8 Impediments on Trade

INTRODUCTION

It was demonstrated in Chapter 4 that free international trade, given certain restrictive assumptions, is the best regime for the world in that it increases countries' potential welfare. It is therefore pertinent to ask why it is that nations erect impediments on their trade. To answer this question one needs to be familiar with the branch of trade theory generally referred to as theory of trade (commercial) policy.

It should be stressed from the start that trade impediments take a variety of forms: the imposition of tariffs, import quota restrictions, export subsidies, differing industrial standards, etc. (see Baldwin, 1971b). To simplify discussion such impediments can be reduced to: tariffs, quotas and 'other' instruments (usually referred to as hidden trade barriers). Furthermore, all trade restrictions except tariffs are known as non-tariff trade barriers (NTBs) or distortions.

However, most discussion of this subject has been conducted in terms of tariffs. The reason is that tariffs are the device most widely used for regulating trade flows. Moreover, except under very special circumstances, tariffs are practically the only measure of trade regulation permitted by GATT. Finally, tariffs operate via the price mechanism, hence the analysis of tariffs can easily be extended to incorporate any trade impediments that operate via the price mechanism.

REASONS FOR TARIFFS

In one of his many formidable contributions to the theory of tariffs, the late Professor Johnson (1965a) stated that the arguments as to why countries impose tariffs on trade fall into three general categories: economic arguments; non-economic arguments; and non-arguments. By non-economic arguments one means socio-political considerations and similar rationales – for instance, a country may deem it necessary for its long-term survival (the preservation of a certain way of life; military independence; security of food supplies; etc.) to be less dependent on trade by being more autarkic. Amongst economic arguments is the existence of a divergence between private and social costs and benefits – it will be remembered that the
rationale for free international trade was provided in terms of private costs and private benefits only. Finally, non-arguments simply refer to fallacies or misconceptions regarding the economic consequences of tariff imposition.

The aim of this chapter is, therefore, to analyse the effects of tariffs and to compare these with the effects of an import quota restriction as an example of non-tariff trade distortion. Further considerations will be introduced in the next chapter, and these will make it possible to discuss one example of each of the three categories of arguments just mentioned.

**EFFECTS OF TARIFFS**

Before discussing the subject in more depth, it should be stressed that tariffs could be *specific*, *ad valorem* or a combination of the two (compound duties). A specific tariff is simply what it says, for example £X collected as a duty per car imported irrespective of the total number of cars, while an *ad valorem* tariff is levied as a percentage of the total value of the imported item. Since a specific tariff can easily be calculated as a percentage rate, the analysis here will be conducted entirely in *ad valorem* terms.

To analyse the economic effects of tariff imposition, consider a partial equilibrium diagram (Figure 8.1) where $P_wS_w$ is W's perfectly elastic supply function for commodity C (i.e. at price $OP_w$ consumers in H can buy any quantity they wish), $SS$ is H's domestic supply curve and $DD$ is its domestic demand curve. Under free trade conditions, H plans to consume $Oq_4$, produce (domestically) $Oq_1$ and import the difference ($q_1q_4$) from W at a total cost of $q_1ABq_4 = q_1q_4 \times OP_w$.

Assuming that tariffs do not affect the terms of trade (i.e. H's demand for and supply of commodity C have no effect on world prices) and that tariffs are completely translated into an increase in the price facing H's consumers, the imposition of a tariff ($t$) raises the domestic price to $OP_w'$ (i.e. shifts W's supply curve up to $P_w'S_w'$). As a result planned consumption falls by $q_1q_4$ (from $Oq_4$ to $Oq_3$), domestic production expands by $q_1q_2$ (from $Oq_1$ to $Oq_2$) and the level of imports falls to $q_3q_4$ (from $q_1q_4$). Hence the tariff imposition is equivalent to a tax on the domestic consumer accompanied by a subsidy to the domestic producer.

In partial equilibrium terms, these are the basic effects of tariff imposition, hence it is important to consider their implications carefully.