Macro II/Aussenwirtschaft
Lecture Slides No 11

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Political Economy of Trade Protection

- we've seen that normative theory mostly suggests free trade
- in reality we do see quite some protection
- how can we reconcile this?
- political economy develops positive theory that takes policymakers objectives into account
- no longer national welfare maximization by a benevolent government — somehwat naive
- but self-interested politician who cater to some interests more than to others

Early approaches not micro-founded

- not micro-founded means w/o modelling decisions of individual agents explicitly
- tariff formation function:
  $\max_{L^l} \pi(p^*(1+1+t(L^l)), 1) - L^l$
- looks at firm decision to lobby and takes tariff formation as a black box (supply)
- political support function:
  $W^{PS} \equiv M(\pi(p) - \pi(p^*), p - p^*)$
- models supply more explicitly but not demand for protection

More modern, i.e. mirco-founded

- employ median voter, due to Mayer (AER 84)
- simple all-purpose political process
- Mayer applies it to HO and specific factors
- let's consider the HO version
- framework from before: $U^h = c_0^h + U(c^h)$
- $\rightarrow V(p, I^h) \equiv I^h + (U(d(p)) - p'd(p))$

$$
\begin{aligned}
I^h &= w + rK^h + T/L \\
&= \frac{1}{L}(wL + \rho^h rK + T) \\
&\quad \text{with } \rho^h = \frac{K^h/1}{K/L} \text{ and } T = tm(p) \\
&= \frac{1}{L}(wL + rK + (\rho^h - 1)rK + T) \\
&= \frac{1}{L}((\rho^h - 1)rK + y_0(p) + py(p) + T)
\end{aligned}
$$

$$
\begin{aligned}
\frac{dV^h}{dt} &= -d(p) + dI^h/dt \\
&= (\rho^h - 1)\frac{dr}{dp}\frac{K}{L} + (y(p)/L - d(p)) + \frac{1}{L}\frac{dT}{dt} \\
&= (\rho^h - 1)\frac{dr}{dp}\frac{K}{L} + \frac{t}{L}m'(p) + \frac{t}{L}m'(p)
\end{aligned}
$$

Note: $T = tm(p)$, so $T' = tm' + m$

- median voter chooses tariff by setting $dV^m/dt =$
- gives $t^m = (1 - \rho^m) \frac{dr}{dp} \frac{K}{m'(p)}$
- typically $\rho^m < 1$ (for empirical distros)
- import labor (capital) intensive: $dr/dp < 0$ ($dr/dp > 0$)
- t is positive, i.e. protection explained
- (t negative if imports capital intensive)
- for specific factors he finds $t < 0$, not so attractive (but can be reversed)

Protection for Sale

- Grossman/Helpman AER 1994
- starting point of a wave of research
- idea: industries offer conditional money to gov't
- in order to obtain protection for their sector
- let's look at the paper