Domestic Politics and Governance of Trade

Steven Saroka

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Today's Class

- Trade and comparative advantage recap
- Why does trade protectionism occur?
- How do international institutions resolve some trade issues?

Key Terms

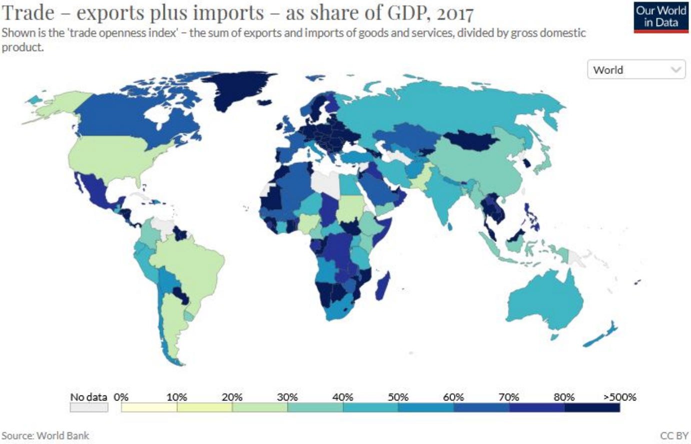
- Ricardo-Viner Trade Theory
- Firm-level trade theory
- Domestic influences on trade
- Winners and losers from trade

Central Question

How do domestic politics impact international trade?

Trade Growth Over Time

Trade Importance Over Space



Why Trade?

- (Neo)classical economic and trade theory show that specialization and trade allow for more production of goods, in an efficient manner.
- Different resources allow for **specialization**.
- Thanks to the territorial limits of sovereignty, resources differ by state.

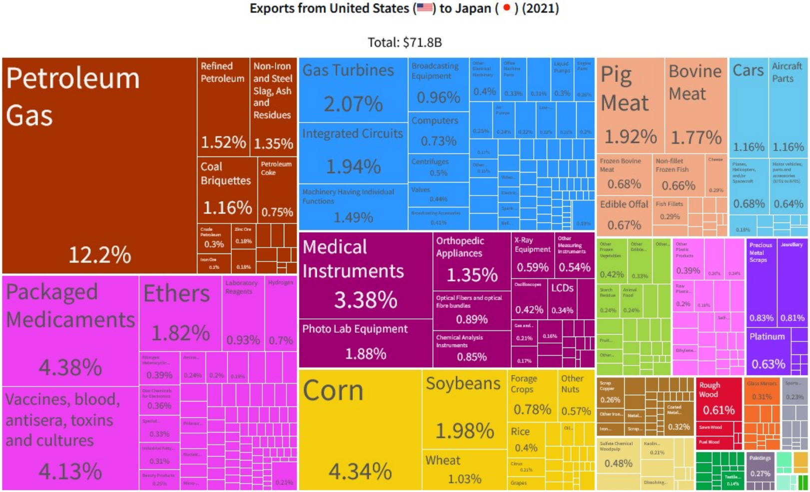
Trade and Comparative Advantage

States specialize according to comparative advantage (**not** absolute advantage).

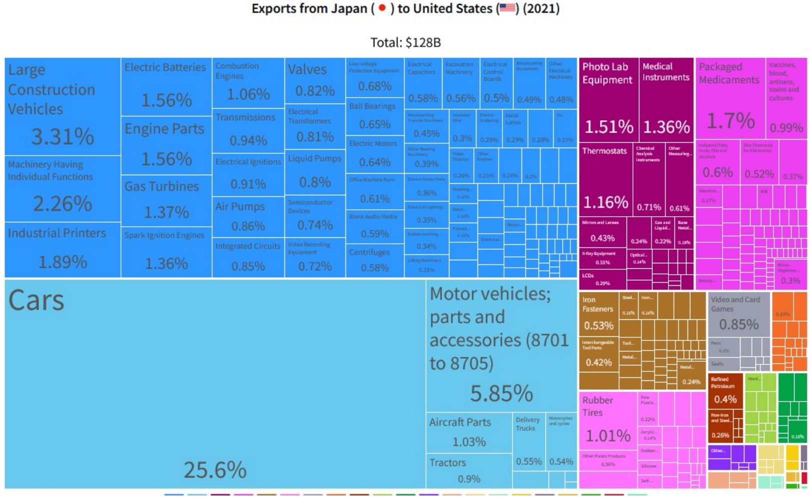
- **Absolute advantage**: the ability of a producer to generate a greater number of goods than other producers using the same amount of resources.
- **Comparative advantage**: the ability of a producer to generate a good more efficiently than other goods it could create, so that its most efficient use of resources is to make that specific good/service.
  - Can be quantified by **opportunity cost** of production.

States export those goods for which they have a comparative advantage, and import those for which they do not.

US Exports to Japan



Japan Exports to US



The Economic Case for Trade

Why bother producing and trading according to comparative advantage?

- Larger consumer surplus due to lower world prices (see FLS 342-345).
- Increasing returns to scale mean more efficient production.
- Spread of technology.
- Greater economic growth.

To summarize the case for free trade according to comparative advantage: more products, more cheaply, in more places while enabling more economic growth.

Sources of Comparative Advantage

At the state level, where does comparative advantage come from?

- **Heckscher-Ohlin trade theory:** comparative advantage comes from an abundance of one or more **factors of production.**
- **Ricardo-Viner trade theory:** comparative advantage comes from specific **sectors/industries**.
- **Firm-level theory:** comparative advantage comes from size and specialization of important companies.

Factors of Production Recap

- Land: farming or natural resource extraction.
- Labor: generally unskilled labor.
- Capital: financial capital and physical capital.
- Human capital: skilled labor (sometimes combined with Capital).

Heckscher-Ohlin and ISFM

- **Heckscher-Ohlin trade theory:** states have a comparative advantage when producing goods that make use of whatever factor(s) they have in abundance.
- HO theory assumes **inter-sectoral factor mobility (ISFM)**: that factors of production can travel easily across economic sectors.
- **Sector:** a component of the economy that produces a specific type of good or service.
  - Examples: fishing, manufacturing, energy, banking, hospitality, etc.
- However, ISFM is really unlikely to be realistic in the short-term...
  - Could physical capital (a factory) used to create cars be used to create pharmaceuticals?

Ricardo-Viner trade theory

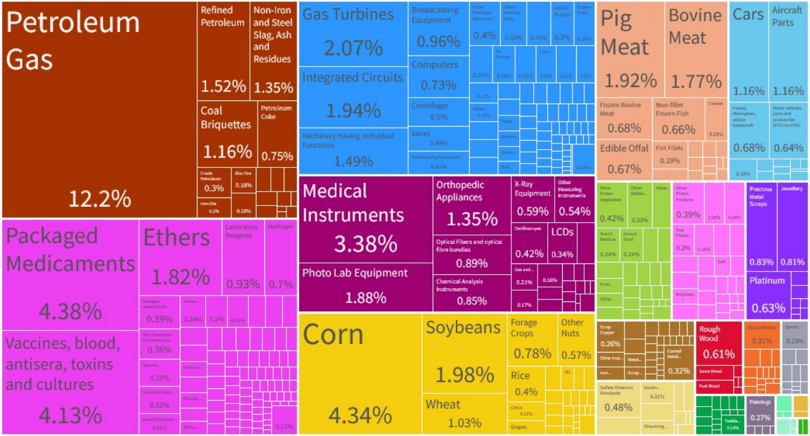
This criticism of ISFM led to Ricardo-Viner trade theory.

- **Ricardo-Viner trade theory:** comparative advantage comes not from general factors of production, but from the specific economic sectors in which those factors are located.
- **How factors are used is more important than the factor itself**. The physical capital used to build cars is not the same as the physical capital used to make pharmaceuticals, even though HO would classify them both as "capital."

US Exports to Japan

Exports from United States to Japan (2021)

Total: $71.8B



Firm-Level Trade Theory

- Motivated by the rise of **multinational corporations** which produce goods in multiple countries.
- In practice, international trade is dominated by relatively few MNCs.
  - In US, top 1% of firms account for more than 80% of exports.
- Given this dominance, these "superstar" firms may be able to lobby for special political treatment, and may have oversized impact on trade policy considerations.

Trade Barriers and Protectionism

- Despite a consensus among economists about the economic benefits of free trade, almost every state in the international system engages in **protectionism**: state-imposed barriers to imports.
- Protectionism takes several forms:
  - **Tariffs:** tax on an import, raising the domestic price of that imported good. Explore: ITA's "What's My Tariff?" tool)
  - **Quotas:** restriction on how much of a foreign good can be imported (e.g. Vietnamese rice into the EU)
  - **Non-tariff measures:** rules often related to quality of imports that naturally restrict quantity (see UNCTAD's online database of NTMs)
- **Tariffs are the most common form of protectionism.**

Costa Rican Tariffs on Ball Point Pens

96081000 - BALL POINT PENS

HS Code	96081000
Description	BALL POINT PENS
Staging Basket	10 Years, Non-Linear
Zero Duty As of	2015
Base Rate	15
Annual Rates	

Year	Tariff Rate
2006	15.0
2007	15.0
2008	15.0
2009	12.0
2010	10.8
2011	9.6
2012	7.2
2013	4.8
2014	2.4
2015	0.0

Central Question 2

Why do states engage in protectionism?

Puzzle of Protectionism

- Protectionism effectively prevents comparative advantage from working to its full effect by altering the balance of imports and exports.
- This is counterproductive, from an economic viewpoint.
- Additionally, citizens frequently rally **against** proposed free trade agreements and in favor of protectionist measures.
- Example: Trans-Atlantic Trade and Investment Partnership.


TAKEOVE
no EU/US 'free trade' deal
TTIP
stopttip.net
NO TTIP

TTIP Protests

Domestic Politics of Trade

- Why protectionism? **Because even though trade may boost the economy as a whole, it still has varied distributional effects.**
- The economic gains in the aggregate obscure that any trade policy will create winners and losers within any given state.
- Thus, the study of the domestic politics of trade is effectively the study of who is hurt or helped by trade in a given state.
- So, who are the domestic winners and losers from free trade?

Who Gains From Free Trade?

- Consumers of imported goods (including as production inputs).
- Exporters (those with a comparative advantage), but which exporters depends on the theoretical approach:
  - Factors/HO theory: trade raises income of relatively abundant factors of production.
  - Sectors/RV theory: trade raises income of export-oriented sectors of the economy.
  - Firm theory: trade raises income of large firms.
- Citizens in general (FLS example: post-Soviet states), who are often consumers.

Who Loses From Trade?

- Producers at a comparative disadvantage who must compete with imports. Again, exact predictions depend on the theoretical approach:
  - Factors/HO theory: Scarce factors of production.
  - Sectors/RV theory: Less competitive sectors of the economy.
  - Firm theory: Smaller firms.
- **Each of these groups has a strong interest in trade protection.**

Gains and Losses by Development Level

To further complicate things, different factors are winners/losers at different levels of a state's economic development. In the **Heckscher-Ohlin/factor-based** approach:

- Winners from trade are owners of relatively abundant factor:
  - In rich countries, this is usually high-skill workers/capital.
  - In poor countries, this is usually (lower-skill) labor.
- Losers from trade are owners of relatively scarce factor:
  - In rich countries, this is usually lower-skill labor.
  - In poor countries, this is usually capital.

Gains and Losses by Development Level

The **Ricardo-Viner/sectoral** approach has a simpler prediction:

- Winners from trade are those employed in sectors that are export industries.
- Losers from trade are those employed in sectors that are import-competing industries.

Conflict Over Trade

- Beneficiaries of trade tend to be larger groups (citizen consumers, abundant factors).
  - Like all large groups, they have a collective action problem.
- Domestic interaction often occurs between comparatively disadvantaged and comparatively advantaged factors/sectors.
  - Ex: import-competing vs. export-producing industries
- The comparatively disadvantaged are generally fewer in number, while feeling the costs of their disadvantage more acutely than the comparatively advantaged (or general citizen consumers) feel the dispersed benefits of trade.
- **Trade protections are thus tend to be narrowly targeted at otherwise uncompetitive factors/sectors that overcome the CAP and lobby for protection.**

Trade Conflict and Domestic Institutions

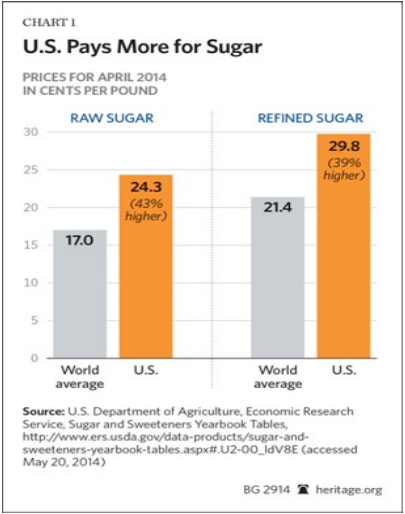
- Due to their ability to overcome the CAP, comparatively disadvantaged groups should benefit from trade protection fairly often.
- However, domestic institutions may impact this, in particular democracy.
- If politicians care about voters' wellbeing, they should (in theory) opt for more free trade.
- This is especially likely in systems where the chief executive (i.e., president) has a national constituency: if consumers all over the country are harmed by trade protection, and benefit is only enjoyed by small local industry, the president should be more likely to favor free trade...

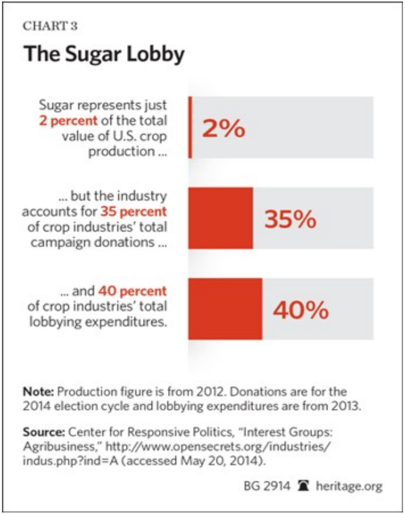
Conflict and Domestic Institutions

Trade Protection Winners and Losers

- The benefit of protectionism is that it protects less-competitive domestic producers from foreign competition, protecting jobs and profits for those producers.
- The costs of protectionism come in the form of price increases for protected goods (impacting consumers in general) as well as the state effectively subsidizing businesses that would otherwise fail.

Example: US Sugar Lobby





Government Responses

- Governments can respond to domestic, anti-trade pressures in one of two ways.
- **Protectionism:** They can institute laws which make it easier for their comparatively disadvantaged interest groups to compete against imports.
  - Subsidies: US to soybeans producers, UAE to Emirates airline.
  - Tariffs and Quotas: EU on hormone-free beef.
  - Non-Tariff Measures: Australian restriction of Canadian salmon on health grounds.
- **Compensation:** using economic gains from trade to provide trade losers with benefits to offset their losses.

Compromise of Embedded Liberalism

- After Great Depression and WWII, US led a coalition of countries to liberalize trade.
- At the same time, these countries expanded their domestic safety nets to help the losers from trade.
  - US: NLRB (1930s), Great Society (1960s)
  - Sweden: solidarity wages, pension reforms
- This was the **Compromise of Embedded Liberalism**: sustain popular support for free trade by ensuring that those from less competitive sectors could recover as trade barriers were removed.

Compromise of Embedded Liberalism

- The compromise largely ended in the 1970s, especially in US:
  - Tax cuts for corporations
  - Scaling back and defunding of social safety nets
  - Expansion of global finance without similar compensation
- Today's Rodrik (2019) article argues that this expansion of globalization without the compromise's safety net ("hyperglobalization") has negative consequences (job losses, financial crises, austerity policies) that have motivated opposition to globalization and economic openness more broadly.

Class So Far...

- Trade produces domestic conflict between winners and losers
- We predict winners and losers using models of comparative advantage
- Domestic institutions structure those conflicts
- Governments can respond via protection or compensation, though both have declined over time

Closing Question

What about international financial exchanges?