Arguments for trade protection

Protection of infant (sunrise) industries

An infant (or sunrise) industry is one that has just opened up and is not yet large enough to take advantage of economies of scale. Latin America, for example, has been in favour of the infant industry argument for protectionism in recent decades. Brazil has been imposing trade barriers and subsidies since the 1990s (https://www.bbc.co.uk/news/business-44902104)to protect its industries from big competitors abroad.

Let us argue that a country would like to support its pharmaceutical industry. Pharmaceuticals have a very long time period of production. Scientists must first take time to develop a drug, then confirm its effectiveness through years of testing and clinical trials. Drug trials can take years because the side-effects of pharmaceuticals can be a matter of life and death. For example, Gilead Sciences released Sovaldi, a breakthrough hepatitis C drug, in the US for USD 84 000. The drug is taken over a 12-week period – one pill per day, at USD 1000 each. The price tag may seem high, but not when you take into account that research and development alone can cost between USD 500 million and USD 2 billion.

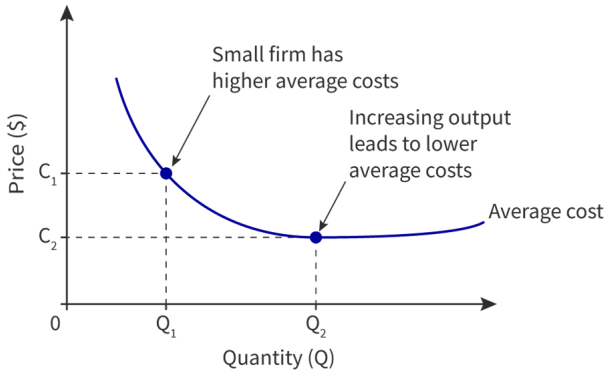

Figure 1. As output increases, firms can enjoy lower costs per unit, or economies of scale.

More information for figure 1

The graph illustrates the concept of economies of scale, where the average cost per unit decreases as the quantity (Q) produced increases. The X-axis represents the quantity (Q) and the Y-axis denotes price ($). It begins at zero and extends to Q2, with marked points at Q1 and Q2. Similarly, the Y-axis is marked at two average cost points, C1 and C2.

The blue curve on the graph indicates an inverse relationship between cost and output: starting at a higher average cost C1 at quantity Q1 and decreasing to a lower average cost C2 at quantity Q2. Annotations on the graph state that a small firm has higher average costs, and that increasing output leads to lower average costs.

[Generated by AI]

The cost of the first pill produced is very high, so Gilead Sciences must regain the upfront costs from the expensive research and development process. Take a look at **Figure 1.** As Gilead Sciences increases production from Q_1 to Q_2, it is

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able to spread the fixed costs of production over more and more output, and the average cost will fall from C_1 to C_2. As costs fall, Gilead Sciences can pass these savings onto consumers by cutting prices.

When a pharmaceutical firm first opens as an infant industry, it faces intense competition from large pharmaceutical companies from abroad. This means it may be unable to increase output, and so it cannot take advantage of economies of scale.

One way in which the government can support infant industries is through protection. Often, governments will use administrative barriers such as product standards to slow (or even stop) the import of pharmaceuticals. Governments may require additional testing and more clinical trials before approval by a domestic agency, such as the Food and Drug Administration (FDA) in the USA.

Making connections

As you will recall from section 4.2 (/study/app/pp/sid-186-cid-754025/book/the-big-picture-id-30700/), the government can protect the domestic economy through tariffs, quotas, subsidies and administrative barriers. Protection encourages domestic industries to increase output, which leads to an increase in employment and economic growth.

National security

There are some goods and services that must be produced domestically for the sake of national security. For example, the EU claims that guaranteed access to food is necessary for security, so it subsidises its agricultural industry to ensure that food is grown on European soil. Another important consideration for national security is the defence industry. Would we want other countries producing all the equipment needed for our country's armed forces?

Student view

Figure 2. This fighter jet was manufactured by the Swedish company Saab.

Credit: Getty Images VanderWolf-Images

Maintenance of health and safety

Governments have an obligation to keep their citizens safe. One way to do this is to enforce health and safety laws on any goods or services to protect consumers. For example, any products that do not meet the country's health and safety requirements are prohibited from import, such as the Kinder Surprise in the US and Chile. This is a chocolate egg that contains a small, plastic toy and is produced by the Italian company Ferrero. It is banned for sale in the US and Chile as the FDA argues that young children could swallow or choke on the small toy.

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Figure 3. The Kinder Surprise product is produced by the Italian company Ferrero, and is banned for import into the USA and Chile.

Source: "Kinder Surprise Egg (https://commons.wikimedia.org/wiki/File:Kinder_Surprise_Egg.jpg)" by United States Customs and Border Protection is in public domain.

In the EU, it is a requirement that all food products have a list of ingredients. This may not be a requirement in all countries, so the EU naturally prevents the sale of foreign products that do not abide by the legislation.

Figure 4. The EU legally requires a list of ingredients on all food products.

Source: "13 - ITALY - Orange juice with ingredients 100% pure italian orange juice made in Italy - Tetra Pack descriptions in more languages for export (https://commons.wikimedia.org/wiki/File:%22_13_-_ITALY_-_Orange_juice_with_ingredients_100%25_pure_italian_orange_juice_made_in_Italy_-_Tetra_Pack_descriptions_in_more_languages_for_export.JPG)" by Pava is licensed under CC BY-SA 3.0 (https://creativecommons.org/licenses/by-sa/3.0/it/deed.en)

More information for figure 4

The image displays a label from an orange juice package, detailing its contents in three languages: English, German, and French. The label states "ORANGE JUICE FROM CONCENTRATE UNSWEETENED" and lists the ingredient as "orange juice." It also mentions an antioxidant, "L-Ascorbic acid." Instructions are provided: "Serve chilled. Refrigerate after opening and use within a few days." It indicates the product is from Italy: "PRODUCT OF ITALY. Best before end: see top." In German, it repeats the same information: "ORANGENSAFT AUS ORANGENSAFTKONZENTRAT OHNE ZUCKERZUSATZ" with "Zutaten: Orangensaft" and "Antioxidationsmittel: L-Ascorbinsäure." Additional instructions in German are to consume the product shortly after opening and keeping it refrigerated, ending with "HERGESTELLT IN ITALIEN." In French: "JUS D'ORANGE OBTENU A PARTIR D'UN CONCENTRE SANS SUCRE AJOUTE," followed by "Ingrédients: jus d'orange" and "Antioxydant: acide L-ascorbique." French instructions similarly advise to "Servir froid" and complete with "PRODUIT D'ITALIE."

Student view

[Generated by AI]

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Environmental standard

Countries may define clear production standards for goods in order to protect the environment. In 2018, the UK banned all cosmetics and personal care products containing microbeads. These tiny pieces of plastic are added to face scrubs, shower gels and even toothpastes. Microbeads are often washed down the drain and into the open sea. The ban stops billions of tiny pieces of plastic polluting the oceans and harming marine life.

Activity

Look in your bathroom cabinet and make a list of all your personal care products.

Check out the 'Beat the Microbead (https://www.beatthemicrobead.org/product-lists/)' website and look up each of the products that you own to see how many contain microbeads.

How many products do you use everyday that contain microbeads? Share your results with your class.

Anti-dumping

Dumping refers to firms exporting their goods at a price below production cost. It is a type of predatory pricing behaviour. An importer may sell or 'dump' goods abroad in order to gain a foothold in a new market. This is deemed illegal by the WTO, and countries may complain if they feel that foreign nations are behaving in a predatory and anti-competitive manner within its borders. A country may respond with its own protectionist measures to protect its domestic industries.

Case study

USA and South Africa: chicken dumping

Student view

The USA and South Africa have had a long-running feud over chicken dumping. South Africa has argued that the USA was exporting chicken into the South African market at a lower price than it was sold in the USA. In response, South Africa imposed tariffs of up to 375 per cent (https://www.reuters.com/article/us-usa-trade-safrica/south-african-farmers-play-chicken-with-trump-tariffs-idUSKCN1LE0YW), (https://www.reuters.com/article/us-usa-trade-safrica/south-african-farmers-play-chicken-with-trump-tariffs-idUSKCN1LE0YW)effectively locking US producers out of the market entirely.

Was the USA dumping chicken onto the South African market?

The WTO says that dumping occurs when imports are being sold at prices below 'normal value' and causing material injury to the domestic industry. But what is 'normal value'?

It depends on how a country calculates 'normal value' and whether or not it is 'fair' on its trading partners. In this case, dark chicken meat, such as thighs and legs, tends to be more popular in South Africa. Compare this to the USA, where white meat, such as the breast or wings of chicken, is preferred. Therefore, the price of dark meat was much lower in the USA, meaning that chicken producers in the USA were able to sell dark meat at a higher price in the South African chicken market.

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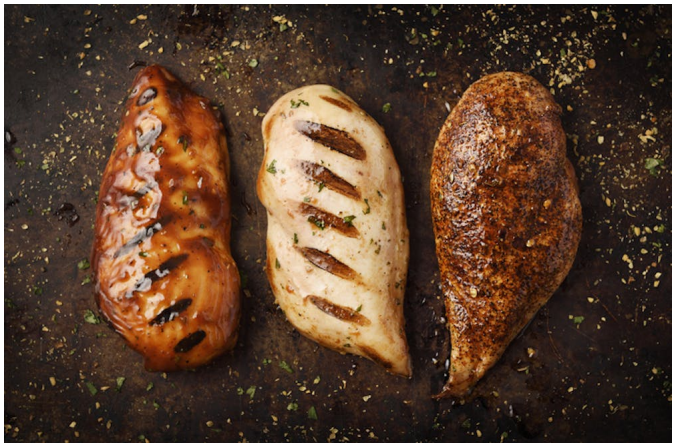

Figure 5. Dark chicken meat is preferred in South Africa, whilst white chicken meat is more popular in the USA.
Credit: Getty Images EasyBuy4u

The USA argued that its export prices for chicken were higher than the domestic prices for dark meat. It seems there was no dumping.

However, South Africa claimed that (https://www.researchgate.net/publication/228837333_Dumping_on_Agriculture_Case_Studies_in_Antidumping)US 'home market prices' were not representative of 'normal value'. It said that the US preference for white chicken meat created a 'particular market situation' and caused the price of dark chicken meat to be artificially low domestically. South Africa also argued that US production of dark chicken meat was mainly for export, and so under these circumstances, the US home market price was not 'normal'.

The dispute has been resolved by South Africa setting a quota for US imports of dark chicken meat.

Questions to consider:

1. Do you think that the USA was guilty of dumping chicken into South Africa? Explain your answer.
2. Do you think a quota is the best solution to the dispute?
3. What are the advantages and disadvantages of imposing a quota?
4. Who are the winners and losers when a quota is imposed?

Find out more about the problems with identifying dumping in the following links.

Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994 (https://www.wto.org/english/docs_e/legal_e/19-adp_01_e.htm)

The Indian Shrimp Industry Organizes to Fight the Threat of Anti-Dumping Action (https://www.wto.org/english/res_e/booksp_e/casestudies_e/case17_e.htm)

Student view

Unfair competition

A country may impose trade protection if it believes it faces unfair competition. A country may believe that intellectual property has been stolen and use tariffs to even the playing field.

Within the domestic economy, the government can protect innovators and inventors by using patents. A patent gives a firm the sole right to exclude others from producing an identical or similar good. It provides firms with the time required to earn substantial profits in exchange for taking the risk to invest a lot of money at the research and development stage. However, patent laws may only have jurisdiction within the domestic economy. It may be possible for firms in other countries to copy new technologies via reverse engineering. Reverse engineering refers to the process of analysing a product to understand how to manufacture a similar one. This is most likely to happen when countries lack the infrastructure to enforce international patent laws.

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Pharmaceutical companies in India and Brazil have used reverse engineering to deconstruct pharmaceutical drugs in order to understand the ingredients of their manufacture. India and Brazil were able to produce cheaper copies of life-saving drugs for domestic sale. In response, the WTO enforced a new legal requirement for member nations to no longer infringe on patents. This was designed to protect the pharmaceutical companies that had invested millions of dollars in research and development. Since then, any country that steals intellectual property may be liable for action from the WTO.

Figure 6. Through reverse engineering, scientists can deconstruct pharmaceuticals to discover their ingredients.

Credit: Getty Images REB Images

Balance-of-payments correction

The balance of payments is the record of transactions in trade, capital and financial flows between a country and the rest of the world.

Student view

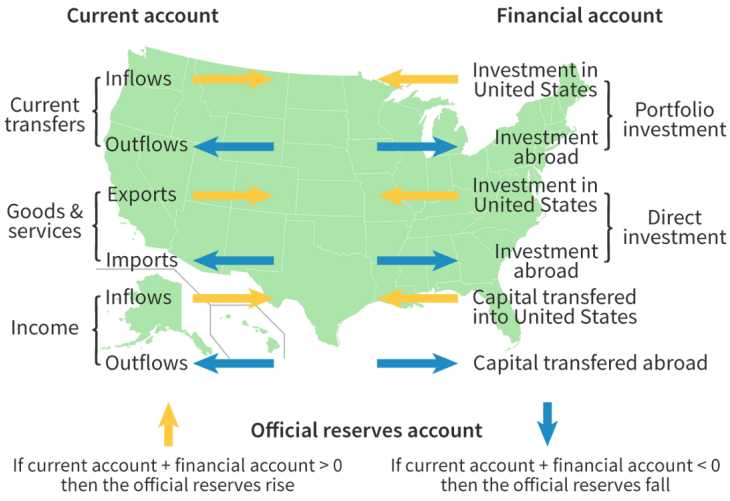

Figure 7. The balance of payments for the US.

More information for figure 7

This diagram illustrates the balance of payments for the United States. It consists of three main accounts:

1. **Current Account**

- **Current Transfers**: Displays inflows and outflows. Inflows are shown with orange arrows pointing in, and outflows with blue arrows pointing out.
- **Goods & Services**: Exhibits exports and imports, again using orange arrows for exports and blue arrows for imports.

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- **Income**: Depicts inflows and outflows with the same orange and blue arrows.

2. **Financial Account**

- **Portfolio Investment**: Investment in the U.S. and investments abroad are marked with arrows.
- **Direct Investment**: Includes various types of capital transfers, such as investment in the U.S., investment abroad, capital transferred into and out of the U.S.

3. **Official Reserves Account**: Indicates shifts based on the sum of the current and financial accounts. The account shows that if the sum is greater than zero, official reserves rise (denoted by an upward orange arrow); if less than zero, reserves fall (indicated by a downward blue arrow).

[Generated by AI]

The total balance of payments must always be equal to zero. Sometimes, extreme trade flows create challenges for the balance of payments. A trade deficit, where imports outweigh exports, causes an outflow of funds. One solution for a trade deficit is to use protectionist policies to slow or stop imports. By restricting trade, the country can rebuild its industry and try to reduce the trade deficit, preventing an outflow of funds.

Sources of government revenue

Tariffs provide governments with the opportunity to earn tax revenue. Often, economically least developed countries (ELDCs) lack a wide tax base. These countries may choose to impose tariffs on imports to raise government revenue. For example, the Bahamas is the Caribbean's wealthiest country, and yet it does **not** impose an income or corporate tax. The island raises 60 per cent of its government revenue from tariffs (https://www.worldfinance.com/strategy/top-5-countries-with-the-highest-trade-tariffs). **Figure 8** shows the average tariff rate levied by selected countries. What do you notice about the countries that impose the highest tariffs?

Student view

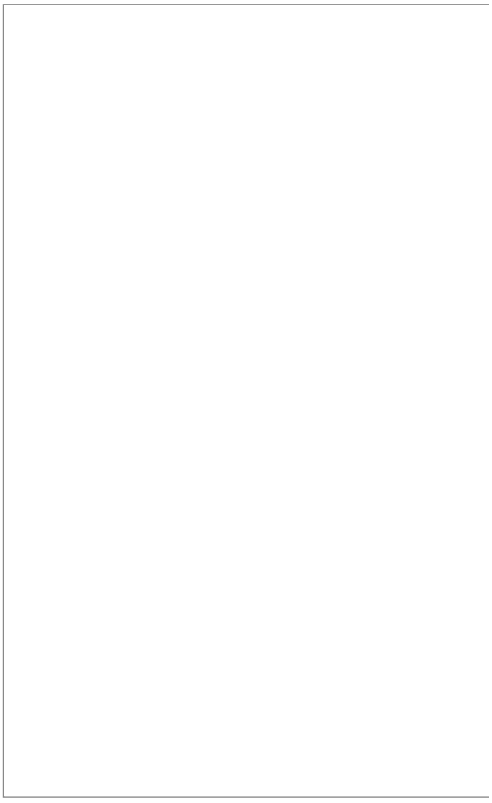

Figure 8. The average tariff rate levied by selected countries.

More information for figure 8

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This interactive world map displays the average weighted tariff rates across all products for different countries in 2018. It allows users to explore and compare tariff levels imposed on imported goods globally. The map uses a color-coded legend to visually differentiate tariff rates, making it easier to compare trade policies across countries. The color intensity corresponds to the tariff percentage: darker shades indicate higher tariff rates, while lighter shades represent lower tariff rates.

Countries shaded in light peach have a lower average tariff rate of less than 4.42. Countries in light yellow fall within a tariff range of 4.42 to 6.98, while golden yellow represents a range between 6.98 and 9.60. Countries in orange have tariffs between 9.60 and 11.86, and dark red represents countries with an average tariff rate greater than 11.86. Countries shaded in gray indicate missing data.

The map highlights that several African and South American countries, marked in dark red, have the highest tariffs, suggesting stronger trade protection policies. Many developed economies, such as those in North America, Europe, and parts of Asia, are shown in lighter shades, indicating lower tariff barriers and more open trade policies.

The interactive nature of the map allows users to quickly identify global trends in trade policies. The color-coding provides a clear visual representation of how tariff rates vary across different regions, making international trade comparisons more intuitive. Additionally, a reset button at the bottom suggests that users can interact with the display, possibly zooming or selecting specific countries for further exploration.

Protection of jobs

A country might use protectionism to protect jobs. As some industries economically decline and are unable to compete with similar industries abroad, the government may step in and offer trade protection. For example, textiles imported into the USA face a 25 per cent tariff (https://www.just-style.com/analysis/us-apparel-imports-from-china-face-extra-25-tariff_id136196.aspx), which ensures security for textile workers and keeps textile-related jobs flourishing. However, the cost to US consumers is high. US consumers must pay more for clothes and pay up to USD 70 000 (https://www.reuters.com/article/us-usa-trade-china-tariffs/cost-to-u-s-consumers-businesses-of-trumps-china-tariffs-surged-in-june-trade-group-idUSKCN1UX2H7)annually per textile worker to keep them employed. Textile workers earn an average USD 20 000 to USD 30 000 per year (https://shenglufashion.com/2018/03/04/wage-level-for-garment-workers-in-the-world-updated-in-2017/). Consumers spending USD 70 000 to keep workers earning USD 30 000 is far from efficient.

Economically least developed country (ELDC) diversification

Student view

Economically least developed countries (ELDCs) may choose to protect key industries in the short run. ELDCs, such as Sudan or Somalia, do not have a well-developed industrial base. This refers to the broad production capabilities of a nation in key industries. For example, if a country can produce steel, it has the inputs to production to produce a wide range of goods, such as bridges, cars and machinery. If a country has a well-developed chemical industry, it has the inputs to produce plastics, fertilisers and pesticides. This will increase its manufacturing output. If an ELDC protects key industries in the short run, then in an absence of competition, domestic industries have a chance to grow and flourish.

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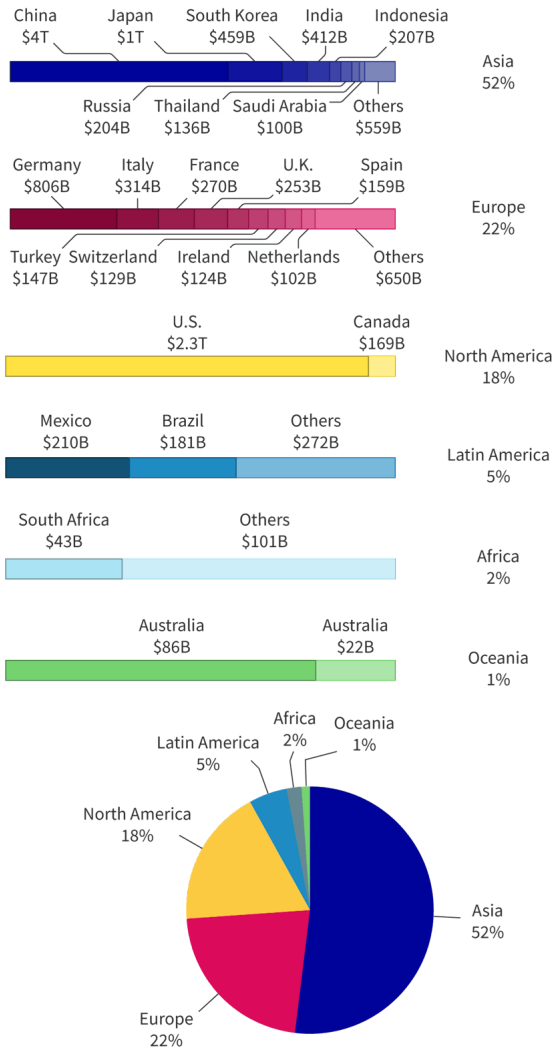

Figure 9. China, the US, Germany and Japan lead the world in manufacturing output.

More information for figure 9

Student view

The image features a bar chart and a pie chart depicting the global manufacturing output by region.

Bar Chart:

- **Asia (52%)**: Countries include China ($4T), Japan ($1T), South Korea ($459B), India ($412B), Indonesia ($207B), Saudi Arabia ($100B), Thailand ($136B), Russia ($204B), and others ($559B).
- **Europe (22%)**: Key contributors are Germany ($806B), Italy ($314B), France ($270B), UK ($253B), Spain ($159B), Turkey ($147B), Switzerland ($129B), Ireland ($124B), Netherlands ($102B), and others ($650B).
- **North America (18%)**: Dominated by the U.S. ($2.3T) and Canada ($169B).
- **Latin America (5%)**: Key countries are Mexico ($210B), Brazil ($181B), and others ($272B).
- **Africa (2%)**: Includes South Africa ($43B) and others ($101B).
- **Oceania (1%)**: Represented by Australia ($86B and $22B).

Pie Chart:

- **Asia** occupies 52% of the chart, representing the largest share.
- **Europe** holds 22%.
- **North America** is 18%.
- **Latin America** covers 5%.
- **Africa** represents 2%.
- **Oceania** accounts for 1%.

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The charts highlight the dominant regions in manufacturing output, with Asia leading significantly.

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Complete section with 3 questions

Start questions

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Student view

Arguments against trade protection

Misallocation of resources

Protectionism creates a misallocation of resources, which occurs when resources are not allocated to their best use. Firstly, tariffs, quotas and subsidies distort prices. Tariffs and quotas increase the price of *imported* goods, while subsidies decrease the price of *domestic* goods. Distorting prices has consequences for resource allocation, since price is an important indicator to consumers to determine the quantity demanded.

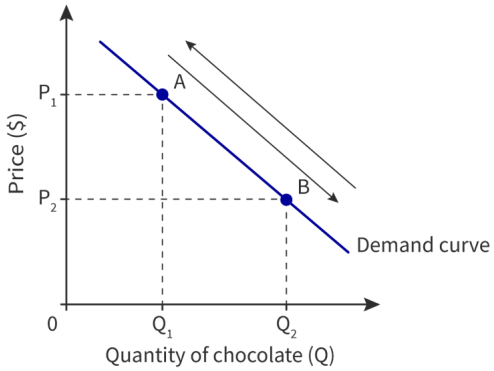

Figure 1. A decrease in price will encourage consumers to buy more of a good.

More information for figure 1

The image is a graph depicting a demand curve. The horizontal axis is labeled 'Quantity of chocolate (Q)' and starts from 0, extending to the right. The vertical axis is labeled 'Price ($)' and starts from 0, extending upwards. The demand curve is a downward-sloping line from the upper left to the lower right, labeled 'Demand curve.'

There are two points marked on the curve: Point A corresponds to a higher price level, P1, and lower quantity, Q1, while Point B corresponds to a lower price level, P2, and higher quantity, Q2. This illustrates the inverse relationship between price and quantity demanded, where a decrease in price from P1 to P2 leads to an increase in quantity demanded from Q1 to Q2.

[Generated by AI]

Exam tip

Make sure the labels for your diagrams are accurate. If you draw a demand curve, with no accompanying supply curve, the label on the *x* -axis must be 'quantity demanded'.

Figure 1 shows how a tariff on chocolate will increase the prices of imports from P_2 to P_1. It will force consumers to buy less of the imported chocolate and more of the domestically-produced chocolate. In the domestic economy, more resources such as milk will be channelled into the production of chocolate, so less milk is available to produce cheese

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and yogurt. But the domestic economy may not be efficient at producing chocolate, and it may be very efficient at producing cheese and yogurt. Therefore, resources may be directed away from their best use, representing a misallocation of resources.

Theory of Knowledge

One of the limitations of the framework of knowledge in economics is the use of assumptions, such as perfect knowledge, rational behaviour, ceteris paribus, and so on.

According to the UN, 33 per cent of the world's fishing resources are overfished. Yet many countries continue to subsidise fishing fleets, which directly leads to overfishing. Using tax revenues to fund large industrial fishing fleets to chase diminishing stocks of fish is clearly irrational behaviour. The subsidy for fishing creates a significant misallocation of resources. We are creating economic policies that will only hurt us in the long run.

Knowledge question: What are the limitations and strengths of using the assumption of 'rational behaviour' in economic theory?

Retaliation

If a country raises tariffs, its trading partner may retaliate by also imposing tariffs or other barriers to trade. Sometimes, escalating retaliation can lead to a trade war, which can cause tension between countries. In 2018, a trade war sparked between the USA and China. Concerned about intellectual property and a lack of competitiveness, the USA imposed tariffs on USD 36 billion worth of Chinese exports. China soon retaliated. By 2020, the trade war had escalated (https://www.bbc.co.uk/news/business-45899310)to the point where the USA has imposed tariffs on more than USD 360 billion worth of Chinese goods, and China has retaliated with tariffs on more than USD 110 billion worth of US products. US farmers are unable to export soybeans to China, and have faced a significant fall in income. Many soybean farms have struggled to survive.

Case study

Student view

Solar panels and tariffs

The USA was once a world leader in solar panel manufacturing. It dominated the solar power industry and produced almost 25 per cent of all solar cells in the early 2000s. However, the rise of the Chinese solar cell manufacturing industry soon meant that the US market share for solar panels decreased significantly as Chinese firms became more competitive.

Figure 2. Solar panels are used to convert solar energy into electricity.
Credit: Getty Images dan tarradellas

What followed was seven years of solar trade wars. The solar panel supply chain between the USA and China was obstructed with multiple trade barriers. There have been three key outcomes of the trade war:

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1. **Tariffs raise prices on US consumers:** The price of solar modules in the US is 20 per cent higher than in the EU, 40 per cent higher than in Japan, and 50 per cent higher than in China.
2. **Tariffs hurt Chinese and Taiwanese producers:** The tariff levied on Chinese and Taiwanese solar panel producers meant they faced higher costs to sell directly to the USA. To avoid the tariff they moved their manufacturing capacities to Vietnam and Malaysia. Chinese and Taiwanese manufacturers had to decide between the lowest-cost production at home and a tariff-free but higher-cost production environment elsewhere. Although Vietnam and Malaysia benefited, it led to job losses and lower investment in China and Taiwan.
3. **Tariffs invite more tariffs:** Shortly after the USA imposed the first round of tariffs in 2012, the Chinese retaliated by imposing tariffs on polysilicon. Polysilicon is a key input for production for solar panel manufacturing. This has caused the polysilicon industry in the USA to cut back, leading to a fall in profits and job losses.

Questions to consider:

1. Rather than a trade war, how else could the USA respond to an increasingly competitive Chinese solar panel industry?
2. What are the costs/benefits of a trade war between the US and China to stakeholders in:

- the USA?
- China?
- Vietnam?
- Malaysia?

Find out more about the solar panel trade war here:

U.S. solar group says Trump tariffs killing jobs; White House says 'fake news' (https://www.reuters.com/article/us-usa-solar-tariffs-idUSKBN1Y71V8)

The US—China Trade Wars and the Solar Industry (https://www.newenergysolar.com.au/renewable-insights/renewable-energy/the-us-china-trade-wars-and-the-solar-industry)

Increased costs

Student view

Tariffs or quotas imposed on raw materials will drive up the cost of production. If a government imposes a tariff, it must be mindful of the effects on downstream industries. A downstream industry uses inputs to production that are intermediate goods. For example, the mobile phone industry is downstream from the lithium-ion battery industry. A tariff on lithium-ion batteries will increase the cost of producing mobile phones and other electronic goods in the domestic economy.

Higher prices

Tariffs and quotas will lead to higher prices, especially for domestic consumers. Tariffs act like a tax which increases the price of goods, whereas quotas create a shortage in the market that puts upward pressure on prices. For example, Argentina imposed a 35 per cent tariff on computers and other electronics, and although the tariff did protect the Argentine electronics manufacturing sector, the cost for consumers was high. Prices for TVs, computers and mobile phones were so high that Argentinians travelled to Chile to buy electronics. The tariff also created a black market for Apple iPhones, where people resold iPhones they bought elsewhere. Argentina had no choice but to eliminate the tariff in 2018 (https://www.reuters.com/article/argentina-trade-tech/argentina-to-eliminate-tariff-on-computers-tablets-idUSL1N1G50OQ).

Less choice

Protectionism limits imports, and therefore limits choice for consumers.

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After World War II, the Codex Alimentarius Commission (http://www.fao.org/fao-who-codexalimentarius/en/)was established to ensure fair trade practices in food produced for international trade. The Food Code contains specific product standards for many foods, such as bananas. These product standards for bananas are so precise that banana exports have become dominated by one variety of banana – the Cavendish. Yet there are almost 1000 different types of bananas. Protectionism and product standards significantly limit the choice for bananas for consumers.

Figure 3. A small selection of the different varieties of banana.

Credit: Getty Images al_la

Lack of incentive for domestic firms to become more efficient

Without the threat of competition from abroad, domestic firms have no incentive to be efficient. Competition forces firms to pursue the lowest-cost method of production. It creates an environment where firms must innovate and invest in research and development. Without competition, the drive to improve disappears and domestic firms may continue to use outdated technologies or processes.

Reduced export competitiveness

Student view

Protectionism creates a higher-cost environment, and reduces the efficiency of firms in the domestic market. For example, Ghana is the world's top exporter of cocoa, while the Netherlands is the world's biggest importer. If the Netherlands imposed a tariff on imports of Ghanaian cocoa, the price of cocoa would rise. This would reduce the competitiveness of Dutch chocolatiers. Chocolate is a very competitive market, and so the Netherlands would be at a great disadvantage from protectionism.

Activity

In 2020, the Canadian government considered placing a tariff on oil.

If Canada and the USA slap tariffs on oil imports, it will be their consumers and refiners who feel the pain (https://business.financialpost.com/commodities/energy/if-canada-and-the-u-s-slaps-tariffs-on-oil-imports-it-will-be-their-consumers-and-refiners-who-feel-the-pain)

In a group of three, carry out your own research into the types of downstream industries that would be affected by the tariff.

Discuss your findings with the class.

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Student view

Complete section with 3 questions

Start questions

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Next section (/study/app/pp/sid-186-cid-75

Free trade versus trade protection

The debate regarding free trade versus protectionism has been going on for centuries. In this section, we will examine how both approaches may or may not support economic growth.

As you may recall, free trade allows countries to specialise in the production of goods for which they have comparative advantage. For example, China should specialise in electronics, Bangladesh should specialise in textiles and Belgium should specialise in chocolate. If every country directs resources into the production of the goods for which they are most efficient, overall world output will rise.

Although world output increases, the benefits of trade are not equally shared. Whether a country benefits from trade depends upon the terms of trade. Even though Mali is the lowest-cost producer of cotton, for example, it does not benefit from trade. This is because the USA offers cotton subsidies to its own farmers, which lowers the world price for cotton to such a level that even farmers earning a dollar per day struggle to compete.

There is an argument that trade protection can lead to economic growth.

Important

Economic growth refers to the percentage change in real GDP. When we calculate economic growth, we must take into account inflation.

Firstly, trade protection methods, such as a tariff on steel, may benefit a country like Kenya. A tariff will make steel imports more expensive and, therefore, make domestic products more price competitive. It should also lead to an increase in output for the Kenyan steel industry.

Figure 1. A Kenyan steel factory.

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This is particularly important for steel producers facing large economies of scale. Steel production has very large fixed costs (the cost of building, maintaining and firing a large furnace) and so will enjoy large economies of scale.

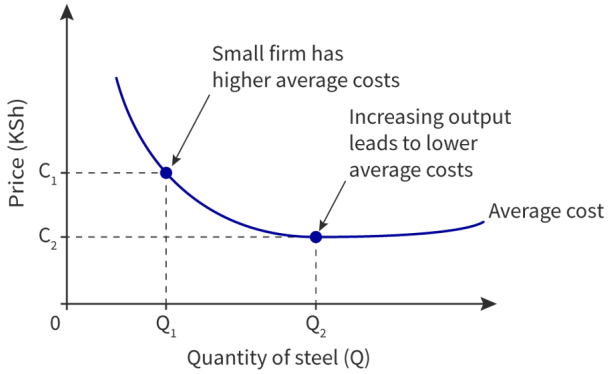

Figure 2. As output increases, firms can enjoy lower costs per unit, or economies of scale.

More information for figure 2

The image is a graph illustrating the concept of economies of scale using an average cost curve. The X-axis represents the "Quantity of steel (Q)" and the Y-axis represents the "Price (KSh)". The graph starts at the origin and is curved downwards, showing a downward sloping average cost curve. Two specific points on the curve are marked. The first point, at quantity Q1, corresponds to a higher cost level C1 and is labeled "Small firm has higher average costs." The second point, at quantity Q2, corresponds to a lower cost level C2 and is labeled "Increasing output leads to lower average costs." The curve is labeled as "Average cost," indicating that as the quantity of steel produced increases, the average costs of production decrease, demonstrating economies of scale.

[Generated by AI]

As domestic producers increase their production of steel from Q_1 to Q_2, they are able to take advantage of economies of scale and move down the average cost curve from C_1 to C_2. At these lower costs, domestic firms become more efficient and so can compete with cheaper steel imports from abroad. If the cost of production (C_2) is low enough, and even below the world price, the Kenyan government can then remove the tariff altogether.

Student view

Assuming that the economies of scale argument holds true and that the Kenyan government can remove the tariff, the Kenyan economy will have access to cheap steel from a reliable source. Steel is an important input to production, so cheaper steel will lower the costs of the domestic production of cars and machinery. Kenya will therefore be much more competitive in the world market.

International Mindedness

In economics, a **beggar-thy-neighbour** policy is where one country attempts to grow its economy at the expense of another country. For example, the EU subsidies Airbus. This decreases the cost of production for Airbus, and makes it more difficult for other aircraft producers worldwide to compete. How can governments use protectionist policies in a way that will not hurt their trading partners?

In the case of the steel industry, we may be able to support the claim that protectionist measures will support economic growth.

However, we must consider to what extent this is true in the long run. Will a protectionist environment really encourage firms to drive down costs and pass that saving on to consumers in the form of lower prices? Unfortunately, due to a lack of competition, steel mills have no incentive to become more efficient. They are less likely to pursue the least-cost method of

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production, innovate or develop new and improved production methods. Without the drive of competition, we should expect a protected steel industry to be less efficient and more costly. Therefore, protectionism will simply create inefficiency and less growth.

Another argument to support the claim that protectionism may lead to economic growth is that the government will earn revenue from tariffs. It is argued that this revenue can be used to build infrastructure, such as roads, ports, bridges, ports and communication systems, which provide a foundation for trade and growth. For instance, money spent improving ports means Kenya can increase its exports, and money spent on bridges means farmers can transport their crops to city markets. Infrastructure is an important driver for economic growth.

But to what extent is this the case? Do governments of ELDCs such as Kenya often spend tax revenue gains on infrastructure?

Firstly, there are instances where governments are susceptible to corruption – will government money be spent in the best way? For example, Indonesia has unfinished infrastructure projects, such as the monorail system that began construction in 2004. The supporting posts for the monorail system can still be seen in central Jakarta. The project collapsed under the weight of unexpected costs and other financial anomalies.

Figure 3. Jakarta City Hall has told the monorail company to tear down pillars.

Credit: Getty Images Fadil Aziz

Student view

Secondly, governments sometimes see other spending as more urgent, such as emergency aid after a natural disaster, helping a neighbouring country in war, or simply paying back debt.

Lastly, even if a government does spend the money to build infrastructure, would these projects be better if built by private firms? Only through the profit motive can we ensure that firms pursue the least-cost method of production and allocate resources to their best use. Therefore, whether tax revenues lead to growth depends entirely on **how** the government decides to spend them.

Be aware

When creating an evaluation, try to create a balanced argument, taking into account different viewpoints and perspectives.

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The final challenge to the claim that protectionism leads to economic growth is resource allocation. The problem is that protectionism creates distortions in the market. For example, a tariff on steel makes foreign steel artificially expensive in Kenya. Kenyan steel mills find their industry more profitable and so more resources, such as labour and capital, are channelled into steel. This means that industries in which Kenya may have comparative advantage (such as agriculture, which takes up nearly a quarter of the Kenyan economy) will not have access to labour. Research on fertilisers, for instance, may be reallocated to research on molten steel. To make matters worse, higher steel prices will make the manufacture of farming tools and machinery more expensive.

Activity

In your class, split into groups and carry out research into the arguments for and against the following statement.

'Protectionism **always** makes a country worse off.'

Have a debate in your class and share your argument.

Complete section with 3 questions

Start questions

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Next section (/study/app/pp/sid-186-ci

Student view