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The economic case for international labour standards

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This paper explores the economic case for international labour standards. Granting workers rights of free association and collective bargaining confers both static and dynamic economic efficiencies. Static efficiencies refer to one-time gains from improvements in economic practice. Dynamic efficiencies refer to gains from improvements to the growth path resulting from a shift away from a 'low road' development path to a 'high road' path. These efficiencies raise wages, employment and output in developing countries, and they can also benefit workers in developed countries. Labour standards are an institutional mechanism for raising the quality of growth in both developing and developed countries. In this sense, they are a 'win–win' institution.

Key words: Core labour standards, Free association, Collective bargaining, Economic growth
JEL classifications: O19, J38, J58, F02

1. Introduction

The late 1990s' financial crises in east Asia, Russia and Brazil have served to reinforce the sense that globalisation is not working out as conventional theory predicted it would. Instead of producing faster, more stable and widely shared growth, globalisation appears to have produced the opposite. Rodrik and Velasco (1999) report that the world economy has experienced 69 banking crises since the late 1970s, and 87 currency crises since 1975. Moreover, this count only runs to the end of 1996, and therefore misses the financial crises of 1997 and 1998.[1] The increase in income inequality in the US is documented by Mishel *et al.* (1999), while rising OECD income inequality is documented by Bernstein and Mishel (1995). Finally, a recent study by Milanovic (1999) documents rising global income inequality.

Some critics of the existing process of globalisation argue that international labour standards, as defined by the International Labour Organisation (ILO), need to be made part of the formal rules governing the global economy. The argument is that the path of

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[1] A banking crisis is defined as a situation in which the banking sector has negative net worth. A currency crisis is defined as a situation in which the currency depreciates by 25% or more in a given year, and 10% more than it did the previous year.

globalisation has been shaped by the 'new rules of the game' for the international economy, where these new rules are the result of both official policy measures and innovation by private sector agents in financial, goods and labour markets. Globalisation is not producing the benefits that theory predicts because these rules are incomplete and inappropriately designed, and a necessary corrective is the formal inclusion of core labour standards.

This paper examines the economic case for labour standards.[1] Opponents charge that they are a form of 'hidden' protection that would prevent developing countries from legitimate competition in an area where they have the greatest comparative advantage. The paper counters this argument and maintains that the pressure of labour standards will raise standards of living and rates of growth in both the developed and developing worlds.[2] Rather than being hurt by labour standards, developing countries stand to gain through official global enforcement.[3]

There are two dimensions to the economic argument in favour of core labour standards (CLS). One is a conventional 'static' economic efficiency argument whereby CLS correct distortions in labour markets. This results in better allocation of scarce resources that raises output and economic well-being. The second argument rests on 'dynamic' economic efficiency: CLS change the pattern of incentives facing business and government. In doing so, they shift economies on to a 'high road' path of economic development in which wages are higher, and in which business competition focuses on productivity and product quality rather than workplace conditions.

The logic of this dynamic argument is as follows. Globalisation has changed the structure of economic arrangements, and in doing so it has changed the pattern of incentives confronting business and government. This new pattern of incentives resembles the infamous 'prisoner's dilemma'. The key feature of the prisoner's dilemma is that in the absence of cooperation, private agents end up in a sub-optimal equilibrium. However, if agents cooperate, the economy can be shifted to a superior equilibrium in which all are made better off. Applied to the global economy, labour (as well as environmental and other social standards) can be viewed as a cooperation mechanism that can help realise the best global economic outcome. This illustrates how CLS serve to enhance developing countries' economic well-being rather than reducing it. Far from being hidden protection, CLS are actually a means of shifting both developed and developing countries to a superior equilibrium.

2. What are core labour standards?[4]

Before turning to the substance of the argument, it is worth noting the specifics of ILO core labour standards. These standards consist of five articles. Three are prohibitive in character,

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[1] In two other papers (Palley 2000A, 2000B), I have provided empirical evidence supportive of many theoretical claims advanced in the current paper regarding the beneficial impact of labour standards on the quality of governance and income distribution.

[2] Another argument that has great political traction is the 'equal treatment' argument. According to this line of reasoning, the Uruguay round of the GATT introduced trade-related intellectual property standards, thereby breaking new ground in international trade law by having it extend into the production process within country borders. Having given such protection to property rights, it is only just and proper that similar treatment now be given to labour and the environment.

[3] This raises questions as to why many developing country governments have opposed their adoption. One reason is that a developing country acting in isolation may have no incentive (or at best has a reduced incentive) to adopt core labour standards. A second reason is that labour standards may result in some change in the functional distribution of income, and this has probably generated opposition from those powerful vested interests whose income share may be at risk. However, the argument that labour standards are a source of economic inefficiency that interferes with the realisation of the gains of comparative advantage has no merit.

[4] My thanks to Elizabeth Drake of the AFL-CIO for providing me with detailed explanations of these standards, and their associated ILO convention number. All errors of fact and interpretation are mine.

and ban forced labour, exploitative child labour and discrimination. Two are affirmative in character, giving workers the right of freedom of association and the right to engage in collective bargaining. These five core labour standards are elaborated in the ILO's Declaration of Fundamental Principles and Rights at Work, which was adopted in 1998. The five core labour standards, with reference to the fundamental ILO Conventions that give them content, are described below.

2.1 Freedom of association

The Freedom of Association and Protection of the Right to Organise Convention (No. 87) establishes the right of workers to form and join organisations, including unions, of their own choosing. Governments may not dictate the form, affiliations or internal operations of such organisations, and may not deny authorisation to nor suspend such organisations.

2.2 Effective recognition of the right to collective bargaining

The Right to Organise and Collective Bargaining Convention (No. 98) protects unions from outside interference. Employers may not discriminate against workers who join organisations of their own choosing, nor may they pay for and establish their own workers' organisations. The state must establish legal mechanisms to prevent this interference. The government must also promote voluntary collective bargaining between workers' organisations and their employers.

2.3 The elimination of all forms of forced or compulsory labour

The Forced Labour Convention (No. 29) and the Abolition of Forced Labour Convention (No. 105) require governments to suppress all forms of forced and compulsory labour in their territories. Forced labour is any form of labour which a worker performs under threat of penalty rather than voluntarily. Though there are very limited exceptions for the military and national emergencies, government prohibitions on forced labour must be comprehensive.

2.4 The effective abolition of child labour

The Minimum Age Convention (No. 138) sets a baseline minimum working age of 15. If a country is insufficiently developed, or if only light work is involved, the minimum age can be lower; conversely, for hazardous occupations, the minimum age is 18. States must adopt and pursue national policies that effectively end child labour and allow children to develop fully both physically and mentally.

2.5 The elimination of discrimination in respect of employment and occupation

The Discrimination Convention (No. 111) requires governments to establish national policies that eliminate discrimination on the basis of race, colour, sex, religion, political opinion and national or social origin. Discrimination includes unequal access to employment and training as well as disparate working conditions, and the national policy must address both unequal opportunities and treatment. The Equal Remuneration Convention (No. 100) completes this standard by establishing the right of men and women to equal pay for work of equal value.

These standards are very much in the spirit of 'rights' and stand independently of a country's stage of economic development. They are 'qualitative' in nature and not 'quantitative', and they do not involve such measures as the setting of minimum wage levels or maximum hours of work, which are labour market interventions that are clearly contingent on the stage of development. Lastly, this rights-like quality of labour standards creates an

additional 'human rights' argument for labour standards that stands alone and in addition to economic arguments.

3. Some background: the economics of globalisation

Globalisation refers to the international integration of national goods, labour and financial markets. In many ways, it can be viewed an extension of economic processes that have already resulted in the creation of unified national and regional economies. These earlier processes were driven by business's search for new markets, and by cross market arbitrage of prices and wages for similar goods and services. Globalisation is being driven by these same forces.

In this regard, it is noteworthy that the earlier creation of a successful unified national economy in the US was accompanied by the creation of new institutions and regulations. In labour markets, the National Labour Relations Act (1935) gave workers the right to form unions and bargain collectively, and established the National Labour Relations Board to oversee relations between unions and firms. The Fair Labour Standards Act (1938) established rules governing minimum wages and work time issues. In the financial sector, in the wake of the banking panic of 1907, the Federal Reserve was established in 1913 to oversee the banking system. The Securities and Exchange Commission was established in 1933, in the wake of the crash of 1929, to ensure probity in financial markets. Finally, interstate commerce, which is governed by Article 1, Section 8, of the US Constitution, has been consistently interpreted in a manner that bars social dumping and a race to the bottom among states (Elmslie and Milberg, 1996).

The above institutional innovations were necessary for the creation of a vibrant national economy that generated prosperity on socially acceptable terms. In terms of Polanyi's (1944) analysis, they ensured that the economy was properly embedded in society. A similar argument can be applied to the global economy, with globalisation creating the need for new institutions to harness and manage the new conditions. These new institutions will not be the same, since integration is now taking place at the international rather than national level. However, the intellectual rationale remains the same.

One way of thinking about the problems posed by globalisation is that it is creating a 'leaky' economic environment (Palley, 1998A, 1998B) distinguished by three different types of leakiness. The first form of leakiness is *macroeconomic leakiness*. This refers to the tendency for demand to leak out of economies owing to increased international trade which raises the propensity to spend on imports. As a result, when economic activity expands, a greater amount of spending leaks out in the form of spending on imported goods and services produced in other countries. Analytically, increased leakiness corresponds to a reduction in the expenditure multiplier.[1] At the policy level, it may discourage governments from pursuing independent expansionary stabilisation programmes to combat domestic recessions. Evidence of increased macroeconomic leakiness is presented in Table 1, which shows how goods' market openness, defined as exports and imports as a share of GDP, has risen in almost every industrial country. For the US, this measure of openness has risen from 9·9% in 1966 to 24·9% in 1997, an increase of 152%.

A second form of leakiness is *microeconomic leakiness*. This refers to the tendency for jobs to leak out of economies to other countries if labour markets are not sufficiently flexible, real

[1] Having imports and exports grow at the same rate prevents the trade balance, measured as a share of GDP, from deteriorating. However, to the extent that imports and exports are growing as a share of GDP, the expenditure multiplier will decrease and macroeconomic leakiness will increase.

Table 1. *Openness of OECD countries, 1966–97. Openness=[Exports+Imports]/GDP*

Country	1966 (%)	1997 (%)	% Change 1966–97
US	9·9	24·9	151
Canada	39·1	78·7	101·3
Japan	19·4	21·0	8·25
Germany	51·1	49·8	-2·54
UK	37·8	57·3	51·6
France	25·0	49·4	97·6
Italy	28·1	46·3	64·8
Austria	51·4	85·0	65·4
Belgium	73·5	139·3	89·5
Denmark	58·5	68·7	17·4
Finland	41·3	70·8	71·4
Netherlands	89·8	104·0	15·8
Norway	83·2	75·5	-9·3
Portugal[a]	54·1	63·6	17·6
Spain	20·2	54·8	171
Sweden	43·8	80·6	83·9
Switzerland	58·7	74·9	27·6
G-7	23·4	36·2	54·7
Europe	40·3	58·9	46·2

Source: Author's calculations using IMF statistics. G-7 and Europe computed using population weights.
[a] 1996 data.

wages are too high or profit tax rates are relatively unfavourable compared with conditions in other countries. It is the result of reduced transportation costs for goods, combined with new technologies which facilitate production in multiple distant locations. It is also the result of policy which has swept away barriers between countries, thereby helping make it possible to increase profitability by shifting production between countries.

There is plenty of evidence documenting microeconomic leakiness. Bronfenbrenner (1997, 2000) presents extensive micro evidence of the use by US corporations in the1990s of the threat to close plants in union wage bargaining rounds and union organising campaigns. Holmes (1998) finds that the location of manufacturing industry in the US is responsive to state right-to-work laws which undermine the ability to form unions. Berik (2001) reports on the Pakistan soccer ball industry, which agreed not to employ child labour, only to find that soccer ball production moved to India. Jessup (1999) reports that, during the 1990s, the share of US foreign direct investment (FDI) going to developing democracies declined, and the share going to undemocratic developing economies increased. He suggests that firms intentionally redirected their FDI to take advantage of conditions in undemocratic countries. Burke (2000) provides evidence showing that US foreign direct investment in China results in an increase in US imports from China and a reduction in US exports to China as production gets reallocated. This claim is backed by Tonelson (2000) in a case study of US manufacturing firms. Tanzi (1996) documents the issues associated with tax competition. Based on US data, Papke (1991) finds that US state taxes only matter for new firm births in some industries, but cross-state cost variations matter for all industries. Rodrik (1997) provides cross-country macroeconomic evidence of international tax competition.

Finally, the third form of leakiness can be termed *financial leakiness*, and refers to the increase in the scale of flows of financial capital between countries. This increase in flows is

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the result of innovations in electronic communication and money transfer technology. It is also the result of policy changes that have abolished legal controls on international movements of capital. Increased financial leakiness has been at the heart of the recent debate over global financial instability, but it may also have had other effects on governments' ability to pursue autonomous national economic policies. This is because financial interests now have increased powers of veto over policies they dislike because they can more easily exit and vote with their feet. Eatwell (1996) documents the increase in financial leakiness. In 1980, foreign exchange (FX) trading averaged $80bn per day, and the ratio of FX trading to world trade was 10:1. By 1995, daily FX trading average $1260bn, and the ratio to world trade was 70:1.

All three forms of economic leakiness have affected the economic structure, and in so doing they have changed the pattern of incentives for both policy-makers and business. Policy-makers are now obliged to follow policies that conform more closely to the interests of business and finance for fear of triggering the displeasure of financial markets or giving business an incentive to move investment and production off-shore. Meanwhile, business and finance have an interest in playing countries off against each other as a way of gaining more favourable tax treatment and labour market rules, and reduced regulatory obligations. Moreover, all three forms of leakiness can interact synergistically. Thus, greater macroeconomic leakiness exposes countries to greater trade deficits over the course of business cycle expansions, and these deficits increase the likelihood of financial instability. Increased macroeconomic leakiness also compounds the problem of microeconomic leakiness by facilitating off-shore production imports.

Addressing the problems posed by these changed incentives requires new international cooperation and regulation that blocks off the inappropriate avenues of development that the new pattern of incentives promote, and CLS can be viewed in this light.

4. Dynamic economic efficiency and the case for labour standards

Labour standards potentially generate two types of economic efficiency gains—static efficiency gains and dynamic efficiency gains. The latter refer to gains that come from changing the path and pattern of economic growth.

4.1 Microeconomic dynamic efficiency gains

Microeconomic leakiness has two adverse consequences. First, it changes the pattern of incentives governing international trade. Without such leakiness, trade tends to be driven by market competition in goods, and results in a lowering of prices and an improvement in product quality. However, microeconomic leakiness can subtly change the pattern of incentives facing firms and prompt them to shift toward wage and workplace standards competition. This is because increased microeconomic leakiness enables firms to use the threat of job relocation to win wage and workplace concessions. This shift in the pattern of trade incentives is of course more pronounced in some industries than others, but the fact that it is operative is clearly evidenced by the increased use of such threats by US business after the passage of NAFTA (Bronfenbrenner, 1996). In an environment of microeconomic leakiness, trade is given a subtle tilt. Its negative distributional impact within developed countries is enhanced, while its positive impacts on real wages, productivity and improved quality of goods are diminished.[1]

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[1] The notion that trade might have significant distributional outcomes was first explored in a seminal paper by Stolper and Samuelson (1941). Their results were developed in the framework of the Hecksher–Ohlin model,

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Second, microeconomic leakiness creates what can generically be termed 'systems competition'. Economies are complex social systems that differ in the extent of social protections, workplace protections and environmental protections. These protections affect production costs and can diminish countries' international price competitiveness. Business therefore has a private incentive to get such protections repealed. It can do so by threatening to move, and it can also blame job losses on these costs, thereby unleashing a political dynamic for their repeal. This pattern of incentives can trigger a 'race to the bottom' in which countries compete standards down, and it partakes of the prisoner's dilemma shown in Figure 1. Each country has an incentive to gain a marginal competitive advantage by lowering standards. If a country lowers standards while another does not, it gains a higher payoff. The global payoff is highest when neither lower standards, and lowest when both lower standards. Owing to the pattern of private incentives, in the absence of binding labour standards, the global economy will only support the equilibrium in which both countries lower standards. Furthermore, the incentives to lower standards are likely to be exacerbated as international trade becomes a larger proportion of economic activity, because the payoff from obtaining competitive advantage is greater. This is suggestive of how macroeconomic leakiness can interact in an adverse synergistic fashion with microeconomic leakiness. Barring this process requires cooperative measures such as international labour standards that solve the prisoner's dilemma. Interestingly, there is a corporate parallel with labour standards concerning bribery, and preventing destructive bribery competition also requires standards.[1]

| | Country A | |
	Maintain Standards	Lower Standards
Maintain Standards	A. Core labor Standards (5,5)	B. (7,0)
Lower Standards	C. (0,7)	D. No Core Labor Standards (3,3)

(Country B labels the rows: Maintain Standards, Lower Standards)

Figure 1. *Systems competition as represented in terms of the prisoner's dilemma (x=country A payoff, y=country B payoff).*

which assumes perfectly competitive markets. However, it intuitively carries over to a more sophisticated world that incorporates bargaining power, with trade potentially altering the distribution of power in favour of business.

[1] The logic behind the need for labour standards to prevent systems competition is exactly analogous to that behind the need for rules to prevent tax competition and bribery. With regard to taxes, countries are trapped in a prisoner's dilemma that has them lowering taxes on capital incomes to attract investment. The net result is to either impoverish the 'fisc' or shift the burden of taxation on to labour incomes, with little gain in terms of global investment spending. With regard to bribery, each individual is better off if they alone bribe. However, when all bribe, the bribes cancel out and the economic system may even function less efficiently because of corruption. Individuals would therefore be better off with globally applied rules outlawing bribery.

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The pathological incentive structure that generates systems competition can clearly afflict developing countries. These countries risk being pushed away from 'high road' development on to a 'low road' path marked by a degraded environment, lack of workplace safety standards, lack of employee rights and absence of rights of free association and rights to bargain collectively. In effect, developing countries and the international economy lack the institutions that have proved essential to promoting high quality economic growth in the developed world.

Empirical detection of a global race to the bottom is at an early stage. Certainly, the evidence on microeconomic leakiness that was cited earlier bears on this issue. The empirical literature on an environmental race to the bottom, which partakes of an identical dynamic, already finds some instances (Mani and Wheeler, 1999; van Beers and and van den Bergh, 1997). However, one caution is that, in a dynamic world with income growth, the race to the bottom may be subtly altered, making it harder to detect—but no less present. Thus, if standards are a normal good, the race to the bottom will take the form of a slower rise in standards. Higher incomes will put upward pressure on standards, but competitive pressures from the prisoner's dilemma will exert downward pressure.

4.2 Macroeconomic dynamic efficiency gains

The role of labour standards in preventing a race to the bottom has garnered most attention. Yet, labour standards also have a vital role in promoting faster, more stable growth. Over the last two decades, developing countries have been increasingly pushed toward export-led growth. Though they have grown, they have grown slowly, and export-led growth has also created a dependence on markets in the developed world that replicates many of the problems of the earlier 'plantation' model of development.

By forcing countries to shift ever more of their output onto global markets, the export-led growth model aggravates the long-standing trend deterioration in developing country terms of trade. There is even a vicious cycle dimension to this problem, with declining terms of trade exacerbating the underlying problem of export-led growth. Thus, falling prices compel developing countries to export even more, thereby compounding the problem of falling prices. This vicious cycle has long been visible for producers of primary products. Now, as a result of the transfer of manufacturing capacity to developing countries who lack the capacity to buy their own output, it may also be present in all but highest-end manufacturing.

This vicious cycle also interacts with developing countries' debt service and repayment problems. These countries borrow in hard currency, and deteriorating terms of trade make it even harder for them to earn the currency needed to service their debts. This in turn forces them to export even more, thereby aggravating the underlying terms of trade problem.

Side-by-side with these negative developing country effects, the export-led growth model has also had negative impacts in the developed economies by causing job loss and wage competition. The addition of developing country capacity to existing global supply, without any commensurate increase in demand, inevitably leads to a situation of demand shortage and excess capacity. This inevitably generates pressures to cut wages and benefits in developed country labour markets as a means of saving jobs.

These features of export-led growth suggest that it is ultimately unsustainable and risks imparting a deflationary bias to the global economy. The unsustainability problem arises because, by definition, one country's exports are another's imports. Thus, whereas one country can successfully pursue an export-led strategy (as Japan did in the period 1950–80), all cannot because all cannot run trade surpluses. If all try to do so, the inevitable outcome is

a global shortage of demand, and such a condition is a reasonable characterisation of the recent global economic environment in which much of the world has been either in recession or growing below potential.

These theoretical arguments about export-led growth stand in stark contrast to the conventional empirical literature, which claims a positive association between growth and exports.[1] However, this existing literature does not disprove the export-led critique, since individual countries can grow under an export-led strategy, especially when only a few countries adopt the strategy. Problems only begin to emerge as more countries start to adopt the strategy. It is possible that the world economy may be reaching this stage, and empirical evidence to this effect is beginning to accumulate. Rodriguez and Rodrik (2000) provide evidence challenging some of the earlier claims about the beneficial impact of trade on growth, and argue that the positive associations come from using proxies for trade opening that incorporate other influences. Among developing countries, the pathologies of export-led growth reveal themselves in terms of declining terms of trade, the emergence of excess export capacity, and export-displacement between rival countries. The declining terms of trade problem represents an extension of the earlier Prebisch (1950) and Singer (1950) findings of declining commodity terms of trade. Sapsford and Singer (1998) report that recent studies confirm the Prebisch–Singer findings, and Sarkar and Singer (1991) report that there is evidence that the declining terms of trade phenomenon now extends to lower-end manufactures. Kaplinsky (1993) argues that there was creation of significant excess capacity in the Dominican and the Caribbean region, where countries targeted export-led development based on labour intensive textiles. Muscatelli *et al*. (1994) document large and statistically significant negative cross-price elasticities in the export demand functions of Asia's newly industrialised countries. Palley (2000A) examines exports to the US market and finds that China has significantly displaced exports from the four East Asian 'tiger' economies (Taiwan, South Korea, Hong Kong, Singapore), while Mexico has significantly displaced Japanese exports.

Lastly, the global demand problematic associated with export-led growth also has implications for the stability of global financial markets. For the foreseeable future, developing countries will continue to be net borrowers on global capital markets as they seek to industrialise. Yet, a global regime of export-led growth implies that sufficiency of demand will continue to be a problem, which implies that balance of payments and currency crises will remain a persistent danger. In such an environment, countries which find themselves short of demand will have an incentive to resort to currency depreciation as a means of gaining international competitive advantage. This threatens to revive the dangerous process of competitive devaluation that was so destructive in the 1930s.

The contradictions inherent in a global export-led growth regime compels a need to shift the stance of development toward a path of domestic demand-led growth. This requires rising wages to support domestic consumption. However, it is exactly this outcome that is blocked by the existing pattern of globalisation. Microeconomic leakiness, macroeconomic leakiness, financial leakiness and export-led growth combine to increase wage competition between developed and developing countries, and they tilt the economic playing field in favour of business at the expense of workers. A levelling of the economic playing field between business and labour is needed for, in the absence of such a levelling, labour will be unable to win the wages necessary to support domestic demand-led growth. The

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[1] Blecker (2000) reviews this literature. Studies reporting a positive association between country export growth and output growth include Belassa (1978, 1985), Michaely (1977), Sachs and Warner (1995) all. Chow (1978) and Darrat (1987) find, for the most part, significant causal effects of exports on growth.

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remedy lies in international labour standards which, by allowing for the formation of independent trade unions that bargain collectively, can ensure a recalibration of the system of income distribution. Such reasoning is tentatively supported by Rodrik (1999A), who finds that democracies systematically pay higher wages. Palley (2000B) qualifies this finding. Democracy and labour standards are positively correlated, but in wage and income distribution regressions containing both democracy and labour standards variables, only the latter is statistically significant. This makes sense from the standpoint of economic causality. Democracy may promote labour standards, but standards are the actual instrument of intervention in labour markets that changes outcomes.

The argument that the global economy needs labour standards and independent trade unions to solve the twin problems of global demand shortage and dysfunctional distribution of income is likely to sit uncomfortably with economists schooled in the economics of perfectly competitive factor markets. This is because Say's Law denies the problem of demand shortage by claiming that every act of production generates sufficient income to purchase supply. And trade unions, instead of being seen as a good, are represented as a market distortion that reduces output and employment. However, this characterisation rests on the unrealistic assumptions of perfectly competitive market theory in which agents have 'no power'. Such assumptions are at odds with the realities of labour exchange, which is quintessentially related to power relations. From this perspective, rather than being a market distortion, independent trade unions are a corrective to market failure—namely, extreme imbalance of power in labour markets. They represent the private sector solution to this market failure, and are superior to a solution of governmentally imposed distribution of income.

4.3 Political economy dynamic efficiency gains

A final source of dynamic efficiency gains concerns the positive political economy effect of CLS on domestic governance. The importance of governance for economic growth and development is being increasingly recognised, as evidenced in a recent IMF conference (November, 1999) entitled 'Second Generation Reforms'. The IMF now recognises that market liberalisation and macroeconomic stabilisation policies are insufficient, and that policy must also promote sound governance.

The emergence of this new perspective stems in part from the IMF's diagnosis of the causes of east Asia's economic collapse, which emphasised economic cronyism and the misallocation of borrowed resources. Initially, the IMF proposed remedying this problem by increasing financial transparency and expanding international financial openness. This prescription rested on the assertion that increased openness would increase market discipline which would correct the problem. However, economic cronyism is ultimately politically sponsored so that market discipline is insufficient to solve the problem. Instead, eliminating it requires political change based on the development of democratic countervailing power that can block cronyistic behaviour. Labour standards and independent trade unions accomplish just this.

The problem of cronyism resonates with the new emphasis on the necessity of good economic governance for development. The importance of good governance has been recognised by the IMF's Interim Committee, which has declared that 'promoting good governance, including the rule of law, improving the efficiency and accountability of the public sector, and tackling corruption' (*Partnership for Sustainable Global Growth*, 29 September, 1996) are essential elements of a framework for economic prosperity. Core labour standards fit within this paradigm since the right of freedom of association promotes political competition.

Finally, the political institutions promoted by core labour standards may also promote economic stability and give countries the ability to deal with economic crises. This is suggested by comparing South Korea and Indonesia in the wake of the recent east Asian financial crisis. Though by no means perfect, South Korea had begun to put in place democratic institutions, including independent trade unions. When the crisis hit, these institutions provided a framework for crafting a national recovery policy, and they also prevented the emergence of a political vacuum that would have caused further economic collapse. This contrasts with Indonesia which lacked such institutions, and the resulting political vacuum caused by the crisis created total economic breakdown. Institutions matter enormously for the ability to deal with economic shocks. Without appropriate institutions, there can easily develop a vicious cycle marked by destabilising feedback between political crisis and economic crisis. Labour standards can help foster institutions that prevent this outcome. The empirical literature studying such propositions is in its infancy, but work reported by Rodrik (1999) supports these claims. Thus, Rodrik finds that democracies tend to exhibit less volatility in economic performance, have greater resilience in the face of economic shocks, and have a more equal distribution of income.

5. Static economic efficiency and the case for labour standards

The above dynamic economic efficiency arguments can be supplemented by conventional static economic efficiency arguments. Such arguments have been explored by Maskus (1997), who argues that CLS can reduce domestic labour market distortions (inappropriate child labour, discrimination and monopsony power), thereby increasing economic efficiency, output and societal well-being.

With regard to inappropriate child labour, this results in excessive provision of labour, which results in excessive sub-optimal employment and output. Imposing child labour standards should reduce employment and output. Society as a whole can gain if the reduction in child labour supplies raises the general level of wages, thereby enabling parents to support lengthened years of schooling which raise future output. Over the medium term, this should also generate significant dynamic economic efficiencies, since human capital acquisition is the key to good development, and having children in school promotes such capital acquisition.

With regard to discrimination, this results in below optimal employment and output, and there may also be a mismatch of skills and jobs because some individuals who are discriminated against are inappropriately excluded from jobs. Reducing discrimination should therefore improve economic efficiency and raise employment and output.

If labour markets are characterised by monopsony, then the level of employment and output will be below the perfectly competitive Pareto optimal level. In this situation, rights of freedom of association and collective bargaining that give rise to the formation of unions can help correct this condition if this pushes wages up and generates a movement along the labour supply curve that increases employment. That labour markets may indeed be characterised by monopsony power is evidenced by a recent empirical study of the US labour market for nurses by Staiger *et al.* (1999), but whether this generalises to developing country labour markets remains an open empirical question.

Lastly, raising wages through labour standards can have beneficial efficiency wage productivity effects by reducing malnutrition and thereby increasing the productivity associated with a given level of worker effort (Liebenstein, 1957; Stiglitz, 1976; Altman, 2001).

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Maskus (1997) concludes that core labour standards can yield static economic efficiency gains in developing countries, but he qualifies his conclusions in two controversial ways. First, he challenges the claim that labour standards will benefit workers in developed countries. Static efficiency gains will increase employment and output in developing countries, but this will lead to an increase in exports and a fall in the price of tradable goods that reduces real wages and employment of workers in tradable goods industries in developed countries. Second, formation of independent trade unions could lead to wages being pushed above their perfectly competitive level, and if pushed high enough could reduce employment. In effect, the distortion of employer monopsony power could be replaced by the distortion of union monopoly power.

The suggestion that developed country workers might lose is unusual, and reverses the standard claim that the push for labour standards by developed country workers is protectionist. However, incentive theory says it would be illogical for such workers to push such a policy, and this suggests that there is something wrong with the Maskus claim that they will lose.

To the extent that CLS generate employment and output gains in the non-tradable goods sector, there are clearly no adverse implications for workers in developed countries. More-over, through their impact on wages and income distribution, CLS should have large income effects in developing economies that can prevent any output gains in the tradable goods sector being shunted onto world export markets. The elimination of discrimination and the granting of collective bargaining rights can be expected to raise wages and redistribute income away from profit. If the marginal propensity to consume out of wage income exceeds that out of profit income, such a redistribution would increase domestic absorption.[1] The additional output generated by the adoption of CLS would therefore be consumed within the economy rather than being shunted onto export markets, and exports could even fall from initial levels if increased domestic absorption caused output to be withdrawn from export markets. Were this to happen, import competition from developing countries would fall, thereby raising employment and wages in developed countries. This illustrates the potential 'win–win' character of CLS for workers in both developed and developing economies, and it is consistent with the dynamic economic efficiency critique of export-led growth.

A second problem with the conventional microeconomic analysis of CLS is the descrip-tion of unions in terms of the monopoly union model. This implies that granting workers the right of free association and collective bargaining merely replaces one labour market distortion (employers' monopsony power) with another (monopoly unions), and fails to capture the true economic efficiency rationale for rights of free association and collective bargaining. An alternative representation of unions has them raising productivity by giving workers a voice and stake within firms. This productivity impact can be understood through a monopsonistic efficiency wage model, a formal version of which is presented in the Appendix. Labour markets outside the firm are competitive. However, labour markets within the firm are monopsonistic. Having accepted a job, workers must deal with their employer who has some degree of market power because it is costly for workers to quit and find new jobs. Firms will therefore have a tendency to exploit this situation, knowing that workers have difficulty moving. Though this strategy maximises profits for the firm, it reduces the provision of effort by workers and labour productivity, employment and output are all lower. By increasing wages, unions can give workers a greater stake in the firm and

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[1] The reasons why there is a higher marginal propensity to consume out of wage income are detailed in Palley (1997).

improve their sense of fair treatment. This in turn induces greater provision of effort, raises the productivity of labour, and gives firms an incentive to create more jobs. Employment and output therefore both rise. Moreover, once again there need be no necessary adverse impact on workers in developed countries if higher developing country wages stimulate domestic consumption and absorption.

6. Conclusion

This paper has presented the theoretical case for core international labour standards. It is important to recognise that the efficiency gains associated with labour standards cannot be realised by competitive markets. Firms' profits are larger when they can discriminate and exploit workers, and firms therefore have a private incentive to prevent the realisation of the static efficiency gains. The realisation of dynamic efficiency gains is blocked by the prisoner's dilemma structure, which gives all agents an incentive to pursue actions privately that result in a sub-optimal outcome. Consequently, the only way to realise these gains is through official intervention that makes CLS the globally applied 'rules of the game'.

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Appendix

This Appendix provides a simple efficiency wage model of a firm which faces competitive product and 'outside' labour markets, but has monopsonistic power with regard to 'inside' labour markets. Firms purchase effort from employed workers by paying efficiency wages. Because it is costly for workers to move between firms, they have some power regarding the setting of efficiency wages. The representative firm's profit maximisation program is given by:

$$\underset{w,L}{\text{Max}}\, V = y - wL \tag{A1}$$

subject to

$$y = f(E, L)\, f_E > 0, f_{EE} < 0, f_L > 0, f_{LL} < 0 \tag{A2}$$

$$f_{EL} = f_{LE} > 0$$

$$E = E(w)\, E_w > 0, E_{ww} < 0 \tag{A3}$$

where V is profits, y is output, w is real wage, L is employment, and E is effort. The function $f(E, L)$ is the production function, and the function $E(w)$ is the effort supply function.

The first order conditions are:

$$f_E E_w = L \tag{A4}$$

$$f_L = w \tag{A5}$$

The distortionary effect of monopsonistic power is illustrated in Figure A1. This figure shows the marginal product of effort, the effort supply schedule, and the marginal cost of effort. The
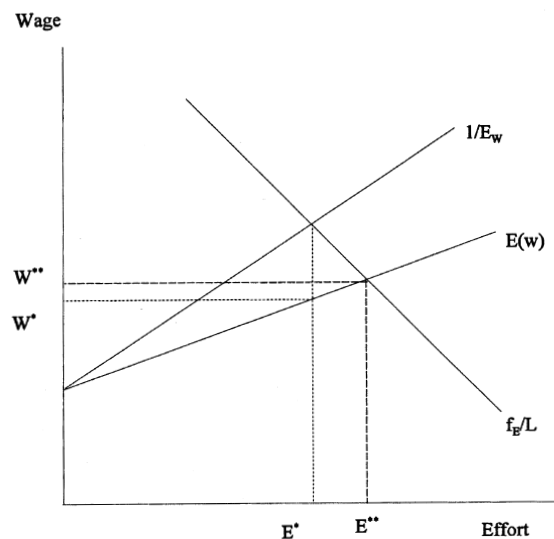

Figure A1. *Determination of wage–effort combination under monopsonistic and non-monopsonistic labour market conditions.*

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monopsonistic firm sets the wage equal to $w^\star$ and purchases $E^\star$ effort. If the firm had no monopsonistic power, it would set the wage equal to $w^{\star\star}$ and purchase $E^{\star\star}$ of effort. With higher effort levels, output would be higher. The marginal product of labour would also be higher, which would give firms an incentive to hire more workers.

Granting workers rights of free association and collective bargaining can offset firms' 'inside' labour market monopsonistic power, thereby raising wages, employment and output in developing countries.