International Economics
Fall 2011
International Trade Policies

Oct. 13, 2011

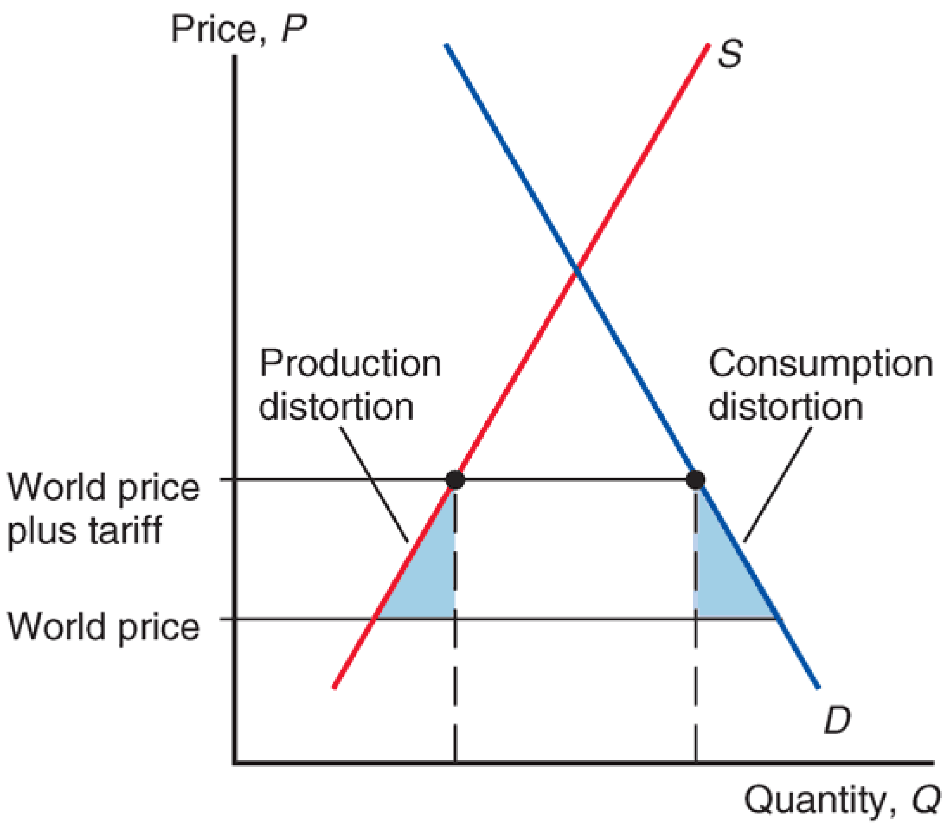
Today's Plan

- The case for & against free trade
- Political economy of trade policy
  - The logic of collective action
  - Politicians for sale
- Two industrialization paths compared
  - Import substituting
  - export-oriented

The Case for Free Trade

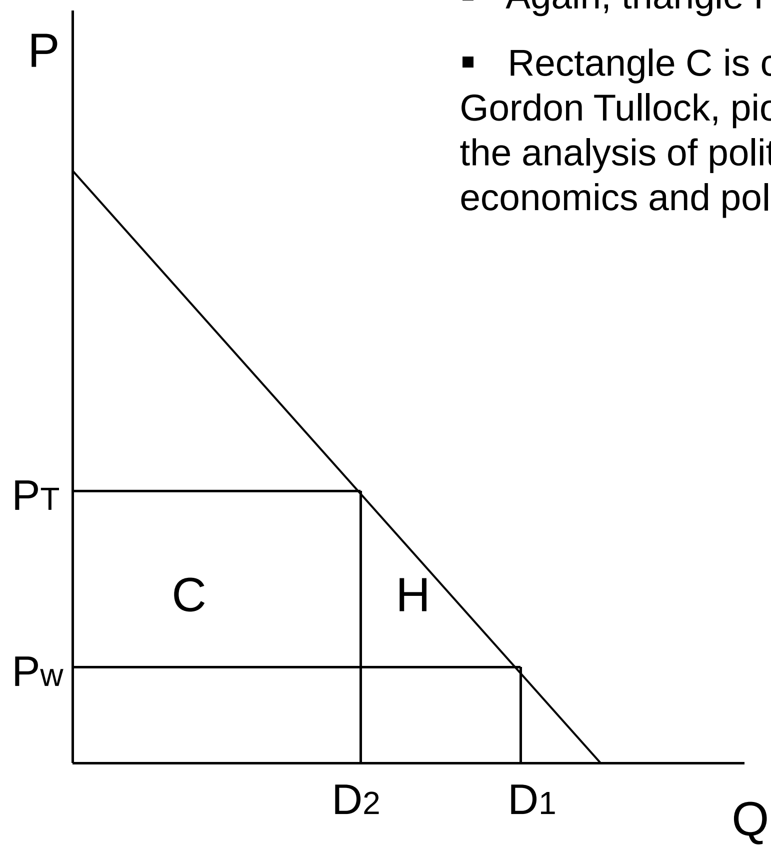
- Efficiency gains from
  - Specialization
    - Countries produce what they're best at
    - Through trade and market exchange, every country gets to consume more, at cheaper prices and with more varieties
  - Economies of scale
    - International trade enlarges domestic market size and expand it to world market
    - Larger market size lowers marginal cost of production and improves efficiency
  - Avoid distortion and misallocation of resources from trade protectionist measures
    - Production distortion
    - Consumption distortion
    - Unproductive rent-seeking activities

The Potential Efficiency Gains from Free Trade – the opportunity cost of trade protectionism



- The blue triangle on the right is called *Harberger Triangle*, named after Chicago economist Arnold Harberger.
- It's a dead-weight loss to society due to tariff. The reason it's called dead-weight loss is because it's a loss that nobody captures it - not the producer, nor the government.
- The blue triangle on the left is called production distortion, part of the consumer surplus loss. It's also a dead weight loss, again, because nobody captures it.

The Case for Free Trade (cont.)



- Again, triangle H is Harberger Triangle, it's a dead weight loss.
- Rectangle C is called *Tullock Rectangle*, named after economist Gordon Tullock, pioneer of public choice theory, which revolutionized the analysis of political economy and had profound impact on economics and political science.

- Tullock argued that the actual loss from higher price as a result of monopoly or tariff is much bigger than H, or (b+d).
- He argued the whole area of C+H could be up for grab among different groups. These groups, be it farmers, steel producers, auto worker unions or consumer advocates have incentives to lobby government to impose tariff, or not to. A lot of resources are wasted in the process of actively seeking part or all of C+H.
- C+H is called rent. It measures the max resources that interest groups are willing to spend on the non-productive activities. All the activities involved in seeking a share of C+H are called rent-seeking activities.

The Case for Free Trade (cont.)

- Dynamic gains from trade
  - Trade ➔ foreign competition
  - How trade-induced competition could spur economic dynamism in home country: the notion of *Creative Destruction* by Joseph Schumpeter:

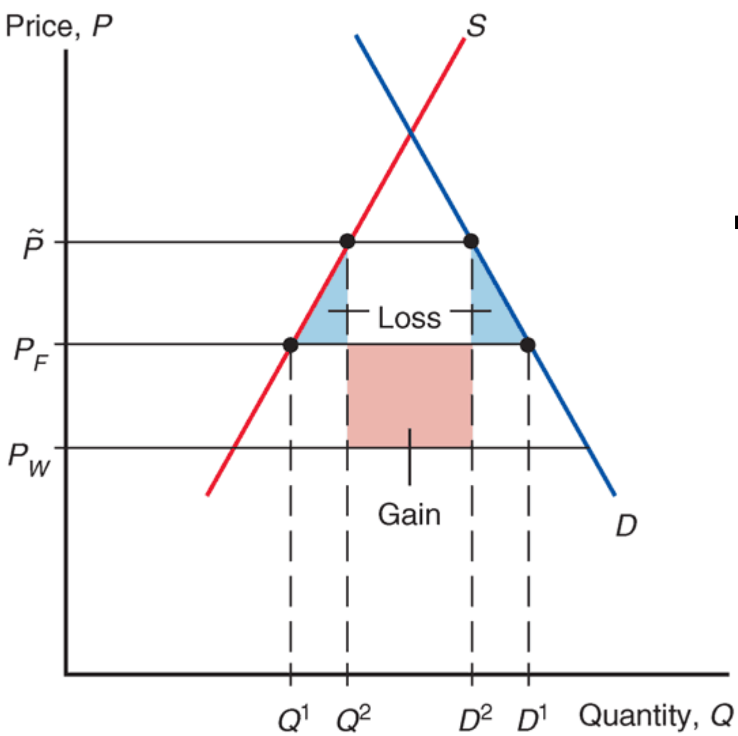
> The fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers' goods, the new methods of production or transportation, the new markets….The process of industrial mutations…that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one. The process of Creative Destruction is the essential fact about capitalism.

The Case for Free Trade (cont.)

- Dynamic gains from trade
  - Trade spurs domestic competition
  - Introduction of <u>new goods</u> into the market
    - Traditional welfare analysis of tariff discusses the situation where higher tariff only lowers volume of imports, and domestic consumers still get to access the imported goods, albeit at higher prices.
    - But in some cases, according to Paul Romer, a small tariff could completely block (or discourage) introduction of new goods into the market, especially when such new goods face high fixed cost in domestic market. Thus, there are no more imports.
    - In such situation, consumers have no access to the new goods (or can be new innovations, e.g. iPad), which reduces the varieties of goods available to domestic market --- the welfare loss could be much bigger than what traditional tariff analysis would imply.

The Case Against Free Trade

- Import tariff brings distortions of both productions and consumptions, but it also increases government revenue, and improves TOT (only for big countries). The net welfare loss is ambiguous, and it's possible tariff can increase domestic welfare.
- The concept of <u>Optimal Tariff</u>



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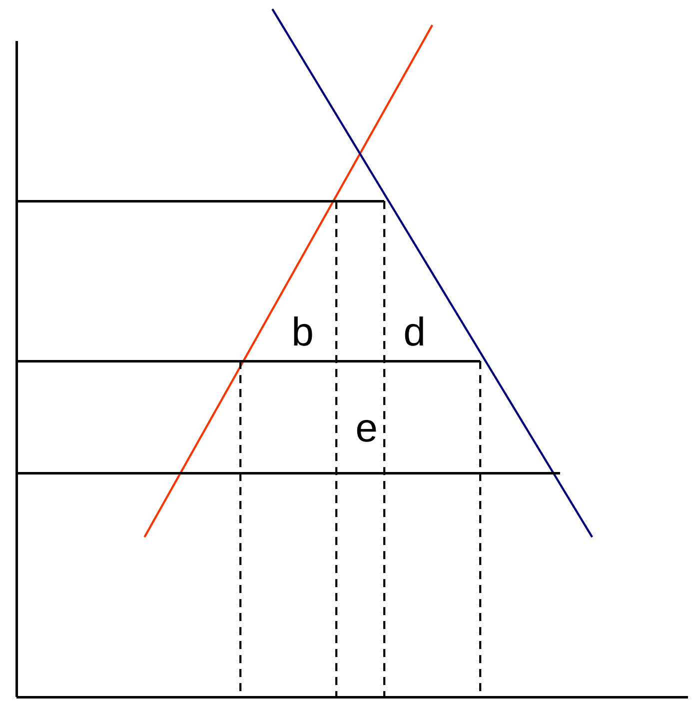
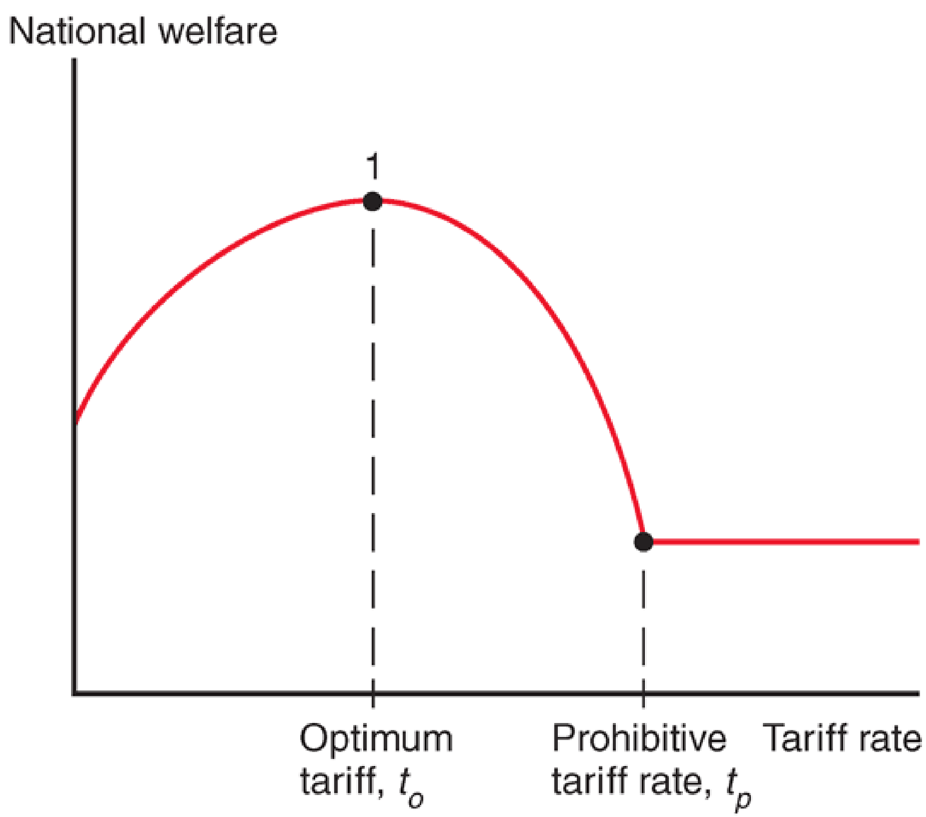


The Case Against Free Trade (cont.)

- Concept of Optimal Tariff



➔ But again, this analysis did not consider the possibility of

1) resources wasted on rent-seeking activities;
2) welfare loss due to unavailability of new goods.

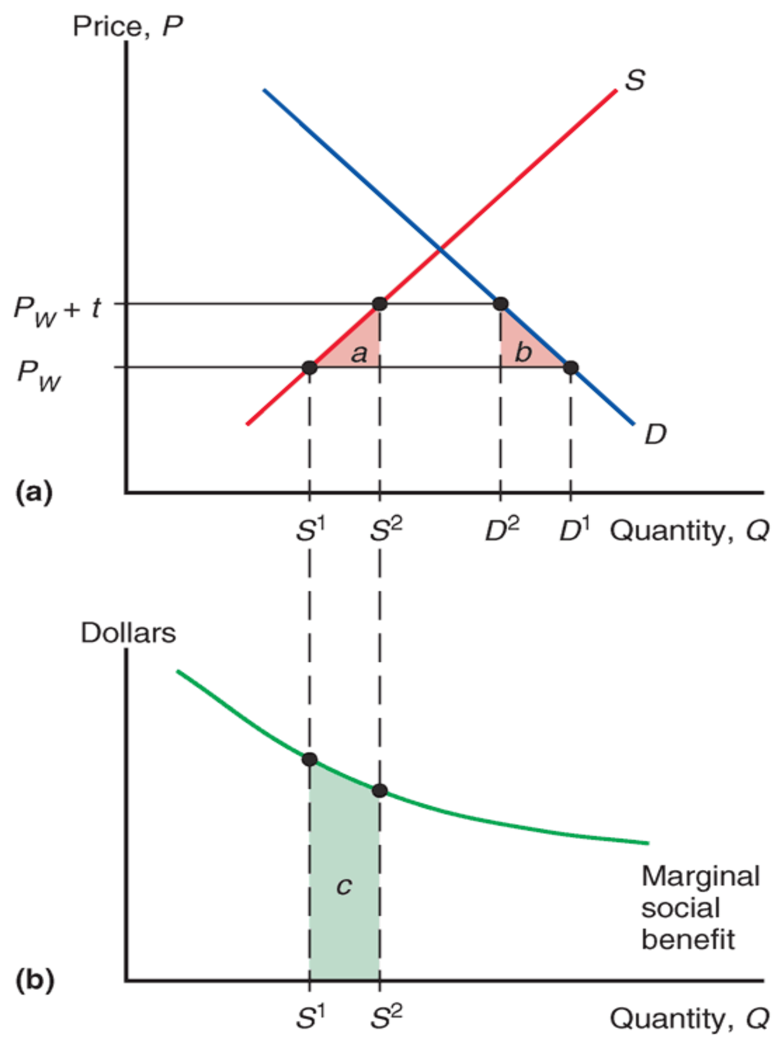
Case Against Free Trade (cont.)

- Export subsidies
  - It unambiguously reduces national welfare
  - So a **negative** export subsidy or a tax on export should improve national welfare, unambiguously.

- When considering **social** benefits of import tariff…➔

Case Against Free Trade (cont.)

- a is called production distortion. It represents misallocation of resources due to distorted price signals
- But if more home production can bring larger social benefits, c, and c>a, then import tariff could be justified.
- What are the potential social benefits?
  - Jobs retained at home
  - Technology spillovers, etc.



Political Economy of Trade Policy

- The Logic of Collective Action
  - Mancur Olson, 1965
  - Understand the logic by comparing the ***opportunity cost of inaction*** of:
    - Individual consumers (the absolute majority)
    - Individual workers in the industries that are especially hit hard by free trade (the absolute minority)
    - Why the opinions of the minority group can dominate the majority group?
  - Plus, smaller groups are much easier to organize – it'll be extremely difficult to organize all consumers for free trade – that's why you always hear more about protests against free trade
  - But why do politicians have incentives to favor a small group, obviously deviating from the interest of the majority, or the median voters?...

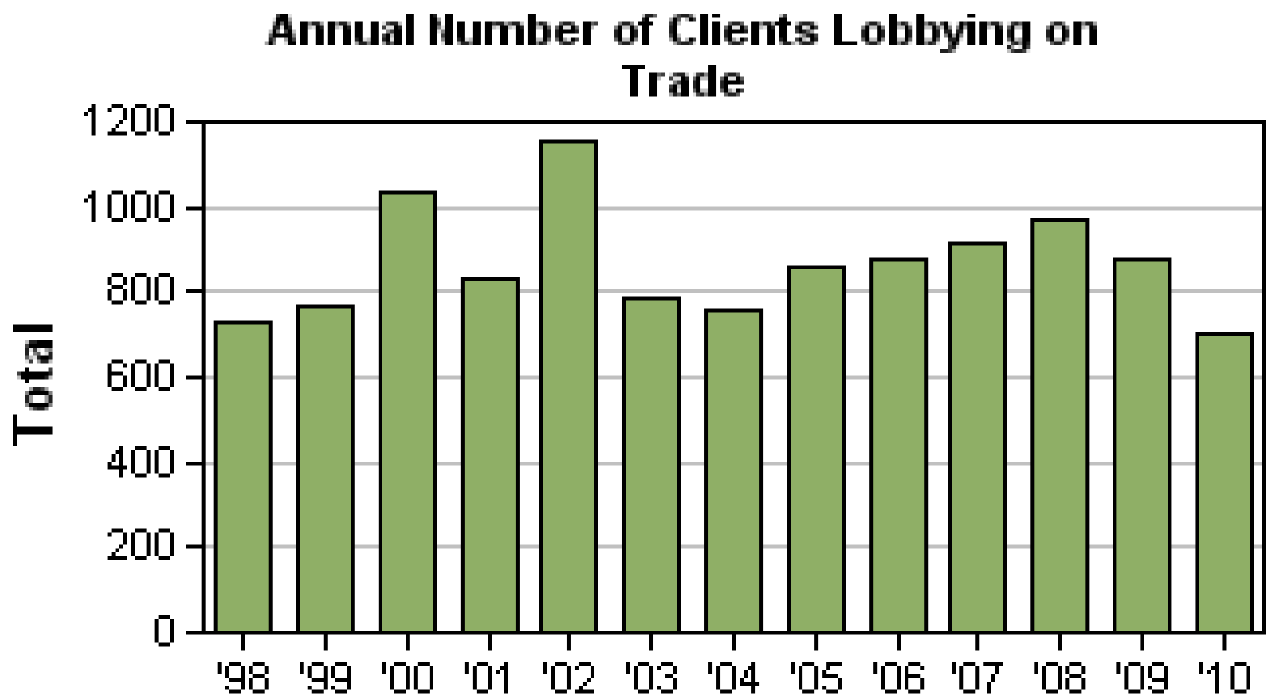
Political Economy of Trade Policy

- Politicians for Sale
  - Politicians as economic men
    - Rational
    - Self-interest
    - Incentive-driven
  - Empirical evidence

	Vote for NAFTA	Vote for GATT
Actual	229	283
Predicted by model	229	290
Without labor contributions	291	346
Without business contributions	195	257
Without any contributions	256	323

Political Economy of Trade Policy

- Politicians for Sale



For more, go to http://www.opensecrets.org/lobby/index.php

Import Substituting Industrialization

- Import substituting industrialization was a trade-growth policy adopted by many low and middle income countries before the 1980s.
- The policy aimed to encourage domestic industries by limiting competing imports.
- It was often accompanied with the belief that poor countries would be exploited by rich countries through international financial markets and trade.

Two Industrialization Paths Compared

- Import-substituting strategy, or import-substitution
  - aims to grow economy by limiting imports
  - the goal is to fend off foreign competition, wait until domestic industries grow strong – the so-called *infant industry argument*
  - Very appealing, adopted by many developing countries in the past, but rapidly disappeared after 1980s
- Export-oriented strategy, or export-led
  - aims to grow economy by exporting goods to developed countries, where demand is strong and consumption accounts for a much larger share of GDP
  - Almost all East Asian economies, more or less, adopted the same growth strategy and achieved great success. These countries include Japan, South Korea, Singapore, and more recently China.
  - East Asia's growth experience is the major empirical evidence that free trade promotes economic growth
  - Recently facing increasing criticism – consider the global imbalances

Import Substituting Industrialization (cont.)

- The principal justification of this policy is the *infant industry argument:*
  - Some industries that are vital to a country's development can not initially compete with well-established industries in other countries.
  - To allow these industries to establish themselves, governments should temporarily support them, until they grow strong enough to compete internationally.

On Infant Industry Argument

- Some historical background

  Alexander Hamilton, the first Treasury Secretary of the US, advocated the idea, when the U.S. was still a developing country in early 1800s.

  He is also the guy on the Ten-dollar bill.

On Infant Industry Argument

- Some historical background

Friedrich List, a German economist, commonly known as the father of infant industry argument, learned the idea during his exile in the US in 1820s.

Back then, Germany was also a developing country when compared to the Great Britain. Facing British cry for free trade, List saw hypocrites:

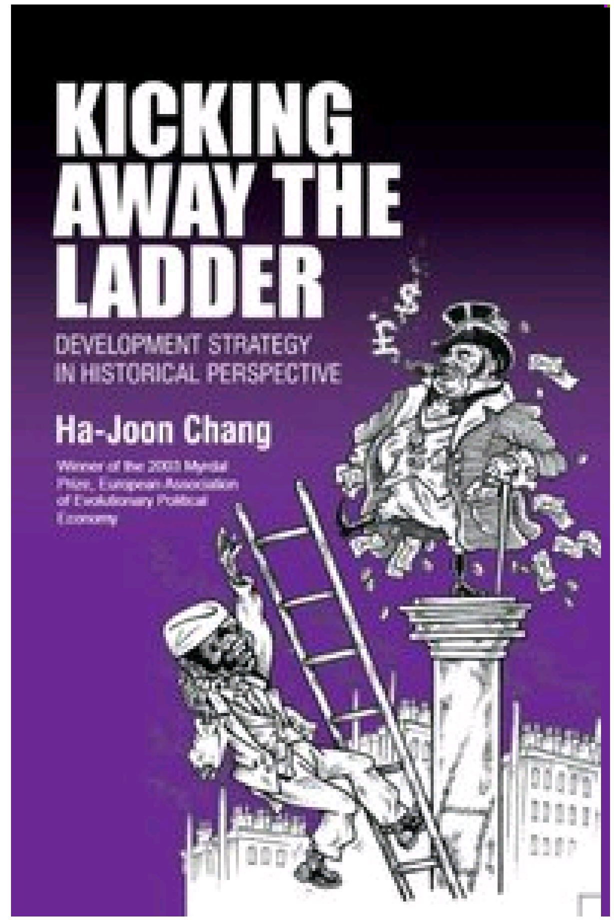
" Any nation which by means of protective duties and restrictions on navigation has raised her manufacturing power and her navigation to such a degree of development that no other nation can sustain free competition with her, can do nothing wiser than to throw away these ladders of her greatness, to preach to other nations the benefits of free trade, and to declare that she has wandered in the paths of error, and has now for the first time succeeded in discovering the truth. "

More on Infant Industry Argument

In his recent book, “**Kicking Away the Ladder**: Development Strategy in Historical Perspective”, Ha-Joon Chang at Cambridge argued:

“Just like yesterday’s Britain, today’s US’ preaching free trade to less advanced countries was like someone trying to ‘kick away the ladder’ with which he had climbed to the top”

➔ **Do you agree with Chang’s assessment?**



Problems w/ Infant Industry Argument

- With protection, and without pressure from competition, infant industries may never “grow up” or never become equally competitive as their international rivals.

- In reality, unfortunately, this was often the case – another good example of economic policies with “good intentions, but bad outcomes”.

- Government knows no better than private sectors and entrepreneurs - instead of direct government intervention, can government provide incentives for private sector to invest in infant industries?

- Government’s handpicking which industries to protect increases the chance of corruption, especially in developing countries, where governments are subject to no (or much less rigorous) checks and balances.

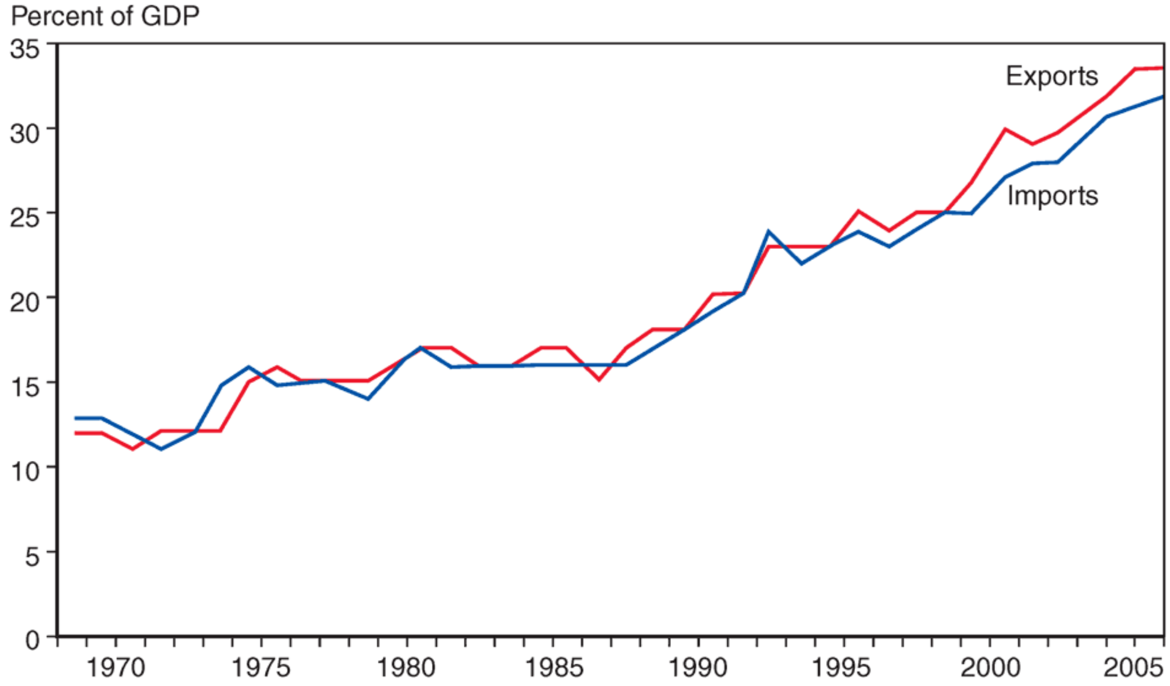
Import Substituting Industrialization (cont.)

- It worked in Latin American countries in the 1950s and 1960s, at least claimed so by the supporters of the policy.
- But if you compare growth experiences across countries,
  - Countries adopting these policies grew more slowly than other countries that did not adopt them
  - The contrast with economic performances of export-led economies is even more pronounced
- Also, if you compare economic performances of the same country during different time periods:
  - China – pre 1980: total “independent” economy in the sense that international trade was non-existent and economic performance was terrible; post 1980s: one of the few countries in economic history with the highest sustainable growth
  - India – pre-1990s (import substitution) vs. post 1990s (trade liberalization)

Export Oriented Industrialization

- Countries or regions that adopted such strategy: Japan, Hong Kong, Taiwan, South Korea, Singapore, Malaysia, Thailand, Indonesia, and China.
- Export-led growth strategy, or trade liberalization in general, has been more favored in developing countries in recent decades.

The Growth of Developing-Country Trade



Export Oriented Industrialization

- One common misconception is: since these economies are export-led, their import volumes must be very small
  - What has been observed is that these economies generated very high volumes in both exports and imports.
  - This is vastly different from the old *Mercantilist* policy, where only exports are encouraged, and imports are discouraged.