E. European Impact

A new rationale for small tariffs

ESCP Impact Paper No. 2022-22-EN

Michael TROEGE

ESCP Business School

ESCP RESEARCH INSTITUTE OF MANAGEMENT (ERIM)

ESCP BUSINESS SCHOOL

ESCP Impact Paper No.2022-22-EN

A new rationale for small tariffs

Michael Troege

ESCP Business School

Abstract

While free trade is always optimal with perfect competition, recent research by Amir, Jin and Troege (2022) demonstrates that under imperfect competition, the welfare of individual countries as well as the world can always be enhanced by well targeted small government interventions such as tariffs or subsidies. While these findings cannot be used to defend large tariffs that interrupt or severely reduce international trade, they provide new justification for limited restrictions on trade that attempt to offset the increasingly harmful effects of oligopolistic market structures.

Keywords: free trade, welfare, import tariffs, export subsidies, production subsidies, consumption tax

A new justification for small tariffs

Free trade is only optimal in perfect competition

Most economists agree that competition is good and tariffs bad. After all, in his famous book "On the Principles of Political Economy and Taxation", published in 1817, David Ricardo demonstrated that in an ideal world with perfect competition, free trade maximizes world welfare.

Unfortunately, competition is almost never perfect. Much of today's international trade is conducted by oligopolies (Head and Spencer, 2017). Even in markets such as agricultural commodities where producers and consumer can be considered atomistic, trade is managed by a small monopoly of commodity traders. This situation seems to be worsening rather than improving. There is increasing evidence that over the last few decades, competition has continually declined across the globe and across industries (Philippon, 2019, De Loecker et al., 2020).

Now it appears that our economic intuition about free trade is wrong if markets are oligopolistic. While, in perfectly competitive markets, government interference with trade will always make things worse, in imperfectly competitive markets, government intervention can often improve the economic outcome. The fact that this kind of counterintuitive effect is possible in specific cases has been known for a long time. For example, Brander and Spencer (1985) constructed a highly specific model in which export subsidies can increase global welfare. In a recent paper, Amir, Jin and Troege (2022) demonstrated that far from being an exception, this type of situation is actually very common. They showed that with imperfect competition, it always possible to improve the welfare of individual countries and even world welfare with either a small subsidy or a tariff.

From a general economic theory perspective, these findings are not new. Lipsey and Lancaster (1957) already showed that multiple distortions in markets do not need to add up, but can also partially offset one another and improve the original situation. It is therefore not surprising that well-targeted trade distortions can increase efficiency if markets are inefficient due to imperfect competition.

Different economic mechanisms can explain why government intervention in trade flows can improve welfare in oligopolistic markets. A very simple effect that explains why subsidies in particular are often good for welfare is based on the fact that subsidies will normally lead to lower prices. Since prices are higher than marginal costs in an oligopoly, this will generally improve welfare.

Another reason why tariffs can improve world welfare, for example, is that in an oligopoly, inefficient firms will produce too much and efficient firms too little, leading to a costly waste of resources. A small tariff that shifts production to more efficient firms, but does not increase overall prices too much, will thus improve overall economic efficiency.

Still another mechanism relies on the different levels of competitiveness in different countries. An import tariff introduced by a very competitive country will not affect prices there very much but might lead to a price decrease in another less efficient exporting country, resulting once again in higher production and welfare overall.

Today's trade policy is at odds with these insights

While very high tariff barriers that interrupt trade between countries exist, they are somewhat rare. In contrast, small tariffs and subsidies are actually surprisingly common. For example, in 2016, 34.8% of US imports were subject to tariffs averaging 3.11% (Leibovici, 2018). Similarly, in the EU, the trade-weighted average of import tariffs in 2015 was 3% (WTO, 2015). Subsidies are equally common, as in agriculture where international trade is dominated by oligopolies (OECD, 2016) or in the high-tech sector. However, to date, the argument that these relatively small tariffs can be optimal in an oligopoly has not been used in policy discussions about trade.

In addition, much of the current trade policy is not consistent with the oligopoly fighting rationale for trade distortions. To generate simple policy implications, Amir, Jin and Troege (2022) ranked the effect of different government interventions such as tariffs, export subsidies, production subsidies, and consumption taxes in a world with imperfect competition. They showed that consumption taxes are always detrimental to welfare. This is surprising since they are usually not even considered as a part of trade negotiations and are instead viewed as an efficient way to raise government revenue (Keen and Ligthart, 2002). In fact, tariffs often turn out to be a more efficient tool to raise government revenue than taxes. In contrast, Amir, Jin and Troege (2022) showed that subsidies are generally beneficial for welfare. This contrasts with the fact that subsidies are increasingly targeted in trade disputes. For instance, export subsidies are explicitly prohibited by the WTO and have been a major cause of the blockage in the Doha Round. Similarly, production subsidies play an increasingly important role in trade conflicts, as in the legal battles between the EU and the US over Boeing and Airbus, or the US-China trade war. The WTO classifies these subsidies as "actionable", i.e., to be prohibited if proven harmful to other countries (WTO, 2006).

Admitting that small tariffs can be useful is not protectionism

Economists have long been reluctant to highlight the potentially positive effects of trade restrictions, fearing that these arguments might be misused by "illiterates in economics incorrectly welcoming me as a new champion of protectionism" (Dixit et al., 2005). However, this position has become increasingly detached from reality. Today, large segments of the population on both the left and the right of the political spectrum share a negative view of free trade, views that were translated into political actions such as Brexit and Trump's trade war. As a result, over the last decade, world trade declined from 60% of GDP in 2011 to 51% in 2020, the first prolonged period of decline since 1945. The Covid-19 pandemic and the ongoing war in Ukraine will likely accelerate this trend. In this context, policy advice limited to arguing for a reduction in trade frictions is unrealistic and could end up being counterproductive (Rodrik, 2017).

Accepting certain types of identifiable small distortions does not contradict with a policy of dismantling major trade barriers and may help to focus the effort of free traders on truly relevant goals. In particular, subsidies should probably be less targeted in trade debates, a relevant insight in a world where many countries need to stimulate their economies following structural damage, supply chain interruptions, and sluggish demand after the shocks triggered by Covid-19.

References

Amir, R., Jin, J., and M. Troege (2022) On the Limits of Free Trade in a Cournot World: When are Restrictions on Trade beneficial? Forthcoming in Canadian Journal of Economics

Amir, R., Jin, J., and M. Troege (2017) "Free Trade versus Autarky under Asymmetric Cournot Oligopoly," Review of International Economics 25: 98-107.

Brander, J., and B. Spencer (1985) "Export Subsidies and International Market Share Rivalry," Journal of International Economics 16, pp. 83–100.

De Loecker, J., J. Eeckhout, and G. Unger (2020) "The Rise of Market Power and the Macroeconomic Implications," The Quarterly Journal of Economics, 135(2): 561–644.

Dixit, A., G. Grossman and P. Samuelson (2005) "The Limits of Free Trade, The Journal of Economic Perspectives," 19 (3): 241-244

Head, K. and B. Spencer (2017), "Oligopoly in international trade: Rise, fall and resurgence, Canadian Journal of Economics," 50: 1414-1444

Keen, M., and J. Ligthart (2002) "Coordinating tariff reduction and domestic tax reform. Journal of international Economics," 56(2), 489-507.

Leibovici, F. (2018) "How Open to Trade Is the US Economy?" Federal Reserve Bank of St. Louis, Economic Synopses, (21), 1-2.

Lipsey, R. G. and K. Lancaster (1957) "The general theory of the second best," Review of Economics Studies, 24:11–32.

McCorriston, S. (2011) "Competition, agricultural trade reform and developing countries," Margin: The Journal of Applied Economic Research, 5(1), 31-46.

OCDE, (2016) "Agricultural policy monitoring and evaluation 2016," Organisation for Economic Co-operation and Development.

Philippon, T. (2019) "The great reversal: How America gave up on free markets," Harvard University Press.

Rodrik, D. (2017) "Straight talk on trade: Ideas for a sane world economy," Princeton University.

WTO (2006) "World Trade Report, Exploring the links between subsidies, trade and the WTO," https://www.wto.org/english/res_e/booksp_e/anrep_e/world_trade_report06_e.pdf

WTO (2015) "World Tariff Profiles," https://www.wto.org/english/res_e/booksp_e/