

Chapter 9

International Trade

MODERN PRINCIPLES OF ECONOMICS
Third Edition



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Outline

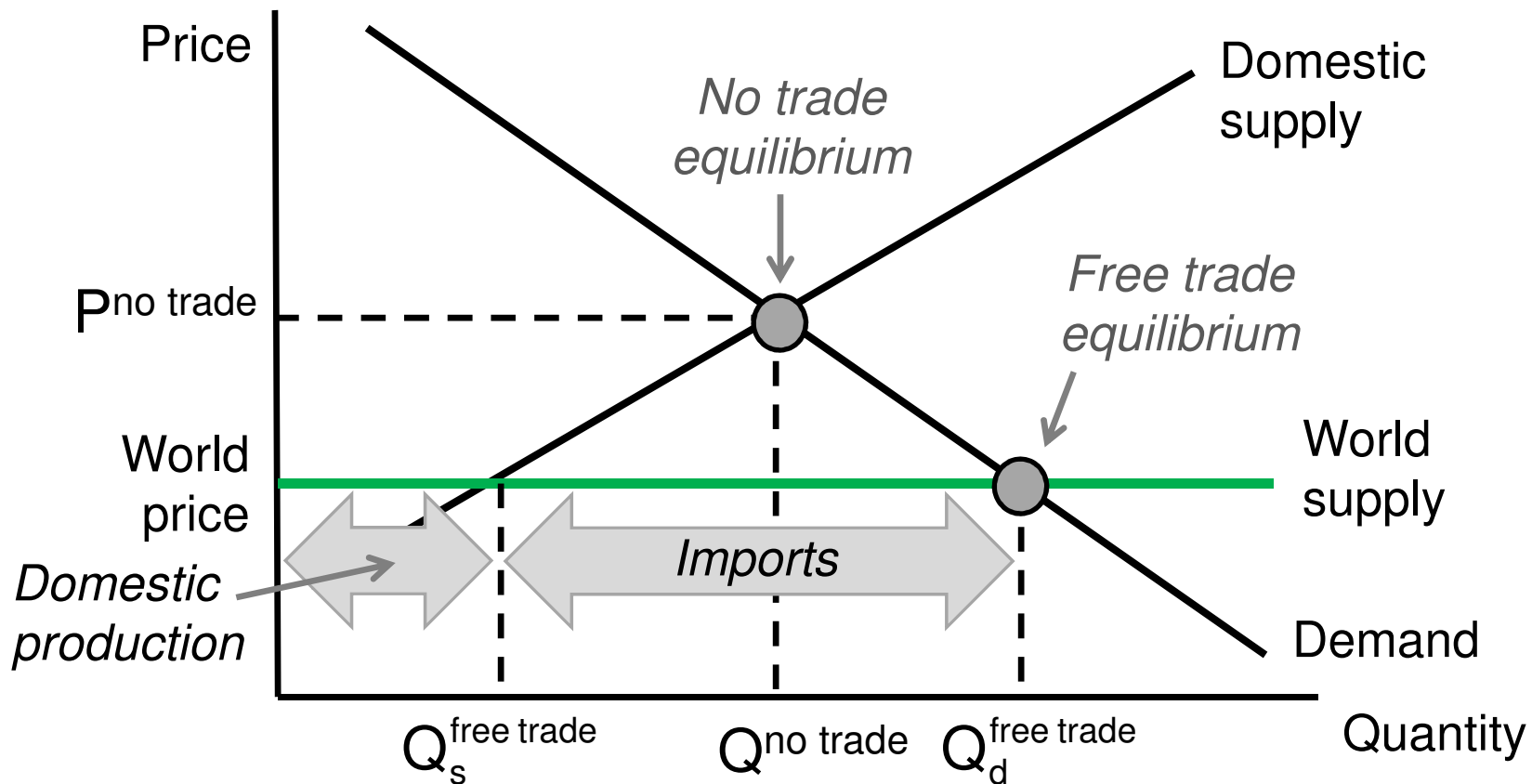
- Analyzing trade with supply and demand
- The costs of protectionism
- Arguments against international trade

Introduction

- International trade is trade across national borders.
- Basic principles of trade still apply:
 1. Trade makes people better off when preferences differ.
 2. Trade increases productivity through specialization and the division of knowledge.
 3. Trade increases productivity through comparative advantage.

Analyzing Trade with Supply and Demand

The difference between domestic demand and domestic supply is made up by imports.



Definition

Protectionism:

the economic policy of restraining trade through quotas, tariffs, or other regulations that burden foreign producers but not domestic production.

Definition

Tariff:

a tax on imports.

Quota:

restrictions on the quantity of goods that can be imported.

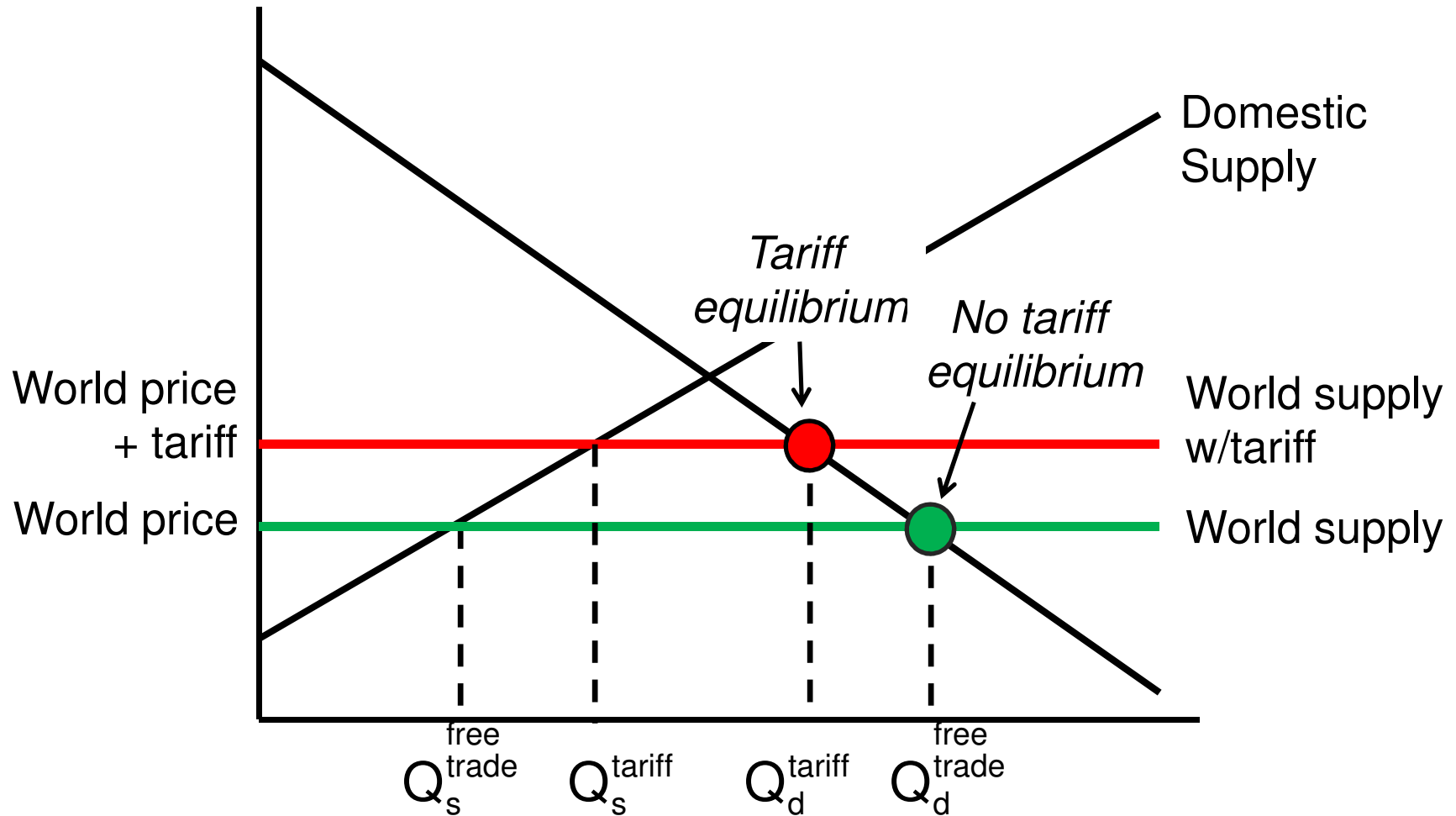
Self-Check

Suppose the U.S. restricted the number of cars that could be imported to 50,000 per month. This is an example of:

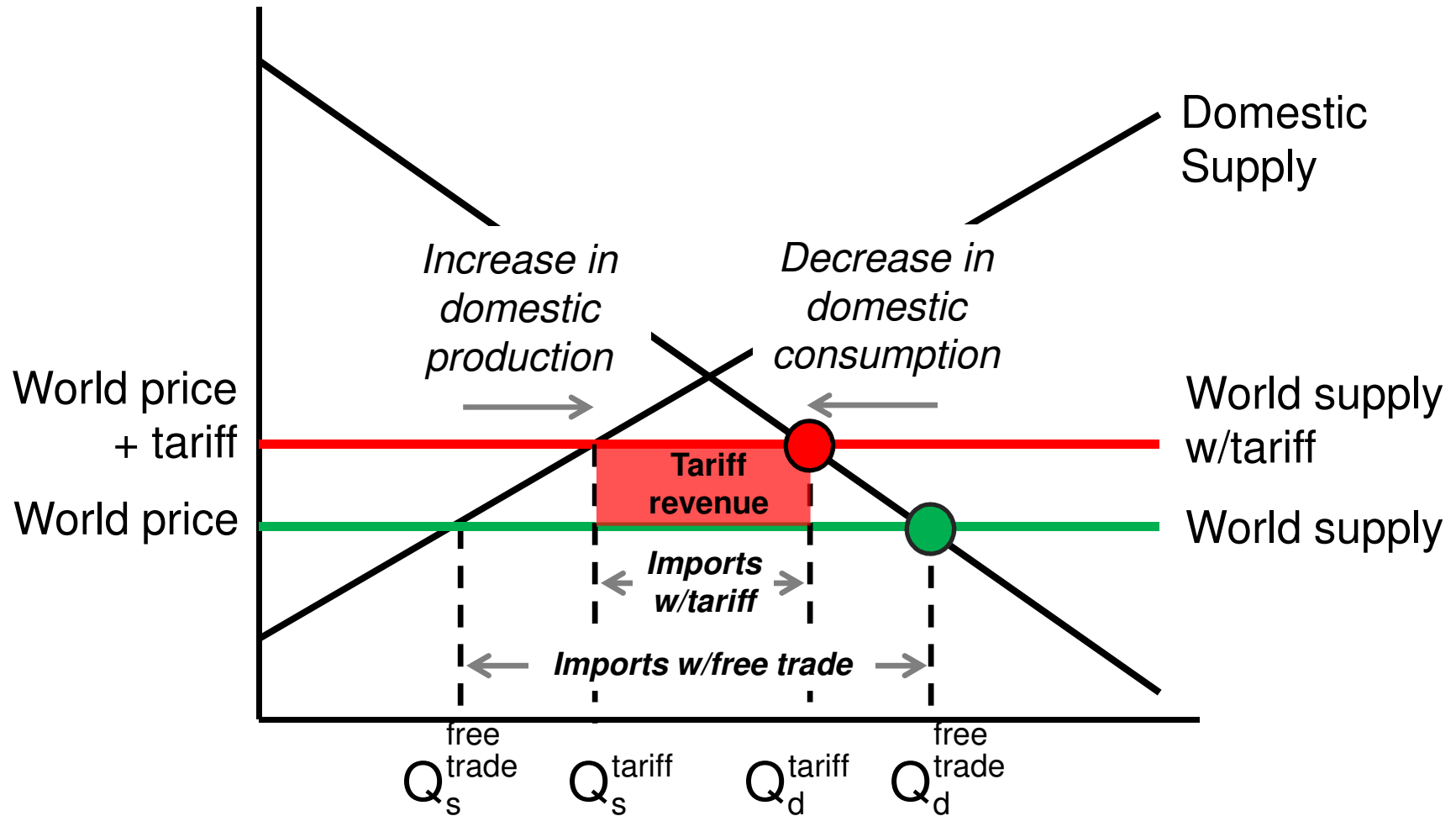
- a. A quota.
- b. A tariff.
- c. Free trade.

Answer: a – *this is an example of a quota.*

Tariffs



Tariffs



Tariffs

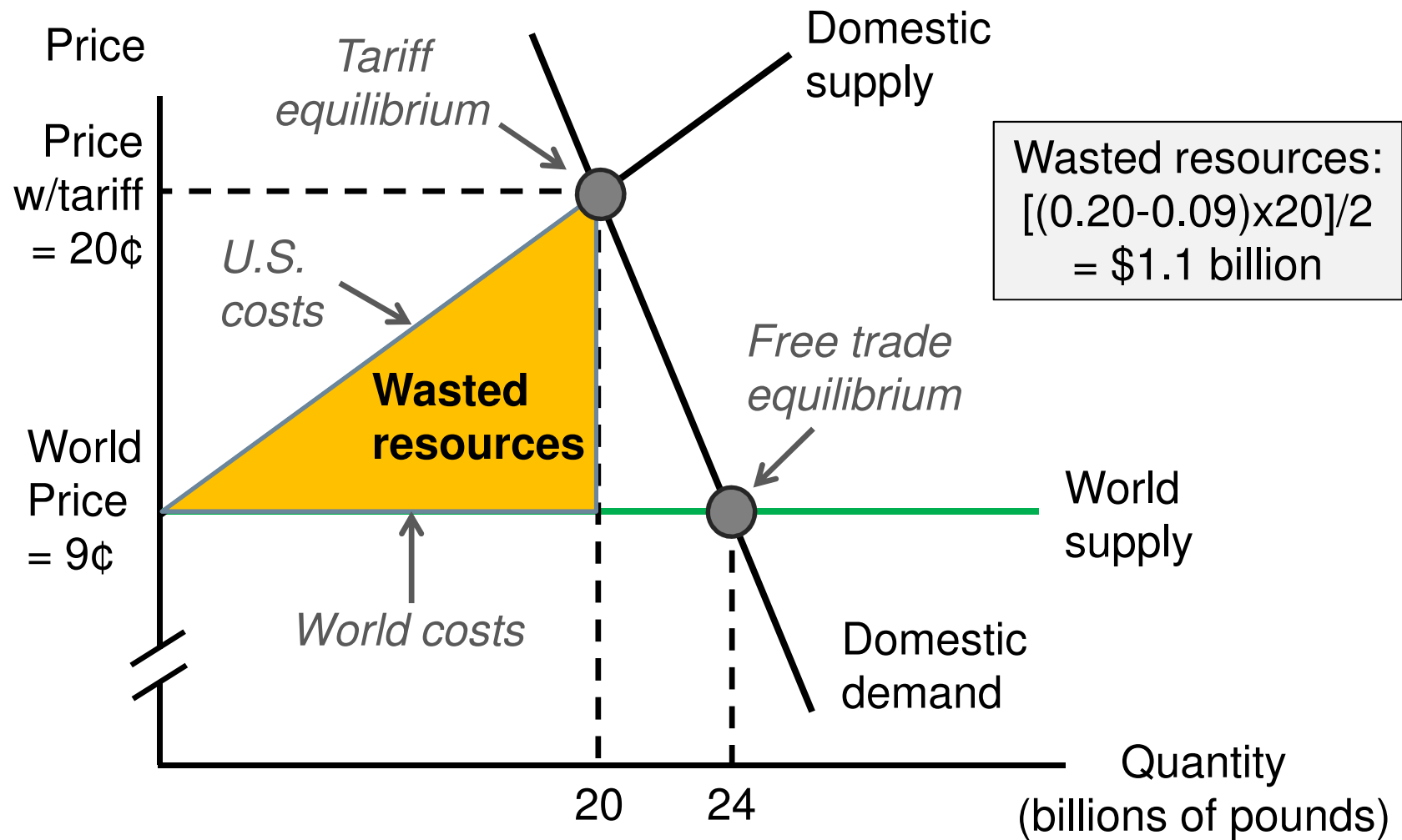
Effects of a tariff:

- Domestic suppliers respond to the higher price by increasing production.
- Domestic consumers respond to the higher price by buying less.
- Imports decrease.
- Government revenue = tariff amount times the quantity of imports.

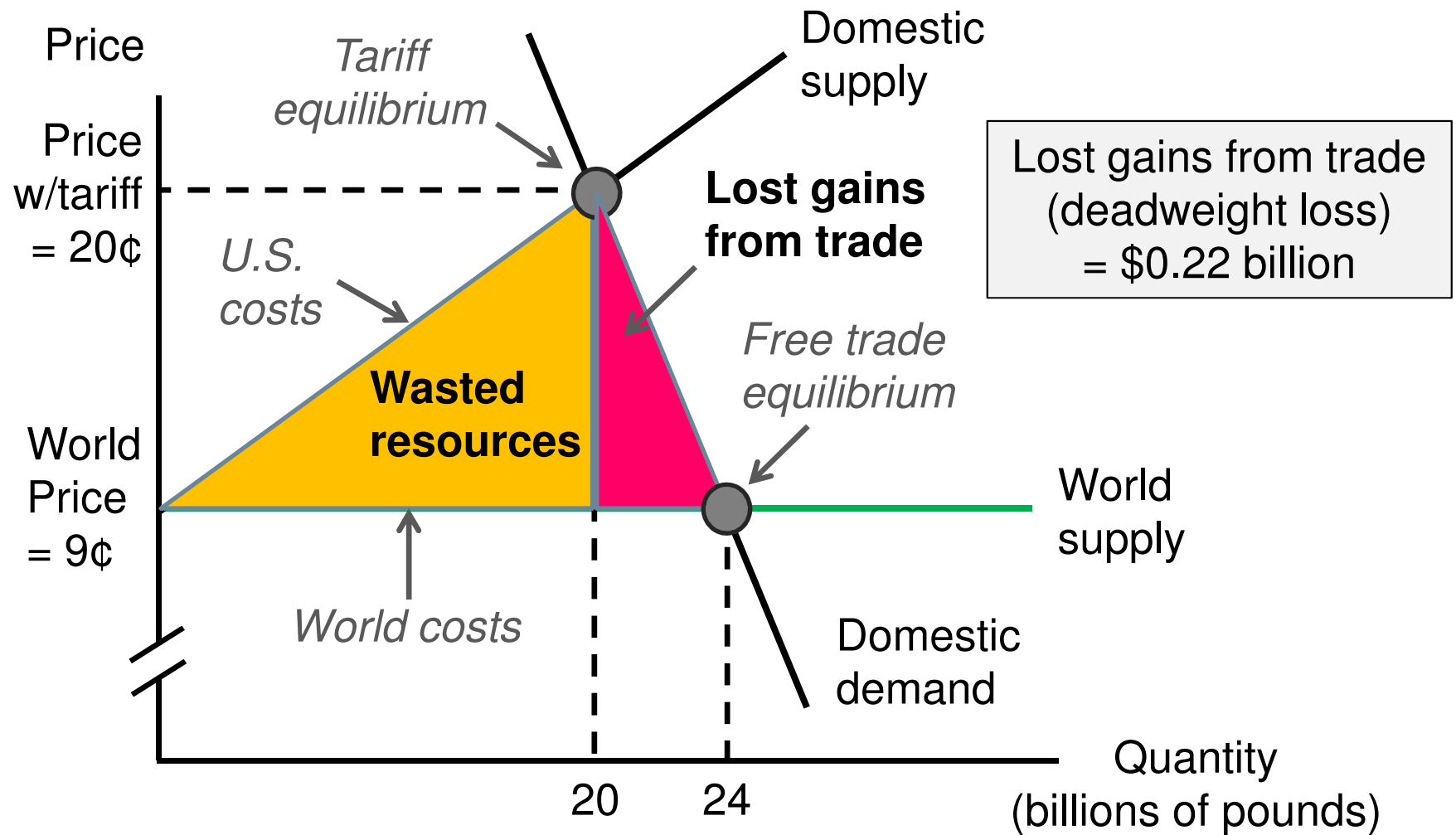
Costs of Protectionism

- The U.S. Government restricts sugar imports.
- As a result, U.S. consumers pay 50-100% more than the world price.
- Our analysis makes two assumptions:
 1. The tariff is so high it eliminates all sugar imports.
 2. If we had complete free trade, all sugar would be imported.

Costs of Protectionism



Costs of Protectionism



Costs of Protectionism

- Total cost of the sugar tariff to U.S. citizens is:
 - \$1.1 billion of wasted resources, plus
 - \$0.22 billion lost gains from trade, equals
 - Total \$1.32 billion.
- Together, wasted resources and lost gains from trade represent the deadweight loss from trade restrictions.

Self-Check

Who benefits from a tariff?

- a. Domestic consumers.
- b. Domestic producers.
- c. Foreign producers.

Answer: b – *domestic producers; a tariff increases price, which increases producer surplus.*

“Unfair Foreign Competition”

“Who is hurt and who benefits? To pay for the subsidies [on products sold to Americans at a cheaper price] the foreign government must tax it's citizens. They are the ones who pay for the subsidies. U.S. consumers benefit. They get cheap TV sets or automobiles or whatever it is that is subsidized. Should we complain about such a program of reverse foreign aid?”

- Milton Friedman - Free to Choose

“Unfair Foreign Competition”

- *“We need tariffs against countries that compete unfairly by subsidizing their industries and dumping their products in our market.”*
- Same as the July 2014 Import-Export Bank renewal arguments (now late 2015 efforts)
- Who benefits from foreign subsidies? Who is harmed?
- Another example of concentrated benefits versus dispersed costs

The Costs of Protectionism

- ***Conclusions:***

- **A tariff reduces economic efficiency:**

- Low-cost producers are prevented from selling.
- Mutually profitable gains from trade are prevented by law.

- *U.S. consumers pay more, and workers in other countries (many of whom are poor) lose income.*

The Costs of Protectionism

One final cost: lobbying

- The loss to domestic consumers is greater than the gains to domestic producers.
- Why does congress pass tariffs?
 - *Small number of producers* → Benefit per producer is high.
 - *Large number of consumers* → Loss per consumer is low.

We're better off with free trade, so why do we have tariffs?

- Trade can be analyzed via public choice theory - a branch of economics that deals with the workings of the political market.
- A tariff makes the inhabitants of the country that imposes it worse off.
- Politicians who pass the tariff are better off, since it benefits a concentrated interest group at the cost of dispersed interest groups.
- More concentrated interest groups are better able to pay politicians to do things for them. Trade policy is optimized, but for the wrong objective.

Arguments Against International Trade

1. Trade reduces the number of jobs in the U.S.
2. It's wrong to trade with countries that use child labor.
3. We need to keep certain jobs at home for national security.
4. We need to keep certain “key” industries at home because of beneficial spillovers onto other sectors of the economy.
5. We can increase U.S. well-being with strategic trade protectionism.

Arguments Against International Trade

1. Trade and Jobs

- When U.S. tariffs are reduced, the industry contracts and jobs are lost.
- Lower prices means U.S. consumers spend more on other goods.
- Increased consumer spending leads to more jobs in other industries.

Arguments Against International Trade

1. Trade and Jobs

- Foreign producers use the U.S. currency to purchase U.S. goods, increasing exports.
- We pay for imports with exports.
- Trade moves jobs from import-competing industries to export industries.
- Trade restrictions save visible jobs, but destroy jobs that are harder to see.

Arguments Against International Trade

2. Child Labor

- By making a country poorer, trade restrictions may increase the number of child workers.
- Studies show that more openness to trade increases income and reduces child labor.

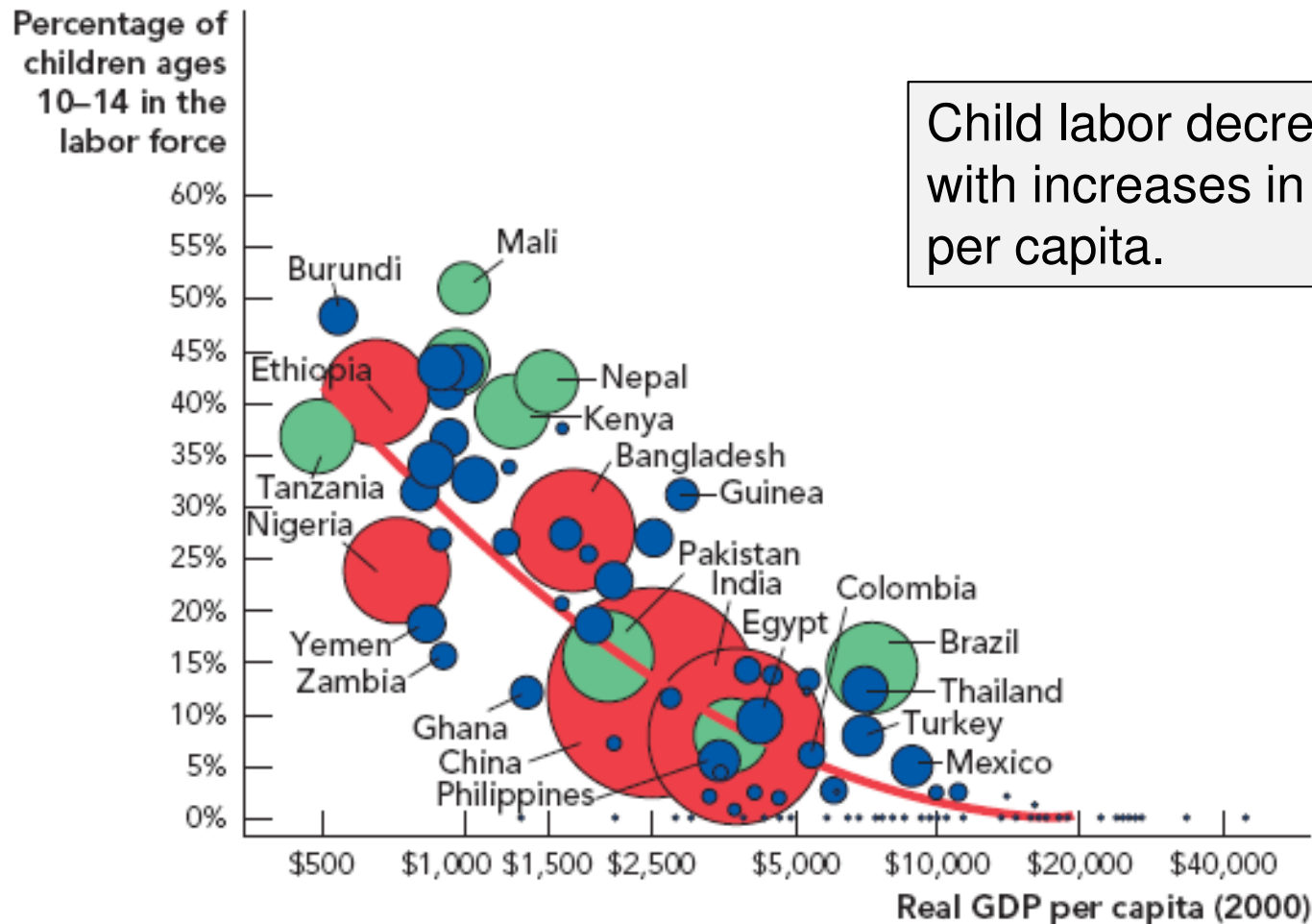
Often the alternative is worse.

Prostitution

Scrounging in refuse dumps

- The real cause of child labor is poverty, not trade.

Child Labor



Note: size of the circle is proportionate to the number of child workers.

Arguments Against International Trade

3. Trade and National Security

- Protection may be justified if a good is vital for national security.
 - Example: Domestic vaccine industry
- This creates an incentive for every domestic producer to claim their product is vital for national security.
 - Vaccine production? Probably a good idea
 - Angora Goat fleece? Be serious
 - Helium? For our killer blimps

Arguments Against International Trade

4. Key Industries

- Key industries, which generate **spillovers** or other benefits, should be protected.
- In theory, a subsidy would work better than protectionism.
- The argument is not compelling.
- It is difficult to know which industries are the ones with the really important spillovers.
 - Computer chips? Yes

Arguments Against International Trade

5. Strategic Trade Protection

- It is possible for a country to use tariffs and quotas to get a larger share of the gains from trade.
- The government helps domestic firms to act like a cartel when they sell to international buyers.
- This is done by limiting or taxing exports.
- Can only work if international buyers have few substitutes for the domestic good.

Self-Check

When U.S. tariffs are decreased, imports increase and U.S. jobs are lost. What else happens to offset the job losses in that industry?

- a. Lower prices increase consumer spending on other goods.
- b. Lower prices increase profitability.
- c. Government revenues increase.

Answer: a – *Lower prices increase spending on other goods, creating jobs in other industries.*

Takeaway

- Demand and supply curves can be used to analyze trade and the costs of trade protectionism.
- Restrictions on trade:
 - Waste resources by transferring production from low-cost foreign producers to high-cost domestic producers
 - Prevent domestic consumers from exploiting gains from trade, creating deadweight loss.

Takeaway

- Domestic producers can benefit from trade restrictions, but they lose more than the producers gain.
- Trade restrictions sometimes persist because
 - The benefits are concentrated on small groups who lobby for protection.
 - The costs are spread over millions of consumers and are small for each individual.