The Underestimated Costs of Protectionism

Protecting markets can create unintended, yet harmful and lasting costs for firms, consumers and society at large. Protectionist measures can bring benefits for some. But the collective costs far outweigh the selective gains. Protectionism can also lead to frictions among trading partners. When these frictions escalate they have the potential to trigger retaliation, resulting in increasingly more difficult and costly access to global markets.

Though governments are meant to serve all citizens, protectionist policies tend to favour a narrow set of domestic producers over consumers or firms that need to import goods or services from abroad. Common protectionist tools such as import tariffs and quotas primarily support domestic production aimed at reducing reliance on imports. Efforts to support local markets might offer short-term benefits to select industries or occasionally consumers, but they often have long-term repercussions as described below.

This note presents five points that canvas some of the most important ways in which government intervention can negatively alter the ways in which multilateral rules-based, non-discriminatory trade can provide gains that underpin growth and economic development. These include but are not limited to:

1. Increased costs for small and large producers, weakening their competitiveness and ability to participate in regional and global value chains. Protectionism, through measures like tariffs and quotas, can increase costs for domestic producers by raising the price of imported raw materials and intermediate goods (that is, an import tariff should be seen as having an effect similar to an export tax). These measures can inflate production costs, making it harder for domestic producers to compete both locally and globally which reduces their ability to enter value chains. Moreover, protectionism can breed complacency, as domestic firms may face less pressure to innovate or increase efficiency in the absence of foreign competition. Over time, this can result in domestic industries becoming less competitive on the global stage, as they lag in innovation and cost-efficiency.

2. Reduced choice for consumers and likely higher prices paid for both domestically produced and imported products and services. Even very small firms rely on imported goods or services to develop, produce, market and sell their products or to improve their services offerings. For example, companies may import raw materials or parts or may use a variety of services platforms sourced from abroad to run their businesses. Protectionism can drive up the costs of obtaining these imports or make it impossible to use foreign goods or services at all. This leaves companies with only domestically-produced alternatives, usually at higher cost. Faced with more limited options, firms are likely to increase their own prices that are then usually passed along to consumers.

3. Attraction of the wrong kind of foreign investment which can reduce incentives to domestic producers to invest into areas of increased productivity: High barriers to imports created by tariffs or non-tariff measures can induce foreign investors to “jump over” these protective walls. However, this investment may not be as beneficial as hoped and may decrease competitiveness in various ways. Restrictive trade policies can suppress investment that would have been based on the competitive strengths of firms and direct it into other areas, slowing down efficiency gains and reducing the positive spill-over effects of new technologies and linkages. This can lower incentives to domestic producers to invest into areas that would have resulted in greater productivity growth. Protecting markets can also stifle investment into intermediate products and in so doing reduce opportunities for local firms to join global value chains and integrate into world markets.

4. More concentrated markets with less competition and greater possible abuse of market power by protected corporations: Barriers to trade usually afford more market control creation and often support firms that have monopoly power, and in turn , are able to influence public policy decision making. Protecting markets from foreign competition can enable a few firms to exert power to reduce supply and product diversity, increase prices and often lower quality. Consumers (intermediate and final) do not have an option other than to buy their goods or go without them. Experience has shown that it is not uncommon for monopolistic firms to display non-productive rent seeking behaviour to obtain import licenses or higher tariffs. In these situations, consumers end up paying higher prices, workers often receive lower compensation and corruption can more easily occur.

5. Loss of access to foreign markets: Producers from **c**ountries resorting to protectionist policies may lose access to foreign markets, either because of retaliatory measures on the part of their trading partners or because their producers become less integrated into the global economy as a result of higher costs. Both lead to a loss of export opportunities. When isolated from the global economy, a country is less exposed to external shocks. But paradoxically, it can find itself having difficulties to secure sufficient supply of essential products and services, as was recently observed during the Covid-19 pandemic. Critically, losing access to foreign markets deprives local firms of the opportunity to participate in regional and global value chains, thus stifling economic development.

See also:

The WTO can cut prices and raise living standards (2017)
Meltzer, J. and M. Solis, The High Costs of Protectionism, Brookings (2017)
Evenett, S. Protectionism, state discrimination, and international business since the onset of the Global Financial Crisis JIBP (2019)
The $10 Trillion Case for Open Trade, BCG (2020)

Notes:

1. This paper doesn’t necessarily represent the views of all FMG members.

2. An important policy trend affecting international trade not addressed in this note is the increasing use of industrial subsidies, especially in high-income countries. Though these behind-the-border subsidies don't fit the classic protectionist mould, they still influence trade competitiveness. Such subsidies both skew domestic allocation of resource and also adversely affect trading partners. The FMG will release a future note on this pressing issue.

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