulation of tuition fees."

On the other hand, the Commissioners appeared clear on instances where they did not recognize a provision as containing a legally demandable right. See for example, the following exchange between Commissioners Maambong and Sarmiento on the State duty to “equally protect the life of the mother and the unborn from the moment of conception” (Article II, Sec.9):

“MR. MAAMBONG: Mr. Presiding Officer, I just want to be clarified on whether this is really a demandable right in the legal sense of the word or it is merely an aspiration. Because if we say it is a demandable right, I fear for the government because as of now, as pointed out by the Commissioner, there are so many pregnant women in our countryside who can ill afford to go to the hospital and they are dying everyday. I should know because I come from a barangay. And if this is a demandable right as stated by the Commissioner, how can the government absorb this burden if all these pregnant women who are not taken care of will go to court and file a case on the basis not of an ordinary law but of a constitutional precept? That is my problem.

MR. SARMIENTO: Considering the situation of our country, what we can say is that at this point in time, that principle is an aspiration. It is a goal that we wish to achieve.”

See Gabino Alita et al. v. The Honorable Court of Appeals et al., G.R. No. 78517, February 27, 1989 (which involved the rights of tenants under the government’s agrarian reform program, where, for the first time under the 1987 Constitution, the Court cited Article XIII as a source of state duties and obligations); Amada Rance et al. v. The National Labor Relations Commission et al., G.R. No. 68147, June 30, 1988 (on the constitutional right of workers to security of tenure); Loida Shauf et al. v. Hon. Court of Appeals et al., G.R. No. 90314, November 27, 1990 (where the Court interpreted the constitutional policy of full protection to labor as authoritative basis against employment discrimination); Association of Court of Appeals Employees v. Hon. Pura Ferrer-Calleja et al., G.R. No. 94716, (2010) J. APP. ECON. 109
methodology for differentiating justiciable socio-economic rights from non-justiciable or aspirational socio-economic Charter provisions.

II. THE SOUTH AFRICAN CONSTITUTIONAL COURT’S ADJUDICATION OF SOCIO-ECONOMIC RIGHTS

Similar to the 1987 Philippine Constitution, the 1996 Final Constitution of South Africa expressly textualizes socio-economic rights. However, two (2) material differences stand from the South African Charter text. First, unlike the 1987 Philippine Constitution which limits its Bill of Rights (Article III) to civil and political rights, the 1996 Final Constitution of South Africa includes civil and political rights as well as socio-economic rights under its Bill of Rights (Chapter 2). Second, the South African Charter expressly provides terms of guidance on the application and implementation of its Bill of Rights. Chapter 2, Section 8 of the 1996 Final Constitution of South Africa states the rules for application thus:

“Application

(1) The Bill of Rights applies to all law, and binds the legislature, the executive, the judiciary and all organs of state.

(2) A provision of the Bill of Rights binds a natural or a juristic person if, and to the extent that, it is applicable, taking into account the nature of the right and the nature of any duty imposed by the right.

(3) When applying a provision of the Bill of Rights to a natural or juristic person in terms of subsection (2), a court-
(a) in order to give effect to a right in the Bill, must apply, or if necessary develop, the common law to the extent that legislation does not give effect to that right; and

(b) may develop rules of the common law to limit the right, provided that the limitation is in accordance with section 36 (1).

(4) A juristic person is entitled to the rights in the Bill of Rights to the extent required by the nature of the rights and the nature of that juristic person.\(^{140}\)

As seen above, South African courts have constitutional authorization to effectuate rights through the development of common law jurisprudence, in the absence of legislative implementation. This basic pre-authorization could plausibly explain the more vigorous judicial approaches taken by the South African courts on socio-economic rights. The South African Constitutional Court’s particular methodology for deriving justiciability of socio-economic rights, however, is comparatively significant. As will be seen below, the Court’s arrives at its determination of justiciability both from its recognition of its institutional role in the South African constitutional system, as well as from a jointly textual and purposive interpretation of the rights themselves in the 1996 Final Constitution.

**History and role of the South African Constitutional Court in the jurisprudential development of socio-economic rights**

Uniquely positioned in South Africa’s constitutional system, the South African Constitutional Court developed socio-economic rights jurisprudence through adept usage of its jurisdiction, powers, and institutional competence.

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\(^{140}\) 1996 Final Constitution of South Africa, Chapter 2, Section 8. Emphasis supplied.

(2010) J. APP. ECON. 111
A commentator on the South African Constitution describes the structure of the Court’s composition, mandate, and functions in the following terms:

“...The Constitutional Court is of seminal importance for the implementation of the new dispensation in order to give credible and cogent effect to the supremacy of the Constitution and a human rights culture. Ultimately it was decided that the task of constitutional adjudication was too fundamental to be entrusted to the Appellate Division of the Supreme Court in Bloemfontein, since its legitimacy and moral authority in recent decades, particularly on crucial human rights issues, had been abysmal, and as a result it was too patently lacking in legitimacy for it to be expected to give expression boldly and imaginatively to the character and ethos of the new constitutional dispensation.

The Constitutional Court is manifestly intended to be the most esteemed court in the land because it is the ultimate guardian of the Constitution which is the supreme law of the Republic, which is the product of the Constitutional Assembly, an elected body representative of the whole nation. It consists of a President, a Deputy President and nine other judges. A matter before the Constitutional Court must be heard before at least eight judges. This eminent court, situated in Johannesburg, is declared to be the highest court in all constitutional matters in the Republic. It may, however, only decide constitutional matters, and issues connected with decisions on constitutional matters; and makes the final decision whether indeed a matter is a constitutional matter or whether an issue is connected with a decision on a constitutional matter.

The Constitutional Court has exclusive jurisdiction in relation to certain matters listed in section 167(4) of the Constitution. Therefore, only the Constitutional Court may:

(a) Decide disputes between organs of the state in the national or provincial sphere concerning the constitutional status, powers, or functions of any of those organs of state;
(b) Decide on the constitutionality of any parliamentary or provincial Bill, but may do so only in the circumstances anticipated in section 79 or 121;
(c) Decide applications envisaged in section 80 or 122;
(d) Decide on the constitutionality of any amendment to the Constitution;
(e) Decide that parliament or the President has failed to fulfil a constitutional obligation; and
(f) Certify a provincial constitution in terms of section 144.

The Constitutional Court takes the final decision whether an Act of parliament, a provincial statute or conduct of the President is constitutional, and must confirm any order of invalidity made by the Supreme Court of Appeal, a High Court, or a court of similar status, before that order has any force. Therefore, the inconvenience created by adopting a centralised form of judicial review in the interim Constitution has been resolved in the 1996 Constitution by empowering the Supreme Court of Appeal and any High Court to decide on the validity of a parliamentary or provincial statute or any conduct of the President, while requiring that such order be confirmed by the Constitutional Court. From a conceptual and procedural point of view this is a decided improvement...the significance of this new formulation seems to be that the Constitutional Court is increasingly being positioned as an appellate court, despite section 167(6) of the 1996 Constitution which requires legislation providing for direct access to the Constitutional Court.”

The scope of the Court’s judicial review, especially in effectuating human rights, is a new development in the South African constitutional system that enables the Court to take “an active and fairly independent path”, but at the same time makes it pervious to critiques based on institutional legitimacy.\(^{142}\)

\(^{141}\) PROF GE DEVENISH, A COMMENTARY ON THE SOUTH AFRICAN CONSTITUTION (Butterworths, Durban, 1998), at pp. 223-224.

\(^{142}\) James L. Gibson, “The Evolving Legitimacy of the South African Constitutional Court”, pp. 229-266 in FRANÇOIS DU BOIS and ANTJE
Against this critical backdrop, it has been observed that the Court has tended to be “highly consensual in its decision-making, with dissents in fewer than five percent of its cases. Presumably, members of the Court believe judicial unity goes some distance toward countering its image as an institution conceived in and engaged with partisan politics.”

The Court’s role in developing socio-economic rights should also be read within the historical foreground of these rights’ inclusion in the Bill of Rights. Not unlike the 1987 Philippine Constitution, the minutes and memoranda in the drafting of these provisions in the South African Constitution show “the strong influence of international law on the drafting of the relevant sections protecting socio-economic rights. For example, the concepts of progressive realisation and resource availability in sections 26 and 27 were based on article 2 of the International Covenant on Economic, Social, and Cultural Rights. According to the Technical Committee, this formulation has the dual advantage of facilitating consistency between South Africa’s domestic law and international human rights norms, and directing the courts towards a legitimate international resource for the interpretation of these rights.”

Long before the approval of the 1996 Final Constitution, scholars had in fact argued that the textualization of socio-economic rights in the Constitution could valuably operate as a strategic limitation on the threat of judicial overreaching.

Precisely due to the complex economic, social, and cultural hierarchies and legal frameworks that fomented apartheid in South Africa, the constitutionalization of socio-economic rights contributed to legitimating the
new political order in post-apartheid South Africa, while warding off criticisms of the new Constitutional Court’s seeming “political” supremacy over other governmental institutions. As an inevitably ‘political’ actor, therefore, the South African Constitutional Court influences the development of socio-economic rights in defining the latter’s substantive content and application by other political branches. At the same time, its institutional legitimacy remains premised on how well it accomplishes the constitutional vision of socio-economic justice.

The South African Constitutional Court’s Methodology for Deriving the Justiciability of Socio-economic Rights

In *Ex Parte Chairperson of the Constitutional Assembly: In re Certification of the Constitution of the Republic of South Africa (Final Certification)*, the South African Constitutional Court certified that the proposed Final Constitution did not conflict with the Thirty-Four Principles previously agreed upon by the African National Congress, the outgoing white minority government, and the other political parties at the Convention for a Democratic South Africa. This case affirmed the inclusion of socio-economic rights in the final constitutional text. In this case, however, the Court expressly noted that nature and enforceability of socio-economic rights was “materially different” from other rights. The

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150 Id. at note 68, at par. 19: “Article 6.1 of the International Covenant on Economic, Social and Cultural Rights (“ICESCR”) ostensibly recognises the right of “everyone” to “the opportunity to gain his living by work which he freely chooses or accepts”. But this right would be subject to what has been said in the preceding paragraph. Even more important is the fact that Article 2.3 of ICESCR itself allows developing countries “with due regard to human rights and their national economy” to “determine to what extent
earlier *Certification* judgment had already acknowledged that at a “minimum, socio-economic rights can be negatively protected from invasion.” Justiciability, according to the Court, could not be barred simply due to the budgetary implications of the enforcement of these rights. Resource allocation and its distributive consequences form part of the ordinary course of rights enforcement: “It is true that the inclusion of socio-economic rights may result in courts making orders which have direct implications for budgetary matters. However, even when a court enforces civil and political rights such as equality, freedom of speech and the right to a fair trial, the order it makes will often have such implications. A court may require the provision of legal aid, or the extension of state benefits to a class of people who formerly were not beneficiaries of such benefits. In our view it cannot be said that by including socio-economic rights within a bill of rights, a task is conferred upon the courts so different from that ordinarily conferred upon them by a bill of rights they would guarantee the economic rights recognized in the present Covenant to non-nationals”. It is subject to the even broader qualification in article 2.1 which makes it clear that the right in question is not fully enforceable immediately, each State Party only binding itself “to the maximum of its available resources” to “achieving progressively the full realization of the rights recognized in the present Covenant”. In no way do we intend to denigrate the importance of advancing and securing such rights. We merely point out that their nature and enforceability differ materially from those of other rights.”

1996 (4) SA 744 (CC), 1996 (10) BCLR 1253 (CC), at par. 78: “[78] The objectors argued further that socio-economic rights are not justiciable, in particular because of the budgetary issues their enforcement may raise. They based this argument on CP II which provides that all universally accepted fundamental rights shall be protected by “entrenched and justiciable provisions in the Constitution”. It is clear, as we have stated above, that the socio-economic rights entrenched in NT 26 to 29 are not universally accepted fundamental rights. For that reason, therefore, it cannot be said that their “justiciability” is required by CP II. Nevertheless, we are of the view that these rights are, at least to some extent, justiciable. As we have stated in the previous paragraph, many of the civil and political rights entrenched in the NT will give rise to similar budgetary implications without compromising their justiciability. The fact that socio-economic rights will almost inevitably give rise to such implications does not seem to us to be a bar to their justiciability. At the very minimum, socio-economic rights can be negatively protected from improper invasion. In the light of these considerations, it is our view that the inclusion of socio-economic rights in the NT does not result in a breach of the CPs.” (Emphasis supplied.)
that it results in a breach of the separation of powers.¹⁵² When the Court interprets the Bill of Rights, it would not merely conduct a standard examination of drafting history. More importantly, the Court would purposely consider the right in conjunction with the social and institutional contexts of its application.¹⁵³

This “purposive approach to interpretation” was first applied specifically in relation to socio-economic rights in *Thiagraj Soobramoney v. Minister of Health KwaZulu-Natal.*¹⁵⁴ According to the Court, the purposive approach “will often be one which calls for a generous interpretation to be given to a right to ensure that individuals secure the full protection of the bill of rights, but this is not always the case, and the context may indicate that in order to give effect to the purpose of a particular provision a narrower or specific meaning should be given to it.”¹⁵⁵ In this case, a patient suffering from chronic renal failure sued a public hospital to compel dialysis treatment, citing the right under Article 27(3) of the Bill of Rights not to be refused emergency medical treatment. Due to the limited number of dialysis machines, the hospital had established guidelines allocating use of the machines to patients whose medical conditions warranted them the most. The Constitutional Court took cognizance of the case as one presenting a justiciable controversy involving state duties to provide emergency medical treatment. Applying a reasonableness test to the hospital’s guidelines, however, the Court concluded that the right under Article 27(3) had not been violated under the facts of the case.¹⁵⁶

¹⁵² Id. at note 70, at para. 77.
¹⁵³ See *State v. Makwanyane*, 1995 (3) SA 391 (CC) (S. Afr.).
¹⁵⁵ Id. at note 73, at para. 17.
¹⁵⁶ Id. at note 73, at paras. 20-22:

“[20] Section 27(3) itself is couched in negative terms B it is a right not to be refused emergency treatment. The purpose of the right seems to be to ensure that treatment be given in an emergency, and is not frustrated by reason of bureaucratic requirements or other formalities. A person who suffers a sudden catastrophe which calls for immediate medical attention, such as the injured person in *Paschim Banga Khet Mazdoor Sanity v State of West Bengal*, should not be refused ambulance or other emergency services which are available and should not be turned away from a hospital which is able to provide the necessary treatment. What the section requires is that remedial treatment that is necessary and available be given immediately to avert that harm.
What is notable from both the Certification and Soobramoney cases is how the Constitutional Court deliberately severs the issue of enforceability (e.g. the availability of state resources) from how it determines justiciability. In Government of Republic of South Africa v. Irene Grootboom and Others, the Court held that the enforceability of a socio-economic right should be determined on a case to case basis. Grootboom involved a group of petitioners who had been illegally occupied private land (already earmarked for low-cost housing) due to “intolerable conditions under which they were living while waiting in the queue for their turn to be allocated low-cost housing”. The group petitioned for a court order requiring the South African government to provide them with adequate basic shelter until they obtained permanent accommodation, based on sections 26 (right of access to adequate housing, and the obligation of the state to take reasonable legislative and other measures to ensure the progressive realisation of the right within its available resources) and 28 (children’s right to shelter) of the Bill of Rights. Grootboom carried a clear restatement of the Court’s position on the justiciability of socio-economic rights:

“[20] While the justiciability of socio-economic rights has been the subject of considerable jurisprudential and political debate, the issue of whether socio-economic rights are justiciable at all in South Africa has been put beyond question by the text of our Constitution as construed in the Certification judgment. During the certification proceedings before this Court, it was contended that they were

[21] The applicant suffers from chronic renal failure. To be kept alive by dialysis he would require such treatment two to three times a week. This is not an emergency which calls for immediate remedial treatment. It is an ongoing state of affairs resulting from a deterioration of the applicant’s renal function which is incurable. In my view section 27(3) does not apply to these facts.

[22] The appellant’s demand to receive dialysis treatment at a state hospital must be determined in accordance with the provisions of sections 27(1) and (2) and not section 27(3). These sections entitle everyone to have access to health care services provided by the state “within its available resources”.”

Government of Republic of South Africa v. Irene Grootboom and Others, 2001 (1) SA 46 (CC) (S. Afr.)

(2010) J. APP. ECON. 118
not justiciable and should therefore not have been included in the text of the new Constitution...

Socio-economic rights are expressly included in the Bill of Rights; they cannot be said to exist on paper only. Section 7(2) of the Constitution requires the state “to respect, protect, promote and fulfil the rights in the Bill of Rights” and the courts are constitutionally bound to ensure that they are protected and fulfilled. The question is therefore not whether socio-economic rights are justiciable under our Constitution, but how to enforce them in a given case. This is a very difficult issue which must be carefully explored on a case-by-case basis. To address the challenge raised in the present case, it is necessary first to consider the terms and context of the relevant constitutional provisions and their application to the circumstances of this case. Although the judgment of the High Court in favour of the appellants was based on the right to shelter (section 28(1)(c) of the Constitution), it is appropriate to consider the provisions of section 26 first so as to facilitate a contextual evaluation of section 28(1)(c).”

The Court went further to require the interpretation of socio-economic rights “in the setting of the Constitution as a whole. The state is obliged to take positive action to meet the needs of those living in extreme conditions of poverty, homelessness or intolerable housing. Their interconnectedness needs to be taken into account in interpreting the socio-economic rights, and in particular, in determining whether the state has met its obligations in terms of them.”

The Court treated the availability of the state’s resources as a legal standard forming part of the socio-economic right. As a legal standard, the availability of the state’s resources constitutes a factor aiding the Court’s assessment of the reasonableness of governmental action under a balancing test. Most importantly, Grootboom demonstrates that the availability of the

158 Id. at note 76, at para. 20. Emphasis supplied.
159 Id. at note 76, at para. 24.
160 Id. at note 76, at para. 46:

“[46] The third defining aspect of the obligation to take the requisite measures is that the obligation does not require the state to do more than its available resources permit. This means that both the content
state’s resources is not an indicator of non-justiciability, but rather one of several axioms for ascertaining the reasonableness of the distribution of such resources. Thus, while the Court could not grant the petitioners’ claims as worded, it did issue a declaratory order specifically requiring the government to undertake a comprehensive and coordinated state housing programme:

“(a) Section 26(2) of the Constitution requires the state to devise and implement within its available resources a comprehensive and coordinated programme progressively to realise the right of access to adequate housing.

(b) The programme must include reasonable measures such as, but not necessarily limited to, those contemplated in the Accelerated Managed Land Settlement Programme, to provide relief for people who have no access to land, no roof over their heads, and who are living in intolerable conditions or crisis situations.

(c) As at the date of the launch of this application, the state housing programme in the area of the Cape Metropolitan Council fell short of compliance with the requirements in paragraph (b), in that it failed to make reasonable provision within its available resources for people in the Cape Metropolitan area with no access to land, no roof over their heads, and who were living in intolerable conditions or crisis situations.”

The Court implemented the same methodology on the justiciability of socio-economic rights in *Minister of Health v. Treatment Action Campaign*. Petitioners in this case involved associations and civil society members concerned with HIV/AIDS treatment. The South African government had

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161 *Minister of Health v. Treatment Action Campaign (No. 2), 2002 (5) SA 721 (CC) (S.Afr.)*
devised a nationwide programme for the distribution of the Nevirapine drug to prevent mother-to-child transmission of HIV. Referring once again to the Certification judgment, the Court declared that socio-economic rights are clearly justiciable rights: “The question in the present case, therefore, is not whether socio-economic rights are justiciable. Clearly they are. The question is whether the applicants have shown that the measures adopted by the government to provide access to health care services for HIV-positive mothers and their newborn babies fall short of its obligations under the Constitution.”

Using the reasonableness metric applied in previous cases, the Court issued mandatory orders requiring the South African government to revise its Nevirapine distribution programme in order to: 1) “remove the restrictions that prevent Nevirapine from being made available”; 2) “permit and facilitate the use of nevirapine for the purpose of reducing the risk of mother-to-child transmission of HIV and to make it available for this purpose at hospitals and clinics when in the judgment of the attending medical practitioner acting in consultation with the medical superintendent of the facility concerned this is medically indicated, which shall if necessary include that the mother concerned has been appropriately tested and counselled”; 3) “make provision if necessary for counsellors based at public hospitals and clinics other than the research and training sites to be trained for the counselling necessary for the use of nevirapine to reduce the risk of mother-to-child transmission of HIV”; and 4) “take reasonable measures to extend the testing and counselling facilities at hospitals and clinics throughout the public health sector to facilitate and expedite the use of nevirapine for the purpose of reducing the risk of mother-to-child transmission of HIV.”

The Certification, Soobramoney, Grootboom, and TAC cases collectively show the Court’s deliberate acceptance of the justiciability of socio-economic rights. The adjudication of these rights appears well-within the constitutional duties, mandate, and powers of the Court. Even if the text of the norms imposed limitations based on the availability of resources of the state, the Court did not treat the government’s policies and distributive programs as political questions exclusively co-opted under the wisdom of the Executive or Legislative Branches. The Court’s judicial review power extends even to these

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162 Id. at note 80, at para. 25.

163 Significantly, the Court in these cases also fulfilled its task of interpretation with reference to international law standards on socio-economic rights. This is a judicial duty under section 39(1) of the South African Constitution.
questions of policy, since policy implementation entails the sufficiency of governmental action in relation to fundamental constitutional values. The Court’s decided position on the justiciability of socio-economic rights ultimately reflects its own consciousness of constitutional ideology, and the importance of socio-economic rights to the fabric of the new socio-political order under the 1996 Final Constitution. Justiciability is not merely a judicial policy of the Court involving restraint or liberality in adjudication, but a broader decision to effectuate constitutional values in light of the Court’s constitutional role.

III. A PROPOSED TRIANGULATED THEORY (“PURPOSE-ROLE-NORM”) TO DETERMINE THE JUSTICIABILITY OF SOCIO-ECONOMIC RIGHTS UNDER THE PHILIPPINE CONSTITUTION

South Africa presents an intriguing comparative lens for the Philippines due to two (2) common factors shared by both constitutional orders. First, considering their respective political-social histories of social injustice, both countries textualized socio-economic rights in their Constitutions to express the normative primacy of these rights. Second, both countries re-conceptualized the power of judicial review of their respective constitutional courts, to enable these institutions to make judicious choices on their competence to adjudicate controversies involving constitutional rights. It is definitely a fact worth noting for the Philippine Supreme Court that the relatively-nascent South African Constitutional Court has been able to deploy its institutional powers to overcome the usual non-justiciability objections, using a clear methodology for adjudication of socio-economic rights. If socio-economic rights are indeed the “heart of the 1987 Constitution”, as the Philippine Supreme Court acknowledges, then the Court’s policy-making processes on justiciability should be amenable to some constitutional rethinking. While the Philippine Supreme Court has declared some socio-economic rights provisions in the 1987 Constitution to be justiciable (such as the right to health in Oposa v. Factoran), the Court has not discussed a methodological framework that explains the Court’s policy on justiciability vis-à-vis non-justiciability.

Considering the institutional role and powers of the Court alongside the constitutional text, intent, and ideology in the 1987 Constitution’s socio-economic rights provisions, I propose a triangulated theory (“Purpose-Role-

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Norm”) on justiciability. When faced with a controversy involving a socio-economic right under either Articles II, XIII, XIV, or XV of the 1987 Constitution, the Court should simultaneously examine three (3) factors.: First, the Court could look at the purpose of the justiciability constraint, and whether, under the circumstances involving socio-economic right deprivations, maintaining a high justiciability threshold is consistent with the purpose of the justiciability constraint. Second, the Court should consider its institutional role in the constitutional system to see whether it can appropriately adjudicate a controversy involving socio-economic right deprivations. Finally, the Court should maintain its practice of investigating the constitutional formulation of the norm providing for a socio-economic right, taking into account the norm’s text and drafting history (which includes its consistency with international treaty standards incorporated under the 1987 Constitution). This framework, patterned after the methodology of the South African Constitutional Court in its socio-economic rights jurisprudence, comprehensively undertakes a “purposive interpretation” of socio-economic rights in the 1987 Constitution.

Purpose of the Justiciability Constraint

In 2007, Professor Jonathan R. Siegel proposed a general theory of justiciability as one of “purposeful doctrine”. He argued that justiciability does not have a strict and reasonably discernible constitutional purpose. Justiciability stands apart from other standard constitutional provisions that either promote the interests of specific individuals or groups; require avoidance of specific evils; or ensure an accountability and representative structure in democratic government. Instead, various alternative purposes are attributed to justiciability, including, among others: 1) improving court performance by giving litigants a stake in the outcome of cases, encouraging a sharper presentation of issues to the courts (“litigation-enhancement theory”); 2) protecting the autonomy of groups indirectly affected by adverse judicial rulings, as when unsuccessful plaintiffs end up provoking the generation of judicial precedents that affect other persons similarly-classed (“representational

theory”); 3) restraining courts from encroaching on the prerogatives of other co-equal branches of government ("separation of powers theory"); or 4) ensuring that courts can safely avoid socially difficult rulings ("passive virtues theory"). The fundamental problem with these theories, according to Professor Siegel, is that “they often accomplish little or nothing other than to make judicial review needlessly cumbersome, and second, even where they appear to do something, the restraints that they impose are not well-aligned with any purpose that they are said to serve. Courts could improve justiciability doctrines by focusing on their purposes. Where justiciability constraints are purposeless, they should be discarded. Where they serve a purpose, there is at least the possibility that they should be retained.” A purpose-driven justiciability doctrine would most likely impact on judicial policies on the importance and scope of adversity, standing, ripeness, and mootness.

Applying this model to the justiciability of socio-economic rights, the Philippine Supreme Court would have to weigh the purposes for which justiciability operates to constrain, at the threshold, the Court’s exercise of its power of review. If the Court were to hold in favour of non-justiciability of a socio-economic right in the 1987 Constitution, it would then be burdened to show that there is at least a comparative constitutional purpose that animates the Court’s rejection of competence to adjudicate in this particular controversial setting. This in itself is not something altogether unprecedented for the Philippine Supreme Court with its expanded judicial review and rule-making powers in the 1987 Constitution. Moreover, it should be recalled that in the Certification and Soobramoney cases, the South African Constitutional Court stressed the constitutional importance of the socio-economic rights involved over objections raised on the “propriety” of judicial intervention in these cases. As the South African Constitutional Court’s jurisprudence has shown, the Court overrode objections based on the litigation-enhancement, representational, separation-of-powers, and passive virtues theories of justiciability. In this sense, the purpose-driven scrutiny of justiciability doctrine is entirely consistent with former Israeli Supreme Court President Barak’s contextual and purposive interpretation model of adjudication for judges in modern democracies:

“An important tool that judges use to fulfil their role in a democracy is determining justiciability. That is, judges identify those issues about which they ought not make a

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166 Id. at note 84, at p. 122.
decision, leaving that decision to other branches of the state. The more non-justiciability is expanded, the less opportunity judges have for bridging the gap between law and society and for protecting the constitution and democracy. Given these consequences, I regard the doctrine of non-justiciability or “political questions” with considerable wariness. Insofar as is possible, I prefer to examine an argument on its merits, or to consider abstaining from a decision for lack of a cause of action rather than because of non-justiciability....My approach does not assume that the court is always the best institution to resolve disputes; indeed, I accept that certain disputes are best decided elsewhere. However, the court should not abdicate its role in a democracy merely because it is uncomfortable or fears tension with the other branches of the state. This tension not only fails to justify dismissing claims, it is even desirable on occasion. It is because of this tension that the freedom of the individual is guaranteed...Overall, the benefit gained from a broad doctrine of non-justiciability is significantly smaller than the benefit gained from a narrow one.”

The South African Constitutional Court’s socio-economic rights jurisprudence reflects decided responses to what President Barak describes as “normative justiciability” (whether there are legal criteria for determining a given dispute) and “institutional justiciability” (whether the dispute should be adjudicated in a court of law at all). As discussed in Part II, the South African Constitutional Court treated the availability of state resources as part of the legal considerations that form the parameters of a socio-economic right. By internalizing the requirement of reasonableness (something President Barak also discusses in his work as a “general principle of public law”) in balancing the substantive content of the socio-economic right and its operative (and ideological) limitations,168 the South African Constitutional Court adequately justified its doctrinal rejection of normative non-justiciability. Finally, the Court also overcame objections based on institutional justiciability by reiterating its express constitutional role in applying the Bill of Rights in the 1996 Final Constitution.

The Philippine Supreme Court has accepted various public interest reasons (“cases of transcendental paramount importance”) to exempt a case or controversy from justiciability requirements. Layering in a purpose test to its determination of justiciability of socio-economic rights does not conceivably

168 Id. at note 86, at p. 180.
depart from the Court’s record of accepting exemptions from the justiciability requirement. The purposive test on justiciability compels the Court to be transparent on its use of justiciability as a mechanism for self-regulation (e.g. checking its institutional justiciability), as well as for testing the presence of genuine legal adversity (e.g. checking normative justiciability). Considering the constitutional importance of socio-economic rights to the achievement of the rejuvenated political-social democratic order under the 1987 Constitution, it may be contended that the Court has an implicit duty to make its policy-making on justiciability both process-transparent and outcome-predictive.  

Institutional Role of the Supreme Court in the Philippine Constitutional System

Part I already extensively discusses the enlarged role of the Philippine Supreme Court in the definition and enforcement of constitutional rights, particularly through the expanded power of judicial review under Article VIII, Section 1 (which newly provides for the “grave abuse of discretion” standard), and rule-making on constitutional rights under Article VIII, Section 5(5) of the 1987 Constitution. To briefly reiterate, the Court has a unique role in the protection of constitutional rights. A broad view of justiciability is incompatible with the Court’s constitutional role.

Moreover, it is equally important to note that the Court possesses a critical function in the incorporation of international legal standards within the Philippine constitutional system. Article II, Section 1 of the 1987 Constitution provides that “generally accepted principles of international law form part of the law of the land.” At the time of the drafting of the 1987 Constitution, the Philippines had already been an active participant in the development of international human rights and humanitarian law. The Philippines was one of the original forty-eight (48) signatories to the United Nations Declaration, officially joining the United Nations as a founding member on October 24,

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169 For a thorough discussion arguing in favour of institutional duties to advance positive rights, see ALAN GEWIRTH, THE COMMUNITY OF RIGHTS (University of Chicago Press, 1996), at pp. 38 et seq.

170 The Philippines was one of the twenty-two subsequent adherents to the January 1, 1942, United Nations Declaration, which had twenty-six original signatories.
1945. Prior to the adoption of the 1987 Constitution, the Philippines had already ratified the following international instruments:

1) International Convention on Civil and Political Rights (ICCPR);
2) International Convention on Economic, Social and Cultural Rights (ICESCR);
3) Convention on the Elimination of Racial Discrimination (CERD);
4) Convention on the Elimination of All Forms of Discrimination Against Women (CEDAW);
5) Convention Against Torture and other Cruel, Inhuman or Degrading Treatment or Punishment (CAT);

The 1987 Constitution was drafted and adopted by the 1986 Constitutional Commission on October 15, 1986, and took effect upon ratification by the Filipino people in a plebiscite on February 2, 1987.

See ratification history at http://www.bayefsky.com and http://www2.ohchr.org (last visited 8 May 2008). Subsequent to the promulgation of the 1987 Constitution, the Philippines also ratified the remaining two (2) major human rights treaties, the Convention on the Rights of the Child (CRC) which was ratified on August 21, 1990 and entered into force on September 20, 1990; and the International Convention on the Protection of the Rights of All Migrant Workers and Members of Their Families (CMW) which was ratified on July 5, 1995 and entered into force on July 1, 2003. The Philippines signed the Convention on the Rights of Persons with Disabilities on September 25, 2007.


Ratified on June 18, 1986, entered into force on June 26, 1987. Amendment on Articles 17(7) and 18(5) accepted on November 27, 1996.


See http://www2.ohchr.org/english/bodies/ratification/7.htm (last visited 8 May 2008).
7) 1949 Geneva Conventions, along with other landmark instruments on international humanitarian law.  

Ultimately, what the framers of the 1987 Constitution did was not merely to textualize universalist norms in Constitutional language and provide for ‘universalist’ mechanisms and institutions that reify the primacy of individual rationality over strong state prerogative. What the Constitutional Commission of 1986 accomplished by expressly maintaining (and even amplifying) the Incorporation Clause in the 1987 Constitution ---- under the foresight that the Philippines must abide by principles ‘the observance of which would necessary to the preservation of the family of nations’ ---- was to build into our Constitutional canon a progressive ‘backdoor’ to the entry of international norms, even as these norms continue to evolve and develop with State practices. In light of its expanded judicial review and rule-making powers, the Philippine Supreme Court also assumes a gatekeeping role with respect to

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international legal standards. Its determination of the justiciability of socio-economic rights should also correspond with its role in the interpretation and application of international legal standards on socio-economic rights. These standards do not merely pertain to the substantive content of the socio-economic rights per se, but also to the rights’ structural and conceptual limitations. Examples of these limitations include the distinction between “obligations of conduct”, “obligations of result”, and “obligations to respect, protect, and fulfil”; the definition of “appropriate means”, “full realization”, and “progressive achievement”, and availability of resources. This is precisely what the South African Constitutional Court undertook in accepting the justiciability of socio-economic rights in the Certification, Soobramoney, Grootboom, and TAC judgments.

**Normative Investigations on the Constitutional Formulation of Socio-Economic Rights**

The last aspect of this proposed triangulated theory is relatively uncontroversial. Scrutiny into the text and drafting history of a socio-economic provision in the 1987 Constitution is simply a standard canon of constitutional interpretation. This aspect should not be neglected in our proposed purposive model for determining justiciability, since it necessarily completes the task of judicial balancing. To reiterate, under the Manila Prince Hotel standard laid by the Philippine Supreme Court, all provisions of the 1987 Constitution are presumed to be self-executing. Before a socio-economic right could be characterized as precluding actionability, the Court should prudently engage in normative investigations on constitutional text, structure, intent, ethos, ideology, and precedents.


183 See KEITH E. WHITTINGTON, CONSTITUTIONAL INTERPRETATION: Textual Meaning, Original Intent, and Judicial Review (University Press of Kansas, 1999 ed.)
CONCLUSION

For the most part, socio-economic rights in the 1987 Constitution have lain dormant and under-utilized because of the Philippine Supreme Court’s characterization of these norms as “aspirational” or non-justiciable in *Basco*. The judicial tendency rejecting constitutional scrutiny of these norms deters the effective invocation of socio-economic rights by the larger population of the socio-economically deprived in the Philippines. This cannot be countenanced in a maturing modern democracy such as the Philippines, and more so under a Philippine Supreme Court vested with extraordinary powers and roles as judges in Philippine democracy.

Comparative examination of the South African Constitutional Court’s jurisprudence on socio-economic rights sets a useful paradigm for the Philippine Supreme Court to rethink its archaic position on the justiciability of socio-economic rights. Time and again, the Philippine Supreme Court under the 1987 Constitution has issued landmark human rights judgments, not just on civil and political rights but also on social rights such as the inter-generational rights to health and balanced ecology in *Minors Oposa v. Factoran*. The Court stands unique among other jurisdictions for radically (and repeatedly) ruling that the Universal Declaration on Human Rights (an instrument internationally-deemed to be non-binding) as having legal effect in the Philippines. In this sense, the Court appears conscious of its more active adjudicating, rule-making, and gatekeeping roles under the present constitutional system in the Philippines. There is no conceivable reason why the Court cannot now harness its constitutional authority to overcome the largely self-imposed (and not constitutionally-predicated) restraint of justiciability for socio-economic rights.

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LEGAL RISKS IN ISLAMIC FINANCE TRANSACTIONS

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Abstract

Islamic Finance is one of the fastest growing and significant parts of the world financial services system. Nowadays Islamic Finance extended worldwide and exploits a highly sophisticated financial products and procedures based on Shariah. The Islamic Financial Institutions draw their founding blocks from Shariah but operate fully under the ‘law of land’ which is the main source of legal risks for Islamic Financial Institutions. Therefore, the existence of an adequate legal and regulatory framework is a critical aspect to the realization of the opportunities offered by Islamic Finance.

I. Introduction

“The reality is Islamic banks draw their founding blocks from Sharia and they operate fully under the ‘law of land’ where they exist”

Abou-El-Fotoh

1. The legal risk

A fairly narrow definition of legal risk is given by Bank for International Settlement (BIS) in the Core Principles for Systemically Important Payment Systems (2001): “Legal risk – the risk of loss because of the unexpected application of a law or regulation or because a contract cannot be enforced.”

A more broader explanation is provided by Abdulkader et al. (2005), which describe the legal risk as “the risk that a particular transaction does not produce the economic results that a party had bargained for, either because there has been a change in law or regulation or more usually because the party...”

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184 First Vice President and Group Head of Corporate Governance and Compliance at ABC Bank Egypt, he is a leading expert on money laundering and terrorist financing controls in the Middle East-North Africa region with extensive experience in AML compliance and training. Statement at ‘Money Laundering Alert 13th Annual International Conference’, Florida, March 17-19, 2008.

185 The Bank for International Settlements (BIS) is an international organisation which fosters international monetary and financial cooperation and serves as a bank for central banks. Established on 17 May 1930, the BIS is the world’s oldest international financial organisation.

186 http://www.bis.org/publ/cpss43.pdf?noframes=1

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failed to appreciate or address one or more of the risks inherent in the transaction.” Similarly McCormick\textsuperscript{188} (2007) identified legal risk as “the risk of loss either (a) as a result of transaction documentation not having the legal effect that one or more of the parties intend or (b) as a result of adverse claims (whether or not resulting in litigation)”\textsuperscript{189}.

A more advanced and most relevant definition of legal risk is offered in a draft of discussion paper widely debated at a working party of the International Bar Association\textsuperscript{190}:

“Legal risk is the risk of loss to an institution which is primarily caused by:

a) a defective transaction; or
b) a claim (including a defence to a claim or a counterclaim) being made or some other event occurring which results in a liability for the institution or other loss (for example, as a result of the termination of a contract); or
c) failing to take appropriate measures to protect assets (for example, intellectual property) owned by the institution; or
d) change in law.

The reference to a defective transaction in (a) above includes:
(i) entering into a transaction which does not allocate rights and obligations and associated risks in the manner intended;
(ii) entering into a transaction which is or may be determined to be void or unenforceable in whole or with respect to a material part (for whatever reason);
(iii) entering into a transaction on the basis of representations or investigations which are shown to be misleading or false or which fail to disclose material facts or circumstances;
(iv) misunderstanding the effect of one or more transactions (for example, believing that a right of set-off exists when it does not or that certain rights will be available on the insolvency of a party when they will not);

\textsuperscript{188} Roger McCormick – acknowledged legal risk expert, Project Director of the Law and Financial Markets Project at London School of Economics and Political Science, and a Visiting Professor at LSE. Since 2002 Roger has been the Co-chairman of the International Bar Association’s Legal Risk Working Party.
\textsuperscript{189} McCormick (2007), p: 283.
\textsuperscript{190} The International Bar Association (IBA), established in 1947, has a membership of 30,000 lawyers and 195 bar associations and law societies. http://www.ibanet.org/
(v) entering into a contract which does not, or may not, have an effective or fair dispute resolution procedure (or procedures for enforcement of judgements/arbitral decisions) applicable to it;
(vi) entering into a contract inadvertently;
(vii) security arrangements that are, or may be, defective (for whatever reason)\textsuperscript{191}.

All those definitions serve to illustrate the twofold nature of legal risk, which is concerned with both the external aspects, such as a change or breach in law or regulation and the internal aspects like a defective contract or transactions procedure.

However, there is no final explanation on what does the legal risk mean. The most comprehensive analysis of legal risk substance is conducted by Tobias Mahler\textsuperscript{192} (2007) in his remarkable article “Defining Legal Risk”\textsuperscript{193} which is based on a presentation at the conference "Risk and Regulation 2006" at the London School of Economics and Political Science (LSE). Even though Mahler (2007) pointed out in introduction “the definitions given for legal risk differ widely, and no generally accepted notion of legal risk seems to exist”\textsuperscript{194}, further he successfully reviewed, systematized and analysed existing definitions of legal risk and finally proposed a context-independent definition and classification of legal risk based on norm theory. In the end Mahler came to the conclusion that, “the combination of the norm-theoretic approach with the distinction of normative and factual uncertainties renders a matrix of legal risk, which should be generally applicable for the identification of legal risks, independent of the context”\textsuperscript{195}. In consequence it is possible to say, that legal risk faced by conventional financial institutions is also applicable to Islamic banking.

2. Islamic finance

\textsuperscript{192} Tobias Mahler, Norwegian Research Center for Computers and Law (NRCCL), University of Oslo, http://folk.uio.no/tobiasm/.
\textsuperscript{193} This article is based on a presentation the author gave at the conference "Risk and Regulation 2006" at the London School of Economics and Political Science (LSE), organized by the Centre for Analysis of Risk and Regulation (CARR). An earlier version of this paper was presented at the conference «Commercial Contracting for Strategic Advantage – Potentials and Prospects», Turku University of Applied Sciences, June 13 -16, 2007. Published in the Conference Proceedings on pages 10 - 31.
\textsuperscript{195} Supra note 11, at p: 235.
Islamic finance services are expanding worldwide. Many of academics (Lee and Ullah 2007, Henry and Wilson 2004, etc.) defined the Mit Ghamr Bank, which was set up in Egypt in 1963 as modern world’s first Islamic bank. At the same time, Hashmi (2003) argued, that interest-free banking in form of “loan cooperatives, influenced by European mutual loan experiments and motivated by religious and ethical ideas, were started” in the Indian subcontinent in the late 1940s. In accordance with KPMG (2006) advisory paper, there are now about 300 Islamic financial institutions in 75 countries. According to recent Moody’s report, there are more than 300 Islamic financial institutions (IFIs) with total combined assets in excess of US$ 250 billion (10-15% growth/year). However, The Banker in the second “Top 50 Islamic Financial Institutions listing” (published 03 November 2008) includes 500 Islamic financial institutions from only 47 countries with the Shariah-compliant assets grown up to reach US$ 639.1 billion. Nonetheless, it is possible to say that Islamic banking is currently practiced in more than 50 countries worldwide (not limited to Islamic countries). Interestingly, the first stand-

204 Established in 1926, The Banker is the premier magazine and acknowledged journal of record for the world’s investment, retail and commercial banking sectors. See Financial Times Business http://www.ftbusiness.com/
206 Islamic banking is practised in the following countries: Albania, Algeria, Australia, Bahamas, Bahrain, Bangladesh, British Virgin Islands, Brunei, Canada, Cayman Islands, North Cyprus, Djibouti, Egypt, France, Gambia, Germany, Guinea, India, Indonesia, Iran, Iraq, Italy, Ivory Coast, Jordan, Kazakhstan, Kuwait, Lebanon, Luxembourg, Malaysia, Mauritania, Morocco, Netherlands, Niger, Nigeria, Oman, Pakistan, Palestine, Philippines, Qatar, Russia*, Saudi Arabia, Senegal, Singapore, South Africa, Sri Lanka, Sudan, Switzerland, Tunisia, Turkey, Trinidad & Tobago, United Arab Emirates, United Kingdom, United States and Yemen. See Beng Soon Chong and Ming-Hua Liu, (2007), p: 125.
For more information see Islamic Financial Institutions in the World from Islamic Institute of Banking and Insurance (http://www.islamic-banking.com/ibanking/ifi_list.php#albania).
alone bank licensed by a non-Muslim country to offer Shariah compliant financial service products is the Islamic Bank of Britain \(^{207}\), which received Financial Services Authority (FSA) authorisation in August 2004.

Nowadays increased economical and social pressures have raised concerns among both state regulators and clientele about the ability of banks to survive. Based on unconventional ethical and religious maxims the Islamic finance seems to be a solution for current worldwide financial disaster. Even the Vatican offered Islamic finance principles to Western banks as a solution for economic crisis. “The ethical principles on which Islamic finance is based may bring banks closer to their clients and to the true spirit which should mark every financial service,” said the Vatican’s official newspaper *Osservatore Romano*.\(^{208}\)

As Gait and Worthington (2007) pointed out, a very large number of definitions of Islamic finance can be found in the literature, “ranging from the relatively simple definitions for specific aspects (say, Islamic banking) to more complex definitions covering all financial operations”\(^{209}\). Warde (2000), for example, defines Islamic finance as follows: “Islamic financial institutions are those that are based, in their objectives and operations, on Quran’s principles (principles of the Muslims’ holy book)\(^{210}\). This particular definition suggests that Islamic financial firms are not just banks, but also other types of financial intermediaries that employ Shariah principles. In a manuscript firstly published as IMF\(^{211}\) Working Paper, Jobst (2007) offered a most comprehensive definition of Islamic finance: “Islamic finance is limited to financial relationships involving entrepreneurial investment, subject to the moral prohibition of (i) interest earnings or usury (*riba*) and money lending, (ii) *haram* (sinful activity), such as direct or indirect association with lines of business involving alcohol, pork products, firearms, tobacco, and adult entertainment, (iii) speculation, betting, and gambling (*maisir*), including the speculative trade

\(^*\) In Russia the Badr-Forte Bank was the only structure in the banking sphere guided by Islamic business rules. Licensed by the Russian Federation Central Bank in 1991, it has been using Islamic funding methods since 1997. However, in December 2006, the Central Bank of Russia revoked Badr-Forte’s banking licence on the grounds of money-laundering activity plus the gross violation of order and period when reporting suspicious transactions. See Bekkin (2006), p: 92.

\(^{207}\) www.islamic-bank.com


\(^{210}\) Warde (2000), p: 5.

\(^{211}\) International Monetary Fund (IMF), www.imf.org.

(2010) J. Appl. Econ. 135
or exchange of money for debt without an underlying asset transfer, (iv) the trading of the same object between buyer and seller (bay’ al-inah), as well as (v) preventable uncertainty (gharar), such as all financial derivative instruments, forward contracts, and futures agreements. These distinctive properties derive from two religious sources predicated on the creation of an equitable system of distributive justice and the promotion of permitted activities (halal) and public goods (maslaha): (i) the Shariah, which comprises the Holy Qur’an (literally, “the way”) and the sayings and actions of the prophet Mohammed recorded in a collection of books known as the sahib hadith, and (ii) the figh, which represents Islamic jurisprudence based on a body of laws deducted from the Shariah by Islamic scholars”212. Accordingly, the very essence of Islamic finance differentiates the nature of risk that the Islamic financial institution faces.

3. Legal Risks in Islamic Finance

Shariah compliant banks generally face all of the same risks as conventional financial institutions, as well as several that are unique to Islamic finance. As Maiya (2008) notes, risks unique to Islamic banks include: “pricing risk under mark-up financing; commodity risk; ownership risk (assets owned as part of financing); reputation risk (for non-compliance with Shariah principles); counterparty risk in the case of Murabaha (declining to honour the “promise to buy” agreement), Istisna (declining to honour the “promise to accept the delivery” agreement), Salam (declining to honour the “supply on time and quality, quantity” agreement)”213.

Furthermore, according to State Bank of Pakistan (2008), Shariah non-compliance risk is “considered as falling within a higher priority category in relation to other identified risks” and “such compliance requirements must permeate throughout the organisation and their products and activities”214.

Thus, it is arguable that those kinds of risks are relevant for each party involved in finance transactions provided by Islamic Finance Institution and can be observed irrespective of particular sort of transactional structures (e.g. Murabaha, Mudaraba, Istisna, Ijara, etc.) or type of financial services providers such as Islamic Banks, Finance companies and Islamic Insurance (Takaful) companies.

The most sufficient analysis of legal risk in Islamic finance is prepared by Reza Djojosugito (2008) in article “Mitigating Legal Risk in Islamic Banking Operations”. This undoubtedly actual paper “elaborates legal risk exposed to parties to Islamic banking transactions encompassing the issues of the capacity of the parties to enter into a contract and its enforceability, uncertainty in laws, regulations, and legal actions pertaining to Shariah; as well as the legality of Islamic financial instruments.”

II. The sources of legal risks in Islamic Finance transactions

1. The deficiency of legal bases

A uniform regulatory and legal framework supportive of an Islamic financial system has not yet been completely developed. According to Turk Ariss and Sarieddine (2007), the existing banking regulations in Islamic countries are based on the Western banking model. Only few countries such as Malaysia and Indonesia have made efforts to develop a separate legal framework under which Islamic banks can operate in a dual banking system. New regulations in Brunei and Pakistan also have supported the expansion of an Islamic finance industry alongside conventional financial services.

Since the late 1990s, according to El Qorchi (2005), the Islamic banking world has accelerated efforts to standardize regulation and supervision. First of all, this is the Islamic Development Bank, which is playing a key role in developing internationally acceptable standards and procedures and reinforcement the banking sector’s architecture in different countries. In addition there are other international institutions which are working to set Shariah-compliant standards and harmonize them across the world. These include the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the International Islamic Financial Market (IIFM), etc.

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215 The author is an employee of the Legal Department at the OPEC Fund for International Development, Austria.
219 Islamic Development Bank (IDB) is a multilateral development financing institution, established [1973] to foster social and economic development of it's member countries and Muslim communities world-wide. www.isdb.org
220 AAOIFI (established in 1990) is an Islamic international autonomous non-for-profit corporate body that prepares accounting, auditing, governance, ethics and Shariah standards for Islamic financial institutions and the industry. www.aaoifi.com
the Islamic Finance Service Board (IFSB)\textsuperscript{222}, the Liquidity Management Centre (LMC)\textsuperscript{223}, and the International Islamic Rating Agency (IIRA)\textsuperscript{224}.

However, as Al Shaali (2008) pointed out, “there are still many countries where the legal and institutional framework is not explicit and transparent about Islamic finance, and the framework developed for conventional finance is being applied to Islamic institutions”\textsuperscript{225}.

Moreover, even the regulatory framework for banking is not enough. As Djojosugito (2008) argues, “the creation of conducive legal framework is inevitable, especially those for operational aspects of Islamic banking, for sufficient infrastructure to allow Islamic banking to grow and for establishing friendly infrastructure toward Islamic banking”\textsuperscript{226}.

Also, as KPMG (2006) suggests, the fact remains “that a large proportion of Islamic banking transactions are conducted within the bounds of international (typically English) law. Islamic financial institutions must address this legal reality and work to ensure that they are able to deal with this hurdle”\textsuperscript{227}.

\textsuperscript{221} IIFM was founded [2002] as an infrastructure institution with the mandate to take part in the establishment, development, self-regulation and promotion of Islamic Capital and Money Market. www.iifm.net

\textsuperscript{222} IFSB (established in 2002) is an international standard-setting organisation that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry. www.ifsb.org

\textsuperscript{223} LMC was established in 2002 for the purpose of facilitating the investment of the surplus funds of Islamic banks and financial institutions into quality short and medium term financial instruments structured in accordance with the Shariah principles. www.lmcbahrain.com

\textsuperscript{224} IIRA (established in 2005) assists the Islamic financial services industry to gain recognition locally and internationally as strong and capable financial institutions, adhering to greater standards of disclosure and transparency. www.iirating.com

\textsuperscript{225} Nasser Al Shaali, the CEO of the Dubai International Financial Centre (DIFC) Authority, speech at the London Sukuk Summit 2008.

\textsuperscript{226} Supra note 32, at p: 113.

\textsuperscript{227} Supra note 19, at p: 17.
2. Inadequacy of existing legal system

The two highly powerful legal systems\textsuperscript{228}, being now a fundamental part of contemporary business world, the Common Law and the Civil Law, regrettably, do not conform to the Islamic doctrine and vice versa. The main effects of this are shown below:

- **The issues of legislative orders in countries following Civil law system**

  Civil law system accentuates on the codification of laws and requires that all rules have to be transformed into written law. This is a basis on which the Civil laws should be created. The imperative part of this is that the lower level laws/regulations cannot contradict higher level laws/regulations. On the subject of the Islamic finance, “this principle potentially presents difficulties as most of the building blocks of the commercial laws which serve as a foundation for the Islamic banking rarely recognize directly the Islamic principles or mention any reference to Islamic legal principles. Even though referral to the unwritten laws as another source of laws may be made, it is difficult to argue that the unwritten laws encompasses Islamic principles as most treatises construe these unwritten laws as the conventions in state governance practices and not as a general principles of laws or a custom where the Islamic principles are likely to be part of\textsuperscript{229}. Quite the contrary for the Common law system it seems easier to make essential changes of existing legislation to accommodate some of the Islamic principles via the “case law”.

- **The inexistence of laws related to the Islamic mode of financing**

  As described in the previous section the most Civil and Common law jurisdictions do not have the comprehensive laws related to Islamic mode of financing. According to Djojosugito (2008), “The reference to Islamic mode of financing usually was implicitly embedded into the legal or regulatory instruments which deals with Islamic bank which may define some Islamic modes of financing and for limited extend the mechanism

\textsuperscript{228} There are many other less considerable legal systems in today’s world such as Hindu law, Pre-Colonial legal systems in Africa and the Americas, and Socialist legal system, developed originally in the Soviet Union.

\textsuperscript{229} \textit{Supra} note 32, at p: 114.
thereof. As a result the judges (courts) can make their own interpretation on some particular Islamic mode of financing.

• The absence of basic laws for Islamic banking

In spite of the fact that Islamic banking is recognized in many countries with different jurisdictions, the existent laws cover only the very basic principles of Islamic banking. Only few countries, such as Sudan, for example, adopted Shariah compliant regulatory frameworks for the entire banking sector in 1984. Also, as Djojosugito (2008) notes, “the laws for instance fail to address the issue of double taxation in Islamic financial transactions or the specific supervisory needs of Islamic bank and sometimes contain general requirements for banking industries which impede the development of Islamic banking.”

Furthermore, as KPMG suggests, “Islamic financial products can be at a disadvantage in the marketplace when it comes to taxation in certain jurisdictions, suffering a relatively greater burden when compared to conventional finance. This disadvantage may be due to a lack of sufficient and appropriate understanding of these products by the relevant tax authorities. Classic examples of such instances include the tendency to treat some Islamic products as equity products rather than confer upon them the taxation benefits of being debt products. Although there have been significant advancements in the taxation treatment of Islamic products, in many countries (the United Kingdom in particular has made a number of changes to existing legislation to accommodate some of these products via the Finance Act 2005) these investigations are at an early stage and further work is required to help enable Islamic institutions to compete on a level playing field with their non-Shariah-compliant peers.

230 Supra note 32, at p: 114.
231 Supra note 22, at p: 1.
233 Supra note 32, at p: 114.
234 Changes in legislation relating to Islamic finance products are announced as part of the Budget, following discussions initiated by Islamic Bank of Britain. The Finance Act 2005 includes changes specifically related to the taxation of Islamic financial products with the aim of putting them on a level playing field with other comparable non-Islamic financial products. Adapted from Islamic Bank of Britain, www.islamic-bank.com
(2010) J. APP. ECON. 140
Apart from conventional taxation, Islamic financial institutions must also consider the need to accrue and provide for Islamic tax - Zakat. There are disparities in the industry around this issue, with some industry participants arguing that the Zakat should be provided by the institution and others arguing it should be provided for by the investor/depositor.

• **Inadequacies of laws related to asset securitization compatible to Shariah**

The traditional assets securitization mechanism utilizes the securitization in form of debts receivables and such method is completely unacceptable for the Islamic counterpart as based on the pure debts. Nonetheless, as Djojosugito (2008) points out, the development of the legal aspects of the assets securitization compatible to Islam was still lagged behind, despite the fact that the asset securitization is one of the most important mechanisms for mobilizing financial resources for Islamic financial institutions.

3. **Uncertainty in laws and regulations appertaining to the Shariah**

As previously discussed, the current situation in most legal regimes is not very helpful to the development of Islamic finance operations due to the fact that any operation undertaken by Islamic banks or other Islamic Financial Institutions create some sort of legal risk. In general, there is ongoing conflict of laws between Shariah and local laws which have arisen within few main legal areas such as follows:

• **Uncertainty in laws, regulations, and legal actions appertaining to the principles of Shariah**

Legal risk arisen from uncertainty in laws, regulations, or legal actions will even affect a transaction which is properly documented. Such uncertainty will occur if the court construes that some transactions do not conform to Shariah. It is also important that many laws related to Islamic finance are imprecise. Particularly for Islamic banks, as Djojosugito (2008) suggests,
“the result can be devastating as the integrity of the whole operations can be questionable if part of it is not interpreted according to Shariah”\textsuperscript{238}.

The other problem concerning this aspect is that some legal institutions are just not competent of delivering judgments related to Shariah. “Judges in non-Shariah court for instance rarely receive proper training in Shariah. Therefore, it is too much to expect that their decision will reflect the Shariah principles”\textsuperscript{239}. However, this kind of legal risk is still present since the final decision is decided by the court.

The other problem is the jurisdiction of Shariah board. For example, the Indonesian National Shariah board’s fatwas are binding upon the Shariah boards of the Islamic banks but not to the financiers of the Islamic banks. This will create problems, as the financiers are free to invest the financing in any way they like\textsuperscript{240}. Consequently, as Djojosugito (2008) argues, “the adherence to Shariah can be included in the covenants or events of defaults in the relevant financing agreements. However, such covenants can only be effective if the interpretation of Shariah by courts is consistent”\textsuperscript{241}.

- **Legality of Islamic financial instruments**

Also, one of the common legal risks faced by Islamic banks is the legality of Islamic financial instruments. “Due to the absence on recognizable laws pertaining to Islamic financial instruments, some transactions might be deemed illegal by law even though Shariah allow such transactions”\textsuperscript{242}.

In addition, according to Djojosugito (2008), “The biggest issue which might arise from the legality of Islamic financial instruments is the probability of selective enforceability. As an Islamic financing structure usually involves several financial instruments, the illegality in parts of the instrument used in the transaction may result in that only the favourable terms in a contract are enforced. The problem with selective enforceability is that most of Shariah compatible financing is conducted through a web of contracts and if any part of such a web fails to function or only part of the

\textsuperscript{238} Supra note 32, at p: 115.  
\textsuperscript{239} Supra note 32, at p: 115.  
\textsuperscript{240} Supra note 32, at p: 115.  
\textsuperscript{241} Supra note 32, at p: 115.  
\textsuperscript{242} Supra note 32, at p: 115.
web is enforced, the integrity of the whole system in term of *Shariah* compatibility might be compromised.

- **Legal capacity to enter into a contract**

Another component of legal risk that affects the operations of Islamic banks is legal capacity. The legal capacity can be defined as the ability to legally enter into a *legally* binding agreement (make a contract). The result of non-existence of any legal capacity is that the contract is deemed *ultra vires*, and is therefore unenforceable.

For example, as do points out it is related to the exploit of special purpose vehicles (SPV) in project finance transactions. “While the *Shariah* will view the SPV as either a *Mudarib* or a *Wakil*, the law will view them as a trustee. At the outset, the difference seems trivial as all of them share many things in common. However, when it comes to the issue of legal capacity of the SPV to enter into a contract, the legal consequences depend on whether the SPV is regarded as *Mudarib*, *Wakil*, or simply a trustee.” Consequently, transactions which are absolutely acceptable under *Shariah* may be declared *ultra vires* by conventional law jurists.

- **Law vs. the principles of *Shariah***

Other problems have religious character. As Hooker (2002) suggests, the “[Islamic] jurisprudence has not been developed by way of precedent, or by way of codification but by way of scholarship. The nearest parallel for the European traditions is the *canon law* at the time of Aquinas [St. Thomas]. Like the canon law, Islamic scholasticism began from the fixed principle of revelation contained in a text, originally received orally but later written down – the *Qur’an*.”

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243 Supra note 32, at p: 115.

244 It is Latin for “beyond the powers”. An action outside the proper authority or power of a corporation or corporate officer as established in the corporate charter. See http://www.corp-gov.org/glossary.php3?glossary_id=126

245 Supra note 32, at p: 116.

246 Canon law is the body of laws and regulations made by or adopted by ecclesiastical authority, for the government of the Christian organization and its members. Canon is derived from the Greek kanon, i.e. a rule or practical direction. see The Catholic Encyclopedia, http://www.newadvent.org/cathen/09056a.htm

Moreover, Islam has various scientific schools (such as Hanafi, Maliki, Shafari, Hanbali, Zaydi, Jaffari, etc.) among two main doctrines – Sunni and Shia. As Egorov et al. note “all schools have different treatments and interpretations of Islamic Banking operation, what impedes to unify and modify Islamic Banking. Besides, almost all Islamic private banks have Religious Supervisory Boards (RSBs). These Boards are given wide powers and authorities to examine any contract, method or activity relating to the conduct of their banks”\(^{248}\). As consequence it is arguable that the Islamic jurisprudence was developed by way of scholarship while the Common law jurisprudence was developed by way of precedent and the Civil law by way of codification\(^{249}\).

The clear example of this inconsistency is provided by Djojosugito (2008) through the Islamic Development Bank (IDB) Sukuk: “It is stated that the decrease in the proportion of the pool to below 25 per cent will trigger a dissolution event. While the decrease in the proportion itself is another type of risk, the treatment arises from such decrease will trigger a legal risk. While such a condition is not acceptable from Shariah point of view and must lead to dissolution of the Sukuk because the prohibition in trading of debts is absolute, the liquidation may not be authorized from legal point of view because the law will see the reason as to why the proportion decreases to such level taking into account the interest of the Sukuk’s holders”\(^{250}\).

The other importance is the fact that all Islamic Finance Institution is governed by laws other than Shariah. The classical example is Shamil Bank of Bahrain v Beximco Pharmaceuticals Ltd and others (2004)\(^{251}\) case, which is a good demonstration on how a court may understand Shariah. The Court held that Shariah principles did not apply and that the financing scheme was enforceable\(^{252}\). “This represents legal risk as a contract which is supposed to be governed by Shariah will be interpreted not according to Shariah”\(^{253}\).

4. Inconspicuous sources of legal risks


\(^{249}\) Supra note 32, at p: 116.

\(^{250}\) Supra note 32, at p: 116.


\(^{252}\) Lovells (2005), p: 3.

\(^{253}\) Supra note 32, at p: 116.
Another challenge for the Islamic Financial Institutions is to understand how to treat their products and services under Environmental laws and Corporate Governance laws.

- **Environmental laws**

Islamic banks, like other financial institutions, are potentially liable for environmental damage that their operations cause. Even if the banking operations are not pollution-intensive and contamination from their own operations is not the crucial environmental concern, there is impending environmental liability which arises from particular financial transactions. As Al-Zumai (2008) notes, “Due to the fact that Islamic finance is asset based liability in general and environmental liability becomes an issue.”

Furthermore, according to Murrey *et al.* (2008), the “poor environmental practices by banks’ customers may reduce the value of collateralised property and/or increase the likelihood of fines or legal liability that reduces a debtor's ability to make payments to the bank.” A classical instance where environmental laws can obstruct the development of Islamic finance in this area is ship building funding. In addition, there are some other cases where banks have been held liable for contamination (US v. Fleet Factors Corporation (1991); US v. Maryland Bank and Trust (1986); and US v. Mirabile (1985)).

- **Corporate Governance laws**

Islamic banking cannot be seen in isolation from an important component of law related to Corporate Governance. However, these significant issues such as compliance with Basel II, Combined Code (2003), Sarbanes Oxley Act (2002), *International Financial Reporting Standards* (IFRSs), IAS 39 (Financial Instruments - Recognition and Measurement), FAS 133 (Accounting for Derivative Instruments and Hedging Activities), USA PATRIOT Act (2001), and Money Laundering Regulations (2007), etc. are not discussed in this paper due to space limitations.

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256 *Supra* note 70, at p: 10.
III. Conclusion

In conclusion, despite the fact that compliance with *Shariah* principles does mean a greater cost, such regulations play an important role in helping the Islamic bank build trust and manage risk effectively. According to Al Shaali (2008), “Significant weaknesses in the legal, governance and systemic liquidity infrastructure are impeding the spread of product innovations in Islamic finance and preventing effective supervision and risk management. There needs to be more done in terms of setting supervisory and regulatory standards tailored to Islamic banks. This is necessary to support industry development.”

259 Nasser Al Shaali, the CEO of the Dubai International Financial Centre (DIFC) Authority, speech at the London Sukuk Summit 2008.
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