Free Trade: What Now?

By

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Ever since Adam Smith invented the case for free trade over two centuries ago in The Wealth of Nations, and founded in the same great work the science of Economics as we know it today, international economists have been kept busy defending free trade. A popular children's story in the United States, by Dr. Seuss, has the refrain "And the cat came back". The opponents of free trade, ranging from hostile protectionists to the mere skeptics, have kept coming back with ever new objections.

The critiques we have had to confront have often come from those who fail to understand the essential insight of Adam Smith: that it pays me to specialize on what I do **best** compared to you, even though I can do **everything better** than you do. Economists call this the Law of Comparative Advantage: each nation would profit from noncoercive free trade that would lead to such specialization. When asked by the famous mathematician Ulam: "What is the most counterintuitive result in Economics?", the Nobel laureate Paul Samuelson chose this Law as his candidate.[1]

Skeptics within Economics

But the most compelling skeptics have come repeatedly from within the discipline of Economics itself. To see why, it is necessary to understand that the case for free trade is, at an essential level, the case for markets. Adam Smith's Invisible Hand will guide you to an efficient allocation of resources only if the markets yield prices that reflect "true" social costs. If there are

[1] I would agree with him, though my longer exposure to politicians has produced other examples that can nearly match Samuelson's. My favourite is the fallacy that Japan is "obviously" protectionist because it has a trade surplus. By this token, Japan became more, not less protectionist, in the last several years when it changed to a surplus while lowering trade barriers simultaneously!

market failures, as when a producer pollutes the air but does not have to pay for this pollution, then the Invisible Hand can lead you in the wrong direction. Or to put it in flamboyant terms, free trade can immiserize you.

So, in virtually each generation, economists have discovered new, or focused anew on old, market failures that will undermine the case for free trade. In fact, John Stuart Mill, over 150 years ago, stated the case for infant industry protection succinctly though naturally not with the sophistication that it commands today: the losses faced by such an industry were presumably outweighed by the social gains from supporting it.

Then again, we all know how, when the world economy was afflicted by the Great Depression, John Maynard Keynes broke ranks with England's free traders: again, when you have massive unemployment due to lack of aggregate demand, tariffs can switch demand from foreign to domestic goods and thus create employment and income; and, in formal terms, market wages no longer represent the true social cost of (unemployed) labour.

And, when Edward Chamberlin of Harvard and Joan Robinson of developed their new theories of monopolistic or imperfect competition in 1929 and 1931 respectively, and also directly addressed (even if unsatisfactorily) oligopolistic competition among firms (in what was then called the case of "small-group" competition), it was immediately obvious that such imperfections constituted market failures, so that any belief in their practical importance would tend to undermine the faith in the doctrine of free trade. As a result, the 1930s were characterised by what John Hicks, a free trader and later Nobel laureate, described as "nihilism": if markets were imperfect, it was no longer possible to believe in the efficiency of free trade.

What we witnessed in the 1980s, with assertions that "strategic trade theory", based on oligopolistic competition, had undermined the case for free trade, was in essence then merely a replay of this “crisis of free trade” that Hicks described so eloquently in 1951 in a brilliant lecture to the Manchester Statistical Society in the following eloquent words:

“the Monopoly-Competition argument [against Free Trade]…is of much less practical consequence than the others [such as the macroeconomic argument that led to Keynes’s defection], but it deserves at least a passing mention, because of the undoubted influence which it undoubtedly exercises --- in a negative sort of way --- upon the minds of economics students… If apparent costs [as reflected in market prices] only equal true [social] costs under conditions of perfect competition, and competition hardly ever is perfect, the bottom seems to drop out of the Free Trade argument. This is in fact a fair description of the state of mind which quite a number of economics students seem to have reached.”

The difference from the 1930s was that the production of the same play was more garish and dramatic. Where Hicks had described the damage to free trade as minor, the damage to it in the 1980s was more potent. Partly, the arguments fell this time into a context of what I have called the “diminished giant syndrome” in the United States, where the rise of Japan, and the fear that the oligopolistic competition among the giant firms of the Trilateral powers would be won by countries whose governments aided the competitive strength of their “national champions”, focused attention fiercely on imperfect competition and how protection would, or could, aid governments in this “strategic” competition.

This renewal of the 1930s worries was aided analytically by the fact that developments in the theory of industrial organization had prepared the profession to analyze the implications of oligopolistic competition much better than ever before. Aiding the entire process, where free trade was widely denounced in the media and policy circles as an obsolete theoretical doctrine, was the activism of some of the proponents of the trade theory built on imperfect competition. Among them, the most prominent was my distinguished pupil, Paul Krugman, fortunately now an articulate convert back to free trade, who extensively wrote and lectured on how the “new” theory of trade under imperfect competition had shown that, at a theoretical level, the case for free trade was “passe”. One of my many other pupils who was clearing his files, sent me just a few weeks ago a 1991 article of Krugman from an influential Washington magazine, with the title: “Protectionism: Try it, You will like It”![2]

The Return of Free Trade

If you survey the academic scene in the 1990s, however, the economist defectors from the doctrine of free trade have returned to the fold; indeed today, there is harmony of agreement among the major economists on this policy position. A huge part of the reason is that the theory of free trade, and here I may self-indulgently on this occasion lay some claim to authorship of the idea, now distinguishes between two propositions:

(1) **if market failures remain unfixed, free trade can harm rather than help;** and

(2) **if market failures are fixed through suitable policy intervention, then free trade can once again be used to exploit best the gains from trade.**

Within the second proposition, economists also emphasize that[3]:

> **If the market failure arises in domestic markets, then the appropriate policy intervention is the use of domestic policy directly targeted at the market failure, while free trade is maintained externally.**

So, in a very sophisticated sense, international economists today have come around to looking at market failures <u>very differently</u> from their predecessors: whereas the earlier economists drew away from free trade and accepted protectionism in a knee-jerk fashion when faced by market failures, today’s economists say: fix those failures through appropriate policies and

[2] I should say that the titles of papers in magazines and newspapers are not chosen by the authors. But, in this instance as other essays written at the time, Krugman’s conclusions were indeed broadly consonant with the title quoted in the text above.

[3] This is known today as The Theory of Domestic Distortions and Policy Intervention.

simultaneously get on with free trade. Free trade and these market-failure-fixing policies then become bedfellows.

In fact, a simple intuitive way to understand all this is also to recall the wisdom of our forefathers in virtually every culture : **you cannot kill two birds with one stone** (leaving out fluke success, of course). So, if you seek to do that, you will likely miss both birds. Nowhere is this better illustrated than in the debate between environmentalists and free traders. I shall return below to other dimensions of that debate; but an important set of differences among the two arise simply because many environmental groups fail to appreciate that, if market failure afflicts pollution because there is no enforcement of the polluter pay principle, we free traders realize immediately from our theory that:

(1) **free trade can hurt both income and the environment; but we also realize that so can protection (compared to free trade);** and that

(2) **(the two targets of) income and the environment will be efficiently pursued by a simultaneous adoption of (the two policy instruments) free trade and the polluter pay principle**.

So, by invoking simultaneous adoption of suitable market-failure-eliminating policies we can rescue free trade finally from the iron fist aimed at it by the conventional market-failure critics over nearly two centuries. Thus, for instance, the answer to Keynes is that, if you manage to reflate and increase aggregate demand directly, you can return to free trade: using tariffs to switch given aggregate demand from others to your own goods is to use a policy that simply switches employment from others to us, but does not increase world employment while damaging gains from trade by cluttering up the trading system with restrictions and, almost certainly, retaliatory trade restrictions by others trying to switch employment back to their own goods in a process that Joan Robinson called "beggar my neighbour" policies!

In fact, that prompts me to admit that the theoretical case for free trade with appropriate other non-protectionist policies aimed at fixing market failures directly has one problem: the market failure in question may itself require an appropriate response in the form of trade tariffs. That does happen to be theoretically the case when there is imperfect competition in products: trade tariffs or subsidies can be shown to improve national welfare over what free trade would yield. In fact, this is only a sophisticated extension of the case made by Robert Torrens, again over 150 years ago; like a monopolist who restricts his sales to increase prices and profits, a nation enjoying monopoly power in world markets can do the same. In short, if the nation adopts free trade instead, it is not maximizing its own income by not fixing a "market failure" under free trade: i.e. its failure to exercise monopoly power. So, here we do have a hole in the reinvigorated case for free trade.

But then, much in the spirit of the rejection of Torrens' argument when free trade was embraced by Prime Minister Robert Peel with the repeal of the Corn Laws, we can still retain free trade as a reasonable policy by citing three quite persuasive arguments:[4]

- **"There is no beef"**: We could argue, as theorists of imperfect competition in trade (such as Avinash Dixit and Gene Grossman of Princeton) have done, that there is no evidence of significant enough imperfections for us to abandon free trade.
- **"The Visible Hand will make matters worse"**: Or, we could take the stronger, definitely conservative, position (as Paul Krugman, among many others, has done)

[4] I have dealt with some of these arguments at greater length in my 1988 Bernhard Harms Prize acceptance speech entitled "Is Free Trade Passe After All?" and elsewhere.

that, if protectionist intervention is attempted, it will make matters worse because governmental interventions will reflect lobbying rather than social advantage.

- **"Retaliation will ruin any chance of one's protection paying off**": As a corollary of the preceding argument, it is not one's own folly in choosing protection unwisely that we will hurt ourselves by abandoning free trade, but it is because other nations will retaliate and everyone will lose, if in varying degrees, from the breakdown of free trade.

And, so, between the new theoretical arguments where domestic market failures can be fixed best through non-protectionist domestic policies while retaining free trade as the best trade policy, <u>and</u> the new (essentially but not exclusively) empirical contentions that intervention is unnecessary or counterproductive when the market failure spills over into the external markets and must itself be fixed in principle through protection (singly or in conjunction with other policies), economists today have returned in hordes back to free trade. The latest revolt, of the 1980s, has died down. Only neanderthals among the economists now militate against free trade: unfortunately, they will never lack an audience but fortunately, they have little effect presently.

The Critics in the Public Arena

The real threats to free trade today come from altogether different directions. I have time only to focus on two today:

- **Trade Hurts Wages:** There is widespread concern that trade with poor countries will produce paupers in the rich countries; and
- **"Fair Trade" before Free Trade**: There are increasing concerns that free trade between countries that are different on a host of conventionally "domestic"

institutions and policies is “unfair” and hence preconditions concerning harmonization of standards must be required of trade treaties.

1.Trade and Wages

A furiously compelling worry about free trade (and investments) has come from the fact that it is a prime candidate for explaining the phenomenon that, since the 1980s until very recently, the real wages of unskilled workers in the United States have fallen and then stagnated. In Western Europe, the pressure on the working class is believed to take instead the form of high unemployment because the labour markets are far more flexible in the United States.

The argument is not the old fallacy that free trade with poor countries is bad for your aggregate income, that your country will be immiserized by such trade. Rather, it is an income distributional argument: while the country gains, the poor will be immiserized, the poor actually getting a smaller slice from the enlarged pie. The mindset behind this argument, of course, is that the progressive inclusion of the poor countries into the world trading system will effectively expand the unskilled labour force in the world economy, driving down the real wages of workers. In fact, Paul Samuelson had written a pair of articles in 1948 and 1949 on what economists call the Factor Price Equalization (FPE) theorem where free trade would drive wages into quality everywhere.

Regarded as a theoretical curiosum at the time, the FPE theorem is now thought instead to provide the compelling reason for the immiseration of the rich countries’ proletariat: in an ultimate irony, Marx, whose prediction of falling wages of workers was proven false by history for the 19th century is now striking again with the aid of a neoclassical economist, Paul Samuelson! But I believe that Marx is destined to fail again. The evidence for the assertion that it is trade with poor countries that is increasing the numbers of the poor, and accentuating their poverty in turn, is simply not compelling.

Needless to say, this is a matter that has engaged the analytical attention of numerous economists. Many, including Robert Lawrence and Matthew Slaughter, have argued that the contribution of trade to the phenomenon is negligible whereas my own research has led me to believe that trade has actually had a favourable effect, moderating the fall in real wages of the unskilled that is being driven by technical change that economizes greatly on the use of unskilled labour.[5] It is hard therefore to believe how economists, among them Dani Rodrik in his unpersuasive but popular pamphlet on Has Globalization Gone too Far? issued by Mr. Bergsten's Institute for International Economics in Washington (which also released on the Washington scene, when Mr. Clinton first came to his Presidency, Laura Tyson's flawed but at-the-time influential Japan-obsessed pamphlet recommending industrial policy), can assert that there is some sort of consensus among economists that trade accounts for a 15-20% of the fall in real wages in the 1980s and beyond! It is hard enough for us to keep educating the citizens and groups that agitate against free trade because of unsubstantiated but real fears. It is mortifying that we have to use our energies also to fight the fires fanned by the economists and think tanks that should set themselves higher standards of scientific argumentation and veracity.[6]

But if trade with the poor countries, or for that matter investments in them, should not be a matter for concern in regard to its income distributional effects, and we can revert to accepting

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[5] I have presented my favourable findings in "Play it Again Sam: Yet Another Look at Trade and Wages", June 1997; Columbia University mimeo.; to be published in a festschrift volume in honour of T.N.Srinivasan of Yale by Elsevier, Netherlands, in 1998.

[6] Frustrated by the repeated shoddinesses in pamphlets put out by some of the think tanks, I have sometimes said undiplomatically that these think tanks are like "people's democracies": they describe themselves as what they certainly are not! I have also argued recently that the public policy writings by academic economists such as myself require the strictest standards: that they must reflect extensive scholarship, attention to clarity of writing, and

the benign view that the favourable influence of trade on aggregate incomes is a sufficient index to the virtues of free trade, I do believe that trade altogether is today a phenomenon that creates **economic insecurity.** Today, comparative advantage is relatively "thin": many industries are "footloose", meaning that slight changes in costs abroad can undercut your competitiveness. The reason is that financial markets have integrated a lot so that interest rates at which you borrow are not as wide apart across countries as they used to be. Technology also diffuses quickly and has converged rapidly among the OECD nations, for sure. Multinationals also move around, seeking small but significant cost advantages. Rival producers in a product or industry in many nations therefore face closely-spaced costs, and hence actual or potential loss of markets due to sudden, small but effective shifts of comparative advantage. There is no great "buffer" or cushion of cost advantage today in most industries. The result is greater volatility in comparative advantage, driven by small changes in costs that are a fact of life. I call this the new phenomenon of **kaleidoscopic comparative advantage**. A flip side of the phenomenon is the widespread notion that "international competition today has been greatly intensified".

What this has done is to contribute to the greater labour turnover which has been observed; and this itself may have put some pressure on the real wages of the unskilled workers since, just as a rolling stone gathers no moss, a moving worker gains no on-the-job skills that lead to increased earnings. But, another effect of this is to create an accentuated need to make **institutional changes** to assist workers in coping with this turnover: adjustment assistance programs, portable health insurance benefits when these are provided by employers (as in the United States) etc. This reinforces the view, expressed forcefully in my slender 1988 book on

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willingness to become a public nuisance in the cause of advancing public good. Cf. Bhagwati, A Stream of Windows: Unsettling Reflections on Trade, Immigration and Democracy, MIT Press: Cambridge, Mass., 1998.

Protectionism (MIT Press), that we need to accompany the freeing of trade and the growth of trade with the institutional changes that increased exposure to international trade necessitates.

2. "Fair Trade" as Precondition for Free Trade

I must say that it is precisely the kaleidoscopic nature of current comparative advantage, with the narrowing or thinning of comparative advantage that it signifies, that has contributed enormously to the demands for "fair trade". Since even a small cost advantage enjoyed by your rivals abroad can be fatal to your health, you will begin to look over their shoulders to see if any difference in their domestic institutions or policies gives them that extra cost advantage: and you will lobby to iron it out, to harmonize standards or "cost burdens". Hence, when there are objections to Japanese keiretsus or to South Asian use of child labour for instance, the objections are principally motivated by competitiveness considerations. And in fact, it is astonishing how many such differences, which we would never have imagined to be relevant to trade issues, have become now part of the trade agenda. More such "fair trade" arguments are just around the corner: for instance, I would not be surprised if, down the road and despite how ludicrous it appears now, population policies also became part of the trade agenda as the rich countries object to "unfair trade" in labour-intensive goods by poor countries that have poor control over their population growth.[7]

But, in conjunction with these demands, there are also morally-driven demands for certain harmonization: e.g. human rights groups will object to the use of child labour even if the children are the progeny of green men from Mars and the earth does not trade with Mars.

[7] I have considered several moral-philosophical, economic, structural and political factors that drive the demands for "fair trade" and harmonization, in Chapter 1 in Bhagwati and Robert Hudec (eds), Fair Trade and Harmonization: Prerequisites for Free Trade?, Vol.s 1 and 2, MIT Press: Cambridge, 1996. I select only a few in the text above.

These two principal, but wildly different, reasons for “fair trade” and harmonization as prerequisites for free trade raise two issues that have bedeviled the move to free trade and need to be resolved with clarity:

First, it is necessary to understand that, when trade is considered “unfair” because of differences in cost burdens due to differences in, say, environmental or labour standards, this is generally speaking a conceptual error. For example, even if we accept the polluter pay principle, there is no reason whatsoever why the payment for a unit carcinogen should be the same in India as in Switzerland. Or, if clean air and clean water are both highly prized, Mexico may well choose to devote its resources and energies to getting clean water first and clean air next as a suitable priority whereas the United States may well choose to go the other route. In each case, the cost burden will differ for the same industry across countries: and for perfectly sensible reasons. It is illegitimate, even unfair, then to force your own standards down the throats of others on grounds of unfair trade!

Again, even if this is granted, there might be a worry about a “race to the bottom” which may lead to a reductions of one’s own standards even when one does not care about unfair competition per se. This race refers to the high-standards country forcing its own standards down to retain or attract investment that would otherwise move to low-standards countries. Theoretically, this is possible, of course, and a coordinated, cooperative solution can yield higher incomes and even standards for each country than under a noncooperative equilibrium (though, it must be emphasized that this cooperative equilibrium does <u>not</u> generally involve harmonization of standards). But much empirical literature shows that this theoretically-correct fear is of little empirical relevance since multinationals typically seem to use the more environmentally-friendly technology even when not required, and there is little evidence either that governments actually lower standards in order to attract investments. Rather, the race to the bottom occurs typically on the fiscal dimension where developing countries, or states within federal nations, competitively offer cheaper land, subsidized inputs, tax holidays or tax breaks in order to attract investments.

Hence, on the usual “unfair trade” grounds, reflecting competitiveness considerations, I see no reason to make harmonization or upgrading demands for standards, domestic institutional and policy structures et.al. to be made part of the trade agenda. I am therefore against “linkage” of “fair trade” to free trade agendas and treaties as far as the competitiveness rationale is concerned.

Second, however, linkage is also demanded at times for moral imperatives. Trade with countries that systematically violate civil and political rights, as China does, may be considered anathema by human rights activists, for instance; so was apartheid. Similarly, at the “micro” level of products produced by processes that are considered ethically unacceptable --- e.g. fur produced with leghold traps, chicken produced in batteries, hogs raised in crowded farms, tuna caught in purse seine nets etc.---, trade in such products may be denied.

These denials of trade may not be consequentialist in the sense that they are aimed at, and to be judged by, their success in changing these unacceptable practices. I may decide not to sup with the devil although the only consequence of that is that I lose a free meal. But most who wish to deny or suspend trade with others do look for efficacy of their actions.

Either way, the question that arises with trade treaties is one that has brought environmentalists in particular into conflict with free traders. These conflicts are twofold.

(i) Free traders, and the WTO in fact, argue that if trade can be automatically and unilaterally suspended by a contracting party on moral grounds, then trade could fall into chaos because morality is subjective and it can be indulged without constraint (e.g. there is no scientific test to constrain its use, as in the hormone-fed beef dispute between the EU and the US). On the other hand, they recognize that morality is important and that you cannot get a country to eat “defiled” products, for instance, if it does not want to: the days of Opium Wars are not gone altogether but the WTO surely cannot be built on those principles! So, the sensible answer is to throw some sand into the tank of unilateral moral denials of market access. The GATT/WTO technique is to require that you pay some “compensation” or allow for “retaliatory” tariffs as Ambassador Carla Hills used in the EU hormone-fed beef dispute while the EU held on to its unilateral ban on such beef imports (and domestic production as well). I see nothing wrong with that. And frankly, the current Shrimp/Turtle decision against the US legislation unilaterally suspending WTO members’ market access for shrimps harvested without the turtle-protecting devices is also sensible in my view since it will prompt the United States into sitting down with the four plaintiffs who have won and will, in turn, lead to a negotiated settlement in form of continued US legislation and attendant US compensation which could well take the form of financing the relatively inexpensive (for rich countries) protective devices that fishermen in these countries are being asked to use. The hysterical bridge-burning reaction of lobbies such as Ralph Nader’s Public Citizen in this as in other instances, as against bridge-building solutions favoured by the less militant environmental groups working with the trade community, is exactly what we need in this area.

I might remind you also that when the action is not unilateral, but you can get a large enough majority to go along with your moral views, then you can suspend entire trade of a WTO member, or any specific offensive part thereof, thorugh majorities set forth in the articles of the WTO. And then again, as with apartheid which was against a GATT member, South Africa, UN embargo procedures are also available. So, again, the agitated propaganda against the GATT as Gattzilla and the WTO as trampling on countries' rights to pursue social and environmental agendas is just that.

(ii) But, while these conflicts relate to existing trade treaties such as the WTO, and the rights and obligations that follow from them, there is the rather more dramatic conflict that has arisen in the context of freeing trade as at a new MTN Round or in the context of the extension of NAFTA to South America. Again, the labour and environmental lobbies argue for linkage to advance standards abroad. But economists such as myself --- and many agree with me, as we petitioned President Clinton on this very issue during the recent fast-track debate which he lost --- argue that the advancement of such agendas on moral grounds through linkage to trade treaties is plain inefficient.

Here, we go back to the "killing two birds with one stone" analogy. Such linkage creates obstacles to freeing trade when trade treaties should be about removing them instead. So, you clutter up and slow down the freeing of trade, thus missing one bird. At the same time, as citizens advancing the social, environmental and human rights agendas, we lose because the choice of the precise content of these issues to be included in trade treaties will inevitably reflect competitiveness considerations. E.g. child labour is included in the proposed Social Clause at the WTO, but not sweatshops or migrant labour rights which afflict the US itself pretty badly and where the consequence of their inclusion in the Social Clause would have a disastrous impact on US textile and agricultural trade. So, by distorting the social and human rights agendas, we miss the other bird as well. In other words, we underachieve both trade liberalization and progress on social and human rights and on environmental objectives.

The efficient answer then is to use trade treaties to advance freer trade and to reap the gains from trade, while pursuing the other agendas proactively at different and appropriate institutions. Thus, the UNICEF could pursue not merely child labour issues but also several other issues relating to children's rights: e.g. the right to avoid capital punishment, which is not available in the US for instance in several states which have passed legislation which permits adults to be executed while also treating children as adults in certain cases. The ILO could pursue rights at work. The UNEP could pursue environmental agendas. True, these agencies are not equipped adequately to undertake these tasks. But then we need to strengthen them. I would even urge that they address themselves to impartial and effective monitoring and review of nations' practices in regard to their conformity to conventions, norms et.al., much as the WTO now undertakes Trade Policy Reviews with great effect. The mere exposure of a country's policies in a coherent and impartial fashion can bring moral pressure to bear for change in the desired direction. I call it the Dracula Effect: expose evil to sunlight and it begins to shrivel and then die.

The Free Trade Agenda Now

That brings me to the principal task before us today. Faced with demands from civil society, often talking in uncivil terms, politicians have begun to think of accommodating the demands on the trading system in the only terms that they can usually appreciate: what can be done to buy peace minimally from these groups and get along with the important task of freeing trade?

But that is exactly the wrong way to set about these problems. Both agendas are of the utmost importance; and each must be pursued aggressively and also efficiently, free from crippling linkage.

As an economist, I want to see free trade advance efficiently and fully. I must add that I also see free trade as an important moral force for good since we cannot effectively rescue the world's millions from continuing deprivation and poverty without pursuing wealth-generating policies --- I call growth the activist "pull up" strategy as against the passive "trickle down" strategy. Growth will also, over time, likely induce values and institutions such as democracy and respect for human rights.

But as a citizen, I want the social and human-rights agendas advanced with all speed, instead of relying simply on these long run processes. If a hapless woman is screaming for help as her husband beats her, it is ludicrous to say: hang in there; as incomes grow, things will get better for you. No, you have to get in right there and nail the husband to the wall.

And, so, free traders must now walk hand in hand with the civil society groups seeking the social agendas. It is not as difficult a task as the first shock of discovering each other seemed to suggest. In fact, it is the task for the first decade of the next millennium.