

CHAPTER 2

Assessing the Usefulness of International Trade Theory for Policy Analysis

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1. Introduction

As trade problems mount, it has become increasingly common to see arguments that international trade theory is fundamentally flawed as a guide for analyzing policy issues. This is a frequent theme in the popular press and has for some time been used by organized labor and some industrialists as a rationale for protectionist policies. The view has even been put forward by some economists. None of those economists wrote this paper.

We believe that most of these criticisms are based on misunderstandings about the nature and content of modern trade theory and on a failure to appreciate its richness. This paper is directed at those who are interested in trade policy, but who are not research economists specializing in the area. Although there are a number of excellent surveys of trade theory,¹ they are typically addressed to economic specialists and can be quite inaccessible to others. In fact, another barrier to clear and widespread understanding of the theory is that much of modern trade research takes the form of sophisticated mathematical modeling and/or highly technical quantitative analysis. Such work is often difficult for other economists to read and understand, and is much more so for practitioners and scholars who are not economists. Our purpose is to characterize in a nontechnical manner major elements of modern trade theory and to evaluate them in light of some of the most common criticisms raised by noneconomists.²

1. For the international economics specialist, there is a valuable recent survey of developments in modern trade theory in Jones and Kenen 1985. A useful guide to current developments for the nonspecialist may be found in Greenaway 1985. Earlier surveys by Haberler (1961) and Corden (1965) remain quite useful and do not require knowledge of advanced economics on the part of the reader.

2. We stress that while a number of the examples of criticisms that we evaluate come from prominent political scientists, such views are far from dominant among the political scientists

We will argue that trade theory is both robust and useful, but even when a body of theory is basically sound, it must be handled with care—theory can easily be misapplied. For example, one trade model may be used where another would be more appropriate. Likewise, economic efficiency is sometimes treated as if it were the sole objective where other considerations are important as well. Enthusiasts with some simple vision of trade theory are as wrong in believing that as long as free trade is maintained there can be no legitimate trade policy issues, as are protectionists who do not understand the possibility of mutual gains from trade and believe that, on balance, all imports cause net harm.

The adequacy of a theory must be judged in terms of the particular uses to which it is put. We believe that much of the criticism of trade theory stems from a failure to appreciate the scope of its modern formulations. Critics frequently focus on the relevance of specific trade models, especially the classical Ricardian and the neoclassical Heckscher-Ohlin factor proportions models, without recognizing that modern theories encompass a much broader range of analysis.

One major source of misunderstanding is the tendency of many to equate trade theory with free trade policies and (not infrequently) with complete *laissez faire*. Thus, one sees criticisms of a particular trade theory or of *laissez faire* in general taken as if each were logically an argument against free trade. Such association by assumption is a non sequitur.

Modern trade theory analysis considers the implications of a wide range of assumptions and models about the behavior of an economy including factor immobility, monopoly power, and dynamic considerations involving government activity. Contrary to frequent popular assertions, modern trade theory does not show that free trade is always the best policy. But it does show that relaxing many of the assumptions of the simplified textbook trade model does not diminish (and in some cases even strengthens) the case for free trade.³ Thus one of our points is that popular debate over the relevance of trade theory

now working most actively in the field of international political economy. Indeed, much recent political science literature makes considerable use of modern economics such as public goods analysis and public choice theory. See, for example, the contribution by Gowa in this volume and the analysis and references in Keohane 1984.

3. By the "simplified textbook trade model" we mean the typical exposition in the international section of introductory economics texts; it is usually this level of theory that is criticized by noneconomists such as Calleo and Rowland, Kuttner, and Jones. Most elementary level undergraduate texts in international economics include some discussion of the issues addressed in this article, for example, Kreinin 1983, Meier 1980, and Richardson 1980. More advanced texts treat in greater depth most of the complications we discuss in this article, for example, Caves and Jones 1985, Eihler 1983, Williamson 1983, Krugman and Obstfeld 1988, and Markusen and Melvin 1988.

is often put in seriously oversimplified and fundamentally misleading terms. Such is sometimes the case in scholarly writings as well.

It is perhaps not surprising that misunderstanding of modern trade theory is so widespread. A cynical interpretation, which we find at times persuasive, is that some authors may engage in deliberate misrepresentation to strengthen their advocacy of specific policies. If one is advocating protection, for example, it is often more politically effective to argue against an oversimplified picture of "academic" trade theory than to attempt to show that the situation meets one of the limited sets of conditions under which modern theory suggests that trade restrictions may make economic sense.

In considering the interrelationships between theory and policy, it is important to be clear on the distinction made by economists between positive and normative analysis. The former refers to the part of economics which aspires to be a science; that is, to be descriptive and predictive. It attempts to predict, for example, what the effects of a change in policy will be. Normative analysis involves value judgments about the objectives to be sought by policy. Differences in policy recommendations may reflect differences in (normative) objectives, or differences in (positive) analysis of how a given set of objectives can best be pursued. Economists do display a strong normative preference for efficiency (discussed in section 3 below), but this need not imply a view that economic goals dominate social and political goals. Whatever the objective, economic analysis is useful in determining how the objective can be achieved at the lowest cost in terms of other objectives. Whether or not a particular economist personally favors policies to protect domestic workers from import competition, his economic analysis can still be used to determine the most effective and least costly way of pursuing this goal.

The question of how conflicting objectives are weighted within the political process is at the heart of political economy. Here again it is useful to distinguish between the positive political economy analysis of how policies are in fact formulated, and the normative political economy analysis of how policies should be formulated. Normative analysis in this case refers not to what particular policies should be, but instead to what the process by which they are chosen should be. Although this paper's focus is the use of trade theory for positive analysis, we shall along the way illustrate its applicability to a range of normative issues.

The following section reviews a number of conceptual distinctions that should be kept in mind when evaluating the usefulness of trade theory. We feel that they are important enough to be emphasized before moving on to evaluation and criticism. In section 3 we evaluate trade theory as a guide to normative analysis, set in the context of criticisms that have appeared in recent literature.

In section 4 we review the main arguments promoted as exceptions to the

rule that free trade will maximize national economic welfare: infant industries and terms-of-trade arguments, and the related concern that free trade policies are disadvantageous to us if others do not also follow free trade policies. Interest in these arguments has recently revived, but nowadays is expressed as a concern with strategic trade and industrial policy and with reciprocity. It is true that each of these arguments involves legitimate problems for public policy. Trade intervention, however, will rarely be the most efficient policy response and can run a serious risk of stimulating trade warfare. In other words, while these concerns raise relevant issues, it does not automatically follow that a good case for trade restriction exists.

Current policy debates reflect differences of opinion about the operation of political processes as much as differences about economic issues, a conclusion that highlights the importance of political economy analysis. In section 5 we consider the role of trade theory in positive political economy analysis of governments' trade policies.

We shall argue that for both positive and normative analysis trade theory by itself is inadequate, but that modern trade theory, blended with political and other considerations, is part of a broader and more satisfactory political economy analysis.

2. Some Important Conceptual Distinctions

The Case for Free Trade Does Not Require Complete Laissez Faire

Although the principle of *laissez faire* implies free trade, free trade does not necessarily imply *laissez faire*. The arguments for free trade and for *laissez faire* are not one and the same; the impression that they are is understandable, but quite incorrect.⁴ Modern economic analysis does stress the power of the market as a mechanism for creating incentives and for coordinating resource allocation, but it does not argue that the market always generates acceptable results or that free trade is always the best policy. Indeed, a considerable portion of economic analysis is devoted to delineating the conditions under which *laissez faire* or the unbridled market will not work well. These include situations where externalities are present or where activities display aspects of public goods.⁵ Even Adam Smith pointed to instances where *laissez faire* was unlikely to be a good idea. He argued that protection of certain industries

might be called for if they were "necessary for the defense of the country." More surprisingly, in cases where foreign countries introduce protectionist policies, he suggested the potential usefulness of a policy of reciprocity; in his words, "revenge in this case generally dictates retaliation."⁶ A considerable amount of work has been undertaken by modern international trade theorists to analyze such situations.⁷ One of the powerful insights they have generated is that in most cases which call for deviations from *laissez faire* on economic efficiency grounds, the forms of government intervention implied do not include restricting international trade. This is consistent with one of the basic propositions in modern applied welfare economics, that distortions or market failures in the economy are best dealt with by policies aimed directly at the sources of the market failure.⁸ Consider, for example, a situation where the infant-industry argument legitimately can be invoked to support government intervention in an industry's behalf, that is, where some market failure precludes the creation of the industry. In this standard example, intervention might take the form of a direct subsidy to the industry (making financing available if the failure is in capital markets) or of insulation from foreign competition through an import tariff. The subsidy generates no byproduct distortions and so is superior to the tariff, which "protects" the fledgling domestic industry but increases consumer prices as well, creating another distortion.

Theories Should Not Be Judged Independently of Their Applications

The adequacy of a theory should not be judged independently of the purpose to which it is being applied. A theory quite useful for one purpose may be seriously deficient for another; failure of one part of the theory to explain certain phenomena may not be an indictment of either that part of the theory in particular or trade theory in general. An example of how judgments about

6. The quotes are from pages 429 and 434 of Book IV of *An Inquiry into the Nature and Causes of the Wealth of Nations* (1937 Modern Library edition), and we are grateful to Bell (1980) for highlighting them on page 166.

7. See, for example, Corden 1974.

8. See, for example, Bhagwati 1971, Corden 1985, and Johnson 1965. Today the only first-best arguments for trade restrictions commonly considered valid by economists are based on national security concerns (discussed later) and on the nationalist terms-of-trade argument. (Of course many economists argue on normative grounds that such nationalistic behavior is inappropriate.) Even here the imposition of a tariff to improve the terms of trade is not as efficient as a bribe to keep the tariff from being imposed. A less nationalistic argument with some validity is that where taxation is costly efficient public finance suggests equating the marginal costs of revenue raising across different sources; this could make it optimal to refrain from reducing tariffs to zero. For a recent analysis of this issue, see *World Development Report* 1988.

4. For an example of discussion suggesting that the case for free trade is the same as the case for *laissez faire*, see chapter 6 of Calvo and Rowland 1973.

5. For further discussion, see Alt and Chrystal 1983, Amacher, Tollison and Willert 1976, and Rhoads 1985.

theories may vary depending on the purpose for which the theory is used in the analysis of the gains from trade. Textbook treatments of the gains from trade based on simple models are, in our judgment, valuable in demonstrating the possibilities of gains and illustrating how they can come about. It is quite a different matter to take such illustrations as proof that free trade is always optimal. To the extent that economists make such a leap, they are open to valid criticism. To the best of our knowledge, such misuse is not common practice.

Another source of confusion and disagreement in evaluating theories concerns whether the theory in question is being judged as a virtually complete explanation of how the world works, or instead as a partial explanation that provides useful but incomplete insight into an issue. Often advocates and critics are not clear on the criteria being applied. Economists undoubtedly tend at times to write as if their theories explain a much higher proportion of behavior than is in fact the case, while critics often unduly minimize the usefulness of economics by succumbing to the fallacy that if a theory does not explain everything, then it explains nothing.

Consider, for example, the usefulness of the standard Heckscher-Ohlin-Samuelson (HOS) factor proportions theory of international trade. Critics quite correctly point out that a substantial proportion of trade flows (such as intra-industry trade) cannot be explained by the natural factor endowments emphasized in this theory. As a complete explanation of trade flows, the HOS model is clearly a failure.⁹ On the other hand, a considerable portion of trade flows are, in fact, explained by relative factor endowments, especially when the simple two-factor labor-capital model is expanded to include such considerations as land and human capital within a multifactor framework.¹⁰

Necessary Versus Sufficient Conditions

It is important to distinguish clearly between necessary and sufficient conditions when evaluating theory. Simple textbook treatments are typically designed to illustrate particular points. This is often best done under quite strong sets of assumptions that are sufficient to obtain the conclusion being illustrated; many of these assumptions may not be necessary for the conclusion to hold. For example, simple trade models assume perfect competition, which (as discussed in section 3) has caused many critics to interpret the assumption

9. The limitations of the HOS model are readily acknowledged in standard textbook treatments. See, for example, Krugman and Obstfeld 1988, 84–86.

10. Such a broadening of the factor endowments theory was quite important in explaining the Leontief paradox—that the United States appeared to be exporting labor-intensive and importing capital-intensive products. On the current state of empirical research on the determinants of trade flows, see Leamer 1984 and Deardorf in Jones and Kenen 1985.

of perfect competition as a necessary condition for free trade to increase efficiency. Such a conclusion does not logically follow, however.¹¹ The existence of imperfect competition may either strengthen or weaken the case for free trade depending upon its particular form and location; this point will be amplified in section 3 in the discussion of appropriateness of assumptions.

Impact Versus General Equilibrium Effects

Another important distinction is that between initial impact (partial equilibrium) effects and final (general equilibrium) effects. The belief that imports cost jobs is one of the most politically powerful arguments for trade restrictions. Yet this typically is true only when analysis is limited to initial impact effects. Increased imports will certainly reduce the demand for domestic production of similar products and this can lead, in turn, to reductions in employment, *ceteris paribus*. However, this greatly overstates the net loss of jobs. Most of these workers will find new jobs, albeit often lower-paying ones.¹² Furthermore, trade restrictions are likely to lead to reductions in employment in export industries. Thus, exclusive focus on impact effects can generate seriously misleading conclusions. (This issue is explored further in section 3, in the discussion of adjustment costs and unemployment.) Taking a more general equilibrium perspective does not necessarily lead to the conclusion that there are no significant problems of adjustment costs associated with free trade, but it does help to put issues in a more appropriate perspective.

3. The Relevance of Trade Theory: A Review of Criticisms

Most policy-oriented criticisms of international trade theory focus either on the lack of realism of the theory's basic assumptions or on the alleged narrowness of the efficiency criterion. For example, in his international political economy survey, R. J. Barry Jones (1983, 175) argues that "the corpus of liberal [trade] theory rests not upon sound simplifying assumptions about reality but upon simplifications which require evasions, or even distortions, of reality if they are to be useable, or a priori assumptions which are quite simply unwarranted"; while Robert Kuttner (1983, 16) argues that trade theory

11. See Richardson 1989 for a survey of four empirical studies of imperfectly competitive situations showing that free trade is still welfare-improving.

12. Where the increase in imports is due primarily to a domestic boom, domestic employment is likely to rise, although by less than if there were no increase in imports. Typically such a reduction in the rate of growth of domestic employment causes fewer political problems than do absolute reductions in employment. For a survey of the debate over changing job quality in the United States, see Loveman and Tilly 1988.

"doesn't fit a world of learning curves, economies of scale, and floating rates." Kuttner does limit his critique to classical and factor endowments theory, but gives the reader no indication that trade theory has developed beyond that.

Although we cannot hope to offer in this paper a detailed summary and evaluation of modern trade theory, we will attempt to evaluate briefly some of the most common criticisms and to answer them with examples from modern theory. Our interest in criticizing the critiques flows from a belief that modern economic analysis provides a useful approach to a wide range of issues; we do not believe that it has all of the answers.

In the first part of this section, we discuss the role of trade theory in a world where our objectives go beyond the maximization of physical production. We concur in spirit with Strange's (1985, 237) comment that economic efficiency is "only one of the four basic values that any politically organized society seeks to achieve for its members . . . wealth, order, justice, and freedom." However, we believe that economic analysis has much to say about how to pursue these objectives efficiently, in ways that minimize the amounts of one objective which must be given up to achieve more of another. The assertions of writers such as Calleo and Rowland (1973, 134) that "the case for freer trade is . . . in its essentials a case for achieving a maximum of consumption" are grossly misleading if consumption is used in the narrow sense implied by these authors. The case for freer trade is a case for increasing real income for citizens of trading nations.

In later parts of this section, we deal with a number of the charges that trade theory is based on highly unrealistic and/or faulty assumptions.

Do Economists Define the Objectives of Trade Too Narrowly?

"Sometimes economists write and speak as if they thought that economic optimality was either the normal or the only desirable objective of public policy. They really know better" (Diebold 1983, 338). Economists are routinely accused of being concerned only with efficiency (Strange 1985, 237), or with the maximization of production and income (Calleo and Rowland 1973, 136-37), or with those actions that occur in the marketplace. For example, Barry Jones (1983) describes the concept of economic rationality as an evasive and distorting assumption before going on to characterize rationality as confining "rational choice to the maximization of only those objectives which can be satisfied through market exchanges and which therefore ignores (and ultimately illegitimizes) all those other needs, wants, and desires which an individual may well seek to satisfy through his actions and choices" (175). This statement is in itself a serious distortion: the economic approach draws no

such conclusions and indeed gives extensive consideration to situations (for example, public goods, issues of taxes, and externalities like pollution) where market exchanges are unlikely to produce efficiency. The concept of efficiency argues for minimizing the costs—including all costs to society—of achieving society's objectives. As Diebold has observed (1983, 337), the analysis of trade-offs is one of the main contributions that economics can make.

Another misinterpretation of economic theory holds that it is concerned only with maximizing consumer well-being and ignores producer interests (Calleo and Rowland 1973, 137-38). Some critics correctly stress that economic policy should be concerned with producer as well as consumer values, but fail to understand how a competitive market system achieves this. The market mechanism—the point of interaction between consumers and producers—depends on maximizing behavior by both agents; and all producers are also consumers. Prices and levels of production are determined by the interaction of supply and demand. Together consumer preferences and alternative sources of supply determine the demand for domestic production, while domestic supply is generated by the combination of cost considerations and producer preferences. Nonmarket considerations are often important aspects of these consumer and producer preferences. For example, it is common (even for economists) to choose jobs other than those that pay the highest money wages because of nonpecuniary considerations such as desirable location or stimulating colleagues.

Calleo and Rowland go so far as to argue (referring to neoclassical economic theory) that ". . . a system which focuses on the welfare of consumers and expects producers to shift for themselves has its priorities backwards . . . a more rational system would orient itself toward production . . . Consumption would then take care of itself" (134). While such ideas certainly underlie some of the more grandiose of the recent proposals for a new industrial policy in the United States, we believe there is considerable evidence that the typical result of sacrificing consumer interests to protect jobs and output in a particular industry is a policy designed for special interests, and ironically one that may well lead to employment losses elsewhere.

Critics also raise serious issues of possible trade-offs between economic efficiency and security, both national and domestic (the latter referring to social and political stability) (Strange 1985, 237-38). Strange notes that economists have paid considerable attention to national defense arguments for trade restrictions. As in the case of infant-industry arguments (discussed below), economic analysis accepts that national defense considerations can present valid reasons for departures from *laissez faire*. Furthermore, the most efficient responses to such concerns may involve restrictions on trade. Economic analysis has also shown, however, that (depending upon the particular type of national defense issue under consideration) trade restrictions may be

less efficient than alternatives such as the stockpiling of strategic materials and the offering of direct subsidies for the maintenance of essential job skills and productive capacity. Policies adopted in the past in the name of national defense have often been inefficient and at times even counterproductive as means of securing these objectives; a good example is the system of oil import quotas in force in the United States in the 1960s.¹³

Economic analysis per se has much less to offer in considering the concern, which goes back at least to Plato, that international trade leads to political conflict among nations. Liberal economics does argue for the possibility of mutual gains from trade and hence suggests more benign social and political consequences of economic activity than do some approaches that see exchange primarily as a zero-sum activity leading to exploitation and alienation (as do Cubertson 1984 and Hager 1986). However, demonstrating that there are mutual gains from trade is quite different from showing that everyone gains from trade; and there is no implication that all of those who gain from trade gain equally. Any observer of recent economic history can see that international economic relations can generate conflict. Developing countries' proposals for a New International Economic Order provide a clear case in point. We believe that most of their complaints against the industrial countries and a more liberal international economic order have much more to do with the distribution of mutual gains than with instances of absolute harm,¹⁴ but this does not counter the argument that economic relationships may generate conflict. So may policies that substantially reduce trade. The imposition of trade restrictions is often a source of international tensions. There appears to be no strong negative correlation between the low level of integration of some developing countries into the world economy and the militancy of their representatives in the United Nations. Furthermore, a notable element of the trade literature, associated particularly with the name of Cordell Hull,¹⁵ argues that liberal trade relations develop good neighbors and reduce the likelihood of war. Although Hull overstated his case, the experiences of the European Economic Community suggest that there is some merit to this view. Today a war between France and West Germany seems inconceivable despite their long history of military disputes.

Economic analysis has little to say about the effects of trade on social stability. That changes in trade patterns can have significant social consequences is undeniable, but Calleo and Rowland (1973) carry their discussion of the "moral poverty" of the economists' assumption of consumer sov-

13. For further analysis and references to the literature on national security and trade policies, see Willert and Jalilipahar 1983-84.

14. On these issues see the contributions and references in Amacher, Haberber, and Willert 1979.

15. For a useful discussion of Hull's views, see Calleo and Rowland 1973.

ereignty too far when they conclude that "its trade theory's basic assumptions would—if they prevailed—mean the collapse of modern civilization" (138). However, considerations of equity and concern for social stability may imply policies to ease the adjustment burdens imposed on individuals by the operation of market forces (and actions by governments). Issues of adjustment assistance programs (to be revisited later) have been a major topic of economic analysis.

It is important to note that there is little difference in the economic and social effects of increased competition from abroad and increased competition among domestic producers. While questions of political strategy can help explain why government policies have often differentiated between the consequences of foreign and domestic competition, there is little basis on efficiency grounds or on grounds of moral principle for this distinction. Structural unemployment generated by domestic innovation is seen as an inevitable byproduct of continuing growth and change; such unemployment generated by imported products is typically characterized as unfair and destructive (AFL-CIO 1986).

Is Trade Theory Based on Inappropriate Assumptions?

A common criticism of orthodox trade theory is that it holds only under the assumption of certain ideal conditions.¹⁶ This charge can usually be traced to a failure to distinguish clearly between the conditions necessary to produce ideal efficiency on the one hand and the case for free trade on the other, much like the confusion between the case for *laissez faire* and that for free trade discussed in section 2. It is certainly true that under an ideal set of market conditions free trade is economically efficient. Deviations from ideal conditions do lower the achievable levels of utility or well-being, but they do not necessarily weaken the case for free trade. We argue that the absence of ideal conditions does not necessarily strengthen the case for government intervention in the economy; rather, cases where government intervention is indicated typically involve a second-best argument for trade restrictions. For example, to return to the infant-industry case examined above in section 2, if there are cogent reasons why direct intervention cannot be undertaken, a tariff to protect the fledgling industry may still be superior to no intervention, provided the gains from fostering the new industry exceed the associated distortion in consumer prices.

We agree with the observation by Tyson and Zysman (1983) that analytical forays moving beyond simple textbook-level assumptions do not always yield clear-cut conclusions. However, we disagree with their argument that

16. Jones 1983, 176-77; Calleo and Rowland 1973, 130-33; and Tyson and Zysman 1983, 26-27.

there are policy issues "that the traditional theory is powerless to grapple with. These questions arise as soon as one moves away from the static orientation and the assumption of perfect competition that characterize traditional trade theory. Once dynamics and market imperfections are allowed to enter the picture, both the theoretical models and their implied policy prescriptions become confused" (26). Tyson and Zysman correctly point out that there exists no single and simple valid generalization about policy questions and that the current trade literature fails to reach unambiguous conclusions about all policy questions. However, neither of these points is a sound reason for characterizing this literature as confused, as opposed to the issues involved being complex.¹⁷

Barry Jones (1983, 175-76) argues that prominent among the "absurd" assumptions necessary to liberal economic theory is that of perfect information. This assertion is an example of the failure to distinguish between necessary and sufficient conditions. It may also reflect a still widespread reliance on Pigovian welfare economics combined with an assumption of ideal government;¹⁸ from this perspective, any deviation from perfect information on the part of consumers and/or producers is grounds for government intervention. Modern public choice analysis, however, asks whether it is plausible to assume that the government has good information when producers and consumers do not; and whether when the government does have better information, it is likely to intervene in an efficient manner.¹⁹ We do not argue that the answers to these questions will always be in the negative, but the recognition of their importance undercuts the argument that the existence of less than perfect information in the private sector is a sufficient condition for government intervention. Indeed, one of the major arguments for the market system has been its perceived ability to economize on the need for costly information (see, for example, Hayek 1945 and Friedman and Friedman 1980). Markets do work more efficiently when information is better; but their operation also generates information, and we cannot assume that the public sector will always do so more efficiently.

As with imperfect information, it is also often argued that the existence of imperfect competition undercuts the case for free trade (Jones 1983, 176-77). Calleo and Rowland (1973, 133) argue that while trade produces more specialization and hence greater economic efficiency, "for the efficiency to be realized, perfect market conditions must prevail." This statement is simply not true (as Richardson's 1989 survey clearly demonstrates). Deviations from

17. Of course we are not arguing that there are no confusions in any of the modern trade theory literature.

18. See Pigou 1932.

19. For applications of public choice analysis to trade issues, see Baldwin 1985, Frey 1984, and Willert 1980.

perfect competition do not necessarily imply that trade cannot increase efficiency (although less than would be the case under ideal conditions). The analysis of this question depends importantly on whether one is considering the effects of oligopoly or monopoly in the domestic or foreign economies. Where domestic monopoly power exists, the case for free trade is generally strengthened rather than weakened. Haberler (1950) argued long ago that free trade is probably the most effective antitrust policy ever devised.

The case of monopoly power abroad is more complicated; it may present a valid terms-of-trade argument for active trade policy, but (as will be discussed later) such issues must be analyzed with care. Ill-conceived policy responses may worsen rather than improve domestic economic welfare. For example, while a tariff will lower the profit-maximizing price of a foreign monopolist, the imposition of a quota, by creating an inelastic demand curve over a particular range, may raise the monopolist's profit-maximizing price.²⁰

Does Trade Theory Ignore Unemployment, Adjustment Costs, and Factor Mobility?

A common objection to trade theory is that it ignores the problem of unemployment and other adjustment costs which may result from free trade (Strange 1985, 238-39). Kuttner (1983, 19) is quite correct when he argues that classical trade theory assumes full employment, but he fails to note that modern trade theory has gone well beyond this simple assumption. Decades ago Haberler (1950) clarified the roles of domestic factor immobility and wage and price rigidities in modifying the gains from international trade. He showed that domestic factor immobility in itself will limit the gains from trade but does not negate the proposition that there are net gains. Wage and price rigidities, on the other hand, may cause unemployment, which reduces the net benefits from free trade and could even make them negative. Such analysis has contributed to economists' emphasis on the possible roles of greater wage and price flexibility, adjustment assistance, and perhaps even temporary protection as superior alternatives to permanent protection (see Cline 1983b). It is common in criticisms of trade theory to jump from showing the existence of unemployment costs to claiming that they outweigh the benefits of free trade. It is true that introductory textbook expositions of the gains from trade generally depict costless readjustments along the country's production possibility or transformation curve; for example, from A to B along the frontier in figure 1.²¹ This clearly oversimplifies reality. In figure 1, point A

20. For analysis of this point in relation to the U.S. response to OPEC, see Willert 1976; 1979.

21. Krugman and Obstfeld (1988, ch. 5) and other textbooks in international economics discuss this model in greater detail; see the additional references in footnote 1.

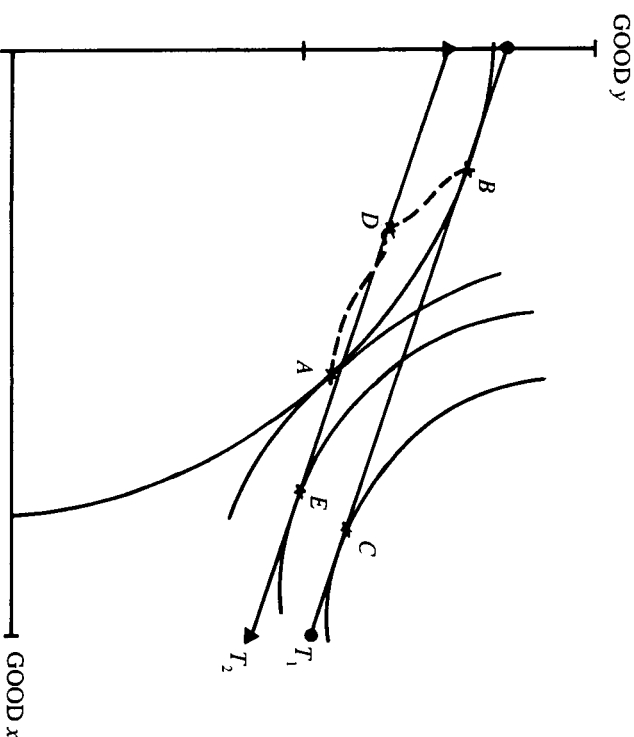


Fig. 1. Adjustments to changing trade conditions

(where the domestic production possibility curve is tangent to a consumption indifference curve) yields the most efficient allocation of resources in a closed economy. Opportunities for international trade can be represented by a terms-of-trade line, T_1 (showing the ratio of price of X to price of Y). Where relative prices on the world market differ from those in the domestic market, efficiency gains are possible by reallocating domestic resources (in fig. 1, from point A to point B). The country now (at point B) produces more of good Y, but is able via international trade to move along T_1 to consume at point C, where T_1 is tangent to a new higher indifference curve. In reality, the reallocation of resources from A to B may be costly. This can be reflected by movement along the dotted line within the production possibility frontier. During this transition the net benefits from liberal trade are lessened and could be negative. Note, however, that gains to consumers from the opportunity for international trade offset the costs of reallocating productive resources. In order for net benefits from liberal trade to be negative, the adjustment costs would have to exceed the gains to consumers. Figure 1 illustrates the case where the production loss (of producing at point D within the production

possibility curve) is more than offset by the consumption efficiency gains, so point E lies on a higher indifference curve than the closed-economy equilibrium at point A, although on a lower curve than the costless adjustment equilibrium at point C. (The price ratio is the same on any line parallel to T_1 .) It should be remembered that the unemployment costs of trade-related adjustments, while quite real, are generally temporary. Thus over time the equilibrium would approach point C. While the conceptual possibility exists, available estimates of adjustment costs suggest that cases where costs outweigh benefits of trade are extremely rare.²² It is interesting to note that studies on this topic are seldom mentioned by critics of trade theory.

Another popular source of concern is that classical trade theory assumes factor immobility between countries, whereas multinational corporations nowadays account for an increasing proportion of international production and exchange.²³ These points are correct, but they ignore the contributions of a substantial modern literature on the role of foreign investment and international factor mobility. One of the major insights offered by traditional trade theory is the role that international trade can play as a substitute for factor mobility. Modern analysis treats national advantage arguments for restrictions on foreign investment as analogous to the traditional terms-of-trade national advantage arguments for restrictions. There are certainly reasons for concern with such issues as the tax effects of multinational corporations, but the existence of foreign investment and multinationals has not undermined the usefulness of trade theory. Instead, these areas have been the subjects of extensive analysis in the modern trade theory literature and have been sources of a number of useful insights.²⁴

Does Trade Theory Depend on Fixed Exchange Rates?

Kuttner's previously quoted statement (1983) that trade theory does not hold in a world of floating exchange rates is incorrect, but his mistake is an understandable one. Classical economists generally thought in terms of a system of fixed exchange rates (typically a gold standard),²⁵ and textbook treatments are often not clear about the balance of payments assumptions underlying their presentations of trade theory. It is therefore not surprising to hear claims that trade theory depends upon the assumption of fixed exchange rates. This is not in fact the case. The necessary assumption is that there is an

22. See, for example, Glenday and Jenkins 1984, Wachter and Eascher 1983, Richardson in chapter 12 of Cline 1983b, and Hufbauer and Rosen 1986.

23. Jones 1983, 177-78; Strange 1985, 245-46; and Tyson and Zysman 1983, 26-27.

24. For a non-technical discussion of these issues and references to the literature, see Tollison and Willert 1982. For a review of the technical literature, see Ruffin 1985.

25. See, for example, Ricardo 1973, 83; or Smith 1937, 284.

efficiently operating international adjustment process so that market exchange rates are at equilibrium levels, which balances the demand for and supply of foreign exchange. This can be achieved either by well-functioning systems of flexible rates with stabilizing speculation, or by fixed rates with wage and price flexibility (the textbook versions of floating rates and/or the gold standard, respectively).

In reality, neither floating rates nor the gold standard have performed ideally, nor have compromise systems such as the adjustable peg system adopted at Bretton Woods. The pegged exchange rates of the Bretton Woods system were often disequilibrium rates that had to be maintained by heavy official intervention in the foreign exchange market, and often by capital and trade controls as well. These led at times to substantial distortions of resource allocation.

The concept of disequilibrium under freely floating exchange rates is more complex; but modern analysis emphasizes that market clearing rates can also be disequilibrium rates if they are generated by speculative forces which do not adequately reflect underlying economic fundamentals. Such rates would not be expected to be sustainable indefinitely and would eventually generate substantial resource misallocations.

Where exchange rates are at disequilibrium levels, domestic and foreign prices are not efficiently translated into one another and a potentially policy-relevant externality exists.²⁶ Indeed, it is only with disequilibrium exchange rates that there is limited validity to the (generally fallacious) popular concern with absolute rather than comparative advantage, expressed in the fear that foreign competition can undercut domestic producers. The maintenance of equilibrium exchange rates will keep the magnitude of trade imbalances limited and as a consequence assures that domestic producers cannot be outcompeted across the board.²⁷ There has developed a substantial literature devoted to analyzing the implications of exchange rate volatility and disequilibrium exchange rates for alternative exchange rate systems.²⁸ Likewise there has been a long-standing and inconclusive debate about whether fixed or flexible exchange rates are more conducive to lowering trade barriers.²⁹ In general, the answer depends on which system is seen as generating less disequilibrium. Those who have argued that pegged rates make the adoption of liberal trade policies more likely tend to assume that the pegged rates are approximately

equilibrium ones, while floating rates display considerable instability generated by destabilizing speculation. Those who argue that flexible rates contribute to trade liberalization, on the other hand, tend to believe that floating rates are dominated by stabilizing speculation, while pegged rates tend fairly quickly toward disequilibrium levels.

The lack of convergence on this issue reflects both a multiplicity of views about relevant concepts of equilibrium and the difficulties of finding measurable counterparts to these concepts. As in the case of imperfect competition, such considerations give rise to complications that in our current state of knowledge leave room for disagreements among knowledgeable people of good will.³⁰ For example, there is still considerable disagreement among experts about how much of the observed instability in our current system of floating exchange rates has reflected destabilizing speculation versus efficient market responses to economic and financial shocks and instabilities in national economic policies.³¹

Still we believe that recent economic analyses of various aspects of the interrelationships of exchange rates and trade policy have generated a number of useful contributions to sensible policy analysis.³² One such contribution is the notion common in mainstream economic analysis that the large U.S. trade deficit of the 1980s is as much or more a reflection of domestic economic policies (primarily of U.S. budget deficits) as it is of deficiencies in the operation of flexible exchange rates or of increases in unfair trade practices abroad.³³ A second useful conclusion is that across-the-board import restrictions, particularly under flexible exchange rates, are unlikely to be a very effective method of reducing the trade deficit, because of the corresponding discouragements to exports which would result.³⁴

Does Trade Theory Assume Static Comparative Advantage?

The argument is advanced by some that, because comparative advantage is so fluid and so susceptible to manipulation, trade models derived from it are not

30. For recent discussions of concepts of equilibrium in the context of the strong dollar of the early and mid-1980s, see Willett 1985a, 1985b; and John Williamson 1985; and for a still useful earlier analysis, see Machup 1955.

31. For recent analysis of this issue and extensive references to the literature, see Arndt, Sweeney, and Willett 1985.

32. See, for example, Bergsten and Williamson 1983 and Richardson 1983a, 1983b; in addition to the papers already cited.

33. It should be noted that this posited causal linkage between the twin deficits is not accepted by all economists; in particular, it is rejected by many supply-side and rational expectations economists. For further discussion and references see Willett 1985b.

34. For discussion and references see Kaempfer and Willett 1987.

26. See Willett 1971 and Cooper 1975.

27. Note that equilibrium exchange rates do not require a zero trade balance. For example, with net capital inflows a trade deficit is required for overall payments balance. The requirements for equilibrium, however, would normally prevent a trade imbalance from growing indefinitely.

28. On this issue and for discussion and references to the literature on the effects of fixed versus floating rates on resource allocation, see Arndt, Thurnbly, and Willett 1985 and Willett 1986.

29. For discussion and references to the literature, see Flacco et al. 1984.

relevant. Comparative advantage therefore may be illusory—or at least the free trade prescription rendered invalid.

Most trade models are static. Thus such charges are quite understandable. There has, however, been considerable attention by trade economists to issues of dynamic comparative advantage. In fact, work on this topic goes back decades.³⁵ It is true, nonetheless, that such dynamic considerations make policy analysis much more difficult and can present a case for ideal government intervention in the economy. It is even possible, as Tyson and Zysman (1983, 30) point out, that “in these dynamic conditions, there are no longer automatic mutual gains from exchange.”

That the pattern of production is changing across countries is clear.³⁶ The more important point, however, concerns what Cline (1983a) calls “arbitrary comparative advantage.” For a number of manufactured goods, highly similar relative endowments in trading partners may fail to reveal a basis for specialization. In fact, for such goods the actual trade flow may be arbitrarily determined by, for example, government intervention. Strategic government behavior might well include an array of tariffs, quotas, subsidies, etc., marshalled to extract some market share in some instances or to prevent its erosion in others.³⁷ It is entirely likely that such strategic behavior by countries or firms will inflict losses on others.

Yeager and Tuerck (1983–84, 662) are appropriately skeptical of the ability of governments to choose the “national pattern of production and consumption,” whether it is the case of attempting to control a market economy through optimal interventions or the case of a planned economy. Furthermore, arbitrary comparative advantage may describe certain kinds of manufactures but is not characteristic of a majority of trade. Thus rejecting more traditional theories of sources of comparative advantage out of hand because arbitrary comparative advantage exists in some sectors seriously overstates the generality of new methods of analysis and ignores the continuing validity of the traditional explanations for much of world trade.³⁸

35. See, for example, Chenery 1960.

36. For examples of studies describing the changing pattern of U.S. production, see Lawrence 1983 and Pugel 1980.

37. It is worth noting that some examples of “successes” in industrial targeting may not be so convincing under further scrutiny. See, for example, Krugman 1983. For a useful discussion of the difficulties of applying the theory to a specific industry, see Pugel 1987.

38. There is in addition a danger of confusing product cycle transitions with arbitrary comparative advantage shifts. The product cycle theory of trade implies that innovation and initial product development and market development occur in higher per capita income countries with higher relative endowments of skilled labor and higher research and development commitments. As product standardization occurs, the comparative advantage in production shifts toward relatively labor-abundant countries. Failure to distinguish between these two types of shifts may well be a source of domestic welfare loss, not gain.

Of course, implementation of policies that target certain industries is fraught with difficulty. The information needed to implement such policies is often extremely hard (if not impossible) to obtain and the intrusion of special interest pressures may be difficult to avoid.³⁹

4. Protectionism Revisited

The New International Economics and Strategic Intervention

The past decade has seen the emergence of a stream of theoretical and policy analysis that focuses on the existence of imperfect competition in international trade and its implications for strategic behavior by firms as well as governments. Much of this literature is written for an audience of specialists; however, Krugman's (1986a) book and a survey article by Stegemann (1989) are explicitly aimed at nonspecialists. Some of the early work by Krugman (1979), Lancaster (1979, 1980), Dixit and Norman (1980), and Helpman (1981) was stimulated by the need for models to explain the prevalence of intra-industry trade among countries, an outcome not generated by the standard neoclassical model. Relaxing assumptions to entertain differentiated products, economies of scale in production, and less-than-perfectly-competitive markets yielded results that accounted for both intra-industry and intersectoral (Heckscher-Ohlin type) trade.⁴⁰ Following this initial work, a variety of lines of exploration have been pursued, especially spillover effects, rent capture, and the “new” reciprocity. These are discussed, respectively, in the next three subsections.

Infant-Industry Arguments: Old and New

It has long been asserted that the infant-industry case is one of the few valid arguments for protection. This argument continues to appear, both in its older version and in a newer one, the former having been addressed in the economics literature and found wanting, and the newer forming the focus of some of the industrial policy debate. Two aspects of the criticism of protection for infant industries are particularly important. First, the call for protection is based on a presumed market failure—that is, domestic business interests for some reason are not creating productive capacity, which once in place would (it is argued) be self-sustaining. Given a “running start,” the industry would

39. See, for example, the arguments in Krugman 1983 and Richardson 1983a.

40. Greenaway and Milner (1986) provide a comprehensive treatment of the literature on intra-industry trade.

be sufficiently profitable to survive the removal of protection. But if there is a market failure here, it is in the capital market, which overlooks an apparently obvious opportunity. Second, even acknowledging that such a failure is possible, we must nevertheless address the issue of the appropriate response.⁴¹ If the failure is a divergence between the market discount rate and some agreed-on social discount rate, then is protection an efficient response? In the context of first-best/second-best responses, a direct solution (such as a financing subsidy) is more efficient than trade restriction. Trade restriction, the equivalent of a tax on consumption and a subsidy to production, represents a second-best response that may nonetheless be optimal if the first-best response in economic terms is not feasible politically. Thus Kuttner's (1983, 17) statement that free trade "as an economic paradigm . . . denies us a realistic appraisal of second bests" gets the logic backward. It is a realistic appraisal of second bests that leads to a clear-eyed assessment from an efficiency standpoint of calls for protection.

Extensions of the infant-industry argument include what Corden (1985, 92) terms dynamic external economies. In one version, firms generate new knowledge in their workers but cannot keep their workers, once trained. Here again, in the context of perfect markets, firms would be rewarded for the training. In the case of market failure, that is, of persistence of the externality, the first-best response is a subsidy linked to knowledge creation.

Krugman (1986b, 13) makes the case as follows: "External economies present a different justification for activist trade policies. By an external economy, economists mean a benefit from some activity that accrues to other individuals or firms than those engaging in the activity. The most plausible example is the diffusion of knowledge generated in one area to other firms and other sectors." Although this externality argument may be persuasive from the standpoint of national economic welfare, determining the form of the policy response to the externality again brings us to the matter of first-best and second-best policies, with no presumption that trade restriction is a first-best response.

Is There a Modern Terms-of-Trade Argument for Protection?

The traditional terms-of-trade argument for protection (Johnson 1965) holds that where a country has market power as a consumer in the market for an important good, there may be net gains in domestic welfare from introducing a tariff which effectively lowers the world price of the good. In effect, the tariff improves domestic welfare at the expense of foreign welfare. As men-

41. See Baldwin 1969 and Johnson 1965.

tioned above, however, there are a number of issues that detract from the simple appeal of such a move. First, on straightforward efficiency grounds, the traditional "optimal tariff" of this type is, in fact, a second-best tariff since the trading partner who would incur losses has an incentive to bribe the domestic government not to impose the tariff. Second, retaliation and tariff warfare are possible outcomes that are disturbingly likely.

Brander and Spencer (1985) and Krugman (1984) have provided a modified version of this motivation for intervention. Krugman (1986b) describes the modern basis for activist trade policy as residing in the ability of the government to extract a portion of economic rent. Rent here means payment to a factor of more than it could earn in its best alternative use. Typically, rent is assumed to be a temporary phenomenon, dissipated by the entry of additional units of those factors receiving rents in that activity. Barriers to entry provide the key to the argument in support of strategic trade policy. If it is true that major industries in tradable goods production are characterized by barriers to entry (economies of scale or learning curves, for example),⁴² then entry into the industry by new firms may be unprofitable despite the existence of rents. Government policies of protection and subsidy may be used to secure a share of the rent in the industry for domestic firms at the expense of foreign firms.⁴³

The existence of this line of inquiry renders moot such criticisms as that by Jones (1983, 176): "Prominent among such absurd assumptions are . . . the general absence of barriers to entry. . . ." Modern trade theory does, indeed, grapple with such questions. In the Brander and Spencer (1985) analysis, the industry consists of two firms, one in each of two countries, providing a homogeneous export to a third country. Brander and Spencer assume Cournot duopoly behavior (each firm takes the other's output as given) and examine three cases of strategic behavior as the two firms vie for the export market. In the first case, if one firm makes a credible commitment to expansion, the other contracts accordingly. Of course, if, as they assume, the two firms are very similar, it would require some kind of external support, such as a government subsidy, to make the expansion credible. In this first case, only one of the firms is able to mount such support and in consequence it expands, the other contracts, and the subsidizing government has effectively assisted in rent capture. In their second case, both firms are able to secure government support, and so neither is inclined to contract its output as the other seeks to expand. The result is a kind of prisoner's dilemma in which both the exporting nations could

42. For a survey of the recent technical literature incorporating such characteristics, see Helpman 1985.

43. Note also that this result (that is, domestic gains from intervention) is very sensitive to model specification. See, for example, the critical assessment by Greenaway and Milner 1986, especially chapters 10 through 12.

be better off if they could agree not to subsidize. The importing nation is of course enjoying the benefits of lower import prices. In their third case, the two exporting nations are able to act cooperatively to generate joint rent-maximizing results. In this instance, because of the peculiarities of the standard Cournot solution,⁴⁴ the optimal response is for the two nations to tax exports so that their firms produce the level of exports equivalent to that generated by a rent- or profit-maximizing cartel.

That strategic circumstances and behavior are treated in the international trade literature is clear. However, the treatments do not reveal any clear policy prescriptions, short of careful modeling of the particulars of each specific case. The policy implications of the Brander and Spencer (1985) rent-capture model change markedly with different assumptions about the rival's behavior and the gains rely on no retaliation. This is an important assumption since the intervention is explicitly predatory. The probability of retaliation is likely to be high.

Foreigners Violate Free Trade Rules; So Should We: Arguments for Reciprocity

According to Calleo and Rowland (1973, 140), "... free trade should be demoted from its central position in American international economic policy. . . . Modern nation-states have long ago abandoned *laissez faire* for welfare mercantilism. There is no reason why trade alone should be exempted from the general progress of modern civilization." The AFL-CIO (1985, 28) contends that "U.S. trade law must be modernized to reflect contemporary realities in a world where the United States is the only country which exposes its industrial foundation to unlimited erosion from imports." And again, Kuttner (1983, 17): "The seductive fallacy that pervades the hand-wringing about protectionism is the premise that free trade is the norm and that successful foreign exporters must be playing by the rules."

That we live in a neomercantilist world is not in dispute. That our trading partners violate free trade norms is not in dispute. In recognizing that others have violated these norms, however, it is important to distinguish between cases where the foreign government has restricted trade and cases where they have subsidized their home producers. Trade restrictions abroad are harmful to us. This has been the major rationale for emphasis on negotiations for multilateral tariff reductions. It is important to note, however, that where our trade policy actions do not influence those abroad, the case for allowing

44. See Nicholson (1989, 563) or other microeconomic theory textbooks.

foreign trade policy actions to influence our own is substantially weakened. While trade barriers abroad harm our economic interests, raising our own trade barriers is likely to make a bad situation even worse.

If there are no externalities and if competitive conditions exist, foreign subsidies may, in fact, generate a transfer to us. In the case of subsidies, the Yeager and Tuerck (1983-84, 184) argument may hold: It should make no difference to us what is the source of the gains from trade, provided only that they exist. Furthermore, "... American workers are no better or worse off if displaced by subsidized imports than if displaced by imports actually produced at low cost, displaced by competition at home, displaced by new and better products, or displaced by changes in the tastes of consumers" (59).

Nevertheless, there may be circumstances when foreign subsidies to their exporters are not welfare-improving for us. First, such support may give rise to dumping. Conceptually, predatory pricing has the possibility of worsening our overall economic welfare. The conditions for this to occur are seldom met in reality, however. Probably a more important reason for antidumping laws is that such pricing seems to offend a general public sense of fairness.

As is emphasized in the recent literature on strategic trade policy, if imperfect competition and externalities are present, there is a potential case for home government intervention on efficiency grounds. Such home government response presents two problems: *a*) what form of intervention should be chosen and *b*) what outcome will ensue after the form has been chosen and implemented. As Richardson (1983a) notes, uncertainty about outcomes is not necessarily a justification for a passive stance. After all, "our policy may be able to improve for us *their* calculation of optimal policy" (emphasis added) (285). A retaliatory stance may well be welfare-improving for the home country. Richardson emphasizes, however, that policies of this type should "be predictable, nondiscretionary, and temporary (contingent on foreign behavior)" (285).

Cline (1983a) provides a careful treatment of the shortcomings of a bilateral, aggressive approach to reciprocity. Among the cautionary notes he sounds is the considerable danger that although reciprocity as a trade strategy may be effective, it may also degenerate into tariff warfare. Threats of intervention in response to barriers may be an effective response, but are less likely to be effective when applied as ad hoc responses. If reciprocity is embedded in a framework of multilateral international agreements, it appears to come closest to the type of policy Richardson describes above. It is certainly not the case that trade theory has ignored the neomercantilist character of modern trading relations. Modern trade theory does point out that free trade is not necessarily optimal and that the choice of intervention and the results of intervention are often ambiguous.

5. Trade Theory and Positive Political Economy

Trade theory alone cannot provide a complete positive theory for trade policy formulation, nor can it provide a complete normative theory of desirable trade policies. In the first case, positive economic analysis must be combined with value judgments about the objectives of policy. In the second, even if economic considerations were the only concerns of policy, economic analysis must be coupled with theories of the operation of the political process. Traditionally, economists have not been altogether clear about this; even normative policy disagreements among economists have often had at least as much to do with differences in views about the operation of the policy process as with differences about economic analysis. These differences in political judgment have typically been implicit rather than explicit. When views about the political process are made explicit, acceptance of some particular one is often treated as being virtually self-evident, with little concern devoted to alternative views of the operation of the political process. The spread of public choice analysis has helped to reduce this lacuna to some extent, although some of the leading contributors to the public choice movement have themselves at times fallen prey to this tendency.⁴⁵

Most economists need a greater awareness of the assumptions about the operation of the political process underlying discussion of policy formulation. The development of greater familiarity with the work of political scientists should be a major priority for economists interested in policy. Among economists who have paid relatively little explicit attention to the political assumptions underlying their analysis, several contradictory perspectives have been adopted. One approach assumes that the political process operates in a way which encourages the adoption of economically efficient policies. In literature on international political economy, this approach corresponds to the liberal or "sovereignty at bay" school.⁴⁶ This tendency toward economically efficient policies is perceived to be the result of the decisions of experts motivated by the public interest, who operate with considerable freedom from the pressure of the general public and from the outcome of vigorous electoral competition. Although this efficiency view enjoyed a good deal of support during the days of progressive trade liberalization among the industrial countries in the 1950s and 1960s, the slowing down and eventual reversal of this trend in the 1970s seemed to demonstrate the limitations of this approach, at least as applied to international trade issues.

45. For further discussion of this set of issues with particular reference to macroeconomic policies, see Willett and Baraian 1988.

46. For discussions of this and the major alternative approaches, see Gilpin 1975, Jones 1983, and Willett 1980.

The other commonly held view is nearly an opposite one. Long before the advent of formal public choice analysis, many trade economists explained protectionism in terms of the political clout of well-organized special interest groups. In this view not only does the combination of concentrated power and poor information under which the political process operates lead to the adoption of excessive protection, but the forms of protection adopted tend themselves to be inefficient. For example, while trade theory suggests that for a given level of trade restrictions a tariff will impose lower inefficiency costs on the economy than quotas and "voluntary" export restraints, the trend has been toward greater use of the latter relative to the former.

An interesting intermediate view, recently emerged from the University of Chicago, emphasizes the importance of the political process and sees rent-seeking activities by interest groups leading to government redistribution policies (see Becker 1983). Such policies will generate deviations from aggregate economic efficiency, but in the new Chicago view the methods of transfer adopted will tend to be efficient in the sense that they will minimize the marginal deadweight costs of redistribution. In other words, while rent seeking may generate an excessive level of trade barriers, the forms of trade protection (for example, tariffs versus quotas) will be efficient. Theoretical and empirical analysis of this view is just beginning to be applied to trade policies. (See, for example, Kaempfer, Marks, and Willett 1988; Kaempfer, McClure, and Willett 1989; and Kaempfer, Tower, and Willett 1989.)

Each of these views offers useful insights but is far from a complete explanation of the operation of the policy process. Trade theory, we believe, offers a useful and essentially correct view of the economic effects of alternative trade policies, but analysis of the formulation of trade (or of any other economic) policy must deal explicitly with the ability of interest groups to influence policy outcomes. Even this is still an incomplete basis for analysis, however, for the proposition that economic interest groups have an important effect on trade policy formulation is far different from the proposition that economic interests are the only important influence. We believe that it is useful to undertake formal modeling on the basis of the former assumption to see what insights may be gained.⁴⁷ But these insights must then be integrated into a broader analysis that takes into account such factors as ideology, foreign policy considerations, and public perceptions of fairness.⁴⁸

The possible influence of ideology on economic policy outcomes has become a topic of debate among economists interested in regulation and trade

47. See Kaempfer 1989, for example.

48. See the paper in this volume by Marks and McArthur. On the need for public choice analysis to go beyond concern with the aggregation of narrowly conceived economic interests, see also Kindleberger 1975, North 1984, and Willett 1980.

policy. It should be noted that public opinion polls commonly show considerable public support for trade restrictions. We believe that this reflects both a lack of appreciation of the full effects of trade restrictions (poll questions often take forms such as "should we restrict imports in order to save American jobs?") and concern with concepts of fairness on the part of citizens and legislators who see little direct stake in the issues in question.⁴⁹

It is also important to recognize that the analysis of the economic effects of alternative trade policies should not be limited to simple two-factor trade models. A considerable amount of the analysis of the income distribution effects of trade policies has taken place in terms of the conflict between aggregate labor and capital shares. Ironically, while the underlying economic theories are quite different, these traditional two-factor trade theory models focus on capital-labor conflicts, just as does Marxist analysis. Some trade policy issues have had a strong component of aggregate labor-capital conflict. More often, however, trade policy pressures result from labor and capital in particular industries operating together with similar interests. The public choice critique of Marxist political theory applies as well to the use of two-factor trade theory as a guide to the analysis of trade policy formulation.⁵⁰ For this purpose, trade analysis based on industry-specific adjustment costs is quite important.⁵¹

As with our discussion of trade theory as a guide for normative analysis, we conclude that modern trade theory is useful in the positive analysis of trade policy formulation. It is only one of several important elements, however. Casual observation is sufficient to show that governments do not always seek simply to maximize economic efficiency. This does not mean that efficiency considerations are irrelevant to positive political economy analysis. Furthermore, trade theory is useful in analyzing the economic impacts of trade policies on various important interest groups, considerations that are certainly important (although not always dominant) in trade policy determination.

6. Concluding Remarks

We conclude with a blunt statement of the point emphasized and illustrated throughout this paper: we find no legitimate support for the view that trade theory is so flawed that it should be discarded as a basis for political economy

analysis. For political economy purposes, however, trade theory must be combined with explicit political analysis.

The assumption often (but not universally) made by economists that whatever policy is most economically efficient will be adopted does not hold up well in the face of empirical scrutiny. Failure of the prediction of the pure economic efficiency approach can occur both because of the pursuit of broader social objectives and because of failures in political markets that allow particular actors to dominate outcomes even when the benefits they receive are not as great as the costs imposed on others.

Modern trade theory reflects an approach to analysis and provides a set of tools for analyzing particular situations. It is not one monolithic theory which implies that *laissez faire* is economically efficient under all circumstances. Debates over the virtues or lack thereof of trade theory in the abstract are pointless and display a lack of understanding of the requisites of constructive policy analysis. The important questions concern which particular theories are useful for particular purposes. The issues are complex and provide ample scope for disagreement among people of intelligence and good will, but this is the appropriate arena for debate and analysis.

We do not believe that trade theory has all the answers; there are many areas crying out for further research, both theoretical and empirical.⁵² For example, the development of strategic trade theory is still in an early stage and our understanding of its likely empirical applicability to various types of industries is more rudimentary still.⁵³ Analysis of adjustment costs and optimal strategies for liberalization are additional topics where a great deal of useful work remains to be done.⁵⁴ The increasing use of computable general equilibrium (CGE) models holds great promise for practical applications.⁵⁵ The effects of the growing use of counter trade is another important topic for research.⁵⁶

At least equally exciting are the many possibilities for combining trade theory with political analysis. For example, while there has been a great deal of analysis by economists comparing the economic efficiency effects of alternative types of trade restrictions, only recently has attention begun to focus

52. For suggestions complementary to our own, see Dixit's 1986 article.

53. In proposing areas for further research, Dixit (1986) notes that the existence of rents remains to be demonstrated in each instance where policy intervention is proposed; further, it remains to be shown that domestic firms cannot capture these rents themselves.

54. Some of the existing work on adjustment costs includes that by Glenday and Jenkins 1984, Wachter and Eascher 1983, Richardson 1983b, and Hufbauer and Rosen 1986. Liberalization considerations are treated in Edwards 1989 and Kreuger 1986.

55. On the design of CGE models, see, for example, Robinson 1989 or Tower 1984. For an interesting application of CGE, see Loo and Tower 1989.

56. See, for example, the article by Banks 1983.

49. For an interesting recent analysis of the influences of concepts of fairness on economic behavior and references to earlier literature, see Kahneman, Knetsch, and Thaler 1986. For discussion of self-interest versus public-interest voting on macroeconomic issues, see Kiewit 1983 and Willett and Banatan 1988.

50. See Olson 1965.

51. See, for example, Magee 1980.

on the comparative political efficiency of such measures under alternative assumptions about the operation of the political process. Paying explicit attention to political considerations opens up a vast area of interesting research for trade theories.⁵⁷ The gains from greater interaction between economic and political analysis run in both directions.

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CHAPTER 3

An Epitaph for Hegemonic Stability Theory?: Rational Hegemons, Excludable Goods, and Small Groups

Joanne Gowa

The political correlates of a stable world market economy remain unclear. Early in the 1970s, a burst of scholarly interest in this subject produced what at the time appeared to be a compelling thesis: the world was safe from tariff wars and great depressions only if a single state or hegemonic power dominated the international political system. Defining international free trade as a public good, "hegemonic stability theory" concluded that its reliable supply depended upon a distribution of international power analogous to that within a privileged group.

In relatively short order, however, critics challenged three assumptions fundamental to hegemonic theory. They argued that: (1) rational hegemons, according to standard international trade theory, adopt an optimum tariff rather than free trade; (2) small groups, as public-good theory itself claims, are close substitutes for privileged groups; and (3) the provision of open international markets implies the supply of excludable rather than public goods. Thus, they concluded, hegemony is not necessary for, and indeed may be antithetical to, a stable world economy based on market exchange.

The potential power of these criticisms is considerable: a persuasive

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