

The Political Economy of Trade Policy

- 1981: US asked Japan to limit its export of cars to the US. This goes beyond the cost and benefits analysis of the VER presented earlier this semester;
- Why do governments decide to liberalize or not trade? Are there any arguments that go beyond the conventional costs/benefits analysis?

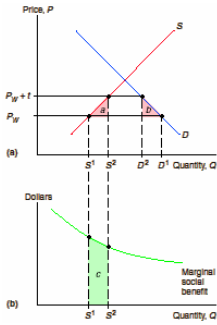
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- **Argument for free trade:**
 - The measured costs of deviating from free trade are large
 - Other gain from free trade. Because of economies of scale, protection leads to inefficient scale of production. Too many firms enter the protected industry because of positive profit.
 - Argentina: in 1964, one efficient scale assembly plant should have produced from 80000 to 200000 automobiles per year. The Argentine industry produced 164000 cars and had 13 firms!
 - Free trade → competition, innovation in the production and distribution processes

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- **Welfare** argument against free trade:
 - **Terms of trade argument** for a tariff. A large country that is able to affect the prices of foreign exporters lowers the price of its imports by setting a tariff. Recall the optimal tariff argument developed in the preceding sessions.
 - **Domestic market failure** as argument against free trade: labor market is not clearing or capital market is not allocating resources efficiently.

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The figure shows the effects of a tariff that raises the domestic price from P_w to P_w+t .

Production rises from S^1 to S^2 with a resulting production distortion indicated by a . Consumption falls from D^1 to D^2 , with a resulting consumption distortion indicated by the area b .

If we considered only consumer and producer surplus, we would find that the costs of the tariff exceed its benefits.

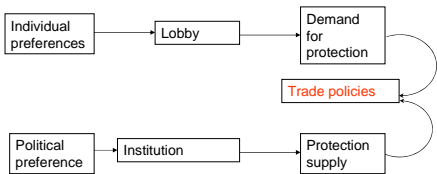
But additional benefit that may make the tariff preferable to free trade. The increase in production yields a social benefit that may be measured by the area c .

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- The domestic market failure argument against free trade is a particular case of a more general concept known as the **theory of the second best**.
 - Example the labor market: if there is unemployment a policy of subsidizing labor-intensive industries might turn out to be a good idea. It would be better to fix the labor market, for example, by making wages more flexible, but if for some reason this cannot be done, intervening in other markets may be a "second-best" way of alleviating the problem.

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- **Income distribution** argument against free trade:
 - there is no such thing as national welfare;
 - only the desires of individuals that want to maximize their welfare as a group or individually;
 - Trade policy might be endogenous;

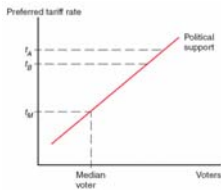


Source: Rodrik (1995)

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- Different type of model
 - **Electoral competition:**
 - Suppose two competing parties, each of which is willing to promise whatever will enable it to win the next election.
 - One policy: the level of tariff.
 - Suppose that voters differ in the policies they prefer.
 - » For example, imagine that a country exports skill-intensive goods and imports labor-intensive goods. Then voters with high skill levels will favor low tariff rates, but voters with low skills will be better off if the country imposes a high tariff (Stolper-Samuelson).
 - We can therefore think of lining up all the voters in the order of the tariff rate they prefer, with the voters who favor the lowest rate on the left and those who favor the highest rate on the right.

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Political Competition

Voters are lined up in order of the tariff rate they prefer. If one party proposes a high tariff of t_A , the other party can win over most of the voters by offering a somewhat lower tariff, t_B . This political competition drives both parties to propose tariffs close to the tariff preferred by the median voter t_M .

The Political Economy of Trade Policy

- Different type of model
 - **Collective action:** interest groups might "influence" policies by offering contributions to the government or the administration that is willing to win the election.
 - Politicians will not ignore overall welfare, but they will be willing to trade off some reduction in the welfare of voters in return for a larger campaign fund.
 - Result: well-organized groups are able to get policies that favor their interests at the expense of the public as a whole.

The Political Economy of Trade Policy

- Discussion so far: difficult to devise trade policies that raise welfare and trade policies are often dominated by interest group policies.
- Yet, the post-WWII has seen a increase in regional trade agreements or preferential trading agreements under which the tariffs applied between partners are lower than those between partners and the rest of the world

Economic Integration

- Most important aspects of the GATT/WTO:
 - Principle of non-discrimination;
 - Multilateral trade liberalization.
- Economic regionalism divides the world into preferred and discriminated partners.
 - compatibility between regional integration and the GATT/WTO;
 - US agrees with Germany to lower its tariff on imported machinery, the new tariff rate applies to machinery from any nation rather than just imports from Germany. Such nondiscrimination is normal in most tariffs. US grants many countries a status known formally as that of "most favored nation" (MFN), a guarantee that their exporters will pay tariffs no higher than that of the nation that pays the lowest.

Economic Integration

- Definition: elimination of economic barrier between 2 of more countries in order to gain the advantage of competition
 - lower prices for similar goods and services, greater quality, wider choice of varieties and challenge for process of production (product design, services, production and distribution process)

Economic Integration

- Examples of tighter interconnection among groups of countries:
 - Most famous example: EU
 - MERCOSUR (Latin America) NAFTA (North America), ASEAN (Asia)
 - WTO experiences ~ 130 agreements and 100 since 1995. Less agreements between LDCs that produce almost the same goods (for instance: agricultural products).

Economic Integration

- Tinbergen (1954): positive and negative integration:
 - positive integration: transfer to common institution or joint exercise of at least some powers;
 - negative integration: removal of discrimination in national economic rules and policies under joint surveillance;
 - in practice both positive and negative integration go together;

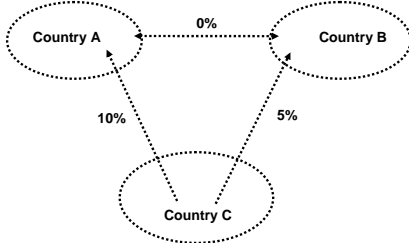
 - Negative integration only → one might not expect regional trade liberalization to work well.

Economic Integration

- The Balassa (1661) stage of economic integration:
 - **Free Trade Area (FTA):** negative integration:
 - tariffs and quotas are abolished for imports from area members;
 - area members retain national tariffs and quotas against third countries (no loss of sovereignty in trade policies);
 - rather complicated form of integration with respect to the rules of origin: where is the location of production within the FTA or from a third country?
 - examples: NAFTA, EFTA (1960): Austria, Denmark, UK, Switz., Sweden, Portugal., Norway.

Economic Integration

- **Free Trade Area (FTA)** need **rules of origin** to avoid trade deflection, that is, to avoid imports to the FTA from a 3rd-party country going through the member state with the lowest tariffs
- A's buyers have an interest to buy the products of C via B.



Economic Integration

- **Custom Union (CU):** negative integration:
 - suppressing discrimination for CU members in product markets;
 - equalization of tariffs and no or common quotas with non members
 - briefly: CU=FTA+common external trade policy;
 - Example: Belgium and Luxemburg before EU, European Union, CARICOM
- **Internal commodity market (CM):** no positive integration and is beyond GATT/WTO .
 - CM abolishes restrictions on factor, goods and services movement;
 - briefly: CM=CU+factors and goods mobility;
 - Example: the Single Market (1992): free mobility of capital, labor good and services within the European Community.

Economic Integration

- **Economic union :** positive integration but remains extremely formless:
 - a CM with some degree of harmonization of national economic policies (for instance: standards) in order to remove discrimination;
- **Total economic integration:** supranationality, unitary state
 - Unification of monetary, fiscal, social and counter cyclical policies;
 - Setting up a supranational authority where decisions are binding for the Member States

Economic Integration

Summary	No visible trade restriction	Common external trade restriction	No invisible trade restriction	Free mobility of factors of production and assets	Harmonization of national policies	Unification of monetary, fiscal and social policies
Free trade area	X					
Custom unions	X	X				
Internal commodity market	X	X	X			
Common market	X	X	X	X		
Economic union	X	X	X	X	X	
Total Economic integration	X	X	X	X	X	X

Economic Integration

- Stages of Balassa degree of integration are presented sequentially for analytical reasons BUT no compelling reasons to follow the sequence:
 - European Economic Community (EEC) have started with a CU, not a FTA
- Problems with Balassa's degrees of integration:
 1. number of experience of economic integration that does not even reach the FTA stage but a part of it (on some products): the 1965 US-Canada automotive agreement;
 2. no real frontier between FTA and CU for some experience:
 - CER (also called ANZCERTA: Australia New Zealand Closer Economic Relation Trade Agreement) and NAFTA contains some elements of a common market;
 - Same for European Free Trade Area (EFTA) and the EEC in 1992.

Economic Integration

3. CM attains the free movement of products, services and factors of production accompanied by the necessary positive integration for the CM to function properly;
4. Justification of the supranational state only in the final stage ?

Economic Integration

- Tariff reduction is a good thing that raises economic efficiency:
 - At first, it might seem that preferential tariff reductions are also good, if not as good as reducing tariffs all around.
 - This conclusion might be too optimistic: it is possible for a country to make itself worse off by joining a FTA or customs union. (Viner, 1950)
- trade-creation and trade-diversion effects.

Economic Integration

- Trade-creation and trade-diversion effects:
 - trade-creation: arise when domestic production is replaced by cheaper products from other parts of the CU (partner country);
 - trade-diversion: arise when imports from countries outside the CU are replaced by more expensive imports from partner countries.

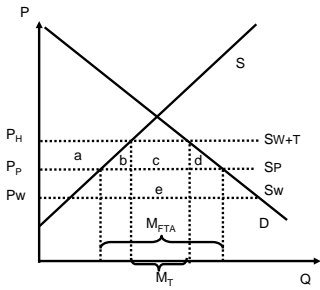
Economic Integration

- Example: consider a single good X

Country	H	P	W
Price=unit costs	35	25	20
Price included 100% tariff	-	50	40
Price included 50% tariff	-	37.5	30

- H is the least efficient producer. Impose a tariff rate of 100%. H provide the entire domestic consumption.
H and P create a CU while the CU maintains a 100% tariff against W, P is the most efficient producer → CU has thus a trade-creation effect. Positive welfare impact
- If the tariff rate is only 50%. H imports from W. The world price is however only 20 (difference is the tariff)
H and P create a CU while the CU maintains a 50% tariff against W, consumers face a lower price 25 instead of 30, but W had 20 → CU has thus a trade-diversion effect.

Economic Integration



- A small country H forms a customs union with a partner P.
- S_H and D_H are the supply and demand curve for H. S_P and S_W are respectively the supply of partner P and outside world;
- Initial situation: H imposes a non-discriminatory specific tariff, T , on its imports;
 - M_T level of import without FTA or CU
 - M_{FTA} : level of import if H and P form a CU or FTA

Economic Integration

- In this example: trade diversion in the Vinerian sense since H imports all its imports from the more expensive producers P;
- But at the same time: reduction of domestic production in favor of cheaper imports from the partner country (positive specialization effect) and an increase of the domestic consumption (positive substitution effect)
→ H total import increase so it is also a trade creating effect.
- → Johnson (1962) suggests to define trade creation and trade diversion more precisely in order to take into account welfare effects.

Economic Integration

- Total welfare effect of the CU:

Consumer's surplus	$a+b+c+d$
Producer's surplus	$-a$
Tariff revenue	$c+e$
Welfare effect	$b+d+e$

- **Positive welfare effect:** more production (b) and more consumption (d). The trade-creation effect is therefore the sum of $b+d$
- **Negative welfare effect:** is due to the terms of trade deterioration which the home country suffer when it substitutes more expensive imports from the P country (e)

Economic Integration

- Empirical studies on the trade effects:
 - European Union: most studies conclude a trade-creation effect that is larger than the trade-diversion effect. For almost all industries except the agricultural sector
 - Same for NAFTA.
 - MERCOSUR: 1991 Argentina, Brazil, Paraguay, and Uruguay, formed a free-trade area known as Mercosur. Within four years the value of trade among the nations tripled. study prepared by the World Bank's chief trade economist concluded that despite Mercosur's success in increasing intra-regional trade, the net effects on the economies involved were probably negative.
 - consumers in the member countries were being induced to buy expensively produced manufactured goods from their neighbors rather than cheaper but heavily tariffed goods from other countries.
