

# *Internationalization and Domestic Politics*

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## The Impact of the International Economy on National Policies: An Analytical Overview

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JEFFRY A. FRIEDEN AND RONALD ROGOWSKI

By virtually any measure, cross-border trade and investment have grown at extraordinary rates over the past thirty years. Representative trade statistics for the industrial economies and the newly industrializing countries (NICs) are presented by Milner and Keohane in the Introduction to this volume. Among the poorest states, as well (the forty-three countries that the World Bank classifies as “low-income,” with per capita GNP of \$610 or less in 1990), merchandise exports grew on average by 5.2 percent annually between 1965 and 1990 (computed from World Bank 1992: table 14). Cross-national flows of capital, as Milner and Keohane also indicate, increased even more sharply, roughly quintupling among the industrialized countries and doubling among the developing states in the single decade between the mid-1970s and the mid-1980s.

Increases of these magnitudes in international transactions – or more precisely, as we argue below, the exogenous easing of international exchange that such flows reflect – have affected domestic politics in virtually every country. Some of the ways in which they have done so are obvious, for example, controversies over trade agreements, common markets, non-tariff barriers, migration, and investment. Other impacts are less obvious but perhaps even more profound, including widespread repudiation of tax, regulatory, and macroeconomic policies that inhibit international competitiveness. This chapter attempts to elucidate how economic integration affects domestic politics, policies, and institutions by using international trade theories to generate testable propositions about the preferences of important groups within societies.

In Sections I and II, we define our independent and dependent variables: respectively, what we mean by exogenous easing of international exchange and what political outcomes we are trying to explain. Section III argues

that exogenous easing affects politics chiefly by way of its impact on relative prices and on the directness with which world prices are transmitted into the domestic market (or, more precisely, into the domestic opportunity structure). Section IV outlines the ways in which exogenous easing – and, more generally, international relative price trends – affects aggregate national welfare and related policies. In Section V, we explore the impact of such trends on domestic actors' preferences for governmental policies. Section VI discusses briefly the role of institutions. Section VII summarizes our argument and is followed by a conclusion.

### I. THE INDEPENDENT VARIABLE

Increasing levels of international trade and investment reflect a deeper change: an exogenous decrease in the costs, or an increase in the rewards, of international economic transactions. Growing global trade and financial flows are an observable result of the changed costs and rewards of doing cross-border business. Of the many underlying causes of such change, we regard five as particularly salient.

*Transport costs* obviously affect the rewards of international economic exchange: much of the great increase in international exchange in the nineteenth century is commonly attributed to the vastly cheaper transport that canals, railroads, and steamships afforded (cf. Rogowski 1989: 21–2). Similarly in the last quarter-century, improved aircraft, containerization, and trucking have eased international trade. A second element of cost may be broadly called *infrastructure*: systems of international communication, settlements, credit, insurance, and forward markets that reduce the overall expense associated with international trade and payments. Some of these are technological in origin; others, such as integrated financial markets, result from combined economic, technical, and policy developments. A third major category of costs is *government policies* toward trade and investment. Most obvious are such barriers as tariffs, quotas, capital controls, and “voluntary” export restraints; but some policies, such as a stable international monetary system, reduce costs. Chief among the factors that may exogenously increase the returns to international trade are the growing significance of production processes characterized by *economies of scale* and growing cross-national disparities in *total factor productivity*.<sup>1</sup> This is not an exhaustive list of factors exogenously affecting the costs and rewards of international economic activity, but it includes important elements of any such list.

We mean by “exogenous easing” of international exchange an overall *decrease in the costs, or increase in the rewards, of such exchange*: either an exogenous reduction in the technical, economic, and political barriers to trade, investment, migration, or payments; or an exogenous change in production processes or endowments that increases the returns to interna-

tional, as opposed to domestic, economic activity. The past thirty years, for example, have almost certainly been marked by a decrease of almost all relevant costs and, at least in many sectors, an increase in international returns; hence this period is one of exogenous easing of international exchange. Two introductory points are in order:

- 1 Movements of services and capital are analogous to those in goods and can be subjected to similar tools of analysis. For purposes of simplicity, we focus on trade in goods, with a few illustrative asides concerning financial and investment flows. In terms of exogenous easing, we emphasize changes in the cost and rewards of carrying out international trade in goods. The general argument does not vary appreciably if extended to the movement of capital or labor, although this is substantially more complex. There are differences worthy of note, but we largely ignore them to avoid overwhelming the argument with nuance and detail.
- 2 We focus on, and regard as central, changes that are not only exogenous to any one nation's policy but that resist manipulation by any one government. Governments often choose to try to isolate their economies from world markets, with effects that we analyze below. However, so long as they lack global dominion, they can do little about technical innovations that diminish costs of international communication and transport, institutional innovations that make international transactions less risky, production processes that guarantee increasing returns to scale, or other states' decisions to raise or lower barriers to exchange and investment. Of course, the policies of all governments are in the final analysis endogenous to the global political economy; but for our purposes and as a first approximation it is adequate to maintain the presumption that countries, and groups within countries, take as given the policy choices of the world's leading governments.

## II. DEPENDENT VARIABLES

We are ultimately interested in understanding the economic policies enacted by individual states. Even small countries' governments can set policy within their borders, and this is a unique and important power. Moreover, although no one government can fully dictate the international environment, some national policies, especially of large countries, affect the international economy in important ways.

We are interested not only in the policies adopted by governments, but in the political institutions within which these policies are debated and by which they are implemented. According to one view, institutions themselves are but "congealed tastes" (Riker 1980: 445), intentionally created to guarantee the pursuit of particular policies. Others hold that institutions simply aggregate interests in ways that make it unnecessary to recalculate continually the balance of political forces; and still others assign a much greater independent weight to institutions – the view taken by Garrett and Lange in this volume. In all three views, institutions matter; and those interested in economic policies must also be interested in the institutions that make those policies.

Inasmuch as policies and institutions respond to the political pressures brought to bear by individuals and groups, it is also important to understand the policy and institutional preferences of these social actors.<sup>2</sup> This includes comprehending why actors aggregate politically in a particular way (say, by region) rather than another (say, by industry). Ideally, for example, we seek to predict what trade policy a particular firm, sector, or group will favor.

Given that socioeconomic and political agents have preferences about policies, and political institutions affect the adoption and implementation of policies, it follows that private agents must have preferences about institutions themselves. If an independent agency is more likely to provide tariff protection than one dependent on the executive, those who prefer high tariffs should want an independent agency while free traders should not. So our second-order set of dependent variables is the policy and institutional preferences of important socioeconomic and political groups.

A third-order set of things to be explained falls out of those set forth so far. If we want to understand policy and institutional outcomes in the first instance, and the policy and institutional preferences of socioeconomic and political actors in the second instance, it follows that we desire implicitly to understand the actual relationship between political institutions and policy outcomes. It only makes sense to ask about preferences and outcomes over *both* policy and institutions if the relationship between them is not immediately obvious; therefore we need to examine how institutions affect policy outcomes.

The dependent variables of interest in this project are thus threefold. The independent variable throughout is exogenous changes in the costs or rewards of international economic exchange. In rough logical order, the dependent variables are:

- 1 the policy preferences of relevant socioeconomic and political agents within countries toward national policies and national policy-making institutions;
- 2 given these preferences, the adoption or evolution of national policies and of national policy institutions;
- 3 given preferences, policies, and institutions, the relationship between a given set of institutions and a given set of policies.

Our proposed explanatory apparatus focuses on the first set of dependent variables, the policy preferences of socioeconomic actors. We by no means regard the others as unimportant, but we feel on firmest ground in making projections on the basis of an existing literature in economics and political economy. Geoffrey Garrett and Peter Lange, in their contribution to this volume, explore the institutional side of the story at much greater length.

In the next section we explain in greater detail why we find it useful to summarize the independent variable – changes in the costs and rewards of

international economic transactions – as reflected in their chief consequence, changes in relative prices. In the sections after, we explain the relationship between relative price changes and the policy preferences of economic actors.

### III. THE EXPLANATORY LINK: INTERNATIONAL ECONOMIC TRENDS AS MOVEMENTS IN RELATIVE PRICES

Changes in the international economy can usefully be regarded analytically as changes in relative prices; and changes in relative prices have predictable effects on the policy preferences of socioeconomic actors. First, we defend the view that for analytical purposes we can treat international economic trends – including exogenous easing of international trade – as changes in relative prices.

Virtually all developments of interest to economic agents have to do with relative price changes. *Prices* matter because they are the basic signal by which economic information is transmitted, and therefore the proximate (if not the underlying) determinant of wages, rents, and profits. *Relative* prices matter because prices have meaning only in relationship to each other, for example, how many bushels of wheat trade for one yard of cloth, or how many hours of labor for one automobile. If all nominal prices suddenly and magically were multiplied or divided by 100, nobody would be better or worse off (leaving aside computational and relabeling problems).<sup>3</sup> Finally, a large and widely accepted literature tells us *how* relative price movements affect the fortunes of economic agents.

Two kinds of changes in relative prices are of particular importance. First are broad trends in world prices, most notably for our purposes the *price convergence* that is brought about by an exogenous decline in trade barriers. Second are *price shocks*, changes in world prices that ensue from, *inter alia*, transient shortages and surpluses, technological innovation, and political disruptions. Price convergence is straightforward: in isolation, wheat is cheaper (trades for less of other goods) in land-abundant Argentina than in land-scarce England. As trade between two such regions becomes easier, wheat becomes dearer in Argentina, cheaper in England; absent such artificial barriers as tariffs and quotas, prices in both countries converge toward a “world” price.<sup>4</sup> Price shocks are theoretically more complex<sup>5</sup> but, particularly since 1973, empirically quite familiar: a world glut of wheat, the discovery of some cheaper source of nutrition, or a multitude of other causes may depress the world price of wheat, and consequently its price in every region where it is traded, relative to other products.

Virtually every change in the international economy that has drawn the attention of historians, theorists of international relations, economists, and journalists, can be recast in terms of one or both of these kinds of price



changes. Technological innovation, international cartels, fiscal or monetary policies of major states, wars hot and cold, booms and busts – all matter in the international economy to the extent that they shift world prices and/or alter the relation between domestic and world prices.

Even where governmental policy contravenes such price changes – by tariffs, subsidies, rationing, price controls – the changes affect “shadow” prices, which define actors’ economic opportunities. Two examples help clarify this point. (1) If, as was typical in the Communist economies, official prices of many consumer goods are set below market-clearing levels, “shadow” prices (those at which markets would actually clear) define incentives for black market activity, queuing, and payments for queuing by others. (2) Many African governments set farmers’ prices below world levels; but world prices, as transmitted through neighboring countries or along seacoasts, determine incentives to smuggle, sell on the black market, or migrate to a less restrictive state (Bates 1981). As we discuss more fully below, an exogenous easing of international trade paradoxically can affect most strongly the relatively *closed* economies that try hardest to shelter themselves from international markets.

It is often useful to disentangle the component parts of an exogenous easing of international trade, for particular aspects of it may have more nuanced effects than the overall trend. The cheapening of ocean-going transportation was especially important to the world steel industry, as it allowed low-cost production of steel at relatively great distances from sources of iron ore; this mattered greatly for Japan, whose steel industry relied on imported raw materials. Developments in shipping, however, had far less (if any) impact on the microchip industry. Telecommunications advances probably had a more direct impact on capital movements than on trade, and contributed to the explosion of world financial markets that has played so central a role in affecting monetary and financial policies (on the LDCs, see Haggard and Maxfield). The cheapening of oil transport by means of pipelines and supertankers in the 1950s and 1960s, and the consequent dependence of many economies on petroleum as an energy source, meant that the OPEC oil price hikes had a devastating effect on some oil-importing countries, especially in the developing world, even while they enriched the oil exporters. Economies of scale have mattered more in chemicals and automobiles than in textiles or food processing (Krugman and Obstfeld 1991: 139). It is important to keep such specific trends in mind, so as not to conflate artificially a series of economic developments into one broad tendency that obscures more than it reveals.

Nonetheless, in the past three decades both general and specific propensities have come together to reduce the costs and increase the benefits of international trade and payments. A combination of technological change, national policies, and other developments have dramatically increased the

degree to which markets are linked across national borders. The next section discusses the impact of this trend on economic activities and interests at the aggregate national level.

IV. RELATIVE PRICES AND NATIONAL ECONOMIES:  
EFFECTS ON AGGREGATE WELFARE

To provide a baseline for analysis, we first analyze the impact of an exogenous easing of international trade generally, and of specific international price shocks, on the aggregate welfare of entire societies. In the next section, we discuss effects on the individuals and groups that constitute nations. In both instances, we rely on the insights of modern theories of international trade. However, these theories are primarily concerned with explaining economic outcomes for societies as a whole, while we are interested in their implications for the policy preferences and political behavior of groups and nations.

First, an easing of international trade increases the impact of global economic trends on domestic political economies – even, we reiterate, where government policy keeps the national economy relatively closed. This is because a decrease in the costs of trade, or an increase in its relative rewards, *raises the share of tradable goods* in each country's economy. By definition, a good is nontradable if the difference between local and international price is less than the cost of moving it. In the eighteenth century, for example, long-distance transport was so expensive that only such low weight-to-value ratio goods as spices and jewels were "tradable" across oceans; in the nineteenth century, cheaper carriage transformed commoner and bulkier goods, such as grain and lumber, into tradables.

As described above, this effect operates even where economies remain relatively closed, by way of the impact of shadow prices on the opportunity costs of particular economic activities. One prominent example is how easier international exchange magnifies the potential domestic effects of price shocks, understood as fluctuations in *terms of trade*, the ratio of export to import prices. As more of a country's products become tradable, favorable or unfavorable shocks to the world price of a good produced locally or imported extensively – Saudi oil, Canadian wheat, Japanese automobiles – affect national welfare more profoundly.<sup>6</sup>

Easing of international exchange heightens the transmission of world economic trends to domestic political economies. In so doing, it intensifies actors' preferences concerning governments' foreign economic policies. We hypothesize that exogenous easing leads to the "import" of global economic trends into domestic politics. This might manifest itself in myriad ways, many of which we discuss below, but we expect most generally that easier trade at the global level will lead to an analogous "internationaliza-

tion” of domestic political economies, in the sense of strengthening the national political ramifications of world economic developments. Specifically, we hypothesize that issues related to the world economy will grow more salient in all countries. As a corollary, insofar as internationally correlated economic developments become more important to all countries, the political dynamics of these concerns will grow more coordinated cross-nationally as international exchange becomes exogenously easier.

In addition to increasing the domestic political salience of internationally related issues, exogenous easing has relatively clear social welfare effects. First, as noted earlier, easier trade inevitably leads to economic pressures for *price convergence* among countries.<sup>7</sup> This affects aggregate welfare directly, for as domestic and world prices converge, the distortionary effects of protective barriers rise. This can perhaps best be understood by considering a country that is relatively closed to world trade. The country bears costs by producing goods at home that could be purchased more cheaply abroad. One set of costs is purely *distributional*: consumers of goods whose domestic price is higher than the world market price lose, while producers of such goods gain. A second set of costs, however, is to *aggregate* social welfare. The price distortions created by protection lead resources to be allocated to activities that do not represent their most efficient possible use. Physical and human capital are invested in industries that are profitable only because they are protected; without protection, these factors would flow toward industries closer to the country’s comparative advantage. These deadweight (social welfare) costs represent income lost to society as a whole.

The welfare cost of closure to the economy as a whole varies with the difference between (a) the “landed” price of protected goods (world price less transport and other costs of trade) and (b) the domestic price created by national protective policy. Generally speaking, the bigger this “wedge” between domestic (protected) prices and effective world market prices, the greater the efficiency costs of protection (and the greater its redistributive impact). This is because the greater the price gap, the more “inappropriate” the allocation of the country’s resources (relative to its comparative advantage).

The costs and rewards of international transactions affect the size of this price “wedge,” and thus the welfare costs of closure. As international trade becomes easier, “landed” prices of the country’s real or potential imports fall and the effective world market price of its exports (that is, the price other countries pay at the source) rises.<sup>8</sup> If the domestic price of protected goods remains the same, the gap between world market and domestic prices increases, and so does the efficiency cost of protectionist policies.

An illustration from capital markets may prove useful. Capital controls that keep national interest rates below world interest rates will (all else

equal) reduce savings and raise borrowing to socially undesirable levels. The efficiency costs are a function of the gap between onshore and world market interest rates; the bigger the gap, the bigger the distortions. If an exogenous shock – financial crisis, macroeconomic trends – raises world interest rates, the gap between world and national interest rates grows, the difference between the politically controlled allocation of resources and that expected in a financially open economy increases, and the efficiency costs of capital controls rise accordingly.

As either the cost of international economic transactions or the world price of a good or service declines, the opportunity cost of economic closure rises. The easier or more potentially profitable it is to trade, invest, borrow internationally, the more a society forgoes by adopting policies that reduce cross-border economic activity. These costs are the *static efficiency costs of closure*, and are increasing in the ease of international economic exchange.

In recent years, analysts have begun paying more attention to the potential *dynamic* costs of closure. A large and growing literature has tended to look beyond short-term efficiency costs to focus on the longer-term impact of insulating a national economy from global trends. There are many different strains of this literature, but most agree that participation in world trade and payments has a complex and cumulative positive effect on national economic growth.<sup>9</sup>

Perhaps most importantly, international economic exposure stimulates domestic economic agents to adopt and adapt new technologies. In relatively closed national markets, incentives to innovate are limited by weak competition. Any firm selling into world markets, however, is forced to match its global competitors in technology, quality, and marketing. Inasmuch as much modern economic activity involves learning by doing and other – potentially intangible but clearly significant – processes that tend to exhibit increasing returns to scale, the widening of markets available to national producers allows (indeed, forces) them to develop new expertise that would be unlikely in a closed national market.<sup>10</sup>

Much of what analysts have in mind here is captured in the view that economic growth can only be understood by incorporating “total factor productivity” (TFP), a residual left *after* the consideration of increased labor and capital productivity.<sup>11</sup> TFP includes knowledge, technological adoption and adaptation, organization, and much else; and a country’s welfare may depend as much on how it develops and uses these skills as on its endowments of land, labor, and capital.<sup>12</sup> Many believe that TFP growth has become increasingly important to complex industrial production, especially that associated with microelectronics;<sup>13</sup> and that the difficulties of very closed developing and Communist economies had to do not primarily with their inefficient uses of land, labor, and capital, but rather with their near-

total inability to generate the growth in TFP that results from innovation, technological creativity, and better managerial organization (Krugman 1994b: 64–9). It may well be that, to the extent that *any* high-tech sector (telecommunications, computers) is sheltered from world competition, it rapidly becomes technically outmoded in ways for which there simply is no short-term “fix.”

In any case, and whatever the precise mechanism, easier international exchange increases the gap between nationally protected (or taxed) and world market prices for goods and services. Where imports are protected, exogenous easing increases the difference between world market and protected prices, transferring more income from consumers to producers and encouraging more (and more inefficient) investment in industries whose products could be imported at ever lower cost. Where exports are taxed, easier international exchange similarly increases the distance between (artificially depressed) returns accruing to national export producers and those potentially available on world markets, analogously leading to *underinvestment* in goods that the country could potentially sell profitably abroad.

It is important to reemphasize that these expectations hold even, and indeed especially, in *very closed economies*. We focus not on how open a national economy is to foreign trade and payments, but rather on exogenous developments in the global economy. If we examined only the former aspect, the argument would be trivial: more open economies are more sensitive to world economic developments. The point here is different. The easier are international economic transactions in general, the greater the social cost of sustaining economic closure for any one country, and the greater the social impact of global economic trends on any one country – no matter how economically closed the country in question. This cost, and this impact, may be mediated through dense networks of government policies and programs, as in many of the former Communist countries and LDCs, but they operate nonetheless; and, given that distortions are greatest where protective barriers are highest, the aggregate benefits of liberalization will be greatest precisely in the most closed economies. Conversely, the losses to such economies from continued closure, exacerbated by foregone dynamic gains and gains in TFP, are greatest; and, over time, are likely to multiply into overwhelming demand for change.

Finally under this rubric, we note that impediments to trade can be (in the infamous phrase of some recent U.S.–Japanese negotiations) “structural,” rather than flowing consciously from trade policy. Entrenched patterns of regulation, government purchasing, even taxation and jurisprudence, can effectively discourage cross-border exchange or investment and thus can create quite as effective a “wedge” between world and domestic prices as any tariff. An exogenous easing of international trade may make

structural barriers costlier in terms of aggregate welfare and thus increase social pressure for liberalization in the broader sense of deregulation and harmonization of standards.<sup>14</sup>

These considerations lead us to quite specific, empirically testable conjectures, namely that an exogenous easing of international trade will (holding all else equal):

- 1 increase pressure within each country to liberalize international trade and payments, including dismantling structural impediments to trade;
- 2 create such broad political pressure as an increasing function of the degree to which the national economy was previously closed; and
- 3 generate such aggregate pressure for change as an increasing function of the degree to which the economy has readily exploitable gains from trade available (such as high levels of total factor productivity).<sup>15</sup>

Governments may well resist pressures to liberalize, however, for policymakers rarely have incentives to behave as benevolent social planners. Aggregate benefits are offset by concentrated costs; long-term social dividends, by short-term pain. Policymakers may well hesitate to reform, bearing instead the cost of slower (or even negative) long-term growth. Postponing our consideration of institutional issues to a later section, we nonetheless note here that whatever attunes policymakers to broad social interests or gives them longer time horizons will make them likelier to internalize the benefits of increased international trade. Speaking concretely, we expect that larger constituencies, more broadly based (for example, “catchall”) parties, a more participatory franchise, longer average terms in office, and more stable partisan loyalties will weight decisions more in favor of aggregate welfare considerations.<sup>16</sup>

International price shocks, no less than price convergence, affect aggregate national welfare – again, even in closed economies.<sup>17</sup> A fall in the relative world price of a country’s exports, or a rise in the price of its imports, is by definition a deterioration in its terms of trade, and reduces national income.<sup>18</sup> Such terms-of-trade shocks affect the welfare costs of closure in ways closely analogous to price convergence. Take a country whose policies reduce exports of a particular good, perhaps by protection on imported inputs or by an export tax. If the world relative price of this good suddenly rises, the national welfare cost of the export-inhibiting policy also rises.<sup>19</sup> Put more generally, an improvement in terms of trade raises the static national welfare costs of closure; a deterioration in terms of trade lowers those costs.<sup>20</sup> From these considerations we advance the following counterintuitive hypothesis:

All else equal, pressure for increased participation in the world economy will rise when a country’s terms of trade *improve*; when terms of trade *decline*, pressure for less exposure to global economic trends will increase. This link will become more

manifest as international trade becomes exogenously easier (and hence as international price shocks are transmitted more directly and deadweight costs of closure rise).

Up to now we have looked at how exogenous easing affects a country's aggregate economic performance. Important as this may be, it is a commonplace of political economy that what is good for national welfare may bear little relation to the policies actually adopted. There are of course settings, mentioned above, in which politicians worry about the consequences of economic trends for the country as a whole, but it is more common for political pressures to emanate from social groups rather than from the entire society. National economic effects are often secondary to the impact of easier international exchange on domestic economic and political agents. It is to this topic that we now turn.

#### V. INTERNATIONAL PRICES AND NATIONAL ECONOMIES: EFFECTS ON ECONOMIC ACTORS AND GROUPS

An easing of international exchange – a reduction in the cost of international transactions – is beneficial for those who consume goods or services associated with international exchange, such as exporters, importers, and consumers of imports. Conversely, such a reduction in international transaction costs hurts those competing with imports.

Internationalization lowers prices paid by consumers of imported goods and raises prices received by producers of exported goods; and it lowers prices received by producers of import-competing goods. (The argument again holds, *mutatis mutandis*, for international payments and investment, but we again restrict discussion here to trade in goods.) The first two categories benefit and the last is harmed. As easier trade widens the price wedge between domestic prices (protected or taxed) and world market prices, it increases the incentives of import competitors to lobby for trade protection and the incentives of potential exporters and import consumers to resist or remove policies that hamper the free movement of goods they wish to purchase or sell.

To move beyond this point, we must be able to predict who will export, who will consume imports, and who will face competition from imports. This is especially important in very closed economies, where – as already noted – the impact of easier trade may be felt most strongly but massive distortions obscure the identity of potential gainers and losers from liberalization. While it is probably not difficult to anticipate that regions with valuable natural resources will gain by economic opening – oil- and uranium-producing areas of the former Soviet Union, for example – it may be far from obvious whether those in more differentiated lines of

production – Brazilian steel producers, Uzbek cotton farmers, Czech textile manufacturers – will win or lose.

We can think of a country as having a comparative advantage in the production of particular goods. Those whose products are most in line with the country's comparative advantage stand to gain most from easier world trade; those "farthest" from comparative advantage (at greatest comparative disadvantage) stand to lose most. Exogenous easing of trade raises the benefits available to those close to the national comparative advantage, but also raises the costs that threaten those far from it. Three main trade theoretic perspectives, which are better regarded as complementary than as mutually exclusive, endeavor in essence to identify who is closer to, and farther from, the national comparative advantage; and thus who will gain, and who will lose, from easier international exchange.

A powerful and influential approach to the problem is that stated, within the context of the Heckscher–Ohlin trade model, by the Stolper–Samuelson Theorem (Stolper and Samuelson 1941). The Heckscher–Ohlin approach concludes that a country will tend to export goods intensive in the factors it has in abundance, and to import goods intensive in factors in which it is scarce. The Stolper–Samuelson extension finds that in each country returns rise absolutely, and disproportionately, to owners of factors that are required intensively in the production of goods whose prices have risen; and they fall absolutely, and disproportionately, to factors required intensively in the production of goods whose prices have fallen.

Wheat, relative say to steel, is land-intensive; steel is labor-intensive.<sup>21</sup> The Stolper–Samuelson Theorem tells us, in essence, that if wheat rises in price relative to steel, landowners in general (and not just those currently engaged in wheat production) will be absolutely better off (able to buy more of all goods); and that workers in general (not merely those currently employed in the steel industry) will be absolutely worse off. Rents are bid up, and wages are bid down, across the board. Moreover, a change in the product price occasions a magnified change in the relevant factor price(s): a ten per cent increase in the price of wheat relative to steel occasions an increase of more than ten per cent in land rents relative to wages.

The Heckscher–Ohlin approach leads to one subset of propositions about the distributional effects of easier international trade. It implies that exogenous easing raises the domestic prices of goods whose production is intensive in the given country's abundant factors and lowers domestic prices of goods intensive in the country's scarce factors; hence easier trade benefits a country's abundant factors but harms its scarce factors. In this view, exogenous easing of trade – which makes the benefits or costs of trade that much larger – raises the incentives for owners of abundant factors to attempt to liberalize trade, and for owners of scarce factors to work to restrict it. We expect to see, in this context, easier trade associated with



intensified conflict between laborers, landowners, and capitalists over foreign economic policy and liberalization generally – with the specific battle lines depending on national factor endowments.

A common alternative, or supplement, to the Stolper–Samuelson view looks not at distributional effects on broad productive factors, but at more narrowly defined factors specific to particular uses. This so-called specific factors (or Ricardo–Viner) approach emphasizes the sector-specific impact of changes in relative prices. Factors specific to particular uses bear the full weight of price changes in their distinctive products. If land in a particular region is suited only for the cultivation of wine, then its price varies with the (projected future) price of wine, not with the price of agricultural products generally. Physical or human capital that is similarly specific (for example, useful only in the production of aircraft) is similarly product-linked.<sup>22</sup>

The Ricardo–Viner perspective suggests that many factors of production are quite specialized, so that we often observe sectoral, rather than broad factorial, effects of changes in relative prices and in analogous political behavior. The U.S., for example, is by most measures capital-abundant and labor-scarce. Price convergence, or a terms-of-trade shift in favor of capital-intensive products, should benefit U.S. capital and harm U.S. labor; but if both labor and capital in an import-competing sector are specific, both are harmed: the American automobile industry is perhaps the most obvious example. Steven Magee (1978) has argued that the sectoral pattern has more often characterized postwar American trade lobbying.

Most concretely, this approach implies: (a) that pressure for or against liberalization will vary with the *specificity* of the relevant actors' assets (most notably their human and physical capital); (b) that sectors will divide between those relatively competitive on world markets and those relatively uncompetitive; and (c) that political cleavages will be sectoral rather than factorial. By definition, nonspecific assets are readily redeployed in response to changing prices and accrue neither windfall profits nor surprise losses. Only owners of sector-specific assets, in the Ricardo–Viner perspective, have incentives to lobby for sectoral protection (if faced with import competition) or for liberalization (if faced with export opportunities).

This subset of propositions clearly diverges from those of the Heckscher–Ohlin approach and leads to different empirical expectations.<sup>23</sup> Not the country's factor endowments, but the specificity of the particular industry's human and physical capital, and its position in world trade and payments, would predict the likely pressure for or against liberalization. Rather than sharpening battles between laborers and capitalists, easier trade would lead to greater conflict between internationally competitive and uncompetitive *industries*, uniting workers and managers alike behind sectoral demands.

A third perspective is associated with aspects of firms and industries related to the scale economy and total factor productivity considerations

mentioned above. There may be a *dynamic* distributional impact analogous to the scale economy and TFP welfare effects of easier trade. Such things as a larger scale of output, learning by doing, and technological adaptation can make the firms and industries involved particularly capable of taking advantage of economic opportunities. In this sense, effects of international relative price changes build on themselves.

In sectors characterized by internal economies of scale (EOS), by definition the sheer scale of the firm's production is crucial to its costs and competitiveness.<sup>24</sup> In such sectors, the opening of world markets increases the advantage of larger over smaller firms, and this advantage grows as access to markets expands. For example, it is conjectured that in an integrated European market only four or five automobile firms, all located within a radius of perhaps 200 kilometers, might survive (Krugman 1991). Inasmuch as the already largest firms are most likely to be able to implement the redeployment of assets and physical relocation necessary to reap fully the larger scale economies, political support for integration is expected from these firms; conversely, smaller firms will be less enthusiastic.<sup>25</sup> To the extent that autoworkers' skills are firm-specific, or that they will incur costs (for example, a new language) to move to a larger, surviving firm, their preferences will parallel their employers'.

A similar case is learning by doing, especially as applied to international trade. The ability of a firm to tap into world markets may depend on networks of suppliers and customers, information about market conditions, and a wide variety of other complex and firm-specific factors. A firm without access to world markets has no incentive to develop this informational and other capital. But if the net benefit of engaging in world trade increases substantially, the firm may be drawn into gradually developing this expertise. And if the knowledge and networks so built are cumulative, each easing of international exchange will be magnified by its accretion to an existing stock of characteristics crucial to international competitiveness. In this way, firms and industries already involved in global economic activities – trade, lending, investment, licensing – may have a substantial cost advantage due to their past actions, and this will amplify their preference for further economic openness.

The converse can also obtain: the substantial adjustments needed to enter into international economic activity may increase opposition to openness from those who most need to make such adjustments. Where, for example, the ability to participate in global trade and payments requires a full-fledged reworking of a firm's managerial and marketing organization, the firm is more likely to resist being thrown into the international marketplace more than if such a reworking were unnecessary. Where, as in the former Soviet economies, virtually all firms face drastic and uncertain restructuring, the resistance is likely to be massive.

In other words, there may be adjustment and informational costs associated with increased (or decreased) participation in world trade and payments. Such “dynamic” costs – retooling complex management structures, retraining employees, rebuilding supplier and customer networks – may be very hard to project or measure, but they may also be extremely important in determining preferences toward international economic policy. Those for whom a liberalization of cross-border economic activity would imply more costly adjustment are less likely to support it; those faced with lower prospective adjustment costs, all else equal, are more likely to look favorably on liberalization. Concretely, we expect that, in sectors characterized by economies of scale (e.g., chemicals and office machines, but not shoes or foodstuffs), support for liberalization will vary with: (a) firm size and (b) existing international contacts and experience (cf. Milner 1988).

These several perspectives agree that exogenous easing of international trade must affect, and usually intensify, domestic political conflict; they disagree, at least for the short run, about precisely *how* domestic politics is affected. Yet each perspective generates eminently testable propositions; and, pitted against each other, the several approaches adumbrate an interesting and fruitful program of research.

At present, for example, developed countries are characterized by an abundance of physical and human capital but a paucity of unskilled labor; LDCs are abundant in unskilled labor, poor in physical and human capital; and most NICs offer an abundance of both human capital and unskilled labor and are deficient only in physical capital. In the Heckscher–Ohlin perspective, exogenous easing of international trade increases potential benefits to capitalists and skilled workers in the advanced countries, to skilled and unskilled workers in the NICs, and to unskilled workers in the LDCs – all of whom are predicted to mobilize on behalf of liberalization. At the same time, easier trade threatens unskilled workers in advanced economies, local capitalists in NICs, and owners of both physical and human capital in LDCs – all of whom will heighten their demands for protection or compensation. Wood (1994) has argued that we observe exactly this in the economic history of the last twenty years.

In the Ricardo–Viner perspective, specific kinds of exogenous easing, and specific price shocks, matter more. As cheaper transport encouraged trade in petroleum in the 1950s, for example, coal owners and workers in many countries mobilized to demand protection and subsidies; auto workers and owners, whose markets would expand with cheaper oil, agitated in most cases to keep markets open; and political leaders, eager to minimize deadweight costs, sometimes suppressed the coal miners quite brutally and at high short-term cost (cf. DeGaulle 1971: 347–51).

The EOS perspective emphasizes the peculiarities of sectors characterized by increasing returns to scale.<sup>26</sup> To the extent that a given industry is so

characterized *and* that capital within it is even moderately specific, an exogenous easing of trade is expected to precipitate conflict between large and small, and between internationally experienced and inexperienced, firms (and, where human capital is also specific, their employees); the former in each case pursuing liberalization, the latter likelier to be protectionist. It would, for example, be quite useful to see whether firm size better predicts attitudes toward European unification in, say, the British chemical industry (EOS) than in the British food-processing sector (non-EOS).

In addition to the broad impact of exogenous easing of trade in and of itself, particular relative price shocks affect the preferences of domestic socio-economic groups. We should note, moreover, that changes in one relative price can have an indirect influence on a wide range of economic actors. A “ripple” impact affects producers of goods that are complementary or substitutive to the directly affected products. The oil price rises of the 1970s expanded demand for coal and natural gas (substitutes) but depressed demand for heavy, fuel-inefficient automobiles (a complement) and hence for steel. It is often crucial to trace through such widening “ripples.”

Perhaps the best known example of a specific relative price shock is the one often described as “Dutch disease,” after the impact of postwar natural gas discoveries on the Netherlands. The general phenomenon is an unanticipated resource inflow, typically associated with increased export volumes or values.

The process is conventionally depicted as beginning with the discovery of a natural resource, but for our purposes it could just as easily be a major increase in the world price of an already known natural resource. This leads funds to flow into the country, and toward the natural resource sector involved. This is good for the booming sector, for obvious reasons. The resource inflow also has an important collateral (or ripple) effect on aggregate demand: those in the booming sector now have more income at their disposal, and this raises domestic demand. Inasmuch as the demand is for nontradables, such as housing, it stimulates the nontradables sector, such as by causing the price of housing to rise. However, as the prices of the booming resource and of nontradables rise, domestic tradables producers face increased input costs and therefore heightened import competition. The result is analogous to that of a real appreciation of the exchange rate, and is typically observed as “deindustrialization” – whether in the modern Netherlands or sixteenth-century Spain.<sup>27</sup>

In this context, a substantial increase in the world price of a commodity leads producers of the exported good, and those in the nontradables sector, to want policies that allow them to realize the full force of this positive terms-of-trade effect. However, those in the nonbooming tradables sector (typically manufacturing and agriculture) want the government to counter

the negative direct and indirect impact on them of the resource inflow – whether by means of protection, subsidies, or something else. There may also be debates over the potential appropriation of the rents accruing to the now more valuable resource.

To take a prominent example of this process, a major rise in the price of oil is expected to lead owners of oil-producing properties to push to capture the full value of their windfall. Nontradables producers will welcome the inflow of resources as it increases demand for their output. Tradables producers outside the oil sector – industry and agriculture, typically – will press the government to protect them from the real appreciation and import surge that would ensue without mediating policy.

An exogenous easing of trade, then, has highly differentiated effects on economic agents within countries. It leads to intensified demands for freer trade and investment on the part of those firms and individuals closest to their country's comparative advantage. In one view this impact is primarily factorial: it helps labor-intensive manufacturing sectors in a labor-rich country, for example. In other views, the effects are principally to sectors and firms with unique advantages over those elsewhere, whether these advantages are associated with scale of output or with firm-specific knowledge or managerial capabilities. On the other hand, easier trade sharpens the desire for protection on the part of those farthest from their country's comparative advantage, on whatever basis this may be calculated. Similar effects are expected in the event of a onetime increase or decrease in a world relative price; and easier trade increases actors' sensitivities to such price shocks.

Again we emphasize that we expect these effects even in relatively closed economies. Exogenous easing should, in this view, increase the pressure for trade liberalization from individuals, firms, and industries that could compete globally – even in highly insulated developing and Communist countries. So too should specific price shocks create pressures from particular potential beneficiaries and losers, even where governments have typically tried to shield domestic economies from such global price trends. Whether these expected pressures lead to actual changes in policy is a function of complicated coalitional and institutional conditions, discussed briefly by us below and at greater length by Geoffrey Garrett and Peter Lange in their contribution to this volume.

## VI. THE ROLE OF INSTITUTIONS

We begin with the fundamental insight of Becker (1983), that deadweight costs offer opportunities to political entrepreneurs: by building the coalitions that can overcome even entrenched or institutionalized resistance, they can capture for themselves part of the resultant gain in aggregate

social welfare. Hence the greater the deadweight loss from a prevailing arrangement, the likelier it becomes that some political entrepreneur will succeed in changing it. Applied to these issues, the Beckerian insight implies: the greater the exogenous easing of trade, the likelier it becomes in every country – including particularly, we reiterate, those previously most closed to the world economy – that liberalization, and where necessary liberalization-favoring institutional reform, will occur.

How smoothly reform progresses (or, indeed, whether it is possible at all under the incumbent regime) is determined in our view chiefly by three factors: (a) the breadth of existing constituencies and coalitions; (b) the credibility (based on experience) of the regime's commitments; and (c) the time-horizons of major decision makers. These broadly institutional aspects, we note, are both exogenous (reformers face a set of established institutions) and endogenous (reformers are motivated to change those institutions in ways that favor, or entrench, liberalization).

(a) As we noted briefly above, politicians are likelier to internalize aggregate welfare and thus to minimize deadweight costs the more they are accountable to, and depend for their continuance in office on, the whole society.<sup>28</sup> A franchise that is limited to landowners, or to the *nomenklatura*, will privilege those groups' interests even at great cost to the larger society. An electoral system in which each representative answers only to a small geographic constituency guarantees that s/he will weigh the constituency's interest over that of the country as a whole. A political party that represents a narrow economic interest will be less attuned to aggregate welfare than a more "encompassing" (Olson 1982) rival. In the specific case of an exogenous easing of international exchange, we hypothesize:

- 1 On average, democratic regimes will liberalize more readily than nondemocratic ones.<sup>29</sup>
- 2 Among equally democratic regimes, and among different elective bodies within the same country, the tendency to liberalize will increase as the number of distinct constituencies decreases.
- 3 All else equal, the likelihood of liberalization will decline with increasing partisan fragmentation (as measured, for example, by Rae 1967).<sup>30</sup>

In the U.S., hypothesis (2) suggests that the President (elected in effect from a single national constituency) will normally support openness more than the Senate (elected from fifty constituencies); the Senate, in turn (and abstracting from its bias toward sparsely settled states), will be more free-trading than the House. Certainly the authors of the Reciprocal Trade Adjustment Act of 1934 and of the "fast-track" procedure for ratifying trade agreements hoped, by delegating significantly greater powers to the Presidency, to favor the odds of freer trade.

Among the total set of democracies, (2) implies that countries that elect from a very few parliamentary constituencies will liberalize more readily

than ones that employ many single-member districts; and the evidence to date appears to support this proposition (cf. Garrett and Lange, this volume; Lohmann and O'Halloran 1994; Mansfield and Busch 1995; Rogowski 1987).

(b) While aggregate welfare gains from trade insure that, with appropriate side payments, liberalization can make everyone better off, many actors are unprepared to believe that promised side payments will be made. To the extent that political leaders can credibly commit to compensation, support for liberalization can be organized more easily and more cheaply. Here history matters: a government that has consistently kept its promises will have greater credibility, and hence will be better able to liberalize successfully to meet an exogenous easing of international trade. Among plausible operational proxies for a government's credibility are: the risk premium on its financial obligations; the independence and neutrality of its judiciary; whether its constitutional provisions are enforceable through some neutral body, such as a constitutional court; and survey responses of its citizenry to questions about political trust. All else equal, we would expect easier liberalization in countries where the rule of law is entrenched and respected, and where both the currency and government-backed bonds are trusted.

(c) It is often argued (as in Grilli, et al. 1991) that longer time-horizons (as gauged by average time in office) make politicians less likely to run deficits. Plausibly, secure leaders will discount the future less and be more willing to incur short-term costs for longer-term social gain. In the U.S., as in many other countries, independent agencies have arisen with some influence over national policy toward cross-border transactions; and insofar as they are less subject to day to day political pressures, they may be more likely to take the lead in pursuing the long-term aggregate interest. With respect to trade policy, we hypothesize that, under an exogenous easing of trade:

- 1 The longer the average life of a cabinet in a given country, the likelier the country is to liberalize.
- 2 Within a country, a cabinet is likelier to liberalize the stabler its majority or the more fixed its term of office.
- 3 The more influential are agencies relatively independent from direct political pressures in the making of international economic policy, the likelier is liberalization.

#### VII. THE EXPECTED IMPACT OF EXOGENOUSLY EASIER TRADE

It is worthwhile to recapitulate salient effects of easier international transactions. Again, we focus on the implications for the policy preferences of socioeconomic actors.

*National effects*

At the aggregate level, an exogenous easing of exchange increases the proportion of tradables in the national economy, magnifies pressure for the convergence of domestic to world prices, and augments susceptibility to world price shocks. Even where the government does not remove barriers to cross-border trade and payments, easier access to international economic activity increases the susceptibility of domestic economic actors to international conditions. In this way, an exogenous easing of trade increases the impact of the international economy on national politics. We expect such a change to be associated with an increase in the domestic political salience of international economic issues – whether or not the country actually opens to world trade and payments as the net benefits of cross-border transactions increase.

Easier trade also raises the static and dynamic costs of isolation from world markets. That, in turn, generally raises the pressure to reduce barriers to international trade and payments. Such pressures will, all else equal, tend to be greater where economies have previously been most closed, and where opportunities for the realization of untapped gains from trade thus are greatest.

The degree to which policymakers respond to the higher efficiency costs of closure will depend on a wide variety of factors, most of them institutional. We anticipate that exogenously easier trade will produce a generally higher level of social pressures for the reduction of barriers to cross-border economic activities. Governments will be more likely to respond to such pressures to the extent that they more accurately represent the broad social interests in the aggregate; can make credible commitments to compensate potential losers; and have relatively longer time-horizons.

*Distributional effects*

At the more disaggregated level, less costly or more rewarding international exchange has a differential impact on domestic groups. Easier international exchange encourages specialization and may well be welfare-improving overall, but societies are divided between those likely to benefit and to lose from such greater specialization.

Economic actors best able to take advantage of newly available opportunities for international trade and payments are expected to support policies that allow them to realize the fullest possible benefits associated with broadened economic horizons. These may include the liberalization of trade and the capital account, macroeconomic policies that encourage global trade and payments, attempts to regulate or harmonize standards in such a way



as to facilitate cross-border commerce and investment, and a whole host of other initiatives.

On the other hand, those who anticipate that the greater specialization attendant upon higher levels of international economic activity will make them redundant can be expected to press for policies to protect them from global economic trends. Again, this extends from such broad policies as trade protection to such narrower ones as regulation. The more past policy has sheltered these sorts of groups, the more severe is the threat of international competition and the fiercer is the likely opposition to removing previous protection.

This leads to the expectation that exogenous easing of trade will be associated with increased demands for liberalization from the relatively competitive, and with increased demands for protection from the relatively uncompetitive, groups. The operationalization of this hypothesis is potentially variegated, for different trade models predict different things about the economic actors likely to win and lose from increased international trade and payments.

In the Heckscher–Ohlin view, the principal actors are such broad factors as land, labor, and capital. Owners of locally abundant factors are the winners from internationalization and will demand liberalization, while owners of locally scarce factors seek protection. In the Ricardo–Viner perspective, relevant divisions are on sectoral lines: the steel industry, wheat farmers, the banking industry. Those industries best (least) able to compete internationally for whatever reason are expected to cohere *as industries* in demanding (opposing) liberalization. Inasmuch as scale economies and other such (often intangible) characteristics of firms and sectors are important, large and internationally experienced firms are expected to be the principal supporters of liberalization. These three viewpoints may all be valid in different sectors and over different intervals of time, but they do give rise to disparate empirical expectations.

### *Specific price shocks*

Particular relative price shocks also affect the preferences of domestic socio-economic groups. Those for whom a global shock implies a potential wind-fall are expected to push for policies that allow them to capture that benefit. Those on whom the shock has a negative effect, on the other hand, will want policies to protect them from it. Simple as this may seem, the full political economy effects of such price shocks can be great, as their impact ramifies throughout the economy. The example of “Dutch disease” shows how many economic interests and policy preferences can be affected by the change in just one price, especially when it is an important component of the country’s export profile.

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Exogenous easing of international exchange, then, affects policy preferences both toward such broad issues as trade liberalization and toward such narrow concerns as particular regulatory policies. Its effects on the preferences of private actors can be understood in a reasonably coherent way, on the basis of the expected impact of easier trade on the relative prices facing particular producers and consumers of goods and services. These preferences, of course, go on to be mediated by existing political coalitions and institutions, in ways that we have sketched above and that are treated in greater detail by Geoffrey Garrett and Peter Lange.

#### CONCLUSION

We emphasize that the framework presented here is neither exhaustive nor all-encompassing. We have ignored many factors that affect the policy preferences of individuals and groups. We have attended only summarily to the impact of institutional arrangements on policy outcomes and have ignored the origins of the institutional arrangements themselves.

The analytical approach developed here does not tell us, in itself, what policy outcomes to expect from a given set of international economic changes. It does not, for example, imply that increased interdependence reduces the probability of war or insures the triumph of particular foreign policies or modes of domestic governance. Indeed, it is largely a plea to eschew impressionistic generalizations, instead attending consciously to the interests and incentives facing all relevant individuals and working up from that point to expectations about their behavior. The presentation of these foundations, we hope, will help scholars interested in the domestic effects of international economic trends to carry out systematic research.