

T

heory & Practice in Free Trade

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Why is trade conducted between countries? The short answer to that question is that “the exchange of goods and services between countries is mutually beneficial.” The bottom line is “mutual benefits”. However, some of the talking points on this issue revolve around the notion that one side suffers nothing but losses from international trade, with the “mutually beneficial” perspective nowhere to be seen. This essay will highlight the gains from free trade and/or trade liberalization from the economic perspective, and then discuss, mainly from the political economy perspective, why free trade has a hard time making progress despite the benefits it supposedly provides.

Why Free Trade Is Good — the Economic Perspective

The most fundamental benefit of trade is that of exchanging goods and services that have low scarcity in your country for goods and services that have high scarcity. The benefit is particularly large when goods and services that are hard to produce, if at all, domestically are being imported. Natural resources such as oil and rare metals or agricultural products such as coffee and bananas are such examples for Japan. Very few people will deny the existence of benefits from importing these products.

The question is whether it is necessary to import goods and services that can be produced domestically without any problems. For example, beef can be produced in Japan. Therefore, some people may think that importing beef is bad because it hurts Japanese cattle farmers. “Go local!” is a phrase that we sometimes hear. Economists counter these arguments with “comparative advantage”, the fundamental concept underpinning international trade. Specifically, even when the goods and services can be produced either domestically or in other countries, productivity differs across countries. So an international division of labor based on the relative productivity among countries becomes mutually desirable.

For example, when Japan and Australia are compared, both countries can produce beef and automobiles, but Australia can produce beef relatively more efficiently than Japan, while the

opposite is true for automobiles. This means that Australia can produce beef relatively more cheaply, while Japan can do the same with automobiles. So, if Japan exports automobiles to Australia and imports beef from the latter, the relative difference in prices generates the “gains from exchange” between automobiles and beef. Furthermore, the “gains from specialization” will enable Japan to shift the factors of production (resources) being used to produce beef to producing automobiles by importing beef from Australia, while Australia will be able to shift the factors of production (resources) being used to produce automobiles to producing beef by importing automobiles from Japan. Behind the resulting increase in the production of exported goods and the decrease in the production of imported goods lies the more efficient reallocation of resources between industrial sectors, which results in a rise in income.

According to traditional theories in international economics such as the Ricardian and the Heckscher–Ohlin models, an environment in which governments do not intervene in the market, i.e. free trade based on comparative advantages, is preferred from the perspective of resource allocation and maximizes the economic welfare of the world as a whole. There are two points to keep in mind regarding this conclusion. First, free trade may maximize gains to the world or a country as a whole, but it does produce “winners” and “losers”. For example, when Japan liberalizes trade more and imports more beef, domestic consumers gain but domestic producers lose. In other words, engaging in free trade will not automatically benefit all the people in that country. But if the groups that lose are compensated by the groups that gain, then everyone will be able to enjoy the gains from free trade.

One matter requires attention here. According to the strict theoretical analysis under the Heckscher–Ohlin model, the impact of free trade differs between the short term and long term. While everyone engaged in an import competing industry loses in the short run, that will not be the case over the long run, as there is a shift of the factors of production (i.e. resource reallocation) from the import competing industry that suffered losses to the export industry that gained benefits. Furthermore, it is known that when multiple factors of production such as labor, land, and physical capital are being used

in an import competing industry, there will be winners and losers in both export industries and import competing industries in the long run (the Stolper–Samuelson theorem). For example, liberalizing agricultural imports results in immediate losses for everyone engaged in agriculture including landowners and agricultural laborers. But in the long run, the landowners may lose, while laborers may gain.

Second, traditional theoretical models assume that “there are no market failures”. More specifically, they assume that the market is omnipotent and functions perfectly in that there is perfect competition in the market, all economic activities are being traded in the market, and so on. However, in reality, it is all but impossible for this premise to be fulfilled. That said, it is important to note that the gains from trade will exist even when there are market failures.

Take a case where the market is not perfectly competitive, the case of imperfect competition where a small number of firms control the market. If the firms control the market because they are protected from foreign competitors, free trade will promote competition in the domestic market. In the opposite direction, there is the following case where domestic producers benefit. One reason why markets become imperfect is “economies of scale”. Economies of scale mean that the average cost of production declines as the quantity of production increases. When free trade expands the market for export industries, export industries with economies of scale will be able to enjoy them even more.

Traditional models basically explain trade between industries, which implies that there will be no trade between two countries if they are identical in every aspect. However, in international trade in the real world, there is more intra-industry trade than inter-industry trade, particularly with regard to intra-industry trade between similar countries (especially with regard to manufactured products). The key to explaining intra-industry trade is imperfect competition. For example, benefits to the consumer (i.e., utility) increase as free trade increases the variety of goods available according to a model that takes product differentiation based on imperfect competition into consideration. There are two kinds of increase conceivable here. First is the notion that in consuming, say, two units of a product with

significant product differentiation, the utility for the consumer is greater when he/she consumes one unit each of two differentiated products than two units of a single product. To put it in another way, when purchasing two cars, the utility for the consumer will be greater with the purchase of a Lexus and a Mercedes Benz instead of two Lexuses. Another is the notion that the utility to the consumer is enhanced when trade broadens the variety of goods in the same category so that he/she is able to acquire goods that are more closely aligned with his/her preferences. For example, trade broadens the variety of watches that are available for purchase, so it becomes easier for a consumer to acquire a watch that is closer to her or his ideal watch even when only one watch is being purchased.

Marc Melitz at Harvard University focused on the heterogeneity in intra-industry productivity and used a product differentiation model to show that economic welfare is increased as the productivity of an industry as a whole is enhanced through trade liberalization that forces low productivity firms to exit from the market.

Some technologies and knowledge spill over even without being the subject of licensing agreements or other market transactions. Free trade encourages the spillover of superior knowledge and technologies from abroad. New technology, for example, is often embedded in imported products, and the new technology and knowledge are encountered and absorbed by importing them. This benefit is particularly important for developing countries. Free trade can also increase technology and knowledge spillovers across firms domestically as clustering of export industries progresses, resulting in productivity gains.

Finally, let me take note of how import liberalization encourages exports. When the cost of acquiring intermediate inputs from overseas declines as trade barriers against intermediate inputs disappear, final goods can be produced more cheaply, which helps the exports of final goods. When demand for final goods increases as trade barriers against final goods disappear, the demand for the intermediate inputs that go into those final goods also grows. If a country that imports final goods also produces intermediate inputs, it may be able to increase the exports of intermediate inputs as a result. Furthermore, ships, aircraft and other means of transportation

normally take on other cargo after they unload their original cargo. Since logistics businesses would like to carry full loads on both legs of a two-way journey, it is conceivable that an increase in imports will lead to an increase in exports.

Why Progress on Free Trade Is Stalled — the Political Economy Perspective

According to a questionnaire survey that asked 10,000 Japanese their opinions on the statement “Imports should be more liberalized” (E. Tomiura, B. Ito, H. Mukunoki and R. Wakasugi, “Individual Characteristics, Behavioral Biases, and Trade Policy Preferences: Evidence from a Survey in Japan”, *Review of International Economics*, 24(5), 2016), 51.5% of the responders chose “Strongly agree” or “Somewhat agree” against more than the 31.5% who chose “Strongly disagree” or “Somewhat disagree”. The reason why protectionist trade policy is more readily maintained or adopted even though people who favor import liberalization are in the majority must be because it is more difficult to have the views of the “winners” of import liberalization incorporated in the policymaking process, while it is easier to have those of the “losers” incorporated. It is also notable that 17% responded “Cannot choose or Unsure”, showing that they did not or were not able to provide a clear opinion.

These numbers indicate that the downside of trade protectionism is not fully understood. It is mainly the consumer who loses from protectionist trade policies. However, there is little awareness among consumers that they are bearing the burden of tariffs or that they are the losers when it comes to protectionist trade policies. One thing that is little understood is that the effect of tariffs is equal to the combined effect of a production subsidy and a consumption tax. Tariffs raise not only the prices of imported products but also the prices of domestically produced products that compete with them. But since the retail prices at storefronts already include the price hike to accommodate tariffs, it is difficult for consumers to discern how much the prices (of domestic products in particular) are being driven up by tariffs.

Food product prices are increased in Japan because agricultural

products and food products are burdened with high tariffs. Since the proportion of food in household expenditures, or Engel’s coefficient, tends to have a negative correlation with income, the low income class suffers relatively larger losses from trade protectionism, a fact that unfortunately does not appear to be widely recognized by the Japanese public.

Economic theory usually posits maximizing overall national economic welfare as the purpose of government, a necessary and indispensable presumption in considering “what government should do” from a normative point of view. However, careful observation of government objectives and behavior is required to figure out why it is difficult to make progress on trade liberalization in the real world. The key point is that the actual policies are also affected by the impact of the policies on the politicians and government officials themselves. For example, a politician, mindful of the next election, is likely to adopt policies that lead to winning votes. A typical example is that Hillary Clinton had promoted the Trans-Pacific Partnership (TPP) as secretary of state, but flipped completely when she became a presidential candidate and turned against it.

Gene Grossman at Princeton University and Elhanan Helpman at Harvard University analyzed trade policy by explicitly incorporating campaign contributions from producers into their trade models. The existence of political financing means that the objective of government is no longer the simple maximization of economic welfare of the nation as a whole. If industries competing with imports make contributions, the government will give more weight to the interests of those industries within the overall economic welfare when designing trade policies. Progress for free trade is stalled as the result.

People involved in the agriculture industry form the core of the opposition to free trade in Japan. Why do they maintain their political influence despite the fact that the agricultural sector has been shrinking? This can be explained convincingly by collective action theory, developed by Mancur Olsen.

Suppose that there are 100 million people (winners) who will gain from trade liberalization with collective benefits that add up to 10 trillion yen, and 1 million people (losers) who will suffer losses that

add up collectively to 8 trillion yen. The economy as a whole will acquire a net benefit of 2 trillion, so it stands to reason that it is better to liberalize trade, yet it proves to be difficult to achieve. This is because the benefit accruing to the winners is 100,000 yen each while the loss accruing to each loser is the princely sum of 4 million yen.

The key here is that there may be a net benefit to the economy as a whole, but that is often widely shared and consequently thinly spread, while the losses are concentrated among a small number of people. Since the amount of loss per loser is large, the losers acquire significant political power by taking active political action such as petitioning Diet members and providing political funds. If the amount of the loss is the same but the number of losers decreases, the loss accruing to each individual becomes larger. In other words, the incentive to resort to political action could become stronger when the number of losers becomes smaller. Moreover, the smaller the group, the easier it is to mobilize the vote. In this case, Diet members can secure political funds and votes more easily and more securely by siding with the losers.

According to collective action theory, political action by special interest groups created by the minority sustains protectionist trade policies. Now, one may think that the majority should prevail when it comes to actual elections, so things shouldn't have to end up the way collective action theory says. But the same mechanism as collective action theory is at work in elections as well. For example, suppose that there are two candidates standing for election in a particular district, one who supports free trade, and the other who opposes it. Also suppose that the majority of the eligible voters benefit from free trade and the others lose. If all eligible voters vote, the candidate who supports free trade should be elected.

However, it is important to take note of the fact that voting itself entails costs. The voter bears not only the transportation cost of going to the voting station but also the opportunity cost of giving up other things he/she could have done such as going for a drive. Since voting comes with a cost, the voter will only vote when the benefits of voting are greater than the cost of voting. Since the benefits of free trade are widespread but individually small, many voters in the group of people who will gain from free trade will not show up to

vote, creating the very real chance that the candidate who opposes free trade is elected.

Conclusion

In this essay, I began my discussion of the benefits of free trade from an economic perspective. However, liberalizing trade makes for hard going in the real world, the reasons for which I explained in terms of political economy. I would like to conclude with a few more comments.

First, free trade is not without its merits from a political economy perspective as well. A government that is staunchly committed to free trade will be able to reduce the opportunity for rent-seeking. In other words, if free trade is unshakable despite political pressure, the pressure itself will subside, with the result that resources will not be wasted. It is also necessary to note that if the government seeks to adopt a trade policy that actively maximizes economic welfare, an enormous amount of information becomes necessary, which in turn incurs enormous costs. This leads to the argument that free trade should be adopted as a second-best solution to avoid the cost of acquiring that information.

Behavioral economics also offers explanations for the difficulty in making progress on free trade. Human beings tend to overvalue losses compared to gains. Even when the gains from free trade are greater than the losses, people will oppose free trade if they overvalue the losses. The tendency to value losses over gains also leads to status quo bias. This leads to the tendency to avoid altering the status quo (in this case liberalizing trade) unless there is considerable dissatisfaction with it. **JS**

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