Optimal Trade Policy and Production Location

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Abstract

This paper studies the role of trade policies in a theoretical framework considering the firm's global production operation subject to trade costs. The production location potentially depends on a combination of trade costs, inclusive of trade barriers, imposed on different stages of the production process. Meanwhile, the trade policy decision of a government alters trade costs, and thereby affects the firm's location decision on whether to offshore the production base and the sourcing decision on whether and which intermediate inputs to source domestically or import from abroad. A government might care about the impact of its trade policy choice on the locations of the firm's global production activities in order to better exploit its market power over world prices with trade policy intervention.

The paper features the assembly-relocation effect and the production-chain effect to explain incentives behind the Nash trade policy intervention with cross-border unbundling of production processes: first, a government sometimes would use an import tariff and/or export tax as a way to shift the location of the final assembly in its favor, forcing an inefficient location, so that, conditional on the assembly relocation, it can maximize its ability to manipulate the terms of trade. Second, a rise in the tariff/tax on inputs could push up the world price of the final good through the production chain.