The Instruments of Trade Policy

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1- Introduction

What is free trade?

- It refers to a situation where a government does not attempt to **restrict** what its citizens can buy from another country or what they can sell to another country

While many nations are nominally committed to free trade, they tend to **intervene** in international trade to protect the **interests of politically important groups**

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What are the effects of various trade policy instruments?

- Who will **benefit** and who will **lose** from these trade policy instruments?

What are the costs and benefits of protection?

- Will the benefits outweigh the costs?

What should a nation's trade policy be?

- For example, should the United States use a tariff or an import quota to **protect** its automobile **industry** against competition from Japan and South Korea?

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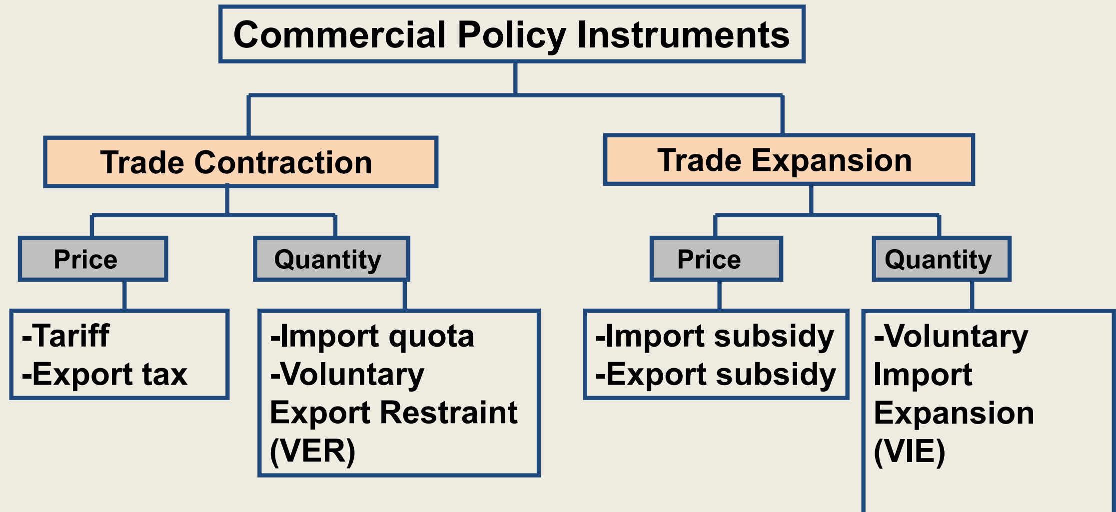

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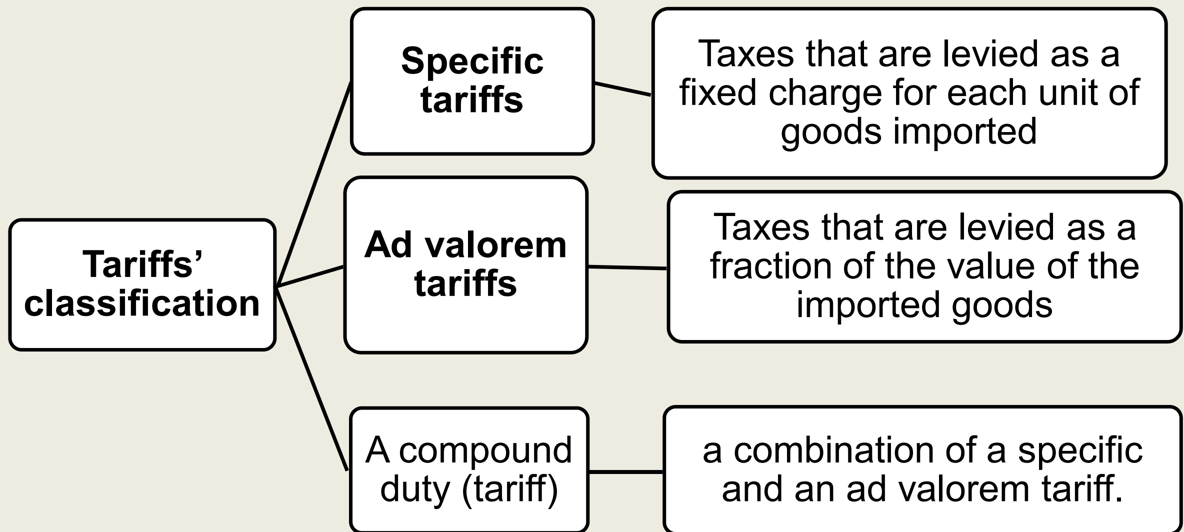

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Example of Specific Tariffs:

A specific tariff of $10 on each imported bicycle with an international price of $100 means that customs officials collect the fixed sum of $10

Example of Ad valorem tariffs:

A 20% ad valorem tariff on bicycles generates a $20 payment on each $100 imported bicycle.

Graphical illustration of Tariff

Supply, Demand, and Trade in a Single Industry

Assumptions

Suppose that there are two countries (Home and Foreign).

Both countries consume and produce wheat, which can be costless transported between the countries.

In each country, wheat is a competitive industry.

Suppose that in the absence of trade the price of wheat at Home exceeds the corresponding price at Foreign.

- This implies that shippers begin to move wheat from Foreign to Home.
- The export of wheat raises its price in Foreign and lowers its price in Home until the initial difference in prices has been eliminated.

To determine the world price (P_w) and the quantity trade (Q_w), two curves are defined:

Import demand curve

- shows the maximum quantity of **imports** the **Home country** would like to **consume** at each price of the imported good.
- **the excess** of what Home consumers demand over what Home producers supply: $MD = D(P) - S(P)$

Export supply curve

- shows the maximum quantity of **exports Foreign** would like to **provide** the rest of the world at each price.
- the excess of what Foreign producers supply over what foreign consumers demand: $XS = S^*(P^*) - D^*(P^*)$

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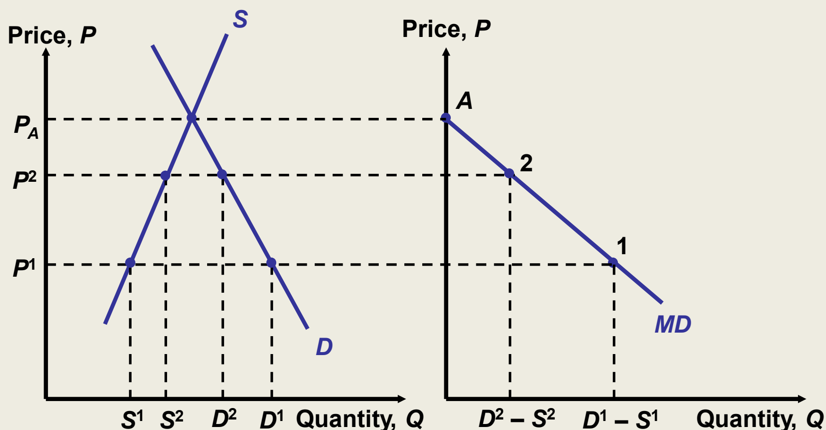
Deriving Home's Import Demand Curve



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■ **Properties of the import demand curve:**

1
It intersects the **vertical axis** at the closed economy price of the importing country.

2
It is **downward** sloping.

3
It is **flatter** than the domestic demand curve in the importing country.

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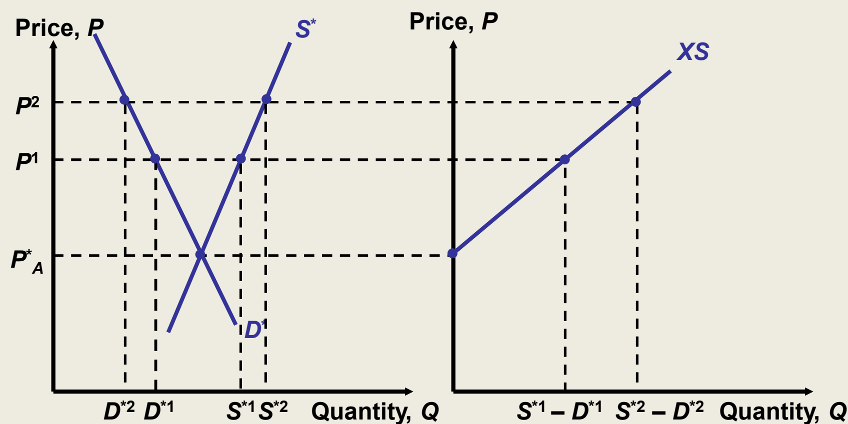
Deriving Foreign Export Supply Curve



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■ **Properties of the export supply curve:**

1
It intersects the **vertical axis** at the closed economy price of the exporting country.

2
It is **upward** sloping.

3
It is **flatter** than the domestic supply curve in the exporting country.

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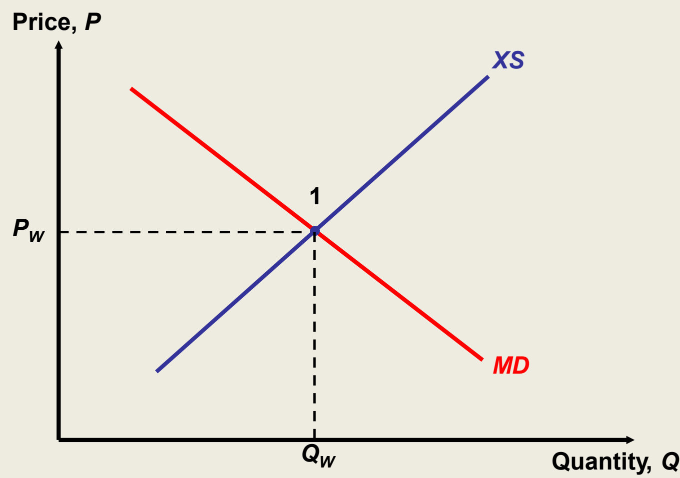
World Equilibrium



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❑ Effects of a Tariff

Assumptions

Assume that two large countries trade with each other.

- A **large country** is a country that **can affect** its terms of trade

Suppose Home imposes a tax of $2 on every bushel of wheat imported.

- Then shippers will be unwilling to move the wheat unless the price difference between the two markets is at least $2.

The following figure illustrates the effects of a specific tariff of $t per unit of wheat.

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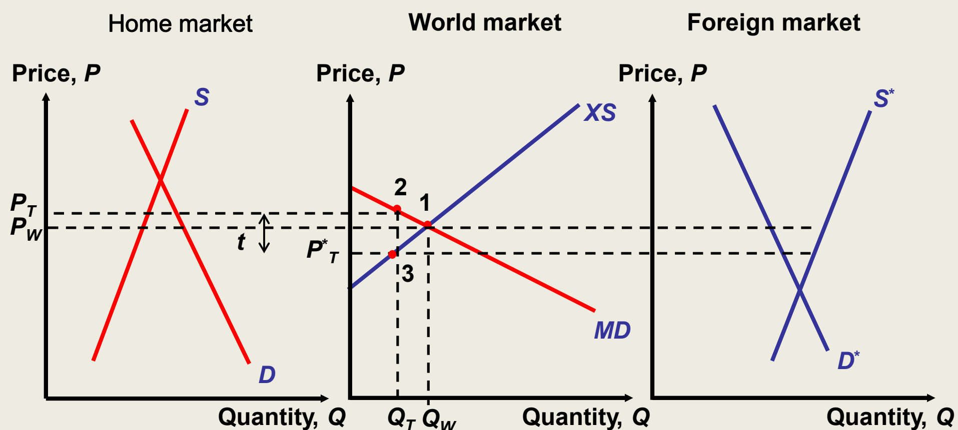
Effects of a Tariff



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In the absence of tariff, the world price of wheat (P_w) would be equalized in both countries.

With the tariff in place, the price of wheat rises to P_T at Home and falls to P^*_T (= $P_T - t$) at Foreign until the price difference is $\$t$.

- The increase in the domestic Home price is less than the tariff, because part of the tariff is reflected in a decline in Foreign' s export price.

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The Effects

In Home

- Producers supply more (due to the higher price)
- Consumers demand less (due to the higher price)
- **so** that fewer imports are demanded.

In Foreign

- Producers supply less (due to the lower price)
- Consumers demand more (due to the lower price)
- **so** that fewer exports are supplied.

Thus, the volume of wheat traded declines due to the imposition of the tariff.

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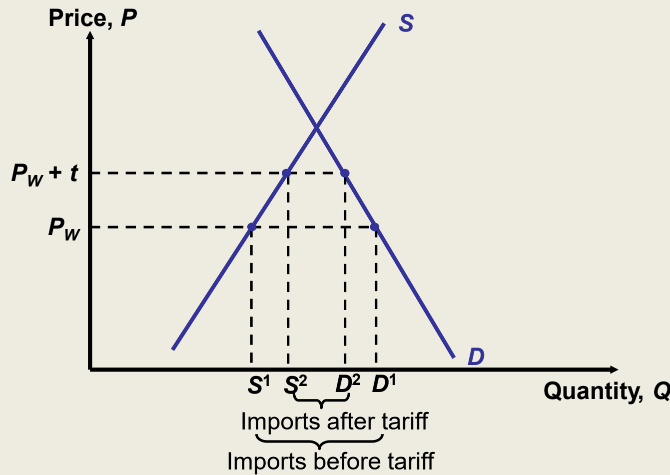
A Tariff in a Small Country

If Home is a small country and imposes a tariff, the foreign export prices are unaffected and the domestic price at Home (the importing country) rises by the full amount of the tariff.



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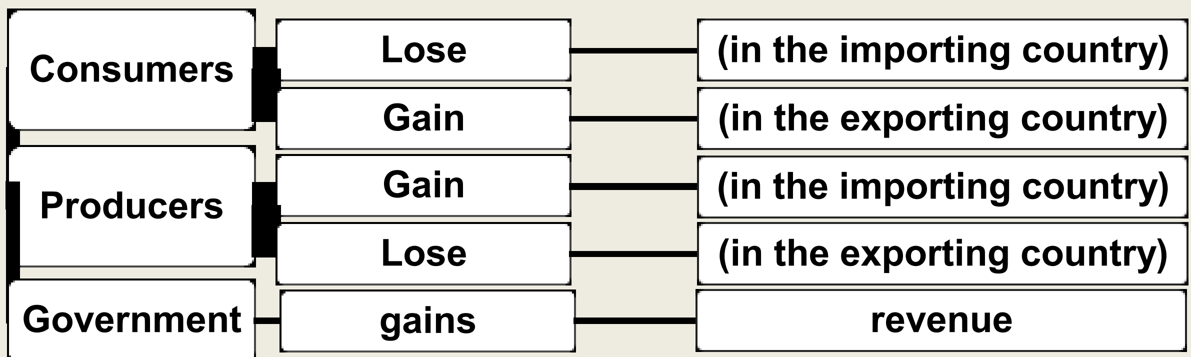
Costs and Benefits of a Tariff

A tariff raises the price of a good in the importing country and lowers it in the exporting country.

As a result of these price changes:



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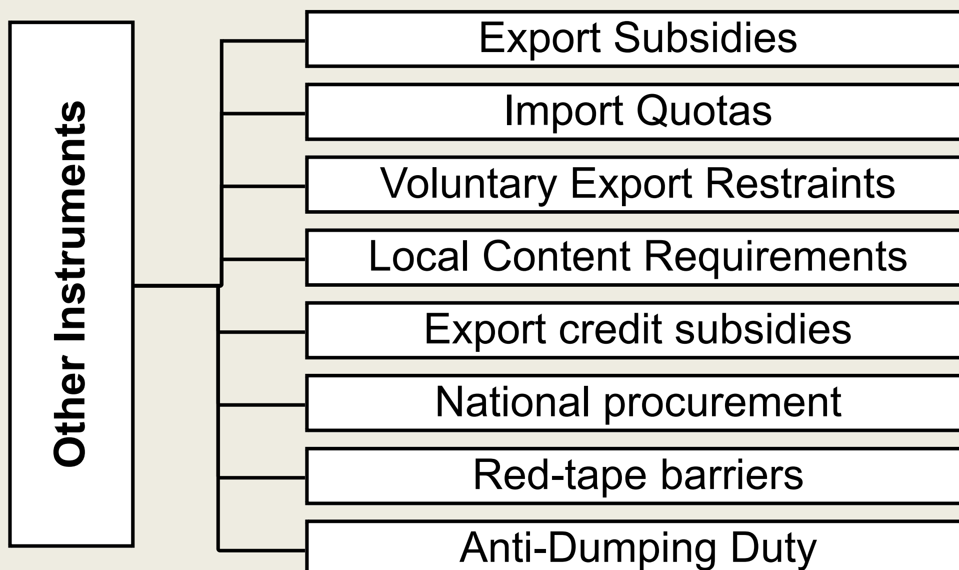
Other Instruments of Trade Policy



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Export Subsidies

A payment by the government to a firm or individual that ships a good abroad.

When the government offers an export subsidy, shippers will export the good up to the point where the **domestic price** exceeds the **foreign price** by the amount of the subsidy.

It can be either specific or ad valorem.

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An export subsidy **raises prices** in the exporting country while **lowering them** in the importing country.

In addition, and in contrast to a tariff, the export subsidy worsens the terms of trade.

An export subsidy leads to costs that exceed its benefits.

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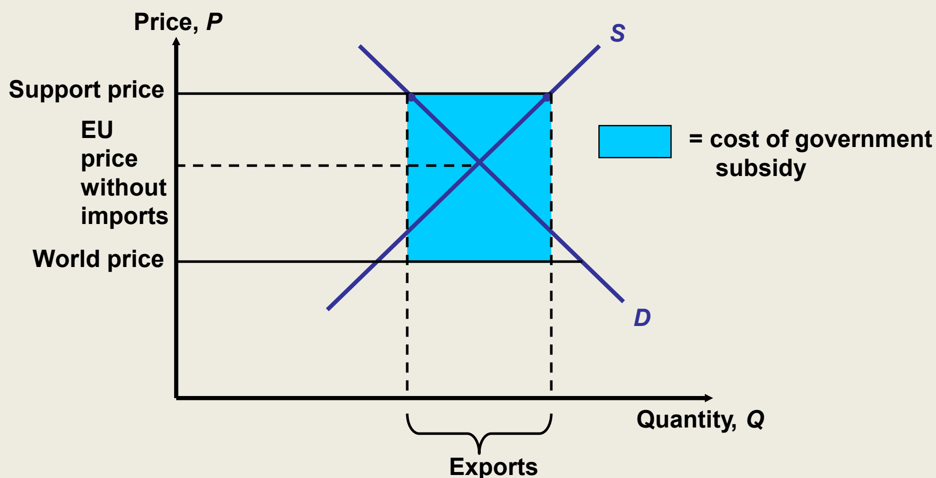
Europe's Common Agricultural Program

a system of subsidies paid to EU farmers.

Its main purposes are to guarantee minimum levels of production



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Import Quotas

An import quota is a direct restriction on **the quantity** of a good that is imported.

- Example: The United States has a quota on imports of foreign cheese.

The restriction is usually enforced by issuing licenses to some group of individuals or firms or governments.

- Example: The only firms allowed to import cheese are certain trading companies

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An import quota always raises the domestic price of the imported good.

License holders are able to buy imports and resell them at a higher price in the domestic market.

- The profits received by the holders of import licenses are known as **quota rents**.

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Effects of import quotas versus of that of tariffs

The difference between a quota and a tariff is that with a quota the government receives *no* revenue.

In assessing the costs and benefits of an import quota, it is crucial to determine who gets the rents.

- When the rights to sell in the domestic market are assigned to governments of exporting countries, the transfer of rents abroad makes the costs of a quota substantially higher than the equivalent tariff.

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Voluntary Export Restraints

A **voluntary export restraint (VER)** is an export quota administered by the exporting country.

- It is also known as a voluntary restraint agreement (VRA).

VERs are imposed at the request of the importer and are agreed to by the exporter to forestall other trade restrictions.

A VER is exactly like an import quota where the licenses are assigned to foreign governments and is therefore very costly to the importing country.

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A VER is always more costly to the importing country than a tariff that limits imports by the same amount.

- The tariff equivalent revenue becomes rents earned by foreigners under the VER.

A VER produces a loss for the importing country.

Local Content Requirements

A **local content requirement** is a regulation that requires that some **specified fraction** of a final good be produced domestically.

- This fraction can be specified in **physical units** or in **value terms**.

Local content laws have been widely used by developing countries trying to shift their manufacturing base from assembly back into intermediate goods.

Local content laws do not produce either government revenue or quota rents.

- Instead, the difference between the prices of imports and domestic goods gets averaged in the final price and is passed on to consumers.

Firms are allowed to satisfy their local content requirement by exporting instead of using parts domestically.

Export credit subsidies

- A form of a subsidized loan to the buyer of exports.
- They have the same effect as regular export subsidies.

National procurement

- Purchases by the government (or public firms) can be directed towards domestic goods, even if they are more expensive than imports.

Red-tape barriers

- Sometimes governments place substantial barriers based on health, safety and customs procedures.

Anti-Dumping Duty

- An **anti-dumping** duty is a protectionist tariff that a domestic government imposes on foreign imports that it believes are priced below fair market value.

The Effects of Trade Policy: A Summary

	Tariff	Export subsidy	Import quota	Voluntary export restraint
Producer surplus	Increases	Increases	Increases	Increases
Consumer surplus	Falls	Falls	Falls	Falls
Government revenue	Increases	Falls (government spending rises)	No change (rents to license holders)	No change (rents to foreigners)

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Summary

- A tariff drives a wedge between **foreign** and **domestic prices**, raising the domestic price but **by less** than the tariff rate (except in the "small" country case).
  - In the small country case, a tariff is **fully reflected** in domestic prices.
- The costs and benefits of a tariff or other trade policy instruments may be measured using the concepts of consumer and producer surplus.
  - The domestic producers of a good gain
  - The domestic consumers lose
  - The government collects tariff revenue

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- An export subsidy causes **efficiency losses** similar to a tariff but compounds these losses by causing a deterioration of **the terms of trade**.
- Under import quotas and voluntary export restraints the government of the importing country receives **no revenue**.

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Thank you

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