

TRADE

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Introduction:

The subject of trade is one area in social science that cannot be claimed by any single discipline in the social sciences. Both economics and political science have jurisdiction over this area, and both, indeed, have something to say. From a purely economics standpoint, any barriers to trade are distinctly irrational. This is because, given each actor's comparative and absolute advantages, economic efficiency is necessarily gained through exchanges of goods and services between the two actors. Simply put, Adam Smith's notion of the specialization of labor gave birth to this very idea. So, the big question is; why are there any barriers to trade at all? Alt et al. (1996) allude to this question themselves, stating that trade policy for any nation is a misnomer because it actually inhibits trade rather than encouraging it (for the most part) by creating market barriers and tariffs that reduce the amount of a nation's imports and cause redistributive inefficiencies. It is not for us to argue for creating open-market economies throughout the world, but rather to explain why nations would strive to keep economic efficiencies at bay.

The answer does indeed come from Political Science. We often think of the economy as a single entity, moved by market forces and nanodecisions of individual investors and consumers until equilibrium is attained. In the case of trade, however, the situation is distinctly different. This is because various owners of the factors of production have varying degrees of influence over policymakers. Thus, in order to gain an insight into why inefficient barriers to trade exist within an economy, one must look to the institutions and methods present within the region to understand why (seemingly) an irrational outcome has taken place. According to the literature, the main impacts on trade come from factor specificity and political action.

Factor Specificity:

Both Alt et al. (1996) and Hiscox (2002) agree that the most important determinant of trade policy is "Factor Specificity". This relates to the ease of movement of the various factors of

production (land, labor and capital) across industries. By the movement of the factors of production, we mean the ease with which one can redeploy excess factors to other avenues of the economy in order to gain efficiencies. Historically, there have been two main models that have differing assumptions over the costs of factor mobility. The Heckscher-Ohlin model assumes costless mobility across industries, whereas the Ricardo-Viner model assumes that specificity is high, and thus the costs of factor mobility do not allow movement across industries (at least in some cases). In basic microeconomic theory, costless mobility is assumed across the board in order to model efficient markets. Indeed, over the long run, this is a safe assumption since each factor can “costlessly” be transferred across industries because the marginal cost of the transfers become negligible over a long enough time horizon. In the short-run, however, owners of a factor of production looking to redeploy across industries would face particular costs (for example, training costs in the case of labor, liquidity costs in the case of capital, etc.).

Thus, for the case of costless mobility, we would expect returns to each industry to be equalized throughout the economy. The logic behind this notion is that excess returns in one sector of the economy would be utilized in other sectors to provide efficiencies in economic activities. However, this is usually not the case since many industries enjoy excess returns on the factors of production, which they do not redeploy into other sectors. There are examples, however, of certain factors that do enjoy costless mobility (for example, unskilled labor). Thus, Alt et al. (1996) argue that factor specificity should not be viewed as a dichotomy, but rather as degrees of variation in the specificity of factors. The intuition here is that the more specific a factor is to a particular industry (i.e. low mobility), the more the owners of that factor would prefer protectionist trade policies, especially if the factor is abundant. What this means in the international context is that the more tied a factor is to the industry utilizing it, and if this factor

is not a scarce commodity among nations, the more the owner will seek to protect it from competition from other nations. Hence, if software professionals can only be utilized by the software industry, and both the US and China have an abundance of software professionals, the US based professionals would seek to protect their job market in the US (by adding barriers to entry on Chinese professionals) in order to keep wages high. Specificity plays a role here, since if software professionals were not tied to the software industry (i.e. mobility is costless), there would be no need to pursue protectionist trade policies because competition from China would simply cause the US professionals to redeploy themselves into other industries and seek other jobs.

Finally, the Stolper-Samuelson theorem establishes the gains and losses from free trade by focusing on abundance in the factors of production. The theory states that owners of abundant factors in an area gain from trade whereas owners of scarce factors would stand to lose. As an example, consider two nations, one with an abundance of labor and another with an abundance of capital. Owners of capital in the labor-abundant nation would stand to lose because they would gain decreased returns due to the additional competition provided by capital owners from the capital-abundant nation. Thus, we would expect the capital owners in the labor-abundant nation to pursue protectionist policies regardless of factor mobility. However, as the mobility of capital decreases, the owners of capital would find it less necessary to *actively* pursue protectionism, since the threat of competition from the capital-abundant nation is diminished. Therefore, protectionist trade policies are really set up to increase the specificity of the factors of production, thus leading to market inefficiencies and excess returns.

Measuring factor specificity is no easy task, however. Hiscox (2002) uses a variety of measures for factor specificity, relying mostly on industry wage and profit differentials. This is

an adequate proxy for factor mobility since if mobility is costless; the differentials would be “arbitraged away” so that equilibrium exists across the economy. Thus, industries with low variation indicate high mobility. In economic terms, this is the elasticity of factor substitution. This indicator is not perfect, since there are reasons other than “maximizing real income” for owners of the factors of production (non-pecuniary benefits such as job safety, prestige, etc.) that would reduce movement, even in high factor mobility situations. Hiscox includes other proxies for mobility (such as rate of labor market turnover, spending on R&D and worker training, etc.) to control for such issues and provide a stronger indicator. Alt et al. (1996) outline four main methods to measuring specificity. Their “rate of return approach” is similar to that used by Hiscox; the “lobbying approach” looks at large lobbying activity as an indicator of high mobility. Another approach suggested is to use “expert survey measures”, conducted by surveying industry experts. This method is powerful in the potential insights it provides, but is difficult to generalize across industries, and suffers from measurement errors. Finally, they suggest indirect (proxy) measures such as R&D spending, number of trade unions etc. to indicate factor specificity. Hiscox uses these indirect measures as crosschecks to ensure validity of his results.

Political Action:

Alt et al. argue that economic reasoning and factor specificity alone do not explain the reasons behind the existence of trade policy. The Heckscher-Ohlin, Ricardo-Viner, and IRS models are factored in as benefits when actors decide on taking political action on trade issues. There are associated costs such as collective action costs, free rider problems and costs imposed by individual domestic institutions that must be accounted for before owners of the factors of production turn toward influencing trade policy. Thus, it is necessarily the interaction between factor specificity and political institutions that produce influence on trade policies. Owners of the factors of production engage in cost benefit analysis to see if the perceived costs of collective

action outweigh the perceived benefits from the models. Mass movements for (or against) trade policy usually have high mobility, low collective action costs and domestic institutions that are attuned to rewarding large groups (vote maximizing strategies). Alternatively, smaller industry-specific coalitions and lobbying activities take form in the presence of low mobility, high collective action costs and institutions that reward small groups (for example, campaign contribution maximizers). Hiscox classifies these two distinct forms of political movements as “class coalitions” and “industry coalitions” respectively. The main methods for individuals to influence trade policy are in the form of political parties, peak associations (such as unions), and lobbying groups. Again, the scarcity and abundance of the factors of production have a role since all these will form protectionist platforms (for scarce factors) or free trade platforms (for abundant factors). Hiscox uses voting patterns to identify party unity, and measures lobbying activity by the number of testimonies volunteered by the lobbying groups for any particular time-period under consideration. He uses these measures as a proxy for political cleavages that shape trade policy.

Conclusion:

Hiscox engages in an extremely deep analysis of political history for six nations, which he presents as evidence for his conclusions. There are distinct parallels that can be drawn between trade policy and risk management. Essentially, owners of the factors of production are hedging their bets. In an industry with low mobility, and with the resource itself being scarce, the losses incurred to the owners of the scarce factor can be great. In order to avoid the potential losses, the owners engage in political activity in order to protect their interests. The type of political avenue they choose depends upon the level of start-up costs, domestic political institutions (and its incentives), and factor mobility. In the low mobility case, industry specific groups are expected to form to provide incentives for policymakers to vote in their favor. Even for owners of

abundant resources, if the mobility is low, they are again susceptible to pursuing protectionist policies. For the high mobility case, the opposite is true, with owners preferring free trade as opposed to protectionism, and choosing class coalitions to influence trade via political parties and peak associations.

In contemporary times, it is safe to say that factor specificity is high (i.e. mobility is low). Hiscox uses the mean coefficient of wage variations to designate the level of factor mobility. Sweden and Australia are two cases of current high mobility, but the other four countries studied are low (US, Britain, France and Canada). However, intuitively I would say that mobility is low across all developed countries given the increasing specialization required for skilled labor, while capital mobility is low as well, given the increased spending in R&D and training. Therefore, owners of capital have to protect themselves against the influx of import-competing industries, especially since both capital and labor are highly industry specific. Furthermore, because of this specificity, the influence avenue pursued by industries is likely to be lobbying-related activity, since the costs associated with start-up are fairly low, and as Hiscox states, the factor returns are tied to the industry, thus providing a further incentive to lobby. This does not imply that the lobbyists will have a protectionist stance, however. That would depend on the abundance of the factor of production.

One final point to note is that as of this writing, the US announced on April 2nd, 2007 that it had struck a deal with South Korea for a free trade agreement for all products excluding rice. Demonstrations took place in South Korea (mostly by rural farmers) against the agreement, for fear of them losing work. The one thing to note in this scenario is that Korea chose a protectionist stance on rice. This reinforces the prediction that owners of an abundant factor with high factor specificity would choose a protectionist stance.

References

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