Chapter 9
The Political Economy of Trade Policy

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1. ◼ Chapter Overview

The models presented up to this point generally suggest that free trade maximizes national welfare, although it clearly is associated with income distributional effects. Most governments, however, maintain some form of restrictive trade practices. This chapter investigates reasons for this. One set of reasons concerns circumstances under which restrictive trade practices increase national welfare. Another set of reasons concerns 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.

One 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, non-distortionary production and consumption choices which occur under free trade provide one set of gains from eliminating protectionism. Another level of efficiency gains 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. 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 success 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 set of arguments rests upon the existence 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. Students may find this point transparent by pointing out that a tariff is 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. 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. Indeed, tariffs theoretically can be set at levels high enough to restrict trade in a product.

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. It is concentrated in four disparate industries: autos, steel, sugar and textiles.

International negotiations have led to mutual tariff reductions from the mid-1930s through the present. Negotiations which link mutually reduced protection have the political advantage of playing well-organized groups against each other rather than against poorly organized consumers. 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 rules governing GATT are discussed, as are the real threats to its future performance as an active and effective instrument for moving toward freer trade. Also, the developments of the Uruguay round are reviewed, including the creation of the WTO and the economic impact of the round. The chapter also notes that 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. However, the failure of the Doha round can be partially attributed to the success of previous rounds of trade negotiations. As the world moves closer and closer to free trade, the marginal gains from further reductions in trade barriers become smaller. This is highlighted by Table 10-5 in the text which shows that even under the most ambitious proposals in the Doha round, the gains from freer trade would only be about 0.18% of global income.

There is also 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; any of which can be used as an example to illustrate the ideas of this section. An appendix proves that there is always
an optimal positive tariff if a country’s protectionist actions affect world prices.

1. ◼ Answers to 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.

2. a. This is potentially a valid argument for a tariff, since it is based on an assumed ability of the United States to affect world prices—that is, it is a version of the optimal tariff argument. If the United States is concerned about higher world prices in the future, it could use policies which encourage the accumulation of oil inventories and minimize the potential for future adverse shocks.

b. Sharply falling prices benefit U.S. consumers, and since these are off-season grapes and do not compete with the supplies from U.S. producers, the domestic producers are not hurt. There is no reason to keep a luxury good expensive.

c. The higher income of farmers, due to export subsidies and the potentially higher income to those who sell goods and services to the farmers, comes at the expense of consumers and taxpayers. Unless there is some domestic market failure, an export subsidy always produces more costs than benefits. Indeed, if the goal of policy is to stimulate the demand for the associated goods and services, policies should be targeted directly at these goals.

d. There may be external economies associated with the domestic production of semiconductors. This is a potentially a valid argument. But the gains to producers of protecting the semiconductor industry must as always be weighed against the higher costs to consumers and other industries which pervasively use the chips. A well-targeted policy instrument would be a production subsidy. This has the advantage of directly dealing with the externalities associated with domestic chip production.

e. Thousands of homebuyers as consumers (as well as workers who build the homes for which the timber was bought) have benefited from the cheaper imported timber. If the goal of policy is to soften the blow to timber workers, a more efficient policy would be direct payments to timber workers in order to aid their relocation.

3. Without tariffs or subsidies, we compute domestic production as S = 20 + 10\*10 = 120 and domestic consumption as D = 400 – 5\*10 = 350, for imports of 230.

a. To analyze the welfare effects of the tariff, it is helpful to draw a diagram for this small country. Not that since this is a small country, the tariff will not affect the world price and the domestic price will rise by the full amount of the tariff, rising from 10 to 15.

 After the tariff is imposed, domestic production will rise to S = 20 + 10\*15 = 170 and domestic consumption falls to D = 400 – 5\*15 = 325, for imports of 155. To analyze the welfare effects of this tariff, consider the diagram below. We know that since this is a small country, the tariff will lead to a net welfare loss as the gains in producer surplus and tariff revenue are smaller than the losses in consumer surplus. The net loss from the tariff is highlighted by the shaded triangles representing deadweight losses from consumption and production distortions.

 Computing the two deadweight loss triangles yields ½ \*5\*50 + ½\*5\*25 = 187.5

Against the losses from the tariff, we must consider the social gain from increased domestic production. After the tariff, domestic production increased by 50 units. The marginal social benefit from each unit of production is 10, so the social gain from increased production is 500. Thus, the net effect of the tariff on total welfare is 500 – 187.5 = 312.5

b. A production subsidy would cause domestic supply to rise by S = 20+10\*(10+5) = 170, an increase of 50 units as with the tariff. However, the domestic price will not change in this country so consumers do not lose any welfare with this subsidy. Rather, the only efficiency loss comes from production distortion costs, the leftmost triangle in the diagram above. The net loss of the subsidy is ½\*5\*50 = 62.5. However, the increase in domestic production caused social welfare to rise by 50\*10 = 500, leading to a net welfare gain of 500 – 62.5 =437.5.

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 optimal subsidy would be for producers to fully internalize the externality by raising the subsidy to 10 per unit. Supply would then rise to S = 20 + 10\*(10+10) = 220. The production distortion would now be ½\*10\*100 = 500, but the total social benefit from increasing production by 100 units would be 100\*10 = 1000. The net welfare gain would be 1000 – 500 = 500.

4. Refer back to the diagram in 3a. The gain in producer surplus from the tariff is equal to the area bounded above by the price of 15, below by the price of 10 and to the right by the supply curve. This area is equal to 725. Government tariff revenue is given by 5 times the quantity of imports = 5\*155 = 775. Finally, the loss in consumer surplus is the area bounded above by the price of 15, below by the price of 10, and to the right by the demand curve. This area is 1687.5. Total welfare from the tariff is 725 + 775 – 1687.5 = 187.5

 However, if the government values every dollar of producer gain as worth $3 of consumer surplus, then from the government’s perspective, the net gain from the tariff is equal to:

 Gain in Producer Surplus = 725

 Political Gain in Producer Surplus = 725\*3 = 2175

 Tariff Revenue = 775

 Loss in Consumer Surplus = -1687.5

 Net Welfare Gain = 1987.5

5. a. This would lead to trade diversion because the lower cost Japanese cars with an import value of €27,000 (but real costs of €18,000) would be replaced by Polish cars with a real cost of production equal to €20,000.

b. Before the addition of Poland to the EU, Japanese cars were not imported since their import price was €36,000. Thus, Poland’s addition to the EU would lead to trade creation because German cars that cost €30,000 to produce would be replaced by Polish cars that cost only €20,000.

c. This would lead to trade diversion because the lower cost Japanese cars with an import value of €24,000 (but real costs of €12,000) would be replaced by Polish cars with a real cost of production equal to €20,000.

6. The United States has a legitimate interest in the trade policies of other countries, just as other countries have a legitimate interest in U.S. activities. The reason is that uncoordinated trade policies are likely to be inferior to those based on negotiations. By negotiating with each other, governments are better able both to resist pressure from domestic interest groups and to avoid trade wars of the kind illustrated by the Prisoners’ Dilemma example in the text.

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.

8. The game is no longer a Prisoners’ Dilemma. As the chapter discusses, protectionist measures are welfare reducing in their own right. Each country would have an incentive to engage in free trade no matter what the strategy of the other country. Only in a more complex dynamic game in which a trade partner will only open its markets if the home country threatens sanctions (and the threats are only credible if occasionally carried out) would we find any welfare enhancing reason to use a tariff.

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.