

# Trade Protection and Liberalization: From efficiency to meeting social objectives

Enhancing the contribution of PTAs to  
inclusive and equitable trade:

Mongolia

19-21 April 2017

Ulaanbaatar



# Workshop outline

- Trade, growth and development
- Trade protection and liberalization: from efficiency to meeting social objectives
- PTAs and multilateral trading system and PTAs in Asia-Pacific
- Trade reforms and PTAs of Mongolia
- Towards PTA's contribution to inclusive and equitable trade
  - Mongolia experience so far
- Getting a PTA done:
  - Stakeholders
  - Negotiation
  - Implementation
- What if the expectations are not met?

**TRADE PROTECTION AND LIBERALIZATION: FROM  
EFFICIENCY TO MEETING SOCIAL OBJECTIVES**

**SESSION 4**

# Key Learning Objectives

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1. Understand the economic implications of **interventionist** trade policy through the lens of **welfare economics** and the concept of **surplus**.
2. Analyze the political economy of trade policy for small and large countries, and understand the dynamics that support policy reform, particularly through international agreements.
3. Identify welfare-superior policy options to promote domestic objectives such as social and environmental priorities.
4. Develop these basic insights to the case of Global Value Chains, where the case for openness becomes stronger because of the cumulative effects of trade policies across countries.



# Outline

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1. Economic Effects of Trade Policy.
2. Political Economy of Trade Policy.
3. Trade Policy and Social (Environmental) Objectives.
4. Trade Policy and Global Value Chains.
5. Conclusion.

# 1. Economic Effects of Trade Policy.

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- ▶ The most common instrument of trade policy is the **tariff**, essentially a special tax on imports that is not paid by domestic producers.
- ▶ Many other instruments of commercial policy can be understood through the tariff lens.
  - ▶ Anti-dumping duties (imposed in response to lower than usual prices).
  - ▶ Countervailing duties (imposed in response to foreign subsidies).
  - ▶ Safeguard measures (imposed in response to import surges).
- ▶ Most tariffs are **ad valorem** (a percentage of price), but to make the analysis simpler, we will consider a **specific** (dollars per unit quantity) tariff. The substance does not change.
- ▶ In contrast to the previous session, we will move to a partial equilibrium (single market) analysis.

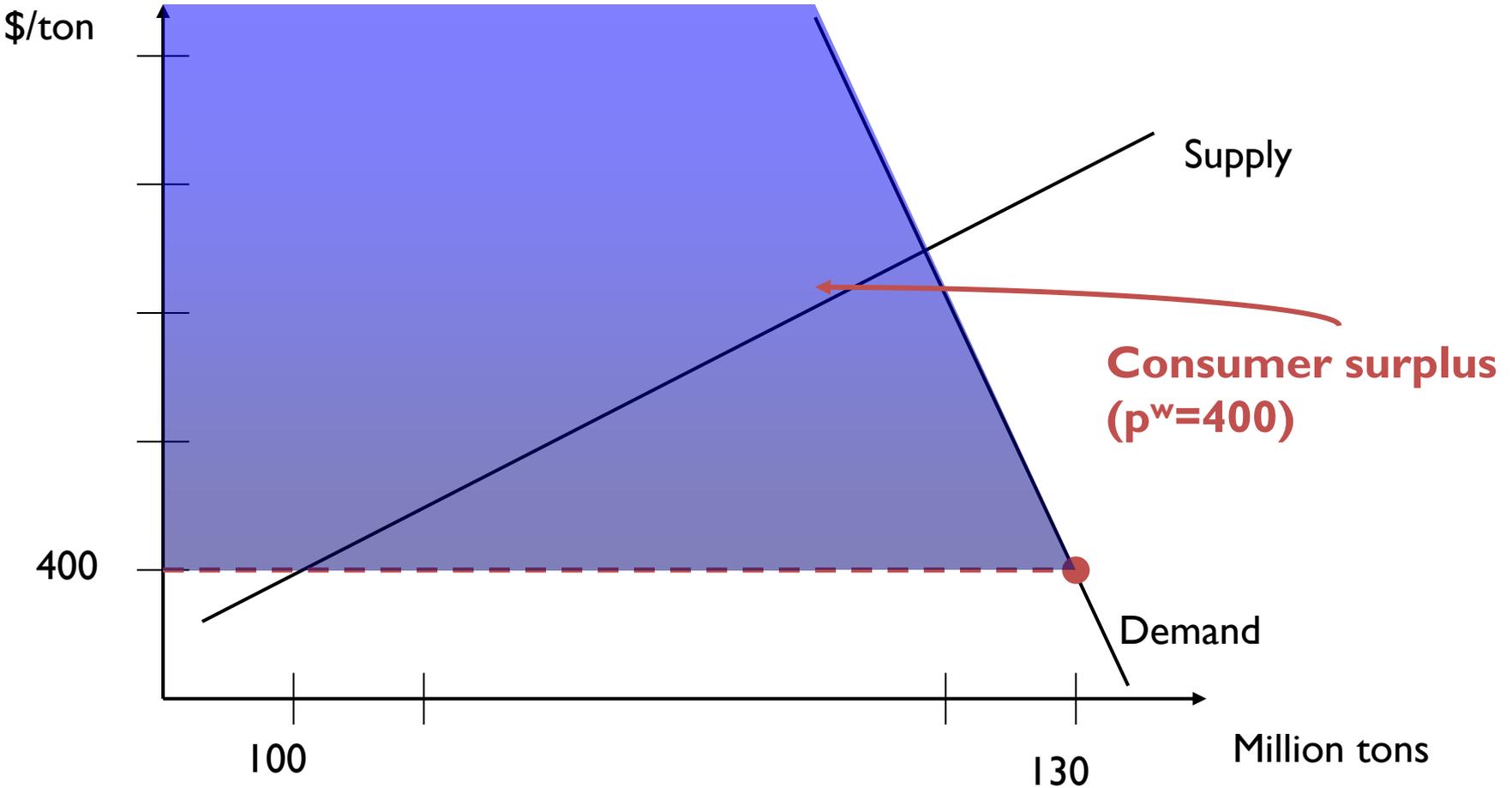
# 1. Economic Effects of Trade Policy

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- ▶ Effects of trade policy (e.g. tariff) on imports (based on a simple - one market analysis for a small country):
  - ▶ Price on the domestic market increases
  - ▶ Domestic production increases
  - ▶ Domestic consumption falls
  - ▶ Imports fall
  - ▶ Tax revenue may increase or fall
- ▶ This seems to suggest that producers “win” while consumers “lose”.
- ▶ But how can we assess the **overall welfare effect** (i.e., for Mongolia as a whole)??? We need to weigh up the effects on:
  - ▶ Consumers
  - ▶ Producers
  - ▶ Government (=“the state”)
- ▶ To do that, we use the concept of ”**surplus**”, i.e. the benefit that economic actors gain from being able to take part in market transactions.

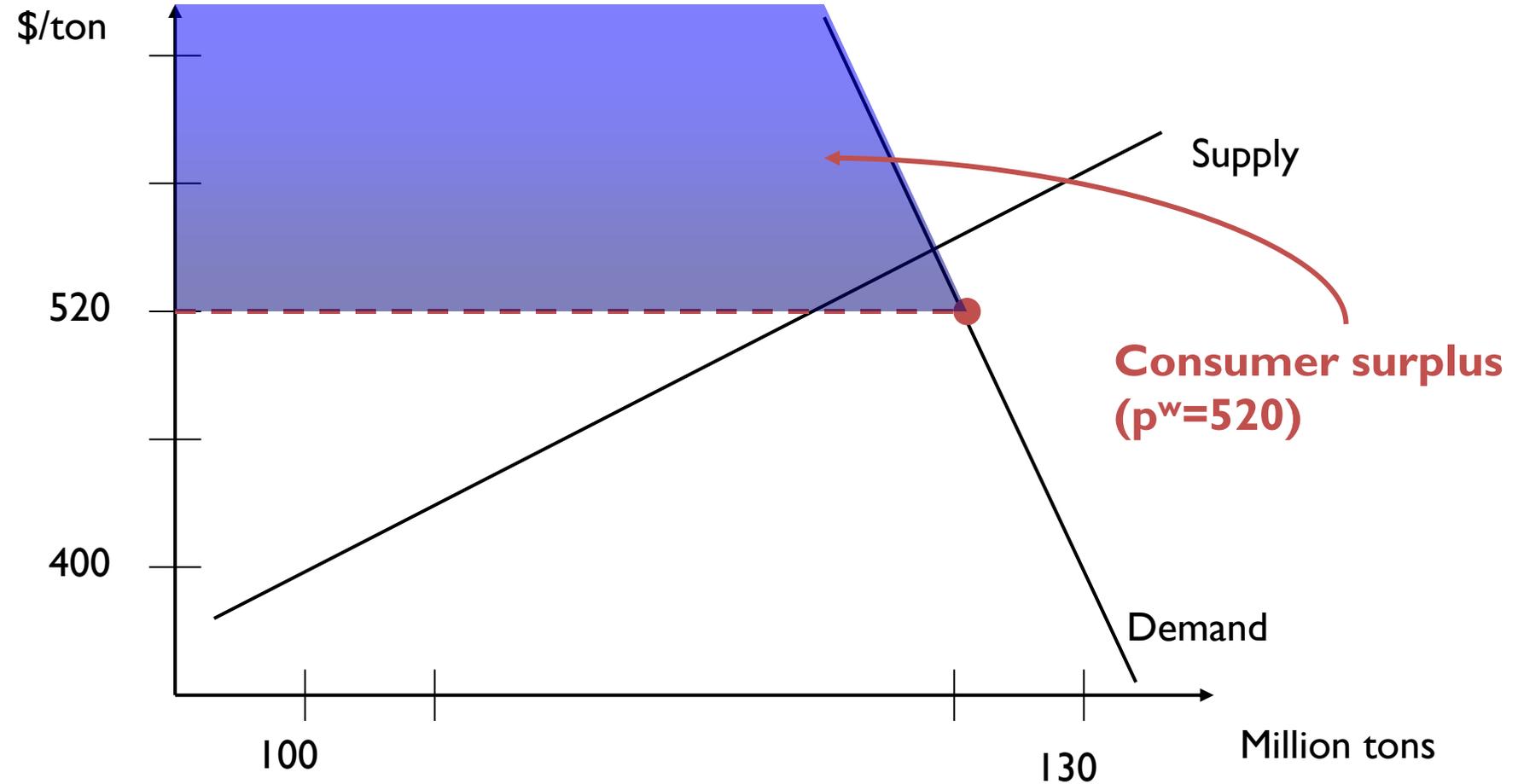
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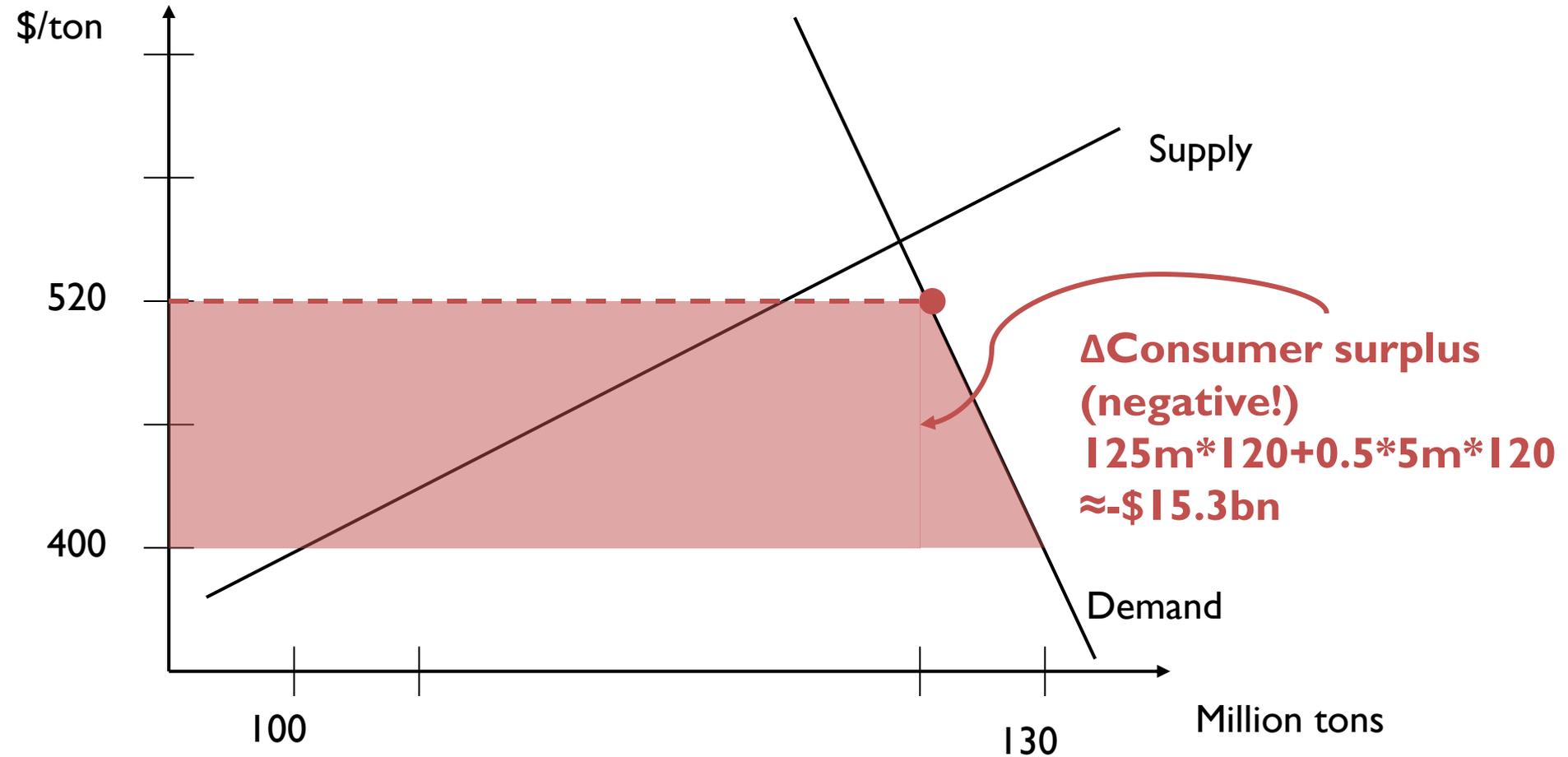
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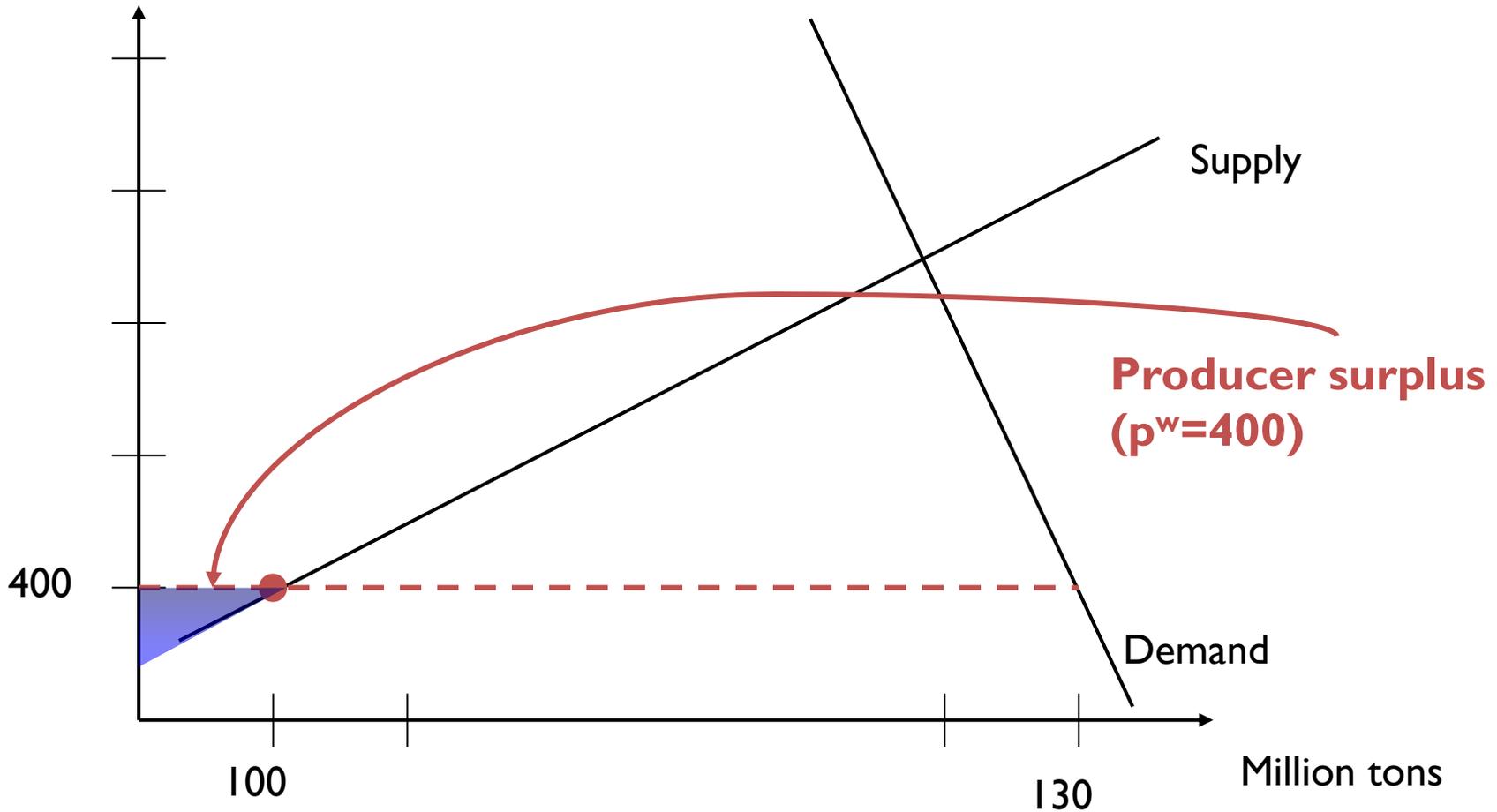
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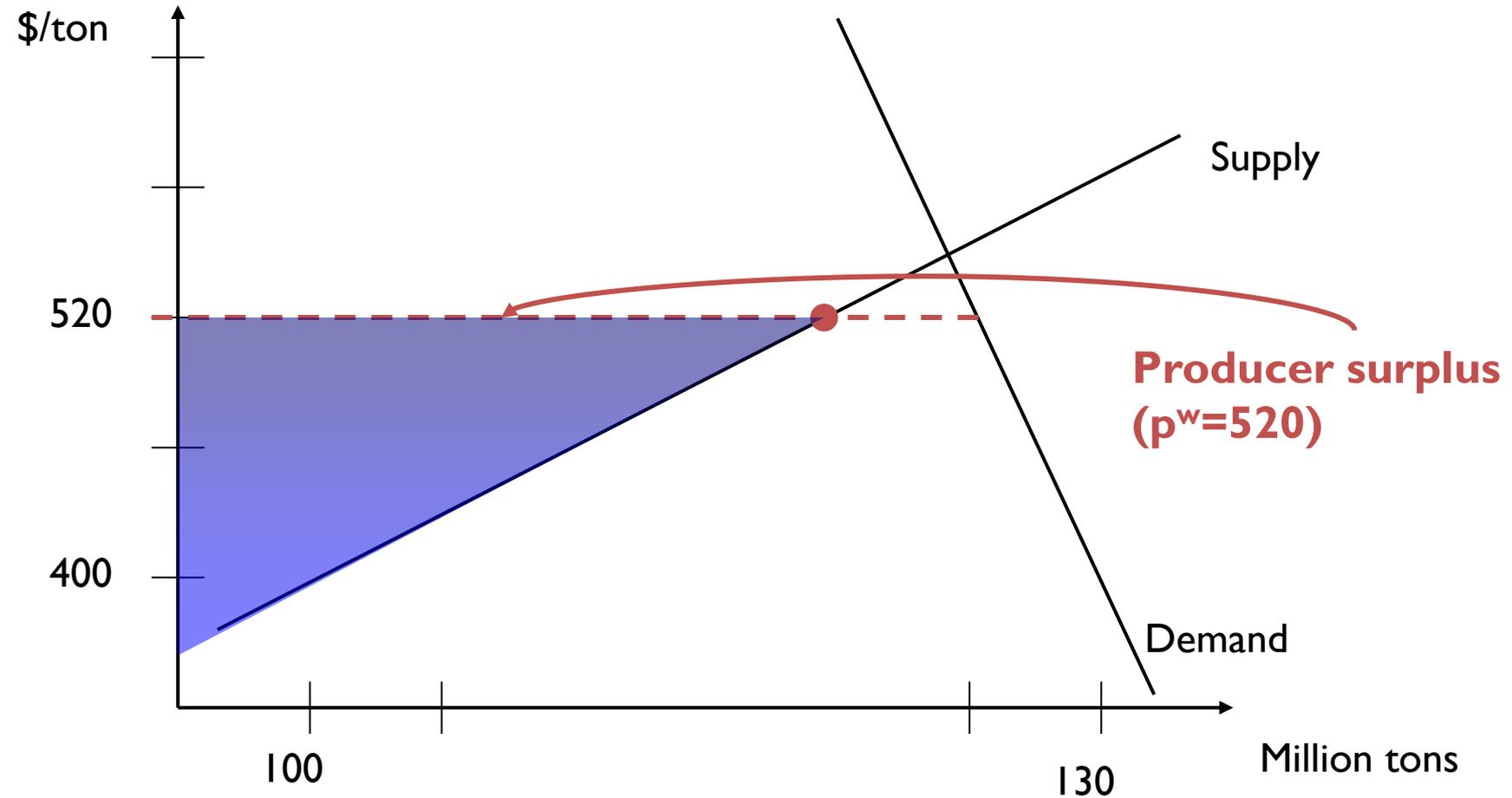
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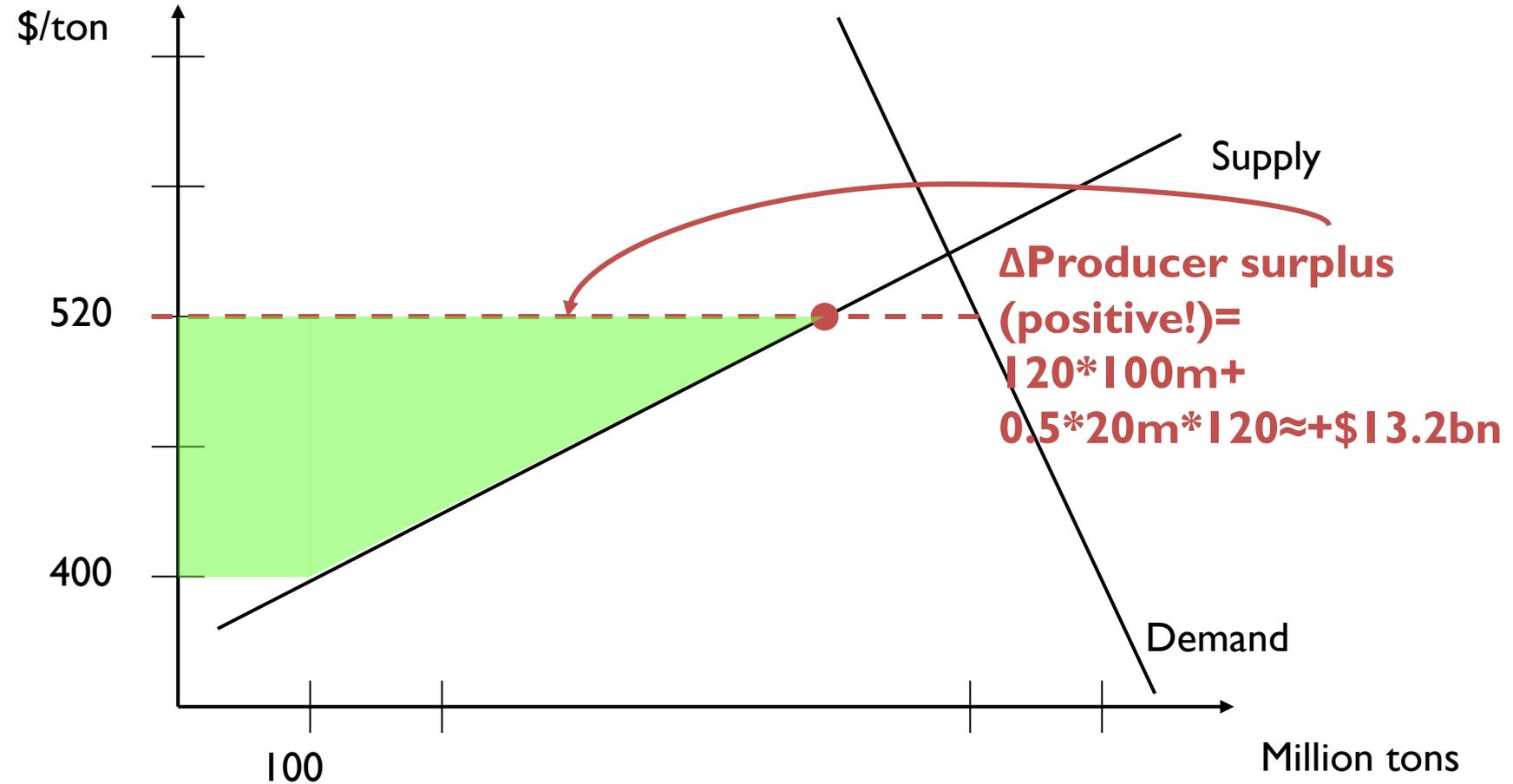


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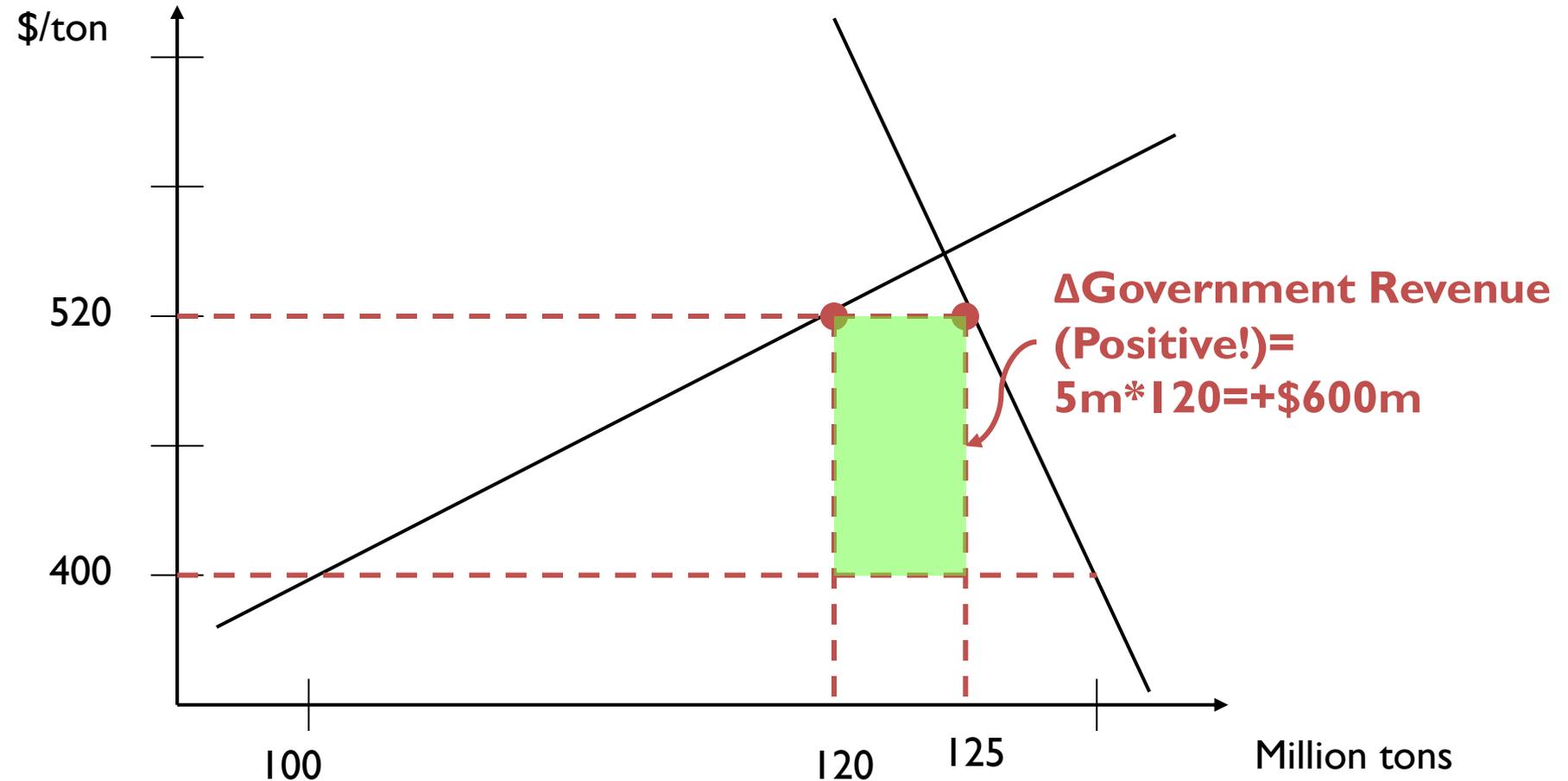


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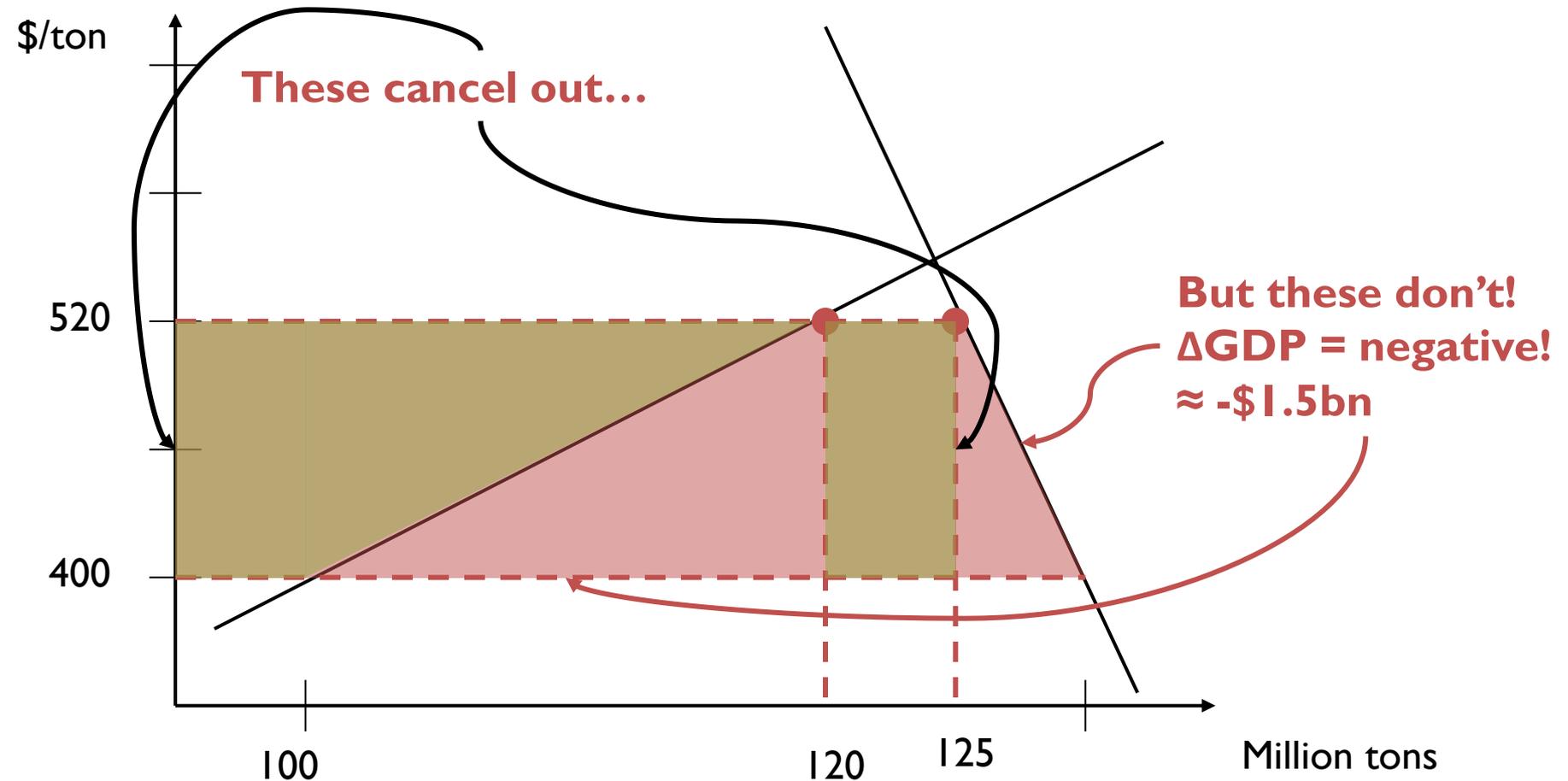


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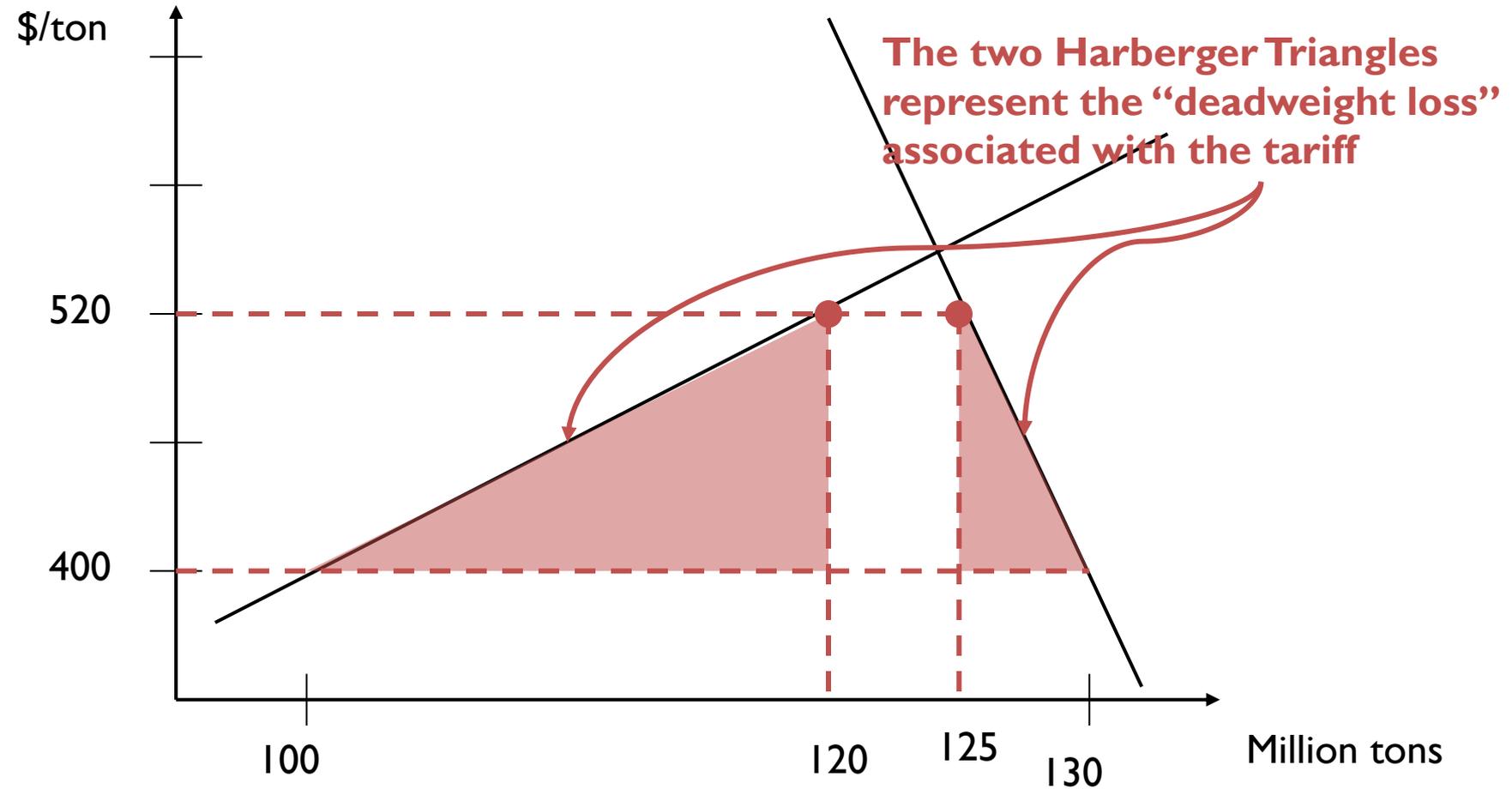


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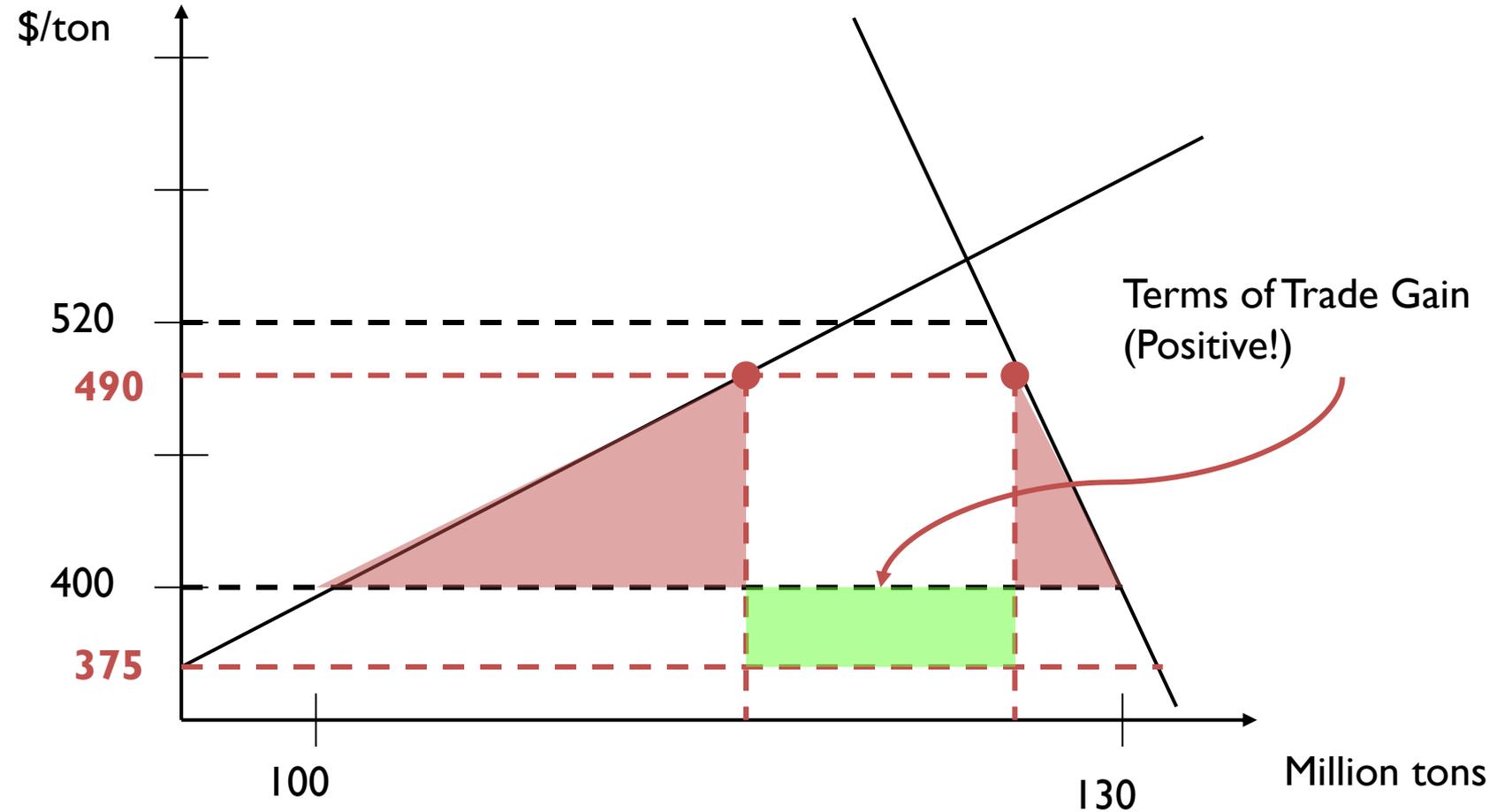
- ▶ The tariff framework can be used to understand many aspects of other types of trade policy, but there are important differences.
- ▶ **Quotas** (import quantity limits) can be converted to a **tariff equivalent**, but the limit creates a **rent** that may be captured by foreigners, instead of government revenue. This effect can be avoided if **import licenses** are auctioned competitively.
  - ▶ Quotas are less transparent than tariffs because price changes on the world market are not transmitted domestically.
- ▶ **Frictional barriers** (like poor trade facilitation) can also be converted to a tariff equivalent, but there is more economic loss because the real resource cost of doing business is higher.

# 1. Economic Effects of Trade Policy

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- ▶ So far, we have considered the case of a “small” country, i.e. one that takes world prices as given.
  - ▶ Small does not refer to geographical size, or even GDP, but rather a country’s relative importance in the particular market being modeled. Even the US and China are not “large” countries in all markets.
- ▶ For a small country, activist trade policy is unambiguously welfare reducing: consumers lose more than producers and the state gain, and there is a net negative impact on GDP.
- ▶ Does the same hold true for a “large” country, i.e. one that can influence world prices (i.e. **terms of trade gain**)?

# 1. Economic Effects of Trade Policy.



# 1. Economic Effects of Trade Policies.

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- ▶ So while small countries always lose from imposing tariffs, large countries can potentially gain.
- ▶ However, one country's gain is another country's loss—this is "beggar thy neighbor" trade policy.
- ▶ How do our models relate to the real world?
  - ▶ If small countries always lose from trade policy, why do they continue to impose tariffs?
  - ▶ If large countries can gain from trade policy, why have they reduced tariffs so significantly after 1945?
- ▶ The answers lie in the **political economy** of trade policy.

## 2. Political Economy of Trade Policy.

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- ▶ First, why do small countries pursue active trade policies through tariffs and other measures?
- ▶ One answer is Olsen's asymmetry, for example:
  - ▶ Consumers lose \$15bn, but there are 175m of them. So each person loses about \$85.
  - ▶ Producers gain only \$13bn, but if there are roughly 200,000 workers involved, each worker wins \$65,000!
    - ▶ Alternatively, the gains are divided amongst an even smaller number of firms!
- ▶ Concentrated gains and diffused losses mean that producers have a much stronger incentive to try and influence the political process—they lobby in favour of protection, often mobilizing social concerns like industrial development as part of their efforts.

## 2. Political Economy of Trade Policy.

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- ▶ Second, why have large countries generally cut tariffs very considerably in the post-war period?
- ▶ One answer is that active trade policy for a large country imposes a terms of trade (TOT) externality on its trading partners...
- ▶ Who then have the incentive to do the same thing in other sectors...
- ▶ Which leads to a “trade war” where everyone loses.
- ▶ Lowering tariffs is like mutual disarmament for large countries.

## 2. Political Economy of Trade Policy.

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- ▶ Trade agreements like the GATT/WTO or PTAs can be attempts to **internalize** the terms of trade externality.
- ▶ The negotiating dynamic (**reciprocity**) means that each country trades off a loss for its producers (in comparative disadvantage sectors) against gains for other producers (in comparative advantage sectors).
- ▶ Multilateral agreements can unambiguously improve global welfare, but the effects of PTAs are more complex...an issue explored in detail in the next session.

### 3. Trade Policy and Social and Environmental Objectives.

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- ▶ Basic trade theory has implications beyond the economic sphere, including for social and environmental objectives.
- ▶ Example 1: a country with a comparative disadvantage in agriculture will need to use more water and fertilizers to produce its food than if it trades with a comparative advantage country—so trade can help reduce resource use.
- ▶ Example 2: if a relatively labour rich country opens to trade, it will tend to specialize in the relatively labour-intensive industry, and the income of unskilled workers will go up, which has implications for equality and inclusion.
- ▶ Example 3: if a country has a comparative advantage in a GVC sector like apparel that uses female labour relatively intensively, trade can tend to boost female employment, which has implications for inclusion and gender equity (but can have some other unexpected consequences!\*)).

\* Such as the latest findings on marriage-able men.

### 3. Trade Policy and Social (Environmental) Objectives.

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- ▶ But it is important to go beyond basic theory to look in more detail at the role of policy.
- ▶ Activist trade policy can be justified in any number of ways in the public sphere.
- ▶ Economic arguments include the need for “**infant industry**” protection: a sector is not competitive today, but will be tomorrow if it is temporarily protected from international competition.
  - ▶ Economic reasoning, but a social objective: industrialization.
- ▶ Social arguments can include:
  - ▶ Protection of labour rights against low standard foreign competition.
  - ▶ Protection of consumers from low standard foreign competition.
  - ▶ Protection of vulnerable populations, including women, in comparative disadvantage sectors.
  - ▶ Protection of the environment.

# 3. Trade Policy and Social (Environmental) Objectives.

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- ▶ In general, trade policy is not a “**first best**” way of addressing social and environmental objectives.
- ▶ In other words, there is usually another policy outside the trade domain that can achieve the objective at lesser economic cost (i.e., lower or no **deadweight loss**).
- ▶ “Trade policy is a bad way of trying to do good things.”
- ▶ It is possible to simultaneously believe that trade should be reasonably free, and that strong regulations to protect the environment, social values, and vulnerable populations are appropriate.
- ▶ The key policy question is how can countries can progress towards a position where the first best policy is feasible. At most, trade policy as a **second best** should be temporary—but the political economy of trade means that it is typically difficult to remove restrictions once they have been enacted.

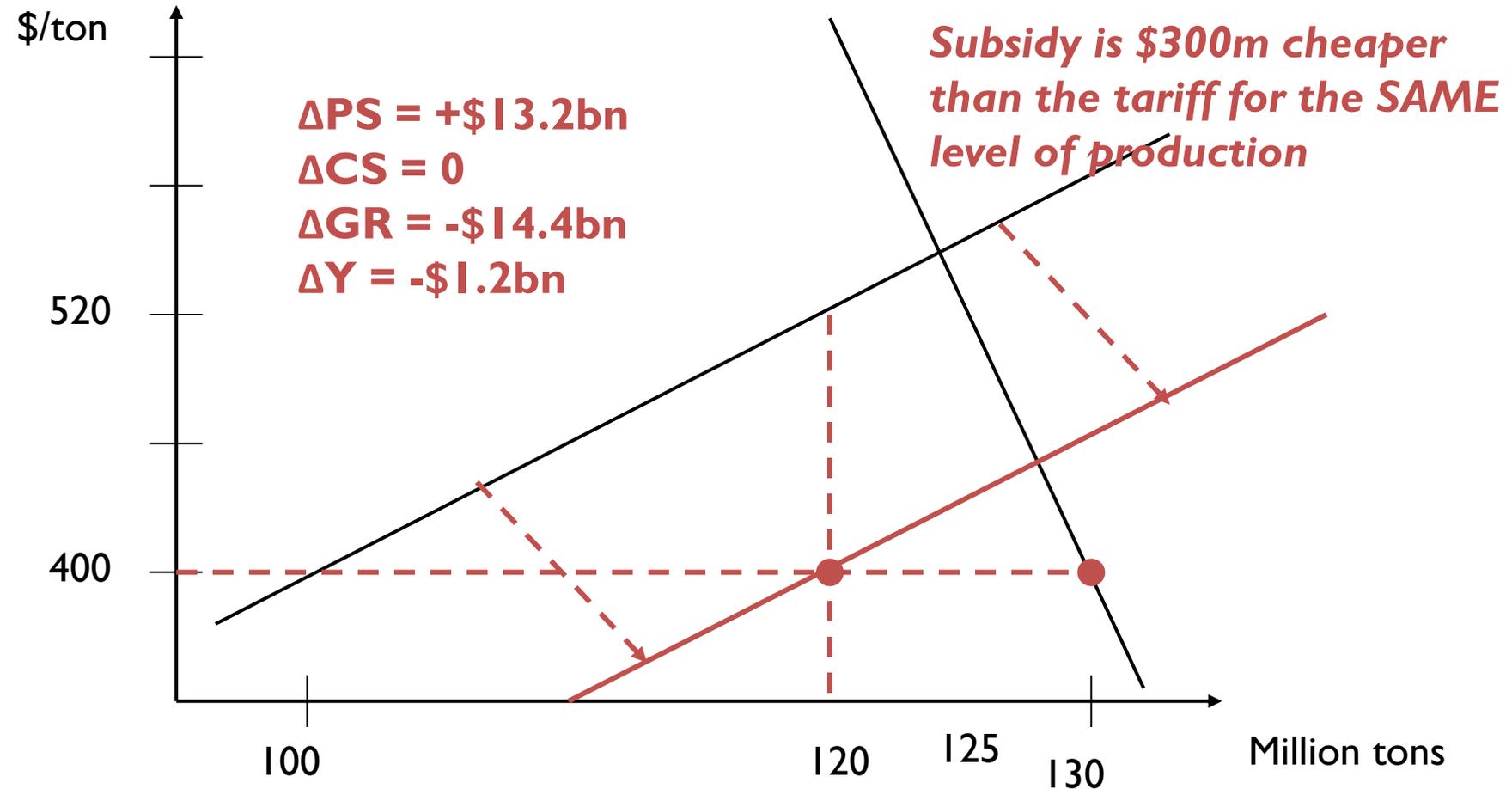
### 3. Trade Policy and Social (Environmental) Objectives.

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- ▶ To fix concepts, consider the case where the Vietnamese government has a target level of output: the same as under the tariff considered previously.
- ▶ An alternative and welfare-superior policy is a production subsidy.
- ▶ Intuitively, it boosts domestic production, but does not distort consumption decisions, so has a lesser economic impact.

### 3. Trade Policy and Social (Environmental) Objectives.

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### 3. Trade Policy and Social (Environmental) Objectives.

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- ▶ Consider the infant industry argument.
- ▶ There can indeed be a market failure when an industry will be competitive tomorrow even though it is not today.
- ▶ But the locus of the failure is in the financial market: firms should be able to borrow to cover initial losses, then pay back the loan when they are profitable.
- ▶ So the first best policy is to intervene to improve the functioning of financial markets.
- ▶ In practice though, many countries have used tariffs to promote infant industries. But now there is very strong evidence that keeping trade costs artificially high in fact holds back sectoral productivity—infants (almost) never “grow up”.

### 3. Trade Policy and Social (Environmental) Objectives.

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- ▶ Consider the case of vulnerable populations in comparative disadvantage sectors.
- ▶ A tariff can prevent a comparative disadvantage sector from contracting, which protects the vulnerable people.
- ▶ But there is a cost: comparative advantage sectors cannot expand as much, so employment there—which can also involve vulnerable populations—is lower.
- ▶ A better policy is to institute a **social safety net**, so that the welfare gains from liberal trade policy do not come at the expense of vulnerable populations.

### 3. Trade Policy and Social (Environmental) Objectives.

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- ▶ Consider the case of environmental standards.
- ▶ Taxing goods from countries perceived as having “low standards” could shift demand to “high standard” local production.
- ▶ But the calculation is more complex:
  - ▶ If the foreign country has better production conditions, it may be able to produce using less energy or chemicals, which is an environmental benefit.
  - ▶ In any event, the tariff would create deadweight loss, whereas an environmental regulation would not.
  - ▶ Another alternative is a subsidy for local production—it has a budgetary cost, but can be optimal if local production produces positive environmental externalities.

### 3. Trade Policy and Social (Environmental) Objectives.

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- ▶ These examples show that trade policy is typically a second best way of achieving important social objectives.
- ▶ Generally speaking, targeted taxes and subsidies are welfare superior to a tariff (or other protectionist policy) where the issue is that economic activities produce externalities that are not fully incorporated in prices.
  - ▶ **Positive externality** (like productivity spillovers from industrialization): production subsidy.
  - ▶ **Negative externality** (like pollution): consumption tax.
- ▶ A tariff combines a production subsidy with a consumption tax, so is not the most targeted intervention—hence why it is welfare-inferior to other policies.

## 4. Trade Policy and Global Value Chains.

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- ▶ GVCs are complex networks of trade and investment linkages.
- ▶ The last session focused on trade in tasks as a crucial part of the GVC paradigm.
- ▶ Another important feature of GVCs is that intermediate inputs—services as well as goods—cross borders multiple times during production.

## 4. Trade Policy and Global Value Chains.

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- ▶ The fact that inputs cross borders multiple times within GVCs means that there is the potential for trade policy to have cumulative effects.
- ▶ For example, a raw material is subject to a tariff when it is imported into one country for processing; the processed intermediate good is then subject to another tariff when it is imported into another country for final assembly; and the final product is subject to another tariff when it is imported into the final consumption market.
- ▶ The concept of **Effective Rate of Protection** captures this connection between input-output relationships and trade policy.
- ▶ The case for open trade is even stronger in the GVC era.

## 4. Trade Policy and Global Value Chains.

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- ▶ GVCs also pose issues of social policy:
  - ▶ Environmental standards.
  - ▶ Labour standards.
  - ▶ Gender inclusion.
- ▶ Value chain governance can have a profound effect on how standards are applied in developing countries.
- ▶ Buyer driven value chains, like “fast fashion”, give considerable scope to developed country consumers to pressure lead firms to impose supply chain traceability.
  - ▶ Labour standards.
  - ▶ Organic standards.
  - ▶ Fair trade.

## 4. Trade Policy and Global Value Chains.

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- ▶ Gender inclusion is a particular issue in some value chains, such as apparel.
- ▶ Research suggests that apparel GVCs use female labour relatively intensively, so specialization by comparative advantage implies an increase in the demand for female labour.
  - ▶ First entry into the formal labour market for many women.
  - ▶ Source of formal sector (money) income.
  - ▶ Change in household power dynamics.
- ▶ But discrimination can be persistent, with some roles seen as “women’s work”, while managerial functions are reserved to men.

## 4. Trade Policy and Global Value Chains.

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- ▶ GVCs are neither good or bad for labour, the environment, or women as such.
- ▶ Everything is in the conditions in which they operate, both countries and sectors.
- ▶ In any case, activist trade policy is not the answer to addressing any of the potential social, environmental, or gender issues associated with GVCs.
  - ▶ The market failures and externalities are domestic, so the appropriate response is also through domestic regulatory policy.

# Conclusion

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1. Tariffs and similar measures act as production subsidies and consumption taxes, and are always welfare reducing for a small country.
2. Large countries can potentially gain from tariffs, but at others' expense, and with the potential for a trade war.
3. International agreements exist as a way of dealing with political and terms of trade externalities that arise from activist trade policy.
4. In general, trade policy is not an efficient way of dealing with a domestic policy issue like social or environmental protection.
5. GVCs make the case for trade openness even stronger because of the potential for trade policy cumulation as goods cross borders multiple times.



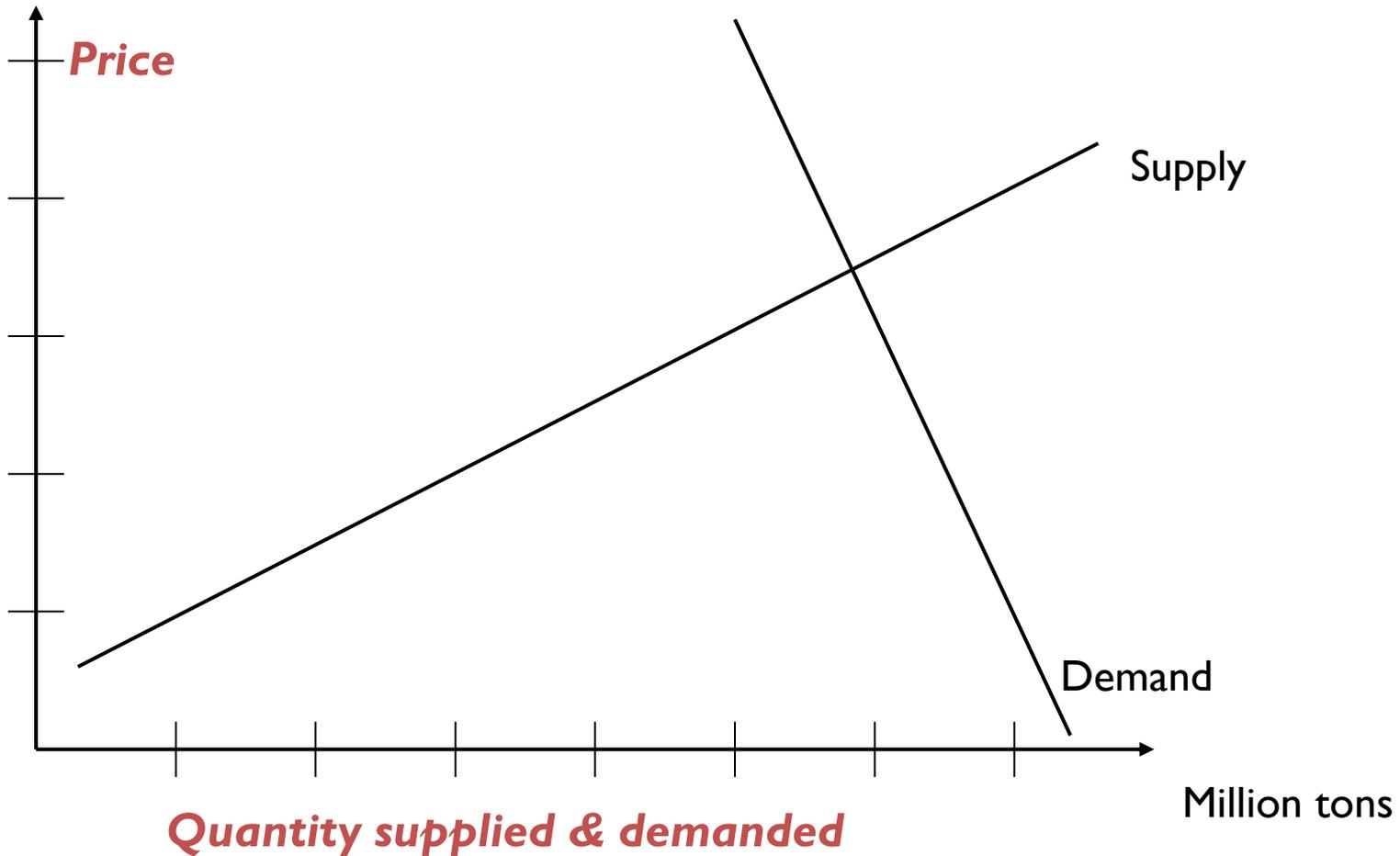
# Annex

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- ▶ Technical demonstration of trade policy (tariff) effects in a small country

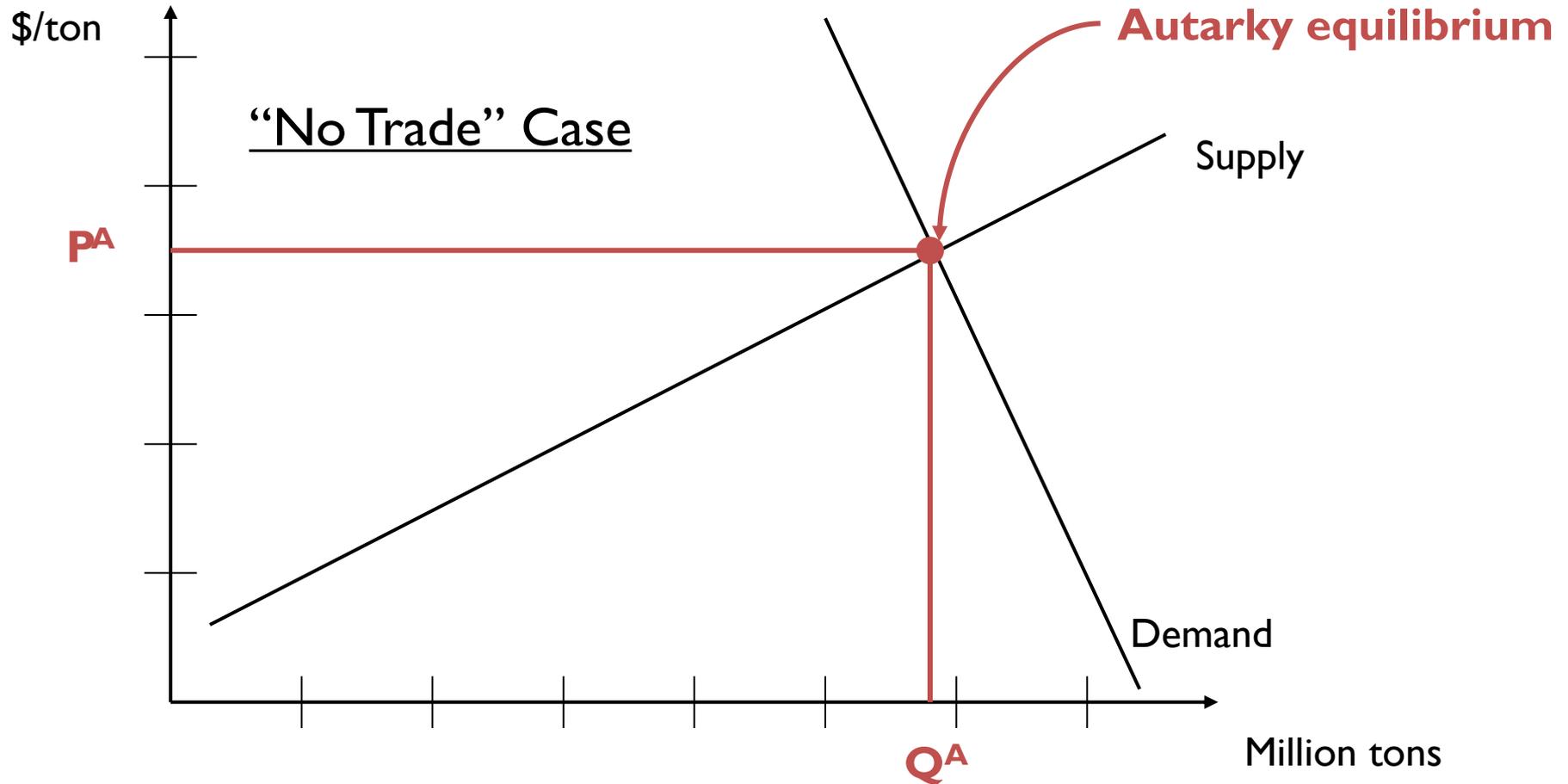
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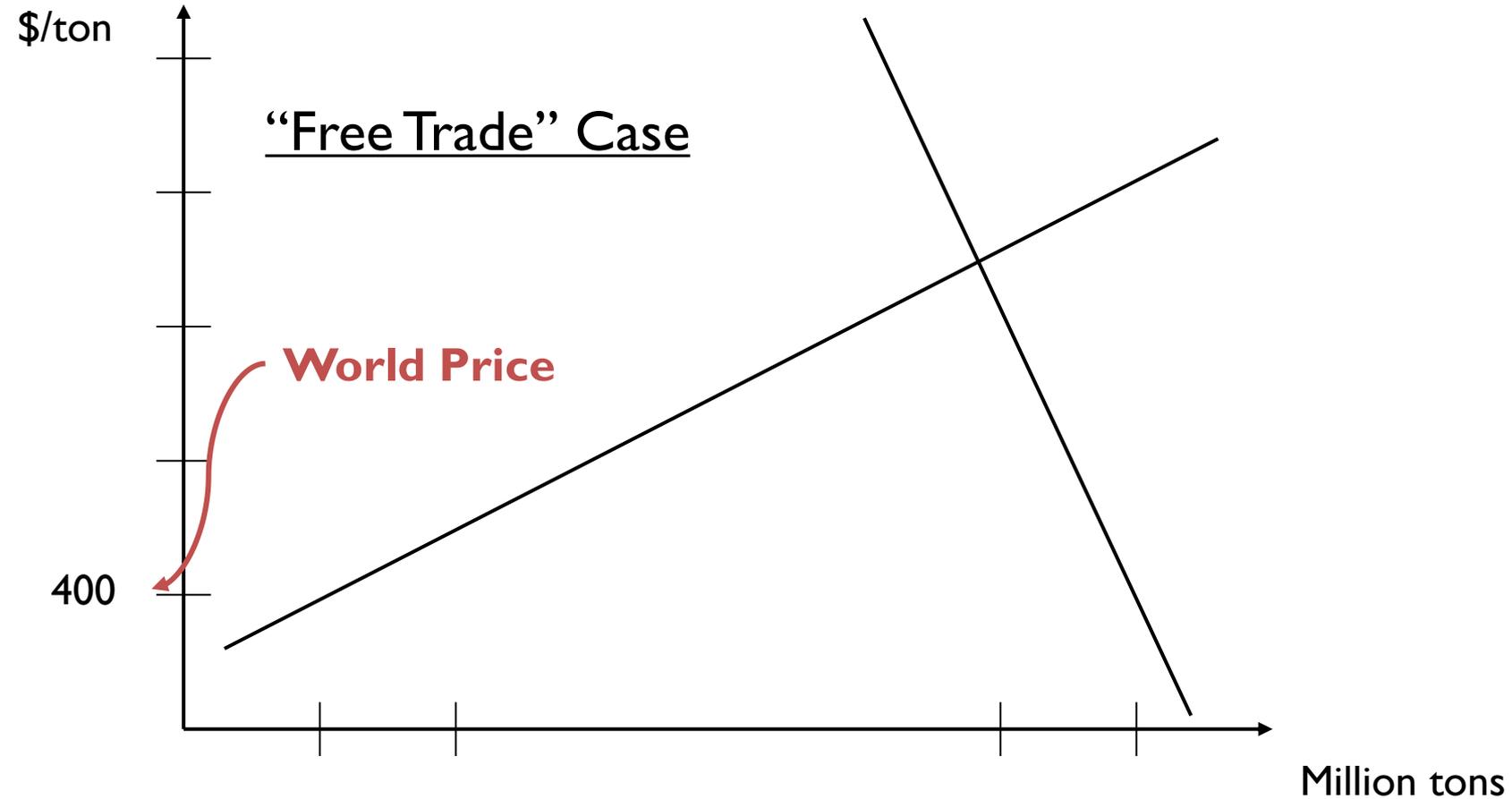
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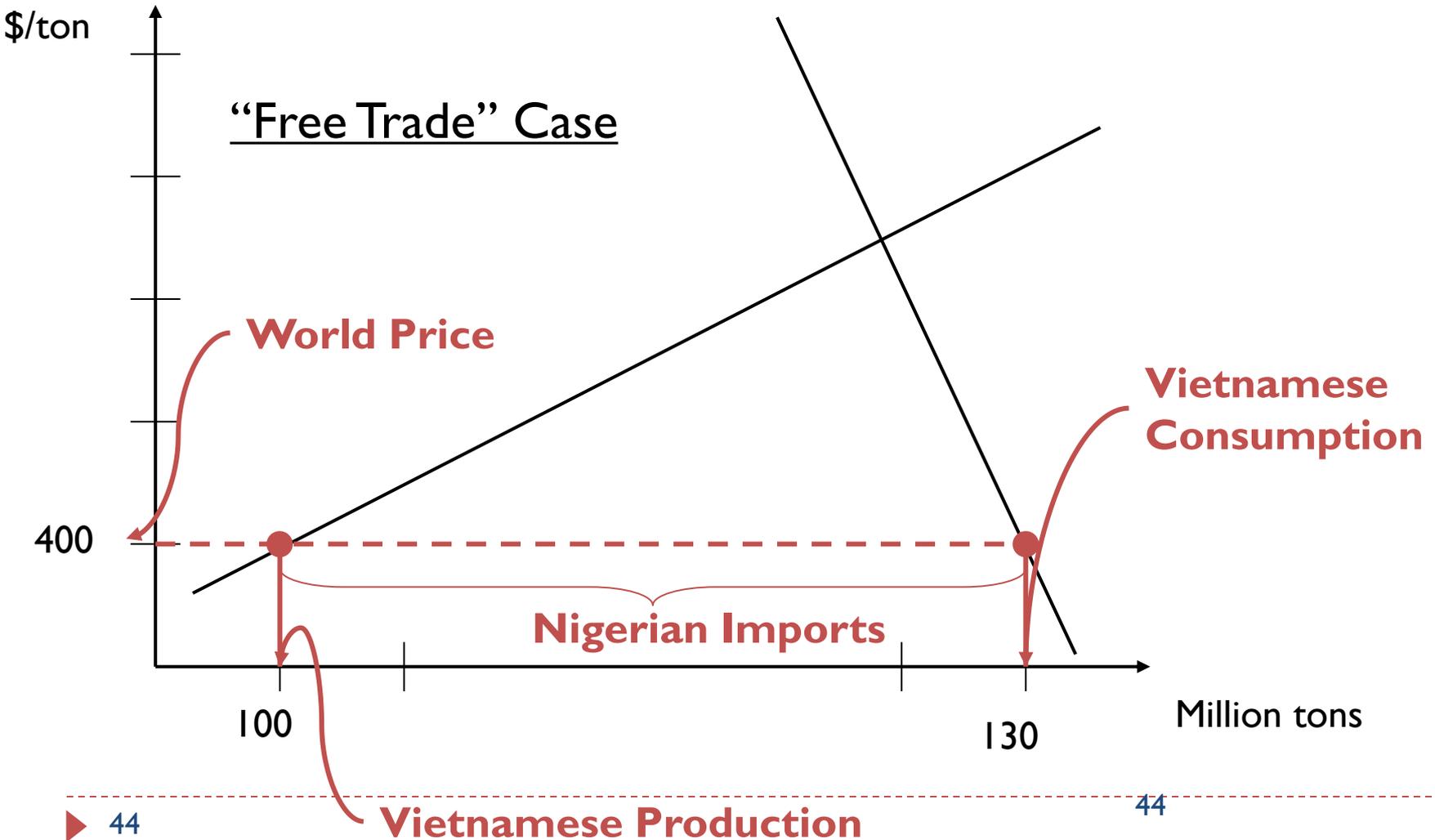


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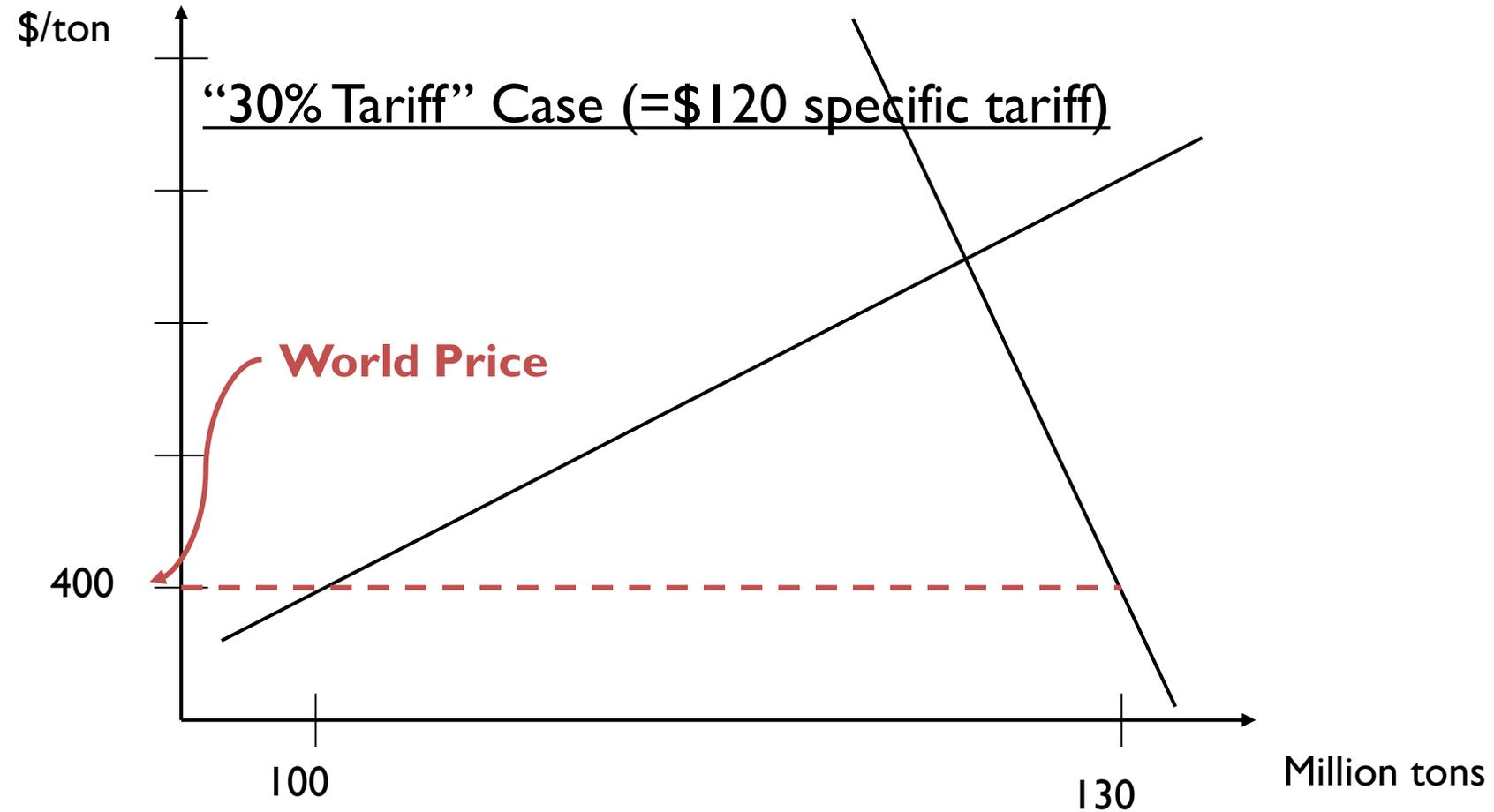


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