

# **Economics, markets and organization**

## Tutorial 12



# Continuous exam 1

- 1. Explain why a country that - out of a situation of autarky – turns into an exporter sees its overall welfare increase. Examine the welfare effects for all relevant groups.





## Continuous exam 2

- 2. Discuss the welfare effects of an export subsidy that is granted by a large country. Why does this export subsidy imply a transfer of wealth from the large country to the rest of the world?





# Key objectives

- Analyzing trade policy tools
- Understanding the key concepts of the political economy of trade policy (median voter theorem, collective action problems, lobbying)
- Understanding the nature of public goods





# TRADE POLICY





1. Domestic market failures can justify protection of domestic producers through trade policy. However, Krugman, Obstfeld and Melitz argue that the imposition of an import tariff is a second best policy if a government wants to stimulate domestic production. They argue that this goal is better served by granting a production subsidy. This preference for a production subsidy is due to the fact that in the case of a production subsidy (compared with an equivalent tariff):

1. The production distortion loss and the consumption distortion loss are smaller.
2. No production distortion loss occurs.
3. No consumption distortion loss occurs.
4. No production distortion loss and no consumption distortion loss are encountered.



## Answer

3 is correct.

The fundamental difference between tariff and production subsidy is that in case of tariffs, the domestic price will increase, causing part of the consumption to happen at higher than free trade prices. This is consumption distortion.

With production subsidy domestic price remains at the free-trade level, and there will be no consumption reduction and no consumption distortion.



## Correct answer to Q1: 3

- Useful video:
- <https://www.youtube.com/watch?v=NWje0rUThC8>



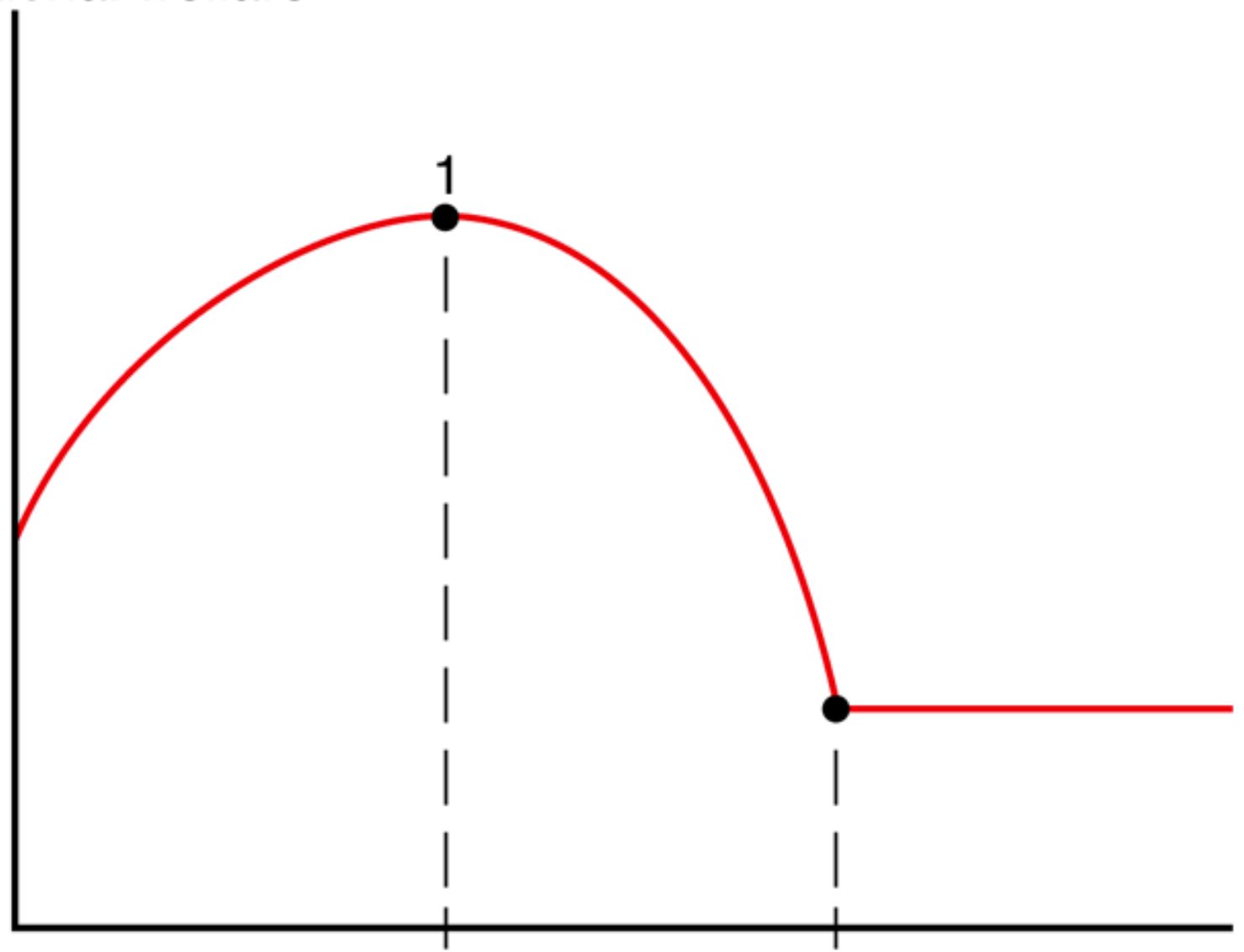




2. According to economic theory, trade policy measures can be justified if they raise overall welfare. An example thereof is the so-called optimal or optimum (import) tariff. Which of the following statements correctly describes an optimal tariff in a large economy?

1. An optimal tariff does not bring about costs in terms of production and consumption.
2. An optimal tariff generates a terms-of-trade gain.
3. An optimal tariff allows the country to fully exploit the advantage of its lower costs (when compared with its foreign competitors).
4. An optimal tariff is only to be imposed when there are domestic market failures.

$\tau$  National welfare



Optimum  
tariff,  $t_o$

Prohibitive  
tariff rate,  $t_p$

Tariff rate



## Answer

2 is correct, since the large importer country can reduce the world market price by introducing tariffs. The terms of trade will shift to its favor.

1 is not correct because import tariffs will increase the cost of consumption.

3 The country did not have lower costs, since it was an importer.

4 This is not true again, you can, if you have monopsonic powers (you can affect world price of the imported good) divert some of the exporters' producer surplus to your consumer's surplus, and customs revenue.



**3.** Assume that each household has (on average) one vote and one worker. The production factor capital is at the same time unequally distributed, such that only a minority of households owns capital. Assume that free trade would benefit capital owners in the export sector but would harm workers. Which of the following statements gives a correct prediction?

I. If the outcome of the political decision making process is determined according to the median voter theorem, the government will decide against free trade.

II. In the case where the group of capital owners in the export sector is well organised, the government will rather install an export subsidy than opt for undistorted international trade.



## Answer

- Both claims are correct.
- Since the majority of voters would experience a welfare loss from trade liberalization, the government would not liberalize trade.
- If exporters are organized, they can lobby for an export subsidy and its introduction would be a likely outcome.



4. Which of the following statements on the political economy of trade policy is not correct?

1. The median-voter model – per definition – cannot explain why small interest groups obtain protection via trade policy.
2. Collective action problems indicate that consumers do not take action against socially undesirable trade measures because individual returns of abolishing them may be low.
3. The insights of the theory on electoral competition alone cannot explain why trade policy that only favours a fraction of the population is still often used by countries.
4. Lobbying for trade policy that increases domestic production can never be justified since it decreases welfare.



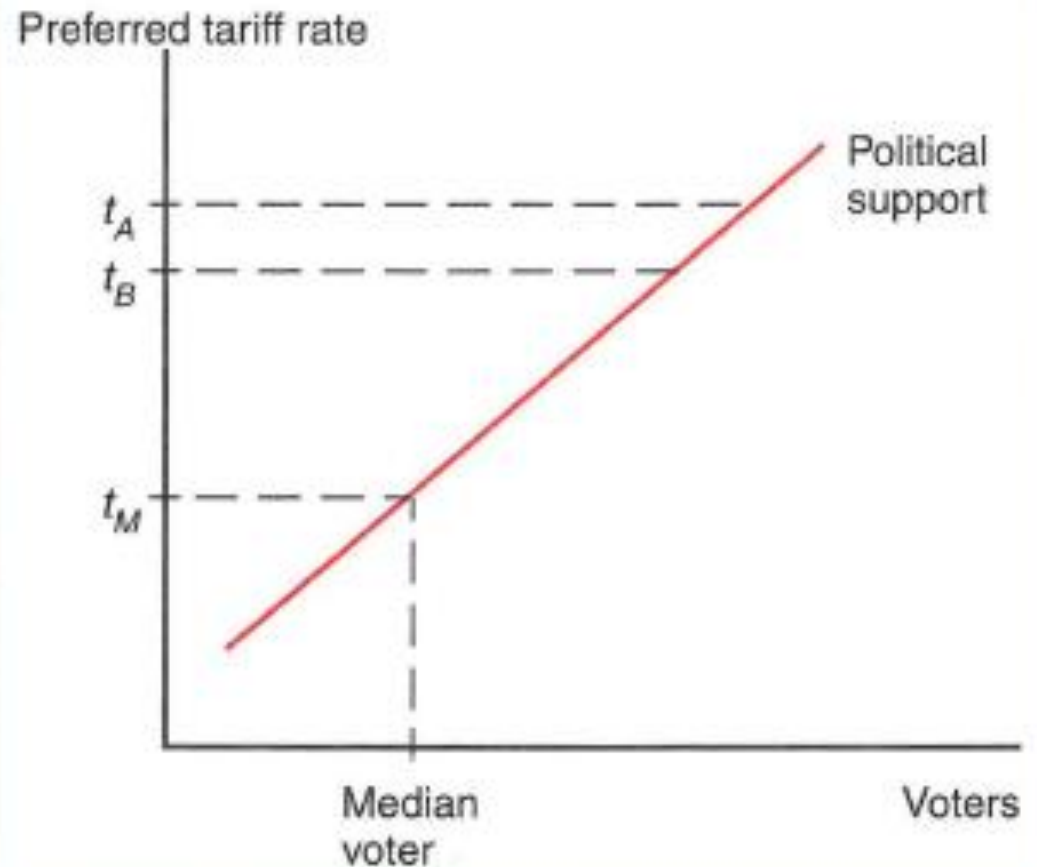
## Answers

1. Is true.
2. Is true, the individual gains would be much lower per voter from reducing tariffs than the gain of exporters from keeping it at a high level. The small group of exporters would be more likely to act.
3. Yes, this is true.
4. This is not correct: optimal tariff theorem. Also positive externalities may exist.

**FIGURE 10-4**

### Political Competition

Voters are lined up in order of the tariff rate they prefer. If one party proposes a high tariff of  $t_A$ , the other party can win over most of the voters by offering a somewhat lower tariff,  $t_B$ . This political competition drives both parties to propose tariffs close to  $t_M$ , the tariff preferred by the median voter.







# PUBLIC GOODS





# Public goods vs. private goods

- Is the good rival?
- Is the good excludable?





**5.** Explain what is meant by a good being “rival”.  
Give three examples of goods that exhibit the characteristics of being rival in consumption.





## Answer

- A rival good is one for which one person's use of it diminishes another person's enjoyment of it.
- Private goods such as pizza are both excludable and rival, since when one person eats it, no one else can eat it. Congested roads and fish in the ocean are other examples



**6.** Define and give an example of a public good. Why would the market not provide public goods? You are also requested to explain the concept of free riding.





## Answer

- A public good is a good that is neither excludable nor rival. An example is national defense, which protects the entire nation. No one can be prevented from enjoying the benefits of it, so it is not excludable, and an additional person who benefits from it does not diminish the value of it to others, so it is not rival.
- The private market will not supply the good, since no one would be willing to pay for it because they cannot be excluded from enjoying it if they do not pay for it. A person who enjoys the benefit of a good without willing paying for it is called a free rider.



**7.** Use the classification of goods and services in Figure 10.1 and explain in which category each of the following goods fall into.

- (a) Police protection
- (b) Road gritting
- (c) Street lighting
- (d) Education
- (e) Rural roads
- (f) City streets



# Figure 1 Four Types of Goods

		Rival?	
		Yes	No
Excludable?	Yes	<p>Private Goods</p> <ul style="list-style-type: none"><li>• Chocolates</li><li>• Clothing</li><li>• Congested toll roads</li></ul>	<p>Natural Monopolies</p> <ul style="list-style-type: none"><li>• The fire service</li><li>• Cable TV</li><li>• Uncongested toll roads</li></ul>
	No	<p>Common Resources</p> <ul style="list-style-type: none"><li>• Fish in the ocean</li><li>• The environment</li><li>• Congested non-toll roads</li></ul>	<p>Public Goods</p> <ul style="list-style-type: none"><li>• Street lighting</li><li>• Flood control dams</li><li>• Uncongested non-toll roads</li></ul>





## Answers

- a) Police protection: non-rival (provided there are enough police officers), non-excludable. Public good.
- b) Road gritting: this is non-excludable, but rival since other roads may not be gritted (limited resources to grit.) Public good.
- c) Street light: Classic case of public good: non-rival, non-excludable



## Answers

d. Education: private good: it is rival and excludable.

e. Rural roads: public good: non-rival, non-excludable

f. City streets: public good: non-rival, non-excludable if they are not crowded. If they are congested then they are common resources because they are rival.

