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# On the Political Economy of Trade Restraints

by Jerry L. Jordan

If you laid all the economists in the world end to end, or so the story goes, they would never reach a conclusion. On one subject, at least, this maxim is inaccurate. Virtually all economists agree that only a liberal world trading order can make every nation better off. They understand, as did Adam Smith, that free trade is truly the source and essence of the wealth of nations. This ideal, however, has never been realized. Instead, history charts a continual ebb and flow of protectionism. We can point to countries, rich in human and natural resources, that have withered behind trade barriers, and others, lacking such endowments, that have traded their way to world prominence.

Over the last 50 years, western nations have largely held the corrosive effects of these protectionist tides in check and have even reclaimed some lost ground. Recent events, however, suggest that we may now have seen their low-water mark, at least for a while. The Uruguay Round of the General Agreement on Tariffs and Trade (GATT), which has been the primary vehicle for advancing the ideal of free trade for the past 46 years, is now stalled. Trade relations among the United States, Japan, and the European Community (EC) seem more strained than usual, and movements toward trading blocs in North America and Europe, *under some circumstances*, could raise ominous possibilities for future conflicts.

Most disconcerting, however, is the United States' recent departure from its traditional role as a vigorous, unequivocal advocate of liberal trade. We now seem more willing to embrace arguments for industrial policies and selective trade restraints based ultimately on the proposition that private markets fail to function perfectly.

Industrial societies have two broad choices: They can allocate resources through market mechanisms or through political forums. The former ideally produces a distribution of resources perfectly consistent with economic efficiency, while the latter ideally furnishes a distribution of resources perfectly compatible with broader, democratically determined norms of social justice. In practice, both the market mechanism and the political approach fall short of their philosophical goals.

The case for free trade, which I will make here, rests not on the argument that private markets function perfectly, but on the proposition that the failures resulting from the political approach are far greater and pose a more serious threat to both our personal freedom and our economic performance than do the failures of private markets.

**Economists advocate free trade not because private markets function perfectly, but because the alternative, allocating resources through the political arena, poses a far greater threat to individual freedom and economic performance than do market imperfections. Only free trade has the potential to enhance the welfare of all nations simultaneously.**

## ■ Markets

Economists have long recognized that free, competitive markets foster the most efficient use of real resources and that expanding markets through international trade magnifies these gains. Moreover—and more important—economists recognize that *all* trading countries can share in the benefits from trade.

The welfare gains from international trade stem from both specialization in production and exchange among nations. Each, however, can involve transitional difficulties. Specialization, for example, requires a shift of economic activity from the least efficient to the most efficient producers. Such reorganizations are often slow, typically create transitory unemployment, and can permanently affect the distribution of income within countries. Nevertheless, these shifts are necessary to foster continuing improvements in living standards, and they are often inevitable even when trade is not their catalyst.

Nations cannot realize the gains from specialization without also engaging in exchange. As this implies, we measure the benefits of trade in terms of greater imports or, more specifically, by our ability to acquire additional units of

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imports at lower unit costs. Usually, countries pay for their foreign purchases out of current exports, but sometimes they finance their imports with claims on future resources. That is, they run trade deficits. This does not imply that deficit countries do not benefit from trade, nor does it indicate that foreigners engage in unfair trading practices. Rather, it ultimately reflects a national preference for consumption over saving.

The claim that free international trade enhances economic welfare rests on a number of assumptions that ensure complete, competitive markets and guarantee a minimal role for government. These concern the nature of goods, the number of buyers and sellers, their access to information, and the existence of property rights. Economists refer to serious violations of these underlying assumptions as market failures, which can then justify government intervention.

Recently, some have theorized that under specific types of market failure, government involvement in international trade can improve a nation's welfare. Sometimes, for example, the unit costs of production decline when a firm increases the scale of its operations or when the size of its entire industry expands. Scale economies often breed markets dominated by a few large firms.[1] These firms can then earn economic rents, or profits in excess of what a more competitive environment might yield. Nevertheless, international trade theory suggests that even with such market imperfections, countries can still benefit from international trade in the sense of being able to consume more goods at lower prices.

International trade is the vehicle through which firms might achieve economies of scale. In fact, economists believe that economies of scale explain a substantial portion of world trade, particularly among large industrialized nations.

Unfortunately, international trade theory tells us little about the *pattern* of trade—that is, which countries will export which goods—when economies of scale are involved. Some patterns may simply reflect historical accidents. (Swiss watches are a noted example.) This creates the possibility that, through the instruments of industrial policy, governments can modify the international pattern of trade to their national advantage. By offering a subsidy, for example, a government might enable a domestic firm to capture a bigger share of the world market and, hopefully, economic rents that exceed the cost of the initial subsidy.[2] One nation then gains at the expense of another. Judging from its recent choice of jargon, including "managed trade," "aggressive unilateralism," and "comparable access," the Clinton administration seems inclined to view trade as a zero-sum game and is entertaining such policies.

These arguments are not new. They have closely related antecedents that attained academic respectability with John Stuart Mills' 1848 edition of the *Principles of Political Economy*.[3] Although economists since Mills have acknowledged these arguments as theoretically insightful, most do not accept them as prescriptions for national policy. These theories have never shaken our profession's belief in the viability of markets and the importance of free trade.

Economists have challenged the policy prescriptions of the new, strategic-trade models on many points, but the greatest shortcoming of these theories arises from their idyllic view of governments and the political process. They portray the government as a referee that acts to maximize a nation's collective welfare in the face of specific and identifiable market failures. The government then imposes taxes, tariffs, and subsidies that address the particular failure, without creating distortions elsewhere in the economy. Political officials next apportion the financial rewards resulting from their actions evenly across all segments of society. Finally, the policy recommendations typically assume that foreign governments will sit passively by while all this occurs.

As one can see, the model makes a number of rather stringent assumptions about the nature of democratic processes. Economists refer to serious violations of these assumptions as government failures. Will substituting *government failures* for market failures make us better off?

## ■ Politics

Economic policies inevitably redistribute income. Consequently, these concerns, rather than arguments about economic efficiency, often dominate policy debates in countries with democratically elected governments. Trade restraints exist because they confer substantial financial benefits on certain segments of society. Limitations on the importation of foreign steel, for example, reward domestic steel producers by enabling them to sell more at home at higher prices. Trade regulations obviously impose economic burdens on others. In the steel example, users of domestic steel must pay more. Restraints, then, benefit some at the expense of others, with a net loss to all because of the economic inefficiencies that ensue.

Both the gainers and losers have incentives to organize: one to seek trade restraints, the other to avoid them. The benefits of trade restraints, however, usually accrue to a relatively small, concentrated, and easily identifiable group, while the costs are borne by a much wider portion of society.[4] Who in fact knows how much the latest tariffs on steel imports will cost him or her personally? You can be sure that the steel producers have calculated their gains. Firms that use steel also know their cost increases, but this group is so diverse that the expense of organizing and lobbying strenuously against the restraints undoubtedly exceeds the expense of passing the costs on to consumers.

Now extrapolate this problem across all goods and services subject to various types of trade restrictions. The typical voter has little ability or incentive to discern the costs of trade restraints on his income and thus can offer only marginal resistance to the proliferation of such policies.[5]

With the benefits of trade restraints so highly skewed, it is little wonder that Congress is amenable to protectionist pressures. Those expecting to profit from national industrial policies have strong incentives to lobby and to exhaust real economic resources to secure such market privileges.[6] The president and many of our current freshmen congressmen were elected in part because they promised to either amend or oppose the North American Free Trade Agreement (NAFTA), and interest groups now expect to collect on their election bets.

When we demonstrate a willingness to allocate resources through the political arena instead of through the market, we encourage individuals to reduce their investments in private economic activities and to increase their investments in political speculation. Through this unfortunate arbitrage, we are all eventually made poorer.

### ■ Checks and Balances

Although democratically elected governments seem predisposed to interventionist, beggar-thy-neighbor policies—particularly when such policies have some intellectual credence—two important factors seem to check this inclination, albeit tenuously at times.

The first factor is internal. Trade restraints place costs on society that, although diffused and difficult to measure, do add up as restrictive legislation proliferates. Even the most ardent seventeenth century mercantilists realized that a nation cannot export if it does not import. A substantial portion of our industries either sell foreign goods or use them in their production processes, and virtually every American household benefits from some foreign products. The costs of additional trade restraints build until, at some point, they outweigh the benefits, and elected governments will not increase them further.

But this "equilibrium" point changes. In due course, the evolution of any dynamic economy will precipitate resource reallocation that leaves some segments of society better off and others worse off. Often, a surge of protectionist pressures is a repercussion of these changes. Perhaps the most important of such developments is the business cycle. When economic activity slows and unemployment rises, protectionist sentiments grow. When the economy once again approaches full potential, such sentiments abate.

Other, more structural events can be equally disruptive. Changes in energy prices, reductions in the demand for military goods, and the introduction of computers and robots to production processes create winners and losers and possible repercussions for national trade policies.

Other constraints on protectionism are external. After a devastating trade war in the early 1930s contributed to the Great Depression, most industrialized countries came to accept that free trade offers the only positive-sum game. That is, it is the sole feasible trading arrangement with the potential to enhance all nations' economic well-being simultaneously. At any given point, an individual country might temporarily improve its economic lot through trade restraints, but if many more countries follow suit, each will be made much worse off than if all had maintained free trade.

Because of this "prisoners' dilemma" aspect of trade policy, it is imperative that each country repeatedly signal its commitment to liberal markets and its willingness to solve trade disputes within a multilateral framework.[7] Since 1947, GATT has provided just such a forum through its ongoing negotiations and its twin principles of reciprocity and most-favored-nation status. Within a continuing commitment to GATT, the world can more readily tolerate the inevitable, temporary deviations from the ideal of liberal trade, knowing that a transgressor has not abandoned the ideal and having a mechanism by which to judge and sanction the offending nation's actions collectively.

Unfortunately, many trade specialists now believe that GATT is in trouble for reasons that go beyond the immediate problems of the Uruguay Round. The proliferation of non-tariff barriers and "voluntary" export restraints, often not explicitly prohibited in the agreement, is one important reason. The relative decline in U.S. economic leadership may be another. Moreover, the threat of communism, which was an effective catalyst to western cohesion and which may have encouraged multilateral trade negotiations, has faded. Whatever the causes, multilateral trade agreements seem increasingly difficult to achieve.

In part because of the problems of working within GATT, interest in preferential trading agreements like NAFTA and the EC is growing. These two trade blocs so far include countries with close, long-established economic interdependencies. By removing trade barriers and enhancing the benefits of specialization and exchange, they promise to strengthen existing economic ties among their members. Moreover, both trading blocs are poised to grow eventually—NAFTA through Central and possibly South America, and the EC through Scandinavia and Eastern Europe—thereby furthering the gains from liberalized trade.

Preferential trading arrangements can be a two-edged sword, however. While enhancing trade among participating countries, they can also reduce economic well-being by diverting trade away from efficient producers outside the bloc. Moreover, many fear that by increasing the collective economic power of member countries, such accords could encourage the strategic use of trade policies. Ironically, then, the long-term effects of trading blocs like NAFTA and the EC may depend on the existence of a multilateral agreement like GATT that can prevent preferential agreements from becoming vehicles for trade wars.

### ■ Conclusion

The United States is the most prosperous nation on earth. We have maintained that status not because we have more natural resources, not because we have a more powerful army, and not because our children are brighter or our executives more clever than those elsewhere in the world. We have done so because, more than any other country in history, we have relied on market mechanisms, despite their

imperfections, rather than on political decisions to allocate our resources.

Many contend that Germany and Japan —our current rivals for economic preeminence—have managed to close the economic gap through national industrial policies and managed trade, a course we should now imitate. While both of these countries have made advances, arguably with more government involvement than in the United States, I question the now-fashionable conclusion that industrial policy and managed trade are the sources of their success. No one seriously believes that we should follow an industrial policy like those of Great Britain and Sweden, or like the managed trade policies of the former Soviet bloc. I suggest, therefore, that the postwar advances in both Germany and Japan have more to do with the willingness of their citizens to embrace economic liberalism and to compete vigorously on a global scale than with their governments' involvement in markets.

Markets, like political systems, do not function perfectly, but they offer the only game in which all nations can be made better off. This is not a theoretical point, but an observation on history.

## Footnotes

1. See Paul R. Krugman, "Is Free Trade Passé?" *Journal of Economic Perspectives*, vol. 1, no. 2 (Fall 1987), pp. 131–44.

2. Two seminal studies on strategic trade are James A. Brander and Barbara J. Spencer, "International R&D Rivalry and Industry Strategy," *Review of Economic Studies*, vol. 50, no. 4 (1983), pp. 707–22; and "Export Subsidies and International Market Share Rivalry," *Journal of International Economics*, vol. 16, no. 1/2 (February 1985), pp. 83–100.

3. For a historical perspective, see Douglas A. Irwin, "Free Trade at Risk: A Historical Perspective," Board of Governors of the Federal Reserve System, International Finance Discussion Paper No. 391, December 1990.

4. This argument is based on George J. Stigler, "The Economics of Information," *Journal of Political Economy*, vol. 69, no. 3 (June 1961), pp. 213–25.

5. This view of voters stems from Anthony Downs, *An Economic Analysis of Democracy*, New York: Harper & Row, 1957.

6. See Gordon Tullock, "The Welfare Costs of Tariffs, Monopolies, and Theft," *Western Economic Journal*, vol. 5 (June 1967), pp. 224–32.

7. Prisoners' dilemma refers to a strategic situation where the policy choice promising the best outcome for an individual is optimal only if others do not respond in kind. When all adopt the same self-focused policy, this outcome becomes the *worst* course of action. An alternative policy choice that considers the response of the group, rather than of the isolated individual, then becomes the best. See David M. Kreps, *A Course in Microeconomic Theory*, Princeton, N.J.: Princeton University Press, 1990.

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