Preferential trade areas: liberalize trade with a sub-set of all trading partners

- EU
- NAFTA
- Mercasor
- ASEAN

Basic issue: preferential trade areas are inherently second best: removing some barriers while leaving others in place.

Theorem of the second best says that this is not guaranteed to improve welfare.

Two opposing forces

Trade Creation - creation of trade from when there wouldn't be any.

Trade Diversion - diversity of imports from a genuinely low-cost source to a high-cost source.

Suppose that we are country A, and can produce a good ourselves, or import it from B or C

Country	A	B	C
Price	35	26	20
100% Tariff	35	52	40
50% Tariff	35	39	30

Suppose that we form a customs union with B, eliminate tariff against B, but not against A.

Initial Situation 1: 100% tariff

Initially no trade, home price is $35.

With a FTA we buy from B at a price of $26.

This is trade creation.

Initial Situation 2: 50% tariff

Initially, we import from C, price is $30.

The "true" price is only $20, since $10 is tariff revenue which goes to our government.

With the FTA with B, consumers will now buy from B at a price of $26 instead of the tariff-inclusive price of $30 from C.

But this is deceiving, since the "true" import price was only $20.

Consumers save $4, but the government loses $10 on each unit switch (diverted), so the loss per unit is $6.

Conclusion: a preferential trade agreement has the potential to make a country worse off when it diverts imports from a truly cheap source to a more expensive source.

Big thing left out by this argument:

1. Import liberalization by the partner country(ies) leads to better export opportunities.

   Unlike domestic export promotion through subsidies, which is generally welfare worsening, getting a foreign country to remove barriers is invariably welfare improving.

   Standard terms-of-trade effect, improving domestic export prices.

Think of a preferential trade area as two separate steps.

Remove domestic import barriers to partner: problem of trade diversion.

Partner removes import barriers to domestic exports: must be welfare improving.

2. Intra-industry rationalization.

   Examples from NAFTA
   - Autos
   - Textiles and Clothing
   - Services

3. Competitiveness of domestic firms against firms from third countries.

   US auto firms and domestic content regulations.

4. Ease and practicality of negotiations.

   Difficulties of multiple issue, multiple country negotiations
   Service industries: require complex negotiations about regulations.

Inquires into the positive explanations of government behavior concerning trade policy.

Basic Postulate:

(1) governments are rational economic actors, acting in their self interest (e.g., to get reelected).

(2) almost every policy change creates gainers and losers

1. Review of Stolper-Samuelson theorem.

2. Median voter model

3. Participation costs, free riding, concentration of costs and benefits.

4. Multiple issues: logrolling

5. Uncertainty and status quo biases

6. Choice of policy instrument

7. Rent seeking, directly unproductive activity

Median voter model: Policy proposal that can capture 50% of the voters plus one wins. This means that politicians go after the median voter.

In many cases, this results in an optimum. Protectionist policies generally favor only a few individuals / firms.

Figure 1

However , voting does not capture intensity of preferences and gains/losses, only +/- . If a minority gets big gains and majority very small losses, outcome may not maximize total surplus.

Figure 2

However, the median voter model often fails to predict the actual outcome.

Individual	A	B	C	D	E	
Gain from policy	10	-3	-3	-3	-3	TOTAL = -2
Cost of voting	-4	-4	-4	-4	-4	
Vote???	Y	N	N	N	N	
NET	6	-3	-3	-3	-3	

Person A is the only one who vote, and the policy passes.

This suggests that when the benefits (costs) of a policy are concentrated whereas the losses (gains) are diffuse, the few may get their way in spite of a social welfare loss.

Now suppose that the government is willing adopt the position of whichever group gives the most campaign contributions (votes for sale).

Free Riding

Individual	A	B	C	D	E	F	
Gain from policy	10	-3	-3	-3	-3	-3	TOTAL = -5
Maximum willingness to contribute	-10	-3	-3	-3	-3	-3	

Suppose that there is no coordination mechanism among the potential losers. Person A offers a campaign contribution of 4. No loser has an interest in matching this offer. In the absence of an ability to collude, there are no opposing contributions and the bad policy is adopted.

One way around pervasive free-rider problems is to “trade votes”, also know sometimes as “logrolling”.

Case 1 Logrolling leads to efficient outcome

Gain or loss to individual:	A	B	C	Net
Issue 1	+20	-5	-5	+10
Issue 2	-5	+20	-5	+10
Combined 1 & 2	+15	+15	-10	+20

Case 2 Logrolling leads to inefficient outcome

Gain or loss to individual:	A	B	C	Net
Issue 1	+20	-15	-15	-10
Issue 2	-15	+20	-15	-10
Combined 1 & 2	+5	+5	-30	-20

Linking issues in international trade negotiations.

(1) developing country wants access to US market for clothing. US does not want to give it.

(2) US wants IPP in developing country, the latter does not want to give it.

If each issue is negotiated independently, there will be no liberalization on either count. Negotiations fail.

However, if both are negotiated together, there is scope for gains.

Figure 3

Uncertainty: Status Quo Bias

It is reasonable that some groups know for sure of they are going to gain or lose from trade liberalization.

Suppose that 60% are going to gain, and only 40% are going to lose.

But there is some uncertainly among individuals, e.g., in non-traded goods sectors.

Only 40% know for sure they will gain, 30% know for sure that they will lose, and 30% are uncertain, with 2/3-1/3 odds in favor of winning.

Thus 60% gainers, 40% losers, but 30% unsure which group they are in.

If the 30% are *risk averse*, they may rationally vote "no" on the proposed policy change.

Figure 4

Uncertainty: the conservative social welfare function

One concept that works well in actually explaining the pattern of protection in the US is the "conservative social welfare function", essentially a "social safety net" policy.

This holds that governments act to help out groups that are unexpected adversely affected by changes.

This view suggests that protection goes to industries that experience sharp increases in import penetration.

This theory works well in explaining US protection.

Form of Protection

Consumers	Subsidies	>	Tariffs	>	Quotas
Protection seekers	Quotas	>	Subsidies	>	Tariffs
Revenue seekers	Tariffs	>	Quotas	>	Subsidies

Not the non-transitivity of voting:

Subsidy defeats tariff 2-1

Tariff defeats quota 2-1

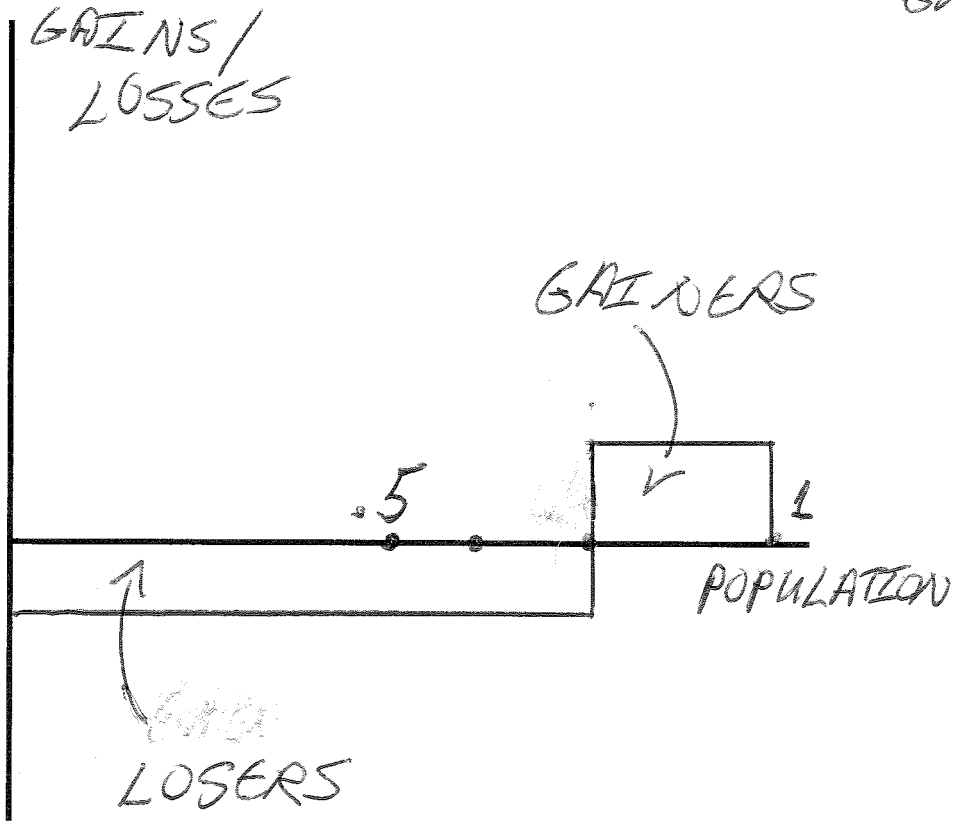
Quota defeats subsidy 2-1

Rent Seeking and Directly Unproductive Activities

1. Rents generated by trade policies are dissipated because they provoke the wasteful use of time and effort in lobbying and in other effects to attract support.

2. Announcement that "trade policies will be considered" causes business people and workers to stop working (resulting in real lost output) and rush to Washington to lobby.

3. In the presence of rent seeking and DUPs, the best policy is to try to credibly maintain a commitment to free markets (examples, India, New Zealand).



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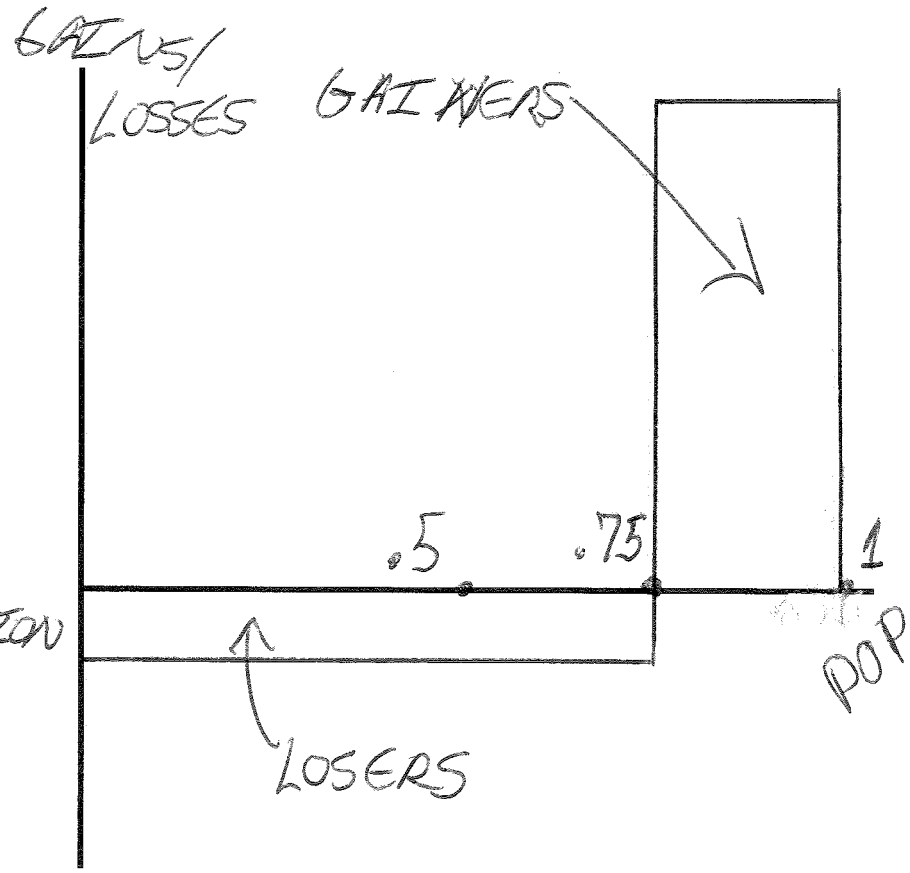

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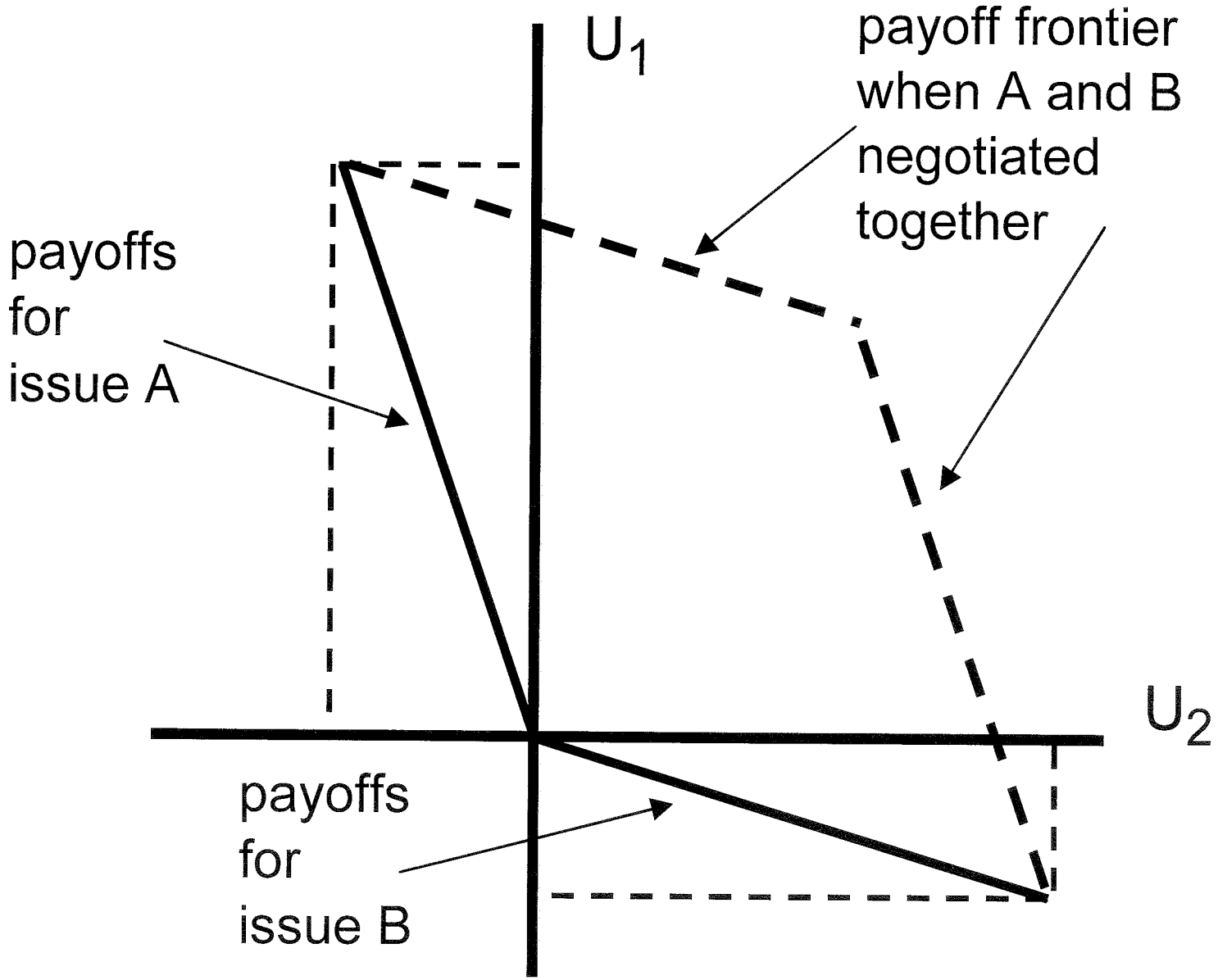

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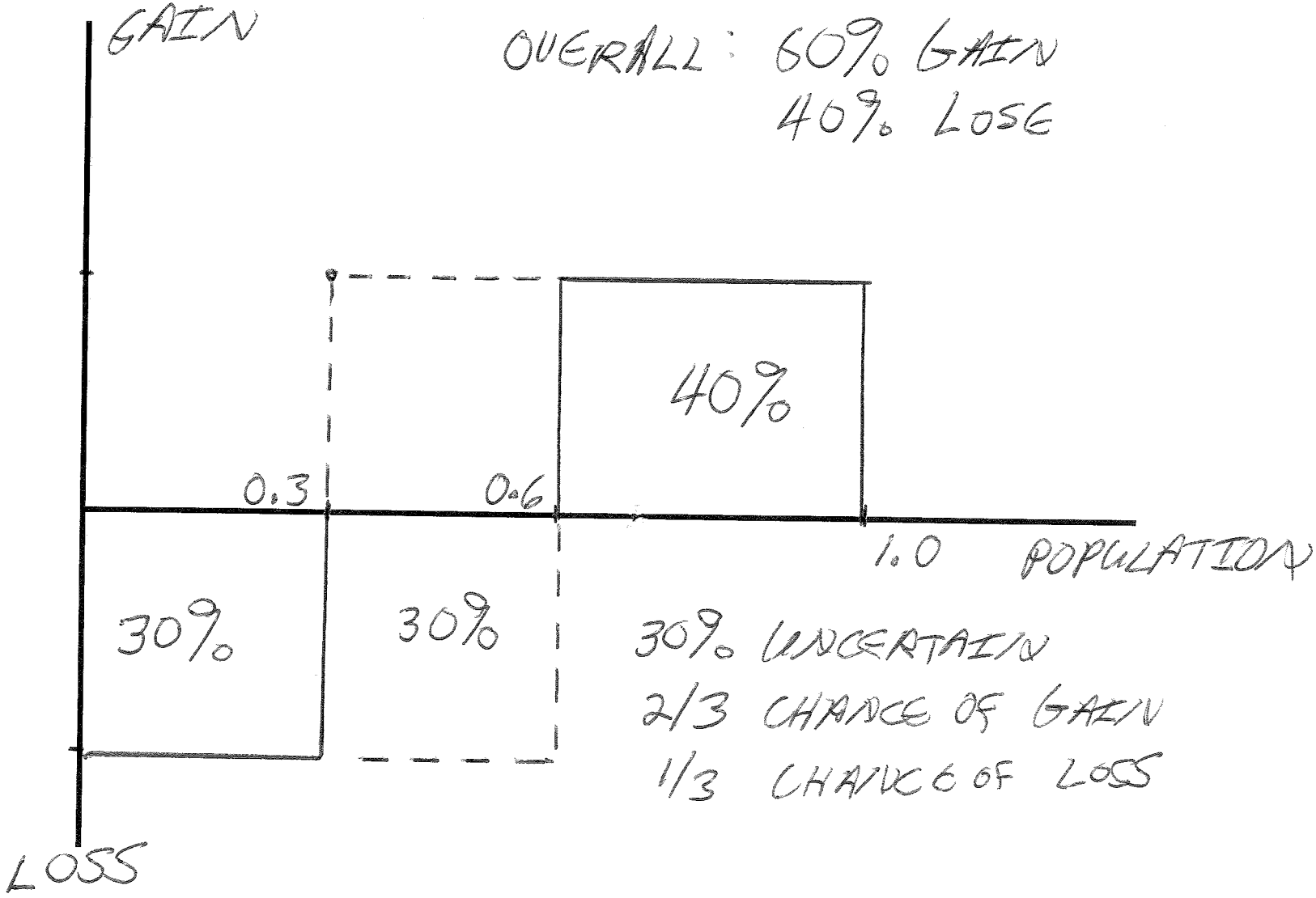

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