

How and why do countries regulate trade?

Have you ever tried to mail a package to another country at the post office? If so, you probably had to fill out a customs declaration. It asked you to list the items you were sending and to indicate whether they were gifts or goods to be sold. This information is required by customs, the government department responsible for examining goods entering a country and enforcing any trade restrictions on them.

Economists have long argued against trade restrictions. Nonetheless, few countries have ever fully embraced free trade, the unrestricted movement of goods and services across borders. Over the years, countries have found many reasons to regulate foreign trade.

Many countries restrict imports in order to shield domestic markets from foreign competition. Such behavior is known as protectionism. Countries do this mainly to satisfy political demands at home. There are many types of trade barriers. The four main types are protective tariffs, import quotas, trade embargoes, and voluntary export restraints.

The most common type of trade barrier is the protective tariff, a tax on imported goods. Countries use tariffs to raise revenue and to protect domestic industries from competition from cheaper foreign goods. Tariffs are among the easiest taxes to impose, since they arouse little domestic protest and can be easily applied to goods before they enter the country.

While protective tariffs may help specific domestic producers, they do not benefit consumers. Tariffs push up the prices of imported goods. So instead of having to lower prices to compete with cheap imports, domestic producers can raise prices to the inflated price level of the imports. Thus, tariffs make all goods more expensive for consumers.

If they are set high enough, protective tariffs can also have negative effects on the entire economy. The Hawley-Smoot Tariff Act, passed by Congress in 1930, raised the average tariff rate on imported goods to more than 40 percent. Although 1,028 economists petitioned President Herbert Hoover to veto the bill, he signed it into law. In response, other countries raised their tariff rates. Foreign trade came to a halt, helping to turn a recession into a worldwide depression.

Despite these drawbacks, most governments are still persuaded that tariffs are needed to protect their country's workers and industries. In 2008, for example, the United States imposed a 4.7 percent tariff on imported pianos, a 6.8 percent tariff on cut roses, and a 4 percent tariff on felt-tip pens.

While tariffs make foreign goods more expensive, they do not limit the quantity of goods that can be imported. An import quota, on the other hand, places a limit on the quantity of a good that can be imported during a specified period of time. For example, an import quota on textiles might limit textile imports from a given country to 10 million garments per year. Once that limit is reached, textile imports from that country must stop for that year.

Beginning in the 1960s, textile quotas were used by the United States and other countries to shield their domestic clothing industries from competition from low-wage countries. The phasing out of these quotas in the 1990s caused an upsurge in inexpensive clothing imports. Many U.S. apparel companies went out of business as a result.

Like tariffs, quotas are designed to protect domestic industries. But they do not raise revenue for the government. They may also lead to corruption and smuggling as producers look for ways to exceed quota limits. Like tariffs, import quotas raise prices for consumers as costlier domestic items replace cheaper imports once the quota limit is reached.

A trade embargo imposes a ban on trade with a country or group of countries, usually for political reasons. For example, in 1960 the United States imposed a trade embargo on Cuba to protest its revolutionary government's seizure of American-owned property. In 1986 the U.S. Congress imposed an embargo on South Africa to oppose its apartheid policy of racial segregation.

Trade embargoes have a mixed record. When successful, they pressure countries to change their policies. South Africa, for example, abandoned its racial segregation policies when faced with trade embargoes from many countries. In contrast, as of 2008, the decades-long U.S. trade embargo against Cuba had failed to bring about a change in the country's government or policies.

The fourth type of trade barrier is known as a voluntary export restraint, or VER. This type of barrier limits the quantity of a good that can be exported from a country during a specific time period. In effect, it is an export quota, self-imposed by the exporting country.

In most cases, however, a VER is not truly voluntary. It is usually established at the insistence of an importing country. It is designed to avoid harsher restrictions, such as tariffs or import quotas. For example, Japan imposed a VER on its automobile shipments to the United States in the 1980s when faced with U.S. threats to restrict Japanese auto imports.

People have long debated the merits of free trade versus protectionism. Economists generally agree that free trade promotes economic growth and is good for consumers. Still, domestic producers, labor unions, and political leaders continue to make the case for trade restrictions. They base this position on a number of key arguments.

The jobs argument. This argument assumes that allowing cheap imports into a country destroys jobs by forcing domestic companies to cut costs, lay off workers, or even go out of business. Protectionists might point to the collapse of the Florence, Alabama, T-shirt industry to support this case.

According to the jobs argument, highly paid workers in a wealthy country like the United States simply cannot compete with low-wage workers in poorer countries. The only way to protect American jobs is to make cheap imports more expensive by imposing tariffs or to limit their availability by imposing quotas.

Economists reply that tariffs and quotas cost more jobs than they save. For example, in the 1980s the United States imposed tariffs on imported steel to protect the domestic steel industry. The tariffs led to higher steel prices. Higher steel prices raised the cost of producing goods made with steel, from pots and pans to automobiles. This hurt domestic producers of such goods, who had to compete with foreign producers using cheaper steel.

By one estimate, the steel tariffs earned roughly \$240 million in profits for U.S. steel companies and saved 5,000 jobs. But they cost domestic industries that use steel \$600 million in profits and 26,000 jobs.

Most economists also dismiss the idea that American workers cannot compete with foreign labor. Low wages in poor countries, they say, reflect low productivity. The cost to an employer of a high-wage worker who is very productive may be less than that of a low-wage worker who is less productive. Free trade encourages firms to specialize in those activities in which their workers are relatively more productive.

Finally, economists note that while free trade destroys some jobs, it also creates jobs. It does so by expanding the industries in which the United States has a comparative advantage. It helps U.S. export industries, since buying imports from foreign countries gives those countries the purchasing power to buy American goods. It also creates jobs for retailers and businesses that sell and service imported goods.

The national-security argument. This argument states that industries that are vital to national security must be protected. Included in this category are defense industries and producers of critical resources like oil and steel. Some would even extend this argument to include the production of basic foods, such as wheat and corn. Those who make this argument say trade restrictions are needed to avoid dependence on foreign suppliers during times of conflict.

Most economists would agree that when the country's security is at stake, trade barriers may be justified to protect key industries. But they are skeptical when calls for such protection come from industry representatives rather than military or intelligence agencies. Industries that are facing stiff foreign competition have an interest in proclaiming their own importance to the country's security.

The infant-industry argument. Sometimes a newly formed industry needs time to become competitive. According to this argument, such "infant industries" will eventually become strong enough to stand on their own. In the meantime, protectionists say, tariffs may be necessary to protect them from cheaper imports.

Economists typically respond that even if one accepts this argument, it is difficult to put into practice. It requires that the government identify which infant industries will eventually make a profit and are therefore worth protecting. In reality, making this selection is notoriously difficult, and the process is all too easily influenced by politics.

Economists also object to the infant-industry argument on principle. New firms, they argue, must be willing to accept losses when starting up if they believe they can become profitable in the long run. Moreover, many new firms have grown into industry giants.

The unfair-competition argument. This argument asserts that trade is fair only if all countries play by the same rules. For example, protectionists argue that some countries "cheat" by providing subsidies to their industries to help them compete with foreign firms. They say that trade barriers are justified to protect domestic industries from subsidized foreign imports.

Protectionists also contend that some countries "dump" their products in foreign markets to force competitors out of business. Dumping means selling a product for less than it cost to produce it. Dumping is considered an unfair trade practice by most trade organizations, and most countries disavow it.

Economists typically reject both parts of the unfair-competition argument. First, they assert that the benefits to consumers of cheap imports outweigh the costs to domestic producers, regardless of whether the imported products are subsidized or not. Second, they say it is nearly impossible to detect dumping because it is difficult to determine a foreign firm's costs. "Often," write economists Campbell McConnell and Stanley Brue, "what appears to be dumping is simply comparative advantage at work."

The protection-as-bargaining-chip argument. This argument states that trade restrictions can be a useful bargaining tool in trade negotiations with other countries. Its advocates claim that the threat of a tariff or import quota can be used to persuade another country to remove or reduce its barriers to trade.

Economists point out that this strategy can easily backfire. When that happens—when the threat of a new trade restriction does not produce the desired result—the country faces a dilemma. It either has to make good on its threat and impose the restriction (which might harm its economic welfare) or back down (which can harm its reputation). Either of these results leaves the country worse off than before.

The environmental-and-labor-standards argument. Some people contend that countries with lax environmental or labor laws have an economic advantage over countries that must comply with stricter laws. To make trade fair, they say, countries with stricter laws should impose tariffs against countries that do not uphold similar standards.

The problem with this argument, say most economists, is that lax standards are most common in the world's poorer countries. These countries have few resources to devote to worker and environmental protection. As they develop their economies, in part through global trade, they will be able to pay more attention to labor and environmental standards. Restricting trade with such countries only slows the pace at which such improvements can be made.

If the view of most economists is correct and trade restrictions do more harm than good, then why do political leaders and the general public still support them? The answer lies in the political process. Producers and workers who are threatened by foreign competition typically organize to seek trade protection. They lobby members of Congress and educate the public on the subject.

On the other hand, those who benefit from free trade—the great majority of consumers—may not even realize that their interests are at stake. And so, as the following analysis points out, they do little to oppose trade restrictions:

The overall cost of tariffs and quotas typically greatly exceeds the benefits. It is not uncommon to find that it costs the public \$200,000 or more a year to protect a domestic job that pays less than one-fourth that amount. Moreover, because these costs are buried in the price of goods and spread out over millions of citizens, the cost born by each individual citizen is quite small. In the political arena, the voice of the relatively few producers demanding protectionism is loud and constant, whereas the voice of those footing the bill is soft or nonexistent.

—Campbell R. McConnell and Stanley L. Brue, *Economics: Principles, Problems, and Policies*, 2008