Understanding Standard-Setting in Academia: The Economics of International Trade

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While long ago the so-called new or strategic trade theory has shown that if one allows for real life phenomena such as economies-of-scale multiple equilibrium can result from trade policy changes, the current mainstream studies analyzing the likely impact of the manifold trade agreements under negotiation use the computable general equilibrium models which allow for only one equilibrium. This divergence of insights and practice calls for an explanation. How can a technique become state-of-the-art in academia despite well-known flawed assumptions underpinning it? An answer to this question needs to deal with the larger question of how standards are set in economics as an academic discipline.
It is too easy to point to the interests of those who commission the trade impact studies. While academia is not isolated from the rest of society, it does also follow its own logic of establishing reputation among its members. Reputation is gained and thereby standard setting powers by coming up with theories, methods or substantial answers that convince many other academics. The knowledge network analysis has opened up a perspective on how societal power constellations might find their mediated way into academia. Membership in such a network offers academics access to input resources for their research and to recognition outside of academia, both of which can enhance ones standing in academia. Nevertheless, the respective academic work has also to resonate with other academics' insights or beliefs.
*Besides developing a knowledge network based theoretical argument on standard setting in academia [**not yet fully spelt out in this draft**], the paper will explore its plausibility empirically by focusing (a) on how the insights of new trade theory were made compatible with the free trade agenda and (b) how computable general equilibrium models have become the standard for assessing the impact of trade policy changes [**will be presented orally**]. The first case highlights the interplay between the fear of some of the prominent protagonists of the new trade theory of the theories' policy implications and the discovery of new trade theory as a justification for regional trade agreements. The second case sheds light on the conditions that are conducive for influencing academic reputation with outside resources. Of importance is the congruence with paradigmatic beliefs held widely in the discipline, e.g. free trade, equilibrium, and mathematical sophistication.*

In the 1980s, against the background of rapidly increasing trade deficits, a debate took place in the USA on the partial revocation of foreign trade liberalization. Foreign trade theorists up until this point almost unanimously cherished the free trade paradigm. Competitiveness-related troubles of the capital- and technology-intensive industries, however, brought the foreign trade theorists under strong pressure to offer explanations. Some of the younger representatives began to take into account imperfect markets, heterogeneous products, increasing returns to scale, learning curves and external effects in their partial equilibrium models. Therefrom they concluded, that trade barriers can indeed have welfare-increasing effects for one's own country's economy. Subsequently, I describe how this challenge to the scientific status quo could gain attention and how eventually "strategic trade theory" was usurped for the justification of further liberalization steps.

The Free Trade Consensus

As in hardly any other policy field, experts of foreign trade policy almost exclusively come from one scientific discipline only: economics. Though it is usually lawyers who negotiate the details of trade agreements, especially persons with a formal economics education are considered to be competent to assess foreign trade policy measures. In no other economic policy topic is the consensus among economists as extensive as in trade policy. In the post-war era the two big camps of the discipline, Keynesians and monetarists, contended that tariffs and import quota impair the economic welfare of a country. Confronted with the statement "*Tariffs and import quotas reduce general economic welfare*" 81% responded with "Yes, 16% with "Yes, but" and only 3% with "No" in a a survey among specialized economists.[1]

The neoclassical-monetarist-minded part of the economists welcomed the opening up of markets as an instrument to increase macroeconomic allocation efficiency. The positive attitude of US-Keynesians towards a liberalization of foreign trade policy however might surprise in light of John Maynard Keynes' ambivalent position towards foreign trade and the critique of the world market levelled by some of his English adherents. Yet, the conditions for national full employment as striven for by all Keynesians present themselves differently in the USA than in the UK. Considering the superior competitiveness of the US-industry a quick revitalization of the world market promised export chances and therewith a safeguard for full employment. From a US-American-Keynesian point of view a liberalization of world trade in the framework of the Bretton-Woods system could be reconciled with the goal of full employment.

This consensus among economists was strengthened by the early commitment of major companies oriented to the world market or by foundations originating in these corporations in promoting expertise within foreign trade policy. Since these foundations, particularly the *Carnegie*- and the *Rockefeller*-Foundation, have decisively contributed to the development of social scientific and economic expertise since the beginning of the 1920s,[2] the economic internationalists have a first mover advantage: The works supported by them set scientific standards.

Admittedly, the external exertion of influence within economics is restricted through the reputations

[1] Pommerehne, Werner W./Schneider, Friedrich/Gilbert, Guy/Frey, Bruno S.: Concordia Discors: Or: What Do Economists Think?, in: *Theory and Decision*, 16(3) 1984, pp.251-308.

[2] Fisher, Donald: *Fundamental Development of the Social Sciences.* Rockefeller Philanthropy and the United States Social Science Research Council. Ann Arbor 1993; Lagemann, Ellen Condliffe: *The Politics of Knowledge.* The Carnegie Corporation, Philanthropy, and Public Policy. Middletown, Conn.1989.

and *tenure*-system, but with money policy advising research institutes could be established, teaching duties could be reduced to encourage university-based research and elaborate, international standard setting research could be promoted.

In the 1980s, faced with the growing US trade deficit and the lack of competitiveness of high-technology-centers, a debate among foreign trade theorists emerged with regard to the following two questions: How far should the USA reinforce its industrial policy measures and to which extent can the threat of closing domestic markets be formulated to make foreign trade partners open their markets? The traditional foreign trade theorists opposed an increase of governmental intervention as well as a deviation from the principle of multilateral rule setting. A younger generation of foreign trade theorists however developed models with which under certain assumptions targeted industrial subsidies and the "strategic" use of the domestic market for liberalization negotiations could be demonstrated to have welfare-improving effects for a large economic space such as the USA. Referring to these results, some authors even called into question the advantages of free trade in general.[3]

With the accession to office of Bill Clinton in 1993, the concepts of strategic trade policy received official recognition by the government office. Clinton appointed high-profile advocates of the active governmental flanking of globalization processes, especially Laura Tyson and Robert Reich, as members of his cabinet. Therewith however, the stellar career of strategic trade policy already reached its climax. Later that year, Clinton pushed the *North American Free Trade Agreement* (NAFTA) and the foundation of the *World Trade Organization* (WTO) the year after through Congress. In view of the failure or the perversion of his big reform projects at the domestic front (health care and welfare-reform) this agenda setting in the field of foreign trade policy characterized his first period of office. How was this rapid backsliding possible?

Theory vs. Empirical Evidence

In the early 1980s industrial policy was the home domain of political scientists, sociologists and especially management experts, who viewed the world from the position of producers as a *Zero-Sum-Society*[4]. Foreign trade theorists by contrast were able to substantiate that the "unfair" trade practices and the industrial subsidies of partner countries, analogous to tariffs, had to be perceived as welfare-reducing distortions of international market activities. For one's own country however they would have a welfare-increasing effect, virtually a "present" from the foreign government to

[3] e.g. Kuttner, Robert: *The End of Laissez-faire. National Purpose and the Global Economy after the Cold War*. New York 1991.
[4] Thurow, Lester C.: *The Zero-Sum Solution: Building a World-Class American Economy*. New York 1985.

one's own customers. Nevertheless, the further growing trade deficit and especially the competitiveness-related problems within the capital- and technology-intensive sectors minimized the persuasiveness of these arguments in the political arena, visible in the journalistic success of the “industrial policy politicians”.

Traditional theory explains trade between countries as a consequence of differential factor endowment. However, a large part of US-foreign trade was conducted with economies such as Japan, compared to which no significant differences in factor endowment or with regard to production technology existed. Moreover, adherents of the traditional theory implicitly assumed – and this was theoretically supported by Vernon's product cycle theorem – that the USA disposes of a factor endowment that is favorable to high technology industry.[5] The unmistakable technological strength of Japanese companies, however, seemed to suggest that comparative advantages could also be created artificially. To this intellectual challenge some younger foreign trade theorists, associated with the private, non-profit foundation *National Bureau of Economic Research* (founded by the *Carnegie Corporation* in 1920), responded with taking into account imperfect markets, heterogeneous products, increasing returns of scale, learning curves and external effects in their partial equilibrium models. They made references to game theory, industrial economics and the new growth theories which endogenize technological progress.[6]

Starting point of the research project probably being central one to the development of strategic foreign trade theory interestingly was not the competition to Japan, but the consequences for US-trade of the industrializing strategies of developing countries financed with OPEC-money. Paul Krugman in the context of this project concluded that technological progress taking place only in the already advanced country, benefits welfare in both countries, whereas such progress in the less advanced country only increases its welfare.[7] At least since Adam Smith it is acknowledged that international trade can lead to increasing returns on scale, i.e. decreasing production costs per unit parallel to growing volumes of production. Therewith, the classical model assumption of decreasing returns on scale is not always met. This problem, however, was for a long time neglected by theoretical research, since the recognition of the phenomenon of increasing returns on scale within neoclassical foreign trade theory would have meant to face simultaneously the problem of complete specialization, multiple equilibria, the indetermination of factors of production and imperfect competition.[8] Especially the consideration of increasing returns on scale and high development

[5]Vernon, Raymond: International Investment and International Trade in the Product Cycle, in: *Quarterly Journal of Economics* 80/1966, pp.190-207.

[6]Krugman, Paul (ed.): *Strategic Trade Policy and the New International Economics*. Cambridge, MA 1986.

[7]Krugman, Paul: Targeted Industrial Policies: Theory and Evidence, in: *Industrial Change and Public Policy,* A Symposium sponsored by the *Federal Reserve Bank* of Kansas City 1982.

[8]Gomes, Leonard: *Neoclassical International Economics: An Historical Survey*. Houndmills, Basingstoke, Hampshire 1990: p.136.

costs led under certain further model assumptions to the conclusion that trade barriers can have welfare-increasing effects for one's own country. This way a domestic company can enjoy returns on scale more rapidly when the foreign competitor can be kept out of the market in the introduction phase. It thereby gains an initial advantage on third markets.

Standoffs

The first results of these efforts induced the fear within the trade theoretical community that these could lead to wrong, namely state interventionist conclusions for trade policy. Particularly one of the leading representatives of this new line of research, Paul Krugman, explicitly did not want strategic trading to be understood as a recipe of foreign trade policy, neither in relation to industrialized countries nor in relation to countries of the so-called Third World.[9] The research community thus relativized the validity of the models. On the one hand the results of these models would be very dependent on the model parameters. Already minor changes of the assumptions would influence the results significantly. Jagdish Bhagwati was warning therefore: *„It is important for the students to appreciate (...) that the literature primarily suggests that policy recommendations are extremely sensitive to parametric assumptions (...) and that therefore the information requirements for a welfare-improving intervention are often mindboggling.“*[10] On the other hand these models would not take into account the potential reactions of partner countries. Strategic measures aimed at the improvement of one's own competitive situation could result in retaliations: “Strategic trade policy only works as long as the trade partner does not react”.[11] Beyond that it has been doubted whether, even if governmental intervention could be theoretically justified, the respective state would really be able to act accordingly. Actors of trade policy were neither thought to have the appropriate level of information nor to be capable to actually orient policies to the common good as being confronted with strong interest groups. The “politological” judgement on the “new foreign trade theory” was, that strategic trade policy only substituted a potential market failure with actual state failure.

These standoffs certainly did not mark the end of strategic trade policy. In view of the further existing pressure, the insights of strategic trade theory could been seized upon by mostly non-specialist representatives with journalistic success. Within the central private foreign trade associations and the world market-oriented and internationalist research institutes as well as

[9]Krugman, Paul: Does Third World Growth Hurt First World Prosperity?, in: *Harvard Business Review*, 72(4) 1994, p. 113ff.; id.: Competitiveness: A Dangerous Obsession, in: *Foreign Affairs* 73 (2).

[10]Bhagwati, Jagdish N. (ed.): International Trade. 2. Edition, Cambridge, MA1987: p.127f.

[11]Borchert, Manfred: Strategische Handelspolitik - alter Wein in neuen Schläuchen?, in: *RWIMitteilungen*, 45(3) 1994, pp.205-220, here: p.220 (own translation).

foundations concepts of strategic trade policy have been extensively discussed under the premise of safeguarding a liberal trade regime. In the course of this, it became clear that the "new foreign trade theory" could be utilized in a double sense to justify further steps of liberalization.

Opening up Foreign Markets

First, the strategic trade concepts have been applied to shift the interest from shielding domestic markets towards opening up foreign markets. A key role in this was played by Fred Bergsten. In the 1980s, this influential director of the *Institute of International Economics* always opposed industrial and trade political measures and conceived a macroeconomic steering of the economy to be sufficient. At the beginning of 1992, however, he permitted Laura D'Andrea Tyson, then director of the strategic trade policy advocating *Berkeley Roundtable on International Economy* (BRIE) to publish her appeal to a "*cautious activist*" industrial and trade policy as a study of his institute: *Who's Bashing Whom*? As she admitted herself in the foreword, she diverged from her initial managed trade concept in the course of the research. In contrast to the BRIE-book *Manufacturing Matters,*[12] she repeatedly stressed, that aggressive unilateralism should only be deployed to encourage competition and trade and also only as long as multilateral rules are missing, i.e. only as a "*stop gap measure*" to defend US-American economic interests.[13] Eventually her trade policy plead amounted to a defense of the practice, dominant in the years before the establishment of the WTO, to force trade partners, particularly Japan, with Super 301 and antidumping proceedings to open up their markets.

As a member of the Clinton administration she even diverged further from her initial positions. The ineffectiveness of her hard trade political stance towards Japan might have contributed to this. In contrast to industrial policy which was soon sacrificed to the efforts of budget consolidation, the budget neutral strategic trade policy was tackled much more energetically by the Clinton government. Already in April 1993 negotiations with the Japanese government began which aimed at enforcing a results-oriented market opening strategy. When the Japanese part strictly repudiated import quotas, President Clinton even went so far to burden the world economic summit which was scheduled later in July in Tokyo, with the continuation of these negotiations. His engagement eventually made the Japanese government sign the *United States-Japan Framework for a New Economic Partnership.* With this agreement Japan committed itself to "significantly" reduce its trade surplus, to remove its non-tariff trade barriers as well as to increase the imports of American

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[12] Cohen, Stephen S./Zysman, John: *Manufacturing Matters. The Myth of the Post-Industrial Economy.* New York 1987.

[13] Tyson, Laura D'Andrea: *Who's Bashing Whom? Trade Conflict in High-Technology Industries.* Washington, D.C 1992: p.254.

supercomputers, satellite products, medical equipment and telecommunication devices. No commitment however could be attained for minimum import quotas from the Japanese government. Also with the following 32 agreements with Japan no results-oriented, quantifiable criteria of success for further market opening steps could be fixed. The Japanese government was able to take a hard stance due to several reasons. First, they could expect strategic trade policy to remain contested in the USA. Twenty-five well-known economists for instance, including the Nobel Prize winners and Keynesians Lawrence Klein, Franco Modigliani, Paul Samuelson, Robert Solow und James Tobin, advised the Japanese government to reject the *"misguided"* demands of a results-oriented market opening as articulated by Clinton during the world economic summit in 1993 as "*myopic*".[14] The high rates of growth of the US-American export industry moreover reduced the interest of the business world to pursue aggressive market opening strategies. In addition, the traditional concerns in terms of security policy towards a too aggressive approach remained valid. Beyond that, all Japanese interest groups as well as other trade partners opposed minimum import quota.

Regional Free Trade Agreements

Secondly, the "new foreign trade theory" could be adduced to justify further, own liberalization steps. Especially the maximization of returns on scale would only be possible with a further specialization in the context of intra-industrial trade which however would require the removal of non-tariff barriers to trade. This argument has been applied effectively to justify deregulation measures in the context of free trade zones, for instance within the *Cecchini-Report* for Europe in 1992 or for NAFTA.[15] This way, also people like Clyde Prestowitz of the *Economic Strategy Institute* who saw the biggest challenge for the USA in Japan, welcomed NAFTA as a means to improve competitiveness. Nevertheless, they wanted to see the text of the contract being strengthened in favor of U.S. companies and insisted on guarantees that no further nation will enjoy the kind of market privileges granted to Mexico.[16]

In the camp of general supporters of free trade it was initially feared that bilateral agreements such as NAFTA would undermine the multilateral GATT. The controversy between bilateral and multilateral approaches was staged in many fora of the economic internationalists. The *Council of Foreign Relations* for example discussed the question whether bi- or multilateral trade liberalisation

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[14] Krauss, Melvyn: *How Nations Grow Rich. The Case for Free Trade.* New York 1997: p.16.

[15] Harris, Richard G.: The New Protectionism Revisited, in: *Canadian Journal of Economics* 22/1995: pp.751-778, here: p.752.

[16] Prestowitz, Clyde V./Cohen, Robert mit Peter Morici u. Alan Tonelson: *The New North American Order: A Win-Win Strategy for US-Mexico Trade*. Lanham, MD 1991.

strategies should be preferred in the framework of its *International Trade Project*. Its long-term director on research, William Diebold, drew a parallel in a study financed by the *Ford Foundation* to foreign minister Hull's bilateral agreements in the 1930s. These would have provided the basis for the multilateral GATT in the post war era. When no progress can be made on the multilateral level, bilateral liberalization steps would be justified as long as they are rooted in a strong multilateral system. They would thus be able to define the next steps for multilateral negotiations.[17] The idea that NAFTA could be used as the precursor to a worldwide implementation of a free trade regime crystallized as a consensus. Already the negotiations on a free trade zone with Canada aimed at influencing the GATT-round, since the first-time inclusion of services into a free trade agreement was supposed to become a model for GATT-rules. The investment and copyright protection envisaged in NAFTA should in turn serve as the basis for multilateral agreements with developing and emerging market countries. These expectations would indeed be satisfied. One year after NAFTA's ratification the multilateral treaty to found the WTO was signed. Through the strengthened dispute settlement procedures moreover, the possibility for unilateral proceedings of the USA, its most important weapon in the arsenal of strategic trade policy, was restricted.

Overall it can thus be stated that the discrepancy between theoretically justified prognosis and actual events opened the space for a “new” foreign trade theory. Its more realistic assumptions clearly questioned the previous conclusions of foreign trade theory which so far turned out in favour of free trade. The scientific community responded to this challenge on the one hand by calling into question with “politological” arguments the political applicability of strategic trade policy and the expertise of the non-economic experts. On the other, they exploited the ambiguity of the new foreign trade theory's statements to justify deregulation measures in the context of free trade zones and the instrumentalisation of US-trade policy for opening up foreign countries' markets. They received support in this from foreign policy and foreign trade policy fora of corporations oriented to the world market. Thus, a hopeful intellectual restart in the field of foreign trade theory ended up in free trade orthodoxy.

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[17] Diebold, William, Jr., (ed.): *Bilateralism, Multilateralism, and Canada in U.S. Trade Policy*. The Council on Foreign Relations series on international trade, Cambridge, MA 1988: pp.181-185.