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Journal of International Economics 71 (2007) 167 – 186

Journal of INTERNATIONAL ECONOMICS

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Can compensation save free trade? ☆

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Received 29 March 2004; received in revised form 8 May 2006; accepted 17 May 2006

Abstract

When the median voter loses from trade reform, liberalization is blocked. Allowing the electorate to vote for compensatory subsidies may reverse this outcome. However, the order of the agenda may matter. The winners who pay the compensation may be sufficiently powerful to block compensation if trade is first liberalized. Seeing the inevitable outcome of sequential votes, the median voter realizes he will not be compensated for his losses and opposes liberalization. In contrast, liberalization can be achieved if compensation is placed first on the agenda. Finally, there is a significant chance that the least efficient compensation scheme will be chosen.

Keywords: Liberalization; Median Voter; Compensation

JEL classification: F130; D720

1. Introduction

Welfare economics generally, and the welfare economics of international trade in particular, has long understood that there is a close connection between liberalization and the need for compensation. While liberalization generally implies gains, it also implies adjustment, and, loosely speaking, the bigger the gains, the bigger the adjustment. For a country unable to influence its terms of trade, we have a sizable number of results, under quite general conditions,

☆ We thank seminar participants at the University of Nottingham and Syracuse University, two anonymous referees, and a co-editor, for insightful comments on earlier drafts of this paper.
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0022-1996/$ - see front matter
doi:10.1016/j.jinteco.2006.05.001

showing that free trade dominates limited trade and, under more restricted conditions, that existing forms of protection could be liberalized in such a way as to produce an increase in aggregate economic welfare. These results, however, rely on two fundamental abstractions: first, these are long-run/comparative static results that do not consider the short-run costs of adjustment from the distorted to the undistorted equilibrium; and, second, these results implicitly or explicitly assume that compensation is carried out in such a way as to ensure that a potential welfare gain is made actual. While both sorts of questions have produced research seeking to evaluate the robustness of gains from trade results to their concerns, in this paper we are interested in the positive political economy of the second question.[1]

The great majority of research on the positive political economy of domestic trade policy can be seen as an attempt to answer the question: if protection is so bad, why is there so much of it? The key result, presented most clearly in Mayer's (1984) fundamental paper: under the assumptions of the 2-good, 2-factor small HOS model, with heterogeneity in household factor ownership, and determination of equilibrium policy by simple referendum, except in the razor's edge case in which the median household factor ownership happens to be identical to that of the economy as a whole, free trade will not generally be an equilibrium policy.[2] This result, of course, relies on an assumption that the government does not possess a redistributive instrument (or does not choose to use it). Given the goals of that paper, and the plausible empirical claim that governments do not, in fact, seem to do much in the way of trade-contingent redistribution, this was an appropriate strategy.

In this paper, we follow Mayer's lead and adopt a referendum-based approach to the political economy of trade policy in which both protection and redistribution are essential components. Specifically, we construct a simple model in which a continuum of heterogeneous agents is inefficiently distributed between two industries due to protection. We assume that these agents face a choice between liberalization and protection, in which they will also choose whether to redistribute (some of) the gains from trade from (some of) the gainers to (some of) the losers. The particular institution involves three stages of voting: in the first stage, voters decide whether to liberalize trade. If liberalization is chosen, then in the second stage they vote on whether to provide compensation to the dislocated workers. Finally, if compensation is chosen, then in the third stage the workers vote on the method of compensation. We then compare the outcome of this political process with the outcome that would emerge if the only choices were uncompensated free trade or no liberalization. As in Mayer, the continuum assumption and the median voter framework allow us to focus on the fundamental question of policy choice/sustainability without getting bogged down in institutional details that have little claim to descriptive accuracy and even less claim to generating additional insight. That is, we can see the referendum as a reduced form for a more detailed representation of the political process.

In the context of this model, we address two interesting questions. First, would coupling trade liberalization measures with policies aimed at compensating dislocated workers increase the chances that free trade will emerge as the outcome of the political process? Many economists have argued that, in addition to moving trade liberalization in the direction of actual, as opposed to

[1] See Davidson and Matusz (2004) for an overview and extension of research on the first question. Fundamental normative research on the second question goes back to debates on the status of potential gain criterion of the Kaldor–Hicks sort, eventually evolving into questions about the feasibility of, and limits to, various compensation schemes. Examples of this latter research include Dixit and Norman (1986), Kemp and Wan (1986), Brecher and Choudhri (1994), Feenstra and Lewis (1994), Hammond and Sempere (1995), Guesnerie (2001), and Spector (2001).

[2] For all of the massive boom in research on the political economy of trade policy, there is surprisingly little substantive content beyond this result.