Free Trade: History and Perception

BY STEPHEN DAVIES

In the natural sciences, such as physics, there is a large number of statements that can be made about the world that command general assent from scientists and those with a scientific education. This is not true to anything like the same degree in the human and social sciences, such as economics and history. The reason for this is the nature of their subject (human beings and their interactions) and the consequent inability to perform controlled and repeatable experiments.

Nevertheless, there are some statements about human beings and the social world that can be made with almost as much certainty as those concerning the natural world. One of these is the principle of comparative advantage and the consequent argument that a policy of free trade, even if followed unilaterally, will act to maximize both human cooperation and material well-being. This is one of the few things on which almost all economists agree, however much they differ in their politics and philosophy or position on other economic questions. Moreover, it is a proposition that has overwhelming empirical support: the brute facts of history resoundingly confirm that free trade increases output and leads to closer cooperation and economic integration among people, often those who are widely separated physically.

David Ricardo (1772–1823)

Despite this, however, the wider public does not share the economists' confidence in the principle. The case for free trade, which economists regard as overwhelming and as certain as is possible in the social sciences, has to be constantly remade in each generation. The contrary case, for protection and local self-sufficiency, has a continuing appeal and frequently carries the day in politics, often with disastrous results. There are a number of reasons for this, not least that the argument in favor of free trade is counterintuitive for many and that the costs of the policy are concentrated and visible while the benefits are frequently widespread and diffuse. However, there are two other related reasons that go a long way to explaining public thinking about this question: 1) the perception of trade as taking place between groups or political entities rather than individuals, and 2) the misunderstanding of history that flows from this. These date back to the first formulation of the idea of comparative advantage and still obscure what is actually at issue in the continuing argument.

Although earlier authors, such as Adam Smith, had pointed out the benefits of unrestricted trade and commercial intercourse, it was the British economist David Ricardo who first articulated the classical argument for free trade on the basis of comparative advantage in 1812. The idea that a part of the world should specialize in producing those products in which it had an absolute advantage was well established by then. What Ricardo did was to show with a simple mathematical argument that it paid for parts of the world to specialize in particular products even if they did not have an absolute advantage; that is, even if the same goods could be produced more cheaply elsewhere. The critical factor was their comparative cost in terms of alternative products forgone.

Ricardo's argument was quickly accepted and remains so among economists to this day. However, the way he presented his argument contained a basic flaw, which is the origin of the misunderstanding referred to earlier. He presented trade as taking place between countries rather than individuals. Quite simply, this is false. Countries do not trade with each other. It is indi-

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viduals and corporate entities, such as firms, that do this. From the economic point of view, trade between persons in Maine and California is no different from trade between persons in California and Japan.

However, most people do not see economic life this way, and that is not how it is reported in much of the media.

Even more important is the way this distorts our understanding of economic history and the lessons to be learned from it. Two common arguments are made by critics of free trade. The first is that Ricardo's model assumes that capital will not move from one country to another. (Ricardo did indeed make this assumption, which is a consequence of his seeing the world of trade in terms of nations rather than individuals.) The second is that empirical history refutes the theory of free trade. The critics argue that the history of a number of nations, in particular the United States, shows that it is protection rather than free trade that brings about economic development and a rising standard of living while for most countries being integrated into a world of free trade means being condemned to low-value production and low incomes.

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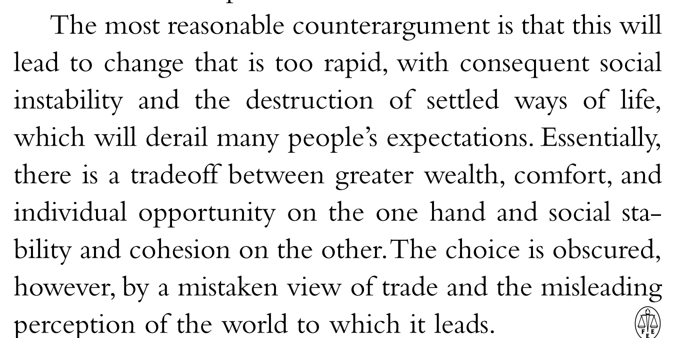
At first sight the evidence for the second argument appears strong. The United States moved sharply in the direction of a protectionist tariff policy after the Civil War and continued to follow this policy right up to the aftermath of World War II. During the same period (excluding the Great Depression and war years), the American economy grew rapidly and the United States became the world's greatest industrial power. How is this compatible with the argument that free trade is the best policy? The answer lies in realizing that trade is a matter of individual exchange rather than exchange between nations. Once you go beyond a society of completely self-sufficient households (if indeed such a thing ever existed) there will always be free trade. The question is not free trade yes or no, but rather how big is the area within which free trade takes place? The degree to which all participants will benefit from trade is a function of the extent of that area in terms of its geographical size and variety and the size and density of its population.

Success Demystified

This makes the success of the nineteenth-century United States easily understandable. The size of its territory and population made it the second largest free-trade area on the planet, after the British Empire. Moreover, Britain's continuing free-trade policy reduced the negative effects of U.S. protectionism on the world economy. Looking at things in this way makes the current debates over globalization easier to understand inasmuch as we can see more clearly what the real issues are. We can also see that the first objection to Ricardo's model is invalid. As with trade, there is no meaningful economic distinction between a capital flow from, say, Somerset to Yorkshire and one from Yorkshire to Lisbon. The real question again is what the size and boundaries of the area within which capital flows should be.

So what are the real issues at stake in the historical and contemporary arguments about trade? The basic one is: how far the economic and political units should coincide. The logic of economics is that if you want to maximize wealth and economic efficiency, then the unit of trade should be as large as possible, preferably the entire planet. Classical liberals argue that this will also bring social and political benefits, above all greater peace and interconnections between different parts of the world.



The most reasonable counterargument is that this will lead to change that is too rapid, with consequent social instability and the destruction of settled ways of life, which will derail many people's expectations. Essentially, there is a tradeoff between greater wealth, comfort, and individual opportunity on the one hand and social stability and cohesion on the other. The choice is obscured, however, by a mistaken view of trade and the misleading perception of the world to which it leads.