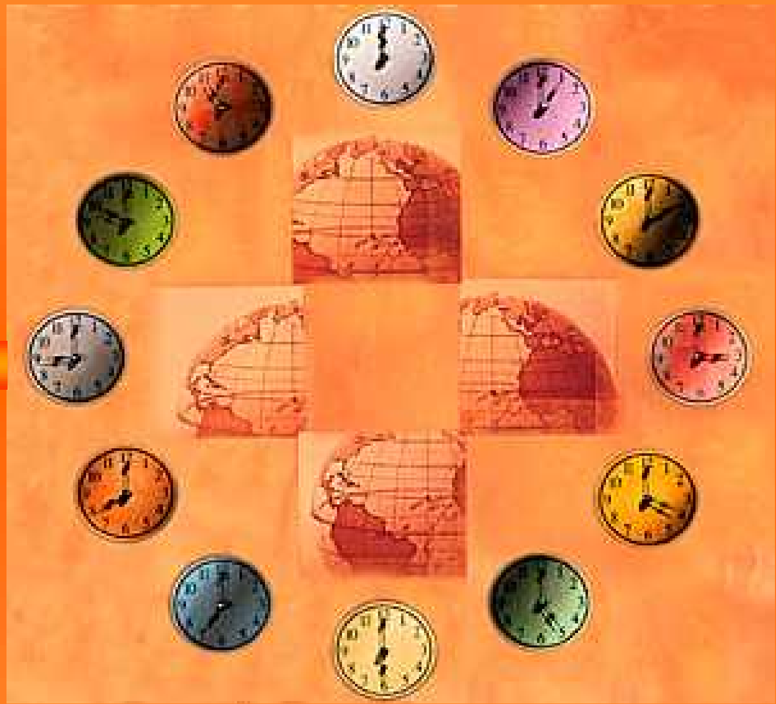
Chapter 9
The Political Economy of Trade Policy



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To Accompany

International Economics: Theory and Policy, Sixth Edition

by **Paul R. Krugman and Maurice Obstfeld**

Chapter Organization

- Introduction
- The Case for Free Trade
- National Welfare Arguments against Free Trade
- Income Distribution and Trade Policy
- International Negotiations and Trade Policy
- Summary
- Appendix: Proving that the Optimum Tariff is Positive

Introduction

- Free trade maximizes national welfare, but it is associated with income distributional effects.
  - Most governments maintain some form of restrictive trade policies.
  - This chapter examines some of the reasons governments either should not or do not base their policy on economists’ cost-benefit calculations.

Introduction

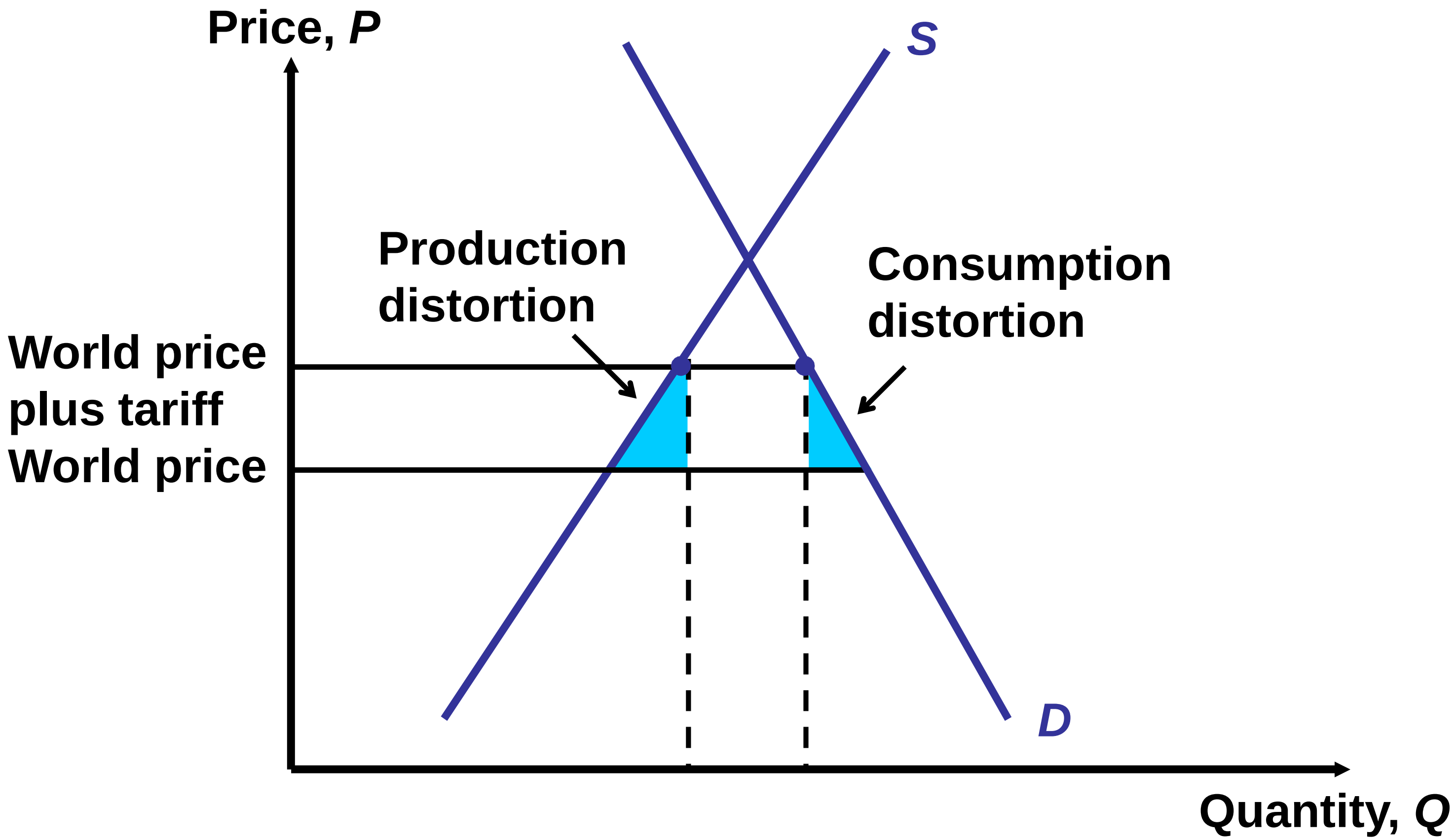
- What reasons are there for governments not to interfere with trade?
  - There are three arguments in favor of free trade:
    - Free trade and efficiency
    - Economies of scale in production
    - Political argument

The Case for Free Trade

- Free Trade and Efficiency
  - The efficiency argument for free trade is based on the result that in the case of a small country, free trade is the best policy.
    - A tariff causes a net loss to the economy.
    - A move from a tariff equilibrium to free trade eliminates the efficiency loss and increases national welfare.

The Case for Free Trade

Figure 9-1: The Efficiency Case for Free Trade



The Case for Free Trade

Table 9-1: Estimated Cost of Protection, as a Percentage of National Income

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

Sources: Brazil: Bela Balassa, *The Structure of Protection in Developing Countries* (Baltimore: The Johns Hopkins Press, 1971); Turkey and Philippines, World Bank, *The World Development Report 1987* (Washington: World Bank, 1987); United States: David G. Tarr and Morris E. Morkre, *Aggregate Costs to the United States of Tariffs and Quotas on Imports* (Washington D.C.: Federal Trade Commission, 1984).

The Case for Free Trade

- Additional Gains from Free Trade
  - Protected markets in small countries do not allow firms to exploit scale economies.
    - Example: In the auto industry, an efficient scale assembly should make a minimum of 80,000 cars per year.
      - In Argentina, 13 firms produced a total of 166,000 cars per year.
  - The presence of scale economies favors free trade that generates more varieties and results in lower prices.
  - Free trade, as opposed to "managed" trade, provides a wider range of opportunities and thus a wider scope for innovation.

The Case for Free Trade

- Political Argument for Free Trade
  - A political commitment to free trade may be a good idea in practice.
  - Trade policies in practice are dominated by special-interest politics rather than consideration of national costs and benefits.

National Welfare Arguments Against Free Trade

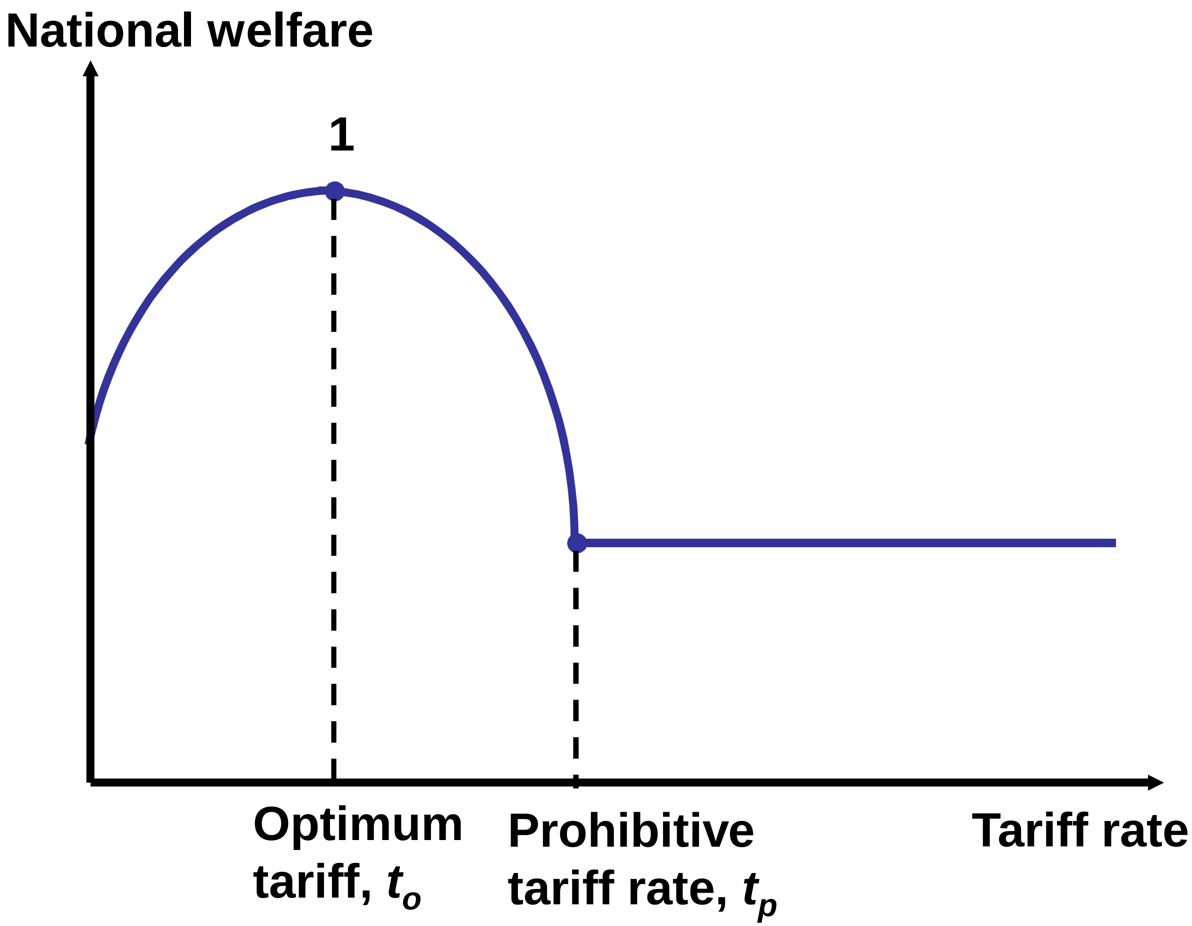
- Activist trade policies can sometimes increase the welfare of the nation as a whole.
- There are two theoretical arguments *against* the policy of free trade:
  - The **terms of trade argument for a tariff**
  - The **domestic market failure**

National Welfare Arguments Against Free Trade

- The Terms of Trade Argument for a Tariff
  - For a large country (that is, a country that can affect the world price through trading), a tariff lowers the price of imports and generates a terms of trade benefit.
    - This benefit must be compared to the costs of the tariff (production and consumption distortions).
  - It is possible that the terms of trade benefits of a tariff outweigh its costs.
    - Therefore, free trade might not be the best policy for a large country.

National Welfare Arguments Against Free Trade

Figure 9-2: The Optimum Tariff



National Welfare Arguments Against Free Trade

- **Optimum tariff**
  - The tariff rate that maximizes national welfare
  - It is always positive but less than the prohibitive rate that would eliminate all imports.
  - It is zero for a small country because it cannot affect its terms of trade.

National Welfare Arguments Against Free Trade

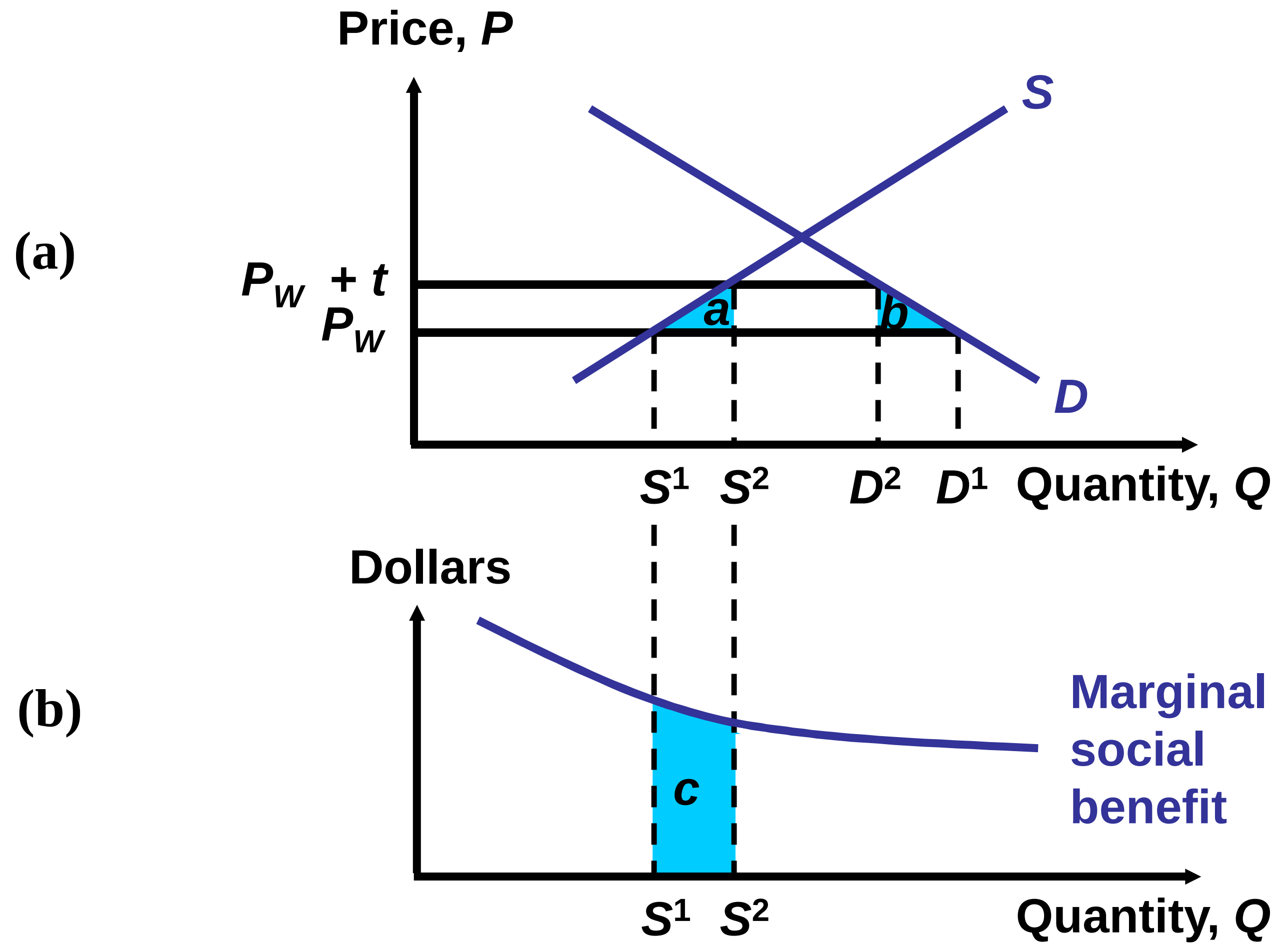
- What policy would the terms of trade argument dictate for export sectors?
  - An export subsidy worsens the terms of trade, and therefore unambiguously reduces national welfare.
    - Therefore, the optimal policy in export sectors must be a negative subsidy, that is, a tax on exports.
  - Like the optimum tariff, the optimum export tax is always positive but less than the prohibitive tax that would eliminate exports completely.

National Welfare Arguments Against Free Trade

- The Domestic Market Failure Argument Against Free Trade
  - Producer and consumer surplus do not properly measure social costs and benefits.
    - Consumer and producer surplus ignore **domestic market failures** such as:
      - Unemployment or underemployment of labor
      - Technological spillovers from industries that are new or particularly innovative
      - Environmental externalities
  - A tariff may raise welfare if there is a **marginal social benefit** to production of a good that is not captured by producer surplus measures.

National Welfare Arguments Against Free Trade

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



National Welfare Arguments Against Free Trade

- The domestic market failure argument against free trade is a particular case of the theory of the second best.
  - The **theory of the second best** states that a hands-off policy is desirable in any one market only if all other markets are working properly.
    - If one market fails to work properly, a government intervention may actually increase welfare.

National Welfare Arguments Against Free Trade

- How Convincing Is the Market Failure Argument?
  - The are two basic arguments in defense of free trade in the presence of domestic distortions:
    - Domestic distortions should be corrected with domestic (as opposed to international trade) policies.
      - Example: A domestic production subsidy is superior to a tariff in dealing with a production-related market failure.
    - Market failures are hard to diagnose and measure.
      - Example: A tariff to protect urban industrial sectors will generate social benefits, but it will also encourage migration to these sectors that will result in higher unemployment.

Income Distribution and Trade Policy

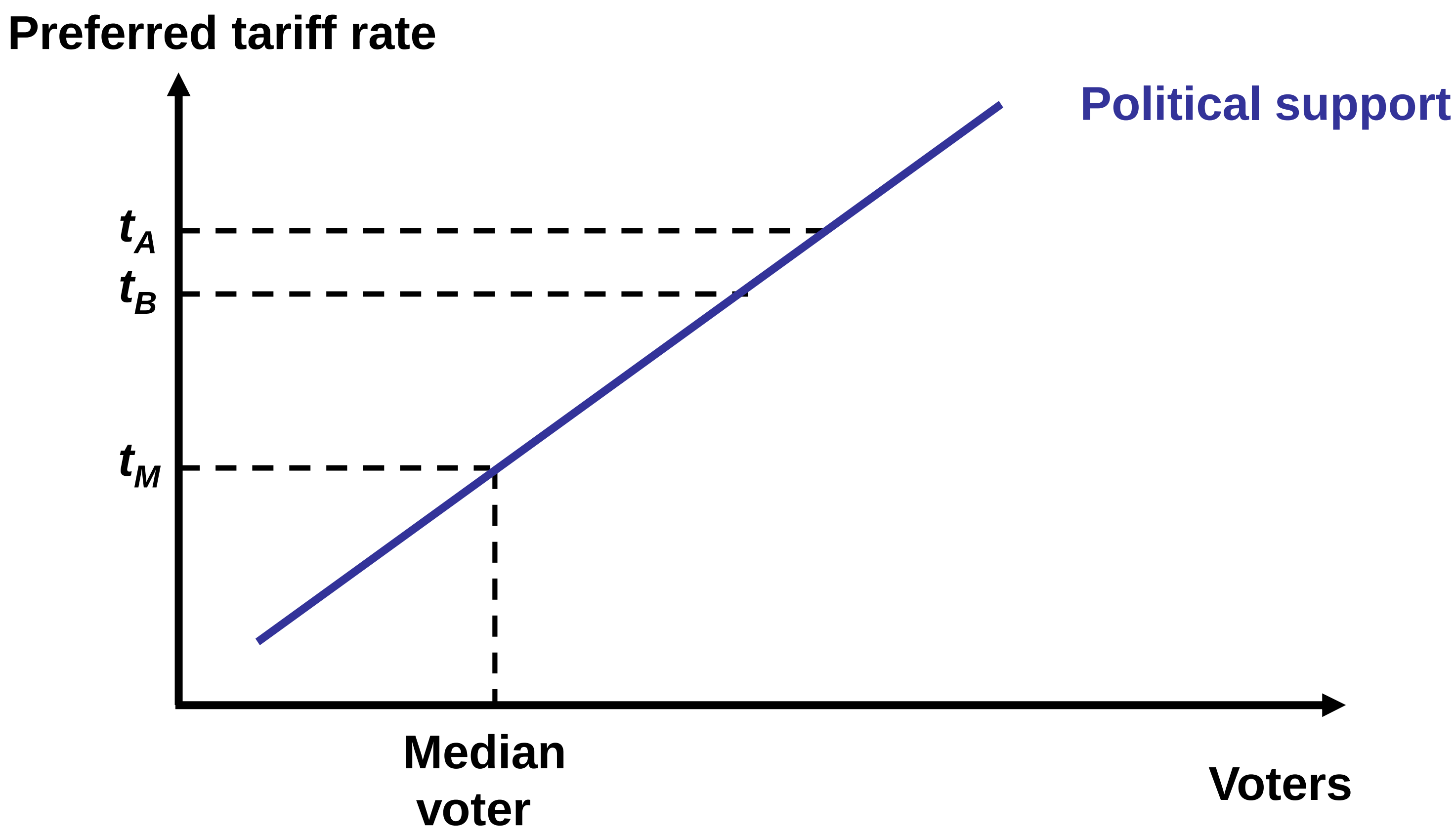
- In practice, trade policy is dominated by income distribution considerations.
  - The desires of individuals get more or less imperfectly reflected in the objectives of government.
    - There exist models in which governments try to maximize political success.
- Electoral Competition
  - Political scientists argue that policies are determined by competition among political parties that try to attract as many votes as possible.

Income Distribution and Trade Policy

- Assumptions of the model:
  - There are two competing political parties.
  - The objective of each party is to get elected.
  - Each party has to decide on the level of the tariff imposed (this is the only policy available).
  - Voters differ in the tariff they prefer.
- What policies will the two parties promise to follow?
  - Both parties will offer the same policy consisting of the tariff that the **median voter** (the voter who is exactly halfway up the lineup) prefers.

Income Distribution and Trade Policy

Figure 9-4: Political Competition



Income Distribution and Trade Policy

- Collective Action
  - This approach views political activity as a public good.
    - For instance, the imposition of a tariff protects all firms in an industry, but the lobbying costs for imposing the tariff are covered by only a few firms.
  - Trade policies that impose total large losses that are spread among many individual firms or consumers may not face opposition.
    - Industries that are well organized (or have a small number of firms) get protection.

- Modeling the Political Process
  - Interest groups “buy” policies by offering contributions contingent on the policies followed by the government.

Income Distribution and Trade Policy

- **Who Gets Protected?**
  - Two sectors seem to get protected in advanced countries:
    - **Agriculture**
      - Farmers are well organized and the structure of the U.S. government enhances their political power.
    - **Clothing**
      - Both textiles and apparel have enjoyed substantial protection. This sector employs less skilled workers and it is unionized as well.
  - Protection is very likely to diminish in the future in both sectors (due to international trade negotiations).

Income Distribution and Trade Policy

Table 9-2: Effects of Protection in the United States ($ billion)

Effect	Apparel	Textiles	All Industries
Consumer cost	21.16	3.27	32.32
Producer gain	9.90	1.75	15.78
Tariff revenue	3.55	0.63	5.86
Quota rent	5.41	0.71	7.12
Producer and consumer distortion	2.30	0.18	3.55
Overall welfare loss	7.71	0.89	10.42

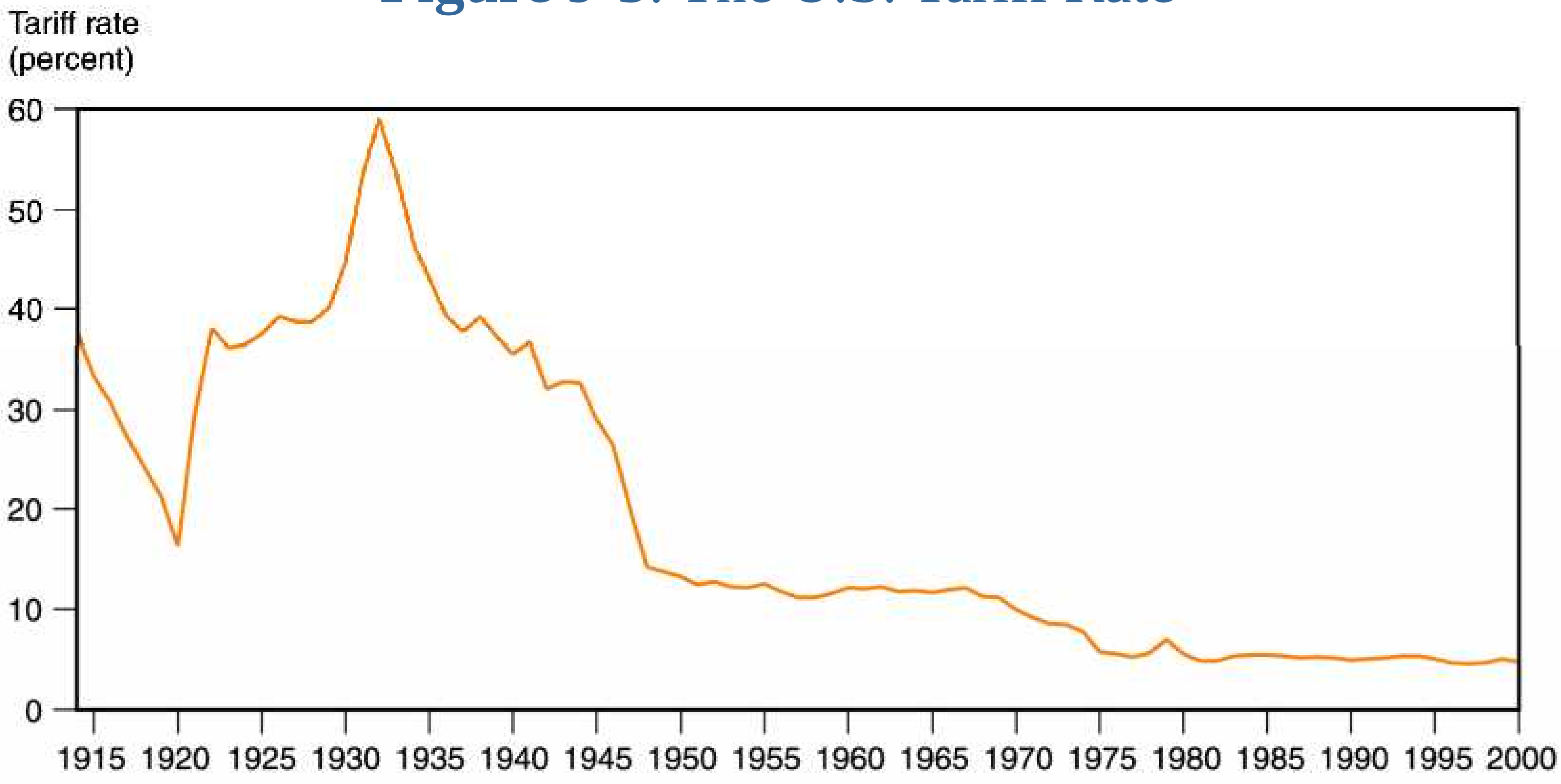
Source: Gary Hufbauer and Kimberly Elliott, *Measuring the Costs of Protection in the United States*. Washington: Institute for International Economics, 1994, pp. 8–9.

International Negotiations and Trade Policy

- International integration has increased from the mid-1930s until about 1980 because the United States and other advanced countries gradually removed tariffs and nontariff barriers to trade.

International Negotiations and Trade Policy

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



After rising sharply at the beginning of the 1930s, the average tariff rate of the United States has steadily declined.

International Negotiations and Trade Policy

- How was the removal of tariffs politically possible?
  - The postwar liberalization of trade was achieved through **international negotiation**.
    - Governments agreed to engage in mutual tariff reduction.
- The Advantages of Negotiation
  - It is easier to lower tariffs as part of a mutual agreement than to do so as a unilateral policy because:
    - It helps mobilize exporters to support freer trade.
    - It can help governments avoid getting caught in destructive **trade wars**.

International Negotiations and Trade Policy

Table 9-3: The Problem of Trade Warfare

U.S. \ Japan	Free trade	Protection
Free trade	Japan: 10; U.S.: 10	Japan: 20; U.S.: -10
Protection	Japan: -10; U.S.: 20	Japan: -5; U.S.: -5

International Negotiations and Trade Policy

- In Table 9-3, each country has a dominant strategy: Protection.
- Even though each country acting individually would be better off with protection, they would both be better off if both chose free trade.
  - In game theory, this situation is known as a **Prisoner's dilemma**.
  - Japan and the U.S. can establish a binding agreement to maintain free trade.

International Negotiations and Trade Policy

- International Trade Agreements: A Brief History
  - Internationally coordinated tariff reduction as a trade policy dates back to the 1930s (the Smoot-Hawley Act).
  - The multilateral tariff reductions since World War II have taken place under the **General Agreement on Tariffs and Trade (GATT)**, established in 1947 and located in Geneva.
    - It is now called the **World Trade Organization (WTO)**.
    - The GATT-WTO system is a legal organization that embodies a set of rules of conduct for international trade policy.

International Negotiations and Trade Policy

- The GATT-WTO system prohibits the imposition of:
  - *Export Subsidies* (except for agricultural products)
  - *Import quotas* (except when imports threaten "market disruption")
  - *Tariffs* (any new tariff or increase in a tariff must be offset by reductions in other tariffs to compensate the affected exporting countries)
- **Trade round**
  - A large group of countries get together to negotiate a set of tariff reductions and other measures to liberalize trade.

International Negotiations and Trade Policy

- Eight trade rounds have occurred since 1947:
  - The first five of these took the form of “parallel” bilateral negotiations (e.g., Germany with France and Italy).
  - The sixth multilateral trade agreement, known as the Kennedy Round, was completed in 1967:
    - This agreement involved an across-the-board 50% reduction in tariffs by the major industrial countries, except for specified industries whose tariffs were left unchanged.
    - Overall, the Kennedy Round reduced average tariffs by about 35%.

International Negotiations and Trade Policy

- The so-called Tokyo round of trade negotiations (completed in 1979) resulted in:
  - Reduced tariffs
  - New codes for controlling the proliferation of nontariff barriers, such as VER's.
- An eighth round of negotiations, the so-called Uruguay Round, was competed in 1994.

International Negotiations and Trade Policy

- The Uruguay Round
  - Its most important results are:
    - Trade liberalization
    - Administrative reforms
- Trade Liberalization
  - The average tariff imposed by advanced countries decreased by almost 40%.
    - More important is the move to liberalize trade in two important sectors: agricultural and clothing.
- From the GATT to the WTO
  - Much of the publicity surrounding the Uruguay Round focused on its creation of the WTO.

International Negotiations and Trade Policy

- How different is the WTO from the GATT?
  - The GATT was a provisional agreement, while the WTO is a full-fledged international organization.
  - The GATT applied only to trade in goods, while the WTO included rules on trade in services (the General Agreement on Trade in Services (GATS)) and on international application of international property rights.
  - The WTO has a new “dispute settlement” procedure which is designed to reach judgments in a much shorter time.

International Negotiations and Trade Policy

- Benefits and Costs
  - The economic impact of the Uruguay Round is difficult to estimate.
    - However, estimates of the GATT and of the Organization for Economic Cooperation and Development suggest a gain to the world economy as a whole of more than $200 billion annually once the agreement is fully in force.
      - Most economists believe that these estimates are too low.
    - The costs of the Uruguay Round will be felt by well-organized groups, while much of the benefit will accrue to diffuse populations.

International Negotiations and Trade Policy

- Preferential Trading Agreements
  - Nations establish **preferential trading agreements** under which they lower tariffs with respect to each other but not the rest of the world.
  - The GATT-WTO, through the principle of non-discrimination called the “most favored nation” (MFN) principle, prohibits such agreements.
    - The formation of preferential trading agreements is allowed if they lead to free trade between the agreeing countries.

International Negotiations and Trade Policy

- Free trade can be established among several WTO members as follows:
  – A **free trade area** allows free-trade among members, but each member can have its own trade policy towards non-member countries.
    – <u>Example</u>: The North American Free Trade Agreement (NAFTA) creates a free trade area.
  – A **customs union** allows free trade among members and requires a common external trade policy towards non-member countries.
    – <u>Example</u>: The European Union (EU) is a full customs union.
  – A **common market** is a customs union with free factor movements (especially labor) among members.

International Negotiations and Trade Policy

- Are preferential trading agreements good?
  - It depends on whether it leads to trade creation or trade diversion.
    - **Trade creation**
      - Occurs when the formation of a preferential trading agreement leads to replacement of high-cost domestic production by low-cost imports from other members.
    - **Trade diversion**
      - Occurs when the formation of a preferential trading agreement leads to the replacement of low-cost imports from non members with higher-cost imports from member nations.

Summary

- There are three arguments in favor of free trade:
  - The efficiency gains from free trade
  - The additional gains from economies of scale
  - The political argument
- There are two arguments for deviating from free trade:
  - The terms of trade argument for a tariff
  - The domestic market failures

Summary

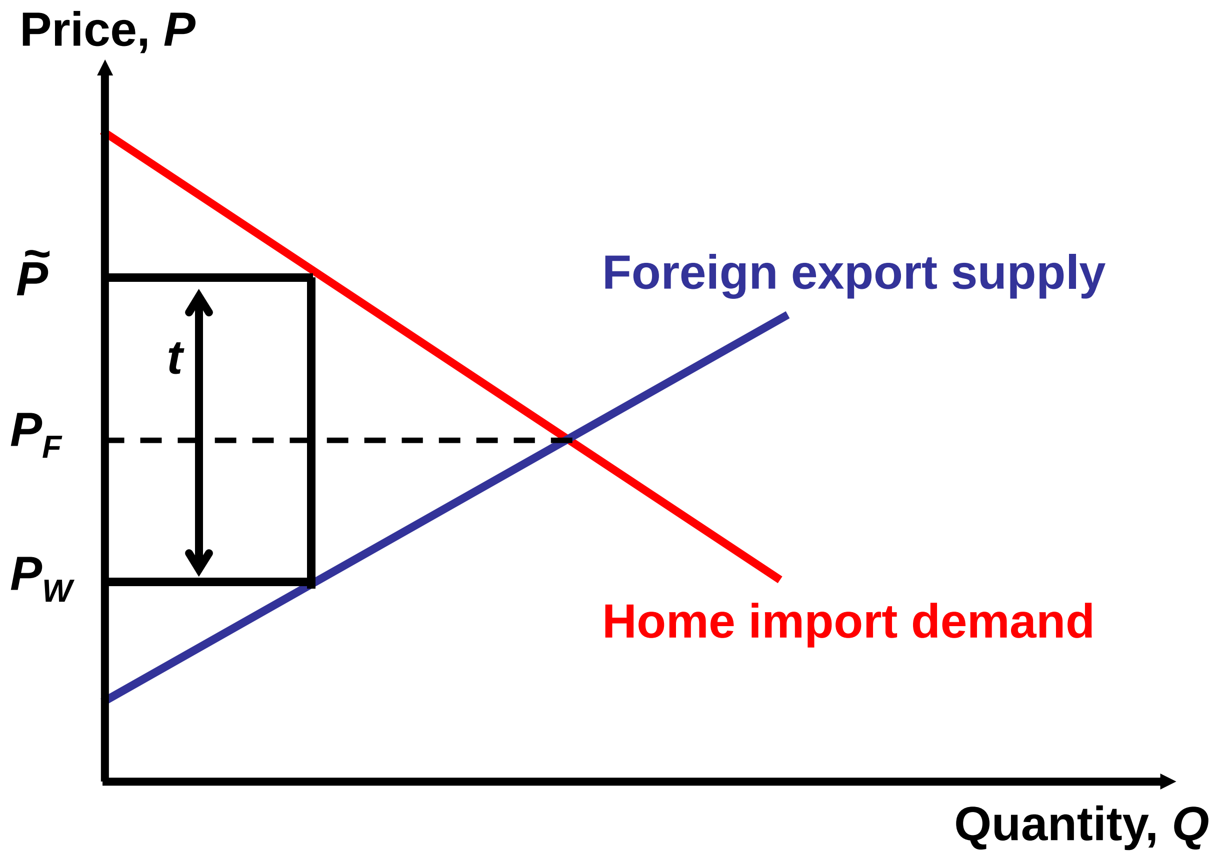
- In practice, trade policy is dominated by considerations of income distribution.
  - Political parties adopt policies that serve the interests of the median voter.
  - Groups that are well organized (or small groups) are often able to get policies that serve their interests at the expense of the majority.

Summary

- International negotiation helps reduce tariffs in industrial countries and avoid trade wars.
- The GATT is the central institution of the international trading system.
  - The most recent worldwide GATT agreement also sets up a new organization, the WTO.
- Three kinds of preferential trading agreements are allowed under the WTO: free trade areas, customs unions, and common markets.
- Preferential trading agreements can be good or bad depending on the magnitude of trade creation and trade diversion effects.

Appendix: Proving that the Optimum Tariff is Positive

Figure 9A-1: Effects of a Tariff on Prices



Appendix: Proving that the Optimum Tariff is Positive

Figure 9A-2: Welfare Effects of a Tariff