# FREE TRADE

Free trade may be defined as a policy of a government which does not discriminate against imports or interfere with trade by applying tariffs (to imports) or subsidies (to exports). In other words it is the unrestricted purchase and sale of goods and services between countries without the imposition of constraints such as tariffs, duties and quotas. Free trade enables nations to focus on their core competitive advantages, thereby maximizing economic output and fostering income growth for their citizens. The idea that free trade is welfare enhancing is one of the most fundamental doctrines in modern economics dating back at least to Adam Smith (1776) and David Ricardo (1816). But the policy of free trade has been in controversy all the time because the countries were not taking choice between free trade and autarky (no trade). They always choose one policy from among a spectrum of free trade regimes with varying degrees of liberalization. Here are some arguments which are placed in favour of the free trade regime.

## 1. The theory of comparative advantage

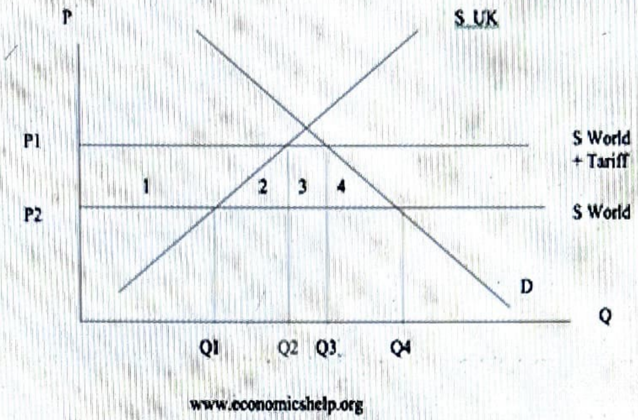
This explains that by specializing and trading goods in which countries have a lower opportunity cost or greater comparative advantage, there can be an increase in economic welfare for all countries. Free trade enables countries to specialize in those goods where they have a comparative advantage. Free trade in lines of comparative advantage is expected to mutually benefit the countries engaged in free trade.

## 2. Trade as a vent for surplus.

Trade is identified as a vent for surplus output of an economy. The dictum is related to Adam smith who identified the importance of division of labour. Smith also maintained that the division of labour is limited by the size of the market. Hence division of labour is expected to raise the domestic production. A deficiency in Aggregate demand may reduce the domestic prices. Here trade can act as a vent for surplus production brought forth through technology and division of labour. Free trade is expected to smoothen this process.

### 3. Reducing Tariff barriers leads to trade creation

Trade creation occurs when consumption switches from high cost producers to low cost producers. Reducing the tariff barriers with an objective to bring about free trade in an economy may help countries for trade creation. The following diagram explains the above idea.




- The removal of tariffs leads to lower prices for consumers and an increase in consumer surplus of areas 1 + 2 + 3 + 4
- Imports will increase from Q3-Q2 to Q4-Q1
- The government will lose tax revenue of area 3
- Domestic firms producing this good will sell less and lose producer surplus equal to area 1
- However overall there will be an increase in economic welfare of 2+4 (1+2+3+4 – (1+3)
- The magnitude of this increase depends upon the elasticity of supply and demand. If demand elastic consumers will have a big increase in welfare

### 4. Economies of Scale.

If countries can specialize in certain goods they can benefit from economies of scale and lower average costs. Economies of scale refer to the capacity of firms to change their output more than proportionately to changes in inputs. This is especially true in industries with high fixed costs or that require high levels of investment. The benefits of economies of scale will ultimately lead to lower prices for consumers. Lowering of trade restrictions enhances this outcome.

### 5. Increased Competition.

With more trade domestic firms will face more competition from abroad. As a result of this there will be more incentives to cut costs and increase efficiency. It may prevent domestic monopolies from charging too high prices.

**6. Trade is an engine of growth.**

World trade has increased by an average of 7% since the 1945, causing this to be one of the big contributors to economic growth.

**7. Make use of surplus raw materials**

Middle Eastern counties such as Qatar are very rich in reserves of oil but without trade there would be not much benefit in having so much oil. Japan on the other hand has very few raw material without trade it would be very poor.

**8. Tariffs encourage inefficiency**

If an economy protects its domestic industry by increasing tariffs industries may not have any incentives to cut costs. Trade liberalization is often justified in terms of the efficient market outcome and efficient price fixation through a competitive price fixing mechanism.

**Arguments against Free Trade**

1. **Infant Industry Argument:** Governments are sometimes urged to support the development of infant industries, protecting home industries in their early stages, usually through subsidies or tariffs. Subsidies may be indirect, as in when import duties are imposed or some prohibition against the import of a raw or finished material is imposed. If developing countries have industries that are relatively new, then at the moment these industries would struggle against international competition. However if they invested in the industry then in the future they may be able to gain Comparative Advantage.
2. **The Senile industry argument:** If industries are declining and inefficient they may require large investment to make them efficient again. Protection for these industries would act as an incentive to for firms to invest and reinvent themselves. However protectionism could also be an excuse for protecting inefficient firms
3. **To diversify the economy:** Many developing countries rely on producing primary products in which they currently have a comparative advantage. However relying on agricultural products has several disadvantages. One of the most important determinants of Agricultural Prices is the environmental factors. Hence they can fluctuate with climatic changes. Agricultural commodities have a low income and price elasticity of demand. Therefore with proportionate rise in economic growth will lead to less than proportionate rise in demand. Agricultural commodities have relatively low price elasticity of supply. A proportionate rise in prices will lead to less than proportionate rise in supply of agricultural commodities. This is because of the time lag involved in the production of agricultural goods. This is given by the fact that the production of agricultural goods at time *t* is determined by the prices prevailing in time '*t-1*'.
4. **Raise revenue for the govt:** Import taxes and tariffs can be used to raise money for the government.

5. **Help the Balance of Payments:** Reducing imports can help the current account. However in the long term this is likely to lead to retaliation

6. **Cultural Identity:** This is not really an economic argument but more political and cultural. Many countries wish to protect their countries from what they see as an Americanization or commercialization of their countries

7. **Protection against dumping:** The EU sold a lot of its food surplus from the CAP at very low prices on the world market. This caused problems for world farmers because they saw a big fall in their market prices

8. **Environmental:** It is argued that free trade can harm the environment because Developing countries may use up natural reserves of raw materials to produce exportable commodities. Also countries with strict pollution controls may find consumers import the goods from other countries where legislation is lax and pollution allowed.