The Heritage Foundation Backgrounder

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THE EIGHT MYTHS OF PROTECTIONISM

INTRODUCTION

Congress is considering a national industrial policy, supposedly to restore U.S. economic vitality by facilitating closer coordination of industry and labor actions with those of government. According to Walter Mondale, a national policy is needed because "Government must work in partnership with the market...to reassert American national interest in a tough competitive world."[1] One result of such a partnership could be a sweeping reform of trade policy.

If words alone could be trusted, this would still be an appropriate time for optimism. After the recent economic summit at Williamsburg, the United States and six other Western nations declared their renewed commitment to "halt protectionism, and... reverse it by dismantling trade barriers."[2] According to U.S. Trade Representative William E. Brock, "the important thing is to acknowledge protection and to establish practices that discourage its proliferation and lead to its removal."[3] And the Reagan Administration appears, at least in terms of official rhetoric, ready to resist the broad-based protectionist demands of industrial policy advocates.

Unfortunately, the record is actually one of reduced trade and increased barriers. The volume of trade decreased in 1982 at least in part because of a growing network of non-tariff barriers (NTBs). Although the multilateral tariff reductions secured by the General Agreement of Tariffs and Trade (GATT) are admirable, there has

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1 The Baltimore Sun, June 5, 1983, p. K4.
2 Section (3) of the 1983 Williamsburg Declaration.
3 "No, Let Us Praise Free Trade," The Washington Post, June 13, 1983.

been a growth in import quotas, export subsidies, and other NTBs. The Tokyo Round of the GATT in the 1970s stressed the need for the eventual elimination of NTBs, but they flourish nevertheless.

Protectionist attitudes are deeply rooted. Existing firms in any industry tend to oppose trade policies that promote competition. They complain of the "unfair" advantages enjoyed by foreign producers using "cheap labor," foreign subsidies, and tax forgiveness for firms, and claim that U.S. companies need protection to compete on equal terms.

As a result of such pressure, the U.S. is now taking a harder line on trade policies in a number of ways. For example, the U.S. is currently revising its "Generalized System of Preference" policy toward the richer less-developed countries. One possible revision would be for foreign governments to make concessions to retain their duty-free access to U.S. markets. Legislation is also pending to provide for the automatic erection of trade barriers when imports reach a certain market share. A revision of the "Escape Clause" of the Trade Act is under consideration to provide more immediate aid to import-competing domestic industries.[4] The charter for the U.S. Export-Import Bank is up for revision, and there is pressure for the bank to provide lower interest loans to increase the ability of foreigners to buy U.S. exports.

Congress also threatens domestic content restrictions and "Buy American," provisions in public and private contracts. The 1982 gas tax act specified that, in federally funded projects, the cement must be 100 percent American made unless that raises the cost by more than 25 percent. In addition, the U.S. is involved in promoting agricultural exports through programs of "blended credits" designed to offset similar subsidies by the European Economic Community. And the U.S. is currently revising the Export Administration Act, which empowers the President to penalize foreign-based firms that violate national security restrictions on trade.

Following the U.S. International Trade Commission's recommendation, President Reagan has imposed countervailing tariffs and quotas on specialty steel imported from Great Britain, France and West Germany, a protectionist move that follows closely the President's ten-fold increase in tariff on motorcycles, an action designed mainly to protect one company, Harley-Davidson.

As George Stigler suggests, it is not due to confusion that barriers are found in most lands, but rather due to "purposeful action" by those who "insightfully use the system."[5] Individuals who rationally and insightfully use the system to their own advantage cannot be expected to do otherwise. Milton Friedman puts

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4 Section 201 of the 1979 Trade Act.

5 National Journal, January 1, 1983.

the issue in perspective: "We should not complain about steel producers making such arguments for protection, but about letting ourselves be taken in by them."[6] It is time that Congress and the Administration recognized the irrationality of the arguments for protectionism and refused to let them influence trade policy.

THE MYTHS OF PROTECTIONISM

The idea that "special interests" have been "feathering their nests" thanks to protectionism is not new. Thomas Jefferson argued against barriers to free competition in reference to the French and American tobacco trading monopolies. But he understood the nature of the political difficulties involved in reform:

> I have been fully sensible to the baneful influence on the commerce of France and America, which this double monopoly will have.... I have struck at its root here, and spared no pains to have the farm itself demolished, but it has been in vain. The persons interested in it are too powerful to be opposed, even by the interest of the whole country.[7]

The "baneful influence on the commerce" consists not only in higher prices and reduced consumer choice and consumption, but also in the invisible costs of lost employment in export and import industries. Tariffs and quotas result in production and consumption distortions. There is reduced consumer choice over products, and there is reduced producer choice over inputs. Such "protection" redistributes wealth away from consumers and exporters and toward domestic producers competing with imports. These domestic producers may enjoy the illusion of competitiveness, but not the reality. The incentive to innovate and improve is reduced, which widens any competitive gap with foreign producers.

Myth 1: An "unfavorable" balance of trade is harmful.

Newsweek recently explained that "With America's trade deficit moving toward $70 billion this year--double the level of 1982--alarm is understandable."[8] Presumably, this unfavorable balance of trade is unhealthy. An unfavorable balance of trade, however, refers simply to the fact that the value of U.S. imports exceeds the value of U.S. exports. Is that consistent with the ordinary meaning of unfavorable? Individuals clearly would prefer to receive as much in "imports" for their "exports" as possible. Their gain from trade is measured by the extra value of their

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6 *Free to Choose: A Personal Statement* (New York: Avon Books, 1981 edition), p. 39.

7 *Letters of Thomas Jefferson*, Jeffersonian Encyclopedia (Ford edition). 1786 letter to Governor Patrick Henry, #5451 tobacco monopoly, iv, p. 137.

8 *Newsweek*, May 30, 1983, p. 26.

imports. For a nation, imports are also the gains from trade--the country hardly needs to be protected from them.

Myth 2: "Buy American"--it's good for the country.

The "Buy American" argument simply uses patriotism to cover up misunderstanding, or, as Milton Friedman expresses it, "misleading terminology...reflects...erroneous ideas."[9]

President Reagan presents the rebuttal to the "Buy American" argument as if Friedman were whispering in his ear:

> New cars would be more expensive. More jobs would be destroyed than protected. We would buy less from our trading partners. They would buy less from us. And the world economic pie would shrink. Recrimination and retaliation would increase.[10]

Exactly so. U.S. imports enable foreigners to buy American exports, and if the U.S. imposes restrictions on buying foreign products, the U.S. simply harms itself in the process. As Trade Representative Brock has explained, "It is simply inconceivable that we might continue to create jobs here through our exports if we don't buy their products."[11]

Myth 3: Cheap labor gives some foreign companies an unfair edge.

Perhaps the most popular protectionist argument of all is that U.S. industries cannot compete with foreign producers who use "cheap labor." Without doubt, this argument has strong emotional appeal. The world is alleged to have an endless supply of subsistence wage labor with sufficient skills to compete with and destroy the jobs of higher-paid workers.

If the cheap labor argument had any validity, however, how could voluntary, mutually beneficial trade ever occur? The argument represents a very naive view of trade. As the Washington Post explains, "The case for protectionism comes down to wages...Japan's wages are about half the American average. But wages in Brazil are less than half as high as Japan's. Both have automobile industries. Why isn't Brazil the stronger competitor?"[12]

As David Ricardo demonstrated a century ago, a nation will tend to export those goods in which it has a "comparative cost" advantage. Thus, even though a nation may produce all goods at an absolute cost disadvantage (perhaps because of "expensive" labor), it still will find partners willing to engage in mutually beneficial

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9 Friedman, op. cit., p. 33.
10 "Reagan Criticizes Protectionist Measure," The Baltimore Sun, June 5, 1983.
11 "No, Let Us Praise Free Trade," The Washington Post, June 13, 1983, op. ed.
12 "A Dubious Case for Protectionism," The Washington Post, June 13, 1983.

trade. This is because it makes sense for countries to specialize in those goods that it can produce more efficiently than other products, and trade with countries specializing in different products, rather than trying to become self-sufficient. It is in the interest of all concerned to trade--no matter what is the level of wages in each country. To understand this point one need only consider domestic trade. Even if one person can outproduce his neighbors in a number of fields, it is still best for him to specialize in a service or product where he has a comparative advantage and trade with other people for the rest of his needs.

Care must be taken, moreover, when claiming that low wages exist in certain countries. To compare wages in Japan and the U.S., for instance, an exchange rate of yen for dollars is necessary. But what determines the exchange rate? The demand for yen is affected by U.S. traders wishing to buy Japanese goods to import into the U.S. The supply of yen is derived from Japanese traders wishing to buy dollars to buy American goods and import them into Japan. Let us assume that U.S. and Japanese workers are equally productive, but that Japanese labor is cheaper. This would mean a large demand for Japanese goods ("cheap foreign imports") and hence a stronger demand for yen. This would increase the value of the yen, making Japanese workers more expensive in terms of their wage rate in dollars. A freely operating foreign exchange market, in other words, tends to bring stabilizing changes to the trade in goods and services and to offset any "cheap labor" advantage enjoyed by one country over another.

Myth 4: The "overvalued" dollar hurts U.S. exports.

Closely intertwined with the "cheap labor" argument is the "overvalued" dollar argument. As the value of the dollar has risen against other major currencies since 1980, so has the chorus of complaints about a loss of competitiveness due to factors beyond the control of industry. Congressman Jack Kemp (R-NY) expresses this view: "It's a crime," he says, "when steel and auto workers in my district have to worry about the state of the U.S. dollar."[13] According to Kemp, action is needed when "they are priced out of the market, and jobs are destroyed merely because the relative value of the dollar is hurtling around like a loose cannon."

Every price change makes someone better off and someone else worse off. When the dollar is stronger and buys more foreign exchange, American consumers enjoy lower-cost imports, while it is more difficult for producers at home. In 1977-1979, when the dollar was weaker, the opposite was the case. U.S. exports were more competitive in world markets, bringing benefits to workers in exporting industries. But imports became more expensive, pushing up costs for consumers in general.

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[13] "A Floating Dollar Costs Us Jobs," The Washington Post, May 15, 1983.

Congressman Kemp criticizes the "sheer confusion and inefficiency" of free floating exchange rates and favors a return to a fixed rate system. By the logic of a floating dollar, according to Kemp, "we ought to abolish standard yards or meters as an interference in the free market."[14] But the comparison is preposterous. Prices are not measures of distance. They are measures of value in exchange. They are as changeable as the temperature--a symptom, not a standard. Flexibility in foreign exchange markets tends to promote stability, not inefficiency. When the dollar is strong, our exports appear relatively expensive while imports appear relatively cheap. As more imports are demanded and less exports sold, the tendency is for the value of the dollar to decline, offsetting the initial "overvalue."

Some critics complain, however, that the exchange rate market does not respond to market forces. Fluctuations, they claim, have little to do with the relative productivity of U.S. and foreign industry, but rather the distortions are produced by an international financial system that reflects the decisions of speculators and financial managers, not those of the producers of goods. This complaint is also vacuous. Destabilizing speculators, who presumably buy dollars when they are "overvalued" (that is, "buy high"), thereby increasing the value further, and sell dollars when the currency is undervalued (that is, "sell low"), do not last long as speculators.

Myth 5: Protection is needed to preserve employment.

Other arguments for protection are based in emotion, rather than fact or logic. Protection must be provided, it is often said, to defend existing market shares or to protect employment in declining U.S. industries. Autos, steel, textiles, and footwear are cited as examples. In response to a petition by the domestic footwear industry, for instance, the U.S. International Trade Commission requested that quotas on Korean footwear be extended for two more years. According to the Commission, the industry is "on the threshold of recovery and extension of the present relief should make it possible to preserve these jobs after extended relief expires."[15] Clearly this is a simple case of special pleading. If a policy goal should be to subsidize employment in declining industries, the most efficient means to achieve that goal is through a production subsidy, rather than foreign trade restrictions. With subsidies, the price of domestic product is lowered to meet the foreign competition. But quotas and tariffs raise the price to consumers.

Myth 6: Unfair foreign subsidies require retaliation.

One of the most sensitive concerns of protectionists in the current debate is the government subsidization of exports. As

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14 Ibid.

15 U.S. International Trade Commission, quoted in National Journal, February 5, 1983, p. 284.

one official puts it, "We cannot continue to lose markets to the Europeans because of subsidies.... Either there has to be some action on their part or we will take action. We don't want to use subsidies, but it is unrealistic to think politically we can continue to let this happen."[16]

It is argued that the U.S. must retaliate to induce the appropriate response from its competitors. But U.S. action simply generates foreign retaliation. Although the GATT commission ruled that there was nothing illegal in the European wheat flour exports, for instance, the U.S. decided to retaliate. One hundred million metric tons of subsidized wheat flour were sold to Egypt in order to change the behavior of our competitors. But the French responded by selling subsidized wheat flour to China, thereby reducing the market share of U.S. producers. And in response to quotas on Chinese textiles, mushrooms, and porcelain, the Chinese have imposed quotas on American cotton and synthetic textiles, soybeans, and wheat.

Retaliation is an ineffective weapon, while sensible trade policy produces behavior on the part of foreign governments that benefits both governments. With 20 percent of U.S. manufacturing jobs and 33 percent of agricultural production generated by exports, the U.S. has much to lose if reciprocal retaliation grows.

Myth 7: Protection is necessary for national security reasons.

Most nations restrict foreign trade on national security grounds or for similar noneconomic considerations. But this does not mean that there are no hidden economic dimensions to their actions. The problem is where and in what manner to draw the line between legitimate and illegitimate national defense requests for protection. And again, emotionalism usually enters the debate. Consider the words of Representative John Seiberling (D-OH):

> The issue is whether the American people and the Congress are going to take steps necessary to see that we survive as a major industrial power....What are we going to do in the event of a war? Have our tanks made in Japan and bring them across the ocean?[17]

Military hardware is, of course, a relatively clear-cut case. But when one moves away from this narrow area, the question of who should receive protection on grounds of national defense has no simple answer. Industries exaggerate the need for barriers to ensure the national defense. According to the United Steelworkers

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16 Richard Smith, Department of Agriculture, Foreign Agricultural Service, quoted in Christopher Madison, "If It Can't Beat Europe's Farm Export Subsidies, U.S. May Opt to Join Them," National Journal, January 15, 1983, p. 116.

17 Quoted in C. Madison, National Journal, January 1, 1983, p. 20.

of America, for instance, "Unless the Reagan administration takes immediate action, the industry will be severely damaged and could disappear. The national interest is clear."[18] Freer trade does lead to more specialization, but rarely complete dependence on overseas supplies. If a certain level of domestic production is needed to assure military self-sufficiency, then the policy should be to subsidize domestic production until stockpiles are complete, and make the cost explicit. Barriers to foreign trade are not the most direct way to reach the chosen goal, for they conceal the real cost.

Myth 8: Infant industries need protection.

Some young industries will achieve competitiveness in world markets, it is argued, if they receive temporary protection from foreign competition. Without it they will be driven out of business in their early years by mature foreign competitors.

One problem with the argument is the word temporary. Once imposed, barriers are difficult to eliminate--witness the textile industry, which received infant industry protection in the early 19th century and is still protected today. The protected industry often uses a portion of its profits from protection to sustain the political support for tariffs and quotas well beyond their reasonable use. As Milton Friedman notes, "the infant industry argument is a smoke screen. The so-called infants never grow up." "Moreover," Friedman continues, "the argument is seldom used on behalf of true unborn infants that might conceivably be born and survive if given temporary protection. They have no spokesman. It is used to justify tariffs [by] rather aged infants that can mount political pressure."[19]

Even if an infant industry becomes established thanks to temporary help from trade barriers, tariffs are not justified. According to Friedman, tariffs benefit consumers, who carry the burden of protectionism, only if they get some return for their subsidization "in some way or another, through prices later lower than the world price, or through some other advantage of the industry. But in that case, is a subsidy needed?"[20]

Furthermore, if private capital markets are working, the market should see the long-term returns from the industry and provide the funds necessary for it to become established. Supporters of protection often reply that the capital markets are imperfect. But this means that policies should center on correcting capital market distortions, not on subsidizing selected industries. If there are indirect benefits to the industry, say the development of skills by workers, that cannot be captured by

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18 U.S. Steelworkers advertisement, Newsweek, June 13, 1983, p. 53.
19 Milton Friedman, op. cit., p. 41.
20 Ibid.

those who provide capital, then the appropriate policy would be to subsidize or provide training for employees in each industry, rather than protection for those industries that can apply political pressure.

CONCLUSION

The demand for barriers against foreign trade as part of a national industrial policy is not going to disappear in the near future. Those industries that already benefit from barriers will fight intensely to preserve their advantage. Other industries seeking protection from competition have plenty of spurious arguments at their disposal. In the short run, the best antidote to these arguments will be a sustained recovery of the world economy. But although recovery may postpone determined protectionist moves for another year or so, it will not silence permanently the advocates of protection.

The issue of protectionism will keep returning in its many guises, and the question ultimately comes down to on whether bureaucrats or consumers should decide which goods reach the market. The United States should strive to reduce barriers, not threaten retaliation--a policy that is doomed to failure. Those who demand and promulgate international trade regulations must be "asked to stop this" self-interested action, according to George Stigler. If they do stop, he argues, they will eventually regain some of their lost benefits in other forms.

History teaches that if freedom is not guarded it is soon lost, and free international markets are no exception. So much effort is spent worrying about the hardware of America, to use the computer analogy, that too little effort is spent on maintaining its precious software--the heritage of political and economic freedom. It must be guarded against the continual attacks of those who would use government to their own advantage.

John Kennedy put forth the following proposition in his inaugural address: "My fellow Americans of the world, ask not what America will do for you, but what together we can do for the freedom of man."[21] The world has been able to look to America as the shining example of that freedom. To bring stability, harmony, and economic growth to the world, the U.S. should set a clear example and reduce its trade barriers, even if its trade partners do not follow the lead.

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21 J. F. Kennedy's Inaugural Address, January 1961.