

Trade Policy - Tariffs

- Trade Policy Tools
- The government often uses “policy instruments” to “interfere” with free trade.
 - When this occurs, we have “managed trade”

- Types of Trade Policy Tools
- Tariffs
- Non-tariff barriers:
- Quotas
 - VER's
 - Subsidies
 - Licensing Agreements

Tariffs

- There are two types of tariffs that we can consider:

- 1) Specific Tariff – fixed monetary amount per unit
- 2) Ad valorem – constant % of unit's value

Why might a specific tariff be used instead of an ad valorem tariff?

Tariff Legislation

- Types of Tariff Legislations

- 1) Preferential Duties

A tariff rate is applied according to its geographical source – a country is given preferential treatment

- 2) Generalized System of Preferences (GSP)

When a DC permits duty-free entry of selected products from a LDC – the same product from a DC does face the tariff.

- 3) Most favored nation (MFN)

Any country that trades with (for example) the US will get the lowest tariff given by the US to any country for that good

MFN

- Somewhat misleading since most countries do have MFN status.
- MFN indicates that a country is not being discriminated against in regard to tariff rates

Example Suppose that US-India bilateral trade agreement

US lowers tariff on cloth from India; India lowers tariff on computers from US

Countries with MFN status will now receive the lower tariff on cloth they export to the US.

How “closed” is a country?

- Tariffs are a means to “protect” a country from foreign goods – reducing trade – the country becomes more “closed” to trade.

How closed is a country? Can we tell from tariff rates?
We can look at tariff rates in several ways.

- 1) Non-weighted Average Tariff Rates
- 2) Weighted Tariff Rates
- 3) Effective Rate of Protection

Which one is a better indication of the level of protection?

Modeling Tariffs

- How do we model tariffs?
- Specific tariffs are per unit price increases that raise the world price

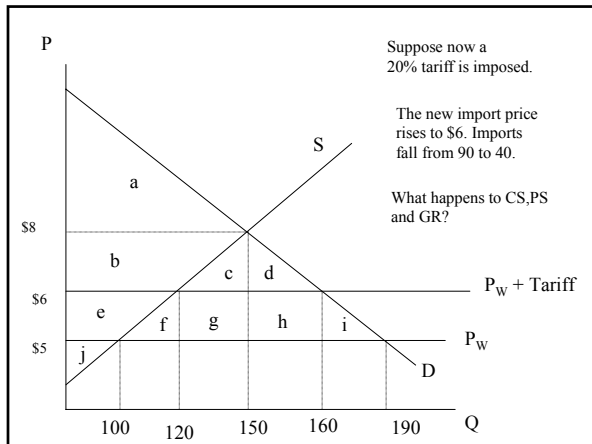
Focus: What happens to domestic production and consumption after the tariff is imposed?

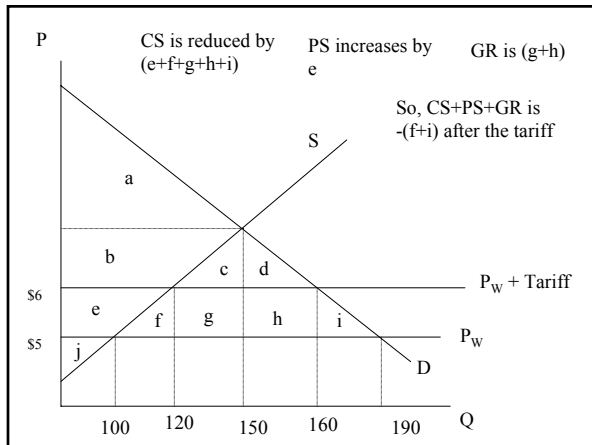
What is government revenue (GR) from the tariff?

National Welfare is now $CS+PS+GR$

Tariff Example

- We first consider a “small country” that wishes to impose a tariff on an imported good.
- A “small country” is a country that cannot affect the world price – it is a “price taker”





Deadweight Loss from Tariff

- For a small country, the deadweight loss from the tariff is the lost consumer surplus that is not gained by increases in PS or GR
- This is welfare that is "lost"

Thus, the optimal tariff (tariff that maximizes national welfare) for a small country, is 0!!

For a small country, tariffs are always welfare reducing!!!

Protection may help an industry, but hurts the country as a whole!

Large Country Tariff

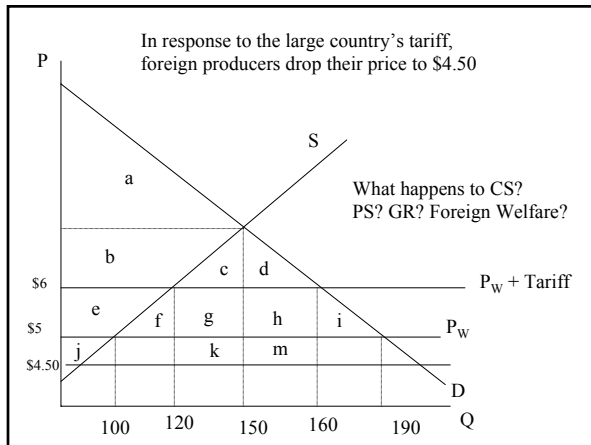
- Do tariffs always reduce welfare in a “large country”?
- “Large country”- a country that can affect the world price (e.g. the US is a large country)

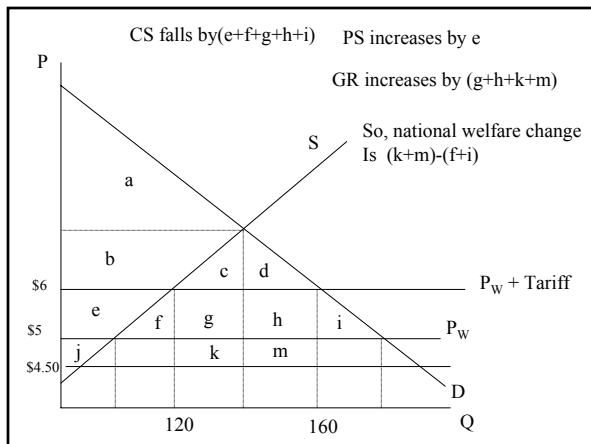
Can a tariff in a large country actually increase national welfare?

Ex. Suppose that the US puts a tariff on imported cars

There now exists a wedge between what we pay and what foreign producers receive

The response by foreign firms may be to drop the price to keep from losing too many exports





Large Country Tariff

- Now, national welfare is not necessarily negative. The deadweight loss of the tariff may be outweighed by the increase in GR.
- Area (k+m) is the amount by which foreign producers “pay” for the tariff by lowering the price to save imports

The larger the area (k+m), the greater the likelihood that the US gains from the tariff – the size of (k+m) comes from the reaction by foreign firms to the tariff.

Note: So government would like to maximize (k+m)- (f+i)

Optimal Tariff for Large Country

- Note that if the country sets too high of a tariff, the foreign reaction may be greater, increasing (k+m), but that also increases (g+h)
- Too low of a tariff, (k+m) small but so is (g+h)

The “optimal tariff” is equal to: $1/(e_{\Pi} - 1)$

Where e_{Π} is the foreign price elasticity of demand
