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Is Free Trade Obsolete? Part 2

by Sheldon Richman

Is it time to throw out all the textbooks that defend free trade? Some people — including one former free trader — think so.

Last month we saw how Ricardo's law of comparative advantage, operating through the price system and the phenomenon of opportunity cost, induces people and groups to specialize in the production of things they are "most best" at making and buy the rest of what they want from other people.

A numerical example will make this clear. (It's taken from David Henderson's discussion in his online [Concise Encyclopedia of Economics](#).)

Imagine countries *A* and *B*, each of which can produce two products of comparable quality, wine and bread. Country *A* requires 5 hours to make a bottle of wine and 10 hours to make a loaf of bread. Country *B* needs 3 hours to make a bottle of wine and 1 hour to make a loaf of bread.

Bottle of Wine Loaf of Bread

A 5 hours 10 hours

B 3 hours 1 hours

A gross examination of this situation might lead one to conclude that *A* is less efficient than *B* in making both wine and bread. So why would *B* trade with *A* for either? The answer lies in the realm of opportunity cost.

Time and resources are scarce. Tradeoffs are omnipresent in life. To get one thing, you have to give up something else. This is true for groups, such as *A* and *B*. Consider *A*'s position. In the time it takes to make 1 bottle of wine, *A* could make half a loaf of bread. But that means that in the time it takes *A* to make a loaf of bread, it could make 2 bottles of wine.

For *B*, in the time it takes to make a bottle of wine, it could make 3 loaves of bread. Therefore, in the time it takes to make a loaf of bread, it can make one-third a bottle of wine.

Comparative Advantage

A 1 bottle = 1/2 loaf

1 loaf = 2 bottles

B 1 bottle = 3 loaves

1 loaf = 1/3 bottle

When it comes to making wine, then, *A*, although less efficient in some sense, faces lower opportunity costs in terms of bread (half a loaf) than does *B* (3 loaves).

Given these facts, it doesn't pay *B* to make wine. Better to specialize in bread and trade for wine. Likewise, *A* will be better off specializing in wine and trading for bread. Each should concentrate on what it is most best (or least worst) at and trade for the other product. Given a free price system and economic liberty, that's what they will tend to do.

This analysis is as close to being void of controversy as it gets in economics. Protectionists have had to ignore this theory and simply play on people's sympathies about jobs lost, while ignoring the jobs created in the industries with the greatest comparative advantage.

But this is now changing. Traditional protectionism has been supplemented by an argument that sounds sophisticated, namely, that Ricardo's law no longer applies because a vital prop supporting it has fallen. According to economist Paul Craig Roberts, an early proponent of supply-side economics and a treasury official during the Reagan years, Ricardo's law depends on the inability of capital and labor to move across national boundaries. Since that condition no longer obtains, the law of comparative advantage no longer operates.

So, for example, if the factors that gave *A* a comparative advantage in wine could move to *B*, they would do so and *B* would not have to buy wine from *A*. *A*'s wine workers would suffer. Thus free trade *with movable factors of production* would harm *A*, which violates the economist's principle that free trade creates mutual benefits.

The problems with this are immediately obvious. The wine workers might lose their jobs, but all consumers will be able to enjoy cheaper wine. Wine drinkers will have money with which to buy other things. All this is ignored in the analysis. As they say in economics, the story is static, which is deadly when attempting to describe a dynamic world. (Any two-product model is stilted right off the bat.)

The new protectionism

When reading Ricardo, one is hard-pressed to see the argument that Roberts makes. Ricardo notes that capitalists are reluctant to move their capital from their home country, but he doesn't say that there would be no gains from trade if that were not the case. In fact, he says consumers in both countries would benefit if capital moved to the more efficient area. So it is hard to see what Roberts is driving at. As George Mason University economist Tyler Cowen writes,

Basically Roberts is peddling snake oil. His argument boils down to old-style protectionism, dressed up in new rhetorical garb, not new substance.

Cowen's charge is substantiated by the fact that Roberts's argument would lead him to accept situations extremely similar to those he condemns. As economist Robert Murphy points out, Roberts is alarmed by an American firm's outsourcing computer-programming to low-wage Asians. (This is equivalent to bringing large numbers of Asian workers to the United States and driving down programmers' wages.) But how does that differ from an Asian firm's hiring the same cheap workers and exporting their products (computer programs on CD ROMs or available online) to the American buyers? The second method would be unobjectionable according to Roberts's understanding of free-trade theory, yet its effect on American jobs would be the same.

It is certainly true that because of cheap telecommunications, low-cost foreign labor is now able to provide services to Americans that couldn't have been provided even a short time ago. American programmers, radiologists, telephone service providers, accountants, and others now have to be concerned about foreign competition. That will require a sharper sense of entrepreneurship in those workers. There will be hardship associated with the need to retrain for new work.

But these new developments do not threaten an end to the mutual benefits of world trade or the law of comparative advantage. In other words, new technology may change the configuration of comparative advantage, but it will not abolish the phenomenon. The gains from trade come from diverging opportunity costs faced by different people doing the same things. As long as opportunity costs differ, there will be the possibility for mutual advantage from trade. Entrepreneurs will discover those possibilities because that is how they will earn profits.

We have enough experience to know that the doomsday trade scenarios being generated are bogus. Several years ago low-cost foreign labor started making computer memory chips, and predictions of the demise of the U.S. high-tech sector were rife. It didn't work out that way. Instead, the price of memory chips plummeted, making computers pervasive throughout manufacturing and the service industries. Productivity skyrocketed. American chipmakers switched to innovative higher-end work. Employment grew rather than shrunk. Living standards rose.

Protectionists have a rhetorical advantage over free traders because the job losses can be pointed to, while the pending job gains cannot be. No one can predict what's around the corner, but we know that something is. People do not sit idle (unless the government pays them to). They search for new avenues for their creative labor. This already is happening. It isn't much heralded, but Americans are major *service* exporters. If government backs off and unleashes people's economic energies, we will see the current fear-mongering for what it is. It will appear as silly as the anti-Japanese propaganda of the 1980s now appears.

Free trade or protectionism?

Roberts is right: it is a new world. While much of the world was under the thumb of socialism, workers in the freer countries, such as the United States, reaped a premium. With socialism fading and economic liberalism increasing in China, India, and elsewhere, Americans now face new competition in lines of work that were formerly sheltered not by U.S. protectionism, but by foreign tyranny.

Americans can respond to this development in one of two ways. They can resent that progress, arrogantly claim that high-tech jobs belong to Americans, and lobby for protectionism. That will only bring stagnation. After all, if American firms don't take advantage of the cost efficiencies of outsourcing, their foreign competitors will.

Or they can lobby for an end to the mixed economy that holds down investment and wealth creation. No society ever got richer by having its government increase the price of goods and services or by stifling the expansion of the division of labor that enables us to get ever more wealth out of scarce resources.

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