

# PubPol/Econ 541

Class 14

## **Why Countries Restrict Trade**

by

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# Announcements

- Note that Paper 2 is due Nov 10. Confer with your team soon and look at the assignment, so that you can ask any questions.

# Outline

- Multiple reasons
- Second best use of tariffs
- Political economy
- Why are trade barriers so low?
- Recent uses of protection

# Pause for Discussion

# Questions on KOM

- What benefits from free trade are not captured in the partial equilibrium model?
- The textbook mentions only two arguments against free trade: terms of trade and market failure. Can you think of others?

# Outline

- **Multiple reasons**
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# Multiple Reasons

- See my Glossary:
  - Lists / Arguments for Protection
  - I list 26, and our examples later suggest more

# Arguments for Protection

Balance of payments

Cultural

Decreasing cost

Domestic distortions

Employment

Environmental protection

Externalities

Fairness

Foreign investment

Graham's

Income redistribution

Infant industry

Labor standards

Monopoly

National defense

Noneconomic objectives

Optimal tariff

Patriotism

Pauper labor

Revenue

Second-best

Self-sufficiency

Strategic industry

Strategic trade policy

Sunset industry

Terms of trade



# Multiple Reasons

- Details on just a few
  - Cultural: Sustain a distinctive culture that would be undermined by imports
  - Foreign investment: Use tariff to induce foreign companies to invest instead of export
  - Infant industry: Let new industry “learn by doing” behind tariff wall
  - Patriotism: Support our own producers

# Pause for Discussion

# Questions (not asked before)

- Which of these seem to have motivated Trump's tariffs?
- Which look like they may be legal under GATT/WTO?

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# Second best use of tariffs

- First, why do economists expect undistorted markets to do well?
  - To the extent that
    - Supply curves measure marginal cost (MC), and
    - Demand curves measure marginal benefit (MB),
  - Then market price equates these
  - $MC=MB$  is the recipe for maximizing benefit net of cost
- But what if the curves don't measure these?
  - Then we say there are “distortions” and market price is not optimal.
  - The harm done by a tariff is an example of this.

# Second best use of tariffs

- Our model says tariffs hurt if all else is perfect. What if there are
  - Market failures?
  - Distortions?
  - Externalities?
  - Imperfect competition?
  - Etc.

# Second best use of tariffs

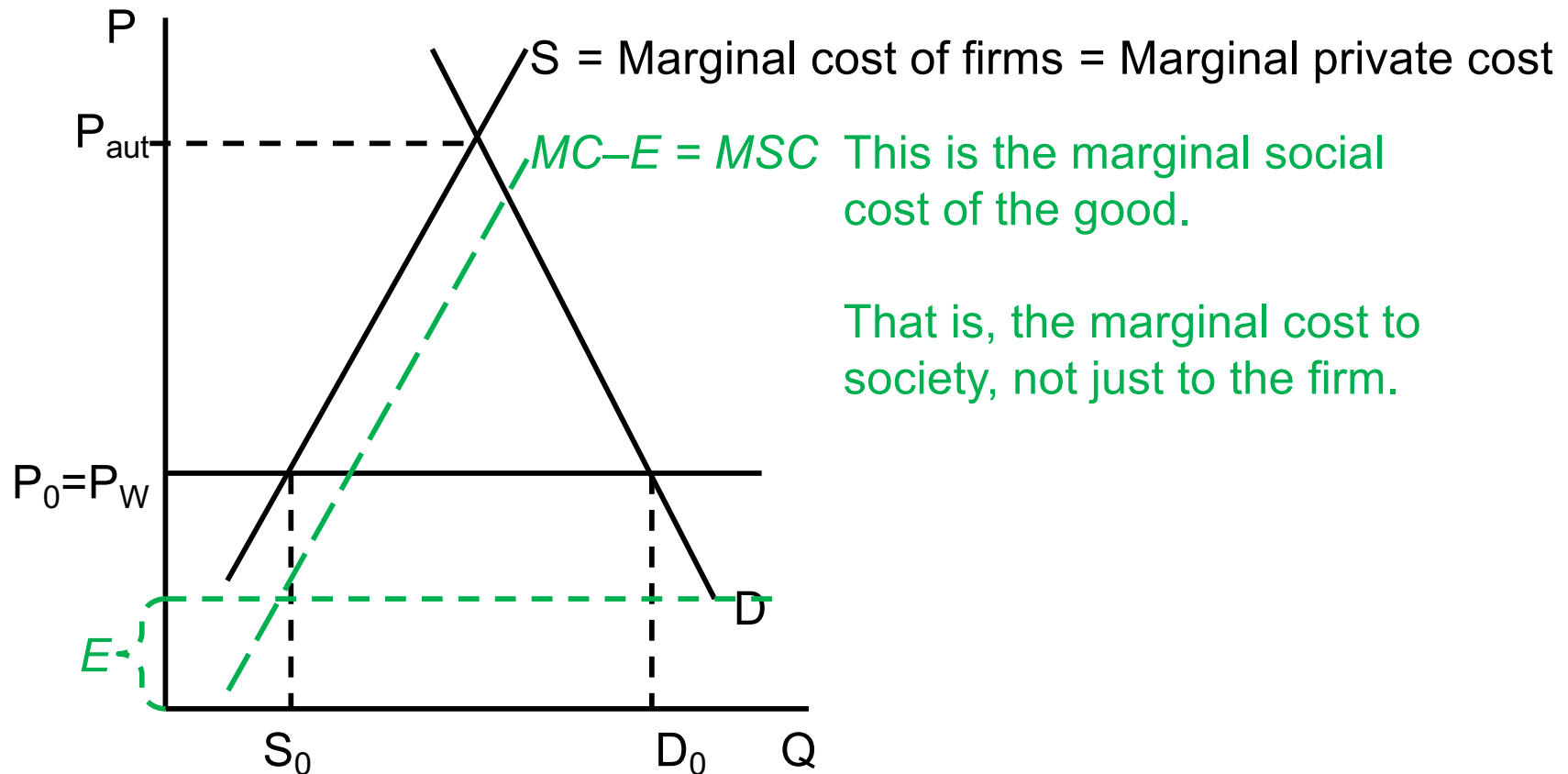
- Answer
  - A tariff can offset some distortions and therefore may raise welfare
  - But there is always another policy that will do better
    - Reason: A tariff creates two distortions (see our triangles of dead-weight loss)
    - One may offset a distortion, but the other makes things worse
  - Hence tariff is “second best”

# Second best use of tariffs

- Example
  - Suppose production yields a “positive externality”
    - Production provides a benefit not captured (or charged for) by producers
  - A tariff stimulates production and so generates more of the externality – That’s good!
  - For example, European farms make countryside attractive to tourists

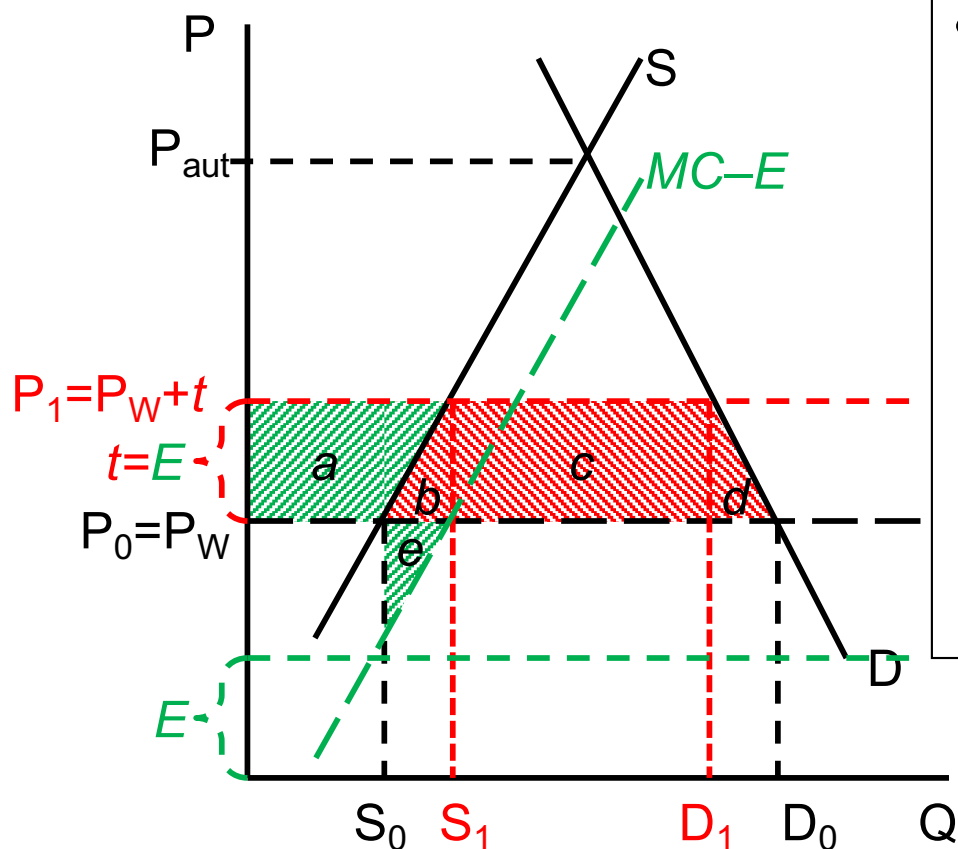


# Small country with positive externality



Positive Externality,  $E$

# Small country tariff with positive externality



- Welfare effects of a tariff, if set equal to  $E$ , starting from free trade:

|                        |              |
|------------------------|--------------|
| – Suppliers gain       | $+a$         |
| – Demanders lose       | $-(a+b+c+d)$ |
| – Government gains     | $+c$         |
| – Externality benefit  | $+(b+e)$     |
| – Country gain or loss | $+e - d$     |

Specific Tariff  $t = E$

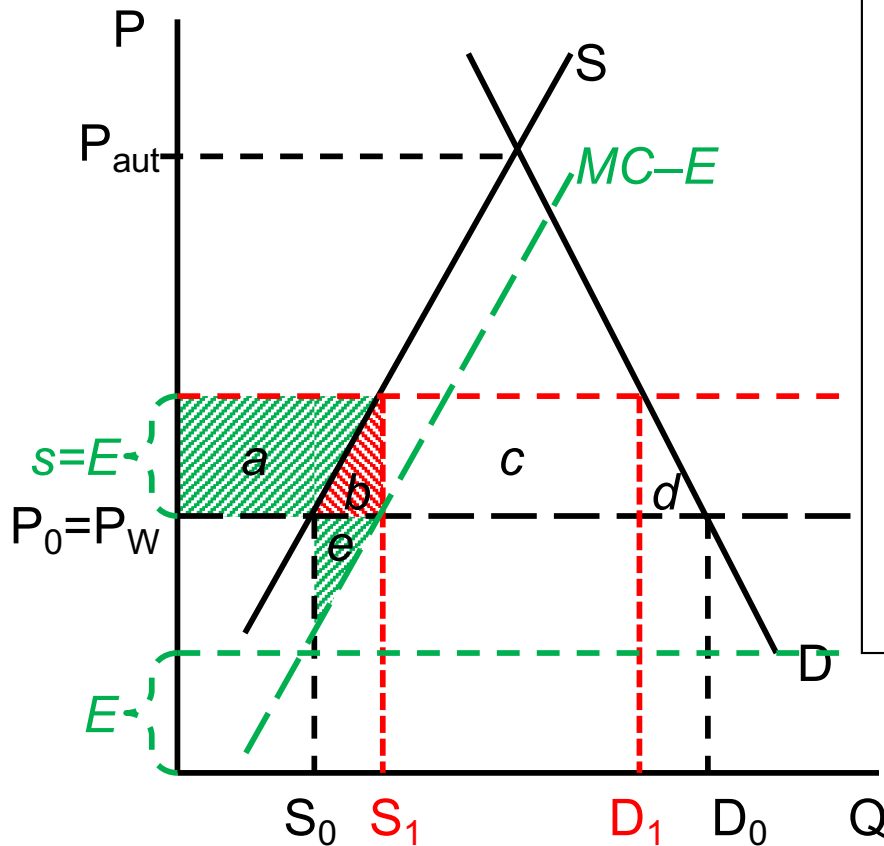
# Second best use of tariffs

- Result
  - Tariff raises welfare if  $e > d$
  - That is, if
    - the benefit of increased externality exceeds
    - the demand-distortion loss of the tariff

# Second best use of tariffs

- But there's a better policy: subsidize supply:
  - That leaves demanders facing world price
  - Lets suppliers be paid  $P_W + E$
- Causes only one distortion, of supply, and
  - That is beneficial because
    - It corrects the distortion of the externality
    - Without also distorting demand

# Small country production subsidy with positive externality



- Welfare effects of a subsidy, if set equal to  $E$ , starting from free trade
 

|                       |          |
|-----------------------|----------|
| – Suppliers gain      | $+a$     |
| – Demanders lose      | $0$      |
| – Government loses    | $-(a+b)$ |
| – Externality benefit | $+(b+e)$ |
| <hr/>                 |          |
| – Country gains       | $+e$     |

But note that:

- Tariff creates revenue
- Subsidy costs the gov't

Production subsidy  $s=E$

# Second best use of tariffs

- In general, distortions (market failures) distort only supply or demand
- A tariff can only correct one by hurting the other
- A more direct policy – tax or subsidy on distorted behavior – will be “first best”
  - Except for budget implications

# Pause for Discussion

# Questions on KOM

- How does the theory of the second best provide reasons that tariffs may be beneficial?
- How does it also provide reasons why tariffs are not the best policy in such cases?

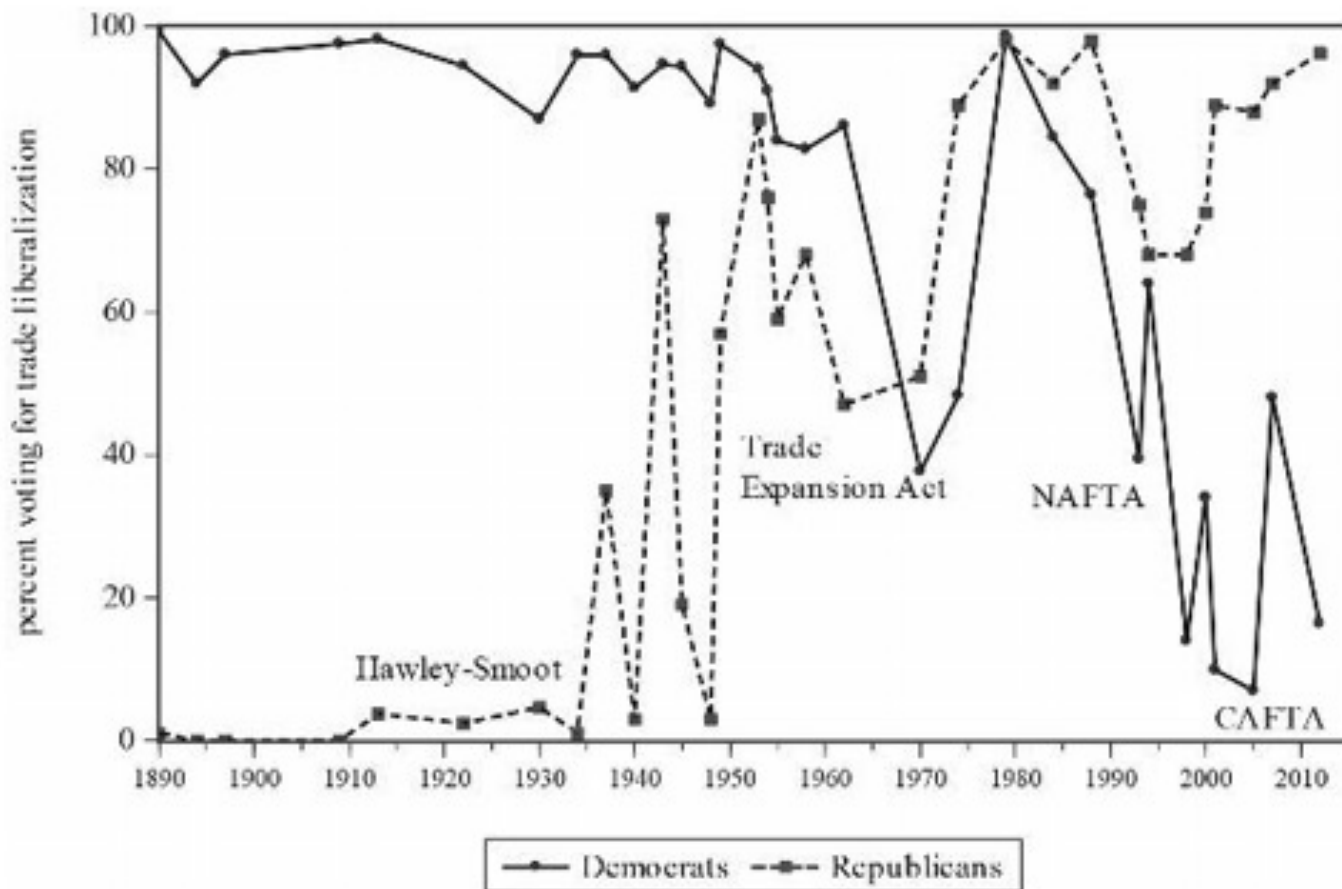


# Outline

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- **Political economy**
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# Political Economy

- Explain policies based on features of the political process
  - Allow for
    - Voting
    - Lobbying
    - Other forms of political pressure by interest groups
  - But also allow policymakers to care about economic well-being as in our models



**Figure 13.2.** House voting on trade legislation, by party, 1890–2015. (Compiled by the author.)

# Pause for Discussion

# Questions on KOM

- What is the “median voter theory,” and why does it seem not to explain protection?

# Questions on Baldwin & Magee

## “Is Trade Policy for Sale?”

- By what mechanisms do theorists suggest that political contributions result in votes for and against trade liberalization?
- Do businesses and labor groups in the US tend to contribute in favor of protection or free trade?
- What were the three Congressional votes studied by Baldwin and Magee? Which side – labor or business – had the greater effect on the voting?

# Questions on Baldwin & Magee

## “Is Trade Policy for Sale?”

- What do they estimate as the “price” of one congressional vote against NAFTA or the WTO?
- Were campaign contributions the only thing that mattered for congressional votes on these trade issues?

# Outline

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- **Why are trade barriers so low?**
- Recent uses of protection



# Why Aren't Tariffs Higher?

- Magee lists 6 possible reasons why tariffs are not higher:
  - ~~1~~ Politicians are not responsive to lobbying efforts
  - ✓2. Welfare costs of tariffs are higher than traditionally measured
  - ✓3. The GATT was successful in reducing trade barriers
  - ✓4. Free riding by firms hinders lobby organization
  - ~~5~~ Users of imported goods lobby against tariffs
  - ✓✓✓6. Protection is given, but by non-tariff barriers, which are high
- Magee's view of the evidence
  - #1, 5 not important
  - #2, 3, 4 play a small role
  - #6 is most important: actual protection is much higher than tariffs

# Pause for Discussion

# Questions on Magee

## “Why Are Trade Barriers So Low?”

- Does the main “political economy” model for explaining tariffs say that politicians care only about campaign contributions?
- Why does Magee give only partial credit to GATT negotiations in explaining the fall of tariffs since the 1930s?

# Questions on Magee

## “Why Are Trade Barriers So Low?”

- How do the following terms or concepts figure in explanations for why trade barriers are low:
  - free riding;
  - peace;
  - imported inputs;
  - non-tariff barriers?

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- **Recent uses of protection**

# Recent uses of protection

- Some examples from earlier (not in this year's readings):
  - India considers tariffs on China after border conflict
  - Pakistan to "halt trade with India" after actions on Kashmir
  - Japan uses export controls on S Korea after Korea seeks compensation for forced labor in WWII
  - US bars arms exports to Hong Kong after China reduces Hong Kong independence

# Recent uses of protection

- More from earlier:
  - China puts tariffs on Australian barley after Australia seeks inquiry on origins of coronavirus.
  - US may stop cocoa imports from Ivory Coast for using child labor.
  - China blocked meat imports from Canada after Canada arrested daughter of Huawei founder.
  - China had a ban (and has now lifted it) on US chicken due to outbreak of avian flu.

# Recent uses of protection

- From this year:
  - US banned avocados from Mexico due to verbal threat made to US inspector in Mexico.
  - US threatened tariffs on countries using a digital services tax.
  - China suspended imports of many food products from Taiwan in response to Nancy Pelosi visit.



# Recent uses of protection

Message from much of this:

Countries often restrict trade to hurt other countries that they are angry at.

# Pause for Discussion

# Questions on Krugman “Two Cheers for Carbon Tariffs”

- Why would Krugman favor a carbon tariff even if it were as economically harmful as a tariff usually is?
- Why does he discuss the economics of the value added tax?
- A carbon tariff set equal to a domestic carbon tax makes sense, but what if the domestic policy is regulation, not tax?
- Why does he give only two cheers, not the usual three?

