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The Politics of Economic Exchange: Carrots and Sticks in Taiwan-China-U.S. Relations*

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This paper is motivated by three ideas. First, analyses of interstate relations have over-emphasized the role of hard power (especially military capabilities) to the relative neglect of soft power (including the important role played by economic statecraft). Second, these analyses have privileged the role of the state while not giving civil society (in the case of this paper business interests) sufficient attention. Evolving relations between the state and civil society influence the feasibility and success of economic statecraft. And third, economic carrots and sticks are two sides of the same coin, and their effects are in part contingent on the alignment of domestic interests and influence. I pursue these ideas in the context of Taiwan-China-U.S. economic relations, offering general heuristics and selective reference to the pertinent literature. After a short introduction, the discussion proceeds to treat (1) the double-edged nature of economic intercourse, (2) relative bargaining power, (3) vulnerability to economic holdup, (4) cross-border signaling, and (5) evolving domestic interests and influence. The paper's conclusion returns to the thesis that carrots and

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sticks are two sides of the same coin when states engage in economic exchanges.

Keywords: economic statecraft; relative gains; security externalities; bargaining power; economic holdup; opportunity costs.

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It hardly needs repeating that China has become a leading trade partner and investment destination for Taiwan. At the same time, China has accumulated a large surplus in merchandise trade with and supplied a large amount of debt financing for the United States. Moreover, the relative importance of the United States for Taiwan's economy has diminished while that of China for the island has correspondingly risen in the recent past.

What are the political implications of these changing economic relations? There is a considerable literature on the pursuit of economic statecraft, mostly on the use of sanctions (negative incentives) and less so on the application of enticements (positive incentives). A great deal of this literature focuses on the international level such as the political ramifications of a state's dependence on international trade and capital. There is, however, also a venerable research tradition attending to the domestic consequences of foreign commerce and investment, such as with respect to the incentives and influence of import-competing and export-competing sectors. Capital being more mobile than labor, it would, for instance, be comparatively advantaged by a reduction in commercial and investment barriers. One would therefore expect the real returns of capital owners to have increased in Taiwan, whereas those of labor to have suffered a relative decline. Moreover, because land is scarcer in Taiwan than in China, those whose incomes are tied to this production factor would be relative losers whereas others who have a stake in large transnational enterprises would be favored. Economic exchanges with China have not only enlarged Taiwan's trade area, but have also had the effect of redistributing income and influence among its domestic groups. They have reflected the pursuit of comparative advantage by the parties. We therefore encounter economic and political cross-currents that ripple within and across multiple commercial partners.

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Commerce as Double-Edged Sword

Economic exchanges promise greater welfare because of efficiency gains and economies of scale resulting from specialization and the pursuit of comparative advantage. They can also engender security externalities when one's partner gains more relatively from these exchanges. The other side's greater gains from trade (or investment) can be used to improve its military. It can threaten to hold up commerce in an attempt to extract political concessions.

A variety of denial strategies—such as trade sanctions, investment boycotts, technology blockades, even economic warfare—have long been an integral part of statecraft.[1] Such coercion may be attempted on a broad scale (such as Washington's ongoing bans against investing in Cuba or the Western countries' restrictions on technology transfers to communist countries during the Cold War);[2] or it could be directed strategically at specific targets (such as Rhodesia's tobacco farmers and Iraqi oil exports).[3] One should not, however, forget that strategies of cooptation and reassurance have also often been applied, sometimes successfully. Commerce has been used to secure alliances, to discourage nuclear proliferation, and to facilitate the Soviet retrenchment and withdrawal from Eastern Europe.[4] Preferential treatment or compensatory side-payment, whether

[1]Leading analyses on the application of economic coercion for political or military gains include David A. Baldwin, *Economic Statecraft* (Princeton, N.J.: Princeton University Press, 1985); and Gary Clyde Hufbauer, Jeffrey J. Schott, and Kimberly Ann Elliott, *Economic Sanctions Reconsidered: History and Current Policy*, second edition (Washington, D.C.: Institute for International Economics, 1990).

[2]Daniel W. Fisk, "Economic Sanctions: The Cuba Embargo Revisited," in *Sanctions as Economic Statecraft: Theory and Practice*, ed. Steve Chan and A. Cooper Drury (London: Macmillan, 2001), 65-85; and Michael Mastanduno, *Economic Containment: CoCom and the Politics of East-West Trade* (Ithaca, N.Y.: Cornell University Press, 1992).

[3]On the trade sanctions against Rhodesia, see David M. Rowe, *Manipulating the Market: Understanding Economic Sanctions, Institutional Change, and the Political Unity of White Rhodesia* (Ann Arbor: University of Michigan Press, 2001).

[4]Paul A. Papayoanou, *Power Ties: Economic Interdependence and War* (Ann Arbor: University of Michigan Press, 1999); William J. Long, *Economic Incentives and Bilateral Cooperation* (Ann Arbor: University of Michigan Press, 1996); and Randall E. Newnham, *Deutsche Mark Diplomacy: Positive Economic Sanctions in German-Russian Relations* (University Park: Pennsylvania State University Press, 2002).

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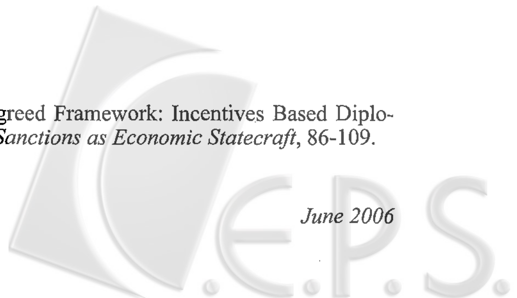
just promised or actually extended, offers an inducement for offsetting accommodation. In the case of commerce across the Taiwan Strait, China has deliberately reached out to select groups or sectors in Taiwan, such as fruit farmers, airline companies, petrochemical firms, and the tourist industry, that have a particular interest in gaining or maintaining access to the mainland market. Presumably, the objective is to increase these groups' stake in ongoing and future commerce, and to decrease the incentive for them to support economic and political rupture.

Three points need emphasizing even if they may underscore the obvious. First, examples such as those just mentioned speak to linkage politics. The actor, or state, in question is deliberately attempting to leverage an economic advantage (or favor) in order to obtain a political concession or, alternatively, to convert political influence into economic gain. Thus, for instance, when a government threatens trade sanctions, it is in effect making a public statement that it cares more about the political concession being demanded from the target than the opportunity costs of lost trade. Conversely, when China offers to give preferential treatment to Taiwan investors, it is communicating a concession (such as refraining from applying a standard rate of taxation) for some implicit reciprocity (even if the latter is no more than general goodwill).

Second, economic carrots and sticks are different sides of the same coin. Attempts at economic coercion and cooptation are integral components of the same policy repertoire. A threat to sanction presumes that there is an ongoing commercial relationship. If there is nothing further to be taken away, a policy of economic denial becomes self-exhausting. Thus, for example, what can the United States threaten to deny North Korea economically, as their commercial relationship is nonexistent?[5] In this situation, offsetting compensation (i.e., carrots) becomes necessary for extracting Pyongyang's concession (say, on terminating its nuclear program). Recalling Albert Hirschman's famous study on the relationship

[5]Curtis H. Martin, "The U.S.-North Korean Agreed Framework: Incentives Based Diplomacy after the Cold War," in Chan and Drury, *Sanctions as Economic Statecraft*, 86-109.



between foreign trade and national power,[6] we note that Nazi Germany, by providing favorable terms of trade for the Balkan countries, gave itself the wherewithal for gaining political influence. The implicit threat of withdrawing the preferential treatment of Balkan imports to Germany buttressed this claim. In the absence of the prior extension of commercial carrots, subsequent threats to apply the stick would not be viable.

Third, whether a policy of economic intimidation or inducement bears fruit depends ultimately on whether it is able to influence the incentives and power of the domestic stakeholders in the target country. After all, target officials shape their responses to external demands based on their judgments about how their own domestic political standing and economic interests may be advanced or impaired.[7] Thus, for example, economic sanctions generally tend to end in conjunction with a change of ruling regime, especially when the regime in question is an authoritarian one.[8] This pattern implies that without such a leadership change, sanctions tend to result in protracted deadlock with a low prospect of bringing about a change in the target's behavior. Intriguingly, and seemingly pointing to the same general implication, the pertinent literature also suggests that sanctions are more promising (in the sense of bringing about a behavioral change) if the target in question is characterized by greater political openness, less power concentration, and more intense domestic competition.[9] These latter characteristics ease the accessibility of a country's elite to lobbying efforts by both domestic and foreign interests.

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[6]See Albert O. Hirschman, *National Power and the Structure of Foreign Trade* (Berkeley: University of California Press, 1945).

[7]The classic statement on this foreign-domestic interaction effect is given by Robert Putnam, "Diplomacy and Domestic Politics: The Logic of Two-Level Games," *International Organization* 42, no. 3 (Summer 1988): 427-60. A good substantive illustration is offered by Leonard J. Schoppa, *Bargaining with Japan: What American Pressure Can and Cannot Do* (New York: Columbia University Press, 1997).

[8]Fiona McGillivrary and Allan C. Stam, "Political Institutions, Coercive Diplomacy, and the Duration of Economic Sanctions," *Journal of Conflict Resolution* 48, no. 2 (April 2004): 154-72.

[9]Sean M. Bolks and Dian Al-Sowayel, "How Long Do Economic Sanctions Last? Examining the Sanction Process through Duration," *Political Research Quarterly* 53, no. 2 (June 2000): 241-65.

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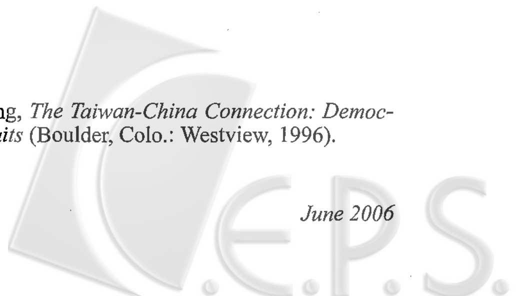
In this respect, it is telling that Taiwan's commercial opening to China was initiated by its private sector, often in the face of objections from the state and working around regulations imposed by the state to control and limit trade and investment across the Strait. It was no coincidence that this initial push came at a time of elite discord and bureaucratic divisions when the island began to democratize.[10] Increased political competition enabled civil society, especially business interests, to gain greater voice relative to the state than it had during the earlier period of state-guided export-led industrialization.

To summarize, the pursuit of economic statecraft can rely on either the carrot or the stick. One party seeks to change another's behavior by threatening to take away or promising to extend some desiderata important to the latter. This initiating party in effect proposes an exchange to its counterpart ("I will do this, or refrain from doing that, if you agree to comply with my demand"). Whether this attempt at influence will succeed depends ultimately on its effects on the domestic alignment of incentives and influence inside the target country (to be discussed later). The extent to which important groups within the target country will be responsive or resistant to external pressure or inducement will depend in part on the power, size, and cohesiveness of its ruling coalition.

Relative Bargaining Power

With these preliminary remarks behind us, what can we say about relative bargaining power among China, the United States, and Taiwan in view of their evolving economic relationships? It is not uncommon to hear Americans alluding to the rising volume of Sino-American trade and especially China's burgeoning merchandise surplus as extending to Washington a source of negotiation advantage. The implicit, often unstated,

[10]See the informative account by Tse-Kang Leng, *The Taiwan-China Connection: Democracy and Development Across the Taiwan Straits* (Boulder, Colo.: Westview, 1996).



reasoning is that a disruption or reduction in this trade will hurt China more than the United States.[11] In contrast, the common talk in Taiwan has been that its increasing trade with China will present a source of vulnerability to the island, even though their bilateral commerce has produced a consistent surplus for Taiwan.

To what extent, if any, does bilateral trade in and of itself give one or the other party a bargaining lever over the other? Is the side with a trade surplus *ipso facto* at a disadvantage because its counterpart (the side suffering a trade deficit) can withdraw from this trade, thereby taking away the trade surplus heretofore enjoyed by this country? Not if one assumes that the existing trade relationship characterizes the best deal both sides could have gotten under the prevailing market conditions. Put alternatively, if the deficit-suffering country could have done better by trading with another country, why did it not do so? Unless it was deliberately manipulating its external trade in order to confer a special gain on its partner enjoying the trade surplus, it does not have bargaining leverage over the latter.

Albert Hirschman underscored this point some time ago.[12] Nazi Germany deliberately chose to import Balkan goods at above-market prices. By refraining from driving as hard a bargain with the Balkan exporters as the prevailing market conditions would have warranted, Berlin in effect extended a concession to these countries. This favor in turn created the basis for Berlin to demand reciprocity from the Balkan countries in terms of political deference to German hegemonic ambitions and market access for German manufactured goods.

R. Harrison Wagner made the same basic point.[13] As already mentioned, the use of foreign trade to extend national influence is, by definition, an attempt at linkage politics. One eschews a commercial advantage

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[11]This expectation was obviously behind Washington's annual debate, until the last few years, on whether to extend to China the "most-favored-nation" trade status. See Steve Chan, "Economic Sanction: The U.S. Debate on MFN Status for China," in Chan and Drury, *Sanctions as Economic Statecraft*, 110-30.

[12]See note 6 above.

[13]See R. Harrison Wagner, "Economic Interdependence, Bargaining Power, and Political Influence," *International Organization* 42, no. 3 (Summer 1988): 461-83.

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in order to extract a political concession. This being the case, the feasibility of the latter attempt is dependent on the former condition. As Wagner has put it, what do the parties have to gain by negotiating a joint deal over two separate issues, compared to striking a separate deal on each? For instance, why would Washington and Beijing want to link the Chinese purchase of American grain to American demands for the release of political dissidents by Beijing? The answer could only be that both feel that they can reach a more favorable overall deal by negotiating these two issues jointly than by treating them separately. That is, this is feasible only when Washington feels that the gains it obtains from Beijing in releasing political dissidents would warrant its concessions on the grain deal. At the same time, this linkage works for Beijing only if its leaders believe that the release of Chinese dissidents is a worthwhile price to pay for getting a better deal on the purchase of American grain. The upshot of this discussion is that unless one can determine that one or the other party in a relationship has deliberately eschewed an advantage that it enjoys in bilateral negotiation, there is no basis for it to demand reciprocal treatment. That is, linkage politics will not work in the absence of this foregone advantage. Such foregone advantage could refer to acts of commission as well as of omission—such as a decision to purchase Boeing aircraft rather than Airbus when they offer comparable commercial terms, or a decision to refrain from engaging in competitive currency devaluation during the Asian financial flu in the late 1990s.

As indicated above, attempts at economic coercion involve in some fashion self-denial. This self-denial can be in the form of some commercial advantage deliberately foregone in order to create a basis for demanding reciprocal concession. Alternatively, it can be a purposive attempt to put both sides in a lose-lose situation by threatening to rupture or actually rupturing an ongoing commercial relationship. For instance, should the United States limit or ban the import of Chinese manufactured goods, rising consumer prices would be a self-imposed cost to the extent that other low-cost suppliers cannot be immediately located to make up for the shortfall created by the reduced Chinese imports. Conversely, if China were to boycott the U.S. debt market, the very rumor—not to mention the actual

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news—of this action would produce market speculation such that the value of the U.S. dollar would decline and the interest rates for U.S. treasuries would rise. This market adjustment would end up devaluing the U.S.-issued debt instruments already held by the Chinese. In both of the hypothetical scenarios just sketched, the Chinese goods or loans displaced from the U.S. market would move to some other location. The relative scarcity resulting from this exit of Chinese goods and loans would in turn cause prices to rise in the United States, which in turn would have the effect of enticing other new suppliers to step in. The causal chain is no different from the dilemma faced by the Organization of Petroleum Exporting Countries (OPEC). When these countries contrived a supply scarcity to drive up energy prices, the rising cost of energy in turn created incentives for prospectors and producers to turn to new sources of crude oil or natural gas, sources (e.g., the North Slope of Alaska, under the North Sea) that were previously unprofitable given the lower energy prices prevailing before OPEC's market manipulation. In short, then, economic sanctions can have self-nullifying effects over the medium and long run.

Opportunity Costs

There is debate in the literature about whether commerce dampens conflict. Some argue that because states are more likely to trade with allies than adversaries, it stands to reason that trading states are less likely to get into war because of selection effects.[14] Others argue that given trade, states are reluctant to get into fights because they do not want to pay the opportunity costs of disrupting existing commerce.[15] Still others suggest that instead of having a direct effect in curtailing conflict, trade and investment

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[14]Joanne Gowa, *Allies, Adversaries, and International Trade* (Princeton, N.J.: Princeton University Press, 1994).

[15]Bruce M. Russett and John R. Oneal, *Triangulating Peace: Democracy, Interdependence, and International Organizations* (New York: Norton, 2001). However, see also Katherine Barbieri, *The Liberal Illusion: Does Trade Promote Peace?* (Ann Arbor: University of Michigan Press, 2002).

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allow states to signal their intentions more credibly—and therefore to reduce uncertainties that can sometimes lead to war.[16] Some of these accounts suggest that commerce just makes conflict less likely, while others propose that it actually promotes cooperation.

Regardless of these alternative perspectives, the opportunity costs of foregone trade rather than the size of current trade is the key factor. As just noted, the current literature tends to emphasize the opportunity costs of disrupted trade or investment. It does not give enough consideration to those other opportunity costs that encourage the parties to enter into commercial relations even when they are political rivals. If Taiwan eschewed trade with and investment in China, it would suffer important opportunity costs with respect to third parties such as Japan and South Korea that are its economic competitors. Therefore, a concern for being put at a relative disadvantage with these other countries would counteract the fear of having its commercial relations with China held up by Beijing for political gain. The opportunity costs of trading thus cut both ways.

Relative vulnerability to trade suspension and investment boycott influences whether a threat to hold up commerce will be effective in gaining political concessions. The pertinent opportunity costs depend on how easy or how costly it is for each party to switch to alternative partners. A party's opportunity costs are reflected in the expected difference between the terms of its current deal and its best alternative deal.[17] If a commodity market is highly concentrated so that only a few suppliers control a preponderant share, this characteristic promotes the efficacy of a sellers' cartel. If the demand for this good is highly inelastic in the short run and the good is not easily substitutable, then the relevant suppliers again gain an advantage over the buyers. Conversely, if the product in question is perishable or

[16]William Reed, "Information and Economic Interdependence," *Journal of Conflict Resolution* 47, no. 1 (February 2003): 54-71. See also James D. Morrow, "Assessing the Role of Trade as a Source of Costly Signals," in *Economic Interdependence and International Conflict*, ed. Edward D. Mansfield and Brian Pollins (Ann Arbor: University of Michigan Press, 2003), 89-95.

[17]Beth V. Yarbrough and Robert M. Yarbrough, *Cooperation and Governance in International Trade* (Princeton, N.J.: Princeton University Press, 1992).

has a short shelf life (such as bananas), tends to be price-sensitive (such as coffee), and is substitutable (such as copper for aluminum, or bauxite), then it will be difficult to manipulate the market for political or economic gain. Physical size and financial staying power would presumably also matter. It is more challenging to blockade or otherwise economically coerce a continental-size, largely self-sufficient country with a large currency reserve than a small, poor, and cash-strapped one. Indeed, even with respect to the latter kind of country—North Korea, Laos, Cuba, Ethiopia, Sudan, Guatemala, El Salvador, Haiti, and Rhodesia come to mind—threats and even the actual imposition of economic sanctions rarely work.[18] Even when circumstances seem to warrant optimism by those who impose economic sanctions, such efforts still typically fail. For instance, the international commodity market for crude oil and for grain was remarkably efficient in making up the local shortfalls caused by the embargo efforts. A network of intermediaries drew supplies from alternative sources and redirected them to the embargoed countries.[19] Even when there is a concerted international campaign to sanction a recalcitrant state, with Iraq and South Africa being the most prominent examples, success is hardly assured by such multilateral efforts.[20]

The upshot of these remarks is that sanctions are rarely applied and, when they are, they are also rarely successful.[21] Most historical instances

[18]Robert A. Pape, "Why Economic Sanctions Do Not Work," *International Security* 22, no. 2 (Fall 1997): 90-136; Robert A. Pape, "Why Economic Sanctions Still Do Not Work," ibid. 23, no. 1 (Summer 1998): 66-77; and David A. Baldwin and Robert A. Pape, "Evaluating Economic Sanctions," ibid., no. 2 (Fall 1998): 189-98. See also the response from Kimberly Ann Elliott, "The Sanctions Glass: Half Full or Completely Empty?" ibid. no. 1 (Summer 1998): 50-65.

[19]See, for example, Roy Licklider, "The Arab Oil Weapon of 1973-74," in *The Utility of International Economic Sanctions*, ed. David Leyton-Brown (New York: St. Martin's, 1987), 167-81; and Robert L. Paarlberg, "The 1980-81 U.S. Grain Embargo: Consequences for the Participants," ibid., 185-206.

[20]Daniel W. Drezner, "Bargaining, Enforcement, and Multilateral Sanctions: When Is Cooperation Counterproductive?" *International Organization* 54, no. 1 (Winter 2000): 73-102.

[21]An excellent discussion of the selection logic that accounts for the rarity of sanctions being applied and also for the rarity of their success is offered by Alastair Smith, "The Success and Use of Economic Sanctions," *International Interactions* 21, no. 3 (1996): 229-45.

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of sanctions were undertaken for symbolic reasons,[22] due to a desire for domestic rent-seeking,[23] or intended by the stronger side in a highly asymmetric contest to bring about regime change in the weaker side which is often totally isolated internationally.[24] Except for these unusual instances, talks about sanctions often are no more than "hot air."

Significantly, most disputes stop well short of sanctions being applied, not to mention the initiation of military action. In fact, traders and investors often deliberately contrive vulnerabilities in order to get mutually rewarding deals started in the first place, and to prevent them from breaking down subsequently. Consider the nature of Taiwan's financial assets invested in China. These assets would be lost if a political rupture occurred. Quite aside from these tied assets, commerce with China means that Taiwan will dedicate more of its production capacity and resources to serving an external market. Naturally, if this external market were to become closed, the consequent surplus capacity would be a severe business liability. Seen in this light, those assets that Taiwan has dedicated to trading with or investing in China serve as a bond to sustain stable and improving political relations.[25] Naturally, joint ventures and partnership in cross-national production chains signal mutual reassurance rather than one-way "hostage giving." The important point to recognize, however, is that such behavior promotes cooperation (including the successful negotiation of commercial deals). In the absence of such reassuring gestures, it would have been difficult to negotiate deals even though they would have been mutually rewarding. Thus, paradoxically, self-imposed and mutual vulnerabilities

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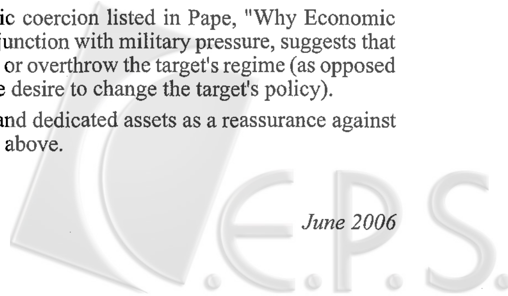
[22]On the promotion of "transcendent" goals sought by the sanction-imposing states, see Chien-Pin Li, "The Effectiveness of Sanction Linkages: Issues and Actors," *International Studies Quarterly* 37, no. 3 (September 1993): 349-70.

[23]On domestic rent-seeking, see William H. Kaempfer and Anton D. Lowenberg, *International Economic Sanctions: A Public Choice Perspective* (Boulder, Colo.: Westview, 1992).

[24]A quick review of those episodes of economic coercion listed in Pape, "Why Economic Sanctions Do Not Work," often applied in conjunction with military pressure, suggests that many of them sought and succeeded to subvert or overthrow the target's regime (as opposed to public declarations suggesting an ostensible desire to change the target's policy).

[25]For a full discussion of the use of "hostages" and dedicated assets as a reassurance against political or business opportunism, see note 17 above.



play an important part in getting cooperative arrangements started and, as already noted, provide incentives to guard against relations going sour.

Signaling Intentions

The dedication of production assets and financial investment in China would not have been undertaken by Taiwan's business people if they were gloomy about the political future of cross-Strait relations. Why would they jeopardize their money? Their decisions to trade and invest would therefore suggest a vote of confidence in the future. By the same token, the burgeoning Sino-American trade, large-scale U.S. investment in China, and the Chinese purchase of U.S. debt instruments also suggest interlocking interests stemming from mutual vulnerabilities. As already noted, a reluctance to suffer the opportunity costs of disrupted trade and investment features prominently in liberal accounts as a motivation for states to refrain from conflict. It is also argued that existing economic exchanges give officials a means to communicate their resolve without necessarily engaging in military action, thereby reducing the danger of unintended war.

There is another kind of signaling that has not been adequately attended to in the current literature. When traders and investors make their business decisions, they are voting with their money. Their actions also signal their judgments about business climate and political trends. These actions communicate to the relevant state authorities the business community's desire for continued economic intercourse and political stability. The more firms are willing to commit to cross-border commerce, the stronger their indicated desire. Indeed, as their business stakes increase enormously over time, it becomes increasingly difficult for politicians and officials to reverse and undermine ongoing commercial ties. In other words, a decision to do business not only signals cooperative intentions, but also constrains the state from future actions that endanger existing cooperative arrangements.

It is easier for one state to threaten or actually impose sanctions on another if it does not currently have an ongoing commercial relationship with

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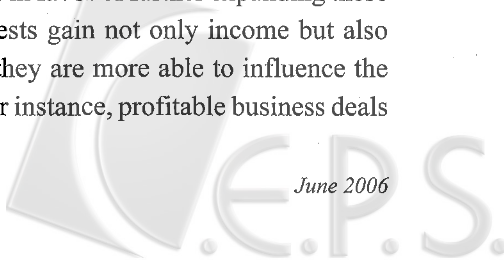
the target or if the ongoing exchanges involve only minor business interests. It is, however, more difficult to cancel or reduce this relationship once it is in place—especially after it has assumed a critical importance in a country's political economy. It is therefore understandable that, during much of the Cold War era, it was easier for the United States to deny technology transfers to the communist states since, unlike its West European and Japanese allies, Washington did not have to face domestic interest groups who were already trading with the target. By implication, it would be more difficult for Washington to actually impose sanctions on Beijing now that there are important stakeholders in the United States who have a vested interest in sustaining and even expanding Sino-American trade. Thus, paradoxically, sanctions are more likely to be undertaken but less likely to be effective when the commercial ties are limited, but they are less likely to be pursued but more likely to be effective when the commercial ties are substantial.

Changing Domestic Interests and Influence

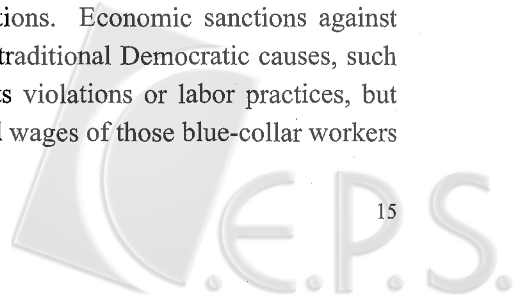
Taiwan's commercial transactions with China in effect enlarged its trading area. This enlargement facilitated the mobility of capital, increasing the real returns of large corporations, financial institutions, and exporters of tradable goods. Conversely, because land and labor are less mobile and scarcer in Taiwan than in China, the real returns on these production factors have suffered a relative decline. International commerce therefore influences the income and incentives of different groups and sectors. Those with an external orientation would, for example, favor a stable and even depreciating currency, whereas those selling nontradables to the domestic market would prefer fiscal stimulation and an appreciating currency. Significantly, once commercial ties are entrenched, these exchanges create vested domestic interests in favor of further expanding these ties. Furthermore, because these interests gain not only income but also influence from their foreign business, they are more able to influence the future direction of state policy. Thus, for instance, profitable business deals



enable large companies to sponsor or make campaign contributions to friendly politicians (or, in the case of Taiwan, to incline business leaders to run for legislative seats), and this increased influence in turn helps to promote more pro-business policies.

Naturally, the alignment of domestic interests and influence affects not only the trajectory of expanding commerce, but also the manner in which economic sanctions can play out. Just as in the case of trade expansion, trade disruption can also redistribute domestic income and influence. Thus, for instance, a hypothetical ban on Chinese manufactured imports to the United States would have more impact on the typical shopper at Walmart than one at Nieman Marcus. And it would have more of an adverse impact on coastal China than interior China. The repercussions of such sanctions are likely to be felt more by those American companies, such as Boeing, General Motors, and International Business Machines, which sell to China or invest and manufacture in China, than by other American firms which tend to focus primarily on domestic rather than foreign sales. The costs of trade restrictions tend to be spread among a large number of consumers, whereas the benefits of protectionism tend to be concentrated among a few sectors or special interest groups (such as the steel and textile workers in the United States).

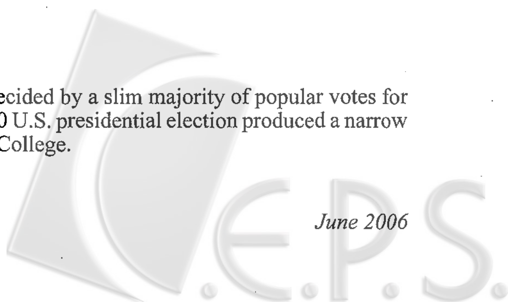
This discussion naturally directs attention to the important question of who are the traditional allies and constituents of important political actors. To the extent that large global corporations have always been a main source of support for the Republican Party, these interests can be expected to self-mobilize to oppose any policy that has the intent or effect of restricting trade or curtailing foreign direct investment. Put somewhat differently, if a Republican administration were to impose an economic sanction against China, the political opposition from big business would have to be included in the cost tally. Conversely, to the extent that the Democratic Party has historically drawn its support from big labor, it can be expected to have an added incentive for pushing sanctions. Economic sanctions against China would not only be popular for traditional Democratic causes, such as punishing Beijing for human rights violations or labor practices, but would also help to protect the jobs and wages of those blue-collar workers



employed in the import-competing industries. Significantly, the distribution of political support across geography matters as much as that across economic sectors. Arguably, a handful of Midwestern states turned out to be decisive in determining the outcome of the 2004 U.S. presidential election. Among these states, Ohio—a traditional manufacturing state reeling from high unemployment and the challenges of outsourcing—was especially pivotal. Surely, politicians are not so dense as to overlook how their trade policies are likely to resonate, or not, with key constituents in the so-called battleground states (in the 2004 U.S. presidential election, these included, besides Ohio, Pennsylvania, Iowa, Florida, Wisconsin, and Minnesota). The support or opposition of select groups in these few pivotal states, rather than the country as a whole or even the largest states (such as California, Texas, or New York), can be critical. Naturally, the more closely contested elections are, the more influential these special interests are likely to be.[26]

Domestic partisanship creates access for foreign actors seeking to forestall economic coercion. Indeed, it also affords opportunities for external attempts to cultivate groups with a vested interest in maintaining and even expanding the ongoing commercial ties. American banks and insurance companies anxious to expand their presence in the Chinese market, American retail distributors selling Chinese imports, and American farmers exporting grain and soybeans to China are some obvious examples. In the case of Taiwan, the political competition between the pan-Blue (泛藍) and pan-Green (泛綠) coalitions provides the space for Beijing's political maneuvering. Significantly, Beijing has heretofore emphasized the courtship of those business interests that have tended to be traditional supporters of the Democratic Progressive Party (DPP, 民主進步黨). Whereas the mainlander-dominated Kuomintang (KMT, 國民黨) controlled government and military establishments in the past, the native islanders have historically been prominent in Taiwan's business com-

[26]Taiwan's presidential election in 2004 was decided by a slim majority of popular votes for Chen Shui-bian (陳水扁). Similarly, the 2000 U.S. presidential election produced a narrow victory for George W. Bush in the Electoral College.



munity. In reaching out to Taiwan's business community, Beijing has not only sought to attract the relocation of large companies such as those in the petrochemical industry or to establish business links with others such as airlines, but it has also promoted ties with the island's fruit farmers and medium-sized firms engaged in labor-intensive production. The latter groups constitute key supporters for the DPP. Of course, the extent to which Beijing has a "hold" over these groups depends in large part on the ease with which they can relocate their manufacturing to other countries (e.g., in Southeast Asia) and the extent to which they can switch their exports to substitute markets (e.g., the United States, Japan, and Europe).

An important insight from the study of positive economic incentives is that initiating and increasing commercial ties produce groups in the other country that are self-motivated to lobby for good relations.[27] Conversely, the application of negative incentives—that is, to threaten and especially to actually impose sanctions—has the effect of producing groups in the other country that have the opposite self-interest. That is, the threat and actual imposition of sanctions would naturally incline the target state to diversify its trade and to develop domestic suppliers to replace the threatened imports. Once the trade patterns and the domestic import-substituting producers have been formed, the pertinent actors can be expected to naturally resist an improvement in the bilateral relationship (between the sanctioning state and the target) since this change would upset their economic and even political interests. Thus, sanctions tend to enrich profiteers, often operating with government protection, in the target country (such as Haitian and Serbian smugglers of gasoline and tobacco), and these rent-seekers have an incentive to perpetuate rather than to remove the commercial barriers. Conversely, and as already implied, economic exchanges can also change incentive structures and political coalitions that incline the stakeholders to push for further expansion of these exchanges.

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[27]See Long, *Economic Incentives and Bilateral Cooperation.*

Conclusion

When a country uses the economic carrot or stick in trying to influence another country, the success of its policy depends ultimately on the target's incentive structure. Johan Galtung and David Rowe concluded from their study of the Rhodesian sanctions episode that economic deprivation can cause a people to rally behind the target government and give the latter increased power and leverage over domestic groups.[28] It would certainly be unwarranted to assume that the likelihood of a target's compliance should somehow bear a simple linear relationship to the amount of economic pain being inflicted on it. Were this to be true, Saddam Hussein should have long ago acceded to Washington's demands, thereby making the U.S. invasion unnecessary. Indeed, by all accounts, the sanctions directed against Baghdad prior to Operation Iraqi Freedom were enormously devastating to its economy and civilian population. Iraq's gross national product was reduced by more than half as a result of this economic embargo.

The sanctions against Iraq offer an important lesson. The amount of economic deprivation being imposed on a target is not the decisive factor in determining whether it will come to terms with the sanctioning country's demands. Rather, the target has to choose whether it would rather pay the costs of conceding to the sanctioning country's demands or pay the costs of continuing with the sanctions. Obviously, the target would prefer to have the sanctions lifted. However, if the price for lifting the sanctions is a loss of national sovereignty or security, territorial integrity, regime popularity, or the incumbent leaders' political control, the decision may very well be to resist foreign demands for concessions.

By implication, would important powerbrokers in Taiwan politics be inclined to accept the costs of Chinese economic sanctions because they value more highly their political autonomy and separate identity from

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[28]See Johan Galtung, "On the Effects of International Sanctions: With Examples from the Case of Rhodesia," *World Politics* 19, no. 3 (April 1967): 378-416; and note 3 above.

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China? Likewise, would Chinese leaders give more importance to the prospective loss of trade with the United States than to their aspirations for national reunification and, possibly, their fear of a domestic political backlash as a consequence of being perceived to have compromised on the Taiwan issue because of American economic pressure? Significantly, as elite competition on both sides of the Taiwan Strait becomes more intense, officials in both Beijing and Taipei will become more sensitive to public opinion. In the case of Beijing especially, a more open and competitive political process is apt to raise rather than diminish the officials' concerns for their nationalist credentials.

At the same time, officials in Taiwan, China, and the United States are likely to be increasingly restrained by the dense and deepening network of interlocking commercial interests connecting them. Their close ongoing trade and investment ties have fostered a "political market" in the sense that they signify an expression of confidence and, indeed, a substantial tangible down-payment on the long-term stability of their political relations. These ties also serve as a bond against political opportunism and defection. With the passage of time, domestic stakeholders on all three sides can be expected to increasingly exert themselves against a resort to economic coercion for political gain. Of course, there will continue to be others who want to apply economic coercion for political purposes and such episodes will surely continue to occur. Still, any attempt at such economic coercion would face mounting political uncertainties and challenges such as those described in this paper.

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