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Continuation from last lecture:

Implications of New Trade Theory

1. Can explain intra-industry trade
2. Countries may lose from trade
3. New reasons for gains from trade (e.g. trade causes more competition)
4. Rationales for restricting trade (for using gov't policy to restrain trade). However, the people who developed new trade theory have warned countries not to use these policies. See assigned reading by Krugman.

Tariffs

I. What are they?

Tariffs are a taxes on imports (sometimes called a duty). They take two main forms:

Ad Valorem ("on value"), which is a percentage tax (e.g. import a car, pay 2.5% of the value of the car).

Specific Tariff, which is levied on units of a good (\$ per unit of the good).

II. Who Uses Them?

Every country uses tariffs. The average tariff in the United States is 2-3%. There are many goods that face no tariffs at US borders and others that face high tariffs such as textiles and apparel, which face tariffs of around 20%. The US tariff structure is stacked against poor countries. LDCs typically have higher tariffs at their borders than developed nations.

III. Effects of Tariffs

A. Small Country Case

1. Effects on quantities and prices

Small country case = the country is too small to matter for the world price. We assume perfect competition in the market. See Graph 1.

t = specific tariff (it will just add to the price)

Effects:

- domestic output of protected good rises
- domestic demand falls
- price rises by the amount of the tariff
- Quantity imported (Q_m) falls (not a surprise, since we are taxing imports)
- domestic suppliers gain
- domestic demanders lose (this can be firms that are importing intermediate inputs, as well as consumers)
- government collects revenue
- world sells us less, but because we're a small country, they do not care.

2. Effects on economic welfare

Suppliers gain = + a

Demanders lose = - (a+b+c+d)

Government gains = + c

Total for country: $-(b+d)$

We have a net loss to society, called a “dead weight loss.” There is no chance a small country could be made better off by a tariff.

B. Large Country Case

1. Effects on P_w

See Graph 2 .

Tariff “ t ” will cause P_w to fall, the new domestic price is $P_w^1 + t$. The domestic price rises, but not by as much as the tariff. So, gains to suppliers are not as much as the small country case. Part of the tax burden is borne by foreigners (since the world price went down). Tariff revenue = $c + e$.

2. Effects on welfare

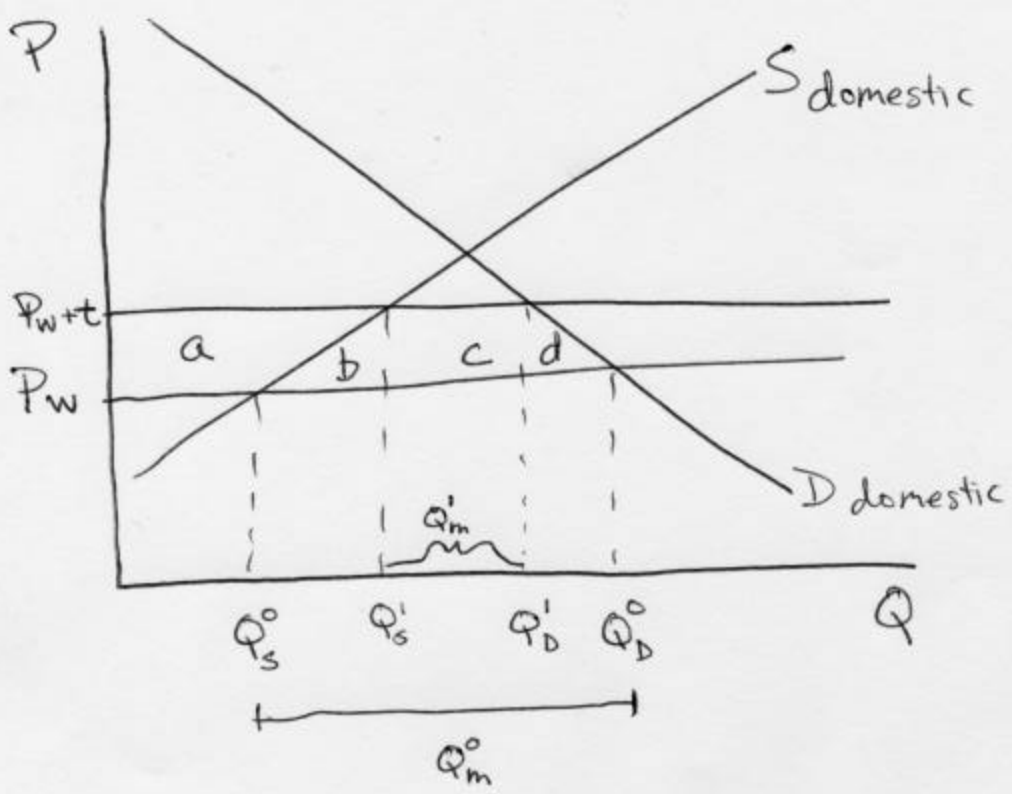
A large country now can gain from a tariff because the tariff drives down the world price. This is very different from the small country case. Here we gain at the expense of the rest of the world, in fact, they lose more than we gain, and there is a reduction in world welfare.

Important reminder: If a large country uses a tariff it is very possible that other nations will retaliate and raise tariffs (which is what happened in the Great Depression). Even if they don’t, use of a policy to benefit a country at the expense of other countries is not something I would ever favor.

C. Size of the Effects

There have been estimates of the welfare effects of U.S. tariffs. As reported by Feenstra, the Dead Weight Loss due to U.S. tariffs in 1985 was in the range of \$1.2 billion to \$3.4 billion. In 1985 U.S. GDP was \$4181 billion. So the DWL was .03% of GDP (three-hundredths of one percent). This is tiny. However, remember that the cost to consumers is much bigger than the DWL.

Graph 1
small country tariff



Graph 2
Large Country

