

Free Trade and the Limits of Public Policy

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Abstract

A widely recognized claim is that free trade as a general rule increases welfare. I show that benefits of trade largely depend on the international framework within which trade occurs. I demonstrate that in the presence of certain types of externalities, free trade as a general rule is not optimal since it forecloses the implementation of optimal domestic internalization policies. If optimal-response-policies aimed at internalizing a particular externality are not feasible, welfare losses are unavoidable. In particular, the question will be considered if fully informed decentralized consumer choices can be an acceptable substitute for binding policy. The vertical differentiation model discussed in the paper shows that individual choice may not be an appropriate substitute for centralized political action as a result of collective decision-making processes. As a result the current WTO rules with respect to tariff and non-tariff barriers need to be re-evaluated in order to properly address the issue of trade in democratic societies.

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