

NINE

International Economics

9

Nontariff Trade Barriers and New Protectionism

In this chapter:

- Introduction
- Import Quotas
- Other Nontariff Barriers and the New Protectionism.
- The Political Economy of Protectionism.



Introduction

3

- In this chapter, we analyze the **effect** of **nontariff** trade barriers.
- Though **tariffs** have historically been the most important form of trade **restriction**, there are many other types of trade barriers such as import quotas, voluntary export restraints, and antidumping actions.
- As tariffs were **negotiated** down during the postwar period, the importance of non-tariff barriers was greatly increased.

- A quota is a **direct quantitative restriction** on the amount of a commodity allowed to be imported or exported.
- Import quotas are **direct** quantitative restriction on the amount of a commodity allowed to be imported.
- They have been used to protect **domestic** industry and agriculture, and/or for balance of payments reasons.



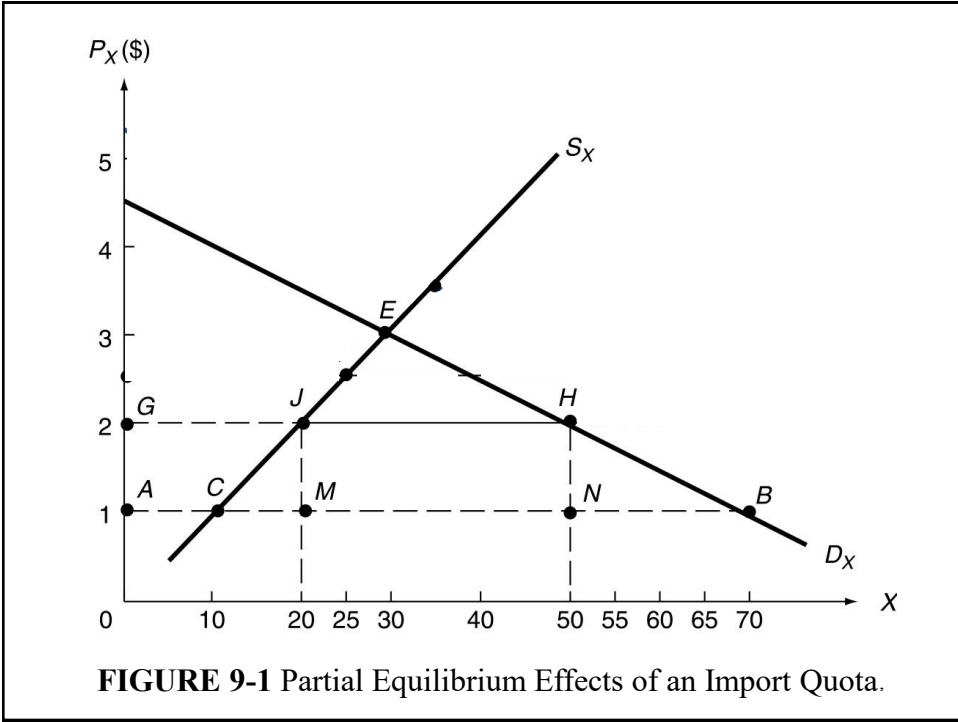
Effects of an Import Quota

- D_X is the demand curve.
- S_X is the supply curve of commodity X.
- With free trade and at the world price of $P_X = \$1$,
 - ✓ The nation will consume 70X (AB), of which 10X (AC) is produced **domestically** and the remainder of 60X (CB) is **imported**.
- With an import quota of 30X (JH)
- **Domestic price of X increases** to $P_X = \$2$, exactly as with a **100 percent ad valorem import tariff** on commodity X.
- The reason is that only at $P_X = \$2$ does the quantity demanded of 50X (GH) equal the 20X (GJ) produced domestically plus the 30X (JH) allowed by the import quota.

Thus,

- **Consumption is reduced by 20X (BN) domestic production is increased by 10X (CM)** exactly as with the 100 percent import tariff.
- If the government also auctioned off **import licenses** to the highest bidder in a competitive market, **the revenue effect** would be \$30 (\$1 on each of the 30X of the import quota), given by area $JHNM$.

Then the import quota of 30X would be equivalent in every respect to an “implicit” 100 percent import tariff.



**Comparison of
an Effect of Import Quota
Vs. an Import Tariff**

What would happen if there exist an upward shift of D_X to D'_X ?

- With an **import quota** of 30X ($J'H'$):
 - ✓ The **domestic price** of X rises to $P_X = \$2.50$,
 - ✓ The **domestic production** rises to 25X ($G'J'$),
 - ✓ The **domestic consumption** rises from 50X to 55X ($G'H'$).
- While, with the given **100 percent import tariff**,
 - ✓ The **price** of X remains **unchanged** at $P_X = \$2$
 - ✓ The **domestic production** remains **unchanged** at 20X (GJ),
 - ✓ But **domestic consumption** rises to 65X (GK)
 - ✓ Imports rises to 45X (JK).

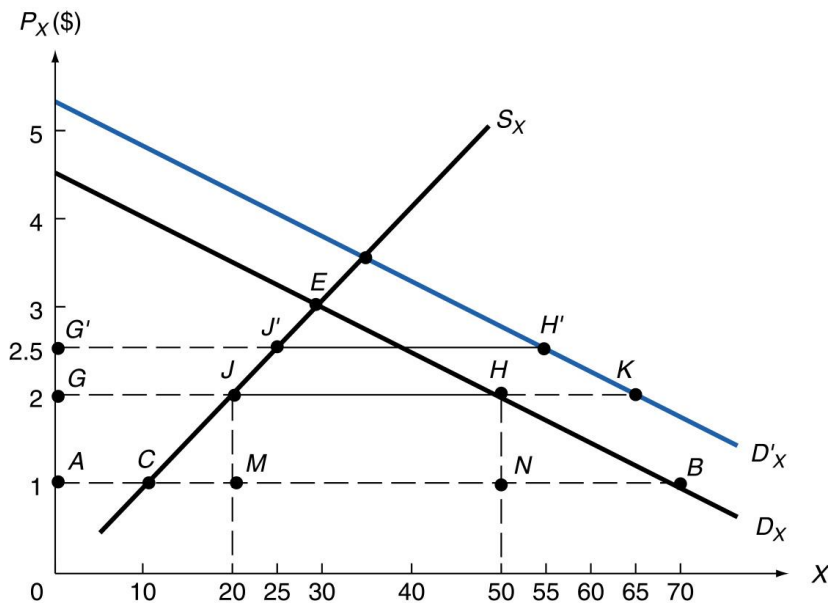


FIGURE 9-1 Partial Equilibrium Effects of an Import Quota.

Import Quota vs. Equivalent (implicit) Import Tariff	
Increase in demand with Import quota results in:	Increase in demand with Import tariff results in:
Higher domestic price than tariff	Domestic price remains unchanged
Higher domestic production than tariff	Domestic production remains unchanged
Imports remains unchanged	Higher imports than quota
<i>It replaces the market mechanism</i>	<i>It Alters the market mechanism</i>
The trade effect of an import tariff may be uncertain .	The trade effect of an import tariff may be uncertain .
It involves distribution of import licenses	No import licenses
More restrictive	Less restrictive

We can observe that:

✓ Since adjustment to any shift in D_X or S_X occurs in the **domestic price** with an (effective) **import quota** but in the **quantity of imports** with a tariff. Therefore,

quota completely replaces the **market mechanism** rather than simply altering it (as an **import tariff** does).

✓ **Import quota** limits imports to specified levels with *certainty*, while the trade effect of an **import tariff** may be **uncertain**. This is because:

- ✓ When elasticity of demand and supply are **not known**, it is difficult to estimate the **import tariff** required to **restrict imports** to desired level.
- ✓ Foreign exporters may absorb all or part of the tariff by increasing their **efficiency of operation** or by accepting lower profits. As a result, the actual **reduction in imports** may be **less than anticipated**. (Exporters cannot do this with an import quota since the quantity of imports allowed into the nation is clearly specified by the quota).

Import Quota vs. Equivalent (implicit) Import Tariff

We can observe the following points:

- i. Since adjustment to any shift in D_X or S_X occurs in the **domestic price** with an (effective) **import quota** but in the **quantity of imports** with a tariff. Therefore,

quota completely replaces the **market mechanism** rather than simply altering it (as an **import tariff** does).

- ii. **Import quota** limits imports to specified levels with *certainty*, while the trade effect of an **import tariff** may be **uncertain**. This is because:

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(Exporters cannot do this with an import quota since the quantity of imports allowed into the nation is clearly specified by the quota).

iii. Import quota may involve **distribution of import licenses**, while tariff does not.

- ✓ If not auctioned by government in competitive markets, receiving firms will **reap** monopoly profits.
- ✓ Allocation decision often based on **arbitrary judgments** rather than **efficiency** concerns.
- ✓ Monopoly profits lead firms to lobby for licenses in **rent-seeking** activities.
- ✓ Thus, **import quotas** replace market mechanism, resulting in **waste**, and possible **corruption**.

iv. Because import quota is **less “visible and more restrictive**, domestic producers **prefer** them over **tariffs**.

However, society would **resist** domestic producers' efforts to use quotas instead of tariffs.



Other Nontariff Barriers and the New Protectionism

19

These include:

- ✓ Voluntary export restraints
 - ✓ Technical, administrative, and other regulations.
 - ✓ International cartels
 - ✓ Dumping
 - ✓ Export subsidies.
- During the past **two decades**, NTBs have become more **important** than tariffs as obstructions to the flow of international trade and represent a major threat to the world trading system.



Voluntary Export Restraints (VERs)

21

Definition: VER

- With VERs, an **importing** country **induces** another **nation** to reduce its exports **voluntarily**, under threat of **higher trade restrictions** when these exports threaten an entire **domestic industry**
- Sometimes called **orderly marketing arrangements**.
- (e.g. US restraints on Japanese cars exports in 1981)

□Effects:

1. When **VERs** are successful, they have all **the economic effects of equivalent import quotas**.

Except that:

- ✓ They are administered by the **exporting** country,
 - ✓ So the **revenue effect** or **rents** are captured by **foreign exporters**.
2. Voluntary export restraints are **less effective** in limiting imports than import quotas because:
 - ✓ The exporting nation agrees only reluctantly to curb their exports leaving the door open for exporting nations to export through third countries.
 - ✓ Foreign exporters tend to fill their quota with **higher-quality** and **higher-priced** units of the product over time.



**Technical, Administrative, Other
Regulations**

Definition: Technical, Administrative, Other Regulations

They are barriers to international trade by raising the **costs** of **imported** products, which **includes**:

- **Safety** regulations for automobile and electrical equipment,
- **Health** regulations for the hygienic production and packaging of imported food products, and
- **Labeling requirements** showing origin and contents.
- **Government procurement policies**: laws requiring governments to buy from domestic suppliers. Government purchasing restrictions may be biased against foreign goods.
- **Rebates** for **indirect taxes** may be given to **exporters** and imposed on **importers** of a commodity.

While many regulations serve **legitimate purposes**, some are implicitly used for **restricting imports**.



International Cartels

Definition: International Cartel

- It is an **organization** of **suppliers** of a commodity located in different nations (or a group of governments) that **agrees** to **restrict output** and **exports** of the commodity with the aim of maximizing or increasing the **total profits** of the organization.
- Cartel behaves as a **monopolist** in maximizing profits.
- Sometimes, there is an **incentive** for any one supplier to **remain outside** the cartel or to **cheat** on it by selling at **slightly** below the **cartel price**.

For example,

- ✓ **OPEC**: a cartel of major oil countries which restricts production and exports of oil.
- ✓ **International Air Transport Association**: a cartel of major airlines that set international fares and policies.

Conditions for Successful International Cartels:

- Existence of **few international suppliers** of an **essential commodity** for which there are **no close substitutes**. Thus,
 - ✓ **Existence of many international suppliers** makes it difficult to organize them into an effective cartel.
 - ✓ **Existence of close substitutes** for the commodity will only lead buyers to **shift** to substitute commodities and that makes it difficult for suppliers to organize them into an effective cartel.
- For the previously **mentioned reasons**:
- Cartels are inherently unstable and often collapse or fail.
- international cartels can't be **created in some industries**.
This explains the failure of international cartels in minerals other than petroleum and tin, and agricultural products other than sugar, coffee, cocoa, and rubber.



Dumping

30

Definition: Dumping

- The export of a commodity at **below cost**, or the sale of a **commodity** at a **lower price** abroad than domestically.

What are different types of Dumping?

Three types of dumping:

1. **Persistent Dumping** (international price discrimination)
2. **Predatory Dumping**
3. **Sporadic Dumping**

1- Persistent dumping or international price discrimination

- It is the *continuous* tendency of a **domestic monopolist** to **maximize** total profits by **selling** the commodity at a **higher price** in the domestic market (which is insulated by transportation costs and trade barriers) than internationally (where it must meet the competition of foreign producers).
- Persistent dumping is **profitable** because the **demand** curve is **less** elastic in the home, and the foreign country's market is **more competitive**.

2- Predatory dumping

- It is the *temporary* sale of a commodity at **below** cost or at a **lower price** abroad in order to drive foreign producers **out of business**, after which prices are raised to take advantage of the newly acquired monopoly power abroad.
- Trade restriction to counteract **predatory dumping** are justified to protect domestic industries from unfair foreign competition.
- These restrictions usually take the form of **antidumping duties** to offset price differentials, or the threat to impose such duties.

3- Sporadic dumping

- It is the **occasional** sale of a commodity at **below** cost or at a **lower price** abroad than **domestically** in order to **unload** an **unforeseen** and temporary surplus of the commodity without having to reduce domestic prices.

Notes on Dumping:

- It is often **difficult** to **determine** the **type** of dumping.
- Domestic producers usually demand protection against any type of **dumping** to discourage imports (the “harassment thesis”) and increase their own production and profits (rents).
- When dumping is proved, violating nation or firm usually choose to **raise prices** rather than face **antidumping duties**.
- In some cases of **persistent** and **sporadic** dumping, the benefit to **consumers** from low prices may actually **exceed** the possible **production losses** of domestic producers.



Export Subsidies

Definition: Export Subsidies

They are subsidies which take the any of the following forms:

- a) **Direct payments** to the **nation's exporters** or potential exporters
- b) Granting of **tax relief** and **subsidized loans** to the **nation's exporters** or potential exporters
- c) **Provision of low-interest loans** to foreign buyers to **stimulate** the nation's exports.

Example: U.S. government agency that extends subsidized loans to foreigners to finance U.S. exports.

Note that:

- Export subsidies can be regarded as a **form of dumping**. thus **Countervailing duties** are often imposed on imports to offset export subsidies by foreign governments.
- Although export subsidies are illegal by international agreement, many nations provide them in **disguised** and not-so-disguised **forms**.

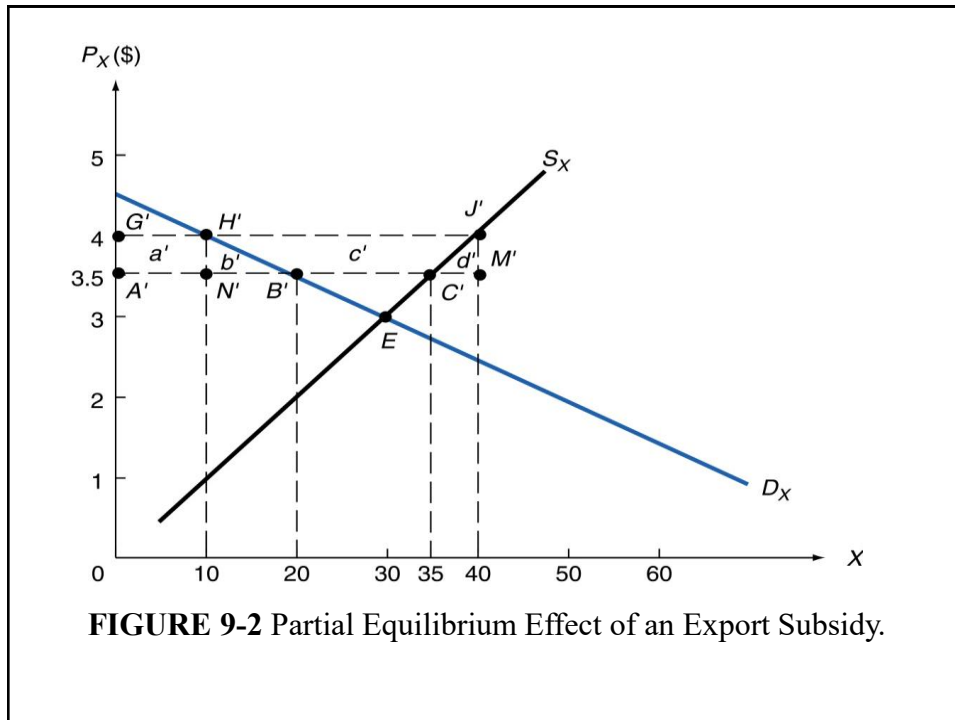
Economic Analysis of Export Subsidies

- D_X and S_X represent Nation 2's demand and supply curves of commodity X.
- If the **free trade world price** of commodity X were **\$3.50**, Nation 2 would:
 - ✓ **Produce** 35X (A'C'),
 - ✓ **Consume** 20X (A'B'),
 - ✓ **Export** the remaining 15X (B'C').
- That is, at **prices above \$3** (point E in the figure), Nation 2 became an **exporter** rather than being an importer of **commodity X**.

- If the **government** of Nation 2 (assumed to be a small country) **provides** a subsidy of **\$0.50** on each unit of commodity **X exported** equal to an ad valorem subsidy of **16.7 percent**.
- P_X **rises** to **\$4.00** for domestic producers and consumers of commodity X.
- At $P_X = \$4$, **Nation 2** would:
 - Produces 40X ($G'J'$),
 - Consumes 10X ($G'H'$),
 - Exports 30X ($H'J'$).
- The higher price of commodity X **benefits** producers but **harms** consumers in Nation 2.
- Nation 2 also incurs the cost of the subsidy.

Specifically,

- **Domestic consumers** lose \$7.50 (area $a' + b'$),
- **Domestic producers** gain \$18.75 (area $a' + b' + c'$),
- **The government** bare cost of subsidy \$15 ($b' + c' + d'$).
- It should be noted that **foreign consumers** gain because they receive 30X instead of 15X at $P_X = \$3.50$ with the subsidy.
- The net effect in Nation 2 : Net Loss: ($b' + d'$).
- The **protection cost** or **deadweight** loss of Nation 2 is \$3.75 (the sum of triangles $B'H'N' = b' = \$2.50$ and $C'J'M' = d' = \$1.25$).



- Since **domestic producers gain less** than the **sum** of the **loss of domestic consumers** and the **cost of the subsidy** to Nation 2's taxpayers
- Nation 2 incurs a **net loss** equal to the protection cost or deadweight loss of \$3.75)
- Note that area d' is not part of the gain in producer **surplus** because it **represents** the rising domestic cost of **producing** more units of commodity X.

To summarize:

- **With free trade:** $P_X = \$3.5$, production is $35X$, consumption is $20X$, and exports are $15X$.
- **A subsidy of \$0.5 on each unit exported** raises P_X to $\$4$ for **domestic** producers and consumers. At $P_X = \$4$, production rises to $40X$, consumption falls to $10X$, and exports rise to $30X$.
- Consumer surplus fall by $(a' + b')$, producer surplus rise by $(a' + b' + c')$, government incurs subsidy $(b' + c' + d')$. **Thus**, country incurs **deadweight loss** of $(b' + d')$.
- **Foreign** consumers gain because they receive $30X$ instead of $15X$.

Then why would Nation 2 subsidize exports?*Ans.*

- ✓ Domestic producers may successfully **lobby** the **government** for the subsidy.
- ✓ Nation 2's government may want to **promote** industry X, if industry X is a desired **high-technology** industry.

Note that:

If Nation 2 were not a small nation, it would also face a **decline** in its terms of trade because of the need to **reduce** P_X in order to be able to **export** more of commodity X.



The Political Economy of Protectionism

45

The Political Economy of Protectionism

- 1. Fallacious** Arguments for Protection
- 2. Questionable** Arguments for Protection.
- 3. Qualified Argument for Protection: Infant-
industry**

Fallacious Arguments for Protection

1. Trade restrictions are needed to protect domestic labor against cheap foreign labor.

- Even if **domestic wages** are higher than **wages** abroad, **domestic** labor costs can be lower if **labor productivity** is higher **domestically** than abroad.
- **Mutually beneficial trade** could be based on **comparative advantage**, with cheap labor nation **specializing** in **labor-intensive** commodities.

Fallacious Arguments for Protection

2. Scientific tariffs are needed so that domestic producers can compete.

- A **scientific tariff** raises the price of **imports** to the domestic price.
- This would **eliminate** price differences and trade in all **commodities** subject to such “**scientific**” tariffs.

Questionable Arguments for Protection

Protection is needed to:

1. Reduce domestic **unemployment**, and
2. To cure a **deficit** in the nation's **balance of payments**
 - Protection lead to **substitution** of imports with **domestic** production.
 - Represent beggar-thy-neighbor arguments for protection as they **come** at expense of other nations.
 - Other nations **retaliate**; all nations lose in the end.

Qualified Argument for Protection: Infant-industry

- **Temporary trade** protection is justified to establish and **protect** a **domestic industry** during its “**infancy**” until it can meet **foreign** competition, **achieve economies** of scale, and reflect the **nation's** comparative advantage.
- To be **valid**, the return in the **grown-up** industry must be high enough to **offset** the higher prices paid by domestic **consumers** of the commodity during infancy.
- More justified for **developing nations** than industrial ones.
- May be difficult to **identify** which industry **qualifies** for **protection**, which, once given, is difficult to remove.

The End