Krugman & Obstfeld (2003)

	Vote for NAFTA	Vote for GATT
Actual	229	283
Predicted by model	229	290
Without labor contributions	291	346
Without business contributions	195	257
Without any contributions	256	323

bill to vote against; business contributions moved 34 representatives the other way. If there had been no business contributions, according to this estimate, NAFTA would have received only 195 votes—not enough for passage.

On the other hand, given that both sides were making contributions, their effects tended to cancel out. Baldwin and Magee's estimates suggest that in the absence of contributions from either labor or business, both NAFTA and the GATT would have passed anyway.

It's probably wrong to emphasize the fact that in these particular cases contributions from the two sides did not change the final outcome. The really important result is that politicians are, indeed, for sale—which means that theories of trade policy that emphasize special interests are on the right track.

*Robert E. Baldwin and Christopher S. Magee, "Is trade policy for sale? Congressional voting on recent trade bills," National Bureau of Economic Research Working Paper no. 6376.

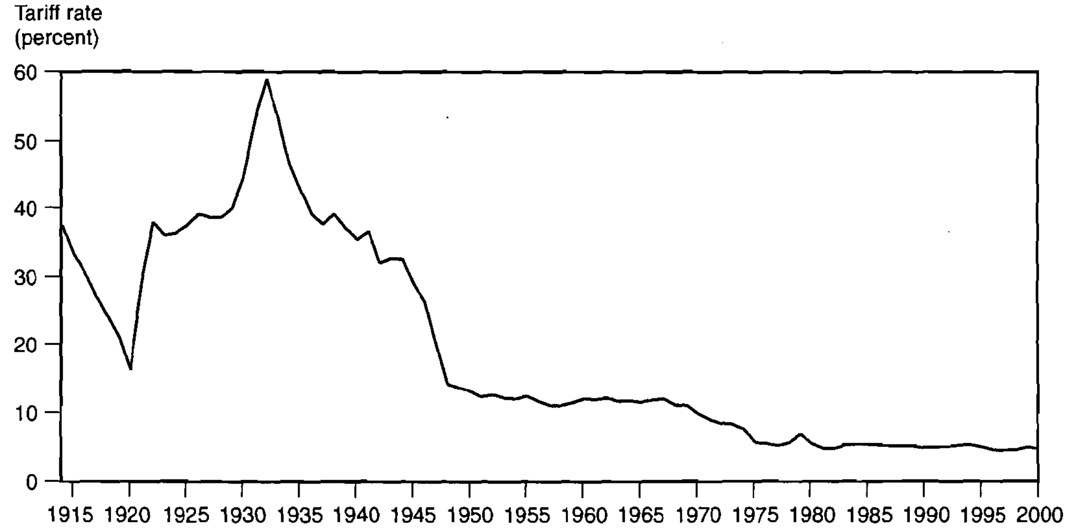
International Negotiations and Trade Policy

Our discussion of the politics of trade policy has not been very encouraging. We have argued that it is difficult to devise trade policies that raise national welfare and that trade policy is often dominated by interest group politics. "Horror stories" of trade policies that produce costs that greatly exceed any conceivable benefits abound; it is easy to be highly cynical about the practical side of trade theory.

Yet, in fact, from the mid-1930s until about 1980 the United States and other advanced countries gradually removed tariffs and some other barriers to trade, and by so doing aided a rapid increase in international integration. Figure 9-5 shows the average U.S. tariff rate on dutiable imports from 1920 to 1993; after rising sharply in the early 1930s, the rate has steadily declined.[7] Most economists believe this progressive trade liberalization was highly

[7]Measures of changes in the average rate of protection can be problematic, because the composition of imports changes—partly because of tariff rates themselves. Imagine, for example, a country that imposes a tariff on some goods that is so high that it shuts off all imports of these goods. Then the average tariff rate on goods actually imported will be zero! To try to correct for this, the measure we use in Figure 9-5 shows the rate only on "dutiable" imports; that is, it excludes imports that for some reason were exempt from tariff. At their peak, U.S. tariff rates were so high that goods subject to tariffs accounted for only one-third of imports; by 1975 that share had risen to two-thirds. As a result, the average tariff rate on all goods fell much less than the rate on dutiable goods. The numbers shown in Figure 9-5, however, give a more accurate picture of the major liberalization of trade actually experienced by the United States.

Figure 9-5 | The U.S. Tariff Rate



After rising sharply at the beginning of the 1930s, the average tariff rate of the United States has steadily declined.

beneficial. Given what we have said about the politics of trade policy, however, how was this removal of tariffs politically possible?

At least part of the answer is that the great postwar liberalization of trade was achieved through **international negotiation**. That is, governments agreed to engage in mutual tariff reduction. These agreements linked reduced protection for each country's import-competing industries to reduced protection by other countries against that country's export industries. Such a linkage, as we will now argue, helps to offset some of the political difficulties that would otherwise prevent countries from adopting good trade policies.

The Advantages of Negotiation

There are at least two reasons why it is easier to lower tariffs as part of a mutual agreement than to do so as a unilateral policy. First, a mutual agreement helps mobilize support for freer trade. Second, negotiated agreements on trade can help governments avoid getting caught in destructive trade wars.

The effect of international negotiations on support for freer trade is straightforward. We have noted that import-competing producers are usually better informed and organized than consumers. International negotiations can bring in domestic exporters as a counterweight. The United States and Japan, for example, could reach an agreement in which the United States refrains from imposing import quotas to protect some of its manufacturers from Japanese competition in return for removal of Japanese barriers to U.S. exports of agricultural or high-technology products to Japan. U.S. consumers might not be effective politically in opposing such import quotas on foreign goods, even though these quotas may be costly to them, but exporters who want access to foreign markets may, through their lobbying for mutual elimination of import quotas, protect consumer interests.

International negotiation can also help to avoid a **trade war**. The concept of a trade war can best be illustrated with a stylized example.

Imagine that there are only two countries in the world, the United States and Japan, and that these countries have only two policy choices, free trade or protection. Suppose that these are unusually clear-headed governments that can assign definite numerical values to their satisfaction with any particular policy outcome (Table 9-3).

The particular values of the payoffs given in the table represent two assumptions. First we assume that each country's government would choose protection if it could take the other country's policy as given. That is, whichever policy Japan chooses, the U.S. government is better off with protection. This assumption is by no means necessarily true; many economists would argue that free trade is the best policy for the nation, regardless of what other governments do. Governments, however, must act not only in the public interest but in their own political interest. For the reasons discussed in the previous section, governments often find it politically difficult to avoid giving protection to some industries.

The second assumption built into Table 9-3 is that even though each government acting individually would be better off with protection, they would both be better off if both chose free trade. That is, the U.S. government has more to gain from an opening of Japanese markets than it has to lose from opening its own markets, and the same is true for Japan. We can justify this assumption simply by appealing to the gains from trade.

To those who have studied game theory, this situation is known as a **Prisoner's dilemma**. Each government, making the best decision for itself, will choose to protect. These choices lead to the outcome in the lower right box of the table. Yet both governments are better off if neither protects: The upper left box of the table yields a payoff that is higher for both countries. By acting unilaterally in what appear to be their best interests, the governments fail to achieve the best outcome possible. If the countries act unilaterally to protect, there is a trade war that leaves both worse off. Trade wars are not as serious as shooting wars, but avoiding them is similar to the problem of avoiding armed conflict or arms races.

Obviously, Japan and the United States need to establish an agreement (such as a treaty) to refrain from protection. Each government will be better off if it limits its own freedom of action, provided the other country limits its freedom of action as well. A treaty can make everyone better off.

This is a highly simplified example. In the real world there are both many countries and many gradations of trade policy between free trade and complete protection against imports.

Table 9-3 The Problem of Trade Warfare

Japan *U.S.*	*Free trade*	*Protection*
Free trade	10 10	20 −10
Protection	−10 20	−5 −5

Nonetheless, the example suggests both that there is a need to coordinate trade policies through international agreements and that such agreements can actually make a difference. Indeed, the current system of international trade is built around a series of international agreements.

International Trade Agreements: A Brief History

Internationally coordinated tariff reduction as a trade policy dates back to the 1930s. In 1930, the United States passed a remarkably irresponsible tariff law, the Smoot-Hawley Act. Under this act, tariff rates rose steeply and U.S. trade fell sharply; some economists argue that the Smoot-Hawley Act helped deepen the Great Depression. Within a few years after the act's passage, the U.S. administration concluded that tariffs needed to be reduced, but this posed serious problems of political coalition building. Any tariff reduction would be opposed by those members of Congress whose districts contained firms producing competing goods, while the benefits would be so widely diffused that few in Congress could be mobilized on the other side. To reduce tariff rates, tariff reduction needed to be linked to some concrete benefits for exporters. The initial solution to this political problem was bilateral tariff negotiations. The United States would approach some country that was a major exporter of some good—say, a sugar exporter—and offer to lower tariffs on sugar if that country would lower its tariffs on some U.S. exports. The attractiveness of the deal to U.S. exporters would help counter the political weight of the sugar interest. In the foreign country, the attractiveness of the deal to foreign sugar exporters would balance the political influence of import-competing interests. Such bilateral negotiations helped reduce the average duty on U.S. imports from 59 percent in 1932 to 25 percent shortly after World War II.

Bilateral negotiations, however, do not take full advantage of international coordination. For one thing, benefits from a bilateral negotiation may "spill over" to countries that have not made any concessions. For example, if the United States reduces tariffs on coffee as a result of a deal with Brazil, Colombia will also gain from a higher world coffee price. Furthermore, some advantageous deals may inherently involve more than two countries: The United States sells more to Europe, Europe sells more to Saudi Arabia, Saudi Arabia sells more to Japan, and Japan sells more to the United States. Thus the next step in international trade liberalization was to proceed to multilateral negotiations involving a number of countries.

Multilateral negotiations began soon after the end of World War II. Originally diplomats from the victorious Allies imagined that such negotiations would take place under the auspices of a proposed body called the International Trade Organization, paralleling the International Monetary Fund and the World Bank (described in the second half of this book). In 1947, unwilling to wait until the ITO was in place, a group of 23 countries began trade negotiations under a provisional set of rules that became known as the **General Agreement on Tariffs and Trade**, or **GATT**. As it turned out, the ITO was never established because it ran into severe political opposition, especially in the United States. So the provisional agreement ended up governing world trade for the next 48 years.

Officially, the GATT was an agreement, not an organization—the countries participating in the agreement were officially designated as "contracting parties," not members. In practice the GATT did maintain a permanent "secretariat" in Geneva, which everyone referred to as "the GATT." In 1995 the **World Trade Organization**, or **WTO**, was established, finally creating the formal organization envisaged 50 years earlier. However, the GATT rules remain in force, and the basic logic of the system remains the same.