Outline

The impact of trade policies

1. Introduction
2. Tariff: The small country case
3. Tariff: The large country case
4. Export subsidy

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Basic tariff analysis

- A tariff is a tax levied when a good is imported
- Specific tariffs are levied as a fixed charge for each unit of goods imported ($ 3 per barrel)
- Ad valorem tariffs are taxes that are levied as a fraction of the value of the imported good (25 %)
- Tariffs are the oldest form of trade policy

Two objectives

- Tariffs are (were) an important source of government income
- Protection of domestic sectors

Basic tariff analysis

- Importance of tariffs had decreased in modern times

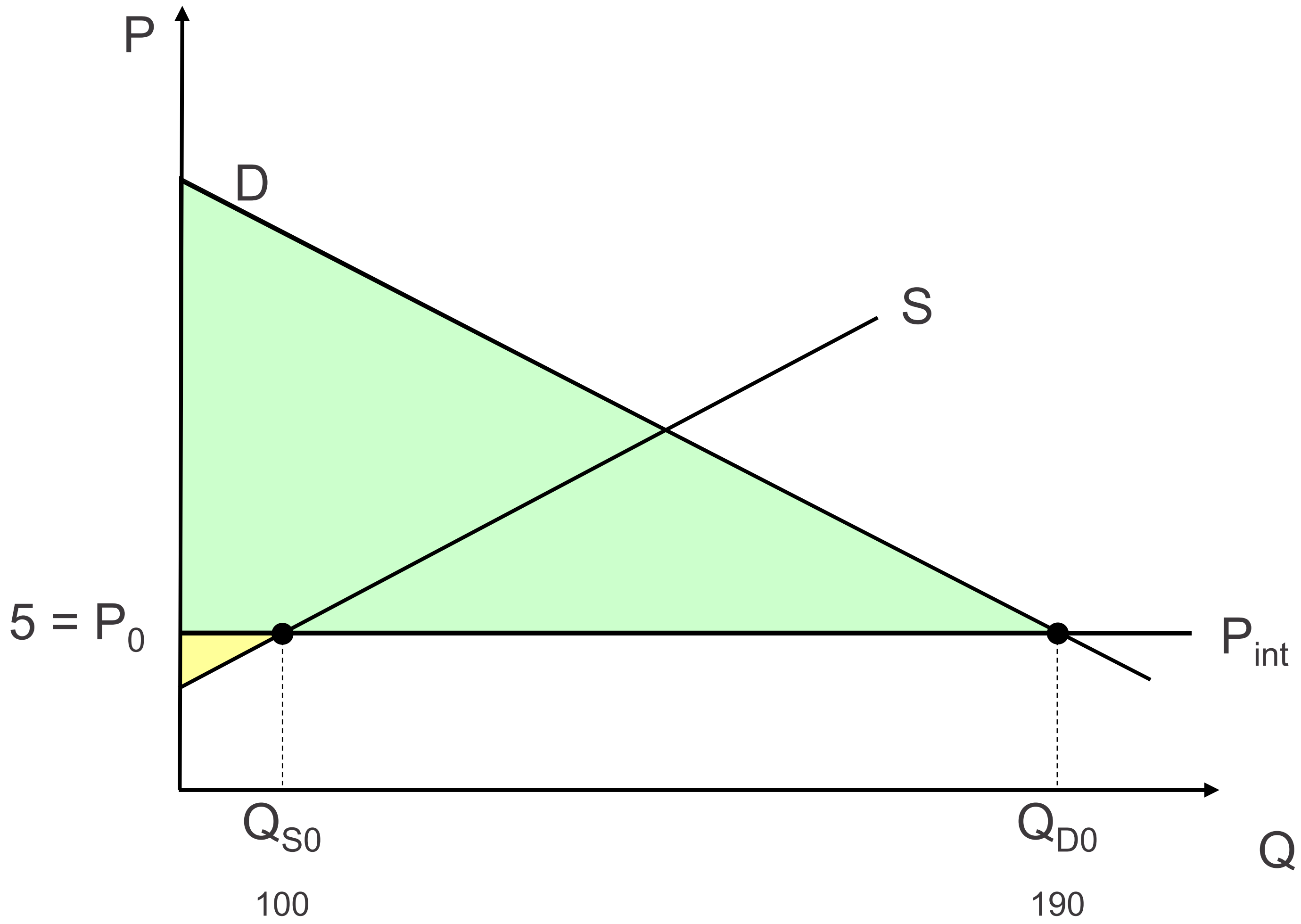
- Importance of non-tariff barriers has increased
- Import quotas (limitations on the quantity of imports)
- Export restraints (limitations on the quantities of exports – usually imposed by the exporters country at the importing country's request)

- Tariff scenario serves as the baseline trade policy measure ➔ all other instruments are evaluated against the tariff

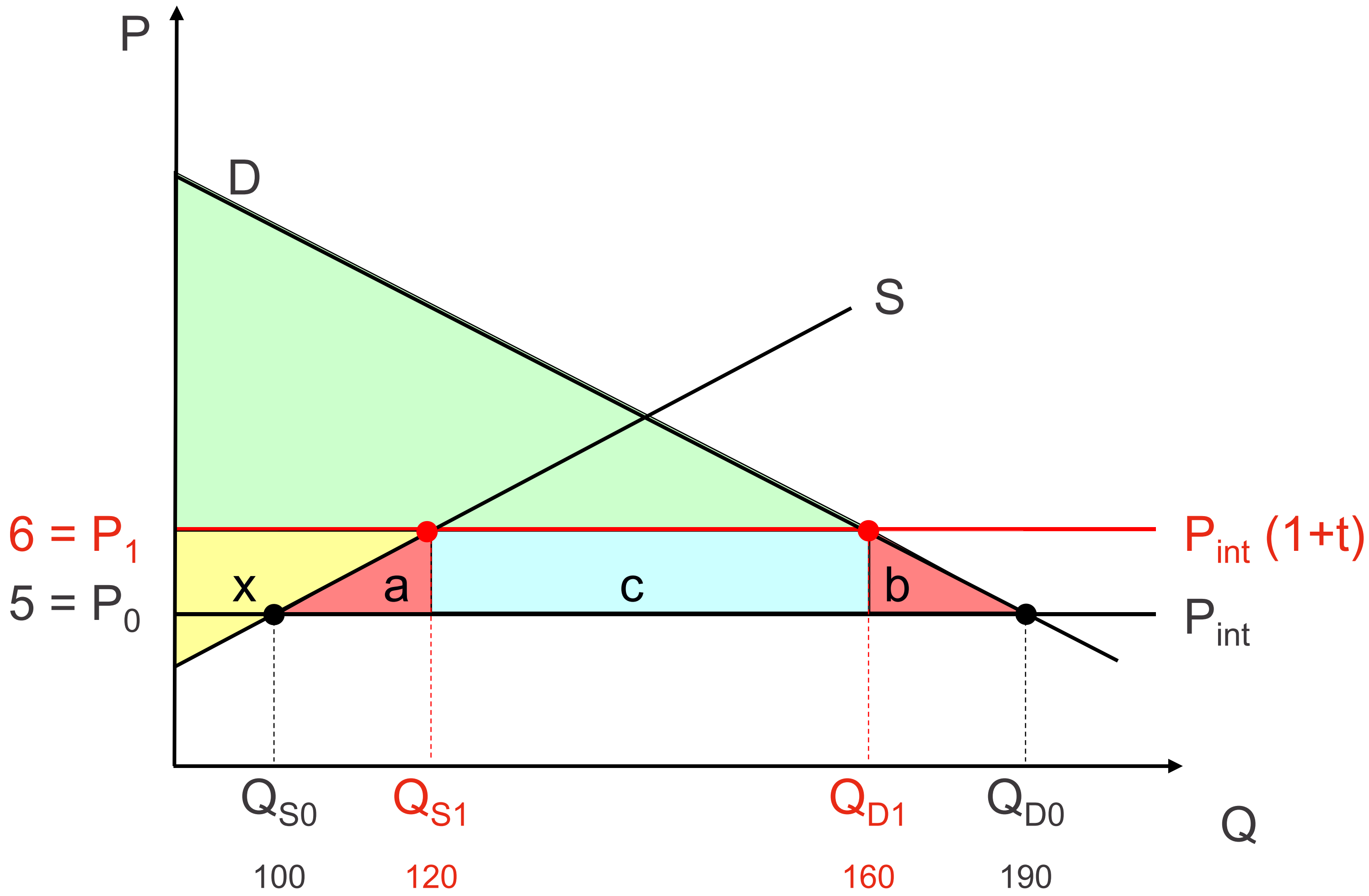
- We follow a partial equilibrium framework and concentrate on that market where tariff is introduced

- Effects on the rest of the economy are out of our focus

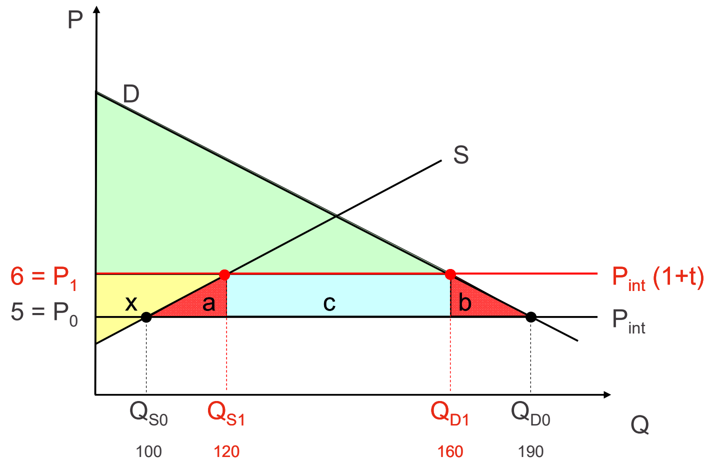
Equilibrium with free trade (AFC Figure 1)



The welfare effects of a tariff in a small country (AFC Figure 3)



Welfare effects of a tariff (small country case)



Net benefit of a tariff =

Change in producer surplus	+ government revenue	+ change in consumer surplus
x	+ c	– (x + a + b + c) = –a –b

- Triangle a: Production distortion ➔ tariff leads inefficient domestic producers to produce too much of the good
- Triangle b: Consumption distortion ➔ tariff leads consumers to consume too little of the good

Welfare analysis by comparison of development of consumer & producer surplus

- Welfare analysis contains interpersonal comparisons
- Gains and losses accrue to different people (Pareto criterion is not met)
- Evaluation of a tariff depends on how much we value a dollar's worth of benefit to each group
- If producer gain accrues to wealthy owners of resources while the consumers are poorer on average the tariff will be viewed differently compared to a situation where the good is a luxury bought by the rich and produced by low-wage workers
- Role of government is ambiguous: Is tariff revenue used for needed public services or wasted on $1,000 toilet seats?

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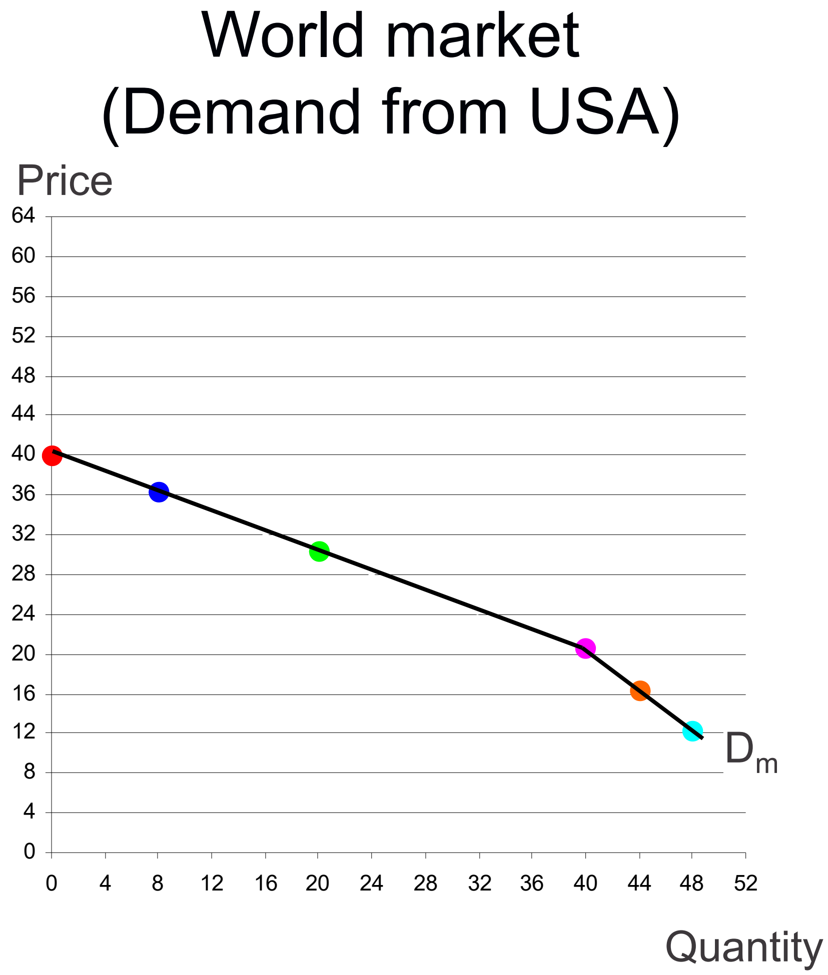
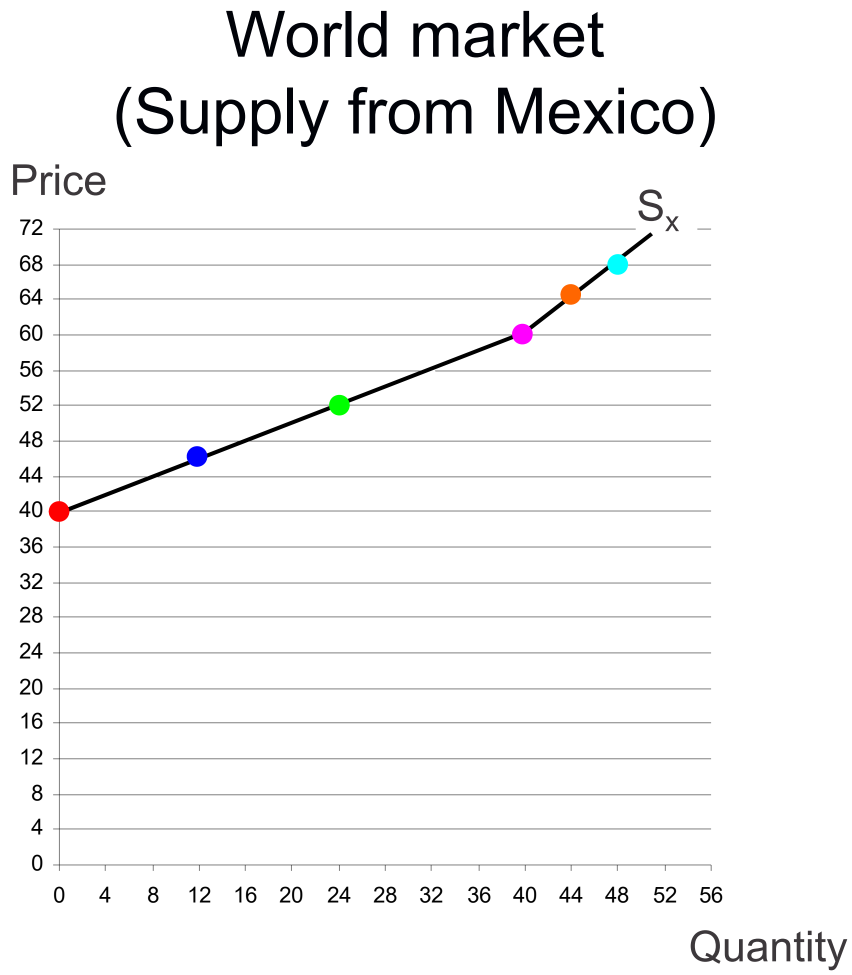
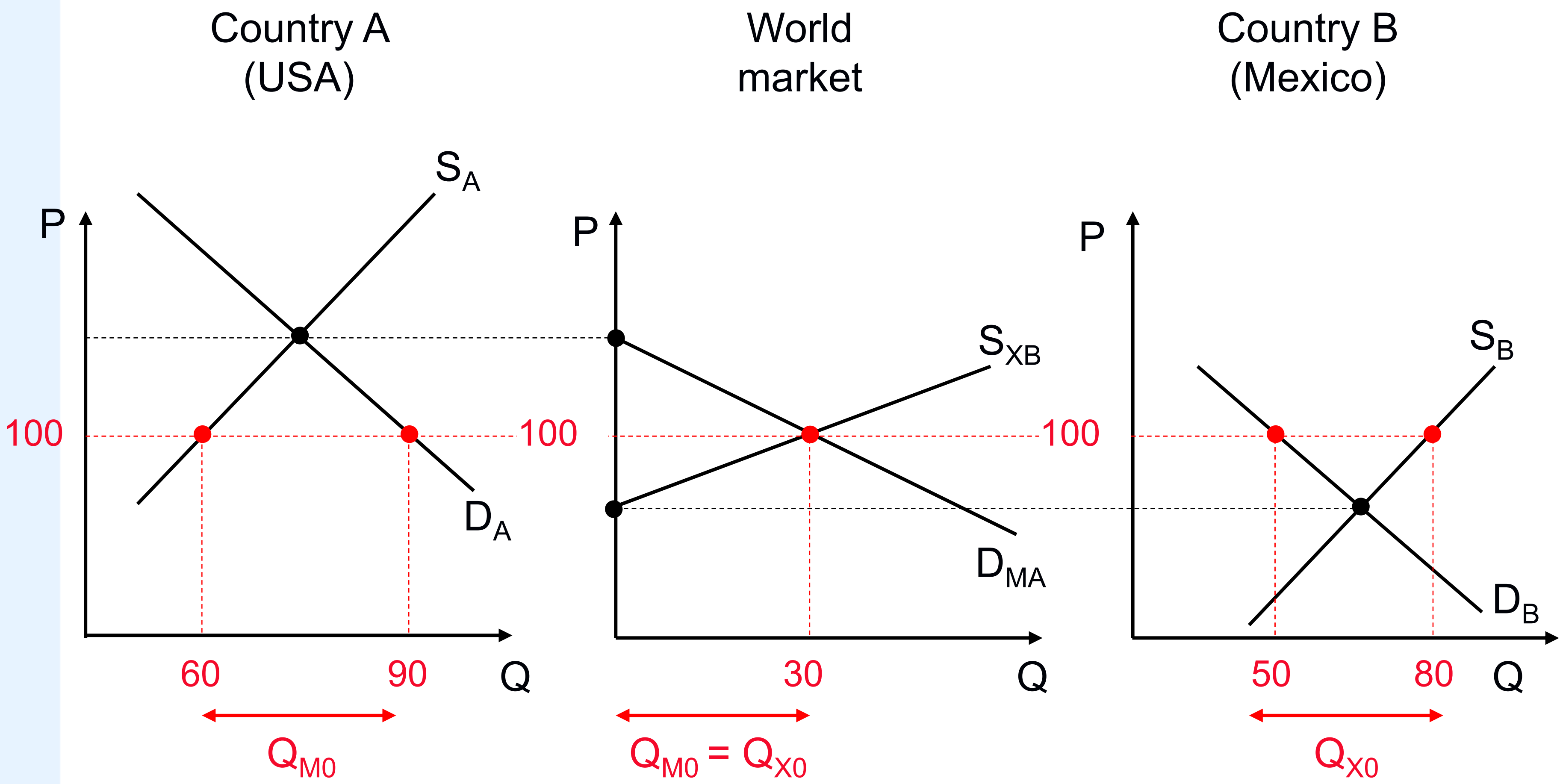
The derivation of a country's demand for imports schedule of a good (AFC Figure 7)



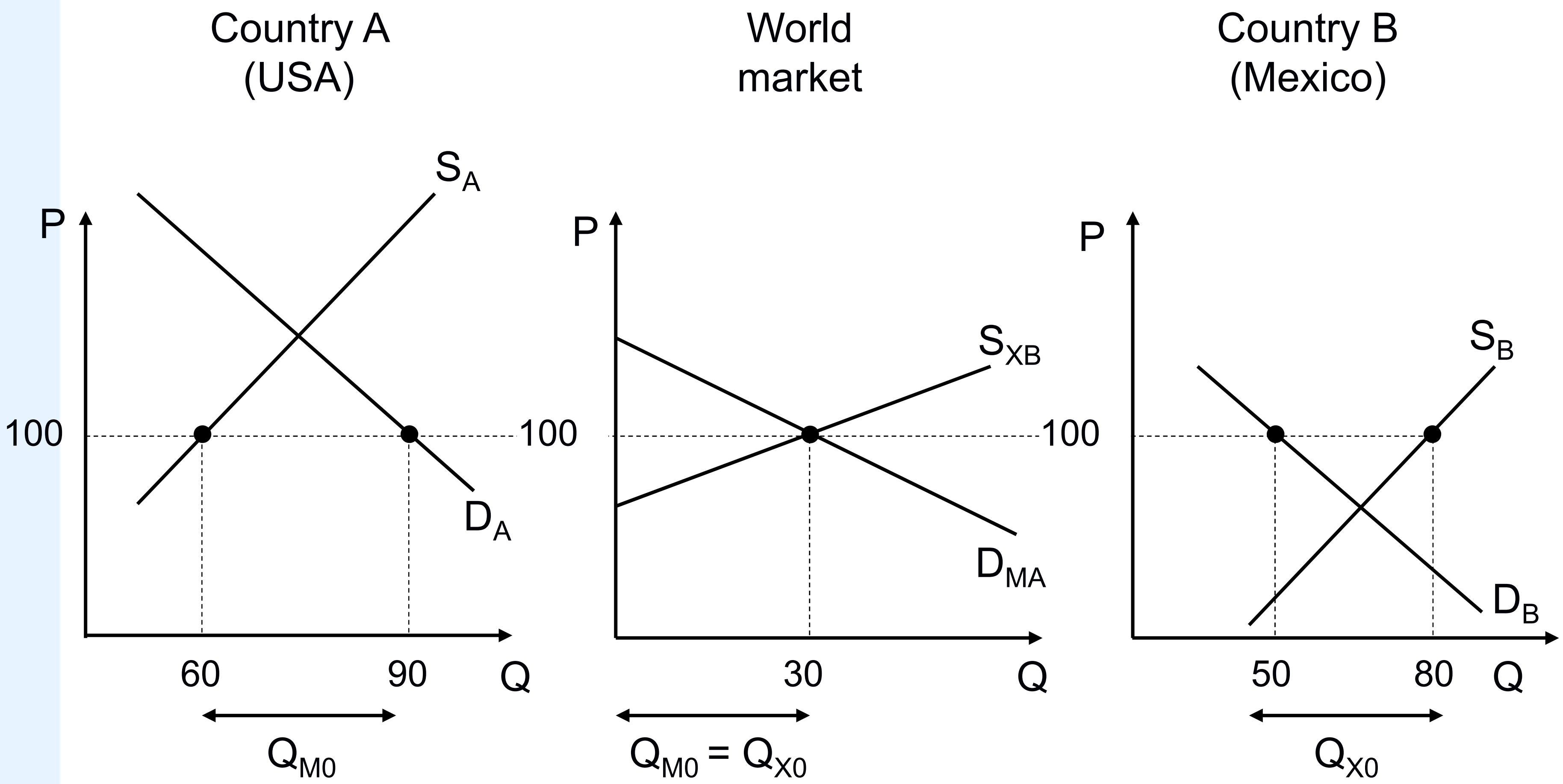
The derivation of a country's supply for exports schedule of a good (AFC Figure 8)



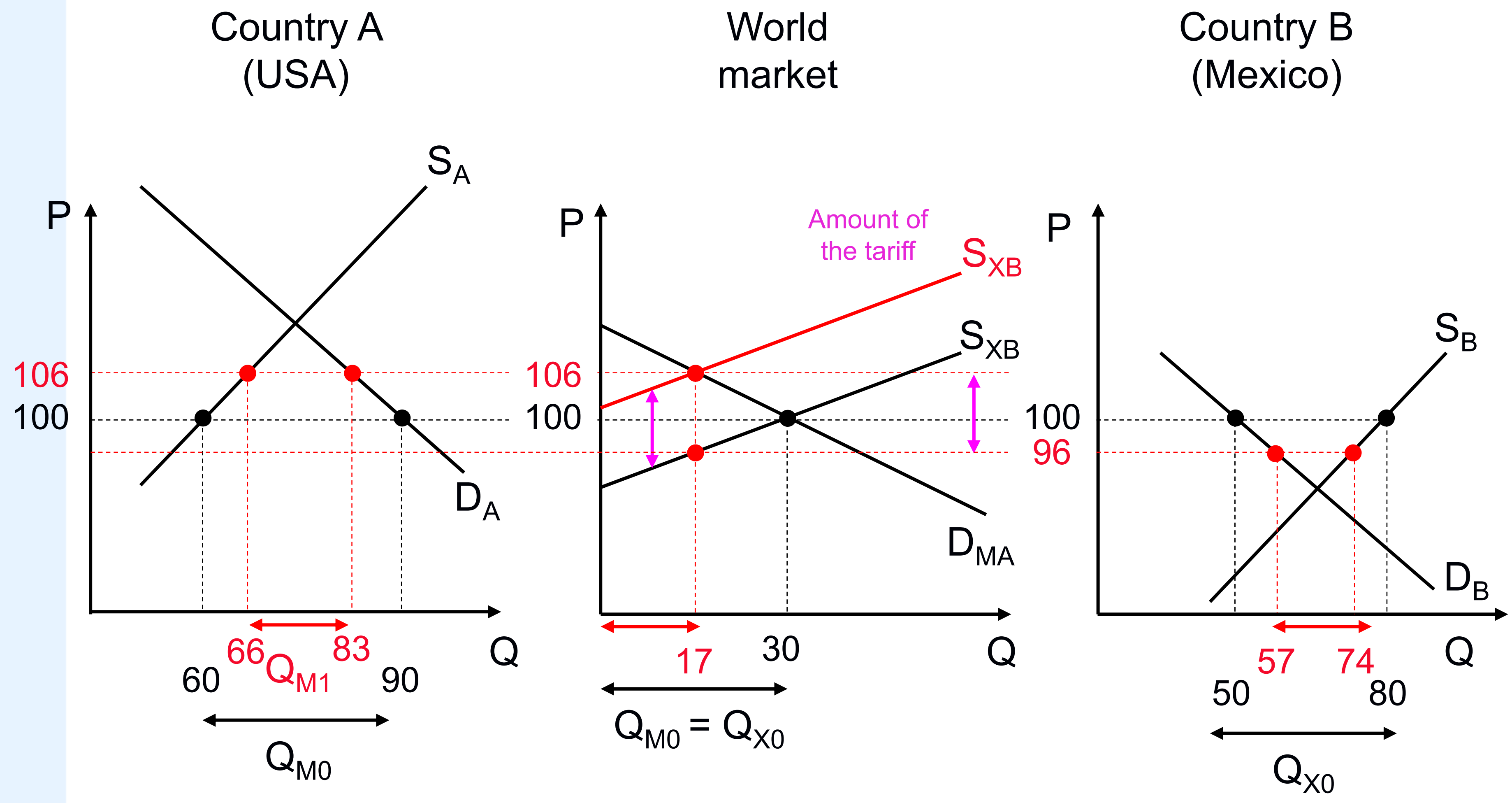
Free trade scenario large country (AFC Figure 10)



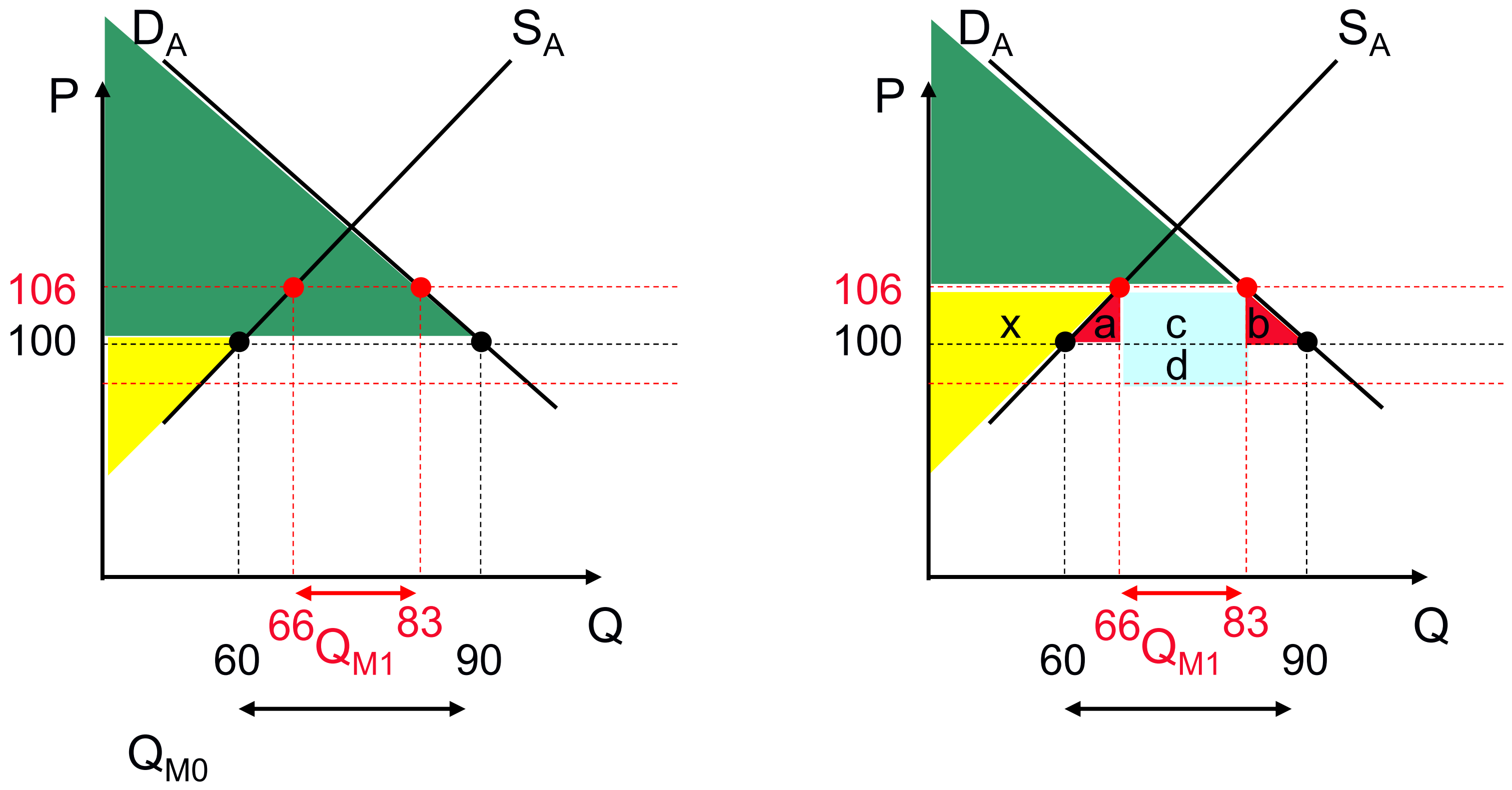
Free trade scenario large country (AFC Figure 10)



The effects of a tariff in a single market in the large country setting (AFC Figure 10)



The effects of a tariff in a single market in the large country setting (AFC Figure 10) Welfare effects in country A



Welfare effects of a tariff in a large country (AFC Figure 10)

- Tariff raises the price in the importing country and lowers it in the exporting country
- Consumers loose in the importing country and gain in the exporting country
- Producers gain in the importing country and loose in the exporting country

Net benefit of a tariff in the country A =

Change in producer surplus		+ government revenue	+ change in consumer surplus	
x	+	c + d	– (x + a + b + c)	= – a – b + d

Welfare effects of a tariff in a large country (KO p. 185, Figures 8-9 and 8-10)

- There are two triangles whose area measures the loss to a nation and a rectangle whose area measures an offsetting gain

- Triangle a: *Production distortion* ➔ tariff leads inefficient domestic producers to produce too much of the good

- Triangle b: *Consumption distortion* ➔ tariff leads consumers to consume too little of the good

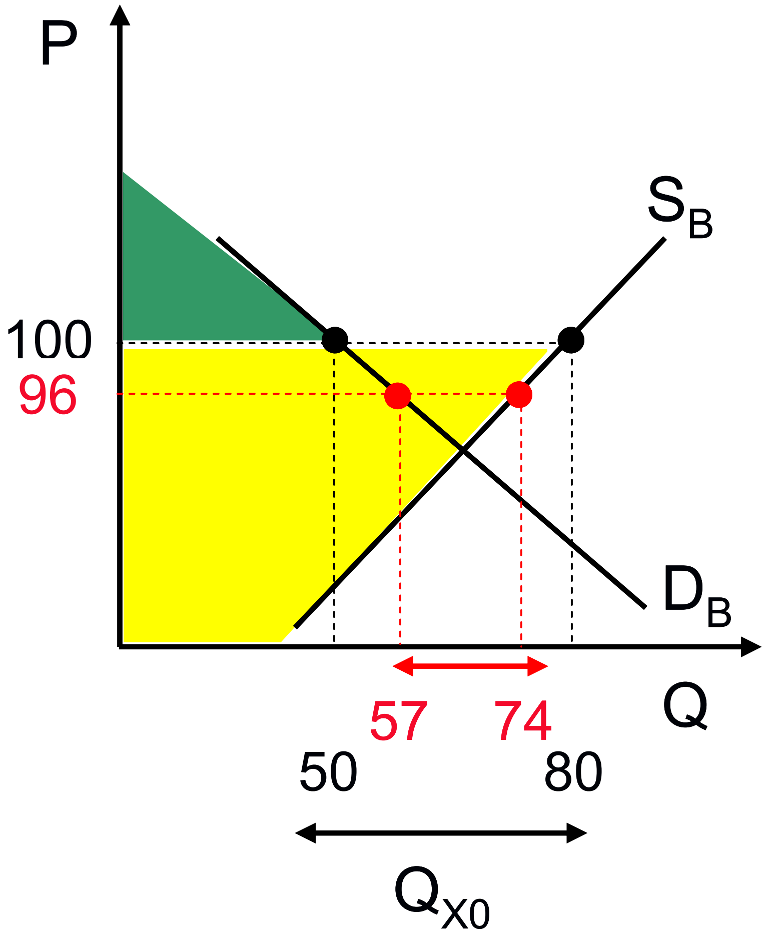
- Rectangle d: represents the *terms of trade gain* that arises because a tariff lowers foreign export prices.
- The gain depends on the ability of the tariff-imposing country to drive down foreign export prices
- If the country cannot affect world prices (small country case), region d, which represents the terms of trade gain, disappears ➔ Tariff reduces welfare in a small country case

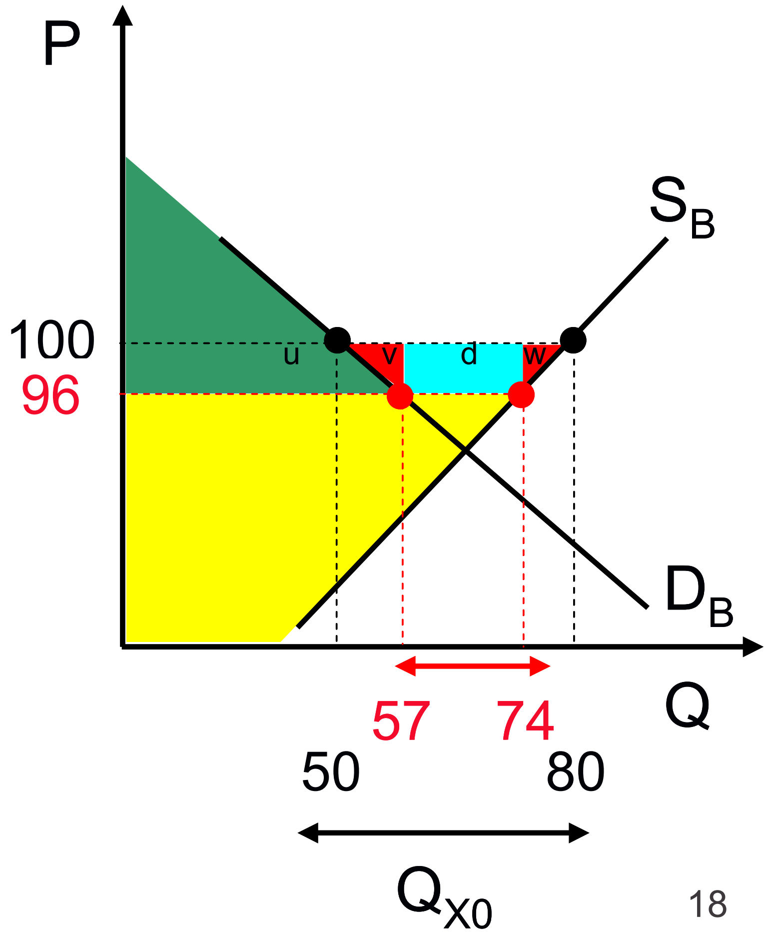
The effects of a tariff in a single market in the large country setting (AFC Figure 10) Welfare effects in country B

Net benefit of a tariff =

consumer gain – producer loss

u – u – v – d – w = – v – d – w





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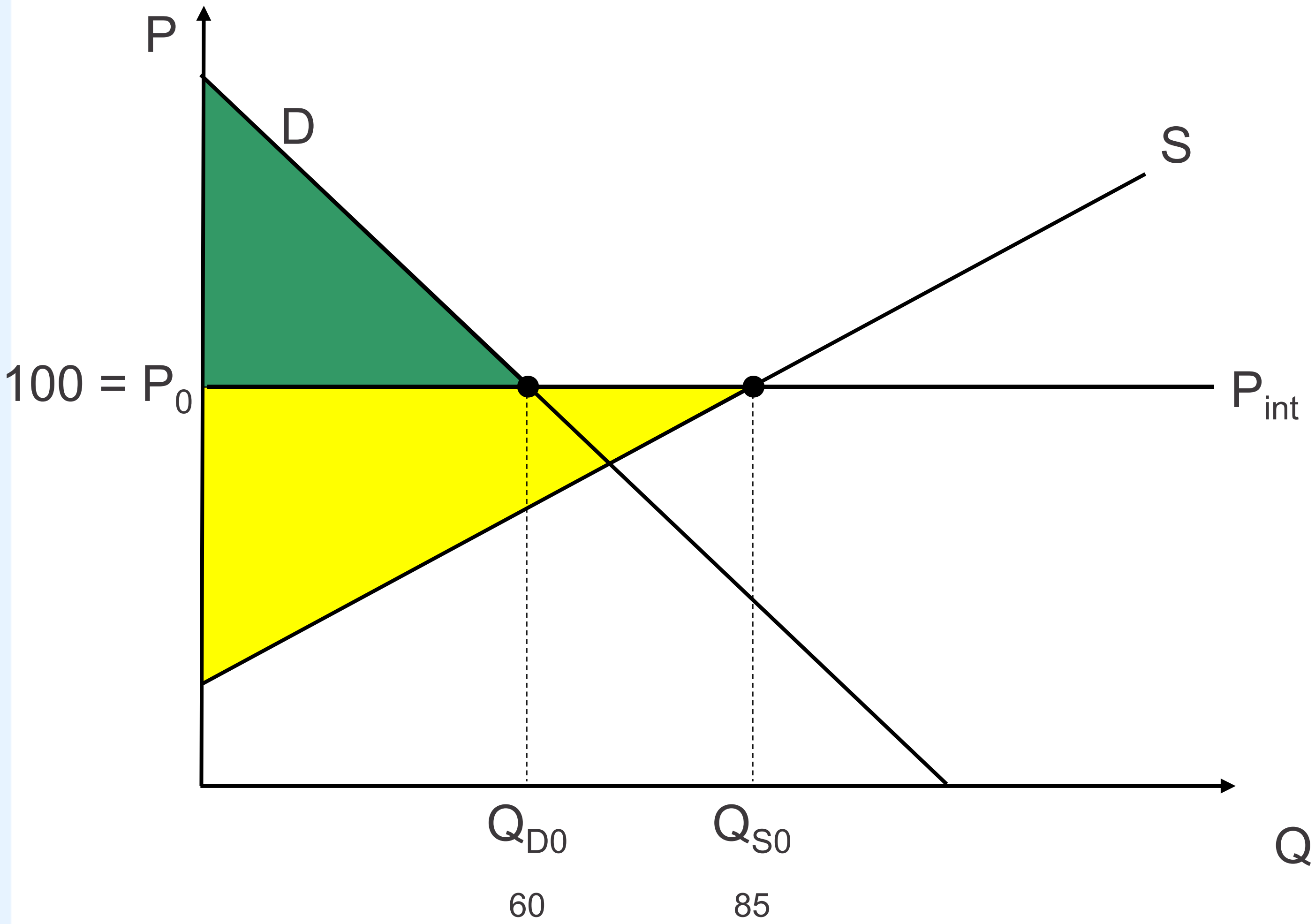
The effects of an export subsidy (AFC Figure 6)

Idea

- The exporting nation implements an export subsidy
- Pay a subsidy for the quantity of goods exported
- Increase the competitiveness of the domestic firms in international good markets

The effects of an export subsidy (AFC Figure 6)

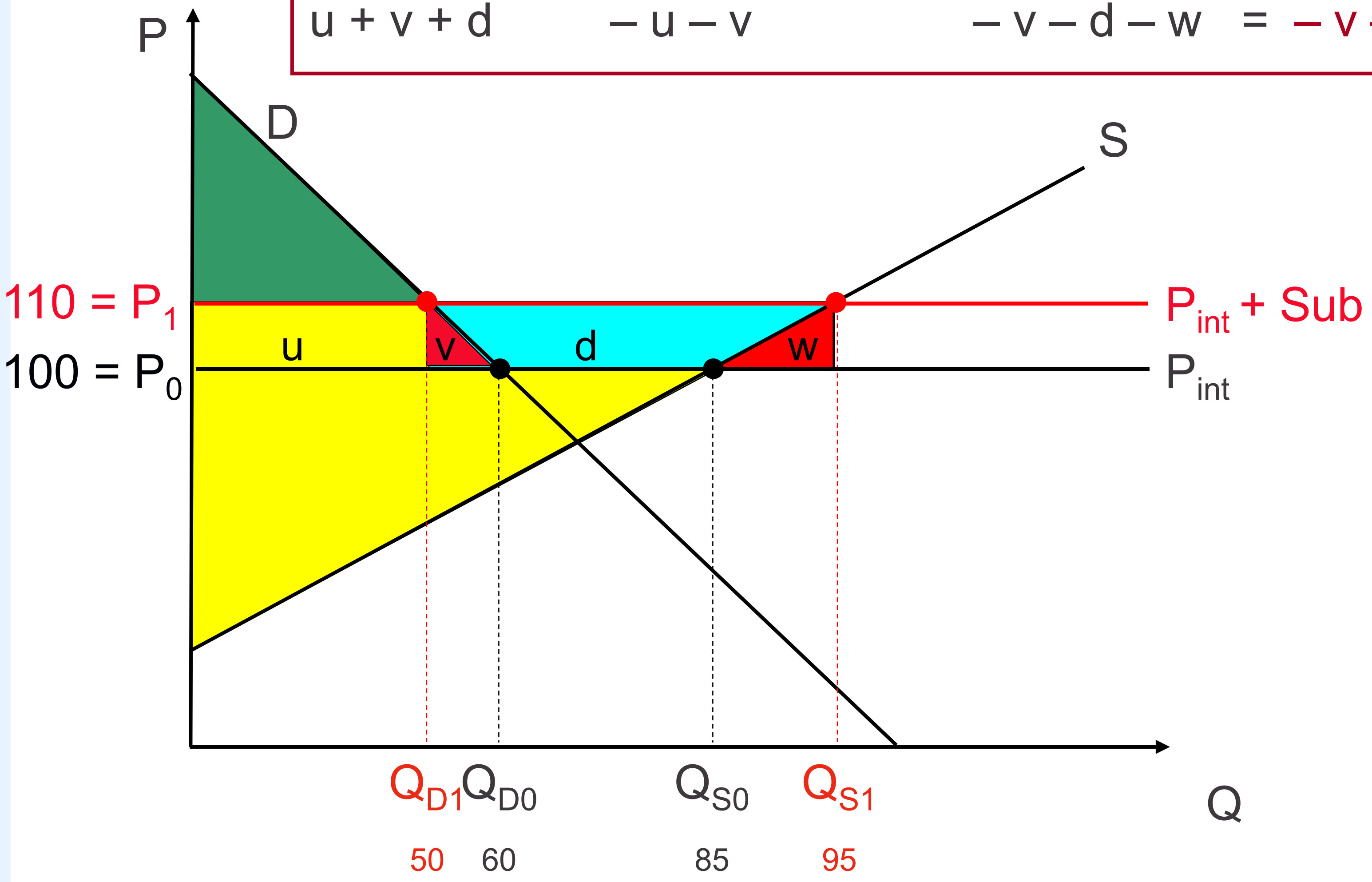


The effects of an export subsidy (AFC Figure 6)

Net benefit of an export subsidy =

producer gain – consumer loss – government spending

u + v + d   – u – v   – v – d – w   = – v – w



Outline

Part 15 (Chapter 9/11 KOM): The political economy of trade policy

- Arguments against free trade
- Arguments in favor of free trade
- The political economy of trade policy
- Strategic trade policy
- Preferential trading agreements

Free trade area versus customs union

Free trade by two different agreements:

- Free trade area (FTA): products can be shipped freely within the FTA but each country has an individual tariff policy against third countries

- Customs union (CU): Free trade among each other + a joined tariff policy against third countries

Free trade area versus customs union (KO Box p. 233)

“The difference between a free trade area and a customs union is, in brief, that the first is politically straightforward but an administrative headache while the second is just the opposite.”

Customs union (CU):

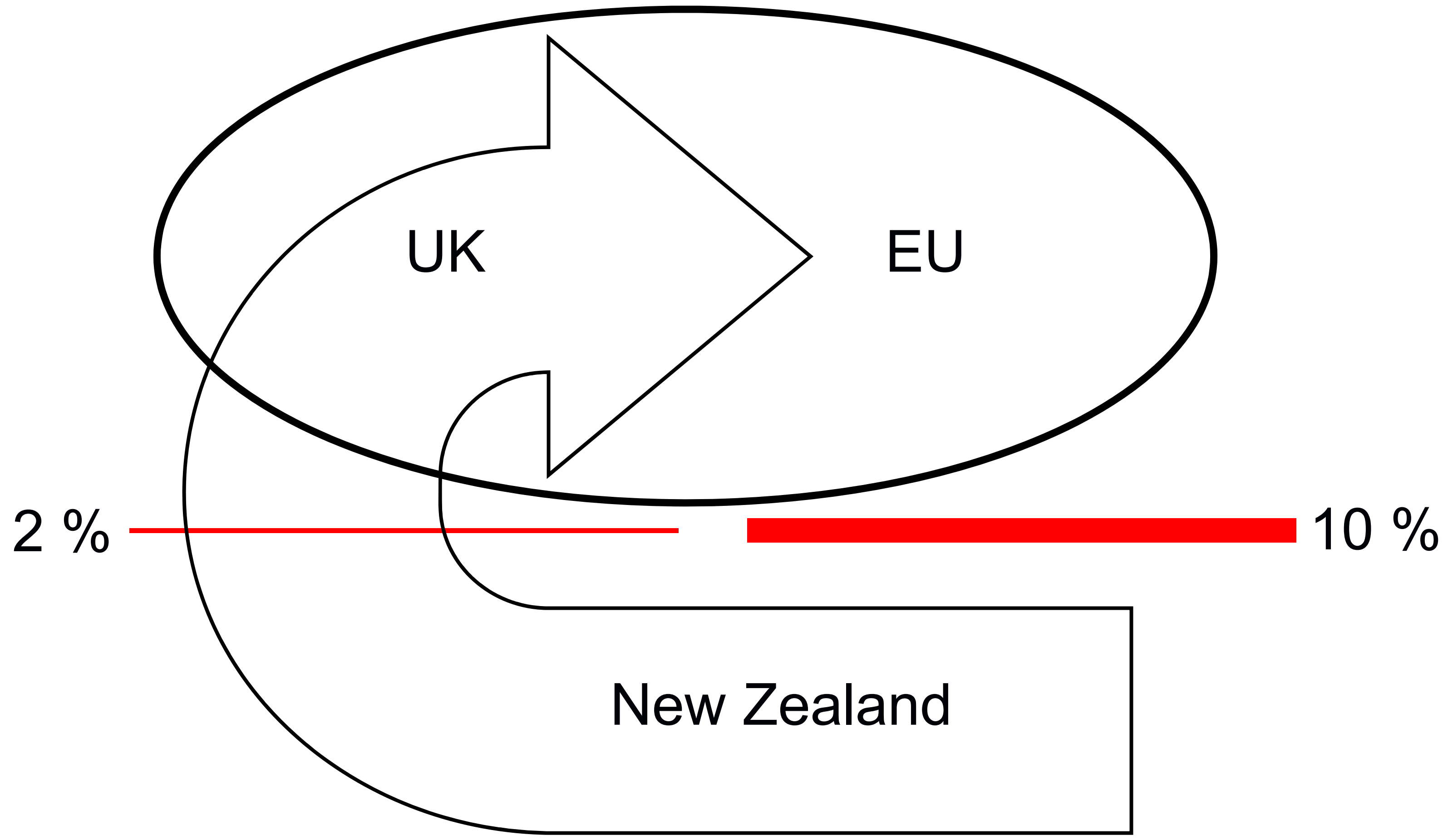
- Goods must pay tariffs when they cross the border from the union, but from then on can be shipped freely between countries.
- The duty must be the same otherwise the importers would choose the point of entry that minimizes their fees.
- Drawback: Countries transfer part of their sovereignty to a supranational entity (for example the EU)

Free trade area versus customs union (KO Box p. 233)

Free trade area:

- Goods (for example butter) can cross the border free of tariff if they where produced in the EU or UK
- How can it be prevented that cheap butter from New Zealand is shipped to the UK and that put on a truck to the EU (Ireland)?
- Customs inspections must still be in place so that only UK goods pass the border and not goods transshipped from third countries!

Free trade area needs local content requirements



Free trade area versus customs union (KO Box p. 233)

What is a New Zealand butter?

- If a butter comes from New Zealand as a 50 Kilo block, but is finally processed in the UK?
- What if New Zealand exports milk, but butter is produced in the UK?
- FTA that is not a CU must check goods at the border AND specify complex "rule of origins" that determine whether a good is eligible to cross the border without paying a tariff.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SCOTLAND
North Sea
Dundee
Edinburgh
Glasgow
United Kingdom
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Isle of Man
Leeds
Manchester
Liverpool
Galway
Dublin
Ireland
Limerick
Amsterdam
The Hague
Netherlan
ENGLAND
Cambridge
Cork
WALES
Oxford
London
Antwerp
Bristol
Cardiff
Brussels
Brighton
Google
Southampton
Lille
Be