The Political Economic Analysis of U.S. Trade and Investment Policy

Gao Guowei

State Grid Energy Research Institute, Beijing 100052, China

Abstract

Free trade and investment policy is the best for the whole economy, but there are still various protective measures to constraint free trade and investment. This study reviews the theory and empirics to explain this paradox. The process of policy making is like a market of policy demand and policy supply, and interest groups promote the formation of protective trade and investment policy. This explanation is well justified in the U.S. trade and investment data.

Keywords: trade; investment; policy; interest group

1. INTRODUCTION

This review includes many issues pertinent to the political-economy theory of trade and investment policy. These literatures want to answer the following questions:

(1) Since free trade is best for a nation as a whole, why free trade policy is never adopted?

(2) How do political-economy theories of trade and investment policy address this problem? Can these theories be justified empirically?

(3) Why does trade lead to the formation of different interest groups? What role do these interest groups play in the process of trade and investment policy making?

(4) Who makes trade and investment policy? How do they make trade and investment policy?

(5) What impacts do these protective trade policies have on economy?

The rest of this review consists of 5 parts, each part corresponding to one of the preceding questions.

2. FREE TRADE PRINCIPLE VS. PROTECTIONISM

Should a country adopt free trade and investment policy or protective trade and investment policy? This question has been controversial. But for an economist it is not so controversial. Most economists agree that free trade benefits a country. Just as Paul A. Krugman said, if there were an Economist's creed, it would surely contain the affirmations "I understand the Principle of Comparative Advantages" and "I advocate Free Trade."

In fact, those who don't believe in principle of comparative advantage or free trade are more influential in policy making, as we can discern from the facts that all countries put some barriers on free trade. Some outstanding economists have persistently preached the benefits of free trade, among which Krugman (1987), Bhagwati (2002) and Irwin (2002) are most persuasive.

We can infer from these books that free trade is the first best policy despite two centuries of theoretical and public challenges. When domestic market failure exists, trade protection is not the right remedy. The best remedies to domestic market failure should be aimed directly aimed at fixing the distortion. Even if distortions exist in the international market, deviating from free trade will likely cause more problems than it solves.

Responding to plausible theory defending protectionism such as strategic trade and investment policy, Paul A. Krugman criticized that it's impossible to formulate useful interventionist policies given the empirical difficulties involving in modeling imperfect markets, and that any gains from intervention will be dissipated by entry of rent-seeking firms. So it unlikely that protective trade and investment policy will do more good than harm.

The question is, since free trade is best for a nation as a whole, why free trade and investment policy is never adopted? The political-economy theory of trade and investment policy gives a best answer.

3. SOME PROMINENT MODELS AND EMPIRICAL RESEARCHES

The answer is that such protective trade policies are politically motivated: tariffs are granted in response to demands by special interest groups. The literatures on political economy of trade and investment policy are to understand how such demand interacts with the supply of trade and investment policy through the political process.

As illustrated in Figure 1, in principle a political economy model of trade and investment policy must have four elements.

First, the political economy model must contain a description of individual preferences over the domain of trade choices available to policymakers (Box A). Most trade theories have analyzed the distributing consequences of trade and investment policy, and some other literatures deal with other elements besides income distribution that affects individual preference over trade and investment policy.

Second, the political economy model must contain a description of how these individual preferences are aggregated and channeled, through pressure groups, political parties, or grass-roots movements, into "political demand" for a particular policy or another. (Box B)

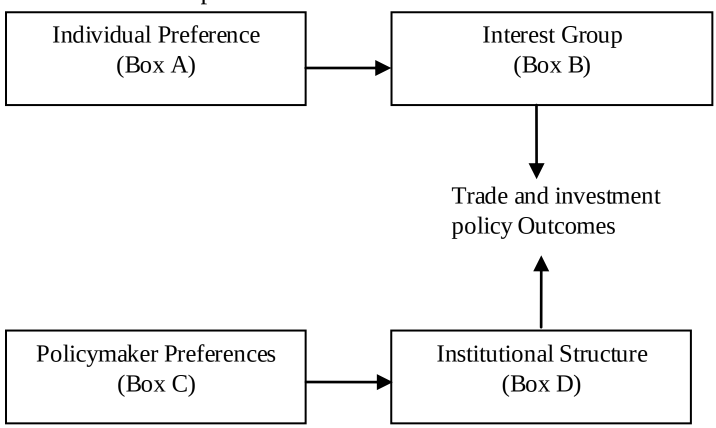

Fig. 1 Structure of Political Economy of Trade and investment

Third, the political economy model must character policymakers' preferences: why do politicians make or vote for such a trade and investment policy? They want to get re-elected? They want to transfer resources to some certain groups? They have a partisan preference? Or just because they want to maximize the country's welfare? This is the "political supply" for a particular trade and investment policy. (Box C)

Fourth, the political economy model must specify the institutional setting to show how "political demand" and "political supply" interact with each other: is congress or the executive that sets the tariff? Who negotiate trade agreement with other countries? Who ratify trade agreement with other countries? (Box D)

Now we turn to some influential models to see how these models address the four elements.

3.1 Models

This literature has been well surveyed many times, including Nelson (1988), Hillman (1989), Rodrik (1995), Helpman (1995), Deardorff and Stern (1997) and Miler (1999). Table 1 is a summary of these surveys.

Of all these models, Grossman and Helpman's "protection for sale" model is most influential and is extended in many directions. It's the first model in political economy literatures to provide microfoundations for the behavior of organized lobbies and politicians.

3.2 Empirical Research

The empirical research on political economy of trade and investment policy has evolved in quite systematic ways. The early empirical work, until at least the late 1980s, mostly involved the examination of correlations between trade policies and various political economy factors that had been conjectured to be relevant in determining trade and investment policy. These factors include seller concentration, buyer concentration, import penetration ratio, unionization, and employment and so on. The most typical research is presented by Baldwin (1985). These results of this research support some conjectures about the political-economy factors affecting trade and investment policy formation. For example, the government acts on social justice grounds and provides greater protection to the low-income groups; the number of firms in the industry is negatively related to the level of trade protection, indicating that the industry with less firms can easily overcome the problem of free-rider in lobbying.

The robustness of these findings provided a quite convincing affirmation of the endogeneity of trade protection. While helping to loosely identify the relative importance of various political economy variables in determining policy, this literature has sometimes been criticized for employing econometric specifications whose links with the theories that motivated them were often only very tenuous. (Gawande and Krishna, 2001)

The emergence of Mayer's Median-Voter model and Grossman and Helpman's Protection for Sale Model makes it easier to deliver specific and empirically testable predictions. Dutt and Mitra (2002) provide striking support for the median voter model in the context of Heckscher-Ohlin model. In addition, Dutt and Mitra finds that this relationship holds better in democracies than in dictatorships.

More empirical researches base on Grossman and Helpman's protection for sale model. The predictions of the Grossman and Helpman model were first tested by Goldberg and Maggi (1999) and Gawande and Bandyopadhyay (2000). Despites different methodologies, both papers find support for protection for sale model. Mitra, Thomakos and Ulubasoglu (2001) have applied the protection for sale model to Turkey. Using and extending the protection for sale model, Gawande, Krishna and Robbins (2004) also suggest that foreign lobbying activity has significantly impact on U.S. trade and investment policy.

3.3 Some Extensions

Political economy approach has been extended to address a vast variety of trade and investment policy issues. In this review I only refer to free trade agreement (FTA), foreign direct investment (FDI) and administered protection.

3.3.1 FTA

We can roughly put all the literatures concerning FTA into 4 categories: the welfare implication of FTA; the formation of FTA; the sustainability of FTA; and the relationship between FTA and multilateral trade agreement. With political economy approach these 4 categories of issues are more thoroughly tackled.

Numerous literatures have probed into the welfare implication of FTA since Viner. Maggi and Rodriguez (1998) provided an answer with political economy approach.

The emergence of FTAs raises the question of whether allowing for such regional trade agreements conflicts with the overall GATT/WTO goal of multilateral tariff reductions. Levy (1997) analyzed the question based on median-voter model and the conclusion is that bilateral free-trade agreements can undermine political support for further multilateral trade liberalization. Krishna (1998) also address the problem and reached two conclusions: first, trade-diverting preferential arrangements are more likely to be supported politically; and second, such preferential arrangements could critically change domestic incentives so multilateral liberalization that is initially politically feasible could be rendered infeasible by a preferential arrangement.

About the formation of FTA, Grossman and Helpman (1995) find FTAs are more likely to be formed when the agreement must cover all bilateral trade and when a few politically sensitive sectors can be excluded from the agreement.

3.3.2 FDI

Grossman and Helpman (1996) have introduced foreign investment into their "protection for sale" model. Branstetter and Feenstra (1999) used political economy approach to China, which has a completely different political regime and is not supposed to be explained by political economy approach of trade and investment policy. They found that the weight applied to consumer welfare is between one-fifth and one-twelfth of the weight applied to the output of state-owned enterprises. They also find that governmental preferences have shifted over time, but even in recent periods the weight on consumer welfare is only one-half of the weight on state-owned enterprises. This suggests that China may find it politically difficult to follow through with liberalizing its trade and investment regimes.

3.3.3 Administered Protection

The antidumping (AD) and countervailing duty (CVD) laws in the United States have become the most pervasive form of import relief sought by domestic producers. Using a computable general equilibrium model, Gallaway et al (1998) estimate that the collective net economic welfare cost in 1993 of these orders to be \$4 billion. Why such welfare-inducing policies are frequently resorted to? Hansen and Prusa (1997) model ITC decision-making to weigh the relative impact of economic and political factors in predicting policy outcomes using detailed industry, import, and political pressure data. They find the ITC's decision-making is significantly influenced by both economic and political factors.

Noland (1997) examined the political economy of USTR attentions and actions and found that the size of the partner country, the existence of bilateral trade imbalances, interest group pressure and some other factors affecting USTR's decision.

4. CONCLUSION: REAFFIRMING THE VALUE OF FREE TRADE

Although there are still some ambiguities in the political-economy theory of trade and investment policy, the political economy approach has provided important insights into how trade policies are made. One of the wisdoms derived from the political-economy theory of trade and investment policy is that there is little evidence to justify the existence of protective trade and investment policy to increase welfare and that protective trade and investment policy is just an income-redistributing tool - an inefficient tool - wielded by politicians, interest groups and various other players.

Among these interest groups, there are public interest organizations which seem morally right. As economists we should persuade these public interest organizations to fight against the real enemy. I conclude the review with Jagdish Bhagwati's speech:

"As an economist, I want to see free trade advance efficiently and fully. I must add that I also see free trade as an important moral force for good since we cannot effectively rescue the world's millions from continuing deprivation and poverty without pursuing wealth-generating policies. I call growth the activist "pull up" strategy as against the passive "trickle down" strategy. Growth will also, over time, likely induce values and institutions such as democracy and respect for human rights."

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