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Tensions between Trade and Domestic Social Arrangements

International trade creates arbitrage in the markets for goods, services, labor, and capital. The tendency for prices to converge as a result is the source of the gains from trade. But trade often exerts pressure toward another kind of arbitrage as well: arbitrage in national norms and social institutions. This does not happen directly, through trade in these ''norms'' or ''institutions,'' as with goods and services, but indirectly, by raising the social cost of maintaining divergent social arrangements. This is a key source of tension in globalization.

I begin with an extended example, that of child labor in international trade. I will use this example as a springboard for some generalizations about how trade connects—or disconnects, as the case may be—with domestic social norms and institutions. Child labor happens to be a convenient example for this purpose, but of course it is also an important case in its own right.

Laying Out the Issues: The Example of Child Labor

Consider the case of XYZ Corp., a hypothetical American mid-sized firm that manufactures shoes in Pleasantville, Ohio. Under increasing pressure from encroaching imports and with profit margins squeezed tight, the firm decides to lay off 300 of its workers in Pleasantville and to subcontract the more labor-intensive parts of its operation to a local firm in Honduras. Outsourcing reduces XYZ Corp.'s costs substantially, and profit margins recover. The laid-off workers in Pleasantville eventually find jobs else-

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where. But many have to move to other towns, and most have to take lower-paying jobs.

By the standards of international trade theory, this is a success story. International trade allows specialization according to comparative advantage, and the result is a larger economic pie for both the United States and Honduras. Trade economists would be quick to point out that the process is unlikely to occur without some distributional consequences, as in the above example. Indeed, in the standard models used by international economists, the distributional consequences of trade typically dwarf its net contribution to national income.[1] Compensation of the losers *could* take care of the problem, as the larger economic pie resulting from trade in principle allows the losers to be compensated in full while leaving the beneficiaries—who must share some of their gains—still better off. And this is indeed the first line of defense in the classroom and in most policy debates when the economist presents the case for gains from trade.

However, compensation rarely takes place in practice and never in full. There are good theoretical reasons, having to do with incomplete information, the impossibility of implementing lump-sum transfers, and the absence of a full set of tax/subsidy instruments, why this is so.[2]

But a much better defense of the distributional consequences of trade can be constituted along the following lines. Note first that preventing trade—that is, blocking XYZ Corp.'s outsourcing activities—also has a distributional effect: that of preventing XYZ's shareholders and remaining workers from raising their incomes. A number of considerations enter into how society evaluates these two distributional allocations—one with trade and one without—and therefore how it decides on whether trade is a good idea. One simple consideration is the relative size of the gains versus losses, as well as their incidence. We are much more likely to approve of a policy that creates large income benefits spread over a wide base than of a policy that creates a small net gain at the cost of a huge redistribution of income. Second, the identity of the gainers and losers matters as well. Rawlsian conceptions of justice, for example, imply that redistributions that enhance the well-being of the most disadvantaged groups should receive priority. Third, we could take a cue from the

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1. Under typical parameters, lowering of a trade restriction will result in $5 or more of income being shuffled among different groups for every $1 of net gain. See Rodrik (1994) for further discussion. Many trade economists also believe in *dynamic* gains from trade—i.e., in higher growth rates resulting from more open trade policies. The theoretical presumptions on this, however, are not very strong, and one can easily come up with models to the contrary. Neither is the empirical evidence on the trade-growth linkage as strong as it is sometimes believed.

2. It is said that an economist is someone who sees something work in practice and wonders if it can also work in theory. This sentence is added for the benefit of the economist who fits the adage.

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''prospect'' theory in economics and weight losses more heavily than gains, which would result in a bias toward the status quo.

In market economies, perhaps the most significant test that is applied in determining whether distributional changes are socially acceptable is the following: is the change in question the consequence of individual actions that do not violate norms of fair play? In other words, is the distributional advantage obtained through *means* that society considers legitimate? If the answer is yes, we are likely to accept the consequences, even if some individuals or groups suffer as a result.[3] Take the case of technological innovation. An inventor who comes up with a new process or product through hard work and ingenuity is hailed as a hero, even if the invention displaces workers committed to the old technology. We would not dream of banning the light bulb to please candle makers!

Opening up to international trade is formally equivalent, in all economic respects, to technological progress. Both result in a larger economic pie at the possible cost of some redistribution of income.[4] If we presume that technological progress is good and ought to be encouraged rather than restricted, why not accept the same for liberalization of international trade as well? The analogy clarifies a central point: distributional implications alone, even if recognized to be adverse, do not provide a justification for imposing restrictions on foreign trade. This, I believe, is the central argument in favor of maintaining open borders to international commerce.

Note, however, that this defense of free trade is a contingent one. It requires, in particular, that the exchanges that create the gains from trade be consistent with the prevailing norms and rules of ''fair play'' at home. Returning to the analogy of technological progress, inventors who achieve their ends through lying, cheating, plagiarizing, or otherwise violating widely held domestic norms are reviled rather than celebrated.[5] Indeed, governments routinely interfere in R&D activities to ensure their consistency with social norms. Experimentation on human subjects and on animals is heavily regulated, for example. Ethical considerations impinge

3. In the concise wording of the philosopher Robert Nozick (1974, 151), ''A distribution is just if it arises from another just distribution by legitimate means.''

4. In the domestic context, we think of a ''production function'' as representing the technology through which intermediate inputs and primary factors are transformed into final goods. International trade is entirely analogous to such a production function: The goods that we sell abroad allow us to purchase imports in return, and hence our exports can be thought of as the inputs that get transformed into imports (the outputs). Prevailing international prices indicate the ''input-output'' coefficients used in this transformation. And, continuing the analogy, a terms-of-trade improvement (due, for example, to lower labor standards in a partner country) acts just like a technical advance in this technology by reducing the input-output coefficients.

5. In the economics field, another relevant example is the ban on insider trading. The ban is motivated less by efficiency considerations—which are difficult to construct and may even go in the opposite direction—than by considerations of fairness.

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heavily on research in biotechnology. And over the last two centuries rich countries have developed labor legislation and standards that tightly circumscribe the nature of the production process. The bottom line is that once we are forced to provide a principled defense of free trade, there is no avoiding issues of fairness and legitimacy.

Perhaps ironically, libertarians, who are the staunchest defendants of free trade, would agree that the case for free trade is deep down a moral one. James Bovard of the Cato Institute, for example, makes this case strongly in arguing that government has no business restricting trade (1991): ''Every trade restraint is a moral issue, forcibly sacrificing some Americans for the benefit of others.'' The unstated corollary is that removing a trade barrier reverses the sacrifices. Hence, strike out the term ''forcibly,'' and I would agree with Bovard's statement. Where libertarians part company from most people, however, is in their belief that laissez-faire is the ultimate criterion for distributive justice—hence the use of the loaded term ''forcibly'' in the quote.

To draw the implications of the argument more concretely, let us return to the XYZ Corp. Suppose that some time after the firm has returned to profitability thanks to outsourcing, a journalist from Pleasantville visits the subcontracting plant in Honduras. He reports that the plant is a sweatshop, where 12-year-old children work under unsanitary and hazardous conditions. The news shocks the community. Picket lines are organized outside the headquarters of the firm, and after several days the president of the company announces that the subcontracting relationship with the Honduran firm has been terminated. He adds that XYZ will be hiring locally again.

What has just transpired is that vocal groups in Pleasantville have declared it unacceptable to displace adult American workers with 12-year-old children working under hazardous conditions. The message is: we do not accept this as a legitimate exchange and a fair way of imposing a burden on a segment of our society. Is this a good thing? And if yes, why not generalize the practice and pass legislation that bans all imports manufactured by child labor?[6] Doing so would be in conflict with the rules of the World Trade Organization, which has an exception on prison labor (Article XX[e]) but otherwise does not allow for discrimination among commodities or countries on the basis of differences in the mode of production.[7]

Most trade economists would also find it objectionable to impose trade restrictions on other countries because of differences in national practices

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6. A bill proposed in the US Congress in 1995, the Child Labor Deterrence Act, aims to do precisely that.

7. For example, when the United States banned imports of Mexican tuna because Mexico had not taken steps to reduce the number of Eastern Pacific tropical dolphins killed due to tuna fishing, Mexico appealed to the General Agreement on Tariffs and Trade (GATT)

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such as labor standards.[8] In one of the most thorough discussions of the issue, T. N. Srinivasan (1995) argues that introducing labor-standard concerns into the formulation of trade policy is a bad idea. Most of his objections have to do with the ineffectiveness of trade policy, or possibly its backfiring, where the well-being of workers in the exporting countries is concerned. For example, by denying the children working in the Honduran footwear industry access to the US market, XYZ could leave them in even more dire circumstances. Further, if individuals in the United States care about these children, they should make transfer payments to them rather than using such an indirect tool as trade policy. The conclusion of Srinivasan and many other economists is that demands for denying entry to exports made with child labor largely reflect US protectionist desires to keep competing imports out.

But while protectionist motives are apparent in many of the discussions on the ''new'' agenda for trade policy—over labor standards, environment, and competition policy—it would be a mistake not to recognize that they also reflect genuine discomfort in the importing countries with the moral or social implications of trade. I offer two bits of evidence. The first comes from a recent paper by Alan Krueger (1996). Krueger undertook an interesting test of the protectionism hypothesis by examining the sponsors of the Child Labor Deterrence Act. The proposed act would prohibit imports made by child labor. Such imports compete most directly with production in districts in which the labor force tends to be low-skilled. If the sponsors of the act were motivated chiefly by protectionist interests, one would expect them to be drawn disproportionately from such districts. In fact, Krueger found the opposite. The greater the proportion of high school dropouts in a district, the *lower* the likelihood that its representative would be a sponsor of the bill. Support for the act came instead from higher income districts and was apparently based on humanitarian rather than material concerns.[9]

The second bit of evidence can be derived from putting a twist on the XYZ story. Suppose that, instead of outsourcing, the company closes its

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and won. Part of the rationale behind the GATT ruling was that the United States had applied a trade restriction on the basis of the process of production.

8. The original International Trade Organization charter was concerned with labor standards and trade. It had a whole article on fair labor standards (Article 7), which stated that ''all countries have a common interest in the achievement and maintenance of fair labor standards related to productivity and thus in the improvement of wages and working conditions as productivity may permit.'' Further, ''Unfair labor conditions, particularly in production for export, create difficulties in international trade, and, accordingly, each member shall take whatever action may be appropriate and feasible to eliminate such conditions within its territory.'' So these issues were very much on the minds of the architects of the postwar international economic system.

9. Krueger also applied his framework to the congressional votes over the North American Free Trade Agreement (NAFTA) and the World Trade Organization (WTO). His findings

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main plant in Pleasantville, opens up a domestic sweatshop near the Mexican border, and brings in 12-year-old children from Honduras as temporary migrants. From the standpoint of economic outcomes, this solution to the firm's competitive problem is indistinguishable from the previous one of outsourcing through trade. The well-being of all the parties—the laid-off workers, the firm's shareholders, and the Honduran children—are affected in exactly the same way.

The difference in practice is that taking this option would break the law. Labor laws in the advanced industrial countries make only a limited number of exceptions to the rule that migrant workers—temporary or otherwise—have to work under the same rules as those that apply to domestic workers. To be sure, the rules are frequently flouted. But when they are and the infractions are discovered, the public outcry is loud and the transgressors are punished. This demonstrates, in my view, the prevailing norm that it is not acceptable to reduce the living standards of American workers by taking advantage of labor practices that are vastly below those enshrined in US standards.

Interestingly, the vast majority of the economists who have no difficulty with the outsourcing example would also accept that it is not good public policy to relax labor standards for migrant workers to the point of allowing sweatshop conditions. Clearly, there is an inconsistency between these two positions. There seems to be greater coherence in the behavior of the lay public, which reacts with equal outrage to the two versions of the parable—outsourcing versus migration—than in the precepts of the economists.

Let me emphasize two key features of my argument. First, there is no conflict with comparative advantage per se, as long as it is founded on processes that are perceived as legitimate at home. That is why, contrary to economists' thinking, there is a difference between comparative advantage created by differences in relative factor endowments or preferences and that created by institutional choices that conflict with norms in the importing country. Second, the argument does not rely on Americans caring greatly about the well-being of the Honduran children; it only presumes that Americans care for other Americans and that there are social norms regarding what is an acceptable manner of imposing a burden on others.

But what about imports that do not compete directly with domestic production and therefore do not displace American workers? Does this mean that the manner in which these imports are manufactured—whether they use child labor or defile the environment—is of no consequence for trade policy in the importing countries? Of course, some if not most Americans also care about the plight of underage workers or about environmental conditions in the rest of the world. But when such global

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there are consistent with the self-interest motive. Representatives from low-skill districts were less likely to vote in favor of NAFTA or the WTO.

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humanitarian motives—as opposed to domestic distributional concerns—are the driving force, there is a good case to be made that they carry very little implication for trade policy.

The reason is simple: it is quite unclear whether trade policies, and import restrictions in particular, are a good instrument to advance the cause of labor or the environment among one's trading partners. The arguments, such as T. N. Srinivasan's above, that there are often far better instruments to achieve these global-humanitarian goals—ranging from allowing migration to providing foreign technical and financial assistance—have to be answered before a good case can be mounted for interfering with trade. Furthermore, as mentioned earlier, restrictive trade policies in the advanced countries often worsen the situation of those in the exporting countries they were designed to help. The alternative for child workers in export industries, for example, may often be worse (e.g., prostitution).

In the case of *noncompeting* imports, then, the standard economics argument on behalf of free trade is on much more solid ground. However, even in this case, there may be other influences on domestic social arrangements, to be discussed shortly, that need to be considered.

Trade and ''Blocked Exchanges''

Every society has restrictions, moral or legal, on what kinds of markets are allowed. Individuals are never completely free to sign certain kinds of contracts. The political philosopher Michael Walzer has called these ''blocked exchanges.'' In the United States, such blocked exchanges cover a number of areas, including the sale of human beings and of political office. They also cover ''trades of last resort'' or ''desperate'' exchanges, as illustrated by laws on the eight-hour day, minimum wages, and health and safety regulations (see Walzer 1983, 100-03, for an exhaustive listing). Some of these restrictions, such as the prevention of enslavement, are hardly controversial. Others, such as minimum wage laws, are more so. Moreover, norms for what should be restricted vary across countries and also change over time. The point is simply that blocked exchanges are part of the social arrangements of every society.

The history of US labor law nicely illustrates how blocked exchanges come into being and evolve. During the early part of the 20th century, there was much resistance to legislation that would reduce hours and improve working conditions. In 1905, the Supreme Court struck down a New York statute prohibiting the employment of bakery employees for more than 60 hours per week (*Lochner v. New York*). The Court's opinion was based on the idea that voluntary exchanges ought not be restricted. In the Court's words, the New York statute was ''an illegal interference with the rights of individuals, both employers and employees, to make

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contracts regarding labor upon such terms as they may think best'' (cited in Sandel 1996, 41). On similar reasoning, the Court also struck down a law that set minimum wages for women and one that prohibited contracts allowing workers to be fired for joining a union.

Facing a threat by President Franklin D. Roosevelt to pack the Court, the Supreme Court reversed course in 1937. In a decision that year (*West Coast Hotel Co. v. Parrish*), it upheld a minimum wage law for women. Its justification this time was that it is proper for legislatures to address sweatshop conditions, and in particular to consider unequal bargaining powers between employer and employee. As the Court put it, women's ''bargaining power is relatively weak, and . . . they are the ready victims of those who would take advantage of their necessitous circumstances.'' Consequently, it was proper to redress this inequality through legislation and restrictions on the individual's right of contract. This watershed case opened the door for subsequent labor legislation that greatly expanded the scope of regulation in the workplace.

Hence US laws since the 1930s have recognized that restrictions on ''free contract'' are legitimate in the case of unequal bargaining power. But consider now a different source of asymmetric bargaining power, one created by trade and capital mobility and discussed in the previous chapter: employers can move abroad but employees cannot. One could argue that by generating an inequality in bargaining power globalization helps undermine 60 years of labor legislation and thus the social understanding those laws represent. After all, there is little substantive difference between domestic workers being able to compete against their fellow workers by agreeing to work 12-hour days, earn below-minimum wages, and agree to be fired if they join a union—all of which would be illegal under US law—and foreign workers doing the same. If society is unwilling to accept the former, why should it countenance the latter?[10]

There is no clear-cut or categorical answer to this question. There are different values and interests to trade off, including the gains and losses at stake and contending conceptions of ''fair'' competition. My point is simply that trade impinges on domestic society in ways that can conflict with long-standing social contracts to protect citizens from the relentlessness of the free market.

The New Trade Issues and Demands for ''Fair Trade''

''Restructuring nations—at least, certain aspects of nations,'' writes Ruggie (1995, 510) ''is what trade disputes increasingly have come to be

10. Note that appealing to national sovereignty and the general unacceptability under international law of attempts to impose domestic legislation on other countries does not get us out of this conundrum. In fact, it cuts the other way. National sovereignty implies

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about.'' That is indeed the common theme that runs through the gamut of the so-called new issues on the WTO's agenda. Whether it is labor standards, environmental policy, competition policy, or corruption, differences in domestic practices have become matters of international controversy. Conflicts arise both when these differences create trade—as in the cases of child labor or lax environmental policies—and when they allegedly reduce it—as with *keiretsu* practices in Japan. Gone are the days when trade policy negotiations were chiefly about interference with trade at the border—tariffs and nontariff barriers. The central trade issues of the future are ''deep integration,'' involving policies inside the borders, and how to manage it. As a *New York Times* editorial (approvingly) put it in connection with the Kodak-Fuji dispute on access to the photographic film market in Japan, ''The Kodak case asks the WTO, in effect, to pass judgment on the way Japan does business'' (11 July 1996, A22).

Economists have ridiculed the notions of ''fair trade'' and of ''leveling the playing field'' that lie behind many of these initiatives. But once it is recognized that trade has implications for domestic norms and social arrangements and that its legitimacy rests in part on its compatibility with these, such notions are not so outlandish; they address the concerns to which trade gives rise. Free trade among countries with very different domestic practices requires either a willingness to countenance the erosion of domestic structures or the acceptance of a certain degree of harmonization (convergence). In other words, some degree of international harmonization (convergence) may be necessary for the gains from trade to be reaped.

If this is the appropriate context in which demands for ''fair trade'' or ''leveling the playing'' field have to be understood, it should also be clear that policymakers often take too many liberties in justifying their actions along such lines. Most of what passes as ''unfair trade'' in US antidumping proceedings, for example, is no more than standard business practice (such as pricing over the product cycle or pricing down to average variable cost during market downturns), and no less in the United States than in other countries. Too often, the US government itself engages in the policies that it labels unfair when undertaken by others. The US government was outraged when the European Community banned the import of American beef produced with growth hormones in December 1988, apparently without scientific evidence that the beef hormones had adverse effects on humans. At the time it maintained a ban on imports of German ham on the grounds that it was unsafe for Americans (for this and similar examples, see Bovard 1991).

Hence, while there may not be a very sharp dividing line between what is fair and what is not in international trade, one clear sign that

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the ability of each country to sever its trade links with others if trade undermines its sovereign choices at home.

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unprincipled protectionism lies at the root of a trade complaint made on fairness grounds is the prevalence of identical or similar practices within the domestic economy of the plaintiff. Fairness cannot be kept out of the thinking on trade policy, but neither can it be used as an excuse for trade restrictions when the practice in question does not conflict with domestic norms *as revealed by actual practice*.

In addition, even when such conflicts are created, fairness considerations can at best justify only the use of trade restrictions at home (to ''protect'' our own values and institutions); they do *not* warrant any attempt to impose our norms or institutions on others. For instance, we might perhaps be justified in keeping Fuji out of the US market if Fuji's behavior grossly violates US norms and business ethics. However, we would not be justified in insisting that Japan change its practices so that Kodak can compete in Japan with Fuji on a level playing field.

Integration and Social Policy in Europe

Among advanced industrial countries, the integration of markets for goods and services is furthest along in Europe. The process of integration within the European Union provides an interesting case study of the tensions between trade and domestic social arrangements.

Discussions of harmonization have a long history in Europe, going back to the days before the creation of the European Economic Community (EEC).[11] The Treaty of Rome (1958) establishing the EEC has numerous clauses related to the harmonization of social policies in the name of assuring fair play and equalizing conditions of competition. Harmonization was called for in two specific areas: equal pay for men and women (Article 119) and paid holiday schemes (Article 120). France demanded the equal pay clause, as it already had legislation requiring equality of pay (while other countries did not). According to Sapir (1996), the French government feared that its textile industry (where a disproportionate number of workers are women) would be jeopardized in the absence of harmonization. In addition, a separate protocol stated that working hours and overtime rates were to converge with the levels prevailing in France in 1956 by the end of the first stage of the common market (31 December 1961). If the convergence were to fail to take place, France would be allowed to undertake protective measures.

In any event, these clauses appear to have had little practical effect. For example, the application of Article 119 on equal pay was repeatedly postponed, and it was not until 1975 that a directive in this area was adopted. As Sapir (1996) notes, the period 1958-73 has been called one of benign neglect as far as social policy is concerned. He ascribes this to the

11. This account of the history of EU harmonization is based on Sapir (1996).

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high degree of social and economic homogeneity among the six original members of the EEC and to the rapid amelioration of living standards during these years. These factors, he argues, were crucial in ''warding off pressures . . . in favor of harmonization'' in the early years (Sapir 1996, 544).

Since the mid-1970s, however, greater heterogeneity and slower growth have increased pressure for harmonization. After 1975 a flurry of directives were adopted on equal pay, labor law, and working conditions, but Sapir (1996) concludes that their scope remained limited. The movement gained force with the agreement on the Single European Act in December 1985 and especially with the adoption of the Social Charter by all member states except the United Kingdom in December 1989. As part of the Single European Act, two new articles on social policy were added to the Treaty of Rome, one on occupational health and safety standards and another on collective bargaining. And as a result of the Social Charter, the EC Commission developed a detailed action program containing close to 50 initiatives, many of which have been adopted. In the words of the Commission, the action program aims inter alia at ''reducing disparities between Member States without interfering in the comparative advantage of the less-developed regions'' (Commission of the European Communities 1993, 10). The fear of ''social dumping'' from new members, particularly Portugal and Spain, appears to have played a crucial role in these developments.[12] In 1993, the European Commission took the view that ''competition within the Community on the basis of unacceptably low social standards, rather than the productivity of enterprises, will undermine the economic objectives of the Union'' (Commission of the European Communities 1993, 59-60).

The United Kingdom, under Conservative governments, has been the main opponent of these moves toward social harmonization. Prime Minister John Major expressed the difference in values that the British government brought to the Community:

> Europe can have the social charter. We shall have employment. . . . Let Jacques Delors accuse us of creating a paradise for foreign investors; I am happy to plead guilty (cited in Leibfried and Pierson 1995, 49).

The United Kingdom argued instead for a decentralized system of rule making and ''competition among rules'' to allow for the emergence of national standards more conducive to superior economic and social out-

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12. An Interdepartmental Working Party appointed by the European Commission defined social dumping in 1988 as ''the fear that national social progress will be blocked or, worse, that there will be downward pressure on social conditions (wages, level of social protection, fringe benefits, etc.) in the most advanced countries, simply because of th[e] competition . . . [from] certain [EEC] countries, where average labour costs are significantly lower'' (cited in Sapir 1996, 559).

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comes. Even though these two conceptions of social policy for an integrated Europe obviously differ a great deal, they share a common feature that is particularly relevant here. The system of "competition among rules," just like harmonization, implies eventual convergence—in this case through the competitive process of "good" rules driving out the "bad."

Sapir concludes that "the Social Charter and the implementing action programme do not appear to have added much in the way of 'social harmonization'—except in the area of occupational health and safety" (1996, 561). That the social dimension of European integration has led to only modest results to date is a widely shared conclusion. But as emphasized by Leibfried and Pierson (1995), that is not to say that integration has not had a significant impact on social policies in member states. While agreements among member states or actions by the Commission may have played a limited role, the interpretation of market compatibility requirements by the European Court of Justice (ECJ) has led to an unmistakable erosion of national sovereignty in the social field. The ECJ has delivered decisions on more than 300 cases on social policy coordination, and such cases account for a growing proportion of a caseload that has increased from 34 in 1968 to 553 in 1992 (Leibfried and Pierson 1995, 51). The thrust of these decisions has been to require that national social policies not restrict the free movement of goods, services, and individuals. In the words of Leibfried and Pierson (1995, 51): "The EU's social dimension is usually discussed as a corrective to market building, but it has proceeded instead as part of the market-building process."

For example, the ECJ has ruled that labor mobility requires identical social welfare benefits to be made available to all EU nationals employed in a member country; member states can no longer target welfare benefits at their citizens only. Similarly, a national government is no longer the sole authority on whether claims for benefits are to be accepted or not; decisions on eligibility made by administrative bodies in other member states may have to be complied with. The use of tax policy to revive economic activity in depressed regions, such as the Italian government's efforts to attract investment to the Mezzogiorno, has also become circumscribed on the grounds that this constitutes "unfair competition."[13] Harmonization may be too ambitious a term to describe this largely Court-based activity. Liebfried and Pierson (1995, 65) prefer to call it "an incremental, rights-based homogenization of social policy."

This brief account of the European Union points to a number of conclusions. First, it is considerably easier to integrate economically when there are shared norms among countries regarding domestic institutions such as labor relations or social welfare systems. Second, as integration deepens,

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13. For these and other examples, with extensive discussion, see Leibfried and Pierson (1995, 50-65).

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it becomes more difficult for countries to adopt or maintain social recipes that differ from those of their trade partners. Third, even within Europe, where there is substantial convergence in income levels and social practices—at least compared with the rest of the world—it has proved difficult to strike the right balance between expanding economic integration and providing governments with room for maneuver on the social front.

Maastricht, the French Strikes, and the Social Dimension

The widespread fear in Europe that economic integration will undermine prevailing social protection schemes is exemplified by the debates surrounding the Maastricht criteria and their implementation. Characteristically, the European governments (with the exception again of the United Kingdom) annexed a Protocol on Social Policy to the main text of the Maastricht treaty to underscore their intention to proceed on a social as well as economic path. The main contribution of the protocol is that it now allows the European Union to adopt initiatives in the social field by qualified majority voting instead of unanimity as before. Nonetheless, the Maastricht requirements on fiscal policy have called into question long-standing social policies in the member states. Consequently, Maastricht has had rough sailing, particularly in those countries in which it was subjected to a referendum. In June 1992 the Danes voted to reject the treaty, and in September of the same year the French came very close to doing so.[14] In Denmark, ''[a]ccording to exit polls, the single most important reason for the negative vote . . . was the fear that the Danish social security system would be negatively affected by its integration with the other social security systems. . .'' (Perotti 1996, 1).[15]

Opposition to Maastricht reached its highest point in the French strikes during the fall and winter of 1995. An account of these strikes makes a good cautionary tale about the social instability and disruption that is perhaps in store for other countries if the issues raised here are not addressed. The widespread popular support of these strikes in France, going beyond those whose interests were immediately at stake, is indicative of the deep nerve that the conflict between international integration and domestic institutions has struck.

The task of fulfilling the Maastricht treaty's fiscal criterion had fallen to President Jacques Chirac, inaugurated in May 1995, and his prime

14. In Ireland, the treaty was approved by a comfortable majority. A second referendum was held in Denmark in May 1993 after the Danish government obtained several concessions in the application of the treaty to Denmark, and the second vote resulted in ratification.

15. A similar concern was voiced by many Canadians in relation to the free trade agreement with the United States.

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minister, Alain Juppé.[16] In 1995, France's public-sector deficit stood at nearly 5 percent of GDP, substantially larger than the 3 percent mark set by the treaty. Because countries were to qualify in 1998 based on 1997 figures, a reduction of the deficit by over one-third in only two years was required.

A serious attack on the deficit meant cuts in the country's social security system, which marked its 50th anniversary in October 1995 and represents half of all public-sector spending. Over the last 50 years, France has created an elaborate system of social protections, which have taken on the status of *acquis sociaux*, or acquired social rights. The unions and the French people generally have aggressively defended this system over the years, and it is not difficult to understand why. France's public health service, one of the most costly in the world, combines free care with freedom of choice: patients can visit virtually any doctor or specialist as often as they like and be reimbursed by the public health fund. All citizens are guaranteed free education through university. Employers are required to provide five weeks of vacation, and workers in high-stress jobs, such as medicine, receive nine weeks. All mothers, regardless of income or marital status, receive subsidies for each child. Larger, poorer families can receive paid holidays, including transportation to a resort, subsidized apartments, and dishwashers and washing machines (*New York Times*, 20 December 1995, A14). In addition, a major source of the social security deficit is the generous pension provisions granted government employees. Unlike private-sector workers, who must work 40 years to be eligible for a pension, civil servants can retire with a pension after 37½ years, and railroad workers can retire with a pension at age 50. Furthermore, pensions are calculated based on employees' earnings in their final six months, allowing many workers to artificially inflate their pensions by working overtime during that period.

Prime Minister Juppé first outlined the government's proposed measures to confront the deficit in a series of meetings with labor leaders in late August and early September 1995. The proposed budget was to impose a new 0.5 percent income tax to pay for the accumulated health and pension deficits, increase health care contributions for the retired and unemployed, shift control of the health care system from the unions to the Parliament, and require public employees to work for 40 years to be eligible for a pension.

The first sign of broad-based unrest was a one-day protest strike on 10 October in opposition to government plans to freeze civil service salaries in 1996. Fifty-seven percent of civil servants stayed away from work in a strike that involved 5 million workers and spread to state-sector industries including transportation, electricity, the postal service, and telecommuni-

16. The rest of this section relies heavily on an account prepared by Matthew Maguire.

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cations. The strike, which effectively shut down the country for 24 hours, was the largest since 1981.

Despite the opposition, Juppé announced his package of spending cuts and tax increases to a session of the National Assembly, France's lower house, on 14 November. The vote, which he called one of confidence in his government, was 463 to 87 in favor of the program. The unions moved quickly to organize large-scale opposition, and on 24 November, the railway workers' unions launched a nationwide strike. On 29 November, they were joined by utility workers, who feared the breakup of the state electric power monopoly (*New York Times*, 30 November 1994, A15).

Support for the protesters among the general public was significant, even though less than 10 percent of French private-sector employees are unionized. A poll published in *Le Parisien* on 2 December showed 62 percent of respondents backing the strikers (*New York Times*, 3 December 1995, 20)—this despite the fact that the strike was essentially shutting down whole sectors of the economy. Parisian workers found their commutes taking up to four hours each way as traffic slowed to a standstill, and bicycles became the new status symbol.

The government initially stood firm. But the strike, initially to have been a short-term measure, continued and broadened. On 2 December, French union leaders called for a strike of all salaried workers, and air transport workers, telephone company employees, and truck drivers joined the walkout. As the strike entered its second week, the franc weakened due to investor fears of a government cave-in. The government declared its willingness to enter discussions with the unions but vowed to press forward with its welfare reform plans. By 7 December, over a third of all public employees were on strike, Juppé was burned in effigy in Bordeaux, where he is mayor, and a poll showed that 53 percent of respondents believed Juppé was wrong not to withdraw the austerity program (*New York Times*, 8 December 1995, A14).

The government, showing a new flexibility, named a mediator and offered discussions with the public employee unions. On 11 December, the government was forced to concede to the railway union on the pension issue, a concession that was extended to all public employees on 12 December. By 15 December, most of the unions had voted to return to work. However, the unions continued to insist on retraction of the new tax and health care cost-control proposals and planned continued demonstrations. On 21 December, Juppé promised "dialogue, consultation, and negotiation" at a "social summit" with labor and business leaders. He agreed to cut payroll taxes as a job creation measure and to impose a moratorium on tax increases, but only after a new system of paying for the health insurance and pension systems was agreed to in 1996. He refused to put off an increase set for 1 January (*New York Times*, 22 December 1995, A7). In January, Juppé secured validation from the Consti-

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tutional Council of a law allowing him to enact his social security reforms by decree.

The cost of the strikes to the French economy was tremendous. On 19 December the government estimated it at between 0.4 and 0.5 percent of quarterly GDP. But the strikes expressed a clear desire on the part of a sizable portion of the country not to sacrifice social protections to trade. ''The French do not want to live like Anglo-Saxons,'' according to Marc Blondel, head of the Workers Force union, which was a primary mover behind the strikes (*San Francisco Chronicle*, 21 December 1995, B2). Or as one citizen stated, ''I think most French people want France's values to be decided by this spirit, not by cold, remote, economic summits that speak of deficits and competition. That was the message of the strikes'' (*New York Times*, 20 December 1995, A14).

Do Differences in National Institutions Have Effects on Trade?

Before the ink was dry on the Maastricht treaty, an event occurred that seemed to verify fears that economic integration would come at the cost of social regress. Hoover Europe, the subsidiary of the American company, announced in January 1993 that it was closing its plant in Burgundy, France, and relocating to Scotland. The company's decision was apparently motivated by the fact that unions in Scotland were ready to accept terms that were decidedly more flexible than those in France. As Sapir (1996, 563) puts it,

> The Hoover affair rapidly became the symbol of the debate on the danger of ''social dumping'' inside the integrated European market. It was probably the first instance of enterprise relocation inside the Community that attracted massive media and political attention. It was the perfect case, pitting France, the champion of ''social harmonization'' and the Social Charter, against the United Kingdom, the champion of ''competition among rules'' and opponent of the Social Charter.

Decisions of this type—where to produce, who to buy from—are made daily by managers of global corporations. Any labor advocate in the United States can provide a long list of cases in which firms previously based in the United States have moved south of the border, allegedly to take advantage of a less costly labor force of near-equal productivity. In comparison with most of Western Europe, of course, the United States is hardly a workers' haven, which sometimes makes for a reverse flow. BMW's decision to produce in South Carolina, for example, was motivated in part by the significant savings in labor costs.

Anecdotes of this kind are plentiful, but systematic evidence is harder to get. The difficulty with the anecdotes is that they don't tell us whether the chief responsibility for trade and investment flows lies with their

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underlying economic and structural determinants—relative factor endowments, productivities, consumer preferences, market size—or with differences in social arrangements, which can sometimes be controversial and construed as unfair. There is a difference between a US firm paying 50 cents an hour for a worker abroad who is one-tenth as productive as a US worker and paying the same for a worker who is equally productive.

So do differences in social institutions really make much difference in practice for trade? The theoretical case that they should is impeccable. After all, if cross-country differences in, for example, labor standards or environmental regulations can be treated ''just like'' any other determinant of comparative advantage—and this is the conventional economic approach to these matters—these differences must have implications for trade flows. The real question therefore is not ''do they?'' but ''how much?'' and ''for what sorts of products and services?''

While social policies generate much heat, there is remarkably little quantitative evidence on their trade implications. In a recent paper, Alesina and Perotti (1995) undertook one of the few rigorous analyses in the context of the countries of the Organization for Economic Cooperation and Development (OECD). They hypothesize that more generous social welfare systems will be associated with lower competitiveness, defined as the inverse of unit labor costs relative to other countries. This is because pension or unemployment benefits have to be financed, in part, by payroll taxes. Workers can pass on some of the costs to employers (more when unionized), which in turn results in a loss in ''competitiveness,'' reduction in exports, and an increase in unemployment. Alesina and Perotti's empirical results confirm the story. They find that ''when taxes on labor increase by 1% of GDP from their sample average of about 24%, unit labor costs in countries with an intermediate degree of centralization [in labor-market institutions] increase by up to 2.5% relative to competitors'' (Alesina and Perotti 1995, 4-5).

In the area of labor standards, the relationship between standards and trade has been examined in Rodrik (forthcoming). Using a wide range of labor-standard indicators, such as ratification of ILO Conventions and US Department of Labor reports on child labor problems, I focused the empirical analysis on three questions: Do labor standards affect labor costs? Do labor standards affect comparative advantage, and thereby trade flows? Do labor standards affect foreign direct investment? There was evidence in the affirmative on all three counts, although not always in the direction expected.

With regard to labor costs, in a cross-section of countries lax labor standards were associated with lower costs (expressed in dollar terms), after controlling for productivity. Moreover, the estimated effects were large, implying that the economic magnitude of the effects is significant as well. For example, an increase of one step in my measure of child labor

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(for example, moving from no child labor legislation to having such legislation) is associated with an increase in annual labor costs of $4,849 to $8,710. This is very large, perhaps implausibly so. However, child labor practices are likely to be indicative of a much wider range of shortcomings in labor standards. Consequently, the parameter estimates are probably an indication of the aggregate effect of all of these.

Turning next to trade flows, I found in a sample of developing countries that a measure of comparative advantage in labor-intensive goods—the ratio of textile and clothing exports to other exports, excluding fuels—was associated with indicators of labor standards in the expected manner: the more relaxed the standard, the larger the revealed comparative advantage in labor-intensive goods. Finally, investment by majority-owned US affiliates in manufacturing was also associated with indicators of labor standards, but not in the direction that is commonly claimed: countries with poor labor standards received less foreign investment than would have been predicted on the basis of their other characteristics. Taking these two results together leads to the hypothesis that poor labor standards result in outsourcing and subcontracting, but not majority-owned foreign investments.

Environmental policy is one area in which there has been substantial empirical research focused on the consequences of regulations on manufacturing ''competitiveness'' and trade. Pollution abatement costs in the advanced industrial countries are currently nonnegligible, and in the range of 1 to 2 percent of GDP for countries such as the United States, Germany, France, and the United Kingdom. Moreover, these costs vary greatly across manufacturing industries, from 25 percent of total capital expenditures in petroleum and coal products in the United States to less than 1 percent in printing and publishing (Jaffee et al. 1995, table 6). Jaffee et al. also survey the empirical evidence and report some evidence that pollution-intensive production has migrated to developing countries, but they find few studies that have concluded environmental regulations to be a significant determinant of competitiveness or comparative advantage. The evidence on plant location within the United States suggests that even relatively large differences in regulations have mild effects on siting. Hence, they conclude that ''there is relatively little evidence to support the hypothesis that environmental regulations have had a large adverse effect on competitiveness, however that elusive term is defined'' (Jaffee et al. 1995, 157). They attribute this finding to difficulties in measuring the impact of environmental regulations, to the fact that, in all but a few industries, complying with such regulations still constitutes a small share of total costs, and to similarities in practices among industrial countries.

In the area of industrial policies, Japan has received the most scrutiny. It is distinctive among the advanced countries in that it engages in low amounts of intra-industry trade and its imports of manufactured goods

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are a relatively small fraction of GDP (Bergsten and Noland 1993). There has been much controversy over whether differences in Japan's industrial structures and industrial-policy traditions have been responsible for these distinctive traits of Japanese trade—see, for example, the exchange between Lawrence (1993) and Saxonhouse (1993). Econometric studies on the relationship between trade flows and factor endowments have yielded ambiguous results and in any case do not speak to the question of why, if at all, Japan is different.

Lawrence's (1991) study on the *keiretsu* is one of the rare econometric studies analyzing the consequences of Japanese industrial structures. The term *keiretsu* refers to a network of affiliated firms, either within a single industry or across a range of industries. Outsiders often see these networks as a deterrent to imports and as an unfair trade practice. Lawrence attempts to distinguish empirically between two contending views of *keiretsu*. One view is that they are simply an efficiency-enhancing arrangement, with no discriminatory effect on imports. He reasons that, under this hypothesis, *keiretsu*-dominated sectors should have both lower imports and higher exports. The second view is that *keiretsu* do act as import barriers, in which case their presence should be associated with reduced imports but not necessarily higher exports. His findings suggest that the *keiretsu* indeed reduce imports, and that higher exports are (weakly) associated only with ''vertical'' *keiretsu*. Moreover, the estimated effects are large. High shares of *keiretsu* sales in an industry are associated with reductions in the import share of consumption by half. A more recent study by Noland (forthcoming) reports broadly similar findings.

Finally, a recent paper by Hines (1995) is noteworthy in that it has documented how national differences in tolerance toward corrupt trade practices can have implications for investment flows. In the wake of the Watergate scandal, the United States passed the Foreign Corrupt Practices Act (FCPA) of 1977, which makes it illegal for US businesses to pay bribes to foreign government officials. Until recently, other developed countries did not have similar legislation, even allowing in some cases tax deductibility of illicit payments.[17] The question Hines posed was whether this difference handicapped American businesses in countries where corruption is rampant. The answer he reached was a definite yes. Hines found that US investment activity in countries in which government officials routinely accept bribes showed ''unusual'' declines after 1977. The same was true for US aircraft exports and joint-venture activities as well. Hence US businesses lost ground in the more corrupt countries to firms from other developed countries not handicapped by similar domestic legislation.

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17. In 1996, an OECD agreement recommended putting an end to this discrepancy.

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Recapitulation

Differences in national choices of social arrangements have implications for trade and investment flows. These flows in turn impinge on domestic social arrangements elsewhere. I have argued here that trade is controversial on both accounts.

The most favorable argument on behalf of free trade is that it acts just like technological progress, expanding the economic pie, albeit at some distributional cost occasionally. Since governments routinely interfere in deciding what kind of technologies are permissible domestically, so as to take into account social costs or national norms, it is difficult to make a hard-line case as to why international trade should be categorically exempt from this same kind of approach. Trade restrictions will not generally be the most appropriate or efficient way to deal with the consequences of eroding domestic norms and institutions. But neither should we treat trade liberalization as an end in itself, without regard to how it affects broadly shared values at home.

Indeed, there are areas such as slave labor and prison labor where a certain degree of international convergence in norms has resulted in multilateral trade rules being written to reflect them. The much tougher cases are those in which no such convergence has taken place. The challenge for the international trading system will be to accommodate national preferences in this area without a free-for-all that could degenerate into blanket protectionism. A starting point is to recognize that nations do have legitimate reasons for worrying about what globalization does to their norms and social arrangements.[18] The final chapter will discuss some guiding principles on how to proceed from there.

18. Interestingly, this point is related to one of the arguments Keynes made in his advocacy of self-sufficiency in trade in a famous article in 1933. After discussing how different countries were each striving for what he called ''new modes of political economy,'' he wrote: ''We do not wish . . . to be at the mercy of world forces working out, or trying to work out, some uniform equilibrium according to the ideal principles . . . of *laissez-faire* capitalism. . . . [T]he policy of an increased national self-sufficiency is to be considered not as an ideal in itself but as directed to the creation of an environment in which other ideals can be safely and conveniently pursued'' (Keynes 1982 [1933], 239-41).

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