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Free Trade, Less Trade, or No Trade?

The last 15 years have been a time of great change on the international trade front. The North American Free Trade Agreement (NAFTA), for example, substantially reduced the barriers to trade among citizens of Canada, the United States, and Mexico. On a global scale, the Uruguay round of the General Agreement on Tariffs and Trade (GATT) was ratified by 117 nations including the United States. Under the terms of this agreement, GATT was replaced by the World Trade Organization (WTO), whose membership now numbers about 150, and **tariffs** were cut worldwide. Agricultural **subsidies** were reduced, patent protections extended, and the WTO is establishing a set of arbitration boards to settle international disputes over trade issues.

Many economists believe that both NAFTA and the agreements reached during the Uruguay round were victories not only for free trade, but also for the citizens of the participating nations. Nevertheless, many noneconomists, particularly politicians, opposed these agreements, so it is important we understand what is beneficial about NAFTA, the Uruguay round, and free trade in general.

Voluntary trade creates new wealth. In voluntary trade, both parties in an exchange gain. They give up something of lesser value in return for something of greater value. In this sense, exchanges are always unequal. But it is this unequal nature of exchange that is the source of the increased productivity and higher wealth that occurs whenever trade takes place. When we engage in exchange, what we give up is worth less than what we get—for if this were not true, we would not have traded. And what is true for us is also true for our trading partner, meaning that partner is better off, too.

Free trade encourages individuals to employ their talents and abilities in the most productive manner possible, and to exchange the fruits of their efforts. The **gains from trade** lie in one of the most fundamental ideas in economics: A nation gains from doing what it can do best *relative* to other nations, that is, by specializing in those endeavors in which it has a **comparative advantage.** Trade encourages individuals and nations to discover ways to specialize so that they can become more productive and enjoy higher incomes. Increased productivity and the subsequent increase in the rate of economic growth are exactly what the signatories of the Uruguay round and NAFTA sought—and are obtaining—by reducing trade barriers.

Despite these gains from exchange, free trade is routinely opposed by some (and sometimes many) people, particularly in the case of international trade. There are many excuses offered for this opposition, but they all basically come down to one issue. When our borders are open to trade with other nations, some individuals and businesses within our nation face more competition. As we saw in Chapter 18, most firms and workers hate competition, and who can blame them? After all, if a firm can keep the competition out, profits are sure to rise. And if workers can prevent competition from other sources, they can enjoy higher wages and greater selection among jobs. So the real source of most opposition to international trade is that the opponents to trade dislike the competition that comes with it. There is nothing immoral or unethical about this—but there is nothing altruistic or noble about this, either. It is self-interest, pure and simple.

Opposition to free trade is, of course, nothing new on the American landscape. One of the most famous examples of such opposition resulted in the Smoot-Hawley Tariff of 1930. This major federal government statute was a classic example of protectionism—an effort to protect a subset of American producers at the expense of consumers and other producers. It included tariff schedules for over 20,000 products, raising taxes on affected imports by an average of 52 percent.

The Smoot-Hawley Tariff encouraged beggar-thy-neighbor policies by the rest of the world. Such policies represent an attempt to improve (a portion of) one's domestic economy at the expense of foreign countries' economies. In this case, tariffs were imposed to discourage imports, in order that domestic import-competing

industries would benefit. The beggar-thy-neighbor policy at the heart of the Smoot-Hawley Tariff Act of 1930 was soon adopted by the United Kingdom, France, the Netherlands, and Switzerland. The result was a massive reduction in international trade. According to many economists, this caused a worsening of the ongoing worldwide depression of the period.

Opponents of free trade sometimes claim that beggar-thy-neighbor policies benefit the United States by protecting import-competing industries. In general, this claim is not correct. It is true that some Americans benefit from such policies, but two large groups of Americans lose. First, there are the purchasers of imports and import-competing goods. They suffer from higher prices and reduced selection of goods and suppliers caused by tariffs and import **quotas.** Second, the decline in imports caused by protectionism also causes a decline in exports, thereby harming firms and employees in these industries. This follows directly from one of the most fundamental propositions in international trade: *in the long run, imports are paid for by exports.* This proposition simply states that when one country buys goods and services from the rest of the world (imports), the rest of the world eventually wants goods from that country (exports) in exchange. Given this fundamental proposition, a corollary becomes obvious: *any restriction on imports leads to a reduction in exports.* Thus any business for import-competing industries gained as a result of tariffs or quotas means at least as much business *lost* for exporting industries.

Opponents to free trade often raise a variety of objections in their efforts to restrict it. For example, it is sometimes claimed that foreign companies engage in dumping, that is, selling their goods in America below cost. The first question to ask when such charges are made is, below *whose* cost? Clearly, if the foreign firm is selling in America, it must be offering the good for sale at a price that is at or below the costs of American firms, or else it could not induce Americans to buy it. But the ability of individuals or firms to get goods at lower cost is one of the *benefits* of free trade, not one of its damaging features.

What about claims that import sales are taking place at prices below the foreign company's costs? This amounts to arguing that the owners of the foreign company are voluntarily giving some of their wealth to us, namely, the difference between their costs and the (lower) price they charge us. It is possible, though unlikely, they might

wish to do this, as a way of getting us to try a product that we would not otherwise purchase. But if so, why would we want to refuse this gift? As a nation, we are richer if we accept it. Moreover, it is a gift that will be offered only in the short run: there is no point in selling at below cost unless one hopes to soon raise price profitably above cost!

Another argument sometimes raised against international trade is that the goods are produced abroad using unfair labor practices (such as the use of child labor) or using production processes that do not meet American environmental standards. It is surely the case that such charges are sometimes correctly levied. But we must remember two things here. First, although we may find the use of child labor (or perhaps 60-hour weeks with no overtime pay) objectionable, such practices were at one time commonplace in the United States. They used to be engaged in here for the same reason they are currently practiced abroad: the people involved were (or are) too poor to do otherwise. Some families in developing nations literally cannot survive unless all members of their family contribute. As unfortunate as this is, if we insist on imposing our tastes—shaped in part by our extraordinarily great wealth—on peoples whose wealth is far smaller than ours, we run the risk of making them worse off even as we think we are helping them.

Similar considerations apply to environmental standards.[1] It is well established that individuals' and nations' willingness to pay for environmental quality is very much shaped by their wealth: Environmental quality is a luxury good; that is, people who are rich (such as Americans) want to consume much more of it per capita than do people who are poor. Insisting that other nations meet environmental standards that we find acceptable is much like insisting that they wear the clothes we wear, use the modes of transportation we prefer, and consume the foods we like. The few people who manage to afford it will indeed be living in the style to which we are accustomed, but most people will not be able to afford much of anything.

Our point is not that foreign labor or environmental standards are, or should be, irrelevant to Americans. Our point instead is that

[1] There is one important exception to this argument. In the case of foreign air or water pollution generated near enough to our borders (for example with Mexico or Canada) to cause harm to Americans, good public policy presumably dictates that we seek to treat such pollution as though it were being generated inside our borders.

achieving high standards of either is costly, and trade restrictions are unlikely to be the most efficient or effective way to achieve them. Just as importantly, labor standards and environmental standards are all too often raised as smoke screens to hide the real motive: keeping the competition out.

If it is true that free trade is beneficial and that restrictions on trade generally are harmful, we must surely raise the question, how does legislation like the Smoot-Hawley Tariff (or any other trade restriction) ever get passed? As Mark Twain noted many years ago, the reason the free traders win the arguments and the protectionists win the votes is this: Foreign competition often clearly affects a narrow and specific import-competing industry such as textiles, shoes, or automobiles, and thus trade restrictions benefit a narrow, well-defined group of economic agents. For example, restrictions on imports of Japanese automobiles in the 1980s chiefly benefited the Big Three automakers in this country: General Motors, Ford, and Chrysler. Similarly, long-standing quotas on the imports of sugar benefit a handful of large American sugar producers. And when tariffs of up to 30 percent were slapped on many steel imports in 2002, an even smaller number of American steelmakers and their employees benefited. Because of the concentrated benefits that accrue when Congress votes in favor of trade restrictions, sufficient monies can be raised in those industries to convince members of Congress to impose those restrictions.

The eventual reduction in exports that must follow is normally spread in small doses throughout all export industries. Thus no specific group of workers, managers, or shareholders in export industries will feel that it should contribute money to convince Congress to reduce international trade restrictions. Additionally, although consumers of imports and import-competing goods lose due to trade restrictions, they too are typically a diffuse group of individuals, none of whom individually will be affected a great deal because of any single import restriction. It is the simultaneous existence of concentrated benefits and diffuse costs that led to Mark Twain's conclusion that the protectionists would often win the votes.

Of course, the protectionists don't win all the votes—after all, about one-seventh of the American economy is based on international trade. Despite the opposition to free trade that comes from many quarters, its benefits to the economy as a whole are so great it is unthinkable that we might do away with international trade

altogether. Thus, when we think about developments such as the North American Free Trade Agreement (NAFTA) and the World Trade Organization (WTO), it is clear that both economic theory and empirical evidence indicate that, on balance, Americans will be better off after—and because of—the move to freer trade.

DISCUSSION QUESTIONS

1. During the late 1980s and early 1990s, American automobile manufacturers greatly increased the quality of the cars they produced, relative to the quality of the cars produced in other nations. What effect do you think this had on (1) American imports of Japanese cars, (2) Japanese imports of American cars, and (3) American exports of goods and services other than automobiles?
2. Over the last 20 years, some Japanese automakers have opened plants in the United States so that they could produce (and sell) "Japanese" cars in the United States. What effect do you think this had on (1) American imports of Japanese cars, (2) Japanese imports of American cars, and (3) American exports of goods and services other than automobiles?
3. For a number of years, Japanese carmakers voluntarily limited the number of cars they exported to the United States. What effect do you think this had on (1) Japanese imports of American cars and (2) American exports of goods and services other than automobiles?
4. Until recently, American cars exported to Japan had driver controls on the left side of the car (as in America) even though the Japanese drive on the left side of the road, and thus Japanese cars sold in Japan have driver controls on the right side. Suppose the Japanese tried to sell their cars in America with the driver controls on the right side. What impact would this likely have on their sales in this country? Do you think the unwillingness of American carmakers to put the driver controls on the correct side for exports to Japan had any effect on their sales of cars in that country?