Cordell Hull Institute

Trade Policy Analyses

Vol. 3, No. 10 December 2001

The Cordell Hull Institute held a one-day Trade Policy Roundtable on December 4, 2001 to discuss strengthening the ILO's role in promoting core labor standards.

The meeting was held at Arnold & Porter, attorneys-at-law in Washington, DC. Pictured above is the well of the firms building.

Following the meeting, **Kenneth Heydon** (above) questioned: "Is China profiting from its low labor standards?" The text is reproduced opposite.

About the Author

Kenneth Heydon is the Deputy Director of the OECD Trade Directorate.

Kenneth Heydon is a former a Deputy Director-General (Economic) at the Office of National

XXXXXXXXXXXXXXXXX...

Is China Profiting from its Low Labor Standards?

Kenneth Heydon

THE QUESTION of trade and labor standards was removed as a potential deal-breaker well before the Ministerial Conference of the World Trade Organization (WTO) that launched the Doha Round negotiations in November 2001.[1] The reference to the trade-and-labor issue in the Doha Ministerial Declaration is very low key:

> "We reaffirm our declaration made at the Singapore Ministerial Conference regarding internationally recognized core labor standards. We take note of work under way in the International Labor Organization (ILO) on the social dimension of globalization."

But the issue has not been totally defused by any means. Developments related to China alone will guarantee that. Given continuing concerns about China's apparent failure to comply with some core labor standards, developments following China's accession to the WTO are likely to be closely watched.

Findings of OECD 2000 Study

This chapter reviews recent findings of studies in the Organization for Economic Cooperation and Development (OECD) on the general relationship between core labor standards and trade. It then moves to examine the particular case of China.

The OECD sought to do some bridge-building on this issue and in 2000 published a number of key conclusions. There are many positives in these findings.

1. The international community has made significant progress in developing a consensus with respect to the definition and recognition of a small set of core labor standards. A milestone came in June 1998 with the adoption of the ILO Declaration on Fundamental Principles and Rights at Work (see Appendix 2),

Assessments (1990-99) in the Government of Australia.

He was also Principal Private Sectary to the Prime Minister (1976-78).

About the Meeting

In November 2001, the International Labor Organization approved the establishment of a World Commission on the Social Dimension of Globalization, but its Director-General was requested to consult further on the Commission's parameters, terms of reference and membership.

To discuss the trade-related aspects of the ILO initiative, the Cordell Hull Institute convened in Washington on December 4 a roundtable meeting of specialists on trade, labor and development. Thirty five participated in the meeting where several presentations were made on the question of enforceable labor standards in trade agreements.

Other Speakers

The speakers at the meeting included: **William D. Rogers**, Partner, Arnold & Porter, and Vice Chairman, Kissinger Associates, Washington, DC; **Daniel W. Drezner**, assistant professor of political science, University of Chicago, Illinois; **Jagdish Bhagwati**, Columbia University, New York, NY and Council on Foreign Relations, New York, NY; **Jeffrey Lang**, Partner, Wilmer Cutler & Pickering, Washington, DC, former Deputy U.S. Trade Representative; **Herwig Schlogl**, Deputy Secretary-General of the OECD, Paris, France.

Other speakers were **Gary N. Horlick**, Partner, O'Melveny & Myers, and Georgetown University,

which succinctly stated four principles, committed the ILO's member countries to respect them and stressed that labor standards are not to be used for protectionist trade purposes. These principles and rights include (i) freedom of association and collective bargaining, (ii) the elimination of all forms of forced or compulsory labor, (iii) the effective abolition of child labor and (iv) the elimination of discrimination in respect of employment.

2. These principles and rights are "operationalized" in the ILO's eight fundamental conventions. Since October 1995, the number of countries that have ratified all seven of the original fundamental ILO conventions has more than doubled. The new fundamental convention on the worst forms of child labor has experienced a rapid pace of ratification. Although the country coverage of ratification is extensive, follow-up is still required to improve monitoring and to include non-ratifying countries. And – although there has been some improvement – there remain substantial gaps between the ratification of the fundamental conventions and the application of principles in practice.

3. There is some evidence of a positive interrelationship between respect for core labor standards and economic development. Countries that strengthen their core labor standards can increase economic efficiency by raising the level of skills in the workforce and by creating an environment that encourages innovation and higher productivity. And countries that develop democratic institutions – here taken to include core labor rights – before the transition to trade liberalization will weather the transition with smaller adverse consequences than countries without such institutions.

4. Recent studies suggesting a negative relationship between observance of labor standards and trade performance do not challenge the OECD finding that countries with low core labor standards do not enjoy better export performance than high-standard countries because these recent studies focus on labor standards generally and not on *core* labor standards. This distinction is crucial for analytical purposes because core and non-core labor standards are expected to have different, and often opposite, effects on economic outcomes.

5. A number of recent studies point out that there are major constraints on a "race to the bottom" in labor standards. Any firm that attempts to gain a competitive advantage by cutting benefits without paying increased money wages is essentially trying to cut wages below the workers' marginal value product. In competitive markets, pressure from other employers will ultimately force the firm to return the total compensation package to the original level if the firm expects to be able to hire workers. But where such competitive pressures are weak the outcome may be different. Often there are costs to search, to finding out what wages other firms are offering, and even greater costs associated with moving

Washington, DC; **Gerard Depayre**, Deputy Head of Mission, Delegation of the European Commission, former Deputy Director-General of External Relations, European Commission; **John M. Weekes**, Chairman, Global Trade Practice, APCO Worldwide, Geneva, former Canadian Ambassador to the WTO, and Chairman of the WTO General Council.

Trade Policy Roundtable

The Cordell Hull Institute's Trade Policy Roundtable is sponsored by seven international law firms in Washington, DC: Akin Gump Strauss Hauer & Feld, Arnold & Porter, Hogan & Hartson, O'Melveny & Myers, Sidley Austin Brown & Wood, Steptoe & Johnson and Wilmer Cutler Pickering Hale & Dorr.

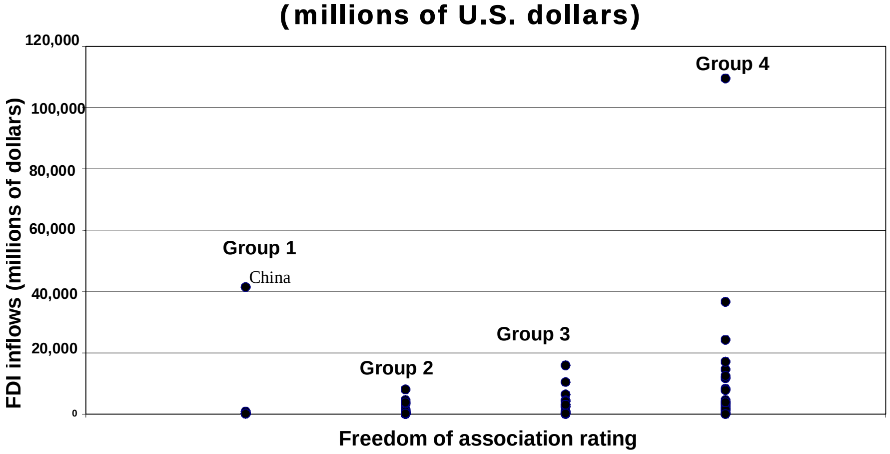
from one employer to another. Again it should be recalled, however, that insofar as discussions of a "race to the bottom" focuses on wage levels, they are not relevant to the question of core labor standards.

6. As far as investment is concerned, recent FDI data confirm that multinational enterprises invest principally in the largest, richest and most dynamic markets. Generally, countries where core labor standards are not respected continue to receive a very small share of global investment flows. There is no robust evidence that low-standard countries provide a haven for foreign firms.

China: a Special Case?

There is, though, a major and striking exception to this observation about investment flows. China, a country with a very poor record of recognition and compliance with core labor standards, is a major beneficiary of inward FDI (see Chart 8.1). China has only ratified two of the ILO's fundamental conventions (*i.e.* those relating to equal remuneration and minimum age).[2] Observers cite numerous abuses, including the lack of freedom of association, which limits worker voice concerning issues in other areas. The U.S. Department of State's country reports on human rights practices cite numerous problems, for example those related to forced labor, particularly in penal institutions.

Chart 8.1: Freedom of Association and Inflows of Foreign Direct Investment[3] (millions of U.S. dollars)



Moreover, there are several hundred export-processing zones (EPZs) operating in China. In some countries, particular labor problems (such as poor enforcement of labor rights) have been associated with enclave zones. China has used an alternative approach to enclaves by declaring whole cities, districts or, in one case, a province – Hainan Island – to be special economic zones. The conditions in these zones generally reflect the difficult labor situation found elsewhere in the country. In some cases, foreign investors apparently are able to bypass labor regulations and discourage strikes and work stoppages in collaboration with the official All China Federation of Trade Unions.

With WTO accession, these characteristics are likely to attract even more attention; some studies estimate that China's accession will boost FDI inflows more than two-fold in the medium term.[4]

In an interesting twist to the trade-and-labor debate, these observations about China, together with the suggestion that as a WTO member China will be more susceptible to peer pressure and WTO disciplines, are being used by organized labor to justify a major WTO role in this area.

So is China's poor record on core labor standards making it a haven for foreign direct investment? A number of factors cast considerable doubt on this suggestion.

First, the investment haven proposition does not seem to tally with investors' motivations. A recent survey of several hundred managers of multinational enterprises (67 percent of respondents) and international experts (33 percent of respondents) provided scores of 0 to 5, not important to very important, for thirteen FDI location criteria.[5] The results are shown in Table 8.1, ranking the criteria in order of importance, most to least, with scores given in parenthesis. "Cost of Labor" is well down the list. Moreover, as pointed out by David Kucera of the ILO's International Institute for Labor Studies,[6] these survey results suggest that if stronger worker rights are associated not only with higher labor costs (a negative for FDI) but also with greater stability and higher quality of labor (positives for FDI) the positive effects may well offset the negative. There is no reason to believe, *a priori*, that these broad findings and observations would not apply to China.

Table 8.1: Criteria on the Location of Foreign Direct Investment[7]

	Criteria	Importance low (0) to high (5)
1.	Growth of market	4.2
2.	Size of market	4.1
3.	Profit perspectives	4.0
4.	Political and social stability	3.3
5.	Quality of labor	3.0
6.	Legal and regulatory environment	3.0
7.	Quality of infrastructure	2.9
8.	Manufacturing and services environment	2.9
9.	Cost of labor	2.4
10.	Access to high technologies	2.3
11.	Fear of protectionism	2.2
12.	Access to financial resources	2.0
13.	Access to raw materials	2.0

Second, international businesses increasingly employ voluntary codes of conduct and guidelines such as the OECD Guidelines for Multinational Enterprises. Consequently, the practices of such global firms – across their operations – tend to conform to the requirements of core labor standards.

Third, the story on export-processing zones is a nuanced one. Wages in EPZs tend to be higher than average wages in the rest of the economy. And increasing international competition is changing the priorities for foreign investors who tend to favor investment locations with highly skilled workers and modern infrastructure. "Smart" EPZs have developed strategies to ensure that labor productivity is continuously upgraded. FDI data for China for the period 1987-1997 shows that the capital intensity of EPZ projects has increased significantly.[8] This in fact is an evolving pattern seen more broadly in respect of FDI inflows into China. During the 1980s inflows concentrated on labor-intensive industries, moving towards more capital-intensive activities in the early 1990s. In recent years, technology-intensive industries have been attracting progressively more FDI.[9] This prominence of FDI in technology-intensive industries is reflected in China's trade, with exports of high and new technology products by foreign affiliates increasing from US$4.5 billion in 1996 to US$29.8 billion in 2000.

Finally, WTO accession will expand opportunities for FDI in China by opening service industries previously largely closed to foreigners, such as telecommunications and financial services.[10] These are activities focused on the domestic market, and are therefore unlikely to attract a foreign investor in search of cheap labor as part of a strategy to compete internationally. Thus one would not expect such sectors to be prone to the abuse of core labor standards motivated by such intentions.

Textiles: a Special Sector?

One major beneficiary sector in China from WTO accession is likely to be the textile industry, which could double its output after the Multi-fiber Arrangement regulating world textile trade is eliminated in 2005.[11] If China overall is not a special case, could textiles in China be a special sector? One element of China's comparative advantage in textiles production stems from an abundance of low-cost workers in a highly labor-intensive industry. It is not clear to what extent poor compliance with labor standards contributes to this situation, but here again it is likely that any substantial core labor abuses will ultimately harm productivity growth and drive away international investors and distributors preoccupied with their image *vis-à-vis* consumers.

A potentially critical area is child labor – but in fact only a very small minority of child laborers is employed in the manufacturing and tradable sectors – internationally, only about 5 percent of child labor appears to be so employed. Kucera therefore finds that more child labor is not associated with lower labor costs at the macro-economic level. One assessment published in the *China Labor Bulletin* notes that according to the available evidence, the situation of children in the labor market in China is not much different from that in other developing countries: it is primarily associated with production for domestic consumption.[12]

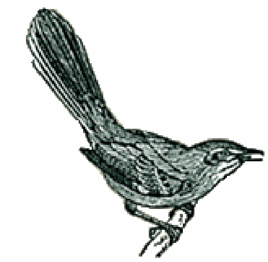
And even in those cases where more child labor does lead to lower labor costs in an export sector it does not appear that trade sanctions are an appropriate response. Turning again to the findings of recent OECD work in this area.

To the extent wage costs are a consideration, it is important to recall that they are primarily associated with labor productivity and relative wages in the economy. Wages in developing countries tend to be low, because worker productivity is low.[13] Low wage costs alone will not guarantee export competitiveness.

Let's assume though that some governments may wish to proceed with export sanctions. Some recent literature suggests that governments of countries in which children are employed may choose to change their laws rather than bear the cost of trade sanctions. It is also suggested that, in certain circumstances, a ban on child labor may be effective in shifting the economy into an equilibrium where adult wages are high and children do not work.[14] This could apply to countries with relatively high labor productivity that are able to support all their children without sending any to work. But the literature also suggests that, in very poor countries, a ban may worsen the condition of households. Moreover, a ban on the import of goods that have used child labor as an input might drive child labor out of export industries and into the informal sector, which is a major employer of child workers in such countries.

Recent analysis, drawing on experience in Brazil and Mexico, suggests that a subsidy to families to keep their children in school is likely to be a superior policy, to trade interventions, for example, in terms of curbing child labor. Trade interventions are not an optimal instrument to abolish exploitative child labor and expand human capital formation.

Finally, and perhaps most importantly, social conditions in China are not static. During the 1990s, real per capita income in China increased at an annual rate of 6.2 per cent. Expanded trade and FDI inflows no doubt contributed to the improvement. Moreover, globalization as embodied in these trade and investment flows seems to be a factor in ensuring that these benefits are widely spread. Recent research suggests that cities in China that experience a greater degree of openness in trade also tend to demonstrate a greater decline in income inequality between those cities and the adjacent rural countries which they administer. Globalization has helped reduce, rather than increase, urban-rural



The **mockingbird** is the state bird of Tennessee. Cordell Hull represented a district of Tennessee in the Congress of the United States, and was elected a senator from there, before becoming U.S. Secretary of State (1933-44).

"The mockingbird is known for fighting for the protection of his home – falling, if need be, in its defense. Mockingbirds are not intimidated by animals larger than themselves and have been known to attack eagles"
– Diana Wells, *100 Birds and How They Got Their Names* (Chapel Hill, NC: Algonquin, 2002)

Trade Policy Analyses

Papers in the online series, *Trade Policy Analyses*, are published by the Cordell Hull Institute, which is a non-profit organization incorporated in Washington, DC, and is tax exempt under Section 501(c)(3) of the Internal Revenue Code.

The Institute's purpose is

to promote independent analysis and public discussion of issues in international economic relations.

The interpretations and conclusions in its publications are those of their respective authors and do not purport to represent those of the Institute which, having general terms of reference, does not represent a consensus of opinion on any particular issue.

income inequality.[15] Progress is also being made in the field of education. In 1999, 99 percent of all rural and urban children aged 6-11 were enrolled in the six-year primary education system – improvement in primary school enrolment probably suggests that there is less child labor.[16]

Conclusion

Low compliance with core labor standards does not appear to afford China an advantage in terms of international trade and investment. The available evidence would seem to indicate that other factors are the primary drivers in the attractiveness of a country to foreign investors. This also applies to the growing inward investment in China, which is likely to be driven largely by factors such as the scale and dynamics of China's domestic market.

This is not to diminish concerns about the seriousness of abuse of core labor standards in China. This issue can and should be addressed using appropriate means. Trade interventions are not an optimal way forward. Instead, efforts should be redoubled by using newly enhanced monitoring, supervisory and promotional mechanisms (such as those available via the ILO, including its 1998 Declaration on Fundamental Principles and Rights at Work).

---

1 The views in this note are those of the author and do not necessarily correspond to those of the Organization for Economic Cooperation and Development (OECD) or its member countries.

2. The United States, as well, has only ratified two of these conventions (forced labor and worst forms of child labor), but its domestic legislation and practise are generally consistent with ILO core labor standards.

3 Notes: The correlation coefficient between the country rankings and levels of FDI inflows is 0.2, i.e. showing a small positive correlation between FDI inflows and respect for freedom-of-association.

The country groupings are composed as follows:

Group 1: China, Egypt, Iran, Kuwait, Syria and Tanzania.

Group 2: Bangladesh, Bolivia, Botswana, Chinese Taipei, Colombia, Guatemala, Haiti, Honduras, Indonesia, Jordan, Kenya, Malaysia, Mauritius, Morocco, Pakistan, Panama, Philippines, Singapore, Sri Lanka, Swaziland, Thailand, Uruguay and Zimbabwe.

Group 3: Argentina, Brazil, Chile, Ecuador, Ethiopia, Fiji, Hong Kong-China, India, Jamaica, Korea, Mexico, Niger, Papua New Guinea, Peru, South Africa, Turkey, Venezuela and Zambia.

Group 4: Australia, Austria, Bahamas, Barbados, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Luxembourg, Malta, the Netherlands, New Zealand, Norway, Poland, Portugal, Spain, Suriname, Sweden, Switzerland, the United Kingdom and the United States.

Data Sources: OECD Secretariat and UNCTAD Secretariat (1999).

4. See, for example, *World Investment Report 2000: Cross-Border Mergers and Acquisitions and Development* (Geneva: UNCTAD Secretariat, 2000).

5. Fabrice Hatem, *International Investment: Towards the Year 2001* (New York: United Nations, 1997).

6. David Kucera, "Core Labour Standards and Foreign Direct Investment", *International Labour Review*, Geneva, Vol. 121, Nos 1-2, 2002. .

[7] Fabrice Hatem, *International Investment: Towards the Year 2000* (New York: United Nations, 1997).

8. *Labour and Social Issues Relating to Export Processing Zones* (Geneva: International Labour Office, 1998).

9. *World Investment Report 2001: Promoting Linkages* (Geneva: UNCTAD Secretariat, 2001.

10. *Economic Outlook*, preliminary edition, OECD Secretariat, Paris, November 2001.

11. See Fan Zhai and Shanton Li, *The Implications of China's Accession to the WTO on China's Economy* (Beijing: Development Research Centre, State Council, 2000).

12. "Child Labour in China", *China Labour Bulletin*, Beijing, No. 57, November-December 2000.

13. Drusilla K. Brown, *International Trade and Core Labour Standards: a Survey of the Recent Literature*, Labour Market and Social Policy Occasional Papers No. 43 (Paris: OECD Secretariat, 2000), revised and updated in Chapter 5 below.

14 . Kaushik Basu and Phan-Hoang Van, "The Economics of Child Labour", *The American Economic Review*, Nashville, TN, Vol. 88, No. 3, June 1998.

15. Shang-Jin Wei and Yi Wu, *Globalization and Inequality: Evidence from Within China*, Working Paper No. 8611 (Cambridge, MA: National Bureau of Economic Research, 2001).

16. "Problems of Labour Market and Social Benefit Policies", CCNM/CHINA(2001)18 and CCNM/CHINA/TAB(2001)18, OECD Secretariat, Paris, 2001.