

## Trade Policy - Tariffs

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## Trade Policy Tools

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

Recall that although free trade is recognized to be beneficial overall to an economy, the Stolpher-Samuelson rule pointed out that there will be people hurt by trade.

Thus, we see a cause for “protectionism.”

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## Types of Trade Policy Tools

Tariffs

Non-tariff barriers:

Quotas	Subsidies
VER's	Licensing Agreements

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## 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?

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## 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

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## 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.

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### 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?

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### Effective Tariff

- Extent to which price of the final good is raised by tariffs
- Analysis is though how tariffs raise the industry’s value added per unit of output.

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### 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

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## 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”

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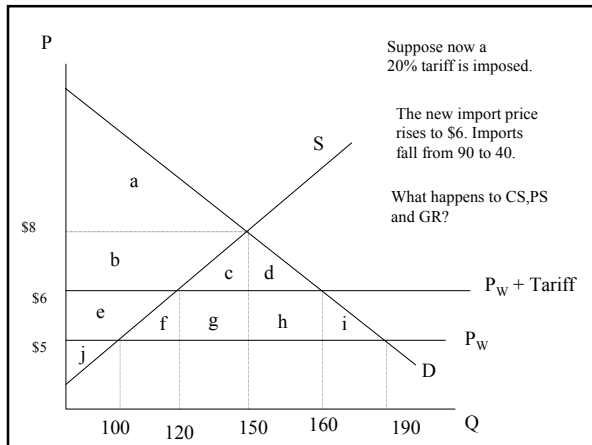
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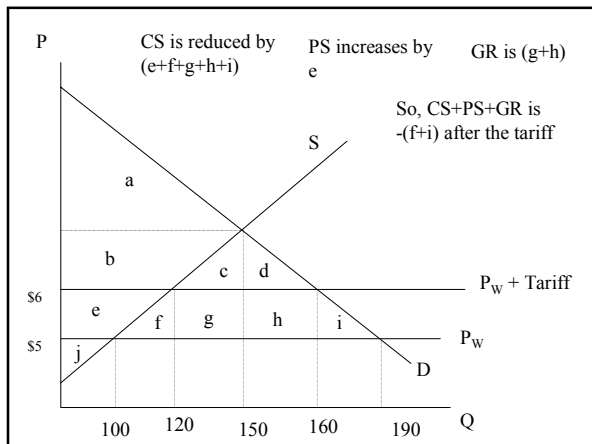
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## Deadweight Loss from Tariff

- 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!

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## 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

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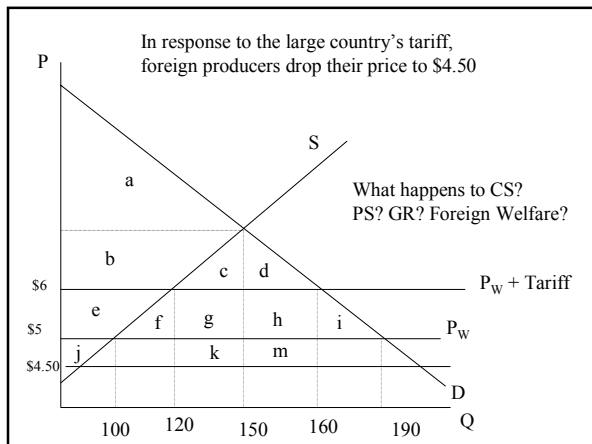
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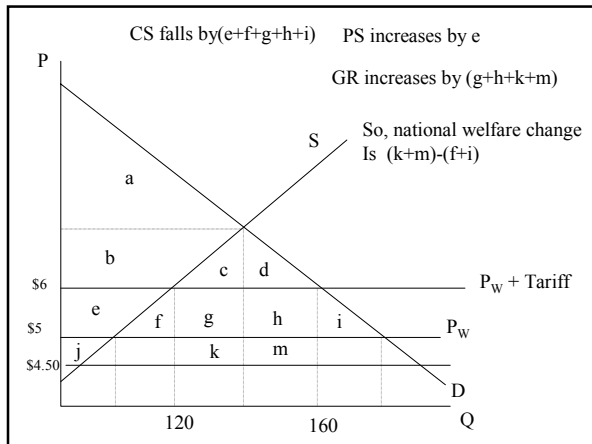
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**Large Country Tariff**

- 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)- (g+h)

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**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  $e_{\pi}$  is the foreign price elasticity of demand

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