

## Analyzing and Endogenizing Protectionism

### I. Introduction

“In a regime of Free Trade and free economic intercourse it would be of little consequence that iron lay on one side of a political frontier, and labor, coal, and blast furnaces on the other. But as it is, men have devised ways to impoverish themselves and one another; and prefer collective animosities to individual happiness” (Keynes 1920). Thus said John Maynard Keynes in the aftermath of the First World War, where impoverishment and collective animosities abounded. Ever since the Physiocrats, Adam Smith, and David Ricardo wrote on the subject, economists have widely recognized the benefits of free trade and the costliness of protectionist trade policy. The agreement of economists as diverse as John Maynard Keynes and Ludwig von Mises (2002, 130-135) on the issue of free trade indicates a broad consensus on the superiority of free trade over protectionism. Free trade facilitates peaceful and productive cooperation among nations while protectionism transforms voluntary exchange into destructive economic conflict across national borders.

While Keynes rightly recognizes the benefits of free trade relative to protectionism, is his whole statement quoted above correct? He is right to point out that national borders would not be an impediment to productive cooperation in the international market under a free trade regime; but is the existence of trade barriers explainable by a preference for “collective animosities” to “individual happiness” like he claims, or does protectionist trade policy persist for some other reason? In this essay, I argue that while Keynes is correct on the benefits of free trade relative to protectionism, he fails to identify the true cause of protectionism. The persistence of protectionist trade policy is caused not by a preference for animosity and poverty over individual happiness, but instead by individuals acting to achieve their ends under restrictive institutional constraints.

### II. The Benefits of Free Trade

Keynes rightly acknowledges that free trade is conducive to “individual happiness.” Unrestricted trade across national borders benefits individuals and nations on both sides of a border for a variety of reasons. Voluntary exchange is mutually beneficial *ex ante*, as neither side would agree to exchange if they expected not to benefit. International trade increases the number of potential exchange partners and thus the number of mutually beneficial exchanges which can take place in the international market.

By increasing the amount of exchange partners in markets, free trade expands the division of labor. As the number of market participants grows, the technical and economic potential for specialization in the division of labor increases. As more laborers are added to the production process, smaller parts of the production process can be handled by productive specialists. A wider division of labor and narrower specialization allows for a greater quantity, quality, and variety of goods to be produced. A small group of families in an isolated village, for example, must produce all of their own food, shelter, and clothing; they can exchange only with each other, and they lack the productive capacity to produce more than basic necessities. As the village establishes trading relationships with other villages, individuals within the villages can specialize in their most efficient lines of production and exchange with each other. The law of comparative advantage ensures that an increased volume of trade from an expanded division of labor is generally beneficial: even if some exchange partners are worse at producing every good compared to other producers, they can benefit by producing whatever good for them has the lowest opportunity cost

of production and exchanging the fruits of their labor with those for whom the opportunity cost of producing that particular good is higher.

Free trade also reduces production costs by increasing the supply of labor and capital. As the market expands to include more people and the capital goods they own and produce, the supplies of labor and capital increase and their relative prices fall. Lower input costs allow producers to make profitable investments in new lines of production, which increases the quantity and variety of consumer goods. Free trade allows producers to purchase inputs from locations where those inputs are cheapest, which lowers production costs and benefits domestic and international consumers by increasing the supply of consumer goods. Overall, free trade benefits producers by lowering their costs and expanding consumer markets, and it benefits consumers by increasing the quantity and variety of available consumer goods and by lowering their prices.

Free trade benefits not only individuals but also nations as a whole by encouraging peace. Nations with established trade relationships have much to lose by going to war with each other. Trade between nations is a substantial source of revenue for producers, goods for consumers, and tax revenue for governments. By interrupting trade, war cuts off these sources of income and prevents further gains from trade between two or more nations. Free trade encourages international peace by drastically raising the opportunity cost of war.

### **III. The Costs of Protectionism**

As Keynes identifies, protectionist trade policy impoverishes the majority of people relative to a regime of free trade, all else held equal. Protectionism prevents mutually beneficial exchanges and reverses the gains from an expanded market division of labor: it shrinks the market and forces producers to use costlier inputs and production arrangements. Protectionism insulates domestic firms from foreign competition, which reduces the supply of consumer goods and weakens competitive pressures to increase efficiency in production. By reducing the supply of factors of production bought from foreign countries, including capital and labor, protectionism raises input costs for domestic firms. Protection makes domestic firms less competitive in the international market and lowers standards of living by increasing consumer goods prices while reducing the available variety of consumer goods. While protection may benefit some domestic firms and industries in the short run, it harms both producers and consumers in the long run by encouraging less productive arrangements, reducing the supply of consumer goods, and lowering living standards.

In addition to reducing living standards, protectionism tends to fail to achieve its stated goals. If the goal of protecting domestic industries is to raise the wages of laborers and help families provide for themselves, protectionism fails on multiple fronts. While it may help workers and families in some industries, other industries downstream in the production process suffer rising input costs, while laborers and families in those downstream industries suffer as a result. For example, the tariffs on steel and aluminum under presidents Trump and Biden may have benefitted the domestic steel industry, but they hurt other manufacturing industries by raising their costs, which resulted in reduced employment in these industries (Durante 2024). If the goal is to protect a particular industry, then protectionism will fail by weakening the industry's productivity and competitiveness while simultaneously harming other domestic industries by increasing their input costs. If protection successfully preserves one local community reliant on a particular industry, other communities which suffer rising costs as a result may dissolve instead. Protectionism cannot insulate communities from change; it can only transfer the short-term burden from one community

to another. Protection can benefit concentrated special interests in the short-run, but it imposes short-run costs on most economic actors and long-run costs on everyone.

#### **IV. Endogenizing Protectionism**

If protectionism is so costly, then why does it persist? Keynes identifies a preference for “collective animosity” as the cause of widespread protectionist trade policy, but this explanation seems unsatisfactory. Why would policymakers and voters prefer for themselves and everyone else to be worse off rather than for individuals generally to be better off? Furthermore, explaining economic phenomena by appealing to preferences is unsatisfying; explanation of preferences is outside the scope of economics and appealing to preferences overlooks material and economic factors that might better explain the phenomenon (Stigler and Becker 1977). Explanation by appealing to preferences becomes less plausible as the preference becomes more costly. An individual’s choice to buy chocolate ice cream rather than vanilla is easily explainable by a preference for chocolate over vanilla; the only cost of this preference is foregoing consumption of vanilla ice cream. A preference for collective conflict, on the other hand, is much more costly; the cost of such a preference in international trade policy is widespread impoverishment. As the cost of a preference increases, a given individual is less likely to hold the preference. Instead of resorting to preference explanations, we should look for robust economic explanations of a phenomenon as costly as trade restriction.

The persistence of protectionism is more satisfactorily explained by appealing to the cost and benefit structures facing individuals involved in the policymaking process. Protectionist trade policies must be costly to repeal, as demonstrated by their continued existence. If the benefit to economic actors of repealing protectionist policy were higher than the cost of doing so, then the necessary costs to repeal them would have already been incurred and a regime of free trade would prevail. A regime of free trade does not prevail, however, so the persistence of protectionist policies must be explained by individuals’ optimization constrained by costs. The relevant question to explore is, what costs do voters, firms, and policymakers face? What makes the repeal of protectionism so costly for these actors that the great benefit of repealing protectionism is insufficient to take on the cost of repeal? In this section, I examine the costs and benefits faced by voters, firms, and legislators to explain why protectionism persists despite the benefit that free trade provides.

In a representative democracy such as the United States, voters exert some influence on policy by electing legislators. Protectionism persists, however, despite the costs imposed on the majority of voters. Why do a majority of voters fail to organize to vote against protectionist policies when these policies benefit only small, concentrated groups while harming everyone else? One reason, as Olson (1971) discusses, is the cost of organization among large groups. While smaller groups who stand to make large gains from protectionism will benefit from incurring the costs of organizing to lobby for protectionist policies, the mass of voters face a smaller benefit of organizing to oppose protectionism. The problem of free riding grows worse as the size of the group increases, as any one member can shirk without damaging the results of the group effort. The benefit for the majority of voters is also relatively small; the benefits of a tariff are concentrated on a firm or industry, while the costs are dispersed among everyone else and are relatively small per individual, so no one individual faces an incentive to expend large amounts of resources on overturning the tariff. Furthermore, because of both the low individual benefit of spending resources to oppose tariffs and the relative unimportance of a single vote, voters are

“rationally ignorant” about policies like tariffs and the costs they impose (Downs 1957). The benefit to be gained by most individual voters for expending time and resources to learn about trade policy and its harmful effects is quite low, as their one vote is unlikely to change the results of an election and the individual benefit they gain from the repeal of a tariff is low. As a result, the benefit to a voter of becoming informed about trade policy is often outweighed by the cost. As explained by rational ignorance and dispersion of costs, the cost to individual voters in general of organizing to oppose protectionism is higher than the benefit. Voters optimize given the costs they face and so fail to overturn protectionist policy.

What structure of costs and benefits do domestic firms face? Domestic firms and industries can exert influence on policymaking through lobbying and by voting according to group interests. Firms can donate to and otherwise support politicians’ election and reelection campaigns in addition to endorsing them and voting for them as a group of employees, managers, and owners with similar interests. As the logic of concentration of benefits and dispersion of costs implies, smaller groups with homogeneous interests find it less costly and more beneficial to organize to achieve political outcomes. To exert influence over policymaking, firms can engage in rent-seeking by incurring costs to transfer resources to themselves through the political process. Resources spent on rent-seeking can be considered as input costs for a firm. Firms then have two broad ways to make income: they can engage in entrepreneurship and invest in productivity and make income through the market process, or they can invest in rent-seeking and make income through the political process. They can choose to compete with other firms through markets or through politics. Firms will allocate their resources to each of these competition processes according to the marginal costs and benefits they face in the market and political processes. As competing in the market becomes more costly and as competing in politics becomes more beneficial, they will on the margin shift away from investing in market competition and toward investing in competition through politics. Various factors can affect the relative costs and benefits of competing through markets and through politics. Certain institutional constraints might increase the cost of market competition; for example, policies like antitrust law, corporate taxes, and various regulations might increase the cost of competing with other firms for more consumers and a larger market share. As these costs grow, firms will find a relatively greater return by investing in political competition to transfer resources to themselves, such as by lobbying for trade restrictions which benefit them. The benefit of competing through politics grows as foreign industries become more productive and competitive because domestic industries benefit from trade restrictions which insulate them from foreign competition. Additionally, domestic firms which face higher input costs because of policies which protect other industries can gain by lobbying for protection for their own industries.

To lobby for protectionism, domestic firms can cooperate with voters who do not have a direct interest in the success of the industry using propaganda and ideology. As Yandle (1983) explains in his parable of the Bootleggers and Baptists, two groups might succeed in lobbying for a policy by an implicit alliance even if they support the policy for different and apparently contradictory reasons. Baptists supported alcohol prohibition because they believed in temperance, while bootleggers supported prohibition because it would drive up their revenues by shifting demand from legal to illegal alcoholic beverages. A similar alliance can form to lobby for protectionist trade policy: domestic industries lobby for protection to insulate themselves from foreign competition, while popular support for protection comes from voters who falsely believe that tariffs will make themselves and their countrymen better off by raising domestic wages. In

cases like this, the incentive structures of voters and domestic firms can align to provide greater support for protectionist policy.

Finally, legislators are incentivized to preserve trade barriers. Domestic industries offer votes and campaign support to politicians who pass protectionist policies. Politicians who seek election and reelection benefit from transferring resources to these special interests through legislation. On the other hand, politicians who decide to support free trade forego votes and campaign support from these special interests who may support an opposing candidate instead. If popular support for trade barriers is driven by ideology and false beliefs that protection will bring a dispersed material or patriotic benefit, then politicians who support free trade risk losing support from a large group of voters. Politicians benefit by competing with other politicians for support from special interests, so they face a strong incentive to support protectionism if the cost of supporting protectionism does not exceed the benefit. Rational ignorance and dispersed costs reduce the cost of supporting protectionism relative to a world with an electorate composed of highly informed and motivated voters, so the marginal benefit to politicians of supporting protectionism is often higher than the cost.

Voters, domestic firms, and politicians in a representative democracy such as the United States face an incentive structure which generally leads them to support—or at least to not oppose—some amount of protectionism in trade policy. For the relevant decision makers, the costs of eliminating all trade barriers exceed the benefits, so protectionism persists despite the potential gains from free trade. Overturning the protectionist regime to maximize gains from trade, as Keynes seems to desire, requires more than a change in people's preferences; it would instead require a change in the cost and benefit structures of political decision makers, which realistically necessitates a change in the institutional structures that shape costs and benefits.

## **V. Conclusion**

While Keynes is correct about the beneficial nature of free trade, he fails to identify the true causes of the protectionist regime's persistence. Protectionism does not persist because of preferences for "collective animosity." Rather, protectionism persists because the costs to decision makers of overturning it exceed the benefits; in other words, the incentives necessary for individuals to abolish protectionism are not aligned. The abolition of the protectionist regime and its replacement by a regime of free trade require a reshaping of the cost and benefits of individual decision makers, which requires a change in the institutions that shape incentives and under which individuals act to achieve their ends.

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