Chapter 12
Controversies in Trade Policy

1. ◼ Chapter Organization

Sophisticated Arguments for Activist Trade Policy

  Technology and Externalities

  Imperfect Competition and Strategic Trade Policy

 Box: A Warning from Intel’s Founder

  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”

The Carbon Tariff Dispute

Summary

1. ◼ Chapter Overview

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 trade policy. Proponents of activist government trade intervention argue that certain industries are desirable and may be under funded by markets or dominated by imperfect competition and warrant some 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 probably has better footing in solid economics than any other argument.

Another set of market failures arises when imperfect competition exists. Strategic trade policy by a government can work to 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 if domestic firms can capture profits from foreign firms. 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. In particular, it examines the concerns over low wages in poor countries. Standard analysis suggests trade should help poor countries, and, in particular, help the abundant factor (labor) in those countries. Protests in Seattle, which shut down 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 is a revision of arguments in Chapter 2. 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.

Anti-globalization protestors were by no means united in their cause. There were also strong concerns that export manufacturing in developing countries was bad for the environment. Again, the issue is whether these concerns should be addressed by tying environmental standards into trade negotiations, and the open question is whether this can be done without destroying the export industries in developing countries.

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.

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. Furthermore, the pollution in these locations tends to be localized and is therefore better left to national rather than international policy. The chapter concludes with a discussion of the cap and trade system for greenhouse gases (an example of transboundary pollution) currently being debated in the U.S. Congress. Part of this policy aimed at reducing carbon emissions is an imposition of a “carbon tariff” on imports from countries that do not have their own carbon taxes. Proponents argue that such tariffs are necessary to prevent production from shifting to pollution havens and to reduce the overall level of carbon emissions, while opponents argue that these tariffs are simply more protectionism masquerading as environmental regulation.

1. ◼ Answers to Textbook Problems
2. 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 country’s 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. Furthermore, it can be difficult to identify both which industries to subsidize and how much to subsidize them. Failure to correctly identify these factors can lead to a net loss from a subsidy.
3. 2. If everyone knows that an industry will grow rapidly, private markets will funnel resources into
the industry even without government support. There is need for special government action only
if there is some market failure; the prospect of growth by itself isn’t enough.
4. 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. 4. A subsidy is effective when the firm in the other country does not produce when the domestic firm enters the market. As the text tables show, a subsidy may present a credible threat of entry and deter production by the other firm: a subsidy encourages Airbus to produce and Boeing not to produce. However, if the numbers in the table are incorrect and Boeing would continue to produce even if Airbus received a subsidy and entered (perhaps because Boeing is the relatively more efficient producer), then the subsidy to Airbus would generate a net cost to Europe. Another key assumption is that the subsidy would not raise costs to consumers in the home country. If it did, then we would need to factor in this loss against the benefit from capturing foreign profits.
6. 5. One argument you could make is the infant industry argument. Because US software firms are already established, European firms would not be able to compete given the relatively steep learning curve in this industry. With protection, the European industry could develop into an efficient scale and be globally competitive. Further, this is likely an industry characterized by external economies of scale, so once the industry develops, it will generate additional gains by creating a local hub of software firms. Of course this argument depends on European software firms eventually becoming competitive. If US firms have some natural comparative advantage, then the European industry may be perpetually in its infancy. We also need to consider whether this industry actually needs protection. Would European software firms be able to compete without protection? If so, then any protection that is afforded may be wrongly credited with growing the industry, the “pseudoinfant industry” effect.
7. Another line of reasoning in favor of protection is that this industry needs support because of low appropriability. If the social gains from an investment exceed the private gains, then a firm making an investment will not be able to capture the full return on its investment and an inefficiently low level of investment will be made. To get over this market failure, the government could subsidize innovation. However, can the government accurately identify the right activities to support? Furthermore, how big will the gains from active targeting be?

 Finally, support could be justified if there is imperfect competition and excess profits in the software industry. A subsidy to the European software industry may yield gains in excess of the subsidy if European firms are able to capture some of the profits of American firms. However, can the government correctly identify who and how much to subsidize? What if this policy leads to retaliation by the American government?

 6. 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.

7. The French may be following an active nationalist cultural policy as an economic or strategic trade policy to the extent that cultural activities, such as art, music, fashion, and cuisine, are linked to other French major industries. Indeed, the fashion industry is tied to the huge textile industry, as well as
to the retail sector and advertising services. One could argue that the promotion of fashion, art, and music will benefit both tourism, and these large strategic trade sectors of the French economy. However, the existence of market failures is not clearly documented in the cultural sector except to the extent that there are other less tangible externalities. Furthermore, the cultural promotions are not, in economic terms, the first best approach to supporting larger industries.

8. 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 12-3 shows, the U.S. is still the world leader in carbon dioxide emissions, and as Figure 1 shows, rich countries moving from Points C to D could help balance poor countries move from A to B. Lastly, 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).

9. Suppose that there were no tariffs on imports in a country that had value added taxes. This would give an incentive for domestic firms to locate their production abroad and export their goods to that country to avoid the value added tax. Thus, a tariff on imports is necessary to maintain the same relative price between domestically produced and imported goods. Similarly, the carbon tariff is put into place to prevent domestic firms from moving their production to a pollution haven with lax environmental regulations. By imposing a carbon tariff on imports, this incentive is reduced and the overall level of pollution (especially important when dealing with transboundary pollution like carbon emissions) will be reduced. An objection over this tariff is that it may be discriminating between domestic and foreign goods. This would hold if it would be more costly for a foreign firm to reduce its carbon emissions than a domestic firm, thus giving an artificial advantage to domestic firms.