INTERNATIONAL TRADE

Chapter 9: The Instruments of Trade Policy: Non-Tariff

Preview

- Export subsidy
- Import quota
- Voluntary Export Restraint
- Local content requirement
- Other trade policy

Export subsidy

- **An export subsidy** is a payment to firm or individual that ship a good abroad
- A **specific export subsidy** is levied as a fixed charge for each unit of exported goods.

  For example, $1 per kg of cheese
- An **ad valorem export subsidy** is levied as a proportion of the value of exported goods.

  For example, a 25 percent U.S. export subsidies on exported wine

Export subsidy

- An export subsidy <u>raises the price</u> of a good in the exporting country, making its **consumer surplus decrease** (making its consumers worse off) and making its **producer surplus increase** (making its producers better off).
- Also, **government revenue will decrease**.

Export subsidy

- An export subsidy raises the price of a good in the exporting country, while lowering it in foreign countries.
- In contrast to a tariff, an export subsidy **worsens the terms of trade** by lowering the price of domestic products in world markets

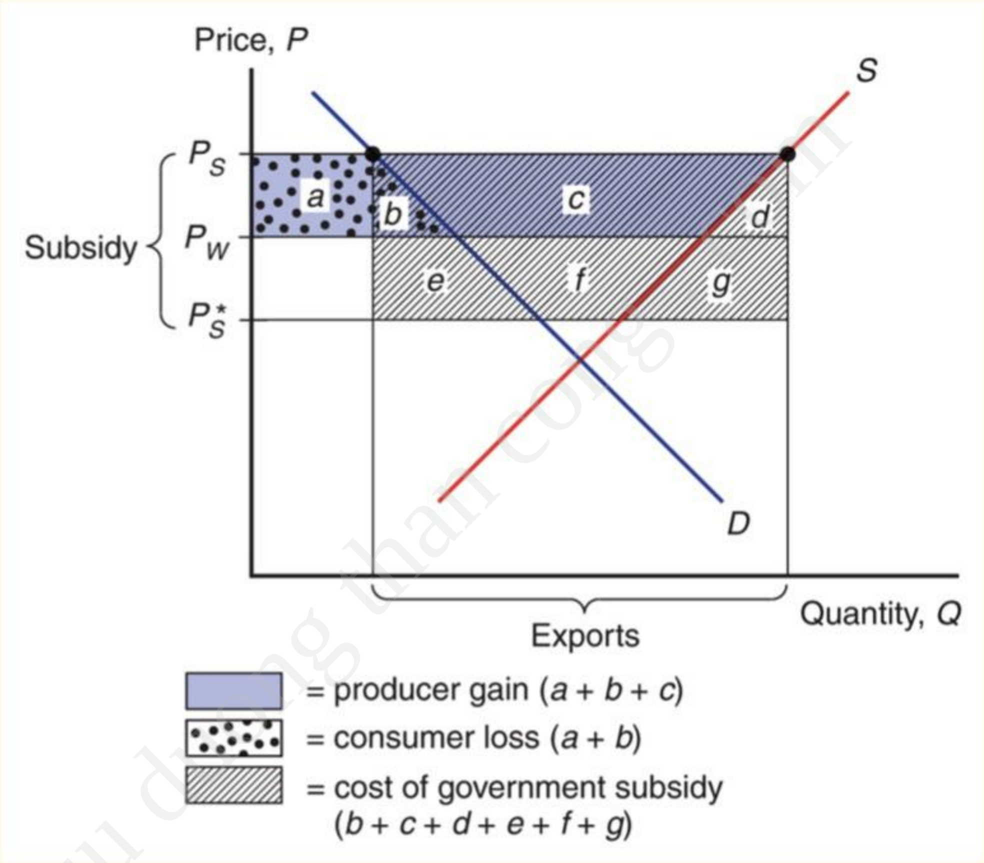


Figure 8-11

Effects of an Export Subsidy

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

Export subsidy

- **The consumer loss: a+b**
- **The producer gain: a+b+c**
- **The government subsidy = b + c + d + e+ f + g**

In addition, the terms of trade decreases, because the price of exports falls in foreign markets to **P*s**

=> Net welfare loss= b + d + e + f + g

Export subsidy

- An export subsidy **unambiguously** produces a negative effect on national welfare.
- The term of trade loss **e + f +g**
- The triangles **b and d** represent **the efficiency loss.**

The tariff distorts production and consumption decisions: producers produce too much and consumers consume too little compared to the market outcome.

Export subsidy

- **The case study: Europe's Common Agricultural Policy (CAP)**

  https://www.youtube.com/watch?v=hvlVJUrj8tQ

- The European Union sets high prices for agricultural products and subsidizes exports to dispose of excess production.

  The subsidized exports reduce world prices of agricultural products.

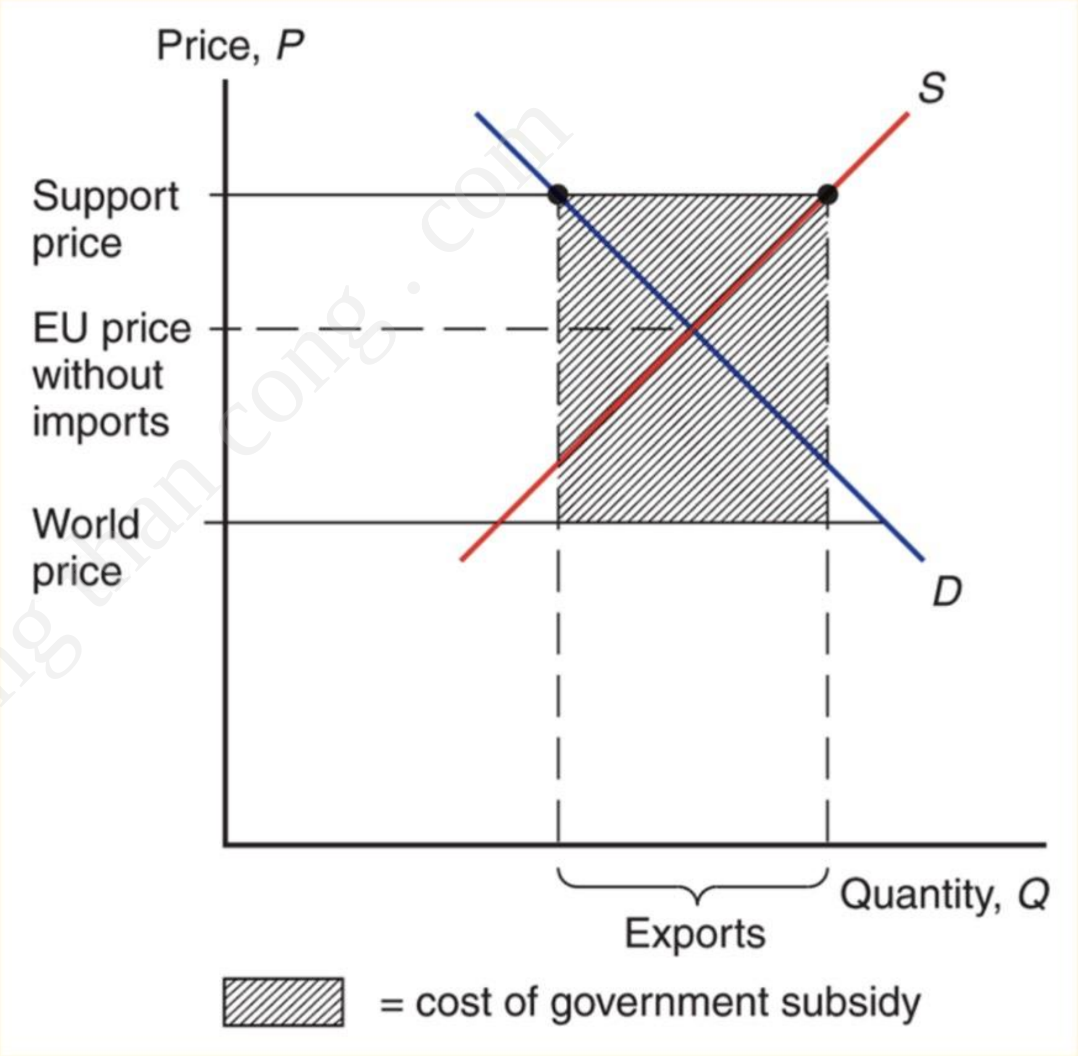
- The direct cost of this policy for European taxpayers is almost $50 billion.

  But the EU has proposed that farmers receive direct payments independent of the amount of production to help lower EU prices and reduce production.'s Common Agricultural Policy

Figure 8-12

Europe's Common Agricultural Program

Agricultural prices are fixed not only above world market levels but above the price that would clear the European market. An export subsidy is used to dispose of the resulting surplus.



Import Quota

- **An import quota** is a restriction on the quantity of a good that may be imported.
- This restriction is usually enforced by **issuing licenses** to domestic firms that import, or in some cases to foreign governments of exporting countries.
- A binding import quota will **push up the price of the import** because the quantity demanded will exceed the quantity supplied by domestic producers and from imports.

Import Quota

- When a quota instead of a tariff is used to restrict imports, the government receives no revenue.

  - Instead, the revenue from selling imports at high prices goes to quota license holders: either domestic firms or foreign governments.

  - These extra revenues are called **quota rents.**

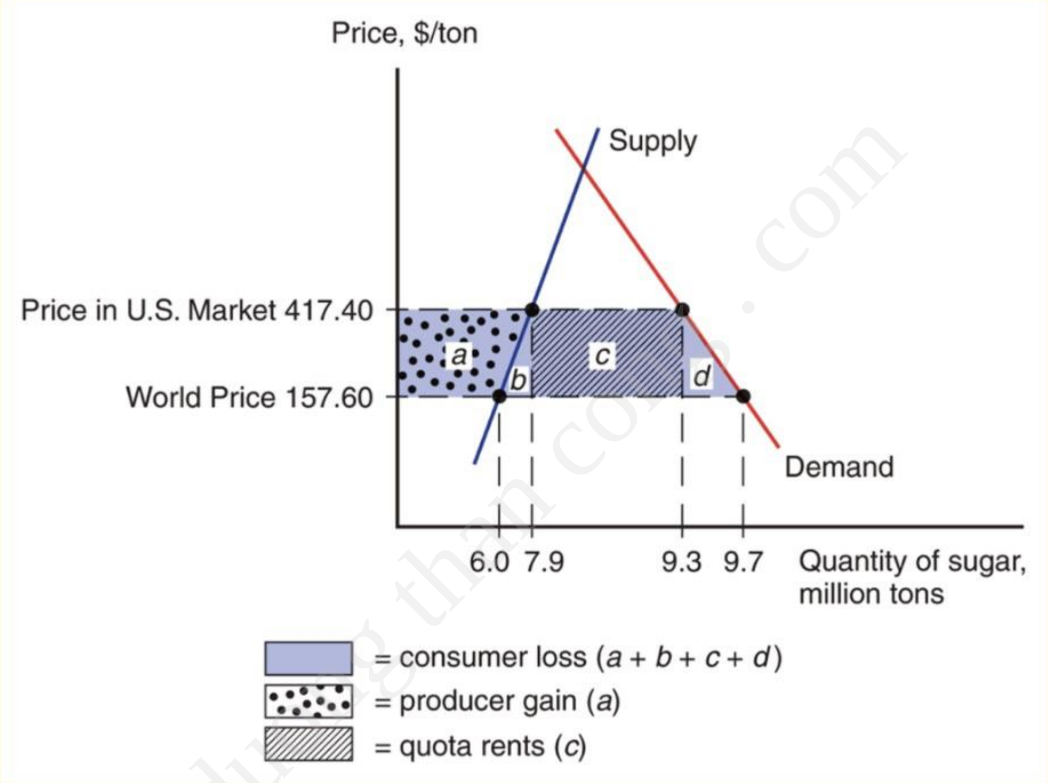


Figure 8-13

Effects of the U.S. Import Quota on Sugar

The sugar import quota holds imports to about half the level that would occur under free trade. The result is that the price of sugar is $417.40 per ton, versus the $157.60 price on world markets. This produces a gain for U.S. sugar producers, but a much larger loss for U.S. consumers. There is no offsetting gain in revenue because the quota rents are collected by foreign governments.

Voluntary Export Restraint

- **A voluntary export restraint** works like an import quota, except that the quota is imposed by the exporting country rather than the importing country.
- However, these restraints are usually requested by the importing country.
- The profits or rents from this policy are earned by foreign governments or foreign producers.

  Foreigners sell a restricted quantity at an increased price.

Voluntary Export Restraint

- Case study: Japanese Auto

Local content requirement

- **A local content requirement** is a regulation that requires a specified fraction of a final good to be produced domestically.
- It may be specified in value terms, by requiring that some minimum share of the value of a good represent domestic valued added, or in physical units.

Local content requirement

- From the viewpoint of <u>domestic producers</u> of inputs, a local content requirement provides protection **in the same way** that an import quota would.
- From the viewpoint of <u>firms</u> that must buy domestic inputs, however, the requirement does not place a strict limit on imports, but **allows firms to import more if they also use more domestic parts.**

Local content requirement

For example: Automobile industry

- The cost of imported parts: $6000
- Suppose that purchasing the same parts domestically cost $10,000
- But that assembly firms are required to use 50% domestic parts

=> The average cost of parts= $8000 = 0.5 x $6000 + 0.5 x $10,000

=> This reflect the final price of the car

Local content requirement

- Local content requirement provides neither government revenue (as a tariff would) nor quota rents.
- Instead the difference between the prices of domestic goods and imports is averaged into the price of the final good and is **passed on to consumers.**
- Allow firms to satisfy their local content requirement by export parts instead of using parts domestically

Local content requirement

- For example, US auto company setting business in Mexico
- Export some parts from Mexico to US, even these parts produced domestically in the US are cheaper
- Because doing so allow them to use less Mexican content in producing car in Mexico for Mexico's market

Other Trade Policies

- **Export credit subsidies**

  - A subsidized loan to exporters

  - US Export-Import Bank subsidizes loans to US exporters.

- **Government procurement**

  - Government agencies are obligated to purchase from domestic suppliers, even when they charge higher prices (or have inferior quality) compared to foreign suppliers.

- **Bureaucratic regulations**

  - Safety, health, quality or customs regulations can act as a form of protection and trade restriction.

Summary

	Tariff	Export subsidy	Import quota	Voluntary export restraint
Producer surplus	Increases	Increases	Increases	Increases
Consumer surplus	Decreases	Decreases	Decreases	Decreases
Government net revenue	Increases	Decreases	No change: rents to license holders	No change: rents to foreigners
National welfare	Ambiguous, falls for small country	Decreases	Ambiguous, falls for small country	Decreases

Summary

- 1. A tariff decreases the world price of the imported good when a country is “large”, increases the domestic price of the imported good and reduces the quantity traded.
- 2. A quota does the same.
- 3. An export subsidy decreases the world price of the exported good when a country is “large”, increases the domestic price of the exported good and increases the quantity produced.

Summary

- 4. The welfare effect of a tariff, quota and export subsidy can be measured by:

  Efficiency loss from consumers and producers

  Terms of trade gain or loss
- 5. With import quotas, voluntary export restraints and local content requirements, the government of the importing country receives no revenue.
- 6. With voluntary export restraints and occasionally import quotas, quota rents go to foreigners.

TABLE 8-1 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