The Balance of Political and Strategic Trade Factors in US Trade Policy Determination

Elizabeth Tolmie

Abstract

Of the numerous theories of trade policy determination, no single one unambiguously explains the real-world decisions concerning protection and trade liberalization. The motivations of policymakers undoubtedly play an important role in choices regarding import tariffs and NTBs. Furthermore, the actions of industry interest groups and constituents have the potential to greatly influence the degree of protection a sector receives. However, the maximization of the social surplus of the government, producers, and consumers cannot be ignored as a goal of trade policy, as outlined in the section on strategic trade policy. My research attempts to provide evidence that foreign industry factors that are essential to strategic trade policy theory play an important role in real-world policy determination along with factors of the political economy.

Summary

Economic theory teaches that a laissez-faire approach to national and international market policy maximizes the sum of the welfares of all players in the market in the absence of market failures. Proponents of laissez-faire economics have argued that trade policy creates deadweight losses that make free trade better for world welfare than policy measures. However, real world economies and industries rarely satisfy a model of perfect competition. Although protectionism does in fact create deadweight losses in many situations, trade liberalization is rarely the social surplus-maximizing alternative in terms of policy decisions. Furthermore, decisions concerning trade policy are not made solely based on the goal of maximizing the welfare of the overall country. The motivations of people who have the ability to influence these decisions arguably play an equally or more important role in trade policy determination than the goal of maximizing national welfare.

In an imperfectly-competitive market, the decisions of firms in both the domestic and foreign market depend on the characteristics and choices of competitors. As a result, the production and profits of an industry have the potential to be shifted between firms in that industry. Domestic policymakers can realize this shift in profits towards firms in the home country by enacting policies that protect domestic production. By lowering the cost of domestic production relative to foreign production through the implementation of an import tariff or export subsidy, the domestic government can achieve an increase in domestic production and decrease in foreign production. This strategic trade policy results in a positive change in producer surplus and, in the case of an import tariff, a positive change in government revenue. A limited range of positive import tariff levels exists that results in a national social surplus level that is greater than the level reached in a domestic market free of protection. Although export subsidization implies a decrease in government revenue, the profit-shifting potential of subsidies can in fact also result in subsidies that will sometimes increases the social surplus. Consequently, strategic trade policy is a possible factor in the lack of trade liberalization in the world market.

In the case of traditional models of perfect competition and strategic trade policy models, an assumption is made that the goal of policy, or lack thereof, is the maximization of national surplus within the constraints of industry characteristics. This goal, however, is not necessarily the most heavily weighted motivating factor in real-world trade policy determination. Because the maximization of domestic welfare is not always consistent with the maximization of the welfare of policymakers, protectionism cannot simply be considered as a macroeconomic optimization problem: the economic and political preferences of individuals must enter the model of policy determination. Much research has been done on political factors, concerning policymaker preferences and interest group characteristics, that are believed to have a greater influence on real policy decisions than those factors that affect social surplus and production decisions.

Of the vast research that exists in the field of international trade policy, however, few studies have considered the influence of both political variables and foreign industry variables that are essential to the determination of the optimal tariff level in strategic trade policy models. In a model of real policy determination, the characteristics of the rival foreign production markets should hold a degree of importance in domestic policy decisions. When considering empirical work on models of political economy, there is a noted absence of variables that explain a potential motivating factor, namely the maximization of social surplus, in the decisions of policymakers.

In my research, I strive to provide evidence that the maximization of domestic social surplus, in conjunction with political economy variables, is an important factor in real-world policy decisions and can be used to explain the notable absence of trade liberalization in the world. In accordance with this hypothesis, the market structure and characteristics of the rest of the world should be significantly correlated with trade policy determination and should not be ignored as potential identifiers of import tariff levels in individual industries. Using the work of Daniel Trefler (1993) as a basis for my study and working within his structure of a system of simultaneous equations, I have considered the role of industry characteristics of the European Union in the level of import tariffs implemented by the United States government in the early 1990s.