NBER WORKING PAPER SERIES

TRADE POLICY, INCOME, AND EMPLOYMENT

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Working Paper No. 1321

NATIONAL BUREAU OF ECONOMIC RESEARCH
1050 Massachusetts Avenue
Cambridge, MA 02138
April 1984

The research reported here is part of the NBER's research program in International Studies and project in Productivity (World Economy). Any opinions expressed are those of the author and not those of the National Bureau of Economic Research.

NBER Working Paper #1321
April 1984

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ABSTRACT

Disappointing recent growth rates, the emergence of structurally unfavorable income and employment conditions, and important institutional changes in the international trading environment have caused policy officials in the advanced industrial nations to reconsider the proper mix of reactive versus active trade policy in easing adjustment to labor market disruptions and dealing with structural changes. This paper first examines the implications of traditional trade theory as well as the new theoretical developments emphasizing imperfect markets for this policy reevaluation. Alternative policy options are then considered within a framework that recognizes the imperfect real world conditions within which trade policies must operate.

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I. Active Versus Reactive Trade Policy

Trade policy can be used in both an active and reactive manner in promoting income and employment.[1] Reactive trade policy is aimed at mitigating the negative income and employment effects of external shocks on output and labor markets. The introduction of restrictive import measures in response to increased imports that cause or threaten serious injury to domestic producers and workers is an example of using trade policy in this sense. Providing adjustment assistance to workers or subsidies to producers under the same set of import circumstances further illustrates the utilization of trade measures to ease the adverse economic effects of trade-related structural changes. Still another important type of reactive policy is the imposition of antidumping or countervailing duties to offset foreign dumping or subsidization that materially injures domestic producers and workers.

Active trade policy, in contrast, seeks to generate new jobs and higher income levels by pursuing a positivist approach to changing international economic conditions. Encouraging infant industries through import protection or production subsidies is the classic example of active trade policy. More generally, the various positive trade measures associated with the term "industrial policy" fit this classification. Other examples of an activist approach to trade policies are introducing import duties or export subsidies to take advantage of international market power and engaging in foreign dumping.

Controversy over the proper use of trade policy in both its active and reactive senses is presently as intense as at any time since the beginning

of the post-World War II international trading regime. This paper examines the factors giving rise to the controversy and then on the basis of this analysis considers alternative trade policy options aimed at the goals of easing the adjustment to labor market disruptions and dealing with structural changes in a positive manner. An effort is made to consider conceptual arguments as well as specific policy measures in a framework that recognizes the real world institutional environment in which international trade takes place and the actual manner in which economic agents react to various incentives and penalties.

Like most important economic controversies, the debate over trade policy has been touched off by a combination of circumstances. Three factors are especially important: (1) the emergence of structurally unfavorable income and employment conditions that do not seem responsive to traditional free-market policy prescriptions; (2) a general recognition that major institutional changes have taken place in the international trading environment that may call for the use of new policies; and (3) the development of new economic analyses in international economics that provide better insights into the appropriateness of alternative policies.

The following three sections review the evidence and arguments relating to each of these three factors. Particular attention is given to the policy implications of both traditional trade theory and recent analyses based on more realistic assumptions. The fifth section appraises the effectiveness of alternative trade policies in increasing employment under actual real world conditions and motivations, whereas the sixth places trade policy within the foreign policy context in which most trade-related decisions are made. Drawing upon the discussion of the preceding sections, the final sec-

tion then sets forth various policy options based on reactive and activist approaches to trade policy as well as on international cooperation.

II. SHIFTS IN THE STRUCTURE OF INTERNATIONAL TRADE

The poor recent record of income growth and employment creation in OECD countries has been well documented in previous OECD studies and will only be briefly summarized here.[2] These studies indicate clearly that the period since the first oil shock in 1973-74 represents a new, less satisfactory economic era for OECD countries. In contrast to the 1960s and early 1970s when real growth rates for these countries averaged 5 per cent annually and the average unemployment rate was only 2.8 per cent, the period since 1974 has been characterized by a significant slackening in growth and a sharp rise in unemployment. Specifically, from 1974 through 1982 real GNP grew at an average annual rate of only 2 per cent, while unemployment averaged 6.6 per cent. Closely related to these declines was a fall in the real growth rate of world trade from 8.5 per cent from 1963-73 to 3.5 per cent from 1973-81. In addition, consumer prices rose at an average annual rate of over 10 per cent from 1973 to 1982 in contrast to less than 4 per cent between 1960 and 1973.

A particularly disturbing feature of the slowdown in economic activity is its uneven geographic, industry and demographic impact. For example, in unlike the United States where employment growth recovered quickly after the first oil shock, employment in Europe has remained flat over the last several years. Similarly, while growth in such sectors as telecommunication equipment, computers, and certain chemicals has been strong, employment has declined in most OECD countries in textiles, the basic iron and steel industries, and shipbuilding and repairing. Young people and women have also borne a dis-

proportionate share of the unemployment. Thus, there is abundant evidence indicating that the problem is not simply a macroeconomic one. There are serious structural elements in the unfavorable economic performance of OECD countries.

The shocks that have played a major role in creating these economic problems have come from many sources: the introduction of new technology, shifts in demand, changes in energy conditions, labor supply developments such as the increase in the proportion of women entering the labor market, new government economic and social policies, shifts in the structure of international trade, etc. It is this last disturbance source that is of special relevance for the theme of this session, since trade policies are usually introduced to deal with economic problems allegedly arising from the international sector.

Among the significant changes in the pattern of international trade that OECD countries have had to cope with in recent years is the emergence of the developing countries as important industrial competitors. As the 1979 report by the Secretary-General, The Impact of the Newly Industrializing Countries on Production and Trade in Manufactures, pointed out, the 1970s were characterized by a marked acceleration in the share of newly industralizing countries' (NICs) share of OECD imports of manufactures. This share rose from 1.6 per cent in 1963 to 8.1 per cent by 1977. As would be expected on the basis of trade theory, the export increases from the NICs have been concentrated in industries based on mature technologies and utilizing high proportions of relatively unskilled labor. They include textiles, clothing, leather and footwear, woodworking, certain types of electrical machinery,

rubber manufactures, some manufactures of metal, and miscellaneous finished manufactures.

A number of these industries were already faced with unemployment problems in OECD countries due to such factors as import increases from other developed countries, sluggish demand growth, and the introduction of labor-saving technology. Consequently, there has been much concern about the additional unfavorable employment impact associated with the rapid rise in the NIC's market share in these product lines. As Professors Sapir and Schumacher report in their paper,[3] Schumacher has estimated that some 600,000 jobs (40 percent of which were in the textile, clothing and leather sectors) were lost in the EEC between 1970 and 1977 as a result of increased imports of manufactures. This equals .6 percent of total manufacturing employment in 1977.

The other side of the picture is that industrial exports from OECD members to the developing countries have also grown rapidly and that OECD countries have a substantial trade surplus in these products with the developing countries. The exports have consisted essentially of investment goods. Thus, as a consequence of these relationships, Schumacher estimates that between 1970 and 1977 1.8 million new jobs were created through OECD exports to developing countries. In other words, while the growing importance of these nations as industrial trades has created significant adjustment problems for certain labor-intensive sectors, on balance this development has been an important net contributor to employment.

Another important shift in international competitiveness that has stimulated debate over the proper use of trade policy is the sharp rise since 1973 in the deficit of most OECD countries with Japan. For example, the U.S. and EEC trade deficits with Japan rose from $2.2 and $1.6 billion,

respectively, in 1973 to $18.3 and $12.5 billion, respectively, in 1981. However, this rise in net Japanese exports of manufactured goods to other industrial countries has been largely offset by a net increase in primary-product imports from the developing nations and certain developed countries. Nevertheless, the rapid growth in Japanese exports of motor vehicles and other transport equipment, machinery, iron and steel, and household appliances has exerted considerable adjustment pressure on labor and management in most OECD countries and has led both to the adoption of numerous trade-restricting measures and the call for further export-promoting activities.

As Sapir and Schumacher document in their paper, broad shifts in the composition of the trade of OECD countries have been another source of structural adjustment pressures in these countries. One of the most important of these shifts is the more rapid growth in services trade than in commodity trade. Although the statistics on the extent of services trade are imperfect, these authors estimate than trade in services is growing about 00 faster than trade in goods. One consequence is a shift in the demand for occupational skills. Services require relatively high proportions of professionals and managers as well as sales and clerical workers, whereas manufactured goods use comparatively large numbers of operatives and craftmen. However, the labor coefficient for services that enter international trade is only slightly lower than for manufactured commodities and the average educational requirements are only moderately higher in the traded services sector.

Shifts in the composition of trade in manufactured goods have also led to structural adjustment pressures in OECD countries. As the developing

countries have gained competitively in labor-intensive manufactures, the export share of textiles, clothing, and leather has declined while the import share has risen. Non-electrical machinery has declined slightly in relative importance on both the export and import side, but this decline has been more than offset by a market rise of electrical machinery and motor vehicles. Chemicals have also become relatively more important as a traded good but more so on the import than export side. Finally, there has been a sharp fall, especially in imports, in the share of primary metal products.

Obviously, as Schumpeter pointed out long ago,[4] economic growth is never likely to be a smooth process that affects all parts of an economy in the same way. Instead, as in the past, it is likely to be a discontinuous, disruptive process that both creates new economic sectors and groups and destroys old ones. Consequently, the various international and other structural shocks described above might be considered as simply typical of the development process. However, what seems unique in the experience of OECD countries over the last decade or so is the suddenness and intensity of some of the shocks coupled with a growing degree of resource inflexibility that makes it increasingly difficult to adjust to exogenous economic events. Doing little more than providing income maintenance support in order to give markets time to adjust in the textbook manner does not seem to be a politically or economically viable option for many governments. Consequently, as in other fields, there are more frequent calls in the international area for the more aggressive use of active and reactive trade policy as a means of coping better with shocks from the international sector.

III. CHANGES IN THE INSTITUTIONAL SETTING FOR TRADE

Both traditional trade theory and the rules of the major international organization established for the purpose of maintaining a liberal international trading regime, namely, the General Agreement on Tariffs and Trade (GATT), are based on a set of institutional assumptions that are very different from actual conditions. Trade theory, for example, has typically assumed that each industry in each country consists of a large number of competitive firms producing homogeneous products. Factor markets are also taken to be competitive with productive factors moving freely among domestic industries and not at all internationally. Governments are assumed not to participate in the production process.

The GATT is also based on a simplified view of the institutional framework within which international trade takes place, although its recently approved set of new non-tariff codes does improve the situation to a considerable extent. For example, there are no rules dealing with restrictive business practices or international investment. State trading enterprises are recognized, but the article dealing with them is concerned mainly with trading organizations established for revenue purpose rather than with producing organizations owned by the government and pursuing development or adjustment goals. Until recently, even the practice of government subsidization of privately owned firms received only modest attention in the GATT and the rules are still very general.

In the last 20 years the institutional framework within which international trade takes place has changed dramatically from that visualized by

either the classical trade theorists or the framers of the GATT. Two changes are particularly important: the greatly increased importance of multinational corporations in world trade and the increased intervention of the state in international trade through various forms of subsidization, nontariff import restrictions, and the ownership of production facilities.

By the middle of the 1970s, multinational corporations (firms that engage in foreign direct investment) accounted for one-fifth of the world's output. Their production has been growing for some years at 10-12 per cent annually, a rate almost twice as high as world output. Furthermore, the intrafirm trade of these corporations accounts for 25 per cent of all trade in manufactures. Since multinationals are characterized by significant size, considerable product and geographic diversity, and an emphasis on R&D as well as product differentiation, their rapid growth has produced an imperfectly competitive international market structure quite different from the static, purely competitive one envisioned in traditional trade theory. The ability of multinationals to shift technology, capital, and managerial skills quickly from one country to another to take advantage of differences in relative costs has also greatly increased the possibilities for disruptive structural shifts in trading patterns.

The greatly increased role of the government in economic affairs has brought about another significant change in the institutional nature of the trading environment. The traditional view confines government intervention in the trade field mainly to tariff protection and the occasional imposition of anti-dumping and countervailing duties. However, in many countries governments are now important, active participants in inter-

national trade. They play a key role in determining which industries will expand and which will contract by means of direct and indirect planning, by supplying low-cost funds for research and investment purposes, by encouraging particular production patterns among firms within an industry, by facilitating access to capital markets, by providing various tax and other production subsidies, etc. Furthermore, more and more governments in the industrial countries are becoming owners of manufacturing and service-oriented firms that are important international suppliers.

The implications that many policymakers, who are trying to cope with sluggish growth and serious structural problems, draw from these two developments are obvious. Instead of viewing the commodity and geographic patterns of trade as being based on an allocation of world resources that is consistent with the basic principles of comparative advantage, they regard a large part of actual trade as being based on private monopoly power and government aids that artifically create comparative advantage in particular product lines. Consequently, when these policy leaders observe industries in their own economies being disrupted by rapid increases in imports or losing exports in third markets to heavily subsidized firms in other countries, they find it hard to accept the advice that they should not adopt an aggressive active or reactive trade policy stance themselves because somehow the existing state of affairs corresponds to basic resource endowment patterns. To them, the real trading world is so far removed from the world of trade theory that to follow traditional policy prescriptions is to risk being exploited by other countries and to fall behind in international competitiveness.

IV. TRADE THEORY: POLICY IMPLICATIONS AND NEW DEVELOPMENTS

The durability of the liberal policy prescriptions derived from traditional trade theory seems to demonstrate the truth of Lord Keynes' observation that "...the ideas of economists and political scientists, both when they are right and when they are wrong, are more powerful than is commonly understood."[5] Given the unsatisfactory economic conditions in many OECD countries and the wide acceptance of the view that actual institutional conditions diverge significantly from those posited under classical trade theory, one might have expected both this theory and its policy implications to be widely discredited. However, traditional trade theory and especially its policy prescriptions continue to be remarkably influential at the highest government levels in most developed nations as well as within the international economic organizations that these countries dominate.

There are several possible reasons for this. It may, for example, be the case that the principles and policies being criticized represent an overly simplified version of traditional trade analysis and that a complete statement of the theory is not open to these criticisms. The fact that the assumptions of traditional trade theory do not closely fit real world conditions also may not be a relevant criticism. Theory often abstracts from reality in order to bring basic relationships out more clearly. Introducing all the complexities of reality may not change the essential policy implications of the theory. Finally, a theory may continue to influence policy thinking even though everyone is aware of its shortcomings simply because a satisfactory alternative analysis of the matter under consideration does not exist. Both scholars and policymakers are reluctant to give up a well-

established theory that provides clear-cut policy prescriptions in favor of an incomplete set of alternative relationships whose implications have not been fully explored in a rigorous manner.

(i) The Policy Implications of Traditional Trade Theory

The basic welfare proposition of traditional trade theory is simply that some trade is better than no trade for any country. In other words, given the usual assumptions about perfect competition, internal factor mobility, and the absence of domestic distortions, it can be shown that a country can raise its real income level by engaging in international trade rather than by producing all the goods it wishes to consume itself. However, if one also assumes that the country is "small" in the sense that the size of its international purchases and sales has no effect on the prices of traded goods, a much stronger conclusion can be derived. It then follows that a policy of free trade will maximize the country's real income level.

Being able to demonstrate under the above conditions that free trade maximizes a nation's real income is not the same -- it should be emphasized -- as showing that every group, e.g., labor, actually ends up better off under free trade than with no trade or some particular level of import protection. The maximization statement is a short-hand way of saying that under a general policy of free trade (given fixed terms of trade and the other assumptions), it is potentially possible to make everyone better off within the country no matter what the initial distribution of income, provided there are no costs of identifying who should be compensated and redistributing income. In moving from (say) a no-trade position to a particular market-determined free trade position, productive factors used

intensively in the production of exported goods tend to gain (since the demand for their services tends to rise) while those involved heavily in import-competing goods tend to lose in real income terms. Thus, since income-compensating arrangements for trade policy changes do not exist in most countries (and those that are in operation generally do not completely offset losses), and redistribution costs could more than exhaust the aggregate gains from free trade, it is necessary to be very cautious in drawing practical policy statements from the statement about free trade maximizing a nation's real income.

What if buyers and sellers of a country represent a sufficiently large part of world markets that by acting collectively they can influence international prices, at least for some commodities? Quite obviously, buyers and sellers in large industrial countries fit this description, and even in many developing countries sellers possess some monopoly power in the markets for their primary product exports. Under these conditions, as trade theorists have pointed out for over a hundred years, a country can raise its real income compared to the free trade level by imposing optimal import or export taxes.[6] Obviously, when sellers or buyers can affect prices, i.e., their terms of trade, when acting together, they can improve their collective economic position at the expense of other countries by exercising this monopolistic or monopsonistic power. However, this conclusion depends upon the assumption that trading partners either do not also possess this power or do not engage in similar actions. When retaliation by other countries can occur, a wide range of outcomes is possible, depending upon such factors as each country's relative size, its tastes and cost conditions, and how each nation expects

others to react to its trade actions. For example, in a simple two-country model one outcome is that both countries end up worse off then under free trade. However, it has also been shown that it is possible for one of the countries to end up being better off than under free trade. If each country recognizes its interdependence with the other, still another possible equilibrium position is free trade, even in the absence of cooperation. Another key policy implication of standard trade theory is that free trade maximizes world production and thus world economic efficiency. More specifically, if it were possible to redistribute income among countries in a costless, non-distorting manner, it would be possible to make every country better off than it would be under any particular non-free trade arrangement. Of course, since governments are primarily interested in the welfare of their own people, this conclusion does not have much practical relevance, even if the fact that redistributional efforts are costly is ignored.

Besides the terms-of-trade argument for trade taxes, classical trade writers set forth another important reason for government intervention in the international sector, namely, the infant industry case for protection. This is an argument for temporary protection based on the failure of private markets to allocate resources efficiently for some reason. The existence of technological externalities associated, for example, with knowledge acquisition, imperfect capital markets, imperfect private information, etc., can justify the introduction of temporary production subsidies or possibly tariffs. Such intervention can raise a country's real income over time without lowering that of other countries.

In the last 20 years the basic idea underlying the infant industry case, namely, the existence of some divergence between private and social cost or valuation such that the private market mechanism does not maximize real income, has been extended to cover many other reasons for intervention by the government in international markets. Factor market distortions, production externalities, and consumption divergences, whether institutional or technologically determined, all give rise to reasons for trade policy interventions by the government.[8] For example, if unemployment prevails because wages are rigid in a downward direction for some reason, a tariff or export subsidies may increase employment and welfare in a country without reducing employment and welfare in other countries. However, in all of these cases where the divergence (or distortion) exists in domestic markets, intervention through trade taxes or subsidies is second-best in the sense that some combination of taxes and subsidies not just confined to traded goods can increase welfare even more. But, when differences in the actual costs of administering such interventionist policies as wage subsidies, production subsidies, export subsidies, etc. are taken into account, it is possible that in some cases trade measures are the best interventionist means.

Trade economists have also long recognized that productive factors, especially capital, move across national borders and that this has international economic policy implications. For example, many developing countries have discovered that protecting certain industries leads to an inflow of foreign investment and thus increases in domestic employment. There are also good arguments for interfering with the free international flow of capital. If the foreign supply curve of capital is upward-sloping, a country can raise its welfare by exploiting this monopsonistic power

through a tax on foreign capital. Similarly, if a capital-supplying country is sufficiently large to affect the rate of return on capital abroad, it can increase its real income by limiting the outflow of capital through taxes or other means. Again, these conclusions are based upon the assumption that other countries do not retaliate.

The preceding summary of the main policy implications of traditional trade theory, as this theory has evolved to the present time, hardly represents a blanket endorsement of free trade. Nor can it be interpreted as generally supporting protectionism and other government interventions in international markets. Instead, the analysis indicates that arriving at appropriate national trade policy decisions is a difficult and complex matter, even at a theoretical level. Detailed knowledge is required concerning such matters as economic conditions in the sectors seeking government assistance, the economic consequences not only of alternative trade policies but of alternative domestic measures, the likely reaction of foreign producers and governments, etc. However, there are also many instances when the argument for protection or subsidization can be easily rejected on general analytical grounds. These cases usually do not try to show in a serious way that a nation's real income can be raised by government intervention, but instead basically involve the request of a particular group to benefit at the expense of the nation as a whole.

(ii) New Analytical Developments

As noted earlier, trade theory has been severely criticized for generally assuming that there are large numbers of suppliers of each product. In fact, however, competition is often imperfect in the sense that there are only a relatively small number of producers in each country who supply similar but not

identical products. A major analytical development in recent years has been to introduce imperfect competition explicitly into trade models and explore its implications for trade policy.[9] As some of the critics of traditional trade theory had maintained, the result of this analysis has been to qualify further the national case for free trade.

To see why a tariff may increase real income in a country when it faces imperfectly competitive market conditions, consider the case where the foreign supplier of a particular product is a monopolist and there are no producers of the item domestically. By charging consumers in the importing country a price that maximizes his profits, the monopolist will earn pure profits. A tariff imposed by the importing country can capture some of these profits. While the monopolist will respond to the cost increase due to the tariff by reducing output and raising foreign price under usual demand conditions, the revenue increase to the tariff-imposing government will more than offset the loss to its consumers due to the higher price. However, under some demand conditions an import subsidy will be the appropriate response since price will fall more than the subsidy.

If a domestic firm also produces the item and the rivalry between the two producers is resolved as a Cournot duopoly, a tariff (or subsidy) will not only increase domestic real income but also domestic employment. Furthermore, these results generalize to situations in which there are not just two firms (duopoly) in each market but several firms that recognize their interdependence (oligopoly). However, more theoretical analysis is needed to determine whether other policies can achieve the same benefits for a country more efficiently.

As in the terms-of-trade case discussed earlier, it is important to recognize that other countries are likely to retaliate by introducing tariffs (or subsidies) themselves. When this occurs, it can be shown that the combined welfare of the countries involved ends up below the maximum level that is achievable. However, when transport costs are so high that unrestricted intra-industry trade is welfare-reducing, this maximum level will involve some positive level of tariffs.

One interesting application of the new imperfectly competitive framework for trade theory helps in understanding why governments adopt export-promoting policies such as export credit subsidies and R&D subsidies. Suppose, for example, that a domestic and foreign firm compete in a third market. In the absence of government intervention they are assumed to be in a Cournot equilibrium situation in which they share a certain level of pure profits. If the government of one of the countries provides export subsidies or R&D subsidies to its domestic firm, this producer may be able to capture a larger share of the world market and increase its profits net of the subsidy. Thus, the country could gain in income and employment terms. The reason for this outcome is that the government's action is credible to the foreign competitor and this foreign firm reduces its output in view of the lower costs of its competitor. If one of the two firms announced it was going to subsidize itself, such a statement would not be treated as sustainable by the other and this other firm would not retrench.

As in the case discussed above, retaliation in the form of subsidies by the foreign government must be expected. This will lead to a noncooperative solution where both countries engage in subsidization and where the joint welfare of the producing countries could be increased by cooperative behavior that reduced

the level of subsidies.

The trade model formulated by the Cambridge Economic Policy Group, a research group in the Department of Applied Economics at the University of Cambridge, represents another analytical development that is especially relevant for the theme of this conference. The policy prescription emerging from this model is that industrial countries experiencing high unemployment levels should introduce general import protection as part of an expansionary government program aimed at increasing employment.[10] The purpose of the import restrictions is not to protect particular industries or to achieve a "beggar-thy-neighbor" balance-of-trade surplus but rather to prevent a worsening in the trade deficit as aggregate demand increases.

Unlike the classical trade model, the Cambridge group postulates an industrial economy in which there is unemployed labor and excess capital capacity. Bargaining by trade unions sets wages at a level that maintains the purchasing power of workers' take-home pay, while management sets the prices of domestic goods on the basis of a fixed mark-up over normal unit costs. Consequently, there is no automatic mechanism that tends to produce full employment and balance-of-payments equilibrium. Indeed, the Cambridge group contends that international price and quality trends are tending to push most industrial countries progressively below their full-employment potential.

Given this highly unfavorable structural unemployment situation, the Cambridge economists advocate expansionary government fiscal and monetary policies coupled with either uniform tariffs on imports of services and manufactures (food and raw materials would be excepted) or quantitative import restrictions. These trade policies are preferred to the conventional policy of currency

depreciation for two main reasons. With tariffs or quotas a country can take advantage of its monopsonistic power and improve its terms of trade by forcing foreign suppliers to bear part of the tariff, i.e., foreigners lower the price (in terms of their own currency) of their exports as the demand for these goods by the tariff-imposing country declines due to the tariff. Devaluation has this effect on the import side but, in addition, it lowers the foreign currency price of the devaluating country's exports. Whether the foreign price of the country's exports falls more or less than the foreign price of its imports depends upon the demand and supply elasticities of the commodities involved, but the Cambridge group's econometric model for the United Kingdom indicates that devaluation, in contrast to a uniform tariff, will worsen the U.K. trading terms.

The second reason for preferring tariffs over devaluation is that the latter policy raises export profits and thus redistributes income away from workers. Both this effect and the terms-of-trade determination cause workers to press for higher nominal wages to restore their real wage and thus set off strong inflationary pressures that tends to frustrate the effort to expand employment. However, according to the Cambridge economists, by employing tariffs or quantitative restrictions to prevent an increased trade deficit and by returning the tariff revenue (or its equivalent) to the workers, inflationary pressures will be much less and the expansionary government policies will be successful in raising employment significantly.

Critics argue that the Cambridge model reaches its conclusions about employment by not giving sufficient weight to certain medium-term and long-run economic relationships that are likely to hold. For example, a general increase in protection by one industrial country is likely to lead to retailiatory tariff increases by its trading partners (especially when their

terms of trade worsen) that offset any favorable terms-of-trade effect. Furthermore, in contrast to devaluation, the imposition of tariffs tends to reduce real income because of the distortion in product prices. If the country's terms of trade do not improve because, for example, foreigners retaliate, this real income loss to workers will tend to touch off a wage-price spiral. When exporters raise their prices in response to higher wages and imported input costs, the resulting decline in their sales and employment levels tends to offset the employment gains in the import-competing sector due to the tariff increases.

The inflationary effects of domestic fiscal expansion also cannot be ignored. The rigidities and inflexibilities that account for the structural unemployment in the first place may cause, first, selective and then general, cost and price rises that frustrate the entire employment-generating effort. It may be necessary to deal directly with these rigidities in order to solve the unemployment problem.

According to its critics, the Cambridge group also does not pay sufficient attention to the adverse long-run effects of reducing profits by raising import prices. By reducing the effective rate of return to saving, this may decrease long-run investment and the rate of employment growth. In other words, short-run employment gains may occur at the cost of greater unemployment in the future.

(iii) Conclusions from Theory

The trade policy implications of the recent efforts to incorporate more fully imperfect competition and the existence of structural unemployment into trade models reinforce those previously reached after considering traditional trade theory -- not in the stereotyped form that it is sometimes presented but in the way it is currently used by trade economists.

There are a variety of conditions in which the introduction of trade-restricting or trade-promoting policies by a government can increase the country's income and employment level. It is useful to divide these conditions into two groups: those where the reason for this possibility is due to the nature of international markets and those where the reason is based on the existence of particular domestic market circumstances. The first category covers both the case where a country's producers are operating in competitive domestic and international markets but the government, through trade policy, can, in effect, get these producers to act collectively in international markets as a monopolist, and the case where domestic and international markets are imperfectly competitive and the country's producers, as well as those of other countries, are behaving accordingly. In both of these situations government actions that raise income and employment in a country do so at the expense of income and employment in other countries. It also follows that if all governments undertake efforts to raise their income and employment levels at the expense of others, the final noncooperative equilibrium is a position that is not optimal for the countries collectively. In other words, by cooperative efforts to lower tariffs from the levels reached in a noncooperative equilibrium, it is possible to make all the countries better off in income and employment terms. However, in certain cases this might have to be coupled with some international redistribution of income.

In the second category of circumstances (where domestic distortions are the reason why a country can gain by interventionist trade policies), a country can raise its income and employment level without necessarily reducing income and employment in other countries. For example, when demonstrating how a tariff or export subsidy can raise a country's income, the theoretical

literature on domestic distortions usually assumes that the country faces fixed terms of trade. This means that other countries do not suffer any losses because of this trade policy action. However, as noted previously, a key result of this analysis is that a domestic policy, e.g., a production subsidy/tax or a factor subsidy/tax, can raise the country's income even more. In other words, using trade policy to correct a domestic distortion is a second-best solution.

For most OECD countries a significant part of their trade takes place in imperfect markets and their government can affect their terms of trade. Trade policies aimed at offsetting a domestic distortion thus can adversely affect other countries and lead to a retaliating sequence which hurts everyone on balance. Similarly, cooperative tariff-reducing efforts among countries may have adverse (or favorable) effects because of the existence of domestic distortions.

The optimal policy mix from a world welfare viewpoint is to utilize domestic policies to offset the unfavorable income and employment effects of domestic distortions and follow a cooperative international approach as far as trade policy is concerned. But difficult choices still arise for individual countries and the international community as a whole, even under this policy mix. For example, while offsetting a domestic distortion with a domestic policy will increase potential world income more than if an international measure is used, the trading terms of other countries may decline because of these domestic policies and they may (and are entitled to under GATT rules) initiate a retaliatory sequence that hurts all countries. Similarly, what if it is not feasible politically for a country to offset a domestic distortion with a domestic policy measure? Others are very likely to retaliate against this second-best policy, even though potential world income might still be

increased. What if an international transfer of income to a country is necessary for it to be worthwhile for this country to engage in a multilateral tariff-reducing exercise that raises collective income and employment? Compensatory international income transfers are rare and usually politically infeasible.

IV. The Ineffectiveness of Trade Policies

Trade theorists have rightly been criticized for making unrealistic assumptions that lead to very simplistic policy conclusions. However, a similar criticism can be made about analyses of the effectiveness of trade (or domestic) policies. Discussions of these matters usually take place in an overly simplified analytical framework based on assumptions that insure that the policies accomplish their intended purpose. Yet these assumptions are often unrealistic and lead to incorrect conclusions about the effectiveness of a particular policy.

This section explores some of the reasons why actual trade policies often fail to accomplish what the government intends.[12] Furthermore, in many cases it is not economically or politically feasible for governments to take steps to offset the factors that cause the ineffectiveness of some trade policies.

Trade policies operate directly upon the relative prices and quantities of imported or exported goods and, by affecting the domestic prices of traded goods, indirectly influence levels of production, employment, factor rewards, and consumption in domestic industries producing similar goods. Sometimes the primary reason for utilizing trade policies is to affect the volume or prices of traded goods, but more frequently the objective is to influence one of the variables that is only indirectly affected by trade measures, such as production or income.

There are three general ways in which a trade policy can be ineffective in attaining its stated purpose. First, domestic prices change in the predicted direction but not by as much as policy-makers expect because of offsetting supply and demand responses. Secondly, domestic prices move in the direction and to the extent desired, but the new prices fail to produce the indirect effects expected. The reason is the failure of the price effect to stimulate the particular response in the private sector that is desired. Finally, domestic prices of imports or exports actually move in the opposite direction to that intended. This paradoxical outcome seems more of a theoretical curiosity than a real world problem and will not be considered further here.

(i) Offsetting Supply and Demand Responses.

There are a variety of both legal and illegal ways in which trade policies can be rendered less effective than expected due to offsetting supply and demand responses. Legal means include: (1) importing or exporting the product in either more or less processed forms that are not covered by the trade measure; (2) changing the quality mix of a traded product; (3) shifting to a substitute product; (4) varying the country or domestic-customer distribution of imports or exports; (5) shifting the country distribution of production; and (6) retaliating with another trade policy measure. Furthermore, trade policies can have offsetting macro effects. Illegal ways of avoiding the restraining or promoting effects of a trade measure include: (1) smuggling; (2) transshipments through third countries; (3) incorrect invoicing; and (4) bribing customs officials. Several actual examples of these various legal and illegal responses are given below. They come from U.S. experiences but can easily be duplicated in other countries.

Avoiding an import restriction by exporting the product in less processed

form is illustrated by the experience with shipments of small trucks to the United States. The U.S. tariff rate on assembled trucks had been raised earlier, but the rate on unassembled trucks was left at 4 per cent. The difference between the duty-inclusive prices of assembled and unassembled small trucks exceeded the cost of assembling "knocked-down" trucks in the United States. Therefore, small trucks were shipped unassembled, and integrated domestic producers of trucks did not receive the degree of protection intended from the tariff on fully assembled trucks.

This technique of avoiding high import duties is frequently followed in the apparel trade. One case involves costs with removable sleeves. By importing sleeves unattached, the rest of the coat comes in as a vest at a lower duty than if the sleeves were attached.

Using substitute components is another common way of avoiding import restrictions. The quotas on imports of sugar into the United States apply only to pure sugar, defined as a 100 per cent sucrose. Importers are avoiding the quotas by importing sugar products consisting mainly of sucrose but containing some sugar substitute, e.g., dextrose. Importers of running shoes also get around the high tariff on rubber footwear by using leather for most of the upper portion of the shoes, thereby qualifying for duty treatment as leather footwear.

The response of Japanese automobile suppliers to their government's agreement to limit voluntarily exports of autos to the United States illustrates how the restrictiveness of quotas can be offset in part by a shift in the quality mix of a product. The introduction of a quantitative restriction in contrast to an ad valorem tariff will in most circumstances lead to a shift in the composition of the protected product from less expensive to more expensive varieties. Such was the result in the auto case (as it had been

earlier when quotas on textile products and on shoes were put into effect). Thus, though the quantity of automobiles imported was reduced, the value of these imports (after correcting for general inflation) increased significantly as Japanese exporters responded to the excess demand for their cars by shifting to their higher quality models. Since the value of imports fell less than expected, employment in the U.S. auto industry increased correspondingly less.

The auto case also illustrates the manner in which shifts in supply sources can offset some of the intended effects of protection. It has been estimated that European suppliers took up one-third of the "slack" created by the quotas on Japanese cars. Furthermore, while the increased production of Japanese cars within the United States -- but outside of the Detroit area --helped overall U.S. employment, it hurt employment in the region suffering most from the auto slump, namely, Detroit. The shift in production facilities to Singapore in response to voluntary export restraints by Japanese for TV sets is another example of this response.

Illegal actions designed to avoid the effects of protection are not a major problem in most industrial countries but do significantly affect effective rates of protection in many developing countries where customs officials are not as well trained and equipped and official levels of protection are very high.

(ii) Uncertain Indirect Effects

As previously noted, a trade policy may not accomplish the desired objective even when it produces the expected effects on domestic prices and trade. This is because trade policies are often used to change economic variables that are only indirectly related to the prices and quantities of traded goods. For

example, an industry faced with a surge of injurious imports frequently seeks temporary protection, arguing that protection will give the industry the time and resources needed to introduce new and more productive equipment and techniques. The modernization will supposedly eliminate the need for protection after a few years.

Standard economic analysis does not suggest this outcome. If an industry can be profitable with new equipment once protection is removed, why can't the industry enter the capital market to obtain the necessary funds to purchase the equipment? The answer often given is that an improved short-term profit performance is necessary both as a source of of capital funds and as an encouragement to other investors. However, a rational investor may attribute the better short-run profit performance to the higher import protection and thus base his judgment about long-term investment upon profit prospects in the absence of protection or else on the likelihood that protection will continue. Furthermore, profits generated by protection may be used by the industry to invest in completely different activities. Workers in the U.S. steel industry have expressed concern that the industry is using its profits -- part of which are attributable to the import protection secured with the help of the workers -- to invest in other industries. Protected producers may also find that, from their viewpoint, the best way for them to use the extra profits is to lobby for continued protection. This may provide employment for some individuals outside of the injured industry but it does not add to the economy's real income.

Similar problems arise when the aim is to help selected groups in an industry or to overcome particular domestic distortions. For example, raising farm prices by means of trade measures in order to encourage family farming may, in fact, increase the relative importance of corporate farming, since

corporate farms are likely to have easier access to capital markets and therefore be able to exploit new profit opportunities more rapidly. Similarly, temporary protection is sometimes justified as a means of overcoming domestic externalities associated with the acquisition of knowledge and on-the-job training. But, in fact, the protection may lead merely to expansion using existing productive techniques and skill mixes. Protection is such a crude and blunt policy tool that it cannot be counted upon to produce many of the indirect effects it is called upon to do.

(iii) Conclusions on the Effectiveness of Trade Policy

In many instances the supply or demand responses making a trade policy ineffective are eventually blocked or a new policy instrument is selected to stimulate some indirect effect. However, often the delay in providing the intended assistance to a sector is so long that much of the unemployment and losses the protection is designed to prevent has already occurred.

The motivations of both industry representatives seeking protection and government officials help to account for this result. Firms injured by imports usually seek to define the industry as narrowly as possible. In this way they have a better chance of proving serious injury. They also like to focus attention on just the exporters who are currently causing the import problem, since this prevents opposition from developing on the part of other exporters. Government officials also like this approach, since it avoids political pressures from other countries supplying the same or similar products. However, what may be gained in securing protection more quickly tends to be lost by its ineffectiveness. Furthermore, while government officials may realize that some simple supply response will undermine a particular protective action, the law

may not permit the new product or source from also being restricted until the supply shift actually occurs.

The policy conclusion to be drawn is simply that government officials and others should become more realistic about what trade measures can accomplish. Generally they are not the panacea for an industry's trade problems that discussions about the proposed measures would lead one to believe, and they often produce unfavorable side effects. Furthermore, it can be shown that those trade policies that are growing most rapidly in popularity, namely, discriminatory measures such as orderly marketing agreements, voluntary export restraints, and selective embargoes, are the very ones likely to be least effective.

VI. FOREIGN POLICY CONSIDERATIONS

As Richard Cooper once pointed out in the title of one of his papers, "Trade Policy is Foreign Policy."[13] Not to appreciate this is to fail to understand some of the key trade policy decisions of national political leaders who bear the main foreign policy and national security responsibilities for their nations. These leaders realize that economic relations can significantly affect political relations, and they take this into account in making their decisions. It may, for example, be possible through government trade interventions to gain economically at the expense of another country. However, this other country may react by taking such actions as discriminating against investors of the country gaining this advantage, failing to support the country in various international political forums, or rejecting cooperative security arrangements. Political leaders must rightfully take into account such interrelationships between trade policy and the many other elements that affect foreign policy.

They are especially concerned about preventing economic confrontations that may escalate to the point where they endanger not only basic trade and investment relations but political relations as well. Consequently, these leaders sometimes justify certain economic actions on economic grounds when they really are taking into account both economic and political factors. Trade economists have also not always been careful in distinguishing between the economic and political arguments for particular trade policies. It is partly for this reason that many business and labor leaders believe that modern economists conclude that free trade is always the policy that maximizes a country's economic welfare.

VII. TRADE POLICY OPTIONS IN A WORLD OF STRUCTURAL CHANGE

As noted at the beginning of the paper, trade measures can usefully be divided into those that are introduced in reaction to disruptive external shocks and those put into effect in anticipation of dynamic international changes. The purpose of the reactive measures is to mitigate the adverse employment and income consequences of the external shocks. In contrast, the aim of an activist trade policy approach is to anticipate dynamic international changes and thereby minimize their negative and maximize their positive income and employment effects. A third option can be termed the cooperative international approach. Whereas the activist and reactive approaches can be pursued independently by any country, the cooperative approach requires consensus among countries concerning what constitutes "good" international trade policy behavior as well as how to resolve any disputes that arise in interpreting "good" behavior. This last section of the paper considers various policy options within these three approaches. It should be emphasized that these three options are not mutually exclusive; all can be followed at the same time.

(i) Reactive Trade Policy Options

There are essentially three different types of policies for offsetting the injurious effects of structural changes emanating from the international trading sector, namely, import restrictions, subsidization, and adjustment assistance. Not only must governments decide upon the proper mix of these policies but there are numerous decisions to be made concerning the particular form each of the different policies will take. For example, if import restrictions are used, should they take the form of tariffs or quantitative restrictions? Should the restrictions be directed at the country or countries from which the disruptive imports are coming or should all exporting countries bear part of the burden of the cutback? Still other issues to be decided are whether the restrictions should be temporary or permanent and selective or general.

Since subsidization can take many forms, there are also numerous matters to be settled if this policy is followed. For example, should the subsidies be directed only on that portion of an industry's output that is exported or at all production? What form should the subsidization take? -- subsidization of sales? investment subsidies? wage subsidies? Government assistance directed at helping workers and firms to adjust to new activities raises similar questions. How much aid should go to workers and how much to capitalists? How should the aid to workers be divided among unemployment payments, retraining benefits, job-search payments, migration assistance, etc?

Two other matters that have been raised in recent discussions and that affect all three policies are, first, whether aid to an industry should be contingent upon the industry agreeing upon and carrying out a specific economic plan for adaptation to the changed international circumstances, and second,

whether the tariff revenue (or its equivalent) generated by protection should be earmarked for assistance to the injured industry.

(a) Import Restrictions

Article 19 of the GATT specifically permits countries to introduce import restrictions if a product is being imported in such increased quantities as to cause or threaten to cause serious injury to domestic producers, and this provision has been utilized many times. However, studies of industries which have received protection generally indicate rather disappointing results. Rather than returning to prosperous conditions after a short term of protection, most assisted sectors have continued to decline in employment terms with even the reduced work force being faced with periodic episodes of unemployment. The reason is that -- unlike the drafters of Article 19 seemed to think -- injurious increases in imports usually have been manifestations of long-run structural changes and not temporary economic shifts. Consequently, domestic producers have been confronted with a continuous lowering of foreign costs relative to their own. Tariffs sufficient to offset the desired fraction of today's relative cost advantage for foreign producers are insufficient to deal with their cost advantage tomorrow. Quantitative restrictions have been tried to overcome this problem but the resulting shifts in the composition of exports have significantly undermined the effectiveness of this means of import control.

Workers in the injured industries have obviously been helped in the short run by import restrictions but some of the longer-run effects have been unfavorable. Management in the affected industries usually concludes that the only chance of remaining competitive is by introducing more modern equipment, much of which is highly labor-saving. Thus, more and more workers are displaced, not by imports, but by labor-saving equipment introduced in response to the

increased imports. Retaliatory actions by other countries also reduced employment in other sectors.

One way in which countries have tried to minimize retaliatory action is by restricting imports only from those countries from which most of the increased imports have come. Voluntary export restraints and orderly marketing agreements have been used for this purpose. As previously noted, however, shifts in supply to Third World countries can undermine these arrangements. They are also inconsistent with existing GATT rules. The developing countries still strongly oppose any changes in GATT safeguard procedures that would permit "selectivity," i.e., discriminatory treatment of imports from different sources.

Extending protection to more and more sectors faced with structural adjustment problems also begins to create macro difficulties in increasing employment. As noted earlier, the reduction in the real purchasing power of a given money wage due to the price increase in imports and domestic substitutes causes workers to demand (and receive) higher money wages. This, in turn, tends to decrease employment in the export sector as foreigners shift to suppliers in other countries. Even if imports decline more than exports, the net beneficial employment effect will tend to be offset by a currency appreciation under the existing flexible exchange-rate system.

In short, experience and economic analysis seem to suggest that, while protection can play an important short-run role in mitigating the employment effects of increased imports, it is not an effective long-run answer to structural employment problems emanating from the international sector.

(b) Subsidies

Subsidization has the appeal of being a more selective method of providing assistance to structurally depressed sectors than tariffs. The aid can be

directed at particular firms, at only the output exported or at particular factors of production, such as labor. Furthermore, the assistance is more closely tied to economic performance.

Wage subsidies are an especially effective means of maximizing the employment impact of industrial assistance. Moreover, in some cases they can be justified on economic efficiency grounds because they offset an economic distortion. For example, in certain industries characterized by imperfect product and factor markets, wages have risen to levels considerably above the national average for workers with comparable skills. This has the effect of keeping employment in these industries below what it would be under a more competitive market structure. If it is impossible to change the market structure directly, the distortion can be offset by a wage subsidy. Depending upon the feasible alternatives for dealing with the output-reducing effects of the imperfection in product markets, a production subsidy may also be appropriate, assuming that other countries do not retaliate.

A problem with wage and production subsidies, however, is that they do not directly stimulate the increased efficiency needed before the industry can compete successfully without government assistance. Investment subsidies are more appropriate for this objective.

GATT rules permit other countries to impose countervailing duties in response to domestic subsidies (most export subsidies are banned outright), provided they cause material injury. Moreover, as the use of subsidies increases, there is a tendency for countries to enforce their countervailing duty laws more vigorously. Thus, even when subsidies can be justified on economic grounds, they may prove ineffective because of retaliatory actions.

Another argument sometimes put forth in comparing subsidies and tariffs is

that the existence of budgetary costs in the case of subsidies introduces political pressures tending to prevent the subsidies from becoming permanent. However, actual experience with subsidies does not seem to indicate that subsidies are likely to be kept in place for shorter periods than tariffs. As in the tariff case, those who benefit from subsidies tend to organize readily into political pressure groups, whereas those who pay for the subsidies do not come together into an effective countervailing pressure group. The pressures from foreign governments during multilateral trade negotiations to reduce tariffs sometimes seem more effective than the domestic interests who bear the budgetary costs of subsidies.

(c) Adjustment Assistance

Adjustment assistance programs are designed mainly to help displaced workers move to new jobs and injured firms develop new product lines. In other words, rather than being based on the assumption that assistance to the industry in the form of import protection or subsidies will enable the industry to regain its ability to compete internationally, the adjustment assistance approach accepts the premise that the industry must decline to some extent and tries to facilitate the shift of labor and capital to new productive employment.

The joint paper submitted by the American and Canadian governments reviews existing trade adjustment assistance programs in detail. The record on their effectiveness is a mixed one. They have clearly provided much needed income support for displaced workers while they were looking for alternative employment. Furthermore, the programs have probably served in some cases to prevent extreme forms of import protection. However, there is also evidence suggesting that workers delay taking new jobs because of the income payments. Moreover, the results from the retraining and relocation components of the

programs have been disappointing.

Various forms of wage subsidization to encourage employers in other sectors to hire the displaced workers have been suggested as a means of avoiding the problem of income payments acting to prolong unemployment. For example, one proposal involves issuing vouchers to displaced workers who then search for suitable education or training and use the vouchers to pay for the costs of training at various schools or employer on-the-job training.

(d) Offsetting Foreign Subsidies and Dumping

One type of injurious shock that receives special reactive treatment is the "unfair" disruptions caused by government subsidization and certain private practices, such as dumping. Countries are permitted under GATT rules to impose special duties equal to the degree of subsidization and the dumping margin in order to offset the injurious effects of these practices. As the extent and forms of subsidization have increased significantly among the industrial countries, the governments of those nations that have not subsidized their industries as much as most have begun to react more vigorously to the subsidizing activities of others. Some officials and private sector leaders in these countries argue that the major cause of the severity of their adjustment problems is not shifts in comparative costs brought about by changes in basic resource and demand conditions, but subsidization by other governments that artificially creates sudden changes in comparative advantage.

(e) Conclusions

There is no single reactive trade policy option that meets all of a government's goals in trying to mitigate the adverse effects of structural changes coming from the international trading sector. Most governments seem to

think that a mixture of the different options is optimal.

One recent suggestion for helping to decide upon the proper mix is to require that major industries receiving assistance in one form or another should, as a condition for receiving the assistance, develop fairly detailed economic plans for correcting their unfavorable economic condition. If, for example, the industry contends that temporary protection will enable firms to meet competition through modernization, they would be required to support their belief by tentative commitments from investors or economic projections appraised by neutral industry experts. To the extent that some shifting of labor and capital to different sectors appears necessary, the plans would provide details on plant closing and layoffs over time. The planning process would also involve setting forth alternative scenarios depending upon the extent and length of government assistance.

Many governments already undertake this type of planning as part of their assistance programs to industries. There are also some examples of cooperative planning among nations. Those who are skeptical about this approach point to the poor record of planners in trying to predict market developments and argue that the planning process is likely to become highly politicized. They also note that foreign producers may take advantage of the greater certainty in the country's behavior to capture an even larger share of world markets.

Another recent proposal aimed at reducing the resistance to using government funds for assistance purposes is to finance the costs from the tariff revenues generated by a temporary increase in protection.[14] This arrangement has appeal on equity grounds, since domestic consumers who benefit from the cheaper imports would be asked to give up a part of these benefits to finance the costs of adjusting to these imports. Under the current practice of restricting imports

quantitatively by means of voluntary export restraints (VERs) or orderly marketing agreements (OMAs), domestic consumers already give up these benefits because the foreign supply price increases by the tariff-equivalent rate. Consequently, domestic consumers are indifferent between tariffs (or an arrangement whereby the quota rights are given to importers or auctioned off by the government) and VERs or OMAs. However, in the tariff case the government obtains revenue with which to finance adjustment assistance.

It is, of course, foreign suppliers who fare better under the VERs than under tariffs, since they reap a windfall gain equivalent to the tariff revenue. However, foreign suppliers also may benefit in the long run with the tariff, since when the tariff revenue is used to finance adjustment, the adjustment process is likely to take place more rapidly and the level of protection may be lowered sooner. However, this latter outcome may not occur. By earmarking tariff revenues for adjustment assistance rather than relying on general revenues for this purpose, it may be more difficult to phase out the tariffs because of the organized resistance of the firms and workers who receive the assistance.

(ii) An Activist Trade Policy Approach

As a result of the generally disappointing experience with reactive trade policies, there are an increasing number of calls for an activist approach to trade policy. A country should not -- it is argued -- passively wait until it is confronted with a structural unemployment problem caused by international shocks but, instead, anticipate and take advantage of dynamic changes in the structure of trade. Such an approach supposedly would ease the problems of short-run adjustment both by facilitating the gradual shift of workers out of structurally weak sectors before they are displaced in large numbers and by

opening up new employment opportunities for these workers. Those who favor a vigorous industrial policy on the part of the government as well as aggressive strategic government behavior in trade matters are usually associated with this activist approach.

(a) Industrial Policy

There are some government economic interventions aimed at stimulating long-run income and employment growth in every OECD country. Countries relying primarily on the private market mechanism to allocate resources over time tend to restrict their interventions to such measures as accelerated depreciation allowances, subsidies for pure research and higher education, infrastructure subsidies, and active anti-trust enforcement. However, other countries are also prepared to target particular industries and geographic areas for growth and to provide these sectors with investment subsidies, assistance for applied research and specific labor training allowances. Some governments futher believe that public ownership of certain industries is necessary both to take full advantage of expansionary opportunities and to carry out long-run adjustment policy effectively.

Because of the dismal structural unemployment outlook in many OECD countries and the fact that in principle most forms of intervention can be justified as means of offsetting various economic distortions and market imperfections, there are strong domestic pressures in these countries for extending government interventions. Options with important trade implications include greatly increased government subsidies for applied research, training, investment, and information activities in industries where export opportunities are expanding more rapidly. Similar assistance is also urged by some for declining import-

competing sectors in order to revitalize them. Alternatively, the government might use its authority to force a faster pace of adjustment in these latter sectors than will occur under imperfect market conditions. Generous early retirement allowances and buy-out payments for unprofitable firms, tax allowance penalties for hiring young mobile workers, and expanded retraining and resettlement allowances would be the type of policies utilized to facilitate resource shifts out of declining sectors.

A key element in the activist approach is better coordination, not only between different government programs and policies, but among government, labor, and business. This could involve reorganizing government agencies dealing with industry, labor, and trade so that they work together more effectively and provide clearer signals to labor and business on the intent of government policy. However, it could also entail detailed government planning with respect to the future industrial structure of the economy and explicit agreements with labor concerning wages, job security, retraining, etc., and with business concerning investment, product, and profit levels. Obviously, there are also many possible intermediate levels of coordination.

Industrial policy has a mixed record of accomplishment. In France during the early postwar period, as well as in Japan, well-defined industrial policy appears to have played an important role in stimulating employment and growth. In contrast, there also seem to be numerous examples where this approach has served to slow down adjustment and growth. Unfortunately, we do not as yet understand why the outcome varies so much among countries and over time and whether success in one country can be replicated in another.

(b) Strategic Behavior

Another form of an activist trade policy approach that is receiving increasing attention is strategic behavior aimed at increasing a country's market share (and thus employment level) or terms of trade at the expense of other trading nations. Since international competition among private producers in many industrial markets is highly imperfect, some argue that a country's government should use its subsidy and tax powers to help shift part of the excess profits existing in such markets toward its own citizens, because other governments will try to do the same regardless of what their own government does. This type of behavior is also justified, especially in third markets, on the grounds that the market position of their competitors is often based on "unfair" government subsidies of one form or another. Still another justification expressed for this type of behavior is that it will force one's competitors to conform more closely to existing international rules of good behavior, or induce them to negotiate new ones when current rules are inadequate.

(iii) International Cooperation

There are valid national reasons why countries may wish to introduce industrial policies or to behave strategically in competing for international markets. However, in the absence of well-defined international rules concerning just what constitutes acceptable international behavior under these policies and setting forth workable dispute settlement mechanisms, there are also dangers with an activist trade policy approach. When each country aggressively pursues this approach and retaliates against others who do so, it is possible that all trading nations end with lower employment and income levels than otherwise as the sequence of actions results in a negative sum

game. Furthermore, when some countries do end up better off, objections can be raised on international equity grounds, since these countries tend to be the ones that are already the economically most powerful and their gain is usually at the expense of the poorest nations.

One response to these dangers is to seek to enhance international cooperation in areas where nationally-oriented active and reactive trade policies can bring about an outcome in which all countries lose, or else in which only those countries that are already comparatively well-off gain. The goal would be to achieve the advantages from an activist approach in helping to solve the structural income and employment problems of OECD countries without jeopardizing the great economic benefits of interdependence. This is, of course, the approach being followed in GATT, OECD, UNCTAD, and other international organizations dealing with trade issues.

The cooperative international approach worked quite well for many years after World War II. However, fundamental changes in the distribution of economic power among countries, coupled with differences among countries in the extent to which they have aggressively pursued active and reactive trade policies, have served to lessen the effectiveness of the rules under which the postwar trading regime has operated. As previously noted, some governments have actively assisted the private sector in trying to develop new product lines, as well as to ease the adjustment problems in older product lines. They maintain that this development assistance has been necessary to offset the size and initial technological advantages of certain other countries. However, as these latter countries have been faced both with appreciable reductions in their shares of world product markets and significant foreign penetration of their own markets, they have become less willing to adopt a passive attitude to extensive

government intervention by the first group of countries. There is, for example, a definite policy shift toward a more vigorous enforcement of countervailing duty, antidumping and other so-called "unfair trade" laws by these countries. Furthermore, they are increasing pressures for their governments also to adopt a more extensive set of activist trade policies.

The present international situation is thus one of disequilibrium in terms of trade policy behavior. Those countries that have been intervening most extensively in the trade field are not prepared to change their policies, whereas those in which the intervention has been the least are now beginning to intervene more themselves. The possibility for a sequence of trade policy actions and reactions in which income and employment end up at lower levels is thus a very real one. Perhaps, as some argue, such a scenario is necessary to bring the governments involved to the negotiating table to hammer out a set of international rules that better fit the realities of the new distribution of international economic power. Countries may have to test their power in today's imperfect markets before they are prepared to agree upon cooperative solutions to today's world trading problems.

Any successful cooperative approach that emerges is likely to require agreements on several key elements of trade policy. One of the most important of these concerns the types of government intervention, especially public subsidization, that should and should not be countered with offsetting actions by other governments. Present GATT rules and practices are not sufficiently precise in this area. National laws on countervailing are also too simplistic to deal with modern conditions. In particular, there is insufficient recognition of the role for activist trade policies. By no means are all such policies aimed at gaining at the expense of others. Some can bring gains to all trading

parties. Yet these are not sufficiently delineated in either GATT or national rules nor are the procedures for settling disputes in this area sufficiently effective.

Greater agreement among the industrial countries concerning temporary assistance to sectors faced with severe adjustment problems is also needed. Countries claiming that their subsidies are strictly for adjustment purposes sometimes find their adjustment problems made worse by countervailing duties imposed by others. The need for a new safeguards code has also been recognized for several years.

Multilateral agreements relating to competition policy seem necessary. When international markets are imperfect, the abnormal profits that are available are tempting targets of government trade policies. However, if international understandings can be developed that discourage cartel-like behavior, abuse of dominant market positions, and attempts to monopolize, much of the incentive for such aggressive trade policies will be eliminated. It is unlikely that competition policy can be dealt with adequately without also strengthening existing agreements relating to foreign direct investment. Greater international cooperation is also needed in the areas of exchange rate, monetary, and fiscal policies. Many countries claim that independent actions by some nations in these policy areas create serious income and employment problems that affect both their trading and non-trade sectors. They argue that without cooperative efforts to mitigate these problems, agreements in such areas as subsidization will not be meaningful or effective.

Footnotes

1. OECD Secretariat, Manpower and Social Affairs Committee, Conference on Employment Growth in the Context of Structural Change - Preliminary Proposals and Rationale, 8 June 1983, pp. 2-3.

2. For example, OECD Secretariat, The Challenge of Unemployment - A Report to Labour Ministers. Paris: Organization for Economic Co-operation and Development, 1982.

3. A. Sapir and D. Schumacher,

4. J. A. Schumpeter, The Theory of Economic Development, tr. by R. Opie, Cambridge, MA: Harvard University Press, 1934.

5. J. M. Keynes, The General Theory of Employment, Interest and Money, New York: Harcourt, Brace and Co., 1936, p. 383.

6. The terms-of-trade argument for protection is usually attributed to J. S. Mill.

7. See, for example, H. G. Johnson, "Optimum Tariffs and Retaliation," The Review of Economic Studies, XXI(2), no. 55, 1953-54, pp. 142-53.

8. See, for example, J. Bhagwati, "The Generalized Theory of Distortions and Welfare" in J. Bhagwati, R. W. Jones, R. A. Mundell and J. Vanek (eds.), Trade Balance of Payments, and Growth, New York: American Elsevier Publishing Co., 1971.

9. Two examples of the work in this area are: P. Krugman, "Import Protection and Export Promotion: International Competition in the Presence of Oligopoly and Economies of Scale" in H. Kierzkowski (ed.), Monopolistic Competition in International Trade, Oxford: Oxford University Press, forthcoming, and B. J. Spencer and J. A. Brander, "International R&D Rivalry and Industry Strategy," Review of Economic Studies, forthcoming.

10. See, for example, F. Cripps and W. Godley, "Control of Imports as Means to Full Employment and Expansion of World Trade: the UK's Case," Cambridge Journal of Economics, September 1978.

11. See, for example, C. Collyns, Can Protection Cure Unemployment, Thames Essay No. 31, London: Trade Policy Research Centre, 1982.

12. For a more detailed analysis, see R. Baldwin, The Inefficacy of Trade Policy, Essays in International Finance, No. 150, Princeton: International Finance Section, Department of Economics, Princeton University, December 1982.

13. R. N. Cooper, "Trade Policy is Foreign Policy," Foreign Policy, 5, 1973.

14. This suggestion is made by, for example, G. C. Hufbauer and H. Rosen in "Managing Comparative Advantage," unpublished paper.