

# The Theory of International Trade Policy

# International trade in Canada

- Canadian...
  - Exports exceed 40% of GDP
  - Imports are just below 40% of GDP
  - Trade is mainly with the US (75%)
- Affected by the...
  - North American Free Trade Association (NAFTA)
  - World Trade Organization (WTO)
- Different regional patterns

# Comparative Advantage

- Example:

Output per worker per month	Components	Assembly
Canada	4	4
Caledonia	2	1

- 240 workers in Caledonia and 120 in Canada
  - How to allocate production to maximize output?
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- Opportunity costs of production

# Comparative Advantage (2)

- Definition:
  - “A country is said to have a comparative advantage in the production of X if the opportunity cost of producing more X is lower in that country than in other countries”
- Further examples: (David Ricardo)
  - Portugal and England in the 19<sup>th</sup> century
- Transition costs
- Countries trade because they are different

# Comparative Advantage, Competitive Advantage and the Exchange rate

- Competitive advantage:
  - ability to produce at a lower cost than international rivals
  - Lowering wages or lowering taxes?
  - Increase productivity!
- Exchange rate:
  - Affects competitive advantage
  - Short-run: influenced by many factors
  - Long-run: reflect comparative advantage

# Increasing returns to scale

- So far, constant returns to scale
- Many production processes have IRS
- Additional reason to increase international trade, even for similar countries:
  - Specialize in the production one good and export
  - Lower average costs
- Example: Canada-US Auto Pact (1965)

# Market structure

- So far, competitive markets
- However, many industries have imperfect competition
- Comparative advantage may not be useful if the industry is concentrated
- Trade introduces competition!

# Import restricting policies (1)

- Tariffs:
  - “Special tax levied on an imported good”
  - Raise revenue and protect competitors
  - Example: textiles
- Quotas:
  - Implemented using licenses
- Government procurement:
  - Give preference to domestic producers
  - Examples: Crown corporations before NAFTA?



# Import restricting policies (2)

- Administrative barriers to trade:
  - Filling forms, lining up at customs offices,...
  - Substantially reduced by FTA and NAFTA
- Regulatory barriers:
  - Usage of regulations to restrict imports
  - Marketing boards?
- Interprovincial trade barriers:
  - Preferential purchasing, administrative barriers,...

# Normative reasons for trade policy

- There are gains from trade
- Best prescription should be free trade
- However...
  - Incentive problems!
  - Some potential benefits from intervention, in the presence of economies of scale and imperfect competition

# Normative reasons for trade policy (1)

- Raising revenue:
  - Efficiency implies imposing taxes such that the loss is the same on all taxes
  - In practice, much above this level
  - However, tariff revenues are small (2% in Canada)
- Non-economic objectives:
  - Military, cultural and others
- Monopoly tariff:
  - If a country has monopoly power in world market, the government can impose an export tariff
  - Example: Brazil in coffee

# Normative reasons for trade policy (2)

- Infant industry:
  - A country might not achieve its natural competitive advantage if other countries are well-established
  - Losses at the beginning (credit rationing, positive externalities)
  - Example: Canadian tariffs after confederation, Japanese consumer electronics and semiconductors
- Profit shifting:
  - Imperfect competition in international markets
  - Increase the share of the above-normal profits
  - Example: automobile insurance in BC

# Normative reasons for trade policy (3)

- Other market imperfections and retaliation
- Income redistribution:
  - Tariffs protecting an industry of a region
  - Tariffs to increase income of people of the industry
  - Example: agriculture
- Employment (?):
  - However, economic analysis and evidence suggest that aggregate employment decreases
    - Protection in one industry damages employment in others
    - Great depression and Post-war period
- Trade balance (?)

# Positive Theory

- Not very strong (normative) arguments for international trade policy
- However...
  - Beneficiaries are easy to identify, the issue is very important for them and are well represented:
    - Workers and owners in the industry
  - Losers are dispersed, do not know who they are and are not represented by any lobby:
    - Consumers (mainly low income)
    - Workers in other industries