

# Modeling Tariffs and Other Interventions

Short Course on CGE Modeling, United Nations ESCAP

John Gilbert

Professor  
Department of Economics and Finance  
Jon M. Huntsman School of Business  
Utah State University  
jgilbert@usu.edu

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# Introduction

- So far we have considered economies that are free from policy-induced distortions to the economic system.
- In this session we will consider how trade taxes, subsidies, and other interventions can be incorporated into the model an open economy.
- This will allow us to examine the production, consumption, trade, income distribution, and economic welfare implications of interventions.
- Since almost all real world trade patterns are riddled with distortions of various kinds, introducing these types of distortions is also a crucial step in building the components we need for a CGE model applied to an actual economic system.

# Session Outline

- 1 Tariffs for the small country
- 2 Symmetry
- 3 Other price interventions
- 4 Quotas

# Small Economy Tariffs

- For a small economy, in the absence of distortions, optimal policy is free trade. In other words the MRS and MRT both equal the world relative price.
- A trade tax/subsidy has the effect of driving a wedge between domestic and world prices. We can define the wedge in percentage terms as  $t_i = (p_i - p_i^*)/p_i^*$ ,  $i = 1, 2$ , with the price of foreign exchange normalized to unity.
- For an importable good (i.e.,  $x_i < 0$ ) a positive value of  $t_i$  represents a tariff.
- A tariff pushes the domestic price up relative to a world price.
- Tariffs can drive the relative domestic price no further away from the relative world price than the relative autarky price. Beyond that point they are said to contain 'water'.

# Formal Problem

- Given world prices, the domestic prices are determined by the tax wedge.
- Solving the production problem reveals that firms will produce on the production possibilities where the MRT is equal to the domestic price ratio.
- Solving the consumer's problem reveals that households will consume where the MRS is equal to the domestic price ratio, and will spend all of their income.
- Finally, we determine income as the sum of the value of output at domestic prices, plus the tariff revenue. This completes the model.
- Note that although the consumption choice affects tariff revenue, this should not form part the consumer decision (why?)

# Other Price Interventions

- For an importable good (i.e.,  $x_i < 0$ ) a negative value of  $t_i$  represents an import subsidy.
- For an exportable good ( $x_i > 0$ ) a positive  $t_i$  represents an export subsidy while a negative value represents an export tax.
- Hence, all price based interventions can be dealt with in the same manner as a tariff.
- Both a tariff and an export subsidy push the domestic price up relative to a world price, while an import subsidy or export tax pushes the domestic price down relative to the world price.
- Like tariffs, export taxes can drive the relative domestic price no further away from the relative world price than the relative autarky price.
- In the two good case, an export tax and an import tariff are the same intervention, a result known as the Lerner symmetry theorem.

- First we need to introduce the tax wedge, either by creating a new equation or by substitution.
- The first order conditions for firms need to be adjusted to reflect decision making at domestic prices.
- The first order conditions for households need to be adjusted similarly.
- Income needs to be adjusted to include tariff revenue.

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