

PROTECTIONISM

The devices or methods which are used to restrict inflow of imports and increase exports are called protectionism. It is a debatable issue because some economists believe there should be free trade for best utilization of resources and other group thinks trade barriers are essential for the survival of certain economies.

The case for free trade

The case for free trade is based on the analysis of trade theories i.e; absolute advantage theory and comparative advantage theory. Free trade allows the maximization of world production, thus making it possible for each consumer in the world to consume more goods than he or she could without free trade. As there more goods and service can be produced country's GDP rises. This leads to rise in per capita income. On the side there is availability to consume more goods and services, therefore living standard can be improved.

Besides comparative advantage free trade increases competition which rises efficiencies. Free trade also expands market of a product which raises level of employment in the economy. Although some argue that rise is at the cost of employment opportunities in other countries. Other advantages may be in terms of economies of large scale, learning by doing, wider choice etc.

The case for protectionism

Non economic advantages of diversification

Comparative advantage might dictate that a country specializes and should produce a narrow range of products. The might decide, that there are distinct social advantage in encouraging a more diverse economy. Citizens should be given wide range of occupation, and social and psychological advantage of diversification would more than compensate for reduction in living standard.

Risk of specialization

If a country specializing in the production of few goods, it might face problems in the long run. One such risk is that technological changes may render its major products obsolete. This is why government encourage a more diversified economy should by protecting industries which otherwise cannot compete.

To alter the terms of trade

Trade restrictions can be used to turn the terms of trade in favour of countries that produce and export a large fraction of world's supply of some products. They can also be used to turn the terms of trade in favour of countries that constitute a large fraction of the world demand for some product that they import.

To protect against 'unfair' actions by foreign firms and governments

Tariff may be used to prevent foreign industries from gaining an advantage over domestic industries by use of predatory practices that will harm domestic industries. Two common practices are subsidies paid by foreign governments to their exporters and price discrimination which is called **dumping** when it is done across international borders. These practices are typically countered by levying tariffs called countervailing and anti-dumping duties.

To protect infant and sunset industries

This is the oldest valid argument for protectionism. In the beginning newly born industries produce on the small scale therefore cost will be high. A trade restriction may protect these industries from foreign competition while they grow up. When they are large enough, they will be able to produce as cheaply as foreign rivals and thus will be able to compete without protection. Similarly there are many dwindling industries which play important role to maintain employment but cannot compete with foreign firms. Therefore government also protect such industries with the intention to protect employment.

To protect employment

This is another important reason for protectionism. This reason is generally related with the developing economies where infant industries or small industries cannot compete with the large scale foreign industries and close down which create unemployment. To maintain the given level of employment government opt the policies of protectionism.

To improve balance of payments

A prolonged and large deficit in balance of payments is not desirable for any economy. It has large repercussions. For instance, government needs to pay out the deficit from foreign reserves or borrow from other financial institutions which increase national debts. If foreign reserves are drained out it will damage the credibility of the state for repayments and in case of national debts state may charge more taxes which are disincentive to work and produce and may raise cost of living in an economy.

Retaliation

Sometimes countries levy tariffs and quotas because rival country has already imposed trade restriction. There may or may not be any economic reason but just the retaliation.

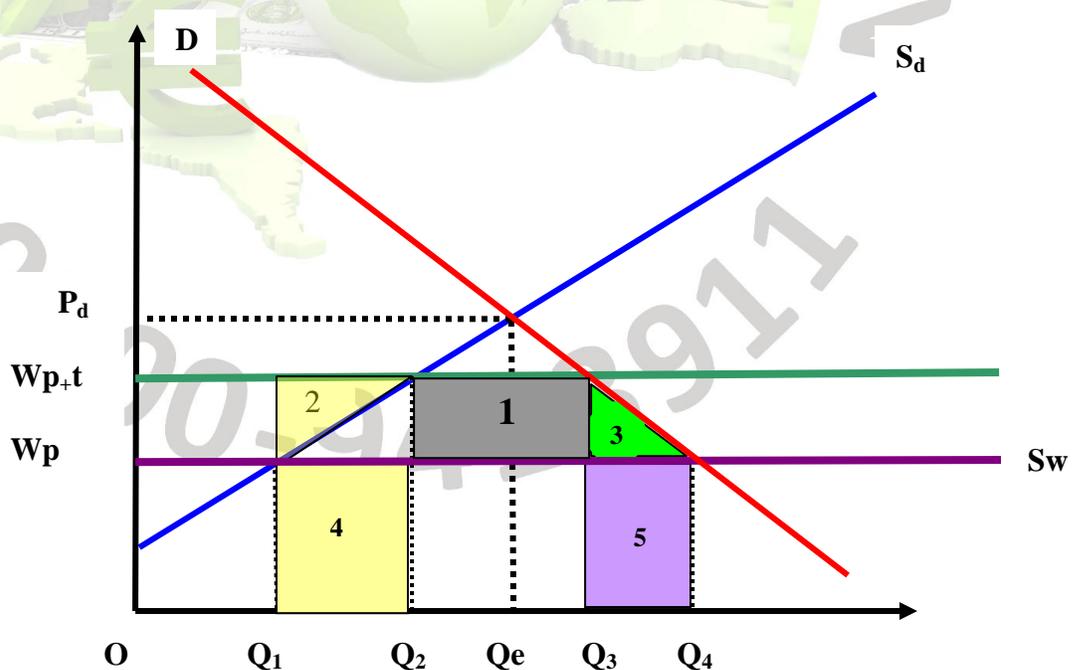
Methods of protection

Tariff

It is a type of policy that directly raises the prices of imported goods. It is often called as import duties. It is of two types, specific and advalorem. Specific tariff is per unit tariff, for example, \$5 per unit, whereas advalorem tariff levies on the value of the product, for example, 5% of the price of the product. Tariffs not only restrict imports but are also main source of revenue for the state. Usually government levies high tax rates on imports of luxury goods and make large revenues.

How does tariff work

As is shown in the following fig. in the close economy where there is no foreign trade price will be **OP_d** for **OQ_e** output. When country becomes the part of international trade where it faces new supply curve **S_w** at the price **W_p**. At this price over all demand for a product will be **OQ₄** where as domestic demand reduces to **OQ₁**.



Therefore output from **Q₁** to **Q₄** will be imported. After imposition of tariff supply curve shifts upwards and new price are **W_p+t**. At this price over all demand for the product will be reduced to **OQ₃** and demand for domestic product will be increased to **OQ₂**.

Rectangle 1 shows revenue which is generated by government due to imposition of tariff.

Triangle 2 shows an increase in domestic producer surplus.

Triangle 3 shows welfare loss due to tariff.

Rectangle 4 shows an increase in the demand for domestically produced goods.

Rectangle 5 shows reduction in the demand for imported goods.

Limitations of Tariff

Tariff policy is effective if demand for imports is **price elastic**; if it is inelastic then there is no considerable change in imports and difficult to get desirable outcomes. However, government is able to generate large revenue. **Secondly**, sometimes domestic goods remain less competitive even tariff is added to prices of imported goods if importers absorb the tariff and do not increase their prices. In some cases even tariff amount is not that much satisfactory to make imports less competitive. **Thirdly**, other economies may retaliate and they also levy tariffs on exports of the given economy, so there is possibility in reduction of exports. **Lastly**, if tariff is levied on imports of raw material or oil, it increases cost of production and which leads to cost push inflation.

Import Quotas

It is a non tariff barrier and do not raise revenue for the government. It is a physical restriction on the import of a product. It is relatively more restricted form of trade barriers as compare to tariff. In case of tariff any quantity one can import after paying custom duties but in quotas only the pre-defined quantity can be imported in the specified period of time. For example if government allows to import 100 cars in a year then importers cannot import even on additional car.

In the following fig. it is shown that before the imposition of quotas demand for the product at the world price is OQ_4 , where Q_1 to Q_4 was imported. As government impose quotas, price rises from OP_w to OP_w+q and demand reduced to OQ_3 .

Following things can be concluded from the following fig.

Rectangle 3 shows an increase in the demand for domestic goods.

Triangle 2 shows an increase in the producer surplus.

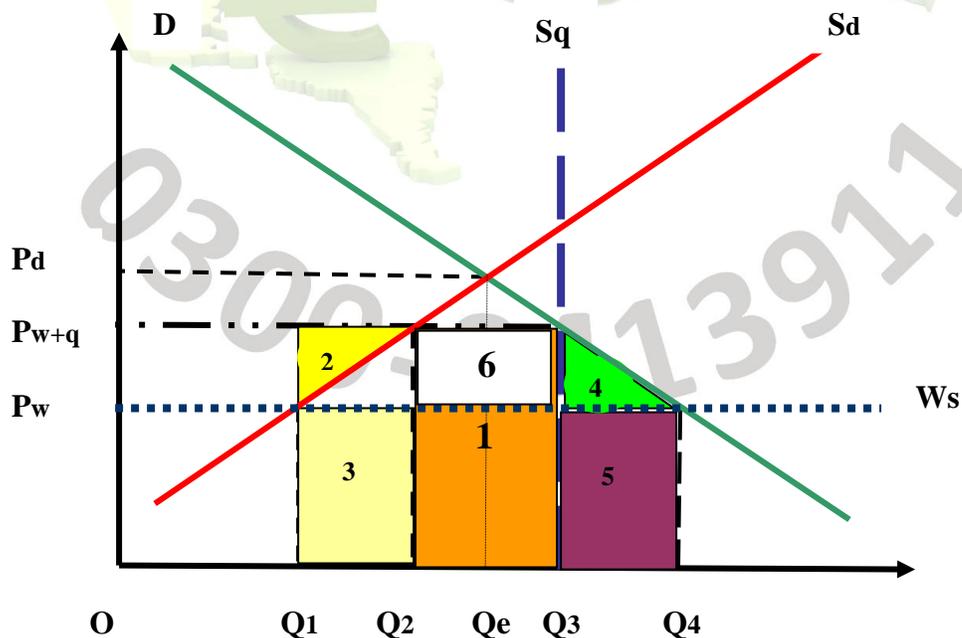
Rectangle 5 shows a reduction in demand for the product.

Total fall in imports 3 & 5

Triangle 4 shows a welfare loss because of imposition of quotas.

Rectangle 1+6 shows spending on imported items.

Rectangle 6 shows extra amount which is paid to exporter due to fixation of quota.



Limitations of quotas

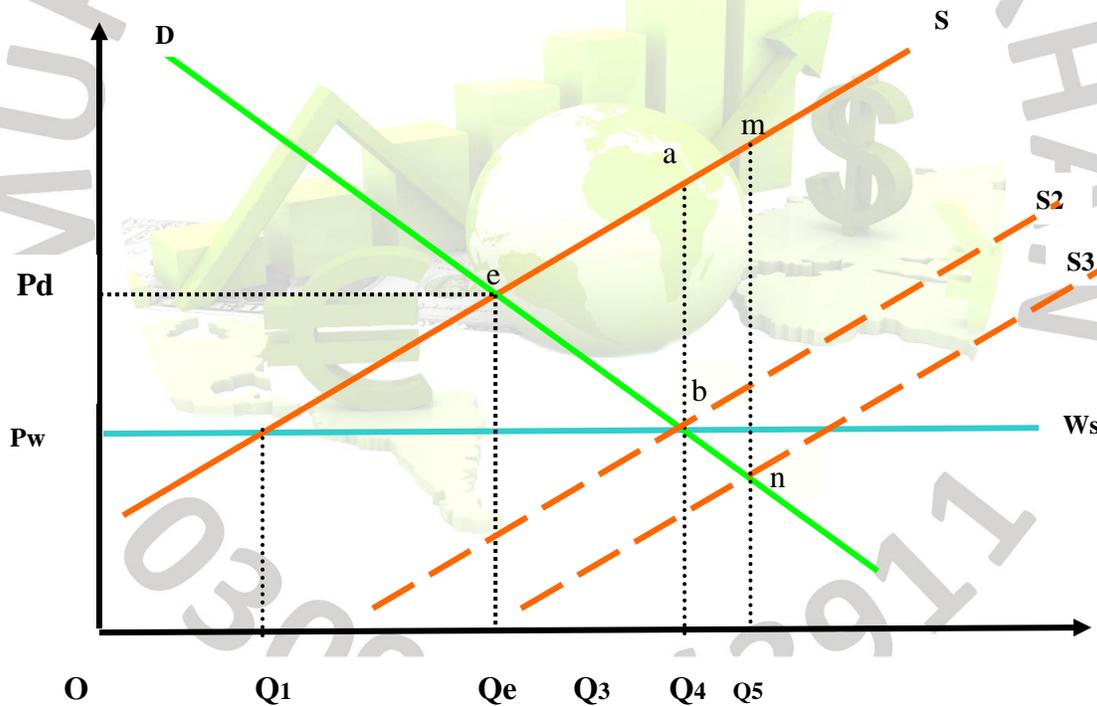
It is effective only if domestic producers are able to meet the shortage. Otherwise, there is a possibility of increase in prices of product(s). There is a possibility of demand pull inflation if the economy is dependent on imports and fix quotas on most of the goods. Quotas can entice other nations to use same method which also reduce exports of the country.

Embargo

It is the most restricted form of trade barriers. Where there is a complete ban on the import of certain goods or from a certain country or a ban on the import of a certain good from a certain country. For instance, pork cannot be imported in an Islamic country or there was trade restriction with South Africa or in late nineties many countries stopped importing beef from UK due to mad cow disease.

Subsidies

In the above mentioned methods other countries may retaliate and adopt the policy of protectionism which restricts exports of the particular country. By giving subsidies a government lower down the prices of certain goods and switch the demand of people towards certain domestic goods.



In above diagram, in free trade at the world price demand for domestic product was OQ_1 where Q_1 to Q_4 was imported. As government subsidized the product (\overline{ab} per unit) demand for domestic product increases to OQ_4 which is equal to the total demand for the product in the economy, hence imports will be zero. Similarly, subsidies can be used if government wants to encourage exports. For instance, in the above figure economy can exports from Q_4 to Q_5 if sufficient subsidy (\overline{mn} per unit) is given to exporters which shift supply curve to S_3 .

However, subsidy has its own repercussions. For example, it increase government spending and government needs to make certain changes in tax pattern as well as in spending pattern. There is a possibility of increase in taxes and reduction in provision of merit and public

goods. Secondly, it can be a short term policy but it is difficult to opt this policy over a longer period of time. Thirdly, it is effective if supply of the product is price elastic, if it is price inelastic then all subsidy will be absorbed by producers and no considerable change in domestic production.

Voluntary export restrictions

VERs is a relatively new trade barrier by which foreign firms “voluntarily” limit the amount of their exports to a particular country. VERs which have the effect of import quotas, are agreed to by exporters in the hope of avoiding more stringent trade barriers.

Thus Japanese auto manufacturers agreed to a VER on export to the US under the threat of higher US tariffs or the imposition of low import quota.

Exchange control policy

Exchange control implies government interference with the buying and selling of foreign exchange. In this way, foreign trade is curtailed and driven into fixed channels. Government allot exchange or ration it out so that importers can buy only a limited amount of goods in foreign countries.

Exports promotion policies

World Trade Organization (WTO) always discourages policies which restrict international trade. Therefore, now- a- days such policies are opted by the state which increase exports. For instance, state departments emphasize to improve quality and quantity of exporting commodities. They establish industry-specific training centres, carry out quality awareness project and provide advice on marketing policies. Certain departments provide first hand information to exporters about exports opportunities and even make arrangements for exports promotion exhibitions.