



Макроекономіка

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**APPLICATION
OF PROTECTIONIST POLICY
IN THE MODERN WORLD**

Abstract

The authors offer a theoretical substantiation of the hypothesis about the direct relationship between investment flows and import restrictions: after introduction of the quota, imposition or increase of the customs duty – the capital starts to inflow into the economy of this country. The major investors in this case are international companies, which view the country that applies protectionist policy instruments as a promising market which is worth of being fought for and participating in its redistribution.

The theoretical substantiation of the hypothesis is supported with propositions about optimization of government's activity in pursuing the protectionist policy, as well as with empirical findings from the history of international companies, including those on the territory of the Belarus Republic.

The authors formulate the theoretical basics of the preventive blow which precedes the imposition of import restrictions.

The sphere of hypothesis application is state management of economy.

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Key words:

Import restrictions, investments, protectionism, import quota, customs duty, decision-making process.

JEL: F13, E22.

Introduction

The problem of attracting direct investments has been subject to sharp discussion in our society. At that, the main tendency consists in developing the theory of free trade, which is partially opposed by the authors. There is still place in the modern economy for the instruments of protectionist policy, the major precondition for their use under globalization being the point-wise character and clear understanding of the aim.

Hypothesis

The authors bring forward the hypothesis that the investment flows, on the one hand, and the volume of import duties and quotas, on the other hand, are directly related.

$$DI = f (...; CT; IQ; ...),$$

where DI – direct investments into the economy of the country which imposes quotas and duties,

CT – level of customs tariff,

IQ – level of import quota.

We can also see that investment inflows are influenced by many factors other than shown in the formula. Today, a large toolkit aimed at intensification of investment activity of the business environment is available. At that, we can not say that three or four instruments will be able to revive the economy. Every situation needs to be thoroughly analyzed; and among numerous investment effects, it is necessary to single out typical cases according to the principle: Which incentive became a trigger? Which policy instruments could it be referred to?

Novelty of Received Results

The hypothesis has not been researched until now. The recommendations on the optimisation of government activity in the area of protectionist policy are also principally new. Also, the investment processes on the Belarusian tobacco market have not been earlier analysed from the protectionist policy perspective.

To substantiate the presented theory, we use the theories of surplus profit, protectionist policy, and managerial decision-making process.

Research Objectives

1. To formulate the hypothesis of investment flows dependence on the volume of customs duty and import quota, to demonstrate that the hypothesis is working (in the conditions of Belarus Republic as well).
2. To provide a theoretical substantiation for the hypothesis.
3. To formulate theoretical basis for the preventive blow preceding the imposition of import restrictions.
4. To present the obtained empirical results of the researched dependence.

Theoretical Research

A. What does surplus profit speak of?

When making the hypothesis, the authors based themselves on the postulate that **the main factor which preconditions investor activity is the amount of received profit** both in absolute, and in relative terms, which is reported in the missions of many international companies. For example, the mission of Japan Tobacco International (JTI) says: «To build a powerful global tobacco company, maximizing value for our key stakeholders while striving for industry leadership». The key requirement of the top managers is to ensure profitability of any market at the phase of its redistribution, and conquering new markets.

Let us consider three basic cases, which differ in the form of direct investing:

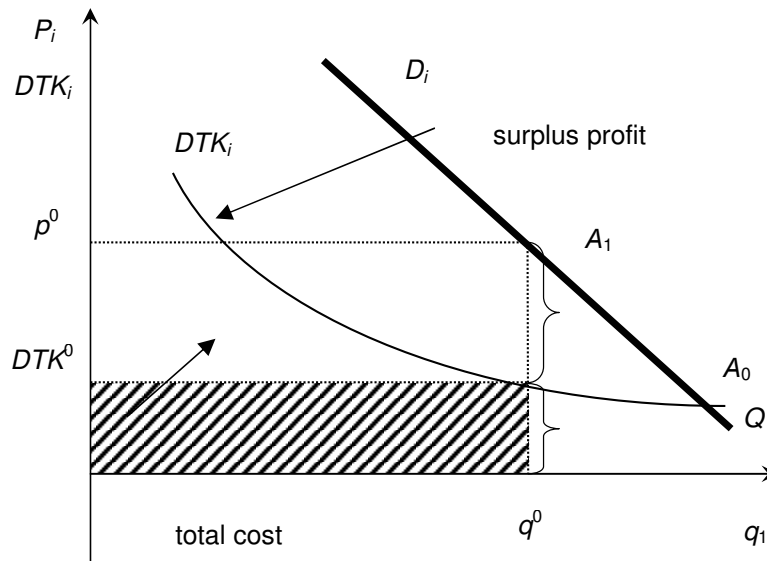
- 1) investing in a sales company;

- 2) investing in production facilities for sales reasons;
- 3) investing in affiliated production facilities for cost reasons.

The analysis is based on the theoretical model of surplus profit shown on Diagram 1, with $P(q)$ – price and Q – quantity of output as coordinating axes.

Diagram 1.

Surplus profit



On the diagram, $D(q)$ and $DTK(q)$ represent respectively the demand curve and the unit cost curve. The sum of unit costs related to production of q_i units of output gives total cost DTK_i .

At the intersection of the demand and total cost curves (point A_0), the company receives normal profit; whereas in the area between the DTK curve and the dash line to the left of A_0 – the company generates surplus profit.

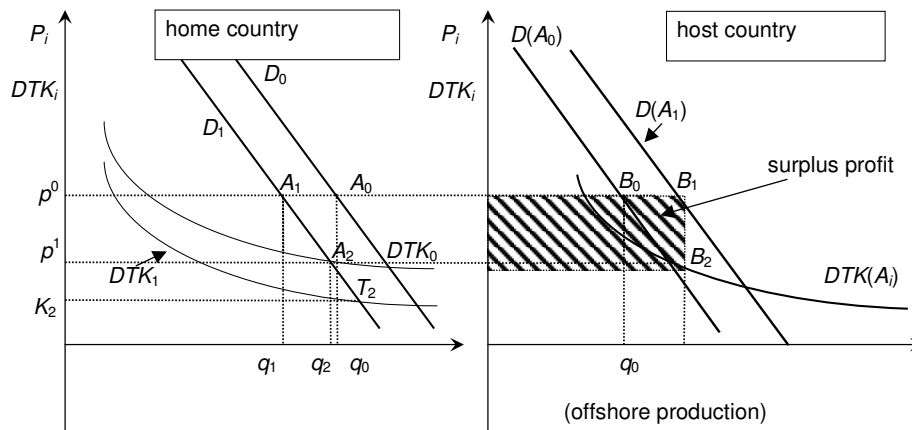
The volumes of total surplus profits generated by the company when it invests in sales companies or production facilities for sales or cost reasons differ, at least in the quality of their contents (the size of profit margin per unit).

When the company undertakes direct investing in the affiliated sales company, short-term exports increase. Finally, in result of establishing the sales company, surplus profits increase.

Surplus profits from investing in production facilities for sales reasons are plotted on Diagram 2.

Diagram 2.

Surplus profit from investing in production facilities for sales reasons



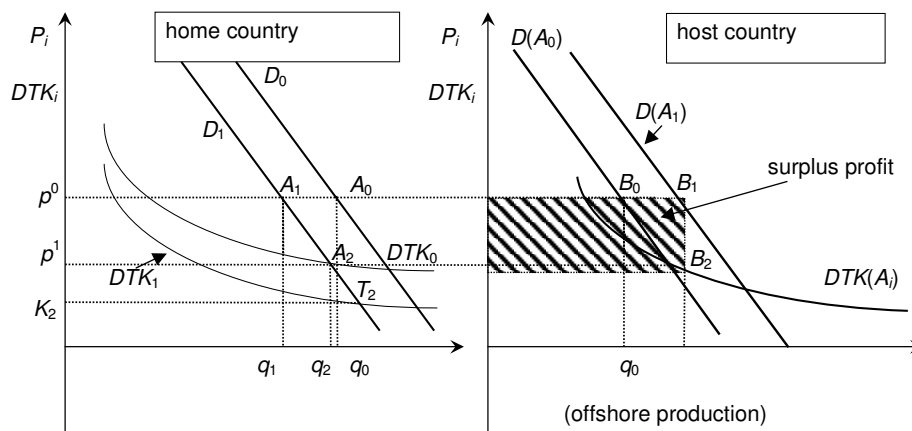
By setting an offshore production, the company *i* aims to gain surplus profit (shaded area) and transfer it into the home country. Given the possibility of mixed calculation (profit transfer), total cost curve shifts downward (DTK_1), which allows the investor to cut product price at the home market, say, from p_0 to p_1 . Meanwhile, the output increases in result of increased population's purchasing power from q_0 to q_1 . Total surplus profit consists of the sum of $P_0B_0MK_1$ and $P_1A_1T_1K_1$ areas.

The case of investing in production facilities for cost reasons is almost similar to the previous one (Diagram 3).

In result of transferred surplus profit from the affiliated company, the unit cost and product price of the parent company decrease. The difference between this case and the previous one consists in the ultimate reduction in the volumes of domestic production: in the case of investing for cost reasons, production is also partially transferred. Foreign investments replace domestic production.

Diagram 3.

Surplus profit from investing in production facilities for cost reasons



In the long-term period of production for cost reasons, the deliveries of intermediate products and spare parts increase. In addition, thanks to improved image and won recognition, the demand can grow, boosting exports to «third» countries (all countries, except for the recipient and home countries, where company i can sell its products). Thus appears a new $DTK(A_i)$ curve.

In the first and second cases of investing, one should take account of the multiplier effect: owing to production activity of company i , economic growth and personal income growth is (or rather should be) observed in the host country. This means that demand is growing not only for products manufactured by the production facilities in the host country, but also for the products produced by the parent company.

In the home country, the company cuts back its production from q_0 to q_1 ; later, due to decreasing unit costs, the company will be able to increase its output by reducing the price, but this output growth will be lower than its previous level, say q_2 .

Total profit in this case will be made of the profit of affiliated company plus the profit gained in the home country (area $P_1A_2T_2K_2$).

Consequently, in the above three cases we can observe that investing companies tend to use scale effects for maximizing the size of surplus profit. The company chooses the type of direct investment depending on the situation in the host country. If the host country imposes import restrictions on the investor's products, the latter considers other ways to use scale effects. For example, instead of establishing a sales company, the investor can set up production in the host coun-

try, thus making import restrictions and bans inapplicable and giving the host country a possibility of receiving additional effects from foreign investments.

B. Analysing the hypothesis from the inside

Different forms of investing need to be further analyzed from the perspective of managerial decision-making theory.

The corporate mission obliges managers to work at profit maximization, as requested by their shareholders. Proceeding from this task, they adjust the company's activity, ensuring its conformity with the plans, objectives and normative characteristics.

If the government decides to manipulate (the modern protectionist policy should be built exactly on manipulation) the behaviour of individuals taking investment decisions by means of customs duties and import quotas for example, it has to arouse «disturbance» about their activity. The major challenge for development of protectionist policy at this stage is that the decision-maker's psychological activity cannot be directly observed. The most widely-accepted research method in this area is the method of indirect observations, or the method of «a black box». According to this method, the researcher tries to heuristically describe the cause-effect relationships between the influences produced on the individual and his doings.

We will define the **decision-maker (DM)** (alias the «black box») as an individual, a group, a team or an organisation, which carries out the decision-making process.

When studying the activity of international companies, we can assume the decision-maker to be not an individual, but a group of top managers who represent the company at the market of the host country introducing import restrictions, as well as some managers from the headquarters in charge of host country's market development. This clarification is connected with the fact that international companies extensively use the "brain-storming" method of decision making, which is objectively preconditioned, since top-managers of representative offices are not authorized to make investment decisions. This function is the responsibility of managers of the regional office (say, office in Europe), who do not see all twists and turns of work in a certain country. The optimal solution in this situation is «brain storming».

On the input side of the «black box» is a large number of facts, factors, probable descriptions of physical (animate and inanimate), and ideal objects of the inner and outer life of the decision-maker. These descriptions are created by «the description generator» represented by either a human brain or a specific software environment (Khant, Marin, Stone, 1970).

The Role of Preventive Blow in Protectionist Policy

The main task of the government which adheres to protectionist policy to some extent is to ensure that the news about introduction of import restrictions get into the DM's knowledge system, containing a great many of factors and rules, before these restrictions are introduced. (The authors will theoretically develop the concept of preventive blow as a component of protectionist policy in more detail later.) One way to achieve this objective could be to put a separate point about probable imposition of customs duties or quotas on certain products into the speech of a government member. Another way could be a written release or publication in the press. It is also possible to pass the word about probable governmental actions to a company's top-management through informal channels (it is very convenient when there are many competitors for a limited number of investment objects).

A preventive blow, in the authors' opinion, is a necessary component of protectionist policy. It neither substitutes nor cancels the application of political instruments, but at the same time, it is an opportunity for the company to participate in market sharing or new market development granted by a positively-oriented protectionist government.

Consequently, the decision maker is consciously and purposefully sent two principal «disturbances»: a preventive blow and introduction (or increase) of a customs tariff or an import quota. Without second «disturbance», the governments' efforts in pursuing their policy in the future would come to nothing, since their words and decisions would not be taken seriously.

According to the theory of managerial decision-making, one should build a set of rules $R = \{R_j\}$, which can be described as a system of logical corollaries:

<IF < respond to preventive blow >

<THEN < advantages for the company at the market = surplus profit >

<THEN < managers are promoted >

<THEN < managers are rewarded >

<THEN < staff of the company on the market is increased >

<THEN <...>

<THEN <...>

<IF < do not respond to preventive blow >

<THEN < search for other options at the market >

<THEN <...>
<THEN < change of the portfolio of manufactured products>
<THEN <...>
<THEN <...>
<IF < respond to imposition of import quotas or customs tariffs >
<THEN < share in the profits received by all agents on the market >
<THEN < managers are promoted>
<THEN < managers are rewarded>
<THEN < staff of the company on the market is increased >
<THEN <...>
<THEN <...>
<IF < do not respond to imposition of import quotas or customs tariffs >
<THEN <the entire market or at least profit is lost >
<THEN < managers' salaries are cut>
<THEN < top-managers' needs in self-realization and communication are unmet>
<THEN <middle- and top-managers are fired>
<THEN <...>
<THEN <...>
<THEN <...>

In our case, four rules are present:

R_1 – respond to a preventive blow;

R_2 – do not respond to a preventive blow;

R_3 – respond to imposition of import quotas, introduction or increase of customs tariff;

R_4 – do not respond to imposition of import quotas, introduction or increase of customs tariff.

There is a set of rules $R = \{R_4\}$, which, from the standpoint of the government applying protectionist instruments, should be complemented and expanded.

Let us come back to the model of a «black box». The facts mentioned below are on the outputs side of the box. The government has to maximally ensure

that the protectionist policy it pursues contributes to achievement of the set objectives. At that, the government should not play its traditional role of a «policeman». Times change, and the government should act more liberally and elaborately when planning negotiations with the representatives of the international companies whose interests are affected by the applied measures: it should take account of their needs and show the benefits of a positive response to the preventive blow and subsequent actions of the government.

The authors suggest including the following components into the negotiations plan containing the stages of policy realization (Tables 1–4).

Table 1.

A part of negotiations plan: company's needs – pursued policy

Needs of the company	Correspondence of pursued policy with corporate needs
Market Leadership	Corresponds given timely positive response
...	...
...	...
...	...
Risk diversification	Quotas will be removed in the future, i. e. corresponds in the long run

Table 2.

A part of negotiations plan: government's needs – pursued policy

Needs of the government	Correspondence of the offered instruments with the needs of the company and/or the government
Organization of production of <i>N</i> -products within certain price range	the company has the needed technological and labour resources for organization of production
...	...
...	...
Additional tax earnings from organization of production	...
Organization of additional workplaces	...

Table3.

A part of negotiations plan: weaknesses of the policy (for the company)

Probable weaknesses of the policy (for the company)	Solution
Financial costs	...
...	...
...	...
...	...
Absence of highly-qualified personnel	...

Table 4.

A part of negotiations plan: weaknesses of the policy (for the government)

Probable weaknesses of the policy (for the government)	Solution
Budget losses	...
...	...
...	...
...	...
Negative influence of the shadow market	...

The data in the plan of protectionist policy negotiations could be altered. The principal advantage is that it gives a clear picture of the objectives set by the government and DMs of the companies affected by the pursued policy, and the ways to achieve these objectives.

The government should be supplement its offer with presentation of the advantages of different responses to introduced measures, depending on the form of investing (in existing sales companies, companies of the host country, production facilities for sales considerations, or production facilities for cost considerations). The government should sell its offer, not force companies to invest.

Governments can sell the international companies the benefits and opportunities realized within well-known strategies.

1. The strategy of using integration processes. Assume there is a small country X (Belarus), which is being transformed into a component of a large country Y (say, CIS-12), which in its turn was provided an opportunity to influence the world price. The countries are referred to either small or large in international economics depending on their ability to influence the formation of the world price. Thus, the country is considered to be small when the change in demand does not bring about the change in the world prices. On the contrary, if the country imposes an import tariff or quota, and this produces an effect on the world price of a certain product, the importing country is considered to be economically important, i. e. it is large. The application of import restrictions in this

case is connected with the fact that some agreements on regional integration turn into systems with a single centre and «rays» coming out of it. This happens, for example, when the members of a customs union conclude separate agreements on free trade with country *X* and country *Y*, but at the same time, there is no trade agreement which would directly bind country *X* and country *Y*. In this case, the customs union is the centre, while countries *X* and *Y* are the «rays» coming out of it. Such trade patterns pull down the FDI structure because there appears an extra stimulus to allocate the FDIs in the centre, from which one can get a duty-free access to all three markets. This cannot be realized in case of investing in separate «rays», since duty-free trade between them is not stipulated.

2. The strategy of risk diversification. Ideally, the organization of production should lead in the future to liquidation of quotas within the integration block, which would allow companies to diversify their risks. For example, in Russia the accounts of JTI's factory "Petro" are currently arrested. Had there been no quotas between Russia and Belarus, the company could have imported cigarettes from Belarus for some time, thus retaining its market share and customers in Russia.

While analyzing the probable response of the decision-maker, it is necessary to take into account all the possible «disturbances» affecting him, complemented with investment motives. These are the factors on the inputs side of the «black box».

A set of factors $K = \{K_i\}$ apparently could be represented as a system of information terms, «written» in the following format: $K_i = \langle f_i | KCn_i | KIm_i \rangle$, where KCn_i and KIm_i are arguments on validity (i.e. the fact does take place) and significance of statement f_i for the DM. These arguments in general could be expressed as values of weighting coefficients. A set of factors that belong to DM is an unstructured object with no relationships set among its elements (facts).

The weighting coefficients of validity and significance fully correspond to the Freudian factors of importance and confidence with regard to expectations, which in the modern cognitive psychology is called the expectations of «self-efficiency» and expectations of results (Bandler, 1982).

Input parameters can include investment stimuli, objective parameters of the company's activity, parameters describing competitors, position of the company at the market, and prospective government actions.

As for investment motives, the survey of German investing firms shows that the sales motive prevails, which means that the company is concerned with seizing new markets and redistribution them to their benefit. The Belarusian market is rather young, and this fact can be used to play with many producers, moreover, if to consider that Russia and Belarus, as well as the CIS as a whole, is slowly, but gradually integrating.

Thus, we can conclude that the protectionist policy should be realized under certain assumptions:

- 1) it should be specific and targeted;
- 2) it should be selective, i.e. oriented at specific commodity groups;
- 3) it should be well planned and worked-through at all stages of implementation.

As far as protectionist policy is concerned, it should be noted that customs tariffs in the CIS countries are badly differentiated. Thus, the commodity nomenclature of foreign economic activity in the CIS countries, for example, includes about 10.8thnds commodity items, while the customs tariff in Belarus – on the whole more than 1.4thnds. With such a small number of commodity items in the customs tariff, it can hardly have the point-wise character. Because of this reason, the average tariffs in Belarus are higher compared to those in the European Union or the USA. We must admit that we are no more ardent adherents of the protectionist policy than the Western countries are. We just use clumsy instruments, as those used by Neanderthals. Belarus and other CIS countries will not be able to speak about their presence and effective membership in the WTO until they give up their image of the Neanderthal.

Testing the Hypothesis

The first empirical evidence of the hypothesis we found in the history of western economy. «Because of the restrictions on car imports, the Volkswagen concern set its first assembly plant in Brazil in 1953 and later, especially in 1990s, markedly expanded its production in the country. The concern also pursues similar policy in China».

Even the Belarusian MAZ is a good example of organizing the production abroad because of trade protectionism: «the plant is actively organizing assembly facilities to the West of the Bug river because customs duties will increase after Poland's accession to the EU».

In 2005, in pursuing its protectionist policy the Belarusian government itself created an example, which proves that the hypothesis about the direct relationship between direct investment flows and customs duties and quotas should exist.

The quotas were introduced on the tobacco market.

In authors' opinion, the preventive blow at the informal level was realized. This statement is based on two facts. First, Chief Manager of JTI Belarus Representative Office Gennadiy Brusnikov was earlier First Assistant Head of the National Bank of BR. Second, JTI entered into negotiations about launching its cigarettes production in Belarus earlier than its competitors.

The data in Table 5 can give a general idea about the dynamics of cigarettes market in the Republic of Belarus.

Until 2005, the main players were such international companies, as Philip Morris International (PMI, brands: Parliament, Marlboro, L&M), British American Tobacco (BAT, brands: Vogue, Kent, Pall Mall), Japan Tobacco International (JTI, brands: Camel, Winston, Monte Carlo), Gallaher Group, Imperial Tobacco.

The policy of quoting the tobacco imports aims to optimize the work of tobacco companies on the domestic market and to organize the production of average-priced cigarettes (e.g. Winston, Pall Mall, L&M, etc.) in the country. By government's decision, the quota on imports of the cigarettes, cigars and cigarillos at the beginning of 2005 was set more than twice lower compared to 2004, i.e. reduced from 3.6bn to 1.5bn pieces. Initially, the Belarusian tobacco market had been estimated at 18.5bn pieces in 2005, which was 500thnd less than in 2004. The major segment of the market was handed over to Hrodnensk tobacco factory «Neman» – 12bn pieces, while the share of JV «Tabak-Invest» made 5bn pieces.

The policy of the Belarusian government has been helpful in achieving the set objective. The production of Winston cigarettes has been organized under the licensed agreement with JV «Tabak-Invest». Belarus becomes the fourth country in the CIS that produces this brand of cigarettes and the first country with organized licensed production. As for competitors, the PMI company is likely to set up its own factory in the country (its temporary inactivity in the BR can be explained by the fact that its main investments are directed to higher-priority Asian countries.) BAT cooperates with Hrodnensk tobacco factory in manufacturing the cigarettes of low-price category. In the future, the investment cooperation of Belarusian tobacco factories and international tobacco companies is planned to be expanded.

Naturally, the policy of quoting has its disadvantages.

First of all, smuggling hinders the collection of taxes and excises. According to Vasiliy Khrol, deputy to Belarusian Parliament, because of this reason the budget yearly receives \$30mn less. In 2005, more than 3bn cigarettes were smuggled into the country, which exceeded the official quota.

Olga Klimanovitch, corporate relations manager at BAT, says that the import structure of 2005 proved that cigarette imports are 2–3 times more beneficial for the country, since no HARMFUL production is organized.

The advantages of introducing quotas on tobacco imports are the following.

First, quotas mean inflows of investments.

Second, Belarusian excises yield large proceeds owing to the unprofitability of using «shadow» schemes in operations with Belarusian cigarettes and due to increased sales volumes. The portion of aggregate excises (including excises on tobacco produce) in the consolidated budget of Belarus equalled 11.1% in 1998, 8.0% in 2000, 6.9% in 2003, and 5.1% in 2004. The portion of excises in the Republican budget made 14.6% in 1998, 11.1% in 2000, 11.0% in 2003, and 6.5% in 2004.

Table 5.

Distribution of imported tobacco products by country

Product group/ country of origin	2002		2003		2004	
	Quantity	Value, \$US	Quantity	Value, \$US	Quantity	Value, \$US
Tobacco products, mn pieces	6025.7	86024	6699.5	107967	5308.7	94259
CIS countries	5189.1	71211	5722.7	90730	4401.1	76658
Russia	4953.9	68971	5637.5	89781	4125.9	72765
Ukraine	234.0	2187	74.1	636	275.2	3893
Non CIS countries	836.6	14813	976.8	17237	907.6	17601
Germany	239.9	3995	589.8	9700	672.4	11946
Korea	97.3	1051	82.5	867	20.0	210
Netherlands	28.7	1071	29.6	1306	25.1	1207
Poland	41.4	563	32.7	592	53.3	1388
Great Britain	48.9	1002	83.5	1751	19.4	495
United States of America	48.1	1071	57.8	1216	9.8	293
Czech Republic	255.9	4414	31.3	572	43.4	777
Switzerland	36.5	1001	16.2	420	13.6	411

Third, additional workplaces are created.

It should be noted that the companies that timely responded to «disturbance», i.e. preventive blow and introduction of the quota, in 2006 achieved great results since the market had been redistributed to their benefit. Here, the following algorithm did actually work:

<IF < respond to preventive blow >

<THEN < advantages for the company at the market = surplus profit >

<THEN <managers are promoted >

<THEN <managers are rewarded>

<THEN < staff of the company on the market is increased>

<THEN <...>

<THEN <...>

Ideally, the organization of tobacco production should lead to future liquidation of quotas on tobacco, at least within the CIS, which would allow tobacco companies to diversify risks. For example, in Russia the accounts of JTI's fac-

tory «Petro» are currently arrested. Had there been no quotas between Russia and Belarus, the company could have imported cigarettes from Belarus, thus retaining its market share and customers in Russia.

Conclusions and Prospects for Further Research of the Hypothesis

The authors' main conclusion is the following: the hypothesis about the dependence of direct investment inflows on customs duties and quotas is proven even under modern conditions, i.e. under globalization. To apply the aforementioned propositions, the commodity nomenclatures used in customs policy should be differentiated. This will allow making the policy instruments point-wise and effective.

The objective set by the authors for future research is to determine the coefficient f of the $DI = f(\dots; CT; IQ)$ dependence, which is different in various branches of production.

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