STATE SUBSIDIES IN THE GLOBAL ECONOMY

NIKOLAOS ZAHARIADIS

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To Lucy and Zena

So much fun, so little time

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Acknowledgments

This book has been a long time in the making. When I began writing about the state's participation in the market in the early 1990s, the themes of subsidies and globalization were already major issues. The old debate on industrial policy was beginning to take a different form away from heavy state intervention and its assumed "beneficial" impact. Although market reforms were still a hot topic of debate, political discourse was markedly shifting in favor of market solutions. The question was no longer whether to reduce subsidies, but how much. Part of this shifting involvement went hand in hand with growing interdependence and global economic integration. Political arguments were made in terms of efficiency and adjustment in the face of global competition rather than development and fairness in the light of income distribution. They still are.

It *is not* surprising to see a downward trend in subsidies around the world, particularly in view of the various international commitments and treaties to which governments are loyal. What *is* surprising is that so many subsidies still exist. Governments continue to subsidize their industries albeit with less zeal than before. Given the free market rhetoric, the key question is: why do they still do it? The answer is, of course, politics. This book is about disentangling this simple answer into various components. Governments, especially democratic ones, dole out subsidies because some organized constituents demand them and because politicians need the votes and money these constituents offer. Under what conditions does this arrangement materialize and are there any exceptions to the rule?

It is often said that behind every author there are many unsung heroes who have read the manuscript, argued and disagreed with the findings, and generally made the author miserable by poking holes into what he erroneously perceived to be the "perfect" argument. This is the case with the present book. Several of my colleagues at the University of Alabama at Birmingham have read and commented on parts of the manuscript. Special thanks go to Holly Brasher who thoughtfully read the first chapter and to Renato Corbetta and

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List of Abbreviations

ACM	after capital mobility
BCM	before capital mobility
CAP	Common Agricultural Policy
CVDs	countervailing duties
DUP	directly-unproductive, profit-seeking activities
EU	European Union
G-H	Grossman and Helpman's political contribution model
GATT	General Agreement on Tariffs and Trade
FDI	foreign direct investment
M&As	mergers and acquisitions
MNC	multinational corporation
NTBs	non-tariff barriers
OECD	Organisation for Economic Co-operation and Development
PR	proportional representation
R&D	research and development
SMEs	small and medium enterprises
VERs	voluntary export restrictions
WTO	World Trade Organization

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Chapter 1

Protection for Rent

Globalization frequently imposes asymmetrical sacrifices—benefits and costs affect different elements of society differently. The losers in that process will seek redress through their political system, which is national.

—*Henry A. Kissinger*[1]

Every nation tries to protect industries it considers strategic.

—*José Montilla, Spanish industry minister*[2]

It has been almost two centuries since David Ricardo first clearly articulated the benefits of free trade and nearly 160 years since the British first implemented such a policy. In the light of the gains vigorously stressed by economists, entrepreneurs, and politicians ever since, one would expect free trade to be the prevailing international rule and impediments to trade the exception. Yet, protectionism, particularly in the form of subsidies, remains strong even as trade barriers are being dismantled. As Irwin (2005, p. 27) puts it regarding market integration and trade, "If we focus not on how far global integration has progressed in the past few decades but on how far it has to go to achieve full integration, we're impressed by how *little* integration there is" (emphasis in the original). The situation is similar concerning capital flows: "Globalization remains far from complete and in fact is only in its infancy as a process" (Sobel, 1999, p. 6).

The volume of international trade and foreign investment has increased substantially since the end of World War II, but so has protection. Currently, the volume of world exports is twice that of world production (Irwin, 2005, p. 20). In 2006, merchandise exports rose by 15 percent to a record $11,760 billion. In terms of rate of increase, trade growth in 2006 was roughly double the rate of output growth (Williams, 2007). Manufacturing exports outpaced manufacturing production in 2004 by a rate of 6 percent! Foreign direct investment (FDI) relative to world output has grown from 5.3 percent in 1980 to 21.9 percent in 2004 (Wolf, 2006, p. 1). At the same time, virtually all countries practice some type of protectionism in the form of tariffs—although rates have gone down dramatically—subsidies, and more generally nontariff barriers (NTBs). More to the point, governments worldwide have in the last 20 years signaled their support for free trade. However, bickering and the failure so far to agree at the World Trade Organization (WTO) meetings (widely referred to as the current Doha Round) offer testament to the resilience of protectionism and the ability of special interests to get what they want out of their governments.

Understanding the politics of protectionism is clearly an important policy priority in the global political economy. As Faryar Shirzad, U.S. deputy national security adviser for international economics, made abundantly clear recently, "We always have to worry about protectionism because politically it is an easy course for people to take. Trade legislation is hard and politically difficult" (Daniel, 2006, p. 4). He should know, being a close adviser to President George W. Bush and intimately involved in world trade negotiations at the Doha Round. If gains from trade are so large and self-evident, why is protectionism easy and free trade difficult to pursue? Put differently, why do governments offer the levels of subsidies that they do and why and how do they choose among different subsidy instruments? Why do governments subsidize some sectors of their economies and not others?

Vilfredo Pareto (1927, p. 377) summarizes the puzzle and presciently provides a clue to the answer:

> Even if it were very clearly demonstrated that protectionism always entails the destruction of wealth, . . . protection would lose so small a number of partisans and free trade would gain so few of them that the effect can be almost, or even completely, disregarded. The motives which lead men to act are quite different.

Pareto clearly alludes to the politics of trade policy, differentiating sharply between the benefits accrued to some groups as opposed to the benefits accrued to society as a whole. "A protectionist measure," Pareto continues, "provides large benefits to a small number of people, and causes a very great number of consumers a small loss" (p. 379). Mapping the circumstances under which some groups support or oppose protection and the conditions under which governments are likely to grant it greatly improves our understanding of political economy and the redistributive consequences of government policy. Most importantly, an explanation of protectionism is a vital first step in public policy. The Nobel Prize winner George Stigler (1975, p. xi) puts it most eloquently: "Until we understand *why* our society adopts its policies, we will be poorly equipped to give useful advice on how to change them" (emphasis in the original). Given current worldwide squabbling over subsidies and talk of reform to reap the benefits of free trade, illuminating the politics of protectionism is a worthwhile academic and policy relevant endeavor.

In this book, I build an asset influence model of trade policy that highlights the motives and ability of social actors to demand and get subsidies from government. I use the terms "protection" and "subsidies" interchangeably because subsidies are a form of protectionism although protection may also take other forms, such as tariffs, quotas, and so on. While there is no universally accepted definition (OECD, 2005a, p. 16), subsidies generally refer to government support to production, which aims to reduce the cost of input factors and consequently to increase the quantity of output produced. I do not deal with consumption (e.g., welfare) subsidies. I offer a political explanation that puts forth the argument that under threat of international competition disbursement of producer subsidies varies systematically with the degree of asset specificity in particular institutional contexts. Asset (factor) specificity refers to the cost incurred from moving factors (assets) across industries. When faced with a decline in prices owing to foreign trade, owners of more specific assets seek to influence policy by making larger political contributions to keep the rate of return, and consequently quasi-rents, high. Quasi-rent is the difference in the rate of asset return between current use and opportunity cost. The rent-seeking capacity of groups affected by free trade and politicians' penchant for campaign contributions make protection "for rent."

Why Are Subsidies Important?

While the literature on trade and tariff protection is vast, the narrower, more recent, and frequently used instrument of subsidies has not received adequate attention. Most trade analysts conceptualize protectionism largely as support for tariffs, which are duties imposed on merchandise imports, even though this particular instrument has lost its potency by successive General Agreement on Tariffs and Trade (GATT) rounds. Member governments of the original GATT mandate in 1947 clearly recognized "that customs duties often constitute serious obstacles to trade" and committed to "sponsor[ing] negotiations from time to time directed to the substantial reduction of the general level of tariffs and other charges on imports and exports" (WTO, 2007b). Because of these negotiations, national governments now have restricted capabilities to impose tariffs at will. Hence the empirical relevance of that literature on protectionism may be limited. However, examining subsidies poses significant challenges. The main reason for the lack of attention is the paucity of cross-nationally reliable data. We just do not have a clear and accurate picture of the extent of subsidization around the world. The situation, however, has changed in recent years, and this study represents a first step in building a theoretically specified and empirically tested explanation of the important problem of subsidies.

The dismantling of trade barriers at the border, such as tariffs, quotas, and the like, has led to a rise in NTBs (Grimwade, 1989; Bhagwati, 1988). As countries become more exposed to the global economy, they seek to protect national cultures and identities with trade barriers that often take the form of NTBs. For example, Europe has recently passed legislation limiting, and in some cases eliminating, the importation of genetically modified foods or protection of geographic labels as product trademarks on the basis of preserving cultural identity or societal norms. Although the rationale may differ, the net effect is clearly protectionism of home markets against undesired imports without erecting tariff walls (Goff, 2005). Examining evidence from members of the Organisation for Economic Co-operation and Development (OECD), Blais (1986) finds that the illegality of protection at the border has given rise to the legality of protection in the domestic economy. He argues that as the rates of tariffs have decreased in the industrialized world, governments have found it necessary to increase disbursement of production subsidies. The pressures for protection have not waned; they have simply changed form. Bhagwati (1988, p. 53) calls this possibility the Law of Constant Protection: when one form of protection is eliminated, another form pops up somewhere else to take its place.

Governments have proved extremely creative in the protection they grant to their domestic industries. Once some of the more overt forms become illegal by treaty, several others are devised to get around the legal obstacles. Protection in the form of NTBs, which constitutes the bulk of harmful distortions to trade, takes many forms. Consider the differences between quotas and voluntary export restrictions (VERs). While quantitative restrictions in the form of quotas are illegal, the same restrictions in the form of VERs were not illegal until the Uruguay Round concluded in 1994. The reason is because quotas are imposed by the recipient government whereas in the latter case, the exporting nation chooses to "voluntarily" restrict shipments. This is one of the ways Washington sought to stem the flood of Japanese automobile imports in the early 1980s, to no avail of course. There is little doubt that the restrictions were not voluntary, but the point is that tariffs were by then an infeasible and illegal instrument of protection. The imposition of numerical restrictions has been shown to be highly ineffective because they tend to be highly commodity specific. Baldwin (1985) provides many examples. If restrictions in coat exports from certain countries exist, importers can easily import sleeveless coats, which are not subject to those restrictions, in addition to separate sleeves, and then assemble everything in the recipient country. Bhagwati (1988, pp. 57–58) adds industry characteristics as a major source of porousness. Some industries, such as garments or footwear, which produce undifferentiated products or have low start-up costs, are more prone to creative bypassing of VERs.

Producer subsidies are a form of NTBs.[3] The effects of subsidies are different from those of tariffs, and so are to an extent the politics of disbursement. Relative to tariffs, subsidies are less transparent, are revenue expending, support home production *and* export, and generate differences between producer and consumer prices (Horvat, 1999, pp. 132–133). In fact, welfare economists prefer direct subsidies over tariffs under certain conditions because they prevent losses to consumer surplus (Corden, 1997, p. 7). It is important to understand the differences if we are to get a better grasp of the allure of subsidies as a "new" form of protection.

Subsidies are less transparent to outsiders than tariffs or most NTBs. Consider the issue of tariffs or VERs. Barriers are erected at the border to prevent or restrict imports from reaching domestic consumers. The transaction involves both exporter and importer, which makes it very likely that exporters from the sender nation will catch a whiff of the barrier. In contrast, subsidies involve only the Treasury and domestic producers, who obviously have incentives not to advertise the transaction. Subsidies are, therefore, more difficult for outsiders to detect and more visible to domestic stakeholders (Hoekman and Kostecki, 2001, p. 170). Moreover, subsidies can be disguised as