The Consequences of a Preferential Tariff System

(Memorandum submitted by the United Kingdom delegation)

General

1. The following note attempts to analyse in general terms the price consequences of the introduction of a preferential system. It deals first with the most simple model of such a system and then deals with various complicating factors and touches on one or two other relevant points.

2. It seeks to show that under a preferential tariff there is always diversion of trade in the sense that importers in the area will always be led to prefer to take their supplies first from the preferential area. Furthermore, when the production in the preferential area is below the requirements of the area the price level in the area is increased above world prices by the amount of the preference and a similar premium is payable to producers in the area.

3. The argument is taken in stages, starting with the most simple model of a preferential system in relation to a single commodity; as follows:

   (i) The commodity is assumed to be homogeneous and the qualities and grades produced in various countries can be directly co-related.

   (ii) The commodity is widely traded on the world markets so that a genuine world price exists for each grade.

   (iii) The production in the preferential area is substantially less than the total requirements of the preferential area.

   (iv) The market in the preferential area (which may be called the "protected market") is only a small part of the whole world market.

   (v) The preferential tariff introduced is X per cent, i.e. a duty of X per cent is levied on the imports from third countries into the protected market while imports from the preferential area pay no duty.
4. If there is no production in the protected market then importers into it will have to pay the world price for all their requirements, to which will be added the \( X \) per cent duty. The price level within the market will then become world price plus \( X \) per cent. (Initially the duty would act in effect as a fiscal charge but would tend to stimulate production inside the protected market.)

5. If there is production in the protected market, the merchant has the choice of two sources of supply, the world market or the protected market. If he is offered production from the protected area at the bare world price he will only buy such production since it will be cheaper for him when it gets into his warehouse by \( X \) per cent. The competition between such merchants will, however, rapidly drive up the price of the product in the protected market and this will go on until the price of that product is world price plus \( X \) per cent or a price very close to that figure (see paragraph 12 below). The whole production in the protected market will thus be taken up and merchants will only then begin to buy the product of other countries to make up the rest of the requirements of the protected market.

6. In these circumstances, therefore, the price level within the protected market will be stabilized at world price plus \( X \) per cent, and the producer within the protected market will obtain world price plus \( X \) per cent for the whole of his production. It is clear also that the whole of his production will go to the protected market since he can obtain an \( X \) per cent better price there.

7. The simplest case where this arises is when the producer in protected markets is in fact the home producer only. The tariff which protects the home producer ensuring \( X \) per cent above the world price for him. The same reasoning applies exactly, however, if the producer is overseas, but is given preferential tariff treatment in the protected market. Freight charges will then complicate the picture a little, any difference in freight being absorbed by which even producer is furthest from the protected market.

Modifications to the Simple Model

8. Commodities are very rarely entirely homogeneous and the problems of grades and qualities must arise. What has been said, however, still applies unchanged if the product of the protected (home or overseas) producer is of a comparable grade in quality to the main grades produced elsewhere. If it is superior or inferior to the main grades a quality differential will arise for that reason, but superimposed upon that differential will still be the \( X \) per cent difference arising from the preference. Similarly, if problems of substitution arise because the product is substantially different from the products of third countries, a price differential will exist for that reason, but again the \( X \) per cent differential arising from the preference will be superimposed upon it and will clearly encourage the use of the substitute coming from the protected market.

9. If production of the protected product (home and overseas) is an appreciable part of total requirements of the protected market the price level in that market will still remain at world price plus \( X \) per cent since merchants will have to buy their marginal supplies at this price from third countries and the marginal
supplies will determine the internal price level. This may not be so if there is a monopoly or an absence of competition between merchants, because arrangements might then be made to pay less than world price plus X per cent to protected producers and use this saving either to average out the higher price of supplies from third countries thus producing a lower average price level in the protected market or for the monopoly to pocket some of the difference itself. Equally, however, a monopoly purchaser could fully maintain the price to protected producers (home or overseas) and governments might wish to ensure this by directions to the monopolist.

10. Once production from protected producers (home or overseas) exceeds total requirements of the protected market, competition between such producers to sell in the protected market will tend to drive the price they obtain for their produce down towards the world level. (This is in fact what has happened in quite a number of cases in the British and French preferential systems.) The preference then is still effective in ensuring that protected producers will obtain the whole of the protected market, but they will have to be content with the bare world price. However, if producers agree amongst themselves not to weaken the market (or if a monopoly purchaser operates on their behalf) it is still possible to arrange for the protected producers to receive world price plus X per cent (or slightly less) since they are still underselling products of third market countries which have to pay the X per cent tariff.

11. There is also the question of what would happen if the protected market is a substantial part of the whole world market and a new preferential régime is introduced. In this case the increase in price level in the preferred market will tend to reduce consumption there and this will have an appreciable affect on total world demand and so produce a general lowering of world prices. The extent of the decline in world prices will depend upon relative elasticities of demand. In the circumstances described in paragraphs 1 - 9 above, protected producers will receive the new world price plus X per cent, but this will be somewhat less than the old world price plus X per cent.

12. In certain circumstances when world demand is weak producers in the protected market may be prepared to sell at a small reduction below the world price plus X per cent in their protected market in order to make quite sure that they retain that market. The reduction need, however, be only fractionally below world price plus X per cent to be effective in inducing importers to prefer their supplies.

13. Modifications also arise from factors such as particular habits or tastes (which may also have the effect of creating virtually separate local markets within the protected market); and also the perishable nature of certain goods which must be sold for consumption shortly after production or importation at the best price which can be obtained. While these factors introduce some complications they do not significantly alter in the long term the above analysis.
14. In practice also merchants may take a little time, on the introduction of a new preferential system, to change their customary sources of supply so that for a period protected producers may not receive the full benefit of the new preferential tariff. However, importers must buy in the cheapest market if they are not to lose their business to other importers so that as soon as the product from the protected market is cheaper they will turn to it. The period of adjustment will not, therefore, be a long one.

15. Attached are extracts from Jacob Viner's "International Economics" which set out the above argument clearly and briefly.

16. The general conclusion is, therefore, that under a preferential tariff in all circumstances trade will be diverted to the products of the preferential area and as long as production there is less than demand in the area the price level will be X per cent above the world price.

**Returns to Producers**

17. In what has been written above it has been assumed that when an importer is prepared to pay X per cent above the world price for the production of the protected market that price premium will reach the producer. However, in a variety of circumstances though the premium will be there it will not reach the producer. If producers are ignorant of market prices a substantial part of the premium (and indeed of the world price) can be pocketed by middlemen. There are, however, elaborate arrangements in force in most parts of British Africa to-day to prevent this happening.

18. Another possibility is that a price equalization fund may be started which will even out the returns to producers over good and bad years. If, however, the object of these funds is to break even over a period of years the total return to producers in the protected market in that period of years will be X per cent above what producers in an unprotected part of the world market will receive during the same period (for the same quantity, grades being equal).

19. A third possibility is that part of the market price will be taken by the local government in the form of a production or export tax. This, however, is a matter between producers and their governments irrelevant to this paper. The returns received by producers would under such a tax have been even less if it had not been for the premium they receive due to the preference.

**Affect of Internal Taxes**

20. The question has been raised whether ad valorem internal taxes will increase the discriminatory element involved in a preferential duty.

21. It has been argued above that the price to the importer into his warehouse, whether he imports from the protected market or elsewhere, will be the same, i.e., world price plus preference. The internal tax will be levied on the warehouse price (or at some later stage in distribution) and as the price is the same (assuming identical grades from the two sources) the duty paid must be the same and further discrimination does not arise.
22. If, however, identical grades are not involved and especially if the production in the protected market is cheap or of inferior quality the product will be sold at a discount below world price plus X per cent and an ad valorem tax applied to that price will be less in its incidence than the tax on the higher priced product from third countries. In those circumstances an ad valorem internal tax would be discriminatory in favour of the lower priced product.

Exports to Third Markets

23. While producers in the protected market will always wish to sell within that market since the price offered will be X per cent above that obtainable elsewhere, their governments may desire, for reasons not connected with the preferential system, to earn foreign exchange elsewhere and to do so may wish to encourage sales outside the protected market. In that case they will need to give export incentives sufficient to overcome this X per cent price disincentive (or use other inducements).
"A remission of import duties on a specified commodity, if confined to the imports from one country not capable of supplying the entire import needs, will reduce the customs revenue (and will impair the protection to domestic industries) without substantially lowering the price to the domestic consumer. It will operate virtually as a subsidy from the treasury of the importing country to the producers in the favoured exporting country. The price in the importing country will continue to be the world market price plus the full duty. The producer in the favoured country will get for his product the world price plus the full duty. If, on the other hand, the favoured country can fully supply the import needs of the country granting the favour, and does so after the remission of duties on its product by the latter, there would be little or no difference in the situation if the concession were extended to the entire world. Whether the remission of duty were special or general, the imports would be supplied in whole, or almost so, by the country to which the remission was originally granted. The price in the importing country would be the same as the world price (assuming the entire duty remitted)."

"Let us assume that the discriminating country A, does not itself produce the commodity in question, that it can be produced by countries B and C, and that imports into A are free of duty if from B, but dutiable if from C. What are the consequences for A of the remission of duty on B's product, while C's product remains dutiable?

There are several possibilities under these circumstances depending on B's capacity to supply A with its needs. Suppose that B can produce as cheaply as C and in quantities sufficient to satisfy A's wants even at the price which would prevail if imports from C were also free of duty. The duty on C's products will then have no adverse effect on A unless the producers in B combine to take advantage of their privileged position by exacting from A a price higher than C's price by all or part of the duty on C's product.

Next suppose that B cannot produce sufficient to satisfy A's wants and that imports from C will continue to some extent in spite of the discriminatory duty on its product. The price in A will then be C's price plus the amount of duty on C's product. The producers in B will get a price equal to C's price plus the duty.

That discriminatory duties work in practice in this way was shown inductively in a study made by the writer some years ago for the United States Tariff Commission on the effect of the preferential free admission of Hawaiian sugar into the United States prior to annexation, and of the preferential reduction of the duty on Cuban sugar from 1903 onwards. In each case as long as it continued to be necessary for the United States to import full duty sugar in order to meet the needs of the domestic consumption, the American price was the world price plus the full duty, and the effect of the preferential remission of duty was simply that the producers in the favoured territories got, at the expense of the American customs revenue, and without any discernible benefit to the American consumer, a substantial bounty."