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The Role of Customs Tariff: A Historical, Theoretical and Empirical Review

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Abstract
Many economists believe that international trade and finance is the place where the discipline of economics has got its origin. But the debates of international trade are not yet entirely solved and, therefore, some issues are still on the agendas of WTO and other concerned international institutions. The Mercantilists favored exports and disfavored imports. The Classical economists introduced the theories of absolute and comparative advantages as well as labor specialization. They also strongly condemned the intervention of the government in trade and suggested that the market forces can do better if they are left alone. But later on, this assumption of the renowned Classical economists was first challenged by two 20th century Neoclassical economists, Eli Heckshher and Bertil Ohlin, both from Sweden (Todaro and Smith, 2006). They replaced the complete labor specialization assumption with "factor endowment trade theory". The Modern economists, who developed the protectionist views, in their turn, challenged both the Classical and the neoclassical economists together. Although most of the economists and schools of thoughts argue for free trade, there are others who support protection, inward-looking strategies and import substitution. Tariff is used by many developing countries all over the world to practice this protectionist view of the Modern economists. Along with its role of protecting domestic infant industries, tariff also has the advantages of generating tax revenue from international trade, controlling the problems of trade deficit and balance of payments, and also attracting investors to the protected sectors. Even from the developed and large countries point of view, the theory of optimum tariff is another argument against free trade. Therefore, the role of tariff is a matter of practical investigations rather than theoretical generalizations.
Keywords: tariff, effective rate of protection, revenue tariff

Introduction

The study of the role of international trade and finance is among the oldest specialties in economics. According to Krugman and Obstfeld (2006: 1), international trade and finance is where the discipline of economics has got its origin. They explain that many of the historians of economic thought usually take David Hume's "Of balance of trade", essay, as the "first real exposition of an economic model". Kenen (1994: 1) also shares this idea stating that the study of international trade and finance "was conceived in the sixteenth century, a child of Europe's passion for Spanish gold, and grew to maturity in the turbulent years that witnessed the emergence of modern states". The separate branch of economics that deals with this aspect of economics is commonly known as "International Economics". What makes this distinct subject matter quite interesting is the everlasting debate amongst renowned economists whether or not the sovereign nations should restrict the exchange of goods and services between themselves.

So far, international trade theory has passed through different stages and has reached the level where it is considered one of the major components of "globalization", along with foreign direct investment (FDI) and other forms of financial flows. The Mercantilists had the view that encouraging exports and discouraging imports helps to strengthen the wealth and power of the states. Differently, the Classical economists brought the theory of comparative advantage, the guiding principle of which is resource endowments and efficiency. They strongly condemned the intervention of the government in trade and suggested that the market forces can do better if they are left alone. However, the Modern economists who have come after the Classical economists argued against the "laissez-faire' approach of the Classical economists. Their reason of argument is that, as the global economy is so intertwined, the domestic policies such as monetary and fiscal policies by some countries may affect their trading partners so that government intervention would be necessary to closely follow and take corrective adjustments and measures.

This Article contains two trade-related issues, trade theory and trade policy. The views of different schools of thought towards theory of trade are captured first, and then, the economic role of one of the tools for trade policies, i.e., customs tariff, are reviewed from protection, revenue collection, balance of payment and economic development perspectives. In this second part, some empirical findings in Ethiopia are included.

Historical Reviews of International Trade Theories

Based on their views about international trade, economists can be categorized at least into four: mercantilists, classical economists, neoclassical economists, and modern economists. These four categories of thoughts towards theories of international trade are reviewed briefly in the following sections respectively.

The Mercantilists' View

In the seventeenth century, Mercantilists such as Jean Baptiste Say and Thomas Mun had the view that exporting more goods to foreign states than importing them from abroad helps a nation to accumulate additional wealth in the form of trade surplus. During this Mercantilist era, foreign exchange in the form of gold and silver was needed to finance the foreign purchases and pay foreign trade taxes. The accumulated trade surplus, along with other domestic revenues such as tax, according to the Mercantilists, in turn enables the crown to strengthen their royal authority both at home and abroad. At home, they use the money to pay for their armies and navies. At the same time, they also use it to compete with their foreign counterparts in building ships. Therefore, the strength of the crown was measured by their ability to mobilize resources from domestic and foreign sources. The concern of the Mercantilists was also on how to strengthen the powers of their governments.

The View of Classical Economists

The theory of international trade continued to attract the leading economists of the eighteenth century and their works are still guiding us in studying the importance and the problems of international trade because the factors that initiated the theory still continue to demand the attention of today's economists and policymakers as well. The eighteenth century Classical economists such as David Hume, John Stuart Mill, David Ricardo and Adam Smith had different views about the role of trade. Even if they stressed the importance of trade more through their subsequent theories, their concern was entirely different from that of the seventeenth century Mercantilists. They were much concerned about the subjects of the crown than the crown themselves (Kenen, 1994). They believed more in the role of the market forces than the rules and regulations of the states. Contrary to the Mercantilists' belief in a "world of conflict and war", the Classical economists believed in a "world of harmony and peace". They proclaimed the doctrine of "laissez-faire", minimum intervention of the government in the economic sphere. Through his quantity theory of money, David Hume elaborated the effect of foreign trade on the domestic prices. He argued that the quantity of money itself is automatically regulated by the prices and trade flows. John Stuart Mill, in his work on the law of demand and supply, also explained the way the international markets determine prices. David Ricardo, the founder of free trade doctrine, demonstrated the importance of free trade through his comparative advantage argument. Adam Smith's productivity doctrine, which went a step further beyond the free trade doctrine, also added the importance of export-drive argument to free trade. For the Classical economists, the national prosperity of a nation is measured in terms of the welfare of the citizens, not in terms of the power of the crowns.

In the real world situation, there are two facts about trade. Firstly, individuals are endowed with different physical resources, skills and abilities. Some are more advantageous than others with one or more of these factors of production. After calculating and identifying their advantages, they prefer to engage in those activities that fetch them more advantages than others. Using their resource advantages, some people can produce and provide more of some goods and services than what they consume for themselves. This is the principle of comparative advantage in domestic trade.

Secondly, even though some people may produce surpluses of some goods, it is not possible for them to produce all other goods they need for themselves and their families. Even if they may be able to produce different goods for themselves, others could be relatively more efficient in producing those goods. This is the theory of specialization in domestic trade.

The Classical economists, therefore, argue that these same theories of comparative advantage and specialization in domestic markets also work for international trade. The major cause behind the comparative advantages, according to the Classical economists, is that prices differ from country to country. The reason behind the price difference is the cost difference. Costs of products, in turn, differ due to the difference in endowments of factors of production such as labor and different abilities to produce. Some factors of production are cheaper in some countries than the others. Therefore, a country can be advantageous if it specializes in products that it can produce at relatively lower costs and then exports those types of goods in exchange for goods which it can produce at relatively higher costs. The Classical economists also believed that people need a place and a system that enables them to dispose of their surplus products in exchange for goods they couldn't or are not willing to produce themselves. In order the people in the world be benefited from the specialization and comparative advantage theories, the Classical economists advocate that the international trade should be free from the intervention of the governments.

Initially, the debate was whether or not trade between countries is beneficial for the countries involved in the international trade. Theories of international trade widely indicated that differences in prices from country to country are the major cause for trade to exist between nations. Trade usually arises if prices are different in the absence of trade. If the domestic price of certain goods, for example leather jacket in Ethiopia, is higher than the price of the same product in China, Ethiopian importers may import the jacket from China, until the price difference is eliminated. The question is, then, "Why do the prices for the same product differ from country to country?"

Prices differ because of cost differences. The cost difference in turn depends upon the availability and scarcity of factors of production which include labor, capital and land as well as technology. David Ricardo's theory of comparative advantage teaches us that products that can be produced cheaper in a county should be exported and products that can be produced cheaper abroad should be imported. In doing so, we can maximize the utilization of scarce resources all over the world.

Empirically also, trade has been an important source of economic growth and development for many of the now developed countries. Many economists, for example Thirlwall (2006), argue that without the raw materials and food supply from the underdeveloped agrarian economies, the nineteenth century industrialization wouldn't have been possible for the developed nations. It was not only the then industrializing countries which were benefited, but the developing countries were also the beneficiaries from the international trade. Their raw materials were demanded by the manufacturers in the industrializing countries and the trade also created fertile environment for foreign direct investments in the developing countries.

Thirlwall (2006) further explains that there seems to be an agreement among economic historians that in the nineteenth century, "trade acted as a powerful engine of growth, not only by contributing to a more efficient allocation of resources within countries, but also because it transmitted growth from one part of the world to another".

The Classical economists substantiate their arguments for free trade by asking questions such as, "Why should the governments force their citizens to produce goods for themselves at higher costs when they can buy the same goods at lower prices from somewhere and someone else?" Adam Smith (1776) wrote that "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." Todaro and Smith (2006: 588) explain this argument as follows: "The *principle of comparative advantage,* as it is called, asserts that a country should, under competitive conditions, specialize in export of the products that it can produce at the lowest *relative cost*." The Classical economists extend their arguments of comparative advantage to the cases when the countries may have absolute advantages. Even if a country may be able to produce all goods at lower absolute unit costs than a trading partner, it will be advantageous if it specializes in the provision of goods in which the cost differences are greater. For example, even though Japan may be able to produce computers and leather jackets at lower costs than Ethiopia, its comparative advantage lies in the products in which the cost difference is greater, obviously in computers. At the same time, even though Ethiopia could be at an absolute disadvantage in comparison with Japan in both types of products, she can be benefited from trade because her absolute disadvantage is lower in leather jackets.

The View of the Neoclassical Economists

The free trade view of the 19th century Classical economists, usually associated with David Ricardo and John Stuart Mill, is based on a complete labor specialization assumption. As per this assumption, trade is caused by the labor productivity differences for different products in different countries. But later on, this assumption of the renowned Classical economists was first challenged by two 20th century neoclassical economists, Eli Heckshe and Bertil Ohlin, both from Sweden (Todaro and Smith, 2006). They replaced the complete labor specialization assumption with "factor endowment trade theory", which assumes that relative labor productivity is the same across the countries in the world. This proposition arises from the assumption that all countries can have access to the technological progress that is believed, by the Classical economists, to cause labor productivity differences for different goods in different countries. According to the factor endowment theory of the neoclassical economists, therefore, the cause for trade is the differences in factor endowments, not the labor productivity differences. The factors that they consider as causes for international trade are land, capital and labor. The factor which is abundant in a country could be scarce in another. The abundant factor is relatively cheap, whereas the scarce factor is relatively expensive. Labor-intensive products, therefore, can be produced cheaply in a country where labor is relatively abundant than capital, for example. Capital-intensive machineries and equipment can be produced cheaply in countries which are endowed with more capital than countries where capital is relatively scarce. According to this theory, if a country that is relatively well endowed with labor concentrates on labor-intensive-products, and if a country that is relatively well endowed with capital concentrates on capital-intensive products; both countries will have relative cost and price advantages respectively. For these benefits to be effected, therefore, trade between the countries should exist.

The two major assumptions of the neoclassical theory of factor endowment, according to Todaro and Smith (2006), are that: firstly, the proportions of factors of production differ according to the type of a product; and secondly different countries are endowed with different factors of production.

The Views of Modern Economists

Later on, both the Classical and the neoclassical economists began to be challenged together by economists who developed the protectionist views. The major critique on them is that they ignored the way in which sovereign states can influence foreign trade. They took the nations of the world just as regions or states of a nation instead of independent countries. But there are many ways through which national governments can affect the behavior of international trade differently from domestic trade. Policy instruments such as taxes, subsidies and quotas that can be applied on foreign goods may not be equally applied on domestic goods. The way every sovereign nation designs and implements these policy tools may affect its trading partners.

The other major opposition came from those who have the view that all countries do not equally benefit from free trade. This group of thinkers believes that the higher proportion of benefits from free trade goes to the developed economies rather than the developing ones. Thirlwall (2006), for example, lists three major reasons for the unequal benefits of trade today: manufacturer in the developed countries preferred low import content of primary goods; technology enabled some producers to substitute synthetic inputs for raw materials; and the developed countries widely followed the protectionist policy on imports from the developing countries.

In addition to these three factors cited against the free-trade theory by Thirlwall, Todaro and Smith (2006) also argue that some assumptions of the neoclassical economists are far from reality. According to Todaro and Smith (2006), some basic assumptions of the neoclassical economists which include: "the 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 the trade gains accruing to nationals are easy to make on paper but difficult to achieve in practice."

Due to these recent changes and unrealistic assumptions of the neoclassical economists, many developing countries encountered the problems of trade deficits and balance of payments. These chronic problems involved them in huge borrowings from abroad, both to pay their debts and finance their development projects. That is what, according to Thirlwall (2006), led some people to develop a slogan '**trade, not aid**'.

These recent changes in the trend of international trade created a new dimension of thinking in the minds of some economists in the field of international economics. The question they are raising now is "not whether there should be trade but whether there should be free trade". The dispute is not whether trade is advantageous or not. Most economists unanimously agree on the importance of trade between sovereign nations. But their doubt is on the distribution of the gains from trade. In order that all parties in the international trade get a fair distribution of the gains, the trade policies that both the developed and developing countries need to pursue is attracting the attention of many policy makers and specialists of the field.

The Major Roles of Tariffs

Even if customs tariff is perceived as a major barrier to trade on the one hand, it has also its own advantages on the other hand. In other words, there are economic benefits that determine the demand for customs tariff. It plays important economic roles such as protective, revenue, income distribution, employment, balance of payments, import substitution and economic growth. Beyond these economic roles, some people argue that sometimes customs tariff is also associated with high levels of "nationalism" and "patriotism" (Carbaugh, 2005), income redistribution and national defense (Lindert, 1986).

The Ethiopian Ministry of Finance and Economic Development (2007) also states the objectives of the Ethiopian tariff as follows:

i. Providing proper protection for the domestic industries and investors ;
ii. Providing "Price Signal" for the producers and the investors;
iii. Encouraging the substitution of imported goods with local products;
iv. Controlling the balance of payments deficit;
v. Prohibiting the importation of hazardous and polluting goods from abroad; and
vi. Serving as a source of government revenue.

This part of the Article reviews these objectives in more detail.

The Protective Role of Customs Tariff

One major objective of imposing customs tariff is that it plays an import substitution role. Import substitution is a strategy used by many and still being used by some of the developing countries to replace goods that are being imported with similar domestic products. "The economic rationale put forward for the establishment of import-substituting manufacturing operations", according to Todaro and Smith (2006), "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." Krugman and Obstfeld (2006) also explain that even if tariffs are traditionally used to raise revenue for the government, the true purpose of tariffs is protecting domestic products from foreign competition. They also have the view that in the early 19th century in the United Kingdom, and in the late 19th century in both Germany and the U.S., tariffs were mainly used for protection purposes. The purpose of protective tariff, according to Carbaugh (2005: 102), is also "to insulate import-competing producers from foreign competition". It is widely understood as "infant industry argument". The theory of tariff for protecting infant industries is taken as a temporary interference with the freedom of trade. For Carbaugh (2005: 102), protective tariff is not the same with prohibitive tariff, which is levied to totally inhibit foreign products from entering the country. Some people, for example Felder (1986), have different view about protective tariff when they explain that protectionist policies include a ban on international trade in the protected commodity, a prohibition on imports only, a tariff on imports, and a quota on imports.

The distinction between nominal tariff rate of protection and effective rate of protection also helps to appreciate more the principle behind protective tariff. The nominal tariff rate of protection, according to Todaro and Smith (2006: 631), "shows the extent, in percentages, to which the domestic price of imported goods exceeds what their price would be in the absence of protection". The "effective rate of protection", for Todaro and Smith (2006: 632), "shows the percentage by which the **value added** at a particular stage of processing in a domestic industry can exceed what it would be without protection". From these distinct definitions it can be observed that the effective tariff rates are the more appropriate basis for assessing the restrictive effect of tariff structure on trade (Thirlwall, 2006:557).

The effective rate of protection is usually used to measure the protection given to each activity and also to measure how a country's tariff schedule affects the allocation of domestic resources (Kenen, 1994). In fact, the protective role of tariff has declined through time, as countries devised different nontariff mechanisms such as import quotas; import licensing, foreign exchange control, export subsidies, and export restraining (Krugman and Obstfeld, 2006).

In 2007, the Ministry of Finance and Economic Development (MoFED) conducted an effective rate of protection study in the country. The study was based on the 2004 and 2005 data collected from 82 manufacturing industries in the country. According to the results of the study, in 2005, there were about 1,207 private and public manufacturing industries in Ethiopia. Amongst them, 31% were owned by the private sector, 31% were food and beverage manufacturers, 21% were household goods manufactures, and 12% were in the mineral and mining sub-sector. The study also revealed that the share of the three sub-sectors, i.e., food and beverage, household goods and mineral and mining, was about 64% of the total manufacturing sector. This indicates that there is high concentration on these three sub-sectors. The number of workers in the three sub-sectors was 95,158. This number had the share of over 52% out of the total number of workers in the manufacturing sector.

From 2000-2005 years, according to the study, the food and beverage sub-sector, had 45.8% value additions. The success is due to the fact that this sector relatively uses domestic inputs and raw materials. Textile, leather and leather products, as well as mineral and mining products also use relatively higher domestic inputs and raw materials. On the other hand, most of the domestic manufacturers use imported inputs and raw materials. Industries such as the manufacturers of steel, car assembly, plastic and plastic products, chemical and chemical products, pulp and pulp products, cigarettes, woods and wood products relatively use imported inputs and raw materials. This exposes them to higher manufacturing costs which affect their competitiveness in the world markets. The country also faces higher foreign currency outflows.

Next to lack of domestic raw materials and inputs, both in quantity and quality, the major problem of domestic manufacturers in Ethiopia is that they are producing below their full capacities. The survey conducted by the Ethiopian Central Statistical Agency (2006) revealed that most of (more than 85%) the sample industries covered in the survey were utilizing only 56.5% of their full capacities. The causes for under-capacity utilization of the industries are identified to be low local demand, lack of skilled manpower, and shortage of power supply, foreign exchange and capital, outdated machinery and equipment, and unfair competition from substandard smuggled goods.

The survey also indicated that low level of tariff protection is one of the factors that impeded the capacity utilization of the industries. A survey conducted by the Ethiopian Ministry of Finance and Economic Development (2007) has also supported this view of low level of tariff protection. Among the ten (10) sub-sectors covered in the study, it is shown that only three (3) of them (beverages, tobacco, and textile) were given sufficient protection. The protection information is indicated in Table 1 below.

Table 1: Nominal and Effective Tariff Rates (in 2005)

Industrial Sub-Sector	Sampled Industries	Nominal Tariff Rates on Inputs	Nominal Tariff Rates on Outputs	Effective Rate of Protection
Foods	7	12.37	19.20	15.60
Beverages	5	13.37	31.14	63.64
Tobacco	1	19.50	34.98	64.64
Leather & Leather-Products	3	9.56	19.06	96.32
Textile	6	9.85	24.60	107.67
Paper/Printing Press	6	8.47	7.37	8.06
Chemicals	28	8.25	16.21	40.37
Woods	3	13.90	19.86	27.30
Non-Steel	10	6.33	11.84	52.46
Steel	13	3.79	9.28	24.45
Total/Average	82	8.35	17.38	

Source: The Ministry of Finance and Economic Development (2007)

The average effective rates indicated in the above Table are very low when compared with the information indicated in the following Table.

Table 2: Effective Protection Rates in Selected Developing Countries

Country	Average Effective Protection Rate (%)
Uruguay	384
Pakistan	356
India	69
Brazil	63
Coted'iviire	41
Thailand	27
Singapore	22
Colombia	19
South Korea	-1

Source: Todaro and Smith (2006: 632)

The Revenue Role of Customs Tariff

Another objective of levying customs tariff is to collect revenue in the form of taxes from the foreign trade. According to Carbaugh (2005: 102) "a revenue tariff is imposed for the purpose of generating tax revenues and may be placed on either exports or imports". Krugman and Obstfeld (2006) also reveal that, before the introduction of income tax in the United States of America, tariffs had been the major source of revenue of the government of the country.

In the developing countries, customs revenue is a major contributor to the public budget. A statistical report of the IMF (2003) indicates that the tax revenue from international trade and transit as a percentage of total central government revenue is 1.10% for the United States (1997), 2.32% for Canada (1994), 2.44% for Australia (1997), 1.24% for Japan (1993), 2.73% for New Zealand (1997) and 1.20% for Iceland. In contrast, the Customs receipts of the 24 developing members of the World Customs Organization amounted to more than 20% (and in 12 cases more than 30%) of total government revenue. This demonstrates that developing countries heavily rely on customs revenue unlike the developed ones.

In the Ethiopian case, for the period between 1959/60-2012/13), it is about 27% of the total revenue earned by the government. It shows that the foreign trade taxes in Ethiopia have also a significant share in the total revenue budget of the government (see Figure 3 below).

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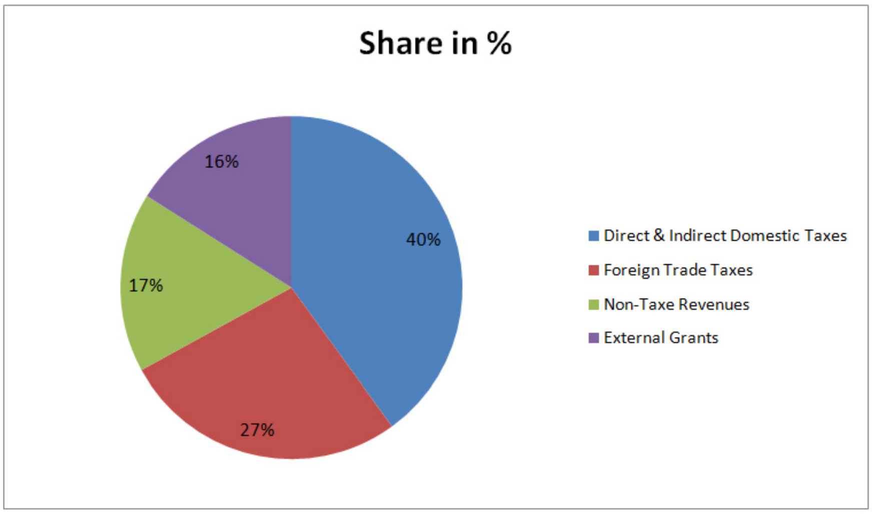
Figure 1: The Percentage Share of Foreign Trade Taxes in Total Revenues (1959/60-2012/13)



Source: Own Computations from the MoFED Data

The Role of Customs Tariff in Capital Formation

The contribution of customs tariff to capital formation in the developing countries such as Ethiopia can be analyzed both from the demand and the supply sides of capital. Some economists believe that it has the demand side contribution. Nurkse (1955), when he tries to analyze the connection between customs tariff and capital formation, explains that there are people who believe that tariff "could at least make a contribution on the demand side by increasing the incentive to invest in domestic industry". The reason behind this argument is that if domestic industries are protected through imposing customs tariff, new investors, both domestic and foreign, could be attracted to invest in the areas where the tariff rate is high enough to protect them from external competition.

There is also another demand side argument that tariff could attract the surplus labor in the agricultural sector to the protected manufacturing sector, whereby the productivity of the labor increases the national income. If the productivity of the transferred labor increases as it is used in the new industry, then it is convincing that this increases the national product.

When it comes to the supply side of capital, it is argued that by imposing customs tariff on consumption goods, it is possible to reduce the expenditure on the importation of consumption goods and allocate it for importation of investment goods. In such a case, a country's stock of capital goods such as machinery and equipment can be made to increase.

"Another possible effect of the restriction of imports", says Nurkse (1955:106) "is that foreign capital will respond to the increased inducement and will come in to set up 'tariff factories' producing for the domestic market." Countries which have large market size, for example Canada, according to Nurkse (1955), attract significant capital from abroad. This way, protecting the domestic industries can attract capital not only from domestic, but also from external sources. But it depends on the purchasing power of the tariff imposing country's citizens.

A very important argument from the supply side capital formation contribution of tariff protection is that through restriction of luxurious consumption goods, it is possible to avail capital for investment goods. Underdeveloped countries that need machinery and equipment for their development projects can discourage import of consumption goods through higher tariff rates and increase the share of imported capital goods, which in turn increases their capital stock. In countries where governments have extensive economic role, they can impose forced saving on the consumers with a view to facilitate investment in capital goods.

The import substitution strategy, widely used by many countries in the 1950s and 1960s, was the major approach for economic development. The import substitution strategy is also known as infant industry argument. The objective of this strategy is basically to protect the infant domestic producers from foreign competitors. The term "infant" is used to indicate that the strategy is basically intended for the industries that are at their initial stage of production, and it also means that the protection is not forever. As their average cost of production at the initial stage is high, they cannot withstand the strong international market competition. However, if they are sufficiently protected at this earlier stage, they will have the opportunity to grow to the level of achieving economies of scale, the stage at which their average cost is lower and where they can also compete with the imported foreign products. When they reach such a stage, the protection tariff can be avoided. Accordingly, the protection of infant industries can lead to the growth of the industrial sector, the structural transformation of the economy, and thereby to the economic development.

On the other side, there are arguments against this economic development role of customs tariff. Higher customs tariff has the role of restricting the importation of capital as well as intermediate goods. The restriction of capital and intermediate goods in turn may affect the domestic production of goods both for exports and domestic market. The decline in production of goods will have negative effect on the growth of GDP. The problem is more severe in developing countries like Ethiopia because the domestic manufactures mainly rely on imported inputs and capital goods from abroad.

Taking data of the 1961-2000 periods, Pawlos (2002) found that in the long run, imported intermediate goods positively and significantly affected the real GDP, whereas the change in imported intermediate goods before one year has a positive and significant effect on the change in current real GDP in Ethiopia. His findings also revealed that the majority of Ethiopia's imports are essentially capital and intermediate goods for which there are sufficient domestic substitutes.

Customs Tariff and Balance of Payments Problems

Customs tariff is sometimes used to reduce the balance of payments deficit. The higher the customs duty rate is expected to result in the higher price for imported goods, and thus the lower the demand for foreign products. The lower the demand for foreign products, in turn, ends up with lower customs tariff collected from imports.

In most of the cases, underdeveloped countries overvalue their exchange rates. This happens because they are engaged in widespread industrialization and import substitution programs, to reduce poverty. The overvalued currencies have the role of reducing the domestic currency price of imports, especially capital and intermediary goods, which are highly needed for industrialization. This will end up in excess demand over supply for foreign currency. In situation of excess demand, say Todaro and Smith (2006), LDCs have three basic policy options: running down their reserves of foreign exchange or borrowing additional foreign exchange abroad and thereby incurring further debts; pursuing commercial policies and tax measures designed to lessen the demand for imports; or rationing the limited supply of available foreign exchange to "preferred" customers. Therefore, commercial policy that deals with the tariff aspect can have an effect on the balance of payments of a country.

Theoretically, therefore, it should be after considering all these roles of customs tariff, and analyzing the zero marginal rate of substitution among all these objectives that a country should fix its customs tariff rate.

Optimum Customs Tariff

One of the arguments against free trade is the possibility of optimum tariff. It is directly related with terms of trade. If a large country, U.S. for example, imposes tariff on imported goods, the exporters in the USA trade-partner countries may be forced to reduce their export prices, of course depending on the price elasticity of demand. If USA can influence the prices of the exporters in such a way, it can gain benefit of terms of trade. In such a case, the tariff is said to be optimum. Krugman and Obstfeld (2006) defined the term "optimum tariff" as follows: "By convention, the phrase *optimum tariff* is usually used to refer to the tariff justified by terms of trade argument rather than to the best tariff given possible considerations." This implies that optimum tariff is achievable only if a country is large enough to influence the prices in the exporting countries.

Summary and Conclusion

The historical and theoretical reviews made in this Article show that although most of the economists and schools of thought argue for free trade, there are others who support protection, inward-looking strategies and import substitution. One of their major reasons is that at the early stages of their economic development, most of the now developed countries used tariffs effectively to protect their infant industries. The other argument is that at the early stages of economic development, collecting sufficient taxes from domestic activities are so difficult due to the subsistence, decentralized and small scale nature of their economic activities. Therefore, the taxes from international trade, mostly from imports, cannot be disregarded. The chronic problems that involved many developing countries in huge borrowings from abroad, both to pay their debts and finance their development projects, which also led some people to develop a slogan '**trade, not aid**', is also another argument for imposing tariffs. Lastly, even from the developed and large countries point of view, the theory of optimum tariff is another argument against free trade.

The debate between trade-optimists and trade-pessimists, although begun many centuries back, still keeps ongoing. Almost all groups agree on the importance of trade but what is debatable is on the distribution of benefits of free trade amongst the developed and the developing countries. Therefore, the role of tariff is a matter of practical investigations and empirical studies rather than theoretical generalizations.

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