THE REASONS FOR PROTECTION

The potential gains from international trade arise from the assumption that free trade between countries takes place in the absence of government protection. Free trade occurs when there are no artificial barriers imposed by governments on the free flow of goods, services and resources between international markets. Free trade relies upon the interplay of market forces to secure the benefits of efficient resource allocation, greater competition (from international specialisation and exchange) and higher living standards for consumers. However in the real world, many national governments protect their domestic industries from international competition by imposing restraints on trade such as tariffs, subsidies, quotas, local content rules, embargoes and export incentives. Multilateral trade agreements (such as the World Trade Organisation) involve many countries attempting to reduce or eliminate such barriers to trade, in order to improve market accessibility, and to promote the growth of world trade and living standards. The goal of greater trade liberalisation has been a major objective of both the Uruguay and Doha Rounds of trade talks under the auspices of GATT and the WTO in the 1990s and 2000s.

Protection refers to any artificial advantage given by governments to domestic industries to protect them from international competition. Protective devices include both tariff and non tariff barriers (NTBs) to trade. The major forms of protection include tariffs (i.e. taxes on imports), subsidies (i.e. cash payments to producers), bounties, quotas, embargoes, local content schemes, technical standards, government procurement programmes, voluntary export restraints (VERs) and anti-dumping legislation. Both economic and non-economic arguments are used to justify the protection of domestic industries from international competition. The following are the five **major economic arguments** used to justify the protection of domestic industries from import competition:

1. The **protection of infant industries** is based on allowing newly established industries sufficient time to achieve economies of scale to compete in global markets. It is argued that only 'temporary protection' from imports is needed until the infant industry is able to become internationally competitive. However investing in infant industries may be inefficient, as firms receiving protection may become reliant upon it, and lack the incentive to innovate. Despite protection, infant industries may remain uncompetitive and inefficient by world standards for long periods of time.
2. The **protection of employment during a recession** is used as an economic argument to justify protection. Proponents of this view argue that 'importing goods exports jobs' during a recession. Erecting tariff walls to protect import competing industries may increase their relative competitiveness, share of production and employment. However, protection of these industries may be at the expense of employment in efficient export industries, and foreign countries may also retaliate with similar schemes to protect their domestic employment. Reducing imports through such schemes may also raise the exchange rate and reduce the competitiveness of export industries.
3. **Protection against the dumping of imports below factor cost** is an economic argument often used to erect barriers to trade. It presupposes that imports are being sold below the cost of production, which is sometimes difficult to prove. Proponents may in fact confuse increased foreign competitiveness with an attempt to dump cheaper goods on the home market.
4. The **terms of trade argument** for protection maintains that a large country can use protection to improve its terms of trade. A tariff may decrease the country's demand for imports, and if the country buys a significant proportion of the world supply, it may encourage foreign producers to reduce prices to offset falling sales revenue. This would improve the home country's terms of trade and the welfare of its residents. However, such an argument ignores the possibility that the foreign country may impose a retaliatory tariff on the home country's exports, nullifying the positive effect of the initial imposition of the tariff on imports. This is known as the **reciprocity argument**.
5. **Reducing a balance of payments deficit** is cited as an economic argument for imposing protection. For example, Australia has historically recorded a large current account deficit and level of foreign

© Tim Riley Publications Pty Ltd

debt, and could use protective devices to reduce import spending and switch import expenditure to domestically produced goods. This policy could have adverse effects, because specialisation is not encouraged according to comparative advantage and resources may be diverted to less efficient industries. Also, export and import competing industries and consumers may face higher prices for imported inputs and outputs, reducing competitiveness and living standards in the economy.

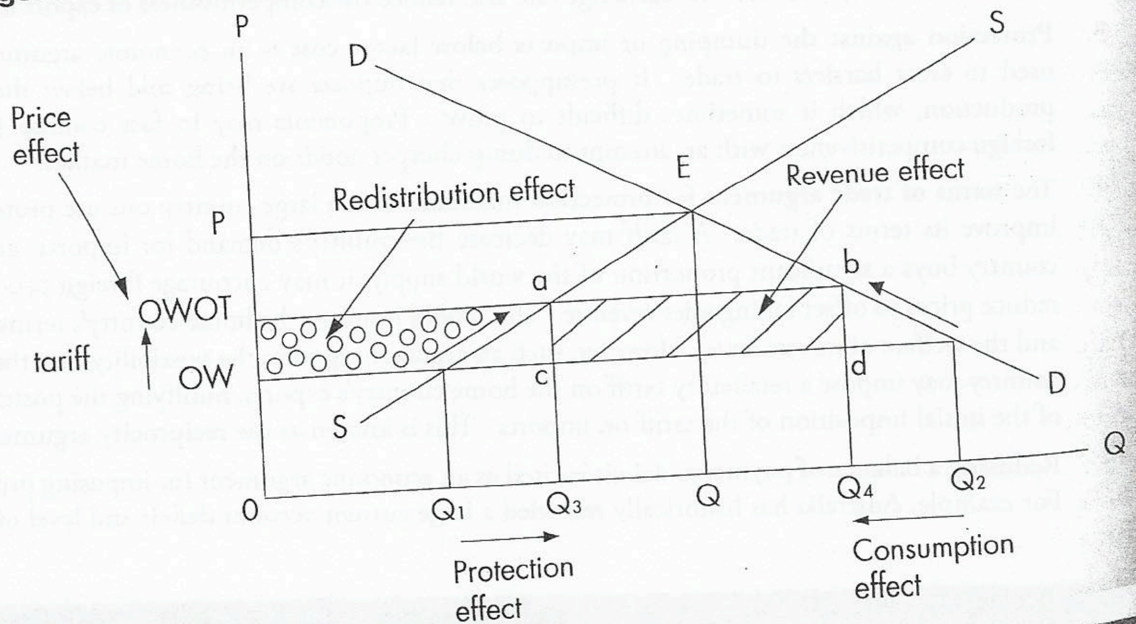
Other arguments used to justify protection may not be based on economic grounds, and may seek to promote political, social or cultural goals. These include the military self-sufficiency or **defence argument** (where national defence industries are protected to ensure war-time supply); and the **national spending argument** such as the 'buy Australia' campaign which encourages expenditure switching from imports to domestic goods, irrespective of prices and quality. Associated with this argument is the desire to protect national sovereignty and Australia's cultural identity such as subsidising local films and television and the entertainment industry. Other arguments for protection include the diversification of industry; using protection as a strategic industry policy to 'pick winners' since the world trading environment is not considered to be a 'level playing field' because it is dominated by MNCs and trading blocs; and to increase government revenue through the imposition of higher tariffs on imports.

THE METHODS OF PROTECTION: Tariffs, Subsidies and Quotas

Both tariff and non tariff barriers are used to protect domestic industries. **Tariffs** are a tax on imports through the payment of customs duty. The payment of customs duty by an importer has the effect of raising the landed price of imported goods. Local producers can then raise their prices and compete more effectively with imports by capturing and maintaining a larger share of the domestic market than would occur in the absence of protection. Tariffs raise revenue for the government and cause resources to be reallocated from efficient and competitive industries to inefficient and uncompetitive industries.

The **effects of a tariff** on a traded good are illustrated in **Figure 2.6.** The domestic demand and supply curves, DD and SS intersect at E to give an equilibrium price of OP and quantity of OQ. The world or free trade price for the product is OW. At the world price OW, domestic firms only supply OQ_1 but consumers demand OQ_2. The shortfall in domestic supply in relation to domestic demand, is made up by imports of Q_1Q_2. If the government imposes a tariff equivalent to OT (OWOT - OW), domestic supply will extend from OQ_1 to OQ_3, but domestic demand will contract from OQ_2 to OQ_4. Therefore imports will contract from Q_1Q_2 to Q_3Q_4. The four direct effects of the tariff are the following:

Figure 2.6: The Effect of a Tariff



© Tim Riley Publications Pty Ltd