**Introduction**

The review of the classical trade theories of Smith, Ricardo, and Heckscher–Ohlin in Chapter 6 showed that in a world without trade barriers, trade patterns are determined by the relative productivity of different factors of production in different countries. Countries will specialize in products they can make most efficiently, while importing products they can produce less efficiently. Chapter 6 also laid out the intellectual case for free trade. Remember, free trade refers to a situation in which a government does not attempt to restrict what its citizens can buy from or sell to another country. As we saw in Chapter 6, the theories of Smith, Ricardo, and Heckscher–Ohlin predict that the consequences of free trade include both static economic gains (because free trade supports a higher level of domestic consumption and more efficient utilization of resources) and dynamic economic gains (because free trade stimulates economic growth and the creation of wealth). This chapter looks at the political reality of international trade. Although many nations are nominally committed to free trade, they tend to intervene in international trade to protect the interests of politically important groups or promote the interests of key domestic producers. For example, the opening case suggests that both Airbus and Boeing have been the recipients of illegal subsidies from various government agencies in Europe and the United States. The purpose of these subsidies has been to give each company an edge in global competition against its primary rival. In large part, the subsidies have been given because aircraft manufacturing employs significant numbers of highly skilled and well-paid labor, and as such has an important impact on the local economies where production operations are based. As described in the case, the World Trade Organization has been called on to rule on disputes between Airbus, Boeing, and the various governments involved. The WTO seems to believe that both Airbus and Boeing have been the recipients of illegal subsidies. This chapter explores the political and economic reasons that governments have for intervening in international trade. When governments intervene, they often do so by restricting imports of goods and services into their nation while adopting policies that promote domestic production and exports. Normally, their motives are to protect domestic producers. In recent years, social issues have intruded into the decision-making calculus.

This chapter starts by describing the range of policy instruments that governments use to intervene in international trade. A detailed review of governments’ various political and economic motives for intervention follows. In the third section of this chapter, we consider how the case for free trade stands up in view of the various justifications given for government intervention in international trade. Then we look at the emergence of the modern international trading system, which is based on the General Agreement on Tariffs and Trade (GATT) and its successor, the World Trade Organization. The GATT and WTO are the creations of a series of multinational treaties. The final section of this chapter discusses the implications of this material for management practice.

**Instruments of Trade Policy**

Trade policy uses seven main instruments: tariffs, subsidies, import quotas, voluntary export restraints, local content requirements, administrative policies, and antidumping duties. Tariffs are the oldest and simplest instrument of trade policy. As we shall see later in this chapter, they are also the instrument that the GATT and WTO have been most successful in limiting. A fall in tariff barriers in recent decades has been accompanied by a rise in nontariff barriers, such as subsidies, quotas, voluntary export restraints, and antidumping duties.

**TARIFFS**

**A tariff** is a tax levied on imports (or exports). Tariffs fall into two categories. Specific tariffs are levied as a fixed charge for each unit of a good imported (e.g., $3 per barrel of oil). **Ad valorem tariffs** are levied as a proportion of the value of the imported good. In most cases, tariffs are placed on imports to protect domestic producers from foreign competition by raising the price of imported goods. However, tariffs also produce revenue for the government. Until the income tax was introduced, for example, the U.S. government received most of its revenues from tariffs. The important thing to understand about an import tariff is who suffers and who gains. The government gains because the tariff increases government revenues. Domestic producers gain because the tariff affords them some protection against foreign competitors by increasing the cost of imported foreign goods. Consumers lose because they must pay more for certain imports.

Whether the gains to the government and domestic producers exceed the loss to consumers depends on various factors, such as the amount of the tariff, the importance of the imported good to domestic consumers, the number of jobs saved in the protected industry, and so on.

In general, two conclusions can be derived from economic analysis of the effect of import tariffs.1 First, tariffs are generally pro-producer and anticonsumer. While they protect producers from foreign competitors, this restriction of supply also raises domestic prices.

Almost all studies find that import tariffs impose significant costs on domestic consumers in the form of higher prices. Second, import tariffs reduce the overall efficiency of the world economy. They reduce efficiency because a protective tariff encourages domestic firms to produce products at home that could be produced more efficiently abroad. The consequence is an inefficient utilization of resources.2 Sometimes tariffs are levied on exports of a product from a country. Export tariffs are less common than import tariffs. In general, export tariffs have two objectives: first, to raise revenue for the government, and second, to reduce exports from a sector, often for political reasons.

**SUBSIDIES**

**A subsidy** is a government payment to a domestic producer. Subsidies take many forms, including cash grants, low-interest loans, tax breaks, and government equity participation in domestic firms.

By lowering production costs, subsidies help domestic producers in two ways: (1) competing against foreign imports and (2) gaining export markets. Agriculture tends to be one of the largest beneficiaries of subsidies in most countries. The European Union has been paying out about €44 billion annually ($55 billion) in farm subsidies.

While the purpose of the subsidies was to help them survive a very difficult economic climate, one of the consequences was to give subsidized companies an unfair competitive advantage in the global auto industry.

The main gains from subsidies accrue to domestic producers, whose international competitiveness is increased as a result. Advocates of strategic trade policy (which, as you will recall from Chapter 6, is an outgrowth of the new trade theory) favor subsidies to help domestic firms achieve a dominant position in those industries in which economies of scale are important and the world market is not large enough to profitably support more than a few firms (aerospace and semiconductors are two such industries). According to this argument, subsidies can help a firm achieve a first-mover advantage in an emerging industry (just as U.S. government subsidies, in the form of substantial R&D grants, allegedly helped Boeing). If this is achieved, further gains to the domestic economy arise from the employment and tax revenues that a major global company can generate. However, government subsidies must be paid for, typically by taxing individuals and corporations.

Rather, they tend to protect the inefficient and promote excess production.

**IMPORT QUOTAS AND VOLUNTARY EXPORT RESTRAINTS**

**An import quota** is a direct restriction on the quantity of some good that may be imported into a country. The restriction is usually enforced by issuing import licenses to a group of individuals or firms.

A common hybrid of a quota and a tariff is known as a tariff rate quota. Under a tariff rate quota, a lower tariff rate is applied to imports within the quota than those over the quota.

A variant on the import quota is the voluntary export restraint. **A voluntary export restraint (VER)** is a quota on trade imposed by the exporting country, typically at the request of the importing country’s government. For example, in 2012 Brazil imposed what amounts to voluntary export restraints on shipments of vehicles from Mexico to Brazil.

Foreign producers agree to VERs because they fear more damaging punitive tariffs or import quotas might follow if they do not. Agreeing to a VER is seen as a way to make the best of a bad situation by appeasing protectionist pressures in a country.

**FIGURE 7.1** Hypothetical tariff rate quota.

As with tariffs and subsidies, both import quotas and VERs benefit domestic producers by limiting import competition. As with all restrictions on trade, quotas do not benefit consumers. An import quota or VER always raises the domestic price of an imported good. When imports are limited to a low percentage of the market by a quota or VER, the price is bid up for that limited foreign supply. The extra profit that producers make when supply is artificially limited by an import quota is referred to as a **quota rent**.

**EXPORT TARIFFS AND BANS**

**An export tariff** is a tax placed on the export of a good. The goal behind an export tariff is to discriminate *against* exporting in order to ensure that there is sufficient supply of a good within a country.

**An export ban** is a policy that partially or entirely restricts the export of a good.

**LOCAL CONTENT REQUIREMENTS**

**A local content requirement (LCR**) is a requirement that some specific fraction of a good be produced domestically. The requirement can be expressed either in physical terms (e.g., 75 percent of component parts for this product must be produced locally) or in value terms (e.g., 75 percent of the value of this product must be produced locally). Local content regulations have been widely used by developing countries to shift their manufacturing base from the simple assembly of products whose parts are manufactured elsewhere into the local manufacture of component parts. They have also been used in developed countries to try to protect local jobs and industry from foreign competition.

Local content regulations provide protection for a domestic producer of parts in the same way an import quota does: by limiting foreign competition. The aggregate economic effects are also the same; domestic producers benefit, but the restrictions on imports raise the prices of imported components. In turn, higher prices for imported components are passed on to consumers of the final product in the form of higher final prices. So as with all trade policies, local content regulations tend to benefit producers and not consumers.

**ADMINISTRATIVE POLICIES**

In addition to the formal instruments of trade policy, governments of all types sometimes use informal or administrative policies to restrict imports and boost exports. Administrative trade policies are bureaucratic rules designed to make it difficult for imports to enter a country. It has been argued that the Japanese are the masters of this trade barrier.

In 2016, only 6 percent of the 4.9 million cars sold in Japan were foreign, and only 1 percent were U.S. cars. American car makers have argued for decades that Japan makes *it difficult to compete by setting up regulatory hurdles, such as vehicle parts standards,* that don’t exist anywhere else in the world.

**ANTIDUMPING POLICIES**

In the context of international trade, **dumping** is variously defined as selling goods in a foreign market at below their costs of production or as selling goods in a foreign market at below their “fair” market value. There is a difference between these two definitions; the fair market value of a good is normally judged to be greater than the costs of producing that good because the former includes a “fair” profit margin. Dumping is viewed as a method by which firms unload excess production in foreign markets. Some dumping may be the result of predatory behavior, with producers using substantial profits from their home markets to subsidize prices in a foreign market with a view to driving indigenous competitors out of that market. Once this has been achieved, so the argument goes, the predatory firm can raise prices and earn substantial profits. **Antidumping policies** are designed to punish foreign firms that engage in dumping. The ultimate objective is to protect domestic producers from unfair foreign competition. Although antidumping policies vary from country to country, the majority are similar to those used in the United States.

**The Case for Government Intervention**

Arguments for government intervention take two paths: political and economic. Political arguments for intervention are concerned with protecting the interests of certain groups within a nation (normally producers), often at the expense of other groups (normally consumers), or with achieving some political objective that lies outside the sphere of economic relationships, such as protecting the environment or human rights. Economic arguments for intervention are typically concerned with boosting the overall wealth of a nation (to the benefit of all, both producers and consumers).

**POLITICAL ARGUMENTS FOR INTERVENTION**

Political arguments for government intervention cover a range of issues, including preserving jobs, protecting industries deemed important for national security, retaliating against unfair foreign competition, protecting consumers from “dangerous” products, furthering the goals of foreign policy, and advancing the human rights of individuals in exporting countries.

**Protecting Jobs and Industries**

Perhaps the most common political argument for government intervention is that it is necessary for protecting jobs and industries from unfair foreign competition. Competition is most often viewed as unfair when producers in an exporting country are subsidized in some way by their government.

On the other hand, critics charge that claims of unfair competition are often overstated for political reasons.

A political motive also underlay establishment of the Common Agricultural Policy (CAP) by the European Union. The CAP was designed to protect the jobs of Europe’s politically powerful farmers by restricting imports and guaranteeing prices. However, the higher prices that resulted from the CAP have cost Europe’s consumers dearly. This is true of many attempts to protect jobs and industries through government intervention. For example, the imposition of steel tariffs in 2002 raised steel prices for American consumers, such as automobile companies, making them less competitive in the global marketplace.

**Protecting National Security**

Countries sometimes argue that it is necessary to protect certain industries because they are important for national security. Defense-related industries often get this kind of attention (e.g., aerospace, advanced electronics, and semiconductors). Although not as common as it used to be, this argument is still made.

**Retaliating**

Some argue that governments should use the threat to intervene in trade policy as a bargaining tool to help open foreign markets and force trading partners to “play by the rules of the game.”

If it works, such a politically motivated rationale for government intervention may liberalize trade and bring with it resulting economic gains. It is a risky strategy, however. A country that is being pressured may not back down and instead may respond to the imposition of punitive tariffs by raising trade barriers of its own.

**Protecting Consumers**

Many governments have long had regulations to protect consumers from unsafe products. The indirect effect of such regulations often is to limit or ban the importation of such products.

**Furthering Foreign Policy Objectives**

Governments sometimes use trade policy to support their foreign policy objectives.14 A government may grant preferential trade terms to a country with which it wants to build strong relations. Trade policy has also been used several times to pressure or punish “rogue states” that do not abide by international law or norms.

**Protecting Human Rights**

Protecting and promoting human rights in other countries is an important element of foreign policy for many democracies. Governments sometimes use trade policy to try to improve the human rights policies of trading partners.

**ECONOMIC ARGUMENTS FOR INTERVENTION**

With the development of the new trade theory and strategic trade policy (see Chapter 6), the economic arguments for government intervention have undergone a renaissance in recent years.

**The Infant Industry Argument**

The infant industry argument is by far the oldest economic argument for government intervention. Alexander Hamilton proposed it in 1792. According to this argument, many developing countries have a potential comparative advantage in manufacturing, but new manufacturing industries cannot initially compete with established industries in developed countries. To allow manufacturing to get a toehold, the argument is that governments should temporarily support new industries (with tariffs, import quotas, and subsidies) until they have grown strong enough to meet international competition. This argument has had substantial appeal for the governments of developing nations during the past 50 years, and the GATT has recognized the infant industry argument as a legitimate reason for protectionism. Nevertheless, many economists remain critical of this argument for two main reasons. First, protection of manufacturing from foreign competition does no good unless the protection helps make the industry efficient. In case after case, however, protection seems to have done little more than foster the development of inefficient industries that have little hope of ever competing in the world market.

Second, the infant industry argument relies on an assumption that firms are unable to make efficient long-term investments by borrowing money from the domestic or international capital market. Consequently, governments have been required to subsidize longterm investments.

Given financial support, firms based in countries with a potential comparative advantage have an incentive to endure the necessary initial losses in order to make long-run gains without requiring government protection. Many Taiwanese and South Korean firms did this in industries such as textiles, semiconductors, machine tools, steel, and shipping. Thus, given efficient global capital markets, the only industries that would require government protection would be those that are not worthwhile.

**Strategic Trade Policy**

Some new trade theorists have proposed the strategic trade policy argument.16 We reviewed the basic argument in Chapter 6 when we considered the new trade theory. The new trade theory argues that in industries in which the existence of substantial economies of scale implies that the world market will profitably support only a few firms, countries may predominate in the export of certain products simply because they have firms that were able to capture first-mover advantages.

**The strategic trade policy argument** has two components. First, it is argued that by appropriate actions, a government can help raise national income if it can somehow ensure that the firm or firms that gain first-mover advantages in an industry are domestic rather than foreign enterprises. Thus, according to the strategic trade policy argument, a government should use subsidies to support promising firms that are active in newly emerging industries.

The second component of the strategic trade policy argument is that it might pay a government to intervene in an industry by helping domestic firms overcome the barriers to entry created by foreign firms that have already reaped first-mover advantages.

If these arguments are correct, they support a rationale for government intervention in international trade. Governments should target technologies that may be important in the future and use subsidies to support development work aimed at commercializing those technologies. Furthermore, government should provide export subsidies until the domestic firms have established first-mover advantages in the world market. Government support may also be justified if it can help domestic firms overcome the first-mover advantages enjoyed by foreign competitors and emerge as viable competitors in the world market (as in the Airbus and semiconductor examples). In this case, a combination of home-market protection and export-promoting subsidies may be needed.

**The Revised Case for Free Trade**

**RETALIATION AND TRADE WAR**

Krugman argues that a strategic trade policy aimed at establishing domestic firms in a dominant position in a global industry is a beggar-thy-neighbor policy that boosts national income at the expense of other countries. A country that attempts to use such policies will probably provoke retaliation.

Krugman may be right about the danger of a strategic trade policy leading to a trade war. The problem, however, is how to respond when one’s competitors are already being supported by government subsidies;

**DOMESTIC POLICIES**

 Governments do not always act in the national interest when they intervene in the economy; politically important interest groups often influence them.

**Development of the World Trading System**

Strong economic arguments support unrestricted free trade. While many governments have recognized the value of these arguments, they have been unwilling to unilaterally lower their trade barriers for fear that other nations might not follow suit. Consider the problem that two neighboring countries, say, Brazil and Argentina, face when deciding whether to lower trade barriers between them. In principle, the government of Brazil might favor lowering trade barriers, but it might be unwilling to do so for fear that Argentina will not do the same. Instead, the government might fear that the Argentineans will take advantage of Brazil’s low barriers to enter the Brazilian market while continuing to shut Brazilian products out of their market through high trade barriers. The Argentinean government might believe that it faces the same dilemma. The essence of the problem is a lack of trust. Both governments recognize that their respective nations will benefit from lower trade barriers between them, but neither government is willing to lower barriers for fear that the other might not follow.20 Such a deadlock can be resolved if both countries negotiate a set of rules to govern cross-border trade and lower trade barriers. But who is to monitor the governments to make sure they are playing by the trade rules? And who is to impose sanctions on a government that cheats? Both governments could set up an independent body to act as a referee. This referee could monitor trade between the countries, make sure that no side cheats, and impose sanctions on a country if it does cheat in the trade game. While it might sound unlikely that any government would compromise its national sovereignty by submitting to such an arrangement, since World War II an international trading framework has evolved that has exactly these features. For its first 50 years, this framework was known as the General Agreement on Tariffs and Trade (GATT). Since 1995, it has been known as the World Trade Organization (WTO). Here, we look at the evolution and workings of the GATT and WTO.

The GATT was a multilateral agreement whose objective was to liberalize trade by eliminating tariffs, subsidies, import quotas, and the like. From its foundation in 1947 until it was superseded by the WTO, the GATT’s membership grew from 19 to more than 120 nations. The GATT did not attempt to liberalize trade restrictions in one fell swoop; that would have been impossible. Rather, tariff reduction was spread over eight rounds.

**1980–1993: PROTECTIONIST TRENDS**

First, the economic success of Japan during that time strained the world trading system (much as the success of China has created strains today).

Second, the world trading system was strained by the persistent trade deficit in the world’s largest economy, the United States.

A third reason for the trend toward greater protectionism was that many countries found ways to get around GATT regulations. Bilateral voluntary export restraints (VERs) circumvent GATT agreements, because neither the importing country nor the exporting country complains to the GATT bureaucracy in Geneva—and without a complaint, the GATT bureaucracy can do nothing. Exporting countries agreed to VERs to avoid more damaging punitive tariffs.

**THE URUGUAY ROUND AND THE WORLD TRADE ORGANIZATION**

The Uruguay Round contained the following provisions:

1. Tariffs on industrial goods were to be reduced by more than one-third, and tariffs were to be scrapped on more than 40 percent of manufactured goods.

2. Average tariff rates imposed by developed nations on manufactured goods were to be reduced to less than 4 percent of value, the lowest level in modern history.

3. Agricultural subsidies were to be substantially reduced.

4. GATT fair trade and market access rules were to be extended to cover a wide range of services.

5. GATT rules also were to be extended to provide enhanced protection for patents, copyrights, and trademarks (intellectual property).

6. Barriers on trade in textiles were to be significantly reduced over 10 years.

7. The World Trade Organization was to be created to implement the GATT agreement.

**The World Trade Organization**

The WTO acts as an umbrella organization that encompasses the GATT along with two new sister bodies, one on services and the other on intellectual property. The WTO’s General Agreement on Trade in Services (GATS) has taken the lead to extending free trade agreements to services. The WTO’s Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) is an attempt to narrow the gaps in the way intellectual property rights are protected around the world and to bring them under common international rules. WTO has taken over responsibility for arbitrating trade disputes and monitoring the trade policies of member countries.

**WTO: EXPERIENCE TO DATE**

By 2016, the WTO had 164 members, including China, which joined at the end of 2001, and Russia, which joined in 2012. WTO members collectively account for 98 percent of world trade. Since its formation, the WTO has remained at the forefront of efforts to promote global free trade. Its creators expressed the belief that the enforcement mechanisms granted to the WTO would make it more effective at policing global trade rules than the GATT had been. The great hope was that the WTO might emerge as an effective advocate and facilitator of future trade deals, particularly in areas such as services.

**WTO as Global Police**

The first two decades in the life of the WTO suggest that its policing and enforcement mechanisms are having a positive effect.

**Expanded Trade Agreements**

As explained earlier, the Uruguay Round of GATT negotiations extended global trading rules to cover trade in services. The WTO was given the role of brokering future agreements to open up global trade in services. The WTO was also encouraged to extend its reach to encompass regulations governing foreign direct investment, something the GATT had never done. Two of the first industries targeted for reform were the global telecommunication and financial services industries.

**THE FUTURE OF THE WTO: UNRESOLVED ISSUES AND THE DOHA ROUND**

Against this difficult political backdrop, much remains to be done on the international trade front. Four issues at the forefront of the agenda of the WTO are antidumping policies, the high level of protectionism in agriculture, the lack of strong protection for intellectual property rights in many nations, and continued high tariff rates on nonagricultural goods and services in many nations.

**Antidumping Actions**

Antidumping actions proliferated during the 1990s and 2000s. WTO rules allow countries to impose antidumping duties on foreign goods that are being sold cheaper than at home or below their cost of production when domestic producers can show that they are being harmed. Unfortunately, the rather vague definition of what constitutes “dumping” has proved to be a loophole that many countries are exploiting to pursue protectionism.

**Protectionism in Agriculture**

Another focus of the WTO has been the high level of tariffs and subsidies in the agricultural sector of many economies. Tariff rates on agricultural products are generally much higher than tariff rates on manufactured products or services.

Protection of Intellectual Property Another issue that has become increasingly important to the WTO has been protecting intellectual property.

**Market Access for Nonagricultural Goods and Services**

Although the WTO and the GATT have made big strides in reducing the tariff rates on nonagricultural products, much work remains. Although most developed nations have brought their tariff rates on industrial products down to an average of 3.8 percent of value, exceptions still remain.

**A New Round of Talks: Doha**

The Doha agenda includes cutting tariffs on industrial goods and services, phasing out subsidies to agricultural producers, reducing barriers to cross-border investment, and limiting the use of antidumping laws.

**MULTILATERAL AND BILATERAL TRADE AGREEMENTS**

In response to the apparent failure of the Doha Round to progress, many nations have pushed forward with multilateral or bilateral trade agreements, which are reciprocal trade agreements between two or more partners.

Multilateral and bilateral trade agreements are designed to capture gain from trade beyond those agreements currently attainable under WTO treaties. Multilateral and bilateral trade agreements are allowed under WTO rules, and countries entering into these agreements are required to notify the WTO.

**THE WORLD TRADING SYSTEM UNDER THREAT**

In 2016, two events challenged the long-held belief that there was a global consensus behind the 70-year push to embrace free trade and lower barriers to the cross-border flow of goods and services. The first was the decision by the British to withdraw from the European Union following a national referendum (Brexit).

The second event was the victory of Donald Trump in the 2016 U.S. presidential election. As discussed in Chapter 6, Trump appears to hold mercantilist views on trade. He seems opposed to many free trade deals. Indeed, one of his first actions was to pull the United States out of the Trans Pacific Partnership, a 12-nation free trade zone that was close to ratification. He has also expressed hostility toward NAFTA and the WTO.