

**The Demands to Reduce Domestic Diversity among  
Trading Nations**

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<sup>1</sup>This paper is part of the research undertaken by Bhagwati for the Bhagwati-Hudec Ford Foundation-financed project on the analytical problems raised by the growing demands to remove domestic differences prior to freeing trade among nations. It will eventually reabsorbed into a substantially larger essay by Bhagwati and Hudec on the issues and findings of the project, circa 1994.

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That free trade requires the harmonisation of the domestic institutions (e.g. the retail distribution system), policies (e.g. environmental and labour standards) and practices (e.g. corporate relationships as in Japanese keiretsus) across trading nations is an idea that has now assumed center stage. The resulting demands to reduce, even eliminate, such domestic diversity among nations that seek freer trade among themselves, raise three central questions:

\*What has led to these demands to reduce diversity?

\*What, in economic logic, are the virtues and vices of diversity?

\*Where diversity is beneficial, how can it be sustained despite the demands for harmonisation that threaten it?

In this paper, I address the first of these questions. The factors that produce harmonisation and demands for it can be divided, for analytical convenience, into philosophical (Section 1), economic and political. The economic arguments, in turn, divide into those resulting from changes in the world economy and hence may be called structural (Section II) and those that derive from the notion that without harmonisation the conventional case for mutuality of the gains from free trade is invalid and hence may be called welfare-theoretic (Section III). The political (Section IV) arguments relate primarily to the use of "fair trade" arguments to extract protection as also to the fear that, in the absence of harmonisation, the higher-standard countries will face political pressures, under free trade with lower-standard countries, to lower their own standards.

## I. PHILOSOPHICAL ARGUMENTS AGAINST DIVERSITY

The philosophical arguments for harmonisation arise in regard to environmental and labour standards in particular, and can be traced to three sorts of reasoning:

\*A sense of transborder obligation owed to others leads those interested in environmental and labour rights (and human rights in general) to demand that the nation states where these others are citizens should sustain those rights, and to use the threat of denial of existing and prospective trading opportunities to prod or coerce these nations into the scaling-up of their environmental and labour standards.

\*Questions of distributive justice also arise when it is feared that freer trade with poor, unskilled-labour-abundant countries that have lower environmental and labour standards will result in the immiseration of one's proletariat (with the gains from trade, and more, accruing to other factors of production), and that even the welfare of the workers in these countries may be further worsened paradoxically.

\*Then, there is simply the fact that firms in higher-standard countries feel that fairness in competition requires that the burdens put on costs by environmental and labour standards ought not to differ across countries in free trade. Fairness, like beauty, is in the eye of the beholder and the fact that this view is now increasingly

held among business groups makes it a potent force, in addition to all others, driving the demands for harmonisation of such standards.

### 1. The Question of Obligation Beyond Borders

In matters of social policy, relating to environment and labour standards, there is at work a sense of the obligation that we as human beings owe one another. This sense of obligation prompts and legitimates the use of the power and instrumentalities of the politically stronger nations to cajole and, if necessary, coerce the weaker nations into implementing policies that conform to the moral behavior that the obligation defines and requires of all nations in the discharge of their authority over their subjects, thus producing upward harmonisation of their environmental and labour standards with one's own.

The sense of transborder moral obligation is of course ancient, long predating the modern nation state. As John Dunn, the Cambridge political theorist, has reminded us eloquently in tracing the origins of the notion of a "human community," and the consequent answer to the question of what human beings owe one another:

...an old answer [to the question of what we owe to others] with deep Greek and Christian roots, is that there is just one human community, "that great and natural community" (Locke 1988, Second Treatise, para 128), as John Locke called it, of all human beings as natural creatures, whose habitat is the whole globe and whose obligations to one another do not stop at any humanly created -- any artificial -- boundary. Locke had a very powerful explanation of why this was so, an explanation which tied human obligations immediately to the purposes of God himself (Dunn 1984). A pale shadow of Locke's conception, with God tactfully edited out, still lives on in modern secular understandings of human rights...and, even more diffusely, in anthropocentric interpretations of the

collective ecological imperative to save a habitat for the human species as a whole.<sup>1</sup>

The weakness of this obligation in reality, and the strength of it in moral philosophy, have preoccupied many over the years. Thus, David Hume, who attributed such obligation to sentiment rather than reason, argued that "it is not contrary to reason to prefer the destruction of the whole world to the scratching of my finger".<sup>2</sup> In a similar vein, Adam Smith argued:<sup>3</sup>

Let us suppose that the great empire of China, with all its myriads of inhabitants, was suddenly swallowed up by an earthquake and let us consider how a man of humanity in Europe, who had no sort of connexion with that part of the world, would be affected upon receiving intelligence of this dreadful calamity. He would, I imagine, first of all express very strongly his sorrow for the misfortune of that unhappy people, he would make many melancholy reflections upon the precariousness of human life and the vanity of all the labours of man which could thus be annihilated in a moment. He would too, perhaps, if he was a man of speculation, enter into many reasonings concerning the effects which this disaster might produce upon the commerce of Europe and the trade and business of the world in general. And when all this fine philosophy was over, when all these humane sentiments had been once fairly expressed, he would pursue his business or pleasure, take his repose or his diversion, with the same ease and tranquillity as if no such accident had happened.

The most frivolous disaster which could befall himself would occasion a more real disturbance. If he was to lose his little finger to-morrow, he would not sleep to-night; but, provided he never saw them, he would snore with the most profound security over the ruin of a hundred millions of his brethren. The destruction of that immense multitude seems plainly an object less interesting to him than this paltry misfortune of his own. To prevent, therefore, this paltry misfortune to himself would a man of humanity be willing to sacrifice the lives of a hundred millions of his brethren, provided he had never seen them?

While moral philosophers have considered how to deduce such obligation, and political theorists have speculated why the sense of such obligation varies over time and across communities, what

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<sup>1</sup>Cf. Dunn (1993, pp. 37-38).

<sup>2</sup>Hume (1911, vol. 2, p.128); quoted in Dunn (1993).

<sup>3</sup>Cf. Adam Smith (1976, pp. 136-137).



concerns us here is to see why and how it has prompted environmental concerns that transcend borders and indeed weaken the nation states' autonomy within their conventionally-domestic jurisdictions.

To see this with necessary nuance, one must understand that obligation implies rights. If then transborder obligations to others elsewhere are accepted, so must the notion that these others have rights which we are expected to sustain.

It follows then that the assumption in international relations since the Treaty of Westphalia, that nation states have exclusive domain over their subjects such that their treatment of these subjects is a matter of domestic sovereignty and international relations therefore must respect moral pluralism, is no longer acceptable. As Raymond Plant (1993) has put it succinctly: "The principle of *cuius regio eius religio* may have been central to the Treaty of Westphalia but the principle of *cuius regio, eius jus* is not compatible with the idea that there are basic human rights the moral authority of which crosses frontiers."

However, intervention on behalf of the subjects of other nation states, following its legitimacy and the delegitimation of the exclusive sovereignty of nation states over their subjects (in regard to these subjects' rights that are regarded as following from our obligation to them), runs into the very same difficulty that the question of rights runs into in the domestic domain. In particular, the problem of sustaining "positive" rights becomes pertinent and difficult.

Thus, "negative" rights such as the right to liberty create obligations that could be described as consisting in refraining from actions harmful to others. As such, they are considered to involve indirect costs in the sense of foregone gains (e.g. if I do not enslave you, I do not get to exploit you and get rich) but they generally do not involve direct costs (e.g. I can simply refrain from enslaving you). Though, even this is not quite accurate since I may have to incur direct costs to ensure that someone else does not deny you your negative right, say to liberty (e.g. I may have to finance an army or a police force to deter those who would otherwise force you into slavery).

But these costs pale into insignificance when we consider the enforcement of obligation to sustain positive rights, such as to shelter, education, clean air, clean water, good health and indeed much else.

This (relative) asymmetry has prompted many rights advocates to attach greater significance to negative rights: habeas corpus outweighs clean air, by this logic. Equally, it is widely thought that, while negative rights can all be demanded of every nation state, this cannot be the case with positive rights: the problem of costs means that we have to choose between clean air and clean water.

These choices are resolved within the nation state in one way or another. In pluralistic nations, they are resolved through debate and politics; in authoritarian states, by fiat and possibly by neglect. But, in either case, the problem of cost is implicitly or explicitly recognized. By contrast, when the positive rights of others in the jurisdiction of foreign nation states are defended, and these are

pursued by demanding that these foreign nations (not one's own) find the resources to sustain them, it does not take much ingenuity to understand that the demands will tend to overreach and even to be "captured" politically by interests in one's own state that have their own agendas. Thus, overarching environmental demands on resource-strapped nations, on threat of punitive trade sanctions, may be made, not just by environmental groups, but by protectionist lobbies who see the resulting possibility of trade sanctions as a benefit to themselves.

Next, we must distinguish between the obligation that we feel we owe others because they are part of humankind and the obligation that we consider we owe to humanity itself. Thus, if environmental obligations are at stake, we may regard Mexican citizens to be entitled to clean air and clean water because they are human as we in the US are and hence we may consider it our obligation to ensure their access to such amenities. But then we may consider that the depletion of the ozone layer imperils humanity itself and that we must ensure therefore that Mexicans contribute, through environmental measures, towards that survival. Interestingly, both kinds of obligation can lead to the use by environmentalists of the power of their own nation state to coerce other nation states, through measures such as trade sanctions, into acceptance of policies demanded of them.

(i). What We Owe Others: It was precisely the sense of obligation to others that led the great developmental economists in the postwar period, Paul Rosenstein-Rodan and Gunnar Myrdal among

them, to seek foreign aid commitments by the rich nations (even though, confronted by the realities of politics, they were reconciled to "selling" foreign aid programs as good for the givers too, not as yielding the pleasure of having done one's duty and discharged one's obligation to others, but as enlightened self-interest in the shape of "containing communism" during the Cold War). Obligation to others then led to the imposition of obligation and sacrifice on one's own government in the form of aid programs.

By contrast, in environmental matters, one's obligation to others prompts demands on their government: the obligation to others in Mexico, for their life chances as in the environmental quality of their habitat, is seen as requiring that we in the United States must use instrumentalities of various kinds to force the Mexican government to ensure that its citizens enjoy a better habitat.

Where therefore the aid question strengthened the legitimacy of (one's) nation state by getting it to give aid (while imposing greater demands on it and hence possibly weakening its eventual legitimacy as an agency that could deliver efficaciously what is required of it by those subject to its authority and whose interests it advances), the environmental question weakens it by delegitimizing the notion that the (foreign) nation state, uncoerced and by autonomous choice, will do well by its citizens.

Then again, we must recall that demands on one's own nation state are different in important ways from demands on others' nation state. Where, for instance, these demands need resources to be spent, the former impose these burdens on oneself whereas the

latter impose them on others. Where therefore the former will be moderated by the presence of resource constraints, the latter will generally tend to assume larger proportions.

(ii). What We Owe to Humanity: But the question of our obligation to humanity, to others of our species, appears to raise different issues. The overriding obligation is evidently Hobbesian and one of survival. Environmental questions such as the depletion of the ozone layer and global warming clearly relate to obligation maximorum of this variety. Though, even here, one must make room for scientific opinion that suggests that the problems are slow to intensify, leaving ample room for scientific innovation to countervail the danger (much as Malthus has been held at bay to date).

But, even if these environmental questions raise for us compelling obligations to ensure the survival of humankind, the issues that were considered earlier will resurrect themselves. For, as soon as costs must be incurred to reach environmental targets (setting which raises, in turn, its own host of issues), the question cannot be evaded: which nation state must incur what costs? "Efficient" solutions, as sophisticated economists know, are not ethically appropriate solutions: being paid a market wage that reflects an efficient economic system, for instance, is not to be paid the just wage.<sup>1</sup>

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<sup>1</sup>This is why the Cambridge economist, Joan Robinson, moved away in her later years from her celebrated definition of "exploitation" as the payment of a wage less than a worker's marginal product: to do so would be to concede implicitly that the market wage was the just wage. Interestingly, the Nobel-laureate Robert Fogel and Stanley Engerman, in their monumental study of slavery, appeared to share the Robinsonian

Thus, an efficient solution (which minimizes the world cost of reducing a unit of CO<sub>2</sub>) to the global warming problem may require Brazil's rain forests to be not cut down and no reduction in the use of gas-guzzlers on U.S. roads because the latter is a more expensive solution (see Figure 1). But then ask Brazil to take the entire burden of reducing global warming is to stick it with the bill: a most unjust outcome when you think that the U.S. is a rich country and Brazil is less so. But the use of the U.S. economic muscle, and the relative efficacy of the U.S.-based environmental groups in demanding compliance from the poor nations elsewhere rather than from their own country where they must fight with powerful groups that oppose them (witness the inability of President Clinton to adopt the BTU tax), mean that the sense of obligation to humanity's survival could translate into effective demands on others and their nation states that are unfair or unjust in relation to demands on oneself and on one's own nation state. Indeed, it does.

(iii). Trade Suspension and Refusal to Liberalize Trade:

The assertion of transborder obligation by environmentalists, labor unions and others can take two alternative forms in regard to trade with other nations: existing trade with, and the trading rights of, other nations can be suspended or extension of trade through further trade liberalization (as in NAFTA for Mexico) can be denied, unless these nations bring their policies into conformity with one's demands.<sup>1</sup>

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definition of exploitation in examining the question whether slavery led to (economic) exploitation of its victims.

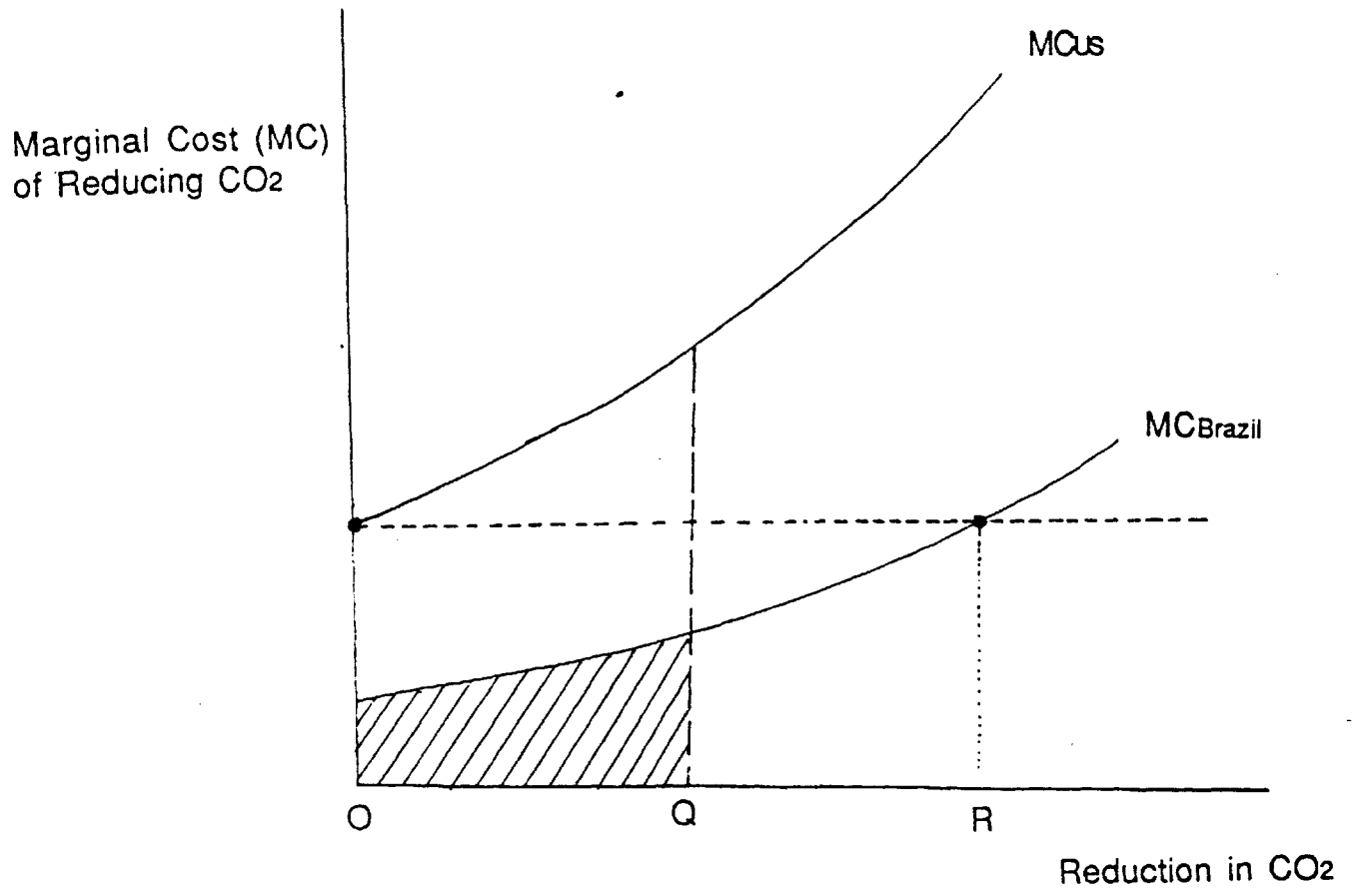


Figure 1

In the figure, the marginal cost of reducing CO<sub>2</sub> in Brazil and in the US are plotted. For a targetted reduction of OQ units of CO<sub>2</sub>, an efficient cost-minimising solution requires that all reduction occur in Brazil, with the striped area representing the total cost. Only for targetted reduction of CO<sub>2</sub> in excess of OR will it be efficient also for the US to cut down CO<sub>2</sub> emissions

Evidently, the former is the more difficult, partly because it involves the suspension of a right already conceded by treaty or a transaction already in place, and partly because it will result in direct and noticeable impact on the economic interests of importers who may be users of intermediates and can then become effective adversaries of the proposed sanctions. By contrast, foregone trade liberalization denies benefits that are only potential.

(iv). The Question of Consequential Ethics: In using either trade sanctions or denial of trade liberalization to secure for others their environmental and labour standards and other rights, the moral motive remains the sense of (transborder) obligation. This, in turn, implies that the use of these methods presupposes, on the part of those who use them, a presumption that they will be effective in securing the stated objectives.

However, that presumption itself cannot be assumed to be always justified. If Mexico is forced to spend more on clean air than it can currently afford, simply to be allowed to join NAFTA, then this could compromise her ability to grow faster and then spend more on clean air later. Or, getting Mexico to forego the use of the more productive purse-seine nets to catch tuna could save more dolphins but reduce productivity in the tuna industry and adversely affect Mexican growth and her capacity to generate resources to spend more on other environmental problems.

Then again, even the implementation of the threat to deny old and new trading rights may not force Mexico into submission, thus imposing costs on her and indeed on oneself that yield no gains in



terms of the desired (environmental or other) objectives. A consequentialist will then abandon the proposed trade measures.

But then one might well have those who feel that one should not sup with the devil even though the only consequence of such denial is that one misses a free meal. Duty, not consequentialism, then drives such environmentalists into rejecting NAFTA with Mexico if Mexico fails to fix her environmental standards as desired. But then one is saying: my obligation to Mexicans requires that I seek to advance their corresponding rights; but if I cannot do so effectively in reality (through trade measures), I nonetheless will refuse to engage with their government in freer trade, expressing my distaste and moral disapproval.<sup>1</sup>

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<sup>1</sup>I suspect however that some of those who would profess this moral point of view are likely, if you probe deeper, to be closet consequentialists. For, they would still hope that the mere act of disapproval in a visible fashion, while producing immediate intransigence by the targetted country, would prompt her eventually to consider concessions instead.

## 2. The Question of Distributive Justice

An important motivation for harmonization, however, is not concern for others elsewhere but concern for the poor among us. Thus, if free trade with poor countries with lower environmental and labor standards will, via competitive pressures, drive down the real wages of our unskilled, then this may be cause for making upward harmonization of these standards a precondition for freeing of trade. This is evidently an argument for distributive justice. Three different arguments of this type can be distinguished in the public domain at the present time.

(i) Immiseration of Our Unskilled: The fear has certainly grown in the countries of the (richer) North that free trade with the (poorer) countries of the South will drive down the real wages of the unskilled in their midst. The growth in unemployment in Europe in the 1980s, and the decline in real wages of the unskilled in the United States during the same period, have fuelled these fears, with globalization of the world economy through North-South trade liberalization considered a villain and also a danger for the future.<sup>1</sup> [Note that this is not the longstanding "pauper labor" argument against free trade: that relates to the notion that there will be no gains from trade if you trade with poor

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<sup>1</sup> There is now a voluminous and growing literature on this subject. It has been reviewed, and extended, in depth in Jagdish Bhagwati and Vivek Dehejia (1993). The fear outlined in the text is shown in this paper to be seriously exaggerated, possibly unfounded, if existing theories and evidence are considered. However, new hypotheses are suggested as to how globalization of the world economy through trade and diffusion of technology may exert a downward pressure on real wages.

countries with numerous paupers. Instead, the present argument says: free trade will increase overall income but it will hurt income distribution, harming our unskilled poor. Some may fear for both gains from trade and for real wages, of course, and probably do! ]

This fear has led to demands from several labor unions, and from politicians, to make raising of wages in the South a precondition for expanded free trade. The most dramatic example of these demands was the debate during the passage of the North American Free Trade Agreement through the US Congress, when both the unions and Ross Perot focused on the low wages in Mexico as a reason to reject NAFTA and President Salinas of Mexico was constrained in fact to advertise his commitment to raise minimum wages in Mexico to smooth the passage of NAFTA.

Equally, it has contributed to the demands for environmental and labor standards harmonization because this also is seen as raising the costs of foreign competitors. This happens also to be the way in which President Clinton, and certainly the US Trade Representative Mickey Kantor, presented the Supplemental Agreements on these matters with Mexico: as measures which would prevent "unfair trade" with Mexico under NAFTA.<sup>2</sup> They legitimated, in consequence, the notion that free trade with the countries of the South required such agreements as "fair trade" preconditions.

(ii) Capital Mobility's Consequences : When capital mobility is introduced, the fear about distributive justice is accentuated. As the NAFTA debate made clear, the fear then extends to capital flowing out to where the wages, labor and environmental standards are lower, thus leaving less capital to work with labor at home and thus reducing the real wages of labor (even if

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<sup>2</sup> The agreements are, as it happens, quite innocuous; I am talking about how they were actually presented and thought of by the Clinton administration.

the outflow of capital enriches the country overall).<sup>3</sup>

(iii) Distributive Justice Abroad: Strange as it may seem, some anti-free-trade critics also fear that real wages at both ends will fall as a result of free trade. In that case, the distributive-justice argument blends into moral obligation towards others. Thus, in the NAFTA debate, it was customary to allege that even the Mexican workers would suffer from free trade.

Was this total nonsense? I would have to say: almost certainly. While freer trade, without induced capital flows, would help improve Mexican wages, the outcome would be even better with induced capital flows into Mexico. For the same reason that capital outflows from the US to Mexico could hurt US workers, they would benefit the Mexican workers.<sup>4</sup> [In the end, both countries could gain capital was that non-NAFTA capital, from the European Union and Japan in particular, would likely flow in far greater magnitude to the region once NAFTA was formed. The European Community experience with the entry of Spain fits this pattern: both Spain and the United Kingdom benefited, the former from EC and the latter from non-EC sources.<sup>5</sup> So, even US real wages could benefit from the induced capital flows resulting from NAFTA.

The concern with workers abroad goes beyond their real wages in employment. The fear is that free trade will lead to industrial employment of erstwhile peasants in industrial employment where their interests will be sacrificed and workers immiserized unless protections via enforced, superior

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<sup>3</sup> This form of argumentation leads also to an alternative scenario, that the effect of such pressures, and the competitive pressures on our industries, will be to cut away at our own environmental and labor standards, producing a "race to the bottom". This argument is considered later in the present paper.

<sup>4</sup> It is hard to understand why the anti-NAFTA critics thought that Mexican workers would be harmed. They were focusing on the "exploitation" and "low wages" which were supposedly "not reflecting productivity", inferring incorrectly that this implied that the change in wages following NAFTA would be adverse.

<sup>5</sup> My Columbia student, Rupa Chanda (1993), has shown this fairly persuasively in her dissertation.

labor standards are provided. Underlying this view, I believe, is the notion that peasants will have regret but be unable to move back to the land if immiseration occurs: as in Brusati's celebrated film, Bread and Chocolate, where the immigrant gastarbeiter from Italy is trapped into his miserable condition in Switzerland and unable to return home. I doubt however that this is a sufficiently likely occurrence to deny freer trade and its advantages to the poor nations of the South without upward harmonization of their labor standards.

### 3. The Question of Fairness

Another compelling argument for harmonization proceeds from the altogether different philosophical notion of "fairness".<sup>6</sup> It might fairly be said that "fairness" and legitimacy in terms thereof of the process within which competition for economic success takes place is a central American value, whereas "justice" and legitimacy instead in terms of the distribution of success is a central European value. In turn, perhaps, this contrast reflects the uniquely different, egalitarian nature of the American society built on free immigration and the traditional, hierarchical nature of European society. Equality of access matters in the United States, equality of success in Europe.

The use of fairness is thus a central feature of the demands in the United States for harmonization. Naturally enough, since fairness like beauty is in the eyes of the beholder and also because the United States is a major player in trade negotiations whether multilateral or bilateral, it follows that the American demands also tend to seek to remake the world in its own image. As Suzanne Berger has said well:<sup>7</sup>

"Americans believe that productivity growth must be based upon legitimate practices in production. . The gains that accrue to producers are

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<sup>6</sup> Cf. Bhagwati (1991) where the rise of fair trade demands, as a threat to the world trading system, was first discussed and some of the explanatory factors analyzed.

<sup>7</sup> Berger (1993, page 2).

legitimate only if they come from legitimate economic arrangements. Gains from sweated or prison labor are seen as legitimate gains. I think that in the American debate, the argument over the legitimacy of the keiretsu is essentially one about whether they should be seen as a form of network organization, in which case they are legitimate and perhaps to be imitated. Or whether the keiretsu are organizations in which large firms beat up on their subcontractors who, in turn, beat up on their workers, in which case they ought to be reformed or eliminated through international pressures. Gains in trade are thus seen as fair to the extent that they are based on national practices which are themselves fair and legitimate. Such debates propel other nations' practices into the center of the international agenda."

The demands for harmonization that ensue from notions of fairness extend to competition in one's own markets (i.e. they relate to one's imports ) or in others' markets (i.e. they relate to one's exports), the latter, in turn, dividing into one's exports to another country's own market or to third markets. Thus, the United States may make fairness claims, and indeed makes them, about Japan's exports to the US market, US exports to Japan's market, and shares of US and Japan in exports to third markets.

Thus, the fairness claims about imports have conventionally related to unfair uses of subsidies and the unfair private practice of (allegedly predatory) dumping. Uses of countervailing duties (CVDs) against unfair subsidies and of anti-dumping (AD) duties have long been sanctioned by national and GATT-legitimated practice. These unfairness claims are now being extended, especially to environmental and labor standards. The argument is that it is unfair competition if your rival in an industry faces lower burdens than one does, because of differential standards. The implied norm of fairness seems to be simply that , no matter what the economic and other justifications for the existence of such differential standards (and, as I shall note later, there certainly are compelling ones), they evidently constitute a lack of symmetry in the environment faced by competing firms in the industry in different nations and

hence ipso facto are unacceptable.

In a penetrating analysis of the norms of fairness underlying the claims regarding unfairness in exports to others' markets, as reflected in the legislative debates and content of successive versions of Section 301 of US trade law, which authorizes retaliatory action by the US against unfair foreign trade practices affecting US exports, Ken Abbott (1993) has distinguished among (1) the norm of adherence to international commitments and law<sup>8</sup>, (2) the norm of nullification or impairment of previous trade concessions or agreements<sup>9</sup>, (3) the norm of non-discrimination<sup>10</sup>, (4) the norm of reciprocity<sup>11</sup>, and (5) the norm of the free market<sup>12</sup>. There is little doubt that the panoply of these norms, legitimating in the eyes of the US complainants in industry and in the Congress the view of foreign practices as unfair and hence actionable, has fuelled significantly the growth in demands for harmonization, i.e. for removal of those practices and to thus harmonize other countries' domestic policies and practices in a variety of areas closer to those of the United States.

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<sup>8</sup> Abbott means by this the claim that a foreign practice violates an accepted commitment, whether at the GATT multilaterally or in bilateral and plurilateral treaties. Evidently, this is the fairest norm! The only, and critical, question it raises is: what procedure is used to establish that a commitment has been violated.

<sup>9</sup> This differs from violation of agreements in the sense that it is not a direct, explicit violation but an indirect de facto violation. Thus, if I see you a house and deny you possession, that is a violation. But if build a moat around it, over which I have control and you do not, that is tantamount to nullifying my contract and your rights indirectly. Article XXIII of the GATT addresses both types of denial of a Contracting Party's rights.

<sup>10</sup> This norm is prominent in the GATT, of course. Abbott considers several cases where the US complainants to the US Trade Representative's office cited discriminatory practices, whether covered by treaty or not, as inherently unfair. These practices discriminated against US firms in favour of domestic firms (the so-called "national treatment" being denied) or in favour of other foreign firms.

<sup>11</sup> This simply matches what we face with what you face. Non-discrimination is clearly compatible with lack of reciprocity. Abbott distinguishes among different notions of reciprocity as revealed by the legislative debates.

<sup>12</sup> By this, Abbott means that a practice is considered unfair because it distorts market outcomes. As I argued earlier in my book, Protectionism (1988), the economic-philosophical basis for free trade is the Darwinian process: markets should determine outcomes. If trade practices distort that process, then their legitimacy is at a discount; unfairness ensues. Abbott discusses practices such as foreign targeting of industries for support as one such unfair practice in the US debates and in the 1988 legislation.

## II. STRUCTURAL ARGUMENTS AGAINST DIVERSITY

The economic (as distinct from the philosophical) arguments for harmonization have arisen from a variety of reasons. Among the principal ones, we must consider structural changes in the world economy. These can be divided into (i) those that are specific to the United States and arise from a sense of relative decline in the world economy, what I have called the "diminished giant syndrome"; and (ii) those that are more general and afflict several economies simultaneously, producing similar reactions internationally.

### I. The Diminished Giant Syndrome

The two decades, 1970s and 1980s, witnessed in the United States the rise of the "diminished giant syndrome": a relative decline in her share of world GNP and trade as the nations of the Pacific, especially Japan, became major players in the world economy, and with it a sense, and hence a syndrome, of absolute decline as well.<sup>13</sup>

This set a historical parallel with the end of the 19th century in Britain where the rise of Germany and the United States as major players in the world economy had also disconcerted many.

In both countries, the reaction was similar. Free trade without reciprocity was decried. In Britain, Fair Trade Leagues and Reciprocity Associations grew up just as the US Congress was seized with similar concerns with

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<sup>13</sup> See, in particular, Bhagwati (1988).



nonreciprocal and unfair access to her markets by her rivals.<sup>14</sup> In the British case, of course, this nonreciprocity was indeed a reality as Britain had long been a unilateral free trader in ideology and in policy since the repeal of the Corn Laws by Prime Minister Robert Peel in 1846. In the case of the United States, which had never accepted unilateral free trade, the belief in her openness while others were closed was exaggerated, though held with great conviction.

Declinism has thus fed, for sure, the ethos in the United States in favour of reciprocal openness. In turn, it has also legitimated demands for fair trade or "level playing fields", prompting great concerns in policymaking with whether the newly successful trading rivals are "cheating" or gaining advantage in competition that is simply unfair.<sup>15</sup> The willingness to play by the rules of free trade has always been easier, as economic historians have observed, for countries that expect to win from Darwinian competition; declinism cuts into that optimism and sets up roadblocks such as demands for fair trade that will, in the guise of demands for level playing fields, in fact gain oneself the higher ground.

Then again, the fact that the foreign nations which had emerged as strong rivals were in the Far East [ though Lester Thurow (1993) would have us confront the European Community and Germany as even more fearsome rivals, a diagnosis that looks increasingly unpersuasive), was a contributory factor.

Now, the British were not exactly sympathetic to the Germans, for sure, and the rise of the United States, a former colony that had chosen the way of

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<sup>14</sup> The parallels and contrasts between the British and the American cases have been developed at length in Bhagwati and Irwin (1987).

<sup>15</sup> Since cheating or unfair trade in foreign countries' practices, including many domestic practices, cannot be alleged if they do what we do, evidently a great number of these objections translate into demands for the foreign nations doing what we do, i.e. into demands for harmonizing their domestic practices with ours.

war and independence, may have been grating too. But, in the case of the United States today, with its generosity towards rebuilding Japan after the Second World War, and her support for Japan's entry into the GATT in the teeth of European objections, resentment of Japan's success does not appear to have been a problem. Rather, the fact that Japan's internal economic and social culture made the penetration of the Japanese market difficult relative to others because of its long history of "controlled openness", and the view since the 1930s that Japan was a predatory exporter which could not be allowed to play trade by rules but had to be continually restrained by quotas on her exports, combined to give credence to the perception that trade with Japan could not be left to the rules of free trade. Instead, fair trade and reciprocity, carried to the length of guaranteed results in terms of expanded imports (Voluntary Import Expansions) and reduced exports (Voluntary Export Restraints) , had to be imposed on Japan.

## 2. Globalization of the World Economy

The demands for fair trade have also come from structural changes in the world economy which afflict several nations simultaneously and in similar fashion.

(i) Kaleidoscopic Comparative Advantage: Chief among them is the fact that, increasingly, the integration of the world economy has made several more industries footloose than ever before, facing fierce competition with a much-reduced cushion for their competitive edge vis-a-vis their rivals abroad. Let me explain why.

The research of the economists Will Baumol, Susan Blackman and Ed Wolff has shown that technological knowhow has converged significantly among the OECD countries in the postwar period through the 1970s. The economist Richard Nelson has argued persuasively that today much

technology can be easily accessed simply by having skilled personnel with the necessary scientific training from the universities; hence some of the frantic search for patent rights (to secure royalties, not to prevent dissemination). Multinationals have also become ubiquitous: they mutually penetrate each others' turf, so that Servan -Schreiber's American Challenge (to Europe) yesterday could be the Tolchins' Japanese Challenge (to the US) today.<sup>16</sup> At the same time, the developed world's capital markets are more closely integrated than before, though the tendency of domestic savings to mimic domestic investment has not been greatly dented.<sup>17</sup>

The net result is that several industries can be readily competed for by many developed countries, with comparative advantage rather fragile, so that the advantage anyone enjoys in any such industry is of a knife edge variety. Comparative advantage in these industries then is kaleidoscopic : it will move across countries almost randomly. In the old jargon, these industries are "footloose".<sup>18</sup>

In this situation, you can fairly expect those who are investing in and managing these industries to be extremely sensitive to any possibility of an "unfair" advantage gained by their foreign rivals: the slightest advantage enjoyed by them becomes suspect because it can be fatal. This implies then that demands will be made, both for zero-tariff or mutually-identical tariff options and for NTB matching among countries, as also for harmonization of any elements of domestic policies and institutions that might be considered to give one's rivals an edge in competition.

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<sup>16</sup> That there could be mutual, direct foreign investment (DFI) in two advanced countries was first noted by Stephen Hymer (1976). That such mutually-penetrating investment (MPI) would increasingly take place within the same industry , as it has amply done since, was noted and theorized about in Bhagwati's (1972) review of Raymond Vernon's (1971) Sovereignty at Bay .

<sup>17</sup> On this issue, see the fine survey by Jeff Frenkel (1993).

<sup>18</sup> The concept and phrase, kaleidoscopic comparative advantage, were developed in Bhagwati (1991 b) and have been elaborated further in Bhagwati and Dehejia (1993).

(ii) Exchange Rates:

Yet another reason why sensitivity to differences in domestic policies and institutions by trading rivals has increased might appear to be the shift to a regime of exchange rate flexibility. However, the shift is to a dirty float and exchange rate volatility is not as pronounced as feared by the proponents of fixed exchange rates. Nor is there any evidence that the shift to flexible exchanges rates , in any event, has reduced significantly the volume of trade transactions<sup>19</sup> .

A more persuasive case instead might be made for the argument that serious overvaluation of a currency could, by making the tradeable sectors highly uncompetitive, fuel their demands for harmonization to moderate the winds of competition in open economies. It may be no coincidence that the rise of fair trade concerns and associated demands for harmonization reached a higher level of political viability during the 1980s when the dollar was substantially overvalued and protectionism was rampant in the Congress.

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<sup>19</sup> See the work of Alexander Swoboda, for instance, on this subject:

### III. ECONOMIC ARGUMENTS AGAINST DIVERSITY

The economic arguments against diversity arise principally from concern with the following question: does the case for mutually-gainful trade between voluntarily trading nations, which is at the heart of the case for free trade, survive if there is diversity in domestic policies and institutions among them? In short, instead of mutual gains from trade, could we get predation for a trading nation if such diversity persists under free trade? Or, since relative gains from trade can also be an issue, one may also ask the related question: even if predation is not inflicted on oneself, does diversity reduce one's absolute or relative gains from trade?<sup>20</sup>

#### 1. The Nullification Idea and Problem:

But prior to discussing this range of problems, I should mention that the the analysis and institutional organization of free trade (as at the GATT) have always reflected a concern with the domestic policies of the trading nations (though not with harmonization thereof, except in a fundamental sense that I spell out below). This is because economists have recognized that the effects of trade policies can be nullified or impaired (to use GATT phraseology) by

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<sup>20</sup> These questions, discussed below, were raised in Bhagwati (1991c) in a paper which provided the analytical guidelines for the economist participants for the Bhagwati-Hudec Ford Foundation project, op.cit.

domestic actions.

(i) The Idea of Equivalence: Thus, economists are aware that imposing a tariff on a commodity is equivalent to imposing instead a consumption tax on it and giving a subsidy to domestic producers of it. For, the tariff raises prices to consumers and for producers: both effects can be directly achieved by the mix of a consumption tax and a producer subsidy. This is just one of many "equivalence" propositions that the students of international economics are alerted to by their teachers.<sup>21</sup>

It immediately follows that any trade concessions can be nullified by imposing an offsetting set of domestic policies. No institutional arrangement that oversees and then monitors trade liberalization can afford therefore to confine its rules and attention to "border" measures. There follows therefore the notion that an institution such as the GATT must have a nullification or impairment clause, as indeed Article XXIII is, to examine complaints that trade concessions have been offset by domestic policies. I should imagine therefore that the inclusion of Article XXIII into the GATT at the very outset was approved, perhaps even suggested, by the distinguished economists associated with its design, chief among them the British Nobel laureate, James Meade.

(ii) The "Systemic" Problem: Markets Matter: But the question of nullification or impairment turns into a "system" question of far more overarching range when we confront the fact that the way an economy is organised, it simply cannot be expected to offer trade concessions that can be translated into meaningful commitments of market access. Let me raise four specific areas where this question has become significant, inside and outside the GATT: (a) State trading; (b) Trade with the former centrally planned

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<sup>21</sup> See, for instance, the graduate-level textbook by Bhagwati and Srinivasan (1983, Chapter 15). Equivalences on one dimension, however, do not always translate into equivalence on other dimensions.

economies (CPEs); (c) Trade with the developing countries; and (d) Trade with Japan.

In each case, the main burden of the concerns voiced by Contracting Parties, and of the demands for corrective action, has related to the presumption that markets matter. If markets do not function adequately because of specific domestic institutions (such as State trading) or the entire domestic economic system (such as that characterizing a CPE), then free trade by rules as contemplated by the GATT system would fail to produce the desired gains from trade.

(a) State Trading: GATT, and economists supporting free trade, presume that "trading enterprises will act on commercial considerations and that the economic theories of comparative advantage will lead these enterprises to extend their international trade in order to reap its benefits".<sup>22</sup>

The architects of the ITO had been concerned with the fact that State trading needed to be regulated in some fashion if it was to be made tolerably compatible with a rules-based system of free trade that would let firms compete meaningfully for markets whose access had been obtained by tariff concessions. Article XVII of the GATT eventually carried over two of the original three provisions in the US ITO proposals, including the requirement that State trading organizations be operated in a nondiscriminatory manner.

Eventually, a 1955 Working Party recommended amendments to Article XVII which were adopted in 1955 and were made effective in 1957. As noted by Jackson (1969), other provisions of the GATT also address the issues raised by State trading organizations: among them, Article II, paragraph 4, and Interpretative Notes relating to Articles XI through XIV and article XVIII. Provisions relating to all other governmental activity also bear on the GATT

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<sup>22</sup> Cf. Jackson (1969, p.330).

obligations imposed on State trading organizations.<sup>23</sup> The exemptions to the State trading obligation, originally permitted for "imports of products for immediate or ultimate consumption in governmental use and not otherwise for re-sale or use in the production of goods for sale", have subsequently been brought under discipline in the Tokyo Round Procurement Code and subsequent negotiations.

(b) Centrally Planned Economies: Jackson (1969, p.361) has well said: "If the existence of state enterprises in an economy that generally follows a free enterprise system poses... problems [for the GATT], consider the problem posed by an economy that is entirely or largely operated by state enterprises !" In fact, the accommodation of the erstwhile socialist countries into the GATT system posed considerable difficulty that surfaced again when the Soviet Union, under Mr. Gorbachev, sought GATT entry and have appeared also in the matter of China's reentry into the GATT.

From the beginning, however, the Contracting Parties were torn between the desire to make the GATT as inclusive in membership as possible and the difficulty of accommodating (into a rules-based markets-presupposing international organization) countries whose economic and political organization was clearly based on nonmarket principles. France, with its attachment to dirigisme, expressed the inclusive principle best through its delegate at the drafting session in 1946<sup>24</sup> :

France wishes to see that the organization which we are planning here extends to the rest of the world... There does not exist, in our opinion, any necessary connection between the form of the productive regime and the internal exchanges in one nation, on the one hand, and on her foreign economic policy on the other. The United States may very well continue to

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<sup>23</sup> See the detailed discussion in Jackson (1969, Chapter 14), especially Section 14.3, pp.336-339.

<sup>24</sup> The following discussion, and quotes, come from Jackson (1969, pp. 361-364).



follow the principle, the more orthodox principle, of private initiative. France and other European countries may turn towards planned economy. The USSR may uphold and maintain the Marxist ideals of collectivism without our having to refuse to be in favor of a policy of international organization based on liberty and equality....

Given the triumphalism that attends market-based capitalism today, the French characterization of the American preference for private initiative as "orthodox", and the indulgence towards the USSR for its Marxist ideals, seems ironic, indeed. But the French statement captures pretty well the general feeling that the world was and would continue to be diverse in the methods chosen to organize national economies, and that the GATT should try to accommodate somehow the socialist nations.

Indeed, the US position at the discussions on the ITO and at the GATT was precisely to find formulas to do so. The solution to the problem of defining market access obligations meaningfully, when markets did not exist in socialist countries, was to go for what we call today "results-oriented", "managed trade", quantitative import obligations in the context of the "Japan problem". Thus, the United States, in its suggested draft of the ITO Charter, suggested that countries with a "complete or substantially complete monopoly of its import trade" (which would include all socialist countries, of course) should conclude agreements undertaking "to import in the aggregate over a period products of the other Members valued at not less than an amount to be agreed upon...subject to periodic adjustment".

As it happened, this technique was used subsequently in defining the obligations of socialist countries acceding to the GATT. Thus, when Poland entered the GATT in 1967, having negotiated its entry during the Kennedy Round, the Schedule for Poland carried the obligation "to increase the total value of its imports from the territories of contracting parties by not less than 7

per cent per annum”.

Of course, the early socialist states in the GATT were Czechoslovakia (which had long joined the GATT before it fell to communism), Yugoslavia (which joined in 1966) and Poland. The latter two were not of importance in world trade. With the Soviet Union and China, the issue was far more potent, given the enormous size and trade potential of the two countries, raising the question of their GATT entry into a qualitatively different phenomenon. The condition of entry would then shift from quantitative import obligations (whose meaningfulness has been challenged effectively in the Japan context by several economists) to a demonstrated commitment to, even successful transition to, markets by these countries.

(c) Developing Countries: The Special & Differential (S&D) Treatment accorded to the developing countries at the GATT amounted to a virtual exemption of these countries from many of the disciplines and norms of the GATT. S&D followed from the postwar theoretical presumption that developing countries were subject to modified economic principles, subsumed under the title of Development Economics, such that they had to be treated differently as a class in international economic arrangements.

Thus, it was not that these countries were not working with markets. It was that the market principles did not apply effectively, given the institutional structures characterizing these countries. Thus, for instance, they had endemic balance of payments problems which required them to work without even current account convertibility, so that import restrictions for balance-of-payments reasons were necessary. But this meant in turn that the developing countries could not be expected to offer real market access to other Contracting Parties at the GATT: the use of Article XVIII (b), permitting the use of trade restrictions for

payments reasons temporarily became, in effect, a permanent matter, constituting an open door through which all developing countries could walk out.

Aside from this economic-theoretic legitimation of S&D treatment of the developing countries, S&D also made political sense in much the same way as the permitted entry into the GATT of the socialist countries did. Developing countries were just not important enough to make much difference to the developed countries, leading them to concede demands for S&D, including lack of reciprocity in trade concessions, without much fuss.

Evidently, in both regards, views have changed dramatically in recent years. Developing countries are much bigger players in world trade today and few developed countries are willing to grant S&D today, except to the countries truly at the bottom of the pecking order, the so-called "least developed countries". But, more importantly, economic theory no longer considers developing countries to be "off the curve", requiring a different kind of economics to understand them and to prescribe suitable policies for them. In particular, it is now thought that current account convertibility can be achieved far more quickly than was thought to be the case earlier. Witness for instance the recommendations being made towards this end to the former socialist countries in light of the new thinking: where the war-ravaged Europe was guided to convertibility over a decade by economists such as Robert Triffin, and developing countries remained on inconvertible currencies for decades in the postwar period, Poland, Russia and others are being advised to go convertible overnight ! Regardless of the soundness of such advice --- and the abysmal failure of "shock therapy" in Russia is a useful reminder that economists can go dramatically wrong ---, the fact remains that modern economic thinking does not admit any longer that developing countries have a unique inability to shift to

macro policies that can restore convertibility to the current account so that trade policy can then be "assigned" GATT-style, not to address balance-of-payments concerns, but to offer rules-based market access and thus to generate the resulting gains from trade both for themselves and for their trading partners.

In fact, today, if the NAFTA negotiations by the United States are any guide, we may well be entering a new era of "reverse S&D" because of the fear (discussed by me in Section I) that trade with the poor countries could hurt the real wages of the unskilled in the rich countries. This fear led to attempts at enforcing minimum wage increases and upgrading of environmental standards (and hence costs) in Mexico that had no parallel in the earlier negotiations with Canada (except that it was in Canada that certain groups had unsuccessfully worried about differences in social legislation between Canada and the US as yielding the US "unfair" advantage); and Mexico had to accept trade sanctions as the ultimate recourse by the US in case of violations of environmental standards whereas Canada successfully rejected this. This asymmetry of obligations, tougher for Mexico than for Canada, may set a pattern that is indeed tantamount to seeking greater obligations for free trade from the developing countries than from the developed.

(d) The "Japan Problem": The question of nullification or impairment because markets do not function as required to make trade concessions meaningful has emerged most dramatically in regard to trade with Japan, however.

The belief that the Japanese market is closed because of "informal" trade barriers that reduce effective market access is held with sufficient conviction to have led the EC to initiate an unsuccessful GATT complaint under Article 23 against Japan (as distinct from a complaint against a specific Japanese industry

or sector). It has also led the Clinton administration to attempt a politically supercharged shift in its Japan policy to impose managed-trade quantitative import targets, VIEs (Voluntary Import Expansions), in several sectors such as vehicles and autoparts.

These VIEs are possibly a substitute for the earlier attempts by the Bush and previous administrations to use the Structural Impediments Initiative (SII) to impose changes in Japan's domestic institutions and policies, more in line with those of the United States, in the expectation that such harmonization would make Japan's markets more accessible, indeed as accessible as those of the United States. But the demands for VIEs may also be seen as a tactical device to extract such harmonization as a more acceptable option for Japan to seize in negotiations. That differences in Japan's domestic institutions and policies amount to making Japan an "unfair" trader is, of course, an assertion that is commonly made in US Congress and by industrial lobbies.

Of course, the critics of Japan consider the problem with Japan to arise not merely in regard to access to her markets. More traditionally, they have focused also on her exports, considering Japanese business practices to be predatory (and hence a natural target for anti-dumping actions). This view is further reinforced by the view that Japan's government, through MITI, targets unfairly specific foreign industries for massive onslaught. Moreover, modern theory has provided greater legitimacy for the view that, by keeping her markets closed, Japan gives unfair advantage to her producers in high-tech sectors where scale economies are important, since Japanese producers enjoy access to both their own and others' markets while others are kept confined to their own markets. Thus, import protection can lead to export promotion:

comparative advantage is shifted unfairly towards Japan in such industries.<sup>25</sup>

Of course, these beliefs are not necessarily justified simply because many hold them, any more than the Jewish people are wicked simply because many anti-semites through the centuries have believed them to be. Indeed, serious examinations of these questions throw considerable doubt on the probity of such accusations.

## 2. Gains from Trade:

Whereas the demands for harmonization come then from the sense that otherwise the trade concessions granted by others will be nullified or impaired, the economist must recognize a different kind of argument that also drives such demands.

This comes from the sense that , whereas the conventional economic view is that free trade between nations is to their mutual advantage, amounting to a positive-sum game, this need not be so when these nations have different domestic institutions and policies behind their borders. That, predation could, often would, follow instead.

Alternatively, even if mutuality of gain is conceded, the fear is that the absence of harmonization will create an unfavorable distribution of the gains from trade. This is a less stark view of the matter: but, as political scientists continually remind economists, relative gains are arguably the more important bone of contention in international conflict and cooperation.

If we examine the earliest debates on harmonization, in the context of

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<sup>25</sup> This is an old argument, made well by Richard Pomfret(19 ) for example. It has been revived, in the context of modern developments in the theory of imperfect competition, by Paul Krugman (198 ), Both authors use the phrasing that import protection leads to export promotion. For an alternative way in which this may happen, even when scale economies are not present, see Bhagwati (198 ).

policymaking and alongside among international economists, these arose in the case of the European Community and in relation to the question of tax harmonization, as one would expect.<sup>26</sup> Interestingly, the dominant view among the economists who led the discussion at the time --- and these included the future Nobel laureates, Jan Tinbergen of Netherlands and Bertil Ohlin of Sweden ---- was that diversity of tax policy among the member states of the EC was compatible with mutual gains from trade. Thus, Reddaway (1958, pp.72-73) argued, citing the difficulty of proving things theoretically but resorting to "some simple facts, which at least give general presumption that harmonization of

taxation and social charges [ as demanded by the French ] is not indispensable":

"This country [UK] had a regime of free trade for many years, the Benelux countries are not so very far away from it now --- they are much nearer to free trade, for example, than to the position of France. Under each of these sets of circumstances --- and it is the ones when barriers were low that are most relevant --- tax systems and tax levels have differed greatly from one country to another, but this has not prevented international trade from flourishing and bringing great benefits to participants. One might indeed press this argument further, and say that the European countries have, in the last eight years or so, taken very important steps through the OEEC liberalization program to reduce the barriers to European trade: few would deny that the expansion of this trade has been very beneficial, despite the extremely varied taxes which the countries impose. In a sense the onus of proof is on those who would argue that further reductions of barriers require an elaborate harmonization of taxes....

Secondly, let us note that in cases [e.g. Benelux] which are broadly analogous to the [European] Free Trade Area tax systems have not been harmonised.... Similarly, in Federal countries like Australia, Canada or the U.S.A., the various States or Provinces show significant differences in their taxes, but trade between them is universally regarded as beneficial."

Similarly, Ohlin (1965, pp.83) challenged the "firm belief" in some quarters that "it is not possible to eliminate duties on trade among a large

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<sup>26</sup> See, for instance, the excellent discussion in Johnson, Wonnacott and Shibata (1967).

number of countries if one does not at the same time bring about a real economic integration, by means of a harmonization of economic and social policy in general”:

“It is not possible to “harmonize” the climate; yet international trade can run smoothly...Trade will adapt itself to differences in the social and financial milieu in the same way it does to differences in climate....there is no prima facie case for harmonization of the tax system in general.”<sup>27</sup>

But if these economists were assertive about domestic diversity being compatible with mutual gains from trade, I detect signs of their admitting that more harmonization could increase the total gains from trade. The question of the distribution of the increased gains from trade was left unraised.<sup>28</sup> Later analyses, as in Shoup (1967), were sharper and did focus better on the theoretical aspects of tax harmonization in the context of trade liberalization such as in the EC: their analysis going so far as to discuss the problem as being symmetric to the question of removal of tariffs themselves, with the concepts of trade diversion and trade creation applied to the effects of domestic tax differences and changes.

Today, of course, the skepticism about the possibility of mutual gains from trade despite diversity in many domestic policies, tax and otherwise, has vastly increased. The presumption of predation from free trade in the absence of harmonization is sufficiently widespread to mark a radical change in attitudes on the question. It has become therefore a key question for economists to analyze in regard to different areas of domestic policy, such as environmental,

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<sup>27</sup> Ohlin's analysis is richer than the quotes above indicate, also extending to questions of international capital mobility.

<sup>28</sup> I base this conclusion on reading Reddaway (1958) and Ohlin (1965), in particular. Reddaway was also a member of the Tinbergen Committee which reported on this question to the EC.



labor and competition policies.

Thus, the questions I distinguished above, about predation and about the relative gains from trade, need to be analytically addressed, so that the virtues and vices of diversity are understood better by economists in terms of their own methods of evaluating the social desirability of alternative policies.<sup>29</sup>

#### IV. POLITICAL ARGUMENTS AGAINST DIVERSITY

Finally, there is a class of arguments against diversity which can be described as belonging conventionally to the political domain. They come from protection-seeking: the protectionist demands are more effectively made when unfair competition, based on (unreasonable) diversity abroad, is alleged. Equally, environmentalist and labor groups are agitated that free trade, given domestic political economy, will pull down domestic standards when lower foreign standards are claimed to be putting one's industry at disadvantage, producing a "race to the bottom". Then again, harmonization demands arise in the context of political integration such as that desired in the European Union. Just as in federal nation states such as India, Canada and the United States, demands are then made for a common set of social standards, not because they are essential for economic reasons but because political integration requires that each State should have at least a minimum set of standards, as in a Social Charter, in common among themselves.

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<sup>29</sup> Therefore, these are the "core" questions being addressed by the economists on the Bhagwati-Hudec project, op.cit.

I. Protection-seeking:

Two arguments may be distinguished.

(i) Eased Supply of Protection: If one thinks of actual protection as emerging from the interaction of those who demand protection (e.g. unions and firms in import-competing industries) and those who supply it (i.e. the Administration and the Congress/Parliament), then it is manifest that the supply would be eased if, instead of simply saying that you were under pressure from foreign competition and that you needed protection, you said: the foreigners are succeeding because they compete unfairly.<sup>30</sup>

The use of traditional "unfair trade" mechanisms, the anti-dumping and countervailing duties (offsetting foreign subsidies) processes, has obviously increased through the 1980s for this, among other reasons. But the objection to all sorts of differences in domestic policies and institutions in foreign countries has also been fuelled by this protectionist ploy. For example, the large numbers of complaints against Japan, a successful trading rival, under the SII are to be explained, partly at least, in this fashion. Either these complaints lead to capitulation and consequent hoped-for increase in the production costs of one's rivals. Else, these demands would be rejected, or informally accommodated in negotiations but without being seriously implemented, in which case the ethos that foreigners are indeed wickedly unfair and untrustworthy would be intensified, making the support of protection correspondingly easier for Congressmen who otherwise espouse free trade.

(ii) The Law of Constant Protection: In addition, the use of unfair trade complaints as a way of securing protection may be simply a substitute for the old-fashioned use of trade and quota barriers that came down with successive multilateral barrier reductions under GATT auspices in several Rounds such as

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<sup>30</sup> See the discussion in Bhagwati (1991 a).

the recently-concluded Uruguay Round. Economists have thus speculated that there may be a Law of Constant Protection: you stop protection in one form and it props up in some other form elsewhere.<sup>31</sup>

## 2. Standards at Bay: "Race to the Bottom":

But the most potent political argument leading to demands for upwards harmonization has been in regard to environmental and labor standards as a precondition for free trade. This argument, often characterized as a "race to the bottom" where different jurisdictions, either local in federal nations or different countries, wind up competing with one another for industry which would otherwise be feared to gravitate to where the standards are the lowest at the outset.<sup>32</sup> Looked at differently, free trade is supposed to lead to harmonization downwards from below. To prevent it, harmonization upwards from the top is demanded by the environmentalists and the labor groups before trade is liberalized with developing countries.

The problem of harmonization downwards can arise from simply trade. It is usually considered, however, in the context of international capital mobility. It is feared then that entrepreneurs will simply close existing plants in the developed countries and move to the poor countries where the standards are lower. The latter problem is the more difficult politically. For, when factories close and the workers and their communities know where the factory has been transplanted abroad, the negative psychological reaction is more focused than when your job is lost to general competition from trade with many different

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<sup>31</sup> See the formulation of this Law in Bhagwati (1988). Recent, unpublished research by Ed Mansfield of Columbia University, using a mass of cross-country data, provides support for this Law.

<sup>32</sup> There is a vast literature in both economics and in law on this problem by now. See, in particular, the legal writings of Stewart (1977a) (1977b) and Revesz (1992), and the economic writings of Tiebout (1956), Buchanan and Goetz (1972), Oates and Schwab (1988), and Wilson (1993) for the Bhagwati-Hudec project, op.cit.

countries. The "hiding hand" of the market that prevents you from knowing who and presumably what caused your loss of a job, in your factory, tends to diffuse the resentment, I think: and this advantage disappears when a furniture factory closes in San Diego and reopens in Tijuana, south of Rio Grande, especially when Mexican environmental requirements on furnitremakers are far more demanding than the tough ones in California.

While my own view is that diversity in environmental standards, within an industry across countries, is perfectly reasonable and is even compatible with equal overall concern with the environment in these countries, I do feel that this extra concern that obtains inevitably with international movement of direct investment in an industry to lower-standard developing countries justifies resorting to a policy in developed countries (with higher standards in an industry) which requires that their (say, US) firms, when they go abroad (say, to Mexico), work with the higher standards (of the US) than with the lower standards (of Mexico). I.e. in Rome do, not as Romans do, but as Bostonians do.

Since firms are legal persons, American firms can be treated (as indeed they are in many matters already) as American citizens, subject to US laws wherever they operate. The conflict of interest that often follows when a country so exercises its jurisdiction on firms operating abroad --- as when the US sought to enforce the embargo against Cuba on American firms in Canada ---, is most unlikely to obtain here: it is hard to see Mexico, for instance, objecting to US firms adopting higher standards of environmental and labor standards in their factories. In fact, when I recently advanced this proposal at a few international conferences and in an op.ed. article in The New York Times (Bhagwati, 1992), the reaction from several Mexicans was favorable, as was that initially from several Americans, including in Congress. In the end, it did not take off, partly because the different approach of the supplemental agreements

for NAFTA was more or less set in cement by that time, and largely because US businesses, which were definitely interested in investing in Mexico contrary to their coached denials of their intentions once they began to be burnt on the issue in the public domain, were reportedly unhappy at the thought that they would be subjected to any restrictions on their ability to exploit whatever local environmental and labor standards Mexico required of all firms, whether Mexican or foreign. There is admittedly a problem of "horizontal equity" among different foreign firms in Mexico: US firms would be abiding by tougher US standards in Mexico whereas Japanese and European firms would not, thus putting our firms at a disadvantage. But surely if you believe that your standards reflect your valuation of environmental damage of a certain variety, you should stick by them even when others who do not share that valuation do not. Moreover, we ignore the dynamic of the proposal: if US firms operate at US standards, that itself is likely to put pressure on other foreign firms to shift to the US standards in Mexico or face adverse political reactions, including from Mexican NGOs

The "race-to-the-bottom" issue itself is highly contentious. Both in terms of economic logic and in empirical terms as to whether lower environmental and labor standards have actually pulled in capital flows as suggested and whether, in that event, standards have actually gravitated downwards in reality in federal setups or across countries, the fears of harmonization downwards from below are certainly disputed vigorously today. Nonetheless, it must be said that these fears certainly drive the demands for harmonization upwards as preconditions for trade liberalization with developing countries.

### 3. Political Integration versus Simply Free Trade:

In contrast to arm's length free trade, politically integrating nations as in

the European Union are observed to supplement elimination of trade barriers with attempts at imposing a minimum set of common standards, especially in the social sphere, on member states. While the EU (originally the Common Market or the EC, the European Community) began its discussions of harmonization, as in the matter of taxation that I discussed above, from the strictly economic viewpoint, and the demands of the French were certainly made in this fashion at the time, it seems that the political rationale for these demands overtook the economic ones as the EC moved ahead. I suspect that this was definitely the case with demands for labor policy harmonization, which eventually turned out to assume the political dimension I have defined here, and which translated eventually into the adoption of the Community Charter of Fundamental Social Rights, as modified at the Strasbourg European Council in December 1989 by 11 of the 12 member states then (the exception being the United Kingdom).

Interestingly, while the NAFTA began originally as a simple free trade arrangement, closely approximating an arm's length free trade negotiation, the dynamic was such that it wound up much closer to the EC model of closer integration, with the supplemental agreements on environment and labor standards becoming critical components of the treaty. The explanation lies partly in several of the factors I discussed earlier, such as the fear of decline in real wages of the unskilled in the US, and the fear also of harmonization downward from below, otherwise. But the notion that the EC provided the correct model to think of NAFTA instead became dominant among the NGOs: the Mexican sociologist Castaneda has particularly emphasized this dynamic of

"unanticipated" transformation of the NAFTA negotiations.<sup>39</sup>

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<sup>39</sup> In some of my writings on NAFTA, I took the similar but essentially different position, not shared by any economist that I know of, that NAFTA was a preferential trade arrangement being undertaken for, and with, Mexico (and not for others) by the United States, and therefore making demands on Mexico for a minimum set of democratic and social standards was thoroughly reasonable as a price to be paid by Mexico. One would not want to make preferential deals for the benefit of countries that did not adhere to some minimum set of such standards.

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