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Look before you leap: Why politicians may have a point to be hesitant about the gains from trade

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A B S T R A C T

Economists emphasize the welfare gains of unrestricted trade, but politicians worry about the income distribution effects of increased competition. We show that the welfare gains of a trade shock become ambiguous if inaccurate information hinders optimal income redistribution with distortionary policy instruments. To be sure about the net welfare outcome of a compensated trade shock, the government must know the size of the trade shock and the corresponding size of the policy instrument that is needed to generate a balanced budget. If this is not the case, politicians may have a point when being hesitant about the gains from trade.

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1. Introduction

Trade and specialization according to comparative advantage cause welfare gains and income distribution effects. This is hardly a new insight. But from a purely economic point of view, it is hard to understand why politicians usually resist the move to free trade. As all economists know, the welfare gains resulting from larger markets should be big enough to compensate the losers without taking away all the gains from the winners. So why is it that politicians do not buy this argument?

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Politicians are obviously less interested in welfare gains than in income distribution effects. As Corden (1997) notes, this attitude goes back at least as far as the Napoleonic Wars. Prominent examples include the institutionalization of the EU's Common Agricultural Policy or the EU's protectionist policy responses to cheap imports of textiles from East Asia in the 1950s and 1960s. Income distribution effects also constitute a prime rationale for countries to engage in multilateral trade negotiations on a reciprocal basis as in the World Trade Organization (WTO). If welfare considerations were all that mattered, there would be no need for multilateral trade negotiations and a WTO.[1]

The focus of politicians on income distribution effects is easily understood from a political economy point of view. But economists also have a point when arguing that the overall welfare effects should matter. We try to improve the communication between economists and politicians by studying the effects of an exogenous trade shock on the income distribution and overall welfare in a way that recognizes the reference system of politicians. In our reading, the reference system of politicians excludes lump-sum transfers to redress income distribution effects and emphasizes that political decisions have to be made on the basis of inaccurate information. The trade shock example is chosen because the trade-offs faced by politicians in response to such a shock can be discussed in terms of two well-known policy instruments, namely a tariff or a subsidy financed by a tax.

Our main argument runs as follows. With additional possibilities for trade in a larger market, i.e., after a positive trade shock, two things will happen. Welfare will be redistributed from "producers" to "consumers" or vice versa, depending on the new product price after the shock, and there will be a net welfare gain. For economists the net gain would suffice to favor the larger market. But politicians will not be interested as long as it has not been made clear how and at what cost the losers of a larger market may be compensated.[2]

The losers of a larger market can be compensated by a tariff or a subsidy, but both measures create net welfare losses relative to the overall welfare gain that would result from a larger market without redressing income distribution effects. The politically relevant question is, therefore, whether a larger market still leads to net welfare gains after the losers have been fully compensated. The textbook answer given by economists is that there remain net welfare gains even after full income compensation with subsidies and distortionary taxation. But, as it turns out, the textbook answer may not hold if politicians do not have accurate information on the size of the initial shock and on the size of the corresponding policy instrument that is needed to generate a balanced budget. Hence, at least from a comparative static point of view, politicians may have a point when being hesitant about the gains from trade that are emphasized by economists.[3]

To show these and other points, we employ partial equilibrium analysis to investigate the welfare consequences of a trade shock when a government uses distortionary measures to redress the income distribution effects. We think of a trade shock as an exogenous fall in transportation or communication costs ("globalization"), which increases the size of the market for all countries.[4] We use a tariff and a subsidy as the two alternative policy responses the government could employ. We first set up a case of correct information, which serves as a point of reference for an analysis of the welfare effects for consumers, producers, government and society at large when the government has to deal with information inaccuracies. We use partial equilibrium analysis because it allows for a simple assessment of the trade-offs faced by the government when redressing adverse income distribution

[1] Except perhaps to escape from the prisoner's dilemma of trade policy setting for large countries, which is based on the terms of trade argument. However, the large country case is typically seen as a theoretically sound but politically irrelevant reason for implementing trade policies.

[2] Corden (1997) hints that a social welfare function based on a constant income distribution may be "particularly helpful for understanding actual trade policies of many countries" (p. 74).

[3] Our argument is related to Acemoglu and Robinson (2013), who emphasize that a given *political* equilibrium may actually rest upon a distortion that inhibits an *economic* equilibrium. The economists' view in favor of removing the distortion because of the overall welfare effects may fail to take into account that a free market policy may strengthen groups and interests that are opposing redistributive measures. Hence, removing a market distortion may not always lead to an improved allocation of resources because it will affect future political equilibria, which are likely to come with other distortions.

[4] The decline in transportation and communication costs is seen as one of the main reasons for the globalization wave that started in the 1980s. See for example IMF (1997) and O'Rourke and Williamson (1999) for a comprehensive survey on the determinants of globalization.

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