

Case Study 9-6 (continued)

compare with regular average tariff rates (shown in Case Study 8-1) of 3.3 percent for the United States, 4.0 percent for the European Union, 2.5 percent for Japan, and 4.0 for Canada in 2004. Smaller developed nations made much less use of nontariff trade barriers than larger nations.

TABLE 9.4. *The Pervasiveness of Nontariff Barriers in Large Developed Nations*

Product	Percent of Tariff Lines Affected			
	United States	European Union	Japan	Canada
Food, beverage, and tobacco	2.8	17.2	5.9	0.4
Textiles and apparel	67.5	75.2	31.9	42.9
Wood and wood products	0.6	0.0	0.0	3.2
Paper and paper products	1.1	0.7	0.0	0.4
Chemicals, petroleum products	3.3	2.9	0.9	0.6
Nonmetallic mineral products	3.6	0.0	0.0	0.0
Basic metal industries	30.4	0.6	5.1	1.7
Fabricated metal products	5.9	0.0	0.0	2.2
Other manufacturing	1.7	0.0	0.0	0.9
Average manufacturing	17.9	13.4	10.3	7.8

Source: WTO, *Market Access: Unfinished Business* (WTO: Geneva, 2001, p. 21) and WTO, *World Trade Report 2005* (WTO: Geneva, 2005), Tabel II.

9.4 The Political Economy of Protectionism

In this section, we analyze the various arguments for protection. These range from clearly fallacious propositions to arguments that can stand up, with some qualification, to close economic scrutiny.

9.4A Fallacious and Questionable Arguments for Protection

One *fallacious* argument is that trade restrictions are needed to *protect domestic labor against cheap foreign labor*. This argument is fallacious because even if domestic wages are higher than wages abroad, domestic labor *costs* can still be lower if the productivity of labor is sufficiently higher domestically than abroad. Even if this were not the case, mutually beneficial trade could still be based on comparative advantage, with the cheap-labor nation specializing in the production of and exporting labor-intensive commodities, and the expensive-labor nation specializing

in the production of and exporting capital-intensive commodities (refer back to Section 2.4).

Another *fallacious* argument for protection is the **scientific tariff**. This is the tariff rate that would make the price of imports equal to domestic prices and (so the argument goes) allow domestic producers to meet foreign competition. However, this would eliminate international price differences and trade in all commodities subject to such “scientific” tariffs.

Two *questionable* arguments are that protection is needed (1) to reduce domestic unemployment and (2) to cure a deficit in the nation’s balance of payments (i.e., the excess of the nation’s expenditures abroad over its foreign earnings). Protection would reduce domestic unemployment and a balance-of-payments deficit by leading to the substitution of imports with domestic production. However, these are *beggar-thy-neighbor* arguments for protection because they come at the expense of other nations. Specifically, when protection is used to reduce domestic unemployment and the nation’s balance-of-payments deficit, it causes greater unemployment and worsened balance of payments abroad. As a result, other nations are likely to retaliate, and all nations lose in the end. Domestic unemployment and deficits in the nation’s balance of payments should be corrected with appropriate monetary, fiscal, and trade policies (discussed in Chapters 18 and 19) rather than with trade restrictions.

9.4B The Infant-Industry and Other Qualified Arguments for Protection

One argument for protection that stands up to close economic scrutiny (but must nevertheless be qualified) is the **infant-industry argument**. It holds that a nation may have a potential comparative advantage in a commodity, but because of lack of know-how and the initial small level of output, the industry will not be set up or, if already started, cannot compete successfully with more established foreign firms. *Temporary* trade protection is then justified to establish and protect the domestic industry during its “infancy” until it can meet foreign competition, achieve economies of scale, and reflect the nation’s long-run comparative advantage. At that time, protection is to be removed. However, for this argument to be valid, the return in the grown-up industry must be sufficiently high also to offset the higher prices paid by domestic consumers of the commodity during the infancy period.

The infant-industry argument for protection is correct but requires several important qualifications which, together, take away most of its significance. First of all, it is clear that such an argument is more justified for developing nations (where capital markets may not function properly) than for industrial nations. Second, it may be difficult to identify which industry or potential industry qualifies for this treatment, and experience has shown that protection, once given, is difficult to remove. Third, and most important, what trade protection (say in the form of an import tariff) can do, an equivalent production *subsidy* to the infant industry can do better. The reason is that a purely *domestic distortion* such as this should be overcome with a *purely domestic policy* (such as a direct production

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subsidy to the infant industry) rather than with a trade policy that also distorts relative prices and domestic consumption. A production subsidy is also a more direct form of aid and is easier to remove than an import tariff. One practical difficulty is that a subsidy requires revenues, rather than generating them as, for example, an import tariff does. But the principle remains.

The same general principle also holds for every other type of domestic distortion. For example, if an industry generates an *external economy* (i.e., a benefit to society at large, say, by training workers who then leave to work in other industries), there is likely to be underinvestment in the industry (because the industry does not receive the full benefit from its investments). One way to encourage the industry and confer greater external economies on society would be to restrict imports. This stimulates the industry, but it also increases the price of the product to domestic consumers. A better policy would be to provide a direct subsidy to the industry. This would stimulate the industry without the consumption distortion and loss to consumers that result from trade restrictions. Similarly, a direct tax would also be better than a tariff to discourage activities (such as automobile travel) that give rise to *external diseconomies* (pollution) because the tax does not distort relative prices and consumption. The general principle that the best way to correct a *domestic* distortion is with *domestic* policies rather than with trade policies is shown graphically in Section A9.3 of the appendix.

Trade restrictions may be advocated to protect domestic industries important for national defense. But even in this case, direct production subsidies are generally better than tariff protection. Some tariffs can be regarded as “bargaining tariffs” that are to be used to induce other nations to agree to a mutual reduction in tariffs. Here, political scientists may be more qualified to judge how effective they are in achieving their intended purpose. The closest we come to a truly valid economic argument for protection is the *optimum tariff* discussed in Section 8.6. That is, if a nation is large enough to affect its terms of trade, the nation can exploit its market power and improve its terms of trade and welfare with an optimum tariff. However, other nations are likely to retaliate so that in the end all nations lose.

9.4c Who Gets Protected?

By increasing the commodity price, trade protection benefits producers and harms consumers (and usually the nation as a whole). However, since producers are few and stand to gain a great deal from protection, they have a strong incentive to lobby the government to adopt protectionist measures. On the other hand, since the losses are diffused among many consumers, each of whom loses very little from the protection, they are not likely to effectively organize to resist protectionist measures. Thus, there is a bias in favor of protectionism. An example is provided by the U.S. sugar quota (see Case Study 9-1).

In recent years, economists have developed several theories regarding which groups and industries get protected, and some of these theories have been empirically confirmed. In industrial countries, protection is more likely to be provided to labor-intensive industries employing unskilled, low-wage workers who would have great difficulty in finding alternative employment if they lost their present