

Obstacles to Free Trade: Thrashing Protectionists' Logic ¹

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The beauty of trade and exchange

Trade and voluntary exchange is good and beautiful. One can be a good physician but he still has to look for a mechanic to repair his car, an architect to design his house, a plumber to repair a leaking faucet, a banker to manage his personal finance, a nanny to help with the kids, and so on. The more options an individual has in choosing people who can supply his needs given his limited budget and other resources, the more free that individual is. That is, a free individual has the freedom to choose; his choice is not restricted by someone, whether a bully or a government body, who limits him to whom he can exchange his products and services, in return for goods and services he needs that were produced by other people. This is consistent with the Hayekian definition of freedom and liberty -- the “absence of coercion, absence of external impediment”.

Hence, freedom to trade, freedom to exchange, is an inherent component of a free society and free individuals. Free trade is an excellent opportunity for people not to be complacent and to be innovative. Because people are always on the look out for something new – something modern or historic, something useful and cheap, something beautiful yet affordable. Yeah, people are happy when they find bargains -- cheap clothes, shoes, computers, fruits, drinks, furnitures, cell phones, and so on. They are happy when they have plenty of choices – products and services to exchange, to buy and sell. In this sense most people advocate free trade whether they know it or not.

When an average household in a rich country makes some \$300 of savings per month from buying cheap commodities from China, India, Mexico and other poorer countries, that household does not burn its savings. In one year it will make around \$3,600 of savings. Some guys may use that money to travel abroad and enjoy the beaches and bars, or mountain resorts and waterfalls, or shopping malls, of the tropics, creating jobs and income in poorer countries. Some guys will use the money to buy more imported tropical fruits and veggies, marine and livestock products, which again expands jobs in poorer countries. Others will use the savings of previous years to hire a nanny for their young kids, and those nannies from poorer countries will send their salaries back home, which finance the basic needs of their families. And all of those job creations from tourism, exports and income repatriation in poorer countries help alleviate poverty there.

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That is why "bargain-hunting" through free trade is a perfectly rational behavior of consumers. But such behavior is also considered "irrational" by some people who oppose free trade, that is why they restrict trade and majority of other people's freedom of whom and where they can buy, by how much quantities, etc.

Three groups of protectionists

We can classify the various shades of people who are allergic to free trade into 3 groups:

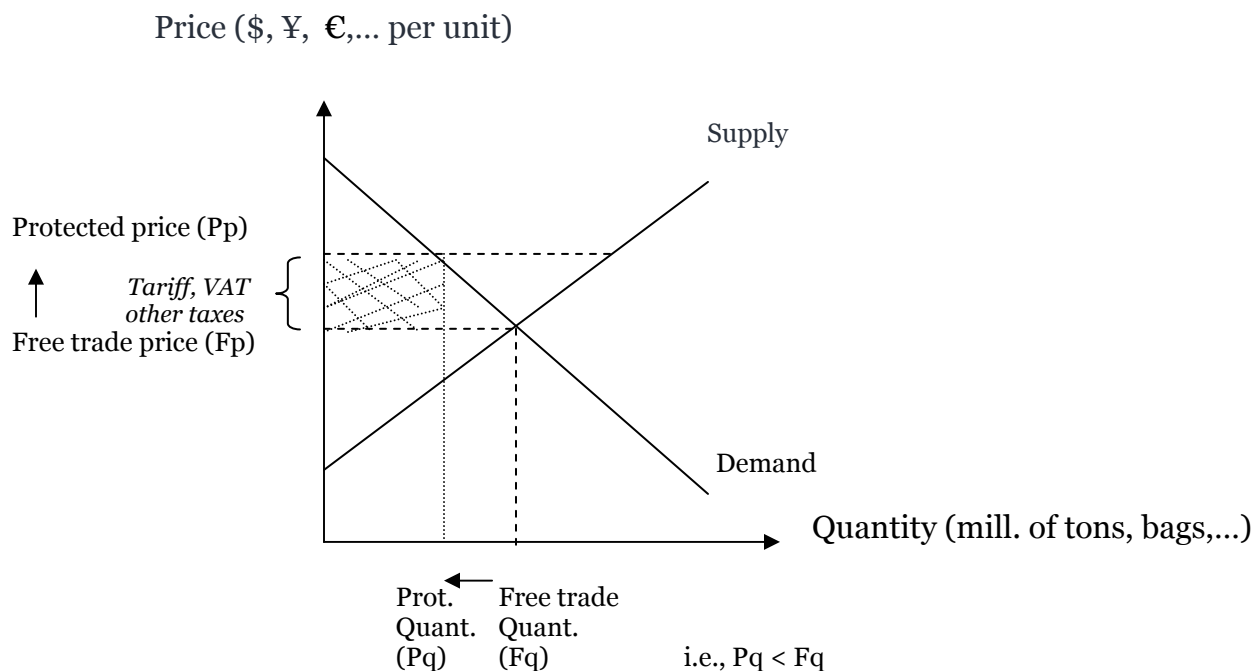
(1) The protectionist interests in the private sector, lobby for high tariffs and/or strict non-tariff barriers (NTBs). They want to restrict imports and competition from abroad, to deny local consumers of more choices, and make themselves among the few, if not the only, producers and distributors of certain goods and services needed by the people. Among the people in this category are the militant farmers and labor unions, domestic manufacturers and professionals.

(2) The paranoid to competition in civil society and NGOs, lobby the same as above. Among the people in this category are the anti-globalization, anti-market, anti-capitalism, almost anti-everything NGOs, ideologues and media people. And yet many of them are globe-trotters.

(3) The bloated bureaucracy and politicians in big governments, including trade negotiators. They listen to noisier, more organized groups, especially #1 and 2 above, despite the fact that everyone in this planet is a consumer. They are addicted to collecting large amounts of import taxes to help finance bloated bureaucracies. And most notably, corrupt leaders benefit from high tariffs, NTBs and bureaucratic paper work, so that some importers and traders will be forced to bribe them in exchange for letting in the restricted commodities.

Groups 1 and 2 are voluntary associations and are highly organized, while Group 3 is an imposed body that has both the law and the guns to implement its rulings. To further understand these 3 groups, consider this graph below.

Graph 1: Effect of Tariff, VAT, other import-related taxes on the price of imported products



Group 1 (protectionist interests) become successful in lobbying to raise the price of imported goods, making these as expensive, if not more expensive, as their locally-produced products. Having Protected price (P_p) much higher than Free trade price (F_p), many consumers who would have patronized the imported goods are discouraged; but the protectionists get lower quantity of sales (P_q) as consumers buy less.

Group 2 (anti-competition lobbyists) feel good that they have helped those in Group 1 retain their businesses and jobs, despite the fact that they themselves also suffer from higher price and consume less.

Group 3 (government bureaucrats and politicians) get taxes, equivalent to:

$$\text{Taxes} = P_p - F_p,$$

$$\text{Tax revenues} = (P_p - F_p) \times P_q$$

(the shaded area in the graph above)

A big portion of these tax revenues goes to pay themselves. In the Philippines for instance, the shaded area comprises about 15 percent of total tax revenues of the national government. Hence, many of the bureaucrats would not care much that total quantity consumed by society as a result of taxes, P_q , is lesser than potential quantity under free trade, F_q .

In effect, the whole society in general is worse off with (a) higher prices and higher taxes, (b) lower quantity consumed, and (c) fewer choices. The minority (groups 1 to 3) benefit from the reduced welfare of the majority.

Most country trade representatives and negotiators do not realize and appreciate "net gains in trade". Take rice trade liberalization, rice being a highly political commodity in many Asian countries. When poor households including non-rice farmers (banana farmers, aquaculture farmers, and so on) save from buying cheaper imported rice than locally-produced rice, they do not burn their savings. They will use the money saved to increase their consumption of other goods and services -- more fruits and vegetables, more fishery and livestock products, have haircut more often, and so on. This price signal will alert some rice farmers to shift to other livelihood like vegetable farming, aquaculture, poultry and livestock farming, and so on. The job displacement is temporary but the economic efficiency of labor and resource re-allocation is more long-lasting.

Commodity price equalization

In international trade theory, globalization and free trade results over the long-term in "commodity price equalization" across countries; or if capital, labor and technology are highly mobile, free trade and globalization results in "factor price equalization". Only transportation cost between and among countries would spell the price difference. Of course, such equalization can be temporary as innovation and competition among enterprises is unceasing.

This means that countries that have surplus output (say, surplus rice in Thailand and Vietnam) will experience declining rice prices domestically if trade is restricted, while rice prices in countries that have low rice output relative to their population's needs (like the Philippines) will be high. Globalization and free trade reallocates resources and products from countries and places where they are abundant, to places and countries where they are scarce and needed. Such resource reallocation is reflected in commodity price (in this example, rice price) that is generally the same across many countries, adjusted for cost of living in those countries.

Consider three countries:

Country **A** has rice surplus production every year (wide and flat riceland, good irrigation, few typhoons, good technology, small population).

Country **B** has rice deficit every year (mountainous and degraded land, poor irrigation, lots of typhoons, poor technology, big population).

And country **C** produces no rice (industrialized and urbanized, imports many of its food requirement).

No trade or restricted trade among them, country A will have very low rice price because of over-supply. Country B will have expensive rice because of under-supply. And country C will have very expensive rice. With free trade, there should be rice price equalization among the 3 of them as whatever surplus in A will be bought and imported by B and C. If A suffers a bad harvest, then all three of them will have expensive rice price.

Graph 2: Commodity price equalization under free trade

Country: A (surplus, exports)

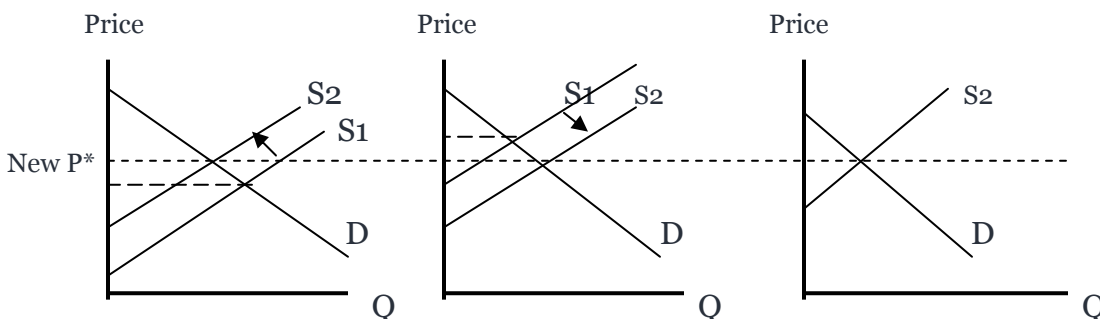
B (deficit, imports)

C (non-producer, imports)

Examples: Thailand, Vietnam

Phils., Japan

Singapore, Hong Kong



The global supply curve tends to move more flat in a regime of free trade and unhampered globalization. A flatter supply curve means a flatter price range (ie, small difference from the most expensive to the cheapest price of a commodity) across a wider and bigger supply of that commodity around the world.

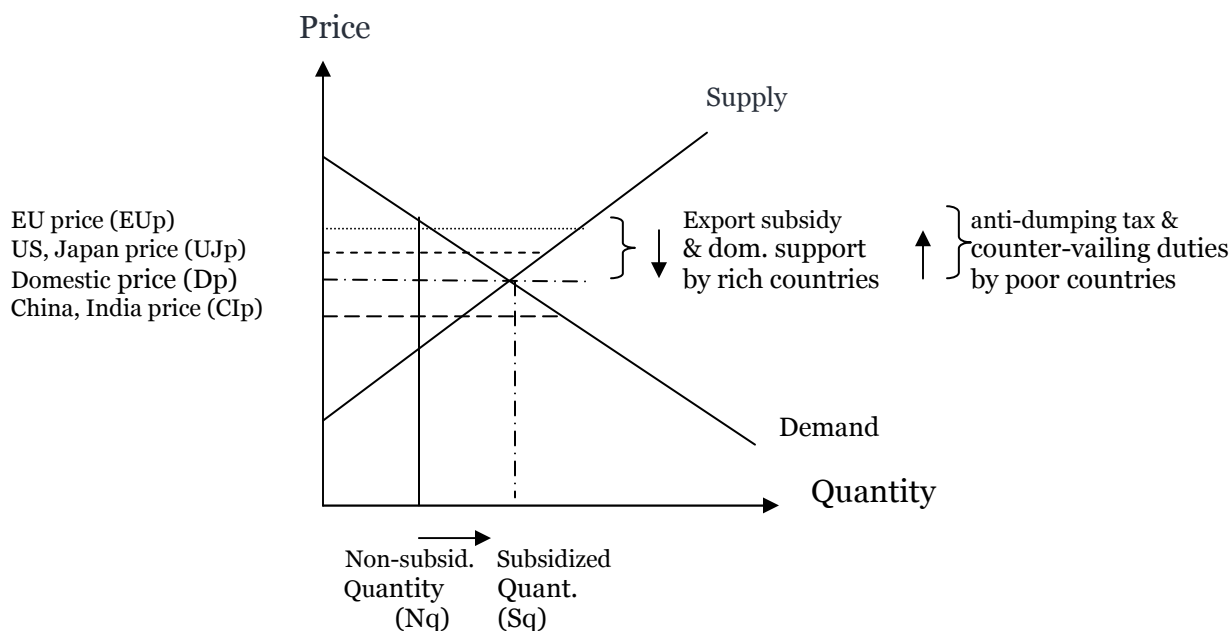
Thus, even in years and periods of robust global economic growth, globalization and free trade should result in modest price rise and stable single-digit inflation rate on average across the world. This is because for countries and places to further expand output, they will have to hire more workers and technology from other countries, import more production inputs (from agricultural raw materials to high-tech farm machineries) from other countries. The fast movement of inputs, intermediate goods and services, and final products around the globe will provide the momentum for such robust global growth to be sustained for several years. This is on the assumption of course that there are no adverse external interruptions like wars, terrorist attacks, and natural disasters.

The arrogance and deceit of exports and domestic subsidies

We now go to the debate on high agriculture subsidy, export subsidy, and domestic support in rich countries. The purpose of export subsidy is to make a subsidizing country's exports become cheaper and more affordable to buyers abroad, while paying their own farmers and manufacturers at higher price. Along the same protectionist line, the purpose of domestic support is to make locally-produced goods cheaper to local consumers so that their prices will be comparable to cheap imports from other countries, the poorer countries in particular.

Graph below will illustrate these points, though country examples are relatively hypothetical.

Graph 3: Effect of export subsidies and domestic support by governments of rich countries on the price of traded goods in poorer countries



The above graph shows why this kind of protectionism is crazy.

Governments of rich countries over-tax their citizens, a portion of taxes are used to finance export subsidies and/or domestic support to their farmers, agri-businessmen, other local producers. Taxing their citizens to subsidize buyers and consumers abroad, so that the latter will buy their products, hoping to extend the mantra of neo-mercantilist aspirations -- be an export powerhouse, minimize imports, and create/save more jobs at home.

Now, Groups 1-3 of people in poorer countries discussed above cry “dumping!” and “predatory pricing!” And so their governments institute so-called “fair trade laws”: anti-dumping tariff and counter-vailing duties. These taxes are supposedly equivalent to the subsidies paid by the governments of rich countries to their local farmers and producers. In short, make those supposedly cheap and subsidized imports become expensive again through those counter-vailing duties and taxes! Taxing their own citizens to make cheaper things expensive again, just to protect local producers and get revenues to help finance the bloated bureaucracies and politicians in poorer countries.

This looks crazy, and one may wonder why many lobbyists would want new complicated laws, why they want products become more expensive, and procedures more bureaucratic. And the WTO bureaucracy and the different country trade representatives that compose it are caught in a seemingly endless blame game, though almost all of them have one thing in common: a passion to continue taxing their citizens’ international trade transactions and other countries’ subsidies as their convenient excuse for doing so.

Hayek has some words of caution for people who behave this way and impose various restrictions on other people's lives. In Chapter 6 of "Constitution of Liberty", he wrote:

"Our two basic propositions: First, no man or group of men possesses the capacity to determine conclusively the potentialities of other human beings and that we should certainly never trust anyone invariably to exercise such a capacity. Second, the acquisition by member of the community additional capacities to do things which may be valuable must always be regarded as a gain for that community."

Importation of various essential drugs and production inputs are discouraged by certain governments of poorer countries because the governments of rich countries where these drugs and production inputs come from, do not want to reduce or phase out export subsidies. Why penalize the sick and dying, the industrious and productive people in their countries, simply because the other governments are protectionists? And why would rich country governments remain protectionist and reduce

In a CATO paper entitled "Ripe for Reform: Six Good Reasons to Reduce U.S. Farm Subsidies and Trade Barriers", authors Griswold, Slivinski, and Preble argued that reducing farm subsidies and trade barriers would benefit Americans in six important ways.

One, reform would deliver lower food prices to tens of millions of American households, especially low income families that spend a large share of their income on food. In 2004, U.S. farm programs transferred \$16.2 billion from U.S. food consumers to producers.

Two, reform would lower costs for U.S. industries, such as confectioners and other food processors, that use agricultural commodities in their final products and would promote trade negotiations to open markets abroad for U.S. exporters.

Three, reducing farm subsidies would save U.S. taxpayers tens of billions of dollars during the next decade. Many of those subsidy payments currently go to large farms and agribusinesses, not to smaller "family farms."

Four, agricultural reform would enhance the environment by reducing the amount of top soil lost and damaging fertilizers and pesticides used by American farmers. It would liberate farmland to be used for reforestation, recreation, and other more environmentally friendly purposes.

Five, agricultural reform would benefit farmers themselves by promoting production of crops that are in demand by consumers. Farm reform would stimulate innovation and productivity gains on the farm and promote more economic diversity and dynamism in rural communities.

Six, lower farm trade barriers would raise incomes of farmers in poor countries, reduce global poverty, create a more hospitable climate abroad for U.S. foreign policy, and enhance U.S. security.

Free Trade Areas (FTAs)

Dr. Khalil Ahmad, a friend and President of Alternate Solutions Institute (www.asinstitute.org) in Lahore, Pakistan, wrote a paper entitled “The Spirit of Regional Free Trade Agreements”, citing the case of the South Asian Free Trade Agreement (SAFTA). South Asia includes India, Pakistan, Nepal, Bangladesh, Sri Lanka, Maldives, among others. Khalil argued that “free trade means freedom to trade; trade agreements are reached between trading partners, not between governments”. And he quoted several clauses which effectively nullify free trade.

Khalil is 100% right. Neither governments nor countries trade with each other; people do. And when people trade with each other, they normally do not set conditions, they do not make paper agreements. For instance, a Filipino software engineer does not require that a Thai garments producer should first buy his software program before he will buy the Thai's new lines of long sleeve shirts. People simply buy certain goods or services from everywhere because they want something of value for their money.

For governments on the other hand, when their officials sign "free trade areas" (FTAs) bilaterally or regionally, one can notice those agreements often have a number of conditionalities, of “provided that”. So at the end of the day, those FTAs are implying "free trade, yes, but 15 or 30 years from now".

The case of ASEAN Free Trade Area (AFTA) is more liberal. The original document, “Agreement on the Common Effective Preferential Tariff (CEPT) Scheme for the Asean Free Trade Area (AFTA)”, signed on January 1992, did not have much conditionalities. It mainly sets 2 timetables for tariff abolition among member-countries: January 2010 for the 6 original member countries -- Brunei, Indonesia, Malaysia, Philippines, Singapore and Thailand; and January 2015 for the 4 new countries – Cambodia, Laos, Myanmar, and Vietnam. This was contained in the Revised Agreement signed in January 2003 by representatives of the 10 member-countries. Now, overall tariffs among the 10 countries is only around 3%; for other countries, between zero (Singapore) to 18% (Vietnam). See Annex tables.

Protectionists and welfarists are confused

And many of them are simply hypocrites. When consumer prices are increasing mainly because of lack of supply of many commodities and services, protectionists complain and pressure governments to subsidize the poor, to subsidize production, even impose price control, and so on. But when consumer prices are decreasing mainly because of huge supply of many commodities (mainly from China), they also cry loud and pressure governments to raise tariffs and import taxes, to protect and subsidize local producers. People are happy when they find bargains, but protectionists hate it when people have access to cheap good and services. The consumers and the jobless don't matter much to them; only the farmers and local producers.

Protectionists apply double standard. They want all their consumption needs and production inputs to be liberalized and to be available at bargains, but want their own

products and services to be protected from competition. It doesn't work that way. Still, governments the world over so often give in to protectionist aspirations. Such is done often in the name of "nationalism" and "helping the poor", but this view is myopic.

Enabling the poor to have access to high quality but affordable food, clothing, medicines and housing or construction materials (made available by markets and competition among producers and sellers) is, itself, "helping the poor". Expanding job creation and employment opportunities as companies expand or the number of small- and medium-sized entrepreneurs grows due to lower production inputs and costs, is also "helping the poor".

If people want protectionism, then everything should be protected, no exemptions. If local farmers want their rice or bananas or pineapples to be protected from foreign competition, then they should not expect to buy cheaper, free-trade-price fertilizers, chemicals, seeds, tractors and their spare parts, and other production inputs. They should not expect to buy cheaper clothes, toys, shoes and other consumer items for their families.

Trade policy choices

Since free trade among many people in the world is not possible, there are other alternatives, especially for free-market oriented groups and institutes.

One, campaign for unilateral trade liberalization. Expand the citizens' freedom of choice. Whatever savings from cheaper imports can be used by the people for more consumption and/or more domestic production. Explain to the country's political leadership and trade negotiators the benefits of free trade and net gains from trade.

Two, allow "dumping" of surplus products and services by other countries. Dumping is good, especially if the "dumped" products are still of good quality. As discussed above, economic and job dislocation of the adversely affected sectors is short-term, but millions of consumers who realized great savings from buying "dumped" clothes from abroad will have extra money to buy other goods and services which they would not buy otherwise if said dumped products are not available.

Three, allow export subsidies by rich country governments and do not make it a hindrance to more trade liberalization. If those governments will over-tax their citizens so that their exports can be sold at a lower price to poorer countries, so what? Buy their heavily-subsidized farm products, let the citizens of recipient countries enjoy cheaper imported food and dairy products.

Conclusion: merit vs. value

In closing, we need to distinguish between effort and merit on one hand, and value on the other. Let me paraphrase Hayek once more, in Chapter 6 of "Constitution of Liberty", he wrote:

"A society in which the position of the individual was made to correspond to human ideas of moral merit would therefore be the exact opposite of a free society. It would be a society in which people were rewarded for duty performed instead of for success... In our individual conduct we generally act on the assumption that it is the value of a person's performance and not his merit that determines our obligation to him... we do not feel that, because a man has rendered us a service at a great sacrifice, our debt to him is determined by this, so long as we could have had the same service provided with ease by somebody else."

Apply these thoughts in international trade, we shall realize that trade protectionism is an embodiment of society rewarding merit and not value. Local producers (from farmers to manufacturers to service providers) are rewarded with tariff protection and non-tariff barriers so that cheaper foreign-produced goods and services become expensive when sold domestically, for the reason that the effort and pain of local producers should be rewarded regardless of the higher price, regardless of the inferior quality, of their output. Freedom to choose, freedom to exchange, is a sacred human value that should be enjoyed by individuals, whether from rich or poor countries. The state's power to restrict those individual freedom should be fought; and the arrogance and deceit of high taxation and trade protectionism should be exposed.

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Annex:

Table 1. Current Average MFN Tariffs, East Asia

Country	Year	Agri	Mining	Maufacturing	Overall
Vietnam	2004	29.40	6.50	17.18	18.5
Cambodia	2004	17.69	10.91	14.87	15.2
Malaysia	2005	3.31	2.39	11.38	10.4
Laos	2004	19.71	5.07	8.77	10.3
Thailand	2005	19.53	1.96	9.20	10.00
Indonesia	2004	11.23	3.96	9.74	9.8
Philippines	2005	11.85	2.47	7.29	7.8
Myanmar	2004	8.84	1.66	5.09	5.6
Brunei	2004	0.00	0.00	0.06	0.05
Singapore	2005	0.00	0.00	0.00	0.0
Korea	2005	42.53	2.76	6.68	12.0
China	2005	14.65	2.87	9.16	9.9
Japan	2005	10.65	0.14	3.39	4.8

Source: WTO-IDB

<http://www.us-asean.org/afta.asp>

Table 2. Philippines' MFN average tariff, 1970-2006 (in %):

YEAR	Agri	Mining	Manufacturing	Overall
1970-79	64.5	19.7	40.3	42.9
1980-89	41.7	15.7	30.8	30.5
1990-99	29.8	8.2	17.2	18.8
2000-06	12.5	2.8	6.5	7.3

Source: Tariff Commission, Philippines