CHAPTER 19

THE POLITICAL ECONOMY OF TRADE POLICY

19.1 INTRODUCTION

So far in this text, policy analysis has been normative in nature. That is, the policy choices discussed have been examined from the perspective of what is "optimal" given the aggregate utility structure of the assumptions in place. In fact, given the presumptions of the theory discussed so far, the only way to explain why we do not always see optimal policies in use is that policy makers might not be aware of what the optimal policy is or of what kinds of distortions arise from the policies actually in place. This suggests that the better we understand the behavior of the economic world, the closer we will be to policy optimality. In this chapter, however, we move from this normative analysis of what policies are "best" given an assumed social welfare function to a positive analysis of policy. In other words, in this chapter we will develop a theory of why countries impose the types of policies that they do, even if those policies are sub-optimal.

Public choice economics is the study of governmental decision-making behavior using economic models. This means that decision makers in the public sector are modeled to be utility maximizers who optimize in the face of constraints on their behavior in the same way as we have modeled decision makers in the private sector. Throughout this part of the book, the repeated conclusion of the analysis has been that direct trade interventions in the form of tariffs or quotas are rarely optimal policies. This might lead inquisitive students to wonder, then, just why we have so many direct trade intervention policies in place worldwide. The analysis developed in this chapter, however, may lead students to wonder why we do not see an even more pervasive use of trade policy.

There are decision makers at many levels of government: members of the executive branch, legislators and other elected officials, bureaucrats, independent commissioners, and more. What informs the decisions they reach? Public choice analysis makes the simple assumption that these individuals behave just like the head of a household who attempts to maximize household utility subject to various constraints on income and time and the like, or like the manager of a firm who attempts to maximize profits for that firm subject to cost, technology, and various market constraints. A governmental decision maker—a legislator, for instance—is ultimately self-interested, aiming to maximize his or her own utility before attaining some socially optimal set of policies.

What things are we likely to find in a policy maker's utility function? When we considered consumption behavior in Chapter 3, consumers were assumed to have a utility function:

$$U = U(X, Y). \tag{19.1}$$

Clearly, other things matter to an individual's level of satisfaction besides the consumption level of goods X and Y. For instance, upholding certain values or norms might be important, or the individual might have altruistic motives regarding the consumption levels of others. However, the conclusions based on the simple model of utility as a function of consumption of X and Y greatly simplified the process and allowed us to draw very clear conclusions. In this fashion, there is undoubtedly a variety of things that are important to a governmental policy maker's level of utility: political ideology, personal wealth (acquired in the form of bribes), the decision maker's place in history, and so forth. However, to simplify the set of important utility-enhancing elements we will assume that elected officials desire to be reelected and will behave in a manner consistent with maximizing the likelihood of this event.

An immediate implication of assuming that governmental officials enact policies in order to maximize their chances of staying in office is that, to a large extent, the public's desires will be served by these officials. However, a number of decision-making problems arise in public choice analysis that create policy distortions—that is, failure of a government to enact socially optimal policies. Thus, the conclusions of this chapter will include the acknowledgement that governmental failure to enact socially optimal policies results not from simple ignorance of what those policies might be but from systematic governmental failure.

19.2 THE MEDIAN-VOTER MODEL

The median-voter model is one way of examining the behavior of governmental decision makers in an indirect fashion. If we begin by assuming that legislators are self-interested and desire to stay in office, then their behavior will be to enact those policies into law that satisfy the voter who lies at the median of a distribution of individual voter preferences on some

issue. In satisfying the median voter's interests, a legislator will maximize the likelihood of reelection because a majority of voters, as represented by the interests of the median voter, will favor the policies put forward by that official. This allows us to model behavior in the policy-making process indirectly by looking at the preferences of voters.

Figure 19.1 is a model of median-voter preferences with respect to some specific policy action under consideration by the government. International trade policies are a natural subject for consideration in the median-voter model because, as the Stolper-Samuelson Theorem of Chapter 8 and the Specific-Factor model of Chapter 9 showed us, trade policies that change relative prices on domestic markets from their world levels create differential welfare effects on easily isolated groups in an economy. The Stolper-Samuelson Theorem, for instance, demonstrates that a tariff that raises the domestic price of the labor-intensive, imported good will raise the real return to labor and lower the real return to capital, regardless of the sector in which these factors are employed.[1]

Suppose our median-voter model is being used to explain the preferences of individuals regarding a piece of legislation that would raise the domestic price of some imported good through an import tariff. In Fig. 19.1, an array of voter preferences on this issue is presented from 0 to 1 on the horizontal axis. Each individual member of the electorate is assigned a position along this array based on the change in utility that he or she will experience if the import tariff is put into place. All those who lose from this tariff are lumped first, followed by those who gain. The preference of the median voter is at 0.5 on the distribution. The actual utility loss or gain is then measured as a negative or positive amount along the vertical axis. In this example, 60 percent of the voters will lose if this tariff is enacted into law.

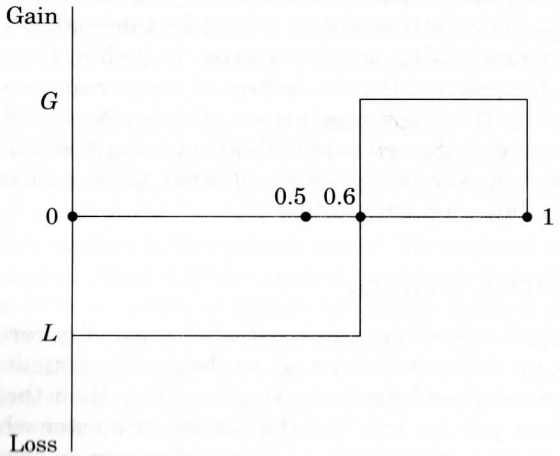

FIGURE 19.1
Median voter choice.

Figure 19.1 clearly makes the simplifying assumption that all winners from the proposed tariff gain an equal amount per individual, G, while all losers are penalized by an amount of L per individual. A more general approach might simply array individual voters along a positively sloped locus from the most harmed to the most benefited. However, such a generalization really adds little to the analysis, and the assumption that all winners gain G and all losers lose L is consistent with previous assumptions regarding factor homogeneity and identical and homothetic tastes. That is, if we assume that labor and capital factors of production are homogeneous and that each individual has identical and homothetic preferences, then individuals should either all gain or all lose from the tariff by equal amounts within their respective groups.[2]

The median voter in Fig. 19.1 loses if this tariff is passed and is thus likely to vote against a legislator who attempts to pass it. This leads us to conclude that a legislator interested in reelection who represents a district like the one in Fig. 19.1 would vote against this measure. If the majority of the legislators voting on this tariff represented constituencies that have individual preferences like those in Fig. 19.1, this tariff would be voted down.

Whether it can be characterized as protectionist (i.e. raising trade barriers) or liberalizing (lowering trade barriers), trade policy is almost always redistributive in nature. That is, it causes some members of a society to gain while others lose. The median voter model, as presented so far, insures that the position of the majority will be followed, which would seem to be a positive outcome except to those who find themselves in the minority group on issue after issue. However, there are several problems that arise from depending upon the preferences of the median voter to decide political outcomes.

19.3 PUBLIC CHOICE PROBLEMS WITH MEDIAN VOTER DECISIONS

Even when the dictates of the median voter are followed, policy decisions are likely to be suboptimal because of the many problems involved in the process of aggregating individual preferences and turning them into political decisions. In this section, we will apply public choice analysis to the median-voter model in order to illustrate some of these policy-making failures. We will begin with one serious flaw inherent to median-voter decisions in particular: the fact that median voter choices fail to register intensity of preferences.

Figure 19.2 examines voter preferences with respect to a second issue. Suppose a trade liberalization issue is under consideration by a policy-making board.[3] Once again, 60 percent of voters will be harmed by the liberalization, while only 40 percent will benefit. However, in this case, the extent of each individual gain or loss is quite different. Each individual who

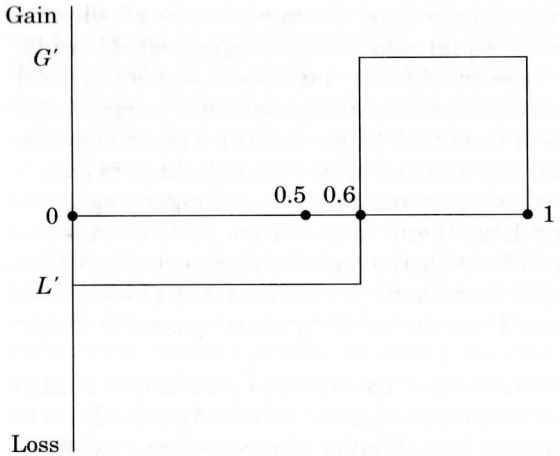

FIGURE 19.2
Preference intensity problems.

benefits from this policy will gain G' from its passage, while each loser will lose L'. Figure 19.2 has been constructed so that $0.4G'$ clearly is greater than $0.6L'$; therefore, the net effect of the liberalization measure on the whole of society is positive. Nevertheless, because the median voter belongs to the group opposed to the measure, the median voter model predicts that the liberalization measure will fail.

Consideration of the implications of the Stolper-Samuelson Theorem in combination with the failure of a median-voter decision-making process to register preference intensity is important for trade policy. In general, in the absence of any other distortion, import protection will lower social welfare for an economy. However, the Stolper-Samuelson Theorem demonstrates that a tariff policy that raises the price of the imported good will raise the absolute return to the scarce factor while lowering the absolute return to the abundant factor. From a median-voter perspective, though, the question is not whether the tariff will be beneficial on the whole (which it would not be), but how many votes these two factors will command in the political system. In most economies, the distribution of factor ownership is skewed so that almost all members of the economy own one unit of labor, while some individuals own many units of capital and none. This suggests that labor interests would tend to have their way in most median-voter decisions. In other words, even in an economy where labor is relatively scarce in economic terms, labor is likely to be the politically abundant factor—that is, in the majority. The empirical implication of this, in accordance with the Stolper-Samuelson Theorem, is that, other things held constant, labor-scarce countries are likely to have higher tariff rates on average than labor-abundant countries.

Studies of welfare economics must grapple with the problem that social welfare redistributions pose for a political entity. The policy measures suggested by Figs. 19.1 and 19.2 are redistributive policies that allow one segment of society to gain only at the expense of some other group. By

the *Pareto criterion* of welfare economics, neither policy choice is "optimal" because only by harming some can there be a gain for others. An alternative way of judging the issue, however, is called the *compensation criterion.* According to this welfare judgement, a policy is socially wise if those who gain from the policy can fully compensate those who lose, even if no compensation is made. Notice that the measure considered in Fig. 19.1 is a poor social choice because the gainers could never fully compensate losers. The measure considered in Fig. 19.2, however, is good social policy because compensation is possible.

While the median voter would vote down the issue considered in Fig. 19.2, there are ways for the minority to prevail. Notice that a market-based election in which voters "buy" votes would allow passage of this issue because the minority's willingness to pay in order to pass the liberalization exceeds the majority's willingness to pay in order to maintain the status quo. Some voting schemes have been used in which intensities of preference are explicitly weighted into the election using this kind of market allocative device. Actually, undertaking compensation is another way of ensuring the outcome with the greatest net benefit to society. A transfer from the benefited group to some or all of the losers may cancel their opposition.

While such compensation schemes may seem impractical, illegal, or perhaps even immoral, they actually take place in the political system all the time under the name of *logrolling,* the colorful name given to vote trading. In Table 19.1, we consider the welfare effects of a pair of simultaneous policy decisions. Three individuals, *A, B,* and *C* will gain or lose the dollar amounts shown in the table from issues 1 and 2. Issue 1 benefits *A* by \$20 at a cost of \$5 each to *B* and *C*. The net social gain of the measure is \$10, but of course *B* and *C* would vote it down two-to-one in a majority election. Similarly, issue 2 would be defeated by a coalition between *A* and *C,* even though it has an identical net social benefit of \$10. However, if *A* and *B* are able to arrange a vote on a package of issues 1 and 2, the issue will pass by a two-to-one vote because the personal benefit to each is \$15, while only *C* will vote against it.

While in this case logrolling solves the compensation problem and allows both *A* and *B* to secure enough votes to enact the policies that are beneficial not only to them but also to society as a whole, logrolling can also lead to nonoptimal policy decisions. Table 19.2 changes the payoffs to

TABLE 19.1
Gains from logrolling

	Gain or loss to individual			
	A	**B**	**C**	**Net**
Issue 1	+20	−5	−5	+10
Issue 2	−5	+20	−5	+10
Issue 1&2	+15	+15	−10	+20

the gainers and losers in such a way that, although issues 1 and 2 are both socially detrimental, a logrolling coalition between *A* and *B* to pass a legislative package of issues 1 and 2 is still possible.

One of the most damaging tariffs in U.S. tariff history, the Smoot-Hawley tariff of 1930, was actually a package of tariff bills for different sectors of the economy rolled into a single package. The political strategy employed in passing the Smoot-Hawley tariff is almost a textbook example of the possibility of welfare losses from logrolling. Legislators, all seeking to gain protection for industries that were politically important to them, agreed to vote for high tariffs for other industries in order to "buy" more votes for their own favored sectors. The result was an increase of average protective tariffs in the United States to more than 50 percent of the value of imports. This level compares unfavorably to current levels of less than 5 percent.

So far, two underlying assumptions have been made in the median-voter model in order to obtain the result that self-interested political decision makers will follow the wishes of the median voter. First, we have assumed that the median voter has full knowledge of the gains or losses that he or she will receive from political measures. Second, we have assumed that individuals actually vote their preferences. In practice, neither of these conditions will hold fully, and as a result, the preferences of the median voter might not win out in political decisions.

It may be rational for members of a political system to maintain ignorance of the issues at stake in the system and the payoffs to them as individuals as well as to abstain from participating in the system. Coming to understand the potential payoffs of a political decision is costly in that resources must be expended to gather and evaluate information. Voting, either directly for an issue in a referendum or indirectly for a set of issues by voting for a political candidate, is also costly to an individual in that time and resources are lost by going to the polls and waiting to vote. While the costs of collecting information on political issues and then voting are undoubtedly small for most individuals, these costs must be compared to the benefits of political participation.

The benefit to an individual from political participation is the likelihood that his or her efforts will actually swing an election to a positive outcome

TABLE 19.2
Losses from logrolling

	Gain or loss to individual			
	A	**B**	**C**	**Net**
Issue 1	+20	−15	−15	−10
Issue 2	−15	+20	−15	−10
Issue 1&2	+5	+5	−30	−20

from a negative outcome for that individual. However, political outcomes are public goods because they affect all members of a political system regardless of whether one specific member participated in the decision or not. This allows individuals to engage in what the public choice literature calls *free riding*—that is, deciding to accept the outcome without engaging in the political process.

In addition, the likelihood that an individual voter will cast the vote that swings an election is effectively zero. Even in local elections where only hundreds or thousands of votes are cast, it is highly unlikely that an election will end up in a tie where the marginal voter seals the outcome. In a larger election with millions of potential voters in the electorate, the likelihood of a tied outcome vanishes. As a result, the benefits to an individual from voting—the result that that person's vote changes an outcome in his or her favor—are quite different from the benefits that accrue to the individual from the election itself. Because individuals can rely on benefiting (or losing) from a political decision whether or not they vote, and because the costs of participation, however slight, are likely to exceed the direct benefits of participation, it is rational to remain ignorant and abstain.[4]

Rational ignorance and rational abstention would not cause any variance from the outcomes predicted by the median voter model if every voter had an equal probability of not participating in an election. However, in this case we cannot make the assumption of identical individuals. In most cases, there are strong asymmetric influences against free-riding by voters. The asymmetric gains and losses shared by many individuals from political outcomes suggest that interest groups of individuals will form. In many cases, these interest groups will be successful in at least partially overcoming free-riding by members of the group. This may allow interest groups to have disproportional influence on political decisions.

Consider a political issue in which a small segment of the electorate gains immensely at the expense of the rest of the voting public if some issue is enacted. In the context of international trade policy, such an issue might be a protective tariff for a specific industry, the redistributional gains and losses from which are interpreted from the perspective of the specific-factor model of Chapter 9. A tariff on some good will probably raise consumer prices of that protected good by only a small percentage at most. Consequently, members of the group losing from this protection will have very small per capita losses. However, to the factors of production that are specific to the protected industry, and to close substitutes for the mobile factors used in the protected industry or goods produced by that industry, the benefits per individual are likely to be very significant.

In Figure 19.3 we examine the political decision to protect an industry. Consumers of the good, shown here as 95 percent of the electorate, will each lose a small amount of *L* if the tariff is passed. However, specific factors in the protected industry, who comprise the remaining 5 percent of the electorate, will each gain the large amount *G* from the tariff. The

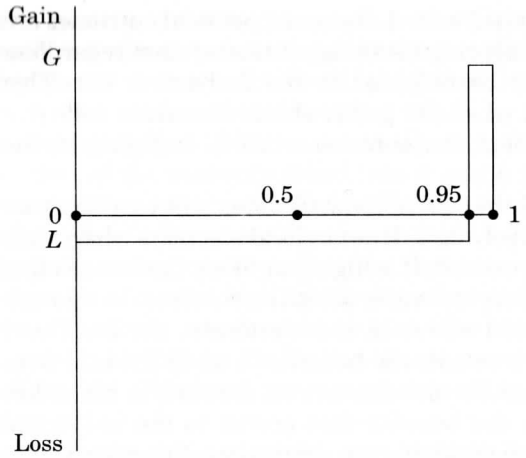

FIGURE 19.3
Special interests.

figure is constructed so that the net social welfare effect of the tariff is negative; that is $0.95L > 0.05G$. This is consistent with the net losses associated with reducing the gains from trade for some good. Furthermore, the median voter is clearly worse off, even if only by a small margin, if the tariff is passed. Nevertheless, special interests in favor of protection often get their way in the political system.

The reason that a tariff can be enacted in spite of the fact that it diminishes total social welfare and is against the best interests of the median voter lies in the differing abilities of interest groups to effect political decisions. Small, well-organized special interests like producer groups are likely to have significant advantages in organization over large but diffuse consumer interests. Special interests in an industry seeking protection will be much more aware of the potential benefits from protection than most consumers will be of the costs of protection. Furthermore, well-organized special interests will be much more successful at controlling free-riding by their members.

An additional factor likely to move political decisions in favor of the interests of small special interests and against the interests of the median voter is the ability of special interest groups to provide funding for political campaigns. So far, we have not included funding in our analysis of political decisions; however, where members of a political system are making rational decisions to remain ignorant and to abstain from voting, funding of political campaigns can provide low-cost information (or misinformation) to potential voters to motivate them toward greater participation. However, well-organized special interests have a comparative advantage in raising political contributions because of their ability to control free-riding by members, and such funding can even be financed out of the benefits expected to accrue to the special interest if the tariff it seeks is imposed.

Political contributions of this kind are called *rent seeking* because the group seeking protection is willing to share its benefits from protection, which are called rents, with the political decision makers in order to affect the political outcome. Of course, rent-seeking expenditures can go far beyond contributions to political campaigns to include bribes and other means of influencing political decisions. The resources expended in rent-seeking activities are sometimes referred to as *directly unproductive activity* because they are exhausted not in producing more goods for society but in merely redirecting the allocations of other goods. Engaging in this unproductive activity wastes resources and may cause policies to be enacted that fail to meet the compensation criterion discussed earlier.[5]

The analysis of tariffs and quotas developed in Chapters 15 and 16 demonstrated that these alternatives to free trade are welfare-improving only in unusual cases and optimal in only extraordinary situations. This might lead a student to ask why trade protection is so widely used. In this section we have examined some of the problems inherent in political decision making that lead to the enactment of policies that are at variance with the interests of the median voter and/or the net social welfare. This understanding allows us to explain the use of tariffs and quotas as well as distortive taxes and subsidies like those examined in Chapter 10. In fact, from a public choice perspective, a frequently asked question is not why tariffs and quotas are so widely used but why they do not get used even more extensively.

19.4 MEDIAN-VOTER DECISIONS UNDER UNCERTAINTY

While the median voter model must be subject to some of the modifications suggested in the previous section for it to satisfactorily describe the policy-making process, it is still a useful starting point for explaining political decisions. In this section we continue to employ it in order to examine political decisions under uncertainty. Our assumption so far has been that the outcomes of political decisions could be predicted with certainty, even if some affected by the decisions did not go to the expense of discovering what their payoff would be. In this section, however, we relax that assumption and allow for some uncertainty as to what the economic results of a political decision might be.

Suppose a decision to move toward free trade is certain to benefit 60 percent of the electorate while harming the remaining 40 percent. Assume that all exporting industries will expand and that all import-competing industries will shrink. However, some industries not currently exporting will begin to do so, perhaps because of mutual liberalization by trade partners. If factors are specific to industries, then factors employed in export industries and newly exporting industries will be better off following liberalization, but factors that remain in those sectors producing import-competing goods will be worse off. However, factors currently employed in the import-competing

sectors are uncertain whether they will be able to switch to the export sector or whether they will be stuck with lower welfare in the shrinking import-competing sector.

If we suppose that all individuals will gain or lose an identical amount, P, then the total net payoff to society of the liberalization is equal to $0.6P - 0.4P$, or $0.2P$. However, as shown by Fig. 19.4, only those factors currently employed in the export sector (40 percent of all factors) are certain of their welfare after the liberalization policies are implemented. The remaining 60 percent of the electorate is uncertain as to whether they will end up better off (a $\frac{1}{3}$ chance) or worse off (a $\frac{2}{3}$ chance). For this entire group, the *expected* payoff from liberalization is a loss of $\frac{1}{3}P$ for each member. Consequently, in the absence of any additional compensation from the 40 percent of the population that is confident of their gains, the median-voter result suggests that this country will vote down liberalization.

While the numbers in this example are arbitrary, they suggest what has been referred to as a *status quo bias* against liberalizing trade policy. Liberalization policies toward freer trade tend to have the promise of improving aggregate welfare, and they definitely will favor certain groups in a nation; however, large portions of the rest of the electorate are unsure whether they will be among the winners or the losers from the move toward free trade. This uncertainty lends itself to a bias toward staying with the status quo rather than adopting the policy change toward liberalization.

Status quo bias can help explain not only resistance to tariff liberalization but also increased protection in many circumstances. Suppose certain sectors, like the steel industry or sugar-producing farmers, are subject to increased pressure from imports because world capacity is rising and world production costs are falling relative to domestic costs. The changing trade equilibrium from these adjustments threatens the standard of living enjoyed

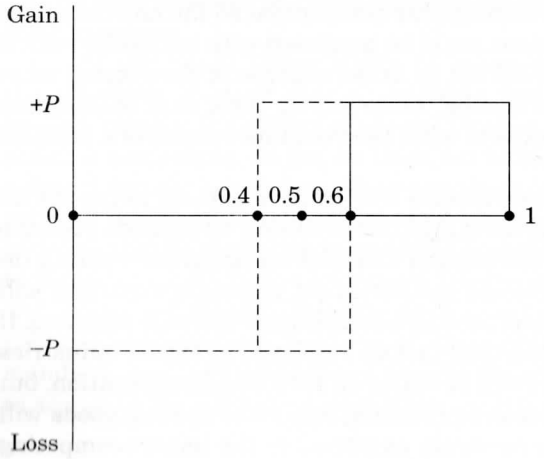

FIGURE 19.4
Uneven distribution of uncertainty.

by specific factors in steel and sugar unless tariffs or quotas are imposed to protect the status quo. It is quite possible that factors in other sectors, say textiles and automobiles, will be willing to support protection for steel and sugar, even if doing so lowers their own standard of living slightly, in an implicit insurance arrangement to protect themselves if they should find themselves in the same position. This type of protectionism is explained by what is called a *conservative welfare function* on the part of society, by which trade policies are formulated in attempts to maintain the existing income distribution among sectors. Each sector buys into the implicit agreement with the understanding that its position will also be protected should it come under a similar threat from increased imports.

19.5 THE FORM OF PROTECTION

The analysis in the previous sections applies to the questions of whether or not protection should exist for some sector of the economy and at what level the protection should be. A somewhat different issue is the decision of what form the protection should take. Chapters 15 and 16 examined tariffs and quotas. The many other policy instruments available for transfering resources to some specific sector of the economy include discriminatory exchange rates, production subsidies, factor-use subsidies, and other types of barriers to free trade such as technical specifications. In this section we will discuss some of the political economy issues involved in choosing instruments of protection by focusing on the choice from among tariffs, quotas, and production subsidies.

Let us assume that there are three interest groups in an economy: consumers, producers of import-competing goods, and a group that benefits by government expenditures of revenue upon their interests. We begin with the consumer group whose interests are easily detailed: consumers gain from eliminating unnecessary distortions in the economy. The analyses of Chapters 15 and 16 help us rank the abilities of these three policies to minimize economic distortions. Assuming perfect competition and constant returns to scale, it is easy to show that production subsidies are the least damaging. Production subsidies distort only the production side of the economy and cause smaller welfare losses than do tariffs and quotas, which distort both producer and consumer prices from their world levels (refer to Fig. 15.4). However, as shown by the analysis in Chapter 16, the welfare losses from quota distortions generally exceed those from tariff distortions. Thus, consumer preferences rank production subsidies as preferred to tariffs, which are in turn preferred to quotas: or $S > T > Q$.

Even though all three instruments of protection will increase output, producers of import-competing goods also have a distinct ranking of the three policy options. The foremost consideration for them is a higher output price for their products on the domestic market. This is attained by all of the policies because in each case, home producers are protected from the price-reducing effects of imports. Consequently, we will call this group

protection seekers. For several reasons, protection seekers prefer quotas to the other two options. First, quotas might allow domestic producers and foreign exporters to collude on a division of market share. With a quota there is a restriction on the quantity of imports that foreign firms can deliver to the domestic market, so further price competition is supplanted by cooperation. Second, where products might be slightly differentiated in some larger product class—for instance, different truck-bed sizes—quotas can be finely tailored to different product categories in a way that helps a producer interest group enforce against free-riding among members of the group. In other words, a larger contribution to the lobbying effort by some firm might be rewarded by a tightening of the portion of the quota that benefits that producer the most. Finally, quotas are thought to be less politically visible instruments of protection than tariffs, so the political efficiency of a protection-seeking group is enhanced by quotas.

The political effectiveness of protection-seeking may be greater for subsidies than for tariffs. As explained earlier, subsidies cause a smaller welfare loss to the economy than tariffs. These smaller welfare losses associated with direct subsidies might mitigate political opposition to them based on the rational ignorance argument. Furthermore, direct production subsidies are likely to be firm-specific benefits, whereas tariffs are public goods, a benefit available to any new firm that decides to produce in the protected industry. Consequently, subsidies might be preferred to tariffs by existing members of a protected industry because subsidies help to control free-riding by members of an industry and are unlikely to be shared with newcomers. All of this allows us to presume that protection seekers will rank their policy choices as $Q > S > T$.

The final group consists of interests that benefit from government expenditures on their behalf. For example, in the presence of effective constraints on deficit spending by the government, government pensioners may act to ensure that more revenues are available to be spent on larger pensions. This kind of activity, known as *revenue seeking,* includes the pursuit of government research grants by college professors and other such noble endeavors. While both tariffs and quotas can be used to enhance government revenues, subsidies are an additional drain on revenues and are thus least preferred by revenue seekers. Tariffs will be the most-preferred policy by this group because, while quotas can be used for revenue purposes when the quota rights are auctioned off, these rights are usually distributed in a way that does not add to revenue.[6] This gives us a policy ranking for revenue seekers of $T > Q > S$.

The policy preferences of the three groups are summarized in Table 19.3. Having already decided to grant protection to the protection seekers, the government now attempts to select a policy instrument for the job. Assuming that the groups are of roughly equal size, subsidies are preferred to tariffs by a 2-1 margin (consumers and protection seekers over revenue seekers). Tariffs are preferred to quotas also by a 2-1 margin (consumers and revenue seekers over protection seekers). However, by an equivalent

TABLE 19.3
Policy preferences of interest groups

Group	Policies		
Consumers	Subsidies	>Tariffs	>Quotas
Protection Seekers	Quotas	>Subsidies	>Tariffs
Revenue Seekers	Tarrifs	>Quotas	>Subsidies

2-1 margin, quotas are seen as superior to subsidies (revenue and protection seekers over consumers). This gives us a nontransitive political ordering of the policies:

$$\text{Subsidies} > \text{Tariffs} > \text{Quotas} > \text{Subsidies}.^{7}$$

The solution to this policy paradox comes from considering the order in which the issues are considered or voted on. Thus, if tariffs and quotas are compared first, with the preferred choice of that pair (tariffs) being subsequently compared to subsidies, subsidies will prevail. Order of consideration is determined by the institutional structure used to decide issues of protection. In the United States, for instance, the Constitution dictates that matters of protection will be considered by the House Ways and Means Committee. This committee is responsible for budgetary issues in general. As such, it gives strong consideration to revenue seekers' concern that subsidies not be used for import protection, and as a result, they rarely are. Furthermore, the GATT has established strong multilateral rules on lowering tariff rates while having only weak rules on the use of quotas. Consequently, while tariffs were the most important protective device until recent decades, quantitative restrictions of various types are now more widely used. This shift in policy is due not to any change in the ordering of policy preferences by the various interest groups but rather to a change in the institutional structure of protection decision making. In the next chapter, the importance of the institutions under which protection is administered will be explained in detail.

19.6 EMPIRICAL EVIDENCE

Studies of the political economy of trade policy have focused on the endogeneity of the level and form of protection (Baldwin, 1985). Tariffs and other forms of protection are the results of interactions in the political arena among various interest groups. So, an industry group in an import-competing sector is likely to have strong protectionist interests, while consumers of the import, or other industries that use the import as an intermediate input, would have free trade interests. In this context, political market failures like free-riding and optimal voter ignorance lead to policy outcomes that would not be described as optimal in the sense of maximizing the public interest.

Tests of the political economy of trade policy have taken several forms: case studies of specific protectionist legislation, microlevel examinations of

relative protection, and time-series analysis of the level of protection. Magee (1980) essentially undertook a case study of the Trade Reform Act of 1973 and used the political economy of trade policy to compare different strands of more general trade policy. Magee examined the positions on the Trade Reform Act of 1973 taken by lobbying groups from labor and management in various industries. He found that labor and capital groups from specific industries almost always took the same position before Congress. From this he inferred that the specific-factor model was supported vis-a-vis the Stolper-Samuelson theory as a determinant of the income-distribution effects of trade policy. Several other authors have studied other specific protectionist legislation or the protectionist history of selected industries. For instance, Coughlin (1985) and McArthur and Marks (1988) examined interest-group interactions during Congressional consideration of the Automobile Domestic Content Bill of 1982, and Tosini and Tower (1987) examined the Textile Bill of 1985. Maskus (1988), on the other hand, has examined the history of protection received by the sugar industry in the United States.

The variance in degree of protection across industries, or *relative protection,* has also been investigated in several studies, including Lavergne (1983) and Ray (1981). Because protection is not universal across sectors, cross-sectional studies generate some understanding of the factors that make certain interest groups more successful than others. Typically, the factors considered that might aid an interest group in its lobbying efforts include, among others, size distribution or concentration ratios of firms, labor intensity, and geographical dispersion of the industry.

Time-series analysis of the political economy of protection rests upon the presumption that over time, the strength, size, or political effectiveness of a given interest group active in trade policy creation will vary. In general, these time-series analyses have been aggregative in nature, and therefore, macroeconomic variables like unemployment, inflation, and real GNP are modeled as being the factors that determine an interest group's effectiveness in gaining protection. For instance, in periods of high unemployment, protectionist interest groups gain political strength by invoking the image of "unfair foreign competition stealing away domestic jobs." Time-series analysis thus posits a "tariff cycle" in which protection ebbs and flows in a manner consistent with the conservative social welfare function (Bohara and Kaempfer, 1991).

19.7 CONCLUDING REMARKS

In this chapter we have examined governmental policy-making behavior from the perspective of public choice analysis. Critical to this approach is the presumption that decision makers attempt to maximize their own utility by selecting policies that maximize their chances of staying in office. Such behavior on the part of policy makers does serve the public interest to some extent in that decisions that favor the majority of voters will be selected. However, several "decision-making failures" are likely to arise that will

lead to suboptimal policies. The principal findings of this chapter can be summarized as follows.

1. The median-voter model can be used as an indirect model of the utility-maximizing behavior of policy makers because policy makers interested in reelection must respect the preferences of the majority of voters in their constituencies.
2. Political decisions based on the preferences of the median voter fail to directly register the intensity of preferences held by those voters. As a result, it is possible that policies can be enacted that are favored by a majority of voters but that decrease the net social welfare. If individuals who gain from some policy can compensate those who lose, the socially optimal policy might be achieved, and logrolling is one mechanism that allows such compensation. However, logrolling is just as likely to result in legislation that reduces net social welfare.
3. Rational ignorance and rational abstention on the part of voters will increase the influence of special interest groups on political outcomes. It is rational for individual voters to remain ignorant of issues and how those issues affect them and to then abstain from voting because the expected benefits to that individual of casting a vote are likely to be so small that even the small costs involved in voting will exceed these benefits. Special interest groups, however, are likely to have organizational advantages in political action.
4. A status quo bias is likely to allow protectionist policies to persist in spite of the fact that they can clearly be shown to be welfare-reducing. The explanation for this may lie in the fact that a policy change will force some individuals to change sectors in the economy, leaving them unsure as to whether they will be winners or losers from liberalization.
5. Preferences of the members of various interest groups can be examined to gain insights into the form that protection is most likely to take. Tariffs, quotas, and production subsidies have all been discussed as policy options for protecting a domestic industry in competition with imports. Which policy option is selected will depend upon the institutional structure used in making the decision to protect.

PROBLEMS

1. Suppose labor and capital are the only factors of production. According to the Stolper-Samuelson Theorem, how would these groups benefit or lose from import protection in a labor–abundant country? How would they benefit or lose according to the specific-factor approach if capital were sector-specific, but labor were mobile between sectors?
2. Suppose the liberalization bill considered in Fig. 19.4 has the same division of benefits but that all members of the electorate are uncertain whether they will gain or lose from the liberalization. What policy decision will be made?

3. Suppose a domestic monopolist is granted a quota of Q units rather than a price-equivalent import tariff. Suppose further that the quota is auctioned off to the highest bidder for government revenue. Explain whether revenue-seeking groups would prefer the tariff or the quota.

NOTES

1. Of course, the distributional conclusions of the sector-specific factor analysis of Chapter 9 are quite different from the conclusions of the Stolper-Samuelson Theorem. One thing that a public choice analysis of trade policy allows us to do is compare these two theories in a policy-making framework to see which one forms a more accurate picture of the policy process. This is the question addressed by Magee (1980).
2. One exception to this would be if individual capital owners own different amounts of capital. Then each would gain or lose from a piece of legislation according to the amount of capital owned.
3. Notice that in this case, the policy is a liberalization (i.e., tariff-reducing) issue rather than a protectionist issue. As explained in Chapter 18, liberalization is as much of a political economy issue as is protection.
4. Using this kind of marginal-cost/marginal-benefit analysis to examine voting might lead one to question why voter turnouts are so high rather than to ask why they are so low. However, there are other utility-enhancing factors, like civic pride, and other costs of not voting, like group or social pressure, that make it rational for many individuals to vote in spite of the minimal direct economic benefits.
5. Another type of directly unproductive activity is the use of resources to smuggle goods into a country in an attempt to avoid tariffs. In the case of smuggling, resources are used up not to produce any direct benefits but simply to avoid the tariff.
6. In the United States, most quotas are given to foreign exporters or foreign countries so that they may determine the allocations and profit by the quotas.
7. This nontransitive ranking is a result that we previously avoided on the individual level by showing that indifference curves could not cross.

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CHAPTER 20

ADMINISTERED PROTECTION

20.1 INTRODUCTION

The preceding chapters have discussed the major tools of trade protection, their effects in different markets, and the political reasons they exist. We turn now to a discussion of how trade policy is formulated and implemented. It is important to understand the institutional framework within which various countries attempt to regulate international trade. This framework is considerably more complicated than what might be suggested by a straightforward consideration of tariffs and quotas. There are important multilateral institutions, such as the General Agreement on Tariffs and Trade, or GATT, that attempt to set rules governing the behavior of international trading partners. Also significant are agreements among groups of countries, such as the European Community, on their mutual rules of exchange. Finally, unilateral actions taken by certain countries, particularly the United States, attempt to induce foreign trading partners to change their policies. The 1980s and 1990s have been periods of considerable activity and change in these arrangements, which are the subject of the next section of the chapter.

A number of particular features of these rules, or abrogations of them, are worth discussing. In the third section we consider various forms of *contingent protection,* or tariffs levied to offset the domestic effects of rapid import surges and imports generated by allegedly unfair foreign trade practices. While such policies make sense in principle, in operation their effects can often be harmful. A final perspective on trade protection is provided in the fourth section, where we illustrate the role of trade policy within a framework of domestic business regulation. The trade implications of regulatory policies for *environmental protection* are considered. Several interesting analytical features are noted, including the fact that different countries may have decidedly different interests in pursuing strong protection for the