Chapter 9
The Political Economy of Trade Policy

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■ Key Themes

While the models presented in preceding chapters generally suggest that free trade maximizes national welfare, it has been shown clearly that free trade has income distributional effects. In the real world we observe that most governments maintain some form of restrictive trade practices. This chapter investigates some reasons for the existence of impediments to free trade, despite the general view that these impediments reduce national welfare. One set of reasons for the existence of trade restrictions is associated with the particular circumstances under which restrictive trade practices increase national welfare. Another set of reasons is associated with the manner in which the interests of different groups are weighed by governments. The chapter concludes with a discussion of the motives for international trade negotiations and a brief history of international trade agreements.

A recurring theme in the arguments in favor of free trade is the emphasis on related efficiency gains. As illustrated by the consumer/producer surplus analysis presented in the text of Chapter 8 and related study guide questions, nondistortionary production and consumption choices which occur under free trade provide one set of gains from eliminating protectionism. Another level of efficiency gains can arise because of economies of scale in production.

Two additional arguments for free trade are introduced in this chapter. Free trade, as opposed to "managed trade," provides a wider range of opportunities and thus a wider scope for innovation. Also, the use of tariffs and subsidies to increase national welfare (such as a large country's use of an optimum tariff), even where theoretically desirable, in practice may only advance the causes of special interests at the expense of the general public. When quantity restrictions are involved, rent-seeking behavior—where companies strive to receive the benefits from quota licenses—can distort behavior and cause waste in the economy.

Next, consider some of the arguments voiced in favor of restrictive trade practices. These arguments that protectionism increases overall national welfare have their own caveats. The ability of an optimum tariff or an optimum (negative) subsidy by a large country to influence its terms of trade depends upon the absence of retaliation by foreign countries. Another important set of arguments relies upon the existence of some form of market failure. The distributional effects of trade policies will differ substantially if, for example, labor cannot be easily reallocated across sectors of the economy as suggested by movements along the production possibility frontier.

Other proponents of protectionist policies argue that the key tools of welfare analysis, which apply demand and supply measures to capture social as well as private costs and benefits, are inadequate. They argue that tariffs may improve welfare when social and private costs or benefits diverge. In general, however, it is better to design policies which address these issues directly rather than using a tariff which has other effects as well. For example, you can think of a tariff as being like a combined tax and subsidy. A well targeted subsidy *or* tax leads to a confluence of social and private cost or benefit. A policy which combines *both* a subsidy *and* a tax has other effects which mitigate social welfare gains.

Actual trade policy often cannot be reconciled with the prescriptions of basic welfare analysis. One reason for this is that the social accounting framework of policy makers does not match that implied by cost-benefit analysis. For example, policy makers may apply a "weighted social welfare analysis," which weighs gains or losses differently depending upon which groups are affected. Of course, in this instance there is the issue of who sets the weights and on the basis of what criteria. A fascinating case study of politicians for sale is provided in the text, and shows the potential role of lobbying in the enactment of trade policy changes. Also, trade policy may end up being used as a tool of income redistribution. Inefficient existing industries may be protected to preserve the status quo.

Divergence between optimal theoretical and actual trade policy may also arise because of the manner in which policy is made. The benefits of a tariff are concentrated while its costs are diffused. Well-organized groups whose individuals each stand to gain a lot by trade restrictions have a better opportunity to influence trade policy than larger, less well-organized groups which have more to lose in the aggregate but whose members individually have little to lose.

Drawing upon these arguments, one would expect that you could generalize that countries with strong comparative advantage in manufacturing would tend to protect agriculture while countries with comparative advantage in agriculture would tend to protect manufacturing. For the United States, however, this argument is not validated by the pattern of protection. The pattern of protectionism in the United States is concentrated in four disparate industries: autos, steel, sugar, and textiles.

International negotiations led to mutual tariff reductions from the mid 1930s to about 1980. Negotiations which link mutually reduced protection across countries have the political advantage of playing well-organized groups against each other rather than against poorly organized consumers. International trade negotiations also help avoid trade wars. This is illustrated by an example of the Prisoner's dilemma as it relates to trade. The pursuit of self-interest may not lead to the best social outcome when each agent takes into account the other agent's decision. Indeed, in the example in the text, uncoordinated policy leads to the worst outcome since protectionism is the best policy for each country to undertake unilaterally. Negotiations result in the coordinated policy of free trade and the best outcome for each country.

The chapter concludes with a brief history of international trade agreements. The early rounds of trade negotiations are covered as is the Uruguay Round, which saw the transition of the GATT (General Agreement on Tariffs and Trade) to the World Trade Organization (WTO). The way in which the GATT and WTO have slowly but surely advanced the world towards free trade are discussed, as are the real threats to its future performance as an active and effective instrument for moving toward freer trade. Indeed, while the WTO places constraints on the imposition of export subsidies, import quotas, and tariffs, it does not govern the ever-increasing incidence of voluntary export restraints (a country constrains its own exports) nor does it govern less explicit forms of barriers to trade. More recent multilateral negotiations (the Doha Round) have stalled, largely over disagreements regarding agricultural subsidies and trade. This has been a disappointment to free trade proponents as it marks the first time a major multilateral trade round has failed to produce a substantial agreement.

The chapter also presents a discussion of preferential trading agreements. Free trade areas and customs unions are compared, and trade diverting and trade creating effects of customs unions are demonstrated in an example. Finally, a case study discusses recent evidence on trade diversion in South America. There are numerous examples of groups of countries moving toward regional economic integration that you can think about to try to envision the real-world implications of the theory. These include the EU, NAFTA, the CACM (Central American Common Market) and Mercosur.

An appendix proves that there is always an optimal positive tariff if a country's protectionist actions affect world prices. As was mentioned in Chapter 8, this arises when a country is large in world markets for a good.

■ Key Terms

Define the following key terms:

1. Efficiency Case for Free Trade _____

2. Political Argument for Free Trade _____

3. Terms of Trade Argument for Free Trade _____

4. Domestic Market Failure _____

5. Theory of the Second Best _____

6. Common Market _____

7. Bound Tariffs _____

■ Review Questions

1. Assume that Foreign is a *small* country which produces automobiles for export and its own consumption. These autos are traded on the world markets at a price of $8000.

   a. If this small country imposes an ad valorem tariff of 25 percent, what will be effect on automobile prices?

   _____

   _____

   _____.

   b. How does this differ from the effect of a large country imposing a similar tariff?

   _____

   _____

   _____.

   c. In what other ways is the small country affected by this tariff?

   _____

   _____

   _____.

   d. Why are the costs of trade protection in the United States considered so low relative to national income?

   _____

   _____

   _____.

2. What type of developing country would be helped by an end to rich country agricultural subsidies? What types of developing countries would be hurt? Why?

   _____

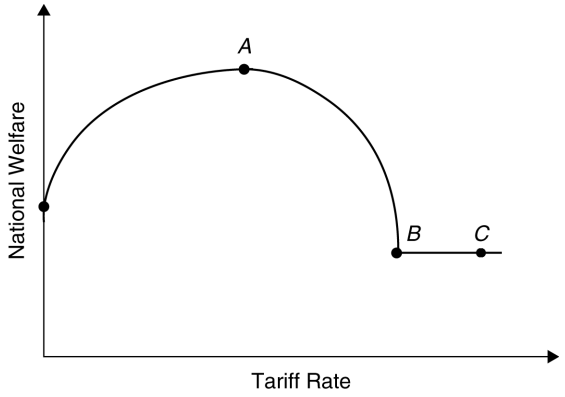
   _____

   _____

   _____

   _____.

3. An export subsidy reduces national welfare, as does a tariff imposed by a small country. However, it is possible that a large country's welfare can improve under certain circumstances when a tariff is imposed. The relationship between national welfare and the tariff rate for a large country is illustrated in the figure below.



a. Up until what point is increasing the tariff rate beneficial to national welfare?

_____

_____

_____.

b. Discuss the intuition behind your response to part (a).

_____

_____

_____.

c. What is the significance of point B on the graph?

_____

_____

_____.

d. Why would a large country be reluctant to use its optimal tariff despite the apparent gains to national welfare?

_____

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_____.

4. a. What is the relationship between the existence of domestic market failure and the use of trade policy?

_____

_____

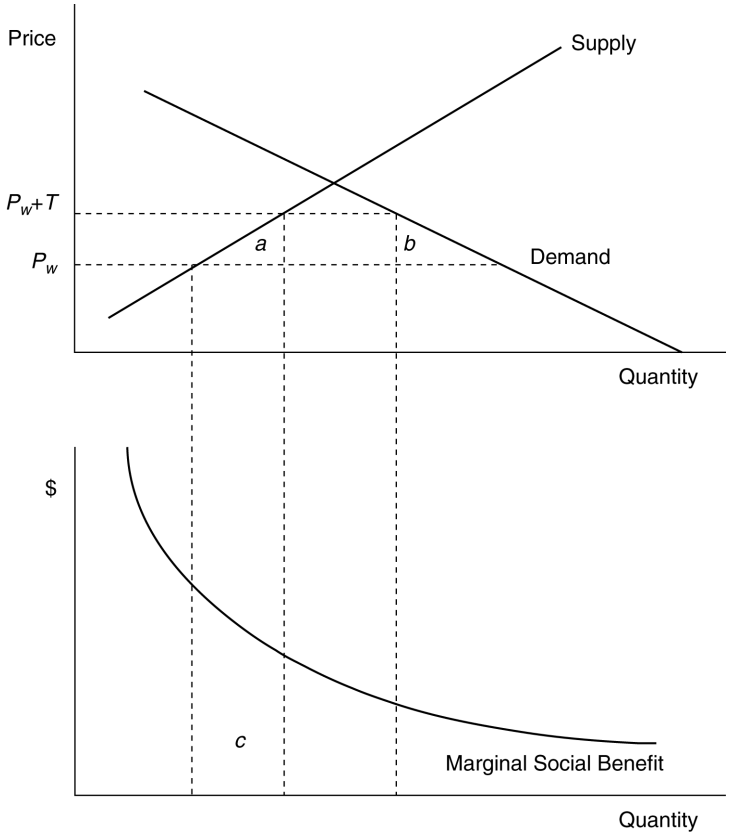
_____.

b. Imagine an economy where production of textiles provides the additional marginal social benefit of innovations and technological spillovers into other industries. Such an economy is depicted in the figure below. If this economy is a small country, what will be the effect of a tariff on production and consumption?

_____

_____

_____.



c. What does standard theory argue will be the efficiency and welfare effects of the tariff?

_____

_____

_____.

d. If there are domestic market failures in this small economy, how would your answer to part (c) change? Why?

_____

_____

_____.

e. If the application of the tariff to correct a market failure is a "second best" policy, what are examples of "first best" policies?

_____

_____

_____.

5. Under most circumstances, a small country imposing a tariff or quota will not generate overall welfare gains.

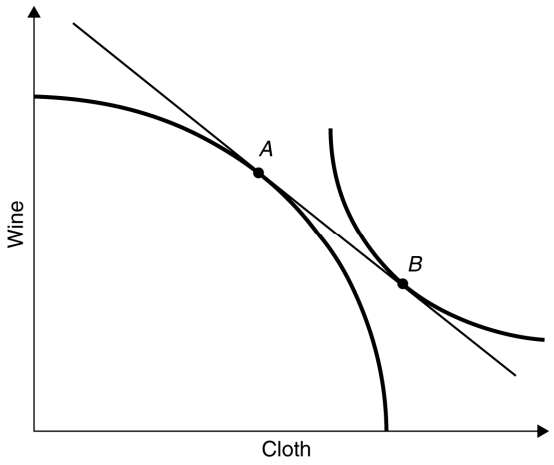
a. Discuss the expected impact of a tariff or quota on a small country.

_____

_____

_____.

b. Graphically illustrate what would happen if the small nation depicted in the figure below imposes an ad valorem tariff of 100 percent on its imports of cloth. Assume that the relative price of cloth (to wine) on the world market is $P_c/P_w = 1$, Home production is at point A and consumption is at point B.



6. Assume that the demand and supply of cloth of a small country are described by the following schedule:

Price (p_c/p_w)	Cloth Supply	Cloth Demand
$2	20 yards	100 yards
$3	40 yards	80 yards
$4	60 yards	60 yards
$5	80 yards	40 yards

At free trade the relative price of cloth is $2.

a. Suppose this small country imposes a 50 percent ad valorem tariff on cloth imports. How will the new domestic price affect consumption, production, and tariff revenues?

b. How would different elasticities of the Home supply and demand curves alter your conclusions to part (a)?

c. What would constitute a prohibitive tariff on cloth?

■ Answers to Odd-Numbered Textbook Problems

1. The arguments for free trade in this quote include:
   - Free trade allows consumers and producers to make decisions based upon the marginal cost and benefits associated with a good when costs and prices are undistorted by government policy.
   - The Philippines is "small," so it will have little scope for influencing world prices and capturing welfare gains through an improvement of its terms of trade.
   - "Escaping the confines of a narrow domestic market" allows possible gains through economies of scale in production.
   - Free trade "opens new horizons for entrepreneurship."
   - Special interests may dictate trade policy for their own ends rather than for the general welfare. Free trade policies may aid in halting corruption where these special interests exert undue or disproportionate influence on public policy.

3. Without tariffs, the country produces 100 units and consumes 300 units, thus importing 200 units.
   a. A tariff of 5 per unit leads to production of 125 units and consumption of 250 units. The increase in welfare is the increase due to higher production of 25×10 minus the losses to consumer and producer surplus of $(25 \times 5)/2$ and $(50 \times 5)/2$, respectively, leading to a net gain of 62.5.
   b. A production subsidy of 5 leads to a new supply curve of $S = 50 + 5 \times (P + 5)$. Consumption stays at 300, production rises to 125, and the increase in welfare equals the benefits from greater production minus the production distortion costs, $25 \times 10 - (25 \times 5)/2 = 187.5$.
   c. The production subsidy is a better targeted policy than the import tariff since it directly affects the decisions which reflect a divergence between social and private costs while leaving other decisions unaffected. The tariff has a double-edged function as both a production subsidy and a consumption tax.
   d. The best policy is to have producers fully internalize the externality by providing a subsidy of 10 per unit. The new supply curve will then be $S = 50 + 5 \times (P + 10)$, production will be 150 units, and the welfare gain from this policy will be $50 \times 10 - (10 \times 50)/2 = 250$.

5. a. This would lead to trade diversion because the lower cost Japanese cars with an import value of €15,000 (but real costs of €10,000) would be replaced by Polish cars with a real cost of production equal to €14,000.
   b. This would lead to trade creation because German cars that cost €20,000 to produce would be replaced by Polish cars that cost only €14,000.
   c. This would lead to trade diversion because the lower cost Japanese cars with an import value of €16,000 (but real costs of €8,000) would be replaced by Polish cars with a real cost of production equal to €14,000.

7. The optimal tariff argument rests on the idea that in a large country tariff (or quota) protection in a particular market can lower the world price of that good. Therefore it is possible that with a (small) tariff, the tariff revenue accruing to the importing country may more than offset the smaller welfare losses to consumers; smaller because prices have fallen somewhat due to the tariff itself.

9. The argument is probably not valid for a number of reasons. One reason is the domestic market failure argument. There is a lack of information regarding safety standards that leads a government to simply ban unsafe products, as opposed to letting consumers choose which risks they would like to take. Thus, it is consistent for the United States to ban unsafe products from China since U.S. regulators also ban unsafe products that are made in the United States. As for restricting products made with poorly paid labor, recall the discussions of the pauper labor argument and exploitation in Chapter 3. Wages reflect productivity and hence competition from workers in low wage countries is providing goods in a sector that is relatively more expensive in the United States. Imports of these goods lift living standards in the United States. At the same time, foreign workers are being made better off relative to their autarky options which are even more low paying than the "low" (relative to the U.S.) wage jobs in the export sector.