THE INSTRUMENTS OF TRADE POLICY

INTRODUCTION

- As we know, under free trade, buyers and sellers from separate economies voluntarily trade with minimum of state interference. The free interplay of market forces of supply and demand decides prices.

- Protectionism, on the other hand, is a state policy aimed to protect domestic producers against foreign competition through the use of tariffs, quotas and non-tariff trade policy instruments.

- Trade liberalization refers to opening up of domestic markets to goods and services from the rest of the world by bringing down trade barriers.

- Trade policy encompasses all instruments that governments may use to promote or restrict imports and exports. The instruments of trade policy that countries typically use to restrict imports and/ or to encourage exports can be broadly classified into price-related measures such as tariffs and non-price measures or non-tariff measures (NTMs).

TARIFFS

- Tariffs, also known as customs duties, are basically taxes or duties imposed on goods and services which are imported or exported.
- They are the most visible and universally used trade measures that determine market access for goods.
- Import duties being pervasive than export duties, tariffs are often identified with import duties and in this unit, the term ‘tariff’ would refer to import duties.
- Tariffs are aimed at altering Change the relative prices of goods and services imported, so as to contract the domestic demand and thus regulate the volume of their imports.
- Tariffs leave the world market price of the goods unaffected; while raising their prices in the domestic market.
- The main goals of tariffs are to raise revenue for the government, and more importantly to protect the domestic import-competing industries.

Forms of Import Tariffs

Bicycle - ₹5000 — ₹1000 - 20% ↓
↑ ₹100.000 - ₹1000 - 1%

1) Specific Tariff: Fixed per unit ~~amount~~ of money per physical unit or according to the weight or measurement of the commodity imported or exported.
Example, a specific tariff of Rs. 1000/ may be charged on each imported bicycle.

👉The disadvantage of specific tariff as an instrument for protection of domestic producers is that its protective value varies inversely with the price of the import

2) Ad valorem Value tariff: Duty is levied as a fixed percentage of the value of the traded commodity.
Example: A 20% ad valorem tariff on any bicycle generates a Rs. 1000/ payment on each imported bicycle priced at Rs. 5,000/ in the world market; and if the price rises to Rs. 10,000, it generates a payment of Rs. 2,000/
👉It gives incentives to deliberately undervalue the good’s price on invoices and bills of lading to reduce the tax burden.

100% unit P=50 Q=10
10% $100 \times 10 + \frac{10}{100} \times (50 \times 10)$

There are many other variations of the above tariffs, such as:

Mixed Tariffs: Mixed tariffs are expressed either on the basis of the value of the imported goods (an ad valorem rate) or on the basis of a unit of measure of the imported goods (a specific duty) depending on which generates the most income (or least income at times) for the nation.

of value

For example, duty on cotton: 5 per cent ad valorem or Rs. 3000/per tonne, whichever is higher.

Compound Tariff or a Compound Duty is a combination of an ad valorem and a specific tariff.

- It is generally calculated by adding up a specific duty to an ad valorem duty.
- Thus, on an import with quantity q and price p, a compound tariff collects a revenue equal to $t_sq + t_apq$, where ts is the specific tariff and ta is the ad valorem tariff.

For example: duty on cheese at 5 per cent advalorem plus 100 per kilogram.

Technical/Other Tariff: These are calculated on the basis of the specific contents of the imported goods i.e. the duties are payable by its components or related items.

For example: Rs. 3000/ on each solar panel plus Rs. 50/ per kg on the battery.

Tariff Rate Quotas: Tariff rate quotas (TRQs) combine two policy instruments: quotas and tariffs. Imports entering under the specified quota portion are usually subject to a lower (sometimes zero) tariff rate. Imports above the quantitative threshold of the quota face a much higher tariff.

Quota - Max Limit

Variable Tariff: A duty typically fixed to bring the price of an imported commodity up to level of the domestic support price for the commodity.

Rice - ₹40/kg

Prohibitive tariff: A prohibitive tariff is one that is set so high that no imports can enter.

Most-Favoured Nation Tariffs: MFN tariffs refer to import tariffs which countries promise to impose on imports from other members of the WTO.

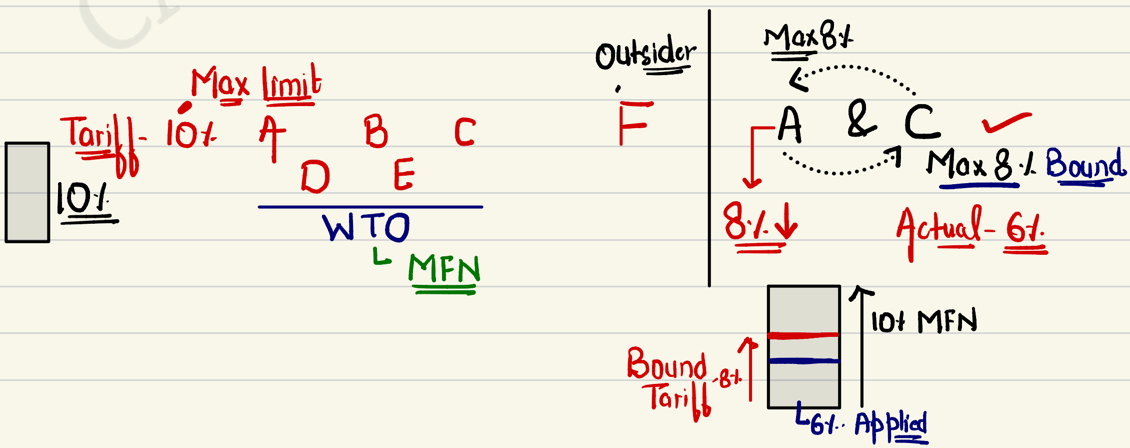
- This means that, in practice, MFN rates are the highest (most restrictive) that WTO members charge each other.
- Some countries impose higher tariffs on countries that are not part of the WTO.

Bound Tariff: Under this, a WTO member binds itself with a legal commitment not to raise tariff rate above a certain level.

- By binding a tariff rate, often during negotiations, the members agree to limit their right to set tariff levels beyond a certain level.
- The bound rates are specific to individual products and represent the maximum level of import duty that can be levied on a product imported by that member.
- A member is always free to impose a tariff that is lower than the bound level. MFN Tariff
- Once bound, a tariff rate becomes permanent and a member can only increase its level after negotiating with its trading partners and compensating them for possible losses of trade.

Applied Tariffs: An 'applied tariff' is the duty that is actually charged on imports on a Most-Favoured Nation (MFN) basis.

- A WTO member can have an applied tariff for a product that differs from the bound tariff for that product as long as the applied level is not higher than the bound level.



Preferential Tariff: Nearly all countries are part of at least one preferential trade agreement, under which they promise to give another country's products lower tariffs than their MFN rate.

A → B

Developed ← Under-developed

- These agreements are reciprocal.
- A lower tariff is charged from goods imported from a country which is given preferential treatment.
- Examples are preferential duties in the EU region under which a good coming from one EU country to another is charged zero tariff rate.

Another example is North American Free Trade Agreement (NAFTA) among Canada, Mexico and the USA where the preferential tariff rate is zero on essentially all products.

- Countries, especially the affluent (developed) ones also grant 'unilateral preferential treatment' to select list of products from specified developing countries.
- The Generalized System of Preferences (GSP) is one such system which is currently prevailing.

Escalated Tariff structure refers to the system wherein the nominal tariff rates on imports of manufactured goods are higher than the nominal tariff rates on intermediate inputs and raw materials, i.e. the tariff on a product increases as that product moves through the value-added chain. Raw Material ↓ Int. Goods ↓ FG ↑

- For example, a four percent tariff on iron ore or iron ingots and twelve percent tariff on steel pipes.
- This type of tariff is discriminatory as it protects manufacturing industries in importing countries and dampens the attempts of developing manufacturing industries of exporting countries.

Import subsidies: Import subsidies also exist in some countries. An import subsidy is simply a payment per unit or as a percent of value for the importation of a good (i.e., a negative import tariff).

Tariffs as Response to Trade Distortions: Sometimes countries engage in 'unfair' foreign-trade practices which are trade distorting in nature and adverse to the interests of the domestic firms.

- The affected importing countries, upon confirmation of the distortion, respond quickly by measures in the form of tariff responses to offset the distortion.
- These policies are often referred to as "trigger-price" mechanisms.

a) **Anti-dumping Duties**: An anti-dumping duty is a protectionist tariff that a domestic government imposes on foreign imports that it believes are priced below fair market value.

- Dumping occurs when manufacturers sell goods in a foreign country below the sales prices in their domestic market or below their full average cost of the product.
- Dumping may be persistent, seasonal, or cyclical.
- Dumping may also be resorted to as a predatory pricing practice to drive out established domestic producers from the market and to establish monopoly position.

- Dumping is unfair and constitutes a threat to domestic producers and therefore when dumping is found, anti-dumping measures may be initiated as a safeguard instrument by imposing additional import duties/tariffs so as to offset the foreign firm's unfair price advantage.
- This is justified only if the domestic industry is seriously injured by import competition, and protection is in the national interest.

- For example: In January 2017, India imposed anti-dumping duties on colour-coated or pre-painted flat steel products imported into the country from China and European nations for a period not exceeding six months and for jute and jute products from Bangladesh and Nepal.

A - Govt. $\longrightarrow$ Subsidy $\longrightarrow$ Producers - Cost ₹100
(-) Sub. 20
₹80

b) Countervailing Duties: Countervailing duties are tariffs that aim to offset the artificially low prices charged by exporters who enjoy export subsidies and tax concessions offered by the governments in their home country.

- If a foreign country does not have a comparative advantage in a particular good and a government subsidy allows the foreign firm to be an exporter of the product, then the subsidy generates a distortion from the free-trade allocation of resources.
- In such cases, CVD is charged in an importing country to negate the advantage that exporters get from subsidies to ensure fair and market-oriented pricing of imported products and thereby protecting domestic industries and firms.
- For example, in 2016, in order to protect its domestic industry, India imposed 12.5% countervailing duty on Gold jewellery imports from ASEAN.

Effects of Tariffs

1) Tariff barriers create obstacles to trade, decrease the volume of imports and exports and therefore of international trade.

2) Tariffs discourage domestic consumers from consuming imported foreign goods. Domestic consumers suffer a loss in consumer surplus. $MU_x - P_x \uparrow$

3) Tariffs encourage consumption and production of the domestically produced import substitutes and thus protect domestic industries.

4) Producers in the importing country experience an increase in well-being as a result of imposition of tariff. The price increase of their product in the domestic market increases producer surplus in the industry.

Imported Goods P↑ $\longrightarrow$ Domestic Goods Demand ↑ $\rightarrow$ Price↑ Profit ↑

5) The price increase also induces an increase in the output of the existing firms and possibly addition of new firms due to entry into the industry to take advantage of the new high profits and consequently an increase in employment in the industry.

6) Tariffs create trade distortions by disregarding comparative advantage and prevent countries from enjoying gains from trade arising from comparative advantage. Thus, tariffs discourage efficient production in the rest of the world and encourage inefficient production in the home country.

7) Tariffs increase government revenues of the importing country by the value of the total tariff it charges.

NTB

NTM

NTB

NON-TARIFF MEASURES (NTMs)

■ The non- tariff measures which have come into greater prominence than the conventional tariff barriers, constitute the hidden or 'invisible' measures that interfere with free trade.

■ Non-tariff measures comprise all types of measures which alter the conditions of international trade, including policies and regulations that restrict trade and those that facilitate it.

■ It should be kept in mind that NTMs are not the same as non-tariff barriers (NTBs).
👉NTMs are sometimes used as means to circumvent (avoid) free-trade rules and favour domestic industries at the expense of foreign competition. In this case they are called non-tariff barriers (NTBs). In other words, non-tariff barriers are discriminatory non-tariff measures imposed by governments to favour domestic over foreign suppliers.
👉NTBs are thus a subset of NTMs that have a 'protectionist or discriminatory intent'.

■ According to WTO agreements, the use of NTMs is allowed under certain circumstances.
Examples of this include :
📝Technical Barriers to Trade (TBT) Agreement and
📝Sanitary and Phytosanitary Measures (SPS) Agreement,

Technical - Product specific
Non Technical

Depending on their scope and/or design NTMs are categorized as:

I. Technical Measures: Technical measures refer to product-specific properties such as characteristics of the product, technical specifications and production processes.

- These measures are intended for ensuring product quality, food safety, environmental protection, national security and protection of animal and plant health.

A) Sanitary and Phytosanitary (SPS) Measures:

- SPS measures are applied to protect human, animal or plant life from risks arising from additives, pests, contaminants, toxins or disease-causing organisms and to protect biodiversity.
- These include ban or prohibition of import of certain goods, all measures governing quality and hygienic requirements, production processes, and associated compliance assessments.
- For example; prohibition of import of poultry from countries affected by avian flu, meat and poultry processing standards to reduce pathogens, residue limits for pesticides in foods etc.

B) Technical Barriers To Trade (TBT): Technical Barriers to Trade (TBT) which cover both food and non-food traded products refer to mandatory 'Standards and Technical Regulations' that define the specific characteristics that a product should have, such as its size, shape, design, labelling / marking / packaging, functionality or performance and production methods, excluding measures covered by the SPS Agreement.

- The specific procedures used to check whether a product is really conforming to these requirements (conformity assessment procedures e.g. testing, inspection and certification) are also covered in TBT. This involves compulsory quality, quantity and price control of goods before shipment from the exporting country.
- Altering products and production processes to comply with the diverse requirements in export markets may be either impossible for the exporting country or would obviously raise costs, hurting the competitiveness of the exporting country. Some examples of TBT are: food laws, quality standards, industrial standards, organic certification, eco-labelling, and marketing and label requirements.

II. Non-technical Measures: Non-technical measures relate to trade requirements; for example; shipping requirements, custom formalities, trade rules, taxation policies, etc. These are further distinguished as:

(a) Hard measures (e.g. Price and quantity control measures),

(b) Threat measures (e.g. Anti-dumping and safeguards) and

(c) Other measures such as trade-related finance and investment measures.

Furthermore, the categorization also distinguishes between:

(i) Import-related measures which relate to measures imposed by the importing country, and

(ii) Export-related measures which relate to measures imposed by the exporting country itself.

(iii) In addition, to these, there are procedural obstacles (PO) which are practical problems in administration, transportation, delays in testing, certification etc which may make it difficult for businesses to adhere to a given regulation.

Following are the most commonly practiced measures in respect of imports:

(i) Import Quotas: An import quota is a direct restriction which specifies that only a certain physical amount of the good will be allowed into the country during a given time period, usually one year.

- Import quotas are typically set below the free trade level of imports and are usually enforced by issuing licenses. This is referred to as a binding quota; a non-binding quota is a quota that is set at or above the free trade level of imports, thus having little effect on trade.

- Import quotas are mainly of two types: absolute quotas and tariff-rate quotas.

100,000 units - Free Trade

Binding Quota - 80,000 units

Non Binding Quota - 1,20,000 units

👉Absolute quotas: Quotas of a permanent nature, limit the quantity of imports to a specified level during a specified period of time and the imports can take place any time of the year.

▶️No condition is attached to the country of origin of the product.

For example: 1000 tonnes of Fruits import which can take place any time during the year from any country.

▶️When country allocation is specified, a fixed volume or value of the product must originate in one or more countries.

Example: A quota of 1000 tonnes of fruits that can be imported any time during the year, but where 750 tonnes must originate in country A and 250 tonnes in country B.

■ With a quota, the government, of course, receives no revenue. The profits received by the holders of such import licenses are known as 'quota rents'.

Quota
A — 10.000
B 20.000

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■ The welfare effects of quotas are similar to that of tariffs.

👉If a quota is set below free trade level, the amount of imports will be reduced. A reduction in imports will lower the supply of the good in the domestic market and raise the domestic price.

👉Consumers of the product in the importing country will be worse-off because the increase in the domestic price of both imported goods and the domestic substitutes reduces consumer surplus in the market.

👉Producers in the importing country are better-off as a result of the quota.

The increase in the price of their product increases producer surplus in the industry. The price increase also induces an increase in output of existing firms (and perhaps the addition of new firms), an increase in employment, and hence an increase in profit.

ii) Price Control Measures: Price control measures are steps taken to control or influence the prices of imported goods in order to support the domestic price of certain products when the import prices of these goods are lower.

- These are also known as 'para-tariff' measures and include measures, other than tariff measures, that increase the cost of imports in a similar manner, i.e. by a fixed percentage or by a fixed amount. Example: A minimum import price established for sulphur.

(iii) Non-automatic Licensing and Prohibitions: These measures are normally aimed at limiting the quantity of goods that can be imported, regardless of whether they originate from different sources or from one particular supplier.

- These measures may take the form of non-automatic licensing, or complete prohibitions.
- For example, textiles may be allowed only on a discretionary license by the importing country.

India prohibits import/export of arms and related material from/to Iraq.

iv) Financial Measures: The objective of financial measures is to increase import costs by regulating the access to and cost of foreign exchange for imports and to define the terms of payment.

- It includes measures such as advance payment requirements and foreign exchange controls denying the use of foreign exchange for certain types of imports or for goods imported from certain countries.
- For example, an importer may be required to pay a certain percentage of the value of goods imported three months before the arrival of goods.

v) Measures Affecting Competition: These measures are aimed at granting exclusive or special preferences or privileges to one or a few limited group of economic operators.

- It may include government imposed special import channels or enterprises
- For example, a statutory marketing board may be granted exclusive rights to import wheat: or a canalizing agency (like State Trading Corporation) may be given monopoly right to distribute palm oil. When a state agency or a monopoly import agency sells in the domestic market at prices above those existing in the world market, the effect will be similar to an import tariff. Govt - Exclusive right to import ... Domestic Market Price ↑

vi) Government Procurement Policies: Government procurement policies may interfere with trade if they involve mandates that the whole of a specified percentage of government purchases should be from domestic firms rather than foreign firms, despite higher prices than similar foreign suppliers.

- In accepting public tenders, a government may give preference to the local tenders rather than foreign tenders.

vii) Trade-Related Investment Measures: These measures include rules on local content requirements that mandate a specified fraction of a final good should be produced domestically.

(a) requirement to use certain minimum levels of locally made components,
(25 percent of components of automobiles to be sourced domestically)
(b) restricting the level of imported components, and
(c) limiting the purchase or use of imported products to an amount related to the quantity or value of local products that it exports. (A firm may import only up to 75 % of its export earnings of the previous year)

A - Export. ₹100
└ 75%. - 750 Import

(viii) **Distribution Restrictions**: Distribution restrictions are limitations imposed on the distribution of goods in the importing country involving additional license or certification requirements.

- These may relate to geographical restrictions or restrictions as to the type of agents who may resell.
- For example: a restriction that imported fruits may be sold only through outlets having refrigeration facilities.

(ix) **Restriction on Post-sales Services**: Producers may be restricted from providing after- sales services for exported goods in the importing country.

- Such services may be reserved to local service companies of the importing country.

(x) **Administrative Procedures**: Another potential obstruction to free trade is the costly and time-consuming administrative procedures which are mandatory for import of foreign goods.

- These will increase transaction costs and discourage imports.
- The domestic import-competing industries gain by such non-tariff measures.
- Examples include specifying particular procedures and formalities, requiring licenses, administrative delay, red-tape and corruption in customs clearing frustrating the potential importers, procedural obstacles linked to prove compliance etc.

(xi) **Rules of origin**: Country of origin means the country in which a good was produced, or in the case of a traded service, the home country of the service provider.

- Rules of origin are the criteria needed by governments of importing countries to determine the national source of a product.
- Their importance is derived from the fact that duties and restrictions in several cases depend upon the source of imports.
- Important procedural obstacles occur in the home countries for making available certifications regarding origin of goods, especially when different components of the product originate in different countries.

(xii) Safeguard Measures: These are initiated by countries to restrict imports of a product temporarily if its domestic industry is injured or threatened with serious injury caused by a surge in imports. Restrictions must be for a limited time and non-discriminatory.

(xiii) Embargos: An embargo is a total ban imposed by government on import or export of some or all commodities to particular country or regions for a specified or indefinite period.

- This may be done due to political reasons or for other reasons such as health, religious sentiments. This is the most extreme form of trade barrier.

EXPORT-RELATED MEASURES

(i) Ban on exports: Export-related measures refer to all measures applied by the government of the exporting country including both technical and non-technical measures.

- For example, during periods of shortages, export of agricultural products such as onion, wheat etc. may be prohibited to make them available for domestic consumption.
- Export restrictions have an important effect on international markets. By reducing international supply, export restrictions have been effective in increasing international prices.

(ii) Export Taxes: An export tax is a tax collected on exported goods and may be either specific or ad valorem.

- The effect of an export tax is to raise the price of the good and to decrease exports.
- Since an export tax reduces exports and increases domestic supply, it also reduces domestic prices and leads to higher domestic consumption.

(iii) **Export Subsidies and Incentives**: We have seen that tariffs on imports hurt exports and therefore countries have developed compensatory measures of different types for exporters like export subsidies, duty drawback, duty-free access to imported intermediates etc.

- Governments or government bodies also usually provide financial contribution to domestic producers in the form of grants, loans, equity infusions etc. or give some form of income or price support.

कम करना

(iv) **Voluntary Export Restraints**: Voluntary Export Restraints (VERs) refer to a type of informal quota administered by an exporting country voluntarily restraining the quantity of goods that can be exported out of that country during a specified period of time.

- Such restraints originate primarily from political considerations and are imposed based on negotiations of the importer with the exporter.
- The inducement for the exporter to agree to a VER is mostly to appease the importing country and to avoid the effects of possible retaliatory trade restraints that may be imposed by the importer.

Indian Domestic
Inc.

- VERs may arise when the import-competing industries seek protection from a surge of imports from particular exporting countries.
- VERs cause, as do tariffs and quotas, domestic prices to rise and cause loss of domestic consumer surplus.

Supply ↓ - Prices ↑

Unit over :)