

# The Political Economy of Tariffs D 47

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*Standard economic analysis suggests that tariffs are inefficient and should be abolished. Textbook models cannot explain the continued existence of tariffs. This article provides an analysis of the politico-economic nature of protectionist tariffs which extends the basic model and offers an explanation of tariffs.*

## Introduction

Students are often dissatisfied with courses on international economics. In the theoretical part of the course they are confronted with abstract models and theories which they (and their teachers) find difficult to relate to the real world. In the applied part of the course the reverse is true: there is discussion of the patterns of trade and tariffs and the functions of international institutions such as the IMF and World Bank, but there is little economic analysis. The theoretical and applied sections of the course rarely connect with each other.

One of the major reasons why students (rightly) feel dissatisfied with such courses is the neglect of the political aspect of international economic relations. There are few areas of economics where the influence of politics is more obvious or more important. Any practical discussion of trade policy, tariffs, or unfair international competition automatically brings to mind political issues both within individual countries and between countries. It is clear that in the real world politics and economics combine to determine trade policies, but economic textbook analysis ignores the political dimension completely.

More recently, economists have set out to overcome the neglect of politics in the analysis of international economics by extending fundamental economic ideas to the study of some aspects of politics. This is the basic approach of the new International Political Economics and this article attempts to introduce this approach and to use it to develop an interesting analysis of tariffs which goes well beyond the standard textbook analysis in providing a fuller explanation of the real world.

## The Standard Analysis

The textbook theory of international trade clearly states that a unilateral reduction in tariffs will be desirable for any country except in the unlikely case where such a reduction causes such a severe reduction in the country's terms of trade that its real income falls. The 'terms of trade' is the name given to the ratio of the price received by a country for its exports to the price it pays

for its imports. The standard situation is illustrated in Figure 1 which shows the domestic demand and supply for a particular internationally traded good. The good trades on the world market at price  $P_1$ , but the government places a tariff of  $t$  on imports so that consumers must pay  $P_1 + t = P_2$  for the good if it is imported. At price  $P_2$  domestic producers supply  $Oq$  and the excess of domestic demand over domestic supply is  $ad$ ; this quantity is imported. Note that we are assuming that the country is too small to influence the world price of the good.

If the tariff is reduced to zero, domestic consumers are made better off by the amount of  $P_2deP_1$  — the gain in consumer surplus arising from the reduction in price from  $P_2$  to  $P_1$ . However, the government loses revenue of  $adfb$ , and domestic producers lose  $P_2acP_1$  in producers' surplus. The net gain from unilateral tariff reduction is therefore shown as the sum of the two shaded triangles in Figure 1.

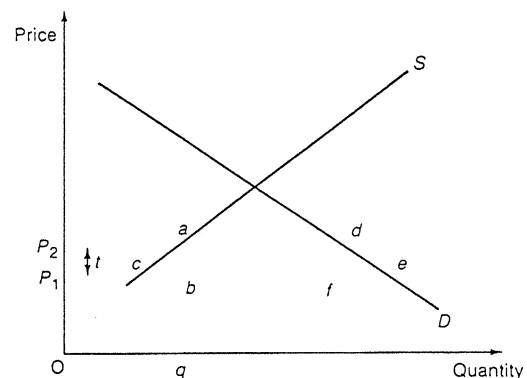


Figure 1

Note that this standard analysis concentrates on the existence of a net gain to society as a whole in demonstrating the desirability of free trade. It is equally clear that some sectors of society — producers and government — lose as a result of the removal of tariffs, but in principle their losses can be compensated out of the gains made by consumers. Of course, it may not be possible to compensate losers in practice.

This theoretical demonstration of the benefits of free trade does not really help to explain the pattern of tariffs we actually observe in the real world. As discussed by David Greenaway in a recent issue of the *ECONOMIC REVIEW* (Vol. 4, No. 4), GATT has had some success in reducing tariffs in some areas but high tariffs are still commonplace — particularly in the less developed countries.

## The Domestic Politics of Tariffs

The politico-economic problem is therefore to explain the continued existence of tariffs and why governments do not take the advice of the standard economic argument and abolish tariffs without involving the slow and expensive negotiating machinery of GATT.

If we think of political decisions being made by popular referenda, so that everyone votes on each issue separately with a simple majority of voters determining the policy, it would again seem that we should expect protectionist tariffs to be abolished. After all, the number of consumers who can expect to gain from the abolition of a particular tariff will normally exceed the number of producers who can expect to lose. To understand the maintenance of tariffs we need to look rather more closely at the political system.

First, we should notice that the benefits from the abolition of a tariff are likely to be spread very thinly over a large number of consumers so that each particular consumer can expect only a very small benefit. By contrast, the losses associated with the abolition of a tariff will fall on a relatively small group and so may involve very considerable losses for each of those individuals. For example, imagine a tariff on the import of, say, shoes. The abolition of such a tariff might benefit the average consumer by £2 or £3 per year, but might threaten redundancy or a severe cut in income to those who work in the domestic shoe industry.

Even though the traditional economic analysis tells us that the benefits of abolition outweigh the costs, this point concerning the relative intensities of the impacts on gainers and losers may be very significant in explaining the continued existence of tariffs. Producers and employees, who stand to lose a lot from abolition (or gain a lot from protection), have a very great incentive to participate in the political system — organising and supporting pressure groups which attempt to influence policy. The average consumer, on the other hand, may not even notice the small change in welfare which results from abolition, and certainly has no incentive to be politically active in fighting for abolition.

This is a general point not restricted to the discussion of tariffs. A relatively small group holding very intense views on a particular issue and willing to invest economic resources — time, money, etc. — in promoting its cause, may strongly influence policy even if the large majority is opposed to its views and even if the costs of its policy exceed the benefits — providing that each member of the majority is only mildly opposed to the policy and so does not think it worthwhile to participate actively in the political process. This argument lies at the heart of the explanation of the effectiveness of minority pressure groups of all kinds and shows that even in a democracy an intense minority can wield considerable influence.

A second point to notice is the influence of voting for political parties rather than on specific issues. If we voted on each issue separately our previous argument would suggest that the intense minority would vote for protection whilst the mild majority might be expected to abstain. The minority may win but there would be a very low turnout and this would

presumably cast some doubt on the validity of the result. But now put yourself in the position of a political party attempting to enlist the support of the electorate. You are first approached by representatives of the shoe industry employers and employees who pledge you their support if you promise to protect their industry. You calculate that whilst such a pledge will gain you a number of votes from the shoe industry, it probably will not lose you many votes elsewhere since — on our previous argument — those who stand to lose from the policy will not translate their losses into political opposition. You reach agreement with the shoe industry. Next you receive a delegation from the furniture industry making exactly the same promise of support. Again you agree, even though you know that your agreement with the furniture producers will harm the shoe makers — since they are furniture consumers — because no-one feels strongly enough for your agreements to cost you votes.

In this way it is easy to see that a political party intent on gaining electoral support may build up a range of commitments to particular pressure groups. In our example these commitments are to protectionist tariffs and each pressure group represents an industry, so it is clear that a political party could introduce or sustain protectionist tariffs in order to increase its political support, even though it may act against the general public interest.

To put the same point in another way. Consider any individual: as a consumer he will be opposed to tariffs, but as a worker in a particular industry he recognises that protection of that industry is in his interest. So, whilst he is opposed to tariffs in principle, he is in favour of a tariff in his own industry as an exceptional case. This yields the situation where everyone claims to be against tariffs in principle, but where any particular proposal to eliminate a tariff will give rise to a storm of politically damaging protest and claims that this industry is an exceptional case.

A third politico-economic argument which helps to explain the continued existence of tariffs is based on the simple fact that they form a source of government revenue. Indeed, as Table 1 indicates, tariffs represent a significant proportion of government income in many countries — particularly in less developed and newly industrialised countries where other tax sources may be severely limited. Other things being equal, a government which reduces or abolishes tariffs will have to raise taxes elsewhere, or reduce public expenditure, or allow an increased public deficit. Each of these options may have undesirable economic and political consequences. This argument suggests that governments will be much more likely to reduce tariffs when they are attempting expansionist policies than when they are concerned with deflationary policies.

This third argument is crucially different from the first two. The first two suggest why a political process which is democratic might nevertheless throw up policies which are not in the public interest, whilst the third points out that, in the short run at least, any government faces a complex tradeoff amongst policies so that it may not choose to reduce tariffs if this interferes with its ability to pursue other policies.

## Empirical Support for the Politico-Economic Model

There have been a wide range of empirical studies in recent years which have attempted to identify the empirical significance of the sort of politico-economic analysis discussed above. In this section I want to summarise some of these empirical findings.

Industrialised countries	4.4
Newly industrialising countries	14.8
per capita income larger than \$250 p.a.	28.2
LDCs: per capita income smaller than \$250 p.a.	40.3

**Table 1** Tariff Revenue as a Share of Total Revenue According to Various Country Groupings, 1972–77 (averages, %)

The first problem in attempting to study tariff policy at the empirical level is knowing precisely how to measure the degree of protectionism. Several approaches are possible. One could attempt to explain the political pressure for protectionist measures — in terms of the votes cast for pro-tariff legislation — or one could try to explain the observed level of tariffs themselves. A third alternative would be to consider the pattern of tariffs across different commodities, and a final possibility would be to view the way in which tariff levels change through time. Each of these approaches has been followed up and each lends some support to the politico-economic viewpoint.

As an example of the first approach, one study set out to discover the major influences affecting the voting of US Congressmen on a trade liberalising bill. Our argument would suggest that Congressmen representing constituencies which include heavy concentrations of industries which compete with imports would be more likely to vote against liberalisation than an otherwise similar Congressman who represents an area which is less dependent on manufacture of internationally traded goods. This result shows up clearly in the empirical work, as does the result that Congressmen who receive campaign contributions from industrial sources (including labour unions) are also much more likely to oppose the liberalisation of tariffs. Clearly, then, the idea that Congressmen vote in ways which maximise their probability of re-election and so identify themselves with locally powerful interest groups seems to gain empirical support.

Several studies have viewed the level of tariff rates and the pattern of tariffs across different industrial products. Here it seems that a central finding is that industries which are relatively highly concentrated are more likely to receive tariff protection than industries that are competitive. Again this result lends support to the politico-economic approach since it is clear that a more concentrated industry will provide a much better basis for an active and effective pressure group than a competitive industry where it will be difficult to organise support. This is an application of the idea that pressure groups are most likely to form in relatively small groups with intense feelings — a concentrated

industry is precisely an example of a relatively small group where each member has a great deal to gain from protection.

Notice that what is important to the pressure group is protection from international competition, not tariffs themselves. Tariffs are merely one way of achieving protection. In recent years, partly as a result of successive rounds of GATT, there has been a decline in tariff rates in many areas, and on the face of it this may look like evidence against the politico-economic approach. But, as David Greenaway noted in his recent article (*ECONOMIC REVIEW*, Vol. 4, No. 4), the fall in tariff rates has been matched by an increase in non-tariff barriers to trade, so that it is by no means obvious that there has been any reduction in the effective level of protection. The evidence suggests that those industries which have relatively high tariffs also have relatively high non-tariff barriers, and this observation supports the politico-economic approach since it suggests that those pressure groups which have greatest influence use that influence to ensure protection in all its forms.

The pattern of tariff rates over time has also been analysed empirically. Protection is expected to be strongest when a country's economic position is weak and there is high unemployment, since such a situation will add to the political weight of protectionist pressure groups. On the other hand, trade liberalisation may be expected when economic circumstances are relatively good and when there is relatively high inflation, since in this case a stimulation of relatively cheap imports may help to moderate price increases. Again, the available evidence supports these expectations; indeed, one study suggests that a 10% increase in the rate of unemployment (e.g. from 5% to 5.5%) is associated with a 9% increase in protectionist pressure, whilst each percentage point increase in the rate of inflation (e.g. from 7% to 8%) lowers protectionist pressure by 5.7%.

## Conclusions

Incorporating explicitly political considerations into an economic model of the setting of tariffs adds considerably to our understanding of the forces at work. Whereas the simple textbook model of tariffs indicates that they almost always act against the general public interest, the politico-economic approach indicates not only why such tariffs might still be chosen in a democratic society, but also where and when they are most likely to be chosen.

The argument presented here only illustrates the importance of the politico-economic approach, which can be developed much further and applied to a very wide range of policy questions. Concentrating attention on the economic analysis of what are normally thought to be political matters offers an exciting way forward to policy analysis.

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