PART I

Optimal regulation and international trade law – theory

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Introduction to Part I

Part I develops an analytical framework to understand (i) how to define optimal regulation; (ii) how governments ought to choose optimal levels of regulation for the societies they preside over; (iii) under which conditions governments are prone to deviate from optimal levels of regulation; and (iv) finally when and why such deviations from optimality ought to be of concern to international trade law.

Throughout the text the following definitions apply. 'Regulation' is understood as 'all forms of governmental action that direct or encourage behaviour which (it is assumed) would not occur without such intervention'.[1] The usual instruments deployed to attain such ends are laws, executive orders and other enforceable governmental acts. Although the following remarks are in principle – i.e. adjustments have to be made in individual instances – applicable to all types of regulation, the focus will be on 'social regulation' as opposed to 'economic regulation'. The former denotes regulation that deals with matters such health and safety, environmental and consumer protection. The latter applies primarily to industries with monopolistic tendencies, such as gas, water and electricity markets, and aims at substituting the outcome of a hypothetical competitive process by means of regulation.[2]

The terms 'protection' or 'safety' more generally will be used synonymously in the sense that a societal value is kept safe from harm. In the context of social regulation, the level of regulation denotes the amount or degree of harm, be it to human beings, animals, the environment or other things people value, which governments are willing to accept; usually as part of a trade-off for some sort of benefit. Examples are product safety laws, food quarantine measures or laws regulating the use of genetically modified crops, to name just a few.

Under WTO law, each state's sovereign right to choose its own level of regulation is called the 'appropriate level of protection' (ALOP) or

[1] Ogus, *Regulation*, 1–2. [2] *Ibid.*, 4–5.

'acceptable risk'. The notion and implications of the ALOP, is key for understanding the controversies on the delimitation between WTO members' regulatory autonomy[3] and the realm of WTO law. Although WTO members maintain full control over the setting of their level of regulation, the instruments they employ to implement these levels of regulation are subject to a plethora of disciplines under the covered agreements. This leads to tensions because the boundaries between the ALOP and the measures necessary to implement it are blurred at times. At face value, the WTO judiciary may accept a member states' ALOP, but then discards the implementing measure. Is the ALOP in such cases indeed 'off limits' for the WTO judiciary? What if the measure at issue was the only measure available to achieve the desired ALOP?

The ALOP is moreover at centre stage of the policy, economic and legal debate in WTO disputes concerning WTO members' social regulations. In policy terms, the ALOP is the dividing line between a member states' right to exercise their sovereignty and the realm of WTO law, in which international bodies scrutinize domestic policies against the benchmark of international commitments. Hence, the ALOP is dispositive for the scope of subject matters on which countries can make unfettered unilateral decisions.

It is precisely this delineation between the national and the international realm that causes many of the perceived collisions between the right to 'democratic self-government' and 'unaccountable international institutions', between the 'peoples' will' and 'the rule of technocratic experts'. The broader the ALOP, the more member states' powers to regulate are unrestrained and *vice versa*. The ALOP is thus dispositive for who decides upon crucial social questions such as what constitutes a risk worth regulating (what the public perceives or what the experts know?), which are the factors that drive the decision to establish a certain level of regulation (public demand or expert knowledge?) and so forth.

In economic terms, the ALOP can play the role of a protectionist device. For instance, governments can use the ALOP to shield their industry from foreign competition by choosing an ALOP that corresponds to the specifications of domestic products but which, at the same time, removes imports from the market that do not meet these requirements. This is probable, if the production technologies of the

[3] 'Regulatory autonomy' denotes the 'freedom WTO members enjoy in crafting their regulations while at the same time fulfilling their obligation under the WTO Agreements', see Du, 'The Rise of National Regulatory Autonomy in the GATT/WTO Regime', 647.

domestic and the foreign industry differ and the ALOP is used to favour the home industry. In addition, by choosing a higher or lower ALOP than would be optimal absent the intention to 'exploit' foreign exporters, 'large' countries with market power can extract profits from foreign traders. The logic behind this and the conditions for such behaviour will be explained in detail in Part I.

The ALOP is also crucial in legal terms. First, the ALOP impacts the standard of review, as it defines the realm of issues that are outside the scope of scrutiny for WTO adjudicative bodies. Since WTO members are autonomous in setting their ALOP, the level of regulation as such is 'off the limits' for panels and the Appellate Body. However, the ALOP is tightly interrelated with WTO disciplines on the application of trade restrictive measures. This relationship plays out in two ways. On the one hand, it can diminish the scope of review, when a subject matter clearly falls into the 'ALOP-zone'. In this respect, the ALOP acts as a shield. On the other hand, this close relationship may have as consequence that the 'unquestionable' ALOP nevertheless becomes questioned by the WTO adjudicative bodies through the 'backdoor'. Instead of openly reviewing the rationality of a member states' ALOP, panels and the Appellate Body may instead find an implementing measure to be inconsistent with WTO law. This allows WTO adjudicative bodies to allege that a member state's ALOP is unquestionable while at the same time effectively condemning the very choice the member state made.

Second, the choice of a specific ALOP can have probative value in assessing a measure's impact on imports. For instance, when dissimilar ALOPs are chosen for products that cause similar regulatory concerns, WTO members need to provide a convincing explanation to escape a finding of discriminatory treatment.

Third, the ALOP is tightly related to the specific obligations enshrined in the TBT Agreement, the SPS Agreement, the application of Article XX GATT, and arguably also Article III:4 GATT. As a result of certain interpretative choices by the WTO judiciary, the ALOP has a bearing on how members have to carry out risk assessments and under which conditions they can adopt precautionary measures. Moreover, the ALOP is crucial in determining whether an alternative measure is as effective as the measure adopted, i.e. whether a measure is 'necessary' (Article XX:(a), (b) and (d) GATT, Article 2.2 TBT Agreement and Article 5.6 SPS Agreement), and to assess whether the chosen level of regulation is 'consistently' applied (Article 5.5 SPS Agreement). In

addition, the ALOP can play a role in determining whether disparate impact is the consequence of a 'legitimate regulatory distinction'.

Thus, questions concerning the ALOP arise at different levels of the analysis. However, the WTO judiciary does not distinguish between these different levels but focuses on concrete legal questions. Policy and economic questions play an implicit role but are not central to the legal debate.

Having established the importance of the ALOP in WTO law, the remainder of this part is structured as follows. First, a response is provided to the question of how the optimal level of regulation is chosen by a rational and social welfare maximizing government under conditions of full information. Thereafter, the reasons of why and how governments might digress from such optimal levels will be analysed. Finally, the questions under which conditions and why international trade law should address deviations from the optimal level of regulation are analysed.

2

Optimal regulation

2.1 Introduction

Governmental regulation is ubiquitous, particularly in developed economies around the globe. Usually, regulatory measures are promulgated with a view to achieve a predetermined goal. Regulation is rarely an end in itself. Instead, the protection or advancement of societal or individual interests constitutes the aim of almost all regulatory actions. The number of possible governmental objectives is almost endless and ranges from such vital interests as the protection of human rights and the preservation of the environment to more specific aims, such as shielding a domestic industry from international competition to protect local jobs. However, the advancement of any objective is always a matter of degree because governments must make trade-offs between competing societal interests.[1] For instance, when a government decides to block imports in order to protect jobs, workers may gain but consumers, who now have to pay higher prices, may lose.

This chapter explains how rational social welfare maximizing governments choose the levels of regulation for the values they wish to protect and promote. To this end, basic concepts of rational choice theory are applied. This is warranted by the fact that choosing the acceptable level of regulation for a given society is first of all a decision problem.[2] Note that for present purposes 'social welfare' is not limited to pecuniary interests but encompasses all matters societies or people value. Thus, social welfare would be increased if society values the environment and environmental protection is enhanced, etc. In addition, it is assumed that the process of social preference aggregation has been completed at the time the governments makes its decision, which is therefore representative for society as a whole. This can be the case because certain preferences have prevailed

[1] This would not be the case if resources were not scarce because then every goal could be pursued infinitely. This, however, does not correspond to the real-world situation.
[2] Fischhoff et al., *Acceptable Risk*, 2.

in the democratic process or because the government has the prerogative to make the respective choices.

Governments who intend to set the optimal level of regulation face a decision problem that consists of the following three questions: (i) what is it the government wants, i.e. what are its preferences?; (ii) what is feasible, i.e. what kind of budget constraint does the government face?; and (iii) which is the most desirable among the feasible alternatives, i.e. which is the optimal bundle of goods given the budget constraint? Thus, deciding on a society's acceptable level of risk is always a decision between various alternatives. There is no single ALOP once and for all that would be appropriate for any society.[3]

Finally, it should be noted that rational choice theory does not predicate anything about an agent's desires. Agents' preferences are simply taken as given, regardless of how absurd they may seem to the rest of the world. Accordingly, the rational choice model does not provide a solution as to what kind of preferences an agent should have, whether zero-risk or laissez-faire policies should be adopted, or whether spending the whole governmental budget on education is more preferable than on environmental preservation. The theory solely provides a solution for the problem of how to maximize the agent's goals, given her preferences. It is important to highlight this aspect, as it neatly fits into the real world of sovereign nation states that have an unfettered right to follow their preferences within the limits of international law.

2.2 The socially optimal level of regulation

2.2.1 When should governments intervene?

When should governments step in and enact regulation instead of relying on market forces to achieve socially desirable goals? There are several circumstances under which the interplay of supply and demand leads to unsatisfactory results, which in turn justifies governmental intervention in order to achieve greater societal welfare. Typical examples are all types of market failures such as information asymmetries, consumption externalities, 'irrational' consumer behaviour and 'public goods'.[4]

[3] *Ibid.*, *Acceptable Risk*, 3.

[4] Viscusi, 'Regulation of Health, Safety and Environmental Risks', 598–606. However, this list is non-exhaustive. Shleifer, for instance, has argued that the main justification for economic regulation is to be found in the imperfection of domestic courts, proposing that regulation is often the more cost-effective alternative: Shleifer, 'Efficient Regulation'.

In spite of differences in the details, all these examples share the common property that the decisions of certain agents impose costs on third parties that did not choose to incur those costs. In other words, there are negative externalities. A negative externality arises when people do not internalize the social costs of their choices. This is likely to happen when there are incentives to consume too much or too little of a good, relative to the social optimum. Think, for example, of car drivers who pollute the environment but do not have to bear the full costs of their behaviour. Under such circumstances everybody has an incentive to drive more than would be desirable from the view of society as a whole.

In more technical terms, negative externalities arise when there is a divergence between society's and individual agents' marginal cost or utility functions. Again, this simply means that individuals have an incentive to demand or supply too much (too little) because the good in question is 'too cheap' ('too expensive') compared to what would be optimal. Therefore, some agents are induced to maximize more or less than would be socially desirable.

Figure 2.1 illustrates this idea graphically. In this example, private agents are induced to produce excessive quantities relative to the social optimum. Note that the same reasoning applies *mutatis mutandis* to consumption instead of production. Although the socially desirable quantity is at Qs, private agents produce more than that, namely the quantity Qp. Since Qp is greater than Qs (Qp > Qs) there is a case of overproduction relative to the social optimum. In order to address this externality and to establish an efficient state of the world it would be necessary to align the social and the private marginal cost functions so that the quantity produced by private agents would move from point Qp to point Qs. Thus, if a government were to aim at tackling the identified overproduction, it would seek to increase the marginal costs for privates up to the point where they would be in line with social marginal costs.

Note that the detection of a 'market failure' does not necessarily warrant governmental intervention. It is conceivable that other institutions, such as the market or the judicial system, provide more, or at least equally, efficient solutions.[5] Yet, if many individuals are concerned and interests are dispersed it is likely that governmental regulation (or the right to claim damages) are more efficient solution compared to

[5] Coase, 'The Problem of Social Cost'.

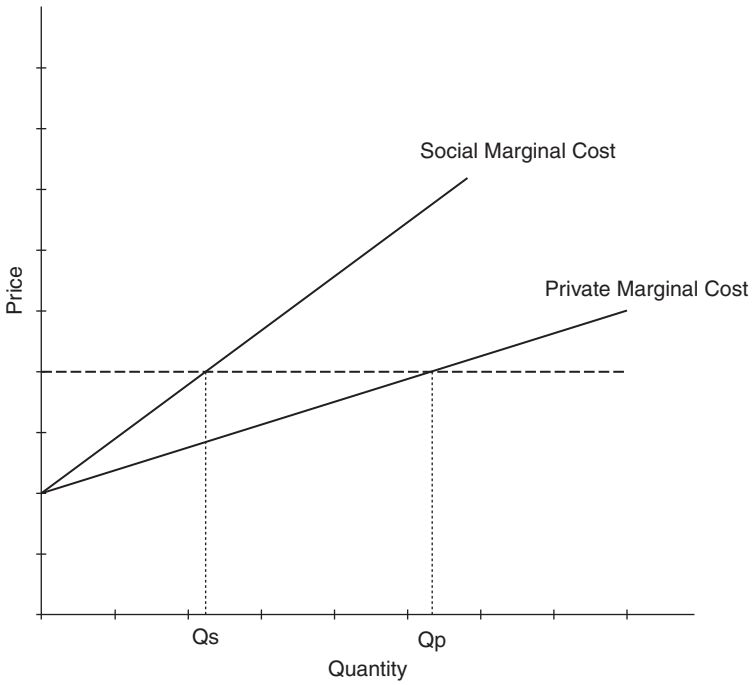

Figure 2.1: Negative externalities

individual bargaining. Therefore, the following discussion of individual 'market failures' will not deal with situations in which externalities can be internalized through private bargaining but focus on instances in which governmental intervention has a positive role to play to set the right incentive structure so that social and private utility functions are aligned.

To sum up, governmental intervention is called for when (i) social and private utility functions diverge; and (ii) there is no other mechanism, such as the market or the judiciary, providing a superior solution. However, it is of course also possible that none of the available institutions is capable of fully resolving the problem.

After this general overview the most common types of market failures, namely information asymmetries, consumption externalities, irrational consumer behaviour and public goods, will be discussed in some more detail.

In the case of information asymmetries product characteristics are not fully reflected in the market price, which can lead to over- or under-consumption. This is so because many goods' health, safety and other