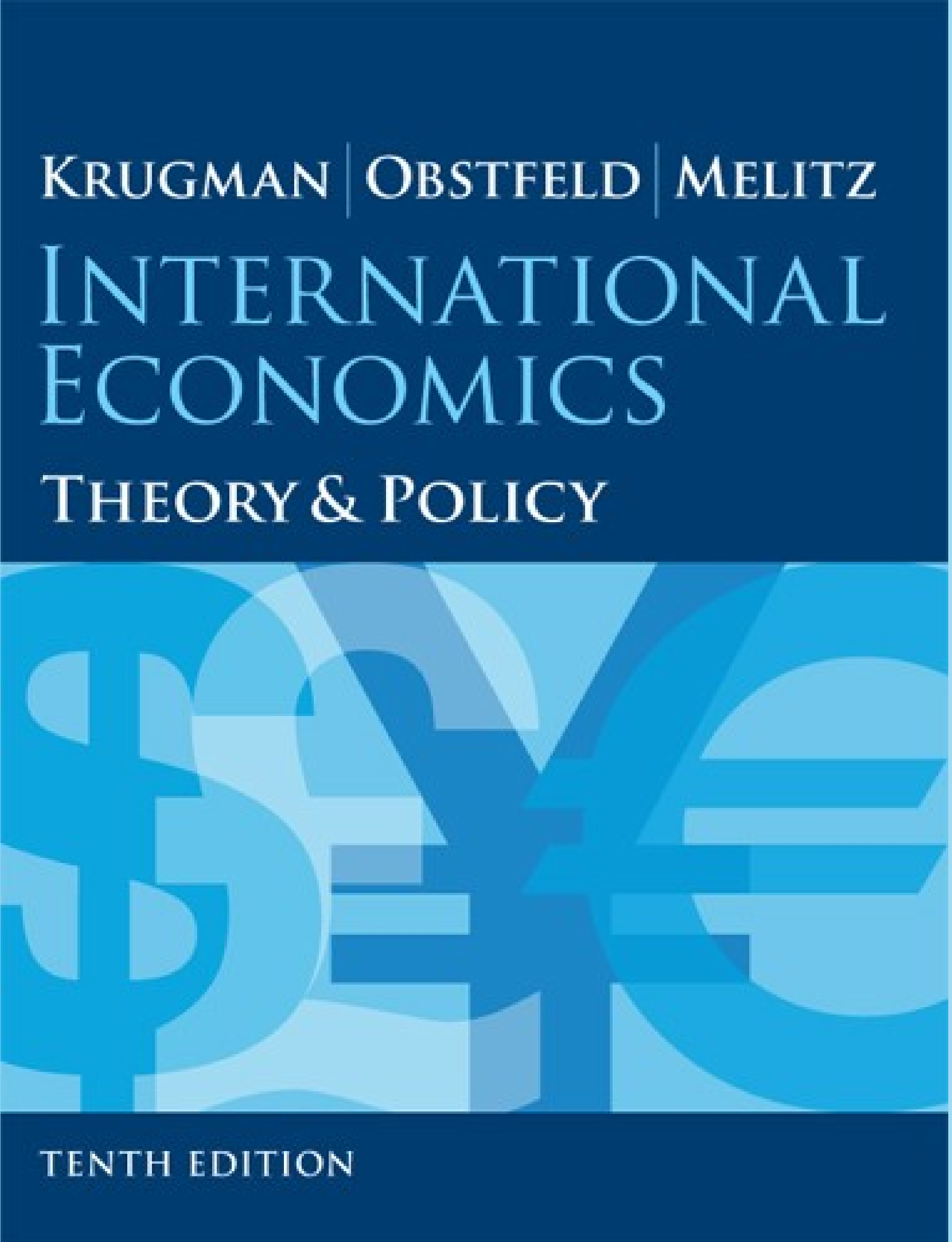


Chapter 10

The Political Economy of Trade Policy

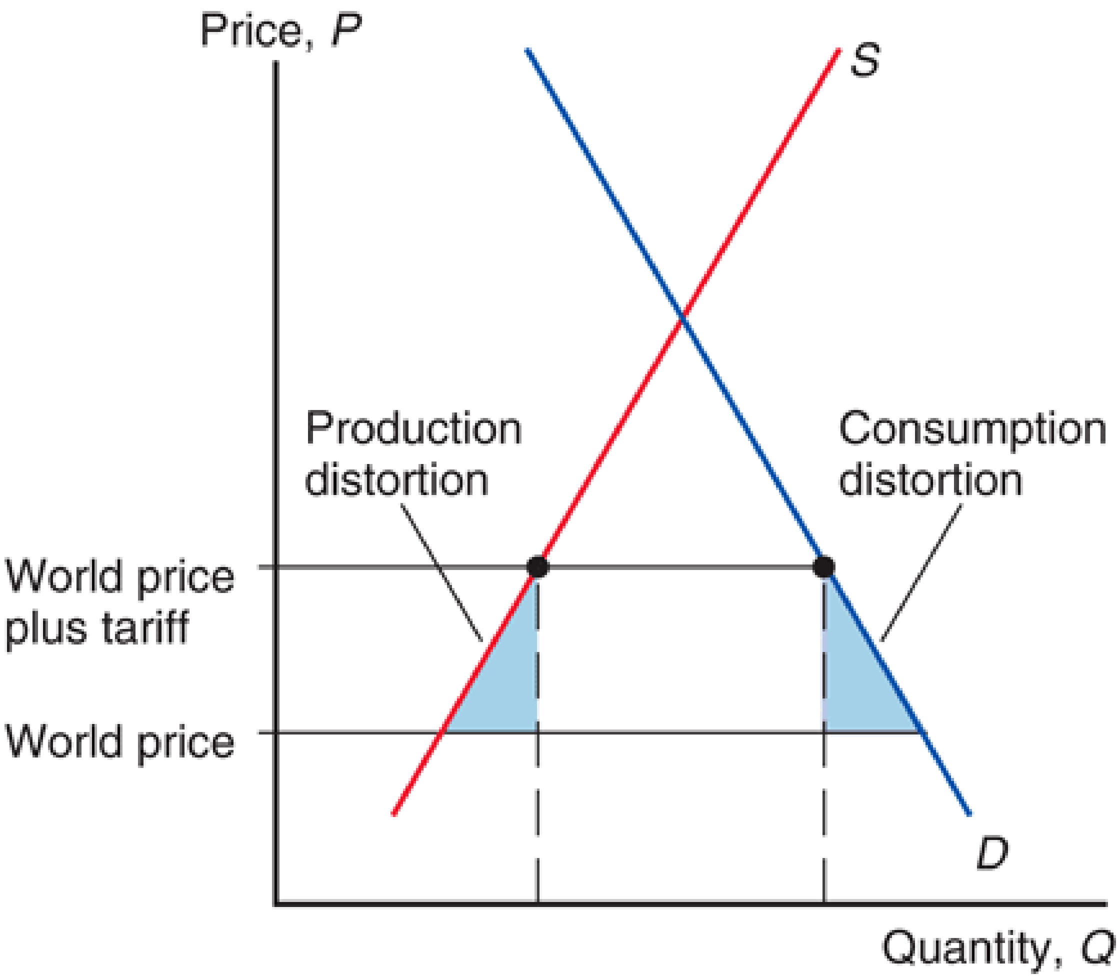
Preview

- The cases for free trade
- The cases against free trade
- Political models of trade policy
  - Median voter theorem
  - Collective action problem
- International negotiations of trade policy and the World Trade Organization

The Cases for Free Trade

- Efficiency argument
- Economies of scale
- Competition and opportunities for innovation
- Avoiding rent-seeking
- Political argument

Fig. 10-1: The Efficiency Argument for Free Trade



The efficiency argument for free trade is that producers and consumers allocate resources most efficiently when governments do not distort market prices through trade policy.

National welfare of a small country is highest with free trade.

With restricted trade, consumers pay higher prices and consume too little while domestic firms produce too much.

Table 10-1: Benefits of a Move to Worldwide Free Trade (percent of GDP)

United States	0.57
European Union	0.61
Japan	0.85
Developing countries	1.4
World	0.93

Source: William Cline, *Trade Policy and Global Poverty* (Washington, D.C.: Institute for International Economics, 2004), p. 180.

However, because tariff rates are already low for most countries, the estimated benefits of moving to free trade are only a small fraction of national income for most countries.

For the world as a whole, protection costs less than 1 percent of GDP.

The gains from free trade are somewhat smaller for advanced economies such as the U.S. and EU and somewhat larger for poorer developing countries.

Tab. 10-1b: The Estimated Costs of Protectionism (percent of GDP)

Brazil (1966)	9.5
Turkey (1978)	5.4
Philippines (1978)	5.4
United States (1983)	0.26

Historically, the costs of protectionism were much higher.

The Cases for Free Trade

- Free trade allows firms or industry to take advantage of **economies of scale**.
  - In the case of external economies of scale, protected markets inhibit the concentration of industries.
  - In the case of internal economies of scale, protected markets lead to the ineficient scale of production for firms.
- Free trade **increases competition and provides opportunities for innovation** (dynamic benefits).
  - By providing entrepreneurs with an incentive to seek new ways to export or compete with imports, free trade offers more opportunities for learning and innovation.

The Cases for Free Trade

- Free trade avoids the loss of resources through **rent seeking**.
  - Spend time and other resources seeking quota rights and the profit that they will earn.
- The **political argument for free trade** says that free trade is the best *feasible* political policy, even though there may be better policies in principle.
  - Any policy that deviates from free trade would be quickly manipulated by political groups, leading to decreased national welfare.

Case Study: The Gains from 1992

- In 1987, the nations of EC agreed on Single European Act, with the intention to create a truly unified European market. The Act went into effect in 1992.
  - The European Community was already a customs union. There were no tariffs or import quotas on intra-European trade.
- What would be the gains from creating this unified single market?
  - The elimination of red-tape barriers (bureaucratic barriers)
  - Politically difficult negotiations, most problems involved food.
  - According to some economists, it should lead to less segmented markets and more efficient production, as the firms can economize on the scale of production.

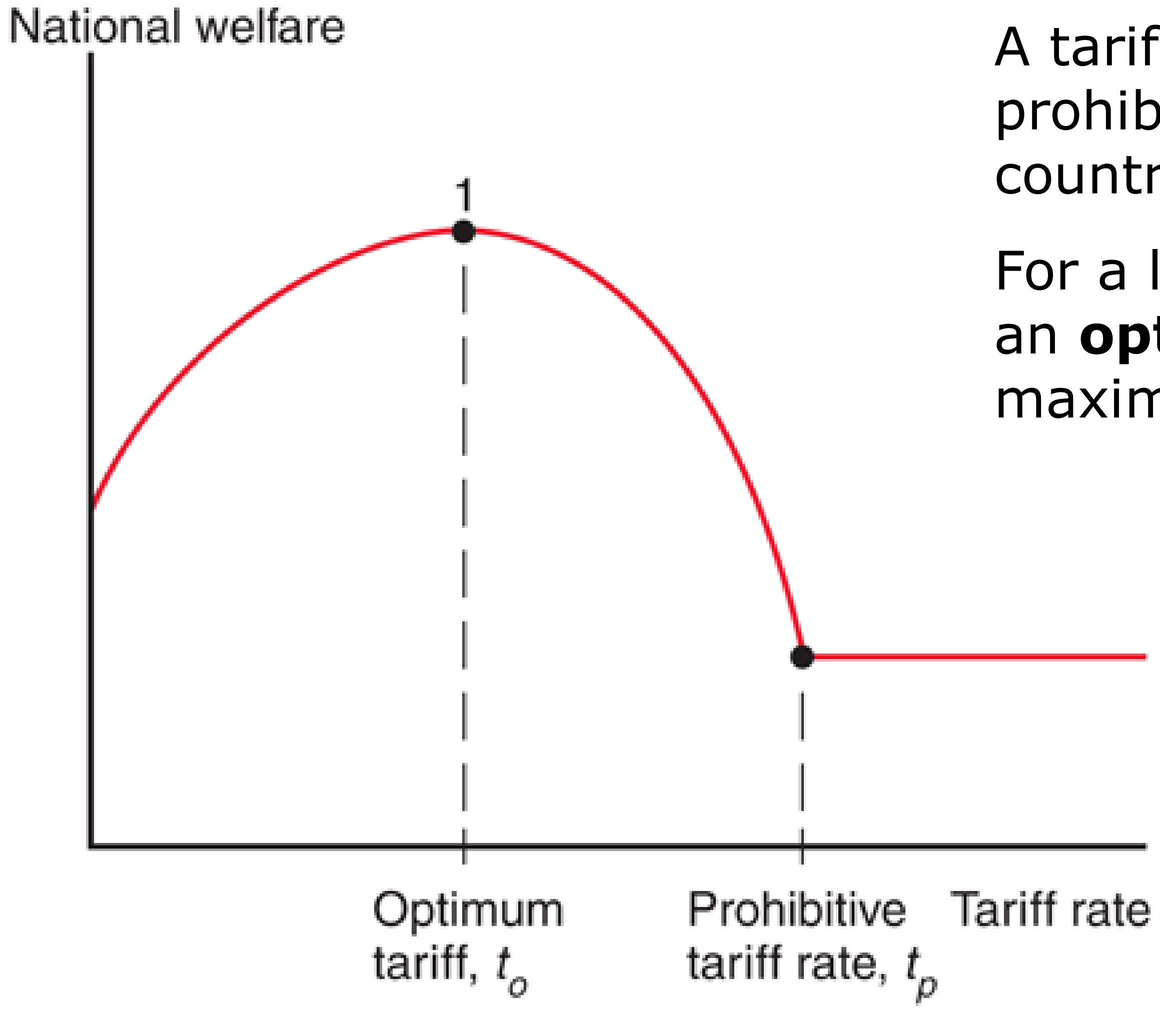
The Cases against Free Trade

- The terms of trade argument
- The domestic market failure argument

The Cases against Free Trade

- For a "large" country, a tariff lowers the price of imports in world markets and generates a **terms of trade gain**.
  - This benefit may exceed the losses caused by distortions in production and consumption.
- A small tariff will lead to an increase in national welfare for a large country.
  - But at some tariff rate, the national welfare will begin to decrease as the economic efficiency loss exceeds the terms of trade gain.

Fig. 10-2: The Optimum Tariff



A tariff rate that completely prohibits imports leaves a country worse off.

For a large country, there is an **optimum tariff** t_O that maximizes national welfare.

The Cases against Free Trade

- An export *tax* (a negative export subsidy) that completely prohibits exports leaves a country worse off, but an export tax rate may exist that maximizes national welfare through the terms of trade.
  - An export subsidy lowers the terms of trade for a large country; an export tax raises the terms of trade for a large country.
  - An export tax may raise the price of exports in the world market, increasing the terms of trade.

Counter-Argument

- For large countries like the U.S., an import tariff and/or export tax could improve national welfare at the expense of other countries.
  – Not applicable to small countries.
- But this argument ignores the likelihood that other countries may retaliate against large countries by enacting their own trade restrictions.

The Cases against Free Trade

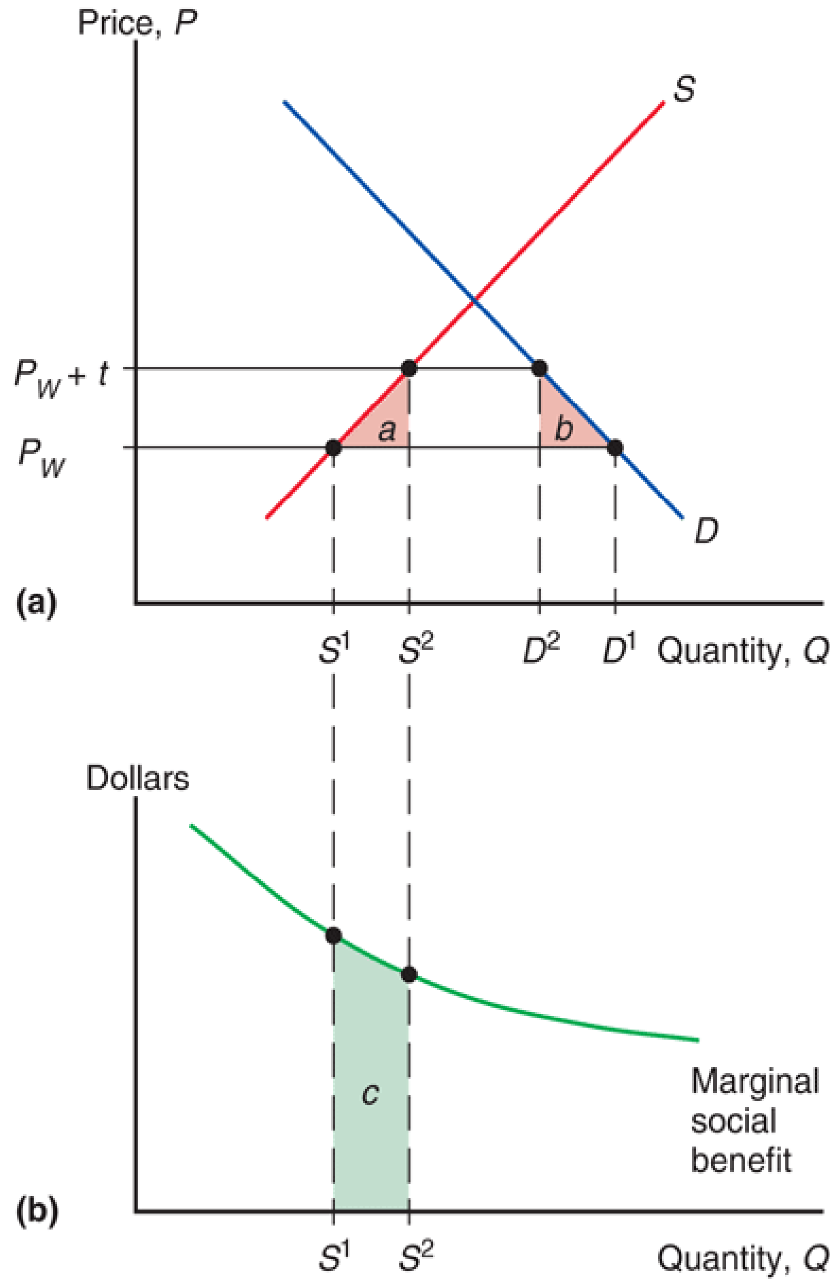
- Another argument is that **domestic market failures** may cause free trade to be a suboptimal policy.
  - The economic efficiency loss calculations using consumer and producer surplus assume that markets function well.
- Types of market failures include
  - persistently high underemployment of workers
  - persistently high underutilization of structures, equipment, and other forms of capital
  - property rights not well defined or well enforced
  - technological benefits for society discovered through private production, but from which private firms cannot fully profit
  - environmental costs for society caused by private production, but for which private firms do not fully pay

Fig. 10-3: The Domestic Market Failure Argument for a Tariff

The **marginal social benefit** represents the additional benefit to society from private production which is not covered by the producer surplus.

Because of that may be calculations of economic efficiency loss misleading – it does not take into account the area *c*.

It's possible that when a tariff increases domestic production, the benefit to domestic society will increase due to a market failure.



The Cases against Free Trade

- The domestic market failure argument against free trade is an example of the **theory of the second best**.
  - Government intervention that distorts market incentives in one market may increase national welfare by offsetting the consequences of market failures elsewhere.
  - If the best policy, fixing the market failures, is not feasible, then government intervention in another market may be the "second-best" way of fixing the problem.

Counter-Arguments

- Economists supporting free trade argue that domestic market failures should be corrected by a “first-best” policy: a domestic policy aimed directly at the source of the problem.
  - If persistently high underemployment of labor is a problem, then the cost of labor or production of labor-intensive products could be subsidized by the government.
  - This policy could avoid economic efficiency losses due to a tariff.

Counter-Arguments

- Unclear when and to what degree a market failure exists in the real world.
  - Government policies to address market failures are likely to be manipulated by politically powerful groups.
  - Due to distorting the incentives of producers and consumers, trade policy may have *unintended consequences* that make a situation worse, not better.

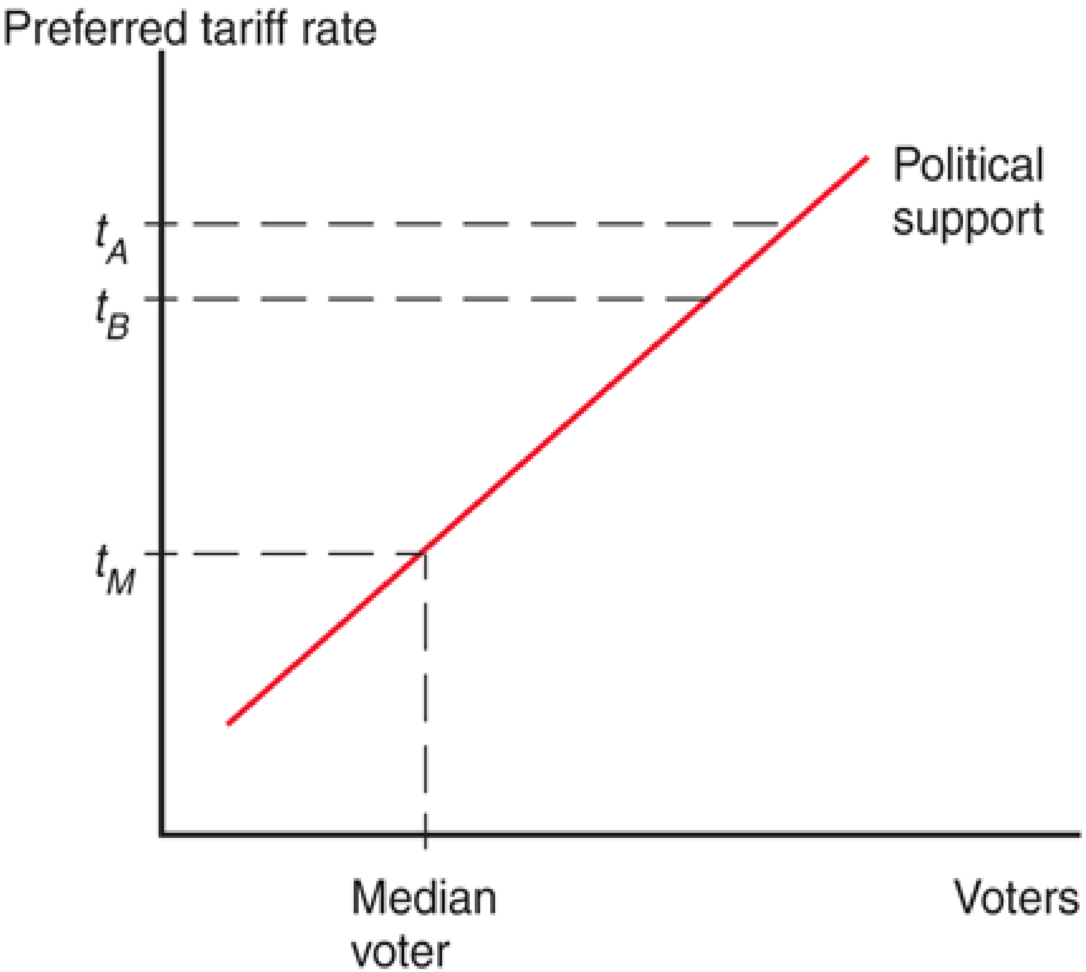
Political Economy of Trade Policy

- We will assume that politicians want to maximize their political success rather than national welfare:
- Two important concepts:
  - Median voter theorem
  - Collective action problem

Median Voter

- The median voter theorem predicts that political parties pick their policies to court the voter in the middle of the ideological spectrum (i.e., the median voter).
- Suppose the level of a tariff rate is the policy issue.
  - Line up all the voters according to the tariff rate they prefer, starting with those who favor the lowest rate.
- Assumptions of the model:
  - There are two competing political parties. The objective of each party is to get elected by majority vote.
- What policies will the parties promise to follow?

Fig. 10-4: Political Competition



Voters are lined up in order of the tariff rate they prefer.

If one party proposes a high tariff of t_A, the other party can win over most of the voters by offering a somewhat lower tariff t_B.

This political competition drives both parties to propose tariffs close to t_M, the tariff preferred by the median voter.

Median Voter

- Thus, the median voter theorem implies that a two-party democracy should enact trade policy based on how many voters it pleases.
  - A policy that inflicts large losses on a few people (import-competing producers) but benefits a large number of people (consumers) should be chosen.
- But trade policy doesn't follow this prediction.

Collective Action

- Political activity is often described as a **collective action problem**:
  - While consumers *as a group* have an incentive to advocate free trade, each *individual* consumer has no incentive because his benefit is not large compared to the cost and time required to advocate free trade.
  - Policies that impose large losses for society as a whole but small losses on each individual may therefore not face strong opposition.
- However, for groups who suffer large losses from free trade, each individual in that group has a strong incentive to advocate the policy he desires.
  - In this case, the cost and time required to advocate restricted trade is small compared to the cost of unemployment.

Political Economy of Trade Policy

- While politicians may win elections partly because they advocate popular policies as implied by the median voter theorem, they also require funds to run campaigns.
- These funds may especially come from groups who do not have a collective action problem and are willing to advocate a special interest policy.
- Models of trade restrictions try to measure the trade-off between the reduction in welfare of constituents as a whole and the increase in campaign contributions from special interests.

Politicians for Sale: Evidence from the 1990s

- Baldwin, Magee (1998) examined congressional votes in U.S. on NAFTA (1993) and GATT (1994).
  - labor unions were strongly against, business groups were strongly in favor; both groups were lobbying (e.g. campaign contributions)
  - both proposals passed, but in both cases it was pretty close
- Authors estimated an econometric model of these votes (yes/no) that controls for several factors
  - economic characteristics of member’s district, labor and business contributions on campaign, ...
- It allows to make the following simulations: *How different would the overall vote had been if for example labor unions had not made any campaign contributions.*

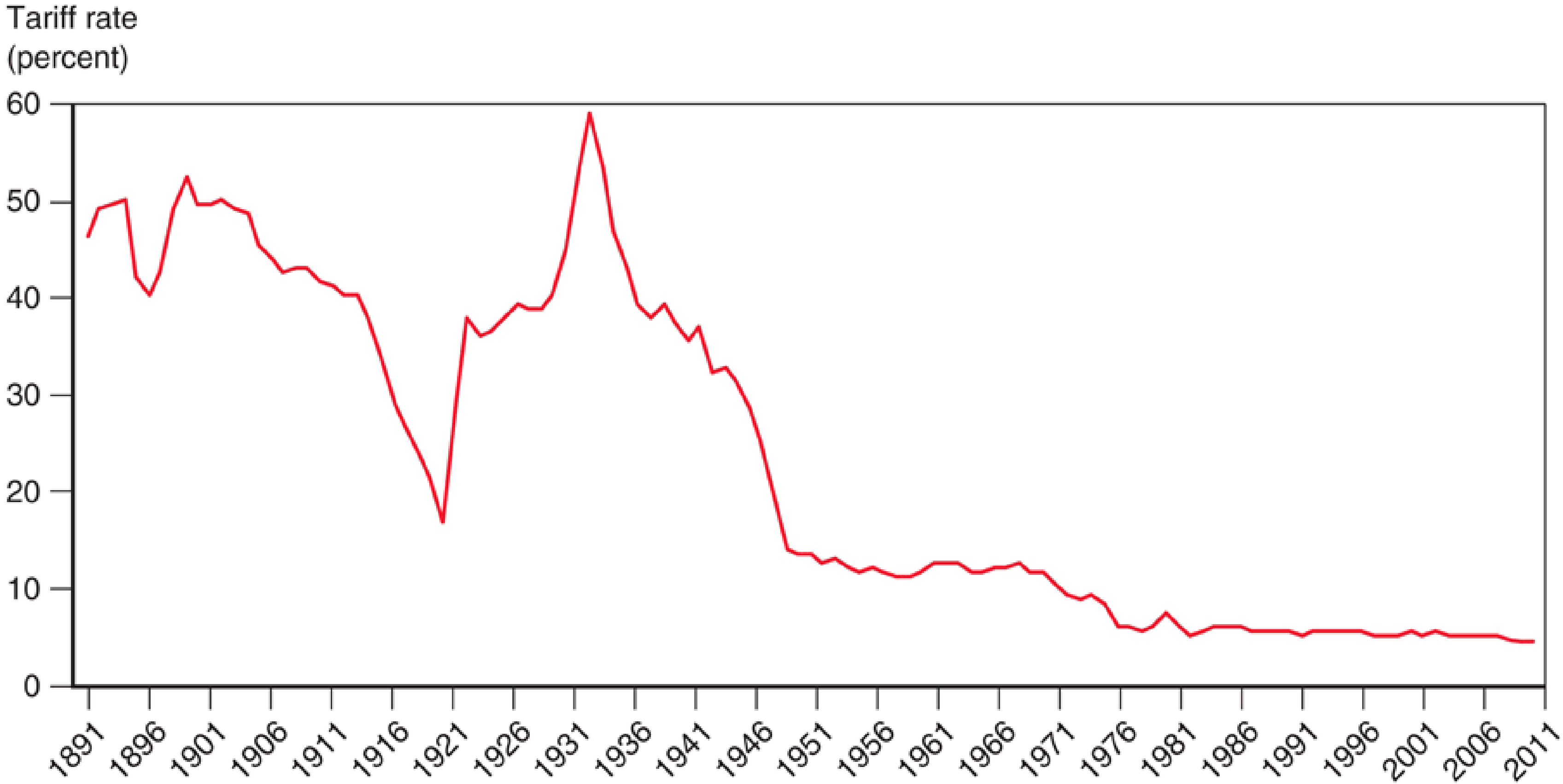
Politicians for Sale: Evidence from the 1990s

	Votes for NAFTA	Votes for GATT
minimum for approval	214	214
actual result	229	283
predicted by model	229	290
without labor contributions	291	346
without business contributions	195	257
without any contributions	256	323

Which Industries Are Protected in Developed Countries?

- Agriculture
  - In the U.S., Europe, and Japan, farmers make up a small fraction of the electorate but receive generous subsidies and trade protection.
  - EU's CAP, Japan's 1000% tariff on rice, sugar quota in USA.
- Clothing
  - labor-intensive
  - workers need relatively little capital and can do the job without extensive formal education
  - small and well organized group of producers

Fig. 10-5: The U.S. Tariff Rate



After rising sharply at the beginning of the 1930s, the average U.S. tariff rate has decreased substantially from the mid-1930s to 1998.

Since 1944, much of the reduction in tariffs and other trade restrictions has come about through international negotiations.

International Negotiations of Trade Policy

- Multilateral negotiations mobilize exporters to support free trade if they believe export markets will expand.
  - This support would be lacking in a unilateral push for free trade. The multilateral approach counteracts the support for restricted trade by import-competing groups.
- Multilateral negotiations also help avoid a trade war between countries, where each country enacts trade restrictions.
  - A trade war could result if each country has an incentive to adopt protection, *regardless of what other countries do.*
  - All countries could enact trade restrictions, *even if it is in the interest of all countries to have free trade*.

Table 10-3: The Problem of Trade Warfare

U.S. \ Japan	Free trade	Protection
Free trade	U.S. 10, Japan 10	U.S. –10, Japan 20
Protection	U.S. 20, Japan –10	U.S. –5, Japan –5

Each country has a dominant strategy **Protection** which leads to the **Nash equilibrium** with payoffs -5 and -5.

The situation with free trade is for both countries a better outcome, as it is associated with payoffs 10 and 10.

What is the name for this game?

International Trade Agreements: A Brief History

- In 1930, the United States passed a remarkably irresponsible tariff law, the Smoot-Hawley Act.
  - Tariff rates rose steeply, other countries retaliated and the U.S. trade fell sharply.
  - It was a response of the U.S. government to recession. It helped to deepen the Great Depression and to spread it worldwide.
- Initial attempts to reduce tariff rates were undertaken through bilateral trade negotiations:
  - U.S. offered to lower tariffs on some imports if another country would lower its tariffs on some U.S. exports.
  - Bilateral negotiations, however, do not take full advantage of international coordination. Benefits can "spill over" to countries that have not made any concessions.

International Trade Agreements: A Brief History

- In 1947, a group of 23 countries began trade negotiations under a provisional set of rules that became known as the General Agreement on Tariffs and Trade, or GATT.
- In 1995, the **World Trade Organization,** or **WTO**, was established as a formal organization for implementing multilateral trade negotiations (and policing them).

World Trade Organization

- WTO negotiations address trade restrictions in 3 ways:

1. **Reducing tariffs** through multilateral negotiations.
   - Kennedy Round, Tokyo Round, Uruguay Round, Doha Round
2. **Binding tariffs**: a tariff is “bound” by having the imposing country agree not to raise it in the future.
3. **Eliminating nontariff barriers**: quotas and export subsidies are changed to tariffs because the costs of tariff protection are more apparent and easier to negotiate.
   - Subsidies for agricultural exports are an exception.
   - Exceptions are also allowed for “market disruptions” caused by a surge in imports.

World Trade Organization

- The WTO is based on a number of agreements:
  - *General Agreement on Tariffs and Trade:* covers trade in goods.
  - *General Agreement on Tariffs and Services:* covers trade in services (insurance, consulting, legal services, banking).
  - *Agreement on Trade-Related Aspects of Intellectual Property:* covers international property rights (patents and copyrights).
- *The dispute settlement procedure:* a formal procedure where countries in a trade dispute can bring their case to a panel of WTO experts to rule upon.
  - The panel decides whether member countries are breaking their agreements. A country that refuses to adhere to the panel's decision may be punished by the WTO allowing other countries to impose trade restrictions on its exports.

First and the Most Controversial Application of the Dispute Settlement Procedure

- In 1995 USA ratified the Clean Air Act which set new rules for the composition of gasoline sold in U.S.
- Basically, this act set a less strict standard for the domestic gasoline than for the imported one.
- Venezuela filled a complaint against U.S. to the WTO regarding discriminatory practices.
  - Gasoline of slighly worse quality was allowed to be sold in U.S. if it was from American producers but not in the case if it was imported gasoline.
- A year later, the panel of WTO’s experts ruled in Venezuela’s favor and in the end USA had to change the law.

First and the Most Controversial Application of the Dispute Settlement Procedure

- The opinion of WTO opponents
  - WTO stopped the act that was supposed to protect the environment
  - WTO is interfering into domestic policy issues
  - WTO deprives the nations of their sovereignty.
- The opinion of WTO defenders
  - If the American law set the same standards for all producers, the WTO would not have any problem with it.
  - In a relatively short time (one year) WTO ruled in favor of small discriminated country and against the world power (USA).
  - A demonstration that WTO is doing exactly what it was supposed to do.

Dispute Settlement Procedure: American Tariff on Imported Steel

- In March 2002, USA ratified 30% tariff rate on steel products.
- The official reason was that the industry face the surge of imports and need time to restructuring the production.
- The real reason was that this industry is concentrated in West Virginia, Ohio, and Pennsylvania; the key “swing” states for presidential election in 2004.
- EU, Japan, China, and South Korea filled a complaint to the WTO.

Dispute Settlement Procedure: American Tariff on Imported Steel

- In June 2003, the panel of WTO's experts ruled in their favor and in December 2003, USA called off the steel tariff.
- The official reason was that the tariff already fulfiled its task.
- Most observers believed that the real reason was the threat from EU to ratify tariffs on American products.
- EU politicians obviously understand political economics, as the potential tariffs proposed by EU would have been targeted on products produced in the "swing" states.

Do Agricultural Subsidies in Rich Countries Hurt Poor Countries?

- We learned in Chapter 9 that subsidies lower the *world* price of products.
  - Since importing countries benefit from cheaper food, why would poor countries want rich countries to remove their agricultural subsidies?
  - Subsidies harm farmers in poor countries who compete with farmers in rich countries.
  - What really matters is what kind of products a country exports and imports.
  - If China exports mainly manufactured products and imports food, how agricultural subsidies affect Chinese national welfare?

Preferential Trading Agreements

- Preferential trading agreements are trade agreements between countries in which they lower tariffs for each other but not for the rest of the world.
  - Under the WTO, such discriminatory trade policies are generally not allowed. An exception is allowed only if the lowest tariff rate is zero.

1. **Free trade area**: free trade among members, but each member can have its own trade policy towards non-member countries.
   - North America Free Trade Agreement (NAFTA).
2. **Customs union**: free trade among members and requires a common external trade policy towards non-member countries.
   - European Union (EU).

Free Trade Area vs Customs Union

- Free trade area
  - politically straightforward
  - administrative headache
- Customs union
  - political headache
  - straightforward for administration
- Why?

Preferential Trading Agreements

- Are preferential trading agreements necessarily good for national welfare?
- No, it is possible that national welfare decreases under a preferential trading agreement.
- How? Rather than gaining tariff revenue from inexpensive imports from world markets, a country may import expensive products from member countries but not gain any tariff revenue.

Preferential Trading Agreements

- Preferential trading agreements increase national welfare when new trade is created, but not when existing trade from the outside world is diverted to trade with member countries.
- Trade creation
  - occurs when high-cost domestic production is replaced by *low-cost imports from other members*.
- Trade diversion
  - occurs when low-cost imports from nonmembers are diverted to *high-cost imports from member nations.*

Trade Diversion in South America

- In 1991, Argentina, Brazil, Paraguay, and Uruguay formed a free trade area: **Mercosur**.
  - Within four years, the value of trade among the nations tripled.
  - Political interpretation – a major success.
- From the major part it was however trade diversion rather than trade creation
  - Consumers in the member countries were being induced to buy expensively produced goods from their neighbours instead of cheaper but heavily tariffed goods from other countries.
  - Because of Mercosur, Brazil’s highly protected and somewhat inefficient auto industry could dominate the market in Argentina and displace cheaper but heavily tariffed imported cars from elsewhere.

Summary

1. The cases for free trade are that freer trade
   - allows consumers and producers to allocate their resources freely and efficiently, without price distortions.
   - may allow for economies of scale.
   - increases competition and innovation.
   - limits rent-seeking.
2. The cases against free trade are that trade restrictions may allow
   - terms of trade gains.
   - a government to address a market failure when better policies are not feasible.

Summary

3. Models of trade policy choice consider the incentives politicians face given their desire to be reelected, and the tendency for groups that gain from protection to be better organized than consumers who lose.
4. Agricultural and clothing industries are the most protected industries in many countries.
5. Multilateral negotiations of free trade may mobilize domestic political support for free trade, as well as make countries agree not to engage in a trade war.

Summary

6. The WTO and its predecessor have reduced tariffs substantially in the last 50 years, and the WTO has a dispute settlement procedure for trade disputes.
7. A preferential trading agreement is beneficial for a country if it creates new trade but is harmful if it diverts existing trade to higher-cost alternatives.