The Journal of International Trade and Diplomacy 2 (1), Spring 2008: 47-92

THE LIMITS TO THE HARMONIZATION OF DOMESTIC REGULATIONS

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"People were always asking for good sound proofs; doubt springs eternal in the human heart, even in countries where the Inquisition read [sic] your thought in your eyes."

Thornton Wilder: The Bridge of San Luis Rey (1923)[**]

I. INTRODUCTION

The debate about harmonization of standards across countries has been going on for decades. Initially, the debate was primarily confined to domestic audiences or at best to the audiences of the European Community (EC) where the debate about harmonized standards has become most pressing. The success with which the EC was initially in the position to coordinate the regulatory policies in different areas provided a basis for optimism even outside the Community. There is no doubt that "regulations" are becoming a "hot" subject also among academic experts in the field of international trade as well as among policy makers in international trade negotiations. The optimism which can be observed within the EC can now also be seen in the international trade community.

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[*] The views expressed in this paper are personal and do not necessarily reflect those of the WTO Members or its Secretariat. I am grateful to Peter Holmes of Sussex University, Ron Ridker of the World Bank and Jan Joost Teunissen, Director of FONDAD for their comments and numerous discussions of the subject. I have further benefited from very useful and stimulating discussions of the subject with professors Richard Cooper of Harvard, Saul Estrin of London Business School, Don Regan of University of Michigan, Petros Mavroidis of Neuchatel and Columbia Universities and Colin Kirkpatrick of University of Manchester and with my colleagues Juan Marchetti and John Hancock. None of these gentlemen should, of course, be linked to any to shortcoming of this paper.

[**] The quote seems to contain a minor grammatically mistake which I have reluctantly retained. It is difficult to argue relevant Oxford Dictionary.

The sudden interest in "regulations" lies in the perception of a growing importance of regulations in economic activities and in the growing role of regulators. These developments have basically four origins. The first reason is that the importance of border measures as impediments to international trade has dramatically declined over the years. New instruments of protection — the so-called non-tariff barriers (NTBs) — are often used by governments as the new impediments to trade. Standards have been increasingly singled out as an important instrument among NTBs.

The second reason for the growing role of regulations is the increased sophistication of consumers and the increased complexity of technological processes. For example, consumers may no longer be only interested in vegetables to enrich their diet but in vegetables grown organically. While they may be in love with their cars, they may not wish to drive cars that are polluting or dependent on imported fuels. Consumers may demand services supplied in hygienic conditions, diamonds from countries forbidding child labor and the use of land mines, etc. In these instances, consumer goods are increasingly allocated not only in the market place through incentive effects of prices but through regulations. *Pari passu,* changes in technological processes are also increasing pressures for more regulations. For example, in several countries buildings must not be built with asbestos; shrimp must not be caught with nets which do not allow trapped turtles (which are on the endangered species list) to escape.

The third reason is the process of deepening integration in some parts of the world. As countries enhance their regional cooperation and expand the policy areas in which they cooperate, they may seek increased cooperation in the area of competition rules, safety and health standards, prudential regulations affecting banks, and so on. The European Union (EU) is the best example in the post-war period in which this deepening of integration has advanced furthest.

Finally, certain economic activities cannot be controlled by government policies relying on market-based instruments. The best examples are in services. For example, competition in the banking sector cannot be stimulated by taxation policies alone. It requires, *inter alia,* rules regulating entry into the sector. Access to educational or health markets cannot be affected by government external tariff policy but by government educational and health standards such as the governments' policies for public services. It is clear, therefore, that negotiations of concessions in trade in services in the World Trade Organization (WTO) will have to increasingly tackle the problem of regulations.

Clearly, there are very good reasons why standards exists, and there may also be good reasons why certain standards should be harmonized. These cases have been discussed in the literature at length and they have been reviewed elsewhere.[1] However, those who argue in favor of harmonization of standards greatly overstate their case and, in my judgment, oversimplify the complexity of the matter. This has become abundantly clear in multilateral trade negotiations in which countries strongly disagree even about the agenda for negotiations. Take the recent controversies in the WTO about the so-called Singapore issues and their introduction into the agenda of the Doha Development Round. When the issues were proposed for the agenda, the proposal was met with hostile criticism from a variety of WTO Members. The Member States

[1] See, for example, Leebron (1996) and also WTO 2005, chapter 2. Section IIB of World Trade Report 2005 of the WTO represents an attempt to provide an economic analysis of standards by making a case for standards and their harmonization in economic activities. The argument is that standards may increase economic efficiency by enhancing compatibility of products and providing information to consumers, firms and governments. They may give scope for economies of scale and network externalities. They may also serve important public policy goals in solving problems associated with asymmetries of information and negative externalities. Section IIC of the report is concentrated on the linkages between standards and international trade with the view of ascertaining the likely impact of standards on trade. The report tries to identify the conditions under which standards are likely to enhance or to impede trade and examines the role of harmonization, equivalence and mutual recognition of standards as instruments of enhancing international trade.

argued, *inter alia,* that the adoption of the Singapore issues would jeopardize their national sovereignty. As a result, three of the issues — competition, foreign investment and public procurement — were dropped from the agenda. Similarly, the negotiations on services in the WTO — General Agreement on Trade in Services (GATS) — provoked sharp reactions of some Member States fearing that the negotiations would involve changes to their system of regulations governing the standards for their educational and health services. It took a great deal of persuasion on the part of the then Acting Director General to assure the skeptics that countries will retain their right to regulate their health and education sectors.[2]

Economists have debated these issues for some time but the questions of whether to regulate or not and, if so, whether to harmonize regulations between countries or not remain highly controversial. How controversial and intellectually difficult the topic is can be seen from the extremely interesting and intellectually stimulating project of Jagdish Bhagwati and Robert Hudec (1996) who assembled a group of highly influential, outstanding economists, lawyers and political scientists to probe the issue from a variety of perspectives. What the project showed is that the debate about regulations in general and harmonization of rules internationally in particular is a difficult subject to handle and that the subject remains in a theoretical vacuum.

For economists and policy makers with interest in trade policy, the debate about harmonization of regulations has been "internationalized" for a very specific reason. With the declining importance of tariffs as trade barriers and the increasing relative importance of NTBs, the role of regulations have also become a subject of debate regarding the competitiveness of countries and the extent to which they are affected

[2] The relevant provisions of the controversy were in Article VI of GATS which explicitly deals with domestic regulations. As we shall see below, the article does not provide unambiguous guidance to Member States, and, when agreed, it was seen as provisional to be subject to further refinements in future negotiations. The issue is discussed in some more detail in Section 5 below.

by regulations. Since standards may differ between countries, the costs of compliance with regulations will also be different. This has led to calls for harmonization of standards through mutual recognition or negotiation of common standards. The matter of diversified standards has already been raised in the WTO in order to settle commercial disputes among WTO members such as in the case of EC — hormone dispute or the GMO dispute between the United States (US) and the EC.

Why is there so much controversy about something that has not even been on the negotiating table? The answer lies, I believe, to a large extent in the difference between economists' perception of regulations and those who look at regulations more broadly as an instrument of social policy and, therefore, a matter of far greater social importance. Most trade economists are usually asking questions such as: What is the economic rationale for standards? In particular, what are the effects of standards on international trade? Do they enhance or retard trade? Do they promote "better" trade, i.e. efficiencies? Do standards help the process of diversification of products or do they lead to the opposite? What is the role of standards in relation to other instruments? What other instruments can be used to address the problem at hand? Are standards and other instruments substitutable? Are standards more or less effective than alternative instruments, if they exist?

These are clearly important questions. However, the fact that there is a great deal of resistance to harmonization in reality seems to suggest that the perceived advantages of harmonization, whatever they may be, are not widely accepted. This could be for a variety of reasons. The complexities of standards and their regulations are far more serious than those arising, say, from a straightforward political resistance. Instead, the problem could also lie in the fact that the treatment of regulations and standards may not be on strong theoretical foundations. As I shall argue in this short paper the current debate about harmonization of rules has marginalized important conceptual and theoretical issues surrounding the debate which is in my judgment a key reason for the

continued controversy. The latter leads to a paradox; as it is possible to argue the merit of harmonization of rules, so it is equally possible to argue in favor of rule diversity. As we shall see, there are strong arguments against harmonization and in favor of diversity, and these must be weighted against each other in the debate about the choices open to governments.[3]

The controversies are not entirely helped by the existing WTO agreements which by their nature may or may not seek a harmonization of regulations. The most obvious case is GATS. As already noted above, services are not by their very nature always amenable to market instruments, and they are typically controlled by governments through their regulatory activities. However, while seeking a common ground among Member States on market access and national treatment, GATS has also allowed for a great deal of flexibility for governments to pursue their policy goals. This was achieved by retaining a (high) degree of "voluntarism" in the modalities of negotiations and by only addressing the question of regulations in general terms. The opening of sectors to competition was restricted to those sectors that were "offered" by governments on the "positive" list, allowing Member States to keep other sectors outside liberalization commitments. Regulations are covered in Article VI (Domestic regulations) but the article only controls regulations in sectors in which commitments were undertaken. Moreover, each Member State should only ensure that all measures of general applications are administered "in a reasonable, objective, and impartial manner."

It is the purpose of this paper to put more light on these controversies — why they exist, what their origins are and why we are facing so many difficulties in reconciling opposing views on the subject of harmonization. The aim is to discuss harmonization of regulations across borders rather within countries. When we shall speak of harmonization of regulations, we shall be referring to cross-border,

[3] The reader may also find it useful to consult the review of Leebron (1996), pp. 41-117.

intra-industry standards to make it clear that that the purpose is to discuss corresponding standards in comparable (same) economic sectors in different countries. There is very little in this paper that is original since it heavily draws on a vast literature that can be brought to this debate. The modest[4] objective of the paper is only to raise some issues that I find extremely important and, of course, relevant to the debate.

The paper is divided into four sections. In the following Section, I shall narrow down the subject matter by identifying and delineating those areas which are a part of the broader debate about harmonization but which will not be covered in the paper. Section 3 attempts to identify several theoretical and conceptual problems which arise in the analysis of harmonization of standards and rules. After a brief review of the reasons for standards, I shall discuss conditions for countries to compete in the general framework of the theory of comparative advantage. I shall then turn to problems of ethics and justice which are raised in the treatment of harmonization of rules. The section is concluded with a brief discussion of the difficulties in measuring the costs and benefits of harmonization. Section 4 will provide a review of important arguments against harmonization of standards. The discussion is not intended to be a review of the relevant issues debated, which is the reason why only selected arguments are presented. These arguments are both theoretical as well as those derived from empirical evidence. The difficulties in addressing the harmonization of regulations are evident from the negotiations of services (GATS) in the WTO, and these difficulties are discussed in Section 5. A few concluding remarks are made in Section 6.

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[4] Kirkpatrick and Parker (2005) provide a more detailed criticism of Article VI of GATS. They point out that there is "an ambiguity as to the range of services covered by GATS, in particular the boundary between 'services provided in the exercise of government authority', which are excluded from the Agreement, and other services that are provided on a 'commercial basis' or 'in competition with one or more services suppliers'." Moreover, they argue, "GATS Article VI also creates problems of interpretation when Members must ensure the 'reasonableness, objectivity, and impartiality' of regulatory administration." See Section 2 or pp. 7-8 of the final draft.

II. CAVEATS

The following discussion is based on the existing literature with the aim of putting the literature in context without the intention of providing new ideas on the subject. I shall be asking in this paper two rather broad questions: (1) The pursuit of harmonization of standards has been considerably influenced by specific economic arguments; does this mean that the case for harmonization has strong foundations in economic theory? (2) We know that there are reasons for standards to be harmonized among countries but is there a case to be made for diversity of standards?

The approach adopted in this study is almost entirely focused on these two issues. I shall first address the issue whether the case for harmonization of rules and standards has solid theoretical foundations. The discussion will be limited to the theory of comparative advantage and to ethics as an aspect of normative economic theory. This will be followed by a discussion of the various arguments in favor of the diversity of standards. However, the case for harmonization is not straightforward.

The scope of this paper is extremely limited. This means that a number of issues related to standards are not covered. In this respect, the paper has the same limitations as many existing studies. In particular, the paper does not include any discussion of the effects of standards. Given the various functions of standards and the needs they meet, it would be extremely interesting to know under what conditions are standards likely to be trade-creating rather than trade-diverting. Economic studies typically trace the origins of pressures for harmonization of rules in business activities or other activities involving economic judgments. As noted above, studies often identify four origins of standards: network externalities, information asymmetries, environmental externalities and standards originating in labor markets, which all have economic origins. As we shall see further below, this characterization is vastly over-simplified.

Furthermore, standards can be designed by different bodies and in different ways — by governments or through private initiatives, or through market arrangements whereby a dominant standard becomes a norm for the industry in question. This fact raises other interesting questions. For example, how does one decide whether it matters who designs a standard? Perhaps more importantly, how does one discriminate among different designs? How can we assess the effectiveness of different designs? Do particular shortcomings of a given standard allow an unambiguous selection and a choice? Should designs be mandatory or voluntary? While all these questions are undoubtedly important for policy makers as well as for firms and households, for reasons of space they are not discussed in this paper.

I shall also avoid any discussion of the meaning of standards. Standards can refer to different activities within a very broad range. A debate about standards should ideally start from the definition of standards but this is not attempted in this study for technical reasons. The debate about definitions would expand the paper well beyond acceptable limits. This means, however, that the paper excludes a discussion of those issues that make standards *sui generis* for particular economic activities.[5] One of such "casualties" is the debate about international cooperation in macroeconomic polices to stabilize different segments of the world economy. The unwillingness to do so may be at least partly related to different perceptions of "financial stability," which is also a serious omission.

One approach to solving the question of diverse standards could be regulatory competition. It is quite easy to argue — as many have done — that rather than enforcing or negotiating harmonized standards, countries should compete with their own standards and test "the value" of their standards in markets. Standards of those countries that would

5 Take an example of attempts to coordinate macroeconomic policies of different countries to achieve and/or maintain financial stability. These attempts often fail for a number of reasons, one of which is a different perception and definition of "financial stability" in different countries.

turn out most "successful" in markets would prevail. It is clear that this approach is fundamentally different from "negotiated" solutions, and its merits and shortcomings are also not discussed in this paper.

Arguably the most serious omission in the paper is absence of any treatment of "market failure." Various economists have justified the need for regulations on the grounds of market failure. For example, employment of child labor may not be socially acceptable even though firms and households may be engaged in this practice. In this case, the price of child labor fails to account for the opportunity costs of keeping children away from school and/or the deterioration of their health. These externalities are not reflected in the market value (wages) of children. Similarly, firms may disregard environmental damages arising from their business or production activities. These externalities become costs to the society, and the society may, therefore, regulate production activities to avoid such externalities. In brief, the fact that the employment of child labor or activities of firms may lead to externalities that are not properly accounted for by markets is seen by economists as evidence of a market failure.[6]

The argument about market failure goes to the core of economics as a social science and its treatment would be clearly beyond the scope of this paper. Imperfect markets distort incentives and have, therefore, allocative and distributional consequences. A (government) intervention in the form of measures such as regulations that would correct for these imperfections is, therefore, desirable. However, whether this would call for harmonized rules is far from obvious.[7]

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[6] There are other example of market failure. Some of these examples are reviewed in WTO 2005, Chapter 2.

[7] A case of domestic distortions is discussed at length in a formal theoretical model by Bhagwati and Srinivassan (1996) to which we shall return below.

III. THEORETICAL AND CONCEPTUAL PROBLEMS (ILLUSTRATIONS)

"Doubt is not below knowledge, but above it."

Alain, Libres-Propos

"Light boats sail swift, though greater hulks draw deep."

Shakespeare, Troilus and Cressida

The Reasons for Rules and Standards

Rules and standards controlling market behavior within a country exist for a variety of reasons. As is well known[8], standards can play a positive role, for example, in enhancing interface linkages, providing conditions for scale economies, etc. These are typical examples of arguments in favor of harmonization of standards on the grounds of economic efficiency. Following the above example, harmonized standards can increase the size of markets and allow firms to reap benefits from economies of scale. But market standards and rules may be also adopted on other grounds. For example, the so-called "affirmative action employer" in the US allows greater opportunities in the employment (or admission) of "underrepresented" minorities and has, therefore, important distributional effects in labor markets. The consumption of genetically-modified foods or the use of asbestos in construction may be prohibited by government regulations, thereby affecting consumer choices and production processes/technology, respectively.

The situation becomes more complex if we consider rules in different countries and the question whether the rules should be harmonized. In general, the origins of pressures for international harmonization are diverse and multiple — the pressures have (1) philosophical, (2) political, (3) economic or (4) structural origin. Bhagwati (1996) elaborates on each one of these origins in greater detail and makes it very clear that the calls for harmonization go much beyond economics. We may be

[8] For a review see, for example, WTO (2005).

concerned about the environment and labor standards and believe that we have the obligation to enforce them beyond our own borders. We are concerned about the poor and may call for a harmonization of standards on the grounds of distributive justice (e.g. by the introduction of minimum wages). Another philosophical origin of calls for harmonization comes from concerns about "fairness." The political argument for harmonization stems from a variety of protection-seeking lobbies which may be concerned about "lower" standards elsewhere and they will push for harmonization at a "higher" level. The pressures may also come from those who are concerned about "the race to the bottom," a concern that unregulated trade will gravitate towards the lowest standards.

There are also several structural arguments for harmonization. They include concerns about distortions in foreign exchange markets and concerns about changes in relative market power leading to changes in the willingness to unilaterally liberalize (to calls for reciprocity). Finally, economic arguments in favor of harmonization include arguments based on economic efficiency, as noted already above. In addition, harmonization can be defended on the grounds that economic gains from concessions in one policy may be nullified or impaired by offsetting actions in other areas.

The existence of different origins of rules and regulations seems to me to suggest that there may be no single answer to the question whether rules should be harmonized or not. Where harmonization of rules may be desirable on economic grounds, it may be rejected on political grounds or *vice versa*. To use two examples, while it may be highly desirable on economic grounds to establish a common market, the resulting partial or complete loss of national sovereignty may not be acceptable on political grounds; similarly, unrestricted entry of violent films into a market may be attractive on the grounds of employment and income in the film industry but it may also be rejected on sociological grounds. In brief, harmonization must involve a clear understanding of not only what we

want to harmonize but also why. Unfortunately, it is the latter that is often ambiguously stated.

The presence of different government objectives means that in confrontation with political, sociological or philosophical arguments, economic arguments may not be entirely convincing. Moreover, the problem is further complicated by the fact that mainstream economic theory is not unequivocally accepted by all economists. The most vulnerable element is arguably welfare economics and its treatment of ethical issues and justice. To put it most bluntly, the problem of the mainstream neoclassical theory is that it tends to be devoid of any ethics unless we reduce the concepts of "profit or utility maximization" — the foundations of the mainstream theory — to the notion of ethical instruments. This limitation of what Amartya Sen calls the "engineering approach" to the study of economics could be quite serious. Sen (1988) and others have criticized in particular what they see to be bizarre notions of "economic rationality," which are critically dependent in the "engineering approach," on the consistency of consumer choice and maximization of self-interest; both of these notions are rejected by Sen. He dismisses the requirement of internal consistency on the grounds of logical inadequacy. Furthermore, while of course recognizing "self-interest" as a motivational force, "the real issue is whether there is a plurality of motivations, or whether self-interest alone drives human beings. It may not be at all absurd to claim that maximization of self-interest is not irrational, at least not necessarily so, but to argue that anything other than maximization of self-interest must be irrational seems altogether extraordinary."[9] There are, of course, other shortcomings of welfare economics and I shall return to some of these limitations further below when I discuss the question of economics and justice.[10]

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9 See Sen (1988), pp. 15 and 19. In the same lecture, Sen provides a vast list of references to studies which take critical positions to the mainstream neoclassical economics. Most of those references concern criticism of particular segments of the mainstream economics.

10 Many of these limitations were discussed already in the well-known study of Little (1957). It is only fair to point out that attempts have been made to incorporate ethical judgments into the theory. This essentially involves incorporation of human rights and

I have obviously greatly oversimplified the subject that has been developed and debated for more than two centuries. I shall come back to some of these issues below and the reader may follow the current debate in more detail, for example, in Dasgupta (2004). My only argument at this point is that economic theory may provide good explanations of the reasons why standards are desirable but it cannot do so without raising additional doubts and questions. This also means that the debate about the harmonization of standards must be equally ambiguous since it rests on the presumption of the existence of standards in the first place.

Conditions to Compete and the Theory of Comparative Costs

One of the arguments in favor of harmonization is that different regulatory systems can lead to different — read "unfair" — conditions of competition.[11] For example, following the infamous WTO disputes EC-Asbestos, Chile-Alcohol, US-Malt Beverages, and the most recent Shrimps and Turtle case, Regan strongly argued in favor of a revision of Article III with regard to the interpretation of the term "so to afford protection*."* He further suggested that "regulatory purpose" be considered in interpreting Article III(4). If adopted, the proposal would have profound implications for international trade since it would shift the debate from "like products" to "competitive conditions." The latter would, by way of reminder, directly touch on the nature of the comparative advantages of nations. One could even suggest that the argument is central to the whole debate about harmonization and its link to the theory of international trade as well as to the role of the WTO.[12]

the "human good" into a broader concept of "human well-being." The aim of those attempts is to show that economic theory is not devoid of ethical considerations. A sophisticated presentation of those arguments can be found in Dasgupta (2004).

[11] Even though the "fairness of competition" argument is well established in the literature and debate, the argument itself is not considered in WTO (2005), Section II B.

[12] The link between regulations and countries' competitiveness has been discussed at length in the literature. See, for example, Trebilcock and House (2002), p. 424 who discuss the subject in relation to environmental regulations.

The response to this argument has two elements. The first issue concerns the link between regulations and the terms of comparative advantages under which countries trade. The point is that different regulatory regimes impose different costs of compliance for firms, and these costs reflect entirely the effects of different government regulatory policies. This, in turn, implies that the production conditions to compete for firms operating under different regulatory regimes are not the same (comparable). To put it differently, the cost structure of firms producing the same good under different regulatory regimes will also differ. This will lead to differences in comparative costs which will translate into different patterns of international trade than those that would prevail in the absence of regulatory interventions.

The question that needs to be answered comes down to the issue whether the regulatory conditions should be the same in every country. For example, if developing countries are expected to abide by the same rules on labor employment, would they not lose or at least impair their comparative advantage in labor-intensive lines of production and technologies? The latter is, after all, assumed to be their comparative advantage! Similarly, if developing countries were to apply the same regulations about environmental controls, would that not seriously impede their competitive advantage? In general, what should constitute comparative costs under such circumstances? Developing countries have resisted these pressures, which they consider to be "back-door" protectionism of developed countries. Given the resistance from developing countries to harmonize their rules with those of rich countries, it is clear that the issue of harmonization is highly complex and controversial.

One possible and, needless to say, powerful answer comes from one of the "architects" of the theory of "comparative advantage" himself, Adam Smith. Smith understood comparative advantage in a very broad way — in which comparative advantage is determined by "socio-economic conditions." He was strongly against regulations because they were seen

by him as only benefiting the rich rather than the poor. Referring to Smith's book, the Wealth of Nations, Sen (1999) writes:

> In modern interpretations of Adam Smith's opposition to the state's regulatory intervention, there may be an inadequate recognition of the fact that his hostility to such regulations related closely to his reading that these regulations were most often aimed at catering to the interests of the rich. Indeed Smith expressed himself quite equivocally on this subject.[13]

A related issue — the second element to the debate about competitive conditions of nations — is the question of which instruments governments should use to address the problem of externalities. If the government objective is to target a particular externality, should it not choose the optimal instrument to do so? It is conceivable, and in many instances desirable, that governments concerned about a public policy issue should be able to draw on the arsenal of domestic policy instruments to address the externality without necessarily applying trade restrictions. In other words, free trade would remain the optimal policy. Free trade would remain the desirable state of affairs and the diversity of standards would be legitimate. Note that the externality would presumably also include distortions generated by "regulatory capture" which can become an important source of comparative advantage.

These issues will be addressed in more detail further below but it may be useful to summarize the relevant argument here. In brief, the argument states that the conditions of trade should not be affected by unilateral measures of countries to restrict trade and their public policy concerns should be addressed with domestic policy instruments. This is precisely what has been proposed in a theoretical model by Bhagwati and Srinivasan (1996). They considered the case of different environmental standards in different countries and derived the conditions for optimal

[13] See Smith (1976), Volume 1, book II, pp. 266-7 and pp. 157-8; cf. Sen (1999), pp.121-4, especially footnote 23.

trade and environmental policies. Their case was limited to environmental externalities that remain domestic and do not have cross-border implications. Their main conclusion is that countries that wish to have both optimal trade and environmental policies should use domestic taxes to address the environmental externality and continue to pursue free trade. The conclusion is basically the same as the one which is typically reached in the assessment of the effectiveness of policy instruments and the theory of second-best.

Whether these kinds of responses provide the ultimate answer to the concerns that I have raised above is still far from clear. Whenever we are dealing with the "classical" cases of market failure, the solutions can be relatively straightforward. Governments simply have to use government policies to target the externalities or other origins of particular distortions and, in theory, they can do so effectively, as convincingly shown by Bhagwati and Srinivasan (1996). However, whenever governments themselves are the origins of the distortions the task is more difficult. Take the case of government administration and its effects on comparative costs in the context of the definition proposed by Adam Smith. If socioeconomic conditions define the comparative costs of each country, they must include not only technology, tastes and factor endowments in the narrowest sense, but also other factors that may affect the operation of markets. The latter may include, for example, market structure, institutions and even the operation of governments.[14] As we shall see further below, the literature on "regulatory capture" makes the strong point that regulations may reflect particular lobbying interests rather than the interests of the whole society and lead, therefore, to sub-optimal outcomes. Moreover, the newly-emerging literature on the costs of entry into markets shows that the costs can differ fundamentally among different countries. These differences reflect different regulations affecting market entry (including ensuing costs

[14] A similar distinction is made by Leebron (1996). My distinction among different forces determining comparative advantage seems to correspond to what Leebron calls "substantive" and "process-based" legitimacy. I shall return this issue as well as to Leebron argument in the next section .

of corruption) and are, therefore, reflections of the work of governments and the quality of their services. The later literature, too, provides evidence that is contrary to the public interest theories of regulations but consistent with the public choice view that entry regulations benefit politicians and bureaucrats.[15]

Justice

The second element of the argument about unfair competition is related to the fact that regulatory differences also imply different impact on segments of society — both within the group of producers and that of consumers. Some producers may be adversely affected by regulations, others not. Some consumers may benefit if they import cheaper products from a less regulated country while others may not. Moreover, regulations are set by governments but it is individual citizens or firms that are ultimately affected and pay the costs. This raises a number of important questions. Since it is households and firms that are affected by the regulations, how are their individual preferences reflected in the government decision to regulate? Are the decisions based on a "majority" view or not? If the "majority principle" is adopted, does it matter how the majority was achieved? In addition, even if governments are democratically elected and the value of regulations represent the value of the majority, should the minority be compensated for the losses due to the adoption of the regulations. If regulations are adopted by governments that are not democratically elected, the value of the regulations will represent those of a minority rather than those of the

[15] See Djankov, LaPorta, Lopez and Schleifer (2002). In building on the work of Djankov et al., Klapper, Laeven and Rajan (2004) show that entry regulations hamper entry, especially into industries that naturally should have high entry. They also show that value added per employee in naturally "high entry" industries grows more slowly in countries with onerous regulations to entry. The literature has grown considerably in the last years and it has expanded into the study of market access conditions for foreign direct investment, such as Bevan and Estrin (2000). For further references, see either of these two references.

majority. These and other types of distributional consequences of regulations raise two important practical and theoretical issues.

On the theoretical level, the fundamental question is that of justice. It is clear from the introduction above that economic theory justifies regulations on efficiency grounds. Rules allowing "interconnectivity" of different technical systems will increase income and improve welfare of participating firms without lowering the welfare of others. Rules protecting the environment may eliminate externalities and, therefore, social costs. In economic theory, rules of this kind will lead to the most efficient allocation of resources and, to put it differently, to Pareto optimality.

However, regulations may be also set by governments for other reasons, as also noted above. One such motivation is governmental concerns for justice and equity. This raises new sets of problems for policy makers. How do we define "fairness"? Is competition "fair" if a strong firm with strict regulations has to compete with a relatively weak firm subject to no regulations? The answers depend entirely on what we believe is "just" and "fair" as well as what our perception and understanding of "justice" is. The definition may differ between the supporters of Christian beliefs of fairness, or those who argue in the tradition of John Stuart Mill or that of Hegel or, let us say, Karl Marx. Since these concepts of justice may differ a great deal, it is clear that an agreement about what is "just" or what is not is impossible and that is where the debate of the subject could also stop. However, it may be useful to explore this issue from an economic perspective in some more detail.

It is perhaps no exaggeration to suggest that mainstream economists did not always pay much attention to the distributional consequences of market outcomes for at least two reasons: they assumed perfect competition and a fairly simplistic motivational network of the *homo economicus*. "Fairness" implied output and wealth was distributed according to the marginal conditions in equilibrium — the Pareto optimum. Welfare is a matter of personal utility and its maximization by

each individual and social utility is, in turn, a result of the sum total of individual utilities. Interpersonal comparisons of utilities have been seen by economists as a matter of "ethics" rather than economics. However, the theory of welfare economics has been subject to severe criticism as already noted above. Moreover, rising pressures within societies and across borders for distributional changes have shown the need to provide for stronger foundations and justifications of social justice and of distributional consequences of market outcomes. For example, following Arrow (1982), Sen (1999) and others, there has been an increasing tendency among economists to regard hunger and poverty as primarily a problem of income distribution (i.e. empowerment) rather than the outcome of other factors such as climate, culture, economic organization etc. [16]

The response to the criticism of welfare economics came from various corners.[17] One of the most comprehensive and influential theories is "The Theory of Justice" by John Rawls (1999) which is often seen as the philosophical counterpart to the neoclassical theory of economic welfare.[18] It would be highly pretentious to attempt to summarize and discuss Rawls' theory in such a short paper as this. Nevertheless, a brief summary of the basic ideas, directly taken from Rawls himself, may be useful.[19]

[16] It would be "unfair", no pun intended, and certainly inaccurate to suggest that economists have been immune to the issue of income distribution. There has been indeed an enormous revival in the issue but primarily as a normative concept or an empirical issue. For a comprehensive list of relevant sources see, for example, Sen (1988), p.32, footnote 3.

[17] Various principles for supplementing the Pareto principle by distributional judgments have been considered, for example, by Fisher (1956), Little (1957), Meade (1976), Atkinson (1975) and (1983) and others. The responses are reviewed in Sen (1988).

[18] An excellent example of somebody who has made a clear link between the mainstream welfare economics and Rawls is Sen. See Sen (1988), especially p. 33.

[19] I am also sure that a brief expose of such a complex theory as Rawls' cannot do the theory of justice.

The main idea of the theory is based on the concept of what Rawls calls "the original agreement."[20] The agreement is assumed to be made by free people who do so for a variety of rational reasons in order to pursue their own interests. The agreement establishes what may be seen as the initial position of equality, and the agreement will regulate all further agreements. To put it differently, the starting position establishes a state of equality and any changes in the future will have to be "fair" and maintain the state of equality agreed to in the initial contract. Otherwise, there is a danger that some may lose, and this may happen to any member of the group. The theory encompasses two basic principles: (1) the equality of rights and duties and that (2) social and economic inequalities are compensated by benefits to all. This is especially the case of inequalities affecting the most disadvantaged members. The reader well versed in the history of ideas will recognize that the theory is derived from the social contract theory of Locke, Rousseau and Kant.

The theory has received a great deal of attention as well as support and criticism. One of the most important criticisms came indirectly from Sen (1988). I should note that the criticism is primarily an indirect one since Sen criticizes, *nota bene*, the role of initial "contract" and hence the distribution of personal endowments. Sen argued powerfully that the so-called "fundamental theorem of welfare economics," which states that under certain conditions every perfectly competitive equilibrium is Pareto optimal and every Pareto social state is also a perfectly competitive equilibrium for some set of prices, is limited for two reasons. First, he considers the Pareto principle to be highly inadequate as a measure of social achievement. Second, he emphasizes that the theorem is critically dependent on the set of initial distributions of personal endowments.

[20] The theory has been influential in wider branches of economics. In his book on “The Rise and Decline of Nations”, Mancur Olson argues about the critical of role "distributional coalitions" of interest groups in shaping domestic policy developments. See Olson (1982).

This makes it possible to supplement the Pareto principle by different distributional judgments.[21]

While in theory it is possible to design a set of compensations that compensate "losers" affected by the regulations, designing an effective system poses an enormous theoretical challenge and is a practical nightmare for policy makers. Designing an effective and efficient system of compensation requires a solution to the highly complex theoretical problem of comparing utilities among different individuals.[22] On a practical level, the policy maker faces additional practical constraints that would impede his or her decision. These constraints include, for example, the absence of information needed to calculate the required initial income distribution or the possibility of distorted incentives to provide accurate information or various political constraints. In brief, the policy maker will face a highly complex problem of measuring inequality and assessing the impact on the poor in particular, an issue to which I shall turn next.[23]

Measuring Costs and Benefits of Harmonization

Another important issue of both a practical and theoretical nature arising from the debate about harmonization of standards and rules is the question about how one can or should assess the costs and benefits of harmonization. If one should do so simply by adding the number of extra shoes, DVDs, TV sets or other products and services resulting from harmonization, the task would be relatively simple. However, the valuation of benefits can be far more complex. A country can attach a higher value to DVDs or TV sets that are subject to domestic standards rather those that may be produced abroad more cheaply. The evaluation

[21] Various distributional judgments have been considered in the literature and they are noted in Sen (1988), p. 35.

[22] This would require dropping the requirement for interpersonal comparisons of utility and relying entirely on some intrinsic value of utility. See Sen (1988), p.38.

[23] There is vast theoretical literature addressing the problem from a variety of angles such as the "index number theory" as discussed in Blackorby and Donaldson (1980) and others.

of costs can be also a daunting exercise. The adoption of common standards can have distributional consequences which an affected country may not accept.

In trying to measure the costs and benefits of harmonization, we face a daunting task to which there is no simple answer. How would one value these costs and benefits considering that utilities may differ among countries? As we have already seen, the value of environmental and labor regulations differ among countries — developed countries tend to value them relatively highly, developing countries relatively less. If countries' utilities were similar but not identical, we still have a difficult problem to resolve. For example, the harmonization of standards is needed to target externalities such as cross-border pollution or cross-border effects of bank failures. While harmonization of standards can go some way towards this objective, it is clear that harmonization *per se* will not necessarily be effective in eliminating negative externalities. Low pollution standards imposed on firms or low prudential requirements for bank management will not eliminate cross-border pollution or bank crises respectively. Moreover, even if countries' utilities were identical, how would we assess the benefits (and costs) for small and large countries? In other words, how would we aggregate the utility functions across countries? In the latter case we are back at the "aggregation problem." These are critical questions for the effectiveness of harmonized measures and thus, for the choice among alternative instruments for harmonization of standards, must be seen as only one in the range of possible instruments to target particular outcomes.[24]

The difficulties of measuring the costs and benefits of harmonization have transpired very clearly in the recent debate about the effects of globalization. In addition to issues related to ethical questions and justice that I have raised above — issues that involve normative judgments as I have noted — economists have run into difficulties

[24] Some of these and other relevant arguments are discussed at length in Heinzerling and Ackerman (2002).

involving different kinds of value judgments. In discussing the distributional effects of globalization, economists have not been able to agree on an unambiguous measure of income inequality. As Ravallion (2004) powerfully argues in his assessment of competing concepts of income inequality, there are three differences in value judgments made in measuring the distributive justice in the globalization debate: (1) whether one should weigh countries and/or people equally when assessing distributional outcomes,[25] (2) whether we focus on the so-called "horizontal" as opposed to "vertical" inequality[26] and (3) whether we are referring to "relative" or "absolute" inequality.[27] Clearly, unless there is an agreement on how to measures these costs and benefits, it will be extremely difficult to make an intellectual argument in favor of one measure or another. The same logic applies to the debate about measuring the costs and benefits of harmonization.

An analysis of standards also faces other serious methodological and conceptual difficulties. Take an example of network externalities. Economic theory suggests that standards can increase economic welfare (and thus be socially desirable) because they increase the network of users adopting the same good or a compatible one. Welfare will increase if the social benefits of one more user joining the network include benefits that accrue to others on the network.[28] Since social marginal benefits exceed private marginal benefits due to the externalities, the equilibrium size of the network is smaller than the socially-optimal size of the network.

In terms of comparative static, the argument is quite clear and straightforward. The problem is, however, that firms operate in a

[25] This issue corresponds, of course, to the theoretical problem of interpersonal utilities and to the problems of "index numbers."

[26] Ravallion defines "vertical" impact as the differences in the mean impact between people at different income levels. "Horizontal" impact is defined as the differences in impact among people who are *ex ante* equal in terms of welfare.

[27] "Relative" inequality refers to proportionate differences in income while measures of absolute level of inequality refer to the absolute differences.

[28] This issue is elaborated in more detail in Section IIB.3 of WTO (2005).

dynamic setting and must choose. Why should extra users join a given network? Does the entry come from their full understanding of the positive externalities that accrue to others in the hope of capturing the externality as a rent? That would assume a perfect knowledge about the behavior of other firms, whether they will adopt the same standard or not and whether they will also try to benefit from these positive externalities. What comes first? The decision to join a network or the decision to create an optimal network? (The former, I venture to say without hesitation). Furthermore, if there are gains to be made from the adoption of standards, what triggers the agreement to harmonize and/or coordinate? Why did it take such a long time before firms decided to cooperate?

The economic profession is sharply divided on the issue of harmonization. The debate about whether to harmonize or not involves the following three fundamental questions: First, should countries regulate or not? Second, if the answer is affirmative, should countries cooperate or compete in setting global regulatory systems? Third, if they should cooperate, how would they do so? Through negotiations? If so, how would they select among competing rules?

The responses to the first and third questions have been focused in the debate on the usefulness of cost-benefit analysis as a method of assessing regulations. Some economists believe in the intrinsic value of the analysis, others are more skeptical. As a result, the debate has not produced any definite conclusions. The supporters of the analysis have used it primarily in the debate about deepening the integration within the EU. Currently, the method is used, for example, across the Atlantic in the debate about the costs of existing regulations in the US (Hahn, 2005). In contrast, the skeptics continue to be highly skeptical. They criticize the attempts to "price the priceless," the tendency to "under-price" the value of future life or to "over-emphasize the opportunity costs" of activities that are not actually traded in markets. In brief, they are rejecting the usefulness of the methods whenever the method is to

be applied to such concepts as human life, health, race, and even environment etc. (e.g. Heinzerling and Ackerman, 2002).

These ambiguities seriously complicate the decision about who should have the final say about rules and related decisions concerning standards. As much as this is a politically sensitive matter internationally, the matter about who decides is highly controversial even within countries. As a result, it has proven to be extremely difficult to establish a truly independent regulatory agency which would be outside of political interference. In the US, for example, the political interference is justified by the proponents of the so-called "unitary executive theory" on the grounds that the President of the US has the ultimate executive power. [29]

There is also no simple answer to the second question. Economists have long been debating the merits of government-sponsored systems of regulations as opposed to regulations that emerge from the operation of markets. The latter — the market-based approach to regulations — is sometimes given as the optimal solution in the choice of different regulatory standards. The question was widely debated, for example, in the context of European integration which again was very much in the forefront of debates about regulatory coordination (e.g. Sun and Pelkmans, 1995).

In brief, measurements of the costs and benefits of harmonization involve serious and highly complex problems of a theoretical and practical nature. In particular, the problems include ambiguities about measuring interpersonal utilities, the value judgments involved in the choice of measurements of distributional costs and benefits as well as

[29] The issue in the center of the debate is the interpretation of Article II of the US Constitution which says that the executive power shall be vested in the President of the United States of America. Unfortunately, the Constitution does not precisely define that power, which has necessitated interpretations of the article through the courts. A brief summary of the issue can be found in WSJ, 5 January 2006, pp. 12-13.

further practical difficulties in obtaining unbiased data and other information that is needed in the exercise of assessing facts.

IV. ARGUMENTS FOR DIVERSITY OF STANDARDS

"All nations have present, or past, or future reasons for thinking themselves incomparable."

Paul Valéry, Extraneous Remarks in Selected Writings (1964)

"We must recognize that every nation determines its policies in terms of its own interests."

John F. Kennedy, Address, Mormon Tabernacle, Salt Lake City, Utah, Sept. 26, 1963

As I have noted above, there has been a growing interest in the academic literature and among policy makers in the harmonization of standards across countries, with calls for harmonization becoming more frequent and vocal. The main thrust of the debate appears to be finding reasons for harmonizing these rules, with those arguing against harmonization seeming to be in minority. Nevertheless, if we insist on pursuing the quest for harmonization, what would be the criteria for selecting among the plethora of different arguments, many of which do not have economic origins as noted? This question still requires an unambiguous answer.

If harmonization of standards were a simple matter and a straightforward exercise, the debate would undoubtedly end in a broad-based agreement. But the case in favor of harmonization is neither simple nor straightforward. The ambiguity primarily lies in unresolved conceptual issues, some of which were raised in the preceding section. The main conclusion of that section was that standards often involve a great deal of "normative" judgments (e.g. about distributive justice or national sovereignty) which makes them fundamentally different from

other economic instruments such as prices.[30] The latter are to a greater extent treated as instruments subject to positive judgments. Moreover, there are at least as many arguments against "harmonization" or in favor of "diversity" as there are arguments in favor of "harmonization." Some of these arguments are reviewed in the rest of this section.

Two of those arguments in favor of "diversity" of rules were put forward by Leebron (1996), when he argued that diversity can be justified on the grounds of what he calls "substantive legitimacy" and "process-based legitimacy." The former term may be translated by economists to mean "the economic determinants of comparative advantage." The main point of his argument suggests that economic differences matter as they push countries to specialize and, therefore, to gain from international exchange. This is, of course, the foundation of the theory of comparative advantage. What is less evident, however, is how comparative advantages are to be determined. That is an issue which has been addressed to some extent in the previous section.

Leebron's second argument against harmonization — "process-based legitimacy" — is somewhat less controversial. It states that countries may simply insist on different rules on the grounds of different distributional preferences or institutions, or by the nature of the given coalition formation. In other words, countries are unique, and any rules or laws of those countries must be seen as legitimate. If countries choose different rules, their choices are a matter of their sovereignty and they do not need to defend the differences.

But there are other, perhaps even more fundamental, objections to attempts to harmonize rules which come from "non-substantive" (read non-economic) factors. To quote Leebron:

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[30] It may be interesting to note that governments may find it difficult to harmonize their environmental standards while they may be completely unopposed to adopting world prices as measures of "efficiency." Needless to say, welfare economics and its considerable reliance on world prices are subject to similar criticism. This point was also made in the previous section.

> First, it will rarely be the case that an outside observer will be able to determine whether a policy difference derives from differences in endowments, technologies, or preferences (i.e. "substantive" differences — ZD) or from a difference that is not regarded as a legitimate source of comparative advantage. Second, even if the difference in laws could not be defended, a difference in institutions that produces the difference in laws might be (p. 73).

Another well-articulated argument was made by Bhagwati and Sriniwasan (1996). They probed the case against harmonization in more detail by using a formal theoretical analysis of markets with environmental externalities and their impact on the optimal trade policies. They distinguished between an environmental problem which is confined to the domestic market and environmental externalities that have global implications as they involve "physical" spillovers across borders.[31] They find that for a small country, free trade will remain the first best policy. Domestic pollution will have to be addressed along with domestic taxation just like any other type of distortion. The optimal pollution taxes will not be equal across countries; when global pollution occurs, free trade will continue to be Pareto optimal with each country levying own pollution taxes. In brief, they argued that the case for free trade with diversified standards remains legitimate and basically robust.[32]

[31] Since their model is complex, Bhagwati and Srinivasan need to restrict it by simplifying assumptions to make the analysis manageable. In particular, one should note that environmental spillovers do frequently have cross-border effects. Moreover, the distinction between environmental and trade effects may be useful for analytical purposes but is somewhat artificial since both effects may occur simultaneously.

[32] Of course, the argument may not hold for large countries which may levy optimal tariff (preventing, therefore, global Pareto optimality) but diversity of pollution taxes will continue to be the case. They also find that imposing one country's pollution tax on another will not be globally Pareto optimal. To put it differently, the "big country" case provides another argument against harmonization. I am grateful to Ron Ridker for making this point more forcefully for me.

They take their analysis even further. In responding to the proponents of harmonization, they make a strong case against those who argue that the absence of standards or "low" standards leads to "unfair" cross-border competition and a loss of "high" standards.[33] Their theoretical analysis shows that different countries will have legitimate diversity of cross-country, intra-industry environmental taxes and standards. The diversity will arise even if they share the same "utility function."[34] The diversity in tax rates can come from differences in technology and in endowments. Clearly, if utilities are different among countries, the case for diversity will be even stronger. Note that the diversity in taxes and standards will also presumably be the case in situations in which firms may be able to influence public policy and thus establish a source of comparative advantage.[35]

Bhagwati's and Srinivasan's argument is taken one step further by Corden and Vousden (2001). The authors asked the question what would happen if governments or multinationals operating in LDCs gave way to outside pressures and adopted higher labor standards. They built a two-sector differential wage model and explored the effects on wages and employment in the LDCs resulting from higher wages due to the harmonization of labor standards. As expected, they found that employment in export industries would fall, labor would transfer into the residual sector, where wages and average income would then fall. Income inequality among wage earners would rise, and the average wage for the economy as a whole would rise or fall depending on the relative sectoral elasticities of labor. The scope for preventing a decline in labor

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[33] These are the well-known arguments that the diversity of standards will lead to the "race-to-the-bottom."

[34] The definition of "endowments" must be understood in broadest sense. This reflects, in fact, precisely the meaning attributed to the term by Adam Smith, as I have argued above. For more details and additional extensions of the argument, see Bhagwati and Srinivasan (1996), pp. 167-8 and 171-9.

[35] This case will arise under the so-called "regulatory capture," an issue which I am addressing further below.

employment is small even in situations in which an LDC might have a monopsonic position in export markets.

Bliss (1996) also makes a case against harmonization — in his case against harmonization of competition policies that target antitrust practices and merger controls. He argues that the nation with tough competition policies is doing the rest of the world a favor by making available its exports cheaper than it would be doing in the absence of such policies. There could still be a case for "retaliation" by the "injured" parties but that could be done by the application of domestic competition policies. The only case for international co-operation and, therefore, harmonization of competition policies is in the case of industries with increasing returns to scale. As in most other cases, protection against predatory practices could be covered by existing GATT/WTO rules. Moreover, even if one must recognize that there do exist cases in which world efficiency would be increased, the practical difficulties of introducing a "fully informed antitrust legislation are insurmountable."[36]

The empirical literature is still in its infancy but it is clear that — until now — the literature did not provide enough support in favor of harmonization. Going through the existing empirical evidence, Levinson (1996), for example, looks at studies examining the effects of low environmental standards on trade and investment, and testing the case whether foreign investors are seeking markets with looser environmental standards. He also analyzes the evidence as to whether countries with high environmental standards export pollution-intensive goods to low-standard countries. He does not find a convincing case to suggest that high-standard countries are seeking pollution havens in other countries.[37]

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[36] Bliss (1996), p. 326.

[37] For more details see Levinson (1996), especially pp. 430-49. For more evidence see also Low (1992) and a number of other studies including an earlier WTO study on "greening the WTO." For an explanation why divergent domestic environmental rules have not necessarily led to "industrial flight" see, for example, Vaughan (2001).

The pros and cons of harmonization are closely related to the question of the sovereignty of states. Each harmonization of domestic rules may involve a surrender of a certain degree of national sovereignty to supranational bodies. This is not a simple matter considering that no national government likes to rescind its powers and reduce its role in rulemaking. It could be argued that this constraint is less critical in highly-integrated communities. In other words, for harmonization to be possible and effective, there must be a political will to integrate the country in question "deeply" into a larger community of nations. For example, as Drabek (2004) argues with supporting evidence, deep regional integration arrangements à la the EU have been effective in maintaining the stability of trade policies of their members despite violent external shocks as well as dramatic political and economic changes in some of the newly acceding states.

Moreover, standards reflect not only the preferences of nations but also the way in which individual preferences are reflected in legal instruments. How do we address a situation in which governments do not reflect their citizens' "true preferences"? Do we value externalities higher or lower than what is implied by a government's attitudes and regulatory policy? For individual preferences to be properly reflected in the aggregate social "utility function," we need to assume a political mechanism which transforms the former into the latter through some form of a democratic system. These are clearly strong empirical assumptions which make assessments of regulations even more ambiguous.[38] For example, if the political process allows the regulatory process to become biased in favor of particular interest groups, regulations, and their harmonization will always lead to socially sub-optimal outcomes. The reader will recognize this to be the conclusion of the regulatory capture literature which also explains that "inefficient bargaining between interest groups over potential utility rents" leads to

[38] These are additional complications to the theoretical problems of aggregation of individual utilities, which I have raised above.

"regulatory capture" of powerful interest group.[39] However, there is no guarantee that deeper regional (or multilateral) cooperation arrangements will lessen the "sovereignty" constraint in each and all cases. Studying the principle of mutual recognition for competition rules, Holmes and Young (2001) investigated the case of the European Union, which is undoubtedly the most successful and deepest integration arrangement in existence today. It is, therefore, easy to imagine that the EU would be a good test case of the extent to which states are ready to give up their attachments to their national sovereignty. Holmes and Young conclude:

> We are (...) sceptical about the argument that in the principle of mutual recognition the EU has discovered the philosophers's stone that will reconcile market opening and national regulatory sovereignty. Our reading of the regulatory convergence debate is, broadly speaking, that unqualified openness requires a certain degree of commonality in regulatory approaches. This is less of a challenge in the EU than in the wider world(...)[40]

Let me conclude the review of the arguments pro and con with one which I find original and most intriguing. Drawing on the work of Hancher and Moran (1989) and Previdi (1997), Holmes and Young (2001) explain the diversity of rules across countries based on a variety of legitimate reasons. The latter include cultural differences and the fact that countries may actually face different problems. In addition, countries may adopt different rules for political reasons as I have already noted above. Holmes and Young supplement the list by another element — the

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[39] Kirkpatrick and Parker (2005) provide a useful and brief review of the literature. The conclusion comes from Laffont (1999) and Newberry (1999) but they also refer to the writings in the Chicago school of Stigler (1971), Peltzman (1976) and, mainly, Reagan (1987) who argue that regulators favor producer interests because of the concentration of regulatory benefits and diffusion of regulatory costs. They also make the point, which is highly relevant for this paper, that the capability of firms to influence public policy is an important source of comparative advantage. See Section 3 and p. 15 of the final draft and, mainly, Shaffer (1995).

[40] Holmes and Young (2001.), p. 224

countries' attitude to risk. If a country is "risk-averse," it will tend to prefer a regulatory framework that would place more emphasis on the "precautionary principle." If another country is a "risk-taker," it prefers to err on the side of putting the burden of proof on those who want to act against the activity in question. It will, therefore, require a high level of scientific proof before it agrees to introduce relevant regulations.[41]

V. WTO AND GATS

The difficulties of harmonizing standards internationally are fully evident in one of the most visible platforms for such negotiations — in the WTO. The WTO is, of course, not the only institution to address domestic standards and regulations but it plays an important role in a variety of negotiations with trade and economic importance. In services, for example, standards have been extensively covered under the umbrella of GATS and in particular in its Article VI. Even though GATS is not the only WTO agreement that establishes disciplines for domestic regulations, it undoubtedly provides a highly illustrative case of the difficulties in harmonization.[42] Before elaborating on the difficulties in negotiating the harmonization of standards in the WTO, it may be useful to briefly summarize the negotiating agenda in GATS on regulation and the main elements of Article VI which explicitly covers standards.[43]

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[41] The authors compare the risk-taking attitudes of the types of countries to what statisticians call Type I and Type II errors. For more details, see Holmes and Young (2001), pp. 205-6.

[42] The other important agreements are the Agreements on Technical Barriers to Trade (TBT) and on Sanitary and Phytosanitary Measures (SPS). An analysis of those two agreements would yield the same conclusion as the one in Section 5 of the text. The problem is probably even more serious than what transpires in the WTO. The recent initiative of the European Commission to introduce a new "services directive" to liberalize the services market in the EU has run into serious difficulties and opposition of some member states. This is surprising considering, in particular, that the Treaty of Rome foresaw single markets both for goods and services. Moreover, the EU has already undergone a considerable process of regulatory convergence as noted in Section 4 above.

[43] The reader may consult, for example, Marchetti and Mavroidis (2004) for more details and references to the legal aspects of GATS in general and of regulations in particular.

Standards are addressed in GATS in a relatively limited framework. This reflects a narrow scope of issues covered in the actual Agreement and a narrow agenda for negotiations in the Doha Development Round. Nowhere in GATS (or GATT) is there a general provision that would impose harmonization of regulations. The agenda is basically taken over from the existing scope of the Agreement, and it covers the issues of (i) transparency, (ii) licensing requirements, (iii) licensing procedures, (iv) qualification requirements and (v) qualification procedures. The aim of the negotiations for transparency is to establish discipline related to the transparency of domestic regulation of standards to ensure that the regulations are based on "objective and transparent criteria" and that economic agents are given full access to the relevant information. The purpose of negotiating licensing requirements (other than qualification requirements) is to establish the discipline required from professional service suppliers in order to supply a service. Licensing procedures refer to the administrative procedures related to the submission and processing of an application for a license. The mandate for negotiation of qualification requirements targets modalities for the establishment of those substantive standards which a professional service supplier is required to fulfill in order to obtain certification or a license. In brief, while the mandate is quite clear, the scope of GATS and its treatment of domestic regulations are extremely modest.[44]

The limitations of GATS with regards to the coverage of standards are particularly evident from the general provisions of Article VI and from a relatively long list of issues that are not subject to negotiations. Article VI only declares that "measures of general application affecting trade in services [be] administered in a reasonable, objective and impartial manner." The wording of Paragraph 4 of the same article goes somewhat further by making a closer link between regulations and their effect on trade. The provision states that "with a view to ensuring that measures

[44] Well-seasoned GATS observers such as Mattoo, Mavroidis or Sauvé regard the treatment of domestic regulations as of the weakest GATS provisions. See Mattoo (2000), p. 483.

relating to qualification requirements and procedures, technical standards and licensing requirements do not constitute unnecessary barriers to trade in services, (...)" Similarly, licensing requirements should "not be more burdensome than necessary to ensure the quality of the service." In other words, the provisions recognize the right of countries to apply domestic regulations and thus also their right to impose restrictions on trade but should "not in themselves [be] a restriction on the supply of the services and that such regulations do not constitute "unnecessary barriers to trade." Given these limitations, member states have been trying to further enforce the above measures through transparency measures and some *ad hoc* disciplines (such as timeframes and, in particular, the so-called "necessity" test).

The ambiguities created by the existing GATS provisions on regulations are perhaps most apparent in the treatment of "necessary and unnecessary" regulations. The distinction between "necessary" and "unnecessary" restrictions to trade may be appealing to policy makers and to negotiators but this approach is fundamentally in contradiction with the views of mainstream economists. As is evident from the debate about harmonization of standards, the core argument of mainstream economists is based on the idea that free trade is the best policy option and that trade restrictions can only be justified under highly-specific and well-identified circumstances such as market failure. This orthodoxy may be controversial but the question whether free trade is or is not the first policy option is critical for policy makers and it is simply not only a matter for academic debate The reason for its importance lies in the fact that policy makers need to be guided in their negotiations by the ultimate objectives of their governments' policies. For example, if free trade is the objective, the policy makers know that trade restrictions of any kind are not desirable, irrespective of the fact of whether they are "necessary" or not. The only issue is how these restrictions are to be removed — unilaterally or in international negotiations.

If free trade is not the objective and the policy makers are guided by other policy objectives, the concept of "unnecessary restrictions" is ambiguous. This leads to another complication for policy makers and negotiators in GATS. Since the concept of "unnecessary restrictions" can be justified on the grounds of other domestic objectives, it is critical that guidelines be provided to define them and the tradeoffs with the objective of trade with other countries. Otherwise, the concept will be subject to different interpretations and will lead to abuses and disputes. However, an agreement on the guidelines is extremely difficult to reach, primarily for reasons discussed in Section 2 above. As a result, no guidelines are typically given to policy makers to define the extent to which some regulations should be deemed "unnecessary barriers to trade."[45]

There are other fundamental problems involved in the treatment of domestic regulations in GATS. One of them concerns the definition of standards. It is quite well known, for example, that standards can sometimes encompass "too much" or "too little". Take an example of capital requirements for banks. Should banks in emerging markets subscribe to standards established under "Basel I or II" or should they rather be subject to different regulations? There are strong arguments for three different answers. The first possible answer is that the banks in emerging markets should be subject to stricter rules since they operate

[45] Various proposals have been made to address this general problem of trade restrictive domestic regulations but none has made any impact on the negotiations nor on the resolution of the fundamental theoretical problems discussed earlier in this paper. See, for example, Mattoo and Subramanian (1998). Other proposals have been made by others to strengthen the GATS articles related to domestic regulations. See, for example, Feketekuti (2000), Nicolaidis and Trachtman (2000), Zampetti (2000), Hoekman and Messerlin (2000) who address different aspects of regulatory requirements such as definition of standards, mandatory versus voluntary regulations, market access through mutual recognition and modalities for regulatory reforms. However, none of the latter proposals has addressed the theoretical and conceptual problems noted above. Moreover, there is an ongoing debate and controversies about many of these proposals such as the debate about the choice of horizontal as opposed sectoral disciplines which further complicates the matter and makes an agreement on the modalities even more difficult.

in riskier environments. In contrast, the second answer is that some economists have argued that strict banking regulations will unnecessarily restrict banking operations in emerging markets. They argue that the latter may need to grow faster and hence may need to have an appropriate access to credit if they are to transform themselves from emerging to mature markets. Finally, the third answer is that it can be also argued that the banks should endorse Basel I and II since this would give them easier access to foreign capital. Not surprisingly, none of these issues have found any resolution in the GATS negotiations.

The list of unresolved and, in some cases, even untouched issues concerning regulations is much longer. For example, should regulations be voluntary or mandatory? Who decides standards? Should the decision be taken entirely in the jurisdiction of governments or should other institutions be involved, such as NGOs or professional associations? If other institutions are involved, what form should the involvement take in order to ensure a full "representativeness" of the regulatory measures? Should the negotiators strive for horizontal measures or adopt a sectoral approach, or a perhaps a hybrid one in which horizontal measures are complemented by sectoral discipline. These and other issues make the debate about standards and their regulations extremely complex and arguably most difficult in the entire GATS negotiations, as noted by Marchetti and Mavroidis (2004). It is not, therefore, surprising that so many of the controversial issues have remained outside of the current negotiations.

Before concluding, I want to make just a few comments about GATT. The controversial treatment of regulations in the WTO agreements is not confined to GATS. Similar controversies have also surrounded GATT. Regulations are covered in GATT in Article III (National Treatment — NT) which is interpreted by some specialists as a *bona fide* provision for regulatory diversity. However, this provision for diversity is seen by others as an origin of measures designed to protect domestic firms.[46] The debate about national treatment and its implications for taxation policy in GATT

[46] See Howse and Regan (2000) and Regan (2002).

Article III was taken up by Horn and Mavroidis (2004). They review a number of legal cases under the Article III of GATT and conclude that the case law has not clarified the interpretation of the article. In other words, the summary of the case law does not provide that a mechanical interpretation of the NT principle requires tax harmonization. The real problem for the authors is the absence of an operational definition of protection. The latter can be explained by serious theoretical inconsistencies as shown in Section 3 above. Taking the perspective of incomplete contracts, they further argue that non-discrimination is not a legal panacea but the provision is in the agreement as *faute de mieux.*

Perhaps the most "advanced" discipline involving the idea of harmonization is contained in the Technical Barriers to Trade (TBT) and the Sanitary and Phytosanitary (SPS) Agreements. Both agreements create a presumption of cooperation by making recourse to international (harmonized) standards. However, neither of these two agreements imposes an obligation to use them nor do these agreements close options for countries to justifiably deviate from those standards.

In commenting on the paper of Mattoo and Subramanian (1998), Farber and Hudec, two world renown international trade lawyers, make the point even stronger than the position taken in this paper:

> The general problem (...) has resisted the best efforts of the (US) Supreme Court (for over 150 years), GATT tribunals, international negotiators, and a host of talented legal scholars. The reason, we believe, is that in some ultimate sense the problem is unsolvable. Negotiating a working border between the two (free trade and regulatory autonomy) depends as much as on history, politics, and local terrain as on any overarching vision. No matter how a legal test is articulated, it cannot satisfactorily answer the tensions between (...) autonomy and free trade in all conceivable cases. In the end, the

> law must have a certain irreducible messiness in dealing with such fundamental tensions.[47]

VI. CONCLUDING REMARKS

"Nothing is more dangerous than an idea, when it is the only idea we have."

Alain, Libres — Propos (1908-14)

"Politics are too serious a matter to be left to the politicians" said Charles de Gaulle in his reply to British Prime Minister Attlee who had earlier noted that "De Gaulle is a very good soldier and a very bad politician."[48] One is tempted to make a parallel conclusion about harmonization of standards across countries — standards and their regulations are too sensitive a matter to be left to the economists.

It should be clear from the foregoing discussion that the case for harmonization of national rules is by no means straightforward. There are both arguments in favor of harmonization and there are also strong arguments for the diversity of rules. These counterarguments are both theoretical and empirical. Even though we have no single theory that would guide our decisions, there are various theoretical propositions derived from formal and rigorous models that can be made to support both choices. Moreover, the propositions favoring harmonization are not based on strong empirical evidence. If anything, the empirical evidence points in the contrary direction in many cases under investigation.

Even more serious is the sheer complexity of the problem at hand which leads to serious technical, theoretical as well as methodological and conceptual problems. These problems arise due to the fact that the establishment of standards and regulations may involve economic as well as political, social and ethical decisions which cannot be handled by economic

[47] Cf. Mattoo and Subramanian (1998), pp. 321-2.

[48] See Clement Attlee (1961): A Prime Minister Remembers, 1961, Chapter 1.

analysis alone. Economists tend to analyze regulations from the point of view of economic efficiency. True, some standards such as clean water may be unambiguously desirable on those grounds, but those are simple cases and there are probably only relatively few. Taking aside different concepts of economic efficiency and accepting that most standards have social, political or ethical origins, the case for harmonization becomes far more complex. Moreover, even if the analysis is confined to economics, the analysts will struggle as long as they have to consider issues such as "fair competition," national sovereignty, and ethics which are by no means easily amenable to rigorous economic analysis. There is no formal agreement about how to handle any of these concepts individually let alone taken all together and analyzed.

In this paper, I have only tried to identify some of the complexities of the harmonization debate without any attempt made to resolve them. Many attempts to do so have been made by others, particularly in the context of the debate about globalization. For example, Rodrik (1997) argued in his critique of globalization that the most serious challenge for the world economy lies in making globalization (read market liberalizations) compatible with domestic social and political stability. This creates a great tension between those who want to harmonize regulations and those who favor their diversity.[49] Similarly, many others have argued that free trade leads to depression of domestic wages and employment, cultural uniformity, a loss of national sovereignty or an adverse effect on social policies.[50]

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49 He identifies three basic sources of tension between global markets and social stability – (1) trade and investment liberalization accentuate the asymmetry between those groups that can cross international borders and those that cannot. (2) globalization genders conflicts between and within nations over domestic norms and social institutions that embody them (!) and (3) it has made it exceedingly difficult for governments to provide social insurance. See Rodrik (1997), pp.5-6.

50 The literature covering these subjects is vast and cannot be included here for reasons of limited space and the rather different objectives of this paper. Nevertheless, the reader may find it useful to consult Trebilcock and House (2002), especially pp. 1-17 for a brief summary of the arguments and the literature.

Given these complexities and controversies, it is not surprising that the extent to which regulations are harmonized on a multilateral level remains very limited. As I have shown in Section 5 above, the WTO deals with regulations to a limited extent only. The TBT and SPS Agreements, as well as GATS, have relatively modest coverage and have by and large avoided disciplining activities of governments that could be seen as affecting their national objectives. This "minimalist" approach may not be very ambitious but it has allowed the successful conclusion to these agreements.

In sum, it is difficult to see how one could generalize in the debate about "diversity versus harmonization". There simply may not be a formal answer that can be derived from a rigorous analysis. Technical standards may create less formidable controversies and tensions even though this conclusion may also not necessarily be true given the history of debates about such matters as traffic rules and disputes about genetically-modified organisms. In addition, regulatory competition is sometimes seen as desirable, and this too will encourage regulatory diversity. When we consider standards with wider social and political implications, the debates become far more controversial. What seems to come out of the debate as well as from the foregoing discussion is the conclusion that each case of regulation may have be analyzed and treated separately. Only then can one possibly reach a conclusion that would allow the choice between one or the other. This approach would correspond to a system in which regulatory practices are established case-by-case by sectors in the same way as law cases contribute to building a common law.[51]

[51] The analogy with law may be useful to understand the complex choices for which there are often no commonly accepted principles that are necessary to reach conclusions. I am grateful to Ron Ridker for bringing this useful analogy to my attention.

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