[Frequently Asked Questions]

[Cost and Benefit Analysis of Tariff and Rate of Effective Protection]

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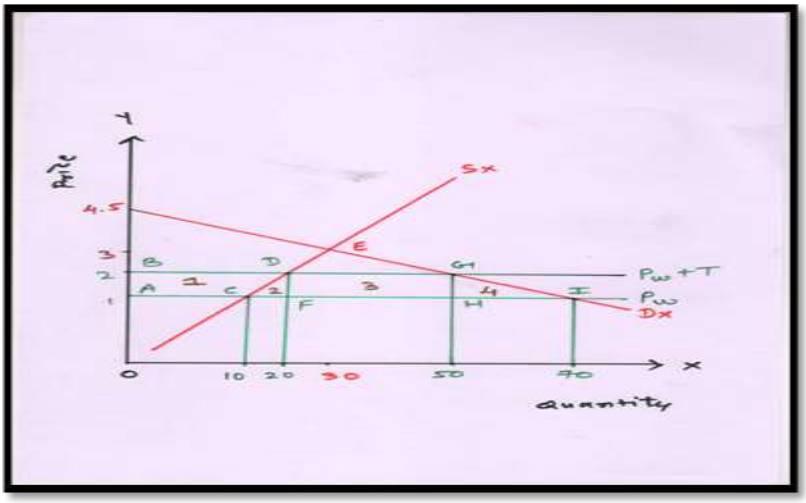
Frequently Asked Questions

(1)Explain the costs and benefits analysis of a tariff.

A. Figure-1 exhibits that, the reduction of the consumer surplus is ABGI = 1+2+3+4 = $ 60, DGHF = $ 30 is collected by the government as import duty and an increase in producer surplus is ABDC = $ 15. It means that $ 15 is redistributed from consumers to producers in the form of increased producer surplus. The remaining $ 15 i.e. 2+4 depicts the protection cost or deadweight loss to the economy due to an import tariff.

Figure 1: Costs and Benefits of a tariff



Area 2 = $ 5 arises due to tariff imposition. An imposition of tariff transferred some domestic resources from more efficient production of exportable commodity to the less efficient production of importable commodity X in nation A. This is the production component of deadweight loss.

Area 4 = $ 10 is the consumption component of deadweight loss. A tariff increases the price of importable commodity in relation to exportable commodity. It twists the consumption pattern in nation A.

This analysis shows that, an imposition of a tariff redistributes income from consumers to producers in the form of increased producer surplus. It also redistributes income from nation's abundant factors which produces export commodity to nation's scarce factor which produces import commodity. This leads to inefficiencies in the economy. This is referred to as protection cost or deadweight loss to the economy due to an import tariff by a small nation.

(2) What is value added?

A. Value added is the difference between the selling price and the production cost of intermediate goods.

(3) Give the meaning of effective rate of protection.

A. Effective Rate of Protection (ERP) is defined as the ratio of difference between the value added at domestic prices and the value added at world prices to value added at world prices.

Therefore, ERP = $(V^{/} - V) / V$

Where, $V^{/}$ = value added at domestic prices i.e. inclusive of tariffs on the final commodity and intermediate inputs.

V = domestic value added under free trade.