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Foreign Trade Policy: Free Trade Versus Protection

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Introduction:

The foreign trade policy is concerned with whether a country should adopt the policy of free trade or of protection. If the policy of protection for domestic industries is adopted, the question which is faced whether protection should be achieved through imposing tariffs on imports or through the fixation of quota or through licensing of imports. The foreign trade policy has been the subject of heated discussion since the time of Adam Smith who advocated for free trade and recommended that tariffs should be removed to avail of the advantages of free trade. Even today, economists are divided over this question of foreign trade policy. Various arguments have been given for and against free trade and protection.

Free trade is the simpler of the two theories: a laissez-faire approach, with no restrictions on trade. The main idea is that supply and demand factors, operating on a global scale, will ensure that production happens efficiently. Therefore, nothing needs to be done to protect or promote trade and growth, because market forces will do so automatically.

In contrast, protectionism holds that regulation of international trade is important to ensure that markets function properly. Advocates of this theory believe that market inefficiencies may hamper the benefits of international trade, and they aim to guide the market accordingly. Protectionism exists in many different forms, but the most common are tariffs, subsidies, and quotas. These strategies attempt to correct any inefficiency in the international market.

Case for Free Trade:

1. Gains in Output and Well-being from Specialization:

The case for free trade is fundamentally based on the gain in output and well-being a country obtains from specializing in the production of those goods in which it is relatively more efficient and therefore export a part of them and in exchange gets those goods from other countries in production of which they are comparatively more efficient.

Specialization and trading in this way would achieve a more efficient allocation of resources and a higher level of output and well-being.

2. Gains from Economies of Scale:

An important gain from trade is that it enables the trading countries to benefit from the economies of scale. If a country does not trade with others, its firms will produce goods to meet the domestic demand for a product. If domestic demand for a product is small, each of them will produce at a higher cost since they would not be able to enjoy the benefits of the economies of large scale production.

Accordingly, the production of goods will be inefficient. Trade allows a country to export goods with the result that level of output of goods in a country will exceed domestic demand within a country. Thus trade expands the market for goods and enables the producers to take advantage of the economies of scale.

3. Raising rate of saving and investment:

Increase in national product or real national income of a country obtained through trade above the level that prevails in autarky leads to a higher level of saving. The higher level of saving ensures a higher rate of investment and capital formation which stimulates growth.

4.Import of capital goods:

Besides trade permits a country to import capital goods in exchange for exports of consumer goods or surplus raw materials, and thereby accelerates industrial growth. Imports of capital goods adds to the capital stock in a country and raises its productive capacity more than it would have been possible without trade. Free trade also often enables a country to borrow from other countries to finance import of capital goods.

5.Transfer of technology:

If different countries worked in isolation the new technology devel-oped in one country would remain confined locally. Through trade technological progress tends to feed on each other. A technology discovered by one is improved by another and so technology goes on being improved successively.

Imagine if every country had to invent a wheel, a steam engine, electricity operating in an isolated manner, how slow would have been the progress in technology. The trade increases international diffusion of technology and in this way transfer of technology from the developed countries to the developing countries have been possible.

6. Promotes Competition and Prevents Monopoly:

The case for free trade also rests on the fact that it promotes competition and prevents the emergence of monopolies in the domestic economy. In the absence of trade and therefore without facing any competition from foreign firms, domestic firms tend to become inefficient which causes rise in cost per unit of output and therefore higher prices of goods. When trade is free, increased competition by foreign firms forces domestic firms to adopt measures to increase their efficiency and make efforts to reduce cost by employing lowest-cost production techniques. Free trade also compels them to be innovative and to improve the quality of their products.

7. Political Gains from Free Trade:

Free trade increases well-being or standard of living of the trading coun-tries and this mutual welfare gains from trade make different nations economically dependent on each other. The economic interdependence raises the likelihood of reduced hostility between countries. Economic interdependence provides powerful incentives for peaceful solution of disputes. Trade between economically interdependent countries increases the potential losses from war and thus reduces the likelihood of armed conflict.

Despite the above gains from free trade, countries have put up various barriers to free trade.

Case for Protection: (Against free trade)

Despite gains from free trade, many arguments have been given against free trade and in favour of protection.

1. Nationalism:

First argument for protection has been that nationalistic feeling or patriotism requires that people of a country should buy products of their domestic industries rather than foreign products. In India recent campaign of 'Swadeshi' appeals to the patriotic feeling of the Indian people that we should protect our indig-enous industries and impose barriers on imports of foreign goods or provide subsidies to our industries.

2.Employment Argument:

An important argument for protection is that it will lead to increase in domestic employment or at least preserves present domestic employment. It is often believed that imports of goods from abroad reduce domestic employment.

Therefore, if instead of imports we produce those goods at home, employment in the country will increase.

3. Infant Industry Argument:

A powerful argument given in support of protection, especially in the context of developing countries is infant industries should be provided protection from the competition of low-priced imports of the mature and well-established industries of the developed industrialized countries.

As a result, over a period of time their cost per unit will go down and will therefore be in a position to compete with the foreign imports. Therefore, for some time they should be protected otherwise they would be de-stroyed by foreign competition.

4. Anti-dumping Argument:

The other important argument for protection is that foreign producers compete unfairly by dumping the goods in another country. Dumping is a form of price discrimination when producers of a country sell goods in another country at lower prices than those charged at home. Of course, consumers in a country in which foreign goods are dumped are beneficiaries, the industries of that country suffer as they are unable to compete with the 'dumped goods'.
Besides, there is more harmful 'predatory dumping' which implies that foreign firms try to sell goods in other countries even below cost to establish a worldwide monopoly by driving competitors out of the market. Once the local industries are competed out, they raise prices to obtain monopoly profits.

5. Correcting Balance of Payments Deficit:

Correcting deficit in balance of payments is also mentioned as justification for imposing tariffs to restrict imports or fixing of quotas of imports. This appears to be a valid argument for providing protection.
However, in our view the solution for fundamental disequilibrium in the balance of payments lies in the adoption of suitable adjustment in exchange rate, appropriate fiscal and mon-etary policies to lower domestic prices so as to encourage exports. The deficit in balance of pay-ments can be reduced by ensuring rapid growth in exports of a country.

6. Redistribution of Income:

Case for protection has also been built up on the ground that it can be used for making desirable redistribution of income from one section of society to another. Protection makes some people better off, while others worse off. By providing protection to domestic producers their profits can be raised at the expense of consumers who suffer a loss in consumer surplus as protection denies them consumption of low-priced imported goods. That is, protection redistributes income in favour of domestic producers.

In some countries one of the objectives of economic policy is to redistribute income from the rich to the poor. This can be done by imposing high tariffs on imports of goods considered to be luxury items and levying tariffs on exports of those goods which are considered as necessities. Higher import tariffs on luxuries will reduce the incomes of the rich as they would pay taxes to the Government. Similarly, higher taxes on exports of necessities ensure greater supplies of them in the domestic market which would lower their domestic prices and benefit the poor.

Instruments of Protection : Tariffs and Quotas

Despite many benefits of free trade, the various countries have put up barriers to trade to protect their domestic industries. A number of instruments are used to protect the domestic industries to free trade but most important are tariffs and quotas. Both tariffs and quotas can be imposed either on imports or exports but they are mostly imposed on imports. Barriers to exports are quite uncommon. We briefly explain below these tariff barriers:-

1. Tariffs:

Tariffs are excise duties imposed on imported goods. The objective of imposing tariffs may be either raising revenue for the Government or providing protection to the domestic industries. Therefore, two types of tariffs are distinguished:

(1) Revenue tariffs, and

(2) Protective tariffs.

Revenue tariffs are usually imposed on the imports of those products which are not produced domestically. Rates of revenue tariffs are generally small but yields a good revenue for the Government. Protective tariff, on the other hand are imposed to provide protection to the domestic producers from foreign competition. The rates of these tariffs are not so high as to completely prohibit their imports into a country. Rise in prices of their products as a result of imposition of tariffs, foreign producers lose their superior competitive power.

2. Import Quotas:

Import quotas are another instrument used to check free trade. Import quotas refer to the maximum quantities of goods which may be permitted to be imported during any period of time. They are also referred to as quantitative restrictions on imports. Quotas are more effective method of reducing trade than tariffs.

A given commodity may be imported in a relatively large quantity despite high tariffs but low quotas totally stop the imports of a commodity beyond the fixed quota of the commodity. Since international negotiations to reduce trade barriers have tended to focus on tariffs, the various countries have resorted to non-tariff barriers to free trade.