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**Article**

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## How States Perceive the Costs of Trade Liberalization in the WTO

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This article examines the relative importance of various costs of trade liberalization in the perception of governments. It is based on a series of interviews led with members of national delegations and WTO employees, as well as on a survey of national delegations. For industrialized countries, political repercussions arising from trade-induced restructuring of economies are found by far to be of gravest concern. Governments in developing countries additionally fear the loss of economic policy space and long-term unemployment, as well as increases in both inequality and poverty. Importantly, neither economic nor political analysis can fully explain developing countries' cost perceptions. Instead, the identity they adopt within the WTO system appear to influence their negotiating positions.

*JEL codes:* F02, F13

*Keywords:* Trade liberalization, WTO, Political economy, Terms of trade, Policy, Space, Unemployment, Inequality

### 1 Introduction

For economists, trade is good. Reciprocal free trade on a multilateral basis is best, but states can still improve their welfare by liberalizing unilaterally even if their trading partners remain protectionist.<sup>1</sup> The puzzle then is to explain why member states of the GATT/WTO have, over the last sixty years, engaged in a gradual and uneven process of liberalization, instead of immediately, completely, and reliably opening their markets. Various costs of domestic trade liberalization could explain why governments are reluctant to commit to multilateral disciplines.

- Removing trade barriers may worsen a country's terms of trade.
- Lowering tariff rates generally diminishes governments' tariff revenues.
- Accepting WTO disciplines limits a country's economic policy space in numerous areas, such as the possibility to foster infant industries.

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1 See BHAGWATI (2002).



- Economic restructuring in the wake of trade liberalization may be economically and politically painful.
- Domestic trade liberalization may aggravate long-term unemployment and increase inequality and poverty.

This leads to three questions: 1) What is the respective weight that governments attribute to potential costs of domestic trade liberalization in WTO negotiations? 2) How do cost perceptions differ between countries, in particular as a function of their level of development? And 3) how rational are governments' perceptions of the costs of trade liberalization? In other words, is there a difference between the cost assessments established in the economics and political-economy literature and the perceived costs, and if so, what is the reasoning behind deviating cost perceptions?

A first approach to find out about governments' cost perceptions is an analysis of their public statements, contained in the negotiating proposals they submit, the minutes of WTO meetings, and press statements and speeches. Yet, these statements are rhetoric devices, serving a strategic purpose at the international bargaining and the domestic political level. Thus, they are not reliable representations of governments' cost perceptions. A second approach is case studies that account for a country's specific policy choices. These studies identify key domestic constituents, their substantive positions, their institutional roles, their actual participation in decision-making processes, the evolution of a national policy stance, and decision-makers' ex-post reasoning of what happened and why. However, it is often difficult to derive sufficiently precise information from case studies about the relative influence of the various costs. Moreover, comparing case studies across countries, sectors, or negotiating instances is inherently problematic.

A third option is to statistically relate levels of, and changes in, protectionist barriers across time, countries, or sectors to the costs of trade liberalization. For instance, tariff levels can be regressed against importing countries' market power to see whether the potential to improve the terms of trade through tariffs is correlated with higher tariffs. However, several problems complicate such an approach. As seen above, the number of potential costs needing to be differentiated is high. For some, it is difficult to find measurable proxies, such as the need for economic policy space. Numerous interfering variables that influence trade policies, such as the perceived benefits of domestic trade liberalization and the international negotiating context, change over time and are heterogeneous across countries and sectors. Furthermore, changes in the perceived costs of liberalization are not immedi-



ately reflected in changing policies; instead, trade policies are long-term commitments whose reversal may be costly at the domestic and international stage.

Given these methodological difficulties, it is unsurprising that opinions on the relative influence of various costs of trade liberalization widely diverge. It seems justified, then, to explore a fourth strategy: systematically tapping the rich, contextual knowledge of experts with first-hand experience in the construction of member states' WTO negotiating positions. To this end, an empirical project was conducted during 2006 in Geneva. The one hundred missions at the WTO in Geneva were asked to fill out up to three questionnaires on negotiations regarding non-agricultural market access, agriculture, and services, respectively. Twenty-eight states provided 44 total responses. In addition, 27 interviews on national negotiating positions and WTO negotiations, lasting about 90 minutes on average, have been conducted with WTO employees and members of the national delegations (mostly among the survey participants). These interviews served primarily to prepare the survey questions but also to interpret the results. The survey method has its disadvantages, notably the subjectivity of responses. Nevertheless, it appears to be a useful contribution in addition to other approaches.

## **2 The Survey**

This section introduces the survey questions, presents the responses, lists the participating countries, discusses the potential nonresponse error, examines the likely quality of responses, and reports the statistical significance of differences in means across questions and industrialized/developing countries.

### **2.1 Questions**

The survey contained the following questions concerning the economic effects – as well as their social and political repercussions – of domestic trade liberalization:

What influence do the following (perceived) costs of liberalizing access to one's own market have on your country's negotiating position?

a) losing tariff revenues



- b) restraining economic policies (such as infant-industry protection or regulation imposed on foreign direct investment to foster technology transfer) that aim at promoting certain sectors, types of businesses, economic activities etc.
- c) incurring the economic, social, and political costs of restructuring (including temporary unemployment)
- d) increasing unemployment in the long run
- e) increasing poverty or inequality, especially by lowering the income of labor with low qualifications

## 2.2 Responses

Respondents could choose between five answers (very low, low, medium, high, very high). The results are shown in Table 1 which gives the frequency with which each of the five possible answers was chosen.

**Table 1:** Survey results on the costs of domestic trade liberalization

	Number of responses	Distribution of responses					Average value	Significant difference
		1	2	3	4	5		
<b>Tariff revenues</b>								
Industrialized countries	8	5	2	1	0	0	1.57	no
Developing countries	36	5	13	6	9	3	2.74	
High-income group	13	3	5	3	1	1	2.26	
Low-income group	23	2	8	3	8	2	3.05	
<b>Economic policy space</b>								
Industrialized countries	8	3	3	2	0	0	1.63	yes
Developing countries	36	3	1	11	16	5	3.61	
High-income group	13	1	1	5	4	2	3.50	
Low-income group	23	2	0	6	12	3	3.68	
<b>Costs of restructuring</b>								
Industrialized countries	8	0	1	3	4	0	3.33	no
Developing countries	36	0	2	10	17	7	3.78	
High-income group	13	0	1	1	6	5	4.06	
Low-income group	23	0	1	9	11	2	3.61	
<b>Long-term unemployment</b>								
Industrialized countries	8	1	5	1	1	0	2.10	yes
Developing countries	36	0	5	10	15	6	3.64	
High-income group	13	0	1	3	4	5	3.98	
Low-income group	23	0	4	7	11	1	3.43	
<b>Inequality and poverty</b>								
Industrialized countries	8	3	4	1	0	0	1.57	yes
Developing countries	36	1	8	5	17	5	3.46	
High-income group	13	0	2	2	4	5	3.80	
Low-income group	23	1	6	3	13	0	3.24	



Answers are coded with numbers ranging from 1 (very low) to 5 (very high). The table also presents average response values constructed by assigning weights to the responses, ranging from 1 (very low) to 5 (very high). Where a country returned two or three (sector-specific) questionnaires, a country-based average was formed first, thus ensuring that all participating countries have the same weight regardless of the number of questionnaires they sent back. Averages are presented on the second-digit level in order to keep the figures from distortion through rounding.

### 2.3 Participating Countries

The survey results are differentiated between industrialized and developing countries. The industrialized countries are (with the number of responses in brackets): Australia (2), Canada (1), the European Communities (3), New Zealand (1), and Switzerland (1) – that is, all countries that are commonly treated as industrialized countries in the WTO with the exception of Japan, Norway, and the U.S. Problematically, two of the missing countries, the U.S. and Japan, have a particular weight in negotiations. The literature does not suggest, however, that they generally pursue goals different from those of other developed countries. Still, it would be highly desirable to attain responses from the absent industrialized countries in a possible future survey.

Out of 102 developing countries with permanent missions to the WTO in Geneva, 23 responded. These are: Angola (1), Antigua and Barbuda (1), Brazil (3), China (3), Colombia (1), Croatia (1), Ghana (1), Hong Kong (1), Israel (1), Jordan (1), Malaysia (1), Mexico (2), Oman (1), Panama (2), Paraguay (1), Qatar (1), Romania (2), Senegal (1), South Korea (2), Taiwan (3), Trinidad and Tobago (2), Turkey (3), and Zambia (1). The potential non-response error is thus greater for developing countries. In order to assess whether the set of responding developing countries is representative, Table 2 splits up responding countries by regions. In so doing, it becomes clear that Africa is underrepresented and that no country from South-Asia has responded, whereas Latin American countries were particularly willing to respond. This geographic representation appears not to be problematic, as the average value of the seven Latin American countries adding up all the five types of costs of liberalization is almost identical with the corresponding average value of the other countries (of 0.02 lower). The only notable deviation is that Latin American countries show less fear of increasing long-term unemployment (their average on this type of cost is 0.48 lower than the average of the other countries).



**Table 2:** Developing countries by regions

Region	Responses	Countries
Europe	2	Croatia, Romania
Latin America	7	Brazil, Antigua and Barbuda, Colombia, Mexico, Panama, Paraguay, Trinidad and Tobago
East Asia	5	China, Hong Kong, Malaysia, South Korea, Taiwan
Africa	4	Angola, Ghana, Senegal, Zambia
Middle East	5	Israel, Jordan, Oman, Qatar, Turkey

The developing countries were further divided into a high-income and a low-income group. The 9 countries with an average per-capita GDP of above \$13,000 are Antigua and Barbuda (1), Croatia (1), Hong Kong (1), Israel (1), Oman (1), Qatar (1), South Korea (2), Taiwan (3), and Trinidad and Tobago (2). The 14 countries with roughly \$12,000 or less of average per capita GDP are Angola (1), Brazil (3), China (3), Colombia (1), Ghana (1), Jordan (1), Malaysia (1), Mexico (2), Panama (2), Paraguay (1), Romania (2), Senegal (1), Turkey (3), and Zambia (1).

## 2.4 Quality of Responses

The reliability and validity of responses depends upon four factors: (1) whether delegates have the requisite knowledge to answer the questionnaire, (2) whether they attribute the same meaning to the questions which is given to them by the researcher, (3) whether they make an effort to be precise in their responses, and (4) whether they do not consciously misrepresent their beliefs.

(1) Knowledge: At first sight, national delegations to the WTO appear not to be the best judges of how the costs of trade liberalization are weighted in the domestic policy-making processes. The disadvantage of their distance to capitals, however, is mitigated by the fact that most delegates have accumulated substantial experience with trade policy-making at the national level before being dispatched to Geneva. Furthermore, they are generally in close contact with their capitals, receiving negotiating orders and also participating in the elaboration of negotiating positions. Delegates even present an advantage over national trade policy makers due to their bird's-eye perspective. They are often in charge of a broad portfolio of negotiating issues. Finally, they enjoy some discretion within their mandate. How they weigh benefits and costs in order to arrive at concrete positions in changing nego-



tiating instances is something that can only be accounted for by the delegates themselves.

(2) **Clarity:** The questions asked in the surveys were developed in preparatory interviews. The subsequent interviews served to interpret the results and confirmed that delegates shared an ordinary understanding of the questions.

(3) **Precision:** Responses were generally highly differentiated across the questions within each questionnaire returned. This indicates that delegates attempted to correctly assess their countries' trade policy-making. Only one questionnaire was eliminated ex-post as it gave the same response to all questions.

(4) **Misrepresentation:** Delegates may bias their responses in order to please certain constituents or to give socially desirable answers. Therefore, delegates were assured total confidentiality. Moreover, they were free not to respond to questions rather than to give distorted answers for political reasons. It is also important to know that the questionnaire contained further sets of questions notably on the benefits of trade liberalization, the relative influence of various domestic constituents in the formulation of WTO negotiating positions, and changes in their respective influence over time. The results attained on these questions are consistent and reasonable – compared across questions, between industrialized and developing countries, and between more and less democratic countries. This suggests the responses on the costs of trade liberalization are also reliable.

Respondents were additionally asked to identify the sector upon which they based their assessment (non-agricultural market access, agriculture, and services). Alternatively, they could choose not to select a specific sector but to base their answers on their experience in the WTO in general. As the majority of delegates selected the latter option, the number of responses for the three sectors is too small for a meaningful interpretation. This sectorspecific information does, however, fulfill a control function. The sector-specific responses are quite evenly distributed (with 1½ responses by industrialized countries and 6/6/7 responses by developing countries that are specific to non-agricultural market access/agriculture/services). Since the differences between non-agricultural market access, agriculture, and services are moderate, the slight difference in the share of responses based on a certain sector does not significantly distort overall results or the relationship between industrialized and developing country responses.



## 2.5 Statistical Significance of Differences in Means

It is necessary to emphasize that the subjective evaluation of delegates and the small sample size allow only to discern approximate patterns of perceived costs. As regards industrialized countries, differences between any pair of means are significant at the 5% significance levels only between the costs of restructuring and all other costs. Regarding developing countries, differences between any pair of means are significant at the 5% significance levels only between the loss of tariff revenues and all other costs.

The differences in means between industrialized and developing countries (as shown in Table 1) are calculated with a t-test at the 5% significance level (the 10% and 20% levels produce the same results). On each question, an F-test at the 5% significance level decides about whether the t-test is conducted with pooled or separate variances.

## 3 Discussion of the Survey and Interview Responses

In this section, governments' perceptions are compared to the assessment found in the economic and political-economy literature, and delegates' reasoning provided in the interviews is reported. The objective here is primarily to assess whether the survey responses are rational for a government that pursues welfare *and* political objectives (including other non-welfare objectives, such as enriching friends or earning bribes). A framing error arises, for instance, when a government chooses trade policies to promote national welfare that are actually welfare-diminishing. Evidences of framing errors are survey responses that cannot be explained by their contribution to economic and political objectives according to mainstream science, though the interview responses do not put forward plausible arguments that cast doubt on mainstream beliefs.

The primary objective is *not* to weigh the influence of welfare vs. political objectives in governments' utility functions. This would be a difficult undertaking simply because the different costs mostly have a political dimension in addition to their welfare implications. Nevertheless, the discussion sheds some light on this question as the influence of political factors differs strongly across costs. In particular, political factors play a dominant role in the costs of restructuring which developed countries rank highest by far, pointing to a political motivation of protectionism in these countries.



### 3.1 Deterioration of the Terms of Trade

The discussion starts with the one potential cost of trade liberalization not included in the survey. The idea behind terms-of-trade losses is that (some) states can set their tariffs in order to manipulate the terms of trade – the conditions of exchange on the world market – in their favor. When a state is a major importer of a certain good and levies a tariff on this good, the demand for the good decreases. This also reduces the global demand for the imported good. Consequently, the world market price of the imported good falls and the large protectionist country experiences a terms-of-trade gain. Thus, states can strategically use their market power as buyers at the cost of their trading partners.

For some economists, the need to deal with this terms-of-trade externality is the driving force behind multilateral trade cooperation. They argue that many markets are sufficiently large so that taxes are not passed through one-to-one to consumers but are partly absorbed by exporters.<sup>2</sup> Others point out that the calculation of optimal tariffs is too complex and that negotiators do not attempt to estimate the terms-of-trade effects when bargaining.<sup>3</sup> Strikingly, detailed analyses of the trade policy making processes of large states with potential market power over long time periods do not mention concerns about terms-of-trade consequences.<sup>4</sup> Moreover, WTO provisions not geared to preclude the manipulation of the terms of trade or to facilitate the enforcement of trade agreements if governments are motivated by terms-of-trade advantages; instead, they are tailored to cope with protectionist pressures from import competing interests.<sup>5</sup> What is even more interesting is that countries do not systematically exploit the possibility of improving terms of trade through export taxes not covered by WTO law. By contrast, they employ export subsidies and voluntary export-restraints (VERs) although these instruments deteriorate their own terms of trade.<sup>6</sup> A deterioration of the terms of trade is therefore a possible, though strongly contested, obstacle to trade liberalization. Though there is much debate on the importance of terms-of-trade effects, they were excluded from the survey. The reason for this is that the preparatory interviews showed that using the notion of 'terms of trade' among delegates evoked the idea of

2 See BAGWELL and STAIGER (2002). In their empirical investigation, BRODA, LIMA and WEINSTEIN (2006) find that even small countries have significant market power, especially in their typical import goods, where transportation costs are high, and where products are differentiated.

3 See FINGER, REINCKE and CASTRO (1999).

4 See DESTLER (1995) and GOMES (2003).

5 See REGAN (2006).

6 See ETHIER (2004) and REGAN (2006).



long-term changes in the relative price between raw material/low-value added industrial goods versus high value added, technology- and capital-intensive goods. This price change was then judged from a global justice perspective. Delegates did not relate it to optimal tariff setting that manipulates the demand for import goods and, thus, strategically changes prices. They were even unaware of this possibility. Accordingly, a question on terms-of-trade deterioration through liberalization would have provoked invalid responses. Upon discussion in the interviews, delegates resolutely rejected the idea that terms of trade would play a role in their negotiating positions.<sup>7</sup>

### 3.2 Loss of Tariff Revenues

Tariff revenues play a marginal role for industrialized countries (1.57). Developing countries attribute greater importance to tariff revenues (2.74); in these states, the low-income group appreciates tariff income more than the high-income group (3.05 vs. 2.26). This is in line with expectations. Tariffs are easy to collect but strongly distort the economy. The more advanced a country's economy, the smaller the excess transaction costs of raising taxes other than tariffs in comparison to the excess economic distortions provoked by tariffs.<sup>8</sup>

The loss of tariff revenues is the least significant among the costs for industrialized countries and for the high- and the low-income group of developing countries. It is worth noting that one reason governments appreciate tariff revenues is that explicit taxation imposes political costs on the government in terms of loss of popularity, whereas consumers may remain unaware that they pay for tariffs through higher goods prices. Therefore, tariffs may be a politically efficient source of revenue for governments. If governments nevertheless attach little importance to tariffs, this shows that governments believe in the advantages of non-tariff taxes from a welfare perspective. (Taken together, this suggests that the strong claim made by many devel-

7 Economically, the attempt to maximize foreign market access while conceding minimal access to the domestic market is equivalent to the strive for terms-of-trade gains for large countries. Thus, it can be argued that countries are implicit terms-of-trade optimizers. Asking for whether countries are mercantilist in market access terms, however, would not have yielded conformation or contradiction for the terms-of-trade argument as the other costs of trade liberalization can also account for mercantilist attitudes.

8 See BAUNSGAARD and KEEN (2005), CORDEN (1974) and KEEN and LIGHTHART (2002) on the (in)efficiency of tariffs for revenue generation. KOWALSKI (2005) and WINTERS, McCULLOCH and McKAY (2004) even argue that a reduction of tariff rates combined with a simplification of the tariff structure, the elimination of exemptions, the reduction of the margin between actual and WTO-bound tariffs, and a modernization of the customs system can actually increase net tariff revenues.



oping countries in WTO negotiations that they need to preserve their tariff levels for public financing may be partly strategic.)

### 3.3 Loss of Economic Policy Space

Economic policy space is of low importance to industrialized countries (1.63) but of rather high importance to developing countries (3.61). There is little difference between the high and the low-income group of developing countries (3.50 vs. 3.68). In order to assess whether this difference can be explained by a greater need in developing countries for industrial policies that might be restrained by WTO policies, the infant-industry argument, the most popular concept of the strategic trade theory, will be considered in greater detail. The basic assumptions are that markets are not perfectly competitive, so that companies with market power can make profits, and that companies learn over time how to reduce their costs of production. The recommendation that results from this is that governments should offer suitable domestic companies temporary protection, giving them time to reduce their costs of production and allowing them to make profits even after the protection is discontinued.

There are numerous criticisms of such an approach. On the implementation level, governments lack the necessary information to determine which companies are most suited to improve competitiveness at relatively low cost and then reap high profits. Governments may also be unable to credibly commit to ending the protection. This triggers a moral hazard on the side of the protected companies that do not sufficiently prepare for full competition.

Furthermore, the governmental agencies in charge of infant industry promotion may fall prey to corruption or political capture. Even if implementation is sound, it is unclear whether the future stream of profits offsets the various costs of infant-industry policies, such as distortions acquired by levying tariffs or financing subsidies, transaction costs of public administration, and wasteful rent-seeking expenditures of companies.

Policy alternatives are available to attain the goals targeted by infant industry policies. Improving capital markets may make companies with ambitious projects requiring high upfront investments less dependent on government protection. Enhancing competition on domestic markets may be a safer way to increase the competitiveness of domestic companies; it will al-



so reduce the profits that foreign companies make on the domestic market and thus eliminate one incentive for infant-industry protection.

Aside from the temporary promotion of infant industries, a case can also be made for the enduring protection of companies in oligopolistic markets. Here, protection enables domestic companies to commit to aggressive production schemes, to which foreign competitors react by reducing their output.<sup>9</sup> It may even be advantageous for a country to subsidize declining industries if markets are imperfectly competitive. The intention then is to drive foreign firms to exit first, so domestic firms can benefit from monopoly power.<sup>10</sup>

While initially these possibilities provided economists with considerable theoretical possibilities, the present prevalent opinion among them is that the various strands of strategic trade management can do little good and considerable harm.<sup>11</sup> There are few supporters of old-style tariff- or quota-based infant-industry protection.<sup>12</sup> More broadly accepted are softer forms of industrial policy focused less on particular companies or products, promoting instead technology transfer, research and development, small and medium enterprises, or inter-firm cooperation and geographical clustering – which are not substantially constrained by the WTO.<sup>13</sup>

Thus, arguing that economic needs cannot explain developing country governments' concern about policy space, two alternative reasons can be brought forward (both of which found some confirmation in the interviews). First, governments act under different political constraints. The more ignorant the general public, the more attractive interventionist trade policies are: They are visible and likely to produce palpable results which the general public values while ignoring opportunity costs. Furthermore, interventionist trade policies are more attractive the less democratic and efficient domestic institutions are: Weak institutions offer opportunities for governments in certain countries to earn bribes or favor the interests of relatives, friends, or political allies. As a consequence, trade-distorting industrial policies are more attractive to developing country governments where the general public is less informed and where institutions are weaker.

9 See BRANDER and SPENCER (1985).

10 See ANIS, BENARROCH and WEN (2002).

11 See BRANDER (1995), BALDWIN (1992), CORDEN (1974), KRUGMAN (1987) and PACK and SAGGI (2006).

12 CHANG (2005) makes a claim for the necessity of infant industry protection. MELITZ (2005) argues in favor of import quotas as superior instruments for infant-industry protection in comparison with tariffs.

13 See HOEKMAN, MASKUS and SAGGI (2005) and WEISS (2005).



Second, industrialized and developing country governments appear to hold different standards. Whereas the former tend to believe that they serve their country best by creating a stable and predictable policy environment for businesses, the latter tend to believe that intervening in the economy corresponds to a government's adequate role and promotes national wealth. Assuming that mainstream economic theory is correct, developing country governments appear thus to be subject to a framing error. In their discourse, delegates did not refer to scientific evidence to substantiate their perceived need for policy space but used general arguments such as tariffs implemented in the 19<sup>th</sup> century by now-developed countries in order to protect their infant industries.

### 3.4 Costs of Restructuring

The costs of restructuring are the greatest worry for both industrialized and developing countries (3.33 and 3.78 respectively). The group of high-income developing countries considers this an even greater stress than the low-income group (4.06 vs. 3.61). Restructuring an economy to adapt to the change in relative prices brought about by trade liberalization depreciates physical, intellectual, and human capital that is specific to the company or sector where it has previously been employed (that is, it creates less value in alternative production processes). Furthermore, the transfer of resources is costly in itself; for instance, when workers need to search for a new job, they can be temporarily unemployed and may need to move to a new location.

It is particularly difficult to estimate the welfare costs of economic adjustment after trade liberalization. Generally, adjustment costs of 'trade liberalization only' (excluding the macroeconomic and sectoral reforms that are often implemented in tandem) are considered to be moderate,<sup>14</sup> not reversing the positive growth effects of openness to trade.<sup>15</sup> Technological innovations, financial market crises, foreign exchange movements and the like provoke substantially stronger shocks to the economy than trade liberalization.<sup>16</sup> Governments' concerns are thus more likely to be grounded in the distributional consequences of adjustment rather than in the net costs to the economy. Indeed, the explanations given in the interviews centered on the distributional consequences of adjustment.

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14 See the literature quoted in Section 3.5.

15 See CHANG, KALTANI and LOAYZA (2005), FRANKEL and ROMER (1999), PANAGARIYA (2004) and WACZIARG and WELCH (2003).

16 See HOEKMAN and WINTERS (2005) and MACCHETTA and MANSEN (2003).



Governments have a political self-interest in avoiding significant income losses for parts of society.<sup>17</sup> One explanation for why governments encounter political problems with trade policies that improve national welfare overall but inflict losses on some individuals is that private agents are subject to bounded rationality in their perception of cause-effect relationships in economic policy. They hold governments responsible for the direct visible costs of trade policy, such as job losses in the wake of import surges, but do not attribute long-term growth to liberal trade policies. Consequently, protectionism maintaining the status quo is politically attractive for governments.

Additionally, interest groups representing capital and labor lobby governments and thus influence policy. Import-competing sectors prefer the protection of domestic markets against foreign competition. Export-oriented sectors favor liberal trade policies as the access to cheaper primary resources and intermediate goods enhances their competitiveness. They also hope to receive additional market access abroad in exchange for their own country's concessions. The problem with these export-oriented sectors is that their interests are often of an uncertain and long-term nature and diffused over a large number of companies and weakly organized employees; furthermore, many potential beneficiaries have made little prior fixed cost investments into building lobbying infrastructure. Consumers are challenged even more, having to discover their own individual benefits of trade liberalization and to organize themselves in order to exert enough political pressure to demand change. Hence, governments tend to benefit politically from caving in to the demands of powerful import-competing interest groups. The relevance of these political motivations for protectionism finds confirmation in countries' patterns of trade barriers that reflect domestic political conditions, as well as in the producer bias inherent in WTO law. In particular, exemptions entitling governments to re-introduce trade measures in case of import surges or unfair trade practices are not tied to losses in national welfare, but to damages done to domestic industries.<sup>18</sup>

17 See GAWANDE and KRISHNA (2003), GROSSMAN and HELPMAN (2002), WTO (2006) and ZAHRT (2008). CORDEN (1974) provides an alternative justification for why governments might dislike the distributional effects of trade liberalization. The 'conservative social welfare function' supposes that "any significant absolute reductions in real incomes of any significant section of the community should be avoided. ... In terms of welfare weights, increases in income are given relatively low weights and decreases very high weights." The welfare rationale for the conservative social welfare function is that it provides insurance for risk-averse citizens and secures social peace. This view was never voiced by the interview partners in the interviews.

18 See MAVROIDIS (2005) and PETERSMANN (2004).



In sum, the attention paid to the costs of restructuring by industrialized and developing countries appears to have a rational explanation – even though it is not grounded in the desire to enhance national welfare but in an attempt to gain political advantages. Given that the costs of restructuring are the strongest concern of industrialized countries by far, the political economy approach is adequate for explaining industrialized country trade policies.

### 3.5 Increase in Long-term Unemployment

Looking again at the results of the survey, long-term unemployment induced by trade liberalization is perceived to be rather unimportant by industrialized countries (2.10); however, it is seen as rather important by developing countries (3.64), and even more so by the high-income group than by the low-income group (3.98 vs. 3.43). How do these figures relate to the literature on trade and employment?

The temporary adaptation effects discussed in the previous section included frictional unemployment provoked by the destruction and creation of jobs in response to the initial shock of trade liberalization. The less efficient the labor market is, the longer the period of unemployment lasts as workers shift from import-competing to export-oriented sectors or as they shift within sectors from losing to winning companies. In addition to this, trade liberalization may affect the steady-state level of frictional unemployment. If an open economy is more volatile, people may spend more time out of their jobs searching for new employment.<sup>19</sup>

Other than triggering the movement of labor between sectors and companies, tariff liberalization can exert downward pressure on wages (at least for certain skill-groups) across entire economies. In the case of inter-industry trade based on different relative factor endowments, wages decline where labor is a scarce factor of production. If trade liberalization is accompanied by more efficient, technologically advanced production processes, wages for unqualified work may be particularly depressed. Long-term unemployment arises if wages do not adapt to downward pressure. This adaptation may fail for diverse reasons; for example, labor unions may negotiate above market-clearing wages or minimum wage legislation and unemployment benefits may form a floor. Companies may also voluntarily pay an efficiency wage

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19 See JANSEN and TURRINI (2004) on a model that relates frictional steady-state unemployment and trade.



that includes a premium on top of the market-clearing wage in order to increase employees' efforts and to reduce employee turn-over.

The economic literature does not explain developing countries' concerns about trade-induced unemployment. 1) Countries relatively rich in (low-skilled) labor compared to capital – that is, most developing countries – tend to import goods and services whose production is relatively capital-intensive and export labor-intensive goods and services. Accordingly, the demand for labor increases.<sup>20</sup> 2) If trade liberalization reduces labor demand, adaptation occurs in developing countries primarily through wages rather than employment levels. 3) Empirical evidence suggests that trade is a minor cause of unemployment in developing countries and often creates more jobs than it destroys.<sup>21</sup> 4) In any case, the first-best measure would be to enhance the flexibility of the labor market or to reduce the tax burden of labor, rather than using protectionist trade instruments to fight unemployment.

The interviews provided no rational explanation for why developing country governments fear negative long-term effects on employment from trade liberalization, either. The interview partners gave examples of potential trade-induced job losses without systematically considering trade-induced job creation.<sup>22</sup>

### 3.6 Increase in Inequality and Poverty

With regard to inequality and poverty, the difference between industrialized and developing countries is particularly strong. Industrialized countries feel little afflicted by effects on poverty (1.57); developing countries, however, fear a poverty-increasing effect of trade liberalization (3.46). This fear is more pronounced in the high-income group of developing countries than in the low-income group (3.98 vs. 3.43).

20 This is the STOLPER-SAMUELSON theorem well-known to economists.

21 See HOEKMAN and WINTERS (2005), ILO and WTO (2007), MACCHETTA and MANSEN (2003), RAMA (2003) and WINTERS, McCULLOCH and McKAY (2004). By contrast, OSLINGTON (2005) argues that long-term unemployment effects of trade liberalization caused by a wage floor are commonly underappreciated.

22 This is in line with the 'identity bias' identified by KRUEGER (1989): Human beings are more concerned with the identifiable person who stands to lose in response to liberalization than with the unknown winners.



The difference between industrialized and developing countries runs counter to the basic economic expectation that poverty should diminish in labor-rich economies that open their markets. As the demand for labor increases, wages stand to rise. This straightforward relationship between trade and poverty/inequality is complicated by the influence of trade liberalization on the factor rewards for different qualities of labor which often exacerbate the wedge between high and low skill labor, on price volatility, and governmental pro-poor policies that are partly financed through tariffs. Empirical results suggest that, while reducing poverty through enhanced growth, trade liberalization in developing countries does not increase inequality in most cases.<sup>23</sup>

There are two complementary explanations to the survey results. First, the quality of social security systems and other equality-enhancing institutions (progressive taxes, free public education) seems to play a role in the different assessment made by developing and industrialized countries. Though changes in factor rewards induced by trade liberalization tend to increase inequality in industrialized countries, their governments are remarkably little concerned. This strengthens the argument that sound social policies facilitate the political viability of trade liberalization. Second, developing country governments appear to hold – despite the differences in institutions – overly pessimistic views on the effects of trade liberalization on inequality/poverty. The reasoning provided in the interviews focused again on the losers from liberalization, while delegates did not attempt to make a systematic assessment of the overall consequences.

#### 4 Conclusion

With regard to industrialized countries, the results lend strong support to the political economy approach in explaining protectionism. The bounded rationality of voters that readily attribute the visible short-term costs (but not the diffuse long-term benefits) of economic restructuring to their governments, as well as the clout of import-competing interest groups, stand out as the most decisive impediments to liberalization. In line with expectations, industrialized country governments do not depend on tariff revenues to finance their budgets; neither do they feel restrained in their economic policy space by WTO disciplines. Similarly, they are little concerned

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23 See GALIANI and PORTO (2006), HARRISON (2006), KIM (2007), KREBS, KRISHNA and MALONEY (2005), MILANOVIC and SQUIRE (2005), REIMER (2002), UNCTAD (2004) and WINTERS (2000).



with adverse repercussions in terms of long-term unemployment and inequality/poverty. The picture is very different when looking at developing countries. Three observations deserve attention. First, developing countries perceive higher costs on all counts than industrialized countries. Second, concerns about economic policy space, long-term unemployment, and inequality/poverty rank almost as high as economic restructuring and its social and political consequences. Third, the two preceding observations hold true for the high- and the low-income group. The high-income group was even more sensitive to the costs of restructuring, long-term unemployment, and inequality/poverty. This evidence emphasizes the importance of perceptions in the construction of trade policy preferences.<sup>24</sup> Following mainstream economics, developing countries should be much less afraid than they are of losing economic policy space, aggravating long-term unemployment, and exacerbating inequality/poverty; they should probably also be less afraid of losing tariff revenues. If lower levels of economic development led to higher costs of trade liberalization, the importance of these costs for the high-income group of developing countries should be somewhere between the ratings given by the low-income group and industrialized countries. Instead, the concerns of the high-income group on economic policy space are slightly below that of the low-income group, and above it in terms of long-term unemployment and inequality/poverty; only on tariff revenue, they remain clearly between industrialized countries and the low-income group. This implies that the status of a developing country is in itself a driver for a pessimistic attitude towards trade.

The interviews corroborated this constructivist perspective. Two interview partners from East-Asian delegations admitted their difficulty to take positions in the Doha Round because they lacked a clear identity. They tended to side historically with developing countries but realized that they shared increasingly greater interests with industrialized countries. One interview partner from a recently acceded member state explained that its country was still trying to figure out whether they should assume a developing or industrialized country perspective. An interview partner from another recently acceded member state felt that his country was in an observer position to determine its interests in the discussion with other states. The findings indicate that stepping up capacity-building and discursive efforts

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24 See RISSE (2000), WENDT (1999), HAAS (1992) and GOLDSTEIN and KEOHANE (1993) as examples of the abundant literature on the role of beliefs in international politics. In the area of trade, constructivism is underrepresented. Most work on the influence of beliefs on trade policy takes a long-term historical perspective, such as GOLDSTEIN (1993) and GOMES (2003). A more recent account can be found in FORD (2002).



both inside and outside the WTO might be advantageous in order to achieve liberalization in developing countries. The capacity-building dimension comprises improvements in the regulatory capacities of developing countries so as to enable them to better implement WTO-legal policies, reducing fears about losing policy space, and to enact complementary policies with trade liberalization, for instance to enhance labor market efficiency and improve social safety nets. The discursive dimension aims at intensifying training and exchange with developing countries on a political and technical level, in Geneva and in state capitals. It might also consist in scaling up the provision and dissemination of accessible analysis revealing where apprehensions about trade liberalization are unfounded. Accordingly, the WTO might not only matter as a forum for exchanging market access concessions but also as a place where countries can learn to recognize their true trade interests.



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