COMMENTS

THE COASE THEOREM AS APPLIED TO TRADE BARRIERS AND OPTIMAL ADJUSTMENT STRATEGIES

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"No thing can be destroyed except by an external cause."[1]

-Baruch Spinoza

1. INTRODUCTION

The two main goals of any financial legislation are efficiency,[2] which seeks wealth maximization within a society, and distribution,[3] which seeks optimal allocation of wealth. A governmental policy that constrains national wealth[4] and has

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[2] Efficiency can be defined using either a Pareto standard or a Kaldor-Hicks standard. For a change in policy to qualify as a Pareto-superior one, it must improve at least one person's position and make no one worse off than they were before the change. See RICHARD A. POSNER, ECONOMIC ANALYSIS OF THE LAW 13 (4th ed. 1992); ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 12 (2d ed. 1997). A change is considered Kaldor-Hicks efficient if it merely results in an aggregate net gain to the society— the winners win more than the losers lose. See POSNER, supra, at 13-14; COOTER & ULEN, supra, at 41. This paper uses the Kaldor-Hicks standard as the relevant measure of efficiency, due to the inherent practical limitations of the Pareto standard. See, e.g., POSNER, supra, at 14 ("[T]he operating definition of efficiency in economics is not Pareto superiority."). See generally Guido Calabresi, The Pointlessness of Pareto: Carrying Coase Further, 100 YALE L.J. 1211 (1991) (describing the analytical limitations of a Pareto standard).

[3] See COOTER & ULEN, supra note 2, at 104-06.

[4] One recent study estimates the annual welfare loss from protection in

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regressive effects would seem the height of irrationality, since it would violate notions of both efficiency and distribution. The United States' maintenance of barriers to free trade has exactly those disturbing consequences.[5]

How could the government enact a poor policy choice and allow it to remain in place for many years? The answer lies in the Congress and its structural susceptibility to pressures from special, regional interests.[6] In the typical trade protection situation, a few people benefit immensely from barriers to free-trade, while numerous people are hurt to a much lesser degree.[7] This gives the beneficiaries of such a policy ("protectionists") a large incentive to lobby Congress to pass the measure, while any individual loser ("consumer") has only a very slight incentive to fight against it. Under a public-choice theory of government, this result appears inevitable.

However, if the multitude of consumers of the protected good compensated the few protectionists for their losses, in exchange for removal of the barriers to free-trade, then the protectionists

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the steel, textile, and automobile industries to be "between $18.3 billion and $26.2 billion." JAIME DE MELO & DAVID TARR, A GENERAL EQUILIBRIUM ANALYSIS OF US FOREIGN TRADE POLICY 98 (1992).

[5] A vast amount of literature exists on the general inefficiency of barriers to trade. *See, e.g.,* JAGDISH BHAGWATI, PROTECTIONISM 24 (1988) (urging that unilateral free trade implies that "a nation would profit most by pursuing a free trade policy and that this was so whether its trading partners were free-traders or protectionists"); Alan O. Sykes, *Protectionism as a "Safeguard": A Positive Analysis of the GATT "Escape Clause" with Normative Speculations,* 58 U. CHI. L. REV. 255, 261 (1991) ("Classical economic theory holds that restrictions of any sort often reduce the economic welfare of *importing* nations, let alone the trading community as a whole.").

The distributional concerns arise in connection with higher prices for consumer goods, which has a regressive effect. *See* ROBERT Z. LAWERENCE & ROBERT E. LITAN, SAVING FREE TRADE: A PRAGMATIC APPROACH 15-16 & n.10 (1986) ("According to one . . . estimate, . . . restrictions on imports of clothing, sugar, and automobiles cost low-income consumers nearly twice as much of their incomes as they did upper-income consumers.").

[6] *See* I. M. DESTLER, AMERICAN TRADE POLITICS 103-04 (3d ed. 1995) (explaining the problems with a trade policy set by Congress, and Congress' eventual ceding of some power to the executive branch to improve structure of trade policymaking).

[7] "A protectionist measure provides large benefits to a small number of people, and causes a very great number of consumers a slight loss. This circumstance makes it easier to put a protection measure into practice." VILFREDO PARETO, MANUAL OF POLITICAL ECONOMY 379 (Ann S. Schwier & Alfred N. Page eds. & Ann S. Schwier trans., Augustus M. Kelley Publishers 1971) (1927).

would no longer have the incentive to lobby against such a change (and would no longer be losers). This is a basic application of the Coase theorem,[8] which posits that if transaction costs are not prohibitive, society contains a self-corrective mechanism towards an efficient equilibrium.[9] However, left to their own devices, the consumers would not compensate the protectionists, because any single consumer would not have enough at stake to organize such a program. The federal government is the ideal vehicle to sit in the stead of the consumers and transfer a portion of the gains from free trade to the protectionists because the federal government has vast resources with which to pursue such a policy and is designed to represent the collective desires of the population.

The second section of this Comment provides an answer to the question of how the government should fund these adjustment payments. Among the various available solutions, the most attractive method would utilize a tax on consumption that is applied equally to both imported and foreign goods.[10] Use of a non-discriminatory consumption tax, phased out over a period of adjustment, would prevent future investment in inefficient domestic industries, while requiring those who enjoy the benefits of lower-priced goods to subsidize the mitigation of the social harms caused by the removal of the trade barriers. It might seem absurdly optimistic to think that a consumption tax, even one set at the full amount of the protected price, would be able to compensate both owners and workers for their losses. Yet, if one

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[8] *See generally* R. H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

[9] Coase contrasts his methodology with that of Pigou, whose writings spawned the dominant view on nuisance law at the time Coase wrote his article. While Pigou insisted that the government should tax polluters in order to encourage production at the socially optimal level, Coase demonstrated that the market contains a self-adjusting mechanism towards the socially optimal equilibrium in the absence of transaction costs. *See id.* at 39-44.

[10] The tax could be varied to attempt to correct for market failures in foreign production, when extant. However, such analysis is beyond the scope of this paper. Some other possible methods to fund adjustment include use of direct treasury revenues and a declining tariff imposed only on imported goods. The latter approach finds support in LAWRENCE & LITAN, *supra* note 5, at 98. *See generally* GARY CLYDE HUFBAUER & HOWARD F. ROSEN, TRADE POLICY FOR TROUBLED INDUSTRIES (1986) (examining post-World War II adjustment to trade competition in troubled industries and suggesting effective future remedial policies).

considers that owners would no longer need to pay any lobbying expenses, then the possibility of such a system becomes more plausible.

The transfer of funds need not simply be "sugar to sweeten the pill" of free trade, but, if properly structured, could have intrinsic efficiency benefits.[11] With proper incentives, trade adjustment assistance to workers displaced by import competition could help reduce unemployment and underemployment. Economists generally associate unemployment of displaced workers with "downward wage-price stickiness,"[12] which is essentially a worker's tendency to refuse available employment that pays wages lower than the previous job. The public at large would probably find compensation of industry owners'[13] losses more controversial; however, if properly constructed, such compensation could at least be efficiently neutral from an intrinsic standpoint, and instrumentally it would help avoid the obstacles thrown up by protectionists.

2. PROBLEMS WITH PROTECTIONISM

Since World War II, most major industrialized countries have

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[11] Transfer payments "may on occasions be given some theoretical justification over and above its undoubted tactical value in sugaring the pill of tariff reductions." J. Peter Neary, *Intersectoral Capital Mobility, Wage Stickiness, and the Case for Adjustment Assistance, in* IMPORT COMPETITION AND RESPONSE 39, 40 (Jagdish N. Bhagwati ed., 1982) [hereinafter IMPORT COMPETITION].

[12] Downward wage-price stickiness, its effects on trade adjustment, and various strategies of mitigation appear in Michael Bruno, *Import Competition and Macroeconomic Adjustment Under Wage-Price Rigidity, in* IMPORT COMPETITION, *supra* note 11, at 11-32.

[13] When thinking of owners, it is intuitive to envision a few, well-heeled investors reaping the lion's share of the profits. However, increasingly stock ownership has diffused throughout pension funds, small individual investors, and individual retirement plans. *See, e.g.,* WILLIAM L. CARY & MELVIN ARON EISENBERG, CASES AND MATERIALS ON CORPORATIONS 245 (7th ed. 1995) (citing 1 *The Brancato Report on Institutional Investment* (1993) (noting that pensions funds, mutual funds and insurance companies owned 38.2% of all equity holdings in 1992, based on total U.S. market equity).

Although it is arguable that owners are compensated for the risk of the removal of trade barriers by increased return on investment and that, notwithstanding notions of return, investors should be fully diversified, broad ownership of industry may make compensation of ownership more appealing on distributional grounds. These arguments against compensation, for both workers and ownership, are analyzed *infra* Section 2.

steadily and substantially reduced impediments to free trade.[14] The General Agreement on Tariffs and Trade ("GATT")[15] helped the United States decrease its average tariff by almost ninety-two percent during the period between the Geneva Round of 1997 and the Tokyo Round of GATT negotiations.[16] Furthermore, the North American Free Trade Agreement ("NAFTA") created the "world's largest free trade zone" when signed on December 17, 1992.[17]

However, some important exceptions to this trend continue to linger in the present economy. For example, the United States often utilizes voluntary export restraints ("VERs"),[18] which are thinly-veiled protectionist quotas that circumvent the provisions of GATT and are usually aggregated with conventional protectionist statistics. Also, certain industries have received special treatment, known as "special protection,"[19] from the

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[14] Countries gain through the reduction of trade barriers by allowing greater specialization in areas where each country possesses a comparative advantage. *See, e.g.*, I.M. DESTLER, AMERICAN TRADE POLITICS 4 (3d ed. 1995) (noting the general reasons free trade is beneficial); *see also* PETER H. LINDERT & CHARLES P. KINDLEBERGER, INTERNATIONAL ECONOMICS 27 (7th ed. 1982) (stating that "[t]he constancy of opportunity costs . . . led us to conclude that each country would maximize its gain by specializing its production completely in its comparative-advantage good"); *c.f.* Matthew Schaefer, *Searching for Pareto Gains in the Relationship Between Free Trade and Federalism: Revisiting the NAFTA, Eyeing the FTAA*, 23 CAN.-U.S. L.J. 441, 475-79 (1997) (arguing that free trade may conflict with federalist goal of states' rights).

[15] *See* General Agreement on Tariffs and Trade, Oct. 30, 1947, T.I.A.S. 1700, 55 U.N.T.S. 188 [hereinafter GATT].

[16] *See* BHAGWATI, *supra* note 5, at 3.

[17] Benjamin Rozwood & Andrew R. Walker, *Side Agreements, Sidesteps, and Sideshows: Protecting Labor from Free Trade in North America*, 34 HARV. INT'L L.J. 333, 333 (1993); *see* North American Free Trade Agreement, Dec. 17, 1992, 32 I.L.M. 296, 32 I.L.M. 605 [hereinafter NAFTA].

[18] *See Uruguay Round Negotiators Begin Talks On Proposed Text for Safeguards Pact*, 6 Int'l Trade Rep. (BNA) 869, 869 (1989). The term voluntary restraint agreement ("VRA") is often used interchangeably with VER. VERs are used to circumvent jurisdiction of the GATT and provide economic rent to the importing country. *See also* BHAGWATI, *supra* note 5, at 3 ("However, the growth of nontariff barriers in the 1970s and the 1980s offset the liberalization of trade that tariff reductions implied."); Sykes, *supra* note 5, at 256-57 (listing imports subjected to VERs).

[19] I adopt the term "special protection" from Hufbauer, Berliner and Elliott, to refer to "exceptional restraints on imports, implemented through high tariffs, quota restraints, or other limitations that go well beyond normal tariff or border restrictions." GARY CLYDE HUFBAUER ET AL., TRADE PROTECTION IN THE UNITED STATES: 31 CASE STUDIES 2 (1986).

pressures of international competition, through more traditional forms of protection— such as quotas and tariffs imposed on imports. Shipbuilders and producers of agricultural products, textiles, steel, and motorcycles are among the most notable recipients of special protection.[20] These exceptions to free trade cost American consumers billions of dollars each year, while preserving comparatively few jobs.[21]

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[20] *See id.* at 1-29; *see also* BHAGWATI, *supra* note 5, at 9 (noting an agricultural exemption contained in the original GATT and its subsequent expansion); Jorge F. Perez-Lopez, *Labor and the North American Free Trade Agreement*, 11 DICK. J. INT'L L. 567-68 (1993) (explaining that many of NAFTA's adjustment provisions simply elongate or suspend the phase-out of tariffs to sensitive industries). The industries most sensitive to import competition are almost certainly the most inefficient and, therefore, a slow phase-out of protection appears inconsistent with the goals of a trade liberalization agreement.

[21] For example, estimated costs to consumers are $60,000 per job in the sugar industry, $220,000 in the dairy industry, $270,000 in the maritime industries, and $1,000,000 in specialty steel. The total gains *to producers* per worker are between $4,000 and $130,000 depending upon the specific industry, but only in exceptional cases do the gains to producers exceed the costs imposed on consumers. *See* HUFBAUER ET AL., *supra* note 19, at 14-16.

While these numbers may have decreased slightly in response to NAFTA, most of the industries in question have been granted extended phase-out periods. These periods usually last 15 years, when they are not altogether frozen. One example is the following:

> Ten-Year phase-out periods were negotiated on manufactured products such as dyes and pigments, some footwear items, ball bearings, bicycles, leather goods, certain chemicals, crude oil, fuels, men's wool suit coats, and rayon fabrics, and on agricultural products such as certain onions, tomatoes, eggplant, chili peppers, squash and watermelons. A limited number of products were granted extra-long [tariff] phase-out periods ... include[ing] certain household glassware products, certain footwear products, ceramic tiles, broomcorn brooms, and certain watches and watch movements, and agricultural and fisheries items include[ing] orange[sic] juice, peanuts, sugar, sprouting broccoli, cucumbers, asparagus, dried onion power[sic], dried onions, dried garlic, canned tuna, cantaloupes, and other melons.

Perez-Lopez, *supra* note 20, at 567-68 & n.8 (citing *Report of the Administration on the North American Free Trade Agreement and Actions Taken in Fulfillment of the May 1, 1991 Commitments,* at 70-71).

The myriad number of products subject to phase-outs is a testament to the power of lobbying and the resulting entrenchment of inefficiency. Also, as discussed *infra,* NAFTA creates new problems rather than solving the pre-existing ones.
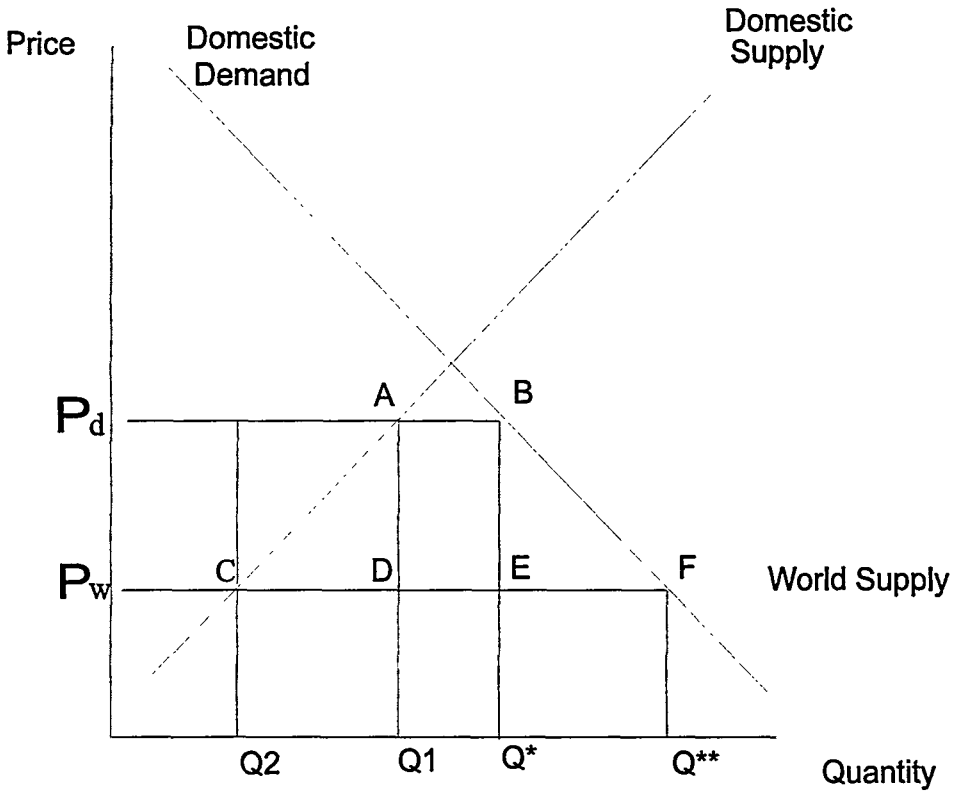
Figure 1 - Protection through a Tariff.

Figure 1 ("Fig. 1")[22] illustrates the general deadweight losses associated with protectionist behavior. The domestic supply curve in Fig. 1 represents the inefficient production of a domestic industry with an elastic supply curve. Domestic production is inefficient when compared to international production, as evidenced by comparing the two supply curves. The letters in Fig. 1 identify the points where the closest intersection of lines occurs. For example, point C identifies the point where "Domestic Supply" intersects with the "World Price." The points P_w and P_d refer respectively to the World (Competitive) Price and the Domestic (Protectionist) Price. P_w and P_d label the points where the price lines intersect with the Y-axis. Domestic supply is much higher ("Q1") at the protected price than it would

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[22] Figure 1 is patterned after Figure 1 in Alan O. Sykes, *Countervailing Duty Law: An Economic Perspective*, 89 COLUM. L. REV. 199, 217 (1989).

be at the competitive world price ("Q2"). Q1 minus Q2 is the amount of inefficient domestic production that is induced by the tariff.

World supply is perfectly elastic. It therefore equals world price and remains constant at all quantity levels. Figure 1 assumes that the U.S. market is not large enough to affect world price, which may not hold true for all industries. World price represents the competitive international price for the good. Price plus tariff equals the domestic protectionist price. Q^* is the total amount consumed of both imported and domestic goods, and Q1 is the total amount produced in the domestic economy with the tariff. Q^{**} and Q2 are the amounts consumed and produced, respectively, without the tariff.

The use of a tariff to reduce imports provides some gain to domestic producers and raises some revenue for the government, but does this at a great cost to consumers. The tariff reduces consumer surplus[23] by the amount represented by the area bounded by points P_w and P_d on one side, and points B and F on the other. The tariff also increases domestic producer surplus[24] by the area bounded by points P_w and P_d on one side, and points A and C on the other. Government revenue from the tariff equals the square ABDE. From a national perspective, the tariff makes the domestic economy worse off by the amount bounded by the triangles ACD and BEF. These triangles represent the "deadweight loss"[25] associated with barriers to free trade. This calculation of deadweight loss is the most tangible and observable net amount of harm the tariff causes to the domestic economy.

Some observers feel that the tariff causes even greater

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[23] "Consumer surplus arises when a consumer's reservation price— the consumer's maximum willingness-to-pay for a good or service— exceeds the price actually paid." Sykes, *supra* note 5, at 261 n.26.

[24] Producer surplus is equal to the sum of economic profits and rents earned by firms and workers. An economic profit arises when the return on the operation of a firm exceeds the 'competitive' return on investment capital. An economic rent arises when the sale of a factor of production (such as land or labor) yields a price in excess of the price available in that factor's next best alternative use.

Id. at 260 n.25.

[25] "Deadweight loss" refers to the amount of consumer surplus in a free-trade regime that is lost in a protectionist regime and is not captured by producers or by the government. It is a pure loss of utility. *See generally* POSNER, *supra* note 2, at 277-78.

deadweight loss than the amount represented by the two triangles. Deadweight loss could exceed the traditional measure described above, because domestic firms are willing to expend any amount less than the amount represented by the area bounded by P_w, P_d, A, and C in order to preserve the tariff. Most observers feel that amounts spent on lobbying (*i.e.*, rent seeking) should be included with the pure deadweight loss, because the money and effort spent on lobbying could otherwise be put into productive use.[26]

If the domestic government used a quota or VER instead of a tariff, the amount of domestic deadweight loss would increase by the square ABED, which the importers would capture instead of the domestic government. This explains why many importing countries[27] are willing to agree to VERs.

The figure also demonstrates why a straight transfer payment from consumers to producers would be more efficient than using protection. Consumers could pay producers the amount represented within P_wP_dAC, giving the producers an amount of surplus equal to the protectionist regime, and consumers would still have an increased surplus of ACFB. The government would lose revenues of ABED, but it could either allow consumers to keep this amount or recapture such revenue through taxation.

2.1.   *NAFTA Is Not a Panacea for Protectionist Woes*

It may appear that NAFTA is designed to eliminate these problems. NAFTA alone, however, only goes a small part of the way towards truly eradicating protectionism and the inefficiencies it causes. Since the United States and Canada already had a free trade agreement prior to NAFTA, the only real change it brought about was U.S. and Canadian free trade with Mexico. While Mexico may have a comparative advantage in some areas that the United States otherwise shields from international competition, it

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[26] *See* Anne O. Krueger, *The Political Economy of the Rent-Seeking Society,* 64 AM. ECON. REV. 291, 295-96 (1974) (arguing that lobbying consumes scarce resources that do not produce any tangible benefit to society); Richard A. Posner, *The Social Costs of Monopoly and Regulation,* 83 J. POL. ECON. 807, 809 (1975). *But see* Mark Glick, *Is Monopoly Rent Seeking Compatible with Wealth Maximization?,* 1994 BYU L. REV. 499, 517 (arguing that lobbying involves a free-market exchange and is therefore a productive activity like any other).

[27] "Importing country" refers to a country that sends its goods into the domestic country. All references to imports and exports are made with respect to their relation to the domestic country.

doesn't necessarily possess a comparative advantage in those industries compared to the world market. Therefore, the effect of NAFTA in such industries, where Mexico is simply less inefficient than the United States or Canada, is to shift inefficient investment and its protectionist spoils from the United States to Mexico.[28] Thus, the mantle of protection is extended over three countries instead of one. The resulting diversion of trade functions as an *ad hoc* subsidy to those industries in Mexico that possess a comparative advantage to the United States and Canada, but are inefficient compared to the world market. It is doubtful that U.S. subsidization of Mexican industry was an intended result of NAFTA.

Also, Mexico is such a tiny market compared with the United States that the removal of trade barriers will probably have little effect on even the most inefficient U.S. industries.[29] Many of the areas where NAFTA probably will have a notable impact, particularly specially-protected areas such as agriculture and textiles, are subject to an extended fifteen-year phase-out of tariffs which fails to ameliorate much of the efficiency loss in the short-term.[30] Thus, ratification of NAFTA has not removed the inefficiencies caused by U.S. protectionism.

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[28] *See* JAGDISH BHAGWATI & ANNE O. KRUEGER, THE DANGEROUS DRIFT TO PREFERENTIAL TRADE AGREEMENTS 3-7 (1995) (arguing against preferential trade agreements such as NAFTA, and stating that such agreements are simply protectionist politics on a larger scale); Sykes, *supra* note 5, at 294 ("If country A imposes a 10 percent [sic] tariff on widgets from country B and a 20 percent [sic] tariff on widgets from country C, and if the market for widgets in country A is substantial, then the result may be to encourage investment in widget production in country B even though producers in country C are more efficient. Considerable deadweight losses may result."); *cf.* Robert W. Benson, *Free Trade As an Extremist Ideology*, 17 U. PUGET SOUND L. REV. 555 (1994) (arguing against ratification of NAFTA and predicting that it promotes the abuse of human rights, degradation of the environment, and erosion of the democratic process in the United States).

[29] *See* Leonard Bierman et al., *The North American Free Trade Agreement: A Market Analysis*, 27 VAND. J. TRANSNAT'L L. 719, 739 (1994) ("[C]areful empirical examination has revealed that the ratification of [NAFTA] had no meaningful effect on U.S. equity markets either on an aggregate or sectoral basis.").

[30] For example, a recent inspection of commodities prices reveals that U.S. domestic sugar continues to be approximately twice as expensive as world sugar. *See Commodity Price Listing*, INVESTORS' BUS. DAILY, Dec. 31, 1997 at B1 (listing the price of a March 1998 number 14 New York delivered contract to purchase sugar closing at 21.83 cents/lb. and a March 1998 number 11 World contract closing at 12.29 cents/lb.).

2.2.   Hidden Costs of Protectionism

There are other negative effects from protectionist policies, in addition to the obvious costs to consumers in the form of higher prices and constrained choices. When the protected good serves as a factor input to other goods produced in the United States, these secondary goods are put at a competitive disadvantage with their free-trading foreign counterparts.[31]   For example, an American manufacturer of frosted cereal must pay almost twice as much for its sugar as a foreign company. This makes American frosted cereal less competitive not only in foreign export markets, but also against imported cereals.[32]

Furthermore, tariffs and quotas (including VERs) attract scarce resources to inefficient industries and away from other industries that can compete on a global level.[33]   This retards innovation[34] and also limits the production of potential exportable goods. Almost without exception, heavily protected goods are sufficiently unattractive to the global marketplace as to preclude their export.   Trade barriers require significant administrative costs, such as border enforcement, origination verification, and the monitoring of exporting countries subject to VERs.[35]   The rise in price of a protected good will also tend to exert upward pressure on the price of substitution goods.[36]   For example, the high cost of sugar makes aspartame more attractive to consumers and therefore more expensive.

Finally, the imposition of barriers to trade can have adverse effects on domestic currency. Tariffs and quotas make domestic goods more attractive than imports. This raises the demand for U.S. dollars as compared with foreign currency, and could

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[31] *See*   PETER   H.   LINDERT   &   CHARLES   P.   KINDLEBERGER, INTERNATIONAL ECONOMICS 116-17 (7th ed. 1982); *see also* BHAGWATI, *supra* note 5, at 9 ("[S]everal empirical analyses . . . have underscored the link between trade liberalization and improved export performance (and, hence, enhanced economic performance).").

[32] The example is illustrative only. The sugar tariff applies to all goods with a stated content of sugar, which would most likely include frosted cereal. Regardless, this policy still leaves U.S. cereal companies at a disadvantage in the international market and also adds a layer of administrative complexity and expense.

[33] *See, e.g.*, LINDERT & KINDLEBERGER, *supra* note 31, at 126-27.

[34] *See, e.g., id.*

[35] *See id.*

[36] *See id.*

strengthen the U.S. dollar.[37] A rise in domestic currency makes all domestically produced products more expensive relative to foreign goods, and consequently undoes some of the protection itself.

2.3. Arguments in Favor of Protectionism

Protectionists use a panoply of arguments to justify barriers to free-trade. Although many of the arguments may appeal to uninformed intuition, they are rarely able to withstand close scrutiny. The only argument that can possess theoretical justification on pure efficiency grounds[38] remains unattractive because of its negative external effects.

2.3.1. Infant Industry Argument

One such frequently repeated argument asserts that a domestic industry in its early developmental stages ("infant" industry) initially needs protection from powerful, fully developed foreign competitors to survive and grow.[39] The superconductor industry is a commonly cited example. The idea behind the argument is that, under the mantle of protection, the domestic industry will travel down the learning curve and become competitive with foreign industry. Once the industry reaches the internationally competitive level, the government removes the trade barriers.

This argument makes several fallacious assumptions.[40] First, it assumes that there is a systematic and pervasive failure in the capital markets which consistently ignores the potential gains to be made in the "infant" industry.[41] While this argument may be conceivable in some small, newly industrialized countries, it almost certainly is not true in the United States, which is home to the largest and most sophisticated capital markets in the world. There is also little reason to believe that the federal government could consistently identify potential growth industries with

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[37] *See id.* at 127-28; *see also* LAWRENCE & LITAN, *supra* note 5, at 68.

[38] Specifically, see the Optimal Tariff Argument, discussed *infra* Section 2.3.6.

[39] *See* LAWRENCE & LITAN, *supra* note 5, at 19-20.

[40] *See id.* at 19-21. *But see* BHAGWATI, *supra* note 5, at 91 (stating that the infant industry argument has "a perfectly legitimate role, even within the classical theory of gains from specialization and trade").

[41] *See* LAWRENCE & LITAN, *supra* note 5, at 19.

greater accuracy than the trained professionals on Wall Street.[42]

This argument also assumes that the protected infant industry will thrive under the protectionist regime and eventually become competitive with the established world market. Without exposure to the competitive pressures of the developed market, it is highly unlikely that this optimistic scenario would ever arise.[43] Also, the learning that takes place in the protected industry could attract scarce resources away from other industries, preventing similar learning within these other industries and possibly leading to a decline in total learning within the economy.[44]

Trade barriers tend to persist for long periods of time, because they trigger an incentive for stakeholders in the protected industry to engage in rent-seeking behavior.[45] Additionally, the imposition of trade barriers frequently leads to retaliatory trade barriers, which could hurt U.S. exporters.

There could be instances where significant, beneficial public externalities are associated with a particular infant industry that would not factor into a private profit calculus, and could therefore cause private lenders to undervalue the total potential social benefit of investment in an industry.[46] If this were the case, the government could develop the infant industry more efficiently through direct subsidization, which would infuse capital into the industry without the distortive effects of protection.[47] The "specificity rule"[48] holds that the most efficient

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[42] *See id.*

[43] *See id.* at 20; LINDERT & KINDLEBERGER, *supra* note 31, at 145-47.

[44] *See* W. MAX CORDEN, TRADE POLICY AND ECONOMIC WELFARE 154 (2d ed. 1997).

[45] *See* Krueger, *supra* note 26, at 291; LINDERT & KINDLEBERGER, *supra* note 31, at 146; Ronald Findlay & Stanislaw Wellisz, *Endogenous Tariffs, the Political Economy of Trade Restrictions, and Welfare, in* IMPORT COMPETITION, *supra* note 11, at 223, 225 ("The social value of the resources used up . . . in this struggle [lobbying for and against a tariff] would constitute a welfare cost over and above the familiar deadweight loss associated with whatever tariff level emerges from the political process.").

[46] *See* BHAGWATI, *supra* note 5, at 91 ("[The] political preference for industrialization often coexisted with a conviction that manufacturing had considerable externalities— such as creation of a scientific mentality conducive to innovation and technical change— that were not fully reflected in market prices.").

[47] *See, e.g.,* LINDERT & KINDLEBERGER, *supra* note 31, at 145 ("If the infant home industry will bring side benefits by causing the labor force and other industries to develop new skills, subsidizing production can achieve this more cheaply than can taxing imports.").

and effective method of dealing with a problem is usually the most direct available method.[48]   In this instance, the rule of specificity prescribes the use of direct subsidies over trade barriers because subsidies would go directly to the improvement of the industry, whereas protection would seek improvement indirectly, through the elimination of foreign competition.[50]

2.3.2. *Declining Industry Argument*

An argument similar to that used in favor of developing industries is often used to justify protection of industries in decline, such as the steel industry. This argument holds that the government must protect domestic industries in decline in order to ease their exit from the market and smooth the transition for their workers.   However, many factors other than foreign competition may contribute to an industry's decline and it seems illogical to place an inordinate amount of emphasis on one factor, especially when the solution leads to widespread inefficiency.[51] Again, the incentive for rent-seeking behavior often entrenches protection that the government intended as a temporary solution, into an ongoing program.[52]   Protection of a declining industry often stipulates that any assistance received be invested back into the industry, however, this is inconsistent with an optimal exit strategy and diverts the flow of scarce resources from other, more efficient industries.[53]

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[48]   *Id.* at 140.

[49]   For example, if a town desires a good bakery, it is unlikely that only allowing one bakery to do business in that town would lead to that result; however, training the bakers and subsidizing equipment purchases may improve the bakery's quality.

[50]   *See* LINDERT & KINDLEBERGER, *supra* note 31, at 148 ("If the [externality] is generated by domestic production itself, then the appropriate policy tool seems to be the domestic production subsidy . . . .").

[51]   *See* LAWRENCE & LITAN, *supra* note 5, at 75 (suggesting other causes of decline).

[52]   *See* Krueger, *supra* note 26, at 302.

[53]   Despite the economic dislocation that may result from competition in the marketplace, however, competition is usually thought to be desirable for its ability to promote efficient resource allocation.   It drives inefficient producers from the market and induces workers to move to firms and industries in which their services are most valuable.   As a result, goods and services are produced at minimum cost, and prices to consumers decline.

See Sykes, *supra* note 22, at 209 & n.55

2.3.3.   National Defense Argument

Another common argument asserts that certain industries, such as national defense, are vital to national interests, and therefore the government must shelter them from international competition. If such an industry truly is vital to national defense, the government should directly subsidize it from the defense budget.[54] Direct subsidization provides proper disclosure as to how the government apportions public tax revenue and what interests the government deems vital.[55]

Applied to the oil industry, as done by anti-OPEC rhetoric, this policy causes the United States to drain its domestic reserves at a faster than efficient rate, leading to an outcome exactly opposite of that desired for national defense.[56] If the nation's goal is to build stockpiles of a strategic resource, then the country could accomplish this goal most efficiently by producing items in which it possesses a comparative advantage, and then acquiring more of the strategic good on the international market.[57]

Also, trade barriers function within a consumptive equilibrium. This means that a protectionist regime causes the domestic country to consume the entire amount of a good that is produced and imported, rather than stockpile it for future, strategic use. The national defense argument invokes specious reasoning and cannot justify the existence of barriers to free-trade.

2.3.4.   Foreign Market Failure Argument

Protectionists frequently argue that foreign countries are able to produce certain goods cheaply because of a specific market

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But see Michael Mussa, *Government Policy and the Adjustment Process, in* IMPORT COMPETITION, *supra* note 11, at 73, 96 (arguing that an optimal declining tariff on the imports of an industry in domestic decline would allow the social cost of imports to equal their actual cost).

   [54] *See* LAWRENCE & LITAN, *supra* note 5, at 6.

   [55] Private income includes consumption and savings. If a consumer must pay a supra-competitive price for a product, it reduces her income by lowering the amount she can consume for the same price, or lowering the amount she could save by consuming the same amount at a lower price. *See, e.g.,* Bruno, *supra* note 12, at 14.

   [56] *See* LINDERT & KINDLEBERGER, *supra* note 31, at 150.

   [57] *See id.* at 149-50.

failure.[58] A country may, for example, have lax environmental standards or employ child labor. These are legitimate concerns on the part of the global community. However, commercial isolationism is not an efficacious tool for dealing with most social problems.[59] The rule of specificity holds that if these market failures are actually the impetus behind protectionist sentiment, then politicians and diplomats would be better served by the use of treaties aimed directly at these market failures.[60] Alternatively, an adjustable tariff could be used as a border adjustment to correct for foreign market failures. However, the United States does not attempt to differentiate between socially responsible and irresponsible producers, but instead imposes blanket trade restrictions.[61]

Often protectionists disguise rent-seeking activity in foreign-market failure rhetoric. Also, to send a clear message of deterrence against the market failure, a protectionist move would have to be a consensus action by all or most of the major global markets. The above cited cases of special protection and VERs are almost exclusively unilateral moves made by the United States.

2.3.5. Strategic Bargaining Argument

Some protectionists argue that certain trade barriers provide the United States with a negotiating option to offer in return for loosening other markets' trade barriers. Although this argument might provide a general justification for the maintenance of moderate tariffs, it does not explain the huge tariffs imposed on imports in specially protected industries and consistent maintenance for many years; nor would it explain VERs, which bribe the foreign producers to limit their imports.[62]

Many Americans erroneously believe that domestic markets

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[58] *See* LAWRENCE & LITAN, *supra* note 5, at 20.

[59] *See id.* at 21-22.

[60] *See id.* at 21.

[61] VERs are an exception in that they are often granted to a single country. However, there is no evidence that the basis of awarding VER output is based on terms of social responsibility.

[62] VERs benefit those producers whose exports to the United States are limited by allowing them to price their goods above the competitive level and capture some of the consumer surplus that a tariff would capture for the government. *See supra* Section 2., Fig.1.

are free of significant trade barriers, while significant foreign markets, particularly Japan, impose unfair duties on American exports.[63] This is not true, at least with respect to the larger, established foreign markets, including Japan.[64]

Under GATT Article XIX, the United States has the right to impose a countervailing duty in the face of a foreign trading partner that subsidizes its exports.[65] Although all GATT signatory nations possess this power, the United States is the only nation to exercise it with any regularity.[66] Here again, many domestic industries plead for invocation of countervailing duties in an attempt to secure economic rent.[67] Even if an importing company threatens predatory behavior,[68] direct subsidies to domestic producers provide a more efficient tool to prevent harm to the domestic industry.[69] In almost all cases, the United States would reap economic benefits if it unilaterally reduced barriers to trade, no matter what foreign actors chose to do.[70] Nevertheless,

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[63] *See* BHAGWATI, *supra* note 5, at 68 ("The contention that 'foreign markets are closed while ours are open' . . . does not [reflect reality] for the United States today . . . .").

[64] *See 1996 National Trade Estimate Report on Foreign Trade Barriers*, 171 (1996) ("Japan was the United States' second largest export market in 1995. . . . U.S. merchandise exports to Japan were $64.3 billion [in 1995]. . . . [President Clinton's results oriented approach] has been successful in creating more avenues for entry into Japan's market.").

[65] *See* Sykes, *supra* note 22, at 202.

[66] *See id.*

[67] *See id.* at 234-35.

[68] Predatory behavior, in this context, refers to a situation where an importer prices its goods lower than it normally would in order to drive-out competition in the domestic market. After ridding itself of competition, the importer would then raise its prices above the competitive equilibrium to extract monopoly rents from consumers. Factors that predispose an industry to this type of behavior include differential economies of scale, significant costs to enter and to exit the market, inelastic demand for the good, and cross-product inelasticity (a low degree of substitution). *See* POSNER, *supra* note 2, at 303-13.

Under the GATT escape clause, the main concern is that foreign governments may subsidize their producers in order to allow them to price competitors out of the market and gain a monopoly position. The escape clause allows the domestic market to impose a countervailing duty to offset the effects of the subsidies. *See generally* Sykes, *supra* note 22 (explaining the theoretical justification for countervailing duties and their resultant inefficiencies for the countries that impose them).

[69] *See* LINDERT & KINDLEBERGER, *supra* note 31, at 24.

[70] A domestic market would capture increased utility in the amount of the dead weight loss under the previous protectionist regime. This remains so,

a policy of cutting tariffs while an importer imposes significant barriers to U.S. exports could have political costs sufficient to outweigh its economic superiority.[71]

2.3.6. *Optimal Tariff Argument*

When the United States possesses monopsony[72] power over a good, it has the ability to impose "optimal" tariffs, which actually provide a net efficiency gain to the domestic economy.[73] Such a gain, however, would come at the expense of American trading partners[74] and would run counter to the stated objectives of GATT.[75] Also, the analysis that calculates an improved economic position under such a tariff neglects the less quantifiable costs to trade barriers, discussed supra, including retaliatory tariffs.[76]

The optimal tariff argument has never provided the rationale for governmental enactment of barriers to importation or the calculation of their proper levels.[77] Politicians view tariffs as a means to protect domestic industry or to prevent deterioration of the current terms-of-trade, but not as a method to improve upon those terms. The amount of monopsony power required to

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regardless of what other countries may choose, although other countries' willingness to accept exports could have an impact on the domestic market. The maintenance of highly restrictive tariffs would not seem to have any rational relation to freeing up foreign markets for exports. *See* BHAGWATI, *supra* note 5, at 24; *see also* discussion *supra* Section 2.

[71] *See* BHAGWATI, *supra* note 5, at 35 ("A free trade regime that does not rein in or seek to regulate artificial subventions will likely help trigger its own demise.").

[72] This would require that the United States dominate the world market sale of a good to such an extent that it could extort favorable terms of trade with the world suppliers. Essentially, the optimal tariff is one that is used to drive down the world price. *See, e.g.,* CORDEN, *supra* note 44, at 81-104.

[73] *See* Sykes, *supra* note 22, at 221; *see also* LINDERT & KINDLEBERGER, *supra* note 31, at 134-38; Mussa, *supra* note 53, at 74.

[74] The optimal tariff would result in a net loss in global wealth. *See* CORDEN, *supra* note 44, at 90-91.

[75] *See* Sykes, *supra* note 22, at 221.

[76] *See* Sykes, *supra* note 22, at 221 n.97 (listing agriculture as a potential target for foreign retaliation); *see also* CORDEN, *supra* note 44, at 92 (arguing that larger countries are likely to elicit retaliation). *But see* T. Scitovsky, *A Reconsideration of the Theory of Tariffs*, 9 REV. ECON. STUD. 89-110 (1942) (suggesting that, on a multi-lateral level, countries would tend to take tariffs as a given rather than attempting to adjust to each trading partner's policies in kind).

[77] *See* Sykes, *supra* note 22, at 220-21; *see also* CORDEN, *supra* note 44, at 93.

successfully implement an optimal tariff may preclude even an economic powerhouse such as the United States from its effective use.[78]   The optimal tariff argument exists only as a theoretical basis for barriers to free trade, and relies on questionable assumptions.

2.3.7.   *Job Protection Argument*

Protection of domestic jobs is probably the most politically popular argument in favor of protection, whether couched in terms of fairness, or otherwise. If the goal of such a policy is overall economic efficiency, it obviously fails.[79]   One study calculated that each dollar of wages protected in the textile, steel, and auto sectors costs consumers twenty-eight dollars.[80]

The extremely high cost per job saved indicates that protectionism allocates labor to unproductive industries that cannot compete on a global level. Also, jobs saved in a protected industry could come at the cost of jobs lost in another sector. For example, research estimates that quotas for foreign textiles added about 71,000 jobs in the domestic textile and apparel industries, but that these gains were almost entirely offset by jobs lost in the retail sector from reduced demand for the finished product.[81] Additionally, protection tends to cause manufacturers to relocate within the United States or replace labor with capital, causing job dislocation similar to that imposed by foreign competition.[82] Long-term protection often leads unions to seek higher than equilibrium wages, which can lead to an entire range of new problems and further impair the competitiveness of the domestic industry.[83]

Efficiency requires the reallocation of labor to the more efficient industries.[84] If the goal of protection is distributional in nature, involving income redistribution from consumers to workers, then it is a clumsy and inefficient tool.[85] Most of the

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[78]   *See* CORDEN, *supra* note 44, at 96-97.

[79]   *See* discussion *supra* Section 2.; HUFBAUER & ROSEN, *supra* note 10, at 17-25.

[80]   *See* DE MELO & TARR, *supra* note 4, at 198.

[81]   *See* LAWRENCE & LITAN, *supra* note 5, at 69 & n.5.

[82]   *See id.* at 70-72.

[83]   *See id.* at 77.

[84]   *See* Sykes, *supra* note 22, at 209.

[85]   *See* LINDERT & KINDLEBERGER, *supra* note 31, at 149.

benefits of a protectionist policy are swallowed up by the owners and shareholders, rather than labor.[86]

The form of the resultant wealth transfer from protectionist policies also raises concerns of regressivity. "According to one ... estimate ... restrictions on imports of clothing, sugar, and automobiles cost low-income consumers nearly twice as much of their incomes as they did upper-income consumers."[87] The government could redistribute income from consumers to workers much more easily, at a lower cost, and with greater vertical equity[88] through a straight transfer payment than through trade protection. This would reduce administrative costs, as well as prevent the other harmful effects of protection, previously discussed in this Comment.

2.4. *Justification for Compensation*

One could argue that, from a risk-to-benefit ratio perspective, workers should not be compensated for their losses. With perfect information and rational actors on both sides, management would pay labor a higher wage rate to compensate it for the risk of job displacement from trade liberalization.[89]

Nonetheless, even if research could prove risk-adjusted compensation empirically, it would be a sound policy to compensate labor for its losses from the removal of trade barriers. Compensation to displaced workers not only makes free trade

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[86] *See* HUFBAUER & ROSEN, *supra* note 10, at 16.

[87] LAWRENCE & LITAN, *supra* note 5, at 15-16 & n.10.

[88] Vertical equity refers to notions of progressivity, defined as a "rate of tax applied to an individual's income [that] increases as income increases." MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 28 (3d ed. 1995). A tariff or quota is really a tax on consumption, with a portion of the proceeds shifted from consumers to producers. *See* discussion *supra* Section 2. This can be seen by the following analysis. An individual's income is defined as her total income plus her total savings. *See* Bruno, *supra* note 12, at 23. A decrease in either portion of income, taken by the government, is a tax. A tariff or quota, by increasing the price of consumer goods, causes consumers to either pay a higher price for the same amount of goods consumed, resulting in a decrease in savings, or to consume less and spend the same amount, a decrease in consumption. Producers enjoy the benefit of the tariff or quota in the form of higher prices than those present in free-trade. The end result is a transfer of wealth from consumers to producers and importers (with a quota) or the government (with a tariff) and a residual deadweight loss.

[89] *See* Sykes, *supra* note 5, at 271.

more politically feasible,[90] but could also serve to promote the smooth transition of labor from the inefficient, protected industry to a more productive industry.[91] The public at large may also desire compensation for the two other main stakeholders in a protected industry, ownership and communities dependent upon the industry.[92] The government must carefully structure compensation to any of the stakeholders, probably in the form of a one-time, lump-sum disbursement, so as to avoid the incentive for rent-seeking behavior.

As the above analysis illustrates, in almost every case of trade restraint, a few people are made far better-off, while a great many are each made slightly worse off, resulting in an inefficient transfer of wealth from the many to the few.[93] Analyzing this situation reflexively, the removal of a trade barrier would result in small, widespread benefits throughout the economy, while the burdens would be concentrated within a small segment of the population.

2.5.   *Compensation as an Application of the Coase Theorem*

When removal of a trade barrier would result in a net gain to the U.S. economy (as will almost always be the case), such a move is Kaldor-Hicks efficient.[94] The Coase Theorem provides that, in the absence of transaction costs, the potential winners would compensate the potential losers to lift the trade barriers and increase societal wealth.[95] Since many of the benefits from free

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[90] *See* J. David Richardson, *Trade Adjustment Assistance Under the United States Trade Act of 1974: An Analytical Examination and Worker Survey, in* IMPORT COMPETITION, *supra* note 11, at 323 & n.3 ("[A public opinion survey found] only 15 percent [sic] [of people surveyed would] 'basically oppose [free trade] if American workers who lost their jobs because of free trade did not suffer any personal financial loss and were retrained in jobs equal to or better than their old ones.'"); LAWRENCE & LITAN, *supra* note 5, at 24 & n.28 ("[A] survey . . . revealed that while most respondents were reluctant to support trade liberaliztion, they voiced support for freer trade if affected workers received compensation.").

[91] *See* Sykes, *supra* note 5, at 272.

[92] *See* LAWRENCE & LITAN, *supra* note 5, at 3; *see also* Jagdish N. Bhagwati, *Shifting Comparative Advantage, Protectionist Demands, and Policy Response, in* IMPORT COMPETITION, *supra* note 11, at 153, 154.

[93] *See* PARETO, *supra* note 7, at 379.

[94] Kaldor-Hicks efficiency provides that "a move is efficient whenever the winners win more than the losers lose." Calabresi, *supra* note 2, at 1221.

[95] *See id.* at 1222. Although it is probably impossible to quantify all of the

trade are not readily apparent, and the beneficiaries are many and diffuse, each of whom only has a relatively small stake in any potential move, the lobby in favor of free trade is ineffective.[96] Todd J. Zywicki highlights this difficulty in his article, *A Unanimity-Reinforcing Model of Efficiency in the Common Law*:

> With respect to externalities, it is claimed that the collective decision-making process of legislative approaches is necessary to eliminate divergences between private and social costs. Ronald Coase's insight that externalities could be dealt with through private contract is considered inapplicable to most externalities cases because high transaction costs make negotiation infeasible.[97]

Therefore, it is apparent that transaction costs have heretofore proven prohibitive to completing these potentially Kaldor-Hicks efficient moves. It is in situations such as these that the government is supposed to intervene in order to benefit society. The government can complete the Coase theorem by having the

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intangible costs associated with unemployment, they are a very real part of the adjustment process and one should not ignore them. The government can establish programs to minimize both the tangible and intangible costs of unemployment. For a graphic description of the intangible costs associated with widespread unemployment, see GEORGE ORWELL, THE ROAD TO WIGAN PIER (1958). *See also* LAWRENCE & LITAN, *supra* note 5, at 25 ("[A]djustment assistance . . . will not . . . provide full compensation for the economic and psychological losses from job layoffs.").

[96] This phenomenon is known in the economic lexicon as the "collective action" problem. *See, e.g.,* BHAGWATI, *supra* note 5, at 73. Coase hints at this as well. *See* Coase, *supra* note 8, at 17-18. Coase notes the following:

> It is clear that the government has powers which might enable it to get some things done at a lower cost than could a private organisation . . . . But equally there is no reason why, on occasion, such governmental administrative regulation should not lead to an improvement in economic efficiency. This would seem particularly likely when, as is normally the case with the smoke nuisance, *a large number of people are involved and in which therefore the costs of handling the problem through the market or the firm may be high.*

Coase, *supra* note 8, at 17-18 (emphasis added).

[97] Todd J. Zywicki, *A Unanimity-Reinforcing Model of Efficiency in the Common Law,* 46 CASE W. RES. L. REV. 961, 961-62 (1996) (footnotes omitted).

winners in a potential change compensate the losers in order to effectuate the change when the private actors themselves are unable to do so.[98]

Congress possesses the power to "regulate Commerce with foreign Nations,"[99] and thus maintains primary responsibility for the imposition and removal of trade barriers. After the debacle of the Smoot-Hawley tariff, Congress realized its own susceptibility to special interests and logrolling that resulted in universal damnation and therefore decided to cede some of its power to the executive branch.[100] This paved the way for a great deal of trade liberalization; however, a small minority of the tariffs remained at their former levels or even increased, usually in response to a particularly strong lobby, such as agriculture.[101]

It seems likely, that to pry open these embattled industries, the government must make an effort to mollify those constituencies which stand to lose by lifting barriers to trade. A transfer payment to the losers of free trade could reduce the political costs to members of Congress who would remove the barriers to trade, and make free trade a more probable political outcome. Transfer payments and social programs can have intrinsic efficiency benefits, in addition to their attractiveness from the distributional and political pragmatist viewpoints.[102] The optimal methods to fund and structure trade adjustment are analyzed in the next two sections.

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[98] *See* Coase, *supra* note 8, at 43.

A better approach would seem to be to start our analysis with a situation approximating that which actually exists, to examine the effects of a proposed policy change and to attempt to decide whether the new situation would be, in total, better or worse than the original one. In this way, conclusions for policy would have some relevance to the actual situation.

Coase, *supra* note 8, at 43.

[99] U.S. CONST. art. I, § 8, cl. 3.

[100] *See* BHAGWATI, *supra* note 5, at 23 ("Stung by its own failure and by a severe electoral judgment, the Congress— which had given in to each sectional interest's demand for tariff protection— acquiesced in a classic shift of power in trade-policy intiatives and management to the executive branch, which was less amenable to constituency pressure."); DESTLER, *supra* note 6, at 14-17.

[101] *See* HUFBAUER ET AL., *supra* note 19, at 2-20.

[102] *See* LAWRENCE & LITAN, *supra* note 5, at 98.

3. FUNDING TRADE ADJUSTMENT WITH A CONSUMPTION TAX

Accepting trade adjustment as an economic necessity, if not also a socially desirable end of itself, leads to an inquiry of how the government should fund such a program. Use of a consumption tax[103] would tie the benefits of freer trade to the payment of compensation for the burdens imposed upon displaced workers and, possibly, owners.[104] If funding for the program were to come from general treasury revenues, then some taxpayers who enjoyed little or no benefit from freer trade would be forced to help pay for it. However, taxpayers fund many social programs from which they may individually derive no benefit or only indirect benefits, and accordingly the attractiveness of matching benefits to burdens need not be dispositive. A properly measured consumption tax would provide the added benefit of matching social costs of imports and import competing goods to their perceived cost by consumers.[105]

3.1.   *Difference Between Consumption Tax and Tariff*

It may be conceptually difficult to discern the difference between a discriminatory tariff and a non-discriminatory consumption tax. The key lies in the fact that the consumption tax is applied equally to domestic and imported goods, which

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[103] *See* DE MELO & TARR, *supra* note 4, at 180 (quoting A. C. PIGOU, A STUDY IN PUBLIC FINANCE 105 (3d ed. 1947) ("[T]he best way of raising a given revenue ... is by a system of taxes, under which the rates become progressively higher as we pass from uses of very elastic demand or supply to uses where demand or supply are progressively less elastic.").

[104] *See* Edward J. McCaffery, *Tax Policy Under a Hybrid Income-Consumption Tax*, 70 TEX. L. REV. 1145, 1158 (1992) ("Market failure occurs when market prices fail to reflect accurately the total benefits and burdens of any given activity .... Market failures are often caused by externalities."); Mussa, *supra* note 53, at 74 (noting that a consumption tax is among the "first-best" options available to government adjustment programs because it would "make the privately perceived price of imports equal to the social marginal cost of imports."); *see also* BHAGWATI, *supra* note 5, at 119 ("[A]n attractive and feasible way to do this may be to integrate the revenues that arise from the use of tariffs to provide temporary protection with the financing of the adjustment assistance in a 'closed loop,' so that, while one hand provides respite, the other encourages exit.") (footnote omitted).

[105] *See* Roger Cowie, *Using Tax Incentives to Improve American Competitiveness*, 31 AM. BUS. L.J. 417 (1993); McCaffery, *supra* note 104, at 1158 ("A good in the marketplace may be underpriced if ... its producers are not compelled to bear all of the costs of the good's production ....").

removes the distortionary effects of a tariff.[106] The imported good would be more expensive than its competitive world price in nominal terms, but it would be on equal competitive footing with domestic goods, removing the trade barrier-created domestic over-incentive to invest in the industry.[107] Michael Mussa notes in his paper that a consumption tax is among the most desirable options available to government adjustment programs because it would "make the privately perceived price of imports equal to the social marginal cost of imports."[108]

This type of program is already in place for the sugar production and import industries, both of which are regulated by the Jones-Costigan Act of 1934.[109] The problem with the sugar program is that it remits the proceeds from the consumption tax to the producers on a periodic basis for an indefinite time period, which creates an incentive for rent-seeking behavior and the inefficiencies that accompany it.[110]   A proper adjustment program, discussed in Section 3 of this Comment, would encourage inefficient producers to exit the market and discourage rent-seeking behavior.   Applied properly, a consumption tax could yield a nearly Pareto-efficient[111] outcome.[112]

Because of the many less quantifiable benefits to free trade and the widespread consumer gains in general, free trade, in the aggregate, can be conceptualized as a public good.[113]   The

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[106] *See infra* Figure 2.

[107] *See* Stephen E. Shay & Victoria P. Summers, *Selected International Aspects of Fundamental Tax Reform Proposals*, 51 U. MIAMI L. REV. 1029, 1047 (1997).

[108] Mussa, *supra* note 53, at 74.   Although this option does not help exporting companies using the taxed good as a factor input.

[109] *See* HUFBAUER ET AL., *supra* note 19, at 24 & n.22.

[110] *See generally* Neary, *supra* note 11, at 59-60.

[111] A Pareto-efficient move "make[s] someone in that society better off and no one in it worse off." Calabresi, *supra* note 2, at 1215. However, the Pareto standard is a slippery concept because individual preferences are notoriously difficult to quantify. *See* Guido Calabresi and A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1108-09 (1972) (discussing the difficulty of determining individual valuations).

[112] *See, e.g.*, BHAGWATI, *supra* note 5 at 119 ("[A]n attractive and feasible way to [fund trade adjustment] may be to integrate the revenues that arise from the use of tariffs to provide temporary protection with the financing of the adjustment assistance in a 'closed loop,' so that, while one hand provides respite, the other encourages exit.").

[113] *See* LINDERT & KINDLEBERGER, *supra* note 31, at 298 ("Each member

government could remove the consumption tax on U.S. exports to prevent any distortion in foreign markets.[114] A nondiscriminatory consumption tax is also much more consistent with the language and spirit of the GATT. The government would eventually phase out the consumption tax in order to equalize the domestic price with the competitive world price.[115]

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of society gains satisfaction from the total output of a public good. No one's satisfaction is diminished by the satisfaction gained by others, and it is not possible for anyone to appropriate a public good for her own personal use, as is the case with ordinary goods.").

In the aggregate, all consumers would enjoy a benefit from freer trade. Even if a person did not consume the good freed from protection, the move would reduce the price of substitute goods, and promote general efficiency in the economy.

[114] The removal of a destination based consumption tax on an exported good is termed a "border adjustment". *See* Shay & Summers, *supra* note 107, at 1046. Because an exporting country can administer border adjustments based on consumption taxes but not on the corporate income taxes, some legal scholars feel that the United States is at competitive disadvantage with countries utilizing a broad-based consumption tax in lieu of a corporate income tax. *See* Cowie, *supra* note 105, at 441-43.

[115] This proposal is very similar to the one proposed by Lawrence and Litan in *Saving Free Trade*, except they recommend use of a tariff instead of a consumption tax. *See* LAWRENCE & LITAN, *supra* note 5, at 98-99. A tariff would raise less government revenue, but would be easier to apply gradually than a consumption tax strategy because a tariff involves collection at only a few border points whereas domestic collection points would necessarily be more diffuse. However, most of the infrastructure for a consumption tax is already in place with the state sales tax system.

Some observers feel that gradual application of free trade is ideal because it helps reduce the sudden flight of capital from the industry and may allow firms and employees to make more thoughtful decisions. *See* Neary, *supra* note 11, at 56-57.

Others feel that a gradual adjustment process simply prolongs the use of scarce resources in an inefficient industry. *See* BHAGWATI & KRUEGER, *supra* note 28, at 10-12.
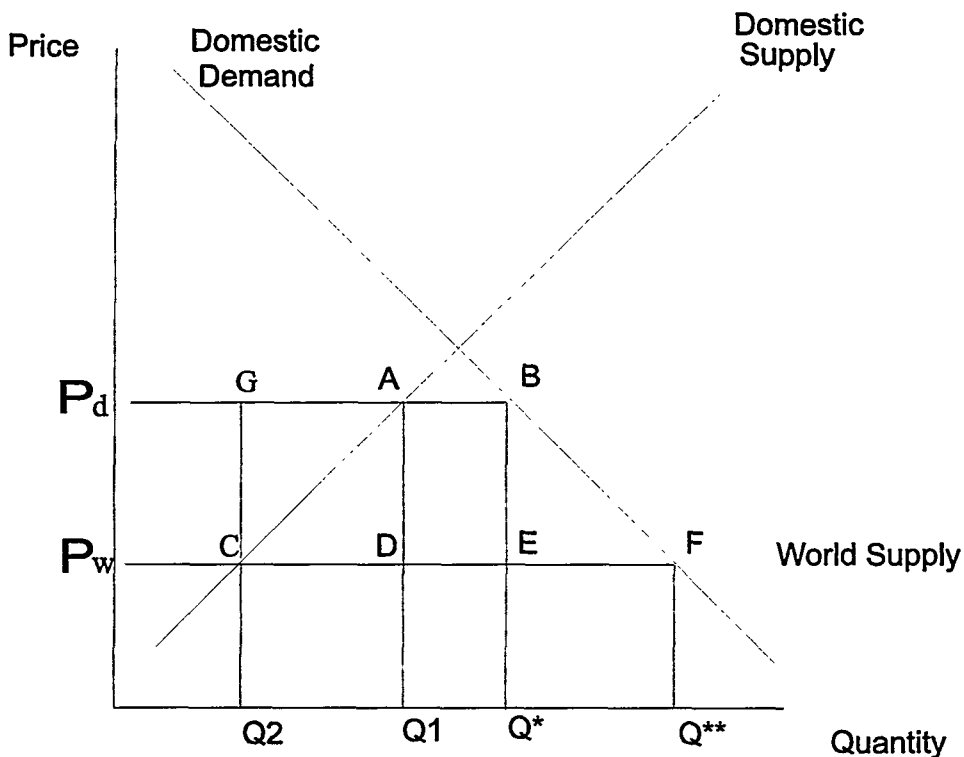
Figure 2. Effects of Consumption Tax.

Figure 2 ("Fig. 2") illustrates the effects of a consumption tax equal to a standard tariff imposed on the good, and is based on the standard tariff regime illustrated in Fig. 1, *supra* Section 2, and the consumption tax regime, above in Fig. 2. The consumption tax is imposed equally on both domestic and imported goods, which eliminates the economic distortion caused by the tariff. The consumption tax reduces domestic producer surplus by the amount bounded by the two price points (P_d, P_w) and points A and C. Government revenue is now the area bounded by $P_d P_w BE$. The government has gained enough revenue from the consumption tax to fully compensate domestic producers for their lost surplus, and has the amount of the area between the points A, B, E and C to compensate displaced workers. Total quantity consumed remains at Q^*, while domestic production falls from Q1 to Q2. Q2 is the efficient level of domestic

production. Importers would supply the amount Q* minus Q2, which is equal to the line GB. The decrease in domestic output releases scarce resources to more efficient uses within the domestic economy.

It is unlikely that the government would fully compensate producers for their lost surplus,[116] but this diagram demonstrates that imposition of a consumption tax would allow the government to do so, and would still leave a residual gain to fund worker adjustment.[117] Also, since actual producer surplus under the tariff regime would have been net of money expended for lobbying, the government would probably only need to compensate producers a fraction of the gross surplus. Therefore, it is highly probable that the consumption tax could be implemented at a much lower price than the former tariff. In addition, the government would probably be in a better position in the long-run than is indicated by this diagram. Inefficient producers would channel their resources into productive activities that would increase the corporate income tax revenues and reduce dependence upon government assistance. The government would also phase-out the consumption tax to bring the price of the good to its competitive level at the long-run equilibrium.

3.2. *Optimal Timing of Change in Trade Policy*

No matter what funding strategy is employed, adjustment is easiest during a cyclical upturn in the economy. One of the major impediments to trade liberalization is the political risk associated with angering various political constituencies.[118] This anger would likely reach its height in the context of a weak economy.[119]

There are also reasons of general economic efficiency for lifting trade barriers during times of financial prosperity. Demand for the protected good will probably be highest when

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[116] The area bounded by P_dP_wAC.

[117] The area bounded by points ABEC.

[118] *See* Sykes, *supra* note 5, at 278-79 ("Although the reduction of protectionist barriers is almost always in the public interest, elected officials or their subordinates may decline to pursue trade liberalization initiatives out of political self-interest . . . .").

[119] *See* James Cassing et al., *The Political Economy of the Tariff Cycle*, 80 AM. POL. SCI. REV. 843, 860 (1986) ("It is thus at the peaks [of cyclical economic growth] that the free traders have their best winning chances.").

the economy in general is strong and people have more disposable income (unless the industry involves the production of an "inferior" good[120]), which would help ease exit from the industry.[121] Workers could also adjust more easily during periods of economic prosperity because the demand for labor would be greater than during periods of economic stagnation.[122]

4. A MARKET BASED APPROACH TO TRADE ADJUSTMENT

After analyzing issues of timing and funding, the next area of concern is how to best accomplish the goals of trade adjustment. Once it is determined that free trade is desirable, and that compensation of affected interests is, to a certain extent, necessary to that end, the remaining question is how to best structure the adjustment program. The three main affected interests include labor, owners, and communities.[123] A determination must be made as to which of these three interests should be compensated and how such compensation should be packaged.

4.1. *Worker Adjustment*

The least controversial aspect of trade adjustment seems to be the compensation and training of displaced workers, yet some disputatious commentators have questioned the logic of such a program. One may argue that international competition is a market force like any other and that workers displaced as a result of trade liberalization should not receive any form of assistance over and above what is offered to any other displaced worker.[124] The counter-argument is that workers displaced by import competition may suffer a greater comparative loss of wealth as

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[120] *See* POSNER, *supra* note 2, at 5 n.4 ("[A] good is inferior if a reduction in the consumer's income will not have a proportionately negative effect on his purchase of the good.").

[121] *See* BHAGWATI, *supra* note 5, at 7 ("[A] growing economy reduces the need to contract industries in response to trade liberalization.").

[122] *See* Bruno, *supra* note 12, at 22 ("One would get the best of both worlds if the initial point happened to be in the R region, that is, if the economy started from an inflationary, generalized excess demand, situation. An import price drop . . . might serve to eliminate excess demand in both the commodity and labor markets . . . .").

[123] *See* Bhagwati, *supra* note 92, at 154.

[124] *See* Sykes, *supra* note 5, at 270 (stating the argument presented here, although not adopting it).

compared to workers displaced by domestic competition.[125] When a firm contracts in response to domestic competition, it is often accompanied by other firms' expansion or entry into the market, which provides the displaced worker an opportunity to use her skill and training for the entering and expanding firms.[126]

Workers displaced by foreign competition may not have this same opportunity if the offsetting expansion takes place overseas.[127] This line of reasoning finds support in empirical research that compares recipients of federal assistance for workers who lose their jobs due to increased import competition[128] with ordinary recipients of unemployment insurance ("UI").[129] Displaced workers, whether displaced by domestic or import forces, are eligible for periodic transfer payments in the form of unemployment insurance. A problem with periodic transfer

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[125] *See id.* at 271.

[126] *See id.*

[127] *See id.*

[128] Trade Readjustment Allowances ("TRAs") are extended federal unemployment insurance benefits which are offered to workers who lose their jobs because of increased import competition. *See, e.g.,* DESTLER, *supra* note 6, at 139, and *infra* note 126.

[129] *See* Paul T. Decker & Walter Corson, *International Trade and Worker Displacement: Evaluation of the Trade Adjustment Assistance Program*, 48 INDUS. & LAB. REL. REV. 758, 761-67 n.18 (1995).

> [P]lant closings and company relocations accounted for a far higher proportion of job loss among TRA recipients [TRAs are extended federal UI benefits which are offered to workers who lose their jobs because of increased import competition] (over 70%) than among the general population of displaced workers or UI exhaustees .... TRA recipients remained jobless for a median of 55 weeks, which is about 40% higher than the median 39-week jobless spell among UI exhaustees .... TRA recipients ... lost more than 20% in weekly wages .... In contrast, the median wage loss among UI exhaustees was 8%. Only about 35% of reemployed TRA recipients ... were earning as much as or more than on their previous job, compared with nearly 40% of UI exhaustees. TRA recipients were also more likely to experience *extreme* wage losses—about 20% of TRA recipients earned less than half of their previous wage, compared with about 12-13% of UI exhaustees .... The TRA recipients were unlikely to return to their previous occupation or industry.

Decker & Corson, *infra.*

Cf. LAWRENCE & LITAN, *supra* note 5, at 14-15 ("[D]isplaced workers [from import competition] ... have had greater difficulties finding other jobs than displaced workers in general ... [but] beneficiaries of trade adjustment assistance have not, on average, experienced significantly higher [wage] earnings losses.").

payments is that they contribute to a general "downward price-stickiness" of wage levels.[130]

4.1.1.   *The Trade Adjustment Assistance Program*

In 1962, Congress enacted the Trade Adjustment Assistance ("TAA") program as part of its Trade Expansion Act of 1962 to provide additional compensation to workers displaced by import competition. The program has undergone several revisions since its original passage,[131] but its primary goals have remained constant: smoothing the transition to new industries and providing compensation for workers displaced by foreign competition.

In order to become eligible for TAA, workers must petition the U.S. Department of Labor ("USDOL") as a group from their particular firm or plant.[132] The USDOL must then determine if international trade contributed to their job displacement.[133] If the USDOL rules in the workers' favor, they are certified to apply as individuals for TAA benefits.[134] Individual workers qualify for benefits if the certified firm or plant laid them off within a time period specified by the USDOL, and "if (1) they worked for 26 weeks in the year before the layoff, (2) they have exhausted all UI benefits, and (3) they have fulfilled the training requirement . . . ."[135]

Qualified workers can elect to enter training before exhausting their UI benefits, but completion of training is mandatory for workers who wish to receive the twenty-six week extension of UI benefits provided by TAA.[136] By most accounts, although "well-targeted,"[137] TAA training provisions have proved ineffective and its compensation provisions poorly tailored to

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[130] *See* Martin Neil Baily, *Wages and Employment Under Uncertain Demand*, 41 REV. ECON. STUD. 37, 46-47 (1974); Robert J. Gordon, *Analysis of Domestic Inflation: The Theory of Domestic Inflation*, 67 AM. ECON. REV. PAPERS & PROC. 128, 130-31 (1977).

[131] The TAA is now codified in the Trade Act of 1974, Adjustment Assistance for Workers, 19 U.S.C. §§ 2271-2322 (1994).

[132] *See* Decker & Corson, *supra* note 129, at 759.

[133] *See id.*

[134] *See id.*

[135] *Id.*

[136] *See id.* at 760.

[137] *Id.* at 772.

smooth worker adjustment to import competition.[138]

4.1.2. Potential Improvements to TAA

TAA should be redesigned in order to minimize the downward price-stickiness associated with worker adjustment.[139] The first and most important step in this regard is to eliminate the twenty-six week extension of UI benefits. This extension creates a moral hazard[140] to under-invest in job search costs.[141] Also, the extension is both over-inclusive and under-inclusive in awarding benefits, since those who return to work[142] before the extension begins receive no additional compensation over standard UI, while some of those who do receive the extension could return to work but prefer to remain unemployed.[143] The

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[138] *See* LAWRENCE & LITAN, *supra* note 5, at 52, 58 ("It is widely acknowledged that the TAA program has failed to accomplish either of its two objectives.") ("[T]he percentage of displaced workers obtaining jobs for which their retraining qualified them [never exceeded ten percent]."); Decker & Corson, *supra* note 129, at 773 ("Our findings, which are consistent with the findings of other studies of training for displaced workers . . . suggest that TAA training did not have a substantial positive effect on earnings of TAA trainees . . . ."). *But see* Decker & Corson, *supra* note 129, at 763 ("Seventy-two percent of pre-[19]88 trainees and [sixty-seven percent] of post-[19]88 trainees completed training. The majority of trainees felt that their training both helped them find a job and gave them useful experience for the job when they became re-employed.").

[139] Richardson, *supra* note 90, at 330 (citing a 1979 survey that found in 1976: less than 10% of TAA recipients took advantage of available employment services; 1 in 30 entered training, 1 in 200 received a job-search allowance, and 1 in 350 received a relocation allowance).

[140] Moral hazard occurs "when the behavior of the insuree changes after the purchase of insurance so that the probability of loss or the size of the loss increases." COOTER & ULEN, *supra* note 2, at 49. A common example is that of an insured motorist who drives less carefully than he would without insurance. In the case of unemployment insurance, the moral hazard manifests itself by a worker's reduced effort in seeking new employment, compared with the effort that he would put forth without unemployment insurance.

[141] Job search costs consist primarily of the worker's time and effort.

[142] Many displaced workers who find new work suffer what appears to be a significant, permanent impairment in their earning power. *See generally* PARETO, *supra* note 7. TAA does not compensate these losses.

[143] If a displaced worker receives assistance of $7/hr, values leisure at $10/hr and receives a job offer paying $15/hr, the worker will maximize his utility by refusing the job and continuing to collect assistance (total value of not working = $17/hr vs. value of working = $15/hr). This result is inefficient, because without the governmental distortion, the worker would accept the job and be better off by $5/hr. An efficient assistance program must look to eliminate this distortionary effect. *See also* James A. Dorn, *Trade*

government could enact a compromise position that requires participation in a job-search program[144] in return for the extension of benefits, but the fundamental incentive to remain unemployed would still exist.

The training provisions of the TAA program are also loosely targeted and ineffectively structured. Since participation in the training program is a mandatory requirement to receive the twenty-six week UI extension, many displaced workers participate for this reason only, and therefore do not possess the desire necessary for effective learning. A survey of TAA workers found that less than ten percent of workers participating in the training program actually found jobs that utilized their training.[145]

The current governmental training program is too inefficient to justify its continuation. A more efficient alternative to the current program would replace it with a private program, such as an educational tax credit which could be granted either to workers themselves who invest in private training, or granted to firms who hire the workers subject to completion of a substantial training program. Even without requiring the training program for continued benefits, a moral hazard for workers to over-train is inherent in a fully subsidized program.[146] If a worker seeks out training on her own initiative she probably has a substantial commitment to it and will receive more benefit from it than a mandatory, standardized program. Similarly, a firm would not provide a training program unless it expected a positive return on its investment.[147]

Adjustment Assistance, 2 CATO J. 865, 887-88 (1982) (noting that many local officials who administered the TAA program believed that the higher levels of unemployment payments discouraged workers from accepting other lower-paying jobs until after unemployment benefits and TAA readjustment allowances were exhausted).

[144] *See, e.g.,* Decker & Corson, *supra* note 129, at 773 (advocating this position).

[145] *See* LAWRENCE & LITAN, *supra* note 5, at 58.

[146] For example, if a worker feels that a training program would increase his lifetime earning power by a present value total of $1,000 and his opportunity cost of participation (lost leisure time/lost job search time) is only $500 he will participate in the program, even if the cost to the government of training him is $5,000 (for a total social cost of $5,500). The moral hazard in this example results in an efficiency loss of $4,500. *See generally id.* at 118 (suggesting that workers pay for a portion of their training programs).

[147] Although subsidization could cause firms to inefficiently over-train their workers. The administrative cost of applying for federal reimbursement,

The compensatory portion of TAA should take the form of a straight, lump-sum transfer, which would eliminate the moral hazard to over-invest in job-search activities. The straight transfer payment has the additional attraction of compensating those workers who find new jobs quickly, but at permanently decreased wage levels. These workers would not receive compensation under the current program and would therefore have an incentive to continue their job search while receiving UI, rather than quickly accepting a lower paying job. Structuring the payments in this manner would help eliminate some of the problems of over and under-inclusiveness in the current program.

To further encourage a return to work, the entire transfer payment could be divided into two parts. The first would be paid upon the worker's initial lay-off. The second would be payable after a continuous six month period of employment, which could consist of one or multiple employers, so long as the worker remained employed during the period. This form of payment provides an incentive to return to work, and alleviates some of the downward price-stickiness of wages, while simultaneously compensating all effected workers for at least some of their losses.

The amount paid could either be an actuarially determined amount based on the workers' expected loss as a class, or it could simply be the present value of the twenty-six week UI extension. Similarly, displaced workers who relocate should receive a reasonable moving allowance to stimulate labor mobility between regions, as is currently provided for in the TAA program.[148]

Although providing the present value of the twenty-six week extension might prove nominally more expensive than the current program (although this is not certain), it is likely that the savings in administrative costs and the efficiency gains through promoting an earlier return to work, added to the costs saved

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the lost interest while awaiting reimbursement and the opportunity cost of lost labor while the worker is in training (although this expense could be included in reimbursement) would probably be sufficient to insure that the firm would not conduct frivolous training programs.

[148] *See* 19 U.S.C. §§ 2297(b)(2), 2298(b) (1994) (providing reimbursement of moving expenses upon a showing that the recipient cannot reasonably be expected to secure suitable employment in her commuting area). *See also*, Neary, *supra* note 11, at 59 (recommending reimbursement of moving costs for displaced workers in order to mitigate against the over-substitution of capital for labor, flowing out from the import-competing industry into other industries).

from the elimination of the training program, should be more than sufficient to offset the added expense.

4.1.3.   TAA Should be Extended to Firms

Currently, firms receive technical and working capital support, but no financial compensation under TAA.[149] The lack of any financial cushion creates a strong incentive for firms to lobby for a continuation of protectionist policies or for implementation of countervailing duties.[150] As illustrated in Figure 2, a shift to a consumption tax regime would raise revenue which could be used to compensate firms injured by import competition. Theoretically, firms could be compensated at their full producer surplus (net of foregone lobbying costs), making the move to freer trade closely Pareto.

Political realities would probably limit ownership compensation somewhat, but some type of compensation would at least help blunt the incentive for rent-seeking behavior. The payment to firms should also be made in the form of a lump-sum transfer, so as to prevent any rent-seeking incentives.[151] Also, the payment should not stipulate as to any mandatory investment in its current industry, because such a requirement would induce inefficient expenditures in an industry that required trade barriers in order to compete.

In return for this transfer payment the government should require the removal of all poison pills and other takeover-prevention devices from the corporate charter for all publicly held companies.[152] If ineffective management is partially responsible for the firm's uncompetitive position, the combination of an unrestricted cash infusion and a lack of impediments to takeover would ensure their replacement, hopefully by more competent successors.

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[149]   *See* 19 U.S.C. § 2344 (1994).

[150]   *See* Sykes, *supra* note 22, at 256.

[151]   *See, e.g.,* POSNER, *supra* note 2, at 46 (explaining that a lack of certainty regarding the ability to secure future payoffs decreases the incentive for rent-seeking behavior). By analogy, an unequivocal belief in the lack of any potential future benefit should eliminate the incentive for rent-seeking behavior.

[152]   *Cf.* LAWRENCE & LITAN, *supra* note 5, at 105-06 (recommending relaxed merger standards for firms eligible for TAA in order to reduce resistance to free trade).

4.1.4. Community Adjustment Assistance

There is a paucity of literature on community adjustment assistance. Lawrence and Litan propose a community insurance program where communities would contribute to a joint fund and would become eligible to draw on the fund's resources upon a showing of significant injury to import competition.[153] This would allow the injured community to provide subsidies or tax incentives to entice new businesses to invest in the area. Such subsidies could inefficiently distort private investment decisions, much like tariffs or quotas, depending on the size of the payment. However, regulations that restrict the compensatory payments to use for community operating expenses, which would replace lost tax revenues from the displaced firm, could prevent inefficient investments. It does not seem that such a program would be essential in order to enact free-trade legislation and therefore, its inclusion in the adjustment program could be considered optional.

5. CONCLUSION

Trade barriers are a hidden source of taxation to consumers, costing them billions of dollars each year and begetting myriad other inefficiencies in their wake. The huge deadweight loss to the economy allows for a great deal of flexibility in structuring a solution. This flexibility allows the winners to eliminate these trade barriers and to compensate the losers, while still leaving an aggregate residual gain.

The Coase theorem posits that, without transaction costs, the winners in such a move— the consumers— would pay the losers to compensate them for their losses to accomplish the end goal of free trade. However, transaction costs prove prohibitive to such a maneuver because most individual consumers do not have enough money at stake to organize or participate in such an action. Although few, the producers each have a large amount of money at stake and are therefore willing to lobby Congress vociferously to continue their subsidization in the form of a protective tariff or quota. Congress, which retains responsibility for much of the foreign trade policy of the United States, is inherently susceptible to lobbying and logrolling, which tends to

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[153] *See id.* at 119-22.

perpetuate these few relics of a bygone protectionist era.

The solution is for the government to complete the transaction that the parties subject to protectionism would strike among themselves if transaction costs were not prohibitive. The federal government would pay the producers to forgo any future protection and assist adversely effected workers.

The funding for such a program could come from a consumption tax on the specific good in question. This would require those who would benefit from the move to pay for it, in direct proportion to the amount of benefit. It would also remove any distortions in domestic investment decisions by making the inefficient, protected industry a less desirable target for investment.

The adjustment program itself requires restructuring to best accomplish its goals. In its current format, trade adjustment assistance creates a moral hazard for displaced workers to remain unemployed. It also mandates a training program for many workers who have no interest or need for one. One solution is to restructure the payment into the form of a lump-sum. Preferably the lump-sum payment could be split into two disbursements, the first available upon lay-off and the second upon a return to work. This would create an incentive to return to the labor market and help reduce the problem of downward wage-price stickiness. The training program, for the most part, appears to be mostly a waste of money that could be used in other areas of adjustment.

The payment to producers is probably a political necessity to accomplish the elimination of trade barriers. The payment should also be in the form of a lump-sum to guard against lobbying for more than the optimal amount due to them. In return, the producers would agree to remove any anti-takeover provisions within their corporate charters. This would facilitate the market's replacement of inefficient management.

The end result of these combined moves would greatly enhance the international competitiveness of the United States and provide widespread gains to consumers while mitigating the losses to producers and labor.

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