Abstract

This paper develops and characterises an index of trade policy restrictiveness defined as the uniform tariff equivalent which maintains the same volume of trade as a given set of tariffs, quotas, and domestic taxes and subsidies. We relate this volume-equivalent index to the Trade Restrictiveness Index, a welfare-equivalent measure, and relate changes in both indexes to changes in the generalised mean and variance of the tariff schedule. Applications to international cross-section and time-series comparisons of trade policy show that the new index frequently gives a very different picture than do standard indexes.

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The Mercantilist Index of Trade Policy

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The Mercantilist Index of Trade Policy

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International trade policies are often compared across countries and over time for a variety of purposes. Analysts use such measures as arithmetic or trade-weighted average tariffs, Non-Tariff Barrier (NTB) coverage ratios and measures of tariff dispersion. All such measures are without theoretical foundation. In this paper we develop and characterise a theoretically-based index number of trade policy which is appropriate to trade negotiations. We also present a sample application which demonstrates the operationality of our index and shows that it differs significantly from previously employed atheoretic indexes.

We call our index the Mercantilist Trade Restrictiveness Index (MTRI), since it takes as its starting point the Mercantilist preoccupation with the volume of trade. Modern avatars of Mercantilist thinking are everywhere, and their concern with trade volumes plays an important constraining role in policy formation. For one example, successive GATT rounds of reciprocal trade negotiations have interpreted reciprocity in tariff negotiations to mean equivalent import volume expansion. The WTO goes further, sanctioning retaliation by the offended party to displace a volume of trade equal to that displaced by the original offending protection. (See Bagwell and Staiger (1997) for discussion.) For another example, interest group pleading and even US government negotiators have focused in recent years on trade volumes in auto parts and in semiconductors, as well as on aggregate US-Japanese bilateral trade volumes. The ubiquity of such examples shows that there is a demand on the part of practical trade policy makers for measures of trade restrictiveness which hold trade volume constant.[1] Such measures thus have a useful role to play both as an input to negotiations and as a performance measure of negotiations.

The MTRI is defined as the uniform deflator which, applied to the undistorted traded goods prices, yields the same trade volume (valued at external prices) as the initial set of distortions.[2] Defining the MTRI as a deflator makes clear its connection with ideal price deflators in general equilibrium (see Anderson and Neary, 1996). The MTRI is the general equilibrium version of an index earlier proposed by Corden (1966), which in a quantity index form was independently proposed by Leamer (1974).[3]

In Anderson and Neary (1996), we addressed the policy index number problem in the context of the welfare effect of trade restrictions. We provided a rigorous theoretical foundation for the Trade Restrictiveness Index (TRI), which operationalises the idea of finding a uniform tariff which yields the same *real income* as the original differentiated tariff structure. We

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[1] An index of home country tariffs which holds constant the real income of the foreign country is an appealing alternative for a two-country world. In a many-country world, this loses its appeal because an index of Japan's trade distortions can hold constant only one of its trading partners' real incomes. Thus there would be *N!1* different indexes of each country's trade policies, differing from each other in complex and unintuitive ways. A single constant-volume index treats no one trading partner as special and is appealing as a summary of a country's restrictiveness relative to the rest of the world.

[2] This definition of the MTRI compares an arbitrary tariff structure with free trade. More generally, when two different tariff structures are compared, the MTRI is defined as the uniform deflator which, applied to the new set of distorted prices, yields the same trade volume as the initial set of distortions.

[3] Neither the Corden nor the Leamer indexes include the disposition of tariff revenue in the analysis. Hence they are not full general equilibrium indexes.

advocated its use in studies of openness and growth and in other applications where it is desirable to have a measure of the restrictiveness of trade policy which is independent of real income.

For purposes of trade negotiations, however, comparing levels of protection with an index which holds constant the level of real income is less appropriate. Nations care about the effect of their partners' policies on their own interests, not their partners' interests. This need is addressed by the MTRI, which operationalises the idea of finding a uniform tariff which yields the same *trade volume* as the original differentiated tariff structure.

The main objective of the theoretical section of the paper is to relate the MTRI to the TRI and to standard atheoretic measures. In particular, we show how changes in both indexes can be characterised fully in terms of changes in two summary measures of the tariff structure, which we call the generalised mean and generalised variance of tariffs. These theoretical linkages are of interest in themselves, especially since they imply that the MTRI must exceed the TRI when trade policies are compared with free trade. In addition, the theoretical results help to explain the clear patterns which emerge from the empirical comparisons of these measures.

For the practitioner, this paper offers a consistent index number of trade restrictiveness which meets the Mercantilist concern with trade volume. The practical analyst is confounded at present by the thousands of different trade barriers and the absence of a theoretically based index number to summarise them. The paper concentrates on tariffs, but also offers an approach to the evaluation of quotas.[4] By offering the first application of the MTRI, the paper shows that use of a proper index makes a great deal of difference.

Section 1 sets out the basic model of the economy and defines the MTRI. Section 2 derives the properties of the MTRI and relates them to the properties of the average tariff and other indexes, especially the TRI. Section 3 extends the MTRI to cover the case of quotas. Section 4 presents the empirical analysis, which uses a 25-country cross-section of data from around 1990, and a 5-country panel of year-on-year changes from the late 1980s. The MTRI differs from standard indexes in its implications, often dramatically. It also differs substantially from the TRI.

1. Theory

The economy is assumed to be in competitive equilibrium, to have no distortions other than tariffs, and to be characterised by a single representative consumer. Traded goods prices are fixed on world markets. (Relaxing these assumptions leads to well-understood complications without adding any insight. In practice, the index we develop can be calculated in the context of any operational model economy.) Section 1.1 lays out the basic formal model of a tariff-distorted open economy, Section 1.2 introduces the import and import volume functions and Section 1.3 defines the MTRI.

1.1 The model of a tariff-distorted open economy

The behaviour of the private sector is described by the trade expenditure function $E(p,u)$. This function gives the expenditure needed by the representative consumer to attain the utility level u

[4] Domestic taxes and subsidies in goods and factor markets can also affect trade significantly, as shown by their prominence in recent policy negotiations. Anderson, Bannister and Neary (1995) extend the TRI to take account of such domestic distortions. A volume-equivalent index of the trade restrictiveness of domestic distortions is readily constructed by combining the methods of this paper with that one.

facing the price vector p of traded goods subject to tariffs, net of the income it receives from its ownership of the factors of production. Both of these in turn are represented by standard expenditure and GDP functions respectively:

$$E(\mathrm{p},u) \equiv e(\mathrm{p},u) - g(\mathrm{p}). \qquad \textbf{(1)}$$

In the background are factor endowments, prices of non-traded goods and factors (which are endogenous given p and u), and prices of traded goods not subject to tariffs. Standard properties of the underlying functions (Shephard's and Hotelling's Lemmas) allow us to identify the price derivatives of the trade expenditure function as the economy's general-equilibrium utility-compensated (or Hicksian) import demand functions:

$$E_{\mathrm{p}}(\mathrm{p},u) \equiv m^{c}(\mathrm{p},u). \qquad \textbf{(2)}$$

For later use, we note the derivatives of these functions:

$$m_u^c \equiv e_{\mathrm{p}u} \equiv e_u x_I \qquad \text{and} \qquad m_{\mathrm{p}}^c \equiv E_{\mathrm{pp}}. \qquad \textbf{(3)}$$

In words, the utility derivatives of the import demand functions equal the Marshallian income derivatives of demand x_I scaled by the marginal cost of utility e_u; while the matrix of price derivatives equals the Hessian of E and so is negative semi-definite (which for convenience and with little loss of generality we strengthen henceforth to negative definite).

The trade expenditure function completely summarises private-sector behaviour in our model economy. In the presence of tariffs, we must add to this the behaviour of the government, whose sole activity is to collect tariff revenue and rebate it to the representative consumer in a lump sum. The outcome of both public and private behaviour is summarised by the balance of trade function:[5]

$$B(\mathrm{p},\mathrm{p}',u) \equiv E(\mathrm{p},u) - (\mathrm{p}-\mathrm{p}').E_{\mathrm{p}}(\mathrm{p},u). \qquad \textbf{(4)}$$

This differs from the trade expenditure function by the tariff revenue term, where the vector $p-p^*$ denotes the tariff wedge between domestic and world prices. The derivative of the balance of trade function with respect to the level of utility is:

$$B_u \equiv e_u\,[1-(\mathrm{p}-\mathrm{p}').x_I]. \qquad \textbf{(5)}$$

This equals e_u times the inverse of the *shadow price of foreign exchange*, which measures the welfare gain to a unit increase in the economy's purchasing power. We assume throughout that it is positive, since otherwise the economy is initially so distorted that welfare would rise if some of its endowment were destroyed. (See Anderson and Neary (1992) for more discussion and

[5] All vectors are column vectors; a prime (′) denotes a transpose; and a dot (.) denotes a vector inner product.

references.) As for the derivatives of the balance of trade function with respect to domestic prices, they equal:

$$B_{p}^{)} \quad ' \quad \&(p\&p^{(})^{)} E_{pp}. \qquad \textbf{(6)}$$

This vector gives the marginal welfare effects of domestic price changes. Since the balance of trade function equals the amount of foreign exchange needed to sustain utility u facing domestic and world prices p and p^*, the *fall* in B following a tariff increase (which raises the corresponding element of p) is a money metric measure of the resulting welfare cost.

The general equilibrium of the economy is reached when utility is at the level consistent with the balance of trade constraint. This requirement equates the balance of trade function to any lump-sum income received from abroad, denoted by b:

$$B(p,p^{(},u) \quad ' \quad b. \qquad \textbf{(7)}$$

The balance of trade function thus allows us to summarise the equilibrium of an economy subject to tariffs in terms of a single compact equation.

1.2 Import and import volume functions

As with an individual consumer, we can relate the economy's Hicksian import demand functions (2) to their Marshallian equivalents.[6] The latter depend on domestic and world prices and on exogenous income b: $m = m(p,p^*,b)$. In equilibrium (given by the balance of payments condition (7)), the Hicksian and Marshallian import demand functions coincide:

$$m^{c}(p,u) \quad ' \quad m[p,p^{(},B(p,p^{(},u)]. \qquad \textbf{(8)}$$

Differentiating this "Slutsky Identity" with respect to u and using (3) and (5) yields:

$$m_{b} \quad ' \quad [1\&(p\&p^{(}).x_{I}]^{\&1} x_{I}. \qquad \textbf{(9)}$$

Thus an increased transfer from abroad raises demand for imports to an extent determined by the marginal income responses x_I, grossed up by the shadow price of foreign exchange. Differentiating (8) with respect to p gives a standard Slutsky decomposition of the effects of price changes into substitution and income effects:

$$m_{p} \quad ' \quad m_{p}^{c} \ \& \ m_{b} B_{p}^{)}. \qquad \textbf{(10)}$$

Of course, world prices are fixed, so income effects of domestic price changes arise only to the extent that tariffs are in place. This is seen more clearly by eliminating B_p using (6), to obtain an alternative expression for the price derivatives:

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[6] For a more formal derivation, see Neary and Schweinberger (1986).

$$m_{\mathrm{p}} \quad ' \quad [I \% m_b(\mathrm{p}\&\mathrm{p}^{(})^{)}]\, m_{\mathrm{p}}^{c}. \qquad \textbf{(11)}$$

where I is the identity matrix.

Finally, since we are concerned with the volume of tariff-restricted trade (measured at world prices), it is convenient to express its equilibrium level as a function of the variables characterising the general equilibrium of the economy. This leads to two scalar import volume functions, one compensated:

$$M^{c}(\mathrm{p},\mathrm{p}^{(},u) \quad / \quad \mathrm{p}^{(}.m^{c}(\mathrm{p},u). \qquad \textbf{(12)}$$

and the other uncompensated:

$$M(\mathrm{p},\mathrm{p}^{(},b) \quad / \quad \mathrm{p}^{(}.m(\mathrm{p},\mathrm{p}^{(},b). \qquad \textbf{(13)}$$

The derivatives of these functions are easily derived from the corresponding derivatives of the import demand functions. Here we note only that the derivative of the Marshallian import volume function with respect to exogenous income is:

$$M_b \quad ' \quad \mathrm{p}^{(}.m_b \quad ' \quad [1\&(\mathrm{p}\&\mathrm{p}^{(}).x_I]^{\&1}\,\mathrm{p}^{(}.x_I, \qquad 0 < M_b < 1. \qquad \textbf{(14)}$$

This can be interpreted as the marginal propensity to consume tariff-constrained imports, valued at world prices, and it plays a crucial role in the analysis below. We assume throughout that it lies between zero and one. Finally, the Slutsky decomposition of the import demand functions given in (10) implies a corresponding decomposition of the price derivatives of the Marshallian import volume function. By analogy with (8), we can relate the Hicksian and Marshallian import volume functions by a Slutsky identity:

$$M^{c}(\mathrm{p},\mathrm{p}^{(},u) \quad ' \quad M[\mathrm{p},\mathrm{p}^{(},B(\mathrm{p},\mathrm{p}^{(},u)], \qquad \textbf{(15)}$$

which, on differentiation, gives the required decomposition:

$$M_{\mathrm{p}} \quad ' \quad M_{\mathrm{p}}^{c} \;\&\; M_b B_{\mathrm{p}}^{)}. \qquad \textbf{(16)}$$

Armed with these results, we are ready to define the MTRI and to investigate its properties.

1.3 The mercantilist trade restrictiveness index

We wish to compare the restrictiveness of trade policy between two equilibria, denoted by "0" and "1" respectively. Following Anderson and Neary (1996), we define the Mercantilist Trade Restrictiveness Index (MTRI) as the uniform price deflator μ which, when applied to the prices in the new equilibrium, p^{1}, yields the same volume (at world prices) of tariff-restricted imports as in the old equilibrium, M^{0}:

$$\mu(p^1, M^0) \quad / \quad \{\mu: M(p^1/\mu) \ ' \ M^0\}. \qquad \textbf{(17)}$$

We simplify notation by dropping the explicit dependence of the trade volume on the exogenous variables p^* and b, which are set at their period-0 values.

The interpretation of the MTRI depends on the policy stance in the new equilibrium. If p^1 equals its free trade value p^*, μ equals the inverse of the uniform tariff factor which is equivalent in volume to the initial distortion structure. The Mercantilist uniform tariff equivalent is defined as $1/\mu \ ! \ 1$. For other values of p^1, μ equals the uniform tariff factor *surcharge* which is volume-equivalent to the changes in trade policy.

Reflecting policy concerns similar to those leading to the MTRI, it may be useful to define other members of a group of trade-balance-constrained trade restrictiveness indexes based on the same logic. For example, in US-Japan trade negotiations, the bilateral trade balance is often a focal point. In this case the relevant constraint for the index number for Japan might include both Japanese imports and exports to the US, both distorted and undistorted. Alternatively, US-Japan negotiations have also focused on bilateral trade in particular product groups, such as motor vehicles and parts or electronics. All cases in this class can be straightforwardly developed using the tools above.

2. Relation to other indexes

Useful insight into the meaning of the MTRI is gained by analysing its relationship with other index numbers. The analysis also helps put in perspective the empirical results in Section 4. We first lay out the MTRI, the TRI and the trade-weighted average tariff in a comparable local rate of change format in Section 2.1. We then show in Section 2.2 that changes in both the MTRI and the TRI can be fully characterised in terms of changes in the generalised mean and variance of the tariff schedule. Finally, Section 2.3 compares the levels of the MTRI and TRI.

2.1 The MTRI, the TRI and the average tariff

Following Anderson and Neary (1996), the TRI is defined as:

$$? (p^1, u^0) \quad / \quad \{? : B(p^1/?, u^0) \ ' \ b^0\}. \qquad \textbf{(18)}$$

This has a similar uniform tariff deflator interpretation to the MTRI. The difference is that its reference point is the base-period level of utility rather than the volume of trade. The value of ? is the uniform tariff deflator which, if applied to the new prices p^1, would ensure balance-of-payments equilibrium at the initial level of utility.

Both the MTRI and the TRI are defined in implicit form, so comparing their levels is difficult in general. However, we can say a great deal if we first consider local changes. The proportional rate of change (denoted by a circumflex) of the MTRI is:

$$\hat{\mu} \quad ' \quad \frac{M_p . dp}{M_p . p}, \tag{19}$$

with M_p evaluated at (p^1/μ). Similarly, the proportional rate of change of the TRI is:

$$\hat{?} \quad ' \quad \frac{B_p . dp}{B_p . p}, \tag{20}$$

where B_p is evaluated at $(p^1/?, u^0)$. Each of these in turn may be compared with the change in the trade-weighted average tariff, t^a:

$$dt^a \quad ' \quad \frac{E_p . dp}{E_p . p}. \tag{21}$$

Considering these three expressions, we see that, multiplying and dividing by prices in the numerator, each can be written as a weighted sum of the proportional changes in prices dp_i/p_i. The change in the MTRI in (19) weights proportional price changes by their marginal volumetric shares, $M_i p_i/M_p . p$. The change in the TRI in (20) weights the proportional changes in prices by their marginal welfare shares, $B_i p_i/B_p . p$. Finally, the change in the average tariff in (21) weights proportional price changes by their *average* trade shares, $E_i p_i/E_p . p$.

An important feature of the MTRI change is that it incorporates the effect of real income changes on trade volume whereas the TRI change does not. To deal appropriately with this, it is convenient to define a "compensated" MTRI:

$$\mu^c(p^1, u^0, M^0) \quad / \quad \{\mu^c: M^c(p^1/\mu, u^0) \ ' \ M^0\}, \tag{22}$$

whose rate of change is:

$$\hat{\mu}^c \quad ' \quad \frac{M_p^c . dp}{M_p^c . p}. \tag{23}$$

Once again, this is a weighted sum of proportional price changes, where the weights can be interpreted as *marginal* trade shares.

Now, suppose the initial levels of μ, and μ^c are the same. Then we can write the rate of change of μ as a weighted average of the rates of change of the other two indexes:

$$\hat{\mu} \quad ' \quad ?\hat{\mu}^c \ \% \ (1\&?)\hat{?}, \tag{24}$$

where the weight is simply:

$$? \quad / \quad \frac{M_p^{\,c}.p}{M_p.p}. \qquad \textbf{(25)}$$

The weight *?* is the ratio of the compensated to the uncompensated effect on import volume of a 1% rise in domestic distorted prices. It is ordinarily between zero and one and it is smaller the more important are income effects relative to substitution effects. (Recall from (11) that *?* is unity in the neighbourhood of free trade.)

2.2 Generalised tariff moments

Next, we wish to relate changes in the MTRI and the TRI to changes in the mean and variance of the tariff distribution. This turns out to be possible provided, following Anderson (1995), we work not with trade-weighted tariff moments but with *generalised* tariff moments, weighted by the elements in the substitution matrix E_{pp} .

At this point it is convenient to switch notation. Define the *ad valorem* tariff on good *i* as $t_i = (p_i - p_i^*)/p_i^*$. Let $\underline{x}$ denote a diagonal matrix with the elements of the vector *x* on the principal diagonal. Then the level of and the change in domestic prices can be written as:

$$p \quad ' \quad \underline{p}^{(}(?\%t) \qquad \text{and} \qquad dp \quad ' \quad \underline{p}^{(}dt\,, \qquad \textbf{(26)}$$

Next, define the matrix of substitution effects normalised by world prices as:

$$S \quad / \quad \frac{\underline{p}^{(}E_{pp}\underline{p}^{(}}{p^{()}E_{pp}p^{(}}. \qquad \textbf{(27)}$$

By construction *S* is a positive definite matrix all of whose elements sum to one: $?)S?=1$, where *?* is a vector of ones. We can now define the generalised average tariff:

$$\bar{t} \quad / \quad ?)St\,, \qquad \textbf{(28)}$$

and the generalised variance of tariffs:

$$V \quad / \quad (t-\bar{t})^{)}S(t-\bar{t}) \quad ' \quad t^{)}St-(\bar{t})^2. \qquad \textbf{(29)}$$

V must be positive (since it is a quadratic form in the positive definite matrix S) but $\bar{t}$ can be negative if tariffs are non-uniform and disproportionately higher on goods with relatively large cross-substitution effects.[7] The changes in these generalised moments are:

$$d\bar{t} = \tau' S dt \quad \text{and} \quad dV = 2(t' S dt - \bar{t} d\bar{t}). \tag{30}$$

The change in the variance of tariffs can also be interpreted as twice the (generalised) covariance between initial tariff rates and their changes:

$$Cov(t, dt) = (t - \bar{t}\tau)' S(dt - \tau d\bar{t}) = t' S dt - \bar{t} d\bar{t} = \tfrac{1}{2} dV. \tag{31}$$

It is now straightforward to express the changes in the three indexes of interest in terms of $d\bar{t}$ and dV. From (23) and (27), the change in the compensated MTRI is:

$$\hat{\mu}^c = \frac{\tau' S dt}{\tau' S(\tau - t)} = \frac{d\bar{t}}{1 - \bar{t}}. \tag{32}$$

Thus the change in the compensated MTRI is identical to the proportionate change in the generalised average tariff. Similarly, the change in the TRI can be expressed as:

$$\hat{\tau} = \frac{t' S dt}{t' S(\tau - t)} = \frac{\bar{t} d\bar{t} + \tfrac{1}{2} dV}{\bar{t}(1 - \bar{t}) + V}. \tag{33}$$

and the change in the MTRI as:

$$\hat{\mu} = \frac{(\tau - M_b t)' S dt}{(\tau - M_b t)' S(\tau - t)} = \frac{(1 - M_b \bar{t}) d\bar{t} + \tfrac{1}{2} M_b dV}{(1 - M_b \bar{t})(1 - \bar{t}) + M_b V}. \tag{34}$$

The role of income effects, represented by the marginal propensity to spend on imports M_b, is clearly crucial: they affect the sensitivity of the MTRI but not of the TRI to changes in the generalised mean and variance of the tariff schedule.

The significance of equations (33) and (34) is that they are completely general, with no restrictions on the types of tariff changes or on the structure of the economy. Their implications can be set out in terms of three propositions and a diagram. First, it is immediate that:

Proposition 1: Assume the denominators of $\hat{\tau}$ and $\hat{\mu}$ are positive. Then, both the MTRI and the TRI are increasing in the generalised mean and variance of the tariff schedule.

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[7] Equation (28) for the generalised average tariff can be written as $S_i w_i t_i$, where the weights are defined as: $w_i / S_j S_{ji}$. Recalling that S is defined to be positive definite, the weight on a given tariff rate is more likely to be positive the higher the own-substitution effect for that good and the more it is complementary with rather than substitutable for other goods. A sufficient condition for all weights to be positive is that the normalised substitution matrix have a dominant diagonal.

Note that, from (33) and (34), an over-strong sufficient condition for the denominators of both $\hat{?}$ and $\hat{\mu}$ to be positive is that $\bar{t}$, the generalised average tariff, be positive.

Next, consider the relative sensitivity of the two indexes to changes in the generalised mean and variance. This is best understood by writing the changes in both indexes as weighted averages of the changes in the two tariff moments. For the TRI, (33) implies:

$$\hat{?} \;=\; a\,\frac{d\bar{t}}{1+\bar{t}} + (1-a)\,\frac{dV}{2V}, \qquad a \;=\; \frac{\bar{t}\,(1+\bar{t})}{\bar{t}\,(1+\bar{t}) + V}. \tag{35}$$

Similarly, for the MTRI, (34) implies:[8]

$$\hat{\mu} \;=\; \beta\,\frac{d\bar{t}}{1+\bar{t}} + (1-\beta)\,\frac{dV}{2V}, \qquad \beta \;=\; \frac{(1+M_b\bar{t})\,(1+\bar{t})}{(1+M_b\bar{t})\,(1+\bar{t}) + M_b V}. \tag{36}$$

Using D_a and D_β to denote the denominators of a and β respectively, the difference between the weights is:

$$\beta - a \;=\; \frac{(1+\bar{t})\,V}{D_a D_\beta}, \tag{37}$$

Assuming the two denominators are positive, a is always less than β. Thus the TRI is *less* sensitive than the MTRI to changes in the generalised mean tariff but *more* sensitive to changes in the generalised variance of tariffs. Finally, the difference between the changes in the two indexes is:

$$\hat{?} - \hat{\mu} \;=\; (\beta-a)\left\{\frac{dV}{2V} - \frac{d\bar{t}}{1+\bar{t}}\right\} \;=\; \frac{-V d\bar{t} + (1+\bar{t})\tfrac{1}{2}\,dV}{D_a D_\beta}. \tag{38}$$

This may be expressed more compactly by defining the *generalised coefficient of variation of tariff factors* and its rate of change as follows:

$$C \;=\; \frac{V^{1/2}}{1+\bar{t}} \qquad \Rightarrow \qquad \hat{C} \;=\; \frac{dV}{2V} - \frac{d\bar{t}}{1+\bar{t}}. \tag{39}$$

Hence, recalling from (37) that $\beta - a$ is positive provided the denominators of $\hat{?}$ and $\hat{\mu}$ are positive, we may conclude:

Proposition 2: Assume that the denominators of $\hat{?}$ and $\hat{\mu}$ are positive. Then, starting from the same point, the TRI increases by more than the MTRI if and only if the generalised coefficient of variation of tariff factors rises:

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[8] From (24), it may be checked that $?=(\beta - a)/(1 - a)$. Moreover, from (29) and (31), $dV/2V$ equals the slope coefficient from a generalised least squares regression of dt on t.

$$\hat{?} > \hat{\mu} \quad] \quad \frac{dV}{2V} > \frac{d\bar{t}}{1+\bar{t}} \quad] \quad \hat{C} > 0. \qquad \textbf{(40)}$$

The full relationship between changes in the TRI and MTRI on the one hand and changes in the generalised tariff moments on the other is illustrated in Figure 1, drawn in the space of *(dV, $d\bar{t}$)*. From Proposition 1, both indexes increase together in the north-east quadrant and fall together in the south-west quadrant. The upward-sloping dashed line is the locus along which $\hat{?} = \hat{\mu}$. Only in the regions denoted I and II (which lie between the $\hat{?} = 0$ and $\hat{\mu} = 0$ loci), do they move in opposite directions. In Region I, the fall in the generalised average tariff is sufficient to offset the rise in the generalised variance as far as μ is concerned but not as far as ? is concerned: μ falls and ? rises. Exactly the opposite configuration applies in Region II. (From (24), the $\hat{\mu} = 0$ locus lies between the $\hat{?} = 0$ locus and the $\hat{\mu}^c = 0$ locus, which from (32) coincides with the vertical axis.) Note that a rise in ? is equivalent to a fall in welfare and a rise in μ is equivalent to a fall in import volume. Hence Figure 1 gives a complete characterisation of the effects on welfare and import volume of arbitrary changes in the generalised tariff moments.

2.3 Comparing the levels of the MTRI and TRI

Having derived the relationships between changes in the MTRI and the TRI, we can now relate their levels, at least for the comparison with free trade. The key result is:

Proposition 3: The MTRI exceeds the TRI for comparisons with free trade, provided the generalised average tariff is positive. The ranking is strict except when tariffs are uniform, in which case all tariff indexes are equal.

Proof: By definition, $\mu(p^0, M^0) = ?(p^0, M^0) = 1$. In words, when the initial tariff policy does not change, both indexes equal one. Hence, comparing the initial tariff policy (p^0) with free trade (p^*), the difference between μ and ? is the same as the difference between their proportional rates of change, provided this is one-signed over the relevant interval:

$$\ln\mu(p^1, M^0) - \ln?(p^1, u^0) \;\; \gtrless \;\; \int_{p^0}^{p^1} \left\{ \hat{\mu}(p, M^0) - \hat{?}(p, u^0) \right\}. \qquad \textbf{(41)}$$

To find a path in price space from p^0 to p^* along which the expression in brackets is always non-negative, we proceed in two stages:

(i) First, we eliminate the dispersion in the initial tariff structure by radial steps:

$$dt = -(t - \bar{t})d\theta, \qquad d\theta > 0. \qquad \textbf{(42)}$$

Substituting from (42) into (30), we see that, along this segment of the path, the generalised average tariff is constant ($d\bar{t} = 0$) and the generalised variance is falling, provided it was strictly positive to begin with ($dV = -2V d\theta < 0$). Hence the generalised coefficient of variation is also falling and Proposition 2 applies. With the initial generalised average tariff $\bar{t}^0$ assumed to be

positive, it also follows from (19) and (20) that both indexes are falling. Hence, along this segment of the path, we have $0>\hat{\mu}>\hat{?}$. Continue in this fashion from p^0 to $p^*(1+\bar{t}^0)$, i.e., until all the dispersion in the tariff structure is eliminated.

(ii) Next, with $C = V = 0$, we implement a uniform radial reduction in tariffs: $dt = !tde$. Again, from (30), this must reduce the generalised mean tariff ($d\bar{t} = !\bar{t}de$) and leave the generalised variance unchanged (since it was zero to begin with): $dV= !2Vde=0$. Hence, from (33) and (34), both indexes fall by the same percentage amount along this segment of the path: $0>\hat{\mu}=\hat{?}$. Proceeding along this segment of the path until we reach free trade, the proposition follows immediately.

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To interpret the proposition, recall that for comparisons with free trade, μ and ? equal the inverses of the uniform tariff equivalents which are import-volume-equivalent and welfare-equivalent to p^0 respectively. So, the facts that μ exceeds ? and that both are less than one means that the welfare-equivalent uniform tariff exceeds the import-volume-equivalent uniform tariff. Thus the tariff levels calculated according to the MTRI logic generally under-estimate the tariff levels which would be appropriate for welfare comparisons.

3. Quotas and the MTRI

Quotas are an important form of trade intervention in many countries. Moreover, other kinds of non-tariff barriers may often be represented as quotas. The application of Section 4 includes many examples of non-tariff barriers treated in this way. Thus it is important to extend the definition of the MTRI to incorporate quotas. For simplicity, we continue to assume that all distortions are in trade only.

Let q denote the vector of quota-constrained goods, with domestic prices p and world prices p^*; while m, p and p^* continue to denote the quantity and prices of tariff-constrained imports. As before, we seek a scalar deflator which, when applied to the policy variables in the new equilibrium, $\{q^1,p^1\}$, will yield the same import volume as the old equilibrium, M^0. However, it would not make sense to deflate the quota vector directly. Instead, we apply the deflation factor to the domestic-market-clearing *prices* of the quota-constrained goods.

To formalise these ideas, we adapt the techniques developed for the analysis of quotas in Anderson and Neary (1992) and applied to derive the TRI in the presence of quotas by Anderson and Neary (1996). The net expenditure on non-quota-constrained goods, called by Anderson and Neary (1992) the distorted trade expenditure function, is:

$$\tilde{E}(q,\mathrm{p},u) \quad / \quad \max_{p}\{E(p,\mathrm{p},u) \& p.q\}, \tag{43}$$

where the undistorted trade expenditure function E is defined in a similar manner to (1). The derivatives of $\tilde{E}$ with respect to p give the compensated import demand functions for goods subject to tariffs, as in earlier sections; while the derivatives with respect to q give (minus) the "virtual" prices of the quotas:

$$\tilde{E}_{\mathrm{p}}(q,\mathrm{p},u) \ ' \ m^c(q,\mathrm{p},u) \qquad \text{and} \qquad \tilde{E}_q(q,\mathrm{p},u) \ ' \ \& \ p(q,\mathrm{p},u). \tag{44}$$

Of course, when *{q,p,u}* relate to the same equilibrium, the virtual prices equal the market-clearing domestic prices. The distorted balance of trade function can now be defined as:

$$\tilde{B}(q,\mathrm{p},u) \;/\; \tilde{E}(q,\mathrm{p},u) \;\%\; p.q \;\&\; (\mathrm{p}\&\mathrm{p}^{(}).m \;\&\; (p\&p^{(})^{)}(I\&\underline{?})\,q\,, \qquad \textbf{(45)}$$

where *m* and *p* are determined from (44) and exogenous variables are suppressed to economise on notation. This is more complex than the corresponding undistorted function (4), since there are now two sets of trade restrictions, and (following standard convention) we assume that the rents generated from each are disbursed differently. The private sector receives all the tariff revenue, as in Section 2, but only some of the quota revenue, with the elements of the *?* vector ($0\leq ?_i \leq 1$) denoting the share of quota rents on good *i* lost to foreigners. Finally, equilibrium utility is determined implicitly by the balance of payments equilibrium condition:

$$\tilde{B}(q,\mathrm{p},u) \;'\; b\,. \qquad \textbf{(46)}$$

These functions allow us to determine the appropriate virtual prices and characterise the equilibrium in the presence of quotas. Next, to define the MTRI itself, we need to define the *un*compensated volume-of-trade function given the prices of the quota-constrained goods. The steps in doing this are similar to those followed in Section 1.2. First, the compensated volume-of-trade function is an extension of (12):

$$M^{c}(p,\mathrm{p},u) \;/\; p.E_{p}(p,\mathrm{p},u) \;\%\; \mathrm{p}^{(}.E_{\mathrm{p}}(p,\mathrm{p},u)\,. \qquad \textbf{(47)}$$

To derive the uncompensated volume-of-trade function from this, we must specify the undistorted balance of trade function. We do this by noting that the undistorted and distorted functions can be equated when the former is evaluated at the appropriate virtual prices. Thus:

$$B(\tilde{p},\mathrm{p},u) \;'\; \tilde{B}(q,\mathrm{p},u) \qquad \text{when} \qquad \tilde{p} \;/\; \&\; \tilde{E}_{q}(q,\mathrm{p},u)\,. \qquad \textbf{(48)}$$

As in (15), the uncompensated volume-of-trade function, *M(p,p,b)*, can now be defined implicitly as follows:

$$M^{c}(p,\mathrm{p},u) \;'\; M\,[p,\mathrm{p},B(p,\mathrm{p},u)]\,. \qquad \textbf{(49)}$$

We are finally able to define the MTRI itself:

$$\mu(q^1, p^1, M^0) \quad / \quad \{\mu: M(\tilde{p}/\mu, p^1/\mu) \text{ ' } M^0\}, \qquad \textbf{(50)}$$

where the virtual prices $\tilde{p}$ are determined endogenously by the requirement that domestic markets for quota-constrained goods clear, i.e., by equations (46) and (48) evaluated at (q^1, p^1). With the quotas reduced to their price equivalents, the interpretation of the MTRI now proceeds in exactly the same way as in the case of tariffs only.

4. A sample application

The MTRI can be made operational with only slight modifications of any standard Computable General Equilibrium (CGE) model. All that is necessary is to define the virtual prices $\tilde{p}$ and the volume of distorted trade M. Then the deflator μ can be calculated. Ideally, the CGE model should be disaggregated with respect to trade distortions (and those domestic distortions which are important in considering trade policy). Most CGE models are highly aggregated with respect to trade and so are not ideally suitable for this purpose. It should be possible, however, with strategic use of nested CES structures, to disaggregate many existing CGE models appropriately.

Applications are chiefly constrained by the paucity of detailed distortion data. While limits on information are notorious for non-tariff distortions, there is also surprisingly little systematic detailed information on tariffs and associated import volumes across a broad spectrum of countries and years. Here, we draw on Anderson's (1998) application of the TRI and use the same data and CGE model as a basis for calculating the MTRI and comparing it with the TRI and the standard indexes.

Anderson (1998) develops a tractable CGE model with a highly aggregated CES/CET industrial structure and a very disaggregated trade structure, and calculates the TRI for both a cross-section of countries and for a few cases of year-on-year changes. The model's main virtue is that it requires relatively little information about the domestic production structure, so a standard model framework can be used across a large group of countries. At the same time, it permits the use of as detailed trade distortions data as the analyst can find.

Limits on detailed trade and trade distortion data dictate the scope of the results presented below. The data were obtained by the World Bank from the TRAINS (TRade Analysis and INformation System) database (UNCTAD (1996)), supplemented by trade and trade distortions data supplied by country economists at the Bank. Non-Tariff Barriers (NTBs) are treated as binding quotas in the model. To obtain consistent trade flow and trade distortions data, more detailed data are aggregated to the four-digit Harmonised System level using trade-weighted average tariffs, and for NTBs using the procedure that a four-digit category is counted as NTB-constrained if 75% or more of its elements are "hard-core" NTB-constrained.[9] Some such atheoretic aggregation procedure is unavoidable due to inconsistencies in classification systems of the most detailed distortion and trade data.

A key practical issue is the treatment of quota rents, bearing in mind that information on domestic prices (and hence on quota premia) are not available. In simulating the move to free

[9] A "hard-core" NTB includes some restrictions which are hardly quantitative, such as being under investigation for dumping. It excludes simple licensing requirements. See UNCTAD's description of their NTB database for details.

trade (i.e., in Table 1 and Figure 2 below) we assume that rent-retaining tariffs capture all the quota rent, so all NTBs are non-binding at the margin in the initial equilibrium.[10] Hence the policy regime is assumed to be one of tariffs only, with quotas replaced by their tariff equivalents. In evaluating year-on-year changes (Table 3 below), we assume instead that binding quotas generate rents which are entirely lost to foreigners or to rent seeking, apart from the fraction which is retained by tariffs. Alternative expedients (discussed in Anderson (1998)) lead to similar qualitative results.

Table 1 presents the results of calculating the TRI and MTRI using the CGE model for a cross-section of 25 countries. In this table we are comparing the actual data for the country and year indicated with free trade (so $p^1=p^*$ and $t^1=0$). Hence we present both the TRI and MTRI in terms of their uniform tariff equivalents (i.e., $1/? \; ! \; 1$ and $1/\mu \; ! \; 1$) to facilitate comparison with the trade-weighted average tariff, t^{a0}. To see why this makes sense, we can rewrite the definition of the MTRI from (17) as follows:

$$M[p'(?\%t^1)/\mu] \quad ' \quad M[p'(?\%t^0)] \quad ' \quad M^0. \qquad \textbf{(51)}$$

With $t^1 = 0$, we seek a scalar measure of the vector t^0. The atheoretic measure is the trade-weighted average tariff t^{a0}, while the theoretically correct measure is $1/\mu \; ! \; 1$, the uniform tariff that is import-volume-equivalent to t^0. A similar argument applies to the uniform tariff equivalent of the TRI, $1/? \; ! \; 1$, which gives the uniform tariff that is welfare-equivalent to t^0. To facilitate comparison of the columns in Table 1, Table 2 presents the results of simple regressions and rank correlations between the columns. Figure 2 illustrates the data from Table 1, with countries ranked by their trade-weighted average tariff.

The first observation suggested by Tables 1 and 2 and Figure 2 is that the MTRI and the trade-weighted average tariff tend to move closely together on average. (The correlation and rank correlation coefficients between the two are 0.987 and 0.972 respectively.) However, for individual countries involved in trade negotiations, this does not mean that the two measures are interchangeable. On the contrary, the average tariff underpredicts the MTRI in all but three of the 25 cases. The effect is not statistically significant (as Table 2 shows) and the underprediction is only 8.9% on average. However, it is important in a number of individual cases, exceeding 15% for Austria, Indonesia, Morocco and the USA. This suggests that in trade negotiations, most countries would prefer to use the MTRI to evaluate their own trade policies but average tariffs to evaluate their partners'. On the other hand, for India, the average tariff *under*predicts the MTRI by 7%. So the choice between the two measures is significant and of unpredictable sign in individual cases.

The second observation suggested by Table 1 and Figure 2 is that the TRI exceeds the MTRI by a significant margin: 48.7% on average. We know from Proposition 3 that μ must be greater than ? (and hence $1/? \; ! \; 1$ must be greater than $1/\mu \; ! \; 1$), for comparisons with free trade (at least when both indexes are generated by the same utility-consistent model, as here). This theoretical prediction is borne out for every case in the table.[11] The relationship between the two is weaker than that between the MTRI and the average tariff (with correlation and rank correlation

[10] Tariffs on NTB-constrained goods are in practice usually quite high.

[11] The numbers in the table are given to only three significant digits, so in one case, Bolivia, the values shown for the two indexes are equal to one another. From the raw data, the percentage excess of the TRI over the MTRI for Bolivia is 0.22%, while the next smallest differential (Peru) is 0.88%.

coefficients of 0.886 and 0.800 respectively). The percentage divergence also varies considerably, ranging from over 100% in three cases to less than 10% for Bolivia, Mexico and Peru. Here too the theoretical results of Section 2 provide some insight. Proposition 2 showed that, for small changes, ? rises by more than μ if and only the generalised coefficient of variation of tariffs increases. This suggests that the *actual* coefficient of variation of tariffs might help predict the divergence between the two indexes (since the generalised coefficient is not available in practice). The last column in Table 1 gives the coefficient of variation of tariffs and the final regression in Table 2 confirms that the percentage excess of the TRI over the MTRI is positively and significantly related to the coefficient of variation of tariffs. Overall, it is clear that the two different purposes of evaluating tariff structures yield very different pictures of the relative restrictiveness of nations' trade policies.

Table 3 turns to consider a small sample of year-on-year changes. We now wish to have a measure of the *change* in the tariff structure from t^0 to t^1. Referring back to (51), the theoretically correct measure is simply μ (rather than its uniform tariff equivalent), while the corresponding atheoretic measure is $(1+t^{a1})/(1+t^{a0})$. Thus, a value greater than one in any of the first six numeric columns of the table indicates that, according to the measure in question, trade policy became *more* restrictive between the two years indicated. Because tariffs on NTB-constrained goods serve the positive function of retaining rent rather than the negative one of restricting trade, we report average tariffs for these separately. We also distinguish between the average tariffs on intermediate and final goods categories. In addition, Table 3 reports the (arithmetic) change in the coefficient of variation of tariffs, and gives information on two measures of NTB restrictiveness: the initial level of and the (arithmetic) change in the NTB coverage ratio, and the (percentage) change in the volume of NTB-constrained imports.

In dramatic contrast to the results of Table 1, the MTRI in Table 3 differs considerably from the standard indexes. This echoes the finding of Anderson (1998), where the TRI was shown to differ dramatically from the average tariff and from all the other standard indicators in evaluating year-on-year changes in policy. There is a good reason for this. In the hypothetical leap to free trade, all standard indicators of trade policy move in the same direction. By contrast, in most real-world trade reforms there are conflicting tendencies which make it much more important to take the structure of index numbers into account. In all cases except the disaggregated average tariffs on intermediate goods, the tariff measures and the MTRI are negatively correlated. As might be expected, comparison of the MTRI and the two direct quantitative NTB measures (the change in the NTB coverage ratio and the proportional change in volume of NTB-constrained goods) shows a closer relationship. Many of the countries analysed had a high initial incidence of NTBs and were liberalising NTBs in the years considered.

Comparing the changes in the MTRI and the TRI, the first columns of Table 3 show that they always have the same sign, but no consistent ranking emerges between them. Surprisingly, in the year-on-year changes, the MTRI and TRI changes are quite highly correlated, with a correlation coefficient above 0.95.

The results overall show that the MTRI is much different from standard measures in practice, enough to matter to practical policy-making. In future tariff negotiations it should be useful to come equipped with MTRI measures of proposed changes in policy. Our results also throw light on the appropriateness of using trade-weighted average tariffs as measures of trade restrictiveness in empirical studies. Table 1 suggests that they may be appropriate in cross-section regressions. However, Table 3 suggests that in panel data studies, such as the estimation of cross-country growth regressions, they are likely to be very poor proxies for the two theoretically based indexes of trade restrictiveness.

Of course, all our estimates of the TRI and the MTRI are dependent on the model used to calculate them. Anderson (1998) reports that results are not very sensitive to elasticity values, a finding which applies here as well. This is consistent with the folklore of CGE modelling, that elasticities do not matter much but that specification of the model does matter. (For an illustration in the TRI context, see O'Rourke (1997).) Where MTRI measures are important, it would be useful to have several different calculations based on differing CGE models. Despite these caveats, the case seems to be made that the standard measures are likely to be very seriously misleading in practice.

5. Conclusion

In this paper we have presented a theoretical analysis of the Mercantilist Trade Restrictiveness Index and compared its empirical performance with other measures of trade policy. The MTRI is defined as the uniform tariff which yields the same volume of imports as a given tariff structure. Since it is a true index number for tariffs, the performance of empirical measures should be evaluated in terms of how closely they approximate to the MTRI. We also showed how the properties of the MTRI can be related to changes in the tariff structure, summarised in terms of two parameters, the generalised mean and variance of tariffs. These techniques seem likely to prove useful in many other contexts. Finally, we have shown how the MTRI can be extended to allow for quotas for tariffs; and it can easily be extended further to account for the trade effects of domestic taxes and subsidies, using the methods of Anderson, Bannister and Neary (1995).

As for our empirical results, we found that on average the MTRI is correlated with the trade-weighted average tariff in comparisons with free trade and with changes in NTB restrictiveness in year-to-year comparisons of trade policy. However, it diverges significantly from both in individual cases, to an extent which makes standard atheoretic measures highly suspect in practice. Especially if tariffs are far from uniform, it seems highly desirable to use the MTRI rather than standard atheoretic measures to evaluate the restrictiveness of real-world protective structures.

Table 1
Alternative Indexes of Trade Restrictiveness

Table 2
Regression Equations Based on columns in Table 1