

The Limits of PROTECTIONISM

Building Coalitions for Free Trade

M I C H A E L L U S Z T I G



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U N I V E R S I T Y O F P I T T S B U R G H P R E S S

Published by the University of Pittsburgh Press, Pittsburgh, Pa., 15260

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Manufactured in the United States of America

Printed on acid-free paper

10 9 8 7 6 5 4 3 2 1

ISBN 0-8229-5843-0

Library of Congress Cataloging-in-Publication Data

Lusztig, Michael, 1962—

The limits of protectionism : building coalitions for free trade /

Michael Lusztig

p. cm.

Includes bibliographical references and index.

ISBN 0-8229-5843-0 (pbk. : alk. paper)

1. Protectionism. 2. Free trade. 3. Free trade—Government policy.

4. Free trade—Political aspects. I. Title.

HF1713.L868 2004

382'.71—dc22

2003027099

To Anika, Chrissy, Madison, Mitchell, Owen, Ryder, and Simon

Acknowledgments

Oftentimes books get started long before the metaphorical pen is set to paper. Such was the case with this one, which came out of a heated debate with a professor in graduate school many years ago. A good deal of time and money were needed to see the idea through to print. Money was the more important. This book could not have been written without the generous financial assistance of the Social Sciences and Humanities Research Council of Canada, which funded this project under the auspices of grant number 410-96-0257. In addition, the University of Western Ontario contributed to this project, both through its federal work-study program and a Vice-President's Grant. Finally, I am grateful to the John G. Tower Center for Political Studies at Southern Methodist University for its financial support. All this monetary support was put to excellent use: the book could not have been completed without first-rate research assistance. My thanks go to Miriam Desjardins, Erin Eckols, Mike Edwards, Lauren Johnson, Laura Stephenson, Nicole Vaz, and Steve Whiting. A special debt of gratitude is owed to Laura Stephenson, who, in addition to putting hundreds of hours into research assistance, coordinated the activities of many of the other RAs. An entire filing cabinet full of photocopies stands as testament to Laura's incredible dedication.

In addition to time and money, this project relied on the brains of others. Countless friends and colleagues took the time to read all or parts of this manuscript and to make important intellectual contributions. For their assistance I am grateful to Paul Brace, James Brander, Mark Brawley, Ian Brodie, Christine Carberry, Peter Dombrowski, Jeffrey Frieden, Patrick James, Douglas Lemke, Nathan MacBrien, Barbi McClennen, Hudson Meadwell, Philip Oxhorn, James Lee Ray, Laura Stephenson, and two anonymous reviewers at the University of Pittsburgh Press. In addition to making a helpful intellectual contribution to the manuscript, Nathan MacBrien and Deborah Meade at the University of Pittsburgh Press rendered the review and publication process incredibly fast and hassle free. Christine Carberry and

Trish Weisman spent hours proofing the manuscript and suggesting innumerable changes. The book could not have been completed without the selfless support of any of them. An early version of the idea contained in this book was published as "The Limits of Rent-Seeking: Why Protectionists Become Free Traders," *Review of International Political Economy* 5 (1998). I am grateful to Taylor and Francis (www.tandf.co.uk) for their very liberal permissions policy.

The final ingredients that went into this book were patience and forbearance. I supplied neither. I extend a huge debt of gratitude to my wife, Chrissy, who, in addition to the intellectual and logistical support noted earlier, provided all the requisite residual support as well. I am deeply grateful to her for this and so many other things.

Acronyms

AAA	Agricultural Adjustment Act (U.S.)
ABM	Asociación de Banqueros de México (Association of Mexican Bankers)
ACM	Australian Chamber of Manufacturers
ACMA	Associated Chambers of Manufacturers of Australia
ALP	Australian Labour Party
AMC	Australian Manufacturing Council
AMIB	Asociación Mexicana de Intermediarios Bursátiles (Mexican Securities Industry Association)
AMIS	Asociación Mexicana de Instituciones de Seguros (Association of Mexican Insurance Institutions)
ANZCERTA	Australia–New Zealand Closer Economic Relations Trade Agreement (see also CER)
APEC	Asia-Pacific Economic Cooperation
ARENA	Aliança Renovadora Nacional (National Alliance for Renewal; Brazil)
ATFNZ	Apparel and Textile Federation of New Zealand
BCNI	Business Council on National Issues (Canada)
BNDE	Banco Nacional de Desenvolvimento Econômico (Bank for National Economic Development; Brazil)
CACEX	Carteira de Comércio Exterior (Foreign Trade Agency, Bank of Brazil)
CAI	Confederation of Australian Industry
CANACINTRA	Cámara Nacional de la Industria de Transformación (National Chamber of Manufacturing Industry; Mexico)
CCE	Consejo Coordinador Empresarial (Business Coordinating Council; Mexico)
CER	Closer Economic Relations (see also ANZCERTA)
CET	Common External Tariff

CFIB	Canadian Federation of Independent Business
CIBA	Council for International Business Affairs (Australia)
CMA	Canadian Manufacturers' Association
CMNH	Consejo Mexicano de Hombres de Negocios (Mexican Businessmen's Council)
CNA	Consejo Nacional Agropecuario (National Agriculture and Livestock Council; Mexico)
CNI	Confederação Nacional de Industrial (National Industrial Confederation; Brazil)
COECE	Coordinadora de Organismos Empresariales de Comercio Exterior (Coordinating Body of Foreign Trade Business Associations; Mexico)
CONCAMIN	Confederación de Cámaras Industriales (National Confederation of Industrial Chambers; Mexico)
CONCANACO	Confederación de Cámaras Nacionales de Comercio (National Confederation of Chambers of Commerce; Mexico)
CONMIA	Confederation of Manufacturing Industry Associations (Australia)
COPARMEX	Confederación Patronal de la República Mexicana (Employers' Confederation of the Republic of Mexico)
CORFO	Corporación de Fomento de la Producción (Chilean Development Corporation)
COSB	Canadian Association of Small Business
CPC	Confederación de la Producción y Comercio (Confederation for Production and Commerce; Chile)
CRI	Committee for Reciprocity Information (U.S.)
CUFTA	Canada-U.S. Free Trade Agreement
DECEX	Departamento de Comércio Exterior (Foreign Trade Department, Bank of Brazil)
DFAT	Department of Foreign Affairs and Trade (Australia)
DUP	Directly unproductive profit seeking
EEC	European Economic Community
EPTI	Export Performance Taxation Incentive (New Zealand)
FTAA	Free Trade Area of the Americas
GATT	General Agreement on Tariffs and Trade
GDP	Gross domestic product
GNP	Gross national product
IAC	Industries Assistance Commission (Australia)

IC	Industries Commission (Australia)
IMF	International Monetary Fund
ISI	Import-Substituting Industrialization
ISIC	International Standard Industrial Classification
Manfed	Manufacturers' Federation (New Zealand)
MDB	Movimento Democrático Brasileiro (Movement for a Democratic Brazil)
MERCOSUR	Mercado Común del Sur (Common Market of the South)
MP	Member of Parliament
MTIA	Metal Trades Industry Association (Australia)
MTN	Multilateral Trade Negotiation (also called Tokyo Round of the GATT)
NAFTA	New Zealand–Australia Free Trade Agreement
NAFTA	North American Free Trade Agreement
NAM	National Association of Manufacturers (U.S.)
NEP	National Energy Programme (Canada)
NIRA	National Industrial Recovery Act (U.S.)
NTB	Nontariff barrier
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of Petroleum Exporting Countries
PAN	Partido Acción Nacional (National Action Party; Mexico)
PDC	Partido Demócrata Cristiano (Christian Democratic Party; Chile)
PDS	Partido Democrático Social (Social Democratic Party; Brazil)
PECE	Pacto para la Estabilidad y el Crecimiento Económico (Pact for Economic Growth and Stability; Mexico)
PICE	Programa de Integración y Cooperación Económica (Program of Integration and Cooperation; Brazil and Argentina)
PMV	Passenger motor vehicle
PND II	Plano Nacional de Desenvolvimento II (Second National Development Plan; Brazil)
PQ	Parti Québécois (Canada)
PRD	Partido de la Revolución Democrática (Party of the Democratic Revolution; Mexico)
PRI	Partido Revolucionario Institucional (Institutional Revolutionary Party; Mexico)

PRONAFICE	Programa Nacional de Fomento Industrial y Comercio Exterior (Program to Promote Industrialization and Foreign Commerce; Mexico)
PRONASOL	Programa Nacional de Solidaridad (Program of National Solidarity; Mexico)
PSE	Pacto de Solidaridad Económica (Economic Solidarity Pact; Mexico)
RTAA	Reciprocal Trade Agreements Act (U.S.)
SAA	Special Advisory Authority (Australia)
SECOFI	Secretaria de Comercio y Fomento Industrial (Secretariat of Trade and Industrial Development; Mexico)
SITC	Standard Industrial Trade Classification
TAA	Temporary Assistance Authority (Australia)
TAC	Trade Agreements Committee (U.S.)
TCF	Textiles, clothing, and footwear
TCS	Tariff Concessions System (Australia)
TMA	Tripartite Monetary Agreement (U.S.)
TPA	Trade Promotion Authority (U.S.)
WTO	World Trade Organization

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1

The Limits of Rent Seeking *A Prescriptive Model*

People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.

ADAM SMITH, *The Wealth of Nations*

It has become a cliché in these troubling times to note that freedom does not come for free. The logic extends into the realm of trade. The price for free global markets is sometimes paid by politicians whose enthusiasm for the economic benefits leads them to underestimate the political costs. More often, risk-averse politicians eschew the benefits of trade, fearing electoral sanction. This risk aversion, however, imposes opportunity costs of its own. There is little debate among economists that free trade is, in the aggregate, economically beneficial. It expands firms' productive capacities, encourages specialization and efficiency in the productive sector, and broadens consumer choice while subjugating prices to the rigor of market competition. It provides incentives for innovation and stimulates foreign investment. It creates jobs and, with time, raises wages. Free trade fosters economic interdependence between nations and hence creates disincentives for trading states to escalate conflicts. Economically speaking at least, under most conditions free trade represents a dominant strategy for states seeking to maximize aggregate wealth.

A significant problem, however, is that the economic benefits of free

trade are not well understood by the general (and voting) public. Free trade might be generally advantageous, but it is not a vote getter; often, in fact, it is a vote loser. Free traders have a much harder time getting out their message than do protectionists. One reason is that there are obvious dislocation costs associated with free trade. Plants close, workers lose jobs, local economies are badly hurt. These are the sorts of human-event stories that are tailor-made for the evening news. Less interesting to viewers, and hence the media, are stories about the economic advantages inherent in Ricardo's theory of comparative advantage (1960), prospects for more favorable economies of scale, and the altered incentive structures for direct and portfolio foreign investment. Al Gore may have out-debated Ross Perot on CNN's *Larry King Live*,¹ but the most memorable event was Perot's earlier reference to the "giant sucking sound" that would be created as U.S. companies pulled up stakes and departed for Mexico to take advantage of labor-cost savings. Gore's own rhetorical stunt, presenting Perot with a framed photograph of the sponsors of the disastrous Smoot-Hawley Tariff of 1930, was not as effective. Nor, manifestly, was the logic that the North American Free Trade Agreement (NAFTA) did not create the low-wage economy and therefore was not terribly likely to have an overwhelming impact on plant closings in the United States. The point that stuck was that NAFTA would create a giant sucking sound.

More problematic for free trade is the fact that protectionist coalitions form far more readily than do advocacy groups. As students of international political economy and public choice theory have long maintained, free trade represents an asymmetric public good (Tullock 1967; Peltzman 1976; Becker 1983; Rowley and Tollison 1988; Lake 1988a; Baldwin 1989). While the aggregate benefits may outweigh the costs, the effects are unevenly distributed. The benefits of free trade are broad but latent. The costs, concentrated and manifest, are borne by a comparatively small number of producers who had enjoyed "rents" derived from the insulation of the domestic market. (Economists define a rent as the return on a factor of production in excess of its opportunity cost. For example, a rent may be thought of as the difference between a professional baseball player's salary and the optimal salary he could earn if not playing ball.) Consumers, often uninspired by (or unaware of) the link between free trade and marginal reductions in retail prices typically fail to man the metaphorical barricades in support of free trade. Protectionist producers—rent seekers—react differently; given the stakes involved, they can be relied on to mobilize for retention of such state-supplied rents as direct subsidies, tax breaks, or impediments to imports

such as tariffs or nontariff barriers.² For their part, elected governments faced with the choice of appeasing indifferent consumers or belligerent producers have an obvious incentive to gratify the latter (see Lavergne 1983; Frey 1984; Lake 1988a; Tullock 1988; Baldwin 1989; Williamson 1994a).³

Governments generally are not indifferent to the economic benefits of free trade. A strong economy typically rewards incumbent officeholders. While the palliative effects of free trade are sufficiently delayed that only the most optimistic incumbents would plan to reap direct benefits, the negative economic effects of protectionism can weigh heavily on a country's economic performance. Even if trade liberalization is not directly politically rewarding, in other words, it may have powerful indirect political benefits. Voters do not necessarily have to know why the economy is performing well; it is enough that they recognize that it is. Finally, government leaders can be expected to look out for the best interests of the countries they govern. Provided that the price is not too high (such as sacrificing a political career), it must be assumed that many government leaders (1) have an interest in national aggregate wealth maximization and (2) recognize that free trade is an efficient means to this objective.⁴

Given that government leaders have an incentive to liberalize trade, it is of fundamental importance to determine circumstances under which trade can be liberalized without incurring excessive political cost. I believe that governments can minimize the political risks associated with significant liberalization of trade. I argue here that under certain conditions, rent-seeking opponents of trade liberalization actually may turn into critically important allies of governments attempting major policy shifts from protectionism to free trade. Where domestic rent seekers are persuaded that the government cannot or will not provide sufficient rents, rent seekers may pursue a second-most-preferred strategy that entails attempting to secure access to cheaper factor inputs and to foreign markets by actively supporting trade liberalization. This transformation of behavior on the part of rent seekers is a condition that can be exploited by adroit government actors, and a menu of options is presented here for governments that seek to reduce rents without suffering severe political backlash.

Free trade should not be presented as an optimal policy choice under all circumstances. I merely assume that, all things being equal, free trade is economically beneficial. This is not a heroic assumption, and countless others, from Ricardo onward, have justified it. That said, in assessing the rationality of any course of action, one must be cognizant of the desired ends. Free trade is sound policy if governments' objectives are to maximize aggregate levels of

wealth. Of course, it is easy to imagine circumstances where governments have other first-order objectives. For example, where governments are more concerned with national security than wealth maximization, free trade becomes less attractive. Ricardian theory proves that the United States would be better served economically to import some of its strategic munitions from low-wage economies rather than produce them itself. For obvious reasons, however, this is unlikely to be a preferred choice. Similarly, as recent protests in Seattle, Genoa, and Quebec City have suggested, many believe (rightly or wrongly) that trade liberalization undermines other important objectives, including environmental protection and sovereignty of less-developed nations.

In addition, I do not assume that free trade will distribute wealth equitably. However, since free trade forces governments to stop redistributing wealth to the productive sector, there is an assumed progressive element to trade liberalization. Indeed, this is why free trade is so intimately tied to early liberal thought. But there is no guarantee that increasing aggregate wealth will benefit all equally or equitably. The worker whose job is sacrificed for the long-term health of his former employer's company or the economy at large takes cold comfort in economic theory. And it is not just workers who suffer real, human costs. Dislocation associated with free trade forces many businesses from the marketplace. A lifetime's work of building a business can be wiped out in a tidal surge of competition unleashed by free trade. Thus, I aim not to lose sight of the fact that the overall objective of freer trade is to maximize wealth, not to maximize justice.

The Costs of Rent Seeking

Economists have long been concerned with two related phenomena: monopoly (or collusive oligopoly) costs and activity that dissipates resources without productive benefit. The latter falls under the broad rubric of directly unproductive profit seeking (DUP),⁵ a subset of which is rent seeking. The costs of monopoly are familiar to all students of elementary economics. The supply curve under monopoly conditions is artificially restricted, leading to less output and higher commodity prices than would have occurred under conditions of free competition. However, the literature on rent seeking, developed initially by Tullock (1967), suggests that the societal deadweight cost of monopolies is much higher. Indeed, the competition for monopoly rents, which includes lobbying and advertising as well as attendant personnel costs, constitutes a dissipation of resources that could otherwise have gone into