



GROUP OF EIGHT

Energy and Trade Policy Update

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Introduction

As the volume of world trade has skyrocketed over the past century, the use of tariffs on imported goods has become controversial in global politics. Tariffs on goods allow governments to make money by taxing foreign imports, but the price that consumers in that country must pay is higher because of the tax, and the revenue that overseas producers receive is decreased because fewer consumers can afford to purchase the imports. This leads to a lower quantity of imports demanded and supplied, and hence less trade volume. In general, tariffs reduce the ability of consumers to purchase the cheapest and most efficiently produced goods available, and thus lead to economic inefficiency and stunt economic growth.

Despite the negative effects of tariffs, many interest groups support their implementation. Politicians do not necessarily think like economists, and do not always act in the long-term interest of their country. Tariffs that are popular for increasing short-run revenue may be difficult to reduce or eliminate. Tariffs may be placed on energy imports such as oil, coal, and natural gas. If a country imports energy, but also produces some oil, coal, and natural gas of its own, companies will seek to limit the competition they face in the domestic economy from overseas producers. They do this by **lobbying** national governments to maintain or increase tariffs on imported energy sources.

The US is an example of this type of country: although American companies such as Texaco produce oil within the US, the domestic supply cannot meet domestic demand, so the US is a net importer of oil from countries such as Venezuela and the Middle East. US oil companies that produce domestically lobby politicians in Washington to support tariffs on oil imports.

Energy costs strongly affect nearly all sectors of an economy. Higher fuel prices increase the cost of transporting people and manufactured goods. Oil is a critical ingredient for plastics production and for many other common materials, and coal is needed for the production of steel. Furthermore, all businesses and households rely on electricity, which is largely generated from fossil fuels. The cost and price volatility of energy sources are therefore crucial determinants of economic growth. This is the analysis offered by economists, who often suggest that tariffs ought to be eliminated so that goods can be bought at the cheapest price possible.

Lobby—to put pressure on political leaders to support a policy that is favorable to a special interest group.

Summary of the Problem

Countries with economies that are based more heavily on exports tend to favor tariff reductions (trade liberalization) in other countries, but seek to preserve tariffs so overseas exporters have little access to their domestic markets. No world government exists, hence tariff reductions must be made country-by-country. This difficult situation resembles the ‘prisoner’s dilemma’, a famous scenario in game theory where it is difficult for countries to cooperate because they each make independent rational choices which result in an outcome that could have been better had cooperation been possible. Governments find it hard to trust other governments because there are strong incentives to cheat and political leaders change regularly, so if a country agrees with another country to reduce tariffs, that country cannot be sure that the other will follow through with its promise. Hence cooperation is difficult, and both countries make the rational choice to leave tariffs unchanged because they fear being the only country with reduced tariffs.

The only solution to this dilemma is to make cooperation easier or to punish those who do not cooperate. The World Trade Organization, comprising most of the world’s developing countries and all of the developed nations, provides such mechanisms. The WTO provides incentives for countries to join, such as the ‘most favored nation principle’ which states that members must extend all other members the most favorable terms of trade and the lowest tariffs. Members must in return reduce their tariffs and other **market-distorting** trade policy tools, such as export subsidies. The WTO ensures that countries have immediate incentives to reduce tariffs and so facilitates cooperation. Countries can also make bilateral or regional trade deals, such as those that exist within the framework of the European Union and in the North American Free Trade Agreement. This has become a very popular alternative, especially among Asian and Latin American nations.

While economists generally stress that tariffs are harmful, there are some legitimate arguments for keeping at least some tariffs. Firstly, tariff reductions that are too sudden or large will generate instability in world markets in the short term. This will cause temporary and unpredictable economic ills until a new price equilibrium is reached by the forces of supply and demand. Secondly, some have argued that higher tariffs should be allowed in developing countries because their growing industries need time to become established and efficient, and competition with already established overseas industries is likely to force them out of the market. Thirdly, tariffs allow a country to be less dependent on imports. In times of war when strategic imports such as military equipment and steel are withheld or unavailable, some level of self-sufficiency gives a country a large advantage. Finally, **unfettered** world trade leads to a higher consumption of fossil fuels, so it has been

Market-distorting—a policy that alters the price and quantity of a good in a market and prevents it from reaching the natural equilibrium.

Unfettered—meaning uncontrolled.

suggested that the environment would be detrimentally impacted by lower energy tariffs.

Recent Developments

Green Trade Tariffs

In 2008, China surpassed the US as the highest emitter of greenhouse gases. Leaders in Europe and the US are worried that steps taken to increase the cost of polluting, such as **tradable emissions permits** and carbon taxes, will put manufacturers in the first world at a great disadvantage to those in China and other developing countries, where the cost of emitting greenhouse gases is very low. A proposal, recently in front of the US Congress, would increase emission controls on US industries, and then place tariffs on imported products from countries that fail to take comparable measures to increase the cost of emitting. The European Commission and French President Nicolas Sarkozy also support similar trade policies.

Were these ‘green tariffs’ to be introduced, the prices of Chinese goods would rise, hurting both the West and China economically. These tariffs could also be in violation of WTO rules, meaning the US and Europe could be punished under the WTO trade regime. According to U.S. Trade Representative Susan Schwab, this could set off a ‘trade war’, potentially significantly reducing the level of world trade. But the measures being considered would give strong incentives to China to take more action to reduce greenhouse gas emissions.

US Tariffs on Brazilian Ethanol

In June 2008, John McCain proposed that the US stop imposing its 54 cents per gallon tariff on ethanol produced in Brazil (these tariffs are a perfect example of protectionist energy tariffs). Doing this, he argued, would reduce America’s dependence on foreign oil and increase the use of the renewable, clean ethanol produced from sugar cane. When June floods destroyed corn crops used for ethanol production in the American Midwest, US prices of ethanol soared and there was even more reason to reduce the tariff so that cheap ethanol could be imported.

Recent Fluctuations in World Oil Prices

2008 witnessed the greatest oil price shock in recent history. On June 11th 2008, oil prices reached a new record high of \$147.27 per barrel, up from an average of around \$40 per barrel during the early 2000s. Many economists blame the recent price surge on increases in world demand that were not matched by supply capacity. During this period in mid-2008, people across the world protested the high petrol prices, and some governments responded by suspending gas taxes and by giving **subsidies** to consumers. However, few countries that had tariffs on im-

Tradable emissions permits—government issued or auctioned permits that allow businesses to emit a specified amount of greenhouse gases; may be bought and sold be-

Subsidies—payments made by the government to producers for each good sold, or to consumers for each good bought.

ports resolved to reduced these.

Since their peak in July, oil prices have fell dramatically, reaching a low of \$33.87 on December 21st 2008. Some economists speculated that the high oil price mid-year, along with the financial crisis, had caused the world economy to slow considerably, reducing overall demand for oil and thus the equilibrium price. But this explanation suggests that, when the world economy picks up speed again, perhaps in the next 2-5 years, demand for oil will increase once more and prices may soar. Tariffs probably hurt some economies particularly hard when oil was expensive in mid-2008, and are likely to hurt economies again the next time prices soar.

Focus of the Debate

There are several important questions that delegates will need to consider. Keeping in mind the current **volatility** in the world economy, delegates should look at whether to alter tariff levels now or at a more stable point in the future. Also, it is important to consider how tariffs could be reduced – unilaterally, bilaterally or multilaterally through the WTO. Which method is more likely to succeed? Furthermore, the developed nations should consider whether developing countries need greater tariffs to protect their not-yet-established industries, which can be crucial for development. While economic theory says that free trade results in the best outcome for economies, are there other legitimate considerations, such as national security, self-sufficiency, the environment, and the development of new industries that could justify the use of certain tariffs?

Volatility—*rapid or unexpected change.*

Questions for Policymakers

Policy makers should consider how to alter tariffs, and perhaps more importantly, how to get other countries to reduce their tariffs and open their markets. Economic theory would predict that lifting all tariffs would result in the best long-term outcome, but this may also cause temporary and unpredictable shocks to the economy. Partially lifting tariffs would allow strategic protection for certain goods which may be important for the national interest (e.g. steel, military equipment). Preserving the status quo would have the least short term effects, and politicians may favor this choice. Raising tariffs is a final option that could lead to lower consumption of fossil fuels and therefore benefit the environment.

Conclusion

Energy and trade policy raises many questions that have economic, social, political, environmental and moral aspects. Countries in the G8 are diverse—some are net energy importers, others are net-energy exporters. Delegates are representing the interests of their country and its government, and must know their country’s position on the various issues that will be discussed.

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