The political economy of protectionism

DO SUBSIDIES JUSTIFY RETALIATORY PROTECTIONISM?

Donald J. Boudreaux

A theoretical case can be made to justify trade protectionism on the ground that foreign governments are subsidising export industries. This case is based on overall international welfare grounds. However, the country receiving the subsidised products benefits from the subsidies. Furthermore, imposing retaliatory protectionist measures risks encouraging rent-seeking behaviour. In practice, it is impossible to define exactly what behaviour does and does not amount to the grant of subsidies by the government of an exporting country.

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Introduction

A frequently used justification for protectionism is subsidies. If a foreign government subsidises firms within its jurisdiction, the conditions on which the classic case for free trade is grounded – namely, the specialisation of producers according to comparative advantage – do not apply.

Subsidised foreign producers might (although might not necessarily[1]) win substantial market share in the home country *not* because those producers have a comparative advantage at producing what they profitably export but, instead, because a foreign government forces their taxpayers to artificially reduce the subsidised producers' costs.

Economists are far more hesitant than are politicians and members of the general public to use the reality of such subsidies as a justification for the home government to impose retaliatory trade restraints.

The most obvious reason, from an economist's perspective, for why foreign governments' subsidies (and other market-distorting policies) do not justify retaliation by the home government is that people in the home market typically benefit, on net, from subsidies given to foreign exporters. If, for example, the Chinese government taxes the Chinese people in order to artificially reduce the prices that Europeans and Americans pay for Chinese exports, why should Europeans and Americans complain? Compared to the no-subsidy alternative, we non-Chinese people get larger quantities of valuable outputs at lower prices. From *our* perspective, it is as if production conditions in China naturally allow firms there to produce at these very low costs. Because economic theory is clear that the home economy benefits if lower-cost foreign suppliers are permitted to serve the home economy unimpeded by protectionist measures, if the costs of creating these artificially low prices of exports fall on foreigners and not on us, we in the domestic economy should welcome such lower prices, whatever their source.

Global consequences versus national consequences

The obvious response to this argument for ignoring foreign subsidies is that, because international trade weaves different nations into a single global market, market distortions created by foreign governments should be opposed with no less vigour than are market distortions created by the home government. Market distortions introduced in one part of the market can adversely affect other parts of the market.

There is merit to this response. Since the publication of *The Wealth of Nations*, economists' research and reasoning on international trade have firmly established the proposition that political borders do not

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define the territories over which mutually advantageous economic activities occur.

But political borders *do* define the populations on whom the burdens of each government's subsidies fall most heavily. The reason is that typically the very purpose of subsidies is to increase a country's exports relative to its imports. To make its country's exports artificially more abundant and artificially less costly for foreigners to buy, a government taxes its citizens, effectively forcing people within that country to bestow benefits on people outside its boundaries.

As an empirical matter, then, the costs of subsidies are borne chiefly by citizens of the country whose government uses subsidies while the benefit of subsidies is enjoyed overwhelmingly by that country's trading partners.

Still – because trade makes markets less and less national and more and more global – the possibility is real that, especially over the very long run, subsidies do reduce the net welfare not only of citizens of the countries that use subsidies but reduce also the welfare of citizens of other countries. And economists have long recognised that it is possible, *in principle*, for a home government to beneficially use retaliatory trade restrictions to pressure foreign governments to end their subsidies and other market-distorting policies.

Economists, however, have also long been sceptical of the ability of such retaliatory measures to work in practice. Because subsidies and protectionist tariffs typically result from successful rent-seeking by politically powerful interest groups, home-governments' retaliations against these market-distorting policies are unlikely to end these policies. The reason is that retaliation seldom diminishes either the absolute or relative power of those interest groups whose political manoeuvres are responsible for the policies in the first place. As long as these rent-seeking groups remain disproportionately influential in determining the economic policies of their countries, these groups will continue to successfully exercise their influence over their governments to maintain the market-distorting policies.

Economists' reluctance to endorse the use of retaliatory trade restrictions springs also from the recognition that home governments cannot be trusted to pursue retaliatory trade policies in welfare-enhancing ways. Home governments, after all, are subject to rent-seeking pressures just as are foreign governments. It is simply too tempting and too easy for a home government to falsely portray its own market-distorting policies – policies implemented for reasons no more noble than to create rents for powerful domestic producer groups – as being parts of a quest to cleanse the global economy (or at least the home economy) of subsidies and other market distortions introduced by dastardly foreign governments.

Economists' realisation that – over the short and medium run – subsidies chiefly benefit, not the countries that impose them but, rather, their trading partners, combines with (1) economists' scepticism of the ability of retaliation to end foreign-governments' subsidies, and (2) with economists' fear of home-economy rent-seeking, to cause economists, generally, to recommend treating foreign-government subsidies as facts of nature to be taken as given rather than as alterable variables that ought to guide a home-government's policy-making.

The ambiguity of subsidies

The case, summarised above, against retaliatory protectionism pretends that there is no ambiguity in defining and identifying a subsidy. In reality, of course, the line separating subsidies from non-subsidies is frustratingly blurred.

Outright cash grants by governments to private producers are obviously subsidies. But what about tax breaks worth the same amount as the cash grants? Today most observers classify such tax breaks as subsidies if they are targeted to a particular firm or industry.[2]

Move a bit further, though. Are government owned and operated engineering schools subsidies to industry? What about government owned and operated primary and secondary schools? What about government vouchers or tax credits used to purchase private schooling? Is government provision of infrastructure such as deepwater ports and motorways a subsidy to industry? How about vigilant government protection of the rule of law, including provision of a non-corrupt court system?

Or how about a government policy of open immigration? If open immigration lowers firms' costs of production, these firms will enjoy a greater advantage in export markets than they would have if their government restricted immigration. Is a policy of open immigration a subsidy?

Is sound money a subsidy?

Even if we stipulate that government-provided public goods are not to be classified as subsidies, legitimate disagreements can arise over what is and what is not a public good. Lighthouses, once a textbook example of a public good, were famously shown by Ronald Coase (1974) to be supplied in many instances by private arrangements. Roads? History offers many examples of highways (Klein, 1990) and even city streets (Beito, 2002) being supplied privately. Sound money is now widely understood by economists to be capable of being supplied by competitive, private banks (Selgin and White, 1994). Even law has been supplied privately (Benson, 1990).

A consequence of the ambiguity of subsidies is that, if retaliatory protectionism is encouraged (or even just tolerated) whenever foreign governments subsidise their exports, sightings of such subsidies by home-market producers, politicians and administrative officials will be too numerous. Rent-seekers at home will routinely leap to the conclusion that exporters' gains in market share are the result of 'unfair' subsidies allegedly enjoyed by these exporters. With no way to separate the vast majority of government expenditures into objectively agreed upon classes of 'subsidies' and 'not subsidies', the best rule of thumb is a policy of free trade followed regardless of foreign-governments' subsidisation of producers within their jurisdictions.

What is a 'distorted market' anyway?

The above discussion assumes that there exists, in principle, an identifiable 'undistorted' market, and that this 'undistorted' market is the ideal against which to compare real-world economic patterns and processes. Practical problems,

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regrettably, make it impossible to fully identify these undistorted market conditions and to deploy policies at home that will prompt foreign governments to adopt policies that are more in line with this undistorted ideal. But the undistorted market remains an objective standard, even if practically difficult to identify and impossible to achieve.

Although useful in some regards, the notion of an ideal undistorted market with which imperfect reality can usefully be compared is ambiguous not only as a practical guide but also in principle.

Recall the above discussion of public goods. Determining what is a public good that should be supplied by the state is not a matter of consulting a textbook or pondering advanced economic theory. The reason is that what is and is not a public good in a particular country is largely a matter of that country's particular array of institutions – institutions such as levels of trust; the contours and development of the law of property, contract and nuisance; available techniques for monitoring usage of non-rivalrous goods – this list is long. And importantly it includes also the prevalent *beliefs* in that society about the nature of public goods and the role of government, as well as of the public's preference for state action as opposed to market activity. If citizens of a country believe that, say, a large agricultural sector is a desirable public good, then government subsidies to agriculture are, in principle, no different than are government expenditures to build city streets or to dredge harbours.

More generally, the role that a government plays in an economy is very much endogenous to that economy and to that society. Therefore, identifying – especially from outside that society – which government regulations, expenditures and taxes are 'distortions' and which are 'natural' parts of that society and economy verges on the impossible.

Consider the following example. Suppose that Bill Gates and Warren Buffett, out of a genuine spirit of philanthropy, combine their immense fortunes to subsidise the export of US pharmaceutical products. As a consequence of Messrs Gates's and Buffett's expenditures on this project, the export prices of US pharmaceuticals fall by half.

Should non-Americans complain? These tens of billions of dollars of expenditures by the USA's two richest men cause job losses outside the USA. These expenditures also cause the patterns of prices and production in the global market to be different from that which would have existed had Messrs Gates and Buffett spent their fortunes differently. From the perspective of non-Americans, the consequences of these 'subsidies' for US pharmaceutical exports are virtually identical to the consequences had these subsidies instead been provided by the government.[3] Yet in this hypothetical example these consequences were caused exclusively by private choices made by individuals who (wisely or not) sought to affect the pattern of economic activity.

In this hypothetical example are the resulting patterns of prices and production 'distorted'? In what is surely an appropriately inclusive view of the range of economic decision-making, Messrs Gates's and Buffett's decision to 'subsidise' American pharmaceutical exports is just as natural as would be their decisions to spend their billions of dollars in any of countless other ways. So there would be no reason to accuse these expenditures on pharmaceutical exports of distorting the market.

The lesson of the Gates-Buffett example does not apply perfectly to decisions made by politicians and government administrators. Political decision-making *is* different from private decision-making. But, except for persons who insist that *all* government decision-making is illegitimate, we must recognise that no objective criteria exist for classifying the vast majority of democratic governments' taxes and expenditures as being either 'distorting' or 'non-distorting'. It is best for outsiders not even to attempt to make such classifications.

Conclusion

Sound practical reasons counsel in favour of a rule that each government pursues a policy of free trade regardless of whether or not foreign governments are subsidising their producers. This counsel to follow a policy of free trade without regard to the policies of foreign governments is strengthened by the realisation that the very concept of an undistorted market is itself more amorphous and far less objective than conventional economic theory makes it out to be.

1. Subsidies are not necessary to enable firms that have a comparative advantage in production over foreign rivals to thrive as exporters. Subsidies to such foreign firms only enable these firms to expand their export sales. Comparing the market distortions created by subsidies to producers that already enjoy a comparative advantage to the distortions created by subsidies to producers whose comparative advantage is the product of subsidies is beyond this paper's reach.
   Also note that subsidies, depending on how they are administered, might *weaken* firms' capacities to compete in the export markets. Insofar as subsidies dampen firms' need or desire to energetically compete for consumer patronage – insofar as subsidies ensure firms some minimum level of profit regardless of their success at attracting consumers – the threat to domestic firms posed by subsidised foreign firms is *weakened* by subsidies (even though these subsidies distort markets no less than do subsidies that make their recipients more vigorously competitive exporters).
2. Note that allowing such tax breaks to count as subsidies makes religion in the USA a subsidised industry. The attempt, powered by the First Amendment to the US Constitution, by government to distance itself as far as possible from religion – to grant churches maximum possible freedom from any dealings with the state – ironically results in religion arguably being subsidised in America. Already we encounter the briar patch of difficulties involved in identifying subsidies.
3. The consequences are different for Americans because, unlike the subsidies supplied by Messrs Gates and Buffett, subsidies supplied by the government are funded by higher taxes.

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