

Restrictions on free trade: Trade protectionism

IB Economics Section 3: International Economics



Restrictions on free trade

IB Economics: Section 3



Economic Arguments for Protectionist Policies

Job protection in domestic industries

- Slowing down industrial decline
- Concern for regional/local economies

Response to dumping allegations

- Reaction to allegations of anti-competitive behaviour

Raise tax revenues

Improve the balance of payments on current account

Development strategy for fledgling industrial sectors

On environmental / market failure grounds

What is Import Dumping?

- Dumping happens when firms sell products abroad at below costs or significantly below prices in the home market.
 - The former implies predatory pricing – which is illegal
 - The latter implies a strategy of price discrimination – this is not illegal
- China's steel industry is experiencing significant excess capacity and China has been accused of dumping its steel products on the European Union, selling them for less than they are worth. That makes it harder for EU steel producers to compete
- Anti-dumping duties (or import tariffs) raise the price of a product to help protect local producers.
- Article VI of the General Agreement on Tariffs and Trade (GATT) permits special anti-dumping duties that are equal to the difference between the import price and the normal value of the product in the exporting country (the “dumping margin”).

What are Anti-Dumping Tariffs?

- Anti-dumping tariffs are allowed under WTO rules when cases of dumping have been established
- There are three main options when introducing an anti-dumping import duty
 1. An ad valorem duty – a % of the net EU frontier price. This is the most common form of import duty.
 2. A specific duty – a fixed value for a certain amount of goods, e.g. €100 per tonne of a product
 3. A variable duty – a minimum import price (MIP). Importers in the EU do not pay an anti-dumping duty if the foreign exporter's export price to the EU is higher than the MIP
 4. The lesser-duty rule is that duties can't exceed the level needed to repair the harm done to European industry by the unfair dumping practices – currently between 9-13% for a range of steel products imported into the EU from China

Understanding: Motivations for Protectionism



Response to export
"dumping" e.g. steel



Response to a chronic
trade gap



Employment
protection



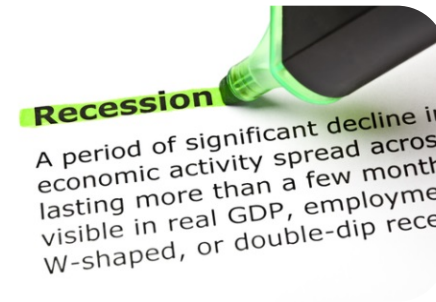
Protect "fledgling" -
infant sectors



Protect key /politically
strategic industries



Raise tax revenues for
the government

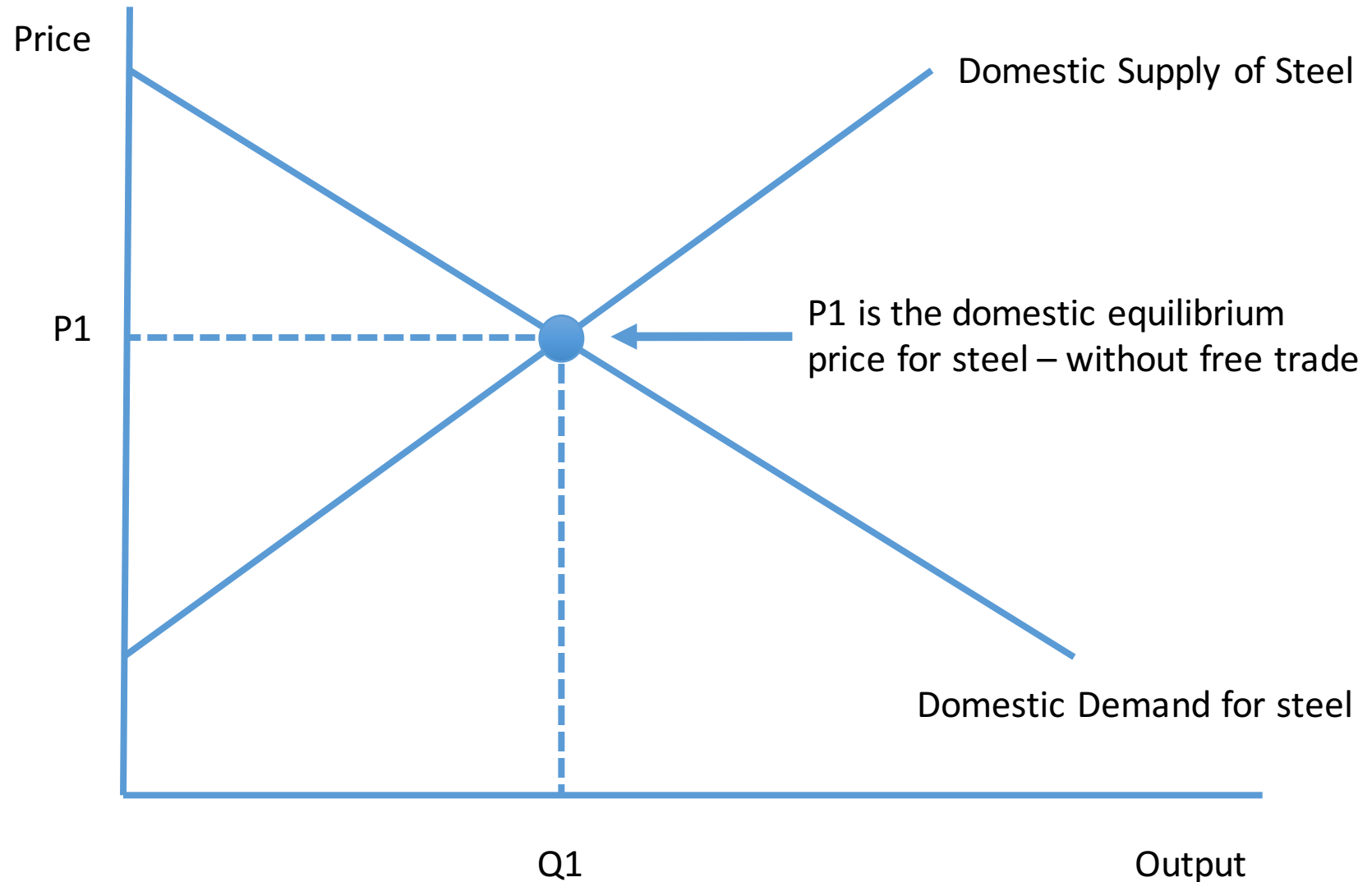


Response to a
recession / low
aggregate demand

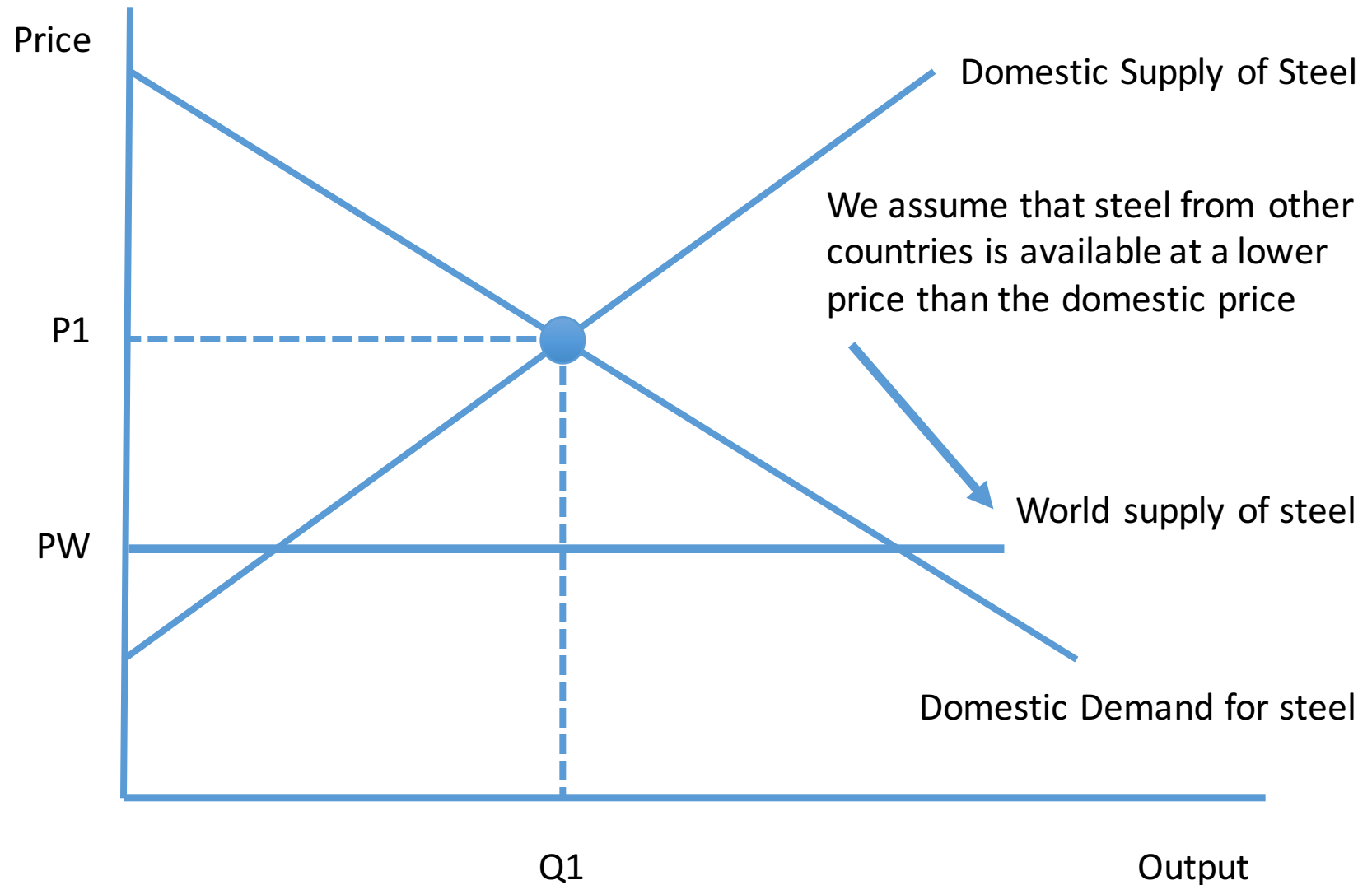
Protectionism – Import Tariffs

- Import tariffs are a form of protectionism
- Tariffs aim to protect domestic industries from overseas competition by increasing the relative price of imports, thereby causing a fall in import demand.
- Thus a higher proportion of domestic demand will be met from domestic suppliers
- Tariffs can also generate tax revenues for the governments who levy tariffs. Indeed for many developing countries, import tariffs are an important source of tax revenues
- A reduction in the quantity of imports as a result of the import tariff may also improve a nation's trade balance

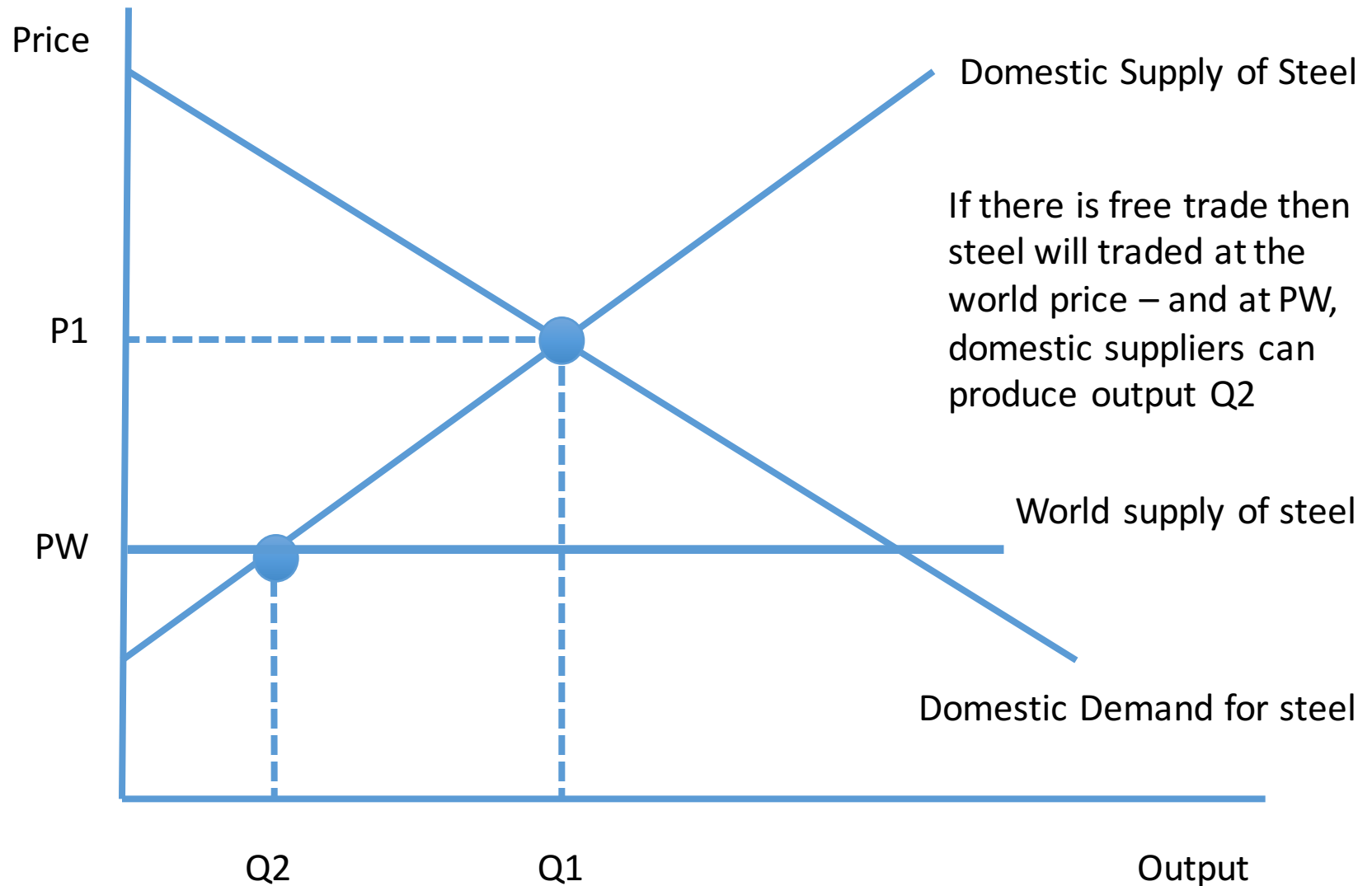
Analysis Diagram for an Import Tariff



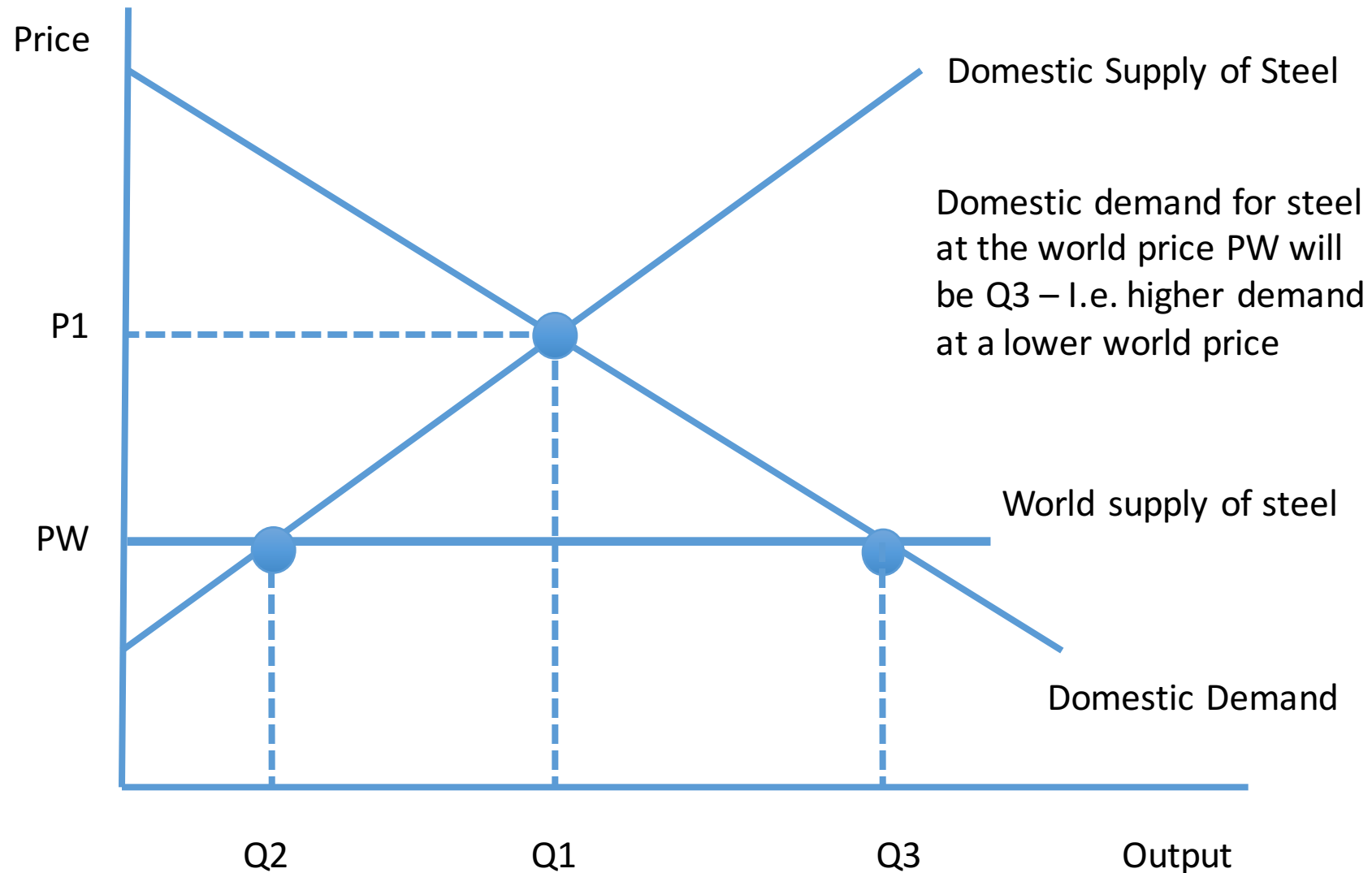
Analysis Diagram for an Import Tariff



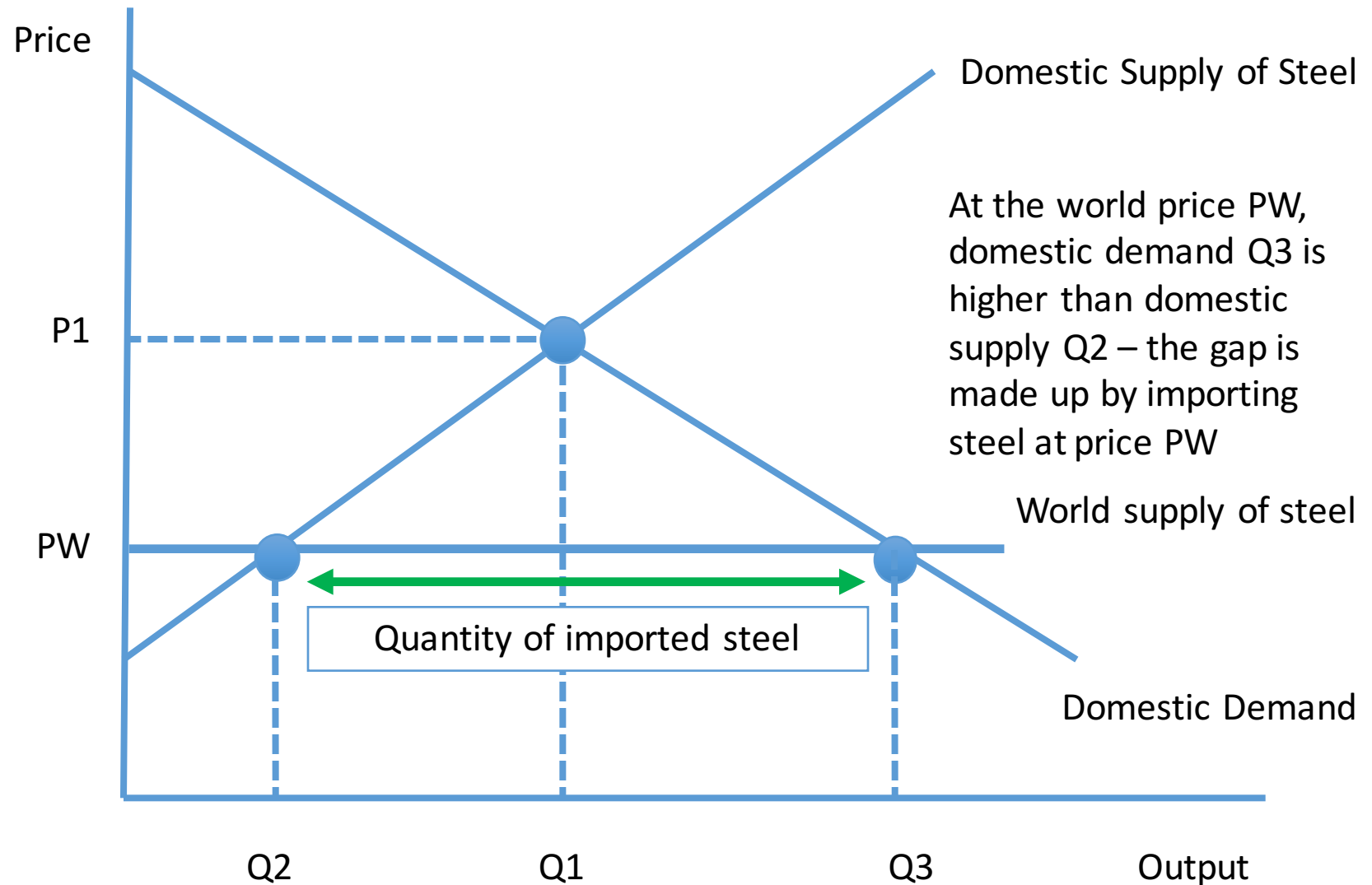
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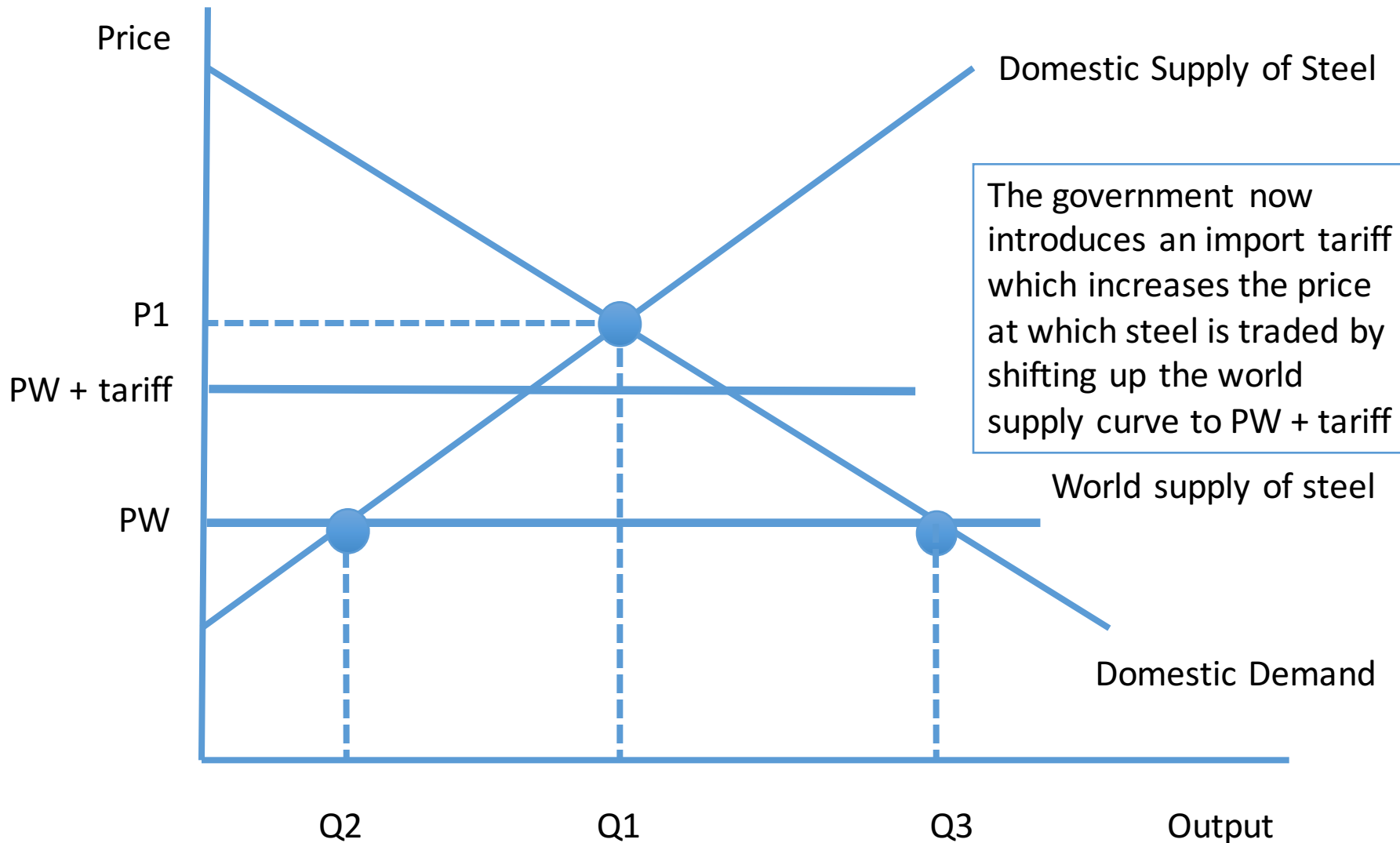
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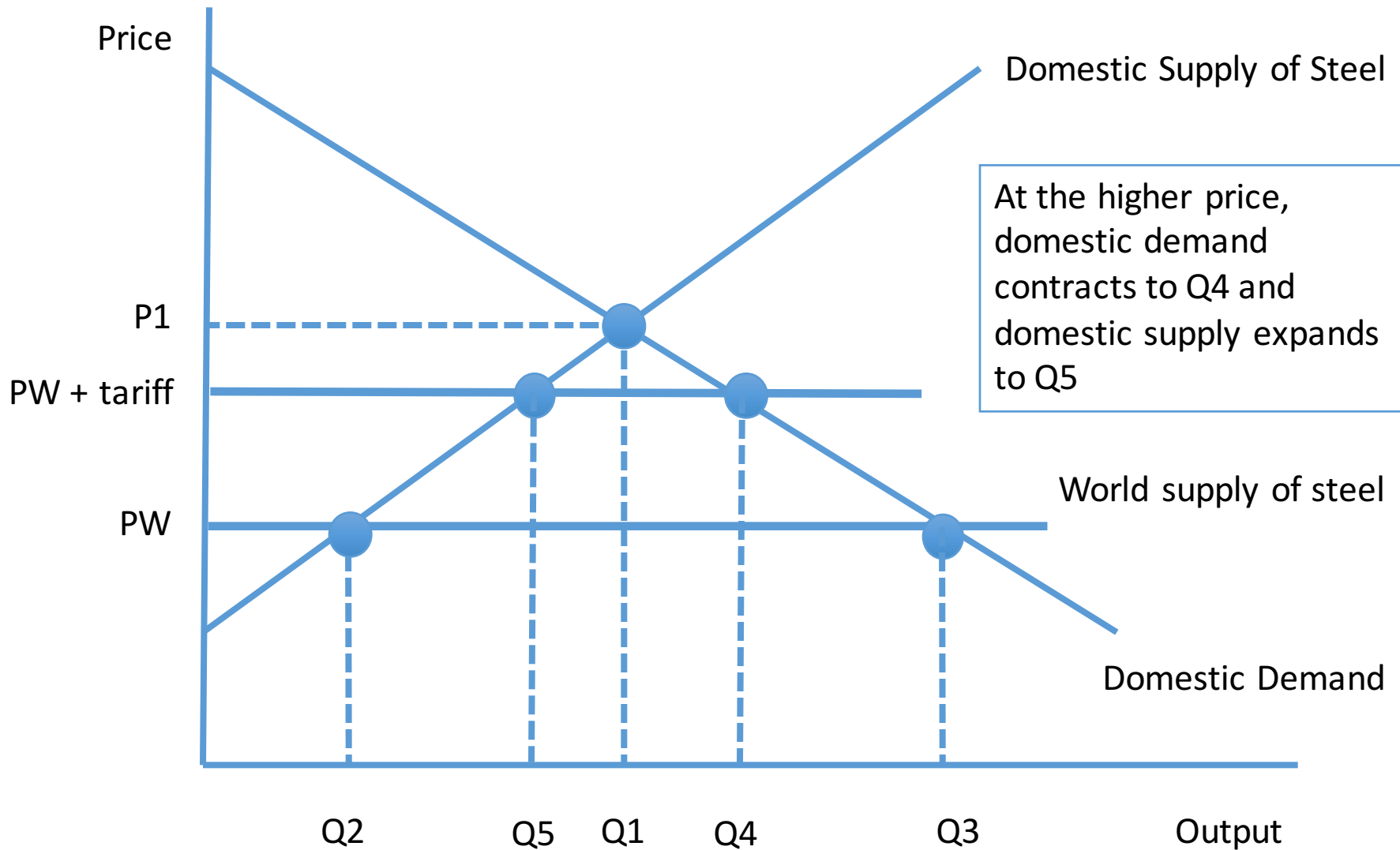
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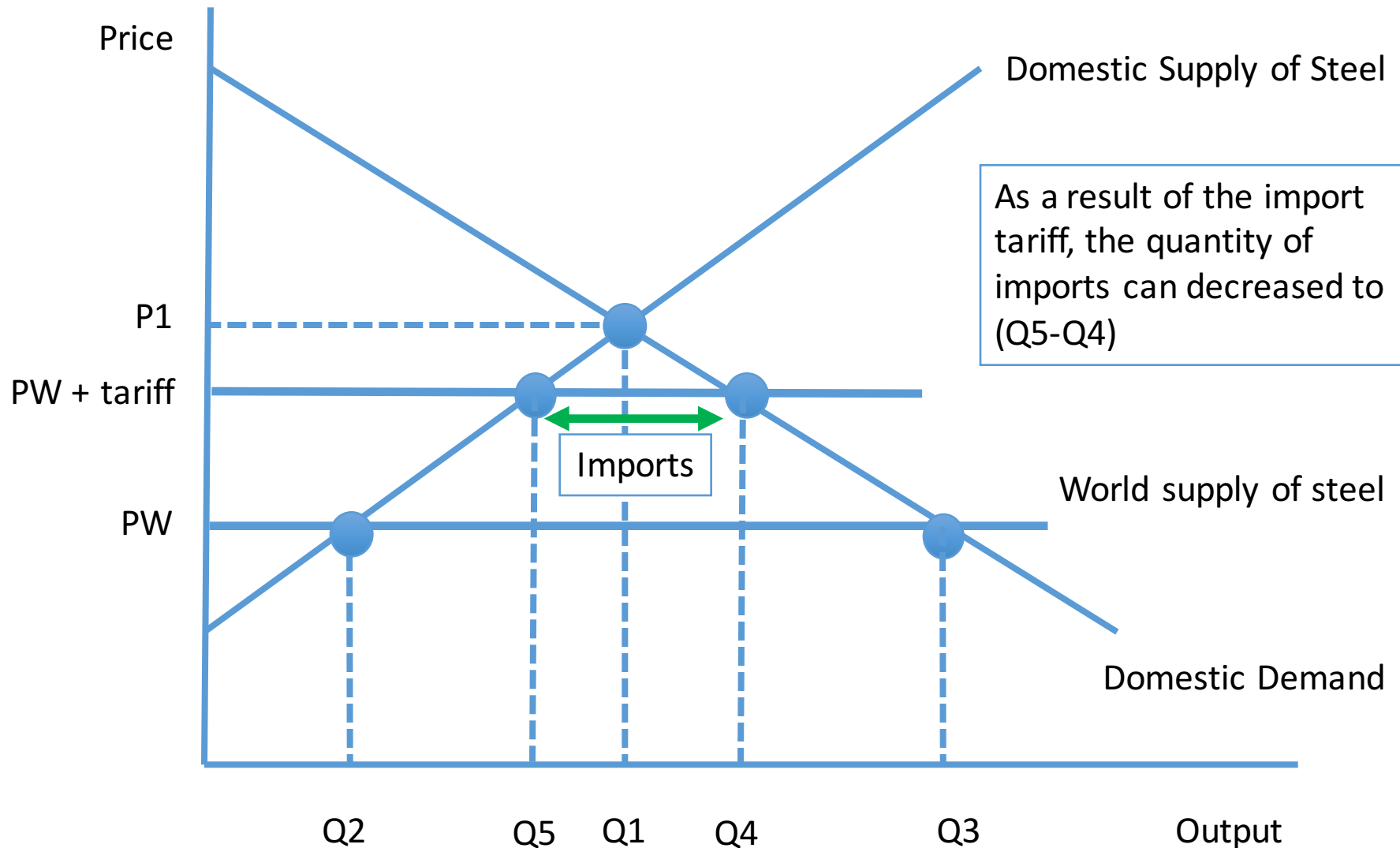
Analysis Diagram for an Import Tariff



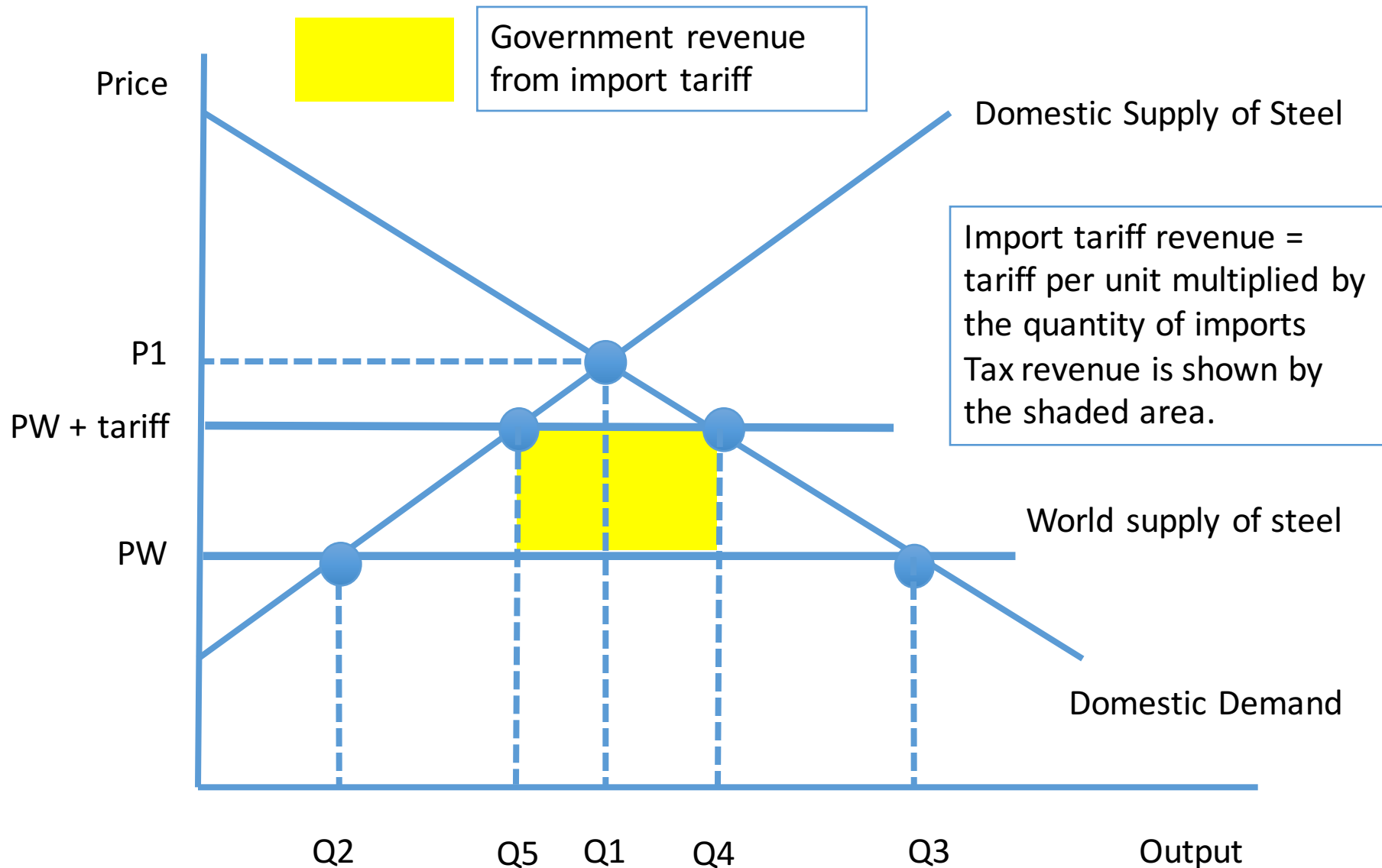
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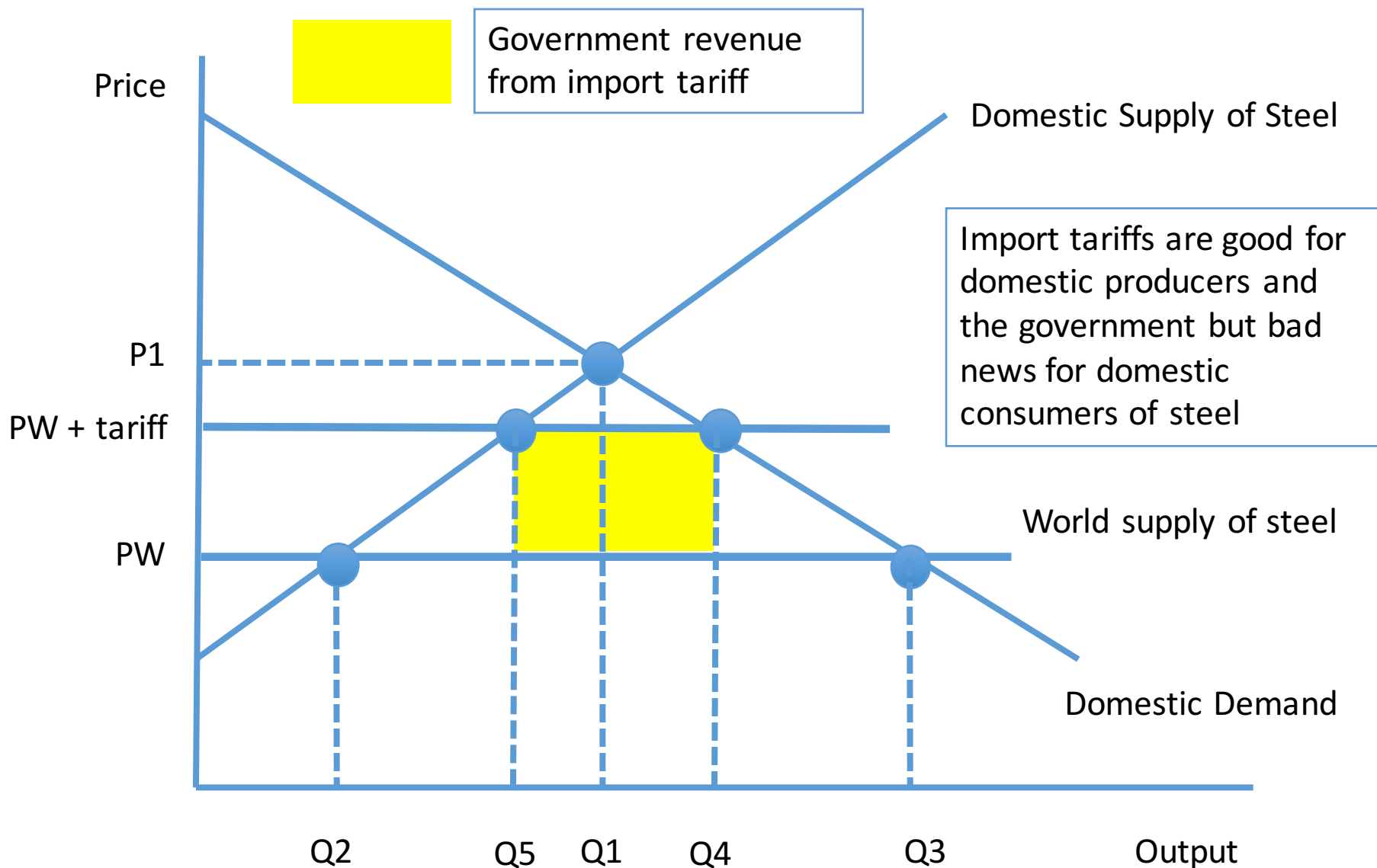
Analysis Diagram for an Import Tariff



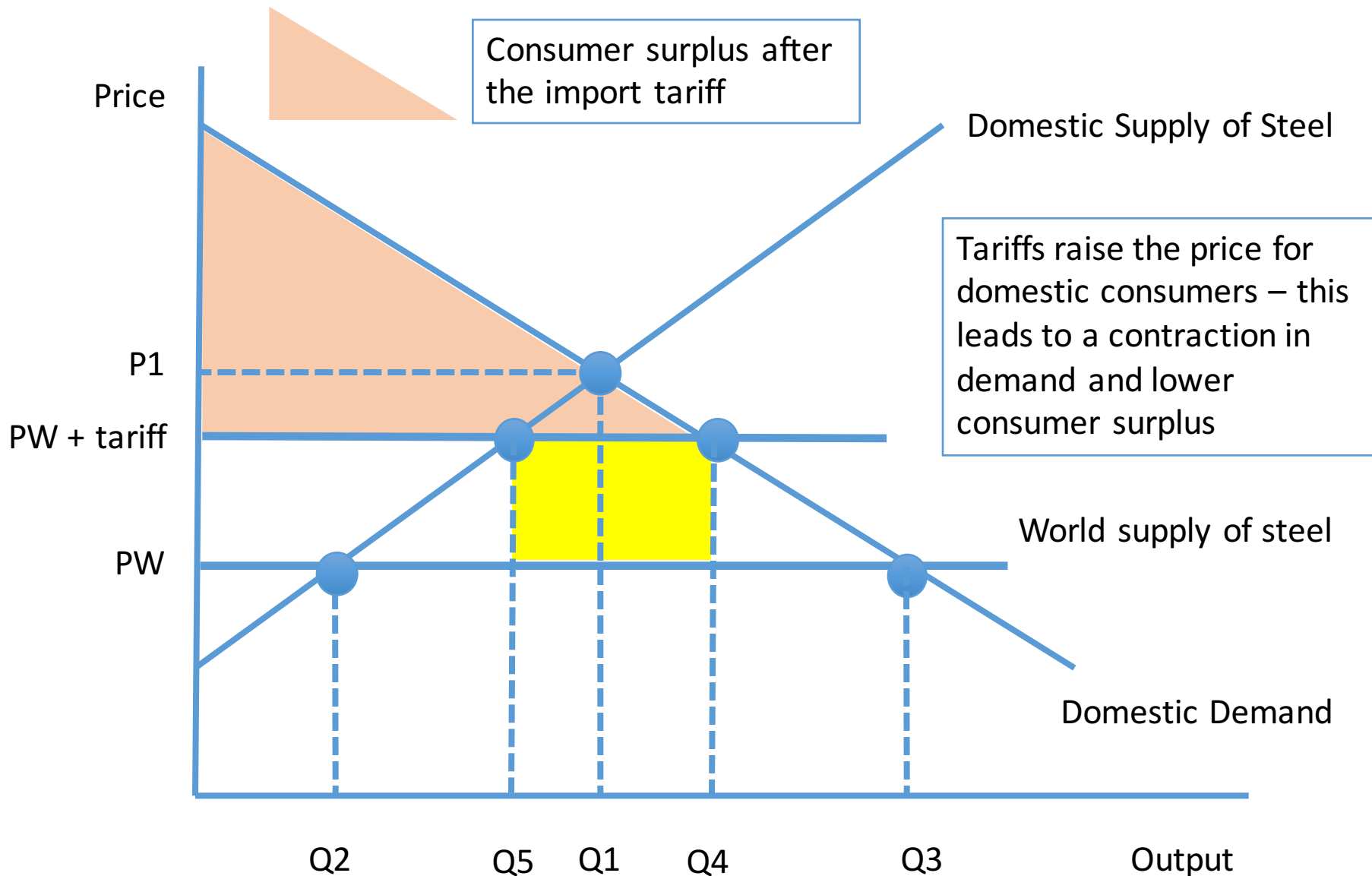
Tariff Revenue from an Import Tariff



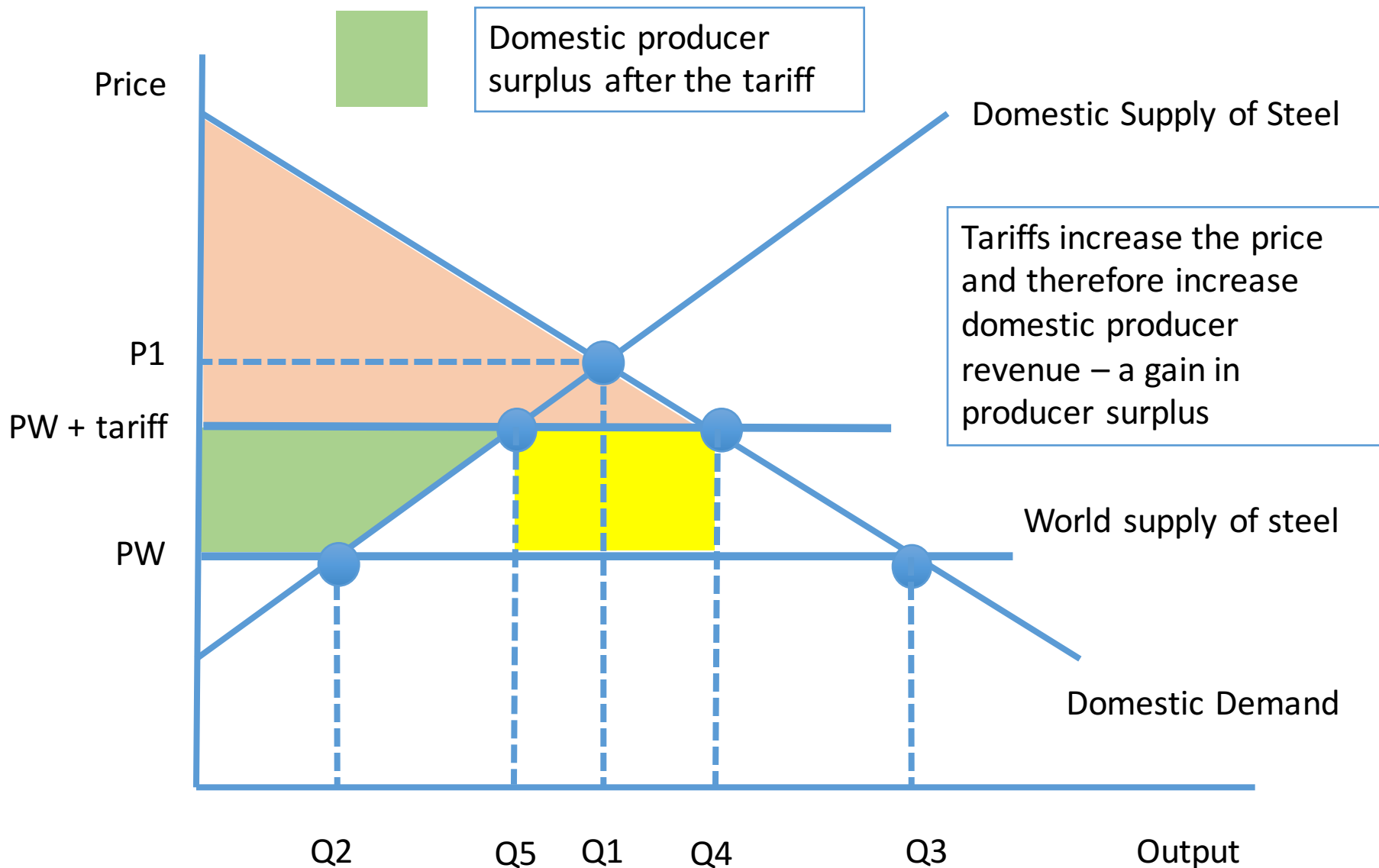
Import Tariffs, Welfare and Economic Efficiency



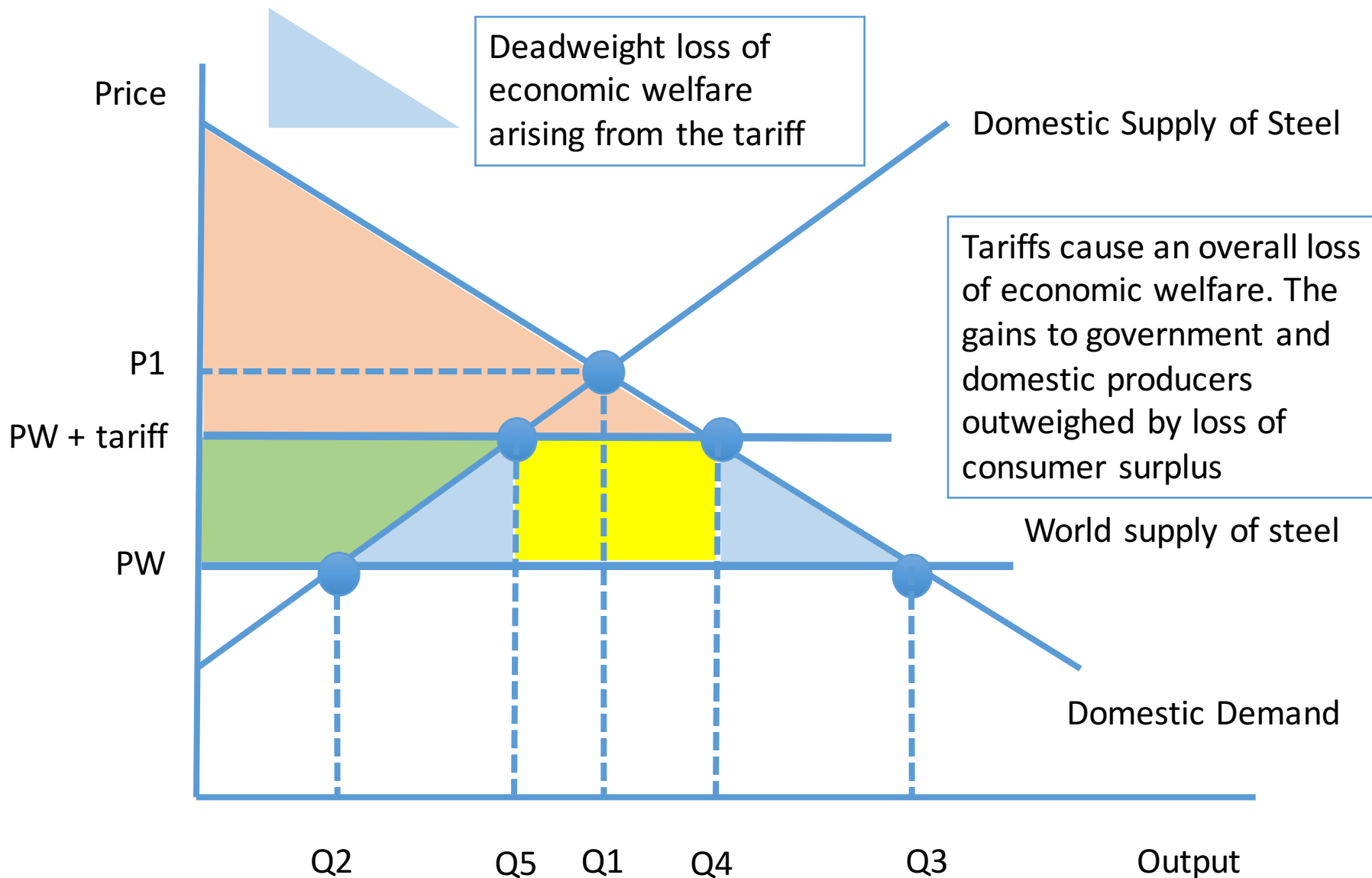
Import Tariffs, Welfare and Economic Efficiency



Import Tariffs, Welfare and Economic Efficiency



Import Tariffs, Welfare and Economic Efficiency



Key Summary: Import Tariffs, Welfare and Efficiency

	Consequence of an import tariff	Comment
Domestic output	Expansion	Higher price from the import tariff incentivizes expansion of output
Domestic demand	Contraction	Higher price reduces the real incomes of domestic consumers
Imports	Fall in volume	Tariff causes expenditure switching towards domestic production
Government tax revenues	Increase	Tariff revenue generates revenue for the government
Domestic producer revenue	Increase	A rise in producer surplus
Foreign producer revenue	Falls	They are selling fewer exports after the tariff – their revenue contracts
Consumer surplus	Falls	Consumers hit by higher prices
Overall economic welfare	Falls	There is a deadweight loss of economic welfare / loss of economic efficiency

Impact of an import tariff on different stakeholders

Impact on	Analysis	Evaluation
Domestic producers	Producers benefit initially from an import tariff – they are protected from lower priced imports and can expect an increase in output at a higher price which increases their revenues and operating profits.	Possible X-inefficiencies because of reduction in intensity of market competition Other producers affected e.g. a tariff on steel raises the cost of car and construction companies
Foreign (overseas) producers	Import tariff is a barrier to trade and squeezes demand leading to lower revenues and profits	Producers may be able to shift production / exports to countries or regions where import tariffs are lower.
Consumers	Consumers face higher prices after the tariff – leading to a fall in real incomes. May affect lower income households more – regressive? Loss of consumer choice (lower utility)	Impact on demand depends on the price elasticity of demand for the affected product. Tariffs on essential items such as foodstuffs tend to have a lower price elasticity of demand.
The government	Government tax revenues rise initially from having import tariffs – rising GDP and increasing profitability of suppliers	Adverse effects of possible retaliatory tariffs on other industries. Slower economic growth from higher inflation.

Recent examples of import tariffs in the news

2016: Rwanda to increase import tariff on secondhand clothes

2016: Brazil renews import tariff exemption on primary aluminum

2016: Canada removes tariffs on imports of 54 high tech goods

2016: Chinese government imposes tariff on EU steel imports

2016: South Africa approves Wheat-Import Tariff Increase

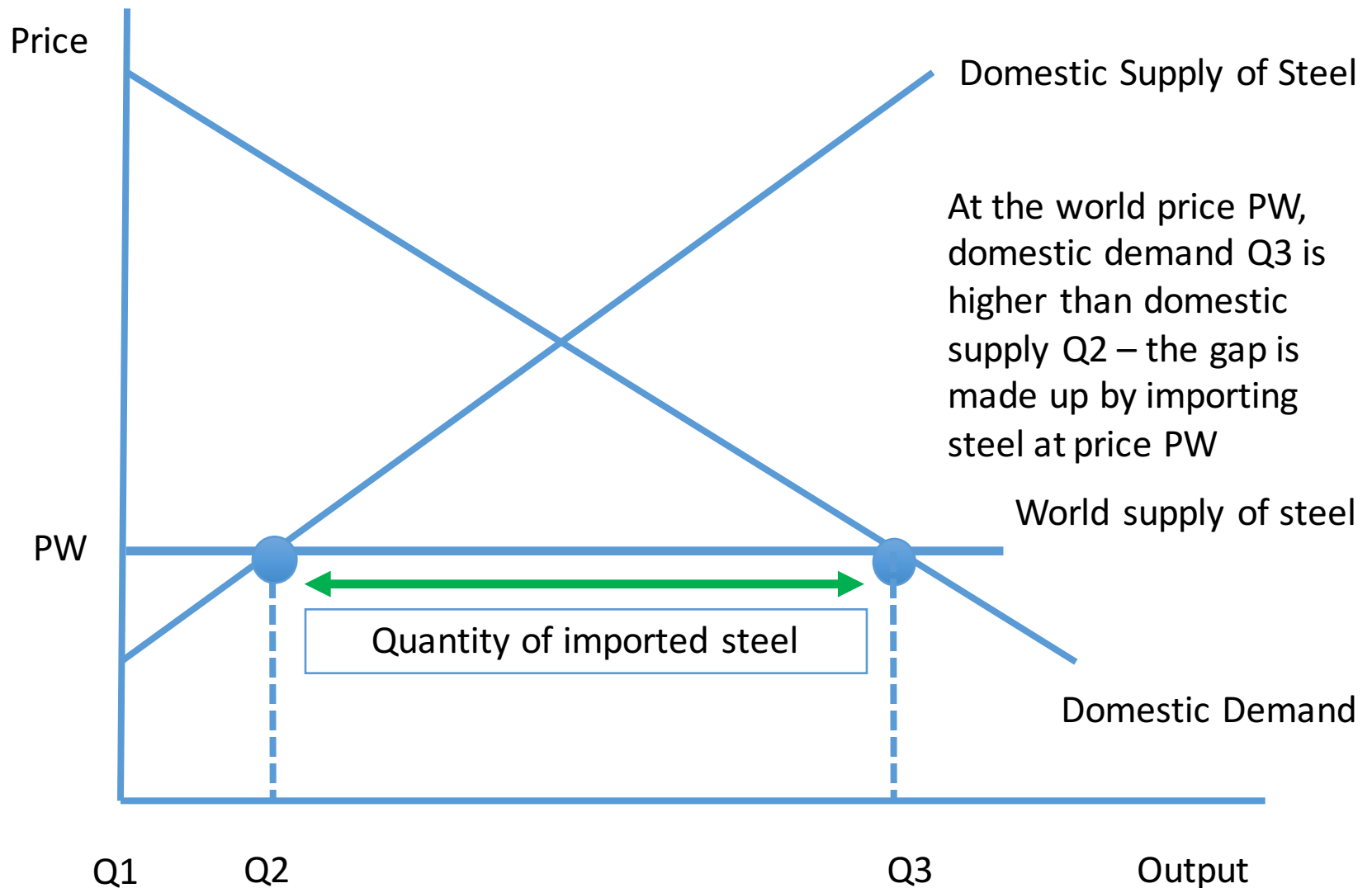
Examples of Non-Tariff Barriers

1. **Intellectual property laws** e.g. patents and copyright protection
2. **Technical barriers to trade** including labeling rules and stringent sanitary standards. These increase product compliance costs
3. **Preferential state procurement policies** – where government favour local producers when finalizing contracts for state spending e.g. infrastructure projects or purchasing new defence equipment
4. **Domestic subsidies** – government help (state aid) for domestic businesses facing financial problems e.g. subsidies for car manufacturers or loss-making airlines.
5. **Financial protectionism** – e.g. when a government instructs banks to give priority when making loans to domestic businesses
6. **Murky or hidden protectionism** - e.g. state measures that indirectly discriminate against foreign workers, investors and traders.
7. **Managed exchange rates** – government intervention in currency markets to affect relative prices of imports and exports

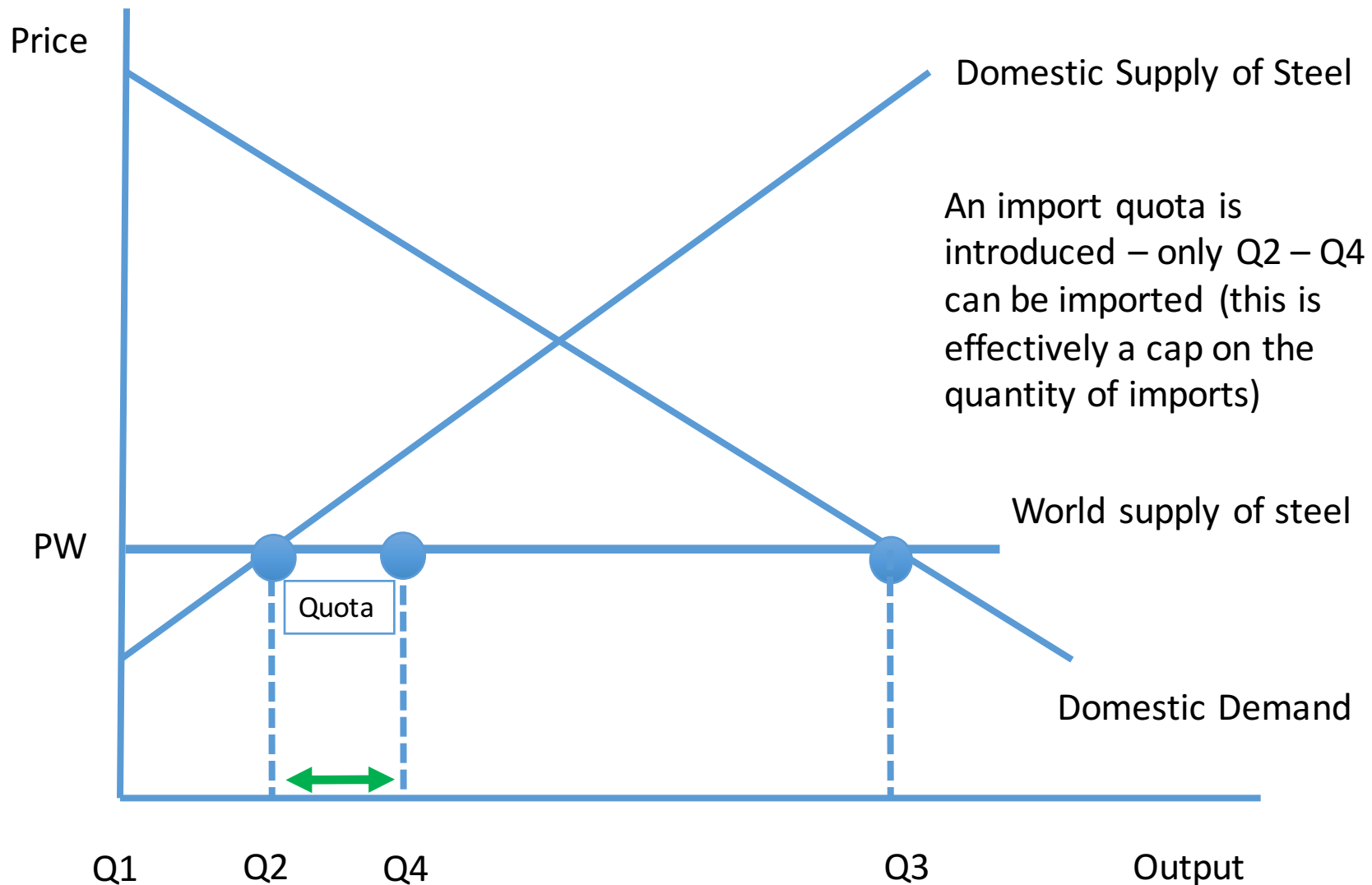
Protectionism – Import Quotas

- A quota places a quantity limit on the volume of imports of a product that can come into a country
- The quota has an indirect effect on market price by creating an artificial scarcity
- A quota caps the volume or quantity of imports
- The effect of a quota is to create excess demand for imports for a given level of domestic demand
- The quota therefore pushes up the market price
- The higher market price incentivizes domestic producers to increase their supply / enter the market
- Domestic supply + the quota is the new domestic supply curve

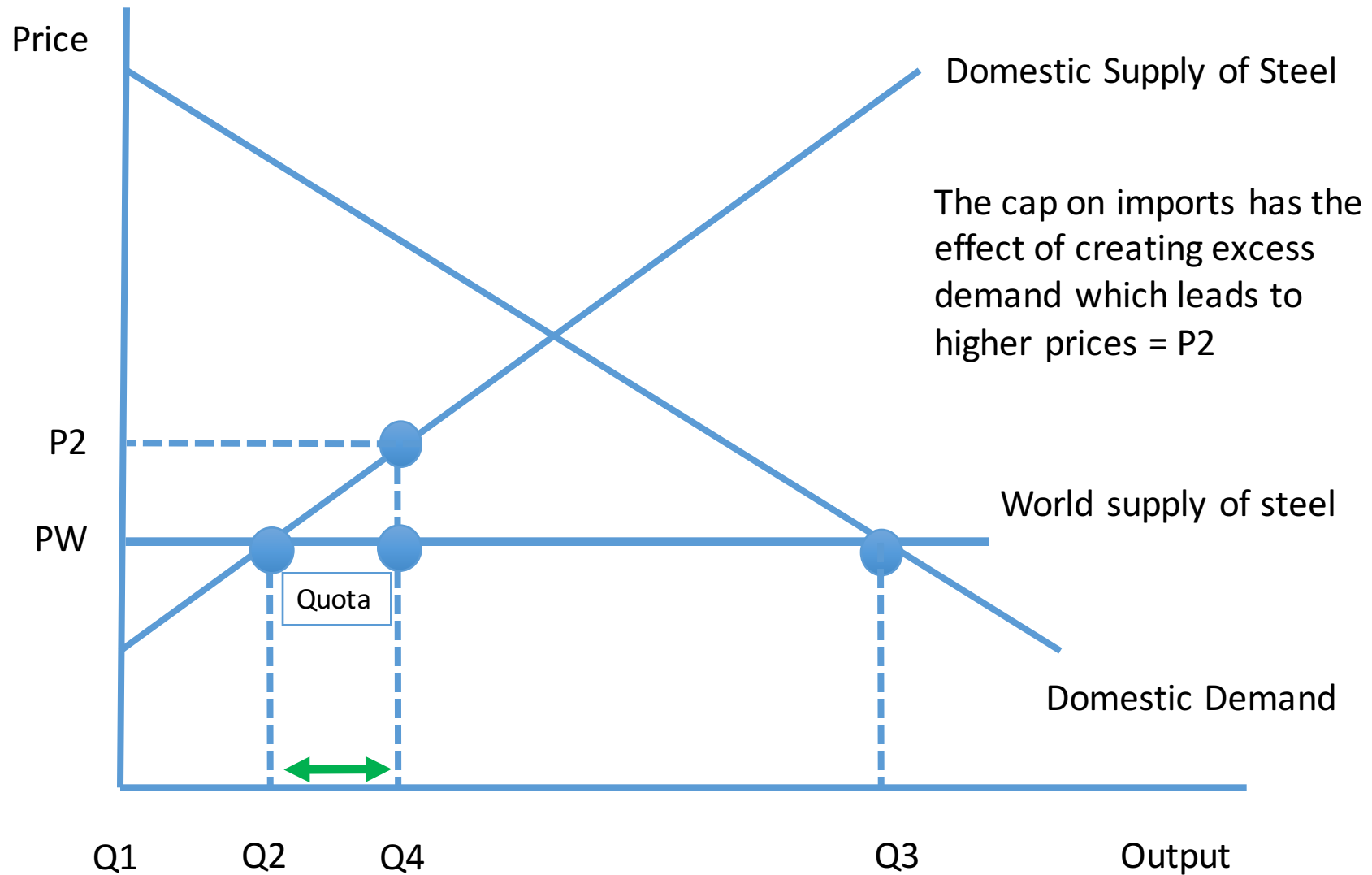
Imports of Steel before an Import Quota



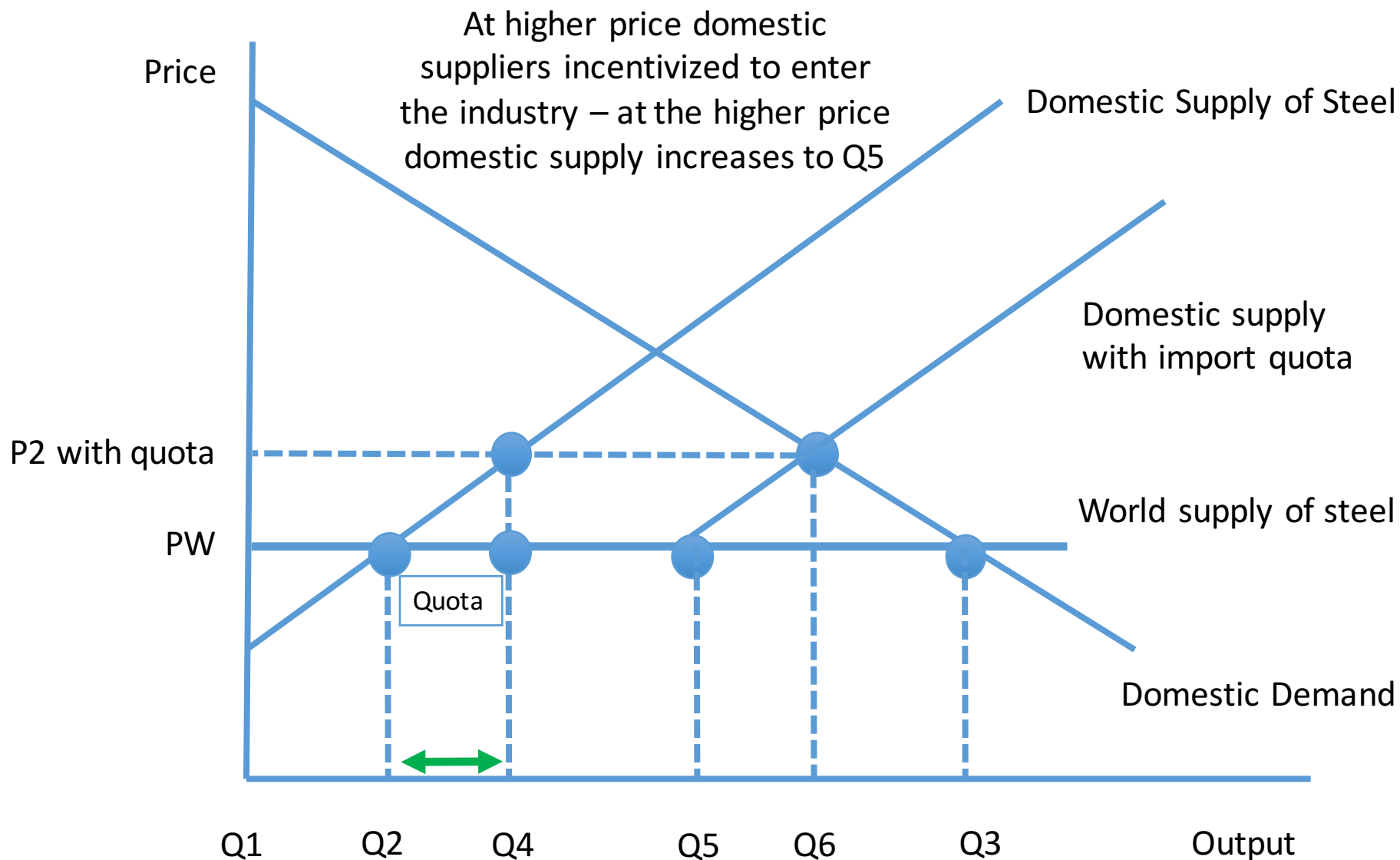
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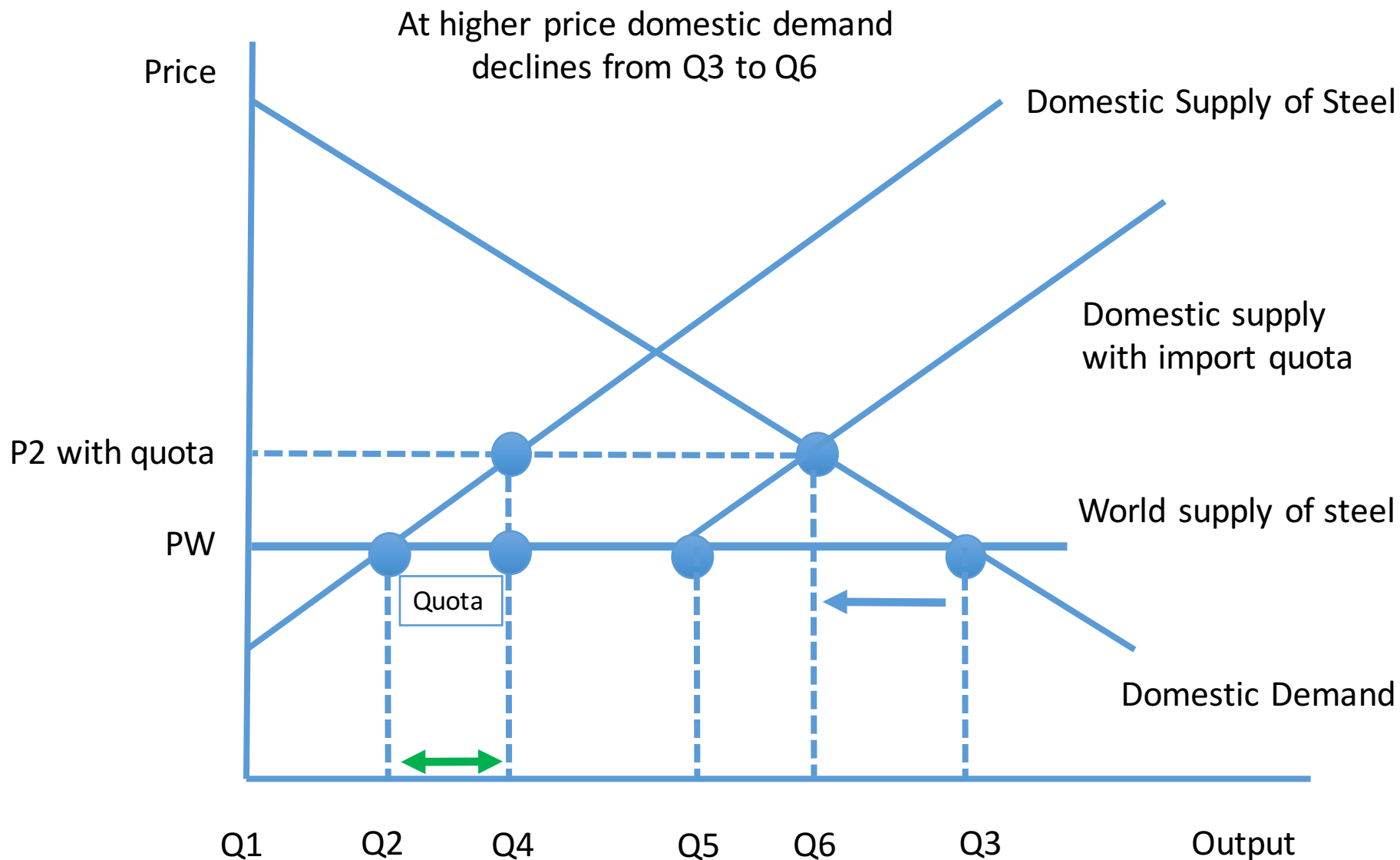
Imports of Steel before an Import Quota



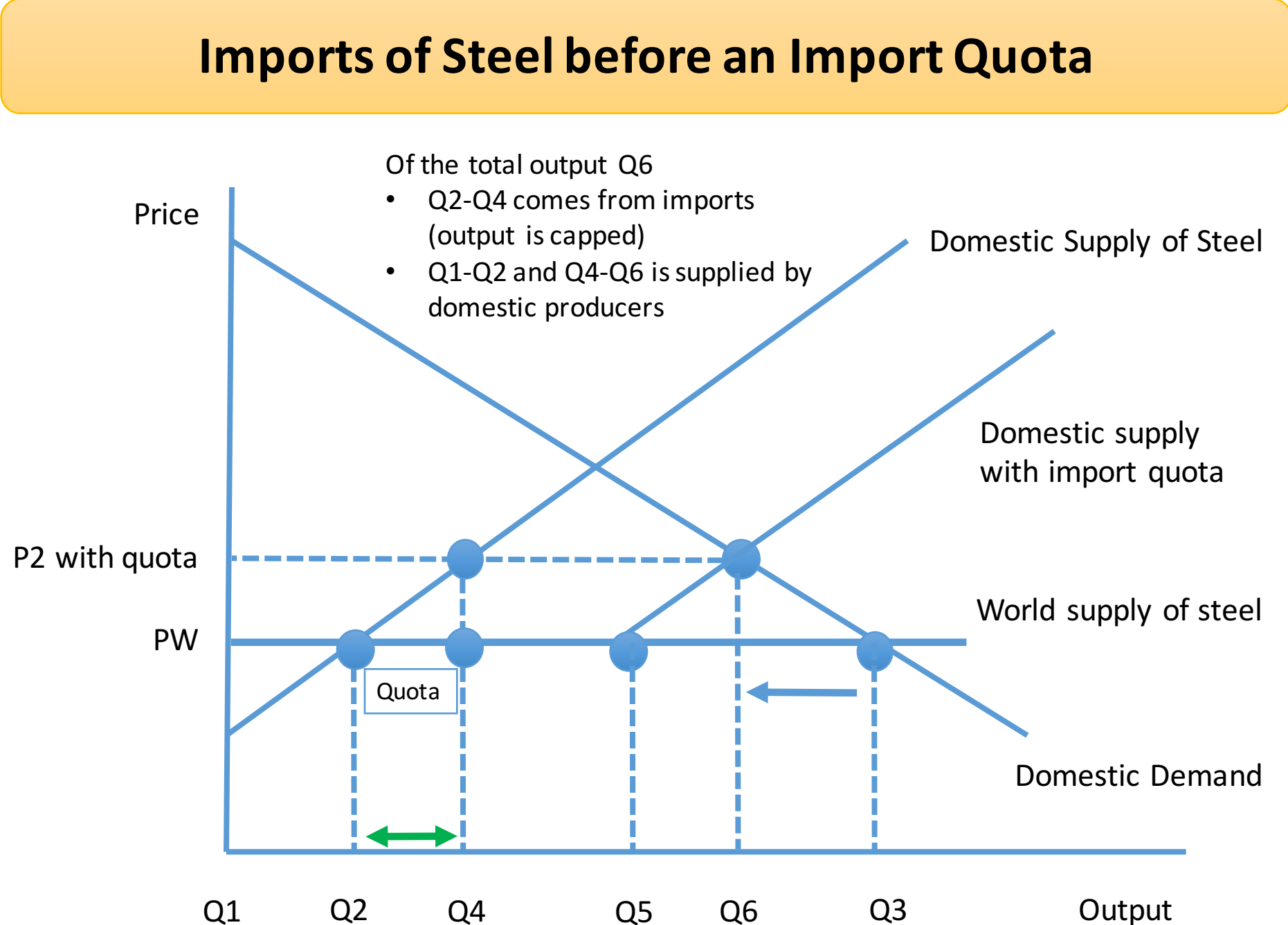
Imports of Steel before an Import Quota



Imports of Steel before an Import Quota



Imports of Steel before an Import Quota



Key Summary: Import Quotas, Welfare and Efficiency

	Consequence of an import quota	Comment
Domestic output	Increases	Higher price makes it more profitable for domestic suppliers to enter
Domestic demand	Contracts	Because the quota reduces the quantity of cheaper imports available
Imports	Contracts	Reduction in quantity depends on how severe is the import cap
Government tax revenues	No direct effect	A quota is different from a tariff
Domestic producer revenue	Increases	Selling increased output at higher price
Foreign producer revenue	Falls	Quota caps how much can be exported into the protected market
Consumer surplus	Fall	Higher prices reduces consumer welfare
Overall economic welfare	Falls	Quota restricts free trade and leads to deadweight loss of economic welfare

Impact of an import quota on different stakeholders

Impact on	Analysis	Evaluation
Domestic producers	Domestic producers benefit from the cap on imports – increases the market price and makes it more profitable for them to stay in / enter the market	Quota is a barrier to trade, might encourage domestic firms to become less productively efficient Some producers hampered by scarce supply of higher quality overseas imports – hurts their competitiveness
Consumers	Consumers likely to face a higher price in the market because of limit on import products. Less competition in the market might also affect the quality of products available – impact on utility	Consumers who work for domestic firms may benefit from higher employment Import cap might stimulate increased investment in alternatives
The government	Improved external balance from the reduction in imports and an expansion of GDP from the increase in domestic production	No immediate tax revenues from an import quota - a contrast with an import tariff

Recent examples of import quotas in the news

(2017) EU sugar import quota scheme will come to an end

(2016) Canada to Increase the size of the Import Quota for EU Cheese

(2015) Russia imposes embargoes on wide range of EU foodstuffs

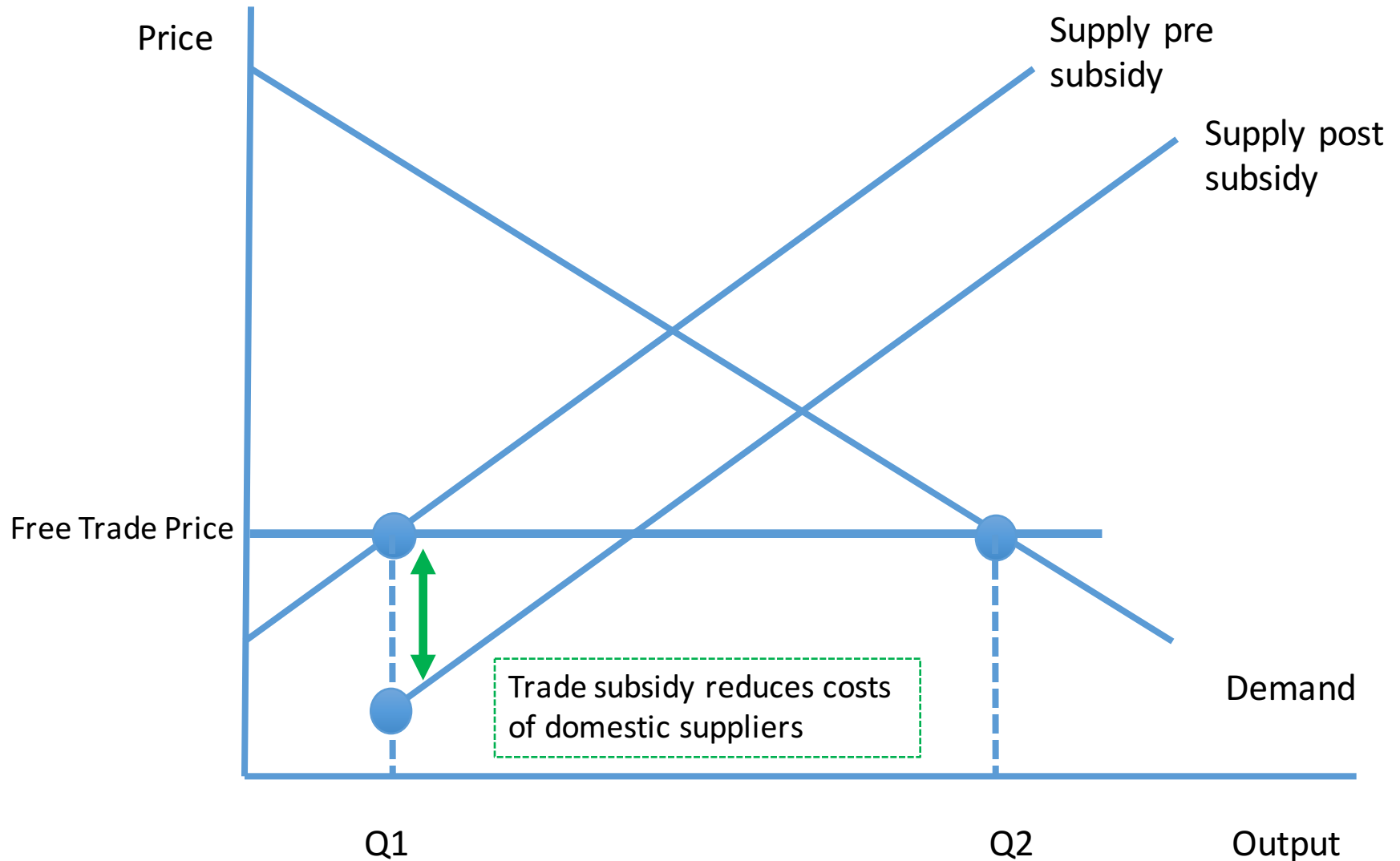
(2015) Indonesia cuts cattle imports from Australia by 80%

(2014) China to cut EU cotton import quotas

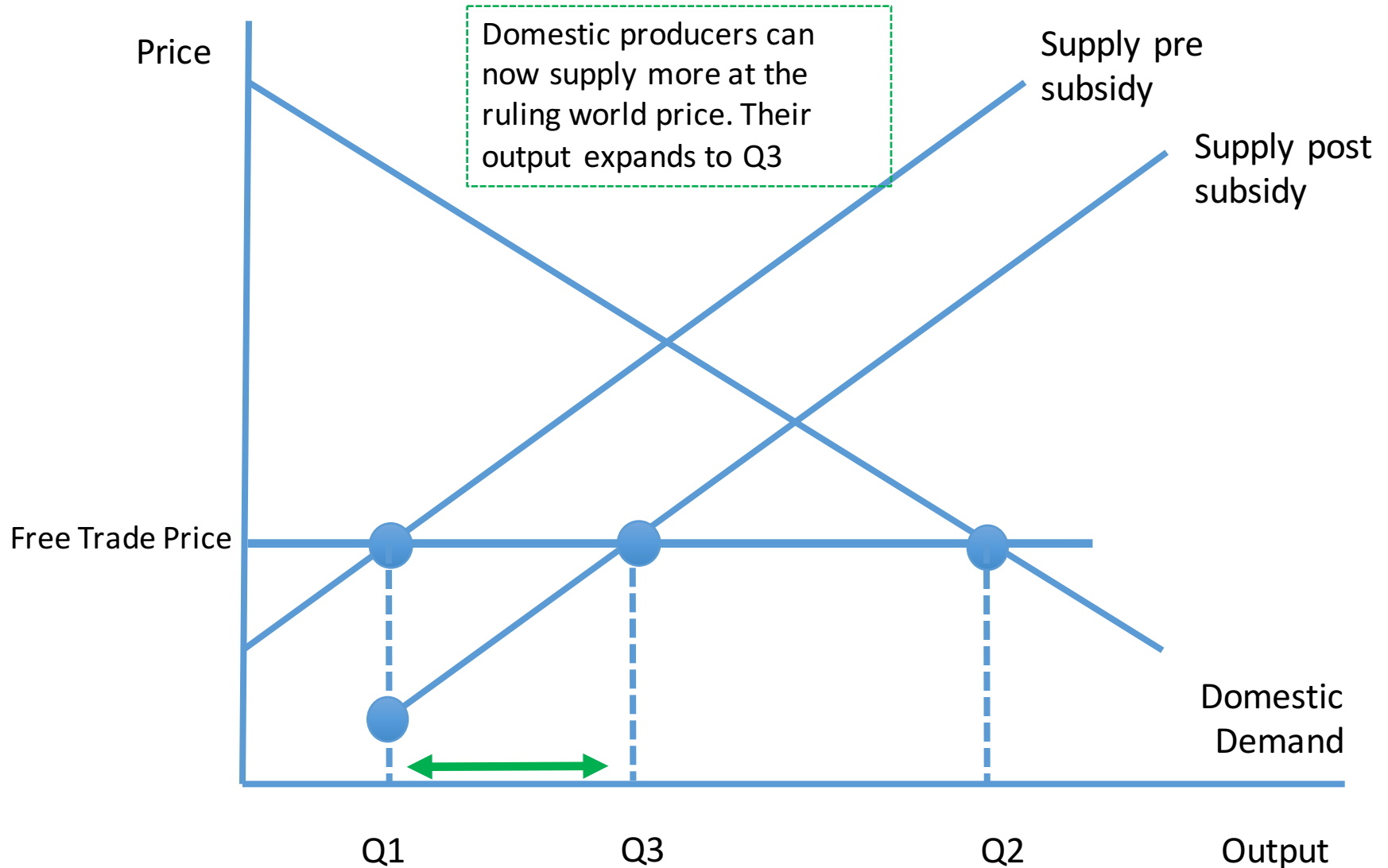
What is a domestic subsidy?

- A subsidy is any form of financial help given to domestic producers in order to lower their costs and help them compete in international markets
- It is a form of non-tariff barrier
- A subsidy given to domestic suppliers causes an outward (downward) shift in the domestic supply
- A unit subsidy will cause a parallel downward shift in the supply curve
- The extent of the reduction in cost depends on the size of the subsidy
- We assume that the subsidy is not large enough to change the world supply price but it does give domestic firms a higher price (= world supply price plus the subsidy)
- The increase in domestic supply reduce import volumes

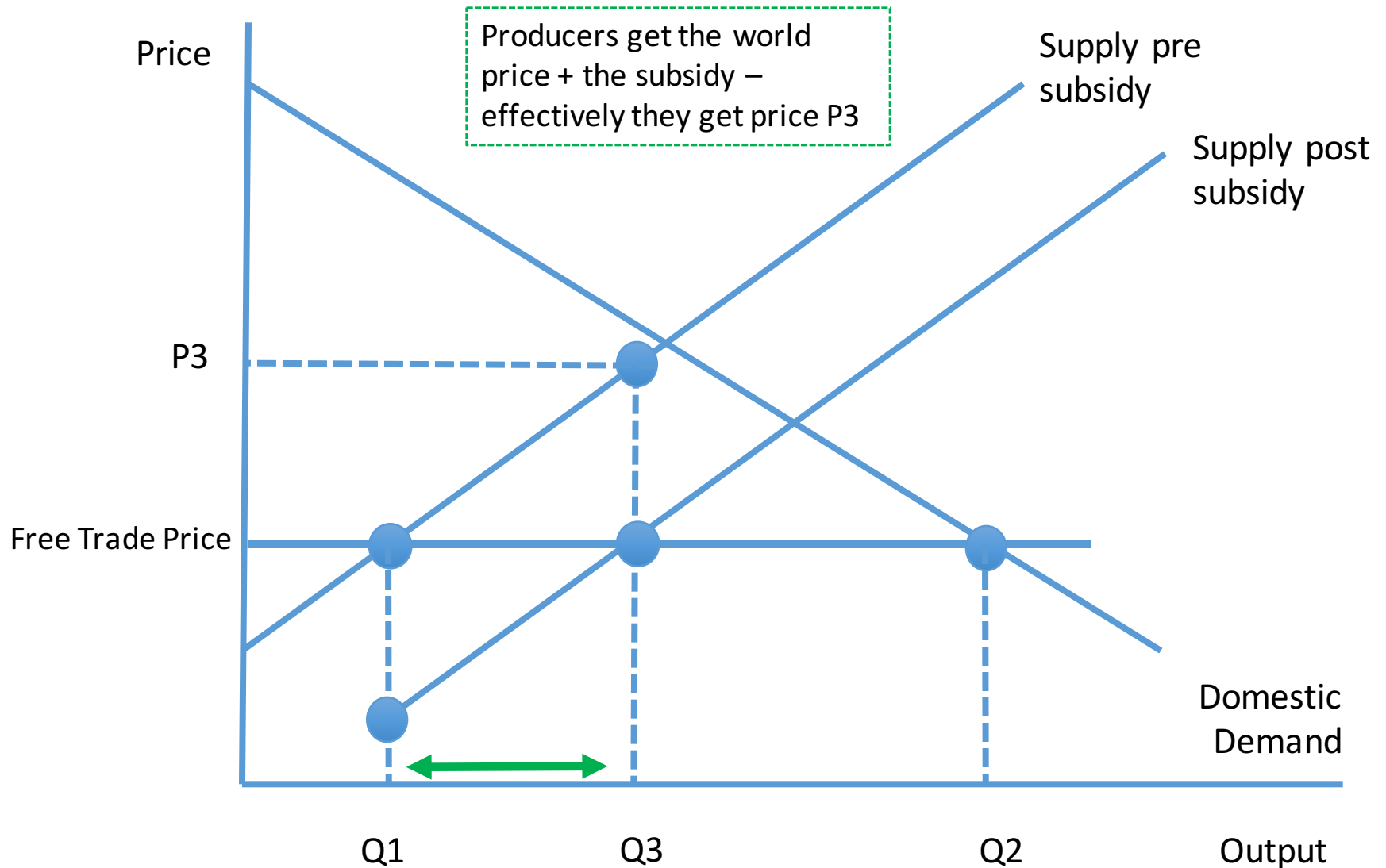
Analysis Diagram for a Domestic Export Subsidy



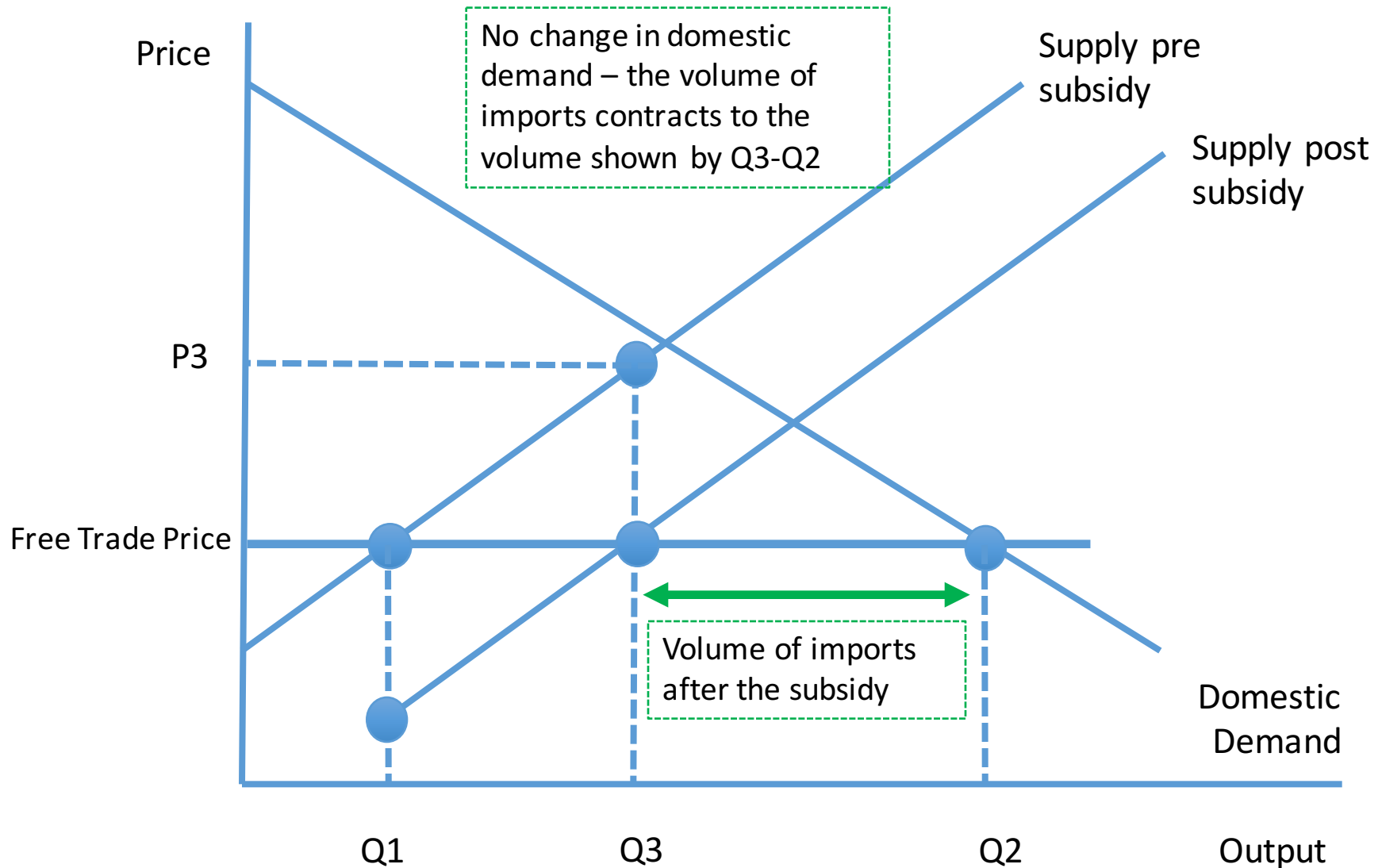
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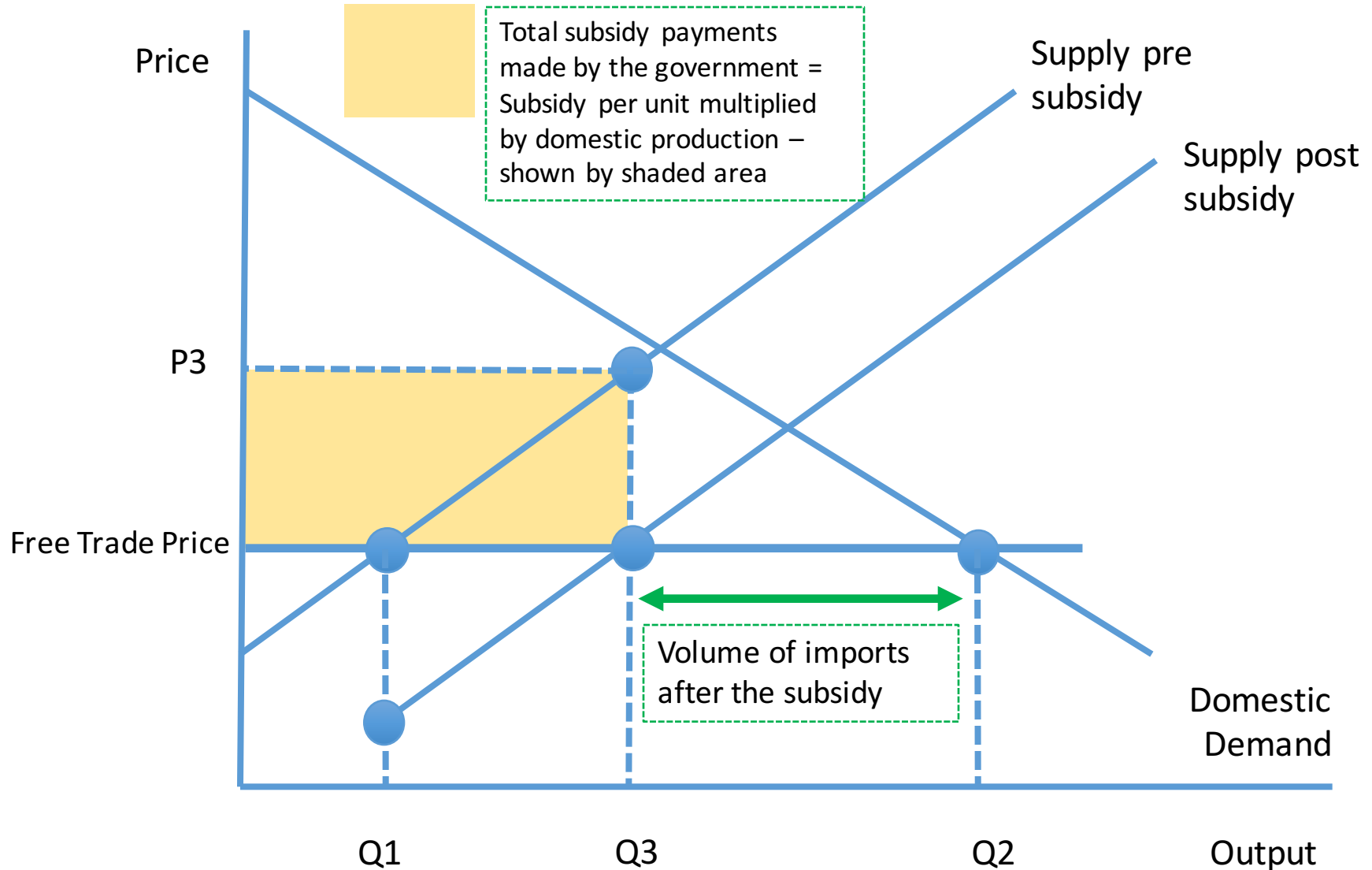
Analysis Diagram for a Domestic Export Subsidy



Analysis Diagram for a Domestic Export Subsidy



Analysis Diagram for a Domestic Export Subsidy



Impact of a trade subsidy on different stakeholders

Impact on	Analysis	Evaluation
Domestic producers	<p>Domestic producers gain directly from the subsidy – they get the world price + a subsidy</p> <p>Higher output and revenues will boost profits and might therefore lead to a higher share price</p> <p>Increased output – possibility of economies of scale</p>	<p>Risk of a dependency culture emerging – i.e. businesses relying on the subsidies rather than taking their own steps to become more competitive by increasing productivity, eliminating inefficiency and accelerating the pace of process/product innovation</p>
Consumers	<p>Assuming that the subsidy is not large enough to change the world price, not direct effect on the prices that consumers pay for their products</p>	<p>They may face higher taxes if expensive subsidies take up a high percentage of government spending</p>
The government	<p>Subsidy can be an effective non-tariff barrier to reduce the volume of imports by encouraging domestic production</p>	<p>Unlike a tariff, a subsidy does not generate tax revenues directly</p> <p>Increased spending on subsidies may cause budget pressures.</p>

Recent examples of trade subsidies in the news



2016: Pakistan government expands export subsidy to sugar mills

2016: China Halts Export-Subsidy Program After US Challenge

2016: India and African nations press the EU and USA to lower cotton production subsidies

2016: Tasmanian growers in Australia undercut New Zealand with export subsidy

Arguments against Trade Barriers / Protectionism



Risk of Retaliation



Market Distortions



Higher prices for consumers



Regressive effect on income inequality



By-passing import controls



Higher costs for exporters

Economic Arguments against Protectionist Policies

Resource misallocation – loss of efficiency

Dangers of retaliation – game theory at work!

Potential for corruption - tariffs higher in less democratic countries

Higher prices for domestic consumers - regressive impact

Increased input costs for home producers

Barrier to entry - reduces market contestability / increases monopoly power

The widely held view is that import tariffs lead to a **deadweight loss of economic welfare** mainly through the effects of higher prices for consumers and also the **distorting effects** of a tariff on market competition, prices and the allocation of scarce resources.

Some Key Terms (Protectionism)

Key Term	Brief Definition
Ad valorem tariff	A tariff rate charged as percentage of the price
Anti-dumping duties	Tariffs on goods deemed to be dumped and causing injury to producers of competing products in the importing country
Customs Union	When member nations of a free trade area apply a common external tariff (e.g. the European Union).
Dumping	When goods are exported at a price less than their normal value or at a price lower than production cost
Free Trade Area (FTA)	Trade within the group is duty free but members set their own tariffs on imports from non-members (e.g. NAFTA).
Subsidy	There are two general types of subsidies: export and domestic. An export subsidy is a benefit conferred on a firm by the government that is contingent on exports. A domestic subsidy is a benefit not directly linked to exports

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