Domestic Policies, National Sovereignty
and
International Economic Institutions

by

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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

\[ p^w M_x(s_p(\tau, p^w), p^w) = F_y(s_p(\tau, p^w), p^w); \]

(1).

\[ M_y^*(s, p^*(\tau, p^w), p^w) = p^w E_x^*(s, p^*(\tau, p^w), p^w). \]

(2).

\[ M_x(s_p(\tau, \tilde{p}^w), \tilde{p}^w) = E_x^*(s, p^*(\tau, \tilde{p}^w), \tilde{p}^w). \]

- 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). \[ \frac{\partial W(s, p, \tilde{p}^w)}{\partial p^w} < 0 \text{ and } \frac{\partial W^*(s^*, p^*, \tilde{p}^w)}{\partial p^w} > 0. \]

- Figure 2.
Figure 2
The world- and local-price effects of a tariff change.
C. Efficient Policy Choices

(1). \[ \max_{\tau, s, \tau^*, s^*} W(s, p(\tau, \hat{p}^w), \hat{p}^w) \]

\[ \text{s.t. } W^*(s^*, p^*(\tau^*, \hat{p}^w), \hat{p}^w) \geq \bar{W}^{*E}. \]

- Efficient policy choices, \((\tau^E, s^E, \tau^*, s^E)\), satisfy:

(4). \[ W_s \times \left( \frac{1}{\partial \hat{p}^w/\partial s} \right) = W_p \times \left( \frac{\hat{p}^w}{\partial \hat{p}^w/\partial \tau} \right); \]

(5). \[ W_s^* \times \left( \frac{1}{\partial \hat{p}^w/\partial s^*} \right) = W_p^* \times \left( \frac{-p^*/\tau^*}{\partial \hat{p}^w/\partial \tau^*} \right); \text{ and} \]

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

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

\[ \lambda = \frac{[\partial \hat{p}^w/\partial \tau]}{[dp/\partial \tau]} < 0; \quad \lambda^* = \frac{[\partial \hat{p}^w/\partial \tau^*]}{[dp^*/\partial \tau^*]} < 0. \]

- Interpretation: Figure 3.
Figure 3: Efficient Policy Choices.
D. Non-cooperative Policy Choices

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

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

- Nash equilibrium choices, \((\tau^N, s^N, \tau^N, s^N)\), satisfy:

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

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

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

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

- Interpretation: Figure 4.
Figure 4: 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.


– Politically Optimal policies satisfy:

(12a). \( W_s = 0; \ W_p = 0; \) and

(12b). \( W_s^* = 0; \ W_p^* = 0. \)

– Politically optimal policies are efficient: Figure 5.
Figure 5: 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 \((\tau, s, \tau^*, s^*)\) 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, $(\tau, \tau^*)$, the home government solves:

\[(III). \quad \text{Max}_{\tau, s} \quad W(s, p(\tau, \tilde{p}^{w}), \tilde{p}^{w})\]

\[\text{s.t. } \tau^* \leq \tau,\]

while the foreign government solves:

\[(III*). \quad \text{Max}_{\tau^*, s} \quad W^*(s^*, p^*(\tau^*, \tilde{p}^{w}), \tilde{p}^{w})\]

\[\text{s.t. } \tau^* \leq \tau^*.\]

**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 6: Negotiations over tariffs alone.
B. GATT Rules: Non-violation Complaints

- For any recorded level of standards $s^0$ and $s^{*0}$, a negotiated pair of tariff bindings $(\tau, \tau^{*})$ implies a world price $\bar{p}^w$ and a level of domestic and foreign market access commitments, $\bar{M}^w_x$ and $\bar{M}^*_y$, respectively.

Two-Stage Tariff Negotiation Game:

Stage 1: Governments bargain over tariffs, a pair of tariff bindings, $(\tau, \tau^{*})$, is determined, and a world price and market access commitments, $\bar{p}^w$, $\bar{M}^w_x$ and $\bar{M}^*_y$, are implied.

Stage 2: Each government is entitled to make unilateral adjustments to its policy mix so long as (i) its tariff does not exceed its bound level, and (ii) its policy adjustments do not erode its implied market access commitments.

- Stage 1: GATT “Round” of tariff negotiations (Article XXVIII bis).

- Stage 2: Freedom to unilaterally adjust trade and domestic policies, subject to (i) bindings and (ii) avoiding non-violation complaint.
Second-stage problem: Starting from \((\tau, s^0, s^*, \tilde{s}^0)\), the home-country government solves:

\[(IV). \quad \text{Max}_{\tau, s} \quad W(s, p(\tau, \tilde{p}^w), \tilde{p}^w) \]

s.t. (i). \(\tau \leq \tau; \) and
(ii). \(M_x(s, p(\tau, \tilde{p}^w), \tilde{p}^w) \geq \tilde{M}_x.\)

while the foreign-country government solves:

\[(IV^*). \quad \text{Max}_{\tau^*, s^*} \quad W^*(s^*, p^*(\tau^*, \tilde{p}^w), \tilde{p}^w) \]

s.t. (i*). \(\tau^* \leq \tau^*; \) and
(ii*). \(M_y^*(s^*, p^*(\tau^*, \tilde{p}^w), \tilde{p}^w) \geq \tilde{M}_y^*.\)

If the foreign government policies \((\hat{c}, s^*)\) meet its market access commitments exactly, the Stage-2 problem for the home government may be rewritten as:

\[(IV'). \quad \text{Max}_{\tau, s} \quad W(s, p(\tau, \tilde{p}^w), \tilde{p}^w) \]

s.t. (i). \(\tau \leq \tau; \) and
(ii'). \(\tilde{p}^w(\tau, s, \hat{c}, s^*) \geq \bar{p}^w.\)

In this case the home government is prevented from altering its policies subsequent to tariff negotiations in a way that would improve its terms of trade.
- As terms-of-trade manipulation is the cause of inefficiency (Proposition 1), and as agreements to reduce tariffs shift this incentive to domestic policies, non-violation complaints may facilitate efficient outcomes.

- Can points on the efficiency frontier be reached with appropriate Stage-1 outcomes, in light of the Stage-2 adjustments that may be anticipated?

- A policy combination can be implemented under tariff negotiations if, for some pair of tariff bindings, it corresponds to a Nash equilibrium in Stage 2 of the Two-Stage Tariff Negotiation Game.
Consider an efficient combination of policies $E=(\tau^E, s^E, \tau^{*E}, s^{*E})$ that requires each government to bind its tariff below its best-response tariff.

The prospect of non-violation complaints allows tariff negotiations to achieve efficient policy outcomes, but not in all circumstances.

- Case a): Existing standards are "overly encouraging" to market access; $E$ can be implemented under tariff negotiations.

  - Figure 7.

- Case b): Existing standards discourage market access; $E$ cannot be implemented under tariff negotiations.

  - Figure 8.

**Proposition 3:** Consider any efficient combination of tariff bindings and standards policies. This efficient policy combination can be implemented under tariff negotiations if and only if existing standards have been set by each government in a way that *encourages* access to its markets relative to the efficient standards policy.
Figure 7
Negotiations over tariffs alone with non-violation complaints when efficiency requires weaker standards.
Figure 8
Negotiations over tariffs alone with non-violation complaints when efficiency requires tighter standards.
C. GATT Rules: Reciprocity

- In the Two-Stage Tariff Negotiation Game, the *level* of market access commitments implied by tariff negotiations will not be eroded by subsequent policy changes.
  - Stage-1 tariff bindings cannot be altered.
  - Non-violation complaints prevent erosion.

- In reality, GATT’s rules *do* provide governments with the right to modify their tariff bindings.
  - Article XXVIII renegotiations subject to *reciprocity*.
  - Non-violation complaints induce governments to modify their market access commitments *explicitly* through Article XXVIII.

- Hence, GATT tariff negotiations secure the *balance* of market access commitments, as defined by *reciprocity*.

- Accounting for this is important: renegotiation an already-available answer to the conflict between GATT commitments and strong labor/environmental standards?

- Accounting for renegotiation provisions of GATT does not alter our basic conclusions.
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?