

## Import Quotas

Both tariffs and import quotas reduce quantity of imports, raise domestic price of good, decrease welfare of domestic consumers, increase welfare of domestic producers and cause deadweight loss.

Tariff raises revenue for the government, import quota may not.

Import quota generates surplus for firms that get the licence to import.

For a firm that gets a licence to import, profit per unit equals domestic price (at which imported good is sold) minus world price (at which good is bought) (minus any other costs. Total profit equals profit per unit times quantity sold.

Government may charge fees for import licence. If the government sets the import licence fee equal to difference between domestic price and world price, the import quota works exactly like a tariff. The entire profit of the firm with an import licence is paid to the government. Thus government revenue is the same under such an import quota and a tariff. Also, consumer surplus and producer surplus are the same under such an import quota and a tariff.

In practice, when a country uses import quotas it rarely sells import licences.

US has pressured Japan to voluntarily limit sale of Japanese cars in the US. Then Japanese government allocated the import licences among Japanese firms. Surplus (profit) from the licences went to those firms.

This kind of import quota is strictly worse from US point of view than a tariff. The tariff unlike this import quota raises revenue for the government.

So why do countries use import quotas instead of always using a tariff?

When an import quota is used, it allows a country to be sure of the amount of the good imported from the foreign country. When there is a tariff, if the supply curve of the foreign country is unknown, the quantity of the good imported may not be predictable.

If world supply in the home country is upward-sloping and less elastic than domestic demand (as may be the case when the home country is the United States) then the incidence of the tariff may fall on producers, and the price paid domestically may not rise by much. Then if the tariff is supposed to make price

of the good rise to allow domestic producers to sell at a higher price, the tariff may not have much of the desired effect. A quota may do more to raise price. However in competitive markets there is always some tariff that raises the price as high as the quota does.

Arguments for restricting trade

### 1. Jobs

Trade with other countries destroys jobs domestically.

In Isoland, when world price is lower than domestic price and free trade is allowed, jobs are lost in the Isoland steel industry because less steel is produced in Isoland.

But free trade causes other jobs to be created in Isoland. The higher consumer surplus that is created in Isoland due to free trade allows more spending on goods other than steel. Also, the countries that sell steel to Isoland get the opportunity to buy other goods from Isoland. It is necessary that Isoland has a comparative advantage over the rest of the world in production of some good. When other countries get more money from selling steel to Isoland, they have more to spend on the goods that Isoland has a comparative advantage in.

### 2. National security argument

An industry may be considered vital for national security. Then it would be necessary to have some home production in case the country went to war with the country it imports from.

For instance steel is used to make guns and tanks. If a war broke out and the steel supply was interrupted, Isoland might not be able to produce enough steel to defend itself.

This argument is used much more often than it really applies. Producers may claim that their good is necessary for national defense even if it is not so important.

Military may even benefit from cheaper imports. For instance having cheaper steel available in Isoland would allow the military to buy a sufficient amount of steel for use if a war breaks out.

Infant industry argument

New industries sometimes claim they need temporary trade restrictions to get started. Once they have reached a level of production at which their costs

are low enough that they can compete with foreign firms, the restrictions could be removed.

Also, older industries sometimes argue that they need temporary trade restrictions while they restructure to become more competitive. In 2002 Bush imposed temporary tariffs on imported steel, claiming the domestic steel industry needed some time to restructure itself.

To effectively protect infant industries, the government would have to be able to decide which domestic industries are likely to be successful once restrictions are removed. Government would also have to decide whether the benefits of protecting those infant industries exceed the costs to consumers of this protection.

It is extremely difficult for the government to make these decisions because of the large amount of knowledge that is required (costs of firms now, future costs once they have been successful at reducing costs).

Political process makes it unlikely that the best possible firms will be chosen. Instead, the most politically powerful industries will be chosen.

Also, if an industry is likely to make positive profits in the future, it should be willing to incur losses now. It could borrow to finance its setup costs and pay them back when the profits arrive later.

The only problem would be credit constraints.

Unfair competition argument

Free trade may be desirable only if all countries play by the same rules. Suppose the government of Neighborland subsidizes its steel industry by giving steel companies large tax breaks. Should the Isolandian steel industry be protected from this unfair foreign competition by a tariff or import quota?

It does not hurt Isoland to buy steel from Neighborland at a subsidized price. The gains of the Isolandian consumers from buying at the lower price exceed the losses to Isolandian producers from having to sell at the lower price.

The taxpayers of Neighborland bear the burden of the subsidy on steel production. Isoland as a whole benefits from this policy.

Protection as a bargaining chip argument

Claim that trade restrictions can be useful when bargaining for trade barrier removal with trading partners. Isoland could threaten to impose a tariff on steel

unless Neighborland removes a tariff on wheat (which Isoland is comparatively better at producing). That way Isoland could become better off by getting Neighborland to remove its tariff on steel.

But Neighborland is making itself worse off by having on tariff on wheat from Isoland.

Isoland will make itself worse off by imposing a tariff on steel. Then the threat to impose such a tariff must be either an empty threat, or Isoland will actually harm itself by imposing it.

### Trade agreements and the World Trade Organization

A country can remove trade restrictions either unilaterally or multilaterally. Unilaterally means it removes them on its own without compensating restriction removal from other countries.

Great Britain did this in the 19th century; Chile and South Korea have unilaterally removed restrictions in recent years.

Multilaterally means it bargains with trading partners to reduce trade restrictions while other countries do the same.

Example of the multilateral approach: North American Free Trade Agreement (NAFTA). In 1993 NAFTA lowered barriers between Canada, USA and Mexico.

General Agreement of Tariffs and Trade (GATT) is a continuing series of negotiations to promote free trade among many of world's countries.

GATT founded after WWII in response to high tariff imposed during Great Depression in 1930s. Many economists believe the high tariffs deepened the depression. GATT has reduced the average tariff among member countries from about 40 percent after WWII to about 5 percent in 2005.

Rules established under GATT enforced by World Trade Organization (WTO), established in 1995. As of February 2005, 148 countries have joined, accounting for more than 97 percent of world trade.

What happens to a country that goes against an agreement made in GATT?

If a country violates an agreement to reduce tariffs on some good, a complaint can be made against them. Then they are brought in front of the WTO court that decides whether the complaint is valid and agrees on a punishment.

The punishment can be that other countries may raise tariffs on goods from the violating country.

An example from year ago: The WTO highest court backed a EU complaint against Brazil. The complaint was that Brazil banned imports of retread tires(!) Brazil argued that Europe was trying to export its pollution of old tires.

However Brazil may be able to justify taxing these imports due to the disposal problem.

There are provisions against dumping in the WTO law. It's not illegal, but countries can apply for a countervailing tariff if dumping is thought to occur.

Dumping is defined in WTO as exporting a product below the minimum of price in the home country and production cost.

If a country engages in dumping, it usually wants to establish a market in the other country where none existed before.