

Trade policy: an overview

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1 Learning objectives

1. Understand why economic analysis by and of itself cannot tell us what a correct policy should be.
2. Reacquaint yourselves with what is the economist's definition of efficiency, and understand how that concept informs many economists' views on policy.

3. Know some of the criterion that are frequently used by people when evaluating whether or not a particular policy should be implemented.
4. Understand how concentrated benefits and diffuse costs or the reverse affect the policy-making process.

2 Introduction

2.1 Sex, money, and power: Monica Lewinsky and trade policy

Sex as part of an economics topic? No, this is *not* thrown in just to get your attention. Well, sort of. Consider the following quote:

"Alfonso Fanjul is so politically powerful that President Bill Clinton interrupted a "meeting" with Monica Lewinski to take a phone call from him. This is according to Lewinsky's testimony as presented in the Kenneth Starr report."¹

For those unfamiliar with the details of the Lewinsky affair, we can only recommend you fill in this gap in your knowledge of U.S. history. Our interest here, though, is in the Fanjul family: what made a U.S. President stop in the middle of whatever he might have been doing at the moment to take immediately a phone call from a member of that family?

The Fanjul family grows and refines sugar cane on their vast land-holdings in Florida and in the Dominican Republic. As such, they make a lot of money from the system of sugar import quotas and price supports that make up United States sugar policy. As a consequence, they can and do make substantial monetary contributions to both U.S. political parties. At a minimum, this appears to get them the power to talk on the phone with the President.

In Chapter 5, we showed that tariffs or quotas on a good or service generally can be expected to increase its domestic price. This tends to restrict consumption and increase domestic production. In the United States, this is what has happened with sugar. Sugar imports are restricted primarily by a system of quotas. This undoubtedly hurts a lot of sugar consumers in the United States. On average, economists estimate the average United States consumer has spent somewhere in the neighborhood of \$10/year more on sugar than she or he would have in the absence of these policies. But sugar producers (and their employees) have been helped. Thus, policy-makers have a dilemma: getting rid of sugar import restrictions helps some people and hurts others. Who is to say what the best policy should be?

We will explore a number of aspects of this dilemma, and see what economic analysis has to say that can help policy makers wrestle with such a dilemma. But part of a recurrent theme is illustrated by our vignette about the connection

¹This quote comes from footnote 24 on page 71 of Douglas Irwin's *Free Trade under Fire* (second edition, Princeton University Press, Princeton, NJ.)

of money and power: the people helped by the trade restrictions are few in number but concentrated and powerful, while the people hurt are numerous but diffuse and with a relatively small personal stake in elimination of the restriction. The U.S. president is *not* about to interrupt affairs (of state, or otherwise) to take an average sugar consumer's call.

2.2 The policy-maker's dilemma

Imagine you are the head of the local library and must make decisions on what types of books to buy. In particular, you must make a decision between purchasing a book on ultimate fighting or one on bird watching. Your existing book on ultimate fighting is almost never on the shelf: as soon as it is returned, someone else checks it out. On the other hand, your existing book on bird watching is seldom used: only one person has checked it out over the past year. What is the right thing to do?

This is a pretty open-ended question, but your first instinct may be that you should buy the ultimate fighting book. After all, it appears that lots of people enjoy this type of book relative to a birdwatching book.

But what do you really know about how much satisfaction people are deriving from these books? Perhaps the readers of the ultimate fighting books are shallow teenagers with many other options for entertainment other than reading this book, and the birdwatching book reader is a house-bound person with a deep interest in birds and few options for entertainment other than watching birds from the house. If this were the case, would the right choice be to buy the birdwatching book?

Basically, there is no "right" choice here. All one can say is that it appears that the ultimate fighting book would be used more. But without some "priestly knowledge" or the wisdom of Solomon, you cannot evaluate which parties are most deserving.² You as a librarian are left with making a choice that hurts someone and helps another.

This simple example captures the basic policy dilemma: virtually all real-world policy choices hurt some people and help others, and there is virtually no criterion for making a choice that is guaranteed to garner universal support: thoughtful people can and will disagree.

Trade policy is even more complex and potentially divisive than our simple library example. The choice made by our librarian, after all, would not be life-altering for any of the parties involved, and affects a limited number of people. Trade policy is both more important and more complex. As an introduction to

²The use of quotations is used to indicate a reference to the following quote:

“No issue divides economists and mere Muggles more than the debate over globalization and international trade. Where the high priests of the dismal science see opportunity through the magic of the market's invisible hand, Joe Sixpack sees a threat to his livelihood.”

This was written in a New York Times column by one of those high priests, Harvard University's Gregory Mankiw. Our point in this example is that there is no special knowledge available even to the high priests of economics.

these complexities, consider the following imaginary scenario involving a newly-elected president and her newly-appointed chief economic advisor, who was most recently a professor. As the President enters the Oval Office, she recognizes her newly-appointed advisor by his clever use of his Phi Beta Kappa pin as a tie-tack for his gravy-stained paisley tie. The dialogue goes like this:

President: As you know, during the campaign I stressed my concern that too many citizens were at risk from further reductions in trade barriers between us and the rest of the world. With a few exceptions, I was roundly criticized by the economics profession at large. Can you give me an explanation of why I should be in favor of reducing trade barriers?

Economist: I can't really do that. I don't know enough about your preferences and about what you want for the country. But I can give you an analysis of the economic trade-offs you face when you contemplate which policy to pursue.

President: You sound like one of those two-handed economists that plagued my predecessor Harry Truman. He got so tired of hearing his economists say "on the one hand, you should do this, but on the other hand, you should do that" that he asked for a one-handed economist. And you don't sound like most economists who during the campaign loudly denounced my concerns about trade. Why were they so certain that free trade is best?

Economist: Well, I can try and tell you what informs their thinking on these matters. But remember, any policy advocacy by an economist involves a value judgement at some level. Perhaps it is best to start with a concrete example: sugar. We have a variety of impediments to free trade in sugar, all of which keep the price paid by U.S. consumers above the world price. Because almost everyone uses sugar—even if you don't pour it in your coffee, it is an ingredient in an enormous amount of food—the great majority of Americans would face a lower price for sugar without these impediments. Estimates are that removal of these impediments would have saved each American on average somewhere in the neighborhood of \$10 per year of spending on sugar.

President: I had no idea. And I bet I'm not different from most Americans. Unless they had an international economics class, they wouldn't know either. But tell me: if people saved this amount on sugar, what would they spend it on, and what would that effect? I did have introductory economics in college, so I can understand some simple economics.

Economist: Well, we don't know for sure what they might spend it on, but my guess would be that different people would spend it on different things. Along with more sugar, some might buy more clothes, some more toys, and so on. This might shift out the demand curve for these products and increase their prices.

President: Wait a minute. You mean if I eliminated impediments to sugar imports, I'd lower sugar prices, but increase other prices? Surely some of my constituents don't consume sugar, but do consume these other products. And surely the sugar growers and refiners in this country would be hurt as well. It appears I would be helping one group—some sugar consumers—but hurting others. Why is that a good thing?

Economist: A good point, Madam President. Actually, many—perhaps most—economists think this is a good thing because it represents a shift in *relative* prices that creates gains to the winners—primarily some sugar consumers, and some exporters—that are greater than the losses to the losers, who would be sugar producers and consumers who don't use much, if any, sugar.

President: Is this a good thing? Do I know that there are more winners—potential voters, mind you—than losers?

Economist: Well, economic theory doesn't tell us that for sure, although in this case it seems likely.

President: OK, let me see if I've got this right. Hypothetically, the lower sugar price leaves sugar consumers more money to spend on other things. If all sugar consumers increased their spending on one thing—say clothing—then there could be a lot of people hurt by this, namely people that spend a lot of their income on clothes but not much on sugar. I see by looking around at you and your fellow economists that this concept of spending a lot of money on clothes might be a little foreign to you. But what am I missing here about why removing impediments to sugar imports would necessarily be a good thing?

Economist: As you say, Madam President, some people are helped, and some are hurt by trade liberalization for sugar. But as I noted, the gains to the winners are greater than the losses to the losers. And I might add that among academics, we economists are known for our sharp dressing! I admit, my wife seems to feel that the scuffed, comfortable sandals I wear don't go well with my three-piece suits, but who notices shoes?

President: I notice shoes. Maybe it is a real-world thing. But back to the issue. So what if the gains to the winners are greater than the losses to the losers? This doesn't seem like a good criterion for deciding about whether a policy is a good one. Imagine only a few people gained, but a lot of people lost. An economist named Blinder argued this might be the case with trade in services such as call-centers, programming, accounting, medical transcription, and even reading medical images like x-rays. And this columnist Paul Krugman seems to now believe that trade has hurt workers, and there are a lot of workers in this country.

Wait! I get it! You economists have ways to shift income from the winners to the losers, so everybody comes out ahead!

Economist: A good point about the failings of the "net gains" criterion, Madam President. But I'm sad to say we economists don't believe the government has tools available to shift income from winners to losers from a policy change such as removal of sugar import impediments. To do this, the government would have to know an extraordinary amount of information about millions and millions of people. And even if the government could gather that information, setting up such a plan would cost a lot. And existence of such a plan might encourage people to "game the system," giving a false appearance of being hurt or not being helped.

The reason most economists like the "net gains" criterion is that if an economy has many opportunities for changes that satisfy the "net gains" criterion, and if these opportunities are distributed more-or-less randomly across the pop-

ulation, then *on average* most everyone will gain. For example, removal of sugar quotas will hurt some consumers and producers, but removal of, say, textile tariffs will probably help those people. Removal of automobile quotas will hurt some consumers and producers, but help others. Because there are "net gains" for each of these individual policy changes, the change for everyone is on average positive.

President: Get real! You are telling me that slightly lower prices for textiles, sugar, and automobiles can compensate some 50-year old who loses her or his job in a sugar refining plant or automobile assembly line? And have you visited some of the former textile mill towns in North Carolina, which have turned into ghost towns because of the contraction of our textile industry? The towns feel like they have been hit by tornados. And if they had been hit by tornados, the country through the government would have felt obligated to help them.

Economist: Well, no, I didn't mean to make the claim that there wouldn't be some people terribly hurt. I guess what I really mean is that over long periods of time, an economy that embraces the chances it gets to adopt policies that meet the "net gains" criterion will be a better place for almost everyone. Maybe the 50-year old workers who lose jobs won't be made better off in their lifetimes, but their children probably will be. Policies that satisfy the "net gains" criterion are much like technical progress: they cause disruptions for people who work in a particularly affected industry, but open doors for these people's offspring, and lead to continual increases in average material well-being. The development of railroads disrupted workers whose livelihoods depended on the Erie Canal, but from our vantage point now, we certainly would not have wanted to stop the development of the railroad.

President: But not everybody has children! You simply cannot be sure that everybody gets some benefit from living in a society that adopts policies that satisfy this "net gains" criterion.

Economist: Well, that is right. But nothing in life is perfect. In contrast, who now would want the world to have been frozen at a level of development that we had two hundred years ago?

President: I see the logic of not exalting the status quo: that privileges the people alive right then and there at the expense of future generations. But isn't there some middle ground? We're a very wealthy country now, and if I could take some of our current wealth and transfer it back a few centuries to people hurt by economic progress, I would. It makes me think that I should do something to help the people hurt now by economic progress. After all, the future generations are the ones that benefit, so leaving a little less for them seems a good idea.

Economist: Well, of course, that's a value judgement, and one probably shared by many economists. And we have policies in place now that actually try and do that. For example, we have something called Trade Adjustment Assistance to compensate workers who lose their jobs because of import penetration. But these policies bring their own problems. No matter how hard we try to make the policies fair, people abuse them, reducing the overall "net gains" they were designed to make possible.

And this discussion reminds me that we have another way of thinking about how to decide what policies should be followed by a society. This is best illustrated by an actual example of how someone actually used this approach to make choices in his life.

You may know, or at least know of, the wealthy investor Warren Buffet. What surprises many people is that he is a member of the Democratic Party. His explanation of this choice is that he imagines what his life would have been if he had been born in different circumstances. He imagines that he had not been born in an advanced industrialized society, or had not been born with the particular skills that have served him so well in the context of our economy. He then asks himself: from behind this "veil of ignorance" about the exact circumstances of his birth, into what kind of society he would like to be born? His answer was that he would want to be born into a society which helped those who weren't lucky enough to be born into the best circumstances. And in his view, the Democratic Party was most likely to implement policies that created such a society.

So, from behind a veil of ignorance about when and where you might be born, what kind of rules would you like a society to follow? From this perspective, you might like society to embrace "net gain" policies that don't privilege the status quo, and give you the highest expected standard of living.

President: Maybe. But maybe I worry about being the unlucky person. This is all getting more complicated than I thought it would be. I'm beginning to feel like my campaign stance wasn't so bad. But your description of the advantages and costs of free trade seems much more nuanced than what I remember reading. Didn't the 2004 *Economic Report of the President* say: "When a good or service is produced more cheaply abroad, it makes more sense to import it than to make or produce it domestically"? This seems a flat-out endorsement of free trade, doesn't it? There are no qualifications such as, "unless it destroys too many jobs," or, "if it is accompanied by other appropriate policies that compensate losers."

Economist: Well, you are right. That sentence was in the Economic Report of the President, 2004, p. 229. I personally would say that we economists have been a little careless in our use of language, probably because we know and fear the kinds of things that can happen when protectionism becomes extreme. For example, the retreat to protectionism following World War I could well have been an important cause of World War II.

President: All this is getting pretty complicated. Let's go back to something concrete: the sugar example. Let me see if I've got this straight: a lot of economists would want me to get rid of impediments to sugar imports, helping in a small way a lot of people who probably will not even realize they have been helped, and destroying a small number of people's livelihood. This hardly seems fair to me.

Economist: I understand the idea that when the choice is people's livelihoods versus cheaper sugar, it is hard to argue that cheaper prices should win. But there are other fairness issues here. Other producers in the United States face hardships that arise from other changes. For example, the development of

word processors eliminated the jobs of workers at typewriter factories. Changes in tastes led to a decline in the demand for beef, hurting cattle ranchers and beef processors. And more recently, a new cheap "panoramic camera" has been developed that will probably put out of business a small industry that makes an expensive motor-driven apparatus that produces panoramic photos. In our society, these risks are accepted as the cost of having a dynamic economy that produces the things that consumers want. What makes the producers of goods that face competition from foreign producers more deserving of special treatment?

President: Okay, I see your point. But look, there is another fairness issue: if I take away protection for sugar, shouldn't I eliminate subsidies to other producers? It hardly seems fair to hurt sugar producers but continue to subsidize other agricultural products. And another thing: should I be working to lower the price of sugar when my Surgeon General says that sugar is a "hidden killer," causing diabetes in uninformed citizens?

Economist: You raise another good point, Madam President. In fact, if you eliminate sugar import restrictions, I would argue that you should work to eliminate other subsidies, both on fairness grounds and economic efficiency grounds. The fairness argument is straightforward, just as you described it. But there is another way of looking at this fairness issue: if you protect or subsidize anything, maybe out of fairness you should subsidize or protect everything! We economists have something to say about that: it can't be done. This means that any policy you follow that helps any one sector hurts someone else, with a few exceptions.

But the efficiency argument is more complicated. In fact, if these other "distortions" such as other subsidies to other agricultural products remain in the economy, we really can't say that removal of the sugar impediments is "efficient." Likewise, if there are unpriced benefits to higher sugar prices because of health benefits of which citizens are unaware, we can't say that removal of impediments to imports is efficient. This is known to economists as the **second-best problem**.

President: Things are getting ever more complicated!

Economist: Well, many economists argue that these considerations are not that important. And frequently we point out that there are better solutions to externalities than trade policy. That is one reason these things are known as second-best problems: there are usually better, direct attacks on the problem. For example, a better approach to the problem of hidden dangers from sugar consumption would be the dissemination of public information, or a tax directly on sugar consumption. But I guess the consistent point of view towards policy would be that you must attack "distortions" on all fronts.

President: But even if I'm convinced this is a good policy, it certainly seems like political suicide: I can almost hear the sucking sound as campaign contributions from sugar growers associations and the sugar refiners associations leave my party and head to the other party. And if that happens, how will I get the campaign contributions that let me educate voters about the woeful quality of my opponents? Perhaps you've heard of the Fanjul family, who are in the

sugar business and have been generous contributors to my campaigns. They were good friends of my husband, too.

Economist: The Fanjuls? They represent many of the things economists find most appalling about U.S. sugar policy. Studies show that they received millions of dollars from the price supports and quota policies!

President: Well, that may be true, but some of this money kept their business going. And if this business disappears, so do thousands of jobs in an area of rural Florida in which there are few options other than working in sugar.

Economist: Well, I guess I don't focus on that. Again, nothing is perfect.

President: As a matter of fact, as I think about the political problem associated with trying something like eliminating sugar quotas, I'm amazed that our country has had such a long stretch of time during which trade liberalization proceeded.

Economist: You are not the only person amazed at the long period of trade liberalization that began in the 1930's. And with good reason: the sugar problem is a perfect example of the problem of concentrated benefits and diffused costs. This problem arises because the potential beneficiaries of a particular policy, such as sugar consumers, are often diffuse and unorganized, while the potential losers from the policy are concentrated and organized. This observation led to a prediction in 1935 that the Smoot-Hawley tariffs imposed in 1930 would forever remain in place. (Remember I mentioned that economists were keenly aware of the bad things that happen when protectionism is in the saddle? The effects of Smoot-Hawley are what I was talking about). The success of dismantling these tariffs is due to the creation of what economists call **incentive-compatible** policies. This history might help you devise strategies to pursue trade liberalization if you so desire.

President: This has been interesting, but I'm not convinced that I should pursue policies of trade liberalization. There are a lot of uncertainties, both about the wisdom of these policies and the practicality of implementation.

Economist: I hope we'll talk more about this. Economists have other observations that may help you clarify your thinking. And in parting, may I add that I love what you've done with pantsuits!

This imaginary dialogue covers some of the key ideas that inform economists' and policy-makers thinking about policy. The most important feature is that advocacy of any economic policy, about trade, or taxes, or anti-trust, involves a value judgement. Economic analysis by and of itself cannot determine what is the "right" policy. It has important insights about the trade-offs available to an economy through its choices of policy, but it cannot tell us more than that.

The dialogue does indicate how most economists think about trade policy, though. First and foremost, when economists think about policy, they think about **efficiency**. For example, in the first chapter we discussed the response by the economist Gary Huffman to the imposition by President Bush ("43") of steel tariffs.³ Huffman said this was "inefficient." Efficiency for economists

³We put 43 in parentheses after "President Bush" to signify that he is the 43rd president. His father, also President Bush, was the 41st president.

means that there are no economic changes that could happen that would satisfy the **Hicks-Kaldor compensation criterion** that we introduced in Chapter 5. In equivalent language, efficiency means that there are no **potential Pareto improvements** that can be generated by any other changes in economic circumstances.

But as our dialogue emphasized, this criterion of efficiency by and of itself is not a good measure of whether a policy is good for the nation. Economists have no special priestly wisdom that lets them tote up the gains to some people and the losses to others and decide whether that is a good thing or a bad one. And they don't have a way to costlessly redistribute gains from winners to losers so that everyone is made better off.

This leads many of them to view satisfaction of the efficiency criterion by some proposed policy as a good thing because of its implications for the economy over the long run. To these economists, observation of the world suggests that there are many potential changes in economic circumstances that satisfy the efficiency criterion, each of which would affect different people differently. In the dialogue, the economist talked about how reductions in trade impediments to autos hurt auto workers, but helped auto consumers, while reductions in tariffs on clothing hurt workers in the apparel industry but helped some consumers. On average, over many such possible changes, everyone could be better off.

Of course, at any moment in time, these changes might not make everyone better off. Older workers who lose their jobs are not likely made better off because they face lower prices on other consumer goods. But when viewed over the *long run*, their children and grandchildren (if they have them) on average will gain.

Note that we have moved beyond standard economic analysis into the realm of moral philosophy when we use these arguments to justify an endorsement of free trade. But the notion of efficiency is the foundation upon which this argument rests.

The dialogue also points out some other issues that we must consider when we discuss policy. First, there is what is known as the second best problem. Basically, economic analysis tells us that removal of one distortion in an economy in which other distortions remain may not satisfy the "net gains" criterion. These other distortions may take the form of things like subsidies and taxes on other goods, or what economists call **non-pecuniary externalities**. As alluded to in the dialogue, if the effects of sugar on health are unknown or unappreciated by the public, then the price of sugar does not capture the true cost of sugar to a consumer.

Second, there are fairness issues that go along with any policy issue. Fairness as a concept might seem not to be in the purview of the economist, but cannot be ignored when the issue is actual policy. An understanding of policy in actual economies benefits from an understanding that claims of "unfair" treatment loom large in any debate about a particular policy. Actual policymakers and "stakeholders" involved in any policy choice might have little understanding or appreciation of Pareto optimality, but are keenly aware of what they perceive as unfair treatment.

Finally, understanding what policies actually get implemented requires an understanding of political economy. As with sugar, policies frequently involve concentrated benefits for a small group, that is, for "special interests," and diffused costs for many unconnected individuals, or the reverse. In these cases, one might expect the "special interests" to prevail in the policy debate. The history of international trade policy provides one example of how policy design can change this expected result.

Given all these complexities, and the impossibility of having a criterion that unambiguously tells us whether a policy is good for the group as a whole, how should a citizen think about policy? Choices must be made. Is there any guidance that we can offer as to what might be a "good" policy? And what does economics bring to this table?

We need to be careful in our discussion to distinguish between **positive** and **normative** analysis. A positive analysis tries to answer the question: what policies get adopted? A normative analysis tries to answer the question: what policies *should* get adopted. To a certain extent they may be related: if what people believe *should* be adopted influences their political behavior, i.e., who they vote for, then this affects what policies actually get adopted.

The remainder of this chapter first will offer some observations on what thoughtful people have put forth as some criteria for evaluating whether a policy is good or bad, while fully appreciating that these will not garner unanimous support. We will then analyze why policies that are actually adopted may differ from these ideas of what are good policies. A brief history of trade policy will then illustrate how these impediments to "good" policies have been ameliorated by changes in policy-making rules and institutions. Finally we analyze some examples of current issues and see how current policies measure up to ideas about good policy.

3 What do people want from policy?

This of course is another problematic question: different people might want different things in terms of any particular policy or even in terms of general policies. The best anyone can hope to do is to offer some criteria that appear to receive broad support as a means to evaluate policies. One key idea that seem to inform the thoughts of policy-makers and public-policy scholars is the scope of the effects of policy on any individual. A second is the idea of fairness. We first take up the scope of effects.

3.1 The size of the distributional stakes

Economists who work on domestic policy issues and public policy officials grapple with the same issue that arises in trade: what is one to say about society in the face of changes in economic circumstances that help some and hurt others? Public policy economists in other sub-disciplines address this issue head-on.

With the impossibility of finding non-problematic criteria for resolving policy-induced social conflicts, public policy economists tend to acknowledge the "efficiency" attributes of the Hicks-Kaldor compensation criterion, then point out the obvious problems with it as a straightforward non-problematic criterion for assessing whether a change in circumstances is "good for society," and finish with a description of the sometimes-used justification based on the grounds that over time things averaged out for a net benefit for any one person.

But they point out the features of the "over time" interpretation that informed Samuelson's description of it as a "quasi-theorem." They then go on to discuss what they see as a consensus view among policy makers of "distributional guidelines" that help them grapple with whether or not a proposed change in economic circumstances should be considered "good for the group as a whole." Among others, these are:

1. A change should be allowed or implemented when the Hicks-Kaldor criterion is satisfied and the winners and losers are in roughly similar circumstances and the changes in well-being are "not of great magnitude." This is the sort of situation described by our imaginary librarian who must choose between buying an ultimate fighting book or a bird-watching book. A reasonable choice might be to buy the ultimate fighting book because it circulates more frequently, and thus is likely to satisfy the Hicks-Kaldor criterion.
2. It is debatable if a change should be allowed or implemented if such a change benefits some groups only by imposing "significant" costs on others. For trade issues, this is frequently the case.

They also point out that, given the problematic nature of resolving conflicts about what constitutes a change in circumstance that is good for the society as a whole, some people have focussed on whether the process by which such conflicts are resolved is "legitimate."⁴

As will become clear, our mantra when it comes to discussing policy is "the devil is in the details." These "distributional guidelines" are just that: guidelines. Consider our discussion of freer trade in sugar. Is the potential loss of jobs and incomes to a relatively small percentage of the population a "significant" cost? The answer depends in part on what we think are the substitution possibilities for these adversely affected people. Can the sugar-beet farmers grow other crops that only leave them with a small income loss? Given that one of the most important beneficiaries of the current policy is one very wealthy family, should we consider their loss relatively small? Evidence can be brought to bear, but there is still no correct answer.

⁴See for example Rodrik 1997, *Has Globalization Gone Too Far?* Institute for International Economics, Washington, D.C. .

3.2 Fairness

Public policy practitioners and scholars observe that legislators and regulators take account of "fairness" issues when contemplating policy. We put fairness in quotation marks to emphasize that this concept is anything but settled. Different people have different ideas about what is fair or unfair in any particular incident. Nonetheless, philosophers back to the time of Aristotle and observers of the human condition have argued that there is a general principle of fairness (or really unfairness) about which most people agree. This proposition is that people think something is unfair when they believe some **contract** or **covenant** has been broken.

3.2.1 Equal treatment of equals

What are some of these contracts? First and foremost is the idea that *equals should be treated equally, and unequals unequally*, in proportion to relevant similarities and differences. As usual, though, the devil is in the details. What makes people "equals?" What are "relevant similarities and differences?" Fortunately, in many situations people seem to be relatively unanimous in their views on this. Students, for example, seem to believe that it would be unfair to treat different students differently on the basis of, say, how much money a particular student might have, or whether a student has red hair.

Of course, the relevant characteristics of "equals" changes over time and over cultures. But it is still a useful question to ask whenever a policy issue arises: is some party deserving of different treatment because of some relevant difference, or are they essentially equivalent to the other affected parties and hence should be treated the same. For example, are farmers in most developed economies somehow different from other citizens and thus deserving of subsidization? They are different, of course, in that they produce food and fiber, and that they are part of a long and continuous tradition. But they are the same as people in any other industry in that they run a standard commercial enterprise, buying inputs and producing outputs so as to make a profit.

3.2.2 Status quo property rights

Another contract that many societies seem to feel strongly about are **status quo property rights** or, equivalently, **grandfathering**. It seems wrong to change the "rules of the game" in the middle of a match, so to speak. For example, after a student matriculates at a university and is told the rules for attaining a degree, it would seem unfair if different more onerous requirements were imposed shortly before graduation.

Sugar producers, for example, have undoubtedly made long-term investments based on the quota policy that has been in place for a long time. It would undoubtedly seem "unfair" to them if the government changed policy.

3.2.3 Society as insurer

In modern developed economies, another contract is an assumption that society will act as an insurer against various disasters. In the United States, ever since the great flood of 1927, the government has been expected to provide natural disaster relief.

A more contentious idea is that the government should insure against economic disasters. But ever since the Great Depression, citizens of modern developed democracies seem to expect the government to insure against economic disaster. Of course, again the devil is in the details. How big a problem and how many people must be affected before the normal ups and downs of a market economy become an economic disaster. Is the potential of severe reductions in housing values that plague both the United States and other countries as of 2008 a disaster? At least at first glance, economic crises differ from natural disasters in that some individuals undoubtedly brought trouble on themselves. But even with natural disasters, individual choices have something to do with the devastation. People don't have to live on barrier islands that can be severely damaged by hurricanes, for example.

3.2.4 Economic inefficiencies and special interests

Finally, people seem to view it as unfair if a significant economic inefficiency exists and at the same time confers benefits on "special interests." This view informs U.S. anti-trust law that outlaws such practices as price-fixing. The basic idea is that price-fixing enriches a few special interests, but at the expense of the "common good." Again, we use quotes to emphasize that there are surely some people, not "special interests," who would benefit from a price-fixing scheme in some market. This is because the change in *relative* prices resulting from such a scheme could benefit some particular consumers that don't consume the price-fixed good but do consume other goods, the price of which might fall as expenditure shifts away from them towards the price-fixed good. But for many instances of policies or practices that interfere with economic efficiency (as thought of by economists), we can be fairly confident that many people are indeed hurt while only a few special interests benefit. The sugar example is one of these cases.

The basic idea behind this belief is best illustrated by thinking in terms of a very short-run specific factors model. In such a model, every one of the forty thousand people who work in the sugar industry are immobile, and get income only from their activities in this industry. Thus, any reduction in sugar prices hurts them: their real income measured in sugar remains the same, but the relative price of sugar vis a vis "other goods" declines. Their budget constraints rotate in from their endowment point on the sugar axis.

In contrast, the 250 million other people in the economy receive their incomes from work in the "other goods" industry. Not being mobile, their income measured in units of "other goods" remains constant, but the relative price of other goods vis a vis sugar increases. Thus, their budget constraints rotate out

from their endowment point on the "other goods" axis.

3.3 Few policies will satisfy all the things people want

One problem with these ideas about what makes a good policy is that they sometimes overlap and fight with each other. This is a little bit like the legal battles we see fought over constitutional issues: sometimes an individual issue satisfies one part of the constitution but not another.

Nonetheless, this brief description of at least some of the features that many people want from policy lets us think about how close actually policies come to satisfying these criteria. These issues arise not only when we think about trade policy, but also when we think about taxes, public utility regulation, and other public policy issues. It also moves the analysis of policy forward beyond the problematic reliance on satisfaction of the Hicks-Kaldor compensation criterion as a justification for freer trade. And it moves the analysis forward in part because it doesn't identify non-free-traders as ignorant or ill-informed people who simply haven't learned their basic economics. That is, it identifies concerns about the kind of distributional consequences that come with trade liberalization as what many people think of as legitimate concerns.

4 The problem of implementing good policies: Concentrated benefits and diffuse costs or the reverse

Suppose, then, that we think we have identified a good policy. What are the obstacles to adopting such a policy, and can they be overcome?

4.1 The Schattschneider Prize

In 1930, the U.S. Congress passed the infamous Tariff Act of 1930, better known as the Smoot-Hawley bill, which raised tariffs to record levels on a myriad of goods. The results were devastating: foreign countries retaliated with their own tariff increases, and a downward spiral in international trade followed. This collapse of international trade surely contributed significantly to the depth and duration of the great depression. And these results were foreseen by economists and other experts. These warnings were ignored, though, by the U.S. Congress, which, by order of the Constitution, was given the power to set tariffs.

At the time, a young political scientist wrote his Ph.D. dissertation on how this disastrous policy came to be. This dissertation was published in 1935 with the title *Politics, Pressures and the Tariff: A Study of Free Private Enterprise in Pressure Politics*. The analysis was so cogent and persuasive that still today a prestigious prize is awarded every other year by the American Political Science Association in its honor: the E.E. Schattschneider Award for the best doctoral dissertation about American government.

Schattschneider's bottom line was that the organization of a representative form of government such embodied by the U.S. Congress would never be able to overcome the power of special interests when it came to tariff legislation. He correctly identified the concentrated benefits that accrued to organized import-competing producers from tariffs and how these concentrated interest groups would influence the congressional decision-making process. He also noted that the costs of tariffs were diffuse, spread in small magnitudes across many uncoordinated individuals.

He thus set out the basic ideas that inform our thinking about the difficulties of making good policy when such policies create concentrated costs and diffuse benefits or the reverse. What is remarkable is that by the time his book was published, "policy engineering" had taken place that set the stage for a long and sustained dismantling of the high Smoot-Hawley tariffs. In fact, the average U.S. tariff has declined from 60% in 1931 to around 5%.

[check latest figures, 3.5% I think]

In the next part of this chapter, we describe the basic policy problem identified by Schattschneider and see what policy changes have taken place that have ameliorated the effects of this problem.

4.2 A classification scheme

We can classify policy issues by identifying the effects on various "stakeholders" in terms of whether they are concentrated or diffuse. Stakeholders are simply people or groups of people who have an important interest in the outcome of a certain policy. If the effects of a particular policy or policy change to stakeholders are concentrated, we mean that they have an intense affect on relatively small group of people who share a characteristic that makes them the object of this effect. For example, removal of sugar quotas affects the forty thousand or so people who make their livelihood from sugar production and refining. These people tend to be geographically concentrated in the sugarcane-producing states of Florida, Louisiana, Texas, and Hawaii and in the sugarbeet-producing states of the upper Midwest. The stakes are high for these people. And by virtue of their geographic proximity and shared interests in how they make their living, they find it easy to coordinate efforts to lobby the government.

If the effects of a particular policy or policy change to stakeholders are diffuse, we mean that they have a small effect on a lot of different stakeholders who have little reason to know each other. For example, removal of sugar quotas helps in a small way millions of sugar consumers, most of whom don't even know they are being helped. It also helps foreign exporters of sugar. Less obvious, probably some U.S. exporters of other goods and services are also helped in some small way: the increased value of sugar imports means that the value of exports must increase as well. Whether this would manifest itself in a few more soybeans being grown and sold abroad or in an extra sale of U.S.-made commercial bakery equipment to China is hard to know, but almost surely it

		Costs	
		concentrated	diffuse
Benefits	concentrated	Health-care reform	Tariffs and quotas
	diffuse	Auto safety standards	Death-penalty abolition

Figure 1: A policy classification scheme

must occur sooner or later.⁵

For any policy action, then, the benefits are either concentrated or diffuse, as are the costs. Thus any policy action could be classified in one of four ways: concentrated benefits and concentrated costs, concentrated benefits and diffuse costs, diffuse benefits and concentrated costs, or diffuse benefits and diffuse costs. Thus, we could construct a two-by-two matrix, with benefits identified as concentrated or diffuse by moving across a row, and costs identified as concentrated or diffuse by moving down a column. We display such a matrix in Figure 1, with a representative policy issue in each box.

In the concentrated-concentrated box, we put as an example health-care reform. Many concentrated interests are on each side of most health-care proposals. For example, many large corporations are (perhaps surprisingly) in favor of some sort of single-payer plan, because they bear a large part of the cost of the large-employer-linked health-insurance system. Opposed are insurance companies.

In the concentrated-diffuse box we put our old friends tariffs and quotas. This placement reflects the basic ideas sketched out in our discussion of the Schattschneider prize. Other candidates for this box might be imposition of pollution controls, with concentrated costs for polluting industries and diffuse

⁵The caveat "almost surely" is there because all we know is that the value of exports equal the value of imports. It could be theoretically possible for the value of exports to increase without an increase in quantity exported, although most economists don't think this is widely relevant.

benefits for the general population that breathes bad air.

In the diffused-concentrated box we put auto safety standards. Requiring seat belts in cars, for example, has concentrated costs for the auto industry and diffuse benefits for the riding public. Finally, in the diffuse-diffuse cell we put death-penalty abolition. Despite the fact that many people feel strongly about this issue, stakeholders on both sides are diffuse.

We now ask what sorts of governmental action we expect from the policy issues in each box. We start with the concentrated-diffuse cell. With diffuse costs, individuals who incur these costs have no incentive to engage in collective action with each other. To see this, again consider the people who incur the costs of sugar quotas. Even if such people learn that they would gain a few dollars from removal of such quotas, the cost to them of *effectively* getting the policy changed is very high. To try and change the policy, they could individually write their congressional representatives and rail about the cost to them of the protection of the sugar "special interests." This would cost an individual the time and effort of composing the letter and the cost of paper, envelope, and stamps. But one letter would have no effect: representatives get a mountain of mail like this, and simply cannot and do not respond with anything more than a form-letter response. To be an effective agent for change in this matter, someone would have to devote all their time to organizing a coordinated campaign by the adversely affected consumers. The benefits here of creating **collective action** would be far outweighed by the costs.

Thus, in the concentrated-diffuse cell, we expect what Schattschneider predicted: government action taken in response to concentrated special interests. These results have been described as "client politics." But note that, even though we still have sugar quotas and many other impediments to freer trade, we have also seen Schattschneider's prediction proved wrong: we have had a long period of time over which tariffs have been reduced. As we will argue later in our discussion of U.S. trade policy history, this occurred in part because of a change in policy-making that effectively moved tariffs from the concentrated-diffuse cell to the concentrated-concentrated cell.

In the concentrated-concentrated box, we expect controversy, as equals battle it out. The policy actually carried out by the government is uncertain. Thus, any policy issue pushed from the concentrated-diffuse cell into this cell at least has a fighting chance of turning out differently than in the case where client politics prevail.

For trade theory, the other two cells are less interesting, as few trade issues fall within these boxes. But for completeness, note that we put auto safety regulation, such as requires seat belts, into the diffuse-concentrated box. This would at first glance seem just like the concentrated-diffuse cell, with its prediction of client politics. But we now know that another outcome is possible: consumer activists have made a living out of coordinating and rallying the otherwise-diffuse beneficiaries, and have in some sense moved the issue into the concentrated-concentrated realm. The archetypical "policy entrepreneur" that has been successful in this arena is Ralph Nader. Perhaps in the future we will see "free-trade activists" doing the same for trade issues.

		Costs	
		concentrated	diffuse
Benefits	concentrated	Interest-group politics, uncertain outcomes	Client politics, gov't. action
	diffuse	Entrepreneurial politics; Naderism	Uncertain gov't. action

Figure 2: Government actions

Finally, we expect uncertain government action in the diffused-diffused cell. In fact, in this category, we are most likely to see simple democratic majority preferences be decisive on the issue, even though it may take some time for such issues to finally arouse sufficient interest to be put on the voting agenda.

These results are summarized and displayed in Figure 2.

With this backdrop, in the next chapter we look at actual trade policies. We start with a brief history of trade policy, which illustrates both the problems of concentrated benefits and diffuse costs associated with trade impediments, and the possibilities of ameliorating these problems through well-designed policies. This is fundamentally a story of the success of the Reciprocal Trade Agreements Act, first passed in 1934, and subsequent institutional innovations designed to foment freer trade.

We then look at a specific policy issue: the relief sought by domestic import-competing industries through the charge of **dumping**. With the success of the Reciprocal Trade Agreements Act and subsequent institutional innovations, the search for protection by import-competing industries moved manifested itself in charges of dumping. We ask how dumping as a policy measures up to the criteria we suggested were broadly appropriate for assessing whether a policy is good or bad.

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