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Is Free Trade Obsolete? Part 1

by Sheldon Richman

In the last several decades, areas of the developing world, particularly Asia, have become politically more stable and free, more open to foreign investment. The populations there are better educated and have access to modern technology, including the Internet. They are thus more productive.

This sounds like something to be welcomed, not only in a humanitarian sense, but in terms of economic self-interest. In contrast to the teachings of nationalists and protectionists, free-market economics has always taught that, since social cooperation through the division of labor generally benefits everyone, the wider spread that division, the better. Thus, as formerly undeveloped areas of the world join the global marketplace, we can expect living standards to rise even higher for everyone participating.

But some people are drawing the opposite conclusion. According to them, we in the rich West are threatened by the progress in the developing world. Specifically, they say we should fear that Asian workers increasingly sophisticated, though still low-paid by Western standards, will take an increasing share of the high-wage, high-tech knowledge jobs held by Americans and leave them with nothing but low-paying work. Those who make this prediction believe it will lead to great economic hardship and political instability here.

Among the people making this prediction are economist Paul Craig Roberts, who is generally a free-market advocate, and U.S. Sen. Charles Schumer of New York. CNN news personality Lew Dobbs is another who has bought into the dismal scenario. They see the sky falling, and they attribute it to the dogmatic belief in free trade. The world has changed, write Roberts and Schumer — and with it have changed the conditions that formerly justified free trade. Or so they say.

Writing in the *New York Times* last January, Roberts and Schumer put it this way:

We are concerned that the United States may be entering a new economic era in which American workers will face direct global competition at almost every job level — from the machinist to the

software engineer to the Wall Street analyst. Any worker whose job does not require daily face-to-face interaction is now in jeopardy of being replaced by a lower-paid, equally skilled worker thousands of miles away. American jobs are being lost not to competition from foreign companies, but to multinational corporations, often with American roots, that are cutting costs by shifting operations to low-wage countries.

In other words, the combination of political stability, an abundant (therefore low-paid) but well-educated workforce, and the mobility provided by the Internet have produced competition for American workers unprecedented in U.S. history.

They offer two examples:

Over the next three years, a major New York securities firm plans to replace its team of 800 American software engineers, each of whom earns about \$150,000 per year, with an equally competent team in India earning an average of only \$20,000 per year. Second, within five years the number of radiologists in this country is expected to decline significantly because MRI data can be sent over the Internet to Asian radiologists capable of diagnosing the problem at a small fraction of the cost.

Concern about foreign competition is nothing new. Free traders have responded to that concern for a couple of hundred years. But Roberts and Schumer see a different kind of threat in this “new economic era” to which, in their view, the old answers don’t apply. Indeed, they write, “The question today is whether the case for free trade made two centuries ago is undermined by the changes now evident in the modern global economy.”

What makes the economic era new, they say, is the wiping out of a critical premise of free-trade doctrine: the immobility of capital and labor.

The law of comparative advantage

To explain this, we have to go back to one of the most important contributions to economic theory, David Ricardo’s law of comparative advantage, which the late Murray Rothbard called “indispensable to the case for free trade.” (According to Rothbard it was James Mill, not Ricardo, who first formulated the law.)

The question Ricardo was addressing was whether a group of people (such as a country) would have an economic interest in trading with another group even if the first was more efficient than the second at producing *all* goods. If the answer is yes, then it can be shown that free trade benefits both groups and, by implication, all participants in the international division of labor.

Here’s how Rothbard describes the law in his book *Classical Economics: An Austrian Perspective on the History of Economic Thought*: The law

shows that *even if*, for example, Country *A* is more efficient than Country *B* at producing *both* commodities *X* and *Y*, it will pay the citizens of Country *A* to specialize in producing *X*, which it is *most* best at producing, and buy all of commodity *Y* from Country *B*, which it is better at producing but does not have as great a comparative advantage as in making commodity *X*. In other words, each country should produce not just what it has an absolute advantage in making, but what it is *most* best at, or even least worst at, i.e. what it has a *comparative* advantage in producing.

Rothbard goes on to point out that if the government of Country *A* interferes with free trade and protects its *Y*-producing industry, it will hurt its own people. Why? Because keeping the *Y*-producing industry in business would artificially (politically) divert scarce capital, labor, and resources to it, depriving the *X*-producing industry of those needed inputs. But by stipulation, Country *A* is even more efficient at producing *X* than it is at producing *Y*. So the protectionist policy would harm the very industry the people of Country *A* should be concentrating on — and would be concentrating on (thanks to the price signals) were it not for the government's intervention. As a result, the people of Country *A* will be poorer than they would have been had they specialized in *X* and traded their surplus for *Y* from Country *B*. Q.E.D.

This law should have intuitive appeal. Even if Jones is more efficient at making bread and cheese than Smith, he could have more of both if he specializes in the one where his superiority is greater and if Smith specializes in the one in which he is least inefficient. This economic principle is often illustrated with a dentist and his hygienist. The dentist may be better not only at filling and pulling teeth but at cleaning them too. But since his effort at filling and pulling teeth is more lucrative than cleaning, every hour he spends cleaning, for a lower return, is an hour he can't spend at filling and pulling teeth, for a higher return. So it pays *him* to pay someone else to do the cleaning, even if the hygienist isn't as good at that activity as the dentist is.

The controlling factor is opportunity cost, in terms of money or goods forgone. The dentist's opportunity cost for cleaning is greater than the hygienist's opportunity cost in the same activity. So trade makes them both better off.

The principle is the same with groups (or countries). It is still individuals performing the activities. The people of a country will not find it to their interest to make everything they want, because to do so they would have to divert resources from activities in which they have a greater advantage. The price system will lead them to discover that they can be richer if they specialize where their advantage is the greatest and buy the rest from others.

This principle is uncontroversial among people who understand economics. But here's the rub: According to Paul Craig Roberts, the indispensable condition for the operation of the law of comparative advantage no longer applies. Thus, he says, the case for free trade has evaporated.

I'll examine that argument next month.

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