Course Title: International Economics

Course Code: ECON3019

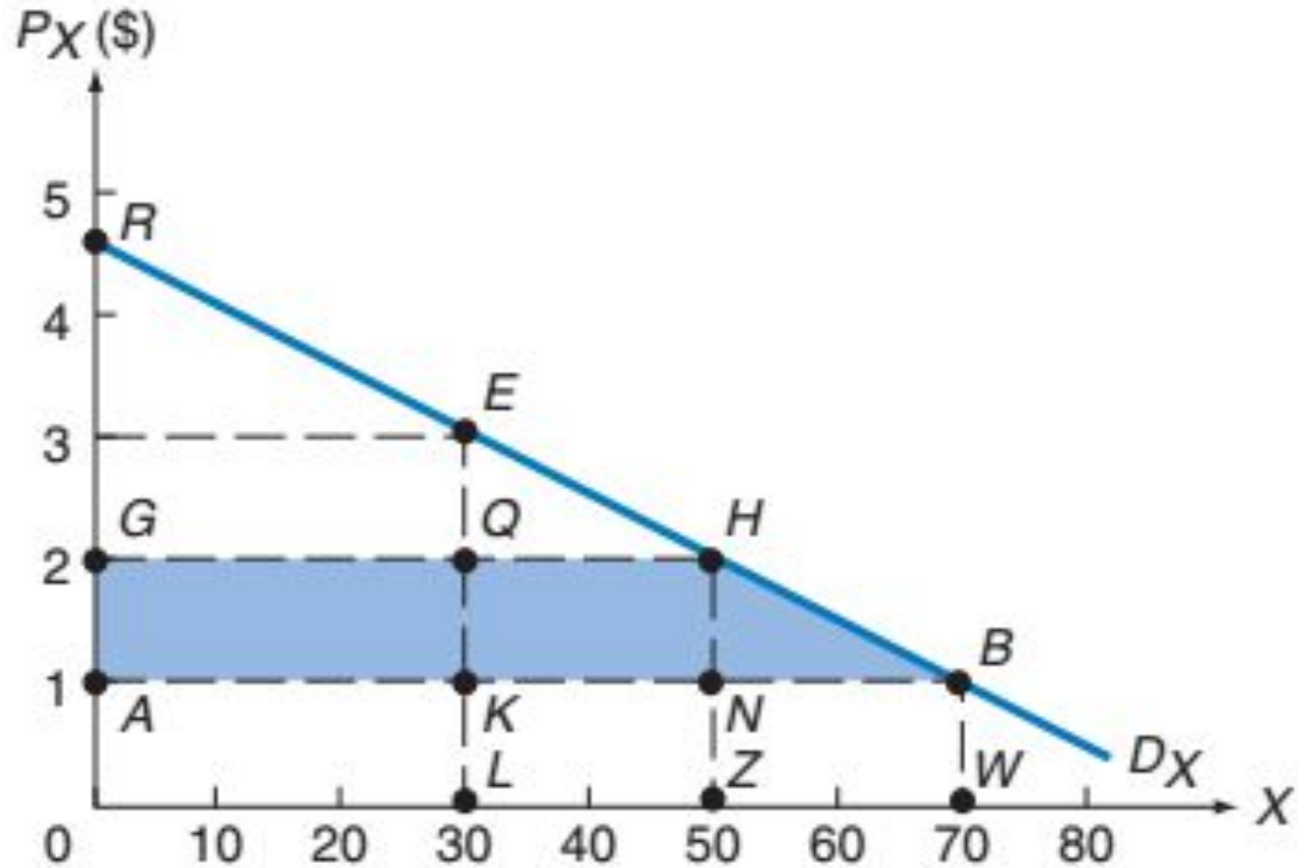
Course Instructor: Mr. Bidhubhusan Mishra

Topic: Effect of Tariff on Producer’s and Consumer’s Surplus

Effect of a Tariff on Consumer and Producer Surplus

- The increase in the price of imported commodity due to the imposition of tariff leads to a *reduction in consumer surplus and an increase in producer surplus*.
- The consumer surplus is the difference between what consumers would be willing to pay for each unit of the commodity and what they actually pay.

Effect on Consumer Surplus

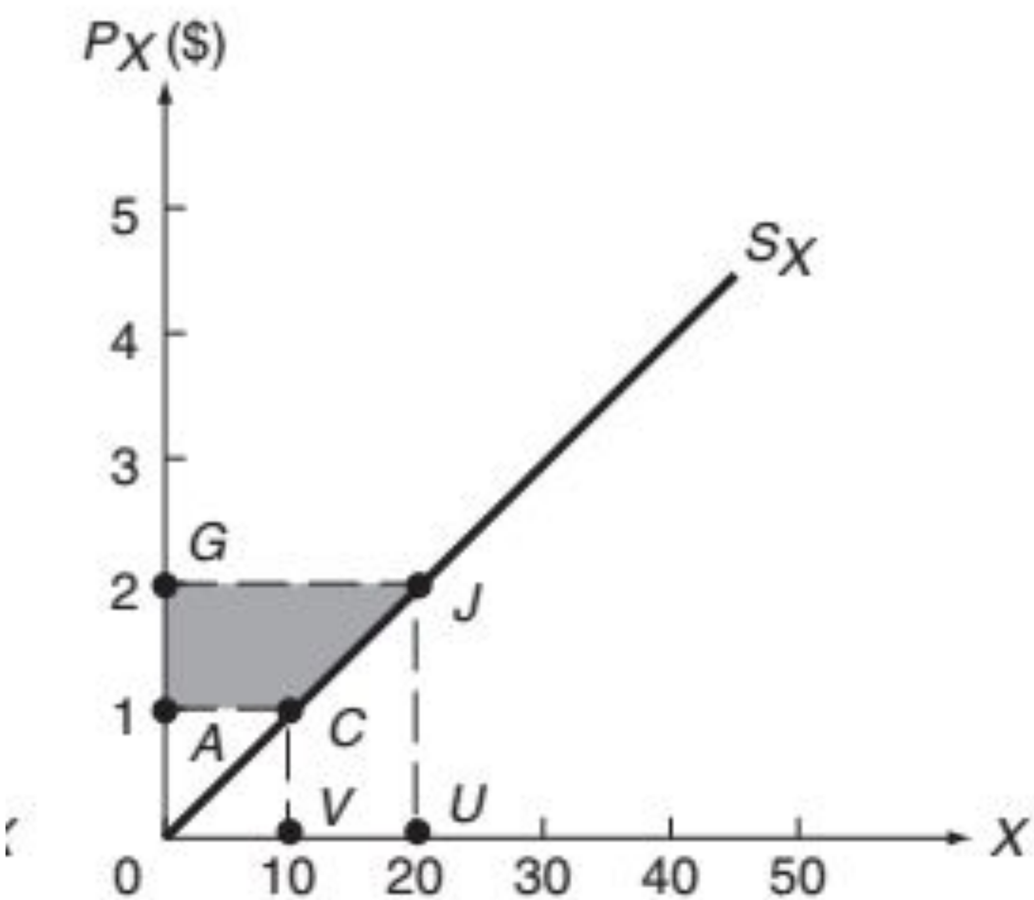


Continued....

- When Nation 2 imposes a 100 percent import tariff, the price of commodity X rises from $P_X = \$1$ to $P_X = \$2$ and purchases of commodity X fall from 70X to 50X.

- The diagram in the previous slide shows that a tariff that increases the price of commodity X from $P_X = \$1$ to $P_X = \$2$ results in a reduction in consumer surplus from ARB to GRH or by shaded area AGHB.

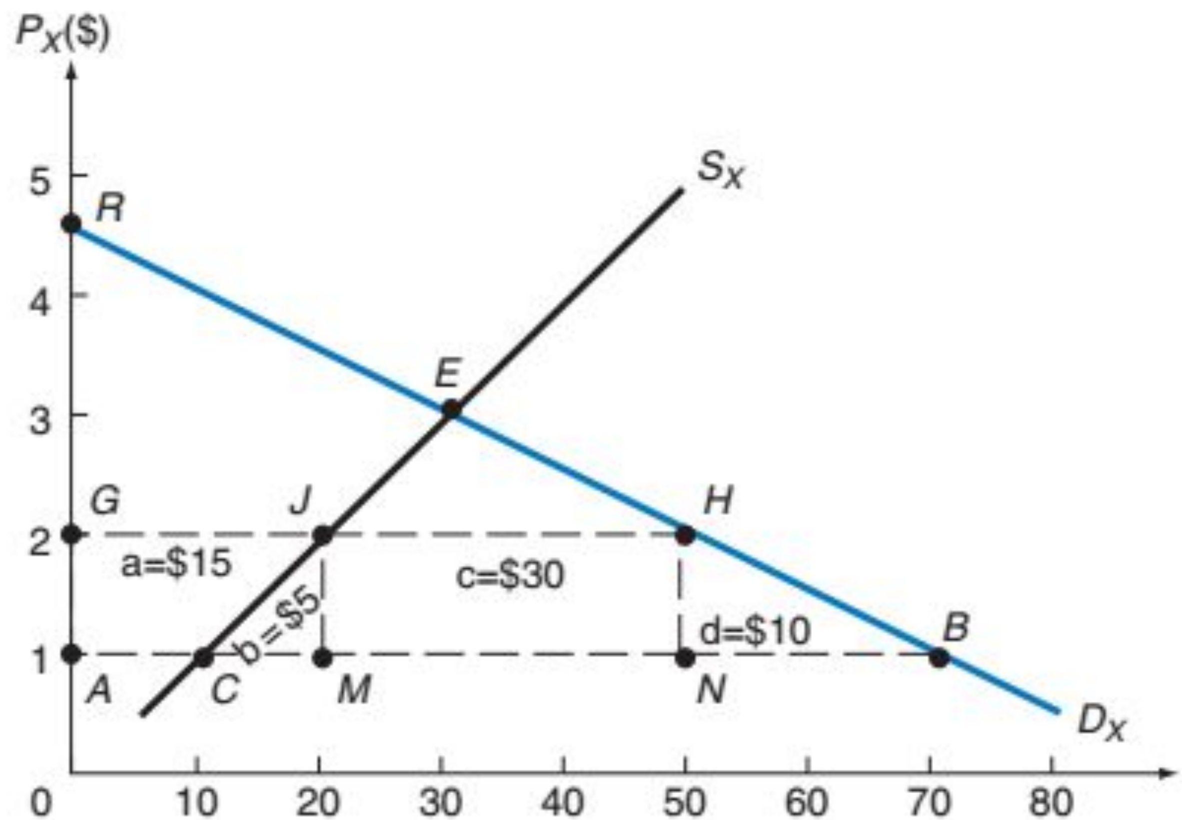
Effect on Producer Surplus



Continued.....

- In the diagram given in the previous slide the increase in rent or producer surplus that results from the tariff is given by shaded area *AGJC* = \$15.
- At free trade P_X = \$1, domestic producers produce 10X and receive *OACV* = \$10 in revenues.
- With the tariff price increases to P_X = \$2, they produce 20X and receive *OGJU* = \$40.
- Here the shaded area *AGJC* = \$15 represents the increase in rent or producer surplus.

Costs and Benefits of a Tariff



Continued......

- The figure in the previous slide shows that with a 100 percent import tariff on commodity X, P_X rises from \$1 to \$2 in Nation 2.
- This reduces the consumer surplus by AGHB = a + b + c + d.
- Of this, MJHN= c is collected by the government as tariff revenue, AGJC = a is redistributed to domestic producers of commodity X in the form of increased rent or producer surplus, while the remaining \$15(the sum of the areas of triangles CJM = b and BHN = d) represents the protection cost, or deadweight loss, to the economy.

- **Reference:**

Salvatore D (1998), International Economics, Prentice Hall.