Analysis Trade Barriers

by Sophia Tutorial

WHAT'S COVERED

This tutorial will cover analysis trade barriers. We will discuss how nations benefit from trade when they are fully employed and specialize according to comparative advantage, as well as the argument for trade barriers that arise when an economy is not fully employed.

Our discussion breaks down as follows:

1. Basis for Trade: Opportunity Cost and Comparative Advantage
2. The Debate Over Free Trade
3. Trade With Full Employment
4. Trade With Unemployment
5. Trade Barriers
    a. Pros and Cons

1. Basis for Trade: Opportunity Cost and Comparative Advantage

If you recall, the key idea about gains from trade is that trade allows countries to enjoy more of both goods being traded, and allows them to move beyond their previous resource and productivity constraints.

Both goods can be produced at the lowest **opportunity cost**, which is the sacrifice made by choosing one value over another, or the value of the foregone opportunity.

We decide who produces what based on **comparative advantage**, which deals with this concept of opportunity cost, or what we give up.

> EXAMPLE Whenever the United States decides to devote resources, like land, labor, and capital, to producing textiles, we give up the opportunity to use those resources to produce something else, like cars. Therefore, what is given up is our opportunity cost.

Comparative advantage, then, is essentially an advantage conferred with a country to one good's production relative to another.

HINT

Another way of thinking of comparative advantage is, "Who gives up less?"

When countries specialize in the goods or services for which they have the lower opportunity cost--meaning they enjoy a comparative advantage--then both countries will benefit.

> EXAMPLE For example, if the United States decided to devote their resources to produces textiles instead of cars, for instance, we give up a lot more in terms of cars than Mexico would, considering the technology and the skill level of our workforce compared to that of Mexico. In this case, Mexico would enjoy the comparative advantage in textiles, because they do not give up as much when they devote their resources to textile production. The United States, then, would enjoy the comparative advantage in cars.

TERMS TO KNOW

Opportunity Cost
The sacrifice made by choosing one value or opportunity over another; the value of the forgone opportunity

Comparative Advantage
Advantage conferred with a country to one good's production relative to another

2. The Debate Over Free Trade

Theoretically, free trade benefits all countries. However, not everyone agrees.

There are a variety of arguments that have been presented in the media for trade barriers (which we will cover in another section), such as:

- Concerns for domestic jobs, which is the primary concern
- Environmental concerns
- Concerns about international labor standards
- Trade is unfair to poor countries
- Other countries benefit more than the United States

3. Trade With Full Employment

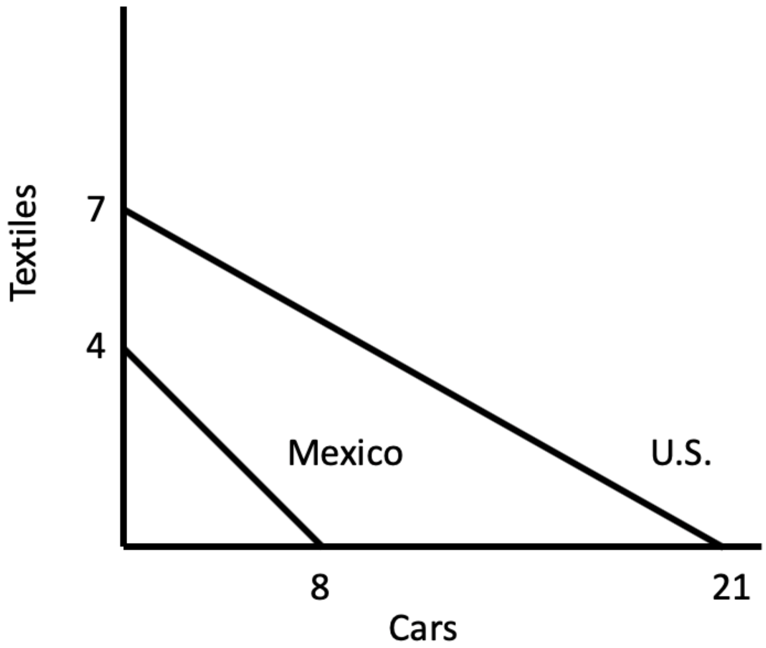
Remember, the basis for free trade was that both nations benefit when specializing in whatever they enjoy the comparative advantage.

For instance, in our previous example, we decided that the United States should produce cars, because they give up fewer textiles when they do that, and Mexico should produce textiles because they give up fewer cars.

However, the advantages and gains from trade were calculated based upon scenarios assuming**full employment** of resources in both nations.

Full employment is defined as equal to the point at which an economy exhibits a natural rate of unemployment, usually around 5%. It occurs when the economy is at its long-run supply capacity.

A production possibility frontier, or PPF, shows the maximum combination of two goods that can be produced when an economy's resources are being utilized.



The x-intercept shows how many cars can be produced when all resources are devoted to car production. In this case, it is 21 for the United States or eight for Mexico.

The y-intercept shows how many textiles can be produced with specialization in textiles--again, seven million in the case of the U.S. or four million in the case of Mexico.

This PPF, then, shows a trade-off. It shows how many of one good we have to give up when we want one more of the other good.

> EXAMPLE For example, for every one textile that the United States decides to produce, they give up the ability to produce three cars. Why do they give up three cars? Because we are assuming that resources are fully utilized and fully employed, so f they want to produce one more textile, they will need to take resources out of cars and put it into textiles.

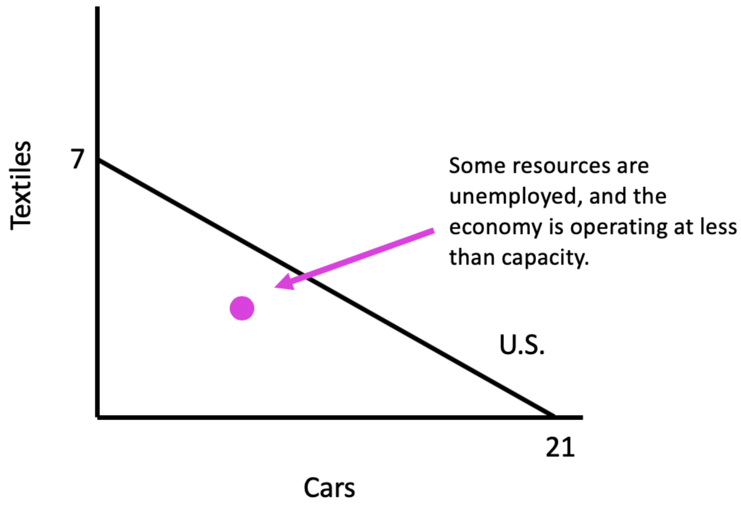
TERM TO KNOW

Full Employment
Defined as equal to the point at which an economy exhibits natural rate of unemployment; occurs when the economy is at its long-run supply capacity

4. Trade With Unemployment

However, what if the United States is in a recession? This would be represented by a production level somewhere inside the curve where they are not actually producing a maximum combination.

This means that some resources are unemployed, and the economy is operating at less than capacity.



So, if the United States switched from focusing all resources on the production of cars back to the production of textiles, they could utilize currently unemployed workers and other resources.

In a way, then, they would not have to give anything up; there is no opportunity cost. This particular trade-off situation is void because, with unemployment, we do not have to give anything up to produce textiles. There are people who want jobs and do not currently have them.

In this case, producing textiles domestically could actually raise U.S. GDP now.

Remember, **unemployment** is measured as the percentage rate of the number of individuals that would like to work and are an active part of the labor force, to the number of individuals that comprise the active labor force.

So, if we have people who are unemployed and not being utilized, and they want to work, we can employ them if we start producing textiles.

Since the idea of comparative advantage no longer applies, this situation presents an argument for a nation to set up trade barriers, which we will cover next.

TERM TO KNOW

Unemployment
Measured as a percentage rate of the number of individuals that would like to work and are an active part of the labor force to the number of individuals that comprise the active labor force

5. Trade Barriers

Trade barriers focus on protecting a domestic industry from competition. They are defined as barriers to free-market pricing set in place to confer advantage of a country.

EXAMPLE Examples of trade barriers include taxes and subsidies.

Trade Barrier	Purpose

Taxes	Placed on imported textiles to make them more expensive, enticing people to buy domestically
Subsidies	Provide domestic producers with payments to give them an advantage over foreign competition
Quotas	Restrict the amount of foreign textile imports allowed, i.e., implement a quantity ceiling, or maximum amount allowed to be imported

TERM TO KNOW

Trade Barriers
Barriers to free market pricing set in place to confer advantage of a country; examples include taxes and subsidies

5a. Pros and Cons

Are trade barriers good or bad? Well, there is much disagreement on the topic, but most people can agree that when an economy is fully employed, trade barriers are unnecessary and counterproductive. In keeping with the theories of comparative advantage and gains from trade:

- Free trade and specialization allow for resources to be used most efficiently.
- Free trade helps economies that are fully employed to achieve economic growth and move beyond their previous production capacities.

However, with high unemployment, trade barriers can actually benefit a domestic economy by utilizing workers and other resources that are currently unemployed.

Critics, though, point out that trade barriers still have some issues. *Some say they are bad for the global economy overall.

- Others say they may only serve special interest groups, like specific industries that are lobbying for protection from foreign competition. *They can reduce the incentive for domestic firms to produce more efficiently, because when we put up trade barriers, competition is reduced and domestic firms do not have the incentive to do it better, less expensive, etc.
- Trade barriers are difficult to remove once the economy has improved because, again, industries get accustomed to those trade barriers being there.

SUMMARY

Today we learned that the **basis for trade** is that people and nations benefit when they specialize in whatever they enjoy a **comparative advantage**, lower **opportunity cost**, and trade. We learned that in an economy with **full employment**, gains from trade are obvious. However, when an economy has **unemployment**, it can benefit from **trade barriers**; one of the **pros** of trade barriers is that a domestic economy can utilize workers and other resources that are currently unemployed. We also learned, though, that the **cons** of trade barriers involve reducing the incentive for domestic firms to produce more efficiently.

Source: Adapted from Sophia instructor Kate Eskra.

TERMS TO KNOW

Comparative Advantage
Advantage conferred with a country to one good's production relative to another.

Full Employment
Defined as equal to the point at which an economy exhibits natural rate of unemployment; occurs when the economy is at its long-run supply capacity.

Opportunity Cost
The sacrifice made by choosing one value or opportunity over another; the value of the forgone opportunity.

Trade Barriers
Barriers to free market pricing set in place to confer advantage of a country; examples include taxes and subsidies.

Unemployment
Measured as a percentage rate of the number of individuals that would like to work and are an active part of the labor force to the number of individuals that comprise the active labor force.