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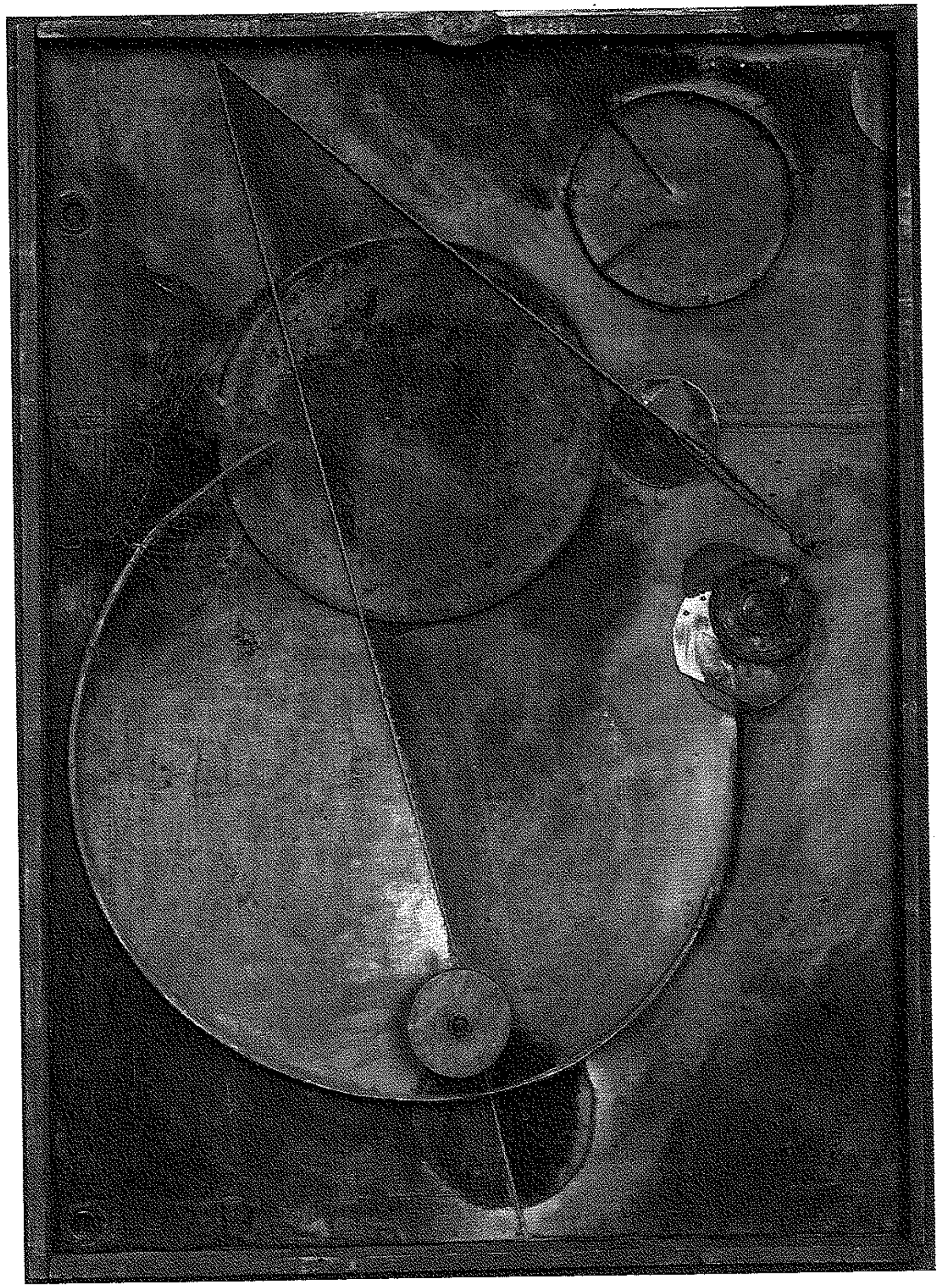

Appleyard & Field

CHAPTER

17

POLITICAL ECONOMY AND RECENT U.S. TRADE POLICY

INTRODUCTION

This chapter first addresses the question of how the setting of trade policy is influenced by institutions and the political process and then summarizes U.S. trade policy developments during the last several decades. We begin with a brief discussion of some common analyses of the interaction between citizens and their elected representatives/policymakers in the process of policy formulation and of the concerns reflected in a country's trade stance. As will be seen, a minority of the population is often successful in procuring policies that benefit it at the expense of general social welfare. We then present an overview of U.S. trade policy since the 1930s. A central point is that the last 60 years have seen a dramatic liberalization of trade in the United States and other industrial countries, a trend that has been reinforced by the recently concluded multilateral round of trade negotiations. By the end of this chapter, you should have a better idea of the complex set of factors that are involved in the determination of trade policy in general and of U.S. trade policy in particular.

THE POLITICAL ECONOMY OF TRADE POLICY

As has often been pointed out, the one issue on which economists are in almost unanimous agreement is the social gains to be made by specializing and trading on the basis of comparative advantage and, correspondingly, opposition to protectionism. In spite of this view, the world continues to experience continual pressures to restrict the movement of goods, services, and factors between countries. Indeed, countries seem to continue to find new and novel ways to restrict these economic activities. Too often as one trade-restricting instrument falls into disfavor and is reduced or eliminated, new trade-restricting provisions seem to pop up. It is little wonder, then, that one is often asked, "If free trade is so beneficial to a country, why are so many groups or individuals trying their best to reduce trade?" Why is it that, as Robert Baldwin (1989, p. 119) so aptly pointed out, "international trade seems to be a subject where the advice of economists is routinely disregarded"?

The answer to this question lies in what is referred to as "the political economy of trade policy." In reality, trade policy takes place within a political-social milieu and is influenced by individuals and groups who feel that they will be better off with restricted trade even though the country as a whole may be worse off. As we have noted in previous chapters, reducing the barriers to trade may make the country better off, but as the corresponding structural adjustments are made, some individuals will be made better off and some worse off. Politicians thus find themselves confronted with a vast array of groups attempting to influence trade policy, and, consequently, they often ignore the advice of economists when establishing the country's trading regime. In the last two decades, an area of research has emerged which focuses on analyzing the actual determinants of trade policy in the political environment within which it is developed. We now turn to a brief discussion of several of the more important strands of research on this topical issue.

The Self-Interest Approach to Trade Policy

The study of the political factors influencing trade policy has proceeded along two major fronts. The first, and perhaps the most pervasive, focuses on the economic self-interest of the political participants.[1] Much of this literature is embedded in **public-choice economics,** which essentially uses economic models to analyze governmental decision-making behavior. In this approach, government decision makers are essentially utility maximizers whose level of satisfaction is dependent upon being reelected and who act in a manner that maximizes the probability that this will in fact take place.[2] An immediate implication of this approach is that the majority of the public will be served by public decision makers who enact legislation to maximize their chances of remaining in office. This is the focus of the **median-voter model,** which holds that the decision maker who votes in such a way as to satisfy the median voter will maximize his or her reelection possibilities. In this approach each individual voter is assigned a position along an array based upon the expected costs or benefits of a particular policy. The median voter is in the center of this array, that is, the middle voter. Should the majority expect to benefit from a particular policy, the median voter will be in favor of the policy and support the politician who favors it. Should the majority feel that they will be harmed by a particular action, the median voter will not favor the policy and will not support a political candidate who attempts to make a case for it. This is a natural model to use in studying international trade policy since, as we have noted in previous theory chapters, trade policy inevitably results in different welfare effects for different groups in the economy.

In the median-voter framework, should a greater number of voters expect to benefit from a particular trade policy than incur a loss, the median voter would be in favor of the proposed legislation and the policymaker would presumably vote in favor of the policy measure. Should the policymaker not support the legislation in this case, the median voter is likely to vote against the legislator in the next election. This approach would thus seem to ensure that the will of the majority would be followed. Unfortunately, however, there are a number of practical problems, which, if they arise, can circumvent the preferences of the median voter and result in policies that are inconsistent with majority benefits. The median-voter model rests on the assumptions that the voters have full information regarding any gains or losses resulting from a particular policy and that they will actually vote consistent with their preferences. Inasmuch as neither of these two assumptions always holds in the real world, it is clearly possible that the preferences of the median voter do not win out. For example, a tariff benefiting only a small group of individuals may end up being supported by a voting majority.

[1] The early background literature on this approach was nicely reviewed by Hillman (1989).

[2] While a number of things such as political ideology, place in history, personal gain, etc., undoubtedly influence the policymaker, nonetheless, remaining in office is central to what the politician hopes to accomplish.

There are a number of situations which can produce these seemingly contradictory results. In the case where there are information-gathering costs as well as opportunity costs associated with actually voting, some potential voters may simply choose not to participate, particularly if expected gains are small and hence the expected net benefits negative. If, in addition, the voter feels that one vote will not actually influence or "swing" the result, he or she may simply accept the outcome without actually engaging in the political process. In this case, voters are acting as "free riders," that is, accepting the outcome without expending any effort or costs. Although this would not be a problem if every voter had an equal probability of not participating, in reality, the differences in the amount of expected benefits and costs (asymmetric gains and losses) strongly suggest that individuals will have different degrees of incentive and that interest groups will form. A particular policy action such as sugar quotas may have only a minor individual or per capita impact on a large group in society (e.g., consumers) but a large per capita impact on a minority (e.g., sugar producers).

Interest groups can influence political outcomes in a variety of ways. Because the costs (benefits) of a policy are relatively great to these groups, they have an incentive to influence political action and are more likely to overcome the free-rider problem of their relatively small number of members. A small group of individuals who stand to gain much from a policy intervention in the market thus obtain a certain group solidarity, participate in the political process, and vote for the candidate who supports their position on protection. At the same time, however, the larger group of diverse consumers who stand to lose with protectionism expect to gain little *individually* by making the effort to acquire information and/or vote; consequently they do not participate. As a result, there is a small voter turnout and the candidate espousing the views of the solid minority block wins. This phenomenon can lead to a **status quo bias** against liberalizing trade policy through lower levels of protection even though doing so carries the promise of improving aggregate welfare. For a large number of people the net personal gains are so small (perhaps even negative) or uncertain that they choose not to participate actively in the political process, and the minority interest group gets its way. There is no doubt that groups such as this are very influential in the conduct of trade policy formation. As Vousden (1990, p. 198) points out, interest or pressure groups tend to be more successful if they are large enough to be visible but small enough to control the free riding of their members, there is a well-defined commonality of interest, and the per capita organizational and information-gathering costs are relatively low.

A second way in which special interest groups can influence political outcomes is through the funding of political campaigns. Funding of campaigns not only contributes to candidate visibility but also can be a relatively low cost way of providing interest-group-centered information to potential voters to motivate them to participate in the political process. In a similar vein, withholding campaign funding or making implied threats to fund an opposition candidate also are effective in getting a politician's attention and support for a particular policy position. Groups that attempt to influence policy in their favor through the use of campaign contributions are said to be carrying on **rent-seeking activity** because the group is committing resources to the pursuit of benefits from protection. Note that the group would not rationally expend resources in excess of the expected benefits that it would receive from the policies in question. (For an interesting discussion of this type of activity, see the description of the political economy underlying recent U.S. policy actions to protect Florida tomato growers in Case Study 1.) Rent-seeking activity can, of course, extend beyond simple campaign contributions to the use of corruptive practices such as bribes to political decision makers to influence their votes. Because the resources used in this type of activity are not producing any good or service but are merely influencing the distribution of income, these actions are often referred to as **directly unproductive activity.**

CASE STUDY 1 POLITICS PUTS THE SQUEEZE ON TOMATO IMPORTS

Recent actions by the Clinton administration to negotiate a floor price on tomato imports from Mexico constitute an excellent example of how the political process can result in a protectionist measure that circumvents the median-voter principle and rewards a small vocal minority (a small number of large Floridian growers) at the expense of the large mass of unorganized free-riding tomato consumers. Led by producer Paul J. DiMare, the Florida tomato producers, who are controlled by a handful of wealthy growers, have argued for years for protection from cheap foreign imports which "are driving Florida farmers out of business." Interestingly, however, the Florida tomato industry has not collapsed even though hurricanes, cold snaps, and other weather-related woes have hindered production. Of recent concern to the growers is the increase in imports from Mexico, which they fear will become even larger as the North American Free Trade Agreement (NAFTA, discussed in Chapter 18) accords come into place. Even though the tariff on Mexican tomatoes was low (1.4 cents/pound) prior to NAFTA, DiMare and others are arguing that the resulting increase in Mexican tomato imports endangers thousands of U.S. jobs and that without help the Florida tomato industry is "going down the tubes." The Florida growers get little sympathy from their counterparts in California, whose summer crop competes directly with Mexico's crop. According to Ken Moonie, vice president of the tomato operations of California-based Calgene Inc., "All this is about protecting four big guys . . . it is not like corn or any other agricultural commodity where thousands of growers are involved."

Imports of tomatoes from Mexico have increased in recent years, cutting into Florida's share of the winter market. Some of this market penetration reflects the simple fact that the taste of the hand-picked, vine-ripened Mexican tomatoes surpasses that of the Florida tomatoes, which are picked green and then gas-ripened prior to shipping. DiMare does not see that consumer preference for the juicier, more tasty vine-ripened fruit has anything to do with the increase in imports, allowing that "it really doesn't matter" how tomatoes taste since they are condiments, seldom eaten alone.

Under the accord reached in October 1996, Mexican growers agreed not to sell tomatoes in the United States below a certain price. The U.S. Department of Commerce stated that this price would be the lowest average price during a recent period when there was a clear absence of any "price suppression" on the part of Mexican producers. This accord was negotiated by Commerce Secretary Mickey Kantor and the Clinton administration because Florida was considered essential in the November elections. According to one Clinton strategist, "It's not that we're afraid that the farmers won't vote for us—there aren't enough tomato farmers down there. The fear is they'll hit us with a negative advertising campaign." The result of the administration's concern regarding campaign funding and possible negative campaigning is that the median voter/consumer ends up with a less tasty, more expensive tomato and U.S. exporters such as pork producers in the Midwest fear that the negotiated tomato settlement may lead to Mexican retaliation against their products.

Sources: Helene Cooper and Bruce Ingersoll, "Playing Catch-Up: With Little Evidence, Florida Growers Blame Tomato Woes on NAFTA," *The Wall Street Journal,* Apr. 3, 1996, p. A1; Robert S. Greenberger, "Mexico Agrees to Temporary Floor on Price of Tomatoes Sold in U.S.," *The Wall Street Journal,* Oct. 14, 1996, p. B3; George Anthan, "Politics Put Squeeze on Tomato Imports; U.S. Growers Prevail," *The Des Moines Register,* Oct. 29, 1996, p. 3A.

Rent-seeking activity can be further complicated when an interest group tacitly agrees to support continued protection in other sectors, even if it means a loss in welfare for its own members, in exchange for support for one's own protection. The idea here is that the combined support of several groups for protection provides a sufficient political critical mass to get the protectionist candidates elected and the trade restrictions maintained. For example, textile and apparel workers (along with sector-specific capital owners in textiles and apparel) might well support the status quo on sugar and steel protection in exchange for the sugar and steel sectors' support of protection in the textile and apparel industry. In this instance, the loss to their membership through higher prices for sugar and steel-using products might well be small compared to the gains obtained through the continued protection of textiles and apparel. This is another example, often called "logrolling," of status quo bias in which a group (or several groups) benefits at the expense of society as a whole. The median voter has again been supplanted in terms of the policy action undertaken because of a large uninvolved free-riding majority and the efforts of an interest-centered pressure group.

Before leaving this discussion, it is important to note that while the self-interest approach has proved quite useful in better understanding the trade policy issue, it ignores the fact that people do things that do not appear to be in their pure economic self-interest. No one would dispute the fact that, although it may be relatively small, individuals have often demonstrated the willingness to sacrifice some of their real income to improve overall welfare, whether it be in their community, their country, or even the world. It is for this reason that we turn to other approaches to political economy.

The Social Objectives Approach

From this perspective, trade policy is conducted taking into account the well-being of different groups in society along with various national and international objectives. In this environment, trade policy is promoted to the public at large in terms of broader social goals such as income distribution, increased productivity, economic growth, national defense, global power and leadership, and international equity. With regard to domestic income distribution, Corden (1974, p. 107) suggests that trade policy appears to have a conservative bias in that governments often seem to give more weight to avoiding real income losses in a particular segment of the economy and assign less weight to increasing the real income of a particular group. Other social objectives which have been discussed in the literature involve minimizing consumer loss, improving the real income of the lowest-income groups, minimizing or delaying adjustment costs for particular industries, and protecting the relative income level of specific socioeconomic groups.[3]

Such a macro approach does, however, create problems. If a country talks a "free-trade talk" and then proceeds *not* to "walk the free-trade walk" by protecting certain import-competing sectors for reasons such as those given above, it quickly loses credibility with the voters. Once pressure groups learn that the government is concerned about income distribution, the verbalized commitment to free trade and structural adjustment is compromised and structural adjustment by both labor and capital slows. The expectation of trade policy relief thus reduces the outward movement of factors from any given declining industry, economic conditions in the industry continue to worsen, and greater and greater pressures are put on the government to intervene to maintain relative income levels and the status quo. The expectation and likely realization of government support of the threatened industry thus results in slowing down the necessary structural change, a loss in overall economic efficiency, and little or no change in equity. The inability to commit to a free-trade policy hence forces the country whose trade policy is influenced by income distribution concerns to maintain protection. It is often argued that this type of analysis is useful in explaining the high level of protection offered to textiles and apparel over time. Deardorff (1987) also suggests that such concerns help explain why governments prefer VERs to tariffs. Finally, Baldwin (1989, p. 129) argues that income distribution concerns can also help explain why governments use protection instead of domestic subsidies to help import-competing firms. With a tariff, quota, or VER, consumers who use the product essentially bear the burden of the policy through higher prices. Inasmuch as they were the group that initially benefited from the import-induced lower prices, an increase in domestic price which returns them more-or-less to the initial higher price leaves them no worse off than they were previously—even if the tariff revenue is not returned to them. Were a production subsidy used to support the affected industry, the burden of the tax (to pay for the subsidy) would

[3]See Baldwin (1989, pp. 126–30) for an excellent overview of these studies.

presumably fall on all taxpayers, thus reducing the relative income of those who do not consume the product and were not affected by the lower product price.

Foreign trade policy has also been used as part of the total foreign policy package. As such, foreign policy concerns have been used to support both increased protection and increased trade liberalization. Since World War II, the United States has been the major hegemonic power in the world. During much of that time, U.S. foreign policy was directed toward limiting the spread of communism and strengthening the noncommunist world economically. U.S. trade and aid policy was clearly influenced by these concerns, and they perhaps explain why the United States chose not to use its hegemonic power to improve its international terms of trade. In addition to hegemonic concerns, there is also evidence that a number of countries have concerns about the international distribution of income that go beyond their own self-interest. Examples of this include the amount of untied foreign aid (i.e., aid that can be spent on goods from any country, not just from the donor country) that has been given to the developing countries as well as the reduced trade restrictions that have been granted both unilaterally and multilaterally through such programs as the Generalized System of Preferences (GSP). Noneconomic analysis of this type has been much more common among political scientists in recent years. We therefore turn to a brief discussion of that line of research with respect to trade policy.

An Overview of the Political Science Take on Trade Policy[4]

Political scientists have taken several tacks in examining the trade policy issue. One tack, similar to the economic self-interest approach, views trade policy as the result of a political process involving competition between various domestic interest groups. A second approach focuses on trade policy as the result of the distribution of economic and political power among trading partners. Building on this focus, others have suggested that the size and/or degree of hegemonic power strongly influences the nature of trade policy. More specifically, writers have argued that the larger the hegemon's international finance and trade interests, the more it will stand to gain from freer trade and the more likely it will work to liberalize international transactions. This proposition has been strongly contested by other political scientists, especially in situations where a few large states tend to dominate world transactions. Others have questioned the logic of such a conclusion, given that a large country can potentially gain from imposing trade restrictions given its ability to pass on part of the domestic costs through changes in international prices (its terms of trade).

From an international relations perspective, it has been tempting for political scientists to focus on the role of the chief executive of a country in influencing not only international policy relating to national security but also policy relating to trade. However, this "unitary actor" approach has been criticized for ignoring the microfoundations of policy formulation which underlie the process by which various pressure groups influence the setting of policy. A perhaps more satisfying approach, also state-centered, focuses on the institutional and ideological structures within a country that lead to the setting of government policy, including trade policy. Again, however, the microfoundations are too often not sufficiently developed.

Baldwin's Integrative Framework for Analyzing Trade Policy

All the previously discussed approaches have enhanced our understanding of various aspects of the policy-setting phenomenon. At the same time, all have certain deficiencies. As Robert Baldwin (1996) has described, what is needed is a general framework that explains not only how policies are set and changed in the presence of "shocks" to the system but also "how the institutions, values and ideologies, and distribution of international economic and

[4]This subsection draws heavily on Baldwin (1996).

political power that shape a country's response to these shocks are themselves determined" (p. 156). Baldwin then sets out a general framework that would address the issue at hand. It is built around four major sets of actors: individual citizens, common-interest groups, the domestic government, and foreign governments/international organizations. The domestic government would be viewed as the key actor, since it ultimately sets policy. Without going into more detail about Baldwin's approach at this time, it is clear that this broader framework would incorporate such diverse factors as the role of the chief executive, the social concerns of citizens, the domestic impact of the policy in question, and the role of relative hegemonic power of the country in question. While we are currently far from the formal specification and application of such a model, it does provide an organizational structure which can be useful in directing and coordinating further work in this area by both economists and political scientists.

With this general background of how interest group behavior and social concerns influence the making of trade policy, we now turn to a summary of both historical and recent U.S. trade policy.

CONCEPT CHECK

1. Explain theoretically why the median-voter principle should result in the will of the majority being revealed in policy decisions.
2. What are the critical assumptions underlying the median-voter model?
3. What is the underlying basis for the social objectives rationale for public policy decisions?

A REVIEW OF U.S. TRADE POLICY

The liberalization of trade can be divided into several stages beginning after the **Tariff Act of 1930,** usually called the **Smoot-Hawley Tariff,** which established extremely high protection in the United States (an average tariff level of about 50 percent). Economists and policymakers generally agree that this tariff worsened the Great Depression of the 1930s. The tariff legislation since that time has occurred largely in response to this impact on the Great Depression and the increasing economic interdependence of countries. We now give a brief overview of trade agreements from 1934 to 1960, followed by an in-depth examination of the Kennedy Round (1960s) and the Tokyo Round (1970s) of trade negotiations. We then discuss the most recent round, the Uruguay Round, which was completed in 1994. We close the chapter with a look at prospects for a future round of trade negotiations and with a review of several recent trade policy actions.

Reciprocal Trade Agreements and Early GATT Rounds

The long process of tariff reduction began with the passage by Congress of the **Reciprocal Trade Agreements Act of 1934.**[5] This act authorized the executive branch to engage in **bilateral negotiations** with individual trading partners on tariff reductions. The act was renewed every three years until the end of World War II. A particular feature of the negotiation process was its employment of an **item-by-item approach,** meaning that rate reductions on goods were bargained individually rather than uniformly agreed upon for a broad range of categories. While significant reductions were made on many goods and on the overall U.S. tariff level, the item-by-item approach does not permit smooth and quick negotiation when many goods are encompassed by the proceedings.

[5]For a good review of tariff policy from 1934 into the 1960s, see "Some Aspects of United States Foreign Trade and the Kennedy Round," Federal Reserve Bank of Cleveland, *Economic Review,* September 1967, pp. 179–82.

At the end of World War II, tariff bargaining took the form of **multilateral negotiations,** meaning that many countries took part simultaneously. The **General Agreement on Tariffs and Trade (GATT)** took effect in 1947. Under this agreement, countries committed themselves to multilateral bargaining for the purpose of easing trade restrictions in all of the participating countries. GATT became an ongoing organization that sponsored regular negotiations of this type. From 1947 until 1962, five **GATT rounds of trade negotiations** were held, in which the participating countries hammered out mutually acceptable reductions of various barriers. The first round, held in Geneva in 1947, was reasonably successful. However, economists did not judge the next four rounds in 1949, 1951, 1956, and 1962, as having attained much success. Nevertheless, some multilateral tariff reductions were achieved, and all these early rounds embodied the most-favored-nation (MFN) principle (discussed in Chapter 13), as did those that followed.

The Kennedy Round of Trade Negotiations

To put new life into the trade negotiation process and to avoid being shut out by the newly forming European Economic Community, the United States led the way into a new round of negotiations from 1962 to 1967. The key stimulus for the round was the U.S. **Trade Expansion Act of 1962.** This legislation authorized the president to negotiate tariff reductions of up to 50 percent, and these reductions could be negotiated through an **across-the-board approach** rather than an item-by-item approach. Broad categories of goods could be discussed all at once and a given rate reduction could apply to the whole group—a more streamlined approach. The Trade Expansion Act also introduced a feature of trade policy known as **trade adjustment assistance (TAA),** which means that, if a tariff reduction injures workers or industries by causing an inflow of imports, displaced workers can, for example, petition for additional unemployment compensation or for help in retraining for other types of jobs. To most economists, this was a marked step forward for public policy, because previously the only alternative considered was to reimpose the tariff (the "escape clause"). Thus, TAA in a broad sense tries to promote internal adjustment to changing international conditions and reduction in protection. It is an attempt to facilitate the movement of the economy along the production-possibilities frontier. Without this assistance, a country's production point might initially move inside the PPF and get back onto the frontier only after a considerable period of time had passed.

With the passage of the Trade Expansion Act, the United States moved into multilateral negotiations in Geneva in what became known as the **Kennedy Round of trade negotiations.** Seventy countries participated, and tariffs on manufactured products were reduced by an average of 35 percent, with at least some reduction occurring in 64 percent of manufactured goods with tariffs. (See Ellsworth and Leith 1984, p. 230.) Note that this success was in terms of cuts achieved in manufactured goods; the Kennedy Round achieved little progress in reducing barriers on agricultural products. In addition, the Kennedy Round did little to ease nontariff barriers.

The Tokyo Round of Trade Negotiations

With the completion of the Kennedy Round of tariff cutting in 1967, no further steps were taken until 1973, when preliminary moves were initiated at a multilateral meeting in Tokyo toward beginning another round of negotiations. A main impetus for the new round was that, while tariff rates had been moving downward, NTBs had been rising and had offset some of the benefits of the tariff reductions.

The **Trade Act of 1974** enabled the United States to participate in this new round, the **Tokyo Round of trade negotiations.** This act of Congress authorized the president to enter into trade negotiations for the purpose of reducing tariff and nontariff barriers. Reductions of up to 60 percent were authorized on existing duties greater than 5 percent, and tariffs could be eliminated altogether on goods whose existing duties were less than 5 percent.

In addition, authorization was granted to enter into individual-sector negotiations to work for the liberalization of NTBs. Other features of interest in this bill were the provision for introduction of the U.S. Generalized System of Preferences (GSP) for the products of developing countries (see Chapter 13) and the provision for more generous treatment of claims for trade adjustment assistance.

Finally, the Trade Act of 1974 attempted to systematize procedures on claims for import relief by import-competing firms. Prominent provisions of the act in this respect (some of which predate 1974) were:

1. *Section 201:* This part of U.S. legislation permits import-competing firms to petition for relief from rapidly increasing imports (or "surges" in imports). The U.S. International Trade Commission (USITC) then investigates whether the rapid increases in imports are causing "substantial injury" to the U.S. industry and, if so, makes a recommendation for protection to the president. The president may or may not accept the recommendation.

2. *Section 232:* The president is authorized to restrict any good that "is being imported into the United States in such quantities or under such circumstances as to threaten to impair the national security." This provision has seldom been used (principally on petroleum in earlier years). In 1986, it was used to limit machine tool imports, which resulted in voluntary export restraints (VERs) with Japan and Taiwan.[6]

3. *Section 301:* This unfair-trade portion of U.S. law permits the president to take retaliatory action in response to unjustifiable, unreasonable, or discriminatory restrictions on U.S. exports by foreign countries. *Unjustifiable* refers to any action that violates the international legal rights of the United States; *unreasonable* refers to unfair and inequitable practices, although these are obviously hard to define; and *discriminatory* means actions that deny national or MFN treatment to the United States.[7] The range of U.S. possible actions is broad, and includes (among others) suspending trade agreement concessions, imposing duties or other import restrictions, and entering into agreements with the other country to eliminate the behavior or to provide compensation to the United States.

In addition to this Section 301 provision, there are Super 301 and Special 301 features of U.S. trade law. *Super 301* refers to executive orders of the president (the latest at the time of writing having been issued in 1999) whereby the U.S. Trade Representative (USTR), a cabinet-level officer in the executive branch, is required to publish a report on which foreign country practices are most important in impeding U.S. exports. This report can then be followed by USTR initiation of a Section 301 proceeding. Under the *Special 301* provisions of U.S. trade law, the USTR identifies countries that are denying adequate or effective intellectual property rights to U.S. industries or persons. Such identification leads to a designation of the offending countries as "Priority Foreign Countries" and can be followed by USTR initiation of Section 301 action.

4. *Section 701:* This covers subsidies to exports by foreign countries. Petition is made by import-competing firms to the Department of Commerce to ascertain the existence of the subsidy; if affirmed, the USITC determines whether or not injury is occurring.

5. *Section 731:* This portion of trade law consists of the antidumping provisions summarized in Chapter 15, page 295.

[6]William J. Long, "National Security versus National Welfare in American Foreign Economic Policy," *Journal of Policy History* 4, no. 3 (1992), pp. 288–91.

[7]*Economic Report of the President,* February 1988 (Washington, DC: U.S. Government Printing Office, 1988), p. 156.

With this enabling legislation in hand, U.S. negotiators took part in the multilateral negotiations in Geneva between 1974 and 1979, which resulted in agreement (see Allen 1979) that (1) tariff rates on manufactured goods were to be reduced by an average of about one-third in a phase-in process over eight years, and (2) new codes of behavior concerning several NTBs were to be adhered to with respect to, for example, government procurement procedures, subsidies and countervailing duties, and valuation of goods for customs duties purposes. (For estimates of the sectoral employment impacts of the Tokyo Round cuts in trade barriers, see Case Study 2.) In addition, agreement was reached that tariff preferences should be given by developed countries to various manufactured exports from the developing countries and that the **nonreciprocity principle** should apply to developing countries. This principle holds that, even though developed countries may reduce barriers on exports from developing countries, no corresponding behavior is required by developing countries on exports to them from developed countries. By embracing tariff preferences and nonreciprocity, the world community basically affirmed the value judgment that the plight of the developing countries in the international economy and the relatively low levels of their per capita income required special, discriminatory measures in favor of these countries.

After the implementation of the Tokyo Round tariff cuts, it was estimated that the average tariff level in the United States on manufactured products had been reduced to 4.3 percent. Other countries appeared to have relatively similar average tariff levels: Canada 5.2 percent, France 6.0 percent, Japan 2.9 percent, United Kingdom 5.2 percent, and West Germany 6.3 percent.[8] Except for Japan, all of these rates were slightly higher than the rate in the United States, but the differences were minor. The low Japanese rate points out one difficulty with these calculations, because they do not adequately include nontariff barriers. Nevertheless, the broad level of tariff rates was substantially lower than the levels existing at the time of Smoot-Hawley.

[8]Alan V. Deardorff and Robert M. Stern (1986), p. 49. Note that the nominal rates for Japan and the United States differ from those in Case Study 3 in Chapter 13, page 242, reflecting different weights and procedures.

CASE STUDY 2 SECTORAL EMPLOYMENT IMPACTS OF TOKYO ROUND TRADE LIBERALIZATION

Alan Deardorff and Robert Stern (1986) estimated the size of labor movements between sectors in selected countries resulting from the Tokyo Round tariff cuts (and reductions in a few nontariff barriers to trade). Their calculations of the number of workers who changed jobs were made using a large model of the world economy (29 industries across 34 countries), of a type known as a computable general equilibrium (CGE) model. The results are presented in Table 1.

The number of job changes as a percent of the labor force in each country is rather small (Chile's 1.52 percent is the largest). However, the absolute numbers of workers are not small; thus, trade liberalization does have some noticeable impact on employment allocation by sector.

TABLE 1 **Workers Reallocated to New Jobs Due to Tokyo Round Tariff Cuts**

Country	*Number of Workers (thousands)*	*Percentage of Labor Force*
Belgium-Luxembourg	29.76	0.77%
France	59.71	0.29
United Kingdom	54.69	0.22
West Germany	108.58	0.44
European Community (9 countries)	342.44	0.34
Canada	26.99	0.28
Chile	42.45	1.52
India	30.31	0.01
Japan	35.95	0.17
Mexico	27.38	0.16
South Korea	13.74	0.11
United States	122.75	0.14

Source: Alan V. Deardorff and Robert M. Stern, *The Michigan Model of World Production and Trade: Theory and Applications* (Cambridge: MIT Press, 1986), pp. 54–55.

The Uruguay Round of Trade Negotiations

The first four years, 1986–1990

Despite the presence of relatively low tariff rates in the industrialized world, a new round of trade negotiations began in September 1986 and was to be completed by December 1990. These talks were initiated in Punta del Este, Uruguay, and became known as the **Uruguay Round of trade negotiations.** Major objectives of this new round included a continuation of the attempt to reduce NTBs, an enlargement of the negotiations to embrace trade in services in addition to the traditional emphasis on trade in goods, and a determination to deal with restrictions on agricultural trade.

The Uruguay Round set forth an ambitious agenda. Members established 15 groups to work on reducing restrictions in the following areas: (1) tariffs, (2) NTBs, (3) tropical products, (4) natural resource–based products, (5) textiles and clothing, (6) agriculture, (7) safeguards (against sudden "surges" in imports), (8) subsidies and countervailing duties, (9) trade-related intellectual property restrictions, (10) trade-related investment restrictions, and (11) services, as well as four other areas dealing with GATT itself (e.g., dispute-settlement procedures and implementation of the NTB codes of the Tokyo Round, especially on dumping).[9] The biggest controversies in the negotiations involved services, intellectual property, and agriculture.

The most heated controversy by far concerned agriculture. Most countries use a wide variety of policies to assist the agriculture sector: price supports, direct production subsidies, export subsidies, quotas on imports, acreage restrictions to raise commodity prices, and others. These interventions lead away from the free-market and free-trade allocation of resources, since they introduce price distortions. (See Case Study 3 for a discussion of the magnitude of such price distortions. See Case Study 4 for an analysis of their welfare effects.) The United States initially proposed a 10-year phaseout of all subsidies that affect agricultural trade and of all agricultural import barriers. The proposal was similar to one made by the Cairns Group, a collection of 14 developing and developed countries with agricultural interests (e.g., Argentina, Australia, Brazil, Canada, New Zealand). The European Community (EC) wanted to go more slowly and to moderate the extent of reduction in agriculture support.[10] By 1990, the wide disparity in subsequent proposals overshadowed all other aspects of the negotiations, and the four-year effort had seemingly ended with no signed agreement on the liberalization of trade.

Continued negotiations lead to success, 1993

Despite the failure of the Uruguay Round talks to meet the originally scheduled completion deadline of December 1990, negotiations continued. President Bush requested and received from Congress in 1991 a two-year extension to continue the talks under the **fast-track procedure.** Under this procedure, which has characterized past trade negotiations, Congress must simply vote yea or nay on a negotiated agreement. No amendments can be made. The debate over fast-track was heated because the authorization also applied to the negotiations for the North American Free Trade Agreement (NAFTA), which is discussed in Chapter 18.

Hope of success for the Uruguay Round began to reappear at the end of 1992 owing to a trade policy threat. The United States had been concerned about a European Community

[9]"GATT Negotiations Essential to Maintain Strong Multilateral Trading System," *IMF Survey,* Dec. 12, 1988, pp. 386–89.

[10]"GATT Negotiations on Agriculture," *IMF Survey,* Dec. 12, 1988, p. 388; "The General Disagreement," *The Economist,* Nov. 26, 1988, p. 81.

CASE STUDY 3 INTERVENTION AND DISTORTIONS IN AGRICULTURE

As noted in the text, agriculture was a stumbling block in the Uruguay Round of trade negotiations, largely because it is one of the most intervention-prone sectors in most economies. Governments are reluctant to make substantial changes because of major economic and political ramifications.

Two analytical measures used to assess the impact of policy and price distortions in agriculture are the **producer subsidy equivalent (PSE)** and the **consumer subsidy equivalent (CSE).** For a given good, the PSE (CSE) indicates the monetary benefit to producers (consumers) because of transfers through government expenditures and price distortions in the economy, stated as a percentage of the value of production (consumption) if these transfers did not occur. Thus, if a farmer would have received \$100,000 from a crop with no transfers but actually received \$120,000 because of a price support program and subsidized inputs (e.g., water), then the farmer's PSE would be 20 percent [= (\$120,000 − \$100,000)/\$100,000]. Analogously, if consumers would have paid \$200 for a good without government intervention but pay \$250 because of price support programs and higher taxes to finance agriculture subsidies, the CSE would be *minus* 25 percent [= (\$200 − \$250)/\$200]. The CSE is negative in this case because it is defined as the "benefit" from intervention, and the benefit (the transfer) is negative. If consumer subsidies were provided (e.g., for food in urban areas in some developing countries), the CSE would be positive.

Table 2 shows PSEs and CSEs for a variety of countries in 1987. These U.S. Department of Agriculture estimates, the latest available, are weighted averages of a number of agricultural goods in each country. It is noteworthy that all the developed countries in the sample provide transfers to producers (i.e., the PSEs are positive), particularly the European Community and Japan. On the other hand, developed countries (with the exception of the then Soviet Union) tax their consumers, as indicated by the negative CSEs.* The pattern is less clear for developing countries, because 6 of the 21 PSEs are negative (reflecting, for example, taxation of agriculture through low government purchase prices) and 4 of the 15 CSEs are positive. However, there is a general tendency to benefit producers at the expense of consumers.

*For any given good, a PSE of one sign (positive or negative) usually implies a CSE of the opposite sign. For Colombia, Kenya, Poland, and the Soviet Union, for which this is not the case in Table 2, the goods used in the calculation of the weighted averages were different for the PSE and for the CSE.

TABLE 2 **Producer Subsidy Equivalents (PSEs) and Consumer Subsidy Equivalents (CSEs), Selected Countries, 1987**

	PSE (%)	*CSE (%)*		*PSE (%)*	*CSE (%)*
Developing countries:					
Argentina	−10	NA	Nigeria	19	−36
Bangladesh	31	−40	Pakistan*	−25	18
Brazil	16	NA	Poland*	7	50
Chile	29	NA	Senegal	39	NA
China	−38	49	South Africa	2	−4
Colombia	−20	−18	South Korea	62	−60
Egypt	−24	4	Taiwan	25	−32
India	2	NA	Thailand	5	−1
Indonesia	8	−8	Turkey	30	NA
Kenya	−10	−14	Yugoslavia*	47	−44
Mexico	56	−35			
Developed countries:					
Australia	8	NA	Japan	79	−50
Canada	39	−13	New Zealand	8	NA
European Community	52	−19	Soviet Union*	25	34
			United States	33	−12

NA = not available.

*Calculations for Pakistan, Poland, the Soviet Union, and Yugoslavia are for 1986.

Source: Alan J. Webb, Michael Lopez, and Renata Penn, eds., *Estimates of Producer and Consumer Subsidy Equivalents: Government Intervention in Agriculture, 1982–87,* Agriculture and Trade Analysis Division, Economic Research Service, U.S. Department of Agriculture, Statistical Bulletin No. 803, April 1990, pp. 4–5.

CASE STUDY 4 WELFARE EFFECTS OF PRICE DISTORTIONS IN SELECTED COUNTRIES

The presence of distortions as reflected in nonzero PSEs and CSEs can have important implications for the welfare effects of policy changes. For example, if there is a positive PSE for a given product in a given country, production is distorted in that too much production of the good is taking place compared to the competitive, efficient allocation of resources. If some policy change in the economy then leads to an expansion of that good's production, welfare is injured because the distortion is being given even more importance in the economy than previously; if production had contracted instead, that would lead to a "gain" because the distortion was being accorded less importance in the economy.

James Anderson (1998) carried this matter of the effects of policy changes on economies with CSE and PSE distortions further in the context of the effects of trade policy. Specifically, he examined estimates of the price changes in agricultural products that were predicted to follow from the Uruguay Round's steps toward worldwide liberalization of agricultural trade. Given the expected price changes (increases for some goods such as basic foods, decreases for others such as cotton), he calculated a terms-of-trade effect of the liberalization on each of nine developing countries. Then, utilizing a computable-general-equilibrium model (CGE) for each country—a model that attempts to capture statistically the structure and the many relationships that occur in an economy—he estimated the production and consumption effects of the terms-of-trade changes, incorporating the fact that these effects were taking place in a CSE- and PSE-distorted environment.

Anderson's results are important for emphasizing the detrimental effects of distortions on an economy's well-being. For his nine countries, the terms-of-trade effect per se indicated small improvements in welfare for four countries and slight declines in welfare for the five others. However, because of the existing PSE and CSE distortions, the production and consumption changes often took place in such a fashion either to work against the terms-of-trade benefits or to augment the terms-of-trade losses. For Thailand and Tunisia, welfare gains from improved terms of trade were partly offset by the new welfare losses from the production and consumption changes associated with CSE and PSE distortions; for India and Turkey, the terms-of-trade gains were *more than offset* by the additional CSE and PSE distortion losses; for Colombia, Indonesia, and (especially) Pakistan, welfare losses from the terms-of-trade changes were supplemented by the losses from domestic agricultural distortions. Only for Bangladesh and Morocco did the PSE and CSE distortions get lessened in their severity because of the production and consumption changes associated with the Uruguay Round agricultural trade policy changes.

The important point of this discussion is not that the Uruguay Round per se can injure some countries' welfare (and such a conclusion would be unwarranted because the above discussion pertains only to agriculture and developing countries are very likely to gain from the Uruguay Round changes made with respect to manufactured products). Rather, the point is that *domestic* distortions such as indicated by PSEs and CSEs can often make the welfare effects of *trade* policies less beneficial than would otherwise be the case. Since the domestic and trade parts of economies are interrelated, policy reforms should be pursued internally as well as internationally.

Source: James E. Anderson, "The Uruguay Round and Welfare in Some Distorted Agricultural Economies," *Journal of Development Economics* 56, no. 2 (August 1998), pp. 393–410.

agricultural support program that harmed U.S. exports of oilseeds (for example, soybeans), and had twice received backing from GATT that the EC program should be modified. In retaliation for the EC subsidy, the United States threatened to impose 200 percent tariffs on EC exports to the United States, valued at \$300 million; if the EC in turn retaliated against this tariff, the United States was ready to impose a second round of tariffs on \$700 million of manufactured exports from the EC to the United States.[11] With this stimulus to renewed negotiations on agriculture, an accord was eventually reached by which the oilseeds export

[11]Bob Davis, "Tough Trade Issues Remain as EC, U.S. Agree on Agriculture," *The Wall Street Journal,* Nov. 23, 1992, p. A6.

subsidies were to be reduced 36 percent by value and 21 percent by quantity over a six-year period. This positive development then set off activity to work again on many other aspects of the Uruguay Round. Finally, after intense discussions, the 117 participating countries in the Uruguay Round reached agreement on December 15, 1993 (the deadline date), and the signing took place on April 15, 1994, in Marrakech, Morocco. After ratification by participating countries, the agreement took effect on January 1, 1995. For estimates of the pre- and post-Uruguay Round tariff rates by country and commodity groups, see Case Study 5.

Provisions of the Uruguay Round agreement

Only a brief look is provided here of the features of this broad agreement.[12] First, tariffs on average were cut by 34 percent (39 percent by developed countries) and were dropped altogether in the developed countries on a variety of products such as pharmaceuticals, construction and agricultural equipment, furniture, paper, and scientific instruments. Second, the value of agricultural export subsidies is to be cut by 36 percent and most domestic support for agriculture by 20 percent, and average developed-country agricultural tariffs will be reduced by 36 percent over a six-year period. Third, textiles and apparel trade is to be moved from the existing quota framework of the Multifiber Arrangement into the GATT framework, with tariffs to be phased out over 10 years. In addition, Japan and South Korea promised to open their markets to some extent for rice imports. Revised rules were also adopted regarding dumping and export subsidies, and voluntary export restraints (VERs) are to be eliminated. Further, action on trade-related intellectual property rights (TRIPs) provided for minimum standards for trademarks, patents, and copyrights. (For example, patents will now be in force for 20 years. In the United States, the previous length had been 17 years.) Some trade-related investment measures (TRIMs), such as local content requirements for foreign investors, were to be eliminated within two years by developed countries, five years by developing countries, and seven years by "least developed" countries.

Considerable friction prevented attainment of some of the goals for services. An important controversy involved France's refusal to permit the import of U.S. motion pictures on the scale the United States wanted. Nevertheless, a specific General Agreement on Trade in Services (GATS) calls for "national treatment" in services, meaning that any country is to treat foreign service providers in the same fashion as domestic service providers, as well as for MFN treatment for services. New procedures were also adopted for the settlement of disputes. Finally, GATT itself was replaced by a new organization, the **World Trade Organization (WTO),** which is now supervising the implementation of the Uruguay Round agreement and is handling trade disagreements.

The impact of the completed Uruguay Round could indeed be beneficial. One early estimate was that the world economy would grow by an additional $5.25 trillion over the first 10 years with a successful round, with growth of $1.4 trillion for the EC, $1.6 trillion for Japan, and $1.1 trillion for the United States.[13] However, there is considerable uncertainty in such numbers—for example, another estimate was that world output would be $270 billion greater in 2005 with the agreement than without it.[14] With respect to trade, the director-general of GATT estimated that world merchandise exports would be $755 billion larger

[12]For fuller discussion, see Bob Davis and Lawrence Ingrassia, "After Years of Talks, GATT Is at Last Ready to Sign Off on a Pact," *The Wall Street Journal,* Dec. 15, 1993, pp. A1, A7; idem, "Trade Pact Is Set by 117 Nations, Slashing Tariffs, Subsidies Globally," *The Wall Street Journal,* Dec. 16, 1993, pp. A3, A11; "Trade Agreement Mandates Broad Changes," *IMF Survey,* Jan. 10, 1994, pp. 2–4. See also Deardorff (1994), pp. 10–11.

[13]Robert Keatley, "Successful Trade Talks within Grasp if the U.S. and EC Put Politics Aside," *The Wall Street Journal,* Nov. 13, 1992, p. A10.

[14]Douglas Harbrecht, "GATT: It's Yesterday's Agreement," *Business Week,* Dec. 27, 1993, p. 36.

CASE STUDY 5 TARIFF REDUCTIONS RESULTING FROM THE URUGUAY ROUND

Given the broad guidelines of the Uruguay Round with respect to tariff reductions, it is useful to examine the actual differences between pre-Uruguay and post-Uruguay Round tariffs at both the country/region level and the commodity group level. Recent WTO estimates of the pre- and post-Uruguay Round weighted-average tariff levels are found in Table 3. Note that developing countries have substantially higher protection (both pre- and post-Uruguay Round) than developed countries and that, among products, textiles and clothing have the highest weighted-average tariff rates.

TABLE 3 **Average Tariffs on Industrial Products**

	Pre-Uruguay Round	*Post-Uruguay Round*
(a) By Country/Region		
Developed countries' imports from:		
World	6.2%	3.7%
North America	5.1	2.8
Latin America	4.9	3.3
Western Europe	6.4	3.5
Central and Eastern Europe	4.0	2.4
Africa	2.7	2.0
Asia	7.7	4.9
Developing countries' imports from:		
World	20.5%	14.4%
North America	23.2	15.7
Latin America	27.6	18.5
Western Europe	25.8	18.3
Central/Eastern Europe	18.4	15.1
Africa	12.3	8.0
Asia	17.8	12.7
(b) By Product		
All industrial products*	6.3%	3.8%
Fish and fish products	6.1	4.5
Wood, pulp, paper, and furniture	3.5	1.1
Textiles and clothing	15.5	12.1
Leather, rubber, and footwear	8.9	7.3
Metals	3.7	1.4
Chemicals and photographic supplies	6.7	3.7
Transport equipment	7.5	5.8
Nonelectric machinery	4.8	1.9
Electric machinery	6.6	3.5
Mineral products and precious stones	2.3	1.1
Manufactured articles, not elsewhere specified	5.5	2.4
Industrial tropical products	4.2	2.0
Natural resource–based products*	3.2	2.1

*Excluding petroleum products.

Source: Report on "The Uruguay Round" obtained from the WTO website, www.wto.org.

than otherwise by the year 2005,[15] while the Organization for Economic Cooperation and Development forecast that the agreement would have few short-term benefits but would enlarge merchandise trade by up to 10 percent a year after 2002.[16] In a survey of various studies done by economists, Alan Deardorff (1994, p. 19) indicated that the Uruguay Round would lead to an increase in global GDP from 0.7 to 1.3 percent, with the increase in U.S. GDP being 0.8 percent. Further, the increase in trade would be from 5 to 20 percent, with trade expanding the most in sectors such as clothing, footwear, luggage, textiles, and agriculture. While there will obviously be some difficulties of adjustment for certain workers and firms in the short run from the various changes, nevertheless it is clear that the Uruguay Round agreement—despite uncertainties regarding estimates—will have important benefits for the world economy. However, because the agreement (and follow-up subagreements) is being implemented over several years, and because economies will take time to respond to the trade flow changes, economists do not yet know which of the above estimates will be closest to the end results.

What's Next for the WTO?

With the successful conclusion of the Uruguay Round, governments in the next several years centered on the implementation of the measures that had been adopted. In addition, further sectoral agreements were pursued (such as completed agreements in telecommunications and financial services) that would put specifics into the broad general framework that had been laid out in the Uruguay Round for particular sectors. However, as the 1990s drew to a close, there emerged a desire on the part of many countries to begin a new round of multilateral trade deliberations (tentatively to be called the "Millennium Round" of negotiations). Many countries wished to attain further relaxation of trade-restricting measures in agriculture and services, to reduce remaining tariffs further, and to consider a variety of other matters pertaining to areas such as antidumping procedures, procedures within WTO, and intellectual property rights. Further, there was a desire by developed countries—but decidedly *not* by developing countries—to discuss the broad general area known as "labor standards." In addition, and again mainly by developed countries, there was pressure to include consideration of the environmental impact of trade and international shifts in production location by firms.

The labor standards question has been one of intense debate in the last several years. The debate revolves around several issues—most importantly child labor, health and safety features of the workplace, and hours of work per day and days of work per week. For example, campus groups in the industrial countries have protested the use of child labor (often children in the lower-teen years or younger) in assembly plants in developing countries. Out of humanitarian concern, these groups demand that their universities and colleges not deal with companies (e.g., Nike) that employ such labor. Similar protests are made, including objections by labor union groups and their employers, in industrial countries regarding the dangerous work environments in developing countries, where little attention is paid to safety procedures, properly operated equipment, and sanitary conditions in the plants. Developed-country labor and employers in labor-intensive industries, of course, claim that it is "unfair" that they have to compete with goods made under such "sweatshop" conditions. The view is that, were developing-country firms forced (by threat of sanctions against their goods by developed countries) to provide a safe, healthful environment and to adhere to the length of workday and workweek adhered to by developed-country firms, this would yield "fair" trade since all firms would be competing on an equal basis.

[15]"Trade Pact's Benefits Seen," *The Wall Street Journal*, Apr. 12, 1994, p. A13. Merchandise exports are now about $5 trillion per year.

[16] Cited in "Finally, GATT May Fly," *Business Week*, Dec. 20, 1993, p. 36.

Generally speaking, economists are very skeptical of this line of thinking. Often the above arguments are being put forth by developed-country labor under the mantle of humanitarian concerns when in fact the real motivation for the "concern" is protection. The Heckscher-Ohlin and Stolper-Samuelson theorems from Chapter 8 would lead us to expect that the scarce factor of production in the United States and other developed countries (labor and, more specifically, relatively unskilled or low-tech labor) would be injured by an expansion of trade and would gain from protection. Further, the specific-factors model in Chapter 8 also indicated that capital owners in import-competing industries in capital-abundant countries lose from trade as well, which can explain the desire of developed-country firms in import-besieged sectors to seek these new, potentially persuasive arguments for protection. With regard to the child labor issue per se, a case can be made that, without the work of children in developing countries, a typical family might find itself in considerably greater economic difficulty. Children can be economic assets in a developing-country setting, and production is also often carried out by the family unit as a whole, such as in carpet weaving in parts of India.[17] Finally, there is a certain uncomfortableness (arrogance?) about developed countries specifying what working conditions should be in developing countries and what should be the organization of production. Imposition of rules from the outside is not behavior that developing countries, many of which have an unhappy history of colonialism, will want to accept with open arms.

Along with the issue of labor standards, concern has been expressed with regard to the role of environmental standards. The reservations expressed here are that freer trade and investment has meant that companies, and therefore production, have been encouraged to locate where environmental protection is the most lax. The upshot is that, since lax environmental standards mean that pollution-control equipment and the like does not have to be installed, firms in the weak-standard countries (usually developing countries) will be able to undercut firms (usually in developed countries) which must pay such costs. Because of the differing environmental standards, firms in developed countries are thus faced with "unfair" competition because their governments have tougher environmental standards in place. Further, world pollution problems worsen because production centers where environmental protection is weakest. In addition, because of the trade disadvantage for firms in the less polluted countries, there is a tendency for those firms to press their governments for a relaxation of standards. This can lead to a "race to the bottom" in terms of environmental protection. An alternative, of course, is for developed-country governments to pressure developing-country governments for tighter standards or to simply impose protection on the products coming from the developing countries.

Certainly environmental concerns are worthy of attention. But a response of economists to the above views is that the problem is essentially one of environmental protection per se, not a matter of trade. The specificity principle of Chapter 15 applies in this context—the solution to pollution problems lies in measures that reduce pollution, not in measures that restrict trade. In addition, especially if multinational companies are engaged in exporting from developing countries, the exporting companies often adhere to higher environmental standards than do domestic firms within the developing countries. If protection in the developed countries restricts developing countries' exports, then factors of production will be forced to move to domestic firms, where even less attention to the environment is paid. Finally, as noted in *The Economist* (October 9, 1999, p. 17), if trade indeed makes countries better off, the countries will want a cleaner environment as they get wealthier, and they will

[17]As a potentially useful alternative to child labor, developed countries or international organizations could provide education grants to offset income losses as well as to enhance the skill levels of the younger members of the labor force (such as has been done in Brazil).

be able to devote more resources to that objective than was previously the case (a point that has been supported by empirical studies). In other words, expansion of trade rather than restriction of trade may be in order.

Besides these debates on labor standards and environmental protection, other matters were proposed for inclusion in a new round of trade negotiations.[18] In a series of meetings, many countries expressed a desire to broaden and deepen trade rules regarding market access for services, as well as a desire to consider foreign investment rules in more detail. The European Union and Japan emphasized the need to include antitrust and competition policy in the negotiations, as such differences across countries can yield different pricing and behavior by firms. There was also concern by some developing countries about the phase-out schedule of the old Multi-Fiber Agreement on textiles and clothing, and some developing countries as well as developed countries urged full integration of agricultural goods into the WTO framework on the same comprehensive basis as manufactured goods. Further issues related to treatment of electronic commerce and progress on elimination of abuses of intellectual property rights.

At the end of November and beginning of December 1999, trade ministers from the 134 WTO member countries met in Seattle, Washington, to discuss and agree upon the agenda for a next round of multilateral trade negotiations. It was widely anticipated that the sessions would be contentious, but what was underestimated was the contentiousness of various groups of non-WTO people opposing further relaxation of trade barriers worldwide. The week of the ministerial conference was marked by large and noisy demonstrations, and in fact by some violence, in Seattle. The groups demonstrating against the WTO were a diverse lot—trade unionists concerned about the threat to their jobs and wages from greater imports of labor-intensive goods from developing countries, "greens" concerned about the environmental damage associated with trade expansion, and opponents of child labor, among others. Also prominent were individuals and groups who (incorrectly) viewed the WTO as an agency with massive power, in effect as an agency of supranational status that could dictate all sorts of rules to its member nations. (For discussion of what the WTO is and is not in this respect, see Case Study 6.)

The end result of the disagreements over the agenda, together with the disruptive demonstrations, was that the conference ended with no agreement for a new round of negotiations. This failure had, in addition, been facilitated by President Clinton, who, though wanting a new round of negotiations, had spoken in Seattle of the desirability of incorporating labor standards into the WTO, a viewpoint which angered developing countries.[19] All in all, economists judge the failure to agree on new trade negotiations as an ill omen for the future of freer trade and enhanced welfare, especially for developing countries that have been eagerly adopting market mechanisms and becoming more integrated into the world economy. The spectacular failure in Seattle has been called a "global disaster" by *The Economist* magazine; such an assessment is not far off the mark in view of the benefits of freer trade that have been stressed throughout this textbook.

Recent U.S. Actions

Several important trade policy actions concerning particular U.S. industries were taken in the 1980s and early 1990s. For example, voluntary export restraints (VERs) were used in several industries, particularly autos and steel. The United States signed a VER with Japan

[18]For discussion of some of these issues, see Edward Wilson, "Preparation for Future WTO Trade Negotiations," USITC *International Economic Review*, May/June 1999, pp. 15–21.

[19]In fact, Dartmouth economist Douglas Irwin entitled an opinion piece in *The Wall Street Journal* "How Clinton Botched the Seattle Summit" (Dec. 6, 1999, p. A34).

CASE STUDY 6 NATIONAL SOVEREIGNTY AND THE WORLD TRADE ORGANIZATION

Much of the recent publicity surrounding the World Trade Organization (WTO) conveys the idea that the WTO has sovereignty over its member nations. Nothing is further from the truth. The WTO is an international institution comprised of member nations whose objective is to facilitate agreements between member countries to reduce barriers to trade and mediate any disagreements between countries which may arise in carrying out the agreements in question. All rules, principles, and agreements are made by or between WTO members, not by the WTO itself. If there is any loss of sovereignty in a given agreement, it is essentially a swap in that access to the home market is exchanged for equally valuable access to the foreign market. Further, any country is free to abandon an agreement in question at any time. However, it will likely lose its foreign access right in the process, since it is unlikely that other members will maintain their side of the agreement if the one participant reneges on its end. One objective of the WTO is to provide a mediating mechanism so that agreements are applied in a nondiscriminatory manner and challenges to trade agreements do not lead to trade wars and an unraveling of the world trading system as happened in the 1930s.

In a recent publication, economists at the Organization for Economic Cooperation and Development (OECD) in Paris usefully clarified what WTO membership rules *do not* require:*

- WTO rules do not prevent member countries from establishing their own policy objectives or applying regulatory measures required to achieve those objectives.
- WTO rules do not require that member countries eliminate all barriers to imports.
- WTO rules do not require that member countries adopt a uniform set of trade regulations or trade procedures but require only that the regulations or procedures be applied in a nondiscriminatory (MFN) manner. However, even here, exceptions are permitted for regional trade agreements as well as for measures which may relate to a legitimate national or international public policy objective.
- WTO rules do not require that member countries reduce tariffs or barriers to foreign services. They do, however, provide a mechanism for binding participants to an agreement in order to provide predictability and market access when there is a freely negotiated agreement.
- WTO rules do not prevent member countries from providing public funds to support domestic policies and regulatory objectives.
- WTO rules do not require that member countries accept each other's product-quality, service, or safety standards. Rather, the WTO membership has adopted rules pertaining to the preparation, adoption, and application of such standards as they relate to legitimate country social objectives. WTO also encourages, but does not mandate, regulatory cooperation directed toward the harmonization of standards or the development of mutual recognition agreements pertaining to each member country's standards.

In sum, the WTO is not a sovereign authority but, rather, an institution made up of and controlled by member nations for the purpose of facilitating the flow of goods and services between members. It is an institutional mechanism for assisting countries in making mutually acceptable agreements to facilitate international transactions, carrying them out in a nondiscriminatory manner, and holding each other to the bargains to which they have agreed.

*Organization for Economic Cooperation and Development, *Open Markets Matter: The Benefits of Trade and Investment Liberalisation* (Paris: OECD, 1998), pp. 125–27.

in 1981 to limit the export of Japanese automobiles to the United States. The initial limitation was for 1.68 million Japanese autos annually, but the permitted volume was later raised to 2.3 million and then reduced to 1.65 million in the 1990s. The restriction became more truly "voluntary" on the part of Japan as time passed, and exports were often below the limit. Japan found the VERs to be of some benefit, since Japan captured the quota profit or rent from the VER. In addition, the quantity limitation led Japanese auto producers to concentrate exports on higher-priced models, for which the markup is greater. Finally, the VER caused Japan to rapidly expand its investment in auto production within the United States to escape the current and anticipated future export limitations (Honda, Toyota, Nissan, Mazda). For a look at such restraints in the steel industry, see Case Study 7.

Another particular industry action occurred in July 1986, when Japan agreed to maintain specific minimum prices on its exported computer chips. The United States had been concerned about the dumping of Japanese chips into both the U.S. and third-country markets. This agreement was significant because Japan agreed to a certain (higher) level of prices on its chips sold to the United States *and* on chips sold to the other countries. (The United States was concerned that Japan's chips, if priced "too low," would undersell American chips in third-country markets.) This was a departure from traditional trade policy in that two countries were agreeing on prices in markets *other than those of the two negotiating countries.*

More broadly, Congress passed and the president signed the **Omnibus Trade and Competitiveness Act of 1988.** Its particular importance is that it authorized the executive branch to participate officially in the Uruguay Round. In addition, the bill authorized funds for training in the context of trade adjustment assistance and made it easier to obtain this assistance, although budgetary constraints hampered the program. However, many economists were worried by the fact that the bill switched the final determination of action in cases of unfair trade (Section 301 of the Trade Act of 1974) from the president to the United States trade representative, an official in the executive branch who must be approved by Congress; this switch of authority was thought to give greater control over trade policy to a protectionist Congress than had previously been the case.[20] See Case Study 8 for discussion of various recent Section 301 actions.

At the time of this writing, there are several controversial issues regarding trade policy. First, 1996 U.S. legislation known as the **Helms-Burton Law** has engendered acrimony with trading partners. This law allows U.S. citizens to sue in U.S. courts any foreign investor utilizing Cuban property that was seized from U.S. citizens when Fidel Castro came to power in 1959. The suits can also be applied to anyone trading with such investors. Further, the law prevents senior executives of foreign firms dealing with the firms now operating on the seized property from entering the United States. This law was temporarily suspended by President Clinton after its initial passage, but it has aroused resentment in foreign countries (especially Canada and the members of the European Union), who claim that the United States cannot interfere with their economic activities in this way. Penalties were in fact continually waived by the Clinton administration, and there seems to be no overwhelming desire in the United States to enforce them. There also seems to be growing pressure in various quarters to remove the embargo on U.S. trade with Cuba altogether. In fact, in summer 2000, the United States Congress moved to relax restrictions on U.S. exports of food and agricultural products to Cuba.

Another trade policy development of note is the continual bickering between the United States and China. Not only is there heated annual debate regarding renewal of MFN status for China, but there is also discussion over intellectual piracy by China (in compact discs, computer software, etc.). In addition, there is divided opinion on the proposed entry of China to the WTO. Issues involved in all of these discussions are China's human rights violations, the extent to which China is pursuing normal trade behavior befitting a full participant in the world economy, and, recently, the political matter of illegal campaign contributions to Democratic candidates in U.S. elections.

However, relations between the United States and China with regard to trade policy improved in late 1999 when the Clinton administration and Chinese trade officials reached

[20]See "The Birth of a Bad Trade Bill," *The Economist,* Apr. 30, 1988, pp. 19–20.

CASE STUDY 7 RESTRAINTS ON U.S. STEEL IMPORTS

In 1984, the Reagan administration granted protection to the U.S. steel industry in the form of negotiated, "temporary" voluntary restraint agreements (VRAs)* with major exporters of steel to the United States. These VRAs were designed to keep overall steel imports to about 20 percent of the domestic market. The 18 separate country agreements were considered an election-year response to calls for import restraint by the domestic industry and to the recommendation for restraints by the 1984 Democratic presidential candidate, Walter Mondale. It was understood that if the VRAs were adopted, the domestic industry would take steps to improve its productivity and competitiveness.

After the 1984 VRAs were put into place, total imports were reduced from 24 percent of the U.S. market in 1983 to 20.8 percent in 1988, and imports from the 29 countries covered by 1989 accounted for 14.7 percent of the market. Productivity increased rapidly in the domestic industry, work practices were streamlined, specialty steel minimills expanded, and the industry increased its profits. Foreign steel exporters also benefited by getting a guaranteed market share and by obtaining higher profits. However, consumers of steel faced higher prices because of the restraints. In addition, opponents of the VRAs indicated that over 5 million workers were employed in the steel-*using* industries—30 times greater than the number employed in steel production itself—and these workers are injured when steel prices rise.

The five-year 1984 accords were due to expire in September 1989, and a debate ensued over whether they should be renewed. The debate was complicated by George Bush's 1988 election promise in steel-producing Pennsylvania to continue the protection. The U.S. industry wanted a five-year extension, while steel users wanted the program ended. The result was a compromise—a two-and-a-half year extension. When this extension expired in March 1992, U.S. steel firms filed antidumping petitions against 19 countries and countervailing-duty petitions to combat foreign subsidies against 12 others. In response, tariffs were adopted in June 1993 that averaged 36.5 percent (with duties ranging up to 109 percent in dumping cases and up to 73 percent in the subsidy cases).

Well into the late 1990s, pressure continued for protection because of the virtually continual rise in steel imports. A major strategy of the domestic industry has been the constant filing of antidumping petitions and petitions for countervailing duties against allegedly subsidized imports. (Note: The U.S. steel industry itself imports steel, although it claims that such steel is not part of the "unfair" trade.) Some duties have been imposed, and some countries such as Russia and Brazil signed agreements to limit their steel exports to the United States in order to avoid punitive duties. Finally, in 1999, the protectionist efforts culminated in a quota bill that passed the U.S. House of Representatives but died in the U.S. Senate. It seems clear that these kinds of efforts will continue because of the increasing penetration of the U.S. market by imports. Indeed, for the first four months of 2000, U.S. imports of steel were 13.5 million net tons, U.S. domestic production (shipments) was 38.4 million net tons, and U.S. exports were 2.2 million net tons. (Imports, production, and exports were, respectively, 30.4 percent, 17.5 percent, and 41.5 percent above the levels of the first four months of 1999.) Hence, the ratio of imports to the domestic market was 37 percent [$= 13.5/(38.4 - 2.2) = 13.5/36.2 = 37$ percent], substantially above the 20 percent limitation sought in the 1980s. The protectionist efforts will likely continue to experience at least some success, too, because of the economic size and political influence of the industry.

*It is totally unclear to us why the export restraints are called VERs for automobiles and VRAs for steel!

Sources: Chris Adams, "Steelmakers Complain about Foreign Steel; They Also Import It," *The Wall Street Journal,* Mar. 22, 1999, p. A1; American Iron and Steel Institute, *AISI Newsletter,* December 1999, obtained from www.steel.org; Stuart Auerbach, "Bush Signs Steel Quota Extension," *Washington Post,* July 26, 1989, pp. D1, D3; "Big Cartel," *The Wall Street Journal,* Mar. 22, 1989, p. A14; James Bovard, "Steel Rulings Dump on America," *The Wall Street Journal,* June 23, 1993, p. A14; "Brazil to Reduce Exports of Steel, in Pact with U.S.," *The Wall Street Journal,* July 8, 1999, p. A10; Helene Cooper, "Russia Agrees to Limit Steel Shipments, Avoiding Antidumping Duties by U.S.," *The Wall Street Journal,* Feb. 23, 1999, p. A4; idem, "Senate Thwarts Bill to Curb Steel Imports," *The Wall Street Journal,* June 23, 1999, p. A2; Asra Q. Nomani and Dana Milbank, "U.S. Increases Tariffs on Steel by Large Margin," *The Wall Street Journal,* June 23, 1993, pp. A3, A5; Art Pine, "U.S. Seeks Reduced Exports of Steel by Three Countries," *The Wall Street Journal,* Sept. 5, 1986, p. 40; Peter Truell, "U.S. Agrees to Quotas on Steel Imports with EC and 16 Other Major Suppliers," *The Wall Street Journal,* Dec. 13, 1989, p. A2.

CASE STUDY 8 RECENT SECTION 301 ACTIONS IN THE UNITED STATES

As indicated on page 331, Section 301 of U.S. trade law pertains to "unfair" trade practices by foreign governments against U.S. exports, practices that are deemed to be unjustifiable, unreasonable, or discriminatory. Actions utilizing Section 301 as a legal basis are frequently undertaken in the United States. We summarize below some of the actions taken during 1996–1998. These illustrative cases demonstrate that enforcement of trade agreements is a continuing process that involves different countries and different types of foreign government behavior.

Canada

On April 29, 1999 the United States Trade Representative (USTR) initiated investigation of certain practices of the Province of Ontario and the government of Canada with regard to sport fishing and tourism. At issue with Ontario was that province's stipulation that fish caught in lakes that straddle the U.S.-Canadian border could not be kept by U.S. anglers if the anglers were lodging in resorts on the Minnesota side of the lake (although the fish could be kept if lodging was in Ontario). Minnesota business establishments clearly felt that this policy discriminated against them! After the investigation, the USTR announced on November 5, 1999 that Ontario was terminating the policy. The same investigation also examined the policy that U.S. fishing guides who take groups into Canada must obtain work authorization permits from Canadian immigration officials. Canada subsequently agreed to have the practice reviewed by a NAFTA panel.

Paraguay

In February 1998 the USTR began investigation of acts (piracy and counterfeiting) of the government of Paraguay that allegedly denied adequate and effective protection of intellectual property rights to economic agents of the United States. The USTR indicated that Paraguay might have unilateral U.S. trade sanctions imposed on it if the acts were not discontinued. In November 1998 Paraguay and the United States signed a Memorandum of Understanding (MOU), in which Paraguay committed itself to addressing the offending practices. The USTR then determined not to take further steps, but it will continue to monitor the situation.

Honduras

In October 1997 the USTR started investigation of copyright piracy by the government of Honduras. Following the investigation, Honduras was deemed to be engaging in unreasonable behavior that burdened or restricted U.S. commerce. The appropriate action to be undertaken was designated as the suspension of the preferential treatment received by Honduras under the Generalized System of Preferences (GSP) and under the Caribbean Basin Initiative (CBI). In response, Honduras took measures to fight television piracy and to protect U.S. intellectual property rights; U.S. action against Honduras was then halted, in June 1998.

Indonesia

In October 1996 the USTR investigated whether Indonesia was awarding special tax and tariff benefits to the country's motor vehicle sector, benefits that violated WTO agreements regarding policies toward import-competing industries. Both in 1997 and 1998, WTO panels ruled against Indonesia in this matter. The government of Indonesia then agreed to comply with the WTO rulings and to refrain from engaging in the offending behavior by July 1999.

Brazil

The USTR in October 1996 challenged particular automotive industry incentives being provided by the Brazilian government. According to the U.S. charge, certain tariff reductions were being given to the industry, *provided* that the industry met specified export performance requirements and domestic content requirements. Such requirements are inconsistent with WTO codes. In January 1997 the United States asked the WTO to begin consultations with Brazil regarding the incentive programs, and by March 1998 Brazil had agreed to comply with its WTO obligations.

India

On July 2, 1996, the USTR began investigation of practices of the government of India that may have led to the denial of patents and exclusive Indian marketing rights to U.S. individuals and firms involved in developing pharmaceutical and agricultural chemical products. A WTO dispute settlement panel upheld the U.S. claim, and India agreed to comply with the WTO ruling by April 1999.

Source: U.S. Trade Representative (USTR), *1999 Trade Policy Agenda and 1998 Annual Report of the President of the United States on the Trade Agreements Program* (Washington, DC: U.S. Government Printing Office, 1999), pp. 250, 252–53, 255; USTR, 2000 Trade Policy Agenda and 1999 Annual Report of the President of the United States on the Trade Agreements Program (Washington, DC: U.S. Government Printing Office, 2000), p. 286; obtained from www.ustr.gov.

agreement on market-opening measures in China in exchange for some U.S. "concessions" but particularly in exchange for U.S. support for China's eager attempts to join the World Trade Organization. The agreement provided for such new steps as permission for increased U.S. ownership (up to 49 percent) of Chinese telecommunications companies, easier entrance into China for U.S. insurance, banking, and securities firms, and a lowering of tariffs by China on U.S. agricultural products. On the U.S. side, an important move was an agreement to phase out U.S. quotas on Chinese textiles by 2005.[21] Further, with admittance to the WTO, China's standing in the world community would be enhanced, and most-favored-nation status ("normal trade relations") would be accorded to the country on a permanent basis. After heated discussion, the agreement was approved by the U.S. House of Representatives; at the time of this writing, the U.S. Senate had not yet acted on the measure.

Two prominent recent disputes need to be mentioned in our review of recent U.S. trade policy. First, in the last several years, the European Union has had in place trade rules that provide preference to Western Europe's former colonies in the Caribbean and Africa with respect to the purchase of bananas. The United States has continually objected to this policy because it constitutes explicit discrimination against the sale of bananas to the EU from Central and South America by two U.S. firms, Chiquita Brands and Dole Foods. The United States appealed the European Union rules to the WTO, which, including its predecessor agency, GATT, ruled against the EU policy five times in six years. Attempts at compromise were unsuccessful. Ultimately, in 1999, the United States levied retaliatory tariffs of *100 percent* against 15 EU products, including candles, specialty pork, cashmere sweaters and pullovers, electrothermic coffee or tea makers, and feta and other sheep's milk cheeses. This tariff action received the support of the WTO. An ironic outcome is that some of the tariffs feed back to injure U.S. firms, such as a Rhode Island company that owns a cashmere-processing plant in Mongolia that in turn supplies goat's hair to EU cashmere sweater manufacturers.[22]

Another area of recent contention in U.S. trade policy has also pitted the United States against the European Union. Specifically, since 1989 the EU has had a ban in place on the import of hormone-treated beef from the United States. This particular instance of genetic engineering poses, in the minds of many Europeans, unacceptable health risks in the form of increasing the probability of developing cancer. (Can we say the EU "beefs about beef," or would you not put much "stock" in that remark?) In the beef situation, as with bananas, the WTO has ruled against the EU policy several times. Supporting the WTO and the U.S. position is the fact that many scientists have given the opinion that the hormone-treated beef is safe for consumption. Nevertheless, the EU had not removed its ban as of this writing, and, just as in the banana dispute, the United States took retaliatory commercial policy action. In July 1999, tariffs of 100 percent were levied on a number of EU products, including French mustard, Roquefort cheese, and truffles.[23]

In the last few years, then, there have been some contentious times (the WTO conference breakdown in Seattle, the United States–EU disputes) that create doubts regarding dramatic future movement toward freer trade. Added to these doubts with respect to U.S.

[21]For details, see "In Historic Pact, U.S. Opens Way for China to Finally Join WTO," *The Wall Street Journal,* Nov. 16, 1999, pp. A1, A19.

[22]See James Cox, "Punitive Actions by U.S. Felt Worldwide," *USA Today,* Mar. 11, 1999, p. 3B; idem, "U.S. Importers Decry Duties," *USA Today,* Mar. 5, 1999, p. 3B; Michael M. Phillips, "WTO Supports U.S. in Dispute over Bananas," *The Wall Street Journal,* Apr. 7, 1999, pp. A3, A8.

[23]See Helene Cooper, "U.S. Imposes 100% Tariffs on Slew of Gourmet Imports in War over Beef," *The Wall Street Journal,* July 20, 1999, p. A6.

policy behavior is the fact that President Clinton was unsuccessful in his second term in his efforts to obtain renewal of fast-track authority. On the other hand, there have been some noteworthy advances toward freer trade—the Uruguay Round was successfully concluded, China began to "open up," several sector agreements were negotiated after the creation of the WTO, and the North American Free Trade Agreement (NAFTA) was adopted (to be discussed in the next chapter). What the future will bring is thus uncertain. The outcome may well depend on the results of the year 2000 elections in the United States.

CONCLUDING OBSERVATIONS ON TRADE POLICY

International negotiations, both multilateral and bilateral, have clearly reduced the level of trade restrictions over the long run in industrialized countries. Any continued advance along these lines requires that countries remain willing to sit down at the bargaining table to negotiate trade policies in their mutual interest. Chapters 15 and 16 discussed various arguments for protection which indicate that sometimes an individual country can gain from the imposition of a trade restriction, even though the welfare of the world is reduced. But a gain under these circumstances tenuously depends on the absence of retaliation from adversely affected trading partners. International negotiations serve the critical purpose of keeping countries from unilaterally imposing new barriers. Historically, these negotiations have demonstrated that it is in a country's interest to reduce barriers rather than raise them. Cooperation, not unilateral action, plays a vital role in enhancing both the welfare of the world and the interests of individual countries.

The Conduct of Trade Policy

Recent disputes in the United States regarding trade policy reveal an underlying broad conflict on the relative extent to which the conduct of trade policy should be rules-based or results-based. A **"rules-based" trade policy** is one that adheres to commonly accepted international guidelines and codes of behavior on trade, such as those embodied in the World Trade Organization. This type of policy embraces MFN treatment, preference for tariffs as the instrument of choice rather than import quotas and VERs (which are more distortionary for resource allocation than tariffs and also discriminatory by country), common procedures on antidumping and countervailing duties, multilateral negotiations on trade barrier reductions, and so forth.

On the other hand, a **"results-based" trade policy** stresses that policy should seek, through aggressive, unilateral action or threat of action, to achieve carefully specified objectives, such as the penetration of a particular foreign market for a particular good by x percent, the limitation of imports of a particular good to y percent of the domestic market, special protection and incentives to particular industries, and attainment of balanced trade with specified trading partners. Or, the policy might be for a home country to treat each individual trading partner country exactly as that partner treats the home country with respect to trade—sometimes called the **"new reciprocity" approach to trade policy.** (See Cline 1983.) This more direct, results-based approach to the guidance of resource allocation is also sometimes known as a form of **industrial policy** or as **managed trade.**

Many observers of recent U.S. trade patterns feel that since other countries are more interventionist in trade than the United States, the United States should respond by according a stronger role to government. These observers advocate the results-based approach. On the other hand, other observers (including most economists) indicate that allocation of resources by government will be inferior to allocation of resources by the market. The superior market allocation is best attained in an environment of an established set of "rules." The broad debate over a general trade strategy was prominent in the 1980s and continued in the 1990s.

Empirical Work on Political Economy

A final observation needs to be made. A number of empirical studies have focused on the role of the political economy factors discussed at the beginning of this chapter in influencing U.S. trade policy. In this work, an attempt is made, for example, to ascertain the characteristics of particular industries or sectors that cause those industries or sectors to be more or less protectionist and to ascertain how elected public officials are influenced in their voting on trade legislation. It has been found (Cheh 1974) that U.S. industries in which large labor adjustment costs would be incurred through tariff reduction are likely to be granted relatively high levels of protection (or relatively smaller reductions of protection) in tariff negotiations. In addition, in the congressional voting on the Trade Act of 1974, the percentage of workers in a representative's district employed in import-substitute industries was associated with a negative vote on that trade bill, as was the size of contributions to individual congressional campaigns by labor unions (Baldwin 1981). In general, a survey of various empirical tests for the United States (Baldwin 1984) indicated that a statistically significant positive relationship exists between the degree of industry protection and, for example, (*a*) the number of workers in an industry; (*b*) the labor/output ratio in the industry [both (*a*) and (*b*) reflect labor intensity but also voting strength that politicians wish to court]; (*c*) the percentage of unskilled workers in an industry, reflecting social concern as well as the relative scarcity of U.S. unskilled labor (remember the Stolper-Samuelson theorem from Chapter 8); and (*d*) the extent to which the product is a consumption good rather than an intermediate good (reflecting the fact that lower prices for intermediate goods are desired by domestic firms). Negative associations have been found between the degree of industry protection and, for example, (*a*) the number of firms in an industry, reflecting less ability to organize for protection, and (*b*) the average wage in an industry, again reflecting lower skills.

Noteworthy in this discussion is the role of income distributional factors in trade policy, a role that is clearly what we would expect from our earlier presentation of trade theory. Although countries and the world as a whole gain from participation in international trade, not all citizens of all countries experience these gains. Remember that the consumption bundle after trade is large enough so that the "losers" from trade can be fully compensated by the "gainers," but this doesn't mean that compensation necessarily takes place in practice. The debates about trade policy therefore center importantly around struggles on income distribution.[24]

The political economy literature has developed specific hypotheses about the determinants of the general level of protection in different time periods. For example, Magee and Young (1987) examined the average level of protection in the United States during 16 presidential administrations from 1905 to 1980, focusing on macroeconomic influences. They found a strong positive association between the average tariff rate and the unemployment rate. Clearly, in slack times, there is greater political pressure for higher tariffs because of the workers' belief that higher tariffs provide greater job and wage security. This pressure is stronger than antiprotectionist sentiment by consumers, who are usually passive on trade policy. Magee and Young also found a significant positive association between the average tariff level and the ratio of the prices of U.S. manufactured goods exports to the prices of U.S. manufactured goods imports. With the assumption that the United States imports labor-intensive (especially unskilled-labor-intensive) manufactured goods, a decline in the relative prices of those goods will lead to greater demands

[24]It can also be noted that the literature has generally found a negative association between protection for an industry and the amount of intra-industry trade in that industry. This can partly be explained by the influence of exporters of the product lobbying against import barriers in general due to fears of retaliation. But it can also partly be explained by the fact that, as noted in Chapter 10, intra-industry trade based on economies of scale may not have the potentially large income distribution impacts that inter-industry trade has. That is, realization of economies of scale means that everyone can potentially gain from trade. See Rodrik 1995, pp. 1481–83.

for protection on the part of labor. Finally, they found a *negative* association between the U.S. inflation rate and the average level of tariffs. While one might think that the greater imports induced by inflation would stimulate a net increase in protectionist pressure because of lobbying by import-competing industry groups, Magee and Young hypothesized that consumers are indeed aroused by high inflation and are more effective in keeping import barriers low during inflationary periods, thus permitting the downward pressure on the price level that imports exert. Further, the possible depreciation of the dollar during inflationary periods raises the domestic price of imported goods and reduces pressure for protection by domestic import-competing firms.

A recent National Bureau of Economic Research empirical study (Krueger 1996) of seven different U.S. industries raised several interesting questions regarding the political economy of U.S. trade policy. General conclusions[25] were the following: First, there is no persuasive evidence that protection was, in general, important in turning an industry around economically. Second, the negative impact or costs of protection are often underestimated because of failure to consider secondary effects outside the affected industry. Third, protection will more likely be granted when there is unanimity within the industry regarding the desirability of it and when there is a well-organized and effective special-interest group to promote it. Finally, there was evidence that the existence of current protection increases the ease with which protection can be maintained in a given industry.

A general point that has emerged in the political economy literature is that, while economists traditionally investigate how protection affects imports, the reverse sequence should also be taken into account—that is, the level of imports affects the degree of protection. Thus, if tariffs and NTBs are reduced, the intensity of lobbying for protection by the affected import-competing industries will increase. If this lobbying is successful and leads to new protectionist devices being put into place, imports may not increase very much on balance. This scenario suggests that trade liberalization efforts face greater obstacles in actually getting freer trade in the world economy than would otherwise be the case. Working in this line of thought, Daniel Trefler (1993) estimated that the "feedback" impact of import penetration had, in the case of nontariff barriers in the United States, reduced imports by almost $50 billion (in 1983) over the situation without the feedback.

The political economy area of research, which has been extended to include the political dimensions of gaining access to overseas markets (see "Mini-Symposium on the Political Economy . . ." 1992), obviously has potential for broadening the scope of trade policy discussions. Students interested in pursuing trade policy further will find this topic a fruitful one for investigation.

SUMMARY

This chapter has examined political economy influences, such as interest groups and social concern, on trade policy, and considered related empirical work in the context of the United States. This was accompanied by a review of U.S. trade policy which highlighted the long-term trend of liberalization of trade, first through bilateral and then through multilateral negotiations. After the disastrous impacts of the Smoot-Hawley Tariff of 1930, the United States began a long process of reducing tariff barriers. The Reciprocal Trade Agreements Act of 1934 initiated a series of bilateral, item-by-item negotiations that achieved some success. These procedures were superseded by the emergence of GATT at the end of World War II, and GATT sponsored eight rounds of multilateral negotiations that brought tariffs on manufactured goods to relatively low levels. Although recent years witnessed the rise of many nontariff barriers and of difficulties in the Uruguay Round with respect to services and agriculture, nevertheless the Uruguay Round was successfully concluded. Attempts to continue the path of long-term liberalization of trade are obviously desirable from the standpoint of increasing world welfare.

[25] Anne O. Krueger, "Implications of the Results of Individual Studies," in Krueger (1996), pp. 99–103.

KEY TERMS

across-the-board approach
bilateral negotiations
consumer subsidy equivalent (CSE)
directly unproductive activity
fast-track procedure
GATT rounds of trade negotiations
General Agreement on Tariffs and Trade (GATT)
Helms-Burton Law
industrial policy
item-by-item approach
Kennedy Round of trade negotiations
managed trade
median-voter model
multilateral negotiations
"new reciprocity" approach to trade policy
nonreciprocity principle
Omnibus Trade and Competitiveness Act of 1988
producer subsidy equivalent (PSE)
public-choice economics
Reciprocal Trade Agreements Act of 1934
rent-seeking activity
"results-based" trade policy
"rules-based" trade policy
Smoot-Hawley Tariff (Tariff Act of 1930)
status quo bias
Tokyo Round of trade negotiations
Trade Act of 1974
trade adjustment assistance (TAA)
Trade Expansion Act of 1962
Uruguay Round of trade negotiations
World Trade Organization (WTO)

QUESTIONS AND PROBLEMS

1. Explain two reasons why a minority in a median-voter model is able to obtain net benefits through a restrictive trade policy that clearly harms the majority group and the country as a whole.
2. In what respects might bilateral trade negotiations be superior to multilateral trade negotiations? In what respects might multilateral trade negotiations be superior to bilateral trade negotiations?
3. Since the number of consumers in the United States far exceeds the number of workers in textiles and apparel, for example, why do we see import restrictions on textiles and apparel despite the obvious losses to consumers?
4. Explain why a government's commitment to income distribution issues can cause policy to be protectionist. Is such policy inevitable if income distribution is a key target?
5. (*a*) Why might an economist see virtue in the concept of trade adjustment assistance (TAA)? What difficulties might be encountered in practice in the implementation of TAA?

   (*b*) Some economists think that TAA is discriminatory because special assistance is given to workers displaced by imports while workers displaced by domestic competition receive no such special favors. Do you think this observation rules out TAA as a desirable policy? Why or why not?
6. Why have tariff reductions been substantial over the years while reductions in nontariff barriers have been minimal? (In fact, NTBs have increased.)
7. (*a*) Build a case in favor of the use of the nonreciprocity principle for developing countries.

   (*b*) Build a case against the use of the nonreciprocity principle for developing countries.
8. If all interventions in agriculture were removed, what would happen to food prices? To the incomes of farmers? To world welfare? Might your answer be different for some developing countries than for developed countries?
9. Some observers have noted that by adopting VERs (or VRAs) instead of tariffs in recent years, the United States has injured itself "twice" rather than only "once." What does this statement mean?
10. What factors explain the considerable variation in the degree of trade restriction across U.S. industries?