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Tariff Equivalent of Technical Barriers to Trade with Imperfect Substitution and Trade Costs

Chengyan Yue, John Beghin, and Helen H. Jensen
Iowa State University

578 Heady Hall, Ames, IA 50011 USA
515-294-6253, Fax: 515-294-6336



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Tariff Equivalent of Technical Barriers to Trade with Imperfect Substitution and Trade Costs

Abstract: The price-wedge method yields a tariff-equivalent estimate of technical barriers to trade (TBT). An extension of this method accounts for imperfect substitution between domestic and imported goods and incorporates recent findings on trade costs. We explore the sensitivity of this revamped tariff equivalent estimate to its determinants (substitution elasticity, preference for home good, trade cost, and to the reference data chosen). We use the approach to investigate the ongoing U.S.-Japan apple trade dispute and find that removing the Japanese TBT would yield limited export gains to the United States. We then draw policy implications of our findings.

Keywords: SPS, WTO, technical barriers, Japan, trade cost.

JEL Code: F1, F18, Q17, Q18

1. Introduction

Article 20 of the General Agreement on Tariffs and Trade (GATT) permits governments to set their own standards and regulations on trade in order to protect human, animal, or plant life or health, provided they do not discriminate among countries or use this motive as concealed protectionism. In addition, two specific World Trade Organization (WTO) agreements deal with food safety and animal and plant health, and with product standards: the Sanitary and Phytosanitary Measures Agreement (SPSA) and the Technical Barriers to Trade Agreement (TBTA). The SPSA allows countries to set their own standards, but it requires that the standards should not arbitrarily discriminate between countries with similar conditions. The TBTA is generated to minimize unnecessary obstacles in regulations, standards, and testing and certification procedures. In practice, however, some governments use stricter health and safety regulations than necessary to isolate domestic producers from international competition. The stricter regulations may lead to questionable impediments to imports that compete with domestic products, in addition to the existing tariff barriers. When the possibility of a disease or pest transmission is very low or threat to food safety is small, these trade impediments often cause welfare losses for importing countries and mercantilist losses for exporting countries due to reduced exports.

These issues have of course attracted the attention of economists (Anderson, McRae, and Wilson, 2004; Bureau, Marette, and Schiavina, 1998; Josling, Roberts, and Orden, 2004; and Roberts and Krissoff, 2003). The growing literature on sanitary and phytosanitary (SPS) regulations and other TBTs often uses a price wedge approach to quantify the impact of a barrier on market equilibrium and trade (see for example, Calvin and Krissoff, 1998; and Campbell and Gossette, 1994). Although not unique or sophisticated, the method has been legitimized in the economics literature with some prescriptions and qualifiers to account for transportation cost and quality differences (Baldwin, 1991; and Deardorff and Stern, 1999). The use of a price wedge approach often abstracts from quality differences or simply addresses the difference by choosing “close” substitutes. Transportation costs may be reduced to the CIF-FOB differential and abstract from the internal transportation cost once imports are landed. All price-wedge estimates we are aware of rely on the assumption of homogeneous commodities and a price arbitrage condition. By assuming that domestic and imported goods are perfect substitutes, the gap between their prices reflects trade impediments from various policies and natural protection. Border tariffs and transportation and transaction costs prevent full arbitrage between the two prices (Head and Mayer, 2002). Hence, in principle, the price gap can yield an estimate of the TBT once transportation and trade costs and other impediments have been taken into account.

In this paper we derive a revamped tariff equivalent of a TBT. We extend the price-wedge framework by first relaxing the homogeneous commodity assumption, a straightforward but instrumental step overlooked in the literature on TBT measurement. We account explicitly for commodity heterogeneity and perceived quality of substitutes. Next, we incorporate recent developments and findings on large and costly border effects arising from transportation, linguistic differences, and poor infrastructure and law enforcement (Anderson and van Wincoop, 2004; and Head and Mayer, 2002; and Hummels and Skiba, 2003). Two major findings of this new literature are particularly relevant to our work. First, trading costs are very large and often greater than policy impediments and cannot be ignored. While CIF/FOB ratios have fallen over time, other transportation and trade costs have remained high and have been underestimated. Second, these costs are structured on a per-unit basis rather than following the so-called iceberg method; that is, they act as a specific tariff rather than an ad valorem tax (Hummels and Skiba, 2003). These per-unit costs shift supply in a parallel manner rather than proportionally, which influences the estimate of the TBT.

We systematically explore the robustness of the tariff-equivalent estimate to underlying assumptions, i.e., commodity heterogeneity, consumer preference for the home good, trading and transportation costs, and the chosen reference data. Using a simple approach, we derive the sensitivity of the tariff equivalent to varying assumptions on these determinants and its implications for welfare analysis.

Our paper bridges two methods often used to estimate the trade effects of TBTs: the tariff-equivalent-price-wedge approach mentioned previously and use of a gravity equation. Recent conceptual developments have provided theoretical foundations to the gravity equation approach and account explicitly for relative prices of traded and domestic substitutes and for trading costs. In addition, they attempt to better measure and decompose “border effects” of trade barriers and transportation costs between trade partners. These new approaches have been applied to aggregate trade data but not to individual commodities (Anderson and van Wincoop, 2004; Head and Mayer, 2003).

In an often-cited paper, Calvin and Krissoff (1998) provide a tariff equivalent of phytosanitary barriers in the Japanese apple market regarding the risk of contamination by fire blight and codling moths that has been the origin of a long WTO dispute between the US and Japan (WTO, 2002-2004). The dispute has attracted much attention and in June 2005, the WTO found Japan to be in violation of the SPS Agreement by maintaining phytosanitary measures that are not supported by sufficient scientific evidence (WTO, 2005). Calvin and Krissoff (1998) use the law of one price under a homogeneous commodity assumption (arbitrage condition) to calculate the tariff equivalent of SPS barriers affecting apple imports in Japan to avoid damages from fire blight and codling moths. By assuming that Japan’s domestic apples and imported apples are perfect substitutes, the gap between the prices of domestic and imported apples accounts for the border tariff and other trade impediments that prevent full arbitrage. The latter authors also abstract from other border effects (internal transportation and transaction costs), leading to a likely overstatement of the TBT barrier. They use several reference years to mitigate annual variations in the reference data used to calibrate the tariff equivalent to the TBTs. Using recent data and the proposed revamped approach, we provide a new investigation of the Japan-US apple dispute. We compute the tariff equivalent of associated Japanese TBT regulations and quantify the impact of removing these policies on welfare and apple trade flows. We also draw policy implications. The apple dispute offers an opportunity to validate our contention that departures from perfect substitution, significant trade costs, and reference data have a substantial impact on the tariff equivalent estimate of SPS/TBT regulation and hence on welfare and policy implications derived from this estimate.

2. Analytical Framework

As in the gravity equation, we use the simple constant elasticity of substitution (CES) model to incorporate the heterogeneity of goods in consumers’ preferences and eventually to calculate the tariff equivalent of a TBT (Hummels and Skiba, 2003). Define domestic and imported goods, D and I. We assume the case of a small country facing a parametric exogenous world price of imports. The price p_D of the domestic good is determined by the domestic good market equilibrium, as explained later in the paper. The representative consumer maximizes utility U subject to a budget constraint:

$$\underset{D,I}{Max} \quad U(D,I) = (aD^r + (1-a)I^r)^{1/r} \quad s.t. \quad p_D D + p_I I = M, \quad (1)$$

where M is expenditure; a, r are parameters reflecting preferences; and p_D and p_I are retail prices of the two goods D and I. Home-good preference implies $\alpha > 1/2$. The associated Marshallian demand functions are

$$D(p_D, p_I, M) = \left(\frac{a}{p_D} \right)^s \frac{M}{a^s p_D^{1-s} + (1-a)^s p_I^{1-s}}, \quad (2)$$

$$I(p_D, p_I, M) = \left(\frac{1-a}{p_I} \right)^s \frac{M}{a^s p_D^{1-s} + (1-a)^s p_I^{1-s}}, \quad (3)$$

and with $S = \frac{1}{1-r}$ being the elasticity of substitution.

The corresponding indirect utility function is

$$V(p_D, p_I, M) = M(a^S p_D^{1-S} + (1-a)^S p_I^{1-S})^{\frac{1}{S-1}}, \quad (4)$$

and adding the corresponding expenditure function, we have

$$e(p_D, p_I, u) = u(a^S p_D^{1-S} + (1-a)^S p_I^{1-S})^{\frac{1}{1-S}}. \quad (5)$$

The importing price p_I includes the import unit cost (CIF price inclusive of the international component of trade cost), the tariff, the tariff equivalent of the SPS or TBT barriers, and the internal transportation cost. All these components translate into a definition of the price

$p_I = p_{CIF}(1+t+t_{TBT})+t_R$, where p_{CIF} is the observed CIF (unit cost plus insurance and freight and other international trade costs) price of I , t is the tariff rate, t_{TBT} is the tariff equivalent of the TBT or SPS measure, and t_R is the per-unit transportation and transaction cost from the harbor to the wholesale internal market. The CIF price can itself be decomposed into an export price from the originating country and an international transportation cost component.

From utility maximization, we know that the marginal rate of substitution is equal to the relative price of the substitute goods or

$$MRS = \frac{MU_D}{MU_I} = \frac{p_D}{p_I} = \frac{p_D}{p_{CIF}(1+t+t_{TBT})+t_R}, \quad (6)$$

where MRS is the marginal rate of substitution, and MU_j indicates the marginal utility of good j . From Equation (8), the ad valorem tariff equivalent t_{TBT} is solved after deriving the MRS from Equation (1) and substituting it back into Equation (6). The equivalence between the price-wedge measure t_{TBT} and the TBT holds D/I constant. The ad valorem tariff equivalent is a function of the relative cost of the two goods, their volumes, the elasticity of substitution, the preference parameter, internal transaction and transportation cost, and ad valorem border tariff:

$$t_{TBT} = \frac{p_D}{p_{CIF}} \frac{1-a}{a} \left(\frac{D}{I} \right)^{\frac{1}{S}} - 1 - t - \frac{t_R}{p_{CIF}} \quad (7)$$

Here we treat internal transaction and transportation cost as specific instead of ad valorem, which mitigates the variability of t_{TBT} to different CIF price values across different reference years. For example, assuming $\sigma=10$, when transportation and transaction cost is treated as specific, t_{TBT} is 170%, 86%, and 131% for years 1998, 1999, and 2000 respectively; but when the cost is treated as ad valorem, t_{TBT} is 186%, 72%, and 137% for the corresponding three years.

To measure the sensitivity of the t_{TBT} to assumptions on unobservables, we hold “observed” variables D , I , P_D , P_{CIF} , and t_R constant and obtain the following sensitivity elasticities of the tariff equivalent of the TBT with respect to its determinants S , and a , $e_{(\cdot)} = \frac{\partial \ln t_{TBT}}{\partial \ln(\cdot)}$:

$$\varepsilon_S = \frac{\partial \ln t_{TBT}}{\partial \ln S} = -\frac{\frac{p_D}{p_{CIF}} \frac{1-a}{a} \left(\frac{D}{I}\right)^{\frac{1}{s}} \ln\left(\frac{D}{I}\right) \frac{1}{S}}{t_{TBT}} < 0 \text{ if } D > I, \quad (8)$$

$$e_a = \frac{\partial \ln t_{TBT}}{\partial \ln a} = -\frac{\frac{p_D}{p_{CIF}} \frac{1}{a} \left(\frac{D}{I}\right)^{\frac{1}{s}}}{t_{TBT}} < -1. \quad (9)$$

Reference data used to calibrate Equation (7) also matter greatly. To measure the sensitivity of t_{TBT} to the chosen reference data, we derive similar elasticities with respect to quantity volumes D and I , relative prices P_D and P_{CIF} , and transportation cost and ad valorem tariff t_R and t :

$$e_D = \frac{\partial \ln t_{TBT}}{\partial \ln D} = \frac{\frac{1}{S} \frac{p_D}{p_{CIF}} \frac{1-a}{a} \left(\frac{D}{I}\right)^{\frac{1}{s}}}{t_{TBT}} > 0, \quad (10)$$

$$e_I = \frac{\partial \ln t_{TBT}}{\partial \ln I} = -\frac{\frac{1}{S} \frac{p_D}{p_{CIF}} \frac{1-a}{a} \left(\frac{D}{I}\right)^{\frac{1}{s}}}{t_{TBT}} < 0, \quad (11)$$

$$e_{p_D} = \frac{\partial \ln t_{TBT}}{\partial \ln p_D} = \frac{\frac{p_D}{p_{CIF}} \frac{1-a}{a} \left(\frac{D}{I}\right)^{\frac{1}{s}}}{t_{TBT}} > 1, \quad (12)$$

$$e_{p_{CIF}} = \frac{\partial \ln t_{TBT}}{\partial \ln p_{CIF}} = -\frac{\frac{p_D}{p_{CIF}} \frac{1-a}{a} \left(\frac{D}{I}\right)^{\frac{1}{s}}}{t_{TBT}} + \frac{t_R}{p_{CIF}} < -1, \quad (13)$$

$$e_{t_R} = \frac{\partial \ln t_{TBT}}{\partial \ln t_R} = -\frac{t_R}{t_{TBT} p_{CIF}} < 0, \quad (14)$$

and

$$e_t = \frac{\partial \ln t_{TBT}}{\partial \ln t} = -\frac{t}{t_{TBT}} < 0. \quad (15)$$

Elasticity ε_σ is large in absolute value for small values of σ and converges to zero as σ increases. Elasticity ε_α , in absolute value, is the largest of the sensitivity measures; it decreases as goods D and I become closer substitutes but remains larger than 1. This fact has implications for gravity equation analyses, which often impose $\alpha = 0.5$. This restriction may strongly bias the estimates of impediments to trade. The measures ε_D and ε_I are equal and opposite in sign and also depend on the value of σ . The values decrease in absolute value as D and I become closer substitutes. Sensitivity measures ε_{P_D} and $\varepsilon_{P_{CIF}}$ are equal in absolute value and larger than one but smaller than ε_α by a factor of $(1-\alpha)$. They decrease as goods are closer substitutes but remain larger or equal to 1 in absolute value. The sensitivity measures ε_{t_R} and ε_t will be small (large) in absolute value if the transportation costs, t_R , and the tariff, t , were to be small (large) and if the estimate of the TBT, t_{TBT} , were to be large (small).

Hence, we can identify a taxonomy of the cases. If goods D and I are known to be poor substitutes (presumption of small σ), the TBT estimate will be very sensitive to the value of σ and parameter α and to chosen reference prices and quantities. However, if goods D and I are known to be very close substitutes (with presumption of high σ), the tariff estimate of the TBT will be much less sensitive to pinning down the exact elasticity of substitution, and to reference data volumes D and I . Sensitivity to chosen reference prices and preference parameter α will still be important and larger than 1 in absolute value. Sensitivity to changes in internal transportation or transactions costs and the tariff rate will depend on their initial values and could be large for protected and poorly integrated sectors.

For the welfare analysis, we use the usual Equivalent Variation (EV) and Compensating Variation (CV) measures of the consumer's welfare, with $EV = e(\bar{p}_0, u_1) - m_0$ and $CV = m_1 - e(\bar{p}_1, u_0)$, where $\bar{p} = (p_D, p_I)$ and subscripts 0 and 1 indicate initial and new prices.

We use a small displacement model to determine the price of domestic apples and eventually infer the impact of removing the TBT barrier on imports and domestic market equilibrium. Let S be the retail supply of domestic apples, which is an increasing function of domestic apple price and exogenous parameter λ :

$$S(p_D, \lambda) = \lambda p_D^{\varepsilon_s}, \quad (16)$$

where ε_s represents the own-price elasticity of the domestic apple supply. Decreases in parameter λ would reflect upward shifts in supply if contamination occurs and induces an increase in the cost of production. Using Equations (2) and (16) the equilibrium domestic price p_D^e and quantity are determined by market equilibrium condition, or

$$D(p_D^e, p_I) = S(p_D^e, \lambda). \quad (17)$$

Equations (2, 3, 7, and 16), and condition (17) constitute the model. With the elimination of t_{TBT} , p_I decreases and p_D will fall as a result if there is no risk of contamination from the increased imports. The demand for domestic products declines with the change in p_I . Then the domestic market adjusts at a lower price such that demand equals supply. Imports expand as the direct effect of the decrease in the import price is larger than the feedback effect of the lower domestic price, by stability. If contamination occurs, the price of domestic apples may not decrease as the domestic supply shifts upward to reflect the increased cost from contamination. The domestic apple equilibrium quantity is further reduced by the contamination. Imports increase. For simplicity, we assume away feedback

effects from apple suppliers into the income of the representative consumer. We turn next to our investigation of the Japan-U.S. apple dispute starting with some key stylized facts on the dispute.

3. The Japan-U.S. Apple Dispute

The high technical barriers to importing apples into Japan have brought repeated complaints from several exporting countries and have led to a 30-year dispute (Elms, 2004). The latest episode of this dispute has been taking place within the WTO. *Japan-Measures Affecting the Importation of Apples* (WTO 2002-2004) relates to the United States' complaint about the Japanese requirements imposed on apples imported from the United States and their inconsistency with WTO principles. The prohibitions and requirements included, for example, the prohibition of imported apples from states other than designated areas in Oregon and Washington; the prohibition of imported apples from any orchard (whether it is free of fire blight or not) if fire blight was detected within a 500-meter buffer zone surrounding such orchard; the requirement that export orchards be inspected three times a year (at blossom, fruitlet, and harvest stages) to check if fire blight is present in order to apply the aforementioned prohibitions; the requirement that at the post-harvest stage apples for export to Japan be separated from fruits for export to other markets; and chlorination of apples for export to Japan.

In 1997, the United States requested that Japan modify its import restrictions on apples based on published scientific evidence that mature, symptomless apples are not carriers of fire blight. In 2000, the United States agreed to carry out joint research proposed by Japan to confirm the results of those earlier studies. The USDA's Agricultural Research Service (ARS) and Japan's Ministry of Agriculture Forestry and Fisheries (MAFF, various issues) conducted the joint research. The research results confirmed that mature, symptomless apples are not carriers of fire blight. This finding provided additional scientific support for the U.S. position. Since the results of this research were released in February 2001, the U.S. government has repeatedly pressured Japan to modify its import restrictions. After extensive bilateral discussions with USDA scientists, Japan refused to modify its import restrictions in October 2001.

In March 2002, the United States requested WTO consultations concerning Japan's import restrictions on U.S. apples. Consultations in April 2002 failed to settle the dispute. In May 2002, the United States requested that the WTO establish a panel to consider the Japanese restrictions. In June 2002, a panel was established by the Dispute Settlement Body (DSB) of the WTO to consider this issue. Before the Panel, the United States claimed that Japan was acting inconsistently with some articles of the SPSA, certain articles of the Agreement on Agriculture, and the so-called "GATT 1994." In July 2003, the Panel found that Japan's phytosanitary measures were maintained without sufficient scientific evidence and inconsistent with Japan's obligation, did not qualify as a provisional measure, and were not based on a risk assessment. In September 2003, Japan appealed the WTO Panel ruling. In addition to Japan's appeal, the United States cross-appealed the Panel Report. At the same time, third participants, such as Australia, Brazil, the European Communities, and New Zealand, filed their submissions. After more investigations, in November 2003, the DSB upheld the findings of July 2003. Therefore, the Appellate Body recommended that the DSB request that Japan bring its inconsistent measures into conformity with SPSA.

Half a year later, in July 2004, the United States held that Japan failed to comply with the recommendations and rulings of the DSB by the end of the reasonable period of time. Therefore, the United States requested that the DSB establish a panel and simultaneously requested authorization on suspension of concessions and other obligations in one or more of the following: tariff concessions and related obligations under the GATT 1994 on a list of products; and concessions and other obligations under the SPS Agreement and the Agreement on Agriculture. Because Japan objected to the United States' suspension request, this matter was referred to arbitration. After consultation with scientific experts, the Panel provided its final report that finds Japan in violation of the SPS Agreement in June 2005, nearly nine years after the initial U.S. complaint.

Between 1971 and 1992, Japan imported only 4,500 boxes of apples, all from South Korea and North Korea. In June of 1993, Japan permitted some import of New Zealand apples. After that, the United States and Australia also exported apples to Japan from year to year. Although Japan opened its door to foreign apples, the importing quantity has been quite low compared with the domestic production. As shown in Table 1, the import shares never exceeded 0.1% between 1998 and 2000. The low import share is partly due to the high tariff and TBT barrier. Table 1 shows that the border price is much lower than the domestic wholesale price.

Table 1. Japanese Apple Production and Imports.

| Year | Domestic Production (MT) | Domestic Wholesale | | Import | | Import Share |
|------|--------------------------|--------------------|----------------|---------------|--------------------|--------------|
| | | Quantity (MT) | Price (yen/kg) | Quantity (MT) | CIF Price (yen/kg) | |
| 1998 | 879100 | 753000 | 217 | 221 | 136 | 0.03% |
| 1999 | 927700 | 668200 | 264 | 308 | 233 | 0.05% |
| 2000 | 799600 | 691600 | 238 | 594 | 156 | 0.09% |

Source of data: Japan Customs. Note: MT denotes metric tons.

In addition to the high technical barrier referred to in the dispute, the higher quality of the domestic product cannot be neglected. Fruits in general and apples in particular are an important part of the Japanese diet (Huang, 2004). Japanese consumers exhibit a strong home-good preference relative to imported apples. This fact has been repeatedly established (Kajakawa, 1998; USDA, 1997; and American University). According to Japanese consumers, domestic apples have a higher quality because of their sweeter flavor and bigger size. For instance, after Japan opened its apple market to imports in 1995, U.S. apples entered Japan at much lower prices than Japanese domestic products. However, after an initial success, the sales of U.S. apples declined because Japanese consumers complained that U.S. apples were too sour and did not cater to Japanese tastes (American University). Japanese consumers prefer apples with brix (a measure of sugar level) in a certain range and a specific brix-to-acid ratio. But imported apples do not meet these requirements. In addition, imports are smaller in size and less juicy (Kajikawa, 1998). For Japanese consumers who believe that apples must have an appropriate brix and acid level, firmness, juice, size, and flavor, imported apples cannot be a perfect substitute for domestic products.

Japanese farmers produce apples with great care and the production of apples is labor intensive. Leaves near each apple are usually plucked away when the fruit is still on the tree, which ensures that the apple receives enough and balanced sunlight to insure full ripening. Several weeks before harvesting, bags are used to protect individual apples in order to prevent any kind of surface marring. This labor-intensive production leads to a higher quality and at the same time comes at a higher cost. Because of the quality difference and trade barriers, Japanese producers are able to pass the higher costs to consumers in the form of a higher price. Hence, the trade barriers do not explain the entire price wedge. A price differential reflecting the quality premium would remain under free trade. In addition, as a fresh fruit, the internal transportation cost for apples is high and cannot be ignored.

4. Quantifying the Apple Dispute

We apply the framework developed in section 2 to imported apples in Japan. We use all imported apples to estimate I and the average import unit cost measured as the CIF price, shown in Table 1, and to compute the tariff equivalent of the Japanese TBT regulations.¹ Then we estimate the impact of eliminating the TBT. The transportation and transaction cost, t_R , is approximately 96 yen/kg. The latter is obtained from Anderson and van Wincoop (2004), who provide a median estimate for

1. Alternatively, we treat imports from different countries as imperfect substitutes using a double-nested CES model and calculate the tariff level of TBTs. Results are quite similar to what we present in this paper. For example, when we assume the elasticity of substitution among imports as 10, and $S = 10$, the TBT is 145%, which is quite close to the 130.54% TBT level obtained by aggregating all imports into one good.

transportation and transaction costs of 55 percent (percentage of CIF unit value), which includes domestic distribution from harbor to wholesale market, border barriers, language, and currency barriers. We apply this estimate to each year and average over the corresponding three years 1998-2000 to obtain the 96 yen/kg as a per-unit cost. The tariff rate is listed in Table 2; the average rate of the three years is 17.6%. As in Calvin and Krissoff (1998), the long-run supply elasticity of domestic apples is assumed to be 1. We follow the estimate of the Australian Department of Primary Industries and Fisheries and assume that with the transmission of pest and disease the production of apples would decrease by a fixed proportion of 20% with the TBT in place.

To test the sensitivity of the value of t_{TBT} to the elasticity of substitution, we assign different values to S , with 5 unit increments. Estimates for $S = 5, 10$, and 15 are shown in Table 2. To test the sensitivity of the value of t_{TBT} to a and to t_R , the transportation and transaction rate, different values are assigned to them (for example, see Tables 4 and 5). The default value for a is 0.5 as assumed in many gravity equation analyses.

4.1. TBT Tariff Equivalent Estimate and its Sensitivity Analysis

The last three columns of Table 2 show the tariff equivalent of the TBT when S is assigned to different values.

Table 2. TBT Tariff Equivalent with Different Values of S .

| Year | Tariff Rate(%) | t_{TBT} ($S = 5$) | t_{TBT} ($S = 10$) | t_{TBT} ($S = 15$) |
|------|----------------|--------------------------|---------------------------|------------------------|
| 1998 | 18.20% | 621.58% | 170.46% | 85.14% |
| 1999 | 17.60% | 368.74% | 85.81% | 30.52% |
| 2000 | 17.00% | 447.76% | 130.54% | 65.70% |

Note: Transportation plus transactions costs equal 96.19 yen/kg. $a = 0.5$.

Source: WTO schedules and Japan Customs.

The t_{TBT} value is relatively low in 1999 compared with the other two years. This is because the border price of that year is much higher than the other two years. The reason is that in 1999, the world price of oil doubled relative to 1998 because of strong world oil demand, an OPEC oil production decline, and low oil stock levels. The higher oil price made the international transportation cost much higher than for other years, which in turn led to a higher border price and domestic wholesale price (this phenomenon also occurred for other fruits such as summer oranges, Japanese pears, and peaches). We can see that t_{TBT} changes noticeably with different values of S . The higher the value of S , the lower the tariff equivalent t_{TBT} . The intuition behind this is straightforward. The higher the elasticity of substitution, the smaller the required change in price P_I in order to have consumers switching to domestic apples.

Table 3 gives the elasticity of t_{TBT} with respect to S (holding t_R , a constant). Measures of e_s show that t_{TBT} is sensitive to S , especially when the value of S is low (imperfect substitutes). For example, when $S = 5$, e_s is less than -1.4, a value which indicates t_{TBT} would differ a lot even if the change in S was to be small. Tripling S reduces the tariff-equivalent estimate by one order of magnitude. Thus, S plays an important role in the calculation of t_{TBT} . When S gets larger, the sensitivity gets smaller in absolute value. When $S = 50$ (approximating perfect substitution), the sensitivity is not as high as before, but it is still significant.

Table 3. Elasticity of t_{TBT} with Respect to S ($a=0.5$; $t_R = 96$ yen/kg).

| S | 5 | 10 | 15 | 20 | 25 | 30 | 50 |
|------------|--------|--------|-------|--------|--------|--------|--------|
| e_s 1998 | -1.627 | -0.813 | -0.54 | -0.407 | -0.325 | -0.271 | -0.163 |
| e_s 1999 | -1.536 | -0.768 | -0.51 | -0.384 | -0.307 | -0.256 | -0.154 |
| e_s 2000 | -1.412 | -0.706 | -0.47 | -0.353 | -0.282 | -0.235 | -0.141 |

Table 4 gives the elasticity of t_{TBT} with respect to a (holding S , t_R constant); t_{TBT} is highly sensitive to a around $a=0.5$ but this high sensitivity decreases somewhat as a increases. Good information on a appears to be critical in estimating the tariff equivalent of the TBT.

Table 4. Elasticity of t_{TBT} with Respect to a ($S=10$; $t_R = 96$ yen/kg).

| a | 0.50 | 0.52 | 0.54 | 0.56 | 0.58 | 0.60 | 0.62 |
|------------|-------|-------|-------|-------|-------|-------|-------|
| e_a 1998 | -4.22 | -3.45 | -2.86 | -2.39 | -2.02 | -1.71 | -1.46 |
| e_a 1999 | -5.71 | -4.43 | -3.53 | -2.87 | -2.36 | -1.96 | -1.64 |
| e_a 2000 | -4.74 | -3.80 | -3.11 | -2.57 | -2.15 | -1.81 | -1.53 |

Table 5 gives the elasticity of t_{TBT} with respect to t_R (holding S , a constant) and shows that t_{TBT} is sensitive to t_R when the latter gets large but goes to zero as t_R decreases. Around the central value (96 yen/kg) used in our computation, the elasticity of t_{TBT} to t_R is approximately -0.5 and hence plays an important role in the calculation of the t_{TBT} .

Table 5. Elasticity of t_{TBT} with Respect to t_R (yen/kg) with $S=10$, and $a=0.5$.

| t_R | 17.5 | 35 | 52.5 | 70 | 87.5 | 105 | 122.5 |
|----------------|--------|--------|--------|--------|--------|--------|--------|
| e_{t_R} 1998 | -0.056 | -0.119 | -0.190 | -0.271 | -0.363 | -0.469 | -0.594 |
| e_{t_R} 1999 | -0.063 | -0.134 | -0.220 | -0.310 | -0.420 | -0.550 | -0.706 |
| e_{t_R} 2000 | -0.062 | -0.132 | -0.210 | -0.304 | -0.412 | -0.539 | -0.690 |

Additional analyses of the elasticity of t_{TBT} with respect to the domestic and imported quantities (not reported here) show the tariff equivalent t_{TBT} is less sensitive to the domestic and imported quantities than it is to their prices. The moderate elasticities remain nearly constant as quantity levels change. In contrast, the elasticity of t_{TBT} with respect to the domestic price is always greater than one and gets larger as the domestic price increases, and the elasticity of t_{TBT} with respect to the CIF price is less than -1 and gets smaller as the CIF price increases. The elasticity of t_{TBT} with respect to t (holding S and a constant) indicates that the sensitivity of t_{TBT} goes up as the value of the tariff rate increases, although all of the estimated values are less than -0.5 (in absolute value) for t , ranging from 0.1 to 0.3.

4.2 Welfare Analysis of the TBT Removal

The import increases are shown in Table 6 for different values of S . By eliminating the TBT (alone and with border tariff elimination), apple imports would increase substantially, between 33 and 145 10^3 MT, depending on the base year and the assumed elasticity of substitution. These magnitudes are in a range of values comparable to those of Calvin and Krissoff (1998). These larger imports

remain moderate relative to domestic apple consumption. Japan imports apples from Australia, New Zealand, South Korea, and the United States. The U.S. share of apple imports by Japan has varied widely over time. In 2000, the value share of U.S. apples into total apple imports was 24%; in 1999, it was 54%; and in 1998, it was 0%. Based on the 2000 share, and $s = 5$, the expansion of U.S. imports by Japan would only amount to US\$48 million, and even less, about US\$13 million, if one assumes $s = 15$.² The losses to U.S. exporters and producers would be smaller than the value of imports, first because they would be valued at lower FOB prices and farmgate prices, respectively, and because producer surplus losses are always smaller than the gross value of forgone production opportunities. The US\$ 48 million figure is about a third of the lost exports claimed by the United States at the WTO (US\$143.4 million).

Table 6. Increase in Imports (103 MT) with the Elimination of t_{TBT} and Tariff ($a = 0.5$).

| Years | Elimination of t_{TBT} | | | Elimination of t_{TBT} + Tariff | | |
|-------|--------------------------|----------|----------|-----------------------------------|----------|----------|
| | $s = 5$ | $s = 10$ | $s = 15$ | $s = 5$ | $s = 10$ | $s = 15$ |
| 1998 | 144.5 | 69.8 | 32.6 | 196.9 | 124.3 | 81.8 |
| 1999 | 66.6 | 13.4 | 0.67 | 102.2 | 33 | 4.32 |
| 2000 | 139.5 | 70.5 | 37.7 | 187.4 | 122.9 | 89.3 |

Figure 1 shows the demand and supply of domestic apples in year 2000. Curve D (solid line) is the initial demand for domestic apples in 2000. D1 is the demand after the elimination of the TBT and D2 is the demand after the elimination of both TBT and the tariff. S is the supply curve of domestic production without the transmission of disease and pests. St is the supply of domestic apples with the transmission of disease and pests. We can see that the demand for domestic apples shifts inward with the elimination of either TBT or the tariff. And the supply of domestic apples shifts to the left (decreases) with the transmission of disease and pests.

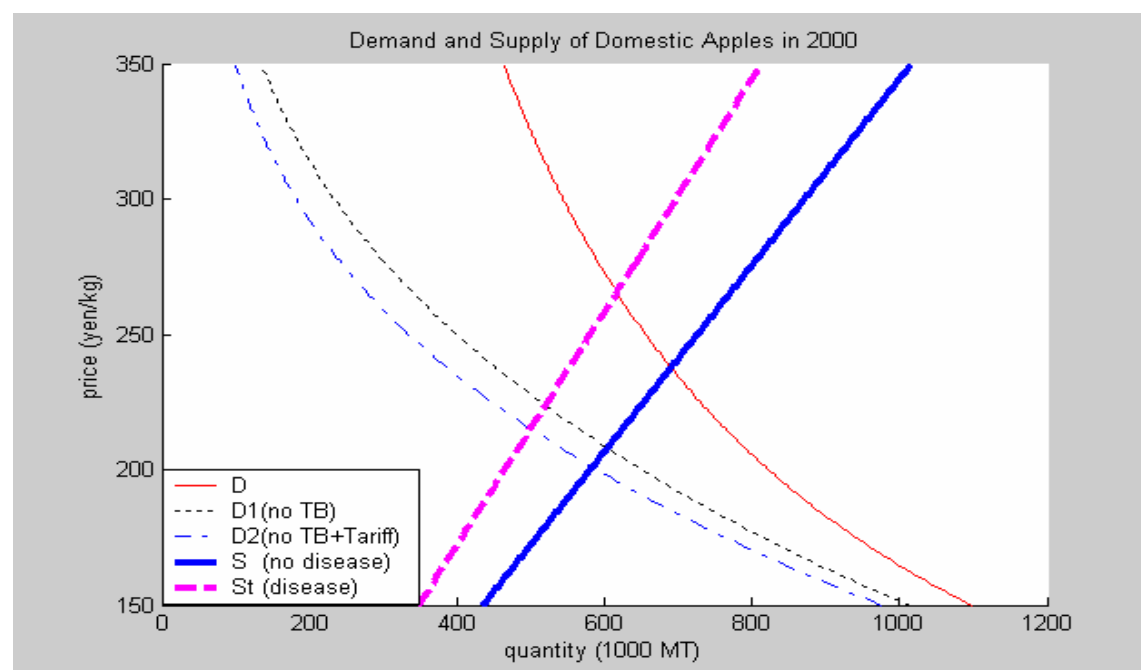


Figure 1. The Demand and Supply Curve of Domestic Apples in 2000 ($s = 5$, $a = 0.5$).

² The incremental US\$ 48 million of U.S. imports come from the 2000 U.S. value share of all apple imports by Japan, or $22249000/92630000 = 24\%$, applied to the expansion in import value ($139.5 \times 10^3 \text{ MT} \times 155.91 \text{ yen/kg}$), expressed in US\$ with an exchange rate of 107.765 yen/\$.

Changes in welfare with elimination of TBT and the tariff under different assumptions on the transmission of disease indicate the relative magnitude of impacts. Table 7 shows the welfare implications of eliminating the TBT and the tariff for 2000, when assuming $\alpha = 0.5$, transportation plus transaction costs of 96 yen/kg, and under the condition of no disease transmission. The table shows that the EV (and CV) and the producer's surplus change dramatically with the change of S . However, when there is no disease transmission, CV net of tariff revenue loss is greater than the loss of the producer's surplus for both elimination of t_{TBT} and elimination of t_{TBT} and the tariff no matter what value S takes. Table 8 shows the welfare implications with disease transmission holding other conditions the same as in the previous analysis. When $S = 5$, the net welfare is positive. But when the value of S is equal to 10 and above, EV plus the tariff revenue do not exceed the loss of the producer's surplus when there is disease transmission. So the elimination of the TBT may not improve welfare. The results apply to the case when both the TBT and the tariff are eliminated.

The results are sensitive to the transportation and transaction cost assumption, as shown in Tables 9 and 10. When the transportation and transaction costs, t_R , are decreased by 64 percent (from 96 yen/kg to 35 yen/kg), the elimination of the TBT leads to an EV net of tariff revenue loss always greater than the loss of the producer's surplus when values of S are less than 30, hence guaranteeing social welfare gains. This is the case either with or without the transmission of disease. When both the TBT and the tariff are eliminated there are social welfare gains for all values of S . From the welfare analysis (Tables 7-10) we see that the welfare implications differ greatly with different values of transportation and transaction costs and a different value σ .

Table 7. Welfare Analysis with Elimination of t_{TBT} (and Tariff)
($t_R = 96$ yen/kg, $\alpha = 0.5$, Without Disease Transmission).

| S | Welfare by Elimination of t_{TBT} | | | | | Welfare by Elimination of t_{TBT} + Tariff | | | |
|-----|-------------------------------------|-------|-------|--------------------------|--------------|--|-------|--------------------------|-------------|
| | Change of Tariff Revenue | EV | CV | Loss of Producer Surplus | Net Welfare* | EV | CV | Loss of Producer Surplus | Net Welfare |
| 5 | 3700 | 36784 | 30070 | 19496 | 20987 | 47441 | 36834 | 23670 | 23755 |
| 10 | 1869 | 13302 | 12308 | 9879 | 5292 | 22379 | 19703 | 15543 | 6820 |
| 15 | 1001 | 6343 | 6108 | 5318 | 2026 | 14443 | 13279 | 11308 | 3119 |
| 20 | 530 | 3176 | 3116 | 2846 | 861 | 10347 | 9736 | 8640 | 1691 |
| 25 | 269 | 1564 | 1549 | 1472 | 360 | 7801 | 7448 | 6787 | 998 |
| 30 | 127 | 731 | 728 | 728 | 130 | 6053 | 5838 | 5422 | 615 |

*Net Welfare=(EV + Change of Tariff Revenue-Loss of Producer Surplus) Note: Welfare is measured in million yen (2000 prices).

Tables 11 and 12 give the welfare implications of eliminating the TBT and the tariff assuming home good preference increases to $\alpha = 0.55$. Results differ from those obtained when an equal preference ($\alpha = 0.5$) is assumed. All welfare measures decrease substantially. For example, under the assumption of no disease transmission, consumer gains (EV) from an elimination of the TBT for $S = 5$ drop from 36,784 under the assumption of $\alpha = 0.5$ (Table 7) to 27,191 when $\alpha = 0.55$ (Table 11). When α varies, the net welfare changes accordingly. The effect of α on the change to consumers' and producers' welfare suggests the need for decisionmakers to account for differences in α in deciding whether the TBT is worth eliminating or not. Gauging α properly is important in providing dependable estimates of the effect of the TBT.

Table 8. Welfare * Analysis with Elimination of t_{TBT} (and Tariff)

($t_R = 96$ yen/kg, $a = 0.5$, With Disease Transmission).

| S | Welfare by Elimination of t_{TBT} Net Welfare | | | | | Welfare by Elimination of t_{TBT} +Tariff | | | |
|-----|---|--------|--------|--------------------------|--------------|---|-------|--------------------------|-------------|
| | Change of Tariff Revenue | EV | CV | Loss of Producer Surplus | Net Welfare* | EV | CV | Loss of Producer Surplus | Net Welfare |
| 5 | 4603 | 26258 | 22648 | 24014 | 6847 | 37765 | 30722 | 28380 | 9369 |
| 10 | 2822 | 3731 | 3648.4 | 16105 | -9552 | 14660 | 13462 | 22565 | -7921 |
| 15 | 1853 | -3411 | -3483 | 11971 | -13529 | 7480.3 | 7155 | 19558 | -12093 |
| 20 | 1260 | -7107 | -7428 | 9355 | -15202 | 3812 | 3726 | 17669 | -13873 |
| 25 | 875 | -9417 | -9988 | 7527 | -16068 | 1540 | 1526 | 16356 | -14832 |
| 30 | 617 | -11013 | -11801 | 6169 | -16565 | -21 | -22 | 15384 | -15421 |

*Net Welfare=(EV + Change of Tariff Revenue-Loss of Producer Surplus)

Table 9. Welfare Analysis with Elimination of t_{TBT} (and Tariff)

($t_R = 35$ yen/kg, $a = 0.5$, Without Disease Transmission).

| S | Welfare by Elimination of t_{TBT} | | | | | Welfare by Elimination of t_{TBT} +Tariff | | | |
|-----|-------------------------------------|-------|-------|--------------------------|--------------|---|-------|--------------------------|-------------|
| | Change of Tariff Revenue | EV | CV | Loss of Producer Surplus | Net Welfare* | EV | CV | Loss of Producer Surplus | Net Welfare |
| 5 | 7345 | 66890 | 47574 | 30145 | 44089 | 87881 | 57309 | 35848 | 52017 |
| 10 | 6123 | 40975 | 32813 | 25137 | 21961 | 62114 | 45107 | 33599 | 28499 |
| 15 | 5500 | 33042 | 27522 | 22583 | 15960 | 54718 | 41075 | 32528 | 22174 |
| 20 | 5114 | 29039 | 24687 | 20999 | 13154 | 51151 | 39032 | 31895 | 19240 |
| 25 | 4849 | 26585 | 22891 | 19911 | 11523 | 49039 | 37790 | 31477 | 17546 |
| 30 | 4654 | 24914 | 21641 | 19112 | 10456 | 47640 | 36954 | 31180 | 16444 |

*Net Welfare=(EV + Change of Tariff Revenue-Loss of Producer Surplus)

Table 10. Welfare Analysis with Elimination of t_{TBT} (and Tariff)

($t_R = 35$ yen/kg ($a = 0.5$, With Disease Transmission).

| S | Welfare by Elimination of t_{TBT} | | | | | Welfare by Elimination of t_{TBT} +Tariff | | | |
|-----|-------------------------------------|-------|-------|--------------------------|--------------|---|-------|--------------------------|-------------|
| | Change of Tariff Revenue | EV | CV | Loss of Producer Surplus | Net Welfare* | EV | CV | Loss of Producer Surplus | Net Welfare |
| 5 | 7345 | 58335 | 43080 | 34892 | 30788 | 80169 | 53926 | 40430 | 39723 |
| 10 | 6793 | 35240 | 29030 | 32273 | 9760 | 57543 | 42647 | 40205 | 17322 |
| 15 | 6787 | 28548 | 24331 | 31011 | 4324 | 51403 | 39178 | 40104 | 11283 |
| 20 | 6778 | 25300 | 21932 | 30262 | 1816 | 48539 | 37492 | 40047 | 8476 |
| 25 | 6767 | 23370 | 20466 | 29764 | 372 | 46881 | 36495 | 40010 | 6855 |
| 30 | 6757 | 22086 | 19475 | 29408 | -565 | 45799 | 35837 | 39984 | 5799 |

*Net Welfare=(EV + Change of Tariff Revenue-Loss of Producer Surplus)

Table 11. Welfare Analysis with Elimination of t_{TBT} (and Tariff)
($t_R = 96$ yen/kg, $a = 0.55$, Without Disease Transmission).

| S | Welfare by Elimination of t_{TBT} | | | | | Welfare by Elimination of t_{TBT} +Tariff | | | |
|-----|-------------------------------------|---------|-------|--------------------------|--------------|---|-------|--------------------------|-------------|
| | Change of Tariff Revenue | EV | CV | Loss of Producer Surplus | Net Welfare* | EV | CV | Loss of Producer Surplus | Net Welfare |
| 5 | 1587 | 27191 | 23339 | 10616 | 8767 | 36545 | 29910 | 13817 | 22712 |
| 10 | 267.1 | 5887 | 5684 | 2281 | 768 | 12129 | 11297 | 4747 | 7366 |
| 15 | 37.65 | 1548 | 1533 | 409 | 40 | 5482 | 5306 | 1542 | 3924 |
| 20 | ----- | -----** | ----- | ----- | ----- | 2823 | 2775 | 450 | 2356 |
| 25 | ----- | ----- | ----- | ----- | ----- | 1590 | 1575 | 113 | 1461 |
| 30 | ----- | ----- | ----- | ----- | ----- | 949 | 944 | 15 | 918 |

*Net Welfare=(EV + Change of Tariff Revenue-Loss of Producer Surplus)Note: ** TBT is negative which is of no economic meaning.

Table 12. Welfare Analysis with Elimination of t_{TBT} (and Tariff)
($t_R = 96$ yen/kg ($a = 0.55$, With Disease Transmission).

| S | Welfare by Elimination of t_{TBT} | | | | | Welfare by Elimination of t_{TBT} +Tariff | | | |
|-----|-------------------------------------|-------|-------|----------------------------|--------------|---|-------|----------------------------|-------------|
| | Change of Tariff Revenue | EV | CV | Loss of Producer's Surplus | Net Welfare* | EV | CV | Loss of Producer's Surplus | Net Welfare |
| 5 | 2066 | 17796 | 16061 | 14065 | 5796 | 24152 | 21064 | 17780 | 6356 |
| 10 | 437 | 2782 | 2736 | 4975 | -1756 | 6016 | 5804 | 9154 | -3154 |
| 15 | 88 | 411 | 410 | 1622 | -1122 | 1731 | 1713 | 5000 | -3285 |
| 20 | 9 | 3 | 3 | 405 | -392 | 446 | 445 | 2705 | -2275 |
| 25 | ----- | ----- | ----- | ----- | ----- | 70 | 70 | 1393 | -1339 |
| 30 | ----- | ----- | ----- | ----- | ----- | ----- | ----- | ----- | ----- |

*Net Welfare=(EV + Change of Tariff Revenue-Loss of Producer Surplus)

Figures 2 and 3 summarize the sensitivity of estimates of welfare and import effects to removing the TBT for varying assumptions on the level of S and t_R change when there is no disease transmission. The welfare measures include EV, producer surplus, and net welfare (EV+Tariff Revenue -Loss of producer's surplus). The transparent plate is the zero plate, provided for reference. Figures 2-1 and 2-2 show the decrease in estimates of EV and producer surplus loss when either S or t_R increases, and that EV decreases faster when S is smaller and t_R is bigger. Figure 2-3 shows change in the net welfare: net welfare is large when S or t_R is small and eventually approaches zero when either S or t_R takes on a larger value. Figure 4 shows that imports decrease as S or t_R increases.

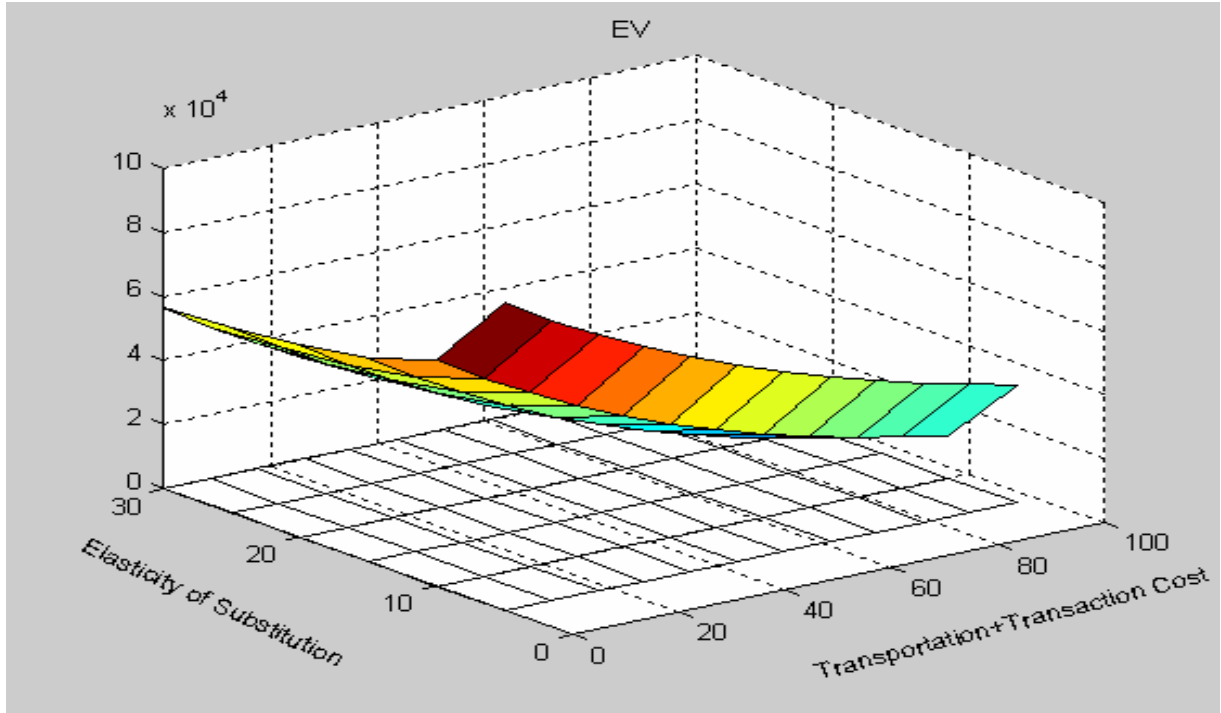


Figure 2. Welfare's Sensitivity to S and t_R with Elimination of TBT
(Without Disease Transmission, $a=0.5$) Figure 2-1 EV's Sensitivity to S and t_R .

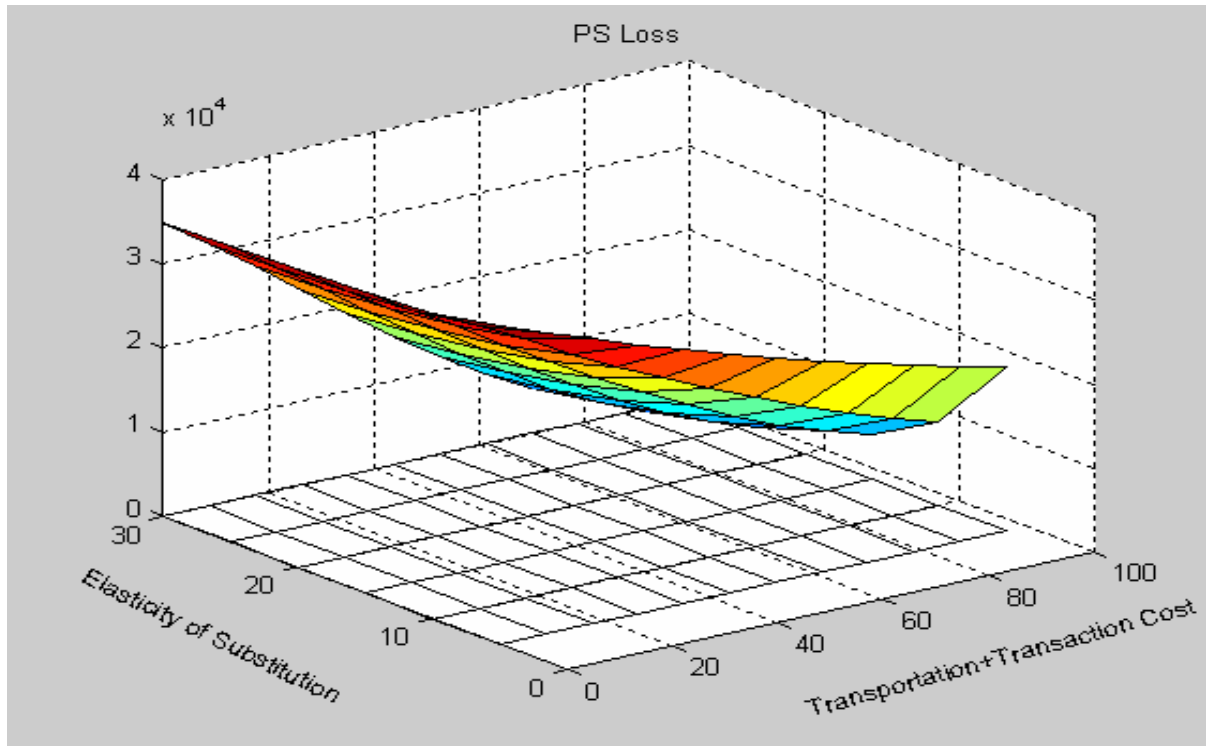


Figure 2-2 Producer Surplus Loss Sensitivity to S and t_R .

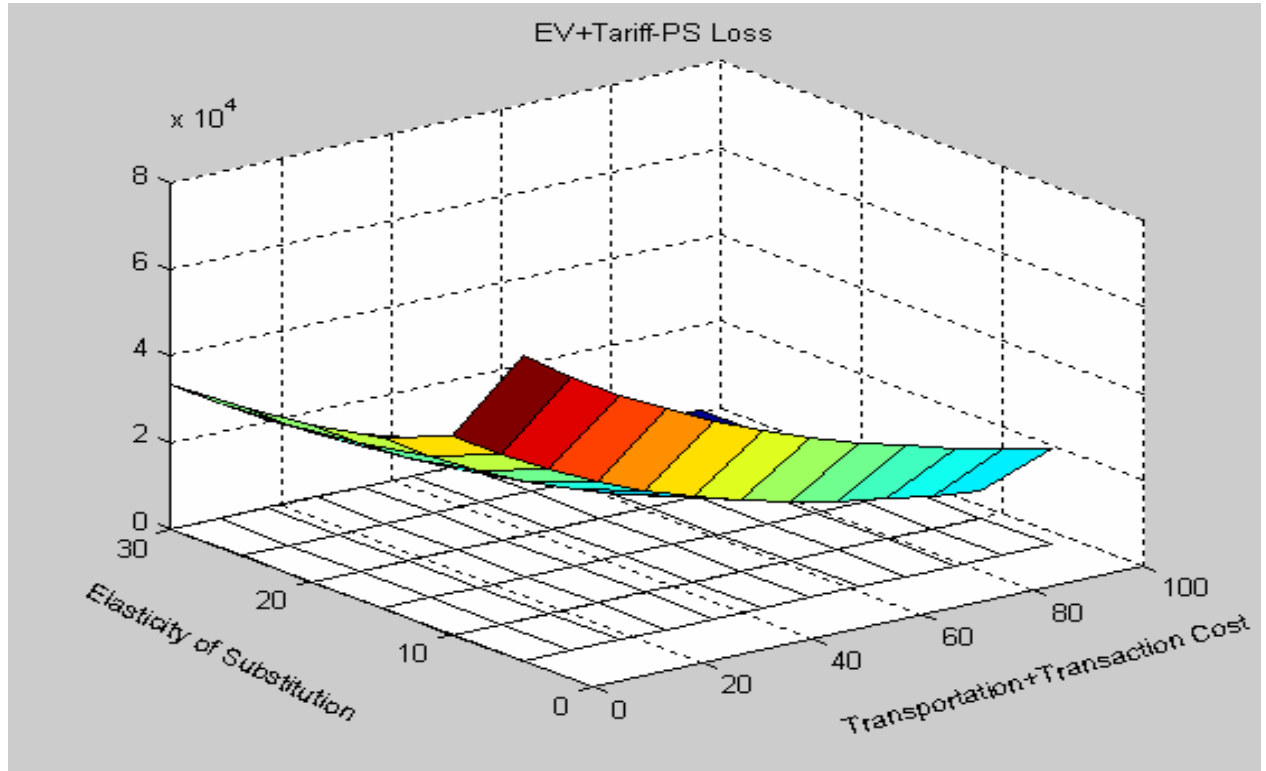


Figure 2-3 Sensitivity of net welfare (EV+Tariff Revenue-Loss of PS) to S and t_R .

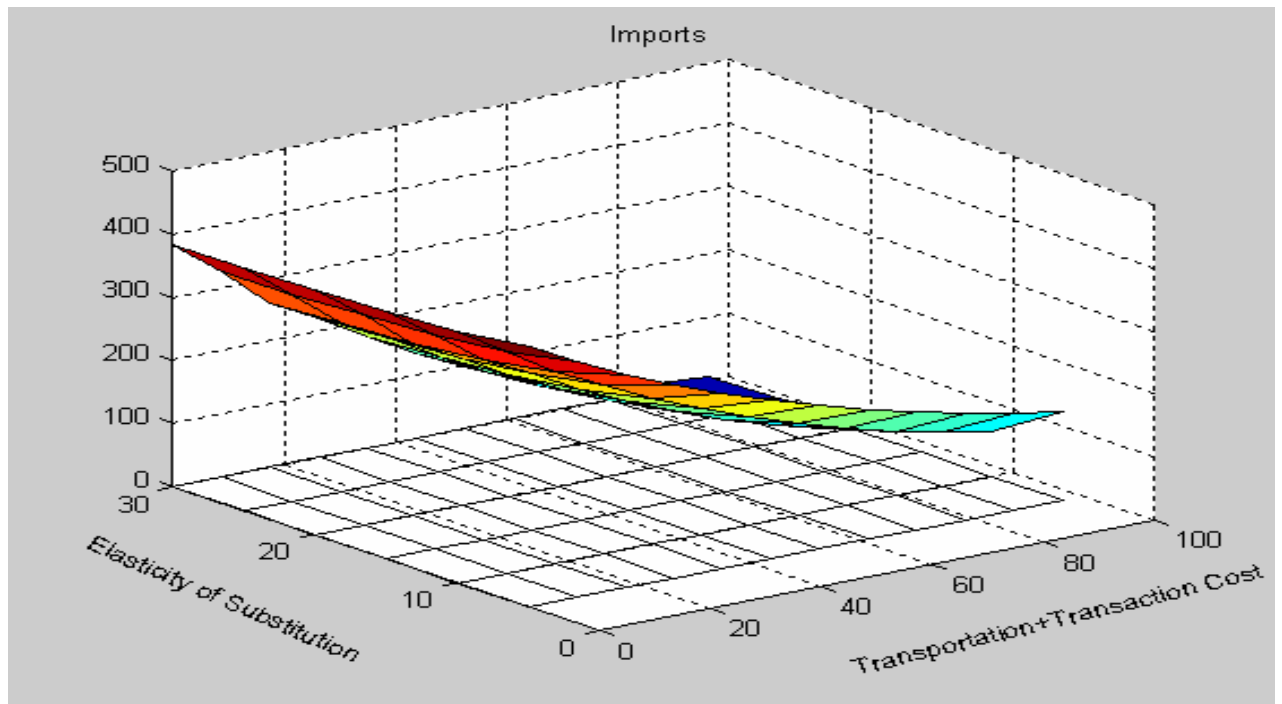


Figure 3. Increase in Imports' Sensitivity to S and t_R with Elimination of the TBT (103 MT).

5. Conclusions

In this paper, we revamped the tariff equivalent of a TBT by relaxing the homogeneous commodity assumption, accounting for perceived quality of substitutes and incorporating recent findings on trade costs. The latter are often larger than policy impediments and cannot be abstracted

from them. Transportation and trade costs are structured on a per-unit basis rather than following the so-called iceberg method. Specific (as opposed to proportional) trade costs reduce the variability of the tariff equivalent estimate of the TBT with respect to the variability of import unit value across different reference years. Their influence on the TBT estimate is mitigated as the import unit value increases. Trade costs and imperfect substitution have offsetting influences in the computation of the tariff estimate of the TBT. Since most previous applications have abstracted from both of them, they have somewhat mitigated the error implied by these two simplifications and dissimulated the inherent sensitivity of the TBT estimate to each of these underlying parameters.

We explored the sensitivity of the tariff equivalent of the TBT with respect to a series of parameters. The tariff equivalent and hence welfare analysis based on the tariff equivalent measures are sensitive to several key parameters, such as the elasticity of substitution, consumers' home preference, and, to a lesser extent, transportation and transaction cost. The sensitivity to the consumers' home preference has some implications for gravity equation models that impose restrictions of equal preference for imported and domestic goods. These models are likely to provide biased measures of trade impediments and should relax this assumption.

We then provided a rigorous investigation of the Japan-U.S. apple dispute. The investigation first validates the approach and indicates the importance of empirical estimates of the magnitude of preferences and trade costs (α , σ , and t_R). More importantly, it raises interesting policy implications. A striking result in the analysis of the apple dispute is that the increase in apple imports would be small (in value) no matter what parameter estimates are used. It appears that the alleged damage in lost exports claimed by the United States at the WTO (US\$143.4 million) is substantially overstated. The political economy of the case is also intriguing. Much political goodwill has been spent on this dispute relative to the small size of the potential direct gains in agricultural exports. Ancillary benefits may exist if the United States eventually succeeds in opening the Japanese market and establishes a reputation as a persistent negotiator. Other countries or protected industries may pay attention to the United States' resolve in opening markets and may refrain from engaging in costly disputes.

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