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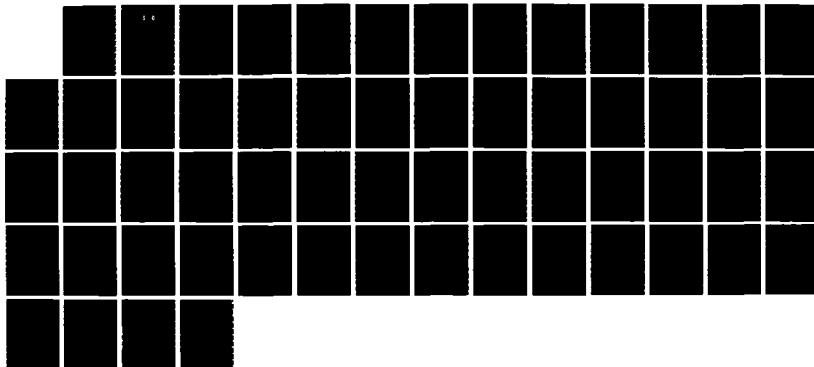
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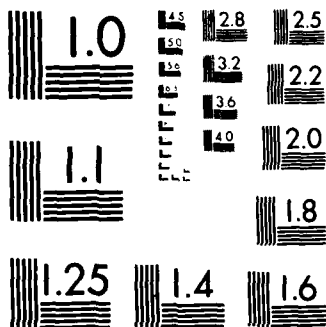
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ANALYSIS OF CONDITIONAL VS. UNCONDITIONAL
MOST FAVORED NATION STATUS

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American Enterprise Institute
and

University of California

July 1986

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EXECUTIVE SUMMARY

As dissatisfaction with the international trading system grows in the United States, the question arises as to how U.S. policy makers might best pursue improvements in the conditions of international trade and related trade policy goals.

Liberal trade, although under attack, is now as before beneficial principally because it ensures that our own productive resources are efficiently deployed, so that national income and wealth may be pushed to their maximum levels. These benefits are, on the whole, available regardless of the policies of other countries. Reciprocity can bring further benefits, and is for this reason worth pursuing, but its absence does not invalidate the case for liberal trade.

Critics of liberal trade assert that market imperfections and distortions invalidate the case for open trade. That argument is incorrect. Market distortions may, however, justify corrective policies; but those policies should in general be domestic regulatory and tax/subsidy policies rather than trade policies, because most market distortions tend to be domestic in origin, in which case trade policy creates new distortions in the process of correcting existing ones.

Strategic trade policy has been advocated when relatively few firms located in a small number of countries compete for world markets. Recent analysis suggests that under certain conditions such policies can tilt market share in favor of domestic firms and capture the benefits of terms of trade improvements and economies of scale. The conditions for success, however, are stringent and the result sensitive to the assumptions, thus precluding generalizable guidelines and rules for legislative and administrative conduct.

Domestic macroeconomic conditions and policies are the major reason for the massive deterioration in the U.S. trade balance. Restrictive trade policies, including those contained in the bill passed recently by the House of Representatives and those being contemplated in the Senate, will do little to improve the trade picture and may make matters worse. Demand-expanding policies abroad will help, but not much. There is simply no escaping the need for better balance in domestic macroeconomic policies.

Unfair foreign trading practices, though not the major cause of our trade deficit, need to be addressed. They include policies and practices that restrict access of Americans to overseas markets, export promotion policies that run counter to comparative advantage, and intellectual property piracy. The GATT mechanism itself needs to be revised, broadened and strengthened.

The policy options for dealing with our grievances against the rest of the world include unilateral, bilateral and multilateral approaches. U. S. practice appears to have been to opt for non-multilateral, conditional approaches in areas where we face elements of comparative disadvantage (as in textiles and apparel, steel, automobiles, machine tools, sugar, and commodity chips) and to

resort to relatively inefficient quantitative remedies (including quotas and voluntary export restraint programs). We continue to press for multilateral solutions within the GATT framework in areas of our comparative advantage (with services and intellectual property the major examples).

Unilateral, bilateral and other preferential arrangements tend to be detrimental to the efficient utilization of resources and hence tend to harm the national interest. This includes their use in trade policy retaliation, unless they succeed in forcing the target country to abandon its unfair trading practices. Further, when policy action must be taken, perhaps for political imperatives, trade policy is almost invariably inferior to a variety of domestic policies and tends to inflict more damage to the economy than is necessary in order to achieve the given policy objective.

Free trade areas represent a particular type of preferential, discriminatory policy which carries a high risk of net trade diversion. Moreover, preference areas focused on the removal of border restrictions run the risk that domestic support programs will negate the gains from trade liberalization.

Adjustment assistance as an element of trade policy is receiving renewed attention. Existing programs as well as recent proposals for revisions are flawed in various ways. Limiting assistance to workers imperiled by foreign but not domestic competitive challenges makes no economic sense and targeting tariffs, auctioned quotas, and user fees on imports as sources for funding adjustment assistance is an invitation for trouble. If adjustment assistance is justified, it is because market distortions prevent socially desirable redeployments of productive resources, in which case the initial cause of the competitive disturbance is irrelevant. And if adjustment assistance is socially desirable, then it is appropriately funded from general revenue sources which do not encumber future efforts at trade liberalization.



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ANALYSIS OF CONDITIONAL VS. UNCONDITIONAL MOST FAVORED NATION STATUS

I. Introduction

Public interest in international trade ebbs and flows, declining when economic growth is strong and surging during periods of economic distress. It has been on a rising tide in the 1980s, pushed by the steady and massive deterioration of the U.S. trade balance and the decline in competitiveness brought on by the soaring U.S. dollar.

The current interest in trade issues, however, is more than merely cyclical and therefore bound to survive an improvement in the overall trade balance. A fundamental reappraisal is underway in America of the international trading system and of the country's role in it. This reappraisal comes with the decline of America's hegemonic position in the world economy and with the rise around the globe of new competitors and of new competitive challenges.¹

The broad support once enjoyed by the liberal approach to trade seems to have weakened, along with confidence in the trading system and in the efficacy of the rules and procedures of the General Agreement on Tariffs and Trade (GATT). Indeed, the principles of non-discrimination and market orientation, upon which the post-war system has been based, are under scrutiny. The success of Japan in particular, perceived to be due to heavy government direction of

industrial development and to protected domestic markets, has been most disturbing to Americans, many of whom have begun to question not only free trade but the market-determined industrial structure of the United States.²

Dissatisfaction with the rules of the game derives from the perception that the playing field of international trade is tilted against the United States and that other countries are drawing unwarranted benefits from unfair trading practices. GATT has come under mounting fire, partly because its focus appears to be on manufacturing trade to the exclusion of trade in agriculture and in services and of issues involving intellectual property rights and international investment, and partly because its success in reducing tariff barriers has been marred by the proliferation of non-tariff restraints to trade. And, finally, a dispute settlements process under GATT that tends to be protracted and inconclusive adds to the frustration and to the perception of a system that cannot cope.

Together these grievances provide considerable impetus to the search for new approaches to trade policy. Whereas the post-war approach has been strongly multilateral in orientation and based upon the idea of non-discrimination embodied in the unconditional most-favored-nation principle, some of the alternatives would abandon non-discrimination in favor of concessions based on reciprocity, thereby converting the system into one of multiple preference areas.

An avowed objective of this appraisal is to solve the free-rider problem in international trade by which some countries benefit from trade liberalization while protecting their domestic

markets from imports. But the two approaches are based on fundamentally different principles, with the former accepting the notion that unilateral liberal trade is beneficial for a country and the latter seeing trade liberalization as a cost that must be offset by reciprocation.

The tension between the two views is evident in the ongoing policy debate, and the drift of U.S. policy toward the conditional approach is evident in many recent trade actions and initiatives, including textiles, steel, automobiles, the Israel-U.S. free trade area and ongoing discussions with Canada on bilateral trade liberalization.

The object of this study is to examine the nature and implications of conditional vs. unconditional most favored nation approaches to trade and trade policy. The basis and justification for unilateral free trade are reviewed in Section II with a focus on the sources of welfare gains and losses. Complications due to market imperfections and distortions are considered and alternative policies for dealing with them evaluated. Section III then examines the major U.S. grievances concerning trade and the trading system, while Section IV recaps the options available to the United States in terms of unilateral, plurilateral and multilateral approaches. A brief concluding section follows.

II. LIBERAL VS. MANAGED TRADE: AN OVERVIEW

The Free Trade Ideal

The idea of free trade is impatiently brushed aside by many as nice in theory but irrelevant in practice. The ability of

unilateral free trade to enhance national income and wealth is either denied outright or deemed not to be worth the perceived costs--unless they are offset by reciprocal liberalization abroad.

The idea of open, non-discriminatory trade, the cornerstone of postwar U.S. trade policy, is simplicity itself. By offering equal access to all competitors, such a system ensures that domestic resources are put to their most effective and productive uses, so that national income and wealth may be maximized. When markets are open to all competitors, the low-cost producers will tend to dominate, supplying goods at least cost and thereby enabling consumers to stretch the purchasing power of their incomes. Since it is the efficient use of domestic resources that is at stake, the attendant welfare gains are independent of how other countries chose to arrange their economies, although free trade abroad brings further benefits. The case for unilateral free trade, in other words, rests simply on its contribution to domestic allocative efficiency and its contribution to overall welfare. Since the critics of free trade rarely dispute this point, the reasons for their objections must be sought elsewhere.

The traditional case for open trade is most compelling in the context of a competitive market economy that is free of distortions and imperfections. Then, market forces automatically bring about resource deployments whose efficiency cannot be improved and whose rearrangement must necessarily make someone worse off.³

It is its assumption of perfect competition that has brought the free trade paradigm the image of a theoretical nicety with little relevance to practice and politics. There is no denying that

imperfections and distortions of the kind found in many real world markets create major problems, but they do not automatically invalidate the case for free trade. And where they justify government intervention, it is rarely trade intervention.

Trade Policy When Markets are Imperfect

Sometimes markets violate the ideal of perfect competition due to the presence of private monopoly, economies of scale, externalities, public goods and government policies themselves. When that happens, the private and social costs and benefits of economic activities diverge, so that those activities may take place at levels that are not optimal from society's perspective. Private costs are the costs that accrue to those who undertake and pay for an activity, be it production or consumption, and private benefits are likewise the benefits that accrue to those who pay for the activities.

But such activities may involve additional costs, such as the destruction of the environment, which are borne by others; or they may involve additional benefits, such as those associated with education and research and development, which accrue to others. Market participants make production and consumption decisions by evaluating the costs and benefits that accrue to them without reference to the additional costs and benefits that may accrue to others. Consequently, those decisions may generate levels of production and consumption at which private but not public costs and benefits are equalized. The purpose of government intervention in these instances is to restore the coincidence of private and public

costs and benefits and thereby to bring about levels of production and consumption that better reflect the underlying public costs and benefits.

Defense and national security are often used to justify government support of strategic or essential industries. It is an argument based on distortions associated with a public good. Products possessing national security attributes provide benefits in addition to the benefits that accrue to those who pay for them, but private markets have no way of charging the indirect beneficiaries for the national security services they receive. Hence, private markets are likely to underproduce commodities of this kind. In such cases, production subsidies may be needed to correct the market's tendency to undersupply such products.

Environmental degradation is an example of an externality at work. Private producers will tend to overproduce a commodity whose production pollutes the environment if they are not responsible for environmental restoration: the private costs of such an activity will be less than the social and more of the product will be supplied than is warranted by comparison of social costs and benefits. Environmental regulation or a production tax are means of bringing the private and social costs and benefits into better balance.

Economies of scale may also distort resource allocation. Too many firms in an industry may prevent the exploitation of scale economies and thus generate average prices that are higher than necessary. On the other hand, when a single firm captures scale economies, the monopoly powers thereby provided may lead it to

prevent potentially more efficient producers from entering the market. There is nothing inherent in private markets that will automatically generate the socially optimal number of firms and the optimal level of industry output.

Research and development as well as manpower training programs often yield benefits to society that go beyond those reaped by the firms who incur the costs. But if firms are limited in their ability to appropriate the benefits from R&D expenditures and from on-the-job training before competitors copy their products or hire away their newly-trained workers, they will tend to undersupply R&D and job training. R&D subsidies and public manpower training programs may then be needed to bring the supply of both to levels more consistent with underlying benefits and costs.

The Basic Policy Rule

The distortions described thus far have one attribute in common, namely, that they are essentially domestic in nature. The broad policy rule in such cases is that domestic distortions are best corrected by domestic rather than trade policy in order to minimize undesirable side effects. The objective is to aim intervention as precisely as possible at the source of the distortion in order to correct it without disturbing the rest of the system. If that distortion is on the supply side of a market, so that the given output level does not properly reflect the underlying costs to the economy, then a production tax or subsidy would work directly on output while a tariff would introduce a distortion in consumption by raising the price charged to users relative to the world price. Thus, in the case of trade policy the removal of a

distortion in production would be achieved at the cost of a new distortion in consumption, so that the net welfare effect of the intervention may be negative rather than positive.

The national security argument serves as a case in point. Suppose that some commodity, which we may assume for simplicity to be traded at a given world price, possesses national security attributes and that the economically optimal level of output exceeds actual output. A production subsidy as well as an import tariff will raise domestic production of the commodity and reduce imports, but the tariff raises its price relative to the world price, while the subsidy does not. Consequently, American users of the product must pay more for it than their foreign competitors. If the product is an important industrial input, used by American exporters as well as by producers competing with imports, the competitive strength of both is impaired by the tariff, but not by the production subsidy. This makes the subsidy a superior policy for achieving the original objective of raising domestic production to levels more consistent with national security objectives.

The basic policy rule is clear: intervention must be aimed as directly as possible at the source of the distortion in order to avoid the introduction of new distortions. When market imperfections are domestic in origin, domestic rather than trade policies are the best remedies. A production tax or subsidy aimed at a distortion in production is superior to a trade action because it corrects the existing distortion without creating new ones. Similar reasoning makes a consumption tax or subsidy aimed at a distortion in consumption a better remedy than trade intervention.⁴

Implementation of that rule is not always easy, and inappropriate intervention may worsen rather than improve the situation. Operationally, government must have the ability to identify the nature of a distortion and then fashion effective remedies, something that is not easy even under the best of circumstances. Intervention may, for example, require production subsidies to be given to selected firms or industries for reasons based on externalities, economies of scale, and the like present in their operation, while others do not need assistance. In such circumstances, politicians may find it very difficult to resist pressures to expand the list of beneficiaries, and if they succumb they increase the likelihood that intervention will compound rather than reduce market inefficiencies and distortions.

Sometimes the policy objective is not to improve the allocative efficiency of the domestic economy, but to correct glaring inequalities in income distribution or to prevent large changes in that distribution.⁵ The rule for effective policy intervention is once again simple and straightforward: domestic tax/subsidy combinations are a more efficient, less destructive means of achieving such distributive objectives than trade policy for reasons that are analogous to those examined above. The distributive case does, however, provide an important insight into the politics of policy making. Income subsidies, whether to farmers or textile workers, have the appearance of welfare payments that carry social stigma in the United States as well as elsewhere in the industrialized world. They are disliked by recipients for this reason, which explains why farmers prefer price supports to income

subsidies and textile workers tariffs, quotas, and international fiber arrangements to income subsidies. Such policies hide the fact that a welfare payment is being made and may thus muster political support where an outright subsidy would not, but they are also more costly and less efficient from society's point of view.

Strategic Trade Policy

But what about industries that are imperfectly competitive not only domestically but on a global scale, with a small number of large firms competing in the world market? In this environment government intervention can in theory play a strategic role in influencing the global size of an industry and the location of that industry's firms.⁶ By helping domestic firms in their efforts to capture scale economies, government policy can make room for domestic firms by bumping foreign firms. The criteria for successful intervention are complex and case-specific and require a great deal of policy fine-tuning by the executive and legislative branches of government. The ability of democratically elected governments to carry out such complex industrial and trade strategies is very much in doubt. On the other hand, the fact that some countries, notably Japan, are perceived as successful practitioners of such intervention, places pressures on the U.S. government to either get into the act or see to it that global rules of conduct are established for regulating trade in strategic commodities. We return to this issue below.

Adjustment Assistance

A characteristic feature of traditional trade theory is its concern with the implications for national welfare of alternative trade policy regimes. The concern is with the effects of policies on national income, output, and wealth, leaving conflicts about the internal distribution of income and wealth to be solved by the political process. The traditional model further assumes that full employment is assured, either because markets function efficiently, with flexible wages and mobile labor, or because macroeconomic policy brings it about. The real world, however, is often a very different place, where price and wage rigidities and resource immobility limit the system's capacity to adjust, especially in the short run. Wages may be fixed by law (as in the minimum wage case) or by contract and cannot, therefore, be instantaneously reduced. Worker mobility may be inhibited by imperfections in capital and housing markets and in the educational system, by racial discrimination, as well as by a host of problems related specifically to job search and retraining. Capital is often sector-specific and hence "mobile" only in the long run (through depreciation in the declining sector and capital accumulation in the expanding sector). Land is equally prone to sector specificity. When resources are sector or job specific, their remuneration contains elements of economic rent which are lost when they transfer to other utilizations. A worker's skills, for example, contain sector or job specific elements which are worthless in other jobs, so that relocation raises the expectation of a loss in remuneration.⁷

These considerations suggest that the adjustment process, rather than being smooth and perfect in the sense of the traditional theoretical ideal, is imperfect and subject to significant short-run distortions. These distortions, moreover, are likely to occur broadly throughout the economy and not just in industries subject to foreign competition. When the adjustment process itself is distorted, corrective government intervention may be needed. A weakness of existing adjustment assistance programs, and of several recent proposals for action, is that they limit assistance to workers impacted by foreign competition. This distinction is arbitrary and illogical, if for no other reason than the fact that adjustment into or out of trade-related industries inevitably affects other parts of the economy.⁸

The basic idea is simple and straightforward. If markets function efficiently, no assistance is needed; if assistance is granted in such cases, more adjustment will occur than is economically optimal. When labor and other markets are distorted, the effect is to prevent economically desirable adjustment and it would be the purpose of intervention to smooth the process of adjustment. Such assistance would be economically desirable regardless of the origin of the disturbance. Since adjustment is economically desirable, and thus not just in the interest of those who adjust, intervention financed from general government revenues makes economic sense. Recent proposals to tap tariff revenues, revenues obtained from auctioning of quotas, or revenues derived from the imposition of "user fees" on imports are ill-advised not

least because they will complicate future efforts to reduce trade barriers.⁹

When factors of production are sector specific or "fixed" in other ways, policy intervention must deal with vested interests and economic rents. Economic agents develop strong preferences for particular policy regimes and will resist efforts to change those regimes. Protection, say, of agriculture raises the domestic prices of agricultural products and hence the price of land; removal of protection reduces landowners' wealth and will be resisted. This phenomenon has two implications. First, since government intervention creates economic rents that will make subsequent policy change difficult, the rent-creating features of proposed policies need careful screening. Second, when changes in policy are made, those whose rents are being destroyed need to be given time and possibly assistance to adjust in a world of imperfect markets.

The Principle of Non-Discrimination

It has been difficult for countries to conduct trade policies in accordance with the non-discrimination principle. From the very beginning of the post-war era exceptions have been granted and even encouraged. Preferential trading arrangements like the European Common Market and the European Free Trade Area, constitute significant violations of the principle of non-discrimination. They were encouraged by the United States in the early years of its post-war hegemony, when international competition was of little concern to U.S. producers and international trade made up but a very small part of total U.S. economic activity. The economic losses

such discriminatory trading areas imposed upon the United States were easily offset by the gains expected from greater political and social stability in Europe.

The Generalized System of Preferences (GSP), which grants less developed nations preferential access to industrial country markets, also violates the non-discrimination principle. It, too, was installed for reasons that seemed to override the need to protect the principle. Once installed, these arrangements create vested interests and economic rents, which in turn build opposition to change and resistance to efforts to "graduate" countries out of the GSP as they advance toward industrial maturity.

Exceptions to the principle of non-discrimination were granted to agriculture, largely at the request of the United States, which insisted that agriculture was a matter of domestic policy and hence not subject to negotiation. This position conveniently ignored the fact that such policies exerted significant influences on world commodity markets and often required trade intervention to make them work. Today, the United States is embroiled in increasingly acrimonious disputes with the European Community over agricultural trade, as both protagonists continue to conduct domestic policies that violate the efficiency criteria discussed above and trade policies that violate the principle of non-discrimination.

The major trading nations of the world seem to be forsaking the idea of non-discrimination in trade in favor of various models of managed discrimination. Reciprocal discrimination has become a prominent feature of trade relations in recent years and the preparations for the up-coming GATT round suggest that reciprocity

will again be important. Each country will make concessions to another country only to the extent that they are reciprocated and such concessions will be available to third countries only on condition that they are properly reciprocated. The danger of this approach is that it diverts trade from low- to high-cost sources and thereby reduces efficiency and welfare.

Summary

This section has considered the major conceptual issues inherent in the contemporary debate on trade policy. The essence of the free trade argument is that it ensures the efficient utilization of domestic resources. The welfare gains from liberal trade policy thus arise from the more productive deployment of domestic resources. Reciprocal practices abroad add further benefits, but their absence does not invalidate the basic free trade argument.

That is the ideal. It is an ideal because its case is most compellingly made in a world of perfectly competitive markets in which the private and public costs of economic activities coincide, so that market decisions that equalize private costs and benefits also equalize public costs and benefits. The real world, on the other hand, is imperfect and subject to distortions that may break the coincidence of private and public costs and benefits. In such instances, production and consumption based upon private maximizing behavior need no longer be economically optimal. Environmental degradation, industrial R&D expenditures, national security, economies of scale, and private monopoly, all break the coincidence

between private and public costs and benefits. Government policies, from minimum wage regulation to farm policy, do the same.

The case for corrective intervention is readily made, but experience suggests that governments do not always master the operational intricacies of such policies, so that intervention leaves the economy more rather than less distorted.

Much attention has recently focused on "strategic" trade policy that would capture the welfare gains associated with terms of trade changes and economies of scale. Those favoring policy activism believe that they have found in strategic trade policy the argument that will dismiss the free trade case once and for all. They are likely to be disappointed, however, because the exacting criteria and the case-specific fine-tuning needed to make such policies successful, suggest that economic distortions due to the failure of strategic trade policies will displace distortions due to market failures as the dominant source of imperfections.

Distortions resulting from market as well as policy failure may afflict the adjustment mechanism itself, thus inhibiting adjustment that may be economically worthwhile. In such cases, intervention may indeed be needed, provided that it truly improves the situation. The tendency of existing programs and recent proposals to limit assistance to those hurt by imports, and of recent proposals to look to trade intervention as a source of the revenues needed to finance adjustment assistance, is ill-advised.

III. GRIEVANCES APLENTY

The preceding section examined the logical underpinnings of free trade and its alternatives. This section reviews the principal grievances that are responsible for the growing dissatisfaction in the United States with the existing trade regime and with the unconditional most-favored-nation principle.

Among the major concerns, especially for U.S. politicians, is the massive and highly visible deterioration in the trade balance. Lack of access to foreign markets is another complaint; it is blamed by some for the trade deficit and by others for the declining competitive fortunes of U.S. exporters. A third grievance focuses on foreign production and marketing practices that create unfair export trading advantages, while a fourth keys on institutional and procedural weaknesses of the multilateral trading system.

Trade Balance Deterioration

There is broad agreement among analysts that the deterioration in the U.S. trade balance in the 1980s is mainly a macroeconomic phenomenon brought about by monetary and fiscal policies in the United States.¹⁰ Fiscal expansion created an upsurge in domestic demand relative to output, necessitating net imports, while monetary stringency forced the budget deficit to be financed by debt issue. The dollar appreciation that accompanied the economic recovery of the early 1980s damaged the competitiveness of the tradables sector, hitting both agriculture and manufacturing.

In a closed economy, a surge in the budget deficit would raise interest rates so as to crowd out private domestic demand and thereby make room for the demand of government. In that event, interest sensitive sectors bear the burden of adjustment. In an open economy, on the other hand, interest rates need only rise enough to bring in the capital that finances the current account deficit. The real value of the dollar rises, so that the burden of adjustment is shared by interest-sensitive and exchange-rate sensitive sectors.

There may be broad agreement among analysts that macroeconomic policies are the major cause of the trade balance deterioration, but the trade bill passed recently by the House of Representatives is curiously silent on this fact, preferring to blame the trade deficit on the policies of other countries. Yet even the most optimistic estimates suggest that substantial compliance by Japan with U.S. trade recommendations would improve our bilateral trade deficit by \$5 to \$7 billion, leaving most of it to be removed by other means.¹¹ The House bill has little to offer that would solve the deficit, or for that matter any of the other trade problems faced by the country, but it has much that would impair competitiveness still further while at the same time provoking our trading partners.¹²

If macroeconomic factors are the fundamental cause of the trade deficit, its resolution must be sought at the macroeconomic level. And that means repairing the budgetary excesses at the federal level in the medium term and restructuring the relationship between saving and investment in the long run. Rather than badgering Japan and other countries about their saving/investment relations, U.S. policy

makers are well advised to tend to their own garden. The danger increases daily that American officials, frustrated in the conduct of sound policies at home, will use legitimate grievances regarding Japan's invisible trade barriers as license to badger that country on a host of issues that are basically domestic and that we, in our own case, refuse to negotiate.

Trade protection will do little to help us out of our policy dilemma. A surcharge on imports from Japan, Taiwan, and Germany, the penalty the House of Representatives proposes to mete out for their large surpluses, will raise the prices paid by American users for a variety of industrial inputs and capital goods, placing our producers at a cost disadvantage relative to their foreign competitors. A surcharge aimed at those countries will shift supply sources to other countries (or to domestic producers), redirecting trade away from low-cost producers. Discriminatory trade restrictions of this type are policy-making at its worst. For, in the absence of better balance between domestic aggregate absorption and output, they will do little to reduce our overall trade deficit; their main effects will be to raise costs and to rearrange our bilateral deficits among our trading partners.¹³

What about a surcharge against all dutiable imports from all countries as a means of offsetting the negative effects of macroeconomic policies on the trade balance? Such a policy may not be consistent with U.S. treaty obligations and other international commitments, but it would avoid the distorting effects associated with discriminatory trade restrictions. There is still trade diversion, but only from foreign to domestic producers; among

foreign suppliers the low-cost producers would retain their competitive edge in the U.S. market.

Still, the probability is high that such a measure would fail to achieve its primary objective of improving the trade balance, as studies by the Congressional Budget Office and others indicate. In order to improve the trade balance, it must reduce domestic absorption relative to output, and for that purpose it is a most inefficient and unreliable instrument.

Although such a policy would not discriminate among imports, it is far from evenhanded because it discriminates against exports by raising the input costs faced by exporters. For exporters, therefore, a general import surcharge makes a bad situation worse, by adding higher input costs to the impairment of competitiveness brought on by the dollar's appreciation. For greater balance and evenhandedness, the revenues generated by the import surcharge would have to be used to subsidize exports.

The conclusion is inescapable: inasmuch as America's trade deficit is the result mainly of macroeconomic policies, changes in those policies are the most promising way of correcting that problem.

Closed Foreign Markets and Unfair Foreign Export Practices

In the opinion of many Americans the decline in U.S. trade competitiveness has been brought on by foreign practices that restrict our access to overseas markets. The practices in question range from Europe's variable levies on agricultural imports to Japan's administrative procedures and technical standards. Access

to the U.S. market may not be entirely unencumbered, but it is perceived to be easy by comparison. The evidence strongly suggests that Americans have a legitimate grievance here and that policy makers will have to find ways of dealing with the problem. It is important to note, however, that there is no evidence that invisible barriers have increased in Japan, so that the deterioration in our bilateral trade balance with Japan cannot be explained in this manner.

For the United States, the challenge is to find the proper means of correcting the problem. If the United States were to take action, it could do so unilaterally, or in collaboration with one or more countries, or by resorting to multilateral procedures. The actions taken would almost certainly target specific commodities or a specific country. The unfair trade practices of different countries would have to be treated differently, if unilateral or bilateral approaches to the problem are pursued. Indeed, U.S. officials have been carrying on dialogues not only with Japan (in the MOSS talks, as well as otherwise), but with various other countries. This places an enormous burden on the resources of the government and suggests that a multilateral approach in which the United States sits down with the target countries and with other aggrieved parties in order to work out a general, that is, non-discriminatory solution, might be more cost-effective in the long run.

The trick is how best to pursue this objective of opening another country's market? The U.S. could threaten to retaliate by closing its own markets, hoping that the mere threat would be enough

to change foreign practices. Such threats have been issued repeatedly by congressional leaders and administration officials. The U.S. could and does negotiate bilaterally, as in the MOSS talks with Japan. The U.S. could negotiate free trade areas with one or more countries, as it did with Israel and is now doing with Canada. It could organize negotiations among "like-minded" countries in order to establish rules and codes for open trade that go beyond what has been achievable within GATT. These approaches all abandon the unconditional most-favored-nation principle in favor of its conditional alternative. This sets them apart from multilateral approaches such as the upcoming GATT round which have the virtue of preserving the non-discrimination principle.

Closely related to concerns over access to foreign markets are complaints about unfair advantages foreign exporters derive from production subsidies and from export credits and subsidies, as well as complaints about foreign dumping and industrial targeting.

Among proposed remedies have been import curbs on dumped imports and on products receiving unwarranted subsidies and credits. For American exporters who must compete in third markets with such products, proposed remedies have included matching of foreign subsidies and credits. In the case of wheat exports, that practice has been adopted by the United States in its battle over subsidized agricultural exports with the European Community. Among bilateral approaches have been the ever-popular orderly marketing arrangement and the voluntary export restraint program.

Plurilateral and multilateral efforts have also been undertaken and have met with various degrees of success. The last trade round

made some progress in the development of a subsidy code, and the OECD countries were able to agree on some standards limiting export credits. Much, however, remains to be done, and the success of the upcoming round of trade talks will certainly be measured in terms of its ability to resolve these problems.

Unilateral Measures

Unilateral measures have their promise and their limits. They work best when the mere threat of retaliation brings a quick and satisfactory response from the offending party. Their effectiveness declines rapidly if retaliation must actually take place, because it typically raises domestic costs.¹⁴ If the retaliation eventually pays off in opening a foreign market or terminating an unfair export practice, the gains may justify the costs incurred during the dispute. If it does not and the foreign market remains closed or the unfair export practice continues, exporters of the initially disputed commodity will not have been made better off, while other American producers are made worse off.¹⁵

Unilateral approaches can be very costly for another reason: they invariably require policy responses to be tailor-made to suit the offense and the offending country. Inasmuch as a general curb on imports would unjustly penalize countries with whom we have no quarrel, the retaliation must be carefully targeted. When several countries are subject to U.S. retaliation, that retaliation may have to consist of several separate policies, tailored to the commodities and countries involved. But selective import curbs always carry the risk that a target country will use third country channels to move

its goods into the U.S. market. To prevent such circumvention, the U.S. customs service will have to expand surveillance, as it has had to in the case of textiles.

The unilateral approach can quickly overwhelm the responsible government agencies, as they try to cope with many countries and many products. Bilateral approaches involving negotiated orderly marketing agreements and voluntary export controls only add to the problem. Casual evidence suggests that this has already happened at the United States Trade Representative.

Bilateral Approaches

Bilateral negotiations have come to play a major role in U.S. trade policy and the preferred policy instruments have been quotas (as in steel, textiles and sugar, for example) and voluntary export restraint programs (exemplified by automobiles, machine tools and semiconductors).

The bilateral approach makes good economic sense when a trade problem is truly bilateral, so that its resolution has no third country effects and thus does not concern other countries. Very few trade problems fall into this category, however, partly because the United States is too large a player and partly because there cannot be many truly bilateral problems in a highly integrated world economy. When the United States and Japan renegotiate beef and sugar quotas, the outcome may be at the expense of Australia. When the U.S. negotiates global marketing agreements in semiconductors with one or more countries, the resulting cartellization of the world market affects other producers and consumers. When the United

States and Canada join in a free trade area, third country producers of a broad range of products are affected by the inevitable trade diversion, but they are not consulted. Those are all acts of unfair competition by a number of standards. They also tend to discriminate against third parties within the United States, as we shall see.

Bilateral arrangements exemplify the drift of U.S. trade policy from unconditional, global approaches to discriminatory country and commodity-specific solutions. They discriminate against third countries and against third parties at home. The impetus for bilateral solutions comes from industry groups and their political friends and supporters in the Congress and the bureaucracy. Solutions are worked out with the minimum of consultation and debate, preferably against a tight deadline. Third countries are not consulted although their interests may be vitally affected; and domestic third parties - consumers, industrial users, etc. - are not consulted. Indeed, the process is deliberately structured so as to exclude third parties, making the arrangements not only bilateral in the country-to-country sense, but in the industry sense as well. The members of Congress who press the incumbent administration to do something are not required to make their case in formal legislative debate and to subject their ideas and proposals to detailed scrutiny and ultimately to the vote. With rare exceptions, the solutions generated by these processes distort the economy; they "save" jobs at costs that exceed by large margins the wages received by incumbent workers.¹⁶

It is often asserted that such actions are required in order to protect critical industries and equally critical skills. This argument is currently fashionable in the United States in relation to machine tools and semiconductors, where it is asserted that the disappearance of the domestic industry would deprive the United States of critical skills and knowledge, the absence of which will impair competitiveness in various up-scale industries. This argument may possess some merit, though that has been difficult to assess and is usually left as a vague, but threatening assertion. In cases of merit, however, the appropriate policy instrument would be domestic subsidies rather than trade intervention, because the latter has the unfortunate side-effect of raising costs. The standard response to this argument is that subsidies would never pass legislative hurdles which, if correct, pretty much sums up the problem.

Agriculture as a Bilateral Issue

Whereas most bilateral arrangements are subject to the criticism that they ignore significant domestic and foreign third party effects, agricultural trade may offer unique opportunities for bilateral resolution by the United States and the European Community, not because there are no third party effects but because the bulk of the dispute involves the two partners. Agriculture and agricultural trade are among the most distorted sectors of the world economy, with highly inefficient "domestic" support programs buttressed and indeed validated by strongly discriminatory trade policies. In most countries, including the United States, the

desire to aid agriculture has been accomplished with the worst of policies. Price-based intervention has distorted markets and created huge surpluses of produce, which have had to be purchased and stored at public expense, and the sheer budgetary burden of which has led to global dumping by the EEC and, in retaliation, by the United States. As price-based policies have raised domestic prices, trade restraints have been required in order to prevent cheap imports from emasculating domestic policies. Ironically, it has long been known that income-based policies would achieve the objectives of preserving the family farm or maintaining greenspace at significantly lower cost.

Given present agricultural programs, however, unilateral liberalization and reform by either the United States or the Community would drive down many world commodity prices and hence raise the dislocations caused by such policy regime shifts. Such would not be the result, or the result would be muted, if the two blocks coordinated policy reform and trade liberalization in agriculture, because the effects on world demand and supply conditions would be partly offsetting. In this case, therefore, a first phase of negotiations could usefully be conducted between the two major players, leaving for a second phase the inclusion of third parties in the process.¹⁷

Multilateral Approaches

The case for multilateral procedures emerges from the problems raised by unilateral and bilateral approaches. Global approaches provide for the proper consideration of third party effects; they

reduce the administrative burdens and costs that attend bilateral diplomacy with many countries involving many products; and to the extent that they are subject to the unconditional most-favored-nation principle, they minimize the adverse welfare effects of trade diversion.

The multilateral approach, at least as formalized in the GATT, has been criticized for its sluggishness, for the inadequacy of its coverage, and for the implicit veto held by large countries or groups of countries. These are well-taken and significant criticisms that must be addressed. In the long run, however, the United States is likely to find that continuation along the present drift away from the multilateral, unconditional approach will raise more problems than it solves. Distortions are being added, not resolved; resources are made less mobile and rents are being created. As bilateral solutions restrict imports in one set of products (say, textiles and apparel), incentives are created for the reallocation abroad of resources into upscale products with higher value-added, foreshadowing future trade problems. A "solution" of our trade problems in computer chips that facilitates the creation of a global cartel is a solution that we shall come to regret.

The list of concerns and danger signals is long indeed. It is generated by a frenzy of activities, that is not only administratively unsustainable, but that shows few signs of coherence and few elements of discipline. Whatever the shortcomings of multilateral procedures, they force a country to develop a coherent approach to trade policy.

Some Flaws in Our Complaints

In the discussion thus far it has been assumed that the trade-restricting foreign practices which so aggravate Americans are in fact unfair. This assumption, though in accord with the contemporary policy debate in the United States, may not always be warranted. Foreign intervention may in some instances at least be aimed at imperfections related to national security or infant industry consideration. Such arguments have been employed by the United States (most recently in the case of machine tools for national security reasons) making it difficult to criticize other countries when they make use of the argument. Infant-industry protection, though not always easy to justify analytically, is widely accepted in trade diplomacy. Hence, a retaliatory reaction to such a policy would not be justified. Inasmuch as such policies are easily abused, however, improving the global criteria for the use of infant-industry and national security justifications and providing for greater surveillance and more effective phase-out provisions would certainly be in order.

The point of the preceding is not to deny the perception on the part of Americans that theirs is a more open economy than many, perhaps most, others, but to observe that we undermine the weight of our case for open trade and against discriminatory trade practices as we proceed to install trade restrictions on the basis of justifications that can easily be used against us. At the end of that road is nothing but endless disputes over whose discriminatory practices are the worst.

In a complex world marred by imperfections and distortions, some subsidies may be legitimate interventions aimed at correcting market failures. Production subsidies may be legitimate in several situations. A country may possess comparative advantage in an industry, but subsidies may be needed to overcome initial scale and infant industry constraints. This may be especially relevant to today's newly industrializing countries. Alternatively, a country that does not possess comparative advantage, may elect permanently to support a given industry because of national security or independence considerations. Both types of subsidies must be distinguished from one that is predatory, designed to force the competition to abandon a market, in order to enable the predator to acquire and exploit monopoly power. Somewhat related is strategic trade and subsidy policy when markets are globally imperfectly competitive, enabling a country to exploit scale and terms of trade effects.

"Legitimate" Subsidies

In the first two cases, retaliation would not be appropriate. If the activist country is subsidizing the development of comparative advantage, in order to allow its firms to become the low-cost supplier, that is a legitimate objective and one that is in the interests of global efficiency. It is also practically the only way in which today's underdeveloped countries can hope to improve their lot. The United States should accept such developments as proper and inevitable and see to it that U.S. resources are redeployed, with government assistance if necessary. Protectionist intervention would in such cases not improve the long-run

competitiveness of U.S. industry and so would have to remain in place permanently even after the activist country removes its infant-industry subsidy. Such a policy therefore imposes a "permanent" budget burden if the countervailing U.S. policy is a subsidy or permanently higher input costs if it is a trade action. From this perspective, U.S. and European textile policies and the Multifiber Arrangement itself are interventions that deny newly emerging countries their rightful place in the global trading system.

If, on the other hand, a foreign country has decided to permanently subsidize an economic activity, and if that decision cannot be reversed by diplomatic and other pressures, the argument against retaliation is much the same, in spite of the fact that the foreign action is an unfair trade practice. Retaliatory policy would reduce the efficiency of U.S. resource deployment and, if it takes the form of trade policy, permanently raise costs relative to world markets. We may not like the foreign practice, and we should persevere in opposing it, but retaliation merely makes a bad situation worse.

It is sometimes suggested that strategic industries are exceptions to the foregoing conclusion because the foreign subsidy may reduce the size of the domestic industry to economically unsustainable levels. There may be merit to such arguments, in which case however a domestic subsidy is preferable to trade action (unless the industry offers potential terms of trade gains and scale effects). The practical difficulty with such policies is that if they are announced, every industry will claim to be of strategic

interest, imposing upon legislatures and governments the impossible task of sorting out the claims.

Predatory Subsidies and Dumping

Predatory foreign economic policies are a different matter. Although predatory subsidies (as well as predatory dumping) readily justify intervention, the nature of the retaliatory response needs careful consideration. If a struggle for the home and world market develops and is protracted, trade policy that limits foreign access to the U.S. market has the disadvantage of raising domestic input prices and thereby raising the cost of domestically produced goods, including exports. The retaliatory weapon of choice should then be a subsidy to the domestic industry.

The problem of responding to a foreign production subsidy illustrates all the contradictions inherent in trade disputes of this type. If the United States limits imports of the subsidized product, prices will rise relative to world price. This places American users at a competitive disadvantage. If the United States responds instead with its own subsidy, it contributes to a further expansion of world supply and hence to a further fall in world price, an outcome that is bound to please world consumers, but displease third country producers. Strengthening the subsidy code and surveillance procedures through multilateral and unconditional approaches may offer the best hope for coping with this issue.

When trade policy is unavoidable, it is well-known that tariffs are superior to quotas and other quantitative restrictions because they yield revenue (which an auctioned quota would preserve) and are less binding over time as demand and supply curves shift. Tariffs

are also more transparent than quotas and voluntary export restraints.

Strategic Trade Policy

The case of strategic trade and industrial policy is in many respects the most difficult of all, because it provides analytical justification for intervention, while raising major operational issues for policy makers. When an industry is imperfectly competitive on a global basis, each country's government may feel compelled to intervene because doing so offers an opportunity to enhance the home firms' share of the world market. If all governments do so, however, the efforts are often mutually cancelling. If, on the other hand, most governments do not while others persist, the free rider problem creates major advantages for the latter group of countries. This suggests the need for some kind of code of conduct. Note that liberalization under such circumstances costs a country the welfare benefits of scale and terms of trade effects unless liberalization is coordinated and reciprocal.

When global markets are dominated by a small number of large firms, two policy approaches are available, one competitive, the other cooperative. The competitive approach has each country pursuing activist strategies designed to wrest larger market share for its firms or at least to prevent other countries from doing so. The outcome is likely to be some form of stalemate with reduced trade and high budget and resource costs. The cooperative approach, on the other hand, starts with the proposition that such industries

are "global" rather than national in a significant sense and hence require global codes and competitive guidelines. Governments must find ways of cooperating in the creation of the competitive environment and the enforcement of rules and standards, while leaving decisions pertaining to the location of firms and plants to market participants. In many cases, the resulting industry structure is likely to be quite multinational, with multi-country production and sourcing and, if capital markets are properly integrated, with multinational ownership. Indeed, if such enterprises are publicly owned and if ownership is widely distributed among countries, the fear that only one country would earn tax revenues can be overcome by agreement that only incomes paid to owners will be taxed and then by the country of residence.

Failures of the Trading System

A trading system that leaves major aspects of trade unregulated and suffers from inadequate enforcement provisions and poorly functioning dispute settlement procedures faces an erosion of confidence in the process and in the idea of non-discrimination. It creates biases that favor those who break the rules and lends substance to the fear that unfair practices are being used to extract unwarranted advantages from the system. Fairness is, of course, in the eye of the beholder, but the GATT system has found it difficult to enforce even the limited number of judgments it has rendered. Unless significant improvements can be made in coverage and enforcement, further erosion of the unconditional most-favored nation approach is inevitable.

There are, from a member country's perspective, many intrinsic advantages in a multilateral process. First, rather than having to deal separately with each trading partner and each grievance, a process that can be quite costly and that tends to produce discriminatory policy responses that may be quite harmful to efficient resource utilization, the country can rely upon the multilateral system and its surveillance mechanisms to maintain free and fair trading practices. Central enforcement of a set of codes and standards can reduce significantly the costs and inefficiencies borne by members.

This conclusion is strengthened by the realization that if many countries engage simultaneously in unilateral and bilateral dispute management, the coordination problem becomes severe due to the presence of spillover effects that damage innocent third countries. In such an environment, a country's welfare is affected not only by what it manages to achieve in its bilateral trade relations, but by the dealings of all other countries. Such a system is most likely to be inferior to multilateral dispute management.

Unfortunately, the dissatisfaction with the GATT system has progressed far enough to have led some to seek solutions in precisely such sub-global, discriminatory approaches, in the mistaken belief that therein lies the way to significant welfare gains. Small countries have especially little to gain from such alternatives. But even the United States runs the danger, if it succeeds in establishing the "bilateral" precedent which is bound to be emulated by other countries, that the process will carve up the trading system into a multitude of preferential arrangements made by

some at the expense of others. This danger is not averted by attaching the conditional most-favored nation provision to bilateral deals because the costs that future participants must incur upon entering arrangements which they had no hand in forming can be so high as to preclude accession. Hence, the conditional MFN principle does not preclude a proliferation of sub-global arrangements that are essentially trade diverting.

The complaints against the trading system are many and vary from country to country, but from the U.S. perspective the main issues are the following. The exclusion from GATT purview of a broad range of international activities, including agriculture, services, and intellectual property. The exclusion of a broad range of anti-competitive, beggar-thy-neighbor practices, including quantitative restraints of various sorts on imports and predatory promotion of exports. The weakness of the dispute settlement function of the GATT and the sluggish negotiation process and its susceptibility to the large country veto.

The GATT's major accomplishment has been the reduction of tariff barriers over the course of several negotiating rounds. But while tariff reductions were being negotiated during the last round, member countries installed distortionary and discriminatory quantitative barriers to trade. As a result, during the period of the Tokyo round negotiations, the overall degree of protection and interference with trade may actually have risen rather than fallen. Certainly, replacing tariffs with quantitative restrictions is a move toward more disruptive, less efficient, and more costly forms of protection.

This tendency raises worrisome questions about the future: what is to prevent countries from installing new and still more exotic trade barriers while they negotiate away the old? Such an outcome is well within the realm of the possible because the next round, like those before it, will not attempt to end discriminatory trade practices, but rather to negotiate reciprocal reductions in discriminatory trade practices. The approach is not to condemn a country for discriminatory practices but rather to offer it a reward for reducing or removing a particular piece of discrimination. A very different but not very popular approach would begin by freezing existing levels of discrimination and then negotiate a gradual reduction of discrimination.¹⁸

GATT has tolerated discrimination when it takes the form of free trade areas and the GSP, for example. But developments in recent years have brought significant erosion in the MFN principle's applicability (often by downgrading unconditional MFN into its conditional relative by which a country will grant to another only those concessions which it has already granted to a third and for which the second extends it the necessary degree of reciprocity).

When non-discrimination is practiced on a broad scale, each country benefits not only from its direct relations with each other country, but indirectly from the greater volume and value of overall trade. As the trading world is carved up into "conditional" trading arrangements, each country (having already forgotten that liberal trade is in its self-interest) comes to see its stake narrowly in each conditional bargain.

The Adjustment Process: Does It Do The Job?

The concern with trade issues includes the fear that the pace of economic change, of legitimate economic change, has become such as to overwhelm the ability of countries to cope, and that the burden of adjustment often falls upon the weakest members of society, those with limited skills and with few alternative opportunities.

As the discussion of Section II stresses, inefficiencies and distortions in the adjustment process itself may necessitate corrective intervention. Distortions may be due to information costs, capital market deficiencies, or imperfections in housing markets, in education, and the like. They may manifest themselves in barriers to entry based in union activities, corporate hiring policies, or racial discrimination. If there is room for improvement, then there is doubtless a role for government. But as Section II makes clear, existing adjustment assistance programs are seriously flawed, and trade policy and protection are generally inappropriate remedies. Structural unemployment, whether the result of external or domestic competitive pressures, is best addressed with domestic policies, because trade intervention tends to stifle and delay adjustment rather than facilitating it. Where assistance is deemed desirable, it should be aimed at the distortion and be as transparent as possible.

Cheap Foreign Labor

It is often alleged that low foreign wages represent an unfair trade practice. This allegation has found its way into the 1986

trade act passed by the House of Representatives. As a general proposition, this argument is incorrect, for lower wages paid to foreign workers are not an unfair trade practice and will not depress American wages.

First, comparison of nominal wages is meaningless and comparison of price adjusted wages is not much better. What should be compared are wages corrected for productivity. American workers earn more than their counterparts in developing countries because they are better trained and educated and because they work with more and better capital (both physical and human). Second, even in industries where technologies are similar at home and abroad, differences in capital/labor endowments and hence in relative factor prices lead to different capital/labor proportions in production at home and abroad. More workers and less capital and skilled labor will tend to be used abroad, reducing labor's value added and therefore necessitating lower wages.

Third, although the House trade bill suggests that workers are systematically exploited abroad (by means of slave and child labor and by suppression of union activities), the mere fact that wages tend to be lower abroad on an economy-wide basis, is not evidence of labor exploitation. Rather, the relatively large supplies of labor, often semi-skilled or unskilled, and the scarcity of capital and skilled labor contribute to an economy-wide low productivity in developing countries. That is why people are poor in much of the world; their productivity is low.

But this also means that the opportunity cost of labor, that is, the wage employers must pay to draw workers away from their

next-best alternatives, is low in comparison with advanced countries. It is this opportunity cost that is the real cost to their societies of a given activity, and if workers in export industries are paid at least their opportunity cost, the competition mounted by those countries is fair.

Such a situation may very well enable firms to earn attractive profits, which they may plow back into their businesses or invest elsewhere. There are many ways of distributing the gains from productive enterprises, but they are by and large a matter of national choice. It is unseemly and inconsistent for the United States to suggest how other countries should distribute their wealth, when we have steadfastly refused such advice from others.

These considerations have considerable relevance for America's "trade-impacted" industries. It is generally accepted, for example, that money wages in the U.S. steel industry were for many years rising not only in relation to other countries, but relative to the U.S. manufacturing average, while productivity was rising less rapidly than the manufacturing average.¹⁹ That is a sure-fire way to lose competitiveness, with or without international trade, as the steady decline in domestic steel demand suggests. In many branches of the textile and apparel industries, innovation, capital (and human capital) accumulation, and R&D were undernourished, therefore reducing productivity growth and thus limiting the advancement of workers' incomes.²⁰

Sometimes the decline in employment in an import-competing industry is used as evidence to support the "cheap" labor argument. A secular decline in employment, however, is not necessarily

evidence of unfair foreign trade practices; rather, it may simply be the result of productivity growth. In the long run, workers' wages can grow only as their productivity grows, and productivity growth occurs as a result of improvements in worker skills and as each worker is given more capital and more skilled labor (human capital) to work with. But productivity growth also means that a given level of output can be produced by a smaller number of workers. This conflict between the twin results of productivity growth, namely, that it makes some workers redundant while raising the productivity and hence the earning power of those who remain employed, has always confounded workers.

Only exceptionally rapid growth in the demand for the product in question can offset the employment-reducing effects of productivity growth. There are some commodities which have experienced such demand growth. Indeed, the American tradition of exploiting mass demand by using productivity growth and economies of scale to drive down unit price exemplifies this approach. Automobiles and consumer appliances are the standard examples. But this approach does not work everywhere, and even the industries in which it has worked are today challenged by competition from abroad. They became targets because they were producing standardized commodities with standardized technologies that could be easily replicated in countries with more abundant and hence cheaper labor.

The days may very well be gone when most Americans could count on spending their working lives, drawing upon the training and education they received as youngsters, holding a relatively narrowly defined job, and producing a narrowly defined group of products.

And the days are probably also gone when American business could construct factories specialized in a narrow range of products to be produced over long time periods. Such inflexibility in labor skills and such product specificity of capital are probably a thing of the past, because economic change has become more rapid and because the life cycles of many products are declining. Companies and plants will have to be more flexible and adaptable and so will workers.

The issue is relatively clear. It is not so much competition from cheap foreign labor that threatens American workers, as failure to push productivity growth and to improve the quality of their skills. More than ever before, American labor and management will have to rely on flexibility to survive in international competition. Inflexible plant and equipment as well as inflexible work rules are bound to create competitive problems. Rather than rely upon particular products and on particular jobs to sustain them for extended periods, management and labor will have to develop flexibility and adaptability in order to survive.

IV. OPTIONS FOR U.S. POLICY: A SUMMING UP

The preceding section has reviewed the major U.S. complaints about the international trading order, an order we created in the days of our hegemony. That order leaves us more and more dissatisfied not only because it is antiquated and imperfect in several important respects, but because it has fostered the emergence of formidable trading partners.

The grievances vary in their specifics, but they carry the common theme of a lack of fairness that is seen to work against the

United States. Americans see themselves as the victims of aggressive, beggar-thy-neighbor practices abroad. We continue to express our belief in a liberal trading order, but suggest that we may be forced into trade policy activism in spite of ourselves. Hence, the debate about the choices among multilateral and other approaches.

The Status of U.S. Trade Policy

The policy debate proceeds apace, and so does policy. The executive branch continues to express commitment to the idea of liberal trade and hopes that the GATT may be improved and rejuvenated so as to enjoy America's continued support. This will require satisfactory resolution of issues involving agricultural trade, trade in services, unfair export practices, intellectual property, and investment-trade linkages.

At the same time, the United States has for many years pursued some of its trade objectives in ways that are either beyond the immediate purview of GATT or violate the unconditional most-favored-nation principle. Trade in textiles and apparel has been managed in the Multi-fibre Arrangement and by means of bilateral quotas and voluntary export restraint programs. Trade in steel and automobiles has been similarly managed. Machine tools and semi-conductors have recently joined the list of trade relations we prefer to handle outside the multilateral, non-discriminatory process. In agriculture we have protected sugar, for example, and for as long as we faced minimal export competition, we were content to keep agriculture beyond the reach of the GATT.

The picture that emerges is easily characterized. We have preferred, in areas where we possess comparative disadvantage and where we face competitive challenges, to manage trade outside the multilateral framework, relying upon our size and economic power to extract "voluntary" concessions from our trading partners or to impose quantitative restraints upon them unilaterally. In areas of our comparative advantage, as in services and technological knowhow, we continue to champion multilateral approaches and are pushing hard to place these issues on the agenda of the next GATT round.

Hence, the question implicit in the title of this study is really whether the United States should continue this practice? One difficulty with such a strategy is that it gives the U.S. very little to bring to the bargaining table in a multilateral round. Another, discussed at great length in the preceding section, is that many of our country- and commodity-specific trade measures are trade diverting in nature, raise costs to consumers and industrial users and thereby tend to reduce living standards and competitiveness.

Among the many options for U.S. trade policy, some serve the general interest while others protect specific interests. Some observe the unconditional most-favored-nation principle and are thus free of discrimination, while others make discrimination the centerpiece. Among discriminatory approaches, some are unilateral while others rely upon bilateral diplomacy, but all carry the danger of trade diversion.

The case for the unconditional most-favored nation approach rests principally on its contribution to the efficient utilization of the nation's own resources. By giving all competitors equal

access to the U.S. market such an approach generates a high degree of competition and maximizes the probability of trade creation, whereas conditional most-favored nation treatment raises the possibility that extensive exclusion of low-cost producers will take place, leading to losses in welfare and competitiveness.

A further advantage of the unconditional approach is that it puts "reciprocity" in its proper place as an objective worth pursuing but not a condition for liberal trade policy. This facilitates the conduct of trade policy by simplifying the policy criteria; it also reduces the cost of trade policy, partly by reducing the negotiating and transactions costs and partly by reducing the likelihood that narrow, preferential trading arrangements will create costly trade diversion. It serves further to insulate governments and legislatures from pressure by domestic groups seeking special treatment; it achieves this by increasing discipline and reducing policy discretion. Indeed, one of the major consequences of the drift in recent years from non-discriminatory to preferential and discriminatory trading arrangements has been an increase in policy by executive order and discretion and hence a decline in comprehensive policy debate.

Country-specific quotas and voluntary export restraints imposed on some countries also invite circumvention by existing suppliers who, in the case of textiles, have tried to ship additional quantities via countries not constrained by quotas; they also induce the world's less efficient producers to enter the U.S. market by taking advantage of the policy-induced rise in U.S. prices. This not only generates the familiar costs of trade diversion, but

provokes costly administrative efforts by U.S. Customs and other agencies to stem circumvention. This explains why the costs per American job saved are often so much higher than the wages drawn by the incumbent workers and suggests that, if assisting a special interest was politically unavoidable, outright income subsidies would be cheaper. They would, of course, also be more transparent and hence more difficult to sell to the voter.

It is often said that strategic industries are an exception to the foregoing. Steel, machine tools and increasingly, semi-conductors and other high-tech products are so classified. The point usually is that the costs of protectionist measures are justified by the strategic ends they serve. Moreover, GATT rules limit the choices of policy instruments available to the U.S. government, and make quantitative restrictions convenient and easy to implement. Industries prefer quantitative restraints because of the greater certainty attached to such a number and because of the fear that foreign suppliers can undercut tariffs by lowering costs.²¹

If an industry warrants support for national security reasons, production subsidies are more efficient, because they achieve the objective without raising price to users. The disadvantage of a VER on machine tool imports is that American industry will have to pay a higher price for them than foreign competitors. A quota or other quantitative restriction on semi-conductor imports will also raise U.S. prices, in conformity with the intention of such a policy. American users, including American exporters, are thus burdened with a cost disadvantage. It is difficult to see how such policies serve

the national interest, especially since the objective of maintaining industry output could have been achieved by means of less distortionary production subsidies.

Preferential Trading Arrangements

If there is little doubt that discriminatory and quantity-based protectionist policy is welfare reducing because it is by definition trade diverting in nature and intent, does discriminatory or preferential trade liberalization offer worthwhile opportunities? Recent U.S. initiatives, including the free trade pact with Israel and ongoing discussions with Canada, would suggest that the answer is yes. A more realistic response is the more conditional response: it all depends.

It depends upon the extent to which low-cost producers are included in the arrangement. It depends upon whether the arrangement is general or excludes important products and services. It depends upon whether domestic policies that affect trade are included in the arrangement or not.

A free trade area has beneficial elements of trade creation, when liberalization shifts supply from higher priced domestic producers to lower-cost producers in the partner country. It also has welfare-reducing elements of trade diversion, when lower-cost third country producers are shut out in favor of higher-cost partner country producers by the discriminatory trade liberalization. The net effect depends upon the relative importance of the two. The narrower the range of a country's trade covered by the arrangement and the greater the complementarity of the partner countries, the

greater the likelihood that low-cost producers inside and beyond the area will be restrained, increasing the likelihood of trade diversion and hence of welfare reduction.²²

In today's world, government policies are very often the cause of market distortions. Domestic subsidy policies support inefficient manufacturers and farms, often creating price-depressing excess capacity around the globe, while domestic price support programs threaten to attract cheaper imports which must be stopped with trade intervention. Elimination of restrictions at the border, which is what a free trade area usually implies, may remove only a part, and a small part at that, of the total of distorting policies.

Agriculture demonstrates the point. If, prior to the free trade arrangement, the two countries employed target prices to support domestic agriculture, they will also have used border restrictions to prevent lower-cost imports from flooding the domestic markets. If the preferential trading arrangement covers such products, removal of border restrictions will emasculate the domestic price support program if the partner country is a low-cost producer. But if the target price program is replaced by, say, production subsidies, the trade creation that would otherwise have occurred will be lost, thereby reducing the welfare improvement forthcoming from the arrangement.

The foregoing suggests that many preferential free trade arrangements may not do much to justify the costs of negotiating them and of bypassing the multilateral, unconditional process embodied in the GATT. Moreover, such arrangements are likely to have adverse welfare effects on third countries. Such outcomes may

damage America's relations with countries not encompassed in the preferential arrangement, and to the extent that other countries enter into preferential trading arrangements that exclude the United States, the latter may be the loser. It is not clear how a world carved up by preferential, i.e., discriminatory trading areas can serve America's long-run economic interest let alone her foreign policy concerns.

A counterargument to the preceding consideration is that trade-liberalizing agreements among like-minded countries can be structured in such a way as to leave open the door for subsequent entry by other countries. The idea is that trade would be liberalized among members on a conditional basis, so that any other country prepared to meet the conditions would be granted the same concessions. This is the notion of reciprocity, extended to all prospective entrants. But the longer the list of exceptions and exclusions and the more significant the role of domestic policies, the more complicated the problem of future accession by third countries, as the lengthy negotiations between the EC and Greece, Spain and Portugal suggest.

This does not mean that expansion of a free trade area is not possible, only that it raises formidable problems. And if preferential trading arrangements are supposed to provide an approach, more promising than GATT, to global trade liberalization, then the experience of the EC, which has become a major obstacle to global trade liberalization, must be viewed with considerable misgivings.

Many of the extra-GATT proposals in fact represent a desire to break the constraining influence of Europe and to get a process of liberalization underway. But any extra-GATT arrangement raises substantial questions about the rules that will govern trade and about their enforcement. Will there be different rules for different parts of the system? Who shall set the standard and how shall enforcement be managed in a world with many conditional and preferential trading arrangements?

V. CONCLUSION

The benefits from non-discriminatory liberal trade flow from the greater efficiency with which the nation uses its own resources. Unless policy makers and the public alike understand and accept this basic notion, trade policy will remain incoherent and scattershot. Reciprocity brings additional benefits by permitting the nation to deploy its resources still more efficiently, but there are gains even in its absence.

It has become fashionable in some quarters to assert that trade is too important to be left to markets, especially to imperfect and distorted markets. This argument has gained new glamor from the writings of some trade theoreticians who have shown analytically that under certain conditions imperfect markets may not fully exploit terms of trade and scale benefits. These findings, however, have extremely limited applicability, are unconfirmed and do not provide the kinds of generalizations upon which legislatures may build coherent and transparent policies.

The root problem with conditional approaches is their dependence upon trade discrimination. Moreover, inasmuch as discrimination is often practiced not at the border, but by means of domestic subsidy and related policies, even trade preference areas offer little promise unless they explicitly deal with discriminatory domestic practices. The U.S. tendency to resort to sub-global, conditional policies in sectors involving U.S. comparative disadvantage not only undermines the multilateral process because it leaves us little with which to bargain, but threatens over time to rigidify the U.S. economy and thereby to impair the advance of living standards and of competitiveness.

Footnotes

I am indebted to Warren Reynolds and the members of the Advisory Group for valuable comments. They are, however, not responsible for the views expressed or for any remaining errors.

1. The decline of America's hegemonic position and its effect on U.S. trade policy is examined in R.E. Baldwin, "The Changing Nature of U.S. Trade Policy Since World War II" in R.E. Baldwin and A.O. Krueger (eds.), The Structure and Evolution of Recent U.S. Trade Policy (Chicago: University of Chicago Press, 1984), pp. 5-27.
2. For discussions of contemporary U.S. trade and industrial policies, see, for example, F.G. Adams and L. Klein (eds.), Industrial Policies for Growth and Competitiveness: An Economic Perspective (Lexington, Mass.: D.C. Heath and Company, 1983) and C. Johnson (ed.) The Industrial Policy Debate (San Francisco: ICS Press, 1984). See also P.R. Krugman, "Targeted Industrial Policies: Theory and Evidence," in Industrial Change and Public Policy (Kansas City: Federal Reserve Bank of Kansas City, 1983), pp. 123-155.
3. For relevant discussions, see R.E. Baldwin (ed.), Recent Issues and Initiatives in U.S. Trade Policy, (Cambridge, Mass.: NBER, 1984), J. Tumlin, Protectionism: Trade Policy in Democratic Societies (Washington, D.C.: American Enterprise Institute, 1985), and M.W. Corden, Trade Policy and Economic Welfare (Oxford: Clarendon Press, 1984). See also A.V. Deardorff and R.M. Stern, "Current Issues in Trade Policy: An Overview," Discussion Paper No. 185, Institute for Public Policy Studies, University of Michigan, April 15, 1983.
4. See Corden, Ibid.
5. Corden, who has examined this issue in detail, suggests that as an alternative to traditional efficiency criteria, governments may be concerned with the equity problems created by large discrepancies among incomes or by rapid and large changes in the incomes of some groups. See M.W. Corden, "Market Disturbances and Protection: Efficiency vs. the Conservative Social Welfare Function," Discussion Paper No. 92 (Australian National University, Centre for Economic Policy Research, March 1984).
6. The theory of strategic trade policy has received much attention recently. For a general review, see P.R. Krugman, "New Theories of Trade Among Industrial Countries," American Economic Review, Vol. 73 (2), May 1983. See also Deardorff and Stern, op.cit.
7. For an analysis of sector-specificity, see S.W. Arndt, "Allocation and Adjustment in an Open Economy with Imperfections," in E. Wille (ed.), Beiträge zur Gesamtwirtschaftlichen Allokation (Lang-Verlag, 1982). For an analysis of the effects of rent-seeking behavior, see R.E. Baldwin, "Rent-Seeking and Trade Policy: An

Industry Approach," NBER Working Paper 1499 (Cambridge, Mass.: NBER, November 1984).

8. Recent proposals include G.C. Hufbauer, and H.F. Rosen, Trade Policy for Troubled Industries (Washington, D.C.: Institute for International Economics, March 1986) and R.Z. Lawrence and R.E. Litan, Saving Free Trade (Washington, D.C.: Brookings Institution, 1986).

9. See Hufbauer and Rosen, Ibid. and Lawrence and Litan, Ibid. and a recent legislative proposal by Senator Roth.

10. For a review of the issues, see S.W. Arndt, "Government Policy and the Decline in U.S. Trade Competitiveness," in P. Cagan (ed). The Impact of the Reagan Program, Essays in Contemporary Economic Problems, 1986 (Washington, D.C.: American Enterprise Institute, 1986).

11. See, for example, C. Fred Bergsten and W.R. Cline, The United States-Japan Economic Problem (Washington, D.C.: Institute for International Economics, October 1985), D. Christelow, "Japan's Intangible Barriers to Trade in Manufactures," Federal Reserve Bank of New York, Quarterly Review, Winter 1985-86, pp. 11-18, and internal AEI estimates.

12. There is far too much concern about bilateral trade balances and especially about the distribution of bilateral deficits and surpluses. The size of a given bilateral trade imbalance does not provide a meaningful way of distinguishing among macroeconomic and microeconomic, fair and unfair trade influences.

13. Unless a policy changes the relationship between private net saving at home and the budget deficit, it will not alter the overall current account deficit. Hence, reducing the bilateral trade balance with one country will simply increase it with others.

14. Suppose, for example, that the United States restricts imports of Japanese semiconductors in retaliation either for Japan's dumping of chips in U.S. markets or for Japan's invisible barriers on U.S. computer exports. The results would be a rise in domestic chip prices relative to prices not only in Japan but in third countries and that rise would be translated into higher U.S. production costs of everything that uses chips.

15. Possible exceptions arise in the case of imperfectly competitive markets where domestic firms may be able to capture economies of scale and market share, and in national security cases. However, the likelihood of an overall U.S. welfare loss is great and calls for caution and reserve in the use of retaliatory moves of this sort.

16. Many estimates been made showing that the cost per job saved exceeds the incumbent worker's wage. See, among representative studies, David G. Tarr and Morris E. Morkre, Aggregate Costs to the

United States of Tariffs and Quotas on Imports (Washington, D.C.: Federal Trade Commission, December 1984), Hufbauer and Rosen, op.cit., Lawrence and Litan, op. cit., and O.K. Kalantzopoulos, "The Cost of Voluntary Export Restraints for Selected Industries in the U.S. and the EC," World Bank, mimeo, January 1985.

17. See S. W. Arndt, Agricultural Trade: A Policy Brief (Washington, D.C.: American Enterprise Institute, forthcoming). On agricultural trade, see also D.G. Johnson, K. Hemmi and P. Lardinois, Agricultural Policy and Trade (New York: NY University Press, 1985). For a critical review of agricultural policy in the European Community and its damaging effects on world prices and markets, see P.M. Schmitz, "The International Repercussions of EC Agricultural Policy," Intereconomics, 20, November/December 1985, pp. 261-267.

18. See Tumlar, op.cit.

19. See, for example, R. W. Crandall, The U.S. Steel Industry in Recurrent Crisis (Washington, D.C.: Brookings, 1981) and M.E. Kreinin, "Wage Competitiveness in the U. S. Auto and Steel Industries," Contemporary Policy Issues, No. 4, January 1984.

20. See Tarr and Morkre, op. cit., and Lawrence and Litan, op. cit.

21. This belief is frequently unjustified because a quantitative restriction induces foreign suppliers to alter the quality of their product. Japanese car makers responded to VERs by loading cars with extras and by shipping upscale models, thereby competing with American producers in higher profit models. Foreign apparel shippers have been forced by quotas to invade the haute-couture end of the market, precisely the area in which Americans were most competitive.

22. See P. Robson, The Economics of International Integration (London; George Allen and Unwin, 1980).

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