FREE TRADE AND PROTECTION

THE BASIS OF FREE TRADE – ITS ADVANTAGES AND DISADVANTAGES

This refers to the removal of artificial barriers to trade. The WTO has campaigned strongly for continued trade liberalism and the removal of protection. Adam Smith in the Wealth of Nations focused on the principles of Absolute advantage whilst Ricardo discussed the efficiencies which derive from Comparative Advantage.

Advantages of Free Trade include:

- Ability of countries to specialise on those goods and services in which they have a comparative advantage (leading to division of labour and increased productivity).
- A more efficient allocation of resources will ensue (medium to long-term).
- Economics of scale will result leading to lower cost structures and decreased prices.
- Increased choice and lower prices for households and firms.
- Decreased imported inflation (with increased imports of consumer and capital goods).
- Increased international competitiveness of exporting and import-competing firms.
- Capital deepening and technological advancement.

Disadvantages of Free Trade include:

- Short-term structural unemployment (e.g. TCF and PMV industries in Australia).
- Rent seeking behaviour from firms facing increased competition.
- Increases in imports and worsening of trade balance (in short-medium term).
- Loss of production in trade liberalising industries, including ‘infant’ industries.
- Dumping of surplus international stock on domestic markets.

The global movement towards free trade increased pace from the 1980s-2000s, with some concern that countries would increase protectionist measures during and after GFC. This, to a large extent, has been averted. Despite this, there are considerable impediments to the removal of all artificial barriers.

REASONS FOR PROTECTION

Despite the obvious benefits to be gained through specialisation and free trade, countries have long continued to impose barriers to free trade in a variety of different forms:

- The prevention of dumping.
- Protection of Infant Industries.
- Protection of domestic employment.
- Diversification and Self Sufficiency.
- National Defence.
- Maintaining National Identity.

There is valid argument for protecting against the practice of dumping and the WTO allows countries to protect domestic industries when a case of dumping is discovered. The infant industry argument is said to be valid as a short term form of protection but becomes less valid the longer it takes for domestic industries to achieve efficiencies which allow them to compete on a level playing field. The protection of domestic employment is often put forward as a strong argument to justify trade barriers but a number of points can be made which identify flaws in this argument.

METHODS OF PROTECTION

Countries are able to use a variety of methods in protecting domestic industries against foreign competition. The impacts of these protective measures vary to some extent but the essential objective of any method of protection is to favour local industry against the pressure of foreign competition, which allows domestic firms a greater share of the market than would have been possible without assistance.

The common forms of protection include such measures as:

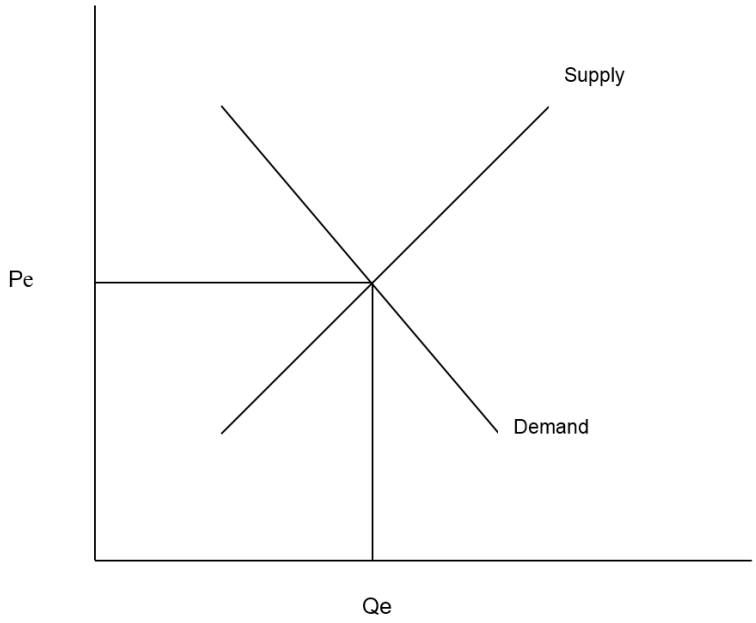
- Tariffs
- Subsidies
- Quotas
- Local content rules
- Export incentives
- Import regulations
- Quarantine regulations (including embargoes/bans on specific types of goods)

The syllabus requires pupils to be able to analyse these measures of protection with particular attention to tariffs, subsidies and quotas.

Tariffs are taxes imposed on firms importing foreign produced goods into the domestic market. For the purpose of analysis, assuming the tariff is set at a per unit value, let us consider how the dynamics of the market change with the use of a tariff to protect a domestic industry.

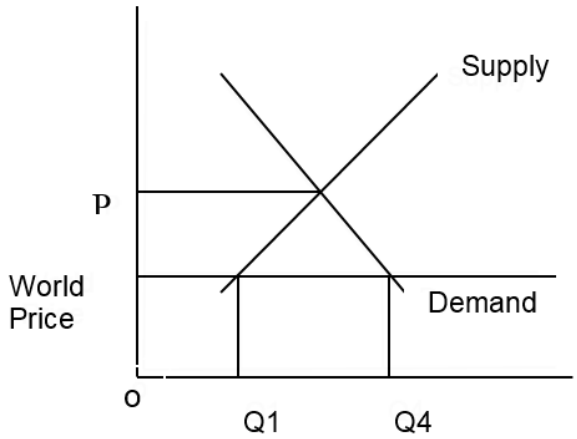
Prior to any foreign competition, market equilibrium is the result of the interaction of domestic demand and supply conditions as demonstrated in Graph 1.

Domestic market Conditions (Graph 1)



With the entry of foreign competition, which charge a lower price than the current domestic price, local firms are forced to lower their price to maintain some level of market share as demonstrated in Graph 2.

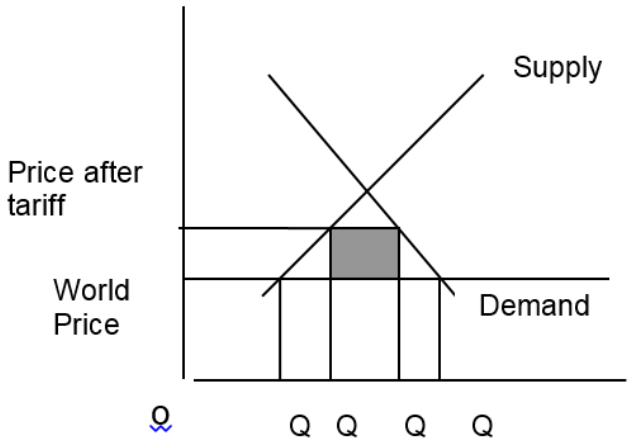
Introduction of foreign competition (Graph 2)



The market share of domestic firms has been reduced to 0Q1 and the share of the local market going to foreign firms is Q1Q4.

Should the government decide to offer the local industry tariff protection then the market conditions will change as demonstrated in Graph 3.

Imposition of a tariff (Graph 3)



The market share going to local firms (after tariff) has increased to 0Q2 and the share going to foreign firms has shrunk to Q2Q3. The shaded rectangular area under the original equilibrium represents the level of revenue the government receives as a result of the tariff.

IMPACTS OF THE TARIFF

Price Effect: The increase in market price as a result of the imposition of the tariff on foreign competition. If tariff protection is widespread then there is a likely to be a higher cost of living across the economy.

Reallocation Effect: The increase in resources now allocated to a relatively less efficient local industry. These resources might have been available to other more efficient sectors within the domestic economy. This is why protection is said to create a distortion in the allocation of resources.

Redistribution Effect: The transfer of income away from domestic consumers in the form of higher prices to local producers and reduced profits of foreign firms lifting the profits of local producers.

Revenue Effect: The tax collected from consumers in the form of higher prices which flows to the government.

Retaliation Effect: The possible retaliation, by way of trade barriers from foreign governments, on the exports of the local economy thereby reducing export profitability.