The Political Economy of Trade Policy

Paul Krugman

P   Tariff analysis (partial equilibrium)

WP + tariff

a   b   c   d

WP

Q
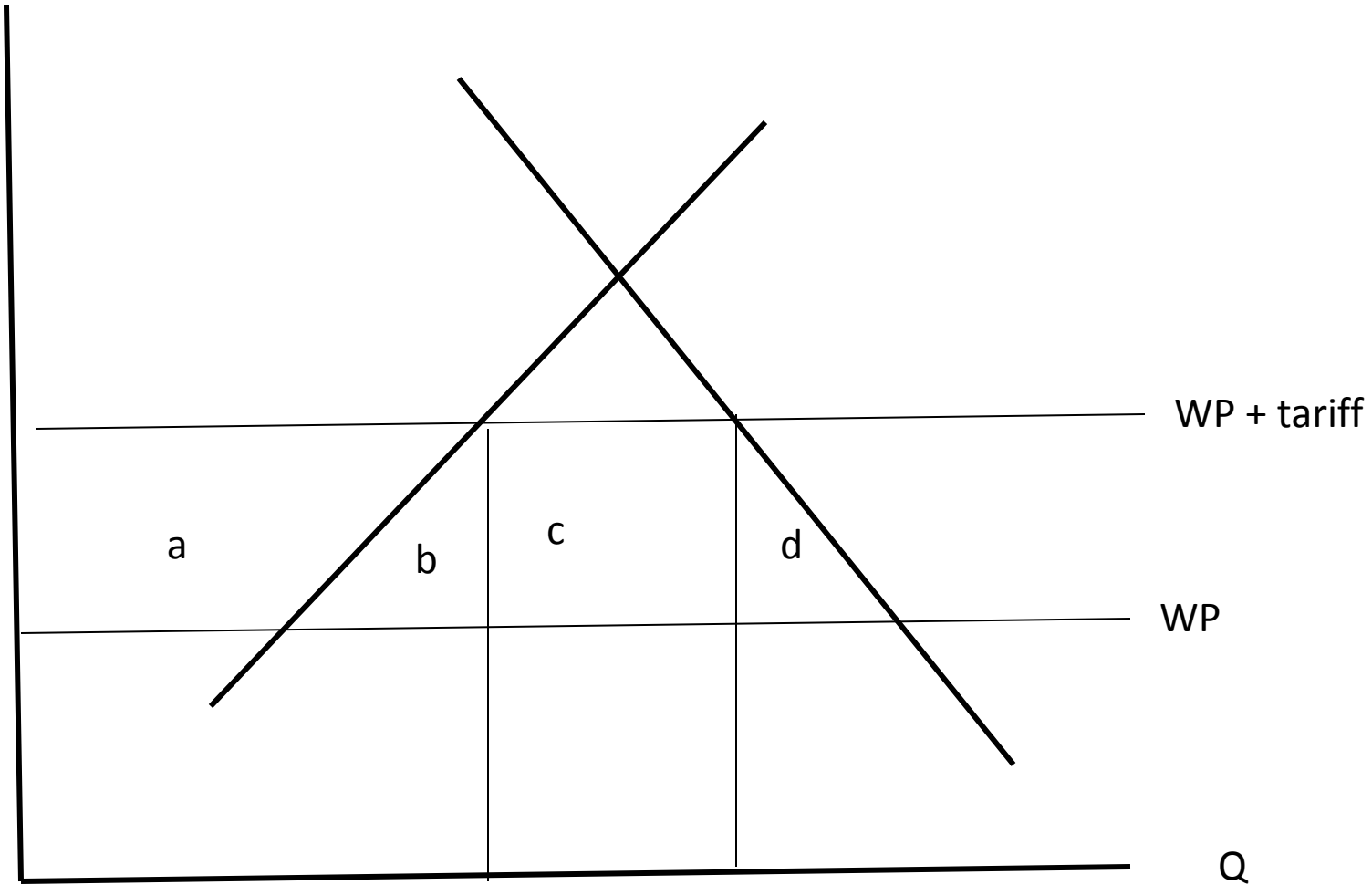
Producer gain = a

Deadweight loss = b+d

Consumer loss = a+b+c+d

Revenue = c
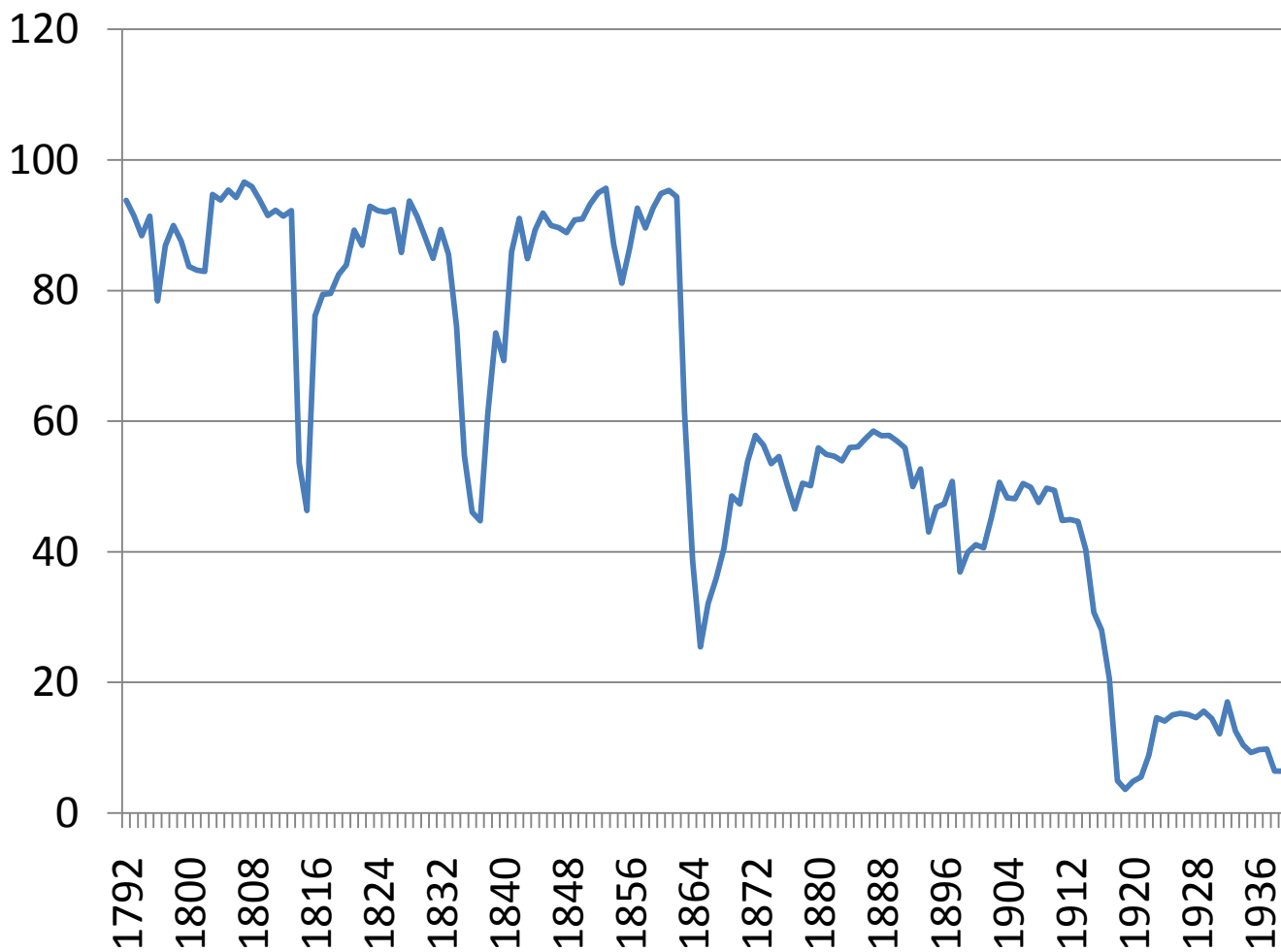
No tariff if the same weight is placed on everyone's gains or losses

But this may not be true:

1. Revenue matters: c may count more than private gains or losses

2. Different groups may be differentially organized

Customs share of revenue

Table 1: Relationship between Trade Taxes and Per Capita Income			
	Dependent variable:		
	All trade taxes as a share of total tax revenue, 1984-86 average	Import duties as a share of total tax revenue, 1984-86 average	Export taxes as a share of total tax revenue, 1984-86 average
Constant	0.353*	0.279*	0.065*
Per capita GDP (1985)	-0.037*	-0.030*	-0.011**
$\overline{R^2}$	0.18	0.12	0.07
number of countries	77	77	77

Organization:

Mancur Olson, *The Logic of Collective Action*: political activity is a public good, tends to be undersupplied

Small, organized groups are more effective than large, diffuse groups

Tends to mean that producers "count" more than consumers

TABLE 2.3 Sugar: summary data, 2005–07[a], and simulation results, 2005–13

Item	Summary data			Simulation, %	
	2005	2006	2007	Baseline 2005–13	Liberali-zation[b]
Employment	*Full-time equivalent*				
Total sugar crop farming[c]	7,489	7,337	—	−18.1	−12.4
Sugarcane[c]	6,088	5,937	—	−35.1	−31.0
Sugarbeets[c]	1,401	1,400	—	−14.6	−9.5
Total sugar processing[d]	13,083	12,758	—	−20.6	−5.7
Raw cane sugar[d]	4,251	3,971	—	−40.8	−32.6
Refined cane sugar[d]	2,722	2,874	—	−8.2	11.0
Refined beet sugar[d]	6,110	6,113	—	−21.2	−10.0

Sugar: per capita consumption is 66 lbs per year

Trade restrictions add $0.08 per pound

So consumer cost around $5 per year per capita, $1.5 billion

Producers get around $1 billion

So this is worth around $50,000 (?) per worker

Information asymmetry between producers and consumers

Most influential approach: Grossman-Helpman

Think of politicians as maximizing weighted sum of overall
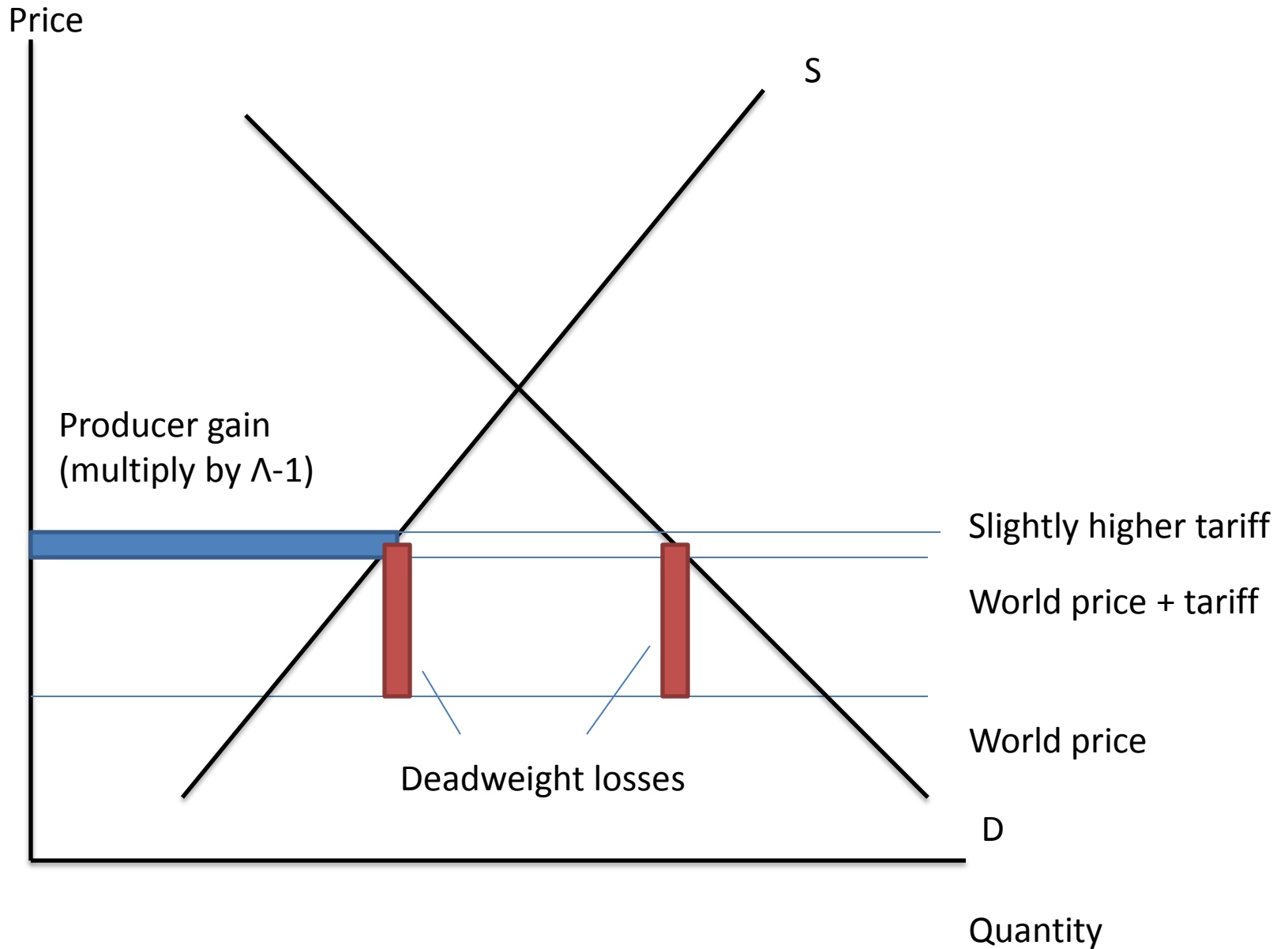 welfare and campaign contributions

Contributions give an extra "weight" to organized groups

So, suppose politicians maximize

Λ* (Producer surplus) + Revenue + Consumer surplus

 with $\Lambda > 1$

Consider a small increase in the tariff:

Price

S

Producer gain
(multiply by Λ-1)

Slightly higher tariff

World price + tariff

World price

Deadweight losses

D

Quantity

Always a net gain starting from zero tariff …

Rodrik's paradox:

Assume political power such that we have to make a transfer of $x to each sugar worker. This could be done by

1. Giving every worker now in the industry $x
2. Giving $x to all current *and future* workers
3. Giving an employment subsidy that raises wages by $x
4. Giving a production subsidy that raises wages by $x
5. Imposing a tariff that raises wages by $x

Welfare ranking 1>2>3>4>5

So why do we do 5?

Possible answers:

Pro-revenue bias

Commitment mechanism: deliberately use inefficient income redistribution to impose self-restraint

Uncertainty, ignorance

Obfuscation?

Related question: why the anti-trade bias (tariffs and quotas much more common than export subsidies)

Maybe terms of trade?
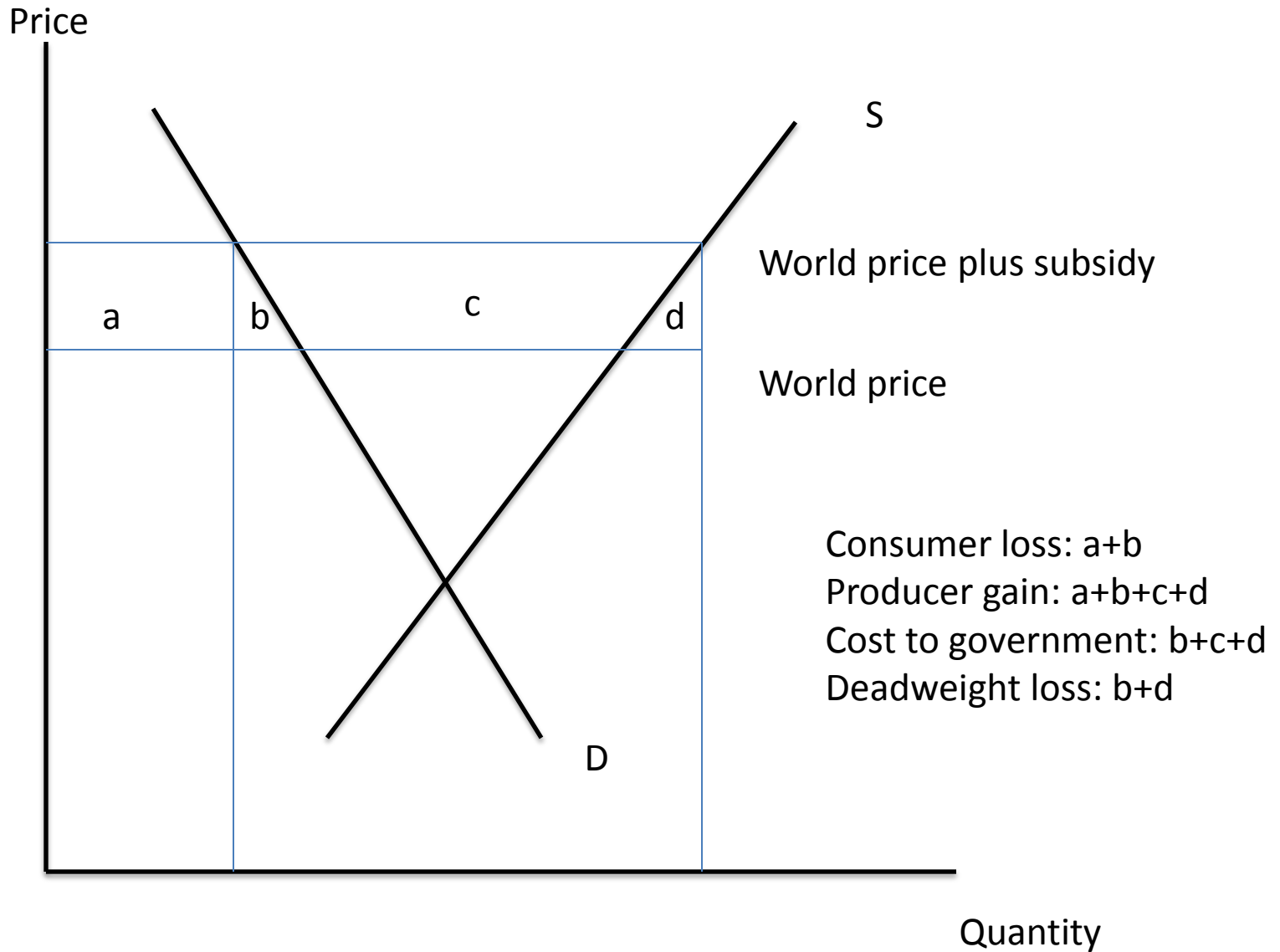
Export subsidies can only be used by few members

■ Only 25 members are entitled to use export subsidies.

■ Combined, the European Union and the United States are entitled to provide around US$10 billion in export subsidies per year. The EU provided a total of around USD16 billion in export subsidies during 2001-05, mainly for dairy, sugar and beef exports.

Export Subsidy Budgetary Entitlements

	USD mill
EU	9,607
US	594
China	0
India	0

Export subsidy: small economy

Price

S

World price plus subsidy

a   b   c   d

World price

Consumer loss: a+b
Producer gain: a+b+c+d
Cost to government: b+c+d
Deadweight loss: b+d

D

Quantity

P

Tariff analysis (with market power)

WP + tariff

a   b   c   d

Original WP

e

New WP

Q
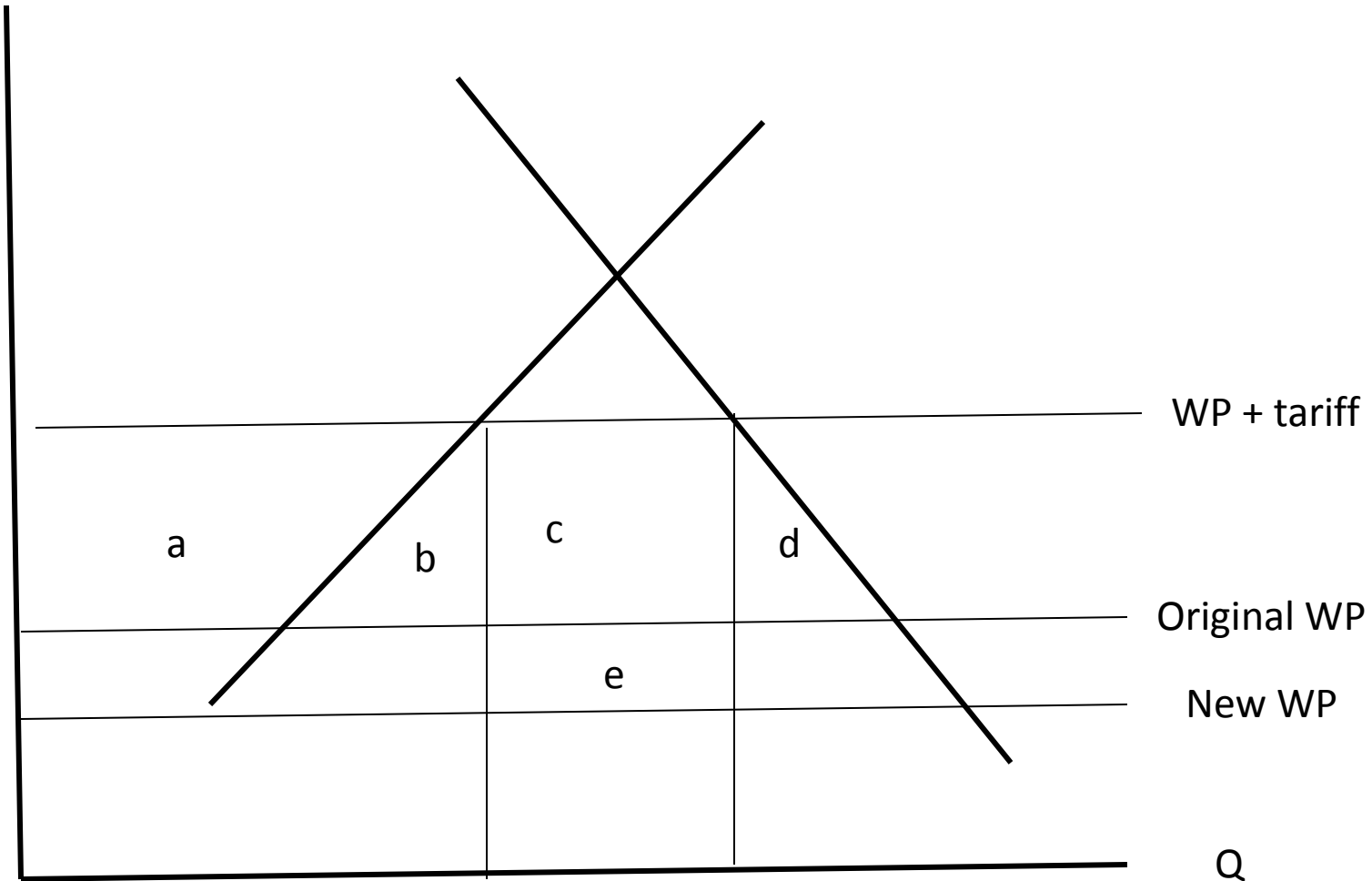
Producer gain = a
Consumer loss = a+b+c+d
Revenue = c + e

Deadweight loss = b+d

Terms of trade gain = e

Export subsidy with market power

Price

S

World price plus subsidy

a   b   c   d

World price before subsidy

e   f   g

World price after subsidy

D

Consumer loss: a+b
Producer gain: a+b+c+d
Cost to government: b+c+d+e+f+g
Deadweight loss: b+d
Terms of trade loss: e+f+g

Quantity