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International Trade

THE PUZZLE *Virtually all economic analysis concludes that trade is economically beneficial. Why, then, does every country restrict trade in some way? Why have policies toward trade varied so much from country to country and over time?*

Above: Economies as a whole benefit from freer trade, but trade policies often create winners and losers. The Trans-Pacific Partnership (TPP), a sweeping trade agreement among 11 nations that border the Pacific Ocean, was met with protests in many of the original signatories, including Malaysia. Some critics of the TPP claim that its policies would enrich multinational corporations at the expense of workers.

The American steel industry employs about 80,000 people. Yet this relatively small industry has received massive assistance from the U.S. government, primarily in the form of protection from foreign competition. This trade protection raises the cost of steel in the United States and thus raises the cost that American consumers pay for goods made with steel. By one estimate, since 1970, protection and other aid to the U.S. steel industry have cost American consumers and taxpayers between $145 billion and $230 billion—a staggering amount for an industry with just 80,000 employees.[1]

The steel industry is hardly alone in being protected from imports, to the benefit of producers and the detriment of consumers. Footwear, dairy products, motorcycles, clothing, cotton, automobiles, and sugar are among the many other goods whose import has been restricted by the U.S. government. One group of scholars estimated that if all barriers to international trade were removed, the U.S. economy would gain some $540 billion by 2025, amounting to over $4,000 for each U.S. household per year.[2] And the United States is hardly alone in erecting obstacles to international commerce; to varying degrees, every country has such trade barriers.

People have traded across borders for as long as borders have existed. In the modern world, international trade has been one of the two most important economic relationships among countries (the other is international investment, which we will examine in Chapter 8). Dramatic reductions in trade barriers and dramatic increases in international trade itself have been a major component of the evolution of the contemporary world economy since World War II. Yet governments have always attempted to control trade across their borders. In fact, trade policy—the restriction of imports and the promotion of exports—has long been one of the most important economic policies, foreign or domestic, that governments undertake. Those who sell or buy from abroad have a great deal at stake in international trade; so too do those who face competition from foreigners, which can threaten their jobs or businesses. Today's very high levels of international trade, the continued attempts of governments to control trade, and ongoing debates over the costs and benefits of international trade serve as the basis for this chapter's discussion.

We first ask why international trade takes the form it does. Most poor countries export almost exclusively farm products and raw materials, and they import manufactured goods. Most rich countries, in contrast, import much of their food and raw materials and export mainly manufactured goods. Those poor countries that do export industrial products typically sell such simple goods as clothing, footwear, and furniture; rich countries' manufactured exports include primarily sophisticated goods, such as commercial aircraft and elaborate machinery. How can we explain these patterns of international trade?

Our exploration of this question raises the additional question of why international trade is so commonly restricted. Although many of us take for granted that protecting national products is good, why should a government purposely raise the prices that domestic consumers pay?

Another question arises from the fact that barriers to international trade vary a great deal. Some countries restrict trade very little, while others come close to prohibiting it. Sometimes governments cooperate closely to maintain and expand their trade relations; at other times, bargaining among governments over trade policy is conflictual and even hostile. In addition, trade barriers have changed dramatically over time: both globally and in individual countries, trade has gone from generally unhindered to tightly regulated over relatively short periods. International trade has been quite free (that is, unrestricted) since the 1990s, but trade has become increasingly controversial over the past decade. Finally, government trade policies themselves often differ among industries, with some goods being strongly protected and others not at all.

1. William H. Barringer and Kenneth J. Pierce, *Paying the Price for Big Steel* (Washington, DC: American Institute for International Steel, 2000); and William H. Barringer, Kenneth J. Pierce, and Matthew P. McCullough, *Still Paying the Price* (Washington, DC: American Institute for International Steel, 2007).

2. Gary Clyde Hufbauer and Zhiyao (Lucy) Lu, *The Payoff to America from Globalization: A Fresh Look with a Focus on Costs to Workers*, Pieterson Institute for International Economics, Policy Brief 17-16, May 2017, https://piie.com/system/files/documents/pb17-16.pdf (accessed 07/20/17). It should be noted that these numbers have been questioned by other scholars, who think they are either too high or too low.

Thinking Analytically about International Trade

Because trade policy stands at the intersection of international and domestic politics, it involves powerful interests, important interactions, and influential institutions at both the domestic and international levels. Foreign trade has powerful effects on domestic producers, consumers, and others. The conflicts of interest between those in a country who want access to world markets and those who want protection from foreign competition help determine a nation's trade policy.

Domestically, trade interests interact in a battle over national policy, with supporters and opponents of freer trade squaring off according to their own economic interests. Interactions among contending domestic interests are mediated through the national political institutions of trade policy making: parties, legislatures, executives, and bureaucracies.

In addition, a given nation's trade policies affect other nations' trade, such that all national policies are made in interaction with those of other governments. Indeed, international trade interactions have often spilled into broader interstate relations—sometimes in a positive way, sometimes negatively.

A network of global and regional institutions has evolved to facilitate bargaining over trade policies. These institutions include treaties among countries, as well as regional and global trade agreements. The most prominent trade institutions have been the two international organizations that have governed world trade for 60 years: first the General Agreement on Tariffs and Trade (GATT); and since 1995, the World Trade Organization (WTO). At the regional level, trade-based institutions include the European Union (EU), which addresses many other issues in addition to those relating to trade, the North American Free Trade Agreement (NAFTA), and the Southern Common Market (Mercosur). All these factors help determine how open a country will be to trade and which domestic industries it will likely protect. When we consider global networks, these factors affect how open or closed international trade as a whole will be.

What's So Good about Trade?

Actors engage in foreign trade for the same reason that they trade with each other within countries: to realize the benefits of specialization. Only a household that produces everything it wants to consume, at a lower cost than available elsewhere, would have no reason to trade. But such a household is unlikely to exist. For example, a farm family could make its own tractor, but it is better off expending its energy in farming and using the proceeds to buy or rent a tractor. Modern societies are based on specialization—some people farm or manufacture, others transport or build—and on trade among people with different specialties. The division of labor permits diverse segments of society to focus on different economic activities in ways that benefit society as a whole. After all, if all households or all villages had to be self-sufficient, they would produce only a fraction of what they could if they specialized.

Specialization—the division of labor—was central to the argument made by Adam Smith in his 1776 founding text of classical economics, *The Wealth of Nations*. Smith and his fellow economic liberals argued, against the then dominant mercantilists, that self-sufficiency was foolish because a greater division of labor made societies wealthier. In a famous example, Smith pointed out that an individual pin maker working alone could make at best 20 pins a day. In the workshops of Smith's time, however, pin making was divided into about 18 steps, with each worker specializing in 1 or 2 steps. In this way, a pin factory with 10 workers produced 48,000 pins a day—making each individual some 240 times as productive as he would be if working alone.[3] Specialization increased productivity, and productivity fueled economic growth.[4]

The classical economists emphasized that specialization requires access to large markets; after all, a single village could hardly use 48,000 pins a day. They argued that restricting market size slows economic growth. A village cut off from the rest of the world and forced into self-sufficiency would have to produce everything it needed, but if that village was part of a larger national or global market, it could specialize in what it did best. Producers need ample markets in order to specialize; the division of labor depends on the size of the market.

The division of labor allows gains from international trade. In farming, temperate countries, such as the United States and Argentina, specialize in temperate crops, such as wheat, while tropical countries, such as Brazil and the Philippines, specialize in tropical crops, such as sugarcane. The nations around the Persian Gulf, with their rich oil deposits, base their economies on oil, while countries with plentiful iron ore gain economic advantages by mining it. Similarly, countries with many unskilled laborers, such as Bangladesh and Egypt, produce goods that require lots of

3. Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (New York: Modern Library, 1937), 4–5. Originally published 1776.

4. *Productivity* in this context refers to the amount produced by one unit of labor with the other factors of production—especially land and capital—at its disposal. In farming, for example, the same amount of labor is more productive on good soil than on poor, more productive with machinery and fertilizer and irrigation than without.

The Scottish thinker Adam Smith's ideas about division of labor help explain the benefits of trade.

unskilled labor, including clothing, footwear, and furniture. Countries with many skilled technicians, such as the European nations, produce goods that require sophisticated technical skills, such as complex machinery and aircraft. Such specialization among countries leads to economic gains based on trade.

Comparative advantage is the core concept of the economics of trade. (See the "Special Topic" appendix to this chapter, on p. 340.) It applies the principle of specialization to countries: like people, they should do what they do best. Thus, comparative advantage implies that a nation gains most by specializing in producing and exporting what it produces most efficiently. By doing so, it can earn as much as possible in order to pay for imports of the best products of other countries. The principle of comparative advantage leads to the conclusion that each country will be best off if it produces what it is best at producing and exchanges its products with other countries in return for imports of things it is not so good at producing.

The word *comparative* in the term *comparative advantage* refers to a comparison among the things a country can do—not between one country and another. Just as personal specialization implies that each individual should do what he does best—not what he does better than all others—the specialization involved in comparative advantage implies that countries should produce what they produce most cost-effectively. In other words, it is not necessary for a country to have an **absolute advantage** (the ability to do something better than others) in producing something for it to be profitable to produce and export that thing; all that is necessary is a comparative advantage.

comparative advantage
The ability of a country or firm to produce a particular good or service more efficiently than the other goods or services that it can produce, such that its resources are most efficiently employed in this activity. The comparison is to the efficiency of other economic activities that the actor might undertake, given all the products it can produce—not to the efficiency of other countries or firms.

absolute advantage
The ability of a country or firm to produce more of a particular good or service than other countries or firms do with the same amount of effort and resources.

The principle of comparative advantage has clear implications for free trade. Since a country gains from following its comparative advantage and engaging in exchange with other nations for goods in which it does not have a comparative advantage, and since barriers to trade impede its ability to do so, trade protection is harmful to the economy as a whole. Government policies that keep out imports force the country to produce goods that are not to its comparative advantage to produce. Indeed, trade protection raises the price of imports and reduces the efficiency of domestic production. Were national governments to follow the principle of comparative advantage, they would unilaterally remove trade barriers and implement free trade. In this state of affairs, trade policy would be fundamentally cooperative in that all countries would gain from the elimination of obstacles to international trade.

Many people find the economic argument for free trade counterintuitive. Policy makers often argue, like the mercantilists did 300 years ago, that exports are good because they create jobs, that imports are bad because they take away jobs, and that governments should stimulate the national economy by restricting imports and encouraging exports. Economic logic insists the opposite: that imports are the gains from trade, while exports are its costs. A country imports goods that it cannot make very well itself, allowing the nation to focus its productive energies on making (and exporting) the goods that it produces best.

Free trade induces a country to follow its comparative advantage, and economic logic implies that free trade is the ideal policy. This is true, according to economic thinking, even if free trade is pursued unilaterally. Protection serves only to raise costs to consumers. The fact that other countries impose trade barriers that raise prices to their own consumers is no reason for us to harm our own consumers in response. Countries should undertake open trade policies regardless of what other countries do.

There is a clear parallel, from this perspective, between the comparative-advantage argument and the choices available to a household. A farm family, for example, "exports" (sells its crops) in order to "import" (buy the goods and services it wants). Because the farm family wants to maximize the imports it buys, it needs to earn more; the best way to do so is to produce more of what it produces best. The principle of comparative advantage illustrates how farmers, workers, and firms gain by specializing and trading, just as countries do.

Why Do Countries Trade What They Trade?

The principle of comparative advantage suggests that countries should produce and export what they do best. But how can we know what a country does best, other than by observing what it exports? And if the only way to predict a country's exports is to observe them, the theory is not of much value—especially given that trade flows are affected by many noneconomic factors, such as trade barriers. In the 1920s, Swedish economists Eli Heckscher and Bertil Ohlin addressed this puzzle and extended the classical view.

The Heckscher-Ohlin approach tries to explain national comparative advantage and therefore national trading patterns. The two economists recognized that comparative advantage is not simply a result of effort; for example, the productivity of farmers depends primarily on characteristics of their land, not on how hard they work. In countries where land is in short supply and expensive, farming is costly; where it is plentiful and cheap, farming is low in cost.

Heckscher-Ohlin trade theory describes the basic economic characteristics of a country in terms of the material and human resources it possesses. Typically, these economic features are summarized according to basic factors of production, resources essential for economic activity. Such factors of production include:

- Land, an essential input into agricultural production
- Labor, usually meaning unskilled labor
- Capital for investment, which refers both to the machinery and equipment with which goods are produced and to the financial assets necessary to employ this machinery and equipment
- Human capital, which refers to skilled labor, so called because the labor has been enhanced by investment in training and education

Countries differ greatly in how they are endowed with these factors of production. Some are rich in land, others have abundant unskilled labor, others have abundant skilled labor (human capital), and still others are wealthy in investment capital. Heckscher-Ohlin trade theory relies on these "factor endowments" to explain what determines national comparative advantage and, in turn, what

Heckscher-Ohlin trade theory
The theory that a country will export goods that make intensive use of the factors of production in which it is well endowed. For example, a labor-rich country will export goods that make intensive use of labor.

countries produce and export. A country with a large population and poor farmland is likely to have a comparative disadvantage in farming; a country with few people but vast supplies of farmland is likely to have a comparative advantage in agriculture. Different products too require different mixes of resources: typically, farm goods require a lot of land, simple manufactured goods require a lot of unskilled labor, and complex machinery requires a lot of investment capital.

Heckscher-Ohlin trade theory argues that a country will export goods that make intensive use of the resources the country has in abundance, and it will import goods that make intensive use of the country's scarce resources. Countries with lots of land, where land is cheap, specialize in producing farm goods; for example, the United States in the nineteenth century was relatively sparsely populated but was rich in very fertile land and exported massive quantities of cotton, tobacco, and wheat. In contrast, countries with very little farmable land import many farm goods—such as Great Britain in the nineteenth century, which relied heavily on imports for its food. Countries rich in investment capital focus on making goods whose production requires a great deal of capital; for example, most North American and western European nations' industries today specialize in sophisticated manufactured goods, such as complex machinery, construction equipment, and commercial aircraft. Regions with abundant labor produce labor-intensive goods: China and other rapidly developing labor-rich nations concentrate on making products that require a great deal of labor, such as clothing, toys, furniture, and other relatively simple manufactures.

According to the Heckscher-Ohlin trade theory, developing countries that are rich in unskilled labor should export labor-intensive manufactured goods. Indonesia's primary exports are textiles and clothing.

This pattern of specialization leads to analogous trade patterns. Poor countries with little capital import the capital-intensive products they need. Today, for example, poor agricultural nations tend to import their farm machinery from capital-rich industrialized nations, just as the United States did in the early nineteenth century. China and India export their labor-intensive manufactures to North America and western Europe and import capital-intensive industrial goods—including the complex machinery needed to operate their domestic factories.[5] Within North America, the capital-rich United States exports capital-intensive machinery (and capital) to Mexico, while labor-rich Mexico sends labor-intensive manufactured products (and labor) to the United States.

Each of the *factors* of production can be associated with different socioeconomic *actors*. A country abundant in land will also, typically, have many farmers. Unskilled or skilled laborers have unskilled and skilled labor, respectively, to sell on the labor market. Investors hold much of the investment capital of a country. When we say a country that is abundant in land will export products that make great use of land, we are saying that farmers and farmworkers will be heavily engaged in producing goods for export. The relative abundance or scarcity of factors of production has a powerful impact on the economic activities of actors within a society.

The Heckscher-Ohlin theory helps explain the broad outlines of international trade. The industrial countries are rich in capital and skilled labor (human capital), and they export manufactured goods that make intensive use of these resources. Most developing countries are rich in land, raw materials, or unskilled labor (or some combination of the three), and they export agricultural products, minerals, or labor-intensive manufactures.

The theory also helps explain changes over time in a country's trade relations. A poor country with abundant land and labor but little capital will export farm goods and simple labor-intensive manufactures. As the country develops, it accumulates capital and its workers become more skilled, such that its endowments change and, with them, its export patterns. This explains, for example, why the United States in the nineteenth century exported almost exclusively raw materials and farm goods, yet today it exports almost exclusively goods and services that require large amounts of capital and skilled labor to produce. In addition to explaining aspects of world trade patterns, Heckscher-Ohlin trade theory has important implications for the domestic politics of trade policy, as we discuss later in this chapter.

There are other potential economic sources of the patterns we observe in international trade. A great deal of modern international trade is related to the activities of multinational corporations, such as sales among the far-flung subsidiaries of North American, Japanese, European, and other international corporations. In fact, it has been estimated that about one-third of all American trade actually takes place *within* a company, from one of its branches to another—say, from a Ford engine factory in Mexico to a Ford assembly plant in the United States.[6]

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5. This argument applies to movements of capital and people, as well as to trade. Countries rich in capital should export capital, and countries rich in labor should export labor. (Land, of course, cannot be traded across borders without changing the borders!)

6. Kim Ruhl, "How Well Is US Intrafirm Trade Measured?" *American Economic Review*, 105, no. 5 (May 2015): 524–29.

Much international trade is in goods with internationally known and desirable brand names. South Korea, for instance, imports European-made cars, even though it has a vibrant automotive industry of its own.

This sort of "intrafirm" trade may not be due primarily to the forces that Heckscher-Ohlin trade theory suggests, but rather to production and distribution networks within companies. These kinds of production and distribution networks also exist among different companies. Indeed, much of world trade is now carried out in "global supply chains" in which parts and components are made in many locations around the world, to be assembled and sold in markets everywhere. One estimate is that more than two-thirds of all the trade of advanced industrial countries is actually this sort of "intra-industry" trade.[7] In this way, much of the manufacturing production that was once carried out in a single location, or a single country, has been "outsourced" to suppliers all over the world.

In addition, a great deal of international trade is in goods whose attraction to consumers has to do as much with brand name, reputation, or other related considerations as it does with price. North America, for example, both imports automobiles from Europe and exports automobiles to Europe. This sort of trade is not the result of fundamentally different factor endowments (and prices) between Europe and North America—both regions are rich in capital and skilled labor and poor in unskilled labor—but rather of European consumer interest in American car brands and American consumer interest in European car brands.

Other economic links among countries encourage trade. Countries that share a currency, such as those in the European Union that use the euro, trade with one another much more than those that do not. Countries that invest heavily in one another's economies also tend to trade heavily with one another.

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7. Organisation for Economic Co-operation and Development, "Measuring Globalisation: OECD Economic Globalisation Indicators 2010" (Paris: OECD, 2010), www.oecd-ilibrary.org/docserver/download/9210031e.pdf?expires=1498499397&id=id&accname=guest&checksum=65E0F936C80321179F50E4510325B068.

Noneconomic factors also affect both what and with whom countries trade. Countries that are geographically close together trade more, since transport costs are lower. Diplomatic and military relations between nations also influence their trade patterns. Countries whose governments are hostile to one another are likely to trade little, whereas those on friendly terms are likely to trade more. There are two reasons for this. First, trade between hostile nations is riskier than trade between friendly nations: businesses avoid engaging in trade that may very well be disrupted by the outbreak of hostilities. Second, governments often pursue close economic ties with their allies in order to cement the alliance and help friendly nations. By the same token, if trade is good for a national economy, a government might shy away from encouraging trade with an unfriendly nation in order to keep from strengthening a potential enemy. During the Cold War, as we mentioned in Chapter 5 in our discussion of the North Atlantic Treaty Organization (NATO), the United States and its allies purposely limited their economic ties with the Soviet Union, just as they encouraged ties among themselves.

Some analysts believe that trade encourages friendly relations as much as friendly relations encourage trade. For example, Cordell Hull, U.S. secretary of state before and during World War II, wrote: "It is a fact that war did not break out between the United States and any country with which we had been able to negotiate a trade agreement. It is also a fact that, with very few exceptions, the countries with which we signed trade agreements joined together in resisting the Axis. The political line-up followed the economic line-up."[8]

After World War II, the two superpowers used their trade relations to reinforce their alliances: the United States and the Soviet Union each encouraged its allies to build a common trading order that excluded members of the other alliance. After the Cold War ended, many policy makers in Europe wanted to encourage trade with the former communist countries of Eastern and Central Europe as a way to encourage cooperative diplomatic relations with them. Regardless of the pattern of cause and effect, international diplomatic realities and international trade are closely related.

But the most important noneconomic source of international trade patterns is national trade policies undertaken to address the interests of domestic constituencies. Discussions of international trade often overlook the fact that while such trade takes place among countries, it really involves individuals and firms with well-defined interests. We say that "Mexico" exports a million tons of steel to "the United States," but in fact, companies in Mexico sell the steel to companies in the United States. Companies in one country profit from the sale, and companies in the other profit from the purchase. For trade is the stuff of domestic politics, as governments attempt to respond to the interests of corporations and consumers, farmers and workers, all of whom have something at stake in their countries' policies toward foreign trade.

We now consider how domestic political and economic factors affect trade policy and trade itself. In this context we examine the interests, institutions, and interactions that lead to national trade policies.

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8. Quoted in Richard Gardner, *Sterling-Dollar Diplomacy in Current Perspective: The Origins and Prospects of Our International Economic Order*, expanded ed. (New York: Columbia University Press, 1980), 9.

protectionism
The imposition of barriers to restrict imports.

trade barriers
Government limitations on the international exchange of goods. Examples include tariffs, quantitative restrictions (quotas), import licenses, requirements that governments buy only domestically produced goods, and health and safety standards that discriminate against foreign goods.

tariff
A tax imposed on imports. Tariffs raise the domestic price of the imported good and may be applied for the purpose of protecting domestic producers from foreign competition.

quantitative restriction (quota)
A limit placed on the amount of a particular good that is allowed to be imported.

nontariff barriers to trade
Obstacles to imports other than tariffs (trade taxes). Examples include restrictions on the number of products that can be imported (quantitative restrictions, or quotas); regulations that favor domestic over imported products; and other measures that discriminate against foreign goods or services. "Buy American" laws that govern what state and local governments can buy, for example, are an implicit—but nontariff—obstacle to the purchase of imports.

Trade Restrictions Are the Rule, Not the Exception

Despite the powerful economic arguments for free trade, every country currently has at least some restrictions on trade with the rest of the world. Some countries have very high barriers to trade; others have much lower ones. Yet government policies to control and contain trade are the norm, today as in the past. **Protectionism**, the use of specific measures to shield domestic producers from imports, has long been one of the most common government policies worldwide. Most of today's rich countries were strongly protectionist at some point in their history.

Virtually all governments restrict at least some imports. For hundreds of years, governments have imposed a wide variety of **trade barriers**, impediments to the importation of foreign goods. Historically, the most common barrier is a **tariff**, a tax on imports levied at the border and paid by the importer. A tariff raises the price of the import directly, so a consumer of the imported good has to pay more for it. Another common form of trade barrier is a **quantitative restriction**, or **quota**, which limits the quantity of a foreign good that can be sold domestically. Because the reduced quantity typically causes an increase in its domestic price, a quantitative restriction has an effect like that of a tariff: it makes the imported good more expensive to domestic consumers. There are many other **nontariff barriers to trade**, such as regulations targeted at foreign goods or requirements that governments purchase from national producers. In all instances, the effect of these policies is to shelter domestic producers from foreign competition. Before we analyze the effects of these policies, it is important to emphasize how common they have been and continue to be.

The degree to which the world's major nations have been open to trade has varied greatly over time and among countries. As we saw in Chapter 1, for more than 300 years after 1492 the major European nations followed the trade policies of mercantilism, a system by which great powers used their military might to control trade with and extract wealth from their colonial possessions. The colonial powers' mercantilist regulations kept foreign goods out of their markets and reserved their colonies' markets for themselves.

Around the middle of the nineteenth century, however, Great Britain and other leading industrial countries moved in the direction of trade liberalization: they pursued policies that involved fewer restrictions on trade. Great Britain adopted free trade, permitting foreigners to sell anything to Britain without tax or restriction. More generally, from the 1860s until 1914, international trade among the principal industrialized nations was quite free. There were tariffs and other barriers, to be sure, and some countries were very protectionist—especially such industrializing nations as the United States, which had some of the world's highest trade barriers at the time. Nonetheless, most of the world's major economies were open, and world trade grew at a very rapid rate.

With the outbreak of World War I in 1914, however, international trade relations entered 30 years of crisis and closure. Efforts to rebuild the trading system after the war were not very successful, especially once the Great Depression hit in

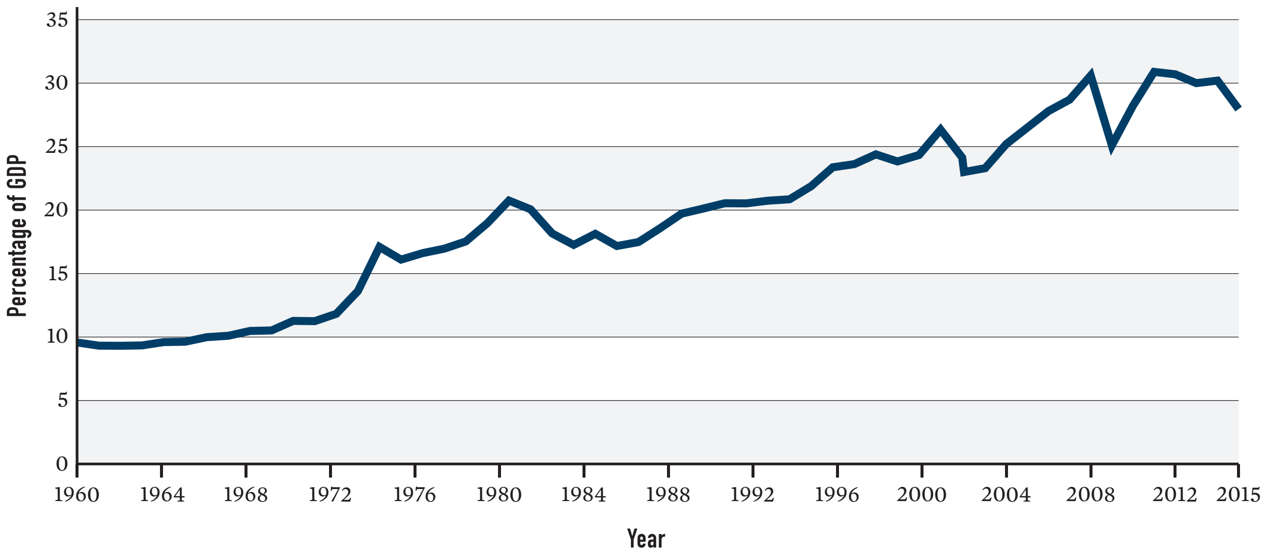
1929. The major powers divided up the world into more or less hostile trading blocs: the British, French, Italian, Japanese, and other empires, along with the less formal German and American spheres of influence.

After 1945, the Western world under American leadership moved gradually to reduce trade barriers among the developed nations. The communist countries and most developing countries protected themselves from world markets, but the industrialized world significantly liberalized its trade. Although the reduction of trade barriers remained controversial, by the 1980s the rich countries had become very open to world trade, as part of the broader march toward economic globalization. Eventually, most developing and formerly communist countries joined the liberalizing and globalizing trend. Since the early 1990s, international trade has once more—as before 1914—been quite open. Thus, in terms of global trade relations over time, we see a pattern in which mercantilist closure gave way to freer trade, then to interwar closure, then to liberalization after 1945 and further liberalization leading to globalization after 1980.

Many nations have, at some point, gone from very closed to very open to trade, or in the opposite direction. Great Britain jettisoned mercantilism in the 1840s. The United States, one of the most protectionist nations in the world through most of the nineteenth and early twentieth centuries, started moving toward freer trade in the 1930s, and by the 1950s and 1960s was leading the charge for trade liberalization. As Figure 7.1 shows, trade became an increasingly large part of the U.S. economy after the 1960s. Developing nations such as Brazil and India were among the world's most closed economies until the 1980s, after which they reduced their barriers dramatically. Trade among European countries was quite free from the 1860s until 1914; in the 1920s and 1930s, the region's nations erected very strict barriers to trade among themselves; today, trade among the 27 EU members is completely unrestricted.

Figure source: World Bank, World Development Indicators, http://data.worldbank.org/indicator/NE.TRD.GNFS.ZS/countries/US?display=default (accessed 09/07/17).

FIGURE 7.1 ***Importance of Trade to the U.S. Economy, 1960–2015***



Even within a single country, there can be significant differences among policies toward trade in different goods—some protected and some not. Almost all developed nations protect agricultural producers much more heavily than manufacturers. Developing nations, meanwhile, tend to protect manufactured products more than farm products. The United States, as well as many other industrial nations, generally protects the steel industry more than most other industries. And despite the industrial countries' rhetoric in favor of freer trade, they have imposed restrictions on many goods that might be imported from developing nations. Why are some producers—farmers, or certain kinds of farmers; industries, or certain kinds of industries—more favored by trade policy than others? Why do different countries' trade policies vary so much? Why has the world's general openness to trade changed so dramatically over time? And, perhaps most central, why have governments almost always, and almost everywhere, ignored economic analysis and advice and imposed restrictions on foreign trade?

Why Do Governments Restrict Trade? The Domestic Political Economy of Protection

For over 200 years, economic analysis has been unambiguous about the benefits of trade for national income, output, and efficiency. This perspective is reflected in the opinions of professional economists, more than 90 percent of whom believe that barriers to trade reduce national well-being (according to one survey of American economists).[9] Yet economists' confidence in the benefits of trade is not shared by most people. Public opinion is much less favorable to trade: 60 percent of respondents in another survey of American views favored trade protection, as opposed to less than 5 percent of economists.[10] Indeed, many people seem wary of openness to international trade. Such wariness is evident in the fact that almost all countries, almost all the time, have substantial barriers to trade that protect their own producers. And in many developed countries, hostility to international trade has grown over recent years, to the point that some analysts anticipate a substantial return to protectionism worldwide.

Trade barriers usually reflect domestic concerns, despite the fact that they implicate foreign relations. William McKinley, a leading protectionist member of the U.S. Congress before he became president, once said of a tariff he was shepherding through the House of Representatives: "This is a domestic bill; it

9. Cletus C. Coughlin, "The Controversy over Free Trade: The Gap between Economists and the General Public," *Federal Reserve Bank of St. Louis Review* 84, no. 1 (January–February 2002): 1.

10. Coughlin, "Controversy over Free Trade," 1.

is not a foreign bill."[11] This statement remains a common view of protection for domestic interests.

Trade policy typically reaches the public consciousness, and the media, when some national producers complain that there is too much or too little trade in the goods they produce. Often, producers are concerned because imported goods cut into their profits or cost them their jobs. Other producers may complain that foreign barriers to their goods keep them out of markets abroad and similarly cut into profits and cost jobs at home. To understand the domestic politics of trade, we need to know the interests in question, the institutions through which these interests are expressed, and how competing interests interact with one another.

There are both benefits and costs to trade barriers. Virtually all tools of trade protection—tariffs, quotas, and other restrictions—make imports more expensive, which allows domestic producers to sell more of their products, to raise their prices, or both. When tariffs are imposed on foreign steel imported into the United States, American steelmakers can expand sales at higher prices. As a result, they may be able to increase profits, raise wages, and hire more workers. Quotas, which restrict the quantity of foreign goods sold in the national market, ultimately have a similar impact in that the reduction in imports reduces supply, thus raising prices. So, trade barriers assist national producers. What could be wrong with that?

The most direct cost of protection is to consumers of the protected good. Tariffs and quotas raise the domestic price of imported goods and may lead to price increases for similar domestically produced goods: for example, a barrier to steel imports makes imported steel more expensive and allows domestic steelmakers to raise prices too. Producers gain and consumers lose from protection; the *redistributive effect* is such that income is redistributed from domestic consumers to the protected domestic industry. But there is another cost as well—in this case to efficiency or the welfare of the society as a whole, the ability of society to use its resources most effectively. A trade barrier introduces economic inefficiencies. It leads domestic producers to make more goods that they are not particularly good at making (otherwise, they would not need protection), and it leads consumers to consume less of those goods that protection has made artificially expensive.

Trade protection also leads to an allocation of domestic resources—labor, capital, land, skills—that is not to the country's comparative advantage. Protection of European wheat leads European farmers to use their land for wheat farming when it might make more sense, from the standpoint of the region's overall economy, to use that land for

NAFTA imposes controls on trade that stipulate that a certain percentage of parts in any car must be made in the United States, Canada, or Mexico. Some car-part manufacturers, like Nemak, locate their factories in Mexico to take advantage of its lower labor costs.

11. Cited in David A. Lake, *Power, Protection, and Free Trade: International Sources of U.S. Commercial Strategy, 1887–1939* (Ithaca, NY: Cornell University Press, 1988), 111.

dairy or vegetable farming or to build houses. (For more on the economic effects of trade restrictions, see the "Special Topic" appendix to this chapter, on p. 340.)

Winners and Losers in International Trade

The domestic politics of trade is infused with battles between winners and losers from protection and with debates over the importance of any inefficiencies that protection may promote. The potential winners and losers constitute the principal actors in national debates over trade policy.

Domestic industries protected by trade barriers receive clear and concentrated benefits. Protection creates returns above the normal rate of profit by artificially restricting competition and supply. However, at least three groups of actors stand to lose from trade protection. First are consumers of the imported good. This group includes consuming industries, which—unlike average consumers—may be powerful and well organized. When the U.S. government imposed tariffs on imported steel in 2002, the American users of this steel—especially in the automobile industry—mobilized strongly against it (as did foreign governments), and the policy was eventually reversed.

A second group that tends to oppose protection is exporters. They worry that their country's protective barriers might provoke retaliation in foreign markets. American farmers, for example, have opposed American barriers to Chinese goods—largely to avoid Chinese retaliation against the many billions of dollars of American farm goods that China imports.

Third, citizens in general may be willing and able to punish politicians for the costs that protection imposes on them, especially if the connection is clear and the issue is prominent. In the 1980s, many people in Soviet-bloc (communist) countries blamed the stagnation of their economies on their governments' pervasive trade controls, and this perception may have created popular sympathy for the subsequent opening of these nations to international trade. In addition, there is evidence that consumers in developing countries favor freer trade because they understand that it will lead to reduced prices for themselves.[12]

Because of the diverse array of industries that compete with imports, use imports, and sell exports, as well as the range of producers and consumers, trade is politically controversial. Which actors do we expect to have an interest in supporting and opposing trade protection within national political systems?

Economic Interests and Trade Policy

The economic characteristics of a country, and of particular groups within it, help explain who might be in favor of and against trade. There are two leading theories of trade-policy interests; each predicts different sets of actors that will support or oppose trade protection.

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12. See, for example, Andy Baker, "Who Wants to Globalize? Consumer Tastes and Labor Markets in a Theory of Trade Policy Beliefs," *American Journal of Political Science* 49, no. 4 (October 2005): 924–38.

The first theory, the Stolper-Samuelson approach, emphasizes the interests of broad factors of production—land, labor, capital. Remember that the Heckscher-Ohlin approach expects that a country's exports will make intensive use of resources that the country has a lot of. A labor-rich country will export labor-intensive goods; a capital-rich country will export capital-intensive goods. This pattern, in turn, affects which groups trade will help or hurt. If the country exports labor-intensive goods, for example, the demand for labor goes up, and so do wages. This first theory argues that trade affects primarily broad factors of production: labor, capital, land, skilled labor.

The second theory, the Ricardo-Viner approach, emphasizes specific sectors of the economy, such as the steel industry or cotton farmers. Both help us think analytically about support for and opposition to trade.

The Stolper-Samuelson Approach The **Stolper-Samuelson theorem** is one explanation of who will support and who will oppose protection. It predicts that trade protection benefits the scarce factor of production. This is simply the counterpart of the argument that more trade helps the abundant factor: as discussed already, in a labor-rich country, labor benefits most from trade. The logical implication is that reducing trade in a labor-rich country will harm labor.

Stolper-Samuelson theorem
The theorem that protection benefits the scarce factor of production. This view flows from the Heckscher-Ohlin theory: if a country imports goods that make intensive use of its scarce factor, then limiting imports will help that factor. So in a labor-scarce country, labor benefits from protection and loses from trade liberalization.

Consider Bangladesh, a poor country with lots of unskilled labor and very little capital. Bangladesh exports mainly clothing and leather goods, which make intensive use of its abundant unskilled labor; it imports such capital-intensive products as machinery, equipment, and chemicals. Trade barriers artificially make imported capital-intensive goods more expensive or harder to buy, which means that at least some of them will have to be produced in Bangladesh. Some Bangladeshi capital will have to be diverted from labor-intensive production in order to produce these capital-intensive goods (from garment factories to chemical plants, for example), which raises the domestic demand for capital and reduces the local demand for labor. This, in turn, raises the return on Bangladeshi capital (profits) and reduces Bangladeshi wages. Protection in a capital-scarce country helps owners of capital and hurts workers; we expect investors to support protection and workers to oppose it.

We can apply the Stolper-Samuelson theorem to a labor-scarce country, such as the United States. The opposite of Bangladesh, the United States has abundant capital but scarce unskilled labor. The United States imports labor-intensive goods, such as clothing and furniture, and exports capital-intensive goods, such as airplanes. Protection restricts the American supply of labor-intensive products and raises their price. This, in turn, increases American production of these labor-intensive products, raises the American demand for unskilled labor, and boosts the wages of American unskilled workers. By the same token, protection in land-scarce countries (such as those of western Europe, as well as Japan) helps farmers and hurts workers and owners of capital.

So, which actors would we expect to support and oppose trade barriers? We expect owners of the scarce factors of production in a country to be protectionist and owners of the abundant factors to favor free trade. In rich societies, which typically have abundant capital and skilled labor but are scarce in unskilled labor, capitalists and skilled workers should be free traders, while unskilled workers should be protectionists. In countries with abundant land, farmers should support trade; in countries where land is scarce, farmers should support protection. In poor societies, which typically have abundant unskilled labor and scarce capital, workers should support trade while capitalists should be protectionists. An important feature of the model is that actors' attitudes toward trade are not fixed, but vary with the country's resources of land, labor, capital, and human capital (skills). Thus, the model expects farmers to be protectionists in land-poor Japan but free traders in land-rich Argentina.

There is a great deal of evidence to support this model. Labor movements in the United States and other rich countries do seem to be relatively protectionist, while people with a lot of capital appear to find free trade more favorable. Japan and Europe have relatively little land, and their farmers are strongly protectionist; Australia and Canada are rich in land, and their farmers usually favor free trade. Notice that the Stolper-Samuelson predictions are about very broad groups or actors—owners of production factors (roughly the same as social classes) such as laborers, investors, and farmers.

But observers of economic policy making in the United States and elsewhere note that many demands for protection come from specific *industries*—the steel industry, sugar growers, shoe manufacturers. Often, everyone in an industrial sector—skilled and unskilled workers, managers, and owners of firms—works together to ask for trade barriers or support for their exports. For example, we tend to think of the American steel industry as relatively protectionist because we group together everyone associated with the industry. This assessment flies in the face of the Stolper-Samuelson focus on labor as a class or investors (capital) as a class. Many detailed studies of trade policy, and of attitudes toward trade, confirm the idea that the industry in which people work has a powerful impact on their trade-policy opinions.[13]

Ricardo-Viner (specific-factors) model
A model of trade relations that emphasizes the sector in which factors of production are employed rather than the nature of the factor itself. This differentiates it from the Heckscher-Ohlin theory, for which the nature of the factor—labor, land, capital—is the principal consideration.

The Ricardo-Viner (Specific-Factors) Approach A second way of predicting trade-policy preferences focuses on why whole industries often act together. The **Ricardo-Viner**, or **specific-factors**, **model** has one key feature that differentiates it from Stolper-Samuelson: some factors of production are tied to their industry; that is, they are *industry-specific*. The relevant actors thus are not classes, but industrial sectors. The approach is based on the principle that the factors of production are not very mobile, that it is difficult for labor or capital to move from use to use.

For example, capital in the steel industry largely takes the form of steel factories and machinery; it cannot simply be turned into capital in the food-processing industry. Since they are "stuck" in the steel industry, steel manufacturers care not about the profits of capital in *general* and in the country as a whole, but rather about the profits available only in steel. The same may be true of workers or farmers,

13. See, especially, Anna Maria Mayda and Dani Rodrik, "Why Are Some People (and Countries) More Protectionist Than Others?" *European Economic Review* 49 (2005): 1393–1430.

The U.S. steel industry, whose capital equipment is specific to the production of steel, often urges the U.S. government to provide protection from what it views as unfair "dumping"—that is, selling steel in the United States below the true cost of production. Cheap steel benefits consumers, but hurts the steel industry.

whose job skills or land can be inherently "specific to" (some might say "trapped in") a particular industry or crop. This gives the owners, workers, or farmers a strong incentive to safeguard their current use—for example, by obtaining government protection from foreign competition.

In this model, the interests of individuals flow from the sectors of the economy in which they are employed. Given the limited mobility of labor and capital, actors associate their interests with the sector in which they are employed. A worker or manager in an industry that faces stiff import competition will be protectionist; a worker or manager in an exporting industry will want free trade. Unlike in the Stolper-Samuelson approach, people's interests are tightly bound up with the interests of others in their sector of the economy, and the pertinent actors in domestic trade-policy debates are economic sectors, not factors.

A Firm-Based Trade Theory A third approach to trade has gained theoretical and empirical support in recent years, motivated by the observation that international trade is dominated by a very few companies. Of the more than 5 million firms in the United States, for example, only 4 percent are exporters. Even in exporting industries, most of the exporting is done by a small number of companies: the top 1 percent of all exporting firms account for more than 80 percent of all American exports.[14]

This observation leads to an approach to trade, and to trade policy, that focuses on firms. The most productive firms in an exporting industry—typically also

14. Andrew B. Bernard, J. Bradford Jensen, and Peter K. Schott, "Importers, Exporters and Multinationals: A Portrait of Firms in the US That Trade Goods," in *Producer Dynamics: New Evidence from Micro Data*, ed. Timothy Dunne, J. Bradford Jensen, and Mark J. Roberts, 513–52 (Chicago: University of Chicago Press, 2009); and Andrew B. Bernard, J. Bradford Jensen, Stephen J. Redding, and Peter K. Schott, "Firms in International Trade," *Journal of Economic Perspectives* 21, no. 3 (2007): 105–30.

the largest—may be most likely to benefit from trade liberalization and to be politically active in the trade arena. Certainly, we are used to seeing very large firms—General Motors, Walmart, General Electric, Google—play a major role on all sides of trade-policy debates.

There is evidence for all three of these approaches in the politics of trade protection. Broad classes—farmers, workers—sometimes mobilize for or against protection. But at the same time, much lobbying for protection is industry-based, consistent with the view that the benefits of protection accrue to industries, not to broad classes or factors. And within industries, it is typically the largest firms that dominate debate. The accuracy of each view may vary among industries and countries, and over time. One study found, for example, that in the late nineteenth century, American labor was quite interchangeable, which contributed to the working class having a clear, distinctive interest in trade policy; in contrast, today's American working class is much more differentiated, so industry-based sectoral interests predominate.[15]

Groups may also support trade policies because they believe those policies help make possible other outcomes that they favor. The economist John Maynard Keynes wrote that protectionism "rests on the principle of making things relatively scarce. To those who are concerned with making these things, this is no doubt advantageous. But it causes an amount of distress more than equivalent elsewhere. The community as a whole cannot hope to gain by making artificially scarce what the country wants."[16]

This is a powerful argument; but later, in the midst of the Great Depression of the 1930s, Keynes came to believe that there could be equally powerful political arguments against free trade. In 1933, in fact, Keynes spoke in favor of "the policy of an increased national self-sufficiency . . . not as an ideal in itself, but as directed to the creation of an environment in which other ideals can be safely and conveniently pursued." Keynes had come to believe that trade barriers might usefully give national governments breathing space as they attempted to combat mass unemployment and economic collapse. Keynes felt that protectionism might permit governments to implement policy measures to alleviate the social and economic distress of the Great Depression.[17]

Understanding the economic interests that are in contention over trade is only a start to understanding national trade politics and policies. At best, this can tell us which actors want more or less protection and what the interests of different groups in trade policy might be. But what determines who wins and who loses in the battles among supporters and opponents of trade liberalization?

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15. Michael Hiscox, "Commerce, Coalitions, and Factor Mobility: Evidence from Congressional Votes on Trade Legislation," *American Political Science Review* 96, no. 3 (September 2002): 593–608.
16. Cited in Robert Skidelsky, *John Maynard Keynes*, vol. 1, *Hopes Betrayed 1883–1920* (New York: Penguin, 1983), 227.
17. John Maynard Keynes, "National Self-Sufficiency," *Yale Review* 22, no. 4 (June 1933): 755–69.

Domestic Institutions and Trade Policy

Since there are always supporters and opponents of protection in any country, how are trade-policy decisions made? Why are some countries more open to trade than others? Why do governments protect some industries and not others? There are many steps between raw economic interests and the actual results in economic policy. Most of them have to do with the institutions of national politics, including the organization and representation of interests, and the ways in which policy decisions are made.

National political institutions can be of stunning variety and complexity, but a general rule of thumb can help orient our understanding of their implications for trade policy. A common view starts with the observation that trade protection tends to help relatively narrow and concentrated groups—the steel industry, skilled workers—but tends to harm the economy and consumers as a whole. It follows that those political institutional forms that are particularly responsive to the interests of more concentrated groups—a particular class, a particular industry—will be more favorable to protection, while those that respond especially to broad national pressures will be less favorable. So, an important question about domestic institutions has to do with whether they favor particularistic interests (in which case they would incline toward protectionism) or broad economic and consumer interests (in which case they would incline toward less protectionist policies).

The Organization of Interests Trade protection affects large groups both positively and negatively. This raises the possibility of free riding, a concept we introduced in Chapter 2. If a trade barrier is imposed, it helps all the beneficiaries of trade protection—whether a factor of production or an industry—regardless of whether they worked to get protection or not. This means that some members of the winning group—some companies, some individuals—have reasons to sit back and wait for others to fight for them. But if all the actors in a class or industry attempt to free ride, nothing will get done. In other words, both supporters and opponents of trade protection face problems of collective action.

As we've discussed in previous chapters, the logic of collective action implies that smaller groups will be better able to organize than larger groups can. We saw in Chapter 4 how smaller, highly motivated groups were better able to influence foreign policy in matters of war and peace. The same principle applies in matters of trade policy. There are typically relatively few producers and a great many consumers, which leads to the expectation that producers will win over consumers in many circumstances. This helps explain, for example, how a relatively small number of steelworkers are able to obtain a policy that benefits them at the expense of the vast mass of American consumers of goods that are made with steel.

Economic interests organize themselves very differently in different societies. In some western European countries, for example, most workers are members of a centralized labor federation that devises policies for virtually the entire labor movement. Even where workers in different industries might disagree, the existence of a class-wide labor federation helps create a common working-class political position and overcome collective action problems. In the United States, by contrast, labor unions tend to be organized by industry; even if there were common trade-policy interests among American workers, it might be difficult for them to express those interests in a common way.

The implication is that an organization reflecting the concerns of broad groups—such as all workers—is more likely to ignore the demands of specific groups or industries. In contrast, interests that are organized into narrower groups are more likely to pursue the particular goals of such special interests.

The Representation of Interests through Political Institutions Just as narrowly based social groups are more likely to favor protection than broader ones are, so political institutions that are more closely tied to narrow interests are more likely to favor trade protection than are institutions that reflect broader interests. This is an example of the sort of bias that political institutions can create or intensify. Generally, to the extent that democracies reflect broad interests while dictatorships are restrictive, we would expect democracies to be less protectionist than dictatorships. Indeed, scholars have found that democratic developing countries are much more likely to liberalize their trade than dictatorships are.[18]

Apart from such broad institutional features as democracy, societies differ in the ways that their partisan, electoral, and legislative institutions represent the interests of their citizens, and these differences are likely to affect the way trade policy is made. For example, many European countries have strong class-based parties: the working class traditionally votes for the socialist parties, and other parties associate themselves more or less explicitly with farmers or business. Although the American labor movement has ties to the Democrats, working-class voters in the United States are somewhat less strongly connected to the Democratic Party as compared with working-class voters and left-leaning parties in Europe. This affects the parties' expression of interests and their bias toward special or general interests, and thus toward protection or freer trade.

National electoral systems vary greatly, and they may cause differences among national party structures. Most industrial countries are parliamentary and have a legislature elected on a proportional basis in which voters choose the party they prefer rather than an individual local candidate. American voters elect the president on a national basis but elect individual local candidates (for the House of Representatives and the Senate) whose ties to the national party may be weak. And there are systems in between, such as the Westminster system (in Great Britain) and hybrid presidential-parliamentary systems (in much of Latin America).

How might these institutions affect trade policy? Politicians with local political constituencies tend to be more responsive to local interest groups, while nationally elected politicians have less reason to cater to particular local concerns. Consider two otherwise identical countries: one with strong national parties and a powerful national executive and the other with weak national parties and a weak national

18. Helen V. Milner and Keiko Kubota, "Why the Move to Free Trade? Democracy and Trade Policy in the Developing Countries," *International Organization* 59, no. 1 (Winter 2005): 107–43.

executive. Politicians in the former are more likely to focus on national effects of policy and favor free trade, while politicians in the latter are more likely to emphasize local concerns and thus favor trade protection that benefits local special interests.

The same holds within a country, where one branch of government may be more sensitive to local pressures than another. The American president, elected nationally, has a strong incentive to consider the impact of trade policies on the country as a whole. Members of Congress, however, have little reason to think about anything other than the effects of the policy on their district. Traditionally, then, Congress is more protectionist than the president—although this relationship has changed in important ways more recently.

Partisan features of government can also affect trade policy, especially if parties are associated with well-defined social groups that have preferences for particular trade policies. For example, in the Stolper-Samuelson framework, labor has well-defined interests in trade: if labor is scarce, laborers will be protectionist; if labor is abundant, laborers will support free trade. In most of the world, labor typically supports left-wing parties. Given this observation, governments of the Left in labor-rich countries (mainly poor nations) should be more open to trade than are governments of the Left in labor-scarce countries (mainly rich nations). Similarly, because business typically is associated with right-wing parties, governments of the Right in capital-rich countries (usually rich nations) should be more open, while in capital-poor countries (usually poor nations) they should be more protectionist.

Thus, leftist governments should support free trade in poor countries and protection in rich countries; rightist governments should support free trade in rich countries and protection in poor countries. One study of a large number of countries indeed found strong support for this joint impact of partisan politics and Stolper-Samuelson interests. For example, Bangladesh and Senegal are similarly labor-rich and capital-poor, but in the 1980s, Bangladesh's right-wing (presumably anti-labor) government had tariffs twice as high as Senegal's left-wing (presumably pro-labor) government.[19]

Although theory and history tend to support these explanations of trade politics, a new mass politics of trade has emerged in many advanced industrial countries in the past decade. This trend is part of a broader backlash against globalization, which has entered mass and electoral politics in very striking ways. In the 2016 presidential campaign in the United States, for example, both political parties had candidates who were strongly and explicitly hostile to international trade. Democrat Bernie Sanders and Republican Donald Trump both criticized American trade policies, arguing that they had cost the country valuable manufacturing jobs and served primarily to enrich a corporate elite.

Donald Trump was elected president after a campaign that was more hostile to existing trade policy than any U.S. presidential campaign had been since the 1930s. The Trump administration has indeed pursued much more protectionist policies

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19. Pushan Dutt and Devashish Mitra, "Endogenous Trade Policy through Majority Voting: An Empirical Investigation," *Journal of International Economics* 58 (2002): 107–33.

Proposed trade deals between the European Union and Canada (CETA) and between the European Union and the United States (TTIP) provoked demonstrations in Poland among citizens who were concerned about the deals' potential impact on domestic agriculture and consumer rights.

than any of its modern predecessors. The new American politics of trade has had its reflection in the rise of similarly "populist" movements, of both the Right and the Left, in other countries. In Europe, antiglobalization sentiment tends to take the form of opposition to the European Union or the euro, and it has been a powerful electoral force in countries from France to Poland. Similar attitudes clearly contributed to the British vote in June 2016 to leave the European Union.

It is probably too early to know whether the emergence of powerful mass and electoral pressures for trade protection in the past few years presage a fundamental change in the politics of trade. Concentrated special interests remain very powerful and continue to play a central role in trade policy. But it may be, at least in some rich countries, that large segments of the electorate now have strong enough views in favor of trade protection to have a significant impact on trade policy.

Costs, Benefits, and Compensation in National Trade Policies

Even if trade liberalization makes a country's economy as a whole better off, it can seriously harm groups within the country. Concentrated groups of potential losers with a lot at stake could conceivably block policy changes that would improve conditions for the nation overall. Indeed, the electoral success of antiglobalization candidates hostile to trade suggests that there is a widespread sentiment in some nations that many citizens have been harmed by freer trade. For those who believe that trade benefits the national economy as a whole, one implication is that the country could be better off if it "bought off" the actors whose interests would be harmed, to give them a reason to cooperate with trade policies that benefit the society as a whole. Such an approach would represent a movement toward the Pareto frontier in the model presented in Chapter 2.

Movement toward the Pareto frontier, called a Pareto improvement, makes everyone better off (or at least unharmed) and nobody worse off. While trade liberalization might hurt some people, the overall gains to the national economy are large enough that the losers can be fully compensated for their losses and the benefits will still remain for the rest of society. Indeed, it is not uncommon for a government to arrange compensation for people who lose from trade liberalization, in order to diminish opposition to a removal of trade barriers that the government wants to pursue. The United States, for example, provides Trade Adjustment Assistance to workers harmed by the country's foreign trade; the assistance ranges from tax credits, to money for retraining, to outright grants.

More generally, the very structure of the post-1945 political economy of most Western societies has, to some extent, been based on the logic of compensation. As the industrialized world substantially reduced trade barriers after World War II, its governments implemented sweeping social policies that provided a safety net to workers, farmers, and others who might be negatively affected by the reopening of world trade. This strategy reflects a kind of compromise between supporters of economic integration on the one hand, and defenders of the welfare state on the other.[20] The Bretton Woods System (introduced in Chapter 1) permitted, even encouraged, this compromise, and it was quite successful at achieving its goal of an integrated world economy and extensive social welfare policies in the industrialized nations.

The issue of compensation has attracted recent attention because many observers believe that trade has led to reduced wages for many workers in the industrial countries. Trade puts unskilled and semi-skilled American workers in direct competition with unskilled and semi-skilled workers in poor countries with much lower wages, which may depress the wages of the former. This is a clear implication of the Heckscher-Ohlin approach: trade will tend to make wages, profits, and other earnings more similar across countries. In this process, the prices of factors of production (the wages of labor, the profits of capital, the returns to land) tend to become more equal across countries. Trade leads countries to export goods that use factors of production in which they are well endowed: labor-rich countries export labor-intensive goods. This increases the demand for labor and raises wages. At the same time, labor-poor countries import labor-intensive goods rather than producing them at home, thus reducing the demand for labor and lowering wages. The implication is that wages in poor countries will rise toward the levels of those in rich countries, while wages in rich countries will fall toward the levels of poor countries.

20. John Ruggie called this compromise "embedded liberalism." See John Gerard Ruggie, "International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order," *International Organization* 36, no. 2 (1982): 379–415.

For example, the wages of unskilled workers in the United States have, in fact, been stagnant or declining since the early 1970s, and trade with developing countries may have contributed to this process. The issue is controversial; some analysts think that the decline in unskilled wages in the United States is due largely to technological changes that have made computer-based skills more valuable in the workplace. Nonetheless, there is little doubt that globalization has created winners and losers in rich countries and that working people are more likely to be on the losing side. This observation has led some analysts to suggest that rich countries will continue to face social and political conflict over economic openness that will be mitigated only if they develop more extensive social safety nets to reduce the negative impact of the world economy on some groups in society.

Clearly, the interests, interactions, and institutions that characterize different national political economies have a powerful impact on national trade policies. Nonetheless, a focus on the *domestic* sources of trade policies misses an important part of the story, because each country's trade relations are part of a broader international environment. While trends in French or Indian trade depend on French and Indian domestic politics, they also depend on the global economic and political situation.

It would be difficult to understand the French turn toward protectionism in the 1930s without the context of the Great Depression, that country's reduction in protection after 1950 without situating it within the Cold War, or its current trade policies without knowing France's place in the single market of the European Union. Similarly, it would be difficult to explain India's protectionism upon independence in 1947, or its turn toward freer trade in the 1990s, without knowing that in both instances it was following policies shared by most other developing countries. The *international* environment—especially the global strategic and institutional setting—has a powerful impact on national trade policies and patterns.

How Do Countries Get What They Want? The International Political Economy of Trade

What a national government wants from trade is only a starting point, for every country's commercial relations depend on the international environment. Certainly, a country can pursue a unilateral trade policy; it can open its borders or close them, regardless of what other countries do. But what a country achieves depends on the actions of others. How can governments get what their constituents want out of the world economy? How do factors abroad, including the policies of other countries, affect the ability of a national government to deliver goods to its people? What is the international political economy of trade?

International economic conditions, for example, have a powerful impact on both the policies a country might like to pursue and their likely effects. The collapse of the world economy in the 1930s drove many countries inward; foreign markets were small and shrinking, and the benefits of openness shrank with them. In contrast, the rapid expansion of world trade since 1945 has given many countries strong incentives to link their economies to dynamic world markets. In addition to global market conditions, the policies of other governments can have an enormous impact: for example, the opening of China and India to world trade has profoundly affected other developed and developing nations. How, then, can we understand the national politics of trade within the broader international context? How does the strategic and institutional environment affect whether countries get what they want from world trade?

Strategic Interaction in International Trade Relations

When governments make national trade policies, they take into account what other governments are likely to do in response. A government that raises tariffs dramatically, for example, might find other countries retaliating with even higher barriers to its exports—so that the benefits to domestic producers sheltered from imports might be canceled out by costs to exporters frozen out of foreign markets. In 1930, for example, the U.S. Congress attempted to provide relief to farmers by raising the tariff on eggs from 8¢ to 10¢ a dozen. This action reduced the already small number of Canadian eggs bought in the United States by 40 percent, from 160,000 to fewer than 100,000. The British imperial trade area (which included Canada) countered by increasing the tariff on eggs to the same 10¢ a dozen, from the previously low 3¢. This move drove down America's very considerable egg exports to Canada by 98 percent, from 11 million to fewer than 200,000. The British-Canadian response meant that American protectionism had backfired.[21]

By the same token, attempts to create regional trading areas such as the European Union or NAFTA, or to affect the international commercial order such as the United States did after World War II, rely on the joint behavior of different nation-states. One government cannot achieve many of its trade-policy goals without considering the actions of other governments. (See "What Shaped Our World?" on p. 320 for a discussion on the evolution of the European Union.)

Two or more governments involved in trade-policy negotiations are engaged in strategic interaction and must take into account the behavior of other governments in trying to do their best. For example, suppose that American farmers decide they would be better off if they had access to Europe's market for farm goods and are willing to reduce American agricultural trade barriers in return. American trade negotiators offer the Europeans a joint reduction of farm trade protection, and the Europeans agree.

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21. Cordell Hull, *The Memoirs of Cordell Hull* (New York: Macmillan, 1948), 355–56.

WHAT SHAPED OUR WORLD?

The Single European Market: From Creation to Crisis and Beyond

In 1945, Europe emerged from the most devastating war in history, a conflict that tore the continent apart. Today, the countries of the European Union (EU) constitute a single market for goods, services, capital, and people, yet opposition to European integration has increased in recent years. How did the single European market emerge from such a troubled past? Why has it become controversial?

Interests European integration was based on the common interests among the states of Western Europe and the United States in the wake of World War II, as all countries looked for a way to rebuild from the war's devastation. At the same time, the Soviet Union had taken advantage of its control of Eastern Europe to install communist regimes. The threats of unrest from within and attack from without created shared interests among the Western European states in security and economic growth. Although these immediate threats dissipated with time, cooperation continued to rest on common interests, particularly the joint gains available through the free flow of goods, money, and people.

Interactions Although common interests are necessary for cooperation, they by no means ensure that cooperation will happen. In the aftermath of war, distrust among the states of Western Europe, particularly toward West Germany, complicated the interaction. The United States played a major role by providing security through the presence of U.S. troops and injecting money through the famous Marshall Plan. The Europeans had to cooperate among themselves to distribute U.S. aid, and this spirit of cooperation continued into the next decade. Given the emerging Cold War competition with the Soviet Union, an early priority of these cooperative efforts was the production of coal and steel, which were vital to both the economic development and the military might of the West.

Institutions From these modest beginnings institutional growth took off. Six original countries moved toward greater integration with the creation of the European Economic Community (EEC) in 1957, a customs union whose members allowed free trade among themselves and imposed a common external tariff on imported goods. However, trade in services remained outside the scope of the EEC, as did many informal barriers to trade in goods, such as product standards and regulatory differences. The next institutional steps created a single European market for goods and services, along with capital and people. Today, the European Union is effectively free of barriers to trade, investment, and migration among its members. And 19 members of the EU share a common currency, the euro, with a common central bank, the European Central Bank (ECB).

Over the past decade, however, European integration has become more controversial. Many countries have political parties that are skeptical about or even opposed to their country's membership in the EU. The most striking demonstration of this was the June 2016 referendum in the United Kingdom in which British voters chose to leave the EU.

Some Europeans feel that their interests are not taken into consideration by EU officials, who are not directly accountable to national political movements. This feeling combines with a loss of confidence in EU institutions, which was intensified by the economic crisis that began in 2008. The eurozone debt crisis, along with an upsurge of immigration from the Middle East and North Africa, fed concerns that the European institutions were inadequate to the task of managing the complex conflicts of interests among and within member states.

The European Union remains a singular achievement—the first time in modern history that a large number of sovereign states have created a truly integrated single market for the movement of goods, capital, and people. Nonetheless, the EU confronts many difficult conflicts of interests that will tax its institutions over the coming decades.

The European single market allows produce from Spain to be sold alongside local produce in France without restrictions.

But the Americans are wary: the Europeans might find hidden ways to maintain their barriers, such as by imposing regulations that apply only to American crops. In fact, some American farmers argue that European bans on the import of genetically modified food, or of meat from animals whose feed contains hormones, are trade barriers in disguise. In other words, the Europeans might find ways to "cheat" on the agreement and gain greater access to the American market without providing anything substantial in return. The Europeans, for their part, have similar concerns: the United States, they fear, will promise them open markets but find devious ways to keep European goods out.

Given this threat, both the United States and the European Union decide not to take the chance, farm trade is not liberalized, and both sides are left worse off than they would have been with an agreement. This scenario is an example of how international trade bargaining problems can resemble a Prisoner's Dilemma (see the "Special Topic" appendix to Chapter 2, on p. 83): both sides would be better off cooperating to reduce trade barriers, but concern that the other side will cheat leads both sides to act noncooperatively, to their common detriment.

This sort of cooperation problem is common in trade relations among countries. To be sure, the logic of comparative advantage discussed earlier implies that countries would maximize their overall economic welfare by unilaterally liberalizing trade. However, governments respond to pressures other than that of the economy as a whole. For this reason, a government's first choice of trade policy is almost never to remove its trade barriers unilaterally; typically, it wants to get concessions from other countries in return for its own.

However, as the example of the Prisoner's Dilemma shows (see Chapter 2), it can be difficult for political actors to arrive at a mutually beneficial accord when there is no way to guarantee that all parties to the agreement will cooperate. Just as in the security relations among countries discussed in Chapters 3–5, in the international trade realm governments that want to collaborate may be hampered by the fear that they will be taken advantage of in an interaction that can have very high stakes. No government can take lightly the possibility that its farmers, companies, or workers might lose money or jobs because the government mismanaged an international trade negotiation. Countries face inherent difficulties in making credible commitments to abide by the terms of trade agreements; as in military matters, this can lead to a breakdown of trust and, eventually, an inability to cooperate.

Strategic problems can also arise when countries try to work out a common approach to a problem, such as which legal rules to use to govern trade. One of the most common difficulties arises when one country accuses another of unfairly subsidizing its exports with grants, loans, and other programs to raise profits artificially. Disputes in world trade often involve accusations that one country's exporters are *dumping* their goods—that is, selling them below the true cost of production in order to drive out competitors. Dumping is widely accepted to be an unfair trading practice, but it is extremely hard to define, let alone measure. Similarly, government subsidies to exporters encounter widespread disapproval. But such subsidies can take many indirect forms (such as regulation of shipping costs, complicated accounting or tax rules, or manipulation of the exchange rate), and there is often no easy way to determine whether, in fact, an actual subsidy is being used. In these cases, even where countries would like to work out their conflicts amicably, there may be serious disagreements about the standards to be used to govern fair trading relations.

For example, one of the longest-standing disputes in world trade has been between the United States and Canada, two countries with generally very friendly relations. Starting in the early 1980s, the U.S. government argued that the Canadian federal and provincial governments, which own most of the country's timber-bearing land, were charging lumber producers artificially low prices to harvest the wood. This would constitute an unfair subsidy to the country's exports of softwood lumber; the Canadians reject the charge. Both countries wanted to maintain their cooperative trade relations, but this cooperation was threatened by conflicting interpretations of trade rules. In these cases of coordination problems, the parties typically want to find a common position or standard but have trouble deciding which one is best.

Overcoming Problems of Strategic Interaction The international politics of trade is full of examples of cooperation and coordination problems; it is also full of attempts to make it easier for governments to overcome these problems. In Chapter 2, we saw that several factors can facilitate cooperation and coordination: small numbers, information, repeated interaction, and linkage politics. These all affect international trade relations.

Small numbers make it easier for governments to monitor each others' behavior; there is likely to be less free riding among small groups of countries than in the world at large. An extreme version of this observation is the theory of *hegemonic stability*, which argues that the existence of a single very powerful nation facilitates the solution of problems of collective action and free riding; the hegemonic power is large and strong enough to be both willing and able to solve these problems for the world as a whole. In economic affairs, this approach argues that when there has been such a hegemonic power over the past two centuries (Great Britain after 1860 and the United States after 1945), trade liberalization was facilitated by the leadership of an overwhelmingly influential world economic power.

Less extreme versions of the approach suggest, more modestly, that smaller numbers of countries—privileged groups (see Chapter 2)—will find it easier to monitor and enforce trade agreements than will very large groups of nations or the world as a whole. Because of the greater ease of monitoring and enforcement, small numbers of countries are more likely to succeed at liberalizing trade.[22] This might help explain why so many trade agreements take the form of regional accords among a few neighboring nations, such as the European Union, NAFTA, and Mercosur.

Small numbers might also help explain why the United States and Canada have often been able to negotiate successfully even in the bitter dispute over softwood lumber, which involved billions of dollars and one of Canada's more important

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22. For a reasoned summary, see David A. Lake, "Leadership, Hegemony, and the International Economy: Naked Emperor or Tattered Monarch with Potential?" *International Studies Quarterly* 37, no. 4 (December 1993): 459–89.

Mercosur began as a regional trade agreement among Argentina, Brazil, Paraguay, and Uruguay in 1991. However, it has not achieved the same level of success in the freer movement of goods, capital, or people as the European Union.

industries. In 1986 and again in 1996, despite long-standing conflict over whether Canada was, in fact, subsidizing its lumber industry, the two countries reached compromise agreements. In the first instance, the United States agreed to reduce its tariff on Canadian imports; in the second instance, Canada agreed to limit its exports to the United States.

Information can also be an important consideration in trade negotiations. Many failures of cooperation are due to fears of hidden actions—such as the fear that one government might use its superior knowledge of its own domestic conditions to take advantage of other governments. In the case of dumping and subsidies, decisions are often made by national bureaucratic agencies about which foreigners may know little.

For example, in 2001 the United States and Canada were unable to negotiate a renewal of the 1996 Softwood Lumber Agreement. Immediately after the agreement expired, the U.S. International Trade Commission and the Department of Commerce found that Canadian lumber was being subsidized, so the United States unilaterally imposed a 27 percent tariff on Canadian imports, triggering a new round of acrimonious conflict. If the Canadians had known about this finding, perhaps they might have reached an agreement with the Americans, but the Canadians did not have access to advance information about the American government's decision. This example suggests that transparency may lead to trade cooperation. It also suggests that establishing some manner by which partners can provide information to one another may facilitate cooperative relations.

Repeated interaction (iteration) between governments on a continuing basis provides a reason to avoid cheating, or even the appearance of cheating. The possibility that the collapse of a current deal might sour future deals can impose a powerful discipline on government behavior and can encourage greater efforts to cooperate. This is especially the case in a trading relationship, which is likely to go on indefinitely. By the same token, governments with a long history of dealing with one another are likely to have more information about each other—and, in good circumstances, more reason to trust one another.

Linking concessions granted in one arena to concessions received in another may also facilitate cooperation on trade. A government that would otherwise be uninterested in negotiating lower barriers in, say, steel might be willing to exchange concessions in steel if its partner gives it concessions in some other industry. Governments can, in other words, trade among trade policies—"giving" in an area they care less about, in return for "getting" in an area they care more about. These exchanges can benefit governments and their citizens. Countries might link agreements in trade (steel for apparel, for example), or they might link agreements in trade with agreements on something else, such as foreign aid or military cooperation.

All these considerations help explain why countries are more likely to have friendly, collaborative trade relations in some circumstances than in others. This is true of pairs or groups of countries: bilateral or regional trade agreements (RTAs) are more likely with smaller numbers, where information about the partners is readily available, where the partners have a long history of interaction, and where trade relations are linked to other economic or noneconomic relations. It may also be true for the world as a whole: when these conditions are met, at least for the leading countries in the international trading system, trade cooperation is more likely. But when there is great uncertainty about the true intentions of some of the major powers (such as Germany and Japan in the 1920s and 1930s), coupled with a real concern for the short term and the absence of a dense network of other relationships among the major powers, international trade cooperation is difficult or impossible.

Because it can be inherently difficult for governments to ensure cooperative trade relations among themselves, they have created international institutions that help overcome the variety of collective action and other strategic problems that have beset international trade relations. International institutions may indeed be the most powerful factor in affecting whether trade relations among countries are collaborative or conflictual. They run the gamut from global organizations, such as the WTO, to regional agreements, such as NAFTA, to bilateral treaties between countries. Most such institutional arrangements have the goal of facilitating trade cooperation among their member states.

International Institutions in International Trade

International organizations represent the principal systematic attempts to bring order to contemporary international trade policy. As we saw in Chapter 2, institutions can play an important part by providing a setting within which cooperation is facilitated. They can help mitigate all the problems that stand in the way of interstate cooperation on trade. Institutions can set standards of behavior that governments are expected to follow. They can gather information to assist member states in monitoring and enforcing compliance with their agreements. By providing an expectation of repeated interaction, they can restrain defection. International institutions can reduce the costs to governments of making joint decisions—a real problem in the very complex trade realm—and can help governments resolve disputes.

For all these reasons, over the years countries have developed institutional arrangements to facilitate their trade negotiations. One is the concept of **reciprocity**, by which a concession granted by one government is met by another—a sort of linkage politics that helps bind agreements. A more general provision of this nature has developed over the course of more than 100 years to serve a similar purpose: **most-favored nation (MFN) status**. Countries that grant one another MFN status agree to extend to each other the same concessions that they provide to all other nations with that status; for example, a tariff reduction given to one country is automatically given to all countries with MFN status. This system, called normal trade relations in the United States, serves to link negotiations between two countries to all their multilateral trade relations.

reciprocity
In international trade relations, a mutual agreement to lower tariffs and other barriers to trade. Reciprocity involves an implicit or explicit arrangement for one government to exchange trade-policy concessions with another.

most-favored nation (MFN) status
A status established by most modern trade agreements guaranteeing that the signatories will extend to each other any favorable trading terms offered in agreements with third parties.

The World Trade Organization The most important international institution in commercial relations has a global reach: the **World Trade Organization (WTO)**, which succeeded the **General Agreement on Tariffs and Trade (GATT)**. The GATT was created in 1947 as one of the original Bretton Woods institutions, and it oversaw a dramatic liberalization of trade relations, in particular among developed countries, for more than 40 years.[23] By the early 1990s, GATT members had come to believe that the GATT's somewhat loose structure was insufficient in an environment in which almost all countries—developed, developing, and formerly centrally planned—were joining the international trading system. The WTO, which opened its doors in 1995, is more structured, more formal, and more encompassing than the GATT, although its goal is very similar: to encourage the expansion of an open international trading system.

World Trade Organization (WTO)
An institution created in 1995 to succeed the GATT and to govern international trade relations. The WTO encourages and polices the multilateral reduction of barriers to trade, and it oversees the resolution of trade disputes.

Both the GATT and the WTO have been enormously successful in their stated purpose of reducing barriers to trade among member nations, with world trade growing faster than world output for virtually all the postwar period. The principal achievement of both organizations has been to arrange a series of "rounds" during which member states negotiate multilateral reductions in trade barriers. The negotiations take place under a loose rule of reciprocity that balances the dollar value of concessions, which are then automatically extended to all other member states under the MFN rule. There are also rules about when and how countries can use safeguards to temporarily protect domestic industries.

General Agreement on Tariffs and Trade (GATT)
An international institution created in 1947 in which member countries committed to reduce barriers to trade and to provide similar trading conditions to all other members. In 1995, the GATT was replaced by the WTO.

Although all members of the WTO have a formally equal vote, in practice the negotiations are dominated by the largest trading states—in particular, the United States, the European Union (which negotiates as a single actor in the WTO), and

23. To be entirely accurate, the original Bretton Woods institution for trade was to be an "International Trade Organization," but it foundered and was never created; the GATT was an interim replacement that lasted far longer than its initiators expected.

Japan. The power of the largest members comes in part from their ability to set the agenda for negotiations. Their power also flows from the fact that they have more attractive outside options: they can more easily contemplate “going it alone” without the WTO. For all these reasons, developing countries have found it difficult to get their concerns onto the international trade agenda.

Conflicts between developed and developing nations have pervaded the most recent series of WTO negotiations, the Doha Round, which began with a meeting in Doha, Qatar, in 2001. Developing nations have accused the rich world of ignoring their concerns. Their principal demand has been for the liberalization of agricultural trade, as many developing countries would benefit from greater access to rich-country markets for food. Such liberalization has been blocked, however, by politically powerful farmers in the developed countries. For their part, developed countries would like greater liberalization of trade in services—most developed countries are major exporters of such services as finance and telecommunications—and stricter rules to protect intellectual property. The Doha Round has been stalled for many years, and there are widespread fears that it may never be completed.

The Doha Round has been a disappointment, and unequal power among countries has been a source of conflict; nonetheless, most WTO member states accept that the WTO, like the GATT before it, facilitates international cooperation: it helps to set standards of behavior, to verify compliance, to ease joint decision making, and to resolve disputes. The WTO makes available a great deal of information about trade and trade policies, including monitoring national compliance with international agreements.

The WTO monitors a country’s compliance in two primary ways. First, members must report actions taken to restrict trade, as well as any RTAs they may enter into

Although the WTO has lowered barriers to international trade, it has often provoked opposition from actors whose interests may be harmed by trade liberalization. The 2009 demonstrations against the WTO in Geneva turned violent as angry protesters torched cars.

(such as NAFTA). Second, countries that believe that foreign exporters or importers are not complying with the rules can file a complaint with the WTO. Complaints are referred to the Dispute Settlement Body, composed of all member states, which then appoints a panel of experts in consultation with all parties to the dispute. The panel investigates the alleged rule violation and issues a report that becomes a ruling within 60 days. Each side can appeal (but not block) the ruling to the WTO's standing seven-member Appellate Body. If not overturned, the ruling becomes binding. A country held to be in violation of WTO rules must bring its policy into conformity with the rules; if it does not, it is subject to sanctions authorized by the organization itself.

However, Donald Trump was highly critical of the WTO and other trade agreements and institutions in his presidential campaign, and the Trump administration has expressed a desire to renegotiate American involvement in these organizations. This position is unpopular with most of the country's trading partners and has led to fears that the international trading regime might begin to unravel, since the United States has typically been a supporter of the WTO.

As the world's largest trader, the United States is the most frequent defendant at the WTO. The United States has usually abided by WTO rules and rulings, even when the complainant is a small country like Costa Rica that the United States could easily ignore. The reason probably is that previous American administrations believed that the United States was more likely to be a complainant than a target and wanted rulings in its favor to be obeyed, which was less likely to occur if the United States itself did not respect WTO rulings. The Trump administration has indicated that it believes the system has not, in fact, worked in America's best interests, and that it would like to see both the WTO and America's regional trade agreements reworked.

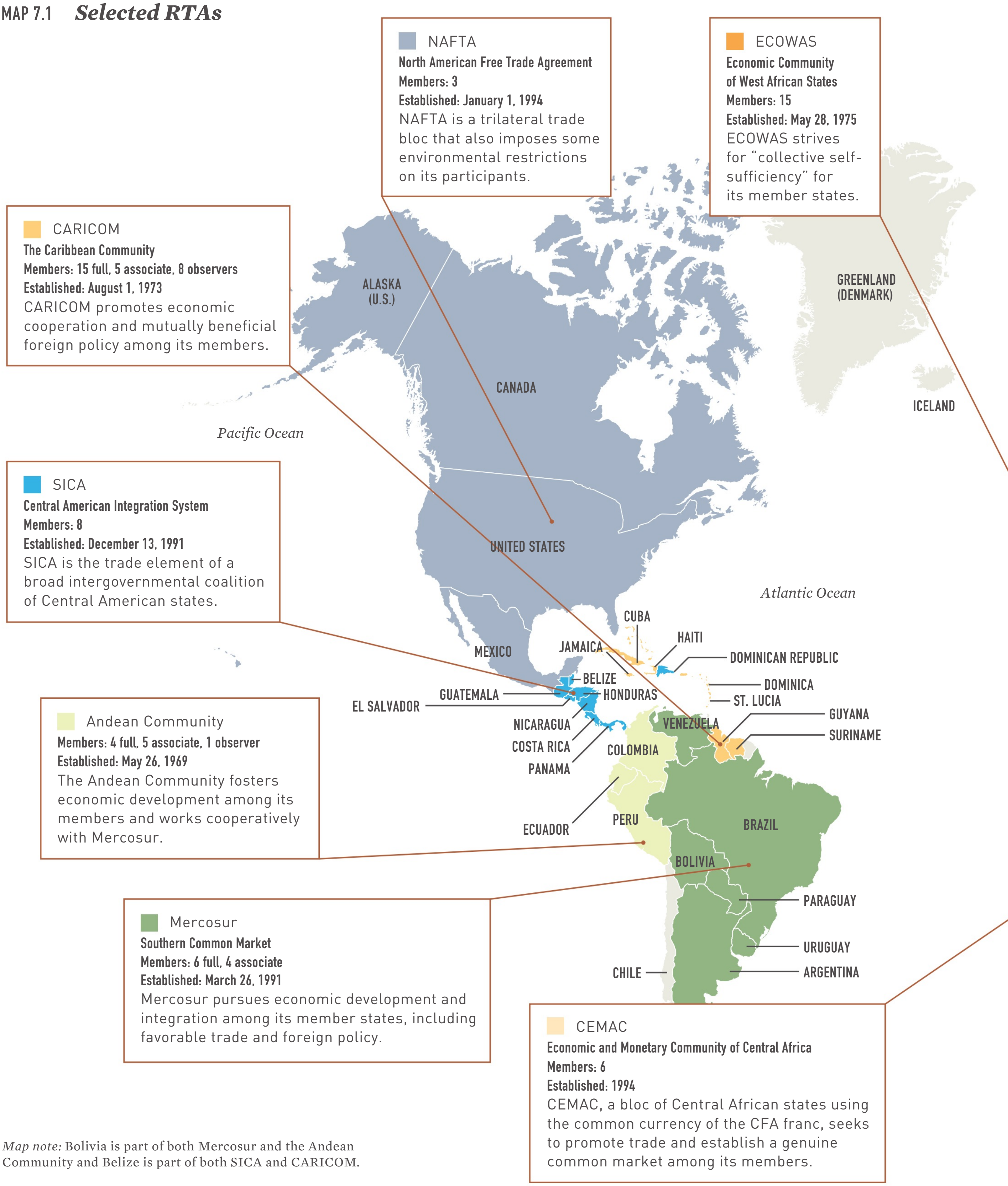
The Trump administration's stance has given rise to concerns in other countries. States usually obey the rules of the WTO because they value the WTO's promotion of an open trading system. Some believe that defiance of WTO rules and decisions, and attempts to restructure America's role in the WTO, would threaten the whole system of trade rules and the gains from trade.

Regional Trade Agreements In addition to the WTO—and perhaps in reaction to some of the concerns about its organization and progress—many similar institutions have arisen at the regional level. In fact, the number and range of **regional trade agreements (RTAs)** has grown very rapidly in the past 20 years, and by 2011 the WTO counted 489 RTAs in force (Map 7.1). The three most prominent are the European Union, which started in 1958 as a customs union of 6 countries and now encompasses 28 nations in a single market; NAFTA, made up of the United States, Canada, and Mexico; and Mercosur, originally comprising Argentina, Brazil, Paraguay, and Uruguay. There are many other such RTAs, of varying size and involving varying degrees of commitment to openness among their members. Many are bilateral, involving only two countries; others involve dozens of countries.[24]

regional trade agreements (RTAs)
Agreements among three or more countries in a region to reduce barriers to trade among themselves.

24. For more information on RTAs, see the WTO's RTA website at www.wto.org/english/tratop_e/region_e/region_e.htm (accessed 01/02/12).

MAP 7.1 ***Selected RTAs***



Map note: Bolivia is part of both Mercosur and the Andean Community and Belize is part of both SICA and CARICOM.

EU
European Union
Members: 28
Established: November 1, 1993
EU, which has roots in the European Common Market established in 1958, is a political and economic body that maintains a single market among member states.

EurAsEC
Eurasian Economic Community
Members: 6 full, 3 observers
Established: March 29, 1996
EurAsEC promotes regional cooperation and seeks to institute a common market.

ASEAN
Association of Southeast Asian Nations
Members: 10
Established: August 8, 1967
ASEAN, a regional political and economic organization, promotes economic and cultural development and regional stability.

SAARC
South Asian Association for Regional Cooperation
Members: 8
Established: December 8, 1985
SAARC promotes regional cooperation and bettering the quality of life in the region through economic and cultural development.

PARTA
Pacific Islands Forum
Members: 16 full, 3 associate, 5 observer
Established: 1971
PARTA promotes regional cooperation and represents its members' interests in the world economy.

SACU
Southern African Customs Union
Members: 5
Established: December 11, 1969
SACU, the world's oldest customs union, ensures the free interchange of goods among its member states.

EAC
East African Community
Members: 5
Established: 1967, collapsed 1977, reestablished July 7, 2000
EAC strives to establish a single market with a common currency, or even to federalize its member states into a single state, the East African Federation.

GCC
Cooperation Council for the Arab States of the Gulf (Gulf Cooperation Council)
Members: 6
Established: May 25, 1981
GCC encourages aligned and mutually beneficial economic and social policy, fosters scientific and technical research and innovation, and seeks to establish a common currency for its members.

Some observers applaud these regional agreements, arguing that they, like the WTO, constitute institutional structures that help mediate or avoid divisive trade-policy conflicts among countries. Others see them more negatively, believing that they may serve to limit trade with nonmembers. In the words of economist Robert Lawrence, the question is whether the RTAs will be "building blocks" or "stumbling blocks" on the road to an integrated world economy.[25] While questions remain, most observers today regard such regional institutions as complementary to the WTO.

To state that the WTO (or the European Union or NAFTA) facilitates cooperation among governments on trade policy is not to pass judgment on whether its actions are good or bad—ethically, economically, or otherwise. Governments may cooperate for purposes that leave some consumers, workers, or businesses worse off. Antiglobalization critics complain that the WTO is too pro-business, that it privileges international corporations over other interests. Those on the left often charge that WTO rules and procedures are biased, especially in their disregard for environmental, health and safety, labor, and social policies. Indeed, WTO rules do tend to focus on trade itself and exclude consideration of other concerns that many analysts regard as important.

Other critics of globalization, such as Donald Trump, argue that the WTO and organizations like it—such as NAFTA—do not serve American interests. Nonetheless, the most common view around the world remains that cooperation among governments is preferable to conflict among them, and that the international institutions of trade contribute to this cooperation.

Explaining Trends and Patterns in International Trade

We can now return to some of the questions about international trade relations with which we began, bringing together what we have learned from the preceding sections to try to explain them. Let's recall the major ways in which trade policies vary.

Why, within a Country, Are Some Industries Protected and Some Not?

Governments often favor some industries over others, some regions over others, some groups over others—and this is certainly true of trade policy. Perhaps the most striking such difference is that virtually all developed countries protect agriculture, whereas they have relatively open trade in manufactured products. Why are U.S. farmers (in particular, its sugar producers) strongly protected, while so many other producers are not?

25. Robert Z. Lawrence, "Emerging Regional Arrangements: Building Blocks or Stumbling Blocks?" in *Finance and the International Economy*, vol. 5, *The AMEX Bank Review Prize Essays*, ed. Richard O'Brien, 25–35 (New York: Oxford University Press, 1991).

We can look at the actors involved and their interests to determine which groups or industries are most likely to benefit from protection. Land is scarce in most developed countries, certainly relative to capital and skilled labor; this explains why their farmers are protectionist. We can then explore how well the actors are able to overcome their collective action problems; the more cohesive and powerful interests are likely to get more government support. Farmers are well organized, whereas consumers of food are rarely organized at all. Perhaps the country's political institutions are biased for or against some regions, classes, or industries. Many nations' electoral institutions favor farm regions over cities, as does the U.S. Senate, which allots a sparsely populated farm state the same number of senators (two) as a densely populated, mostly urban state. Farmers and their parties are often pivotal in parliamentary systems, as they occupy the crucial center of the political spectrum.

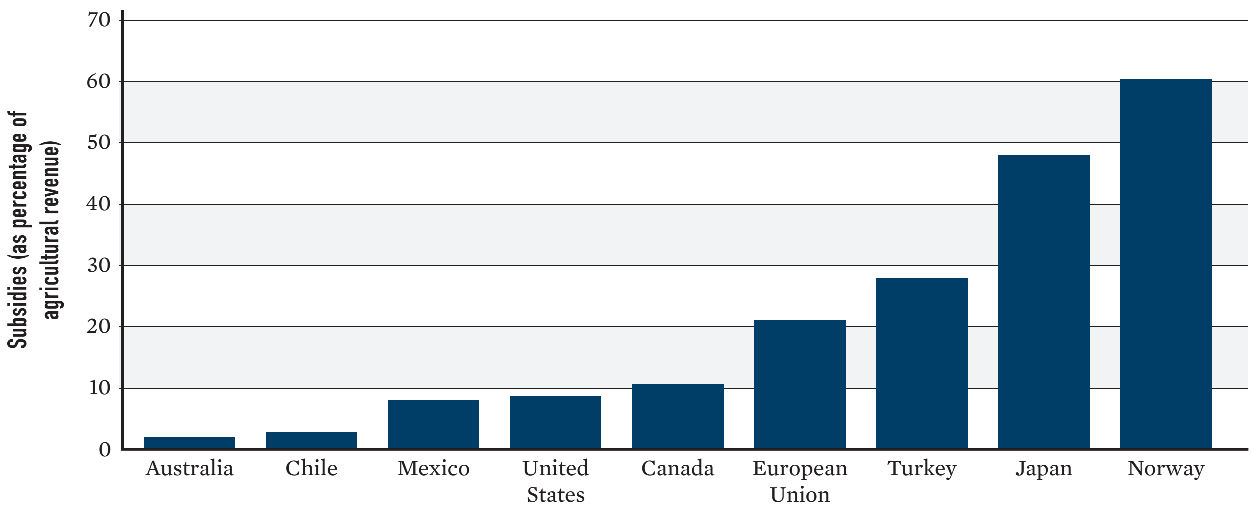
All these considerations help explain why some sectors receive more trade protection than others and, in particular, why farmers in rich countries are so commonly favored. In the case of American sugar producers, they have very high stakes in protection—the country's sugar farms might shut down without it—and their numbers are small enough to be extremely well organized and well represented in Congress. Figure 7.2 shows selected examples reflecting the protection of farmers in various countries.

Why Have National Trade Policies Varied over Time?

There have been many striking instances of countries shifting from openness to closure or from protectionism to trade liberalization. The United States in the 1920s was one of the most protectionist industrial nations on earth; starting after 1945, however, it led the Western world toward substantial trade liberalization. More recently, the Trump administration has shown itself to be sympathetic to higher levels of trade protection (see "Controversy" on p. 332). How can we explain such shifts?

Figure source: OECD, Producer and Consumer Support Estimates, www.oecd.org/unitedstates/producerandconsumersupportestimatesdatabase.htm#tables (accessed 09/07/17).

FIGURE 7.2 ***Agricultural Subsidies in Selected Countries, 2016***



CONTROVERSY

What Should Be Done When International Trade Harms Workers?

The 2016 American presidential election may have been the most anti-trade election campaign in the United States since the 1930s. Democratic candidate Bernie Sanders claimed that “trade is . . . a significant reason why Americans are working longer hours for low wages and why we are seeing our jobs go to China and other low-wage countries.”[a] Republican Donald Trump expressed similar views, calling NAFTA “the worst trade deal in history” and arguing that “China’s entrance into the World Trade Organization . . . enabled the greatest job theft in the history of our country.”[b]

Such views are hardly unique to the United States. In the United Kingdom, many Britons voted to leave the European Union in June 2016, in part because of the EU’s perceived impact on British workers. Elsewhere in the European Union, many trade union leaders oppose new international trade deals, such as one negotiated with Canada in 2017, because they believed it could threaten labor rights. What should be done when workers are hurt by international trade?

→ **Applying the Concepts**

Trade policy often divides actors in society: while some powerful groups have a strong **interest** in international trade and its benefits, there are many others who are harmed by foreign competition. These groups’ domestic **interactions** have recently become especially bitter. The precise nature of the interactions often depends on the **institutions** that determine whether policy is made by the legislature, the bureaucracy, the executive, or—in the case of the European Union—by European institutions.

In Europe, the United States, and other countries, many workers have been hurt by trade competition. One influential study found that regions of the United States more exposed to imports from China experienced higher unemployment, lower wages, and more political polarization than other regions.[c] But we also know that many people, including many American workers, have an interest in maintaining or expanding trade. A government study found that exports created nearly 12 million American jobs in 2015.[d] So, this topic pits those with an interest in trade against those who are hurt by it.

How should a society weigh the positive effects of trade on some workers against the negative effects on others? These issues have informed political battles between supporters and opponents of trade in many different political arenas. Usually these interactions are limited to legislative or bureaucratic battles among special interests, largely out of the public eye. However, the economic crisis that began in 2008 heightened concerns about job losses in manufacturing due to import competition. Politicians responded to these concerns: those in areas more affected by imports became more protectionist—or they lost elections.[e]

Amid a broader backlash against globalization in advanced industrial countries, opposition to trade became a prominent issue in the 2016 American presidential race. Many of the communities most harmed by trade are in the American “rust belt”—industrial states of the Midwest, which also happen to be crucial swing states in most presidential elections. The general unpopularity of trade in these states contributed to Donald Trump’s presidential

British member of Parliament Boris Johnson encouraged voters to support Brexit as a means for the United Kingdom to take back control of its trade policy.

In the 2016 U.S. presidential election, Donald Trump mobilized supporters in rust-belt states with a "Buy American, Hire American" platform.

victory and seemed to presage a more protectionist foreign economic policy in the United States.

However, in the United States the institutional separation of powers means that trade policy is determined not only by the president, but also by Congress and by such other trade-policy institutions as the International Trade Commission. Although President Trump promised higher trade barriers, individual members of Congress have powerful, perhaps competing incentives to represent their constituents. Rust-belt swing states may be especially important in a presidential election season, but in the making of trade policy, representatives from other states attempt to protect their own constituents—whether that means endorsing trade protection or opposing it.

Institutions have a significant influence on trade policy in other countries as well. One of the sources of British discontent with the European Union was that trade policy was being made by European, not British, institutions—within which the United Kingdom was only one among many actors.

Some analysts suggest an alternative to making the difficult choice between winners and losers from trade. If trade makes a country as a whole better off—as most economists believe—then the government should tax the winnings of the beneficiaries and use the revenue to compensate the victims. In this way, the country gains from trade, while those individuals and regions that are hurt are helped to overcome its negative effects.

This *Pareto improvement* makes theoretical sense, but in practice it is very difficult to overcome conflicts of interest mobilized by trade. In the United States, these conflicts have typically led to political polarization. But other countries, in particular some in northern Europe, have developed strong social and public institutions that address these concerns. These governments provide support for workers hurt by trade, such as retraining programs and assistance finding new jobs, which seems to limit political conflict. American politicians and voters have not typically supported these more active government responses to the social effects of trade. Perhaps, however, they will be a more prominent part of the political agenda as conflicts over the country's trade relations continue.

Thinking Analytically

1. Why does international trade benefit some groups within a country more than others? Which groups tend to have an interest in protectionism? And which tend to have an interest in freer trade?
2. In what way do programs that mitigate the negative impacts of trade create a Pareto improvement? Why do you think there is relatively little support for such programs in the United States?

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a. "Bernie Sanders on Free Trade," OnTheIssues, www.ontheissues.org/2016/Bernie_Sanders_Free_Trade.htm (accessed 07/24/17).

b. "Full Transcript: Donald Trump's Jobs Plan Speech," *Politico*, June 28, 2016, www.politico.com/story/2016/06/full-transcript-trump-job-plan-speech-224891.

c. David Autor, David Dorn, and Gordon Hanson, "The China Syndrome: Local Labor Effects of Import Competition in the United States," *American Economic Review* 103, no. 6 (October 2013): 2121–68; and David Autor, David Dorn, Gordon Hanson, and Kaveh Majlesi, "Importing Political Polarization? The Electoral Consequences of Rising Trade Exposure," December 2016, https://economics.mit.edu/files/11499.

d. Chris Rasmussen and Susan Xu, "Jobs Supported by Export Destination 2015," Department of Commerce, Office of Trade and Economic Analysis, November 8, 2016, http://trade.gov/mas/ian/build/groups/public/@tg_ian/documents/webcontent/tg_ian_005508.pdf.

e. James J. Feigenbaum and Andrew B. Hall, "How Legislators Respond to Localized Economic Shocks," *Journal of Politics* 77, no. 4 (October 2015): 1012–30.

Interests may change; for example, a nation's ability to compete in world markets might improve, giving rise to more actors favorable to trade and reducing the concerns of actors opposed to trade. Institutions may change too: perhaps democratization gives more pro-trade groups, such as consumers, access to political influence and reduces a bias toward protectionist producers. Some such national changes may be driven by changes at the international level that affect the nation in question, such as a dramatic change in the price of its principal export product. The winners and losers from trade policy may change in such a way that affects national policy, as when one factor becomes more abundant or one industrial sector develops powerful export interests. And national political institutions can affect policy by strengthening the hands of groups that want to push policy in a certain direction.

The American experience is an example of how a country's policies can shift from very high levels of trade protection to support for liberalization—and how they might be shifting back. The turn away from protection after World War II was undoubtedly assisted by the wartime destruction of foreign economies: the United States faced very little serious industrial competition, which made it relatively easy for the country to opt for trade liberalization.

As the Cold War began, the geopolitical concerns associated with a desire to bind together a pro-American Western alliance reinforced support for an open Western trading system. At the same time, the rise of powerful American manufacturing industries interested in exporting and in investing overseas increased the range of actors in support of economic integration. This too was encouraged by institutional changes in the making of American trade policy in the 1930s, which gave the generally more trade-friendly president greater influence than the usually relatively protectionist Congress. All these factors and more may have affected American policy.

Why might trade protection have become more popular in the United States since 2000? Interests may have changed or become more intense: the rise of China as a trading power has certainly put major new pressures on many American industries and workers. Institutions play a role as well, since many of those most harmed by trade competition are in swing states in the American Midwest that play a major role in presidential elections. It remains to be seen whether these trends will lead to a thoroughgoing and lasting reorientation of American trade policy, and of the United States' place in the world trading order.

Scholars continue to present arguments and evidence for and against these hypotheses. They may not, in fact, be mutually exclusive. National policy changes may be better explained in some cases by the global context, in others by the domestic interests engaged, and in still others by domestic institutions.

Why Do Some Countries Have Higher Trade Barriers Than Others?

Even within a common international trading system, national policies can differ. In the late 1930s, as the United States and some Western European nations began moving away from trade protection and toward liberalization, most other industrial

Research has shown that democratization in developing countries is often associated with trade liberalization. Bolivia, which transitioned to democracy in the 1980s, has seen a significant increase in its exports of zinc and other mined minerals.

countries—especially Germany, Italy, and Japan—erected extremely high barriers to trade. In the 1980s, China became a global exporting powerhouse while many other developing nations remained very closed to trade.

Again, actors and their interests matter: these differences among nations may be driven by different factor endowments or sectoral features. In line with the Stolper-Samuelson approach, for example, the interests of landowners in two countries might be diametrically opposed: in favor of trade in a land-rich country, opposed to it in a land-poor country. If identical pro-farmer parties were in power in the two nations, one would reduce trade barriers while the other would raise them. A country whose economy is dominated by well-organized exporters will tend to be less protectionist than one that has very few exporters. In today's world, in which major portions of world trade are managed by huge international corporations, the role of individual firms can also have an impact on national trade policies.

The source of these differences, however, might be in national institutions, such as a party system or legislative structures biased in favor of the protectionist class (scarce factor) or protectionist sectors and regions, or—on the other hand—in favor of powerful exporting companies. A democracy might give labor or consumers more influence than a dictatorship would. (See "How Do We Know?" on p. 336 for the connection between democracy and free trade in developing countries.) Anything that affects the domestic interests, institutions, or interactions of a country may well affect its trade policies.

HOW DO WE KNOW?

Why the Move to Free Trade in Developing Countries?

Beginning in the 1980s, many developing countries around the world reduced their barriers to trade and encouraged their producers to sell into global markets. One by one, countries as diverse as the Philippines, Bangladesh, Mexico, and Ghana reduced tariffs on imported manufactured goods and agricultural products and shifted to an export-oriented development strategy. This change puzzled many observers who believed that entrenched special interests would prevent governments in these countries from opening their economies to foreign competition and directing their industries toward foreign markets.

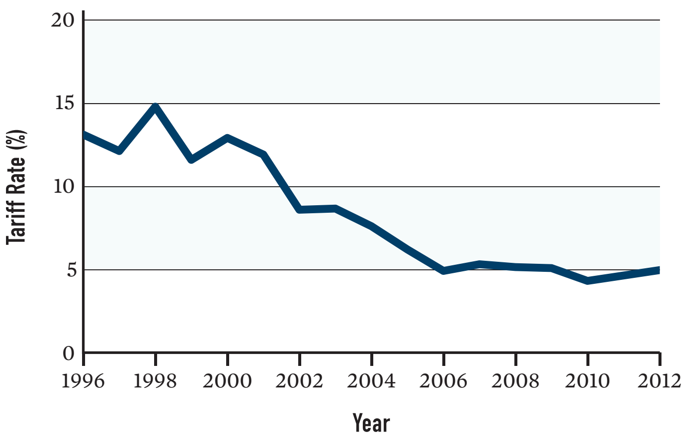
Helen Milner and Keiko Kubota tackled this important puzzle by demonstrating a connection between trade liberalization and democratization.[a] In authoritarian countries in which the majority of citizens cannot vote, many people who would benefit from free trade—such as unskilled workers in a labor-abundant country—are not able to directly influence the government's trade policies. Elites, however, such as owners of scarce capital and land, might have special channels in which to press the government for continued trade protection. Developing countries sustained high average tariff levels through the 1980s, creating a protectionist equilibrium. Milner and Kubota argue that the process of democratization—defined as a movement toward majority rule with universal voting in competitive elections—disturbed this historical equilibrium.

After a country transforms from autocratic rule to democracy, elected leaders must adjust their policies to respond to the preferences of the expanded electorate. Previously disenfranchised groups, including women, unskilled workers, and individuals who do not own land, are suddenly able to assert their preferences and influence trade policy. As the authors note: "Democratic political competition meant that leaders were likely to liberalize trade to appeal to these new groups to ensure their political survival."[b]

Testing this argument was no easy task. First, Milner and Kubota needed to find data on trade policy for a large number of developing countries. Trade-policy data for each country and each year over a long period are difficult to find because there are so many different ways to restrict trade, including tariffs, quotas, regulations, and other tools. The authors settled on two different measures: the average statutory tariff rate (used in Figure A), and a simpler binary indicator that takes the value of 1 (liberalized trade) if a variety of trade restrictions fall below certain thresholds, and 0 otherwise.

Second, the authors had to find a reliable measure of democracy. Here, they used a well-regarded index of democratization, from the Polity Project, that measures whether or not countries have regular competitive elections, universal suffrage, and a number of other indicators. Using these measures and a series of statistical models, the authors found that as countries transition to democratic rule, they are more likely to reduce their trade barriers.

FIGURE A *Average Tariff Rates in Developing Countries*



Source: World Bank, World Development Indicators, https://data.worldbank.org/indicator/TM.TAX.MRCH.WM.AR.ZS?locations=XO (accessed 1/3/18).

a. Helen V. Milner and Keiko Kubota, "Why the Move to Free Trade? Democracy and Trade Policy in Developing Countries," *International Organization* 49, no. 1 (Winter 2005): 107–43.

b. Milner and Kubota, "Why the Move to Free Trade?" 113.

Why Has the World Trading Order Been More or Less Open at Different Times?

Global trends are usually best explained by international factors, and trade is no exception. Three causes of the ebb and flow of open trade relations are most prominent: international economic conditions, the role of one or a few very large countries, and the creation of international institutions. Forbidding world economic conditions in the 1930s were a major source of the protectionist turn of many countries' trade policies, just as global economic growth in the 1990s encouraged trade liberalization among developing and formerly communist countries, while the crisis that began in 2008 led to an upsurge in protectionist sentiment in many nations. The ability of one or a few large countries to organize a leadership role in international trade relations—Britain and France in the late nineteenth century, the United States and its principal allies after World War II—also appears to have been important in affecting global trade, which means that the change in American policies may remake the trading system. The presence of such institutions as the WTO has helped countries overcome some of the problems of cooperation that bedevil international trade relations, encouraging and facilitating collaborative trade ties among governments; current challenges to these institutions may lead to an erosion of these collaborative ties.

Conclusion: Trade and Politics

International trade is the centerpiece of international economic relations, and government policies toward trade have long been among the most hotly contested. They are controversial *within a country*, as supporters and opponents of freer trade clash. Trade policies can also be controversial *among countries*, as governments contend over their respective policies. This contention often breeds further discord; as the American statesman Cordell Hull said of the 1930s: "The political line-up followed the economic line-up."[26]

National policies toward foreign trade have been important to the development of the world economy and to international politics more generally. How open a nation is to trade affects its pattern of economic and social development, as well as its relations with other nations. In turn, a country's trade policies are determined by the nature of its prevailing economic interests and political institutions, and by its interactions with other nations. Today, international trade has become one of the more contentious issues in many nations—including, prominently, the United States—and the future of the international trading system is very much an open question.

26. Quoted in Gardner, *Sterling-Dollar Diplomacy*, 9.

Study Tool Kit

Interests, Interactions, and Institutions in Context

- Economists are virtually unanimous in concluding that international trade brings important benefits and that reducing trade barriers—trade liberalization—is good for a nation's economy.
- While trade may be beneficial for a country as a whole, it can harm the interests of groups and individuals in the society. Trade can create both winners and losers.
- The nature of a country's economy determines which groups have an interest in expanding or restricting trade with the rest of the world. National political institutions shape the outcomes when these interests come into conflict.
- The politics of international trade also involves strategic interaction among national governments. Governments can face difficult problems of bargaining and cooperation, which sometimes lead to trade conflicts among nations.
- The institutions of the international trading system can facilitate cooperation among governments as they confront the demands of both their own constituents and their foreign counterparts.

Key Terms

comparative advantage, p. 298

absolute advantage, p. 298

Heckscher-Ohlin trade theory, p. 299

protectionism, p. 304

trade barriers, p. 304

tariff, p. 304

quantitative restriction (quota), p. 304

nontariff barriers to trade, p. 304

Stolper-Samuelson theorem, p. 309

Ricardo-Viner (specific-factors) model, p. 310

reciprocity, p. 325

most-favored nation (MFN) status, p. 325

World Trade Organization (WTO), p. 325

General Agreement on Tariffs and Trade (GATT), p. 325

regional trade agreements (RTAs), p. 327

For Further Reading

Chase, Kerry. *Trading Blocs: States, Firms, and Regions in the World Economy*. Ann Arbor: University of Michigan Press, 2005. Describes and analyzes why countries decide to form RTAs such as NAFTA and the European Union.

Davis, Christina L. *Why Adjudicate? Enforcing Trade Rules in the WTO*. Princeton, NJ: Princeton University Press, 2012. Analyzes why countries tend to obey the WTO's dispute settlements, and more generally how international institutions contribute to more cooperative trade relations.

Destler, I. M. *American Trade Politics*. 4th ed. Washington, DC: Peterson Institute for International Economics, 2005. Surveys and analyzes the political economy of trade policy in the United States.

Guisinger, Alexandra. *American Opinion on Trade: Preferences without Politics*. Oxford: Oxford University Press, 2017. An innovative look at how to understand the contradictory nature of American public opinion on trade relations, particularly relevant in light of current debates.

Hiscox, Michael. *International Trade and Political Conflict: Commerce, Coalitions, and Mobility*. Princeton, NJ: Princeton University Press, 2002. Evaluates the relative importance of factoral (class) and sectoral (industry) demands for protection and of variation among these considerations over time.

Hoekman, Bernard, and Michel M. Kostecki. *The Political Economy of the World Trading System*. 3rd ed. New York: Oxford University Press, 2009. Comprehensive overview of the structure and functioning of the WTO and international institutions in the international trade arena.

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Rodrik, Dani. *Straight Talk on Trade: Ideas for a Sane World Economy*. Princeton, NJ: Princeton University Press, 2017. A leading economist assesses current debates over world trade, and the best ways policies might address them.

Rogowski, Ronald. *Commerce and Coalitions: How Trade Affects Domestic Political Alignments*. Princeton, NJ: Princeton University Press, 1989. Develops an analysis, based on the Stolper-Samuelson theorem, of how trade affects politics within nations.

SPECIAL TOPIC

Comparative Advantage and the Political Economy of Trade

Economists generally agree that international trade is good for the aggregate welfare of societies. Where does this consensus come from? In this appendix we introduce the concept of comparative advantage, which for centuries has been the backbone of economic thinking on international trade. We also illustrate the redistributive and welfare effects of opening the domestic economy to international trade and the countervailing effects of imposing a tariff.

Comparative Advantage

At the heart of economic analyses of international trade is *comparative advantage*. In short, the idea of comparative advantage implies that all countries benefit from trade if each country specializes in the production of certain goods. Which goods should countries produce? Economist David Ricardo[a] provided the straightforward answer in the early 1800s: countries should focus their production only on goods that they can produce most efficiently relative to other goods. If a country is good at mining copper or growing coffee beans or producing steel, then it should focus its productive capacities on producing these goods and rely on international trade to obtain all the other goods that it needs.

What if a country is not very good at producing anything? To answer this question, it is important to distinguish between *absolute advantage* and comparative advantage. A country has an absolute advantage if it can produce a good more efficiently than any other country. Comparative advantage, on the other hand, is determined within a country: of all the possible goods that a country might produce, it can produce some more efficiently than others. This means that *all* countries have a comparative advantage in something. A country might not be the most efficient in the world at producing coffee, but it still has a comparative advantage in coffee if it can produce coffee more efficiently than steel, airplanes, or any other good.

Consider the following example used by Ricardo himself to explain the concept of comparative advantage. Assume that there are two countries in the world, Portugal and England, and that these two countries can produce only cloth and wine. Further assume that the only input in the production process is labor, such that one unit of each good (a bolt of cloth or a barrel of wine) has a cost in man-hours. For example, in England it takes 15 man-hours to produce a bolt of cloth and 30 man-hours to produce a barrel of wine. In Portugal, it takes 10 man-hours to

a. The idea of comparative advantage—not the term itself—was introduced by David Ricardo in Chapter 7 of his *On the Principles of Political Economy and Taxation*, www.econlib.org/library/Ricardo/ricPCover.html (accessed 01/10/12).

TABLE A.1

COUNTRY	CLOTH	WINE
	Cost in Man-Hours per Bolt	Cost in Man-Hours per Barrel
England	15	30
Portugal	10	15

produce a bolt of cloth and 15 man-hours to produce a barrel of wine. Note that it takes fewer man-hours to produce both cloth and wine in Portugal than in England; indeed, in this example, Portugal has an absolute advantage in the production of both goods, cloth and wine (Table A.1).

To understand the impact of each country's choice of which goods to produce, it is helpful to examine the *opportunity cost of production*. This is the value that a country forgoes in order to make one product rather than another. The resources (in this example, labor) that each nation uses to make cloth are unavailable to make wine, so the country must forgo a certain amount of wine in order to make cloth. How many bolts of cloth must a country give up to produce a barrel of wine, and vice versa?

England must give up two bolts of cloth to produce an additional barrel of wine (30 ÷ 15); alternatively, it can give up a half barrel of wine to produce a bolt of cloth (15 ÷ 30). In contrast, Portugal must give up one and a half bolts of cloth to produce an additional barrel of wine; alternatively, it can give up two-thirds of a barrel of wine to produce an additional bolt of cloth. Table A.2 presents these results.

Note that the opportunity cost of producing cloth is lower in England than in Portugal, whereas the opportunity cost of producing wine is lower in Portugal than in England. From these figures we can conclude that England has a comparative advantage in the production of cloth, and Portugal has a comparative advantage in the production of wine.

What happens if these two countries engage in international trade? If England focuses all its man-hours on producing cloth, and Portugal does the same for wine, then the total world production of cloth and wine will be considerably higher than

TABLE A.2

COUNTRY	OPPORTUNITY COST OF PRODUCING . . .	
	One Bolt of Cloth	One Barrel of Wine
England	$^1/_2$ barrel of wine	2 bolts of cloth
Portugal	$^2/_3$ barrel of wine	$1^1/_2$ bolts of cloth

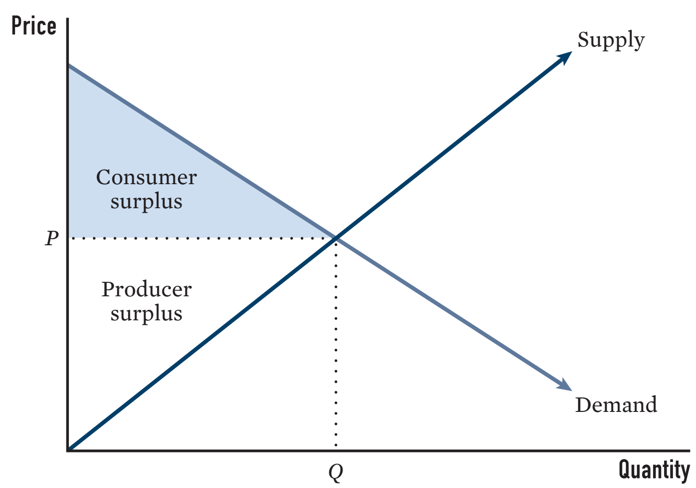
if the two countries did not specialize or engage in trade. Ricardo's simple model tells us that international trade based on comparative advantage increases aggregate welfare, measured by the total amount of goods produced in this two-country world. The increase in aggregate welfare occurs even though England does not have an absolute advantage in the production of either good.

Distributional and Welfare Effects of Trade

Economists largely agree that international trade makes society as a whole better off, whereas tariffs and other forms of trade protection are inefficient and costly for societies. A few simple graphs can illustrate the logic behind these claims. Consider first a country in a state of autarky, in which there is no international trade. The domestic price of any good is therefore determined by the intersection of the two lines of domestic supply and domestic demand. All else being equal, producers will supply more of a good as its price increases, and consumers will demand more of a good as its price falls. Therefore, the supply line slopes upward and the demand line slopes downward. The intersection indicates the good's domestic price (*P*) and quantity demanded (*Q*), as shown in Figure A.1.

The effects of the production of the good in autarky are measured by the concepts of *consumer surplus* and *producer surplus*. Consider first the fate of consumers. The downward-sloping demand line means that the lower the price, the more people demand the good. The shaded region represents the aggregate welfare benefit for consumers; it is called a surplus because it represents the gains to consumers who would be willing to pay more than *P* for the good. Similarly, there are some producers in the country who would happily supply the good at a lower price than *P*. The region beneath *P* and bounded by the two lines represents the producer surplus. This region captures the gains to

FIGURE A.1 ***Autarky***



producers who benefit from a higher price than they would otherwise tolerate for selling the good.

Now consider how the price and quantity of the good change as the country begins to trade freely with other countries. Note that the world price of the good will be lower than the domestic price in autarky. The world price is determined by the intersection of global, not domestic, supply and demand. For simplicity, we assume that the country in this example is small relative to the world economy. In other words, it is a "price taker": its own domestic supply and demand of the good will not appreciably affect global supply or demand.

Figure A.2 indicates that the new domestic price declines to the (lower) world price (P_w) after the country moves from autarky to international trade openness. At this lower price, domestic consumer demand increases to Q_d because more people can enjoy the good at the new lower price. Domestic supply of the good decreases to Q_s because fewer producers are willing to produce the good at the lower price. The larger consumer demand is satisfied by imports from the rest of the world (equal to the distance between Q_s and Q_d).

Note that under free trade, the consumer surplus increases considerably because consumers are better off with the lower price. The regions labeled A and B represent the additions to consumer surplus that result from free trade. The producer surplus declines as a result of the lower world price. However, note that the combination of consumer and producer surplus—an overall measure of aggregate welfare—is larger under free trade than in autarky. There are two important implications: opening to trade redistributes income from producers to consumers, and opening to trade makes society as a whole better off.

As a final exercise, consider the implications to redistribution and to aggregate welfare of a tariff on the good. The tariff—which is a tax by the government on the imported good—increases the domestic price of the good to P_t, as shown in

FIGURE A.2 ***Free Trade***

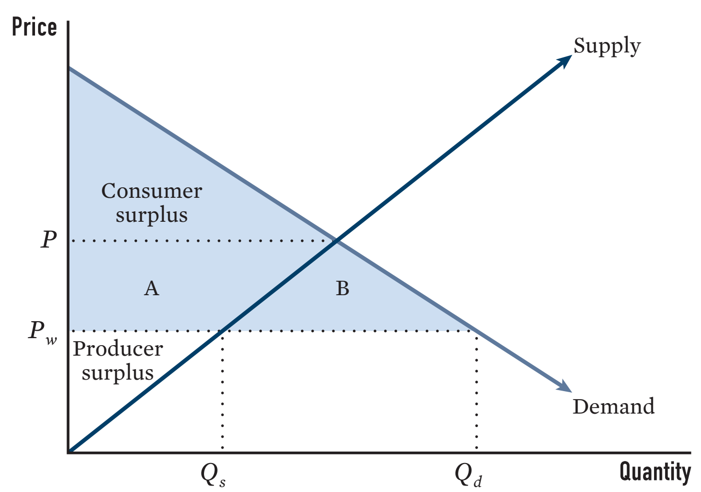


FIGURE A.3 ***Tariff***

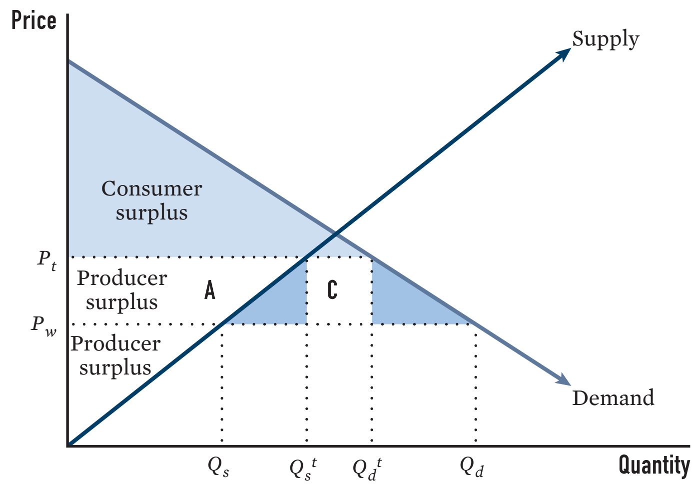


Figure A.3. The quantity demanded by consumers falls to Q_d^t because of the higher price, whereas the quantity supplied by domestic suppliers increases to Q_s^t. As expected, the consumer surplus declines, because many consumers who wish to purchase the good cannot afford the higher price. The producer surplus increases by the amount represented by Region A, as more producers benefit from a higher price than what they would normally receive. What of the remaining regions? The amount represented by Region C accrues to the government as a result of the tariff revenue. But the two dark triangular regions on either side of Region C do not benefit anyone! Known as the *deadweight loss* of the tariff, they represent the efficiency losses that trade protection imposes on society.

Where does the deadweight loss come from? The best way to understand this loss is to reflect on the concept of comparative advantage. The tariff causes an artificially higher price, which leads domestic producers to shift their production away from whatever they were previously producing and toward the higher-priced good. Suppose the country in question is England, which has a comparative advantage in the production of cloth. If England imposes a tariff on imported wine, then more English producers will shift their production away from cloth and toward wine to take advantage of the higher price, even though they are relatively inefficient in producing wine. In other words, a tariff interferes with the efficient allocation of production and works against the concept of comparative advantage.

By the same token, the artificially high price of the protected good leads consumers to reallocate their consumption away from it and toward a good they would not otherwise purchase, which is another loss to society. The losses to efficiency are represented by the dark triangles in Figure A.3. When we combine these efficiency losses with the decline in domestic consumption caused by the higher price, we can see why economists are generally in agreement that tariffs cause society as a whole to be worse off compared to free trade.

This simple set of graphs captures the essence of the political economy of trade policy. First, international trade improves aggregate welfare. However, certain producers who previously produced exclusively for the domestic market can be harmed when the country moves toward free trade. Trade tariffs lead to a decline in aggregate welfare and cause deadweight losses to society. They also result in an increase in the producer surplus and a reduction in the consumer surplus. If producer groups can successfully lobby the government for protection, they can reap great benefits. These benefits come at the expense of consumers, in the form of a reduced consumer surplus (owing to higher prices), and at the expense of the country as a whole, in the form of an efficiency loss.