

Infant Industries and the Dubious Benefits of Barriers

While I was teaching at the John Locke Institute, our Summer School sponsored a debate on free trade between Daniel Hannon and Terence Kealey. Kealey rested his case for protectionism squarely on the classic infant-industry argument. Kealey's version: While free trade does indeed improve efficiency at the moment, the long-run effect is to suppress economic growth in poorer countries. Why? Because you don't improve at doing things that you don't do.

Suppose a rich country can produce cell phones for \$200 each, while a poor country can only do the same for \$1000 each. Under free trade, Kealey's argument goes, the poor country will produce zero phones – and its cost of production will forever *remain* \$1000 a pop. If 400% tariffs raise the price of foreign phones to \$1000, however, domestic phone production will launch. And once it does, domestic phone factories' costs will start to fall.

If you replicate this policy across a vast range of industries, the low-productivity – hence poor – country transforms into a high-productivity – hence rich – country. Yes, tariffs temporarily made the poor country even poorer. In the long-run, however, the tariffs had the opposite effect.

Kealey also combined this argument with vague claims that every rich country got rich via protectionism, but the theoretical argument was clearly the heart of his argument. After all, it wasn't like he had a big multiple regression showing that all else equal, protectionism works wonders. Instead, he looked at history, saw tariffs, and attributed nations' success to these tariffs. Why did he credit tariffs, instead of the thousand other factors at play in economic development in the past quarter millennium? Because the theory made so much sense to him.

But does Kealey's theory really make sense? Not really. Yes, high-cost businesses *could* respond to tariffs by improving their efficiency. But they could just as easily respond in the opposite way.

Why? Ponder this analogy. You ban all players over 7 feet tall from the NBA. How will the remaining players react?

The optimistic scenario is that previously demoralized shorter players suddenly see a fantastic opportunity for stardom. They start practicing like crazy – and improvement naturally follows.

The pessimistic scenario, however, is that shorter players realize that they no longer *need* to practice like crazy to stay in the NBA. So instead of redoubling their efforts, they slack off. Their skills stagnate – or even get worse.

Notice: Even in the optimistic scenario, it is wishful thinking to assume that the shorter players will eventually improve so much that they actually become *better* players than the 7-foot-plus players who were summarily banned from the sport. If you're lucky, the shorter players will improve for a while, then hit a plateau well below the standards of the players they replaced. If you're unlucky, they'll see the weak competition, breathe a sigh of relief, and relax.

The same goes for protectionism. If you're lucky, protected industries will start improving, then hit a subpar plateau. And if you're unlucky, protected industries will rest on their laurels, secure in the knowledge that domestic consumers have no choice but to "buy local."

In wonkish terms, innovation is subject to both the substitution and income effects. Giving firms a protected market raises the incentive to improve (the substitution effect), but also gives firms the breathing room they need to take it easy (the income effect). Contra Kealey, the theoretical effect of protectionism on innovation is quite unclear.

Is there any way to gain greater clarity? You could try running bona fide experiments, but that's ultra-unlikely to happen. In the world of trade policy, "experimentation" is an fig leaf for more protectionism, not a sincere attempt to figure out if protectionism works.

The alternate path to clarity, however, is to remember that the large majority of trade is domestic, anyway. Why? Because of (a) physical transportation costs, and (b) poorly-connected social networks. The upshot is that every country has powerful *natural* trade barriers. If Kealey is right, these natural trade barriers should have exactly the same effects as man-made trade barriers. Yet so far, these natural trade barriers have plainly failed to make the vast majority of poor countries rich. Indeed, a standard result in development economics is that being landlocked is very bad for growth.

I wouldn't be shocked if a carefully-crafted experiment showed that under special circumstances, Kealey isn't entirely wrong. Once in a while, the substitution effect for innovation might overpower the income effect. But once you acknowledge the ubiquity of natural trade barriers, it's hard to believe that Kealey is right often enough to matter. And that's ignoring another substitution effect so prevalent in actually-existing protectionism: When your firm's fate rests on government favoritism, you have a strong incentive to focus on pleasing the government rather than your customers.

And yes, learning by doing works here, too. If the main thing you do is lobby the government, expect to become a master lobbyist.