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13 European Community Protection against Manufactured Imports from Developing Countries: A Case Study in the Political Economy of Protection

Eric Verreydt and Jean Waelbroeck

In recent years the European Community (EC) has been torn between its natural mandate as an institution set up to promote free movement of goods and production factors, and the strong pressures for protection resulting from the recession and from the sharp difficulties experienced by a number of industries. Through agreeing to the Tokyo Round package, the EC committed itself to participate in a unprecedentedly wide ranging package of multilateral trade liberalization, the precise significance of which still remains to be hammered out in the GATT committees which will implement the newly agreed to codes of behavior. The Lome agreement has been renegotiated, and the Generalized Scheme of Preferences will be renewed soon. Both are basically bilateral agreements concluded before the recession. On the other hand, there have been sharp turns of the protection screw for textiles and clothing and for steel especially, whereas the EC has found itself involved in trying to moderate a subsidy war in shipbuilding.

The aim of the present paper is to review these developments from the point of view of the political economy of protection. This approach, developed by a number of recent authors, focuses on the political motivations of protection and leads to conjectures many of which have been verified econometrically. In this paper we take a noneconometric approach. It appears worthwhile to look at the recent history of protec-

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tion in the EC in the spirit of a case study and try to explain recent events using this new approach to international trade theory. This may also be a useful way of verifying its validity and may help to put flesh on abstract ideas. Finally, the case study approach may point out aspects of the problem that have been underresearched.

Throughout this paper, we will assume that the reader has read the excellent survey of this theory by Baldwin (chapter 10 of the present volume). This will relieve us from the task of restating the theory and the main concepts.

The paper is organized as follows. We first discuss the institutional aspects of decision making in the market for protection. The instruments available are presented (tariffs and import quotas, trade adjustment assistance subsidies, and control of cartels). This is complemented by a description of the interrelations between the four decision levels involved in the formulation of trade policies. The paper then turns to the general goals of these policies: efficiency, income distribution, avoidance of retaliation, and provision of public goods, in particular creating a stable political and economic framework for future growth of the EC. The last section describes the objectives of interest groups and the EC's policy responses to their demands.

13.1 Decision Making in the Market for Protection

It is useful to organize the discussion of EC protection policies around the concept of a political market for protection, where special interest groups seek to pressure policy makers to supply desired measures. The description should recognize the way in which national interests perceived by voters may through the "adding machine" of democratic decision making block the measures sought by interest groups.

The usual presentations of the political economy of protection are quite vague about the institutions through which the political market operates, because of the concern for generality of their authors. This is no reason to be so vague in a case study. Accordingly, we shall discuss at length institutional aspects of trade policy making in the EC.

13.2 The Institutional Framework

Under the Rome Treaty, the EC is responsible for the establishment of trade policies. To an academic economist used to considering trade theory as a separate subject, this looks like a clear mandate. In practice, the range of government policies which have an impact on trade is extremely wide, including for instance social legislation, safety and health regulations, and other policy areas which at first sight would not seem to be relevant.

13.3 Tariffs and Import Quotas

Even for decisions which are clearly related to trade, governments of member countries retain significant residual powers. Tariffs are firmly under control of the EC but not customs regulation—which is important in enabling countries to resort to outward processing to carry out labor-intensive stages of fabrication in low-wage countries. The transfer of import quotas to EC control is not complete: France and Italy in particular continue to impose drastic quotas on imports of automobiles and electronic goods from Japan, for example. There is a broad penumbra of quotas run via market-sharing arrangements at the business level (e.g., imports of Japanese cars into the United Kingdom), backed by governments and carefully designed not to run afoul of EC anticartel regulations. Finally, a third country (usually a developing country) may get a sharp warning that it should restrict exports of a good to an EC country "voluntarily" for the sake of good commercial relations, and (usually) decides to obey; no visible measure is taken by a public authority in the EC, but imports are clearly restricted. Even quotas which are formally established by the EC may be allocated between member countries, and the reshipment of the imported goods across frontiers within the Community is then controlled as provided for under Article 115 of the treaty. Such quotas are formally initiated by the EC, but it is clear that the country affected has a good deal to say about their management.

There has been a slow, and in principle irreversible, process under which the residual import quotas of member countries have been gradually transferred to Brussels. Progress in this direction is embodied in a "liberalized list" of goods over which member countries have given up the right to impose import quotas. It is important not to lose sight of the fact that Community institutions have no enforcement power on national governments. Under the "I am your leader, I must follow you" philosophy their actions may be dictated by the concern to forestall or to take over illegal trade restrictions by member governments. This was quite obvious at the time of the 1977 renewal of the MFA, when the very tough negotiating stance of the EC was in part motivated by France's introduction of quotas on textiles and clothing in violation of Community rules, and clear indications that other member countries might introduce illegal restrictions if the EC did not act to restrict imports sharply.

The EC itself is subject to the rules of the GATT, and thus does not control fully the trade policy instruments which are in principle available to it. Governments do (fairly rarely) violate EC rules and (much more frequently) fail to observe or implement them; but the Community, whose only power resides in respect of the legal superstructure created on the basis of the Rome Treaty, has to be narrowly legalistic in respecting GATT treaties.

This essentially deprives it of control over normal tariffs (imposition of antidumping and other temporary tariffs is of course possible). As the implementation of the Tokyo Round leads to the establishment of agreed codes of behavior, the freedom of action of the Community is becoming further restricted (conceivably implementation of the Tokyo Round may be so successful that GATT rules might regulate aspects of national policies such as public procurement over which the EC has not succeeded in establishing effective control).

13.4 Trade Adjustment Assistance, Subsidies

Economic theory has tended to regard adjustment assistance more and more as a trade policy instrument which is as important as tariffs and other measures of restriction. The pressures of interest groups, to the extent that they cannot be controlled, can lead to market-distorting measures of import restriction—and hence to a waste of resources—or the interest groups can be bribed by offers of assistance which reduce their losses and give them time to find other profitable employment. These two ways of dealing with protectionist pressures are sometimes termed "negative" and "positive" adjustment.

The concept of trade adjustment assistance is clear in the academic way of looking at problems, in which trade theory is a sharply defined and distinct area of investigation. The idea is much more difficult to apply to the real world, in which agents are continually subjected to shocks of all types and origin. Trade adjustment assistance is a workable policy concept only if a way is formed of "tagging" agents whose problems are caused by trade, but such tagging is extremely difficult to carry out fairly and accurately. To the extent that agents whose misfortune is due to trade are better treated than agents whose misfortune has other causes, a problem of equity arises; inevitably there is pressure to extend the scale of trade assistance benefits across the board, and this can prove very costly.

It is finally very hard to distinguish trade adjustment assistance from subsidies. The difference between these two is that at some point in the future the beneficiary of the first will shift his production resources to a new type of activity which does not require public aid to be viable. If he does not, he is relying on a subsidy to continue an inefficient productive activity as wastefully as if he were protected by a tariff.[1] Indeed, economists have sometimes used the term "domestic protection" to describe the economic impact of subsidies. The gift of prophecy is needed to distinguish between the two types of aid, and this is a second reason to doubt that the theoretician's concept of "trade adjustment assistance" is useful for analysis of the real world.

So it is probably not unfortunate that lack of funds prevents the EC from engaging in a big way in the dubious business of allocating trade adjustment assistance. Two special funds were set up initially: the European Social Fund, and the ECSC reconversion and readaptation fund, set up under the Rome Treaty and the ECSC Treaty, respectively. In 1975, a European Regional Fund was created to provide resources for regional reconversion; this fund is a good deal smaller than initially envisaged. The European Investment Bank and the Ortoli Facility could also be useful to create jobs in regions affected by trade adjustment. Existing studies, however, suggest that these various funds are not very effective. The sums they can distribute are not large; more important, it seems difficult to bring potential users to make effective use of the system.

What this means is that the EC has little ability to compensate individuals in member countries for losses suffered from changes in international trade; this is probably as it should be, as the Brussels Eurocrats have enough to do without also getting heavily involved in compensating individuals, industries, or regions in every member country. It might perhaps be thought desirable that they should have funds to compensate countries for trade losses—to shift funds to France if French wine producers are suffering from the entry of Spain into the Community, subject to the French government's redistributing the money as it sees fit. In practice, EC negotiating sessions haggle over so many issues that there is ample scope to buy off one country's objections to a measure by offering it satisfaction on another issue.

In practice, adjustment assistance is therefore a national responsibility, and adjustment to trade is carried out under the same schemes as adjustment to other disturbances.[2] The operation of this assistance in member countries has been bewilderingly complex, and subject to much grassroots improvisation as politicians and bureaucrats at all levels have sought to reduce the social and economic costs of the recession. Bureaucrats and politicians have used instruments ranging from delays in payment of taxes and social security contributions to permission to violate pollution regulations, from interest rebates to wage subsidies, from tax relief and preferential access to outward processing licenses to subsidies and nationalization, from government purchases of the products of an enterprise to pressures on other producers to inject capital into ailing firms and to encouraging cartels. These instruments can in turn take a wide range of legal forms, be justified by a great diversity of pretexts, and be decided at any level or in any part of the administration. The Ministry of Foreign Affairs has directed aid projects to help particular enterprises, the Ministry of Health has tried to save others by ignoring antipollution regulations, the Ministry of Education has pushed schools to purchase equipment from enterprises in difficulty. Most of these interventions have required lengthy efforts and numerous contacts on the part of those concerned—a vast expenditure of efforts inspired by a laudable sense of public duty, the result of which has, however, mostly been the pushing around of unemployment: destroying jobs in the enterprises which compete with those getting assistance.

From this point of view, the treaty provisions which empower it to eliminate market distortions have been one of the most important policy instruments the EC wields. The directorate general for competition monitors inter alia government aids and subsidies; controversies are put before the Court of Justice if agreement cannot otherwise be reached. It is of course not possible to monitor all schemes (there are more than 1,200 laws in force in the nine member countries), but the EC can control the larger, more visible ones. As the Rome Treaty binds governments, individuals can challenge before the courts aids which have been granted to their competitors. Of course, civil servants like to forget to notify the commission of aids which they have proudly contrived to help countrymen to beat foreign competitors; these foreign (and sometimes national) competitors often lack the firm evidence required to bring a case before the courts. Many trade-distorting interventions therefore escape the watchful eye of Community institutions. But there is no doubt that the EC's control of government interventions has been an important element of trade policy, and has been useful to firms outside the EC as much as to EC firms in making markets more accessible and transparent than they would otherwise be.

13.5 Regulation of Cartels

The Rome Treaty antitrust provisions have likewise developed into an important instrument of trade policy. Forming a "recession cartel" is a classic reaction to the recession of enterprises in concentrated industries. These cartels may have as large an effect in restricting trade as import quotas; they may cause price distortions through dumping and other means. In Europe, governments have generally been inclined to support these cartels as a way of safeguarding production resources they fear might otherwise be destroyed.

In fact the ECSC Treaty explicitly grants to the EC the power to regulate in time of crisis production and prices of coal and steel, i.e., to run a recession cartel. This power has not formally been invoked, but it provides the background for the Davignon Plan for the steel industry.

13.6 Levels of Trade Policy Decision Making

Decision making with respect to trade policy making is obviously not concentrated in the hands of one "government" or even of a group of "politicians" as envisaged by presentations of the political economy of protection. Reality is a good deal more complex. In practice, it is useful to think of a four-tier apparatus of decision making, where each tier is subject to a different degree of control by interest groups and voters.

a) At the bottom, an enormous number of decisions which are individually small but important in the aggregate are taken at the level of the bureaucracy. The decision level is here what Messerlin (1979) has called the *bureaus*; it is decisions at this level which are alluded to when economists try to explain why Japan has such low imports, or claim rightly or wrongly that Germany's liberal trade policy stance does not correspond to its real behavior. These decisions are almost invisible, and thus represent an ideal area for exertion of pressures by special interest groups. Indeed, because complaints are bad for the careers of bureaucrats and because bureaucrats come to be sympathetic to the people they administer, it is frequent to find agencies within the administration which have become as devoted to the interests of special interest groups as the lobbies financed by these groups.[3]

b) What *elected politicians* do is more visible than what is done at the level of the bureaus, and the influence of the general voters is correspondingly larger. This is the decision level that advocates of the political economy of protection have in mind in their analysis of decision making in the market for protection. Perhaps the theory would become more realistic if a way were found to recognize that governments are only one echelon of a ladder of decision makers; that they have only a dim understanding and cognizance of what is decided by the bureaus and do on the whole respect the restraints on their freedom which are imposed by treaties to which they have subscribed.

c) The views of interest groups and voters filter up to government via a complex system of parties, lobbies, and institutions for the concerted action of socioeconomic groups, which in Europe sometimes have significant influence. Distortions may take place, and it is often clear that (sometimes to their detriment) governments have misread the strength of the political forces which are affected by a particular decision. The accuracy of what filters up to the *European Community level* is even more questionable, and indeed most of the activity of the Brussels bureaucracy is concerned with remaining in contact with the politico-administrative base in member countries, in order to strike compromises which balance interests nationally and internationally. Because the only source of its influence is legitimacy, the Community must be even more careful than governments in respecting the treaties under which it was established and the GATT agreements it helped to negotiate.

d) *The GATT* is the top tier of the system, its operation has tended to be rigidly formalistic. Initiatives at that level have been dominated by the United States, Japan, and the EC. Developing countries in particular have tended to feel that the GATT forum was not one in which they could get their views across effectively.

A key property of this edifice is the changing balance between special and general interests as one moves up from one tier to the next. As pointed out by the "theory of the core," there are good reasons to believe that a completely open and general negotiation between economic agents will lead to a "point in the core of the economy" which coincides with a situation of free trade; and indeed, this idea appears to be more than a theoretical construct. As international contacts have become closer, the role of negotiating forums such as the GATT and the European Community has grown, the operation of which has visibly operated in favor of a free exchange of goods and services across countries.

Another property of this edifice is the extent to which the discretionary decision making which is so important at the level of the bureaus gives way to the operation of formal rules at higher levels. Economists have been very interested[4] in analysis of the advantages of stable decision rules as a framework for the operation of a market economy, freeing agents from the need to outguess or influence government decisions and allowing them to concentrate on using resources efficiently. From this point of view also, the postwar tendency to shift decisions from lower to higher decision levels has probably contributed to efficiency.

13.7 European Institutions and Their Relations to Lobbies and General Voters

Theoretical analysis glosses over the practical difficulties of reconciling conflicting interests or of obtaining agreement on stable formal decision rules. In practice, achieving these goals is far from a trivial task, and this leads us finally to a brief sketch of how Community institutions have evolved to deal with this problem.

The core of the system of European institutions is the Commission, which directs the work of the Secretariat and is controlled by the Council of Ministers. The function of these bodies is to implement the treaties forming the EC. The Court of Justice in Luxemburg decides on cases bearing on the interpretation of the treaties; it has turned out to be an important component of the system, tending quite systematically to give a broad interpretation of the authority granted to the Community by the treaties. The court can hear cases submitted to it by governments and individuals as well as by the EC, so that it provides one link with the political base of the EC.

The European Council brings together heads of states, and its agenda is not restricted to items which fall under the scope of the treaties. This is a new organ which has not as yet found a stable role—if it has to have one. Its meetings have sometimes sounded as shrill as an opera performance where several prima donnas compete for the role of Carmen, a common feature of summit meetings. Hopefully, creation of the council will broaden the sphere of European cooperation (the European Monetary System is a first result).

The European Parliament—500 kilometers away from Brussels in Strasbourg—is now elected, but has limited powers. It can reject the budget and revoke the EC—and then what? Its main function appears to be to act as a sounding board for the views of political parties, which are one of the main political forces the Community must understand to orient its decisions correctly. The Economic and Social Council, also a weak body, brings together representatives of economic and social groups; to speak in the language of the political economy of protection, it represents lobbies. In spite of their sometimes sizable staff, the Brussels lobbies have little power: they serve mainly as yet another (two-way) channel of information between the Community and political forces in member countries; on key issues they are often bypassed by members of national lobbies or of large firms.

The main channel through which both lobbies and general voters influence the Economic Community is the governments of member countries, via the Council of Ministers. The commissioners are usually themselves politicians. And it is perhaps not sufficiently recognized by outsiders to what extent the Secretariat is a political intelligence agency, the function of which is not to get to the bottom of problems and map solutions, but to run a complex and often apparently pointless system of committees and working groups (in six languages with simultaneous interpretation), the basic function of which is to keep the EC in close contact with government thinking in member countries. Nor is it recognized to what extent important decisions are influenced by personal contacts between the commissioners or members of their staff, and influential politicians, civil servants, businessmen, and trade union leaders (in nine countries).

13.8 The Genesis of Trade Policy

The formulation of trade policy by politicians strikes a balance between the pressures exerted by lobbies and more general objectives accepted by voters. The role of lobbies can on occasion be extremely crude—e.g., the lengths to which France went to sustain the import ban on British lamb, widely understood to be directly related to the importance of sheep raising in the constituency of the leader of one of the majority parties; or the connection between the slide of the Labour Party to a protectionist stance and the frantic canvassing for support in the Callaghan/Tony Benn rivalry.

As in the United States, this juggling for the support of interest groups is tempered by the need of politicians to convince voters that they are dealing effectively and responsibly with the country's general problems.

How voters form their judgment is something that even politicians do not know very well. Voters know little about trade policies: there is an astonishing contrast between the accuracy and timeliness of the lobbies' knowledge of measures even before they are announced and the vague information about these measures which can be gathered even from serious newspapers. The diffusion of decisions between four interdependent levels of decision making also makes it easy for politicians to claim credit for popular measures and to shift to others the onus for unpopular ones.

Though Eurocrats do not confront voters directly, there is no reason to believe that their keenness to satisfy public opinion differs in a fundamental way from that of politicians and civil servants in national governments. Oversimplifying things a bit, we shall first describe their perception of the EC's general interest as they may sense it to be understood by voters. We shall then describe the concerns of interest groups which have played a key role recently and the EC's response to their demands. We shall finally describe how the Community has sought to use its trade policy to achieve a number of more general objectives.

13.9 Efficiency

Efficient use of resources, the basic goal of trade, is the first of these general objectives. At present there is a marked inconsistency in EC policymaking between the remarkable scaling down of most external trade barriers, which was not interrupted by the recession (cf. the conclusion of the Tokyo Round), and the parallel consolidation of extremely restrictive import policies for agriculture and for textiles and clothing. It is too early to say how other recently erected barriers will evolve (for shoes, steel, and synthetic fibers, for example).

The high barriers on textiles (and agriculture) affect large sectors and accordingly generate considerable waste. The extent of this is not widely appreciated. The growing criticism of the Common Agricultural Policy has focused on its budget implications, and has largely disregarded the invisible transfers implied by price distortions; it has furthermore hardly even dealt with the resource misallocation it causes. The Multifiber Agreement has largely escaped such public criticism because it does not have a budget impact.

An important aspect of debates in Europe about the impact of protection on efficiency is the widely accepted view that the free play of competition may lead to a wasteful destruction of resources in a situation of unemployment. It is argued that keeping enterprises afloat by government intervention is better that leaving the resources they employ unused: in effect what is argued is that there is a special type of market failure. As usual, of course, the enterprises and groups which ask for protection or other types of assistance claim that the light is at the end of the tunnel, so that all that is needed is a temporary boost.

Public opinion has, however, moved perceptibly to a more realistic view of things. "I am not a naive believer in perfect competition" remains the standard way to start a statement on market intervention. But there is growing realization that the assistance given out since the beginning of the recession has been costly and ineffective; that much of it has gone to firms which did not really need it, and in particular to a few large groups which have enough skilled staff to understand how the system works; and that milking the assistance and subsidy system has become so profitable that it is absorbing valuable productive resources, a type of rent seeking associated with significant deadweight costs.

"But I don't think that lame ducks should be coddled" has accordingly become the quasi-automatic follow-up of expressions of disbelief in the efficiency of competition, reflecting a growing understanding that there are considerable dynamic economies to be reaped by letting workers and employers understand that they have to confront competition through greater efficiency rather than by securing subsidies, or even by allowing bankruptcy to detach workers and capital goods from inefficient managers. Recent elections and the evolution of the stock language of politicians have provided clear indications that the shift in attitude has a broad base in public opinion.

13.10 Income Distribution

As indicated above, the EC's concern for income distribution within countries is essentially symbolic: the activity of such bodies as the European Social Fund is not a major component of the Community's trade policy. Distribution of income between countries is another matter: negotiators understand well the costs and benefits of trade diversion.

Trade diversion is the Achilles heel of customs unions, as it is acceptable to losers only if external protection is low; this is the basic reason why customs unions between developing countries have failed up to now. The sharp tensions about the Common Agricultural Policy illustrate this danger. As discussed below, similar disputes may arise in the not so distant future over textiles and clothing protection. Hopefully, the EC will understand the risk which maintenance of the present very high barriers to this trade poses for the future cohesion of the Community.

13.11 Fear of Retaliation

The fear of retaliation has been one of the main reasons why interest groups have found it difficult to get support for protective measures from the general public. One of the main achievements of the Rome Treaty has been the constitution of a trading block with enough power to persuade United States officials and the United States public that protectionist measures will bring forth meaningful retaliation. Japan's inability to obtain normal treatment of its exports by the EC is to a significant extent due to the fact that its trade with the Community is so unbalanced.

From this point of view a striking aspect of the trade of developing countries with the EC (and other developed countries) is their inability or unwillingness to retaliate against the strongly discriminatory protection to which they have been subjected. The reasons for this are many.

a) A very large fraction of their exports comes from a few countries which have very little bargaining power. Hong Kong is a colony of an EC member; a trade war would be disastrous both to its and to Singapore's trade. Taiwan's international situation also argues for cautiousness, as does South Korea's need for United States military support.

b) The VER system which is the main means of protection against developing countries generates significant rents, which are appropriated to an overwhelming extent by exporting firms in those countries. The effortless profits yielded by this rent farming in effect bribe exporters not to press their governments too strongly to complain about protection.

c) Despite very low wages, most developing countries are not capable of meeting the competition of the large developing manufactured goods exporters, as shown by the fact that a surprising number of them do not reach the low textile and clothing quotas allocated to them by the EC. They have a deep and probably exaggerated fear of what they perceive to be China's enormous competitive potential. Why should they press for the suppression of a system of complex and detailed import controls which protects them against their competitors? Likewise why should the present large exporters desire the abolition of a system which grants them the lion's share of exports of sensitive goods from developing to developed countries, the existence of which has in past years deterred so effectively potential exporters like India from daring to undertake the transition to an export-oriented strategy?

d) The strongly protectionist policies pursued by almost all developing countries have excluded inessential goods from their imports. They therefore cannot afford the import cuts required to implement policies of retaliation.

e) The developing countries have been unable to constitute effective bargaining units. The Group of 77 is an instrument for the dramatized expression of dreams; apart from OPEC, developing countries have not been able to form groups with enough interests in common and a large enough size to extract trade concessions from the EC, the United States, or Japan.

13.12 The EC as a Producer of Public Goods

The function of governments is not only to create conditions conducive to maximum production of market goods, but also to produce a number of "public goods" valued by voters, such as national security, access to culture, and national prestige, which the market cannot provide. The EC has sought to fashion its trade relations with developing countries to create a number of such goods.

13.12.1 Maintenance of Good Regional Relations

The EC maintains a four-tier system of agreements with developing countries, granting them different degrees of preferential treatment. The strongest preference is granted to new entrants, under agreements preparing for entry to the Community. A complex system of regional and national treaties regulates relations with Mediterranean countries; the most important concession is that these countries' exports to the EC are not regulated by the Multifiber Agreement (MFA), but by informal agreements which have turned out to be more favorable than the MFA. The Lome countries, mostly African colonies, benefit under the Lome Convention from a slightly better treatment of manufactured exports than that provided for by the EC's Generalized System of Preferences (GSP). (Their exports were exempted from quantitative controls by the Lome I Convention, but this important advantage did not survive in Lome II.) Other developing countries benefit from the tariff quota system defined by the GSP.

This system is intended to promote stability in the region to which the EC belongs, and to promote the enlargement of the Community. It also maintains cultural and other ties which are valued by member countries, such as consolidating the "community of francophone countries."

13.12.2 Stabilizing Future Markets and Supplies of Raw Materials

This system of agreements has also a more directly practical value in helping businessmen to retain the commercial advantages acquired when Western Europe dominated the Mediterranean and black Africa politically. The EC has tried to go further by having developing countries agree to guarantee its access to their raw materials, and to undertake not to nationalize its investments. This policy has been unsuccessful.

Finally (also unsuccessfully up to now) the EC has sought to promote via the "graduation principle" a process of integration of the more advanced developing countries into the constitutional framework of world trade by having them accept gradually the obligations imposed on the developed signatories of the GATT.

13.12.3 Diversification of Developing Countries' Exports of Manufactured Goods

The exports of developing countries have been distributed over an extremely narrow range of goods. A greater diversification would make it easier for producers in developed countries to adjust to the expected large growth of these exports. Promotion of such diversification is a "public good" to which public opinion in developed countries attributes a good deal of value.

This goal is pursued by both a very weak and a very strong instrument. The weak one works in favor of developing countries; the strong one is probably quite costly to them.

The weak instrument is the Generalized System of Preferences (GSP), which establishes duty-free quotas for manufactured goods exported by developing countries. The scheme distinguishes three categories: highly sensitive, sensitive, and nonsensitive goods, which are offered preferences scaled according to the degree of sensitivity.[5] The scheme, like the analogous schemes enforced by the United States, Japan, Sweden, and other countries seems in principle to be an ingenious way of fostering "infant exports" in developing countries while safeguarding the interests of the weaker sectors in the EC. For several reasons the scheme has made only a small contribution to achievement of its stated goal. Its provisions are complex and subject to yearly revisions, leading to an uncertainty and opaqueness which reduce its impact on investment in developing countries. Most of the easily produced goods which are the mainstay of the early phase of developing countries' export drives are "highly sensitive goods," poorly treated under the scheme and subject to the threat of MFA discrimination. Tariffs in developed countries are low anyway and have been getting lower. The evidence, econometric and otherwise, is that the EC GSP scheme, like the schemes designed by other trading nations, has had little impact on exports of manufactured goods from developing countries.

The negative instrument is the sword of Damocles hung over export-oriented investments of developing countries by the threat of discriminatory import quotas imposed as selective safeguards. Imposition of such quotas is possible under the EC MFA regulations, authorized as an exception to Article XIX of the GATT. The Community has pressed strongly in the Tokyo Round and subsequently for extending this exception to other goods under an appropriate code, and has threatened to impose selective safeguards even if agreement on such a code is not possible.

This ill-defined threat to future exports represents a powerful instrument of preventive protection, by discouraging investments which are hardly profitable, or even by discouraging timid (prudent?) developing countries from undertaking the sweeping and politically costly policy changes required by a switch from an import-substituting to an export-oriented trade strategy. It is likely that this threat has a considerable impact on the level and pattern of exports of developing countries in the direction sought by the EC.[6] To the extent that—as is highly probable—developing countries have felt driven to promote the export of goods for which their comparative advantage is less than for their traditional exports, the result is a (probably large) waste of resources.

13.13 Interest Groups, Their Objectives and Achievements

13.13.1 Producers of Textiles, Clothing, and Shoes

From the point of view of the political economy of protection, it is not immediately clear why lobbying for protection plays so large a role in the industrial strategy of the textiles and clothing sector. This industry has a very elastic long-run supply curve, so that protection has less impact on unit earnings of capital and labor than in most other industries. Entry is relatively easy; because of the sharp separation between the textile machinery producers and the textiles and clothing sector, and because of well-developed training programs for workers and staff, technology is available to anyone willing to enter the industry. Exit is easy too. A large number of firms obtain a very low return on assets even when the latter are valued at liquidation prices (textile machinery has a market, and much capital is tied up in inventories). The owners of such firms must be tempted to invest their money elsewhere, and indeed government-administered schemes, in the United Kingdom in particular, designed to bring about a shrinkage of productive capacity have identified readily enough producers who were willing to be bribed to cease production.

It is debatable how mobile labor is. To a significant extent the industry recruits its labor force in "pockets" of the labor market containing workers with low mobility who are willing to accept low wages: women in regions where female employment is low, young girls between high school and marriage, illegal immigrant workers sheltered from the police by the anonymity of big cities. On the other hand, labor turnover is typically high, so that the work force can be reduced by attrition with less social tension than in most other industries. Wages are very low, so that if other jobs can be created by market forces or "adjustment policies" or by widening job opportunities through better education, the workers who shift out of textiles will gain significantly. The industry finally requires few skills: little human capital is lost by workers who move to other sectors.

Yet it is elasticity of supply which from a deeper point of view accounts for the strong unity of the industry in support of protection. Textiles and clothing producers are deeply afraid of the competition of low-wage countries with their huge labor reserves and proven ability to expand output very quickly; their only hope for survival is to deny low-wage countries entry into markets in developed countries. This explains the paradox that an industry with an elastic supply curve, where the large number of producers and their diversity make it difficult to reach a common view, should have lobbied so hard for protection. What has welded the industry together is the feeling that producers in low-wage countries can destroy most of the textiles and clothing industry in the EC: not only is it marginal producers who feel threatened; even prosperous firms are afraid of going out of business.

This fear is excessive, because it does not allow for the great diversity of the industry. Large subsectors would indeed disappear—mostly those producing the "highly sensitive goods" of the EC MFA agreement regulations. But the fact that EC exports and imports are in rough balance shows that there are subsectors which can meet open competition. Clothing is competitively much weaker than textiles, but it should be remembered that effective tariffs on clothing are of the order of 20 percent in the EC, so that domestic producers would retain substantial protection even if MFA quantitative controls were relaxed. Technology is becoming more and more capital-intensive, reducing the impact of wage costs on output: for certain types of weaving one worker can tend some one hundred looms, and microelectronics is beginning to make possible automation of key operations in the clothing industry. Specialization is often an asset: German industrial textiles and carpet making on the "carpet freeway" in Flanders are strong and expanding subsectors. That adjustment to competition from low-wage countries is possible finally is shown by the example of the Swiss textiles industry. Despite very high wages, specialization has enabled this industry to survive, although Switzerland has not introduced quotas on imports from developing countries.

However exaggerated the fears of the industry, it is what it believes that has led it to wield its considerable power to force policymakers to supply the protection it believes to be needed. This power results to a significant extent from its size: the textile and clothing vote is very worthwhile competing for by any party—and the regional concentration of the industry provides it with the assured and loyal support in parliament of a number of members.

The weakness of trade unions does not handicap lobbying, to the extent that it reflects close personal contacts between owners and workers in the typically fairly small plants which characterize the industry. The resulting climate of cooperation has facilitated the formulation of common demands to government.

This lobbying proved decisive when in 1977, at a time of recession when developing countries were expanding rapidly their market shares in the Community, the EC drastically reinforced controls on textiles and clothing imports from low-wage countries through a set of voluntary export restraint (VER) agreements imposed under the second Multifiber Agreement (MFA II). The new system proved very effective, curbing import growth from 25 percent per year in volume in 1973–76 to 4 percent in 1976–79 for MFA countries. Rates of growth of imports from preferential countries have been marginally higher.

As similar measures were taken at the time by other developed countries, what happened was the establishment of a worldwide system of strongly discriminatory import controls against developing and Eastern bloc countries: developed countries have formed a kind of textiles and clothing common market to which the Third World has only limited access.[7] In equivalent tariff terms the external barriers are highly variable (and hence unnecessarily wasteful):[8] of the order of 100 percent for some articles of clothing, a few percent only for many textiles. Some German textiles firms have been able to export to Hong Kong, and for their products the equivalent tariff is zero. The welfare cost to consumers of these barriers is obviously high, particularly for low-income groups, as the comparative advantage of developing countries is greatest for the cheaper types of clothing.

A striking consequence of this system of worldwide discrimination was the trade diversion it has caused. In the EC, Italy has improved its net exports rapidly, at the expense of its northern neighbors. United States producers have likewise registered sharp gains, reflecting an edge in technology and marketing techniques, the fall of the dollar, and the availability of pockets of low-wage black and Hispanic labor.[9] Northern EC countries have gained a respite for their producers, who would have had to contract output more rapidly if protection had not been tightened. But as production and employment shrinks, this gain is diminishing; in fact, two such countries, Germany and the Netherlands, seem to have been achieving to a significant exent the purported goal of the MFA of shifting output to products which do not need protection. For these countries the advantage of continuing protection are shrinking, but the extra cost to the consumer of buying from high-cost sources is a permanent loss.

One of the sources of strength of the textiles lobby in the EC has been that the net exports of different countries were not too different. As Italy continues to gain—and as Greece, Spain, and Portugal join it to form a low-wage EC sunbelt—producers in the North will have to concentrate more and more on special articles and capital-intensive products which can meet competition from developing countries. Their interest in protection will decrease. At the same time the shift to export-oriented policies by a number of developing countries, in particular the influential countries of South Asia, will strengthen the hostility of the Group of 77 to the MFA. There are therefore hopes that the balance of negotiating forces which has generated the present system of protection will shift in favor of freer trade.

The synthetic fibers sector is undergoing a severe crisis in EC countries and has resorted to a cartel to deal with the situation. The Community at one time was inclined to give its blessing to this cartel, but decided to avoid so blatant a violation of the Rome Treaty. The cartel came into being anyway, and the Commission, with obviously ambiguous feelings, is watching and trying to moderate its action.

There was no "external component" to the original Davignon proposal of support to the cartel. As always trade distortions generate demands for government intervention, and synthetic fibers producers have recently been fighting hard for the external protection required to stabilize their cartel, arguing that energy price distortions in the United States give producers in that country an unfair competitive advantage; these demands benefit from a favorable political climate, because of EC resentment over the threatened imposition of antidumping duties on steel. We will not discuss further the details of this story of incipient escalation of distortions, intervention, and retaliation, as developing countries are not likely to become large exporters of synthetic fibers and yarn (those which have cheap energy, e.g., natural gas, may someday become exporters). The most interesting lesson from their point of view is the contrast between the interplay of effective threats and counterthreats between the United States and the EC, and their own inability to put up a fight in 1977 for fair treatment under the MFA.

Of greater immediate relevance is the leading role played by producers of synthetic and artificial fibers in support of protection of the textiles and and clothing industry. These producers have played a key role in the relevant lobby, providing it with a good deal of the basic analysis and data required to present a convincing case to policymakers. To some extent therefore producers in the higher stages of the industry, where output is not concentrated, have been free-riding on the lobbying effectiveness of a few highly concentrated primary producers who wish to help the downstream producers who absorb their output.

The EC shoe industry includes Italy, a low-cost producer, and will probably include Spain, which can be expected to recover a competitive strength sharply reduced by the social problems which have accompanied the move to democracy. Special quota protection is therefore not necessary. The shoe lobby is also much weaker than the textiles and clothing lobby. In the wake of the 1977 MFA negotiations, some European governments have, however, moved to impose VER agreements on the world's main shoe exporters.

13.13.2 Steel

The steel industry is almost a textbook illustration of the forces which bring about demands for protection. The elasticity of supply is low except in the long run, so that the industry can easily hold on to gains secured as a result of protection. The supply of capital is unresponsive to prices; almost none of the capital stock can be retrieved once production stops, as there is little variable capital and as most equipment cannot be moved. Prices would have to be a good deal higher to justify construction of new mills.

Labor is also not mobile. Much of the employment is in practice for life, so that it is hard to reduce the work force by attrition; work practices are rigid, for technical reasons and because of union resistance. Steelworkers are well paid, and often owe part of their income to special skills and seniority which would be lost if they changed jobs.

As in the textiles and clothing sector, the industry is welded together in its lobbying by realization that the adjustment effort which is required is large and unpleasant. Production fell by 20 percent from 1974 to 1975, and has hardly recovered since; EC countries, like the United States in earlier years, seem to have reached a stage of development where growth has little impact on the demand for steel. At the same time, technological progress is strongly biased toward equipment with a very large unit capacity. As a result, modernization tends to increase capacity; this tendency is reinforced by the efforts of trade unions and regional politicians to maintain employment, which leads them to press for plans which increase capacity. It is therefore very difficult to close the gap between a slowly increasing demand and a capacity growth which is hard to curb.

The prospect for closing this gap is worsened by the fact that in the long run the EC will probably not be able to maintain the level of its net exports. Japan's steel industry has obviously lower costs than do EC producers. In the last decades there has also been a marked shift in comparative advantage in favor of developing countries, because technical progress has reduced the need for special skills, key on door plants can now be acquired quite readily, and a number of developing countries have cheap energy (e.g., natural gas) and iron ore. Production in these countries is growing very fast, and a few are now exporters.

Rationalization of the EC steel industry finally requires a major geographical shift. This industry consists in reality of two very different parts. The older and larger component was built up close to sources of coal and iron ore which now have vanished or are more costly than imported materials. These factories, which were built at a time when the optimal scale of output was far smaller than today, have crowded plants which are not as conveniently laid out as in factories built on greenfield sites. Productivity is in many instances held back by work practices to which trade unions have been clinging in spite of the evolution of technology. During the long postwar years of prosperity they were well placed to resist technical changes which would have eliminated jobs. Opposition to rationalization has continued in the recession, with less success.

Costs are lower in the modern and efficient plants built on the seacoast. These embody the latest technology and process low-cost imported materials.[10] These producers seem to have weathered the recession successfully. A broad long-term shift of the industry to the coast would, however, cause considerable political resistance in the older steel-making areas, except of course in countries like Holland or Italy, where the industry is already there.

This brings us finally to a discussion of the strength of the steel lobby, which has a remarkable record of achievement in milking governments for special benefits. Steel making is a highly concentrated industry, with very strong unions and a concentration of employment in limited areas. It enjoys a peculiar prestige as a symbol of industrialization. These advantages have enabled the industry in postwar years to enjoy privileged access to low-interest loans and grants to nationalized companies. When the recession started, some governments, e.g., Belgium and France, virtually opened their pockets to steel makers to enable them to cover their losses (leading after a few years to nationalization, the ultimate subsidy). The confidence of the industry in its power to extract money from the government was illustrated in 1980 by the United Kingdom steel strike, in which workers quite rightly never doubted that the government would pay up their wage claims.

The main limit to the drive for protection of the steel lobby is that its interests are opposed to those of the much larger metal-working industry. It obviously makes no sense to shelter steel from a needed adjustment at the expense of losses of jobs and exports in the automobile, shipbuilding, and other large steel-using sectors which also have difficulty in meeting outside competition. Steel users understand their need for access to low-price raw materials and have enough lobbying power to moderate protection of their supplies of steel.[11] It is not surprising, for example, to find that Germany, the largest exporter of metal products, has been insisting firmly on a strong link between the renewal of the current steel protection scheme and continuing progress in rationalizing output.

The EC's response to these pressures has been to back a recession cartel. Under the Davignon Plan and later through the imposition of production controls under Article 58 of the ECSC Treaty, producers have been pressed to respect minimum price and production guidelines; the plan, which is supported by VER agreements with other steel producers (including some developing countries), is in practice part of a worldwide recession cartel. As for the MFA II agreement, the EC scheme is a component of a scheme enforced by the cooperation and joint power of developed countries.

Whether this protection will become permanent is uncertain at present. The EC, which runs highly protectionist Common Agricultural and (via the MFA) Common Textile Policies, may find that it has fathered a third highly restrictive system, holding up domestic prices and dumping surpluses on world markets. This would be disadvantageous to developing countries, whose steel expansion would be thwarted by EC dumping, and to the EC metal-using industry.

Ending this steel protection hinges on successful rationalization of the industry. And in fact rationalization has made creditable progress. Governments and employers have in the last two years not hesitated to confront trade unions on the issue of productivity and production cutbacks, forcing through employment cuts in spite of major strikes in the Federal Republic of Germany, France, and the United Kingdom. It appears that there is a definite possibility that the Common Market steel industry will not follow the pattern of gradual permanent isolation from world markets which seems to be establishing itself in the United States. The main uncertainty lies in the EC's ability to force through the cuts in production capacity which are required to reestablish balance between supply and demand, as is needed to make it possible to abolish the plan.

Marked progress can be expected in the next few years from scrapping uneconomic plants, increasing productivity in others through rationalization, eliminating excess capacity, and reducing energy costs by continuous casting and other means. In the longer run a change in the regional balance of the industry is required, with a shift of basic steelmaking processes to the coast and perhaps even to countries with cheap energy (Australia? the Middle East?). This will be difficult to achieve in a declining and politically powerful industry.

13.13.3 Shipbuilding

Shipbuilding like steel is an excellent example of an industry which can gain significantly from protection and has natural advantages in pressing the government for favors.

The industry is not capital-intensive. Unlike steel there is appreciable freedom of entry. The inelasticity of supply results rather from the need to keep production going to keep together a crucial core of engineers and skilled workers.

Some shipyards are in large harbor cities like Hamburg, Rotterdam, and Antwerp, where alternative employment opportunities are numerous, but a large fraction of the capacity is in depressed areas of Scotland and Brittany.

Demand for ships fell sharply after 1973, as it is geared to the rate of increase of world trade, and in particular of shipments of oil. For a time activity was sustained by order backlogs; but the ships which were launched thus added to the excess supply which had to be absorbed before recovery became possible.

The industry confronts the most unpleasant adjustment of all: extinction. Apart from a few specialized yards, notably those building warships, it appears that shipbuilding will die out. In spite of generous subsidies and of creditable efforts to overcome the rigid work practice rules which prevented modernization of the industry, especially in the United Kingdom, EC shipbuilders could take only a small fraction of the increased orders generated by the 1978–79 recovery in demand. Japan is by an overwhelming margin the dominant builder today, but a number of developing countries such as Korea, Brazil, and India have shown themselves capable of exporting ships at competitive prices. Developing countries have a comparative advantage in a sector where the capital output ratio is low and where the need for skilled labor can be reduced through prefabrication. To the extent that Japan loses part of the market it will be to the benefit of the Third World, not of Europe.

The shipbuilding industry has organized very effectively to win favors from governments. Like steel it is endowed with a mysterious prestige, which has helped in persuading the authorities to set up intricate schemes to promote construction of merchant ships in home shipyards. The strength of the powerful unions has been helpful from this point of view.

Like steel, the action of the shipbuilding lobbyists has to take account of the countervailing demands of their client, the shipping industry. In fact the structure of the shipping industry makes it almost impossible to promote shipbuilding by tariffs or quotas, prohibiting the use of these classical tools of trade policy. Shipping is par excellence a world market activity. There is little point in protecting domestic shipbuilders by tariffs, as national shipping firms would simply buy elsewhere. Forcing them to buy at home would be pointless, given the ease with which capital can emigrate and escape governmental control by the flags of convenience device. It is for this reason that protection of shipbuilding has been extended almost always through subsidies rather than through tariffs and quotas. The subsidies were sometimes quite indirect, such as the obligation to carry United States aid on ships flying the American flag, which channeled to national shipping and shipbuilding firms a part of the aid intended for developing counries.

Protection of shipbuilding has therefore been the responsibility of governments. The Community's role has depended on its power to regulate aids and subsidies and to approve mergers; its efforts have curbed somewhat the absurdly generous aids granted by member countries. The EC has nevertheless proposed a Community scrap and build scheme to bring about a resurgence of demand. The response of governments to this plan has not been enthusiastic, and it is doubtful that it will get off the ground.

Discussions of that plan illustrate the difficulty of getting support for protection in the EC when the costs and benefits are not balanced between countries. In this instance the proposal was killed by the objections of Germany—where the shipbuilding industry has shrunk very sharply—and Denmark.

13.14 Conclusions

We embarked on this case study as a way of verifying the empirical validity and usefulness of the political economy of protection approach to the study of trade policy. Our feeling is that the experiment was successful. The approach enabled us to classify facts and events in an interesting and suggestive way, and to illuminate reality convincingly. Its main weaknesses appear to be as follows:

a) It neglects complications resulting from the fact that trade policy decisions are taken at several levels, that many decisions may be taken jointly, rather than *one* tariff being set by *the* government. In fact it would be worthwhile to analyze rigorously from a theoretical point of view why decisions taken simultaneously at higher decision levels tend to be more liberal than the blow-by-blow decisions of the government bureaus.

b) Trade adjustment assistance is not a useful concept empirically, because of the difficulty in determining whether agents' problems are due to trade or to other forces, and because it is so easy to use adjustment schemes to grant subsidies.

c) It may be worth stressing even more than is done by the political economy of protection the enormous difference in accuracy and timeliness of the information on protection which is available to lobbies as opposed to general voters. The EC has made laudable efforts to explain the reasons for its decisions; the performance of the United States government in this respect is, however, markedly better. The information distributed by governments on subsidies and protection is abysmally poor. Even members of the administration find it well nigh impossible to keep track of what is decided.

d) We have been surprised to realize to what extent, from the Davignon Plan to the Tokyo Round, from the GSP to the MFA, trade policy is made today at the world rather than at the national or EC level. This also is a fact that the political economy of protection has overlooked.

The most important policy conclusions are not unexpected:

a) Study of the record confirms the fear that—with MFA II and the Davignon Plan—the EC is sliding into permanent support of an increasing number of "Common Restrictive Policies." Experience with the

Common Agricultural Policy illustrates the way in which distortions lead to remedial measures and thence to further distortions, leading to disputes which undermine European unity. Hopefully, the danger will be perceived in time.

b) Under MFA II a "Common Textile Policy" embraces the developed world; developing countries rightly perceive that the EC insistence on selective safeguards aims at legalizing this way of organizing world trade under the GATT. De facto the selective safeguards discrimination against developing countries is of course already widely applied, without significant resistance from the Group of 77.

c) There are, however, hopeful signs that public opinion is getting less receptive to proposals for intervention in favor of particular industries. It has seen that the measures adopted in recent years did not lead to the hoped for results and that not adopting other proposals did not lead to the announced catastrophes. In a nutshell, voters are in effect becoming reassured about the flexibility of the economic system. If this evolution of thinking continues—and if the business cycle situation does not deteriorate catastrophically—there may be hope of easing MFA controls and discarding the Davignon Plan.

Notes

1. Adjustment assistance will of course also cause some waste, except if it takes the form of lump-sum transfers. But this waste is likely to be small and is temporary.
2. The brave scheme introduced by the Dutch government to help adjustment by enterprises affected by import competition from developing countries was a failure. The scheme was little used and has in practice been abandoned.
3. By the same token, the Ministry of Foreign Affairs is commonly the most free-trade-oriented body within the administration, because of its unique exposure to the points of view of other countries.
4. In particular, in the recent spate of work on rational expectations.
5. For nonsensitive goods, there is no quota; however, if exports grow substantially, these goods are transferred to the "sensitive" or "highly sensitive" categories for which the amounts which can be sold free of duty are limited.
6. And other industrial countries which have pursued similar policies.
7. The system has roots in looser import control schemes going back to 1962.
8. Assuming linear supply and demand curves, the welfare cost is proportional to the square of the rate of protection. It is therefore desirable to avoid sharp tariff disparities in policies of trade restriction.
9. And, for synthetic fibers, low energy costs.
10. The price of which has, however, been distorted by input levies designed to protect domestic coal against foreign competition.
11. Naturally, they have no reason to object to subsidies.

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Comment William R. Cline

Verreydt and Waelbroeck have prepared an excellent summary assessment of current European protection against manufactured imports from developing countries. They have found the same pattern that exists in the

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United States: these imports are highly concentrated in a few product sectors, causing problems of domestic adjustment even though their aggregate level is minor. The sectors are generally the same as in the United States: textiles and clothing, shoes, and television sets, although for Europe (but not for the United States) LDC competition is also a conspicuous problem in shipbuilding.

The authors believe they can identify a slowdown in protectionism in Europe. They cite the public's fatigue with costly industrial subsidy programs and the pressure from Germany for a free trade policy. The optimist might reach the same conclusion for the United States, but for a different reason: anti-inflationary concern. In the past two years the administration has resisted demands for automobile protection, rejected International Trade Commission recommendations to protect leather wearing apparel and extend shoe quotas to Italy, and abolished the trigger price mechanism for steel. The President has repeatedly cited the need to reduce inflation in these and other actions resisting protection. Nevertheless, it may be premature to declare even interim victory for open trade. The atmosphere is heavy with protectionist pressures, and recession will make matters worse. The renewal of the Multifiber Agreement in 1980 will be a major test of the force of protectionism.

Verreydt and Waelbroeck offer several perceptive thoughts on the political economy of protection. They remind us that the more advanced developing countries may have a vested interest in quota regimes that insulate them from newcomer competition; that the inattention of LDCs to trade in the North-South dialogue reflects the high concentration of manufactured exports among a few LDCs; and that Europe is embarking on an integration of the Mediterranean countries that will by itself be a large adjustment, making the prospects dimmer for digesting still further growth in manufactured imports from the Third World. They also discourage any illusions that meaningful planning for adjustment exists on an EC–wide basis, suggesting that Europe is not as far ahead of the United States in this area as one might think.

I have some doubts about the paper's statement that manufactured exports from developing countries have approximately equal penetration in the EC and United States markets but lower penetration in Japan. Estimates in a current Brookings project using United Nations trade and output data for 1976 show average penetration ratios of 2.24 percent for the United States, 2.43 percent for Japan, and a range from 1.89 percent for France to 2.88 percent for the United Kingdom. These and other measures suggest that penetration is no lower in Japan than in the United States and Europe, and that the range of variation among individual European countries is relatively high. Except perhaps within Europe, no individual nation appears holier than any other.

On textiles, the authors make the interesting point that the sector's low-wage, unskilled labor is easier to shift than would be high-wage, specially trained workers in other sectors such as automobiles and steel. The reverse argument is usually made in the United States; there is a tendency to assume, as Baldwin does in chapter 10 of this volume, that labor adjustment is more difficult for the low-wage, unskilled workers. In the American case it is usually added that textile workers tend to be aged, female, black, and located in rural towns, reducing flexibility. But it is an interesting theoretical question whether labor mobility in general is positively or negatively related to skill and wage level, as the influences of skill specificity and worker expectations play off against different unemployment rates by skill level.

The paper's discussion of textiles would be improved by a more direct separation of textiles from apparel. The textile industry tries to keep the two sectors together in order to evoke sympathy for protection, but in fact imports are a problem only for apparel. The EC has a substantial trade surplus in textiles, but is has had a rapidly growing deficit in apparel; for the United States, trade is roughly in balance for textiles but shows a large deficit in apparel. Moreover, technological change has been able to strengthen United States competitiveness in textiles, but the same solution is unlikely to be feasible in labor-intensive apparel.

The paper's discussion of footwear leaves out an important point: most of Europe's import problems appear to come from Italy and other Mediterranean nations, not developing countries. The Brookings estimates find LDC penetration ratios of 10 percent in the American market for nonrubber footwear but approximately 3 percent in Germany and the United Kindgom and less than half a percent in Italy.

The discussion of steel raises another important issue: much of recent protectionist conflict has been among the industrial countries, not between North and South. The paper gives the impression of a cozy cartel within the North against steel from the South, but the real conflict in steel has been among the United States, Europe, and Japan. LDC exports in steel remain marginal, although their import substitution has affected exports from the North. Another issue raised by the case of steel is that of distortions from state firms in trade. With state ownership of steel in much of Europe, already complicated issues in dumping and countervailing duties become all the more complex and subject to charges of unfair trade practices on both sides of the Atlantic.

For policy purposes, the study could have given much more emphasis to the Safeguards Code. Inability to reach agreement on this code was the largest failure of the Tokyo Round from the standpoint of the developing countries. The authors suggest the EC should not be so reluctant to agree because they can impose voluntary export restraints in any case, but a major United States objective in the code was to place international discipline on VERs. Verreydt and Waelbroeck do leave some room for hope, as they note that the EC is prepared to give up some of its present protective flexibility in exchange for international legitimacy now lacking under the restrictions imposed largely outside the GATT.

The paper's somewhat cynical view of adjustment assistance does not follow even if it does not move workers out of industries or retrain them, because, at a minimum, adjustment assistance is an income transfer to workers in industries affected by imports, and such a transfer is socially efficient when it enables politicians to adopt trade liberalization that provides larger benefits to the rest of the community. Quite apart from politics, adjustment assistance viewed as a transfer follows the welfare economics principle that compensation must actually be paid to the losers if we are to say that actual welfare has improved from efficiency gains through freer trade. In the United States, changes in the 1974 act made this transfer much larger (and indeed opened it to nongermane use for unemployment due to recession largely unrelated to trade, as in the case of autoworkers in 1980), although hopefully there is still room to make adjustment assistance play an adjustment as well as a transfer role. Finally, the assertion that exchange rates are used for protection sounds outdated. We are no longer in the interwar period of competitive devaluation but in an environment where in the fight against inflation, industrial countries often seek to avoid devaluation rather than promote it for mercantile reasons. To be sure, there are signs that Germany and especially Japan tried to moderate appreciation in 1977–78, but they intervened massively to avert devaluation against the dollar in 1979–80.

Overall, the state of protection in Europe and the United States raises two broad questions of trade strategy. For the North, the question is whether we are going to create more and more pockets of industries insulated from LDC competition and sustain them more or less indefinitely despite their inefficiency, as we have done for textiles and apparel and are on the road to doing for footwear and television sets. For the South, the question is whether to rely on traditional comparative advantage and as a result confront stiff protection in labor-intensive industries, or instead follow a second-best strategy, pursuing a whole range of other products with much less product concentration, but also less comparative advantage, than in the past.

Comment Gene M. Grossman

The interesting paper by Verreydt and Waelbroeck raises the question of how much of the adjustment in various industries in the EC has been necessitated by competition from imports from non–EC, and particularly

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less developed, countries. In any dynamic, open economy resource allocations between sectors have many proximate causes, including differences in the rates of accumulation of alternative factors of production, which may effect changes in relative factor prices, and therefore in relative costs of production; differences in the income elasticities of demand across goods; differences in the rates of technological progress across sectors; and differences in the extent of trade competition that arise from changes in the structure of world production and demand. As a microeconomic phenomenon, import competition becomes potentially problematic if the short-run dislocations of labor that are associated with shifts in the foreign supply curve are large relative to those caused by other economic factors.

Much recent research has been devoted to assessing the effect of import competition on employment. The overriding conclusion of investigations of many countries (many of them nicely reviewed in Martin 1979) is that historically the changes in employment that have been "caused" by import competition have been miniscule in comparison to those associated with the other causes mentioned above, and in particular technological progress. Indeed, Verreydt and Waelbroeck subscribe to this view in their discussion of the textile and clothing industry in the EC. Often the inference is then drawn, and has been disseminated by influential organizations (e.g., IBRD President McNamara's recent speeches), that the costs of structural adjustment to changes in comparative advantage are small—absolutely, and in relation to other dynamic adjustment costs that must be borne in a growing economy. This leads to the conclusion that protection from import competition is *not* justified if it is to be based on adjustment cost calculations. While this may in fact be correct, I believe that the methodology used by many previous researchers to allocate changes in sectoral employment to their various causes is inappropriate and does not allow these writers to draw their strong conclusions.

Most writers have employed an accounting framework that has been developed, apparently by Karsten Laursen, to examine the extent to which imports have been responsible for adverse trends in employment in particular industries. Recent studies using this approach by Krueger (1980) and Frank (1977) on the United States, Cable (1977, 1978) on the United Kingdom, and Wolter (1977) on West Germany have been unanimous in their findings that "technological progress" has been a much more important determinant of employment shifts than has import competition. I base my criticism of this approach obviously not on the validity of the identity on which it is based, but rather on its interpretation.

The authors (see, for instance, Krueger 1980) define $a = Y/L$, the average productivity of labor, and $S = Y/C$, the share of domestic output in apparent consumption. They then write the identity $L \equiv CS/a$, and log differentiate to obtain

(1) $$\hat{L} = \hat{C} + \hat{S} - \hat{a}.$$

Finally, they collect data for two observations on each variable and attribute changes in employment to consumption growth, import competition, and technological progress, respectively. In almost all cases in which employment has been observed to fall, they find that $\hat{C}$ is relatively large and positive, $\hat{S}$ is negative, but small, and $\hat{a}$ does all the work in "explaining" the change in employment. The authors qualify their findings slightly by suggesting that consumption growth and technical progress may not be exogenous to import competition, if for example a shift in the foreign supply curve allows increased consumption of the good or spurs technical progress domestically.

My objection concerns the interpretation of changes in the average product of labor as reflecting "technological progress." Consider a competitive industry that produces according to a CES production function that is augmented by Hicks-neutral technological progress (labor-saving technological progress would alter the detail, but not the thrust of the argument),

(2) $$Y = e^{\pi t}(\alpha L^{-\rho} + (1 - \alpha)K^{-\rho})^{-1/\rho}.$$

Profit maximization implies

(3) $$\frac{w}{p} = \frac{\alpha}{e^{\pi(1-\sigma)t/\sigma}}\left(\frac{Y}{L}\right)^{1/\sigma}.$$

Note that equation (3) holds as a first-order approximation for any production function, and nothing in the discussion hinges on the use of a CES production function. Finally, log differentiation of (3) gives

(4) $$\hat{a} = \frac{\hat{Y}}{L} = \sigma\left(\frac{\hat{w}}{p}\right) + \pi(1 - \sigma).$$

Only if $\sigma = 0$ (fixed-coefficient technology) can we associate changes in the average product of labor exclusively with technological progress. In fact, for a Cobb-Douglas production function ($\sigma = 1$), the average product is *independent* of the technology parameter (π).

Now, consider a small industry for which the product price is determined on the international market (i.e., $p = Ep^*$, where p^* is the foreign currency price of the imported good and E is the exchange rate). If a shift in the foreign supply curve (or the exchange rate) causes Ep^* to fall, this will cause an increase in the average product of labor in the domestic industry, provided that a fall in w does not completely offset the fall in p. It is therefore impossible to attribute changes in the average product of labor to technical progress rather than to import competition, once we admit the possibility of movements along isoquants in addition to shifts in isoquants.

How then can we measure the effect of import competition on sectoral employment? Unfortunately, there is no short cut that satisfactorily averts the need for specification and estimation of an econometric model that simultaneously determines employment and imports. If all one is interested in is the ultimate effect of various variables on employment, it may be possible to resort to reduced-form estimation, thereby sidetracking some of the difficult data problems that plague empirical trade research. However, methodologies that promise answers while avoiding estimation completely must ultimately be based on the assumption of the exogeneity of important economic variables.

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