Edexcel Economics A-level

Unit 4: The Global Economy

Topic 2: Trade and the World Economy

2.5 Restrictions on free trade

Notes

- **Reasons for restrictions on free trade:**

- Protectionism is the act of guarding a country's industries from foreign competition, by imposing restrictions on free trade.

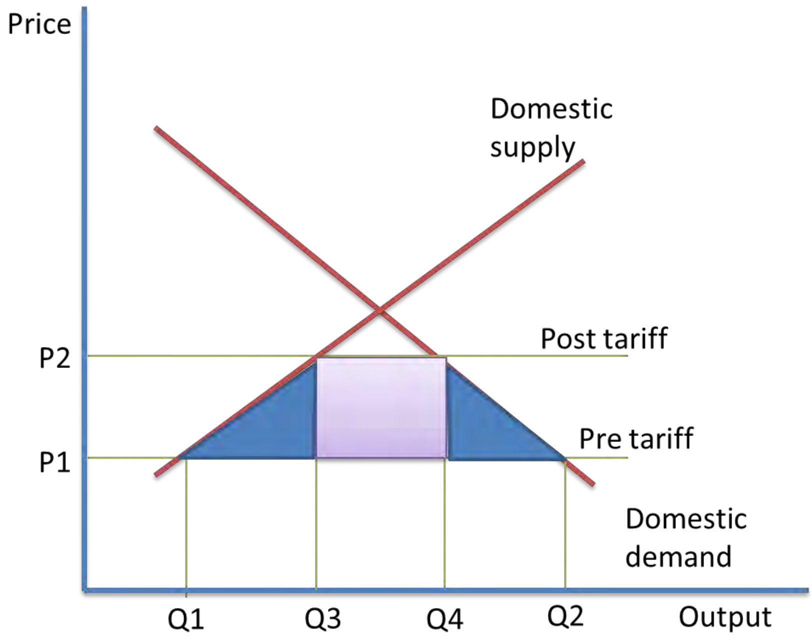
- If a country employed several protectionist measures, then a trade deficit would reduce. This is because they will be importing less due to tariffs and quotas on imports.
- Infant industries might need protecting. These are industries which are relatively new and need support. Protectionism is usually short term until the industry develops, at which point the industry can trade freely. It is based on the concept of new industries facing high start-up costs, which fall as the industry develops. In order to help the industry survive, it receives support.
- Protectionism could be used to correct market failure. It can deal with demerit goods and protect society from them.
- Governments might want to protect domestic jobs and avoid them being offshored.
- Some countries might impose trade restrictions as a form of retaliation against trade barriers imposed by other countries.

- **Types of restrictions on trade:**

  - **Tariffs**

Tariffs are taxes on imports to a country. It could lead to retaliation, so exports might decrease. The impact of tariffs is that the quantity demanded of domestic goods increases, whilst the quantity demanded of imports decreases.

Tariffs result in higher prices for consumers and a loss in consumer surplus.



The tariff diagram illustrates the effects of imposing a tariff. The original quantity of imports is Q2 – Q1, and the new quantity of imports is Q4 – Q3.

The purple shaded rectangle shows the revenue the government gains from imposing the tariff. This could help finance government expenditure.

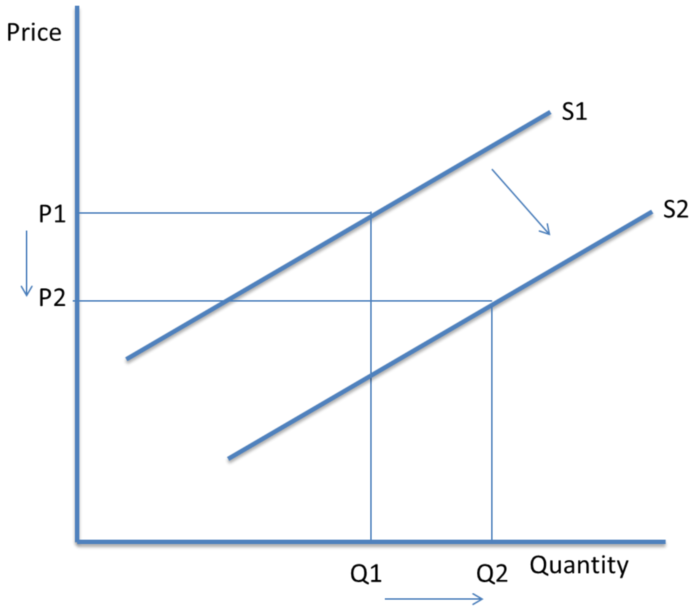
The two blue triangles show the area of deadweight loss of welfare, as a result of the tariff.

- **Quotas**

A quota limits the quantity of a foreign produced good that is sold on the domestic market. It sets a physical limit on a specific good imported in a set amount of time. It leads to a rise in the price of the good for domestic consumers, so they become worse off.

- **Subsidies to domestic producers**

This makes domestic goods relatively cheap compared to imports. It encourages domestic production to increase, as shown by a right shift in the supply curve, and the average price falls.



However, it depends how the subsidy is spent. In the EU, the Common Agricultural Policy subsidises domestic farming. This helps the UK retain some sort of primary sector. The subsidy might encourage a surplus to be produced, which could be wasteful. It also depends on government finances, and it should be considered whether the industry is worth subsidising or not.

Non-tariff barriers

○ Voluntary export restraints (VERs)

This is when two countries make an agreement to limit the volume of exports to one another over a period of time. They are used when governments want to protect domestic industries from competing imports.

It is usually suggested by the exporting country, to avoid even less flexible trade barriers being imposed.

○ Embargoes

This is the complete ban on trade with a particular country. It is usually politically motivated.

- **Excessive administrative burdens (‘red tape’)**

Excessive administration increases the cost of trading, and hence discourages imports. It makes it difficult to trade with countries imposing red tape, and is particularly harmful for developing countries which are unable to access these markets. It is harder to notice this type of protectionism.

- **Impact of protectionist policies:**

- Protectionism could distort the market and lead to a loss of allocative efficiency. It prevents industries from competing in a competitive market and there is a loss of consumer welfare. Consumers face higher prices and less variety. By not competing in a competitive market, firms have little or no incentive to lower their costs of production.

- It imposes an extra cost on exporters, which could lower output and damage the economy.

- Tariffs are regressive and are most damaging to those on low and fixed incomes, which could increase income and wealth inequality. However, taxes could raise more revenue for the government, which could be used to redistribute income to the poor or improve public services.

- There is a risk of retaliation from other countries, so countries might become hostile.

- Protectionism could lead to government failure.