Trade Policy Transitions: Three Eras of US Trade Policy *

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Abstract

Major transitions in US trade policy are analyzed using a two-factor, two-good, two-country endowment model, where domestic policy is the outcome of political bargaining between two parties representing each factor owner—*globalists* and *protectionists*. The parties agree on either a unilateral tariff, or free trade with transfers. Policy change must be Pareto improving relative to the status quo, and political conditions determine the agenda-setter. When the status quo trade policy is high unilateral tariffs (US 1860-1931), free trade results only if accompanied by sufficiently high transfers and when foreign tariffs are very high. Consistent with this, in 1934 the globalist Democratic party offered the protectionists Republican party transfers to replace the benefits of the tariff. We show that low social transfers leads to a return to unilateralism. Thus the recent rise of China as an exporter of capital-intensive manufactures is not enough to explain the unilateral imposition of tariffs beginning in 2018. Our results suggest that insufficient social transfers are also to blame.

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Summary

In 2018 the United States unilaterally imposed tariffs between 10 and 50% on imports from several countries and across a variety of goods. This marked a significant departure from the previous 75 years of trade-policy making, which had relied on a rules-based, multilateral system of reciprocity and overseeing persistently low tariffs. The retreat from global cooperation between 2016 and 2018 was furthered by the withdrawal of the US from the proposed Trans-Pacific Partnership (TPP), renegotiation of the existing North American Free Trade Agreement (NAFTA/USMCA) and refusal to renew judges to the World Trade Organization's Appellate Body. The negative economic impacts were immediate. Handley & Kamal (2020) showed lower US export growth as a result of the new US tariffs, Kong & Weinstein (2020) estimated that investment growth would decline by 1.9 percentage points by 2020, and Fajgelbaum et al. (2019) estimated real income loss to the US of $7.2 billion (to name a few studies). The direct economic effects of the tariffs could be expected, but the political economy forces leading up to them are not adequately accounted for in the extant literature. We seek a theoretical framework to shed some light on the interaction between the politics and economics leading to the recent unilateralism in trade policy, and consistent with other periods of transition.

We focus on the transition between three distinct eras—1860-1931, 1932-2015, and 2016 to the present. Irwin (2017) refers to the first two eras as *Restriction* and *Reciprocity* respectively. Figure 1 plots the evolution of average tariffs on dutiable imports in the United States from 1859 to 2021 in green. The persistently high average tariffs (sometimes over 50%) in the *Restriction* era is clear, so too is the dramatic decline in tariffs in the *Reciprocity* era. The increase in average tariffs on dutiable imports as a result of US trade policy since 2016 is visible, marking a clear shift into a new era of trade. We call this era *Redistribution* for reasons to become clear as we describe the model and results.

The long term features of the *Redistribution* era are still uncertain, but some coincident patterns in economic and political variables offer guidance. Figure 1 shows the US and China fraction of the World Capital Stock in purple, and red respectively for the period 1953-2019. The dramatic decline in US capital share is coupled with the steady increase in China's. The year in which China overtakes the United States is 2016. One could argue that these economic fundamentals are the only source of the transition in 2016. Autor et al. (2013, 2016) demonstrate that the increase in imports from China negatively affected labor incomes in import-competing industries, providing support to this line of reasoning. But is it clear that such a transition would have materialized without a turn in the Republican party away from free trade and towards unilateralism? Moreover, could it have occurred without Republican control of the government at the same time? We argue that the answers two these two questions is no.

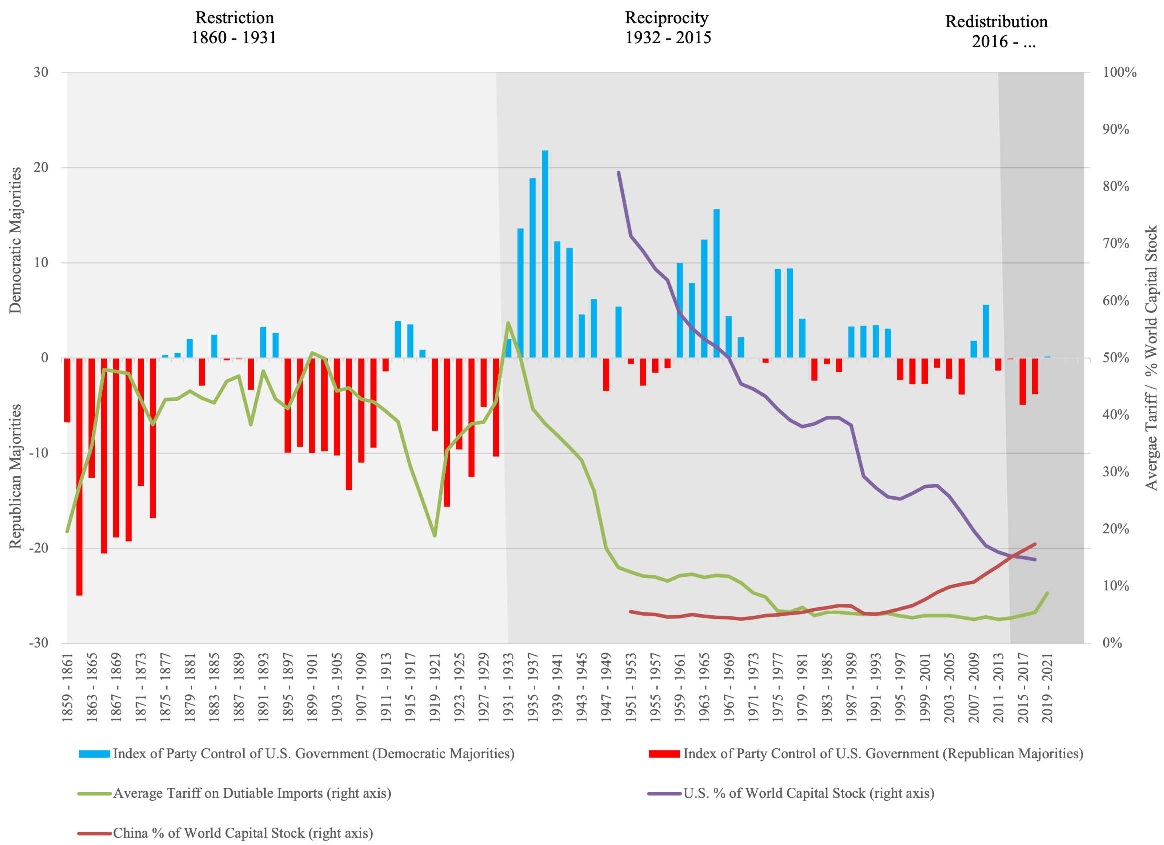

Figure 1: Party majorities, Average Tariffs and US/China % World Capital Stock 1859-2021

Figure 1 also plots the Index of Party Control for the period 1859-2019.[1] The blue bars represent Democratic majorities and red bars represents Republican majorities. It is clear that the transitions between trade policy eras were marked by significant changes in US politics. We refer to *Parties*, *Process* and *Power Shifts* to help define the political features of the three eras in U.S. trade policy. As well-documented in Irwin (2017), throughout US history, trade policy has been characterized by two major parties taking opposite stands on trade. These party positions are determined by the dominant exporting and import-competing industries. In this paper we refer to these parties as the *globalists* and *protectionists*. Process refers to the institutional features that govern trade-policy setting. In the US, Congress is charged with setting trade policy and it is thus the outcome of a negotiation between the globalists and

[1]The Index of Party Control is based on Lee (2016). It is the average of the Democratic Party's share of the total national popular vote for president (*CQ Press, Vital Statistics of the Presidency* 2021, Table 3-1), and House and Senate seats (*Brookings Institution, Vital Statistics of Congress* 2021, Table 1-20). We subtract 50 from the average to differentiate Republican Party majorities (red bars below the zero line) from Democratic Party majorities (blue bars above the zero line).

protectionist parties.[2] This bargaining is done in the shadow of some existing status quo. Given all the checks and balances in the US political system, movements from the status only occur with major political or economic changes. Power shifts refer to the pivotal moments in history where agenda-setting power changed hands. As can be seen in Figure 1, from 1861 to 1932, the Republican party dominated American politics. This rise to power was precipitated by the Civil War, but after World War II the Democratic Party emerged as the leader. Since the 1990s, neither party has been dominant. These political features interact with the economic fundamentals to determine major shifts in US trade policy.

Motivated by the facts presented in Figure 1, we argue that to understand the current and previous transitions in trade policy, at least three factors need to be accounted for—global economic conditions, the identity of the agenda setter in US politics, and the status quo trade policy. To this end, we study a stylized game between two countries. In each country there are two industries each producing a good using a sector-specific factor. Given our assumption on endowments, one sector is import-competing and one is an exporter. Each factor owner is represented by a party—the *globalist* party represents the owners of the factor used in exports, and the *protectionists* represent owners of the factor used in the import-competing sector. Given the structure of the model with two countries, two goods, two factors and two parties, we refer to this as a $2 \times 2 \times 2 \times 2$ model in the spirit of extending the Hecksher-Ohlin model to include politics. For tractability we adopt a partial equilibrium economic structure as in Grossman & Helpman (1994, 1995) and quadratic preferences as in Maggi & Rodríguez-Clare (2007).[3]

Following the agenda-setting model of Romer & Rosenthal (1978), policy is set by consensus between the two parties, and the status quo prevails if there is no agreement. There are two regimes that parties can propose and vote for—unilateral trade policy, or free trade. Under unilateral policy, the agenda setting party proposes a tariff rate, which the responder must either accept or reject. Rejection implies the status quo policy prevails. The status quo may either be a unilateral policy or free trade. Many observers suggest the populist backlash against globalization reflects the failure of governments to provide enough compensation to the losers. This compensation is through the standard modes of social transfers—health insurance, social security—and other more direct trade-related payments, such as Trade Adjustment Assistance (TAA). We incorporate this in the model by allowing transfers from the exporting to the import-competing industry when free trade is proposed. These transfers are a part of the status quo when the status quo is free trade.

Our simple model allows us to derive single-peaked preferences over the single-dimensional unilateral tariff. This facilitates the analysis of the political bargaining game over unilateral policy. We first show that with a unilateral trade policy, the

[2] See Bowen & Broz (2020) for a summary of the importance of Congressional leadership in setting US trade policy.

[3] We elaborate on the connection to these papers in the Literature Review below.

globalist party has a lower (positive) ideal tariff than the protectionist party. Moreover, it is immediate from the model that the globalist strictly prefers free trade without transfers to unilateral trade policy whenever the protectionists has opposite preferences. The only way to enact free trade is with transfers.

If the status quo is a unilateral tariff, either party, as agenda setter, will set their ideal trade policy as long as the status quo tariff is very high or very low, conditional on selecting a unilateral policy. Once an intermediate status quo tariff is in place it remains. This generates stable unilateral tariffs as observed in the *Restriction* era. An economic or political shock would generate a preference to shift from the new status quo, and a replacement stable policy would require agreement.

Under a unilateral status quo, free trade is selected if and only if the *foreign* tariff is sufficiently high. The basic intuition is that there is enough surplus to be gained by reciprocal free trade when foreign tariffs are high. This allows the globalist to benefit to a sufficient degree to compensate losses to protectionists via transfers. This is consistent with the transition to multilateralism going into the *Reciprocity* Era.

When the status quo is free trade, both parties prefer to revert to unilateral policy if social transfers are low. The reason is that with low transfers, the protectionists are cheap to buy off and the globalists can achieve their ideal tariff. Protectionists, on the other hand are not receiving sufficient transfers to incentivize openness.

Low transfers accompanying a return to protectionism is consistent with what is observed in the data. Figure 2 modifies Figure 1 by substituting US and China capital stock with US social transfers since 1885.[4] It is well established that prior to World War II (in the *Restriction* era), social transfers in the United States was zero. The movement to the *Reciprocity* era was spurred by economic and political events surrounding the Great Depression. The globalist Democrats went from minority to majority status at the national level. They remained for the next five decades enacting an ambitious set of policies that laid the foundations of the modern welfare state, and embraced international economic cooperation. Social transfers were part of the bargain with the protectionist republicans that facilitated openness. This sharp increase in social transfers is observed up to the mid 1970s. At this time, transfers experience lower growth, and by the time of the *Redistribution* era, there was zero growth in transfers.

The model also shows that when the foreign export sector endowment expands, the constraint on transfers gets slacker, creating a greater incentive to revert to unilateralism for both parties. More specifically, as the endowment in the foreign export sector expands, foreign exports and domestic imports expand as a consequence. Under free trade, with little redistribution, protectionists are very disadvantaged and have a strong preference to revert to unilateralism. As a consequence, they will accept unilateralism under almost any conditions, including accepting the globalists' low ideal tariff. The export oriented, globally minded winners from free trade realize that some

[4]Source for data on Social Transfers. Peter H. Lindert, Growing Public: Social Spending and Economic Growth Since the Eighteenth Century, Volume I: The Story. New York: Cambridge University Press 2004. Chapter 2, table 1.2. P12-P13. OECD Social Expenditure Database (SOCX) 1980-2018.

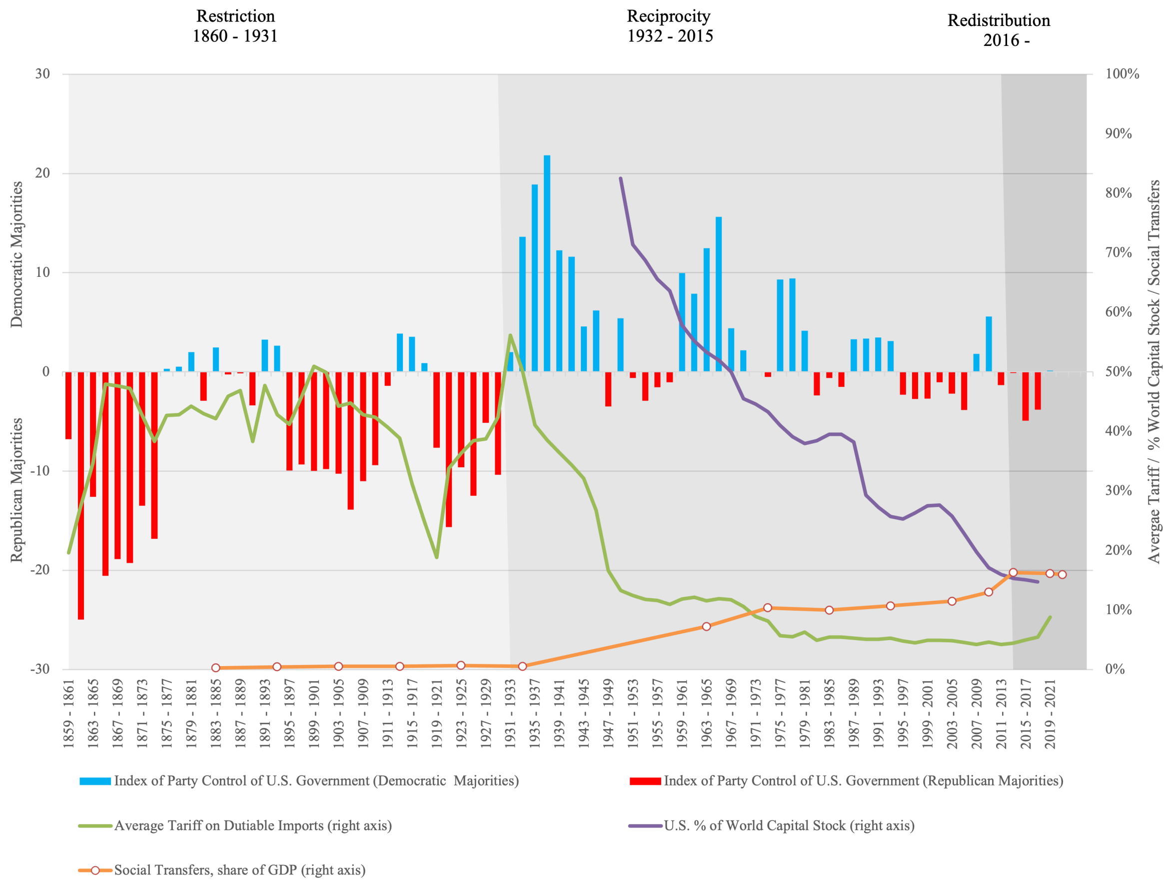

Figure 2: Party Majorities, Average Tariffs, US Capital Endowment and Social Transfers 1859-2021

protection offers several benefits relative to the status quo. First the redistributive costs are not as large because domestic losers from trade gain some protection; second the export sector benefits from some (potentially small) share of any tariff revenues that accrue. This motivates the export-oriented sector to desire a small positive tariff, which improves outcomes for the protectionists (relative to the free trade status quo). To keep the exporters at the current level of wellbeing, and as a rising export power abroad emerges, low tariffs emerge as the bargained domestic policy.

Notably, the model predicts bi-partisan consensus for a return to protectionism, consistent with what has emerged in US politics since the mid-2010s. While the growth in the foreign export sector contributes to the motive for protectionism, our results show that it in isolation it is not sufficient. Transfers and the resulting break down in political consensus for free trade are equally important. This is the main contribution to the extant literature on the political economy of trade policy and is why we refer to the current era as *Redistribution*. We argue that a potential avenue to mitigate a return to protectionism is by sufficiently increasing social transfers.

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