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The Limits of Rent Seeking
A Prescriptive Model

People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.

Adam Smith, *The Wealth of Nations*

It has become a cliché in these troubling times to note that freedom does not come for free. The logic extends into the realm of trade. The price for free global markets is sometimes paid by politicians whose enthusiasm for the economic benefits leads them to underestimate the political costs. More often, risk-averse politicians eschew the benefits of trade, fearing electoral sanction. This risk aversion, however, imposes opportunity costs of its own. There is little debate among economists that free trade is, in the aggregate, economically beneficial. It expands firms' productive capacities, encourages specialization and efficiency in the productive sector, and broadens consumer choice while subjugating prices to the rigor of market competition. It provides incentives for innovation and stimulates foreign investment. It creates jobs and, with time, raises wages. Free trade fosters economic interdependence between nations and hence creates disincentives for trading states to escalate conflicts. Economically speaking at least, under most conditions free trade represents a dominant strategy for states seeking to maximize aggregate wealth.

A significant problem, however, is that the economic benefits of free

trade are not well understood by the general (and voting) public. Free trade might be generally advantageous, but it is not a vote getter; often, in fact, it is a vote loser. Free traders have a much harder time getting out their message than do protectionists. One reason is that there are obvious dislocation costs associated with free trade. Plants close, workers lose jobs, local economies are badly hurt. These are the sorts of human-event stories that are tailor-made for the evening news. Less interesting to viewers, and hence the media, are stories about the economic advantages inherent in Ricardo's theory of comparative advantage (1960), prospects for more favorable economies of scale, and the altered incentive structures for direct and portfolio foreign investment. Al Gore may have out-debated Ross Perot on CNN's *Larry King Live*,[1] but the most memorable event was Perot's earlier reference to the "giant sucking sound" that would be created as U.S. companies pulled up stakes and departed for Mexico to take advantage of labor-cost savings. Gore's own rhetorical stunt, presenting Perot with a framed photograph of the sponsors of the disastrous Smoot-Hawley Tariff of 1930, was not as effective. Nor, manifestly, was the logic that the North American Free Trade Agreement (NAFTA) did not create the low-wage economy and therefore was not terribly likely to have an overwhelming impact on plant closings in the United States. The point that stuck was that NAFTA would create a giant sucking sound.

More problematic for free trade is the fact that protectionist coalitions form far more readily than do advocacy groups. As students of international political economy and public choice theory have long maintained, free trade represents an asymmetric public good (Tullock 1967; Peltzman 1976; Becker 1983; Rowley and Tollison 1988; Lake 1988a; Baldwin 1989). While the aggregate benefits may outweigh the costs, the effects are unevenly distributed. The benefits of free trade are broad but latent. The costs, concentrated and manifest, are borne by a comparatively small number of producers who had enjoyed "rents" derived from the insulation of the domestic market. (Economists define a rent as the return on a factor of production in excess of its opportunity cost. For example, a rent may be thought of as the difference between a professional baseball player's salary and the optimal salary he could earn if not playing ball.) Consumers, often uninspired by (or unaware of) the link between free trade and marginal reductions in retail prices typically fail to man the metaphorical barricades in support of free trade. Protectionist producers—rent seekers—react differently; given the stakes involved, they can be relied on to mobilize for retention of such state-supplied rents as direct subsidies, tax breaks, or impediments to imports

such as tariffs or nontariff barriers.[2] For their part, elected governments faced with the choice of appeasing indifferent consumers or belligerent producers have an obvious incentive to gratify the latter (see Lavergne 1983; Frey 1984; Lake 1988a; Tullock 1988; Baldwin 1989; Williamson 1994a).[3]

Governments generally are not indifferent to the economic benefits of free trade. A strong economy typically rewards incumbent officeholders. While the palliative effects of free trade are sufficiently delayed that only the most optimistic incumbents would plan to reap direct benefits, the negative economic effects of protectionism can weigh heavily on a country's economic performance. Even if trade liberalization is not directly politically rewarding, in other words, it may have powerful indirect political benefits. Voters do not necessarily have to know why the economy is performing well; it is enough that they recognize that it is. Finally, government leaders can be expected to look out for the best interests of the countries they govern. Provided that the price is not too high (such as sacrificing a political career), it must be assumed that many government leaders (1) have an interest in national aggregate wealth maximization and (2) recognize that free trade is an efficient means to this objective.[4]

Given that government leaders have an incentive to liberalize trade, it is of fundamental importance to determine circumstances under which trade can be liberalized without incurring excessive political cost. I believe that governments can minimize the political risks associated with significant liberalization of trade. I argue here that under certain conditions, rent-seeking opponents of trade liberalization actually may turn into critically important allies of governments attempting major policy shifts from protectionism to free trade. Where domestic rent seekers are persuaded that the government cannot or will not provide sufficient rents, rent seekers may pursue a second-most-preferred strategy that entails attempting to secure access to cheaper factor inputs and to foreign markets by actively supporting trade liberalization. This transformation of behavior on the part of rent seekers is a condition that can be exploited by adroit government actors, and a menu of options is presented here for governments that seek to reduce rents without suffering severe political backlash.

Free trade should not be presented as an optimal policy choice under all circumstances. I merely assume that, all things being equal, free trade is economically beneficial. This is not a heroic assumption, and countless others, from Ricardo onward, have justified it. That said, in assessing the rationality of any course of action, one must be cognizant of the desired ends. Free trade is sound policy if governments' objectives are to maximize aggregate levels of

wealth. Of course, it is easy to imagine circumstances where governments have other first-order objectives. For example, where governments are more concerned with national security than wealth maximization, free trade becomes less attractive. Ricardian theory proves that the United States would be better served economically to import some of its strategic munitions from low-wage economies rather than produce them itself. For obvious reasons, however, this is unlikely to be a preferred choice. Similarly, as recent protests in Seattle, Genoa, and Quebec City have suggested, many believe (rightly or wrongly) that trade liberalization undermines other important objectives, including environmental protection and sovereignty of less-developed nations.

In addition, I do not assume that free trade will distribute wealth equitably. However, since free trade forces governments to stop redistributing wealth to the productive sector, there is an assumed progressive element to trade liberalization. Indeed, this is why free trade is so intimately tied to early liberal thought. But there is no guarantee that increasing aggregate wealth will benefit all equally or equitably. The worker whose job is sacrificed for the long-term health of his former employer's company or the economy at large takes cold comfort in economic theory. And it is not just workers who suffer real, human costs. Dislocation associated with free trade forces many businesses from the marketplace. A lifetime's work of building a business can be wiped out in a tidal surge of competition unleashed by free trade. Thus, I aim not to lose sight of the fact that the overall objective of freer trade is to maximize wealth, not to maximize justice.

The Costs of Rent Seeking

Economists have long been concerned with two related phenomena: monopoly (or collusive oligopoly) costs and activity that dissipates resources without productive benefit. The latter falls under the broad rubric of directly unproductive profit seeking (DUP),[5] a subset of which is rent seeking. The costs of monopoly are familiar to all students of elementary economics. The supply curve under monopoly conditions is artificially restricted, leading to less output and higher commodity prices than would have occurred under conditions of free competition. However, the literature on rent seeking, developed initially by Tullock (1967), suggests that the societal deadweight cost of monopolies is much higher. Indeed, the competition for monopoly rents, which includes lobbying and advertising as well as attendant personnel costs, constitutes a dissipation of resources that could otherwise have gone into

more productive activity. As Brooks and Heijdra (1988, 32) suggest, "The basic explanation of why wealth-seeking behavior here generates waste is that individuals withdraw resources from some sector of the economy, and spend these resources on rent-seeking activities without at the same time expanding the output of the sector they wish to enter."[6]

In the aggregate, those in competition for monopoly rents often will allocate resources in excess of the total amount of the rents they seek to capture. (Here we can think of a lottery. The total money spent on tickets is greater than the total prize payout.) The opportunity costs for this competition are lost to society as a whole. Finally, as Krueger points out, rent seeking alters societal incentive structures, providing, for example, resource-diverting competition among those who seek personal utility by virtue of being in a position to supply monopoly rents.[7] Rent seeking in the trade policy arena involves largely the pursuit of monopoly or oligopoly rents in the form of barriers to import penetration and/or direct subsidies (see Lavergne 1983).

In sum, protectionist rent seeking tends to be inefficient. Devices such as tariffs, import licenses, quotas, and voluntary export restrictions impose deadweight costs onto society at large. Because it skews incentive structures within the marketplace, import protection diverts resources from sectors enjoying comparative advantage toward those that operate less efficiently (Ricardo 1960; Tullock 1967; Krueger 1974). An important qualification, however, concerns infant industries. Industries in newly developed countries, potentially competitive in world markets save for catch-up costs associated with late entry into the game, might efficiently be protected in the early years of their development. Such protection represents an investment in the prospect for long-term competitiveness of the new industry. Most industrializing countries, therefore, have allowed their nascent manufacturing sectors to develop behind tariff walls.[8]

Nevertheless, such a strategy has the potential to generate negative byproducts. Domestic protectionism provides incentives for producers to emerge in sectors that suffer comparative disadvantage. In many cases, such producers can exist only as long as the state provides sufficient import protection. Even for industries in other, potentially more competitive sectors, import protection may discourage innovation, quality control, efficiency, and international competitiveness. As long as production for the domestic market is profitable, there may be no incentive to assume the risks and costs of restructuring operations to compete in world markets. Indeed, inertia may prolong protectionist policies even after they become suboptimal. Goldstein (1993a, 226) points to postwar opposition by American farmers to

agricultural trade liberalization under the General Agreement on Tariffs and Trade (GATT) as an example. Insofar as American farmers were internationally competitive in the 1940s, the failure to liberalize agricultural trade under the GATT meant that foreign markets, potentially receptive to American agricultural exports, were rendered less accessible. In short, protectionist strategies designed to provide temporary shelter for infant industries become institutionalized, and governments seeking to reduce tariff rates face opposition from powerful domestic rent seekers.[9] It is for this reason that departure from the tradition of protectionism is so difficult politically. As Anderson and Garnaut (1986, 171) put it, "Producer groups in each industry can be viewed as the demanders of protection for their industry, and political leaders as the suppliers. It seems reasonable to assume . . . that political leaders tend to adopt policies so as to maximize their chances of remaining in office, while groups who expect to gain (lose) from a particular policy seek (oppose) its adoption by investing in lobbying and propagandising up to the point where they perceive that expected net benefits from further expenditure are zero."

Conversely, because radical shifts toward trade liberalization do occur, it is clear that the policy is not wholly intractable. Moreover, experience shows that countries that open their economies to external competition often are able to maintain free trade while fighting only limited rearguard battles with domestic rent seekers. Indeed, under such circumstances, former protectionists often tend to be in the forefront of the fight for further liberalization of trade, and at the very least offer little resistance to freer trade.

I have two objectives here: (1) to explain the conditions under which formerly protectionist interests become free traders and (2) to identify a prescriptive means by which risk-averse governments can engage in difficult trade policy decisions, while assuming a minimum of political cost and risk. I offer the limits of rent seeking model to explain behavioral changes—both individual and aggregate—among rent seekers and the rent-seeker population. Case studies illustrate the process by which governments are able to induce and predict certain behavioral characteristics on the part of rent seekers.

The Limits of Rent Seeking

The limits of rent seeking argument can be made most clearly in ideal-typical terms (see also Lusztig 1998). Imagine a world in which producers have two means of creating profits. They can dedicate resources to competi-

tion in world markets (call this adjustment); alternatively, they can seek rents in the pursuit of a protected domestic market in which they are well placed to secure a pertinent market share (call this rent seeking).[10] Given this profit-making dichotomy, it is possible to construct for each producer an indifference curve between expected utility from adjustment and from rent seeking. Each producer implicitly selects a production strategy that entails a degree of adjustment and a degree of rent seeking. Some firms, of course, will adopt an asymptotic position, eschewing in any meaningful sense one strategy or the other.

Points selected by individual producers on the indifference curve will largely be a function of circumstances such as past history, relations with the state, changes in technology and market opportunities, risk acceptance, and even inertia. Of course, a producer's decision in selecting the optimum production point also is influenced by the cost of adjustment relative to the cost of rent seeking. Where protection is relatively cheap, more producers will prefer production points that involve limited adjustment; by the same logic, where protection is relatively expensive (that is, where governments are less inclined to grant rents), a larger share of the producer population will opt for production points involving a greater degree of adjustment.

Producers who select production points involving a good deal of adjustment can be expected, broadly speaking, to support trade liberalization initiatives. Adjustment typically entails increased reliance on low-cost factor inputs (e.g., labor and unfinished goods), many of which may be imported, as well as reciprocal access to export markets. Those more reliant on state-supplied rents are classified as protectionist rent seekers and are of more immediate interest.

Within the rent-seeker population, and again imposing ideal-typical classifications, we can suppose a further dichotomy. One category of rent seeker consists of domestic producers whose capital is immobile and who have invested in sectors that, due to competitive and comparative disadvantages, could not possibly compete internationally. These producers, in other words, select a production point heavily skewed in favor of rent seeking. For them, should there be a dramatic increase in cost or decrease in availability of state-supplied rents, the results would be disastrous, the degree of requisite adjustment prohibitive. A mythical and extreme example would be olive farmers in Finland. Theoretically (given large and expensive greenhouses), such producers could survive, but they would require enormous state-supplied rents. Should these rents be significantly reduced, such producers would be unable to survive import competition and would be forced to exit

the market. These producers are styled inflexible rent seekers. For them, state-supplied rents are necessary for survival.

The second ideal-typical category of rent seeker also prefers rent seeking to adjustment but conceivably could restructure operations to compete internationally. Although there are costs involved, such producers, by virtue of enjoying fairly mobile capital and relatively cheap access to critical factor inputs, could substitute profits from adjustment for profits from rent seeking should the costs of protection rise significantly or the environment in which they find themselves change dramatically. These are flexible rent seekers. Akin to the idle adolescent who prefers a parental allowance to getting the metaphorical haircut and job, flexible rent seekers are those who will not starve if forced to survive by earning their living in the free market. Of course, upon choosing to adjust to increased import penetration, flexible rent seekers actually prejudice their own chances to receive state-supplied rents in the future. As Hathaway (1998) notes, strong market performance in the face of import competition demonstrates to governments that state-supplied rents are no longer vital to industry performance. In other words, as flexible rent seekers adjust to new conditions, they undermine their ability to convince governments of the need to supply rents.

This distinction between flexible and inflexible rent seekers is of interest because the two groups will respond differently to significant reductions in state-supplied rents. The distinction between flexible and inflexible rent seekers is important for governments attempting to determine the downside political risk of comprehensive free-trade policies. A rent-seeking population that is predominantly flexible responds differently to the policies enacted by a liberalizing government than does a predominantly inflexible population. Flexible rent seekers ultimately will dedicate fewer resources to punishing governments that liberalize trade. (Such punishment manifests as a range of behavior from temporarily withdrawing political support for the government all the way to actively campaigning to defeat and replace it.) Instead, the preponderance of resources will be dedicated to restructuring operations to withstand import competition. Such restructuring includes product and service innovation, rationalization of product lines and personnel, and perhaps most important, exploration of new markets to replace market shares lost at home.[11] Moreover, as firms and industries become more export oriented, they seek a general reduction in domestic tariffs and other import barriers, both to generate reciprocal concessions abroad (Finger 1991, 126) and to reduce the costs of imported factor inputs and hence make their own products more competitive internationally. A related point is

that more liberal domestic trade policy increases the foreign-exchange earning capacity of other countries, thus potentially expanding demand for the exports of the liberalizing country (Pugel and Walter 1985, 468).

Flexible rent seekers will rely on governments to create market opportunities abroad and will seek to foster influence with them. They are predicted to shift from protectionists to free traders when state-supplied rents drop below a critical level—that is, the level below which it no longer pays flexible rent seekers to produce predominantly for the domestic market. Note that this critical level is not a universal threshold; it will vary from industry to industry and firm to firm. Consequently, reducing rents below the critical level actually turns flexible rent seekers into (long-term) allies of governments that have a preference for freer trade (see also Hathaway 1998). Former protectionists become integral to an emerging free-trade coalition; what we witness is actually a reversal of rent seeking on the part of flexible rent seekers.

Inflexible rent seekers, on the other hand, may be expected to do one of two things. The more politically benign reaction is to exit the marketplace voluntarily (see Staiger 1995). The less benign is to retaliate against governments that reduce rents. There are few opportunity costs for inflexible rent seekers who seek to punish governments that reduce rents below the critical level;[12] such rent reduction is a death sentence. The result is a "short shadow of the future" (Axelrod 1984) for relations between the government and inflexible rent seekers. Of course, governments that survive the wrath of inflexible rent seekers typically find themselves in a stronger position. The least efficient strata of the producer population are culled—either through voluntary exit or inevitable attrition—providing greater flexibility with respect to trade policy in the future.

Flexible and inflexible rent seeker are ideal-typical classifications, and most rent seekers ultimately conform to the characteristics of one category or the other, but some rent seekers demonstrate traits associated with both. Thus, some firms and industries, even as they adapt to increased import competition, continue to lobby the government for a return to increased protectionism. Similarly, as certain industries decline, they may shift from being flexible rent seekers to having mixed characteristics and begin pressing for increased protectionism.[13]

Also, while examination of each sector or firm's capital mobility and international competitiveness may provide some predictive insights, these axiomatically will be imprecise. Some industries will not be sufficiently introspective and risk accepting, nor enjoy the prescience, to predict ahead of time to which category of rent seeker they conform. Faced with a choice be-

tween the certainty of the status quo and uncertainty associated with change, many firms will eschew risk even where the potential for reward is greater. Such risk aversion does not constitute a serious problem for this analysis. It merely indicates that there may be a time lag between the elimination of state-supplied rents and the predicted behavior of domestic rent seekers. Over the short term, rent seekers unable to gauge their international competitiveness may be expected to conform to the predicted behavior of both flexible and inflexible rent seekers. That is, they will seek to force restoration of state-supplied rents *and* restructure operations to compete in world markets. Eventually, the grim force of the market will force inflexible rent seekers to come to terms with their economic mortality. By contrast, flexible rent seekers, recognizing that they can compete, will modify their behavior; rather than attempting to force restoration of rents, newly aware flexible rent seekers will switch tactics and lobby for greater access to foreign markets.

Finally, reliance on broad ideal-typical classifications presents certain empirical challenges. I provide no a priori means to establish what sort of producer profile will generate what behavioral response in any given firm, nor do I attempt to predict the ultimate behavior of government actors. Many of the same factors that influence firms' decisions about the optimal trade-off between rent seeking and adjustment (especially historical development and state-society relations) also influence the behavior of government actors. Therefore I do not attempt to establish a set of causal sequences that generate specific policy outcomes. Rather, I rely on the logic of the limits of rent seeking model to articulate a menu of policy options. Part of what makes the analysis in the case studies so interesting is the variation across cases in selections from the policy menu.

It is with respect to policy outcomes that the current analysis differs most markedly from studies that rely on factor-based models (see Rogowski 1989 and especially Hiscox 2002).[14] I do not set up my argument as an alternative to factor-based analysis per se, and there is a good deal of logical overlap between my study and Hiscox's; many of the cases are common to both analyses. My argument, however, is more sensitive to the idea that government actors play a proactive role in the formation of trade policy. Indeed, because governments can manipulate the levels of available rents, they can also alter the incentive structures for those within the producer population. While the limits of rent seeking model suggests that coalitions are critical to the realization of trade policy objectives, this model is based on the premise that it is not possible to make predictions about what sorts of coalitions will form.

Rather, the characteristics of emerging coalitions will be determined in large part by the strategies adopted by governments seeking to liberalize trade.

Avoiding the Blame

Given the basic logic of the distinction between flexible and inflexible rent seekers, three variables emerge to determine the extent to which governments will be punished for reducing rents. From these, prescriptions can be gleaned for future governments seeking to reduce state-supplied rents.

Catalysts for Rent Reduction

The first relevant variable turns on why rents are reduced in the first place. There are three processes that may trigger rent reductions: crisis, mandated change, or shifting government objectives. These vary in the extent that they expose liberalizing governments to risk.

The first trigger mechanism is economic crisis. As the term is used here, crisis describes depressions, severe and sustained recessions, or discrete events that have the effect of disrupting commerce in a particular sector or industry for a sustained period. Crises are widely recognized as catalysts for policy change because they lower, for both governments and society as a whole, the utility derived from the status quo (see Skowronek 1982; Krasner 1984; Gourevitch 1986; Goldstein 1988; Putnam 1988; Grindle and Thomas 1991; Keeler 1993; Williamson 1994a; Rodrik 1996). In addition, crises generate increased and more widespread demands on governments to distribute public resources. At the same time, however, governments find that during times of crisis, there are fewer resources available for distribution. The result tends to be a decline in each rent seeker's share of state-supplied subsidies, or, put differently, an increase in the cost of rent seeking.

In addition, for at least two reasons, crises create incentives for governments to reduce barriers to import protection. First, because crises often are a function of unsustainable trade deficits (usually combined with insufficient foreign funding for these deficits), they force countries to rely on strategies of export-led growth. In turn, by the logic of reciprocity, export-led growth exerts downward pressure on import barriers. Second, crises narrow the utility gap for governments between the status quo and policy reform. In normal times, governments are loath to lower import barriers, because the trade policy status quo is supported by the rent-seeker population, and any attempt to reduce rents will be met with political resistance. However, crises decrease the marginal political costs of orthodox economic reform vis-à-vis

the status quo (which axiomatically produces negative utility). The short-term adjustment costs associated with trade liberalization are masked somewhat by the crisis. Thus, crises serve to increase the benefits and lower the risk of trade liberalization.

The second potential catalyst for rent reduction is mandated change. Most world governments are members of at least one, and typically several, international regimes. Each of these regimes—the most prominent are the GATT (now the World Trade Organization, WTO), the International Monetary Fund (IMF), and the International Bank for Reconstruction and Development (World Bank)—enjoys at least some ability to compel member states to comply with its rules. On occasion, a regime may put pressure on a state to liberalize trade. After each round of the GATT, for example, member states are expected to live up to agreed-upon reforms. Similarly, states that avail themselves of loans from the IMF or World Bank may find those regimes imposing structural adjustments as a condition of continued access to credit. When international regimes mandate a reduction in state-supplied rents, governments must choose whether or not to comply.

I put qualified emphasis on the fact that governments have a choice under such circumstances. I do not mean to imply that mandates from international regimes are wholly exogenous factors, outside of the control of governments that are themselves parties to international organizations. On the other hand, the costs of noncompliance are generally perceived to be high, a perception shared by state actors and their domestic constituents. Countries often are dissatisfied with the decisions taken by international regimes; typically, however, they operate within the constraints imposed on them by the regime. Excellent examples are Canada's capitulation to the tariff reductions mandated by the Tokyo Round of the GATT (chapter 5) and Mexico's adherence to the neo-orthodoxy prescribed by the IMF, World Bank, and GATT during the 1980s (chapter 4). In other words, there are meaningful examples of regime-mandated rent reductions that, while technically endogenous to a government's decision to reduce rents, are operationally exogenous. Moreover, the apparently exogenous nature of such rent reductions is manifest; governments may make credible claims to their domestic constituents, including rent seekers, that they had no option but to reduce state-supplied rents in the face of a mandate from an international regime.[15]

In this way governments can insulate themselves from some of the harshest criticisms (and penalties) generated by the reform process. A good example of this is the Canadian government's insistence in the aftermath of

the Uruguay Round of the GATT that it had fought valiantly, but unsuccessfully, to prevent the elimination of agricultural supply management devices and import quotas. Canadian farmers accepted the government's decision to replace these nontariff barriers with much more visible and temporary (albeit high) tariff barriers and did not mobilize to punish the government or to lobby for noncompliance with the GATT (see Finger 1991; Reguly 1993).

Mandated change alters governments' incentive structures regarding trade liberalization. As with crises, mandated change lowers the utility of maintaining the status quo, while mitigating, at least somewhat, the risks involved in liberalizing trade. Both crises and mandated change can be thought of as structurally imposed rent reductions. What they have in common is that both provide governments with "plausible deniability" that they had an option in the decision to reduce rents. Similarly, both create circumstances in which the status quo no longer yields positive utility. The third trigger mechanism, however, affords no such protection.

The third catalyst is reduction in rents based on strategic considerations.[16] Under such circumstances, the decision to reduce rents is unambiguously endogenous. Although this is a risky course of action, under some circumstances the strategic reduction of rents may serve the government's interest, even at the expense of alienating rent seekers. For example, governments with a first-order preference for freer trade might seek to reduce rents by gambling that initial opposition to free trade will be offset by long-term support for the policy by flexible rent seekers. The risks to such a strategy may be mitigated by reducing rents incrementally.

Another strategic consideration is what I have called the high-risk model of trade liberalization. Political entrepreneurs may enact free trade as a means of realizing other objectives that provide sufficiently generous payoffs to offset the political costs involved in alienating rent seekers. This argument is spelled out comprehensively elsewhere (Lusztig 1996); however, in its briefest form, it is as follows. Typically, governments pursue their objectives in the legislative arena, a task that involves the construction of a coalition of interests in support of these objectives. On occasion, however, governments seek more ambitious goals, such as significant transformation of the polity. These transformations might be called alignment games, and they constitute attempts to affect electoral realignments. Realignments are sharp, durable transformations in party identification created when parties are able to attract the support of groups not previously aligned with that party (see especially Key 1955; Burnham 1970). A catalyst for realignment occurs when political entrepreneurs attempt to alter the regime-defining (or institu-

tional) structure of the polity. The creation (or elimination) of institutions can have an abiding impact on the bases of a party's political support. An oft-cited example is President Lincoln's abolition of slavery, which saw the Republican Party capture the preponderance of the African American vote in the decades following emancipation. It was not until another major institutional innovation—the New Deal—that the African American vote switched overwhelmingly to the Democrats.

Where the realization of institutional reform dedicated to electoral realignment is the primary objective of the political entrepreneur, the conditions may be right for the enactment of radical policy innovation, such as the reduction of state-supplied rents. To reach desired institutional objectives, the political entrepreneur must construct a facilitating coalition consisting of all actors with the ability to block the institutional initiative. Where such actors are indifferent, or even hostile, to the political entrepreneur's overarching objective, they must be enticed into the coalition through the use of direct incentives. These incentives may take many forms. The one of greatest interest is policy innovation. Specifically, on occasion political entrepreneurs are obliged to offer trade liberalization, even at the cost of alienating rent seekers, as a means of buying support for their institutional objective.[17] Strategic rent reductions may offer high political payoffs but do not offer much in the way of protective camouflage for liberalizing governments.

Distribution of Rent Seekers

The second variable regulating the punishment absorbed by governments is the distribution of rent seekers, specifically, the proportion of rent seekers who are flexible versus inflexible. Where populations are largely flexible, governments that reduce rents below the critical threshold for most producers can expect relatively little resistance. By contrast, where the rent-seeker population is largely inflexible, the punishment to which government will be exposed will be greater. Indeed, while retaliation by inflexible rent seekers axiomatically will be temporary, by their nature democratically elected governments are more sensitive to short-term than to long-term considerations.

In part governments can make objective assessments about the ability of their producer populations to survive increased import competition. However, these assessments often are of limited utility. Even if such studies could predict accurately the abilities of firm and industry managers to make the correct decisions in restructuring operations to meet increased import competition, these analyses could not be expected to capture more nebulous is-

sues. Risk acceptance is an excellent case in point. Few producers know ahead of time, with absolute certainty, the extent of their competitiveness in global markets. That is, not all rent seekers will be immediately certain as to their status as flexible or inflexible. Over the long term, of course, this is not a problem. Flexible rent seekers come to recognize their global competitiveness; inflexible ones exit the market. But in the short term, risk-averse flexible rent seekers may be slow to recognize the economic reality and may seek to exact political punishment. The unfortunate political fate of Sir Robert Peel in the aftermath of Corn Law repeal illustrates this point (see chapter 2). Indeed, it is the danger of catching risk-averse, flexible rent seekers off guard that tells against the use of the so-called big bang strategy for rent reductions.

Even the best economic analyses, then, are expected to be weak predictors of political behavior. The issue is further confused by the fact that all rent seekers have an incentive to portray themselves as inflexible and as operating close to the threshold necessary for survival. Producer groups rarely admit that high tariff or subsidy levels are necessary to ensure high profits. Rather, state-supplied rents tend to be portrayed as necessary for firm or industry survival. Because flexible rent seekers have an incentive to mimic inflexible rent seekers, governments find themselves having to play games with incomplete information (see Lusztig, James, and Kim 2003).

The propensity to mimic creates incentives for governments unable to gauge the makeup of the rent-seeking population to eschew the risk of reducing the supply of rents. The logic is simple. Trade liberalization provides marginal political benefits to government. In fact, free trade typically is politically unpopular, and the political benefits are derived over the medium and long terms (when the government may be out of office) through improved performance of the national economy. On the other hand, where governments are unable to gauge the makeup of the rent-seeker population, the risks of trade liberalization are high. A large rent reduction in a rent-seeker population that is predominantly inflexible can have disastrous political consequences. Indeed, the high-risk to low-direct-benefit ratio of trade liberalization policies explains the historic reluctance of governments to engage in such action.

Other issues are raised by the facility with which flexible rent seekers can portray themselves as inflexible. While both flexible and inflexible rent seekers use the same tactics in seeking rents, other actions provide contrast. Differences between flexible and inflexible rent seekers leave historical traces. It is relatively easy, therefore, to distinguish flexible from inflexible rent seekers ex post facto, when rent-seeking activity is unsuccessful. When state-sup-

plied rents are reduced below the level necessary for survival, inflexible rent seekers will continue to try to force the government to restore rents. Ultimately, of course, inflexible rent seekers will be notable for their failure to survive. Under the same circumstances, flexible rent seekers will pursue a second-most-preferred strategy: restructuring for international competition and seeking access to a greater range of export markets.

The issue of distinction becomes more problematic before the fact, however, when governments must decide on a course of action in the absence of much knowledge regarding the portion of flexible rent seekers in the rent-seeker population. (The same problem exists for analysts attempting to offer prescriptive solutions.) If the rent-seeker population consists of too great a share of inflexible rent seekers, governments can expect to be punished severely. As well, the resulting negative economic climate will affect the government's popularity. Opposition parties can be expected to capitalize on the government's unpopularity and to reverse (or at least promise to reverse) the reduction in rents upon coming to power.

Of course, discussing the fact that the distribution of rent seekers affects the extent to which governments will be punished provides few prescriptive clues. What is needed is a mechanism by which governments can identify the distribution of flexible and inflexible rent seekers within the producer population. A clue to the nature of this identification mechanism is found in the literature on international crisis bargaining. One of the problems facing negotiators in a crisis is that those who are irrevocably committed to their position often cannot distinguish themselves from those less committed but with an incentive to mimic committed negotiators. As Wagner (1989, 189) suggests, "Because there is nothing a nonbluffer can do that a bluffer would not have the ability and incentive to imitate, the recipient of a threat can never be completely convinced that the threatener is not bluffing."

In such a circumstance both the nonbluffer and the recipient have an incentive to deter the bluffer. One method that nonbluffers use to distinguish themselves from bluffers is to send signals that are costly to communicate as a means of demonstrating commitment to their position.[18] By this logic, bluffers can be distinguished from nonbluffers because they are unlikely to be willing to bear the price of costly signals. Wagner suggests, for example, that the U.S. blockade of Cuba during the missile crisis was a costly signal, because it risked a military confrontation with the Soviet Union but served to signal U.S. resolve over Cuba (Wagner 1989).

Another means of separating bluffers from nonbluffers is for the recipient of the threat to create conditions under which the former are forced to

take actions that distinguish themselves from the latter. In such circumstances, recipients may be said to force signals. Flexible rent seekers represent bluffers (they mimic inflexible rent seekers when lobbying for retention of state-supplied rents), while governments interested in liberalizing trade—the recipient of the bluffs—must find a way to force a signal (see Lusztig, James, and Kim 2003).

One means by which the government can force signals is to reduce rents, observe the behavior of the rent-seeking population, and then make its calculations accordingly. Provided that rents are reduced below the critical-level threshold for some proportion of the rent-seeking population, the reduction of rents forces a separation in the behavior of flexible and inflexible rent seekers.[19] The obvious flaw, of course, is that while this constitutes an effective identification mechanism, it is no better (and indeed, no different) than the government's original objective. What is required is a means of reducing rents in a relatively costless way as a prelude to a more significant reduction that might be undertaken after the government has had an opportunity to evaluate the costs by observing the behavior of the rent-seeking population. This is where the third relevant variable comes into play.

Size and Sequence of Rent Reductions

The third and final relevant variable is the size and sequence of rent reductions. At one level, the point that the size of rent reduction is related to the punishment governments may absorb is entirely intuitive. There is a certain linearity implied. Rent seekers will be angry about a rent reduction of q and roughly twice as angry about a rent reduction of 2q. On the other hand, given the logic of the limits of rent seeking model, the larger the rent reduction, the greater the likelihood that producers will be obliged to abandon their current production points. Generally speaking, the smallest rent reductions will motivate only a few rent seekers to abandon their equilibrium production point, because only a few will find that the marginal reduction is sufficient either to force them into a nonviable position (for inflexible rent seekers) or to induce them to seek their profits in more market-oriented ways (for flexible ones). By contrast, larger reductions have the potential to affect a larger number of producers at the margin—that is, trigger the conversion of flexible rent seekers into free traders and inflexible ones into market casualties. Ironically, then, larger rent reductions may be less politically costly than smaller ones. On the other hand, it can be very difficult to estimate the optimal size of rent reductions. Where governments guess wrong, large rent reductions can lead to large political costs.

Where rent reductions are structurally imposed, the size of the rent reduction may be less relevant. However, when governments reduce rents for strategic considerations (and governments may well seek to follow structurally imposed reductions with strategic ones), issues of size and sequence become more important. Generally speaking there are four ideal-typical strategies for rent reductions from which governments can choose.

The first strategy is the big bang approach. This is a swift, bold reduction in rents whereby the government engages in large-scale rent reductions and then tries to weather the storm the best it can. The trick is to ensure that the rent reduction is sufficiently large to ensure behavior modification on the part of the rent-seeker population. The advantage of this approach is that the pain—for both government and rent seeker—is over quickly. The disadvantage is that, at least over the short term, the government assumes a large and cohesive mass of opposition. Indeed, not only will inflexible rent seekers have plenty of allies with whom they can mobilize, but flexible rent seekers, caught off guard and perhaps unaware of their abilities to compete internationally, may also retaliate. Indeed, as Roger Douglas, the architect of the successful reform of the New Zealand economy, notes (1993, 223), "Vested interests continuously underestimate their own ability to adjust successfully in an environment where the government is rapidly removing privilege across a wide front." Governments that choose this strategy, especially in the absence of some protective camouflage (in the form of a concurrent crisis or regime mandate to reform) are extremely risk acceptant. The big bang strategy was employed without such protective camouflage in three cases discussed here. In Britain and Australia, more than a century apart, Sir Robert Peel and Gough Whitlam, respectively, used the strategy with politically disastrous results. Only in Chile, under the brutal dictatorship of Augusto Pinochet, did such a tactic have the desired effect of altering the production profile of rent seekers without generating a backlash sufficient to bring down the government.

More effective are circumstances when the big bang approach is used in conjunction with, or in the aftermath of, a rent reduction generated by crisis or regime-mandated change. In such cases—Canada and Mexico are good examples—the big bang approach did not lead to political backlash, either because rent seekers were convinced of the inevitability of trade policy reform or because the structurally imposed rent reduction had already forced the behavior modification predicted by the limits of rent seeking model.

A second strategy is divide and conquer. Here, a government faced with rent-seeking interests from a number of broad sectors within the economy

uses a modified form of the big bang strategy but does not subject all sectors of the economy to it simultaneously. Instead, relevant sectors are treated to large and swift rent reductions seriatim. For example, if agriculture gets its dose first, the government is faced with only one angry constituency. By the time that constituency has restructured and rationalized, it is at least as eager as, or more eager than, the government that the liberalization process be extended—both on the grounds of fairness and to reduce, as quickly as possible, the costs of factor inputs. New Zealand used the divide-and-conquer approach successfully in the 1980s and 1990s. Indeed, starting with the far more competitive agricultural sector, the New Zealand government forced inflexible rent seekers from the marketplace and obliged flexible rent seekers to become more competitive. As a result, it was the farmers who served as standard bearers in the assault against the long-standing policy of industrial import protection.

The third strategy that governments may employ is iteration. As with the divide-and-conquer approach, the government seeks to build its free-trade coalition over time. However, while divide and conquer takes on one broad sector at a time, culling the inflexible rent seekers and making allies out of the flexible, iteration reduces rents across a wide range of industries, albeit gradually, using a series of incremental rent reductions. The effect is the same. With each reduction, a new stratum of rent seekers is affected. Inflexible ones die off; flexible ones join the pro–free-trade coalition. Like the divide-and-conquer approach, iteration has the advantage both of demonstrating the government's resolve and of signaling its intent. While this may cause groups to mobilize in opposition to these strategies preemptively, opposition may be muted by concomitant reduction of factor input costs that facilitate the restructuring process. Alternatively, soon-to-be-affected groups may also see the handwriting on the wall and either exit the market or adjust preemptively. The United States in the 1930s is an excellent illustration of the success of the iteration strategy.

The advantage of both divide and conquer and iteration is that they are far safer than the big bang technique. The pace of reform can always be modified in response to the reactions of rent seekers. Thus, governments are able to update their assessments of the extent to which the rent-seeker population is flexible, as well as to determine the optimal size of rent reductions to force behavioral changes on the part of rent seekers. There are disadvantages, however. These strategies take longer than the big bang approach, which serves to extend the length of time that governments are exposed to risk. Moreover, over time governments can lose the initiative, and the process can bog down.

Indeed, America's use of iteration under President Franklin D. Roosevelt took years to generate significant change in the policy demands of many important business groups. Similarly, the New Zealand government's divide-and-conquer strategy was forced to survive a change in government in 1990. While this change did not affect the reform process, there was fear and speculation that it might.

The final strategy is the path of least resistance. The government pursues rent reductions in the absence of a comprehensive game plan. Here government, recognizing the need to liberalize, and perhaps even responding to structurally imposed imperatives to do so, reforms in an ad hoc fashion. Rent reductions follow the path of least resistance. Protection is granted to groups strong enough to put pressure on the government, and the toughest decisions are put off until the future. A hallmark of the path of least resistance is that governments make progress in lowering aggregate levels of rents but continue to concentrate assistance in the least efficient sectors of the economy—that is, the ones in most dire need of the discipline imposed by exposure to global competition. The advantage is that this technique is safe. The least committed rent seekers are encouraged to join the free-trade coalition, while the government is insulated from severe retaliation—those who fight back are granted compensatory rents. Thus, the government is able to build a pro–free-trade coalition at little risk.

The disadvantages are that the technique thwarts the logic of the limits of rent seeking model. The least efficient strata of the rent-seeking population are not culled. Rather, they form a powerful, rival coalition to the free traders. Indeed, the path of least resistance approach creates an incentive for flexible rent seekers to redouble lobbying costs in the face of painful cuts rather than attempt to adjust. (In other words, the cost of rent seeking relative to adjustment is low.) Indeed, endogenous tariff studies have demonstrated that protection-seeking behavior intensifies according to the size of the rents available as well as the likelihood of achieving them (Brock and Magee 1978; Pugel and Walter 1985). Australia's inability to convert to a free-trading nation, despite apparently significant reforms dating to the early 1980s is testimony to the inefficacy of such a strategy. Similarly, Brazil has used the strategy to ill effect.

In sum, the logic of forced signaling and incremental rent reductions provides governments that have a first-order preference for trade liberalization a means of strategic rent reduction that entails limited political risk. Critical to the success of such an initiative, however, independent of patience and the ability to estimate optimal rent reductions, is political determina-

tion. Indeed, at the same time that government attempts to force behavioral changes from the rent-seeker population, it must maintain a firm whip hand. Where government falters and reverses policy on rent reduction, it risks creating the incentive for flexible rent seekers to delay restructuring in the hopes of convincing government to backtrack. As de la Cuadra and Hachette (1991, 276) caution, "Lack of faith in the permanence of reforms is self-fulfilling; it retards any major adjustment and further fuels pressure on the authorities to reverse the policy."

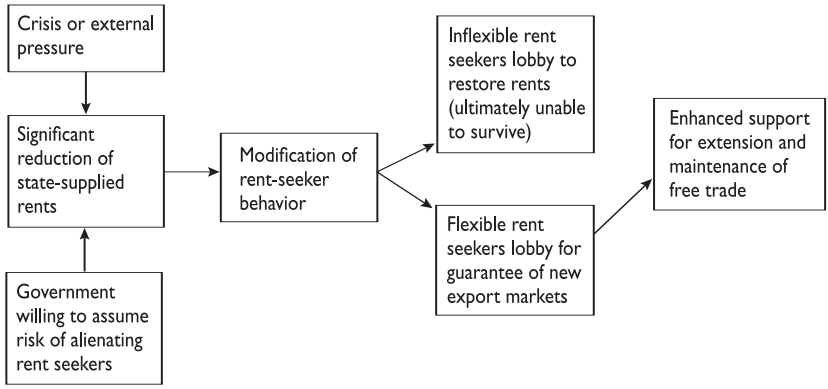
The Model

The full form of the limits of rent seeking model is as follows. It begins with a reduction in rents that pushes rents below the critical threshold for at least some of the rent-seeker population. This reduction may be structural in nature—that is, necessitated by crisis or by the dictates of an international regime—or it may be strategic. In either case, it leads to some form of separation in behavior among some portion of the rent-seeker population. This initial reduction increases the government's information about the proportion of flexible rent seekers within the producer population. (The greater the initial reduction of rents, the greater the information received.) Depending on the signals the government receives, and its risk propensity, the government may then seek an additional reduction in rents (or multiple reductions). Ultimately, when rents are reduced below the critical threshold for the preponderance of the rent-seeker population, a major source of protectionism is removed. Flexible rent seekers actively support, or at least acquiesce to, free trade, whereas inflexible rent seekers are culled from the producer population. The argument is illustrated schematically in figure 1.1.

It should be borne in mind that the dependent variable is the behavior of rent seekers, not the policy outcome. Thus, while the two tend to be highly correlated, they are not identical; the transformation of flexible rent-seeker behavior will not axiomatically translate into policies of freer trade. Producer groups exercise considerable influence over government, but their voices are not decisive. Other sources of domestic opposition—labor and cultural organizations are important examples—may dissuade governments from pursuing greater trade liberalization, even if rent-seeking producer groups alter their trade policy strategies.

Domestic economies also feature sources of dynamism other than that stimulated by the reduction of state-supplied rents. Factors such as technological development, reduced transport costs, major wars, and shifting access

Figure 1.1: Rent seekers and the reduction of state-supplied rents



to markets abroad may stimulate flexible rent seekers to operate more efficiently to increase exports and no longer seek protection at home (Ferguson 1984; Gourevitch 1986; James and Lake 1989; Rogowski 1989; Uslaner 1994). These groups will lobby for free trade independently of state reduction of rents.

On the other hand, none of these domestic factors is able to account for the creation and maintenance of support for free-trade policies in the cases examined here. In Canada, Chile, Mexico, New Zealand, and, to a lesser extent, Australia and Brazil, long traditions of business support for protectionism were reversed extremely quickly. Similarly, in Britain the agricultural sector abandoned the commitment to protection rapidly. While factors such as technological change and reduced transport costs affected business attitudes, it is not clear what specific developments could have triggered so rapid a reversal in the policy demands of the business communities. Indeed, the twentieth century was replete with examples of significant technological change, which, while undoubtedly responsible for changing trade policy demands among some within the business communities studied here, did not trigger rapid, widespread reversals in policy demands.[20] The U.S. case is slightly different, given that a world war and concomitant technological change intervened between the start of the rent-reduction process and the full conversion of flexible rent seekers. However, there is strong evidence that the limits of rent seeking model is a persuasive explanation of shifting trade policy preferences among American industrial producers.

The model is not a perfect predictor. For Australia and Brazil, the model simply does not work. In spite of large and significant rent reductions in

both countries, a significant, seemingly immutable coalition of protectionists persists, acting as a drag on the extension of the liberalization process. This failure in predictive capacity is both good and bad for the model: it provides demonstrable falsifiability but also needs to be explained.

It is possible that the apparent failure of the Australian and Brazilian cases is simply an artifact of insufficient historical perspective. After all, Chile during the first half of the 1980s could have been judged a failure by the criteria employed here. I suspect, though, that neither Australia nor Brazil is misclassified via the illusion of perspective. Unlike Chile, both Australia and Brazil chose poorly from the prescriptive menu explained here. I predict that in the absence of another round of rent reductions, which will entail abandonment of the path of least resistance strategy, neither Australia nor Brazil will benefit from the logic spelled out in the limits of rent seeking model.

A final objection that might be raised is that trade policy preferences among flexible rent seekers changed in all countries as the result of market closure abroad. While intuitively sound, this hypothesis stands up poorly to closer inspection. The British free-trade experiment, for example, came during a period in which world markets were opening. In the United States, market closure in Europe occurred in direct response to the Smoot-Hawley Tariff. Yet, as late as 1939 (nine years after world markets closed), a strong majority of small and medium-sized businesses in the United States preferred higher tariffs to lower ones. Trade liberalization occurred in Chile and began in Australia prior to the rise of the "new protectionism." In Canada, while rising U.S. protectionism in the early 1980s constituted a threat, it is important not to overemphasize this point.[21] Even in 1982, when congressional action against foreign imports reached its height, only a fraction of cases targeted Canada, with even fewer of these being successful (Watson 1987, 340). In Mexico, NAFTA was initiated in 1990, well after the deepest wave of U.S. protectionism had passed. Moreover, prior to the opening of the Mexican economy in the middle of the 1980s, the bulk of Mexican exports were in minerals and crude oil, products not threatened by U.S. protectionism (Ramirez 1993, 183–84). Finally, New Zealand was forced to alter its export profile in the early 1970s with Britain's entry into the European Common Market but did not embrace free trade for at least a decade thereafter.

Trade politics is an excellent illustration of risk-benefit analysis on the part of governments. Most political leaders (and the vast preponderance of their economic advisors) accept Ricardo's virtual truism that under almost all circumstances free trade (even if unilateral) works to the aggregate economic benefit of the liberalizing nation. However, because there is imbalance

in the distribution of costs and benefits (with the former highly concentrated, and hence significant, and the latter widespread and, at the individual level, marginal), there are high political risks and low political benefits involved in trade liberalization. Thus, the typical equilibrium outcome is the maintenance of significant barriers to import penetration and other forms of state-supplied rents.

Reduction in these rents, it follows, occurs when the risk-benefit ratio is altered. What I have characterized as structural causes of rent reduction—crisis and mandated change—serve to lessen the risks involved in trade liberalization. Strategic reductions, by contrast, take place under conditions when political leaders sense the potential for heightened political benefits from the liberalization of trade.

The limits of rent seeking model builds on this logic, suggesting that dynamics inherent in the liberalization process can help leaders mitigate cost and help assess risk. Trade policy need not be structurally determined by the preferences of societal forces (Ikenberry, Lake, and Mastanduno 1988). In a prescriptive sense, this implies that democratically elected governments may have a good deal more flexibility in the making of trade policy than the prevailing literature suggests. In this context my analysis also contributes to an emerging literature about the conditions under which states are able to enact policies with broad-based (but shallow) social appeal, yet which offend concentrated (but deeply committed) interests (see Bhagwati 1989; Arnold 1990; Rodrik 1992; Bates and Krueger 1993; Douglas 1993; Williamson 1994b; Lusztig 1996; Kingstone 1999). In other words, it challenges the dominant (demand-driven) theory that small, concentrated, and homogenous groups consistently will subvert the national interest in the framing of public policy (Olson 1965, 1982; Lavergne 1983; Frey 1984; Lake 1988a).

The model also complements and extends existing theories within international political economy.[22] Indeed, the emphasis on the demise of inflexible rent seekers reinforces Milner's position (1988, 1993) that the business sector is an important force resisting protectionism in the United States. The model builds on Milner's argument in a number of ways. First, it provides antecedent explanations about how free-trade policies come to be passed. Second, the model explains why business shifts its preferences from protectionism to free trade.[23] Third, the present argument strengthens Milner's theory by suggesting that because protectionist businesses tend to be culled from the population, business is more likely to support free-trade policies well into the future.

Finally, the model also is consistent with Olson's argument (1982) that traditionally stable systems encourage the proliferation of rent seekers. The shocks provided by exogenous forces (such as crisis), or by governments seeking to reduce deadweight costs, prove fatal to inflexible rent seekers previously sheltered in the rarefied atmosphere of the protected economy.

Countries included in this study range from modern liberal democracies to hegemonic and prehegemonic powers, and to underdeveloped protodemocracies on the path to democratic transition. They span four continents, while the period under study extends from the present back to the middle of the nineteenth century. These countries were selected to illustrate the applicability of the arguments over a wide variety of times and locations.