

THE VALIDITY OF STATE CONTRACTS ARBITRATION: A ‘LAW AND ECONOMICS’ PERSPECTIVE

IVÁN GUEVARA-BERNAL*

INTRODUCTION

This article addresses the nature of state entities’ participation in commercial contracts where the parties have agreed that any disputes arising from such contracts will be resolved by international arbitration. It will be argued that such participation is pre-eminently of an economic nature, irrespective of the hybrid character of the legal regime applying to the parties and/or the contracts involved. From this it follows that any conflict that leads to the application of an arbitral clause is also economic and should be apprehended as such even in a legal context. We believe that an understanding of the economic nature of the role played by the state when entering into contractual arrangements of a commercial kind will help to dispel doubts about the arbitrability of conflicts resulting from such arrangements, which the traditional approach of contemplating such arrangements in terms of public/private law has singularly failed to do.

After describing the aforementioned traditional approach, we shall propose elements for an economic approach capable of transcending the dichotomy between the public law principles governing state entities and the well-established duty to respect freely

* Doctor IVÁN GUEVARA-BERNAL is a law graduate from Pontificia Universidad Javeriana Law School in Bogotá and a former adviser to the Colombian Minister of Finance. Dr Guevara-Bernal is Ph.D in Law from the University of Cambridge, M.Phil in Latin American Studies also from Cambridge and LL.M in International Business Legal Studies from the University of Exeter. He also holds postgraduate degrees in Public Management and in Financial Law from Los Andes University Law School in Bogotá. He is a regular lecturer and visiting speaker at leading universities in the UK, USA, EU and Colombia. He is a member of Lyndales solicitors in London, and also a former intern at the ICC Court of International Arbitration in Paris.

and validly agreed commercial contracts. By presenting the state as an economic actor, we shall attempt to provide a better understanding of the legal nature of its participation in commercial contracts, including its capacity to enter into contracts containing arbitration clauses. Taking this argument further, we shall go on to consider the economic nature of the contractual failings that lead to conflicts, drawing a connection between the economic concepts of externalities and property rights and a juridical understanding of conflicts. While the fundamental purpose of any system of conflict resolution is the redistribution of legal rights, this is materialized in the reallocation of economic resources. Arbitration therefore is not only a legal but also an economic tool, whose role is to ensure that the needs initially expressed through the conclusion of a contract are correctly satisfied in accordance with the terms agreed by the parties. Seen in this light, arbitration will hopefully appear less of a threat in countries such as Colombia, where part of the economy has been deprived of its benefits, to the detriment of international trade.

GENERAL BACKGROUND

It not infrequently happens that state entities invoke their public status to challenge *ex post facto* the validity of an arbitration clause or the arbitrability of the dispute as a whole. This is not a new phenomenon and has already been the subject of debate, especially in jurisdictions that follow the civil law tradition in the developing world¹.

A politico-legal approach that attempts to overcome such difficulties by seeking analogies between governmental and private activities appears to be unable to provide satisfactory answers. Indeed, such an approach has had adverse effects on the acceptance and enforceability of international commercial arbitration awards in countries such as Colombia². Players in international trade come from countries all over the world. Some of these countries have modernized their position on arbitration, while others have not. In the latter case, the involvement of public entities in international transactions and arbitration may still be a problematic issue and can lead to 'abuses of public power

1 See e.g. E. SILVA-ROMERO, 'ICC Arbitration and State Contracts' (2002) 13:1 ICC IC Arb. Bull. 34, where, after examining ICC's extensive experience of state contract arbitration, the author concludes that '[t]he approach to state contracts in international commercial arbitration is characterized by its oscillation between two contrasting tendencies, one economic, the other political. This contrast is reflected in the use of legal language'. For an academic perspective on the subject, see J. Crawford & A. Sinclair, 'The UNIDROIT Principles and their Application to State Contracts' in *UNIDROIT Principles of International Commercial Contracts: Reflections on their Use in International Arbitration*, Special Supplement, ICC IC Arb. Bull, 2002, 57.

2 See e.g. the Colombian High Administrative Court's decision of 1 August 2002 on the ICC *Termorio* award, Consejo de Estado, Sala de lo Contencioso Administrativo, Sección Tercera. Expediente 21.041.

where the state party attempts unjustifiably to frustrate or deny a contract³. In our view, an alternative and more viable answer would appear to lie in an economic approach that lifts arbitration out of a purely legal context and puts it into a broader economic setting.

When a state party in a commercial contract attempts to extend the applicability of its public law regime to challenge the validity of an arbitration clause, the contract containing it and ultimately the enforceability of any award that is rendered, great difficulties may arise. These are often linked to the terms in which such situations are apprehended. Public and private laws use different languages and function according to different principles. For instance, the notion of ‘commercial’, as applied to international arbitration, is commonly associated with private law and therefore private interests, as opposed to the public interest espoused by state entities. It is a general principle of law in most legal systems that the public interest takes precedence over private interests.

Can we still regard arbitration as commercial when it involves a public entity? Leading authors in international arbitration have answered yes on two grounds: the commercial nature of these transactions is determined by the presence of a foreign undertaking as one of the contracting parties, and arbitration is the result of a contractual clause⁴. However, this approach does not resolve the apparent incompatibility between the public and commercial interests present in state contracts.

The UNCITRAL Model Law on International Commercial Arbitration is of little assistance here. It merely mentioned in a footnote that the term ‘commercial’ ‘should be given a wide interpretation so as to cover matters arising from all relationships of a commercial nature, whether contractual or not’. Arbitration specialists are of the opinion that this footnote aimed to convey ‘the idea that all exchanges of property, services and assets will be commercial’⁵. In other words, the notion of ‘commercial’ includes all kinds of economic transactions (excluding family and labour matters), irrespective of the private or public status of the parties involved or their categorization as merchants or non-merchants.

‘Commercial’ therefore refers to economic exchange transactions. In connection with such transactions, parties may agree amongst other things that the resolution of any conflicts will be sought through arbitration. Admittedly, the presence of a public entity may bring to the transaction certain principles deriving from the public law

3 See J. Crawford & A. Sinclair, *supra* note 1 at 75.

4 See Fouchard, Gaillard and Goldman, *International Commercial Arbitration*, Kluwer Law International 1999, 36.

5 *Ibid.* 36.

rules that govern the operation of such entities, but this is not in itself a reason to challenge the validity of agreements to arbitrate conflicts related to such transactions.

We argue that the only interest at stake in commercial contracts (regardless of whether the parties are public or private) is the parties' common economic interest in the proper and timely performance of the contract that binds them. In our understanding, 'commercial' therefore kinds. Thus, international commercial arbitration should be perceived as a tool chosen by the parties for the same purpose, i.e. to satisfy needs through economic exchange. If for some reason the contractual provisions made by the parties prove inadequate or insufficient to regulate their exchange, arbitration offers an independent and reliable route to resolve the difficulty accurately and efficiently.

The process of exchange that takes place in international commercial markets (economics) and the re-allocation of the conflicting interests of those who partake in such exchange by formalizing contracts (law), should not be confined to external categorizations based on legal principles alone. This is particularly the case when the reality and language we are dealing with is economic in nature⁶. In this context, irrespective of its social and political duties, the state should be thought of as a large firm that actively participates in the process of economic exchange, acquiring contractual rights and obligations like any other actor trading in the market. The state may have particular motives for entering into transactions, but this does not alter the basic economic nature of such transactions⁷.

No matter how creative and skilful lawyers might be in drafting contracts, it is not infrequent for disputes to arise at some point during the life of a contract. The rational actor in economics enters a deal with a certain degree of trust and the conviction that it will work. If for some reason the deal fails, trust is then placed in an effective system of conflict resolution that can be agreed in advance by the parties themselves. It is in this context that conflicts are often submitted to international commercial arbitration, and the ICC Rules of Arbitration constitute a good example of an independent source of trust in the resolution of a conflict⁸. However, when arbitration involves

6 It should be observed that parties to contracts are not necessarily lawyers and their purpose in concluding a contract to satisfy their particular needs through the benefits of economic exchange. It may be assumed that their thoughts are not on the conflicts that may subsequently arise and the legal categorization of such conflicts as public or private.

7 It may be added that an economic interest does not necessary mean an interest in profit. Even non-profit-making NGOs enter into the market of transactions as they also have economic needs that can be satisfied through the process of exchange.

8 A non-state party that is a foreign investor would normally be reluctant to submit its disputes to local courts, while the state party would be unwilling to submit the dispute to foreign laws and even less so to a foreign courts. ICC arbitration is able to offer the necessary neutrality in such situations.

states or state entities, it is sometimes the target of state interference and manipulation. As Lauterpacht observes, ‘if a respondent State sees a possible escape from the jurisdiction, it will use it’⁹.

An administrative measure adopted by the state in its capacity as regulator may suddenly prevent a state party from fulfilling its contractual obligations. The same may happen when a state decides to restrict imports or exports of specific goods or services¹⁰. Environmental regulations and government decrees protecting the cultural and natural heritage have also been used to the detriment of international contracts. ‘The underlying tension revealed is the clash of public and private interests: the contracting state’s need to govern and regulate in the national interest and the other party’s desire for commercial certainty’¹¹. On occasions, state entities have sought to escape their contractual duties by characterizing such legislative and governmental acts as *force majeure*. They have also used the same argument to challenge the arbitrability of disputes¹². This is a sensitive issue as the certainty and effectiveness of arbitration as a system for resolving disputes in the international business community is at stake. No commonly accepted guidelines have as yet been established on how to handle such situations. Different approaches have been adopted.

One is what may be called the ‘governmental public interest approach’, which is very much influenced by the French notion of *contrat administratif*. It focuses on the status of the parties and in particular the presence of a state entity as contracting party, which it interprets as meaning that there is an element of public interest in the agreement. According to this approach, by virtue of its public status and the rules governing its functions, the state party is in a privileged position, irrespective of the nature of the transaction in question. The second approach seeks a balance between the state’s governmental and private activities. It insists that privileges should not be allowed to distort the equality of the relationships upon which economic exchanges are based. The adoption of one or other approach may have an impact on the way the arbitrability of the conflict is viewed and the subsequent enforceability of the award¹³.

9 LAUTERPACHT, E., *Aspects of the Administration of International Justice* (Cambridge: Grotius, 1991) at 50-51.

10 See e.g. *Czarnikow Ltd v. Centrala Handlu Zagranicznego* (‘Rolimpex’), [1979] A.C. 351 (H.L.), which affirmed [1978] Q.B. 176 (case of sugar following a poor harvest). Reference may also be made to an *ad hoc* award of 9 September 1983, (1987) XII Y.B. Comm. Arb. 63 (importation of industrial investment goods at a time when there was a national budget deficit).

11 J. Crawford & A. Sinclair, *supra* note 1 at 67-68.

12 See e.g. the comments by BEJARANO, R. on *Ambito Juridico*, Legis, Bogota 11 al 24 de Nov., No 117, ‘Juriscritica’ No 4.

13 It may be recalled that the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention) states that such recognition and enforcement can be challenged when the parties to the arbitration agreement ‘were, under the law applicable to them, under some incapacity, or the said agreement is not valid under the law to which the parties have subjected it’ (Article V(1)(a)).

We would argue that there is yet another approach, that transcends the confrontation between the special principles governing public law entities and the need to respect freely agreed contracts in international trade. This is by way of an economic analysis. The particularity of this approach is to characterize the state as an economic actor, rather than using public/private law criteria, which has proved to be a serious stumbling block in international commercial transactions.

THE ECONOMIC NATURE OF PUBLIC ENTITIES' INVOLVEMENT IN INTERNATIONAL TRANSACTIONS

As a preliminary remark, it may be observed that public law entities are increasingly involved in international transactions through agreements with private foreign undertakings. These agreements very often include dispute resolution clauses referring conflicts to rules of institutional international commercial arbitration.

CAPACITY OF PUBLIC LAW ENTITIES TO ENTER INTO INTERNATIONAL COMMERCIAL TRANSACTIONS

Major economic development projects form a large part of the international transactions in which states are involved. These projects typically involve public resources, produce contractual obligations to be performed under the rules of administrative law in the territory of the state concerned, and have a significant public interest element. In such projects, the party with which the state entity contracts will often be a foreign private enterprise. In practice, state entities engage in economic activities regardless of the label they may be given. The public/private distinction should only apply internally within the territory of a country to establish the relationship under administrative law between the public administration and those subject to its rules (local private persons)¹⁴. However, this distinction cannot be transposed to international contracts where the non-state party is a foreign private enterprise and the private/public law divide completely alien to the contract by which it is bound (unless the parties have specifically agreed otherwise). In principle, the only binding rules in international contracts are those contained in the contractual clauses. The label 'state contract' should therefore

14 This is an important aspect of those systems of administrative law that follow the French tradition where the relationship between the public administration and citizens is categorized by a number of special factors based on procurement and protection of the citizens' common interest by the state.

be reserved for domestic transactions only and has no place in international economic transactions.

The fact remains, however, that the involvement of a public entity in a contract introduces elements that distinguish the relationship from that between purely private parties. The state very often has at its disposal a number of prerogatives provided by its administrative laws for the sake of protecting the common interest and public resources involved in its activities¹⁵. Moreover, the state expresses itself in many different ways and state powers cover various domains and activities such as legislative, judicial and executive, which overlap and counter-balance each other¹⁶. Although essentially one, the state is existentially diverse and may act in different capacities¹⁷.

In what capacity, then, does the state act when entering into an international commercial contract? In our view, when negotiating a contract and making contractual undertakings, the state does so as the administration. In economic terms, this means that it does so by exercising its executive powers through its several autonomous institutions, whose role is to allocate resources in the name and on behalf of the state in accordance with a given legal regime¹⁸. So, provided that such regime does not expressly prohibit the agreement of an arbitral clause, the state is to be bound by the contract as a whole. The public law principle that public servants can only do what the law expressly authorizes cannot possibly be extended to international commercial transactions freely agreed and duly performed.

Consequently, state entities are normally free to organize commercial activities as private persons do and to have their senior officials negotiate contracts and give the authorizations necessary for the transactions through which the state implements its development plans and functions as an organization¹⁹.

15 This is particularly the case in civil law countries whose administrative codes contain rules allowing the administration to exercise unilateral exorbitant prerogatives to protect the public interest.

16 Nonetheless, the state remains essentially one and cannot possibly erase with one hand what it has already undertaken with the other. This principle is, of course, sadly often flouted.

17 For instance, the state does not act in the same capacity when it issues a regulatory directive through its banking commission as when it appoints a public servant, enforces a judicial order or bans an economic activity.

18 This is an important factor to take into account as far as the enforcement of international arbitral awards is concerned. The New York Convention, Article V(1)(a), provides that an award might be refused in the event that the parties to the contract 'were, under the law applicable to them, under some incapacity'. This means that the boundaries of capacity for the state entity must always be established when negotiating a contract.

19 Cf. J. Crawford & A. Sinclair, *supra* note 1 at 60.

THE ECONOMIC PRINCIPLE OF COMMITTED CAPACITY

If a state uses its administrative legal capacity to negotiate and sign contracts, the terms under which that capacity is exercised should be respected and maintained within the limits of the contractual clauses throughout the performance of the agreement. This principle, known as the 'committed capacity' principle, aims to prevent abuses by parties to a contract, especially in the context of international trade. It of course applies in particular to clauses covering the resolution of any conflict that might arise from the contract. Once the state has exercised its capacity, it is committed as a whole to respect the clauses of the contract, which means that public servants holding other state functions should not be able to use their *imperium* to interfere with or manipulate the allocation of resources that has been agreed²⁰.

From this perspective, the administration acts like any other entrepreneur, coordinating transactions and allocating resources through the administrative structure of a firm-like economic organization. The source and definition of these transactions is thus not to be sought in purely legal categorizations, centered on the distinction between public and private law. Rather, the state and its entities enter into international economic transactions for a reason that is rooted in both law and economics: law, because they act in accordance with the legal regime governing their capacity; economics, because they enter into exchange arrangements with other firms in order to satisfy their needs. Such is precisely the objective underlying the clauses of a commercial contract, including its agreed system of dispute resolution. Anything outside the mutual ordering expressed by such arrangements should not be binding or applicable²¹.

THE STATE AS AN ECONOMIC ORGANIZATION

Economic activities are conducted between organizations of different forms in a given society. In economic terms, an organization²² is basically a relationship system connecting

20 Besides, from a social cost perspective, it is more beneficial for the state to commit one of its capacities to the strict terms of the agreement entered into (including the arbitration clause), than to incur great cost by using other capacities to try to escape compliance or responsibility.

21 Our reasoning here is economic and should not be considered in any way as political. We refer to the public administration giving and taking concessions in the normal bargaining process, so as to keep open the chances of foreign investment and foster economic development through international exchange. We are not suggesting that the state is of the same nature as a private undertaking. We maintain, however, that it may use its capacity to participate in international trade like any other economic organization in order to ensure the maximization of economic benefits through the clauses of a commercial contract.

22 In ALCHIAN A. and DEMSETZ H, (1972) 'Production Information Costs and Economic Organisation' in BUCKLEY P.J. & MICHIE J. (eds) (1996) *Firms, Organizations and Contracts*, Oxford Univ. Press, at p. 77 define , economic organization is defined as 'the classic relationship in economics that runs from marginal productivity to the distribution of income that allocates rewards to resources in accord with their productivity'.

different owners of resources within a space where they co-operate under a given set of pre-defined rules. When entering into commercial transactions through its various entities, the state is a good example of an organization, as it possesses both the political power and the legal capacity to effectively centralize a system of relationships through administrative acts and contractual agreements.

The cooperation embodied in contractual arrangements acquires particular importance where the state is concerned, as a form of economic co-ordination²³. States thus have an interest in entering into commercial transactions with other firms and actors in the market, irrespective of considerations as to their legal status.

In a world faced with high transaction costs and limited resources for satisfying needs, it is rational for the state to use long-term relationships with private enterprises based on mutual trust. Such long-term relationships, mostly expressed in contractual clauses, justify the existence and operation of a central forum or organization²⁴. This is precisely the function of the state when acting through its administrative legal capacity: it serves as the focus for a multitude of complex relationships established in accordance with the terms and conditions of formalized contractual clauses. In this way, the economic reality of parties paying the costs of negotiating conflicting needs is given a legal structure²⁵.

THE STATE AS A FIRM-LIKE ECONOMIC ORGANIZATION

The system of co-ordinated relationships embodied by the state resembles a very specific form of economic organization, commonly known as the firm. In this context a firm is basically a nexus of contractual relations extracted from the market. The state regularly operates as a firm-like organization, by entering into binding agreements with private

23 For further discussion on the notion of co-operation as a form of economic co-ordination, in contrast to competition, see DEAKIN S.F. & WILKINSON F., 1996; Loasby, 1995:248-65(1997) 'Trust Relations and Incentives for Co-operation: A Comparative Study' in Deakin S.F. and Michie J. (eds) *Contracts, Co-operation and Competition. Studies in Economics, Management and Law*, Oxford Univ. Press, at 248. For the notion of co-operation as an intention or willingness to maintain a trading relationship and avoid adversarial behaviour, see LORENZ N., (1988) 'Neither Friends nor Strangers: Informal Relations of Subcontracting in French Industry', in GAMBETTA D. (ed.) *Trust: Making and Breaking Co-operative Relations*, Oxford;Blackwell at 166. 1988:166.

24 According to JENSEN M.C. and MECKLING W.H., in (1976) 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure', *Journal of Financial Economics*, 3. 305, 1996:108 'it is important to recognize that most organizations are simply legal fictions, which serve as a nexus for a set of contracting relationships among individuals. This includes firms, non-profit institutions such as universities, hospitals and foundations, mutual organizations such as mutual saving banks and insurance companies and co-operatives, some private clubs and even governmental bodies such as cities, states and the Federal Government.'

25 See JENSEN M.C. and MECKLING W.H., (1976) *Op. Cit.* pág. 24.

enterprises from which society as a whole may expect social development to take place and, thus, the satisfaction of needs. This legitimate economic expectation is translated into the legal wording of contractual clauses. When concluding such transactions, like any other firm, the state uses its governance structures with a view to reducing transaction costs. As the state has a responsibility to ensure that public resources are spent in the most beneficial way possible, it is important for it to agree and commit itself in advance on rules and procedures that provide a quick and accurate way of resolving potential problems. In this context, an arbitration clause, providing a means of achieving a final and quick outcome to a dispute concerning a mega-project for the satisfaction of the needs of a given society, may be regarded as an economic tool bringing a reduction in transaction costs in terms of time and efficiency²⁶.

Of course, the effectiveness of public administration depends more on the state's ability to negotiate and agree on well-structured contracts rather than the existence of an arbitration clause. Arbitration is available to provide an answer whenever shortcomings in contracts give rise to controversy. An adverse decision in arbitration proceedings should be blamed on badly negotiated contracts and not on the instruments freely used by the parties to solve their conflict.

Let us now consider the nature of the conflict giving rise to the application of an arbitration clause in a commercial contract to which a state is party.

THE NATURE OF CONFLICTS ARISING FROM STATE CONTRACTS

In a world of high transaction costs, contracts are often incomplete, leading to miscomprehension and conflict. Not even the state is immune from this fact of life. In such situations, economic actors seek a rapid and reliable decision reallocating resources by way of damages, costs, etc., whether from a court or an arbitral tribunal²⁷. Clauses providing for dispute resolution through arbitration therefore fulfil the economic function of establishing a system for the redistribution of rights between the parties according to

26 'When economic agents interact with one another, they incur "transaction costs" that vary with the mode of interaction. In the market, agents interact by negotiating exchanges, with prices serving as signals of the opportunities facing each supplier of a service or demander of a product'. See this notion in Putterman L. and Kroszner R.S. (1996) 'The Economic Nature of the Firm: A New Introduction' in Putterman L. and Kroszner R.S. (eds), *Corporate Personality in the 20th Century*, Hart Publishing, Oxford at 9.

27 Arbitration is likely to be the more attractive option in an international context, as greater independence may generally be expected from an arbitral tribunal than from the courts of the country from which one of the parties – normally the state-party – originates.

a process that is chosen by the parties. This is perfectly compatible with the socio-political duties of the state when taking part in contractual arrangements. To understand the particular economic nature of a conflict that triggers the application of an arbitral clause in a commercial and possibly international transaction, it is useful to consider the economic notions of property and externalities.

Externalities correspond to what in legal terms we commonly refer to as damages, both in contracts and in torts²⁸. From an economic perspective, the legal notion of conflict describes a situation in which a party causes disadvantages by imposing costs on other parties, the community, the state, other firms, the environment, corporate stakeholders, etc. A conflict materializes when there is a perception that the free exploitation of scarce resources is being abused²⁹.

It should be pointed out however that the notion of externalities and their adequate legal treatment has been a matter of economic debate. PIGOU was the first to address this issue systematically from a welfare economics perspective, where taxation is proposed as the remedy for the internalization³⁰ of externalities³¹. In our view it was not until the publication of the Coase theorem that externalities were properly approached. COASE greatly contributed to the abandonment of the Pigouvian tradition by stressing that taxes and subsidies ‘could lead to worse results in terms of efficiency than would the very existence of externalities they wish to remedy’. When two parties bargain over the agreement of a contract, they seek to obtain an efficient result through the most optimal allocation of resources, no matter how the property rights were originally structured. It is within this bargaining process that potential conflicts are considered and anticipated and the possible means of resolving them agreed upon. If we lived in a world at zero transaction costs this process would be different. MATTEI argues in this respect that ‘in the absence of transaction costs, nobody imposes costs on anybody else’. so the likelihood of conflicts arising is much less.

28 Externalities are ‘nothing more than the economic concept describing the interrelationships between individual activities. In a world of scarce resources such interrelationships inevitably become the source of reciprocal nuisances, which may produce economica.

29 See this discussion in MATTEI, 1998: Op. Cit. p. 47 where he points out that ‘external effects of externalities were discovered for the first time by MARSHALL, while analyzing the interrelationship between the activities of firms’. See also MARSHALL, (1916) Principles of Economics, and Introductory Volume at 267.

30 In this context internalization refers to the internal bearing of different sorts of costs by a firm.

31 See PIGOU, 1932. The Pigouvian tradition in respect of externalities is summarized as follows: ‘PIGOU believed that an increase in welfare could stem from a redistribution of property from the rich to the poor provided that this would not diminish national income. This assumption led PIGOU to research the divergence between private costs and social costs. In so doing, he provided a first, and quite precise, definition of externalities’. See MATTEI, 1998: 47.

These two approaches have given rise to two models for the institutional control of externalities. The Pigouvian model is based on centralized regulations, while the Coasian decentralized model is based on the enforcement of property rights by the courts. The latter seeks to distribute property rights and the legal remedies necessary for courts to put this into effect. Such remedies may be effective property rules or mere rules of internalization [???].

The remedies available for controlling externalities vary from one legal system to another. In countries with a strong court system where litigation is practised to great effect, as is the case in the Anglo-American common law tradition, a system of property rights administered by courts and tribunals of all kinds (including arbitration) is conceived as an efficient way of tackling externalities (Coasian approach). On the other hand, in countries like France, Germany and Italy, which follow the civil law system, there is much less inclination to enter into lengthy and expensive litigation and a far wider belief that it is not the duty of the courts to provide for public policy solutions when deciding about individual rights. In these countries, externalities are therefore tackled through public law regulation (Pigouvian approach) and alternative systems of conflict resolution such as arbitration are generally disliked.

When the free exercise of property through the arrangements of a contract is restricted through an externality, each legal system defines how such rights should be exercised. In the common law, externalities are dealt with through compensation awarded to the victim by the courts and tribunals. In the civil law systems, property rights are limited by duties of social responsibility imposed through public law regulation, whether constitutional or administrative. This in part explains the reluctance of civil law systems to accept that arbitration of state contracts can be a reliable tool for the reallocation of property rights. In practice, however, the distinction is not so clear-cut and combinations of the two approaches can be found.

Whichever approach is adopted, the purpose of distributing property rights is to ensure that scarce resources are not consumed without this being reflected in costs. Economic law must therefore find the right balance between economic freedom and responsibility. This should happen not only in the restricted context of private exchange but also as a way of social interaction. Although both private law and public law have contributed equally to this economic debate, the issue is essentially economic. Hence, when economic activity is conducted in such a way that it breaches contracts, this results in an externality to which the cure may be sought through any form of conflict resolution. Arbitration clauses are therefore an adequate response to counterbalance possible externalities, both in law and economics

It should be noted that the combination of private economic exchanges with elements of public interest should not upset the normal operation of economic activity where every one is looking to profit from a secure a position in the market irrespective of the status of the parties involved. It is certainly not a reason for arguing against the arbitability of externalities. What is arbitration, after all, but one means among others of re-establishing the proper balance that economic freedom and relations aim to achieve?³².

CONCLUSION

We have argued in this article that the state has the power and capacity to negotiate and enter into international commercial agreements with private undertakings (national or foreign), provided administrative law does not expressly prohibit this (which is rarely the case). Although such capacity derives from the administrative legal regime that applies to the state entity in question, the rules governing the contractual relationship will be those contained in the clauses freely agreed by the parties.

The state's participation in these commercial contracts is of a fundamentally economic nature. In a world of scarce resources and multitudinous needs the state cannot itself provide everything that is needed in a given society. For this purpose, it has the option –and sometimes even the duty– to enter into cooperation arrangements based on exchanges with other owners of resources, in order to satisfy its needs. When doing so, the state operates through the executive powers of its administration operating as a firm-like economic organization.

When a scheme of co-operation is successfully negotiated and agreed, the state commits its administrative legal capacity to the terms of the agreement. This commitment is formalized in a commercial contract that not only binds the parties but must also be respected by all other emanations of the same state.

State commercial contracts fulfil the economic function of allocating resources on the basis of mutual trust. If for some reason the contract founders and a conflict arises, that trust is then shifted to a reliable system of dispute resolution. Ideally, that system should be one that allows resources to be reallocated in a timely and accurate manner and with due respect to the parties' original agreement. Arbitration meets these criteria. It has been argued that the conflicts that typically arise from state contracts are of a

³² Arbitration is not a set of substantive laws but a contractual proceeding for the application of substantive laws, which is quite different.

specific nature and cannot come within the scope of validly agreed arbitration clauses. This has been a popular argument amongst some administrative lawyers in Colombia, who claim that arbitration cannot be used to circumvent mandatory rules of administrative law, which is a general duty that has nothing to do with arbitration any way. However, the referral of a conflict to arbitration is merely a transfer of jurisdiction from an ordinary court to a panel of specialized independent arbitrators appointed by the parties themselves, including the state. It is that and no more than that. The duty of these arbitrators will be to resolve the conflict applying the laws indicated by the contract itself. If these include mandatory rules of administrative law, the arbitrators will of course be obliged to apply these when making their decision.

It is true that local administrative judges have jurisdiction over the resolution of conflicts deriving from state contracts, especially if these involve administrative acts subject to mandatory law. However, there is a fundamental exception to this principle of jurisdiction – namely, when parties (i.g. the state) freely agree to transfer that jurisdiction through an arbitration clause. As we have seen, this option is open to the state when acting through its administration as a firm-like economic organisation. Moreover, it is an option that lies in the state's interest, given its relative rapidity and its compatibility with the economic principles underlying the operation of any society.

Perhaps it is time to accept the fact that international arbitration is not a luxury reserved for private multinationals. On the contrary, it is a tool that may be used for the benefit of all of those involved in a contract, including the state. To try to challenge the validity of state contract arbitration on the grounds of the public nature of the state entity involved is not only a costly mistake but makes no sense. Commercial contracts take place because parties require access to the benefits deriving from economic exchange. This is the reality that legal science should take into account when addressing this matter.