

Free Trade Versus Protection

1. FREE TRADE

Meaning

Free trade policy refers to a trade policy without any tariffs, quantitative restrictions and other devices obstructing the movement of goods between countries. Prof. Jagdish Bhagwati defines free trade policy, "as absence of tariffs, quotas, exchange restrictions, taxes and subsidies on production, factor use and consumption"¹. This is an exhaustive definition. Prof. Lipsey gives a very simple definition. According to him, "A world of FREE TRADE would be one with no tariffs and no restrictions of any kind on importing or exporting. In such a world, a country would import all those commodities that it could buy from abroad at a delivered price lower than the cost of producing them at home." Thus the policy of free trade means simply complete freedom of international trade without any restrictions on the movement of goods between countries. However, there is an exception. Import duties can be levied for revenue and not for protection even under free trade. This can be understood with the help of an example. If the government levies a duty of 15 per cent on all imports, all foreign goods which enjoy a cost advantage of more than 15 per cent will not be affected by this duty, and trade will continue as usual. But if even a simple foreign good enjoys a cost advantage of less than 15 per cent, it means the end free trade and import duty is for protection and not for revenue alone. Thus a country following the free trade policy levies import duties which are lower than the cost advantage enjoyed by the lowest cost foreign good.

The Case for Free Trade

The classical economists were in favour of the free trade policy. Of the modern economist, Haberler² advanced the following arguments in favour of free trade.

1. Maximisation of Output. The case for free trade arises from the theory of comparative advantage which states that a country specialises in the production of those commodities in which it possesses greater comparative advantage or least comparative disadvantage. Therefore, under free trade a country specialises in the

¹ International Trade, 1986, p. 10.

production of those commodities which it is relatively best suited to produce and exports them in exchange for those imports which it can obtain more cheaply. This maximises the output of all the participating countries because all gain from trade which, in turn, increases the real national income of the world economy. Thus free trade leads to the maximisation of output income and employment.

2. Optimum Utilisation of Resources. Free trade leads to international specialisation and geographical and territorial division of labour. Each country specialises in the production of those goods for which it has abundant supply of natural resources. As a result, the existing resources in each trading country are employed more productively and the resource allocation becomes more efficient. There is more efficient utilisation of factors within a firm or industry. Thus international trade and division of labour leads to optimum utilisation of resources.

3. Optimisation of Consumption. Free trade secures the optimisation of consumption. In other words, it benefits the consumers when they are able to buy a variety of commodities from abroad at the minimum possible prices. This, in turn, has the effect of raising their standard of living.

4. High Factor Incomes. Under free trade, there is perfect mobility of factors of production. They can move from one place to another and between countries in order to earn more. Thus such factor incomes as wages, interests, rents and profits are high under free trade. There is increase in the real income of the world economy and of its participant countries.

5. Educative Value. According to Haberler, free trade has an educative value. International competition encourages home producers to sacrifice leisure in order to increase productivity. For this, they innovate and bring improvements in organisation and methods of production.

6. Wide Markets. Free trade leads to wide extent of markets for goods. As the demand for goods is not confined to one country but to a number of countries, the entire world becomes the market for all types of goods. This leads to the production of quality goods at low prices because of world competition.

7. Prevents Monopolies. Free trade prevents the establishment of monopolies. Under free trade each country specialises in the production of a few commodities, and the firms or industries are of the optimum size so that the cost of production of each commodity is the minimum. Thus free trade ensures a lower price for exports as well as imports and the price mechanism under perfect competition prevents the formation of monopolies.

8. Encourages Inventions. Free competition and trade encourage nations to produce the best and the cheapest products in order to gain more. It stimulates them to invent new techniques and processes of production, to find new markets, new sources of raw materials, etc.

9. Develops Transport and Communications. Free trade encourages the development of the means of transport and communications not only within countries but also among countries. Rail, road, sea and air transport systems expand with better and more cargo facilities which move safely and quickly

The Case Against Free Trade

The policy of free trade, with all its advantages noted above, was abandoned after the Great Depression by the countries of the world. There are certain theoretical and practical difficulties in following the free trade policy.

1. Laissez Faire and Perfect Competition do not Exist. Free trade presupposes the existence of *laissez-faire* and the working of price mechanism under perfect competition. But these conditions do not exist in the present day world. Monopoly, monopsony, cartels, imperfect labour markets and tariffs led to the abandonment of free trade.

2. One-sided Development. Under the policy of free trade, some industries expand in which the country possesses comparative advantage but other industries are not developed. An agricultural country may develop only agriculture and neglect the industrial sector. Or, one type of industries may be developed while others may remain undeveloped. This naturally leads to the one-sided development of the economy.

3. Production of Inferior and Harmful Goods. There being no restrictions on the movement of goods under free trade, substandard and harmful commodities are likely to be produced and traded. This leads to diminution of social welfare. Trade restrictions on the import of such commodities become necessary.

4. Cut-throat Competition and Dumping. Countries with better factor endowments are able to produce certain commodities cheaper than others. This led to cut-throat competition in the world market under free trade. So certain countries like Japan resorted to the policy of dumping whereby they would sell huge quantities of their products at rock-bottom prices in the foreign markets. Naturally, this policy led to the imposition of trade restrictions.

5. Emergence of Multinational Corporations and Monopolies. Free trade

leads to the emergence of international monopolies and local monopolies, according to Haberler. Such monopolies developed with the spread of multinational corporation under free trade which proved harmful to the other countries and the domestic interests. This factor also led to the adoption of the policy of protection.

6. Exploitation and Colonisation of Countries. Economists do not agree with Haberler that the free trade policy helps in the development of under-developed countries. Rather, this policy led to the exploitation and colonisation of countries during the 19th and early 20th centuries.

7. Economic Dependence. Free trade leads to economic dependence which is harmful for a backward country. Such a country has to depend on the imports of varied types of consumers and capital goods, raw materials, *etc.* on developed countries both in war and peace.

8. Trade Cycles. Free trade leads to international business fluctuations. Booms and depressions spread among countries. But the danger of depression is more as was the case of the Great Depression of the 1930s. Depression in America spread to the whole world, except Russia which was a closed economy at that time.

2. PROTECTION

Meaning

The term protection refers to a policy whereby domestic industries are to be protected from foreign competition. The aim is to impose restrictions on the imports of low-priced products in order to encourage domestic industries, may be protected by imposing import duties which raise the price of foreign goods by more than the price of domestic goods. Or, they may be protected by quotas or other non-tariff restrictions which make imports of cheap foreign goods difficult or impossible. Or, the domestic industries may be paid subsidies, or bounties to enable them to compete with cheap foreign goods.

Arguments for Protection

Haberler has divided the arguments for protection into two groups: economic and non-economic. We discuss these one by one.

A. Economic Arguments. The economic arguments which are usually given in favour of protection are :

✓ Terms of Trade Argument. The terms of trade argument is given to correct disequilibrium in the balance of payments of a country. It is argued that the imposition of a tariff on imports improves the rate at which the country's exports are exchanged for imports. This means that a tariff improves its terms of trade because the foreign exporter is forced to pay some part of the import duty. The extent to which a country can improve its terms of trade by imposing import duty will depend upon the relative demand and supply elasticities at home and abroad. A country which imports a large quantity of a particular commodity, whose demand is less elastic, will be in a better position to impose a tariff duty and improve its terms of trade than a country which imports a small quantity of

2. Bargaining or Retaliation Arguments. It is argued that the imposition of tariffs is necessary to bargain in trade negotiations with other countries. Since international trade is based on reciprocal basis, tariff is used as a weapon to persuade or dissuade the other country to lower its tariff wall. Thus the fear of retaliation may induce countries to give reciprocal concessions to each other.

But the bargaining argument for protection is not sound on many counts. *First*, tariffs as a weapon for bargaining may lead to retaliation on the part of the other country, thereby harming both the countries. *Second*, vested interests may be created in the country which may be so powerful that they may not allow reduction in tariffs and reciprocal bargaining. *Third*, retaliation may lead to economic sanctions between countries and to rivalry. *Fourth*, it may lead to the shrinkage of world trade.

3. Anti-dumping Argument. Protection is advocated against the practice of dumping. Dumping means selling a product in a foreign market at a lower price than in the home market, after taking into account transport and other costs of transfer. Dumping aims at flooding a foreign market with low-priced commodities.

* The following explanation is for higher classes.

As a result, the import competing firms are ruined. To protect such firms, a high tariff is imposed. This will raise the price of the product in the importing country and removes the threat of dumping.

4. Diversification Argument. Another argument advanced in support of protection is to diversify the domestic industries. It means that there should be a balanced growth of the economy so that all the sectors of the economy develop side by side. For this purpose, agriculture and manufacturing industries should be protected from foreign competition. This is a valid argument, for experience has shown that countries which are not developed in a balanced way are affected more by international economic disturbance, such as crop failures, depressions, inflations, wars, *etc.* Therefore, they should diversify and become self-sufficient by protecting their industries. But it is not possible to diversify completely and attain self-sufficiency even by the richest country of the world. In fact, no country has all resources for a balanced growth of the economy. It has to depend upon other countries in one way or the other. Moreover, protection is not the only means to diversify an economy.

5. Infant Industry Argument. The infant industry argument is the oldest and the most accepted argument for protection. It was formulated by Alexander Hamilton in 1790 and was popularised by Friedrich List in 1885. This argument "rests on the assumption that the country has a latent comparative advantage in the industry or group of industries to be protected." It is, therefore, argued that if industries in their infancy are not protected from established foreign producers, they must attain the optimum size so as to operate most efficiently and competitively and to produce at lower costs. Protection is also needed to facilitate the flow of resources into infant industries, even though consumers have to bear the burden of higher prices temporarily. Further, there may be "imperfection of the information flow" to infant industries in the form of difficulty to borrow funds for investment, knowledge of infrastructure facilities, labour market, *etc.* All these requires government protection to such industries. The economic justification lies in that social benefits exceed private benefits from investment in such industries. It means that the protection should be given to those infant industries which generate larger externalities than other industries not given protection. Moreover, infant industries require time to undergo the process of learning-by-doing to become competitive in the long-run. Therefore, they should be protected. Johnson regards the infant industry arguments as being explicitly dynamic arguments 'for temporary intervention of correct transient distortion.'³ So infant industries need protection for a while so that they may grow without any threat from foreign producers. When they attain adulthood, protection can be withdrawn and then they should be left free to face foreign competition.

than the world price, the LDC can export this commodity.

The infant industry argument explained above is meant to encourage domestic production of the commodity. It is based on the argument that *Nurse the baby, protect the child and free the adult*. It means that unless an industry becomes capable of competing with foreign producers, protection should not be removed. But when it is able to face foreign competition, protection should be withdrawn. But the experience is that once protection is given to an industry, it likes to remain an infant industry for ever. Again, when an industry is protected through import tariff, it becomes difficult to remove it.* Therefore, economists prefer production subsidy to an import tariff. *First*, A subsidy is superior to a tariff because it leads to more consumption at point E_1 on the CI_1 curve than at point P on CI curve in Fig. 2. *Second*, if there is a properly functioning capital market, the profitability of the protected industry may lead to long term investment in it. *Third*, a subsidy can be reviewed every year, being a part of the annual government budget. *Fourth*, a subsidy can be raised or reduced according to the requirements of the protected industry without distorting relative prices and domestic consumption. But these arguments against an import tariff do not hold ground in LDCs because they lack a developed capital market, and even necessary knowhow to operate an infant industry. Moreover, a subsidy is a big burden on the tax-revenue system, while a tariff brings much needed revenue to the government. In the light of the above arguments, it can be concluded that the infant industry argument is suited for LDCs.

6. Sunset Industries Argument. This is a very recent argument for protection which has emerged in Europe. From the 1970s onwards, some established labour-intensive industries such as producing steel products, textiles, clothing, footwear, etc. have been losing competitiveness to Japan, Taiwan, Malaysia, Korea, India and other East Asian countries. This argument implies that sun is setting on such mature industries of Europe which should be granted temporary protection so that they may be able "to re-equip and regain competitiveness". In the absence of protection, it will lead to displacement of labour and capital in such industries. This has actually led to the imposition of import tariffs on textiles, clothing, footwear and such products in the European Countries. However, critics point out that is a political argument to solve the unemployment problem in such countries. Moreover, once protection is granted to such industries, it is difficult to remove tariffs.

7. Socially Important or Key Industries Argument. Protection should be given to socially important industries such as agriculture or strategically important industries as iron and steel, heavy electricals, machine making, heavy chemicals, etc. There is no dispute over this argument because the development of key and other socially important industries under protective tariffs is one of the principal aims of trade policy in a country.

8. Employment Argument. A usual argument for protection is that it is a

* For other points of criticism, refer to the previous page.

"Whether a country has high or low tariff has nothing to do with the acuteness of its crises and depression." *Third*, there may be permanent unemployment which can again be removed by the imposition of a new tariff duty in the case of one industry but not for the entire economy. However, only high tariffs can cure permanent unemployment if it is due to very high wages. But high tariffs lead to retaliation. Under the circumstances, it is not high tariffs but readjustment of wages are needed to cure permanent unemployment. Haberler concludes that "leaving aside a few exceptional cases, a favourable result can be expected only in the short-run, so that tariffs can be advocated on this ground only from a short-run, and indeed, short-sighted, standpoint."

✓ **9. Balance of Payments Argument.** This is one of the important arguments for protection, especially by LDCs. Tariffs help in restricting the imports of unnecessary goods and try to reduce the balance of payments deficit. They assist in conserving foreign exchange which can be used for importing essential goods and services for import-substitution industries and for the export sector. The expansion of the import-substitution and export sectors, in turn, raises employment and income in the country. And the increase in income increases savings and the supply of loanable funds which reduce the interest rate and encourage investment. Consequently, more employment and income are generated.*

In fact, both developed and less developed countries have used tariffs as an effective instrument to reduce their balance of payments deficits. This is illustrated in Fig. 4 where *D* is the domestic demand curve and *S* the domestic supply curve of importables. *OP* is the constant world price at which the importers are prepared to sell their commodities in the domestic market. Thus the horizontal line *PB* is the supply curve of imports which is perfectly elastic at *OP* price. Under free trade (before the imposition of a tariff) the equilibrium market position is given by point *B* where the domestic demand curve *D* intersects the world supply curve *PB* at price *OP*. The total demand for importables is *OQ₃*. The domestic supply is *OQ*. The difference between domestic demand and domestic supply

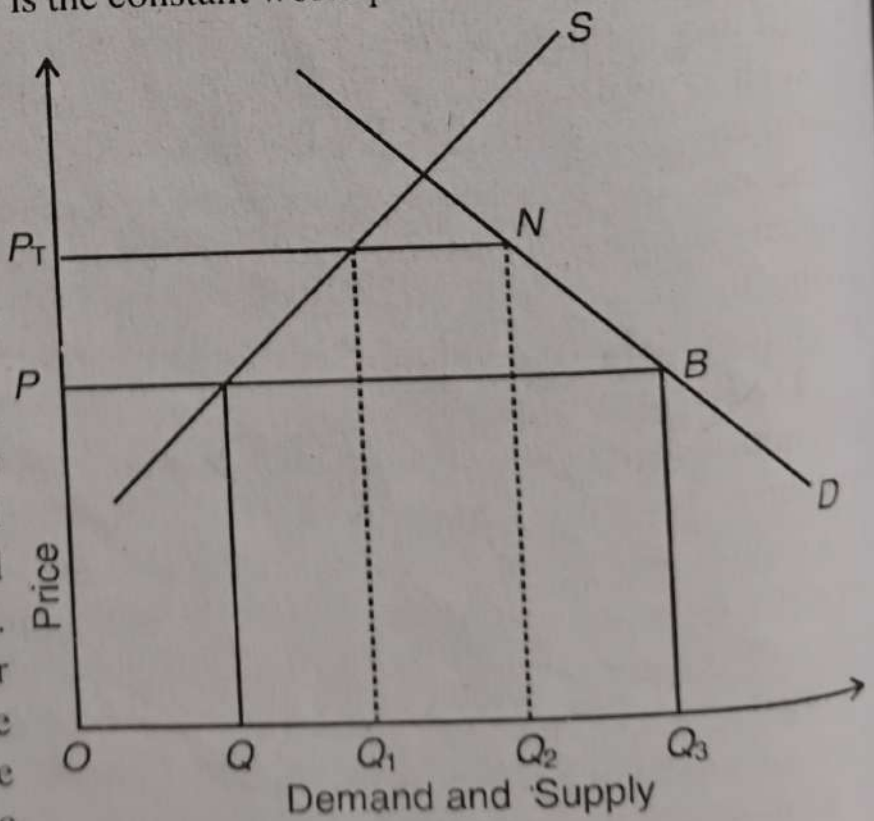


FIG. 4

is QQ_3 . The imposition of a tariff by PP_T amount raises the domestic price to OP_T and reduces the deficit from QQ_3 to Q_1Q_2 because domestic demand is OQ_2 and domestic supply is OQ_1 and $OQ_2 - OQ_1 = Q_1Q_2$.

But when the export surplus increases employment and income in one country, the import surplus in the other country reduces employment and income there. *Second*, such a policy will lead to retaliation by the other country. *Third*, this policy adversely affects the volume of world trade, and international specialisation suffers. Therefore, Johnson does not regard the imposition of tariffs to reduce balance of payments deficit as an optimum policy and prefers a cut in domestic expenditure or devaluation to tariffs.

10. Factor Income Redistribution Argument. Another argument, particularly related to LDCs, is to redistribute income. There is a large labour-intensive sector with low incomes and a small capital-intensive sector with high incomes. The latter sector is mainly dependent on imports. It is argued that the imposition of tariffs on the imports of this sector will encourage the production of the labour-intensive sector where real incomes will rise. Factors of production will move from the former to the latter sector in the long run. However, the capital-intensive sector releases more capital but less labour which the expanding labour-intensive sector wishes to absorb. This causes wages in the labour-intensive sector to rise even more. At the same time, wages in the capital-intensive sector rise because the producers find it difficult to retain workers from moving to the other sector. Eventually, both the industries pay equal wages. Thus tariffs lead to equalisation of factor incomes in the long-run growth process. But, in reality, factor incomes are never equalised. Rather a tariff may harm the scarce factor more than it may benefit the abundant factor in such countries due to inherent sociological, political and economic constraints. But tariffs are not the most efficient instrument for redistribution of income. The best course is to resort to lumpsum redistributions of income without causing malallocation resources by taxing the high-income groups and giving the proceeds to low-income groups through various incentives and providing productive employment opportunities.

11. Revenue Argument. Tariffs are levied to generate revenue for the government and to protect domestic industries from foreign competition. In LDCs, revenue collection is considered the main objective of import and export tariffs. This is not a correct view because raising revenue is a by-product of protection to domestic industries. However, if such governments depend more on tariffs as a source of revenue, it may lead to some negative side-effects. If the demand for imported goods is fairly inelastic, tariffs may bring more revenue. On the contrary, in the case of highly elastic demand, tariffs may stop trade altogether and reduce the government revenue. Similarly, taxes (duties) on exports reduce the sales of exports and foreign earnings, thereby creating balance of payments difficulties.*

* The following paras are for higher classes.