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1 Introduction

Jagdish N. Bhagwati

As the threat of "new protectionism" has grown during the 1970s and the governments of most developed countries are struggling to keep intact the "liberal international economic order" of the three postwar decades, the question of import competition has risen to the forefront of policy discussions. A great body of literature has developed in response to this reality, most of which is empirical and often consists of case studies. What has been missing is the development of a corpus of respectable theoretical work that conceptualizes the issues raised by import competition and enables the empirical analyst to examine the phenomenon of import competition insightfully. It is this task that the bulk of the papers in this volume aim to fulfill.

There are, indeed, three major empirical papers at the end of the volume. They provide important insights into the adjustment processes set into motion by import competition, as in Dore's simply splendid account of the Lancashire town of Blackburn, in decline since the beginning of the century (chapter 11); into the complex mosaic of reality that constrains and determines the impact of real-life adjustment assistance programs, as in Richardson's masterly analysis of the working of trade adjustment assistance under the United States Trade Act of 1974 (chapter 12); and into the political economy of protectionist demands in response to imports, as in the informed account by Verreydt and Waelbroeck of the European Community situation vis-à-vis imports of manufactures from the developing countries (chapter 13). These papers can be read with great pleasure and profit.

Jagdish N. Bhagwati is the Arthur Lehman Professor of Economics at Columbia University. He has written on trade theory, developmental theory and policy, internal and international migration, and education models. He is editor of the *Journal of International Economics* and author (with T. N. Srinivasan) of *Lectures on the Theory of International Trade*, to be published by MIT Press.

But the central thrust of the volume is provided by the theoretical contributions. How do these relate to one another? In what follows, therefore, these theories are brought into a coherent whole, so that the reader is not baffled by the different approaches that many of them take to the problem at hand but rather sees them within a common framework. To do this, we begin by first reviewing the "traditional" textbook approach to import competition and then contrasting the contributions in this volume to that.

1.1 The Traditional Perspective

The "pure," traditional core of international trade theory on the subject of import competition is set out readily as follows. In figure 1.1, a shift in the external terms of trade, lowering the relative price of the importable good, leads to a shift in production along the long-run production possibility curve AB from P_1 to P_2. This shift furthermore represents a welfare-improving move in the Pareto sense. A system of lump-sum transfers could improve someone's welfare without reducing that of others; the standard procedure is to use a well-behaved social utility function to demonstrate the welfare gain.

The theory of trade and welfare, as exemplified in the work of Bhagwati, Ramaswami, Srinivasan, Johnson, etc., can then be used to consider different market imperfections that require policy intervention such that the terms of trade improvement indeed translate into a welfare-improving move. For example, in such an analysis of a generalized sticky wage à la Brecher, different policy interventions can be rank-ordered according to their impact on welfare.

1.2 Alternative Extensions of Traditional Analysis

The papers in this volume make important departures from this traditional perspective, modifying the theory in several realistic and policy-oriented ways.

1.2.1 Adjustment Paths

The papers by Neary (chapter 3) and Mussa (chapter 4) essentially model the *path* that the economy would take in going from P_1 to P_2 in figure 1.1 and discuss the issue of "adjustment costs" and the rationale for governmental policy intervention by reference thereto. "Adjustment costs" are to be distinguished in their work as being *either* costs that arise from the socially necessary utilization of resources to make the transition (as in Mussa) such that, *over* the time path, the net production of goods is inferior to the long-run possibility curve AB and unavoidably so, *or* those that arise from the inescapable constraints on the rate at which capital at

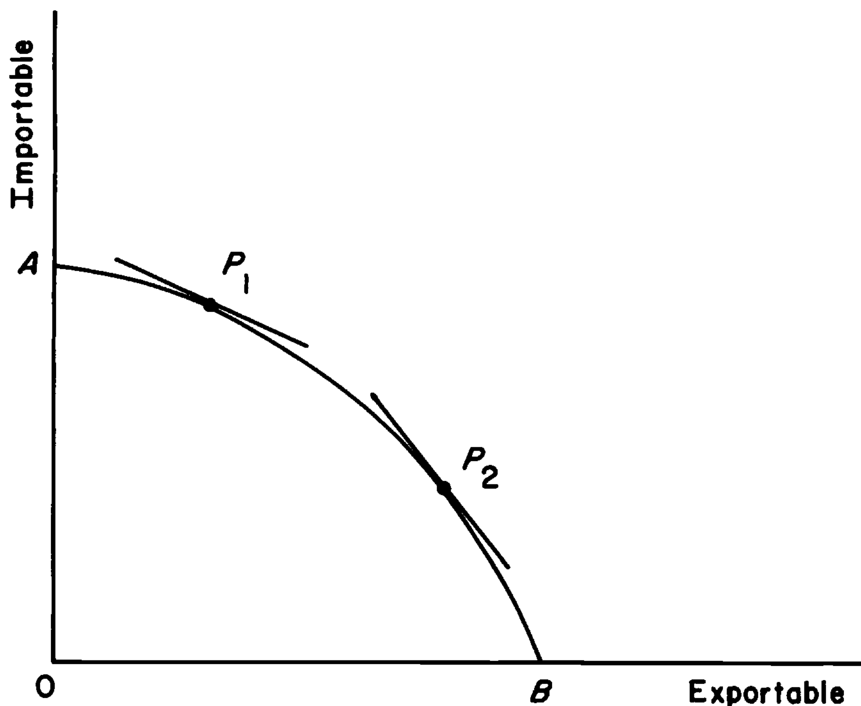

Fig. 1.1

P_1 can be shifted (via depreciation in one sector and net investment in the other) to P_2 (as in Neary's basic model), *or* those that arise from *market imperfections* of the kind additionally modeled in Mussa and alternatively in Neary. The former two kinds of adjustment costs are socially necessary, and they may be estimated, as Neary suggests, as the present discounted value of the equivalent-variational measure of the loss along the path vis-à-vis the optimal, long-run shift to P_2. (E.g., in figure 1.2, at P_3 on the adjustment path from P_1 to P_2, the loss at the new terms of trade is QR; this cost, and others corresponding to each point at different moments of time on the path $P_1P_3P_2$, would be discounted back to their current value to get the measure of the adjustment cost.) On the other hand, the market imperfections add an avoidable loss to this measure of the adjustment cost and equally entail a set of policy measures that should, in principle, eliminate this loss, as indeed discussed by both Mussa and Neary for their respective market imperfections. In devising these policy measures, both authors of course continue assuming implicitly or explicitly the possibility of lump-sum transfers, thus holding on to this critical element of traditional argumentation, which is instead what is relaxed in the work of some of the other papers in the volume.

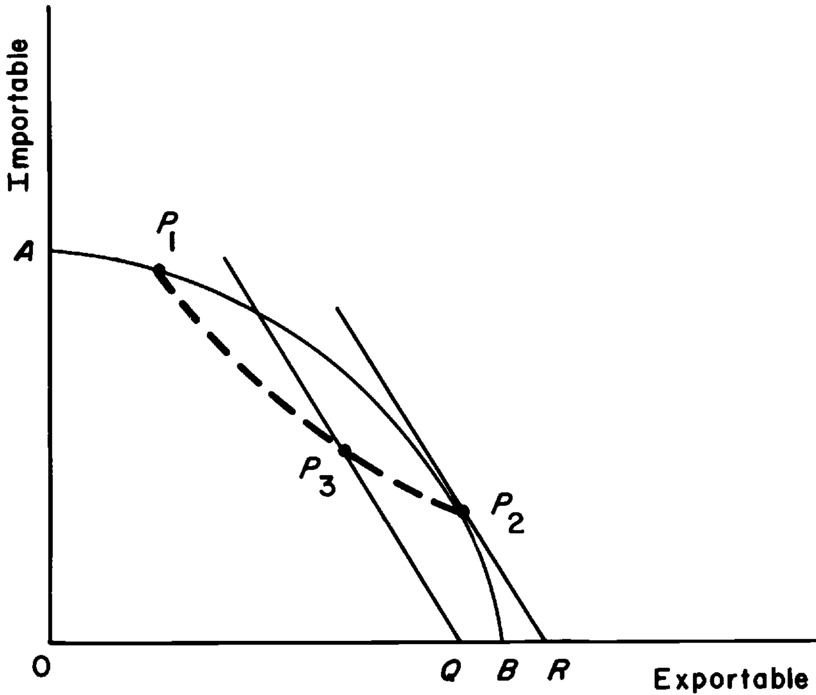

Fig. 1.2

The important paper of Bruno (chapter 2), in contrast, does not consider policy questions explicitly but addresses itself to the response of an economy to import competition, modeling the economy in the framework of macrodisequilibrium along the lines pioneered by Barro and Grossman and developed further by the so-called French school. Hence, conceptually, the economy is working in a "fix-price" system, i.e., subject to *market imperfections*, so that the adjustment costs in Bruno's analysis must reflect this set of assumptions rather than the Mussa-Neary type of socially necessary utilization of resources underlying the transition between two situations, before and after the goods price change implied by import competition.

1.2.2 Lobbying Responses

Other papers in this volume approach the problem at hand by formally introducing into the analysis of import competition not the distinction between the time path of adjustment and the instantaneous shift to the long-run equilibrium, but rather the possibility of lobbying that is triggered off by the income distributional and related implications of the shift in import competition (construed formally as an exogenous shift in the

external terms of trade). Such lobbying itself uses real resources—and this resource diversion may be on a steady-state basis since lobbying is likely to be needed on a continuous basis to keep certain policy interventions in place—and will frequently be successful in getting its sought-after policy interventions implemented. Therefore an alternative concept of adjustment costs follows: namely, the social waste that accrues vis-à-vis the optimal long-run equilibrium without such lobbying and the policy distortions that probably result from such lobbying.

Two papers that formally model the lobbying response to import competition, as well as its welfare implications, are by Feenstra-Bhagwati (chapter 9) and Findlay-Wellisz (chapter 8). Whether lobbying will actually materialize, and in what likely form, is discussed in the papers by Bhagwati (chapter 6) and Krugman (chapter 7) from different angles and utilizing very different implicit and explicit models of the economy. (The Dore paper, on the other hand, gives a beautiful account of the process of adjustment, and hence also of the different lobbying groups, in the Lancashire town of Blackburn.) The Baldwin paper (chapter 10) again, in its elegant synthesis of the existing work on the political economy of protectionism, offers much that is useful in explaining the existence of different kinds of lobbying responses to import competition.

While the Findlay-Wellisz paper formally considers a Madisonian problem in a Jones-Neary model where the landed interests and the capitalists in the manufacturing sector are locked in lobbying combat, with one seeking protection and the other resisting it, it is easy to recast the analysis such that, in response to import competition, the class that is damaged by the terms of trade improvement seeks to lobby for a tariff so as to restore its real wages whereas the other seeks to maintain its improved earnings. The Findlay-Wellisz analysis leads to a tariff-equilibrium, with the government "acquiescing" in the outcome, whose welfare implications are then examined in the customary fashion: with the aid of a well-behaved social utility function. The "adjustment costs" in this model can then be defined, simply and meaningfully, as the equivalent-variational difference between the nonlobbying long-run equilibrium after the postulated terms of trade shift and the actual outcome with the lobbying process and its distortionary outcome both in place. By contrast, the Feenstra-Bhagwati paper analyzes the traditional 2×2 model and assumes that the factor damaged by the terms of trade change will be able to lobby for a tariff (up to the point of restoring it but not beyond), and then works out the lobbying-inclusive tariff equilibrium that will emerge. However, while the "adjustment cost" as just defined in the context of the Findlay-Wellisz model can also be deduced from this lobbying-inclusive equilibrium vis-à-vis the nonlobbying equilibrium at the new terms of trade, Feenstra-Bhagwati develop the analysis in a very different direction, examining whether the government can improve on

the lobbying equilibrium by utilizing the tariff revenues (generated by the successful lobbying itself) to bribe labor into accepting a lower-cost tariff that, with the bribe, will yield a payoff identical to that yielded by the pure lobbying equilibrium (in the absence of such a bribe); an exercise that represents yet a different class of innovation (to be discussed below).

While the lobbying in the Feenstra-Bhagwati and Findlay-Wellisz papers is for tariffs, the lobbying response to a situation of import competition is by no means confined to this. The Bhagwati paper, for instance, opens up the possibility that, in labor-intensive industries in particular, given the fact that it is governmental policy to control immigration, a response by entrepreneurial lobbies to increasing competition from abroad may well be to ask the government to relax the immigration quotas and to let in more *gastarbeiters*, for instance. Bhagwati formally analyzes the welfare consequences when this lobbying response is successful, contrasting the outcome with that under a successful tariff-seeking response; and, in each case, the "adjustment cost" of the chosen response can be defined vis-à-vis the case where the economy is allowed to shift without lobbying to the traditional long-run equilibrium at the improved terms of trade. Bhagwati, like Findlay-Wellisz, formally assesses the welfare impact again by reference to a well-behaved social utility function.

1.2.3 Policy Intervention in the Absence of Lump-sum Taxation

It is fair to say that the theoretical papers reviewed above generally assume (1) either (as in Mussa and Neary, following the traditional analysis in Bhagwati, Johnson, et al.) that the government will be able to intervene with suitable policy requiring subventions from the budget, if necessary, without there being a revenue constraint or any constraint on the ability to raise lump-sum revenues; (2) or (as in Findlay-Wellisz and Feenstra-Bhagwati) that the government will *not* intervene, using lump-sum transfers, to "bribe" the offending lobby into accepting the Pareto-better, long-run improvement from the terms of trade.

But two theoretical papers depart from this extreme set of assumptions and consider whether the government can improve the situation without utilizing lump-sum transfers. The Feenstra-Bhagwati paper does this in the context of the lobbying activities, arguing that the tariff revenue in the lobbying equilibrium can itself be utilized, in an earmarked fashion, to "bribe" (in a Stackelberg fashion) the lobby into accepting a welfare-improving tariff outcome. On the other hand, the Diamond paper (chapter 5) takes a model with no role for lobbying but takes the modern public-finance-theoretic approach to ask: If the shift to the new long-run equilibrium results in an income distribution that cannot be fixed by lump-sum transfers to achieve a Pareto-superior outcome where someone is actually better off and others are not actually worse off, is there a suitable mix of policy instruments that can achieve a second-best out-

come? His model thus explores a mix of two policy instruments: a production subsidy to improve the incomes of those remaining in an industry whose relative prices have fallen due to import competition, and a subsidy on moving out that serves principally to offset the deleterious effect of the production subsidy on the incentive to move to an industry whose prices have increased; the revenue cost of the two subsidy instruments being financed by a poll tax that is nondistortionary. Note two differences from the Feenstra-Bhagwati approach. (i) The poll tax does away with the revenue constraint in the Diamond model; of greater empirical relevance could be an analysis of the combined effects of a tariff on the import-competing industry (in lieu of the production subsidy) and the outward-movement subsidy, with the revenue from the tariff financing the subsidy on mobility so that no poll tax would have to be relied upon to raise the revenues, as is in fact done in the Feenstra-Bhagwati analysis. (ii) In Feenstra-Bhagwati the revenue is used as a "bribe" to secure a lower-cost outcome by inducing the lobby into modifying their wasteful lobbying activities, whereas in the Diamond model the subsidies (as in analyses like that of Mussa-Neary) are simply used to induce economic agents into taking decisions that are in the welfare-improving direction in accordance with the specified social welfare function.

1.3 Concluding Remarks

This volume offers a rich and variegated menu for those who wish to think seriously about the various responses to import competition. In addition, the volume contains analyses of important recent developments in the theory of international trade, albeit in discussing the topic of import competition. Thus, for example, the Krugman paper and the Comments to it by Lancaster, Mussa, and Chipman (chapter 7) offer a comprehensive and penetrating analysis of the recent theories of trade in "similar products." Again, the papers of Findlay-Wellisz (chapter 8) and Feenstra-Bhagwati (chapter 9) offer analyses that bear directly on the recent developments in the theory of trade and welfare which relate to lobbying and other directly unproductive, profit-seeking (DUP) activities (Bhagwati 1980, 1982).

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