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What Should Trade Negotiators Negotiate About?*

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IF ECONOMISTS RULED the world, there would be no need for a World Trade Organization. The economist's case for free trade is essentially a unilateral case: a country serves its own interests by pursuing free trade regardless of what other countries may do. Or, as Frederic Bastiat put it, it makes no more sense to be protectionist because other countries have tariffs than it would to block up our harbors because other countries have rocky coasts. So, if our theories really held sway, there would be no need for trade treaties: global free trade would emerge spontaneously from the unrestricted pursuit of national interest.[1]

Fortunately or unfortunately, however, the world is not ruled by economists. The compelling economic case for unilateral free trade carries hardly any weight among people who really matter. If we nonetheless have a fairly liberal world trading system, it is only because countries have been persuaded to open their markets in return for comparable market-opening on the part of their trading partners. Never mind that the "concessions" trade negotiators are so proud of wresting from other nations are almost always actions these nations should have taken in their own interest anyway; in practice, countries seem willing to do themselves good only if others promise to do the same.

But in that case, why should the tits we demand in return for our tats consist only of trade liberalization? Why not demand that other countries match us, not only in what they do at the border, but in internal policies? This question has been asked with increasing force in the last few years. In particular, environmental advocates and supporters of the labor movement have sought with growing intensity to expand the obligations of WTO members beyond the conventional rules on trade policy, making adherence to international environmental and labor standards part of the required package; meanwhile, business groups have sought to require a "level playing field" in terms of competition policy and domestic taxation. Depending on your point of view, the idea that there must be global harmonization of standards on employment,

* *Fair Trade and Harmonization: Prerequisites for Free Trade?* Vol. 1. *Economic Analysis*. Vol. 2. *Legal Analysis*. Edited by JAGDISH BHAGWATI AND ROBERT E. HUDEC. Cambridge and London: MIT Press, 1966. Vol. 1: Pp. xi, 598. ISBN 0–262–02401–2; Vol. 2: Pp. vi, 294. ISBN 0–262–02401–0.

[1] Students of international trade theory know that there is actually a theoretical caveat to this statement: large countries have an incentive to limit imports—and exports—to improve their terms of trade, even if it is in their collective interest to refrain from doing so. This "optimal tariff" argument, however, plays almost no role in real-world disputes over trade policy.

environment, and taxation is either the logical next step in global trade negotiations or a dangerous overstepping of boundaries that threatens to undermine all the progress we have made so far.

In 1992 Columbia's Jagdish Bhagwati (one of the world's leading international trade economists) and Robert E. Hudec (an experienced trade lawyer and former official now teaching at Minnesota) brought together an impressive group of legal and economic experts in a three-year research project intended to address the new demands for an enlarged scope of trade negotiations. *Fair Trade and Harmonization: Prerequisites for Free Trade?* is the result of that project. This massive two-volume collection of papers is unavoidably a bit repetitious. One also wonders why only economists and lawyers were involved—what happened to the political scientists? (More on that later.) But the volumes contain a number of first-rate papers and offer a valuable overview of the debate. In this essay, I will not try to offer a comprehensive review of the papers; in particular I will give short shrift to those on competition and tax policy. Nor will I try to deal with the quite different question of how much coordination of technical standards (e.g., health regulations on food—remember the Eurosausage!), or safety regulations on consumer durables—is essential if countries are to achieve "deep integration." Instead, I will try to sort through what seem to be the main issues raised by new demands for international labor and environmental standards.

I. *The Economics and Politics of Free Trade*

In a way, the most interesting paper in the Bhagwati-Hudec volumes is interesting precisely because the author seems not to understand the logic of the economic case for free trade—and in his incomprehension reveals the dilemmas that practical free traders face. Brian Alexander Langille, a Canadian lawyer, points out correctly that domestic policies such as subsidies and regulations may influence a country's international trade just as surely as explicit trade policies such as tariffs and import quotas. Why then, he asks, should trade negotiations stop with policies explicitly applied at the border? He seems to view this as a deep problem with economic theory, referring repeatedly to the "rabbit hole" into which free traders have fallen.

But the problem free traders face is not that their theory has dropped them into Wonderland, but that political pragmatism requires them to imagine themselves on the wrong side of the looking glass. There is no inconsistency or ambiguity in the economic case for free trade; but policy-oriented economists must deal with a world that does not understand or accept that case. Anyone who has tried to make sense of international trade negotiations eventually realizes that they can only be understood by realizing that they are a game scored according to mercantilist rules, in which an increase in exports—no matter how expensive to produce in terms of other opportunities foregone—is a victory, and an increase in imports—no matter how many resources it releases for other uses—is a defeat. The implicit mercantilist theory that underlies trade negotiations does not make sense on any level, indeed is inconsistent with simple adding-up constraints; but it nonetheless governs actual policy. The economist who wants to influence that policy, as opposed to merely jeering at its foolishness, must not forget that the economic theory underlying trade negotiations is nonsense—but he must also be willing to think as the negotiators think, accepting for the sake of argument their view of the world.

What Langille fails to understand, then, is that serious free-traders have never accepted as valid economics the demand that our trade liberalization be matched by comparable market-opening abroad; and so they are not being inconsistent in rejecting demands for an extension of such reciprocity to domestic standards. If economists are sometimes indulgent toward the mercantilist language of trade negotiations, it is not because they have accepted its intellectual legitimacy but either because they have grown weary of saying the obvious or because they have found that in practice this particular set of bad ideas has led to pretty good results.

One way to answer the demand for harmonization of standards, then, is to go back to basics. The fundamental logic of free trade can be stated a number of different ways, but one particularly useful version—the one that James Mill stated even before Ricardo—is to say that international trade is really just a production technique, a way to produce importables indirectly by first producing exportables, then exchanging them. There will be gains to be had from this technique as long as world relative prices differ from domestic opportunity costs—regardless of the source of that difference. That is, it does not matter from the point of view of the national gains from trade whether other countries have different relative prices because they have different resources, different technologies, different tastes, different labor laws, or different environmental standards. All that matters is that they be different—then we can gain from trading with them.

This way of looking at things, among its other virtues, offers an en passant refutation of the instinctive feeling of most non-economists that a country that imposes strong environmental or labor standards will necessarily experience difficulties when it trades with other countries that are not equally high-minded. The point is that all that matters for the gains from trade are the prices at which you trade—it makes absolutely no difference what forces lie behind those prices. Suppose your country has been cheerfully exporting airplanes and importing clothing in return, believing that the comparative advantage of your trading partners in clothing is "fairly" earned through exceptional productive efficiency. Then one day an investigative journalist, hot in pursuit of Kathy Lee Gifford, reveals that the clothing is actually produced in 60-cent-an-hour sweatshops that foul the local air and water. (If they hurt the global environment, say by damaging the ozone layer, that is another matter—but that is not the issue.) You may be outraged; but the beneficial trade you thought you had yesterday has not become any less economically beneficial to your country now that you know that it is based on these objectionable practices. Perhaps you want to impose your standards on these matters, but this has nothing to do with trade per se—and there are worse things in the world than low wages and local pollution to excite our moral indignation.

This back-to-basics case for rejecting calls for harmonization of standards is elaborated in two of the papers in Volume 1 of Bhagwati-Hudec: a discussion of environmental standards by Bhagwati and T. N. Srinivasan, and a discussion of labor standards by Drusilla Brown, Alan Deardorff, and Robert Stern. In each case the central theme is that neither the ability of a country to impose such standards nor its benefits from so doing depend in any important way on whether other countries do the same; so why not leave countries free to choose?

Bhagwati and Srinivasan also raise two other arguments on behalf of a laissez-faire approach to standards, arguments echoed by several other authors in the volume. The first is that nations may legitimately have different ideas about what is a reasonable standard. (The authors quote one environmentalist who asserts that "geopolitical boundaries should not override the word of God who directed Noah" to preserve all species, then drily note that "as two Hindus . . . we find this moral argument culture-specific" pp. 182.) Moreover, even nations that share the same values will typically choose different standards if they have different incomes: advanced-country standards for environmental quality and labor relations may look like expensive luxuries to a very poor nation.

Second, to the extent that nations for whatever reason choose different environmental standards, this difference, like any difference in preferences, actually offers not a reason to shun international trade but an extra opportunity to gain from such trade. It is very difficult to be more explicit about this without being misrepresented as an enemy of the environment—an excerpt from the entirely sensible memo along these lines that Lawrence Summers signed but did not write at the World Bank a few years ago is reprinted in my copy of *The 776 Stupidest Things Ever Said*—so it is left as an exercise for readers.

The back-to-basics argument against harmonization of standards, then, is completely consistent and persuasive. And yet it is also somehow unsatisfying. Perhaps the problem is that we know all too well how little success economists have had in convincing policy makers of the case for unilateral free trade. Why, then, should we imagine that restating that case yet again will be an effective argument against the advocates of international harmonization of standards?

Confronted with the failure of the public to buy the classical case for free trade, and unwilling simply to preach the truth to each other, trade economists have traditionally followed one of two paths. Some try to give the skeptics the benefit of the doubt, attempting to find coherent models that make sense of their concerns. Others try to make sense not of the skeptics' ideas but their motives, attempting to seek guidance from models of political economy. The same two paths are followed in these volumes, with several papers following each approach.

II. *Second-best Considerations and the "Race to the Bottom"*

The general theory of the second best tells us that if incentives are distorted in some markets, and for some reason these distortions cannot be directly addressed, policies in other markets should in principle take the distortions into account. For example, environmental economists have become sensitized to the likely interactions between pollution fees—designed to correct one distortion of incentives—with other taxes, which have nothing to do with environmental issues but which, because they distort incentives to work, save, and invest may crucially affect the welfare evaluation of any given environmental policy.

There is a long history of protectionist arguments along second-best lines. (Among Bhagwati's seminal contributions to international trade theory was, in fact, his work showing that many critiques of free trade are really second-best arguments—and that the first-best response rarely involves protection.) Here's an easy one: suppose that an industry generates negative environmental externalities that are not properly priced, and that international trade leads to an expansion of that industry in your country. Then that trade may indeed reduce national welfare (although of course trade may equally well have the opposite effect: it may cause your country to move out of "dirty" into "clean" industries, and thereby lead to large welfare gains).

However, the advocates of international environmental and labor standards seem to be offering a more subtle argument. They seem to be claiming that an environmental (or labor) policy that would raise welfare in a closed economy—or that would raise world welfare if implemented by all countries simultaneously—will reduce national welfare if implemented unilaterally. Thus the independent actions of national governments in the absence of international standards on these issues can lead to a "race to the bottom," with global standards far too lax.

What sort of model might justify this fear? In an extremely clear paper in Volume 1, John D. Wilson gives the issue his (second) best shot, showing that international competition for capital—in a world in which the social return to capital exceeds its private return, for example due to capital taxation—could do the trick. Other things being the same, tighter environmental or labor regulation will presumably decrease the rate of return on investments, and thus any country which has a pre-existing tendency to attract too little capital will have an incentive to avoid such regulations; whereas a collective, international decision to impose higher standards would not lead to capital flight, because the capital would have nowhere to go.

Is this a clinching argument? Not necessarily. For one thing, like all second-best arguments it is very sensitive to tweaking of its assumptions. As Wilson points out, capital importation may have adverse as well as positive effects, especially from the point of view of an environment-conscious country. In that case a positive rate of taxation is appropriate—and if the actual rate of taxation is too low, countries may adopt excessively strong environmental standards in a "race to the top." If this seems implausible, Wilson reminds us of the NIMBY (not in my backyard) phenomenon in which no local jurisdiction is willing to be the site for facilities the public collectively needs to locate *somewhere*.

Even if you regard a race to the bottom as more likely than one to the top, there is still the question of whether such second-best arguments are really very important. This is doubtful, especially where environmental standards are concerned. The alleged impact of such standards on firms' location decisions looms large in the demands of activists who want these standards harmonized. But the chapter by Arik Levinson, surveying the evidence, finds little reason to think that international differences in these standards actually have much effect on the global allocation of capital.

So while it is possible to devise second-best models that offer some justification for demands for harmonization of standards, these models—on the evidence of this collection, at any rate—do not seem particularly convincing. The classical case for laissez-faire on national economic policies is surely not precisely right, but it does not seem wrong enough to warrant the heat now being generated over the issue of harmonization.

Simply pointing this out, however, while important, does not make the phenomenon go away. So it is at least equally important to try to understand the political impulse behind demands for harmonization, and in particular to ask whether the political economy of standard-setting offers some indirect rationale for insisting on harmonization of such standards.

III. *The Political Economy of Standards*

Consider—as Brown, Deardorff, and Stern do—a single industry, small enough to be analyzed using partial equilibrium, in which a country is considering imposing a new environmental or labor regulation that will raise production costs. As they point out, if the costs of the regulation are less than the social costs imposed by the industry in its absence, then it is worth doing regardless of whether other countries follow suit. But the distribution of gains between producers and consumers does depend on whether the action is unilateral or coordinated. If one country imposes a costly regulation while others do not, the world price will remain unchanged and all of the burden will fall on producers; if many countries impose the regulation, world prices will rise and some of the burden will be shifted to consumers.

So what? Well, it is a fact of life, presumably rooted in the public-goods character of political action, that trade policy tends to place a much higher weight on producers than on consumers. So even though the national welfare case for the regulation is not weakened at all by the fact that the good is traded, the practical political calculus of getting the regulation implemented could quite possibly depend on whether other countries agree to do the same.

This suggests an alternative version of the "race to the bottom" story. The problem, one might argue, is not that *countries* have an incentive to set standards too low in a trading world. Rather, it is that *politicians*, who respond to the demands of special-interest groups, have such an incentive. And one might argue that this failure of the political market, rather than distortions in goods or factor markets, is what justifies demands for international harmonization of standards.

An environmentalist or defender of workers' rights might also make a related argument. He or she might say "You know that countries aren't in a zero-sum competition, and I know that they aren't, but the public and the politicians think they are—and industry lobbies consistently use that misconception as an argument against standards that we ought to have. So we need to set those standards internationally in order to neutralize that bogus but effective political ploy."

It is very difficult for trade economists to reject this line of argument on principle. After all, it is very close to the reason why free-traders who know that the economic case for liberal trade is essentially unilateral are nonetheless usually staunch defenders of the GATT: trade negotiations may be based on a false theory, but by setting exporters as counterweights to producers facing import competition they nonetheless are politically crucial to maintaining more or less free trade. That is, the true purpose of international negotiations is arguably not to protect us from unfair foreign competition, but to protect us from ourselves. (When the United States recently imposed utterly indefensible restrictions on Mexican tomato exports, an Administration official remarked off the record that Florida has a lot of electoral votes while Mexico has none. The economically correct rebuttal to this sort of thing is to point out that the other 49 states contain a lot of pizza lovers; the politically effective answer is to subject U.S.-Mexican trade to a set of rules and arbitration procedures in which the Mexicans do too have a vote.)

While one cannot dismiss such political-economy arguments as foolish, however, the problem is to know where to stop. Here is where it would have been useful to hear from some political scientists, who might be able to tell us more about when international negotiations over standards are likely to improve domestic policies, and when they are likely simply to serve as a cover for protectionist motives. But while I would have liked to see an analysis from that point of view, much of the legal analysis that occupies Volume 2 of the Bhagwati-Hudec books does shed light on the problem.

IV. *Standards and the Rule of Law*

Economists pronounce on legal matters at their peril: law, even international trade law, is a discipline all its own, with a jargon just as impenetrable to us as ours is to them. Let me therefore tread cautiously in interpreting the arguments here.

As I understand it, the problem involved in defining the limits of free trade is not too different from that of defining the limits of free speech. Take it as a given that countries can do things that are perceived to be economically harmful to other countries—it does not necessarily matter whether this perception is correct. Which of these things can realistically be prohibited, and which should be tolerated? The answer is a matter of degree. The fellow at the next table who insists on talking loudly to his partner about marketing is annoying, but one cannot reasonably ask the law to do anything about him; the person who shouts "Fire" in a crowded theater is something else again. Where does one draw the line in international economic relations?

The prevailing principle of international law derives from the seventeenth century Treaty of Westphalia, which ended the Thirty Years' War by establishing the rule that states may do whatever they like (such as imposing the sovereign's religion) within their borders—only external relations are the proper concern of the international community. By this principle, labor law, or environmental policies that do not spill across borders, should be off limits.

Now in practice we do not always honor the principle of the hard-shell Westphalian state. We are sometimes willing to impose sanctions or even invade to protect human rights. Even in trade negotiations, it is an understood principle that if a country de facto undoes its trade concessions with domestic policies—for example, offsetting a tariff cut with an equal production subsidy—it is considered to have failed to honor its agreement. But while borders are fuzzier in legal practice than they are on a map, the structure of trade negotiations is still basically Westphalian.

The demand for harmonization of standards is, in effect, a demand that this should change. We have seen that the strictly economic case for that demand is fairly weak, but there may be a stronger case on grounds of political economy. But what do the legal experts say?

The general answer, as I understand it, is that they don't think it is a good idea. A lucid chapter by Frieder Rousseler grants that the political argument for harmonization has some force, but concludes that to give in to it would open up too wide a range of potential complaints, much the same as would happen if I were allowed to sue people whose words annoy rather than actually slander me. Other authors, such as Virginia Leary and Robert Hudec himself, seem to have a similar point of view, suggesting only that nations might want to enter into specific environmental and labor agreements that would then be enforced by the same institutions that enforce trade agreements. (One essay, however, a piece by Daniel Gifford and Mitsuo Matsushita on competition policy, seems more economistic than the economists: it argues that the international acceptability of competition policies should be judged on whether they seem likely, or at least motivated by the desire, to enhance efficiency.)

To an economist, at least, the legal case here seems fairly similar to the economic case for trade negotiations. We have a purist principle: unilateral free trade, the Westphalian state. We recognize based on experience that it is useful to compromise that principle a bit, so that we work with mercantilists rather than simply castigating them and allow a bit of international meddling in internal affairs. But while a bit of pragmatism is allowed, the principle remains there; and it is not a good idea to stray too far.

On the evidence of these volumes, then, the demand for harmonization is by and large ill-founded both in economics and in law; realistic political economy requires that we give it some credence, but not too much. Unfortunately, that will surely not make the issue go away. Expect many more, equally massive volumes to come.