Identity Politics and Trade Policy

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What's Going On?

- Why the sudden shift to economic nationalism: anti-trade, anti-immigration, anti-EU?
- We propose to link this to shifts in social identity
  - Changing landscape of identity politics
  - In particular, rise in populism
- Goal of this paper: Introduce "identity politics" into political-economy model of tariff formation
  - Focus on the level of protection
  - Study endogenous shifts in self categorization triggered by changes in economic conditions (e.g., rising income inequality due to trade or technology) or by political opportunism that accentuates racial and ethnic differences

Social Identity

- Social Identity is the element of an individual's self-concept that derives from perceived membership in relevant social groups
- In social identity theory (e.g., Tajfel and Turner,1979)
  - Person's sense of who he/she is based on his/her group membership(s)
  - Groups (e.g., social class, family, religion, ethnicity, football club) are source of pride and self-esteem
  - Self image enhanced by the status of the groups to which people imagine themselves belonging; but also source of cognitive dissonance that arise from differences
  - Self categorization: Individuals choose the set of groups with which they identify (endogenous!)
    - No permission needed
    - No coercion
- In Economics: Akerlof and Kranton: (*QJE*, 2000; *Identity Economics*, 2010)

Our Approach

- Closest to our approach is Shayo (*APSR*, 2009)
  - Defines a social identity equilibrium in which individual behaviors are consistent with social identity, social identities consistent with the social environment, and the social environment is determined by individual behaviors
- Imagine electoral competition à la Lindbeck and Weibull (1987), Dixit and Londregan (1996) or Grossman and Helpman (1996) that leads to pliable policies that maximize utilitarian welfare
  - Here, welfare includes both material well-being and psychosocial components
  - For robustness we also examine median voter outcomes
- Individuals differ by socioeconomic class and by ethnicity, and they choose whether to identify with their socioeconomic group, their ethnic group, or the nation
- Changes in the environment induce continuous policy changes as long as the identification pattern does not change, but discrete policy responses when the identification pattern changes

The Environment

- Begin with a simple structure: two skill levels and no ethnic divisions
  - Later extend to three skill levels (polarization?) and an ethnic division along majority-minority lines
- Small country, Heckscher-Ohlin production structure
  - Two goods: Z and X (import-competing and exportable)
  - Two factors: h and ℓ (skilled and unskilled)
  - Normalize the population to equal 1, with fractions λ_h, λ_ℓ
  - Assume that Z is intensive in unskilled workers
- Quasi-linear materialistic utility: $v_i = c_{Xi} + v\left(c_{Zi}\right)$
- Two psychosocial components of utility:
  - Pride and self-esteem from group membership, associated with "status" of group: average material well-being
  - Dissonance costs of group membership, associated with personal distance from average group member

The Politics

- Political competition
  - Two political parties, distinguished by (exogenous) ideological platforms
  - Parties have fixed ideological positions
  - Parties propose trade policies instrumentally: to maximize votes
  - Voters are heterogeneous in ideological views, vote for preferred party based on ideology and trade platform
- If the distributions of ideological preferences are common in different groups, the instrumental policies converge to those that maximize aggregate welfare (otherwise, weighted sum of welfare levels)
  - Now "welfare" includes material and psychosocial components
  - Add up across individuals; find policy that maximizes this sum
  - Look for Social Identity Equilibrium à la Shayo

Social Identity Regimes

- Three potential identity groups: *Working Class*, *Elite*, *Americans*
- Who identifies as Working Class?
  - Less-skilled are homogeneous, so no cost to doing so; all unskilled identify as working class (not necessarily so with ethnic divisions)
  - Dissonance costs for skilled are too high for them to identify as working class; no skilled identify as working class
- Who identifies as Elite?
  - Skilled are homogeneous, so no cost to doing so; all skilled identify as elite
  - Dissonance costs for unskilled are too high for them to identify as elite
- Who identifies as Nationals?
  - Here it means to identify with broad group of nationals, not only certain "real" nationals
  - Compare status benefit with dissonance cost ($\mathbb{I}_h^b = 1$ or 0; $\mathbb{I}_\ell^b = 1$ or 0)

The Maximand: Socioeconomic Classes

- World price and domestic price of X equal one; world price of Z equals q and the domestic price is $p = q(1+t)$
- Material well-being: $w_i(p) + T(p,q) + \Gamma(p)$
  - $w_h(p)$ a declining function, $w_\ell(p)$ an increasing function
- Utility of h from identification:

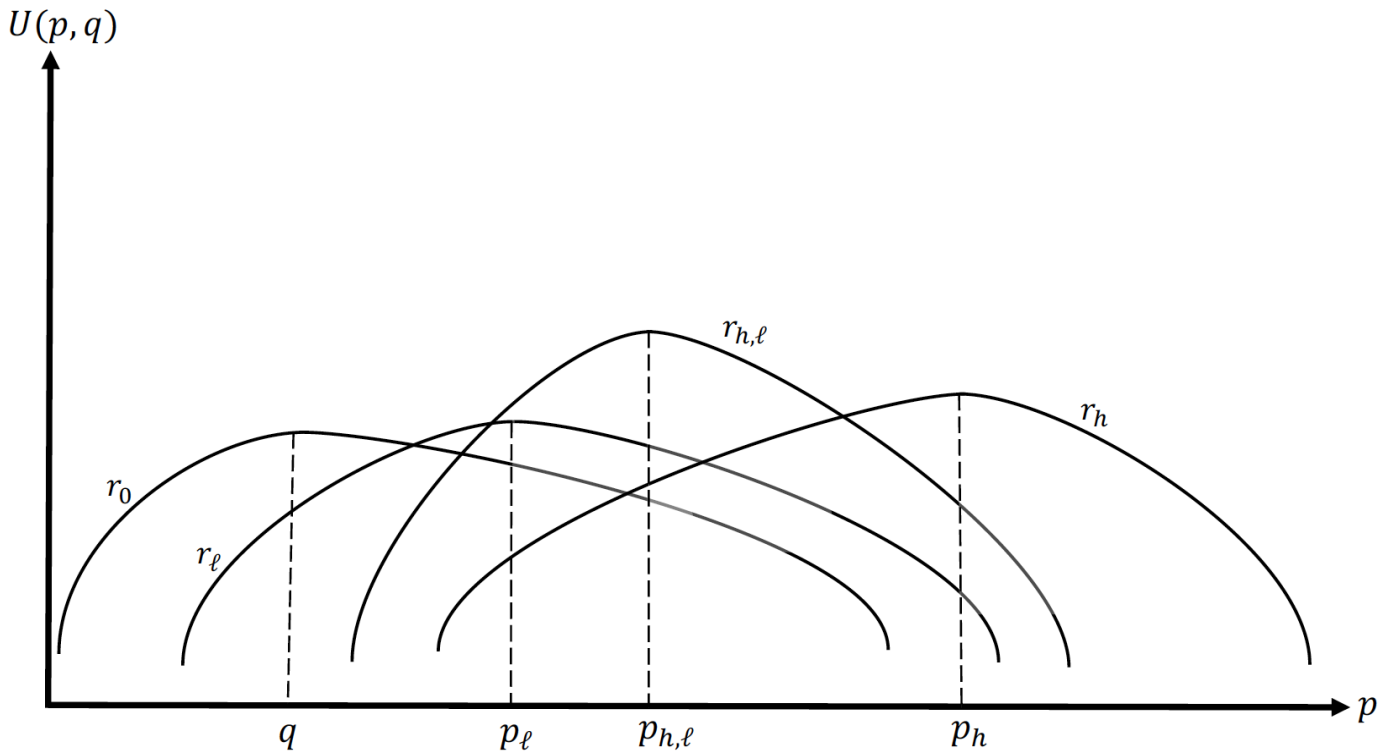
$$A_h^\varepsilon + \alpha \nu_h(p,q) + \mathbb{I}_h^b \left\{ A_h^b + \alpha^b \bar{\nu}^b(p,q) - \beta_h^b \left[\nu_h(p,q) - \bar{\nu}^b(p,q) \right]^2 \right\}$$

- Similar for ℓ
- Aggregate utility $U(p,q)$ equals:

$$\begin{aligned}
&\lambda_h A_h^\varepsilon + \lambda_\ell A_\ell^\omega + (1+\alpha)\left[Y(p) + T(p,q) + \Gamma(p)\right] \\
&+ \lambda_h \mathbb{I}_h^b \left\{ A_h^b + \alpha^b \left[Y(p) + T(p,q) + \Gamma(p)\right] - \beta_h^b (1-\lambda_h)^2 \left[\delta(p)\right]^2 \right\} \\
&+ \lambda_\ell \mathbb{I}_\ell^b \left\{ A_\ell^b + \alpha^b \left[Y(p) + T(p,q) + \Gamma(p)\right] - \beta_\ell^b (1-\lambda_\ell)^2 \left[\delta(p)\right]^2 \right\}
\end{aligned}$$

Equilibrium Policy

- Competition for votes leads parties to tariff that maximizes $U(p, q)$ subject to self-caterogization constraints
- Draw $U(p, q)$ for each possible identification regime: r_0, r_h, r_ℓ, $r_{h,\ell}$
- Outcome is global max of $U(p, q)$, because self-categorization constraints always satisfied at this point



Characterizing Equilibrium Trade Policy

- In the absence of social identification, policy maximizes aggregate material well-being, which calls for free trade (our benchmark)
- If no one identifies broadly with the nation ... aggregate welfare includes status benefits from identifying (only) with own social class
  - Concerns for own social class offset
  - Free trade!
- When individual identifies with broad nation, wage inequality is costly
  - Altruism, but for selfish reasons
  - Protection reduces dissonance costs
  - As usual, material welfare cost of small tariff is second order
  - In aggregate, protection addresses social aversion to inequality

Proposition

Suppose that $\beta_h^b > 0$ *and* $\beta_\ell^b > 0$. *If neither skill group identifies with the nation, the equilibrium tariff is zero. Otherwise, it is positive.*

Comparative Statics: Fixed Identification Regime

- The FOC is $U_p(p,q)=0$, where:

$$\begin{aligned} U_p(p,q) &= \left(1+\alpha+\alpha^b\sum_{i=h,\ell}\lambda_i\mathbb{I}_i^b\right)(p-q)\,\Omega'(p) \\ &\quad -2\sum_{i=h,\ell}\beta_i^b\mathbb{I}_i^b\lambda_i(1-\lambda_i)^2\,\delta(p)\,\delta'(p) \end{aligned}$$

- Within an identification regime this implies:

$$\operatorname{sign}\frac{dp^\circ}{d\xi}=\operatorname{sign}\frac{dU_p(p^\circ,q)}{\xi}$$

Comparative Statics: Heightened Sensitivity to Social Differences

Proposition

Suppose that skill group i identifies with the nation in some initial political equilibrium ($\mathbb{I}_i^b = 1$) and that an increase in β_i^b does not induce a change in the identification regime. Then an increase in β_i^b generates an increase in the equilibrium tariff rate.

Comparative Statics: Technical Progress

- Model factor-augmenting technological progress: π_h, π_ℓ
  - Neutral or skill-biased technological progress widens wage gap: increases marginal desirability of tariff to alleviate dissonance
  - Technological progress often will increase marginal efficiency cost of tariff, which affects aggregate material welfare and status from identification
- Despite apparent ambiguity, Hicks-neutral technological progress induces higher tariff rate
- Skill-biased technological progress?
  - Tariff rises if technologies are Leontief in both sectors
  - Tariff rises if technologies are Cobb-Douglas in both sectors
  - We also provide more general sufficient conditions

Comparative Statics: Terms of Trade

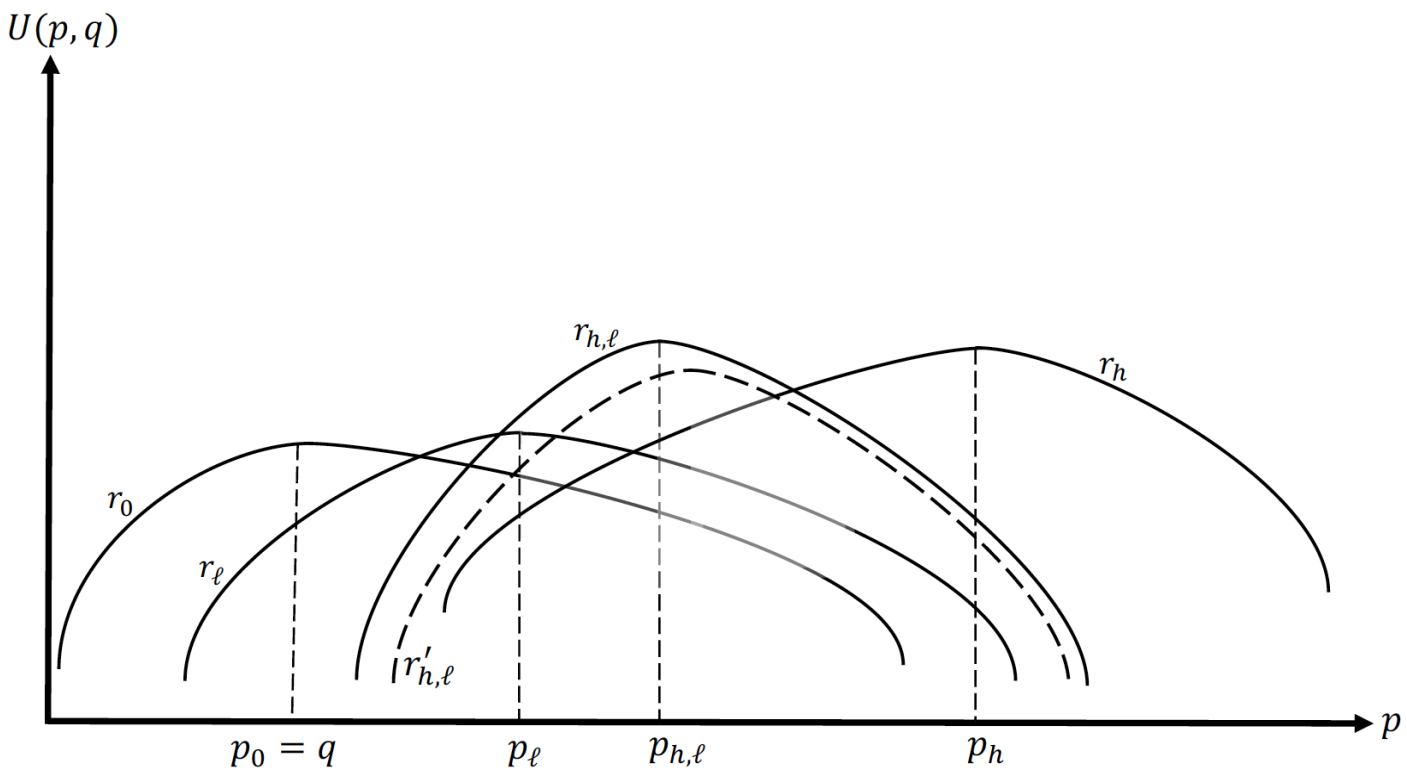
- When TOT improve ($q \downarrow$)
  - Domestic price $p \downarrow$; i.e., at least some pass-through
  - But potentially offsetting forces on tariff rate
    - Change in marginal efficiency cost of tariff depends on how elasticity of import demand changes with p
    - Change in marginal benefit of tariff depends on how the response of wage gap to tariff changes with p
- If import demand becomes less elastic as price falls and if responsiveness of wage gap to price rises as price falls $\Rightarrow$ tariff rate will increase
  - We provide necessary and sufficient conditions

Populist Revolution

- Turn now to change in identification regime. Focus on a "populist revolution."
- What is Populism?, Jan-Werner Müller defines populism as anti-pluralist, elite-critical politics with a moral claim to representation ("...populists do not just criticize elites; they also claim that they and only they represent the true people ...")
  - Populism is a particular form of identity politics
  - Populism classifies the elites as "them" and the everyman as "us"
  - Populism seeks to justify policy in the name of the people (i.e., "us")
- Consider a shift in the economic or political environment that induces the working class to identify more narrowly than before
  - No longer consider the elites to be "real nationals"
  - Could be caused by increase in inequality, due to SBTC or globalization

Populist Revolution: Effects on Trade Policy

- Initially, everyone identifies broadly with the nation: $r^{\circ} = r_{h,\ell}$
- Then working class ceases to identify broadly, instead identifies only narrowly with others in the same social class: $r^{\circ} \longrightarrow r_h$
- p rises discretely iff $p_h > p_{h,\ell}$



Condition for Rise in Protection

- $p_h > p_{h,\ell}$ if and only if

$$\beta_h^b \alpha^b (1-\lambda_h)^2 > \beta_\ell^b \left(1+\alpha+\alpha^b \lambda_h\right) \lambda_h$$

  - There exists λ_h^* such that the inequality is satisfied for $\lambda_h < \lambda_h^*$ and violated for $\lambda_h > \lambda_h^*$
  - More likely when β_h^b is high relative to β_ℓ^b
  - If $\beta_h^b = \beta_\ell^b = \beta^b$ and $\alpha = \alpha^b = 0.1$, the tariff rate jumps upward when the elite are less than 7.7% of the population

- Envy of out-groups
  - Social psychology literature suggests that individuals may envy those in out-groups with higher status
  - If ceasing to identify with broad nation causes working class to envy the elites, then range of λ_h for which tariff jumps upward is larger

Ethnic/Racial Identification

- Societies have more cleavages: wider menu of identity choices
- One of these sociocultural distinctions has become increasingly salient in recent elections in the United States and Europe: that perceived along ethnic and racial lines
  - Perhaps due to political opportunism?
- We extend the model to allow for an ethnic majority M and an ethnic minority m, as well as three skill levels: h, ℓ, k
- There are now three goods: X, Z, S, with S being a nontraded service produced by k-type workers
- Material well-being is $c_X + v\left(c_Z, c_S\right)$ or $w_i\left(p\right) + T\left(p, q, p_S\right) + \Gamma\left(p, p_S\right)$
- The price p determines wages and the price of services, $p_S\left(p\right)$, with $w_k\left(p\right) = p_S\left(p\right)$
- $p_S\left(p\right)$ is a declining function if and only if Z and S are complements in consumption

Identification Patterns

- Individuals with ethnicity j and skill level i may identify with others of the same ethnicity ($\mathbb{I}_i^{j,j} = 1$) or not ($\mathbb{I}_i^{j,j} = 0$), they may identify with others in their own social class ($\mathbb{I}_{i,i}^{j} = 1$) or not ($\mathbb{I}_{i,i}^{j} = 0$), and they may identify with the nation ($\mathbb{I}_i^{j,b} = 1$) or not ($\mathbb{I}_i^{j,b} = 0$)
- The benefit from identifying with ethnic group j is $\alpha^e \left(\sum_i \lambda_i^j \nu_i \right) / \lambda^j$, the benefit from identifying with social class i is $\alpha \nu_i$, the benefit from identifying with the nation is $\alpha^b \sum_i \lambda_i \nu_i$
- Dissonance costs now have two components: the first component is proportional to the squared distance in the space of material well-being, as before, given by $\beta \left(\nu_i - \bar{\nu}^g \right)^2$; the second component of psychological cost for individuals with ethnicity j who identify with some group g is $\beta^e \left(E^j - \bar{E}^g \right)^2$ (distance in "ethnic space"; distance in conceptual space)
- Without loss of generality, we assign individuals in the majority an ethnic value of one ($E^M = 1$) and individuals in the minority an ethnic value of zero ($E^m = 0$)

Comparative Statics: Ethnic/Racial Salience

Imagine that politicians increase salience of ethnic distance, β^e rises, perhaps due to opportunistic behaviors by politicians

- This affects cost of identification with social class and with broad nation
- But no interaction with trade policy
- Marginal costs and benefits of protection unchanged, and therefore

Proposition

Suppose that a change in β^e does not induce a change in identification regime. Then the equilibrium tariff rate is not affected.

Comparative Statics: Ethnic/Racial Salience

- An increase in β^e may lead to narrower identification pattern
- Changes in identification will affect preferences over tariffs

Proposition

Suppose that β^e rises and that the import good Z and nontraded services S are gross complements in demand. If the least-skilled workers (k) of any ethnicity cease to identify with the nation or with their social class, the rate of protection jumps upwards. If the middle-skilled workers (ℓ) of any ethnicity cease to identify with the nation and if their wage is at least as great as the economy-wide average, then the rate of protection jumps upward.

- These are sufficient conditions, not necessary

Concluding Remarks

- Voter preferences and behavior:
  - People do not always vote their narrow economic interests
  - Voters have concern for others, but not all others
  - Social identity theory consistent with these observations
- Model incorporating social identity necessarily requires many specific choices:
  - We are not wedded to the details specified here, e.g. determinants of benefits and costs of identification
  - We do believe that changes in identification (from whatever cause) generate changes in policy preferences, which in turn affect policy outcomes via the political process
  - Could apply to additional issues: immigrations policy? growth-friendly policies?
  - Large question: What determines salient divisions in society (potential identity groups) and characteristics of prototypical member?
  - Large question: What mechanisms can politicians use to shift costs or benefits of various identification patterns?