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Commentary

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Drusilla Brown's paper has two key points. The first is that there is no role for labor standards under current World Trade Organization (WTO) rules. Brown's second point is that if enforcement of labor standards were brought into the WTO, the result would likely be weaker enforcement of trade rules and a reduction in welfare from the status quo.

Brown is correct that weak or nonexistent labor standards are not a violation of current WTO rules. This does not necessarily mean that labor-standards concerns cannot be addressed by the WTO, however. In an important and thought-provoking recent paper, Kyle Bagwell and Robert Staiger (1999) argue that changes in labor standards, if they have implications for trade flows, may be grounds for "non-violation" complaints under General Agreement on Tariffs and Trade (GATT) Article XXIII. These non-violation complaints are allowed when a change in a trading partner's policy offsets market access commitments previously made, even if the policy change is GATT-legal. Furthermore, they claim, non-violation complaints under Article XXIII offer a way of correcting the inefficiency that arises when governments have a legitimate interest in the effects of labor standards, but are restricted to bargaining only over trade instruments.

Bagwell and Staiger recognize that governments may care about the standards of their trading partners: foreign standards are an externality, either *pecuniary* (having an effect on the terms of trade) or *non-pecuniary*. An example of a pecuniary effect is the cost advantage gained by a low or nonexistent minimum wage, which will improve the terms of trade of the country with the weak standard. A non-pecuniary externality is the effect of cross-border pollution, which directly affects welfare in the receiving country even if there is no terms of trade impact. Bagwell and Staiger argue that many pecuniary externalities can be handled under improved implementation of current WTO rules, and others can be handled by reasonable extensions of current rules.

In the Bagwell-Staiger model, governments care about local standards, local prices, and the terms of trade—they don't care directly about foreign standards. The policy instruments available are standards and tariffs. Nash bargaining between governments in tariffs and standards choices is inefficient, and GATT negotiations over tariffs alone only partially correct this inefficiency. With tariffs constrained by GATT bindings, governments will have an incentive to choose standards to manipulate the terms of trade. The equilibrium standards choice is distorted, and a "race to the bottom" is possible.

Bagwell and Staiger's proposed solution to this inefficiency is to have governments bargain over market access levels, and then choose their two instruments (standards and tariffs) optimally to deliver that access. The resulting tariffs may be higher than they otherwise would be, but as long as market access is maintained, the freedom to set standards and tariffs together will deliver an efficiency gain over the case when governments bargain only over tariffs. For example, suppose that a developing country abolishes its minimum wage, flooding the United States with cheap, labor-intensive imports. Under the Bagwell-Staiger proposal, the United States could demand compensation in the form of higher tariffs to restore the value of the status quo market access. This is efficient because the foreign country is better off (they have chosen their standards optimally), while the United States is no worse off (its terms of trade are restored to the status quo by the compensating tariff).

As ingenious as this interpretation is, it only solves half the externality: What if the home country changes a labor standard that *benefits* its trading partner (for example, an increase in the minimum wage, which leads to higher imports)? There is no mechanism for compensating the home country for this market access gift, so the home country will distort its standards choice, and the potential for a "race to the bottom" reappears. Bagwell-Staiger offers the following proposal to correct this inefficiency: Allow the home country to raise its tariffs to compensate for the improved market-access effect of changing standards. As discussed above, this is efficient because the foreign country is no worse off, while the home country is better off by choosing its standards optimally.

Of course, practical problems with the Bagwell-Staiger proposal abound. Is it realistic to suppose that the dispute settlement procedures can handle claims of trade-affecting standards changes? The proposal also offers no solution to non-pecuniary externalities (such as cross-border pollution, genuine concern over child labor, etc.). But in the wake of the Seattle debacle, it may not be wise for free-traders to dismiss well-grounded proposals to bring standards into the WTO.

Returning to Brown's paper, she argues that bringing standards enforcement into the WTO could distract the WTO from its primary mission of liberalization, and that principal-agent considerations might lead to lower welfare than the status quo. This insight seems correct and potentially important. But Brown's model looks at only half of the game: She takes equilibrium tariff and standards choices as given, and does not analyze how governments will choose their policy instruments under different potential arrangements for the WTO. As a result, her conclusions about welfare and equilibrium punishments cannot be regarded as reliable. An extended model, which incorporated the decisions of governments in a context where principal-agent problems are important, would seem to be required to answer the questions in which she is interested.

REFERENCE

Bagwell, Kyle, and Robert Staiger. "Domestic Policies, National Sovereignty, and International Economic Institutions," National Bureau of Economic Research Working Paper 7293, August 1999.