Is Domestic Market Protection to the Advantage of Most People in the Country?

Before answering this question, it is necessary to examine why two countries may choose to trade with each other in the first place. The main reasons for the existence of free trade are as follows:

- Firstly, consumers within the countries concerned gain an increased choice; there may be goods which one country is unable to produce due to a lack of technology, the wrong climate, or other such reasons.
- Secondly, economies of scale may be achieved from specialisation within countries. This will be covered in detail under absolute and comparative advantage theories later in the essay.
- Trade will also give both countries access to larger markets; this advantage is usually greater for one country. If, for example, the USA was to trade with Monaco, Monaco's firms would benefit from a huge increase in demand, while the USA's would hardly notice the difference.
- Fourthly, the increased competition from abroad will probably erase all the problems associated with domestic monopolies, as it is possible that the barriers to entry for new firms may be broken by large foreign companies. Competition will also force the world to be more efficient.
- The fifth reason concerns the varying prices (or opportunity costs) of factors of production; again, this will be discussed later.
- There are various political advantages as well, but these will not be discussed here since they have little impact on the economics of the argument.

Before we explore the two main trade theories, certain assumptions must be made: there is full employment of factors in all countries, there are no transport costs, there is sufficient demand to allow increased production, there is perfect factor mobility within countries, but factors are immobile between countries, and there are always constant returns to scale.

The model used must also be explained. It looks at a case where there are two countries producing two goods, and initially each country employs half of its factors in each industry.

Absolute advantage theory explains why countries may wish to trade if each produces more of a different good initially. If, for example, country A (say, France) produced 40 units of wine and 10 units of beer, and country B (Germany) produced 20 units of wine and 30 units of beer, it can be seen that initially the world produces 60 units of wine and 40 units of beer. By using trade to effectively join the countries' economies together, each can specialise in what they are best at; in this case, France is better at producing wine, and Germany is best at making beer. If they were to invest all of their factors in wine making, France could produce 80 units of wine (and no beer); note here that the assumption of constant returns to scale is important. Similarly, Germany could produce 60 units of beer alone. The total production can be seen to have risen by 20 units of beer and 20 units of wine, and so the world, as a whole, is better off.

Comparative advantage theory is similar to this, but it explains why trade is theoretically advantageous even if one country is better at producing both goods, and both countries are best at producing one of the two goods. An example here shall involve China and India, and the goods produced shall be maps of Asia, and Union flags. Obviously, China, being the largest economy, will have an absolute advantage in both goods, and we shall assume that both countries are better at producing maps than flags. We shall say that China initially has a production of maps and flags of 200 units and 50 units respectively, and India's production shall be of 20 units of maps and 10 units of flags before trade. The world totals of maps and flags are therefore 220 units and 60 units, in that order. It is important to note that the ratios of maps to flags are different for the two countries; if they were not, trade would not be economically advantageous.

India can be seen to be better at producing flags than China; for every flag it makes, it has to give up two maps, while China has to sacrifice four. We can therefore deduce that India specialises in flags. By using 100% of its factors in this industry, India produces 20 units of flags. China specialises in maps, and produces 400 units.

This does not, however, prove anything – the only way to draw a conclusion is to show that the world is now producing more than was possible before trade. To show this, we must increase the world's production of flags to the initial level. The only way to do this is to put some of China's factors back into the industry, and they must produce 40 units (to bring the world total to 60, as it was initially). Since 50% of China's factors initially produced 50 units, and there are constant returns to scale, 40% of the factors will need to be employed in making flags in our world after trade. This will leave 60% of China's factors producing maps, and given that 50% produced 200 units, we can find that 60% will produce 240 units. Thus the world is better off to the tune of 20 units of Asian maps.

This is, obviously, a simplified model of trade. It was developed by David Ricardo in the early 19th Century, yet despite its simplicity it forms the basis for all trade theories today.

A good few of the reasons why trade may not be absolutely desirable all relate to this theory, and are all mainly criticisms of the assumptions made. While absolute advantage theory has large gains and can survive without some of the assumptions, comparative advantages result in smaller gains, and thus are more dependant.

Firstly, trade may not take place if transport costs are high, relative to the price of the good. If a rational consumer was given the choice between domestically-produced paper at, say, £10 for 1,000 sheets, or imported paper of a similar quality at £20 for 1,000 sheets (the extra £10 being due to transport costs), there would be no demand for imports, and thus no trade.

Demand cannot be assumed to be at a perfect value, either. If demand is less that ideal, one country may not specialise completely, in order to satisfy demand. However, it is only important that there is excess demand in one good, not both. If one good is fully satisfying demand at the initial allocation, trade only needs to increase production of the other good.

Factors of production are seldom perfectly mobile (both occupationally and geographically), and full employment is not a necessarily true assumption (although monetarists would argue that it is in the long term!). Given these two facts, we can see that trade will lead to long term structural unemployment, and it can therefore be argued that trade is absolutely disadvantageous in this case.

Finally, it is unlikely that countries will experience constant returns to scale. While economies of scale are possible, it is far more likely that diseconomies will develop of a considerable size, thus losing a country its comparative advantage.

There are a number of disadvantages of trade, which tend to lead to the erection of trade barriers, and thus these are the points that will mostly influence any final decision on a conclusion to the essay question.

Political reasons are a major factor. If there is a threat of war, countries may wish to remain self sufficient (for obvious reasons). Also, during a war, or immediately following one, trade is exceptionally unlikely between opposing nations – the exception would be in the case of humanitarian aid and trade concessions for surrender.

If an industry is in its infancy, it could be damaging to allow heavy competition from abroad. Thus trade barriers may be set up in order to encourage growth in that industry. This basis for protectionism is called the infant industry argument, and before barriers are erected, governments are advised to determine whether the industry would be likely to develop increasing returns to scale given time to develop, and thus be able to compete with foreign firms.

Protection is often needed against other countries' 'dirty tricks'. Among these is the process of dumping, where exporters attempt to sell their produce off at less than cost price, in order to kill off domestic industry, and thus obtain a long-term monopoly. There are other reasons for dumping, such as for political or charitable reasons, or, indeed, due to a high demand for the importing country's currency.

The decreasing returns to scale produced by specialisation may cause long term economic disruption if firms aim for short-term profits, and this also applies for any production causing externalities. The varying value of goods may also discourage trade and cause national economic problems, as countries specialising in raw materials are unlikely to be able to become relatively rich; raw materials, by their very nature, do not encourage large profits.

If the comparative advantage is not apparent, due to inaccuracies in how exchange rates reflect production costs, trade will, again, seem undesirable. Any lack of full information could, in fact, lead to a situation where trade is carried out even if it is not advantageous to the world as a whole, with countries specialising in the wrong good.

Finally, gains from trade may not be evenly distributed between countries; trade barriers could help redistribute income from exports so gains were similar.

Given that there are so many arguments against trade, why is it that all countries do not have trade barriers against all others? The reasons lie with the disadvantages of tariffs, quotas, and other barriers.

Trade barriers encourage factor immobility, and increased inefficiency in domestic industries, due to a lack of competition. This could, however, be cured by making trade barriers short term, and other methods being used to increase mobility.

Also, trade barriers can also disrupt political agreements, causing war, which lowers standards of living considerably. Barriers may lead to both political and economic retaliation from other countries; the reduction in exports here may lead to unemployment, and thus can be considered unwanted.

There can therefore be no real answer to the essay question; the desirability of protection will depend on many independent factors, such as the degree to which structural unemployment is effected by competition, or the likelihood of war. However, in general, domestic protection is not to the advantage of the population of the country; the six main advantages mentioned in the first section outweigh all criticisms, and thus trade is advantageous. This can be seen from the abundance of trade in the world today, and the way in which trade barriers are steadily being eroded.

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