The Instruments of Trade Policy

Basic Tariff Analysis:

Tariffs, as taxes imposed on imports. It provides a fundamental analysis of how tariffs work, illustrating their effects on prices, consumer surplus, and producer surplus. The analysis is conducted within a partial equilibrium framework, focusing on a single industry while assuming other markets remain unchanged. This approach simplifies understanding the immediate impacts of tariffs on domestic markets.

Supply, Demand, and Trade in a Single Industry

Here, the chapter delves into the mechanics of supply and demand within a specific industry that is subject to international trade. It describes how the introduction of a tariff affects the equilibrium prices and quantities, both domestically and internationally. This section includes diagrams and mathematical models to depict shifts in supply and demand curves due to tariffs.

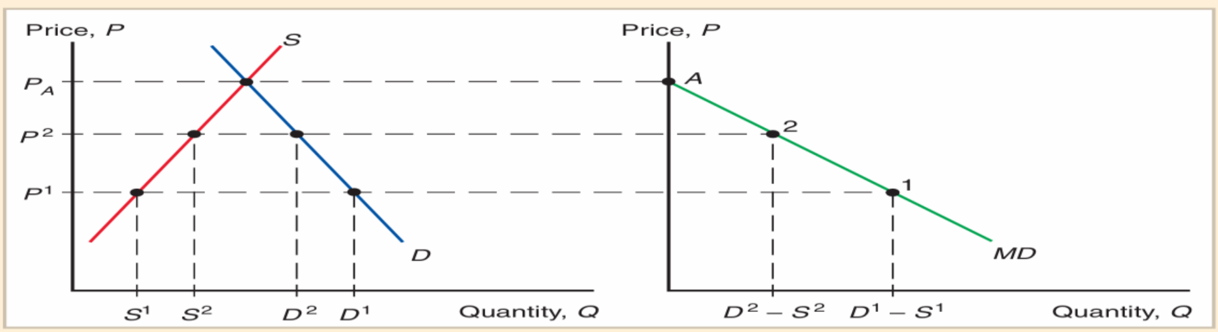


Figure 9-1
Deriving Home's Import Demand Curve
As the price of the good increases, Home consumers demand less, while Home producers supply more, so that the demand for imports declines.

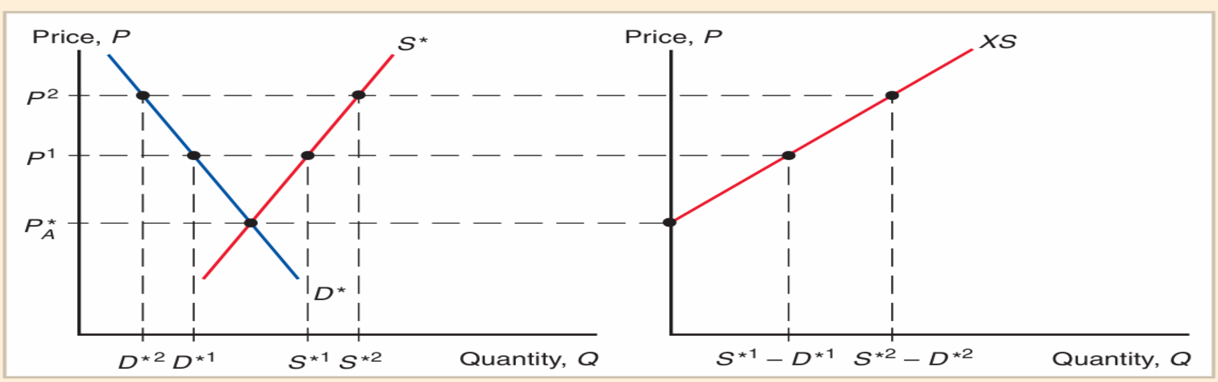
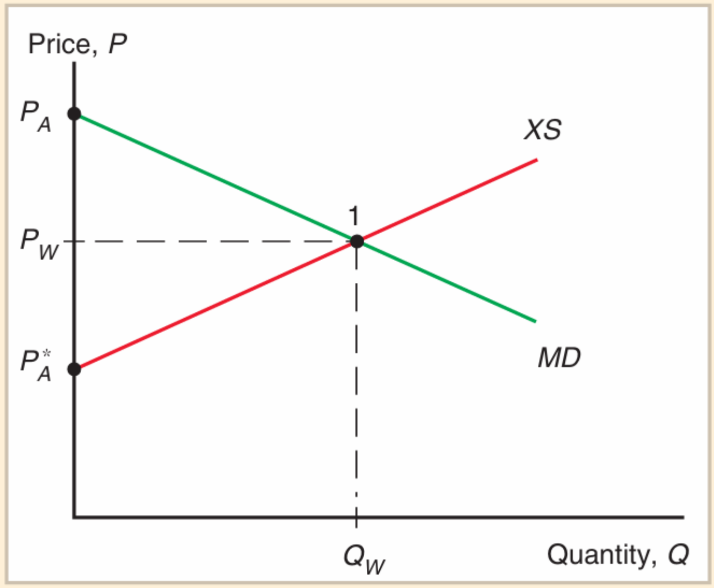


Figure 9-2
Deriving Foreign's Export Supply Curve
As the price of the good rises, Foreign producers supply more while Foreign consumers demand less, so that the supply available for export rises.

Figure 9-3

World Equilibrium

The equilibrium world price is where Home import demand (*MD* curve) equals Foreign export supply (*XS* curve).



Effects of a Tariff

This part outlines the various effects a tariff has on the economy, highlighting changes in consumer and producer surplus, government revenue, and overall welfare. The discussion includes both graphical and algebraic representations to show the distribution of gains and losses among different economic agents. The section emphasizes the welfare loss due to tariffs, known as the deadweight loss, which represents the efficiency cost to society.

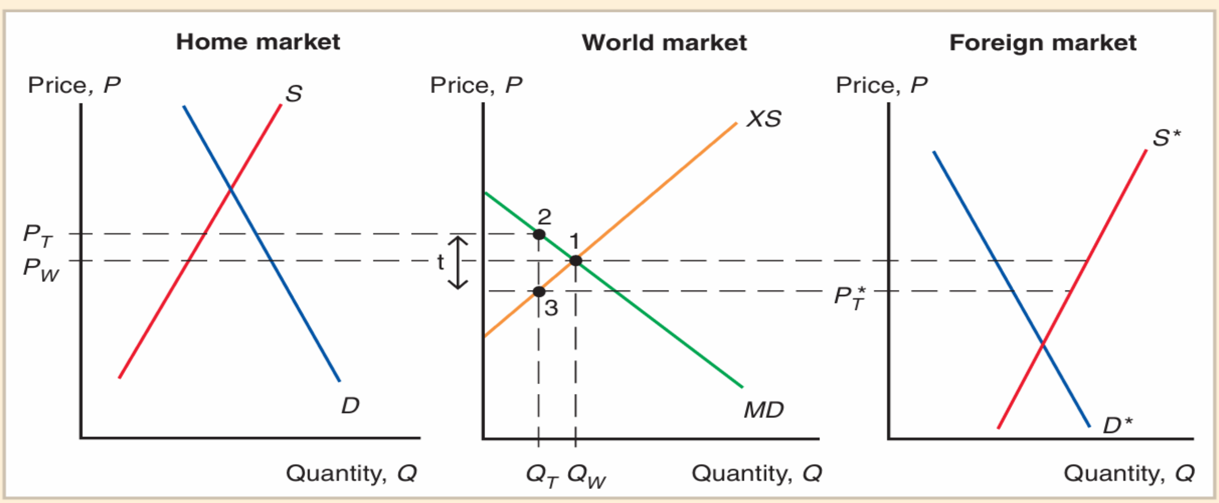


Figure 9-4

Effects of a Tariff

A tariff raises the price in Home while lowering the price in Foreign. The volume traded thus declines.

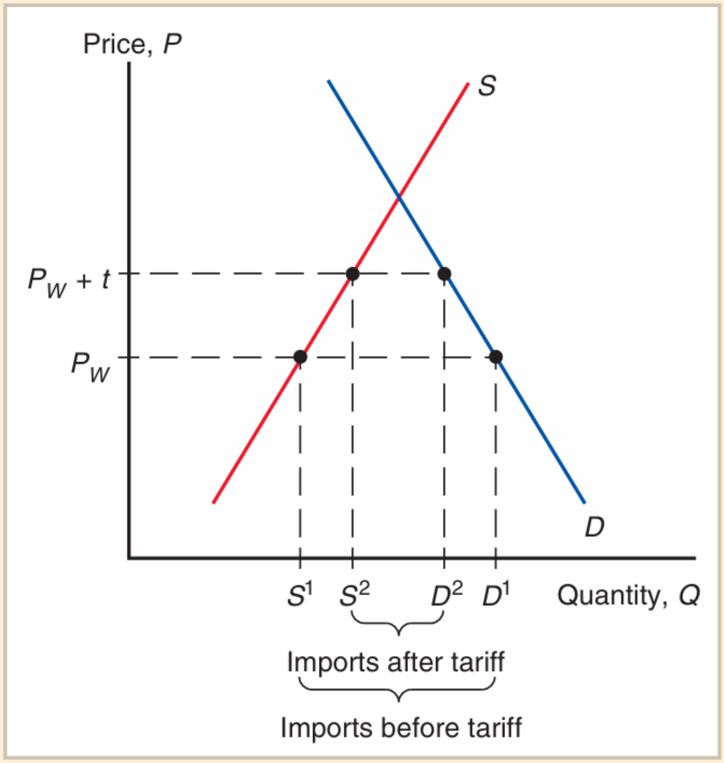
Measuring the Amount of Protection

The chapter continues by discussing how to measure the level of protection afforded by tariffs. It introduces the concept of effective rate of protection, which considers not only the tariffs on final goods but also those on intermediate goods. This measure provides a more accurate picture of the protective effect of trade policies on domestic industries.

Figure 9-5

A Tariff in a Small Country

When a country is small, a tariff it imposes cannot lower the foreign price of the good it imports. As a result, the price of the import rises from P_W to $P_W + t$ and the quantity of imports demanded falls from $D^1 - S^1$ to $D^2 - S^2$.



Costs and Benefits of a Tariff

In this section, the analysis focuses on the detailed costs and benefits of imposing a tariff. It breaks down the effects into specific components: the gain to domestic producers, the loss to domestic consumers, and the revenue gained by the government. The section also introduces the concept of deadweight loss, illustrating how tariffs can lead to inefficiencies in the market.

Consumer and Producer Surplus

This part explains the concepts of consumer and producer surplus in detail. Consumer surplus is defined as the difference between what consumers are willing to pay and what they actually pay, while producer surplus is the difference between the market price and the minimum price producers are willing to accept. The section shows how tariffs affect these surpluses, leading to a redistribution of welfare.

Measuring the Costs and Benefits

The chapter provides methods for quantifying the costs and benefits of tariffs, using consumer and producer surplus as key metrics. It discusses how to calculate changes in these surpluses and the overall impact on social welfare. The section also covers the revenue effects of tariffs and their implications for government budgets.

Figure 9-9

Costs and Benefits of a Tariff for the Importing Country

The costs and benefits to different groups can be represented as sums of the five areas *a*, *b*, *c*, *d*, and *e*.

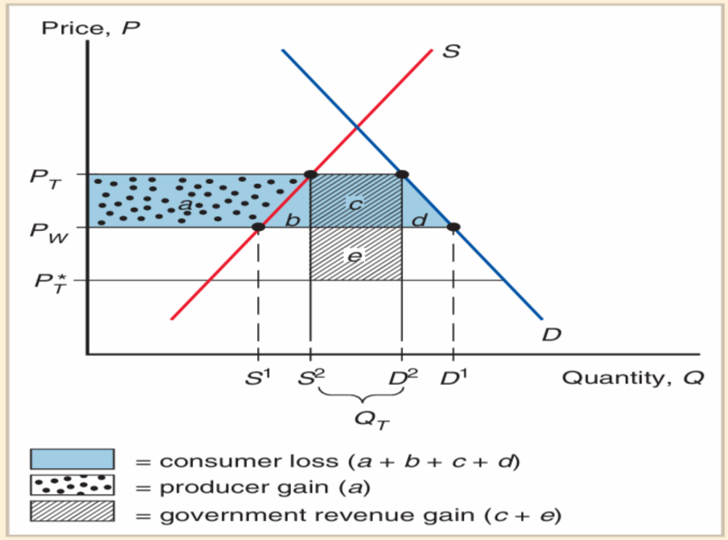
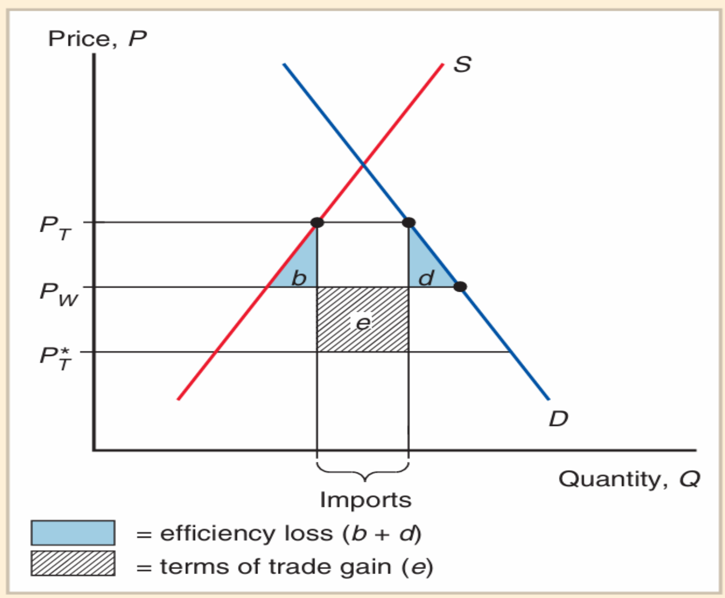


Figure 9-10

Net Welfare Effects of a Tariff

The colored triangles represent efficiency losses, while the rectangle represents a terms of trade gain.



<u>Other Instruments of Trade Policy:</u>

Beyond tariffs, this section explores various other trade policy instruments such as quotas, subsidies, and voluntary export restraints. It explains how each of these instruments works, their economic implications, and how they compare to tariffs in terms of effectiveness and impact on welfare.

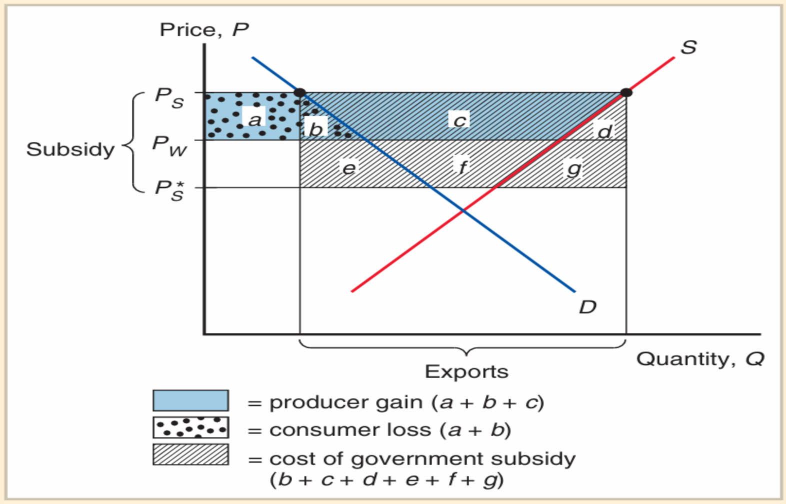
Export Subsidies: Theory

This part examines the theoretical underpinnings of export subsidies, which are payments made by the government to encourage domestic firms to export. It discusses the intended benefits of such subsidies, like increasing market share abroad, and their potential downsides, including trade distortions and retaliation from other countries.

Figure 9-11

Effects of an Export Subsidy

An export subsidy raises prices in the exporting country while lowering them in the importing country.



Import Quotas: Theory

The chapter discusses import quotas, which are limits on the quantity of a good that can be imported. It explains the economic rationale behind quotas, their effects on prices and quantities, and how they differ from tariffs in terms of market outcomes and welfare implications.

Voluntary Export Restraints

Voluntary export restraints (VERs) are agreements between exporting and importing countries where the exporter agrees to limit the quantity of goods exported. This section explains how VERs work, their economic effects, and why countries might prefer them over other trade restrictions.

Local Content Requirements

Local content requirements mandate that a certain percentage of a final good must be produced domestically. This section explores the rationale behind these requirements, their economic impact, and their role in trade policy.

Other Trade Policy Instruments

The chapter concludes with a discussion of various other trade policy tools that governments use to influence international trade. These may include anti-dumping duties, countervailing duties, and regulatory barriers. The section highlights the diversity of instruments available and their varying effects on trade and welfare.

<u>The Effects of Trade Policy: A Summary</u>

This summary section recaps the key points discussed in the chapter, providing a consolidated view of how different trade policies affect economic welfare. It compares the effectiveness of tariffs, quotas, subsidies, and other instruments, emphasizing their common goal of protecting domestic industries while noting the trade-offs involved.

TABLE 9-1 Effects of Alternative Trade Policies

	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