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Trade policy, cross-border externalities and lobbies: do linked agreements enforce more cooperative outcomes?

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Abstract

We analyze whether linking international cooperation in trade policy to environmental policy (or other issues with nonpecuniary externalities) promotes more cooperation in both policies, or whether cooperation in one is strengthened at the expense of the other. In the context of self-enforcing agreements, we show that if the policies are independent in the government's objective function, then linkage promotes cooperation in one policy at the expense of the policy that is easier to enforce under no-linkage. However, if the linked policies are not independent and if these policies are strategic complements, then linkage can sustain more cooperation in both issues than no-linkage. The policies are strategic complements only if (i) the production externality has cross-border effects; (ii) the weight on the externality cost is high; (iii) import competing lobbies are not "powerful".
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1. Introduction

In trade policy agreements, trade concessions are increasingly made conditional on cooperation in nontrade issues, what is known as "linkage". This trend is clear in

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multilateral, bilateral, and regional trade agreements. Multilaterally, compliance with intellectual property rights is now enforced through the threat of import barriers, sanctioned by the World Trade Organization (WTO).[1] Moreover, the trend to link will surely intensify. At the end of the last multilateral trade liberalization round, a long list of issues was proposed for similar treatment by the WTO including investment and competition policy, as well as labor and environmental standards. Therefore, linkage has become one of the most important and contentious issues in trade policy.[2]

Perhaps the most obvious role of linkage in agreements is not as an enforcement tool but rather as a side payment. If cooperation on an individual issue benefits country A but hurts B, then the agreement requires either a transfer to B or cooperation in a different issue that benefits B. The use of linkage as a side payment when there are asymmetric benefits across countries is important in the case of regional trade agreements between large and small countries (Abrego et al., 2001 and Limão, 2002b), and it has also been analyzed in the context of environmental agreements (Cesar and de Zewe, 1996).[3]

Despite the prominence of linkage in policy debates, there is little theoretical support for it in terms of its impact on enforcement. The majority of work in the trade literature focuses on static standard trade models to examine what is the impact of harmonizing labor or environmental standards on factor and goods prices or welfare for different countries and economic agents.[4] In this context, one of the most frequent objections to linkage, arising from the optimal policy targeting literature, is that "trade policy measures are usually not the best instruments for achieving social objectives" (Anderson, 1998, p. 244). However, we argue that the important policy question behind linkage is whether the threat of tariffs is effective in *enforcing* more cooperation in another agreement and vice versa. This question cannot be addressed by the targeting literature, which has no basic predictions regarding enforcement.

To explain the motivation and consequences of linkage from an enforcement perspective, we must first understand two key features of international cooperative agreements. First, one of their main objectives is to internalize the costs of countries' actions. When countries impose tariffs, they do not internalize any costs this may have

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[1] Bilaterally, the United States and the EU attach investment, environmental and labor clauses to trade preferences given to developing countries via the Generalized System of Preferences. Regionally, NAFTA includes an environmental and a labor agreement.

[2] Including nontrade clauses in trade agreements is not an entirely new phenomenon (Charnovitz, 1998). The main difference is the willingness to enforce those clauses and the availability of effective mechanisms to do so such as the dispute settlement system of the WTO. Certain multilateral environmental agreements such as the Montreal Protocol on CFCs include the threat of trade restrictions in response to noncompliance. However, some of these measures are inconsistent with GATT rules and therefore according to the European Commission "...problems could arise if a country imposed a trade measure for environmental purposes on another WTO member which had not signed the multilateral environmental agreement. The EU wants WTO members to agree that this should not be allowed to happen"<http://trade.info.cec.int/europa/2001newround>.

[3] See also Horstmann et al. (2001) for the effects of linkage in the context of Nash bargaining. Conconi and Perroni (2000) use a cooperative approach to study the effect of linkage on blocking coalitions in a three-country model. For an early analysis of linkage in the political science literature, see Sebenius (1983).

[4] See, for example, Esty (1994) and the volumes edited by Bhagwati and Hudec (1996) and Anderson and Blackhurst (1992).