



The World's Largest Open Access Agricultural & Applied Economics Digital Library

This document is discoverable and free to researchers across the globe due to the work of AgEcon Search.

Help ensure our sustainability.

Give to AgEcon Search

AgEcon Search

<http://ageconsearch.umn.edu>

aesearch@umn.edu

*Papers downloaded from **AgEcon Search** may be used for non-commercial purposes and personal study only. No other use, including posting to another Internet site, is permitted without permission from the copyright owner (not AgEcon Search), or as allowed under the provisions of Fair Use, U.S. Copyright Act, Title 17 U.S.C.*

No endorsement of AgEcon Search or its fundraising activities by the author(s) of the following work or their employer(s) is intended or implied.



Working Paper Series

FSWP2009-1

TARIFF DE-ESCALATION WITH SUCCESSIVE OLIGOPOLY

Steve McCorriston

University of Exeter, UK

Ian Sheldon

Ohio State University

In this paper, we explore the issue of a simultaneous reduction in tariffs at different stages of a vertically-related market where each stage is oligopolistic. When vertically-related markets are characterized as a successive oligopoly, reducing tariffs by an equivalent amount on upstream and downstream imports will have a differential effect on market access and hence profits at each stage due to a combination of horizontal and vertical effects. As a consequence, in order to maintain parity between the upstream and downstream stages in terms of changes in domestic firms' profits, tariffs on downstream imports should be reduced proportionately more than tariffs on upstream imports. This provides a rationale for tariff-reduction formulae aimed at reducing tariff escalation.

Key Words: Vertical markets, successive oligopoly, tariff escalation

JEL Code: F12, F13

**Food System Research Group
University of Wisconsin-Madison
<http://www.aae.wisc.edu/fsrg/>**

January 2009

Authors emails:

sheldon.1@osu.edu

s.mccorriston@exeter.ac.uk

This research was supported by a USDA grant to the Food System Research Group,
University of Wisconsin, Madison.

FSRG *Working Papers* are published with the intention of provoking discussion
and helping drive future work. The papers are formatted to conform
with other working papers but are not formally edited.

All views, interpretations, recommendations, and conclusions expressed are those of
the author(s) and not necessarily those of the supporting or cooperating institutions.

Copyright © by the author(s). All rights reserved.

Readers may make verbatim copies of this document for noncommercial purposes
by any means, provided that this copyright notice appears on all such copies.

Introduction

Tariff escalation, and the associated concept of effective protection, has been a long-recognized issue in the trade policy literature (Balassa, 1965; Corden, 1971; Ethier, 1977, Anderson, 1998; Greenaway and Milner, 2003, *inter alia*). Tariff escalation occurs when tariffs on downstream imports tend to be higher than tariffs on upstream imports such that the level of protection offered downstream, where goods are typically more processed, exceeds that upstream for less-processed intermediate goods. Cadot *et al.* (2004), drawing on World Trade Organization (WTO) data, report that nominal protection escalates with the degree of processing for both industrial and agricultural goods in developing and developed countries. For example, over the period 1997-99, fully processed industrial goods on average received 55 and 450 percent more protection than first-stage processed goods in developing and developed countries respectively. The extent of tariff escalation, especially its impact on developing country food and agricultural exports, has also been highlighted in the context of the current Doha Round negotiations (UNCTAD, 2002; Oxfam, 2003; World Bank, 2003). While the phenomenon of tariff escalation in vertically-related markets is well known to those who follow trade policy issues, less well-publicized is the fact that, following negotiated tariff reductions in the Uruguay Round that concluded in the mid-1990s, tariff escalation increased across a number of sectors. Based on OECD weighted average tariffs (both average and most-favored nation (MFN) tariffs), the OECD reports that tariff escalation increased in 20 sectors covering both agriculture and industrial sectors (OECD, 1996).

The existence of tariff escalation provides a rationale for formula approaches to reducing tariffs in trade negotiating rounds since they have the aim of reducing high tariffs by a greater proportion than lower tariffs that, in turn, would reduce the incidence of tariff escalation. Francois and Martin (2003) summarize the use of formula approaches and how they may reduce tariff escalation. Indeed, in the current Doha Round negotiations, the Falconer proposal, laying out the modalities for agriculture, has an explicit formula for reducing tariff escalation (WTO, 2008). Specifically, given the proposed tiered formula for the reduction of bound tariffs, a processed product in one tariff band, will be subject to the tariff cut suggested for the next highest tariff band. For example, the bound tariff on a processed product in the second band, instead of being subject to a 57 percent reduction will be subject to the 64 percent reduction for the third band.¹ Though this proposal applies specifically to agricultural and food commodities, as we show below, the employment of a formula-based approach would remove any obstacle to trade reform within a country where the source of opposition to reform could emerge from firms at different stages of a vertically-related market. As such, the paper offers a new insight as to why formula-based approaches to reducing tariffs may be necessary.

Despite empirical evidence for the phenomenon, there has been little formal analysis of the effects of reducing tariff escalation beyond either considering alternative approaches to formula-based reductions (see Francois and Martin, *ibid.*) or by simulating formula-based reductions in simple commodity market models (Sharma, 2007). This is especially

¹ There are two key exceptions to the tariff escalation rule: first, no extra adjustment is required if the gap between processed and primary products after application of the normal tariff formula is 5 percent or less; and second, full adjustment is not required if the tariff on the processed product would be reduced below that for the primary product, instead the final bound tariffs on the processed and primary products should be left equal.

true in markets where both downstream and upstream stages of a vertically-related industry are imperfectly competitive, i.e., where there is successive oligopoly. Therefore, the issue explored in this paper is that when tariffs on downstream and upstream imports are *simultaneously* reduced, and where both downstream and upstream stages are imperfectly competitive, the effect of tariff reductions on domestic firms' profits varies between these two stages. In turn, this non-equivalence highlights a potential obstacle to trade reform.

The reason for this differential effect is that, in the context of successive oligopoly with simultaneous tariff reductions at each stage, there is both a within (or horizontal) stage effect and a between (or vertical) stage effect. The latter effect comprises of a pass-through of tariff reductions from the upstream to the downstream stage and a pass-back effect as the derived demand for upstream inputs changes following tariff reductions at the downstream stage. In the context of successive oligopoly, these effects are non-equivalent. Moreover, due to differences in the perceived marginal revenue functions at each stage, the horizontal effect also differs at each stage for given reductions in upstream and downstream tariffs.

The non-equivalence by stage of the between and within-stage effects is an important source via which the change in profits at one stage in a vertically-related market differs from the change in profits at another. To the extent that firms are concerned about their relative profitability following trade reform, this outcome provides a potential source of opposition to tariff reductions. Specifically, we show that in order to keep the change in

firms' profits the same at both stages, tariffs on downstream imports should be reduced by more than tariffs on upstream imports. Thus the model provides a formal justification for tariff de-escalation that has hitherto not been addressed in the literature. Although interest groups are not specifically modeled in this set-up, the analysis gives an alternative insight to that of Grossman and Helpman (1994) who argued that the nature of interest group competition would see domestic downstream firms receive more protection than domestic upstream firms. In this context, this would limit the extent of tariff de-escalation, diluting the impact on domestic downstream firms, thereby resulting in a greater impact on domestic upstream firms. In the context of successive oligopoly, even though a lower tariff reduction downstream would soften the impact on domestic upstream firms, vis-à-vis the pass-back effect, it would not be sufficient to offset the horizontal effect arising from the impact on domestic upstream firms' profits which is not equal to the comparable effect on domestic downstream firms' profits. Our results therefore provide a theoretical motivation for tariff-reduction formulae, but also identify that the political weights on domestic downstream firms would have to be 'high' in order for tariff reductions to result in an increase in tariff escalation.

The analysis presented here explores the consequences of simultaneous reductions in tariffs in an environment of successive oligopoly. As such, the analysis differs considerably from previous research that addresses the issue of optimal tariffs in a vertically-related market set-up (Spencer and Jones, 1991, 1992; Ishikawa and Lee, 1997; Ishikawa and Spencer, 1999). Moreover, other research that addresses the issue of optimal policies has recognized the trade-off between a horizontal (or strategic) effect

and a vertical (or cost related) effect and how this may change the argument for strategic export subsidies targeted at the downstream stage (see, for example, Bernhofen, 1997). Instead, the focus of this paper is on the differential effects on firms' profits resulting from equivalent and simultaneous reductions in tariffs affecting each stage.

The paper is organized as follows. In section 1, we outline a basic model of successive oligopoly where tariffs are applied on imported goods that enter both the downstream and upstream stages. The model is sufficiently general to allow intermediate and final goods to be either strategic substitutes or complements. In section 2, we explore the effect of simultaneous reductions in tariffs on downstream and upstream imports and consider the relative effect on market access for the two stages. In section 3, we focus on what would be the appropriate reduction in the downstream tariff for a given reduction in the upstream tariff, if a policymaker were aiming to avoid differential effects on domestic firm's profitability at each stage. In section 4, we present a general discussion of the potential implication(s) of the results, while in section 5, we summarize and conclude.

1. Model Structure

The model introduced here is one of successive oligopoly, i.e., both the upstream (intermediate good) and downstream (final good) stages are imperfectly competitive. At the downstream stage, a domestic firm competes with imports of the final good that are subject to a tariff t^d . At the upstream stage, a domestic firm competes with imports, where the intermediate good is homogeneous and sold at a common price such that the domestic downstream firm is indifferent between alternative sources for the intermediate

good. Imports of the intermediate good are also subject to a tariff t'' . With tariff escalation in the initial set-up, the tariff on the final good exceeds the tariff on the intermediate good, i.e., $t^d > t''$, although the initial degree of tariff escalation is not crucial for the analysis. The technology linking domestic downstream production and the upstream intermediate good is one of fixed proportions. Formally, $x_1 = \phi x''$, where x_1 and x'' represent output of the domestic downstream firm and upstream stage respectively, and where ϕ is the constant coefficient of production. To ease the exposition, ϕ is set equal to one in the framework outlined below. Arms' length pricing between the domestic downstream firm and the upstream stage is also assumed, i.e., the downstream firm takes the price of the intermediate good as given.

The model consists of a three-part game. First, the domestic government sets tariffs on both downstream and upstream imports, while the second and third parts consist of Nash equilibria at the upstream and downstream stages. The timing of firm's strategy choice goes from upstream to downstream. Specifically, given costs and the derived demand curve facing the upstream stage, upstream firms simultaneously choose output to maximize profits, which generates Nash equilibrium at the upstream stage. The price of the intermediate good is taken as given by the domestic downstream firm which, simultaneously with its foreign competitor, chooses output to maximize profits, thus giving Nash equilibrium at the downstream stage. In terms of solving the model, equilibrium at the downstream stage is derived first and then the upstream stage. In addition, all equilibria are assumed to be sub-game perfect.

Equilibrium at the Downstream Stage

Let x_1 equal the output choice of the domestic downstream firm and x_2 the output choice of its foreign competitor. Their revenue functions can be written as:

$$R_1(x_1, x_2) \quad (1)$$

$$R_2(x_1, x_2). \quad (2)$$

We assume downward sloping demands and substitute goods.

Given (1) and (2), the relevant profit functions are given as:

$$\pi_1^d = R_1(x_1, x_2) - c_1 x_1 \quad (3)$$

$$\pi_2^d = R_2(x_1, x_2) - c_2 x_2 - t^d x_2, \quad (4)$$

where c_1 and c_2 are the domestic and foreign downstream firms' respective costs, and t^d is the tariff on imports of the final good. Downstream firms' costs relate to the purchase of an intermediate input and excluding any other costs, the costs for the domestic downstream firm are equal to the price of the intermediate input, p_1^u .

The first-order conditions for profit maximization are given as:

$$R_{1,1} = c_1 \quad (5)$$

$$R_{2,2} = c_2 + t^d, \quad (6)$$

Equilibrium at the downstream stage can be derived by totally differentiating the first-order conditions (5) and (6):

$$\begin{bmatrix} R_{1,11} & R_{1,12} \\ R_{2,21} & R_{2,22} \end{bmatrix} \begin{bmatrix} dx_1 \\ dx_2 \end{bmatrix} = \begin{bmatrix} dp_1^u \\ dc_2 + dt^d \end{bmatrix}. \quad (7)$$

The slopes of the reaction functions are found by implicitly differentiating the firms' first-order conditions:

$$\frac{dx_1}{dx_2} = r_1 = - \frac{R_{1,12}}{R_{1,11}} \quad (8)$$

$$\frac{dx_2}{dx_1} = r_2 = - \frac{R_{2,21}}{R_{2,22}}. \quad (9)$$

With this set-up, we can deal with both strategic substitutes and strategic complements where the variable of interest is the cross-partial effect on marginal profitability, i.e., given $R_{i,ii} < 0$, $i=1,2$, then $\text{sign } r_i = \text{sign } R_{i,ij}$. Consequently, with reference to equations (8) and (9), if $R_{i,ij} < 0$, then $r_i < 0$. In this case, we have the case of strategic substitutes, and the reaction functions are downward sloping. However, if $R_{i,ij} > 0$, the reaction functions are upward sloping and we have strategic complements. The distinction between strategic substitutes/complements relates to the “aggressiveness” of firms' strategies (Bulow *et al.*, 1985). With strategic substitutes, firms' strategies are less aggressive than those associated with strategic complements, i.e., with strategic substitutes (complements), an increase in the output of firm 1 would be met by a decrease (increase) in that of firm 2. Whether we have strategic substitutes or complements depends on the second derivatives of the demand function.

Given (7), the solution to the system is found by re-arranging in terms of dx_i and inverting where Δ is the determinant of the left-hand side of (7):

$$\begin{bmatrix} dx_1 \\ dx_2 \end{bmatrix} = \Delta^{-1} \begin{bmatrix} R_{2,22} & -R_{1,12} \\ -R_{2,21} & R_{1,11} \end{bmatrix} \begin{bmatrix} dp_1^u \\ dc_2 + dt^d \end{bmatrix}. \quad (10)$$

To simplify the notation re-write (10) as:

$$\begin{bmatrix} dx_1 \\ dx_2 \end{bmatrix} = \Delta^{-1} \begin{bmatrix} a_2 & a_1 r_1 \\ a_2 r_2 & a_1 \end{bmatrix} \begin{bmatrix} dp_1^u \\ dc_2 + dt^d \end{bmatrix}, \quad (11)$$

where $a_1 = R_{1,11}$ $a_2 = R_{2,22}$. For stability of the duopoly equilibrium, the diagonal of the matrix has to be negative, i.e., $a_i < 0$, and the determinant positive, $\Delta^{-1} = a_1 a_2 (1 - r_1 r_2) > 0$.

Equilibrium at the Upstream Stage

Given the fixed proportions technology and $\phi = 1$, total output at the domestic upstream stage is given by $x'' (= x_1)$. It is assumed that there are two upstream firms, one domestic and one foreign whose combined output equals x'' , i.e., $x_1'' + x_2'' = x''$. As noted earlier, given the intermediate good is assumed to be homogeneous, the domestic downstream firm is indifferent about the relative proportions of x_1'' and x_2'' used in its production process. The foreign upstream firm is subject to a tariff on its exports of the intermediate good as given by t'' . Assuming that the domestic downstream firm faces no costs other than the price it pays for the intermediate good, the inverse derived demand function facing firms at the upstream stage can be found by substituting p_1'' for c_1 in (5) where superscript u denotes the upstream stage. Firms' profits at the upstream stage are, therefore, given by:

$$\pi_1'' = R_1''(x_1'', x_2'') - c_1'' x_1'' \quad (12)$$

$$\pi_2'' = R_2''(x_1'', x_2'') - c_2'' x_2'' - t'' x_2'', \quad (13)$$

where c_1'' and c_2'' are the domestic and foreign upstream firms' costs respectively.

Given this, and following the outline above, equilibrium at the upstream stage is:

$$\begin{bmatrix} dx_1^u \\ dx_2^u \end{bmatrix} = (\Delta^u)^{-1} \begin{bmatrix} a_2^u & a_1^u r_1^u \\ a_2^u r_2^u & a_1^u \end{bmatrix} \begin{bmatrix} dc_1^u \\ dc_2^u + dt^u \end{bmatrix}, \quad (14)$$

where $a_i^u < 0$ and $(\Delta^u)^{-1} > 0$ for stability.

Equations (11) and (14) characterize equilibria in the downstream and upstream sectors respectively. However, while the signs of the elements of (11) and (14) are the same, they differ in magnitude. This is because in models of successive oligopoly, perceived marginal revenue declines at a greater rate at the upstream compared with the downstream stage. This feature of successive oligopoly is summarized in the following lemma:

Lemma 1: Since the slope of firms' perceived marginal revenue functions at the upstream stage are steeper than firms' perceived marginal revenue functions at the downstream stage, then $|a_i^u| > |a_i|$.

Proof: $R_{1,11}$ is equal to $2p' + p''(q)$. Note that by definition, $R_{1,1} = c_1$ and hence

$c_1' = R_{1,1}^u = c + c'(q)$. By extension, $R_{1,11}^u = 2c' + c''(q)$. Note that c' can also be written as

$2p' + p''(q)$. Given this:

$$\frac{R_{1,11}}{R_{1,11}^u} = \frac{2p' + p''(q)}{2c' + c''(q)} = \frac{2p' + p''(q)}{2(2p' + p''(q)) + c''} = \frac{2p' + p''(q)}{4p' + 2p''(q) + c''}.$$

Since $R_{1,11} = a_1$ and $R_{1,11}^u = a_1^u$, then it follows that $|a_i^u| > |a_i|$. For example, with monopoly at each stage and linear demand such that $p'' = c'' = 0$, the slope of the perceived inverse derived demand function facing the firm upstream is twice the slope of the inverse demand function facing the firm downstream.

With this model of successive oligopoly, where tariffs apply to both upstream and downstream imports, we can now consider the potential effects on market access at each stage arising from a simultaneous change in t^d and t^u .

2. Impact of Tariff Reductions on Market Access

Consider a scenario of tariff reform in this vertically-related market where both t^d and t^u are reduced, and initially the tariffs are assumed to be reduced by the same amount. We focus initially on the effects on market access at the downstream and upstream stages, i.e., by how much imports change in both these stages, in order to capture the potential differential effects of tariffs at each stage. To highlight the mechanisms associated with changes in tariffs with successive oligopoly, we initially take the tariff changes at each stage separately.

Key to identifying the effects of tariff changes in this setting is to note that changing a tariff at one stage has an effect not only on market equilibrium at the stage which the tariff affects directly but also on the vertically-related stage. So, for example, a change in the upstream tariff will not only change the level of imports of the intermediate good but by doing so, will also affect the competitiveness of the domestic downstream firm vis-à-vis its foreign competitor since the change in level of market access upstream changes the price of the intermediate good purchased by the domestic downstream firm. If the upstream tariff is reduced, and for a given level of costs and tariff facing the foreign downstream firm, the domestic downstream firm will benefit from a fall in the price of

the intermediate good. The change in the price of the intermediate good arising from the change in the upstream tariff is known as the ‘pass-through’ effect.

Similarly, keeping the upstream tariff unchanged, a change in the downstream tariff will not only directly affect equilibrium at the downstream stage but also generates feedback to the upstream stage which in turn affects the price of the intermediate good. For example, suppose there is a reduction in the downstream tariff. This decreases the market share of the domestic downstream firm which then purchases less of the intermediate good. This decrease in derived demand changes the price of the intermediate good which (typically but not always) falls and, therefore, partly offsets the decrease in market share of the domestic downstream firm arising from the reduction in the downstream tariff. This feedback effect on the upstream market arising from changes in the downstream market is known as the ‘pass-back’ effect (Ishikawa and Lee, 1997; Colangelo and Galmarini, 2002). Importantly, the ‘pass-through’ and ‘pass-back’ effects are unlikely to be equal.

Specifically, the pass-through of changes in the upstream tariff into changes in the price of the intermediate good is given by $dp_1''/dt'' = p_{1,1}''(dx_1'' + dx_2'') = p_{1,1}''D$, where $p_{1,1}''$ is the derivative of the upstream price with respect to x'' , and D is given by $\{(\Delta'')^{-1} [a_1''(1+r_1'')]\}$. Since $p_{1,1}''$ is negative, and D is negative, a reduction in the upstream tariff will decrease the domestic downstream firm’s costs. As is well-known from the public finance literature, the impact of a tax on the price of a good can be greater or less than the level of the tax when industries are imperfectly competitive. For

reasonable characterizations of the demand function, we are likely to have ‘under-shifting’, i.e., $p_{1,1}''D < 1$. For example, a linear, or, more generally, a weakly convex, demand curve will generate under-shifting.²

For the pass-back effect, the focus is on the impact of the tariff on the downstream imported good on demand for the intermediate good. Specifically, the tariff will lead to a shift in the derived demand for the intermediate good which subsequently changes its price. Formally, and noting that $dx_1 = d(x_1'' + x_2'')$, the pass-back effect is given by:

$$\frac{dp_1''}{dt^d} = \frac{dp_1''}{d(x_1'' + x_2'')} \frac{d(x_1'' + x_2'')}{dt^d},$$

which can be re-written as:

$$\frac{dp_1''}{dt^d} = \Delta^{-1} a_1 r_1 (1 + p_{1,1}'') \quad (15)$$

With strategic substitutes, $r_1 < 0$, the pass-back effect is positive and is likely less than one for reasonable characterizations of the demand function. With strategic complements, the pass-back effect is negative. Intuitively, with strategic substitutes, a reduction in the tariff on the final good decreases the demand for the intermediate good, thereby lowering its price. However, with strategic complements, a reduction in the tariff increases imports of the final good, and output of the domestic downstream firm also increases, leading to an increase in demand for the intermediate good, thereby raising its price. We summarize the pass-through and pass-back effects in the following lemma:

² See Fullerton and Metcalf (2002) for a summary of tax incidence in imperfectly competitive markets.

Lemma 2: In a vertically-related market, tariff changes at one stage have an impact on prices faced by the related stage. The pass-through and pass-back effects associated with these related market changes are not equivalent to each other. Moreover, with strategic substitutes, a tariff reduction at either the downstream or upstream stage will reduce the price of the intermediate good. However, with strategic complements, a reduction in the upstream (downstream) tariff will reduce (increase) the price of the intermediate good.

Proof: It is easy to see that $p_{1,1}''(\Delta^{-1})''[a_1''(1+r_1'')] \neq \Delta^{-1}a_1r_1(1+p_{1,1}'')$.

Consider now the effects of reductions in tariffs in this successive oligopoly at both the stage in which the tariffs directly apply and also at the vertically-related stage:

(i) *Effect of a change in upstream tariff on imports of intermediate good:*

$$\frac{dx_2''}{dt''} = (\Delta^{-1})'' a_1'' . \quad (16)$$

Since $a_1'' < 0$ and $(\Delta^{-1})'' > 0$, a decrease in the upstream tariff increases imports of the intermediate good.

(ii) *Effect of change in the upstream tariff on imports of final good:*

$$\frac{dx_2}{dt''} = \frac{dx_2}{dp_1''} \frac{dp_1''}{dt''} = (\Delta^{-1})a_2r_2p_{1,1}''[(\Delta^{-1})''(a_1''(1+r_1''))] \quad (17)$$

With $a_2 < 0$ and $(\Delta^{-1}) > 0$, the impact of a reduction in the upstream tariff on downstream market access depends on the sign of r_2 . With strategic substitutes (complements), imports of the final good fall (rise) with a reduction in the upstream tariff. Intuitively, since the fall in the upstream tariff lowers the price of the intermediate good, this makes the domestic downstream firm more competitive. As a result, with strategic substitutes, imports of the final good fall. With strategic complements, the increase in sales of the domestic downstream firm is matched by an increase in imports of the final good.

(iii) *Effect of reduction in downstream tariff on imports of final good:*

$$\frac{dx_2}{dt^d} = \Delta^{-1} a_1 [1 + a_2 r_1 r_2 \Delta^{-1} (1 + p_{1,1}^u)]. \quad (18)$$

Since $[\cdot] < 1$, $a_1 < 0$ and $(\Delta^{-1}) > 0$, (18) is negative. Intuitively, as the downstream tariff is reduced, imports of the final good increase even though the magnitude of this impact is conditioned by the pass-back effect to the intermediate good price.

(iv) *Effect of reduction in downstream tariff on imports of intermediate good:*

There are two factors to be taken into account in considering the impact upstream of a reduction in the downstream tariff. First, reduction of the downstream tariff affects the derived demand for imports of the intermediate good. Second, the reduction in the downstream tariff also affects the price of the intermediate good upstream which, in turn, affects the extent of the change in derived demand for imports of the intermediate good. Note that in deriving the effect on the upstream stage, we are interested only in the effects of reducing the downstream tariff on imports of the intermediate good, i.e., dx_2^u / dx_1 .

Since $x_1 = x^u = (x_1^u + x_2^u)$, then $dx_1 = d(x_1^u + x_2^u)$. Re-arranging, we have $(dx_2^u / dx_1) = 1 - (dx_1^u / dx_1) = s$ which corresponds to a change in upstream imports for a given change in output by the domestic downstream firm. The effect of reducing the downstream tariff on upstream imports can therefore be given by:

$$\frac{dx_2^u}{dt^d} = s(\Delta^{-1}) a_1 r_1 [1 + a_2 \Delta^{-1} (1 + p_{1,1}^u)]. \quad (19)$$

In the case of strategic substitutes ($r_1 < 0$), and given that $[\cdot] < 1$, $(\Delta^{-1}) > 0$ and $a_1 < 0$, imports of the intermediate good will fall following a decrease in the downstream tariff.

This is due to the decline in the sales of the domestic downstream firm that reduces demand for imports of the intermediate good, although the extent is ameliorated somewhat by the decrease in the upstream price. In the case of strategic complements ($r_1 > 0$), imports of the intermediate good will increase following a reduction in the downstream tariff.

Finally, we want to consider the net change in market access for each stage following a simultaneous reduction in tariffs downstream and upstream. For the upstream stage, the net change is given by (16) and (19) and, for the downstream stage, by (17) and (18). For the upstream stage, the net change in market access is given by:

$$\frac{dx_2^u}{dt^u} + \frac{dx_2^u}{dt^d} = (\Delta^{-1})^u a_1^u + s(\Delta^{-1}) a_1 r_1 [1 + a_2 \Delta^{-1} (1 + p_{1,1}^u)]. \quad (20)$$

This is likely negative since the second argument is weighted by $s < 1$ and by $[.] < 1$. This will hold in both the strategic substitutes and complements cases. With trade liberalization, tariff reductions at the upstream stage will reduce imports which is partly offset by the effect of a decrease in derived demand from the downstream stage as the tariff reduction at the downstream stage reduces the competitiveness of the domestic downstream firm.

For the downstream stage, the net change in market access is given by:

$$\frac{dx_2}{dt^u} + \frac{dx_2}{dt^d} = (\Delta^{-1}) a_2 r_2 p_{1,1}^u \{ (\Delta^{-1})^u [a_1^u (1 + r_1^u)] \} + \Delta^{-1} a_1 [1 + a_2 r_1 r_2 \Delta^{-1} (1 + p_{1,1}^u)] \quad (21)$$

where $a_1 \approx a_2 = a$ has been assumed. Since $[.] > 0$, and since $(\Delta^{-1} > 0)$, and $a_i < 0$, then imports of the final good increase when both downstream and upstream tariffs are

simultaneously reduced. This holds for both the strategic substitutes and complements cases. However, to some extent, this horizontal effect on downstream imports is offset by the lower prices resulting from tariff reductions at the upstream stage which improves the competitiveness of the domestic downstream firm. As long as this vertical effect is not ‘too’ strong, imports will be expected to rise, as a result of trade liberalization though the net effect is tempered by trade liberalization affecting the upstream market.

We are, however, interested in the question of which stage is most affected by the simultaneous change in tariffs. This can be derived by comparing (21) with (20), the net effect on market access between the two stages is given by:

$$\left. \frac{dx_2}{dx_2^u} \right|_{dt''+dt^d} = \frac{\Delta^{-1} a_2 r_2 \{p_{1,1}^u (\Delta^{-1})^u [a_1^u (1 + r_1^u)] + a_1 [1 + a_2 r_1 r_2 \Delta^{-1} (1 + p_{1,1}^u)]\}}{(\Delta^{-1})^u a_1^u + s \Delta^{-1} a_1 r_1 (1 + a_2 (1 + p_{1,1}^u) \Delta^{-1})} \quad (22)$$

Several observations can be made concerning (22). First, by (20) and (21), tariffs affect imports in the same way whatever the nature of strategic interaction so (22) will be positive. Second, it is unlikely that (22) equals one. Given the slope of the perceived revenue functions at the downstream and upstream stages as well as the vertical (pass-through and pass-back) effects not being equal, a simultaneous reduction in tariffs for both stages in this successive oligopoly will lead to differential changes in market access. However, whether the differential effect falls more on the domestic downstream or upstream firm depends on whether (22) is greater or less than one.

To investigate further, recall $(\Delta^{-1})^u > 0$ and $a_i, a_i^u < 0$. Note also that by *Lemma 1* $|a_1^u| > |a_1|$, and noting that the determinant can be written as (suppressing the superscripts for the upstream stage for convenience) $\Delta^{-1} = a_1 a_2 (1 - r_1 r_2)$, then the second term in the numerator is greater than the first term making (22) positive. The denominator is also positive given that $|a_1^u| > |a_1|$ and $(\Delta^{-1})^u > \Delta^{-1}$, the positive effect being reinforced if the pass-back is sufficiently low. The tendency for the numerator to be less than the denominator is reinforced if $\{1 + [\cdot]\} < 1$. This would arise with strategic substitutes, a relatively high degree of pass-through and a low value of s for upstream imports. Noting that $|a_1^u| > |a_1|$ and $(\Delta^{-1})^u > \Delta^{-1}$, this will also be true in the case of strategic complements. These effects are summarized in the following proposition.

Proposition 1: A simultaneous reduction in tariffs on imports of final and intermediate goods will have differential effects on market access at each stage. Final good imports are likely to change by less than imports of the intermediate good if competition is characterized by a sufficiently high degree of pass-through, a sufficiently low degree of pass-back and a sufficiently low level of change for imports of the intermediate good following the change in domestic downstream output. These effects will also arise in the case of strategic complements.

To the extent that one stage in this vertically-related market is more affected by an equivalent change in tariffs is crucial in understanding the potential implications of trade reform. Specifically, it may provide a rationalization for why some firms within the same (vertically-related) industry may take a different stance on the magnitude of the trade reform proposals and why tariff escalation could rise even if the industry as a whole faces reduced tariffs. We explore the effect on profits in the following section.

3. Relative Tariff Changes and Profits

With any proposed trade reform, arguably firms are more concerned about the impact on their profits not market access *per se*. In order to address this, we take the framework outlined above to explore whether there are varying effects on the profits of firms at different vertical stages. Totally differentiate profits as given by (3) and (12) above, so that for the domestic downstream firm:

$$d\pi_1^d = R_{1,1}dx_1 + R_{1,2}dx_2 - c_1dx_1 + \pi_{1,c_1}^d dc_1 \quad (23)$$

and for the domestic upstream firm:

$$d\pi_1^u = R_{1,1}^u dx_1^u + R_{1,2}^u dx_2^u - c_1^u dx_1^u + \pi_{1,c_1}^u dc_1^u \quad (24)$$

Taking the downstream firm first, divide (23) by dt^d , then:

$$\frac{d\pi_1^d}{dt^d} = \Delta^{-1}a_1[r_1R_{1,1}\Delta^{-1}a_2(1+p_{1,1}^u) + R_{1,2}] \quad (25)$$

Assuming the pass-back effect is not ‘too strong’, i.e., $R_{1,2} > r_1R_{1,1}\Delta^{-1}a_2(1+p_{1,1}^u)$, profits will be reduced with a reduction in the tariff on imports of the final good (which is what one should expect).

To consider the effect of the upstream tariff on the downstream firm’s profits, divide (23) by dt^u . This gives:

$$\frac{d\pi_1^d}{dt^u} = R_{1,1} \frac{dx_1}{dt^u} + R_{1,2} \frac{dx_2}{dt^u} - c_1 \frac{dx_1}{dt^u} + \pi_{1,c_1}^d \frac{dc_1}{dt^u} \quad (26)$$

which can be re-written as:

$$\frac{d\pi_1^d}{dt^u} = [(\Delta^{-1})(R_{1,1}a_1 + R_{1,2}a_2r_2) - x_1]p_{1,1}^u(\Delta^{-1})^u[a_1^u(1+r_1^u)] \quad (27)$$

Consider (24) for the upstream case. This time, there is no pass-back, only pass-through.

So, $c_1 \frac{dx_1}{dt^u} = 0$ and $\frac{dc_1}{dt^u}$ is the pass-through effect. So, we have for the effect of the upstream tariff:

$$\frac{d\pi_1^u}{dt^u} = (\Delta^{-1})^u a_1^u [R_{1,1}^u r_1^u + R_{1,2}^u] \quad (28)$$

This is positive but note that the effect on upstream profits will be different from the downstream case (even setting aside the differences in $R_{1,1}, R_{1,2}$ in the downstream market from the corresponding $R_{1,1}^u, R_{1,2}^u$ in the upstream market) because here upstream costs are constant and do not change unlike in the downstream case. Hence (27) and (28) will not be equal.

Taking (24) and dividing through by dt^d gives:

$$\frac{d\pi_1^u}{dt^d} = (\Delta^{-1})a_2[\Delta^{-1}a_1r_1(1+p_{1,1}^u)](sR_{1,1}^u + (1-s)R_{1,2}^u) \quad (29)$$

for the effect of the downstream tariff. Assuming the pass-back effect is positive (but note the possibility it is not in the strategic complements case), and s is not too small, given $R_{1,1}^u > R_{1,2}^u$, the effect on profits is positive i.e., the expansion at the downstream stage will benefit the upstream firms, the extent to which this happens depending on s . Again, casual observation suggests that (28) and (29) will not be equal.

These effects are summarised in *Proposition 2*:

Proposition 2: Reductions in tariffs at either stage will have a differential effect on firms' profits depending on the stage in which they are located. Reducing tariffs on downstream imports will lower profits for the domestic downstream and upstream firms but the effects will not be equal. Reducing tariffs on the upstream imported good, will lower profits for the domestic upstream firm, but likely increase profits for the domestic downstream firm. The relative magnitude of these effects will depend on the perceived marginal revenue functions at each stage, pass-through and pass-back effects and whether the goods are strategic substitutes or complements.

To focus directly on the issue of tariff de-escalation, we take the effects on profits due to a simultaneous change in upstream and downstream tariffs, and pose the following question: by how much would the downstream tariff have to change given a unit reduction in the upstream tariff, in order to keep the change in domestic firms' profits equal between the two stages? Formally, this tariff rule is to find \hat{dt}^d such that:

$$\hat{dt}^d = \frac{\left[\left(\frac{d\pi_1^d}{dt^u} \right) + \left(\frac{d\pi_1^u}{dt^u} \right) \right] dt^u}{\left(\frac{d\pi_1^d}{dt^d} + \frac{d\pi_1^u}{dt^d} \right)} \quad (30)$$

It is not clear from casual perusal of (30) what the outcome is since it reflects a combination of the simultaneous change in tariffs at both stages on profits. In principle, (30) could be positive or negative; while the components of the denominator have the same sign, the components of the numerator have opposite signs i.e., a reduction in upstream tariffs will increase downstream profits while a reduction in upstream tariffs reduces upstream profits. The net effect will depend on a number of factors including the relative differences in the perceived marginal revenue functions at each stage, coupled with the non-equivalence of the pass-through and pass-back effects.

Consider, first of all, only the horizontal effects of tariff reductions affecting profits only at the stage in which the tariffs directly apply. Reducing tariffs will reduce profits at both stages though the effect on upstream profits will be greater. This arises from *Proposition 1* which showed that the effect on the upstream stage is greater because of the differences in the perceived marginal revenue functions between the two stages. Adding in the vertical effects changes the outcome but does not outweigh the horizontal effect: both the pass-through and pass-back effects will (typically) be less than 1 and also, given the differences in the perceived marginal revenue functions, pass-back will have a greater impact in reducing profits at the upstream stage than the impact of pass-through in reducing profits at the downstream stage.

To explore further, consider a numerical example. We sign and evaluate (30) with respect to equations (25) and (27)-(29). Assume linear demand so $p'' = c'' = 0$. Let $p' = -0.05$, $p = 1$, $x = 10$ and $n^{d,u} = 2$. With these numbers, this implies $R_{11,1} = R_{22,2} = -0.75$ and $R_{11,1}'' = R_{22,2}'' = -1.25$. Recall that we need $|r_1| > |r_2|$. Assume strategic substitutes for the moment. Recall that $r_1 = -\frac{R_{11,2}}{R_{11,1}}$ and $r_2 = -\frac{R_{22,1}}{R_{22,2}}$. So, to ensure the constraints outlined above are satisfied, choose values for the numerators for each case. The numbers chosen are: $R_{11,2} = -0.375$ and $R_{22,1} = -0.3$ which gives $r_1 = -0.5$ and $r_2 = -0.4$. For strategic complements these numbers become positive; $r_1 = 0.5$ and $r_2 = 0.4$. For the upstream stage, do the same. This gives: $r_1'' = (-)\frac{0.375}{1.125} = (-)0.333$ and $r_2'' = (-)\frac{0.3}{1.125} = (-)0.267$. These numbers then imply

$\Delta^{-1} = 2.7586$ and $(\Delta^{-1})'' = 0.84982$. $p_{1,1}''$ is just the slope of the perceived upstream marginal revenue function and equals -0.75 . Finally, the values for the marginal revenue effects that arise from the above are, respectively: $R_{1,1} = 0.5, R_{1,2} = -0.5, R_{1,1}'' = 0.25$ and $R_{1,2}'' = -0.75$.

With these numbers, the adjustment to the downstream tariff, given a unit change in the upstream tariff is: for strategic substitutes, $d\hat{t} = 6.06$ and, for strategic complements, $d\hat{t} = 4.43$. Hence, with linear demands and, more generally, where the demand function is not too convex, the appropriate change in the downstream tariff should be greater than the change in the upstream tariff if the aim is to avoid a change in profits for the domestic firm at one stage of the vertically-related market being greater than the change in profits for the domestic firm at the other stage. In other words, there should be tariff de-escalation.

In sum, when the vertical effects associated with pass-through and pass-back are added into the picture, coupled with the horizontal effects of tariff reductions that may impact differentially on domestic upstream and downstream firms, there is no reason *a priori* why the effects of simultaneous tariff reductions in a successively oligopolistic framework should have an equal effect on profits of firms located in either stage.

The differential effects of tariff reductions on profits in this vertically-related set-up also carry over to the case of strategic complements. The mechanisms are broadly the same though the precise magnitudes will obviously differ. There are two additional points to

note about the strategic complements case. First, tariff reductions will likely increase output of the domestic firms given the slope of the reaction functions (see equations (8) and (9)). Also, the pass-back effect will imply an increase in costs for the domestic downstream firm which serves to disadvantage it and benefit the domestic upstream firm. Again, the non-equivalent effect on downstream and upstream firms' profits persists, though the role that each mechanism plays differs in the strategic complements case.

This is summarized in the following proposition:

Proposition 3: With linear (or not 'too' convex) demand, in order to avoid the domestic firm at one stage of a vertically-related market losing commensurately more than the domestic firm at another, a reduction in the upstream tariff should be matched by a more than proportionate reduction in the downstream tariff. This holds for both strategic substitutes and strategic complements. As a consequence, in order to maintain parity in profit changes between the domestic firms at the two stages, there should be tariff de-escalation.

4. Discussion and Policy Implications

Consider the potential implications of the above analysis for trade negotiators. Suppose a country's negotiators propose to reduce all tariffs equally. The above analysis predicts that, in the context of successive oligopoly, the impact on the domestic upstream firm will be greater than on the domestic downstream firm. This may result in the domestic upstream firm being (even more) opposed to trade liberalization as this would impact more on the profits of the domestic upstream firm than the domestic downstream firm. In turn, to the extent that vested interests oppose trade liberalization, this is more likely to arise from the upstream market not just because profits will be reduced as a result of trade liberalization but because the losses from trade liberalization are greater than the losses

incurred by the domestic downstream firm. Note that, even though there is no explicit political economy in the model presented above, this is a different insight into the potential for opposing trade liberalization in vertically-related markets. The above analysis shows that the incentive for the domestic upstream firm is stronger than for the domestic downstream firm; in contrast, Grossman and Helpman (1994) argue that opposition is likely to be stronger from the domestic downstream firm. To the extent that this is true, this may result in lower reductions in downstream tariffs (and possibly tariff escalation) while the domestic upstream firm suffers more from trade liberalization.

In sum, the overall policy implication implied by this framework suggests an important justification for formula approaches to tariff reductions that has not been identified before. Not only do they make negotiations potentially simpler (the common justification for such approaches), but have some formal basis in terms of the mechanisms that arise in successively oligopolistic markets. To the extent that formulae approaches to tariff reductions can counteract the influence of domestic downstream and upstream firms (and ensure that the gains to consumers from trade liberalization can be fully realized), they have the potential to ensure that the effects of trade liberalization are not unequally distributed between the domestic upstream and downstream firms or, at least, that the relative profitability effects are dissipated.

5. Summary and Conclusions

In this paper, we have focused on the issue of simultaneous changes in tariffs in a vertically-related market where each stage can be imperfectly competitive. We show that,

due to a combination of horizontal and vertical mechanisms that arise in a vertically-related sector, an identical and simultaneous change in tariffs at each stage is likely to have a differential effect on market access and profits for domestic firms at each stage, specifically the domestic upstream firm will see its profits changing by more than the domestic downstream firm. This has potential insights for trade reform that have been largely unexplored. Though tariff reduction formulae have been widely employed as part of the trade negotiating process, their advocacy has often been on an *ad hoc* basis relating to the reduction in tariff peaks that typically arise in more processed goods. In this context, the mechanisms explored in this paper show that tariff de-escalation is a necessary part of ensuring that the burden of adjustment to trade liberalization is not unequally felt by a domestic firm at one stage compared to another. As such, rules that promote tariff de-escalation ensure (a greater extent of) parity in terms of the changes in profits between domestic upstream and downstream firms in successively-oligopolistic markets.

References

- Anderson, J.E. (1998) "Effective Protection Redux" *Journal of International Economics* (44): 21-44.
- Balassa, B. (1965) "Tariff Protection in Industrial Countries" *Journal of Political Economy* (73): 573-594.
- Bernofen, D.M. (1997) "Strategic Trade Policy in a Vertically Related Industry" *Review of International Economics*, 5: 429-433.
- Bulow, J.I., J.D. Geanakoplos, and P.D. Klemperer (1985) "Multi-Market Oligopoly: Strategic Substitutes and Complements" *Journal of Political Economy* (93): 488-511.
- Cadot, O., J. de Melo, and M. Olarreaga (2004) "Lobbying, Counter-Lobbying, and the Structure of Tariff Protection in Poor and Rich Countries" *The World Bank Economic Review* (18): 345-366.
- Colangelo, G. and U. Galmarini (2001) "Ad Valorem Taxation on Intermediate Goods in Oligopoly" *International Tax and Public Finance* (8): 53-74.
- Corden, M. (1971) *The Theory of Protection*, Clarendon Press: Oxford.
- Ethier, W.J. (1977) "The Theory of Effective Protection in General Equilibrium: Effective Rate Analogues of Nominal Rates" *Canadian Journal of Economics* (10): 233-245.
- Fullerton, D. and G.E. Metcalf (2002) "Tax Incidence", in A.J. Auerbach and M. Feldstein (eds.) *Handbook of Public Economics*, Elsevier Science: Amsterdam.
- Francois, J. and W. Martin (2003) "Formula Approaches for Market Access Negotiations" *World Economy* (26): 1-28.
- Greenaway, D. and C. Milner (2003) "Effective Protection, Policy Appraisal and Trade Policy Reform" *World Economy* (26): 441-456.
- Grossman, G.M. and E. Helpman (1994) "Protection for Sale" *American Economic Review* (84): 833-850.
- Ishikawa, J. and K.D. Lee (1997) "Backfiring Tariffs in Vertically Related Markets" *Journal of International Economics* (42): 395-423.
- Ishikawa, J. and B.J. Spencer (1999) "Rent-Shifting Export Subsidies with an Imported Intermediate Product" *Journal of International Economics* (48): 199-232.

- OECD (1996) *Tariff Escalation and the Environment*. OECD, GD(96) 171, Paris.
- Oxfam (2003) *Northern Agricultural Policies and World Poverty: Will the Doha 'Development Round' make a difference?* Oxfam: Oxford.
- Sharma, R. (2007) "The Doha Round Agricultural Tariff-Cutting Formulae and Tariff Escalation" in J. Morrison and A. Sarris (eds.) *WTO Rules Compatible with Economic Development*. FAO, Rome.
- Spencer, B.J. and R.W. Jones (1991) "Vertical Foreclosure and International Trade Policy" *Review of Economic Studies* (58): 153-170.
- Spencer, B.J. and R.W. Jones (1992) "Trade and Protection in Vertically-Related Markets" *Journal of International Economics* (32) 31-55.
- UNCTAD (2002) *Export Diversification, Market Access and Competitiveness*, United Nations, UNCTAD/TD/B/COM.1/54: Geneva.
- World Bank (2003) *Global Economic Prospects: Realizing the Development Promise of the Doha Agenda*, World Bank: Washington, D.C.
- World Trade Organization (2008) *Revised Draft Modalities for Agriculture*. WTO, TN/AG/W/4/Rev.2, Geneva.