

Can Openers and Comparative Advantage: Alternative Theories of Free Trade and Globalization

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It is an epic battle, fought on many levels. In the streets this weekend, protesters from around the hemisphere will once again face police, tear gas, and chain link fences. In daily economic and political life, environmental advocates, labor unions, and other critics of unregulated markets face the growing legal power of the bankers, multinational corporations and governments who favor the elimination of all barriers to free trade.

And in the world of ideas, the critics of globalization face the theory of free trade, which is endorsed by the great majority of economists. I want to address the critique of that theory and the creation of an alternative, a different perspective on the global economy that we can counterpose to the dogma of unrestricted trade.

At the heart of the free trade position is a complex economic argument, which I will come to in a moment. However, the debate is not solely a matter of economic theory. The strength and persuasiveness of the case for free trade rests heavily on two simpler points: one observation about comparative advantage, which has a limited validity; and one claim about freedom and democracy, which is almost entirely mistaken.

1. There are gains from specialization and trade

First, there are undeniable benefits of specialization and trade. Only some countries can produce aluminum or grow bananas. Yet people everywhere drive cars that contain aluminum, and enjoy eating bananas. Other countries must therefore find something to exchange with those who produce aluminum and bananas; the older method of conquering and colonizing the producing regions has fortunately gone out of fashion.

The benefits of specialization are also important in industrial production. Only the very largest economies could attempt to produce the full range of manufactured goods that are used today. It makes sense for countries to specialize in producing some things and exchanging them for others.

This idea has a significant but limited validity. It is one thing to observe that if Canadians want to eat bananas, they have to trade with countries a bit farther south. It is another thing to assert that this is the only important principle that should govern the economy of Canada, or its banana-producing partners.

The error made by the partisans of free trade is taking the simple truth about comparative advantage to be the only truth that matters.

2. Markets are not the same thing as democracy

The critics of globalization have of course rejected the moral and political arguments for free trade. But we should not ignore the popular appeal of those views. Competitive markets are said to offer freedom of choice to all participants. The exercise of that freedom supposedly leads to efficiency in resource use, the maximum possible satisfaction, and decentralization of decision-making. Advocates of the market often confuse these economic freedoms with democracy. We all *vote* in the marketplace and the result is the best possible outcome for all.

Does freedom consist primarily of the freedom to shop? Will markets protect the environment? To respond briefly, markets are not the same thing as democracy for two reasons.

First, many important decisions are not about things that can be bought and sold. Are clean air and clean water commodities that we can buy at the store, or are they fundamental human needs that should be accessible to all? Should national parks and endangered species be sold to the highest bidder?

Second, markets distribute *votes* in proportion to incomes, giving the rich far more influence than the poor. Responding to consumer demand, an unregulated market economy will produce a wide range of luxuries; it will provide high-income communities with excellent health care and a clean environment; and it will protect all the habitats and species that people with money are willing to pay for. Real democracies often make different decisions, which is one reason why trade agreements clash with national laws and regulations.

3. Free trade leads to ideal outcomes only in a world of textbook abstractions.

Turning now to the economic theory of free trade, we confront the technical claim that unregulated market outcomes are good for everyone involved. In the simplest version, Adam Smith's metaphor of the *invisible hand* explains how competition and the pursuit of private gain leads to an ideal allocation of resources. Academic economists have elaborated this metaphor into the arcane mathematics of general equilibrium theory, saying the same thing in a different dialect.

The details of the mathematics are not at issue here. The result of the theory is a proof that the unregulated market does the best possible job of producing things that consumers are willing to pay for *if* we accept a long series of unrealistic assumptions about how the world works.

Perhaps you have heard the old joke about the group of academics stranded on a desert island with canned food but no tools to open the cans. While the scientists and engineers work on complex schemes to use rocks, sea shells, or reflections of the sun's rays to open the cans, the economist says, *Assume that we have a can opener.*

Back on the mainland after being rescued, that same economist assumes that we have a world in which free trade can be proved to be optimal. It's really better to admit that we don't have a can opener **B** and to acknowledge the unrealistic assumptions in the standard theory of free trade.

That theory assumes that everything, the environment included, has a market price reflecting its true social value. For this reason resources can only be used by producers who are willing to pay the going price for them. But there is no price for the air and water that surround us; they are not marketed commodities. So anyone is free to pollute the air and water, unless government regulation prevents it. In an unregulated market polluters do *not* pay, and nothing stops pollution.

Consider what happens when the U.S. exports corn to Mexico, thanks to the elimination of trade barriers under NAFTA. Strange as it may seem, U.S. agribusiness produces corn at much lower market cost than Mexican peasants can. As explained in a recent study by Alejandro Nadal, there are many environmental and social costs to the substitution of U.S. exports for traditional Mexican agriculture. Among these are the loss of genetic diversity in Mexico, the country where corn originated, and the destruction of traditional rural communities.

These impacts, however, do not have market prices; no one has to buy the right to eliminate genetic diversity or traditional communities. As a result, the market will allow unchecked destruction of biodiversity and traditional community. There are no uncertainties, no unknown risks, no grounds for a precautionary principle in this theory: the market acts like it knows exactly what everything is worth, and often acts like the environment is worth nothing at all.

Let's follow this example a little farther. In theory, low-cost U.S. corn displacing higher-cost Mexican corn should mean lower prices for consumers in Mexico. But as Nadal demonstrates, the monopolization of the tortilla industry in urban Mexico by a few big companies allowed them to increase tortilla prices, even as corn prices were falling. This is impossible in the world of free-market economic theory, because there are no giant corporations! Instead, price decreases are always passed on to consumers thanks to endless competition among countless tiny companies; new businesses can be formed at any time, in any industry.

What will Mexican peasants do when they lose their jobs due to U.S. corn exports? Based on free trade theory, a good guess is that they will move to the city and become computer programmers. This will be easy for them thanks to two crucial assumptions of the theory: labor and capital can move effortlessly from one industry to another, and the same technologies are available for use everywhere, in every country. That's why the high-tech sector is booming in the prosperous new suburbs on the outskirts of major cities throughout the hemisphere **B** at least in the land of fantasy found in economic textbooks, if not in the real world as we know it.

Take away these and other unrealistic assumptions, and the theoretical edifice of free trade crumbles.

Since displaced workers cannot always move effortlessly into new jobs, it is entirely possible for trade to cause prolonged unemployment, as the famous economist John Maynard Keynes pointed out seventy years ago. The reality of corporate power means that we cannot rely on competition to bring us the lowest possible prices for tortillas or countless other goods. In the numerous cases where the environment is unpriced and unregulated, more trade can mean more degradation of nature. When regulations differ from one country to another, foreign trade and investment can lead to dirty industries moving to pollution havens **B** creating a tragic form of comparative advantage in activities that poison citizens and communities.

4. Free trade alone has never been the answer

In practice, free trade alone has rarely solved the problems of either development or the environment. For a history of trade and development that makes this point, see the recent book by Alice Amsden, *The Rise of ~~A~~the Rest*. Economic development, in Europe, East Asia, or the Americas, has always involved extensive government intervention in the market. This includes not only setting tariffs, but also organizing and funding research and development, picking and promoting key industries, creating financial institutions, offering export subsidies, and a host of other activist policy measures. Development based primarily on free trade, according to Amsden, has occurred only in the special cases of Hong Kong and Switzerland, two small trading centers with uniquely fortunate positions in the larger world economy.

The same is true of the environment. Without active government intervention, environmental protection doesn't happen. Environmental advocates have always known this. Yet some free trade theorists claim that economic growth alone is the fastest way to solve environmental problems. One hypothesis is that production always becomes cleaner as incomes rise (the so-called ~~A~~environmental Kuznets curve hypothesis); while much debated among economists, this hypothesis remains controversial, and the evidence for it is weak.

A related political view suggests that environmental protection is a luxury which people become interested in when their incomes rise. This overlooks the fact that many low-income communities are passionately concerned about their local environment. Those with higher incomes are more successful in winning environmental protection, but that is due to their greater political power.

The notion that economic growth should always come first is little more than an attack on movements for environmental protection. In the U.S., conservatives have long maintained that economic growth is better for us than regulation. The latest ~~A~~proof of this idea goes as follows: Since richer people are healthier, and expensive environmental protection measures could make us poorer, environmental regulation could lead to worse health overall. This bizarre logic is popular with oil executives and others in the Bush regime that has recently come to power in Washington.

5. The alternative is active management of globalization to protect people and nature.

What will an alternative theory of globalization look like?

Economic theory must be reformulated to address the real problems of the global market system. Its assumptions must include the existence of grave environmental risks and damages, powerful corporations, extreme social and economic inequality, and barriers to movement between industries. In real-world economics, there is no presumption in favor of unregulated markets; on the contrary, there is a constant, fundamental need for active government intervention and regulation. The market is a powerful motor of development, but it is not the steering wheel. We must decide where we want to go, and then act to steer the market in that direction.

If international institutions are going to harmonize national regulations, we need to decide which way to move: harmonizing upward is very different from harmonizing downward. I have a dream that someday the WTO will impose sanctions on the United States for unfairly subsidizing energy-intensive transportation, industry, and agriculture, because of our failure to adopt normal European-level energy taxes. This would make as much sense as many actual WTO and NAFTA rulings, and would have the benefit of pushing U.S. technology in an energy-conserving direction.

Of course, many countries cannot afford to raise environmental and labor standards to normal European levels overnight. How should we address the diversity of standards during the transition to sustainable development? This is one of the hardest dilemmas in the trade debates: how do we avoid having agreements like FTAA lead to harmonizing everything downward?

On the one hand, the world, or the hemisphere, has the resources to set a higher minimum level of environmental and social standards than exists at present. We could collectively afford to feed the hungry, ban children's industrial labor under a certain age, and eliminate some of the most toxic, dangerous, and destructive environmental practices. This would require substantial contributions from developed countries and major corporations **B** but it could, and should, be done.

On the other hand, all standards cannot immediately be harmonized upwards. For some time to come, developing countries will have a comparative advantage in low-wage and low-standards industries. However, continued increases in local minimum standards should be the top priority. National governments should see industries that depend on low wages or loose environmental rules as explicitly temporary expedients to be phased out as rapidly as possible - which puts a different frame on such activities, and dramatically reduces the incentives they should be given.

As standards converge upward, the patterns of comparative advantage and the location of production will change. Industries that existed solely on the basis of low wages or loose environmental standards will be forced to modernize or go out of business. Meanwhile, rising incomes in developing countries

will attract many consumer goods industries and service providers, since many things are easier to produce closer to where they are used.

In short, comparative advantage will always be part of international trade, but it will have a very different, more benign meaning under the equitable and sustainable global system that we look forward to creating.