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ORIGINAL ARTICLES

Strategic Behavior in the International Burley Tobacco Market

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This note uses an international trade model to investigate the competitiveness of the world burley tobacco market. Results support the contention that governments can take advantage of market imperfections to shift rents to the domestic economy. Both tariffs and quotas lead to larger domestic welfare compared to baseline results. However, a lowering of the price support lead to similar overall welfare increases without the retaliatory responses by competitors. © 2000 Society for Policy Modeling. Published by Elsevier Science Inc.

Key Words: Burley tobacco; Calibration; Strategic trade theory; Welfare analysis.

1. INTRODUCTION

This economic note examines the theoretical and empirical justifications for government intervention in the U.S. burley tobacco market. Models of strategic trade acknowledge a government's ability to enter an imperfectly competitive market and extract rents from foreign firms through tariffs and quotas. The general findings of the strategic trade literature is that by committing itself to a particular trade policy a government can take advantage of imperfections in a market and shift rents to the domestic economy (Brander and Spencer, 1985; Dixit, 1988a).

Empirical applications of strategic trade theory has been limited by the lack of general theory and arguments that advocates of an

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activist trade policy might utilize the results to justify protectionist policies. The new trade is founded on the observation that industries are more complex than models based on perfect competition, and thus modeling efforts should include strategic interactions as markets become more imperfect. Given the limited application of these models, there is a need to determine if empirical results support the theoretical arguments.

2. U.S. BURLEY INDUSTRY

Rents above normal economic profits do not exist in many agricultural markets. But previous research suggests that rents have existed and have been extracted from foreign buyers in the U.S. tobacco industry (Johnson and Norton, 1983). In the past, the United States accounted for a relatively large portion of the volume of burley tobacco produced and traded in the world market. Foreign and domestic tobacco purchasers were willing to pay a large premium for the superior quality and availability of U.S. tobacco. However, during the past 2 decades, the volume of burley traded in the international market has escalated, with the United States facing an increasing amount of competition from foreign producers. As a result, the United States' share of the world burley export market has declined over the past 2 decades, while the import share has grown. The relatively large policy-induced price differential between United States and foreign burley tobacco has contributed to this decline, especially given the narrowing quality differential between U.S. burley and foreign burley (Snell and Reed, 1993).

In an effort to reduce imports, policy makers from the United States passed domestic content legislation in 1993, which subjected U.S. tobacco companies to relatively large financial penalties if their cigarette blends contained more than 25% foreign tobacco. Consequently, U.S. burley imports fell by nearly 50% under this law in 1994 and 1995 relative to 1993 import levels. However, an international GATT panel ruled in 1995 that the tobacco domestic content law was inconsistent with GATT, and an annual tariff rate quota replaced the domestic content provisions. The value of U.S. leaf imports nearly doubled in 1996 compared to 1995 imports under this new restriction, and continue to grow in 1997. As a result, policymakers continue to evaluate ways to increase the utilization of U.S. burley in both foreign and domestic tobacco markets.

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