

Commercial Policy

Commercial Policy

“Commercial policy” is an umbrella term describing the regulations and policies that dictate how companies in different countries can conduct commerce with each other. Commercial policy includes tariffs, import quotas, export constraints, and restrictions against foreign-owned companies operating domestically.



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The Costs of Protectionism

There are several reasons why further trade opening is beneficial even if the dollar values of the gains are not that high.

1. keep their markets open when there is a severe downturn avoids protectionist and retaliation behavior and no one gained an advantage.
2. trade increases exposure of countries to each other, and in the process, it leads to new knowledge.
3. trade protection is grossly inefficient in achieving the goals it seeks

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The Logic of Collective Action

- Given that the costs of tariffs and quotas are high to consumers, why do consumers tolerate them?
- Economist Mancur Olson's studies make two points:
 - The costs of tariffs and quotas are borne by a great many people: everyone pays a little for protection
 - The benefits of protection is concentrated in a few industries: few benefit a lot from protection
 - Thus, there is an asymmetry in the incentives to oppose the policy: those benefiting from protection have much greater incentives than those hurt by it to lobby for it

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Why Nations Protect Their Industries: Revenue

- In a developing country's economy, a large percentage of economic activity is unrecorded making income taxes and sales taxes are difficult if not impossible to impose.
- Tariffs, can be relatively easily collected at the ports and border crossings.
- Poorer regions (Africa, South Asia, parts of the Middle East) rely more on tariffs as a source of government revenue.
- Tariffs may still be used for other purposes, but for some countries, the primary goal is to generate income for the operation of government services.

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Why Nations Protect Their Industries: The Labor Argument

- **The Labor Argument:** Protection must be used against imports from countries where wages are much lower
 - **Problem:** Does not consider differences in productivity between different workforces: As productivity rises, so will wages



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Why Nations Protect Their Industries: The Infant Industry Argument

- **Infant Industry Argument:** mainly associated with the tariff policies of developing nations to protect their “infant” industries against the competition of more mature firms in industrial countries.
 - **Assumes:** (1) market forces do not allow for the development of a certain industry and (2) the industry has positive externalities—spillover benefits (valuable linkages to other industries or technologies)
 - **Problems:** does not demonstrate that there is some inherent advantage in making something as opposed to buying it

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Why Nations Protect Their Industries: The National Security Argument

- **National Security Argument:** Certain industries must be protected in order to guard national security (military security, cultural values)
 - Prohibitions imposed on exports or tariffs on imports to develop domestic mineral or other resources are often not an optimal policy.
 - Usually more efficient to build stockpiles of minerals and other materials by buying large quantities in peacetime when less expensive.

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Why Nations Protect Their Industries: The Cultural Protection Argument

- The cultural industries include movies, television programming, music, print media, theater, and art.
- Goal of protecting national cultural values is usually an argument in favor of protecting a nation’s filmmaking, television programming, and music production against complete domination by its U.S. counterparts

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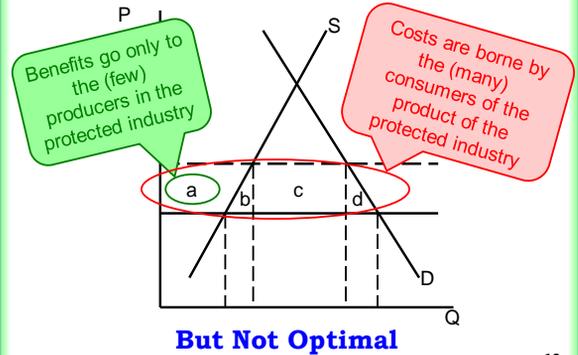
Why Nations Protect Their Industries: The Retaliation Argument

- **Retaliation Argument:** Another country's trade barriers must be countered with trade barriers
- **Problems:** Although retaliation can provide an incentive for trade negotiations, it can also lead to escalating trade wars

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Protect a Favored Industry



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Un-sensible Reasons for Protection

- “Un-sensible”?
 - Reasons that are based on misunderstanding of what protection will actually do
- Pauper Labor Argument
 - “We hold that the most efficient way of protecting American labor is to prevent the importation of foreign pauper labor to compete with it in the home market...” (Democratic Party Platform, July 9, 1896)
 - Based on belief that trade with poor countries will drive US wages down to the very low (“pauper”) levels of poor countries

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Un-sensible Reasons for Protection

- Pauper Labor Argument – Answer
 - See Ricardian Model: Labor in poor countries earns low wages because it is less productive than labor in rich countries. Trade will in fact raise wages in both
 - Caveat: Heckscher-Ohlin Model implies Factor Price Equalization (FPE)
 - At level above poor-country autarky wage But below the rich-country autarky wage Thus an element of truth to the pauper labor argument
 - But empirical evidence indicates technology differences account for much of the wage difference, preventing FPE
 - Thus rich-country wages may fall due to trade, but not nearly to poor-country levels

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Un-sensible Reasons for Protection

- **Fairness Argument**
 - It is “unfair” to make workers compete with those who are either more productive or lower paid.
 - Analogy is to players in a game, who want a “level playing field” because one side must lose.
- **Answer**
 - Trade is not a “zero-sum game”: There are benefits for both countries
 - If “field is tilted” favoring another country’s exports (e.g., by a subsidy, low wages, or cheap currency), we actually benefit from that through cheap imports.
 - Also, even those who lose can be compensated by others in their countries, who gain

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Un-sensible Reasons for Protection

- **Patriotism Argument**
 - “We should buy from producers inside our country, so that the benefit goes to them instead of to foreigners.”
- **Patriotism Argument - Answer**
 - This confuses costs and benefits: in fact, buyers benefit from consumption, while sellers incur the cost of production
 - If we import and don’t export, then we enjoy the fruits of someone else’s labor
 - If we both import and export, then comparative advantage says that we (and they) both benefit more



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Un-sensible Reasons for Protection

- **Retaliation Argument**
 - “If others use tariffs against our exports, then we should use tariffs against their exports.”
 - This assumes that their tariffs hurt us (which they do), and that we gain by fighting back
- **Answer**
 - From the theory, foreign tariffs are irrelevant to the effects of our own tariffs
 - If using a tariff would hurt us when others do not protect, then it will also hurt us when they do
 - So retaliation does not help us

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Sensible Reasons for Protection

- **“Sensible”?**
 - Reasons based on effects that protection may actually have
 - These too have counter-arguments
 - Why they may not work
 - Why another policy would work better
- (that is, protection is “second best”)

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Sensible Reasons for Protection

- **Revenue Argument**
 - Tariffs collect revenue for government
 - Tariffs may be the only tax that a weak government can manage
 - Tariffs are easier to collect than other taxes, because you only have to monitor the border (not the whole inside of the country)
- **Counter-argument: Tariff is 2nd best**
 - If other taxes are feasible, then almost any other tax causes less distortion than a tariff
 - Reason: A tariff distorts both supply and demand
 - Example: Tax consumption...

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Sensible Reasons for Protection

- **Optimal Tariff Argument**
 - We saw this when we analyzed a large country: Tariff can improve the country's terms of trade and thus raise its welfare
- **Counter-arguments**
 - **Optimal tariff benefits the country only at the expense of other countries**
 - Other countries lose more than this country gains
 - Use of a tariff for this purpose is therefore both inefficient and unethical
 - It's **NOT NICE!**
 - **More practically, other countries are likely to retaliate, with tariffs of their own**
 - Then everybody loses (probably)

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Sensible Reasons for Protection

- **Infant Industry Argument**
 - When a developing country is trying to start a new industry, there are reasons why a tariff may help
 - We'll discuss this further later, when we look at trade and development
- **Counter-argument: Protection is 2nd best**
 - As we will see, a direct subsidy to the industry is a less costly way of helping an infant industry (in terms of welfare, not budget)

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Sensible Reasons for Protection

- **National Security Arguments**
 - Protect a military capability (e.g., steel, motor vehicles)
 - Reduce vulnerability to disruptions of supply (e.g., oil)
 - Note: Reading by Kain, which sites National Security. But his argument is not about this. We'll see it later.
- **Counter-argument: Protection is 2nd best**
 - Direct subsidy to industry is better
 - Other even better options also exist (e.g., stockpile the good, as in the US Strategic Petroleum Reserve)

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Sensible Reasons for Protection

- **Cultural Argument**
 - Imports displace products of domestic culture
 - French films
 - Canadian music
 - By limiting imports, distinctive domestic producers are allowed to survive
- **Counter-argument: Protection is 2nd best**
 - Direct subsidy to industry would be better
 - Subsidy leaves consumers free to choose: perhaps they really prefer foreign culture

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Sensible Reasons for Protection

- **Unfair Trade**
 - If foreign exports are “dumped” or subsidized (thus below a “fair” price), domestic producers deserve protection
 - See Mastel, “Keep Anti-Dumping Laws Intact”
 - He cites: industrial subsidies, market collusion, government pricing, and sanctuary markets
- **Counter-argument:**
 - Domestic import-competing firms do lose from “unfair trade,” but consumers in their country gain more than the firms lose, from the cheap imports
 - Protection is “sensible” here because it does benefit domestic producers
 - But here again it is second best.

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Sensible Reasons for Protection

- **Protect Favored Industry**
 - Sometimes governments simply want to help an industry
 - To get their political support
 - And/or because workers in the industry are suffering
 - Protection (tariff or quota) certainly does help the protected industry (area “a” in our figures)
- **Counter-argument: Protection is 2nd best**
 - Direct subsidy to industry can help just as much, at lower cost
 - Subsidy is also more transparent and easier to evaluate

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Sensible Reasons for Protection

- **Retaliation**
 - Direct effect of retaliation: Negative, as we’ve seen
 - Our retaliation against foreign barriers makes us worse off
 - Possible indirect effect of retaliation: May change behavior of foreign governments
 - Tariffs against “unfair” trade policies: May cause those policies to cease.
 - Tariffs in retaliation against optimal tariff: May cause optimal tariff to be withdrawn
 - WTO uses permission to retaliate as a means of enforcing its rules

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