

# Chapter 9

## **The Political Economy of Trade Policy**

(Chapter 10 of the text book)

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### Preview

The cases for free trade

The cases against free trade

Political models of trade policy

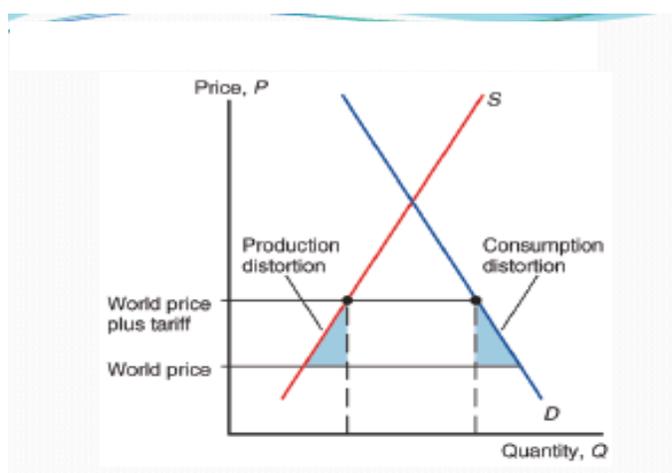
## Efficiency argument

- Efficiency argument: When adopting free trade policy
    - Producers and consumers **allocate resources most efficiently**.
    - National welfare of a small country is highest with free trade, no deadweight loss
    - If using restricted trade policy, price is distorted, resulting in inefficient production increase. Consumers pay higher prices. Distorted prices also cause overproduction either by existing firms producing more or by more firms entering the industry.
- => Free trade helps the economy perform efficiently

## Efficiency argument (cont.)

Fig. 10-1: The Efficiency Case for Free Trade

A move to free trade eliminates these distortions and increases national welfare => **static benefits**



9-4

## Efficiency Argument (cont.)

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.

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.

9-5

## Rent seeking argument

- Rent seeking (hành động tìm kiếm đặc lợi)
- Rent seeking: a concept developed by Anne Krugger (former IMF's Deputy Director)
- Rent-seeking involves seeking to increase one's share of existing wealth without creating new wealth (therefore must decrease other wealth => inequality, poor allocation of resource, lost government revenue...)
- Rent-seeking will result in protection for domestic enterprises. Under this protection, the domestic enterprises will not try to innovate and increase competitiveness, but only try to retain protection from the government (through lobbying e.g...)

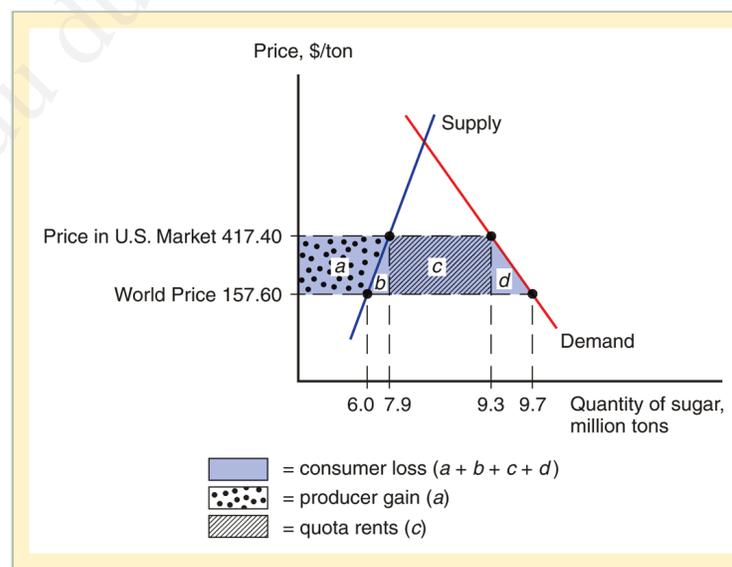
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## Rent seeking argument (cont.)

- Rent seeking => presence of trade barriers
- When quotas are used instead of tariffs, costs can be magnified through **rent seeking**.
  - E.g: US canned tuna tariff rate quota: in-quota tariff rate 6%, out-of-quota tariff 12.5%
    - right to import canned tuna is assigned by a first come, first served basis
    - costly race to import canned tuna in US as quickly as possible => stockpiling large quantities of canned tuna in Custom bonded warehouse
    - The money importers spend on warehousing lots of tuna represents a loss to the whole US economy.
- => To seek quota licenses or the rights to sell a restricted number of imports and the profit, individuals or institutions need to spend time and other resources.
- Thus, free trade allocates resources efficiently

9-7

## US Import Quota on Sugar



## Political argument

- **Political argument for free trade**
    - In many cases, political reasons result in protectionism (car industry)
    - Economists often argue that trade policies in practice are dominated by special interest politics rather than by consideration of national costs and benefits
    - Any policy that deviates from free trade would generally be manipulated by political groups/interest group, leading to a protection to politically influential sectors => decreased national welfare.
- => Therefore, free trade must be supported because free trade will be not influenced by political reasons and bring about efficiency for the whole economy

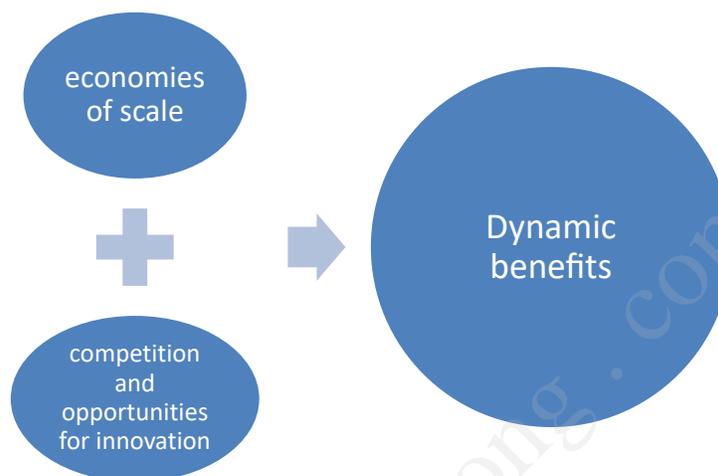
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## Additional gains from free trade

- Free trade allows firms or industry to take advantage of **economies of scale**.
  - Specialization
  - Lower unit cost, more efficient production
  - Variety of goods for consumption
- Free trade provides **competition and opportunities for innovation**.
  - An incentive to seek new ways to export or compete with importers
  - More productive firms to engage in exports
  - Free trade makes the economy as a whole to be more efficient
  - Today, no two forces are driving this global economic transformation more than technology and trade (World Trade Report 2017)

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## Additional gains from free trade (cont.)



## Additional gains from free trade (cont.)

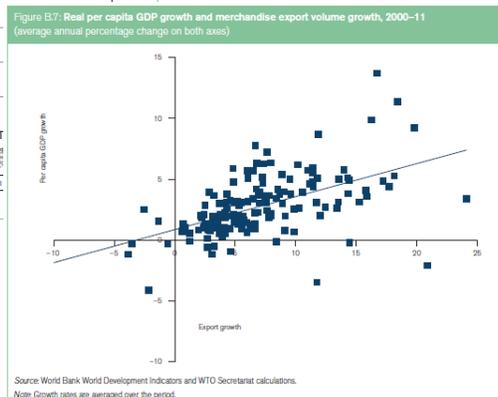
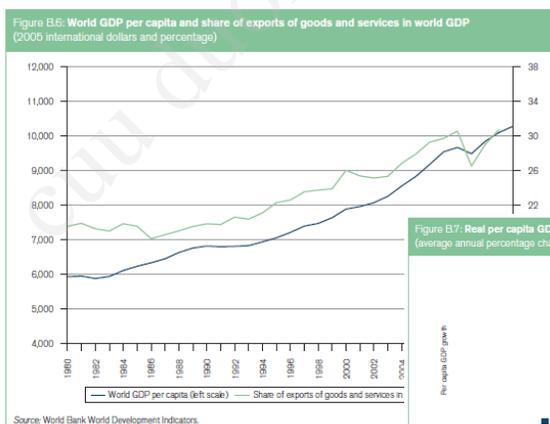
- Allocate efficiently resources at global scale
- Promote comparative advantage => specialization => Reach economies of scale
- Increase productivity and efficiency => economic growth => increase welfare
- Create employment
- Good for consumers: lower prices, more variety
- Labor will be better off when moving to other countries with higher wage

9-12

## Additional gains from free trade (cont.)

- Attract foreign investment/and technology transfer through trade channel
- Lower government spending (e.g: subsidies)
- Encourage the participation in global value chain: Toyota
  - In 1980s: Toyota produced cars that were “Made in Japan”
  - today it produces cars that are “Made in the World”.
  - The Japanese workforce: before was employed on assembly lines; now increasingly engaged in running a highly integrated and technologically complex system of global production
  - The rise of such global production networks – in effect “world factories” – is only possible because of the marriage of open trade and integrating technologies.<sup>9-13</sup>

## Trade and development



## Preview

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The cases against free trade

Political models of trade policy

## Terms of trade argument for a tariff

A large country imposes tariff

Lower the price of imports in the world market

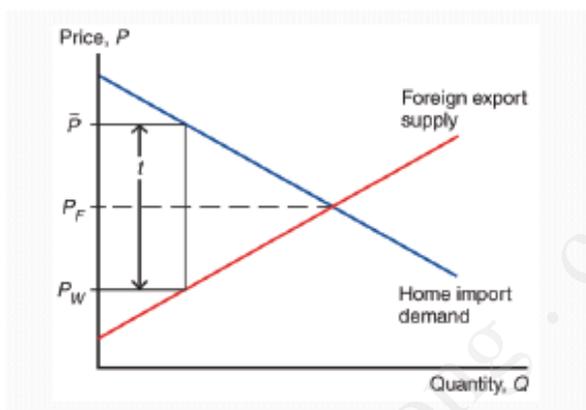
Improve Terms of Trade (TOT)

Improve welfare if  $e > b+d$

Optimum tariff

## Terms of trade argument for a tariff (cont.)

Effects of a Tariff on Prices in a large country case



9-17

## Terms of trade argument for a tariff (cont.)

Welfare Effects of a Tariff



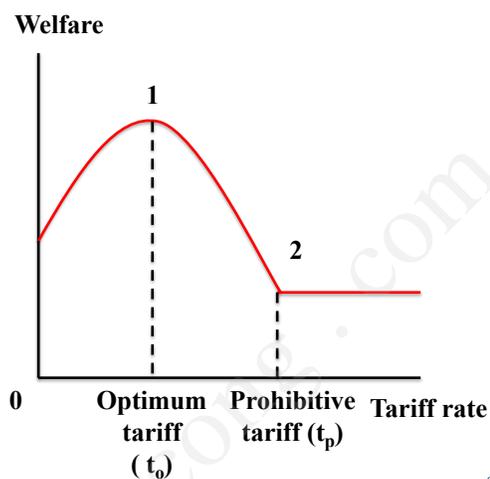
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## Terms of trade argument for a tariff (cont.)

### The Optimum Tariff

In fact, a small tariff will lead to an increase in national welfare for a large country.

But at some tariff rate, the national welfare will begin to decrease as the economic efficiency loss exceeds the terms of trade gain.

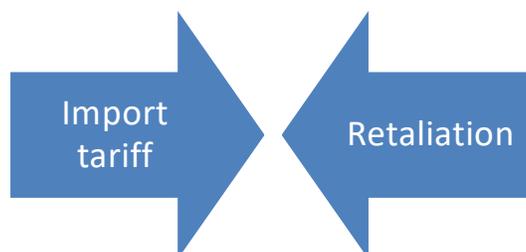


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## Terms of trade argument for a tariff (cont.)

### Counter-Argument

- Terms of trade argument for tariff is applicable to only large countries that can affect the world prices => improve their term of trade
- However, even in large country case, import tariff can lead to retaliation => eventually lower welfare



## Domestic market failure argument

- Domestic market failures include
    - Failure of labor market
    - Externalities
    - Monopoly
    - Asymmetric information
- => Require trade protectionist policies to overcome market failure

9-21

## Domestic market failure argument (cont.)

- Failure of labor market
  - Labor market is not clearing, labor is unemployed or under-employed
  - Trade Measures: subsidize labor-intensive industry, impose import tariff on labor-intensive industry

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## Domestic market failure argument (cont.)

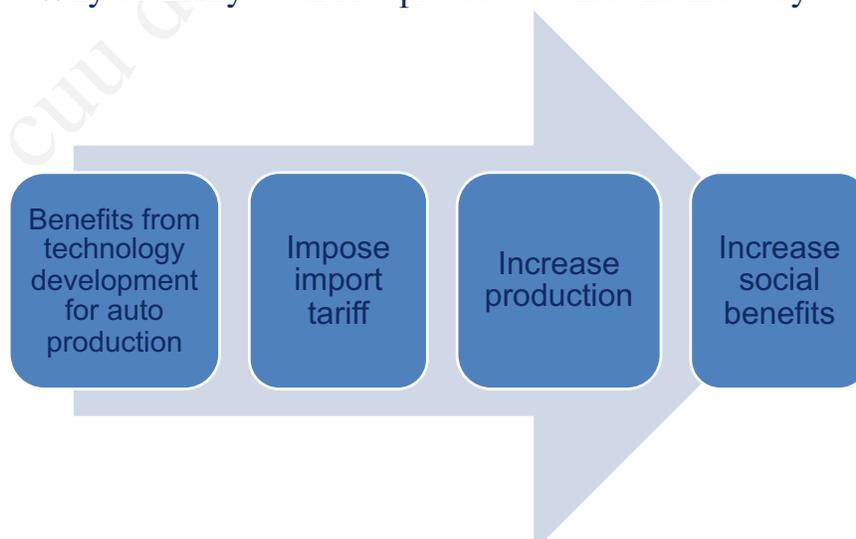
- Externalities

- Positive externalities: Technological benefits for society discovered through private production, but from which private firms can not fully profit
  - E.g: Develop clean and modern technology, vaccination
  - Produce less than optimal production
  - Measures: export subsidies, domestic subsidies, import tariff...
- Negative externalities: Environmental costs for society caused by private production, but for which private firms do not fully pay
  - E.g: Using backward tech => pollute environment
  - Produce more than optimal production
  - Measures: Regulations on waste limit, required technology, and production process; pollution tax

9-23

## Domestic market failure argument (cont.)

Why do many countries protect automobile industry?



## Domestic market failure argument (cont.)

### ❖ Asymmetric information

- Whenever one party possesses greater knowledge and information than the other party in economic transaction. Almost all economic transaction involve information asymmetry.
- Eg: The seller of a goods has greater knowledge and information than the buyer. Consumers therefore are at disadvantage in economic transaction.

### • Trade measures

- Regulations on labels to provide information to buyers, helping them to know quality of products and buy the right product, and making sure that the goods are sold at the right price
- Subsidize exports to encourage the foreign buyers to imports “pilot products”
- Fitting room to try clothes

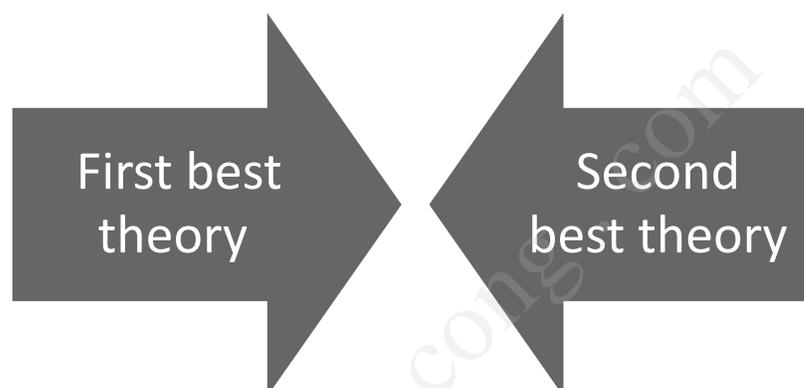
## How convincing is the market failure argument?

- It is very difficult to identify when and to what degree a market failure exists in the real world
- It is unclear when and to what degree government policies should respond/intervene.
- Government policies to address market failures are likely to be manipulated by politically powerful groups.
- Because government intervention distorts the incentives of producers and consumers, a trade policy may have unintended consequences that make a situation worse, not better.

9-26

## How convincing is the market failure argument? (con.)

What should government do? Should government adopt trade policies to fix market failure?



## The “first-best” policy

- Domestic market failures should be corrected by domestic policy
- Domestic policy is the “first-best” policy because it aimed directly at the source of the problem.
  - E.g: unemployment
  - First best policies: using domestic policy such as making wages more flexible, provide re-training...
- ❖ But if the government cannot use “the first-best policy”, it can use “the second-best policy”

9-28

## The “second-best” policy

- Trade-related policy might be the second best policy – the second best way of fixing the problems.
- E.g: Unemployment
  - The second best policy: subsidizing labor – intensive industries, imposing tariff on industry with high unemployment
- ❖ The domestic policies should be used first rather than trade policies because
  - ❖ trade policies can result to unexpected negative impacts on the domestic economy (retaliation...)
  - ❖ The cost of trade policies are often larger than the cost of domestic policies.
- ❖ However, in practice, trade policies are often used because their costs are less transparent and the community often are not fully aware of their damage.

9-29

## Political argument

- Political activity is often described as a **collective action problem**:
  - While consumers *as a group* have an incentive to advocate free trade, each *individual* consumer has no incentive because his benefit is not large compared to the cost and time required to advocate free trade.
  - Policies that impose large losses for society as a whole but small losses on each individual may therefore not face strong opposition.

## Political argument

- Political activity is often described as a **collective action problem**:
  - The number of producers is small, therefore benefits from protection as a whole is small but large benefits on each individual
  - Producers have big incentive to carry out collective action to lobby the government approve trade protectionist policies
- ❖ Trade policies are manipulated by political groups through lobbying activities, funding (especially in voting campaign)
  - ❖ E.g: tariff on steel and aluminum of the US

## Other arguments against free trade

- Income Inequality
- Competition
- Protect culture
- Reduce government revenue
- Outsourcing => Unemployment
- Expand gap between developed and developing countries
- Harm environment, exhaustion of natural resources
- National security and sovereignty
- Some adjustment costs for the developing countries: e.g IP

9-32

## Preview

The cases for free trade

The cases against free trade

Political models of trade policy

## Political Models of Trade Policy

- How is trade policy determined?
- Models that address this question:
  1. Median voter theorem
  2. Collective action
  3. A model of trade policy that combines aspects of collective action and the median voter theorem

9-34

## Median Voter Theorem

- Assumptions of the model:
  1. There are two competing political parties
  2. Tariff rate policy
  3. The objective of each party is to get elected by majority vote
  4. Voters can be ranked according to whether they desire high or low tariff rates.

9-35

## Median Voter Theorem (cont.)

- What policies will the parties promise to follow?
  - Both parties will offer the same tariff policy to court the median voter (the voter in the middle of the spectrum) in order to capture the most votes on either side of the median voter.

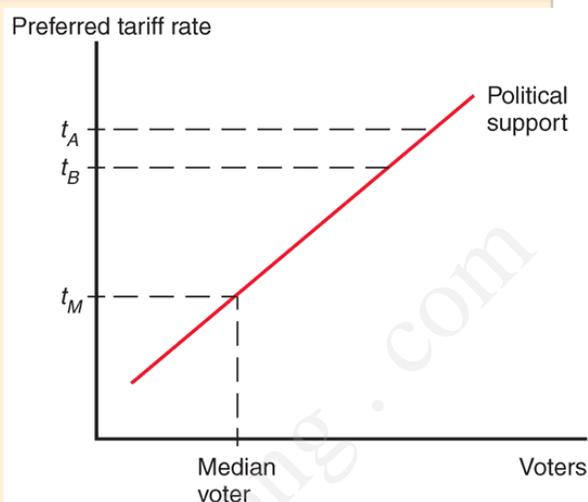
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## Political Competition

**Figure 10-4**

### 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  $t_M$ , the tariff preferred by the median voter.



9-37

## Median Voter Theorem (cont.)

- Thus, the median voter theorem implies that a two-party democracy should enact trade policy based on how many voters it pleases.
  - A policy that inflicts large losses on a few people (import-competing producers) but benefits a large number of people (consumers) should be enacted into law.
- But trade policy doesn't seem to follow this prediction.

9-38

## Collective Action

- Political activity is often described as a **collective action problem**:
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9-39

## Collective Action (cont.)

- However, for those groups who may suffer large losses from free trade (for example, unemployment), each individual in that group has a strong incentive to advocate the policy he desires.
  - In this case, the cost and time required to advocate restricted trade is small compared to the cost of unemployment.

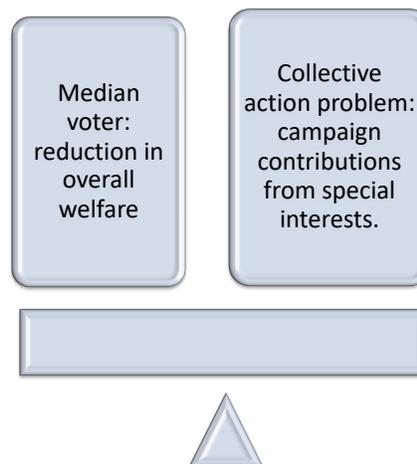
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## A Model of Trade Policy

- While politicians may win elections partly because they advocate popular policies as implied by the median voter theorem, they also require funds to run campaigns.
- These funds may especially come from groups who do not have a collective action problem and are willing to advocate a special interest policy.

9-41

## A Model of Trade Policy (cont.)



9-42

## Which Industries Are Protected?

- **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.

9-43

## Which Industries Are Protected? (cont.)

- **Clothing:** textiles (fabrication of cloth) and apparel (assembly of cloth into clothing).
  - Until 2005, quotas licenses granted to textile and apparel exporters were specified in the Multi-Fiber Agreement between the U.S. and many other nations.

9-44

## Summary

1. The cases for free trade are that
  - It allows consumers and producers to allocate their resources freely and efficiently, without price distortions.
  - It may allow for economies of scale.
  - It increases competition and innovation.
  - Other dynamic impacts
2. The cases against free trade are that trade restrictions may allow
  - Terms of trade argument
  - Market failure argument – First best policies and second best policies
  - Political arguments
  - Other arguments
3. Policy choice for Vietnam

9-45

## Summary (cont.)

3. Models of trade policy making consider incentives to adopt popular policies as well as incentives to adopt unpopular policies if these policies are advocated by groups that make political contributions.

Agricultural and clothing industries are the most protected industries in many countries.

9-46

END OF CHAPTER 9

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9-47

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