

# The political economy of international trade

Chapter 9 on  
Democracy, Institutions and Economic Policy

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## **9. The political economy of international trade**

The most basic form of relationship between two national economies is through the flow of products between them, i.e. the export and import of goods and services. The first dimension therefore of the internationalization of an economy is the degree of international trade. From the work of David Ricardo on the principle of comparative advantage, we know that the free movement of goods between countries is, in principle, beneficial for both economies, thanks to the mutual gains generated by the specialization of each economy in those products for which it has a comparative advantage.

The Ricardian argument in favour of free trade is simple and powerful. For many economists, moreover, the advantages of free trade go far beyond those generated simply by the international specialization described in Ricardo's model. Thanks to trade, it is argued that competition is increased, innovation is encouraged and the transfer of knowledge between countries and the incorporation of new technologies into production processes is facilitated. Although there are economic theories that argue that, in certain circumstances, protectionism could be beneficial from a collective point of view, the applicability of these theories is generally very limited<sup>1</sup>. Why do national governments, despite

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1 For a critical review of these theories, see Irwin (1996).

**Box 9.1      Why is economic openness beneficial?  
The Ricardian model of trade and  
the principle of comparative advantage**

In 1817, the British political economist David Ricardo developed the elegant model of international trade that showed how all the countries that participate in international trade simultaneously benefit from it.

Let us suppose that there are two countries (let's call them Spain and Morocco) in which only two goods (cars and bicycles) are produced. The availability of capital and/or the different human capital formation of each country means that, on average, a worker in Spain is able to produce one car or fifty bicycles in a year, while a Moroccan worker in the same period can produce only a tenth of a car or forty-five bicycles. Spain, therefore, has an *absolute* advantage in the production of both bicycles and cars. David Ricardo showed that, although Spain produced both bicycles and cars more efficiently, it is in its interest to trade with Morocco. Let's see why.

In this scenario, the *opportunity cost* of producing a bicycle in Spain is 0.025 (1/50) cars. And that of producing a car is 50 (50/1) bicycles. Therefore, for every bicycle that is produced, 1/50 part of a car is not manufactured, and for every car that is produced, they have to stop producing fifty bicycles. In Morocco, the opportunity costs are not the same. For every bicycle that is produced, they stop producing 0.002 (0.1/450) cars, and for every car, 450 (30/1) bicycles. When comparing these different opportunity costs, we see that Morocco has a *comparative* advantage in the production of bicycles, because it has to give up producing a smaller number of cars to produce them. Spain, on the other hand, has a *comparative* advantage in the production of cars, because producing them is cheaper in terms of bicycle production.

Let's assume that each country has one million workers and, for the moment, that Spain and Morocco cannot trade with each other. The demand for cars and bicycles in each country is such that Spain produces (and consumes) 750,000 cars and 12.5 million bicycles, and Morocco, 50,000 cars and 22.5 million bicycles. Let's imagine now what would

this, often resort to protectionist measures to block the entry of foreign products into the domestic market? Although often justified with economic rhetoric, the causes of these measures are ultimately and fundamentally political. Below we review

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	Production possible per worker-year		Cost of opportunity		Production (and consumption) without trade (millions)	Production with trade (millions)	Consumption with trade (millions)
	Cars	Bikes	1 car	1 bicycle			
Spain	1	50	50 bikes	0.025 cars	0.75 cars, 12 bikes	1 car	0.9 cars, 20 bikes
Morocco	0.1	45	450 bikes	0.002 cars	0.05 cars, 22.5 bikes	45 bikes	0.1 car, 25 bikes
Total					0.55 cars, 35 bikes	1 car, 45 bikes	1 car, 45 bikes

happen if the two countries specialized in the product where they have a comparative advantage and could trade with each other. First they have to agree how many bicycles a car is worth (i.e. in terms of the exchange). For the trade to benefit Spain, bicycles should not be more expensive than 0.025 cars —if Morocco offered a higher price, Spain would prefer to produce bicycles themselves. Similarly, to benefit Morocco, a car must be exchanged for less than 450 bicycles; otherwise, they would prefer to produce them in Morocco. Let's imagine that both countries agree some terms of exchange with one car for every two hundred bicycles (or 0.005 cars for each bicycle), and that they exchange one hundred thousand cars produced in Spain for twenty million Moroccan bicycles. Spain will therefore produce one million cars, dedicating 900,000 to the domestic market and exporting 100,000 to Morocco. Morocco will produce 45 million bicycles, and will export 20 to Spain. As the table shows, Spanish consumers can benefit from 900,000 cars and 20 million bicycles, and Moroccans, 100,000 cars and 25 million bicycles. Thanks to specialization and trade, both Spaniards and Moroccans benefit from more cars and bicycles than in an autarky state.

different types of theories that have been offered from the international political economy to explain the enormous prevalence of protectionism, despite having been theoretically discredited.

1. The international strategic environment

In view of the simple neoclassical model of international trade that we have reviewed, international trade is indeed good because we can import products from abroad at a lower cost than what it would cost to manufacture them domestically. However, for reasons of a political nature that we will analyse later, governments generally dislike opening domestic markets to foreign products and instead prefer that other countries allow them to export goods and services produced domestically. Often, therefore, national governments are only willing to open their economy if another country reciprocally agrees to open theirs. This is in fact the typical way in which international trade has been opened up —through the signing of bilateral or multilateral agreements of reciprocal liberalisation. In this context, the achievement of a liberal trade order is always problematic because it requires concerted action by at least two governments. To appreciate this, we can depict the problem of bilateral trade cooperation as a “prisoner’s dilemma”, such as the one presented in the table (9.1).

Table 9.1 Reciprocal liberalisation as a prisoner’s dilemma

		Morocco	
		Open (O)	Closed (C)
Spain	Open (O)	2.2	0.3
	Closed (C)	3.0	1.1

The numbers in the boxes reflect the “payments” that each country receives in each possible combination of strategies (the first number is the payment to the country represented in the rows, and the second is the one corresponding to the player in the columns). These payments reflect the (ordinal) preferences of each player about each possible combination of game strategies. Thus, for Spain, the preferred situation is that Morocco opens its borders

to Spanish products, but that Spain does not have to open its borders to Moroccans. The next best result is that the two countries open their borders to trade, which is preferable to both countries remaining closed. The worst result for Spain is, ultimately, to open its economy to the entry of Moroccan products without Morocco opening its own to the Spanish. Formally, the benefits for the two players follow the following preference orders:

$$U_{\text{ESP}}(C,O) > U_{\text{ESP}}(O,O) > U_{\text{ESP}}(C,C) > U_{\text{ESP}}(O,C), \text{ for Spain, and} \\ U_{\text{MAR}}(O,C) > U_{\text{MAR}}(O,O) > U_{\text{MAR}}(C,C) > U_{\text{MAR}}(C,O), \text{ for Morocco.}$$

In this strategic context (the actions of one player will yield different results depending on the actions of the other player), what is the optimal strategy for each country? If Spain decides to open its economy to Moroccan products, the best thing Morocco can do is close its own, given that  $U_{\text{MAR}}(O,C) > U_{\text{MAR}}(O,O)$ . And if Spain closes its economy, for Morocco it is also preferable to close its own, because  $U_{\text{MAR}}(C,C) > U_{\text{MAR}}(C,O)$ . Regardless of what Spain does, for Morocco it is always preferable to close its economy. In summary, closing the economy is a dominant strategy for Morocco. Given that Spain's preferences are symmetrical to those of Morocco, Spain's dominant strategy is also to not allow the entry of Moroccan products. The equilibrium of this game is, therefore, that both countries close their borders, (C,C). And this is true even though this is a suboptimal result: both parties would be better off if they simultaneously opened their borders [ $U_{\text{ESP}}(O,O) > U_{\text{ESP}}(C,C)$ , and  $U_{\text{MAR}}(O,O) > U_{\text{MAR}}(C,C)$ ], but the strategic structure of the game makes it not in the interest of either player to implement the strategies that this result requires.

The situations in the type of prisoner's dilemma (i.e. situations in which hypothetical mutual gains cannot be obtained due to the absence of guarantees on the behaviour of the other party) are very common in economic, political and social life. In all these areas, there are, roughly speaking, two types of institutional remedies that partially solve this problem, thus allowing both parties to cooperate and obtain mutual gains.

### 1.1. Hegemonic stability theory

One first possibility is the existence of an external power with the ability to enforce the agreement through the distribution of rewards and punishments to each of the parties to ensure that they have no incentives to deviate from the socially optimal cooperative strategy.

This is undoubtedly one of the main roles played by the State in the economy: the establishment of a legal and policing system in order to ensure that private agreements between individuals are fulfilled. In the international arena, the establishment of this third party with an ability to force the parties (countries) to cooperate is hampered by the existence of the principle of sovereignty, which implies that there can be no authority over national wills. Although there is no world State, it is possible that hegemonic States indirectly fulfil this role. The theory of hegemonic stability proposes, in fact, that since international trade (or, in more generic terms, global economic stability) is a public asset, it will only be proportionate when there is an actor that, because of the magnitude of the individual benefits that it would receive from its existence, has an interest in privately supporting the costs of its maintenance.

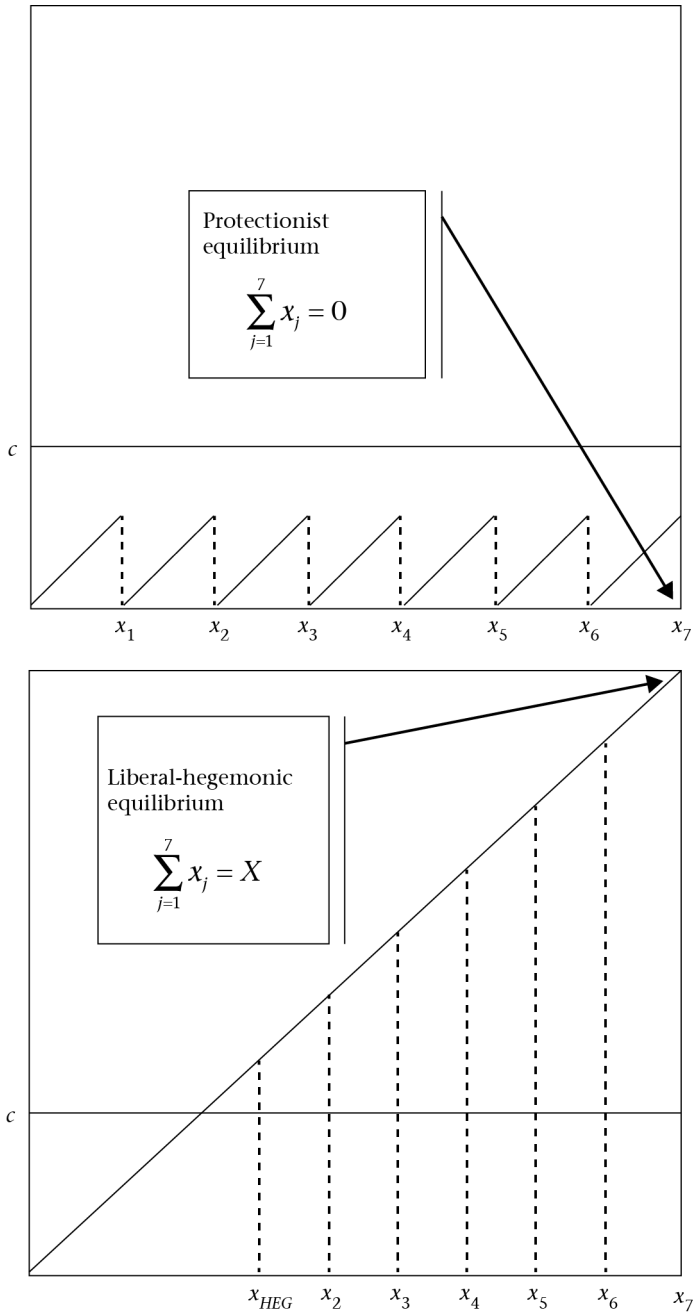
To view the logic behind hegemonic stability theory from a more analytical perspective, let us imagine that governments have to decide whether to open their economy or not, assuming that the positive effect of opening the domestic economy depends on the portion of the world economy that is open, but that opening one's own economy is individually costly. A country  $j$  will decide to open its economy if the benefits that this brings exceed the costs, i.e. if

$$\left( \frac{x_j + \delta}{X} \right) - c > 0,$$

where  $x_j$  ( $0 < x_j < X$ ) represents the portion of the world economy ( $X$ ) that corresponds to country  $j$ , and the parameter  $\delta$  ( $0 < \delta < X$ ), the portion of the rest of the world economy that has been liberalised. Let's imagine that the world is composed of many countries of similar economic size. In this situation, the countries will not open as long as the individual costs of opening are greater than the benefits (if  $c > x_j/X$ ). It is easy to see that the smaller the size of the countries ( $x_j/X$ ), the more difficult it is for the countries to decide to open. To simplify, we normalize the size of the world economy to 1 ( $X = 1$ ). If  $c > x_j$  for all countries, none will open their economy which implies that  $\delta$  is always 0. The equilibrium, in this scenario, is that domestic economies remain closed. Let us suppose instead that there is a sufficiently large (hegemonic) country that, for it,  $x_{HEG} > c$ , which means it will prefer to open its economy. Given that now  $\delta = x_{HEG}$ , the greater the hegemonic country, the more likely that the benefits of opening ( $x_j + \delta$ ) are greater than the costs, meaning more countries will decide to open their economy. In both parts of the graph (9.1) these two



**Graphic 9.1 Hegemonic stability theory**



possible equilibria are shown respectively. On the horizontal axis, the countries are ordered by their economic size, and on the vertical axis, the individual costs of opening ( $c$ ), and the potential benefits ( $x_i + \delta$ ) are reflected. In the graph above, the “world” is made up of seven countries ( $x_1, x_2, \dots, x_7$ ) whose small size means that the individual costs of opening are always greater than the benefits. Given it is not individually beneficial to open for any country, all decide to maintain protectionist policies. At the bottom, the only difference that has been introduced is the existence of a “hegemonic” country ( $x_{HEG}$ ), for which it is beneficial to unilaterally open ( $x_{HEG} > c$ ). The opening of this country means one or greater for the rest, meaning for the other countries it is now beneficial to open. Thanks to the existence of this hegemonic power, therefore, the problem of collective action that prevented the achievement of a liberal international economic order is solved.

For advocates of hegemonic stability theory<sup>2</sup>, it is therefore no coincidence that the periods of economic openness match those where political and economic power exists. In the liberal era that preceded the First World War, Great Britain was this global hegemonic power that fostered free trade. The absence of a great world power until the Second World War coincided with interwar protectionism, and only after the emergence of the United States as a hegemonic power in the forties could a liberal order be restored on the international economic plane.

### 1.2. The role of international organisations

On the theoretical level, one possible way for cooperative strategies to emerge in situations such as the prisoner’s dilemma described above is through indefinite repetition of the game (Axelrod 1984). When players worry about payments in future rounds of the game, the development of “give and take” —type reciprocal strategies (*tit-for-tat*) can be an equilibrium. This strategy consists of cooperating in

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2 The standard reference for hegemonic stability theory is Kindleberger (1975). In his study on the causes of the great world economic crisis in the thirties, he pointed out the main cause as the absence of a hegemonic power able to adopt the necessary measures to maintain a stable economic order: Britain was no longer the first economic power, and the United States used to be politically controlled by isolationist forces. For a comparison of the validity of this theory in different historical eras, see Lake (1991).

the first round of the game and, thereafter, imitating the behaviour of the other in the previous round. But for this strategy to be an equilibrium, governments have to be sufficiently concerned about the payments in future rounds of the game and obviously have to be able to observe the strategy of the other player in the previous round. For some authors, the institutionalisation of trade relations through the creation of international organisations helps so that these two conditions are met and therefore lead to mutual trade liberalisation.

First, international organisations can facilitate the task of objectively finding out when a country has breached its contractual obligations in terms of free trade. Often, trade disputes are very complex, since protectionist measures can be disguised as many perfectly legitimate policies by the State: regulations on the quality of products, environmental measures, etc. An independent international agency that judges whether the countries' trade policies comply with the agreements that the country has signed, undoubtedly facilitates the task of "monitoring" by its trading partners, where mutual "give and take"-type strategies are more easily sustainable. In fact, the precise mechanism through which the World Trade Organization (WTO) currently operates is to ensure the maintenance of this combination of strategies in order to guarantee cooperation and free trade. Under the WTO regime, if a member country is found to have violated its contractual obligations, the WTO authorises its trading partners to impose protectionist policies against the offending country.

The institutionalisation of trade relations through the creation of international organisations also facilitates the mutual commitment of maintaining free trade through a second mechanism: extending the time horizon of mutual business interactions. If the establishment of these institutions (or participation once constituted) is somewhat economically and politically costly, it is conceivable that only those countries wishing to maintain trade relationships for a long period are willing to pay those costs. In this sense, participation in international organisations would serve as a *sign* of the willingness of potential trade partners to maintain trade relationships for a long period of time. These long time horizons, in turn, facilitate the maintenance of current cooperative strategies. This is a way of explaining the success of the European Union in maintaining very high levels of economic openness in the continent: the dense network of institutions and common policies on which the EU sits serves as a guarantee to each member country that none will break the cooperative strategy.

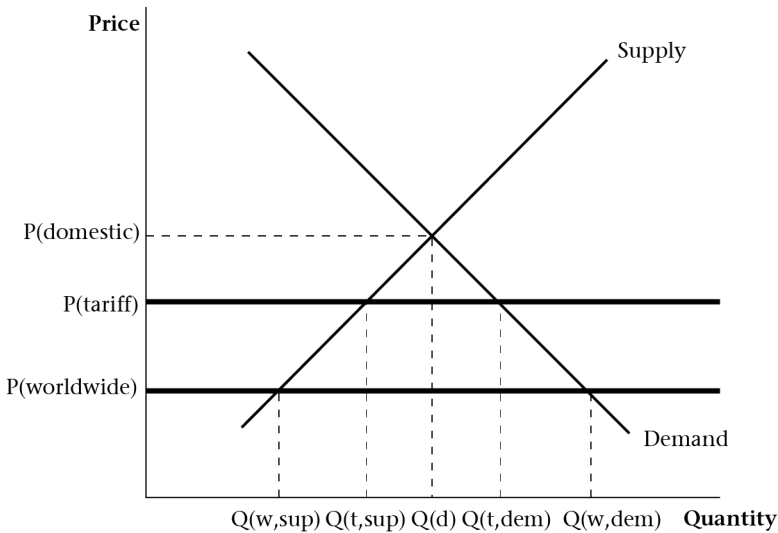
## 2. The political economy of protection

If, as we saw in the classic model of David Ricardo, free trade is beneficial because it allows us to enjoy a variety and greater quantity of goods thanks to productive specialisation, why are governments so reluctant to open their markets without obtaining trade-offs for domestic producers abroad, as we assumed in the previous section of this chapter? To understand the reasons behind this form of protectionism, the starting point is that *although* trade openness is beneficial for the country as a whole, it also creates groups of winners and losers, and often the latter are politically more powerful than the former. In the next section of the chapter we will analyse several theories about the distributive effects of economic openness that will help us to identify these winners and losers. For now, we will use a crude distinction between producers and consumers to analyse how the opening affects these two groups asymmetrically.

Let us take the market of any product. In a competitive domestic market, the market price of that product and the quantity offered by producers are given by the supply (ascending, since at a higher price, more producers are willing to produce those goods) and demand curves (descending, since more consumers will want the product the cheaper it is) of those goods. Imagine that the country is so small in the international scenario that, through its production and consumption decisions of this product, it will not affect its world price. In other words, the price in international markets is therefore given by the country in question. To analyse the case of protection, imagine a situation where the world price of the goods is lower than the domestic price, as represented in the graph (9.2). At the world price, the demand for those goods is much greater, up to point Q (worldwide, demand). At that price, however, domestic production will be reduced to Q (worldwide, supply). The rest of the demand ( $Q_{\text{worldwide, demand}} - Q_{\text{worldwide, supply}}$ ) will therefore be satisfied by imports from abroad.

What will happen if the government introduces a tax on products from abroad, i.e. if it establishes a tariff? The price of foreign goods will rise in proportion to the size of the tariff. This price increase will make fewer consumers want those goods (the quantity falls to  $Q[\text{tariff, demand}]$ ), the domestic production increases to  $Q[\text{tariff, supply}]$  and so less products are imported ( $Q[\text{tariff, demand}] - Q[\text{tariff, supply}]$ ).

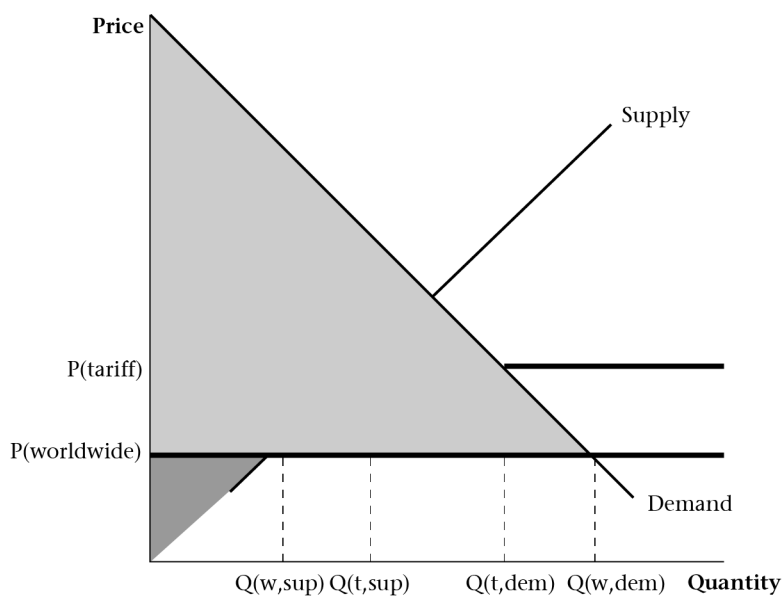
It is evident that domestic producers are the great beneficiaries of the tariff, while consumers are disadvantaged. But how much do some earn in relation to what the others lose? Consumer gains can

**Graphic 9.2 The effect of a tariff on the domestic supply and demand of a product**

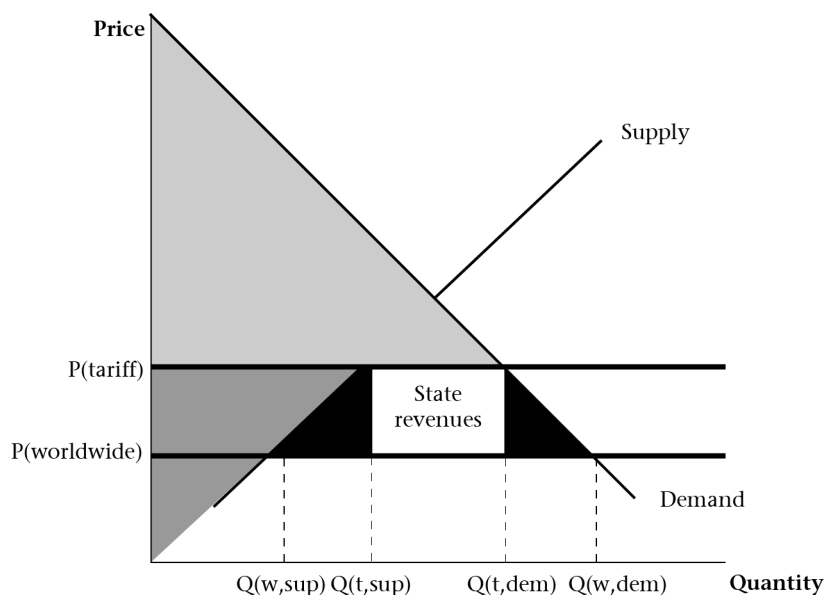
be measured as the area on the left of the demand curve until it is cut off by the supply. The lower you cut the supply on the demand curve (the cheaper the products are), the greater the consumer's profits (more consumers will be able to benefit from being able to buy that product at a lower price than they would be willing to pay). The profits of domestic producers, on the other hand, can be measured as the area left of the supply curve to the point where it cuts off demand (the higher the cut, the more producers will want to produce that product). Graphs (9.3) and (9.4) show these two areas, also called "surplus" of consumers (the speckled area) or producers (grid), for the cases of opening and protection, respectively.

As can be appreciated by comparing the size of the areas in the two scenarios, because of the introduction of the tariff, the surplus of consumers is reduced, and that of the producers increases, but not in the same size. Part of the reduction of the surplus of consumers happens to be enjoyed by the producers. Another part becomes State revenues, deriving from the collection of customs duties (the area of the State revenues is not greater than the multiplication of the quantity of imported products by the tariff that is applied to each of them). But the two coloured portions of the graph do not happen to be enjoyed by anyone: it is the efficiency costs that the

**Graphic 9.3 Consumer and producer surplus in an open situation**



**Graphic 9.4 Consumer and producer surplus in a protection situation**



tariff entails. The reason is that the tariff causes domestic producers to overproduce, and that consumers under-consume those goods, which involves a net cost for the whole of society.

This brief explanation on the distributive consequences of protection serves very well to illustrate some of the theories that, from the international political economy, have been proposed to explain the tendency of governments to adopt protectionist policies, even at the cost of imposing a burden on the economy as a whole<sup>3</sup>.

### **2.1. Protectionism as a State fiscal policy**

An initial explanation based on the schematic description of the distributive consequences of protectionism made above is that, given that the tariff generates additional tax revenues for the State, it will always have incentives to introduce it. Historically, it is in fact in the revenue-raising needs of weak state structures where the origin of many tariffs is often found. For modern times, however, this argument is becoming less and less convincing, mainly because the State increasingly has alternative collection methods at its disposal that cause less economic distortions. In fact, as graph (9.5) shows, recourse to tariffs as a source of tax revenue is something typical of poor countries nowadays that lack the administrative structures necessary to finance themselves via other means.

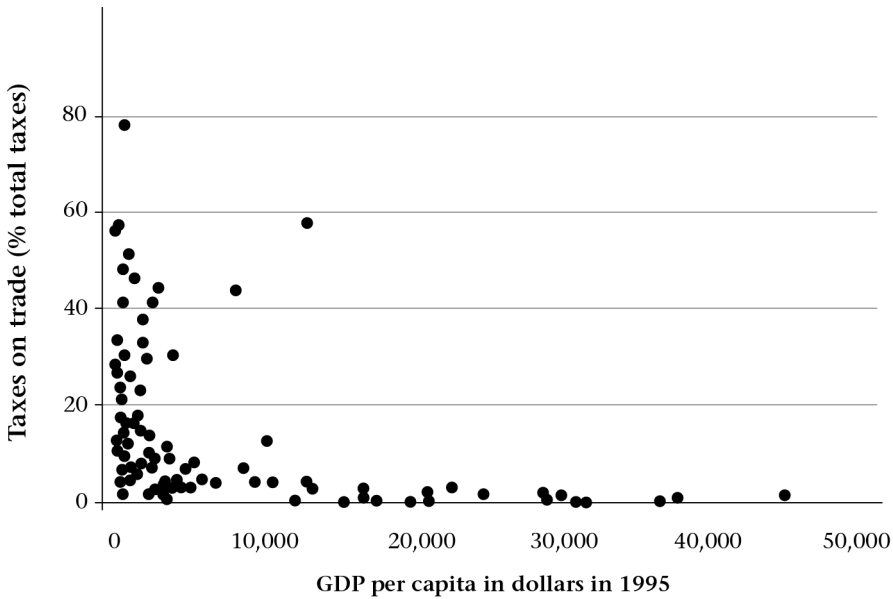
### **2.2. The distributive consequences of international trade and the costs of collective action**

A really common argument to explain the tendency of governments to favour producers at the expense of consumers is the political advantage in organisational terms that the former have over the latter. Since producers are smaller in number, they tend to be geographically concentrated and their interest in maintaining protection is always greater than the diffused and disorganised

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3 Hatbauer and Eliot (1994) have attempted to quantify the costs of tariff protection for the twenty most protected industries in the United States. According to their calculations, because of these tariffs consumers lose 32 billion dollars (in 1994 dollars), producers earn 16 billion dollars and the State earn 6 billion. The costs of efficiency of protection would rise therefore to 10 billion dollars.

**Graphic 9.5 Per capita income and weight of tariffs on state revenues, 1995**



SOURCE: The World Bank

interest of consumers. Governments tend to have more incentives to respond to the demands of the former than the latter. A good example of this perspective can be found in Peter Gourevitch's analysis (1977) of the late nineteenth century trade policies in France, Great Britain, the United States and Germany. After examining the validity of different hypotheses to explain the structure of protection in the different countries, he discovers that "there is a striking similarity in the identity of winners and losers from country to country: producers over consumers, large industrialists over producers of consumer goods, landowners over small farmers and owners over workers". What characterizes the winners is always "having more resources, access to power and being a compact group". The smaller size of the group (as Olson's collective action model would predict) and the greater concentration of its interests (the protection of a given product is a policy that is generally much more central to consumers) tend to make these groups successful in the domestic political arena. Note, however, that the greater power of concentrated groups does not always have to be linked to protectionist policies. In many cases, the groups that

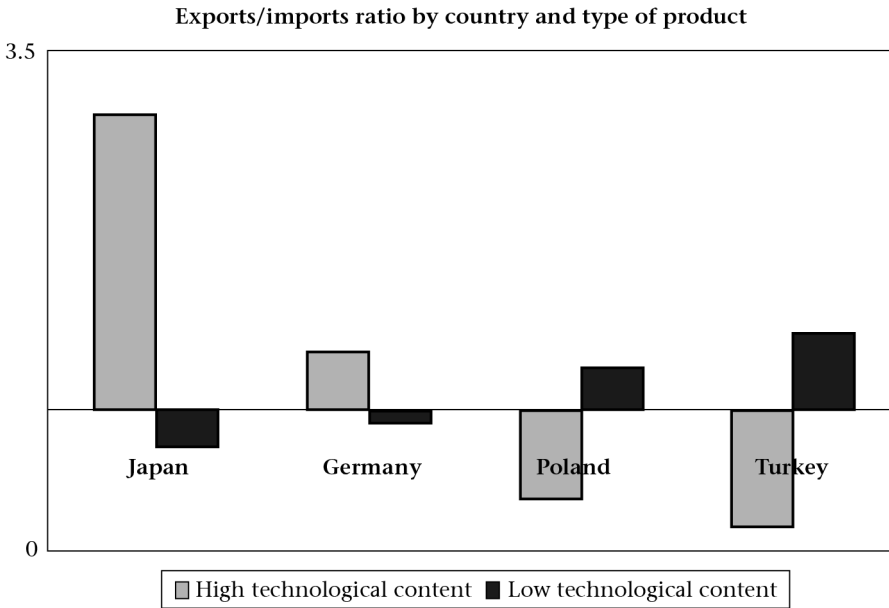


can benefit from external openness (exporters) also usually enjoy certain organisational advantages. It is not surprising, therefore, that the policies of opening the domestic market (which generate diffused winners and concentrated losers) are only attractive for governments if they are accompanied by reciprocal liberalisations abroad, because these manage to attract the support of concentrated group and therefore those who are politically powerful —the exporters (Gilligan 1997).

What the argument about the costs of collective action indicates, then, is that the preferences of producers will always tend to be more politically relevant than those of consumers and, therefore, unilateral liberalisation will be a measure that is generally not very attractive for government leaders. Only if the liberalisation of the local economy is accompanied by the opening of markets abroad, that is, if the choice is not between letting in foreign products or not, but between living in an environment of open economies or closed economies, then the producers that can benefit from the existence of new markets abroad can act as a lobbying group in favour of opening the domestic market.

Which economic groups benefit from economic openness and which groups are disadvantaged? Different economic models, each with different assumptions about the mobility of production factors, arrive at opposite conclusions about the distributive consequences of economic internationalisation. If we assume that the production factors (physical capital, skilled labour, unskilled labour, land, etc.) are easily transferable between different uses (that is, if the return on that capital, labour, etc., does not depend on the specific use in which that capital or that work is being used), then the “winners” and “losers” of the opening will be entire production factors. Following the model of Heckscher-Ohlin, the countries that participate in international trade will specialize in the production of those goods that involve intensive use of those factors where that country has a relatively larger allocation. Thus, those countries that are abundant in capital and skilled labour in relation to the rest of the world will export products whose production requires an intensive use of these factors, such as products with a high technological content, while economies that are, in comparative terms, abundant in low-skilled labour will tend to export products for which their manufacture requires an intensive use of labour. Graph (9.6), for example, shows how the ratio between exports and imports varies considerably depending on the type of goods for countries with different relative allocations of production factors. Thus, while in

**Graphic 9.6 Exports/imports ratio by country and type of product, 1995**



SOURCE: OECD.

1995 Japan exported three times more high-tech products than it imported, in countries less abundant in capital and highly skilled labour such as Turkey, the foreign sector was dominated by goods that incorporate little technology into the productive process.

What distributive consequences will the change in the country's productive structure have as a consequence of trade openness? In the simplest model of international trade by Hecksher-Ohlin<sup>4</sup>, the owners of those production factors that are (comparatively) abundant in each country will benefit from the possibility of exporting goods that require an intensive use of their production factor, while the owners of scarce production factors in each country will be disadvantaged. The reason is that economic internationalisation implies a convergence of the prices of these factors: in countries where, for example, labour was scarce with respect to the rest of the world (and therefore wages, i.e. the payments to this factor, were higher), the economic openness will

<sup>4</sup> In Rogowski (1989) you can find a summary of this model and in particular its political implications.

cause the price of labour (wages) to fall, as its scarcity decreases. On the contrary, those factors of abundant production (for example, capital in the most advanced economies) will see, in principle, an increase in their possibilities of usage beyond national borders, where their price will increase. This would explain, for example, why land owners tend to be protectionist in countries where land is a relatively scarce factor (Europe, Japan) but tend to want more economic openness in countries with an abundance of arable land (for example, in developing countries). The validity of this model centred on production factors, however, rests on the assumption that these factors can be used interchangeably in different sectors of the economy.

On the contrary, if the yield of the production factors depends on the specific use in which the factor is being used—for example, the capital invested in the construction of a tunnel-boring machine is not very productive unless it is used to open tunnels, or the human capital of typographers is of little use outside this profession—, it will be the entire sector that will be benefited or disadvantaged by greater or lesser economic openness<sup>5</sup>: as the factors are in this case “tied” to the sector in which they are being used. Their fortunes will be determined not by the relative abundance of capital, labour or land in the domestic economy, but by how the entire sector is affected by economic internationalisation. Those factors used in sectors that are internationally competitive will benefit from economic openness, and those that are not will prefer protectionist policies that keep them protected from international competition. The sector model would explain, for example, how workers and entrepreneurs of certain industries come together to favour a certain trade policy that is beneficial for their sector.

These two models, although they predict different political conflicts on the issue of openness (while the factorial model predicts a conflict between abundant and scarce classes within each country, the sectoral model predicts that interclass coalitions will form within each sector), they are perfectly compatible if the degree of asset specificity is taken into consideration. When the production factors are very specific, in other words, when their performance depends to a large extent on the specific use in which they are being used—for example, the capital invested in the construction of a tunnel-boring machine is not very productive unless tunnels

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5 Faced with the factorial model of Hecksher-Ohlin, this is known as the sectoral model of Ricardo-Viner.

are built, or the typographers' human capital is not very useful if printing presses disappear—, then the sectoral model will be the one that best explains the distributive consequences of openness. But if capital and labour are freely “mobile” between sectors (for example, high liquidity capital or general human capital, easily transferable between sectors or activities), then the Stolper-Samuelson model will be the most appropriate to understand political preferences regarding openness<sup>6</sup>.

### **2.3. Political institutions and trade policy**

The argument just described about the political power of concentrated groups implicitly assumes that governments always have the same incentives to respond to social demands. But extensive institutionalist literature shows how the different ways in which political systems aggregate social interests and transform them into policies can explain the variation in the type of policies applied by governments in different institutional contexts. In the case of trade policy, it is evident that the government's incentives to favour one group or another (producers vs. consumers, in the example we have been dealing with) will depend on the existing political institutions. For example, the democratisation of political systems, which implies the same voting power of all individuals, has brought with it an increase in the weight of consumer preferences on the decisions of the government: in general terms, for large producers it is easier to control the political process when only a few can participate in it than when the whole government has to respond to at least a majority of the citizens. In this sense, those political systems that place greater importance on certain interest groups should favour the interests of producers, while those more democratic systems where the “number” of civic supporters for a policy is the most important factor when deciding their adoption should choose to favour consumers<sup>7</sup>.

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6 In the classic coalition study on international trade, Rogowski (1989) showed the usefulness of the Stolper-Samuelson approach to understand the conflict of classes over economic internationalisation in different historical periods and political contexts. Hiscox (2001, 2002) analyses the role of asset specificity in the applicability of the different models.

7 Works like those of Rogowski and Kayser (2002) and Milner and Kubota (2005) find evidence that corroborates these hypotheses.

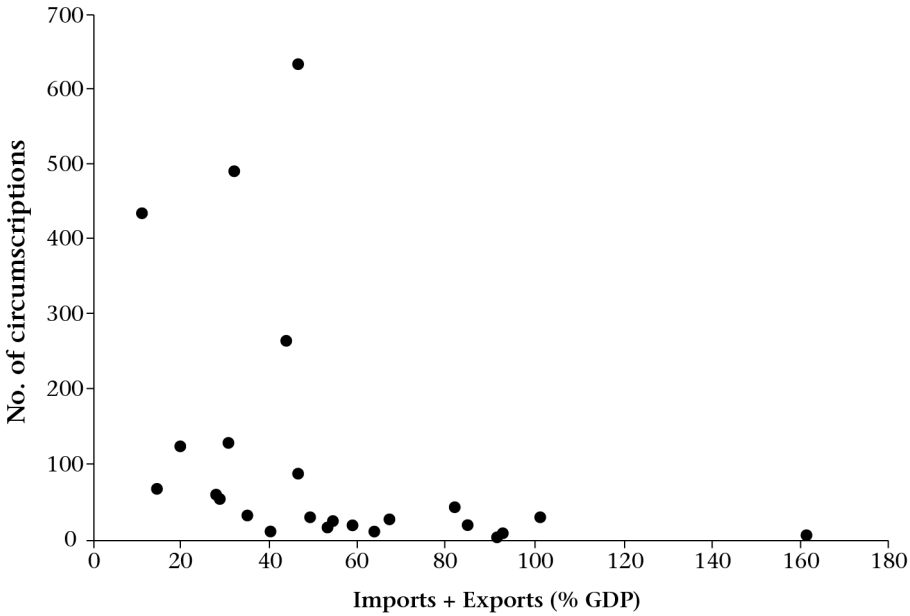
But the explanatory power of institutions is not limited to the effects of the political regime. Even within democratic systems, the rules of decision making can crucially condition the characteristics of trade policy. The literature on the historical evolution of US trade policy offers a clear example of the power of institutional explanations<sup>8</sup>. In 1930, in response to the protection demands of a large part of the American industry that was suffering the consequences of the financial crash of 1929, the American Congress voted in the Smoot-Hawley Law, which involved a historic rise in domestic tariffs of up to 60 percent. Despite the warnings from economists at the time about the disastrous consequences of these protectionist measures, the Congress, dominated by the traditionally Republican protectionists, and imprisoned by the *log-rolling*<sup>9</sup> logic, ended up approving this massive tariff increase that provoked protectionist reprisals in all its business partners and ended up sinking the American economy even more. In 1934, when the Democrats regained control of the chamber, Congress passed the historic Reciprocal Trade Agreements Act (RTAA), which drastically changed the institutional framework upon which trade policy was designed. The new law, in the first place, gave the president the power of negotiation in international treaties. The president, unlike the congressmen, was elected nationally, which meant his incentives to respond to the demands of geographically concentrated sectors were lower. Secondly, the RTAA linked trade liberalisation to the opening of markets abroad, where potential exporters began to politically lobby in favour of free trade. After the introduction of this institutional change, US trade policy was radically liberalised. The average tariff, which had varied around 40 percent in the first few years of the century and went up to almost 60 percent with the Smoot-Hawley law, began a spectacular decline, it being lower than 40 percent even before the start of the Second World War and reaching 10 percent in the fifties. More importantly, the reform was able to permanently defeat protectionism forever, thanks in part to the republican conversion to free trade after the Second World War.

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8 The argument is developed in more detail in Bailey, Goldstein and Weingast (1997) and in Irwin and Kroszner (1999). Hiscox (1999) offers an alternative explanation for the liberalisation of US trade policy based on the effects of the war on the national economic structure.

9 A typical process of vote marketing among the legislators of the US Congress whereby congressmen with strong preferences for a certain policy gain the support of other congressmen in exchange for reciprocal concessions.

**Graphic 9.7 Number of districts and trade openness**



SOURCE: Rogowski (1987).

Using a similar institutional logic, Rogowski (1987) argues that when electoral constituencies are large (as in proportional systems), policies tend to be less protectionist. The reason is that proportional systems with large constituencies make politicians prefer universal and general policies (such as trade openness), in contrast to the uninominal majority systems in which politicians tend to pay more attention to locally concentrated interests. It is for this reason that, according to Rogowski, countries highly dependent on international trade (and for which protectionist policies would be enormously costly for society) tend to adopt representative institutions with few and large electoral constituencies, as the graph suggests (9.7).

## 2.4. The paradox of (no) compensation

Ultimately, if protection involves a net cost to society as a whole, as argued above, the explanations in purely distributive terms (i.e. the losers of openness are politically more powerful than those that are potentially winning) are not sufficiently convincing. If the producers are politically powerful and the State needs fiscal

resources, what prevents consumers from transferring part of their profits to these groups, what prevents consumers from transferring part of their profits to these groups to stop protection from paying off? In view of the graphs (9.3) and (9.4), in a situation of full openness, consumers could transfer to the producers the area that they would obtain if there were a tariff, to the State what they would obtain as taxes, and the two coloured areas would still be left over to be distributed among consumers, producers and the State. In other words, if openness is a socially optimal policy, reasons of a distributive nature should not prevent its adoption, because the losers should always be able to be compensated<sup>10</sup>. To explain the adoption of suboptimal policies, we therefore have to understand what makes compensation impossible. Two works are reviewed here that have tried to provide an answer to this problem.

Fernández and Rodrik (1991) show how uncertainty about the distributional results of economic reforms can cause a bias towards the status quo. Let us imagine that there are ten individuals who must vote on a reform that will increase the income of six of them but reduce the income of the other four remaining individuals by the same amount. The individuals know the identity of four of the “winners”, but not of the other two. These four individuals, therefore, will vote in favour of the reform. For the remaining six, if the reform is approved, the probability that they fall into the group of “losers” is greater than if they are “winners” (2/3 against 1/3). Therefore, even though they are risk neutral, they will vote against the reform. One might think that these six voters could “insure themselves” through a transfer programme from the six winners to the four losers. However, this “insurance” is not politically sustainable because, once the reform was approved, the six winners who are now the majority block any compensatory transfer since it does not benefit them. In short, the existence of uncertainty about the identity of the winners, a reasonable assumption in the case of decisions about opening to international competition, together with the impossibility of making credible commitments in democracies, explains the maintenance of socially suboptimal policies, such as protectionist ones, in the model of Fernández and Rodrik.

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10 The hypothesis of “compensation”, in fact, links the expansion of State redistributive programmes to the process of economic internationalisation: the governments, according to this hypothesis, are obliged to compensate certain groups for suffering the negative consequences caused by a greater degree of economic openness.



Acemoglu and Robinson (2001) try to explain why redistributive policies (such as protectionism) tend to be economically inefficient. In their model, since in democratic systems it is impossible to make credible commitments on future policies —political power will always depend on the majority at any given time— groups with the ability to influence current policies will seek policies that guarantee political power in the future. And since political power (especially in democracy) depends to a large extent on the size of the group, they will prefer that the redistributive policy increases or at least retains the size of the group and, therefore, its ability to influence future policy. In the case of trade policy, producers benefiting from a tariff will prefer the tariff to another more efficient redistributive policy (such as a direct transfer of income) because the tariff manages to preserve the size and political power of the group of producers. While the existence of a tariff gives incentives to the permanence of economic stakeholders in that sector (and the arrival of other new stakeholders from other sectors), a transfer of income would not prevent some of the producers from leaving the sector and relocating towards more productive sectors, thereby compromising the ability of the group to influence future policy.

One constant among the explanations for the adoption of inefficient redistributive policies is that, in politics, commitments on future decisions are never fully credible (although the existence of certain institutional arrangements can increase the credibility of these commitments). And as redistribution in the future will depend on the political power of the respective groups at that time, and not on the commitments reached in the present, there are purely political reasons for advocating redistributive policies, such as trade protection, even though they may be economically inefficient.

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## 4. Questions

- 9.1 Why, according to the Ricardian model, do all countries have a comparative advantage in the production of some goods?
- 9.2 What role does the international political structure play in facilitating economic relations between countries?

- 9.3 Why should we not expect protectionist policies to exist? What political arguments have been offered to explain their existence?
- 9.4 What institutional characteristics are associated with more liberal trade regimes? What are the mechanisms that make openness more “politically attractive” in these contexts?
- 9.5 What prevents the groups disadvantaged by economic openness from being compensated by the groups that benefit from it? In what contexts would you expect this compensation to occur?