National Taiwan University
Department of Political Science
International Political Economy (Spring 2024)
Mock Midterm Exam Solution Guide

March 29, 2024

First of all, we have talked about the following trade models in class so far:

- **Ricardian Model**: Countries trade according to their comparative advantage, instead of absolute advantage.
- **Stolper-Samuelson Theorem**: An increase in the **relative price** of a good will increase the real return to the factor used **intensively** in that good, and reduce the real return to the other factor.
- **The Heckscher-Ohlin Theorem**: Each country will export the good that uses its abundant factor intensively.
- **Specific Factor Model**: Trade benefits the factor that is specific to the **export sector** of each country but hurts the factor specific to the **import-competing sectors**, with ambiguous effects on **mobile factors**.

1. In 2013, the European Union and Canada reached a consensus on the Comprehensive Economic and Trade Agreement (CETA), according to which both sides would cancel 98% of the total tariffs for each other. Based on an EU estimate, the bilateral trade in goods and services would increase by23% and the EU's GDP was expected to grow annually by 12 billion Euros after CETA took effect. According to CETA, Canada agreed to raise annually the import quota on cheese from 20 thousand to 37 thousand tons, among which 30 thousand would be from the EU. Correspondingly, the EU agreed to import more Canadian beef and pork. In addition, the increase in the imports could be completed in three to seven years so those affected by CETA had time for making adjustments. Nonetheless, Canadian dairy farmers were still very angry when hearing the news about the trade agreement, and wonder if it would drive small and local dairy manufacturers out of business.

   (a) Based on the milk price in Quebec (assume that it represents the price in Canada) from Figure 1, please use the Stolper-Samuelson theorem to explain the distributional effects of CETA in Canada.

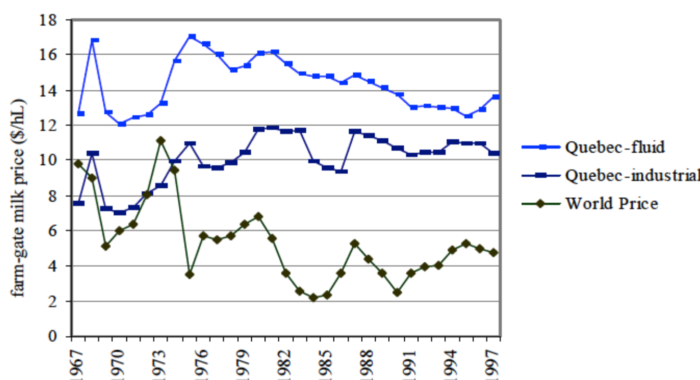
   - First of all, the singing of CETA increased the import of the European cheese and therefore induced a price change in the Canadian cheese. According to the Stolper-Samuelson Theorem that predicts changes in the returns to factors used in the production process owing to the changes in product prices, we should be able to see the corresponding changes in the returns to the factors used for producing Canadian cheese.

- Since the question doesn't provide the details for how the Canadian cheese is made, you are free to define the composition of its factor employment yourselves. For example, if you choose to define the cheese (dairy) industry in Canada as labor-intensive, then apparently, its laborers are going to suffer, while the other factors (could be capital or land) it uses less intensively will gain from trade by contrast.

(b) Since CETA allowed for an adjustment period of 3-7 years (despite the anger from Canadian dairy farmers), the policy would actually reduce the welfare gain for consumers in the short run. How can we explain this policy outcome from the perspective of domestic trade politics?

- The key message here is that Canada didn't have to entirely lift the quota limit immediately after CETA took effect. In other words, the full price effect and the increase in consumer/social welfare were delayed in the following three to seven years. During this period, Canadian consumers in fact still subsidized their local dairy farmers. According to the information provided by the question, this was very likely the result from dairy farmers' lobbying activities or politicians' electoral concerns if they had many cheese manufacturers in their districts.
- Moreover, since consumers are less organized and therefore unable to overcome their collective action problem, it's difficult for their voices to be heard in the political process.
- The domestic politic is also affected by political institutions, which tell us how interests are aggregated. We have also mentioned in class that, compared to the parliamentary system, the presidential system is found to be more pro-trade since presidents have a larger constituency to deal with and therefore are less vulnerable to special interests in particular districts.

Figure 1: Milk prices 1967-1997: Quebec and World



Sources: Kathy Baylis. 2006. "Rent-Seeking and the Canadian Dairy Industry." Mimeo