The Political Economy of Reciprocity: A Comment

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In an interesting article dealing with reciprocity clauses in tariff reductions (Arndt 1994) Professor Arndt poses the intriguing question why reciprocity is so frequently demanded although economists have always preached (proved?) that unilateral tariff reductions or tariff removals by themselves are a sure way towards greater efficiency and welfare. To this he adds the further question why – in spite of this general tradition of reciprocity – several countries in the Asian-Pacific region have recently embarked on unilateral trade liberalisation. The following remarks try to supplement Arndt's arguments which – so it seems to me – leave out some important aspects.

Starting from the classical and perennial free trade bias of economic theorists based on the argument of allocative efficiency, Arndt does not treat the insistence on reciprocity as a "fact" simply to be taken into account when one describes and analyses economic reality, but as something whose existence has to be "explained" because it runs counter to the "obvious" welfare arguments of economists. According to Arndt, two *political* factors are mainly responsible for the insistence on reciprocity: firstly, the superior power of producer interests in following their aim to gain or maintain market access in industries subject to foreign competition, and secondly the popularity of "voodoo economics", i.e. the "prevalence of protectionist fallacies among the general public in most countries" (p. 264) which adds political support to the producers' demands.

□ Wien (Austria).

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Now I do not deny in the least that these political factors play an important role in the demand for reciprocity. That rent-seeking industrial lobbies – often representing both owners and the respective labour force – are reluctant to give up protectionist barriers and can only be persuaded or forced to do so if one can obtain a reciprocal "gain" is an undisputed and important fact. In this case it is only the weak representation of consumer interests in the political process (plus protectionist fallacies) which prevents welfare-increasing unilateral tariff reductions. There may also be – as Arndt concedes – good *economic* reasons for maintaining an infant industry tariff for some time. This is, however, irrelevant in the reciprocity context. For to be effective as a basis for the infant industry such a tariff must be maintained. Its reduction cannot be compensated by concessions in other fields.

Where my doubts come in is Arndt's light-hearted dismissal of the popular support for a policy of reciprocity (as against unilateralism) as being completely fallacious, irrational, "voodoo". Arndt may be right in saying that this popular bias is partly or predominantly based on mercantilist notions, on wrong ideas about a "favourable" trade balance or even on narrow nationalistic sentiments. But this does not mean that these wide-spread popular preferences – though based on wrong theoretical ideas (as is the case in many fields of economic policy) – are necessarily unfounded. Their persistence may be the consequence of experiencing an *economic* reality which makes sense of the reciprocity postulate.

It is not a new insight but one that has obviously to be repeated from time to time that free trade (including unilateralism in free trade policy) is the ideal prescription for maximum allocative efficiency and maximum (economic) welfare *in the presence of perfect competitive and frictionless markets*. This seems to be the background against which Arndt looks at reciprocity. But this picture changes radically when we turn to a less-than-perfect reality. Two factors now become important which affect the reciprocity aspect: (1) problems of unused capacity, unemployment, demand deficiency etc. ("macro-inefficiency"), and (2) problems of structural adjustment in a less than fully flexible economic environment. Let me take each of these two factors in turn.

Inefficiencies in real market economies are – as we know – of two kinds. Allocative inefficiency resulting from monopoly, "wrong" prices etc., and inefficiencies stemming from unused capacities and

unemployment. In principle one could regard these two kinds of inefficiency as two independent categories, each to be tackled separately (as far as possible) by adequate policy measures, e.g. a competition policy (including an unqualified free trade policy) on the one hand and a full employment policy on the other. If this were the case then free trade could be demanded pure and simple without bothering too much about reciprocity. But the problem is that these two questions are not completely separate. In particular, the aim of achieving and maintaining national full employment within a highly integrated world economy creates serious trade-off problems between employment and trade requirements. When a country is more concerned about employment than its trade partners and tries to embark on an expansionary policy, it can run into balance of payments difficulties which may stop its endeavour. Devaluation and/or protectionist measures might be of help, but they may be excluded by internal or external constraints and are in any case undesirable, because they mean the replacement of one inefficiency (unemployment) through another (allocative inefficiency). Reciprocity in trade negotiations can at least help – for the presence and the future – to ease the access to foreign markets and thus to reduce the danger of import-export imbalances in case of diverging employment policies.

In this context it should also be mentioned that under conditions of Keynesian underemployment (insufficient demand) the popular – and indeed the official – view that "exports are good, imports are bad" is not quite so absurd as Arndt wants us to believe. He is of course right when he points out "that if every country resorts to attempts to export its unemployment, all are worse off" (p. 264). But in a world which has international agreements and obligations concerning trade flows but none whatsoever for maintaining employment, it is "rational" (though perhaps not "moral") for a single country to try in times of sales difficulties to increase *its* exports, no matter what happens to others. This after all is what we expect *internally* from competitive firms: they should try to increase their share of the market irrespective of the effects this may have on competing firms. If we want to reduce the negative asymmetric effects of such competing national export drives we would need – ideally – a concerted international effort for fuller employment. But in the absence of such measures reciprocity in trade negotiations makes sense: it can shift attempts to achieve one-sided advantages in limited markets towards a more balanced expansion of international trade.

The second factor relevant for the reciprocity argument is the problem of structural change and adjustment. The free trade argument referred originally to the opening up of a static world to international trade. Free trade should enable each country to specialize in the fields for which it is best suited and this would help to achieve maximum world output. In principle this could be seen as a once-for-all task which might cause frictions in its emergence but would then lead to a permanent optimal division of labour in the long run. In a dynamic world, where technical and regional changes occur all the time free trade requires *continuous* adjustment processes to new situations. With structural changes becoming more rapid and sunk costs and human capital being not easily transformed, structural adaptations can become very costly in terms of lost production and structural unemployment. To protect endangered industries can bring considerable short-term advantages, but is dangerous and disadvantageous in the longer run. Reciprocity has a role to play in this context. It makes it easier for a country to accept the transition costs for its exposed "weak" sectors if its efficient branches get a better chance to expand abroad. This argument is further strengthened if we allow for increasing returns in firms and industries. Easier access for foreign goods of a certain kind will not only reduce sales of domestic firms but will also (because of lower output) increase their unit costs of production, thus reducing still further their competitiveness. Reciprocity will compensate this by enabling export branches to increase production with beneficial effects on costs and competitiveness. Efficiency will be increased allround.

My remarks so far have tried to show that – in contrast to Arndt's arguments – reciprocity is not *only* a political phenomenon – the child of narrow producer interests and mistaken popular beliefs – but can also be advanced for "good" economic reasons in a world of imperfect and imperfectly flexible markets and separate sovereign states. A word remains to be added about Arndt's final section where he points to recent tendencies towards unilateral liberalisation in several far-eastern countries and in Australia seeing them as "a new approach that may achieve freer trade without the troublesome handicap of explicit reciprocity" (p. 268). While it may be true – as Arndt implies – that this development is due to enlightened insights into the advantages of free trade measures without asking for reciprocity, I believe that this is only half the story. One should also take into account that in this case we are faced with a group of countries

which characteristically had high tariffs, of which many served the protection of infant industries, in order to allow the countries to enter the world market as industrial nations. But under such conditions – very high tariffs and infant industries which have grown up – unilateral measures are indeed an obvious policy on the path of development. That does not mean that reciprocity might not be helpful and welcome also in these cases, but it is of minor importance. The aim to obtain cheaper imports of productive inputs and to accept international competition is dominant and overshadows the trade vs. employment dilemma. In short we should conclude that while reciprocity demands are often based on political factors they also "make sense" economically – *depending on circumstances* – in a world of unemployment and structural rigidities.

REFERENCES

ARNDT, H.W. (1994), "The political economy of reciprocity", *Banca Nazionale del Lavoro Quarterly Review*, vol. 48, no. 190, pp. 259-269.