

# Deconstructing the argument for free trade

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Deconstruction: In popular usage the term has come to mean a critical dismantling of tradition and traditional modes of thought. See also postmodernism; poststructuralism.

## 1 Introduction

Economists' views on free trade are more synchronous than on almost any other policy question: they almost universally support free trade as a policy. For example, Alan Blinder wrote in 2007:

"Like 99% of economists since the days of Adam Smith, I am a free trader down to my toes."

<sup>1</sup>Other economists have noted this widespread consensus as well. Carlos Diaz-Alejandro (1975) wrote about "... the ultra-pro-trade-biased obiter dicta of the professional mainstream..." And Magee (1975), in writing about why researchers might have a subconscious desire for empirical justification of an assumption of satisfaction of the Marshall-Lerner conditions, noted:

"Since most international economists are free traders..."

This remarkable consensus spans over two centuries, having held together through enormous changes in the foundations of economic analysis. The claim we make here is that, in light of the apparent settled nature of economists' judgement on the issue of trade liberalization, the profession has stopped thinking critically about the question and, as a consequence, makes poor-quality arguments justifying their consensus. That is, this consensus is now an *institution* that, like some other institutions, can best be described as "centuries of tradition, unmarred by progress"<sup>2</sup>∇

To develop support for this claim, I analyze the quality of the arguments that economists make in support of "free trade."<sup>3</sup> In particular, I will look at how these arguments are posed in textbooks and other writings aimed at students and other non-professional economists. In this arena, where the profession should be most concerned to make a careful argument, the arguments gloss over a key issue the resolution of which is anything but obvious: What does it mean for a change in economic circumstances to be "good for the nation as a whole", even when some members of that nation are hurt by the change?

Our critique goes beyond this, though. Consider a scene in the movie *Dead Poets Society*, in which the all-boys-school poetry teacher portrayed by the actor Robin Williams asks his students: What is the purpose of language? They predictably answered: to communicate. Their teacher then corrected them: the purpose of language, he claimed, is to "woo women!"

Of course, in some contexts, wooing women is a worthy goal. But scientific writing about policy issues shouldn't be like writing poetry. Unfortunately, most economic writing on the welfare implications of trade are not a balanced weighing of the evidence or a critical evaluation of the pros and cons of arguments, but rather are more akin to a zealous prosecutor's advocacy of a point of view. As such, this writing is designed to persuade rather than to give the reader the information needed to form an educated point of view. Much like

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<sup>1</sup>As reported in *The Wall Street Journal*, Wednesday, March 28, 2007, page A1, in an article titled "Pain from free trade spurs second thoughts."

<sup>2</sup>This phrase is sometimes used to describe military institutions that, for example, use training techniques that lost their functional use centuries ago, e.g., marching in formation.

<sup>3</sup>The parentheses signify that "free trade" is, for most economists, a close substitute, at least linguistically, for "trade liberalization." Consider, for example, the title to Douglas Irwin's book: *Free trade under fire*. The world has almost never had pure free trade, so the more correct, but less successful, title might have been "Trade liberalization under fire."

the zealous prosecutor, economists writing about the welfare effects of trade emphasize the arguments and evidence that supports their case for free trade, and ignore or work to de-emphasize the points not in their favor.

My point is not that the economics profession is *not* on the side of angels in the policy debate over trade liberalization—although I will argue that a more careful argument should lead to a more nuanced view—but that the argument is poorly made. This reflects negatively on the credibility of the economics profession as a whole: critical thinkers might believe all economic arguments are as poorly supported as is the one in support of free trade; others might believe economists are mere propagandists and handmaidens in service of some philosophical or political goal. Furthermore, it obscures some key ideas that should be part of a persuasive argument in support of free trade. And finally, it has confused many people into false beliefs about what economic analysis really says about the effects of international trade. For example, in the January 30, 2007 issue of the New York Times, on page C7 in an article titled "To mend the flaws in trade: economist wants business and social aims to be in sync," the journalist Louis Uchitelle writes:

"Like most economists, Mr. Rodrik believes that unrestricted trade enriches the participating nations, helping more people than it hurts."

Whether Dani Rodrik really ascribes to this view is not the point: many people already believe, and others will infer from this statement, that a *logical* implication of economic analysis is that more people are helped than are hurt. While this may be true as an empirical proposition (although I am not sure there is rigorous empirical evidence that this is the case), I suspect that most non-economists aren't so nuanced in their understanding.

Even professional economists seem to have fallen prey to misconceptions about what economic analysis can tell us about the effects of free trade. For example, in McClosky 1999, we find:

"The subject, though, is the exchange of goods and services, Japanese autos for American timber, ... If exchange is a game, it resembles one in which everyone wins, like aerobic dancing... Trade ... is positive sum. ... How does an economist know? Because the trade was voluntary. ..."

I should note that a similar critique could perhaps be made about how the profession responds to any event or policy that is a potential, but not actual, Pareto improvement. For example, profit-driven technological change is quite similar in its effects as trade liberalization: some people are helped, others harmed, but the gains to the winners are greater than the losses to the losers.

As with free trade, such changes in economic circumstances seldom draw critical thought anymore. For example, to call someone a "Luddite" is to insult them with an implication that they don't understand the virtues of technological progress. An attempt to argue that perhaps the Luddites had a point—after all,

it was their livelihood at stake—tends to elicit comments from other economists such as "you must be someone who favors bringing back the hand loom."

I focus on trade here, though, in part because of its larger literature and its standing as a significant sub-discipline in economics.

Again, let me reiterate: the purpose of this note is not to argue that protectionism is better than free trade, or that the status quo should be awarded pride of place when considering economic policy. Rather, it is to focus attention on the quality of argument brought to bear by economists in defence of free trade. The hope is that this will encourage production of better arguments about the issue.

## 2 The economist's argument

### 2.1 The basic structure

I start by seeing how most undergraduate texts go about making the case for free trade. As noted, in this arena one would hope for the best analysis the profession has to offer. The basic outline is much like that found in Krugman and Obstfeld's best-selling undergraduate textbook.<sup>4</sup> First, in the introductory material, most texts set the tone by saying something along the lines of what is found in Krugman and Obstfeld (2006):

"While nations generally gain from trade, however, it is quite possible that international trade may hurt particular groups *within* nations... ." (p. 4, their italics).

That is, they assert that free trade is good for the nation, but note that it may not be good for every member of that nation. By starting the discussion of free trade with such an unqualified assertion, the authors suggest that the concept of "good for the nation" is not problematic, and that there is only the task of proving the assertion in the body of the text.<sup>5</sup>

Second, most texts then develop the two-country, two-good Ricardian model and use it to illustrate that, if the pattern of trade is determined by comparative advantage, then no one (in either country) can be hurt by trade and some people are made better off by it.

Of course, anyone who pays attention to current events knows that actual cases of trade liberalization do hurt some people. Textbooks acknowledge this by moving quickly to a more complicated model in which trade creates winners and losers. This might be the specific and mobile factors model, or

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<sup>4</sup>We will tend to focus on this textbook for our examples not because we think it is a bad text, but because it is so widely used.

<sup>5</sup>Krugman and Obstfeld, though, do eventually make the following assertion on *page 217!*: "We need to realize that economic theory does *not* provide a dogmatic defense of free trade, something that it is often accused of doing." We suggest that this statement's position in the book is such that it does not make much of an impact on the reader, especially in contrast to the placement of the aforementioned assertion on page 4.

the Heckscher-Ohlin model, or even the endowment economy model in which residents of a country have different tastes.

At this point, textbooks frequently introduce the concept of community indifference curves, and show how free trade puts a nation on a higher indifference curve. Alternatively, other textbooks argue that there exists a compensation scheme that redistributes goods from winners to losers so that everyone could be (hypothetically) better off under free trade than under autarky. They might even point out that there are government programs in place specifically to "compensate" those identifiable individuals who lose from free trade. To make this point about existence of a hypothetical compensation scheme, Krugman and Obstfeld, for example, show that a country's aggregate budget constraint under free trade contains bundles of commodities that dominate the autarkic consumption bundle (which of course is also the autarkic production bundle), and argues that this illustrates that the *consumption possibilities frontier* under free trade dominates the autarkic consumption point.

The argument is usually fleshed out with a variety of analogies and appeals to some auxiliary ideas that support the argument for free trade. In addition, writings frequently "cherry pick" the implications that support the view of free trade as a good policy, but ignore closely related implications that don't. Finally, writings frequently use empirical evidence that fails to come to grips with the key question about compensation that implicitly undergirds the free trade argument.

Are non-textbook writings different? Take, for example, the Op-Ed column by Edward Prescott in the Thursday, February 15, 2007 *Wall Street Journal*, titled "Competitive Cooperation."<sup>6</sup> Prescott starts his column as follows:

"Of all the thankless jobs that economists set for themselves when it comes to educating people about economics, the notion that society is better off if some industries are allowed to wither, their workers lose their jobs, and investors lose their capital—all in the name of globalization—surely ranks near the top."

I take this statement to mean that he views as a job of the economics profession the teaching to non-economists that "fact" that free trade is good for the society as a whole. Such a view surely entails the idea that economists have solved the problematic nature of knowing what is good for society even when some members of that society are hurt.

What criterion does Prescott use for deciding when a change in economic circumstance is good for society? He says:

"But broadly speaking—and these broad operating principles matter—those countries that open their borders to international competition are those countries with the highest per capita income."

Perhaps he really has a more nuanced view, and simply believes that a thorough exposition of such a view is beyond the scope of an Op-Ed column.

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<sup>6</sup>p. A19.

After all, he later uses fuzzier notions when he writes that openness is "the key to bringing developing nations up to the *standard of living* enjoyed by citizens of wealthier nations, and that "countries that commit to competitive borders will ensure a *brighter economic future* for their citizens (italics mine). But consider some of the evidence he brings to bear: a comparison of *per capita GDP growth* for areas of the globe that have had different levels of protectionism.

It is hard for me to believe that the targeted audience of this piece would not come away with the view that the economics profession knows something authoritative about what it means for a change in economic circumstance to be good for society as a whole. My guess would be that the readership believes it means something along the lines of what Uchitelle attributed to Rodrik: more people are helped than are hurt.

## 2.2 How persuasive is the argument?

### 2.2.1 The problematic nature of the concept of "good for the nation"

First consider the assertion that "nations generally gain from trade, however, it is quite possible that international trade may hurt particular groups *within* nations... ." What could the authors mean by this? It is probably not problematic for most people to believe that if every member of a nation is helped by a particular policy such as free trade, then one would be justified in claiming such a policy is "good for the nation." But if parts of the nation ("groups *within* nations") do not benefit, what implicit criterion is being applied to determine if something is good for the nation? Economists know the end of the story: the criterion is that there must exist a hypothetical distribution of goods to citizens under free trade such that all citizens would be better off under free trade than they would have been under autarky. And in fact, Krugman and Obstfeld (2006) finally introduce this concept in Chapter 4. We will have more to say on whether satisfaction of this criterion is a persuasive argument for free trade. But first, what might the targeted readers think?

In my undergraduate trade classes, I ask students this question of what criterion they think is being applied to determine if some change in economic circumstance is "good for the nation." Many say they think the authors must mean something along the lines of: more people are helped than are hurt. Students with a smidgen of economics sometimes phrase their answer as "it provides the greatest good for the greatest number," "it increases total utility," or "it increases GDP."

After some discussion, most of these students appreciate the problematic nature of Krugman and Obstfeld's statement, and tend to agree that the only criterion of "what is good for a nation" that would be non-controversial, that is, that if satisfied it would be universally agreed upon as characterizing the change as "good for the nation," is one that would classify any change in circumstance that makes *everyone* better off as "good for the nation." Clearly this is not what Krugman and Obstfeld are talking about, because they combine "good for the nation" with "members lose."

The students also understand, after discussion, the potential objections to other possible criterion. For example, if the criterion were "it made *more* people better off than were made worse off, this would be good for the nation, then a drawback might be that maybe the people that are helped are only helped a little, while the people hurt are hurt a lot. For example, suppose everyone in a group except one person received a gift of ten cents, while the one other person lost a kidney.

They also appreciate that the same sort of criticism would also apply to the criteria of "if the gains to the winners are larger than the losses to the losers," "if it increases GDP," or "if it increases total utility."

Of course, my students aren't the first to appreciate the problematic nature of the social choice problem. In regards to the compensation criterion, even Hicks, one of its progenitors, argued that it must be augmented by something along the lines of what Samuelson later identified as the conditions of a "heuristic theorem:"

*Heuristic theorem:* Most technical changes or policy choices directly help some people and hurt others. For some changes, it is possible for the winners to buy off the losers so that everyone could conceivably end up better off than in the prior status quo. Suppose that no such compensatory bribes or side payments are made, but assume that we are dealing with numerous inventions and policy decisions that are quasi-independent. Even if for each single change it is hard to know in advance who will be helped and who will be hurt, in the absence of known "bias" in the whole sequence of changes, there is some vague presumption that a hazy version of the law of large numbers will obtain: so as the number of quasi-independent events becomes larger and larger, the chances improve that any random person will be on balance benefitted by a social compact that lets events take place that push out society's utility possibility frontier, even though any one of the events may push some people along the new frontier in a direction less favorable than the status quo."

from Samuelson, P.A., (1981), Bergsonian welfare functions, in *Economic welfare and the Economics of Soviet Socialism*, ed. Rosefield. Cambridge: Cambridge University Press. (p. 227)

As Samuelson's quote makes clear, the use of the compensation criterion as an argument for a policy of free trade should not be thought of as based on a straightforward logical implication of standard economic analysis. There are numerous empirical leaps of faith ("quasi-independent," "hazy version," and so on). But clearly, by starting their discussion of the "gains from trade" with a statement that makes it seem as though there is nothing problematic about the concept, Krugman and Obstfeld are leaving readers with the impression that the criterion is *not* problematic. As we will further argue, the basic structure used as an extended argument for the support of free trade in not just Krugman

and Obstfeld but in most textbooks (and in such books as Irwin's *Free Trade Under Fire*) reinforce this impression.

### 2.2.2 The irrelevance of the argument based on Ricardo

To begin fleshing out the argument that free trade is a better policy than autarky, most textbooks develop the two-country two-good Ricardian model and the associated idea of comparative advantage. As usually presented, this model assumes that labor is the only factor of production, and production takes place under constant returns to scale. The theorem developed states: if the pattern of trade is determined by comparative advantage, then no one (in either country) can be hurt by trade and some people are made better off.

The appeal of this model as a basis for promoting free trade is surely based in part on the readily understood *individual-model* analogies that illustrate the concept of comparative advantage. Almost everyone can understand the logic of why Tiger Woods should not weed wack his yard, or why an incredibly good typist who is also a brain surgeon should hire a typist and specialize in surgery. But are these analogies to the point?

Of course not. The analogies help us understand the *model*, and help us understand the benefits of *individual* specialization along the lines of comparative advantage, but the model is inappropriate for thinking about actual trade situations in which people are *not* identical.

At the end of the day, what is the argument for free trade that is based upon the Ricardian model? It says: we have a *model* that implies free trade is good for everyone. Of course, anyone who pays attention to current events or is familiar with a little history knows that actual cases of trade liberalization do hurt some people. Hence, if we are looking for a model to address the question of whether, *in actual economies*, free trade is good for the nation as a whole, this is not a good one.

In an article titled "Reconsidering Free Trade," Hahn (1998) made similar points. He set out in this paper to "reconsider whether on balance economic theory can make a convincing case for free trade."<sup>7</sup> He developed the textbook Ricardian model, and then went on to point out "a number of important assumptions and simplifications ... which need to be firmly kept in mind." He concluded that only if "losers" from trade can be identified and compensated can there be any propositions such as "country A is better off under free trade."

Two further points. This critique is *not* a critique of the use of simplified models to help us organize thought and understand the world. The Ricardian model does help us understand some things about the world, e.g., the pattern of trade in a world of perfect competition. But the implications of the model for "gains from trade" should not be used as an argument in favor of a policy of free trade: it is just not the right model for helping us think about this question.

Second, many economists claim that the Ricardian model is a necessary antidote to the arguments of Philistines in the world who believe that all trade,

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<sup>7</sup>Page 13, first paragraph.

whether between two individuals or between two countries, must be a zero-sum game. I would argue that the appropriate use of the Ricardian model is then to counter the zero-sum argument about trade between two individuals. It is simply over-reaching to try and use this model to counter the zero-sum argument about trade between countries, and it destroys the profession's credibility: the student who, having diligently learned the "free trade is good" lesson of the Ricardian model, and who realizes later in life that the individual analogy is a poor one for countries, might be tempted to dismiss all the economics learned at that earlier age.

As noted, textbooks acknowledge that, in actual economies, trade creates winners and losers, and thus quickly move on from the Ricardian model to richer models that account for this fact. But by arguing first that the Ricardian model teaches appropriate lessons about "gains from trade," they are implicitly arguing that the problematic nature of the concept of gains from trade in the more realistic models is not something to worry about. Thus, they are encouraging readers to *not* think critically about the implications of these more realistic models.

### 2.2.3 Fleshing out the argument further

**Consumption possibilities versus production possibilities** After introducing models that imply some individuals are likely to be hurt by trade, Krugman and Obstfeld (p.68-71) then get around to pointing out the problematic nature of the concept of "gains from trade." Their answer to this problem is to assert:

"A better way to assess the overall gains from trade is to ask a different question: Could those who gain from trade compensate those who lose, and still be better off themselves? If so, then trade is a source of potential gain for everyone." (page 69)<sup>8</sup>

To prove that it is possible for the winners to compensate the losers, they point out that the aggregate budget constraint for the economy as a whole includes consumption pairs that include more of both goods than does the autarkic production/consumption point. They conclude:

"This shows, then, that it is possible to ensure that everyone is better off as a result of trade" (page 69).

This of course is not quite right. First, an aggregate budget constraint is not like an individual's budget constraint in the following sense: an individual's budget constraint can legitimately be thought of as describing a menu of

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<sup>8</sup>Also see Caves, Frankel, and Jones (2007), p.27-8, where they first acknowledge the problematic nature of "what can be said about the community as a whole" and then quickly add that, because of this, "the economist is tempted to ask about the *possibility* of compensation so that all parties can gain by the move." Why this mere possibility means the change in circumstance is good for the community is never fleshed out.

possibilities, while an aggregate budget constraint cannot. An aggregate budget constraint *reflects* individual choices, but to be interpreted as a menu of possibilities requires us to think about how a government could move aggregate consumptions along the constraint. Such movements may be politically difficult, surely would require the use of real resources as a government sets up and runs the necessary bureaucracies, and might induce serious deleterious incentive effects. Nothing in our theory tells us that the gains from trade must outweigh such costs of redistribution.

Samuelson (1966) made this point long ago. Within that paper, in section VII titled "A warning about feasibility," he asked:

"What in the way of policy can we conclude from the fact that trade is a *potential* boon? As I pointed out in my 1950 paper, we can actually conclude very little."

He supposed "as is the simple truth," that ideal lump-sum transfers are not available. Then, feasible redistributions give rise to "substitution and other effects" such that autarky could be preferable to free trade. He claimed this shows "how difficult must be any rigorous interpretation of "potential improvement."

The correct interpretation of the compensation principle is thus as a *hypothetical* thought experiment. This interpretation surely has informed thought on the usefulness of this principle as a guide to real world policies as encapsulated in the aforementioned quote by Samuelson (1981). This interpretation also makes clear that the gains from trade as defined as satisfaction of this criterion are a long-run phenomenon.

Clearly, Krugman and Obstfeld understand that there is a problem with a hypothetical criterion, because they go on to immediately say that while everyone could gain, not everyone actually does. And they point out that, given this reality, economists *still* "do *not* generally stress the income distribution effects of trade."(p.70) By feeling the need to give additional reasons beyond the compensation criterion, they imply that the compensation principle is not reason by itself to argue that free trade is good.

In summary, what Krugman and Obstfeld have done is to introduce the idea of the compensation principle as the appropriate criterion for assessing whether a free trade policy is desirable, but have not finished the argument a la' Hicks (and others). A thoughtful reader is likely to be confused: why argue that the mere existence of *hypothetical* redistributions of income is a good criteria? For the argument that free trade is a good policy to be persuasive, the development of the compensation principle must be followed by further arguments about why this can inform, but not conclude, thought on this topic.

**The arguments for why economists stress potential gains rather than possible losses** As representative of other (and most) international economists, Krugman and Obstfeld give three reasons why economists, while aware

of the losses imposed on some members of the nation by a change from protectionism to free trade, generally support free trade. Are these reasons persuasive justifications for the support of free trade by economists?

Point one starts by noting that every change in a nation's economy creates winners and losers. They then note that if every change were only allowed after examination for distributional effects, "economic progress could easily end up snarled in red tape." By equating these changes with "economic progress," I assume that they are referring to changes that are potential Pareto improvements, i.e., changes that satisfy the compensation principle. Of course, as argued above, this concept of "economic progress" is not persuasive without a further development of *why existence of a potential Pareto improvement is a good criterion for assessing whether a change in economic circumstance is a good thing*. But note that this point does seem to be arguing that *actual* redistribution may more than offset the improvements that might accrue from the economic change ("snarled in red tape").

Point two argues that it is better to allow trade and compensate those hurt. They say this would be true of other forms of economic change as well. This is subject to the critique developed above about why the compensation criterion needs to be thought of as a hypothetical redistribution: we have no theoretical assumption that the costs of redistribution don't outweigh the benefits of the change in economic circumstances. In fact, this point stands in direct contradiction to point one!

Furthermore, the logic of this point is that economists should always advocate a *joint* policy of free trade and compensation schemes that cushion losses. But in reality, such choices of joint policies may not be available because of political costs. In practice, adoption of freer trade policies frequently seems to entail simultaneous adoption of other inefficient policies. For example, legislative support of CAFTA by representatives of districts where sugar beets were an important crop was "bought" by subsidies to production of sugar beets into ethanol.<sup>9</sup>

Thus, the logic of these two points seems to be: on the one hand, we should ignore the problem of losers because of the costs of compensation; on the other hand, the problem of losers is so important that we should only advocate free trade as part of joint policy which insures potential losers. These can't both be correct. Again, it appears to me that non-economists can only make sense of this dichotomy if they have seen the "fleshed out" arguments about why the compensation principle should inform one's thinking about policy.

Finally, the third point says that losers from free trade are better organized politically than those who stand to gain. The economist's role is to provide a counterweight to this political bias by "pointing to the overall gains." This has force only if the case for "overall gains" has been made, which, I argue, has not yet been done in the traditional arguments as presented in popular writings by economists and in textbooks.

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<sup>9</sup>This happened before anyone could argue that such subsidies were really efficient because of purported positive externalities.

What could account for the juxtaposition of these partially-contradictory points? It seems to me that it is simply an uncritical view of the rightness of a policy of free trade, a view that no longer invites critical thinking from the promulgators of this view.

### **Cherry-picking implications: the questions not asked**

**The "lower price" fallacy** Consider the following quote from Krugman and Obstfeld:

"There is widespread sympathy in the United States for restrictions on imports of garments and shoes, even though the restrictions raise consumer prices." (p.70)

Or consider the discussion between "Dave" (Ricardo) and "Ed" in Russell Roberts fable of a return by Ricardo to the United States in 1959, *The Choice: A Fable of Free Trade and Protectionism* (2007). Ed owns a television-producing firm, and is considering supporting a presidential nominee (in 1960) who favors protectionism. A key part of the story is a discussion by Ricardo (illustrated by a trip to the future in the year 2005) of how resources that were used to produce televisions have been released to produce pharmaceuticals, which are exported. At one point, Ed and Ricardo engage in a conversation about the effects of a tariff on televisions (Chapter 7, "Do Tariffs Protect American Jobs?"). Dave convinces Ed that a \$25 tariff will raise the price of a television by \$25. Dave points out that this makes consumers of televisions worse off, and argues that the efficient policy would not do this, but would allow TV imports that free up resources to work in a pharmaceutical plant.

This line of argument that says "consumers" benefit from free trade because of lower prices is ubiquitous: news stories frequently make this point, as did a Wall Street Journal article that pointed out the benefit to consumers of lower prices for baby clothes that would arise if restrictions on Chinese imports were eliminated.<sup>10</sup>

The question *not* asked, in Krugman and Obstfeld, in the imaginary dialogue between Dave and Ed, and in newspaper articles, is: would *other* prices be higher without protectionism? The answer is most likely yes. Consider the question not asked in the dialogue about the higher price of TV's under protectionism: what is the price of pharmaceuticals under TV protectionism, relative to free trade? The answer, given the assumptions Russell makes about increasing marginal costs and upward-sloping supply functions, is that they are *lower*.

This of course is a fairly general proposition. Tariffs, by changing relative prices, move an economy along the PPF, leading to a lower quantity supplied of some other goods. This implies that the relative price of these other goods has gone down. Put another way, the Lerner symmetry theorem alerts us that

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<sup>10</sup> "Imports Help Consumers—if Not Politicos," by David Wessel, *Wall Street Journal*, March 25, 2004, Thursday, Section A, Page 2.

exports pay for imports. Under most conditions, this will mean that fewer imports will lead to fewer exports, and a lower price for these exports, i.e., leads to a movement towards lower quantity along the export-good supply curve.

Economists are fond of invoking the "exports pay for imports" argument to point out that protectionism might save import-competing-sector jobs but also logically entails loss of export-sector jobs. But the "exports pay for imports" argument also implies something about prices as well. The observation that the prices of televisions are higher with protection doesn't necessarily imply *consumers* are worse off. Surely there are *some* consumers who don't care about televisions but do buy drugs. Likewise for the case of clothing: consumers of clothing pay a higher price for clothing under protectionism, but a lower price for some exported good, e.g., food.

**The (mis)use of producers' and consumers' surplus** Almost all textbooks use the partial-equilibrium consumers'/producers' surplus apparatus to demonstrate the inefficiencies of tariffs or quotas. In these analyses, imposition of a tariff leads to a higher domestic price of the good in question and the well-known deadweight loss. The question not asked here is: what happens to surplus in the other markets in the economy? As every Economics 100 student knows, a change in a related price shifts the demand and supply curves in other markets. What happens to surpluses in these other markets?

It would be one thing if texts at least addressed this implication, and offered some defense of why the surplus changes in other markets should be ignored. But the thoughtful students who raise this question in their own minds are left, again, wondering about the veracity and soundness of the other economic arguments that they have been taught.

Of course, this is not to argue that Marshallian partial-equilibrium analysis should never be used. Certainly the simplifying assumption that a market is "small" is appropriate for questions such as what happens to quantity and price in a particular market. But when asking about welfare by use of surplus, we must be aware that the perhaps "small" changes in surplus in other markets are to be added up. This summing is over many markets, and can conceptually be a large number.

As an alternative explanation for this use of surplus, it may be that the profession at large has not thought carefully about the issue. Wildasin (1988) wrote the following in regards to the general-equilibrium effects of a change in economic circumstances:

"But a practical-minded economist might anticipate that these effects, if not literally zero, are often 'negligible', and that the evaluation of the most important pecuniary externalities associated with a project need not be hopelessly complex. Behind such an argument is intuition like the following: a given policy will have a major impact on certain prices, the distributional consequences of which are of first-order importance for benefit-cost analysis. But a policy which directly affects only one region or sector of an economy will generally

result in rather small price changes in other sectors or regions, and these can safely be ignored." (p. 801)

After providing some examples of papers in which such an assumption had been made, Wildasin went on to write:

"This intuition certainly seems most reasonable, and it is probably tacitly accepted rather widely. However, it overlooks the fact that while many of the price changes resulting from some project may be rather small, they may be spread over large numbers of households. *It does not therefore necessarily follow that the aggregate effect is small.* That is, the sum of very many very small numbers need not be negligible." (p. 802, italics his)

The remainder of his paper showed that this is indeed the case. If Wildasin is correct about the "tacit acceptance" of the misleading intuition about general-equilibrium effects on welfare, then the persistent use by the profession of partial-equilibrium analysis for welfare calculations reflects an assumption that does not withstand careful scrutiny.

**The use of analogies to persuade** A favored analogy used to make the argument for free trade comes from Adam Smith:

What is prudent in the conduct of every family can scarce be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we can ourselves make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage ...<sup>11</sup>

As with analyzing the usefulness of any analogy as an aid to thought, we must ask in what ways families and countries are similar and in what ways different. The key insight of this analogy concerns specialization and the division of labor: a family that was forced to be self-sufficient would undoubtedly be worse off than that same family in a world in which members could specialize. The Ricardian model gives us a formalization of when the same is true of a country.

But families and countries are different in ways that makes false the glib assertion that "what is prudent ... of every family ... can scarce be folly .. in ... a great kingdom." Families are composed of relatively small numbers of intimately connected individuals. A move from autarky to trade might create some "losers," but these could be easily identified and compensated. This is just not the case for a nation with many millions of individuals.

Another often-invoked metaphor is that found in Bastiat's *Petition of the Candle Makers*. In this satire, candlemakers were said to petition the legislature for relief from "unfair competition" from the sun. But notice the subtle framing of this satire: the status quo is free light from the sun. In the satire,

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<sup>11</sup>Smith 1976, p. 457.

candlemakers are petitioning to take away from non-candlemakers something that they have historically been given for free. There is much about which this metaphor can teach, but it is not that "free trade is good." It fails to grapple with the fundamental question that must be addressed about the beneficence of free trade, namely, what can one say when some members of society are helped and others hurt?

**What about all those empirical studies?** Most empirical studies quantifying gains from trade rely on some version of showing the consumption-possibilities frontier moves out, or implicitly assume some representative citizen. Is this sound? Consider the analogous idea of saying the U.S. is better off in 2007 than four years earlier because GDP has grown. If, as some assert, all of this growth has been accounted for by growth of income for people in the upper parts of the income distribution, is GDP the right measure of "good for the nation?" Reasonable people surely can disagree on this question.

Of course, a claim has been made that there is much empirical evidence about the gains from trade. Irwin (2002) wrote:

"The economic case for trade, however, is not based on outdated theories in musty old books. The classic insights ... have been refined and updated... More importantly, ... economists have gathered extensive empirical evidence that contributes appreciably to our understanding of free trade." (p. 21).

Some of the empirical evidence that Irwin (2002) reviews is subject to the above critique. Some, though, is evidence about the "refined and updated" insights. For example, he points out that trade might be expected to lead to an expanded range of consumer and intermediate varieties available to the domestic economy. He also points out that trade contributes to productivity growth because it serves as a conduit for the transfer of foreign technologies and because it forces domestic industries to become more efficient, and he provides references to studies that support this view.

Leamer (2007) also addresses the contribution of trade to what he calls "the mobility of ideas."<sup>12</sup> He points out that "stowaway ideas" travel with goods and services and lead to technological progress. He claims that after the Second World War, one third of the globe formed a trading network and the other two thirds looked inward. He argues that the technological progress created in the trading group left the other two thirds so far behind that they eventually abandoned their inward-looking strategies.

Finally, in his Op-Ed column, Prescott (2007) argued that research provides evidence that competitive barriers are the reason that one part of Leamer's inward-looking group, Latin America, had growth over the period 1950-2001 that lagged far behind that of Europe, the United States, and Asia.

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<sup>12</sup>On page 104, Leamer (2007) devotes a section of his book review of Thomas Friedman's *The World is Flat* to this topic.

I would not claim that increased variety and "stowaway ideas" are not part of the gains that countries reap from participation in the global economy. I would point out, though, that there have been thoughtful criticisms of the evidence about these and related gains, and that the evidence is more qualified than is sometimes claimed.

First of all, consider the wide criticism of the inward-looking import-substitution industrialization (ISI) strategies of Latin-American post-World War Two economies, in which tradition are Leamer's (2007) and Prescott's (2007) points. As noted by Diaz-Alejandro (1975), growth rates for many Latin American economies that followed ISI strategies were, at least until 1973, quite good. Furthermore, he argued that there was persuasive evidence that many LDC import-substituting industries were *not* as "inefficient, uncompetitive, and economically stagnant" as the many critics of ISI portrayed them to be. Cardoso and Helwege (1992, p. 11) assess the evidence as follows:

"Import substitution industrialization played a successful role in fomenting Latin America's high growth rates prior to the 1980's, but it erred in downplaying the market role."

Indeed, if we look at the 1950-1980 sub-sample of the data used as evidence by Prescott (2007), the period for which ISI policies were most prevalent, we find average annual per capita GDP growth rates for Latin America to be 2.7% over this period, better than that for the U.S. and roughly on par with the outward-looking part of the globe referred to by Leamer (2007).<sup>13</sup>

Diaz-Alejandro (1975) also suggested that the evidence we had at the time was in an important sense too fragile for the making of confident policy prescriptions. As he put it:

"In history, as in cross-section research ... our small and young planet does not seem to provide enough variance or degrees of freedom to test our theories unambiguously." (p. 107).

A related point about the evidence of the trade-growth nexus has been made more recently by Rodriguez and Rodrik (2001). They argue that econometric problems make the conclusions that trade begets growth also unreliable.

The point is not that there is no evidence that good things happen to many people as a result of trade. Rather, the question is why evidence that is less supportive of the idea that there are gains, or that these gains are due to a combination of policies and not just trade liberalization, gets short shrift? Diaz-Alejandro (1975) believed that part of the problem came from the disproportionate influence of Anglo-Saxon and Scandinavian economists, who were overly influenced by their own countries' positive experiences with trade liberalization.

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<sup>13</sup>Using data from Summers and Heston (1984), we find that, for example, the average per capita real GDP growth rates for Brazil and Mexico to be 4.6% and 2.9%, respectively, while the rates for France and Sweden were 3.6% and 2.7%, respectively. Other examples were similar, with some noteworthy exceptions like Japan and India.

Perhaps another reason is that, even though they are scientists, economists suffer from cognitive dissonance: they see what they want to see. Magee (1975) noted that empirical researchers of the 1950's and 1960's who estimated trade elasticities, "free traders" that they were, had what he suggested may be " a subconscious desire for empirical justification of these normative judgements."

### 3 How (and why) does the argument differ from a generic public policy approach?

Economists in other sub-disciplines grapple with the same issue that arises in trade: what is one to say about society in the face of changes in economic circumstances that help some and hurt others? In contrast to the international trade literature, the work of economists in other sub-disciplines addresses this issue head-on. For example, Edith Stokey and Richard Zeckhauser point out that there is an "inability to find unassailable criteria for resolving conflicts on social policy."<sup>14</sup>

With this impossibility in mind, they introduce the Hicks-Kaldor compensation criterion, point out the obvious problems with it as a straightforward non-problematic criterion for assessing whether a change in circumstances is "good for society," and finish with a description of Hick's justification based on the grounds that over time things averaged out for a net benefit for any one person.

But they point out the features of Hicks' "over time" interpretation that informed Samuelson's description of it as a "quasi-theorem." They then go on to discuss what they see as a consensus view among policy makers of "distributional guidelines" that help them grapple with whether or not a proposed change in economic circumstances should be considered "good for the group as a whole." Among others, these are:

1. A change should be allowed or implemented when the Hicks-Kaldor criterion is satisfied and the winners and losers are in roughly similar circumstances and the changes in well-being are "not of great magnitude." They illustrate this by a description of a librarian who buys more gardening books than ornithology books because the existing gardening books circulate more than twice as often as the ornithology books.
2. "It is not clear" if a change should be allowed or implemented if such a change benefits some groups only by imposing "significant" costs on others.

They finally point out that, given the problematic nature of resolving conflicts about what constitutes a change in circumstance that is good for the

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<sup>14</sup>See p. 283 of *A Primer for Policy Analysis* (1978).

society as a whole, people have focussed on whether the process by which such conflicts are resolved is "legitimate."<sup>15</sup>

Zajak (1995) discusses the issue in terms of how he thinks legislators and regulators take account of "fairness" issues when contemplating policy. He emphasizes that these people take account of such things as the inherent fairness of status quo property rights, societal insurance against large economic loss from exogenous economic changes, and removal of "significant" inefficiencies that benefit "special interests." And somewhat like Stokey and Zeckhauser, he points out that notions of fairness with respect to decision processes is important to people who are affected by and who make economic policy.

Note that these authors are providing a *positive* theory about a *normative* issue. Furthermore, the epistemological basis of their theories is admittedly a distillation of their experiences. But it certainly moves the analysis of policy forward beyond what most international economists put forward as a justification for free trade. And it moves the analysis forward in part because it doesn't identify non-free-traders as ignorant or ill-informed people who simply haven't learned their basic economics. That is, it identifies concerns about the kind of distributional consequences that come with trade liberalization as what many people think of as legitimate concerns.

## 4 What might be the elements of a good argument for free trade?

### 4.1 Be clear about what economic analysis can say about the matter

First, it would seem necessary that economists stipulate at the outset that advocacy of any policy, be it free trade or protectionism, involves, at some level, value judgements. This point of view is not new, but has not gained many adherents over the years. As I.M.D. Little wrote in 1950:

"The idea that there exists some *a priori* ground for saying that free trade is desirable is the direct result of having a welfare theory which ignores the distribution of real income."<sup>16</sup>

The necessity of such an up-front statement was also addressed by Little:

"The implicit assumption that free trade is a good thing...is very likely to give rise to accusations of cant and hypocrisy against those economists, or politicians, who make this assumption."<sup>17</sup>

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<sup>15</sup>Rodrik (1997) is the only trade economist known to me who has focussed on the importance to people of process legitimacy.

<sup>16</sup>I.M.D. Little, 1960, *A Critique of Welfare Economics*, second edition, Oxford paperbacks, Oxford, England, p.257.

<sup>17</sup>Little (1957), p. 256.

Put more bluntly, an argument that defends or advocates a policy of free trade because it "increases the size of the pie" cannot *by and of itself* be a good argument in favor of such a policy. But this does not mean that the "increased size of the pie" result cannot be part of an extended argument that points out what the implications of *policies* that increase pie size can mean for societies over time.

Let me be clear about what I think is *not* a clear statement of what economic analysis cannot say about "gains from trade." In a textbook, we find early on, immediately after a brief description of net national gains as measured by changes in surplus, the following statement:

There is no escaping the basic point that *we cannot compare the welfare effects on different groups without imposing our subjective weights to the economic stakes of each group.*<sup>18</sup>

The book goes on to say that "economists have tended to resolve the matter by imposing the value judgement that we shall call the **one-dollar, one-vote** metric..."

This is a step in the right direction, but needs to expand upon *why* economists have "tended to resolve the matter... ." Without this expansion, readers are left to their own devices in figuring out why economists have tended in this direction. Surely an expansion along the lines found in the above Public Policy texts would help readers understand this "tendency."

## 4.2 Make a distinction between policies and one-off choices

Over the years, I have asked many economists the question: "Why do you think economists favor free trade?" One response that seems to resonate with many of the economists with which I have discussed this topic goes as follows: Imagine two distinct economies, one of which embraces free trade along with other changes in economic circumstances that satisfy the Hicks-Kaldor compensation criterion, and the other which doesn't. These economies persist through time. If you did not know *when* you were to be born, into which of these economies would you like to be born?

From such a Rawlsian "veil of ignorance" perspective or Harsanyi-esque "initial position," the power of a *policy* that follows the Hicks-Kaldor criterion when thought about through time in contrast to a policy that exalts the status quo through time is most clear. In contrast, when thought about in a static context, the Hicks-Kaldor criterion has little force.

A policy is a rule that tells one what is to be done in certain situations that occur in different times and places. It appears that many people can understand that a policy may help one over the long haul, even though in any instant one might dislike the application of the policy. I favor enforcement of speed limits as a policy, even though there are times at which I wish they would be suspended.

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<sup>18</sup>Pugel (2007), p. 26

Of course, rules are meant to be broken. Under extraordinary circumstances, an argument can sometimes be made that an otherwise good policy should be suspended. For example, one might argue that if offshoring is going to be as disruptive to as many U.S. residents as is sometimes claimed, then a policy of free trade should be suspended. Of course, one could argue the other side: suspending the rule destroys its credibility, and leads to opportunistic behavior. The point here is that the subject is open to discussion: one can disagree on whether the premise of vast dislocations is correct, or one can argue about the incentive effects of breaking the rule, but there is no a priori "correct" answer.

### 4.3 Bring fairness issues into the debate

A key principle of fairness about which most people agree is that equals should be treated equal. Oftentimes, policies adopted towards economic interactions between home and foreign countries end up treating essentially similar citizens of the same country differently.

For example, why should workers in import-competing industries that are hurt by import penetration be given special consideration in comparison to workers who lose jobs because of changes in demand, or changes in technology? Or, why should domestic firms that allege harm from foreign firm predatory pricing, i.e., foreign dumping, be treated differently from domestic firms that allege harm from predatory pricing by domestic firms?

These arguments are straightforward and resonate with most people's sense of how a society should treat its members. They are made by economists in their defense of free trade, but usually as part of a bundle of arguments about why economists don't worry about income distribution.<sup>19</sup> There is no reason to entangle these fairness claims with more problematic issues.

### 4.4 Do what economists do best: emphasize trade-offs

When asked by non-economists, "What should I say about the benefits of free trade to a worker who has lost his job to import competition?", I sometimes respond by telling them we as a nation should also care about the export worker, or the import worker, or the worker in a downstream industry, who would lose her or his job if imports were curtailed. Or perhaps I mention that we should also care about the yet-to-be-born individual who benefits from the bigger pie. What economists are good at and trained for is to see the trade-offs involved in different policy choices. These trade-offs are not obvious to non-economists. In fact, this area is where books such as Irwin's *Free Trade Under Fire* or Robert's *The Choice* shine.

President Truman allegedly got so tired of hearing economists tell him "on the one hand..." that he wished for a one-armed economist. But frequently the best advice we can give is a menu of effects that flow from different choices. Trying to come up with a valid measure of the *net* effects is above our pay grade.

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<sup>19</sup>See the previous discussion about the Krugman and Obstfeld (1976) treatment of this.

## 5 Conclusion

At one time, Edward Leamer exhorted our profession to "take the con out of econometrics." He wasn't exhorting economists to stop doing empirical research, or even to do it in a particularly different fashion. Rather, he was exhorting them to be forthright about what could be claimed about the research, e.g., that it was a "specification search." Trade economists should do likewise: they should be forthright about what and what not economic analysis has to say about the desirability of free trade, and they should be forthright about the epistemological basis of their policy advocacy of free trade.

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