WORKING PAPER

A Transactions Cost Politics Analysis
Of International Child Labor Standards

Drusilla Brown
Department of Economics
Tufts University

Discussion Paper 98-19
Department of Economics
Tufts University

Department of Economics
Tufts University
Medford, MA 02155
(617) 627-3560

A TRANSACTIONS COST POLITICS ANALYSIS OF INTERNATIONAL CHILD LABOR STANDARDS

by

Drusilla K. Brown
Tufts University

May 1998

(revised)

Prepared for a conference on the Social Dimensions of U.S. Trade Policies, James Madison Building, Mary Pickford Theater, U.S. Library of Congress, Washington, D.C., sponsored by the School of Public Policy at the University of Michigan and the Congressional Research Service, April 16-17, 1998.

SUMMARY

This paper reviews some of the issues that pertain to the treatment of child labor in the international arena. A review of the standard prescriptions for reducing child labor provide little hope that the welfare of children can be improved in the absence of world-wide economic growth, development and increased adult wages.

Familiar prescriptions such as import tariffs levied against goods produced with child labor are likely to leave children with lower wages and/or in more damaging occupations. Similarly, product labeling, intended to identify goods produced without child labor, can have adverse consequences for working children. If the premium paid for labeled products is not sufficient to compensate firms for the cost of using adult labor only, then no firms will label. If the premium paid for labeled products is just barely sufficient to cover the cost of using adult labor only, then all of the label premium will be dissipated by the use of an efficient technology. Some firms will use only adult labor and label their products to that effect, but the wages and employment of adult and child workers will be unaffected. If the labeling premium is more than enough to compensate firms to shift to adult labor-only production, then adult wages will rise and child wages will fall. Children will be made better off only if the increase in adult wages is sufficient to place family income above the threshold level where child labor begins to decline. As a consequence, if the labeling premium is effective in improving the welfare of children the reason is that the label premium raises family income, not because it provides a disincentive to firms to hire children.

The allocation of the task of monitoring child labor to the ILO rather than the WTO is also analyzed using the transactions cost politics approach. One interpretation of the separation of the dual tasks of monitoring trade and labor standards between the two agencies stems from the fact that fair trade standards can be established without regard to level of income of participating countries. This is not the case for many labor market outcomes which depend critically on the level of economic development. As a consequence, compliance with fair trade standards is more easily observable than compliance with labor standards. In an agency with the responsibility of monitoring both trade and labor standards, compliance with trade standards would receive closer scrutiny, while labor markets would be inadequately monitored. However, as an historical matter, the separation of monitoring tasks between the two agencies has been sought by those principals who want little or no monitoring of labor standards, not by those principals who seek greater monitoring of labor practices.

An alternative explanation is that, the separation of monitoring tasks across agencies stems from the fact that international agencies are controlled by multiple principals. The United States has sought to both include labor standards in the WTO and to use a logical connection between labor market practices and WTO rules to enforce those standards. The U.S. position was ardently and successfully opposed by developing countries who fear that the United States is motivated by an attempt to protect domestic labor from low-wage competition. The discrepancy between the ability of the principals to agree on trade rules relative to labor standards argues in favor of high trade standards with strict punishments for protection and labor standards with weak punishments. However, the United States was unable to successfully pre-commit not to exploit the incompleteness of the WTO charter and seek to apply strict punishments to labor standards violations.

Partitioning the labor and trade monitoring tasks between two agencies allowed each standard and the associated punishment for deviations to be set at the highest level to which the principals were able to agree. The comparatively strict rules of the WTO reflect the high degree of consensus for an open trading regime. The consequent ease of monitoring improves compliance. By comparison, the low level of agreement on labor standards is reflected both in the weak language of the ILO and the absence of any meaningful enforcement mechanism.

Finally, we turn to the issue of agency shopping. The United States, having failed to achieve its objectives with regard to labor standards in the WTO, has most recently turned to the IMF as a vehicle.

I. Introduction

Child labor is perhaps the most painful face of poverty. The specter of small children working long hours in dangerous and brutal working conditions is difficult for most members of the industrialized world to fully comprehend. Even worse is the thought of a small child delivered into bonded labor in order to discharge a parent's debt. UNICEF (1991) estimates that there are 80 million children aged 10-14 worldwide whose work is "so long or onerous that it interfered with their normal development." Labor force participation rates for smaller children aged 6 to 11 have been recorded as high as 25 percent in some communities. (For examples, see Grootaert and Kanbur, 1995.)

A natural response for an economist is to begin to search for some evidence of a correctable market failure that could justify a market intervention, thereby at least reducing the level of child labor. Non-economists are likely to simply want to do away with the practice through legal prohibitions enforced with some sort of economic sanctions.

The search for suitable corrective tools, however, has yielded frustrating little in terms of policy recommendations that might reasonably be expected to reduce child labor in the near term in a manner that can reasonably be expected to serve the working child's interests. The fact of the matter is that in many low-income countries, the economic value of a child is still active at the margin.

For example, Hoffman (1988) surveys cross-country motivations for having children. The results, reported in Table 1, clearly demonstrate the economic value of childbearing in developing countries. Of respondents in Indonesia (Japanese), 94.1 percent identified economic/utility as a reason for having children and no other reason was offered more often than 22 percent of the time. Similarly high rates were reported for Indonesia-Sudanese (79.6%), the Philippines (71.3%) and Thailand (74.6%). Even for Turkey, an economic motivation was cited by 54 percent of respondents and was the most common reason offered. By comparison, only 6 percent of respondents in the United States identified economic motivation as important. Rather, American parents seem largely motivated by the search for primary ties and affection.

Beyond the economic motivations for bearing children, there are several other reasons why it is difficult to identify the problems concerning child labor that are amenable to corrective measures. Some are enumerated below.

1. Banning child labor will very likely make the family poorer, thus lowering the welfare of the child. Appropriate labor market outcomes are dependent on income level. For many families, the work of children is essential to the survival of the family.
2. Subsidizing a mother's wages can have perverse results if the objective is to increase the formal education of her children. In the case of girls, work in the home frequently makes it possible for the mother to engage in market work. The opportunity cost to the family of formal education, then, is the wage earned by the mother, rather than the child's wage. A rise in the mother's wage can, at some income levels, increase female child labor in the home by drawing the mother into the work place. A similar relationship has been established between adult male wages and the homework of their male children.
3. Child labor in some cases is used to reduce risk associated with a poor harvest or other instability in family income. Legal restrictions against child labor or mandatory schooling are not likely to be effective in manipulating the behavior of a family close to subsistence.
4. Child labor that arises simply because the wellbeing of children has low value in the family is particularly hard to address with any policy tool. Prohibiting or circumscribing child labor may actually lower the value of the child to the family.
5. Identifying inappropriate child labor is difficult. Some labor, particular apprenticeships, may be more education than work. Children may acquire marketable skills, even though reading, writing and arithmetic are not among them. In communities where the quality of formal education is extremely poor, work may provide higher-valued skills than formal schooling.
6. The outright banning of child labor is unlikely to eliminate the practice. However, it will remove it from the scrutiny of any regulatory agency.

Historically, the most effective strategies for reducing child labor have been the byproduct of economic growth. Once adult wages reach a threshold level, child labor begins to decline. Furthermore, technological change and mechanization reduce the demand for the skills possessed by children by virtue of their small size and nimble fingers.

Some standard market failure stories that one might appeal to in order to justify market intervention seem to miss the mark in terms of the welfare of children. For example, one might point to a failure in the market for education due to the externality generated by an educated populace. However, the welfare loss that is the target of the policy prescription in this case is born by someone other than the child. Correcting the market failure may improve the welfare of the general population, but only inadvertently addresses a source of child poverty. Presumably, the focus of attention should be on market failures that directly affect the welfare of the working child. Arguments based on child labor that results from incomplete markets for managing risk by marginally viable households have more appeal. In this case, improving access to insurance directly raises expected family income and lowers the probability of falling below subsistence.

II. Trade Sanctions and Child Labor

Among the most popular proposals in industrialized countries for dealing with child labor is to tax or prohibit imports of goods produced by children. Perhaps the most airtight (if not compelling) case for trade sanctions has been made by Basu and Van (1998). In their model, children are offered for market work only if the adult wage leaves the family below subsistence. Once subsistence is reached, children are withdrawn from the labor force and sent to school. As a consequence, there is a discontinuity in the labor supply curve at the subsistence wage. Labor demand is generated by competitive firms who hire only labor and the production function exhibits diminishing marginal productivity of labor.

The labor market for this economy is depicted in Figure 1. As can be seen, there are two labor market equilibria. At point A, firms pay a high wage, W_h , and families send children to school. However, the equilibrium at point B is characterized by a low wage, W_l, which is below the subsistence wage, W_s. At the low-wage equilibrium, families are forced to offer their children for work. The policy recommendation that emerges from the Basu-Van analysis is that if child labor is legally prohibited then the low-wage equilibrium will be eliminated. Presumably, the market will then find its way to the high wage-no child labor equilibrium.

The special market characteristics that are necessary to support a prohibition against child labor in the Basu-Van model are difficult to guarantee. In fact, the point has been made many times in many contexts that a prohibition against child labor can leave children in far worse occupations at lower wages than the ones prohibited.

Furthermore, attempts by high-income countries to enforce a ban on child labor with import tariffs could have the effect of lowering the wages of children who continue to work. One example of this type of analysis is developed by Maskus and Holman (1996). They consider a two-good model in which child labor is specific to the labor-intensive export sector of a developing country. The importing country may attempt to punish the exporter for producing goods with child labor by imposing an import tariff.

If the price received by the exporter falls, so will the demand for children. Some children will, indeed, leave the work force for home work, alternative employment or school. This could raise social welfare if there is a negative externality generated by child labor and the alternative employment is better for the child than working in the export sector. However, the wage for those children who remain employed in the export sector will decline, thus making them worse off.

Not only will children who remain in the work force be made worse off but there is no guarantee that the children who leave the work force will find themselves in more desirable occupations. It is possible that a prohibition against work introduces a constraint in the parent’s resource allocation problem which causes them to find that the next best alternative for the family is to place the child in a less onerous form a home work or, even better, to place the child in school. However, it is equally likely that the alternatives for the child will be worse rather than better.

III. Product Labeling

Freeman (1994) has suggested an alternative approach. He sorts all labor standard issues into those that are *process*-related and those that are *outcome*-related. *Process*-related issues such as freedom from forced labor, freedom of association, and the right to organize, are supported as fundamental human rights to which we can all agree and can be achieved independent of income level. These rights are most appropriately administered with legal prohibitions. *Outcome*-related labor market characteristics such as minimum wages, maximum hours of work, hazardous working conditions, and minimum age of work are all functions of the income level of each country. Blanket requirements across all countries are not feasible or even desirable. Whatever labor standards that are established must be sensitive to specific market conditions.

In Freeman's view, the failure that necessitates intervention in the labor market stems from the negative external effect that a consumer experiences knowing that he is consuming a good produced under working conditions that the consumer finds distasteful. Freeman's proposed solution is to place a *label* on the product to characterize the conditions under which the good was produced. If the negative externality is significant then presumably the consumer would be willing to pay a higher price for goods produced under *desirable* working conditions rather than *undesirable* working conditions.

There are already in existence several labeling efforts particularly targeting child labor. The Child Labor Coalition was formed in 1989 and consists of religious, human rights, and union groups. Their objective is to inform consumers in high-income countries about child labor employed and conditions of work in the production of goods such as rugs in South Asia. The coalition has sponsored the *Rugmark* campaign which provides a label certifying that the product was not produced using child labor. The United States has sought to use the ILO to extend the *Rugmark* label to clothing and other products. In addition, several firms have voluntarily established a code of conduct regulating labor practices. Some examples are Levi Strauss, Liz Claiborne, Nike, Reebok, Sears, Timberland, and Walmart.

However, if the net impact of labeling is to switch demand away from goods produced by children, the consequence for child workers could actually be quite negative. Those who leave the tradable goods sector may find poorer employment prospects elsewhere. Those who remain employed in the tradable goods sector may remain there only at reduced wages.

In order to guarantee that the label benefits the intended target (the worker), the worker and the label must remain connected to each other through the product. For example, the objective may be to change a production process that is hazardous to workers. A firm who changes the hazardous practice at some cost labels the product to this effect. The consumer pays a higher price for the good, which finances the change in the hazardous practice. The employee, now working in safer conditions, is the beneficiary (as is the socially conscious consumer).

However, in the case of child labor, the intended beneficiary (the child) and the label are no longer connected. A label that identifies a product as having been produced with adult labor may raise the price of that good. As a consequence, the adult wage may rise. The impact on the working child, who is now in a new occupation, is undetermined. If labeling is to be beneficial for children, its success must rely on secondary effects that emerge in the general equilibrium.

In fact, the outcome from labeling where child labor is concerned can be quite perverse. Consider, for example, a two-good two-factor model of a price-taking developing country. Both the import-competing and export sectors employ adult and child labor, which are imperfect substitutes. The export sector, X, is taken to be child labor-intensive as compared to the import-competing sector, M. Factor market equilibrium for adult (A) and child (C) labor is depicted in Figure 2. The unit value isoquants for each sector are shown to be tangent to a \$1 isocost line. The slope of the isocost line is, of course, the relative wage rates of child and adult labor.

Now introduce product labeling. A premium, L, is paid by western consumers for a dollar's worth of the X-good that is labeled as has having been produced using adult labor only. In order to qualify for the label, producers in the X-sector must produce using an adult-only technology. That is, X producers must use the technique of production denoted by point K in Figure 2.

In order to be viable, the adult-only technology must cost no more than \$1+L. If the \$1+L isocost line falls short of the adult-only technology, point K, then no firms will label. Child labor practices will continue as is.

However, if the \$1+L isocost line intersects the A-axis exactly at point K, as shown in Figure 2, then firms are indifferent between using adult-only technology, applying the label and receiving the label premium or continuing with their current practice of hiring both adults and children. Some X-sector firms may decide to adopt the adult-only technology. In this case, the impact of production and factor employment can be seen by examining the Edgeworth Box in Figure 3.

The pre-labeling equilibrium is given by point H where the factor proportions rays, R_x and R_y, intersect. After labeling, $O_y L_A$ amount of adult labor is deployed to the adult-only firms in the X sector. The adult labor remaining and all child labor supplied are then distributed between the X and M sectors with equilibrium at point J. As the Rybczynski Theorem would lead us to expect, production of the import-competing good contracts and production of the export good expands.

We are now in a position to draw two conclusions. First, since both factor employment and wages are unchanged, labor income must be unchanged. Furthermore, since the labeling premium was just barely enough to cover the increased cost of the adult-only technology, profits are unchanged. However, it is clear that western consumers are paying more for the labeled goods than before. As a consequence, it must be the case that the labeling premium, L, has been completely dissipated due to the use of the inefficient adult-only technology. The only social benefit obtained is the good feeling that western consumers experience knowing that they are consuming a good that was not produced by child labor. However, the amount of child labor and each child's family income are unchanged. Children are no better off than they were before labeling.

Second, the one impact that labeling does have is to expand the export sector and contract the import-competing sector at fixed world prices. So we can conclude that the developing country will trade more. If we now relax the assumption that the developing country is a price-taker, we can conclude that a terms-of-trade deterioration is possible. Further, since child labor is the relatively abundant factor, the Stolper-Samuelson Theorem tells us to expect a decline in the wage-rate for child labor.

Returning to Figure 2, if the $1+L isocost line intersects the Adult-axis above point K then all exporting firms will want to adopt the adult-only technology. The resultant increase in the demand for adult workers will raise the adult wage relative to the wage of child workers, ultimately stemming the flow of X-sector firms adopting the adult-only technology.

The new labor market equilibrium is depicted in Figure 4. The wage of child labor has fallen relative to the adult wage, as indicated by the flattened isocost line. The X-sector firms using an adult-child technology have now adopted a more child-labor intensive process given by point N in response to the lower relative cost of child labor.

Firms in the import-competing M-sector will also attempt to reduce cost by substituting children for adult labor. However, since the M-sector is adult labor-intensive as compared to the X-sector, the rise in the adult wage must raise costs for M-sector firms as compared to the X-sector firms which use the adult-child technology. Therefore, if X-sector firms are breaking even, the M-sector firms must have negative profits. This can be seen in Figure 3, in which the M-sector unit value isoquant now lies uniformly above the $1 isocost line. As a consequence, no import-competing firms will survive once labeling is introduced

The fact that the M-sector is eliminated is not a surprising result. The introduction of a labeled good has essentially converted the two-good two-factor price-taking economy into one of three goods and two factors. Consequently, it is virtually certain that one of the three sectors will not be able to break even in the post-labeling equilibrium.

Since the M-sector has been eliminated, the relative wages of adult and child workers is determined so as to make X-sector firms indifferent between using an adult-only technology and an adult-child technology. Therefore, the adult wage will rise until the additional cost of producing X using the adult-only technology is just barely covered by the labeling premium, L. X firms using the adult-only technology are once again breaking even on the $1+L isocost line at point K.

The impact on children in all three cases appears to be either zero or negative. Of course, the adults in the labor force are likely to be the parents of the children in the labor force. One might hope that raising the adult wage in the third case might reduce the need for the child’s contribution to family income. Furthermore, the fall in the child’s wage lowers the opportunity cost to the family of formal schooling.

However, it must be kept in mind that, at least for this example, the total payment to a typical family (adult plus child workers) is virtually unchanged. As in the previous case, much if not all of the labeling premium has been dissipated through the use of the inefficient adult-only technology. Product labeling will raise the welfare of children only if the labeling premium is far more than the amount necessary to compensate firms for the higher cost of the adult-only technology. In order to succeed, the labeling premium has to be large enough to raise the adult wage to the threshold level at which child labor begins to decline. In other words, when labeling succeeds, it succeeds because it provides an income transfer to families, not because it provides a disincentive to the firm to hire children.

There is a more fundamental weakness with the labeling approach. The issue that presumably should concern western consumers is not whether they are offended by consuming goods produced by a child. Surely, the real issue is the working child's welfare. As a consequence, the consumer must distinguish between child labor that actually serves the child's interest and child labor that is somehow exploitative, reflective of the child's low standing in the family, etc.

Labeling does little to address the sources of market failure that result in inefficient child labor and miserable outcomes for children. For example, a breakdown in the market for insurance for subsistence families may result in too much child labor. However, labeling, will either reduce the child's wages or, at best, leave them unchanged. For a subsistence family, the child is likely to be on the downward-sloping part of the labor supply curve. That is, a cut in the wage will induce the child to work more in a now more desperate struggle to keep the family above subsistence. The result, obviously, is to worsen the child's expected outcome.

It would take an extraordinary amount of sophistication on the part of the consumer and quite a detailed label if the consumer is to distinguish between child labor that is inappropriate by some standard and child labor that is actually in the interest of the child. Confronted with a label that says that this product was produced by a child, it is quite likely that the working child's welfare will rise if the good is purchased, thereby raising the child's wages, rather than if it is shunned by the consumer. What one would actually need to see is a label that says something like, "this good was produced by a *child* in a community in which the elasticity of supply of child labor is negative," in which case you should buy the product, or "this good was produced by *adult* labor in a community where the elasticity of child labor with respect to parental wages is negative," in which case you should buy the good.[1]

---

[1] This is not as far-fetched as it sounds. There are some such elasticities estimated. For example, Levy (1985) estimated that for Egypt, a 10 percent increase in women's wages would lead to a 15 percent decline in the labor of children aged 12-14 and a 27 percent decline in the labor of children aged 6-11.

Buying the goods produced by a child, thereby raising the child's wages, generally should expand the child's opportunity set.[2] So the presumption is that one should buy child-produced goods, not avoid them. There are two reasons why this may not be the case. One possibility is that the child's earnings are being expropriated by other family members. The second is that either the child or the parent making decisions for the child under-appreciate the value of education or the negative consequences of hazardous and/or grueling working conditions. In other words, the market-failure that is occurring must be within the child's household.

In addition, labeling does not address market failure associated with child labor if the disutility of children working is a public good, as Freeman points out. Labeling can, however, play a role in transferring resources from a western consumer to poor children. For example, a product label can state that some fraction of the purchase price has been donated to an educational institution or a community agency.

IV. The Transactions Cost Politics (TCP) of International Labor Standards

There are several aspects of the treatment of labor standards in the international arena that reflect the transactions costs of political bargaining.[3] Consider, for example, the allocation of monitoring tasks across international agencies. As an historical matter, the characterization and monitoring of labor standards has been allocated to the much-maligned International Labor Organization (ILO). Currently, the ILO is the single international agency that addresses labor standards. However, the ILO has been given little real enforcement power. As a consequence, their activities have been constrained to promulgating conventions that establish minimal labor standards, monitoring, disseminating information and providing technical assistance. Product labeling is the most aggressive that the ILO has become in attempting to penalize countries or producers with poor labor practices.

---

[2] There is an added complication in that it is difficult to establish the connection between goods prices and the underlying factor returns. For example, in a two good-two factor world, if the export good is also child-labor intensive, then a fall in its price will lower the wage paid to children. However, in a world of many goods and factors, there is no reliable link from the price of any particular good to a factor price.

[3] For a introduction to Transactions Cost Politics see Dixit (1996).

The ILO Secretariat did attempt to connect labor standards and international trade with the objective of improving enforcement. The ILO and the World Trade Organization (WTO) were to work together in monitoring the protection of core labor standards. However, the working party suspended future discussion of the use of trade sanctions in 1995.

Multitask Agencies

One aspect of the incentive system faced by multitask agencies has been brought to bear in understanding the exclusive assignment of labor issues to the ILO. It is argued that the appropriate international <u>trade</u> standards to which we should and can agree can be established with much greater clarity than is the case for <u>labor</u> standards. Further, it is far easier to observe compliance with international trade law than with international labor law. As a result, a WTO that is assigned both monitoring tasks will assign greater effort to monitoring of trade violations than to monitoring labor violations. Therefore, labor issues should be assigned a separate agency so as to increase the monitoring effort labor standards receive.

However, the interpretation that monitoring assignments across international agencies arise from the difficulty of observing labor standards enforcement relative to trade standards enforcement is not consistent with the historical evolution of the issue. The United States has, for some time, attempted to draw labor standards under the umbrella first of the General Agreement on Tariffs and Trade (GATT) and then the WTO. The apparent purpose is to attempt to use the enforcement mechanisms of the GATT, and now the WTO, to improve compliance with what the United States considers to be fair labor standards.

Most recently the United States placed the issue of labor standards on the agenda for the WTO Ministerial Meeting held in Singapore in December 1996. The Clinton Administration claimed that its objective was to signal U.S. workers that competition from low-wage countries would not be intensified due to the denial of basic human rights.

Administration officials went to some lengths to dispel the view that the United States sought to erect trade barriers or to discriminate against low-wage competitors. Most importantly, Administration officials claimed that they were not seeking to use trade sanctions to uphold labor standards. However, the U.S. delegates did want the WTO ministers to link the maintenance of an open world trade system to the promotion of core labor standards such as freedom of association, prohibition of forced labor and elimination of exploitative child labor. Furthermore, they did seek to establish a working party to identify links between labor standards and WTO rules.

However, it was not to be. The U.S. position received little support from European ministers and was vigorously countered by the trade ministers of South East Asia and India, who opposed any discussion of trade and labor standards in the WTO. The Singapore Ministerial Declaration that was adopted on December 13, 1996 stated:

> "We renew our commitment to the observance of internationally recognized core labour standards. The International Labour Organization (ILO) is the competent body to set and deal with these standards, and we affirm our support for its work in promoting them. We believe that economic growth and development fostered by increased trade and further trade liberalization contribute to the promotion of these standards. We reject the use of labour standards for protectionist purposes, and agree that the comparative advantage of countries, particularly low-wage developing countries, must in no way be put into question. In this regard, we note that the WTO and ILO Secretariates will continue their existing collaboration."

Labor standards were only mentioned in the Singapore Ministerial Declaration to the effect that, (1) the ILO was the appropriate body for addressing labor standards internationally, (2) economic growth and trade are the appropriate tools for promoting standards, (3) the use of labor standards for protectionist purposes is rejected and (4) the comparative advantage of low-wage countries should not be questioned. In effect, the Ministerial unequivocally placed labor standards under the jurisdiction of the ILO.

Clearly, the pressure to divide trade and labor monitoring tasks between the WTO and ILO is driven by those principals, such as India, who seek minimal enforcement of labor standards, not by those principals who seek to intensify enforcement, such as the United States. Therefore, it is unlikely that the allocation of the labor monitoring task to the ILO is intended to improve enforcement as the multitask agency argument discussed above would suggest.

Multiprincipal Agencies

An alternative explanation for the division of labor and trade standards monitoring, which is more consistent with recent history, is that labor issues would receive far too much attention in the WTO, rather than too little. Excessive monitoring of labor issues could stem from the fact that the WTO must respond to multiple principals with conflicting objectives.

The fundamental objective of international trade negotiations is to alleviate the prisoner's dilemma. Each country's interests lie in optimal protection of its own sectors but little or no intervention by its trade partners. However, the collective interest is served when all countries follow an "open" trading regime.

Defining a set of rules of fairness regulating international trade is easy when compared to developing an international protocol on issues like labor standards. Most importantly, the trade rules can serve the interests of all participants without regard to specific country characteristics such as stage of economic development. Optimal labor market characteristics, however, depend heavily on each country's level of income. Labor market standards which do not threaten the interest of the poorest countries have been frustratingly elusive. Even if developing countries were to agree that a set of standards is desirable, achieving them may difficult or impossible.

An enforcement mechanism that the participants in an international trade and labor organization might adopt would specify a relationship between a vector of trade and labor standards, S, and actual performance, A, to a vector of punishments, P, for deviations from those standards. If the punishment parameter, t, is uniform across all standards, then we have

$$P = t(A - S)$$

In a negotiated agreement there will be a trade-off between the power of the incentive, t, and the stringency of the standard, S. Since there is a large group of countries who have poor labor-market conditions and will have difficulty meeting even minimal labor market standards, one outcome could be to set a weak punishment parameter. This is sub-optimal, however, since it produces a set of low-power incentives for an open trading regime on which all participants were able to agree. A more attractive alternative would be to adopt very weak standards for labor market performance while setting a stiffer punishment parameter.

An optimal approach, however, is to represent the punishment parameter as a matrix, which has been partitioned between trade and labor standards. For example

$$\begin{bmatrix} P_L \\ P_T \end{bmatrix} = \begin{bmatrix} t_L & 0 \\ 0 & t_T \end{bmatrix} \begin{bmatrix} A_L - S_L \\ A_T - S_T \end{bmatrix}$$

where the L (T) subscript denotes labor (trade) standards (S), performance (A), punishment parameter (t) and punishment (P).

Under this configuration it would be possible to set the trade penalties suitably high to reflect the consensus on the desirability of an open trading regime. The power of incentives for achieving labor standards would be considerably lower, reflecting the diversity of optimal labor standards that are appropriate across countries.

The partitioned configuration was pursued by the United States during the Singapore Ministerial. The Clinton Administration proposed setting the punishment parameter for labor standards at zero in the hope that it could obtain a set of rigorous labor standards. However, the WTO charter is an incomplete contract. It would ultimately fall to a working party to interpret the operational consequences of the WTO's charter. The United States was clearly signaling an intent to use the interpretation process to reduce labor standards to their trade equivalent. Ultimately, the United States could not credibly pre-commit not to pursue the link between labor standards and WTO trade rules, thereby using the power of the trade punishment parameter against labor standards violations.

The outcome of the WTO Ministerial was to accept the notion of partitioning of penalties and to accept a rigorous definition of labor standards. However, in order to prevent any possibility that trade penalties would apply to labor standards violations, labor standards were partitioned right out of the WTO.   The ILO, a distinctly different entity, would address the issue of international labor standards. Much is made of the weakness of the ILO and the absence of enforcement powers. However, a more charitable view of the agency is that labor standards have been allocated to the ILO precisely because it has no power to punish. The low power of the incentives used by the ILO is entirely appropriate given the general inability to identify a set of uniform labor standards that can be applied in all settings.

Designing the charter of a multitask/multiprincipal agency is difficult when the intensity of enforcement should vary markedly over the various tasks. This is particularly the case if one of the principals would like to apply the high enforcement power of one set of tasks inappropriately. It may be necessary to sort tasks across agencies so that the maximum enforcement power of the agency is consistent with the task that it undertakes that should have the lowest intensity of enforcement. The end result is that some agencies may have a very small range of tasks and virtually no power of enforcement, as is the case with the ILO.

This is not unlike the fundamental transactions cost that bedevils multiprincipal and multitask agencies. When several principals are attempting to affect decision-making in an agency, they will provide positive incentives for desirable actions and negative incentives for undesirable actions. To the extent that the principals disagree or tasks vary in observability, bargaining can produce a set of low-powered incentives. Holmstrom and Milgrom (1991) and Dixit (1996) have shown that the power of incentives can be improved if some of the actions of the agent and principals can be controlled in an *all-or-nothing* manner.

A similar principle applies here. The United States would like to apply the high-powered punishments for trade barriers to labor-standards violations. Given this fact, the impact must be to either lower the punishments for trade barriers or lower the labor-standards, neither of which is optimal. The optimal solution is to prohibit the United States from switching punishments that are intended for trade violations over to the labor-standards violations. Partitioning tasks across international agencies is a particularly effective strategy for enforcing the prohibition.

Sorting tasks by international agency can also be understood as a strategy for coping with the comparatively rigid rules that are optimal for regulating international trade while leaving the flexibility for managing international labor standards. Clear and transparent trade standards reduce the ambiguities which must be left to interpretation by a dispute resolution panel. Clarity and simplicity have the potential, therefore, to improve compliance. Meaningful labor standards, by contrast, must be flexible and responsive to individual country conditions. Sorting trade and labor enforcement by international agency can help diminish the tension between rigid rules that improve commitment to principles of trade liberalization and the flexibility that outcome-related labor standards require.

Agency Shopping

If the United States is to successfully press its case for labor standards internationally, it is going to need to meet four preconditions. First, it needs leverage. The United States threatened to walk out of the WTO Ministerial if it did not get its way with labor standards. However, such a threat lacked credibility. Given the current set of issues still unresolved in the WTO, the United States is asking for more than it has to offer. As a consequence, walking out would gain the United States nothing but could potentially cost a great deal. Second, the United States needs a mechanism that will allow standards to vary with the individual country characteristics. Third, the policy device must reasonably be expected to actually improve the welfare of the intended beneficiaries of the policy. Fourth, the consequences of intervention will probably require popular support within the targeted country.

The Clinton Administration thinks that it has found such an agent in the International Monetary Fund (IMF). As is well known, the standard IMF package offers loans to bridge a balance of payments crisis, but in return demands that the country government conform to certain fiscal, monetary and exchange rate policy prescriptions. However, during the financial crisis in Asia in November and December 1997, the IMF substantially broadened the concept of *IMF Conditionality*. The South Koreans call the new regime *IMF Plus*.

IMF Plus includes the standard conditions concerning monetary, fiscal and exchange rate policy prescriptions. However, the South Koreans were subject to additional conditions concerning trade policy and other market reforms and even went so far as to stipulate accounting practices that must be adopted by Korean firms. The intent of IMF Plus is to eliminate the practices of “crony capitalism” that are believed to be a central contributor to the financial crisis. The IMF targeted eight reform areas which include foreign ownership of equity capital, foreign participation in banking and insurance, and barriers to industrial imports. Note that all of the conditions have previously been sought by the United States with limited success in rounds of trade liberalization.

Indonesia was subject to similar conditions. The long list of reforms imposed on Indonesia included such items as setting the price of gasoline and the manner in which plywood was sold. Corrupt business practices used to enrich President Suharto's family and friends are also to be curtailed.

However, the Administration has already signaled its intent to press further. Under the right circumstances, future IMF conditions will address the *quality* as well as the *quantity* of fiscal spending. For example, the Administration officials have already suggested that it might be appropriate to attempt to force governments in a financial crisis to divert expenditure on military armaments and palaces to expenditure on education.

Such a change in IMF policies obviously raises serious questions about national sovereignty. However, sovereignty aside, there are several reasons why the Clinton Administration is far more likely to enjoy success working through the IMF than through the WTO.

First, balance of payments crises provide the United States the leverage that it lacks in the WTO. Experience with the Latin American debt crisis in the 1980s strongly suggest that the economic and social turmoil that results from a severe and unrelieved financial crisis can be catastrophic and long-lived. By comparison, the IMF, in conjunction with the industrialized countries, moved swiftly to relieve the financial pressure in Asia. Although the financial crisis in Asia has taken its toll, a decade-long economic collapse seems unlikely.

The Clinton Administration identified the Asian crisis as a clear threat to the economic welfare of the United States, but also saw a military threat, as well. As a consequence, the South Korean government attempted to bargain over the conditions of IMF Plus precisely because they realized that the Clinton Administration officials perceived U.S. interests to be so closely tied to the financial stability of East Asia.

However, the United States was unmoved. It was the view of U.S. Treasury officials that without fundamental market reform, the preconditions for financial stability would not be met. Another crisis would occur. This belief gave the Administration officials the credibility they needed to press for the reforms they believed were appropriate.

Similar reasoning could apply to fiscal and financial reform that the United States would like to press on many developing countries in Asia and Africa. For example, to the extent that there is a break-down in the market for education which can be alleviated through government action and poor educational opportunities play a significant role in slow economic development, the IMF will have the leverage that it needs to press for a reallocation in government spending against a country in a financial crisis.

The role that the IMF would play in the domestic politics of its target countries is also somewhat different than for conventional IMF conditionality. When the IMF's policy prescription is one of fiscal and monetary contraction, the immediate impact is negative. It is commonly argued that the IMF, by imposing conditions for loans, can help a government credibly commit to a plan of fiscal and monetary contraction that would otherwise be politically nonviable.

However, if the Clinton Administration turns its focus to the content of fiscal policy rather than its level, the impact of the new IMF conditions will be redistributive rather than contractionary. IMF conditions that require a reduction in spending on a repressive police force, for example, and increased spending on education, electrification, etc. could have a "populist" quality. The role, then, of the IMF would be to strengthen the hand of the political entities who seek a more equitable distribution of wealth and a more efficient fiscal structure.

Finally, using the IMF as a vehicle provides the flexible rules that outcome-related labor standards require. As discussed above, the characteristics of an efficient labor market outcome depend heavily on the level of income and economic development as well as the precise nature of whatever market-failure that may be contributing to unnecessarily poor outcomes for children.

Tailoring labor standards to individual country conditions is virtually impossible in an organization like the WTO where great emphasis is placed on uniform rules applying to all countries. However, the IMF commonly undertakes individual country studies which are intended to ferret out the origins of a financial crisis. The Clinton Administration will be sorely tempted to take the opportunity to identify circumstances that are contributing to slow or negative growth and impose conditions on those practices, as well.

Breakdowns that occur within family decision making that have negative consequences for children will remain unattended by an IMF channel. But market failures can be addressed, particularly those that slow economic growth, which is ultimately the greatest source of child poverty.

V. Conclusions

The foregoing discussion gives little hope that arms-length intervention on behalf of working children is likely to be beneficial. Neither trade sanctions nor incentives offered by consumers to improve the lot of children necessarily improve their welfare as a group. This paper reviews some of the issues that pertain to the treatment of child labor in the international arena. A review of the standard prescriptions for reducing child labor provide little hope that the welfare of children can be improved in the absence of world-wide economic growth, development and increased adult wages.

Familiar prescriptions such as import tariffs levied against goods produced with child labor are likely to leave children with lower wages and/or in more damaging occupations. Similarly, product labeling, intended to identify goods produced without child labor, can have adverse consequences for working children. It is shown that some, if not all, of the premium paid for labeled goods is dissipated due to the use of an efficient technology by firms that hire adults only. Child labor practices are altered only if the premium paid is sufficient to raise adult wages above the threshold at which child labor begins to decline. As a consequence, if the labeling premium is effective in improving the welfare of children, the reason is that the label premium raises family income, not because it provides a disincentive to firms to hire children.

The allocation of the task of monitoring child labor to the ILO rather than the WTO is also analyzed using the transactions cost politics approach. One interpretation of the separation of the multiple tasks of monitoring trade and labor standards between the two agencies stems from the fact that fair trade standards can be established without regard to level of income of participating countries. This is not the case for many labor market outcomes which depend critically on the level of economic development. As a consequence, compliance with fair trade standards is more easily observable than compliance with labor standards. In an agency with the responsibility of monitoring both trade and labor standards, compliance with trade standards would receive closer scrutiny, while labor would be inadequately monitored. However, as an historical matter, the separation of monitoring tasks between the two agencies has been sought by those principals who want little or no monitoring of labor standards, not by those principals who seek greater monitoring.

An alternative explanation is that, the separation of monitoring tasks across agencies stems from the fact that international agencies are controlled by multiple principals. The discrepancy between the ability of the principals to agree on trade rules relative to labor standards argues in favor of high trade standards with strict punishments for protection and labor standards with weak punishments.

Partitioning the labor and trade monitoring tasks between two agencies allowed each standard and the associated punishment for deviations to be set at the highest level to which the principals were able to agree. The comparatively strict rules of the WTO reflect the high degree of consensus for an open trading regime. By comparison, the low level of agreement on labor standards is reflected both in the weak language of the ILO and the absence of any meaningful enforcement mechanism.

We also found that sorting trade and labor enforcement by international agency can help diminish the tension between rigid rules that improve commitment to principles of trade liberalization and the flexibility that outcome-related labor standards require. Sorting also improves the credibility of a commitment to the principle that efficient labor market conditions vary with stage of development and that cross-country variations should not be punished with trade sanctions. As a consequence, the U.S. position on child labor may be best served by embracing the ILO, accepting its limited capacity of enforcement and attempting to work with country-specific incentive schemes rather than punishment.

Finally, we turn to the issue of agency shopping. The United States, having failed to achieve its objectives with regard to labor standards in the WTO, has most recently turned to the IMF as a vehicle.

REFERENCES

Aggarwal, Mita. 1995. “International Trade, Labor Standards, and Labor Market Conditions: An Evaluation of the Linkages,” USITC, Office of Economics Working Paper No. 95-06-C (June).

Basu, Kaushik and Pham Hoang Van. 1998. “The Economics of Child Labor.” *American Economic Review*, forthcoming.

Brown, Drusilla K., Alan Deardorff and Robert M. Stern. 1997. “Issues of Environmental and Labor Standards in the Global Trading System,” manuscript.

Dixit, Avinash K. 1996. *The Making of Economic Policy: A Transaction-Cost Politics Perspective*. Cambridge: The MIT Press.

Feldstein, Martin. 1998. “Refocusing the IMF.” *Foreign Affairs*, March/April, vol. 7, no. 2.

Freeman, Richard B. 1994. “A Hard-Headed Look at Labor Standards.” *International Labor Standards and Global Economic Integration: Proceedings of a Symposium*. Gregory K. Schoepfle and Kenneth A. Swinerton (eds.) U.S. Department of Labor, Bureau of International Labor Affairs. Washington, D.C.

Grootaert, Christiaan and Ravi Kanbur. 1995. “Child Labour: An Economic Perspective.” *International Labour Review*, Vol. 134, No. 2.

Hoffman, L. W. 1988. “Cross-Cultural Differences in Child-Rearing Goals.” In R.A. LeVine, P.M. Miller, and M. M. West (Eds.). *Parental Behavior in Diverse Societies: New Directions for Child Development.* San Francisco: Jossey-Bass.

Holmstrom, Bengt, and Paul Milgrom. 1991. “Multitask Principal-Agent Analysis: Incentive Contracts, Asset Ownership, and Job Design.” *Journal of Law, Economics, and Organization* 7, Special Issue, 24-51.

Krueger, Alan. 1997. “International Labor Standards and Trade,” *Annual World Bank Conference on Development Economics 1996.* Washington, D.C.: The World Bank, 281-302.

Levy, Victor. 1985. “Cropping Pattern Mechanization, Child Labour, and Fertility Behaviour in a Farming Economy: Rural Egypt.” *Economic Development and Cultural Change* (Chicago), Vol. 33, No. 4. July.

Maskus, Keith E. and Jill A. Holman. 1996. “The Economics of Child Labor Standards.” In process.

Organization for Economic Cooperation and Development (OECD). 1996. *Trade, Employment and Labour Standards: A Study of Core Workers’ Rights and International Trade.* Paris: OECD

Roderik, Dani. 1996. “Labor Standards in International Trade: Do They Matter and What Do We Do About Them?” In Robert Lawrence, Dani Rodrik, and John Whalley, *Emerging Agenda for Global Trade: High Stakes for Developing Countries*. Washington, D.C: Overseas Development Council.

UNICEF. 1991. *The State of the World’s Children 1991.* Oxford University Press.

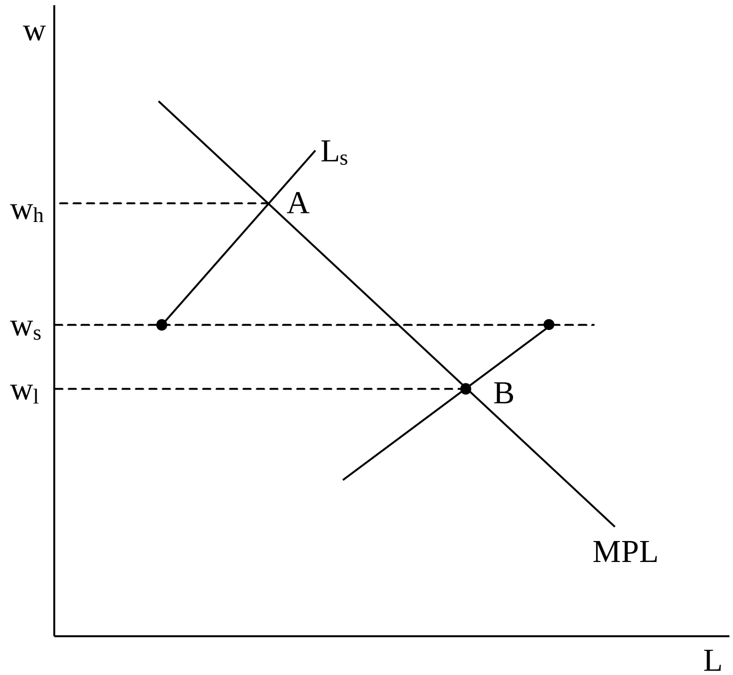

Figure 1

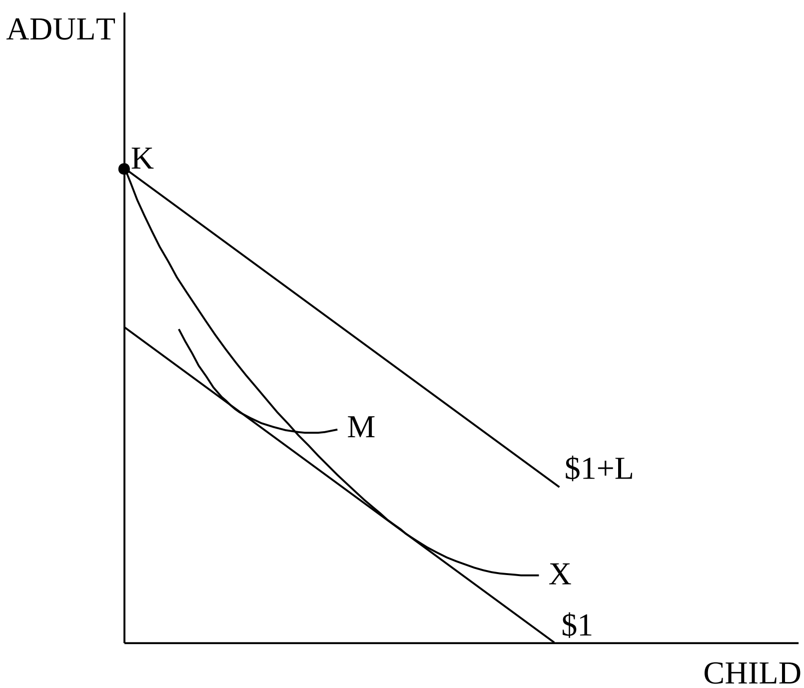

Figure 2

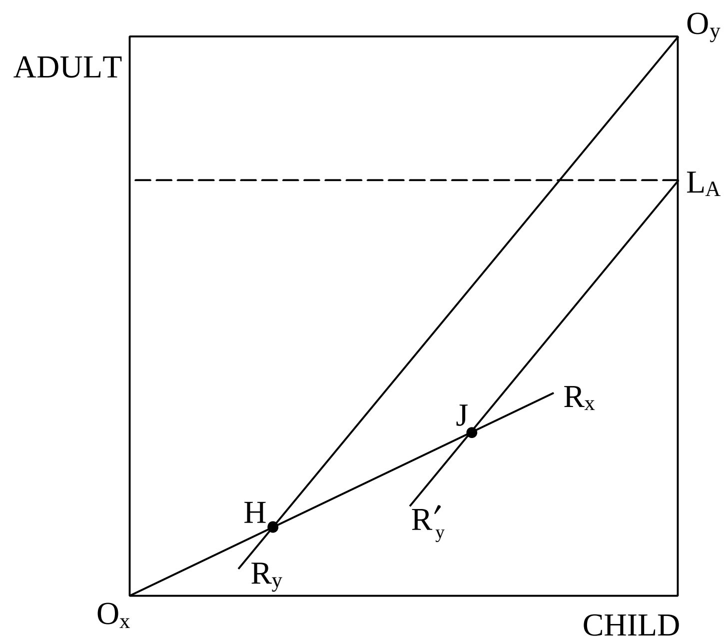

Figure 3

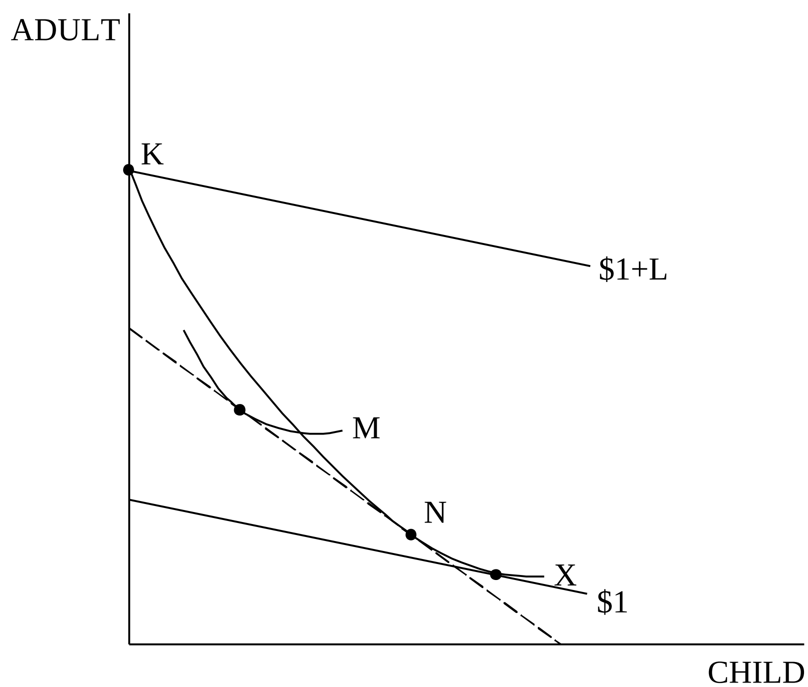

Figure 4

TUFTS UNIVERSITY
ECONOMICS DEPARTMENT

DISCUSSION PAPERS SERIES 1998

98-19 BROWN, Drusilla; A Transactions Cost Politics Analysis Of International Child Labor Standards.

98-18 PEPALL, Lynne and George NORMAN; Product Competition and Upstream Flexible Specialization.

98-17 YU, David; Two Equivalence Theorems For Government Finance.

98-16 YU, David; Rational Bubbles Under Diverse Information.

98-15 MELLOR, Jennifer, and Jeff MILYO; Income Inequality and Health Status in the United States: Evidence from the Current Population Survey.

98-14 DE FRAJA, Gianni, and George Norman; Product Differentiation and the Location of International Production.

98-13 NORMAN, George, and Lynne PEPALL; Mergers in a Cournot Model of Spatial Competition: Urban Sprawl and Product Specialization.

98-12 MCMILLAN, Margaret; A Dynamic Theory of Primary Export Taxation: Evidence From Sub-Saharan Africa.

98-11 MILYO, Jeffrey; The Political Economics of Campaign Finance: Lessons for Reform.

98-10 NORMAN, George; Foreign Direct Investment and International Trade: a Review.

98-09 MILYO, Jeffrey and Samantha SCHOSBERG; Gender Bias and Selection Bias in House Elections.

98-08 NORMAN, George and Jacques-François THISSE; Technology Choice and Market Structure: Strategic Aspects of Flexible Manufacturing.

98-07 MILYO, Jeffrey and Joel WALDFOGEL; The Effect of Price Advertising on Prices: Evidence in the Wake of *44 Liquormart*.

98-06 MILYO, Jeffrey; The Electoral Effects of Campaign Spending in House Elections: A Natural Experiment Approach.

98-05 DOWNES, Thomas, and David FIGLIO; School Finance Reforms, Tax Limits, and Student Performance: Do Reforms Level-Up or Dumb Down?

98-04 NORMAN, George and Lynne PEPALL; Horizontal Mergers in Spatially Differentiated NonCooperative Markets: a Comment.

98-03 NORMAN, George and Jacques-François THISSE; Should Pricing Policies be Regulated when Firms may Tacitly Collude?

98-02 BIANCONI, Marcelo; Intertemporal Budget Policies in an Endogenous Growth Model with Nominal Assets.

98-01 METCALF, Gilbert E.; A Distributional Analysis of an Environmental Tax Shift.

Discussion Papers are available on-line at

http://www.tufts.edu/as/econ/papers/papers.html