

The Political Economy of Trade Policy

International Economics

Krugman et al. 2018 Chapter 10

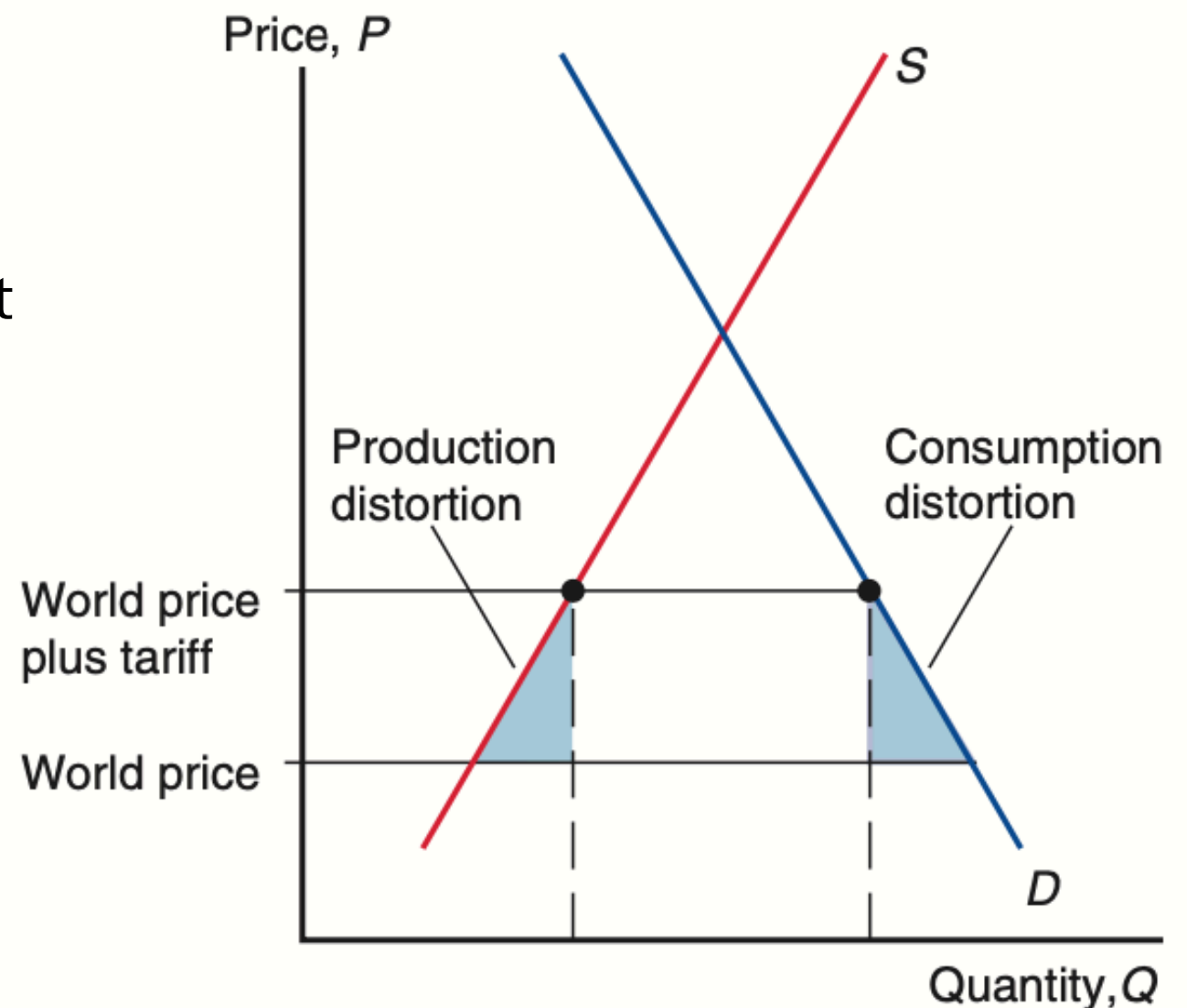
Topics

- The Case for Free Trade
- National Welfare Arguments against Free Trade
- Income Distribution and Trade Policy
- International Negotiations and Trade Policy
- The End of Trade Agreements?

The Case for Free Trade

Free Trade and Efficiency

- The efficiency case for free trade
 - The reverse of the CBA (cost-benefit analysis) of a tariff
- Generally, tariff cause a net loss in small country.
 - If country is not small, the net effect is ambiguous
 - Production distortion, and Consumption distortion
- \Rightarrow Free trade eliminate distortions



Estimation of Benefits of Free Trade

TABLE 10-1 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.

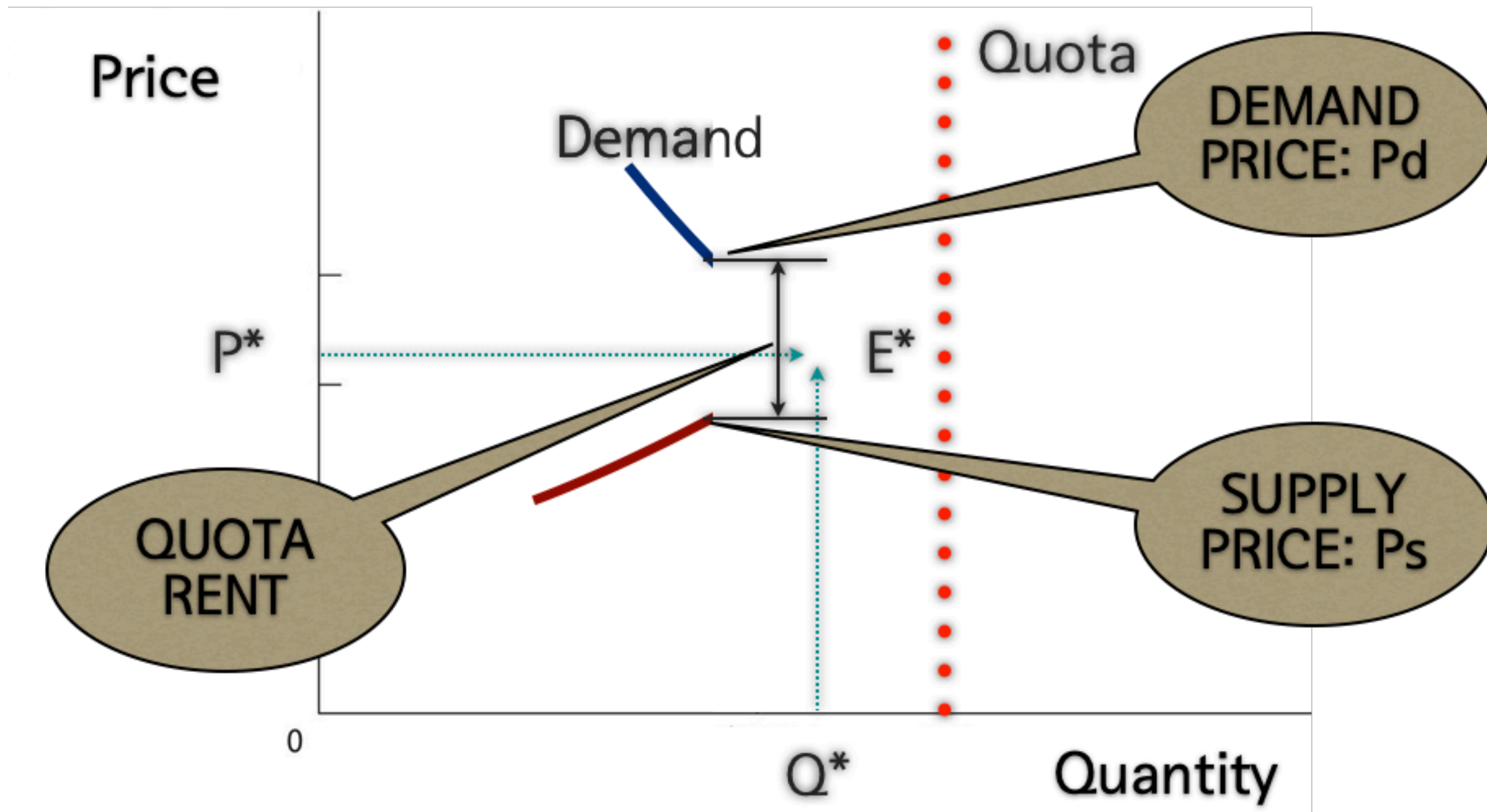
- Gain: < 1% of GDP
- Gains are relatively larger in developing countries
- Why? tariff rates are low + import quotas are relatively rare

Additional Gains from Free Trade

- For small & developing countries, they can gain more from
 - Economies of scale
 - Technological progress;
- Estimation is highly difficult
 - There is no consensus about the size of additional gain
 - A few study indicates that total gain will be larger than those of table 10-1

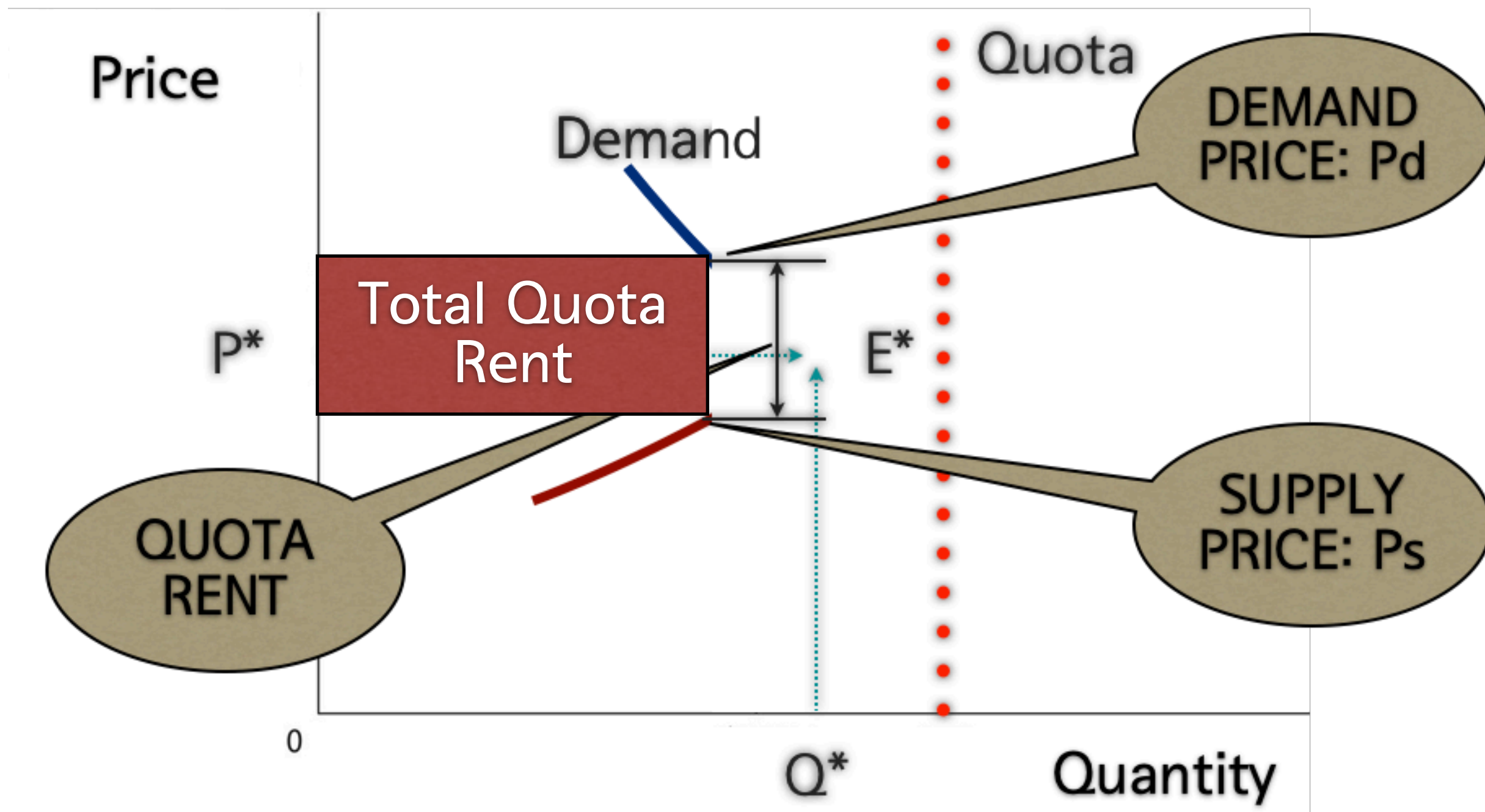
Rent Seeking

- The cost of quota $>$ the cost of tariff
- Rent seeking process magnify the cost of quota



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Case study: U.S. Imports of Canned Tuna

- Tuna is protected by TRQ(Tariff-rate Quota)
 - Tuna up to 4.8% of U.S. consumption can be imported at tariff rate of 6%
 - Any imports beyond 4.8% face a 12.5% tariff
- Consequence: Importers stock large quantities of canned tuna in late December and release them as soon as the year begins
 - The money for the warehousing lots of tuna in December = The additional cost of protection

Political Argument for Free Trade

- Political commitment to free trade may be a good idea in practice **EVEN THOUGH THERE MAY BE BETTER POLICIES**
- The attempt to pursue a sophisticated program of intervention in trade would probably be captured by interest groups and converted into a device for politically influential sectors
- Then, it may be better to advocate free trade without exceptions

Standard View of International Economists: Summary

- Basic costs of deviation from free trade are large
- There are additional benefits from free trade that add to the costs of protectionist policies
- Any attempt to pursue sophisticated deviations from free trade will be subverted by the political process

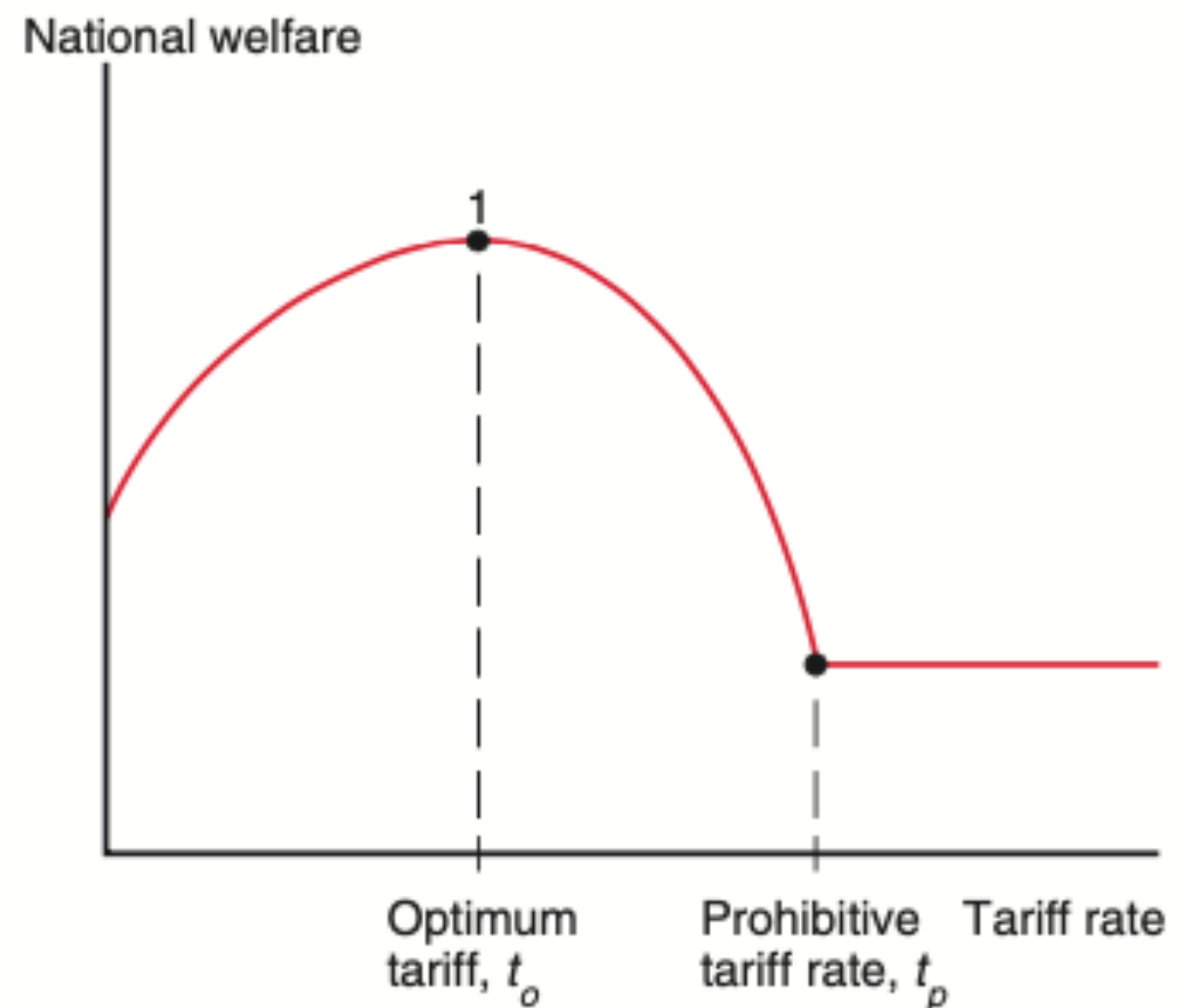
National Welfare Arguments against Free Trade

National Welfare Arguments against Free Trade

- There are some theories that activist trade policies can sometimes increase the welfare of the nation as a whole

The Terms of Trade Argument for a Tariff

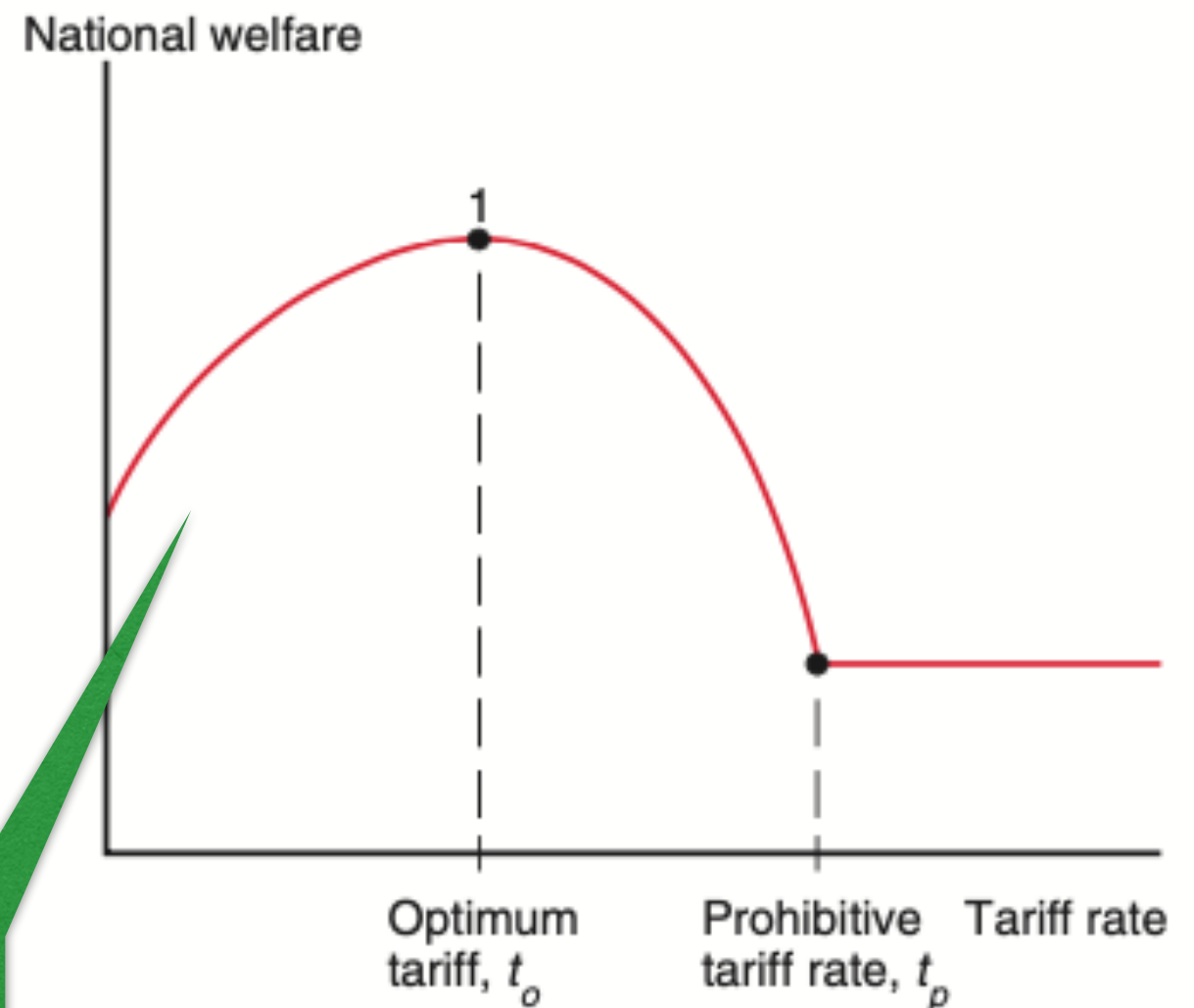
- For a large country (that can affect the prices of foreign exporters),
 - A tariff lowers the price of imports \Rightarrow a terms of trade benefit
 - If [Benefit of tariff] > [Cost of tariff] \Rightarrow tariff can be beneficial



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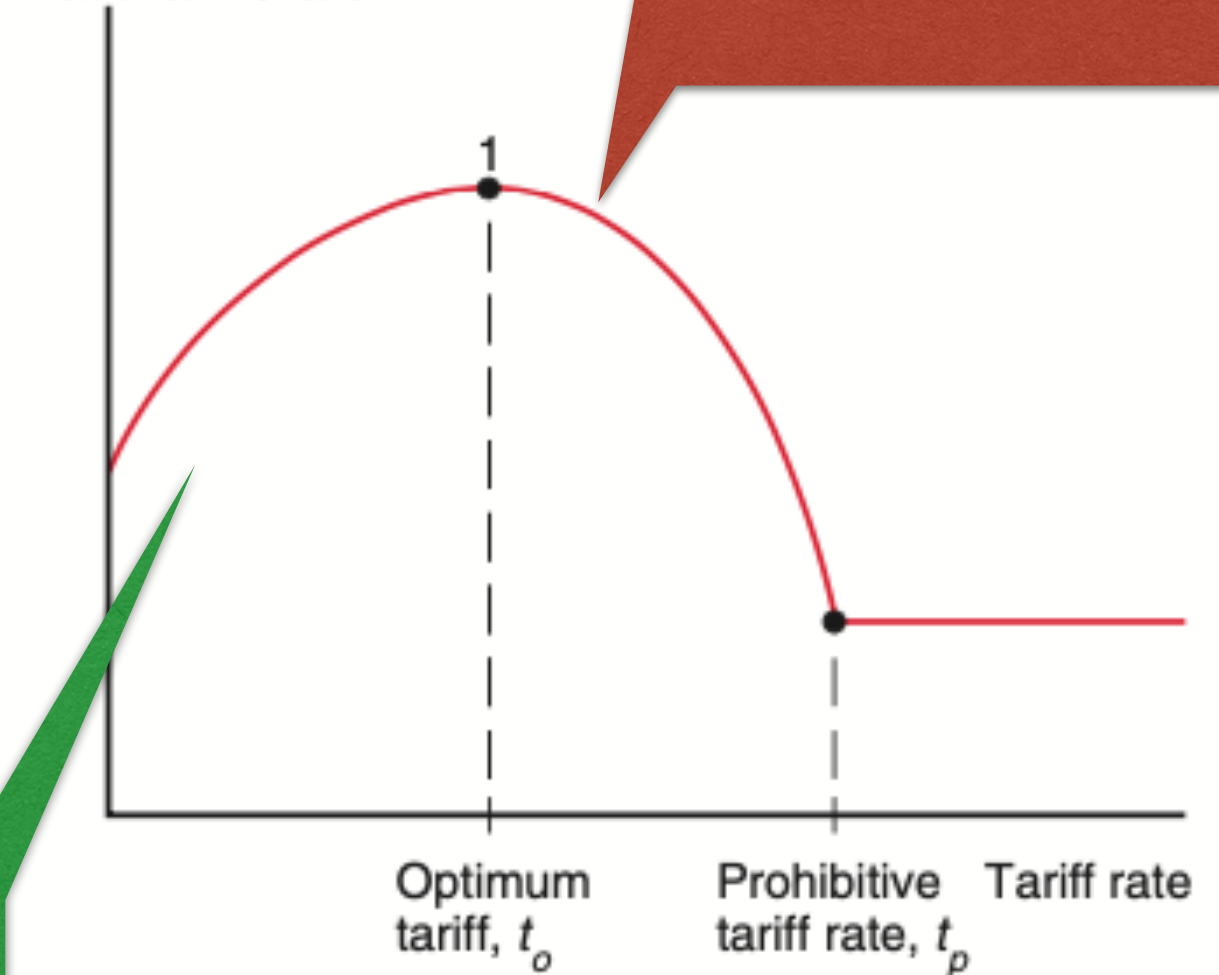


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National welfare



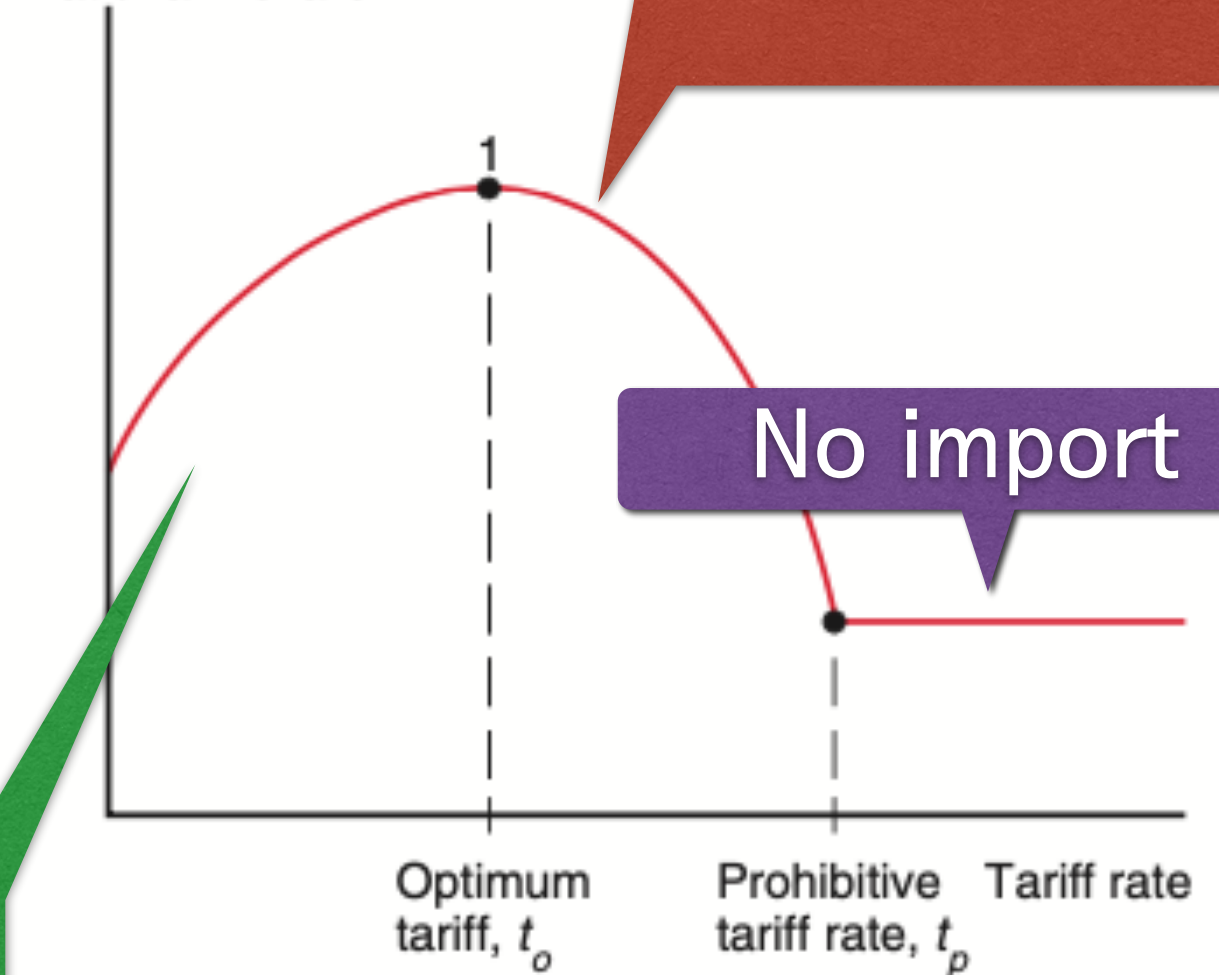
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National welfare



Benefit < Cost

No import

Limitations

- Only valid for large countries
 - Import tariffs / export taxes of most small countries cannot affect the world price \Rightarrow No change in the terms of trade
- For large countries, the terms of trade argument can be regarded as a predatory policy \Rightarrow Retaliation from other large countries

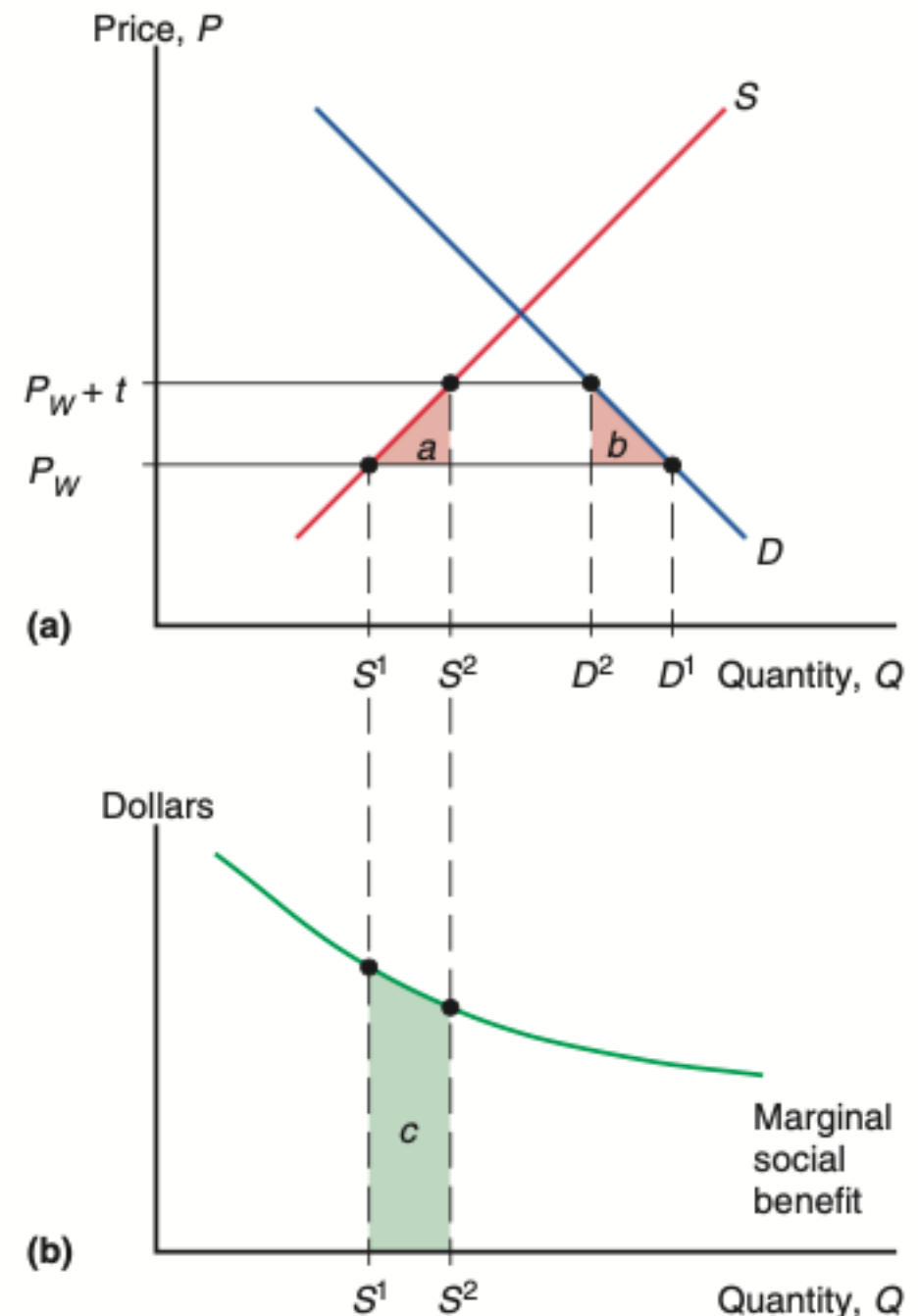
The Domestic Market Failure Argument against Free Trade

- Many economists think that producer surplus do not properly measure costs and benefits of producing a good
- Reasons: domestic market failures
 - A possibility of labor employed (would otherwise be unemployed)
 - Existence of defects in the capital or labor markets (low mobility)
 - Possibility of technological spillovers from producing

Marginal Social Benefit (MSB) to Additional Production

Small country

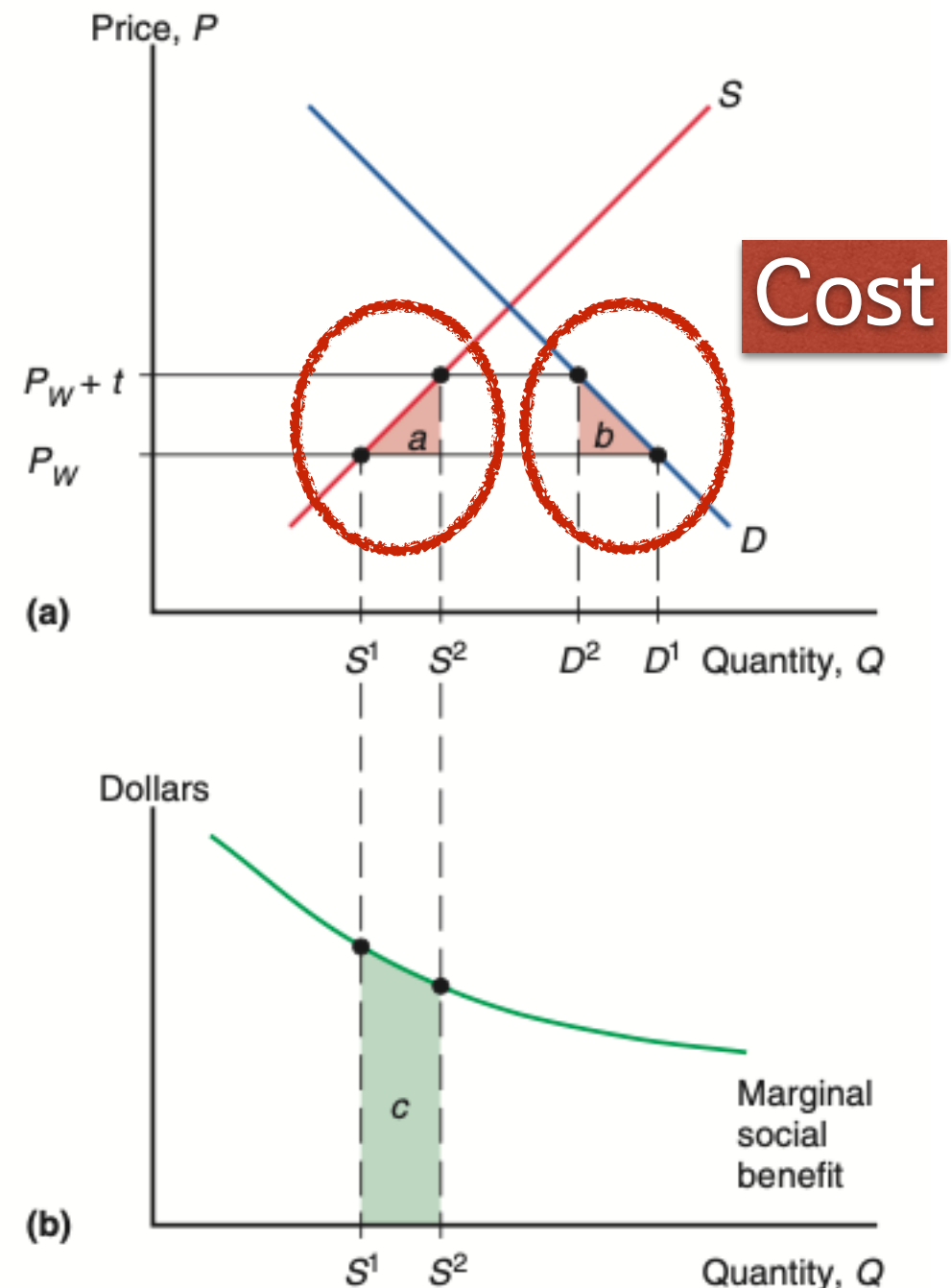
- Producer surplus measure cannot capture marginal social benefit to additional production
 - Example: Knowledge spillover from additional production
- MSB can serve as a justification for protectionist policies



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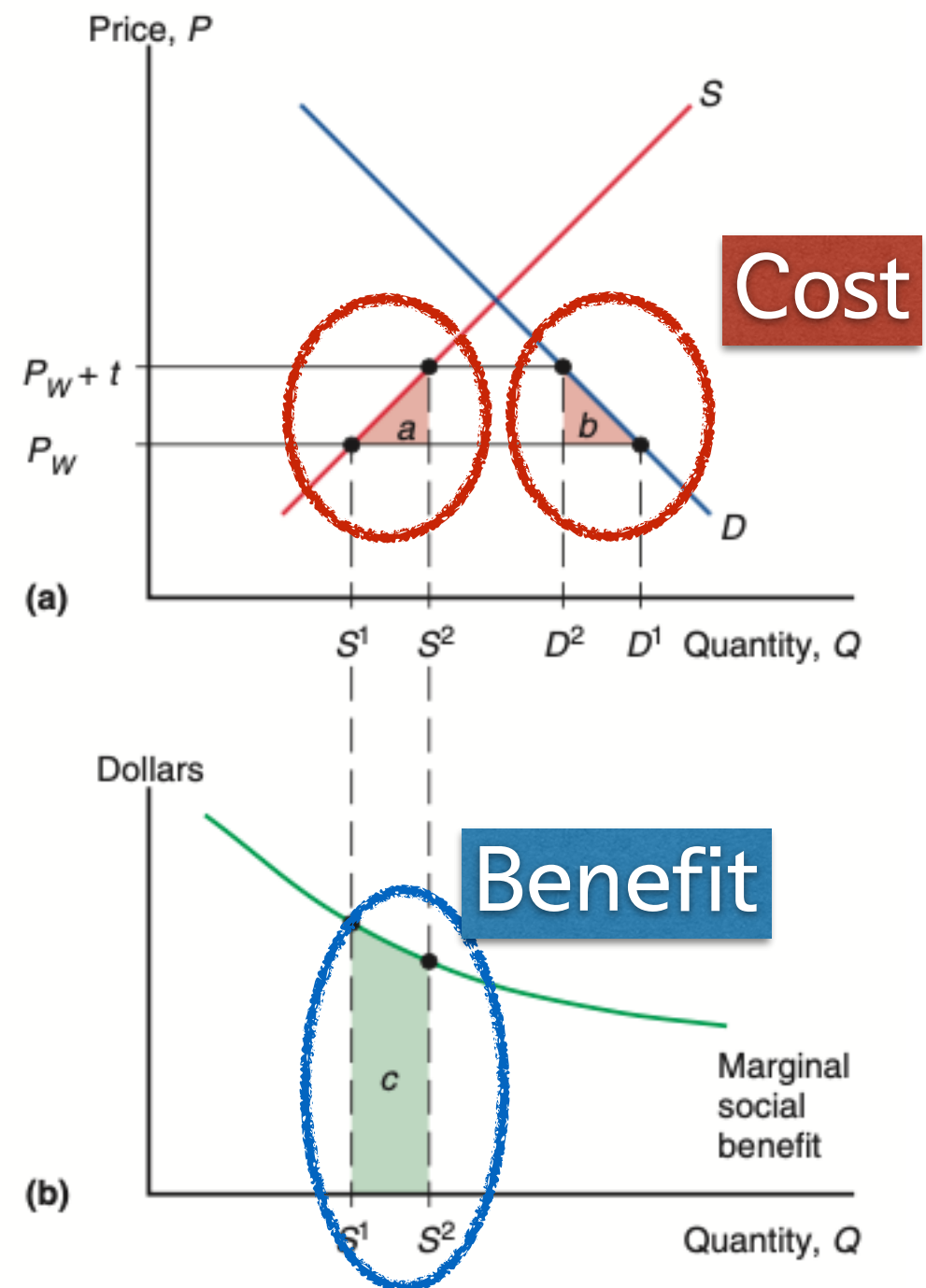
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The Theory of the Second Best

- A hands-off policy (such as free trade) is desirable only if all other markets are working properly.
- If markets are not working properly, government intervention might be able to increase welfare

Examples of the Second Best Policies

- A policy of subsidizing labor-intensive industries
 - It can be a good idea if the labor market cannot in the state of full employment
- This argument suggests that trade policy can provide at least a partial solution

How Convincing Is the Market Failure Argument?

- Markets in many poor nations are in the state of unemployment
- Even in the advanced countries there are some rooms to suggest major market failures as well
 - The inability of innovative firms which cannot receive full rewards of their innovations

Two Lines of Defense for Free Trade

- Domestic market failures should be corrected by domestic policies aimed directly at the problems' sources
 - It is always preferable to deal with market failures as directly as possible to avoid unintended distortions
 - They are always "second-best" rather than "first-best" policies
- Economists cannot diagnose market failure well enough to prescribe policy
 - Market failures are typically hard to identify precisely

Income Distribution and Trade Policy

Other Approach of Government Policy

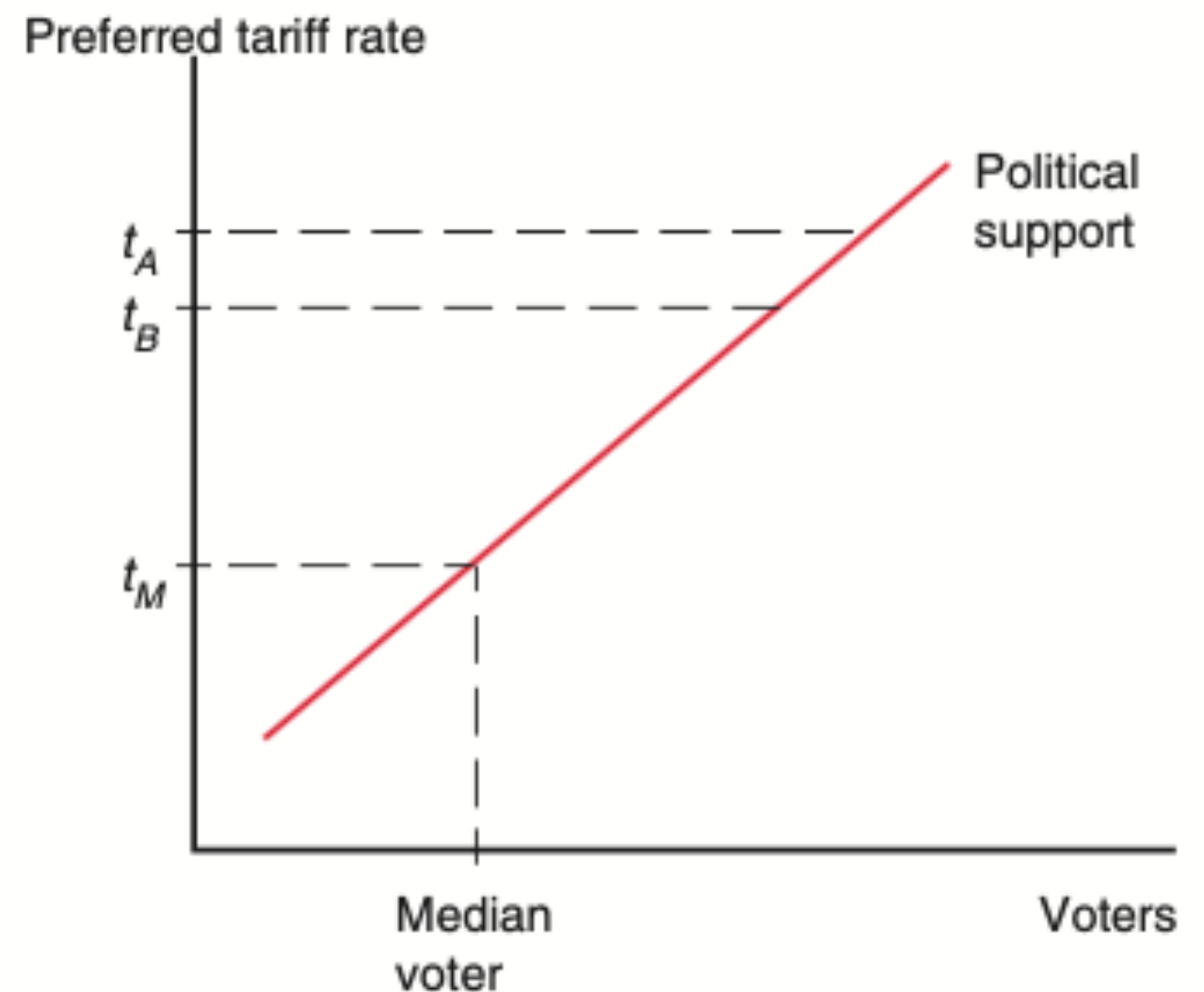
- Until now, governments are assumed that their aim is to maximize the national welfare
- But when looking at the actual politics of trade policy, governments seem to try to maximize political success rather than national welfare

Electoral Competition: Model Assumptions

- There are two competing parties
- Policy can be described along a single dimension (the level of the tariff rate)
- Voters differ in the policies they prefer
 - Example: a country exports skill-intensive goods and imports labor-intensive goods
 - Voters with high skill levels favor low tariff rate
 - Voters with low skill levels favor high tariff rate

Median Voter Theorem

- t_M : Tariff preferred by the median voter
 - Median voter: the voter who is exactly halfway up the policy lineup
- If one party suggest the tariff rate of t_A , then the other party can win the election by suggesting t_B
- Consequence: all the parties suggest t_M



Median Voter Theorem: Limitations

- In practice, the median voter model does not work very well in explaining trade policy
- From the median voter theorem, a politician should choose the policy which is beneficial to a large number of people
- However, many protectionist policies protect small groups at the cost of majorities

Collective Action

- There is a problem of collective action
 - It is hard to achieve when the group is huge and the individual benefit is small
- The problem of collective action can be overcome when:
 - a group is small
 - individual benefit is large
 - group is well organized

Case Study: US Dairy Protection

- U.S. dairy industry is protected by tariffs and quotas
- This protection is beneficial only 0.1% of the population
- Each U.S. customers pays for the protection by \$3 per year
- Reason: dairy producers are well organized to press the politicians



Modeling the Political Process

- Politicians need money to win their election
- If a politician can get money by protecting a industry, it can be a better policy to the politician
- As a result, well-organized groups will be able to get policies that favor their interests at the expense of the public as a whole

Who Gets Protected?

- In practice, much protectionism is concentrated in just two sectors:
 - Agriculture
 - Clothing

Agriculture

- In modern economies, there are not many farmers
- Usually, farmers are well-organized and politically powerful so as to achieve protection
 - EU's Common agricultural policy
 - Japan's tariff barrier for rice (1,000% in 1998)

Clothing

- The clothing industry consists of textiles and apparel
 - Textiles: spinning and weaving of cloth
 - Apparel: assembly of cloth into clothing
- Apparel have been protected heavily and was subject to the Multi-Fiber Arrangement (MFA) until 2005

Characteristics of Apparel Industry

- Labor-intensive
 - Low-wage countries have comparative advantage
- Well-organized in advanced countries
 - The expiration of the MFA lowered total welfare costs of U.S. Protection

TABLE 10-2 Welfare Costs of U.S. Protection (\$ billion)

	2002 Estimate	2015
Total	14.1	2.6
Textiles and apparel	11.8	0.5

Source: U.S. International Trade Commission.

International Negotiations and Trade Policy

International Negotiation

- From the mid-1930s until 1980, most of the advanced countries gradually removed tariffs and other barriers to trade
- It leads to a rapid increase in international integration
- It was achieved through international negotiation toward mutual tariff reduction

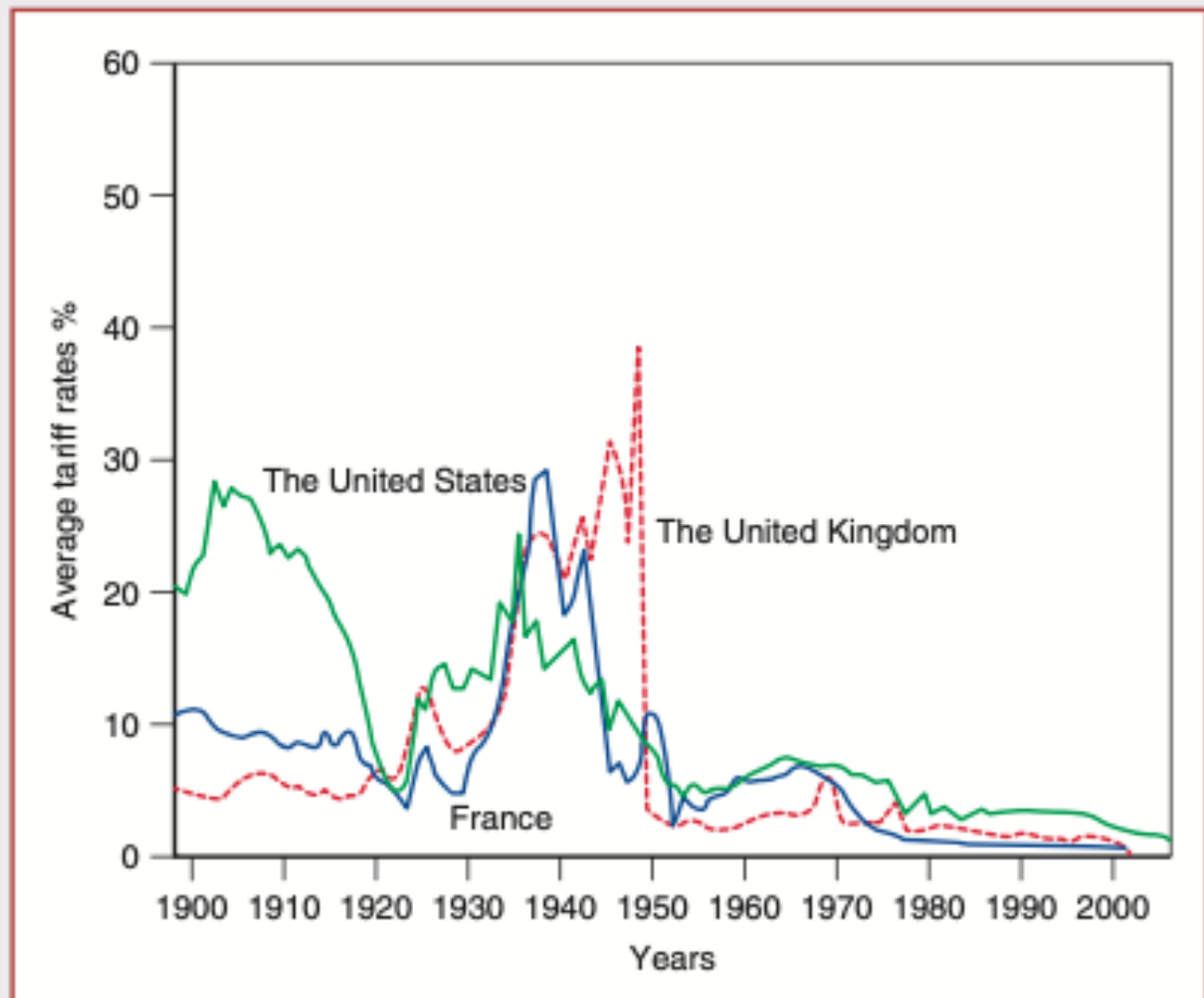


FIGURE 10-5

Average Tariff Rates on Total Imports (France, U.K., U.S.)

The Advantages of Negotiation

- To lower tariffs as part of a mutual agreement is easier than to do so as a unilateral policy because:
 - A mutual agreement helps mobilize support for free trade
 - It can help government avoid from trade wars

Political Support for Free Trade

- Usually, import-competing producers (disagreeing free trade) are better informed and organized than customers (agreeing free trade)
- International negotiations can bring in domestic exporters (agreeing free trade) as a counterweight
 - They are well informed and organized

Avoiding a Trade War

- Trade war (Protection - Protection) has the structure of a Prisoner's dilemma game
- The only way to avoid trade war is international agreement of free trade (Free trade - Free trade)

TABLE 10-3 The Problem of Trade Warfare

		Japan	
		Free trade	Protection
U.S.	Free trade	10, 10	-10, 20
	Protection	20, -10	-5, -5

A Brief History of International Trade Agreements (ITA)

- General Agreement on Tariffs and Trade (GATT)
 - 1947, 23 countries
- World Trade Organization (WTO)
 - established in 1995

GATT-WTO Approach to Trade

- Binding (ratchets)
 - A bounded tariff cannot be raised in the future by agreement
- Trade round (levers)
 - A large group of countries get together to negotiate a set of tariff reductions and other measures to liberalize trade
 - Eight rounds have been completed
 - The last round: Uruguay Round (1994)
- Ninth round Doha round (2001) did not complete for not (2019)

From the First Round to the Seventh Round

- The first five trade rounds (under GATT)
 - Parallel bilateral negotiations
 - Each country negotiates pairwise with a number of countries at once
- Sixth round (Kennedy Round, 1967)
 - Average 35% reduction in tariffs by major countries
- Seventh round (Tokyo Round, 1979)
 - New codes for controlling nontariff barriers

The Uruguay Round

- Began in 1986 at Punta del Este, Uruguay
- After eight years of hard negotiation, the agreement was signed in Marrakesh, Morocco in April 1994
- Result summary:
 - Trade Liberalization
 - Administrative Reforms

Trade Liberalization

- Average tariff rates fell almost 40%
 - Average 6.3% → 3.9% (small changes)
- More important result was to liberalize trade in agriculture and clothing
 - Agriculture: gradual reduction of trade barrier
 - Clothing: gradual process to end MFA (Multi-Fiber Agreement)

Administrative Reforms: From the GATT to the WTO

- WTO: established in 1995
- A full-fledged international organization
- It includes GATS (General Agreement on Trade in Services)
- And intellectual property (Agreement on Trade-Related Aspects of Intellectual Property)
- However the most important new aspect of the WTO is its "dispute settlement" procedure

Dispute Settlement Procedure

- Before WTO, (i.e., under GATT) it took several years to solve the issue
- The Uruguay round agreement introduced a more formal and structured procedure
 - The process cannot exceed one year

Benefits and Costs of Uruguay Round

- Hard to estimate
- GATT and OECD (Organization for Economic Cooperation and Development) estimates a gain to world economy is over \$200 billion annually, raising world income by about 1%
- The costs were felt by concentrated, well-organized groups
- The benefit accrued to broad, diffuse populations

Doha's Failure

Doha Round

- Began in 2001 at the Persian Gulf city of Doha
- No agreement was ever reached
- In fact, Doha's failure owes a lot to the success of previous trade negotiations

Reasons of Failure

TABLE 10-5 Percentage Gains in Income under Two Doha Scenarios

	Ambitious	Less Ambitious
High-income	0.20	0.05
Middle-income	0.10	0.00
China	-0.02	-0.05
Low-income	0.05	0.01
World	0.18	0.04

Source: See Table 10-4.

- Poor countries: Little incentive from agreements
- Rich countries: Under the political risk of powerful interest groups without something in return

Preferential Trading Agreement

- The international trade agreements should be nondiscriminatory
- All countries granted Most Favored Nation (MFN) status pay the same rates
- Preferential trading agreements: impose lower tariffs than other countries
 - Violation of the MFN principle
 - GATT forbids preferential trading agreements in general except for the case of free trade

Two ways of establishing Free Trade

- Free trade area
 - Inside of the area: no tariff
 - Outside of the area: can levy tariff
 - ex: NAFTA
- Customs Union
 - Inside of the union: no tariff
 - Union should levy same tariff against the outside of the union
 - ex: European Union

Effects of Customs Union

- Trade Creation (Desirable Effect)
 - Joining customs union can lead to new trade between other union members
- Trade Diversion (UNdesirable Effect)
 - Joining customs union also can just substitute trade with countries outside the union

Assignment Notice

- STEP1: Select article about international economics
 - If you have no idea what to read, choose one of the articles in the syllabus
- STEP2: Summarize to the Slide file (ex: pptx, google slide, etc)
- Pass or Fail
- Upload to blackboard assignment board until December 12

Next Topics

- Trade Policy in Developing Countries
- Chapter 11

Thank You!



Thank You!

