

Chapter 11

Controversies in Trade Policy

■ Chapter Organization

Sophisticated Arguments for Activist Trade Policy

Technology and Externalities

Imperfect Competition and Strategic Trade Policy

Case Study: When the Chips Were Up

Globalization and Low-Wage Labor

The Anti-Globalization Movement

Trade and Wages Revisited

Labor Standards and Trade Negotiations

Environmental and Cultural Issues

The WTO and National Independence

Case Study: Bare Feet, Hot Metal, and Globalization

Globalization and the Environment

Globalization, Growth, and Pollution

The Problem of “Pollution Havens”

Environmental Issues and Trade Negotiations

Summary

■ Key Themes

While the text has shown why, in general, free trade is a good policy, this chapter considers two controversies in trade policy that challenge free trade. The first regards strategic or activist trade policy. Proponents of such activist government trade intervention argue that certain industries are desirable and may be underfunded by markets or dominated by imperfect competition and warrant government intervention. The second controversy regards the recent debate over the effects of globalization on workers, the environment, and sovereignty. While the anti-globalization arguments often lack sound structure, their visceral nature demonstrates that the spread of trade is extremely troubling to some groups.

As seen in the previous chapters, activist trade policy may be justified if there are market failures. One important type of market failure involves externalities present in high-technology industries due to their knowledge creation. Existence of externalities associated with research and development and high technology make the private return to investing in these activities less than their social return. This means that the private sector will tend to invest less in high technology sectors than is socially optimal. While there may be some case for intervention, the difficulties in targeting the correct industry and understanding the quantitative size of the externality make effective intervention complicated. To address this market failure of insufficient knowledge creation, the first best policy may be to directly support research and development in all industries. Still, while it is a judgment call, the technology spillover case for industrial policy is probably the strongest case to be made for active industrial policy.

Another set of market failures arises when imperfect competition exists in an industry. Strategic trade policy by a government can deter investment and production by foreign firms and raise the profits of domestic firms. An example is provided in the text which illustrates the case where the increase in profits following the imposition of a subsidy can actually exceed the cost of a subsidy to an imperfectly competitive industry. While this is a valid theoretical argument for strategic policy, it is nonetheless open to criticism in choosing the industries which should be subsidized and the levels of subsidies to these industries. These criticisms are associated with the practical aspects of insufficient information and the threat of foreign retaliation. The case study on the attempts to promote the semiconductor chips industry shows that neither excess returns nor knowledge spillovers necessarily materialize even in industries that seem perfect for activist trade policy.

The next section of the chapter examines the anti-globalization movement that gained momentum in the late 1990s. Particular emphasis is given to concerns over low wages and poor working conditions in developing countries. Standard analysis suggests trade should help poor countries, and, in particular, help the abundant factor (labor) in those countries. Protests in Seattle, which shutdown WTO negotiations, and subsequent demonstrations at other meetings showed, though, that protestors either did not understand or did not agree with this analysis.

The concern over low wages in poor countries can be framed using the types of arguments developed in Chapter 3. Analysis in the current chapter shows again that trade should help the purchasing power of all workers and that if anyone is hurt, it is the workers in labor-scarce countries. The low wages in export sectors of poor countries are higher than they would be without the export-oriented manufacturing and while the situation of these workers may be more visible than before, that does not make it worse.

Practically, the policy issue is whether or not labor standards should be part of trade pacts. While such standards may act in ways similar to a domestic minimum wage, developing countries fear they would be used as a protectionist tool that will end up shutting the developing countries out of markets where they want to compete.

Finally, globalization raises questions of cultural independence and national sovereignty. Specifically, many are disturbed by the WTO's ability to overturn laws which do not seem to be trade restrictions, but which nonetheless have trade impacts. This point highlights the difficulty of advancing trade liberalization when the clear impediments to trade—tariffs or quotas—have been removed, yet national policies regarding industry promotion or labor and environmental standards still need to be reformed.

Anti-globalization protestors are by no means united in their cause. There are also strong concerns that export manufacturing in developing countries is bad for the environment. The final section of the chapter examines the link between trade and the environment. In general, production and consumption can cause environmental damage. Yet, as a country's GDP per capita grows, the environmental damage done first grows and then eventually declines as the country gets rich enough to begin to protect the environment. As trade has lifted incomes of some countries, it may have been bad for the environment—but largely by making poor countries richer, an otherwise good thing. In theory, there could be a concern of "pollution havens" where countries with low environmental standards attract "dirty" industries. There is relatively little evidence of this phenomenon thus far.

■ **Key Terms**

Define the following key terms:

- 1. Externalities _____

- 2. Excess Returns _____

- 3. Strategic Trade Policy _____

- 4. Beggar-Thy-Neighbor Policies _____

- 5. Brander-Spencer Analysis _____

- 6. Anti-Globalization _____

- 7. Environmental Kuznets Curve _____

■ Review Questions

1. Strategic trade policy encompasses attempts by a government to encourage the shift of resources into particular, targeted sectors of the economy. Since there are limited resources available to any economy, this implies that the expansion of targeted sectors will occur at the expense of the contraction of other sectors.

a. What is the significance of the existence of market failures for the formation of strategic trade policy?

b. What mistakes are commonly made when a government chooses the particular sectors to be targeted?

c. Should U.S. strategic trade policy target and encourage those industries which have been selected for promotion by other countries? Why?

2. The existence of market failures in labor, capital, and final goods industries is more prevalent in less developed countries than in developed economies. In fact, the existence of market failures is much more difficult to establish for many industrialized nations.

a. Discuss the types of market failures which are identified as relevant to the industrialized nations and to the formation of strategic trade policy.

b. Discuss the meaning of knowledge creation as it relates to research and development in the high technology sector.

3. How might the spectacular growth in Internet-related businesses, and the United States' success in these industries be used as an argument against targeted industrial policies and strategic trade policies?

4. If the United States banned the importation of computers made at factories that do not meet U.S. environmental standards, would this violate the WTO rules? What if only U.S. firms currently meet such standards? How do these questions relate to protests concerning sovereignty or the environment?

5. Who benefits from tighter labor standards in low-wage countries? Consider each group separately: rich-country workers, rich-country consumers, poor-country workers, poor-country consumers.

6. In what settings are increased trade bad for the environment? Would a reduction of trade barriers between the United States and China have adverse environmental impacts? What would be the environmental consequences of a reduction of trade barriers between the United States and South Korea?

■ **Answers to Odd-Numbered Textbook Problems**

1. The main disadvantage is that it can lead to both “rent-seeking” and beggar-thy-neighbor policies, which can increase one country’s welfare at the other countries expense. Such policies can lead to a trade war in which every country is worse off, even though one country could become better off in the absence of retaliation. This is the danger in enacting strategic trade policy: it often provokes retaliation, which in the long run, can make everyone worse off.
3. The results of basic research may be appropriated by a wider range of firms and industries than the results of research applied to specific industrial applications. The benefits to the United States of Japanese basic research would exceed the benefits from Japanese research targeted to specific problems in Japanese industries. A specific application may benefit just one firm in Japan, perhaps simply subsidizing an activity that the market is capable of funding. General research will provide benefits that spill across borders to many firms and may be countering a market failure, externalities present in the advancement of general knowledge.
5. Key assumptions in the model are that economies of scale are large for each firm, while the market is of a limited size. Because of these assumptions, there is only room for one firm to profitably produce the new jet aircraft. In the absence of economies of scale, both firms can share the market and divide the profits. If the market were larger, both firms could enter into the market profitably even with economies of scale.

7. Advantages to such policies are that some workers are able to enjoy higher standards in the workplace. The disadvantages with such policies are that they may serve as a deterrent to employment creation in developing countries as costs increase to producers of locating manufacturing in these countries. Policy makers have to weigh the trade-off between insisting on decency in working conditions, with imposing standards of the already industrialized countries on the developing world, as these policies may cost large numbers of jobs in manufacturing in developing countries.
9. The main critique against the WTO with respect to environmental issues is that the WTO refuses to impose environmental standards on countries, but rather does not allow countries to discriminate against imported goods that are held to a different standard than domestically produced goods. In some respects those opposed to globalization would rather see the WTO have more power than it actually claims for itself, power to impose environmental laws as well as resolve trade disputes. However, the WTO does in one sense intervene in environmental issues of member countries by forcing member countries to apply the same standards to imported goods as to domestically produced goods.
11. The concern is seen clearly in the idea of the environmental Kuznets curve where environmental damage increases as a country moves from very poor to middle income and declines as the country gets subsequently richer. The problem comes if the fastest growing countries are the ones moving from poor to middle income, especially large countries such as India and China who are almost certainly on the up slope of the curve. Thus, the countries doing increasing environmental damage are relatively poor, making stopping growing environmental damage a challenge. On the other hand, as Figure 11-2 shows, the United States is still the world leader in carbon dioxide emissions and as Figure 11-1 shows, rich countries moving from points C to D could help balance poor countries move from A to B. Last, it is possible that rich countries could make side payments or share technologies to help the growth of poor countries be less environmentally damaging (effectively flattening the curve).

