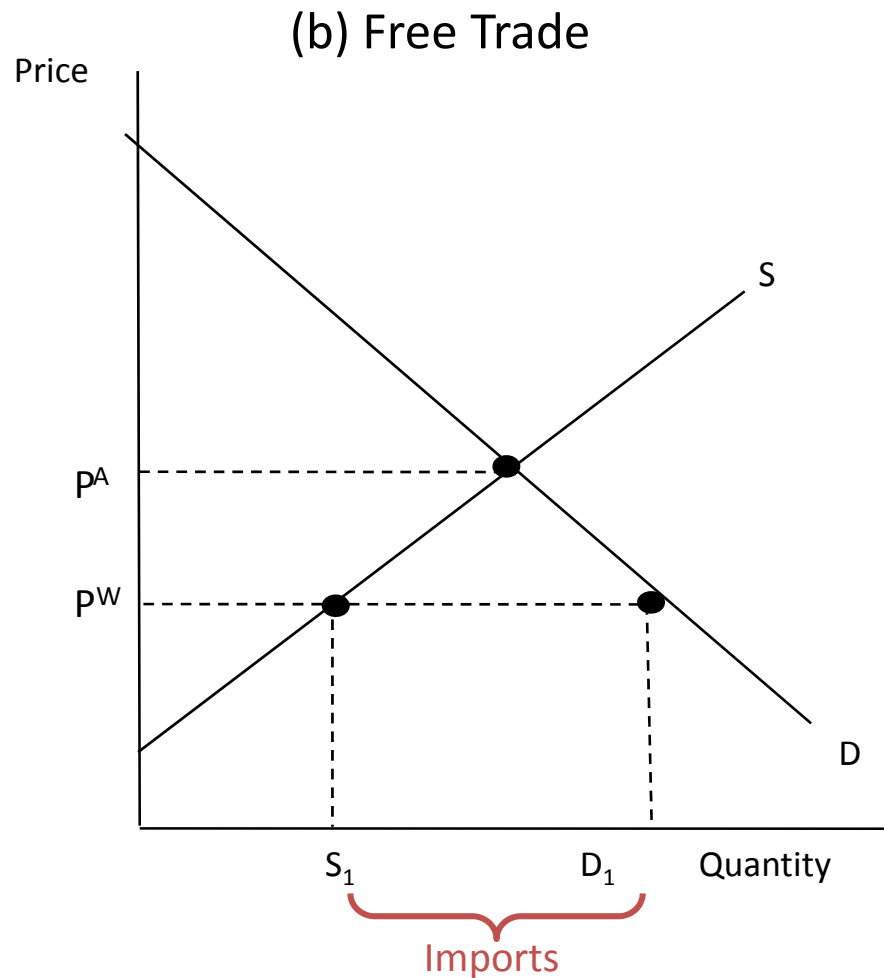


- **Case 1: Small Country + Tariffs**

- The world price P^W is determined by the supply and demand in the world market
- Suppose Home is a small country
 - Price taker in the world market
 - Faced a fixed price at P^W
- If $P^A > P^W$ then country Imports good, else Exports

- Free Trade Situation

Figure 8.2

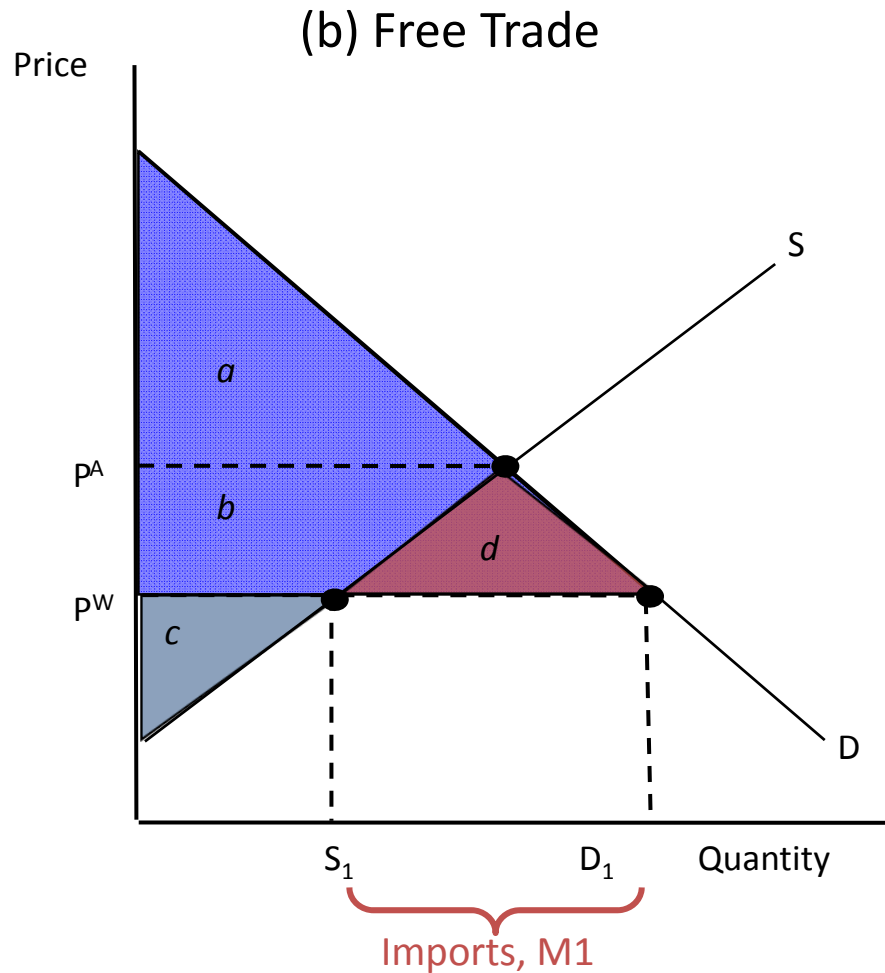


At the free trade price of P^W , Home supply will fall to S_1 and Home demand will rise to D_1 .

Imports will make up for the excess demand and will equal $(D_1 - S_1)$

- Welfare Changes due to Trade

Figure 8.2



Change in CS = $b + d$

+

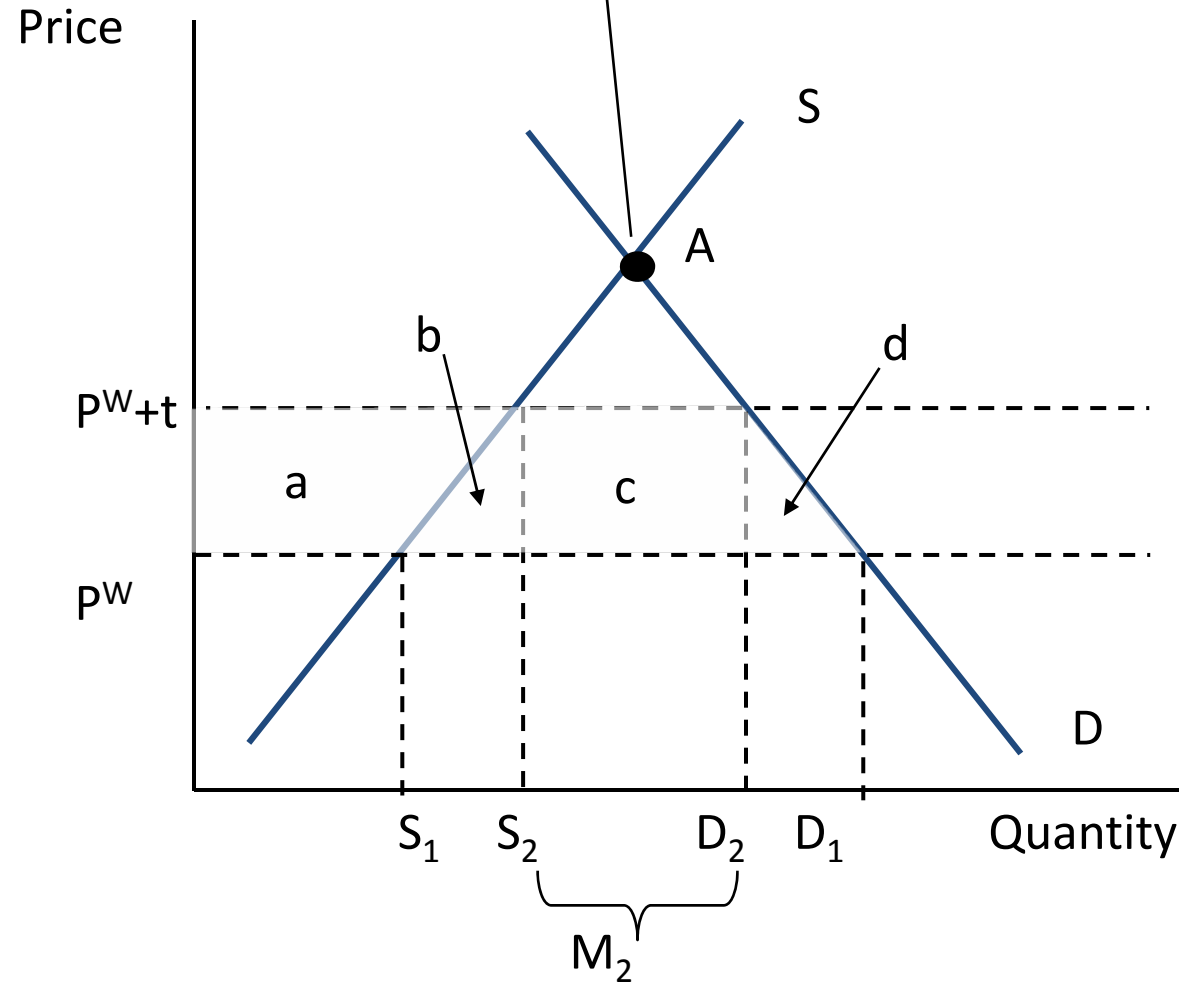
Change in PS = $-b$

Change in Welfare = d

Gain in trade is triangle d with area equal to $\frac{1}{2}(M_1)(p^A - p^W)$

- Govt. imposes Tariff = \$ t per unit

No-trade equilibrium



- Good leaves China at \$ P^W

- We pay $P^{USA} = \$(P^W+t)$

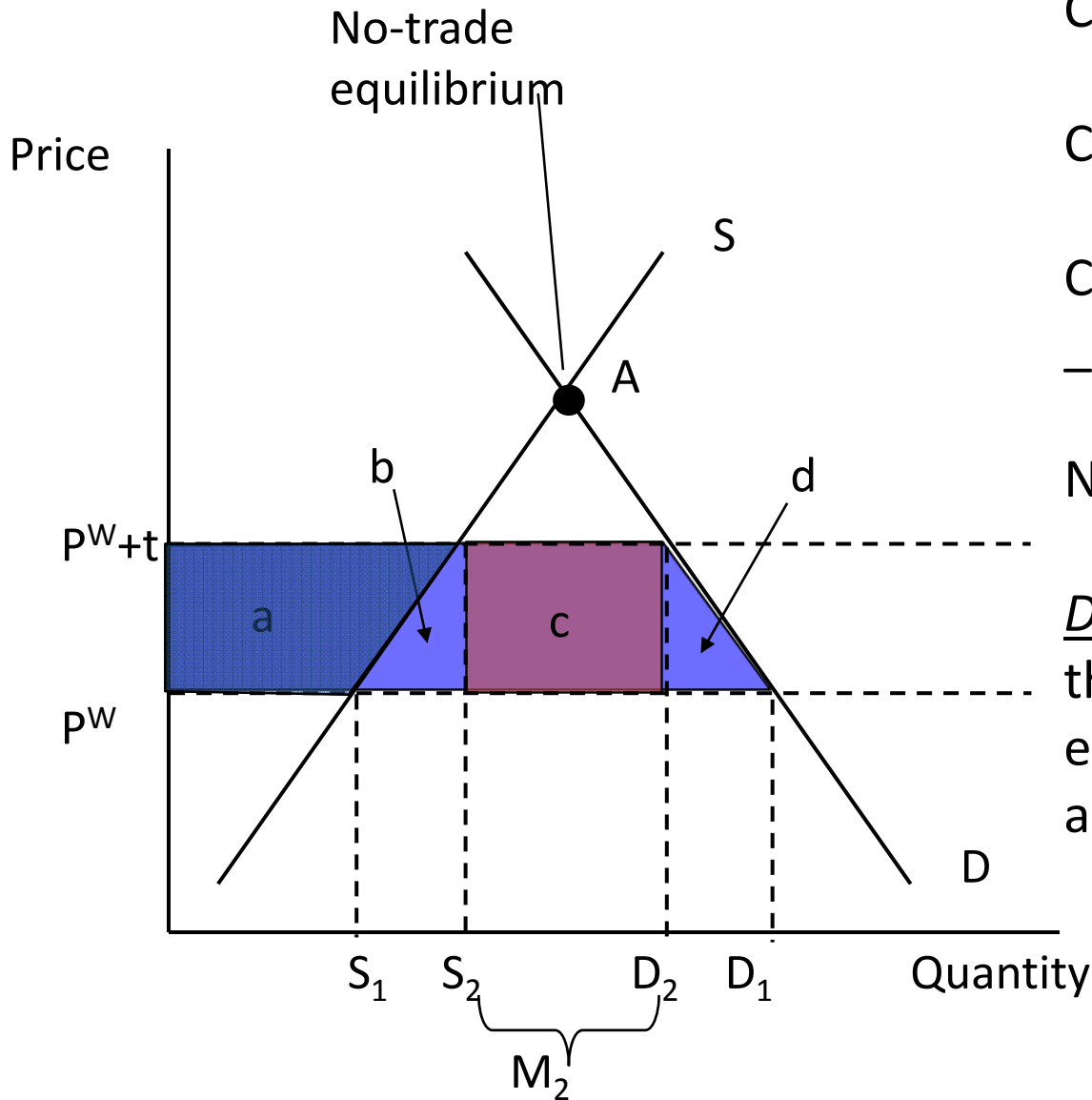
- Did the world price change? No

- But consumers & producers *perceive* that it has changed!

- Consumption *falls*

- Production *rises*

Welfare Impact of Tariff



$$\text{Change in CS} = -(a+b+c+d)$$

+

$$\text{Change in PS} = a$$

+

$$\text{Change in Revenue} = c$$

$$\text{Net Welfare} = -(b+d)$$

Dead Weight Loss = welfare that was taken away from one economic agent, but did not accrue to any other agent

- **Conclusions: Small Country**

- Small country *always* loses as a result of tariff!
- Area b = production loss or *efficiency loss*—due to producing at marginal costs above world price
- Area d = loss of welfare due to consumption inefficiency
- Redistribution of Income from consumers to producers
- Consumers and producers organizing politically
 - Producers few, each very interested in issue
 - Consumers many, each interested only a little
 - Tariff is hidden in price of the good
 - "logic of collective action"

Some suggestive political economy arithmetic.

- Consequences of a tariff
- Suppose 100 million consumer-citizens lose \$1
 - and 50% don't vote
 - and 90% of voters don't understand the tariff
 - and 99% who do understand won't change vote

⇒ politicians lose 50,000 votes
- Suppose one producer gains \$50 million
 - gives 20% in campaign contributions
 - suppose \$100 produces one vote

⇒ politicians gain 100,000 votes
- The tariff
 - reduces overall economic welfare by \$50 million
 - nets politicians 50,000 extra votes