CHAPTER18, “International Trade,” FROM THE BOOK:

The Science of Economics

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1. The case for international trade

The principle that modern economies are based on exchange is accepted by both economists and the public, and it is generally agreed that trade within a country should not be restricted among cities, provinces, and states. But many people have a different opinion about trade among countries. **What is it about a national boundary that makes it desirable to have trade barriers, aside from political reasons such as national defense? National boundaries rarely map out an area that is self-sufficient. Trade allows a nation to concentrate on producing that combination of goods for which it is most efficient.**

"Gains from trade" are the additional output that takes place when parties exchange goods. There are two sources of gains from trade:

- one is that, among nations, differing natural resource endowments will lead to advantages in the production of certain kinds of commodities.
- The second source of gain stems from the decreasing cost of production that results from specialization.

Resource endowments include land (including agricultural land, rainfall, minerals and oil, water, climate, and ports), labor (including skills and the wage level), and capital goods (including technology, knowledge, and historical capital such as architecture and culture).

The most obvious type of gain is an absolute advantage, which is the ability to produce a greater quantity of some product than another country, using the same inputs. Imagine that with one unit of resources, the U.S. can produce 10 units of apples and 6 units of shoes, and that with the same resources, the European Community can produce 5 units of apples and 10 units of shoes. The US then has an absolute advantage in apples and the EC has an absolute advantage in the production of shoes.

The more resources are transferred from shoes to apple production in the US and vice versa in the EC, the greater will be the overall and most efficient production of both goods.

However, will trade still occur if the US has an absolute advantage over the EC in the production of both apples and shoes? David Ricardo in 1817 resolved the question with the theory of comparative advantage. Suppose a lawyer can earn $100 per hour doing legal work, and can type 100 words per minute. Suppose secretaries can be hired for $10 per hour, but they can only type 50 words per minute. The lawyer has an absolute advantage in typing. Should he hire the secretary anyway? Yes, because the secretary has a relative advantage in typing. If he does his own typing, he saves $20 per hour (from two secretaries), but loses $100 in legal work, for a net

loss of $80. He is better off hiring two secretaries to do what he could do in an hour. The same principle applies to trade between countries.

There can be gains from specialization and trade even when there is no absolute advantage. By concentrating in what it is best at, a country will be better off exporting that item and importing what it is relatively less efficient at. Gains can be derived from the process of specialization itself. An economy which specializes in the production of certain goods will develop economies of scale - greater efficiency with greater output, as with automobile manufacturing. Secondly, an economy will gain skill in efficiency, quality, and variety. Comparative advantage is not a given, but can be created, and lost. The theory of comparative advantage is dynamic, as both natural and created advantages change over time.

Gains from specialization depend on the "terms of trade." This concept measures the amount of imported goods that can be obtained per unit of exported goods. A rise in the price of imported goods, while that of exports remains unchanged, reduces the terms of trade. The dramatic increase in oil prices in the 1970's led to a decrease in the terms of trade for oil-importing countries. In the last few decades, some developing countries have seen the prices for their export commodities steadily decline. Markets adjust to changing terms of trade by importing less of the item increasing in price (such as conserving oil and finding substitutes) and switching from exports that lose relative value to those, such as manufactures, which are gaining in relative value.

2. Free trade and trade barriers

Free trade is the exchange of goods without any trade barriers such as quotas and tariffs. Trade barriers consist in interference by the government to "protect" domestic industries. This trade limitation is commonly referred to as a protectionist policy. Protectionism is also called "mercantilism," from the mercantile economic system that European countries pursued from the 1500s to the 1700s, when trade was tightly regulated. Adam Smith, in ***The Wealth of Nations***, showed how trade limitation reduces wealth, since if all countries restrict trade, the result is less wealth in each country. Yet, most governments impose restrictions on trade in an effort to "protect" domestic industries. There are political reasons for mercantilism - some industries influence the government to favor their special interest at the expense of the public well being.

The two basic types of trade limitation are tariffs and quotas.

- **A tariff or import duty is a tax on imported goods**. Tariffs raise the price of the good, reducing the quantity demanded and thus reducing the amount imported and making domestic production more profitable.
- **An import quota is a limitation on the quantity of an import, which enables domestic producers to raise their prices**. Either way, consumers are worse off, due to the higher prices and lower quantities of the goods. The ultimate quota is zero - an embargo or prohibition on the import and export of goods. For example, the United States has had an embargo on trade with Cuba. Some countries also impose a tax on exports,

which by making exports more expensive reduces their production. Despite the negative effects on the economy, many less-developed countries impose taxes on foreign trade because such taxes are easier to collect than taxes on production, and such taxes enable them to avoid taxing land, which may be opposed by powerful elites.

Another option available to the government wishing to restrict imports, is to reduce the demand for the imported good. One way to do this is to legally require a percentage of domestic production in some goods. The demand for foreign goods can also be restricted by limiting the use of foreign exchange and also by manipulating currency exchange rates, making the domestic currency less valuable relative to foreign money, increasing the price of imports, reducing the quantity demanded.

All such restrictions on free trade damage the general welfare, at least in the short run. Those advocating trade barriers argue that these encourage economic development in the long run by protecting "infant industries" until they can mature and obtain more experience and a lower cost. But another way to protect such industries is with **subsidies**, which leave fewer distortions in the relative price structure and make the cost more explicit. More fundamentally, there is no guarantee that the protected industry will become more efficient; just the opposite can occur, as the firms rely on artificially high prices to remain inefficient. Also, trade limitation subjects the process to political influences. It is also not clear why the initial time when the industry is getting started should not be paid for by the investors rather than the taxpayers. The infant-industry argument is therefore weak at best and subject to the problem of the lack of knowledge as to whether it will succeed and to manipulation by special interests. Once an industry is given a privileged position, it becomes a special interest that will perpetually seek to preserve its privilege.

Many trade limitations, involving both subsidies and quotas, do not involve infant industries at all, but are an attempt to preserve the economic condition of an industry such as agriculture which cannot be sustained at current market prices. For example, the Common Agricultural Policy of the European Common Market costs its taxpayers 23 billion British pounds per year. In the European Sugar Policy, the European Community subsidizes the overproduction of beet sugar in inefficient places such as Great Britain and Portugal. Indeed, every country in the EC is producing sugar, despite of the fact that France and Italy alone could adequately supply all of Europe's needs. The result of the EC Sugar Policy is to produce three million more tones of beet a year than Europeans can consume. The damage caused by this policy goes beyond the waste of taxpayers' money. The surplus production is dumped on the world market, reducing the price of cane sugar exported by developing countries (Rowling, 1987, p. 70).

The United States also restricts sugar imports with quotas as well as price support, further depressing world market prices.

In an attempt to protect farmers from world prices, the US Government sets target prices for crops and pays the difference. The US government also uses quotas. Peanuts, for example, have both a quota on imports and price supports, and milk, butter, and cheese have been protected with price supports.

Trade limitations are also imposed to protect labor from lower-wage competition abroad. Manufacturing enterprise has been shifting labor-intensive production such as textiles to economies with lower labor costs, and workers in the domestic industries then lobby for trade barriers on the lower-priced imports. In the interventionist markets of today, displaced workers often have a difficult time finding other work of the same wage scale. In a free market, prosperity and the absence of a tax wedge on wages would provide a continuous demand for skilled labor, so that those who become trained in new fields or are willing to relocate to growing areas would find ready employment.

Trade barriers are defended as a superficial treatment of effects, rather than as the fundamental remedy of the cause, of low wages and unemployment. As Henry George (1886, p. 9) stated in his book ***Protection or Free Trade***,

"the advocates of protection ... extol the virtues of protection as furnishing employment, without asking how it comes that any one should need to be furnished with employment; they assert that protection maintains the rate of wages, without explaining what determines the rate of wages."

Advocates of trade limitation inconsistently advocate tariffs between countries but not within countries, and they do not advocate other barriers which would have the same effect. If trade barriers are beneficial, why not others? As George (1886, p. 35) put it,

"Who would think of recommending a site for a proposed city or a new colony because it was very difficult to get at? Yet, if the protective theory be true, this would really be an advantage."

Piracy would also be welcomed as increasing the cost of imports. Also, we regard canals, railroads, and better ships as beneficial, yet how can tariffs then be beneficial? Improved transportation reduces the cost of bringing in foreign goods, while tariffs increase the cost.

"We maintain a tariff with the avowed purpose of keeping out the products of cheap foreign labor; yet machines are daily invented that produce goods cheaper than the cheapest foreign labor" (p. 36).

George also asks (p. 37),

"Is there not, in the first place, an obvious absurdity in taking the nation or country as the protective unit and saying that each should have a protective tariff!"

National boundaries have been changing constantly.

"Political changes in no wise alter soil, climate, or industrial needs" (p. 39).

If Virginia goods must be protected from those of France, why not also protect them from the imports of New York or California? If Virginia was a separate country, there would likely be such tariffs. Would it be for political or economic reasons? Aside from national defense, there is no economic difference between domestic exchange and international exchange.

To counter trade barriers and promote international trade, especially in manufactured goods, the General Agreement on Tariffs and Trade (GATT) was signed in 1947. Since GATT was founded, significant reductions in tariffs have been achieved by the member states. Many developing countries which maintained protectionist policies are now liberalizing their trading policies. Regional trading blocks such as the European Community and the North American Free Trade Agreement (NAFTA) are reducing trade barriers in continental regions.

3. The impact of trade on land

A major problem with international trade is the unequal environmental policy among countries. For example, as US companies relocate south of the border in search of cheap labor, some companies have dumped toxic waste into the Rio Grande, causing serious health and water-supply problems in the area. But such pollution is not part of "free" trade. A truly free market consists of voluntary exchanges, and dumping pollutants is not voluntary to the victims. Polluting is an act of force unless it is agreed to. The second best solution is compensation for the damage cause. Hence, in a free market, polluters must be charged for the social costs. As noted in Chapter 13, this charge is a type of rent for the use of land (including water and air as economic land) as a dump.

The problem in free trade is then to equalize such pollution charges, otherwise some countries will have an unjust advantage. Those with lower pollution charges will have lower production costs, but these are really environmental costs being imposed on others. Free trade thus requires an international agreement on common charges for environmental destruction.

A comprehensive agreement would include fees, fines, and other charges on any use and abuse of natural resources, including pollution, the destruction of wildlife, deforestation, and soil erosion.

The other impact that trade has on land is the increase in land rent and land value that accompanies an increase in productivity and investment. A substantial amount of the benefits will go to landowners. The collection of this rent by local and national communities will enable the population as a whole to benefit equally from this increase in prosperity. We can look to Great Britain for an illustration. During the days of the British Empire, the western UK ports - Bristol, Liverpool and Glasgow - were the most prosperous. After the decision to align Britain more closely with European countries, British ports on the east coast became the new centers of prosperity, with a subsequent increase in land values. The land owners of the east received a windfall from the activity of the ports. The collection of the land rent by the UK would equalize this benefit rather than letting it fall to those who did nothing to cause it.

The issue of international trade thus has an intimate connection with public revenue and environmental policy. Truly free trade requires the community collection of rent, including pollution charges, just as it requires the removal of taxes and restrictions on trade.