

# THE ECONOMICS OF FREE TRADE

From *The Economist*, September 22, 1990 (Survey of World Trade). ©1990 The Economist Newspaper Group, Inc. Reprinted with permission.

## Summary

What is the classical case for free trade? Why has it been misunderstood?

THE leading academic authority on the new trade theory is Mr Paul Krugman, of the Massachusetts Institute of Technology. He begins one of his articles on the subject\* by saying that "the case for free trade is currently more in doubt than at any time since the 1817 publication of Ricardo's Principles of Political Economy." If this is true, it is partly because the challenge that the new theory poses to the classical case for free trade has been badly misunderstood. To see why, it is necessary to recall what the classical case for free trade actually says—because that theory, too, has been misunderstood.

These days politicians all over the world declare themselves in favour of free trade. When it comes to voting for it, they are not so sure. The reason is not just the pressure of special-interest politics. It is also that most people have imbibed the prejudice that free trade is a good thing, without imbibing the economics that ought to lie behind it. What this prejudice says, in fact, is that free trade is a good thing only if everybody else joins in; one-sided, or unilateral, free trade is a mug's game. The classical case for free trade argues exactly the opposite: free trade is good for a country even if other countries do not return the favour.

Writing 40 years before Ricardo, Adam Smith had already had a lot to say about the gains from trade. He saw it as, among other things, a way of promoting efficiency, both because it fostered competition and because it provided opportunities to specialise and gain economies of scale. Specialisation was a matter of absolute advantage: trade allows countries to produce what they are best at, and buy in the rest.

This view begged a question: what if Britain, say, is bad at making everything? Does this not mean that trade would drive all its producers out of business? David Ricardo answered the question by formulating the principle of comparative advantage. This is perhaps the single most powerful idea in economics. ✓

## Help yourself to wine and cheese

Suppose there are two countries, Utopia and Flatland, and that these countries use labour to produce just two goods, wine and cheese. In Utopia it takes one hour of labour to make a pound of cheese and two hours of labour to make a gallon of wine. In Flatland it takes six hours to make a pound of cheese and three hours to make a gallon of wine. Note that Utopia is more productive than Flatland in both goods: it has an absolute advantage in wine

\*"Is Free Trade Passé?" *Journal of Economic Perspectives*, Vol 1, No 2, 1987

and cheese. But its greater advantage, its comparative advantage, is in cheese. This will determine what happens when the two countries trade.

The precise outcome will depend on the pattern of demand, and hence on the price of each good in terms of the other once trade begins. Assume that a pound of cheese trades for a gallon of wine. This is for simplicity's sake; the argument does not turn on the price chosen. In Utopia, which is better at making both goods, an hour of labour can make either a pound of cheese or half a gallon of wine. But since a pound of cheese can be traded for a gallon of wine, it makes sense for Utopia to specialise in producing cheese, and then trade some of its cheese for wine. In this way it can consume as much cheese as before and twice as much wine, or some combination of more wine and cheese.

Flatland is less efficient than Utopia at making both goods. But in Flatland too it pays to specialise. An hour of its labour can make one-sixth of a pound of cheese or one-third of a gallon of wine (which is worth one-third of a pound of cheese in the international market). So Flatland specialises in the production of wine, and trades some of its wine for cheese. Trade means that it can consume as much wine as before and twice as much cheese, or some combination of more of both.

From the assumptions this example has already made, it is possible to deduce the market-determined wage that will be paid in each country. The hourly wage in Utopia will be a pound of cheese (equal to a gallon of wine) and the wage in Flatland will be one-third of a gallon of wine (equal to one-third of a pound of cheese). In other words, the wage in Utopia will be three times the wage in Flatland. This reflects the relative price of the two goods, together with the fact that Utopia is six times more productive in cheese and  $1\frac{1}{2}$  times more productive in wine.

Here is another way to think of it. Utopia is more efficient overall, so its wages are higher. This gives Flatland an opportunity to produce at lower cost, provided it specialises in wine, the good in which it has a comparative advantage (that is, a smaller absolute disadvantage). Utopia can make a gallon of wine with two hours of labour, whereas Flatland needs three—but because its wages are only one-third of Utopia's, Flatland can produce wine more cheaply. (Despite the fact that its wages are lower, Flatland cannot produce cheese more cheaply.)

Trade does not equalise incomes when productivity differs across countries, it just makes all sides better off than they would otherwise be. Moreover, trade always uncovers opportunities of this kind. Repeat, nothing central to the argument rests on the particular assumptions about price and productivity that have been used in this example.

The example has been borrowed, by the way, from an excellent textbook, "International Economics", written by Messrs Paul Krugman (the very same) and Maurice Obstfeld. You will find it on page 22—the principle of comparative advantage is not exactly advanced material. In parts of the real world, though, the free-trade debate still seems to be struggling with page xi (List of Contents). Messrs Krugman and Obstfeld quote with amusement an article from the *Wall Street Journal* ("The Coming Overthrow of Free Trade") which observed, "Many small countries have no comparative advantage in anything." One can imagine the writer prefacing that jewel of economic illiteracy with "Of course, we all believe in free trade, but . . ."

#### Please be realistic

Many refinements and extensions of this simplest possible trade model (two countries, two goods, one factor of production) are needed to paint a lifelike picture of the world. This picture has to include the fact that most countries are generalists, not narrow specialists. They produce, export and import a wide range of goods. The Ricardian theory was duly refined and extended. In its modern, sophisticated form it retains what is essential in Utopia and Flatland: (a) if trade is unimpeded, it will be driven by comparative advantage; (b) free trade makes countries better off. Note that these findings have nothing to do with reciprocity or "fair" trade.

In more modern guise, the classical case for unreciprocated free trade is summarised in the supply-and-demand diagrams in the box above. A tariff will increase a country's production of the protected good and raise the price paid to producers, who therefore gain. The government collects some extra revenues, too. But consumers buy less of the good than before and have to pay more for it, so they lose. Consumers lose more than the combined gain of producers and the government. Therefore stick with free trade.

Incidentally, an import quota is analysed in exactly the same way. Like a tariff, a quota raises prices in the domestic market. The only difference is that instead of collecting that handy block of tariff revenues, a government imposing a quota lets this money be gathered by the wicked foreigners to whom the quota applies. That is why the VER, a quota of sorts, is a particularly brainless way to protect.

Most modern classicists, in fact, would say that the gains from trade are certain to be a lot bigger than the two triangles in the last diagram. Protection takes the competitive pressure off producers, and therefore fosters inefficiency. The triangles ignore this crucial effect. Also, if practised on a large scale (as in Latin America in the 1960s and 1970s), protection denies the economy access to new tech-

niques: imports often supply both the spur and the means to innovate.

#### Exceptions ancient and modern

The developing countries' bitter experience with autarkic plans of "import substitution", it might seem, should have settled the argument. Instead, the debate has flared up anew. However, trade-theory revisionists such as Mr Krugman (once he gets to page 261) were not the first to see difficulties with the case for free trade. Economists in the classical tradition have long allowed for qualifications to the idea that free trade is always and under all circumstances best.

One such qualification is the possibility of an "optimal tariff". The idea is simple. If a country is large enough, it may be able to depress the price of its imports on the world market by demanding less. In this way, it can use a tariff to improve its terms of trade (raise its export prices relative to its import prices). Conceivably, this could improve its welfare by more than the triangles and the other costs of protection reduce it. The optimal tariff would be the tariff that maximised this gain.

Another exception is the case for infant-industry protection. This idea (like many others) goes back to Adam Smith. It is often argued that new industries need to be sheltered when young. Without such help, enterprises that might be profitable in due course will fail to establish themselves. The infant-industry argument rests on the view that the market fails in some way; otherwise a new business would be willing to incur initial losses in the expectation of making big profits later.

Short-sighted financial markets might be one such market failure: they might make it impossible for a new business to finance its initial investment. Another sort of market failure happens when "externalities" are involved. A new company may incur costs in starting up that benefit others following it into the industry (for instance, the costs of adapting foreign technology for local use). The first company into the business is not fully rewarded because it cannot keep the benefits all to itself. As a result, too few new industries become established.

All these cases have long been recognised and analysed in the literature. Yet the case for free trade remained almost universally accepted by economists—no other proposition could command such support from that argumentative profession. The qualifications to the case for free trade were regarded as interesting but unimportant. The economic risks of trying to act on the exceptions were seen as out of all proportion to the likely costs. These included trade-policy retaliation by other countries (even though such retaliation would, in the classical view, be ill-advised), and the danger that protection for infants would be captured by vested interests and extended through adolescence, adulthood and premature senility. Behind it all was the unbudgeable view that an open international trading system was worth preserving.

#### Reading Questions

1. If the United Kingdom is bad at producing everything, will international trade drive its producers out of business? Explain
2. Economists in the classical tradition have long allowed for <sup>exceptions</sup> qualifications to the idea that free trade is always and under all circumstances best. Explain.
3. Is free trade ~~X~~ good for a country even if other countries do not return the favor?