

**The Political Economy of Trade Policy: Theory and Applications to  
Latin America<sup>†</sup>**

*By*

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Final Version

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## **Introduction**

Classical trade theory has analyzed gains from trade in the form of gains from exchange and specialization, while the recent trade literature has emphasized other gains in the context of imperfect competition. The recent empirical and theoretical literature has also looked at the effects of trade on growth and on poverty.

While economists clearly understand the benefits of free trade, they have always found it difficult to explain departures from it in the real world, especially taking the form of import protection. The last two decades have seen the emergence of the political economy literature in international trade theory. Political economy models try to explain the existence and the extent of the anti-trade bias in trade policy. Part of this literature has also tried to explain why more efficient policy instruments that have not been used. An important contribution of this literature, of empirical interest, has been to uncover the industry-specific and the country-specific determinants of protection.

By the time economists were somewhat successful in resolving the puzzle regarding the existence of harmful import protection, several countries had liberalized or had started liberalizing their trade regimes. What can explain such liberalization? Can a simple comparative static exercise in the political economy models of protection explain these reforms? Probably not. One of the main objectives of this paper is to understand this puzzle. There are some new interesting models of trade reforms, which we will discuss in this paper. However, they are far from satisfactory and much work needs to be done in this direction. What is it that changed in the world that led so many countries to liberalize trade recently?

We do not have a good answer to this question. At the same time, however, I would also like to caution the reader that though much headway has been made in liberalization, it is far from fully done.

Next , I would like to point out that all the models and theories discussed in this paper have applications to and lessons for Latin America. One aspect that very few of these models emphasize is the role of ideas. In this region, ideas were supported by the region's adverse macroeconomic conditions. These conditions were brought about by failed import-substitution policies and state ownership of a large portion of productive resources. Chile is a glaring example of how the ideas of an important and influential group of people can change trade policy. However, despite the power of ideas under adverse economic conditions, a package of policies needs to be carefully designed so that it has the support of the majority and keeps the powerful interests happy. I am also arguing in favor of a policy of uniform tariffs since it results in the least amount of distortions in relative prices and at the same time reduces the incentives for lobbying and makes it fairly ineffective. A few Latin American countries also committed to low tariff bindings at the WTO that led to the erosion of domestic lobbies that in turn resulted in further reductions in tariffs which ultimately went below bindings. A lot of the above policy recommendations have already followed and have been successful in Chile. While Chile is an outlier in Latin America, I will argue in this paper that looking at it might still be useful for other countries in this region where conditions are a lot different.

While the low dependence of Latin American governments on tariff revenues (as compared to many other developing countries) should make us optimistic about freeing trade in Latin

America, there are constraints such as the high concentration of economic power (as reflected in Gini coefficients) that we should be concerned about.

### **The Benefits of Free Trade**

One of the standard results in trade theory is the optimality of free trade for a small country not facing any distortions or market imperfections, irrespective of the trade policies pursued by its partner countries. In a general-equilibrium, multi-good setting, it is easy to demonstrate the gains from trade and break it down into the gains from specialization and the gains from exchange. In a partial equilibrium setting where we focus on only one good, it is easy to see the deadweight loss from protection in terms of Harberger triangles in a demand and supply diagram. Free trade, which is the absence of any protection, results in the absence of such triangles. Thus, unilateral trade reforms in a small country are welfare enhancing.

The above traditional argument for free trade, based on allocative efficiency, was made under the assumption of perfect competition. In addition, it has been argued that in imperfectly competitive markets, trade liberalization will bring further welfare gains. These gains are from the reduction, under free trade, of the dead weight losses created by domestic monopolies and oligopolies under autarky. Opening domestic markets to free trade results in new competition from foreign firms and in turn in the reduction of price-marginal cost markups.

While there is fairly strong agreement among economists regarding the static welfare gains from trade, the theoretical relationship between trade and growth is somewhat unclear.

Trade can promote innovation by accelerating industrial learning since it can facilitate international exchange of technical information. It can improve the efficiency of global research by eliminating the duplication of research effort in different countries. However trade can adversely affect research by diverting resources away from R&D or can improve growth by bringing resources into R&D, depending upon the abundance of skilled labor or the efficiency in R&D of any country relative to the rest of the world. Also, trade can reduce the market size of domestic, import-competing firms, which can reduce the incentives faced by domestic producers to innovate. On the other hand, each domestic import-competing firm will face a more elastic demand due to the presence of imported substitutes, which will increase the returns from cost reduction. In turn, this will speed up innovation.

Since the theory appears to suggest that virtually anything may happen to productivity growth after opening up to trade, the trade and productivity question has largely become an empirical one. The micro (firm-level and industry-level) evidence so far provides fairly strong support for the growth-enhancing effects of trade. Such evidence comes from studies by Harrison (1994), Krishna and Mitra (1998), Kim (2000), Ferreira and Rossi (2003) and Nuchsuwan (2004) for Cote D'Ivoire, India, Korea, Brazil and Thailand respectively. There also have been some macro-level studies on this issue. While Dollar (1992), Sachs and Warner (1995) and Edwards (1998), using different measures of openness, in many cases constructed from standard policy measures, showed positive effects of trade on growth, these papers have been strongly criticized by Rodriguez and Rodrik (2001) for the problems with measures of trade openness and the econometric techniques used as well as for the difficulty in establishing the direction of causality. And while Rodriguez and Rodrik (2001) have criticized the measure of openness used by Sachs and Warner (1995) as capturing many

aspects of the macroeconomic environment in addition to trade policy, Baldwin (2003) has recently defended that approach on the grounds that the other policy reforms captured in the measure, though not trade reforms per se, accompany most trade reforms sponsored by international institutions. Therefore, using such a measure tells us the value of the entire package of trade and accompanying reforms. Wacziarg and Welch (2003) have updated the Sachs-Warner dataset and have again shown the benefit of such reforms in driving growth.

The empirical trade literature recently has shifted focus to levels from growth rates. Frankel and Romer (1999) look at the effect of trade share in GDP on income levels across countries for the year 1985. They construct an instrument for the trade share by summing up the gravity-model driven, geography-based predicted values of bilateral trade flows across all trading partners. The variables used to predict bilateral trade flows include distance, country size variables such as land area and population and dummies for whether the countries are landlocked, have a common border etc. They find that their instrumental variables approach produces positive effects of trade on income levels that are greater than the estimates produced by ordinary least squares. Irwin and Tervio (2002) apply the Frankel-Romer approach to cross-country data from various periods in the twentieth century to show that this trade-income relationship is indeed highly robust.<sup>1</sup>

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<sup>1</sup> Building on two literatures, namely the one on institutions and incomes and the other on trade and incomes, Rodrik, Subramanian and Trebbi (2002) have looked at the simultaneous effects of institutions, geography and trade on per capita income levels. Using a measure of property rights and the rule of law to capture institutions and the trade-GDP ratio to capture openness in trade, and treating them both as endogenous in their growth regressions, they use the instruments that Acemoglu, Johnson and Robinson (2001) and Frankel and Romer (1999) use to instrument institutions and trade openness respectively (and separately). Rodrik, Subramanian and Trebbi (2002) find that “the quality of institutions trumps everything else”. However, trade and institutions have positive effects on each other, so that the former affects incomes through the latter. Similarly, geography also affects institutions.

Moving from growth rates and incomes to poverty, Dollar and Kraay (2002), in a cross-country study of 92 countries over the last four decades, find that policies that promote overall growth promote growth in the incomes of the poor. These policies include trade openness, macroeconomic stability, moderate government size, financial development, and strong property rights and the rule of law. Thus, in another paper, Dollar and Kraay (2004), based on data from the post-1980 “globalizing developing economies”, argue that per capita income growth arising from expansion in trade in those countries has led to a sharp fall in absolute poverty there in the past 20 years. Evidence of the poverty reducing effect of trade has also been shown by Hasan, Quibria and Kim (2003) in their recent empirical work. In their paper, poverty is measured as the headcount ratio.

Thus there seems to be fairly strong evidence for the various beneficial effects of trade in terms of standard efficiency gains (the static welfare gains), higher productivity growth, higher real incomes and lower poverty rates. Thus most countries should be better off liberalizing trade, even if they had to do it unilaterally. Yet we have seen strong reluctance on the part of individual countries, especially developing countries, to liberalize trade. I discuss in detail in the next section the possible reasons for the opposition to free trade in these countries.

### **Traditional arguments explaining the existence of protectionist policies**

First let me start by saying that even for a small country, there are conditions under which protection can prove useful. These are conditions under which we have distortions and direct, corrective policies are not at the disposal of the government for one reason or the other. One such condition is the presence of an infant industry where there is potential for

learning by doing. In the absence of protection, this industry will get wiped out by foreign competition. Protection will allow the industry to produce and acquire experience that will increase its future productivity and reduce its future costs of production. Thus temporary protection will help this industry grow out of infancy and will in some time enable it to compete against outside competition. While this argument is theoretically correct, it only holds under appropriate conditions. Therefore the question is whether or not the capacity to learn is overestimated. In fact, the experience has been quite the opposite. Instead of the build up in productivity, what we saw in countries like India was the solidification of inefficient monopolies under high walls of protection. This also created vested interests who wanted to continue with protection. One might also argue here that there are other direct, more efficient policies such as direct subsidies that could have been used. The problem of course with such a policy is that while such a direct policy costs revenues, protection can generate revenues.

Non-economic objectives are given as another reason for protection. An example of such a non-economic objective is self-reliance in manufactured products in which a country might not have a comparative advantage relative to the rest of the world. One could question the objective itself or one could again argue for more direct policies. The revenue consideration again comes into play as in the case of infant industry protection. These non-economic objectives have come out of centuries experience with imperialism, which resulted in a lack of trust in developed countries and therefore, in a perceived need for self sufficiency. Clearly, multilateral negotiations to exchange concessions along with a building of trust would be useful in this regard.



After having discussed the above arguments that do not have much of a political content, we focus in detail on some political economy considerations. Free trade might be welfare enhancing. However, it does create gainers and losers. What the efficiency or welfare argument for free trade says is that gainers from free trade can compensate losers (or just make them a little better off) and still be better off. In other words, free trade might not make everyone better off even though it has the potential to do so. In the real world however, it is not politically feasible to make the gainers from free trade compensate the losers, which forms the basis for the political economy forces behind trade protection. I will now illustrate these factors using a few examples.

Suppose you lower the tariff on imported furniture, which results in cheap imports of furniture produced in China. This will reduce the size of the market for domestic furniture. This reduces output and therefore, employment in this industry. Profits and returns to capital are also lower in this industry as a result. Clearly both capitalist and workers in this industry will lose in the short run, the short run being defined as period of time during which factors are sector-specific and immobile across sectors. This specificity in turn depends on the adjustment costs in terms of both resources and time. If the horizon of these people tied to this sector is not too long, they will oppose trade reforms. Even in developed countries, people employed in their declining industries (industries in which they have been losing comparative advantage over time) have been opposed to reforms. In the United States, domestic furniture manufacturers are opposed to free trade. Thus in a model where there are specific factors of production (factors of production specific to a sector), owners of such factors in import-competing industries will be against trade reforms while those that are in the export sector will be for them. This explains why specific-factors

models are so popular in the political economy literature in international trade. But, even though this approach gives us some clues towards explaining the anti-trade bias in trade policy, it does not explain away the puzzle. While it is true that import-competing sectors or rather the specific factor owners in such sectors will lobby for protection, those in export sectors will effectively lobby against it as it is relative prices that matter. Thus, there is no reason for trade policy to have an anti-trade bias. For the bias to hold, for some reason the import-competing specific factors should be better organized than the one in the export sector. Many lobbying models in the trade literature just start out by assuming that the import-competing interests and not export interests are represented by lobbies. The question then is why are export interests not as well organized as the import-competing interests.

Findlay and Wellisz (1982), in their pioneering work, look at tariff formation in a two-sector model through the lobbying in favor of it by specific factor owners in the import-competing sector and against it by those in the export sector. However, the tariff is constrained to be non-negative in order to get around the problem of getting a pro-trade or pro-export political-economy equilibrium. Grossman and Helpman (1994) get around this problem in a different way. They really do not allow any substitutability between non-numeraire goods, each of which is imperfectly substitutable with the numeraire good produced using only labor, a factor out of the lobbying process by assumption. Thus there is specific trade policy for each non-numeraire sector. Each such sector uses a specific factor and the mobile factor, labor. Thus, an import-competing sector could be faced with an import tariff or an import subsidy and an export sector an export tax or subsidy. The type of trade policy used for a sector obviously depends on whether the sector is an import-competing or export sector and whether it is politically organized or unorganized. The magnitude of this policy depends on

the nature of the government (how much it cares about welfare relative to contributions), the extent to which the population of the country is politically organized, the degree of import penetration in that sector and the import-demand or export-supply elasticity. Sectors are, in their model, taken as exogenously organized or unorganized.<sup>2</sup>

While the above channels for the demand for protection are those that arise in a specific-factors or a short-run setting, it is also useful to analyze these issues in a more long-run context of perfectly mobile factors, which is the opposite polar case. In a two-good, two-factor setting, the Stolper-Samuelson theorem says that an increase in the relative price of a good results in an increase in the price of the factor service used relatively more intensively in the production of the good and a reduction in the price of the other factor. In other words, in a setting with capital and workers being the two factors of production, an increase in the relative price of the capital-intensive good results in an increase in the rental on capital and a reduction in the wage rate of workers. Therefore, if the capital-intensive good is the import-competing good, a tariff raises the rental and reduces the wage rate, which means capitalists will favor protection and be against trade reforms, while workers will be against protection and favor trade reforms. The opposite will be the case in a country with a comparative advantage in the capital-intensive good. Thus, when there is perfect intersectoral mobility of capital and labor in this model, the two factors will be against each other on trade policy, and should lobby against one another as in Feenstra and Bhagwati (1982). In a majority voting model, as shown by Baldwin (1982), the equilibrium policy will be one that favors workers as the majority of the population would comprise of workers as

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<sup>2</sup> Mitra (1999) is the first paper to endogenize lobby organization which means in that paper whether a lobby is organized or not is not taken as exogenously given.

opposed to capitalists. Mayer (1984b) allowed for ownership of both factors by any individual in the economy. Arranging individuals in increasing or decreasing order of the ratio of their capital to labor ownership, the political economy equilibrium tariff is the most-preferred tariff of the median individual in this ranking. If this median individual's capital to labor ratio is less than the economy's overall capital to labor ratio, i.e., if the asset distribution in the economy is unequal, the equilibrium trade policy turns out to be different from free trade.

Thus we see that trade policy, when used as an instrument for income redistribution to favored groups, is different from free trade. This idea can be illustrated using lobbying models or models of majority voting. While this is only a partial explanation for observing deviations from free trade, a more complete explanation should consist of reasons why the redistribution has to be towards specific factors used in import-competing sectors or towards a general factor used intensively in such sectors. One reason could be that these factor owners are better organized. But why? May be they are smaller in size and more concentrated, which reduces coordination problems in lobbying activity. However, in my opinion the bias in favor of import-competing lobbies may arise from the fact that export subsidies cost revenues even in countries where import tariffs are not an important source of government revenue. While this can serve as an important explanation for the anti-trade bias in trade policy, it can to a great extent also explain why a more efficient policy like a production subsidy that also costs revenues is not used. In addition there are other political economy reasons for the use of indirect and inefficient policies like trade policy to redistribute incomes to favored groups. As argued by Grossman and Helpman (1994), when efficient redistributive policies are used, there is more intense lobbying by interest groups

competing for such redistribution, thus resulting in a considerable waste of resources. Thus lobbies may tie the hands of the government to use more inefficient policies. Also constitution writers might prefer tariffs to production subsidies, due to the lower endogenous level of the former from its general or public good nature when it comes to lobbying for it as opposed to the firm specific nature of the latter which also might result in a congestion problem in lobbying.<sup>3</sup>

A model that helps us understand status-quo bias in trade policy is Fernandez and Rodrik (1991). Let consider an economy that initially has a certain given tariff on it imports. Eliminating this tariff will result in a movement of workers from the import-competing sector to the export sector. What is ex ante unknown is which of the workers initially in the import-competing sector will be successful in moving to the export sector. All the workers who are in the export sector right from the beginning will gain while those who are always in the import-competing sector and remain there after the reforms lose. Another group that gains is the group of movers from the contracting import-competing sector to the expanding export sector. Suppose 30 percent of the population is in the export and 70 percent in the import competing sector to start with. After the reforms, let us suppose that this split is 60 and 40 percent respectively. This means that 60 percent of the population will gain ex post from the reform. While 30 percent who are initially in the export sector know for sure ex ante they are going to benefit, the remaining 70 percent do not know which 30 percent out of them will lose and which 40 percent will gain. If they know for sure that the loss incurred by the losing 40 percent is greater than the gain to the remaining 30 percent, then all the voter who are initially in the import-competing sector will vote against the reform. Due to

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<sup>3</sup> See, for instance, Rodrik (1986).

the individual-specific uncertainty faced by workers in the import-competing sector, each of them will work on the basis of an expected loss, arising from the fact that losers in this sector lose much more than what gainers in that sector gain. Thus, even though ex post a majority gain from the reforms, ex ante a majority of the workers vote against the trade reforms. However, if a dictator or an international financial institution forces upon these people a reform, it will not be reversed since as we know in this case ex ante there is going to be a majority support for the reforms.

While we now understand why trade policies in practice are different from what we consider to be optimal policy, the above discussion raises an important question: If trade policy is endogenous, why have we seen unilateral trade reforms in so many countries recently? Have there been any changes in the fundamental determinants of trade policy that can explain such switches in trade regimes.

### **What can explain the recent unilateral trade reforms by countries?**

As explained above, politics prevents countries from embracing free trade, and I have gone over some theories of trade policy formulation that focus on the economic incentives involved in political decision making. These are either majority voting or lobbying models, and the message from these models of decision making through political interactions is that the kind of trade policy that emerges from such interactions can indeed be very different from free trade. So, what can explain the shifts away from such policies? Several explanations have been provided. One explanation that sounds quite plausible is that countries that have bad policies in general also experience periods of severe macroeconomic crises. During such periods, governments in these countries turn to international

organizations such as the International Monetary Fund or the World Bank whose help and funds come attached with the strong conditionalities of economic reforms of various types. Another explanation has to do with a threshold size of the economy which make the formation of an efficient internal revenue infrastructure economically feasible, i.e., because of economies of scale, a certain minimum size of the economy makes the net benefits from instituting such a machinery positive. Therefore, once a country attains this economic size, it no longer remains dependent on tariffs as its main source of revenues and so can do away with them. One can also provide other explanations such as a change in the ideology of the government when a new government takes over. The new government could also be more closely aligned with exporters. Alternatively or additionally, there could be an increase in the influence of well-trained technocrats in policy making. There is also the possibility some learning that might take place from other successful, liberalizing countries.

While the above reasons sound very convincing, there are some fairly rigorous, formal economic models that show how a unilateral trade reform can be an equilibrium outcome in a political-economy setting.

### **Models of Endogenous Unilateral Trade Reforms**

Some of the models discussed here are part of the literature on the signing of trade agreements. However, these models focus on small countries whose actions have no effect on their external terms of trade. Thus, other countries are not going to care about their actions and the signing of trade agreements by them will have to be completely unilaterall. Thus, in the small country contexts, I see no difference in a unilateral trade reform and a

voluntary, unilateral signing of a free trade agreement in the absence of any non-trade incentives, except that the latter is more irreversible than the former.

#### **A. Unilateral commitment to free trade as a means of preventing capital misallocation**

Maggi and Rodriguez-Clare (1998) have an elegant and interesting political economy explanation for the unilateral commitment to free trade agreements by small countries. They formalize the frequently heard argument that free trade agreements “provide a way for the government to credibly distance itself from the domestic special-interest groups that lobby for protection.” More specifically, “the idea is that, by committing to free trade, a government may be able to foreclose political pressures at home.”

The setting in Maggi and Rodriguez-Clare is one in which owners of capital first decide in which sector to invest and then those who invest in a particular sector (the import-competing sector) lobby the government for protection. The lobbying is modeled as a Nash bargaining game between the import-competing lobby and the government over tariffs and political contributions. The lobby ends up at least compensating the government for the deadweight losses purely generated in the second stage. However, it may not compensate the government for the welfare loss through the intersectoral misallocation of capital in the first stage in the expectation of protection in the second stage. In such a situation, it is possible that a government may exercise its option, if available, of committing to a free trade agreement in a prior (to stage one) stage zero. Such a situation is one in which, in the absence of the agreement, the welfare loss from the resource misallocation in the first stage is valued more by the government than its gain from sharing the redistributed surplus in the second stage.



## **B. Unilateral commitment to free trade as a means of preventing wasteful political (organizational) activity**

The Maggi–Rodriguez-Clare framework demands a government with a long enough horizon as intersectoral capital mobility is a fairly long-run phenomenon. Such an assumption is perfectly valid when the focus is on developed countries that have stable governments. However, in the recent past, quite a few developing countries have joined or have expressed a desire to join the GATT/WTO. In such countries, governments are generally weak and often do not last long. In such situations, they could hardly be expected to care about long-term problems such as capital misallocation and thus capital mobility may not be an aspect one would like to focus on. With the frequent entry and exit of parties into and from power, lobbies need to constantly incur costs build new relationships

In this context, Mitra (2002) builds on the Maggi–Rodriguez-Clare version of the Grossman–Helpman framework, augmenting it with the decision to incur fixed costs (build relationships with politicians in power and/or to form a lobby) prior to the actual lobbying, but, importantly, not providing room for any capital-mobility. However, the main result of the Maggi–Rodriguez-Clare model goes through even in this newly modified set up. This is the result that generally governments with low bargaining power with respect to domestic lobbies are the ones that want to precommit to free trade agreements.

Thus, there is a general point to be made here, which is that the precommitment to a free trade agreement does not have to be driven specifically by the possibility of capital misallocation alone (or solely by the possible incurring of organizational costs) arising in the

expectation of protection. It is applicable to any kind of resource costs (including for example costs of political organization) incurred prior to lobbying through actions taken in the expectation of successful lobbying in the next stage. In this respect, the paper by Mitra and the one by Maggi and Rodriguez-Clare are complementary.

### **C. Trade Liberalization Imposed by an International Financial Institution (IFI)**

Mayer and Mourmouras (2002) introduce another actor, namely an IFI in a Grossman-Helpman type political economy model which has a government, that maximizes a weighted sum of aggregate welfare and political contributions, and a politically organized import-competing that lobbies for protection. In the absence of an IFI, the equilibrium outcome of the model is an import tariff. However, the IFI, whose objective is to bring about an economic reform, will try to counter the effect of the import-competing lobby through its promise of financial assistance that has a positive impact on aggregate welfare. This additional force, under certain reasonable conditions, can lead to trade reforms.

### **Unilateralism versus Reciprocity in Trade Liberalization**

So far our analysis of trade reforms, in terms of their desirability and feasibility, has been in the simplest possible setting and form, namely unilateral trade liberalization by a small country. We go beyond this form and setting in this section and do a comparative evaluation of the different approaches to trade reforms.

Using Bhagwati's (2002) typology, there are four basic approaches by which trade has been freed in the world. While two of these approaches are "unilateral", the other two have to do with reciprocal bargaining. The two forms unilateralism in trade policy takes are (a)

aggressive unilateralism which refers to the extraction, through threats, of unilateral reductions in a partner country's trade barriers, and (b) conventional unilateralism which merely refers to an unconditional, unilateral reduction in one's own trade barriers. Reciprocity in trade policy on the other hand is used to refer to a country's trade liberalization that is conditional on liberalization by its partners. While one type is based on multilateral negotiations facilitated by an organization like the WTO, the other is reciprocity in preferential trade agreements.

As far as aggressive unilateralism is concerned, this approach has been used by hegemonic powers to extract trade concessions from weaker countries. While it is obvious that none of the Andean countries can practice this approach (since they are small and are in no sense international or regional superpowers), there is a possibility that they can be the target of such an approach either by a regional power like Brazil or a world hegemon like the US. However, historically this form of trade liberalization has been virtually non-existent in Latin America and therefore, we not discuss any further this particular type of reforms.

Next I would want to explore the feasibility of Bhagwati call "conventional unilateralism" or "going alone" As argued earlier in this paper, while it is hard to question the economic wisdom of this approach for a small country, there are certain political-economy constraints that can make this approach difficult if not infeasible. Whereas the size of the overall pie expands as a result of trade reforms, there are both gainers and losers from trade reforms. The expansion in the size of the pie clearly means that gainers could potentially compensate losers and still be better off, the question in our context is whether an appropriate system of accompanying policies that carries out such compensation is politically feasible. We will

discuss this in the Latin American context in the next section. In order to make trade reforms politically feasible, we need to come up with alternative methods of compensating the losers and even the ultimate gainers during the process of transition. Wage insurance has been suggested by many in the US. This amounts to paying a proportion of the difference between the higher wage of the earlier job and lower wage of the new job. This is better than most other kinds of compensation since it strengthens the incentives for finding a job during a period of unemployment. Again, education eases the transition process and hence, again the importance of public education and establishing technical schools.

Another factor determining the desirability and feasibility of a unilateral approach to reducing trade barriers is the response of partner countries to such unilateralism. It has been argued in the literature (Bhagwati 2002, Krishna and Mitra, 2004 and Coates and Ludema, 2001) that unilateral liberalization can lead to sequential reciprocity. For example Krishna and Mitra (2004) clearly show using a formal model with endogenous trade policy and endogenous lobby formation that unilateral trade liberalization by a country may induce reciprocal tariff reductions by the partner country. Intuitively, unilateral liberalization by one country has the effect of increasing the incentives for the export lobby in the partner country to form and lobby effectively against the import-competing lobby there for lower protection. Such induced reciprocity will lead to welfare benefits for the unilaterally liberalizing country through terms of trade gains. One crucial point to note here is that this channel relies on whether the actions of the unilaterally liberalizing country or a collection of such countries has any impact on the world terms of trade.

Bhagwati (1990, 1991 and 2002) has argued that reciprocal liberalization leads to greater gain as countries gain from their own liberalization as well as the liberalization by their partners. He also argues that it makes trade liberalization more feasible during times of recession. Politically, reciprocal trade liberalization empowers exporters and helps them organize, thus helping them neutralize the political strength of the import-competing producers. Bhagwati (2002) further argues that reciprocity in trade reforms appeals to the sense of fairness of lay people, in that this constitutes an exchange of market access, i.e., we provide bigger markets for your exporters and you provide the same for our exporters. However, at a more basic level, when we talk in terms of economic theory, a policy stance of reciprocity relies on the large country assumption that leads to directly trade-related distortions in the form of “terms-of trade” effects with or without political-economy forces in the economy. Thus, for instance, Mayer (1981) showed that in the presence of terms of trade motivations for tariffs, international negotiations could lead to a better outcome than the non-cooperative Nash outcome derived earlier by Johnson (1953). Equally, political economy influences have been considered in models explaining agreed-upon reciprocal trade liberalization in the work of Mayer (1984a), Hillman and Moser (1996) and Bagwell and Staiger (1999) among others.<sup>4</sup>

### **Applications to Latin America**

One of the most important determinants of trade policy in Latin America has been “ideas”. While most people realize that bad ideas can lead to bad policies, the power of good and strong ideas should not be underestimated. As we have discussed above, periods of macroeconomic crises are associated with economic reforms in general and trade reforms in

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<sup>4</sup> In this context, see also Grossman and Helpman (1995) where they analyze the merits of “trade talks” over “trade wars” in a two country, specific-factors setting with lobbying taking place within each country.

particular. In many developing countries, including Latin American countries, these crises have led governments to seek the advice of technocrats with or without the help of IFIs. This has opened the door for their ideas to influence policies and in many cases, has led to reforms.

As discussed in detail in Edwards and Lederman (2002), in Chile, after being ignored for a couple of decades, the “Chicago Boys” who were US-trained academic economists slowly started exercising their influence.<sup>5</sup> As one would imagine, they were for minimal government intervention, which in the trade arena means nothing other than free trade. As we know, political constraints cannot be ignored. These economists got around political constraints by cleverly designing innovative compensation schemes as well as a coherent and balanced package of reforms. One can argue that if such packaging was needed in Chile, it would be needed much more in many other Latin American countries that are much more democratic and where, therefore, distributional aspects of policies are much more important. Even in a dictatorship at the time of reforms like Chile, the technocrats, the Chicago Boys, were heard only under adverse macroeconomic conditions. The factor that worked in their favor was the public’s clear disillusionment with old interventionist policies, and at the same time propagation of the idea that these trade reforms would lead to higher growth (which they did). This additional growth came a long way in building the popular support for reforms.

Rather than follow a gradualist approach, the Chicago boys were in favor of following a big-bang approach. A slow pace of reforms would prevent reforms from gathering momentum,

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<sup>5</sup> Note that a lot of my discussion of the Chilean case draws on the work of Edwards and Lederman (2002).

thereby endangering their continuation. There should not be scope for the protectionists to organize against the initiated reforms. Economists differ on this issue. While some argue that gradualism is a way of breaking the political constraint, others argue that it is a sub-optimal approach. Political constraints are very important in the more democratic countries of Latin America and gradualism may be the more prudent approach there.

As we have seen in Fernandez and Rodrik, sometimes the initial opposition to reforms can just arise out of the individual-specific uncertainty regarding post-reform identity. This opposition might vanish once the trade reforms are implemented. In that case it might be wise to impose reforms in the form of shock therapy. Also, appropriate sequencing of reforms is key. For example, labor market reforms are essential prior to trade reforms, as they will remove barriers to intersectoral labor mobility which can otherwise translate into high costs of these reforms to people working in the import-competing sectors. Governments in many countries have also made use of a clever sequencing to minimize the short run costs of reforms. Such sequencing of reforms has not been used in a democracy like India where a decade of trade reforms has passed without any labor-market reforms. This has resulted in the slowing of trade reforms and a delay in reaching the point of full reform, precisely due to the political opposition unleashed by the lack of reforms in other areas.

Another policy recommendation I want to make is the use of uniform tariffs. Again this policy has been used successfully in Chile. This policy has positive welfare implications and at the same time makes trade reforms politically more feasible. A policy of uniform tariffs creates minimum distortion in the vector of relative prices. It rules out giving additional

protection to downstream sectors through lower protection to manufactures of intermediate inputs. Panagariya and Rodrik (1994) have clearly shown how a policy of uniform tariffs can lead to a free rider problem in lobbying and thus lower endogenous tariffs. Since any tariff that applies to one sector should apply to all sectors, it distributes the benefits of lobbying by one sector to all other import-competing sectors. This reduces the overall incentives to lobby.

We next discuss the idea of reform packages and compensation schemes in the context of political economy forces at work. As discussed by Edwards and Lederman, the different kinds of reforms can be presented as a package and that is essential for economically political heterogeneous countries of Latin America. The successful implementation of reforms in Chile required such packaging, which clearly goes to show that this is certainly a necessary condition in other more democratic countries where distributional concerns are more important. Even though all the reforms do not take place exactly at the same time, the different interest groups have the opportunity to take a stand on the entire package but not necessarily on the components separately. Different compensation schemes can also be incorporated in the reform package. As Edwards and Lederman also argue, it is convenient and makes a lot of sense for our purposes to divide the actors in Chile into six broad groups, namely

- (1) Import-competing producers: These include capitalists and landowners in import-competing sectors. They are mainly producers of manufactures and traditional agricultural products like wheat, sugar and oilseeds.



- (2) Exporters: This group consists of export-oriented producers, including enterprises that are directly or indirectly involved in mining. This category also includes producers of non-traditional exports.
- (3) Producers of non-tradables: This includes non-tradable industries such as construction and transport.
- (4) Grupos: These are financial conglomerates, that control a large part of the banking sector and significant portions of the export industry
- (5) Formal organized/unionized labor
- (6) Informal labor.

The reform package consisted of trade liberalization, export promotion, devaluation, bank privatization, financial deregulation, pension reform, capital account liberalization, privatization of real sector firms and labor reforms. Each of the above groups of people benefited from at least one of the components of the reform package. From trade liberalization, import-competing producers would obviously lose and so would unionized labor, but exporters, non-tradable producers, “grupos” and informal labor would gain. The import-competing group would obviously gain from devaluation, capital account liberalization, privatization and labor reforms, while organized labor would benefit from pension reform. Labor reforms would benefit every group except for organized labor and so would privatization. In other words, with such packaging of reforms, there is adequate scope for making the package generally palatable to all the groups or at least to groups that together constitute a majority of the population. The packaging also provides the government more degrees of freedom in carrying out economic reforms.

Another country that has certainly introduced reforms in the form of a comprehensive package is Colombia. According to Fleischer (1994), their reforms in the 90s included labor-market reforms, reform of the foreign investment regime, financial sector reform, liberalization of foreign exchange controls, increasing central bank independence, drastic elimination of red tape for business and the privatization of ports and railroads. Clearly, these reforms benefited diverse groups of the country's population. Thus as Rodrik (1995) has argued an agenda setter has great flexibility and this applies strongly in the Latin American context.

There are many direct and indirect compensation schemes that can be used and have been used in some developing countries. Direct compensation can take the form of rebates on the value added tax, rebates on import duties paid for inputs to be used in output to be exported and subsidies to fishing and tree planting for lumber exports (as in Chile). Depreciation of the real exchange rate is an important indirect compensation to the import-competing sectors. Repression of the labor union can be, as in Chile, an important indirect compensation to many different kinds of owners of sector-specific factors. Programs guaranteeing minimum employment are also very useful in this context.

One observation by Ranis (1990) is the cyclical movement in tariffs in Latin America during the twentieth century, and this movement coincides with movements in terms of trade. When a country's terms of trade with respect to the rest of the world improves, we see trade liberalization, while a worsening of the terms of trade results in an increase in import protection. This is a classic example of how theories of political economy might be applicable. In Krishna and Mitra (2004a), we show how an improvement in a country's terms

of trade improves the profitability of exports, which in turn helps exporters get politically organized and neutralize the existing import-competing lobby and get rid of the existing tariff. Krishna and Mitra (2004b) show how such a terms of trade improvement can lead to the popular support for reforms. An improvement in the terms of trade makes working in the export sector much more attractive relative to working in the import-competing sector. Thus, not only do the people who are in the export sector to begin with but also a large number of the people who move to it upon the implementation of the trade reform support it. One factor that determines a country's terms of trade would be the trade policy of its trading partners. As long as its trading partners have a liberal trade policy towards it, there will be incentives for this country itself to have trade policies close to free trade. If its partners eliminate their tariffs, there is a larger potential market for exporters in this country where they would keep the pressure on to keep trade barriers low.

Another important observation is about some of the Latin American countries where actual tariffs are below its tariff bindings at the WTO. This is considered to be somewhat of a puzzle. I have tried to explain it in Mitra (2002). If lobbying has fixed organizational costs, then a tariff binding will reduce the net benefits from lobbying to the import-competing lobby, which in turn will cause the lobby to drop out of the political arena. Thus the import tariff will fall to zero. In the real world, it may not fall to zero but to a much lower level than the binding. Thus, a tariff binding to which a country might commit to at the WTO can have a longer term effect of destroying import-competing lobbies and getting rid of protection.

One of the characteristics of Latin American countries is their high levels of asset and income inequality. This makes it easier for asset owners such as capitalists to get politically

organized. One of the examples that is used in the US is the example of the sugar industry which is highly protected. The domestic price of sugar in the US is twice its world price. The import quota on sugar results in a loss of about \$2 billion to consumers, which is \$8 per consumer. The protection results in a gain of roughly \$1 billion to sugarcane and sugarbeet producers, half of which accrues to 17 big farms in Florida. In other words, the losses are thinly dispersed while the gains are highly concentrated. So for each big producer, trade policy in this industry matters a lot but for each consumer it does not matter much, even though in the aggregate the losses from protection might far outweigh the gains. This is a problem when productive assets in import-competing industries are very unequally distributed, i.e., they are concentrated in the hands of very few people. Such high concentration of asset ownership is evident from the high Gini coefficients in most of the Latin American countries, lying in the range of 50 to 60 (See Dollar and Kraay, 2002). In contrast, in East Asian countries, this range is roughly 30 to 40. As I have argued earlier, in Mitra (1999), this has led to the formation of a large number of lobbies, each receiving a high level of protection in Latin American countries, while in East Asia, we have had fewer lobbies with lower levels of protection. Thus, in the long run, the key to maintaining low levels of protection in Latin American countries is to bring down inequality. Credit market imperfections and lack of proper public education prevent people from acquiring assets in the form of physical and human capital, and the ability to attack these problems will be important in the long run.

Next, we analyze the dependence of the governments of these countries on tariffs for their revenues. For most Latin American and especially for the Andean countries, the reliance of the government's budget on tariff revenues is quite low. Roughly, only between 5 to 15% of

the total tax revenue of the government is from import duties (See World Bank, 2004). Initially, Ecuador had a high reliance on import duties but over time has reduced this reliance to single digits (in percentage terms). I think this is good news as in most countries it is reliance on tariff revenues that can directly or indirectly lead to the anti-trade bias in trade policy. If the government really needs these revenues, it will resort to protection no matter what. Additionally, reliance on these revenues can also create the bias in the political arena in favor of import-competing sectors relative to export sectors. Fortunately, this source of bias does not seem to exist in Latin America.

Next we turn to the issue of unilateral and reciprocal trade liberalization, both of which are options for Latin American countries. In the Chilean case, a lot of the trade reforms were almost purely unilateral and the popular support came from the appropriate packaging of reforms. Even some of the commitments to WTO bindings they made in a multilateral setting were unilateral. However, there have been more than 20 bilateral and multilateral trade agreements effective in the region since 1990 (Fleischer, 1994). Among Andean countries, Colombia and Venezuela were at the forefront of many of these agreements. As I have argued earlier, reciprocal trade liberalization strengthens exporters and increases their incentives to get political organized and neutralize the import-competing lobbies. As Irwin (2002) explains, this channel worked wonderfully in the US through the Reciprocal Trade Agreements Act (RTAA) which later got extended to the GATT. Examples of other reciprocal trade agreements in the Andean region are the Colombia-Chile Free Trade Agreement, the Colombia-Venezuela Free Trade Agreement and the Andean Pact. While appropriate reform packaging was also done in some of the Andean countries, especially Colombia, a lot of the liberalization took place through multilateral negotiations and regional

integration. Pressure was exercised by the US through trade discussions, which was part of the Americas Initiative. The World Bank also exercised monetary force through trade adjustment loans for these countries to reform their trade regimes. This is a direct application of the Mayer-Mourmouras model discussed in the previous section.

Thus there are many lessons to be learnt here for countries in Latin America and the political economy literature on trade policy has a lot to offer us in terms guidance in reforming the trade regimes of these countries. Recognizing political and economic constraints is of paramount importance in any further reforms of the trade regimes in these countries. In the light of these constraints, my policy recommendations would be to go for appropriately designed, multidimensional policy reform packages, to recognize the complementarity of unilateralism and reciprocity in the movement to ultimate free trade, to use the strategy of uniform tariffs, to design appropriate compensation schemes to build support for reforms and minimize adjustment costs borne by workers, and to reduce concentration of economic and political power by bringing about a more equitable distribution of income and assets through a better system of primary, secondary and college education. Finally, international financial institutions should use their leverage with financial aid to put pressure for trade reforms.

## **Conclusions**

In this paper, I first give a detailed account of channels through which free trade might benefit the citizens of a country. In this context, I discuss the standard and non-standard channels. I then go on to discuss the tenuous relationship between trade and growth in the theoretical literature, which is followed by a discussion of somewhat more comforting results

in the empirical literature. Then I go on to explain the traditional arguments explaining the existence of protection. In this context, I discuss the infant industry argument, non-economic objectives such as self reliance or self sufficiency and the revenue motive. I then go on to discuss the political economy literature in detail and show how theories here can be used to explain the existence of import protection as well as the preference of the government for such instruments over more efficient forms of income redistribution. Following this discussion, I also throw some light on why we have seen unilateral trade reforms in the more recent past and in that context discuss some recent models. Finally, I discuss in detail the applications of these theories to Latin American countries and how they can aid us in the process of freeing trade in Latin America.

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