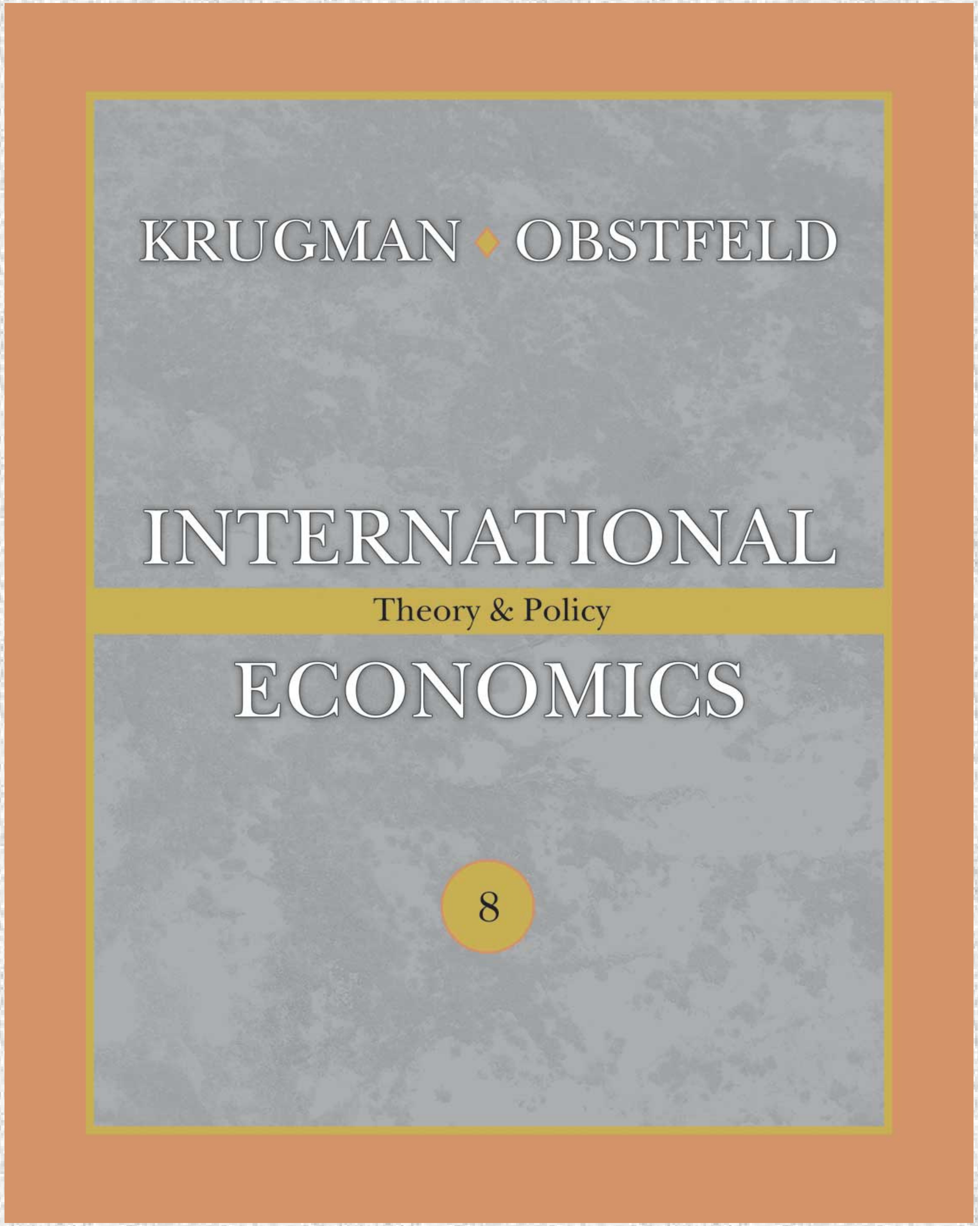


Chapter 9

The Political Economy of Trade Policy

Slides prepared by Thomas Bishop

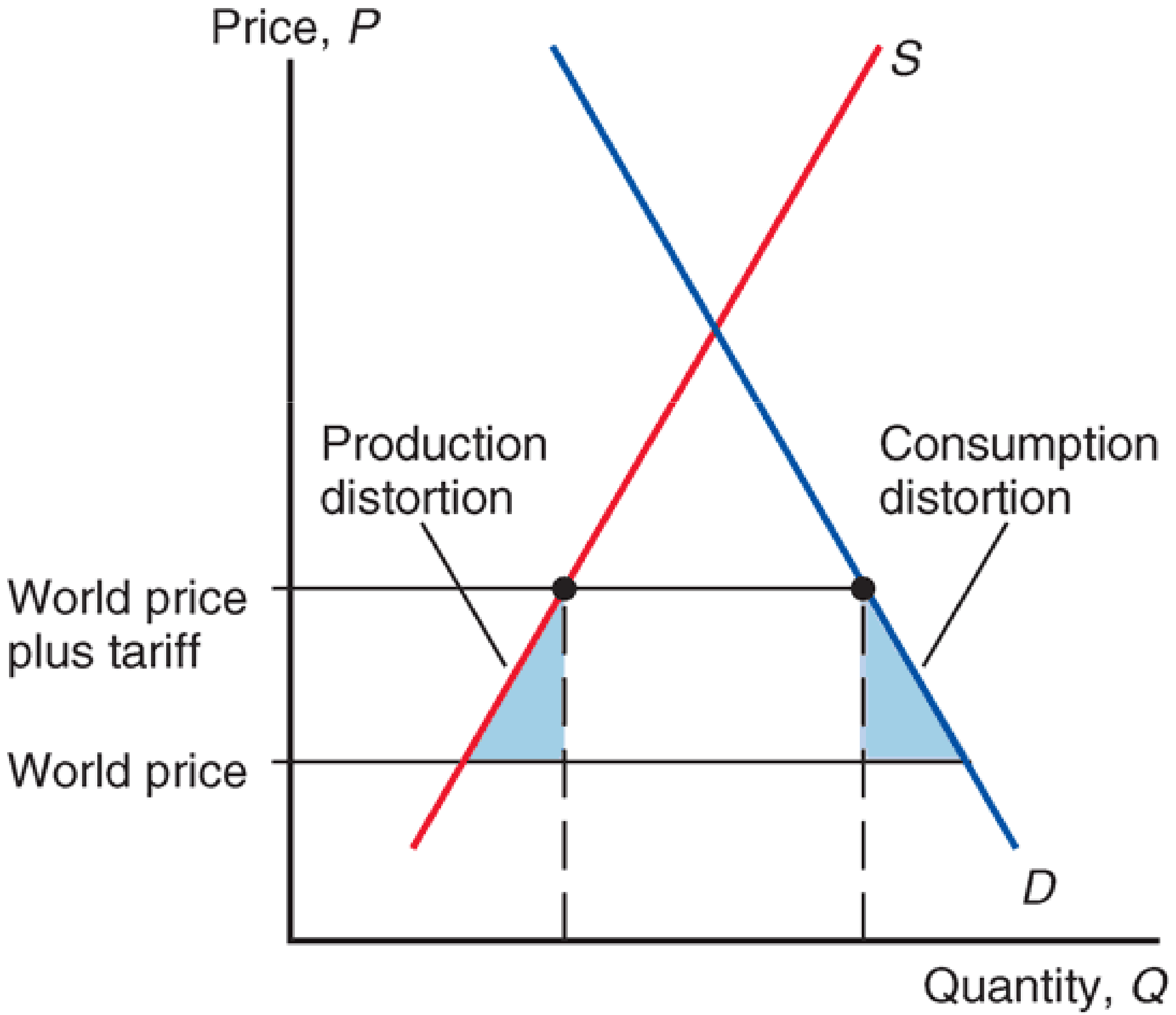
Preview

- The cases for free trade
- The cases against free trade
- Political models of trade policy
- International negotiations of trade policy and the World Trade Organization

The Cases for Free Trade

- The first case for free trade is the argument 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.
  - With restricted trade, distorted prices cause overproduction either by existing firms producing more or by more firms entering the industry.

Fig. 9-1: The Efficiency Case for Free Trade



The Cases for Free Trade (cont.)

- 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.

Table 9-1: 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.

The Cases for Free Trade (cont.)

- Yet when quotas are used instead of tariffs, costs can be magnified through **rent seeking**.
  - ♦ To seek quota licenses or the rights to sell a restricted number of imports and the profit that they will earn, individuals or institutions need to spend time and other resources.
- Thus, another reason why trade allocates resources efficiently is that it avoids the loss of resources through rent seeking.

The Cases for Free Trade (cont.)

- A second argument for free trade is that it allows firms or industry to take advantage of **economies of scale**.
- A third argument for free trade is that it provides **competition and opportunities for innovation**.
- These are dynamic benefits, unlike the static benefits of eliminating the efficiency losses caused by distorted prices and overproduction.

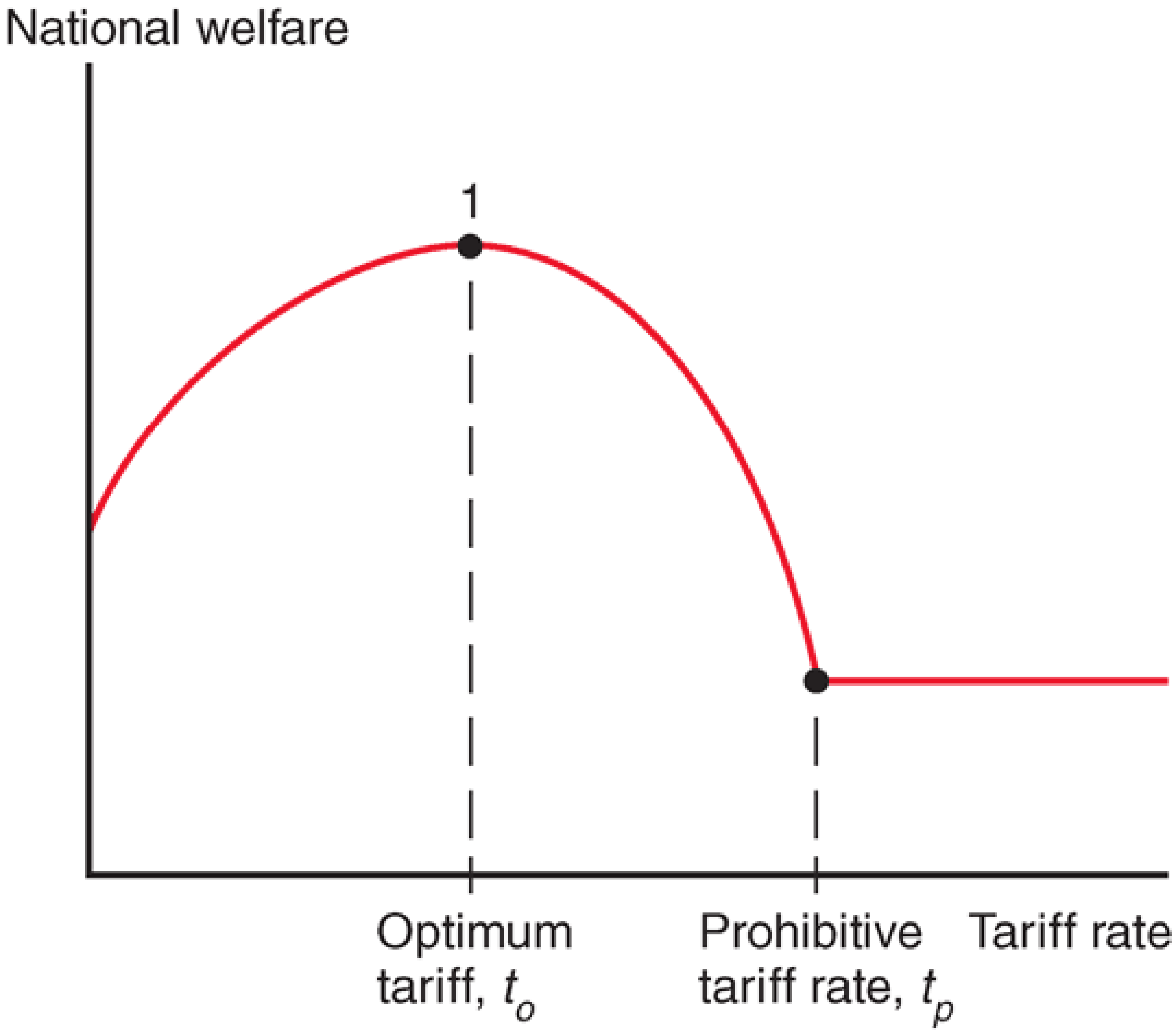
The Cases for Free Trade (cont.)

- A fourth argument, called 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.

The Cases Against Free Trade

- For a "large" country, a tariff or quota 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.
- In fact, 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. 9-2: The Optimum Tariff



The Cases Against Free Trade (cont.)

- A tariff rate that completely prohibits imports leaves a country worse off, but tariff rate t_0 may exist that maximizes national welfare: an **optimum tariff**.

The Cases Against Free Trade (cont.)

- 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 some countries like the U.S. an import tariff or and export tax could improve national welfare at the expense of other 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 (cont.)

- A second argument against free trade is that **domestic market failures** may exist that cause free trade to be a suboptimal policy.
  - The economic efficiency loss calculations using consumer and producer surplus assume that markets function well.

The Cases Against Free Trade (cont.)

- Types of market failures include
  - ♦ Persistently high under-employment of workers
    - surpluses that are not eliminated in the market for labor because wages do not adjust
  - ♦ Persistently high under-utilization of structures, equipment and other forms of capital
    - surpluses that are not eliminated in the market for capital because prices do not adjust
  - ♦ Technological benefits for society discovered through private production, but from which private firms can not fully profit
  - ♦ Environmental costs for society caused by private production, but for which private firms do not fully pay

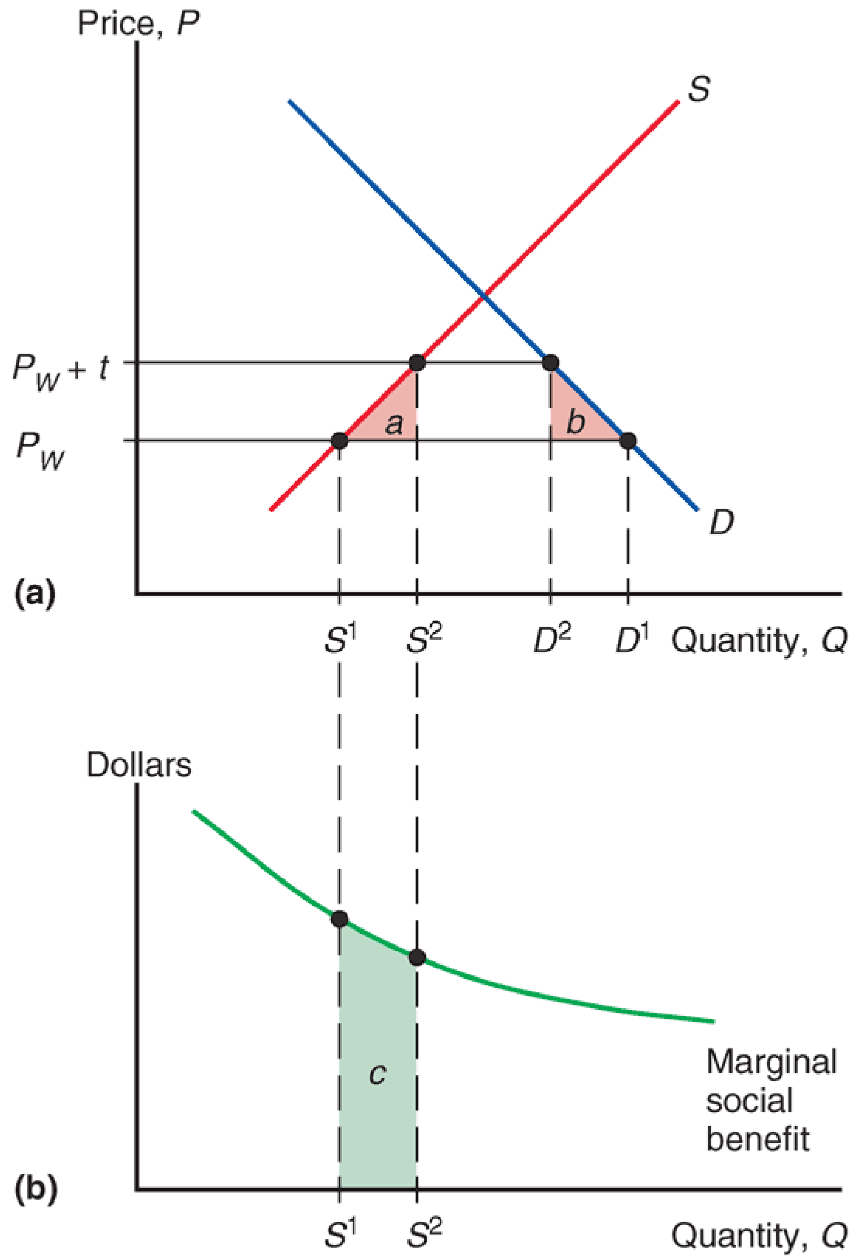
The Cases Against Free Trade (cont.)

- Types of market failures include
  - property rights that are not well defined or well enforced
  - sellers that are not well informed about the (opportunity) cost of production or buyers that are not well informed about value from consumption

The Cases Against Free Trade (cont.)

- Economists calculate the **marginal social benefit** to represent the additional benefit to society from private production.
  - ♦ With a market failure, marginal social benefit is not accurately measured by the producer surplus of private firms, so that economic efficiency loss calculations are misleading.
- It is possible that when a tariff increases domestic production, the benefit to domestic society will increase due to a market failure.

Fig. 9-3: The Domestic Market Failure Argument for a Tariff



The Cases Against Free Trade (cont.)

- The domestic market failure argument against free trade is an example of a more general argument called the **theory of the second best**.
- This theory states that government intervention which distorts market incentives in one market may increase national welfare by offsetting the consequences of market failures elsewhere.
  - The best policy would be to fix the market failures themselves, but if this is not feasible, then government intervention in another market may the "second-best" way of fixing the problem.

Counter-Arguments

- Economists supporting free trade counter-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 under-employment of labor is a problem, then the cost of labor or production of labor-intensive products could be subsidized by the government.
  - These subsidies could avoid the economic efficiency losses due to a tariff.

Counter-Arguments (cont.)

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

Political Models of Trade Policy

- How is trade policy determined?
- Models that address this question:
  1. Median voter theorem
  2. Collective action
  3. A model of trade policy that combines aspects of collective action and the median voter theorem

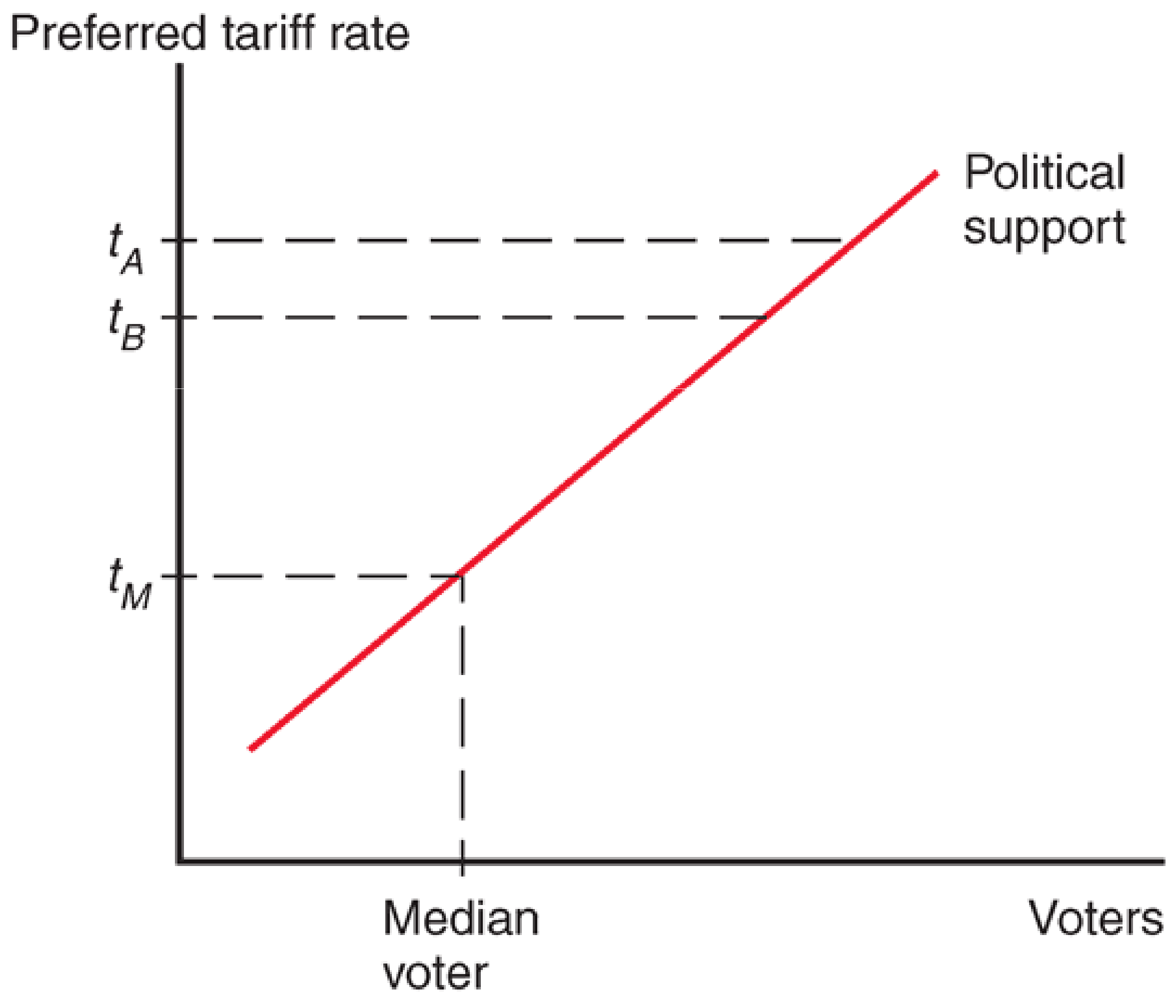
Median Voter Theorem

- The median voter theorem predicts that democratic political parties may change their policies to court the voter in the middle of the ideological spectrum (i.e., the median voter).
- Suppose that this ideological spectrum is defined only by a tariff rate policy.
  - And suppose that voters can be ranked according to whether they desire high or low tariff rates.

Median Voter Theorem (cont.)

- Assumptions of the model:
  1. There are two competing political parties.
  2. The objective of each party is to get elected by majority vote (not to maintain ideological purity).
- What policies will the parties promise to follow?
  - Both parties will offer the same tariff policy to court the median voter (the voter in the middle of the spectrum) in order to capture the most votes on either side of the median voter.

Fig. 9-4: Political Competition



Median Voter Theorem (cont.)

- 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 enacted into law.
- But trade policy doesn't seem to 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.

Collective Action (cont.)

- However, for those groups who may suffer large losses from free trade (for example, unemployment), 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.

A Model 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 restriction policy 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.

Which Industries Are Protected?

- **Agriculture**: in the U.S., Europe, and Japan farmers make up a small fraction of the electorate but receive generous subsidies and trade protection.
  - Examples: European Union’s Common Agricultural Policy, Japan’s 1000% tariff on imported rice, America’s sugar quota.

Which Industries Are Protected? (cont.)

- **Clothing**: textiles (fabrication of cloth) and apparel (assembly of cloth into clothing).
  - Until 2005, quotas licenses granted to textile and apparel exporters were specified in the Multi-Fiber Agreement between the U.S. and many other nations.

Table 9-2: Welfare Costs of U.S. Protection ($ billion)

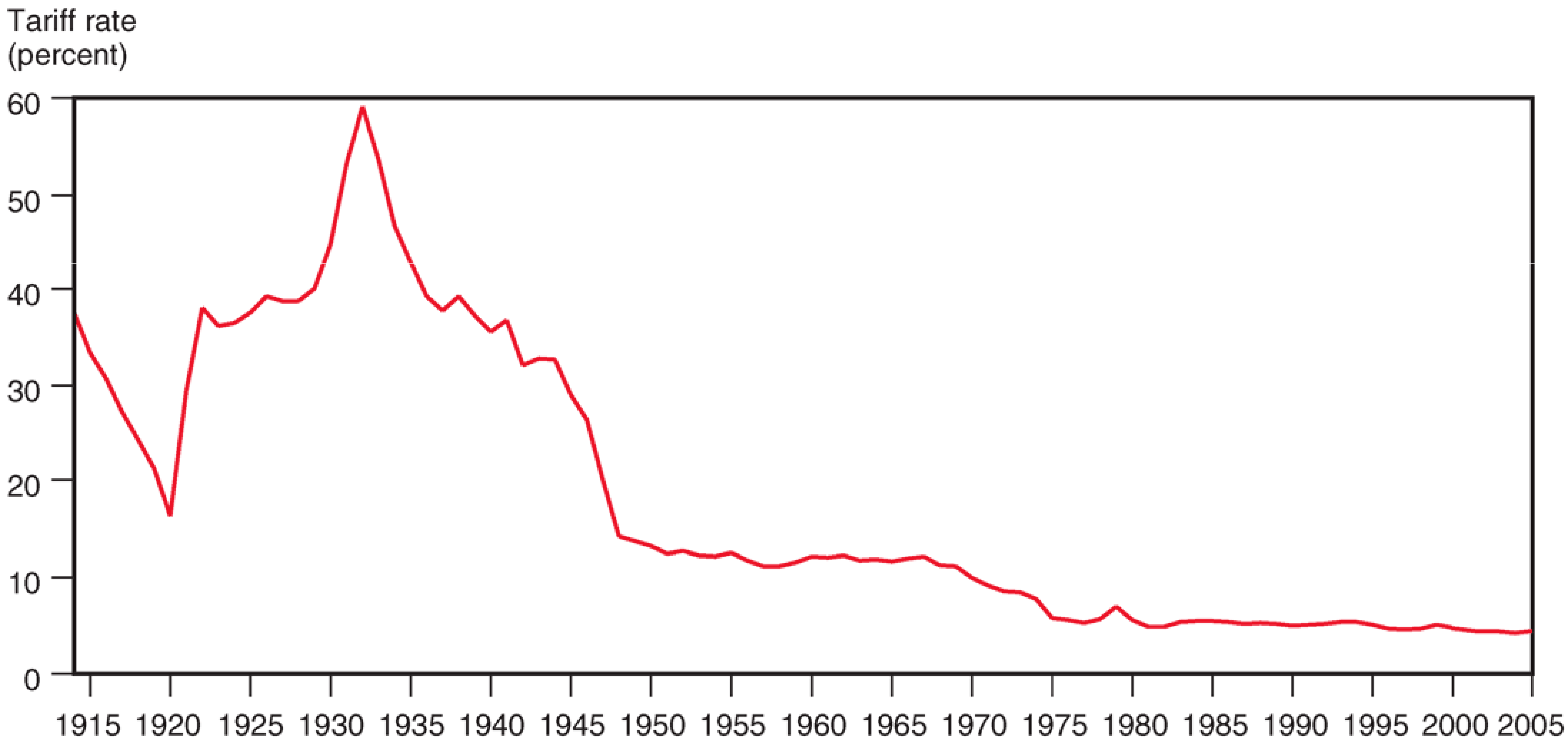
	2002 Estimate	2011 Projected
Total	14.1	3.7
Textiles and apparel	11.8	1.9

Source: U.S. International Trade Commission.

International Negotiations of Trade Policy

- The average U.S. tariff rate on dutiable imports has decreased substantially from 1920–1993.
- Since 1944, much of the reduction in tariffs and other trade restrictions came about through international negotiations.
  - The **General Agreement of Tariffs and Trade** was begun in 1947 as a provisional international agreement and was replaced by a more formal international institution called the **World Trade Organization** in 1995.

Fig. 9-5: The U.S. Tariff Rate



International Negotiations of Trade Policy (cont.)

- 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.
  - This support counteracts the support for restricted trade by import-competing groups.

International Negotiations of Trade Policy (cont.)

- 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 a political interest (due to political pressure) to protect domestic producers, *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*.
- Let's use a simple example to illustrate this point.

International Negotiations of Trade Policy (cont.)

		EU	
		Free Trade	*Protection*
US	**Free Trade**	**$10B** ***$10B***	**-$10B** ***$20B***
	Protection	**$20B** ***-$10B***	**-$5B** ***-$5B***

International Negotiations of Trade Policy (cont.)

- In this simple example, each country acting individually would be better off with protection, but both would be better off if both chose free trade.
- If Japan and the U.S. can establish a binding agreement to maintain free trade, both can avoid the temptation of protection and both can be made better off.

World Trade Organization

- The WTO negotiations addresses trade restrictions in at least 3 ways:

1. **Reduction of tariff rates** through multilateral negotiations.
2. **Binding**: a tariff is "bound" by having the imposing country agree not to raise it in the future.

World Trade Organization (cont.)

3. **Prevention of non-tariff barriers**: quotas and export subsidies are changed to tariffs because the costs of tariff protection are more apparent.
   - Subsidies for agricultural exports are an exception.
   - Exceptions are also allowed for “market disruptions” caused by a surge in imports.

World Trade Organization (cont.)

- The World Trade Organization was founded in 1995 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 (ex., insurance, consulting, legal services, banking).
  - Agreement on Trade-Related Aspects of Intellectual Property: covers international property rights (ex., patents and copyrights).

World Trade Organization (cont.)

- 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 cases are settled fairly quickly: even with appeals the procedure is not supposed to last more than 15 months.
- The panel uses previous agreements by member countries to decide which ones are breaking their agreements.

World Trade Organization (cont.)

- A country that refuses to adhere to the panel's decision may be punished by allowing other countries to impose trade restrictions on its exports.

World Trade Organization (cont.)

- The GATT/WTO multilateral negotiations, ratified in 1994 (called the Uruguay Round),
  - agreed that all quantitative restrictions (ex., quotas) on trade in textiles and clothing as previously specified in the Multi-Fiber Agreement were to be eliminated by 2005.
- But as the restrictions were eliminated, China had to reimpose quotas until 2011 due to political pressure.

World Trade Organization (cont.)

- In 2001, a new round of negotiations was started in Doha, Qatar, but these negotiations have failed to produce an agreement.
  - Most of the remaining forms of protection are in agriculture, textiles and clothing—industries that are politically active (see “Collective Action” above).

Table 9-4: Percentage Distribution of Potential Gains from Free Trade

	Full Liberalization of:			
Economy	Agriculture and Food	Textiles and Clothing	Other Merchandise	All Goods
Developed	46	6	3	55
Developing	17	8	20	45
All	63	14	23	100

Source: Kym Anderson and Will Martin, "Agricultural Trade Reform and the Doha Agenda," World Bank, 2005.

Do Agricultural Subsidies in Rich Countries Hurt Poor Countries?

- We learned in chapter 8 that subsidies lower the *world* price of products because domestic producers are enticed to produce more.
  - So why should poor countries want rich countries to remove their agricultural subsidies?
  - The likely answer has to do with the desires of farmers in poor countries who compete with farmers in rich countries.
  - Yet, urban residents and farmers who do not compete (ex., coffee farmers) actually benefit from the lower prices of subsidized food on world markets.
    - For example, because China imports a lot of food, it would be hurt by the removal of agricultural subsidies in rich countries (ex., the U.S. and Europe) according to the Doha negotiations.

Table 9-5: Percentage Gains in Income under Two Doha Scenarios

	Ambitious	Less Ambitious
High-income	0.20	0.05
Middle-income	0.10	0.00
China	–0.02	–0.05
Low-income	0.05	0.01
World	0.18	0.04

Source: See Table 9-4.

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:
  - Each country in the WTO promises that all countries will pay tariffs no higher than the nation that pays the lowest: called the “most favored nation” (MFN) principle.
  - An exception to this principle is allowed only if the lowest tariff rate is set at zero.

Preferential Trading Agreements (cont.)

- There are two types of preferential trading agreements in which tariff rates are set at or near zero:

1. A **free trade area**: an agreement that allows free trade among members, but each member can have its own trade policy towards non-member countries
   - An example is the North America Free Trade Agreement (NAFTA).

Preferential Trading Agreements (cont.)

2. A **customs union**: an agreement that allows free trade among members and requires a common external trade policy towards non-member countries.
   - An example is the European Union.

Preferential Trading Agreements (cont.)

- 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 (cont.)

- 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 non-members are diverted to *high cost imports from member nations.*

Summary

1. The cases for free trade are that
   - It allows consumers and producers to allocate their resources freely and efficiently, without price distortions.
   - It may allow for economies of scale.
   - It increases competition and innovation.
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 (cont.)

3. Models of trade policy making consider incentives to adopt popular policies as well as incentives to adopt unpopular policies if these policies are advocated by groups that make political contributions.
4. Agricultural and clothing industries are the most protected industries in many countries.

Summary (cont.)

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.
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.

Additional Chapter Art

Table 9-3: The Problem of Trade Warfare

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

Fig. 9A-1: Effects of a Tariff on Prices

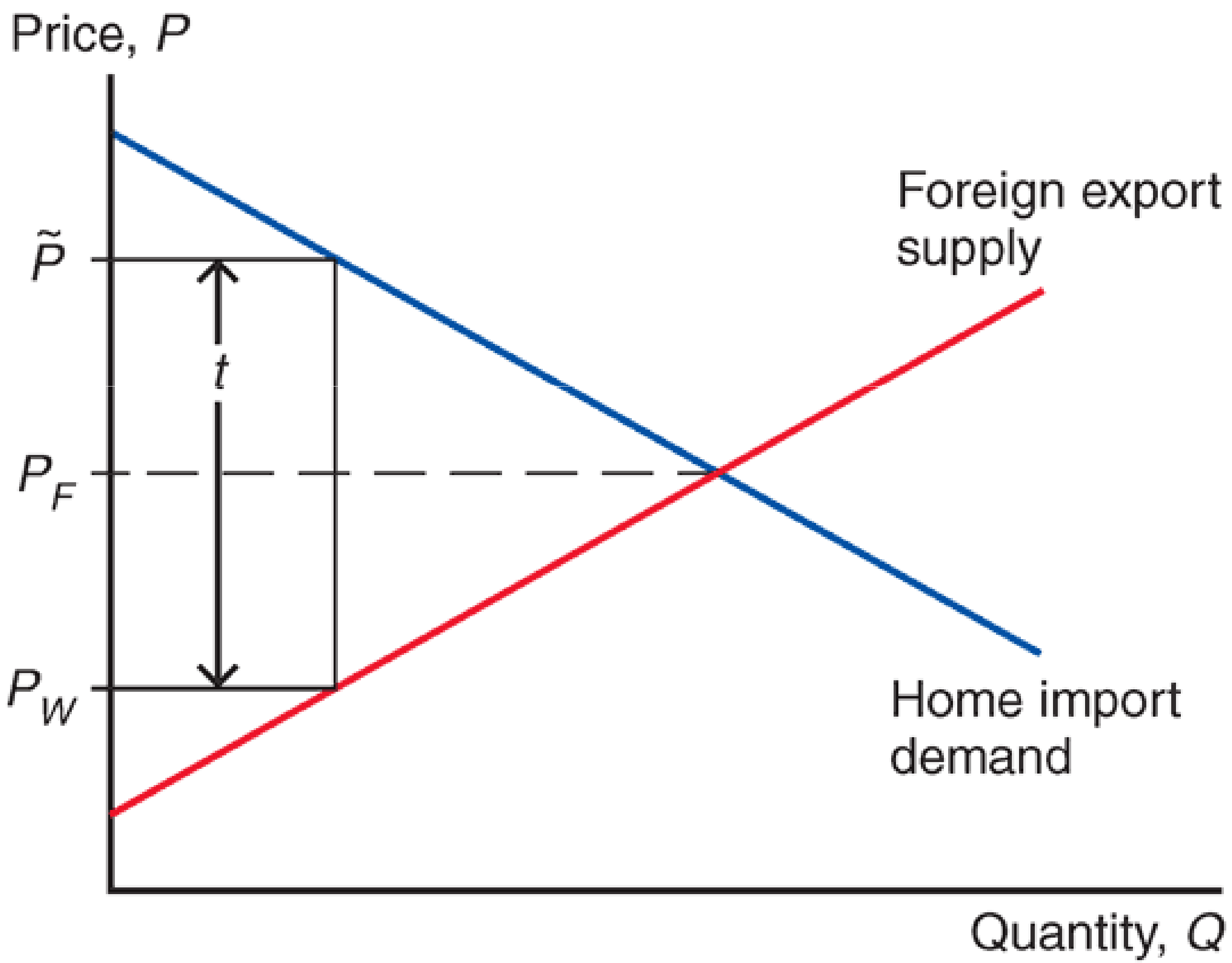


Fig. 9A-2: Welfare Effects of a Tariff