

# What are the Main Causes and Effects of Economic Protectionism?

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<https://www.e-ir.info/2012/08/28/the-causes-and-effects-of-economic-protectionism/>

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Classical liberal economic theory widely recognises and portrays the benefits of free trade. The maximum benefits can be gained from the markets only when barriers to trade are open and the state does not pose limitations to trade. A lot has been written to defend this position, and economists have even aspired to explain it in scientific terms, through such theories as the law of comparative advantage. So widespread is the theoretical support for free and open trade, that economists face somewhat of an embarrassing paradox when they analyse the reality around them. It is safe to say that no state in the world has eliminated all of its trade barriers, and a wide variety of protectionist measures are adopted throughout nation-states and regions of the world [1]. This essay looks at why, despite being so strongly and lengthily criticized as sub-optimal, protectionism is widely adopted. It looks at the reasons for which a state might pursue protectionist policies, and at the effects that these policies have. The effects are both the expected effects (those that are desired when implementing the policy), and the unexpected ones (the side-effects in a way), and are seen both as strictly economic effects (which largely correspond to the criticisms of the neo-liberals), and as more widely social and political. The causes are grouped under two main domains: the more strictly mercantilist causes, and the liberal/ public choice theory causes, which incorporate domestic political and group interests, and collective action reasoning. The effects are partly included in the discussion of the causes (mainly the intended, expected effects), and partly addressed separately. It is concluded that the two sets of causes reinforce each other through a common focus on political factors.

### The Marvels of Free Trade

When trade faces no barriers, it increases the size of the market. There are thus gains because of declining per unit production costs, and consequential economies of scale as production becomes 'international'. Overall economic activity grows, and this increases economic growth. Open trade also reduces the monopoly power of some producers at the domestic level because of increased competition. This drives prices down and increases product variety, both of which are beneficial for consumers. Another benefit of open trade is the diffusion of technology, which is brought to developing countries by firms and transnational corporations (TNCs) and allows them to by-pass stages of development which would require them to acquire those technologies. While these benefits are debatable on theoretical terms, in particular because of the assumptions on which they rest, this is not dealt with here. It is important here simply to note how much theoretical support there is for open trade. In what has been arguably the biggest contribution to the idea of free trade between nations, David Ricardo developed the theory of comparative advantage, in which he demonstrated that two nations (or any two economic actors, for that matter) who have different relative costs in the production of the same goods benefit from trade, having specialized in the production of the good for which they have the greatest comparative advantage [2]. Crucially, this applies even if one nation has the absolute advantage in the production of both goods. Even though more recent views of the concept of comparative advantage regard it not as fixed but as the result of corporate and state policies [3] and of the historic use of wealth and power [4], much of the (widespread) contemporary support for free trade in policy circles has its roots in this argument.

### Protectionism is Costly

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The effects of protectionism, for economic theory, are clear and multiple. Protectionism requires resources (e.g. tax revenue) which are taken away from other industries, the output of which consequently falls. It also takes resources away from individuals and households, who face higher prices for the protected goods: as a consequence both their consumption of that good and their overall consumption fall, in the latter case because of reduced purchasing power. Output in the competitors' states is also reduced as a result of the reduction of sales in the protected country. More generally, uncertainty in trade policies undermines growth in itself, for firms are unsure about how much to invest and when in case of higher future barriers. Many studies have shown the (high) costs of protectionism [5]. Some also have found that increased imports do not cause higher unemployment [6] and that trade restrictions do not create greater employment [7]. It is even possible that a reduction in imports, by reducing foreign incomes, reduces demand for exports and thus in turn reduces the domestic incomes of the protectionist country. Others have shown that the costs of protecting local jobs and firms through tariffs and quotas are greater than the cost of retraining workers and relocating jobs. Similarly, the costs of subsidies are likely to be higher than the costs of shifting production to more competitive industries [8]. It is not clear whether these calculations include also the 'hidden' costs of losing jobs (in terms of the psychology and self-esteem of the workers, the effects on their families) and of changing the structure of the economy, but they are nonetheless of great importance to the debate. Tariffs, quotas and subsidies are also believed to discourage innovation and advancement in domestic industries, which do not face the incentives of competition to lower their costs and improve the efficiency of their production process.

## Some Causes of Protectionism

Why then is there protectionism? The literature stresses the size of the contradiction. From the moderate Rodrik, who writes "Adam Smith and his followers have won the intellectual battle, but the facts on the ground tell a more ambiguous story" [9], to the harsher Milner, who describes protectionism as "one of the most visible theoretical gaps [in economic theory]" [10].

The first set of causes are mainly mercantilist, and include the infant industry argument, spillover effects, national security, the unequal exchange perspective, fair trade and state interests divergent from global income maximization.

An infant industry is one which is newly established in a country. In an open trade system, such an industry will immediately face strong competition from foreign producers which are already established in the market for that particular good. These competitors thus have an advantage over the new industry which, until it reaches the required technology and the low production costs to make it competitive, will incur severe losses and possibly be driven out of the market. Protection of that industry in the initial stages of its development, mercantilists argue, is beneficial, at least until it reaches the competitiveness required to survive on the market. A related argument for the causes of protectionism is the idea of spillover effects, by which the protection of a certain industry generates spillover benefits for other domestic industries connected through the supply chain (these may themselves demand protectionism). Such externalities are not internalized by the market for the industry which generates them, and should therefore be internalized through state intervention. Empirical evidence shows, on the other hand, that the removal of tariff protections on what are initially 'infant' industries is not easily achievable, for as the industry grows its political influence also grows, and through the latter the industry will seek continued protection. With continued protection the industry is also unlikely to develop an adequately efficient production process that will enable it to be competitive on the global markets.

As has been shown through the law of comparative advantage, supporters of free trade explain how specialization of individual countries in the production of a few goods benefits all countries. This, however, does not take into account that states are concerned with their security and sovereignty, and that being dependent on trade with other countries for the availability of vital goods (e.g. arms, certain types of food, water and sources of energy production) is not a desirable situation. As realists would stress, on the international stage there is anarchy, and no rules, treaties or alliances can assure the safety of any country. States may thus have an argument in protecting certain industries which ensure a greater degree of safety.

The unequal exchange perspective provides yet another insight into why protectionism may be pursued. While classical economics lies on the assumptions that trade is fair and equal, that all actors in the exchange of goods have

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the same bargaining power, the same (perfect) degree of information and the same constraints, in the real world, critics argue that trade relations are not equal. Power, wealth, historic relations and path dependency (colonialism contains elements of all four) all contribute to create an imbalance in trade relations which nearly invariably favours the rich developed countries at the expense of the developing ones [11]. Thus developing countries have a justification for restricting free trade to partly balance the situation, both as single countries and as a group in international forums such as the WTO (for example refer to the controversies on the Doha round).

Another argument which refers to imbalances in trade (this time on behalf of developed countries) lies in the advocacy of 'fair trade', in opposition to 'free trade'. Many industries in developing countries are highly competitive on the global market as a result of the low wages and loose legal rights for workers. In western countries such cheap labour is not available to firms, and workers are protected by unions and laws in defence of their rights. This, in the view of developed countries, creates an 'uneven playing field' where competition is not based on the same conditions. This is combined to, and reinforced by, concerns about social conditions and human rights of workers in developing countries. Protectionism thus provides the means of disallowing entry into the domestic market of products which do not abide to minimal standards of human rights and working conditions. Another unfair practice is the dumping [12] by foreign firms of their products onto the market, which drives competitors out of the market. The EU alone has issued more than 300 anti-dumping measures since 1998 [13]. Of course, anti-dumping and fair trade may easily become excuses for more private interests. Evidence shows that anti-dumping in the EU targets products for which European comparative advantage has been declining (e.g. raw materials, textiles, industrial inputs), and that duty levels are significantly higher than bound tariffs [14]. Also, low wages have served the interests of western TNCs when outsourcing to developing countries, so there is a degree of incoherence in the argument.

Protectionism provides also a strong source of government revenue. While this may not be considered in the liberal view, where states are given a minimalist role in the economy and are believed to pursue the only goal of wealth maximization, it is of considerable importance, and is just an initial realization of the fact that states have a variety of interests which may cause a trade off with that of income maximization. These include a greater focus on relative gains than on absolute gains (i.e. even if the global economic cake is made smaller, states are mainly interested in having the largest portion of it to themselves), the preservation of political sovereignty and territorial integrity (national security), possibly the enhancement of soft power (such as the international prestige of the national language and culture [15] ), and distributional and welfare objectives. Some scholars have also noted that growing democratic participation may be in itself, if not a direct cause, a contributing cause to the continued use of protectionist policies, as more groups in society have a voice in representing their interests [16]. The next section analyses the role of groups and lobbying in more detail, providing a strong explanation for the continued existence of protectionism in spite of its costs. It is to be noted that, as with the causes above, focus is once more on political mechanisms and processes. The two sets of causes, although distinct, reinforce each other in this respect. Where economic interests seem to be the ones that cause protectionism, it is their partial (as opposed to global) nature which requires political elements and justifications. Thus the infant industry argument justifies political state intervention with reasons of equality of opportunity and justice for developing countries, of improved welfare for the nation's citizens who often live in poverty; the national security argument is very clearly political in its ultimate defence of national political sovereignty; the unequal exchange perspective refers to international political relations; and the fair trade argument is made in defence of human rights in the most altruistic version and of western country workers and industries in its more self-interested version. Politics is the means by which these concerns and interests are transmitted, represented and protected.

## Domestic Politics, Group Interests and Collective Action

The state may pursue protectionist policies also with the aim of balancing the balance of trade, which entails improving 'national economic health' by reducing or eliminating a trade deficit, or increasing a balance of trade surplus. This in itself does not necessarily improve the national economy (especially because as a result of protectionism prices rise, reducing consumers' purchasing power), but by increasing exports in relation to imports domestic production is increased, and domestic producers are made better off. This may also increase domestic employment.

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Employment and the protection of jobs may be in itself a cause for protectionism. While some reports have shown that the overall effects from an increasing imbalance of trade (more imports relative to exports) on overall (global) employment are negligible [17], workers and resource owners in individual countries are affected differently. The country that is importing more faces costs in terms of moving productive resources to other industries, of workers changing jobs and of workers and capital owners relocating to other areas and cities. This causes workers and owners in the targeted industry to lobby for trade restrictions. But the costs of protectionism, it has been shown, are higher than the costs of adjustment and relocation [18]. So why is lobbying successful in obtaining trade restrictions? The Olsonian logic of collective action provides here a highly valuable explanation. Olson theorizes that individuals subscribe and contribute to a group if there is a benefit reserved to the group members only [19]. This is mainly because the benefits from contributing to a public good do not depend strictly on participation, but can as easily be obtained by free-riding (letting the others contribute to the group, and reaping the benefits obtained from their action). Individuals are thus likely to act collectively for a private good, but not for a public one. This logic applies to protectionism too. The costs of trade barriers are borne by all of society through increased prices. Such costs are difficult to identify and relatively small because they are spread out between all consumers. Even supposing citizens are aware of these costs and of their cause, the decision to rally and campaign for free trade faces the Olsonian logic, and does therefore not lead to collective action. Workers and asset owners in a specific industry which seeks protection, on the other hand, reap high benefits from individual involvement in collective action. The costs of participating in the group are smaller than the benefits, and thus collective action is undertaken. Politicians are thus subject to lobbying for protectionism, and are incentivised by the votes and the campaign contributions of the lobbies to respond positively to them. Actually, it would be reasonable to note that consumers have a lot more power in influencing governments, because their aggregate votes far outnumber those of an industry or lobby group. Individuals however are rarely aware of the fact that the prices they face are inflated by protectionism measures, and this lack of awareness substantially erodes their power to counter private industrial interests.

The Olsonian logic has further effects. Because the increase in prices and the reduction in consumer choice of products are equally spread amongst individuals, they will have a larger effect on the poorer groups in society. A 10% increase in the price of bread, for example, will hit a poor family much harder than a family which is better off, even though the latter faces the same 10% increase. Thus there is an argument for the support of free trade in a more 'leftist' liberal view. To go even further, what will make the poorer worse-off is protectionism on those products on which the majority of their disposable income is spent, namely food, clothing, energy and the like. The industries producing these products are often the most protected, and this is in spite of the social consequences outlined above. Protectionism on luxury goods would not have such an effect on the most economically vulnerable groups in society. A similar process is observable at the international level, particularly in the agricultural sector, which is subject to intense lobbying for protectionism in rich countries, despite the comparative advantage which the developing countries possess in agriculture. It has been estimated that agricultural protectionism costs developing countries around US\$ 24 billion per year in lost income [20], thus contributing to keep the North-South divide wide.

## Conclusions

Protectionism represents a source of puzzle and frustration for neo-classical liberal economists. Liberal economic theory has widely demonstrated the benefits of free trade in providing the global society with the maximum levels of income and material economic welfare. Nevertheless, the use of protectionism in international trade is very widespread. This essay has outlined some of the principal causes and effects of the adoption of protectionism measures.

Mercantilist explanations of the causes of protectionism are based on the underlying belief that state interests do not coincide with global income maximization, but that another set of interests are at play which form a trade off with the latter. In this view states are concerned with relative rather than absolute gains, and thus have an interest in maintaining domestic industries, protecting infant ones, and enhancing domestic production and employment. States are also concerned with national security, and are therefore inclined to ensure that they maintain independence in the production of certain fundamental goods. Additionally, states are interested in maintaining an equal playing field in trade, and use protectionism to this purpose, particularly with regards to working standards and wages.

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Liberals, on the other hand, identify the causes of protectionism more strictly in the functioning of domestic politics and representation. In this view, lobbying, group formation, and the interests of politicians distort policy in favour of protectionism, despite the costs that the latter imposes on the whole of society. This is due to the success of lobbying in favour of private interests of restricted groups in society, in contrast with the difficulties rooted in mobilizing collective action for a public good, as explained by the Olsonian logic. This is possibly the strongest explanation for why protectionist policies are adopted. It is important to stress that it brings into the equation political processes and interests, which contribute to the case more than reasons of strict economic interest and efficiency. The incongruence between free trade economic theory and real world trade relations is to be explained mainly through factors in the political realm, which represent the variety of dimensions of the relationship between trading actors, and form the institutional channels for the pursuit of private and corporate economic interests. It is not by chance that we use the framework of International Political Economy to look for explanations. In this sense, the mercantilist view proves not conflicting but rather complementary to the liberal one in analysing “the constraints and opportunities that private economic activity faces, and the ability to create a sense of national purpose around economic goals” [21].

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12 i.e. Selling a certain product more cheaply abroad than at home, sometimes even at a price lower than the cost of production.

13 Lucy Davis 'Ten years of anti-dumping in the EU: economic and political targeting', ECIPE Working Paper no. 02/2009, p. 1.

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*Date written: March 2012*