Learning Objectives

1. Describe the various situations in which a country may rationally choose to protect some industries.
2. List the most common fallacious arguments in favour of protection.
3. Explain the effects of a tariff or quota on imported goods.
4. Explain why trade-remedy laws are sometimes just thinly disguised protection.
5. Distinguish between trade creation and trade diversion.
6. List the main features of the North American Free Trade Agreement.

1 Free Trade or Protection?

Any departure from free trade designed to protect domestic industries from foreign competition is called protectionism.

An important example of a protectionist policy is a tariff — a tax designed to raise the price of foreign goods.

Nontariff barriers (NTBs) are policies or procedures other than tariffs that are designed to reduce the flow of imports — examples are import quotas and customs procedures that are deliberately more cumbersome than necessary.

The Case for Free Trade

Free trade encourages countries to specialize in producing goods and services in which they have a comparative advantage. This specialization allows an increase in average living standards.

However, free trade does not necessarily make <u>everyone</u> better off — the abolition of tariffs generally harms those industries that were once protected.

But the gains from specialization and trade make the country as a whole better off — the gains to the many outweigh the losses to the previously protected groups.

The Case for Protection

There are two important arguments for protection:

1) A country may have objectives other than maximizing national income.

There may be perceived advantages from a diversified pattern of production — tariffs may assist such diversification.

Countries that specialize in the production of only a few products — typically small countries — face considerable risks from fluctuating world prices.

For social and other reasons, public policy may also be aimed at the protection of specific groups — such as unskilled labour or workers in specific “strategic” industries.

2) A country may want to maximize national income, possibly at the expense of other countries' incomes.

This can be accomplished by:

- altering the terms of trade in your favour (large country),
- protecting "infant" industries,
- encouraging learning-by-doing, and
- earning pure profits through "strategic" trade policy.

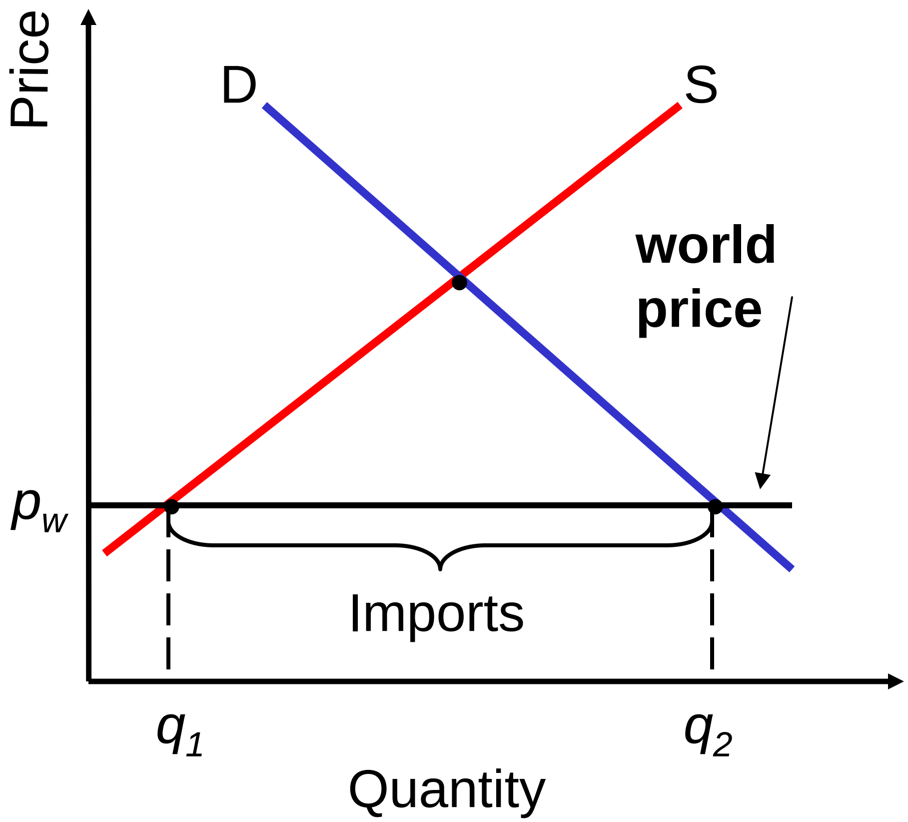
Fallacious Arguments for Protection

Many arguments against free trade are based on the misconception that in every transaction there is a winner and a loser. Other common misconceptions include:

- protectionist policies “keep the money at home,”
- we should protect ourselves from low-wage foreign labour,
- exports are “good”, and should be promoted, whereas imports are “bad”, and should be blocked, and
- protectionist policies will create more domestic jobs.

2 Methods of Protection

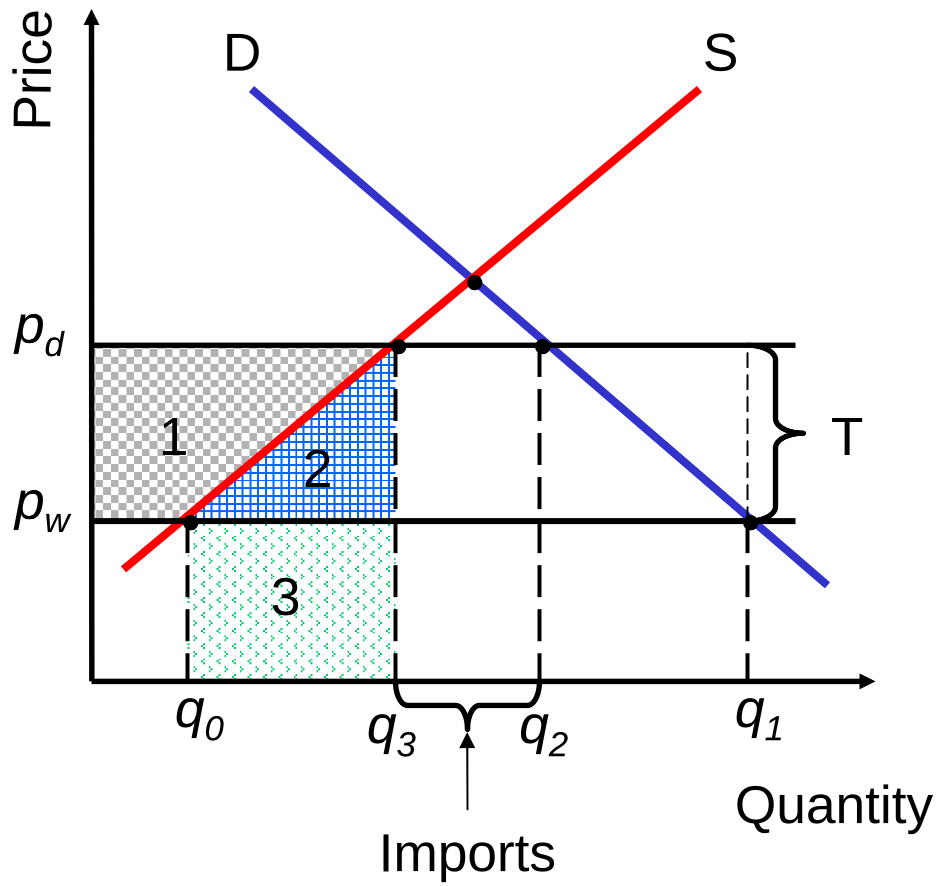
Tariffs



Consider the market for some imported good with a world price of p_w .

Under free trade, domestic production is q_1, domestic consumption is q_2, and imports are $q_1\,q_2$.

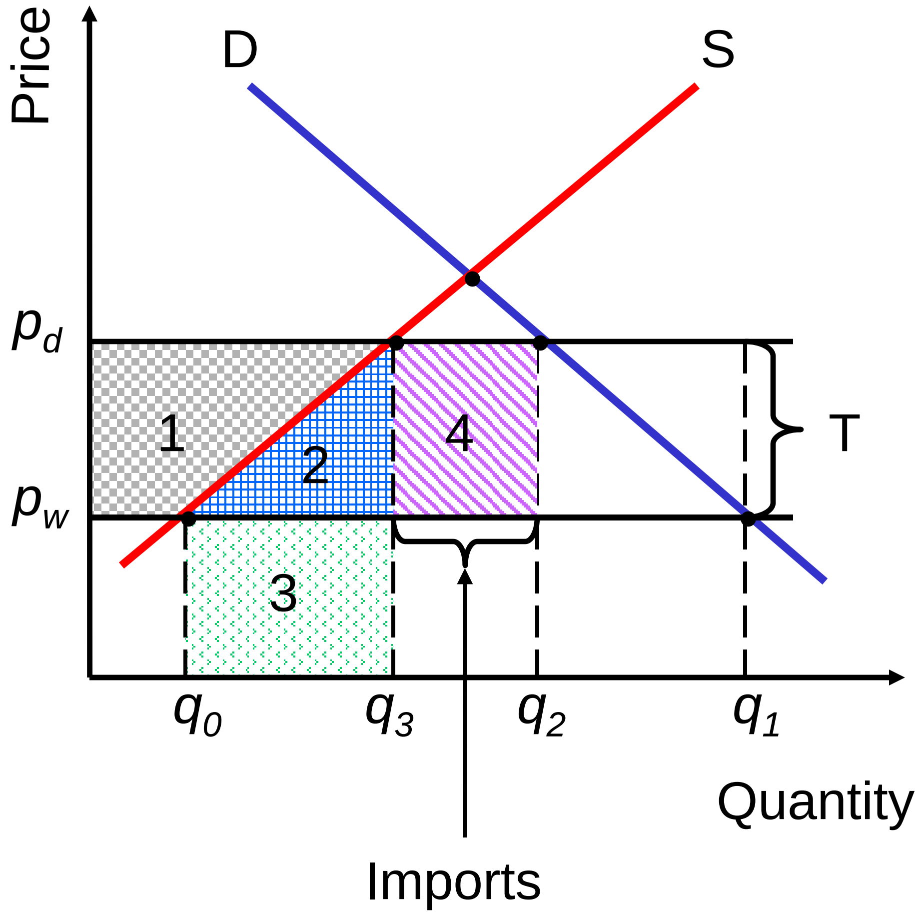
Levying a tariff of $T per unit raises the price to p_d in the domestic market. Domestic consumption falls, whereas domestic production rises. Imports fall.



Domestic output rises from q_0 to q_3, and producers' revenues rise by areas 1, 2, and 3. Domestic firms are better off than without the tariff.

Imports fall from q_0q_1 to q_3q_2. But the government receives revenue from the extra amount paid for the imported units as a tariff (area 4).

Revenues of domestic firms are higher and tax (tariff) revenues are higher. Who loses?



Domestic consumers lose on two counts.

First, they consume less of the product than they otherwise would. Second, they pay a higher price for the amount that they do consume. (Less consumer surplus on both counts.)

The money from the higher prices that consumers pay ends up in two places:

- some to domestic producers,
- some to the government’s tax revenues.

But the loss to consumers outweighs the gain to firms and government tax revenue. Can you spot the deadweight loss associated with the tariff?

Quotas and Voluntary Export Restraints (VERs)

The same result can be accomplished by a quantity restriction, either a quota or a voluntary export restriction (VER), that restricts imports to q_3q_2.

This drives the domestic price to p_d and has the same effect on domestic consumers and producers as the tariff.

However, since foreign producers now receive p_d for each imported unit (instead of the initial world price), area 4 now represents additional revenues for foreign producers rather than tariff revenues for government.

Tariffs Versus Quotas?

In general, a quota and a volume equivalent tariff usually have different welfare implications for both the importer and the exporter. From the perspective of the exporting country, a quota is preferable because it allows that country to capture some surplus.

A Current Trade Dispute

The US has protected its softwood industry in recent years with both tariffs on the import of Canadian softwood and by pressuring Canadian governments to impose export quotas on producers. Given a choice between these two non-free-trade options, the quotas allow the Canadian producers to capture some surplus, while the tariffs generate a surplus for American consumers of softwood.

Trade-Remedy Laws and Nontariff Barriers

Some NTBs were originally created to remedy problems that arise from international trade.

Dumping occurs when a commodity is sold in export markets for a lower price than in the domestic market for reasons unrelated to the costs of servicing the two markets.

Countervailing duties act as a tariff to “level the playing field” when foreign governments subsidize exporting firms.

The countervailing duty is only imposed if the subsidy is large enough to cause significant injury to competing domestic firms.

3 Current Trade Policy

The GATT and the WTO

Under the General Agreement on Tariffs and Trade (GATT), countries agree to reduce trade barriers through multilateral negotiations and not to raise them unilaterally. The GATT has greatly reduced world tariffs since its inception in 1947.

At the end of the Uruguay Round in 1994, the GATT was succeeded by the World Trade Organization (WTO).

The most contentious issue to emerge during the Doha Round, which began in 2000, is agriculture.

The Doha Round also included efforts to put together free trade in financial capital and investment. But there has also been much political opposition within many of the countries involved.

In addition to disputes between governments, non-governmental organizations and other civil society actors have become involved in seeking to influence the decisions made by the WTO. This has been important in getting labour standards and environmental issues to be included in the agenda of the talks.

Regional Trade Agreements

Attempts to liberalize trade over a much smaller group of countries include:

- free-trade agreements,
- customs unions, and
- common markets.

A free trade area (FTA) is the least comprehensive of the three. It allows for tariff-free trade among the member countries, but leaves each country free to design its own policy with respect to non-member countries.

The North American Free Trade Agreement (NAFTA) is the world’s largest and most successful free-trade area.

A <u>customs union</u> is a free-trade area in which the member countries agree to establish a common trade policy with the rest of the world.

An example is Mercosur, linking Argentina, Brazil, Paraguay, and Uruguay.

A <u>common market</u> is a customs union that also has free movement of labour and capital among its members.

The <u>European Union</u> (EU) is the world's largest and most successful common market.

A major effect of regional trade liberalization is to reallocate resources. Economists divide these effects into two categories: trade creation and trade diversion.

When countries trade more as a result of a trade agreement, importing rather than producing the goods (inefficiently) themselves, this is trade creation. Trade creation represents efficient specialization according to comparative advantage.

When countries in a trade agreement import from high-price members rather than from lower-price non-members, this is trade diversion. From the global perspective, trade diversion represents an inefficient reallocation of resources.

The North American Free Trade Agreement

NAFTA is guided by the fundamental principle of national treatment, which means that governments cannot discriminate on the basis of a firm's nationality.

Other provisions include:

- the elimination of tariffs by 1999,
- national treatment to foreign investment,
- trade restrictions are "grandfathered" or have "sunset" clauses, and
- some goods remain subject to non-tariff trade restrictions (such as cultural industries in Canada).

Under NAFTA's <u>dispute settlement</u> mechanism the imposition of countervailing duties and antidumping duties must be subject to a review panel made up of experts from all three countries.

By and large, the NAFTA agreement has worked out as expected by its supporters. Industry has clearly restructured in the direction of greater export orientation in all three countries, and trade creation has occurred.

All three countries are exporting more to and importing more from each other.