Name: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ Period# \_\_\_ Topic 7.6 – Trade and World Economy

**What Is Free Trade? Definition, Theories, Pros, and Cons**

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**Read the following article & answer the critical reading questions in the right column, in your own words!**

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| In the simplest of terms, free trade is the total absence of government policies restricting the import and export of goods and services. While economists have long argued that trade among nations is the key to maintaining a healthy global economy, few efforts to actually implement pure free-trade policies have ever succeeded. What exactly is free trade, and why do economists and the general public view it so differently?  Key Takeaways: Free Trade   * Free trade is the unrestricted importing and exporting of goods and services between countries. * The opposite of free trade is protectionism—a highly-restrictive trade policy intended to eliminate competition from other countries. * Today, most industrialized nations take part in hybrid free trade agreements (FTAs), negotiated multinational pacts which allow for, but regulate tariffs, quotas, and other trade restrictions.   **Free Trade Definition**  A tariff is a tax imposed by a government of a country or of a supranational union on imports or exports of goods. Besides being a source of revenue for the government, import duties can also be a form of regulation of foreign trade and policy that taxes foreign products to encourage or safeguard domestic industry  Free trade is a largely theoretical policy under which governments impose absolutely no [tariffs, taxes, or duties](https://www.thoughtco.com/the-economic-effect-of-tariffs-1146368) on imports, or quotas on exports. In this sense, free trade is the opposite of [protectionism](https://www.thoughtco.com/protectionism-definition-and-examples-4571027), a defensive trade policy intended to eliminate the possibility of foreign competition.  In reality, however, governments with generally free-trade policies still impose some measures to control imports and exports. Like the United States, most industrialized nations negotiate “[free trade agreements](https://www.trade.gov/fta/),” or FTAs with other nations which determine the tariffs, duties, and subsidies the countries can impose on their imports and exports. For example, the [North American Free Trade Agreement](https://ustr.gov/trade-agreements/free-trade-agreements/north-american-free-trade-agreement-nafta) (NAFTA), between the United States, Canada, and Mexico is one of the best-known FTAs. Now common in international trade, FTA’s rarely result in pure, unrestricted free trade.  In 1948, the United States along with more than 100 other countries agreed to the [General Agreement on Tariffs and Trade](https://www.thoughtco.com/us-government-4133021) (GATT), a pact that reduced tariffs and other barriers to trade between the signatory countries. In 1995, GATT was replaced by the [World Trade Organization](https://www.wto.org/) (WTO). Today, 164 countries, accounting for 98% of all world trade belong to the WTO.  Despite their participation in FTAs and global trade organizations like the WTO, most governments still impose some protectionist-like trade restrictions such as tariffs and subsidies to protect local employment. For example, the so-called “[Chicken Tax](https://www.thoughtco.com/chicken-tax-4159747),” a 25% tariff on certain imported cars, light trucks, and vans imposed by President [Lyndon Johnson](https://www.thoughtco.com/lyndon-johnson-36th-president-united-states-104806) in 1963 to protect U.S. automakers remains in effect today.  **Free Trade Theories**  Since the days of the Ancient Greeks, economists have studied and debated the theories and effects of international trade policy. Do trade restrictions help or hurt the countries that impose them? And which trade policy, from strict protectionism to totally free trade is best for a given country? Through the years of debates over the benefits versus the costs of free trade policies to domestic industries, two predominant theories of free trade have emerged: mercantilism and comparative advantage.  **Mercantilism**  Mercantilism is the theory of maximizing revenue through exporting goods and services. The goal of mercantilism is a favorable [balance of trade](https://www.thoughtco.com/history-of-the-us-balance-of-trade-1147456), in which the value of the goods a country exports exceeds the value of goods it imports. High tariffs on imported manufactured goods are a common characteristic of mercantilist policy. Advocates argue that mercantilist policy helps governments avoid trade deficits, in which expenditures for imports exceeds revenue from exports. For example, the United States, due to its elimination of mercantilist policies over time, has suffered a [trade deficit](https://www.thoughtco.com/history-of-the-us-balance-of-trade-1147456) since 1975.  Dominant in Europe from the 16th to the 18th centuries, mercantilism often led to colonial expansion and wars. As a result, it quickly declined in popularity. Today, as multinational organizations such as the WTO work to reduce tariffs globally, free trade agreements and non-tariff trade restrictions are supplanting mercantilist theory.  **Comparative Advantage**  Comparative advantage holds that all countries will always benefit from cooperation and participation in free trade. Popularly attributed to English economist David Ricardo and his 1817 book “Principles of Political Economy and Taxation,” the law of comparative advantage refers to a country’s ability to produce goods and provide services at a lower cost than other countries. Comparative advantage shares many of the characteristics of [globalization](https://www.thoughtco.com/what-is-globalization-3310370), the theory that worldwide openness in trade will improve the standard of living in all countries.  For example, England was able to manufacture cheap cloth. Portugal had the right conditions to make cheap wine. Ricardo predicted that England would stop making wine and Portugal stop making cloth. He was right. England made more money by trading its cloth for Portugal's wine, and vice versa. It would have cost England a lot to make all the wine it needed because it lacked the climate. Portugal didn't have the manufacturing ability to make cheap cloth. Therefore, they both beneﬁted by trading what they produced the most eﬃciently: Portugal had the comparative advantage in wine, England had the comparative advantage in cloth.  This theory of comparative advantage became the rationale for free trade agreements. Ricardo developed his approach to combat trade restrictions on imported wheat in England. He argued that it made no sense to restrict low-cost and high-quality wheat from countries with the right climate and soil conditions. England would receive more value by exporting products that required skilled labor and machinery. It could acquire more wheat in trade than it could grow on its own.  The theory of comparative advantage explains why trade protectionism doesn't work in the long run. Political leaders are always under pressure from their local constituents to protect jobs from international competition by raising tariﬀs. But that’s only a temporary ﬁx. In the long run, it hurts the nation's competitiveness. It allows the country to waste resources on unsuccessful industries. It also forces consumers to pay higher prices to buy domestic goods.  Diversity also helped the United States became a global leader in banking, aerospace, defense equipment, and technology. Silicon Valley (the California region known for its technological innovations & businesses,) harnessed the power of diversity to become a leader in innovative thinking. Those combined advantages created the power of the U.S. economy. Investment in human capital is critical to maintaining a comparative advantage in the knowledge-based global economy. Unfortunately, the United States is falling behind other developed nations.  **Pros and Cons of Free Trade**  Would pure global free trade help or hurt the world? Here are a few issues to consider.  **5 Advantages of Free Trade**   * It stimulates economic growth: Even when limited restrictions like tariffs are applied, all countries involved tend to realize greater economic growth. For example, the [Office of the US Trade Representative](https://ustr.gov/) estimates that being a signatory of NAFTA (the North American Free Trade Agreement) increased the United States’ economic growth by 5% annually. * It helps consumers: Trade restrictions like tariffs and quotas are implemented to protect local businesses and industries. When trade restrictions are removed, consumers tend to see lower prices because more products imported from countries with lower labor costs become available at the local level. * It increases foreign investment: When not faced with trade restrictions, foreign investors tend to pour money into local businesses helping them expand and compete. In addition, many developing and isolated countries benefit from an influx of money from U.S. investors. * It reduces government spending: Governments often subsidize local industries, like agriculture, for their loss of income due to export quotas. Once the quotas are lifted, the government’s tax revenues can be used for other purposes. * It encourages technology transfer: In addition to human expertise, domestic businesses gain access to the latest technologies developed by their multinational partners.   **5 Disadvantages of Free Trade**   * It causes job loss through outsourcing: Tariffs tend to prevent job outsourcing by keeping product pricing at competitive levels. Free of tariffs, products imported from foreign countries with lower wages cost less. While this may be seemingly good for consumers, it makes it hard for local companies to compete, forcing them to reduce their workforce. Indeed, one of the main objections to NAFTA was that it outsourced American jobs to Mexico. * It encourages theft of intellectual property: Many foreign governments, especially those in developing countries, often fail to take intellectual property rights seriously. Without the protection of [patent laws](https://www.thoughtco.com/guide-to-patent-rights-and-ownership-1992248), companies often have their innovations and new technologies stolen, forcing them to compete with lower-priced domestically-made fake products. * It allows for poor working conditions: Similarly, governments in developing countries rarely have laws to regulate and ensure safe and fair working conditions. Because free trade is partially dependent on a lack of government restrictions, women and children are often forced to work in factories doing heavy labor under slave-like working conditions. * It can harm the environment: Emerging countries have few, if any environmental protection laws. Since many free trade opportunities involve the exporting of natural resources like lumber or iron ore, clear-cutting of forests and un-reclaimed strip mining often decimate local environments. * It reduces revenues: Due to the high level of competition spurred by unrestricted free trade, the businesses involved ultimately suffer reduced revenues. Smaller businesses in smaller countries are the most vulnerable to this effect.   In the final analysis, the goal of business is to realize a higher profit, while the goal of government is to protect its people. Neither unrestricted free trade nor total protectionism will accomplish both. A mixture of the two, as implemented by multinational free trade agreements, has evolved as the best solution.  \*Complementarity: When both people/countries possess goods/services wanted by the other. It makes trade more desirable & helps establish a basis for trade. | 1. What is free trade?  2. What are tariffs & why would a govt. impose them?  3. Explain how free trade agreements, such as NAFTA, benefit a country.  4. Why would countries choose to participate in free trade agreements or groups like the World Trade Organization?  5. How might implementing tariffs impact a state’s trade balance?  6. How does the theory of comparative advantage support the idea of free trade agreements?    7. Explain how comparative advantage & globalization are connected.  Outsourcing: contracting work out to independent companies to do work for less money  8. Explain how eliminating tariffs increases outsourcing.  9. Explain how outsourcing increases globalization.  10. Analyze what might happen when complementarity does not exist between countries. |

\*\*Neoliberal policies, (economic philosophy that is characterized by free trade, privatization, and deregulation,) including free trade agreements, have created new organizations, spatial connections, and trade relationships that foster greater globalization.

Briefly summarize the purpose/goals of these supranational organizations, including member states/regions.

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| EUROPEAN UNION | WORLD TRADE ORGANIZATION |
| MERCOSUR: Market of the South (South American trade bloc) | OPEC |