

**Domestic Policies, National Sovereignty
and
International Economic Institutions**

by

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GATT and National Sovereignty.

- How did GATT rules approach the issue of national sovereignty?
 - At a broad level, GATT rules were designed to respect national sovereignty to the degree consistent with the need to secure the “property rights” to market access created by the voluntary exchange of tariff reductions. GATT legal obligations exist primarily for the purpose of securing the commercial opportunities implied by negotiated tariff reductions, and the substantial degree of domestic policy autonomy that remains under GATT rules is checked (by non-violation nullification and impairment complaints) only if the exercise of that policy autonomy would undermine these market access commitments (Petersmann, 1997, pp. 135-176).

“In contrast to the case law of the EC Court of Justice concerning the legal protection of ‘legitimate expectations,’ non-violation complaints in GATT/WTO law are neither designed to protect private expectations of traders nor do they limit the policy autonomy of member countries (e.g., to grant production subsidies) by prohibiting the ‘abuse of right.’ Their function is to balance this policy autonomy, and to prevent the circumvention of the provisions in GATT Article XXVIII as well as in GATS Article XXI on ‘Modification of Schedules’ if a member, rather than withdrawing a concession *de jure* in exchange for compensation or equivalent withdrawal of concessions by affected contracting parties, withdraws a concession *de facto*.” (Petersmann, 1997, pp. 172-173).

- How to secure commercial opportunities implied by negotiated tariff reductions against nullification by “domestic” measures/national regulations?
 - GATT. First line of defense: Article III; Article XI. Second line of defense: Article XXIII(b).
 - WTO. First line of defense: GATT Article III; GATT Article XI; SCM Agreement; SPM Agreement; TBT Agreement. Second line of defense: Article XXIII(b).

- Hudec (1975, pp. 3-43) describes the early development of the ITO legal system and of the notion of non-violation nullification and impairment (from which the basic elements of GATT evolved) as reflecting a tension between the need to ensure that negotiated tariff commitments would provide meaningful commercial opportunities and the need to maintain a broad degree of domestic policy autonomy:

“The dominant purpose of a trade agreement was the exchange of tariff reductions. The concept of a balanced exchange [reciprocity] was central...Concern for reciprocity stimulated the general code of trade policy rules that traditionally went along with the exchange of tariff reductions. Tariffs were only one instrument of trade policy, and unless other trade policy measures were held in check, the commercial opportunity of a tariff reduction could easily be nullified by some other collateral measure. To maintain reciprocity, therefore, prohibitions against quantitative restrictions, discrimination, and the like were essential. Even so, it was impossible fully to guarantee reciprocity by means of legal commitments. The standard trade policy rules could deal with the common types of trade policy measure governments usually employ to control trade. But trade can also be affected by other “domestic” measures, such as product safety standards, that have nothing directly to do with trade policy. It would have been next to impossible to catalogue all such possibilities in advance. Moreover, governments would never have agreed to circumscribe their freedom in all these other areas for the sake of a mere tariff agreement. The shortcomings of the standard legal commitments were recognized in a report by a group of trade experts at the London Monetary and Economic Conference of 1933. The group concluded that trade agreements should have another more general provision which would address itself to any other government action that produced an adverse effect on the balance of commercial opportunity.” (Hudec, 1975, pp. 19-20).

- How were GATT rules to be enforced, and what role did GATT play in their enforcement?
 - GATT rules were to be enforced through the threat of retaliation by other GATT members, and the role of GATT was to authorize *when* this retaliation would be acceptable and to *limit* its severity to “match the crime.”
 - “There are many commitments in the Charter, some of them general, some of them specific. But if any of these commitments are violated, there is only one sanction that can be applied. And that, in its crudest terms, is retaliation by another state. Now this sanction was not invented by the framers of the Charter. It has existed from time immemorial. It exists today. It will exist tomorrow, even though the Organization that we have conceived is never brought to life. What then have we done in Article 35? We have introduced a new principle in international economic relations. We have asked the nations of the world to confer upon an international organization the right to limit their power to retaliate. We have sought to tame retaliation, to discipline it, to keep it within bounds. By subjecting it to the restraints of international control, we have endeavored to check its spread and growth, to convert it from a weapon of economic warfare to an instrument of international order.” Statement of a U.S. delegate in Geneva, 1947, speaking about both legal violations and other kinds of nullification and impairment, as quoted in Hudec (1975, p. 36).
- Hence, in both its rules and the enforcement of those rules, GATT was far from a sovereignty-crushing organization.

The Economic Integration Trilemma

- (Then-) U.S. Treasury Secretary Summers describes the broad challenge faced by the United States and the world economy, referring to this challenge as the “economic integration trilemma:”

“International economic integration is a good thing, and it is in the U.S. national interest. But it raises tensions with other good things. In the view of most of us, public management of the economy is a good thing in helping stabilize and regulate economic activity and in providing some degree of social insurance to citizens. So also, in the view of most of us, is sovereignty a good thing. We do not just want regulation and a government that can provide social insurance: we want the relevant choices to be made by our government officials, who are elected by our country’s citizens, and for whom our interests are paramount.

“Every country and every supporter of integration faces the challenge of overcoming the special interest with the general interest. These arguments point up a, if not the, broad task of international political economy in the years ahead. That is, reconciling as well as possible the three goals of greater economic integration, proper public economic management, and national sovereignty -- or the “economic integration trilemma.” (Lawrence Summers, *JEP*, Spring 1999).

- The existing principles of the GATT/WTO – in respecting national sovereignty to the degree consistent with the need to secure the property rights to market access created by voluntary exchange of tariff reductions; and in limiting the frequency and severity of retaliation – may provide the best solution to the economic integration trilemma.

I. Introduction

To what extent must nations cede control over their economic and social policies if global efficiency is to be achieved in an interdependent world?

–The “Economic Integration Trilemma.”

–Reconciling economic integration, public economic management, and national sovereignty.

–An expanded role for the WTO in the realm of labor and environmental standards?

Current GATT rules reflect the primacy of market access concerns in GATT practice.

–GATT becomes involved only if a government’s domestic standards choices begin to erode its market access commitments.

–This orientation is seen increasingly as unfriendly to labor and environmental causes.

–Race to the bottom: tuna-dolphin; beef hormone.

–A set of minimum international standards proposed as solution: GATT “social clause.”

Questions:

- Could agreements to liberalize tariffs lead to inefficient domestic standards choices?
- Can globally efficient trade and domestic policies be achieved under current GATT rules?
- Must countries cede additional sovereignty to attain global efficiency?
- Is GATT’s market access orientation misplaced?
- Can a set of minimum international standards solve the problem?

Framework:

- General equilibrium trade model, augmented to incorporate domestic standards policies.
- General government objectives over trade and domestic policies.
- Focus on pecuniary international externalities associated with standards choices.

Results:

–Could agreements to liberalize tariffs lead to inefficient domestic standards choices?

–Yes: standards choices will be distorted to reduce market access.

–Can globally efficient trade and domestic policies be achieved under current GATT rules?

–No, unless existing standards encourage market access relative to the efficient standards policies.

–Must countries cede additional sovereignty to attain global efficiency?

–No: global efficiency can be achieved by granting governments *more* sovereignty.

–Is GATT’s market access orientation misplaced?

–No: it targets the source of the policy distortions.

–Can a set of minimum international standards solve the problem?

–No: the “social clause” is fundamentally flawed as a solution to the “economic integration trilemma.”

II. The Basic Model

A. The Economic Environment

$$(1). \quad p^w M_x(s, p(\tau, p^w), p^w) = E_y(s, p(\tau, p^w), p^w);$$
$$M_y^*(s^*, p^*(\tau^*, p^w), p^w) = p^w E_x^*(s^*, p^*(\tau^*, p^w), p^w).$$

$$(2). \quad M_x(s, p(\tau, \tilde{p}^w), \tilde{p}^w) = E_x^*(s^*, p^*(\tau^*, \tilde{p}^w), \tilde{p}^w).$$

- Marshall-Lerner stability condition; $dp/d\tau > 0 > dp^*/d\tau^*$ and $\partial \tilde{p}^w / \partial \tau < 0 < \partial \tilde{p}^w / \partial \tau^*$ to rule out the Lerner and Metzler paradoxes.

- Figure 1.

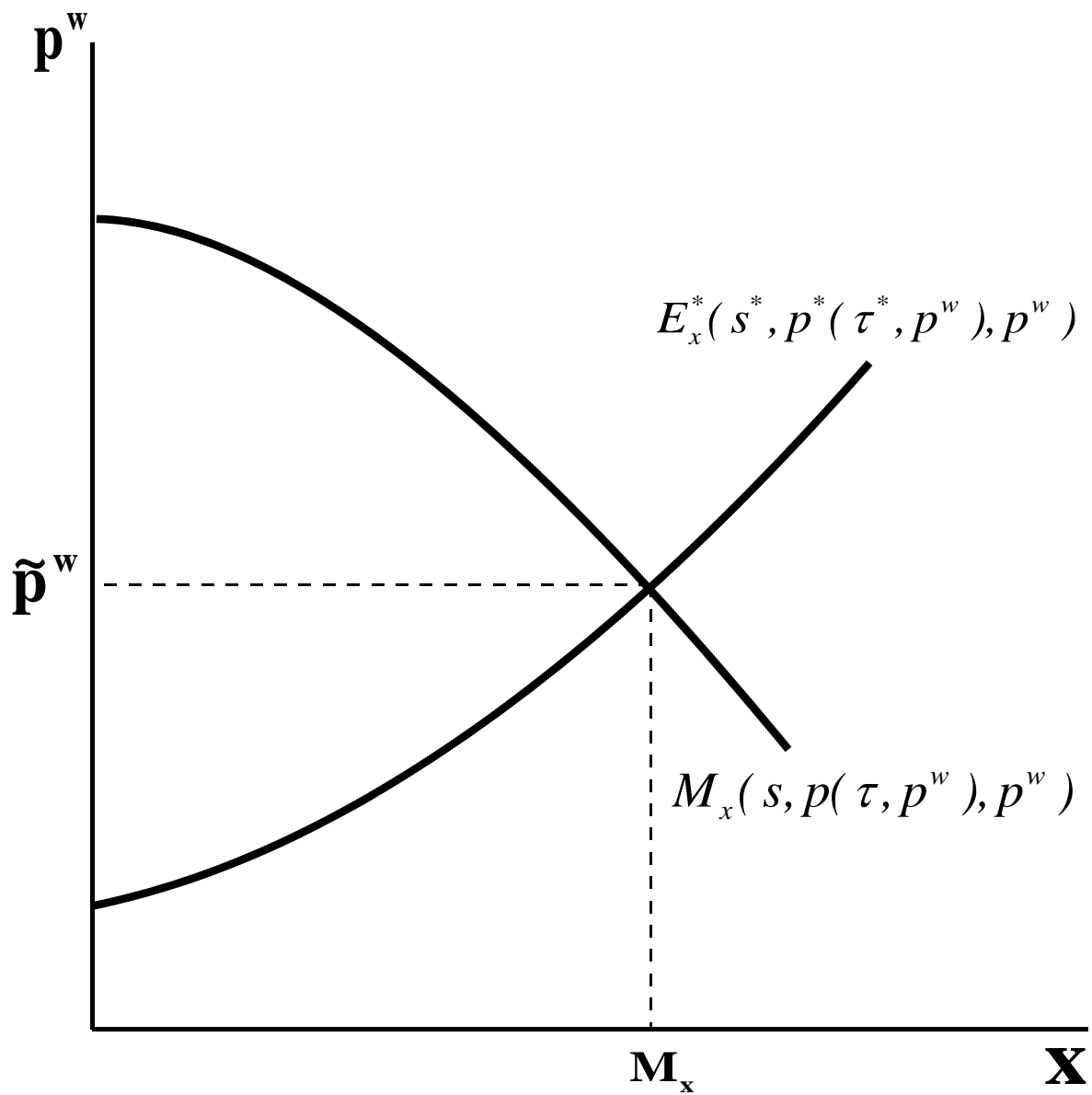


Figure 1: The determination of international equilibrium.

B. Government Objectives

- $W(s, p(\tau, \tilde{p}^w), \tilde{p}^w)$ and $W^*(s^*, p^*(\tau^*, \tilde{p}^w), \tilde{p}^w)$.
- Each government cares about the policy choices of its trading partner only *indirectly*, through the effects that these choices have on *world prices*.
 - Exclusion of global social concerns and international non-pecuniary externalities eliminates direct effects.
 - The nature of international economic interaction channels all indirect effects through world prices.

(3). $\partial W(s, p, \tilde{p}^w) / \partial p^w < 0$ and $\partial W^*(s^*, p^*, \tilde{p}^w) / \partial p^w > 0$.

- Figure 2.

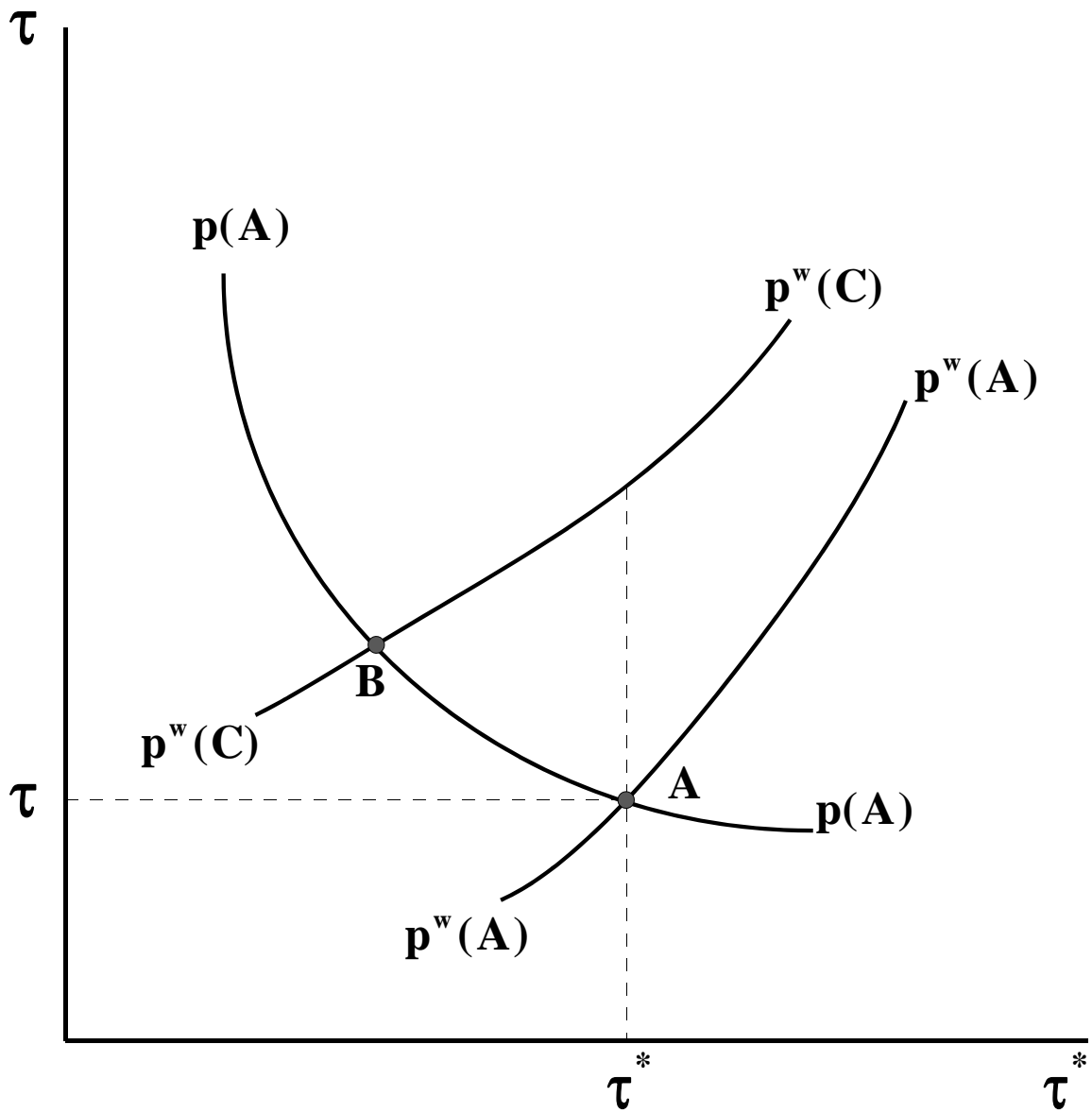


Figure 2: The world- and local-price effects of a tariff change.

C. Efficient Policy Choices

$$(I). \quad \text{Max}_{\tau, s, \tau^*, s^*} \quad W(s, p(\tau, \tilde{p}^w), \tilde{p}^w)$$

$$\text{s.t.} \quad W^*(s^*, p^*(\tau^*, \tilde{p}^w), \tilde{p}^w) \geq \bar{W}^{*E}.$$

– Efficient policy choices, $(\tau^E, s^E, \tau^{*E}, s^{*E})$, satisfy:

$$(4). \quad W_s \times \left(\frac{1}{\partial \tilde{p}^w / \partial s} \right) = W_p \times \left(\frac{\tilde{p}^w}{\partial \tilde{p}^w / \partial \tau} \right);$$

$$(5). \quad W_{s^*}^* \times \left(\frac{1}{\partial \tilde{p}^w / \partial s^*} \right) = W_{p^*}^* \times \left(\frac{-p^* / \tau^*}{\partial \tilde{p}^w / \partial \tau^*} \right); \text{ and}$$

$$(6). \quad (1 - AW_p)(1 - A^*W_{p^*}^*) = 1,$$

where $A \equiv (1 - \tau\lambda) / (W_p + \lambda W_{p^w})$; $A^* \equiv (1 - \lambda^* / \tau^*) / (W_{p^*}^* + \lambda^* W_{p^w}^*)$;

$$\lambda \equiv \frac{[\partial \tilde{p}^w / \partial \tau]}{[dp / d\tau]} < 0; \quad \lambda^* \equiv \frac{[\partial \tilde{p}^w / \partial \tau^*]}{[dp^* / d\tau^*]} < 0.$$

– Interpretation: Figure 3.

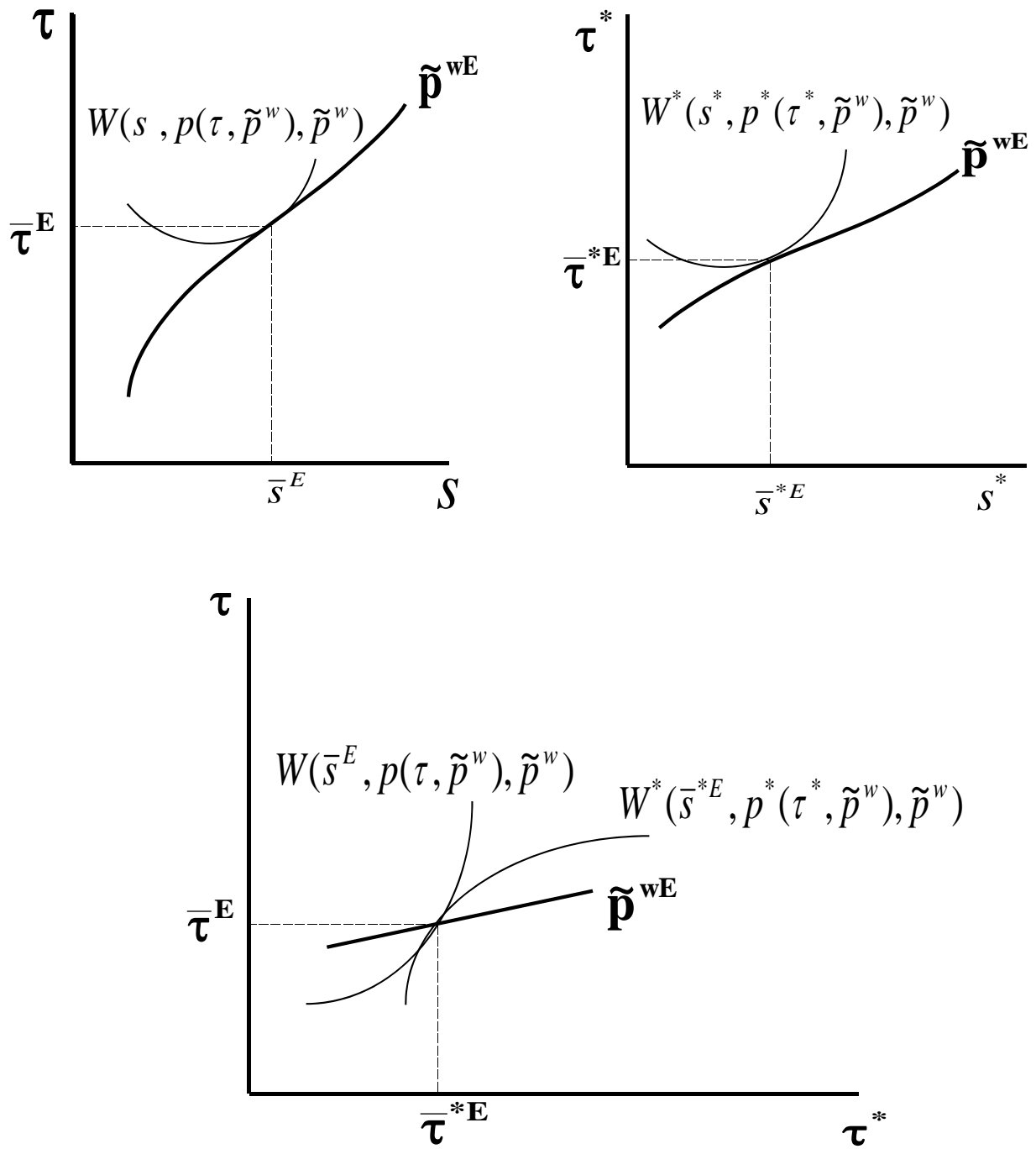


Figure 2: Efficient Policy Choices.

D. Non-cooperative Policy Choices

$$(II). \quad \text{Max}_{\tau, s} \quad W(s, p(\tau, \tilde{p}^w), \tilde{p}^w).$$

$$(II^*). \quad \text{Max}_{\tau^*, s^*} \quad W^*(s^*, p^*(\tau^*, \tilde{p}^w), \tilde{p}^w).$$

– Nash equilibrium choices, $(\tau^N, s^N, \tau^{*N}, s^{*N})$, satisfy:

$$(7). \quad W_s \times \left(\frac{1}{\partial \tilde{p}^w / \partial s} \right) = -[\tau W_p + W_{p^w}];$$

$$(8). \quad W_p + \lambda W_{p^w} = 0;$$

$$(9). \quad W_{s^*}^* \times \left(\frac{1}{\partial \tilde{p}^w / \partial s^*} \right) = -\left[\frac{1}{\tau^*} W_{p^*}^* + W_{p^w}^* \right]; \text{ and}$$

$$(10). \quad W_{p^*}^* + \lambda^* W_{p^w}^* = 0.$$

– Interpretation: Figure 4.

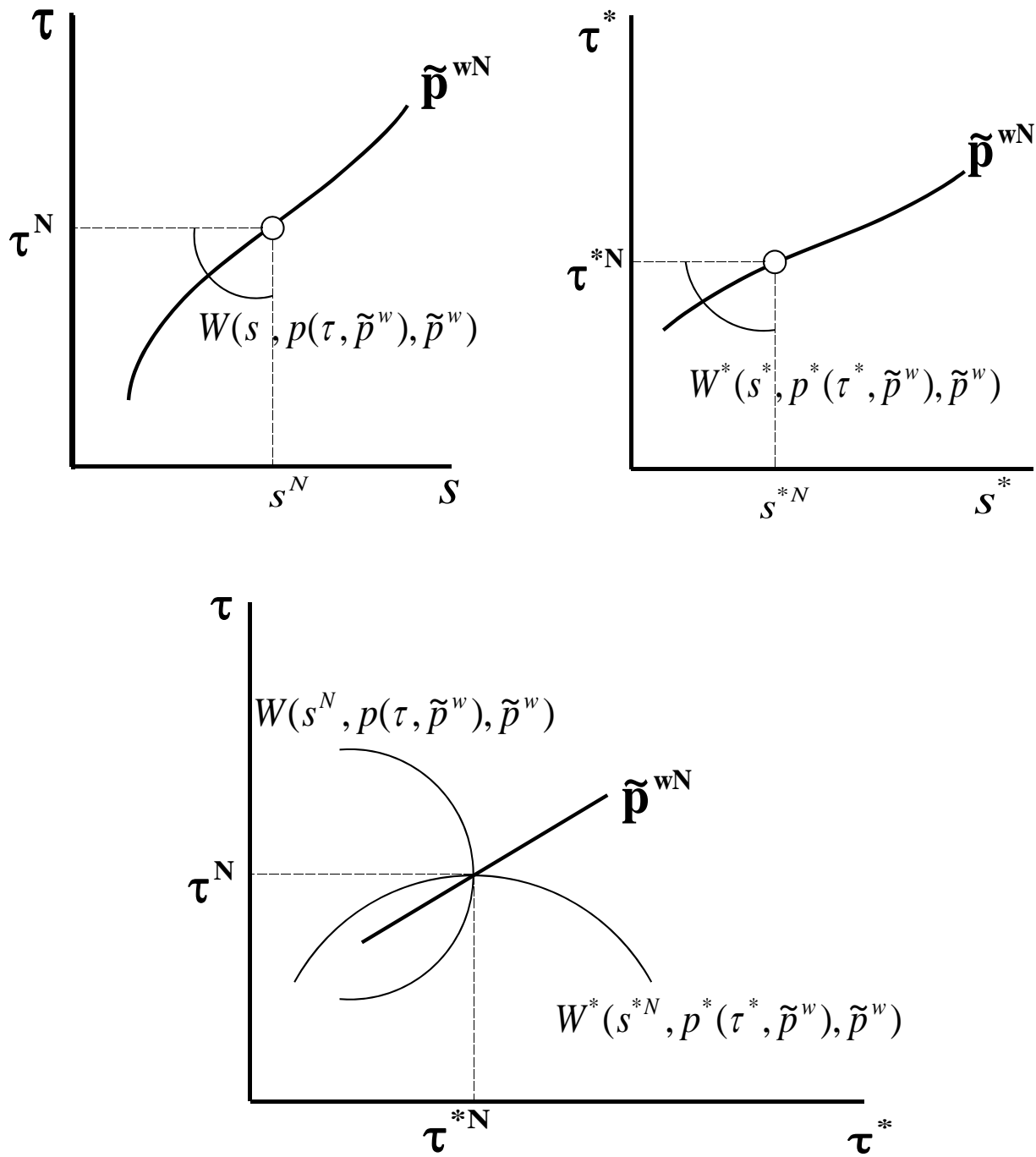


Figure 3: Nash Policy Choices.

E. Efficiency Properties of the Nash Equilibrium

- The inefficiency associated with Nash policy choices arises because of inefficient volumes of trade.
 - (7) and (8) imply (4); (9) and (10) imply (5); (Figure 3); (8) and (10) violate (6).
- Nash policy choices restrict market access to inefficiently low levels.
 - The market access which a country provides its trading partner is the volume of imports it would accept at a particular world price.
 - Each government must negotiate additional market access from its trading partner to benefit.
- Why? Terms-of-trade manipulation.
 - *Politically Optimal* policies satisfy:

$$(12a). \quad W_s = 0; \quad W_p = 0; \text{ and}$$

$$(12b). \quad W_{s^*} = 0; \quad W_{p^*} = 0.$$

- Politically optimal policies are efficient: Figure 5.

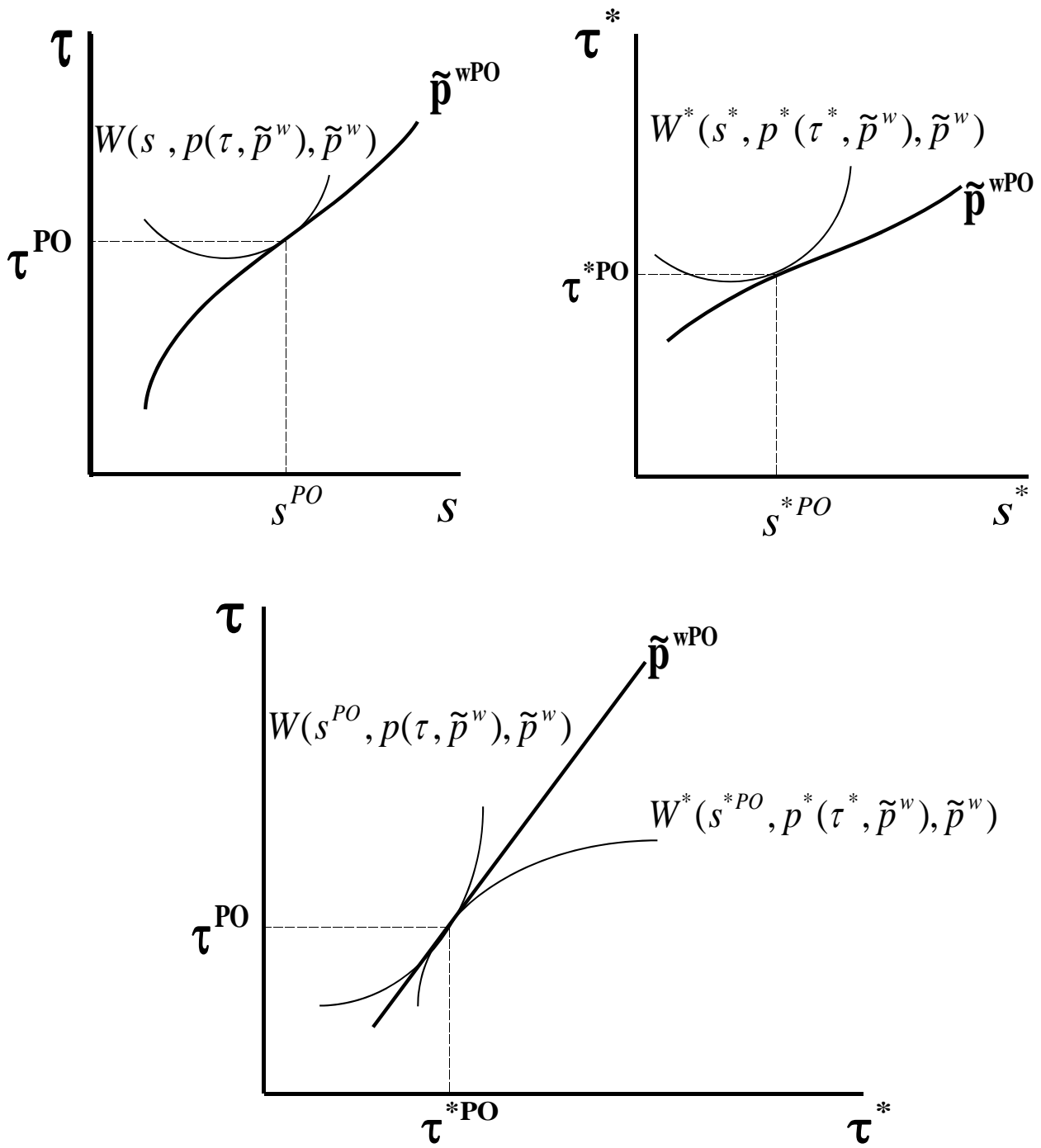


Figure 4: Politically Optimal Policy Choices.

Proposition 1: Nash policy choices are inefficient, and the incentive to manipulate the terms of trade is the source of the inefficiency. This incentive does not distort the policy mix chosen by each government, but Nash market access levels are inefficiently low, and each government must secure additional market access from its trading partner in order to reach a mutually beneficial agreement.

- It is clear that direct negotiations over (τ, s, τ^*, s^*) could generate outcomes on the efficiency frontier.
- Can direct negotiations over tariffs alone be structured so as to generate outcomes on the efficiency frontier as well?

III. Tariff Negotiations, Domestic Policies and GATT Rules

A. Unrestricted Sovereignty over Local Standards

- Suppose that governments cooperate over tariffs, and then set local standards non-cooperatively.
- Starting from any negotiated pair of tariff bindings, $(\bar{\tau}, \bar{\tau}^*)$, the home government solves:

$$(III). \quad \text{Max}_{\tau, s} \quad W(s, p(\tau, \tilde{p}^w), \tilde{p}^w)$$
$$\text{s.t.} \quad \tau \leq \bar{\tau},$$

while the foreign government solves:

$$(III^*). \quad \text{Max}_{\tau^*, s^*} \quad W^*(s^*, p^*(\tau^*, \tilde{p}^w), \tilde{p}^w)$$
$$\text{s.t.} \quad \tau^* \leq \bar{\tau}^*.$$

Proposition 2: When governments are granted unrestricted sovereignty over their local standards, agreements to reduce tariff levels create an incentive to restrict market access and manipulate the terms of trade through domestic policy choices, and therefore tariff negotiations cannot achieve efficient outcomes.

- Figure 6.

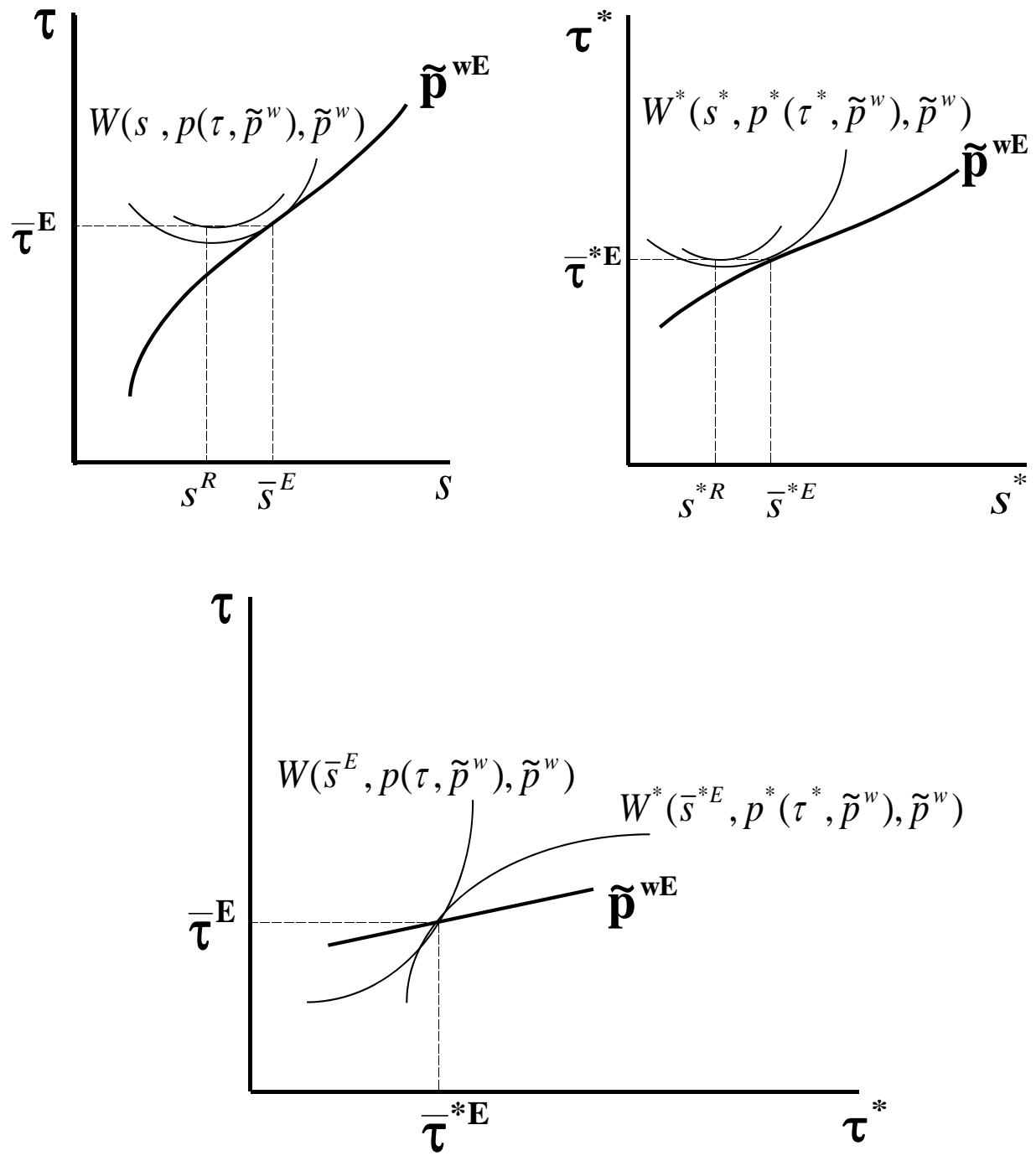


Figure 5: Negotiations over tariffs alone.

The race-to-the-bottom/regulatory-chill problem.

Suppose that a government has agreed to hold its tariffs low as a result of a WTO negotiation.

Scenario 1 (Race-to-the-bottom): The government faces pressure from import-competing interests to offer additional protection from imports.

If its WTO commitments prevent the government from responding with a tariff increase, then it might instead choose to relax a labor standard.

Scenario 2 (Regulatory chill) : The government faces pressure from labor interests to introduce new and more stringent standards that serve to enhance workplace safety but which also raise the costs of production of its import-competing firms.

If its WTO commitments prevent the government from raising its tariff to offset the competitive effect of imposing the tighter standards on its firms, then the government might hesitate to introduce these new and improved standards.

- If property rights over negotiated market access levels were sufficiently complete, the race-to-the-bottom/ regulatory chill problem would not arise.

How can these property rights be completed?

A Simple Rule.

Once a government has agreed to lower its tariffs in a WTO negotiation:

It should not be permitted to take subsequent unilateral policy actions that undercut its implied market access commitments; but

It should be otherwise allowed to configure its unilateral policies in anyway it desires.

Existing GATT/WTO principles are not that far away from approximating this simple rule.

Scenario 1: The government should not be permitted to offer protection to its import-competing industry by weakening its standards.

If it desires to provide additional protection from imports, it should be required to renegotiate with its trading partners to select a higher tariff level.

- In principle, “non-violation” nullification-or-impairment complaints can guide governments toward efficient renegotiations (and thereby protect against a race to the bottom).

Scenario 2: The government should be allowed to raise its tariff as it tightens its standard.

But its tariff increase can do no more than offset the competitive effect of the tighter standard.

- In principle, renegotiations could involve a commitment to higher standards as “compensation” for tariffs bound at higher levels (and thereby prevent a regulatory chill).

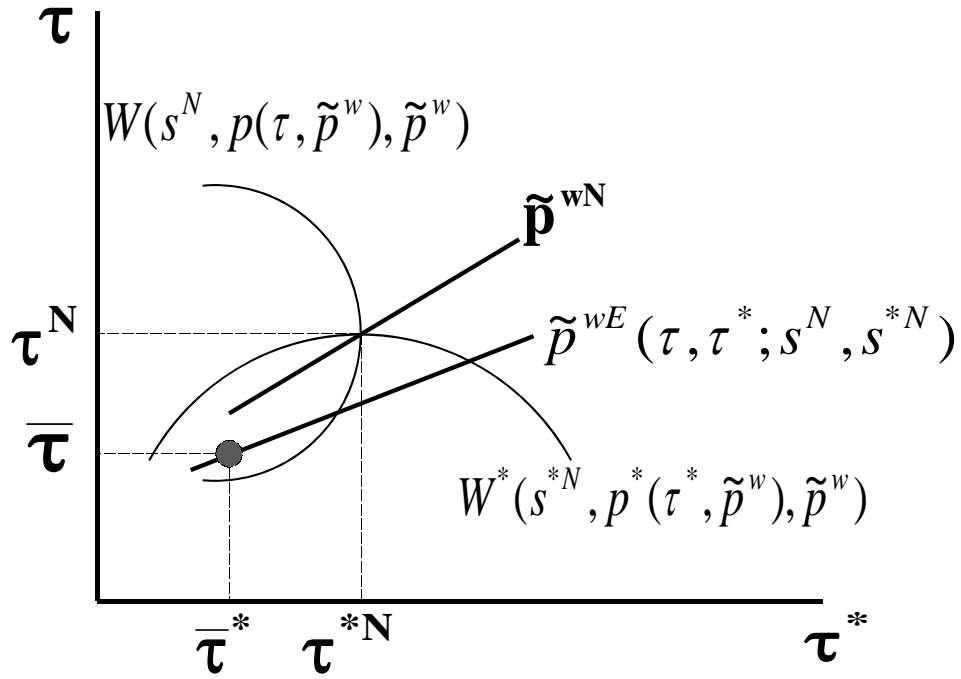
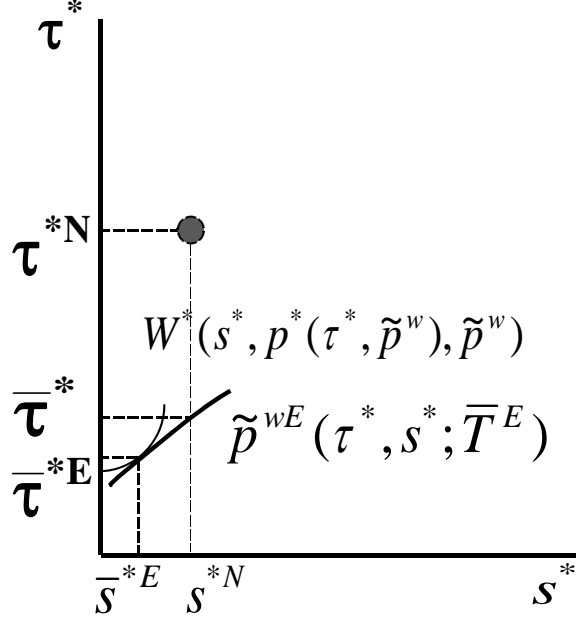
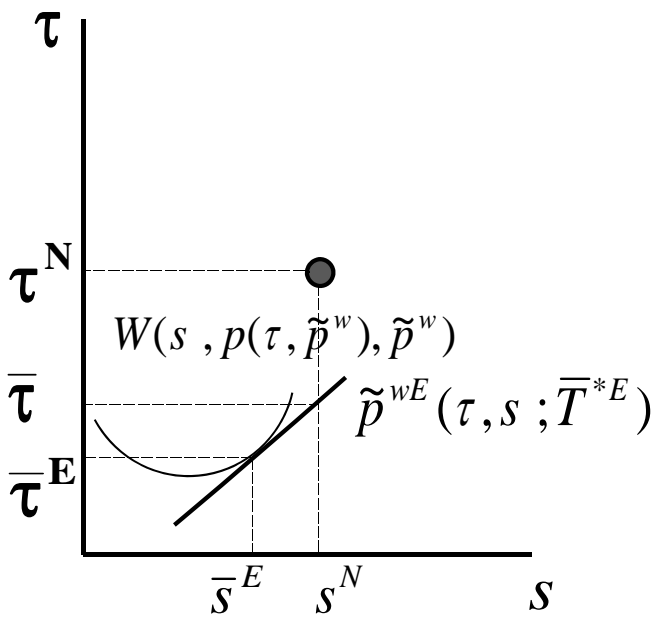


Figure 6: Negotiations over tariffs alone with non-violation complaints when efficiency requires weaker standards.

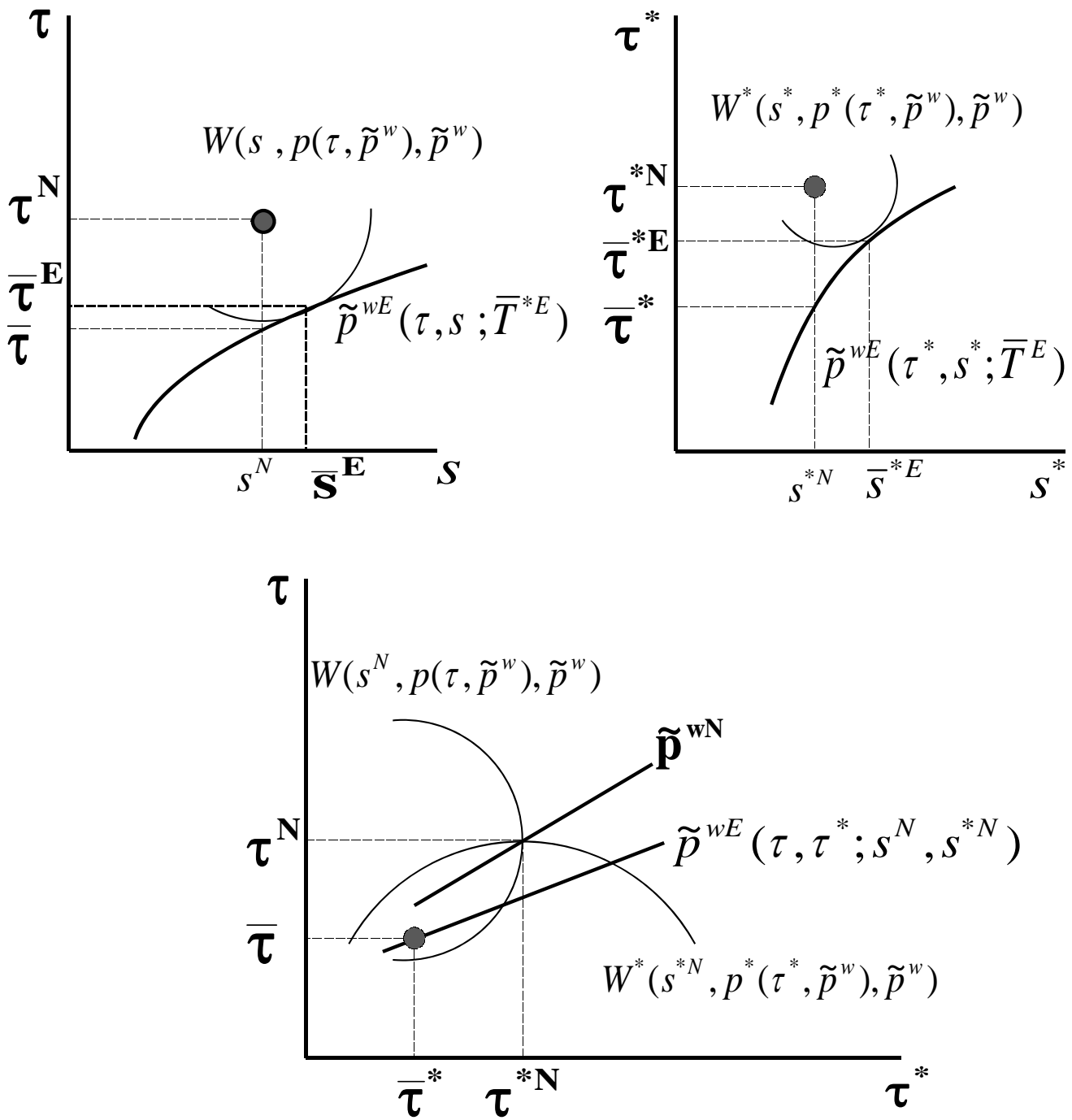


Figure 7: Negotiations over tariffs alone with non-violation complaints when efficiency requires tighter standards.

IV. Tariff Negotiations and National Sovereignty

- An important impediment to achieving globally efficient policies arises whenever existing standards discourage market access relative to efficient standards levels.
 - GATT rules may not provide governments with adequate means to offset the trade pressures that could impede implementation of efficient standards.
 - This bears some resemblance to race-to-the-bottom-type fears, under which trade pressures delay the introduction or enforcement of stricter standards.
- Governments must be permitted to *raise* their bound tariffs, when making changes to domestic policies that would otherwise *increase* access to their markets.

Proposition 4: If governments were granted the freedom to stabilize their implied market access commitments by *raising* their bound tariffs, when making changes to domestic policies that would otherwise *increase* access to their markets, then any efficient combination of tariff bindings and standards policies could be implemented under tariff negotiations.

- Effectively, this additional freedom would eliminate constraints (i) and (i*) from (IV) and (IV*), respectively, granting governments additional sovereignty over their policy choices.
- By contrast, under the proposed GATT social clause:
 - Countries would first negotiate a set of minimum international standards \bar{s} ;
 - And then an additional constraint would be added of the form $(s \geq \bar{s})$ to (IV), and of the form $(s^* \geq \bar{s})$ to (IV*).
 - This could yield efficient outcomes only in the special case where efficiency required uniform standards across countries.
- The social clause reflects the following logic:
 - The race to the bottom is fueled by the policy choices of low-standards countries and the trade pressures that these choices exert on the industrialized world.
 - It can be stopped by making access to one's markets conditional on the standards choices of one's trading partners.

- The flaw in this logic is that the potential race to the bottom under GATT rules is fueled by the loss in competitiveness that would result from a tightening of one's *own* standards, *not* by greater import competition from a low-standards trading partner.
- Hence, it is the link between one's tariff bindings and one's own standards – not the standards of one's trading partners – that should be strengthened.

V. Conclusion

- How should the issue of domestic standards be handled in the WTO?
- GATT's principles are well-equipped to address this issue and, with some modification, could allow governments to attain globally efficient trade and domestic policies.
 - Permit governments to increase their bound tariffs when making changes to domestic policies that would otherwise increase access to their markets.
 - This modification can be viewed as a refinement of existing GATT rules that is consistent with GATT principles.
- Caveats.
 - Slippery slope.
 - Measurement.
 - Political economy?