



International Political Economy

**INTERESTS AND
INSTITUTIONS
IN THE GLOBAL
ECONOMY**

Thomas Oatley

A critical perspective on the WTO, NAFTA, and globalization more generally can be found at The Global Trade Watch homepage: <http://www.citizen.org/trade/>.

The International Labor Organization is a good source of information about international labor standards: <http://www.ilo.org/public/english/standards/norm/whatare/index.htm>.

The Exchange Between the WTO and Global Exchange can be found at the two following sites:

Global Exchange Criticisms:

<http://www.globalexchange.org/economy/rulemakers/topTenReasons.html>.

The World Trade Organization's Response:

http://www.wto.org/english/thewto_e/minist_e/min99_e/english/misinf_e/01multi_e.htm.

SUGGESTIONS FOR FURTHER READING

For a readable historical account of the development of the theory of comparative advantage and of those theories that have challenged the central claim of this theory see Douglas Irwin, *Against the Tide: an Intellectual History of Free Trade* (Princeton: Princeton University Press, 1996). For an approach that emphasizes the intuition of the theory of comparative advantage and downplays explicit theory see Russell D. Roberts, *The Choice: A Fable of Free Trade and Protectionism* (Upper Saddle River, NJ: Prentice Hall, 1994).

For a detailed discussion of the origins and development of the rules governing international trade see John H. Jackson, *The World Trading System: Law and Policy of International Economic Relations* (Cambridge: MIT Press, 1997).

Unfortunately, there is no single book that provides a good overview of the GATT bargaining rounds. Detailed treatments of the political dynamics of the last three rounds of negotiations can be found in Ernest H. Preeg, *Traders and Diplomats: An Analysis of the Kennedy Round of Negotiations under the General Agreement on Tariffs and Trade* (Washington, D.C.: the Brookings Institution, 1995); Gilbert R. Winham, *International Trade and the Tokyo Round Negotiation* (Princeton: Princeton University Press, 1986); and Ernest H. Preeg, *Traders in a Brave New World: The Uruguay Round and the Future of the International Trading System* (Chicago: University of Chicago Press, 1995).

The most elaborate and detailed critique of the World Trade Organization has been written by Lori Wallach and Michelle Sforza, *Whose Trade Organization? Corporate Globalization and the Erosion of Democracy* (Washington, D.C.: Public Citizen, 2000). A more academic account of the emergence of the antiglobalization movement can be found in Susan A. Aaronson, *Taking Trade to the Streets: The Lost History of Public Efforts to Shape Globalization* (Ann Arbor: University of Michigan Press, 2001).

CHAPTER 3

THE DOMESTIC POLITICS OF TRADE POLICY

Governments in the advanced industrialized countries have progressively opened their markets to imports through the multilateral trade system. Yet, even as tariffs have fallen these same governments have continued to protect specific domestic producers from foreign competition. While the United States, the European Union, and Japan were negotiating tariff reductions through the Uruguay Round, for example, the United States and the European Union were also negotiating bilateral agreements with Japan to limit the number of automobiles Japanese producers could export to the American and European markets. The contrast between multilateral trade liberalization on the one hand and unilateral or negotiated protection on the other is not unique to the auto sector. Indeed, throughout the past 30 years industrialized governments have simultaneously pushed for multilateral tariff reductions that open domestic markets to imports and for unilateral, bilateral, and multilateral measures that protect specific domestic producers from foreign competition. This chapter explores the domestic politics of trade policy to understand why governments have combined liberalization with protection.

Our exploration of domestic trade politics is organized around three central questions. First, to what extent and in what industries do governments in the advanced industrialized countries continue to rely on protection? As we will see, the pattern of liberalization and protection is not random. Advanced industrialized countries have been most willing to liberalize trade in capital-intensive manufacturing, and least willing to liberalize trade in labor-intensive manufacturing, in agriculture, and in high-technology industries. Second, what are the economic consequences of this protection? Standard economic theory suggests that in most instances protection reduces national welfare. More recent studies suggest that protection under certain circumstances can raise national welfare in high technology industries. Finally, how do we explain the pattern of protection and liberalization that we observe? Why have governments in the advanced industrialized countries been willing to liberalize trade in capital intensive manufacturing, but unwilling to do so in the other sectors? Answering this question requires us to focus on how interests and institutions shape the domestic politics of trade policy.

This chapter presents two different approaches to the domestic politics of trade policy. A society-centered approach asserts that patterns of protection and liberalization reflect politicians' responses to the demands made by domestic interest groups. A state-centered approach asserts that these patterns reflect efforts by autonomous states to enhance the nation's position in the international system. While the two approaches are often seen as alternative explanations, this chapter argues that the two fit together to help us make sense of different parts of the domestic politics of trade policy. The society-centered approach helps explain why governments in the advanced industrialized countries have been willing to liberalize trade in capital-intensive manufactured goods, but have been unwilling to liberalize trade in labor-intensive sectors and in agriculture. The state-centered approach helps explain why governments have intervened in their respective domestic economies to protect and promote high technology industries. Both approaches highlight how interests and institutions interact to shape trade policy.

PROTECTION AND ITS CONSEQUENCES

We begin this chapter by taking a closer look at protectionism in the advanced industrialized countries. Two central questions guide us. First, we want to know whether it is possible to identify a common underlying pattern of liberalization and protectionism in the United States, in the EU, and in Japan. That is, even though these three political actors are different in many respects, do they maintain similar tariff structures? If so, can we identify a simple explanation that accounts for this similarity? In order to answer this question we look at which industries are heavily protected and which are not in each of the three economies and then highlight the commonalities that are apparent. Second, how does protectionism affect the creation and distribution of income within these societies? We explore this question using standard tariff analysis and evidence drawn from the United States.

The Structure of Protection in the Advanced Industrialized Countries

Governments in the advanced industrialized countries continue to use tariffs and non-tariff barriers to protect some domestic producers from competition with cheaper imports. How much protection remains? Table 3.1 provides a summary of industrialized countries' tariff rates, calculated both by the currency value of imports and by the type of good imported. About one-third of all imports by value enter duty free, and more than 90 percent of all imports by value enter with tariff rates less than 10 percent. The picture changes somewhat when we shift from import value to import category, which

Table 3.1
MFN Tariff Rates in Advanced Industrialized Countries

	By Value	By Product Category
Duty Free	33%	14%
Low Tariffs (below 10%)	61%	68%
High Tariffs (above 10%)	6%	18%

Source: Finger and Olechowski 1987, 40.

A CLOSER LOOK

Trade Policy Instruments

Tariffs: A tariff is a tax imposed by the government on goods entering the country from abroad. This tax raises the price of the foreign good in the domestic market of the country imposing the tariff. While tariffs distort international trade, most economists believe that tariffs are the least distortionary of all trade barriers.

Quotas: A quota is a numerical cap that limits the number of goods that are imported. Because quotas restrict the number of foreign goods available for purchase in the domestic market below the amount demanded by domestic residents, they allow foreign producers to charge a higher price for each unit sold. This price difference is often called a quota rent. The GATT (Article XI) prohibits quotas.

Voluntary Export Restraints (VERs): VERs are quota-based forms of protection. They differ from quotas in two ways. First, they are created and administered by at least two countries—the importer and the exporter. Second, rather than the importing country imposing a quota on the number of foreign goods it will allow into the market (a practice that is illegal under the WTO), the exporting country limits the number of goods it exports to the importing country. Under an agreement reached during the Uruguay Round, all existing VERs were to be phased out, and new ones are prohibited.

Administered Protection: Administered protection refers most often to tariffs that are raised as a result of an administrative process initiated by a national government in response to two specific practices that are prohibited under the rules of the WTO.

Anti-Dumping: a government can raise tariffs to protect a domestic industry if it can prove that a foreign firm in the same industry is selling its goods at a price that is below "normal value." Normal value has traditionally been defined as the price the good sells for in the market of the exporting country. In such cases, the government can raise the tariff to offset the dumping margin.

Countervailing Duty: a government can raise the tariff to protect a domestic industry if it can prove that a foreign government has provided an export subsidy to one of its firms. What precisely constitutes an export subsidy remains a source of controversy in the multilateral trade system, with some governments arguing for a broad definition that includes production subsidies and others calling for a narrower definition that excludes such support. When an export subsidy is being used, the government in the importing country can raise tariffs to offset the subsidy.

In both cases, a higher tariff offsets the advantage gained through what have been generally recognized to be "unfair" trade practices. Before raising tariffs in response to dumping or subsidies, however, the national government must investigate whether dumping has occurred or an export subsidy has been provided. In addition, the government must determine that dumping or the subsidy has in fact injured domestic producers. Only then are they allowed to raise tariffs to counter the effects of these policies.

Nontariff Barriers (NTBs): Nontariff barriers cover a broad array of government policies and practices. Essentially, any barrier to trade that is not a tariff, such as a quota or a VER, fits into this category. Yet the term NTB is often used to describe government regulations and practices that create barriers to trade, either intentionally or accidentally. Health and safety regulations, environmental regulations, product standards, and government procurement practices, all of which can be enacted for public policy reasons can also restrict international trade. An EU policy banning imports of hormone-treated

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beef, for example, while perhaps justifiable on the basis of public health concerns, also restricts the ability of American cattle ranchers that use such hormones to export to the EU market. NTBs also include practices that have obvious protectionist intentions. French policy once required that all factories producing pharmaceuticals for sale in France be inspected by French officials, yet the relevant French inspectors were not allowed to travel abroad (Jackson 1998, 383). This practice obviously restricted the ability of foreign pharmaceutical firms to sell their products in France. As quotas have been eliminated and tariffs reduced, these nontariff barriers have emerged as one of the most important remaining obstacles to international trade and have thus become an increasingly important issue in the WTO.

measures the type of good being imported. This alternative measure reveals that almost 20 percent of industries are protected by tariff rates above 10 percent, while just over 80 percent of industries are protected with tariffs of 10 percent or less. Thus, about 6 percent of industrialized country trade by value and almost 20 percent of industrialized country trade by category is protected by tariff rates greater than 10 percent. In general, therefore, while the tariffs that industrialized countries impose on imports from other WTO members are quite low, they have not been eliminated.

What industries continue to receive tariff protection and which have been more fully liberalized? Protection in the United States, the European Union (EU), and Japan tends to be concentrated in labor-intensive manufacturing industries, in agriculture, and in high-technology industries. Table 3.2 lists 11 of the most heavily protected American industries. With three exceptions, (ball bearings, frozen orange juice concentrate, and polyethylene resins), the production of each of these goods relies heavily on low-skill labor, a result that will take on particular significance when we discuss the politics of trade policy in the next section. A similar pattern of tariff protection is evident in the EU (Table 3.3). EU industries protected by tariffs higher than 10 percent include textiles and apparel, footwear, paper products, glassware, radio and television sets, motor vehicles, and microprocessors. EU high tariff sectors thus share some of the characteristics of American high-tariff sectors, namely that

Table 3.2
High Tariff Sectors in the United States

Product Category	Tariff Rate
Ball Bearings	11.0%
Canned Tuna	12.5%
Ceramic Articles	11.0%
Ceramic Tiles	19.0%
Frozen Concentrated Orange Juice	30.0%
Glassware	11.0%
Luggage	16.5%
Polyethylene Resins	12.0%
Rubber Footwear	20.0%
Womens' Footwear, except athletic	10.0%
Womens' Handbags	13.5%

Source: Hufbauer and Elliot 1994, 5.

Table 3.3
High Tariff Sectors in the European Union

Product Category	Tariff Rate
Apparel	14%
Footwear	20%
Textiles	25%
Paper Products	12.5%
Radio and Television Sets	15%
Electrical Machinery	15%
Motor Vehicles	22%
Glassware	12.5%

Source: WTO 1995.

many of these items are produced with low-skill labor. EU tariffs also protect one sector that we do not see in the American case, electrical machinery, with a particular focus on microprocessors. The United States and the EU have also protected domestic industries with voluntary export restraints and other nontariff barriers. These measures have been concentrated in agricultural products, in the labor-intensive textile and apparel industry, and in the steel and auto industries.

Japanese protection displays a pattern quite similar to what we see in the United States and the EU. In contrast to the United States and the EU, however, Japan relies little on tariffs to protect domestic industries. According to the WTO, only three Japanese manufacturing industries are protected with tariffs higher than 10 percent, and only 12 manufacturing sectors receive tariff-based protection between 5 and 10 percent. Most protection in Japan is provided through nontariff barriers to trade, and once these are taken into account the structure of Japanese protection looks very much like the structure we see in the EU (Sazanami et al. 1995). Agriculture is the most heavily protected sector in Japan, with NTBs providing protection equivalent to a tariff of 272.5 percent. Rice producers are shielded most heavily, receiving protection equivalent to a 737 percent tariff. Japan also protects labor-intensive manufacturing sectors, particularly in footwear and apparel (WTO 1998b; Sazanami et al. 1995). Finally, Japan protects a number of high technology industries, which on average receive nontariff forms of protection equivalent to tariffs of 140 percent. The most heavily protected high tech industries include telecommunications (tariff equivalent of 236.5%), semiconductors (tariff equivalent of 106.6%), and computers (tariff equivalent of 75.8%).

This brief survey suggests a fairly clear and common pattern of protectionism and liberalization across the advanced industrialized countries. Governments in the United States, the EU, and Japan, have been least willing to liberalize trade in labor-intensive manufacturing industries, in agriculture, and in high-technology industries. Textiles and apparel remain heavily protected in all three economies. In addition, agriculture is heavily protected in the EU and Japan, and, though somewhat less heavily, in the United States. Finally, EU governments and Japan have protected high-technology industries, particularly information technology industries, fairly heavily. Advanced industrialized country governments have been most willing to liberalize trade in capital-intensive manufacturing industries. With the important exceptions of steel and automobiles, capital-intensive industries are largely absent from our lists of heavily protected industries in the United States,

the EU, and Japan. In general, therefore, governments in advanced industrialized countries have liberalized trade most in industries in which their producers hold a comparative advantage—capital-intensive manufacturing—and have liberalized trade least in industries in which their producers are at a comparative disadvantage: labor-intensive manufacturing for all, and agriculture and some high-technology industries for the EU and Japan.

The Economic Consequences of Protection

What are the domestic economic consequences of such protection? Standard economic theory highlights two such consequences. Protection has *distributional consequences*, as it transfers income away from consumers to producers and the government. Protection also has *aggregate welfare consequences*, as it makes societies poorer than they would be in the absence of trade protection. We turn our attention to these consequences, looking first at the standard economic model of tariffs to understand how protection transfers income and reduces social welfare in theory. We then examine some evidence about the size of the transfers and welfare losses that result from trade protection in the United States.

The economic effects of tariffs. Standard tariff analysis is presented in a **comparative statics** framework. The analyst uses a simple supply and demand framework to describe the domestic market for a particular product in two different worlds, one in which the market is not protected by a tariff and one in which a tariff is applied. Comparing the two outcomes yields conclusions about the effect of the tariff on the economy. We adopt this approach here, comparing an open and a protected market in order to see how a tariff affects domestic production, domestic consumption, imports, and aggregate social welfare.

The domestic market for a single good is presented in Figure 3.1. While it does not matter what good we focus on, to make the discussion less abstract we will focus on the market for polo shirts, the kind sold by major retailers like The Gap. The horizontal axis in Figure 3.1 represents quantity, that is, the number of polo shirts demanded by domestic consumers and supplied by domestic apparel manufacturers. The vertical axis represents the price of polo shirts. The figure also provides demand and supply curves. The demand curve, the downward sloping line labeled d , tells us the total number of polo shirts that domestic consumers will want to buy at every price. This curve has a negative slope because consumers will want to buy more polo shirts as the price of these shirts falls. The supply curve, the upward sloping line labeled s , tells us the total number of polo shirts that domestic producers will want to supply at every price. The supply curve has a positive slope because domestic producers will want to sell more shirts as the price they receive for these shirts rises.

Introductory economics tells us that the number of polo shirts that will be produced and consumed, as well as the price for which they will sell, will be determined by the intersection of the supply and demand curves. Therefore, the quantity of polo shirts produced is Q in Figure 3.1, and these shirts should sell at price p . While this conclusion is technically correct, international trade changes how the domestic price for an internationally traded good like polo shirts is determined. In an open economy, domestic prices for internationally traded goods are determined by the interaction between world demand and world supply rather than by the interaction between national supply and na-

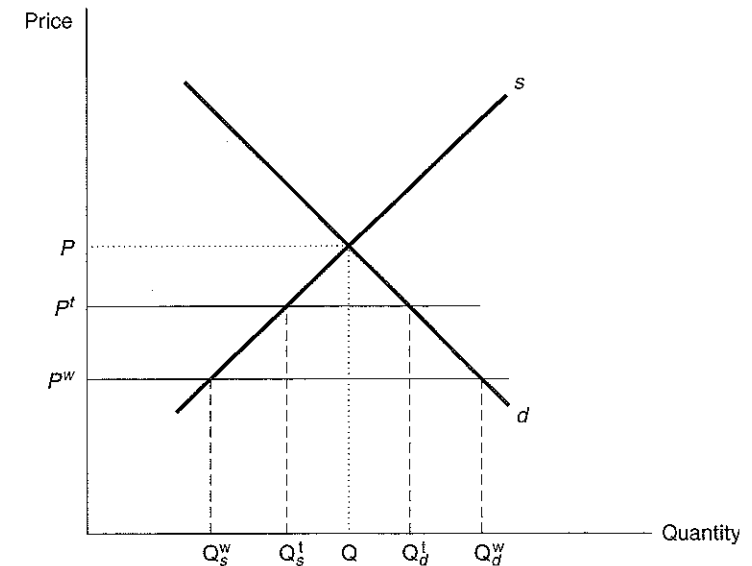


Figure 3.1 The Economic Effects of Tariffs.

tional demand. Moreover, because most national economies are small in relation to the world economy, each national economy's individual demand for and supply of goods will not affect total world demand or total world supply. Therefore, domestic producers and domestic consumers of polo shirts (and all other internationally traded goods) have no influence on the price of the goods sold in the domestic market. This logic is identical to that of individual producers and consumers operating in a perfectly competitive market, where each individual is a "price taker." Rather than focus on an individual in the domestic market, here we focus on a national economy in the global economy. And, just as no individual in a perfectly competitive market is a large enough producer or consumer to alter prices in that market, no single country is a large enough producer or consumer of polo shirts to affect the world price of polo shirts. Thus, domestic producers and consumers of polo shirts are "world price takers." The world price, which is depicted in Figure 3.1 as p^w , is taken as a given by domestic producers and consumers.

Given the world price, how many polo shirts will domestic producers want to sell and how many shirts will domestic consumers want to buy? Domestic producers are willing to supply polo shirts up to the amount Q_s^w , the point at which the world price line intersects the domestic supply curve. Domestic consumers are willing to buy polo shirts up to the amount Q_d^w , the point at which the world price intersects the domestic demand curve. At the world price, therefore, domestic consumers want to buy more polo shirts than domestic producers are willing to supply. In the absence of international trade, this demand for polo shirts in excess of domestic supply would cause the price of polo shirts to rise. As prices rose, domestic production would increase, and the interaction between price increases and expanding domestic production would lead to equilibrium price and quantity levels where the domestic demand and supply curves intersect. Because the economy does engage in international trade, however, we know that the domestic price cannot rise

as a result of the excess demand for polo shirts. Instead, the domestic price remains at p^w and domestic producers continue to produce at Q_s^w . Domestic demand for polo shirts in excess of domestic production, an amount equal to $(Q_d^w - Q_s^w)$, is satisfied by imports.

Suppose now that the government imposes a tariff. This tariff is a tax that the government adds to the world price, thereby raising the domestic price of polo shirts. In Figure 3.1 this effect is illustrated by the shift from the world price p^w to the higher price p^t . Now notice what has happened to domestic supply, domestic demand, and imports as a result of the increase in the domestic price for polo shirts caused by the tariff. Domestic producers are now willing to supply more polo shirts, and domestic production therefore expands from Q_s^w to Q_s^t (the point where the new domestic price (p^t) intersects the supply curve). Because the price for shirts has risen, consumers want to buy fewer of them, so the demand for polo shirts falls from Q_d^w to Q_d^t (the point where the new domestic price (p^t) intersects the demand curve). Finally, because domestic supply increases while domestic demand falls, imports of polo shirts fall from the amount equal to $(Q_d^w - Q_s^w)$ to the amount equal to $(Q_d^t - Q_s^t)$. Thus, relative to the free trade world, the imposition of a tariff has increased domestic supply while reducing both domestic demand and imports.

To evaluate how tariffs affect social welfare we need to introduce two concepts: consumer surplus and producer surplus. Producer and consumer surplus are aggregate measures of utility for society's producers and consumers. Consider **consumer surplus** first. If you look at the demand curve in Figure 3.2 it should be clear that a few people (those represented by the top left portion of the demand curve) would be willing to pay a high price to buy polo shirts. Yet, these people are actually able to purchase polo shirts at the much lower market price. The difference between what these people would have been willing to pay and the market price that they actually did pay provides them a surplus. Consumer surplus aggregates all of these individual consumer gains, and total consumer surplus is equal to the area below the demand curve and above the price line. **Producer surplus** is the analogous concept on the supply side. It is clear that some producers would be willing to supply a limited number of polo shirts for a relatively low

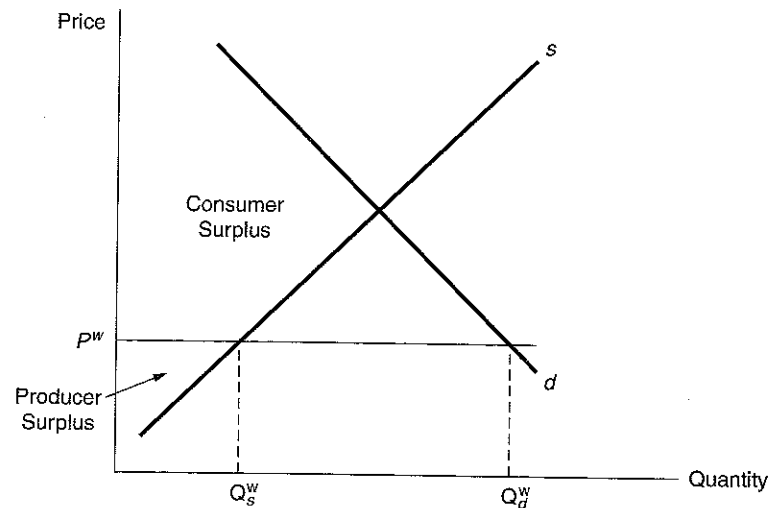


Figure 3.2 Consumer and Producer Surplus.

price (those represented by the lower left portion of the supply curve). Yet, when these same producers do sell the polo shirts they produce, they receive the much higher market price. The difference between how much each producer would have been willing to receive to produce polo shirts and what they actually do receive in the market represents that producer's surplus. Producer surplus aggregates all of these individual producer gains and is equal to the area above the supply curve and below the price line.

Producer and consumer surplus allow us to evaluate the welfare consequences of tariff-based protection with greater precision. Look first at how the tariff affects consumer surplus (Figure 3.3). When the government imposes a tariff, the area under the demand curve and above the price level is reduced by the amount labeled A, B, C, and D. The tariff reduces consumer surplus. Since we know that consumer surplus measures consumer welfare in the economy, we know that consumers have been made worse off by the tariff. Conversely, the tariff increases producer surplus. Because the tariff raises the price producers get from selling their shirts, the tariff increases the area above the supply curve and below the price line by the amount equal to the area labeled A. Since we know that producer surplus is a measure of producer welfare, we know that producers have been made better off by the tariff. Thus, the first consequence of a tariff is a transfer of welfare from consumers to producers.

What happens to the rest of the consumer surplus lost from the tariff? We have accounted for A, the transfer from consumers to domestic producers, but we have not yet examined what happens to the areas labeled B, C, and D. A portion of this lost consumer surplus, the area labeled C, is transferred to the government as tariff revenue. The total amount of this transfer is equal to the size of the tariff times the number of polo shirts being imported. This leaves the regions labeled B and D. These regions represent **efficiency losses**: the losses of consumer surplus that are not offset by an increase in

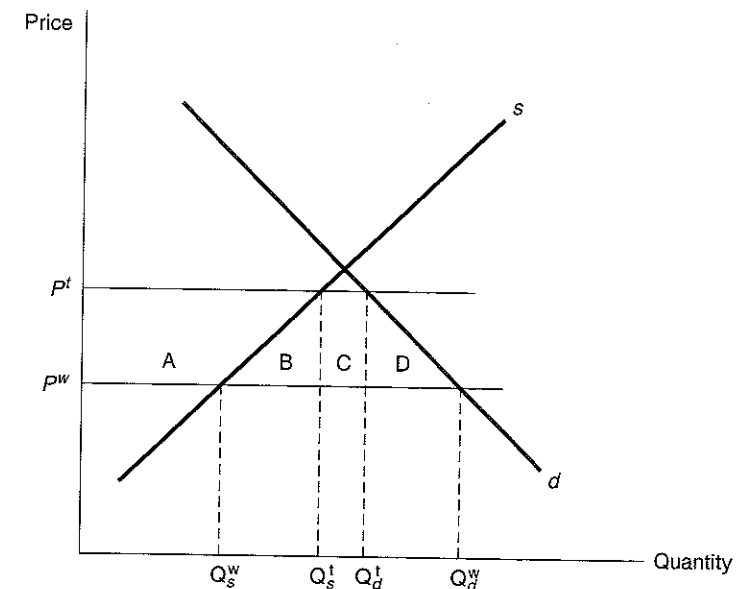


Figure 3.3 The Welfare Consequences of Tariffs.

producer surplus or government tariff revenue. Efficiency losses take two forms. The triangle labeled *D* is called a **consumption distortion** loss. It arises because the tariff causes domestic consumers to buy too few polo shirts given their preferences and the world price for these shirts. The triangle labeled *B* is called a **production distortion** loss. It arises because the tariff causes domestic producers to produce too many polo shirts, given domestic production costs and the world price (Krugman and Obstfeld 1991). These losses are the social welfare losses that give protectionism a bad name.

The case of the United States. How large are the income transfers and efficiency losses of protection in practice? We can get a sense of their magnitude by looking at the distributional and efficiency consequences of tariffs and nontariff barriers in the United States (see Table 3.4).¹ Let's examine the scale of redistribution from consumers to producers first. Lost consumer surplus in the 11 most heavily protected sectors in the American economy amounts to almost \$2.3 billion. While the magnitude varies across sectors, from \$376 million in women's footwear to \$64 million in the ball bearing industry, consumers are made worse off by the imposition of tariffs in every

Table 3.4
The Costs of Protection in the United States (Millions of Dollars)

Product Category	Loss of Consumer Surplus (A+B+C+D)	Gain in Producer Surplus (A)	Tariff Revenue or Quota Rents (C)	Deadweight Loss (B+D)
Tariffs				
Ball Bearings	64	13	50	1
Canned Tuna	309	127	172	10
Ceramic Articles	102	18	81	2
Ceramic Tiles	139	45	92	2
Frozen Concentrated Orange Juice	281	101	145	35
Glassware	266	162	95	9
Luggage	211	16	169	26
Polyethylene Resins	176	95	60	20
Rubber Footwear	208	55	141	12
Women's Footwear, except athletic	376	70	295	11
Women's Handbags	148	16	119	13
Total	2,280	718	1,419	141
Voluntary Export Restraints				
Apparel	21,158	9,901	8,956	2,301
Textiles	3,274	1,749	1,345	181
Machine Tools	542	157	350	35
Total	24,974	11,807	10,651	2,517

Source: Hufbauer and Elliot 1994.

¹While the discussion here focuses on the United States, similar studies of the costs of protection in Japan and the EU can be found in Sazanami et al. 1995 and Messerlin 1999.

instance. Producers capture about one-third of these consumer losses (\$718 million). And while producer gains also vary in magnitude, from \$162 million for glassware producers to \$13 million for ball bearing producers, producers always realize some increase in income as a result of protection. Identical consequences are evident in the sectors protected by voluntary export restraints. VERs governing trade in apparels reduce consumer surplus by more than \$21 billion and increase producer surplus by almost \$10 billion. The three most important VERs reduce consumer surplus by almost \$25 billion and raise producer surplus by almost \$12 billion.

As we expect, American producers gain by less than the full amount lost by American consumers. Part of this difference is transferred from consumers to other agents. For all of the industries protected by tariffs, about \$1.4 billion of the consumer loss is transferred to the government in the form of tariff revenue. In sectors protected by VERs, a portion of consumer losses is transferred to foreign producers as a quota rent. A **quota rent** is an above market return created by the imposition of a quota on imports. A quota rent arises because a VER, or any other import quota, restricts the number of foreign goods that can be sold in the domestic market below the level that domestic consumers want to buy. With supply held below demand, foreign producers can charge a higher price for each good they sell in the domestic market. Suppose, for example, that during the 1980s American consumers wanted to buy 4 million Japanese cars at the market price. The VER that the United States negotiated with Japan, however, allowed Japanese auto producers to export only 2.3 million cars to the American market. Because the VER kept the number of Japanese cars supplied to the American market substantially below the number Americans wanted to buy, the price for each Japanese car sold in the U.S. market was higher than it would have been in the absence of the VER. The quota rent is the difference between the high price Japanese auto producers received for each car with the VER and the lower price they would have received in the absence of the VER. Such quota rents can be quite large. In the apparel industry, which has been heavily protected with a quota-based international agreement, quota rents total almost \$9 billion per year. Here, total transfers from American consumers to the U.S. government as tariff revenue and to foreign producers as quota rents amount to about \$12 billion.

Finally, the U.S. economy suffers efficiency losses from protection. Table 3.4 suggests that the magnitude of these efficiency losses is moderate but still significant. Efficiency losses are largest in frozen orange juice concentrate industry and smallest in ball bearings, but in each sector they are positive. In total, American society is deprived of more than \$2.5 billion as a direct result of protection in these 14 sectors of the American economy. Are these efficiency losses substantial? The answer to this question depends upon the context we use to evaluate them. Efficiency losses that result from protection are small as a percentage of total American income, amounting to much less than one percent of American GNP per year. This amount may seem even smaller if we apportion it equally across all the people that participate in the American economy—only about \$13 per person, per year. Paying such a low price to protect American workers' jobs in these industries may seem quite reasonable. Yet, we get a different picture if we consider how much it costs American consumers and American society as a whole to save a single job. Every job that protection saves costs American consumers \$170,000 per year, an amount that is about six times the average annual income for the typical manufacturing worker. This cost does fall substantially to

\$54,000 per job if we consider only the efficiency losses rather than the total loss of consumer surplus. But even this lower figure is almost twice as high as the average annual income of manufacturing workers (Hufbauer and Elliott 1994, 11). Seen in this context, the costs of protection are rather high.

In general, therefore, economic theory and evidence drawn from the United States suggest that protection has two economic consequences. First, protection transfers income from consumers to producers. While the scale of this transfer in the United States varies, producers realize income gains while consumers realize income losses in every industry where protection is used. Second, society as a whole loses from protection. A portion of the income lost by consumers is not transferred to other groups in society, but simply disappears. Exceptions exist, of course, and we will examine the most important one below. Still, the general point remains: protectionism makes societies worse off than they could be otherwise.

A SOCIETY-CENTERED APPROACH TO TRADE POLICY

Protectionism is costly; it renders consumers and society worse off than they would be if tariffs and nontariff barriers were dismantled. Why then have governments liberalized trade in some industries but continued to protect others? A society-centered approach argues that the answer lies in the interaction between societal trade policy preferences and political institutions. Consider, for example, recent congressional votes on fast track legislation in the United States. Under **fast track**, Congress grants the executive the authority to negotiate international trade agreements. Under this arrangement Congress must approve (by simple majority) any trade agreement that the executive concludes before the agreement enters into law. And it must do so within 90 days. In voting on trade agreements, however, Congress cannot propose amendments; it must vote the agreement up or down in the form it is presented to them. Fast track authority greatly affects the ability of the United States to negotiate trade agreements with other governments. With fast track authority, the president can engage in constructive bargaining in the WTO and conduct meaningful negotiations on the Free Trade Area of the Americas. Without fast track authority, America's trade partners will conclude that Congress will pick apart any trade deal that may be reached, and they will be understandably reluctant to conclude any agreements with the United States. Fast track authority is therefore central to additional trade liberalization. Prior to the mid-1990s, Congress had regularly granted the authority to negotiate trade agreements to every president. Most recently Congress had granted this authority to President George H.W. Bush in connection with the Uruguay Round and the NAFTA. Fast track authority expired in 1994, however, and the Clinton Administration sought renewal in 1997 in order to pursue the Free Trade Area of the Americas and a new WTO round. Clinton's effort was unsuccessful, however. In 1997, fast track legislation was never put to a vote because it did not have enough votes to pass; in 1998 the legislation came to a vote but was defeated decisively as 240 representatives voted against and only 180 voted in favor. The House finally passed fast track legislation in December 2001 by the slimmest possible margin, with 215 voting in favor and 214 voting against.

A society-centered approach suggests that there are two important and interesting questions to ask about fast track legislation. First, what factors determine the votes by individual legislators on fast track authority, or on any other trade legislation for that matter? To answer this question we could start with a simple party politics hypothesis. We might expect Democrats to vote one way on trade legislation and the Republicans to vote the other way. Whichever party holds a majority in the House will then win the legislative battle over trade policy. In the 1998 fast track vote, for example, 151 Republicans voted for fast track while 171 Democrats voted against. In 2001, 194 Republicans voted for fast track while 189 Democrats voted against. There does seem to be considerable evidence, therefore, that the Republicans support trade liberalization while the Democrats oppose it. Yet, the power of an explanation based solely on political parties fades once we look more deeply. On the one hand, a large number of legislators voted across party lines. Twenty-nine Democrats voted in favor of, while 70 Republicans voted against fast track in 1997. A narrow focus on parties doesn't help us account for these votes. On the other hand, and more importantly, a focus on parties doesn't really help us explain trade votes. True, we observe that Democrats often vote against trade liberalization while Republicans often vote in favor, but what we really want to know is why these voting patterns exist. That is, why did so many Republicans vote for fast track while so many Democrats voted against? To answer this question we need to look beyond legislators' party affiliations and examine the societal interests that they represent. As we will see, the Democrats who voted against fast track typically represented societal groups that are harmed by international trade, while the Republicans that voted for fast track typically represented groups that gain from international trade. As a first step toward understanding how domestic politics shape trade policy, therefore, we must understand which societal groups win and which lose from trade liberalization, and then use this knowledge to illustrate how the economic characteristics of the constituents that legislators represent shape their votes on trade legislation.

The second question a society-centered approach asks is how do political institutions transform these societal interests into trade policy? Political institutions set the rules governing who has access to the political system and they determine how and where government decisions on trade policy are made. By doing so they exert a powerful influence on trade policy outcomes. Consider, for example, the impact of fast track legislation on American trade policy. To appreciate the impact we must know three things about the American political system. First, the U.S. Constitution assigns to Congress the authority to make trade policy. Second, for reasons we examine in detail below, the nature of legislative politics is such that when Congress determines tariff rates the result is often a higher level of protectionism than any individual legislator desires. Finally, and again for reasons we explore below, the president has incentives to adopt a relatively liberal trade policy. Thus, congressional control will produce a relatively protectionist trade policy, while executive control will produce a relatively liberal trade policy. Given these few details it is not hard to see that fast track has a profound impact on American trade policy. Fast track transfers the authority to make trade policy from a protectionist Congress to a trade-liberalizing executive. The United States therefore pursues a more liberal trade policy with fast track authority than it would without fast track. Thus, different political institutions, in this instance different rules about whether Congress or the president makes trade policy,

can generate very different trade policies. To understand how societal interests shape trade policy, therefore, we must examine how the specific political institutions in place transform these interests into actual policies.

In short, a society-centered approach argues that trade policy emerges from the interaction between societal interests and political institutions. We develop this approach in this section, looking first at each component individually and then examining how they interact to shape trade policy. We look first at how international trade affects the fortunes of economic groups within society and, by doing so, creates interest group demands for trade liberalization or protection. This provides a solid understanding of the source and content of societal preferences over trade policy. Second, we examine some of the ways in which political institutions shape how these societal preferences are brought into the political system and transformed into trade policies. Finally, we bring these components together to examine how the interaction between interests and institutions have shaped American trade policy during the last 100 years.

Trade Policy Preferences

At one level we can think of the domestic politics of trade as competition between societal groups, some of which want the government to liberalize trade while others prefer to be protected from trade. We could conceptualize contemporary American trade politics, for example, as competition between labor unions on the one hand, which oppose fast track authority and further liberalization, and American businesses on the other, many of which have supported fast track and additional liberalization. In order to understand why different groups in society hold different trade policy preferences we need to examine the distributional consequences of international trade. For even though trade raises national welfare, not everyone benefits from trade. For some groups, international trade brings rising incomes, while for others international trade causes incomes to fall. The groups that gain from trade have a preference for liberalization while those that lose have a preference for protection.

Economists have developed two different models to show how the distributional consequences of international trade shape the trade policy preferences held by societal groups. Both models agree that the losers from international trade prefer protection while the winners from international trade prefer liberalization. The two models differ, however, in the assumptions they make about how easy it is for workers and business owners to move from one industry to another in response to the changes in the profitability of particular domestic industries generated by international trade. These different assumptions generate two different portraits of trade policy preferences, one that emphasizes competition between labor and capital, and one that emphasizes competition between industries. We examine both models, focusing first on the model that emphasizes labor-capital competition and then turning our attention to the model that emphasizes competition between industries.

Factor incomes and class conflict. Our first model, called the **factor model**, argues that the domestic politics of trade policy are characterized by competition between labor and capital. Each group has a distinct trade policy preference because international trade has a differential effect on their incomes: in the advanced industrialized countries, trade reduces the income of labor and raises the income of capital. To

understand the factor model, we need to examine how and why international trade has this differentiated effect on the incomes of labor and capital.

We learned in Chapter 2 that cross-national differences in factor endowments give rise to different factor prices that provide the basis for mutually beneficial trade. What we did not cover is the fact that international trade in turn affects factor prices. International trade will exert pressures that lead eventually to a phenomenon called **factor price equalization** (Stolper and Samuelson 1941). Factor price equalization means simply that the price of the factors of production in all economies that are open to international trade will be the same. Thus, if it costs \$4 an hour to hire a worker in the United States, it will cost \$4 an hour to hire a worker in Mexico. International trade causes factor price equalization through a two-step process. First, trade forces the prices of internationally traded goods to equalize. We can understand why by returning to our polo shirt example from the previous section. The availability of low-cost polo shirts produced in a developing country will cause consumers in the advanced industrialized country to shift their purchases away from domestic shirts to the cheaper imports. As consumers shift to the less expensive imported shirts, shirt producers in advanced industrialized countries must reduce their prices in order to remain competitive. In the developing country, the increased demand for shirts generated by exports to the advanced industrialized country causes the price of their shirts to rise. These price changes will stop only when the price of shirts is the same in both countries. The convergence of goods prices will then exert pressure on factor prices. The price of a polo shirt, or any good for that matter, reflects the cost of the factors of production used in the manufacturing process. Thus, unless firms can raise **productivity**, that is, unless they can increase the number of polo shirts their workers can produce in a given amount of time, advanced industrialized country producers can reduce the price they charge for polo shirts and still make a profit only by reducing the amount they pay their workers. Conversely, the higher price that producers in developing countries now receive for polo shirts allows them to pay higher wages to the workers they employ.

It should be fairly clear that factor prices correspond directly with factor incomes. A factor price is simply the amount a producer pays to employ a factor of production for a specific amount of time. The price of labor is the wage paid to workers; the price of capital is the interest rate paid to capitalists. And while wages and interest rates are costs for the producer who hires labor and capital to manufacture goods, these payments are obviously income for workers and capitalists. Because international trade changes the amount a producer must pay to hire labor or capital, it must also alter the incomes earned by workers and capitalists. We can say something quite specific about whose incomes will rise and whose incomes will fall as a result of international trade. A society's scarce factors are priced higher at home than in countries where they are abundant. The income of the scarce factor must fall, therefore, as a consequence of factor price equalization. A society's abundant factor is priced lower at home than in countries where it is scarce. The income of the abundant factor must rise, therefore, as a consequence of factor price equalization. In general, the factor price equalization driven by international trade raises the income of society's abundant factor and lowers the income of society's scarce factor.

The trade policy preferences of specific societal interest groups follow directly from these income effects of international trade. The scarce factor, whose income falls as a result of trade, will want to minimize the amount of trade the domestic economy engages in. This group will therefore prefer trade policies that protect the domestic market from

imports. The abundant factor, whose income rises as a result of trade, will want to maximize the amount of trade the domestic economy engages in. This group will therefore prefer trade policies that promote trade liberalization. In the United States and other advanced industrialized countries, the factor model predicts that owners of capital will prefer liberal trade policies while workers will prefer protectionist trade policies. In developing countries, the factor model predicts that labor will prefer liberal trade policies while owners of capital will prefer protection. It suggests, therefore, that because the distributional consequences of international trade fall along factor lines, trade politics will be characterized by conflict between labor and business (or capital).

Class conflict and the politics of globalization. The factor model provides insight into how economic interests are driving the political debate over globalization. It leads us to expect American workers and the organizations that represent them to prefer trade protection to trade liberalization. Indeed, we see these preferences in the political debate over globalization. The AFL-CIO, a federation of 64 labor unions representing a total of 13 million American workers, has been among the most prominent critics of globalization. While the AFL-CIO does not consider itself protectionist, it played a leading role in organizing the protest against the WTO in Seattle in December 1999. In addition, it has fought consistently during the 1990s to prevent congressional passage of fast track authority. Conversely, the factor model leads us to expect American business to prefer trade liberalization to trade protection and thus to support globalization. These business preferences are also evident in the contemporary political debate over globalization. The Business Roundtable, a business association that brings together the chief executives of the largest American corporations, strongly supports globalization. It has been an active lobbyist for fast track authority, it supports the proposed FTAA, and it was a strong proponent of China's entry into the World Trade Organization. The National Association of Manufacturers, which represents about 14,000 American manufacturing firms, also supports multilateral and regional trade liberalization. Thus, in the United States the pattern of interest group preferences regarding trade liberalization and, more generally, globalization, is consistent with the factor model. The scarce factor, American labor, tends to oppose trade liberalization while the abundant factor, American capital, tends to support trade liberalization. While we will add nuance to this broad approach below, it helps us conceptualize how the economic dynamics of international trade drive political conflict over trade liberalization and globalization.

Specific factors and sectoral conflict. Our second model, called the **specific factors model**, characterizes the domestic politics of trade policy as a competition between industries rather than as a competition between labor and capital. In this model, the distributional consequences of international trade affect industries rather than factors. That is, the labor and capital employed in some industries both gain from trade, while the labor and capital employed in other industries both lose from trade. To understand the specific factors model, we need to examine why the distributional consequences of international trade might fall on industries rather than on the factors of production.

The key difference between the specific factors model and the factor model lies in the assumptions each makes about factor mobility. **Factor mobility** refers to the ease with which labor and capital can move from one industry to another in response to the changes

in relative prices caused by international trade. The factor model assumes a high degree of factor mobility, that is, it assumes that labor and capital can move easily out of one industry and into another. Suppose for example that some capital is currently being used to produce apparel in North Carolina and that the return to capital in the American apparel industry begins to fall as a result of increased imports from developing countries. The factor model assumes that this capital can quickly be shifted from apparel production to another industry, such as semiconductors, where the return on capital is high and rising.

In contrast, the specific factors model assumes that factors cannot be easily reallocated from one industry to another in response to changes in relative prices. Instead, capital is tied to, or specific to, the sector in which it is currently employed and cannot be easily or quickly moved to another use. Capital employed in apparel production is essentially stuck in this industry, at least in the short run. Nor can labor move easily from one industry to another. Workers often have industry-specific skills that do not always transfer easily from one sector to another. A worker who has spent 15 years as a welder in an auto plant cannot easily transfer these skills to the production of pharmaceuticals or semiconductors. In addition, the geography of industry location often means that quitting a job in one industry and taking a job in another requires workers to physically relocate. Shifting from apparel production to automobile production might require a worker to move from the south, where much of the apparel production takes place, to the midwest where the bulk of car manufacturing takes place. Logistical obstacles to physical relocation can be insurmountable. What if a worker cannot sell his house because the decline of the local industry has contributed to a more general economic decline in his community? Complex social and psychological factors also intervene. How easy is it for people to abandon the network of social relations that they have developed over the course of many years? The combination of specific skills, logistical problems, and attachments to an established community mean that labor cannot always move from one industry to another in response to economic changes caused by international trade.

When factors are specific to a particular industry, international trade will affect the incomes of all factors employed in a given industry in the same way. Consider the American apparel industry. As producers in developing countries begin to export their products to the American market, the price of clothing begins to fall in the United States. We know already, based on the factor model, that rising imports from developing country producers will place downward pressure on wages paid to American workers in this labor-intensive industry. The specific factors model tells us that these imports will also place downward pressure on the returns to capital employed in American apparel production. As long as the capital employed in apparel production cannot easily be shifted to the production of some other good, then the owners of this capital will see their incomes fall as a result of international trade. Thus, in addition to the falling wages for apparel workers that we saw in our discussion of the factor model, international trade in the apparel industry will reduce the profit earned by the owner of the apparel plant, that is, trade will reduce the return to capital employed in apparel production. Labor and capital employed in the apparel industry both lose from international trade. Conversely, consider the American pharmaceutical industry, which is highly competitive in the global pharmaceutical market. The return to capital invested in U.S. pharmaceutical production will rise as foreign markets open to U.S. exports. Moreover, because pharmaceutical companies are exporting, there is upward rather

than downward pressure on the wages earned by the workers they employ. Capital and labor employed in the American pharmaceutical industry therefore both gain from international trade. The specific factors model tells us that international trade will cause the incomes of labor and capital employed in the same sector to rise and fall together.

We can identify the industries that will gain from international trade and those that will lose. Labor and capital employed in industries that rely intensively on the society's abundant factor will both gain from trade. As a group, these industries are usually referred to as the **export-oriented sector**. In the advanced industrialized countries, this predicts that labor and capital employed in capital intensive and high technology industries both gain from international trade. The owners of plants that produce semiconductors or pharmaceuticals and the workers employed in these plants will both realize rising incomes as a result of trade. Labor and capital employed in sectors that rely most heavily upon society's scarce factor both lose from trade. As a group, these industries are usually referred to as the **import-competing sector**. In the advanced industrialized countries, this predicts that the owners of the capital employed in labor-intensive sectors such as apparel and footwear and the workers they employ will both experience falling incomes as a result of international trade. In contrast to the class conflict suggested by the factor model, the specific factors model characterizes trade politics as common interests among classes and competition between the import-competing and export-oriented sectors.

A recent case illustrates the pattern of trade policy preferences highlighted by the specific factors model. A worldwide slowdown in economic growth following the 1997 Asian financial crisis triggered a flood of steel imports into the United States.² The American price of steel fell by about 20 percent between 1997 and late 1999 and this intense import competition reduced the profitability of American steel companies. Six American steel companies declared bankruptcy in 1999 and approximately 10,000 jobs in the industry were lost. Steel workers and the steel companies united in pursuit of government policies to protect them from these imports under the umbrella of a coalition called "Stand Up For Steel." The steel companies applied for trade protection under American antidumping laws, while the steel workers' union, the United Steel Workers of America, lobbied Congress for more comprehensive government action to support the industry. International trade hurt both capital and labor employed in the American steel industry, and both responded by seeking protection from imports.

Sectoral conflict and the politics of globalization. The specific factors model also adds nuance to our understanding of the political debate over globalization. Whereas the factor model suggests that the debate over globalization pits labor against capital, the specific factors model suggests that this political debate often pits capital and labor in import competing industries against capital and labor in export oriented industries. We might expect therefore that both UNITE (the Union of Needletrades, Industrial and Textile Employees), the principle union in the American apparel industry, and the American Textile Manufacturers Institute, a business association representing American textile firms, would oppose globalization. Indeed, this is what we find. UNITE has been a vocal opponent of NAFTA, of the Free Trade Area of the Americas, and of fast

²Based on material available at the websites of the United Steel Workers of America (<http://www.uswa.org>) and the Steel Manufacturers Association (<http://www.steelnet.org>).

Table 3.5
Two Models of Interest Group Competition Over Trade Policy

	The Factor Model	The Specific Factors Model
The Principal Actors	Factors of Production or Classes	Industries or Sectors
How Mobile are Factors of Production?	Perfectly Mobile Across Sectors of the Economy	Immobile Across Sectors of the Economy
Who Wins and Who Loses from International Trade?	<i>Winner:</i> Abundant Factor—capital in the advanced industrialized countries. <i>Loser:</i> Scarce Factor—labor in the advanced industrialized countries.	<i>Winner:</i> Labor and Capital Employed in Export-Oriented Industries. <i>Loser:</i> Labor and Capital Employed in Import-Competing Sectors.
Central Dimension of Competition Over Trade Policy	Protectionist Labor <i>Versus</i> Liberalizing Capital	Protectionist Import-Competing Industries <i>Versus</i> Liberalizing Export-Oriented Industries

track authority. For its part, the American Textile Manufacturers Institute has not been critical of all trade agreements, but it has opposed free trade agreements with South Korea and Singapore, has been very critical of the American decision to grant China permanent normal trade status, and does not support further opening of the U.S. market to foreign textiles through multilateral trade negotiations (AMTI 2001). In general, labor and capital employed in textile and apparel are both skeptical of globalization.

Conversely, the specific factors model predicts that capital and labor employed in export-oriented industries will both support globalization. Among firms based in export-oriented sectors of the American economy, such support is relatively easy to document. A coalition of business associations representing American high-tech firms—including the Consumer Electronics Association, Electronic Industries Alliance, Information Technology Industry Council, MultiMedia Telecommunications Association, and The Semiconductor Industry Association—has supported fast track authority, the approval of normal trade relations with China, NAFTA, and the FTAA. It is more difficult to document the attitudes toward globalization held by workers employed in these industries, in large part because these workers are not organized to the same extent as low and medium skill workers in manufacturing industries. However, workers in high-tech industries are predominantly high skilled, and on average, high-skilled workers are more supportive of trade liberalization than low-skill workers (Scheve and Slaughter 2001). While this is indirect evidence, it is consistent with the prediction of the specific factors model that both labor and capital employed in American high technology industries will support globalization.

Overall, both of the society-centered models we have explored here argue that the trade policy preferences held by domestic interest groups are determined by the distributional consequences of international trade. Trade raises the incomes of some groups and

lowers the income of others. Those who gain from trade prefer trade liberalization, while those who lose prefer protectionism. We can conceptualize the resulting patterns of trade policy preferences according to our two models (see Table 3.5). The factor model states that the distributional consequences of international trade fall along factor lines and give rise to conflict between labor and capital. The specific factors model states that the distributional consequences of trade fall along sector lines and give rise to conflict between import competing and export oriented industries. In both cases, the domestic politics of trade policy are driven by competition between the winners and losers from international trade.

The Collective Action Problem and Trade Policy Demands

The trade policy preferences held by domestic interest groups are not transformed automatically into political demands for trade policies. Individual preferences must be aggregated and collective action in pursuit of trade policy must be organized. Not all groups with a common interest in trade policy will be able to organize for collective action. This might seem counter-intuitive. If people are rational, and if international trade affects incomes in predictable ways, then why wouldn't people who share a common interest join forces to lobby the political system for their desired trade policy? Groups don't always lobby because of the collective action problem (Olson 1965). The **collective action problem** refers to the fact that "rational, self-interested individuals will not act to achieve their common or group interests. . . . Even if all of the individuals in a large group are rational and self-interested, and would gain if, as a group, they acted to achieve their common interest or objective, they will still not voluntarily act to achieve that common or group interest" (Olson 1965, 2). In the context of trade policy, this means that even though all consumers benefit from free trade, or all workers and firms engaged in a particular industry would benefit from a particular trade policy, they will not necessarily be able to act as a group to achieve their preferred trade policy outcome.

The collective action problem arises from a phenomenon called free riding. **Free riding** describes situations in which an individual relies on others to bear the costs of a program from which he or she derives benefits (Sandler 1992, 17). My experience with public radio offers a very good example. My local public radio station uses voluntary contributions from its listeners and businesses to finance 87 percent of its budget. Without these voluntary contributions, the station would be forced to go off the air. As a regular listener to many programs on this station, I benefit immensely from the station's existence and my life would be greatly diminished were the station forced off the air. Yet, in spite of the fact that I do benefit, I have never made a financial contribution to the station. Instead, I rely upon others to pay for the station's operations. In other words, I free ride on the contributions made by others. Free riding takes place because in any large group with a common objective, be that the continued existence of the public radio station or trade liberalization, all group members will realize benefits once the common objective has been achieved, but the contribution toward this goal made by each individual member of the group is too small to affect the final outcome. In my case, I recognize that whether I contribute \$100 to the radio station or not is unlikely to determine whether the station continues to operate or is shut down.

To take a more meaningful example, consider consumers and trade policy. As a group, the 200 million or so consumers that live in the United States would all gain

from free trade. These 200 million people thus have a common interest in seeing the U.S. government implement a trade policy based on the principle of unilateral trade liberalization. The problem, however, is that consumers will have to lobby the government in order to achieve this goal. Such lobbying is costly—money is required to create an organization, to pay for a lobbyist, and to contribute to politicians' campaigns, and time must be dedicated to fundraising and organization. No individual consumer has an incentive to pay these costs. Instead, most consumers will perform the following very simple calculation: my contribution to this campaign will make no perceptible difference to the group's ability to achieve the final outcome. Moreover, I will realize the benefits of free trade if the group is successful regardless of whether I have contributed or not. Therefore, I will let other consumers spend their money and time, that is, I will free ride on the efforts of other consumers. Because all consumers have the same incentive to free ride, no one contributes time and money, no one lobbies, and consumer interests fail to influence trade policy. Thus, even though consumers share a common goal, the collective action problem prevents them from exerting pressure on politicians to achieve this goal. And what is true for consumers is true for all groups with a common interest. The incentive to free ride on the contribution of others makes collective action in pursuit of a common goal very difficult.

The severity of the collective action problem that a group faces depends upon the size of the group. In large groups, each contribution is very small, relative to the total contribution, and as a result each individual will have less of an impact on the ability of the group to achieve its objective. In large groups, therefore, the incentive to free ride faced by each individual is very strong and large groups face very severe collective action problems. In small groups, each contribution is large relative to the total contribution, and each contribution will therefore be more likely to affect the group's ability to achieve its common goal. As a result, the incentive to free ride and the collective action problem is somewhat weaker (though not altogether absent) in small groups. This simple logic of group size tells us a lot about why consumers have not been a powerful force in the domestic politics of trade policy. Because all consumers face a strong incentive to free ride, contributions to a "Consumers for Free Trade" interest group are substantially less than the underlying common interest in free trade would seem to dictate. Producers, in contrast, can more easily overcome the collective action problem because most industries are composed of a relatively small number of firms. Producer groups can thus lobby the government much more effectively in pursuit of their desired trade policy. This logic helps us understand why producers' interests dominate trade politics while consumer interests are often neglected.

The collective action problem also helps us answer a puzzle we encountered in Chapter 2: why have governments rarely liberalized trade unilaterally but have been willing to do so through reciprocal trade agreements? We see that in the absence of reciprocal trade agreements, import-competing industries can overcome the collective action problem and influence trade policy while groups hurt by protection cannot. A tariff provides benefits to the few firms based in the protected industry. A higher tariff on steel, for example, benefits only steel producers and their workers but imposes costs on the very large group of consumers and firms outside the protected industry. It harms those who use steel as an input in other production processes such

as automakers, and it harms all consumers who buy finished goods containing steel. The benefits of protection, therefore, are concentrated on a small group that can easily overcome the collective action problem, while the costs of this protection are imposed on a large and heterogeneous group that cannot overcome the collective action problem. In the absence of reciprocal trade agreements, therefore, domestic trade politics are dominated by import-competing industries and demands for protection. Liberalizing trade will be difficult in this political environment.

Reciprocal trade agreements pave the way for trade liberalization by enabling export-oriented industries to overcome the collective action problem (see Bailey et al. 1997; Gilligan 1997; Milner 1991). By opening foreign markets to domestic exports, reciprocal trade agreements transform the large and heterogeneous pro-liberalization interests into smaller groups of export-oriented industries that can overcome the collective action problem and lobby for trade liberalization. This transformation occurs because reciprocal trade agreements provide large benefits in the form of access to foreign markets to small groups of export-oriented firms. Reducing foreign tariffs on microprocessors for personal computers, for example, provides substantial gains to the three American firms that dominate this industry (Intel, Advanced Micro Devices (AMD), and Motorola). These three firms will solve the collective action problem they face rather easily and lobby for trade liberalization at home in exchange for the removal of foreign barriers to their exports. Thus, whereas only protectionist interests mobilize when the government pursues unilateral trade policy, both protectionists and liberalizers mobilize when the government pursues a reciprocal trade policy. This change in the balance of political pressure makes trade liberalization possible.

Political Institutions and Trade Politics

Societal interests are not transformed directly into trade policies. Instead, societal interests are brought into the political arena and transformed into policy outcomes through a highly institutionalized political process. Political institutions, the rules governing political activity, have a powerful influence on trade politics because they determine the structure of interest representation and the location of decision making authority. Consider first the impact of competitive elections, which many would suggest is the defining characteristic of democracy, on the representation of societal interests. Elections create powerful incentives for politicians to represent the economic interests of their constituents. Electoral success requires politicians to respond to the demands made by those members of society who keep them in office. Yet, even though electoral politics create incentives for politicians to represent constituent interests in all democracies, the specific rules governing elections can shape how these interests are represented in the political system—that is, whether trade politics will revolve around sector- or factor-based competition. Consider, for example, the impact of an electoral system based on single-member districts. Under this system the nation is divided into mutually exclusive electoral districts, and one person is elected to represent each district. Consequently, political representation is explicitly tied to geography. In order to maintain political office in this system, representatives must make policies that satisfy the demands of the constituents in their districts. District residents will typically be employed in only a few industries. The wages paid in these industries will in turn play a large role in supporting the rest of the local economy—the retail and other service oriented businesses that provide jobs for many other people in the community. The fortunes of a

district's largest industries in turn will shape the electoral fortunes of the politicians representing them. If the representative supports policies that raise incomes in the industries in her district, she is likely to be rewarded with campaign contributions and votes. If the representative supports policies that reduce incomes in these industries, she is likely to be punished as business owners and workers support other candidates. In a single-member district electoral system, therefore, national trade politics will be characterized by competition between industries because political representation is directly linked to specific territorial districts with unique economic characteristics.

The 1998 vote on fast track legislation in the House of Representatives provides plenty of evidence that U.S. legislators do in fact vote their district's economic interest (see Baldwin and Magee 2000). The typical representative that voted against fast track legislation represented a district dominated by import-competing industries. A low percentage of the residents in his district had been to college, and most were therefore employed in low-skill jobs. The manufactured goods produced in the districts were generally low-skill labor intensive goods, and thus not competitive in world markets. The typical opponent of fast track legislation therefore represented a district that was likely to be harmed by additional trade liberalization. Robin Hayes, for example, who represents the 8th District in North Carolina, voted against fast track in 1998 because textiles and apparel firms provide about 40 percent of the jobs in the district. Conversely, the typical representative who voted for fast track represented a district that was dominated by export-oriented industries. The typical worker in this district had a college education and was therefore employed in a high skilled job. Firms in the district were engaged in physical and human capital-intensive production and were therefore highly competitive in world markets. The typical supporter of fast track, therefore, represented a district that was likely to gain from trade liberalization. Jim DeMint, for example, who represents the 4th District in South Carolina, voted for fast track in 2001 in large part because his district is home to a large number of highly competitive, export-oriented producers such as BMW, Michelin, Hitachi, General Electric, and Lockheed Martin.

In contrast, proportional representation electoral systems are more likely to give rise to trade coalitions organized around factorial rather than sectoral lines. Under proportional representation, legislators are selected from party lists in correspondence with the share of the vote each party gains in a national election. In such systems political representation is not explicitly linked to geography. Consequently, we might expect national trade politics to revolve around class- or factor-based coalitions, particularly in countries where political parties have developed close ties to class-based organizations. In Western Europe, for example, Socialist and Social Democrat parties have had historical links with national labor unions while parties of the right have had close ties to business associations. Because politicians do not need to maintain the support of geographically specific constituents, they need not emphasize the interests of specific industries. Because politicians often need to appeal to nation-wide class-based constituents, politicians will often need to emphasize the interests of specific classes in order to maintain power. Thus, in democracies with proportional representation we might expect trade politics to be characterized by class-based or factor-based competition rather than by sectoral competition. Different electoral systems, therefore, are likely to create different kinds of trade politics. Systems based on single member districts will give rise to sector-based competition, while systems based on proportional representation will give rise to factor-based competition.

Elected officials bring the interests they represent into the political system, and this system in turn influences how these competing demands are aggregated and transformed into trade policies. The political system determines where decision-making authority lies and who has access to key decision makers. Consequently, different political systems will give rise to different trade policy processes. Consider the contrast between a presidential and a parliamentary system. The American presidential system divides power between the executive branch and the legislature. The U.S. Constitution gives Congress sole authority over trade policy. In the United States, therefore, trade policy is powerfully influenced by legislative politics. Congressional decisions emerge from the aggregated votes of hundreds of legislators, each representing a specific geographic territory. Electoral rules, therefore, encourage legislators to emphasize the narrow sectoral interests of their districts. The sectoral orientation of interest representation is further strengthened by weak political parties, which means that the party leadership cannot easily compel party members to vote the party's position, and by the fact that Congress is very open to lobbying by private interest groups. The result is a trade politics process in which narrow interests receive lots of representation while broader interests are under-represented.

This institutional framework has two important consequences for American trade policy. First, congressional dominance makes the direction of American trade policy unpredictable and somewhat unstable. Such instability is evident in American history. Tariffs regularly rose and fell between 1846 and 1930 in response to changes in the majority party in Congress. When the Democrats, who at that time represented the interests of Southern export-oriented agriculture, held a majority of seats they would pass legislation that reduced tariffs; when the Republicans, who were then representing the interests of Northeastern import-competing manufacturers, held a majority, they would pass legislation that raised tariffs (Bailey, Goldstein, and Weingast 1997). It is also evident in recent trade legislation; Congress voted against fast track authority in 1998 and then approved the measure in 2001. Second, congressional dominance constrains the ability of the executive to participate in international trade negotiations. The recent history of fast track legislation highlights this effect quite clearly. The president cannot easily pursue WTO or regional trade negotiations without fast track authority, yet Congress has struggled to provide a large and stable coalition in support of fast track legislation. Fast track did pass the House in 2001, but there is no assurance that Congress will ratify any trade agreement concluded in current WTO negotiations. In the American presidential system, therefore, the legislature and narrow industry interests exert a powerful influence on trade policy.

Now consider trade politics in a parliamentary democracy like Japan. In parliamentary democracies the executive and legislative branches are fused. The executive dominates policymaking and the legislature plays little role. In the Japanese system, executive branch dominance has enabled three executive agencies to play the leading role in formulating and implementing postwar trade policy. The most important has been the **Ministry of Economy, Trade, and Industry** (METI) (until quite recently, METI was called the Ministry for International Trade and Industry, or MITI). METI's primary responsibility has been the formulation and implementation of industrial policy, or what the Japanese have called "administrative guidance." Because trade policy has been a critical component of Japanese industrial policy, METI created an International Trade Policy Bureau that has responsibility for multilateral and bilateral

trade negotiations. In conducting international trade negotiations, the International Trade Policy Bureau attempts to ensure that the trade concessions that Japan gains and grants in the WTO and other trade negotiations are consistent with their industrial policy objectives. The Ministry of Foreign Affairs has primary responsibility for conducting international negotiations, and it has created international trade bureaus to facilitate trade negotiations. The Ministry of Foreign Affairs thus duplicates many of METI's trade responsibilities, and as a consequence, the two ministries are frequently involved in jurisdictional conflict (Higashi 1983, 42). Finally, the Ministry of Agriculture, Forestry, and Fisheries (MAFF) has responsibility for international trade and international trade agreements involving products that fall under its domain.

This political structure has two consequences for Japanese trade policy. First, the government can pursue a consistent and stable trade policy under the leadership of executive branch agencies. In contrast with the United States, the executive is not greatly constrained by the legislature. Second, the role of executive branch agencies in formulating trade policy makes it difficult for groups that are not close to the ruling party, the Liberal Democrats, to gain access to decision makers. METI, for example, interacts most heavily with export-oriented industries, and consequently its policies favor export-oriented producers over import-competing industries (Okimoto 1988, 310). The MAFF maintains close contact with Japanese agricultural and fishing interests. It sees its primary task as protecting the incomes of Japanese citizens engaged in import-competing agricultural production (Okimoto 1988, 310). The contrast with the American system is again quite stark. Whereas interest groups can gain access to key decision makers in the United States by lobbying Congress, access to decision makers in the Japanese system is much more restrictive. Japanese labor organizations have a hard time gaining access to the decision-making arena, as do many import-competing manufacturing industries. In a parliamentary democracy like Japan, therefore, the executive is insulated from competing interest group pressures and consequently has the ability to pursue a consistent and coherent trade policy.

We could look at other differences in political institutions. We might consider, for example, how trade politics in a multi-party coalition government in a parliamentary system, such as one finds in many West European countries, would differ from trade politics in a single party government like Japan. While such a comparison could be interesting, it would only reinforce the more fundamental point: the specific political institutions in place in a society exert a powerful influence over how societal interests are brought into the political arena and transformed into trade policy. In order to understand the domestic politics of trade policy, it is necessary to examine the pattern of societal trade policy demands and the specific political institutions through which these competing demands are transformed into policy outcomes. Doing so often entails undertaking a detailed, fine-grained analysis of the interplay between interests and institutions within a specific political system.

Interests and Institutions in American Trade Politics

The United States provides an excellent lens through which to examine how societal interests and political institutions interact to shape trade policy. The case provides a fascinating

A CLOSER LOOK

Trade Politics in the European Union

National governments do not fully control trade policy in the EU. Instead, the European Union's founding document, the Treaty of Rome, gives the European Commission the authority to determine EU trade policy toward nonmembers. Because it is a customs union, the EU imposes a common external tariff on imports entering the union from outside. In WTO negotiations, therefore, the EU negotiates as a single actor, and it is the European Commission that conducts these negotiations on behalf of all of the member governments. The ability of the EU Commission to exercise its authority over trade policy is limited, however, by the political and institutional relationships within which it operates (see Hayes 1993, 15; Schuknecht 1992, 37; Johnson 1998; Meunier and Nikolaidis 1999; Nugent 1994). Of particular importance in this regard is the Council of Ministers, the EU's principal decision-making body. In the context of trade policy, the Council of Ministers is composed of the trade ministers of each of the EU member governments, and these trade ministers set the parameters within which the Commission must operate as it negotiates in the WTO or in other international arenas. The process works in the following manner. The Commission develops a general set of recommendations for a proposed round of multilateral negotiations. In developing these recommendations it works closely with the "Article 113 Committee," which is an EU committee composed of national civil servants, usually the national trade ministers' top aides (Gray 1985). The Commission's recommendations are then submitted to the Council of Ministers for approval. Often such approval is accompanied by strict limits on the ability of the Commission to make concessions that extend beyond the agreed recommendation. As a consequence, when the Commission is faced with the need to make a large concession to achieve one of its objectives in the WTO, it will usually have to go back to the Council of Ministers to gain the approval of national governments. Thus, even though the EU Commission has legal authority over trade policy, it exercises this authority under the close scrutiny of the EU's member governments.

The trade policy objectives that EU member governments instruct the Commission to pursue reflect the demands placed upon these national governments by domestic interest groups. While it is impossible to trace such demands in each of the 15-member countries, we can sketch out the basic pattern of demands that are present in the EU. As in the United States and Japan, export-oriented industries in capital-intensive manufacturing and services have lobbied for multilateral trade liberalization. But there have been important exceptions as mature capital-intensive manufacturing industries such as steel and automobiles have grown increasingly protectionist in the face of international competition. As in the United States and Japan, internationally traded services, particularly financial services based in London and Frankfurt, have lobbied for liberalization of trade in services since the early 1980s. Again in parallel with the United States and Japan, politically influential import-competing manufacturers have lobbied for protection and against multilateral liberalization. European-based textile and apparel industries have been the most important opponents of liberalization, as they have been in the U.S. and increasingly in Japan. European firms in high technology sectors have also been at a disadvantage internationally, and have therefore been ambivalent about liberalization. Finally, European agriculture is not competitive internationally, and EU farmers have lobbied consistently for protection. As a consequence, European agriculture is heavily pro-

Continued

protected from foreign competition. Overall, EU trade policies reflect a pattern of societal group interests quite similar to what we see in Japan: capital-intensive manufacturing and service industries promote liberalization, while labor-intensive manufacturing industries, high-technology sectors, and agriculture promote protection.

example of how a coalition of export-oriented interests determined to pursue a liberal trade policy in the context of political institutions biased toward protectionism created new political institutions that made trade liberalization possible. It also highlights how the contemporary congressional debate over fast track authority has implications that extend well beyond the terms under which the United States participates in the current WTO negotiations or can conclude a free trade agreement with Latin American countries.

A coalition of export-oriented interests has provided the political support for post-war trade liberalization. This coalition first came to power in 1932 under the banner of the Democratic Party. The New Deal realignment of the American political party system of the early 1930s brought capital-intensive manufacturing, export-oriented agriculture, and organized labor (most of which was based in capital-intensive manufacturing) together in support of Franklin D. Roosevelt's bid for the presidency (see Ferguson 1984; Frieden 1988). In the 1932 elections, the Democrats captured the White House and gained majorities in the House and Senate. This coalition, and the societal groups they represented, had a clear interest in trade liberalization. There was little chance, however, that they could rely upon Congress to achieve this objective. Indeed, at the onset of the Great Depression in 1930, Congress had passed the very protectionist **Smoot-Hawley Act**, which raised the average tariff to an historic high of almost 60 percent (Pastor 1980, 77–78). The problem that the pro-liberalizing coalition faced extended beyond Smoot-Hawley, and resided in the protectionist bias at the core of congressional tariff politics. We saw above that in the absence of reciprocal trade agreements industries that benefit from protection have a stronger incentive to organize and lobby than do groups that benefit from low tariffs. Legislators thus faced interest group pressure for protection and little countervailing pressure. Moreover, the dynamics of legislative politics worked in such a way that any effort to protect a single industry would be transformed into legislation that protected lots of industries. Suppose that a representative from Pennsylvania introduced legislation that proposed to raise tariffs on steel. A higher tariff on steel would benefit steel producers based in a few congressional districts, but it would also impose costs on all of the districts that did not have steel producers but were instead consumers of steel. Consequently, in order to get representatives from, say, Michigan (where the auto industry is very important and a large consumer of steel) to vote for a high tariff on steel, the representative from Pennsylvania would have to support a high tariff on automobiles. The initial legislation is thus transformed into a bill that raises tariffs on steel and cars. Other legislators will now ask for higher tariffs for industries in their districts as the price for their support for this bill. The legislation is again amended to add the higher tariffs on these goods. This dynamic, a process that has been called **logrolling**, produces a final tariff bill that raises tariffs on a much larger number of items than any individual legislator desires. This is precisely what happened in the Smoot-Hawley Act. The initial legislation proposed only a moderate increase of tariffs on farm products. Once it entered Congress, however, legislators from farm districts dominated by small farmers facing

competition from imported potatoes, cream, butter, and eggs joined forces with legislators from districts dominated by labor-intensive manufacturers of such items as shoes, watches, apparel, gloves, and some luxury goods. The bill was amended more than a thousand times in the Senate, and the resulting bill raised tariffs on almost 20,000 items in the American tariff schedule (Pastor 1980, 78; Eichengreen 1989b).

Legislators cannot easily escape this logrolling dynamic. While each may want to limit the amount of protection granted to industries outside his district, each also recognizes that a refusal to support protection for industries in other districts will cause other legislators to refuse to support protection for industries in his district. As one senator stated in the debate over Smoot-Hawley Act, "I will not vote for a tariff upon the products of another State if the Senators from that State vote against protecting the industries of any State" (quoted in Pastor 1980, 80). Cordell Hull, a staunch proponent of free trade who had represented Tennessee in the House and then the Senate before becoming Roosevelt's Secretary of State, recognized that Congress greatly limited the prospects for durable trade liberalization. "It would have been folly to go to Congress and ask that Smoot-Hawley be repealed or its rates reduced . . . This [approach had] . . . always resulted in higher tariffs because the special interests enriched by the tariffs went to their respective congressmen and insisted on higher rates" (quoted in Destler 1986, 13). Durable trade liberalization could be achieved only by institutional reform that took the tariff out of congressional politics. Thus, while Smoot-Hawley was unique in the level of protection it provided, the dynamic that produced this legislation was not. It would be difficult to pursue lasting trade liberalization through Congress because congressional logrolling would always be more likely to generate protection than trade liberalization.

The desire to pursue trade liberalization coupled with the need to take the tariff out of congressional politics to do so led to institutional reform through which tariff-setting authority was shifted from Congress to the executive. The executive was more likely than Congress to pursue a liberal trade policy for two reasons. First, the president represents a national constituency rather than a single district. Because individual legislators represent a single district, they can gain the benefit of protection for producers based in their districts and impose the costs of protection on people and businesses living outside their district. The president, whose constituency extends into every district, has nowhere to push the costs of protection. Instead, the president must weigh the benefits gained by one district from a higher tariff against the costs that such tariffs impose on other districts. As a consequence, trade policy set by the president is likely to be less protectionist than trade policy set by legislators. Second, the executive can negotiate reciprocal tariff agreements with foreign governments. As we saw above, such reciprocal agreements create an incentive for export-oriented interests to lobby in support of trade liberalization, thereby altering the balance of interest group pressure in a direction that favors liberalization. The executive is thus more likely than Congress to pursue a liberal trade policy and in doing so, will be better able to attract the political support that liberalization requires.

The Roosevelt Administration proposed such a shift of authority in 1933 and Congress responded by passing the **Reciprocal Trade Agreements Act** (RTAA) of 1934. Under this legislation Congress allowed the executive to reduce tariffs by as much as 50 percent in exchange for equivalent concessions from foreign governments. Why would a Congress so intent on raising tariffs in 1930 pass legislation that authorized

the executive to lower tariffs only four years later? Students of American trade policy have suggested a number of explanations for this reversal. Some have argued that Congress passed the RTAA because it recognized that it was producing bad trade policy (Destler 1994; Lohman and O'Halloran 1994). As foreign governments raised tariffs on American exports in retaliation to the Smoot-Hawley Act, and as the American and world economies fell deeper into depression it became clear that high tariffs were not solving the economic crisis. Aware that they could not escape the political logic that led to protectionism, Congress delegated authority to the executive "to protect themselves from the direct one-sided pressure from producer interests that had led them to make bad law" (Destler 1994, 14). Others argue that the liberal emphasis of the RTAA resulted from shifting party majorities in Congress (Pastor 1980). The Republican Party, which throughout the nineteenth and early twentieth centuries was the party of protection, held a majority of seats in Congress in 1930 and used it to pass the protectionist Smoot-Hawley Act. The Republicans lost the majority to the Democrats in both the House and Senate in the 1932 elections, however. Democrats used this majority to pass trade-liberalizing legislation. The Smoot-Hawley Act and the RTAA simply represented a continuation of a longer historical pattern in which Republican majorities raised protection and Democrat majorities lowered it.

Still others highlight the importance of the RTAA itself (Bailey, Goldstein, and Weingast 1997). These students argue that even though the Democrats enjoyed a congressional majority after 1932, they did not have enough votes to reduce American tariffs unilaterally. Many Democrats at the time argued that unilateral tariff reductions would generate a flood of imports, and consequently support for legislation that proposed unilateral reductions would be "politically dangerous" (Bailey, Goldstein, and Weingast 1997, 317). Yet, by linking reductions of American tariffs to the opening of foreign markets to American exporters, the RTAA created a large congressional coalition in support of trade liberalization. "It [was] easier to build majority support for reductions (and harder to form a coalition to negate an agreement) when tariffs [were] coupled with changes in access to foreign markets" (Bailey, Goldstein, and Weingast 1997, 318). The logic behind this claim should be familiar by now: reciprocal reductions created an incentive for export-oriented firms to lobby their representatives on behalf of trade liberalization. This in turn balanced the interest group pressures that legislators faced. While each of these explanations highlights a different reason for the passage of the RTAA, all agree that the RTAA represented a fundamentally important change in the institutional framework governing American trade politics. By delegating authority for trade policy to the executive, Congress removed tariffs from a legislative process that made sustained liberalization difficult. This institutional change has had a lasting impact on American trade politics. The basic approach initiated in 1934 remains at the center of U.S. trade politics, as current wrangling over fast track legislation indicates (see Table 3.6). As a result, Congress has not voted on a comprehensive tariff act since 1930. Instead, U.S. tariffs have been changed through GATT negotiations and through administrative procedures that we look at below. In short, postwar trade liberalization was made possible through the interaction between the interests of export-oriented producers and institutional change that reduced congressional influence over tariffs.

In delegating trade policy authority, Congress has not given the executive a completely free hand. Instead, Congress has continued to influence trade policy by setting the parameters within which the executive operates (see O'Halloran 1994). In part,

Table 3.6
Important American Trade Legislation, 1934–2002

Legislation	President
1934 Reciprocal Trade Agreements Act	Roosevelt
1937 RTAA Extension	Roosevelt
1940 RTAA Extension	Roosevelt
1943 RTAA Extension	Roosevelt
1945 RTAA Extension	Roosevelt
1948 RTAA Extension	Truman
1949 RTAA Extension	Truman
1951 RTAA Extension	Truman
1953 RTAA Extension	Eisenhower
1954 RTAA Extension	Eisenhower
1955 RTAA Extension	Eisenhower
1958 RTAA Extension	Eisenhower
1962 Trade Expansion Act	Kennedy
1974 Trade Act	Nixon
1979 Trade Agreements Act	Carter
1984 Trade and Tariff Act	Reagan
1988 Omnibus Trade Act	Reagan
2001 Trade Policy Authority Act	Bush

this has been achieved by writing explicit constraints on executive action into the legislation delegating authority and in part by delegating authority only for short periods of time. The 1934 RTAA, for example, authorized the president to reduce American tariffs only by 50 percent, and even this authority expired after three years. Subsequent extensions adopted essentially the same approach. In addition, in a practice that began with the 1974 Trade Act, Congress now requires all trade agreements negotiated under this delegated authority to be ratified by Congress under the fast track procedure. Congress instituted fast track in 1974 because the GATT's Tokyo Round included a number of issues that would require changes to American trade law. Of particular concern were negotiations on antidumping and countervailing duty investigations. Congress was unwilling to give prior consent to any changes to American laws that might emerge from the Tokyo Round. At the same time, however, it could not easily establish parameters within which the executive would have to negotiate. The solution that Congress adopted was to provide the executive with the authority to negotiate, but to require Senate approval of the resulting agreement. The need to secure congressional approval of the trade agreements that the executive concludes ensures that congressional concerns are taken into account during the negotiating process.

Congress also created a new agency inside the Executive Office of the President, called the **United States Trade Representative** (USTR), to lead and coordinate American trade policy. During the early postwar period the State Department took the lead in GATT negotiations. By the late 1950s, however, Congress was becoming concerned that the State Department was not the best representative of American commercial interests. Too often, the congressional leadership argued, State Department officials approached trade negotiations from the context of America's broader

foreign policy objectives. As a consequence, the State Department was too often willing to achieve these broader objectives by sacrificing the interests of American industries, in essence opening American markets to imports without gaining equivalent access to foreign markets. To ensure that American commercial interests were well served in GATT negotiations, Congress created a new agency called the Special Trade Representative (STR), as part of the 1962 Trade Expansion Act. The STR was to be the "chief representative of the United States during trade negotiations" and it was to coordinate the positions of various executive branch agencies for these negotiations. In addition, Congress required the STR to seek advice from industry, agriculture, and labor during trade negotiations. During the 1970s Congress made the USTR a statutory unit of the Executive Office and gave it its current name. Today, the USTR sets and administers U.S. trade policy, is the nation's chief trade negotiator, and represents the United States in the WTO and other international trade organizations. Through all of these mechanisms, Congress has maintained a considerable degree of influence over how the executive uses the trade policy authority that Congress delegates.

Congress has not been entirely unresponsive to the interests of import-competing industries. Congress established a rule-based system of administered protection to handle demands for protection from individual industries (see Goldstein 1986). Industries can seek protection through two different administrative channels. First, an industry can pursue protection through the "escape clause" included in American trade legislation (Sections 201 and 204 of the 1974 Trade Act) and embodied in Article XIX of the GATT. Article XIX of the GATT states that governments can provide protection if "any product is being imported . . . in such increased quantities and under such conditions as to cause or threaten serious injury to domestic producers." To gain import protection under this remedy, the industry must file a case with the **United States International Trade Commission** (ITC), an independent and non-partisan quasi-judicial federal agency that provides trade expertise to Congress and the executive. The ITC then conducts an investigation in order to determine whether imports are causing substantial damage to the industry in question. If the ITC determines that imports are causing substantial harm to the industry, it recommends to the executive that relief be granted. The executive then decides whether or not to provide such relief. When President George W. Bush raised tariffs on imported steel in the spring of 2002, for example, he did so on the basis of an ITC investigation undertaken during 2001 under Section 201 of the 1974 Trade Act. Second, a firm can apply for protection in cases of "unfair trade," which are cases in which a foreign firm is dumping goods in the American market or a foreign government is subsidizing the production or export of a good. Petitions for relief from unfair trade go through a two-stage administrative process. In the first stage the Commerce Department determines whether foreign firms are dumping or a foreign government is providing subsidies. If Commerce finds evidence of such practices the case then goes to the ITC, which determines whether dumping or subsidies are a cause of substantial injury to the domestic industry. If the ITC and the Commerce Department both reach positive findings, then the tariff will be raised to offset the margin of dumping or the subsidy. This system of administered protection allows industry demands for protection to be handled on a case-by-case basis within a system guided by legal rules and administrative procedures.

In short, desiring liberalization but facing a legislative process that made this difficult to achieve, politicians representing export-oriented interests created political institutions that reduced the role played by Congress in making American trade policy. The interaction between societal interests and these institutional arrangements created a political system within which trade liberalization could be lastingly achieved. This institutional framework allowed the United States to participate in GATT, and through the GATT process the United States progressively reduced barriers to trade. It is unlikely that the United States would have been able to pursue a trade policy that was as durably liberal in the absence of this institutional change. The executive could have participated in GATT negotiations without delegated authority. But the need to submit the resulting agreements to Congress, and the ability of Congress to amend these agreements, would have greatly reduced the chances that multilateral negotiations would succeed. Thus, the creation of institutions that limited the role played by Congress in trade policy has been a critically important aspect of postwar liberalization. Equally important was the process established for handling industry demands for protection. Individual demands for protection could not simply be ignored, because the affected industries might then build a legislative coalition that reversed the liberal emphasis of American trade policy. The system of administered protection allowed demands for protection to be handled on a case-by-case basis. This in turn allowed protectionist pressure to be diverted away from the legislature, where congressional dynamics could generate broader protectionist legislation, to administrative agencies immune to such dynamics.

This historical context makes it clear that the contemporary congressional debate over fast track authority has implications that extend beyond the terms under which the United States participates in the current round of WTO negotiations. This debate suggests that congressional support for the institutions that have made postwar liberalization possible is weakening. At the base of this weakening support lie some important changes in the interests of many American industries. As postwar reconstruction was completed in Europe and Japan, as American tariffs have been reduced, and as competitive manufacturing industries emerged in East Asia and Latin America, American industry began to confront a much more competitive economic environment. For many industries, tougher competition implied costly adjustment. As a consequence, some economic groups that had supported trade liberalization in the early postwar period became advocates of protectionism. Perhaps chief among these groups is organized labor. Since the early 1970s the AFL-CIO has grown more critical of the pro-liberalization stance of American trade policy and has in many instances advocated a more protectionist policy. Mature capital-intensive manufacturing industries such as the auto and steel industries also have become less supportive of trade liberalization. Such industries have repeatedly, and often with considerable success, sought protection from foreign competition during the last 25 years. It is not surprising that these two groups would become wary of liberalization. Most labor unions represent workers employed in mature capital-intensive manufacturing industries like the auto and steel industries, and these industries have seen the comparative advantage they enjoyed in the years immediately following World War II gradually erode. Their change from export-oriented industries to import-competing industries has been accompanied by a change in their trade policy preferences.

As we would expect, Congress has been responsive to growing demands for protection. Indeed, current reluctance to approve fast track authority is only one in a series of decisions that highlight the growth of protectionist sentiment in Congress. During the 1970s Congress loosened the guidelines governing administered protection (Destler 1995, Chapter 6). These changes reduced the threshold for determining whether an industry is injured from imports from the prior standard that imports be the major cause of injury to the much less stringent requirement that imports be a "substantial cause of injury or threat thereof" (Destler 1995, 143). Congress also granted the ITC greater independence, greatly reduced the time frame within which petitions for relief had to be decided, and transferred authority for investigating antidumping and countervailing duty petitions from the Treasury Department to the Commerce Department, which it was believed would be more receptive to demands for protection (Destler 1995, 150). These changes made it easier for industries to get a positive finding, and therefore, made it more likely that firms facing import competition would petition for relief. As a result, petitions for relief, and the amount of relief provided, both rose sharply in the wake of these legislated reforms (See Destler 1995, Chapter 6). And as we saw in Chapter 2, during the 1980s and early 1990s Congress began to pressure the executive branch to adopt a more aggressive policy toward countries engaging in what it believed to be "unfair" trade practices through Section 301 of American trade law.

Current congressional reluctance to support fast track legislation is thus the most recent manifestation of a 25 year trend of growing protectionist sentiment in Congress and growing congressional assertiveness in American trade policy. These changes in congressional trade politics in turn reflect changes in the balance of power among the industry groups that legislators represent. They suggest a growing influence for groups in import-competing industries and a weakening of influence for export-oriented industries. The outcome of this political competition will in turn shape the future direction of American trade policy in part by shaping the institutions through which American trade policy is made. Congressional support for fast track legislation will safeguard the pro-liberalization orientation of American trade policy and allow the executive to pursue additional liberalization in multilateral and regional negotiations. Defeat of fast track will make international negotiations extremely difficult, if not altogether impossible, and may in fact herald the transition back to the old system in which Congress fully dominated trade policy. Such developments would almost surely bring greater protection.

Weaknesses of a Society-centered Approach

While a society-centered approach helps us understand how the interaction between societal interests and political institutions shapes trade policies, it does have weaknesses. Let us now turn to the three most significant weaknesses. First, a society-centered approach does not explain trade policy outcomes. It tells us that trade politics will be characterized by conflict between the winners and losers from international trade, and it does a fine job telling us who the winners and losers will be. It does not help us predict or explain which of these groups will win the political battle. Presumably, a country's trade policy will embody the preferences of the most powerful interest

groups. To explain trade policy outcomes, therefore, we need to be able to evaluate the relative power of the competing groups. The society-centered approach provides little guidance about how to measure this balance of power. The temptation is to look at trade policy outcomes and deduce that the most powerful groups are those whose preferences are reflected in this policy. Yet, looking at outcomes renders this approach tautological; we assume that the preferences of powerful groups are embodied in trade policy, and then infer the power of individual groups from the content of trade policy. Thus, the society-centered approach is better at explaining why trade politics is characterized by competition between societal groups than at telling us why one group outperforms another in this competition for influence.

Second, the implicit claim at the center of this approach that politicians have no independent trade policy objectives and play no autonomous role in trade politics is probably misleading. Politicians are not simply passive recorders of interest group pressures. As Ikenberry et al. (1988, 8) note, politicians and political institutions "can play a critical role in shaping the manner and the extent to which social forces can exert influence" on trade policy. Politicians do have independent trade policy objectives and the constellation of interest groups that politicians confront is not fixed. Indeed, politicians can actively attempt to shape the configuration of interest group pressures that they face. They can, for example, mobilize latent interest groups that have a preference for liberalization or protection by helping them overcome their collective action problem. By doing so, politicians can create coalitions of interest groups that support their own trade policy objectives. Political institutions also affect the extent to which societal groups can influence policy. In some countries, political institutions insulate politicians from interest group pressures, thereby allowing politicians to pursue their trade policy objectives independent of interest group demands. We will examine this in greater detail when we look at the state-centered approach in the next section.

Finally, the society-centered approach developed here does not address the motivations of noneconomic actors in trade politics. Societal interest groups other than firms, business associations, and labor unions do attempt to influence trade policy. In the United States, for example, environmental groups have played a prominent role in trade politics, shaping the specific content of the North American Free Trade Agreement and attempting to shape the negotiating agenda of the Millennium Round. Human rights groups have also become active participants in American trade politics. This has been particularly important in America's relationship with China. Human rights groups have consistently sought to deny Chinese producers access to the U.S. market in order to encourage the Chinese government to show greater respect for human rights. The assumption that trade politics are driven by the reactions of interest groups to the impact of international trade on their incomes provides little insight into the motivations of noneconomic groups. The society-centered approach tells us nothing about why groups that focus on the environment or human rights spend resources attempting to influence trade policy. Nor does it provide any basis with which to make sense of such groups' trade policy preferences. In the past, such a weakness could perhaps be neglected because noneconomic groups played only a small role in trade politics. The contemporary backlash against globalization suggests, however, that these groups must increasingly be incorporated into society-centered models of trade politics.

A STATE-CENTERED APPROACH TO TRADE POLICY

A state-centered approach assumes that trade policy, as well as economic policy more broadly conceived, is set by the state in pursuit of the national interest. The state occupies a privileged position in any country; it defines the rules within which others act, it alone has the authority to make definitive decisions about these rules, and it alone has the coercive capacity necessary to extract resources from society and to allocate them in line with its economic objectives. The state-centered approach argues that states use this power to intervene in the economy in pursuit of objectives that are determined independent from domestic interest groups' narrow self-interested concerns. The state-centered approach therefore depicts a process of economic policy-making in which protection and liberalization reflect the interests and power of the state. We examine the state-centered approach with a specific focus on government intervention designed to promote national economic development. We look first at the broader economic justification for protectionism aimed at creating internationally competitive industries, and then narrow our focus to the use of such measures by the advanced industrialized countries in high technology industries. In the concluding section we look briefly at the weaknesses of this approach.

States and Industrial Policy

A state-centered approach assumes that governments and government bureaucracies can operate independently of interest group pressures. As a consequence, trade and economic policies do not necessarily reflect the interests of societal pressure groups, but instead embody the goals of state policymakers. The ability to formulate and implement policy independent from societal group demands allows the state to pursue objectives that enhance national welfare, however that may be defined, rather than raise the income of specific interest groups. This approach argues that states use their capacity for autonomous action to intervene in the domestic economy in order to promote the development of industries that will make a positive contribution to national economic development and to discourage those industries deemed less likely to make a positive contribution. As we will see below, governments in many of the advanced industrialized countries have used such policies in some form during the postwar period, and some authors attribute Japan's postwar economic success to such policies.

The intellectual justification for state intervention in the economy rests on the claim that targeted government intervention can create internationally competitive industries. Historically, this justification has been provided by the infant industry case for protection. The **infant industry case for protection** applies to cases in which a country's newly-created firms (infants, so to speak) could not *initially* compete against foreign producers in an established industry, but would be able to do so eventually if they were given time to mature. The infant industry case for protection rests on a presumed disjuncture between the social and private returns from manufacturing (Balassa and Associates 1971, 93). While manufacturing activity yields high social returns (that is, it provides large benefits to society as a whole), the short-term private returns (the profits realized by the person or firm making the investment) are at best uncertain and at worst negative. This disjuncture between the social and private returns can arise

because a new firm that might be profitable in the long run might operate at a loss in the short run because it cannot produce goods at a cost that is competitive with established firms. Over time, however, the new firm will gain experience that will enable it to reduce its cost of production and become competitive with older established firms.

The logic of the infant industry case for protection applies most directly to **late industrializers**—countries that are trying to develop manufacturing industries in competition with established manufacturing industries in other countries. This term obviously describes most developing countries in the contemporary international economic system. But it once described many of today's advanced industrialized countries, including the United States, as they attempted to develop manufacturing industries in the face of dominant British manufacturing power in the nineteenth century. It also describes modern Japan and the continental European states, all of which were trying to develop advanced manufacturing industries in the face of American competitive advantages in these sectors during the twentieth century. Protecting domestic firms in such cases can enable them to overcome their initial competitive disadvantages by allowing them to gain experience by producing for the domestic market (we will look more closely at why protection might facilitate the development of competitive industries in the next section). Once domestic firms become competitive in world markets, protection can be eliminated.

The infant industry argument for protection is not universally accepted. Critics charge that a tariff or another form of protection is probably not the best response to the central problem the firm confronts. If a firm will be profitable in the long run, but must operate at a loss in the short run, the firm should be able to borrow from private capital markets to cover its short run losses. Such borrowing would obviate the need for trade protection, because the firm could sell its goods at the same price as the established firm and use the borrowed funds to cover its losses until it begins to reduce its production costs. If capital markets are not sufficiently developed to allow infant industries to borrow the necessary funds, the government can do more to raise social welfare by improving the capital market to make such lending possible than by imposing a tariff to protect the infant industry (Baldwin 1969). While this criticism questions the use of protection to promote industry development, it does not challenge the central claim of the infant industry argument, namely that firms that can be competitive in the long run might need some form of government assistance in the short run.

Industrial policy takes the infant industry argument one step further by suggesting that governments can create internationally competitive industries through a combination of protection and subsidies. The term **industrial policy** refers to an assortment of policies including tax policy, government subsidies, traditional protectionism, and government procurement practices. By using such policies, the state channels resources away from some actors and industries and directs them toward those actors and industries that it wishes to promote. The use of such policies is typically based on long-term economic development objectives defined in terms of boosting economic growth, improving productivity, and enhancing international competitiveness. The specific goals often are determined by explicit comparisons to other countries' economic achievements (Wade 1990, 25–26). In postwar Japan, for example, the explicit goal of Japanese industrial policy was to catch up with the United States in many high-technology industries. In formulating and implementing industrial policy, the state rarely secures

full independence. Instead, it formulates and implements policy through a process of continuous consultation and coordination with private sector actors (Wade 1990, 26).

Not all states are well suited for the design and implementation of an effective industrial policy. The critical factor is state strength. **State strength** refers to the degree to which the state is insulated from domestic interest group pressures. **Strong states** are states in which policymakers are highly insulated from such pressure, while **weak states** are those in which policymakers are fully exposed to such pressures. Strong states are characterized by a high degree of centralization of authority, a high degree of coordination among state agencies, and a limited number of channels through which societal actors can attempt to influence policy. In contrast, weak states are characterized by decentralized authority, a lack of coordination among agencies, and a large number of channels through which domestic interest groups can influence economic policy. These political institutional characteristics make it easier for strong states to formulate long-term plans embodying the national interest. In weak states, policymakers must respond to the particularistic and often short-run demands of interest groups. Strong states may also be more able than a weak state to remove protection once an infant industry has matured. In addition, strong states may be more able to implement industrial policies that redistribute societal resources because policymakers need worry less that policies that redistribute resources from one domestic group to another will have a negative impact on their position in power.

Japan is often depicted as the preeminent example of a strong state that has been able and willing to use industrial policy to promote economic development (see, e.g., Johnson 1982). The Japanese state centralizes power and provides limited channels of access to domestic interest groups. Because of this highly centralized state, Japan has been able to pursue a coherent industrial policy throughout the postwar period. The Ministry of International Trade and Industry (MITI) (now called METI) and the Ministry of Finance (MoF) were the principal agencies involved in developing and implementing industrial policy. In the immediate postwar period, these agencies gave priority to economic reconstruction and to improving the prewar industrial economy. Since the 1960s, greater emphasis has been placed on promoting rapid economic growth and developing internationally competitive high technology industries (Pempel 1977, 732). With this goal firmly in mind, the Japanese state pursued an active industrial policy (called administrative guidance) through which it channeled resources to those industries it determined critical to Japanese success. Together, MITI and MoF targeted specific industries for development, starting with heavy industries (steel, shipbuilding, automobiles) in the early postwar period and then shifting to high technology industries during the 1970s. The state pressured firms to invest in the industries targeted for development, and those that made such investments benefited from tariff and nontariff forms of protection, tax credits, low-cost financing, and other government subsidies. Some scholars suggest that Japan's remarkable postwar economic performance was a direct result of this state-centered approach to economic development (Johnson 1982).

France also relied heavily upon industrial policies throughout much of the postwar period (Wilkinson 1984; Hart 1992). The French state is highly centralized and French bureaucracies are tightly insulated from societal group pressures, as in Japan. This structure allowed the French government to pursue an industrial policy aimed at developing key industries with little direct influence from domestic interest groups. A

former Director of the Ministry of Industry described the policymaking process: "first, we make out a report or draw up a text, then we pass it around discreetly within the administration. Once everyone concerned within the administration is agreed on the final version, then we pass this version around outside the administration. Of course, by then it is a *fait accompli* and [interest group] pressure cannot have any effect" (quoted in Katzenstein 1977, 18). In the early postwar period, the French state formulated development plans to "establish a competitive economy as an essential base for political independence, economic growth, and social progress" (Katzenstein 1977, 22). French industrial policy in this period was based on a strategy of "National Champions," under which specific firms in industries deemed by the French state to be critical to French economic development received support. In the 1950s and 1960s, for example, two French steel companies and a small number of French auto producers (Renault, Simca, Peugeot) received state support. During the 1960s and 1970s, the French state attempted to develop a domestic computer industry by channeling resources to specific French computer companies such as Machines Bull. This strategy is now widely acknowledged to have been unsuccessful as French national champions failed to become competitive in international markets (Hart 1992).

In contrast to Japan and France, the United States is characterized as a weak state (Katzenstein 1977; Ikenberry et al. 1988). Political power in the United States is decentralized through federalism, through the division of powers within the federal government, and through independent bureaucratic agencies. This decentralization of power in turn provides multiple channels through which domestic interest groups can attempt to influence policy. Consequently, "American state officials find it difficult to act purposefully and coherently, to realize their preferences in the face of significant opposition, and to manipulate or restructure their domestic environment" (Ikenberry et al. 1988, 11). American trade and economic policy therefore more often reflects the interests of societal pressure groups than the "national interest" defined by state policymakers. This does not mean that the United States has been unable to support critical industries. American national security and defense policies have channeled substantial resources to maintaining technological leadership over potential rivals. To maintain this lead, the U.S. government has financed the basic research that underlies many high technology products, including computers, telecommunications, lasers, advanced materials, and even the internet. In addition, Department of Defense contracts have supported firms that produce both military and civilian items. Thus, even though the United States is a weak state, we do see a form of industrial policy in the U.S. government's support for basic research and in its defense-related procurement practices designed to meet national security objectives.

The state-centered approach therefore argues that state policymakers can use industrial policy to promote domestic economic development by helping domestic firms gain international competitiveness. The ability of policymakers to pursue such policies, however, is strongly influenced by the institutional structure of the state in which they operate. In strong states, such as Japan and France, policymakers are insulated from domestic interest groups and can therefore use industrial policy to promote economic development in line with the national interest. In weak states, such as the United States, policymakers cannot easily escape interest group pressures and as a consequence trade and economic policy is more likely to reflect the particularistic demands of these groups than any broader conceptions of the national interest.

Industrial Policy in High-technology Industries

High-technology industries have been one area in which governments in many of the advanced industrialized countries have relied heavily upon industrial policies. Boosting the international competitiveness of such industries has been the principal goal of such policies. High-technology industries are highly valued for the contribution they make to national income. These industries tend to earn **rents**, that is, they earn a higher than normal return on an investment, and they pay higher wages to workers than standard manufacturing industries. In addition, relatively recent developments in economic theory that build on the basic insight of the infant industry case for protection suggest that governments can use industrial policy to create internationally competitive domestic high technology industries. We examine these issues here, focusing first on the economic theories that justify the use of industrial policy in high-technology industries and then examining two cases in which industrial policy appears to have enabled high-technology firms based in Japan and the EU to become internationally competitive at the apparent expense of high-technology firms based in the United States.

Strategic trade theory. Strategic trade theory provides the theoretical justification for industrial policy in high technology industries. **Strategic trade theory** expands on the basic insight of the infant-industry case for protection, and asserts that government intervention can help domestic firms gain international competitiveness in high-technology industries by helping them overcome the competitive advantages enjoyed by established firms. Competitive advantage in high-technology industries often comes from the combination of economies of scale and oligopoly. **Economies of scale** occur when the unit cost of producing a good falls as the number of goods produced increases. Economies of scale often arise from the knowledge acquired in production. In early stages of production, workers continually confront new tasks, learn new techniques, and discover unrecognized bugs in the production line. As the number of units produced rises, tasks and techniques that had once been novel become routine and workers become better at producing the good. The time it takes to produce a particular good falls and consequently the costs of production fall as well. For example, when the European commercial aircraft producer Airbus Industrie built its first jet, 340,000 man-hours were required to assemble the jet's fuselage. As output expanded, however, this time fell rapidly. By the time that Airbus had produced 75 aircraft, only 85,000 man-hours were required to assemble the fuselage, and eventually this number fell to 43,000 man-hours (McIntyre 1992, 36). The cost savings realized as a result of these dynamics are often called "moving down the learning curve."

Economies of scale give rise to oligopolistic market structures. **Oligopoly** refers to markets in which a very limited number of firms operate. In contrast to perfectly competitive markets in which all firms are price takers, that is, a single firm's output has no impact on the market price of its good, in oligopolistic markets each firm is a price maker—the decisions it makes about how much to produce will have an impact on the market price of its products. Oligopoly so often characterizes high-technology industries because world demand for the goods produced in these industries is usually large enough to support only a few firms operating at the level of output necessary to realize economies of scale. The market for commercial jets, for example, is large enough to support only two or three aircraft manufacturers operating at peak efficiency. In oligopolistic market structures, the behavior of each individual firm has an

impact on other firms. The successful entry of a new firm into an established industry, for example, will reduce the profitability of established firms and can even force these firms to exit the industry. But in such an environment, economies of scale provide the firms that enter a particular high-tech industry first with a large cost advantage over potential rivals. As a consequence, firms that would be competitive if they could move down the learning curve and realize economies of scale are deterred from entering the industry because the cost advantage enjoyed by the established firm makes success unlikely. The nature of the disadvantage is simple: who will buy the new entrant's higher cost output? Absent such sales the new firm will never realize the scale economies essential to long-term success. As a consequence, international competitiveness, as well as the pattern of international specialization in high-technology industries, can be attributed as much to the timing of market entry as to underlying factor endowments.

The dynamics of competition in high-technology industries can be illustrated with a simple game borrowed from work by the economist Paul Krugman (Krugman 1987). This game highlights how industrial policy can help a new firm entering a high-technology industry gain competitiveness at the expense of established firms. Let's assume that there are two firms, one American and one Japanese, interacting in a high-tech industry that will support only one producer. Each firm has two strategies, to produce or to not produce. The payoffs that each firm gains from the four possible outcomes are depicted in Table 3.4a. There are two possible equilibrium outcomes in this game, one in which the American firm produces and the Japanese firm does not (cell II), and one in which the Japanese firm produces and the American firm does not (cell IV). Thus, this particular high-tech industry will be based in the United States or in Japan, but never in both.

Which country will capture the industry? That depends upon which firm is first to enter the market. Let's suppose that the American firm is first to enter the industry and has realized economies of scale. The Japanese firm has no incentive to enter the industry because by doing so it would earn a profit of negative 5. If we assume that the Japanese firm is first to enter the market, then it realizes scale economies and the American firm has no incentive to enter the market. Thus, even though both firms could produce the product equally well, the firm that enters first dominates the industry. According to strategic trade theory, therefore, international specialization in high-technology industries has little to do with underlying factor endowments. The firm that is first to enter a particular high-technology industry will hold a competitive advantage, and the country that is home to this firm will capture the rents available in this industry.

Against this backdrop we can examine how governments can use industrial policy to help domestic high-technology firms. Government intervention can help new firms enter an established high-technology industry to challenge and eventually compete with established firms. Government assistance to these new firms can come in many forms. Governments may provide financial assistance to help their new firms pay for the costs of research and development. Such subsidies help reduce the costs that private firms must bear in the early stages of product development, thereby reducing the up-front investment a firm must make to enter the industry. Governments may also guarantee a market for the early and more expensive versions of the firm's products. Tariffs and quotas can be used to keep foreign goods out, and government purchasing decisions can favor domestic producers over imports. The Japanese government, for example, purchased most of its supercomputers from Japanese suppliers in the 1980s, even though the supercomputers produced by the American firm Cray Industries were cheaper and

performed at a higher level. The guaranteed market allows domestic firms to sell their high-cost output from early stages of production at high prices. The combination of financial support and guaranteed markets allows domestic firms to enter the market and move down the learning curve. Once the new firms have realized economies of scale, they can compete against established firms in international markets.

We can see the impact of such policies on firms' production decisions using the simple game developed above (see Figure 3.4b). Suppose that the American firm is the first to enter and dominates the industry. Suppose now that the Japanese government provides a subsidy of 10 units to the Japanese firm. The subsidy changes the payoffs the Japanese firm receives if it produces. In contrast to the no subsidy case, the Japanese firm now makes a profit of 5 units when it produces even if the American firm stays in the market. The subsidy therefore makes it rational for the Japanese firm to start producing. Government support for domestic high-technology firms has a second consequence that stems from the oligopolistic nature of high-tech industries. Because such industries support only a small number of firms at profitable levels of output, the entry of new firms into the sector must eventually cause other firms to exit. Thus, government policies that promote the creation of a successful industry in one country undermine the established industry in other countries. This outcome is also clear in our simple game. Once the Japanese firm begins producing, the American firm earns a profit of negative 5 if it continues to produce, and a profit of 0 if it exits the industry. Exit, therefore, is the American firm's rational response to the entry of the Japanese firm. Thus, the small 10-unit subsidy provided by the Japanese government enables the Japanese firm to eliminate the first mover advantage enjoyed by the American firm and ultimately drive the American firm out of the industry. As a consequence, Japan's national income rises by 100 units (the 110 unit profit realized by the Japanese firm minus the 10 unit subsidy from the Japanese government) while America's national income falls by 100 units. A small subsidy has allowed Japan to increase its national income at the expense of the United States.

		Japanese Firm	
		Produce	Not Produce
American Firm	Produce	-5, -5	100, 0
	Not Produce	0, 100	0, 0

3.4a Payoff Matrix with No Subsidy

		Japanese Firm	
		Produce	Not Produce
American Firm	Produce	-5, 5	100, 0
	Not Produce	0, 110	0, 0

3.4b Payoff Matrix with Japanese Subsidy

Figure 3.4 The Impact of Industrial Policy in High-Technology Industries.
Source: Based on Krugman 1987.

Strategic rivalry in semiconductors and commercial aircraft. The semiconductor industry and the commercial aircraft industry illustrate these kinds of strategic trade rivalries between the United States, Japan, and the EU in the contemporary global economy. In the semiconductor industry, American producers enjoyed first mover advantages and dominated the world market until the early 1980s. The semiconductor industry prospered in the United States in part due to government support in the form of funding for research and development (R&D) and for defense-related purchases. The U.S. government financed a large portion of the basic research in electronics—as much as 85 percent of all R&D prior to 1958, and as much as 50 percent during the 1960s. At the same time, the U.S. defense industry provided a critical market for semiconductors. Defense-related purchases by the United States government absorbed as much as 100 percent of total production in the early years. Even in the late 1960s the government continued to purchase as much as 40 percent of production. These policies allowed American semiconductor firms to move down the learning curve and realize economies of scale. This first mover advantage was transformed into a dominant position in the global market. In the early 1970s, U.S. semiconductor producers controlled 98 percent of the American market and 78 percent of the European market.

Beginning in the 1970s, the Japanese government targeted semiconductors as a sector for priority development and used two policy measures to foster a Japanese semiconductor industry. First and most important, the Japanese government used a variety of measures to protect Japanese semiconductor producers from American competition. Tariffs and quotas kept American chips out of the Japanese market. The Japanese government also approved very few applications for investment by foreign semiconductor firms and restricted the ability of American semiconductor firms to purchase existing Japanese firms. As a direct result, American semiconductor firms were unable to jump over trade barriers by building semiconductor production plants in Japan. Japanese industrial structure—a structure in which producers develop long-term relationships with input suppliers—helped ensure that Japanese firms that used semiconductors as inputs purchased from Japanese rather than American suppliers. Finally, government purchases of computer equipment discriminated against products that used American chips in favor of computers that used Japanese semiconductors. The extent of Japanese protectionism can be appreciated by comparing U.S. market shares in the United States, EU, and Japanese markets. Whereas American semiconductor firms controlled 98 percent of the American market and 78 percent of the EU market in the mid-1970s, they held only 20 percent of the Japanese market (Tyson 1992, 93). Second, the Japanese government provided financial assistance to more than 60 projects connected to the semiconductor and computer industry. Such financial assistance helped cover many of the research and development costs Japanese producers faced.

By 1976, Japanese firms were producing highly sophisticated chips and had displaced American products from all but the most sophisticated applications in the Japanese market. Success in the Japanese market was followed by success in the global market. Japan exported more semiconductors than it imported for the first time in 1979. By 1986 Japanese firms had captured about 46 percent of global semiconductor revenues, while the American firms' share had fallen to 40 percent (Tyson 1992, 104–105). By protecting domestic producers and subsidizing research and development costs, the Japanese government helped Japanese firms successfully challenge American dominance of the semiconductor industry.

A similar dynamic is evident in U.S.–European competition in the commercial aircraft sector. Two American firms, Boeing and Douglas (later McDonnell Douglas) dominated the global market for commercial aircraft throughout the postwar period, in part because of U.S. government support to the industry provided through the procurement of military aircraft (Newhouse 1982; Office of Technology Assessment 1991, 345). Work on military contracts enabled the two major American producers to achieve economies of scale in their commercial aircraft operations. Boeing, for example, developed one of its most successful commercial airliners, the 707, as a modified version of a military tanker craft, the KC-135. This allowed Boeing to reduce the cost of developing the commercial airliner. Both jets in turn benefited from the experience Boeing had gained in developing the B-47 and the B-52 bombers (OTA 1991, 345). As Joseph Sutter, a Boeing executive vice president noted, “We are good . . . partly because we build so many airplanes. We learn from our mistakes, and each of our airplanes embodies everything we have learned from our other airplanes” (quoted in Newhouse 1982, 7). The accumulated knowledge from military and commercial production gave the two American producers a first-mover advantage in the global market for commercial airliners sufficient to deter new entrants.

In 1967, the French, German, and British governments launched Airbus Industrie to challenge the global dominance of Boeing and McDonnell Douglas. Between 1970 and 1991, these three European governments provided between \$10 and \$18 billion of financial support to Airbus Industrie, an amount equal to about 75 percent of the cost of developing Airbus airliners (OTA 1991, 354). As a consequence, by the early 1990s Airbus Industrie had developed a family of commercial aircraft capable of serving the long-range, medium-range, large passenger, and smaller passenger routes. Airbus's entry into the commercial aircraft industry had a dramatic impact on global market share. As Table 3.7 makes clear, in the mid-1970s Boeing and McDonnell Douglas dominated the market for large commercial airliners. Airbus began to capture market share in the 1980s, however, and by 1990 it had gained control of 30 percent of the market for large commercial airliners. In 1994 Airbus sold more airliners than Boeing. As a consequence of Airbus's success, a substantial portion of the rents available from the production and sale of commercial airliners has been transferred from the United States to Europe. Thus, by subsidizing the initial costs of aircraft development, European governments have been able to capture a significant share of the global market for commercial aircraft, and the income generated in this sector, at the expense of the United States.

Strategic trade rivalries of this kind have been a source of conflict in the international trade system. Countries losing high-technology industries as a consequence of the industrial policies pursued by other countries can respond by supporting their own

Table 3.7
Market Share in Global Commercial Aircraft

	Boeing	McDonnell Douglas	Airbus
1975	67%	33%	0
1985	63%	20%	17%
1990	54%	16%	30%

Source: Calculated from Data in Tyson 1992, 158–159.

firms to offset the advantages enjoyed by foreign firms or by attempting to prevent foreign governments from using industrial policy. In the United States, which considered itself a victim of the industrial policies adopted by Japan and the EU, the national debate has focused on both responses. Considerable pressure emerged during the 1980s and early 1990s for a national technology policy. Proposals were advanced for the creation of a government agency charged with reviewing global technology and "evaluating the likely course of key American industries; comparing these baseline projections with visions of industry paths that would be compatible with a prosperous and competitive economy; and monitoring the activities of foreign governments and firms in these industries to provide an early warning of potential competitive problems in the future" (Tyson 1992, 289). Many recommended that the U.S. government reduce its R&D support for military and dual use projects (dual use refers to projects with military and commercial applications) and increase the amount of support provided to strictly commercial applications. Proponents of a national technology strategy also encouraged greater cooperation between the public and private sector on precompetitive research in a wide range of advanced technologies. Such proposals played an important role in the first Clinton Administration's thinking about international trade, a role reflected in Clinton's selection of Laura D'Andrea Tyson, an economist and one of the most prominent proponents of such policies, to be the Chair of his Council of Economic Advisors.

The United States also put considerable pressure on other governments to stop their support of high-technology industries. A series of negotiations with Japan that were conducted during the 1980s and early 1990s were designed to pry open the Japanese market to internationally competitive American high-technology industries. Such negotiations took place in semiconductors, computers, telecommunications, and other sectors. The rationale for these negotiations is evident from the previous discussion about first mover advantages. If Japanese firms could be denied a protected market for their early production runs, they would never realize the scale economies required to compete in international markets. Opening the Japanese market to American high-technology producers would prevent the emergence of competitive Japanese high-technology firms and thereby help maintain American high-technology leadership. During the 1980s and early 1990s, therefore, the United States responded strategically to the use of industrial policies by Japan and, to a lesser extent, the EU and adopted policies designed to counter them.

Weaknesses of the State-centered Approach

While a state-centered approach directs our attention to the important role that states play in shaping the structure of their domestic economies, it does have some important weaknesses. Three such weaknesses are perhaps most important. First, the state-centered approach lacks explicit micro-foundations. The approach asserts that states act in ways that enhance national welfare. A critical student must respond to this assertion by asking one simple question: what incentive does the state have to act in ways that do in fact enhance national welfare? Anyone who has visited the Palace of Versailles in France, or that has spent anytime reading about the experience of other autonomous rulers knows that autonomous states have as much (if not more) incentive to act in the private interests of state officials as they have to act in

the interest of society as a whole. Why then would autonomous state actors enrich society when they might just as easily enrich themselves? Answering this question requires us to think about how state actors are rewarded for promoting policies that enhance national welfare and punished for failing to do so. In answering this question we develop micro-foundations—an explanation that sets out the incentive structure that encourages state officials to adopt policies that promote national welfare. But the state-centered approach currently does not offer a good answer to this question. The reward structure that state policymakers face cannot be elections, for that pushes us back toward a society-centered approach. The reward structure might be security related; one could reasonably argue that states intervene to enhance the power and position of the nation in the international system. We must still explain, however, how these broad concerns about national security create incentives for individual policymakers to make specific decisions about resource allocation. The point is not that such micro-foundations could not be developed, but rather that as far as I am aware, no one has yet done so. As a result, the state-centered approach provides little justification for its central assertion that states will regularly act in ways that enhance national welfare.

Second, the assumption that states make policy independent of domestic interest group pressure is misleading. Even highly autonomous states do not stand above *all* societal interests. While interest groups need not dictate policy, as the society-centered approach claims, they do establish the parameters in which policy must be made. Even in Japan, which comes closest to the ideal autonomous state, the LDP's position in government was based in part on the support of big business. Is it merely a coincidence that Japanese industrial policy channeled resources to big business, or did the Japanese state adopt such policies because they were in the interest of one of the LDP's principal supporters? Thus, whereas the society-centered approach assumes too little room for autonomous state action, the state-centered approach assumes too much state autonomy. We may learn more by fitting the two approaches together. This would lead us to expect governments to intervene in the economy to promote specific economic outcomes, but that often such policies are consistent with and shaped by the interests of the coalition of societal groups upon which the government's power rests.

Finally, strategic trade theory itself, which provides the intellectual justification for government intervention in high-technology industries, has considerable weaknesses. Strategic trade theory is as much a prescriptive theory—one used to derive policy proposals—as it is an explanatory theory. As such, it has some important limitations. The claim that government intervention can improve national welfare is not particularly robust. The conclusions one derives from any theory are sensitive to the assumptions one makes when building the theory. If the conclusions change greatly when one alters some of the underlying assumptions, then the confidence one has in the accuracy of the theory must be greatly diminished. Strategic trade theory has been criticized for producing strong conclusions only under a relatively restrictive set of assumptions. While the specific criticisms are too detailed to consider here, the bottom line is that altering the assumptions about how one country's established firms respond to a foreign government's subsidy of its firms, about how many firms are in the sector in question, and about where firms sell their products can either weaken the central

claim considerably or introduce so much complexity into the model that the policy implications become opaque.

Thus, strategic trade theory does not provide unambiguous support for the claim that government intervention in high-technology industries can raise national income. In addition, even if we assume that strategic trade theory is correct, it is not easy for governments to identify sectors in which intervention will raise national income. It is difficult to identify sectors that offer such gains and then to calculate the correct subsidy that will shift this activity to domestic producers at a net gain to social welfare. If governments choose the wrong sectors, or provide too little or too much support, intervention can reduce rather than raise national welfare. Thus, the precise policy implications of strategic trade theory are unclear, in part because the theory itself is weak, and in part because it is not easy to translate its simpler conclusions into effective policies.

CONCLUSION

This chapter has focused on one basic question: how do we explain the pattern of trade liberalization and protection that we see in the advanced industrialized countries? We saw that while the multilateral trade regime did promote the reduction of barriers to trade during the postwar period, governments in the industrialized world continue to protect certain sectors of their economies. This pattern of protection and liberalization corresponds with advanced industrialized countries' comparative advantages. Governments have been willing to liberalize trade in sectors in which their producers are comparatively advantaged, such as capital-intensive manufacturing. These same governments have been reluctant to liberalize those sectors in which their domestic producers are comparatively disadvantaged, such as labor-intensive manufacturing for most advanced industrialized countries, and agriculture and high technology for Japan and the EU.

We have explored how this pattern of protectionism and liberalization is a product of the interaction between interests and institutions in the domestic political arena. This chapter has presented two different ways of thinking about how domestic politics shape trade policy. The society-centered approach emphasizes the central role of societal interest groups to assert that trade policy emerges from competition between the winners and losers from international trade. Firms and workers in some industries realize rising incomes from international trade and therefore want trade liberalization, while firms and workers in other industries realize falling incomes from trade and therefore want protection. Because politicians must represent the interests of the districts and states that elect them, these groups' interests are brought into the legislative process where they give rise to competition over trade policy. In the advanced industrialized countries, this approach expects governments to liberalize sectors in which they are comparatively advantaged—capital intensive manufacturing—and to resist liberalization in industries in which they are comparatively disadvantaged—labor-intensive manufacturing for all countries, and agriculture in the case of the EU and Japan. The

state-centered approach emphasizes state-level interests and political institutions and asserts that trade policy is produced by autonomous states pursuing the national interest. In conjunction with strategic trade theory, this approach leads us to expect states to intervene in the domestic economy to protect and to subsidize domestic high-technology industries. Together, these two theories provide a good explanation of the pattern of protection and liberalization that we see in the advanced industrialized countries.

KEY TERMS

Collective Action Problem	Oligopoly
Comparative Statics	Producer Surplus
Consumer Surplus	Production Distortion
Consumption Distortion	Productivity
Economies of Scale	Quota Rent
Efficiency Losses	Reciprocal Trade Agreements Act
Export-oriented Sector	Rents
Factor Mobility	Sector
Factor Model	Smoot-Hawley Act
Factor Price Equalization	Specific Factors Model
Fast Track	State Strength
Free Riding	Strategic Trade Theory
Import-competing Sector	Strong States
Industrial Policy	United States International Trade Commission
Infant Industry Case for Protection	United States Trade Representative
Late Industrializers	Weak States
Logrolling	
Ministry of Economy, Trade, and Industry	

WEB LINKS

You can visit the United States Trade Representative at <http://www.ustr.gov>. See the links in Chapter 2 for trade policy in Japan and the EU.

For the positions of American businesses on international trade, visit:

The U.S. Trade Alliance at http://www.us-trade.org/other/about_ustrade.htm.

The Business Round Table at <http://www.brtable.org/issue.cfm/9>.

For the positions of American unions on international trade, visit:

The AFL-CIO at www.afl-cio.org.

UNITE at <http://www.uniteunion.org/index.htm>.

The United Steelworkers of America maintain a number of trade-related websites that can be reached through <http://www.uswa.org/tradesites.html>.

SUGGESTIONS FOR FURTHER READING

The literature on U.S. trade politics is enormous. The best available introduction is probably I.M. Destler, *American Trade Politics*, 3rd edition. (Washington, D.C.: Institute for International Economics, 1992). Unfortunately, there has been much less written in English on the trade policy process in the EU and Japan. For the EU, see John P. Hayes, *Making Trade Policy in the European Community* (London: The MacMillan Press, 1993). For Japan, see Chikara Higashi, *Japanese Trade Policy Formulation* (New York: Praeger, 1983).

On the issues posed by industrial policy in high-technology industries, see Laura D'Andrea Tyson, *Who's Bashing Whom? Trade Conflict in High Technology Industry* (Washington, D.C.: Institute for International Economics, 1995). For a more polemical discussion written by a former trade negotiator in the Reagan Administration, see Clyde V. Prestowitz, *Trading Places: How We are Giving Our Future to Japan and How to Reclaim It* (New York: Basic Books, 1988). For a more technical treatment, see Paul R. Krugman, ed., *Strategic Trade Policy and the New International Economics* (Cambridge: Cambridge University Press, 1986).

CHAPTER

4

TRADE AND ECONOMIC
DEVELOPMENT IN THE SOUTH

The relationship between developing countries and the international trade system has changed fundamentally during the last 20 years. Throughout most of the post-war period, developing countries participated little in the multilateral trade system. Instead, in an attempt to promote industrialization most governments constructed very high trade barriers and intervened extensively in the domestic economy. To the extent that developing countries participated at all in the GATT, they sought to alter the rules governing international trade. Convinced that the GATT was biased against their interests, developing countries worked through the United Nations to create international trade rules that they believed would be more favorable toward industrialization in the developing world. These policy orientations have both changed fundamentally since the late 1980s. Most developing countries have dismantled the protectionist systems they had created and maintained in the first 30 years of the post-war period, and most have greatly reduced the degree of government intervention in the domestic economy. At the same time, developing countries have abandoned the quest for far-reaching changes to international trade rules and have become active participants in the WTO, seeking to liberalize trade to further their own interests.

This chapter examines how political and economic forces have shaped these trade and development policies. We look first at why governments in most developing countries chose to insulate their economies from international trade, why they greatly expanded their participation in the domestic economy, and why they sought changes in international trade rules. To understand these policies, we focus specifically upon how economic theories concerning rapid industrialization dovetailed with the interests of domestic groups to shape the trade and development policies adopted by most governments in developing countries. We then turn our attention to why so many developing countries have reversed course during the last 20 years. Why, after having pursued protectionism at home and reform abroad for more than 30 years, did developing countries begin to dismantle protection at home, abandon reform in the international system, and become active participants in the WTO? In making sense of this change, we focus upon the interaction between domestic and international developments.