

The Politics of International Trade

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Abstract

Traditional international trade models explain comparative advantage and describe aggregate gains for a country from trade and from terms-of-trade improvement but do not address the politics of international trade policy. A positive or predictive model that studies the politics of trade policy requires two premises, both with public choice origins: (1) that political self-interest underlies policy determination of trade policy rather than social-welfare objectives, and (2) politically assignable rents are preferred to budgetary revenue from trade restrictions and aggregate gains from terms-of-trade improvement. Originating political-economy models of protectionism and reciprocal trade liberalization acknowledge on both premises. Subsequent popular (and popularly replicated) models of trade policy include the first premise but not the second. The popular models are inconsistent with the actual conduct of trade policy. We also present public-choice perspectives on strategic trade policy, the most-favored nation clause, preferential trading, duty-free zones, globalization, and direct voting on trade policy, and we review and interpret empirical evidence.

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Keywords: political support, rent creation, budgetary revenue, trade negotiations.

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1. Introduction

Traditional models of international trade focus on comparative advantage and countries' aggregate gains from trade and terms-of-trade improvement (for an exposition, see for example Ethier 1995). The traditional trade models do not address the actual conduct of trade policy, which requires a 'political-economy' perspective. Two public-choice premises are the foundations for a political-economy perspective on trade policy. The first premise is:

- Political decision makers are primarily motivated by political self-interest and personal gain and not social welfare.

In political-economy models of trade policy, policies are correspondingly described as chosen to maximize political support or personal benefit of political decision makers (Hillman 1982; Grossman and Helpman 1994). The second public-choice premise follows from the study of rent seeking, and political rent creation and rent extraction (Tullock 1967, 1989;

Congleton 2018). Political decision makers prefer politically-assignable rents to budgetary revenue from trade restrictions (Hillman 2015, Cassing and Hillman 2017). Aggregate gains from terms-of-trade improvement are distributed through tariff revenue (James and Hillman 1970). If tariff revenue is not a primary concern of political decision makers, nor are the terms of trade. Therefore:

- Consistently with political objectives, political decision makers are concerned with politically-assignable rents that can be used for political support, with political disinterest in budgetary revenue and aggregate gains from terms-of-trade improvement.

We document how in the actual conduct of trade policy the second premise is expressed in governments forgoing budgetary revenue from trade restrictions in preference for politically created rents, and we show how, contrary to seeking terms-of-trade improvement, terms-of-trade deterioration is willfully sought for political benefit.

Both public-choice premises are present in originating renditions of political-economy models of protectionist trade policy (Hillman 1982) and politically motivated trade-liberalization negotiations for 'exchange of market access' (Hillman and Moser 1994, 1996). In these models, political decision makers have political objectives furthered by rent creation and rent assignment, with budgetary revenue from trade restrictions and the terms

of trade of no political (and therefore policy) significance. Subsequent popular renditions of the political economy of protection and trade-liberalization negotiations (Grossman and Helpman 1994; Bagwell and Staiger 1999, 2001) include the first public-choice premise that political decision makers are motivated by political self-interest but do not account for the second premise that political benefits from rent creation override concerns of budgetary revenue and the terms of trade. The popular political-economy models cannot in consequence offer reliable predictions about the politics of international trade policy. We shall elaborate on why the exclusion of the second premise from the popular models is important. We present public-choice perspectives on other aspects of trade policy and review empirical evidence on political determination of trade policy. We exclude agricultural protectionism, which has distinct attributes, including food security (on these issues, see Anderson 2014).

2. Trade policy in traditional trade models

2.1 Comparative advantage and the gains from trade

Traditional models of international trade describe comparative advantage under assumptions of perfectly competitive markets with no market failures (externalities, public goods, or information asymmetries). The

models point to several possible sources of comparative advantage.¹ Whatever the source of comparative advantage, the welfare conclusion for a 'small' country (by definition unable to influence the terms of trade) is that free trade is efficient for a country as a whole, in that, relative to autarky (no trade), gainers gain more than losers lose (Samuelson 1939). Gainers from free trade can in principle compensate losers for Pareto improvement (Samuelson 1962; Kemp 1962; Kemp and Wan 1972). 'Large' countries that by definition can influence world prices can seek to increase national welfare through tariffs that improve their terms of trade (Baldwin 1948, 1952).²

¹ Comparative advantage is determined by a comparison of countries' pre-trade domestic relative prices (or domestic autarky relative prices compared to free-trade relative prices). Influences on relative prices therefore underlie comparative advantage. A view dating back to David Ricardo (1817) bases comparative advantage on productivity differences between countries' workers (the classical model). The neo-classical Heckscher-Ohlin model (Heckscher 1919; Ohlin 1933; Jones 1956; Heckscher and Ohlin 1991), in its simplest form, assumes away technological and demand differences between countries and bases comparative advantage on relative factor endowments, with trade in goods becoming trade in embodied services of factors of production (see Jones 1965). Linder (1961) described trade as due to inter-country differences in consumption preferences, through different income levels that determine the quality of goods that people wish to buy. Another model describes exports as due to competitive advantage as an attribute of firms rather than countries (Melitz 2003). Cultural preferences can also explain international trade (Bala and Long 2005). Trade is usually described as in goods, but conclusions apply in general to trade in services (Francois and Hoekman 2010).

² The terms of trade are given by the ratio of an index of export prices to an index of import prices. An improvement in the terms of trade occurs through an increase in export prices or decrease in import prices, either of which is, in the aggregate, welfare-improving for a country. In models of international trade, it is usual for convenience to assume two goods (Jones and Scheinkman 1977) and the terms of trade are given by the relative world price of the two goods.

1.2 Income distribution in traditional trade models

Traditional trade models also describe how trade and trade policy can influence income distribution. These effects depend on whether factors of production are domestically mobile between industries. From a long-run perspective, all factors in a country are mobile. Coalitions seeking to influence trade policy are then factor-based.³ The application is to long-term consequences of trade policy.⁴ A short-run 'specific-factors' model assumes immobile factors of production and implies industry-based coalitions for policy influence.⁵ Income earners specific to export and import-competing industries, respectively, lose and gain from protection.⁶

³ The long-run view is expressed in the Heckscher-Ohlin model through the Stolper-Samuelson theorem (Benham 1935; Stolper and Samuelson 1941), which describes gainers and losers from trade policy according to whether factors are abundant or scarce in the domestic economy relative to global factor supply. Protection benefits a country's relatively scarce factor and free trade benefits the relatively abundant factor. The conclusions can be extended to more than two goods and two factors (Ethier 1974).

⁴ See Rogowski (1989). For example, the Brigden Committee (1929), appointed by the Australian government to evaluate the country's trade policy, justified protectionism on the grounds that the tariff, by increasing real wages, attracted immigrants (see Hillman 1977).

⁵ In the specific-factors model (Jones 1971), capital is usually regarded as immobile and labor as mobile. A factor might however be imperfectly mobile and therefore identify with the interest of the industry in which it happens to be employed (Grossman 1983; Baldwin 1984). Neary (1978) describes factor-market adjustment.

⁶ The model does not unambiguously establish whether an intersectorally mobile factor (usually identified as labor) is better off with free trade or protection. Ruffin and Jones (1977) suggested the basis for a presumption that mobile factors are better off with free trade.

1.3 The Musgrave policy separation

In traditional trade models, factors are inelastically supplied.⁷ Lump-sum taxes and transfers therefore facilitate the Musgrave (1959) policy separation between efficiency and income-distribution policy objectives. Income can then be redistributed domestically without efficiency losses (Hillman 2015). Traditional trade models consequently require reasons other than income redistribution to explain protectionism.

1.4 Protectionism in traditional trade models

In the traditional trade models, protectionism can increase social welfare. Justifications for protectionism rest on the presence of market failures, called 'distortions' (Bhagwati 1971). For example, in the long-run Heckscher-Ohlin model, a minimum wage (a distortion) can give the impression that a country is relatively labor-scarce, when in fact the country is relatively labor-abundant. Closing the country to international trade increases social welfare by avoiding trade contrary to comparative advantage (Brecher 1974a, 1974b). Trade contrary to comparative advantage can also result when an environmental externality distorts

⁷ See however Kemp and Jones (1962) on variable factor supply.

domestic prices (producers do not make allowance for environmental costs), in which case closing the economy to trade may be socially beneficial.

Trade policy can also be a response to policy failures of foreign governments (Bhagwati and Hudec 1996, Anderson 2001, Hillman 2005a). A foreign government may set lax environmental standards, thereby giving its producers a cost advantage over 'home' producers. A 'race-to-the bottom' in environmental standards takes place when home producers request the same lax standards as prevail in the foreign country. To maintain high domestic environmental standards, the home government can respond by protecting its producers from 'unfair' foreign competition (Ederington and Minier 2003). Child labor or workers denied reasonable working conditions in foreign countries can be a concern for citizens of a high-income country, who would like to, but cannot, directly influence policies of foreign governments; citizens of the high-income country may be willing to forego gains from trade to disallow imports produced abroad by unacceptable means. Such 'second-best' justifications for departing from free trade are logically sound and are applicable when targeting products is possible.

3. Protection and politics

3.1 Protectionism and political support

The political-economy approach to trade policy (Hillman 1982, 1989a, 1992; Grossman and Helpman 1994) takes no issue with the normative conclusions of traditional models. The questions asked in the political-economy approach are different. The objective to explain the willful creation of inefficiency that is part of the actual conduct of international trade policy. Peltzman (1976) proposed political support as a motive for industry regulation. In the context of trade policy, political support is measured from a free-trade reference point that shifts when the world price of import-competing output changes (Hillman 1982). Gainers and losers from policy decisions use the free-trade reference point to ask 'what have government trade-policy decisions done for me compared to outcomes that I would have with free trade?' The government chooses policy by maximizing a political-support function that uses the free-trade reference point in trading off political support from industry interests against support from voters and other industry interests who lose from protectionism.

3.2 Declining industries

A natural beginning for a political-support approach to trade policy is a declining industry confronting a falling world price (Hillman 1982). When the world price of import-competing output falls, the improvement in the terms of trade results in aggregate country gains, but, applying the short-run specific-factors model, individuals and firms with incomes tied to the declining industry lose. The losers could be compensated through budgetary transfers with the gainers still gaining (subject to the deadweight losses of taxation and income subsidization). A protective tariff is also a means of compensation. There is under-compensation. Denote the domestic relative price of the declining industry's output by (P^*+T) with P^* the world price and T the tariff. P^* declines exogenously and the policy response is an increase in T . This moderates gains and losses. Protection increases, but the domestic price declines (the increase in T is insufficient to offset the decline in P^*). Losers from the lower world price of imports are grateful that their losses are moderated. Gainers still gain. In this model, budgetary revenue from a tariff has no role (tariff revenue is fiscally and politically unimportant in the policy decision) and the political policy response focuses on industry rents at the expense of diminished benefits for the population at large from a terms-of-trade improvement.

The declining-industry model requires 'rational ignorance' (Downs 1957) facilitated by asymmetries in responses of gainers and losers from protection. Losers from the decline in the world price earn their incomes in the one industry, whereas gainers are dispersed among industries and are diversified in consumption. The losers can be expected to be politically active and focused on seeking to stem their losses. For gainers, spread throughout the economy, policy toward the declining industry is not central to their incomes and consumption.

Gainers from the lower world price can be expected to be more numerous than losers. If a direct vote were to take place (Mayer 1984), gainers from industry protection could not be expected to have a majority. With representative democracy, it is however politically advantageous to be able to target policy benefits to defined stable groups, such as income earners in a declining industry.

The protectionist rents for industry interests are presumptively accompanied by rent seeking. Gordon Tullock (1967) included rents from protection when describing social losses from contestable rents.

Groups differ in their ability to provide political support. Other things equal, among import-competing industries, more politically

influential industries are predicted to be characterized by less import competition and greater protectionist rents.⁸

3.3 Extensions of the political-economy model

There have been a number of extensions of the political-economy model of trade policy. Rather than declining smoothly down an industry supply function, import-competing industries have at times abruptly collapsed, leaving regions near destitute. Conditions are created for sudden industry collapse through changes in political support, when intersectorally mobile labor can immediately exit an industry and industry-specific capital exits only slowly through depreciation (Cassing and Hillman 1986).

In Hillman and Ursprung (1988), domestic and foreign firms make Nash-equilibrium campaign contributions to political candidates who choose Nash-equilibrium policy announcements. When tariffs are used, the candidates' policy announcements are divisive (one candidate declares support for free trade as sought by foreign exporters and the other candidate supports a prohibitive tariff as sought by domestic import-competing producers); but when a voluntary export restraint is the policy

⁸ Overviews of models of political exchange applied to trade policies are provided in Hillman (1989, 2015) and Ethier (2011, 2012).

means, the candidates converge as in the standard Hotelling model to a common policy, resulting in consensus in the political equilibrium.⁹

Study of the links between trade policy and the environment do not necessarily address the politics of international trade (for a study without politics, see Neary 2006). The political-economy approach to trade policy has incorporated the role of environmental interests in influencing trade policy. In Hillman and Ursprung (1992, 1994), 'greens' concerned with the local environment are distinguished from 'supergreens' concerned with the global environment. Both types of environmental interest groups can politically influence trade policies through support for candidates in political competition. Greens join a coalition with free-trade interests to allow environmentally unfriendly goods produced abroad to displace domestic polluting production. Supergreens ally themselves with protectionist interests to reduce imports and thereby reduce global production of environmentally harmful goods.¹⁰

Much of international trade is conducted within the multinational firm.¹¹ Multinational firms face a choice between supplying a market

⁹ For models of trade policy and political (or electoral) competition, see also Magee, Brock and Young (1989) and Grossman and Helpman (1996).

¹⁰ A subsequent literature developed aspects of the relation between the political economy of trade policy and the environment (for example, Fredriksson 1999, Schulze and Ursprung 2001, and Damania and Fredriksson 2003).

¹¹ On the multinational firm, see for example Ethier (1986), Markusen (1994, 2004) and

through local production or through imports (if trade policies permit imports). Hillman and Ursprung (1993) showed how multinational firms might participate in the political determination of trade policy.

3.4 Protection for sale

In an influential exposition, Grossman and Helpman (1994) presented a model that yields explicit trade-policy predictions that can be tested empirically. Political support is based on explicit micro foundations. Their model describes organized groups seeking to influence trade policy by offering political contributions to a politician 'selling protection'. An exogenous subset of industry interests is organized for collective political effectiveness; there are no internal-organization or free-rider problems; and consumers are not organized.¹² The equilibrium outcome is different levels of protection for organized industry interests, described by a Ramsey-type rule (Ramsey 1927) that includes import-demand elasticities. Organized export interests receive subsidies, as do imports corresponding to unorganized import-competing industries, and unorganized exports are taxed. In public-choice terms, this is a model of political rent extraction.

Ethier and Markusen 1996).

¹² In other models, the political effectiveness of the lobbying group or industry depends on the internal structure of the group and allocation by group members of resources to the group's collective objective. See Hillman, Long, and Soubeyran (2001)

Rent extraction by the political monopoly supplier of protection depends on the equilibrium outcome that emerges and need not be complete. The politician is restrained in selling protection by decreases in social welfare, or by diminished political support. The model relies on distribution of tariff revenue to placate losers from protection. The model is consistent with the public-choice premise that political decision makers have political objectives but is at odds with the public-choice premise that budgetary revenue from trade restrictions does not influence trade policy decisions.

3.5 Why use trade policy to redistribute income?

A question that needs to be addressed when considering the politics of international trade is 'why is trade policy used to distribute income?' Lump-sum taxes and transfers if available would allow income to be redistributed with no efficiency losses, Lump-sum taxes and transfers are in general unavailable but income can nevertheless be redistributed through the government budget rather than through trade policy. Trade policy is used to redistribute income because of the rational ignorance of voters (and perhaps lack of economic literacy). A subsidy makes a government an intermediary through the government budget in transferring public money (tax revenue) to private interests (domestic producers). Through a protectionist policy, the income transfer takes place

without the government as intermediary. The price that consumers directly pay to domestic producers includes protectionist rents (Hillman 2009, pp. 277-278). Protectionism is an inefficient but politically expedient way to create rents and redistribute income (Tullock 1989; Hillman and Ursprung 2016).¹³ Protectionism contradicts Gary Becker's famous theorem (Becker 1983, 1985) that the most efficient (or least wasteful) means of income redistribution will always be chosen.

3.6 A principle-agent problem with diversified investors

A principal-agent problem can exist between diversified shareholders and management in import-competing industries. Diversified investors seek overall asset-value maximization. Management is rewarded according to individual-firm profits and so has an interest in lobbying for protection. But the protection would be detrimental for diversified shareholders, who bear the efficiency costs of protection through the reduced value of their overall investment portfolios (Cassing 1996).

¹³ As will be discussed below, protection can also partly shift abroad the costs of redistribution through a 'terms-of-trade externality'.

4. Rents without rent seeking

'Strategic trade policy' is a case for intervention within a standard non-political-economy trade model. There are multiple variations (see Krugman 1985, Grossman and Richardson 1985, Helpman and Krugman 1985, Eaton and Grossman 1986). The common element is the possibility, when international markets are imperfectly competitive, of rent capture by shifting profits from a foreign to a domestic firm. The rent shifting increases a country's welfare, defined as consumer surplus plus profits of home producers. Because strategic trade policy creates rents for domestic producers, public-choice premises raise the questions 'who will be chosen to benefit from the rents,' and 'would not political decision makers who can choose beneficiaries of rents be subject to influence,' and 'would not rent seeking come into play in contesting the rents?'¹⁴ These questions are not part of the strategic-trade-policy discussion. Although government policy shifts rents to domestic beneficiaries, the concept of rent seeking (Tullock 1967, 1989) is not considered. The rent seeking that would be expected to be associated with rent shifting is socially costly, because of the wasteful use

¹⁴ Strategic trade policy is closely related to a classical exception to the case for free trade known as the 'infant-industry' argument (Kemp 1960). Both arguments depend crucially upon a failure of comparative-advantage assumptions. For the infant-industry argument, if investment in import-competing production is worthwhile in present-value terms, private investors will make the investment without government support (Baldwin 1969) unless externalities prevent that. Moral hazard is also expected because producers know that infant-industry protection will persist for as long as domestic production cannot compete with imports (Tornell 1991).

of resources in seeking the favor of the policy makers deciding on beneficiaries of the rents. If incentives for rent seeking and for political rent sharing are not acknowledged, politically expedient policy can be misinterpreted as socially benevolent political behavior (Hillman 1998).¹⁵

5. The political unimportance of tariff revenue and the terms of trade

We return now to the public-choice premise that tariff revenue and the terms of trade are unimportant in the politics of international trade. We first describe the benefits from improvement in the terms of trade, and the role of tariff revenue in realization of terms-of-trade benefits, in the traditional trade model. We then point to observations that substantiate the premise of political unimportance of tariff revenue and the terms of trade in the actual conduct of trade policy.

5.1 The terms of trade and tariff revenue in the traditional trade models

In the traditional trade models, large countries can influence their terms of trade. An improvement in the terms of trade, by itself, is nationally

¹⁵ There are other problems with strategic trade policy. If both home and foreign firms are publicly traded on the stock market, investors can diversify their stock portfolios by owning shares in both companies. The strategic-trade-policy proposal then introduces uncertainty that is welfare-reducing for risk-averse investors (Feeney and Hillman 2001).

desirable (imports become less expensive relative to exports). In traditional models, a (small) tariff that departs from free trade, given foreign trade policy, is *always* advantageous for a large country: The national benefit from the terms-of-trade improvement outweighs the negative effects of reduced trade. Gainers gain more than losers lose. The national welfare gain rests on monopsony power in world markets. Suppose that a large country imposes a tariff on coffee, increasing the domestic price of coffee and reducing domestic demand, which then reduces world demand and so decreases the world price of coffee relative to other goods. For the country, coffee is cheaper (the terms of trade have improved). For domestic consumers, coffee is more expensive. Domestic coffee drinkers can however be more than compensated for the higher domestic price by receiving back tariff revenue from the government. Tariff revenue is critical in the model for national gain from the terms of trade improvement.¹⁶

In practice, tariff revenue in high-income countries is not fiscally significant.¹⁷ Nor, in accord with our second public-choice premise, is the

¹⁶ From a public-choice perspective, domestic consumers (the coffee drinkers in our example) have no assurance that they will be compensated through tariff revenue for the higher domestic price because of the tariff (James and Hillman 1970). A 'leviathan' government would consume the revenue. Tariff revenue can also be distributed domestically according to political preference (see for example Long and Vousden 1991).

¹⁷ See <https://stats.oecd.org/Index.aspx?DataSetCode=REV> (accessed April 13, 2017). Tariff revenue can however be fiscally significant for low-income countries (see Baunsgaard and Keen 2005). The usual exposition of two-good trade models can exaggerate the fiscal importance of tariff revenue. In the usual trade model, tariff revenue from taxed imports is the only source of budgetary

revenue politically significant. The political preference for politically-assignable rents over revenue, and thereby also over welfare gains from a terms-of-trade improvement through distribution of tariff revenue, is consistently expressed in the practice of trade policy in various ways (Hillman 2015).

5.1.1 Rent creation and terms-of-trade improvement in declining-industry protection

In the case of declining-industry protection (Hillman 1982), protection created industry rents by denying consumers the full benefits of a terms-of-trade improvement.

5.1.2 Budgetary revenue and rents in the choice between tariffs and quotas

Bhagwati (1965) compared consequences of tariffs and quotas on the assumption that both provide budgetary revenue (quotas by being competitively auctioned).¹⁸ In practice, quota rights are rarely if ever competitively auctioned. Quotas are rather used to create private rents.

revenue.

¹⁸ On the implied political preferences for tariffs and quotas under the Bhagwati assumption that both means of protection provide budgetary revenue, see Cassing and Hillman (1985).

Tariff revenue is forgone in preference for private-rent creation (Cassing and Hillman 2017).

5.1.3 Voluntary export restraints

Voluntary export restraints were, for half a century from 1960, a prominent means by which governments managed trade (Harris 1985, Krishna 1989, Ethier 1991a, 1991b). A quota on imports to the domestic market was negotiated between governments. The quota created protectionist rents for domestic producers. Foreign producers were assigned the quota to create a foreign export cartel. Producers, both foreign and domestic, benefited at the expense of domestic consumers, whose interests were disregarded. Compared to a positive non-prohibitive tariff, budgetary revenue is forgone in the creation and assignment of quota rents to foreign producers and, because foreign exporters' prices increase, a government willfully deteriorates its terms of trade (Hillman and Ursprung 1988, Ethier 1991a).¹⁹

¹⁹ The VER trade restrictions were voluntary and so did not lead to GATT disputes (see Hoekman and Kostecki 2009). Still, such restrictions were themselves subsequently explicitly restricted by the Uruguay Round of multilateral trade negotiations.

5.1.4 Administered protection

Governments constrained by trade agreements unilaterally conduct trade policy by means of administered protection rather than through traditional tariffs or quotas. Administered protection often involves a country reducing import competition by compelling a terms-of-trade deterioration (an increase in the price of imports). This can occur when accusations of dumping (setting export prices lower than comparable domestic prices in exporters' home markets) initiate legal investigations (Finger, Hall, and Nelson 1982) but foreign sellers are given the option to negate the threat of anti-dumping duties by an undertaking to increase prices in the domestic market (Tharakan 1993). Faced with a choice between paying anti-dumping duties and avoiding the duties by increasing price, the foreign seller increases price. The foreign seller could perhaps instead accept the duty and attempt to set a still lower price, resulting in a terms-of-trade improvement for the importing country. The foreign seller knows, however, that this would simply result in a still higher anti-dumping duty because governments are unwilling to accept a terms-of-trade improvement that disadvantages domestic import-competing producers. Once more, the actual conduct of trade policy contradicts the premise that governments value tariff revenue and value terms-of-trade improvements.

5.1.5 The Byrd Amendment

The U.S. Byrd Amendment exemplifies the political preference for private rent creation over budgetary revenue. The Amendment gave the revenue from anti-dumping and countervailing duties, which had previously been included in the U.S. government budget, to domestic producers who had claimed to be disadvantaged by unfairly priced imports.²⁰

5.1.6 Government procurement

Another instance of political willingness to accept deterioration in the terms of trade is a domestic supply preference in government procurement when imports are less expensive (Evenett and Hoekman 2005, 2006). Favorable terms of trade are forgone.²¹

²⁰ The Byrd Amendment, officially the Continued Dumping and Subsidy Offset Act (2000), was in place until October 2007. The procedure of directing revenue from antidumping and countervailing duties to domestic firms had been found as not in compliance with WTO rules. The Amendment was named for its primary sponsor, Senator Robert Byrd.

²¹ Procurement however often involves defense equipment, for which there are exceptional considerations that can deter reliance on comparative advantage (Mayer 1977; Arad and Hillman 1979).

5.1.7 Export taxes, revenue, and the terms of trade

Export taxes, like import tariffs, can be used to raise revenue, and, for large countries, to improve the terms of trade. If budgetary revenue and terms-of-trade improvement were priorities for governments, we would expect to see export taxes employed with a frequency similar to tariffs. Or, indeed, at a greater frequency, because trade agreements bind (or constrain) thousands of tariffs, but very few export taxes are similarly bound. In fact, export taxes by governments of high-income countries are extremely uncommon. Tariffs are welcomed by domestic import-competing firms, whereas export taxes are resisted by exporting firms. The political implications of the two means of terms-of-trade improvement therefore differ. The economy-wide implications of tariffs and export taxes are however similar: A concern for trade-tax revenue and for the overall terms of trade is an economy-wide concern. The practical relevance of budgetary revenue and terms-of-trade concerns in the conduct of trade policy is further dramatically called into question by the absence of export taxes and by the absence of provision for such taxes in trade agreements (Ethier, 2004, 2011, 2012).

5.2 The terms of trade and tariff revenue in popular models of trade policy

The above observations demonstrate the premise that rents are politically preferred to tariff revenue and that governments are willing to deteriorate their country's terms of trade for the pursuit of political objectives. Yet popular models of protectionism rely on tariff revenue and concern for the terms of trade for their conclusions about how trade policy is conducted. In the small-country, unilateral-policy, 'protection for sale' model of Grossman and Helpman (1994), social welfare declines when protection is pushed beyond the level at which falling trade volumes reduce tariff revenue. A decline in tariff revenue available for distribution reduces the utility of voters and so decreases consumer welfare or political support from voters. A concern for trade-tax revenue thus plays a crucial role in the trade-policy predictions of the 'protection-for-sale' model. The explicit predictions of the 'protection-for-sale' model collapse without the political use of tariff revenue.

A popular large-country model of reciprocal trade liberalization by Bagwell and Staiger (1999, 2004) is also inconsistent with the lack of political concern with tariff revenue, and is inconsistent with the willingness of governments to deteriorate the terms of trade for political objectives. We now turn to the politics of reciprocal trade liberalization. We now assume two countries that can influence their terms of trade. We subsequently

describe multilateral trade liberalization, and also political incentives for unilateral trade liberalization

6. The politics of reciprocal trade liberalization

6.1 Traditional models and the terms-of-trade prisoners' dilemma

In traditional trade models in which the focus is on aggregate welfare of a country and politics is absent, a government of a large country can seek to increase national welfare by imposing a tariff that improves the terms of trade. The trade equilibrium then moves off the efficient contract curve. A foreign government can also impose a tariff to improve its terms of trade. The conflict over the terms of trade may or may not result in a 'winner' (Johnson 1953-54). The countries' tariffs however reduce global welfare (through reduced trade and countries' deadweight losses in production and consumption). Reciprocal trade liberalization that restores the countries to the contract curve can be mutually beneficial (McMillan 1986). There is however a prisoners' dilemma: If one country lowers its tariff and the other does not, the terms of trade of the liberalizing country deteriorate. Cooperation to implement mutual or reciprocal liberalization avoids the asymmetric outcome of loss for one country and benefit for the other. Such cooperation to avoid asymmetric outcomes of the prisoners' dilemma is the

only reason for trade negotiations in the traditional non-political trade liberalization model.²²

6.2 Terms-of-trade externalities and trade agreements

We now introduce governments' political objectives. When a large country uses a tariff to protect a domestic import-competing industry, the protective tariff at the same time improves the country's terms of trade, so (in a two-country model) shifting part of the cost of the protection onto the (single) trading partner, whose terms of trade have deteriorated. The benefit through the terms-of-trade improvement is however incidental. The political objective was protectionist rents for the domestic industry. There was nonetheless a terms-of-trade externality through the effect of the protectionist policy on the terms of trade, to the detriment of the trading partner.

When trade liberalization negotiations take place, the negotiations can be modelled as directly involving the terms of trade, because of aggregate welfare gains and losses due to terms-of-trade changes (Bagwell and Staiger 1999). Yet aggregate welfare gains or losses through the terms

²²There is a qualification. Governments might use negotiated trading agreements as means to preempt domestic demands for protectionism. See Maggi and Rodriguez-Claire (2007).

of trade (which require tariff revenue distribution) are not a concern in the actual conduct of trade policy. Rent creation for political distribution is at the forefront of political calculations. We could of course simply observe the subject matter of international trade negotiations. Such observations confirm (see Regan 2006, 2015) that aggregate country gains and losses due to the terms of trade are not on the agenda of trade negotiations.

Still, then, with the terms of trade the possible link between two negotiating countries' economies, what are the negotiations about? If national governments can achieve their objectives unilaterally, trade negotiations between countries are not required. In the popular model of trade negotiations of Bagwell and Staiger (1999, 2004), domestic political objectives for example can be addressed unilaterally.

Reciprocal trade liberalization that does not change the terms of trade allows both countries to gain by trading more. This notion of reciprocity focuses on country aggregate welfare gains and is described adequately in the traditional no-politics trade model.²³

²³ Trade negotiations have been modeled in a prior model by Grossman and Helpman (1995a). The model includes interest groups seeking foreign market access and encompasses political contributions by interest groups in one country to politicians in another country. Policies are described as outcomes from a non-cooperative game and a cooperative bargaining solution. A companion paper (Grossman and Helpman 1995b) models bilateral negotiations to determine the conditions for the political viability of a free-trade agreement when domestic producers make political contributions to influence their governments' policy stance. The *only* international externality in these models is that of the

6.3 Political exchange of market access

Trade liberalization has been modelled and described as ‘political exchange of market access’ (Hillman and Moser 1994, 1996; Hillman, Long, and Moser 1995). The terminology corresponds to the way in which trade-policy practitioners view the purpose of trade negotiations – which is to resolve issues arising from the *domestic politics* of trade policy, without aggregate welfare concerns due to the terms of trade.²⁴

In the model of political exchange of market access, two governments each maximize political support from their import-competing and export sectors. The governments’ objectives are political without regard for aggregate welfare gains or losses through the terms of trade and the outcome of negotiations need not be free trade, because of political consequences of trade liberalization in each country. What is the reason for trade negotiations if the terms of trade are not the subject of negotiations? We can identify ‘political externalities’ associated with rent creation and

terms of trade. See Ethier (2007).

²⁴ Bagwell and Staiger (2004) propose that there is no contradiction between negotiations aimed at ‘exchange of market access’ and concern to resolve terms-of-trade externalities. They state: ‘the terms-of-trade consequences and the market-access implications of trade policy choices are different ways of expressing the same thing’ (Bagwell and Staiger 2004, p 5). This is true in common trade-negotiation models, but appears inconsistent with the actual conduct of trade negotiations (see Ethier 2013, Hillman 2015, and Regan 2006, 2015).

income distribution as the reason for reciprocal trade negotiations. The political externalities are quite distinct from terms-of-trade externalities that involve countries' aggregate welfare. Governments grant protection to their import-competing sectors, but political support from these sectors requires a credible commitment that the protection will not be permitted to be undone by foreign trade policy. The commitment to protect is embedded in a countervailing duty law and in other methods of administered protection that disallow 'unfair' import competition through dumping or foreign government subsidies. The commitment to protect, imperfect as it in fact is, constrains a *foreign government* from using policies to assist its export industries because such policies will elicit a countervailing policy response by the governments of trading partners. There is therefore a *political externality* from a foreign country's trade policy. The political externality is that, in committing to protect import-competing producers, a government prevents other governments from aiding their exporters. The political externality establishes a basis for trade negotiations that is distinct from a terms-of-trade externality (Ethier 2013).

Given that governments are constrained from assisting their export industries through subsidies, the only way to provide benefits (or rents) to exporters is, in the language of trade negotiations, by governments making mutual 'concessions' in allowing foreign producers increased access to their

home markets (Hillman and Moser 1994, 1996). Each government allows exporters from the other country access to its home market and exporters in both countries benefit (the specific-factors model is in the background). Both governments thereby please and obtain political support from export interests (Hillman and Moser 1996, Ethier 2013). Import-competing industries retain the contingent protection of anti-dumping and countervailing duties. The trade negotiations involve the industry-specific domestic political concerns of the governments of the trading partners, indicated in general in the appendix to the trade agreement. The agreements have consequences for the terms of trade and aggregate national welfare but such consequences are incidental to the governments' domestic political objectives, which involve rents and income distribution. If domestic political objectives warrant, there will be no objections by trade negotiators to deterioration of their country's terms of trade.

6.4 The MFN clause and nondiscrimination

Although models often describe bilateral liberalization, exchange of market access in practice has often been multilateral through the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO), which require that market-access benefits or 'concessions' given to any trading partner be given to all other participating nations. This most-

favored nation (MFN) requirement had previously often been a clause included in bilateral trade agreements. The reason for the clause can be illustrated as follows. Suppose country *A* and country *B* agree to exchange market access by reducing their tariffs on each other's goods by 50%. *A* might, absent an MFN clause in the agreement, subsequently bargain with *C* to reduce tariffs by 60%, thereby transferring to *C* the market access *A* had promised *B*. Yet by itself the MFN clause gives only limited protection against such behavior. The clause would not prevent *A* from extending to *C* the *same* tariff reductions *A* had granted *B*, thereby forcing *B* to share its increased access to *A*'s market with *C*. The true benefit from MFN comes from the fact that it is *universal* (within the GATT-WTO). The benefit to *B* is not so much that in the agreement *A* has given *B* MFN status; it is that *A* has given *every* country MFN status, and therefore will not make *B* offers subject to benefit-reducing *ex post* maneuvering. It is the *multilateral externality* of MFN that is crucial. This is why GATT-WTO imposes MFN as a basic universal requirement, instead of, as with tariffs, something to be negotiated about. The MFN clause protects against strategic behavior in trade negotiations and explains why trade liberalization is in practice in general multilateral (Ethier 2002; Ludema and Mayda 2009).

6.5 Why accuracy in describing trade negotiations matters

The trade agreements that are negotiated are agreements between sovereign states: The agreements must be self-enforcing: Individual governments will act unilaterally, whether legally consistent with trade agreements or not, to further their own interests. The agreements are also necessarily incomplete in constraining any country's trade policy. A multilateral trading order as exists in practice requires a way of dealing with such unilateral government actions. How individual countries' governments behave is critically sensitive to what the trade agreements try to constrain. Understanding that is central to designing a feasible multilateral order. If the purpose of trade agreements is to deal with terms-of-trade manipulation, the agreements need to be designed to deal with unilateral efforts to improve the terms of trade; but if the agreements attempt to constrain protectionism, the threat is instead a unilateral denial of domestic market access to foreign firms. A traditional tariff for large countries does both, but, with such tariffs bound by trade agreements, countries instead use administered protection, which, as we have seen, may deny market access while worsening the terms of trade. Thus it matters crucially that the institutional aspect of trade agreements – dispute settlement and trade law more generally – be designed to deal with the real threats. Thus, if the aim of a trade agreement were to constrain countries

from unilaterally improving their terms of trade at the expense of trading partners, the agreement would have no reason to limit voluntary export restraints, but it would comprehensively address export taxes. Fortunately, actual policy makers and negotiators have ignored the academic view that, even in a model with political objectives, retains the supposition from traditional trade models of centrality of aggregate welfare gains and losses through the terms of trade as the reason for negotiation of trade agreements. They have instead tried, with more or less success, to deal with the actual threats to the multilateral trading system.

6.5 Small countries

Small countries by definition do not influence their terms of trade and firms in these countries can, in traditional trade models, sell as much as they wish in competitive world markets at given world prices. Yet the evidence is that governments of small countries enter into negotiations for exchange of market access, with producers in small countries encouraging their governments to negotiate foreign market access for their products, just as do producers in large countries that can influence their terms of trade. The usual trade models, with or without politics, do not explain motives of firms in small countries in seeking foreign market access, or indeed in seeking new markets anywhere. There are clearly elements missing from

traditional trade models required to explain why small countries (or producers in small countries) want market access. The usual trade models do not include benefits from market access when there is unutilized productive capacity: in general, production is not always at full capacity (Corrado and Matthey 1997). When competition is technological, access to markets allows newly developed products to be sold to recover fixed costs of product development. We have of course now left the perfectly competitive markets of the traditional trade models.

7. Unilateral trade liberalization

In traditional trade models, a welfare-maximizing government might *unilaterally* liberalize to achieve aggregate gains from trade. In a political-economy model, politics can lead to unilateral liberalization. For a small country (so setting terms-of-trade issues aside), if all people could diversify their sources of income to be in complete correspondence with the shares of income sources in national income, there would be no special interests seeking protectionist policies and governments would have no political incentive to choose a trade policy other than free trade. The consequences of diversification of income sources for trade policy have been studied by introducing stock markets and asset ownership into the specific-factors model of international trade (Feeney and Hillman 2004). A much-studied

case of unilateral trade liberalization is the 19th century repeal of the UK Corn Laws. The liberalization can be attributed to a disposition of political decision makers towards the social benefit of free trade and an increase in the political power of the industrial class. Evidence also shows (Schonhardt-Bailey 1991, 2006) that the land-owning interests who had benefitted from the protection of the Corn Laws diversified through the stock market into ownership of assets outside of agriculture and thereby became more attuned to the broad efficiency benefits of free trade, compared to a previous focus on sector-specific benefits from protection of the agricultural sector.

8. Partial trade liberalization

8.1 Preferential trading areas

Viner (1950) observed that, because of trade diversion, preferential trading does not ensure gains from trade.²⁵ Kemp and Wan (1976) showed that a

²⁵ Trade creation through specialization according to comparative advantage generates gains, but there are losses through trade diversion when consumers switch from a low-cost source at world prices to a high-cost import source at world prices (the switch occurs when the domestic price of imports from the low-cost source includes tariffs but the domestic price of imports from the high-cost source does not). Trade diversion occurs when trading opportunities have expanded, but there has been no restriction of pre-existing trading opportunities. How do expanded trading opportunities result in a social loss? The loss can be shown to be due to a multi-person prisoners' dilemma (Hillman 1989b).

common external set of tariffs for a customs union can, with lump-sum transfers among the members of the union, leave no country worse off than before the union. This suggests the possibility that governments might move to global free trade through progressive enlargement of a customs union.²⁶

Preferential trading often involves geographically contiguous countries, which eliminates border corruption and smuggling between member countries. The agreements often seem politically motivated, to create blocs of contiguous countries with more political prominence than the individual countries on their own. National bureaucracies gain from extension to supranational levels (Vaubel 1986; Vaubel, Dreher, and Soylu 2007; Vaubel 2015).

8.2 Special duty-free economic zones

Governments in various countries have established duty-free economic zones in which producers have special tax privileges. The justification has been attraction of export-oriented foreign investment without exposing

²⁶ Lump-sum taxes and transfers required among the members of the customs union might be difficult administratively and politically. Moral hazard to evoke transfers can be envisaged: Regulation would be required to ensure that reported costs of production by custom-union members are real and not just a means of evoking compensatory income transfers.

domestic producers to foreign competition. The zones are therefore means of protection of domestic producers. Benefits have been difficult to identify through traditional trade theory. Hamada (1974), in a theoretical analysis using a standard Heckscher-Ohlin model, with protection taking the form of an import duty and with free movement of factors between the duty-free zone and the remainder of the economy, found no welfare advantages from a duty-free zone in the absence of foreign investment; but with such investment (and with the domestic economy incompletely specialized), Hamada found that national income evaluated at world prices declines. Rodriguez (1976) showed, in the framework studied by Hamada, that, with free factor movements between the duty-free zone and the rest of the economy, the equilibrium for the economy is the same as in free trade and all trade takes place through the duty-free zone. Other investigations have been concerned with the implications of such zones for national welfare. Public-choice premises introduce the consideration that borders create rents through different values of outputs and inputs in the zone and in the rest of the country (Hillman 2005b). Intermediate goods imported duty-free into the special zone can find their way across the 'border' where the same legal imports are taxed. Even though in principle the duty-free areas are export zones with output not intended for the domestic market, rents are created through smuggling into the taxed economy. Special duty-free zones

are characteristically found in low-income countries often with rampant corruption. The zones could allow producers to escape corruption and the need for bribes in the broader economy. Yet corruption facilitates rents through smuggling of untaxed goods into the taxed economy. The export zones have also been a means of money-laundering: Capital that has been taken abroad returns through investment in the duty-free zone by a nominally foreign entity (Chen and Liu 2015).

9. Empirical evidence

9.1 Protection

Empirical studies reveal the presence of political-economy aspects of protectionist policies. Tavares (2006) reported evidence suggesting that industry interests acting as lobbying groups became more pronounced with the institution of the common European market and common European trade policy. She also found (Tavares 2007) that country size influenced the determination of common European trade policy, with individual countries' political weights approximated by a country's share of voters in the European Union. In a further examination of European trade policy, Francois and Nelson (2014) concluded that political weights given to producer interests were two to three times the weight given to social welfare. They also found that industries important to particular member

states of the European Union received higher protection, confirming the conclusion of Tavares (2007) regarding country influence on European trade policy.

The Grossman-Helpman protection-for-sale model has been much addressed empirically (Goldberg and Maggi 1999; Gawande and Bandyopadhyay 2000; Mitra, Thomakos, and Ulubaşođlu 2002; McCallum 2004; Facchini, Van Biesebroeck, and Willman 2006). The results have revealed consistency with the general political-economy predictions of the model, but not for the model-specific predictions associated with the central role of trade-tax revenue (Ethier 2006, 2012). The empirical results generally imply very high government weights to social welfare, in contrast to the above empirical results suggesting otherwise.

If an elasticities-based rule determines the structure of protection, politicians offering protection for sale should know the elasticities, as should the industries buying protection. An explanation is required for how the structure of protection implied by the elasticities would naturally emerge.²⁷

²⁷ Such an explanation would parallel, for example the evolutionary argument that firms that survive competition are maximizing profits whether consciously or not (Alchian 1950).

9.2 Do countries use tariffs to manipulate their terms of trade?

Broda, Limao and Weinstein (2008) reported evidence for various countries that tariffs are negatively correlated with foreign export-supply elasticities. They interpret this as suggestive of the existence of optimum tariffs, which imply just such a correlation. The problem is that the same correlation is also implied by other possible policy objectives. If the objective is purely domestic, linked to a domestic-price target but motivated not at all by a concern for the terms of trade itself, a lower foreign export-supply elasticity would require a higher tariff to reach the domestic target.

9.3 Empirical aspects of trade liberalization

Under the auspices of the GATT, substantial trade liberalization has taken place through multilateral negotiations, and also through free-trade agreements and customs unions (including the European Union). The negotiations have involved exchange of market access (Regan 2015). An empirical question is whether the negotiations have also involved the terms of trade. There is no evidence that the terms of trade have been an issue in trade negotiations (*ibid*). Ludema and Mayda (2013) reported finding empirical effects of terms-of-trade internalization in trade negotiations, but we do not know if the terms-of-trade effects are the consequence or the

objective of the negotiations. An important question is whether the negotiations were over the trade *consequences* of terms-of-trade manipulation rather than over the terms of trade themselves. Bagwell and Staiger (2011) have presented evidence that trade negotiations have resulted in cutting tariffs in ways that would be called for were the initial trade volumes reflective of terms-of-trade concerns. But the tariff reductions might also be the result of quite different concerns.

The substantial trade liberalization that has taken place shows that, consistently with the predictions of the exchange-of-market-access approach, governments are prepared to forgo budgetary revenue by mutually relinquishing tariffs to provide exporters with increased market access, at the political cost of exposing import-competing industries to greater foreign competition.

An increase in a tariff can *both* improve the terms of trade and deny market access to foreign firms. So one cannot infer motive from the act itself. Given the existence of trade agreements, traditional tariffs are no longer the unilateral instruments of trade policy. The use of administrative protection does help to disentangle the potential motives. Very often, as has been noted, such protection in effect ‘purchases’ a denial of market access by accepting a terms-of-trade deterioration (Ethier 2013). This is consistent with the exchange-of-market access view of trade liberalization.

10. Globalization

Globalization has had political-economy consequences. The nature of international trade has changed (Hillman 2008). Goods and services have become traded that previously were not (for example, radiologists can report results for patients in other countries). The internet has eliminated international boundaries for buying and selling. Global terror has added costs to air travel and shipments of goods. Globalization has changed the 'world' factor endowments relevant for international trade, so changing countries' comparative advantage. Trade theory predicts that returns to factors of production will be made more equal by free trade. Globalization has indeed decreased wages of unskilled labor (Freeman 1995; Wood 1995) and has benefitted skilled labor (Gregory, Zissimos, and Greenhalgh 2001) in high-income capital-abundant countries. But, contrary to the equalization prediction, such a skilled-labor premium has also appeared in their low-income, labor-abundant trading partners. The predominant view is that the skilled-labor premium has much more to do with skill-biased technical change than with trade liberalization. Less clear is the degree of causality between the latter and the former (Ethier 2005).

11. Voting on trade policy

The political-support approach that we have been describing utilizes the background of representative democracy. A median-voter model of trade-policy determination formulated by Mayer (1984) describes trade policy as the outcome of direct voting. Mayer's results depend crucially upon giving trade-tax revenue a central role. Also, however, median-voter models are models of collective choice but not models of political economy. Voters in a median-voter model confront no political principal-agent problems. Political decision makers are absent and 'government' is reduced to an implementing bureaucracy.

In the direct-voting model of trade-policy, beneficiaries of protection for any industry would in general be a minority of voters. If voting is based on industry interests (the specific-factors model), supporters of a protectionist policy would never have a majority - unless logrolling takes place.²⁸

There have instances of direct voting on trade policy. Weck-Hannemann (1990) a 1975 Swiss referendum on a tariff on imports of processed foods. Irwin (1994) found in a UK election in which trade policy

²⁸ See Hillman (2009, chapter 6.2) for a comparison of voting under direct and representative democracy. In particular, Ostrogorski's paradox shows how voting outcomes under direct voting and the delegated voting of representative democracy can result in opposite outcomes.

was a principal issue that voting reflected self-interest within the classifications of the specific factors model and voters with incomes associated with non-traded goods sectors supported free trade.

12. Conclusion

This chapter has presented a public-choice overview of the politics of international trade policy. The traditional normative trade models do not require public-choice premises.²⁹ A political-economy perspective adds realism to the study of trade policy through two public-choice premises. Political decisions are motivated by political objectives, and, in pursuit of the political objectives, policy-created politically-assignable rents have priority over budgetary revenue and aggregate gains from terms-of-trade improvement. The initial models introducing politics into trade policy accounted for both public-choice premises. Subsequent popular models acknowledge the first premise (political objectives of political decision makers) but not the second premise (political preference for political rent creation). In not accounting for the second premise, the popular models omit an essential element of the actual conduct of trade policy. The omission of the second premise compromises the popular models as

²⁹ See Holcombe, R. G. (2016) for an overview of public-choice premises.

explanations of the politics of international trade because tariff revenue and the terms of trade do not influence actual trade policy decisions.

We have described the role of the MFN clause in multilateral trade liberalization and political incentives for unilateral trade liberalization, and we have observed that opportunities for political discretion and expanded career opportunities in administering bureaucracies may motivate preferential trading agreements. Borders created by duty-free zones suggest opportunities for rent creation. We have summarized and reinterpreted empirical evidence on trade policy. Globalization has affected rents. There have been limited instances of direct voting on trade policy: at the industry level, models of direct voting on trade policy require that a minority of voters who gain be able to outvote the in-general much greater number of losers from protection of an industry. Under representative democracy, groups that would not secure a majority of votes nonetheless are able to have policies implemented from which they gain at the expense of society at large.

13. References

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