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Are Quotas Worse Than Tariffs?

Written by: Holly Smith

With all the focus on tariffs these days, it is easy to overlook the return of another protectionist tool: quotas.

Just over a year ago, the Trump Administration controversially used Section 232 of the Trade Expansion Act of 1962 to impose tariffs of 25% on specified steel imports, and 10% on specified aluminum imports. [1] U.S. steel and primary aluminum producers continue to face extreme competitive pressure as a result of sustained global excess capacity originating primarily from China. [2] The Trump Administration argues that U.S. production capacity has been eroded to the extent that it threatens U.S. national security, and that Section 232 tariffs applied globally are an appropriate response.

Three countries – South Korea, Brazil, and Argentina – made agreements with the United States to apply quotas to their steel exports in lieu of the Section 232 tariffs. Argentina also agreed to quotas on its aluminum exports.

According to numerous reports, U.S. negotiators were seeking similar agreements with Canada, Mexico, Japan, and the European Union (EU). [3] On May 17, 2019, though, the governments of the United States, Canada, and Mexico announced that they had reached a deal to lift steel and aluminum tariffs without imposing quotas, choosing instead to adopt a monitoring system with the right to re-impose tariffs only on these products if surges are detected in the future. [4] This deal could also serve as a template for agreements with Japan and the EU to address their steel and aluminum tariffs.

As a protectionist measure, however, quotas are still on the table in other sectors. This report explores the potential impacts of quotas versus tariffs.

On May 17, President Trump also announced that he would delay imposing Section 232 tariffs on imports of automobiles and automotive parts. In doing so, he directed the U.S. Trade Representative to negotiate agreements with the EU, Japan, and others to address the "threatened impairment of [U.S.] national security" caused by automotive trade with such countries. [5] If past is precedent, U.S. negotiators are likely to propose the adoption of quotas as part of any agreement. Canada and Mexico have already signed a side agreement to the U.S.-Canada-Mexico Agreement (USMCA) imposing a quota on their auto exports, meant to preempt any Section 232 tariffs on autos that the Trump Administration may adopt. And, going forward, the U.S. Department of Commerce may recommend imposition of quotas under the ongoing Section 232 investigations on imports of uranium ore, and titanium sponges.

What are Quotas?

Quotas and tariffs are both tools to protect domestic industries by artificially raising prices in the domestic market. Their administration and effects, however, differ in specific ways:

- Quotas, specifically, import quotas, are a restriction on the quantity of a good imported from a country. Tariffs are a charge levied on the value of goods imported from a country. [6]

Volume restrictions on imports.

- While tariffs generate revenue that is paid to the importing country's treasury, the value of a quota, or, a quota rent, generally goes to the foreign exporters who are able to sell goods subject to the quota at higher prices and collect higher per unit revenue. In both cases, domestic consumers in the importing country pay the costs of tariffs and quota rents. [7]

- While tariffs are simply collected by a customs authority as goods enter a country, quotas can be much more complicated to administer. Customs authorities can monitor imports directly to ensure that no goods above the quota amount are imported, or, can award licenses to specific companies, giving them the right to import the amount allowed under the quota. Quotas can also take the form of a voluntary export restraint (VER), where the exporting country administers the quota. [8]

More complicated, less transparent and predictable than tariffs.

- Costs and pricing under a tariff regime are more transparent and predictable compared to quotas. If a good is subject to 10% tariffs, then the good should cost about 10% more than it did before the tariff was imposed. With a quota the price of that good can increase as long as demand for the good continues and the supply remains constrained. This can mean that quota rents are ultimately more costly to domestic consumers than a tariff, and a larger welfare loss to the importing country, since the quota rent is transferred to foreign exporters. A good example of how costly the welfare loss can be comes from the Multifiber Arrangement (MFA) governing textiles trade. A 1992 study calculated that the total welfare loss in the United States in 1984 from the MFA amounted to $10.4 billion, of which $6 billion was paid to foreign exporters in the form of quota rents. [9]

Government of importing country receives no revenue.

- Quota regimes are more susceptible to rent seeking and corruption than tariffs. When governments administer quotas by selling or auctioning exclusive rights to importers or exporters to fill a quota, firms may pressure governments for those rights, through costly or even corrupt means. [10]

- Quota regimes may also lead to suboptimal outcomes with respect to product quality and consumer welfare in the importing country. On the one hand, quota regimes may incentivize foreign producers to upgrade the quality of their exports under a quota system, leading to more direct competition with domestic producers and a higher-quality, higher-price product mix for consumers. [11] On the other hand, if foreign producers export low quality goods under a quota regime, prices and profits for both foreign and domestic producers of low quality goods will rise because of quotas, while domestic consumers may be forced to pay more for lower quality goods. [12]

Quotas banned under WTO rules.

- General Agreement on Tariffs and Trade (GATT) Article XI prohibits quotas and other quantitative restrictions, with specific exceptions (including for "security reasons"). GATT parties agreed that quantitative restrictions were overly restrictive and distortive compared to duties or taxes, which are permitted.

Case Study: South Korea, Brazil, and Argentina

South Korea, Brazil, and Argentina likely perceived real advantages in agreeing to quotas rather than accepting tariffs. Yet, their example demonstrates just how complicated and restrictive quota regimes can be.

The Basics

South Korea, Brazil, and Argentina each agreed to product-specific absolute quotas on 54 separate steel articles based on each country's average annual import volumes of steel from 2015 through 2017.

- South Korea's quota equals 70% of its three-year average. [13]

- Brazil's quotas equal 70% of its three-year average for finished products, and 100% for semi-finished products. [14]

- Argentina's quota equals 135% of its three-year average. [15]

Argentina only country with both steel and aluminum quotas.

Argentina also accepted product specific absolute quotas on two aluminum product categories in lieu of tariffs, each equal to 100% of its 2015-2017 average. [16] The United States administers the South Korea, Brazil, and Argentina quotas with maximum possible bite, giving exporters the least possible flexibility, [17] including through:

South Korea, Brazil, and Argentina quotas highly restrictive and inflexible.

- *Absolute quotas:* once the quota limitation is reached, no additional amount can enter the United States for any price, unless an exclusion is granted.

- *Application to full calendar year:* although the quotas went into effect on May 1, 2018 (South Korea) and June 1, 2018 (Brazil and Argentina), each quota applies to imports for the full calendar year. In some cases this meant that the quota was nearly full the minute it took effect. [18]

Quotas filled on a quarterly basis.

- *Quarterly limitations:* in any given calendar quarter, no more than "500,000 kg and 30% of the total aggregate quantity" permitted of a product can enter the United States. [19] Once a quota is filled in a given quarter, importers must wait until the next quarter until they can bring the product into the United States. If goods are prohibited from entering because of a filled quota, they can be stored in a warehouse or a foreign trade zone until the quota for the next quarter opens; returned or re-exported; or destroyed – all costly and inefficient options. [20]

- *No flexibility over time or between product categories:* quota availability cannot be saved and used in a subsequent quarter or borrowed from future quarters. [21] If the quota for one product goes unfilled, the excess amount cannot be transferred to another product. [22, 23]

No flexibility over time or between product categories.

The Perceived Good

For U.S. steel and primary aluminum producers, Section 232 tariffs, and to a limited extent, quotas, [24] are accomplishing their goal of bolstering U.S. manufacturing capacity and allowing their firms to become profitable again, at least in the short run. [25] Industry representatives also argue that any negative impact of the Section 232 program on downstream industries is far more limited and manageable than predicted. [26]

Section 232 tariffs and quotas working well for U.S. steel and aluminum producers.

It is unclear how much of the Section 232 program's success is attributable to quotas, or whether tariffs alone could have accomplished its goals. Though some proponents of the Section 232 protections do not advocate for quotas specifically, and recognize their downsides, others argue that quotas are, in fact, a necessary component of the Section 232 program.

First, for industries seeking protection, quotas arguably provide greater certainty than tariffs that imports will be limited. Under tariffs, if importers can bear the costs, or exporters can reduce their prices, imports will continue to flow in and competition will remain high. For example, Vietnam's 2018 exports of flat steel products, which are covered by Section 232 tariffs, increased by 79% compared to 2017. [27] If strict quotas were applied instead of tariffs, Vietnam's 2018 exports likely would have decreased. [28]

More certainty about import flows.

Second, steel and aluminum manufacturers argue that without quotas, "countries that have exemptions [to the Section 232 tariffs] would likely redirect their metals exports to the United States to take advantage of higher prices there, undermining the purpose of the tariffs." [29]

Prevent exporters exempt from tariffs from undermining protections.

Finally, the Trump Administration perceives that Section 232 quota agreements with U.S. trading partners and security allies, in combination with tariffs, are helping to pressure and incentivize allies to take seriously the problem of global excess capacity. [30] U.S. unilateral tariffs may also have the opposite effect, though, – making allies less willing to work cooperatively with the United States to address fundamental global problems. [31]

Pushes other countries to take global excess capacity more seriously.

Downsides for Downstream Industries

Business uncertainty and supply constraints for downstream manufacturers.

According to a letter sent to the Trump Administration by 33 business organizations, for U.S. downstream manufacturers, the quotas have entailed "severe supply constraints" and "created even more business uncertainty than tariffs". [32] Importers may no longer be able to guarantee that their goods can enter under the quota, or at all. They may encounter unanticipated costs in the form of storage charges and shipping fees if the quota is filled while goods are in transit. They may face unpredictably higher prices for goods subject to a quota. They may have to find new suppliers and bear all the costs of negotiating new contracts, building new relationships, and shipping from a new location. The exclusion process implemented on August 29, 2018, nearly four months after the South Korea quota went into effect, [33] may provide some relief for importers under supply pressure, though its application may also introduce more uncertainty. [34]

Tangible negative impacts on specific importers.

Anecdotally, one importer, Shell Chemical Appalachia, delayed construction of an ethane cracker facility in Pennsylvania when steel pipe imported from Brazil was barred from entering the United States because of a filled quota. The delay was resolved when Shell was granted an exclusion. [35] In addition, U.S. oil and gas industry representatives claim that quotas are straining pipeline expansion projects, such as the Cactus II pipeline from the Permian Basin, which rely heavily on imports of specialty oil line pipes. [36]

Overall effect of raising input prices and chilling investment and growth.

More generally, downstream manufacturers argue that Section 232 quotas and tariffs raise prices inhibiting their competitiveness, and have a chilling effect on growth, employment, and investment. [37] Although many businesses have been buoyed by the strong U.S. economy, they say that employment and sales in their industries would have increased even more were it not for tariffs and quotas raising prices. Moreover, downstream industries using steel and aluminum products employ more Americans than steel and primary aluminum manufacturers, so many jobs are vulnerable if supply contracts too much. [38]

Foreign Exporters Feel the Bite

Imports from South Korea, Brazil, and Argentina down year on year.

For South Korea, Brazil, and Argentina, quotas have reduced export volumes and revenue. According to U.S. Department of Commerce data, the overall quantity [39] of steel South Korea, Brazil, and Argentina exported to the United States in 2018 compared to 2017 dropped significantly, by 26.2%, 14.6%, and 20.1%, respectively. [40] In terms of value, according to the Congressional Research Service, South Korea and Argentina's steel exports subject to quotas dropped by $430 million and $1 million, respectively, from 2017 to 2018, while the value of Brazil's steel exports under the quota increased by nearly $145 million in 2018. [41]

According to data from the U.S. International Trade Commission, Argentina's aluminum exports subject to the quota dropped by approximately 86.8 million kilograms from 2017 to 2018, by 32.8%, with a decrease in value of approximately $101 million.

Even with a 135% quota level, imports from Argentina decreased in 2018.

Although South Korea, Brazil, and Argentina have benefitted from generally higher prices in the United States for steel and aluminum, so far, the quotas are effectively reducing U.S. imports from these countries.

Good News - United States, Canada, and Mexico Avoided Steel and Aluminum Quotas

In order to move forward with passage of the USMCA, the three countries first had to address the steel, aluminum, and retaliatory tariffs in place since 2018. Although all parties considered quotas as a possible way forward, in the end, they agreed to lift all steel, aluminum, and related retaliatory tariffs, as well as withdraw pending WTO litigation, without imposing quotas. [42] In exchange, the three countries agreed to:

U.S., Canada, and Mexico took a positive step by lifting tariffs while avoiding quotas.

- prevent the importation of aluminum and steel that is unfairly subsidized and/or sold at dumped prices;
- prevent the transshipment of aluminum and steel made outside of Canada, Mexico, or the United States to the other country; and
- establish a monitoring process to detect surges of aluminum and steel imports among them. [43]

If imports surge "meaningfully beyond historic volumes of trade over a period of time" the Section 232 tariffs may be re-imposed, but retaliatory tariffs imposed by Canada and Mexico can only be placed on steel and aluminum products. [44]

This agreement is a positive development for two key reasons: the parties removed tariffs while avoiding quotas, and agreed to address the underlying cause of U.S. industry distress – global excess capacity.

Canada, Mexico, South Korea, and Brazil are currently the four largest exporters of steel to the United States, and Canada is by far the largest exporter of aluminum to the United States. If the U.S., Canada, and Mexico had instead agreed to a quota regime similar to the one currently in place, supply constraints and price increases likely would have been magnified, with a considerable impact on downstream industries. Quotas on Canada and Mexico would have had a particularly onerous impact on manufacturers in all three countries who have built long-term, cross-border supply chains under the

Shifting to quotas would have magnified supply constraints and led to higher prices.

North American Free Trade Agreement. With these concerns in mind, the Canadian and Mexican governments, along with North American industry groups and businesses, pushed back against the adoption of quotas, and their views appear to have prevailed.

Perhaps more importantly, the agreement just made between the U.S., Canada, and Mexico also set aside protectionist barriers in favor of steps to address the greater challenge of global excess capacity. Global steel and aluminum excess capacity is caused largely by government subsidies [45] to producers, and is driven largely by China, a result of state-led policies and practices designed to grow China's production capacity quickly and on a massive scale. Over-production and dumping of Chinese steel and aluminum products depresses global prices for these goods to a level at or below production costs, harming U.S. and other producers' ability to compete or continue operations. While China is by far the largest producer of both aluminum and steel and the largest provider of government subsidies, other countries, including Australia, Brazil, and Canada, also provide subsidies that contribute to global excess capacity. [46]

Agreement takes steps to address global excess capacity issues, but future agreements should go further.

Although addressing subsidized imports and transshipment issues are important steps, the United States, Canada, and Mexico could have agreed to do even more to address global excess capacity. Going forward, the United States might consider lowering or eliminating Section 232 tariffs and quotas on its trading partners in exchange for even stronger actions, which could include:

- Eliminating all subsidies and other forms of government support, including at the state, provincial, and local levels, in countries that contribute to global excess capacity;

- Adopting measures to prevent displacement and transshipment in the steel and aluminum sectors;

- Coordinated use of domestic trade remedy measures directed specifically at China and other countries that use subsidies and contribute the most to global excess capacity;

- Restructuring industries to eliminate inefficient facilities and practices that can lead to over-production and waste;

- Coordinated outreach to countries like Indonesia and India that are aggressively expanding production capacity to encourage adoption of responsible practices that will not contribute to excess capacity; and

- Coordinated efforts in international fora, including the G-20, the OECD, and the WTO, to advance enforceable rules on subsidies directed at the greatest over producers.

Next step: focus on eliminating subsidies, keeping pressure on China and other over-producers. International coordination is key.

Though tariffs and quotas may provide short-term relief, solving underlying global excess capacity problems is critical to addressing U.S. industries' long-term challenges, and any long-term solution will require more than the mere application of protectionist measures. The United States will have to work closely and creatively with its trading partners to address this challenge directly and to persuade the world's largest producers, including China, to reduce global excess capacity.

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Footnotes

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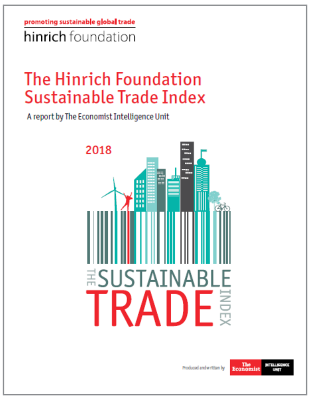

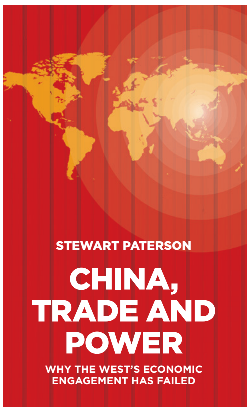

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