

The Effects of Loss Aversion on Trade Policy: Theory and Evidence

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Abstract

We study the implications of loss aversion for trade policy determination and show how it allows us to explain a number of important and puzzling features of trade policy. An important question concerning trade policy is why a disproportionate share of protection goes to declining industries. We show that if individual preferences exhibit sufficient loss aversion, higher protection will be given to sectors in which profitability is declining. In addition, by endogenizing lobby formation, we show that an industry will be more likely to become organized and lobby for protection if it has a loss. We also show that if the coefficient of loss aversion is large enough, there will be an anti-trade bias in trade policy. The anti-trade bias refers to the fact that trade policy tends to favor import-competing sectors and thus restricts rather than expands trade, and is considered an important puzzle in the literature. Our lobby formation predictions also reinforce the anti-trade bias result. We use a nonlinear regression procedure to estimate the parameters of the model and test its predictions. We find support for the model and the estimates of the loss aversion parameters are very close to those obtained by Kahneman and Tversky (1992) using experimental data. Protection is found to be more responsive to losses than to gains, and the estimates of the coefficient of loss aversion are about 2. The results are also consistent with diminishing sensitivity to income changes for both gains and losses, a prediction that distinguishes loss aversion from risk aversion. We also test some predictions on the lobbying side and we find evidence of loss aversion in lobby formation. Finally, but importantly, we find that the data favors our model over the current leading political economy model of trade protection, due to Grossman and Helpman (1994).

Keywords: Trade policy; protection; anti-trade bias; loss aversion; lobby formation.

JEL classification codes: F10; F13.