

THE JOURNAL OF **&** INTERNATIONAL
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STATEMENT OF PURPOSE

The *Journal of Politics & International Affairs* at New York University is a student-run publication comprised of original student research on relevant, thought-provoking topics in the global landscape. Student submissions are evaluated on their critical analysis as well as their ability to stimulate scholarly discourse. Editors select respected academics, prominent public figures, and thought leaders to headline each issue with an article of their choosing. The rest of the articles are written and edited exclusively by NYU students. The *Journal* provides a forum for students, believing their contributions to be not only legitimate, but also crucial to the intellectual growth of students at New York University and of students nationwide.

CONTRIBUTIONS

The *Journal of Politics & International Affairs* will consider proposed or completed unpublished articles of any length that concern domestic politics, international affairs, or derivative subjects for publication. Proposals should be submitted via e-mail at jpia.club@nyu.edu.

NOTES

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EDITORS' NOTE

The articles in the *Journal of Politics & International Affairs* do not represent an agreement of beliefs and methodology. Readers are not expected to concur with all the opinions and research contained within these pages; the *Journal* seeks to inform and inspire the NYU community by presenting a wide variety of topics and opinions from a similarly broad range of ideologies and methods.

Manuscripts submitted to the *Journal of Politics & International Affairs* are handled by an editorial board at New York University. Papers are submitted via e-mail and selected after several rounds of reading by the staff. Final selections are made by the editors-in-chief. Papers are edited for clarity, readability, and grammar in multiple rounds, during which at least three editors review each piece. Papers are assigned on the basis of fields of interest and expertise of the editors, in addition to a variety of other considerations such as equalization of the workload and the nature of the work necessary.

SOME THOUGHTS ON LEADERSHIP AND ETHICS

AFTER 49 YEARS IN THE WORKFORCE

MARSHALL N. CARTER

Marshall N. Carter has served as Chairman of the Board of Directors of the NYSE Group or its predecessor, New York Stock Exchange, since April 7, 2005. Mr. Carter has been a director of the NYSE since November 2003. He most recently was a lecturer in leadership and management at the Sloan School of Management at Massachusetts Institute of Technology and Harvard's Kennedy School of Government, where from 2001 to 2005 he was a Fellow at the Center for Public Leadership and the Center for Business and Government. The following is a lecture from the Flaum Leadership Lecture Series given at Fordham University.

Having graduated from college in 1962, I'm now at age 70. It's my forty-ninth year in the workforce and I am continuously amazed at how we arrived at this point of widespread "uncertainty" about many of our largest financial and business institutions, less-than-enthusiastic support for many of our government actions, and serious concern about the near-term job prospects and economic outlook for young graduates of our colleges and universities.

Over the past six or seven years I've been lecturing and teaching at numerous colleges — including your sister institution Creighton University in Omaha in November — and I'm constantly asked: What is the future of capitalism? And can we be confident that ethical behavior, a historical norm of U.S. business, will be the norm of the future? What's the relationship between the leadership of a company and its ethics?

And finally, how do we, as new graduates, choose a company or industry that holds leadership and ethics in high regard? Let me share with you their concerns, as many of you and your companies are hiring this generation.

Most recently they have been asking:

- Can you be an ethical person and an effective business person?

- Is the recent widespread criticism of business and especially the financial services industry justified or has the drive by the industry for profits squandered the trust upon which businesses and the economy have been built?
- Is business an easier target than government policies and regulatory oversight that have failed?

In a recent New York Times column, economist Ben Stein wrote of the standard of care that financial institutions should exercise. Stein emphasizes the central role that trust once played in finance and investment, writing, "Without trust, there can be no free-market capitalism."

A major concern of our college students and graduates is how they reconcile the demands of capitalism with both the common good and their own spiritual and psychological needs as individuals. Last year 45,000 recent graduates applied to Teach for America, so this generation does have solid concern for our society.

What I attempt to do is explain, but not excuse, how we got here. When the Wall Street Journal publishes a list of 25 major U.S. firms, as they did a few years ago, that have had "ethical lapses" — starting with Adelphia and ending with Xerox — we know we are faced with a challenge to re-establish American capitalism and business based on sound leadership and ethical behavior. We must do this in a rapidly changing environment; over the past few years, companies have seemed to favor Wall Street-based financial transactions over a company's basic commercial operations.

The Business Environment

As we all know business leaders at all levels, not just the CEO, have specific responsibilities that fall into three areas — ethical, legal and economic (and here "economic" means the company's business model). They are expected to make decisions balancing the demands of all three. Their decisions must balance all three simultaneously. However, as the Wall Street Journal list shows, things weren't that well balanced.

Why and how did this happen?

The 1990's were to some extent the "Go-Go" years, characterized by:

- The longest bull market in history
- The Internet explosion and IPOs that produced instant millionaires
- Merger mania
- A focus on corporate earnings, rising stock prices and celebrity CEOs

Everyone seemed to want to get rich, have an advantage over another company through earnings and IPOs and be perceived as a great corporate leader as measured by salaries, lifestyle and stock holdings or options.

Corporate Boards of Directors were often accused of lackadaisical oversight, with a focus on compliance with specific rules and regulations and an ignorance of conflicts of interest or risky businesses. One result was the very onerous Sarbanes-Oxley law that attempted to "right" the governance of corporations through additional controls.

Students also ask, "What's the correct 'metric' for corporate leaders?" Clearly large salaries, bonuses, stock, options, and performance shares are part of the problem, not part of the solution, but they do have the advantage of being measurable and quantifiable.

What about the ethical and economic "metrics" of a company? How do we or can we quantify those? Is the new trend to measure or assess corporate social responsibility (known as CR or CSR) going to be sufficient? And will it be accepted by investors and share-holders?

Companies of the 21st Century

As we look to the future, this generation will probably work for six or seven companies, not the three or four of their parents' generation or the one or two of my pre-baby boomer generation. What's more startling is that they will have 1.7 children and 2.2 marriages!

These companies will also look quite different, and will actually require more leadership and an increased focus on values and ethical cultures because they will probably be global companies and have to balance varying norms of behavior and cultures. Some of you are probably already meeting these challenges.

Characteristics of 20th Century Companies

Structure

- Bureaucratic, multi-leveled
- Organized with the expectation that senior management will manage and command and control operations
- Characterized by policies and procedures that created many complicated internal interdependencies
- But with limited horizontal control issues; you could actually manage and lead face-to-face because of the control environment and narrow spans of control

Culture

- Inwardly focused
- Centralized
- Slow to make decisions
- Political
- Risk averse

These companies thrived in the manufacturing world, but now with 77% of the U.S. economy being “service sector,” we see a different approach — some of which I'm sure many of you are incorporating into your own organizations.

Characteristics of 21st Century Companies

Structure

- Non-bureaucratic, with fewer rules and employees
- Limited to fewer levels, greater spans of control
- Organized with the expectation that senior management will lead, lower-level employees will manage specific tasks
- Characterized by policies and procedures that produce dedicated and vertically structured organizations to serve customers

Culture

With an operating style that is:

- Externally oriented and global
- Empowering at all levels
- Quick to make decisions
- Open and candid
- More tolerant of business risk

So, the graduates ask, how will leaders act and how will they establish an ethical culture in these companies? And how do young people evaluate them as a place to work?

First, they want their leaders to be totally committed.

Being totally committed yields dramatic results for two reasons:

- It proves that the goal is worthwhile and important
- It confirms that the leader isn't going to quit before the objective is achieved

Second, they want their effective leaders at all levels to take time to ensure the correct values are believed and implemented throughout the company or organization. This is especially important as the companies decentralize to face their markets and serve global markets.

They often ask: how do leaders do that? My responses are that leaders must:

- Develop and encourage a shared sense of the organization's goals and purpose throughout the company
- Ensure open and candid discussions, including dissent
- Encourage autonomy of subordinates to achieve their goals
- Establish high ethical standards, including some practical cases spelled out and easy to understand
- Take action to ensure the leaders and executives are "role models" for all employees, again including publishing good and bad examples

I urge them, before going to work, to satisfy themselves that the company is truly committed to strong leadership and ethics.

Personal Ethics

While what I tell them about the business leadership environment is interesting, we and they are also in an era of much greater legal, market, regulatory and public scrutiny. The responsibility falls on all employees to act ethically.

For them to be successful, I urge them to:

First, act and think ethically, creating and living in a moral culture within their business or activities, not to mention within the law. While you can make a case for various interpretations of accounting rules in cases like Enron and WorldCom, the acts still contained illegal events designed to defraud.

Second, it's often not the large, possibly illegal act that occurs when you are young and just entering the workforce. It's more like these examples. These are events that I have been personally involved with or that happened to me. For young people these are good examples because it's often difficult to tell exactly what is the illegal act, if any.

1. Your company would like to be involved in the underwriting of some municipal bonds, but to do so you have to "pay to play" and contribute \$5,000 to a fund raising breakfast for the mayor – expensive eggs! Do you go along, thinking everybody does it – it's standard market practice – or do you stand your ground that this is "buying business?"
2. You hire a new person from a competitor. She arrives the first day of work with a copy of the competitor's numbered and confidential strategic plan. Is this windfall business intelligence or theft?
3. You are asked to evaluate a customer or company that you know has potential for a large business relationship with your company, but is highly sensitive to criticism. You are tempted to "ease off" on your analysis to hopefully gain the business for your company.
4. You work in a brokerage or stock trading operation. It is two minutes past the deadline for posting mutual fund trades, but your supervisor gives you a stack of trades from a large mutual fund

company with the comment, “Your watch is fast, this is our biggest customer!”

5. Or in my case, as a 26 year-old junior Marine Corps infantry commander in combat in Vietnam, I’m asked to verify enemy dead, but to do so will place my troops in extremely dangerous circumstances – here the metric was “body count”. Do I obey higher officers, who are many miles to the rear, or protect my troops from sure danger just to enhance some colonel’s metrics report?
6. You work for a college that does government research. The college president is getting married on campus and you are asked to include some of the wedding expenses in the normal governmental research overhead charges.
7. You are asked by the CEO to pay annual bonuses in December, not February, because there is a new income tax bill that becomes effective on January 1 and would subject the executive bonuses to a significantly higher tax rate.
8. You have an employee who is terminally ill but on his spouse’s healthcare plan, not your company’s, and it’s out of money or has reached its payout limit of \$150,000. Do you put him on your company’s plan during open enrollment? Even with this serious prior condition?
9. You are leaving a Middle Eastern country to fly to London, but to depart you have to give the airport manager \$100 U.S. to get on a “full” flight that has empty seats. How do you put that “bribe” on your expense report?
10. You work for a bank and a customer is behind on home mortgage insurance payments. The bank offers or demands another, more expensive policy, but the bank gets a 15 percent kickback and finders fee. Is that a place you want to work long term?

Conclusion

So, where is this generation?

First, they realize that leadership is tightly linked and inextricably tied to ethics. The leaders of any organization at all levels — be it business, NGO, non-profit, academic or whatever — must set and maintain the ethical tone.

Second, the actions that are illegal are usually straightforward. It’s the gray areas often occurring in day-to-day activities that require personal ethical compasses.

Third, they, like us, realize we don’t have a lot of noteworthy national role models, or at least they don’t get the same level of scrutiny and exposure as the bad role models.

So, the answers to questions posed by students at the beginning:

If you plan on a career, or even just a first job, in business or finance, I think you should ask yourself the following questions:

- Can you be an ethical person and an effective business person? Yes, but you may at some point in your career have to change companies if you’re not happy with the ethical environment.
- Is the widespread criticism of business, and especially the financial services industry, justified? Or has the drive for profits squandered the trust upon which our economy has been built? Criticism is justified and I believe a lot of trust has been squandered, especially regarding Main Street’s view of Wall Street (e.g. zero-percent interest home loans).
- Is the industry an easier target than government policies and oversight that have failed? Yes. For example, Congress forced growth of Fannie and Freddie, but are not doing any self-analysis nor even addressing its role in the recession.

HOW DOES PROTEST TOPPLE A GOVERNMENT? AND WILL EGYPTIAN PROTESTERS COME BACK?

JOSHUA TUCKER

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In the midst of Egyptian President Hosni Mubarak's resignation last week, my colleague Peter Rosendorff posed the interesting question of why governments ever fall simply because there are protesters in the street. After all, most crucial government functions don't take place in the street. Can't governments simply go about their business of governing and wait for the protesters to go home?

Note that this is a different question from two very well-studied topics: Why it is that some authoritarian regimes fail, or how it is that protesters are able to overcome collective action problems and actually take to the street in protest? Instead, the question is simpler: Once protesters are out on the street, why does the government ever capitulate to demands that the government be replaced?

So to answer this question, we started with the most extreme and obvious explanation, and then tried to walk our way backwards:

- 1) If protesters actually "storm the palace" and kill the current leader(s) of the government, then protest will yield government change (e.g., Romania and the execution of Nicolae Ceaușescu).
- 2) If protesters stop short of killing the current leader(ship) but somehow forcibly exile him/her/ them, then protest will yield government change.

3) If the continued persistence of protest leads the current leader(ship) to think that either Options One or Options Two will come to fruition, then it is possible the leader(ship) will step down and/or flee (e.g., Askar Akayev in Kyrgyzstan in 2005), in which case protest will lead to a change in government.

However when we look back at what transpired in Egypt, none of these three scenarios seem to describe what happened particularly well. Hosni Mubarak wasn't killed or forcibly exiled, and nor did he seem to step down in anticipation of either of these events happening. And yet he is definitely out of power, and there is no doubt that without the protests, he would still be in power.

So this seems to suggest a need for another explanation of how protest can cause regime change:

4) If protest convinces other pivotal actors in society that they would be better off with a different government in place, these actors may take actions in order to bring about a change in government. In this case, we could again say that protest has led to a change in government.

So this proposition would force us to identify two key factors. First, who are the pivotal actors in society that can actually force a change in government? Clearly—as was the case in Egypt—the military is always a possible candidate here. But are there others? Party leaders? Key economic figures? Major civil society players? Or is this explanation inevitably a story about the military? Put another way, will we look back on events in Egypt and describe what changed on Day 17 simply as the military deciding that Mr. Mubarak was now a liability, and little more than that? And even if we look at other protest-induced transitions where power passed from civilians to civilians—such as the Orange Revolution in Ukraine—do such stories also inevitably have to include the caveat that they only came to fruition because the military eventually signaled it would not protect the outgoing regime?

The second factor this last proposition points to is the question of what exactly it is that protest does to convince these pivotal actors that a change in government is necessary. Here are four suggestions:

First, it could be simply the bad public relations that can come with protesters getting beaten or killed while the whole world watches. We might expect that this would in turn making it harder for the country to manage its international relations with other countries (e.g., in Egypt's case, harder to protect its relationship with the U.S. and U.S. military aid).

Second, it could be more of an economic concern. This could be a direct result of the protests, such as protesters actually preventing commercial activity from occurring where they are protesting. Or it could be more of an indirect effect, such as a concern that extended protest will adversely affect industries like tourism. Either way, we could imagine that these pivotal actors would decide that the continued economic cost of the current regime remaining in power had become too high.

Third, it could be a security concern, whereby it comes to seem more likely that security can be maintained by acceding to the protesters' demands than by either allowing the protest to continue or by forcibly suppressing it.

Finally, it might actually be something more normatively pleasing. Perhaps our pivotal actors are willing to let the current regime stay in power as long as they believe the regime has the support of a significant proportion of the population. In the case of non-democratic regimes without real elections, our pivotal actors most of the time are going to be forced to make educated guesses about this level of support. Massive protest may ultimately prove to be a major corrective to these estimates.

Of course, how we answer these questions is also likely to be determined by who the pivotal actors are in a given country; the answers may be different for economic and military elites (if they are in fact different people). Furthermore, there may also be interactions between these different factors. Bad P.R. may have adverse effects on economic developments beyond the original impact of the protests, and the public realization of the fact that regime support is low may also complicate relations with allies. This, however, may depend on the regime type of one's (potential?) allies, thus suggesting the possibility of a different dynamic developing in Iran. In my previous post, I addressed the question of why protest might ever bring down a government.

Here, I turn to an important follow up: Having successfully brought down a government, what

do we expect protesters to do in the future? Will they return to the streets if they are dissatisfied with their new government? Or is it likely that what we just witnessed in Egypt—even as it appears to be spreading throughout the Middle East—might turn out to be a one-shot deal?

In the heat of the moment, it seems unimaginable that what's going on in Egypt couldn't be the start of something new. After all, commentator after commentator has described the dawning of a "new day" in Egypt. The Egyptian people have risen up to take control of their own fate and will no longer tolerate oppressive governments. Any attempts by future governments to oppress the Egyptian people will obviously meet a similar fate from a now-emboldened population. After all, they took to the streets today: Why wouldn't they take to the streets tomorrow?

And yet, we've heard this story before, and the ending isn't always so happy. One need only look to Ukraine, the site of the now famous Orange Revolution in 2005, when hundreds of thousands of people took to the streets to prevent Viktor Yanukovich from using electoral fraud to steal the 2004 Ukrainian presidential elections. Fast forward to 2011, and look who is president of Ukraine: the very same Viktor Yanukovich, his 2010 election to the presidency featuring a dramatic decline in turnout and barely any response from protesters. Or look next door to Russia, where large crowds turned out to support Russian democracy in the early 1990s, as opposed to today when it is difficult to get thousands or even hundreds supporters onto the streets for pro-democracy protests. Why has this been the case?

More generally, as political scientists we would like to know what could have happened in the intervening time between a protest that successfully overthrows a government and some future event which we might expect to draw protesters back on the streets but doesn't (e.g., will Egyptian protesters return to the streets five years from now if Mubarak's successor begins to exercise Mubarak-like powers?)

This is precisely the subject of a paper I am writing with Professor Adam Meiowitz of Princeton University. In the paper, we propose a model that focuses on the decision making of the protester in his or her effort to secure a good government. More specifically, we are interested in the circumstances that could give rise to a one-shot deal scenario in terms of protest.

Some of the predictions that emerge from the model are fairly obvious. If the new government performs well, then we wouldn't expect protesters to return to the streets to replace it. Similarly, if the new government raises the cost of protesting to a point where it is too high—e.g., the new government credibly commits to shooting every protester in the future—then we wouldn't expect to see protests in the future either.

However, a third conclusion from the model is a bit less obvious. Namely, we find that the one-shot deal scenario may be more likely when citizens have less certainty about the nature of the universe of potential governments. To put this more intuitively, in an established democracy, we might expect that citizens generally believe the quality of the government will be "good." (By "good" we don't necessarily mean that the government is above average for the governments in that country, but only that it meets some basic threshold such as competently executing government policy, not being corrupt, not stealing from the population, etc. Governments that fail to meet this threshold could be considered "bad.") Thus in an established democracy, when by misfortune citizens happen to get the odd "bad" government, it is worth a potentially costly effort (i.e., an extended protest) to replace that government, because you are confident your replacement will probably be good.

In a new regime, however, citizens may have much less confidence about the universe of potential governments, i.e., whether in general most governments are good or most governments are bad. Consider the case of Ukraine in 2005 following the Orange Revolution. Citizens have observed a number of bad governments. This may be because (a) non-democratic governments are bad or (b) most Ukrainian politicians are corrupt. At the time of the Orange Revolution, Ukrainians may have been motivated to protest because they believed (a) to be the case, and thus switching to a more democratic system would usher in a period where governments would be generally good. However, if 2005-2010 reveals nothing more than a series of bad, democratically elected, governments in Ukraine, then Ukrainian citizens may come to believe that they are simply living in a world where all Ukrainian governments are bad. And if that's the case, why bother

protesting again?

Which brings us back to Egypt. If political developments proceed as expected, then at some point in the near future Egypt will have democratic elections. My post today should be taken as a warning that to expect the events of early 2011 to serve as a guarantee of good governance in the post-Mubarak era might be naïve. Indeed, to the extent that any post-Mubarak government fails to live up the expectations of the Egyptian citizenry, it might counter-intuitively make those citizens less likely to protest in the future. Thus the stakes for Egypt's initial post-Mubarak governments may be even higher than we already expect.

WHERE DOES THE UN INTERVENE?

ARE THE INTERESTS OF THE PERMANENT FIVE MEMBERS OF THE SECURITY COUNCIL DETERMINING FACTORS IN UN INTERVENTION?

ISHA DANDAVATE

The Security Council of the United Nations is responsible for issuing mandates for peacekeeping interventions in civil war-torn countries. The Permanent Five members of the Security Council can veto any proposed intervention and thus are the subject of my research. Are P5 member decisions to support or prevent peacekeeper deployment influenced by factors other than crisis characteristics? This paper explores how three indicators of the political and economic relationships between P5 members and target countries—alliance similarity, voting affinity, and trade—impact the probability of UN intervention in a civil war. The results show the three independent variables to be significant, indicating that the relationships between the P5 members and target countries impact the likelihood of UN intervention.

Introduction

Since World War II, civil wars have been responsible for about 16.5 million deaths, whereas 3.3 million deaths are due to interstate conflicts.¹ The United Nations (UN) deploys peacekeepers with the intention to save lives in civil war-torn nations, and to create incentives for peace over war. Yet the UN does not intervene in all conflict situations. The United Nations Charter grants the Security Council the right to deploy peacekeeping operations, but it does not clearly identify conditions under which the Security Council should issue a mandate. The only condition mentioned is that the Security Council should intervene in “any dispute, the continuance of which is likely to endanger the maintenance of international peace and security.”² It is arguably due to the abstract wording of this section of the UN charter that many journalists, politicians, and academics question the impartiality of UN decision-making. I seek to understand why the UN does or does not intervene in particular civil wars.

1 Fearon, James D. and John D. Laitin, "Ethnicity, Insurgency, and Civil War," *American Political Science Review* 97.1 (2003): 75-90.

2 United Nations, *Charter of the United Nations and Statute of the International Court of Justice*. San Francisco: United Nations Department of Public Information, 1985.

Because of their veto power, the Permanent Five members (P5) have a stronger say in peacekeeping mandates than the general elected members. My research seeks to understand how P5 members' relationships with target countries impact their decisions to intervene in intrastate conflicts. The independent variables I examine are alliance similarity and voting affinity in the UN General Assembly (GA) (indicative of political relationships), and the amount of trade between countries (indicative of economic ties). The dependent variable is UN intervention, and the unit of analysis is country year. I find that the economic relationships between the P5 members and target nations have a significant impact on decisions to intervene, but my research is not conclusive on whether political relationships have a direct or indirect impact. I also show that, after the end of the Cold War, lower alliance similarities increase the likelihood of intervention while higher voting affinities decrease this likelihood.

My findings serve two significant purposes: first, to assess whether the normative framework of the United Nations is accurately reflected in deployment of peacekeepers, and second, to test previous claims that peacekeepers go to countries in which the P5 have national and economic interests. Gilligan and Stedman explore how characteristics of conflict and regional bias impact the decision to intervene. They find that the UN tends to intervene in conflicts with higher death tolls—perhaps demonstrating a humanitarian impulse—but that regional bias plays a strong role in the decision to intervene. Fortna evaluates the findings of previous intervention research—including Gilligan and Stedman's article—and concludes that “the strategic interests of the great powers are not generally a good predictor of where peacekeepers go,” with a few exceptions.³ She finds that there are not typically interventions in countries close to P5 members, and that peacekeeping is less likely in more democratic nations.

Fortna,⁴ Gilligan and Stedman,⁵ and many others observe that there were far fewer civil war interventions during the Cold War. One explanation for this finding may be the United Nations' statement that peacekeeping began originally as “a tool for managing inter-state conflicts.”⁶ Some academics treat the Cold War as a control variable and some choose to only use data from the post-Cold War period. Despite the disparity in frequency of civil war interventions, I choose to include Cold War data and simply separate my data into Cold War and post-Cold War while running regressions. In doing so, I am able to compare and contrast the significance of independent variables in the two periods.

Literature Review

According to Gilligan and Stedman, relatively little research has been done on the determinants of UN interventions. Existing research approaches UN interventions from the supply-side and demand-side perspectives. Supply-side research considers the impact of P5 interests on the deployment of peacekeeping troops, while demand-side research considers which states are more likely to request or consent to UN intervention.

Fortna's research focuses on the target country's impact on the UN decisions to intervene, but she dedicates two chapters of her book to assessing previous conclusions on the impact of the P5's interests. She writes regarding the P5:

Because most peacekeeping operations are undertaken, or at least authorized by, the United Nations Security Council, and because the five permanent members...can veto any operation they dislike, there has been understandable attention paid to the interests of the Perm-5 in determining where peacekeepers go. A number of scholars suggest that peacekeeping is more likely where these veto-wielding states have interest in the conflict, but less likely if a great power has intervened in the conflict directly, or where

3 Fortna, Virginia Page, *Does Peacekeeping Work? Shaping Belligerents' Choices after Civil War*, Princeton: Princeton University Press, 2008. Pg 44.

4 Ibid. Pg 26.

5 Gilligan, Michael and Stephen John Stedman, "Where do the Peacekeepers Go," *International Studies Review* (2003): 37-54. Pg 42.

6 United Nations Department of Peacekeeping Operations, "United Nations Peacekeeping Operations: Principles and Guidelines," (New York, 2008).

the target state itself is a great power.⁷

Fortna examines the “national interests of the great powers” by looking at historical relations, threat to peace, cost of war, democracy, relative strengths of government and rebels, expected war outcomes, sovereignty, trust, economic conditions and factions. She also considers the “humanitarian impulse” of the United Nations, the deadliness of conflicts, and the apparent “ease” of intervention. Fortna uses regressions and case studies to assess the accuracy of previous work, concluding that “peacekeeping is a result of both supply-side and demand-side considerations,” and that “peacekeepers tend to deploy to more difficult cases rather than to easier ones.”⁸

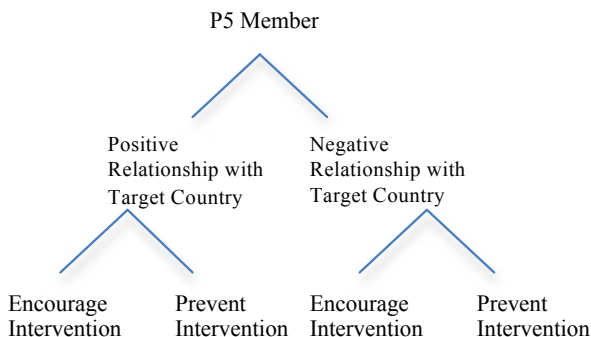
I focus on the relationship between countries, whereas Gilligan and Stedman assess a wide range of P5 interests. They consider the following characteristics: primary export markets of the target country, whether the country is a democracy, whether the country is a former colony of a P5 member, pre-war population, size of the target country’s army, and the rebels’ aims in the conflict. Their dependent variable is the amount of time before the UN intervenes. Gilligan and Stedman conclude that the UN does not use consistent reasoning across all regions of the world when making the decision to intervene:

The organization responds to basic power considerations—both in terms of the importance that the Security Council places on different regions and in its reluctance to intervene in states that have greater lethal capacity.⁹

Gilligan and Stedman’s conclusions evidence a regional bias—particularly against Asia—in UN decisions to intervene. I will examine how relationships between individual P5 members impact the decision to intervene, looking beyond the idea of the UN as a collective body while considering the power and interests of veto-holding Security Council members.

Theory

There are two ways in which P5 members can influence the decision to intervene: either they can encourage other members to vote for intervention, or they can exercise (or threaten to exercise) their veto to prevent intervention. In order to assess why a P5 member might encourage or discourage intervention, I must assess how individual members would be inclined to act in the event of a positive or negative relationship with the target country. I expect that a P5 member with a positive relationship would be inclined to support intervention and that a P5 member with a negative relationship would prevent intervention. The possible outcomes are illustrated by the diagram below:



7 Fortna, Virginia Page, *Does Peacekeeping Work? Shaping Belligerents' Choices after Civil War*, Princeton: Princeton University Press, 2008. Pg 19.

8 Ibid, Pg 44.

9 Gilligan, Michael and Stephen John Stedman, "Where do the Peacekeepers Go," *International Studies Review* (2003): 37-54. Pg 51.

The decision to mandate a UN intervention is an aggregate decision, resulting from negotiations among the five permanent members.¹⁰ So, in order to understand the decision as a whole, I must first understand which individual P5 members are more likely to influence other members. I do this by isolating certain individuals; I run regressions on selected subsets of the independent variables. With the values for alliance similarity (tau-b scores) and affinity of GA voting history (voting affinity), I create three subsets: the P5 member with the least similar (minimum) score, the P5 member with the most similar (maximum) score, and the score of the most important P5 member with reference to trade.¹¹ Concerning the values of trade (more specifically, the ratio of total trade to target country's GDP), I select the minimum and maximum values; I also create a variable that isolates trade with the US. I do this because many academics claim that the US has the most power of the five permanent members, as the "principal financier of the organization"¹² and contributor of 26 percent of the peacekeeping budget.¹³ I expect that results will show that trade with the US has a significant direct relationship with the Security Council's decision to intervene.

I also expect that the minimum relationship will have a significant impact on the likelihood of intervention because the P5 members' strongest power is their ability to exercise a veto. While there is a possibility that a P5 member could encourage or negotiate with other permanent members to support intervention, it would be much easier for the P5 member to prevent intervention. Thus, I predict that the country with the worst relationship with the target country will be the most likely to prevent intervention. I also predict that a high minimum value—indicating that the worst relationship is actually positive—will increase the probability of intervention. I expect that the maximum relationship will be significant in predicting intervention, but that the minimum will be a stronger indicator of the decision to intervene. I chose not to include the mean relationship as a subset along with minimum, maximum and most important P5 relationships. Taking an average treats the P5 as a singular entity, which is not a realistic representation of the body's decision-making process. As mentioned earlier, the decision to intervene is an aggregation of the interests of five individual countries. Strong desires, for or against intervention, are significant because they influence other decision-makers, but are not significant as averages.¹⁴

To draw from previously stated expectations, it is likely that extremely low values (negative relationships) or extremely high values (positive relationships) of alliance similarity and voting affinity will have a higher probability of intervention, whereas neutral values will not. High and low values indicate that the P5 member has strong opinions about the given target country, and is thus more likely to want intervention either for or against the existing government. For this reason, I expect that the relationship between alliance similarity and UN intervention, and between voting affinity and UN intervention, will be parabolic rather than linear. I adjust my regression calculations accordingly.

The Security Council's widely known paralysis during the Cold War discourages the use of data from this period. Author Stephen Ryan writes,

The Security Council was used less and less as the Cold War progressed. Whereas between 1946 and 1948 it met on an average 132 times per year, in the 1950s it never met more than 72 times a year, and in 1959, only five meetings were held.¹⁵

Many UN intervention researchers assert that the Cold War time period was highly atypical. Gilligan and Stedman write, "mission selection procedures have changed dramatically with the end of

10 The ten elected members also play a role in this decision, but for the purpose of this paper, I concentrate on the P5.

11 See Table X for the breakdown of how many country years in which each P5 member's alliance portfolio or voting affinity value was used as the most important value.

12 Bongang, Benn L. *The United States and the United Nations: Congressional Funding and UN Reform*. New York: LFB Scholarly Publishing LLC, 2007. Pg 2.

13 The Better World Campaign, "U.S. Dues and Contributions to the United Nations," 2008, *Better World Campaign*, 23 March 2010

14 In order to confirm that my expectation is correct, I ran regressions on the mean values and found them to be insignificant.

15 Ryan, Stephen. *The United Nations and International Politics*. New York: St. Martin's Press, 2000. Pg 49.

the Cold War."¹⁶ Fortna does not include Cold War intervention data in her research,¹⁷ and Gilligan and Stedman treat it as a control variable. I use all country years in my data analysis, and separate the Cold War and post-Cold War time periods in order to observe and test existing claims about the differences in decision-making.

Hypotheses

Hypothesis I: The P5 member with the minimum values of alliance portfolio or voting affinity will be most significant in the decision to intervene. A positive relationship will increase, and a negative relationship will decrease, the likelihood of intervention.

As developed above, I expect the minimum model to have the greatest impact on likelihood, because the source of the P5 member's power lies in the veto—the P5 member who has the worst relationship with the target nation could easily prevent intervention by exercising the veto.

Hypothesis II: The alliance portfolio and voting affinity of the most important P5 member will have a significant direct relationship with the likelihood of UN intervention.

The P5 country with the most significant trade relationship has the greatest interest in preserving the target nation's stability, and consequently the biggest incentive to persuade other nations. Therefore I expect that the most important country, in reference to trade, will have a direct relationship with the likelihood of UN intervention.

Hypothesis III: The P5 member with the maximum values of alliance portfolio or voting affinity will be significant in the decision to intervene, but less so than the minimum or most important models.

Similar to the logic in the previous hypothesis, the P5 member with the best relationship will have an interest in preserving that relationship and will act accordingly—which, in this case, means encouraging other P5 members to support intervention.

Hypothesis IV: Trade with the United States will have a significant impact on the UN Security Council's decision to intervene.

The United States is a major contributor to the UN budgets and is said to have a significant influence on decision-making. I use the fourth hypothesis to test this theory.

Hypothesis V: A negative relationship, as measured by the three independent variables, will decrease the likelihood of intervention more than a positive relationship will increase the likelihood of intervention.

As mentioned earlier, the P5 members have a unique power because of their right to veto any given Security Council proposal. However, the question arises whether they would choose to exercise the veto in the case of strong feelings for or against the target country. The fifth hypothesis explores whether a positive or negative relationship has a greater impact on the Security Council's decision to intervene.

¹⁶ Gilligan, Michael and Stephen John Stedman, "Where do the Peacekeepers Go," *International Studies Review* (2003): 37-54.

¹⁷ Fortna, Virginia Page, *Does Peacekeeping Work? Shaping Belligerents' Choices after Civil War*, Princeton: Princeton University Press, 2008. Pg 10.

Data Description

I tested the hypotheses outlined in the previous section with data on intrastate conflicts from 1946 to 1999.¹⁸ The unit of analysis I use is the country-year of each conflict. Some academics use conflict as the unit of analysis, but because much of the data I use is available in country-year, it made sense to use this same unit of analysis. This also allowed my research to differentiate between conflicts in which the UN intervened early and conflicts in which the UN intervened later on. Additionally, I include in my regressions country-years that do not have UN interventions to strengthen the accuracy of my conclusions. By understanding the characteristics of conflicts that did not receive a UN mission, I verify that the characteristics of conflicts that receive missions are not also present in cases without intervention.

There are 879 country-year observations, of which 66 country-years had a UN intervention. In the regression, I separate observations into two groups—Cold War and post-Cold War—with the use of a dummy variable. There are 566 country-year observations in the Cold War period, 18 of which had UN interventions, and 313 country-year observations in the post-Cold War period, 48 of which had UN interventions. By separating the regressions, I am able to compare observed patterns within the two periods.

Variables

Civil War: I use Fearon and Laitin's definition based on which a conflict must fulfill three criteria to be considered a civil war: it must be conflict between "agents of the state" and "nonstate groups," have caused at least 1000 deaths with an average of 100 deaths a year, with at least 100 deaths on either side.

UN Intervention (*un_interven*): The dependent variable is a dummy variable, with 1 indicating that a UN intervention occurred, and 0 indicating there was no UN intervention.

Cold War (*coldwar*): The dummy variable coded to separate Cold War conflicts from post-Cold War conflicts separates the civil war data into two groups: conflicts before 1990 (*coldwar* = 1), and conflicts occurring in 1990 and beyond (*coldwar* = 0).

Alliance similarity with P5 members (*tauB gloUS*, *tauB gloUK*, *tauB gloFR*, *tauB gloRS*, *tauB gloCH*): Alliance portfolio is a measure of the similarity in the two nations' set of alliances. I assess this value with Kendall's tau-b coefficient. The tau-b score is calculated by creating a contingency table, as the one presented below.¹⁹

¹⁸ The data set of intrastate conflicts was originally collected by James D. Fearon and David D. Laitin.

¹⁹ Bruce Bueno de Mesquita, *The War Trap* (New Haven: Yale University Press, 1981). Pg 117.

Table I: Contingency Table

**Congruence of Interests between the United States
and Argentina in the Americas, 1965**

USA	<i>Argentina</i>			
	<i>Defense pact</i>	<i>Non- aggression pact</i>	<i>Entente</i>	<i>No alliances</i>
Defense pact	USA, ARG, BOL, BRA, CHI, COL, COS, DOM, ECU, SAL, GUA, HAI, HON, MEX, NIC, PAN, PAR, PER, URU, VEN			CAN, UK, FRN, HOL, POR
Nonaggression pact				
Entente				
No alliances				CUB, USR, SPN

When all of the alliances fall on the principal diagonal, the tau-b score is 1, and when all alliances fall on the opposite diagonal, the tau-b score is -1. All other values of tau-b fall within that range (like the table above). Below is the summary of the alliance portfolio data.

Table II- Alliance Portfolio Summary Data

Variable	Obs	Mean	Std. Dev.	Min	Max
ccode	879	548.7088	246.6984	40	910
year	879	1982.041	12.86369	1946	1999
tauBглоUS	879	.0661618	.3212347	-.313568	1
tauBглоUK	848	-.0220448	.1893932	-.300018	1
tauBглоFR	879	.0110543	.2525107	-.258365	.973628
tauBглоRS	870	-.0181279	.1426509	-.298882	.958492
tauBглоCH	870	-.0175541	.0925291	-.11636	.699528

Voting affinity with the P5 members (*voteffUS*, *voteffUK*, *voteffFR*, *voteffRS*, *voteffCH*): Voting affinity ranges from -1 to 1, indicating the closeness of the P5 member's and the target country's votes in the UN General Assembly. A voting affinity of 1 indicates 100% agreement, whereas a voting affinity of -1 indicates that the countries never agree. The spread of cases with and without interventions aided me in the initial assessment of my hypotheses on the impact of voting affinity.²⁰

Trade Flow with the P5 members (*USpercent_tradeI*, *UKpercent_tradeI*, *FRpercent_tradeI*, *RSpercent_tradeI*, *CHpercent_tradeI*): The original trade data was collected by the Correlates of War Project. For my research, I scaled the values by calculating trade—both imports and exports—as a percentage of the target country's real GDP. Below is the summary data for the trade flow values.

Table III- Trade Flow Summary Data

Variable	Obs	Mean	Std. Dev.	Min	Max
ccode	879	548.7088	246.6984	40	910
year	879	1982.041	12.86369	1946	1999
USpercent_~1	759	.0000143	.0000221	0	.0002448
UKpercent_~1	759	3.33e-06	5.73e-06	0	.0000852
FRpercent_~1	759	9.57e-06	.0000679	0	.0014201
RSpercent_~1	658	2.37e-06	.0000177	0	.0004251
CHpercent_~1	737	2.52e-06	.0000172	0	.0003746

Control Variables

Distance from P5 members (*IndistUS*, *IndistUK*, *IndistFR*, *IndistRS*, *IndistCH*): Others have found distance between the P5 members and the target countries to be a significant independent variable, so it makes sense to use this variable as a control. I scaled the values of distance by taking the natural log of distance. I do this because absolute values hold different meanings in different contexts. For example, when a target country's distance from China is 3000 miles but its distance from the UK is only 300 miles, an increase in distance of 100 miles would be significant for the UK, but not as significant for China. Taking the natural log allows me to consider the scale of change.

External intervention (*nonun*): I use the deployment of an external intervention as a dummy variable to understand whether another country's intervening in the conflict has an impact on the likelihood of UN intervention. In cases with an external intervention, the variable is equal to 1; in cases with no external

20 I test two datasets of voting affinity—the set mentioned above has some missing data. The second set is interpolated for the missing data. The interpolated values do not change the results, and so I decided not to include them.

intervention, the variable is equal to 0.

Polity (polity): The Democratic Peace theory asserts that democracies do not wage war with other democracies. The UN's goal is to decrease future conflicts by spreading democratic regimes, then the polity score must be taken into consideration. I use polity score as a control. The values range from -10 (strongly autocratic) to 10 (strongly democratic).

Population of the target country (lnpop): Some contend that the UN is more likely to intervene in "easy" cases.²¹ Population is one of the determinants of an "easy" case; countries with a larger population require more resources for intervention. I expect that the UN is less likely to intervene in a country with a large population (for example, China), so I use population as a control. I scale the population values—for the same reason I scale the distance—by taking the natural log.

GDP per capita (lngdp): I take the natural log of per capita GDP to scale the variable, as I did for population and distance. Some academics have found that the UN tends to intervene in more difficult cases than in easier cases. GDP and population are other indicators of the ease of intervention.

Results

I use logit regressions to test the hypotheses, a method similar to that of ordinary least squares (OLS), but is used when the dependent variable has dichotomous outcomes—in this case, intervention or no intervention. The regression equations look like the following:

$$P(\text{un_interven}=1) = F(\beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \dots + \beta_a X_a)$$

In each regression, I test one independent variable and all of the controls. For alliance portfolio and voting affinity regressions, I run three models: the "most important" model, "minimum" model, and "maximum" model. The "most important" model uses the tau-b or voting affinity score of the P5 member with the greatest amount of trade with the target nation in every given country year. The "minimum" and "maximum" models use the tau-b or voting affinity score of the P5 member with the minimum and maximum scores in every country year (the worst and best relationships). With these three models, I explore different characteristics of the P5 dynamic that might affect the collective decision to intervene. For trade regressions, I run the "minimum" and "maximum" models, along with a model that uses US trade values.

The results indicate that a significant relationship exists between the three independent variables—alliance portfolio, voting affinity and trade—and the UN's decision to intervene. The results can be interpreted in two steps. I first identify which models are significant (the most important, the least friendly, or the most friendly) and interpret the coefficients of the variables in the regressions. The significance of the models indicates which P5 member has the strongest influence on the decision to intervene, and the coefficients indicate the direction of the relationship. In logit models, the numerical values of the coefficients do not indicate the degree of impact, as in standard OLS regressions. In order to understand the impact of a change in the independent variables, my second step is to use Clarify, a program that generates predicted values of change in probability of UN intervention as the independent variables move from their minimum to maximum values within the data sample. The predicted changes indicate the degree by which the variables affect the likelihood of UN intervention.

Below, I discuss the first step by assessing the results of regressions. I then discuss the predicted values in the second step. Finally, after analyzing patterns within individual relationships, I assess how individual interests cause P5 members to influence the aggregate decision.

21

"Gilligan and Stedman[s] ... findings suggest that while the international community responds to the loss of life, it is more likely to react, and react quickly, in easier cases." (Fortna 20)

Alliance Portfolio:

The regression table is presented below:

Table IV: Alliance Portfolio Regression Results

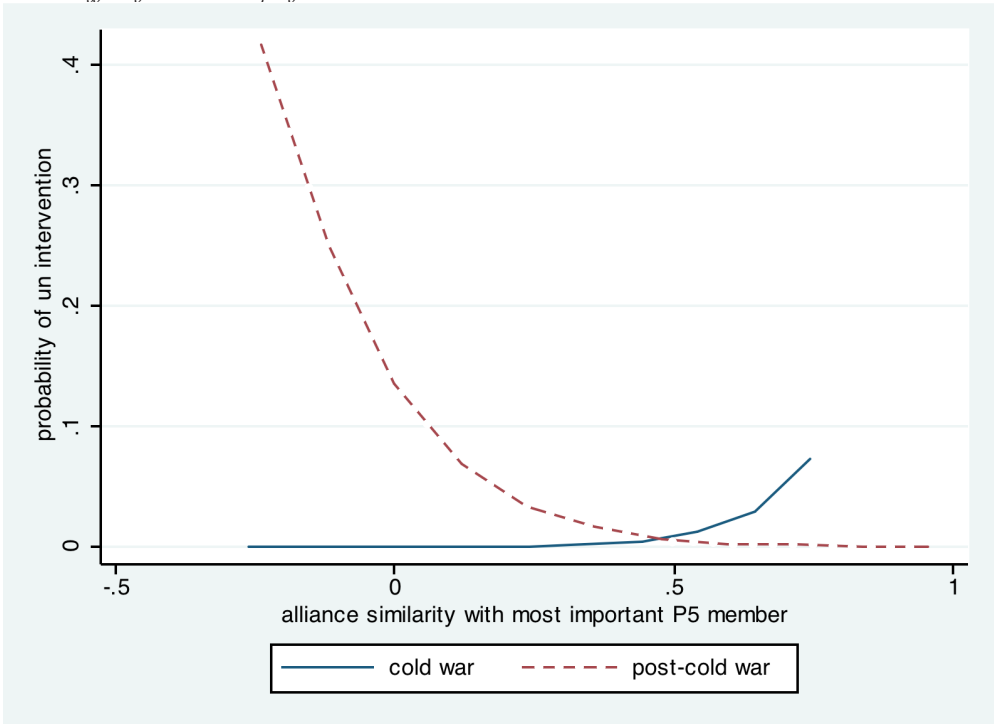
variables	ALLIANCE PORTFOLIO					
	COLD WAR			POST-COLD WAR		
	most important	maximum	minimum	most important	maximum	minimum
alliance similarity (tauB)	9.025* (5.0367)	82.233 (60.516)	-114.833 (78.380)	-6.272** (3.139)	-0.344 (7.313)	-167.530*** (28.973)
alliance similarity squared (tauB ²)	-18.761** (8.4262)	-152.934 (104.080)	-460.806* (246.373)	10.094*** (3.215)	2.499 (8.067)	-632.258*** (121.928)
log(distance from US)	-1.488 (3.236)	-0.8433* (4.749)	7.234 (4.716)	-0.458 (1.701)	0.421 (1.687)	3.487** (1.522)
log(distance from UK)	11.227 (133.512)	-190.949 (210.744)	-194.525 (150.326)	34.246 (30.087)	21.638 (31.655)	-25.977 (38.389)
log(distance from FR)	-11.778 (122.676)	177.928 (195.827)	175.132 (137.491)	-29.486 (27.096)	-18.116 (28.973)	26.170 (35.866)
log(distance from RS)	-0.203 (.283)	-0.800** (0.317)	0.384 (0.353)	-47.113*** (0.179)	-0.339** (0.144)	-0.442** (0.182)
log(distance from CH)	-0.727 (0.494)	-1.094 (0.702)	-0.739 (0.658)	-0.63 (0.171)	-0.019 (0.139)	0.022 (0.155)
non-UN intervention	0.156 (1.013)	-0.496 (1.811)	-0.047 (0.937)	-0.258 (0.051)	-0.453 (0.693)	-0.442 (0.594)
polity	-0.099 (.198)	0.289** (0.142)	-0.092 (0.173)	-0.003 (0.051)	-0.032 (0.048)	0.077 (0.068)
log(population)	-2.903*** (.886)	-6.284* (3.485)	-3.769*** (0.985)	-1.051* (0.557)	-1.256* (0.629)	-1.335*** (0.430)
log(per capita GDP)	2.861* (1.699)	3.316** (1.697)	3.585* (2.145)	-0.393 (0.627)	-0.441 (0.641)	-0.762* (0.462)
year	0.265 (.274)	0.519* (0.289)	0.290 (0.268)	0.059 (0.094)	0.043 (0.105)	0.051 (0.123)
n	323	323	323	205	205	205
R ²	0.729	0.848	0.734	0.293	0.269	0.406

*10% significant **5% significant ***1% significant

The results indicate that, during both the Cold War and in the post-Cold War periods, the “most important” model and the “minimum” model reveal a more significant relationship with the incidence of UN intervention than the “maximum” model.²² This shows that in both time periods, the most important P5 member and the member with the worst relationship have the greatest impact on the decision to intervene. However, the impact is not consistent in both time periods, so I cannot assert whether alliance similarity has a direct or indirect correlation with the decision to intervene. The comparison between the “minimum” models during and after the Cold War can be seen in the graph on the following page.

²² While the alliance similarity coefficient in the minimum Cold War model is not significant, this statement refers to the combined significance of the tau-b and the tauB² variables, which is a more accurate indication of the significance of these variables. See Table XI for combined significance values.

Table V: Effect of min alliance portfolio on the decision to intervene



The graph shows that the probability of UN intervention was overall less likely during the Cold War, and that alliance similarity operated in opposite ways during the two time periods. Through the data and graphs, it can be inferred that there is a positive correlation between alliance portfolio and the probability of intervention during the Cold War period, and a negative correlation thereafter.

Voting Affinity:

Table VI: Voting Affinity Regression Results

variables	VOTING AFFINITY					
	COLD WAR			POST-COLD WAR		
	most important	maximum	minimum	most important	maximum	minimum
voting affinity	-0.938 (0.785)	-64.854* (38.365)	-2.531* (0.940)	0.478 (1.329)	-93.662** (45.503)	2.689** (1.070)
voting affinity ^2	1.504 (1.745)	45.795* (26.983)	5.782 (5.161)	0.417 (1.154)	51.503** (25.782)	-2.316* (1.378)
log(distance from US)	-1.133 (2.023)	-2.522 (3.022)	-0.234 (1.791)	-0.355 (1.151)	-0.469 (1.274)	-0.342 (1.115)
log(distance from UK)	23.187 (104.017)	45.062 (129.874)	-3.132 (117.398)	18.386 (31.055)	30.534 (31.604)	18.029 (30.048)
log(distance from FR)	-23.270 (95.763)	-43.901 (119.580)	1.236 (107.452)	-14.883 (28.458)	-25.864 (29.070)	-14.604 (27.383)
log(distance from RS)	-0.405* (0.239)	-0.608 (0.410)	-0.364* (0.197)	-0.309** (0.143)	-0.279* (0.151)	-0.300** (0.137)
log(distance from CH)	-0.691* (0.384)	-0.577* (0.297)	-0.591 (0.379)	-0.054 (0.136)	-0.149 (0.157)	-0.433 (0.112)
non-UN intervention	0.186 (0.799)	0.445 (1.056)	-0.351 (0.510)	-0.479 (0.655)	-0.365 (0.670)	-0.347 (0.694)
polity	-0.653 (0.095)	-0.272 (0.089)	0.001 (0.159)	-0.049 (0.052)	-0.050 (0.051)	-0.060 (0.053)
log(population)	-2.581*** (0.718)	-2.856*** (0.935)	-2.496*** (0.614)	-1.168* (0.656)	-1.372** (0.686)	-0.945* (0.511)
log(per capita GDP)	2.191** (1.125)	2.288** (1.124)	2.122* (1.230)	-0.129 (0.528)	-0.365 (0.652)	-0.230 (0.442)
year	0.197 (0.228)	0.221 (0.217)	0.051 (0.316)	0.038 (0.104)	0.010 (0.085)	-0.019 (0.135)
n	320	320	320	205.00	205	205
R ²	0.711	0.740	0.722	0.263	0.275	0.309

*10% significant **5% significant ***1% significant

The results show that the minimum voting affinity model is significant in both the Cold War and the post-Cold War periods. In the Cold War period, the “minimum” model has an indirect relationship with the likelihood of UN intervention, meaning that as the voting affinity of the least friendly P5 member increases, the probability of UN intervention decreases. This is an interesting observation—when the minimum value is higher, one can assume that the voting affinities of the other P5 members are also higher. The implied relationship is that when the P5 members all had a closely aligned voting history with the target country, they were less likely to intervene during the Cold War.

In contrast, during the post-Cold War period, the “minimum” model has a direct relationship with the probability of UN intervention, indicating that the greater the lowest voting affinity, the more likely that a UN intervention will occur. It also shows that a higher overall voting affinity brings about higher chance of UN intervention.

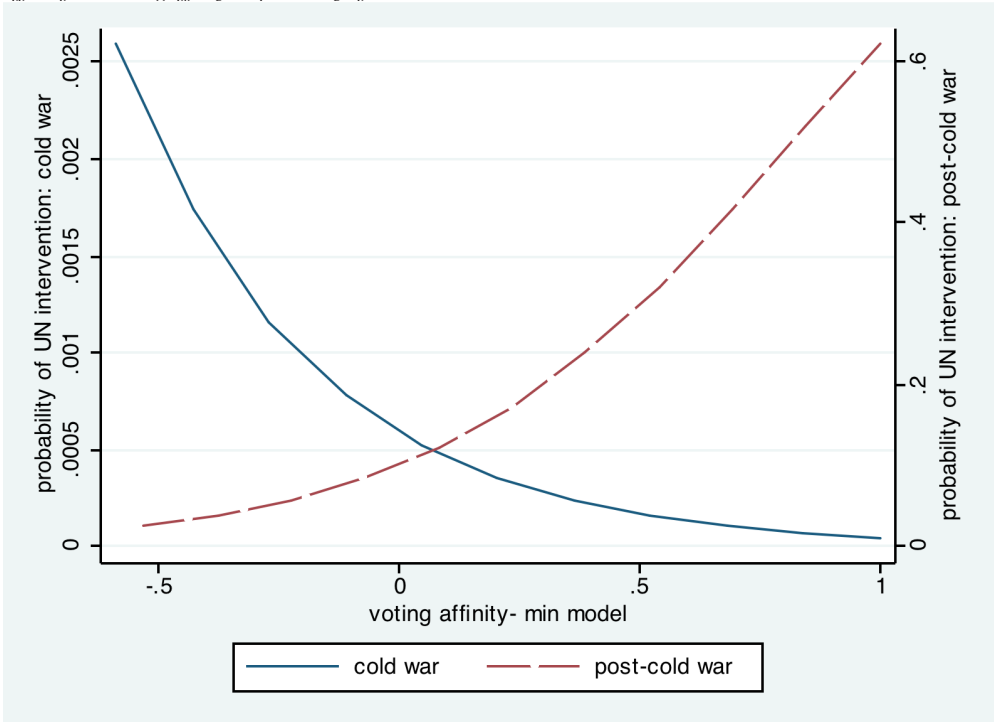
In the Cold War period, combined significance of the “maximum” model does not indicate a meaningful relationship. In the post-Cold War period, the “maximum” model has combined significance, but it indicates an indirect relationship, unlike the relationship of the post-Cold War “minimum” model. Comparing the results of the “minimum” and “maximum” models in the period, the “minimum” model has a greater combined significance and a greater range²³, suggesting that it is more accurate and relevant.

An interesting pattern is revealed when comparing the “minimum” models of the Cold War and post-Cold War periods, as illustrated by the graphs below: the correlations are opposite.

²³ The range of voting affinities in the minimum model is -0.532 to 1, whereas the range in the maximum model is 0.292 to 1.

Table VII:

Effect of min voting affinity on probability of intervention



The above graph shows again that the probability of intervention has been higher since the end of the Cold War. Because the values of Cold War probability are so much lower, I chose to draw the graph with two separate y-axes so the shapes of either curve would be clear, depicting the drastic difference of the correlation between voting affinity of the least agreeable country and likelihood of UN intervention in the two periods.

This difference reveals the value of separating the civil war data into two time periods, and further shows that the dynamics of the UN Security Council have changed drastically since the end of the Cold War. During the Cold War, there was a higher likelihood of intervention if the voting affinity between the target country and the least friendly P5 member was low. After the end of the Cold War, probability of intervention increased as the voting affinity increased. This means that either through the use of the veto or the threat of veto,²⁴ a P5 member with a negative relationship was more likely to prevent intervention after the end of the Cold War.

24 Ryan, Stephen, *The United Nations and International Politics*, New York: St. Martin's Press, 2000. Pg 45.

Table VIII: Trade Regression Results

variables	TRADE					
	COLD WAR			POST-COLD WAR		
	maximum	minimum	trade with US (% of GDP)	maximum	minimum	trade with US (% of GDP)
trade	124850*** (51923)	-1.99E07 (1.98E07)	248437*** (59474.32)	11937 (13343)	869057* (520160)	31279** (13322)
log(distance from US)	1.684 (3.401)	5.203 (8.125)	7.068* (3.757)	0.282 (1.522)	-0.810 (1.423)	1.317 (1.833)
log(distance from UK)	-100.613 (90.133)	-145.803 (276.217)	-329.824** (115.876)	19.290** (28.033)	35.081 (35.174)	-4.093 (35.808)
log(distance from FR)	89.036 (83.352)	130.255 (253.274)	296.623* (107.685)	-15.889 (25.459)	-29.852 (31.801)	5.491 (32.945)
log(distance from RS)	-0.417* (0.244)	0.048 (0.314)	0.037 (0.225)	-0.355 (0.173)	-0.452** (0.200)	-0.320* (0.190)
log(distance from CH)	-0.916** (0.428)	-0.141 (0.743)	-1.528** (0.492)	-0.096 (0.151)	-0.086 (0.177)	-0.061 (0.164)
non-UN intervention	1.207* (0.675)	1.024 (2.293)	1.904** (0.866)	-0.394 (0.781)	-0.509 (0.700)	-0.279 (0.780)
polity	-0.417 (0.135)	-0.094 (0.066)	0.036 (0.102)	-0.055 (0.064)	-0.026 (0.054)	-0.059 (0.068)
log(population)	-3.665*** (1.100)	-1.622*** (0.440)	-4.257*** (0.649)	-1.086* (0.592)	-1.459 (0.916)	-1.059** (0.473)
log(per capita GDP)	2.922 (1.136)	1.989 (1.351)	3.278*** (1.106)	-0.116 (0.585)	-0.207 (0.683)	-0.401 (0.542)
year	0.197** (0.230)	0.009 (0.211)	0.144 (0.203)	0.053 (0.097)	0.043 (0.093)	0.012 (0.110)
n	323	323	323	204	204	204
R ²	0.751	0.822	0.784	0.303	0.295	0.384

*10% significant **5% significant ***1% significant

In both time periods, the “trade with US” model is significant and has a positive correlation, indicating that as the target country’s trade level with the US (as a percentage of the country’s GDP) increases, so does the probability of intervention. During the Cold War period, the “minimum” model is not significant, but the “maximum” model is significant and has a positive relationship. In contrast, after the Cold War, the “minimum” model has a significant direct relationship but the “maximum” model does not.

This shows that during the Cold War, the support of the country with the highest trade (and thus the most economic interest in the target nation) is significant in the decision to intervene, whereas after the end of the Cold War, the support of the country with the lowest trade (and thus the least economic interest in the target nation) is significant. The latter reveals the same pattern that arose earlier: the “minimum” model is significant when examining the worst relationship (in terms of trade): the better this relationship is, the better the overall relationship between the P5 members and the target country. So the P5 is more likely to vote for intervention as a whole when the least economically-interested nation has higher trade levels with the target country.

The general pattern observed with trade is that the level of trade between the P5 members—especially the US—has a direct correlation with the probability of intervention.

Controls:

The most consistently significant control is population.²⁵ In all regressions but one, population indicated a significant indirect relationship, implying that the UN is more likely to intervene in less-populated countries. This supports Gilligan and Stedman’s findings that the UN is more likely to intervene in easier cases. Another significant control is the target country’s distance from Russia.²⁶ This variable has an indirect effect in both Cold War and post-Cold War regressions, which shows that countries close to Russia are less likely to receive UN interventions. The third, fairly consistent significant control is per

25 Population values are scaled by using log (population).

26 The distance values are scaled by using log (distance).

capita GDP²⁷ This variable has a significant direct impact only during the Cold War period, indicating that during the Cold War, richer countries were more likely to receive interventions. Compounded with the impact of population, the findings in the Cold War period strongly support claims that the UN tends to intervene in easier cases. Finally, a variable that is slightly significant during the Cold War period is the target country's distance from China. It is only significant in the voting affinity and trade regressions, so I hesitate to draw a strong correlation between China's proximity to a country and the Security Council's decision to intervene.

Predicted Probabilities

The table of predicted probability, generated by Clarify, is below. The highlighted fields indicate which variables were significant in the regressions.

Table IX: Changes in Predicted Probability of Intervention

Variables		Change in probability of UN intervention	st. error	variables		Change in probability of UN intervention	st. error	
COLD WAR				POST COLD WAR				
Alliance Similarity	most important	17.82%	0.234	Alliance Similarity	most important	-40.36%	0.242	
	best relationship	82.75%	0.5106		Alliance Similarity	best relationship	17.76%	0.535
	worst relationship	-77.03%	0.406			worst relationship	-99.99%	1.88E-06
Voting Affinity	most important	-0.44%	0.020	Voting Affinity	most important	4.69%	2.01E-01	
	best relationship	-90.19%	0.3239		Voting Affinity	best relationship	-95.62%	0.240
	worst relationship	-1.18%	0.0338			worst relationship	52.55%	0.235
Trade	best relationship	12.23%	0.2041	Trade	best relationship	73.78%	0.385	
	worst relationship	13.23%	0.350		Trade	worst relationship	89.51%	0.229
	trade with US	64.12%	0.339			trade with US	85.60%	0.208

The first noticeable pattern among the significant variables is that the change in probability is more drastic during the post-Cold War period, implying that the relationship between the P5 members and the target country (as defined by the independent variables) had a greater impact on the Security Council's decision to intervene. This is most likely because the Security Council met less often as the Cold War progressed, effectively limiting the impact of interactions on the decision-making process. And, as observed in the graphs²⁸, the overall likelihood of intervention has been much higher since the end of the Cold War.

Another pattern that arises is the difference between the impact of the “minimum” and “maximum” models.²⁹ In the case of every variable, the change in probability caused by the “minimum” model is greater than the change caused by the “maximum” models. This shows that, as hypothesized, the P5 member with the worst relationship has the greatest impact on the decision to intervene. However, there is no consistency in the direction of the change.

Individual Desires in the Context of an Aggregate Decision

The variables discussed so far have had influence on the desires of individual P5 members—the least friendly, the most friendly, the most important, and the US. However, the desires of these individual countries do not necessarily translate into final decisions. According to authors Evan Luard and Derek Heater, “the Council is best viewed as a ‘bargaining mechanism’ through which compromise decisions are pursued that ultimately depend on the political will of the member states for implementation.”³⁰ Thus the relationships observed through my research are key influencers on the decision to intervene, but they are subject to an aggregate decision-making process.

Along with the five permanent members, there are ten elected members to the Security Council. Each member has one vote, and any decision requires nine votes to be approved. According to the UN

27 The per capita GDP values are also scaled by using log (GDP).

28 See Tables XII, XIII and XIV

29 For ranges of the variables see Table XV.

30 Qtd. in Smith, Courtney B., *Politics and Process at the United Nations: The Global Dance*, Boulder: Lynne Rienner Publishers, Inc., 2006. Pg 170.

Charter, for “procedural matters,” these may be votes from any nine members, but for “substantive issues” the nine votes must include “concurring votes” of the P5.³¹ The decision to intervene in a civil war would fall under the category of a “substantive issue.”³² Members bring their arguments to meetings and, “through a process that combines elements of public speechmaking and private negotiation,” they attempt to reach a decision. However, it is important to note that casual interactions between members outside formal meetings are a common platform for negotiation. In fact, “informal consultation has become a central way the Council conducts its business.”³³

According to Smith, there are two types of informal consultations: the first, a “consultation of the whole,” is an informal meeting between all Security Council members; the second “involves the efforts of a subset of Council members to coordinate their positions in Council debates.”³⁴ It has become common since the mid-1980s for the P5 members to work out agreements in informal meetings before even opening up the debate in a “consultation of the whole.”³⁵ Once again, the power lies with the P5: through bargaining and negotiating, and sometimes the threat of use of the veto, the five individual members make an aggregate decision.

In the aggregate decision, however, my research shows that individual members have reasons for supporting or preventing intervention. During the Cold War, the Security Council became a place for rivalries to play out. Post-Cold War results show, however, that P5 members who have strong negative relations or vested economic interests have more motivation in taking action to influence the final decision—whether through negotiations or by veto.

Since the end of the Cold War, the use of the veto has declined. During the Cold War period, the USSR used the veto most of all the countries. In the post-Cold War period, the US has used the veto most. But while the use of the veto has decreased, P5 members still use the threat of a veto to influence decisions, a tactic called the hidden veto.³⁶ The incentive to exercise that power—perhaps in the case of a high alliance portfolio or low voting affinity—has a significant impact on the Security Council’s decision to intervene.

Conclusion

By assessing the conditions under which the UN has deployed peacekeeping missions, my research shows that the relationships between the P5 members and the target countries were significant in determining the likelihood of UN intervention. I assessed intrastate conflicts during and after the Cold War separately—to control for the strained interactions within the Security Council before 1990—and found that the impact of the three independent variables were very different in the two time periods.

I found that the results reflected the drawbacks of the Cold War accurately: the probability of intervention during the Cold War period was much lower than the probability of intervention in the post-Cold War period. The predicted changes in probability of intervention were also less during the Cold War. Essentially, relationships between the P5 and the target countries had a smaller impact on the decision to intervene. This is somewhat counterintuitive: the Cold War rivalries did have a strong impact on the UN, but because the veto was exercised so often and the Security Council met progressively less, there was little room for bargaining between P5 members.

In the post-Cold War period, the results confirmed my hypothesis that the P5 member with the worst relationship has a greater impact on the probability of intervention than the P5 member with the best relationship. However, the direction of impact was not consistent for alliance portfolio and voting affinity. When the alliance portfolios of the target country and P5 members are more similar, there is a lower probability of intervention. In contrast, when their voting histories are more similar, the least friendly P5 member is more likely to support intervention. Thus my research cannot draw a strong conclusion on the impact of political relationship on the probability of UN intervention.

In order to obtain a firmer grasp on the impact of whether a positive or negative political

31 Smith, Courtney B., *Politics and Process at the United Nations: The Global Dance*, Boulder: Lynne Rienner Publishers, Inc., 2006. Pg 174.

32 The UN Charter does not spell out the difference between substantive issues and procedural matters, but over time the Council has resolved some of the ambiguity through establishing precedents.

33 Smith, Courtney B., *Politics and Process at the United Nations: The Global Dance*, Boulder: Lynne Rienner Publishers, Inc., 2006. Pg 172.

34 Ibid, Pg 241.

35 Ibid.

36 Ryan, Stephen. *The United Nations and International Politics*. New York: St. Martin's Press, 2000. Pg 44.

relationship is more likely to cause intervention, I would suggest differentiating between interventions that benefit the existing government and those that benefit the rebels. My research did not take this into account. If a P5 member has an extremely negative relationship with a target country, I expect that they would support intervention on the side of the rebel faction but prevent an intervention that aims to assist the existing government. Because the United Nations does not outwardly support any one side of a conflict, it is difficult to determine whether intervention benefits the existing government or rebel factions. Future research could add this differentiation as a control variable in regressions, or separate intervention data into two groups as I did with the Cold War and post-Cold War time periods.

Unlike alliance similarity and voting affinity, trade had a consistent direct correlation with the decision to intervene—which confirmed my reasoning in using “most important” P5 member with reference to trade in the two other sets of regressions. In the Cold War period, the P5 member who traded most with the target country had a strong influence on the decision to intervene. It is important to note that this could again be a reflection of Cold War rivalries. Countries traded with other countries within their bloc, relationships determined trade rather than trade determining relationships.

In the post-Cold War period, the P5 member with the least trade and the trade level with the US had a significant direct impact on the probability of intervention, showing that economic interest in a target country increases the likelihood that the P5 will support intervention. The trade relationship of the US and the trade relationship of the least economically interested country have comparable impacts on the decision to intervene. This is interesting because the relationships of the least economically interested countries are actually indicative of the relationships of the P5 as a whole. My results show the individual economic interest of the US’s role in the UN’s decision to intervene to be equal to the collective economic interests of the other P5 members.

In conclusion, these findings reveal that the power structure within the UN Security Council’s decision-making process—specific to peacekeeping in intrastate conflicts—hinges significantly on the economic relations between countries, and not solely on the interests of the international community. These findings provide useful insight for future research and reform of United Nations’ responses to global crises.

Appendices

Table X—How often each P5 member is the most important relationship

	# of observations when the given P5 member is the most important relationship	
	alliance portfolio	voting affinity
US	524	546
UK	128	172
France	147	186
Russia	40	87
China	42	83

Table XI- Combined Significance (Fearon)

COMBINED SIGNIFICANCE		
variables	Cold War	Post-Cold War
VIPtauB	0.023	0.001
maxtauB	0.064	0.190
mintauB	0.030	0.000
VIPvotaff	0.490	0.596
maxvotaff	0.236	0.080
minvotaff	0.001	0.038

Table XII:

Effect of min voting affinity on probability of intervention

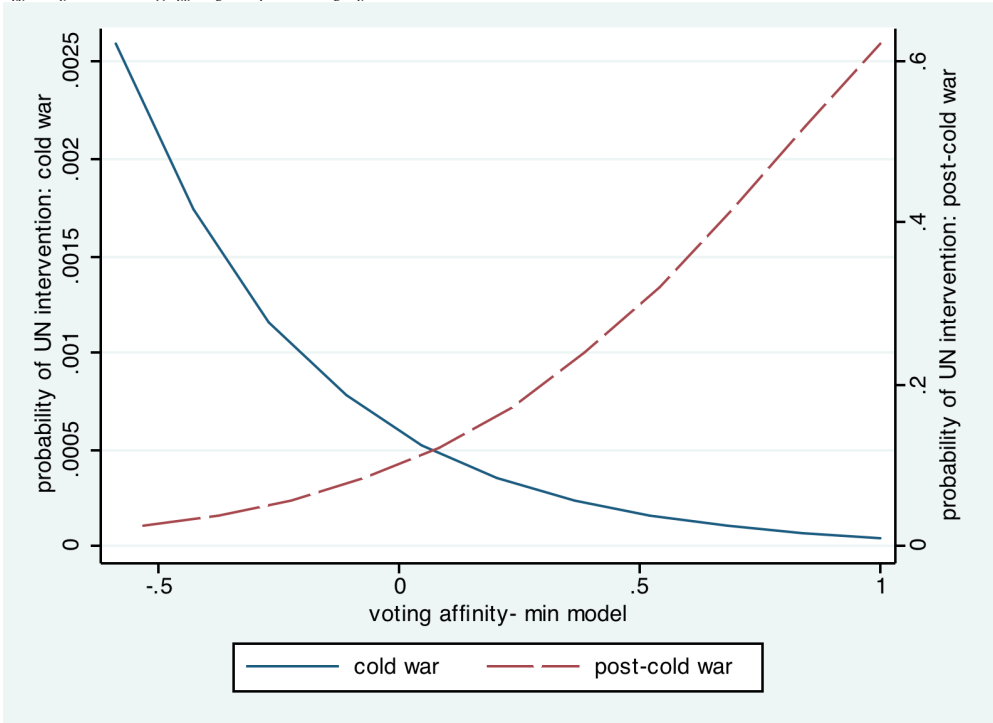


Table XIII- Impact of trade/GDP of P5 member with most trade on the probability of UN intervention

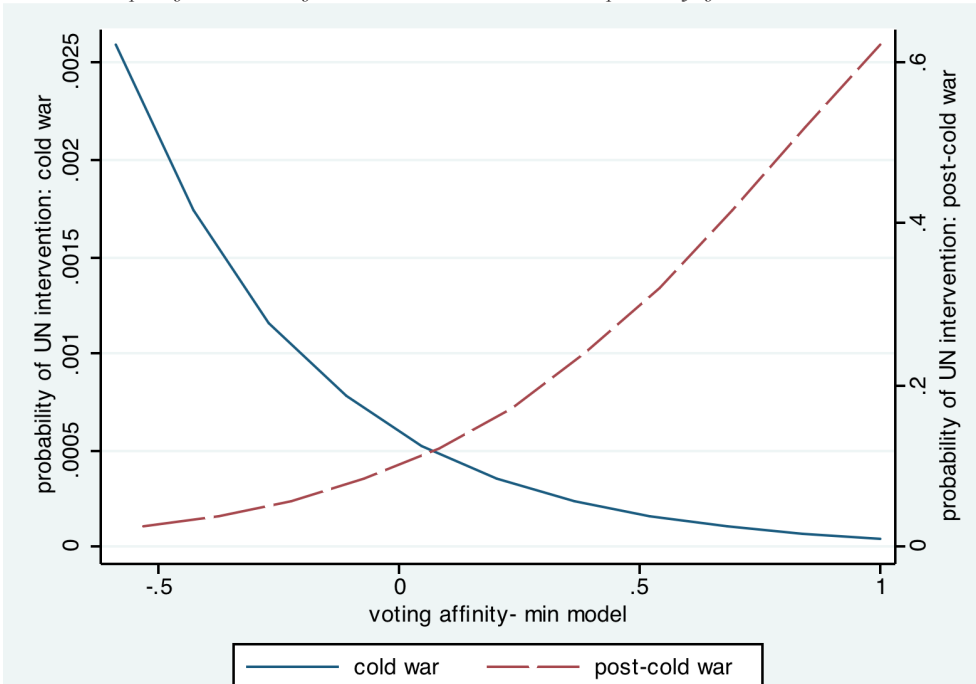


Table XIV – Impact of trade/US GDP on the probability of UN intervention

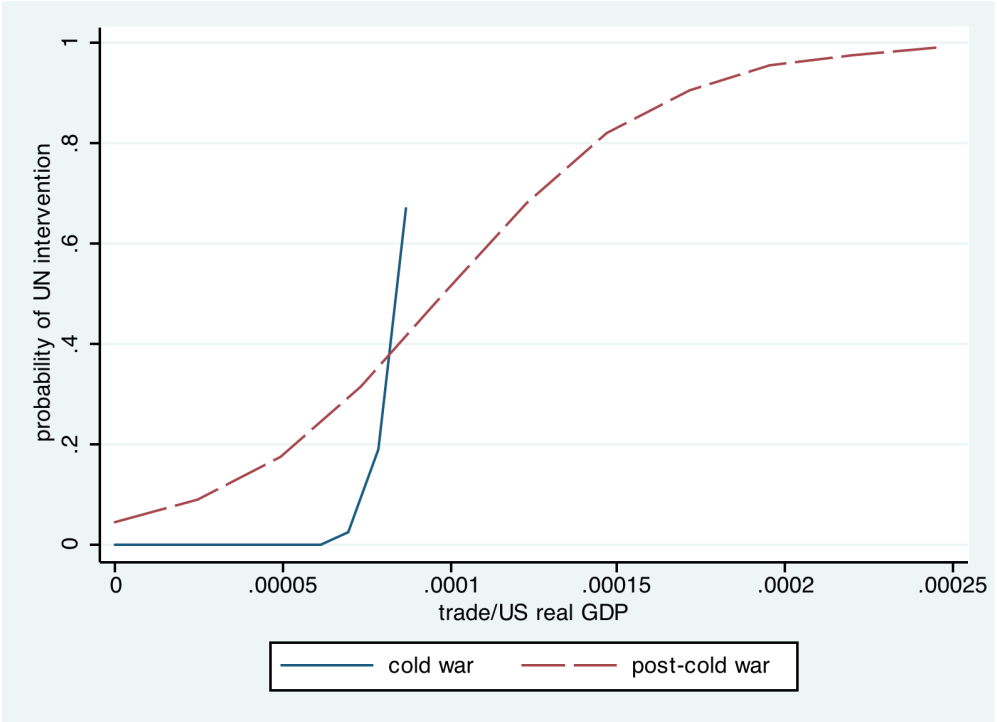


Table XV – Range of Minimum, Maximum, and Most Important Variables

Variable		min	max
Alliance Similarity	most important	-0.300	1
	minimum	-0.314	-0.011
	maximum	-0.075	1
Voting Affinity	most important	-0.596	1
	minimum	-0.596	1
	maximum	-0.422	1
Trade	minimum	0	0.00009
	maximum	0	0.00142
	US trade	0	0.00024

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THE OLD PEOPLE'S REPUBLIC OF CHINA: DEALING WITH A "GRAYING" CHINA

老人

NEAL PATEL

Confucianism, despite being an over 2000-year-old belief system, still permeates many aspects of modern Chinese society. Confucius' philosophy on ethics and politics have been followed, studied, and commented on by scholars for over two millennia. His principle of respect for the elderly is still regarded as an integral belief in Chinese culture. The youth of China are expected to take on the burden of caring for their parents and grandparents. This burden, for the most part, is readily accepted, but social and economic trends show it will be much more difficult to fulfill in the future.

An Aging Population

The current Chinese population stands at a staggering 1,325,639,982 people.¹ It is the largest population in the world, and will likely remain so until about 2035, when India is projected to overtake China in population.² The problem at hand is neither the size nor projected growth of the Chinese population, but rather its demographic composition. Figure 1 shows the changing demographics of the population since 1953, with projections for the future until 2050. The major rearrangement of the demographic breakdown is a direct result of the population control policies adopted by the Chinese government in 1979, when the government under Deng Xiaoping enacted the infamous "One Child Policy." The National Population and Family Planning Commission of China holds that this policy was introduced in an effort to alleviate social, economic, and environmental pressures associated with rapid population growth. Aside from numerous other shortcomings in the implementation of this policy, the one child "solution" inevitably leads to the problem of how to take care of the nation's aging population. As Figure 1 shows, the proportion of the elderly is on the rise; as it stands, almost 150 million people--about 11 percent of the Chinese population--are above the

¹ Development Data & Statistics." World Bank Development Indicators. The World Bank Group, 2008. Web. 10 Dec. 2009. <<http://web.worldbank.org/WBSITE/EXTERNAL/DATASTATISTICS/0,,contentMDK:20535285~menuPK:1192694~pagePK:64133150~piPK:64133175~the> it

² Nancy E. Riley, "China's Population: New Trends and Challenges," Population Bulletin 59, no. 2 (Washington, DC: Population Reference Bureau, 2004)

age of 60, the retirement age for men (it is 55 for women). The burden of caring for this increasingly large population will fall upon the youth who are at a growing disadvantage due to their decreasing population size. By 2020, it is estimated that the ratio of workers to retirees will be 2.5 to 1—a figure that in 1980 once stood at 20 to 1.³

The “One Child Policy” is not the only factor driving the “graying” phenomenon. Advances in medicine have also significantly lowered both infant and adult mortality rates and have improved life expectancy. In 1953, the official death rate was 14 deaths per 1000 people (a government figure likely underestimated). By the turn of the century, the official number was cut in half to seven deaths per 1000 people. Along with the growth of immunization against polio and measles among children—about 79 percent of all Chinese children were immunized in 2001⁴—this demographic shift is expected to become even more dramatic over time. Additionally, the current policies on retirement have failed to provide adequate coverage for a majority of the Chinese population. In order to ensure the long-term viability of Chinese population policy, serious reforms must be undertaken on both the political and the financial sides of this issue.

Chinese by Age Group, Selected Years, 1953 to 2000 and Projections to 2050

Percent of population

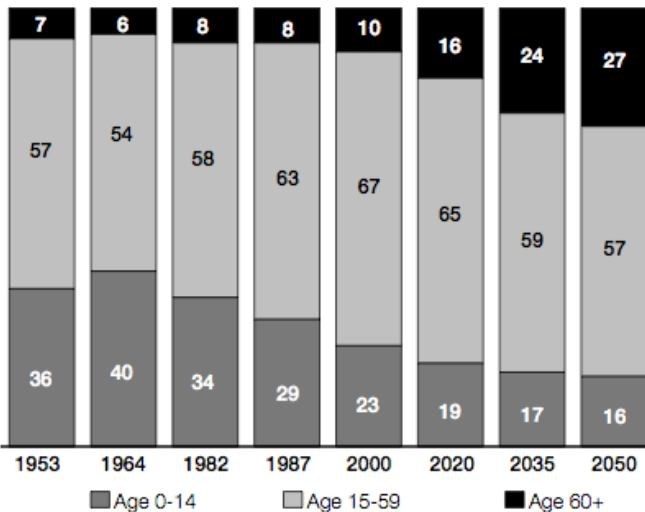


Figure 1 - Source: Population Reference Bureau

Political Reforms

To date, the Chinese policy on pensions and retirement has gone through many phases of reform, but has remained ineffective in addressing the needs of the people. This ineffectiveness is largely due to governmental inefficiency, which results in conflicting policies across the nation. By streamlining the process through which decisions and policies are determined, the government can move forward in the decades-long reform process.

Recommendation for Streamlining Government

The Chinese government is notorious for its enormous bureaucracies, which result in inefficiencies and contradictions in policy and, in the case of retirement reform, non-standardized policies. The Ministry of Human Resources and Social Security (MOHRSS) is the main body tasked with regulating the public and private pension systems of China. However, the State-Owned Assets Supervision and Administration

³ Brown, Elizabeth Nolan. "Special Report: Aging in China." AARP Bulletin Today. 7 July 2008. Web. 7 Dec. 2009. <http://bulletin.aarp.org/yourworld/family/articles/special_report_aging.html>.

⁴ See Reference 3

Commission (SASAC), the Ministry of Finance (MOF), and the State Taxation Administration (STA) all have authority in shaping national framework on retirement policy. Consequently, due to the complexity of the necessary financial reforms (to be discussed later), it is essential that a singular body, hereafter referred to as the National Retirement Administration, be set up to address all aspects of retirement planning in China. Ideally, this administration would be placed directly under the jurisdiction of the State Council, to ensure quick responses to problems that might arise, as opposed to the often lengthy process of approval required from the several aforementioned government organizations. The creation of a National Retirement Administration (NRA) could not only usher in the necessary financial reforms, but also help to address the shortcomings of the current system.

The 1980s economic reforms brought change to the unsustainable social welfare policies instituted under Mao Zedong. One key policy that did not undergo major change was the system of raising capital to finance retirement pensions: the PAYE (Pay As You Earn) system. In this system, funds are collected from the employers as a percentage of gross payrolls and then distributed to those collecting benefits during retirement. One of the major downfalls of this system is the inability to move the surpluses of some pension funds of rich regions in China to the areas where the pension funds are running a deficit. In some cases, the pension fund managers opt to invest the surplus instead of pooling their resources with other ailing regions.⁵ This lack of coordination between the pension fund managers occurs because funds are managed at the city and county levels. By creating the NRA, the Chinese government could pool the resources of every locality, allowing them to make use of the "cross-subsidization" strategy that many insurance companies currently employ. This strategy funds the deficits of one region using the surpluses of another. However, it should be noted that due to the rapidly rising demand for retirement benefits, the surpluses of some regions might not be large enough to cover the shortfalls of other regions. Therefore, it is important that the government transition the system into one of investment-based individual accounts (expanded upon in the "Financial Reforms" section).

The current system is further complicated by the legacy of costs of the 1980s economic reforms, when China began the transition to a market economy. As a result of this transition, massive downsizing occurred in many of the inefficient SOEs. As a result, millions were left unemployed. The majority of current pension expenditures go towards paying benefits to this group of individuals.⁶ The current policy is structured so that today's workers bear the entire responsibility of paying these costs—an enormous and undue burden that instigates reluctance to participate in the system. Martin Feldstein of Harvard University argues that "since the benefits of this transition [to a market economy] will be shared by many future generations, it is appropriate to share the costs over many generations as well."⁷ He supports the government assuming the entirety of the cost as national debt. In the event of the creation of the NRA, the MOHRSS could have a significantly lowered responsibility, allowing it to be tasked with sorting out the legacy of debt from previous pension plans. The MOHRSS could negotiate the sharing of the responsibility for these costs with the local governments that distributed these benefits in the first place. Additionally, it could utilize its assets (in the form of SOE shares and a small percentage of tax revenue) to finance the interest on the debt and begin to pay it off over time.

Financial Reforms

The majority of the responsibility for the NRA would come in the form of managing a modernized pension fund system in order to ensure long-term viability. The first order of business in securing the desired long-term viability is changing from the PAYE system to one where individuals are given personal investment-based accounts. This enormous shift must occur in conjunction with major financial reforms for the new system to be effective in matching the future rise in demand for retirement benefits.

5 Dunaway, Steven, and Vivek Arora. Pension Reform in China: The Need for a New Approach. Working paper no. H55. International Monetary Fund, 2007. Print.

6 Feldstein, Martin, and Jeffrey Liebman. "Realizing the potential of China's Social Security Pension System." *China Economic Times* 24 Feb. 2006. Print.

7 See Reference 6

The Big Shift

The PAYE system has been the most prominent system used in retirement policy throughout China. The current system is two-tiered; the second tier is, which consists of personal contributions to an individual retirement account, is used by only a few people and understood by even fewer. It is this tier that is the key to the future of Chinese retirement policy.

Traditionally, lack of confidence in the PAYE system has caused most Chinese people to fear the prospect of financial ruin due to an expensive illness. One consequence of this fear is an astronomical rate of savings in China, estimated at 49.9 percent in 2007 by Zhou Xiaochun (governor of the People's Bank of China).⁸ Most of these savings are held in the form of bank deposits, a result of a lack of faith in the stock market and insufficient capital (for the non-elite members of society—the majority of China) for real estate investment. Unfortunately, even this enormous savings rate is becoming less and less sufficient to address medical and educational expenses, especially considering the low and sometimes even negative rates of return on bank deposits (as low as -7.4 percent).⁹ This inefficient form of investment can be remedied through the introduction of, and mandatory participation in, an investment-based retirement fund. A system in which individuals would make personal contributions to a fund that is invested in the market professionally (under heavy government regulation).

There are several advantages of a personal retirement account system over the current PAYE system. The first is, according to estimates in a study done by the Center for Strategic and International Studies (in conjunction with the Prudential Foundation), that benefits can be distributed with a lower rate of contribution on the part of the employee. On the other hand, the growth of the financial foundation of the PAYE system is inherently tied to a growth in the real wage rate (higher real wage translates to higher income since funds are collected on a percentage basis). The argument could be made for the short-term continuation of the PAYE system, since real wage growth has been in the double digits in recent years. This growth, however, will be short-lived; as a developing nation, huge increases in productivity allow for huge growth in real wage rate. As China becomes more developed, these advances will be exhausted and the real wage growth rate will likewise decline. The numbers most certainly don't lie: in the first quarter of 2009, Forbes reported a real wage growth rate of 13.4 percent, but this number was down from 18.3 percent in the same quarter of the previous year.¹⁰ The investment-based system of personal accounts could provide more stable and adequate growth over a longer period of time. Indeed, without a doubt there is risk in any sort of market investment; this risk, however, is outweighed by the political risks of staying the course and heading for financial (and possibly even social) instability.

Implementation

The transition to a system of only individual accounts would have to be done through a gradual phasing out of the first tier (PAYE). This gradual transition enables the PAYE fund to make use of the short-term rapid real wage growth as a method of financing. It also allows for the financial infrastructure and regulatory mechanisms to be adequately developed in order to ensure the functionality of the new system. During the transition period, many key reforms must take place before a fully functional system can be established. First and foremost is the aforementioned establishment of the NRA as the regulatory body focused on managing the new system. This system can be structured in one of two ways, modeled after either the Chilean or the Swedish model of reform.¹¹ In the Chilean model, employees can choose a pension fund management company, to which contributions are given directly for administration and investment. In the Swedish model, the freedom to choose a fund manager is still available, but the contributions are

8 Xin, Zhou. "UPDATE 2-China can't reduce savings rate quickly-c.bank chief." Reuters. 10 Feb. 2009. Web. 7 Dec. 2009. <<http://www.reuters.com/article/idUSPEK23112320090210>>.

9 Lardy, Nicholas R. "Financial Repression In China." Policy Brief - Peterson Institute for International Economics (2008). Print.

10 Wang, Tina. "China's Other Worry: Wage Slowdown." Forbes. 5 May 2009. Web. 8 Dec. 2009. <<http://www.forbes.com/2009/05/05/china-consumer-wage-business-economy-growth.html>>.

11 Jackson, Richard, Keisuke Nakashima, and Neil Howe. "China's Long March to Retirement Reform". Tech. China: CSIS and Prudential Foundation, 2004. Print.

first given to the NRA, which administers the accounts as a type of “clearinghouse.” The funds are then forwarded to fund managers who focus on investment alone. While the second model allows for a more efficient movement of funds and an easier regulation of the system, it also requires a costly advanced data management system. Due to the enormous financial capabilities of China, the Swedish model is certainly feasible and could provide greater benefits.

Fund Managers

Due to the enormous importance of fund managers in the success of this new system, it is of paramount importance that strict regulations are put in place for licensing. Historical rates of return, years of experience, movement of accounts, and valuation of assets under their management are all extremely important criteria that should be used in filtering applicants. Workers are often reluctant to move from their place of residence for fear of losing the pension benefits they have earned. The underlying cause of this reluctance is the absence of an extensive network to facilitate the movement of accounts. Assuming that a Swedish model is used, requiring potential fund managers to establish a nation-wide network would enable employees to simply re-register in their new place of residence. The individual's records could be forwarded from the NRA managed database to the local office.

One area that requires less stringent policy is the number of licenses required. Chinese law mandates that the licenses for Trustee, Custodian, Investment Manager, and Administration be separately issued (though the administration license is not required in the Swedish model).¹² This policy is unique to China—nothing comparable exists in any Western nation due to the inherent inefficiencies.

The selection of fund managers should occur either directly through the local tax bureau or through the employer. The tax bureau would collect the contributions, since its pre-existing routing system gives it an advantage in moving the funds around. The NRA database would be managed through these local tax bureaus, so that accurate records of funds could be kept. If an employer fails to choose a fund manager, a default one should be assigned on the basis of performance. The performance of fund managers, however, depends on the markets in which the funds are invested, which brings into question the Chinese capital markets.

Investment Practices

High savings rates have led to enormous capital accumulation in the Chinese economy. The problem is with the banks where this money is held. The low and even negative rates of return make the investments extremely inefficient and useless to the investor. Nevertheless, the ratio of bank deposits far outweighs the value of total tradable stock, a trend that is the opposite in the United States as shown by Figure 2.¹³ Moreover, most of the bonds in the market are distributed by the central government. Local government bonds (used by many developing countries for capital financing) are non-existent. Also missing from the market are small to medium-sized companies, which generally find it difficult to meet the capital and regulatory requirements by the government.

The problem of enormous bank deposits and lack of diversified investment opportunities within the Chinese market requires two major reforms. The first is to build the confidence of the consumer in the Chinese market through transparent accounting practices for listed companies and pension fund transactions. To complement these measures, a regular individual report should be distributed to keep investors informed about the activity in their retirement accounts. This will build faith in the market and in the government, which will increase participation in the retirement program and involvement in stock markets. The second recommendation is for fund managers to make all initial investments in offshore markets until the Chinese market can provide an adequately diversified stock market. Diversification is the golden rule in investment; without it, investments have high risk, which is unacceptable in investing retirement funds. These offshore

¹² Hu, Y. and F. Stewart (2009), "Licensing Regulation and the Supervisory Structure of Private Pensions: International Experience and Implications for China", OECD Working Papers on Insurance and Private Pensions, No. 33, OECD publishing, © OECD.

¹³ See Reference 11

investments should be regulated using the quantitative asset restriction approach (QAR). This approach would allow the government strict control over where and how much money is flowing out of the country in order to prevent shortages of capital that might result from a massive outflow of investment abroad. As Chinese markets develop, regulation can slowly follow the “prudent person” approach, through which individuals can select fund managers who take higher risk for the possibility of risk-adjusted returns. Limits on the number of allowed fund managers that change over time, as well as forced movement into safer investments at an age near retirement, will still be necessary to ensure logistical feasibility for the NRA, as well as safety of the investment directly prior to retirement.

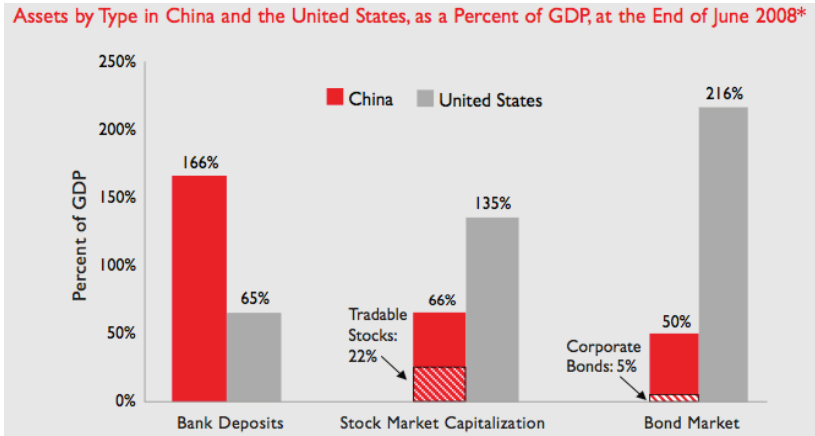


Figure 2- Source: Center for Strategic and International Studies

Conclusion

The recommendations in this report certainly do not encompass every aspect of the retirement reform issue. One major issue will be helping the hundreds of millions of people understand the complexities of the new system through education, government awareness initiatives, and reliance on peers. Moreover, the transitional period will be crucial in determining the success of the proposed new system. While there is urgency in the matter, due diligence is equally important in making sure that nothing is overlooked in creating a functionally viable system. This transition period will certainly be a substantial in length; the Swedish reform effort took approximately 16 years.¹⁴ The Swedish transition is based on gradual decline of benefits received through the old system, with equally increasing increments coming from the new system. But one lesson to learn from the Swedish and Chilean models is that a switch to individual accounts works.

In Chile, the switch to the investment-based retirement system has yielded very positive results. Since the introduction of the system, the average monthly benefit collected by individuals has ranged from USD 258 to USD 318¹⁵ compared to the United States, with a per-capita income over three times higher¹⁶ and a monthly retirement income range of USD 506 to USD 780.¹⁷

14 Sunden, Annika. "The Future of Retirement in Sweden." Working paper. Pennsylvania: Pension Research Council, 2004. Print.

15 Rodriguez, Jacobo L. "The Current State of Chile's Private Pension System." CATO Institute. 31 July 2001. Web. 8 Dec. 2009. <<http://www.cato.org/testimony/ct-jr073101.html>>.

16 "CIA World Factbook - Chile/USA." World Factbook. Central Intelligence Agency, 2008. Web. 14 Dec. 2009. <<https://www.cia.gov/library/publications/the-world-factbook/geos/ci.html>>.

17 See reference 15

This reform will aid not only the elderly in China, but also younger generations. Deeper capital markets will develop as a result of reforms, opening up more opportunities for investments. As a result, consumerism in China will have a greater opportunity to grow, since apprehensions about future medical and financial uncertainty will be, for the most part, ameliorated. Ultimately, the reforms of the system will indicate the modernization of China and will enable its capital markets to compete with those of the West.

Confucius also said, "If you do not economize, you will agonize." The inefficiencies of the current retirement policies will certainly agonize the government, the elderly who are not receiving benefits, and the proportionally shrinking young generation charged with paying the costs. Without action, China will, in fact, become an "Old People's Republic."

SOVEREIGN DEBT RESTRUCTURING: LESSONS FROM ARGENTINA

FRANCIS CHUKWU

Historically, countries have taken a variety of actions to manage issues relating to both domestic and external debts. While a country's management of domestic debt is, substantially, a domestic matter with little risk to the international financial system, the issue takes a different and serious turn with respect to external debts. Countries' management of external debt problems has had major systemic and systematic implications and continued to pose daunting challenges to the international financial system. The sheer complexity of the external debt structure, which arises from a diversified creditor base, a highly liquid secondary market for debt, heterogeneous interests among creditors, and political influence, makes restructuring of such debts an uphill battle for countries faced with an unsustainable debt burden. Using Argentina as a case study, this paper examines the implications of the actions of countries with unsustainable debt burdens in managing debt crisis on both the domestic and international levels, as well as the impact of the actions or inactions of the international community in the course of the interplay of law and politics in managing the debt crisis.

The fallout of the Argentine debt crisis is yet unfolding, and events—particularly international arbitrations and enforcement of awards and judgments—are developing at a fast pace. This paper is thus limited by the information available to the writer at the time of writing (Fall 2010).

The Argentine Exchange Rate Crisis

By 1989, when President Carlos Menem took the reigns of power in Argentina, the country was in a state of depression, with spiraling unemployment figures, inflation as high as 200 percent per month, and GDP in steady decline.¹ As part of the new president's programs of economic recovery and expansion, the Argentine Congress passed a law declaring the austral² convertible to the U.S. dollar in a ratio of 10,000 australes to the dollar.³ The four zeros were later suppressed and the name of the currency was changed to peso, so that 1 Argentine peso equaled 1 U.S. dollar, and dollars and pesos were freely exchangeable.⁴ To guarantee the convertibility of the peso, a currency board was established, with the mandate in law to maintain the unencumbered reserves of the Central Bank—foreign exchange and gold—at all times at least

1 See Andreas Lowenfeld, *International Economic Law* (New York: Oxford University Press, 2008) 2nd ed. at p. 720

2 The Argentine currency between June 15, 1985 and December 31, 1991

3 Argentine Law No. 23, 928 of March 27, 1991

4 Argentine Decree No. 2128/1991 of October 10, 1991

equal to the supply of pesos.⁵

The reforms introduced by President Menem initially led to high growth in the Argentine economy, capital inflow and an end to inflation. Exports increased by an average of 12 percent per year from 1991 to mid-1998. By the end of the decade, however, the model began to crack. When Russia defaulted on its debts, foreign investors began to withdraw their funds and the risk premium on interest rates on Argentine bonds increased sharply. Brazil, fearing a domino effect and notwithstanding the commitments in Mercosur, devalued its currency by 40 percent. When Menem's term ended in December 1999, unemployment was rising to close to 15 percent, and public sector debt stood at 46 percent of GDP.⁶ In other countries, devaluation may have helped at this point, but—perhaps because of the currency board and legislation of exchange rate system—this was not considered an option. Fiscal policy, at this point, meant either raising taxes (or their rate of collection) or increased borrowing from abroad.⁷

President Menem failed to secure a constitutional amendment permitting him to run for a third term, so his successor, Fernando de la Rúa, inherited an ailing economy with fiscal deficit, ballooning government debt, and shrinking tax revenue. By late 2000 Argentina was the largest emerging-market borrower on the international credit market, with outstanding obligations amounting to slightly more than 20 percent of the entire asset class.⁸

The IMF Interventions

In March 2000, the International Monetary Fund (IMF) approved a three-year stand-by of SDR 5.4 billion to support the economic programs of the new administration for 2000-2002, replacing an extended agreement approved in 1998. The government had committed itself to a program based on a growth in GDP of 3.5 percent in 2000, projected to rise to 4 percent in subsequent years. The gains were projected to be achieved by the elimination of the consolidated public deficit over two years, through broadening of the tax base, strengthening of tax enforcement and compliance, increased transparency, and reform of fiscal relations between national and provincial levels of government.⁹

With the economic reforms put in place by the new government in Buenos Aires—including further structural reforms such as labor market legislations, social security reform, promotion of competition in the telecommunications and energy sectors—the stand-by was supposed to be “precautionary” in that its use was considered unlikely.¹⁰

The Argentine economy, however, did not develop as expected. Growth in GDP for 2000 was near zero, and borrowing costs for Argentina rose substantially when new credit was available.¹¹ By November 2000, the fear was palpable that Argentina would be out of compliance with the fiscal deficit target set out in the March stand-by, even as that target had been relaxed somewhat in September. However, when the government approached the IMF for additional support under a new program, it was not greeted with enthusiasm. Torn between the moral and economic hazard of extending further credit to an Argentine government that had not complied with its stated fiscal targets, and the dire prospect of watching the currency board fail and the Argentine economy collapse, the IMF came out with a proposal for a massive Fund-supported credit extension for Argentina.¹² The credit was to augment the existing stand-by by SDR

5 A currency board is a monetary authority (in this case the central bank) that issues notes and currency convertible into a foreign anchor currency (in this case the U.S. dollar) at a fixed rate and on demand. A currency board has no discretionary powers, and cannot influence the rate of the domestic currency. In theory, the inflation rate of the domestic currency should move in parallel with that of the anchor currency, though this may not occur, and did not occur in the case of Argentina. Countries and areas that have employed currency boards in recent years include Lithuania, Bulgaria, and since 1983, Hong Kong. See Andreas Lowenfeld, *supra* note 33, *id*

6 For facts and figures discussed here, see “Keeping the Reform Alive”, *The Economist*, October 23, 1999.

7 See Andreas Lowenfeld, *supra* note 33, at p. 721

8 See Michael Mussa, *Argentina and the Fund: From Triumph to Tragedy*, 27 (Institute for International Economics, July 2002)

9 Andreas Lowenfeld, *supra* note 33, at 721 – 722

10 Argentina, *Memorandum of Economic Policies*, February 10, 2000, IMF Press Release No. 00/17 (March 10, 2000)

11 Andreas Lowenfeld, *supra* note 33, at p. 722

12 *Id*

5.2 billion to a total of SDR 10.6 billion (about \$14 billion) with the equivalent of \$3 billion available for immediate drawing, and three further drawings of about \$1.3 billion during the year, following completion of further review of the Argentine economy by the IMF.¹³

The IMF package expected a growth in Argentine GDP of around 2.5 percent in 2001, and an increase in investment by nearly 6 percent, following a cumulative decline in investment of 20 percent in the two prior years. The Argentine government was expected to reduce fiscal deficits and complete structural reforms such as deregulation of some specified industries, implementation of the competition law, and increased flexibility in the labor market. Though ambitious, these policies were crucial to maintaining the currency board and the parity between the peso and the dollar.¹⁴

Sadly, the government was not able to observe the fiscal targets specified under the stand-by for the first quarter of 2001. When the first quarter reports came in, Argentina requested a waiver, and the IMF complied.¹⁵ By mid-summer, though, Argentina had to pay 14 percent interest on dollar denominated short-term debt, and it lost \$3 billion worth of reserves in one week.¹⁶

By mid-summer 2001, despite several measures taken by the Argentine government to stem the brewing economic crisis, the prospects of success were even more remote. In late July 2001, the Argentine government requested accelerated disbursements of the stand-by. In August, it formally requested an increase of \$8 billion in the amount available under the stand-by.¹⁷ Once again, despite not being sanguine about Argentina's performance under a potentially enhanced and accelerated stand-by, both the U.S. government and the IMF caved in to a self-imposed ethical dilemma. They did not want to be seen as pulling the rug out from under Argentina. In a press release that also mentioned that an additional \$3 billion of the drawings for 2002 might be brought forward to support a "voluntary and market-based operation to improve Argentina's debt profile,"¹⁸ the IMF acceded to Argentina's request.

The postponed day of reckoning finally arrived in the fall of 2001. The zero-deficit policy could not be implemented as opposition parties won control of the Argentine Congress in October 2001. Revenues shrank as economic activities declined steadily. In mid-November 2001, Cavallo announced that he would go back to Washington to request further disbursements from the IMF, but this time the Fund told him he was not welcome. There would be no release of the fourth quarter installment under the augmented stand-by.¹⁹

The Run on Banks and Declaration of Default

Following the unsuccessful attempt by Argentina to draw further from the IMF's stand-by were an economic panic and an unprecedented run on Argentine banks in the fall of 2001. Riots, financial chaos, and panic plagued the country. By the last week of November 2001, deposits were being withdrawn from Argentine banks at about \$1 billion per day. The government reacted by closing all the banks, and then reopening them with a withdrawal cap of \$250 per week, a measure that became known as the "corralito."²⁰ Travelers leaving the country were only permitted to take \$1,000 with them. Strangely, Cavallo insisted that there would be no devaluation of the peso, and sought once more to persuade the IMF to release the next

13 Id; The World Bank and the Inter-American Development Bank also pledged another \$5 billion, and Spain pledged \$1 billion, thus making the total package came up to about \$20 billion.

14 Id

15 See Letter of Intent of May 3, 2001, and IMF News Brief 01/44, May 2, 2001

16 See 'Argentina and Turkey are Standing on the Brink of Financial Chaos', *The Economist*, July 19, 2001

17 This formal request is contained in the Argentine 'Letter of Intent and Supporting Memorandum' of August 30, 2001

18 A 'voluntary and market-based operation to improve Argentina's debt profile' as contained in IMF Release No. 01/37, September 7, 2001, has been described as "a subtle, but not too subtle hint that it was time to consider debt restructuring, but that the Fund would not attempt to compel such an effort. Indeed, Paul Blusten, in *And the Money Kept Rolling In (and Out): Wall Street, the IMF, and the Bankrupting of Argentina*, 145 (2005), reports a telephone conversation between Argentine Minister of the Economy, Domingo Cavallo, and U.S. Treasury Secretary O'Neill, in which the U.S. Treasury Secretary asked what interest Argentina was paying on its debt. When Cavallo said 14 per cent, O'Neill replied, 'Domingo, you have to find a way to tell your creditors "instead of paying 14 per cent, we will pay 7 per cent.'

19 Andreas Lowenfeld, *supra* note 33, at p. 725

20 Decree 1570/2001 of December 1, 2001

installment of the stand-by without success.²¹ The weak Argentine economy continued to be tied to a strong currency, and the centre was increasingly falling apart.

On December 19, 2001, following a spate of riots and looting throughout the country, President de la Rúa declared a state of siege. The following day, he resigned and the President of the Senate became provisional president. On December 23, 2001, Aldo Rodríguez, a provincial governor, was elected interim president and immediately declared a default on Argentina's public debt. He resigned one week later, paving way for Eduardo Duhalde (who had lost to Rúa in the 1999 election) to assume the presidency on January 1, 2002.²²

On January 6, 2002, Congress passed a law repealing the standard that equated one peso to one dollar, and delegated constitutional power to the president to take the necessary measures to re-organize the financial, banking, and exchange rate regimes.²³ A new exchange rate of 1.4 pesos to one dollar set by the president under in January 2002 was unable to hold, as the peso traded at two to the dollar at the unofficial rate.

After a couple of spirited but failed attempts to maintain the fixed exchange rate system, in February 2002 the Argentine government finally gave up and allowed the peso to float. By this time, the cumulative damage done to the Argentine economy by a high and unserviceable debt profile, rigid exchange rate coupled with large current account deficits, and poor economic policies was near irreversible. Thus, the run on banks did not cease, inflation reached 10 percent by April 2002, and GDP declined by 11 percent in 2002. All sectors of the economy were affected. By September 2002, more than half of the Argentine population was living below the poverty line, with 25 percent in extreme poverty.²⁴

Understanding Sovereign Debt and Defaults

The question of what constitutes sovereign debt may be less than a mere academic exercise when it is distinguished first from other financial liabilities of a sovereign, and then from private debt.²⁵

Further, domestic sovereign debts²⁶ are not included in my discussion of sovereign debts, not because they are not sovereign debts, but because they are usually managed using the instruments of the sovereign debtor's laws and administrative apparatus in accordance with its fiscal and macro-economic policies. They are, in most cases, usually negligible, and because they are within the manipulative powers of the sovereign debtor, they do not pose the same serious risk to international financial stability as foreign debts.

It is widely acknowledged that the modern secondary market for sovereign debt was borne out of the Latin American debt crisis in the early 1980s.²⁷ In the years following the crisis of the 1930s, the majority of loans to the governments of emerging market economies were made by public institutions, including the International Monetary Fund, World Bank and the Inter-American Development Bank, as well as by other

21 Andreas Lowenfeld, *supra* note 33, at 726

22 *Id*

23 Law 25,561 of January 6, 2002

24 Andreas Lowenfeld, *supra* note 33, at pp. 727 – 728. Argentina's economy appeared to have started on a path of recovery after the default, particularly from year 2003. The 2003 presidential elections ushered in a new regime that negotiated vigorously with the IMF, and in fact succeeded in paying of the IMF. In the following years, Argentina's socio-economic indicators improved markedly – unemployment, the share of the population living below the poverty line, and the share of the population living in extreme poverty, for instance – improved. By year-end in 2005, the poverty rate stood at 34 per cent compared to 57 per cent in 2002, while the share of the population living in extreme poverty stood at 12 per cent (half of its 2002 peak level). See IMF Public Information Notice No. 06/93 reporting conclusion of 2006 Article IV consultation with Argentina.

25 For the usefulness of the distinction between private and public lending in restructuring, see Alfred Mudge, "Restructuring Private and Public Sector Debt: Country Debt Structure?" in 20 *Int'l Law* 847, at pp. 1 – 4.

26 These are debts owed by a sovereign to entities within its territory, and usually denominated in that country's currency, and is opposed to foreign debts which are owed to entities outside the sovereign debtor's territory and are, in most cases, denominated in foreign currency.

27 See Jill Fish and Caroline Gentile, "Vultures or Vanguard: The Role of Litigation in Sovereign Debt Restructuring", in 53 *Emory L. J.* 1043, at pp. 1054 – 1070; James Gathii, "The Sanctity of Sovereign Loan Contracts and its Enforcement Litigation", in 38 *Geo. Wash. Int'l L. Rev.* 251, at pp. 255 – 262; and Alon Segev, "When Countries Go Bust: Proposals for Debtor and Creditor Resolution", in 3 *Asper Rev. Int'l Bus. & Trade L.* 25, at pp. 41 – 43.

countries, notably the United States.²⁸ A shift in this pattern of lending and borrowing, however, occurred in the 1970s as international commercial banks located in the United States and Western Europe became the principal source of loans to sovereign debtors in Latin America. The oil crises of the decade, beginning with the dramatic increase in oil prices in 1973, provided both funds and incentives for the commercial banks to make loans to Latin American countries. Oil-exporting countries, unable to spend the revenues they received from their exports on imports, deposited surplus "petrodollars" with the banks. The banks, seeking high rates of return on investments of the deposits, faced limited demand for loans among the industrialized countries as economic recessions in those countries reduced the need for capital. The governments of the emerging market economies in Latin America, however, desired loans to finance their more costly imports of oil. Consequently, the banks recycled petrodollars into loans to these countries.²⁹

With greater resources emerged greater responsibilities. Emerging markets, having easily obtained the petrodollar "windfall" loan, had to service the loans. In August 1982, Mexico declared that the country could no longer service its debts to foreign creditors, especially commercial banks. In the ensuing months, Brazil, Argentina, Bolivia, and Venezuela made similar announcements.³⁰ In subsequent years, many other sovereign debtors fell into arrears on their debts, and several sovereign debtors suspended debt service altogether.³¹

What followed the chain of defaults, mostly by Latin American countries during the period under review, was a series of negotiations on restructuring between the defaulting countries and various creditor commercial banks (called the "London Club" to differentiate them from the official "Paris Club" lenders), IMF pressure on commercial banks to continue lending to these defaulters in order to stem the tide of default, and yet further defaults and restructurings, followed.³² The London Club negotiations and lending into arrears were not wholly successful because the smaller banks were less worried than the big banks about maintaining long-term relationships with the distressed sovereigns and wanted to get their money back even if relationships were hurt. As Buchheit puts it:

The first round of debt rescheduling for a particular country may have enjoyed unanimous participation, but the second, third and fourth rounds did not. Within two years of the first rescheduling, fissures appeared in the cohesion of the banking community: big banks versus small banks; regional banks versus money centre; banks with large loan loss reserves versus banks without such provisions.³³

Because the majority of the commercial banks hit by the debt crisis were U.S. banks, and considering its strategic policy interest in Latin America, the U.S. government had to step in to improve both the restructuring process and the outcome of the restructurings.³⁴

On March 10, 1989, Treasury Secretary Nicholas Brady articulated a series of new principles for resolving debt crises, which became known as the "Brady Plan."³⁵ These principles included a reduction in the total amount of debt owed by sovereign debtors in exchange for both a commitment on the part of the debtors to adopt specified reforms designed to achieve sustainable growth, notably the privatization of state-owned enterprises and greater assurances of the collectability of the debt. In addition, these principles included the use of different forms of debt to increase liquidity in the international capital markets. Finally, the principles included complementary support from a variety of official sources, including the rescheduling

²⁸ See Vinod Aggarwal & Brigitte Granville, *Sovereign Debt Origins, Crisis and Restructuring* (London: Royal Institute of International Affairs, 2003) at p. 14
²⁹ Jill Fish & Caroline Gentile, *supra* note 6, at p. 8

³⁰ Philip Power, "Sovereign Debt: The Rise of the Secondary Market and Its Implications for Future Restructurings", in 64 *Fordham L. Rev.* 2701, at 2708

³¹ Lex Reiffel, "Restructuring Sovereign Debt: The Case for Ad Hoc Machinery", cited by Fish & Gentile, *supra* note 8, at p. 8

³² *Id.*

³³ Lee Buchheit, "Majority Action Clauses May Help Resolve Debt Crisis", in *Int'l Fin. L. Rev.* (Aug. 1998) at p. 13

³⁴ Jill Fish & Caroline Gentile, *supra* note 8, at p. 1055

³⁵ See Nicholas F. Brady, Remarks to the Brookings Institute and Bretton Woods Committee Conference on Third World Debt (Mar. 10, 1989), in *Brookings Dialogues on Public Policy, Third World Debt: The Next Phase* 69 (Edward R. Fried & Philip H. Trezise eds., 1989) (outlining principles for resolving debt crises)

of loans owed to official creditors and new loans from bilateral aid agencies and export credit agencies.

To implement these policies, the loans made by the commercial banks to each sovereign debtor participating in the Brady Plan were securitized. The securitized loans were then exchanged for a brand new class of bonds that became known as "Brady Bonds," which were guaranteed, at the time, by the U.S. government to serve as an incentive to investors to invest in what would otherwise be toxic debt. These bonds were sold publicly to investors, and proceeds from their sale were used to repay the loans. As a result of these transactions, the commercial banks substantially exited the sovereign debt market with appreciable measure of success, and investors holding Brady Bonds virtually replaced them.³⁶

Although regulators initially viewed Brady Bonds as "appropriate only for a limited audience of speculative investors," the high rates of return provided by the bonds attracted many investors.³⁷ The governments of emerging market economies, particularly in Latin America, realized that they could access the bond markets for a significant portion of their financing needs and implemented strategies to do so.³⁸

Besides the important advantages of flexibility and longer maturity dates as compared to loans from commercial banks, the covenants in the agreements governing such bonds are generally less restrictive than those contained in the agreements governing commercial loans.³⁹ In addition, the bonds are easily listed and traded on the stock exchanges, and have relatively simple clearing and settlement procedures. The rating agencies also assign credit ratings to sovereign bonds, providing investors with inter-country comparisons of the risks associated with the bonds. This information, in turn, facilitates daily market pricing and trading, both of which serve to increase the attractiveness of sovereign bonds to investors.

During the 1990s, bonds issued to investors in the capital markets replaced loans from commercial banks as the main form of private capital flows to emerging market economies.⁴⁰ As a result, the secondary market for sovereign debt thus became nearly as liquid as any ordinary securities market, and arguably more liquid than the cross-border securities market.

Creditor Diversification and the Heterogeneity of Interests

The diversity in sovereign bond restructurings reflects the diversity among investors in sovereign bonds. Large commercial banks, smaller commercial banks, local banks, investment banks, insurance companies, pension funds, mutual funds, retail funds, hedge funds, nonfinancial companies, and retail investors now hold sovereign bonds. These diverse investors, like the commercial banks that held sovereign debt in the 1970s, differ in many ways: their level of exposure, the regulatory environments they confront, the extent of their relationships with sovereign debtors, and their involvement in the international capital markets.

The level of heterogeneity among these investors, however, is greater than the differences among commercial banks. Generally, commercial banks follow a common business plan. They make loans to borrowers and hold cash deposits. They expect to make profits from the spreads between the interest rates charged on the loans and the interest rates paid on the deposits, as well as from fees for their services.⁴¹

Investors in sovereign bonds, on the other hand, are engaged in a wide variety of businesses, and they purchase sovereign bonds for many different reasons. For example, most mutual funds strive to create a

36 Evidence of this virtual replacement could be found in the percentage of bondholders among sovereign creditors. In the case of Argentina (discussed later in this paper), for instance, about 48.7% of the total debts eligible for restructuring were bonds held by investors.

37 Estimates put it that the debts restructured using the Brady bond initiative at the material time involved a total of \$170.2 billion of debt, and resulted in a reduction in total debt service costs of \$76 million, representing about 45% of the total. See Hal Scott, "A Bankruptcy Procedure for Sovereign Debtors?", in 37 *Int'l Law* 103, 106 (2006)

38 Jill Fish & Caroline Gentile, *supra* note 8, at p. 1067; the new species of sovereign bond financing was particularly appealing to developing market economies because, unlike commercial bank traditional loans or notes, they have longer maturity dates, and thus suited the long term infrastructural development and investment strategies of the countries.

39 See J. Speed Carroll, "Legal Aspects of Project Finance: The Borrower's View", in *Sovereign Borrowers: Guidelines on Legal Negotiations with Commercial Lenders*, (Sweden: Dag Hammarskjöld Foundation, 1984) at pp. 210 - 222.

40 Jill Fish & Caroline Gentile, *supra* note 8, at p. 1068

41 See Lex Reiffel, *supra* note 10, at 38

diversified portfolio of assets and so they invest only a small portion of their funds in sovereign bonds, while hedge funds typically purchase relatively large positions in sovereign bonds.⁴² Retail investors, in contrast, often hold sovereign bonds as part of a long-term investment strategy, so as to provide income during their retirement years.⁴³ Moreover, the institutions and individuals holding the bonds of any particular sovereign debtor continually change as the bonds are traded in the market.⁴⁴

Investors in sovereign bonds also differ significantly in their levels of exposure to the risk of default on the bonds. The value of the bonds held in each portfolio compared to the total value of assets in the portfolio varies across various types of investors as well as within various classes of investors. Some investors may experience bankruptcy upon a default on the bonds; others may only experience a small loss.⁴⁵

Due to growth of the secondary market, investors purchase sovereign bonds in the market at different prices. Unlike the restructurings of the 1930s in which investors had purchased bonds from banks at equivalent prices, and unlike the restructurings of the 1980s in which most of the commercial banks made loans to the sovereign debtors through the syndication process, investors today may purchase bonds at substantial discounts from their face values.⁴⁶

Investors in sovereign bonds also face significantly different regulatory environments. Banks and other institutional investors record the values of their portfolios of sovereign bonds at market prices, often daily and certainly monthly or quarterly.⁴⁷ Retail investors typically do not perform this exercise. By "marking to market," banks and other institutional investors record their gains and losses almost as they occur.⁴⁸ Retail investors typically record gains and losses only upon sales of bonds. Because the values of their portfolios already reflect the losses due to financial distress, banks and other institutional investors may choose to exit a restructuring by selling their bonds in the market, rather than holding the bonds and working to complete the restructuring process.⁴⁹ These sales further depress prices and create losses for other investors, including retail investors. Moreover, as secondary trading leads to shifts in the ownership of the distressed debt, it hinders efforts to reach consensus among the bondholders.

Sovereign Debt Default and the Need for Restructuring

It is difficult to predict when sovereign debt defaults will occur. Classical or neo-classical contractual theories argue that any "event of default" such as failure to pay an interest as it falls due or an attempt to restructure the bond instrument constitutes a default. Relational contract theory argues that "adjustments within social and political processes" necessary to secure the beneficial interests (short term, long term, or both) of both parties are not default, even if they entail non-payment of one or more interest or some other non-conformity with the strict terms of the instrument.⁵⁰

Arguments for or against either proposition are not within the scope of this paper. However, while one may not solve the riddle between the classical and relational contract theories here, it is necessary to point out that, particularly for restructuring purposes and discussion here, default must be distinguished from repudiation.

In standard sovereign debt models, countries borrow during hard times and repay when economic conditions improve. However, a sequence of output shocks or an unforeseen balance of payment crisis could result in a situation in which the country borrows beyond its servicing capacity, and if the negative situations

⁴² *Id.*, at 39

⁴³ See Suzanne Miller, "Lessons From Argentina", *The Banker*, Feb. 1, 2002 (describing the spread of retail investors who purchased sovereign bonds issued by Argentina as ranging "from dentists in Belgium to housewives in Japan").

⁴⁴ See Stephen Schwarcz, "Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach", in 85 *Cornell L. Rev.* 956, 1005 – 06

⁴⁵ See Daniel McGovern, "Different Market Windows for Sovereign Debt: Private Sector Credit from the 1980s to the Present, in *Sovereign Debt Origins, Crisis and Restructuring*, *supra* note 7, at pp. 82 – 83.

⁴⁶ Jill Fish & Caroline Gentile, *supra* note 8, at p. 1072

⁴⁷ Daniel McGovern, *supra* note 22, at 79

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ See generally Keith Palzer, "Relational Contract Theory and Sovereign Debt", in 8 *NW.J. INT'L L. & BUS.* 727, at pp. 729 – 734.

continue, may opt to seek restructuring (technically default) rather than further tighten consumption at a time when this is particularly painful and most likely unpopular.⁵¹

The above concept is a good example of what is largely known and popularly understood in sovereign debt literature as “default.” Actions that may be taken in this regard include suspension of payment of interests or interests and principal on a debt instrument as they fall due, imposition of caps on payments, altering due payment dates, and declaration of a moratorium on the entirety of debts or a class of them.⁵²

Default is understood to differ markedly from repudiation. A country repudiates its debt if it denies liability for any part or the entirety of it or declares absolute non-payment of a debt or interest on it. Repudiation is most argued in the context of odious debts.⁵³ Even in the context of odious debt, countries have tried to explore other means of resolving their debt problem other than through repudiation.⁵⁴ The need for debt restructuring, therefore, arises from the very nature and essence of a default: the debtor fully acknowledges its indebtedness, but, being unable to meet the debt obligations as they fall due, seeks a rescheduling of same that would enable it meet the restructured debt obligations. The ink that has flown, the several proposals that have been proffered, and all other efforts made on debt restructuring seek models that would achieve this and at the same time preserve the genuine interests of creditors, the liquidity of the market, and the stability of the international financial system.

Argentina’s Unilateral Restructuring

On September 22, 2003, following the declaration of default on its public debts, Finance Secretary Dr. Guillermo Nielsen gave a speech presenting “Argentina’s Restructuring Guidelines” to a diversified conference of the country’s creditors in Dubai.⁵⁵ The proposed restructuring would impose a cut of approximately 75 percent on the various classes of eligible bonds and was presented as a “take it or leave it” option.⁵⁶

In effect, private creditors were being asked arbitrarily to forgive debts exceeding \$70 billion to the Government of Argentina. Bondholders were asked to choose one of the following types of new bonds and simultaneously execute a swap of their existing debt.

- **Discounted bonds:** this would involve a reduction (approximately 75 percent) in the face value of the bond, in which case the new bonds swapped for the old would become serviceable under the terms of the new offer.
- **Par Value Bonds:** these were bonds that would be issued at par value with the old bonds (this, in practice, actually meant with a small or no face value reduction), but with significantly lower coupons and longer terms.
- **C Bonds:** these were bonds issued at par value with a twenty-year amortization period and ten-year grace period. A portion is redeemed annually at the expiration of a six-year grace period. The bonds were issued at a steep discount rate but structured to capitalize the difference from the expiration of the grace period over a period of time.⁵⁷

51 See generally, Ugo Panizza, Federico Sturzenegger, and Jeromin Zettelmeyer, “The Economics and Law of Sovereign Debt and Default”, in *Journal of Economic Literature* 2009, 47:3, 653 at p. 669 – 671.

52 Most Latin American countries adopted one or more of these during the 1980 and later years debt crises.

53 See Anna Gelpern, “Odious, Not Debt”, in 70 – *SUM Law & Contemp. Probs.* 81, at pp. 87 to 89.

54 Argentina has, however, declared a repudiation of the debts it owed to all creditors who refused to participate in its latest restructuring. See Hal Scott, “Sovereign Debt Default: Cry for the United States, Not Argentina”, in *Washington Legal Foundation Critical Legal Issues Working Paper Series* No. 140, September 2006, at pp. 4, 5, 42 – 43; Sabine Michalowski, *Unconstitutional Regimes and the Validity of Sovereign Debt* (Hampshire: Ashgate Publishing Company, 2007) at pp. 129 to 130.

55 See Speech of the Secretary of Finance (Argentina) available at http://www.argentinedebtinfo.gov.ar/documentos/discurso_gn_dubai_con_diap_english.pdf

56 Id

57 Id

The restructuring was designed to obtain a 75 percent reduction in the nominal value of the stock of eligible debt. The new bond issues were denominated in USD, Euro, Yen, and Argentine peso and governed by the laws of New York, England, Japan and Argentina.⁵⁸

The government of Argentina made it abundantly clear to bondholders that it had no intention of resuming payment on any bonds eligible for restructuring that were not tendered for any of the above swaps or otherwise part of the restructuring process.⁵⁹

The offer, finally and formally made to holders of eligible bonds in December 2004, was accepted by 76 percent of the bondholders.⁶⁰

Key Restructuring Principles

Argentina's professed restructuring principles and objectives were targeted at facilitating a quick resolution to the debt crisis and paving the way for economic growth and a return to the bond market in the near future.

First, the restructuring process was meant to foster economic growth in the country and reverse the trend of indicators that point to a steep decline in all developmental indices in the country. The success of the restructuring required sound economic policies that would pave the way for sustained growth in the economy. At the same time, the government was careful to guard against policies that had the potential of increasing the impoverishment of an already-beggared citizenry. According to Finance Secretary Guillermo Nielson:

The (economic indicators) table you have seen shows that we should significantly improve our social situation, so that Argentine people may have the life quality that used to distinguish our country from other countries of the region.⁶¹

Second, the debt proposal was meant to be fair and equitable to all creditors. Inter-creditor equity (a concept largely ignored in contract-driven sovereign debt workouts) was stated to be a major cornerstone of the Argentine restructuring.⁶² With a record diversity in its creditor base and the highest number of defaulted bond issues in history, it was always going to be difficult for Argentina to achieve reasonable inter-creditor equity in its restructuring, even among the participants in its unilaterally decreed workout.⁶³

Third, the sustainability of Argentina's debt profile, and its prospects of a quick return to the bond market, was a central issue in the restructuring process. Debt reduction and sustainability were both pursued in line with a policy that sought to restore solvency through an improvement in key economic indicators such as the debt to GDP ratio and the annual debt service to taxation revenues ratio. In this regard, liquidity with a new maturity profile in line with the country's realistic payment capacity was of the utmost importance.⁶⁴

⁵⁸ Id

⁵⁹ See Republic of Argentina Registration Statement No. 333 as filed with the Securities and Exchange Commission, United States, on July 2, 2004, at p. 14

⁶⁰ Hal Scott, *supra* note 32, at p. 4

⁶¹ *Supra* note 57, at p. 11

⁶² Id

⁶³ Whether or not this was achieved in the process is an entirely different issue.

⁶⁴ *Supra* note 57, at pp. 13 – 14; Critics have lampooned Argentina's arguments that its unilateral haircuts and debt restructuring were meant to pull the country out of a crippling economic turmoil. They argue that at the time the country imposed the haircuts on its creditors, all available indices point to the fact that Argentina was recovering from its economic malaise and that marked improvements were already being experienced among all sound economic indicators in the country. Critics therefore classify Argentina's default as unavoidable, but its unilateral restructuring as inexcusable. They readily point to the fact that Argentina was able to pay off the IMF between the 2001 default declaration and 2006, and argue that the country's actions respecting its creditors were nothing but a forceful taking of private property by a country that ought to honor its obligations, while the international community looked the other way. See for instance Arturo Porzecanski, "From Rogue Creditors to Rogue Debtors: Implications of Argentina's Default", in 6 *Chi. J. Int'l. L.* 311, at pp. 317 – 325; Hal Scott, *supra* note 32, at pp. 2 – 7. On the other hand however, it appeared that the international community viewed the restructuring as part of Argentina's legitimate efforts to deal with its economic crisis and therefore opted not to interfere with the process. The high degree of 'acceptance' of the proposal among the creditors appeared to justify this stance – as would be recalled, in December 2004, the swap exchange offer was accepted by 76 per cent of the holders

Finally, only eligible debts fell within the proposed restructuring. Eligible debts were simply defined as all bonds issued before the December 31, 2001 cut-off date.⁶⁵ The table below shows the relative proportion of eligible and non-eligible debts in the total debt profile as at the year 2003 restructuring proposal.

Table 1: Eligible Debts

ELIGIBLE DEBT	MILLIONS IN USD	% IN TOTAL DEBT PROFILE
Bonds	87,050	48.7
Bilateral loans	5,217	2.9
Commercial bank loans	1,724	1.0
Other Creditors	311	0.2
Total	94,302	52.7

Table 2: Non-eligible Debts

NON-ELIGIBLE DEBT	MILLIONS IN USD	% IN TOTAL DEBT PROFILE
International financial institution debts*	30,792	17.2
BODENS	22,580	12.2
Guaranteed loans	15,558	8.7
Provincial guaranteed bonds	10,200	5.7
Exception payments	606	0.3
Others	4,727	2.6
Total	84,493	47.3

*Apart from the debts owed to International Financial Institutions, all other non-eligible debts were obligations incurred by Argentina after the December 31, 2001 cut-off date.

Source: *Argentina's Restructuring Guidelines, Mecon 2003*.

The total bond instruments that were restructured consisted of 152 bonds denominated in seven currencies and issued in eight different jurisdictions. The new bonds were denominated in USD, Euro, Yen and Argentine Peso, and the governing laws were those of New York, England, Japan and Argentina.⁶⁶

Holdout Litigation and the Difficulties in Enforcement of Holdout Judgments

As previously observed, the bonds unilaterally restructured by Argentina were subject to the laws of various jurisdictions. However, though U.S. residents held less than 10 percent of the bonds, more than half of them were denominated in US dollars and made subject to the jurisdiction of US courts. That means, essentially, that they were subject to a waiver of sovereign immunity, application of US States and

of eligible bonds under the proposed restructuring. As noted by Lowenfeld (supra note 33 at p.741) "in any proposed settlement with holders of defaulted bonds, the aim of the sovereign (debtor) seeking re-entry into the market is to secure maximum consent on the part of the creditors, and to resist, as far as possible, litigation brought in national courts on behalf of non-consenting creditors. Argentina, in the period 2003 – 2006, achieved both of these aims to a surprising extent".

⁶⁵ Id

⁶⁶ Andreas Lowenfeld, supra note 33, at. pp. 741 – 742

Federal Laws, and designation of New York as dispute resolution forum.⁶⁷ About one-third of the bonds were denominated in Euros, with choice of laws split between Germany and England.⁶⁸

All bonds issued under German law contained a choice of law clause, a choice of forum clause, and a waiver of sovereign immunity, without exception. In the first case brought by the holdout creditors against Argentina in Germany in 2003, the court of first instance in Frankfurt decided in favor of the creditors. The court rejected Argentina's defense based on Argentina's emergency law on the ground, *inter alia*, that a sovereign debtor cannot unilaterally free itself from its own obligations. Consequently, the Court issued a judgment in favor of the creditors and confirmed an order of attachment on the country's real property.⁶⁹

The German Court of Appeal at Frankfurt stayed the judgment of the trial court on the ground that the effect of a declaration of emergency by a foreign sovereign on private actions raised a question of international law, and therefore might be subject to the exclusive jurisdiction of the Constitutional Court.⁷⁰

In February 2006, before the Constitutional Court could rule on the matter, the Court of Appeal came to the conclusion that Argentina could no longer invoke the state of emergency necessity, since President Kirchner had declared in March 2005 that the restructuring of its debt had overcome Argentina's international insolvency. The Court compared Argentina's debt situation with other countries in Europe, whose debt situations were as precarious as Argentina's or worse. It also alluded to the consistent growth in the Argentine economy since 2002 and the fact that it had paid off the IMF.⁷¹

In two other separate decisions, both the German Constitutional Court and the Court of Appeal upheld the rights of holdout creditors seeking judgments against Argentina. They rejected Argentina's defense of state of emergency in light of substantial improvements in its economy. The Court of Appeal cited not only various statistics showing Argentina's recovery, but also Article 25 of the Articles on State Responsibility of the International Law Commission and the International Convention on Settlement of Investment Disputes (ICSID) Tribunal in *CMS Gas Transmission Inc. v. Argentine Republic*, which had rejected the necessity defense altogether.⁷²

Creditors in Germany are still looking for a means to enforce their judgments because Argentina held no other assets besides few physical assets attached under the judgment of the court. Evidently, the Argentine government took pains to shelter its foreign-held assets that might be subject to attachment from its creditors.⁷³

When the suits against Argentina were filed in the New York courts, there was little doubt as to what the outcome would be. The courts of New York had in the recent past upheld creditors' rights against defaulting sovereigns and roundly rejected the arguments Argentina leveled in justification for its unilateral restructuring and against the suits brought against it in national courts.⁷⁴

Thus in the first of the series of cases—*Lightwater Corporation Ltd. v. Republic of Argentina*⁷⁵—the New York District Court not only refused to agree with Argentina on all the defenses it proffered before the German courts but also rejected Argentina's new argument: that there is a principle of international law which could bar plaintiffs from suing on their bonds at the time when an issuer is having severe economic crisis.

67 *Id.*

68 *Id.*; About 10 per cent of the bonds were held by residents of Switzerland and 15.6 per cent by residents of Italy, but those countries were not designated as dispute resolution fora. Argentine citizens held just fewer than 40 per cent of the bonds.

69 Judgment of 21st Civil Chamber, Landgericht, Frankfurt, of 14 March 2003; 2-21-O 294/02 (liability), 2-21-O 509/02 (attachment).

70 Decision 8U 52/03 of the German Court of Appeal, Frankfurt, on July 7, 2003; questions of international law are, by Article 25 of the German Basic Law, an integral part of Federal Law, to be decided not by the ordinary civil courts but by the Constitutional Court.

71 Decision 8U 107/03 of February 16, 2006.

72 ICSID Case No. ARB/01/70, Award of May 12, 2005. See generally Andreas Lowenfeld, *supra* note 33, at p. 743.

73 *Id.*, at p. 744.

74 See for instance, *Republic of Argentina v. Weltover*, 504 U. S. 607 (1992); and *Allied Bank International v. Banco Credito Agrícola de Cartago*, 757 F. 2d 516 (2nd Cir. 1985).

75 2003 WL 1878420 (SDNY April 14, 2003, per Griesa, J.)

In the case of *NML Capital Limited & Another v. The Republic of Argentina*,⁷⁶ after the plaintiffs had succeeded in obtaining a judgment against Argentina on the defaulted bonds, the plaintiffs moved to attach the bonds that were to be exchanged by the creditors participating in the restructuring as they were being tendered to the Bank of New York as exchange agent. The judge first granted the order of attachment, but a day before the scheduled exchange vacated the order on the ground that part of the contractual rights of the sovereign was the right to cancel the bonds as they were tendered. The Circuit Court affirmed this decision, without resolving the issue whether the tendered bonds were to be regarded as assets or debts of Argentina.⁷⁷

In further proceedings on the case, the plaintiffs sought to attach monies the Argentine Central Bank (Banco Central de la Nación) was about to pay to the IMF to shore up its monetary base and repay its debt to the Fund. The plaintiffs were granted temporary orders of attachment by another judge, but on January 12, 2006, Judge Griesa, after hearing arguments from both sides, vacated the orders on the grounds chiefly that monies belonging to the Argentine Central Bank belonged to a different entity, under the separate identity doctrine;⁷⁸ that making payment to the IMF was not a commercial activity and therefore could not come under the commercial activities exception under the Federal Sovereign Immunities Act; and that the funds held at the New York Federal Reserve were immune, being the assets of a foreign central bank. In two other cases, however, both the District Court of New York and the 2nd Circuit Court refused attachment of assets belonging to distinct organs of the state (such as the Argentine Central Bank) on the same ground the District Court had used earlier in *NML v. Argentina*: that assets belonging to such distinct state entities were not assets belonging to the Republic of Argentina, and could therefore not be used to satisfy judgments against the Republic.⁷⁹

What has emerged after seven years of litigation by holdout creditors is largely a situation of frustration and untold loss—the loss of the value of bonds now clearly repudiated by Argentina, and the heavy costs of litigation. Very few, as far as could be ascertained, have made any headway in litigation or enforcement proceedings against Argentina.

LESSONS FROM THE ARGENTINE EXPERIENCE

The Role of Collective Action Clauses in Sovereign Debt Workouts.

None of the 152 classes of bonds restructured by Argentina contained a Collective Action Clause (CAC). A CAC allows holders of the class of bond containing that clause to take a majority action under a proposed debt restructuring in their collective interest, and presumably also in the interest of the debtor. Such a clause would enable a majority of the bondholders to make a decision that would bind any dissenting minority that owns part of the concerned bonds.

In the context of market-driven debt restructuring, the CAC remains the most popular singular instrument favored by academics, creditors, debtors, and the international financial community.⁸⁰ CAC has, since the debt crisis of the 1980s, replaced the hitherto traditional Unanimous Action Clauses (UACs)

76 2005 WL 743086 (SDNY 2005, per Griesa,J.)

77 The Circuit Court affirmed on the ground that it would not disturb an exercise of jurisdiction by the District Court, where as it saw it, the discretion was properly exercised. See *EM Ltd v. Republic of Argentina*, 131 Fed. Appx. 745 (2d Cir. May 13, 2005). Andreas Lowenfeld exhaustively discussed these cases at supra note 2, pp. 744 – 745. The litigations in these cases have several facets, take several dimensions, and are yet to be fully resolved. Further discussions about them are required but yet unripe.

78 That is, that property belonging to the bank was not property belonging to the Republic, and thus could not be used to satisfy judgment against the Republic.

79 See *Aurelius Capital Partners, LP v. Republic of Argentina* (2d Cir. 10/15/2009), and *Capital Ventures Int'l v. Republic of Argentina*, 280 F. Appx. 14, 15 (2d Cir. 2008).

80 See generally, Robert Shapiro and Nam Pham, *Discredited – The Impact of Argentina's Sovereign Debt Default and Debt Restructuring on U. S. Tax payers and Investors*, available at http://www.sonecon.com/docs/studies/argentina_1006.pdf; Jill Fish and Caroline Gentile, supra note 6, at pp. 1093 to 1095; Lee Buchheit and Mitu Gulati, *Sovereign Bonds and the Collective Will*, 51 *Emory L.J.* 1317, 1340 – 47; Under Secretary of Treasury John Taylor, "Sovereign Debt Restructuring: A U.S. Perspective", (Remarks at the Conference on Sovereign Debt Workouts: Hopes and Harzards?) Institute for International Economics, April 2, 2002, available at <http://www.treas.gov/press/releases/po2056.htm>

that were the hallmark of bonds issued in or governed by New York or U.S. law. Recent studies, as well as responses from major players in the sovereign debt market, indicate that most concerned parties view the use of CACs in sovereign debt contracts positively as a contractual approach that avoids the shortcomings of a more intrusive regulatory solution.⁸¹

In spite of the market positive disposition towards the use of CACs, they are not without major setbacks. First, CACs do not eliminate the strategic use of litigation by creditors to frustrate the restructuring process. First, there is the risk that in the course of trying to reach a majority decision on the debt workout, inter-creditor lawsuits may even derail the restructuring process.⁸² Second, CACs could only be used in new bond instruments or in existing instruments where they are contained. In existing bond instruments without CACs (such as Argentina's 152 restructured bonds) they are of little or no significance. A rather ingenious proposal for overcoming this problem has been presented by Ed Bartholomew and Ernie Stern of J. P. Morgan. Under this proposal, a country with an unsustainable debt approaches its creditors will first be met with an effort to exchange all existing debt for debt instruments (Interim Debt Claims or IDCs) containing CACs. Various incentives, including some up-front cash, would be offered by the debtor to induce creditors to accept the exchange.

The new instruments would be made additionally attractive by structuring them to be highly liquid to permit the exit of those creditors so disposed. A stick, in the form of exit consents (as employed by Ecuador in 1999), could also be used to convince recalcitrant creditors that their rights would be significantly reduced if they held on to the original instruments.

The clauses included in the new instruments described the rules for creditor representation and for majority action. Once the original debt had been converted, the provisions of the IDCs would facilitate a restructuring agreement between the debtor and its creditors.⁸³

This approach cleverly addresses some of the problems of the CAC approach—in particular, the debt stock problem. Moreover, it requires no new legislation while accomplishing aggregation, and presumably deals with the potential problem of multiple jurisdictions and the risk of conflicting interpretations by issuing the IDCs under a single jurisdiction.

While it has been suggested that the difficulties feared under this approach should not deter its usage, and that they are better met in real time and dealt with in the course of a restructuring,⁸⁴ several basic questions remain. Will bondholders, or other claim holders, be willing to accept the IDCs? Where will a country in crisis, or near crisis, get the resources for the up-front cash inducement? Which CACs would be used and would they be up to the tasks of second-stage restructuring? Will minority or holdout creditors, in fact, be made legally powerless, especially if they have managed to accumulate concentrated positions in a particular instrument, making exit consents ineffective? Would the exit consents themselves be subject to challenge? And could all of this be done in a sufficiently expeditious fashion to limit disruption to the economy?

Finally, CACs may not be fair to some creditors, particularly in cases where a few institutional investors hold the bulk of the bonds and a large number of retail investors hold a reasonably smaller proportion. Here the fear of tyranny of the majority is real. The majority bondholders may deal with the minority unfairly. It has already been established that the motives that drive these variegated classes of investors while they make their investment decisions are as different as their names. Although some commentators have argued that the majority's decision to restructure is constrained by the implied covenant of good faith and fair dealing,⁸⁵ it has not been reasonably demonstrated how this clause prevents a creditor from pursuing its own interests in the event of a debt workout and compels it to pander to the interests of

81 See the propositions of Ed Bartholomew and Ernie Stern of J. P. Morgan, discussed by Jill Fish and Caroline Gentile, *Id*

82 *Id*

83 *Id*

84 See generally Jack Boorman, *Alternative Approaches to Sovereign Debt Restructuring*, *Cato Journal*, Vol. 23, No. 1 (2003) (adapted from the author's presentation at the Cato Institute's 20th Annual Monetary Conference, cosponsored with *The Economist*, October 17, 2002.)

85 William Bratton and Mitu Gulati, "Sovereign Debt Restructuring and the Best Interest of Creditors", 57 *Vand. Law Rev.* 3 (2004), at pp. 65–74.

any other bondholder. Indeed, in the case of *Redwood Master Fund Limited v. T. D. Bank Eur Limited*,⁸⁶ an English Court evaluated the duties of majority creditors in negotiating a sovereign debt workout subject to a CAC and found that majority bondholders had no obligation to negotiate on behalf of all creditors rather than in their own self interest.

As noted earlier in this paper, the bonds restructured by Argentina did not contain Collective Action Clauses. Even if they had, it is difficult to contemplate how the deployment of the clause would have resulted in an orderly debt workout between the country and its creditors. Major issues that would have hampered a CAC-driven restructuring include the unprecedented number of bond issues the country restructured and the different laws governing them, the harsh economic crisis,⁸⁷ and the unprecedented diversification of its creditor base.

However, the potential usefulness of a CAC-driven restructuring in the Argentine workout cannot be overstated. It is clear that the international community was sympathetic to Argentina in the course of its economic crisis and debt default. Indeed, the decisions of the German courts in our study show that the courts were prepared to protect Argentina from holdout litigation if the country was perceived as trying to pull itself out of a severe economic crisis while genuinely negotiating a restructuring of its debt with its creditors. A CAC-driven restructuring would have presented good evidence to the court that the country was not the “rogue debtor,” but a debtor in need of help to pull itself out a crisis. Regardless of what the strict contractual rights of the creditors say, this may have made all the difference in a lot of the cases where Argentina was successfully sued.⁸⁸

The two-way option proposed by Ed Bartholomew and Ernie Stern of J. P. Morgan could have been adopted in Argentina. In fact, the proposal came in 2002, just a couple of months before Argentina announced to its creditors at the Dubai Conference that it was going to impose unilateral haircuts, and may have been a subtle hint to Argentina of the pulse of the market regarding its debt crisis.

The lesson remains for future guidance—until a permanent and workable solution could be found for sovereign debt workouts, the use of CACs would be a viable tool of restructuring.

Reputation in Sovereign Debt Transaction: A Multi-Dimensional Approach?

The issue of reputation in the context of sovereign debt has always been approached from the angle of creditors’ view of the sovereign borrower. This view sees the reputation of a sovereign debtor through the prism of creditors, and thus demands that sovereigns approach their debt issues in manners that secure a favorable reputation for them in the debt market. This would ensure that the country is able to access credit at will, that its bonds are freely traded and enjoy high liquidity in the secondary market, and that its costs of borrowing are as minimal as possible.⁸⁹

What emerges from the case of Argentina, however, is that the issue of reputation becomes even more compelling when a foreign court is called upon by holdout creditors to decide on the actions of a sovereign who has defaulted on its debt and is engaged in debt restructuring. The case of Argentina brings to the forefront a case of foreign courts’ willingness to protect a distressed sovereign engaged in an honest attempt to restructure its debt obligations and the importance they attach to that country’s reputation (particularly in the context of that debt restructuring) in making their decisions. The decisions of the German and American courts (discussed above) illustrate this point.

First, the decisions of the German courts⁹⁰ were clearly informed by their perception of Argentina

86 [2002] All E. R. (D) 41

87 A CAC-driven restructuring would not have yielded the massive haircut Argentina dished out to its creditors; it would have demanded far greater financial commitment from Argentina, and in view of the opposition party’s (then recent) sweep to power, the government would not have been willing to agree to a solution that would require further tightening of the belt on already beggared citizenry.

88 Recall that even in the U.S. both the Federal Government and the New York Reserve Bank supported Argentina in the domestic courts. The rouge character of the country brought by the unilateral imposition of haircuts contributed a lot to the loss of goodwill it suffered in several quarters in the U.S.

89 See Tomz Micheal, *supra* note 1, at pp. 14 – 36.

90 Footnotes 72 – 74 above.

as a dishonest debtor engaged in a scheme calculated to cheat its creditors. While the courts appreciated that Argentina underwent a serious economic crisis and had to take actions on its debt to avert a total collapse of its economy, they were less impressed by the perceived fact that at the time Argentina imposed the haircuts on its creditors, all economic indices indicated that its economy was quickly recovering, and it could have paid its debts without suffering a collapse of its economy. In fact, this later perception appeared to have been decisive in the judgments handed out by the courts. The following observations of the German Court of Appeal in two of the cases⁹¹ are instructive:

Argentina's sovereign debt stood at 80 per cent of GDP – better than a number of members of the European Union, and not significantly better than that of Germany... Argentina's GDP had grown by 9 per cent in the past two years, and its unemployment rate had declined significantly. Nor, had Argentina proved that compliance with its payment obligations would jeopardize its essential government functions. In these circumstances, the court would not find a basis for a defense of emergency or necessity, regardless of the fact that the Argentine government had proclaimed an extension of the emergency law.

Next are the proceedings in *NML v. Argentina*⁹² in the United States. In a jurisdiction well-known for its pro-creditor rights approach to sovereign debt issues, the District Court of New York refused to attach bonds that were to be tendered by the Argentine Central Bank at the Bank of New York for the purpose of executing the exchange brokered between Argentina and its creditors who agreed to participate in the debt swap, on the ground that part of the Republic's contractual right was the right to cancel the bonds as they were actually tendered, and that attachment would frustrate the restructuring.

In the same case, but in another proceeding to attach the payments that were to be made to the IMF by the Central Bank of Argentina, the Court refused the attachment chiefly on the grounds that the Argentine Central Bank was a distinct entity from the Republic, and that funds in its hands could not be regarded as funds belonging to the Republic. The payments to the IMF were not considered "commercial activity" within the meaning of the Foreign Sovereign Immunities Act, and were therefore protected from attachment. The Circuit Court affirmed this decision. It is instructive that, against "conventional thinking," both the New York Federal Reserve Bank and the U.S. government supported Argentina in this case.

The U.S. Supreme Court, however, granted certiorari on October 1, 2007 and upon a review of the matter, remanded it back to the District Court.⁹³ The District Court reached the opposite decision when the matter first came before it—it held that the Central Bank was an agent of the Republic, and the monies could therefore be attached. But the following pronouncements of the judge in the matter remain indicative of how reputation can play out even in holdout litigations:

The Court has fully considered the Federal Reserve's position, and fully recognizes that the Federal Reserve is surely a most important institution in this country, and that its relationships with central banks in other countries is of importance to the United States. However, there are other institutions. One of them is the court system. What is going on between the Republic of Argentina and the Federal Court system is an exercise of sheer willful defiance of the obligations of the Republic to honor the judgments of a Federal Court...the Republic's prominently declared position is to refuse this course; and the Republic has thus enmeshed the court into years of wasteful litigation with no end in sight. As to BCRA (the Argentine Central Bank), the records show that it has been the servant of the Republic in enabling the Republic to pay off billions of dollars of debt, for political or diplomatic reasons, the Republic has desired to pay,

⁹¹ Decision of OLG Frankfurt February 16, 2006, 8 U 107/03; and Judgment of OLG Frankfurt, June 27, 2006, 8 U 213/03; See also Andreas Lowenfeld, *supra* note 33, at 742 – 743.

⁹² *Supra* note 79

⁹³ See Andreas Lowenfeld, *supra* note 2, at 747

leaving the plaintiff bondholders to their difficult judicial struggle.⁹⁴

The above discussion highlights just how important reputation can be both for policy makers and for the courts in circumstances where the relevant officials have to make decisions concerning a distressed sovereign and its creditors, particularly in the context of a restructuring. How countries might learn from this in the future remains to be seen.

The Indispensable Role of the International Community in Sovereign Debt Workouts

I find the following assertion by Anna Gelpern to be both thought-provoking and illuminating:

Iraq and Argentina highlight the obvious point that is often ignored by debt relief advocates and technocrats alike—it is impossible to separate politics and finance from sovereign workouts; both are central and neither is a sideshow. While the IMF was busy designing a complex sovereign restructuring mechanism, the UN Security Council simply shielded an important country from its creditors.⁹⁵

Of course, the fact that the United Nations (UN) Security Council passed a resolution banning anyone from seeking to satisfy Iraqi debts from its oil resources—though such an action has never been taken with countries that were far poorer and in greater need of protection than Iraq at the time—speaks volumes of the extent to which politics has permeated the sovereign debt market. Countries take actions that help or hurt sovereign debtors and creditors alike in accordance with their foreign and domestic policy dictates.⁹⁶

With increasing public aversion to the activities of “vulture funds,” both the U.K. and the U.S. have initiated substantial legislation to curtail or totally bar creditors perceived as vulture funds from proceeding against or recovering from Heavily Indebted Poor Countries through the instrumentality of their court systems.⁹⁷ These legislative initiatives were undertaken in spite of the adverse consequences they may have on the liquidity of the sovereign bond market, the rights of investors, and the stability of the international financial system.⁹⁸

The European Union, possibly due to the experiences of bailing out Greece and facing the scary prospect of having to extend another bailout to Ireland and other potentially “on the brink” Eurozone countries, has called for a permanent system for resolving sovereign debt problems. The Union rose from its October 28, 2010 meeting in Brussels with a resolve to make limited changes to the bloc’s treaty to accommodate a German-Franco call for the creation of a “permanent system to handle debt crisis”⁹⁹.

Besides the pockets of actions being taken by developed countries respecting the debt crisis, Argentina’s unilateral restructuring shows that there is more to sovereign debts than rights and duties spelled out by the bond instruments and financing agreement. It represents a case where a country decided to deal with its debts in a way that ignored the interests of its creditors.

A sovereign is a sovereign, not a corporation; this is another lesson we can learn from the Argentine crisis. There is an urgent need for a concerted action by the international community to find a permanent solution to the problem of sovereign debt restructuring. This solution is not likely to come without statutory instruments and a permanent institutional regulation, but its exact details are a subject for further research..

94 *Supra* note 79, at pages 70–71 of the certified opinion of the court.

95 Anna Gelpern, “What Iraq and Argentina Might Learn From Each Other”, in Vol. 6 *Chicago Journal of International Law* No. 1, at p. 414

96 Consider, for instance, the U. S. filing scores of amicus briefs on the harping on the contractual right of creditors and the non-applicability of the sovereign immunity in cases such as *Allied Bank v. Banco Credito Agrícola de Cartago*, 757 F.2d 516 (2d. Cir. 1985), and *Libra Bank v. Banco Nacional de Costa Rica*, 570 F. Supp. 870, 875 (SDNY, 1983), only for it to turn around and argue against the same principles in *NML v. Argentina*, *supra* note 78, where it felt its policy interests so demanded.

97 See the Debt Relief (Developing Countries) Act, 2010 (U.K.) and the “Stop Vulture Funds” Bill, No. HR 2932, currently pending before the 111th congress of the U.S.

98 Arguably though, their potential benefits outweigh the feared negative effects. It suffices to note, however, that this is just an instance of the many action countries may take on their own that may have potential substantial impact on the sovereign debt market.

99 <http://www.aljazeeraah.info/News/2010/October/29%20n/EU%20Leaders%20Agree%20on%20Limited%20Treaty%20Changes,%20New%20Budget%20Rules,%20to%20Handle%20Debt%20Crisis.htm>

TRANSPARENCY IN MICROFINANCIAL DISCLOSURE

SAMPOORNA DASGUPTA

The advent of information technology and electronic banking has changed the landscape of microfinancial reporting. In the past decade, researchers and practitioners from across the world have come together to share information about the financial and social performance indicators of microfinance institutions (MFIs). This information is made available through the Microfinance Information eXchange (MIX) for international investment funds and private donors to analyze before deciding which MFIs to invest in. Transparency in microfinancial disclosure is designated as an antecedent to trust and investor confidence. This paper uses the numbers of financial and social performance indicator disclosures by MFIs from 1995 to 2007 as a proxy for level of transparency in disclosure practices. The relationship between the level of transparency in an MFI's disclosure policies and the size of its gross loan portfolio is quantified. This paper also investigates whether the relationship between the gross loan portfolios of MFIs and the MFI's level of transparency in disclosure is stronger than the relationship between the gross loan portfolio and country-level variables such as the national per-capita income and the level of corruption in the country that the MFI is located in. The analysis developed in this study aims to address whether transparent disclosure policies are as important as country-level variables in the development of the microfinance industry and the gross loan portfolios of MFIs.

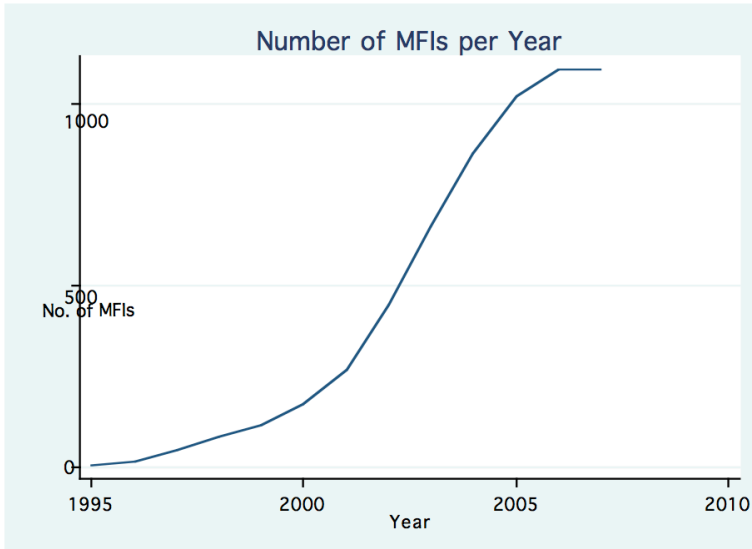
1 Introduction

The microfinance revolution started with banks and non-governmental organizations -- broadly referred to as microfinance institutions (MFIs) -- offering uncollateralized loans to low-income individuals to help them out of the cycle of poverty. The revolution has gone on to raise incomes and broaden financial markets worldwide by incorporating small-scale entrepreneurs into the broader economy. In recent years, the advent of information technology and electronic banking has changed the landscape of microfinancial reporting. There have been growing efforts to improve the transparency of microfinancial reporting based on the claim that timely economic data has a positive impact on private credit received by MFIs (Islam 2007). Full performance disclosure tremendously benefits MFIs. Full performance not only legitimizes MFIs and their mission in the eyes of the public, but also attracts donor money from all over the world (Tucker 2001). High quality disclosure habits can increase liquidity and investor confidence for MFIs that receive money from private funds and investors (Diamond and Verrachia 1991).

One common platform for the disclosure of financial and social performance indicators by MFIs

is the non-profit organization, Microfinance Information eXchange (MIX), founded by the Consultative Group to Assist the Poor (CGAP) in 2002. Today, the MIX is a leading business information provider that aims to improve financial transparency in the microfinance industry and information infrastructure in developing industries. The MIX also publishes a Microbanking Bulletin that serves as a benchmark of performance indicators in the microfinance industry (MIX Market 2009). The number of MFIs for which the MIX provides data of performance indicators has also risen in the last few years. Assuming that the data before 2002 was obtained after the inception of the MIX, there is still a sharp rise in the number of MFIs that the MIX provides data for from 2002 onwards, as shown in Figure 1.

Figure 1



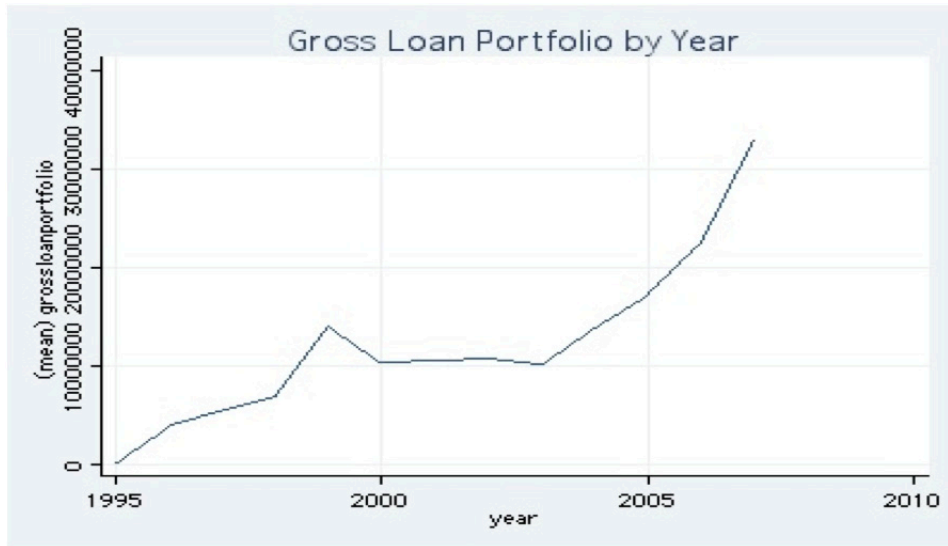
While the industry has come a long way in financial disclosure, MFIs still disclose information on a voluntary basis. MFIs are required to provide financial documentation, audited reports, and income statements; however, no independent third party or central regulatory authority verifies the information provided by the MFIs. The reporting process is further obscured by the fact that some MFIs operate more like banks and others like non-profit organizations or social businesses, making it difficult for industry-wide practices to be established. The impact of introducing transparent disclosure policies to the microfinance industry, nevertheless, is significant. Financial disclosure implies greater accountability of the MFIs to their donors, investors, and clients. Essentially, such a policy brings the microfinance industry into the broader economic framework of global financial markets.

Increased transparency also improves the allocation process of funds and investments and monitors returns in a timely and effective manner. The disclosure of social performance indicators by MFIs is also important to consider because a number of MFIs place their social impact goals, such as outreach to female borrowers and educational objectives, above conventional goals of financial sustainability and operating independence (operating without subsidies).

This paper conducts empirical tests, using data obtained from the MIX, to determine if transparency in disclosure practices is positively and significantly related to the gross loan portfolios of MFIs. The yearly aggregate of the gross loan portfolios of all the MFIs disclosing information with the MIX displays a general upward trend for the time period 1995 to 2007, as shown in Figure 2. This paper investigates the extent to which transparency is significantly correlated with the overall increase in the gross loan portfolios

of MFIs throughout the world. One key question is whether or not (and to what extent) transparency in disclosure policies influences the increasing amount of funds received by an MFI, as reflected in its gross loan portfolio. The answer to this question will affect policies enacted in the microfinance industry in years to come.

Figure 2



More specifically, this paper examines whether the number of financial and social indicators disclosed with the MIX is significantly correlated with the gross loan portfolios of MFIs. The number of financial and social indicators disclosed by each MFI is a proxy for the level of transparency in the MFI's disclosure policies. That is to say, a more transparent MFI will disclose more performance indicators than a less transparent one. The gross loan portfolio variable measures how much funding the MFI has available for its loans, indicating its strength and impact. The size of the loan portfolio is also important in determining the overall impact of the MFI as a tool for economic development. This paper also determines if disclosing financial or social performance indicators has a more significant effect on the gross loan portfolio of an MFI. Further, this paper investigates whether the gross loan portfolio of MFIs is significantly related to country-level variables like national per-capita income and corruption levels. This paper analyzes whether transparency in disclosure policies matters more than country-level variables in increasing the size of the MFIs' gross loan portfolios.

2 Background

The modern microfinance revolution began in the 1970s to encourage the development of micro-businesses. The microfinance revolution aims to raise incomes and broaden financial markets by providing financial services to small-scale entrepreneurs who otherwise would have lacked access to capital markets (Armendariz and Morduch 2000). Institutions like the Grameen Bank in Bangladesh, BancoSol in Bolivia and the Bank Rakyat Indonesia (BRI) pioneered the microfinance revolution. These institutions provide uncollateralized loans to the rural poor and share a commitment to serving clients who have been excluded from the formal banking sector (Morduch 1999). The Grameen Bank, for example, has been

providing uncollateralized loans to the rural Bangladeshi population since 1976. Its success is supported by its consistently high average loan recovery rate, which has always been between 92 and 98 percent (Grameen Foundation 2009). The Grameen Bank started off with the group lending mechanism in 1976, in which a group was held jointly responsible for an individual's repayment, taking advantage of local information and social collateral (Besley and Coate 1995). Since then, the Grameen group-lending model has been replicated in different regions of the world, including Sub-Saharan Africa and South America, as a tool for alleviating poverty and simultaneously catering to populations that conventional financial institutions previously disregarded (Sengupta and Aubuchon 2008).

Much of the enthusiasm surrounding the microfinance movement revolves around an ideal win-win proposition: MFIs that are able to employ good banking practices are also able to alleviate poverty (Morduch 2000). There is, however, a disjoint between this rhetoric and empirical studies. Morduch (2000) stresses the need for efficiency, transparency, and appropriate management incentives in achieving the diverse agenda of MFIs, be it financial sustainability or economic and social impact goals. According to Morduch (2000), addressing this schism is essential to paving the foundation for future innovations in microfinance. Key to Morduch's argument is the subsidy trap, which many MFIs have been trying to fight their way out of. Gutiérrez-Nieto (2005) writes that MFIs require more incentives to seek commercial funding than relying on subsidies. One way for an MFI to attract more investments from private and institutional investors is to pursue more transparent policies, especially in the disclosure of information. Because seeking and obtaining loans in an open market also requires the microfinance industry to have a solid financial structure, efforts are made to incorporate MFIs into a formalized system of lending (e.g. the Inter-American Development Bank and the CGAP cover 80 percent of the costs incurred by MFIs in obtaining a credit rating in Latin America). Hence, consistent levels of transparency in microfinancial disclosure could prove crucial for MFIs if they wish to maintain or increase the level of investment and funding they receive from investors and donors.

3 Literature Review

3.1 Microfinance and Regulation

Regulation in the development context is seen as an agreed set of rules to promote developmental objectives along with competitiveness and consumer interests (Arun 2005). The issue of regulation and supervision has attracted a growing interest in the microfinance sector, akin to that in the formal financial sector. Regulation in the formal financial sector aims to solve information asymmetries and maintain a balance between the interest of the depositor and that of the shareholder (Stiglitz 2004). The benefits of regulation include diversified products and enhanced legitimacy in operations, while incurring costs in monitoring. Wright (2000) claims that although MFIs serve a large section of the population and have contributed to financial deepening in developing countries, they do not pose any systemic risk to the financial system as a whole and that regulation is not needed in the microfinance sector. However, there is still a case for regulation in the microfinance sector. Regulation seems justified when we consider the level of uncertainty that clients are exposed to and the fact that the financial failure of MFIs could impact the formal financial sector by affecting commercial banks that lend to MFIs (Arun 2005). The failure of MFIs could also have a tremendous impact on public confidence.

The regulation of MFIs, however, is difficult to implement. Most MFIs are registered as non-governmental organizations (NGOs), which are not generally included under the regulatory authority of central banks. MFIs located in developing countries also face a lack of institutional capacity to incorporate them into a broader and more formalized framework. Christen and Rosenberg (2000) write that the process of integrating MFIs into a licensed environment should be gradual, due to the unfamiliarity of the regulatory procedure in the microfinance sector. Arun (2005) also stresses that appropriate regulation is dependent on country-specific characteristics, such as the level of development and institutional capacities. The specific

role and relationship country-level variables have with regulation in the microfinance sector, however, is yet to be determined.

3.2 Transparency in Financial Disclosure

One step towards the regulation of MFIs is implementing and maintaining transparency in their disclosure policies. Transparency is considered an antecedent to trust in the microfinance sector (Gutierrez-Nieto and Serrano-Cinca 2009). MFIs obtain funds from donors and investors who consider transparent disclosure policies as a precursor to secure investments. The CGAP is particularly concerned with transparency. It has established a set of disclosure guidelines on microfinance reporting requirements, as well as a Financial Transparency Award to promote greater transparency in disclosure procedures (Rosenberg, Mwangi, Christen and Nasr 2003). While the MIX does not seek to bring MFIs under its umbrella, transparency in the disclosure of financial and social performance indicators brings practitioners from the microfinance industry to a common platform. Such information also allows for the comparison of MFIs across different regions and the evaluation of their impact and performance.

MFIs' incentives for disclosing financial information can be understood through the legitimacy theory, which states that the more prominent an entity is, the more information it will disclose (Patten 2002). This is due to the pressure it receives from its donors, markets, and deposits to prove that it is managed well and capable of fulfilling its social mission (Gutierrez-Nieto et al. 2008). Research in legitimacy theory has also shown that the larger the size of the MFI, the more likely it is to disclose financial information (Adams et al. 1998). Other factors affecting the level of financial disclosure of MFIs are public exposure on the Internet, the level of development in the country of operation, and regional transparency (Gutierrez-Nieto et al. 2008).

While economists have emphasized the importance of microfinance as a development tool, the groundwork for the ideal policies concerning the regulation and disclosure policies of MFIs has yet to be solidified. In this light, it is important to examine the relationship between the level of transparency in the disclosure policies of an MFI and the size of its gross loan portfolio, before industry-wide policies are formulated. It is also important to determine whether factors such as income and corruption levels in a country affect the gross loan portfolio of an MFI operating there more than transparency in its disclosure policies.

4 Theoretical Framework

Transparency is a key variable of analysis in studies concerning banking and finance. The MIX Microbanking Bulletin measures transparency by the number of years of audits and annual reporting that an MFI has gone through with the MIX (MIX Global 100 Composite Ranking, 2010). This is a rather narrow definition of transparency because it does not account for the quality of information and the quantity of indicators disclosed by each MFI. This definition also does not consider the number of years of reporting as a percentage of the total number of years an MFI has been in operation. Calculating transparency in this other way could be useful to measure changes in the level of transparency across organizations over time.

This paper uses the numbers of financial and social performance indicators disclosed by an MFI as a proxy measure of the level of transparency in that MFI's disclosure policies. Tallying the performance indicators this way considers the two key aspects of MFIs: their financial sustainability and their social impact goals. Whether or not an MFI is providing information about these two main groups of indicators affects the amount of money investors and donors are willing to provide towards the MFI's gross loan portfolio. This way of measuring transparency allows for comparisons to be made within and across MFIs over time.

5 Model and Variables

This paper conducts an empirical study to quantify the relationship between the number of financial and social performance indicators disclosed and the gross loan portfolio of MFIs. As mentioned, the number of financial and social performance indicators disclosed by each MFI per year indirectly measures the level of transparency in the MFI's disclosure policies. The gross loan portfolio variable is used as a measure of the strength and reach of the MFI. This variable measures the amount of funds an MFI has available to lend to its clients. The number of borrowers an MFI can have, and its strength in reaching out to its clientele, can be directly measured using the gross loan portfolio variable. Legitimacy theory would suggest that MFIs with a high level of transparency in their disclosure policies would have a higher gross loan portfolio. Hence, a positive and significant relationship is expected between the gross loan portfolio and the number of financial and social performance indicators disclosed by each MFI.

5.1 Relationship between Transparency and the Gross Loan Portfolio

This study uses panel regression techniques to determine the relationship between transparency in disclosure and the gross loan portfolios of MFIs. The dataset is obtained from the MIX, in the form of an unbalanced panel for the years 1995 to 2007. The natural log of the gross loan portfolio is used to achieve a normal distribution in this variable and to limit the effect of outliers. Using a log-level model also allows for a direct estimation of the percentage change in gross loan portfolio caused by disclosing an additional unit of financial or social performance indicator. The number of financial and social indicators disclosed is tallied, also using data from the MIX. The breakdown of financial and social indicators is as follows:

Financial indicators: gross loan portfolio, total assets (not inclusive of the gross loan portfolio), total equities, deposits, total borrowings, capital/asset ratio, debt/equity ratio, average loan balance per borrower, average loan balance per borrower per GNI per capita, average deposit balance per borrower, average deposit balance per borrower per GNI per capita, return on assets, return on equity, financial revenue/assets, nominal yield on gross loan portfolio, financial expense/assets, provision for loan impairment/assets, operating expense/assets, operating expense/loan portfolio

Social indicators: number of personnel employed, number of women borrowers, total number of active borrowers, number of depositors, the write-off ratio, the portfolio at risk (percent), the number of depositors per staff member, the number of borrowers per staff member and the cost per borrower.

Regular as well as fixed effects regressions are conducted to estimate this relationship. Pooled Ordinary Least Squares (OLS) regression allows comparisons to be made across MFIs over time. Fixed effects regression, with the organization (MFI) as the group variable, allows comparisons to be made within MFIs. Fixed effects regression controls for time-invariant differences across organizations, such as managerial capabilities, the type of lending contract used by the MFI (group or individual lending contracts) and geographic placement in the country of operation (rural or urban, village bank or mobile loan officers). These variables are not quantified in this study, but their effect on the relationship between transparency and the gross loan portfolio may be significant.

The regression equation estimated is as follows:

Ln (gross loan portfolio) = α + β_0 (no. of financial indicators) + β_1 (no. of social indicators) + ϵ , where β_0 and β_1 are the coefficients of the number of financial and social indicators and ϵ is the error term. A high positive correlation of 0.752 is observed between the number of financial and social performance indicators revealed, meaning

that an MFI that discloses financial indicators is also more likely to disclose social ones. Although the relationship does not exhibit perfect collinearity, the high correlation may cause difficulty in isolating the effect of a unit-change in the number of financial and social indicators disclosed on the gross loan portfolio. The correlation matrix is shown below:

Table 1: Correlation Matrix

	No. of financial indicators	No. of social indicators
No. of financial indicators	1	-
No. of social indicators	0.752	1

Number of observations = 5884

To combat this issue, a variable called the total number of indicators is generated, which sums the number of financial and social indicators disclosed by each MFI per year. In this case, the regression equation estimated is:

$$\ln(\text{gross loan portfolio}) = \alpha + \beta_0 (\text{total no. of indicators}) + \varepsilon,$$

where β_0 is the coefficient of the total number of indicators disclosed and ε is the error term. The table below shows the summary statistics for the variables mentioned above.

Table 2: Descriptive Statistics for Transparency Indicators

Variable	Obs	Mean	Std. Dev	Min	Max
Ln (gross loan portfolio)	5849	14.468	2.085	2.701	21.968
No. of financial indicators	5884	14.30	4.229	0	19
No. of social indicators	5884	7.089	1.640	0	9
Total no. of indicators	5884	21.390	5.567	0	28

Table 2: Descriptive Statistics for Transparency Indicators

The mean of the natural log of the gross loan portfolio is 14.468, with a standard deviation of 2.085 for 5849 MFIs from 1995 to 2007. The mean number of financial indicators disclosed by each organization is approximately 14 and the mean number of social indicators disclosed is approximately 7. The average of the total number of indicators disclosed is approximately 21.

5.2 Relationship between Financial and Social Performance Indicators

To supplement this analysis, this paper investigates the relationship between the disclosure of financial or social performance indicators and the gross loan portfolios of MFIs. In other words, does transparency in social performance impact the gross loan portfolio of an MFI more than transparency in financial performance? To investigate this relationship, dummy variables for four key variables are generated: total assets and total equities (financial indicators) and the number of personnel employed and the number of women borrowers (social indicators).

A total of 5884 observations were generated for each of these dummy variables, with 1 indicating the presence of the indicator in the MFI's disclosure records with the MIX and 0 indicating its absence. The breakdown of the binary variable for each indicator is summarized in

Table 3:

Variable	Obs	Present in no. of obs (1)	Absent in no. of obs (0)
assets_dum	5884	5835	49
equities_dum	5884	5827	57

Table 3: Descriptive Statistics for Dummy Variables

personnel_dum	5884	5620	264
women_dum	5884	1328	4564

Here, the regression equation is estimated as follows:

$$\ln(\text{gross loan portfolio}) = \alpha + \beta_0 (\text{assets_dum}) + \beta_1 (\text{equities_dum}) + \beta_2 (\text{personnel_dum}) + \beta_3 (\text{women_dum}) + \varepsilon,$$

where β_0 , β_1 , β_2 , and β_3 are the respective coefficients of the four dummy variables and ε is the error term. This equation is also estimated with controls for fixed effects to remove time-invariant differences across organizations, as in Section 5.1.

5.3 Relationship between Country-Level Indicators and the Gross Loan Portfolio

Further, this study conducts panel regression to investigate the relationship between an MFI's gross loan portfolio and country-level variables such as national per-capita income and corruption levels in the country in which the MFI operates. The purpose of this regression is to determine the relative relationship significance of transparency in disclosure policies (as measured by the tallied number of financial and social performance indicators disclosed per year) and country-level variables with the MFI's gross loan portfolio. Again, the natural log of the gross loan portfolio variable is used to attain a normal distribution in the regression. For the country-level variables, real Gross Domestic Product (GDP) per capita (using current prices) is used to measure the per-capita income level. This data is obtained from the Penn World Tables compendium. The use of constant prices helps to strip out the effects of price changes on output levels and is seen as a more accurate measure of the real GDP per capita. The base year for this data is 2005. The average real GDP per capita was \$4517, with a standard deviation of \$3340.

The lowest value was \$360 for Liberia in 2005 and the highest was \$21548 for Chile in 2007. Transparency International's Corruption Perception Index (CPI) is used as a measure of the level of perceived corruption in each country. This index is computed yearly, using surveys and polls of business people and country analysts. CPI scores run from 0 to 10, with a higher CPI score implying less corruption in the country or territory's public sector. The average CPI score for the data set is 2.76, with a standard deviation of 0.775. The lowest CPI score is 0.4 for Bangladesh in 2001 and the highest is 7.5 for Chile in 2002. The summary statistics for the country-level indicators are shown in the table below:

Table 4: Descriptive Statistics for Country-Level Indicators

Variable	Obs	Mean	Std. Dev	Min	Max
cgdp	5860	4517.482	3340.155	359.85	21548.43
cpi score	5447	2.764	0.775	0.4	7.5

In this case, the regression equation estimated is as follows:

$$\ln(\text{gross loan portfolio}) = \alpha + \beta_0 (\text{total no. of indicators}) + \beta_1 (\text{real per-capita GDP}) + \beta_2 (\text{CPI score}) + \varepsilon,$$

where β_0 , β_1 , β_2 , are the respective coefficients and ε is the error term.

The hypothesis is that domestic wealth and institutional capabilities matter more than disclosure policies in their relationship with the gross loan portfolio of an MFI. This is because country-level variables are likely to influence the decision of investors and private equity funds more than disclosure practices of specific organizations when it comes to deciding which MFI to invest in. For example, investors are concerned about their returns on investments. Whether they are able to repatriate their profits depends on the quality of institutions and the level that property rights are enforced in the country they are investing in more than the particular MFI in which they are investing and its performance disclosure policies. A positive relationship is expected between the gross loan portfolio of the MFI and the country's real per capita GDP and its CPI score; i.e. investors are more willing to invest in MFIs located in richer countries and in countries with less corruption (a higher CPI score) as this will assure them of the returns they earn from their investments.

6 Empirical Analysis

6.1 Relationship between Transparency and the Gross Loan Portfolio

As hypothesized, the natural log of the gross loan portfolio indicates a positive relationship between the number of financial and social performance indicators disclosed by an MFI. However, this relationship is not a significant one. This relationship is estimated by the following regression equation:

$\text{Ln}(\text{gross loan portfolio}) = 14.2 + 0.014(\text{no. of financial indicators}) + 0.008(\text{no. of social indicators})$. (Equation 1)

The equation above implies that for a one-unit change in the number of financial performance indicators disclosed, the MFI's gross loan portfolio rises by 1.4 percent and that for a one-unit change in the number of social performance indicators disclosed, the MFI's gross loan portfolio rises by 0.8 percent. The disclosure of financial performance indicators appears to influence the gross loan portfolio more than the disclosure of social ones, but the p-values for both variables are not significant at the 95 percent confidence level.

When only the number of financial performance indicators disclosed is regressed on the natural log of the gross loan portfolio, a positive and significant relationship is obtained. This relationship is estimated as follows:

$\text{Ln}(\text{gross loan portfolio}) = 14.2 + 0.017(\text{no. of financial indicators})$. (Equation 2)

The p-value for the "no. of financial indicators" variable in this equation is 0.009, making it significant at the 99 percent confidence level. Similarly, when only the number of social performance indicators disclosed is regressed on the natural log of the gross loan portfolio, a positive and significant relationship is also explained and estimated as follows:

$\text{Ln}(\text{gross loan portfolio}) = 14.2 + 0.036(\text{no. of social indicators})$. (Equation 3)

In this case, the p-value for the "no. of social indicators" variable is 0.030, indicating significance at the 97 percent confidence level.

So far, the results show that the number of financial and social performance indicators has a positive and significant relationship with the MFI's gross loan portfolio on their own (as in Equations 2 and 3), but not together (Equation 1). This could be because of the high correlation between these two variables, as mentioned in Section 5.1. The relationship between the total number of indicators disclosed (the sum of

the financial and social performance indicators) and the MFI's gross loan portfolio is also examined below.

This relationship is estimated as follows:

$$\text{Ln (gross loan portfolio)} = 14.2 + 0.013 (\text{total no. of indicators}). \text{ (Equation 4)}$$

In this case, the p-value for the "total no. of indicators" variable is 0.009, implying significance at the 99 percent level of confidence. Overall, the number of performance indicators disclosed seems to have a positive and significant relationship with the gross loan portfolio, but not when financial and social indicators are considered simultaneously.

When fixed effects across organizations are considered, the number of indicators displays a negative and insignificant relationship with the gross loan portfolio and is estimated as follows:

$$\text{Ln (gross loan portfolio)} = 14.6 - 0.004 (\text{no. of financial indicators}) - 0.004 (\text{no. of social indicators}). \text{ (Equation 5)}$$

The negative relationship persists and becomes a significant one when the "total no. of indicators" variable is regressed on the natural log of the gross loan portfolio. This equation is estimated as follows:

$$\text{Ln (gross loan portfolio)} = 14.6 - 0.004 (\text{total no. of indicators}). \text{ (Equation 6)}$$

The p-value for the "total no. of indicators" variable is 0.109, making it significant at the 90 percent level of confidence. The results suggest that time-invariant differences between organizations, such as managerial capabilities, type of lending contract, and geographical locations within the MFI's country of operation play a part in their relationship with the MFI's gross loan portfolio. These factors are not included in this study, but what is striking is that when their effects are removed, and comparisons are made within MFIs, there is a negative and significant relationship between the gross loan portfolio and the total number of performance indicators disclosed. This could be a cause for concern when enacting policies in the microfinance arena, especially with regard to transparent disclosure, as the data suggests a negative relationship between transparency and the amount of funding received by an MFI.

6.2 Relationship between Financial and Social Performance Indicators

Next, this paper investigates whether the disclosure of information on financial performance indicators has a more or less significant relationship with the MFI's gross loan portfolio than social performance indicators have with the gross loan portfolio. As mentioned earlier, this relationship is examined by generating dummy variables taking values of either 0 or 1 for the following variables: total assets, total equities, number of personnel employed and the number of women borrowers of an MFI. The regression equation is estimated as follows:

$$\text{Ln (gross loan portfolio)} = 18.20 - 0.189 (\text{assets_dum}) - 0.182 (\text{equities_dum}) - 3.03 (\text{personnel_dum}) - 2.04 (\text{women_dum}). \text{ (Equation 7)}$$

Equation 7 suggests that the acts of disclosing information about assets, equities, numbers of personnel and women borrowers alone have a negative relationship with an MFI's gross loan portfolio. Contrary to what the literature states about the importance of transparency in disclosure, the empirical evidence suggests otherwise. MFIs that disclose information about these variables receive less funding and investment than MFIs that do not. The p-values for the personnel and women dummies are significant at all conventional levels of confidence, while those for assets and equities are not. This implies that disclosing information

about social performance indicators (such as the number of personnel employed and the number of women borrowers) significantly lowers the amount of funds received by an MFI, more so than disclosing information about financial performance (such as total assets and equities). Thus, disclosing information on social performance indicators has a stronger (although negative) relationship with an MFI's gross loan portfolio.

The same relationship is also investigated with controls for fixed effects across MFIs. Gross loan portfolio's negative relationships with all but one of the dummy variables persist; the only exception is the relationship between gross loan portfolio and the total assets variable. The regression equation is estimated as follows:

$$\ln(\text{gross loan portfolio}) = 16.70 + 0.289(\text{assets_dum}) - 0.586(\text{equities_dum}) - 1.77(\text{personnel_dum}) - 1.10(\text{women_dum}) \quad (\text{Equation 8})$$

Here, although the coefficient for total assets is now positive, its p-value remains insignificant at the 95 percent confidence level. The p-value for the total equities dummy is now significant at the 95 percent confidence level, meaning that the negative relationship between disclosing information on an MFI's total equities and its gross loan portfolio is a significant one. The coefficients for the social indicators (number of personnel and women borrowers) remain negative and their p-values are still significant at all levels of confidence. Equation 8 suggests that when we look within organizations, there is a negative relationship between disclosing these four variables and the amount of funds received by the organization. This provides evidence against purported claims of transparency in disclosure policies, and is an issue of concern when governments or regulatory authorities attempt to establish industry-wide disclosure standards in the microfinance industry.

6.3 Relationship between Country-Level Indicators and the Gross Loan Portfolio

This study also examines the effect of country-level variables on the gross loan portfolios of MFIs. As described earlier, the two main country-level variables of interest are the real per capita GDP and the CPI score given by Transparency International. The relationship between the gross loan portfolio, real per capita GDP and CPI score is estimated as follows:

$$\ln(\text{gross loan portfolio}) = 13.5 + .00004(\text{real per capita GDP}) + 0.300(\text{CPI score}) \quad (\text{Equation 9})$$

This means that a one-unit (\$1) change in GDP increases the MFI's gross loan portfolio by 0.004 percent and a one-unit change in the CPI score raises the gross loan portfolio by 30 percent. Both the p-values for real per capita GDP and the CPI score are significant at all conventional levels of confidence. This shows the importance of national per capita income and a country's level of corruption in influencing the choices of donors and investors in where to direct their funds, thereby affecting the gross loan portfolios of MFIs operating in each country. The real per capita GDP and CPI score variables are also positively and significantly related to the gross loan portfolio when regressed separately (See Equation 9a and 9b in Appendix).

Next, to compare the effects of transparency and country-level variables, the numbers of financial and social indicators are added as dependent variables. The following equation is estimated:

$$\ln(\text{gross loan portfolio}) = 13.2 + .00004(\text{real per capita GDP}) + 0.300(\text{CPI score}) + 0.008(\text{no. of financial indicators}) + 0.029(\text{no. of social indicators}) \quad (\text{Equation 10})$$

In the equation above, there is a positive relationship between the number of financial and social indicators disclosed by an MFI and its gross loan portfolio, but the p-values for these two variables continue to be

insignificant at the 95 percent confidence level. The relationship between the gross loan portfolio of an MFI and the real per-capita GDP and CPI score of the country in which the MFI is located continues to be positive, with significant p-values at all conventional confidence levels.

Then, instead of adding the number of financial and social indicators to the regression separately, the total number of indicators is added as a single variable. The following equation is then estimated:

$$\text{Ln (gross loan portfolio)} = 13.2 + .00004 (\text{real per capita GDP}) + 0.299 (\text{CPI score}) + 0.0136 (\text{total no. of financial indicators}) \text{ (Equation 11)}$$

Now, the total number of performance indicators disclosed has a positive and significant relationship with an MFI's gross loan portfolio. A one-unit change in the number of indicators disclosed raises the gross loan portfolio by 1.36 percent. The p-value of this variable is also significant at the 99 percent confidence level. Real per-capita GDP and the CPI score continue to be positively and significantly related to the gross loan portfolios of MFIs.

7 Conclusion

With regard to transparency, the conclusions derived from analysis in this paper are two-fold. Firstly, when comparisons are made across firms, there is a positive relationship between transparency and the gross loan portfolio of MFIs. It must be noted that this relationship is most significant when the total number of indicators disclosed is regressed on the gross loan portfolio, not when the number of financial and social indicators disclosed are regressed separately. Next, when comparisons are made within firms, transparency is inversely related with the gross loan portfolio of MFIs. This is contrary to what the literature emphasizes about the importance of transparent disclosure policies. Given that transparency is hard to measure directly and that tallying financial and social performance indicators may have posed some limitations on this study, there is still reasonable cause for concern when enacting industry-wide policies in the microfinance sector. Future studies may have access to more robust and innovative measures of transparency to further investigate its effect on the amount of funds received by MFIs. This study also emphasizes the importance of time-invariant differences across organizations, such as managerial capability, type of lending contract, and geographic placement within a country, which can be incorporated into future works in this field.

More importantly, this study reveals the importance of country-level variables in directing funds towards the loan portfolios of MFIs. The results suggest that high income and low corruption levels have a significant relationship with the gross loan portfolios of MFIs. Also, country-level variables have a more significant relationship with an MFI's gross loan portfolio than the variables that measure transparency in its disclosure policies. This paper concludes that country-level variables are a primary determinant of the size of an MFI's gross loan portfolio and that transparency in disclosure policies is only a secondary factor. The key policy implication of this paper is that country-level variables should be the focus of improvement for MFIs if they want to increase the amount of funds they receive.

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Appendix I

Table 1
MIX Data on Number of MFIs and their Loan Portfolios

Year	No. of MFIs	grossloanportfolio	ln(grossloanportfolio)
1995	2	57126.5	10.95302339
1996	13	3922565	15.18225633
1997	46	5501108	15.52046008
1998	82	6853785.1	15.74031163
1999	115	13965567	16.45210536
2000	173	10421741	16.15940466
2001	266	10467064	16.16374412
2002	449	10717919	16.18742757
2003	664	10056577	16.12373741
2004	862	13710780	16.43369294
2005	1022	17289104	16.66558703
2006	1094	22437949	16.92626424
2007	1096	32742689	17.30419026

Table 2
Correlation Statistics (obs = 5884)

	no. of financial indicators	no. of social indicators
no. of financial indicators	1	
no. of social indicators	0.752	1

Table 3
Descriptive Statistics
Panel 1: MFI Disclosure Data (1995 to 2007)

Variable	Obs	Mean	Std. Dev	Min	Max
lnglp	5849	14.468	2.085	2.701	21.968
no. of financial indicators	5884	14.30	4.229	0	19
no. of social indicators	5884	7.089	1.640	0	9
total no. of indicators	5884	21.390	5.567	0	28
cgdip	5860	4517.482	3340.155	359.85	21548.43
cpi score	5447	2.764	0.775	0.4	7.5

Table 4
Descriptive Statistics
Dummy Variables

Variable	Obs	Present in no. of obs (1)	Absent in no. of obs (0)
assets_dum	5884	5835	49
equities_dum	5884	5827	57
personnel_dum	5884	5620	264
women_dum	5884	1328	4564

Table 5
Regression Summary - 1 (Section 6.1)

Summary of Coefficients and Standard Errors in brackets; bolded and starred to indicate significance levels

ln _g l _p	Equation 1	Equation 2	Equation 3	Equation 4	Equation 5 (fe)	Equation 6 (fe)
no. of financial indicators	0.014 (0.01)	0.017** (0.006)	0.036** (0.017)	-	-0.004 (0.005)	-
no. of social indicators	0.009 (0.025)	-	-	-	-0.004 (0.016)	-
total no. of indicators	-	-	-	0.013** (0.005)	-	-0.004 (0.003)
cgdp	-	-	-	-	-	-
cpiscore	-	-	-	-	-	-
assets_dum	-	-	-	-	-	-
equity_dum	-	-	-	-	-	-
personnel_dum	-	-	-	-	-	-
women_dum	-	-	-	-	-	-
cons	14.204**	14.229**	14.212**	14.195**	14.560**	14.560**
Number of obs	5849	5849	5849	5849	5849	5849
Number of groups	-	-	-	-	1382	1382
R-squared	0.0012	0.0012	0.0008	0.0012	0.0006	0.0006
Marked as	<u>Confidence level</u>					
bold	90%					
bold*	95%					
bold**	99%					

(fe) denotes fixed effects regressions

Table 6
Regression Summary - 2 (Section 6.2)

ln _g l _p	Equation 7	Equation 8 (fe)
assets_dum	-0.189 (0.515)	0.289 (0.328)
equity_dum	-0.183 (0.478)	-0.586* (0.304)
personnel_dum	-3.026** (0.115)	-1.770** (0.100)
women_dum	-2.040** (0.058)	-1.096** (0.057)
cons	18.195**	16.704**
Number of obs	5849	5849
Number of groups	-	1382
R-squared	0.2765	0.1361
Marked as	<u>Confidence level</u>	
bold	90%	
bold*	95%	
bold**	99%	

(fe) denotes fixed effects regressions

Table 7
Regression Summary - 3 (Section 6.3)

	Equation 9	Equation 9a	Equation 9b	Equation 10	Equation 11
lngdp	0.00004**	0.00008**	-	0.00004**	0.00004**
cgdp	(9.05 x 10 ⁻⁶)	(8.12 x 10 ⁻⁶)	-	(9.07 x 10 ⁻⁶)	(9.05 x 10 ⁻⁶)
cpiscore	0.300**	-	0.374**	0.300**	0.300**
	(0.039)	-	(0.036)	(0.039)	(0.039)
No. of financial indicators	-	-	-	0.008	-
	-	-	-	(0.101)	-
No. of social indicators	-	-	-	0.029	-
	-	-	-	(0.026)	-
Total no. of indicators	-	-	-	-	0.014**
	-	-	-	-	(0.005)
cons	13.492**	14.093**	13.489**	13.165**	13.200**
	(0.103)	(0.046)	(0.104)	(0.161)	(0.150)
Number of obs	5396	5825	5414	5396	5396
R-squared	0.023	0.017	0.019	0.024	0.024

<u>Marked as</u>	<u>Confidence level</u>
bold	90%
bold*	95%
bold**	99%

ABOVE THE MONEY

THE IMPACT OF POLITICAL ACTION COMMITTEE MEMBERSHIP DEMOGRAPHICS ON SENATORIAL LEGISLATIVE SUPPORT

VLADISLAVA SOSHKINA

In 1971, Congress passed the Federal Election Campaign Act to limit campaign contributions. In 1974, they amended the act with even stricter limitations on individual giving and set the stage for Political Action Committee power to rise. Since the 1970s, political research has focused on the effects of Political Action Committee (PAC) contributions on legislative campaigns and elections. This study, however, focuses on the field of PAC membership demographics, observing the effect of PAC demographics on the Senate for Congresses between 1998 and 2008. Several recent studies have determined that contributions actually have little to no effect on legislative support. This raises the following question: what helps PACs garner legislative support? Labor and trade union PACs are extremely active in the political arena and although they do provide contributions, they also function on a very basic principle: collective action. This study seeks to empirically analyze the relationship between the demographics of member-based Political Action Committees and legislative support to determine if factors outside of political contributions may actually influence the legislative vote.

Introduction

Since the passage of the 1974 Federal Election Campaign Act, Political Action Committees (PACs) have been an important area of focus for political research and legislators. With a ceiling of \$1,000 placed on individual contributions, Political Action Committees were a more expedient target for legislators. Although the Bipartisan Campaign Reform Act of 2002 slightly diminished the efficiency of soliciting funds from PACs by raising the bar for individual contributions to \$2,000, PACs are still capable of providing a great deal of support to legislators. However, most PACs do not contribute amounts even close to their capacity. Ansolabehere et al. note that while PACs do contribute, the amount that they give is paltry compared to the financial worth of the laws they lobby for. This discovery led Ansolabehere et al. to discount the idea of

contributions as investments in the political marketplace and instead to view contributions as consumption goods. While their final conclusion is open to debate, their findings raise the question: if contributions do not garner legislative support for PACs, then what does?

The PAC realm is diverse and filled with many conflicting interests. As of January 1, 2008, there are 4,324 PACs within the United States. Although the majority of active PACs are corporate, labor and trade unions also maintain a significant presence. While corporate PACs represent large non-individual entities, labor and trade organization PACs represent individual members. Much of the focus on PACs has been on their fundraising power, but labor and trade PACs provide a separate avenue of research. Labor unions function on the premise of collective-action strength. Through collective actions such as strikes, labor unions are able to affect the decisions and actions of employers and legislators. This study focuses on the relationship between the size and fiscal demographics of a PAC's membership and senatorial support, and will test whether higher membership, per capita income and voter turnout positively affect senatorial support.

Current Research and Literature Review

a. PACs: An Overview

PACs represent special interest groups, or “organized bodies of individuals who share specific goals and who try to influence public policy.” Interest groups “are active either continuously, occasionally or with respect to single events...[and] their influence attempts are geared toward political institutions and possibly face opposition by other groups” (Daxhammer 19). Most research on PACs since 1974 has focused on the strategic nature of committee contributions. In the latter part of the 20th century, campaign costs rose exponentially. With the strictly enforced campaign rules of the 1974 FECA, politicians sought out all possible avenues for campaign funding. PACs—organized committees with clearly established causes and interests—presented an easily reachable and more profitable area of focus than individuals. PACs are, generally, as strictly separated by ideology as individuals, and while there are certainly PACs that support both parties in Congress, many are tied to one party. Many corporate PACs, for instance, are closely tied with the Republican Party and often provide substantial contributions to Republican candidates. Labor PACs, on the other hand, have had a long relationship with the Democratic Party. This is not to say that PACs support a single party exclusively. Because PACs are strictly focused on garnering legislative support for those they represent, they are not above supporting legislators across political lines that hold positions of power or are sympathetic to a PAC's cause (Jacobson 70).

In their 2002 study on PACs and contributions, Ansolabehere, Figueiredo and Snyder explore the concept of PAC giving as an investment in an open market of goods. They argue that the investments PACs make towards legislators are minimal when compared to the amount of money they stand to gain through legislative action. “The discrepancy between the value of policy and the amounts contributed strains basic economic intuitions. Given the value of policy at stake, firms and other interest groups should give more... (this) implies astronomically high rates of return on investments” (Ansolabehere et al. 111). Ansolabehere et al. also test the effect of contributions on vote scores generated by six different organizations, including the Chamber of Commerce, the National Education Association and the AFL-CIO. Ansolabehere et al. find that a \$50,000 increase in labor PAC contributions results in a six-point increase in a zero to 100 scale for the Chamber of Commerce. Although this shows that an increase in contributions correlates with an increase in support, Ansolabehere et al. argue that this increase is insignificant compared to the much higher increases associated with party affiliation. They also show that controlling for district-fixed effects completely eliminates the effects of contributions on legislative support. All in all, the study concludes that contributions cannot reasonably be viewed as investments in a market for goods but should instead be viewed as consumption goods. Although this conclusion of the study is not unquestionable, it does show that contributions are not necessarily the main strength of PACs.

While there is much discussion about the fiscal actions of PACs, there has been little empirical analysis on the effect of the memberships they represent. Although collective action is a commonly used

term, many scholars do not believe that it is effective. In 1965 Mancur Olson composed his Theory of Collective Action, which addressed the diminishing returns of participation in a group. If special interest groups operate to provide public goods for their members, they can quickly encounter the problem of free riders. As more and more people join an organization, the value of each individual member falls. As this number continues to grow, rational individuals find it too costly to remain in an organization. After all, why should an individual pay the cost of membership when they can still enjoy a public good achieved by other members? Following a personal cost-benefit analysis, an individual would realize the benefits gained by leaving an organization before it reached “the optimal amount for the group as a whole” (Daxhammer 1995 51). Special interest groups are thus limited by the rationality of individuals.

Because of the sub-optimal nature of special interest groups, little focus has been given to the effects of a group’s membership on their related PACs. Instead, much more attention has been paid to their fiscal capabilities. In particular, when studying PACs and their contributions, scholars have neglected the demographics of the organizations a PAC represents. Ansolabehere et al. note that most studies exploring the effects of contributions “lack crucial control variables, such as the strength of a donor group or interest in the legislative district.” (Ansolabehere 114). Since PACs are closely aligned with their respective special interest groups, attention must be paid to these factors.

Voter apathy is another issue that has likely stalled research into this sector. Voting is costly. In the U.S., voting is conducted on a weekday and the process may take several hours. In addition, Olson’s Theory of Collective Action is relevant as voters realize that the probability of their vote being decisive is extremely low, and so would rather free ride on others’ votes (Morton 27). These two factors contribute to an extremely low voter turnout, with a turnout of slightly over fifty percent during on-year elections (presidential elections) and a turnout of approximately one third in off-year elections (non-presidential elections). While special interest groups focus heavily on voter mobilization, much political and political-economic analysis has determined that these tactics may be ineffective. Since special interest group membership and the respective actions therein are voluntary, researchers hold that “special interest groups are usually not in a position to deliver all of their members’ votes on Election Day” (Daxhammer 109). In recent years, many special interest groups have been able to overcome their inherent collective action problems by offering selective benefits which can be “social or purposive...informational and material” (Morton 188). Furthermore, the financial actions of PAC members such as contributions to the PAC and membership dues make members much more invested in the actions of the PAC. As a result of both private incentives and the fiscal investiture of PAC members, individuals may actually be much more responsive to group interests than previously theorized. Legislators are very conscious of PACs and their voter base. They can easily be influenced not only by the contributions of a PAC, but also by the PAC’s potential body of voters.

b. Labor Unions and political contributions

Labor unions have been one of the driving forces in political change for the working class since the late 1800s. With the establishment of PACs, labor unions were able to translate their collective-action strength into fiscal support for sympathetic legislators. Historically, the labor movement has been a Democratic stronghold. Labor contributions have generally fallen into Democratic hands, although unions are not opposed to supporting more liberal and sympathetic Republicans. There has been a lot of research on the effects of PAC contributions on legislative support for labor, and the results are mixed and contentious. Al Wilhite examines the effect of union membership and contribution on legislative support through roll call votes in his 1988 article “Union PAC Contributions and Legislative Voting.” His study examined campaign contribution affects on both the House and Senate, a topic rarely covered in PAC-related studies. Wilhite sought to determine the effects of labor union contributions through a logistic quantal response model by utilizing AFL-CIO ratings as a measure of senatorial voting support for pro-labor bills (Wilhite 81).

The study utilized two separate equations, one with union contributions as the dependent variable and the other with pro-union voting as the dependent variable. The use of two separate equations helped account for the different timelines of voting and PAC contributions and addressed the issue of causality. The study covered three election cycles, from 1982 to 1986. The results were somewhat varied. For instance, in

most cases (except for the 1984 election) contributions proved to have a positive and significant relationship with voter turnout, but the relative effect was fairly small. Furthermore, the effect of percentage of district (or state) unionized also proved to have a positive and significant effect on pro-union votes. However, the study barely discussed this statistic and focused much more on the contributions and their effects.

Ten years after Wilhite's study, Delaney et al. conducted a study that looked closely at the composition of a PAC's membership demographics, as opposed to the effects of PAC contributions. They found that "union PACs are funded by members' voluntary contributions and dues cannot legally be used to fund donations to political candidates. This gives union members substantial and direct influence over union PAC activity" (Delaney 281). As previously discussed, this voluntary action by PAC members represents a higher than average level of political action and mobility. This level hints that unions can deliver a greater number of supportive voters to the polls than Olson and the diminishing return of voting theory may suggest. Delaney et al.'s study also addresses the issue of member income and its possible positive effect on the number and size of PAC contributions. Delaney et al.'s study concludes that both higher wages and higher income result in higher fiscal political activity from PACs.

These two studies provide very different perspectives on the political contributions of labor PACs. However, combining the membership focus of Delaney et al.'s study with the roll call analyses of Wilhite provides an even more comprehensive view. Considering that Delaney et al. show that contributions rise with membership size and income and Wilhite shows that legislative support (in several instances) rises with contributions, it is possible that legislative support simply rises with rising income and union membership.

Recent academic literature has observed diminishing contributions of labor organizations in the political arena. As established, the labor sector has regularly supported Democrats. However, since the late 1990s the financial impact of labor contributions has become insignificant: "in the 2000 election cycle, business is out-spending labor by 15 to 1; the gap is already nearly half a billion dollars wide" (Miller 8). Despite this, labor unions and trade associations for example, the ADA, have managed to garner political victories. The article also noted that this situation was particularly confusing when taking into account the "revival" of "organized labor's new found energy and muscle" (Miller 8).

The article "Issue Visibility and the Effects of PAC Money" provides an interesting insight to this paradox. Jones and Keiser examine the effects of issue visibility on legislative support for labor. Jones and Keiser observe roll call votes from the House of Representatives for the first session of the 96th Congress to determine how media exposure on labor-related issues affected legislative support. While Jones and Keiser were more concerned with the effects of contributions on low-visibility issues, their observations on high-visibility issues are more pertinent to this study. The article points out that on issues with high visibility, "liberal and Democratic members of Congress should be expected to be committed to their ideological and partisan coalition and vote on the side of labor even when they have received little union money" (Jones 171). As mentioned by Miller and Sifry in the *American Prospect* article "Labor's Loss," labor unions and other trade-related PACs have significantly enhanced their performance since the late 1990s, particularly in member education.

With the rise of the Internet and a growing ease in communication with members, organizations are now better able to inform their members about both pertinent issues and supportive legislators. In the 1980s, information was not as easily disseminated as it is today, but Jones and Keiser still found a strong relationship with high issue visibility and consistent labor support. With growing television coverage of political affairs and a strong push for public visibility and support from labor unions in recent years, it is even more likely that labor contributions play a small or diminishing role in garnering legislative support.

A growing disillusionment regarding the effects of PAC contributions, however, has caused political research to take an extended break from examining PACs. As is clearly visible through these articles, most research on PACs is dated. Current research pays little attention to PACs and usually focuses on corporate contributions and support. However, with the growth in labor exposure and a revitalization of union and trade organization memberships, union PACs could provide many new and interesting insights into which bills could garner legislative support. This study seeks to examine these unexplored influences.

Research Focus:*a. Labor and Memberships*

Most research in the field of special interests and PACs has focused on the financial strength of these organizations. Studies that have collected information on memberships have failed to consider the demographics of an organization as a possible main force behind legislative support. Instead, they have considered contributions to be much more effective as legislative incentives. This study attempts to close this oversight in current research and utilize contributions as a control variable while viewing PAC memberships and demographics as the deciding forces of legislative support.

This study will also focus on union and professional organizations, as these organizations are very strongly based on membership and rely solely on their members' voluntary donations in order to fund their PAC contributions. The decision to not utilize only labor unions is based on the fiscal inequality between labor and other sectors. Labor unions in general represent workers on the lower end of the income scale. The median percapita income ranges from about \$28,000-\$69,000. Only very specialized trade unions such as the National Air Traffic Controller Union and the Machinists and Aerospace Workers Union manage to achieve salaries close to or beyond the six-figure mark. Introducing professional unions such as the American Dental Association and the National Association of Realtors allows an inclusion of higher income brackets, which will ensure that a possible lack of legislative support is not simply due to labor unions being lower income organizations. Since this study specifically focuses on the demographics of organizations, it is also not particular to labor unions and can be applied to any PAC sector that is based on membership. Membership size in unions also fluctuates consistently, and in the past decade unions have experienced several extreme trends in membership. Therefore, membership numbers will provide strong variations that will help ensure accurate results.

TABLE 1: POLITICAL ACTION COMMITTEE MEMBERSHIPS 1998-2008

Political Action Committee	1998*	2000	2002	2004	2006	2008
American Association for Justice**	47688	49354	51020	52686	54352	56000
American Dental Association	154057	153126	158980	164982	167678	169554
American Federation of Government Employees	186000	197196	200600	226599	235678	248845
American Federation of State, County and Municipal Employees	1147138	1300000	1350000	1350000	1470095	1467138
American Federation of Teachers	669672	706973	741270	816300	822504	856178
American Maritime Officers	3491	3743	3995	3891	2931	3583
American Nurses Association	153452	152726	152000	148799	157055	207394
American Pharmacists Association**	56210	56980	57750	58520	59290	60060
Bricklayers Union	96612	99870	101499	99892	94115	95455
Communication Workers of America	487716	499557	589143	576153	720534	549791
International Association of Bridge, Structural and Reinforcing Iron Workers	129268	130439	135072	127009	127222	140406
International Brotherhood of Boilermakers	72858	76375	79892	71930	65691	64509

International Brotherhood of Electrical Workers	750452	727836	722095	682605	699053	708638
International Union of Operating Engineers	372014	379309	390388	388804	397348	408658
Laborers International Union of North America	796876	818412	840180	692558	657197	668973
Machinists/Aerospace Workers Union	740622	730673	673095	627408	646933	641723
National Air Traffic Controllers Association	13066	13682	15331	14794	14571	14932
National Association of Realtors	718483	766560	876195	1102250	1357732	1197529
National Education Association	2404364	2530000	2668925	2698504	2767696	3215904
Office and Professional Employees International Union	114597	117997	136586	139056	103335	100996
Painters and Allied Trade Union	94503	102402	115511	128351	129499	133997
Seafarers International Union	10475	11000	11055	12050	11862	10199
Service Employees International Union	1265966	1374300	1464077	1702639	1575485	1807635
Sheet Metal Workers International Association	141949	146400	148378	144480	149149	152530
Teamsters Union	1426667	1402000	1350000	1350000	1398573	1402878
United Association of Plumbers/Pipefitters	303190	307454	324349	324557	327000	342846
United Auto Workers	704984	671853	638722	654657	538448	431037
United Brotherhood of Carpenters and Joiners	539766	534023	531839	524237	523126	511053
United Food and Commercial Workers Union	1401771	1280722	1380507	1338625	1304061	1319966
United Transportation Union	63603	65752	67901	65593	84679	74682

*1998 data (except for the National Association of Realtors and American Dental Association is estimated from growth trends within each individual PAC as the ll-2 forms for those years were not available.

**ll-2 forms not required to be filed. Membership numbers estimated from historical data provided on PAC websites.

***Data obtained manually through Quarterly Census of Employment and Wages BLS database.

Table 1 provides a list of all 30 PACs utilized in the study along with membership numbers from 1998-2008. While some PAC memberships have experienced consistent growth, others have lost much of their membership and still others have remained on par over past years. This consistent variation will also help ensure that any positive correlations are not simply a result of general growing pro-labor trends within the nation.

Despite the relatively small contributions of PACs, it is important to consider the aggregate effects. While Labor has become much smaller in the political arena when compared to larger donors such as Corporate PACs, they still do shed sufficient sums of money in order to garner legislative support. However this support may be interpreted, we cannot discount possible effects of contributions. As a result, this study will include PAC gifts to Senators for six election cycles between 1998 and 2008. Only contributions to Senators who were eventually elected will be included as it is these elected Senators who have a say in pertinent bills.

b. *Senatorial focus*

The House of Representatives is historically the unit of analysis for Roll Call related studies. This study, however, will be utilizing the Roll Call vote for Senators from the 105th to 110th Congresses. While it is true that in most studies the House of Representatives provides a much more accurate and detailed representation of the nation, for this study the utilization of the House may heavily skew the data. Many labor unions are geographically focused. While some districts may have a preponderance of union members within their boundaries, other districts may have close to none. This study assumes that legislators are rational, utility-maximizing agents whose primary goal is to be reelected. In order to maximize their chances of reelection, legislators seek to serve their constituents needs through supporting popular legislature and providing federal funds and benefits for their districts. A House Representative with no members of a particular labor union in their district would have no incentive to vote in favor of that labor union if pertinent bills were to arise in Congress. Senators, however, have much larger constituencies to consider and are much less likely to have such skewed perceptions of labor unions. Unions and professional organizations span all fifty states and it is much more likely that there are union members in all fifty states as opposed to in all 435 districts. This is a basic assumption of the study and will ultimately help eliminate negative effects that could be caused by a lack of union or professional organization membership within a region.

Research Design:

a. *Hypothesis*

This study focuses on the basic game theoretic assumption that legislators are rational and self-interested, and will thus make decisions to ensure their political survival. In order to do this, legislators must not only raise sufficient funds to run a successful election, but they must also meet their constituents' needs. Legislators must consider several factors during elections and these include the interests of their constituents, both in economic and social/ideological matters. Senators must also consider the most efficient ways by which they can reach prospective voters and how they can most easily garner the support of these voters. As representatives of organized special interest groups, PACs could serve as a very convenient avenue through which Senators can reach and support members of their constituency. Not only do PACs have memberships in the thousands, those members are also politically motivated, with clearly defined goals and interests. This study will seek to test whether the demographics of PACs do in fact affect legislative support and will test the following hypotheses.

Model 1:

Hypotheses (H1): Higher membership, income and/or voter turnout will all have positive effects on the probability of senatorial legislative support.

Alternative Hypotheses (H2): Higher membership, income and voter turnout will have a negative effect on senatorial legislative support.

Null Hypothesis (H0): Higher membership, income and/or voter turnout will have no effect on senatorial legislative support.

H1 will not be rejected if increases in membership and related demographics possess positive and significant coefficients when regressed with roll call votes. However, there is a question of simultaneity in this study. While it may well be that legislators increase support as PAC memberships and other pertinent demographics increase, it may also be the case that that membership and other demographics increase as a response to a lack of senatorial support. If this is the case, regressions will show a negative coefficient for any or all of the PACs demographics.

The second and third models tested in this thesis will have similar hypotheses except that H1 will be expanded to include the new variables utilized in the model. The hypotheses are as follows:

Model 2:

Hypotheses (H1): Higher percentages of state population will have positive effects on the probability of senatorial legislative support.

Alternative Hypotheses (H2): Higher percentage of state population will have a negative effect on senatorial legislative support.

Null Hypothesis (H0): Higher percentage of state population will have no effect on senatorial legislative support.

Model 3:

Hypotheses (H1): Stronger interactions between percentage of state population and national membership/voter turnout/contributions will have positive effects on the probability of senatorial legislative support.

Alternative Hypotheses (H2) Stronger interactions between percentage of state population and national membership/voter turnout/contributions will have a negative effect on senatorial legislative support.

Null Hypothesis (H0): Stronger interactions between percentage of state population and national membership/voter turnout/contributions will have no effect on senatorial legislative support.

Model 3 applies to all of the interaction variables separately, and positive or negative correlations with one variable do not imply the same correlation or hypothesis for each of the other interaction variables.

b. Equations and Experimental Design

In order to test our hypothesis, this study will utilize a probit qualitative choice model. This regression will utilize senatorial roll call votes from the 105th to the 110th Congresses as dependent variables and PAC demographics as the independent variables. The regression equation for the first model this study will be utilizing is as follows:

Model 1: Roll Call Vote=F-1(probability)=B0+B1(election year)+ B2(membershipsize)+ B3(percapitaincome)+ B4(voterturnout)+ B5((onoroffyear)+ B6(partyid)+ B7(contributions)+e

The probit regression tests how variables affect the probability that the dependent variable will be equal to 1. As previously mentioned, the dependent variable in this study is senatorial roll call vote and so the probit regression will show how each variable changes the probability that senators will vote with a PAC on a bill. As legislative choice can never truly be determined by anyone other than the individual, the term probability is also particularly effective in this study.

The above equation shows the first basic probit regression that we will run. This regression uses the cross-national membership of PACs as the term “membership size.” While the general size of a PAC is important and PACs explicitly aim to expand membership, for the purposes of this study the concentration of members in a state may be an even more appropriate variable. The preferred variable would represent the percentage of state residents who participated in each union. Most unions focus on several industries and occupations and so their membership numbers are spread and hard to pinpoint, especially within local districts. Also, the records of a particular union may not include state figures. However, most unions do have one major industry in which their members are centered, and industry numbers are calculated per state by the Bureau of Labor Standards and so for this study we will utilize per state industry membership numbers

as a percentage of state population to represent Union influence in a state.

Because senators may also not have a perfect idea of union numbers within a state, it is reasonable to assume that the strength of an industry can be utilized to substitute the number of union members and added to the probit regression to provide another measure of membership strength. The second equation utilized in this study will include state percentage as an independent variable and the model will have two separate equations:

Model 2a: Roll Call Vote = $F-1(\text{probability}) = B_0 + B_1(\text{election year}) + B_2(\text{membershipsiz}) + B_3(\text{percapitaincome}) + B_4(\text{voterturnout}) + B_5(\text{onoroffyear}) + B_6(\text{partyid}) + B_7(\text{contributions}) + B_8(\text{percentofstatepop}) + e$

Model 2b: Roll Call Vote = $F-1(\text{probability}) = B_0 + B_1(\text{election year}) + B_3(\text{percapitaincome}) + B_4(\text{voterturnout}) + B_5(\text{onoroffyear}) + B_6(\text{partyid}) + B_7(\text{contributions}) + B_8(\text{percentofstatepop}) + e$

The first of the equations for this model will include both membership size and the percentage of industry workers in a state workforce and the second will only include percentage of industry workers in a state workforce. As the two variables represent similar elements, they may cancel each other's effects within an equation. Conducting two separate regressions—one inclusive, the other exclusive—will show whether the two variables cancel each other or can be utilized inclusively.

The third model will examine the effects of interaction variables. Many of the demographic variables, while certainly capable of providing significant influence on their own, may be even more influential when combined with another variable. For instance, while membership may prove to be a significant and positive variable, it may be even more significant when combined with another variable such as income. To test the effect of these interactions the third model will include interaction variables in the regression. The equation for model three will be:

Model 3: Roll Call Vote = $F-1(\text{probability}) = B_0 + B_1(\text{electionyear}) + B_2(\text{membershipsiz}) + B_3(\text{percapitaincome}) + B_4(\text{voterturnout}) + B_5(\text{onoroffyear}) + B_6(\text{partyid}) + B_7(\text{contributions}) + B_8(\text{percentofstatepop}) + B_9(\text{interactionpercentmember}) + B_{10}(\text{interactionpercentcontribution}) + B_{11}(\text{percentstateincometurnout}) + e$

The final equation will also be utilized to determine—for those interaction variables that are significant—how much the increased strength of one variable can influence the interaction variable as a whole. This model will also have three versions so that the independent effects of each interaction variable can be observed.

c. Variables

This study will focus on testing the demographics of PAC memberships and will utilize limited legislator fixed effects to help control for outside influences. Table 2 presents a list of the variables as well as the type of variable and a description of each.

TABLE 2: STUDY VARIABLES AND DESCRIPTIONS

Variable	Type	Description
Roll Call Vote	Dependent Variable	A dummy variable representing Senatorial roll call votes from 1998-2008.
Membership	Independent Variable	Cross-national membership size numbers.
Per Capita Income	Independent Variable	Median per capita income for PAC occupations.
Voter Turnout	Independent Variable	Voter turnout affiliated with income group as determined by PAC occupations.
Percentage of State Population	Independent Variable	Industry workers within a state as a percentage of total state population.
Interaction percent state income turnout	Independent Variable	Interaction variable of the percentage of state population and the voter turnout as related to income group.
Interaction percent contribution	Independent Variable	Interaction variable of the percentage of state population and contributions.
Interaction percent member	Independent Variable	Interaction variable of the percentage of state population and cross-national membership size.
Election Year	Independent Control Variable	Controls for the growth in population over time. Simply represents the election year.
On or Off year	Independent Control Variable	Dummy variable for on or off year elections to help control for the variation in voter turnout in on and off years.
Party ID	Independent Control Variable	Democratic, Republican or Independent party identification to control for party ideology.
Contributions	Independent Control Variable	Contributions by PAC per election cycle.

Roll call votes were compiled by Keith T. Poole and collected from the Vote View website of the University of California, San Diego. For the purposes of this study, the roll call votes were converted from the vote view scale to binary variables. 1 was utilized for a vote with the PAC on a bill (i.e. if the PAC opposed a bill and a Senator voted against a bill the roll call vote would be a 1 and vice versa). Abstained votes and absences were counted differently depending on the circumstance of the vote (i.e. if a PAC supported a bill and a Senator did not vote the roll call vote would be a 0 and vice versa.) The bills utilized in this study were chosen through the AFL-CIO issue score card for those unions affiliated with the AFL-CIO, Change to Win issue center (for those affiliated with Change to Win), and individual PACs' website issue pages for those unions or organizations which were not affiliated with either.

PAC membership numbers were collected mainly from LL-2 forms that PACs are required to file with the Office of Labor Management Standards. 1998 numbers, however, were estimated through growth trends within each separate PAC in combination with histories and numbers provided on each PAC's individual website. The National Association of Realtors provided complete data on membership on their website and the ADA compiled official numbers upon a personal request. In accordance with H1, membership size is expected to be positively correlated with roll call votes, meaning that a higher membership should increase the probability that a legislator will vote with a PAC. If the correlation between membership and roll call votes is negative, H1 will be rejected and H2 would be the supported hypothesis. If the correlation is non-existent or insignificant the null will be dominant.

Median Per Capita Income data was collected from the Occupational Employment Statistics FTP (flat) files found on the Bureau of Labor Statistics. Incomes were calculated across the most pertinent occupations within a given PAC and median income was utilized since medians are less likely to be skewed by inordinately high outliers. Per capita income is expected to be positively correlated with senatorial support for H1 but may be positive or negative if H2 is the supported hypothesis. Voter turnout data was collected through the Census Bureau Population (P20) characteristic reports and is also expected to be positive if H1 is dominant but expected to be negatively correlated to roll call voted if H2 is supported.

Percentage of state population was calculated utilizing raw data from Bureau of Labor Statistics FTP (flat) files, which presented numbers of employees within a given industry per state. Total state populations were obtained from the Census Bureau population estimates from 1998-2008 and both numbers were utilized to calculate the percentage. For the American Federation of State, County, and Municipal Employees' numbers were collected from the Quarterly Census of Employment and Wages and then utilized with Census state population data to calculate percentages. State percentage is expected to be positively correlated if H1 is supported and could be either if H2 is supported. Percentage of state population was then utilized with voter turnout, membership size and contributions, respectively, to form interaction variables. Party IDs were collected through the Vote View website and converted into a dummy variable with 1 standing for Democratic affiliation and 0 standing for everything else (independent or Republican). Contributions were collected from opensecrets.org for each election cycle (and verified with FEC files). Party IDs and contributions serve as control variables but will likely be positively correlated with roll call votes.

Results

Model 1, the first and simplest of this study's models, provides significant but slightly varied results. All variables are significant at the 1% significance level. Membership had a negative but significant coefficient, which shows that an increase in membership results in a decrease in the probability that Senators will support a PAC. While the coefficient was relatively small, this allows H1 to be rejected for membership. Per capita income, on the other hand, has a stronger and positive coefficient. An increase in per capita income causes an increase in the probability that senators will support PACs, while voter turnout has a negative and strong coefficient that again causes H1 to be rejected. The dummy variable for on/ off year elections, party ID, and election year all have positive and significant coefficients, as expected. Contributions also have a positive coefficient, but the coefficient indicating the correlation is very weak. Table 3 presents a complete picture of the probit results along with the standard error for each coefficient and the change in

TABLE 3: EFFECTS OF MEMBERSHIP DEMOGRAPHICS ON ROLL CALL VOTES (NOT CONTROLLING FOR % OF STATE POPULATION)probability of support (ΔF) as a result of a change in the independent variable (ΔX).

Variable	Coefficient (Standard Error) $\Delta F/\Delta X$
Election Year	.02635*** (.00407) .01044
Membership Size (in thousands)	.02635*** (.00407) .01044
Per Capita Income (in thousands)	.00445*** (.00089) .00176
Voter Turnout for Income Bracket	-1.49226*** (.29951) -.59154
Dummy Variable for On/Off year elections	.46457*** (.04449) .18252
Party Identification	1.42504*** (.02152) .51843
Contributions	.00002*** (2.30e-6) 9.55e-6
Constant	-52.97561 (8.07653)
# of Observations	18051
Log Likelihood	-9702.4668

*** Significant at 1%

Model 2 provides a slightly more complex view that takes into account the percentage of industry employees in each state. Model 2a includes the percentages along with national membership while Model 2b excludes national membership sizes in order to remove possible negative influences that could arise from a similarity between the effects of national membership size and state percentages. Table 4 provides complete data for regression results along with the standard error and $\Delta F/ \Delta X$.

TABLE 4: EFFECTS OF MEMBERSHIP DEMOGRAPHICS ON ROLL CALL VOTES CONTROLLING FOR STATE MEMBERSHIP

Variable	Model 2a (Including National Membership)	Model 2b (Excluding National Membership)
Election Year	.02681***	.02630***
	(.00408)	(.00408)
	.01062	.01042
Membership Size (in thousands)	-.00004*	
	(.00002)	
	-.00002	
Per Capita Income (in thousands)	.00450***	.00465***
	(.00089)	(.00089)
	.00178	.00184
Voter Turnout for Income Bracket	-1.54051***	-1.53674***
	(.30201)	(.30198)
	-.61057	-.60909
Dummy Variable for On/Off year elections	.47093***	.47094***
	(.0448)	(.0448)
	.18498	.18499
Party Identification	1.42527***	1.42574***
	(.02152)	(.02152)
	.51853	.51869
Contributions	.00002***	.00002***
	(4.30e-6)	(4.29e-6)
	.9.50e-6	9.30e-6
%of State Population	-.95763	-1.80739***
	(.78276)	(.64805)
	-.37955	-.71637
Constant	-53.85778	-52.87968
	(8.10984)	(8.0938)
# of Observations	18050	18050
Log Likelihood	-9701.4507	-9703.3634

First Number in the cell is the variables coefficient, italicized number in parentheses is standard error and third number is $\Delta F/ \Delta X$.

*= Significant at the 10%

**= Significant at the 5%

***= Significant at the 1%

In model 2a per capita income and voter turnout change only slightly in their coefficients and remain significant at the 1% significance level. The membership size coefficient decreases in size, and in model 2a, membership size is only significant at the 10% level. The introduction of percentage of state population makes membership size a much weaker and less effective variable in this regression. Percent of state population itself is not significant in model 2a. All of the model's control variables remain significant and positively correlated. Model 2b, however, excludes cross-national membership size and this results in a large change in the significance and coefficient of the state population variable. In model 2b, the percentage of state population is significant at the 1% significance level and the coefficient is strong and negative (-1.807394).

Model 3, the last and most complicated of this study's models, includes three interaction variables that utilize the percentage of state population along with membership, contributions, and voter turnout to test for interactive effects and relationships between variables. Table 5 presents the results alongside previously-collected Model 2a results. Columns 3-5 also present regressions that utilize each interaction variable separately within the regression. Column 6 represents the full regression.

TABLE 5: EFFECTS OF MEMBERSHIP DEMOGRAPHICS WITH INTERACTIONS

Variable	Model 2a (Including National Membership)	Model 3 (interaction percent voter turnout)	Model 3 (interaction percent member) (interaction percent member)	Model 3 (interaction percent contribution)	Model 3 Complete
Election Year	.02681***	.02750***	.02776***	.02681***	.02777***
	(.00408)	(.0041)	(.00412)	(.00409)	(.00412)
	.01062	.0109	.01076	.01062	.01101
Membership Size (in thousands)	-.0000417*	-.00005**	-.00006*	-.00004*	-.00006*
	(.0000213)	(.00002)	(.00003)	(.00002)	(.00003)
	-.00002	-.00002)	-.00002	-.00002	-.00002
Percent State Population and National Membership Interaction			.00104		.00802
			(.00145)		(.00146)
			.00041		.00032
Per Capita Income (in thousands)	.00450***	.00497***	.00452***	.00450***	.00498***
	(.00089)	(.00091)	(.00089)	(.00089)	(.00091)
	.00178	.00197	.00179	.00179	.00197
Voter Turnout for Income Bracket	-1.54051***	-1.81869***	-1.57928***	-1.54115***	-1.84524***
	(.30201)	(3.24309)	(.30675)	(.30219)	(.02154)
	-.61057	-.72083	-.62593	-.61082	-.73135
Percent State Population and Voter Turnout Interaction		15.2615**			15.02584**
		(6.47882)			(6.49867)
		6.04883			5.95539

Dummy Variable for On/Off Year Elections	.47093***	.48873***	.47566***	.47102***	.49224***
	(.0448)	(.04544)	(.04527)	(.04482)	(.04586)
	.18498	.19184	.18680	.18502	.19319
Party Identification	1.42527***	1.42576***	1.42525***	1.42523***	1.42568***
	(.02152)	(.02153)	(.02152)	(.02153)	(.02154)
	.51853	.51868	.51852	.51852	.51866
Contributions	.00002***	.00002***	.00002***	.00002***	.00002***
	(4.30e-6)	(4.30e-6)	(4.32e-6)	(5.03e-6)	(5.04e-6)
	9.50e-6	9.53e-6	9.52e-6	9.44e-6	9.44e-6
Percent State Population and Contributions Interaction				.00001	.00002
				(.00024)	(.00048)
				5.90e-6	9.19e-6
%of State Population	-.95763	-8.50458***	-2.080134	-.97227	-9.27743***
	(.78276)	(3.29455)	(1.74142)	(.81706)	(3.56966)
	-.37955	-3.37075	-2.08014	-.38535	-3.67704
Constant	-53.85778	-55.14397	-54.52275	-53.87103	55.65763
	(8.10984)	(8.12964)	(8.16241)	(8.11262)	(8.18077)
# of Observations	18050	18050	18050	18050	18050
Log Likelihood	-9701.4507	-9698.6737	-9701.1914	-9701.4487	-9698.5146

First Number in the cell is the variables coefficient, italicized number in parentheses is standard error and third number is $\Delta F/\Delta X$.

*= Significant at the 10%

**= Significant at the 5%

***= Significant at the 1%

While model 3 presents several different variations on the regression, in all cases the interaction variable for percentage of state population and membership size, as well as the interaction variable for percentage of state populations and contributions, are not significant. Their inclusion or exclusion results in slight variations to the coefficients of all other independent variables, particularly to the significance of membership size. Inclusion of these two interaction variables (both or either independently) causes membership to only be significant at the 10% level, while exclusion of these two variables and the use of the percentage population and voter turnout interaction variable makes it significant at 5%. There are no other statistically significant variations in the remaining independent variables. The percent state population and voter turnout interaction variable is significant and has a high positive coefficient. The Pseudo-R² for all three models is .22, which is relatively low but does not necessarily declare this model as a weak fit as we do not know how other model *s*(utilizing alternative demographics) would fit. An interpretation of Pseudo-R² for this model would require it to be analyzed in conjunction with other regressions.

Analysis

a. General Analysis

While there is variation across all three models in terms of significance levels, there are many similar trends. For Model 1, H1 must be rejected for cross-national membership size as well as for voter turnout by income groups, as both variables have a negative correlation with senatorial roll call votes. H1 cannot be rejected, however, for median per capita income, as per capita income does have a positive correlation with legislative support. Although it almost seems counter-intuitive for membership size and voter turnout to be negatively correlated with senatorial support, it is actually quite realistic. PACs only have to submit their membership sizes once a year, but bills are voted on across a period of months; one bill may be voted on in October while another may be voted on in March. As a result, membership may be calculated well after a certain bill is voted on and any changes in size may be directly related to the passage or failure of a bill. To be more specific, rises in membership size may be direct responses to a lack of legislative support for a PAC. Political discontent may prompt people to action and subsequently cause an increase in political activity, which could include joining relevant unions. The negative relationship between voter turnout and legislative support may be similarly explained. If senators vote against the preferences of a PAC prior to an election, then PAC members may turn out in larger numbers in order to show their displeasure, causing a negative correlation between voter turnout and legislative support.

Model 2 includes percentage of population for industry employees in each state as part of the probit regression. The change in percentage of population significance when excluding cross-national population is much stronger than was expected. The change is reasonable, as cross-national membership and percentage of state population are very similar variables. While the percentage of population was calculated using industry, rather than union state population, numbers, it still fairly accurately represents the strength of a particular sector in a given state; cross-national employment numbers represent the strength of the union across the nation. Senators are likely aware of both the national and state-specific strength of a union, and so these numbers may have a very similar effect on a Senator's support or mentality. The percentage of state population is a one-unit breakdown of the cross-national membership size variable, and so the variables may cancel each other out when considering their effects in this regression. This becomes very clear when the simple exclusion of cross-national membership size causes percentage of state employment to become significant at the 1% level and doubles the coefficient, which remains negative.

The negative correlation between percent of state population and legislative support is quite perplexing. While membership size in a union is responsive to changes in legislative support, employment in a particular industry or sector is not. If anything, legislative action which is negative for a given industry would likely decrease employment in that industry and vice versa and so the relationship should be positive. The negative relationship may be a result of varying occupations within a given field. While industry population is a good estimate for PAC membership size in a state, it is not exact. Also, members of the industry who partake in occupations outside of PAC-related industries may have opposite legislative preferences and

the negative correlation may showcase legislative response to these preferences. Furthermore, a negative or negligent change in percentage of state population may not provide a clear picture of the percentage a given industry comprises in the state workforce. While an industry's membership may only comprise a small number of the general state population, it may also comprise a large, even growing, number of the state's workforce. Utilizing a percentage of workforce statistic may have shown a positive correlation. This negative correlation also allows H1 to be rejected and leaves H2 as the supported hypothesis for this study.

Model 3 utilizes three interaction variables that combine percentage of employment with three other variables to test for relationship effects. The insignificance of the interaction variables utilizing cross-national membership size and contributions allows both H1 and H2 to be rejected and the null to remain the supported hypothesis for those variables. The interaction variable for percentage of state employment and voter turnout by income group, however, is significant and has a very high positive coefficient. The inclusion of this interaction variable also causes a strong change in the percent of state population variable on its own. In model 2a, when cross-national membership size is included, percentage of population becomes completely insignificant.

In model 3, percentage of state population becomes significant at the 1% level even with the inclusion of cross-national membership so long as the percentage of population and voter turnout variable is included in the regression. The strong and significant coefficient of percentage of state population shows the effect on the probability of legislative support when percentage of state population increases by one percent ignoring (controlling) the effect of percentage and voter turnout. The interaction variable itself shows the change in the probability of senatorial support that occurs as a direct result of the interaction between the percent of state population. The coefficient for the interaction variable is 15.02584, by far the strongest coefficient in all three models utilized in this study.

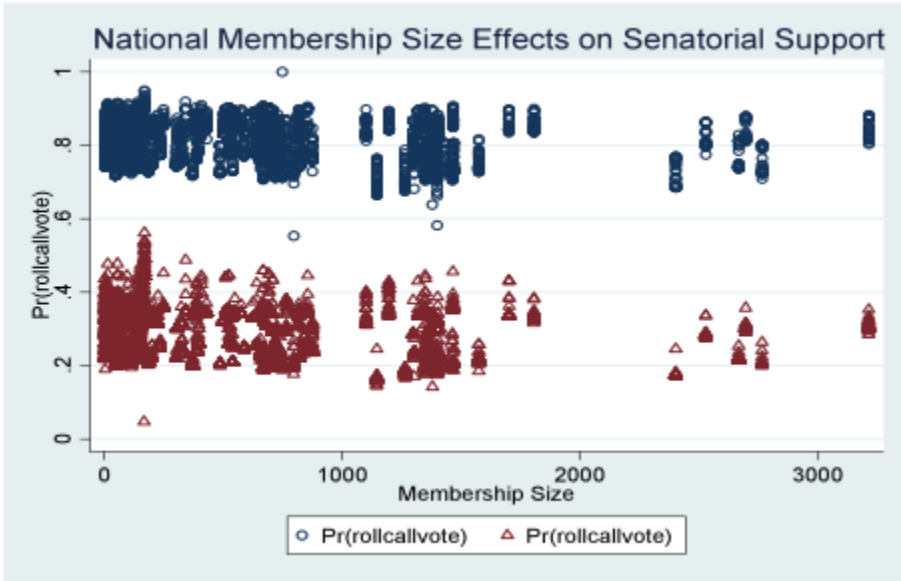
The extra punch delivered by the interaction variable can be explained by looking at a simplified version of our Model 3 equation: $F-1(\text{probability}) = B1\text{percentofstatepop} + B3\text{voterturnout}$. If, for instance, voter turnout is held constant at .44 and percentage of state population changes by .005 (lets say from .02) then the change in probability of support would be equal to $F-1(\text{probability}) = -1.8452(.005) + 15.02584(.44)$. The effect of a change in the percentage of state population is supplemented by the strength of the variables' interaction with voter turnout, and the same is true if we wish to observe the increased effect of a change in voter turnout. This is quite logical, as Senators would certainly be more supportive of a high turnout income group who is present in large numbers within their constituency. It is intriguing that while the two variables on their own have a negative effect on legislative support, in conjunction, they have a strong positive effect.

Through all three models the variables for contributions, election year, party ID, and the dummy variable for on/off year elections remain positive and statistically significant at the 1% level. Since these variables are utilized as controls, it is expected that the coefficients and significance levels experience little change while the pertinent independent variables are altered. All in all, these three models shows that PAC demographics do in fact have an effect on legislative support, although the effects of each demographic is varied and not as uniform as was originally expected.

b. Graphical Analysis

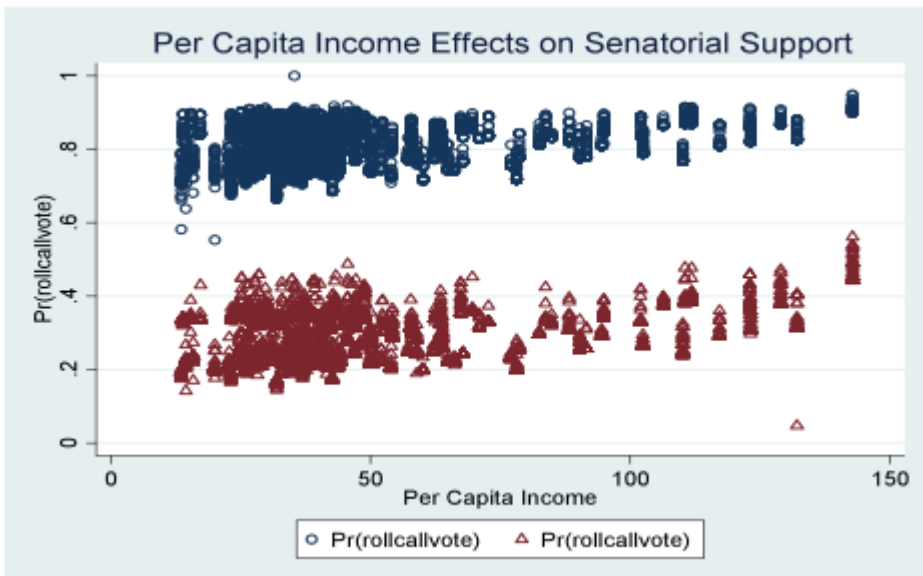
Because this study utilizes a probit model, it does not necessarily lend itself well to graphical interpretations. However, some simple graphs can provide an interesting visual insight into this regression.

Graph 1: The following graph shows a regression that shows the effect of national membership size on the probability of Senatorial legislative support.



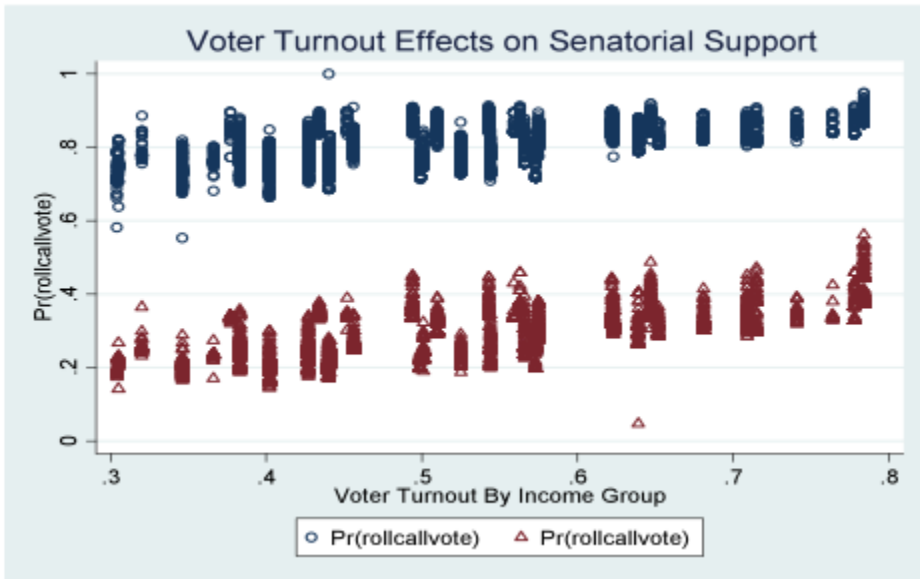
This graph clearly illustrates the small and negative relationship between national membership size and roll call vote. The most obvious feature of this graph (and the next two) is the large concentration of points on either end of the probability spectrum. These two distinct spaces clearly illustrate the difference between Republican and Democratic support for labor unions. While the trends are similar in both the Republican and Democratic blocs, this graph also indirectly illustrates the strong effect of party affiliation on senatorial support as there are very different starting probabilities for senators of different parties.

Graph 2: The following graph illustrates the relationship between roll call votes and per capita



This graph provides some interesting insight into the effects of per capita income on senatorial support. While the regression analysis shows that there is a positive relationship between per capita income and legislative support, the coefficient is only .00445, showing a relatively weak correlation. However, upon looking at the graph one can see that the effect of per capita income is much stronger toward the end of the income spectrum. The general concentration of incomes for this study's observations is in the \$20,000-\$50,000 range; a \$1,000 change in income in that range does not appear to have a strong effect on legislative support. A \$1,000 change in the higher income ranges however, seems to have a much stronger (steeper) relationship with an increased probability of legislative support. Again the clear divide between Democratic and Republican support is visible.

Graph 3: The third and final graph shows the effect voter turnout has on the probability of legislative senatorial support.



The visual representation of this graph provides a very different picture from the one we acquire from our regression. In this study's regression, in any model, voter turnout has a negative and strong coefficient. This graph, however, shows a positive relationship towards the end of the voter turnout spectrum (closer to 100%). The leftmost section of the graph that relates to PAC members with low turnout rates shows a negligent and slightly negative relationship that in the regression seems to erase and even negate the positive relationship between the rightmost (higher turnout) PAC memberships. There also seem to be slight differences in the impact that voter turnout has on Republicans and Democrats as the Democratic section (the top portion of the graph) seems to be flatter, which shows that Democrats will help labor and trade unions even if voter turnout is low. Republicans, which in general are less supportive of labor or trade unions, appear to be much more affected by higher turnout rates and are more likely to support trade union PACs if their members turn out in higher numbers.

c. Areas of Weakness

The issue of simultaneity arises several times in this study and is an inherent weakness in the experimental design. It may in fact be responsible for the negative relationships of both cross-national membership size and voter turnout with senatorial support as well as for the low Pseudo-R2 in the regression. The choice of bills in this study provides another weakness. While bills were chosen with care through PAC

websites and affiliate organization vote scores (i.e. AFL-CIO), choosing different bills or utilizing several bills in the regression by averaging voting decisions could have altered correlation results. Furthermore, utilizing percentage of state workforce as opposed to percentage of state population may have varied—and possibly more accurate—results.

Furthermore, ideological trends and events unaccounted for in the study (such as 9/11) could also have a strong influence on different variables. For instance, 9/11 caused a huge spike in construction-related industry employment, and this anomaly could have detracted from the significance and correlation strength of membership size. Ideological trends would influence roll call votes and a specific trend could cancel out or even alter the effects of independent variables. While this study does have significant results, adjusting for these weaknesses would certainly increase the robustness of the data.

Future Research

This study has shown that PAC membership demographics have an effect on legislative senatorial support, but there is much more research to be done in the field. One of the first and foremost areas for further research in this field would be to expound on state-specific “fixed effects.” Ansolabehere et al., in their own study on PAC contributions, complained of the lack of district-specific fixed effects in studies focused on the effects of contributions (Ansolabehere 114). While this study has a completely different focus, the warning is still pertinent as state-specific fixed effects—such as the strength of an organization’s activities in a state, or the general attitude of constituents towards a PAC—may have the potential to influence the support senators provide to a PAC. The addition of these effects may also have a strong influence on the demographics already included in this study, and it would be intriguing to expound on these possible relationships.

Other avenues of study would require an expansion of focus. This study focuses on labor unions and professional organizations, but these are not the only membership-based PACs active in the political field. Single-issue and non-connected PACs such as NOW and the AARP rely heavily on their memberships for political clout and financial strength. In fact, these PACs exist solely on their members’ contributions and inputs. Acquiring information for this type of research may be unfeasible in the near future as many of these single-issue and non-connected PACs are fairly close mouthed about their membership numbers and demographics. Possible future regulation and record-keeping on these organizations would make the data much more accessible.

Research on varying effects of membership sizes could also prove to be quite interesting. While this study included all membership sizes in the statistical analysis, it may well be that up to a certain point an increase in membership causes an increase in legislative support. Is there a point of satiation with membership growth, and could PACs and organizations be wrong on assuming that a maximization of their membership maximizes their influence? Other demographics variables such as ethnic diversity of PACs and measures of extremism would provide additional insight. This additional research could provide another facet to be combined with this current study to retest the regression.

Conclusion

This study has shown that membership demographics do have an effect on legislative senatorial support. While most current studies have focused on contributions as the main area of focus in PAC research, this study shows that relationships between PAC demographics is a new and legitimate area of research. This study not only reveals insights about demographics, but may also shed new light on the strength and relevance of PAC contributions. Perhaps contributions can be interpreted as legislative signals and provide a way in which PACs can attract legislative attention to their memberships. This would explain why PACs give below their legally established limits and would provide a new avenue of study that could combine research into PAC contributions and demographics.

The negative relationship between membership size and voter turnout shows that PACs may have a membership that is very sensitive to trends in legislative support, while the positive correlation between

median per capita income and legislative support shows that senators are more responsive to higher-income constituents and organizations. The relationship between state-industry membership as a percentage of state population is slightly confounding, but can most likely be adjusted if full union numbers were provided. The interaction variable of percentage of population and voter turnout is very highly and positively correlated with legislative support and does in fact give evidence that senators are cognizant of strongly-voting PACs within their constituencies.

The effects of PAC demographics have been little-discussed and even less-researched, but further study could yield interesting results. PACs would benefit their own agenda by furthering research in this sector and investing in a stronger exploration of the relevant demographics of their memberships. After all, if some factors have stronger effects than others, PACs would be better-served by shifting their attention from projects focused on increasing membership to increasing factors such as diversity or member density. Only further analysis could show whether such actions would be necessary.

A CRITICAL LOOK AT WESTERN PERCEPTIONS OF CHINA'S INTELLECTUAL PROPERTY SYSTEM

BRIAN J. SAFRAN

Transatlantic corporations have channeled their energies into their respective Chambers of Commerce to complain about China's lack of enforcement of Intellectual Property Rights (IPR). However, evidence suggests that such firms are not availing themselves to the protections the Chinese system affords. This paper inquires into the basis for western perceptions of China's intellectual property system and attempts to assess whether they truly reflect the business operating environment in China. The analysis is framed using the "Theory of Reasoned Action," and concludes that a combination of a series of misguided attitudes and subjective norms have ultimately served to discourage corporate directors, officers, and executives from choosing to participate in China's IP system. It is shown that China's intellectual property system is not as weak as commonly believed, and that well-advised western business executives should seek to participate in China's IP system. This means filing for IP protection with Chinese authorities, consulting with local counsel and business consultants, and submitting to available administrative, judicial and criminal procedures for enforcing their IP rights.

Introduction

On June 29, 2010, the European Union Chamber of Commerce in China released its Business Confidence Survey 2010. While 66 percent of survey respondents believed China's written intellectual property law to be adequate, only 22 percent believed the enforcement of this law to be adequate ("Business Confidence Survey" 2010). Twenty-nine percent of respondents ranked intellectual property (IP) rights protection among the top five regulatory obstacles to conducting business in mainland China. Forty percent of survey respondents indicated that China's regulatory environment is likely to worsen over the next two years ("Business Confidence Survey" 2010). The Business Confidence Survey follows a report issued in April 2010 by the American Chamber of Commerce (AmCham) in China, which similarly concluded that 74 percent of American businesses operating in China believe the IP system to be weak and ineffectual ("Business Climate Survey" 2010). The following study argues that a series of flawed assumptions have contributed to the low confidence level that Western business leaders have in China's IP system today, and that China's IP system is not as weak as the survey data above would suggest. Furthermore, the study will

show that the relationship between Western perceptions of China's intellectual property system and the ultimate decision of whether to pursue IP protection in China can best be explained by the Theory of Reasoned Action set forth by American social psychologists Martin Fishbein and Icek Ajzen ("Outreach and Extension" 2008).

Chinese Intellectual Property and the West

Western companies do not take full advantage of the enforcement opportunities afforded by China's existing IP system. According to time-series data released by China's State Intellectual Property Office, 934,129 patent applications were filed between January and July 2012. Of these applications, 860,555 (92.1 percent) were from domestic sources and only 73,574 (7.9 percent) were from foreign sources ("Total Applications for Three Kinds of Patents" 2010). Over the past few years, the percentage of foreign patent applications has declined from 15 percent in 2007 to 13.4 percent in 2008 and 10.1 percent in 2009 ("Total Applications for Three Kinds of Patents" 2010). By comparison, in the U.S., approximately 50 percent of patent applications are from foreign sources ("U.S. Patent Statistics" 2010). Furthermore, according to an April 2009 White Paper issued by China's Supreme Court, only 4.3 percent of the IP-related cases closed by Chinese courts in 2009 involved foreign litigants ("Supreme People's Court" 2010; "Intellectual Property Protection by Chinese Courts" 2010). Considering that "about one-third of Chinese commerce involves foreign enterprises," it is undeniable that a large proportion of these companies are leaving themselves out of the Chinese legal process (Bewley 2010: 1).

The American Chamber survey asked respondents "How would you rate China's enforcement of intellectual property rights?" ("Business Climate Survey" 2010: 11). Similarly, the European survey asked respondents to rate the "perceived effectiveness of enforcement of China's IPR laws and regulations" ("Business Confidence Survey" 2010: 15). The phrasing of both questions was such that even business leaders that are not attempting IP rights enforcement using China's system could answer the questions based on their subjective perceptions. Furthermore, regarding the American report, while only 146 of the Chamber's over 3,000 members responded to the question pertaining to IP rights, the Chamber nonetheless reported the results as demonstrating the views of U.S. companies as a whole ("Business Climate Survey" 2010: 11; Truckety 2010). Similarly, although the European survey sample size was less than 150, the results were extrapolated to the European business community as a whole ("Business Confidence Survey" 2010: 3, 15). There is no indication that either Chamber has taken additional measures to ensure statistical accuracy and to compensate for the small sample sizes, other than maintaining internal consistency by using the same survey questions from year to year (Truckety 2010; "Business Confidence Survey" 2010). Given that the responses to the relevant questions were not limited to those companies actually attempting to enforce their IP rights through the Chinese system, that survey respondents could conceivably have answered the questions based solely on their perceptions, and the relatively small sample sizes of the data which were collected without verification of statistical accuracy, it is difficult to conclude that the results reported by the two Chambers of Commerce truly reflect the overall business environment in China.

In June 2010, representatives of AmCham in Shanghai suggested that even attempting to enforce IP rights in China is not worthwhile for Western businesses, which often find prevailing in Chinese courts too costly, and that the average judgment in an IP case issued by a Chinese court is approximately \$25,000 (Truckety 2010; Honig 2010). Yet several notable cases over the past few years call into question the validity of this 'static' statistic.

In the Schneider Electric case, the Chinese company the Chint Group was issued a judgment against the French Company Schneider Electric (China) Investment Co. Ltd. for approximately \$48.5 million in response to the latter's infringement of a patent possessed by the former pertaining to a circuit breaker (Bai "Yes" 2010; Bai "Ignore" 2010). The parties settled the suit for approximately \$22 million (Bewley 2010; Bloch 2009). This is the largest settlement agreement ever reached for an IP-related matter in China, and evidences the emergence of a modern IP system in which parties on both sides are increasingly aware

of the potential for significant damages in IP cases heard in Court (Lim 2008). The Schneider Electric case has been called a “wake-up call” to foreign companies who must now consider the ever-growing possibility of Chinese companies going into court to protect their IP rights (Bewley 2010: 1). Although the IP system may be improving for Chinese companies, one might wonder whether the same changes can be seen with respect to foreign parties in Chinese IP lawsuits.

Several decisions suggest that the operating environment for foreign businesses within the Chinese legal system is also improving significantly. For example, in one case the German bus manufacturer Neoplan Bus GmbH sued the Chinese Zonda Industrial Group for plagiarizing the design of a bus. In January 2009, the Beijing No. 1 Intermediate People's Court awarded the German company a judgment of 21 million Yuan, or approximately \$3.1 million (Li 2009, “Top Ten Trials” 2009). The Zonda Automotive Group and its subsidiaries Yancheng Zhongwei Passenger Coach Co. Ltd. and Beijing Zhongtong Xinhua Automobile Sales Company were accused of effectively reproducing Neoplan's Starliner model coach bus while designing their own A9 model (Li 2009: 4). The Neoplan verdict represents the largest award ever issued by a Chinese court in favor of a foreign company for patent infringement (Bai “Yes” 2010). The case is an example of foreigners gaining significant rewards by participating in China's evolving IP system (“Top Ten Trials” 2009). In addition to the significant amount of the damages, the case was notable because it indicated that traditional notions of the placement of the burden of proof on the defendant could be enforced effectively against Chinese companies (Field 2010; Ordish 2008): The Court's decision emphasized that “Zonda could not provide enough evidence to prove that the Zonda A9 is a result of their own research” (Li 2009: 4). The Neoplan case is often cited as an example of the supposed exorbitant costs of working within the Chinese legal system, as the plaintiff had to actually purchase a model of the infringing bus in order to meet the notoriously high standard of evidence required by the Court (“Top Ten Trials” 2009; Shmailov 2010). Yet, the cost of a model of the infringing bus amounted to only a small fraction of the total judgment amount awarded by the Court (“Top Ten Trials” 2009).

A second case involved the British kettle manufacturer Strix suing two Chinese manufacturers for infringing a design patent possessed by Strix for the manufacture of safety valves in kettles which automatically shut off when the water inside the kettle boils (Bai “Yes” 2010, Harris 2010). Here, the British company was awarded a judgment approximating \$1.3 million in February 2010 (Bai “Yes” 2010). This case was notable not only for the size of the judgment, but also because the Beijing No. 1 Intermediate People's Court froze the defendant's liquid assets, including bank accounts, at the commencement of the proceeding, helping to ensure that the plaintiffs would be able to collect in the event that they won the case (Harris 2010: 1). The Strix case indicates a willingness on the part of a Chinese court to protect a foreign party from a potential loss in the event that Chinese defendants were to be found liable. The Strix case and the aforementioned measures taken to protect the foreign litigants evidence the gradual emergence of an IP system amenable to supporting foreign complainants in suits levied against domestic infringers.

Another example of a case in which a foreign company was able to attain a significant judgment was Educational Testing Services vs. Beijing New Oriental School. In a decision issued in December 2004, a court in Beijing issued judgments amounting to \$1.2 million in favor of Educational Testing Services, a U.S.-based company that provides test preparation services and materials to prospective graduate students, and against the Beijing New Oriental School, which was deemed responsible for copying test materials and infringing upon trademark and copyright protections possessed by the plaintiff (Teng 2005; Bloch 2009). Although on appeal the judgment on the underlying trademark case was overturned on largely technical grounds, the judgment on copyright infringement was sustained and the school was required to pay ETS approximately \$450,000 (Bloch 2009).

A fourth set of cases indicating an improving IP environment for foreign businesses are those won in recent years by Microsoft related to piracy of its operating system software. One such case was the Microsoft-Tomato Garden case, in which the main perpetrator was an individual named Hong Lei. Mr. Hong was responsible for creating a clone of Windows XP known as the Tomato Garden edition, as well overseeing a complex distribution network that brought the operating system to computer users without

cost (Chao 2009; Bewley 2010; Shmailov 2010). In August 2009, Mr. Hong and three of his associates were fined approximately 1 million RMB, or \$150,000, and sentenced to three-and-a-half years in prison (Bewley 2010; Hille 2010). In another Microsoft case, a court in Shanghai ordered Dazhong Insurance to pay 2.17 million yuan, or \$317,900, to Microsoft for allegedly installing and permitting the use of several pirated Microsoft software applications on their employees' computer terminals ("Microsoft Wins" 2010). This case was the first in which Microsoft had "taken a large Chinese company to court over copyright infringement" and represents the "largest sum of damages" Microsoft has been awarded in China to date ("Microsoft Wins" 2010: 1).

The amount of the damages awarded in the civil judgments noted are undoubtedly less than those to which many Westerners might be accustomed. However, legal practitioners are quick to point out that the system does not discriminate against foreigners, and they note that overall, foreign IP-holders have an even easier time winning IP cases through the Chinese courts than do domestic IP-holders (Chen 2010; Bai "Ignore" 2010). It is noted that the basis for the discrepancy in damages is not national origin, but rather the emphasis placed by the Chinese legal system on injunctions, or court orders that mandate the infringing party to stop their illegal activities and seek to prevent future infringing conduct (Chen 2010). On the other hand, in the West, emphasis is placed on the allocation of punitive damages, which seek not only to put an end to the illegal activities, but also to punish the wrongdoer for their past misconduct (Chen 2010). In China, except in the limited area of product liability, punitive damages are not available (Neumann 2009; Chen 2010). Despite these differences in legal culture, the relatively large awards referenced above evidence a system adaptable to change and committed to improvement. Furthermore, they demonstrate the emergence of a system of courts increasingly willing to award unprecedentedly large IP judgments and, more specifically, to award these judgments to foreign companies over the objections of Chinese defendants. Although one might see cases such as those referenced to be exceptions to the rule, the fact is that a similar array of case decisions could not have been cited just a few years ago (Wang 2010; Chen 2010; Bewley 2010).

Theoretical Framework: The Theory of Reasoned Action

The Theory of Reasoned Action (TRA) is perhaps best equipped to explain how Western perceptions of bias in the Chinese IP system contribute to business leaders' unwillingness to take part in the existing system, despite evidence that conditions for them might actually be improving. The TRA has its roots in social psychology. It was first explained comprehensively in 1980 by American social psychologists Martin Fishbein and Icek Ajzen (Ajzen 1980). The TRA seeks to examine the relationships between beliefs, attitudes, intentions, and behavior ("Theory of Planned Behavior" 2004: 1). Fishbein and Ajzen start from the premise that individuals are rational and that behavior is "under [one's] volitional control" (Denison 1996: 10). According to the theory, "a person's behavior is determined by his/her intention to perform the behavior and that this intention is, in turn, a function of his/her attitude toward the behavior and his/her subjective norm," ("Theory of Planned Behavior" 2004: 1). The Theory of Reasoned Action posits that intentions are "the best predictor of whether or not a . . . behavior is performed" (Montano 2008: 1). Intentions are best described as "cognitive representation[s] of a person's readiness to perform a given behavior," and are presented as the "immediate antecedent of behavior" ("Theory of Planned Behavior" 2004: 1). Intentions are said to be directly determined by one's "attitude towards the behavior and subjective norm associated with the behavior" (Montano 2008: 1). Attitudes are "personal beliefs about the positive or negative value associated with a . . . behavior and its outcomes," whereas subjective norms are "a person's positive or negative value associated with a behavior" (Montano 2008: 1). Notably, with respect to subjective norms, individual behavior is said to be dependent on "the person's beliefs that specific individuals or groups think he/she should or should not perform the behavior and his/her motivation to comply with the specific referents" (Ajzen 1980: 8).

As a theory of individual decision-making, the Theory of Reasoned Action can and has been

applied to senior management officials making business-related decisions (Yang 2008; Mykytyn 1993). Regarding IP, the theory can be applied to those executives, managers, and directors who are responsible for deciding whether or not to move operations to China, and whether or not to seek the assistance of local counsel to file for IP protection. These executives also decide whether or not to enforce their IP concerns through Chinese courts and existing administrative procedures. Ultimately, the decision of whether or not to file for IP protection in China—and whether or not to enforce rights through the Chinese courts or available administrative procedures—is largely a product of the decision-maker's attitudes and subjective norms associated with the Chinese IP system. Those responsible for deciding whether to file and enforce IP rights in China often have a set of underlying “attitudes,” or “personal beliefs about the positive or negative value associated with” participating in China's IP system (Montano 2008: 1). However, many of the beliefs that lead decision-makers to refrain from participating are based on flawed assumptions.

With respect to subjective norms, it can be argued that individual business leaders confronted with making IP decisions in China might engage in groupthink and find “motivation to comply” with the negative views and expectations of China's IP system shared by the Western business community, the members of which act as “specific referents” in establishing subjective norms (Denison 1996: 12). The American Chamber of Commerce and European Union Chamber of Commerce report that use extrapolated survey data from a small sample in part shape these subjective norms. It is important to note that these organizations are tasked with the primary function of lobbying the Chinese government for policy changes that would benefit the business community. Therefore, it is not unexpected that they would take a critical view of the Chinese IP system. Too often, however, the views they present are considered indicative of the operating environment in China, and their conclusions are accepted as truth as they become part of the larger business consciousness. Another contributing factor to subjective norms relating to the Chinese IP system rests with China itself, and a political culture that has traditionally been reluctant to reform. Subjective norms are further shaped by the issuance of reports by political leaders, such as the “Special 301 Report” issued by Ambassador Ron Kirk, the United States' Trade Representative to China, which castigates Chinese leaders for establishing the ‘indigenous innovation law’ and for failing to maintain adequate protection for American IP holders (Kirk 2010: 19-27; Chow 2003: 413). Thus, the largely negative views of China's IP system shared by top decision-makers in the business community, who are called upon to make decisions as to whether to file and enforce their IP concerns through the Chinese system, are a product of individual attitudes and the subjective norms drawn from the views and expectations of the larger business community. The statements and positions of political leaders, the general views on Chinese legal history and culture, and organizations representing business interests influence these views.

Western Perspectives and the Shaping of Attitudes and Subjective Norms

The aforementioned decisions demonstrate the emergence of an IP system in which foreigners can seek relief so long as they file for protection and can enforce that protection when their rights are violated. Yet, several arguments have entered the business dialogue and have begun to shape attitudes and norms and to discourage decision makers from participating in China's IP system. Based on Fishbein and Ajzen's Theory of Reasoned Action, this section will show how a series of flawed assumptions and mistaken expectations have contributed to the development of certain attitudes and subjective norms which influence decision makers' views and ultimately lead them to refrain from participating in China's IP system upon choosing to do business in China.

Some have argued that even though the case decisions cited above are noteworthy, they do not necessarily indicate a trend, as the courts in question appear primarily to be limited to the major cities of Beijing and Shanghai (Inch 2010). It has been suggested that though there is evidence of improvements in enforcement in major cities, many of the courts in rural areas are trailing behind (Inch 2010). One basis for this conclusion is the alleged persistence of local protectionism in China's more remote regions (Guttman 2010). While it is true that the majority of IP cases have come to courts in the major population centers, this

fact alone does not necessarily prejudice foreign businesses seeking to enforce their IP rights in China. In the major cities, specialized tribunals dedicated to IP hear IP cases (Gao 2010; Chen 2010). As a result, courts in these areas have more experience and expertise in adjudicating IP disputes (Gao 2010). In fact, it has been suggested that the judges that adjudicate IP disputes in major cities are often more educated than similarly-situated judges in Western countries; many Chinese judges have degrees in electrical engineering or have other technical and practical backgrounds (Bai “From Infringement to Innovation” 2007). Additionally, the court system is designed such that patent cases are automatically adjudicated in the first instance in the Intermediate Level People’s Courts (or in the IP division thereof), which are located in the capital city of each province (Chen 2010). Therefore, at least with respect to patents, these cases are never actually heard outside of the larger cities (Chen 2010; Ordish 2008). Third, and perhaps most significantly, jurisdictional rules in China permit litigants to bring a case either at the place of infringement, the defendant’s domicile, or even at the place of distribution (Ordish 2008; Chen 2010). This permits the plaintiff a certain degree of leeway in choosing a forum. For example, in *Motorola v. Guangzhou Weierwei* (2008), Motorola brought an action to enforce a design patent on a two-way radio against a Chinese radio manufacturer in Guangdong province (Lim 2008). Despite the fact that the alleged incident occurred in Guangdong, Motorola and its legal team were able to take advantage of China’s permissive jurisdictional rules and bring the case in Beijing, allowing the company to avoid the possibility of local protectionism in Guangdong province and permitting it to take advantage of the experience of the Beijing courts in dealing with IP matters (Lim 2008). Some have argued that the Chinese legal system operates in an environment where interpersonal relationships are considered more important than the law, and that any attempt to understand the Chinese system through case decisions or legal procedures ignores the cultural setting. (Xu 2010; Brauchle 2010) “Guanxi,” or “connections” are said to permeate all bases of the Chinese society (Inch 2010). It has been argued that “people tend to operate outside the framework of law” and that as such, “for China to build a social system based on law is impossible” (Field 2010; Xu 2010). However, even if legal matters are, in several contexts, deemed secondary to personal relationships, applications for IP protection and lawsuits seeking to enforce that protection are still being filed though foreigners are not primarily making these filings (Safran 2010).

Many have spoken of the so-called ‘indigenous innovation policy’ as one reason why foreign firms are turning away from filing for IP protection with the Chinese authorities and using Chinese courts to enforce their rights (Chao 2009; China Post 2010). This “indigenous innovation policy” refers to a group of regulations that seek to promote domestic innovation by giving preference to domestic innovators in procurement contracts, and boosting domestic research and development capabilities (Gruenwald 2010: 1; Jarrett 2010). Some have suggested that this indigenous innovation policy permits Chinese companies to “buy up foreign . . . intellectual property” and “demand technology transfer to China” (Hilton 2010: 1-2). Others have noted that the policy “tries to compel transfers of intellectual property rights for key technologies as the price of market access” (Holleyman 2010: 1). However, these statements appear to be embellishments on the truth regarding the operation of the policy. According to one prominent Chinese IP attorney, although the indigenous innovation law might require a foreign company to transfer their IP concerns to a Chinese company, the Chinese company to which they transfer their IP rights can be a subsidiary of the foreign company. As such, the Chinese company does not have to be “unaffiliated” with the foreign company (Abrams 2010: 2). Therefore, the notion that China is somehow “stealing” foreign IP through its indigenous innovation policy appears to be without merit (Holleyman 2010: 1; Abrams 2010: 2; Safran 2010).

Some have said that the exorbitant cost associated with filing and enforcing IP rights in China is another reason why foreign firms refuse to take part in the Chinese IP system (Honig 2010, Mita 2010; Bloch 2009). These costs are so high in part because there is no discovery procedure—the process by which opposing counsel share pertinent information with one another about the case—in China as there is in the U.S. (Ordish 2008; Cox 2006). In China, counsel must rely on their own research, hire private investigators, or even purchase replicas of the infringing goods at issue, as in the Neoplan case (“Top Ten Trials” 2009). In

fact, a prominent business consultant said that he would not even “pick up the phone” to provide advice to a foreign company on IP matters for less than \$2,000 (Honig 2010). Traditional evidentiary rules requiring that only original, notarized documents be submitted to the court for examination also increase costs (Lin 2009; Bai 2007). Since there is no Chinese equivalent of being held in “contempt” for lying to a court, judges traditionally presume all parties to be lying unless proven otherwise by concrete, original, and written evidence (Ordish 2008: 194). Finally, concerns are often voiced regarding the rampant corruption facing the Chinese legal system as a whole, given the widespread belief that favorable judicial decisions can be bought by the highest bidder (Xu 2010; Jarrett 2010). According to some, on the rare occasion that an injured party chooses to go to court, often the “outcome depends on who offers the judge the largest bribe” (Xu 2010). However, further analysis suggests that all three factors supposedly contributing to high costs are exaggerated. Prominent lawyers in the field note that while, on average, an IP case might cost a company between one and two million dollars in the United States, a similar case brought in China might cost that company \$100,000 or less (Wang 2010). On average, the costs of legal services in China are less than one-half of the costs of similar legal services in the United States (Chen 2010). Furthermore, Chinese practitioners suggest that the absence of discovery is actually to the plaintiff’s advantage insofar as it limits the amount of evidence that must be shared with the defendant; in China, the defendant has the burden of proving his or her innocence (Wang 2010; Field 2010; Ordish 2008). Also, cases progress through the Chinese legal system much more rapidly than similar cases progress in Western countries, also reducing the total cost of legal services in China (Chen 2010; Lim 2010).

With respect to requirements that original, notarized documents be submitted to Chinese courts, recent decisions indicate that judges are increasingly becoming willing to undertake “detailed analysis” and utilize photographs instead of requiring the submission of original documentation, indicative of the growing “sophistication,” “thoroughness,” and “maturity” of court decision-making practices (Zhang 2010: 2-3). Finally, despite the widespread concerns of corruption in the Chinese legal system, statements by prominent attorneys in the field suggest that corruption is not the norm (Chen 2010, Wang 2010). One reason offered for the absence of corruption in IP cases is that many cases are automatically referred to intermediate courts located outside of rural areas and within which judges are more scrutinized than they might be outside of the cities (Chen 2010). Additionally, there is a significant amount of prestige associated with being a Chinese judge, and judges are often reluctant to do anything that might jeopardize their positions, including asking for or accepting bribes (Chen 2010).

Another basis for Western criticism is the supposed lack of law enforcement by the police against IP theft perpetrators (Paun 2010). The issue, however, is not that authorities are refusing to enforce criminal sanctions but rather that business representatives are failing to understand and work within the Chinese system. In China, enforcing IP-related criminal statutes is not considered to be within the mainstream public interest (Wang 2010). Instead, law enforcement authorities act only upon complaints submitted to the proper administrative authorities (Ordish 2008; Wang 2010). When complaints are submitted in this manner, the police will conduct raids, seize and destroy the offending goods, and imprison those responsible for the counterfeit goods with sentences of up to seven years (Wang 2010; Chen 2010; Ordish 2008). Each year, approximately 300 people are imprisoned for IP infringement (Bai 2010). This year, a specific coordinated effort to crack down on IP infringement surrounding the Shanghai Expo led to over 60 arrests at one site. (Carothers 2010: 1) Therefore, the allegation that China does not provide for the enforcement of criminal sanctions against perpetrators of IP infringement appears to lack merit.

Some argue that one reason for the relatively low rate of foreign IP filings in China is that an alternative system exists whereby filings can be made through the World Intellectual Property Organization, or WIPO (Inch 2010). For instance, the so-called “Madrid System for the International Registration of Marks,” an arm of the WIPO framework, permits the holder of a trademark in one country to secure IP rights abroad simply by “filing one application directly with his own national or regional trademark office” (“Madrid System” 2010: 1). This procedure permits the trademark owner to amend or renew his filing application with “a single procedural step” (“Madrid System” 2010: 1). China has been a signatory to a

similar treaty for patents, known as the “Patent Cooperation Treaty,” or PCT, since 1993 (Xu 2006: 3). The PCT permits patent owners to “fil[e] one ‘international’ patent application under the PCT” allowing them to seek protection of their patents “simultaneously in a large number of countries” (“International Patent Filings” 2010: 1). Although each of these agreements provides IP owners with an efficient system for registering and protecting their IP internationally, they have significant shortcomings when it comes to utilizing WIPO registration procedures to protect IP in China. According to business and legal practitioners operating in China, securing IP protection by way of domestic channels gives the IP rights-holder a “much stronger position” and “better legal standing” in court when compared to those who limit their IP profile to international filings through WIPO, simply because of “legacy concerns” (Inch 2010). Therefore, even if the statistics noted above fail to account for the foreigners who choose to file for IP protection through WIPO, these foreigners are still placing themselves at a competitive disadvantage by refraining from filing directly with domestic authorities. As such, filings made by foreign IP holders through WIPO, and not made directly with domestic authorities, only confirm the basic argument that Western companies are not taking full advantage of the IP protections that exist for them in China.

It has also been suggested that basing a study of IP on official data or written laws and policies is insufficient, as these indicators may not give a complete understanding of China’s IP system (Brauchle 2010). In fact, the Chinese government may be intentionally boosting statistical data on domestic IP filings to show the world that Chinese companies are becoming increasingly innovative. At the same time, there exists a significant discrepancy between policy enactment and practical enforcement (Xu 2010). China, in fact, has more laws on its books than any government in the world (Xu 2010). Yet no one suggests that the mere passing of a law will inevitably lead to its enforcement throughout the country (Guttman 2010). It is for these reasons that relying on statistical data provided by government sources or simply comparing written law is insufficient. The present study’s conclusion that Western businesses are largely refraining from participating in the Chinese IP system is not solely based on statistics provided by the Chinese government, nor does it seek to provide comparative analysis of laws as they may appear on the books. Rather, the methodological focus is on examining the current IP environment through the experiences and insights of leading Chinese academics, lawyers, and business practitioners.

Finally, while others have criticized the Chinese IP system for its lack of consistency (“American Business in China” 2010), anecdotal evidence suggests that in recent years, the win rate for multinational companies bringing their IP cases to court has exceeded 50 percent, and in some cities, more than 90 percent. (Bai “Ignore” 2010). Although there may be a need for greater consistency on the part of the Chinese government and the Chinese courts, given the fact that the first Chinese patent law was devised only in 1984, China’s IP system has come quite a long way in a relatively short amount of time (Chen 2010; Zhang 2010). Legal practitioners note that although China’s IP system might be weaker than systems in the United States and Western Europe, it is still stronger than those of India, and even South Korea and Taiwan (Wang 2010; Chen 2010). Still, the aforementioned analysis shows significant untapped resources available to foreign businesses seeking to protect and enforce their IP rights in China.

Implications and Strategies for Western Businesses

Groupthink has been shown to prevail in discussions of China’s IP system, ultimately leading top-level decision-makers to refrain from critically analyzing the basis for their subjective perceptions and to choose to avoid participating in China’s IP system. Yet the aforementioned analysis has demonstrated that the Chinese IP system, despite its complexities, is one from which foreign parties can increasingly benefit if only they chose to take part in it.

Organizations such as the American Chamber of Commerce and the European Chamber of Commerce are lobbying organizations. Their primary purpose is to lobby for policies that promote and protect the interests of a particular constituency (Wang 2010, Truckety 2010, Safran 2010). This is most readily apparent in publications such as AmCham’s 2010 White Paper entitled “American Business in China,”

which presents an unbalanced view of China's IP system, providing only very general commendation for improvements made, and offering much more specific and detailed criticisms of China's IP system complete with a slew of complaints aimed at convincing Chinese leaders to transform almost every aspect of the Chinese socio-legal system ("American Business in China" 2010). Rather than continuing to channel their collective energies into organizations such as these in an attempt to change Chinese policy, well-advised businessmen would realize that they may find it more fruitful to learn to work within the existing system. This means filing for IP protection, consulting with local counsel and business consultants, and submitting to available administrative, judicial, and criminal procedures available for enforcing those rights. Companies with IP concerns should seek to obtain a "robust portfolio" of patents, copyrights, and trademarks before operating in China (Lim 2008: 1). By virtue of the fact that filings made through the World Intellectual Property Organization are looked down upon by the Chinese courts, businessmen should seek to file their IP concerns directly with the proper domestic administrative authorities (Inch 2010).

Many business owners to date have chosen to focus on "achieving rising market share value and volume" without investing in IP protection (Ordish 2008: 15). Yet, as demonstrated by the significant award issued in the Neoplan case, foreign parties to IP lawsuits willing to make the initial investments into evidence-gathering as required to meet China's unique evidentiary requirements and to familiarize themselves with Chinese legal procedures can stand to attain significant protection ("Top Ten Trials" 2009). It is noted that "IP protection strategies used at headquarters are [often] not transplanted to China for implementation" and that business executives "often choose to send operational staff who have little to no understanding of China, and of the need to invest in IP protection strategies" (Ordish 2008: 9, 14). Businesses which seek to take full advantage of China's IP system therefore must be willing to "send technical or IP professionals to oversee their proprietary property" and assist them in navigating the system (Ordish 2008: 9). Multinational companies must therefore not only be willing to sue to enforce their IP rights, but must choose a team capable of providing the business with an "in-depth understanding of the Chinese judicial system and relevant legal doctrines and an ability to maneuver through the intricacies of law and politics" (Bai "Yes" 2010: 1).

As famously suggested by Jiang Zhipei, the Chief Justice of the Intellectual Property Rights Tribunal of the Chinese Supreme People's Court, "foreign companies should take their complaints to courts rather than to the newspapers or their politicians" and "foreign companies should complain less and act more" (Ordish 2008: 182), especially given the improvements of China's IP system over the past several years.

Conclusions

The foregoing analysis suggests that decision-making by Western business leaders in China is reflective of the Theory of Reasoned Action, which they faced when choosing whether or not to build a comprehensive portfolio of IP rights and to enforce those rights through the Chinese system upon infringement. Based on a combination of personal attitudes and subjective norms within the business community, executives, managers, and directors investing in China have largely chosen to avoid partaking in China's IP system. Yet this study has demonstrated that these attitudes and norms are largely based on a series of misguided and flawed assumptions.

It has been suggested that there is a widespread belief that China's IP system is weak. Yet the aforementioned case decisions demonstrate that Chinese courts have shown an increasing willingness in recent years to rule in favor of non-Chinese IP owners and assess significant damages in IP-related cases. Despite these decisions, some have noted that improvements are limited to major cities and that IP enforcement in rural areas remains weak. Conversely, it has been shown that China maintains relatively loose jurisdictional rules that permit the IP rights holder to file their lawsuit in these major cities without much impediment. It is further suggested that in the Chinese socio-legal culture, personal relationships trump legal relationships, discounting the relevance of legal processes and court decisions. Notwithstanding

the cultural divergences between China and the West, it was suggested that Chinese residents are indeed filing for IP protection and seeking to enforce their rights through the Chinese courts, whereas foreigners are largely choosing not to do the same. Some have focused on the 'indigenous innovation law' and the perceived risk of IP thievery in China based on the requirement that IP be transferred to a Chinese entity before a foreign business can register to do business in China. However, the 'indigenous innovation law' does not prohibit the foreign firm from establishing a business relationship with a Chinese subsidiary and transferring the IP to it in satisfaction of this requirement, therefore circumventing the supposed obligation that IP be placed into the hands of an entity totally unrelated to the foreign company. Evidence has also shown that concerns regarding the costs of enforcing IP rights in China are largely misguided and that such costs are significantly less than the expenses associated with enforcing such rights in Western countries. Furthermore, despite concerns that China fails to enforce criminal sanctions against those responsible for IP infringement, evidence suggests that China does in fact enforce such sanctions, subject to its own complaint-filing requirements.

Some have also taken issue with the statistics related to foreign participation in China's IP system cited above, viewing them as an insufficient basis for the conclusion that Western businesses are not attempting to enforce their rights through the Chinese system. Yet, as noted, practitioners in the field assert that IP owners who fail to file directly with Chinese authorities are left at a competitive disadvantage upon attempting to enforce their rights in Chinese courts. Some also argue that any effort to analyze China's IP system based on government statistics or written statutes fails to encompass the true operation of China's legal system. For this very reason, this study has focused on the views and experiences of those business and legal practitioners with direct expertise in the field. Finally, despite general concerns regarding the inconsistent application of laws, this study suggests that ample opportunities exist for foreigners to enforce their IP rights in China. Given the relative infancy of China's IP system and the fast-paced improvements made to that system over the past few years, there can be no doubt that China's IP system will provide an even more consistent framework for doing business in China as the years progress.

The conclusions reached by the American Chamber of Commerce and the European Chamber of Commerce fail to accurately depict the opportunities available to Western businesses for enforcing their IP rights in China in 2010. Based on the opportunities available, it benefits local businessmen to file for Chinese IP protection, to seek representation by local counsel, and to use the Chinese court system to enforce their rights regardless of their negative expectations of the Chinese system.

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