FACULTY OF JURIDICAL SCIENCES

Lecture-3

ECONOMIC THEORIES

As Prof. McDougal put it, social theories have the unfortunate habit of travelling in the pairs of opposites. Free trade and protectionism have always been there in international commercial relations; and they manifested under different garbs. At a given point of time, one theory may appear to be dominant; but its opposite has been waiting in the wings to take the central stage.

The idea of modern state system within a defined territory came into existence in 1644 with the conclusion of the Treaty of Westphalia. Many social theories came up around that time mainly with a view to strengthening the nascent state system. The basic idea was to strengthen the Central authority against centers of power based on feudalism or religion. Mercantilism as a theory on international trade was developed for this purpose. Along with the corresponding political theory of power politics, it held that the acquisition of power, i.e. economic power of a state. In the absence of modern banking and currency system, economic power meant acquisition of precious metals – mainly gold. To acquire gold from other states, a state should achieve export surplus vis-à-vis other states. It could also simply cutting down imports from other states so as to curtail thy outflow of precious metals which served as money: nationally and internationally. In brief, protectionism under the garb of strengthening the central authority became the dominant ideology.

The limitation of this theory was obvious: aggressive pursuit of export surplus is a zero sum game, which would soon lead to the shrinking of international trade. However, in the context of power politics, such an aggressive pursuit was considered legitimate.

With the dawn of industrial revolution in 18th century, mainly in the U.K., a more enlightened trade theory emphasizing the expansion of trade was required, because the industrialized countries required to export their industrial products and to import raw materials. Adam Smith, in his Wealth of Nations, published in 1776, met that need. In consonance with the emerging republican spirit emphasizing individual liberty, he argued that a nation's strength should be judged by the wellbeing of the people rather than possession of precious metals. It meant that people engaged in agricultural must not be squeezed to promote industries. Further, Adam Smith believed that division of labor and consequent emphasis upon specialization would contribute to general prosperity. He explained the rationale for free trade as follows:

It is the maxim of every prudent master of a family never to attempt to make at home what it will cost him more to make than to buy. The tailor does not attempt to make his own shoes, but buys them from shoe-maker. The shoe-maker does not attempt to make his own clothes, but employs a tailor. ---- All of them find it for their interest to employ their whole industry in a way in which they have some advantage over their neighbors and to purchase with a part of their produce whatever they have occasion for.

What is prudence in the conduct of every private family can scarce be folly in that of great kingdom. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage.

In brief, Adam Smith proceeded on the assumption that just like an individual having some advantage over other individuals in respect of skills, a state has also advantage over other states. Hence his exposition is known as the doctrine of Absolute Advantage. But with the advancement of technology, every state can produce almost everything it requires; and a technologically advanced state can have absolute advantage over other states. In this context, David Ricardo advanced the doctrine of Comparative Advantages as a corrective to Adam Smith's doctrine of Absolute Advantage. According to him, even if country A has absolute advantage over country B in production of many goods, it is better for country A to concentrate on producing those goods in which it has relative advantage compared to the production of other goods. To quote his classic example:

Suppose in England a gallon of wine costs 120 and a yard of cloth 100 unites of work, while in Portugal, a gallon of wine costs 80 units of work and a yard of cloth costs 90 units. Portugal has absolute advantage in both wine and cloth; but England has comparative advantage, since the production of a yard of cloth in England involves in giving up production of 5/6 (100/120) of a gallon of wine, whereas the production of a yard of cloth in Portugal involves giving up 1 1/8 (90 /80) of a gallon of wine. Assuming constant costs, prices accurately reflect costs and ignoring transport and handling, a piece of cloth anywhere between 5/6 and 1 1/8 of the prices of wine would make it profitable for Portugal to import cloth and export wine and for England to export cloth and import wine. If the same amounts of resources, as before trade, are committed, the output for the two countries will be both more wine and more cloth.

According to Paul Samuelson, if there is one economic theory which has withstood the test of time, it is Daniel Ricardo's theory of comparative advantages; because it has clearly demonstrated how mutually profitable division of labor enhances national production for all nations.

In the recent time, Heckscher and Ohlin developed Ricardo's ideas further by substituting capital and labor. According to them, international trade is determined by fact or endowments and factor intensities.

Even as Adam Smith's theory was gaining acceptance, there was counter attack from Europe. Protectionism in the sense of state intervention to protect community's interest emerged under a new garb: infant industry protection. Friedrich List, a German economist, in his book "National System of Political Economy" argued that free trade would be harmful to countries like Germany which were inferior to England, at that point of time, in industrialization. Free trade for Germany would mean that, it would be flooded with cheap English products; and Germany would never be able to develop its potential. Hence he argued for the protection of nascent industries in Germany through high tariff walls. Around the same time, in the U.S.A., Hamilton, one of the prominent authors of Federalist Papers, argued for encouraging manufacturing in the U.S.A through protectionist policies: and thereby openly repudiating Adam Smith's ideas.

MERCANTILISM

Mercantilism was an economic system of trade that spanned from the 16th century to the 18th century. Mercantilism is based on the principle that the world's wealth was static, and consequently, many European nations attempted to accumulate the largest possible share of that wealth by maximizing their exports and by limiting their imports via tariffs.

- Mercantilism was an economic system of trade that spanned from the 16th century to the 18th century.
- Mercantilism was based on the idea that a nation's wealth and power were best served by increasing exports and so involved increasing trade.
- Under mercantilism, nations frequently engaged their military might to ensure local markets and supply sources were protected, to support the idea that a nation's economic health heavily relied on its supply of capital.

Mercantilism is an economic policy whereby a nation aims to maximize exports and minimize the imports. Originally adopted by European nations between 1500 and 1800, mercantilist nations implemented policies such as tariffs and subsidies in order to boost exports and make international imports more expensive.

Mercantilism originates from the term 'mercantile', which refers to merchants and trade. By extension, mercantilism is the philosophy and belief that trade with other nations should be regulated through what is now known as 'protectionism'.

Key Points

- The balance of trade was a key component of mercantilism – imports were bad, and exports were good.
- Mercantilism focused on controlling gold in order for colonists to pay for its large armies and expand its empire.
- At the core of mercantilist belief was that one nation could only benefit at another nations expense.

History of Mercantilism

Mercantilism was the dominant theory in Europe between 1500 and 1800. Countries all wanted to export more than they imported. In return, they received gold. It powered the evolution of nation-states out of the ashes of feudalism. Holland, France, Spain, and England competed on the economic and military fronts. These countries created skilled labor forces and armed forces.

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Before that, people focused on their local town, kingdom, or even religion. Each municipality levied its tariff on any goods that passed through its borders. The nation-state began in 1658 with the Treaty of Westphalia. It ended the 30 Years War between the Holy Roman Empire and various German groups.

The advent of industrialization and capitalism set the stage for mercantilism. This phase strengthened the need for a self-governing nation to protect business rights. So, merchants supported national governments to help them beat foreign competitors. An example was The British East India Company who defeated the princes of India with 260,000 mercenaries. It then plundered their riches as the British government protected the company's interests. Many members of Parliament owned stock in the company.
As a result, its victories lined their pockets.

Mercantilism depended upon colonialism as the government would use military power to conquer foreign lands. Businesses would exploit natural and human resources. The profits fueled further expansion, benefiting both the merchants and the nation.

Mercantilism also worked hand-in-hand with the gold standard. Countries paid each other in gold for exports. The nations with the most gold were the richest. They could hire mercenaries and explorers to expand their empires. They also funded wars against other nations who wanted to exploit them. As a result, all countries wanted a trade surplus rather than a deficit.[7]
Mercantilism relied upon shipping. Control of the world's waterways was vital to national interests. Countries developed strong merchant marines and imposed high port taxes on foreign ships. England required all imports from Europe to come in its own vessels, or in a vessel registered in the country where the goods originated.