Introduction

It is a consensus standpoint among economists that international trade is affected by the interplay of politics and economics. Thus, any positive analysis of trade policy must consider the political environment in which it is being executed, as well as the governmental decision-making process. Given the apparent discrepancy between economic theory and practice in international trade, it therefore seems important to better understand the role played by political aspects in the policy formulation of trading nations.

Why do countries impose the types of trade and regional policies that they do, even if those policies are sub-optimal? And what does politically motivated regional policies imply for the location of industrial production? Furthermore, can international economic relations in the form of strategic interaction between governments, or alternative legislative procedures, explain part of the trade policy outcomes actually observed? The thesis at hand explores how such questions might be answered. It consists of three self-contained papers where concepts of political economy are introduced into models of economic geography and trade policy. Below follows a description of the background and results of each essay.

Essay 1: Location Equilibrium with Endogenous Rent Seeking

Chapter 1 is motivated by two empirical observations: the growing importance of regional lobbying, and the fact that the politically most powerful regions—when it comes to determining the distribution of regional subsidies—are not always the economically largest.

The basic models of the New Economic Geography generally predict that in some circumstances, smaller peripheral economies can be de-industrialized due to economic integration. In contrast, in this chapter, it is argued that smaller regions are better able to capture the political gains through a rent-seeking contest for government transfers, which slows down or even reverses the agglomeration process implied by the standard geography models.

Specifically, this essay analyzes the interaction between the location of manufacturing activity and regional integration, when regional policy is determined by endogenous rent seeking. The economic framework builds on the by now familiar geography model, with size asymmetries, of Martin and Rogers (1995), which predicts that a larger region becomes the core when trade barriers are sufficiently low. However, when lobbying for regional subsidies is allowed for in the setting, this standard result no longer holds. In
fact, it is shown that the equilibrium location of industry in the economically smaller region is increasing in the level of economic integration, once trade becomes freer than a certain critical value. Furthermore, introducing regional lobbying slows down the agglomeration process, whereas the home market magnification effect becomes weaker. The reason for these findings is that rent seeking agents from a larger region are less willing to expend resources on a marginal increment of subsidies to its industrial sector, due to a higher rate of rent dissipation in the political equilibrium. This will shift the equilibrium policy variable in favor of the smaller region and, as trade barriers are reduced, government transfers to manufacturing production become relatively more efficient in attracting industrial activity. As a result, when free trade prevails, and rent-seeking activities are taken into consideration in the analysis of the equilibrium geography, the relocation of manufacturing activities takes place up to the point where both regions are of the same economic size.

Essay 2: Endogenous Tariff Formation and the Political Economy of Trade Retaliation

Chapter 2 builds on the experience gained from U.S.–EU trade disputes, that the voting pattern in one country seems to influence trade policy outcomes elsewhere. The paper extends the notion of endogenous tariff formation under representative democracy by incorporating a dynamic political process of protection, retaliation and trade wars, where domestic electoral competition restricts foreign tariff policy.

Instead of focusing on the role of lobbying activity in the shaping of trade protection (see, for example, Findlay and Wellisz [1982]; Hillman [1982]; Magee, Brock, and Young [1989]; Grossman and Helpman [1994]), the view is taken, like in Mayer (1984) or Yang (1995), that the tariff schedule is determined by the preferences of the domestic electorate. However, the model developed relaxes the standard assumption of a small or isolated country, which sets trade policy without regard to existent policies and possible reactions of its trading partners. Accordingly, as opposed to earlier research along these lines, the approach here takes into account the extent to which international economic relations affect domestic politics. In other words, the framework captures the notion of policy interdependence and the ongoing strategic interaction between governments to be observed in the international arena of trade and investment. In this way, the analysis introduces aspects of the political economy of trade policy in a strategic environment where
interdependent firms and governments interact. The purpose is to clarify how the political climate in one country restricts policy outcomes in another, and how ideological shifts in the domestic electorate influence politicians and condition their trade relations with foreign counterparts.

Specifically, it is argued that the equilibrium level of protection in the tariff setting country is a weighted mean of the sector-specific densities of the expected domestic swing voters, in accordance with the findings of Yang (1995), as well as those of the ideologically neutral voters in competing trading nations. It follows that ideological shifts in the population which systematically alter the political power of different voter groups in a country influence the tariff-setting behavior among its trade partners.

**Essay 3: On the Indeterminacy of Trade Policy under Different Electoral Rules**

Chapter 3 takes the view that economic policies vary across countries with different electoral rules; hence making this specific type of institutional arrangement of importance for newly emerging democracies, but also for industrial countries seeking to change their election scheme. However, current research has found ambiguous results with respect to the effects of the type of electoral regime on trade policy. The final essay proposes a solution to this indeterminacy.

Roelfsema (2004) argues that countries with a majoritarian electoral system are more inclined to have a high level of trade protection. The reason is a higher competition intensity for swing districts, if compared to countries with proportional representation. Following this view, Persson (2005) makes the case that since proportional democracies seek consensus among broader coalitions of voters, they should have relatively less protectionist trade policies. Moreover, if proportional representation leads to the election of legislators who maximize aggregate welfare, because their election is not tied to particular geographic or economic interests, then the model of Grossman and Helpman (2005) predicts higher average rates of protection in countries with majoritarian elections than in countries with proportional representation. Hatfield and Hauk (2003), on the other hand, obtain the opposite result, i.e., that proportional systems have higher average tariffs than majoritarian institutions.

In Chapter 3 it is, however, shown that both these policy outcomes are possible by incorporating an export industry producing for foreign markets using a sector-specific factor. It is argued that trade policy is more (less)
restrictive under proportional electoral regimes as compared to majoritarian institutions, if marginal districts are populated by relatively more (less) factor owners with stakes in the exporting sector. This result is explained by stiffer electoral competition in the majoritarian system, where politicians focus relatively more on the type of factor owners who represent the largest fraction of the voting population in the swing districts. Empirical results from a cross-section regression analysis of 56 countries support this claim: countries with a proportional electoral rule, where the swing districts consist of relatively more (less) factor owners with stakes in the exporting industry, on average have about 0.5 (10) percentage points higher (lower) tariff rates as compared to their majoritarian counterparts.
References


