Foreign Trade Policy: Free Trade and Protection

UNIT 2

What is Protected Trade?

- It refers to Restricted trade.
- In this trade policy, the government intervenes in the trading activities of the nation.
- They are regulated with a number of measures like tariff and quotas.
- Restrictions are imposed to encourage exports and discourage or restrict the inflow of imports.

This thought of protectionism swept the world after the World war II (1939)which ended in 1945.

- Though ‘some trade was better than no trade’, philosophy was accepted but acceptance for “Free Trade”, was not accepted , as it was not considered the best.

So what was before Protected Trade and what is it now?

>>> The trade policy prior to protectionism was dominated by the classical thoughts of Free Trade, championed by Adam Smith and David Ricardo, for about 2 hundred years.

- They always argued for free free flow of goods and services, that is, unrestricted trade without government intervention.
- According to them, it is free trade which gives the trading nations the benefit to specialise in the production of commodities in which they have a comparative advantage and thus each country can reap the gains from trade.

Can protected trade cause a gain from trade?

- LDCs, by imposing tariff and duties, made an attempt to secure maximum benefits from international exchange of commodities. But the last quarter of the 20th century saw the revival of free trade all over the globe as protection failed to provide enough gains which the countries required.

- International Monetary Fund (IMF) and the World Bank also favours the free trade philosophy.

Free Trade:

- International trade that takes place without barriers such as tariff, quotas and foreign exchange controls is called free trade.
- Thus, under free trade, goods and services flow between countries freely.
- In other words, free trade implies absence of governmental intervention on international exchange among different countries of the world.

Arguments for Free Trade:

- i. Advantages of specialisation:

- Firstly, free trade secures all the advantages of international division of labour.
- Each country will specialise in the production of those goods in which it has a comparative advantage over its trading partners.
- This leads to the optimum and efficient utilisation of resources and, hence, economy in production.

ii. All-round prosperity:

- Secondly, because of unrestricted trade, global output increases since specialisation, efficiency, etc. make production of large scale possible.
- It enables countries to obtain goods at a cheaper price. This leads to a rise in the standard of living of people of the world. Thus, free trade leads to higher production, higher consumption and higher all-round international prosperity.

iii. Competitive spirit prevails:

- Thirdly, free trade keeps the spirit of competition of the economy. As there exists the possibility of intense foreign competition under free trade, domestic producers do not want to lose their grounds. Competition enhances efficiency. Moreover, it tends to prevent domestic monopolies and free the consumers from exploitation.

(iv) Accessibility of domestically unavailable goods and raw materials:

- Fourthly, free trade enables each country to get commodities which it cannot produce at all or can only produce inefficiently.
- Commodities and raw materials unavailable domestically can be procured through free movement even at a low price.

v)Greater international cooperation:

- Fifthly, free trade safeguards against discrimination. Under free trade, there is no scope for cornering raw materials or commodities by any country. Free trade can, thus, promote international peace and stability through economic and political cooperation.

- **(vi) Free from interference:**

- Finally, free trade is free from bureaucratic interferences. Bureaucracy and corruption are very much associated with unrestricted trade.
- In brief, restricted trade prevents a nation from reaping the benefits of specialisation, forces it to adopt less efficient production techniques and forces consumers to pay higher prices for the products of protected industries.

Arguments against Free Trade:

- Following arguments are often cited against free trade:
- (i) Advantageous not for LDCs:
- Firstly, free trade may be advantageous to advanced countries and not to backward economies. Free trade has brought enough misery to the poor, less developed countries, if past experience is any guide. India was a classic example of colonial dependence of UK's imperialistic power prior to 1947. Free trade principles have brought colonial imperialism in its wake.

(ii) Destruction of home industries/products:

- Secondly, it may ruin domestic industries. Because of free trade, imported goods become available at a cheaper price.
- Thus, an unfair and cut-throat competition develops between domestic and foreign industries.
- In the process, domestic industries are wiped out. Indian handicrafts industries suffered tremendously during the British regime.

(iii) Inefficient industries remain perpetually inefficient:

- Thirdly, free trade cannot bring all-round development of industries. Comparative cost principle states that a country specialises in the production of a few commodities.
- On the other hand, inefficient industries remain neglected. Thus, under free trade, an all-round development is ruled out.

(iv) Danger of overdependence:

- Fourthly, free trade brings in the danger of dependence. A country may face economic depression if its international trading partner suffers from it.
- The Great Depression that sparked off in 1929-30 in the US economy swept all over the world and all countries suffered badly even if their economies were not caught in the grip of depression. Such overdependence following free trade becomes also catastrophic during war and other calamities.

(v) Penetration of harmful foreign commodities:

- Finally, a country may have to change its consumption habits. Because of free trade, even harmful commodities (like drugs, etc.) enter the domestic market. To prevent such, restrictions on trade are required to be imposed.

- **In view of all these arguments against free trade, governments of less developed countries in the post-Second World War period were encouraged to resort to some kind of trade restrictions to safeguard national interest.**

Protection:

- Thus, protection is the anti-thesis of free trade or unrestricted trade.
- Government imposes tariffs on ad valorem basis or imposes quota on the volume of goods to be imported.
- Sometimes, export taxes and subsidies are given to domestic goods to protect them from foreign competition.
- These are the various forms of protection used by modern governments to restrict trade.

Arguments for Protection:

- The concept of protection is not a post-Second World War development. Its origin can be traced to the days of mercantilism (i.e., 16th century). Since then various arguments have been made in favour of protection.
- The case for protection for the developing countries received a strong support from Argentine economist **R. D. Prebisch** and **Hans Singer** in the 1950s.

All these arguments can be summed up under three heads:

- (i) Fallacious or dubious arguments;
- (ii) Economic arguments; and
- (iii) Non-economic arguments.

(i) Fallacious Arguments:

- Fallacious arguments do not stand after scrutiny. These arguments are dubious in nature in the sense that both are true. 'To keep money at home' is one such fallacious argument.
- By restricting trade, a country need not spend money to buy imported articles. If every nation pursues this goal, ultimately global trade will squeeze.

(ii) Economic Arguments:

- **(a) Infant industry argument:**
- Perhaps the oldest as well as the cogent argument for protection is the infant industry argument.
- When the industry is first established its costs will be higher. It is too immature to reap economies of scale at its infancy. Workers are not only inexperienced but also less efficient. If this infant industry is allowed to grow independently, surely it will be unable to compete effectively with the already established industries of other countries.
- Thus, an infant industry needs protection of a temporary nature and over time will experience some sort of 'learning effect'. Given time to develop an industry, it is quite likely that in the near future it will be able to develop a comparative advantage, withstand foreign competition and survive without protection.

b. It is something like the dictum:

- An underdeveloped country attempting to have rapid industrialisation needs protection of certain industries.
- However, in actual practice, the infant industry argument, even in LDCs, loses some strength. Some economists suggest production subsidy rather than protection of certain infant industries. Protection, once granted to an industry, continues for a long time. On the other hand, subsidy is a temporary measure since continuance of it in the next year requires approval of the legislature.
- A time period of 5 to 10 years may be required by an industry to achieve maturity or self-sufficiency. Under the circumstances, infant industry argument loses force.

(c) Diversification argument:

- As free trade increases specialisation, so protected trade brings in diversified industrial structure. By setting up newer and variety of industries through protective means, a country minimises the risk in production. Comparative advantage principle dictates narrow specialisation in production.

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- This sort of specialisation is not only undesirable from the viewpoint of economic development, but also a risky proposition. Efficiency in production in some products by some countries (e.g., coffee of Brazil, milk product of New Zealand, oil of Middle East countries) results in overdependence on these products.

Above all, this sort of unbalanced industrial growth goes against the spirit of national self-sufficiency.

Protection is the answer to this problem. A government encourages diverse industries to develop through protective means.

(d) Employment argument:

- Protection can raise the level of employment. Tariffs may reduce import and, in the process, import-competing industries flourish. In addition, import- substituting industries—the substitution of domestic production for imports of manufactures,develop. The strategy of import-substituting industrialisation promotes domestic industry at the expense of foreign industries.
- Thus, employment potential under protective regime is quite favourable. In brief, tariff stimulates investment in import-competing and import substitution industries. Such investment produces favourable employment multiplier.

(e) Balance of payments argument:

- A deficit in the balance of payments can be cured by curtailing imports. However, imports will decline following a rise in tariff rate provided other trading partners do not retaliate by imposing tariff on a country's export.
- However, import restrictions through tariff may be uncalled for if the balance of payments crisis becomes serious and chronic. In view of this and other associated problems of tariff, it is said that tariff is a second best policy.

(f) Anti-dumping argument:

- Usually, we hear about unfair competition from firms of low-cost countries. One particular form of unfair competition is dumping which is outlawed by international trade pacts, such as WTO.
- **Dumping is a form of price discrimination that occurs in trade. Dumping occurs when a country sells a product abroad at a low price because of competition and at a high price in the home market because of monopoly power.**
- In other words, dumping is a kind of subsidy given to export goods. This unfair practice can be prevented by imposing tariff. Otherwise, workers and firms competing with the dumped products will be hit hard.

(g) Strategic trade advantage argument:

- It is argued that tariffs and other import restrictions create a strategic advantage in producing some new products having potential for generating some net profit. There are some large firms who prevent entry of new firms because of the economies of large scale production.
- Thus, these large firms reap pure profits over the long run during which new firms may not dare enough to compete with these established large firms. **Thus, the large scale economies themselves prevent entry of new firms.**
- New firms showing potential for the future must be protected. "If protection in the domestic market can increase the chance that one of the protected domestic firms will become one of the established firms in the international market, the protection may pay off."

(iii) Non-Economic Arguments:

- (a) National defense argument:
- There are some industries which may be inefficient by birth or high cost due to many reasons and must be protected. This logic may apply to the production of national defence goods or necessary food items. Whatever the cost may be, there is no question of compromise for the defence industry since 'defence is more important than opulence'. Dependence on foreign countries regarding supply of basic food items as well as defence products is absolutely unwise.

Miscellaneous arguments against protection:

- There are some ‘side effects’ or ‘spillover effects’ of protection. This means that it produces some undesirable effects on the economy.
- Firstly, protection distorts the comparative advantage in production. This means that specialisation in production may be lost if a country imposes tariff. All these lead to squeezing of trade.
- Secondly, it imposes a cost on the society since consumers buy goods at a high price.
- Thirdly, often weak declining industries having no potential future stay on the economy under the protective umbrella.
- Fourthly, international tension often escalates, particularly when tariff war begins.

contd.

- Usually, a foreign country retaliates by imposing tariff on its imports from the tariff-imposing country.
- Once the retaliatory attitude (i.e., 'beggar-my-neighbour policy') develops, benefits from protection will be lost.
- Finally, protection encourages bureaucracy. Increase in trade restrictions means expansion of governmental activity and, hence, rise in administrative cost. Bureauc racy ultimately leads to corruption.

Conclusion:

- The classical golden age of free trade no longer exists in the world. But, free trade concept has not been abandoned since the case for free trade is strongest in the long run. Protection is a short term measure. Thus, the issue for public policy is the best reconciliation of these two perspectives so that gains from trade (may be free or restricted) become the greatest.

concl.

Most of the countries (164 in 2023) are members of the World Trade Organisation (WTO) which favour more free trade than restricted trade. This philosophy gathered momentum in the Dunkel Draft and General Agreement on Tariffs and Trade (GATT) negotiations.

The aims of both the GATT (abolished in 1995) and now the WTO are trade liberalisation rather than trade restrictions.

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