LECTURE NOTES
in
INTERNATIONAL TRADE POLICY (*)

(ITR402)

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(*) These lecture notes mostly depend on the textbooks of Dominick Salvatore (International Economics, 9e), Paul R. Krugman & Maurice Obstfeld (International Economics, 3e), Gregory Mankiw (Principals of Economics, 4e) and Halil Seyidoğlu (Uluslararası İktisat, 17e), with our own contributions.
1. Introduction

In the international Economics course, we examined the theoretical basis of trade among nations:
- Why do nations trade?
- What are the gains of nations from trade?
- At what prices do they trade (terms of trade)?
- And, some related subjects (transportation costs, environmental standards, economic growth/development – trade interactions, and so on)

In this course of International Trade Policy, we will analyze the trade policies.

Before analyzing the effects of trade policies, we should learn the tools of welfare economics, because we will use them to understand the effects of trade policies.

In this context, we will learn
- Consumer surplus
- Producer surplus
- Market efficiency
- The deadweight loss

After this introductory information, some of the subjects of trade policies are following:
- How free trade affect welfare in an “exporting country”?
- How free trade affect welfare in an “importing country”?
- The effects of a “tariff” (who gains and who loses from a tariff imposition?)
- The effects of a “quota” (who gains and who loses from a quota limitation?)
- The arguments for restricting trade (for protectionism)
- The rate of effective protection
- Theory of economic integration
2. Tools of welfare economics

- What is the best price that maximizes the total welfare of consumers and producers?

To answer this question, we should know the concepts of consumer surplus and producer surplus.

- Yet, before analyzing the consumer and producer surplus, let’s give the answer to the question above:

‘The equilibrium of supply and demand in a market maximizes the total benefits received by buyers and sellers.’

In other words, ‘the price that balances the supply and demand for a commodity is the best one because it maximizes the total welfare of the consumers and producers.’

2a. Consumer Surplus

Consumer surplus is the amount that buyers are willing to pay for a good minus the amount they actually pay for it.

Figure 1.1

- If the equilibrium price is \( P_1 \), all buyers will buy at price \( P_1 \).
- However, there are a lot of buyers who can buy at higher prices than \( P_1 \).
- E.g., consumer A is willing to buy at price \( P_2 \), but actually pay \( P_1 \) for the good.
- Then, \( Aq_2 - Bq_2 = \) Consumer A’s surplus.
  - \( Aq_2 = \) The consumer is willing to pay for the good,
  - \( Bq_2 = \) The consumers actually pays for the good.

- By applying the same logic, the sum of the intervals between the demand curve and the price line is the consumer surplus (the area of the triangle \( CP_1D \)).
At price $P_1$, the consumer surplus is $AP_1C$.

At price $P_2$, the consumer surplus is $AP_2D$.

`:; A lower price raises consumer surplus. On the contrary, a higher price falls consumer surplus.

2b. Producer Surplus

We apply the same logic.

→ All producers (sellers) sell at price $P_1$. (Equilibrium price)
→ But there are many producers who can sell at lower prices.
→ E.g. producer A, whose cost is $Aq_2$ ($=P_2$) is able to sell at price $P_2$ but she actually sells at price $P_1$)
→ Then, $P_1P_2$ ($Bq_2-Aq_2$) is the producer A’s surplus.
→ All producers up to point C on the supply curve benefit from the difference between the actual price and the price they are willing to sell.
→ Then, $P_1CD$ is the producer surplus, the area above the supply curve and below the price line.
Figure 1.4

- A higher price raises the producer surplus.

Because when price rises, the less efficient firms can meet their high costs and start to produce. Plus, initial firms produce more to earn more.

- At price $P_1$, the producer surplus is the area of the triangle $P_1AC$. (Initial producer surplus)

- When price rises (from $P_1$ to $P_2$), the producer surplus increases by the area of $P_1ABP_2$.

  - $P_1ADP_2$ is the increase in initial producers’ surplus.
  - (Additional producer surplus to initial producers)

  - $ABD$ is the producer surplus to new producers.

2c. Total Surplus

Figure 1.5

Total Surplus - the sum of consumer and producer surplus - is the area between the supply and demand curves up to the equilibrium quantity.
Recall that the demand curve reflects ‘the value to buyers’ and that the supply curve reflects ‘the cost to sellers’.

At quantities less than the equilibrium quantity, the value to buyers exceeds the cost to sellers.

At quantities greater than the equilibrium quantity, the cost to sellers exceeds the value to buyers.

Therefore, the market equilibrium maximizes the sum of producer and consumer surplus.

As a result, any policy imposing a price less or greater than equilibrium price causes a decrease in total surplus.

2d. Market Efficiency and Market Failure

- Keep in mind that these analyses depend on the assumptions of freely competitive markets.

  When the assumptions of perfectly competitive market do not hold, our conclusion that the market equilibrium is efficient may no longer be true.

- ‘Market power’ and ‘externalities’ can distort the market efficiency. This phenomenon is called ‘market failure’.

- When markets fail, public policy can potentially remedy the problem and increase economic efficiency.

- Despite the possibility of market failure, the invisible hand of the marketplace is extraordinarily important.

- In many markets the assumptions of free markets work well, and the conclusion of market efficiency applies directly.

- The analysis of market efficiency can be used to shed light on the effects of various government policies.

- Two policies will be considered; taxation policy and international trade policy.
3. The Deadweight Loss of Taxation

Figure 1.7 (The effect of a Tax)

Note: For simplicity, the shift of the supply curve to the left with the effect of tax will not be shown in other graphs.

Figure 1.8 (Tax Revenue)

Now, what happened with the tax?

✓ With the tax,

• The quantity sold in the market decreased (from \( q_1 \) to \( q_2 \))
• The price that buyers pay differentiated from the price that sellers receive.
• The total surplus decreased by the area of triangle ABE.
• This area (ABE) is called deadweight loss. Because the market contracted by the amount of \( q_1q_2 \); some sellers and buyers left the market.
Figure 1.9 (Welfare effects of a tax)

<table>
<thead>
<tr>
<th></th>
<th>WITHOUT TAX</th>
<th>WITH TAX</th>
<th>CHANGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumer Surplus</td>
<td>A+B+C</td>
<td>A</td>
<td>-(B+C)</td>
</tr>
<tr>
<td>Producer Surplus</td>
<td>D+E+F</td>
<td>F</td>
<td>-(D+E)</td>
</tr>
<tr>
<td>Tax Revenue</td>
<td>None</td>
<td>B+D</td>
<td>+(B+D)</td>
</tr>
<tr>
<td>Total Surplus</td>
<td>A+B+C+D+E+F</td>
<td>A+B+D+F</td>
<td>-(C+E)*</td>
</tr>
</tbody>
</table>

*: The area C+E shows the fall in total surplus and is the deadweight loss of the tax.

- Definition of Deadweight Loss:
  
  *It is the fall in total surplus that results from a market distortion, such as a tax.*

4. The Determinants of Deadweight Loss

- What determines whether the deadweight loss from a tax is large or small?

  The answer is the price elasticities of supply & demand.

Figure 1.10

(a) inelastic supply  
deadweight loss is small  
size of the tax

(b) elastic supply  
deadweight loss is large  
size of tax
**The Result:** the greater (smaller) the elasticities of supply and demand, the greater (smaller) the deadweight loss of a tax.

**5. The Deadweight Loss and Tax Revenue As Taxes Vary**

What happens to the deadweight loss and tax revenue when the size of a tax changes?

**Figure 1.11**

- **(a) small tax**
- **(b) medium tax**
- **(c) large tax**

- In these three panels, the demand and supply curves are held constant.

Only the ‘size of tax’ changes, in order to show how tax revenue changes when the size of tax changes.
Note that, for the small tax in panel (a), the area of deadweight loss triangle is quite small.

But as the size of the tax rises in panel (b) and (c), the deadweight loss grows larger and larger. \( \frac{ah}{2} \rightarrow 2a \cdot \frac{h}{2} = 2ah = 4 \times \left( \frac{ah}{2} \right) \) (Area of a triangle is half the base times the height. If you increase the base twice, the area, the deadweight loss, increases four times.)

Indeed the deadweight loss of a tax rises even more rapidly than the size of the tax.

From this analysis, we can conclude that as the tax size rises, first the tax revenue gets larger and then it gets smaller because the market shrinks.

This case can be illustrated by the ‘Laffer Curve’. (Because Arthur Laffer first pointed out this fact in 1974).

Figure 1.12

As it is shown in Figure 1.12, the tax revenue rises to a certain size of the tax and after that it starts to fall.


But subsequent history failed to confirm Laffer’s conjecture that lower tax rates would raise tax revenue.

When Reagan cut taxes after he was elected, the result was less tax revenue, not more.

The views of Laffer and Reagan became known as ‘supply-side economics’

The validity of supply-side economics is debated. However, there is no debate about the general lesson:

‘How much revenue the government gains or loses from a tax change cannot be computed just by looking at tax rates. It also depends on how the tax change affects people’s behavior.’ (Elasticities are important.)
CHAPTER 2
AN APPLICATION FOR WELFARE ECONOMICS
(International Trade)

→ In this chapter we will see:

✓ How international trade affects economic well-being,
✓ Who gains and who loses from free trade among countries, and
✓ How do the gains compare to the losses?

→ To answer these questions we’ll use the tools of supply, demand, consumer and producer surplus and so on.

→ In the following analyses, we suppose the country is Turkey, and the good is steel.

2.1. The Equilibrium without International Trade

Figure 2.1

- When Turkey cannot trade in world markets, the price adjusts to balance domestic supply and demand.
- This figure shows consumer and producer surplus in equilibrium without international trade for the steel market.
2.2 The Winners and Losers from Trade

Figure 2.2 (In the case of exporting country)

→ We suppose that Turkey is an exporting country. And assume that it is a small country, which means that its actions do not affect world price. It is a price taker.

→ Once trade is allowed, the domestic price rises to equal the world price.

2.3. How Free Trade Affects Welfare in an ‘Exporting Country’?

We should compare the changes in producer and consumer surplus before and after trade.

Figure 2.3

<table>
<thead>
<tr>
<th></th>
<th>Before Trade</th>
<th>After Trade</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumer Surplus</td>
<td>A+B</td>
<td>A</td>
<td>-B</td>
</tr>
<tr>
<td>Producer Surplus</td>
<td>C</td>
<td>B+C+D</td>
<td>+(B+D)</td>
</tr>
<tr>
<td>Total Surplus</td>
<td>A+B+C</td>
<td>A+B+C+D</td>
<td>+D*</td>
</tr>
</tbody>
</table>

*: The area D shows the increase in total surplus and represents the gains from trade.
This analysis of an exporting country yields two conclusions:

1) When a country allows trade and becomes an exporter of a good, domestic producers of the good are better off, and domestic consumers of the good are worse off.

2) Trade raises the economic well-being of a nation in the sense that the gains of the winners (B+D) exceed the losses of the losers. (-B)

**2.4. How free trade affects welfare in an ‘importing country’?**

Again, we should compare the changes in producer and consumer surplus before and after trade.

**Figure 2.4.**

→ Turkey is a small country.
   It is a price taker.
→ Once trade is allowed, the domestic price falls to equal the world price.

<table>
<thead>
<tr>
<th></th>
<th>Before Trade</th>
<th>After Trade</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumer Surplus</td>
<td>A</td>
<td>A+B+D</td>
<td>+(B+D)</td>
</tr>
<tr>
<td>Producer Surplus</td>
<td>B+C</td>
<td>C</td>
<td>-B</td>
</tr>
<tr>
<td>Total Surplus</td>
<td>A+B+C</td>
<td>A+B+C+D</td>
<td>+D*</td>
</tr>
</tbody>
</table>

*: The area D shows the increase in total surplus and represents the gains from trade.

.: This analysis of an importing country yields two conclusions parallel to those for an exporting country:

1) When a country allows trade and becomes an importer of a good, domestic consumers of the good are better off, and domestic producers of the good are worse off.

2) Trade raises the economic well-being of a nation in the sense that the gains of the winners (B+D) exceed the losses of the losers (-B)

Now that we have completed our analysis of trade, we can conclude that ‘trade can make everyone better off’
If Turkey opens up its steel market to international trade the change will create winners and losers, regardless of whether Turkey ends up exporting or importing steel.

In either case, however, the gains of the winners exceed the losses of the losers, so the winners could compensate the losers and still be better off.

In this case, trade can make everyone better off. But will trade make everyone better off? Probably NOT.

\[ \therefore \] In practice, compensation for the losers from international trade is rare.

Without such compensation, opening up to international trade is a policy that expands the size of the economic pie, while perhaps leaving some participants in the economy with a small slice.

2.5. The Effects of a Tariff

**Definition of Tariff:** ‘A tariff is a tax on imported good.’

→ If Turkey becomes a steel exporter, you can quickly realize that a tariff on steel will have no effect.

A tax on steel imports is irrelevant, because no one in Turkey is interested in importing steel.

→ The tariff matters only if Turkey becomes a steel importer.

→ To see the effects of a tariff, we should compare welfare with and without the tariff.

**Figure 2.5**

![Figure 2.5](image-url)

Figure 2.5 shows the Turkey’s market for steel.

- Under free trade, the domestic price equals the world price ($P_W$)
- A tariff raises the price of imported good above the world price by the amount of the tariff. (from $P_W$ to $P_t$).

Domestic suppliers of steel can now sell their steel for the world price plus the amount of the tariff ($=P_t$)
Thus the price of steel—both imported and domestic—rises by the amount of tariff and is, therefore, closer to the price that would prevail without trade.

The change in price affects the behavior of domestic buyers and sellers

→ **Prices and quantities:**

- **Without tariff:**
  - $P_W$ is the world price.
  - $q_s^d$ is the quantity supplied by domestic sellers.
  - $q_d^d$ is the quantity demanded by domestic buyers.
  - $q_s^d - q_d^d$ is the amount which is imported (under free trade/with no restriction).

- **With tariff:**
  - $P_t$ is the price with tariff
  - $q_s^d$ is the quantity supplied by the domestic seller after the tariff. (Because price rose/because of the law of supply)
  - $q_d^d$ is the quantity demanded by the domestic buyers after the tariff. (Because of the law of demand)
  - $q_s^d - q_d^d$ is the amount which is imported after the tariff.

- Thus, ‘the tariff reduces the quantity of imports and moves the domestic market closer to its equilibrium without trade’.

- Now consider the gains and losses from the tariff:
  → Because the tariff raises the domestic price, domestic sellers are better off, and domestic buyers are worse off.
  → The government raises revenue.

To measure these gains and losses, we look at the changes in consumer surplus, producer surplus and government revenue.

<table>
<thead>
<tr>
<th></th>
<th>Before Tariff</th>
<th>After Tariff</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumer Surplus</td>
<td>$A + B + C + D + E + F$</td>
<td>$A + B$</td>
<td>$-(C + D + E + F)$</td>
</tr>
<tr>
<td>Producer Surplus</td>
<td>$G$</td>
<td>$C + G$</td>
<td>$+C$</td>
</tr>
<tr>
<td>Government Revenue</td>
<td>None</td>
<td>$E$</td>
<td>$+E$</td>
</tr>
<tr>
<td><strong>Total Surplus</strong></td>
<td>$A + B + C + D + E + F + G$</td>
<td>$A + B + C + E + G$</td>
<td>$-(D + F)^*$</td>
</tr>
</tbody>
</table>

*: The area D+F shows the fall in total surplus and represents the deadweight loss of the tariff.

→ Area D represents the deadweight loss from the ‘overproduction’ of steel. (Because some resources are used at higher costs)

→ Area F represents the deadweight loss from the ‘underconsumption’. (Because the society reduces its consumption)

### 2.6 The Effects of an Import Quota

**Definition of Import Quota:** ‘An import quota is a limit on the quantity of imports’.

→ Imagine that the Turkish government distributes a limited number of import licenses. Each license gives the license holder the right to import 1 ton of steel into Turkey from abroad.
Now we want to compare welfare under a policy of free trade and welfare with the addition of this import quota.

**Figure 2.6**

Figure 2.6 shows the Turkey’s market for steel.

→ Under free trade, the domestic price equals the world price (\(P_W=\) Price without quota)

→ A quota raises the price of imported steel above the world price by any amount (determined by the size of quota). Suppose that the price has risen to \(P_q\), which is closer to the price that would prevail without trade.

→ The change in price affects the behavior of domestic buyers and sellers

→ Price and quantities:

- \(P_W\) is the world price.
- \(q_1^s\) is the quantity supplied by domestic sellers (under free trade)
- \(q_1^d\) is the quantity demanded by domestic buyers (under free trade)
- \(q_1^s - q_1^d\) is the amount which is imported (under free trade/with no restriction)

**With the imposition of quota:**

- \(P_q\) is the price with quota
- \(q_2^s\) is the quantity supplied by domestic sellers after the quota. (because price has risen/because of the law of supply)
- \(q_2^d\) is the quantity demanded by the domestic buyers after the quota (because of the law of demand)
- \(q_2^s - q_2^d\) is the amount which is imported after the quota (the size of the quota)

- Thus, ‘the quota limits the quantity of imports and moves the domestic market closer to its equilibrium without trade.'
→ Now consider the gains and losses from the quota:

- Note that the effects are identical with those of a tariff.
- Because the quota raises the domestic price, domestic sellers are better off, and domestic buyers are worse off.
- However, the surplus from the quota is different from the case of a tariff. (This is important and the distinctive character of a quota from a tariff).

To measure the gains and losses, we look at the changes in consumer surplus, producer surplus, and quota surplus.

(Because a quota is distributed to the license holders, the surplus from the quota can be called ‘License-holder surplus’).

<table>
<thead>
<tr>
<th></th>
<th>Before Quota</th>
<th>After Quota</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumer Surplus</td>
<td>A+B+C+D+E+F</td>
<td>A+B</td>
<td>-(C+D+E+F)</td>
</tr>
<tr>
<td>Producer Surplus</td>
<td>G</td>
<td>C+G</td>
<td>+C</td>
</tr>
<tr>
<td>License-Holder Surplus</td>
<td>None</td>
<td>E</td>
<td>+E</td>
</tr>
<tr>
<td>Total Surplus</td>
<td>A+B+C+D+E+F+G</td>
<td>A+B+C+E+G</td>
<td>-(D+F)*</td>
</tr>
</tbody>
</table>

*: The area D+F shows the fall in total surplus and represents the deadweight loss of the quota.

Again, if you compare the analysis of import quotas in Figure 2.6 with the analysis of tariffs in Figure 2.5, you will see that they are essentially identical.

→ Both tariffs and import quotas,
- raise the domestic price of the good,
- reduce the welfare of domestic consumers,
- increase the welfare of domestic producers, and
- cause deadweight losses.

→ There is only one difference between these two types of trade restriction:
- A tariff raises revenue for the government, whereas
- An import quota creates surplus for license holders.

→ But tariffs and import quotas can be made to look even more similar by using some mechanism to allocate the import licenses.
- One mechanism is that the government can set the license fee as high as the price differential (between the world price and the domestic price with quota)
  If the government does this, the license fee for imports works exactly like a tariff.
- On the other hand, when the government imposes a quota, the licenses will go to those who spend the most resources lobbying the government. In this case, there is an ‘implicit license fee’-the cost of lobbying.

The revenues from this fee are spent on lobbying expenses. Then the deadweight losses from this type of quota include not only the losses from overproduction
(area D) and underconsumption (area F) but also whatever part of the license-holder surplus (E) is wasted on the cost of lobbying.

### 2.7 The Lessons for Trade Policy

By considering the analyses so far, we can arrive at some conclusions: (Suppose the traded good is steel, the country is Turkey).

1. What happens to domestic price?

2. What happens to the quantity?

3. Who gains and who losses from free trade, and do the gains exceed the losses

- Once trade is allowed (i.e., in case of free trade), the price of steel is driven to equal the price prevailing around the world.

- Two cases are possible:
  **First**, if the world price is higher than the price in Turkey;
  - Our price rises,
  - We consume less (because of the law of demand)
  - Our suppliers produce more,
  - Turkey becomes a steel exporter, (This occurs because Turkey has a comparative advantage in producing steel)

  **Second**, conversely, if the price is lower than the price in Turkey;
  - Our price falls,
  - We consume more (because of the law of demand)
  - Our suppliers produce less ( because of the law of supply)
  - Turkey becomes a steel importer (This occurs because other countries have a comparative advantage in producing steel.)

- The answer depends on whether the price rises or falls when trade is allowed.

  (In other words, it depends on whether Turkey becomes an exporting or importing country).

1) If the price rises (i.e., Turkey exports),
   - producers of steel gain,
   - consumers of steel lose.
2) If the price falls (i.e., Turkey imports),
   - consumers gain,
   - producers lose.
3) In both cases, the gains are larger than the losses. Thus, free trade raises the total welfare of Turkish people.

4. Should a tariff or an import quota be part of the trade policy?

- A tariff, like most taxes, has deadweight losses: The revenue raised can be smaller than the losses to the buyers and sellers.

- An import quota works much like a tariff and cause similar deadweight losses.

- Thus, the best policy, from the standpoint of efficiency, is to allow trade without a tariff or an import quota.

∴ Then, why do countries restrict trade? We will see the arguments! But, before that, we need to consider other benefits of trade beyond those emphasized in the standard analysis.

2.8 Other Benefits of International Trade

✓ Our conclusions so far have been based on the standard analysis of international trade.

✓ As we have seen, there are winners and losers when a nation opens itself up to trade, but the gains to the winners exceed the losses of the losers.

✓ Yet, the case for free trade can be made even stronger. There are several other economic benefits of trade beyond those explained in the standard analysis.

Here are some of these other benefits (in short) (Dynamic Benefits)

- **Increased variety of goods:**
  Goods produced in different countries are not exactly the same. Free trade gives consumers in all countries greater variety from which to choose.

- **Lower costs through economies of scale:**
  Some goods can be produced at low cost only if they are produced in large quantities—a phenomenon called ‘economies of scale’.

  Free trade gives firms in small countries access to larger world markets and allows them to realize economies of scale more fully.

- **Increased Competition:**
  A company shielded (defended) from foreign competitors is more likely to have market power. This is a type of market failure.

  Opening up trade fosters competition and gives the invisible hand a better chance to work its magic.
Enhanced Flow of Ideas:
Technological advances, managerial skills and like are available through international trade.
For example, the best way for a poor nation to learn about the computer revolution is to buy some computers from abroad, rather than trying to make them domestically.

2.9 The Arguments for Restricting Trade

Why do governments restrict trade?

Put differently, why do the representatives of some industries want their production to be protected from foreign producers?

Here are the main arguments for trade restrictions:

1) The Jobs Argument
2) The National Security Argument
3) The Infant Industry Argument
4) The Unfair Competition Argument
5) The Protection As a Bargaining-Chip Argument

1) The Jobs Argument

<table>
<thead>
<tr>
<th>Opponents of free trade often argue that</th>
<th>‘Trade with other countries destroys domestic jobs’ (It reduces employment in the steel industry) (some workers will be laid off.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advocates of free trade claim that</td>
<td>Yet free trade ‘creates’ new jobs at the same time. Under comparative advantage, workers will eventually find new jobs. Even though the transition may impose hardship on some workers in the short run, free trade allows a high standard of living as a whole.</td>
</tr>
</tbody>
</table>

2) The National Security Argument

When an industry is threatened with competition from other countries,

<table>
<thead>
<tr>
<th>Opponents of free trade often argue that</th>
<th>The industry is ‘vital’ for national security. (e.g., steel is used to make guns and weapons. If a war broke down, the nation might be unable to produce enough steel and weapons to defend their country).</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economists acknowledge that</td>
<td>Protecting key industries may be ‘appropriate’ when there are ‘legitimate concerns’ over national security.</td>
</tr>
</tbody>
</table>
Yet, this argument may be used too quickly by producers eager to gain at consumers’ expense.

(e.g., the U.S. watch making industry long argued that it was vital for national security, claiming that its skilled workers would be necessary in war time.)

\[\therefore\] It is tempting for those in an industry to exaggerate their role in order to obtain protection from foreign competition.

3) The Infant-Industry Argument

- **New industries sometimes argue for ‘temporary’ trade restrictions. Because**
  
  After a period of protection, these industries will ‘mature’ and ‘be able to compete’ with foreign competitors.

- **Similarly, older industries sometimes argue that**
  
  They need ‘temporary protection’ to help them adjust to new conditions.

- **Economists are often ‘skeptical’ about such claims. Because**
  
  **First,** this argument is difficult to implement in practice: which industries will eventually be profitable.
  
  So, ‘picking winners’ is extraordinarily difficult.

  **Second,** it is made even more difficult by the ‘political process’. (Politically powerful industries can obtain protection permanently.)

  **Third,** theoretically, even though an industry is young and unable to compete against foreign rivals, it can be profitable in the long run. Therefore, ‘protection is not necessary for an industry to grow’ (many industries incur temporary losses in the hope of becoming profitable in the future, and many firms succeed without protection; such as internet firms).
### 4. The Unfair Competition Argument

- **A common argument is that**

  Free trade is desirable only if all countries play by the same rules.

  If firms in different countries are subject to different rules, then it is unfair to expect the firms to compete in international marketplace. Therefore, domestic industry facing unfair competition should be protected.

  (Subsidies are an example of this case…)

- **Advocates of free trade say that**

  Certainly, domestic producers would suffer from subsidized prices. But ‘domestic consumer would benefit from the low price’.

  ‘And the taxpayers of subsidizing country bear the burden.’

### 5. The Protection as a Bargaining-Chip Argument

- **This argument (for trade restrictions) concerns**

  The strategy of bargaining

- **This argument claims that**

  ‘Trade restrictions can be useful when we bargain with our trading partners.’

- **This argument claims that**

  The threat of a trade restriction can help ‘remove’ a trade restriction already imposed by a foreign government.

  (A country might threaten to impose a tariff on its imported goods unless its trading partner removes restrictions on the goods of that country).

  An example of this occurred in
<table>
<thead>
<tr>
<th>1999. The U.S. government accused Europeans of restricting the import of U.S. bananas. The United States placed 100 percent tariffs on a range of European products.</th>
</tr>
</thead>
<tbody>
<tr>
<td>In the end, not only were Europeans denied the benefits of American bananas, but also Americans were denied the benefits of European cheese!</td>
</tr>
</tbody>
</table>

**The problem with this bargaining strategy is that**

‘The threat may not work’

If it doesn’t work, the country has a difficult choice:
- either it implements the trade restriction, and accordingly reduces its own economic welfare,
- or it can back down from its threat, and accordingly loses prestige in international affairs.

**CONCLUSION:** Economists and the general public often ‘disagree’ about the ‘free trade’. There is an eternal battle between opponents and advocates of free trade.

**2.10 The New Protectionism**

So far, we examined

- The traditional trade barriers (tariffs and quotas) and their welfare effects (static effects)
- Other benefits of trade (dynamic effects) and
- Arguments for restricting trade.

While tariffs and quotas are traditional tools for the purpose mainly to protect domestic industries, there are other barriers which have become more important in the world of today.

These trade barriers are seen as ‘the tools of new protectionism’.

The tools of new protectionism are:
1) Voluntary export restraints,
2) Technical, administrative, and other regulations,
3) International cartels,
4) Dumping,
5) Export Subsidies.
1) Voluntary Export Restraints (VERs):

- With such an arrangement, an importing country induces another nation to reduce its exports of a commodity ‘voluntarily’.(under the threat of higher all-round restrictions).

- VERs sometimes called ‘orderly marketing arrangements’

- When VERs are successful, they have all the economic effects of equivalent import quotas, except that:
  - They are administered by the exporting country,
  - So the revenue effect is captured by foreign exporters.

- Voluntary export restraints might be less effective in limiting imports than import quotas because the exporting nations agree only reluctantly to curb their exports.

- Foreign exporters also tend to fill their quota with higher-quality and higher-priced units of their product over time. This product upgrading was clearly evident in the case of Japanese voluntary restraint on automobile exports to the United States.(For an example of VERs, see Case Study 9-1, p. 33 of this Lecture Notes)

- There were such agreements between industrial countries (U.S., E.U. and Canada) and developing countries (see p.291-293, Salvatore, 9e). The Uruguay Round required the phasing out of all VERs by the end of 1999 and the prohibition on the imposition of new VERs.

2) Technical, Administrative and Other Regulations:

These include:

- Safety Regulations (for automobile and electrical equipment)
- Health Regulations (for the hygienic production and packing of imported food products)
- Labeling Requirements (showing origin and contents)

Note: While many of these regulations serve legitimate purposes, some are only veiled disguises for restricting imports.

- Government Procurement policies (laws requiring governments to buy from domestic suppliers)
• Border Taxes (rebates for internal ‘indirect taxes’ given to exporters and imposed - in addition to the tariff - on importers); e.g. sales and value-added taxes.

• International Commodity Agreements (for the stabilization of export prices, they restrict the production and selling of the certain commodities; e.g. International Tin Agreement, set up in 1956, ).

• Multiple Exchange Rates (higher exchange rates on luxury and nonessential imports and lower exchange rates on essential imports).

3) **International Cartels:**

→ An international cartel is an organization of suppliers of a commodity located in different nations that agrees to restrict output and exports of the commodity with the aim of increasing the total profit.

→ The power of international cartels cannot easily be countered because they do not fall under the jurisdiction of any one nation.

  • OPEC is the example.

4) **Dumping:**

   Dumping is the export of a commodity at below cost or at least the sale of a commodity at a lower price abroad then domestically.

   Dumping is classified into three types:

   - **Persistent Dumping:** (International Price Discrimination; continuous tendency)

   - **Predatory Dumping:** (Yıkıcı Damping)
     It is the temporary sale of a commodity at below cost or at a lower price abroad to drive foreign producers out of business.

   - **Sporadic Dumping:**
     It is the ‘occasional sale of a commodity at below cost (or at a lower price abroad then domestically) in order to unload an unforeseen and temporary surplus of the commodity without having to reduce domestic prices.

∴ Trade restrictions are applied to protect domestic industries from unfair competition (dumping) from abroad.

   The restrictions usually take the form of ‘antidumping’ duties.
5) **Export Subsidies:**

→ Export Subsidies include:

- direct payments to exporters,
- “granting of tax relief” and “subsidized loans” (to the nation’s exporters or potential exporters),
- low-interest loans to foreign buyers

so as to stimulate the nation’s exporters.

→ As such, export subsidies can be regarded as a form of dumping.

→ Though export subsidies are illegal by international agreements, many nations provide them

- In disguised forms and
- Not-so-disguised forms

→ For instance, almost all industrial nations give foreign buyers low interest loans to finance the purchase through agencies called Export-Import Bank.

**Figure 2.7:** Partial equilibrium effect of an export subsidy
Without Subsidy | With Subsidy
---|---
World price: $P_w$ | $P_w$ rises to $P_w + s$ (for domestic consumers & producers!)
Exports: $q_{d1}$ $q_{s1}$ | (Note that world price doesn’t change!)

- Nation produces $0q_{s2}$
- Nation consumes $0q_{d2}$
- Nation exports $q_{d2}q_{s2}$
- $A+B \rightarrow$ Decrease in domestic consumer surplus
- Domestic producers gain by the area of $A+B+C$
- Government subsidy is $B+C+D$
- Deadweight loss is $B+D$

(B $\rightarrow$ is the consumption cost)
(D $\rightarrow$ is the production cost)

2.11 Some Concepts Used in Trade Policy Debates

The rate of effective protection and the optimum tariff are the two concepts which are widely used in discussing tariff structure and protection.

A-The Role of Effective Protection:

→ If Turkey imposes a tax of 10 percent on a final good, this is called ‘the rate of nominal tariff’ and the domestic production of that good is said to be protected by 10% nominally.

→ Economists developed another concept called ‘the rate of effective protection’ considering the tariff rates levied on the imported inputs of the substitutes produced domestically.

→ Consider an example. Suppose that Turkey imports wool for the production of suit.
  - Free trade price of suit = $100
  - The imported wool used for the production of suit = $80
  - Nominal tariff rate imposed on each imported suit = 0.10 (10 percent)
• The price of suits to domestic consumers = $110 (of this, $80 represents imported wool, $20 is domestic value added, $10 is the tariff.)

• Nominal tariff rate = 0.10 (10 percent) = $10 (tariff) / $100 (free trade price)

(Nominal tariff is calculated on the price of the final commodity)

• Effective tariff rate = 0.50 (50 percent) = $10 (tariff) / $20 (domestic value added)

(Effective tariff rate is calculated on the value added domestically to the suit)

• In this example, there is no tariff imposed on imported inputs.

• This represents a much greater degree of protection than the 10 percent nominal tariff rate.

• This high degree of protection provides a competition advantage for the domestic producers.

The rate of effective protection is usually calculated by the following formula:

\[
g = \frac{t - a_it_i}{1 - a_i}
\]

Nominal tariff rate - (Ratio of imported input to final commodity X Nominal tariff rate on imported input)

\[
g = \frac{t - a_it_i}{1 - a_i}
\]

\[
g = 0.10 - (0.80 \times 0) / (1 - 0.8)
\]

\[
g = 0.10 / 0.2 = 0.50 \text{ (or 50 percent)}
\]

→ Now, let’s suppose that the nominal tariff rate on the imported input was raised to 5 percent (that is, \( t_i = 0.05 \)). What would be the effective tariff rate?
\[
g = \frac{(t - a_i t_i)}{1-a_i}
\]

\[
g = 0.10 - (0.80 \times 0.05) / (1-0.8)
\]

\[
g = 0.30 \text{ (or 30%)}
\]

(The rate of effective protection decreased.)

With \( t_i = 20 \text{ percent} \),

\[
g = 0.10 - (0.80 \times 0.20) / (1-0.8)
\]

\[
g = -0.30 \text{ (or, -30 percent)}
\]

(The rate of effective protection became negative!)

→ From examining the formula and the results obtained with it, we can reach the following important conclusions or the relationship between the rate of effective protection \( g \) and the nominal tariff rate \( t \) on the final good.

1. If \( a_i = 0 \), \( g = t \)

   *If there is no imported input, then ‘the effective protection’ equals ‘the nominal protection’.*

2. \( g \) is larger, the greater is the value of \( t \).

   *If the nominal tariff rate \( (t) \) increases, the effective rate of protection \( (g) \) increases as well* (for given values of \( a_i \) and \( t_i \)).

3. \( g \) is larger, the greater is the value of \( a_i \).

   *If the ratio of imported inputs to final commodity increases, the effective rate of protection increases as well.

\[
g = 0.10 - (0.90 \times 0.05) / (1-0.9)
\]

\[
g = (0.10-0.045) / 0.10
\]

\[
g = 0.055 / 0.1
\]

\[
g = 0.55 \text{ (for given values of t and } t_i)\]
4. g gets smaller as the value of t_i gets larger;

\[
g = \frac{0.1 - (0.8 \times 0.1)}{1 - 0.8}
\]

\[
= \frac{0.1 - 0.08}{0.2}
\]

\[
= \frac{0.02}{0.2}
\]

\[
= 0.10
\]

Even g might be negative with high nominal tariff rates on the imported inputs (as in the following case).

5. g is negative when a_i \cdot t_i exceeds t.

When the value of the ratio of imported inputs and nominal tariff rate on them together exceeds the nominal tariff rate, the effective rate of protection becomes negative.

\[
g = \frac{0.10 - (0.80 \times 0.20)}{1 - 0.8}
\]

\[
= - \frac{0.06}{0.2}
\]

\[
= -0.30 (-30\%)
\]

→ The meaning of negative protection:

- Note that a tariff on imported inputs is a tax on domestic producers that increases their costs of production, and reduces the rate of effective protection.
- Therefore, it discourages domestic production.
- As we have just seen above, the nominal tariff on imported inputs might be so high that makes effective protection negative.
- In this case, less of the commodity is produced domestically than would be under free trade.

*How can we illustrate the effective rate of protection’s effect when it reduces the domestic production less than would be under free trade?*
Figure 2.8: Graphical illustration of negative protection (When $g$ is negative)

1) $q_{sd}$: quantity supplied domestically under free trade.
   $qd$: quantity demanded under free trade
   $AB$: quantity imported under free trade
   $P_{w+Tx}$: world price + tariff size
   $P_{dc}$: price that domestic consumers face after tariff imposition
   $A'B'$: quantity imported after tariff

2) → Negative effective rate of protection increases the cost of domestic production.
   → This means that domestic supply curve ($S$) shifts to the left ($S'$)
   → At price $P_{w+Tx}$, domestic producers can sell (or produce) by the amount $q'sd$.
   → $q'sd$ is less than the case of free trade.
   → Quantity imported may increase.

   → Consequently, the nominal tariff rate can be very deceptive and does not give even a
   rough idea of the degree of protection actually provided to domestic producers of the
   import-competing product.
Furthermore, most industrial nations have a ‘cascading’ tariff structure with very low or zero nominal tariffs on raw materials and higher and higher rates the greater is the degree of processing.

The highest rates of effective protection in industrial nations are often found on simple labor-intensive commodities, such as textiles, in which developing countries have a comparative advantage.

(Read and discuss case study 8-5, page 34)

**B- The Optimum Tariff**

→ When a large nation imposes an import tariff, its volume of trade decreases, but the nation’s terms of trade improve.

→ The optimum tariff is one that maximizes the net benefit resulting from improvement in the nation’s terms of trade against the negative effect resulting from reduction in the volume of trade.

→ However, since the nation’s benefit comes at the expense of other nations, the latter are likely to retaliate. In the end, all nations usually lose.
Case Study 9-1  Voluntary Export Restraints (VERs) on Japanese Automobiles to the United States and Europe

From 1977 to 1981, U.S. automobile production fell by about one-third, the share of imports rose from 18 to 29 percent, and nearly 300,000 autoworkers in the United States lost their jobs. In 1980 the Big Three U.S. automakers (GM, Ford, and Chrysler) suffered combined losses of $4 billion. As a result, the United States negotiated an agreement with Japan that limited Japanese automobile exports to the United States to 1.68 million units per year from 1981 to 1983 and to 1.85 million units for 1984 and 1985. Japan “agreed” to restrict its automobile exports out of fear of still more stringent import restrictions by the United States.

U.S. automakers generally used the time from 1981 to 1985 wisely to lower breakeven points and improve quality, but the cost improvements were not passed on to consumers, and Detroit reaped profits of nearly $6 billion in 1983, $10 billion in 1984, and $8 billion in 1985. Japan gained by exporting higher-priced autos and earning higher profits. The big loser was the American public, which had to pay about $660 more for U.S.-made automobiles and $1,300 for Japanese cars in 1984. The total cost of the agreement to U.S. consumers was estimated to be $15.7 billion from 1981 through 1984 and 44,000 U.S. automakers’ jobs were saved at the cost of more than $100,000 each.

Since 1985, the United States has not asked for a renewal of the VER agreement, but Japan unilaterally limited its auto exports (to 2.3 million from 1986 to 1991 and 1.65 million afterward) in order to avoid more trade frictions with the United States. From the late 1980s, Japan invested heavily to produce automobiles in the United States in so-called transplant factories, and by 1996 Japan was producing more than 2 million cars in the United States and had captured 23 percent of the U.S. auto market. By 2008, Japanese automakers share of the U.S. market had reached 35 percent (between domestic production and imports).

Following the U.S. lead, Canada and Germany also negotiated restrictions on Japanese exports (France and Italy already had very stringent quotas). A 1991 agreement to limit the Japanese share of the European Union’s auto market to 16 percent expired at the end of 1999, when the share of Japanese cars (imports and production in Europe) was 11.4 percent of the European market. That share exceeded 13 percent in 2008 and was expected to continue to rise in the future. At the end of 2008, U.S. automakers received a government loan of $17.4 billion to restructure and avoid bankruptcy.

Case Study 8-5  Rising Tariff Rates with Degree of Domestic Processing

Figure 8.4 shows that industrial countries imposed an average import tariff of about 2.1 percent on raw materials, 5.3 percent on semimanufactures, and 9.1 percent on finished products before the completion of the Uruguay Round in 1993. Although average tariff rates on imports at all stages of processing have fallen during the past decade as a result of the implementation of the Uruguay Round, the figure shows that the cascading tariff structure or the tariff escalation with the stage of processing remains. Thus, the effective rate of protection exceeds the nominal tariff rate by larger percentages, the greater the degree of domestic processing.

**Figure 8.4.** Pre-and Post-Uruguay Round Cascading Tariff Structure in Industrial Countries.

Chapter Three  
ECONOMIC INTEGRATION

3.1 Introduction:
In this chapter, we examine ‘economic integration’ in general and ‘customs unions’ in particular.

The theory of economic integration refers to the commercial policy of discriminatively reducing or eliminating trade barriers only among the nations joining together.

There are various degrees of economic integrations ranging from preferential trade arrangements to economic unions.

After definitions of the types of economic integrations, we’ll explain the effects of custom unions, and the theory of second best.

3.2 Degrees (types) of Economic Integrations:

a) Preferential Trade Arrangements:
This type of integrations provides lower barriers on trade among participating nations than on trade with nonmember nations.

→ This is the loosest form of economic integration.

→ The best example of this type is the ‘British Commonwealth Preference System’.

(It was established in 1932 by the United Kingdom with members and some former members of British Empire. (for detail, see (http://tr.wikipedia.org)-İngiliz Milletler Topluluğu.)

b) Free Trade Area:
It is the form of economic integration wherein all barriers are removed on trade among members, but each nation retains its own barriers to trade with nonmembers.

→ The best examples are:

• *European Free Trade Association* (EFTA)
  ✓ Formed in 1960.
  ✓ By the United Kingdom, Austria, Denmark, Norway, Portugal, Sweden and Switzerland (with Finland joining as associate member in 1961)

• *The North American Free Trade Agreement* (NAFTA)
  ✓ Formed in 1993 by the United States, Canada, and Mexico.
c) Customs Union:
   A customs union allows no tariffs or other barriers on trade among members (as in a free trade area), and in addition it harmonizes trade policies (such as the setting of common tariff rates) toward the rest of the world.

   → The most famous example is the ‘European Union (EU)’, or ‘European Common Market’.
     ✓ Formed in 1957.
     ✓ By West Germany, France, Italy, Belgium, the Netherlands, Luxembourg. (Now, 27 members)

d) Common Market:
   A common market goes beyond a customs union by also allowing the free movement of labor and capital among member nations.

   → Example: The European Union (EU) achieved the status of a common market at the beginning of 1993.

e) Economic Union:

   → It goes still further by ‘harmonizing or even ‘unifying’ the monetary and fiscal policies of member states.

   → This is the most advanced type of economic integration.

   → An example of ‘complete economic and monetary union’ is the United States.

   Benelux is another example (formed by Belgium, the Netherlands, and Luxembourg after World War II and now part of the EU).

   The European Union has made strides in forming an economic union to a great extent.

f) Duty-free Zones (or free economic zones):

   There are areas set up to attract foreign investments by allowing raw materials and intermediate products duty free.

   Such areas can be set up in different locations of a country.
3.3 Trade Creating and Trade Diverting Effects of a Customs Union

A customs union results in two opposite effects: trade creation and trade diversion. The net effect on the world welfare is measured by comparing of these two effects.

A. Trade Creation:

→ Trade creation occurs when some domestic production in a member nation is replaced by lower-cost imports from another member nation.

→ This increases the welfare of member nations because it leads to greater specialization in production based on comparative advantage (assuming that all economic resources are fully employed before and after formation of the customs union.)

→ A trade-creating customs union also increases the welfare of nonmembers because some of the increase in its real income spills over into increased imports from the rest of the world.

→ Illustration of a trade creating customs union:
  • Suppose that there are only three nations in the world.
  • The commodity produced and traded is X.
  • Nation 1 can produce commodity X at a cost of $1.
  • Nation 2 can produce commodity X at a cost of $3.
  • Nation 3 can produce commodity X at a cost of $1.5.
  • Nation 2 initially imposes a nondiscriminatory ad valorem tariff of 100 percent on the imports of commodity X.
  • In this case, only Nation 1, whose price also represents the world price, can sell commodity X to Nation 2 at $2, as shown in figure 3.1.
Nation 2 does not import commodity X from Nation 3 because the tariff-inclusive price of commodity X imported from Nation 3 would be $P_X = 3$.

- Now, Nation 2 forms a customs union with Nation 1. That is, Nation 2 removes tariffs on its imports from Nation 1 only.

Then, $P_X = 1$ in Nation 2.

→ In this case,

- Nation 2 consumes 70X (AB) of commodity X.
- Nation 2 produces 10X domestically.
- Nation 2 imports 60X from Nation 1.
- Nation 2 collects no tariff revenue.

→ The benefit to consumers in Nation 2 (resulting from the formation of the customs union) is equal to AGHB. (i.e. increase in consumer surplus).

→ However, only part of this represents a net gain for Nation 2 as a whole. Because, AGJC represents a reduction in producer surplus.

MJHN represents the loss of tariff revenues.
In this case, the net gain for Nation 2 equals:

\[
[\text{Increase in consumer surplus (AGHB)}] - [\text{reduction in producer surplus (AGJC)}] + [\text{the loss of tariff revenues (MJHN)}]
\]

That is, it is equal to ‘CJM’ + ‘BHM’. Here, ‘CJM’ refers to the production effect and ‘BHM’ refers to the consumption effect.

As you can recall, the sum of the areas of shaded triangles (CJM+BHN) represents deadweight loss in case of tariff imposition.

In other words, deadweight loss before customs union becomes net gain for the importing nation afterwards.

**B. Trade Diversion:**

→ Trade diversion occurs when lower-cost imports from outside the customs union are replaced by higher-cost imports from a union member.

→ Trade diversion reduces welfare because it shifts production from more efficient producers outside the customs union to less efficient producers inside the union.

→ Thus, trade diversion worsens the international allocation of resources and shifts production away from comparative advantage.

→ A trade diverting customs union results in both

  ✓ Trade creation and
  ✓ Trade diversion

And therefore can increase or reduce the welfare of union members, depending on relative strength of these two opposing forces.
→ Illustration of a Trade Diverting Customs Union

**Figure 3.2**

**Before The Customs Union**

- **OU** = domestic production
- **OV** = domestic consumption
- **JH (=UV)** = Nation 2’s imports from Nation 1
- **JMNH** = Tariff revenue of Nation 2

**After The Custom Union with Nation 3**

- **OT** = domestic production
- **OR** = domestic consumption
- **C’B’** = imports from Nation 3
- **C’J’** = Part of imports produced by Nation 3 (higher cost than that of Nation 1)
- **C’J’ J** = Production effect
- **H’B’** = part of imports consumed by Nation 2 (Trade creating effect)
- **HH’B’** = Consumption effect (Trade creating effect)
- **CBB’C’** = Trade diversion.

In addition to figure 3.2, $S_3$ shows the perfectly elastic supply curve of Nation 3. And suppose that Nation 2 forms a customs union with Nation 3.
→ Of this trade diversion,

- $CT'C'$=deadweight loss resulting from production.
- $BR'B'$=deadweight loss resulting from consumption.
- $C'T'R'B'$=welfare loss resulting from higher costs production than that of Nation 1.

→ So, $C'J'J + HH'B'$ is compared to $CBB'C'$ to measure the net effect of the customs union.

If $C'J'J + HH'B' > CBB'C'$, then net effect is positive.
If $C'J'J + HH'B' < CBB'C'$, then net effect is negative.

→ The several attempts to measure the static welfare effects resulting from the formation of the European Union all came up with surprisingly small ‘net static’ welfare gains.

C. Dynamic Benefits from a Customs Union

Beside the static welfare effects discussed above, the nations forming a customs union are likely to receive several important ‘dynamic’ benefits.

These are due to:

✓ Increased competition
✓ Economies of scale
✓ Stimulus to investment, and
✓ Better utilization of economic resources.
Chapter Four
SPECIFIC TRADE REGIMES

4.1 Introduction

Goods imported by a nation are, as a rule, subject to the import regime of the nation, and the tariffs are paid for them according to the customs tariff schedule.

However, some foreign trade transactions, because of their specifications, are realized without being subject to normal customs procedures of the country.

In this chapter, these specific customs regimes will be explained briefly.

4.2 Temporary Imports and Temporary Exports

4.2a Temporary Imports (Inward processing regime): Temporary imports regime are applied for the goods which are imported with the condition that they will be taken out of the country after a certain time. Under this regime, imported goods are not subject to tariffs.

Examples:
- Overseas goods that will be repaired or improved.
- Construction equipment and machinery lease from abroad.
- Goods brought into the country from a foreign country for fairs and demonstrations.
- Tools brought by circus and theatrical companies.
- Model products, packages, films and like.

4.2b Temporary Exports (Outward processing regime): As opposed to temporary imports, under this regime, the goods that are exported are brought into the home country after a certain time.

For example: Bringing back of mineral ore which is exported in order to be melted.
4.3 Free Zones

→ Free zones are the areas set up within the national borders but regarded outside the customs area.

→ Legal and administrative rules in effect of the country are either not applied or applied to a certain extend in these areas (free zones).

→ Types of free zones:

   • **Free Trade Zones**: This type of free zones is set up rather for commercial purposes. Goods stored in these zones are sent to importing countries later on.

   • **Free Production Zones**: This type of zones is set up for the production and assembling (montage) of light products. These zones are sometimes called “export processing zones” because the aim is to attract foreign investments by allowing raw materials and intermediate products duty-free, thereby to increase exports.

   • **Free Ports**: These zones are set up in the main arteries of commerce for the commercial activities such as export, import, re-export and transit trade.

     Free ports are critically important for landlocked countries in order to stand out to ocean trade roads.

→ Why free zones to establish:

   In short,

   1. To produce with lower costs benefiting from incentives and advantages provided by the home country, and thereby to increase the exports.

   2. To attract foreign investments and technologies.

   3. To obtain raw materials and intermediate goods in time and easily.
4. To ease the “transit merchandise trade”.
5. To raise employment level.
6. To increase foreign currency inflow.

→ In Turkey,

- The first free zones were established in Mersin and Antalya in 1987. There are 19 free zones (2010). There were 21 in 2009.
- Total trade volume was $24.5 billion in 2007 and $18.5 billion in 2010.
- Of this volume, more than 30 percent are exported to European Union countries.
- Total employment is 48,684 people (2010).

4.4 Warehouses (Entrepot, Storehouse)

→ Warehouses are closed spaces where goods are stored under the customs authority for a long time.

→ There is no tariff payment for these goods as long as they are stored in the warehouse. The goods are subject to customs duty when they are imported by the host country.

→ Warehouses provide many facilities for road trade (as well as free zones for maritime trade).

- The buyers (importers) can see the goods on-site, and have a chance to import in parts.
- The sellers (exporters), on the other side, have a chance to wait for selling their goods at favorable prices.
- The importers do not have to pay all customs duties in one go when they import in parts.
4.5 Transit Transportation

→ Transit transportation means that goods sent from one country to another are gone through the borders of a third country.

→ Today, the main principle in transit transportation is “the right of free entry”.

→ Among the multilateral agreements regulating transit transportations, TIR Agreement (Transit International Routier) of 1959 holds the first place.

→ Transit transportation is sometimes confused with “transit merchandise trade.” Reexport, exportation and importation from free zones are regarded as transit merchandise trade.

→ Transit merchandise trade is benefited from export incentives as well as exports of other goods and services.

4.6 Border and Coastal Trade

→ It is a type of trade that a nation trades with the nations they have common land and sea frontiers, which is subject to a specific regime.

→ The aim of border and coastal trade is to meet the needs of people living on both sides of the frontiers.

→ In this type of trade, import and export certificates are not needed. Also, there is no need for “bill of entry” and “certificate of clearance outward.”

4.7 Unpaid Non-Quota Imports (Unpaid Importations)

→ Unpaid importation includes imports of some personal and non-traded goods bought by income that is earned abroad, and with no transfer of foreign exchange from the country.

→ In this type of importation, only custom duty is not paid; but, other taxes such as value added and private consumption taxes are levied.