Theories of International Trade

Subjects: Development Studies

Contributor: Haya Hoja , Pei Yu

Economists have developed theories explaining World Trade, which are called” theories of international trade”. Theories of international trade explain what exactly happens in international trade, such as mercantilist theory. This theory was popular in the sixteenth and eighteenth centuries. During that time, a nation’s wealth consisted only of gold or other types of precious metals, so theorists suggested that nations begin to accumulate more and more gold and other types of metals.

World Trade theories of international trade

1. Introduction

European countries began to do this. Adherents of mercantilism during this period stated that all these gems signified the wealth of the nation, and believed that the state would only be strengthened if the nation imported less and exported more. Here, trade policy in the context of intermediate and final good exchange were focused. Tariffs on finished items are typically greater than those on inputs, a phenomenon known as tariff escalation. However, neoclassical trade theory—and, in particular, current Ricardian trade models—struggle to explain this. In the context of scale economies, it is showed that tariff escalation may be defended on efficiency grounds. A unilateral tariff in any sector raises a country’s relative wage while also increasing the size and productivity of each sector, both of which improve welfare. International trade theory has progressed through several stages and is now regarded as one of the primary components of “globalization”, alongside foreign direct investment (FDI) and other types of financial flows. The Mercantilists believed that stimulating exports while limiting imports helped governments increase their wealth and power. Classical economists, on the other hand, introduced the idea of comparative advantage, which is based on resource endowments and efficiency. They were outspoken in their condemnation of government interference in trade, arguing that market forces can perform a better job if left alone. The Modern economists who came after the Classical economists, on the other hand, fought against the Classical economics’ “laissez-faire” approach. Because the global economy is so linked, domestic policies such as monetary and fiscal policies by certain nations may have an impact on its trade partners, necessitating government action to closely monitor and implement remedial adjustments and remedies. Two aspects of trade are discussed: trade theory and trade policy. The viewpoints of many schools of thought on trade theory are first recorded, and then the economic role of one of the tools for trade policies, the customs tariff, is examined from the perspectives of protection, revenue collection, the balance of payment, and economic growth. Reviews of international trade theories of economists may be divided into four groups based on their perspectives on international trade: Mercantilists, classical economists, neoclassical economics, and contemporary economists. These four schools of thought about international trade ideas are briefly discussed in the parts that follow.

2. The Mercantilists’ Point of View

Mercantilists such as Jean Baptiste Say and Thomas Mun believed that exporting more commodities to other governments helped a nation amass greater wealth in the form of trade surpluses than importing them from outside in the seventeenth century. Overseas exchange in the form of gold and silver was required during the Mercantilist era to finance foreign purchases and pay foreign trade taxes.

According to the Mercantilists, the accumulated trade surplus, together with other domestic resources such as tax, allowed a monarch to increase their royal authority both at home and abroad. They spend the money at home to fund their armies and fleets. Simultaneously, they use it to compete with their overseas peers in the shipbuilding industry. As a result, the crown’s strength was determined by its capacity to mobilize resources from both local and foreign sources. The Mercantilists were similarly concerned about how to enhance the authority of their governments.

3. Classical Economists’ Point of View

The theory of international trade drew the attention of the most prominent economists of the eighteenth century, and their works are still used to guide in understanding the importance and problems of international trade because the factors that prompted the theory still demand the attention of today’s economists and policymakers. Classical economists such as David Hume, John Stuart Mill, David Ricardo, and Adam Smith had opposing views on the significance of commerce in the eighteenth century. Even if their following views emphasized the necessity of commerce more, their focus was not the same as that of the seventeenth-century Mercantilists. They were more worried about the crown’s subjects than the crown itself [1]. They believed in the role of market forces rather than official rules and restrictions. Classical economics believed in a “world of harmony and peace”, in contrast to the Mercantilists’ belief in a “world of struggle and war”.

They preached the idea of “laissez-faire”, or little government interference in the economy. David Hume developed the influence of international commerce on local prices through his quantity theory of money. He claimed that prices and trade that flow naturally regulate the amount of money in circulation. In his work on the law of demand and supply, John Stuart Mill also demonstrated how foreign markets decide to price. Through his comparative advantage argument, David Ricardo, the originator of the free trade ideology, emphasized the necessity of free commerce. The relevance of the export-driven argument was further added to free trade by Adam Smith’s productivity thesis, which went beyond the free trade concept. For Classical economics, a country’s success is assessed in terms of its inhabitants’ well-being, not in terms of the monarchy’s authority.

4. Neoclassical Economists’ Point of View

The free trade views of 19th century Classical economists such as David Ricardo and John Stuart Mill are founded on the premise of perfect worker specialization. According to this theory, trade is fueled by disparities in labor

efficiency between nations for various products. However, two 20th-century neoclassical economists, Eli Hecksher and Bertil Ohlin, both from Sweden, contested this premise of the prominent Classical economists [2].

They replaced the complete labor specialization assumption with “component endowment trade theory”, which posits that global relative labor productivity is the same. This argument is based on the idea that all nations can benefit from technical advancement, which Classical economists think causes disparities in labor productivity for various commodities in different countries. The source of trade, according to neoclassical economists’ factor endowment theory, is variations in factor endowments, not differences in labor productivity. Land, capital, and labor are the components they view to be causes of international commerce.

5. Modern Economists’ Points of View

Later on, economists who formed protectionist ideas began to confront both classical and neoclassical economists at the same time. The main criticism leveled against them is that they overlooked the effect that sovereign governments have on international trade. Instead of being separate countries, they treated the world’s nations as regions or states inside a nation. However, national governments may influence international trade behavior in a variety of ways that are not available to domestic commerce. Taxes, subsidies, and quotas that can be applied to imported commodities may or may not be equally applied to domestic goods. Every sovereign nation’s approach to designing and using these policy instruments may have an impact on its trade partners. The other main source of criticism came from individuals who believe that free trade does not benefit all countries equally. This school of thought contends that industrialized economies reap a greater share of the advantages of free trade than emerging countries. Thirlwall [3], for example, identifies three significant explanations for today’s uneven trade benefits: Manufacturers in developed nations wanted primary products with low import content, technology allowed certain companies to replace synthetic inputs for raw materials, and developed countries favored low import content of basic goods.

Todaro and Smith [2] believe that several of the neoclassical economists’ assumptions are far from reality, in addition to the three criteria identified by Thirlwall as being against the free-trade hypothesis. Some basic assumptions of neoclassical economists, according to Todaro and Smith [2], include: “fixed resources, full employment, and international immobility of capital and skilled labor; unemployment, resource underutilization, and the vent-for-surplus theory of international trade; fixed, freely available technology and consumer sovereignty; and trade gains accruing to nationals are easy to make on paper but difficult to achieve in practice”. Even if customs tariffs are seen as a big commercial obstacle on one hand, they also provide their own set of benefits on the other. In other words, the demand for customs tariffs is determined by economic gains. Protective, revenue, income distribution, employment, balancing of payments, import substitution, and economic growth are all key economic functions it performs. Beyond these economic functions, some suggest that high levels of “nationalism” and “patriotism” [4], wealth redistribution, and national security are sometimes linked to customs tariffs [5].

One of the main goals of applying customs tariffs is to act as an import substitute. Import substitution is a method that many developing nations have tried and continue to employ to replace imported commodities with equivalent

indigenous ones. According to Todaro and Smith [2], "the economic rationale put forward for establishing import substituting manufacturing operations is either that the industry will eventually be able to reap the benefits of large-scale production and lower costs (the so-called infant industry argument for tariff protection) or that the balance of payments will be improved as fewer consumer goods are imported". Even though tariffs are historically employed to raise income for the government, Krugman and Obstfeld [6] emphasize that the fundamental goal of tariffs is to safeguard domestic products against international competition. They also believe that tariffs were mostly utilized for protection in the early nineteenth century in the United Kingdom and in the late nineteenth century in Germany and the United States. According to Carbaugh [4], the goal of protective tariffs is "to shield import-competing manufacturers from international competition". It is sometimes referred to as the "infant industry argument". The tariff argument for defending argument industries is viewed as a transitory impediment to free trade. Protective tariffs, according to Carbaugh [4], are not the same as prohibitive tariffs, which are imposed to completely prevent foreign items from entering the nation. Some people, such as Felder, hold a different perspective on protective tariffs, explaining that they include a ban on international commerce in the protected item, a prohibition on imports solely, an import tariff, and an import quota. The contrast between nominal and effective tariff rates of protection aids in better understanding the idea underlying protective tariffs. According to Todaro and Smith [2], the nominal tariff rate of protection "states the amount, in percentages, to which the domestic price of imported products exceeds what their price would be in the absence of protection. Previous authors [2] defined the "effective rate of protection" as "the proportion by which the value generated at a specific step of processing in a domestic business can surpass what it would be without protection". The effective tariff rates are the more appropriate basis for measuring the restricting effect of tariff structure on trade, as can be shown from these different definitions [3]. The effective rate of protection is commonly used to assess the level of protection provided to each activity as well as the impact of a country's tariff schedule on domestic resource allocation [1]. In reality, as governments invented nontariff procedures such as import quotas, import licensing, foreign exchange control, export subsidies, and export restricting, tariffs' protective influence waned [6].

The theoretical literature indicates that the tariff has two purposes: A fiscal function to produce income for government spending, and a protective role to provide assistance to troubled or strategic local infant industries by limiting foreign competition. For example, Slaughter [7] and Tybout [8] argue that protectionism, whether in the form of tariffs or non-tariff obstacles, permits emerging sectors to "learn by doing" and increase productivity before entering international commerce. The infant industry argument allows infant enterprises to develop, gain economies of scale, raise productivity, and compete favorably in the home market without being pressured by overseas competition.

Suranovic [9] believes that a short increase in domestic pricing helps small businesses to finance their high manufacturing expenses while staying competitive. It also enables businesses to reach a certain degree of efficiency and competency, allowing them to compete more effectively with their international peers. Essentially, young businesses have an opportunity to develop without external influence [10].

On the other hand, the study by Shafaeddin [11] warns that continuing protection of an infant industry might stifle its growth as an efficient manufacturing process that would allow it to compete in the global market.

In order to reduce foreign competition, infant industry protection should be transitory and not excessive, taking into account the conditions of the nation of interest.

The theory of trade recognizes the need for trade limitations, where interferences such as protectionism would be ideal in the event of domestic market failures. Import demand is projected to fall if tariffs are raised, easing competitiveness for domestic enterprises, particularly small ones, as import costs rise. In contrast to a moderate tax, which gives different preferences to imports based on their country of origin or the threshold existing before the application of partial duty reductions via reciprocity measures, Oslington [12] claims that when a tariff is high but constant across all imports regardless of their origin, trade may be diverted from its free flow.

In general, trade theorists believe that tariffs cause economic distortions, resulting in unequal resource allocation. These distortions may result in a loss of income, which the government uses to fund a variety of public programs, especially if appropriate policies are not implemented in tandem with the tax changes. Despite this, the country's revenue is heavily reliant on import duties. Furthermore, they wreak havoc on demand and supply patterns, as well as residents' well-being [13]. Tariff liberalization, on the other hand, provides better resource allocation by causing changes in relative pricing, hence increasing output and consumption.

According to Davids et al. study [14], chicken ranked first in South Africa's meat sector, accounting for 17.9% of agricultural production in 2011. Simulations were performed using a partial equilibrium framework to examine the implications of various import tariff scenarios on this effect. Their findings demonstrated that greater taxes on chicken imports would benefit local producers since their prices would rise, but on the other side, the purchase price would rise as well, affecting consumption, particularly among the poor. As a result, they pushed for a more "balanced" strategy to reduce the impact on consumer costs, such as a "zero VAT rating".

This is a scenario in which protectionism may skew consumer pricing, producing a fall in welfare while the sector thrives, which is contradictory to the assumption that protectionism leads to higher domestic demand for local products as well as increased production.

Blanchard et al. [15], using a competitive model, show that when a country's final-good imports include its local added value, the terms-of-trade motivation for final-good tariffs survives but is reduced. The fact that modelling input versus final-good production separately, and that allows for trade and tariffs on both types of goods, is a fundamental distinction between these previous studies. In conclusion, it was demonstrated that import duties raise revenue while lowering consumer welfare.

References

1. Magas, A.I. Financial Adjustment in Small, Open Economies in Light of the "Impossible Trinity" Trilemma. Financ. Econ. Rev. 2018, 17, 5–33.

2. Todaro, M.P.; Stephen, C.S. Economic Development, 9th ed.; Version of the Harmonized Commodity Description and Coding System; Addison-Wesley: Boston, MA, USA, 2006.
3. Markaki, M.; Economakis, G. International Structural Competitiveness and the Hierarchy in the World Economy: Theoretical and Empirical Research Evidence. World Rev. Political Econ. 2022, 12, 195–219.
4. Carbaugh, R. International Economics, 10th ed.; Publisher Thomson South-Western: Mason, OH, USA, 2005.
5. Lindert, P.H. International Economics; Irwin Professional Publishing: Homewood, IL, USA, 1991.
6. Krugman, P.R.; Obstfeld, M. International Economics: Theory and Policy; Pearson Education: London, UK, 2009.
7. Slaughter, M.J. Infant-Industry Protection and Trade Liberalization in Developing Countries; USAID: Washington, DC, USA, 2004.
8. Tybout, J.R. Manufacturing firms in developing countries: How well do they do, and why? J. Econ. Lit. 2000, 38, 11–44.
9. Suranovic, S. International Trade: Theory and Policy; Flat World Knowledge: Irvington, NY, USA, 2010.
10. Adelman, I. Fallacies in development theory and their implications for policy. In Frontiers of Development Economics: The Future in Perspective; World Bank Group: Washington, DC, USA, 2001; pp. 103–134.
11. Shafaeddin, M.A. Free Trade or Fair , Fallacies Surrounding the Theory of Trade Liberalization and Protection and Contradictions in International Trade Rules: An Inquiry into the Causes of the Failure in the Recent Trade Negotiations; discussion paper, forthcoming; UNCTAD: Geneva, Switzerland, 2000.
12. Oslington, P.; Viner, J. The cost of protection, and customs unions: New light from a Manitoba consulting assignment. Econ. Hist. Rev. 2012, 55, 73–79.
13. Goerzen, A.; Schussler, B.; Suriano, N. Econometric Analysis: Effect of Barriers on Trade; Georgia Tech Library: Atlanta, GA, USA, 2016.
14. Davids, P.; Meyer, F.H.; Louw, M. Evaluating the effect of proposed tariff protection for the South African broiler industry. Agrekon 2015, 54, 70–95.
15. Blanchard, E.J.; Bown, C.P.; Johnson, R.C. Global Supply Chains and Trade Policy; No. w21883; National Bureau of Economic Research: Cambridge, MA, USA, 2016.

Retrieved from https://encyclopedia.pub/entry/history/show/60171