

Homework 3 Answers

1. A domestic tariff on avocados raises the price of avocados at home and in the rest of the world.
False. A domestic tariff raises the price at home. Abroad there are two possible effects. In the case of a “small” country, a domestic tariff does not affect world prices. In the case of a “large” country, the tariff reduces the price of avocados in the rest of the world as home consumers demand fewer avocados and home producers supply more avocados as a consequence of the domestic price rise.
2. A domestic quota for imports of avocados raises government revenue.
False (Uncertain). This depends how the quota rents are distributed. If the government gives quota licenses away, the government does not receive any revenue. If the government auctions off quota licenses in a competitive auction, the proceeds of the auction equal the proceeds from an equivalent tariff.
3. A domestic quota for imports of avocados increases the quantity of avocados produced at home.
True. The domestic quota raises the price of avocados at home and producers respond with increased production.
4. A quota imposed by the US on imports of semiconductors from Japan and a voluntary export restraint self-imposed by Japan on exports of semiconductors to the US have the same impact on US welfare.
False. A VER transfers any possible terms of trade gains to foreigners; a quota need not depending upon how the quota licenses are allocated.
5. The consumption distortion associated with a tariff reflects the use of domestic prices rather than world prices by home consumers choosing their optimal consumption bundle.
True. This is the meaning of the consumption distortion. Consumers make their optimal consumption decisions on the basis of domestic prices and they can not do better given the prices they face. In the presence of a tariff, however, domestic prices are not efficient: they do not reflect the true costs of goods. The true, efficient prices of the goods are their prices on world markets. Why? World prices reflect the price to the economy of obtaining more of the import or selling more of the export. See the discussion in the handout of (i) partial equilibrium tariffs and (ii) general equilibrium tariffs in a small open economy.
6. The median voter theory provides a reasonable explanation for observed patterns of trade protection.
False. If it did, we would have virtually no trade protection. The median voter will generally be opposed to any industry-specific tariff.
7. Member countries may not benefit from a free trade area even if the free trade area creates trade amongst the member countries.
True. If trade diversion exceeds trade creation, members of a free trade area suffer a loss in welfare.
8. In theory, national gains from trade permit the winners from freer trade to compensate the losers from freer trade and still leave everyone better off.
True. In the absence of political frictions, some of the national gains from trade can be transferred from those who stand to gain from trade to those who stand to lose from trade. The pie is larger with trade than without.

9. Under what circumstances can a tariff increase welfare in an importing country?

A tariff reduces consumer surplus, increases producer surplus, generates government revenue and creates deadweight losses. If the (world) price of the good does not change, the net effect is a welfare loss. However, if the importing country is large, it may reduce the world price of the good. This is known as an improvement in the terms of trade. If the price reduction is large enough it may offset the deadweight loss of the tariff.

10. If the aggregate gains from trade are positive, why do we ever see protection?

There are several possible answers, but they all come down to the distributional effects of trade as opposed to overall efficiency gains. If those who lose from free trade are concentrated and winners are diffuse, winners may not get involved in the political process.