

Chapter 9

The Political Economy of Trade Policy

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Preview

- Political models of trade policy
- International negotiations of trade policy and the World Trade Organization

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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

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Median Voter Theorem

- The median voter theorem predicts that democratic political parties may change their policies to court the voter in the middle of the ideological spectrum (i.e., the median voter).
- Suppose that this ideological spectrum is defined only by a tariff rate policy.
 - ◆ And suppose that voters can be ranked according to whether they desire high or low tariff rates.

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Median Voter Theorem (cont.)

- Assumptions of the model:
 1. There are two competing political parties.
 2. The objective of each party is to get elected by majority vote (not to maintain ideological purity).
- 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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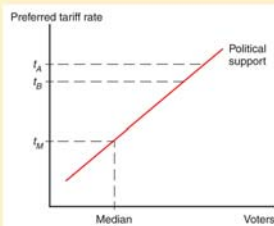
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Median Voter Theorem (cont.)

Figure 9-4

Political Competition

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



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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.

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Collective Action

- 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 (*free rider problem*).
 - ◆ Policies that impose large losses for society as a whole but small losses on each individual may therefore not face strong opposition (ex. Sugar import quota in the US).

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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.
- Models of policy making try to measure the trade off between reduction of overall welfare of constituents in return for additional campaign contributions.

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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.
 - ◆ Examples: European Union's Common Agricultural Policy, Japan's 1000% tariff on imported rice, America's sugar quota.

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Which Industries Are Protected? (cont.)

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

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Which Industries Are Protected? (cont.)

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.

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International Negotiations of Trade Policy

- The average US tariff rate on dutiable imports has decreased substantially from 1920–1993. This applies also to other major industrialized countries' average tariff
- 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 (WTO)** in 1995.

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International Negotiations of Trade Policy (cont.)

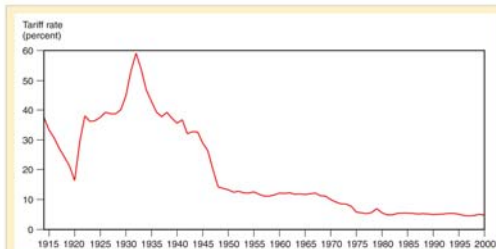


Figure 9-5
The U.S. Tariff Rate

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

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The role of International Negotiations of Trade Policy

- A) Multilateral negotiations 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 ("prisoners dilemma" problem)*
 - Let's use a simple example to illustrate this point.

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The role of International Negotiations of Trade Policy(cont.)

TABLE 9-4 The Problem of Trade Warfare

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

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The role of International Negotiations of Trade Policy(cont.)

- 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 (in this non-cooperative game the only Nash equilibrium is [Protection,Protection])
- If Japan and the US can establish a binding agreement to maintain free trade, both can avoid the temptation of protection and both can be made better off.

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The role of International Negotiations of Trade Policy (cont.)

B) Multilateral negotiations also 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.

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Development of the World Trading System

- **GATT** - multilateral agreement established in 1948 under US and UK leadership
 - ◆ Objective is to liberalize trade by eliminating tariffs, subsidies, and import quotas
 - ◆ 19 original members grew to 151 (as of September 2007)
- One basic principle: **Non discrimination**
- Two applications of this principle
 - **Most favored nation** clause
 - **National treatment** clause

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Development of the World Trading System

- Used 'rounds of talks' to gradually reduce trade barriers
- Uruguay Round (1986-93)
 - ◆ Creation of WTO
 - ◆ Mutual tariff reductions negotiated
 - ◆ Dispute resolution only if complaints

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The WTO

- 153 members as of December 2008
- Represents more than 90% of world trade
- 9 of 10 disputes satisfactorily settled
- Tariff reduction from 40% to 5%

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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.

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World Trade Organization (cont.)

3. **Prevention of non-tariff barriers**: NTBs are changed to tariffs because the costs of tariff protection are more apparent.
 - ♦ Subsidies for agricultural exports are an exception.
 - ♦ Exceptions are also allowed for “market disruptions” caused by a surge in imports.

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World Trade Organization (cont.)

- The World Trade Organization 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:** covers international property rights (e.g., patents and copyrights).

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World Trade Organization (cont.)

- ◆ The **dispute settlement procedure:** a formal procedure where countries in a trade dispute can bring their case to a panel of WTO experts to rule upon.
- ◆ The cases are settled fairly quickly: even with appeals the procedure is not supposed to last more than 15 months.
- ◆ The panel uses previous agreements by member countries to decide which ones are breaking their agreements.

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World Trade Organization (cont.)

- ◆ A country that refuses to adhere to the panel's decision may be punished by allowing other countries to impose trade restrictions on its exports.

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WTO at work

- 351 disputes brought to WTO between 1995 and October 2006
- 196 handled by GATT during its 50 year history
- US is biggest WTO user
 - ◆ Big wins: beef - bananas
 - ◆ Big loss: Kodak

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WTO: basic structure

In a nutshell

The basic structure of the WTO agreements: how the six main areas fit together — the umbrella WTO Agreement, goods, services, intellectual property, disputes and trade policy reviews.

Umbrella	AGREEMENT ESTABLISHING WTO		
	Goods	Services	Intellectual property
Basic principles	GATT	GATS	TRIPS
Additional details	Other goods agreements and annexes	Services annexes	
Market access commitments	Countries' schedules of commitments	Countries' schedules of commitments (and MFN exemptions)	
Dispute settlement	DISPUTE SETTLEMENT		
Transparency	TRADE POLICY REVIEWS		

World Trade Organization (cont.)

- With the creation of the WTO two sectors were brought back into the trade liberalization process:
 - a) **Textile-Clothing:** it was decided that all quantitative restrictions (e.g., quotas) on trade in textiles and clothing as previously specified in the Multi-Fiber Agreement were to be eliminated by 2005.
- But as the restrictions were eliminated (mostly in 2005), political pressure to again restrict trade in textiles and clothing has grown.

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World Trade Organization (cont.)

b) **Agriculture:** the agreement required agricultural exporters to reduce subsidies by 36% (in value) and volume of subsidized export by 21%. In addition all NTBs had to be replaced by tariffs (“tarrification”)

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WTO in Seattle

- **Millennium round** was aimed at further reduction of trade barriers in agriculture and services
- WTO meeting disrupted by
 - ◆ Human rights groups
 - ◆ Trade unions
 - ◆ Environmentalists
 - ◆ Anti globalization groups
- No agreement was reached

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Doha Agenda -WTO

- Cutting tariffs on industrial goods and services
- Phasing out subsidies
- Reducing antidumping laws
- WTO regulation on intellectual property should not prevent members from protecting public health
 - ◆ TRIPS agreement

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The Doha Round

- The **Doha Round** officially started at Doha, Qatar in November 2001, after the collapse of the Seattle meeting two years before.
- The contrasts among the various countries have produced a series of failures at the Ministerial Meetings of Cancun (September 2003) and Hong Kong (December 2006).

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The Doha Round

- One of the tables on which the negotiation stalled has been that of agricultural liberalization.

The European Union with the Common Agricultural Policy and the United States with their agricultural subsidies have opposed the request of substantial liberalization advanced by a group of emerging economies with a comparative advantage in that sector.

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Preferential Trading Agreements (PTA)

After the II WW there have been two major approaches to trade liberalization:

- The **multilateral-non discriminatory approach** (GATT-WTO)
- The **discriminatory approach** (Preferential or Regional Trade agreements)

Notwithstanding their differences, these two approaches managed to cohabit well for a long period (GATT allows various exception to the non-discrimination principle).

Is this now finished?

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Preferential Trading Agreements

- Preferential trading agreements are trade agreements between countries in which they lower tariffs for each other but not for the rest of the world.
- Under the WTO, such discriminatory trade policies are generally not allowed:
 - ◆ Each country in the WTO promises that all countries will pay tariffs no higher than the nation that pays the lowest: called the "most favored nation" (MFN) principle.
 - ◆ An exception to this principle is allowed only if the lowest tariff rate is set at zero.

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Levels of Economic Integration

- In a **Free Trade Area** all barriers to the trade of goods and services among member countries are removed (an example is the North America Free Trade Agreement (NAFTA)).
- A **Customs Union** eliminates trade barriers between member countries and adopts a common external trade policy
- A **Common Market** has no barriers to trade between member countries, includes a common external trade policy, and allows factors of production to move freely between members

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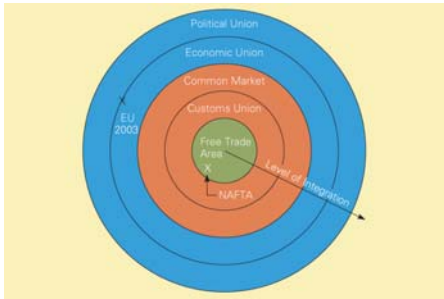
Levels of Economic Integration

- An **Economic Union** involves the free flow of products and factors of production between member countries and the adoption of a common external trade policy, but it also requires a common currency, harmonization of members' tax rates, and a common monetary and fiscal policy
- A **Political Union** occurs when a central political apparatus coordinates the economic, social, and foreign policy of the member states

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Levels of Economic Integration



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PTA: 27 European Union Members 2007



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Preferential Trading Agreements (cont.)

- Are preferential trading agreements necessarily good for national welfare?
- No, it is possible that national welfare decreases under a preferential trading agreement.
- How? Rather than gaining tariff revenue from inexpensive imports from world markets, a country may import expensive products from member countries but not gain any tariff revenue.

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Preferential Trading Agreements (cont.)

- Preferential trading agreements increase national welfare when new trade is created, but not when existing trade from the outside world is diverted to trade with member countries.
- **Trade creation**
 - ◆ occurs when high cost domestic production is replaced by *low cost imports from other members*.
- **Trade diversion**
 - ◆ occurs when low cost imports from non-members are diverted to *high cost imports from member nations*.

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PTA: ASEAN Countries



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PTA: Asia Pacific Economic Cooperation APEC

- Founded in 1990 to 'promote open trade and practical economic cooperation'
 - ◆ 'Promote a sense of community'
 - ◆ 21 members
 - ◆ 60% of world's GNP
 - ◆ 47% of global trade
- Despite slow progress, if successful, could become the world's largest free trade area

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PTA: APEC Countries



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Regional Trade Blocs in Africa

- African countries have been experimenting with regional trade blocs for half a century; there are now 9 trade blocs on the continent
- Progress toward the establishment of meaningful trade blocs has been slow
- In 2001 Kenya, Uganda, and Tanzania committed themselves to relaunching the East African Community trade bloc 24 years after it collapsed
 - ◆ The intent is to establish a customs union, regional court, legislative assembly, and a political federation

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