

International Trade Theory is Still Relevant*

It has become commonplace to argue that the theory of comparative advantage and international trade is no longer relevant to the realities of the world economy and that concepts such as free trade versus protectionism are outdated. Perhaps the strongest, but by no means the only example of this, has been given in recent statements by representatives of the AFL-CIO. This view appears to have been a major factor in the shift of the AFL-CIO away from freer trade toward protectionism.¹ It is the contention of this paper, however, that international theory still has much to offer as a guide for policy.

There can be no doubt that there have been profound changes in the world economy in the postwar period and that some of the trends which have developed in recent years, such as the more rapid spread of technology and the growth of the multinational corporation, will probably accelerate during the decade of the 1970's. During any such period of rapid change it is always a wise policy to rethink the relevance of the concepts and theories with which one operates. But it does not follow that the tools which were previously applicable must always be discarded. Changing circumstances may or may not affect the applicability of a particular way of looking at things. In this paper I shall spell out some of the assumptions of international trade theory which are required to support its presumption in favor

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¹ See, for instance, *International Trade*, Report of the Economic Policy Committee to the AFL-CIO Executive Council, February, 1970, the AFL-CIO pamphlet, *The Export of American Jobs*, and numerous public statements by AFL-CIO representatives reported in the press.

of free international exchange under most conditions and also some assumptions frequently mentioned but which in actuality are not necessary to derive these presumptions. Such clarification seems essential for any meaningful discussion of whether changing circumstances have undermined the relevance of theory.²

I. The most crucial assumption: prices roughly reflect social costs

Of course, the essence of any theory is simplification — to focus on certain key interrelationships of a situation. As such the assumptions of a theory will seldom be fully realistic in the sense of describing with precision the phenomena under investigation. What we must consider is whether observed differences between assumptions and reality are so important as to destroy the usefulness of the conclusions of the theory. For instance, most of microeconomic theory, of which the theory of international trade and specialization may be considered a subset, makes the assumption that prices reflect the social cost of production. Where this is the case, it can be shown that a free market will be able to attain maximum economic efficiency. Now it is obvious that one of the conditions usually assumed to demonstrate a strict equality of prices and costs, the existence of perfect competition, is not generally met. But economists

² Two brief methodological comments are in order. The first is that I shall not attempt to rigorously specify what I mean by international trade theory. Generally speaking I have in the mind the body of theoretical knowledge presented by professional economists specializing in this area. What is probably one of the most useful expositions for the general reader may be found in LEBLAND B. YEAGER and DAVID G. TIERCK, *Trade Policy and the Price System* (Scranton: International Textbook Company, 1966). Clearly written, but at a somewhat more advanced level are two surveys published by the International Finance Section of Princeton University, GOTTFRIED HABERLER's *A Survey of International Trade Theory*, 1961 and W. M. CORDEN, *Recent Developments in the Theory of International Trade*, 1965. Specific reference to more recent theoretical developments will be cited where appropriate. Two earlier papers on the relevance of classical trade theory which are of interest are GOTTFRIED HABERLER, "The Relevance of the Classical Theory under Modern Conditions", *American Economic Review*, May 1954 and JACOB VINER, "International Trade Theory and its Present Day Relevance", in ARTHUR SMITHIES *et al.*, *Economics and Public Policy* (Washington: The Brookings Institution, 1955).

The second methodological point is that the approach followed here should not be construed as implicitly accepting the argument that the validity of a theory can be directly or only ascertained by the realism of its assumption. I shall leave this statement as an assertion, for a full justification would take us into some murky aspects of methodology which are well beyond the scope of this paper.

are generally of the opinion that most sectors of the American economy are sufficiently competitive, and that the assumption that prices reflect costs is a reasonable guide for most policy questions.³

Another obvious exception to the strict validity of the assumption that prices reflect costs is the existence of what economists call external effects or externalities. One example of such effects which does have considerable quantitative importance is pollution of the environment which is not taken into account in the cost and price calculations of the firm and the consumer. Another example, also long discussed in the economic literature, is the combination of interdependencies of investment decisions and economics of large scale production upon which many of the arguments of infant-industry protection are based. Both are examples of "market failure" in the sense that the free market will not yield utopian efficiency. Hence they may offer legitimate reasons for government action to supplement or supersede free market forces. But in the view of most economists such market imperfections are not sufficiently pervasive to justify the scrapping of the heavy reliance which the American economy places on the working of the price system. In other words, we assume that prices generally do reflect social opportunity costs tolerably well and look for specific instances in which this is not the case as the basis for public actions such as the initiation of antitrust proceedings or the use of regulations or taxes to reduce pollution.

It is worth noting here that while deviations of prices from social opportunity costs have been one of the most frequent sources of arguments for tariffs or other impediments to international exchange, (and there are certainly cases in which it can be shown that such action would improve the situation) the erection of barriers to international exchange to compensate for domestic distortions is almost always a needlessly roundabout and inefficient method of correction. Economists have long had the vague feeling that this was the case, but only recently has this been shown rigorously to

³ This may be phrased alternatively that in most industries it is judged that prices more closely reflect varied costs than would be likely to be the case if government operation or regulation were substituted. Unfortunately, a strong case can be made that government regulation of some industries has increased rather than decreased divergences between prices and social costs. On the general point that it is illegitimate to assume that government action is costless see JAMES M. BUCHANAN, "Policies, Policy and Pigovian Margins", *Economica*, February 1962.

be true.⁴ In other words, while restrictions on international trade because of "market failure" in the domestic economy can be justified as second-best policy which may improve a given situation, they will in themselves generally create other distortions which will make their use nonoptimal on the grounds of economic efficiency.⁵

The assumption that prices generally roughly reflect social costs, at least to an extent sufficient to justify widespread use of the market system, is the most important one needed for the demonstration of the major normative conclusions of international trade theory. This is not surprising since the case for free international trade is merely the case for the extension of trading domains to cover more than one country. In other words, it is the case that the benefits of specialization and exchange do not end at a country's border.

In the standard textbook illustration of the static allocative gains from trade, it is demonstrated how countries (or individuals) with different comparative costs can mutually gain by specialization and exchange. This gain comes from the ability to obtain some goods more cheaply in a roundabout procedure via exchange than by devoting domestic resources directly to the production of the goods in question. Countries export those goods in which they have a comparative advantage and import those in which they have a comparative disadvantage. Of course in the real world market, traders do not look at costs, but at prices. This is, in fact, one of the major virtues of the price system. It economizes on the knowledge needed for an economy to operate. The purchaser generally need not be concerned about the technical details of the cost of production of the goods which he buys. He need only compare qualities and

⁴ J. BHAGWATI and V. K. RAMASWAMI, "Domestic Distortion, Tariffs and the Theory of Optimum Subsidy", *Journal of Political Economy*, February 1963 and HARRY G. JOHNSON, "Optimal Trade Intervention in the Presence of Domestic Distortion", in ROBERT BALDWIN *et al.*, *Trade, Growth and the Balance of Payments: Essays in Honor of Gottfried Haberler*. (Chicago: Rand McNally, 1965).

⁵ The oil import program offers an example. The ostensible purpose of this program is to decrease our dependence on foreign oil for reasons of national defense. In other words, to safeguard against disruptions in the availability of oil to the domestic economy in the case of disruption of foreign supply. This is a collective demand which would not be adequately reflected in a free market situation. However, it is not at all clear that the best way to take this objective into account is to limit the importation of foreign oil during peace time. A more rational approach, aimed squarely at the objective, would be to subsidize directly the availability of sufficient excess capacity in the domestic industry. The cost of this approach to the general public should be much less than that which results from the barriers to oil imports.

prices. Where the relative prices in the domestic economy reflect relative social opportunity costs, the decentralized pricing system will lead to good results.

II. Equilibrium exchange rates

There is a special complication involved in international exchange, however. The international trader compares prices at home and abroad and these will generally be denominated in different currencies. The trader makes his comparison by converting foreign into domestic prices at the rate of exchange between the two currencies. It is important that this exchange rate be realistic, otherwise price signals will be distorted. If the exchange rate were not at approximate equilibrium, a country's balance of payments would be in disequilibrium and international transactions based on market prices would not fully reflect the long-term opportunities available to the country. An over-valued exchange rate would lead to greater imports than could be maintained in the long-run. Such transactions would in effect create negative externalities in the sense that not only would the parties directly involved be affected by transaction, but the society's stock of international reserves would be run down because of the corresponding deficit in the country's balance of payments. Similarly, for the country with an undervalued exchange rate, the market incentives to export would be excessive and the incentives to import would be deficient.

Of course a disequilibrium exchange rate would not be maintained indefinitely. There are limits to the amount of reserves which deficit countries own or can borrow, and in surplus countries there are limits to the proportion of the national income which the country is willing to invest in accumulating international reserves instead of greater consumption or more productive forms of investment. Balance-of-payments adjustment will eventually take place, either through the use of controls, or changes in price levels or exchange rates, or reversals of trends in productivity and technology, etc. This explains why one country, even though technologically superior to another in the production of all products, i.e., having an absolute advantage in the production of all goods, would not undercut the prices of a less productive country across the board on

all goods. While trade at any point in time is based upon the comparison of absolute money prices at home and abroad as translated at the prevailing exchange rate, persistent imbalances would be corrected. Thus over the longer-term, changes in trade patterns would be caused by changes in comparative advantage rather than by changes in absolute advantage.

Concern over changes in the "competitiveness" of a country's exports makes no sense within the context of trade theory because, as traditionally expounded, trade theory assumes the existence of a costless adjustment mechanism, either via changes in price levels in response to payments disequilibrium or via adjustments in exchange rates. Of course in the real world adjustment is not costless, either in political or economic terms, and for these reasons there has been a tendency to postpone adjustments too long. Within this context, one can interpret concern over competitiveness as concern that explicit measures for balance-of-payments adjustment may be required if particular trends in various components of the balance of payments do not reverse themselves.

There can be little doubt that the deterioration of the U.S. trade balance during the late 1960's was a major stimulant to concern over U.S. trade policy. But changes in the overall levels of exports and imports should be of concern primarily in terms of their implications for balance-of-payments adjustment policy, rather than for trade policy per se. While a detailed discussion of balance-of-payments adjustment goes beyond the scope of this paper, let me note that recent fears of the emergence of a large U.S. trade deficit have not been well founded — for, given the present structure of our other international transactions, this would imply a balance-of-payments deficit of unsustainable proportions. Adjustments in exchange rates or other variables would take place. To repeat, from the distinction between absolute and comparative advantage, there is no reason to fear that American industry will perish from being undercut across the board by foreign competitors. If there were such a trend (and I should note here that there is strong evidence that the deterioration of the trade balance has bottomed out and that it should strengthen over the next several years), the proper response would be in the form of a coherent program of balance-of-payments adjustment, not the ad hoc erection of a series of barriers to imports.

In practice much of the confusion between what should be the concern of balance-of-payments policy and what should be trade has occurred because the international adjustment process has not worked as well as it might. The first prerequisite for any balance-of-payments program is a responsible set of macroeconomic policies. But these are not always sufficient to avoid the emergence of disequilibrium or to restore equilibrium. Different trends in productivity, wage pressures, technological advance, demand patterns, etc. can cause balance-of-payments disequilibrium which cannot be corrected by macroeconomic policies alone without the sacrifice of full employment in deficit countries or price stability in surplus countries. In such circumstances, exchange-rate adjustments are called for.

There are costs to making exchange rate adjustment either too frequently or too sparingly. In the first case, premature adjustments (say, in the case of a cyclical movement in the balance of payments) may prove to have been unnecessary. A more appropriate response would have been to finance the temporary payments imbalance. On the other hand, needed exchange-rate adjustments may be put off for too long, encouraging a speculative crisis and/or the resort to controls, and increasing the magnitude of structural change ultimately required. In looking over the experience of our international monetary system in the postwar period, it is clear that countries have generally erred on the side of postponing desirable adjustments. Growing recognition of this fact has been one of the major factors behind the current international monetary discussions on the desirability of greater flexibility in the use of exchange rates. The prompt actions of the Canadians last year in floating their exchange rate in the face of rapidly accumulating reserves illustrates that these lessons from the past may have an important impact on the operation of the international monetary system in the future. One cannot foretell at this point in time just what the specific outcome of the current IMF discussions of greater exchange-rate flexibility will be. But it seems clear that in recent years the use of exchange-rate adjustments has been restored to the arsenal of economic policy instruments considered legitimate by the international community. I am hopeful that this exercise will have and perhaps already has had a substantial beneficial effect in terms of improving the operation of the international adjustment process. Not one of the lesser benefits of improvement in the adjustment process would be the reduction of the difficulty of making clear to the

public the difference between what should logically be balance-of-payments problems and those which are legitimate trade-policy problems.⁶

III. Foreign prices reflect competitive costs

Now let us turn to a discussion of an assumption which the traditional exposition of the gains from trade does not require. This is that prices in a country's trading partner reflect competitive costs in that economy. It is frequently argued that the increase in the degree of national management of economies reduces the relevance of trade theory to today's world — that the traditional case for free trade requires that it be practised by both countries. This is not the case. The gains from trade illustrated in textbook treatments of comparative advantage rely upon the opportunity to purchase goods from abroad at different relative prices from those which would exist in the domestic economy in the absence of trade. Where adjustments in the domestic economy are not costless, one may be concerned over the permanency of foreign prices. In other words, it would be quite legitimate to be concerned by predatory price cutting by foreign firms designed to drive domestic firms out of business so that they may then raise their prices to monopoly levels.⁷ But apart from this legitimate concern over predatory dumping, the cause of the foreign countries' lower price on a particular product makes no difference to the domestic economic gains from international trade. If the domestic economy can obtain

⁶ There is, of course, also the specific question of the balance-of-payments policies to be followed by the United States. Because of the central role which the dollar plays in the international financial system, it is more difficult for the United States to adjust its exchange rate directly than for other countries to adjust theirs. However, exchange rates are relative prices. The U.S. exchange rate vis-à-vis other currencies is the reciprocal of their rates of exchange vis-à-vis the dollar. Similarly, balance-of-payments disequilibria are mutual imbalances. Hence, more appropriate use of exchange-rate adjustments abroad should have beneficial effects on the U.S. payments position. For suggestions concerning appropriate U.S. balance-of-payments policy see GOTTFRIED HABERLER and THOMAS D. WILLET, *U.S. Balance-of-Payments Policies and International Monetary Reform* (Washington: American Enterprise Institute for Public Research 1968) and *A Strategy for U.S. Balance of Payments Policy* (Washington: American Enterprise Institute, 1971).

⁷ It should be mentioned that for such actions to be rational for the foreign firm there would have to be substantial barriers to entry which would keep domestic firms from coming back into the market once prices had been increased.

goods more efficiently by indirectly exchanging exports for imports than by producing the goods domestically, it makes no difference whether the cause of this opportunity for exchange is superior technology or abundant natural resources in the foreign country, or spinoffs from Government sponsored defense and space research or even a direct subsidy by the foreign government.

This does not mean that the trade policies of foreign countries are of no concern to us. Economists have long discussed the terms-of-trade argument for tariffs, this being that by restricting its purchases a country may be able to improve the terms on which it trades and that up to some point this gain will more than offset the loss caused by the reduction in the volume of trade. This result is analogous to the case of the monopolist who restricts sales in order to raise price and (up to some point) profits. In other words, it is possible for a country by taking restrictive actions to secure a monopolistic advantage at the expense of others. Even the danger of retaliation by others does not completely eliminate the possibility that a particular country could gain in such a manner at the expense of others, although retaliation would clearly reduce the gain which such a country might be able to secure. Such gains to an individual country or group of countries could only be made at the expense of efficiency from a world point of view. Thus the international community does have a legitimate interest in the trade policies followed by individual countries, because such monopolistic or monopsonistic restrictions can represent beggar-thy-neighbor policies from which one country gains only at the expense of others.

Two points should be kept in mind though. One is that the terms-of-trade or optimal tariff argument says that only up to some point can restrictions increase a country's national advantage from international trade and there is reason to believe that generally restrictions are already above that level, so that additional restrictions will harm the country which imposes them as well as its trading partners.⁸

A second point is that while foreign restrictions on imports and inducements to exports are often lumped together in discussions of actions by foreign nations which undermine the basis for free trade, the effects of these two types of policies are actually quite

⁸ See, for instance, HARRY G. JOHNSON, "The Gain from Exploiting Monopoly or Monosony Power in International Trade" *Economica*, May 1968.

different. As was just noted, restrictions tend to contract international trade and improve the terms of trade of the country which imposes them. But an export subsidy tends to expand international trade and worsen the terms of trade of the country which pays the subsidy. That is, it improves the terms of trade of the country which imports the subsidized exports. Hence it is not appropriate to lump together in discussions of trade policies the effects of import restrictions and exports subsidies, for they have just the opposite effects on the terms of trade. In fact, it has been shown that if exchange rates or price levels are adjusted to maintain balance-of-payments equilibrium both before and after, the effects of a restriction on exports will have the same effect as a restriction of imports, and a subsidy to imports will have the same effect as a subsidy to exports.⁹

IV. The protection of domestic employment

While it is quite appropriate to be concerned with foreign measures which impede our exports, it is important not to forget the reason why we should be concerned with foreign policies. It is all too easy to fall back into the mercantilist view that the proper role for policy is to maximize exports and minimize imports. This view was based on a confusion between money and real wealth and a failure to understand the mutual benefits of trade. In the mercantilist conceptual framework, exchange was considered to be essentially unproductive, taking place only because each party felt that he was putting something over on the other. The object of trade was to secure gold by running an excess of exports over imports. On the other hand, trade theory, as developed by Adam Smith and following generations of economists, illustrates how both parties may gain from exchange, i.e., that exchange may in itself be productive. The ultimate goal of exchange is to obtain goods (imports) at lower costs in terms of the resources at one's disposal. The primary importance of exports is that they are the most important method by which foreign exchange may be earned in order to have the means with which to pay for imports.

Now there is an argument, which might best be termed neo-mercantilist, which does have a limited degree of validity. This is

⁹ A. P. LERNER, "The Symmetry between Import and Export Taxes" *Economica*, August 1936.

the point argued by Keynes in his *General Theory* that a surplus of exports over imports will have an expansionary effect on the economy and will thus in a situation of general unemployment be able to create employment. This argument is perfectly valid as far as it goes. An excess of exports over imports has an expansionary effect on the economy in just the same way as an excess of investment over savings or of Government expenditures over taxes. In Keynesian terminology, investment, exports and Government expenditures are all injections into the spending stream, while savings, imports, and taxes are leakages.

But the fact that manipulation of the trade balance can be used to stimulate employment does not mean that this is the most appropriate means by which to do so. Were unemployment a general problem in the world economy, with only this means of employment creation at countries' disposal, success by one country could only come at the expense of others. This would be a genuine zero-sum game with any one country's employment gain via a trade surplus coming only at the expense of additional unemployment in other countries. In such a situation, one might expect a succession of trade restrictions and competitive exchange-rate depreciations whose primary net impact would be a strangulation of international trade without providing a cure for deficient employment. And this is in fact what did occur during the Great Depression.

Fortunately, today we know a great deal more than we did then about the way in which monetary and fiscal policies affect the economy. We cannot, of course, control every dip or spurt in the economy, but appropriate domestic monetary and fiscal policies are much more effective than trade policies in maintaining approximate full employment over the long-run, and do so in a manner which is not injurious to the international community. Where macroeconomic policy does keep the economy at full employment on average, it makes no sense except in a very limited short-run context to speak of increases in exports as creating jobs and increases in imports as destroying jobs. Changing patterns of both the domestic and foreign economies do generate continual adjustments in the economy, and specific jobs are continually being created and destroyed. But we must be wary lest the rhetoric of job creation and job loss due to exports and imports be thought of primarily in net terms as the permanent loss or creation of jobs.

This does not mean that there are no difficulties of adjustment to changing patterns of trade. This is a point which is not always stressed sufficiently in textbook treatments of trade theory. The standard trade theory assumptions of wage and price flexibility and perfect factor mobility within a country cause the most common geometric treatments of the gains from trade to abstract from the transitional cost of reallocating factors of production in response to changing trade patterns.¹⁰ Factor mobility within the United States is generally quite high and much of the dynamism of the American economy is due to the speed and efficiency with which labor, management, and capital react to changing market conditions. But some factors of production are more mobile than others and adjustments sometimes cannot be made without imposing severe hardships on particular individuals. It is sometimes difficult or impossible to convert fixed investment to alternative uses and the need for retraining or relocation of individuals in order to secure alternative employment may fall particularly severely on some, especially on older workers. In such instances special help in the form of adjustment assistance and manpower policies, technological assistance, etc. may be efficient as well as equitable, and a strong case can be made that access to such help should be liberalized. What does not make sense is to attempt to freeze the pattern of employment so that adjustments do not take place. The ability to adapt to change is one of the most important factors necessary for the maintenance of the strength of the American economy.

¹⁰ Let me note that, as has been demonstrated by my colleague Gottfried Haberler, the existence of factor immobility alone does not destroy the case for free trade in the face of prospective changes in trade patterns. Factor immobility will eliminate the production gains which could otherwise occur from the opportunity to trade, but consumption gains would remain intact and there would be no offsetting losses to the economy as a whole. What could cause a country as a whole to be worse as the result of the opening up of a trading opportunity is the combination of factor immobility and wage and price rigidity. In this instance the resulting fall in demand for the domestic production of import substitutes would be reflected in permanent unemployment rather than a reduction of wages and price and earnings in the import competing industry. In technical terms, the fall in employment would cause the economy to operate within rather than on its production possibility or transformation curve. There could be either a net gain or loss to the economy as a whole, depending upon the relative sizes of the consumption gain and the employment loss. While such a situation can thus provide a case for tariff protection, as noted toward the beginning of this paper, the first best approach will usually be to attack directly the causes of the factor immobility and/or the wage and price rigidity. See GOTTFRIED HABERLER, "Some Problems in the Pure Theory of International Trade", *Economic Journal*, June 1950.

V. International factor mobility and the multinational corporation

When the relevance of trade theory to today's world is questioned, mention is almost always made of the growth of foreign investment and the multinational corporation. The traditional assumptions of classical trade theory were that factors were perfectly mobile within countries, but immobile between countries, and some have argued that the assumption of factor immobility between trading partners was one of the key factors which justified international trade theory as a distinct sub-discipline of economics. Thus it is easy to understand the charge that the clear unrealism of the assumption of factor immobility between countries today undermines the applicability of trade theory. This is not the case, however. While the assumption of factor immobility was made by most of the classical and neoclassical international trade theorists, it is not required for the important conclusions of trade theory. In fact one of the major contributions of the classical theorists was to explain how trade would substitute for factor movements, the trade of products bringing about the indirect exchange of the services of the factors of production embodied in them.

In recent years, a number of economists have more thoroughly explored the relationships between trade and factor movements.¹¹ Substantially the same result will be brought about either by the perfect mobility of goods or by perfect mobility of the factors of production. In the face of either condition, the need for the other as a condition to achieve maximum efficiency would disappear. In other words, with perfect factor mobility there would be no need for trade and with costless trade there would be no need for factor mobility. In fact there are of course barriers to the international exchange of both final products and factors of production. One need

¹¹ See, for instance, ROBERT MUNDELL, "International Trade and Factor Mobility", *American Economic Review*, 1960; J. CARTER MURPHY, "International Investment and the National Interest", *S.E.J.*, July 1960; A. E. JASAY, "The Social Choice Between Home and Overseas Investment", *E.J.*, March 1960; T. BALOGH and P. P. STREETEN, "Domestic Versus Foreign Investment", *Bulletin of the Oxford University Institute of Statistics*, August 1960; G. D. A. MacDOUGALL, "The Benefits and Costs of Private Investment from Abroad: a Theoretical Approach", *Bulletin of the Oxford University Institute of Statistics*, August 1960; R. F. MIKESSELL, *U.S. Private and Government Investment Abroad* (U. of Oregon Press, 1962) especially chs. V-VII and XVII-XIX; M. C. KBMP, "The Gain from International Trade and Investment", *A.E.R.*, Sept. 1966; and R. W. JONES, "International Capital Movements and the Theory of Tariffs and Trade", *Q.J.E.*, Feb. 1967.

only mention transportation costs on the one hand and information costs on the other. In our imperfect world, both trade and factor movements contribute to the promotion of economic efficiency, the proportion of one to the other depending upon the relative ease with which they may be undertaken. In other words, whether one trades imports or outputs depends upon the relative costs of doing each.¹²

There are analogs between most of the propositions concerning the effects of free trade and of factor movements, such as their effects on factor returns and on economic efficiency. Likewise there is an analog between the terms of trade argument for optimum tariffs and for government interference with the free flow of capital in order to obtain the maximum monopolistic national advantage. In fact, conditions for the optimal relationship between the two have been worked out in the economic literature.¹³ My point here is not to advocate restrictions on capital flows but rather to emphasize that trade theorists have not ignored international factor mobility and that such factor movements generally do not undercut, but rather help to more fully achieve the advantages of international specialization and exchange. The possibility of increasing a country's economic position by exploiting latent monopoly power may exist in instances in which restrictions do not already exceed the optimum, but in a dynamic world it is generally both good economics and good foreign relations to forgo attempts to secure any such short-run advantages which might be obtained only at the expense of a general increase in the impediments to international exchange which would be in the interest of no country.¹⁴

In the literature on capital flows and national advantage another question has been raised, however, which may be of considerable importance. This concerns the taxation of income from foreign investments. The private investor has little incentive to care whether he pays a given amount of tax to his home or to a foreign government. However, in the case of domestic investment, the whole pre-tax income on investments contributes to domestic GNP. Under the prevailing tax arrangements foreign subsidiaries are allowed to count tax payments to the host country as a credit against their tax

¹² See the succinct discussion by ROBERT E. BALDWIN, "The Theory of Trade in Inputs and Outs", *American Economic Review*, May 1970.

¹³ See, for instance, LERNER, *op. cit.*

¹⁴ See, for instance, the discussion by CHARLES P. KINDLEBERGER, *American Business Abroad* (Yale University Press, 1968), Chapter 2.

liabilities in the United States. Thus, under such arrangements it is only the after tax income on foreign investments which contributes to domestic GNP. Looking only at tax payments will overstate the quantitative importance of this consideration, because the location of the investment will also have some influence on the cost of government services. But when this is netted out, there still may remain a substantial difference in return. Where capital exporting countries are engaged in policies to aid capital importing countries, then the forgoing of national advantages from the taxation of investment earnings would certainly seem to be a wise policy. It would be an important component of the total aid program. But in the case of capital exports to other developed countries, the net advantages of the present tax arrangements seem less clear.

Now let us turn to two other aspects of foreign investment and the multinational corporation which have frequently been the subject of misleading discussions. One concerns the fact that the percentage of U.S. trade accounted for by intracompany transfers has become quite substantial. Thus, it is argued, theories based on the assumption of competitive relationships between prices and costs are not applicable to much of U.S. trade, since the prices set on intracompany transfers are influenced heavily by considerations of minimizing tax liabilities and at times of "smuggling" capital out of a country by the systematic overstating of imports and understating of exports. These points are very relevant for questions of tax policy or for the enforcement of exchange controls. They need not imply, however, substantial deviations from competitive resource allocation. Regardless of what prices they set on intracompany transfers for tax purposes, firms have a profit incentive to properly take into account the opportunity costs of their activities. To the extent that this is done and the markets in which the multinational firms operate are reasonably competitive, then such intracompany transfers will not give rise to allocative distortions. This question has been investigated in considerable detail in the economic literature on the efficiency effects of vertically integrated firms.¹⁵ There are a number of factors which influence whether the overall effects of vertical integration tend to increase or decrease competitiveness and overall efficiency. These include such considerations as the existing

¹⁵ See, for instance, SAM PETZMAN and J. FRED WESTON (eds.), *Public Policy Toward Merger*, Goodyear 1969.

structure of the various markets in which the firm operates, the difficulty of new entry into these markets, and the scope for internal economies of scale. The net effect of these factors may vary on a case-by-case basis. The actual performance of firms which are vertically integrated across national borders clearly needs to be studied much more carefully. In fact this has recently become a popular topic for economic research. Pending the results of further investigation, however, it seems safe to say that the charges that the effects of the multinational corporation are generally anti-competitive are not proven and hence do not provide a basis for arguing that the relevance of international trade theory has declined.

Another charge frequently made is that products which are manufactured less expensively abroad with the aid of American capital, management, and technology and then shipped back to the U.S. market, tend to sell at the same price as comparable domestically produced products, with the result being no reduction in price for the domestic consumer but only increased profits for the company. This argument misses the point that such imports will increase the aggregate supply of the product available for domestic consumption and hence will put downward pressure on price. If the domestically produced and foreign produced goods are in fact comparable, then one would expect them to sell for the same price in a competitive market. From economic theory one would expect that the effects of an increase in supply of comparable products would be to reduce the market price for all goods of the particular type or keep prices from going up as much as they otherwise would, not to create a differential in price between products which are the same except for being produced by different sources of supply.¹⁶ Thus the fact that comparable domestically produced and foreign produced goods sell for the same price does not mean that consumers gain to benefit from the existence of the source of supply located abroad.

¹⁶ It should be noted that differences between costs at home and abroad (as expressed in home currency) for comparable products is evidence of disequilibrium, but it need not imply that all production will be eventually shifted to the country which is currently lower cost producer. Where supply curves are upward sloping, the resulting expansion of production in the lower cost country and contraction or reduction in the rate of growth of production in the higher cost country would raise costs in the first country and lower them in the second until costs were equalized. Consideration of differentiated products also reduces (but does not eliminate) the likelihood that a particular domestic industry would completely go out of business as the result of the emergence of lower cost suppliers located abroad.

VI. Concluding remarks

I hope that the preceding discussion is sufficient to indicate why I believe that international trade theory has not lost its relevance and that the presumption which may be derived from it in favor of free international exchange as a general policy remains a wise basis for international trade and investment policy in the 1970's. This is not to say that there are no unsolved theoretical issues. (The welfare effects of the production and international transmission of knowledge, for instance, are still not well understood). Nor is it to take a blind stance that there are never instances in which impediments to international exchange may increase the general welfare as well as that of particular groups. But it does indicate that we should be wary of many of the arguments that have been put forth recently in support of an abandonment of the United States' role as a major leader in the drive for freer trade in the world economy.

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