PENANG SANGAM HIGH SCHOOL

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LESSON NOTES –WEEK 18

Subject: Economics **Year:** 11

Strand: 4- International Trade **Sub Strand:** 4.2.1

Content Learning Outcome: Discuss Free Trade and Protectionism with its implications

Lesson Notes Free Trade versus Protectionism

- ✓ Free trade- trade without any trade barriers/ restrictions.
- ✓ Advantages.

1. Efficiency of Resource allocation

- Free Trade allows each country to specialize in production of those commodities in which it has the greatest comparative advantage. This means that countries produce commodities with least opportunity cost.
- Free Trade therefore involves most efficient allocation of resources in each country.
- This leads to higher productivity and increase in total world output of goods and services. As more goods and services become available to satisfy consumer demand, those countries engaged in free trade experience rising living standards, increased real income and higher rates of economic growth.

2. Higher Living Standards

- Free Trade promotes higher living standards by encouraging both imports and exports.
- On the import side, free trade gives each nation unrestricted access to goods and services produced by other nations.
- By increasing the quality and variety of goods and services available to the domestic consumers, producer's free trade improves both present and future living standards. Increased exports on the other hand can improve domestic living standard.

3. Increasing Domestic Employment

- When other nations buy locally produced goods there is greater demand for domestic resources. This increases in demand, provides either new employment opportunities to idle resources or the incentives to improve productivity.
- Giving domestic producers accesses to larger market. This encourages large scale production which in turn results in economies of scale and increased profit.

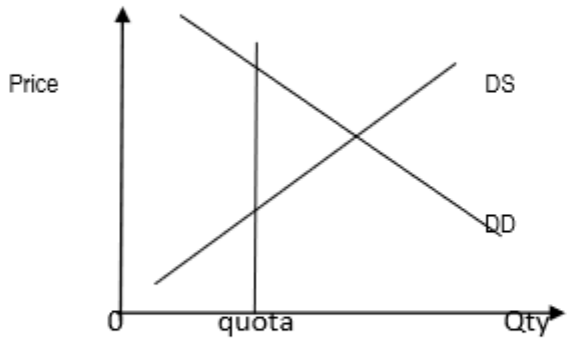
4. Greater Competition

- Free trade gives overseas producers unrestricted access to local markets. This represents greater competition of domestic producers and has the added advantage of the development and expansion of local monopolies.
- Consumers also gain from the lower prices of goods and services. The increased competition arising from free trade has several other important implications.

Despite the benefits of free trade government of all nations protect their domestic industries. Protection occurs when the artificial advantage is given to domestic firms facing competition from foreign producers.

- ✓ Protection- trade with trade barriers/ restrictions
- ✓ Forms Of Protection
  1. Quota
  2. Embargo
  3. Subsidies
  4. Local content rule
  5. Quarantine regulations
  6. Voluntary restraint
  7. Tariffs

1. Import Quotas
   - A quota is the most serious type of restriction since it generally takes the form of physical limit to the quantity of commodity which is allowed to enter the country.
   - Quota brings in no revenue to the state and foreign producers cannot overcome them by reducing the prices, as they might do in the case of tariff.



Quota

2. Embargo
   - An embargo is total ban on imports or exports of a commodity. In some cases it gives a local producer a monopoly in the domestic market. In Fiji, embargos are placed on goods that are considered to be socially undesirable e.g. narcotics.
   - It is used to protect the future of domestic industries i.e. by safeguarding certain stocks of commodities. E.g. Australia totally banned export of iron ore and merino sheep in order to safeguard the stock level.

3. Subsidies
   - Cash payments made by the government to local firm in order to encourage domestic production are called subsidies. A Subsidy offsets the domestic firm's high production and is the difference between the price consumers pay and the cost incurred by the producers. The lower selling price allows local producers to compete more favourably with foreign competition. Subsidies are generally preferred to tariffs for a number of reasons. These include:

   a. Subsidies are part of government expenditure and as such are reviewed annually in the government budget. Tariffs do not face the same review and tend to become permanent.

b. Consumers receive the same quantity at the same price when a subsidy is used. Tariff raises the price of the goods and lowers consumers demand.

c. A tariff is a regressive tax. Subsidy is paid out by government which is mainly collected through progressive income tax.

4. Local Content Rule

- Local content rule require that certain goods be constructed with a specified minimum % of locally produced components.

5. Quarantine Regulations

- The purpose of this barrier is to prevent the international spread of diseases. However the cost and delays of this restriction temporarily gives local producers an artificial advantage over imports.

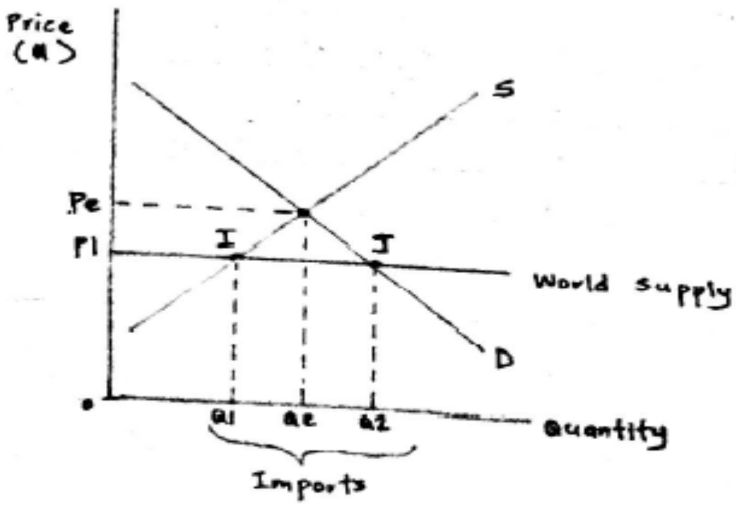
6. Voluntary Restraint

- Involves agreement between national governments and foreign suppliers. Governments may enter onto such agreement in order to avoid the imposition of tariffs and quota.

7. Tariff

- Is tax on imported goods. Tariff raising the prices of imports results in locally produced goods become more competitive in the domestic market and domestic producers increase their share of the market at the expense of foreign producers.

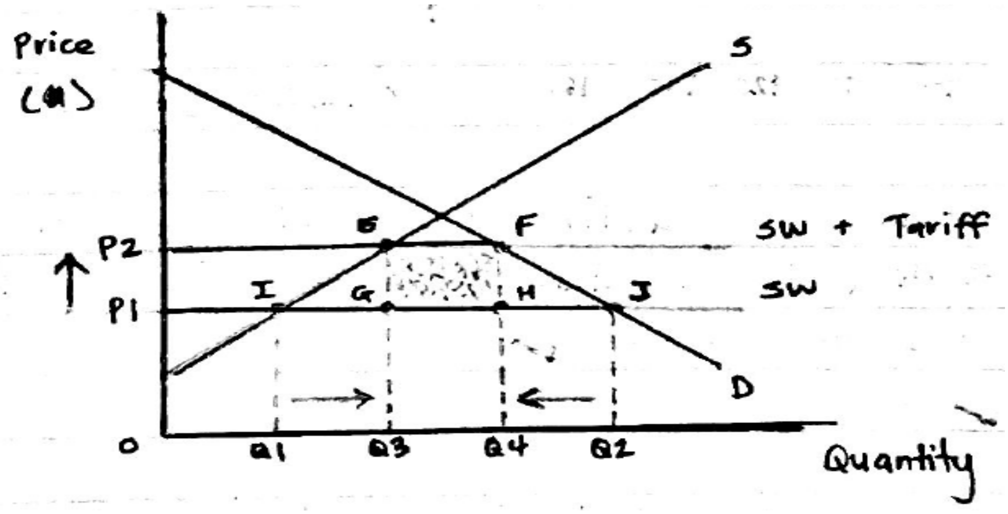
Before Imposition of Tariff



Interpretation

1. Without trade the equilibrium price is Pe, and quantity Qe.
2. World price is at P1. (Free trade leads to fall in domestic market price).
3. At P1, local producers are willing to supply Q1 units but the demand is Q2. Therefore, the difference of Q1 and Q2 (Q2-Q1) is met by imports.
4. Amount received by domestic producers is 0PI I Q1 which Q1 I J Q2 goes to foreign producers.

Effects of Imposition of Tariff



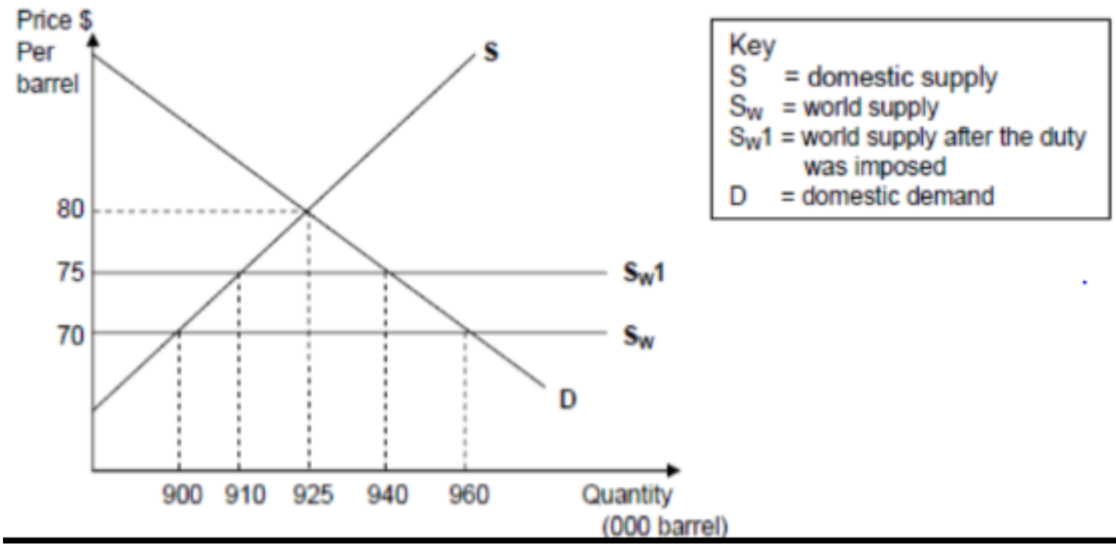
Interpretation

1. Tariff per unit is the difference between (P2 – P1).
2. Domestic production increases from Q1 to Q3. This is referred as protective effects of tariff.
3. Domestic consumption level decreases from Q2 to Q4.
4. The effects of domestic protective and consumption effects gives rise to trade. The trade effect is reduction in imports from Q1 Q2 and Q3 Q4.
5. Tariffs earn revenue for the government. Tariff revenue is area GEFH or (P2 – P1) X (Q4 –Q3).
6. Sales revenue for domestic producers increases from 0P, IQ to 0P2 EQ3.
7. Foreign exchange earnings of overseas producers fall from Q, I J Q2 to Q3 G H Q4.

Tax Concessions and Export Incentives

Tax concession is simply a special tax deduction granted to domestic producers to encourage them to be more competitive with foreign firms.

Class Activity



i. Identify the equilibrium quantity and price of oil in Pacifica. Initially assume that Pacifica is a close economy with no free trade.
ii. From the graph assuming that Pacifica trades with other countries, calculate the following :
   a) Total consumer expenditure before imposing import duty.
   b) The quantity of oil imported after imposing import duty.
   c) The total government revenue rose from oil import duty.
iii. Explain why the world supply curve (Sw) is drawn as a horizontal line.

- ✓ Reasons for Protection / Arguments for Protection

1. Infant Industry Argument- To protect infant industries from foreign competition.

2. Promoting Domestic Employment-protection such as tariff gives consumers an incentive to substitute locally produced goods for imported goods. ↑in demand for locally produced goods increases local employment opportunities.

3. Prevention of Dumping-this occurs when foreign producers sell goods on domestic market at prices which are below their own production costs.

4. Cheap Foreign Labor Argument-local producers require protection because they cannot compete with cheap foreign labour.

5. Diversification-the argument is that a diversified economy is one which is more flexible and more capable of adjusting the changes demanded by a competitive international environment.

6. Military Self-Sufficiency – The Defence Argument.

- ✓ Effects/ Arguments against Protection

1. Misallocation of Resources

All forms of protection involve transfer of resources from efficient industries to inefficient ones. Industries that are productive and competitive levels are effectively disadvantaged to give assistance to less productive and uncompetitive industries. This misallocation of resources means that scarce resources are wasted and hence output in the economy is less than it could be. That means lower living standards and lower rates of economic growth.

2. Inflationary Effects

Protection especially in the form of tariffs raises the price of imports and allows domestic producers to maintain the high price of their goods and services.
The higher prices are left by both producers and consumers in other industries unless demand for imported goods is highly inelastic, consumers react to the increased prices by lowering consumption levels

3. Redistribution of Income

The reallocation of resources brought about by protection, necessarily means a redistribution of income in the economy. Protection increases the profitability of inefficient industries. Moreover the higher prices paid by consumers as a result of protection means a redistribution of income away from consumers and towards producers in protected industries.

4. Reduced Incentive to Innovate

Protection shields domestic industries from competition. Without competition the pressure on domestic industries to respond to changing demand patterns and to introduce new methods of production and technological advances is weakened.

5. Decreased Welfare

Protection result in higher cost, lower productivity, inefficient use of scarce resources, less consumer choice, lower consumer demand, decrease in demand for exports, redistribution of income and reduced international competitiveness. In the long run, therefore protection leads to a fall in living standards and lower rate of economic growth. The overall effect is a decrease in the general level of welfare in the economy.

6. Retaliation Effect

Protection of import competing industries can adversely affect export industries by lowering demand from trading partners.