

(Re-) distributive Effects of Trade and FDI and the Political Economy of Protection and Liberalization

1. The Heckscher-Ohlin theorem
2. Ricardo-Viner theorem
3. Lobbying and the Case for Protection
4. Democratization and Liberalization
5. Crises (International Organizations) and Liberalization

Ricardo-Viner

Last week we saw that if two countries open their economy, allow free trade and therefore specialize on the production of goods for which they have an absolute or a comparative advantage, both countries will be better off.

How can such a scenario lead to distributive conflicts?

Heckscher-Ohlin

“A model of international trade in which comparative advantage derives from differences in relative factor endowments across countries and differences in relative factor intensities across industries.” (Deardorff)

Assume two factors of production (capital and labor), two countries (i and j) and two goods (A and B). Country i is relatively rich of capital (capital abundant) and labor is relatively scarce, country j is capital scarce and labor abundant.

In autarchy, capital is relatively cheap and labor relatively expensive in i, and vice versa in j.

Assume further that the production of good A is relatively capital intense and the production of good B is relatively labor intense.

Under this assumptions, i has a comparative advantage in the production of capital intense goods and j has a comparative advantage in the production of labor intense goods.

Does this lead to a conflict over trade policy?

Heckscher-Ohlin and Trade Policy

Does this lead to a conflict over trade policy?

Not always (or: not necessarily),

since capital and labor can move from sector B to A in country i and from sector A to B in country j.

(Let's ignore the alternative option that capital and labor change countries rather than sectors).

Distributional Conflicts

But under some additional, reasonable conditions:

Institutional barriers to the movement of capital and labor between sectors.

Workers have acquired sector-specific skills, for which there is no demand in the other sector. Hence, they will lose their wage premium.

Labor market rigidities (wages are inflexible).

Else?

Stolper-Samuelson theorem

Assume two factors of production (capital and labor), two countries (i and j) and two goods (A and B).

Country i is relatively rich of capital (capital abundant) and labor is relatively scarce, country j is capital scarce and labor abundant.

(well, we had that before)

Let's assume further that – according to Heckscher-Ohlin – country i specializes on the production of capital-intense goods and country j on the production of labor-intense goods.

This implies that the production of good A (B) in country i (j) increases.

It follows that the demand for the factor that is used abundantly in the production of good A increases as well. Hence, the demand for capital (labor) in country i increases (declines) – and vice versa in country j.

- The price of capital (interest) in country i increase.
- The price of labor (wage) in country j declines.
- The price of capital in country j declines.
- The price of labor in country j increases.

Stolper-Samuelson and Trade Policy

Does this lead to a conflict between capital and labor over trade policy?

What are the predictions of the model?

Is there empirical evidence for the predictions?

Stolper-Samuelson and Trade Policy

Does this lead to a conflict between capital and labor over trade policy?

The model predicts conflict between capital and labor. Owners of the relatively scarce factor always prefers protection, the owners of the abundant factor prefer free trade.

What are the predictions of the model?

Owners of the relatively scarce factor always prefers protection, the owners of the abundant factor prefer free trade.

→ In the capital rich country, capital prefers free trade and labor opposes free trade.

→ In the labor rich country, labor prefers free trade and capital opposes free trade.

Is there empirical evidence for the predictions?

Not much, but some.

Magee, Brock and Young 1989

analysis of the position of interest groups (capital and labor)

		Industry's Labor	
		protectionist	free trade
Industry	protectionist	distilling textiles chemicals shoes cutlery watches	tobacco
Capital	free trade	petroleum	paper machinery tractors trucks aviation

US Congress 1973

Adrian Wood 1994

The increase in imports from low labor countries leads to a widening income gap between low and high-skilled workers OR to an increase in unemployment in OECD countries.

In Stolper-Samuelson terms: the demand for low-skilled labor declines if wages are sticky, OR the wages have to decline to keep demand constant.

Specifically:

It leads to rising income inequality if labor markets are flexible.

It causes an increase in unemployment if labor markets are inflexible – especially if wages cannot decline.

Empirics: Wood 1994 page 312

Rodrik 1999

An increase in economic openness leads to an increase in the number of economic shocks (and to an increase in market uncertainty). Accordingly, the demand for social insurance rises. Responsible (i.e. opportunistic) governments react by increasing government spending.

→ Trade Openness leads to a higher share of social security transfers to GDP.

empirics: Rodrik 1989 page 89

HOWEVER:

Larger markets are less volatile.

(The world economy is larger than national economies).

Hence: Foreign economic liberalization increases macroeconomic stability
– contrary to what Rodrik suggests.

Milner and Kubota 2005

Democratization in low wage countries leads to foreign economic liberalization, because the influence of workers (low-wage earners) on economic policy is higher in democracies.

Sachs-Warner trade liberalization

variable	(1)	(2)	(3)	(4)
regime	0.332*** (0.104)	0.332*** (0.118)	0.367*** (0.129)	0.521*** (0.147)
lnpop	43.425*** (8.802)	49.808*** (10.545)	69.062*** (15.040)	29.559** (14.293)
gdppc	0.000 (0.001)	0.001 (0.002)	0.000 (0.002)	0.004* (0.003)
eccrisis	0.652 (0.987)	0.496 (1.050)	0.531 (1.108)	1.563 (1.423)
bpcrisis	0.271 (0.653)	0.395 (0.715)	0.019 (0.775)	0.505 (0.957)
imf	0.465 (0.614)	0.780 (0.641)	0.197 (0.773)	
office	0.078 (0.105)	0.083 (0.102)	0.050 (0.095)	
gatt	4.771*** (1.675)	4.900*** (1.650)	5.111*** (1.746)	
usheg	55.151** (24.594)	18.073 (28.659)		
avopen	39.132*** (14.251)			
fdi	0.038 (0.408)			
fiveopen	2.632 (1.826)			
Observations	982	872	872	829
LRchi2	955	862	869	834
Probchi2	0.00	0.00	0.00	0.00
Loglikelihood	43.85	37.93	34.33	27.74

HOWEVER: In almost all countries that opened the economy and democratized, liberalization took place BEFORE democratization.