

# PROTECTIONISM, THE WELFARE STATE AND THE THIRD WORLD

*Melvyn Krauss*

## Introduction

American liberals and European social democrats appear to suffer from split personalities. With one exception, they believe government should intervene anywhere and everywhere in the economy. That exception is foreign trade. It is hard to meet a liberal-left economist these days who does not believe simultaneously in the welfare state and free trade.

How can the leftist support for free trade be explained? Are they "closet Ricardians" in left-wing drag? On the contrary, adherence to free trade for leftists has little to do with their belief in David Ricardo's theory of comparative advantage. If it did, they would not be interventionists in the first place. Comparative cost theory applies as much to internal as international economic exchange.

"Internationalism" better explains the free trade sentiments of the left-leaning economists. Like anti-Semitism, protectionism no longer is quite respectable in intellectual circles. International cooperation has become the social democrats' *sine qua non*, while protectionism and the beggar-my-neighbor policies of the 1930s are viewed as the nadir of what respectable foreign economic policy should be. So long as internationalism remains fashionable, the social democrats and their fellow travelers can be expected to suppress their interventionist instincts as far as foreign trade is concerned.

The intellectual inconsistency of free trade on the one hand and the welfare state on the other is obvious once one realizes that the welfare state is itself the major motivation for protectionism presently

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The author is Professor of Economics at New York University and a Senior Fellow at the Hoover Institution, Stanford, Calif. 94305.

existing in the global economy. To be in favor of the welfare state *ipso facto* is to be in favor of protectionism. Left-leaning economists want to have it both ways. But in serious intellectual life that simply is not possible.

## The New Protectionism

Mercantilism, at least in the Baron Von Hornick sense of the term, no longer is the force it once was in international commercial policy. Nor is the character of protectionism today neo-Marxist. Labor versus capital sounds as outdated as *Louis vs. Schmeling*, *Mays vs. Mantle*, and *Truman vs. Dewey*. In today's world, and perhaps yesterday's as well, labor and capital in certain uses conspire together against labor and capital in other competing uses. Thus, in the United States, for example, labor and capital in the steel industry conspire against labor and capital in export industries. Protectionism, in other words, appears more an interindustry conflict than an interfactorial one. Most economists, however, cling to their Stolper-Samuelson, labor versus capital, conceptual apparatus for viewing this problem.

In my book *The New Protectionism*, I noted that the character of protectionism has changed to accommodate internationalist sensibilities.<sup>1</sup> Instead of tariffs and quotas, the subsidy has become the prime protectionist device in the industrial countries. Because they do not explicitly discriminate between the foreign and domestic sectors of the economy, subsidies do not appear as beggar-my-neighbor as do tariffs.

Appearances may accommodate the fashionable affectations of the internationalists. But the subsidy is just as deadly, even more so than conventional protective devices, for at least two reasons:

1. The protective effect of subsidies is not as obvious or subject to empirical verification as that of tariffs and quotas.
2. Governments consider subsidies as a purely domestic matter and thus are less willing to subject them to international negotiations.

Protectionism rendered by subsidies, in other words, is harder to combat than protectionism rendered in the conventional manner.

Subsidies serve a variety of purposes in the welfare state. One is to enforce welfare-state objectives of promoting labor immobility. In a competitive economy, of course, labor movement is essential to

<sup>1</sup>Melvyn B. Krauss, *The New Protectionism: The Welfare State and International Trade* (New York: New York University Press, 1978.)

promote efficiency in the allocation of resources. But today the welfare state frowns upon labor mobility, because of its alleged negative social impact. The present belief is that a proper function of government is to bring work to the workers—via subsidies—rather than workers going to work via the free market.

The result is not only a misallocation of resources in the domestic economy, but international protectionism since the subsidy either blocks the entry of competitive goods from abroad or encourages their export from the welfare state.

### The Pitfalls of Industrial Policy

Those who advocate a “new industrial policy” for the United States—namely, Robert Reich and Lester Thurow—are precisely the types I refer to as favoring free trade only in the sense of being against tariffs and quotas. Their championing of the subsidy makes it easy and profitable for protectionists to forego the tariff; the subsidy is all that they need to obtain their objectives. The subsidy, in other words, has become a wolf dressed in sheep’s clothes. And the neo-liberal version of free trade is free trade without a bite.

Moreover, Reich and Thurow’s “new industrial policy” simultaneously favors government subsidizing labor immobility for social reasons, and a reallocation of government subsidy efforts from supporting sunset to sunrise industries. If ever there was a cacophonic “fiddling on the roof,” the “new industrial policy” is it.

The very reason governments subsidize sunset industries in the welfare state is to prevent labor mobility. Strong industries do not need subsidization because their very strength protects them from international competition. The subsidized industries are the ones subject to shifting comparative advantages. Steel, for example, is an industry in which the focus of efficient production has shifted from Northern Europe and America to the Pacific rim area. Textiles and apparel are further examples.

It simply is not possible for governments to practice more efficient subsidization at home while, at the same time, defending workers from labor mobility. Robert Reich has an excuse at least—he was not trained as an economist. But Lester Thurow is a professor in one of the country’s most prestigious economics departments.

Subsidies to defend workers against labor mobility are part of the “workers’ rights” movement, particularly in the Northern European welfare states. Citizens of the welfare state believe they all have a right, not only to free speech, press, and assembly but to a job, in the industry of their choice, at the geographic location of their choice,

and at an income that permits politically determined minimum-consumption standards. Equal political and economic rights go hand in hand in the welfare state.<sup>2</sup>

To secure citizens their economic rights, government may subsidize labor and capital in low-productivity uses. Subsidies to inefficient private firms constituted a high-growth factor in the public budgets of the welfare states during the 1970s. Nationalization of private firms is on the increase in the welfare state for the same reason. While it is generally recognized that "workers' rights" programs damage the overall economy of the subsidizing country, it has not been recognized that they strongly disadvantage the economies of the poorer nations as well.

Consider, for example, a less developed country (LDC) that becomes an international competitor in the production of standardized steel products. If the world economy operated on a free-market basis, the locus of production of standardized steel products would shift from the developed to the less-developed countries. For the LDC this would mean a reallocation of domestic resources from other industries to steel. The reverse would be true in the industrialized country. Both would be made better off by these reallocations because they imply in each country a shift of factor resources from low-productivity to high-productivity uses.

But the relocation of factor resources is likely to be resisted in the developed country if it is a welfare state. Because of workers' rights programs, steelworkers can be expected to insist that the welfare-state government "protect their rights" by subsidizing the domestic steel industry, even though the workers could protect their rights by taking a necessary cut in pay to keep the firms they work for in business. The subsidy, by artificially lowering the costs of the domestic steel industry, prevents the industry's contraction and thus the need for steelworkers to find jobs in other locales. Unfortunately for the LDCs, the subsidy also prevents its steel products from entering the market of the welfare state. Had government allowed the steel industry in the social democracy to go out of business or shrink, steelworkers either would have had to accept a cut in wages or lose their jobs to their Third World counterparts.

This example makes it clear that at least part of the cost of subsidizing inefficient workers in sunset industries in the developing countries is borne by competitive industries in the Third World. Furthermore, workers in the LDCs are being hurt not because the

<sup>2</sup>See Melvyn B. Krauss, "Ill Fares the Welfare State," *Policy Review* 18 (Fall 1981): 133-38.

steelworkers in the welfare state face certain unemployment, but because the steelworkers refuse either to accept pay cuts in their present jobs or to accept jobs in other industries or locales. The welfare-state worker makes exacting demands on the government. And it is the LDC worker who often must pay.

It is interesting, in this regard, to note that Northern European social democrats and American liberals see themselves as the champions of the Third World interests. But no amount of conscience money—that is, foreign aid—is going to change the fact that what the social democrats give in aid, they more than take away by restricting trade.<sup>3</sup>

Because the internationalism of the left is based on fashion rather than sound economic doctrine, its scope has been rather limited to explicit international trade-restricting devices. But international *trade* is only one facet of international economic *exchange*; there is also international capital and labor mobility to consider. In some ultimate sense, the three forms of international exchange can be substitutes for one another. Restrictions on international trade can provoke more capital and/or labor mobility between nations than otherwise would have occurred, and vice versa. International economic exchange would be truly cut off only if all three of its facets were closed down.

The internationalism of the left does not extend to international capital and labor flows. American liberals and European social democrats support both restrictions on capital outflow to protect against the alleged “export of jobs” to foreigners, and restrictions on labor inflow to protect the bloated real wages the welfare state has bestowed upon workers in the industrialized countries. This is but another way the welfare state damages Third World countries. Cheap wages in the South attract capital there, while dear wages in the North attract labor here. International labor and capital flows thus are two of the three ways prosperity gets transferred from North to South.

The international transfer of prosperity via international exchange is preferable to the international transfer of income favored by the left, at least if one is interested in raising the living standards in the less developed world. But the transfer of prosperity is blocked by the welfare-state programs that subsidize both labor and capital within their confines.

Labor subsidization in the welfare state is only part of the problem. Capital subsidization also offends since it artificially keeps capital from seeking higher productive returns elsewhere. In the welfare

<sup>3</sup>See Melvyn B. Krauss, *Development Without Aid* (New York: McGraw-Hill, 1983), especially chap. 7.

state, programs are evolving for “capital rights” as well as for “worker rights.” It must always be remembered that the welfare state is just a variant of Mussolini’s “corporate state,” whose claim to intellectual respectability and early source of appeal to such personages as Franklin Delano Roosevelt and Gunnar Myrdal was that it alleged to reconcile the Marxian conflict between labor and capital. The welfare state, I suggest, should be viewed more in “corporatist” terms than Marxian ones.<sup>4</sup>

### The Anti-Growth Bias

A further way the welfare state damages the Third World—in addition to promoting protectionism—is to downplay the importance of economic growth. Economic growth is said to ruin the environment. And in societies where leisure has become a way of life, the hard work that economic growth implies has become anathema. This is tragic for the poorer nations of the world economy whose very survival depends upon rapid growth in the industrialized countries.

Of course, fashionable Club of Rome biases against economic growth have something of the “let’s make a virtue out of a vice” about them. When the Northern European welfare states were growing well in the 1950s and 1960s, economic growth was not considered such a bad thing. But the “sick seventies” have demonstrated that economic growth is incompatible with both the high taxes and many of the social welfare programs that are endemic to the modern welfare state. Rather than face up to the long-run consequences of this incompatibility, it is much more comfortable for welfare-state advocates to put their heads in the sand and make believe growth no longer counts.

It only will be when the welfare state in the northern industrial powers is dismantled that protectionism there will cease to be a problem for the Third World.

<sup>4</sup>See Melvyn B. Krauss, “Reich’s Friendly Fascism,” *The American Spectator* (September 1983).