International Trade

L17

Instruments of trade policy

- Tariff
- Export Subsidies
- Import Quotas
- Voluntary export restraints
- Local content requirements

Export Subsidies

- An **export subsidy** is a payment to a firm or individual that exports goods abroad.
- Like a tariff, an export subsidy can be either specific (a fixed sum per unit) or ad valorem (a proportion of the value exported).
- When the government offers an export subsidy, firms will export the good up to the point at which the domestic price exceeds the foreign price by the amount of the subsidy.
- Export subsidy includes-direct payments, low cost loans, tax relief designed to encourage exports

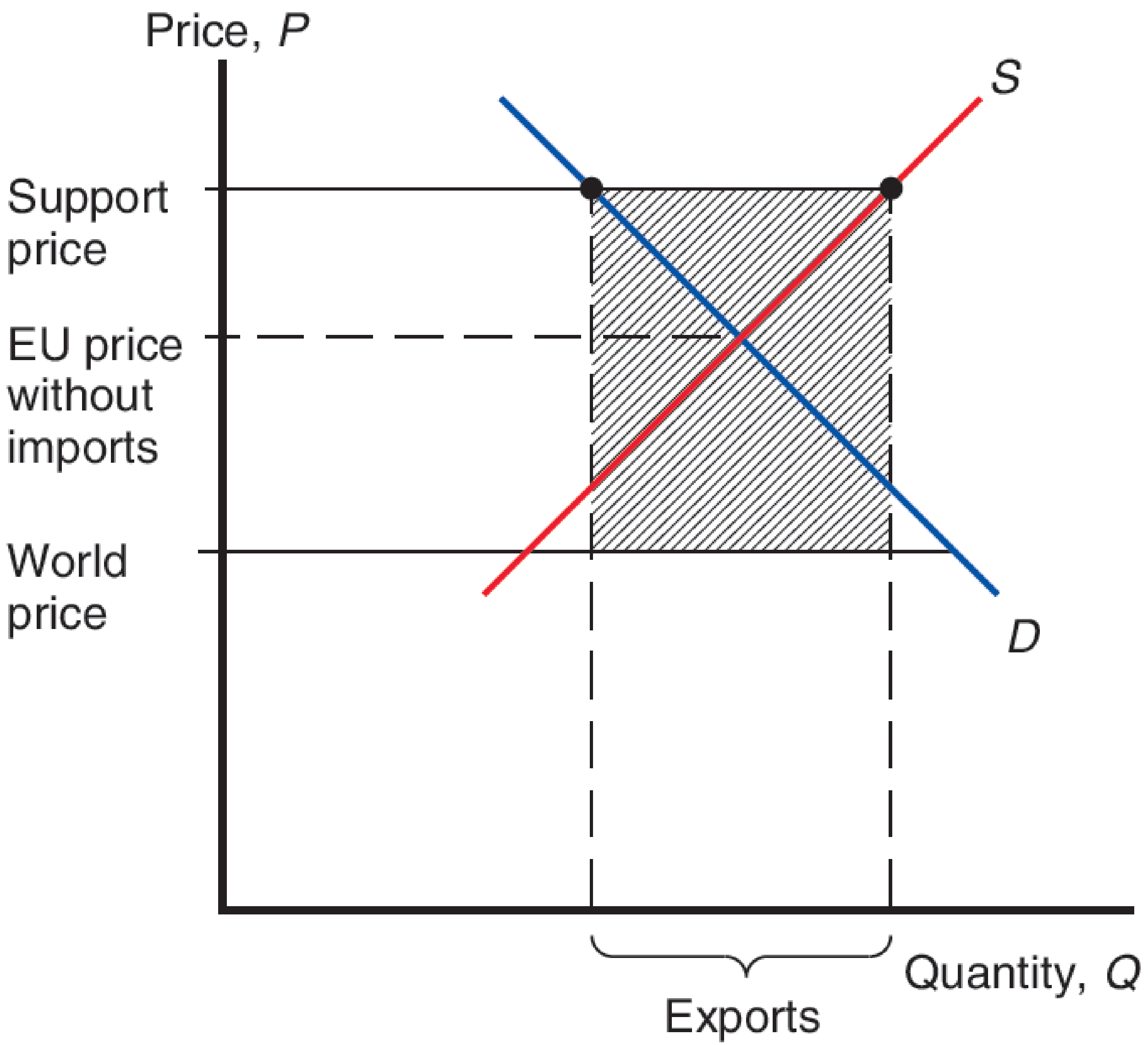
European common agricultural policy (CAP)

- Six Western European nations—Germany, France, Italy, Belgium, the Netherlands, and Luxembourg—formed the **European Economic Community in 1957.** Now called as the **European Union (EU),**
- Its two biggest effects are on trade policy.
- First- all member countries removed all tariffs with respect to each other – creating **Customs Union (CU)**
- Second-the common agricultural policy (CAP) of the EU resulted into massive export subsidy program

European common agricultural policy (CAP)

- CAP – started as a measure to **guarantee high prices to European farmers** by having the EU buy agricultural products whenever the prices fell below specified support levels.
- **To prevent** this policy from drawing in **large quantities of imports**, it was **initially backed by tariffs** that offset the difference between European and world agricultural prices.
- Since the 1970s, however, **the support prices** set by the European Union have turned out to be **so high** that Europe—which, under free trade, would be an importer of most agricultural products—**was producing more than consumers were willing to buy**. As a result, **the European Union** found itself obliged **to buy and store huge quantities** of food.
- To **avoid unlimited growth in these stockpiles**, the European Union turned to a **policy of subsidizing exports to dispose of surplus production**.

EU-CAP



Price, P
S
Support price
EU price without imports
World price
D
Exports
Quantity, Q

European common agricultural policy (CAP)

- The subsidized exports themselves tend to **depress the world price**, **increasing the required subsidy.**
- the **welfare cost to European consumers exceeded the benefits to farm producers** by nearly $30 billion in 2007-
- Despite the considerable net **costs of the CAP to EU consumers and taxpayers**-political strength of farmers in the EU has been strong that the program has been difficult to withdraw.
- Further source of pressure started coming from outside EU- **US and other food exporting nations complain that EU's export subsidies drive down the price of their exports**.
- **Later Reforms** in Europe's agricultural policy represent **an effort to reduce the distortion** of incentives caused by price support while continuing to provide aid to farmers. **Farmers will increasingly receive direct payments that aren't tied to how much they produce**; this should lower agricultural prices and reduce production

Import Quota

- An import quota is a direct restriction on the quantity of some good that may be imported.
- The restriction is usually enforced by issuing licenses to some group of individuals or firms.
- ***An import quota always raises the domestic price of the imported good.***
- When imports are limited, the immediate result is that at the initial price, the demand for the good exceeds domestic supply plus imports. This causes the price to be bid up until the market clears.
- **In the end, an import quota will raise domestic prices by the same amount as a tariff that limits imports to the same level.**

Import Quota

- The difference between a quota and a tariff is that with a quota, the **government receives no revenue.**
- When a quota (instead of a tariff) is used to restrict imports, **the sum of money** that would have appeared with a tariff as government revenue **is collected by whoever receives the import licenses.**
- **License holders- buy imports and resell- at a higher price in the domestic market**. The profit received by the holders of import license are known as **Quota rents**.
- When the rights to sell in the domestic market are assigned to governments of exporting countries (which is often the case)-transfer of quota rent abroad makes the cost of quota substantially higher that equivalent tariff.

Tariff Rate Quota origin: Case study

- The **bound tariff rate**, which is the maximum allowable rate under a country's WTO commitments, in most cases is quite high, particularly in developing countries.
- India had a 40 percent **applied tariff**, but imposed a 100 percent bound tariff rate. (binding overhang)
- In International trade- oilseed products most highly traded agricultural product (followed by grains and meat).
- Oilseeds- have high oil content –soybeans, sunflower, flax, cottonseed
- In 1990s-world trade in oilseeds-moderate applied tariffs and bound tariffs

Tariff Rate Quota origin: Case study

- Tariff rates on oilseed products (for example, vegetable oils and oilseed meal) were much higher than those on whole oilseeds.
- This situation is called ***tariff escalation*** and its practice was designed mainly for two main reasons:
    - to protect both domestic oilseed crushing industry and vegetable oil refineries, and
    - to discourage the development of processing activities in the countries of its origin.

Tariff Rate Quota origin: Case study

- Although the duty on soybeans imports was bound duty-free under WTO commitment, all other oilseeds and oilseed meals imports also had free of duty import status under the Dillon round (1960).
- An **alternative measure** in the form of **non-tariff policies (NTM)**, specifically **domestic price support and subsidies served producers as a substitute.**
- These policies encouraged- excess production and distorted trade flows as well as reduced world imports, increased export subsidies, encouraged low-price selling on world markets.
- The EU oilseed **production subsidies, real price supports, budgetary expenditures or oilseed crops increased substantially- domestic producers increased oilseed production**

Tariff Rate Quota origin: Case study

- EU tripled oilseed production (b/w 1980-1990)= resulted in export drop of around 53 % in soyabean from US to EU- led to oilseeds dispute between US and EU- later solved by **Blair House Agreement on oil seeds** (Uruguay Round Agreement on Agriculture-URAA)
- **URAA** - reduction of protection (trade barriers) ; tariff cut on Agri products; lowering volume of and expenditures on subsidized export; and reducing domestic programs for agriculture

Tariff Rate Quota origin: Case study

- URAA commitments:
  - Developed countries required to reduce existing tariff on agricultural products on average of 36%. Developing countries-on average of 24% tariff reduction (relatively smaller) and longer transition period compared to developed nations.
  - Committed to convert existing non-tariff agricultural trade barriers to tariffs-establishing a **tariff rate quota (TRQ).**
  - Tariffs were to be reduced from base level to a bound level
  - The size of quota was aimed to be equal or greater than actual import levels during a recent period

Tariff Rate Quota origin: Case study

- **TRQ/ Applied tariff** : was to impose a lower tariff rate to imports below a certain quantitative limit and higher tariffs to imports above that initial limit
- TRQ implies easier market access
- In 1997, out of total TRQs to increase quotas-9% were applied to oilseeds and products
- For instance, Iceland had 22 TRQs—Colombia, 20; Venezuela, 19; South Africa, 8; Guatemala, 7; and Thailand and Morocco had 6.8
- The URAA fixed an upper bound on tariff levels for agricultural commodities, however these limits were often quite high, varying by country.

Quota origin: Case study

- The establishment of TRQ aimed to bring more transparency of non-tariff barriers to trade and though was a major achievement, the level of trade creation resulting from these TRQs were quite modest.
- For TRQ quotas to be more effective and for the trade to be more liberalized reduced tariffs (or elimination) on imports above the quota or increased the quota level would be far better options for overall trade.
- The modest result was mostly linked to high over-quotas tariff rates, which was a barrier to trade in oilseeds and products.
- Overall tariff-rate quota became a more often used form of domestic market protection and in a way a gradual alternative to international trade liberalization form.

Voluntary Export Restraints (VER?VRA)

- A variant on the import quota is the **voluntary export restraint (VER),** also known as a voluntary restraint agreement (VRA).
- VER is a quota on trade imposed from the exporting country's side instead of the importer's.
- VER are generally imposed at the request of the importer and are agreed to by the exporter to forestall other trade restrictions- certain political and legal advantages have made VERs preferred instruments of trade policy in some cases.
- Economic point of view: VER is exactly like an import quota where where the licenses are assigned to foreign governments and is therefore very costly to the importing country.
- The most famous example is the limitation on auto exports to the United States enforced by Japan after 1981.

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Voluntary Export Restraints (VER?VRA)

- A VER is always more costly to the importing country than a tariff that limits imports by the same amount.
- The difference is that what would have been revenue under a tariff becomes rents earned by foreigners under the VER, so that the VER clearly produces a loss for the importing country. Thus VER- beneficial for exporting country
- The most famous VER multilateral agreement is the Multi-Fiber Arrangement, which limited textile exports from 22 countries until the beginning of 2005. Such multilateral VER are known as **OMA, for “orderly marketing agreement**.”
- VER no longer allowed under WTO rules

VER case study: Japanese auto in US market

- 1960s-1970s US auto industry insulated from import competition by difference in preference of US car consumers
- US consumers face low gasoline taxes-preferred larger cars than Europeans or Japanese (small-car markets). Hence foreign firms has chosen not to challenge US large-car markets
- 1979- sharp oil price increase- gasoline shortage- US market preference shifted to small cars
- Japanese producers (low cost comparative advantage to US firms) filled the new demand
- Result- Japanese market share soared, US output fell

VER case study: Japanese auto in US market

- Strong political forces in US demanded protection
- To avoid the risk of trade war, US govt demanded Japanese govt to restrict its exports
- Japanese govt. – to avoid unilateral protectionist methods from US-agreed to limit the exports- Agreement in 1981 and it lapsed in 1985
- Effect of VER- ambiguous:
  - A) Japanese and US cars were not perfect substitutes
  - B) Japanese industry responded to VER by upgrading quality and selling large autos with more features-increasing competition to US firms

VER case study: Japanese auto in US market

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  - A) Japanese and US cars were not perfect substitutes
  - B) Japanese industry responded to VER by upgrading quality and selling large autos with more features-increasing competition to US firms
  - C) Auto industry not perfectly competitive
- VER result: Price of Japanese car in US increased- with higher benefit flow to Japanese
- Total cost to US (around $3.2 billion in 1984) primarily in transfers to Japan rather than efficiency losses

Local Content Requirements (LCR)

- LCR is a regulation that requires some specified fraction of a final good to be produced domestically
- This fraction is specified in physical units or in value terms (by requiring that some minimum share of the price of a good represent domestic value added)
- LCR more attractive as a non-tariff form of protectionsim
- Local content laws have been widely used by developing countries trying to shift their manufacturing base from assembly back into intermediate goods
- For domestic producers of parts, a local content regulation provides protection in the same way an import quota does

LCR

- Firms must buy locally- but with no import restriction. Firms can import more provided they also buy more domestically
- This means that the effective price of inputs to the firm is an average of the price of imported and domestically produced inputs.
- The important point is that a local content requirement does not produce either government revenue or quota rents. Instead, the difference between the prices of imports and domestic goods in effect gets averaged in the final price and is passed on to consumers.
- However LCR- pushes domestic employment and industrial production

Effects of Alternative Trade Policies

Policy	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)
Overall national welfare	Ambiguous (falls for small country)	Falls	Ambiguous (falls for small country)	Falls

Effect of Trade policies

- All four trade policies benefit producers and hurt consumers.
- The effects of the policies on economic welfare are at best ambiguous
- Two of the policies definitely hurt the nation as a whole, while tariffs and import quotas are potentially beneficial only for large countries that can drive down world prices.

Assignment

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