

Econ 340

Lecture 7

Reasons for Protection

News: Sep 23-29

- Japan-US trade deal signed -- WSJ: [9/26](#) | [Canvas](#) | NYT: [9/25](#) | [Canvas](#) | FT: [9/25](#) | [Canvas](#) | Economist: [9/26](#) | [Canvas](#)
 - President Trump and Prime Minister Abe, meeting on the sidelines of the UN in New York, signed a new but very limited trade agreement. It includes rules on digital trade, but mainly deals with tariffs. The deal says nothing about trade in cars and car parts, which account for about 2/5 of Japan's exports to the US, and on which Trump has threatened 25% tariffs, though the agreement does promise to "refrain from taking measures against the spirit of these agreements."
 - Japan will reduce or eliminate tariffs on "beef, pork, wheat, cheese, corn, wine and so much more," said Trump. The US will reduce or eliminate tariffs on some industrial goods, including certain machine tools, fasteners, steam turbines, bicycles, bike parts and musical instruments, and also on some plants and flowers, green tea, chewing gum and soy sauce.
 - The deal is small, to avoid the need for approval by the US Congress, but because of that it likely violates rules of the WTO, which requires that free trade agreements cover "substantially all trade." To accord with that, the joint statement announcing the deal said that soon after it comes into force, Japan and the US would finish a broader agreement.
- US to remain in postal treaty -- NYT: [9/25](#) | [Canvas](#) | FT: [9/25](#) | [Canvas](#)
 - The US had threatened to pull out of the 192-country Universal Postal Union, which sets postage rates for international mail and small packages. The objection was that developing countries, including China, were given low rates in order to encourage development. As a result, China has been able to ship to the US for less than it costs to ship within the US, putting US companies at a disadvantage.
 - A 2 kg package shipped within the US costs \$19-23, while China Post pays only \$5 to ship anywhere within the US.
 - China and others have now agreed, at a meeting in Geneva, Switzerland, to increase the rates for sending parcels to the US. Representing the US at the meeting was President Trump's trade advisor, Peter Navarro. The US position was backed by several other countries, including Canada, Brazil, and several in the EU. China also backed the deal, to limit the damage that would result if the US pulled out of the UPU. No country has ever exited the UPU, since it was established in 1874, but the US had said it would pull out on October 17. Now it will not.
- Trump considers blocking Chinese firms from listing on US stock markets. -- NYT: [9/27](#) | [Canvas](#) | FT: [9/27](#) | [Canvas](#)
 - The White House has begun to discuss whether to prohibit Chinese companies from listing on US stock exchanges. "No decision is imminent," however. Stock market prices dropped on Friday after news of this, as did the value of China's currency. This is in the context of renewed negotiations with China regarding trade, tariffs, and aspects of China's behavior, talks that are expected to begin in early October.
 - While such a move could be done by Congress, it is also possible that the President could impose restrictions on national security grounds, arguing that American money flowing to Chinese companies poses a threat to the US.
 - The effects of such a ban could be large. As of the start of this year, 156 Chinese companies were listed in the US, with market capitalization of \$1.2 trillion. At least 11 of these are state-owned. Members of both the administration and the US Congress are concerned that Chinese companies have benefitted from access to US capital.

News: Sep 23-29

- Japan-US trade deal signed
 - President Trump and Prime Minister Abe, meeting on the sidelines of the UN in New York, signed a new but very limited trade agreement. It includes rules on digital trade, but mainly deals with tariffs. The deal says nothing about trade in cars and car parts, which account for about 2/5 of Japan's exports to the US, and on which Trump has threatened 25% tariffs, though the agreement does promise to "refrain from taking measures against the spirit of these agreements."
 - Japan will reduce or eliminate tariffs on "beef, pork, wheat, cheese, corn, wine and so much more," said Trump. The US will reduce or eliminate tariffs on some industrial goods, including certain machine tools, fasteners, steam turbines, bicycles, bike parts and musical instruments, and also on some plants and flowers, green tea, chewing gum and soy sauce.
 - The deal is small, to avoid the need for approval by the US Congress, but because of that it likely violates rules of the WTO, which requires that free trade agreements cover "substantially all trade." To accord with that, the joint statement announcing the deal said that soon after it comes into force, Japan and the US would finish a broader agreement.





The agreement with Shinzo Abe, left, Japan's president, gives Donald Trump, right, a trade achievement to tout even as other worries persist © AP

News: Sep 23-29

- US to remain in postal treaty
 - The US had threatened to pull out of the 192-country Universal Postal Union, which sets postage rates for international mail and small packages. No country has ever exited the UPU, since it was established in 1874, but the US had said it would pull out on October 17. Now it will not.
 - The objection was that developing countries, including China, were given low rates in order to encourage development. As a result, China has been able to ship to the US for less than it costs to ship within the US, putting US companies at a disadvantage. A 2 kg package shipped within the US costs \$19-23, while China Post pays only \$5 to ship anywhere within the US.
 - China and others have now agreed, at a meeting in Geneva, Switzerland, to increase the rates for sending parcels to the US. Representing the US at the meeting was President Trump's trade advisor, Peter Navarro. The US position was backed by several other countries, including Canada, Brazil, and several in the EU. China also backed the deal, to limit the damage that would result if the US pulled out of the UPU.



Peter Navarro, left, a White House trade adviser, threatened to pull the United States out of an international postal treaty unless the rate system was resti

Screenshot

Fabrice Coffrini/Agence France-Presse — Getty Images

News: Sep 23-29

- Trump considers blocking Chinese firms from listing on US stock markets.
 - The White House has begun to discuss whether to prohibit Chinese companies from listing on US stock exchanges. "No decision is imminent," however. Stock market prices dropped on Friday after news of this, as did the value of China's currency. This is in the context of renewed negotiations with China regarding trade, tariffs, and aspects of China's behavior, talks that are expected to begin in early October.
 - While such a move could be done by Congress, it is also possible that the President could impose restrictions on national security grounds, arguing that American money flowing to Chinese companies poses a threat to the US.
 - The effects of such a ban could be large. As of the start of this year, 156 Chinese companies were listed in the US, with market capitalization of \$1.2 trillion. At least 11 of these are state-owned. Members of both the administration and the US Congress are concerned that Chinese companies have benefitted from access to US capital.

Outline: Reasons for Protection

- Reasons that DO NOT Make Economic Sense
 - Pauper Labor
 - Fairness
 - Patriotism
 - Retaliation
- Reasons the DO Make Economic Sense, with Counter-Arguments
 - Revenue
 - Optimal Tariff
 - Infant Industry
 - National Security
 - Culture
 - Unfair Trade
 - Protect Favored Industry
 - Retaliation...
- Production Subsidy versus Tariff
- Why Aren't Tariffs Higher?

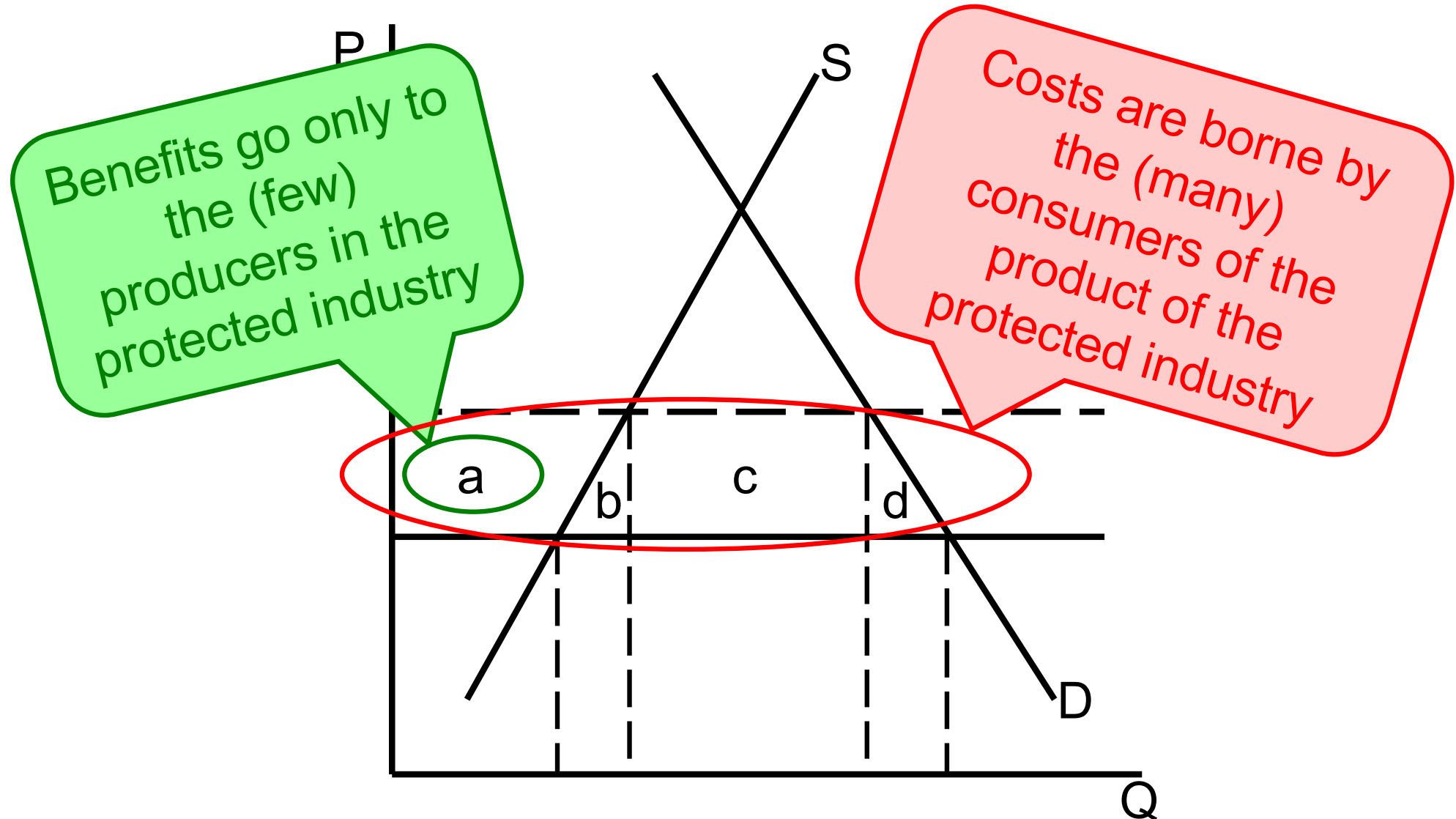
Why Do Countries Use Protection?

- Models say that tariffs, quotas, etc. mostly hurt the countries that use them
- But almost all countries do use them, and always have, even more than today. Why?
- Many reasons have been given (I list 26 arguments in my Glossary); we'll go through some of them.
- Of these, what usually explains actual protection today is

Protect a Favored Industry

- Why?
 - Benefits of protection go to a few
 - Costs of protection, though larger, are spread over many
 - And are therefore much, much smaller for each

Recall Effects of Tariffs



Outline: Reasons for Protection

- Reasons that DO NOT Make Economic Sense
 - Pauper Labor
 - Fairness
 - Patriotism
 - Retaliation
- Reasons the DO Make Economic Sense, with Counter-Arguments
 - Revenue
 - Optimal Tariff
 - Infant Industry
 - National Security
 - Culture
 - Unfair Trade
 - Protect Favored Industry
 - Retaliation...
- Production Subsidy versus Tariff
- Why Aren't Tariffs Higher?

Un-sensible Reasons for Protection

- “Un-sensible”?
 - Reasons that are based on misunderstanding of what protection will actually do

Un-sensible Reasons for Protection

- 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

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
 - Other sources of gain from trade (New Trade Theory) help all
 - Thus rich-country wages may fall due to trade, but not nearly to poor-country levels

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 (in principle)

Un-sensible Reasons for Protection

- Some years ago, I got an e-mail from something called Third Way, promoting harsher treatment of China in trade.
 - Their report: “China’s Trade Barrier Playbook: Why America Needs a New Game Plan”
 - And their graphic...

CHINA'S TRADE PLAYBOOK

BLOCKING U.S. EXPORTS

#1 Lock-Out Players

Import barriers keep America from playing in China's market.

#2 Enhance Performance

"Pumping-up" Chinese firms with subsidies and currency manipulation.

#3 Home Field Advantage

Regulators play favorites with China's state-owned companies.

#4 Change the Rules

Using "homegrown" technical rules to unfairly help Chinese firms.

#5 Steal the Play

Robbery and forced transfer of valuable U.S. ideas.

#6 Hide the Ball

Not publishing or allowing comment on important rules.

#7 Change the Play

Replacing one unfair trade barrier with another.

#8 Bend the Rules

Using unfair loopholes to violate key trade principles.

#9 Run Out the Clock

Stalling on promises to play by trade rules.

**GAME PLAN:
SLOW THE FLOW
OF U.S. GOODS
AND SERVICES!!**

SCOUTING REPORT: CHINA

SIZE: Big

The U.S. is the largest non-Asian exporter to China. America exported \$13 billion goods and services to China in 2010.

SPEED: Fast

China is the fastest rising market for U.S. exports, averaging over 15% annual growth.

UPSIDE: Huge

260 million new middle class Chinese consumers by 2020.

SIZE: U.S. Trade Representative
SPEED: U.S. International Trade Commission Database
UPSIDE: Congressional Research Service

From the Third Way report "China's Trade Barrier Playbook: Why America Needs a New Game Plan" available at: <http://www.thirdway.org/publications/483>

© 2011 Third Way. Free for re-use with attribution/link. Visit Third Way at www.thirdway.org.
Infographic by Bill Rapp and Ed Gerwin.

Official



third way

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.”



Un-sensible Reasons for Protection

- 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
 - By “buying American” we substitute higher cost goods produced here for the greater amounts we could have bought, paid for with our exports.
 - Recall “Buying Local” reading last time.

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; it just hurts us more

Clicker Question

Why is the patriotism argument for protection not “sensible”?

- a) Because tariffs generate revenue for the government
- b) Because free trade does not hurt anyone
- ✓ c) Because protection makes the country as a whole worse off
- d) Because quotas, not tariffs, would make the country stronger

Clicker Question

If another country taxes our exports, how does this change the benefit of our taxing imports from them?

- ✓ a) It doesn't change it
- b) It increases the benefit from our tax
- c) It decreases the benefit from our tax
- d) Whether the benefit from our tax rises or falls depends on whether our imports are greater or smaller than our exports

Outline: Reasons for Protection

- Reasons that DO NOT Make Economic Sense
 - Pauper Labor
 - Fairness
 - Patriotism
 - Retaliation
- Reasons the DO Make Economic Sense, with Counter-Arguments
 - Revenue
 - Optimal Tariff
 - Infant Industry
 - National Security
 - Culture
 - Unfair Trade
 - Protect Favored Industry
 - Retaliation...
- Production Subsidy versus Tariff
- Why Aren't Tariffs Higher?

Sensible Reasons for Protection

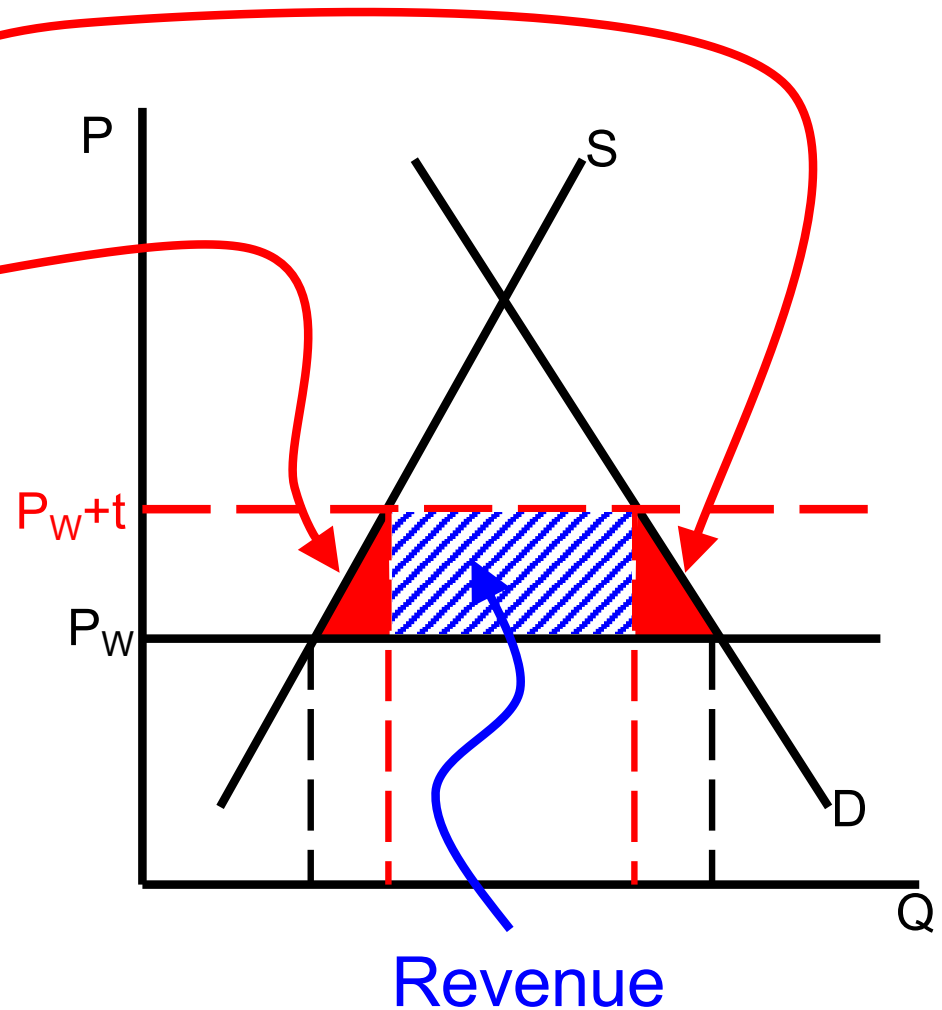
- “Sensible”?
 - Reasons based on effects that protection may actually have
 - These too have counter-arguments
 - Why they may not work
 - Why another policy would work better
(that is, protection is “second best”)

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...

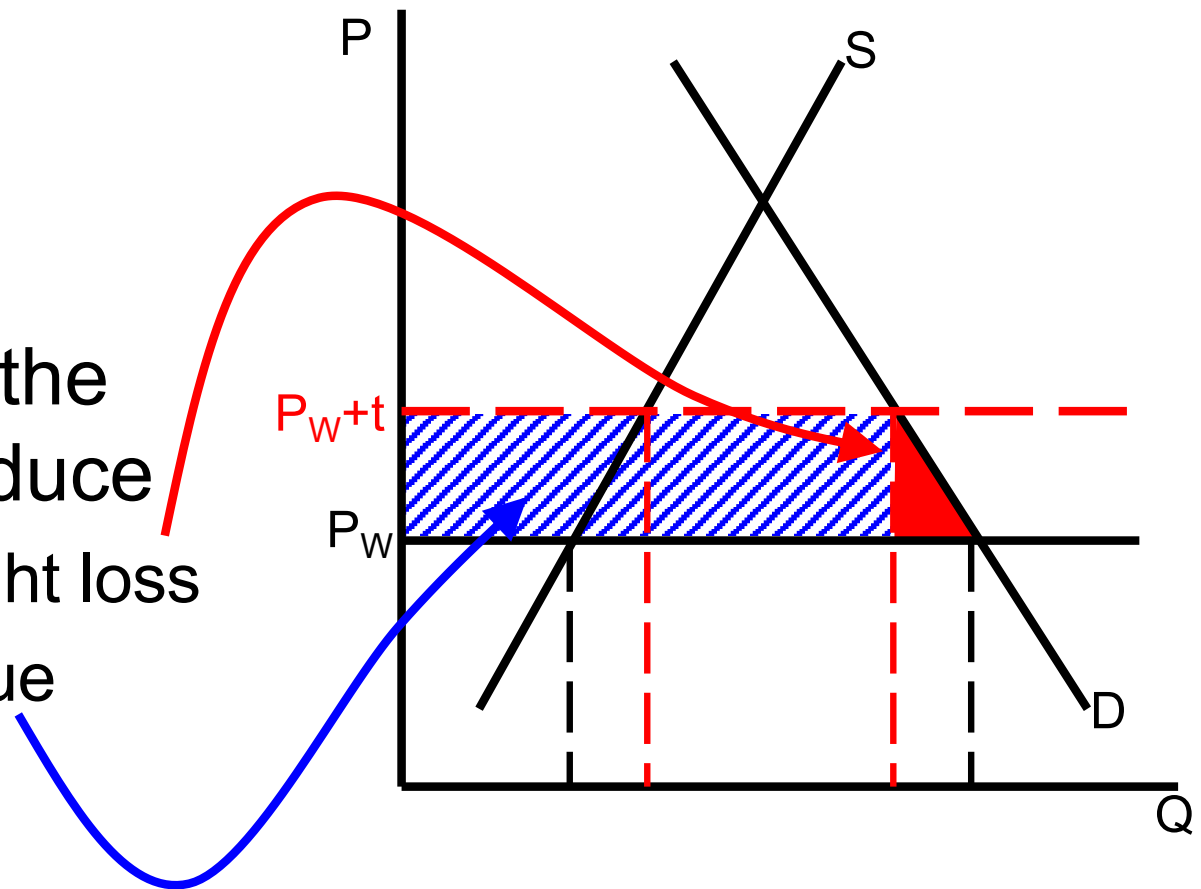
Recall Effects of Tariffs: Small Country

- Because demanders and suppliers both are led by the tariff to behave as if the good's value were $P_W + t$,
- when in fact the country can buy or sell it for P_W .



Effects of a Consumption Tax: Small Country

- A tax on, say, consumption of the good would produce
 - Less dead-weight loss
 - More tax revenue



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

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

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: Kain reading cites “National Security.” But his argument is not about this. We’ll see his 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)

United States Strategic Petroleum Reserve

In August 2005 it held 700 million barrels of oil, contained in salt caverns

Compare: In 2005 US imported about 13 million barrels per day

SPR could replace imports for more than 50 days

Recent report (2016):

- Questions the need for this today
- Says the infrastructure needs maintenance



Sensible Reasons for Protection

- National Security Arguments
 - Trump's National Security Strategy (announced Dec. 18, 2017) included: “economic security is national security”
 - He views economic security as not having a trade deficit
 - Trump administration imposed tariffs on aluminum and steel imports, based on national security
 - It is also considering tariffs on imported cars for the same reason (decision put off until Nov 13)

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

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.

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

Sensible Reasons for Protection

- Protect Favored Industry: Example
 - Reading by Kain, “Protectionism and National Security”
 - He believes that US should keep
 - Good jobs
 - Self-sufficiency in agriculture
 - Views this as a matter of morality:
 - “But I think a nation that’s lost its builders, its carpenters, its laborers, its blue collar workers, its middle class, becomes a nation ready for collapse. We become morally bankrupt, and literally bankrupt as well, as our entire system becomes one reliant upon debt and growth. There is a missing piece in all of this free trade econo-speak, and that is the moral element, the question of good, civil order and proportion.”

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

Clicker Question

Why is a tariff a “second best” way to raise revenue for the government?

- a) A tariff, like any tax, distorts markets
- ✓ b) It could raise more revenue at less economic cost with another policy
- c) The country would be better off with less revenue and a smaller government
- d) An import quota, if auctioned off, would raise more revenue with the same reduction in imports
- e) If the country is large, the tariff will reduce the world price

Clicker Question

Why do economists not advocate the use of an “optimal tariff” by a large country?

- a) Other countries lose, though not as much as the large country gains
- b) Though called “optimal,” the optimal tariff actually reduces the welfare of the large country
- ✓ c) Other countries are likely to retaliate, leaving all countries worse off
- d) Raising tariffs is not legal under rules of the WTO
- e) The benefits from an optimal tariff could be achieved more cheaply another way

Clicker Question

How does the WTO use retaliation as a means to enforce its rules?

- a) The WTO levies a fine on offenders
- b) Countries that have not broken rules are encouraged to dump exports into the markets of those who have
- c) Countries that break rules must turn over their tariff revenues to the WTO
- ✓ d) The WTO permits other countries to put tariffs on the offending country's exports
- e) The WTO instructs the IMF not to lend to a country that breaks the rules

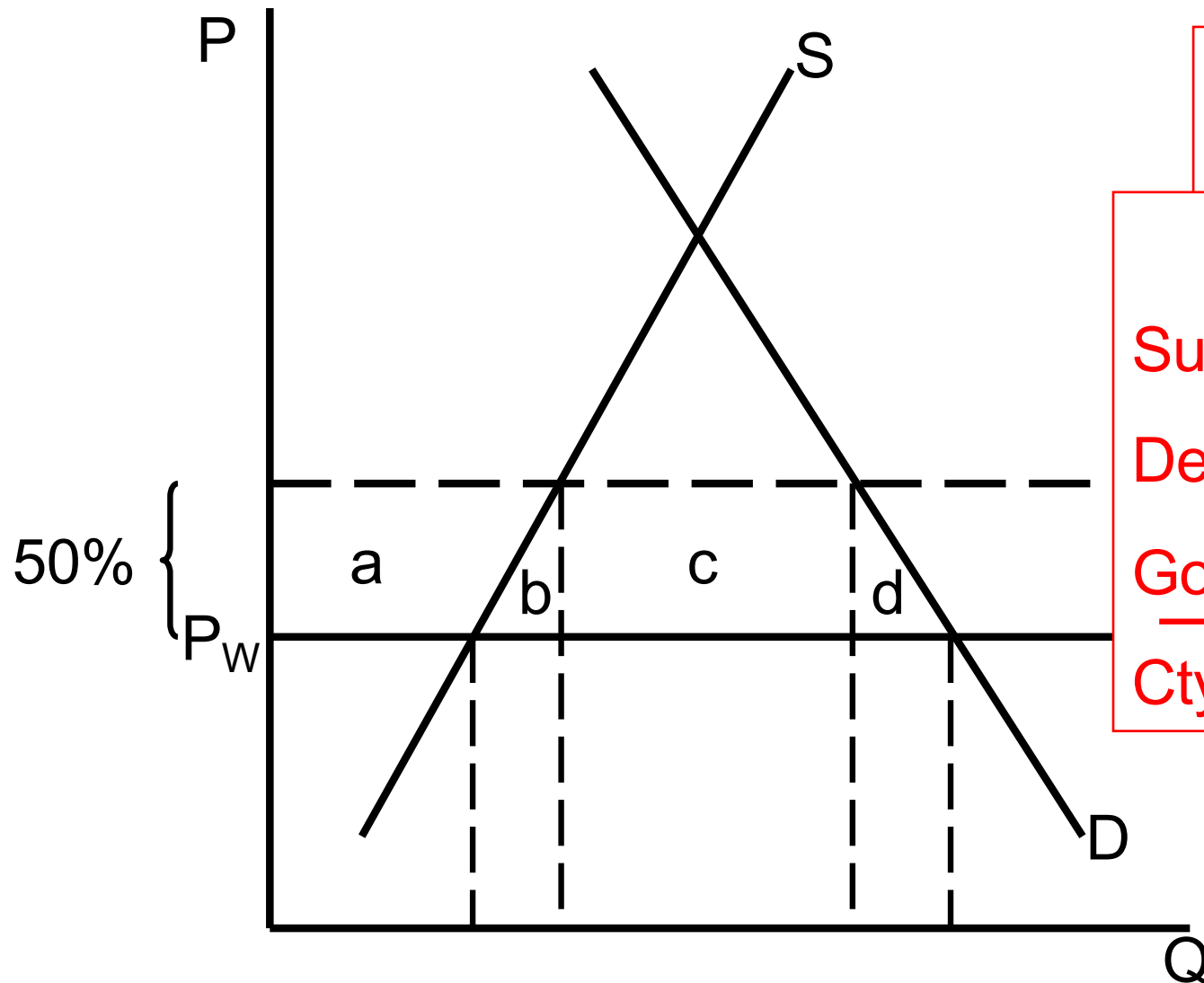
Outline: Reasons for Protection

- Reasons that DO NOT Make Economic Sense
 - Pauper Labor
 - Fairness
 - Patriotism
 - Retaliation
- Reasons the DO Make Economic Sense, with Counter-Arguments
 - Revenue
 - Optimal Tariff
 - Infant Industry
 - National Security
 - Culture
 - Unfair Trade
 - Protect Favored Industry
 - Retaliation...
- **Production Subsidy versus Tariff**
- Why Aren't Tariffs Higher?

Production Subsidy versus Tariff

- Why a tariff is 2nd best for any of the above purposes that seek to increase domestic production of an industry
 - Compare a 50% tariff with a 50% production subsidy (small country case)
 - Tariff raises domestic price by 50%
 - Subsidy leaves price unchanged, but gives producers an extra 50% payment
 - Either way, producers get 50% more for their output
 - What are the welfare effects? ...

Compare 50% Tariff and 50% Subsidy



Effects on Welfare

	Tar	Sub
Sup	+a	+a
Dem	-(abcd)	0
Gov	+c	-(ab)
Cty	-(bd)	-b

Subsidy versus Tariff

- From the figure:

- Net cost of tariff is Dead Weight Loss we saw before: $(b+d)$

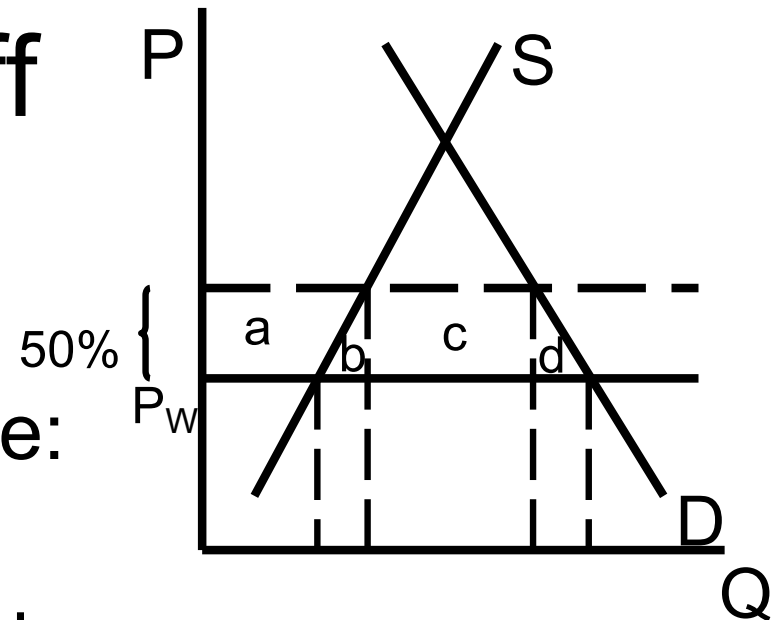
- Net cost of subsidy is only b , thus smaller

- Reason: Subsidy does not distort buyers' behavior, only sellers'

- But there is an important difference

- Tariff is revenue for government

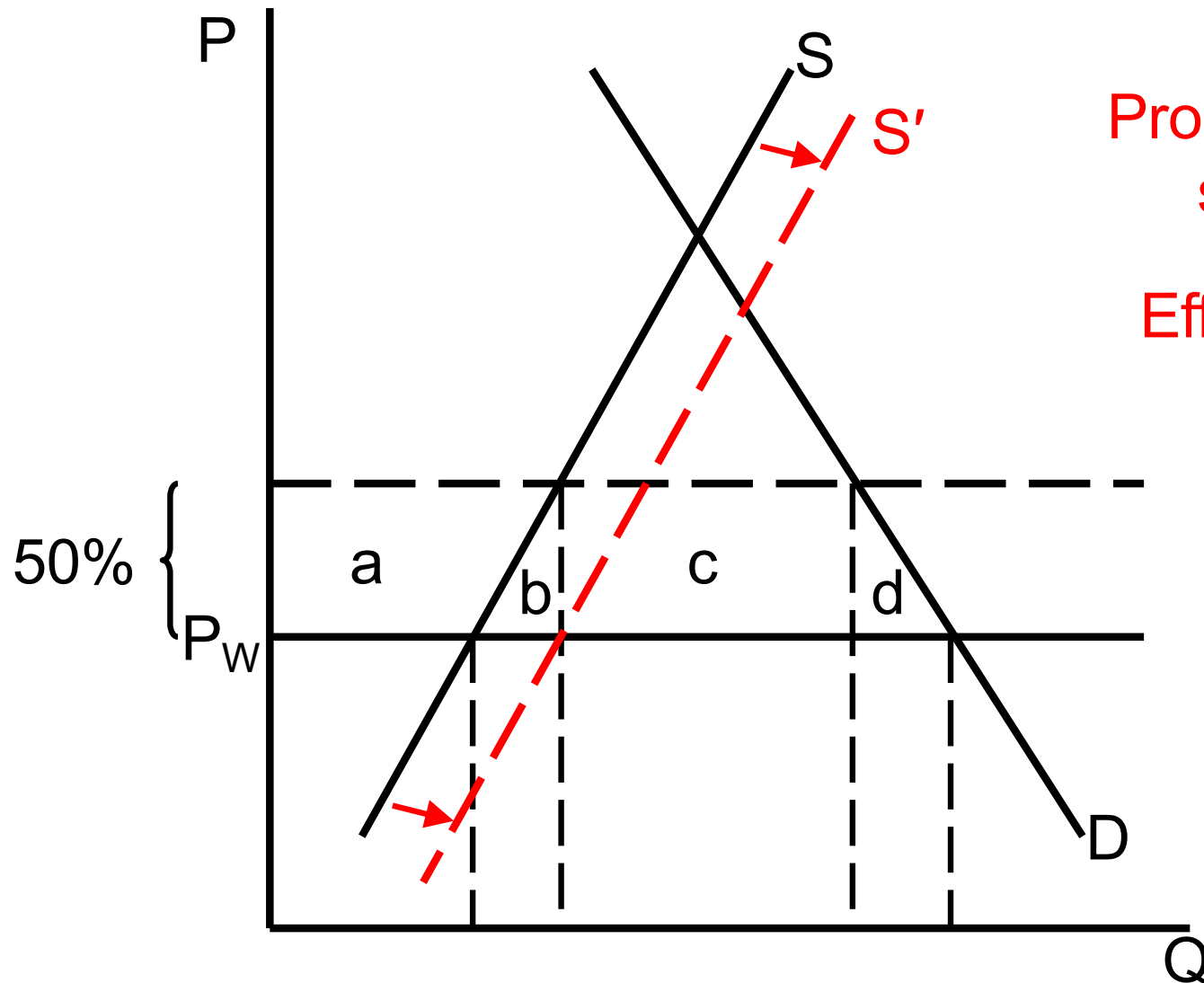
- Subsidy is budgetary cost for government



Production Subsidy versus Tariff

- Alternative analysis
 - In Econ 101 you may have learned to analyze a subsidy by shifting the supply curve
 - That is equivalent to what I showed above
 - Production subsidy shifts supply curve enough to get the same increase in output
 - But be careful to use the old supply curve to measure producer surplus

Compare 50% Tariff and 50% Subsidy



Production subsidy
shifts S to S'

Effects are same
as before

Outline: Reasons for Protection

- Reasons that DO NOT Make Economic Sense
 - Pauper Labor
 - Fairness
 - Patriotism
 - Retaliation
- Reasons the DO Make Economic Sense, with Counter-Arguments
 - Revenue
 - Optimal Tariff
 - Infant Industry
 - National Security
 - Culture
 - Unfair Trade
 - Protect Favored Industry
 - Retaliation...
- Production Subsidy versus Tariff
- Why Aren't Tariffs Higher?

Why Aren't Tariffs Higher?

- With all these reasons for protection (albeit, not very good ones), why are US tariffs on average so small: only 2-3%?
(See Magee)

Why Aren't Tariffs Higher?

- How do reasons for protection become protection?
 - Politicians balance
 - Contributions from those who would benefit from protection
 - against
 - Their perception of the benefits to society
 - Result is said to be “Protection for Sale”

Why Aren't Tariffs Higher?

- Magee lists 6 possible reasons why tariffs are not higher:
 - ~~1~~ Politicians are not responsive to lobbying efforts
 - ✓2. Welfare costs of tariffs are higher than traditionally measured
 - ✓3. The GATT was successful in reducing trade barriers
 - ✓4. Free riding by firms hinders lobby organization
 - ~~5~~ Users of imported goods lobby against tariffs
 - ✓✓✓6. Protection is given, but by non-tariff barriers, which are high
- Magee's view of the evidence
 - #1, 5 not important
 - #2, 3, 4 play a small role
 - #6 is most important: actual protection is much higher than tariffs

Clicker Question

Why does Magee give only small credit to the GATT for today's tariffs not being large?

- a) GATT negotiations failed to reduce tariffs
- ✓ b) Many tariff reductions were done unilaterally, rather than as part of the GATT process
- c) Ad valorem tariffs fell on their own due to inflation
- d) Tariffs are actually higher than they appear, due to other restraints on trade
- e) The GATT never intended to reduce tariffs; its purpose was to facilitate trade

Next Time

- US Trade Policies and Institutions
 - Who handles trade policy in the US
 - What policies the US uses
 - Dumping and Anti-Dumping
 - Why the US Protects
 - Trends in US Trade Policy