INTERNATIONAL TRADE

Chapter 9: Political Economy of Trade Policy

Preview

- **The cases for free trade**

- Static benefits

- Dynamic benefits

- **Arguments against free trade**

- Big countries case

- Market Value

- **International negotiations of trade policy and WTO**

The cases for free trade

- The first case for free trade is the argument that producers and consumers **allocate resources most efficiently** when governments do not distort market prices through trade policy

  - National welfare of a small country is highest with free trade

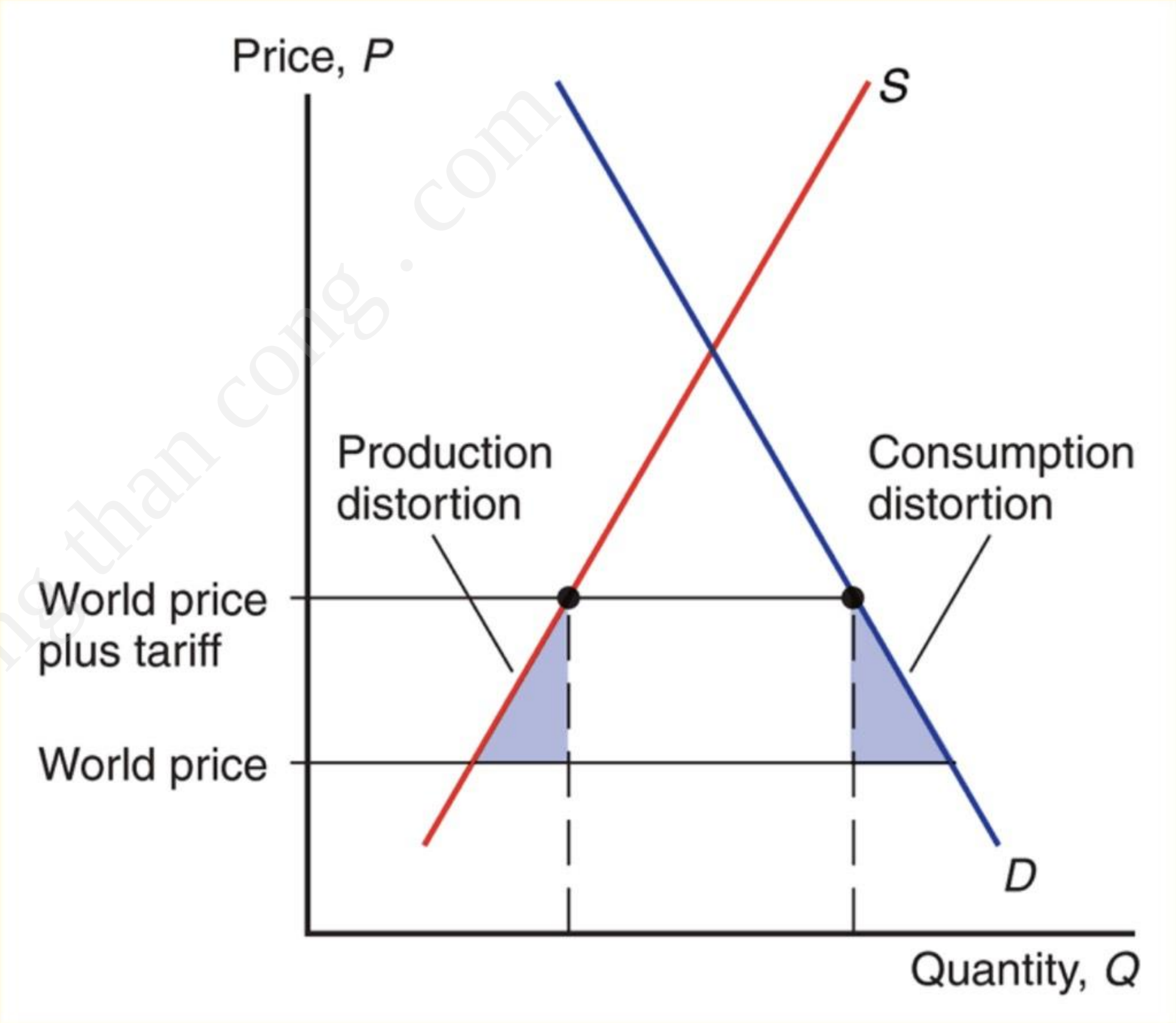
  - With restricted trade, consumers pay higher prices

  - With restricted trade, distorted prices cause overproduction either by existing firms producing more or by more firms entering the industry

Figure 9-1

The Efficiency Case for Free Trade

A trade restriction, such as a tariff, leads to production and consumption distortions.



The cases for free trade

- However, because tariff rates are already low for most countries, estimated benefits of moving to free trade are only a small fraction of national income for most countries
- In the modern world, tariff rates are generally low and import quotas relatively rare. As a result, estimates of the total costs of distortions due to tariffs and import quotas tend to be modest in size

TABLE 9-1 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.

Yet for some countries in some time periods, the estimated cost of protection was substantial.

TABLE 9-2 Estimated Cost of Protection, as a Percentage of National Income

Brazil (1966)	9.5
Turkey (1978)	5.4
Philippines (1978)	5.4
United States (1983)	0.26

Sources: Brazil: Bela Balassa, *The Structure of Protection in Developing Countries* (Baltimore: The Johns Hopkins Press, 1971); Turkey and Philippines: World Bank, *The World Development Report 1987* (Washington, D.C.: World Bank, 1987); United States: David G. Tarr and Morris E. Morkre, *Aggregate Costs to the United States of Tariffs and Quotas on Imports* (Washington, D.C.: Federal Trade Commission, 1984).

Dynamic benefits

- A second argument for free trade is that allows firms or industry to take advantage of **economies of scale**
- A third argument for free trade is that it provides **competition and opportunities for innovation**
- These dynamic benefits would not be reflected in static estimates of the elimination of efficiency losses of producers, caused by distorted prices and overproduction

The cases for free trade

- A fourth argument called the **political argument for free trade**, says that free trade is the best feasible political policy, even though there maybe better policies in principle
- Any policy that deviates from free trade would be quickly manipulated by special interests, leading to decreased national welfare

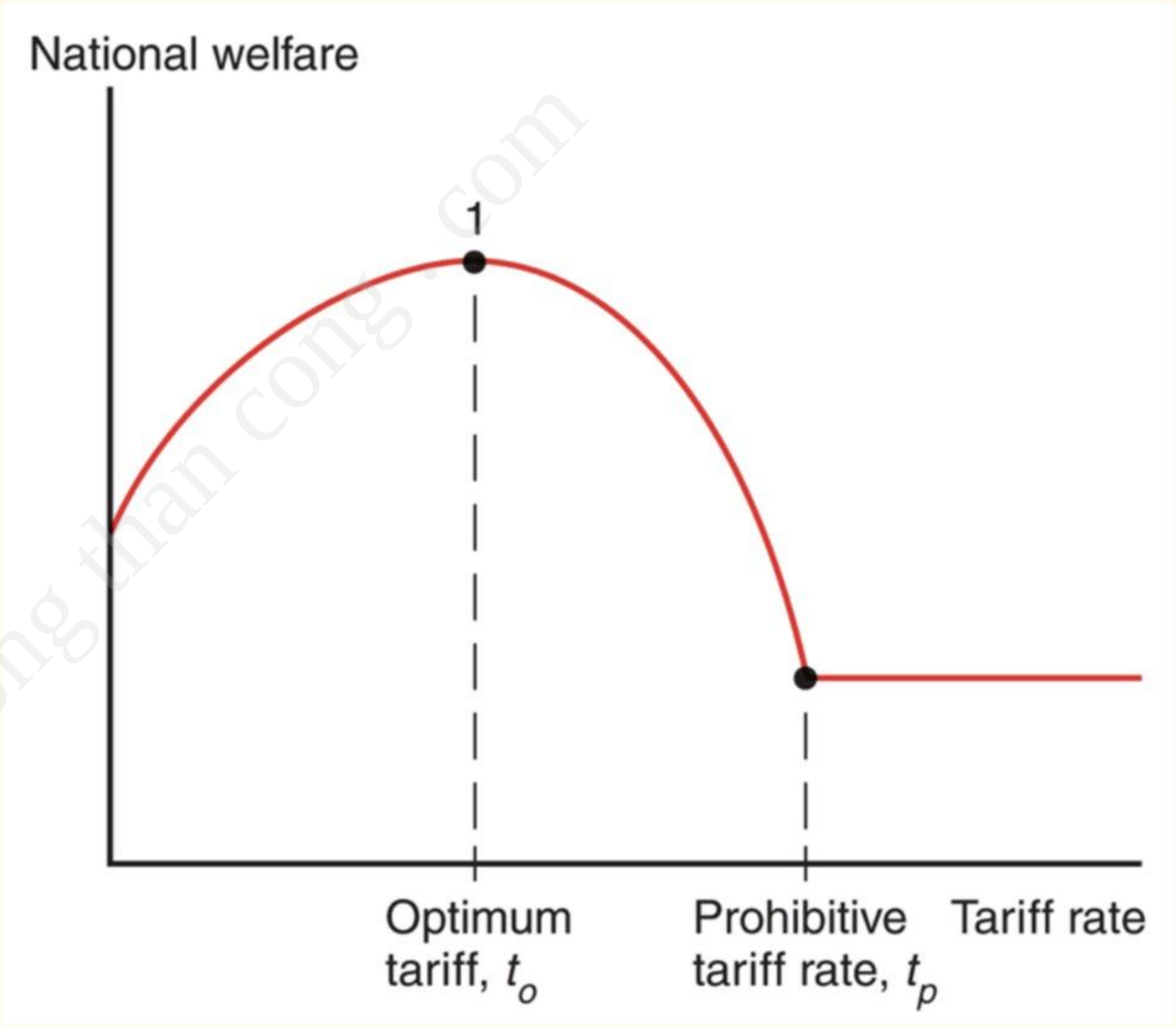
The cases against free trade

- For a large country, a tariff or quota lowers the price of imports in world market and generates **a terms of trade** gain
- This benefit may exceed production and consumption distortions.
- 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 efficiency loss exceeds the terms of trade gain

Figure 9-2

The Optimum Tariff

For a large country, there is an optimum tariff t_o at which the marginal gain from improved terms of trade just equals the marginal efficiency loss from production and consumption distortion.



The cases against free trade

- A tariff rate that completely prohibits imports leaves a country worse off, but tariff rate t_0 may exist that maximizes national welfare: **an optimum tariff**

The cases against free trade

- An export subsidy lowers the terms of trade, and therefore unambiguously reduces national welfare
- **An export tax** (a negative export subsidy) a *tax* on exports that raises the price of exports to foreigners
- An export tax may raise the price of exports in the world market, and **increase the terms of trade**
- An export tax rate may exist that maximizes national welfare through the terms of trade

The cases against free trade

- **For example:** The policy of Saudi Arabia and other oil exporters has been to tax their exports of oil, raising the price to the rest of the world.
- In case of small countries, their import or export have very little ability to affect the world prices, thus the terms of trade argument is of little practical importance to them

The cases against free trade

- In case of big countries as the US, a import tariff or and export tax 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 cases against free trade

- A second argument against free trade is that **domestic market failures** may exist that cause free trade to be a suboptimal policy
- For example, some market in the country is not doing its job right—the labor market is not clearing, the capital market is not allocating resources efficiently, and so on.
- The economic efficiency loss calculations using consumer and producer surplus assume that markets are functioning efficiently

The case against free trade

Type of market failures include

- Persistently high under-employment of labor
- Persistently high under-utilization of capital
- Technological benefits for society from additional production that are not captured by individual firms
- Environment costs for society from additional production that are not paid for by individual firms

The cases against free trade

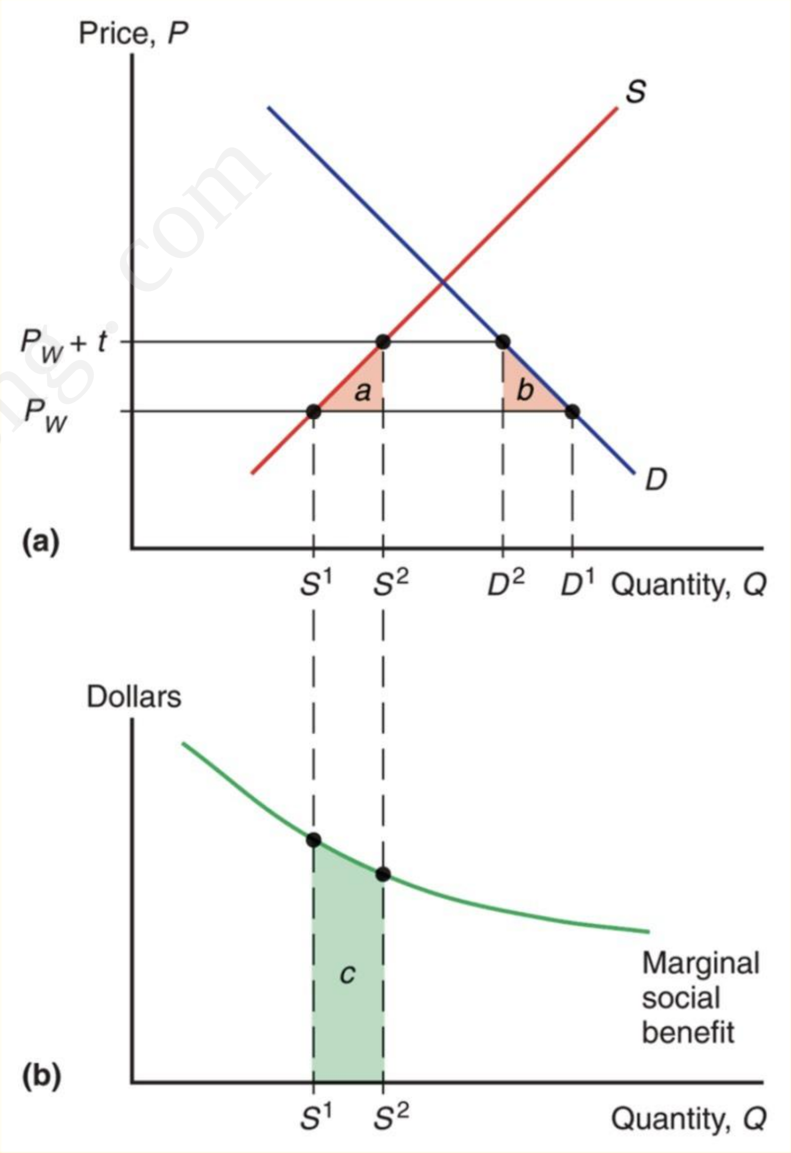
- Economists calculate the **marginal social benefit** to represent the additional benefit to society from additional benefit to society from additional production
- In each of the market failure cases, marginal social benefit is not accurately measured by the producer surplus of private firms, so that economic efficiency loss calculations are misleading
- It is possible that a tariff raises domestic production, thereby increasing the benefit to domestic society because a market failure

The Cases Against Free Trade (cont.)

Figure 9-3

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

- 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, production distortion: *a*.
- Consumption falls from D^1 to D^2, consumption distortion: *b*.
- The increase in production yields a social benefit that may be measured by the area under the marginal social benefit curve from S^1 to S^2, indicated by *c*

The cases against free trade

- The domestic market failure argument against free trade is an example of a more general argument called the **theory of the second best**
- This theory states that government intervention which distorts market incentives in one market may increase national welfare by offsetting the consequences of market failure elsewhere
- The best policy would be fix the market failures themselves, but if this is not feasible, then government intervention in another market may the "second-best" way of fixing the problem

The cases against free trade

- Economist supporting free trade counter-argue that domestic market failure should be corrected by **a "first-best" policy**: a domestic policy aimed directly at the source of the problem
- If persistently high under-employment labor is a problem, then the cost of labor or production of labor-intensive could be subsidized by the government
- These subsidies could avoid the economic efficiency loss for consumers due to a tariff

Which industries are protected?

- **Agriculture**: in the US, Europe and Japan, farmers make up a small fraction of the electorate but receive generous subsidies and trade protection
- Example: European Union' Common Agricultural Policy, Japan's 1000% tariff on imported rice and America's sugar quota

Which industries are protected?

- **Clothing**: textiles (fabrication of cloth) and apparel (assembly of cloth into clothing)
- Import licenses for textile and apparel exporters are specified in the Multi-Fiber Agreement between the US and many other nations

TABLE 9-3 Effects of Protection in the United States ($ billion)

Effect	Apparel	Textiles	All Industries
Consumer cost	21.16	3.27	32.32
Producer gain	9.90	1.75	15.78
Tariff revenue	3.55	0.63	5.86
Quota rent	5.41	0.71	7.12
Producer and consumer distortion	2.30	0.18	3.55
Overall welfare loss	7.71	0.89	10.42

Source: Gary Hufbauer and Kimberly Elliott, *Measuring the Costs of Protection in the United States* (Washington, D.C.: Institute for International Economics, 1994), pp. 8–9.

International negotiation of Trade Policy

- The average US tariff rate on dutiable imports has decreased substantially from 1920–1993.
- Since 1944, much of the reduction in tariffs and other trade restrictions came about through international negotiations.
- The General Agreement of Tariffs and Trade (GATT) was begun in 1947 as a provisional international agreement and was replaced by a more formal international institution called the World Trade Organization in 1995.

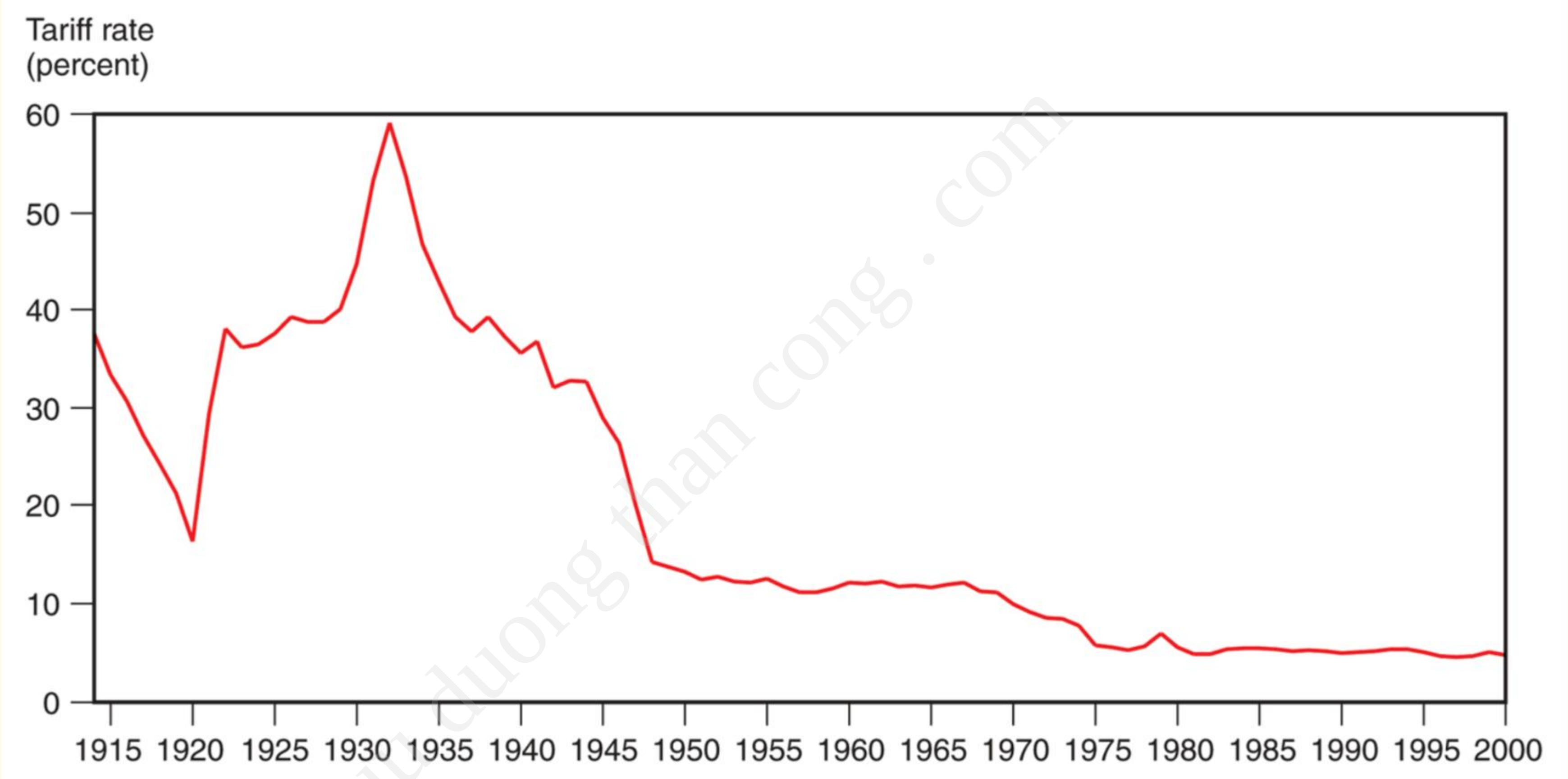


Figure 9-5

The U.S. Tariff Rate

After rising sharply at the beginning of the 1930s, the average tariff rate of the United States has steadily declined.

International negotiation of Trade Policy

Multilateral negotiation mobilize exporters to support free trade if they believe export markets will expand.

- This support would be lacking in a unilateral push for free trade.

- This support counteracts the support for restricted trade by import-competing groups

International negotiation of Trade Policy

- Multilateral negotiations also help avoid a trade war between countries, where each country enacts trade restrictions.
- If each country has a political interest (due to political pressure) to protect domestic producers, regardless of what other countries do,
- Then all countries could enact trade restrictions, even if it is in the interest of all countries to have free trade.
- Let’s use a simple example

TABLE 9-4 The Problem of Trade Warfare

U.S. \ Japan	Free trade	Protection
Free trade	U.S.: 10; Japan: 10	U.S.: –10; Japan: 20
Protection	U.S.: 20; Japan: –10	U.S.: –5; Japan: –5

International negotiation of Trade Policy

- In this simple example, each country acting individually would be better off with protection, but both would be better off if both chose free trade.

- If Japan and the US can establish a binding agreement to maintain

The World Trade Organization

The WTO was founded in 1995 on a number of agreements

- General Agreement on Tariffs and Trade: covers trade in goods

- General Agreement on Tariffs and Services: covers trade in services (e.g., insurance, consulting, legal services, banking).

- Agreement on Trade-Related Aspects of Intellectual Property:

The World Trade Organization

The WTO negotiations addresses trade restrictions in at least 3 ways:

1. **Reduction of tariff rates** through multilateral negotiations.

2. **Binding**: a tariff is "bound" by having the imposing country agree not to raise it in the future.

3. **Prevention of non-tariff barriers**: quotas and export subsidies are

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.

2.The cases against free trade are that trade restrictions may allow

- terms of trade gains

Summary

3. Models of policy making for trade policy 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.

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