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FREE TRADE VERSUS PROTECTIONISM

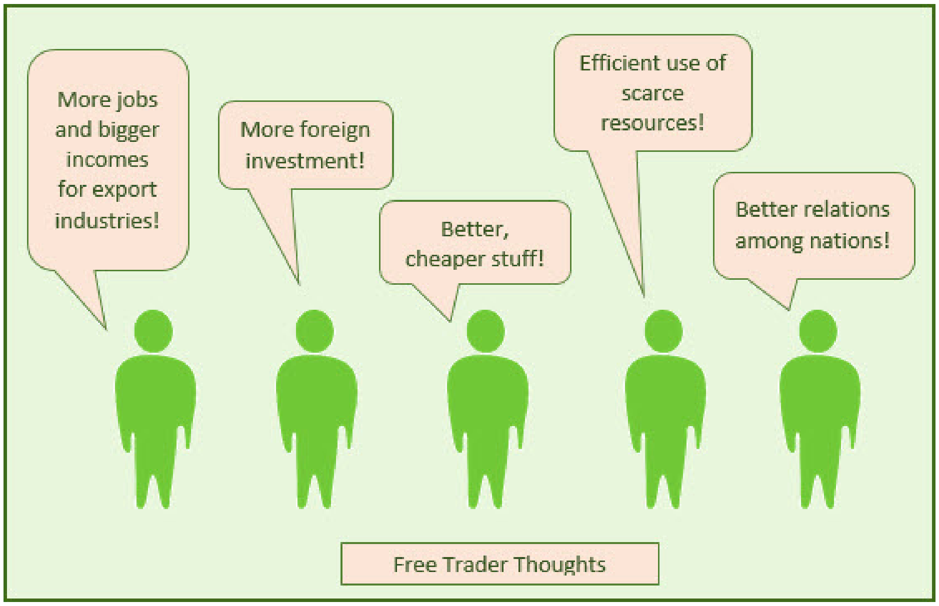
President Trump Speaking in Ypsilanti, Michigan: March, 2017

Unit Overview

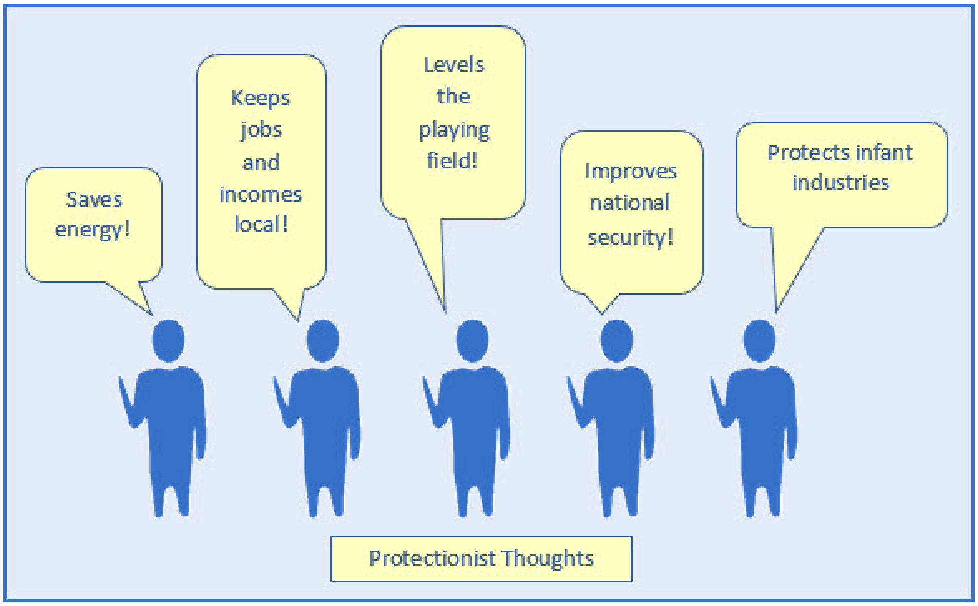
In the previous unit, you looked at some simple examples of the economic principles underlying the international exchange of goods and services. Trade, however, does not occur in a vacuum, and a number of factors impact how it is conducted. One of the most significant is government regulation. Many Americans argue that quotas, tariffs and subsidies are necessary to save jobs and to protect growing industries. Others insist that these actions only harm consumers and put off inevitable changes in employment patterns. Should producers benefit at the expense of consumers? Do we need more or fewer laws governing trade? Is free trade the most beneficial course of action? Let's see how it all works.

Free Trade and Protectionism

Free trade is a system that permits nations to exchange goods and services without government interference. This eliminates regulations, taxes and licenses. Since each country has a comparative advantage when it produces certain items, free trade, at least in theory, is the most efficient way to use scarce resources. For this reason, it wins the approval of most economists. For consumers, it offers more choices, better quality and lower prices. Jobs and incomes naturally increase in export industries, and the overall standard of living rises. Free trade also inspires countries to work together and encourages foreign investment. So what's not to love about free trade?



It is often assumed that free trade benefits everyone, but this is not true. Although its overall impact is often positive, not all regions within a country profit equally. Therefore, for some people, there is plenty not to love about free trade. These individuals propose that the government establish **trade barriers**, such as tariffs, quotas and subsidies, to give the home country an advantage over foreign imports. This policy is called **protectionism**. Since some trading partners ignore human rights, pay very low wages and have weak environmental standards, protectionists advocate trade barriers to keep domestic industries competitive. This is sometimes referred to as *leveling the playing fild*. Protectionists contend that it helps to keep jobs and incomes in local communities. In addition, critics of free trade warn that it is dangerous to become too dependent on imported goods. Because some products may be essential to national defense, governments may choose to impose trade barriers. By taking this action, they ensure that certain industries continue to operate. Protectionism also shelters **new, or infant, industries** as they grow and strengthen. At the same time, proponents insist that protectionist policies conserve energy and decrease environmental damage. Goods produced and sold within national borders result in less packaging and lower fuel consumption. Because both sides continue to present valid arguments, it appears that the controversy surrounding free trade will not be resolved anytime soon.



Go to Questions 1 through 7.

Trade Barriers

Today, most nations have some barriers that limit free trade. A trade barrier is defined as any restriction that prevents foreign goods and services from freely crossing a country's borders. Common trade barriers include quotas, voluntary export restraints (VERs), tariffs and subsidies. As with all choices, these options come with opportunity costs.

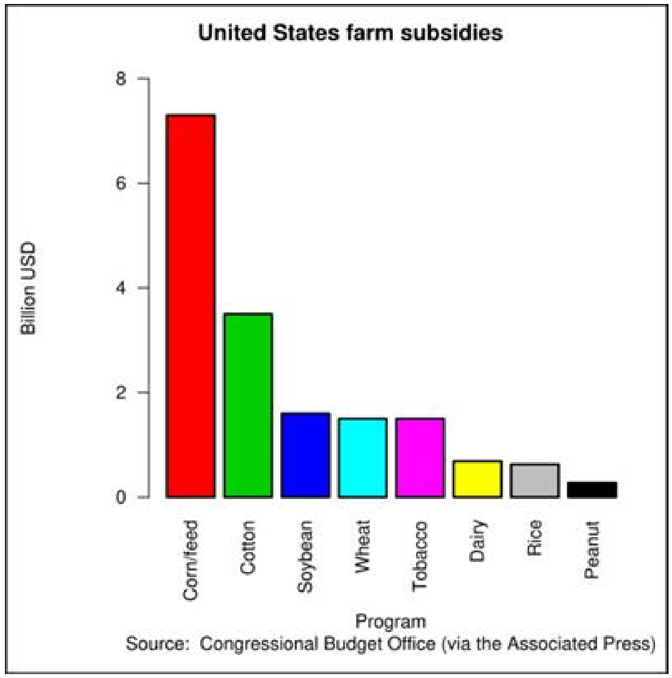
- **Quotas**: A quota is a law that sets a specific limit on the amount of a good that can be imported. It reduces the total supply of a particular product and keeps prices high for domestic producers. For example, the United States restricts the amount of sugar than can legally enter the country by setting a quota of 5.8 billion pounds per year. Once shipments from foreign countries reach this total, the importation of sugar ceases. As a result, the price of a pound of sugar within the U.S. averages $.43, but the average price per pound on the world market is $.27. American producers benefit at the expense of consumers, who pay higher prices. On the other hand, if sugar imports remain unlimited, most U.S. producers would be out of business, and an estimated 3,000 jobs would be lost.

Sugarcane Fields in Brazil, the World's Largest Sugar Producer: Image Courtesy of Mario Roberto Duran Ortiz

- **Voluntary export restraints**: Unlike a quota, a voluntary export restraint (VER), is not a law. It is a self-imposed limit on the number of products that one nation can ship to another. In 1981, lower-priced Japanese vehicles competed intensely for American customers. This threatened the stability of the U.S. auto industry. The Reagan administration asked Japan to lower the amount of its auto exports to the United States voluntarily. The Japanese government agreed because U.S. negotiators threatened to set up harsher trade barriers if Japan refused. Although this deal benefitted American manufacturers, it came with trade-offs. This voluntary export restraint reduced the choices available to consumers and increased the prices of all vehicles sold in the United States.

- **Tariffs**: Before the collection of personal income tax, taxes on imported goods, or tariffs, were the American government's primary source of revenue. Today, most tariffs are levied to protect U.S. farmers and manufacturers from foreign competition. Here is an example of how it works. Let's say that it costs $1 to produce a stress ball in the United States. However, an American retailer can import the same stress ball for $.35. By placing a tariff of $.95 on this item, the cost of the foreign stress ball increases to $1.30. The American-made stress ball is now cheaper than the foreign import. While this protects those who produce stress balls in the United States, it forces consumers to pay more for the same item.

- **Subsidies**: National leaders recognize that certain businesses are necessary for the well-being of their citizens and for economic stability. When these industries struggle to survive due to competition from foreign imports, governments sometimes provide cash payments or tax reductions to help. These supports are called subsidies. The U.S. government provides this assistance to a variety of businesses, groups and individuals, including American farmers. When used for this purpose, economists consider subsidies barriers to trade because they permit farmers to sell at low, competitive prices while maintaining their income. Proponents of this policy argue that it keeps family farms in business and decreases dependency on overseas markets for food. However, all income earners pay for these subsidies in the form of higher taxes.



U.S. Farm Subsidies: Graph Courtesy of Arichnad

- **Other barriers**: Safety regulations, health standards and licenses sometimes represent less formal barriers to trade. If a business must obtain a license to sell goods in a certain country, high fees and slow processing can delay and eventually prohibit sales. Countries may also apply health and safety regulations that are very demanding and, in turn, discourage imports. By establishing rules that are too difficult for most sellers to follow, a nation can sharply reduce and even eliminate competition within its borders.

Go to Questions 8 through 14.

Trade Wars

Although trade barriers can benefit the country that initiates them, they can cause long-term, negative outcomes. When one country limits imports, its trading partners may respond by setting their own restrictions. This creates an escalating cycle of trade barriers, known as a **trade war**, and it can have serious economic consequences for all the nations involved. Just as increased trade benefits all trading partners, a decrease in trade harms all trading partners.

The United States learned just how devastating a trade war can be in 1930. To combat the effects of the Great Depression, Congress passed the **Smoot-Hawley Tariff**. This act raised the tariff on all imports to 50%. Congress reasoned that this law would protect American workers from foreign competition and would provide income to buy American products priced lower than their foreign counterparts. Other countries, however, quickly responded and raised tariffs on American-manufactured goods. This resulted in a trade war that closed foreign markets to U.S. products and reduced the demand for goods worldwide. International trade declined dramatically, and economic conditions worsened around the globe.

U.S. Representatives Willis Hawley and Reed Smoot: 1930

Although trade wars still occur, they typically evolve around a few specific products rather than everything that a country imports. When these controversies do arise, international organizations, such as the World Trade Organization (WTO) founded in 1995, try to resolve them before they become destructive. In 2002, the American steel industry was experiencing difficult times. Plant closings, downsizing and over thirty declarations of bankruptcy jeopardized local economies and resulted in demands for government intervention. Steel manufacturers laid the blame squarely on foreign imports and requested tariffs on steel from overseas.

Although some nations were exempt due to trade agreements, the federal government established tariffs ranging from 8 to 30% on imported steel. Since steel tariffs had traditionally ranged anywhere from 0 to 1%, these rates seemed extraordinarily high, but steel producers pointed out these taxes were similar to those placed on shoes and clothing. The European Union threatened to retaliate by placing tariffs on American products. With the threat of a trade war looming, the World Trade Organization investigated the case and ruled against the U.S. tariff on steel. When President George W. Bush announced plans to keep the tariff in place in spite of the WTO's response, the European Union declared it would attach tariffs to oranges from Florida and autos from Michigan. This was enough to convince the Bush Administration to disband the tariff in 2003 rather than end it as scheduled in 2005.

Jay Rockefeller, West Virginia Senator from 1985 to 2015, Speaking at a Steel Rally: 2002

The controversy over steel imports and their effect on the U.S. steel industry heated up again in 2016. American manufacturers and the Commerce Department accused China and several other countries of **dumping**, a practice that is a form of predatory pricing. It occurs when one country tries to increase its share of a particular market by selling goods for less money than it took to produce them. In terms of international trade, this is done with the intent of driving other nations out of the market. The video listed below explains why dumping is considered a negative aspect of free trade.

Those who favor free trade view dumping as beneficial to consumers because it results in lower prices. In contrast, protectionists claim that it causes diminishing sales for domestic companies. This has a number of negative consequences, such as job losses and business closures. In April, 2017, President Donald Trump ordered an investigation of the steel dumping in the United States. When questioned about this decision, President Trump said the following: "Steel is critical to both our economy and out military. This is not an area where we can afford to become dependent on foreign countries."

Go to Questions 15 through 20.

What's next?

In recent decades, the world has experienced a large increase in the volume of international trade. The number of preferential trade agreements, which reduce trade barriers among member nations, has also grown. At the same time, multinational trade organizations, such as the World Trade Organization and the World Bank, have expanded their membership and their roles in ensuring that trade flows smoothly and fairly across the globe. Before learning about these topics in the next unit, review the names and terms found in Unit 16; then, answer Questions 21 through 30.

Go to Questions 21 through 30.

Below are additional educational resources and activities for this unit.

[Unit 16 Main Points Worksheet]

[Unit 16 Barriers to Trade Worksheet]

[Unit 16 What is a tariff? An economist explains Article and Quiz]