

Drusilla K. Brown is an associate professor of economics at Tufts University.

International Labor Standards in the World Trade Organization and the International Labor Organization

Drusilla K. Brown

For some time, the United States has attempted to draw labor standards under the umbrella first of the General Agreement on Tariffs and Trade (GATT) and then the World Trade Organization (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 attempted to place the issue of labor standards on the agenda for the Millennium Round at the Seattle Ministerial Meeting in 1999. As in the past, President Clinton appeared to seek a joint working party between the WTO and the International Labor Organization (ILO). However, he went further and suggested that the United States might impose sanctions against countries that violated core labor standards.

By contrast, during the Singapore Ministerial in 1996, the Clinton Administration claimed that its objective—with regard to labor standards—was only 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 intended to use trade sanctions to uphold labor standards. The U.S. delegation only sought to link the maintenance of an open world trade system to the promotion of core labor standards and to establish a working party to identify links between labor standards and WTO rules.¹

The United States has had virtually no success with either attempt. The Singapore Ministerial Declaration stated that the ILO was the appropriate body for addressing labor standards internation-

ally. During the Seattle Ministerial, the delegates were unable to agree on any language concerning labor standards.

LINKAGE BETWEEN CORE LABOR STANDARDS AND TRADE DISCIPLINES IN THE WTO

Given the U.S.'s inability, thus far, to establish labor standards as an explicit aspect of the WTO agenda, the United States is left with the option of linking labor standards to existing trade disciplines. There are several provisions in the WTO Agreement that could, at least potentially, provide such a link. These are discussed below.²

Anti-Dumping

According to Article VI of GATT 1994, exports may be subject to an anti-dumping duty if a product is being exported at a price below its normal value and the sale of the product can be shown to be causing or threatening to cause material injury to domestic producers. It has been argued that selling products produced under sub-par working conditions constitutes *social dumping*. A product can be shown to be selling below its normal value if there is evidence of price discrimination. That is, the product can be shown to be sold at a higher price in a third-country market. Another way to show a product is selling below its normal value is on the basis of a constructed production cost. In this case, dumping occurs when the good is sold at a price below the cost of production. Therefore, under current WTO rules, the investigative authority would be prohibited from asserting that a violation of core labor standards has occurred, which can only be shown to have depressed the cost of production, unless the violation also resulted in a below-normal price.

¹ At the time of this writing it remains unclear whether there has been a change in the Clinton Administration's position on labor standards in the WTO.

² For a fuller discussion of potential avenues of linkage between trade and labor standards, see Organization for Economic Cooperation and Development (1996), pp. 169-76.

Countervailing Duties

Alternatively, government-enforced wages and working standards that depress the cost of production can be seen as an export subsidy that might be subject to countervailing duties if injury to the domestic industry can be shown. However, under GATT Article XVI, a subsidy must take the form of a financial contribution by the government or other public body, an income support, or a price support. Suppression of core labor standards does not involve an income transfer, an income support, or a price support and, thus, is unlikely to be viewed as a subsidy eligible for a countervailing duty.

Even if government-enforced suppression of wages can be seen as a regulation of prices, violation of labor standards does not meet other criteria of Article XVI. For government intervention to constitute a subsidy, it must be specific to certain enterprises. Therefore, poor labor standards that exist country-wide could not be considered specific to a subset of firms.

General Exceptions Provisions

GATT 1994 Article XX does provide for certain exceptions to free-trade provisions. For example, under Article XX(e) countries may bar exports of goods made by prison labor. However, no other labor standards are itemized in Article XX. The possibility of applying Article XX(d) on “measures necessary to secure compliance with laws or regulations not inconsistent with the GATT” to labor standards was discussed during the negotiations of the Havana Charter, but rejected.

Nullification and Impairment Provisions

Article XXIII provides that a member may submit for dispute resolution if the “application by another of any measure ... or the existence of any other situation...” impairs or nullifies benefits that would otherwise be forthcoming under GATT rules. However, even if a complaint of poor working conditions was found to fall under Article XXIII, the Article does not provide for any remedy. The countries in question are merely encouraged to find a “mutually satisfactory adjustment.” In 1953, the United States attempted to explicitly incorporate workers’ rights into the nullification and impairment provisions, but the proposal was rejected.

Opt-Out Provisions

GATT Article XXXV allows current members of the GATT to refuse to extend GATT privileges to other members of the GATT for any reason. However, this provision applies only to newly acceding members and cannot be applied retroactively to countries already in the GATT.

Trade Policy Review Mechanism (TPRM)

In principle, labor standards could become part of the deliberations on export zones in the framework of the Trade Policy Review Mechanism. However, the outcome of such discussions cannot become part of dispute-resolution procedures or impose new commitments on members. In other words, such a review of labor practices would not trigger any penalties. Furthermore, as a practical matter, developing countries have vigorously and successfully resisted the inclusion of labor practices in TPRM discussions.

Given the foregoing discussion, it is difficult to see how the United States might successfully link labor and trade standards within the current provisions of the GATT. Some provisions would have to be added that would create a channel directly to labor standards. Thus, at least for the near future, labor standards remain solidly within the purview of the ILO.

LABOR STANDARDS IN THE ILO

As a historical matter, the characterization and monitoring of labor standards have been allocated to the ILO. However, the ILO has been given little real enforcement power. As a consequence, their activities have been confined to establishing conventions that set minimal labor standards. The ILO also monitors, disseminates information, and provides technical assistance.

The ILO Secretariat did attempt to connect labor standards and international trade with the objective of improving enforcement. The ILO and the 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 *trade* standards can be established with much greater clarity than *labor* standards. Further, it is far easier to observe compliance with international trade law than with international labor law.

Holmstrom and Milgrom (1991) established that when there are several monitoring tasks that compete for an agency's attention, and the agency's efforts at each task are not equally observable, then the agency will devote a suboptimal level of effort to the less observable tasks. The implication of this result for labor standards is that a WTO that is assigned both monitoring tasks will assign greater effort to monitoring *trade* violations than *labor* violations. Therefore, labor issues should be assigned to a separate agency so as to increase the monitoring effort that labor standards receive.

However, the interpretation stating that monitoring assignments across international agencies arise from the difficulty of observing labor standards enforcement relative to trade standards enforcement is not consistent with historical evolution. Clearly, the pressure to divide trade and labor monitoring tasks between the WTO and ILO is driven by principals, such as India, who seek minimal enforcement of labor standards, and not by 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 was intended to improve enforcement as the multitask agency argument discussed above suggests.

Multiprincipal Agencies

A more plausible explanation is that labor standards 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.

Establishing a set of fair rules 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 the stage of economic development.

Optimal labor market characteristics, however, depend critically on each country's level of income. Reaching any agreement on labor market standards

that does not threaten the interest of the poorest countries has been frustratingly elusive. Even if the developing countries were to agree that a set of standards is desirable, achieving them may be difficult or impossible.

The difficulty in establishing and enforcing a widely acceptable set of labor standards makes inclusion in the WTO problematic. The WTO charter is an incomplete contract. It would ultimately fall to the dispute-resolution board to interpret the operational consequences of regulations concerning labor standards in the WTO's charter. The United States has clearly signaled the intent to use the interpretation process to reduce labor standards to their trade equivalent. Ultimately, the United States could not credibly precommit *not* to pursue the link between labor standards and WTO trade rules, thereby using the power of the trade disciplines against labor standards violations.

To prevent any possibility that trade penalties would apply to labor standards violations, labor standards were partitioned 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, which 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/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 ex-

tent 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 also can 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 that 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.

Below, we present a formal model of labor and trade standards in the WTO. However, before doing so, we must first consider the institutional characteristics that govern monitoring and dispute resolution.

DISPUTE RESOLUTION IN THE WTO

The portion of the Uruguay Round that established the WTO also laid down a “dispute-settlement understanding” or DSU. The DSU created, for the first time, binding text covering dispute settlement. The DSU is similar in institutional structure to the system that evolved in the GATT. However, subtle changes in some key provisions distinctly altered the binding nature of the process.

Under the DSU, a panel of experts considers disputes brought before the WTO. Members of the

panel are not government representatives, but rather are acting in their own right and are required to evaluate the evidence fairly and within the context of GATT law. The panel makes a report to the Council that either accepts or rejects the panel’s findings. A country that is dissatisfied with the Council decision may appeal to a three-person appellate panel. A report by the panel of experts that successfully passes through both stages of review is binding on all participants. For some legal systems a binding conclusion in the WTO takes on the force of domestic law.

Under the GATT system, a decision by the panel of experts required unanimous consent in the Council before it was considered to be adopted. Hence, all of the dispute resolution-power ultimately lay in the hands of the Council. Any country could block a finding by the panel of experts in the Council merely by voting against it.

However, under the DSU in the WTO, the reverse is the case. A report by the panel of experts is accepted unless there is a consensus in the Council to reject it. The same is true of an appeal. The appeal is accepted unless there is a consensus in the appellate panel to reject. As a consequence, virtually all of the monitoring power lies with the independent panel of experts.

Of course, countries faced with an adverse decision can always refuse to draw its domestic law into compliance with the decision of the dispute resolution panel. As consequence, the true enforcement power depends on the adverse effects that a country may incur when not in compliance with international law.

Several other characteristics of the dispute resolution process have been carried over from the GATT system. First, there are two kinds of cases: violation and nonviolation. The nonviolation cases are those that are brought under the “nullification and impairment” clause and, thus, do not actually consist of a claim that a member has violated any aspect of GATT law.

Second, WTO law continues the evolution toward a process governed by rules driven by real treaty obligations. Jackson (1998) argues that originally dispute resolution in the GATT merely assisted parties to settle their disputes in a mutually satisfactory manner. However, during the tenure of the GATT, dispute resolution increasingly came to be a process whereby the countries were informed of their treaty-enforced obligations.

Third, the legal effect of a finding by the dispute resolution board remains unclear. Some have

argued that the DSU requires countries to bring their domestic law into compliance with the final report resolving the dispute. Others have argued that a country can evade the report by paying compensation. However, under DSU Article 22:8, "...the matter remains on the agenda of the Dispute Settlement Board (DSB) until compliance occurs." This is the case even if compensation is paid. Hence, performance appears to be required, not merely compensation.

Fourth, the increased power of the committee of experts raises the possibility of "judicial activism." For example, the United States has signaled some interest in using the "nullification and impairment" clause to press issues such as intellectual property rights. Labor standards would be a natural target as well. However, the language in Article 3:2 requires that judgment by the panel not "...add to or diminish the rights and obligations provided in the covered agreement." Jackson (1998) has argued that such language encourages judicial restraint.

Finally, it is important to note that the greatly expanded responsibilities of the WTO in resolving disputes require funding. In comparison to the GATT, dispute resolution in the WTO is more elaborate and, therefore, expensive. The appellate body must be funded and there is a commitment to provide legal assistance to developing countries during DSB procedures. Furthermore, the issues likely to arise in future cases are exceedingly technical, requiring great expertise and more serious examination of the facts. The panel of experts may choose to develop its own facts rather than rely on the litigants for such information. Currently, the DSB is receiving adequate funding, unlike the rest of the WTO. However, funding may become an issue either if the number of cases is unexpectedly large or member governments providing funding grow dissatisfied with the process.

A MODEL OF INCENTIVES IN THE WTO

We now turn to a model in which the WTO is modeled as a multitask agency controlled by multiple principals. In particular, the WTO is monitoring the conduct of members and their firms with regard to their adherence to previously established trade and labor standards. The priorities of the members do not coincide with each other nor do they necessarily coincide with the priorities of the agency. This is particularly the case for labor standards. The United States, for example, argues

for relatively high labor standards that are to be rigorously enforced. Many of the developing countries, fearing hidden protectionism, seek minimal standards and enforcement. The agency may have reservations concerning the enforcement of labor standards because they are not obviously related to the original mission of fostering free international trade.

The role of the agency is to enforce previously established trade and labor standards. This is done by monitoring behavior and then establishing a penalty for each deviation from the preset standard. The penalties are established by applying a rate to the degree of deviation from the standard. That is, the vector of penalties is given by

$$(1) \quad \begin{bmatrix} P_L \\ P_T \end{bmatrix} = \begin{bmatrix} t_L & 0 \\ t_{LT} & t_T \end{bmatrix} \begin{bmatrix} S_L - A_L \\ S_T - A_T \end{bmatrix},$$

where P denotes the punishment, t is the penalty rate, S is the standard, and A is the action subject to dispute resolution. The subscript T denotes trade standard and the subscript L denotes labor standard. The penalty rate matrix is taken to be lower triangular in order to reflect the possibility that deviations from the labor standard might be evaluated in terms of their implications for free trade. This is the linkage that the United States seeks to introduce into the WTO.

Case 1: Perfect Information and No Linkage

We will assume first that the principals can monitor the conduct of the agents perfectly. That is, the WTO members can observe the deliberations and actions of the Committee of Experts.

Following the analysis of multiprincipal-multitask agencies in Dixit (1996), we will assume that the agent's utility function has constant risk-aversion given by

$$(2) \quad u(w) = -\exp(-rw),$$

where w is money income minus a quadratic cost of effort and

$$(3) \quad \frac{1}{2} t' C t.$$

The matrix $C = cI$ is taken to be a diagonal, positive definite matrix. The vector t in equation 3 is given by

$$(4) \quad t = \begin{bmatrix} \tilde{t}_L \\ t_T \end{bmatrix} = \begin{bmatrix} t_L + t_{LT} \\ t_T \end{bmatrix},$$

and the benefit to the world of enforcing standards is given by

$$(5) \quad b't = \begin{bmatrix} b_L & b_T \end{bmatrix} \begin{bmatrix} t_L + t_{LT} \\ t_T \end{bmatrix}.$$

The implication of equation 5 is that the value to the world of enforcing a labor standard is independent of whether labor standards are enforced through labor standards directly or whether they are first linked to trade standards.

The first best outcome is obtained by choosing t to maximize total surplus, given by

$$(6) \quad \max_{\{t\}} TS = b't - \frac{1}{2} t' C t.$$

The first-order condition for the maximization problem in equation 6 is

$$(7) \quad b = C t$$

or

$$(7') \quad t = C^{-1} b.$$

Equation 7' describes the set of optimal punishment rates.

In order to simplify the analysis, we will assume that bargaining is taking place between the United States, on the one hand, and the developing countries, on the other. We also will assume that it is equally costly to the agent to enforce trade and labor standards. Under these assumptions, the optimal punishments can be written as

$$(7'') \quad \begin{aligned} \tilde{t}_L &= \frac{1}{c} [b_L^{US} + b_L^{LDC}] \quad \text{and} \\ t_T &= \frac{1}{c} [b_T^{US} + b_T^{LDC}], \end{aligned}$$

where b_i^j is the benefit to country j of a unit of enforcement of standard i .

Case 2: Perfect Information with Linkage

The type of linkage between labor standards

and trade standards that the United States is pursuing is one that interprets poor labor market conditions as interfering with fair trade in goods and services. Therefore, the type of penalty that the United States envisions for labor standards violations would be linked to the penalty applied to trade standards violations. That is

$$(8) \quad t_{LT} = k t_T,$$

where k is presumably close to one. In this case, the benefit from levying penalties is given by

$$(5') \quad \begin{aligned} b't &= \begin{bmatrix} b_L^{US} + b_L^{LDC} & b_T^{US} + b_T^{LDC} \end{bmatrix} \begin{bmatrix} t_L + k t_T \\ t_T \end{bmatrix} \\ &= \begin{bmatrix} b_L^{US} + b_L^{LDC} & b_T^{US} + b_T^{LDC} + k(b_L^{US} + b_L^{LDC}) \end{bmatrix} \\ &\quad \times \begin{bmatrix} t_L \\ t_T \end{bmatrix}. \end{aligned}$$

In this case, the optimal punishments become

$$(9) \quad \begin{aligned} t_L &= \frac{1}{c} [b_L^{US} + b_L^{LDC}] \quad \text{and} \\ t_T &= \frac{1}{c} [b_T^{US} + b_T^{LDC} + k(b_L^{US} + b_L^{LDC})]. \end{aligned}$$

To find the full impact from labor standards violations we must include both the direct penalty plus the trade-linked penalty. That is

$$(10) \quad t_L + k t_T = \frac{1}{c} [(1 + k^2)(b_L^{US} + b_L^{LDC}) + k(b_T^{US} + b_T^{LDC})].$$

We are now in a position to draw three conclusions.

1. If $b_L^{US} + b_L^{LDC} < 0$,

that is, the social benefit of punishing labor standards violations is negative, then the penalty imposed on trade violations is under-powered. However, if the net social benefit from enforcing labor standards is positive, then the penalty imposed on trade violations is over-powered.

This result can be seen by comparing the trade penalty in equation 9 with the optimal trade penalty given in equation 7". The opportunity to link labor standards to trade disciplines leads the United States to increase the intensity of the trade standards violations because of the added benefit it gets through the enforcement of labor standards.

2. It is likely that the penalty for labor standards violations will be over-powered.

If the social benefit to enforcing labor standards is positive, then a comparison of equation 10 and the labor penalty in equation 7" clearly demonstrates that the linked labor standards penalty is larger than the optimal penalty. In the event that the social valuation of enforcing labor standards is negative, then it is still likely, but not inevitable, that the labor standards penalty will be over-powered.

To see the second point, first note that if the social valuation of enforcing labor standards is negative, then $t_L = 0$, as can be seen from equation 9, since it is not possible to impose a negative penalty. In this case, the only penalty imposed on labor standards violations is the linked penalty. That is

$$t_L + kt_T = kt_T.$$

So, as long as the punishment for trade violations is positive, the total penalty on labor violations will be positive as well. Hence, the punishment for labor standards violations is over-powered.

3. It should be noted that as long as the possibility of linkage between labor standards and trade violations exists, then developing countries will likely prefer to partition labor standards and trade standards into separate agencies, whereas the United States will prefer to integrate both standards into a single agency.

If agency partitioning occurs, then the benefit to the LDCs of the activities of the two separate agencies is given by

$$(11) \quad W_{LDC}^* = b_L^{LDC} \tilde{t}_L + b_T^{LDC} t_T \\ = \frac{b_L^{LDC}}{c} (b_L^{US} + b_L^{LDC}) + \frac{b_T^{LDC}}{c} (b_T^{US} + b_T^{LDC}).$$

However, if linkage occurs, then LDC welfare is given by

$$(12) \quad W_{LDC}^L = b_L^{LDC} \tilde{t}_L + b_T^{LDC} t_T \\ = \frac{b_L^{LDC}}{c} [(b_L^{US} + b_L^{LDC})(1+k^2) + k(b_T^{US} + b_T^{LDC})] \\ + \frac{b_T^{LDC}}{c} [(b_T^{US} + b_T^{LDC}) + k(b_L^{US} + b_L^{LDC})].$$

As long as the social valuation of enforcing labor standards is approximately zero, then the welfare for developing countries in equation 12 with linkage will be smaller than the welfare gain when partitioning occurs, as given by equation 11. This is the case because the developing countries' own valuation of labor standards are negative. It is straightforward to demonstrate that the opposite is the case for the United States since the U.S. valuation of labor standards is positive.

Case 3: Unobservable Action.

Given the recent changes in dispute resolution within the WTO, it is now possible that actions by the committee of experts will no longer be perfectly observable. With unobservable action, the best that the principals can do is to offer an incentive contract contingent on observable x where

$$(13) \quad x = t + \varepsilon$$

and ε is normally distributed with mean 0 and variance matrix Ω .

Here we will take the incentive contract to be linear in x given by

$$(14) \quad \alpha' x + \beta.$$

Dixit (1996) has shown that the equilibrium incentive contract produces penalties that are given by

$$(15) \quad t = C^{-1} \alpha,$$

where α can be characterized by

$$(16) \quad b = (I + rc\Omega)\alpha.$$

Equations 15 and 16 illustrate the now-familiar result that if the principals are unable to perfectly observe the efforts of the agent and the agent is

risk-averse, then the incentive scheme will under-reward desirable behavior. From equation 16, we can see that every element of b is larger than α since all of the elements of C and Ω are positive. Therefore, it must be the case that the punishment vector given by equation 7', when effort is observable, is larger than the vector of punishments given by equation 15, when actions of the agent are unobservable.

In addition, the members do not necessarily act as a unified principal, but rather attempt to lobby the Committee of Exports independently. Dixit (1996) has shown that in this case, the equilibrium contract is characterized by

$$(16') \quad b = (I + 2rc\Omega)\alpha.$$

Again, the incentives are under-powered.

However, we have shown above that linkage leads to over-powered labor standards incentives. There is no reason to expect that linkage will just barely correct for under-powered incentives in the presence of hidden action.

POSTSCRIPT

Despite the apparent failure of the United States in the Singapore Ministerial, U.S. efforts were not without effect. The United States has never been satisfied with the ILO as an organization in which to pursue its interests in international labor standards. Indeed, the United States withdrew from the ILO on three separate occasions: 1919-34, 1938-44 and 1977-80.

Braithwaite and Drahos (2000) argue that the United States, by withdrawing from the ILO, was trying to threaten a forum shift of labor standards to the WTO in order to pressure the ILO to pursue a labor standards agenda that is consistent with U.S. priorities. However, the ILO has established pre-eminence on the labor standards issue that is not easily weakened by a forum-shifting strategy by the United States.

Nevertheless, in June 1998, two years after the Singapore Ministerial, members adopted the ILO Declaration on Fundamental Principles and Rights at Work. This declaration obligates members to promote basic rights covered by ILO Conventions on freedom of association, elimination of compulsory labor and child labor, and elimination of discrimination in respect of employment and occupation—even for members who have not ratified the relevant

conventions. Braithwaite and Drahos argue that the United States succeeded in internationalizing labor standards (albeit in the ILO) over the long-standing objections of the developing countries because of the implicit threat to shift the forum on labor standards to the WTO, where disciplines are more demanding.

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