M10_KRUG6654_09_SE_C10.QXD 11/8/10 12:34 PM Page 224

Their reasoning relied to a large extent on the view that the unification of the European market would lead to greater competition among firms and to a more efficient scale of production. Much was made of the comparison with the United States, a country whose purchasing power and population are similar to those of the European Union, but that is a borderless, fully integrated market. Commission economists pointed out that in a number of industries, Europe seemed to have markets that were segmented: Instead of treating the whole continent as a single market, firms seemed to have carved it into local zones served by relatively small-scale national producers. The economists argued that with all barriers to trade removed, there would be a consolidation of these producers, with substantial gains in productivity. These putative gains raised the overall estimated benefits from 1992 to several percent of the initial income of European nations. The Commission economists argued further that there would be indirect benefits, because the improved efficiency of the European economy would improve the trade-off between inflation and unemployment. At the end of a series of calculations, the Commission estimated a gain from 1992 of 7 percent of European income.[2]

While nobody involved in this discussion regarded 7 percent as a particularly reliable number, many economists shared the conviction of the Commission that the gains would be large. There were, however, skeptics who suggested that the segmentation of markets had more to do with culture than with trade policy. For example, Italian consumers wanted washing machines that were quite different from those preferred in Germany. Italians tend to buy relatively few clothes, but those they buy are stylish and expensive, so they prefer slow, gentle washing machines that conserve their clothing investment.

Now that a number of years have passed since 1992, it is clear that both the supporters and the skeptics had valid points. In some cases there have been notable consolidations of industry. For example, Hoover closed its vacuum cleaner plant in France and concentrated all its production in a more efficient plant in Britain. In some cases old market segmentations have clearly broken down, and sometimes in surprising ways, like the emergence of British sliced bread as a popular item in France. But in other cases markets have shown little sign of merging. The Germans have shown little taste for imported beer, and the Italians none for pasta made with soft wheat.

How large were the economic gains from 1992? By 2003, when the European Commission decided to review the effects of the Single European Act, it came up with more modest estimates than it had before 1992: It put the gains at about 1.8 percent of GDP. If this number is correct, it represents a mild disappointment but hardly a failure.

National Welfare Arguments Against Free Trade

Most tariffs, import quotas, and other trade policy measures are undertaken primarily to protect the income of particular interest groups. Politicians often claim, however, that the policies are being undertaken in the interest of the nation as a whole, and sometimes they are even telling the truth. Although economists often argue that deviations from free trade reduce national welfare, there are, in fact, some theoretical grounds for believing that activist trade policies can sometimes increase the welfare of the nation as a whole.

[2] See Michael Emerson, Michel Aujean, Michel Catinat, Philippe Goubet, and Alexis Jacquemin, "The Economics of 1992," *European Economy* 35 (March 1988).

M10_KRUG6654_09_SE_C10.QXD 11/8/10 12:34 PM Page 231

Politicians for Sale: Evidence from the 1990s

As we explain in the text, it's hard to make sense of actual trade policy if you assume that governments are genuinely trying to maximize national welfare. On the other hand, actual trade policy does make sense if you assume that special-interest groups can buy influence. But is there any direct evidence that politicians really are for sale?

Votes by the U.S. Congress on some crucial trade issues in the 1990s offer useful test cases. The reason is that U.S. campaign finance laws require politicians to reveal the amounts and sources of campaign contributions; this disclosure allows economists and political scientists to look for any relationship between those contributions and actual votes.

A 1998 study by Robert Baldwin and Christopher Magee* focuses on two crucial votes: the 1993 vote on the North American Free Trade Agreement (generally known as NAFTA, and described at greater length below), and the 1994 vote ratifying the latest agreement under the General Agreement on Tariffs and Trade (generally known as the GATT, also described below). Both votes were bitterly fought, largely along business-versus-labor lines—that is, business groups were strongly in favor; labor unions were strongly against. In both cases the free trade position backed by business won; in the NAFTA vote, the outcome was in doubt until the last minute, and the margin of victory—34 votes in the House of Representatives—was not very large.

Baldwin and Magee estimate an econometric model of congressional votes that controls for such factors as the economic characteristics of members' districts as well as business and labor contributions to the congressional representative. They find a strong impact of money on the voting pattern. One way to assess this impact is to run a series of "counterfactuals": How different would the overall vote had been if there had been no business contributions, no labor contributions, or no contributions of any type at all?

The table on the following page summarizes the results. The first row shows how many representatives voted in favor of each bill; bear in mind that passage required at least 214 votes. The second row shows the number of votes predicted by Baldwin and Magee's equations: Their model gets it right in the case of NAFTA but overpredicts by a few votes in the case of the GATT. The third row shows how many votes each bill would have received, according to the model, in the absence of labor contributions; the next row shows how many representatives would have voted in favor in the absence of business contributions. The last row shows how many would have voted in favor if both business and labor contributions had been absent.

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

If these estimates are correct, contributions had big impacts on the vote totals. In the case of NAFTA, labor contributions induced 62 representatives who would otherwise have supported the bill to vote against; business contributions moved 34 representatives the other way. If there had been no business contributions, according to this estimate, NAFTA would have received only 195 votes—not enough for passage.

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

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

*Robert E. Baldwin and Christopher S. Magee, "Is Trade Policy for Sale? Congressional Voting on Recent Trade Bills," Working Paper 6376, National Bureau of Economic Research, January 1998.

M10_KRUG6654_09_SE_C10.QXD 11/8/10 12:34 PM Page 240

suppliers. The GATT's neglect of trade in services became an increasingly glaring omission, because modern economies have increasingly focused on the production of services rather than physical goods. So the WTO agreement includes rules on trade in services (the General Agreement on Trade in Services, or GATS). In practice, these rules have not yet had much impact on trade in services; their main purpose is to serve as the basis for negotiating future trade rounds.

In addition to a broad shift from producing goods to producing services, advanced countries have also experienced a shift from depending on physical capital to depending on "intellectual property," which is protected by patents and copyrights. (Thirty years ago, General Motors was the quintessential modern corporation; now it's Apple or Google.) Thus defining the international application of international property rights has also become a major preoccupation. The WTO tries to take on this issue with its Agreement on Trade-Related Aspects of Intellectual Property (TRIPS). The application of TRIPS in the pharmaceutical industry has become a subject of heated debate.

The most important new aspect of the WTO, however, is generally acknowledged to be its "dispute settlement" procedure. A basic problem arises when one country accuses another of violating the rules of the trading system. Suppose, for example, that Canada accuses the United States of unfairly limiting timber imports—and the United States denies the charge. What happens next?

Before the WTO, there were international tribunals in which Canada could press its case, but such proceedings tended to drag on for years, even decades. And even when a ruling had been issued, there was no way to enforce it. This did not mean that the GATT's rules had no force: Neither the United States nor other countries wanted to acquire a reputation as scofflaws, so they made considerable efforts to keep their actions "GATT-legal." But gray-area cases tended to go unresolved.

The WTO contains a much more formal and effective procedure. Panels of experts are selected to hear cases, usually reaching a final conclusion in less than a year; even with appeals, the procedure is not supposed to take more than 15 months.

Suppose that the WTO concludes that a nation has, in fact, been violating the rules—and the country nonetheless refuses to change its policy. Then what? The WTO itself has no enforcement powers. What it can do is grant the country that filed the complaint the right to retaliate. To use our Canada–U.S. example, the government of Canada might be given the right to impose restrictions on U.S. exports without being considered in violation of WTO rules. In the case of the banana dispute described in the box on page 248, a WTO ruling found the European Union in violation; when Europe remained recalcitrant, the United States temporarily imposed tariffs on such items as designer handbags.

The hope and expectation is that few disputes will get this far. In many cases the threat to bring a dispute before the WTO should lead to a settlement; in the great majority of other cases, countries accept the WTO ruling and change their policies.

The following box describes an example of the WTO dispute settlement procedure at work: the U.S.–Venezuela dispute over imported gasoline. As the box explains, this case has also become a prime example for those who accuse the WTO of undermining national sovereignty.

Benefits and Costs

The economic impact of the Uruguay Round is difficult to estimate. If nothing else, think about the logistics: To do an estimate, one must translate an immense document from one impenetrable jargon (legalese) into another (economese), assign numbers to the translation, then feed the whole thing into a computer model of the world economy.

M10_KRUG6654_09_SE_C10.QXD 11/8/10 12:34 PM Page 243

So the WTO passed a big test. Still, it's one thing for the United States to defer to a complaint from the European Union, which is an economic superpower with an economy roughly the same size as that of the United States. The next question is what will happen when the WTO rules in favor of smaller economies against major economic powers like the United States or the EU.

In March 2005, in a landmark decision, the WTO agreed with Brazil's claim that U.S. subsidies to cotton producers were illegal. The United States said that it would comply and eliminate the subsidies, but by 2009 had made only partial moves toward compliance; at that point, the WTO authorized Brazil to retaliate with substantial sanctions on U.S. exports.

The Doha Disappointment

The ninth major round of world trade negotiations began in 2001 with a ceremony in the Persian Gulf city of Doha. Like previous rounds, this one was marked by difficult negotiation. But as of the summer of 2010, it appeared that something new had happened: For the first time since the creation of the GATT, a round of trade negotiations appeared to have broken down with no agreement in sight.

It's important to understand that the apparent failure of the Doha Round does not undo the progress achieved in previous trade negotiations. Remember that the world trading system is a combination of "levers"—international trade negotiations that push trade liberalization forward—and "ratchets," mainly the practice of binding tariffs, which prevent backsliding. The levers seem to have failed in the latest trade round, but the ratchets are still in place: The reductions in tariff rates that took place in the previous eight rounds remain in effect. As a result, world trade remains much freer than at any previous point in modern history.

In fact, Doha's apparent failure owes a lot to the success of previous trade negotiations. Because previous negotiations had been so successful at reducing trade barriers, the remaining barriers to trade are fairly low, so that the potential gains from further trade liberalization are modest. Indeed, barriers to trade in most manufactured goods other than apparel and textiles are now more or less trivial. Most of the potential gains from a move to freer trade would come from reducing tariffs and export subsidies in agriculture—which has been the last sector to be liberalized because it's the most sensitive sector politically.

Table 10-4 illustrates this point. It shows a World Bank estimate of where the welfare gains from "full liberalization"—that is, the elimination of all remaining barriers to trade

TABLE 10-4 Percentage Distribution of Potential Gains from Free Trade

	Full Liberalization of:			
Economy	Agriculture and Food	Textiles and Clothing	Other Merchandise	All Goods
Developed	46	6	3	55
Developing	17	8	20	45
All	63	14	23	100

Source: Kym Anderson and Will Martin, "Agricultural Trade Reform and the Doha Agenda," *The World Economy* 28 (September 2005), pp. 1301–1327.