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Paper- 1 (Macroeconomics)
Topic : Protectionism

Protectionism

Meaning :

Protectionism is the economic policy of restraining trade between states through methods such as tariffs on imported goods, restrictive quotas and a variety of other government regulations designed to allow (according to proponents) “fair competition” between imports and goods and services produced domestically. Sometimes, the prevailing market conditions may be viewed as unfavourable by a country. It may therefore seek to put barriers in the way of foreign trade, i.e. it may put restrictions on trade. This type of policy is known as ‘protection’.

Arguments in favour of protectionism :

So, why do some governments still protect trade? The main reasons include:

- To safeguard domestic employment - as protectionist policies reduce import penetration. In terms of the identity $AD = C + I + G + (X-M)$, the lower is M, the greater will be aggregate demand and thus the higher the level of domestic output and employment.
- To correct balance of payments disequilibrium - as demand for imports is dampened and exports promoted. This makes the domestic output appear to be more competitive.
- To prevent labour exploitation in developing economies - this is really a moral argument as it rests on making imports more accurately reflect their true cost of production. However, it might also reduce imports from some of the poorest economies in the world.
- To prevent dumping - which is where economies sell goods in overseas markets at a price below the cost of production. Domestic consumers pay more than those buying overseas. Such low prices are part of a policy to destroy rivals in export markets.
- To safeguard infant industries - as shifts in comparative advantages arise, so some countries become able to enter new markets. Their fledgling industry needs some protection from the power of already established competitors.
- To enable a developing country to diversify - this is similar to the infant industries argument. Many developing countries are heavily dependent on

exports of primary commodities. This can leave them very exposed to changes in international commodity prices. If they want to diversify and develop new export revenue streams, they may need to protect these new industries from full exposure to international competition for a while.

- Source of government revenue - where protectionism takes the form of a tariff, apart from reducing demand for imports via the impact of a higher price, this will also raise revenue for the government, like any other tax. The revenue raising function will be most successful where the demand for imports is price inelastic.
- Strategic arguments - a particular product or industry might be of strategic importance to a country, e.g. agriculture or coal, and protectionism may be justified on the grounds that it is keeping alive an industry which plays a vital part in the economy, perhaps because of social, political or military reasons.

Arguments against Protectionism :

Protection, however, imposes cost on a nation also. This can be summarised as follows:

- *Protection to achieve some objective may be at a very high opportunity cost. Other things being equal, there will be a net loss in welfare from restricting trade. Due to this reason, any gain in government revenue or profits to firms would be outweighed by a loss in consumers surplus.*
- Restricting trade is unlikely to be a first-best solution to the problem, since it involves costs of side-effect.
- Restricting trade may have adverse world multiplier effects.
- Protection may encourage retaliation.
- Protection may allow inefficient firms to remain inefficient.
- Restrictions may involve considerable bureaucracy and possibly even corruption.