

Factor Price Equalisation Theorem

Part 1

Factor Price Equalisation Theorem

- The factor price equalisation theory is an important corollary/outcome of the H-O theory of trade.
- Free movement of factors would lead to complete factor price equalization like that of goods.
- However, in the absence factor movement (assumed by trade theory), what would happen to factor prices is explained by this theory.

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- Heckscher - International trade in commodities as a substitute for the international mobility of factors
- leading to a **complete equalisation** of the costs or factor prices.
- Ohlin, on the other hand, recognised only an **incomplete or partial equalisation** of prices of factors.

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- Samuleson (1948) and Lerner (1953) - possibility of a **complete equalisation** of factor prices.
- Factor price equalisation argues that goods trade acts as substitute for factor;
- The increasing demand for capital intensive commodity increase the demand for capital and make capital scarce in capital abundant country and raise its price;

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- While supply of capital intensive products by capital abundant country relieves the pressure on capital in capital scarce country and reduce the price of capital.
- Hence, goods mobility in absence of factor mobility brings the factor price towards equalization between trading countries.

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- **Assumptions:** Samuelson's theorem is based on following assumptions:
 - (i) There are two countries, say **I and II**.
 - (ii) These countries produce two commodities, say **A and B**.
 - (iii) The production of these commodities requires only two factors of production—labour and capital.
 - (iv) There is free competition both in the product and labour markets.
 - (v) There is an absence of tariff and transport costs.

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(vi) The production function related to each commodity is identical in both countries and are homogeneous of degree first. It implies the production is governed by constant returns of scale.

(vii) The factor-intensities are different for the two commodities. For instance, the commodity **A** is labour-intensive, while commodity **B** is capital-intensive. It means there is an absence of reversal of factor intensity.

(viii) Capital and labour are qualitatively identical in the two countries.

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- (ix) The availability of factors is quantitatively different in the two countries. The country **I** is supposed to be capital-abundant whereas country **II** is labour-abundant.
- (x) There is absence of complete specialisation. It means both the countries continue to produce both the commodities even after trade takes place between them.
- (xi) The factor supplies are fixed in the two countries.
- (xii) In each country, there is full employment of both the factors.
- (xiii) There is no mobility of factors between the countries.

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(xiv) The marginal-physical product of each factor is diminishing.

(xv) The tastes are identical in the two countries.

To be continued

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THANK YOU