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PROTECTION AND TRADE PREFERENCES

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At conferences of this sort there is usually shared a presumption in favor of regional cooperation and within that broad concept a presumption also in favor of some form of preferential trading arrangements. I find myself also generally sharing this presumption, but in this paper I want to raise some critical questions about it, particularly in relation to the various kinds of industrialization and trade policies that the countries of the region have adopted. The focus will be on protection and its relation to trade preference.

The case for trade preference among less developed countries rests ultimately on the case for protection. Traditional customs union theory has assessed the advantages and disadvantages of preferential trading systems on criteria that if applied unqualifiedly would lead to free trade with the world as the best of all customs unions. [Cooper and Massell re-established the case for a more limited customs union by assuming that there is initially a reason for a country to

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adopt a protectionist policy -- a reason, however, that comes from outside of the economic calculus. They then demonstrated that industries might be more efficiently protected in a customs union.¹

It is not necessary, however, to reach outside of economic considerations for a rationale for protection. In addition to the terms of trade argument, infant industry and factor price disequilibrium² can serve as grounds for protection of industry. Of course, tariffs or similar instruments of protection are considered to be second-best to subsidies as remedies; but it is sometimes forgotten that subsidies have to be financed and there is no assurance that the tax or other means of financing employed will have less of a distorting effect than customs duties or quotas. In any case, whether justified or not by economic considerations, most less developed countries have adopted protection as a means to industrialization; and there is a growing consensus that the "inward looking industrialization" that is thereby fostered is less effi-

¹C.A. Cooper and B.F. Massell, "Toward a General Theory of Customs Unions for Developing Countries," Journal of Political Economy, October 1965.

²Factor prices disequilibrium means a wide gap between the wage rate modern industry must pay and the marginal social opportunity cost of labor, the latter depending essentially on labor's marginal product in agriculture and other traditional sectors.

cient than one in which trade could occur in a wider market³. It seems then, that if there is a rationale for protection there is a rationale for trade preferences among the protecting countries.]

Applying this principle to a region like Southeast Asia involves, first of all, identifying the element of protection in each country's policies and attempting to measure it. This is an extremely difficult task, though we are beginning to find more sophisticated ways of doing this.⁴ I will bypass this problem, however, and for the sake of simplifying the theoretical argument will instead identify three ideal types with respect to degrees of protection. I will, moreover, identify particular Southeast Asian countries as examples of each type. This means only that I think the particular countries identified with one type come closer to that type than do the countries identified with another type. My lack of familiarity with most of these countries means that the identification are merely impressionistic and I will not try very hard to defend them.

³Raul Prebisch has put this argument very forcefully in a dramatic reversal of his earlier views in Towards a New Trade Policy for Development: Report by the Secretary-General of the United Nations Conference on Trade and Development (New York, United Nations, 1964).

⁴See, for example, The Structure of Protection in Developing Countries by Bela Balassa and Associates, a forthcoming publication of the World Bank.

✓ The first type is the country with zero or minimal protection. Hongkong and Singapore come to mind. They are what might be called "monistic industrial" countries rather than dualistic like most of the countries of the region. Factor price disequilibrium may therefore be less evident. Infant industries must be to a large extent export industries. Finally, the countries are far too small to affect their terms of trade significantly. There is, then, no apparent rationale for protection and it is not surprising that, comparatively speaking, they have had freer trade policies than other countries in the region. Malaysia is another with relatively free trade, but here the reason has been successful primary exports that led the growth of income in the economy, bringing a natural import-substituting industrialization in its wake.⁵

✓ The second type is the country with relatively high protection, exemplified by the Philippines and, more recently, Thailand. Because of a large primary producing sector there is less of an urgency to export manufactures than in Hongkong or Singapore. Hence infant industries tend^{to}/be thought of as substituting for imports. Moreover, factor price

⁵The trend in recent years in both Singapore and Malaysia seems to be in the direction of more protection, however.

disequilibrium is more evident, with the result that their primary exports can sell in world markets at an exchange rate that requires high protection for manufacturers and discourages their export.⁶

It is very important for what follows to be more precise at this point about the meaning of protection. *In particular I want to define "net protection" as the maximum proportion by which the domestic prices of importables could rise as a result of the combined effects of the protection and the undervaluation of foreign exchange that it defends. This easiest to see in the case of tariff protection,⁷ Suppose, for example, that a uniform ad valorem tariff rate of T prevails and that there is balance of payments equilibrium. If one has estimates of the various international trade elasticities he can estimate the proportional change in the exchange rate that would imply balance of payments equilibrium if free trade replaced the tariff. This is actually an esti-

⁶I don't want to be misunderstood as defending these protectionist policies. What I am saying is that conditions are such as to make it easy to adopt them, whereas Hongkong and Singapore must export manufacturers or die.

⁷I am assuming uniform tariff rates. This means abstracting from all of the interesting questions deriving from the structure of protection. For the essential purpose of this paper these can be ignored, however, and the analysis is greatly simplified thereby.

mate of overvaluation of the domestic currency. If this is symbolized by K and the corresponding undervaluation of foreign exchange by U , then $U = \frac{K^P}{1 + K}$. With T as the ad valorem tariff rate, the rate of net protection, N , is equal to $(1 + T)(1 - u) - 1$, or $\frac{1 + T}{1 + K} - 1$.

The extent to which overvaluation of a currency reduces net protection below the tariff depends on the extent to which the adjustment of the trade balance depends on the import change rather than the export change. With low elasticities of supply and demand for export, net protection can be very much below the apparent protection offered by the tariff.⁸ It is therefore ironic that policy-makers often use an alleged low elasticity of demand for their exports as an excuse for a protectionist policy. The above analysis assumes an equilibrium exchange rate, however, with tariffs as the protective instrument. If import or exchange controls are employed, the exchange rate can be maintained at a disequilibrium level. Then protection would be eroded only to the extent that controls are not pervasive or are circumvented.

✓ The third type is the country that has matched its protection of industries in the home market with subsidies for export. If this were done uniformly for all tradeable goods the

⁸If the world demand elasticity is less than unity, net protection is negative for any tariff level.

system would be defending an overvaluation of currency exactly equal to the common tariff and subsidy rates.⁷ Suppose, for example, that tariff rates are uniformly 50 per cent and 50 per cent subsidies are given to all exports. Then, with the elimination of the tariffs and subsidies, a 50 per cent rise in the price of foreign exchange would precisely offset these changes to maintain balance of payments equilibrium. Or to put it another way, in the original situation the undervaluation of foreign exchange was exactly offset for import substitutes by the tariff and for exports by the subsidy.

So net protection is zero for type three countries; and this is true no matter how high tariffs are set, provided that matching subsidies are given to exports.. We can say that "effective overvaluation" is also zero in this case, since the situation corresponds to one of free trade.⁹

It is more difficult to identify countries of this type. Here is where we would really need a careful and thorough evaluation of the protection system. But my impression is that Japan comes nearer to this ideal than most countries in Asia, and that Taiwan and South Korea may be following Japan's example. Japan, with its dual system of tariff protection to import substitutes and subsidies to exports may in fact have effectively undervalued its currency, as is suggested by its chronic tendency toward a

⁹This is true only for commodities, however, if there are no duties or subsidies for services. I am abstracting from this complication.

balance of payments surplus.

It can be noted here, as an aside, that this equivalence of a system of tariff and matching subsidy with a regime of free trade renders very ambiguous the concept of dumping. Suppose, for example, that the system which appears to incorporate dumping is replaced by free trade. The required devaluation to restore balance of payments equilibrium would provide exactly the same incentive to exports as did the subsidy. The point is important because the subsidy of exports might be one of the most practical means by which a country of type two could hope to rationalize its trade policies and thereby reduce its effective overvaluation

So long as the subsidy to exports does not exceed the nominal protection accorded import substitutes we cannot say that the country is "effectively" dumping.

Countries of types one and three are successfully competing with imported products in domestic markets and successfully exporting to the world at or near zero net protection -- that is at or near a free trade situation or its equivalent -- this, in the case of type three countries, despite appearances of protection in the form of tariffs and subsidies. These countries, then have apparently not felt that net protection was necessary or good for their economies. Therefore, they do not fit the Cooper-Massell case -- i.e., they do not need to find a more efficient

means of protecting their industries. They might, then, think twice before joining a system in which their trade would be diverted away from the world toward a small group of countries.¹⁰

It is rather those with substantial protection -- type two countries for whom the case for mutual trade preferences is strongest. And this is true not only because of the inefficiencies of isolated protection, but also because there is a need to correct an existing bias against trade with each other, a bias that arises from their mutual protection systems. Put most simply the bias results from the fact that when two countries have similar rates of tariff protection, they are defending similar rates of overvaluation of their currencies.¹¹ Thus they have overvalued currencies in relation to the world, but not in relation to each other. There is therefore, no offset to the tariff in trade with each other while the effect of the tariff is reduced by the undervaluation of foreign exchange in the case of imports from the world. This means that the world is given a competitive advantage vis-a-vis each in sales in the other's market.

¹⁰An alternative possible interpretation is that they have opted for free trade or its equivalent only because of the inefficiencies of isolated protection. It is possible that, given the alternative of protection within a free-trade bloc, they would choose that. My impression is, however, that countries with type three policies have been very successful in promoting exports, industrialization and growth.

¹¹This assumes that the international trade elasticities are similar for the two countries.

Let me put this more precisely in a simplified example. Let B represent the bloc of countries with identical uniform tariffs and rates of overvaluation; and let A represent any number of the bloc. Assume that with this protection there are still imports from the world, though less than with free trade. Prices of imports in A will be equal to the world price raised by the tariff and converted by the exchange rate. Compared to prices under free trade, import prices will be higher by net protection, the combined effect of the tariff and the undervaluation of foreign exchange. Thus if free trade prices are F , prices under protection will be $F(1+T)(1-U)$. Of course the protection will mean that domestic production in A will partially displace imports, but at the new equilibrium exporters from B to A will receive the price discounted by the tariff, or

$$F(1+T)(1-U)\left(\frac{1}{1+T}\right) = F(1-U),$$

While exporters from the world to A will receive the same raised by the overvaluation of A's currency, or $F(1-U)\left(\frac{1}{1-U}\right) = F$. Imports into A from the world will, therefore, tend to displace those from B. Exporters in A, on the other hand, will find their proceeds lower than under free trade by the extent of undervaluation of foreign exchange both for sales to the world and to bloc members. The net result for each member of adopting these

common protectionist policies is, then, to reduce imports and exports generally and to bias the source of imports toward the world, away from the bloc members.

These various results are shown in line 2 of the accompanying table. Also given in the table are the results under various modifications of the protection system, including export subsidies and trade preferences. It can be seen from line 3 that a general export subsidy (equal to the tariff) restores the free trade situation. If the tariff is removed for trade among bloc members but retained for the world (the customs union case), we have the results shown in line 4. The bias against trade within the bloc is more than removed, since there is now a net advantage for intra-bloc exports over world exports to the bloc. The advantage is only net protection, not the tariff, however, because of the undervaluation of foreign exchange. The advantage reaches the level of the tariff forgiven only if a matching export subsidy is added to the tariff discrimination, as is shown in line 5. (Lines 3b and 5b simply show the penalty on exports to the world when the subsidy applies only to intra-bloc exports.)

My conclusion from this analysis of trade bias under protection with various modifications is that strengthens the

EXPORT PROCEEDS UNDER ALTERNATIVE POLICIES

	Within Bloc	Bloc to World	World to Bloc
1. Free Trade	F	F	F
2. Non-Discriminatory Tariff	$F(1-U)$	$F(1-U)$	F
3. Non-Discriminatory Tariff plus			
a) General Export Subsidy	F	F	F
b) Discriminatory Export Subsidy	F	$F(1-U)$	F
4. Discriminatory Tariff	$F(1+T)(1-U)$ = $F(1+N)$	$F(1-U)$	F
5. Discriminatory Tariff plus			
a) General Export Subsidy	$F(1+T)$	F	F
b) Discriminatory Export Subsidy	$F(1+T)$	$F(1-U)$	F

Notation Guide: F is free trade proceeds.
 U is undervaluation of foreign exchange.
 T is ad valorem tariff rate.
 N is net protection.

case for preferential trade among countries of type two, since it removes an unwarranted bias against their trade with each other. This could be done, however, by having each country individually rationalize its trade policies by adding a matching export subsidy, as type three countries have done. The difference between the two situations is, however, that the former goes beyond removing the bias to create a positive preference for intra-bloc exports. This must be justified by the finding that bloc protection is more efficient than isolated protection.

In contrast, the preceding discussion of type three countries suggests that it might not be advantageous to them to divert their trade toward the bloc, away from the world. Moreover, there is an additional complication involved in joining type two and type three countries in a preferential trading arrangement. Type two countries would surely claim that type three countries are dumping, despite the demonstration above that they are no more doing so than are type one countries. If type three countries would respond to this by agreeing to suspend export subsidies for intra-bloc exports the result would be to reduce the effect of the tariff preference on their exports to the level of net protection, the same as for the exports of type two countries.

Finally, it must be admitted that this just scratches the surface of the interrelation between protection and trade preference. In particular, the complexities that arise from non-uniformity of tariff rates, as well as from the employment of protective instruments other than tariffs, have been ignored. Hence any conclusions must be only tentative.

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