

Political economy
Lecture 10
Political economy of international trade

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Outline

- Why do we observe trade distortions?
- What determines trade policy?
 - Political factors
 - Economic factors
- Why people often perceive export as sth good and import as sth bad?
- Why the discussions are producers'-oriented?
- Lecture based on:
 - Grossman & Helpman (1995)
 - Mitra et al. (2002)
 - Krugman & Obstfeld (2009) – chapter 9

2

Why do we have tariffs?

- „It is often said that bad economic policy reflects disagreement among the experts; that if all economists gave the same advice, economic policy would be good. Economists often do disagree, but that has not been true with respect to international trade. Ever since Adam Smith there has been virtual unanimity among economists, whatever their ideological position on other issues, that international free trade is in the best interests of trading countries and of the world. Yet tariffs have been the rule” – Milton Friedman (Free to choose)

Some background information

- Globalisation
 - Complex effect; see the example of Mexico-USA
- World Trade Organisation (WTO)
 - Douha round negotiations
- Political economy models
 - Economic policies being traded on the market
 - Politicians maximising their chances for remaining in office
 - Trade policy as a public good

4

Some hypotheses

- Trade policy being determined by:
 - Interest groups (M. Olson)
 - Majority of voters
 - Status quo
 - Desire to max. budget revenues
 - Political repercussions
 - Govt. ideology
 - Income redistribution

5

An example

- Suppose we trade with shoes
- Crucial actors: consumers and producers of shoes
 - # of consumers >> # of producers
 - Obviously interests of consumers = interests of producers
 - Both groups want to influence policy/politicians
- Ass: policy determined by the efficacy of lobbying
- Lobbying needs funds

6

An example – cont.

- Consumers:
 - need to identify & inform themselves,
 - costs to individual consumer of a tariff relatively small
 - Would not like to spend much on information
 - Would not like to contribute much to lobbying fund
 - Temptation to free-ride
- Producers:
 - Easier to identify them and inform
 - Large benefits from tariff
 - Less incentives to free-ride (higher benefits, reputation)
- Politicians

7

Trade & growth

- Direct & indirect effect of trade
 - Acemoglu et al. (2005) – Atlantic traders
- How can we argue in favour of positive relationship?
 - Increase in productivity
 - Spillover effects – to sectors not involved in trade (transfer of technology)
 - Economies of scale
- Does economic theory provides us with arguments against it?
 - Free exit may be disputable (not developed financial markets & sunk costs)
 - Smaller sales opportunities for domestic companies may reduce their incentives to invest in R&D

8

Protection for sale

- Grossman & Helpman (1994):
 - Interest groups make political contributions in order to get trade policy they want (influence government's choice of trade policy)
 - They provide campaign support
 - Ass: Contributions are correlated with tariffs in the same way that profits are
 - Politicians optimise their utility (being a function of contributions and social welfare)
 - With only one interest group, this group captures all benefits from lobbying
 - If all sectors are organised, we have free trade (govt. captures all benefits from political relationships)

Protection across sectors

- Protection higher in import-competing sectors than in sectors producing exportable products
- Note that govt. cannot favour one domestic industry except at the expense of others

10

Protection in declining industries

- Assymetry in ability of interest groups to benefit from lobbying activities
 - In expanding industries: political rents attract new entries that erode these rents
 - In declining industries: this is not the case
- Loss aversion
 - Aggregating Individual preferences for loss aversion lead to policies that favour loss-making industries

11

Protection in agricultural sector

- Based on Swinnen (2010)
- Mancur Olson: Small share in total employment:
 - Low costs of political organisation
 - Low costs for the rest of society to support
 - Note declining share of agric. in employment
- Changes in the structure of the economy affect distribution of political costs & benefits
 - Declining share of food expenses with rising incomes
 - Decline in relative agric. income

12

Some basic facts on agric. protection

- Positive correlation between:
 - Agric. protection & average country incomes
- Shift from taxation to protection of agric. sector as countries get richer
- Agric. protection is countercyclical to market conditions

13

Next lecture

- Surprise lecture
- 9 May 2011
- **All the best for Easter!**
- **Thank you for your attention**