The Effects of Endogenous Protection on the Economic Landscape

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Idea

Political Concerns

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Economic Landscape

Trade Policy

The author studies the impact of political economy variables on the spatial distribution of industry building a model that relates two backgrounds.

Grossman and Helpman (1994)

Martin and Rogers (1995)

Idea

Short run: Political game

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Capital factor is immobile

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Capital owners engage in Lobbying activity

Long run

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Capital factor can move

↓

Spatial distribution of economic activity

The Framework: Assumptions

- Two regions: the small economy and the ROW (*)
- Two productive factors: Labour and Capital
- Two sectors:
  - The agricultural:
    - CRS
    - Perfect competition
    - Labour
    - Freely traded
  - The industrial:
    - IRS
    - Monopolistic competition
    - Labour and Capital
    - Costly traded

The Framework: Assumptions

- Preferences: Quasilinear utility function

$$U = c_A + \mu Ln\left(nc^{\frac{\sigma-1}{\sigma}} + n^* \overline{c}^{*\frac{\sigma-1}{\sigma}} \right)^{\frac{\sigma}{\sigma-1}}$$

numeraire

Local variety

Foreign variety

- The Iceberg trade cost:
  - Domestic trade cost: $\tau = 1 + t$

Endogenously determined

Tariff income

$$\overline{p} = \tau \frac{\sigma}{\sigma - 1} a_m^*$$

The Framework: Incentives

Individuals

- Tariff income
- Wages
- Profits

Lobby

It chooses the optimal level of contribution maximising $V_g = W_g - C_g$

where the gross welfare is:

$$W_g = l_g + \sum_{i=1}^{n} \pi_i [p, \mathrm{P}(\tau)] + \alpha_g [R(\tau) + S(\mathrm{P}(\tau))]$$

Fraction of the voting population that owns capital and belongs to the lobby

The Framework: Incentives

The Government:

$$G = C_g + aW\left(p, \mathrm{P}\left(\tau\right)\right)$$

The weight that the incumbent attaches to the society's welfare

The short run equilibrium

$$\frac{dC_g^{\circ}\left(\tau^{\circ}\right)}{d\tau} = \frac{dW_g^{\circ}\left(p^{\circ}, \mathrm{P}^{\circ}\left(\tau^{\circ}\right)\right)}{d\tau}$$

Locally truthful contribution schedule

They induce the Government to maximise: $aW + W_g$

Short run equilibrium

- The short run expression:

$$\left[-\phi+\phi^{\frac{\sigma}{\sigma-1}}+s_n\left(\phi-\phi^{\frac{\sigma}{\sigma-1}}+\phi^{\frac{1}{\sigma-1}}\sigma\right)\right]=-\underbrace{\frac{(1+a)}{(\alpha_g+a)}}_{\text{Political variables}}\underbrace{\frac{(\sigma-1)}{\sigma}}_{\text{Inverse of mark up}}s_n+\sigma\overbrace{s_n}^{\text{Industry share}}$$

Level of freeness $\phi=\tau^{1-\sigma}$

- The equilibrium contribution: the lobby contributes an amount that is proportional to the excess burden that its most preferred equilibrium tariff imposes on the society.

Short run equilibrium: Predictions

- A Government that has a remarkable concern about the general welfare will avoid creating an excess burden.
  - As α_g increases, also ϕ increases

$$\downarrow$$

The deadweight loss faced by the lobby increases

- At a lower mark up, the lobby is more worried about persuading the government to set a tariff.
- The government follows the Ramsey rule.
- The initial spatial distribution of firms may also affect the level of protection: ambiguity

The Long run equilibrium

Now $\longrightarrow$ Capital can flow

The Long run equilibrium occurs when movements of capital stop.

The equilibrium division of industry:

$$s_n = -\frac{\phi}{(1-\phi)} + \frac{(1-\phi\phi^*)s_\mu}{(1-\phi)(1-\phi^*)}$$

The spatial distribution of expenditure: small economy assumption

The Home Market effect

- The market access advantage
- The market crowding disadvantage

$$HME = f\left(\phi\left(a, \alpha_g, \sigma, \bar{s}_n\right)\right)$$

The Long run equilibrium: Predictions

Asymmetric trade costs

⇓

High level of protection creates a positive profit gap

⇓

Capital moves from the region with high level of freeness to one with high level of protection

⇓

$$\frac{\partial s_n}{\partial \phi} < 0 \quad \text{and} \quad \frac{\partial s_n}{\partial \phi^*} > 0$$

- A Government scarcely weights the general welfare.
- Owners of capital are few in number.
- The mark up of the firm is low.

Concluding remarks

The model

Determinants of trade policy and the spatial distribution of economic activity

New insights

- A low mark up leads the lobby to persuade the government to set a tariff.
- The initial distribution of industry may matter.

- Trade policy as a channel: *capital owners might make capital flow to look for protection*

  → Welfare effects ?

- Political variables may act as a dispersion force.