

**The WTO's Agenda: Environment and Labour
Standards, Competition Policy and
the Question of Regionalism**

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Competition Policy and the Question of Regionalism***

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It is now manifest that the WTO, the successor to the GATT, will have a new agenda whose outlines are already clear.¹ Among the principal issues will be:

- *trade and the environment;
- *trade and labour standards; and
- *competition policy

While these issues are “universal”, and cut across all nations, the precise nature of the demands for change in the WTO they have generated and the solutions which the new leadership of the WTO, yet undecided, must shape, cannot be understood without realizing that, in essence, the environmental and labour standards issues are being driven by concerns that create a North-South divide, using these appellations simply to describe the developed and developing countries, whereas competition policy has emerged as an issue because primarily of North-North concerns.

The WTO must now confront the phenomenon of a proliferation of preferential trading arrangements, regional and non-regional Free Trade Areas, that characterize the world trading scene. It must seek a new equilibrium between the WTO and these arrangements, the former embodying nondiscrimination among trading nations while the latter are inherently preferential and discriminatory. This is not an issue that member nations are eager to put before the WTO any time. Yet it speaks to the very core of a free, open, multilateral trading system, as envisaged at the end of the Second World War and as, in fact, sought by many of us today; and the new leadership of the WTO must address it on its own initiative.

¹ In addition to the new agenda, the WTO can expect to be long occupied with the task of implementing the Uruguay Round accords.

II. The WTO: The Main Agenda

Permit me to begin with the phenomenon of the increased trade and investment flows, and the opportunities from it that characterise the world economy and the problems that it is feared to pose to trading nations.

Economists are generally likely to see the increasingly interdependent world, with its growing exchange of goods and services and flows of funds to where the returns are expected to be higher, as one that is gaining in prosperity as it is exploiting the opportunities to trade and to invest that have been provided by the postwar dismantling of trade barriers and obstacles to investment flows. This is the conventional "mutual-gain" or "non-zero-sum game" view of the situation. I would argue that it is also the appropriate one.

1. An Ironic Reversal

It is also a view that many developing countries that were skeptical about, even hostile to, this benign-impact view of the interaction between themselves and the world economy at the beginning of the postwar period, and indeed through much of it, have now embraced. But I must point to an irony: where the developing countries (the South) were skeptical of the benign-impact view and the developed countries (the North) were confident of it, today the situation is the other way around.

(i) The Earlier Situation: Thus, if you look back at the 1950s and 1960s, the contrast between the developing countries (the South) and the developed countries (the North) was striking and made the South strongly pessimistic about the effects of integration into the world economy while the North was firmly optimistic instead:

* The South generally subscribed, not to the liberal, mutual-gain, benign-impact view, but to malign-neglect and even malign-intent views of trade and investment interactions with the world economy.² It was feared that “integration into the world economy would lead to disintegration of the domestic economy”. While the malign-neglect view is manifest most clearly in the famous dependencia theory that President-elect Cardoso of Brazil formulated in his radical youth as Latin America’s foremost sociologist, the malign-impact view was most vividly embodied in the the concept and theory of neocolonialism.

Trade thus had to be protected; investment inflows had to be drastically regulated and curtailed.³ The inward-oriented, import-substituting (IS) strategy was the order of the day almost everywhere. Only the Far Eastern economies, starting mainly in the early 1960s, shifted dramatically to an outward-oriented policy posture: the results, attributable principally to this contrast in orientation to the world economy but partly also to initial advantages such as inherited land reforms and high literacy rates, were to produce the most remarkable growth experiences of this century (and, as I shall presently argue, to facilitate by example the reversal of the inward-looking policies in recent years). But, at the time, the developing countries were certainly in an inward, cautious mode about embracing the world economy.

* By contrast, the developed countries, the North⁴, moved steadily forward with dismantling trade barriers through the GATT Rounds, with firm

² These different economic-philosophical positions are discussed in depth in Jagdish Bhagwati (ed.), The New International Economic Order: The North-South Debate, Cambridge: MIT Press, 1977, Chapter 1.

³ This attitude extended to other areas too: the outward flow of skilled manpower was thus considered a “brain drain” rather than an opportunity for one’s citizens to train and work abroad that would lead to a beneficial impact as this diaspora expanded.

⁴ They were called the West, of course, then. The changing nomenclature of the poor and rich countries reflects a shift from a historical, cultural and imperial divide into East and West to a contemporary, post-colonial and development-related divide into South and North.

commitment to multilateralism as well, subscribing essentially to the principles of multilateral free trade and of freer investment flows as the central guiding principles for a liberal international economic order that would assure economic prosperity for all participating nations.⁵

(ii) Role Reversal: The Turnaround: Today, however, the situation is almost reversed. The fears of integration into the world economy are being heard, not from the developing countries which see great good from it as they have extensively undertaken what the GATT calls “autonomous” reductions in their trade barriers, i.e. unilateral reductions outside the GATT context of reciprocal reductions. Of course, not all these reductions, and increased openness to inward DFI, have resulted from changed convictions in favour of the liberal international economic order and its benefits to oneself, though the failure of policies based on the old pro-inward-orientation views and the contrasting success of the Far Eastern countries following the pro-outward-orientation views have certainly played an important role, especially in Latin America and Asia. But some measure of the shift must also be ascribed to necessity resulting from the conditionality imposed by the World Bank and, at times, by the IMF, as several debt-crisis-afflicted countries flocked to these institutions for support in the 1980s, and equally from their own perceived need to restore their external viability by liberal domestic and international policies designed to reassure and attract DFI.

But if the South has moved to regard integration into the world economy as an opportunity rather than a peril, it is the North that is now fearful. In particular, the fear has grown, after the experience with the decline in the real

⁵ See, for example, Jagdish Bhagwati, Protectionism, Bertil Ohlin Lectures, Cambridge: MIT Press, 1988, on the question of free trade, and The World Trading System at Risk, Harry Johnson Lecture, Princeton: Princeton University Press, 1991 on the issue of multilateralism.

wages of the unskilled in the United States and with their employment in Europe in the 1970s and 1980s, that by trading with the South with its abundance of unskilled labour, the North will find its own unskilled at risk.⁶ The demand for protection that follows is then not the old and defunct "pauper-labour" argument which asserted falsely that trade between the South and the North could not be beneficial. Rather, it is the theoretically more defensible, income-distributional argument that trade with countries with paupers will produce paupers in our midst, that trade with the poor countries will produce more poor at home.

Now, it is indeed true that the real wages of the unskilled have fallen significantly in the United States during the previous two decades. In 1973, the "real hourly earnings of non-supervisory workers measured in 1982 dollars ...were \$8.55. By 1992 they had actually declined to \$7.43 --- a level that had been achieved in the late 1960s. Had earnings increased at their earlier pace, they would have risen by 40 percent to over \$12."⁷ The experience in Europe has generally been similar in spirit, with the more "inflexible" labour markets implying that the adverse impact has been on jobs rather than on real wages.⁸

But the key question is whether the cause of this phenomenon is trade with the South, as unions and many politicians feel, or rapid modern information-based technical change that is increasingly substituting unskilled labour with computers that need skilled rather than unskilled labour. As always, there is debate among economists about the evidence: but the

⁶ The evidence in support of this phenomenon in the 1980s, both for the United States and for several other countries, is reviewed and synthesized nicely by Marvin Kosters in Chapter 1 of Jagdish Bhagwati and Marvin Kosters (eds.), Trade and Wages: Leveling Wages Down?, Washington D.C.: American Enterprise Institute, 1994.

⁷ Cf. Robert Lawrence, "Trade, Multinationals, & Labor", Cambridge: National Bureau of Economic Research, Working Paper No. 4836, August 1994.

⁸ See Employment Outlook, Paris: OECD, July 1993.

preponderant view today among the trade experts is that the evidence for linking trade with the South to the observed distress among the unskilled to date is extremely thin, at best. In fact, the main study by labour experts that first suggested otherwise has been shown to be methodologically unsound in not appreciating that if real wages were to fall for unskilled labour due to trade with the South, the goods prices of the unskilled-labour-intensive goods would have to have fallen;⁹ and subsequent examination of the US data on prices of goods shows that the opposite happened to be true!^{10 11}

While therefore the consensus currently is that technical change, not trade with the South, has immiserized our proletariat, the fear still persists that such trade is a threat to the unskilled. In Europe, there has thus been talk of the difficulty of competing with "Asiatic ants"; such talk leads to talk of protectionism, in turn.

Alongside with this is the fear that multinationals will move out to take advantage of the cheaper labour in the poor countries, as trade becomes freer, thus adding to the pressure that trade alone, with each nation's capital at home,

⁹ See Jagdish Bhagwati, "Free Traders and Free Immigrationists: Strangers or Friends?", New York: Russell Sage Foundation, Working Paper No. 20, 1991.

¹⁰ This empirical work by Robert Lawrence and Matthew Slaughter is reviewed in Jagdish Bhagwati and Vivek Dehejia, "Freer Trade and Wages of the Unskilled --- Is Marx Striking Again?", in Bhagwati and Kesters, op.cit. A subsequent empirical study by Jeffrey Sachs and Howard Schatz, "Trade and Jobs in US Manufacturing" in Brookings Papers, 1994, claims to overturn the Lawrence-Slaughter findings by taking out computers (a procedure that is debatable at best). Even then the coefficient with the changed sign is both small and statistically insignificant. So, while Noam Chomsky has educated us that two negatives add up to a positive in every language, it is wrong to claim that the two negatives of a statistically insignificant and small parameter of the required sign add up to a positive support for the thesis that trade has been depressing the real wages of the unskilled!

¹¹ The work of Adrian Wood, North-South Trade, Employment and Inequality, Oxford: Clarendon Press, 1994, argues in support of the trade-hurting-real-wages-of-the-unskilled thesis but his arguments have been effectively criticized by Lawrence, op.cit., 1994. See also the most recent review of the theory and evidence in Jagdish Bhagwati, "Trade and Wages: Choosing Among Alternative Explanations", Federal Reserve Bank of New York Economic Policy Review, January 1995.

brings on the real wages of the unskilled. Of course, this too is unsubstantiated fear: but it has even greater political salience since the loss of jobs to trade is less easily focused on specific competing countries and their characteristics than when a factory shuts down and opens in a foreign country instead. As it happens, I suspect that, at least in the United States, the flow of capital also is in the wrong direction from the viewpoint of those who are gripped by such fear. For, during the 1980s, the United States surely received more DFI than it sent out elsewhere, both absolutely and relative to the 1950s and 1960s. Besides, if foreign savings are considered instead, the 1980s saw an influx, corresponding to the current account deficit that has bedevilled US-Japan trade relations for sure.

2. North-South Issues¹² :

These fears have intensified acutely, bringing to center stage the demands that have spread in the US and in Europe for inclusion of Environmental and Labour Standards in the WTO, requiring that either they be moved up in the developing countries or else the developed countries should be allowed to countervail the "implied subsidy" represented by these lower

¹² While I distinguish among "North-South" and "North-North" issues here, let me stress again that these descriptions are only broadly true, and reflect the principal historical origins of the issues; the issues are universal and now cut across nations in both groups. Thus, for example, the demands of eco-dumping duties (which I discuss below) have the potential of creating frictions among the OECD countries, and not just between them and the countries of the South. Nor should my use of these short-hand labels lead the audience to conclude that there are coalitions of the North and of the South to that effect on the issues being discussed. In fact, I was among the first to discount the enduring effectiveness of a coalition of the South when, in the flush of the OPEC success, the so-called Global Negotiations were demanded by the G-77 countries at the United Nations: the developing countries got nowhere on these demands. Indeed, they have been substantially fragmented politically since then, as discussed by me in "Dependence and Interdependence: Developing Countries in the World Economy", Ernest Sturc Memorial Lecture, Johns Hopkins University, SAIS, Washington D.C., 1987; reprinted in Jagdish Bhagwati, Political Economy and International Economics, edited by Douglas Irwin, MIT Press: Cambridge, Mass., 1991.

standards. Proposals for such legislation have already been introduced in the US Congress, as in Congressman Gephardt's so-called "blue" and "green" bill which would authorize the administration to impose "eco-dumping" duties against lower Environmental (i.e. *green*) standards abroad and "social dumping" duties against lower Labour (i.e. *blue-collar workers*') standards abroad.

Several factors contribute to the emergence of these demands. But a principal one among them surely is the desire to raise, in one way or another, the costs of production of your rivals abroad: and what is more easy to do than to say that they are deriving unfair trade advantage by having lower Environmental and Labour standards? In fact, it is surely easier to get a sympathetic ear of the politicians if the appeal to them for assistance in shape of protection or otherwise is couched in terms of, not a simple appeal that one cannot cope otherwise and wants relief, but the contention instead that one's distress is the result of one's rivals' perfidious, unfair ways.

(i) Environmental Standards: Why indeed should one object to differences in different nations' environmental standards in the same industry (what I call Cross-country Intra-industry, CCII, differences in standards, typically in shape of pollution tax rates) ? Note that we are talking here about purely domestic environmental problems: e.g. a country is polluting its own lakes, not about the environmental problems that arise when one's pollution creates transborder externalities, as with global warming, ozone layer depletion, and acid rain (which raise problems about the WTO of a different, and more compelling, nature).

(a) Indefensible Demands for Eco-dumping: In fact, for an economist, the basic presumption instead is that different countries, even if they accept the

same “polluter pay principle”, will have legitimate diversity of CCII environmental taxes/standards for Environmental problems which create purely domestic pollution.

This diversity will follow from differences in tradeoffs between aggregate pollution and income at different levels of income, as when richer Americans prefer to save dolphins from purse-seine nets whereas poorer Mexicans prefer to put people first and want to raise the productivity of fishing and hence accelerate the amelioration of Mexican poverty by using such nets. Again, countries will have natural differences in the priorities attached to which kind of pollution to attack, arising from differences of historical and other circumstance: Mexicans will want to worry more about clean water, as dysentery is a greater problem, than Americans who will want to attach greater priority to spending pollution dollars on clean air. Differences in technological knowhow and in endowments can also lead to CCII diversity in pollution tax rates.

The notion therefore that the diversity of CCII pollution standards/taxes is illegitimate and constitutes “unfair trade” or “unfair competition”, to be eliminated or countervailed by eco-dumping duties, is itself illegitimate. It is incorrect, indeed illogical, to assert that competing with foreign firms that do not bear equal pollution-tax burdens is unfair. I would add two more observations:

* We should recognize that if we lose competitive advantage because we put a larger negative value on a certain kind of pollution whereas others do not is simply the flip side of the differential valuations. To object to that implication of the differential valuation is to object to the differential valuation itself, and hence to our own larger negative valuation. To see this clearly, think only of a closed economy without trade. If we were to tax pollution by an industry in such an economy, its implication would be precisely that this industry

would shrink: it would lose competitive advantage vis-a-vis other industries in our own country. To object to that shrinking is to object to the negative valuation being put on the pollution. There is therefore nothing "unfair" from this perspective, if our industry shrinks because we impose Higher Standards (i.e. pollution taxes) on our industry while others, who value that pollution less, choose Lower Standards (i.e. pollution taxes).

* Besides, it is worth noting that that the attribution of competitive disadvantage to differential pollution tax burdens in the fashion of CCII comparisons for individual industries confuses absolute with comparative advantage. Thus, for instance, in a two-industry world, if both industries abroad have lower pollution tax rates than at home, both will not contract at home. Rather, the industry with the comparatively higher tax rate will. The noise that each industry makes on basis of CCII comparisons, aggregated to total noise by all industries, is then likely to exaggerate seriously the effect of different environmental valuations and CCII differences on the competitiveness of industries in Higher-Standards nations.

But one more worry needs to be laid at rest if the demands for upward harmonization of standards or eco-dumping duties in lieu thereof are to be effectively dismissed. This is the worry that free trade with countries with Lower Standards will force down one's Higher Standards. The most potent of these worries arises from the fear that "capital and jobs" will move to countries with Lower Standards, triggering a race to the bottom (or more accurately a race towards the bottom), where countries lower their standards in an inter-jurisdictional contest, below what some or all would like, in order to attract

capital and jobs.¹³ So, the solution would lie then in coordinating the standards-setting among the nations engaged in freer trade and investment. In turn, this may (but is most unlikely to) require harmonization among countries to the Higher Standards (though, even then, not necessarily at those in place) or perhaps there might be improvement in welfare from simply setting minimum floors to the standards.

This is undoubtedly a theoretically valid argument. The key question for policy, however, is whether the empirical evidence shows, as required by the argument, that: (1) capital is in fact responsive to the differences in environmental standards and (2) different countries/jurisdictions actually play the game then of competitive lowering of standards to attract capital. Without both these phenomena holding in a significant fashion in reality, the "race to the bottom" would be a theoretical curiosity.

As it happens, systematic evidence is available for the former proposition alone, but the finding is that the proposition is not supported by the studies to date: there is very weak evidence, at best, in favour of interjurisdictional mobility in response to CCI differences in environmental standards.¹⁴ There are in fact many ways to explain this lack of responsiveness: (1) the differences in standards may not be significant and are outweighed by other factors that affect locational decisions; (2) exploiting differences in standards may not be a good

¹³ John Wilson, in "Capital Mobility and Environmental Standards: Is There a Theoretical Basis for a Race to the Bottom?", mimeo., September 1994, a paper prepared for the Ford Foundation and American Society for International Law project directed by Jagdish Bhagwati and Robert Hudec, demonstrates that there can even be a "race to the top". This possibility is disregarded in the analysis above, as in the public discourse.

¹⁴ The evidence has been systematically reviewed and assessed recently by Arik Levinson, "Environmental Regulations and Industry Location: International and Domestic Evidence", mimeo., September 1994, University of Wisconsin; forthcoming in the 2-volume set of papers on Harmonization and Fair Trade: Prerequisites for Free Trade?, edited by Jagdish Bhagwati and Robert Hudec, 1995, from a research project on the subject, financed by Ford Foundation under the auspices of the American Society of International Law.

strategy relative to not exploiting them; and (3) lower standards may paradoxically even repel, instead of attracting, DFI.¹⁵

While we do not have similar evidence on the latter proposition, it is hardly likely that, as a systematic tendency, countries would be actually lowering Environmental standards in order to attract capital. As it happens, countries, and even state governments in federal countries (e.g. President Bill Clinton, when Governor of Arkansas), typically play the game of attracting capital to their jurisdictions: but this game is almost universally played, not by inviting firms to pollute freely but instead through tax breaks and holidays, land grants at throwaway prices etc., resulting most likely in a "race to the bottom" on business tax rates which wind up below their optimal levels! It is therefore not surprising that there is little systematic evidence of governments lowering Environmental standards in order to attract scarce capital. Contrary to the fears of the environmental groups, the race to the bottom on Environmental standards therefore seems to be an unlikely phenomenon in the real world.

I would then conclude that both the "unfair trade" and the "race to the bottom" arguments for harmonizing CCI standards or else legalizing eco-dumping duties at the WTO are therefore lacking in rationale: the former is theoretically illogical and the latter is empirically unsupported. In addition, such GATT-WTO-legalization of eco-dumping will facilitate protectionism without doubt. Anti-dumping processes have become the favoured tool of protectionists today. Is there any doubt that their extension to eco-dumping (and equally to social-dumping), where the "implied subsidy" through Lower standards must be inevitably "constructed" by national agencies such as the Environmental

¹⁵ These factors are analyzed in Jagdish Bhagwati and T.N.Srinivasan, "Trade and the Environment: Does Environmental Diversity Detract from the Case for Free Trade?", July 1994, appearing in Bhagwati and Hudec, ibid. Their analysis is based on Levinson, op.cit.

Protection Agency in the same jurisdiction as the complainant industry, will lead to the same results, even more surely?

The “fixing” of the WTO for environmental issues therefore should not proceed along the lines of legitimating eco-dumping.¹⁶ However, the political salience of such demands remains a major problem. One may well then ask: are there any “second-best” approaches, short of the eco-dumping and CCII harmonization proposals, that may address some of the political concerns at least economic cost?

(b) A Proposal to Extend Domestic Standards in High Standards Countries to their Firms in Low Standards Countries, Unilaterally or Preferably through an OECD Code: The political salience of the harmful demands for eco-dumping duties and CCII harmonization is greatest when plants are closed by one’s own multinationals and shifted to other countries. The actual shifting of location, and the associated loss of jobs in that plant, magnify greatly the fear of the “race to the bottom” and of the “impossibility” of competing against low standards countries. Similarly, when investment by one’s own firms is seen to go to specific countries which happen to have lower standards, the resentment gets to be focussed readily against those countries and their standards. However, when jobs are lost simply because of trade competition, it is much harder to locate one’s resentment and fear on one specific foreign country and

¹⁶There are other issues. One main class relates to the current GATT restrictions, as reflected in recent GATT Panel findings as in the two Dolphin-Tuna cases involving the United States , on “values”-inspired restrictions on imports of products using processes that are unacceptable, which will have to be clarified and will be the subject of new negotiations. My own views on the best solution to this class of problems, as also to the other main class of problems raised by environmentalists who fear that it is too easy for countries to challenge the Higher Standards which they have enacted in their own countries (an issue that was at the heart of the latest GATT Panel finding, mostly in US favour, in the EU-US case on differentially punitive US taxes and standards on higher-gasoline-useage cars) are developed at length in Bhagwati and Srinivasan, ibid.; unfortunately, I have no time to address them today.

its policies as a source of unfair competition.¹⁷ Hence, a second-best proposal could well be to address this particular fear, however unfounded and often illogical, of outmigration of plants and investment by one's firms abroad to low standard countries.

The proposal is to adapt the so-called Sullivan Principles approach to the problem at hand. Under Sullivan, US firms in South Africa were urged to adopt US practices, not the South African apartheid ways, in their operations. If this principle that the US firms in Mexico be subject to US environmental policies (choosing the desired ones from the many that obtain across different states in this federal country) were adopted by US legislation, that would automatically remove whatever incentive there was to move because of environmental burden differences.¹⁸

This proposal that one's firms abroad behave as if they were at home--do in Rome as you do in New York, not as Romans do--can be either legislated unilaterally by any High Standard country or by a multilateral binding Treaty among different High Standard countries. Again, it may be reduced to an exhortation, just as Sullivan Principles were, by single countries in isolation or by several as through a nonbinding but ethos-defining and policy-encouraging OECD Code.

The disadvantage of this proposal, of course, is that it does violate the diversity-is-legitimate rule (whose desirability was discussed by me). Investment flows, like investment of one's own funds and production and trade therefrom, should reflect this diversity. It reduces, therefore, the efficiency gains from a freer flow of cross-country investments today. But if environmental tax

¹⁷ This, of course, does not apply equally to trade in highly differentiated products like autos where one can get fixated on specific countries, e.g. Japan.

¹⁸ See Bhagwati, "American Rules, Mexican Jobs," The New York Times, March 24, 1993.

burden differences are not all that different, or do not figure prominently in firms' locational decisions, as the empirical literature (that I just cited) seems to stress, the efficiency costs of this proposal could also be minimal while the gains in allaying fears and therefore moderating the demand for bad proposals could be very large indeed.

Yet another objection may focus on intra-OECD differences in High Standards. Since there are differences among the OECD countries in CCII environmental tax burdens in specific industries for specific pollution, this Proposal would lead to "horizontal inequity" among the OECD firms in third countries. If the British burden is higher than the French, British firms would face a bigger burden in Mexico than the French firms. But then such differences already exist among firms abroad since tax practices among the OECD countries on taxation of firms abroad are not harmonized in many respects. Interestingly, the problem of horizontal equity has come up in relation also to the demands of the poor countries (that often find it difficult to enforce import restrictions effectively) that the domestic restrictions on hazardous products be automatically extended to exports by every country. That would put firms in the countries with greater restrictions at an economic disadvantage. But agreement has now been reached to disregard the problem.

Other problems may arise: (i) monitoring of one's firms in a foreign country may be difficult; and (ii) the countries with Lower Standards may object on grounds of "national sovereignty." Neither argument seems compelling. It is unlikely that a developing country would object to foreign firms doing better by its citizens in regard to environmental standards (that it itself cannot afford to impose, given its own priorities, on its own firms). Equally, it would then assist in monitoring the foreign firms.

(c) Transborder Externalities: Global Pollution and WTO: The preceding analysis considered the trade issues which arise between countries even when the Environmental problems are purely domestic in their scope. They can arise, of course, even when these problems involve transborder spillovers or externalities. However, the latter are generally more complex. Let me consider only the problems that arise when the problem is not just bilateral (as with, say acid rain, where the US and Canada were involved) or regional, but truly global.

The chief policy questions concerning trade policy when global pollution problems are involved instead, as with ozone layer depletion and global warming, relate to the cooperation-solution-oriented multilateral treaties that are sought to address them. They are essentially tied into noncompliance ("defection") by members and "free riding" by nonmembers. Because any action by a member of a treaty relates to targeted actions (such as reducing CFCs or CO₂ emissions) that are a public good (in particular, that the benefits are nonexcludable, so that if I incur the cost and do something, I cannot exclude you from benefiting from it), the use of trade sanctions to secure and enforce compliance automatically turns up on the agenda.

At the same time, the problem is compounded because the agreement itself has to be legitimate in the eyes of those accused of free riding. Before those pejorative epithets are applied and punishment prescribed in form of trade sanctions legitimated at the GATT/WTO, these nations have to be satisfied that the agreement being pressed on them is efficient and, especially, that it is equitable in burden-sharing. Otherwise, nothing prevents the politically powerful (i.e. the rich nations) from devising a treaty that puts an inequitable burden on the politically weak (i.e. the poor nations) and then using the cloak of

a “multilateral” agreement and a new GATT/WTO-legitimacy to impose that burden with the aid of trade sanctions with a clear conscience.

This is why the policy demand, often made, to alter the GATT/WTO to legitimate trade sanctions on Contracting Parties who remain outside of a treaty, whenever a plurilateral treaty on a global environmental problem dictates it, is unlikely to be accepted by the poor nations without safeguards to prevent unjust impositions. The spokesmen of the poor countries have been more or less explicit on this issue, with justification. These concerns have been recognized by the rich nations.

Thus, at the Rio Conference in 1992, the Framework Convention on Climate Change set explicit goals under which several rich nations agreed to emission level-reduction targets (returning, more or less, to 1990 levels), whereas the commitments of the poor countries were contingent on the rich nations footing the bill.

Ultimately, burden-sharing by different formulas related to past emissions, current income, current population etc. are inherently arbitrary; they also distribute burdens without regard to efficiency. Economists will argue for burden-sharing dictated by cost-minimization across countries, for the earth as a whole: if Brazilian rain forests must be saved to minimize the cost of a targeted reduction in CO₂ emissions in the world, while the US keeps guzzling gas because it is too expensive to cut that down, then so be it. But then this efficient “cooperative” solution must not leave Brazil footing the bill. Efficient solutions, with compensation and equitable distribution of the gains from the efficient solution, make economic sense.

A step towards them is the idea of having a market in permits at the world level: no country may emit CO₂ without having bought the necessary permit

from a worldwide quota. That would ensure efficiency¹⁹, whereas the distribution of the proceeds from the sold permits would require a decision reflecting some multilaterally-agreed ethical or equity criteria (e.g. the proceeds may be used for refugee resettlement, UN peacekeeping operations, aid dispensed to poor nations by UNDP, WHO fight against AIDS, etc.). This type of agreement would have the legitimacy that could then provide the legitimacy in turn for a GATT/WTO rule that permits the use of trade sanctions against free riders.

(ii) Labour Standards and the Social Clause

The question of labour standards, and making them into prerequisites for market access by introducing a Social Clause in the WTO, has both parallels and contrasts to the environmental questions that I just discussed.

The contrast is that labour standards have nothing equivalent to transborder environmental externalities. One's labour standards are purely domestic in scope: in that regard, the demands for "social dumping" for lower labour standards that parallel the demands for eco-dumping have the same rationale and hence must be rejected for the same reasons.

But a different aspect to the whole question results from the fact that labour standards, unlike most environmental standards, are seen in moral terms. Thus, for example, central to American thinking on the question of the Social Clause is the notion that competitive advantage can sometimes be morally "illegitimate". In particular, it is argued that if labour standards elsewhere are different and unacceptable morally, then the resulting

¹⁹ This efficiency is only in the sense of cost minimization. The number of permits may, however, be too small or too large, and getting it right by letting nonusers also bid (and then destroy permits) is bedeviled by free rider problems.

competition is morally illegitimate and “unfair”.

Now, when this argument is made about a practice such as slavery (defined strictly as the practice of owning and transacting in human beings, as for centuries before the Abolitionists triumphed), there will be nearly universal agreement that if slavery produces competitive advantage, that advantage is illegitimate and ought to be rejected.

Thus, we have here a “values”-related argument for suspending another country’s trading rights or access to our markets, in a sense similar to (but far more compelling than) the case when the United States sought to suspend Mexico’s tuna-trading rights because of its use of purse-seine nets.²⁰ The insertion of a Social Clause for Labour Standards into the WTO can then be seen as a way of legitimating an exception to the perfectly-sensible GATT rule that prohibits the suspension of a Contracting Party’s trading rights concerning a product simply on the ground that, for reasons of morality asserted by another Contracting Party, the process by which that product is produced is considered immoral and therefore illegitimate.

The real problem with the argument, however, is that universally-condemned practices such as slavery are rare indeed. True, the ILO has many Conventions that many nations have signed. But many have been signed simply because in effect they are not binding. Equally, the United States itself has signed no more than a tiny fraction of these conventions in any case. The question whether a substantive consensus on anything except wellmeaning and broad principles without consequences for trade access in case of noncompliance can be obtained is therefore highly dubious.

²⁰ I talk of the United States suspending Mexico’s trade rights since the GATT Panel in the Dolphin-Tuna case upheld these rights for Mexico. If it had not, I should be talking simply of the United States denying market access to Mexico.

Indeed, the reality is that diversity of labour practices and standards is widespread in practice and reflects, not necessarily venality and wickedness, but rather diversity of cultural values, economic conditions and analytical beliefs and theories concerning the economic (and therefore moral) consequences of specific labour standards. The notion that labour standards can be universalized, like human rights such as liberty and habeas corpus, simply by calling them "labour rights" ignores the fact that this easy equation between culture-specific labour standards and universal human rights will have a difficult time surviving deeper scrutiny.

Take the United States itself and one sees immediately that its easy presumption that its labour standards are "advanced" and that it is only providing "moral leadership" on the question vis-a-vis developing countries, is hard to sustain and that the US logic on the question can lead the US itself into a widespread and sustained suspension of its own trading rights if there was an impartial tribunal and standing to file complaints was given to concerned citizens and NGOs rather than to governments that would be intimidated by the power of the United States from taking it to court.

Thus, for instance, worker participation in decisionmaking on the plant, a measure of true economic democracy much more pertinent than the unionization of labour, is far more widespread in Europe than in North America: would we then condemn North America to denial of trading rights by the Europeans? Migrant labour is ill-treated to the level of brutality and slavery in US agriculture due to grossly inadequate and corrupt enforcement, if investigative television shows on CNN and CBS's 60 Minutes programme are a guide; does this mean that other nations should prohibit the import of US agricultural products? Sweatshops exploiting female immigrants in textiles with

long hours and below-minimum wages are endemic in the textile industry, as documented amply by several civil-liberties groups: should the right of the US to export textiles then not be suspended by other countries as much as the United States seeks to suspend the imports of textiles made by exploited child labour? Even the right to organize trade unions may be considered to be inadequate in the US if we go by "results", as the US favors in judging Japan: less than 15% of the US labour force in the private sector today is unionized. Indeed, it is no secret, except to those who prefer to think that labour standards are inadequate only in developing countries, that unions are actively discouraged in several ways in the United States. Strikes are also circumscribed. Indeed, in essential industries they are restricted: but the definition of such industries also reflects economic structure and political realities, making each country's definition only culture-specific and hence open to objection by others. Should other countries have then suspended US flights because President Reagan had broken the Air Traffic Controllers' strike?

Lest you think that the question of child labour is an easy one, let me remind you that even this raises complex questions as indeed recognized by the ILO, though not in many of the arguments heard in the United States today. The use of child labour, as such, is surely not the issue. Few children grow up even in the US without working as babysitters or delivering newspapers; many are even paid by parents for housework in the home. The pertinent social question, familiar to anyone with even a nodding acquaintance with Chadwick, Engels and Dickens and the appalling conditions afflicting children at work in England's factories in the early Industrial Revolution, is rather whether children at work are protected from hazardous and oppressive working conditions.

Whether child labour should be altogether prohibited in a poor country is

a matter on which views legitimately differ. Many feel that children's work is unavoidable in the face of poverty and that the alternative to it is starvation which is a greater calamity, and that eliminating child labour would then be like voting to eliminate abortion without worrying about the needs of the children that are then born.

Then again, insisting on the "positive-rights"-related right to unionize to demand higher wages, for instance, as against the "negative-rights"-related right of freedom to associate for political activity, for example, can also be morally obtuse. In practice, such a right could imply higher wages for the "insiders" who have jobs, at the expense of the unemployed "outsiders". Besides, the unions in developing countries with large populations and much poverty are likely to be in the urban-industrial activities, with the industrial proletariat among the better-off sections of the population, whereas the real poverty is among the nonunionized landless labour. Raising the wages of the former will generally hurt, in the opinion of many developing-country economists, the prospects of rapid accumulation and growth which alone can pull more of the landless labour eventually into gainful employment. If so, the imposition of the culture-specific developed-country-union views on poor countries about the rights of unions to push for higher wages will resolve current-equity and intergenerational-equity problems in ways that are morally unacceptable to these countries, and correctly so.

One is then led to conclude that the idea of the Social Clause in the WTO is rooted generally in an ill-considered rejection of the general legitimacy of diversity of labour standards and practices across countries. The alleged claim for the universality of labour standards is (except for a rare few cases such as slavery) generally unpersuasive.

The developing countries cannot then be blamed for worrying that the recent escalation of support for such a Clause in the WTO in major OECD countries derives instead from the desire of labour unions to protect their jobs by protecting the industries that face competition from the poor countries. They fear that moral arguments are produced to justify restrictions on such trade since they are so effective in the public domain. In short, the "white man's burden" is being exploited to secure the "white man's gain". Or, to use another metaphor, "blue protectionism" is breaking out, masking behind a moral face.

Indeed, this fearful conclusion is reinforced by the fact that none of the major OECD countries pushing for such a Social Clause expect to be the defendants, instead of the plaintiffs, in Social-Clause-generated trade-access cases. On the one hand, the standards (such as prohibition of child labour) to be included in the Social Clause to date are invariably presented as those that the developing countries are guilty of violating, when some transgressions thereof are to be found in the developed countries themselves. Thus, according to a report in The Financial Times, a standard example used by the labour movement to garner support for better safety standards is a disastrous fire in a factory in Thailand where many died because exits were shut and unusable. Yet, when I read this report, I recalled an example just like this (but far more disconcerting when you noted that the fatalities occurred in the richest country in the world) about a Tyson Foods chicken plant in Arkansas, I believe under Governor Clinton's watch. Yet, the focus was on the poor, not the rich, country! On the other hand, the choice of standards chosen for attention and sanctions at the WTO is also clearly biased against the poor countries in the sense that none of the problems where many of the developed countries would be found in significant violation ---such as worker participation in management, union

rights, rights of migrants and immigrants --- are meant to be included in the Social Clause. The stones are to be thrown at the poor countries' glass houses by rich countries that build fortresses around their own. Symmetry of obligations simply does not exist in the Social Clause, as contemplated currently, in terms of the coverage of the standards.

In fact, as I argued at the outset, the salience which the Social Clause crusade has acquired in the US and Europe, and its specific contents, owe much to the widespread fear, evident during the NAFTA debate in the United States, that trade with the poor countries (with abundant unskilled labour) will produce unemployment and reductions in the real wages of the unskilled in the rich countries. The Social Clause is, in this perspective, a way in which the fearful unions seek to raise the costs of production in the poor countries as free trade with them threatens their jobs and wages.

If not Social Clause, What Else? If this analysis is correct, then the idea of a Social Clause in the WTO is not appealing; and the developing countries' opposition to its enactment is justified. We would not be justified then in condemning their objections and unwillingness to go along with our demands as depravity and "rejectionism".

But if a Social Clause does not make good sense, is everything lost for those in both developed and developing countries who genuinely wish to advance their own views of what are "good" labour standards? Evidently not.

It is surely open to them to use other instrumentalities such as nongovernmental organization (NGO)-led educational activities to secure a consensus in favour of their positions. In fact, if your ideas are good, they should spread without coercion. The Spanish Inquisition should not be necessary to spread Christianity; indeed, the Pope has no troops. Mahatma

Gandhi's splendid idea of nonviolent agitation spread, and was picked up by Martin Luther King, not because he worked on the Indian government to threaten retribution against others otherwise; it happened to be just morally compelling.

I would add that one also has the possibility of recourse to private boycotts, available under national and international law; they are an occasionally-effective instrument. They constitute a well-recognized method of protest and consensus-creation in favour of one's moral positions.

With the assistance of such methods of suasion, a multilateral consensus must be achieved on the moral and economic legitimacy of a carefully-defined labour standard (and formally agreed to at the ILO today in light of modern thinking in economics and of the accumulated experience of developmental and labour issues to date, and with the clear understanding that we are not just passing resolutions but that serious consequences may follow for follow-through by the signatory nations). The ILO is clearly the institution that is best equipped to create such a consensus, not the GATT/WTO, just as multilateral trade negotiations are conducted at the GATT, not at the ILO.

In turn, the annual ILO monitoring of compliance with ILO conventions is an impartial and multilateral process, undertaken with the aid of eminent jurists across the world. Such a process, with changes for standing and for transparency, should be the appropriate forum for the annual review of compliance by nation states of such newly-clarified and multilaterally-agreed standards. Such monitoring, the opprobrium of public exposure, and the effective strengthening therewith of NGOs in the offending countries (many of which are now democratic and permissive of NGO activity) will often be large enough forces to prod these countries into corrective action.

In extraordinary cases where the violations are such that the moral sense of the world community is outraged, the existing international processes are available to undertake even coercive, corrective multilateral sanctions against specific countries and to suspend their entire trading rights.

Thus, for instance, under UN embargo procedures, which take precedence over GATT and other treaties, South Africa's GATT membership proved no barrier to the embargo against it precisely because the world was virtually united in its opposition to apartheid. Even outside of the UN, the GATT waiver procedure has permitted 2/3rds of the Contracting Parties to suspend any GATT member's trading rights, altogether or for specific goods (and now, services).

I must add one final thought to assure those who feel that their own moral view must be respected at any cost, even if others cannot be persuaded to see things that way. Even they need not worry under current international procedures. Thus, suppose that (say) American or French public opinion on an issue (as in the Tuna-Dolphin case for the former and the Beef-Hormone case for the latter) forces the government to undertake a unilateral suspension of another GATT member's trading rights. There is nothing in the GATT, nor will there be anything in the WTO, which will then compel the overturning of such unilateral action. The offending Contracting Party (i.e. the one undertaking the unilateral action) can persist in a violation while making a compensatory offer of an alternative trade concession or the offended Party can retaliate by withdrawing an equivalent trade concession. Thus, unless one resents having to pay for one's virtue (since the claim is that "our labour standard is morally superior"), this is a perfectly sensible solution even to politically-unavoidable unilateralism: do not import glass bangles made with child labour in Pakistan or

India, but make some other compensatory trade concession. And remember that the grant of an alternative trade concession (or tariff retaliation) makes some other activity than the offending one more attractive, thus helping one to shrink the offending activity: that surely should be a matter for approbation rather than knee-jerk dismissal.

3. North-North Issues

So far, I have discussed issues that touch primarily on the North-South questions as they are emerging in the new world economy of freer trade and investment, cautioning against the proposals to modify the WTO to sanction and legitimate eco-dumping, social dumping and the inclusion of a Social Clause in the WTO.

But the enhanced integration of the world economy, and the sensitivity to “unfair trade” of all varieties, have prompted increased friction and demands for harmonization of policies among the developed countries as well.

Competition Policy: The principal area in which demands for such (predominantly) North-North harmonization are emerging is competition policy. I need hardly remind a Japanese audience that the main impetus behind the emergence of this demand has been the suspicion that the keiretsu and the retail distribution systems of Japan lead to impaired market access, in effect “nullifying and impairing” the value of Japan’s trade concessions.

It is important to observe that these problems are not endemic only to Japan. For example, we have recently been reminded that the EU also provides exemption from its competition directives to its auto industry so as to permit exclusive dealerships and has just renewed it. Besides, the keiretsu system is now widely recognized to be an efficient system and its side-effects on market access may be no more than those accruing from the vertical integration

that is more widely practiced in the United States and works against outside suppliers more directly.

The WTO will have to move in the direction of bringing these questions into its purview fairly soon as they are now beginning to prompt unilateral approaches and solutions.

My view is that, while we do this, it is possible even under current GATT rules to use Article XXIII 1(b) on nonviolation to bring competition-policy-related questions before the GATT and to develop jurisprudence that will reflect some minimal "norms" that are commonly shared, while serving to soothe the tensions that unilateral actions bring and simultaneously advancing the important principle that impartial rules must be deployed so as to apply symmetrically to all Contracting Parties instead of being invoked arbitrarily and only against others.

IV. Regionalism versus Multilateralism or FTAs versus FT.

But if the matters above are broadly characterized as North-South and North-North issues, the one overriding phenomenon in the world economy today is that of the proliferation of inherently-preferential Free Trade Areas and hence the issue of how we view them: do they detract from, or add to, multilateral free trade; or, as I remarked several years ago²¹, are they building blocks or stumbling blocs to the ultimate goal of a world trading system ensuring freer trade to all?

In my view, there are only two compelling arguments for giving up the nondiscrimination implied in all-embracing multilateralism in trade:

* That a smaller group of countries wants to develop a Common Market in

²¹ Cf. Jagdish Bhagwati, The World Trading System at Risk, 1991, op.cit.

this case, not just trade, but also investment and migration barriers are eventually eliminated just as in a federal state and the full economic and political advantages of such integration follow; and

* That it is not possible to move to fully multilateral free trade (FT) for all through multilateral trade negotiations (MTN), at the GATT or now WTO, so that the only feasible way to continue reducing trade barriers is to go down the route of open-ended, easy-to-join preferential free trade areas (FTAs) among as many willing nations as you can find.

The former argument underlay the European initiative for the Common Market. The latter argument provided a key motivation for the United States, a keen opponent of preferential trading arrangements (PTAs) and an avid supporter of multilateralism throughout the postwar period, to shift course and to embrace PTAs by initiating the Canada-US Free Trade Agreement (CUFTA) in 1983. The failure to secure agreement from Europe and the developing countries to start a new Round of MTN at the GATT Ministerial in November 1982 led Ambassador William Brock to this approach; and the intention then was certainly to use an ever-expanding set of FTAs, with the US acting as both catalyst and nucleus, to achieve the worldwide free trade that could not be reached via the GATT any more.

With Secretary James Baker, this open-ended approach, where the US-centered FTAs would be open to any nation anywhere --- they were informally discussed with Egypt and ASEAN nations at the time ---, became captured by the proponents of "regionalism" who linked it instead, and constrained it, to the Americas, as part of President Bush's Initiative for the Americas. Thus grew the fears that the world was dividing into 3 blocs: the EU, the Americas, and possibly a Japan-centered Asian bloc.

In the event, the US expanded CUFTA to NAFTA, and is now poised to go down the FTA route more energetically, promising to take Chile and then other South American nations on board. While the idea of regionalism is not dead, the Washington policymakers, in response to criticisms including mine²², have occasionally expressed the view that the earlier open-ended nonregional FTAs approach will be adopted instead. Thus, President Bush, in a major speech in Detroit at the end of the Presidential campaign, promised that he would extend NAFTA to Eastern European nations and to the Far East. And recently, the Clinton administration has tentatively explored the possibility of extending NAFTA to South Korea and Singapore.

But we must ask: is this infatuation with FTAs, including the pressure alleged to be exerted by the United States to move APEC in the direction of an FTA, desirable when the multilateral trading system has already been jumpstarted with the impending ratification of the Uruguay Round and the birth of the WTO? Would it not be wiser for the world's only remaining superpower, and currently also its most robust economy, to take again the leadership role on multilateral free trade and to focus on converting NAFTA into a Common Market instead of seeking to extend it to more members and, given the inherently-preferential nature of such free FTAs, spreading what can be properly considered to be a stain on the now-realistic vision of a nondiscriminatory world trading system?

This question becomes compelling as soon as one realises that FTAs are preferential, discriminatory trading arrangements. It is time that we admitted that

²² Cf. Jagdish Bhagwati, "President Clinton's Trading Choices: Beyond NAFTA What?", *Foreign Policy*, Summer 1993. I advocated there the position taken above that the best course was to return now to multilateralism and to give up on further FTAs. But that, if FTAs were to be pursued, then nonregional FTAs were better than regional ones because, among other reasons, the regional approach would be more likely to promote fragmentation of the world economy into preferential blocs.

the phrase Free Trade Areas is Orwellian newspeak. It lulls us, indeed editorialists and columnists and politicians as well, into focusing only on the fact that trade barriers are lowered for members to the exclusion of the fact that, implicitly, the barriers are raised (relatively) for nonmembers. FTAs are therefore two-faced: they embody both free trade and protection. The reason is that they are inherently preferential and discriminatory. Perhaps, as economists interested in the quality of public policy discourse, we should take a pledge to rename the FTAs henceforth as PTAs (i.e. preferential trade areas) .

In that regard, let me say also that, during the lobbying campaign for NAFTA --- I should really call it NAPTA if I was to act on my suggestion above ---, an incompetently drafted statement of support for NAFTA made the rounds for our signatures. It was notable for its implied equation of the case for the proposed FTA with the case for free trade, obfuscating the real issues²³ . I was not asked to sign it and so the absence of my signature was not indicative of my views. [In fact, the media, in writing on NAFTA, occasionally described me as a notable signatory, assuming that I must have signed since I was a "free trader" or, as an irate administration economist of great distinction who was upset with my views and writings on Japan once denounced me, a "hyper-free trader".] I

²³ The debasement of the economic discourse from the opposite viewpoint comes, on the other hand, from the occasional suggestion that, to join FTAs, countries need to satisfy prior conditions on macro-stability et.al. Thus, in a recent study, the wellknown economists Gary Hufbauer and Jeff Schott of the Institute of International Economics in Washington appear to list several criteria for countries to be invited to join NAFTA, assigning weighted grades for this purpose. This leaves me puzzled, if I have understood them correctly. Free Trade requires no such preconditions, so why should FTAs? If it is correct to impose such prior conditions for us to let them join us in freeing trade within an FTA, then we would have to revise all our textbooks and treatises on international economics which argue that, no matter what other countries' own policies, we will generally profit from freeing trade in a nondiscriminatory fashion. [The only difference would arise from the discriminatory nature of FTAs: we may be hurt by a trade-diverting FTA, in which case the FTA may be regarded as undesirable but the focus then is not on our potential FTA partner fulfilling prior preconditions but we ourselves doing so.] The Hufbauer-Schott type of thinking is thus not merely incorrect, insofar as (let me repeat) I understand it correctly. It could also be harmful if it spread from FTAs to thinking about Free Trade generally among policy circles.

have little doubt that many economists signed the ill-tutored statement of support for NAFTA simply because, once the protectionist Ross Perot had staked out his opposition to NAFTA, there seemed to be only a binary choice much like the choice from two tasteless entrees in a restaurant: support protectionism or support NAFTA. Signing the imperfect statement in support of NAFTA must have seemed the lesser of two bad choices, quite obviously.

Now that Ross Perot is out of the way, NAFTA has passed, and the Clinton administration is embarked on extending NAFTA into new countries starting with Chile and is understood also to be desirous of turning APEC into an FTA, it is surely time to subject this pro-FTA policy to fierce scrutiny.²⁴ Such scrutiny, in my view, would expose this policy of the administration as a folly.²⁵

For, in essence, the proliferation of such PTAs, where countries extend preferences in different trading arrangements, creates a "spaghetti bowl" phenomenon. Thus, the EU has different types of association agreements with countries outside of the core members; the US has hub-and-spoke arrangements with free trade with Israel which, in turn, is not a partner of NAFTA; Israel has arrangements with EU and US; Mexico is a member of NAFTA and of an aspiring APEC FTA; Mercosur is about to enter into negotiations for a preferential trading arrangement with the EU, and so on. As

²⁴ The Economist, in a brilliant lead editorial in the end-of-the-year Double Issue, December 24th- January 6th, entitled "Battle Lines", raised much the same issue, asking for an examination of the "increasing enthusiasm for regional, as opposed to global, agreements to liberalize trade" and avoiding "the mistake of unreservedly supporting everything Ross Perot attacks". I congratulate this magazine which, along with The Financial Times, has played a distinguished and impressive role in raising the key analytical issues in regard to the world trading system in the last half a decade, while the US business magazines have done little except to play to nationalist and lobbying business viewpoints on issues such as NAFTA and Japan-bashing.

²⁵ For a fuller analysis, see also my 1994 Wincott Lecture in London, to be published by the Institute of Economic Affairs and my Keynote Address in Tokyo in October 1994 at the Symposium organized by Nihon Keizai Shimbun and the Ministry of External Affairs in celebration of the 30th Anniversary of Japan's accession to the OECD.

countries reach out for special deals, not just among developing countries (as they have done for decades) but with the major trading nations as well, the analogy with an orgy, with bodies intertwined and reaching out in different directions, may be more apt in the increasingly salacious Washington.

The Spaghetti Bowl: Problems with Preferential Trading Arrangements

Such spaghetti-bowl proliferation of preferential trading arrangements clutters up trade with discrimination depending on the “nationality” of a good., with inevitable costs that trade experts have long noted. In particular, consider the following points, some relevant only to Free Trade Areas, the others more general.

(i) Rules of origin, which are inherently arbitrary despite the Codifications we must live with, multiply under Free Trade Areas because different members have different external tariffs, making the occupation of lobbyists (who seek to protect by fiddling with the adoption of these rules and then with the estimates that underlie the application of these rules, as in the recent Canadian Honda case) and of customs officers (who can make much money by assigning goods to different origins as suggested by those fetching gifts) immensely profitable at our expense. Anne Krueger and Kala Krishna have written extensively and illuminatingly on this problem; so has the distinguished lawyer-cum-trade-commentator, David Palmetier.

(ii) More generally, it is increasingly arbitrary and nonsensical to operate trade policy of all kinds on the assumption that you can identify which product is whose. When I was a student at Oxford in the 1950s, there used to be a Who’s Whose, designed to list the bondings (or “steady relationships” in our slang) among the undergraduates. Needless to say, the sexual revolution and the rise

of uninhibited promiscuity put an end to it. Similarly, with the phenomenal globalization of investment and production, a Who's Whose in defining trade policy is an increasing anomaly, tying up trade policy in knots and absurdities and facilitating protectionist capture.

Take some telling examples. We have tried assiduously to tell the Japanese that exports from their transplants in the US to Japan are not to be counted as US exports. On the other hand, when the Europeans tried to include the cars exported from these very transplants in their VER quotas on Japanese cars, Mrs. Carla Hills was up in arms! Again, just because imports from Japan are sought to be controlled, rather than imports from all sources without discrimination (as would be the case simply with a tariff or an auctioned VER), we have the EU getting into knots about whether Japanese transplants in UK are to be allowed freedom of access within the EU, and when would a car produced in Oxfordshire be British rather than Japanese.

Indeed, as the world economy increasingly muddies up the idealized picture of Japanese, American, British, Indian and Mexican goods that drives much of trade policy including particularly the pursuit of Free Trade Areas, the more we trade economists can see the wisdom of the great trade theorists of the past, Viner, Meade et.al., who were strongly wedded to nondiscrimination and hence to MFN and multilateralism. As usual, a quote from Keynes, who had renounced his earlier skepticism of nondiscrimination during the British-American discussions of the design of the postwar Bretton Woods institutions, from his speech in the House of Lords in 1945, says it best:

“ [The proposed policies] aim, above all, at the restoration of multilateral trade... the bias of the policies before you is against bilateral barter and every

kind of discriminatory practice. The separate blocs and all the friction and loss of friendship they must bring with them are expedients to which one may be driven in a hostile world where trade has ceased over wide areas to be cooperative and peaceful and where are forgotten the healthy rules of mutual advantage and of equal treatment. But it is surely crazy to prefer that ."²⁶

(iii) Again, it is frequently claimed that trade creation will be the order of the day with FTAs and customs unions (CUs); hence we need not fear trade diversion. But, as I noted some years ago, when protection is administered (in the form of VERs, anti-dumping actions etc.), it is selective and variable. The endogeneity of such protection means that trade creation can turn into trade diversion. Thus, if the US crowds Mexico in an industry, potentially creating trade in the Vinerian sense, Mexico can, and probably will, start anti-dumping action against nonmember suppliers and seek to accommodate thus both its own and the US firms at the expense of nonmember suppliers, transmuting trade creation into trade diversion.

At my suggestion a few years ago when I was Economic Policy Adviser to the Director General of the GATT and we were planning an Annual Report on Regionalism, Brian Hindley of LSE and Patrick Messerlin of Paris investigated this possibility empirically to see if the well-documented anti-dumping actions (especially against Japan and the Far East) of the EC could be so interpreted as responses to the internal "trade-creating" competitive pressures rather than to exogenous intensification of competition from abroad. Their verdict was: yes,

²⁶ Quoted (p.64) in The World Trading System at Risk, Princeton University Press: Princeton, 1991, based on the Harry Johnson Lecture that I delivered in July 1990. Italics have been inserted.

there is evidence in some cases that this had happened.²⁷

The NAFTA's economist supporters, many untutored in any of these nuances because few had any professional competence in the complexities of trade analysis and realities, simply missed this important issue, focusing at best only on the observed trade barriers. When you combine this observation with the fact that our negotiators helped to weaken the improvement in discipline on anti-dumping at the Uruguay Round, as I observed above, the folly of our trade policy becomes obvious. Indeed, if you want to go down the PTA route, and to minimize the possibility of trade diversion, be sure that there is far more (not less) discipline on administered protection than we currently have!²⁸

(iv) In regard to trade diversion, furthermore, Arvind Panagariya of the University of Maryland, a distinguished trade theorist and policy analyst, has raised the question: would not Mexico, and potential future developing countries of South America seeking to join NAFTA, themselves suffer from harmful trade diversion from joining NAFTA? Arguing that the US and Canada are largely open, and comparing with the alternative of nondiscriminatory trade liberalization, Panagariya has argued that trade diversion is indeed what Mexico et.al. face, with the US and Canada gaining from the preferential trade

²⁷ The Hindley-Messeriin paper has now appeared in a volume edited by Kym Anderson and Richard Blackhurst for the GATT and published by Harvester Wheatsheaf (UK), 1994.

²⁸ Of course, trade diversion itself may be the principal driving force behind the choice of FTAs rather than nondiscriminatory trade liberalization as far as business lobbying is concerned. This "incentive" or "political economy" aspect of FTAs versus FT has been raised by me in "Regionalism versus Multilateralism: An Overview", published in 1994 in the World Bank volume on the subject, edited by Panagariya and de Melo. It was also the subject of an Economics Focus column in 1993 in The Economist. That business lobbies, interested in exports, may prefer to go for preferential trade barrier reductions in their favour rather than investing efforts in opening markets for their rivals as well is what I have long been stressing, noting the differential lobbying in favour of NAFTA as against the Uruguay Round and the GATT. This idea has been analytically pursued in recent theoretical papers by my Columbia University student Pravin Krishna and by Arvind Panagariya and Ronald Findlay, the latter forthcoming in Gene Grossman and Robert Feenstra (ed.), The Political Economy of Trade Reform, Essays in Honor of Bhagwati, MIT Press: Cambridge, Mass., 1995.

liberalization of Mexico et.al. and the latter losing from it.²⁹

One may well object: why should Mexico et.al. then want to join NAFTA? If the question is raised because it is inconceivable that the governments of these countries would not be rational in their policy choices, then that assumption itself must be clearly rejected. For one thing, as we know well from aid experience and literature, one can seek something which sounds good but actually does harm. Besides, the objectives of the leaders may be diversified. Thus, for instance, they may expect to gain political kudos by going along with NAFTA because, by granting preferential access to the US exporting interests, and through the implied underlining of Mexico's special relationship to the US, they may gain the support of the US in reaching out for prizes in a variety of unrelated political arenas. Thus, for example, in the absence of NAFTA and the willingness of President Salinas to put almost everything on the line for its passage, can one seriously imagine that the US would have gotten Mexico into the OECD³⁰ or backed President Salinas for the important job of the Director General of the WTO³¹ ?

(v) Perhaps the most frequently-repeated "non-economic" argument on

²⁹ Panagariya actually makes a persuasive case that Mexico et.al. are most likely to suffer a welfare loss even if the comparison is with the initial situation rather than with unilateral trade liberalization by them. In the latter case, the loss by Mexico et.al. is certain, of course, since US and Canada are assumed to be open in all situations being compared. Cf. Panagariya, "The Free Trade Area of the Americas: Good for Latin America?", University of Maryland, mimeo., 1994.

³⁰ One may wittily remark that Mexico's undistinguished, low growth rate (by the standards of most developing countries) during the 1980s qualifies it as an OECD country ! Seriously, however, it is wellknown that Mexico got in because the US wanted this badly: as one of the highest officials of the OECD told me in private conversation, "Secretary Lloyd Bentsen [a major supporter of NAFTA] was very keen on it".

³¹ Remember that Mexico got into the GATT only in 1985, nor is it exceptional among the leading developing countries in terms of income level, sustained and high growth rates, effective assault on poverty, level of industrialization, degree of scientific achievement, and other indices that normally command one's attention. None of this, of course, is to detract from the significant accomplishments of the young Mexican leaders and technocrats, including Finance Minister Pedro Aspe, Trade Minister Jaime Serra and others in the splendid Salinas team, in moving Mexico through difficult political and economic reforms.

behalf of Mexico et.al. joining a preferential trade arrangement such as the NAFTA has been that it helps to “lock in the reforms”, giving them credibility. But if this means locking in trade liberalization, I have argued that acceptance of GATT bindings can equally lock in the liberalization. Besides, it is as difficult for a small power like Mexico to get out of GATT obligations as it is to leave NAFTA once you are in.

As regards NAFTA giving credibility to Mexico’s reforms, the recent crisis in Mexico lays that claim to rest just about as well as could be done. Real credibility in your reforms can come only from the credibility of your economic policies, not from an external pact like NAFTA, just as the announced commitment to a fixed exchange rate carries no credibility if the underlying macroeconomic policies are not themselves credible: it is the latter that give credibility to the announced fixed exchange rate, not the other way around!

Thus, it is obvious that NAFTA has done little or nothing to establish the credibility of Mexico’s reforms at home or abroad; claims that it would and did were simply so much hype that, repeated long enough by NAFTA proponents, came to be accepted as incontrovertible truth by many.

I therefore find it difficult to be enthusiastic about the US pursuing FTAs, with all these drawbacks, when the WTO is already jumpstarted and therefore the second of the two arguments cited earlier in support of FTAs is lacking in force today. However, it has been asserted, in defense of pursuing FTAs despite the preferential nature of FTAs and the success of the WTO, that there is a benign, symbiotic relationship between FTAs and the multilateral system, and that the former is a faster process and, in turn, speeds up the process of dismantling trade barriers and making progress generally at the WTO. Superficially, this scenario sounds plausible. But, on closer examination, it is

seen to be an untenable view.

In particular, consider the popular argument that FTAs, at least where led by the United States, will be of the “open regionalism” variety so that, with steadily increasing members, we will arrive at full multilateralism. As proponents of this view put it, “you get two members and the third will want to be in”, and then the fourth and, to draw on Agatha Christie, “then there will be all” in the FTA, arriving effectively at worldwide free trade just as we multilateralists want. By contrast, and by implication, the WTO cannot lead to effective and speedy liberalization on its own: it is too unwieldy.

But this contention is naive for several reasons. Take the question of speed. FTAs are at least as hard to negotiate as multilateral trade treaties like the Uruguay Round. After a decade, there are three countries in NAFTA; by contrast, the Uruguay Round took over seven years to negotiate, with over 115 nations and negotiations over a large range of old and new issues.

To argue that NAFTA expedited or smoothed the way for the conclusion of the Round would be equally silly, though it is often done. Thus, President Clinton's success with NAFTA is supposed to have helped him with his passage of the Round through the Congress. True, President Clinton found his free-trade voice on NAFTA; but why should we assume that he would not have found it on the Round if it was the only game in town?

Also, remember the immense political divisions (far greater than over the Uruguay Round) that arose over NAFTA. The proximity of Mexico, and the fear that trade would only intensify the adverse effect that the much-noticed and feared Mexican illegal immigration was exerting on real wages of the unskilled in the United States, wound up making the freeing of trade with the poor

countries a fiercely controversial issue.³² It is hard to imagine that, with so many issues and so many countries involved in the Round and hence diffusion of focus instead of the exclusive focus on one particular country feared by the unions and the workers as a palpable threat to their living standards, the politics would have been as difficult on the Round by itself. The baggage of the NAFTA fight was thus hurtful (in giving remarkable political salience to an issue that was almost created in the NAFTA crucible) to the cause of multilateral free trade extended to developing countries generally, and hence to the passage of the Uruguay Round and to the future functioning of the WTO (where issues such as the Social Clause have also therefore gained more credibility), not helpful.

NAFTA's passage also was subject to Mexico's acceptance of the Supplemental Agreements on environmental and labour standards. But, as Anne Krueger and I have already argued, this is exactly the wrong way to go: why should such agreements be a precondition for freer trade? These demands could have been successfully resisted, as they are so far, at the GATT, whereas Salinas caved in simply because this was a superpower bargaining in a one-on-one format with a vastly inferior power. In turn, this has strengthened the environmental and labour lobbies into arguing that because NAFTA did it, so must the WTO, and the Clinton administration has not been able to stand up to these demands. In short, the NAFTA has made the WTO's business more

³² Free trade and free immigration are indirect and direct ways, respectively, in which a poor country with abundant unskilled labour could reduce the real wages of our unskilled labour. This has long been understood, both in the theoretical literature on trade and on immigration, and was also implicit in the great debate in Britain prior to the enactment of the 1905 national legislation restricting immigration: at the time, free traders were also free immigrationists and free immigration was often called "free trade in paupers". For a detailed analysis and documentation of these questions, see my "Free Traders and Free Immigration: Friends or Strangers?", Russell Sage Foundation, New York, 1991. It was thus perfectly plausible to me that, during the NAFTA debate when the administration and Salinas kept talking about how NAFTA would reduce illegal immigration, the response of many was contemptuously dismissive: according to them, we needed to stop NAFTA and to stop illegal immigration directly by closing the border more effectively.

complex, not less.

In fact, I have argued that these and other lobbies cannot have escaped the conclusion that the smart way to go is through US-centered FTAs rather than through the WTO, since you can first get Mexico to buckle under to these demands, then tell Chile and others: this is how NAFTA is, so you must accept these “nontrade” terms and conditions if you wish to come on board. Of course, this strategy works so much better than trying to impose these extraneous, indeed harmful, conditions through multilateral trade negotiations where all these countries are together and have more bargaining power! So much then for the idea of “open regionalism” or Ambassador Brock’s idea of rapidly expanding open-ended FTAs. Yes, if you agree to several extraneous, essentially trade-unrelated “side payments” (to use the terminology of John Whalley in his work on CUFTA) or “conditions” which have nothing to do with trade liberalization, you can qualify to join, not otherwise! It is like saying: my bridge club is open to everyone provided they wear mustaches, smoke pipes, wear ties and shine their shoes. This is openness indeed!

In fact, then, FTAs have become a process by which a hegemonic power seeks to (and often manages to) satisfy its multiple nontrade demands on other, weaker trading nations better than through multilateralism; the persistence of FTAs despite the success of the WTO must be traced at least partly to an awareness of this reality.³³ And, if this analysis has an element of truth to it, then FTAs seriously damage the trade liberalization process by facilitating the capture of it by extraneous demands that aim, not to reduce trade barriers, but to increase them (as when market access is sought to be denied on grounds such as “eco dumping” and “social dumping”).

³³ See the discussion in my “Threats to the World Trading System: Income Distribution and the Selfish Hegemon”, Journal of International Affairs, 1994.

To sum up, my view therefore is that the FTAs, aside from being preferential trading arrangements with the economic drawbacks I outlined earlier, are a particularly damaging institutional arrangement to legitimate in the world trading system. The time has surely come for international economists to cut through the Orwellian newspeak, and the sloppy argumentation, of Free Trade Areas and begin to think the unthinkable: should FTAs really continue to qualify under Article XXIV or should it be revised to apply only to groups of countries aiming to create a Common Market ?³⁴

³⁴ As far as I know, the archival research has not been done to tell us why both FTAs and CUs were included in Article XXIV. I speculate on the original rationale of Article XXIV in The World Trading System at Risk, op.cit.

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