IV Current Arguments for Protection

Numerous arguments for protection have been put forward at various times. Some have already been discussed, namely those resting on the belief that protection improves the current account, that exchange rate instability or misalignment justifies protection, and that protection increases employment.

An argument that goes right back to the nineteenth century in the United States and that has had a recent revival is one based on "fairness" or a "level playing-field." It used to be argued that it is unfair to import products from cheap-labor countries because producers in high-wage countries are put at a disadvantage by their high labor costs and because such imports support the "exploitation" of labor in poor countries. This was called the "pauper-labor argument for protection." It is fallacious since it ignores the principle of comparative advantage. Countries with cheap unskilled or semi-skilled labor have a comparative advantage in labor-intensive products just as more developed countries have a comparative advantage in industries that are skill or capital intensive. This type of trade provides a principal basis for the gains from international trade. Furthermore, it has to be remembered that if protection by developed countries reduces the demand for the products of cheap-labor industries in developing countries, it will reduce employment in these industries and is thus likely to bring about further declines in the wages they pay. If the concern is humanitarian, it is contradictory to advocate policies that reduce employment and wages in cheap-labor countries.

Currently, however, the fairness argument is more concerned with protection by other industrial countries, where labor costs may be similar or even higher. This raises the question whether one country's protection can be justified by the protection policies of its trading partners. This subject will be discussed more fully at the end of this paper in connection with protection by developing countries. The broad answer is that, aside from negotiating or bargaining considerations, protection by one country damages not just its trading partners but also itself, and this is true even when the other country practices protection.

One might consider many other protectionist arguments. The "antidumping" argument is well known, and has some validity when the dumping is "predatory" (that is, when it is designed to kill competition, after which prices are raised again) but not when it just means that a foreign supplier's exports are subsidized on a long-term basis. In the latter case the net effect is to cheapen the cost of imports and hence improve the terms of trade of the importing country. Three further arguments which are particularly relevant for developing countries will now be considered in some more detail.

Infant Industry Argument

This is the classic argument for temporary protection in developing countries. A major objection is that protection once provided is often not removed. Leaving that aside, this argument can rest on either of two bases.

First it could be based on imperfections of the local capital market—resulting in an inability to raise capital to finance initial losses for an enterprise or industry that will eventually be profitable. Such imperfections do exist in developing countries, but hardly apply to the subsidiaries of multinational companies which can finance their initial losses from profits elsewhere in their companies or on the world capital market. In any case, a preferable and more direct policy when these capital market inadequacies cannot be removed would be subsidized loans. Of course, a first-best policy is clearly to improve the capital market and especially to remove imperfections resulting from specific government policies.

A second argument for protecting an infant industry rests on the presumed existence of external economies of a dynamic kind applying to a group of firms, perhaps through the mutual creation of an "atmosphere" favorable to new kinds of activities, usually thought of as manufacturing. This version of the argument needs to be treated with some skepticism. Protection of one industry is always at the expense of others (through general equilibrium effects to be discussed below), and it has to be asked not just whether the firms or potential firms in the industry generate external economies, but whether they generate more than some other enterprises might. In developing countries the infant industry argument is usually used to justify protection of manufacturing industry. But it is hard to see why the possibilities of

spill-over effects through learning by doing should be greater in manufacturing than in agriculture.

The infant industry argument is also used to justify protection of high-technology or other new industries in industrial countries. While it is undeniable that such industries—or, more precisely, the development of particular products—may need to incur losses for prolonged periods before becoming firmly established and earning the returns required to justify the investment, it is difficult to defend subsidization by consumers or from the public purse in such cases. After all, capital markets in industrial countries are highly developed, and, in addition, large companies can finance losses of new activities out of profits from their other activities. There may conceivably be externalities, but it would have to be shown that they are greater than when similar public funds are applied to other uses.

Finally, modern analysis has added an important qualification to the use of tariffs or quotas for infant industry protection. If an infant industry is to be protected (or, a better word, "promoted") it should be protected not just for sales to the home market but also for exporting. Most developing countries have very small home markets so that if production is to be at adequate levels it should eventually, even if not at the very beginning, aim for the world market. Thus assistance, if it is to be provided, should not be by tariffs or quotas but rather by other forms of assistance that do not discriminate between home and foreign sales (for example by the provision of subsidized infrastructure or expenditures on education to build up a suitable work force).

Terms of Trade Argument

The restriction of the supply of exports to the world market may raise the prices of these exports and the reduction of demand for imports may reduce their prices. Hence the restriction of trade by a country may improve its terms of trade. This is the basis for another classic argument for protection that is sometimes used. The restriction of trade may be brought about by export taxes or export controls or by import tariffs or quotas. The gains to one country are then clearly achieved at the expense of other countries. It is important to stress that the large economies need to take the possibility of retaliation into account when directing such protection against each other. As major actors and trend setters in the world economy, they must also bear in mind the adverse effects on the world trading system.

The major objection is that small economies—and almost all developing countries are relatively small in world trade—can hardly affect their terms of trade by supply or demand restriction, other than in the very short run. Of course, there are possibilities of concerted restriction of supply by a group of countries and the gains may last for some time. But eventually the benefits are usually eroded as alternative sources of foreign supply emerge in response to the higher prices and as consumers move towards cheaper substitutes. But the application of the terms of trade argument for restriction of trade when applied to short-term policies of developing countries and to the question of "export pessimism" will be returned to later.

The modern version of export restrictions which improve the terms of trade is the acceptance of voluntary export restraints by exporting countries such as Japan and various developing countries that export clothing and textiles. These restraints raise the prices that they can charge to consumers in their export markets, and so tend to improve the exporters' terms of trade. This is particularly so if the alternative that is avoided by voluntary export restraints is the imposition of import quotas imposed by some importing countries, which would force the exporters to unload their products at low prices in other markets.

Tariffs and Export Taxes for Revenue

Taxes on trade that are imposed for fiscal purposes may have protective side effects. This is particularly relevant for the design of Fund programs. In many of the low-income developing countries, especially in Africa, and also in some of the middle-income ones, tariffs or export taxes are important sources of government revenue. Collection costs of taxes on trade are often low compared with other kinds of taxes. Historically (as in the nineteenth century in the United States) raising revenue was also the primary role of tariffs in countries that are now developed.

From a short-run fiscal point of view it may well be convenient to maintain or even raise such taxes. Indeed, this is often a concern when the immediate macroeconomic problem hinges on an excessive budget deficit. But there are likely to be long-term adverse effects through encouraging uneconomic import-competing production and discouraging more socially efficient export production. There are important issues here because it is a matter of balancing the short-term versus the long-term interest.

The imports on which tariffs for revenue purposes are levied may be luxury consumption goods of which there is initially little or no local production. In the absence of adequate income taxes such import taxes may have a favorable distributional effect. But local production of similar, if not identical, goods is likely to be encouraged, so that protection of local industries that produce consumption goods for high-income earners would be an undesired by-product of tariffs designed for revenue. Furthermore, the revenue itself would gradually decline as import substitution progresses. The desirable policy is

then to supplement the tariffs with taxes on local producers at the same rate, the net result being to convert tariffs into consumption or sales taxes. There will then be no special or distorting incentive for import-substituting production of these kinds of goods.

The taxation of exports is similar in its effect to a tariff on imports. Production for exports becomes less profitable, and is discouraged. Indirectly, through an exchange rate or general equilibrium adjustment, import-competing production will be stimulated. Reduced exports resulting from export taxes may require the exchange rate to be more depreciated than it would otherwise be in order to maintain balance of payments equilibrium, and this depreciation will then stimulate import-competing production; alternatively, wages and other factor costs may fall (or rise less than they otherwise would) as export production becomes less profitable, and the lower costs and readier availability of labor will then stimulate import-competing production.

A general equilibrium adjustment designed to maintain employment is, of course, desirable, given that export taxes have been imposed. But the net result is to reduce the volume of trade and to replace economic export production with less economic import-competing output.

The adverse effects on long-term resource allocation, and hence possibly on growth, of such taxes on imports or exports must thus be borne in mind. Tariffs should be supplemented by taxes at the same rate on domestic production of similar goods (converting the tariff, in effect, into a nondiscriminatory consumption tax), or modest levels of export taxes should be supplemented by taxes on domestic output of all kinds sold at home. But the qualification has to be noted here that in some countries there may be obstacles, at least in the short run, to the efficient collection of sales taxes or taxes on domestic production.

Numerous considerations enter into the construction of an optimal taxation system, notably effects on income distribution and relative collection costs of various kinds of taxes. Here attention is drawn to the distorting effects on resource allocation of trade taxes, and that consumption taxes (of which import tariffs may be a component) are likely to be preferable to tariffs on their own.

It should be noted that tariffs that were imposed primarily to raise revenue and that appear to be at modest levels may actually represent high degrees of protection and thus have marked protective effects eventually. This follows from the distinction between the nominal rate of tariff protection and the effective rate of protection. The latter refers to protection provided for value added.

It is common for inputs or components to enter at low rates of duty, or possibly not to pay any tariffs at all, while final goods or goods at later stages of processing pay a revenue tariff. In that case the effective rate of protection will be considerably greater than the nominal rate. For example, if the nominal rate is 20 percent, if the share in cost of an imported input at free trade prices is 50 percent and if this input is not required to pay any tariff, then the effective rate of protection is 40 percent. The same applies if the input is produced locally and is potentially exportable, so that its domestic price is determined by the world market price. Since the shares of imported inputs in the cost of production of local products are likely to vary a great deal, a uniform rate of nominal tariff designed for revenue may yield very uneven rates of effective protection. For example, producers of two products that both obtain 20 percent nominal tariff protection may both use as inputs various other products which are all obtained without any duty having to be paid. If the share in cost of these inputs at world prices is 50 percent for one product and 75 percent for another, the effective protection for the first is 40 percent and for the second 80 percent. The result of a uniform tariff is thus to create uneven incentives not only relative to exporting but also between protected industries.

Political Economy and Protection

There are obviously numerous possible reasons for trade policy measures, and some of the most commonly used arguments for protection have just been discussed. But often the arguments given are couched in terms of the national interest when better explanations for various measures can be found in a concern for sectoral interests, possibly a response to particular political pressures. While economic theory can be useful in analyzing the consequences of protection, explanations of why protection comes about, why it takes particular forms, and why it continues, would often appear to be more in the realm of political economy.

In mature industrial countries the principal explanation for recent protectionist pressures and for actual increases in protection appears to be a concern to preserve industries that would otherwise decline or, at least, to slow up or ease the decline. The motivation is essentially "conservative." The potential decline of an industry may be caused by shifts in comparative advantage or by other structural factors, or (in the United States for several years recently) by real appreciation induced by macroeconomic policies. The objective of protectionist proposals is to preserve regional or industry-specific incomes, even though this would be at the cost of a loss of national income overall from the loss in national efficiency.

One might say that trade policy is, to some extent, used as a system of social insurance, the idea being to help industries in trouble at the cost of the rest of the community. The implication is that investors and employees in other industries who bear the current loss

from protection would also get some help if they needed it. This reason for protection no doubt also applies in some developing countries.

Sometimes the original explanation for protection lies elsewhere—in a balance of payments crisis or an infant industry argument—but the original justification has disappeared and the continuance of protection is caused by a concern for sectoral income maintenance. One could argue that it is simply the result of sectoral pressures combined with a general failure to appreciate the costs of protection, especially the long-term costs, in the form of a loss of aggregate national output. Alternatively, it could be given a "social insurance" rationale.

When the objective is to prevent severe declines in sectoral incomes, owing possibly to exogenous shocks, adjustment assistance would be preferable to trade protection. The latter is clearly not first best both because it has various ancillary distortionary effects that lower national income and because it is rarely temporary. At the same time, aside from political considerations, there is little justification for adjustment assistance that deals only or specifically with trade-related shocks. Presumably unemployment benefits, assistance in retraining, education, and so on, can be justified irrespective of the source of the shocks. Another obvious difficulty is the fiscal cost of adjustment assistance. On the other hand there is the political factor: if adjustment assistance can avoid protection, or make possible a liberalization that would not otherwise take place, there is likely to be a net benefit from trade-related adjustment assistance.[8]

[8]This view, with respect to the current protectionist threat in the United States, is put in Lawrence and Litan (1986).