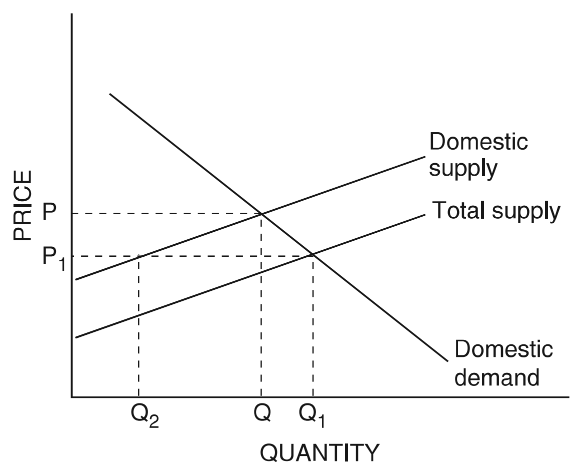
Barriers to Trade

There are gains from trade. Total output is greater when countries specialize according to their comparative advantage and trade rather than trying to be self-sufficient. The theory of comparative advantage explains the mutual benefits countries receive from free trade. Policies to promote free trade attempt to achieve the efficiency benefits from free trade. For example, groups of countries create free trade areas to promote international trade. Examples of these efforts include the North American Free Trade Agreement (NAFTA), the World Trade Organization (WTO), the European Union (EU), and the Asia-Pacific Economic Cooperation (APEC) Forum.

However, other policies interfere with free trade and prevent countries from receiving the efficiency benefits of free trade. For example, countries sometimes impose trade barriers to protect domestic industries. Trade barriers include tariffs and quotas. A *quota* is a limit on the quantity of imports allowed into a country. A *tariff* is a tax on imports.

In Figure 7-2.1, the demand curve represents the demand by the domestic economy for a commodity that is produced domestically and also imported. The domestic supply curve indicates what the domestic suppliers are willing and able to produce at alternative prices. The total supply includes the domestic supply and the supply of imports. If there were no international trade or a complete ban on imports, the domestic demand and supply would determine the equilibrium price of P and the equilibrium quantity of Q. The total output would be produced by domestic firms.

Figure 7-2.1
International Trade



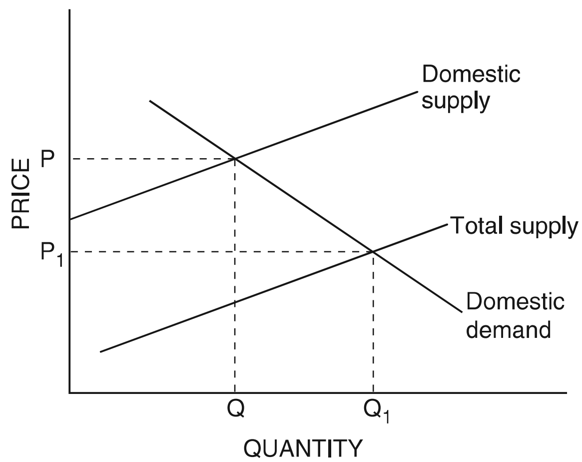
If there is free international trade, the total supply curve represents the production by domestic and foreign producers. Domestic consumers would pay P_1 and consume Q_1. They consume more of the commodity at a lower price. Also, at P_1, domestic firms are producing Q_2 and foreign producers are producing $(Q_1 - Q_2)$. Thus, domestic firms are producing less under free trade than they would if the nation did not import the commodity.

Tariffs

A tariff is a tax on imports. The imposition of a tax increases the cost of each unit, which is represented by a decrease in supply. This would result in an increase in equilibrium price and a decrease in equilibrium quantity.

1. Use Figure 7-2.2 to show the effect of an import tariff of $T per unit. Graph the "Total Supply with Tariff" curve, and indicate the amount of the tariff on the graph. Label the equilibrium price and quantity after the tariff as P_T and Q_T on the graph.

Figure 7-2.2
Effect of Import Tariff



2. What is the effect of the tariff on the equilibrium price and quantity for domestic consumers compared with the free trade levels?

3. Identify the arguments frequently used to impose some type of trade barrier. Discuss the pros and cons of three arguments.