LECTURE 1

Confronting Conventional Threats to Free Trade: The Postwar Revolution in the Theory of Commercial Policy

Why Free Trade Fails to Persuade

Conventional Dissent from Within:
Key Role of Market Failure or Distortions

Returning to Free Trade:
Fixing Domestic Distortions Directly

Tackling External Distortions:
Restoring Free Trade Differently

Theory of Directly Unproductive Profit-Seeking Activities:
Reinforcing the Case for Free Trade

Free Trade and Growth

The merit of free trade was discovered and disclosed by Adam Smith in his monumental work *The Wealth of Nations* (though, as with Newton and Leibniz on calculus, we must recognize the remarkable work of Abbé de Condillac, whose essay *Commerce and Government* was published in the same year as *The Wealth of Nations* and is a far more elegant and sharp statement of this case).[1] The rationale for free trade is thus over two centuries old. Building his case on the gains from trade to be had from specialization reflecting the division of labor, Smith had the essence of the argument right. But it was left to David Ricardo (building on James Mill) to clinch the case formally. Ricardo used a stripped-down model—only one factor of production with constant productivity of

[1] *Commerce and Government* is now available in a splendid translation by the historian Shelagh Eltis. Cf. Etienne Bonnot, abbé de Condillac, *Commerce and Government,* with introduction by Shelagh and Walter Eltis (Cheltenham, U.K.: Edward Elgar, 1997). Interestingly, Condillac was also a philosopher of the French Enlightenment.

The contrasting styles of Adam Smith and Abbé de Condillac remind one of Marshall set against Walras. Thus, for instance, as the vast scholarship on Smith has variously demonstrated, his more discursive style and work sets out several "practical" exceptions to the case for free trade, and to the larger case for laissez-faire. See, for instance, Jacob Viner's essay "Adam Smith and Laissez Faire," reprinted in his *Essays on the Intellectual History of Economics,* ed. Douglas Irwin (Princeton: Princeton University Press, 1991), 85–113.

labor in two goods, but with relative productivity between the goods different across two countries—to show that both countries could gain from trade via specialization.[2] The Ricardian analysis implied that this "technical possibility" of gaining from trade would be realized if a policy of free trade were adopted in an institutional setting where prices guided resource allocation. But the analytically satisfactory proofs of trade's benefits that we modern economists demand are the handiwork of theorists working in the twentieth century.[3]

[2] Thus, I have argued since my "Survey of the Pure Theory of International Trade," *Economic Journal* 74 (1964): 1–26, that the interpretation of the Ricardian analysis, not in normative terms, but as a positive theory of comparative advantage explaining the pattern of trade, is not meaningful if one reads Ricardo in the original and sees that, when it came to positive analysis, he and other classical economists deployed a more complex and fuller-bodied model as in their analysis of the approach of the stationary state. Yet, of course, that is how many trade economists continue to this day to interpret it.

[3] In particular, after the early work of Paul Samuelson in 1939, he and Murray Kemp took important steps in mid-1950s towards demonstrating that free trade was Pareto-superior to autarky in static analysis. Cf. Paul Samuelson, "The Gains from International Trade Once Again," *Economic Journal* 72 (1962): 820–29; and Murray Kemp, "The Gains from International Trade," *Economic Journal* 72 (1972): 803–19.

The complete proof of the static gains from trade was finally provided by Jean Michel Grandmont and Daniel McFadden, "A Technical Note on Classical Gains from Trade," *Journal of International Economics* 2 (1972): 109–25. The extension of the case for free trade in an intertemporal setting owes to several authors, chief among them Torsten Persson and Alan Stockman, Avinash Dixit and Paul Samuelson. Questions relating to trade, growth, and welfare raise a separate set of issues that are touched upon later in this lecture.

Why Free Trade Fails to Persuade

But if the heuristically quite persuasive (and for its time even scientifically compelling) Smith-Ricardo demonstration of the gains from trade via specialization and the associated case for free trade was to win approval from a majority of economists in nearly every generation since the publication of *The Wealth of Nations*, it is also a fact that it has only infrequently carried credibility with the populace at large. Why?

Part of the reason has to do with the counterintuitive nature of the argument that free trade leads to greater good. When asked by the mathematician Stanislaw Ulam (the brother of the great historian Adam Ulam) which proposition in the social sciences was the most counterintuitive yet compelling, Paul Samuelson chose the law of comparative advantage: in other words, the underlying argument for free trade. Most people think it intuitively sound that you should do most things that you do better than others, not specialize. Then again, they seem to attach an infinite weight to jobs that they lose to trade and zero weight to jobs that are created and which they might obtain, in an optical illusion that reflects the way some experimental psychologists think we think when confronted with change.

Today, however, free trade is the target of a growing anticapitalist and antiglobalization agitation among the young that derives from what I like to call the *tyranny of the missing alternative*. The collapse of communism, the ideological system that rivaled capitalism, and the rise of Fukuyama-led triumphalism about markets and capitalism[4] have created

[4] Cf. Francis Fukuyama, *The Last Man* (New York: Free Press, 1990).

an intolerable void among the idealist young whose social conscience is attuned to the conviction that capitalism is a source of injustice. They do not see that capitalism can destroy privilege and open up economic opportunity to the many. I wonder how many of them are aware that Mrs. Thatcher was a grocer's daughter and that, with all her failings, her leadership of the Conservative Party saw the rise to high levels of many who had, not a BBC accent or an inherited title, but simply merit. How many understand that socialist planning in countries like India, aimed at replacing markets with quantitative allocations, often accentuated, instead of reducing, unequal access because the latter meant queues that the well-connected and well-endowed could jump with their moneys, whereas the former allowed a larger number to get to the desired targets?[5] The untutored conviction that markets and capitalism are to be equated with social injustice has fueled the frustration that spills over into the street theater staged against free trade and its principal institution, the World Trade Organization.

Then again, many students in literature and sociology in the English-speaking world on both sides of the Atlantic have been captivated and captured by the poststructural deconstructionism associated with the French philosopher

[5] This paradoxical conclusion was reached by me and Padma Desai in our book *India: Planning for Industrialization* (Oxford: Oxford University Press, 1970) in the OECD project directed by Ian Little, Tibor Scitovsky, and Maurice Scott. This conclusion has been reached also by many other empirical analysts of trade and industrialization policies in the developing countries.

Jacques Derrida, leaving many among them, principally because of its advocacy of an "endless horizon of meanings," without any anchor. As Terry Eagleton, the sympathetic chronicler of modern developments in literary theory, has said eloquently:[6] "Derrida is clearly out to do more than develop new techniques of reading: deconstruction is for him an ultimately *political* practice, an attempt to dismantle the logic by which a particular system of thought, and behind that a whole system of political structures and social institutions, maintains its force." By deconstructing any political ideology, the Derridean technique can lay before itself a political wasteland where belief and action yield to cynicism and anarchism. This leads equally to the paradox that a highly intellectual theory feeds anti-intellectual attitudes, including a distrust of, and hostility to, economic expertise and the "elitism" of economists.

Permit me to tell just three anecdotes to illustrate what I mean. In a debate at the Smithsonian Institute in Washington, D.C., that I had with Lori Wallach, an architect of the Seattle protests and Ralph Nader's chief aide on trade issues, she argued that my expertise on trade entitled me to no more attention by the GATT (General Agreement on Tariffs and Trade) or the WTO than she demanded for herself.

I must also recall that Sylvia Nasar, the former *New York Times* economics reporter, once told me that students in her class at the Columbia School of Journalism had told her that "Bhagwati stands for special interests as much as the unions

[6] Terry Eagleton, *Literary Theory: An Introduction* (Oxford: Basil Blackwell, 1983), 148.

do; he speaks for free trade and for the GATT." In short, we economists may profess expertise; but we really serve masters and interests that can be deconstructed from our arguments and advocacy.

Then again, I should retell the amusing story of how militant students at Heidelberg during the years of the Vietnam War declared that expertise was the enemy of genuine democracy and argued that democracy therefore required that professors teach courses that they knew nothing about, so that they and the students could start with equal ignorance, and hence without unequal power, on their journey towards knowledge. I must confess that I would have opted for this brilliant suggestion. It would mean that I would not have to exert myself to harness my knowledge to lecture to my students, so that I would be on perpetual sabbatical, something that some of my tenured colleagues (who must naturally remain unnamed) have been enjoying for years without the benefit of the Heidelberg doctrine!

But let me say also that the case for free trade in the public domain has suffered from neglect because few of us have been prepared to enter the fray in its defense. Faced with the critics of free trade, economists have generally reacted with contempt and indifference, refusing to get into the public arena to engage the critics in battle. I was in a public debate with Ralph Nader on the campus of Cornell University a couple of years ago. The debate was in the evening, and in the afternoon I gave a technical talk on free trade to the graduate students of economics. I asked, at its end, how many were going to the debate, and not one hand went up. Why, I asked. The typical reaction was: why waste one's time? As a consequence, of the nearly thousand students who jammed the theater where the debate was held, the vast majority were anti–free traders, all rooting for Mr. Nader. I managed pretty well, but I must confess that the episode brought home to me that unless we confront these misguided critics, the public-policy stage will be occupied solely by the critics of free trade, and then politicians cannot be blamed for having to listen and attend to the chorus of free trade's critics.

This task of ceaselessly defending our scientific findings in favor of free trade (and indeed of other economic wisdom) is an obligation that I teach tirelessly to my students, not just in emulation of their teacher, but in exercise of their own talents and conscience. Thus, among them, I must cite in particular the distinguished writings in the media of Paul Krugman (my remarkable MIT student) and Douglas Irwin (my gifted Columbia student).[7] But that is still not an army

[7] Among the friends and coauthors who write frequently on trade policy are Arvind Panagariya of Maryland, T. N. Srinivasan of Yale, Dani Rodrik of the Kennedy School, Harvard, and Robert Baldwin of Wisconsin, all world-class trade economists. After the Seattle debacle in late 2000, I and other international trade economists felt the need to start an ongoing group of trade scholars at universities that would enter the policy scene with policy briefs and multisignature statements on important policy issues of the day. Such a group, ACIT (the Academic Consortium on International Trade), has now been formed and is housed at the University of Michigan under the active leadership of the distinguished trade economists Robert Stern and Alan Deardorff. Its first piece of activism was the issuance of a letter to presidents of U.S. colleges and universities on the issues raised by the campus activism against sweatshops regarding the

that, unlike Russell Crowe in the film *Gladiator* with his Roman legions, I can "command" and that we need.

When I was at Seattle and facing a tough Chinese Red Guards–style female demonstrator who was blocking my way illegally down a road and threatening me with bodily harm if I persisted, my good friend Gary Sampson (a distinguished trade economist, formerly of the GATT and WTO) drew me away from a confrontation that would have surely left me bloodied, saying, "You are the foremost free trader today; we cannot afford to lose you!" It was meant to be funny, and it was. But it also was a pointed reference that there were not too many of us out there, fighting the fight for free trade. We need to change that.

I would be remiss, however, if I do not also record here the *fallacy of aggregation* that has made large segments of the public today gratuitously more skeptical of free trade worldwide thanks illogically to the dramatic recent financial crises in the world economy. For reasons that are difficult to fathom, the antiglobalization agitationists seem to think that globalization is some sort of gigantic blob of a concept or phenomenon where every element necessarily implies every other and that if you are for free trade, you must also be for free short-term capital flows, for free direct foreign investment, for free immigration, for free love, for free whatever![8]

---

suppliers of apparel to these academic institutions, arguing that the presidents were often succumbing to agitationist demands without informed analysis of the issues involved.

[8] I have dealt with the fallacy of aggregation and a number of other fallacies that feed today's antiglobalization rhetoric and agitation in my

So, if the imprudently hasty and unregulated freeing of financial flows helped create the panic-fed Asian financial crisis, then somehow that is also a reason to dread and to oppose freer trade. Indeed, *any* substantial international financial crisis, in this way of seeing things, is an argument against freer trade. Thus, the American critics of NAFTA (North American Free Trade Agreement) have pointed to the November 1994 peso crisis as justifying their hostility to NAFTA. Similarly, I have been surprised that even sophisticated economists who are distrustful of globalization, such as Dani Rodrik of Harvard, have occasionally argued as if the need to fix the world financial system because of recurring financial crises implies also that the world trade system needs to be fixed.[9]

Conventional Dissent from Within: Key Role of Market Failure or Distortions

But it would be a big mistake to think that the case for free trade has been assailed by doubts only from outside the sanctum. Indeed, from Adam Smith's time, major economists have abandoned the cause of free trade, reflecting in-

review-essay "Globalization in Your Face," *Foreign Affairs* 79, no. 4 (2000): 134–39.

[9] Cf. Dani Rodrik, "The Global Fix," *New Republic,* November 2, 1998; and my letter to the editor, critiquing the article, on December 14, 1998. The letter has been reprinted in my book of essays on public policy, *The Wind of the Hundred Days: How Washington Mismanaged Globalization* (Cambridge: MIT Press, 2001).

tellectual developments that often interacted with, and at times were even triggered by, the economic events and concerns of the time. In fact, it is remarkable that the cry of a "crisis" in free trade has been raised over the last two centuries by economists as diverse and renowned as John Maynard Keynes (who led the critics) and John Hicks (who lamented the crisis instead).

In each of these instances, which I shall proceed presently to review, the key element causing the crisis for free trade was the presence of a "market failure" or what, following my work and terminology introduced in the 1960s, is also characterized as the presence of a "distortion."

Heuristically, the argument is best seen as follows. The case for free trade rests on the extension to an open economy of the case for market-determined allocation of resources. If market prices reflect "true" or social costs, then clearly Adam Smith's invisible hand can be trusted to guide us to efficiency; and free trade can correspondingly be shown to be the optimal way to choose trade (and associated domestic production). But if markets do not work well, or are absent or incomplete, then the invisible hand may point in the wrong direction: free trade cannot then be asserted to be the best policy. Theoretically, this leads to the first of two key insights or propositions of the postwar theory of commercial policy.[10]

[10] This proposition owes, in my view, to Gottfried Haberler's article "Some Problems in the Pure Theory of International Trade," *Economic Journal* 60 (1950): 223–40, where he considered distortions such as sticky real wages and argued that free trade could worsen welfare. He did not

PROPOSITION 1

In the presence of market failure (i.e., distortion), free trade is not necessarily the best policy.

One (in my view, unimportant) implication is that, since free trade equilibrium in such a distorted economy is clearly suboptimal, an infinitesimal tariff would generally improve welfare, thus yielding a "second-best" argument for protection.

The other implication, of course, is that one can generate, by postulating a yet different market failure, an endless number of cases where freeing trade from an arbitrarily given level of protection is harmful rather than helpful, immiserizing rather than enriching.

This latter implication is, in fact, key to understanding the occasional crises in the case for free trade that plagued the profession over two centuries of economic thought and policy analysis.

---

draw the conclusion as sharply and as a generic problem for free trade under distortions as I do above; but it certainly stimulated my own thinking in this direction when I read the paper as a student at Cambridge.

The other proposition, which is the key and most important insight of the postwar theory of commercial policy in my view and that of most other trade theorists as well, is that if another policy is deployed to offset the market failure, the case for free trade gets restored. As I say below, in the next section, this is obvious once you see it; but the fact is that for over 150 years, no one really saw it that way and that the insight, when developed first in "Domestic Distortions, Tariffs, and the Theory of Optimal Subsidy," the paper that I and V. K. Ramaswami published in the *Journal of Political Economy* 71 (1963): 44–50, revolutionized the way we have thought about free trade ever since.

Market Failures or Distortions from the 1840s

Let me now give you an eye-scan of the main such market-failure-centered crises or challenges to the doctrine of free trade.

But, in doing so, let me also clarify one central point that will otherwise escape economists not exposed to the modern theory of commercial policy. This is that, when we speak of free trade from the viewpoint of *nationa*l advantage, distortion will characterize the economy even when there is no domestic market failure but the economy enjoys monopoly power *in trade* (i.e., its terms of trade depend on its volume of trade) even while its producers are atomistic and competitive.[11]

This is because the true social cost of unit imports is no longer measured by the average world prices that free trade transposes to your domestic producers for their allocation decisions; it is instead the marginal world prices. Under free trade, such a "large" country (i.e.. one that can influence its terms of trade) will then trade too much, and the case arises for an optimal tariff.

As it happens, this is the oldest case against free trade and goes back to Torrens in 1844;[12] and it played a role in the

[11] General nontrade theorists are used to thinking entirely in terms of Pareto-optimality of a competitive system, and this corresponds to talking about cosmopolitan advantage or worldwide efficiency in the theory of commercial policy. In *that* context, there is no distortion if a country has (unexercised) monopoly power. Distortions or market failures therefore cannot be defined except by reference to what your problem is.

[12] Cf. Robert Torrens, *The Budget: On Commercial and Colonial Policy* (London: Smith, Elder, 1848).

parliamentary debates at the time that Prime Minister Peel repealed England's Corn Laws to introduce (unilateral) free trade in England in 1848. As we shall see, the 1980s literature on trade policy under imperfect product markets has an affinity to this early example of free trade's suboptimality and hence inappropriateness relative to an optimal tariff because of what can be properly called a distortion or market failure in a country's "external" market(s).

The other classic exception to the case for free trade also relies on market failure. This is the case for an infant industry tariff that John Stuart Mill made in 1848 in one simple but elegant paragraph that is sufficiently carefully phrased to pass our scrutiny even today.[13] One can fit a number of possible failures in "domestic" producer or labor markets into this hat; though the ease with which infant industry protection has been invoked for protectionist purposes in reality has given some credence to the fearful prophecy of Corn Law League activist for free trade, Richard Cobden, that this one paragraph of Mill would do more damage than all the good done by his many writings on political economy![14]

We must jump three-quarters of a century to get the next important analytical challenge to free trade, but one that was more frontal and with yet more political salience. It came with the onset of the Great Depression. In his lecture on *Free Trade and Modern Economics* in 1951 to the Manchester

[13] Cf. John Stuart Mill, *Principles of Political Economy* (London: Longmans, Green, 1848).

[14] Cf. Quoted by Douglas Irwin, *Against the Tide: An Intellectual History of Free Trade* (Princeton: Princeton University Press, 1995), 128–29.

Statistical Society, John Hicks recounted how the unemployment of these years had seriously undermined the belief in free trade:[15]

> The main thing which caused so much liberal opinion in England to lose its faith in free trade was the helplessness of older liberalism in the face of massive unemployment, and the possibility of using import restriction as an element in an active programme fighting unemployment. One is, of course, obliged to associate this line of thought with the name of Keynes. It was this, almost alone, which led Keynes to abandon his early belief in Free Trade.

As it happens, Keynes's eventual breaking of ranks with free traders in Britain had been hinted at in 1930 in *A Treatise on Money* and also in his evidence before the Macmillan committee in February 1930, where he offered the view that tariffs, while unwise as a long-term policy, could immediately help fight the slump. This view became more pronounced through 1931, culminating in Keynes's celebrated controversy with Lionel Robbins and a riposte to Keynes's apostasy by Robbins, Hicks, and others in 1932 in *Tariffs: The Case Examined.*[16]

The Keynesian warming to protection in times of unemployment due to deficiency of aggregate demand evidently

[15] Cf. John R. Hicks, *Essays in World Economics* (Oxford: Clarendon Press, 1959), 48.

[16] Cf. J. M. Keynes, *A Treatise on Money* (London: Macmillan, 1931); and W. Beveridge, ed., *Tariffs: The Case Examined* (New York: Longmans, Green, 1932). See also the discussion of Keynes's views in Irwin, *Against*

derived from the notion that tariffs could divert aggregate demand from foreign to domestic goods. But from the viewpoint that I am setting forth here about the role of market failures in undermining the case for free trade, it is equally possible for us to see that since the social cost of labor in a situation of massive unemployment is clearly less than its (market) wage,[17] this is a market failure, and free trade is no longer a compelling policy. That the optimal policy mix would still be to remove that market failure by creating sufficiently more aggregate demand, instead of diverting a given aggregate demand towards yourself, and then holding on to free trade, is a matter that I shall turn to in the context of proposition 2 in the next section.

While the 1930s witnessed therefore the Keynesian defection from free trade, and its importance in providing intellectual support for the outbreak of competitive raising of trade barriers (and currency depreciations) should not be underestimated, these years also saw the emergence of a threat to free trade from an altogether different direction. It came, not from economic circumstance as had the Keynesian case for protection from the huge slump, but entirely from autonomous theoretical progress: and that too in a curiously tangential way.

As the 1920s ended, Edward Chamberlin in 1929 and Joan Robinson in 1931 independently came up with important

the Tide; and Barry Eichengreen, "Keynes and Protection," *Journal of Economic History* 44 (1984): 363–73.

[17] Keynesian unemployment is attributable to a sticky market wage such that it does not fall and increase hiring to the level of full employment.

theoretical analysis of imperfect competition, opening up to systematic exploration the middle ground between perfect competition and pure monopoly.[18] The result was to undermine the notion that market prices reflected social costs, calling into question more widely the virtue of laissez-faire and more narrowly the case for free trade. As Hicks observed in his 1951 lecture:[19]

> the Monopoly-Competition argument . . . is of much less practical importance than the others [e.g. the Keynesian one], but it deserves at least a passing mention, because of the undoubted influence which it undoubtedly exercises—in a negative sort of way—upon the minds of economics students. . . . If apparent costs only equal true costs under conditions of perfect competition and competition is hardly ever perfect, the bottom seems to drop out of the Free Trade argument. This is in fact a fair description of the state of mind which quite a number of economics students seem to have reached.

Two observations are in order for now. First, you will have noticed that what Hicks calls the "Monopoly-Competition argument" is little more and nothing less than the argument

[18] Cf. Edward Chamberlin, *The Theory of Monopolistic Competition* (Cambridge: Harvard University Press, 1929); and Joan Robinson, *The Economics of Imperfect Competition* (London: Macmillan, 1931).

[19] Hicks, *Essays in World Economics,* 46. He also remarks, "Free Trade is no longer accepted by economists, even as an ideal, in the way it used to be . . . the preponderance of economic opinion is no longer so certainly as it was on the Free Trade side" (41–42). Evidently, he is writing about English economists and economics students.

that imperfect competition in *product* markets can destroy the presumption that market prices will reflect social costs. But this is precisely the argument that emerged in the 1980s (a period I will address below) in the work of brilliant young trade theorists such as James Brander, Barbara Spencer, Paul Krugman, Elhanan Helpman, Avinash Dixit, Gene Grossman, and Jonathan Eaton. But whereas Hicks recorded how the reaction against free trade was essentially nihilistic because, as Hicks observed in the preface to *Value and Capital*, there was (despite the Chamberlin-Robinson revolution) no theoretically adequate way to deal with imperfect competition at the time, this was not so during the 1980s. In that latter period, the trade theorists could draw on the recent developments in the theory of industrial organization to fill out better the space between perfect competition and pure monopoly, so one could go beyond nihilism to say how precisely, if at all, free trade would have to be departed from under different types of imperfections (e.g., the small-group case of oligopoly versus the large-group case on which Chamberlin had made true progress).

Second, while Hicks (writing in 1951) was right to say that the argument had no political salience in the 1930s and later, this was not the case in the 1980s. The rise of Japan, the "diminished-giant syndrome" in the United States (hard to recollect now that the United States has emerged as what the French like to call a hyperpower),[20] the growth of compe-

[20] This term was introduced by me at the time and discussed especially in *Protectionism* (Cambridge: MIT Press, 1988). Some have called this syndrome *declinism*. See also my articles on the subject, reprinted in *A Stream of Windows: Unsettling Reflections on Trade, Immigration, and Democracy* (Cambridge: MIT Press, 1998).

tition among large firms producing differentiated products, and the conviction that Japan was not playing by rules of free trade, had all provided the necessary conditions for the monopoly-competition argument to have a public audience this time around!

The role of market failure or distortions in creating skepticism towards free trade within the economic profession took yet a different form after the Second World War. The newly independent developing countries were determined to use the "infant industry" argument of John Stuart Mill to push ahead with industrialization under an import substitution strategy.

Equally, they considered such industrialization to be essential for developing a modern society, expressing therefore what the theorists of commercial policy have come to call from the 1960s a "noneconomic objective." This would trigger a different kind of commercial-policy literature, one that asked what kinds of departures from free trade would *minimize* the cost of achieving such an objective.[21]

But this case for infant industry protection was strongly reinforced by the prevailing view that the developing countries were marked by a number of *factor* market imperfections (some of which were in fact cited as the underlying

[21] This literature has a heuristically "dual" relationship to the literature that I cite and use under the rubric of proposition 2 below, as noted in my article "Generalized Theory of Distortions and Welfare" in *Trade, Balance of Payments, and Growth: Essays in Honor of Charles P. Kindleberger,* ed. by Bhagwati, Ronald Jones, Robert Mundell, and Jaroslav Vanek (Amsterdam: North Holland, 1970).

reasons for infant industry protection of new manufactures). These distortions in the factor markets fell into three broad groups: a distorting wage differential between rural and urban sectors despite flexible wages; identical wages across sectors but a generalized sticky wage; and a sticky or minimum wage in one sector but flexible wages that could then endogenously lead to a wage differential between sectors.

In all these cases, it was clear that market prices would then diverge from social costs, thus raising new arguments for protection. In fact, in his 1958 article, Everett Hagen developed a case for protecting manufactures precisely because a distorting wage differential operated to raise inefficiently the cost of labor to manufacturers.[22] So did the argument of Gottfried Haberler that sticky wages could lead to real income loss from resulting unemployment under free trade that could outweigh the gains from trade.[23]

The final revolt against free trade from within would emerge in the 1980s, prompted (you may recall) by the in-

[22] This is the so-called Manoelesco argument for protection in developing countries. In fact, the Bhagwati-Ramaswami paper "Domestic Distortions," which led to proposition 2 below and revolutionized the theory of commercial policy, owed directly to the argument of the Hagen paper and of the 1950 Haberler paper, "Some Problems."

[23] Haberler, "Some Problems." The important theoretical papers by Richard Brecher on generalized sticky wages in an open economy are an outgrowth of the analysis initiated by Haberler. Cf. Richard Brecher, "Minimum Wage Rates and the Pure Theory of International Trade," *Quarterly Journal of Economics* 88, no. 1 (1974): 98–116; and "Optimum Commercial Policy for a Minimum Wage Economy," *Journal of International Economics* 4 (May 1974): 139–50.

tense competition felt by the United States from Japan and the fear that the U.S. hegemony was yielding to a Pacific one. Thus, while the 1980s shared with the 1950s through 1970s the distinction of having the theory of free trade extended into an analysis of the consequences of imperfect competition, there was one dramatic difference. Where the earlier period had been concerned with *factor* market imperfections, the latter period was concerned with *product* market imperfections. The former had fed protectionism in the developing countries; the latter would do so in the developed countries.

From the viewpoint of the positive theory of international trade, the "new" theory of imperfect competition that took center stage was evidently a major conceptual advance. But in the long view of the market failures that I have outlined and particularly in the perspective of the 1930s challenge from the monopoly-competition argument, the 1980s challenge to the theory of free trade was fairly conventional.

But in the public-policy arena, the 1980s challenge was seen as novel because the implication of the "new" theory for free trade was presented, not as an old insight that was now refined (in terms of policy implications for the nature of departure from free trade that was called for, these implications now drawn elegantly by exploiting the latest advances in the theory of industrial organization that were not available earlier), but as a radical new insight into, and as a powerful and unprecedented dent, in the case for free trade.

In fact, Paul Krugman, in his youthful surrender to irrational exuberance, went so far as to propagate the view that, in light of these new developments, it was not possible now to oppose protectionism on theoretical grounds, that free trade was passé, and that the case for it was now reduced to one of empirical judgment.[24] Of course, this contention, which appeared like a confirmation of what protectionists had always suspected, had an electrifying effect on them; but, as is evident, it was not credible, as you will immediately appreciate if your mind has not been wandering during this lecture!

Besides, every economic policy has to reflect empirical judgment. That judgment relates essentially to deciding which theoretical model is applicable to the problem at hand (and then also choosing the correct parameters to feed into the selected model). Of the numerous market failures that I have touched upon, you would have to decide which are pertinent and which might be considered to be theoretical *curiosa.* Thus, the objection raised by Torrens to Peel's repeal of the Corn Laws on the ground that Britain had sufficient monopoly power in trade to require a positive optimal tariff was obviously a theoretical objection; but it was being applied to the British context of that time. Today, the weight of the evidence seems to have settled in favor of Peel's position, with Douglas Irwin having argued convincingly (against Donald McCloskey's view) that Britain possessed significantly less monopoly power than McCloskey had presumed.[25]

[24] Cf. Paul Krugman, "Is Free Trade Passé?" *Journal of Economic Perspectives* 1 (1987): 131–44. Also see my earlier critique in "Is Free Trade Passé after All?" chapter 1 in my *Political Economy and International Economics,* ed. Douglas Irwin (Cambridge: MIT Press, 1991).

[25] Cf. Donald McCloskey, "Magnanimous Albion: Free Trade and British National Income, 1841–1881," *Explorations in Economic History* 17 (1980): 303–20; and Douglas Irwin, "Welfare Effects of British Free Trade: Debate and Evidence from the 1840s," *Journal of Political Economy* 96

Immiserizing Growth

In conclusion of this line of over 150 years of detractions from the case for free trade since Adam Smith's time, starting from Torrens and Mill, all centering on market failures or distortions of one kind or another, let me suggest yet another way in which theorists can understand why a distortion in place will undermine the case for free trade.

This has to do with the theory of *immiserizing growth*. In 1958, I published in the *Review of Economic Studies* what fortuitously turned out to be an influential paper showing that growth in an open economy with monopoly power in trade could immiserize it.[26] The key was that the primary gain from growth could be more than offset by the induced loss from a deterioration in the terms of trade. I established also the conditions under which this could happen. The paper was politically salient because the developing countries, you will recall, were bent on an import substitution strategy and thought that my theoretical analysis gave them the underpinnings for their prescription.

In fact, it did. Because this paradox arose in a country practicing free trade when the postulated monopoly power in trade required instead an optimal tariff policy, the growth

(December 1988): 1142–64. The optimal tariff calculated by Irwin here is lower than what McCloskey had estimated; and Irwin also argues that the demonstration of British gains from freeing trade may have also reduced foreign tariffs, a general question that I take up in the last lecture.

[26] J. Bhagwati, "Immiserizing Growth: A Geometric Note," *Review of Economic Studies* 25 (1958): 201–5.

(through technical change or capital accumulation) was occurring in the presence of a distortion, that is, market failure. Presented with yet another case of immiserizing growth produced by Harry Johnson in the *Economic Journal* in 1967 where growth subject to a distorting tariff in a small country with no monopoly power led to immiseration,[27] I realized instantly, and wrote a sequel paper in the *Review of Economic Studies* in 1968, that the source of the paradox of immiserizing growth was the distortion.[28] The primary gain from growth, measured at optimal policies, was being overwhelmed by accentuated loss from the distortion. And to make my argument concrete, I produced added examples of immiserizing growth, using different distortions.

Why do I mention this? Because free trade is tantamount to augmenting your possibility set,[29] compared to autarky and restricted trade for a small country. If so, it is immediately obvious that you can get the kinds of examples of free trade's being inferior to autarky that Hagen and Haberler had produced: they were analytically identical to the para-

[27] H. G. Johnson, "The Possibility of Income Losses from Increased Efficiency or Factor Accumulation in the Presence of Tariffs," *Economic Journal* 77 (1967): 151–54.

[28] J. Bhagwati, "Distortions and Immiserizing Growth: A Generalization," *Review of Economic Studies* 35 (1968): 481–85.

[29] Just think of the free trade Baldwin locus. All this is spelled out, with many important applications and implications, in the chapter on immiserizing growth in the graduate textbook by Bhagwati, Arvind Panagariya, and T. N. Srinivasan, *Lectures on International Trade* (Cambridge: MIT Press, 1999), the second and enlarged edition of the Bhagwati and Srinivasan text.

doxes of immiserizing growth! Does this insight help? I daresay it does. For, there are usually different ways of looking at a result; one appeals to some, another to others. As our proverb goes: to each according to his taste. The Japanese proverb puts it more pungently: some prefer nettles.

Returning to Free Trade: Fixing Domestic Distortions Directly

I must now recall the breakthrough that got us out of this box into which distortions, or market failures, had landed generations of economists espousing free trade. The solution is so simple that it is hard to see its importance and why the paper that I wrote (jointly with the late V. K. Ramaswami) in 1963 in the *Journal of Political Economy* stating it has turned out to influence all subsequent contributions to the theory of commercial policy.[30]

Coming from both Haberler and Hagen, we saw in a flash that free trade could not be declared the necessarily best policy for a small country (or even a better policy than autarky for any country, small or large) in the presence of a distortion. But we also realized, as no one had pointedly

[30] See, for instance, Arvind Panagariya, "Bhagwati and Ramaswami: Why It *Is* a Classic," University of Maryland, 1999, typescript; Douglas Irwin, "Profile: Jagdish Bhagwati," *Review of International Economics,* 1997; and contributions by T. N. Srinivasan and by Paul Krugman in *The Political Economy of Trade: Essays in Honor of Jagdish Bhagwati,* ed. Robert Feenstra, Gene Grossman, and Douglas Irwin (Cambridge: MIT Press, 1995).

done earlier, that if a suitable policy was addressed to offsetting that distortion, then we could get back to endorsing free trade.

Of course, if the distortion was in domestic markets, that meant that a domestic policy, suitably designed and targeted to offsetting that distortion, could be combined with free trade to produce the best outcome. If, however, the distortion or market failure occurred in external markets, then the suitable policy to offset it would involve trade (tariff and subsidy) policy, and free trade, ipso facto, could not be maintained in the optimal equilibrium.

What the Bhagwati-Ramaswami analysis did, then, was to eliminate the earlier, nihilistic loss of faith in free trade in the presence of market failure. Arguing that free trade could be maintained as the best policy when used in conjunction with a domestic policy addressed to the domestic distortion, the Bhagwati-Ramaswami analysis narrowed hugely the use of protection to the case(s) where the distortion occurred in the foreign or external markets.[31] So let me formulate the second, more important proposition of the postwar theory of commercial policy.

[31] I omit other important legacies of the Bhagwati-Ramaswami article, such as the rank-ordering of different policies in the presence of distortions, which have now become the standard toolkit of all trade theorists. An important follow-up was my 1970 article "Generalized Theory of Distortions and Welfare," where the vast theoretical literature on optimal and second-best interventions under a variety of distortions that followed the 1963 Bhagwati-Ramaswami article was synthesized and a set of propositions in the generalized theory of distortions and welfare in an open economy was formulated. T. N. Srinivasan's important article in Feenstra,

PROPOSITION 2

(1) Where the distortion is domestic, a domestic (tax-cum-subsidy) policy targeting it will be appropriate, and free trade can then be restored as the suitable first-best trade policy; and (2) Where the distortion is external, free trade must be departed from as part of the suitable first-best trade policy addressed to that distortion.

Yet another way in which one can view proposition 2 insightfully is in terms of the theory of economic policy. This theory says that, generally speaking, you need as many instruments as you have targets. This is best explained to the public at large by invoking the ancient proverb, which is possibly to be found in every culture, "You cannot kill two birds with one stone." Generally, you need two stones to kill two birds unless you have inhuman strength, the birds happen to get on to one trajectory from your position, and providence grants you good luck. If you have a domestic distortion, this requires that it be addressed by a domestic policy; and maximizing the gains from trade requires free trade. Thus, in the Hagen-Manoelesco case of a distorting wage differential where Hagen had argued for protection, Bhagwati and Ramaswami showed that the first-best policy consisted of a wage tax–cum-subsidy plus free trade. If a producer-market distortion occurred through uncompensated production externality, the first-best policy would be a production tax–cum-subsidy plus free trade.

Grossman, and Irwin, *Political Economy of Trade,* does the same for the vast literature on the theory of commercial policy since the early 1970s.

Tackling External Distortions: Restoring Free Trade Differently

The case for free trade was thus released in a significant way from the stranglehold that market failure had put on it over two centuries! This was victory enough, but it was not a total victory.

For where the nation-state had monopoly power in trade (the Torrens argument) or the firms had it (as in the 1930s monopoly-competition argument and in the 1980s imperfect competition argument), the distortion was in the external markets, and then the use of trade tariffs (and subsidies) remained theoretically part of the appropriate first-best policy intervention. So how would one deal with that? In fact, this problem was endemic to the question raised by the presence of imperfect competition in product markets: this *necessarily* created a distortion in the external market.

The Bhagwati-Ramaswami revolution furnished no help in this class of distortions. What would one do to resurrect the policy of free trade in this case? The answer lay in precisely the reaction to the monopoly-competition argument of the 1930s. Two lines of response had been made to this argument: both at a more general level of the efficiency of market allocations and hence the Pareto-optimality of the competitive system rather than the specifics of free trade.

The *first* is what might be called the Chicago School response. If the naked eye perceived imperfect competition, Chicago asked whether that was a significant enough imperfection. Was there not "as if" competition if you only looked at the matter carefully, econometrically testing for the hypothesis that the industry was as if competitive? If, therefore, in current conceptualization, markets were contestable, the presumed monopoly power and imperfect competition were not matters to worry about for policymaking. So econometrics became the handmaiden to slaying the doubts raised by the casual empiricism of the naked eye.[32] In terms of American slang, where one asks where the beef is in the hamburger, the question is, where's the beef? As it happens, the younger trade theorists of imperfect competition in product markets, such as Avinash Dixit and Gene Grossman,[33] came back to the fold of free trade precisely on the ground that the gains to be had from pursuing a policy of optimal departures from free trade in selected industries characterized by imperfect competition were not large enough to justify intervention.[34]

[32] So, I have argued, in my obituary of Harry Johnson, reprinted in *A Stream of Windows*, that econometrics became important in Chicago in these years. By contrast, mathematical economics, which, at least in the hands of Arrow, Debreu, and others, seemed to probe existence, uniqueness, and stability of the competitive system and thus throw up roadblocks to Adam Smith's otherwise persuasive case, was not so popular.

[33] See, in particular, Avinash Dixit, "International Trade Policy for Oligopolistic Industries," *Economic Journal* 94 (1984): 1–16; Gene Grossman, "Strategic Export Promotion: A Critique," in *Strategic Trade Policy and the New International Economics,* ed. Paul Krugman (Cambridge: MIT Press, 1996); and David Richardson, "Empirical Research on Trade Liberalization with Imperfect Competition: A Survey," *OECD Economic Studies,* spring 1989, 7–50.

[34] There is also an interesting literature justifying the small-country assumption for developing countries econometrically. Cf. James Reidel,

The *second* route back to free trade is more associated with the public choice school than with Chicago: but it is no stranger to Chicago. This response concedes that there is beef here. But it contends that intervention to take advantage of it may, indeed (in the more fashionable stronger version) will, make matters worse. In short, the invisible hand may be frail, but the visible hand is crippled.

This response has been embraced by many, including Paul Krugman in his firm retreat back to free trade, but must be regarded as resting on a view of government that may not be shared naturally by everyone. True, when one sees how special interests capture trade (and often other economic) policy, it is easy to understand why those of us who prescribe interventions as if they will always be implemented by politicians who are our puppets doing our bidding in the national interest are making a heroic assumption.[35] On the other hand, one cannot deny that some degree of general interest does affect policy outcomes.[36] So one could well be some-

"The Demand for LDC Exports of Manufactures: Estimates from Hong Kong," *Economic Journal* 98 (1988): 138–48; and Arvind Panagariya, Shekhar Shah, and Deepak Mishra, "Demand Elasticities in International Trade: Are They Really Low?" *Journal of Development Economics* 64, no. 2 (2001): 313–42.

[35] I use the phrasing *puppet government* instead of the *benign government* to describe conventional, politics-free theory of government that is simply assumed to take the economist's advice. This comes from my 1990 essay, "The Theory of Political Economy, Economic Policy, and Foreign Investment," reprinted as chapter 9 in my *Political Economy and International Economics.*

[36] See my more extended discussion of these issues in "Is Free Trade Passé?"

what agnostic on the probability of improving matters through intervention when there *is* beef.

But there is a good alternative argument that things could most likely get worse through trade intervention when there is imperfect competition in external markets: and that proceeds from the possibility of trade retaliation. For the traditional, Torrens variety of optimal tariff in the case of national monopoly power in trade, with firms competitive, it was generally believed, and Tibor Scitovsky underlined, that retaliation would make everyone worse off, and hence it was best to stick to free trade. But then, in a classic paper using the Cournot model of optimum tariff retaliation, Harry Johnson showed that the end result of a tariff war could be to leave the one that first used the optimum tariff still better off than under free trade. And Carlos Rodriguez restored the general presumption in favor of free trade by using optimum trade quotas rather than tariffs: an assumption that is more realistic for the 1930s after the infamous Smoot-Hawley tariff of the United States and the competitive raising of trade barriers worldwide.[37] Evidently, depending on what assumptions you make, it is possible to rescue the possibility that, despite retaliation, the initial use of an optimal tariff by a country with monopoly power in trade will leave it still better off than under free trade. But that reality is not certain,

[37] Cf. Tibor Scitovsky, "A Reconsideration of the Theory of Tariffs," *Review of Economic Studies* 9 (1942): 89–110; Harry Johnson, "Optimum Tariffs and Retaliation," *Review of Economic Studies* 21 (1953–54): 142–53; and Carlos Rodriguez, "The Non-equivalence of Tariffs and Quotas under Retaliation," *Journal of International Economics* 4 (1974): 295–98.

whereas it is surely overwhelmingly likely that even the small "little-beef" gains to be had from the use of trade barriers in the presence of external distortion will shrink further when retaliation takes place.

Theory of Directly Unproductive Profit-Seeking Activities: Reinforcing the Case for Free Trade

Thus, between (1) the theory of domestic distortions and welfare, whose central insights I have shown above to have revolutionized the case for free trade—contrary to those believers who think that little has changed since Adam Smith—and rescued it effectively from the historically countless domestic-distortions-defined detractions, and (2) the theoretical and econometric arguments that have deflated the plausibility of welfare-enhancing protectionist departure from free trade in the presence of varying forms of external monopoly power, we ended the twentieth century with a far firmer case for free trade than the one we inherited at the end of the Second World War.

But at least one more theoretical development of considerable importance has also strengthened that case greatly. It comes from an indirect route. Let me explain. Ever since the Harberger-Johnson estimates of the cost of protection, measured as the deadweight losses (the so-called Harberger triangles) that typically ran at 2–3 percent of GNP, there has been a sense that, even if free trade is the best policy, protection is not anything you need to worry about too much since the cost of it is rather small.

In my 1967 Frank Graham Lecture at Princeton, I rejected such a presumption by arguing several points.[38] First, even 2–3 percent of GNP was not small, and most economic reforms involved similar, or even smaller, shares of GNP. Next, it was important to remember that reforms were usually packaged together and a policy package of small-yielding reforms often added up to a large-yielding policy reform. Besides, dividing the gains from free trade by GNP always made the number look small. Then again, the Harberger-Johnson numbers inevitably depended on parametric assumptions about elasticities within postulated models, but it was easy to encounter realistic models where, as in the developing countries with heavy exchange and trade controls that I was talking about, it was possible to think realistically of larger losses from these protectionist policies. For instance, the lack of accessibility to imported components to repair a machine could hold up output, yielding in that case a huge loss equivalent to that of the entire plant, a situation in which the elasticities would be very different from those postulated in the Harberger-Johnson estimates.[39]

[38] Cf. "The Theory of Commercial Policy: Departures from Unified Exchange Rates," Special Papers in International Economics, No. 8, Princeton University, 1968; reprinted as chapter 1 in my collected essays, *International Economic Theory,* vol. 1, ed. Robert Feenstra (Cambridge: MIT Press, 1983).

[39] These and other ways in which protection could be harmful in a big way were brought home to me from the work that I did in the 1960s with Padma Desai for our book, under a large OECD project on trade and industrialization policies of several semi-industrialized developing coun-

What has happened since I wrote almost four decades ago, objecting to the inevitability of the smallness of the cost of protection and hence the possibility of indifference to trade reforms to bring about free trade, is that trade economists have moved steadily in favor of the view that the Harberger-Johnson estimates need to be revised upwards.[40]

Some of this has had to do with emphasis on freer trade's favorable effects *via* one or more factors such as (1) increased exploitation of economies of scale, (2) enhanced diversity of choice among differentiated goods, (3) what Harvey Leibenstein used to call x-efficiency (i.e., the effect of competition through openness on pressuring firms to upgrade the productivity of their resource use instead of "goofing off"), (4) the demonstrated possibility that trade can be a conduit for know-how that can (as with a public good) be appropriated without acquisition cost, and (5) increased marginal

---

tries, directed by Ian Little, Tibor Scitovsky, and Maurice Scott. Cf. Bhagwati and Desai, *India: Planning for Industrialization.*

[40] See, for instance, the recent articles by Robert Feenstra, "How Costly Is Protectionism?" *Journal of Economic Perspectives* 6 (1992): 159–78, and by Paul Romer, "New Goods, Old Theory, and the Welfare Costs of Trade Restrictions," *Journal of Development Economics* 43 (1994): 5–38, both arguing that the cost of protection is fairly large. Recall also from the text that in countries with import or exchange restrictions, there will be large costs arising from such forms of protectionism because they lead to inflexibilities: a screw may become difficult to import and an entire machine on an assembly line may go out! This idea has recently been formally modeled by Michael Kremer, "The O-Ring Theory of Economic Development," *Quarterly Journal of Economics* 108, no. 3 (1993): 551–75.

efficiency of capital, leading to enhanced productive investment thanks to integration into world markets.[41]

But an important cause of this revisionism in favor of a large cost of protection has lain in the domain of political-economy theory that I have christened the theory of *directly unproductive profit-seeking* (DUP) activities.

Following Anne Krueger's important 1974 *American Economic Review* paper on the rent-seeking society, which basically argued that quotas fetched rents and then led to rent-seeking activity that compounded the cost of protection by leading to wasteful use of resources in chasing rents instead of producing goods and services that would add to national income, I introduced the DUP concept in my own 1980 *Journal of Political Economy* paper, which was both more general and free from some central problems inherent in the rent-seeking conceptualization.

The essence of the argument was that resources were being diverted to earn income in ways that did not produce goods and services. So it was not helpful to confine it to seeking that was triggered by quantitative-restrictions-generated rents. It could be extended readily, and needed to be, to phenomena such as smuggling to make an income by bypassing the legal channels of taxed trade, or to chasing revenues produced by price rather than quantity restrictions (e.g., to tariff-revenue-seeking as well).

[41] This argument has been developed by me, in the context of explaining the East Asian miracle, in "The Miracle That Did Happen: Understanding East Asia in Comparative Perspective," reprinted as chapter 4 in *The Wind of the Hundred Days.*

Besides, one had to distinguish between direct and indirect welfare effects. If a distorting tariff or a quota was in place, then the act of seeking them and the waste of resources used in chasing them was directly or at source harmful, but, because of the distorted suboptimal situation in which it was arising, it could lead indirectly or eventually to a gain of welfare. In other words, adding one distortion to another does not necessarily add to welfare loss, but may subtract from it. Thus, the unproductive profit-seeking activity in question could not be assumed, as proponents of rent-seeking were wont to do, to be necessarily wasteful in its final outcome as against its immediate impact.

Hence, I moved away from the notion of rents (with its connotation of quota-generated windfall profits) as too restrictive and felt that the concept and phrasing should simply refer to unproductive profit-seeking (which could be activities other than chasing rents). I also felt that the concept must explicitly recognize the fact that the waste in question was direct, as indirectly it may add to welfare if it was integrally triggered by policies such as trade barriers that had resulted in a highly distorted economy. The result was the concept and phrase of directly unproductive profit-seeking activities.[42]

[42] I have a series of theoretical papers on these and related issues, among them "Directly-Unproductive Profit-Seeking (DUP) Activities," *Journal of Political Economy* 90 (1982): 988–1002; "DUP Activities and Rent Seeking," *Kyklos* 36 (1983): 634–37; and *The New Palgrave* entry "Directly Unproductive Profit-Seeking (DUP) Activities," reprinted along with my other essays on DUP activities in *Political Economy and International Eco-*

Whether you wish to stick to the narrower concept of rent-seeking or to the broader concept of DUP activities, the fact is that the cost of protection *can* be higher with it than when you measure it Harberger-Johnson style as the deadweight loss from the departure from free trade. Indeed, I believe that this is likely to be so except in very highly distorted economies where resources have a negative shadow price at the margin.[43]

We go, then, to measuring the cost of protection, not just as the deadweight loss from it, but also adding to it the loss from the DUP activities associated with it.

But once we think of DUP activities, we need to distinguish sharply between two main types that have conceptually very different implications for arguments about the added cost of protection:

- *Upstream* DUP activities, which relate to the endogenizing of the tariff or trade quota and hence essen-

nomics. In some of the important papers on the subject, I have also collaborated with T. N. Srinivasan and with Richard Brecher: e.g. Bhagwati and Srinivasan, "Revenue-Seeking: A Generalization of the Theory of Tariffs," *Journal of Political Economy* 88 (1980): 1069–87; and Bhagwati, Brecher, and Srinivasan, "DUP Activities and Economic Theory," reprinted as chapter 7 in *Political Economy and International Economics*.

[43] There *are* instances of such economies, of course. T. N. Srinivasan, Henry Wan Jr., myself, Michael Mussa, and others have written extensively on this subject. Its mirror-image relationship to the phenomenon of immiserizing growth, discussed earlier, has also been extensively remarked upon. See in particular chapter 38 in Bhagwati, Panagariya, and Srinivasan, *Lectures on International Trade*.

tially to the cost of lobbying (or what might be called in the rent-seeking terminology "rent-creating" activity).

- *Downstream* DUP activities (the focus of Krueger's analysis), which relate instead to seeking activities triggered by the given tariff or quota: for example, in the case of tariff revenue, these revenues may be sought by lobbies that expend resources to do so, just as trade quotas are sought by lobbies because of the premiums they fetch.[44]

The upstream DUP activities raise a fundamental conceptual problem: how can the lobbying costs, even when measured properly as positive,[45] be attributed to protection meaningfully when the political process is endogenized to solve for the observed level of protection whose total cost we seek to measure?[46] To argue that the lobbying costs must be added to the conventional cost of observed but politically determined protection is to effectively say: Imagine a politics-free world where the politically determined tariff is imposed without the politics, calculate its cost conventionally (à la Harberger-Johnson), then add the lobbying costs

[44] Induced smuggling, when using resources as it almost always does, would be another instance.

[45] On this question, see my clarifications in "Lobbying and Welfare," *Journal of Public Economics* 14 (1980): 355–63; and "Lobbying, DUP Activities, and Welfare: A Response to Tullock," *Journal of Public Economics* 19 (1982): 335–41.

[46] This question has been extensively addressed in Bhagwati, Brecher, and Srinivasan, "DUP Activities."

implied by the loss of resources expended on the political lobbying that has led to the tariff being what it is. But that lobbying cost is really the cost of the *political process*, and not the cost of the observed protection in any meaningful sense that I can think of![47]

But there is no such conceptual problem with the downstream DUP activities. They will add to the conventional Harberger-Johnson cost of protection (ruling out as improbable in most cases the possibility of the paradox of beneficial DUP activity as discussed above). Whether they are large—Anne Krueger's estimate of their cost for Turkey, looking at the entire Turkish set of licensing restrictions, was of the order of 40 percent of GNP—or small depends on your view of how a specific economic-cum-political regime works. If everyone expects, for example, the rulers' brothers-in-law to get the revenues or the rents, then few will waste resources trying to get them (though, I daresay, some resources will be devoted by a handful of optimistic aspirants to becoming a brother-in-law).[48] And indeed there is now a

[47] One can only say that if somehow the politics of making and opposing tariffs were eliminated by a constitutional amendment mandating free trade, then we would know (for the specific politics built into one's political-economy model) what gains we would have in terms of freed up resources plus the avoided conventional cost of protection. This is true, at best, only for protectorates or colonies.

[48] See, in particular, the important paper by Arye Hillman and John Riley, "Politically Contestable Rents and Transfers," *Economics and Politics* 1 (1989): 17–39.

literature on the subject, getting away from Krueger's "competitive" assumption that a dollar worth of rents will lead to a dollar worth of resource waste. It is likely, in my judgment, that many systems will indeed show a downstream DUP cost that would more than double the deadweight losses of the Harberger-Johnson variety.

Free Trade and Growth

So the case for free trade today has surmounted, in my view, the difficulties that have afflicted it for over a century and a half. But while there is always a tendency to carry one's success too far, I must say that the recent debate over whether free trade (or rather freer trade) will lead to greater *growth* (and not just current welfare) goes also in the direction of adding to the virtues of free trade.

Of course, anyone who knows theory well also knows immediately that the case for free trade, while valid in an intertemporal setting (as argued cogently by Avinash Dixit), does not imply that a country will have a higher growth rate as well. Indeed, in a large variety of models free trade may actually reduce the growth rate or, in steady state, leave it unaffected.

Thus, consider the case where fiscal policy is not an available instrument to set the savings ratio at a desired level but is a function solely of market-determined income distribution. Imagine then a Harrod-Domar growth model where the growth rate depends on two variables: the (average) saving ratio divided by the (marginal) capital-output ratio. Free trade will minimize the latter but may reduce the former, thus lowering the growth rate on balance.[49]

On the other hand, in Robert Solow's neoclassical model of growth of the 1960s, trade policy *cannot* affect, in steady state, the growth rate. But then, as T. N. Srinivasan has emphasized, using the Feldman-Mahalanobis putty-clay model and the Cass-Koopmans model of optimal growth, there are models in which the steady state is not an exogenous constant and therefore they can be used to generate growth effects from choice of trade policy.[50]

So those who assert that free trade will also lead necessarily to greater growth *either* are ignorant of the finer nuances of theory and the vast literature to the contrary on the subject at hand *or* are nonetheless basing their argument on a different premise: that is, that the preponderant evidence on the issue (in the postwar period) suggests that freer trade tends to lead to greater growth after all. In fact, where theory includes several models that can lead in different directions, the policy economist is challenged to choose the model that is most appropriate to the reality she confronts. And I would

[49] See, for instance, the careful analysis by Prasanta Pattanaik, "Trade, Distribution, and Saving," *Journal of International Economics* 4 (1974): 77–82, which formally relates the rate of saving in the conventional two-by-two model to trade policy via income-distributional impact of the trade policy.

[50] See, in particular, T. N. Srinivasan, "Trade Orientation, Trade Liberalization, and Economic Growth," in *Development, Duality, and the International Economic Regime: Essays in Honor of Gustav Ranis,* ed. Gary Saxonhouse and T. N. Srinivasan (Ann Arbor: Michigan University Press, 1999).

argue that, in the present instance, we must choose the approaches that generate favorable outcomes for growth when trade is liberalized.

That, in fact, is the substance of the response by Srinivasan and me to Dani Rodrik's recent critique of us and others (chiefly Bela Balassa, Anne Krueger, and, most recently, Jeffrey Sachs) who have argued for this relationship.[51]

But then one may grow more ambitious and look for yet other good things in life that might follow from free trade. For instance, does free trade also promote democracy? One could argue this proposition by a syllogism: openness to the benefits of trade brings prosperity that, in turn, creates or expands the middle class that then seeks the end of authoritarianism.[52] This would fit well with the experience in South

[51] Since the issues need careful argumentation, it is best to read them directly and at necessary length in Srinivasan and Bhagwati, "Outward-Orientation and Development: Are Revisionists Right?" chapter 1 in *Trade, Development, and Political Economy: Essays in Honour of Anne O. Krueger,* ed. Deepak Lal and Richard Snape (London: Palgrave, 2001). The paper is also on our websites. See also Francisco Rodriguez and Dani Rodrik, "Trade Policy and Economic Growth: A Skeptic's Guide to Cross-National Evidence," NBER Working Paper No.W7081, 1999. Its critique of the Sachs-Warner regression findings is well taken; but we discount both Sachs-Warner and Rodriguez-Rodrik types of cross-country regressions as inappropriate to a meaningful analysis of the complex questions involved. See Jeffrey Sachs and Aaron Warner, "Economic Reforms and the Process of Global Integration," *Brookings Papers on Economic Activity* 1995:1–118.

[52] Edward Mansfield, Helen Milner, and Peter Rosendorff, "Free to Trade: Democracies, Autocracies, and International Trade," *American Po-*

Korea, for instance. It was also the argument that changed a lot of minds when the issue of China's entry into the WTO came up in the U.S. Congress recently. I guess there is something to it.

But then one must also contend with the many today who argue *against* free trade on such grounds. They contend that free trade is incompatible with important broader goals such as egalitarian income distribution, environmental protection, labor standards, and human rights. Thus, even as the doctrine of free trade has emerged triumphant over the conventional challenges that I dealt with in this lecture, it now faces a new and original crisis. I turn to it in my next lecture.

litical Science Review 94 (2000): 305–21, have interestingly argued for the reverse relationship: that is, that pairs of democracies tend to reduce trade barriers more than mixed-country pairs.