Webnote 422

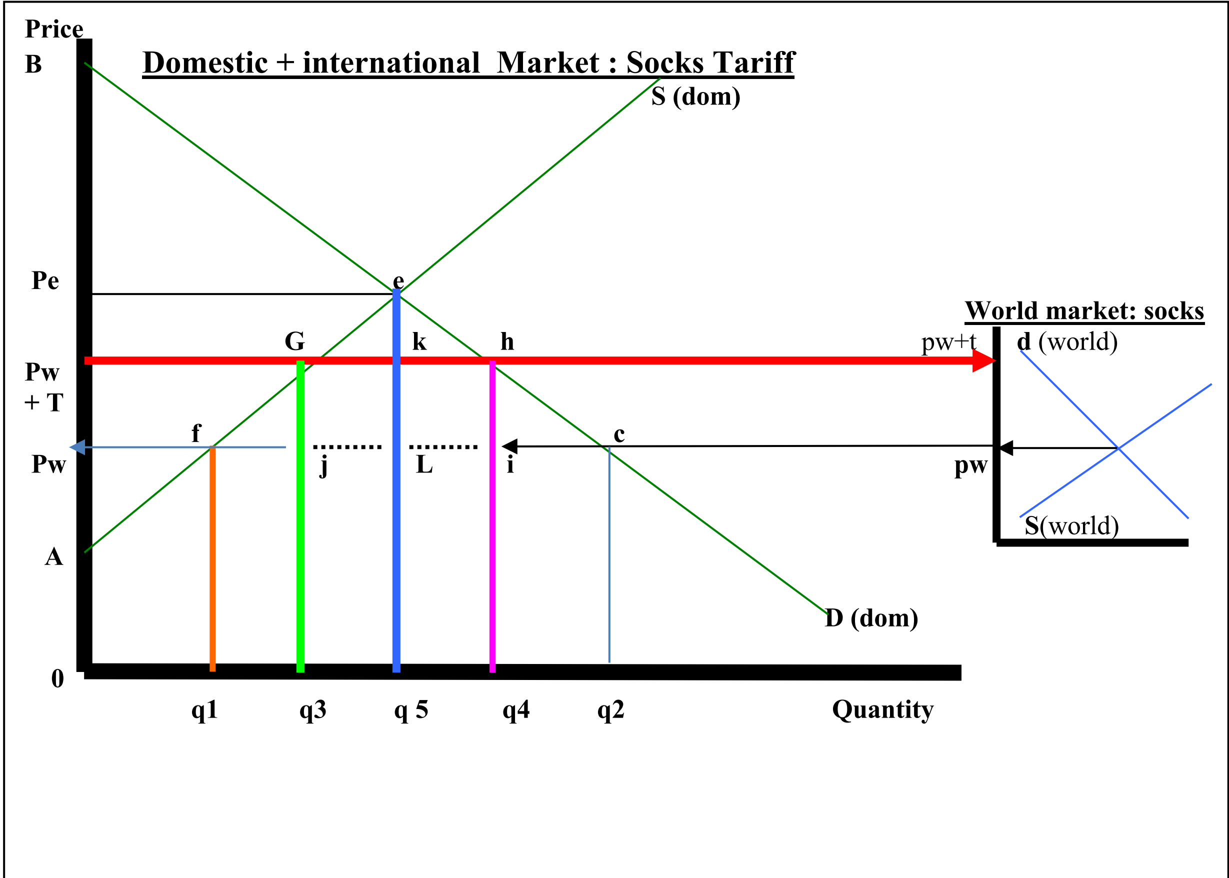
Syllabus Reference 4.2[1] Syllabus Reference 197-207

Grade weight = 4

Source: Rees + Smith Economic Development pp 121-122

Type of economy:	Closed economy	Protected economy	Free Trade
Equilibrium P + Q	Pe q5 (no trade)	Pw + t, q4	Pw q2
Domestic consumer Surplus	Pe B e	Pw+t b h	Pw b c
Domestic producer Surplus	A Pe e	A pw+t g	A pw f
Welfare loss	none	Gfj + hic	fel
Imports with tariff	none	Q 3 Q4	lec
Government revenue	none	ghij	none

Example i : The welfare implications of a tariff in a Closed, Protected and Free Trade Economy



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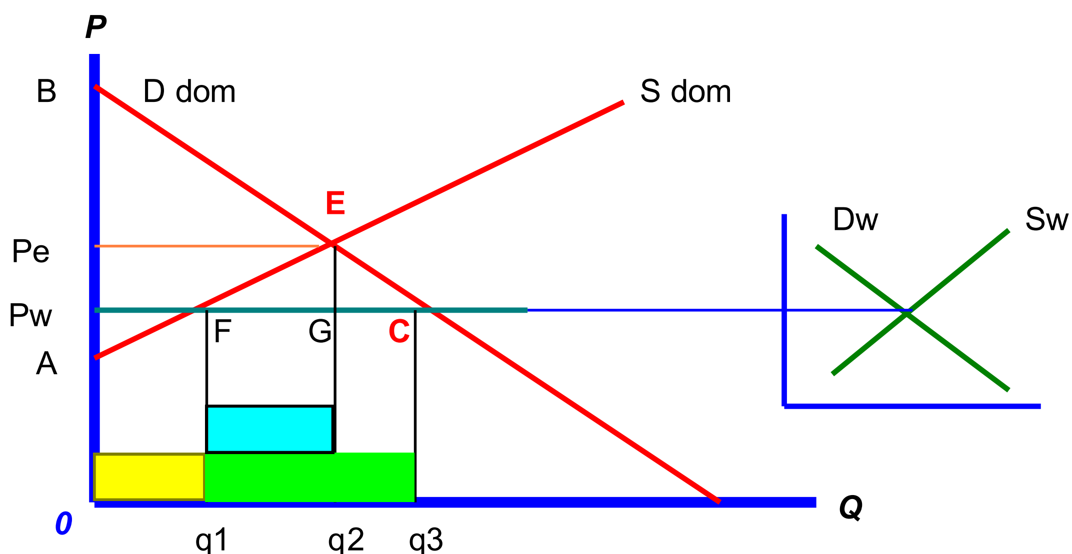
How is welfare impacted by protection?

Example ii: The welfare implications of a Free Trade Economy

- Sdom = supply in the domestic market without competition from imports
- Ddom = domestic demand curve
- Pe = Equilibrium in the domestic market without imports
- PwSw = world supply curve at world price i.e. free trade
- Dw = world demand curve
- Sw = world supply curve in the world market

Points to Note about welfare following free trade/protectionism:

Market for socks in a LDC



1. **World price (Pw)is lower than Pdom / Pe on the assumption that the foreign producers are more efficient over some but not all of the domestic producers. This would most probably be an economies of scale problem for some domestic producers in an LDC**
2. **Horizontal supply curve in the domestic market as a result of the imports – see Pw Sw – suggests that the LDC is a 'price taker' and cannot produce quantities to influence the world price**
3. **The domestic producers face a serious threat as the world market can satisfy the entire domestic demand**
4. **Producer Surplus falls from APeE to APwF**
5. **Consumer Surplus rises from PeBE to PwBC**
6. **Wider selection of goods in domestic market and standard of living has improved because of the price fall and the selection of socks.**
7. **The end result is that Pw acts as a ceiling price and therefore efficiency is a must if domestic producers are to survive.[i] Unemployment occurs in LDC as a result of loss of production /output q1 – q2.**

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[i] FEG =CS due to transfer of production abroad. GEC = no win no loss area, socks are cheaper and Qd has increased