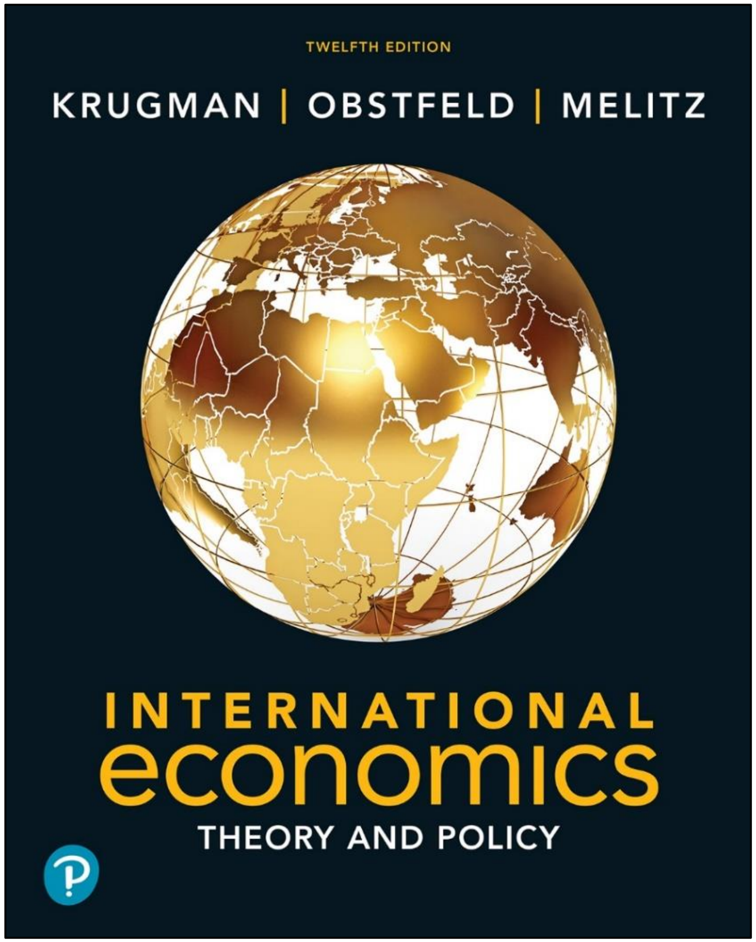
International Economics: Theory and Policy

Twelfth Edition



Chapter 10

The Political Economy of Trade Policy

Preview

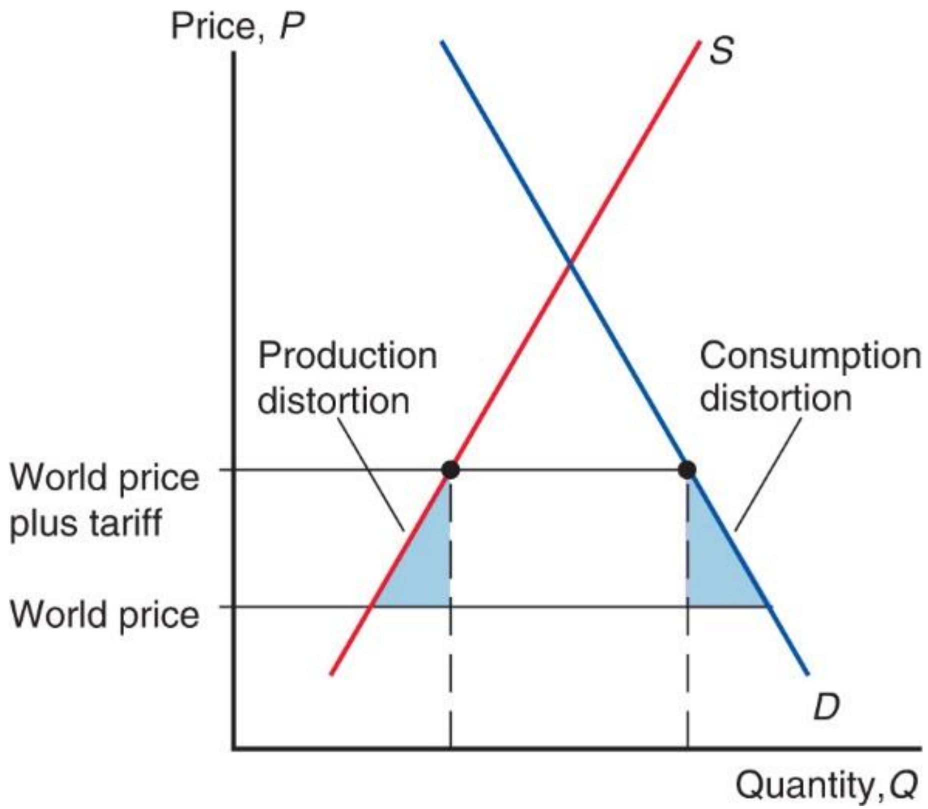
- The cases for free trade
- The cases against free trade
- Which industries are protected?

The Cases for Free Trade (1 of 6)

1. The argument that producers and consumers **allocate resources most efficiently** when governments do not distort market prices through trade policy.

- With restricted trade, consumers pay higher prices and consume too little while firms produce too much.

The Efficiency Case for Free Trade



The Cases for Free Trade (2 of 6)

- 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.
  - For the world as a whole, protection costs less than 1 percent of GDP.
  - The gains from free trade are somewhat smaller for **advanced economies** such as the United States and Europe and somewhat larger for poorer **developing countries**.

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 (3 of 6)

2. Free trade allows firms or industry to take advantage of **economies of scale**.

- Protected markets limit gains from external economies of scale by inhibiting the concentration of industries:
  - Too many firms to enter the protected industry.
  - The scale of production of each firm becomes inefficient.

The Cases for Free Trade (4 of 6)

3. Free trade provides **competition and opportunities for innovation** (dynamic benefits).

- By providing entrepreneurs with an incentive to seek new ways to export or compete with imports, free trade offers more opportunities for learning and innovation.

The Cases for Free Trade (5 of 6)

4. Free trade avoids the loss of resources through **rent seeking**.

– Spend time and other resources seeking quota rights and the profit that they will earn.

The Cases for Free Trade (6 of 6)

5. 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 (1 of 8)

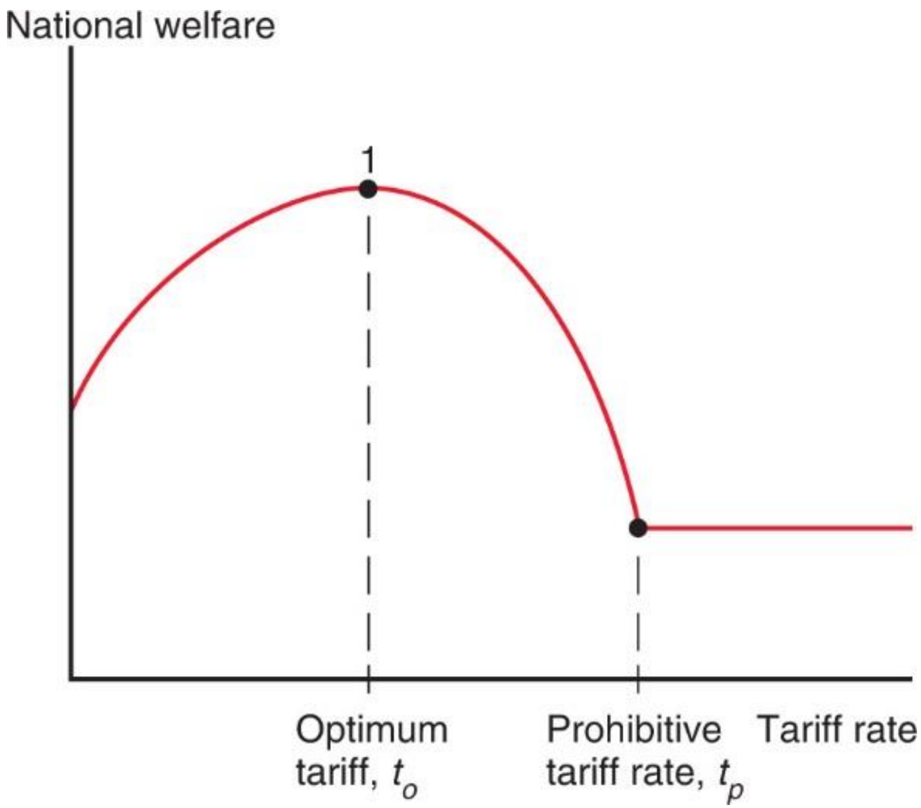
1. For a “large” country, a tariff lowers the price of imports in world markets and generates a **terms of trade gain**.

- This benefit may exceed the losses caused by distortions in production and consumption.
- At some tariff rate, the national welfare will begin to decrease as the economic efficiency loss exceeds the terms of trade gain.

The Cases against Free Trade (2 of 8)

- A tariff rate that completely prohibits imports leaves a country worse off, but tariff rate t_O may exist that maximizes national welfare: an **optimum tariff**.
- For some large countries like the **U.S.**, an import tariff 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 Optimum Tariff



The Cases against Free Trade (3 of 8)

- 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.

The Cases against Free Trade (4 of 8)

2. 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 (5 of 8)

- Types of market failures include
  - Persistently ***high underemployment*** of workers
    - surpluses that are not eliminated in the market for labor because wages do not adjust
  - Persistently ***high underutilization*** of structures, equipment, and other forms of capital
    - surpluses that are not eliminated in the market for capital because prices do not adjust
  - ***Property rights*** not well defined or well enforced

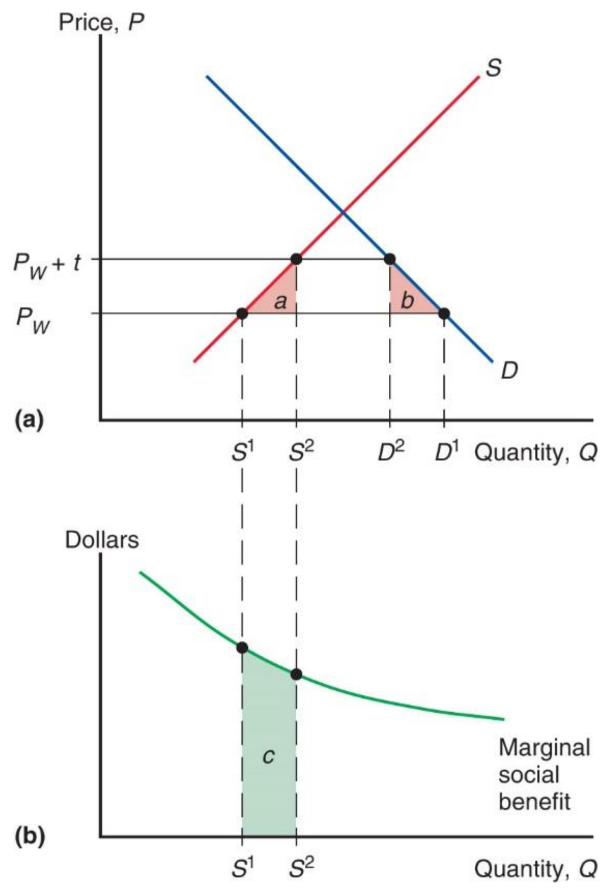
The Cases against Free Trade (6 of 8)

- Types of market failures include
  - ***technological benefits*** for society discovered through private production, but from which private firms cannot fully profit
  - ***environmental costs*** for society caused by private production, but for which private firms do not fully pay
  - 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 (7 of 8)

- 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's possible that when a tariff increases domestic production, the benefit to domestic society will increase due to a market failure.

The Domestic Market Failure Argument for a Tariff



If production of a good yields extra social benefits [measured in panel (*b*) by area *c*] not captured as producer surplus, a tariff can increase welfare.

The Cases against Free Trade (8 of 8)

- The domestic market failure argument against free trade is an example of a more general argument called the **theory of the second best**.

- *Government intervention that distorts market incentives in one market may increase national welfare by offsetting the consequences of market failures elsewhere.*

Which Industries Are Protected? (1 of 2)

- **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? (2 of 2)

- **Clothing**: textiles (fabrication of cloth) and apparel (assembly of cloth into clothing).
  - Until 2005, quota licenses granted to textile and apparel exporters were specified in the Multi-Fiber Agreement (MFA) between the United States and many other nations.
  - Phase-out of MFA drastically reduced the costs of U.S. protection