Trade and Globalization—Historical Perspective

Ever since mid-eighteenth century, when the French Physiocrats first advocated "*laissez faire et laissez passer*" ("let do and let pass"), so-called "free trade" has attracted passionate advocates and opponents. (I put "free trade" in quotes, because, as I will show, interpretations vary.) Economists, who almost universally support free trade, generally dismiss objections as just the self-interested protests of those whose monopoly rents are threatened. This was obviously the case when nineteenth century British landlords opposed reducing the "corn laws," tariffs on imported grain. But today, many activists oppose free trade, especially international free trade, in the name of protecting the poor from exploitation. How can we untangle the issues here?

First, I will look at the classical economists' case for free trade, as explained by Adam Smith, David Ricardo and Henry George. Second, I will look at changes in laws, economies and government since the nineteenth century, in particular the rise of larger and more powerful government. Third, I will look at how that enlarged government is now expected to regulate trade, for instance to protect consumers, workers and the environment. Finally, I will look at how neoclassical economics has redefined trade issues, and how changes in language have given free trade a meaning almost the opposite of its original meaning. I conclude that today's opponents of free trade might well find themselves in agreement with the classical economists.

The Classical Case for Free Trade

Adam Smith and David Ricardo on the Benefits of Trade

In the first pages of *The Wealth of Nations* (1776), Smith lays out a powerful case for free markets and free trade: Cooperation and exchange vastly increase productivity by permitting division of labor and encouraging innovation. As a "trifling example," Smith gives us a tour of a pin factory. Here, "One man draws out the wire, another straights it, a third cuts it, a fourth points it, a fifth grinds it at the top for receiving the head; to make the head requires two or three distinct operations; to put it on, is a peculiar business, to whiten the pins is another; it is even a trade by itself to put them into the paper; and the important business of making a pin is, in this manner, divided into about eighteen distinct operations…" In this fashion, where a man operating alone could make maybe one pin a day, a factory of ten men can make "upwards of forty-eight thousand pins in a day." [1]

Smith of course isn't particularly interested in pin factories. Rather, the pin factory graphically illustrates the staggering productivity made possible by cooperation, specialization and innovation, not just within individual businesses, but through market exchange. Division of labor, Smith writes, is limited only by "the extent of the market."[2]

In addition to labor specialization, Smith also recognizes the benefit of regional specialization. Different locations have different natural resources; some areas have fishing ports, others have mines, yet others have rich farmlands. Trade means goods can be produced in the lowest cost areas, and exchanged to mutual benefit. In *Principles of Political Economy and*

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[1] (Smith, : I,1.3)

[2] (Smith, : I.3.1)

Taxation (1817) David Ricardo extended Smith's argument with the principle of comparative advantage: two regions or countries can still trade advantageously even if one is absolutely better at producing everything. Ricardo gives a hypothetical example of Britain and Portugal. If Portugal can produce both wine and cloth more cheaply than Britain, but Britain is "more cheaper" at producing cloth than wine, then Britain can still specialize in cloth and Portugal in wine.

Classical Free Trade Policy

The obvious large benefits of exchange, both domestic and international, lead Smith and the other classical economists to oppose tax and other barriers to domestic and international exchange, including domestic excise taxes, tariffs and quotas on imports, and government-protected monopolies. These arguments sufficiently impressed the drafters of the US Constitution in 1787, that they included the "Commerce Clause" (I:8:3) giving the Federal Government broad powers to regulate trade among the states, effectively limiting states' ability to discriminate against each other. In England, David Ricardo, who spent 1819-1823 in Parliament, vigorously opposed the so-called "corn laws", which imposed heavy tariffs on the import of grain. The "corn laws," enacted in 1804 at the behest of large landowners, increased their rents at the expense of workers' wages. The laws were repealed in 1846 due to a growing free-trade movement, which by then had broad support among English merchants and manufacturers.

The classical economists vigorously opposed monopolies (single sellers) and monopsonies (single buyers), both local and national. Monopolists, lacking competition, can artificially restrict the quantity of goods they produce or exchange in order to push up prices. Monopsonists can reduce the prices the pay for inputs--like labor in a company town, or fish at the sole cannery--again by artificially restricting production. Both monopolists and monopsonists—often one and the same—gain economic rent from constraining production and exchange.

As the classical economists recognized, monopolies arise from government grants of privilege. That's true both for "natural monopolies" like the ownership of land, and artificial monopolies like the exclusive right to sell a certain good or provide a certain service. Smith especially attacks the mercantile guilds that controlled occupations in the cities. To become a tailor or a baker, you had first to be accepted by guild member and serve years as an unpaid apprentice. Like today's Medical or Bar associations, the guilds acted as cartels, keeping up prices by restricting membership and preventing competition.

While cities created guilds, monarchs or Parliament issued charters. These were special trading privileges, such as a monopoly on silk imports or the right to found a colony, granted to influential nobles or merchants. In fact, tariffs often served to protect these monopolies—and enrich the monarch. England, France, Netherlands, Spain and Portugal were perennially at war over trading monopolies. The British Navigation Acts barred the American colonists from manufacturing, and forced them to trade only with the mother country. When the British East India Company teetered on the verge of bankruptcy, Parliament gave it a special monopoly to sell tea in the colonies—inspiring the 1773 Boston Tea Party. The colonial revolutionaries played on British-French animosity to get vital French aid. The classical economists hoped international free trade would put an end to war!

The classical economists did not oppose all taxes. On the contrary: they supported taxes on the value of land and other natural resources. The British "financial revolution" of 1690-94 was founded on a stiff land tax (four shillings to the pound—20%!), used to pay interest on bonds. (The bonds were issued to fight an ongoing war against the French.) Land taxes did not impede exchange, but rather fell on passive wealth. Henry George advocated placing all taxes on natural resources.

Classical Limitations of Free Trade

The classical economists argued loosely that while exchange and innovation might destroy some jobs, they would also create new jobs. As evidence, Adam Smith observed that overall the condition of working people was improving. However, Ricardo does in passing give an example of how a new technology might in net destroy jobs. Henry George adds a further condition for trade to be net beneficial: equality. In *Progress and Poverty*, he sums it up as the Law of Progress: "association in equality is the law of human progress." That is, it takes a dense population of relatively equal people for a nation to progress in wealth and civilization. In his next book, *Protection or Free Trade* (1886), Henry George proclaims that "protectionism teaches us to do to ourselves in time of peace, what enemies try to do to us in time of war." But he nonetheless concludes that—absent tax reform—the primary benefits of free trade will go as rents to landowners, worsening inequality.

Domestic versus International Trade

The classical economists applied their arguments equally to domestic and international trade—though Smith clearly sees domestic trade as conferring more important benefits. However, free international trade met two especially strong opposition arguments: wage protection and "infant industries." In the late 19th century US, labor organizations supported tariffs in order to keep up wages in protected industries. George addressed his arguments for free trade especially to workers, who were otherwise his allies. The "infant industries" argument called for "temporary" protections for newly-established industries until they gained sufficient economies of scale to thrive on their own. In fact protective tariffs did help the US industrialize in the face of British competition. Of course the infant industry could be and often was simply an influential monopoly crying for protection.

Changes in Law and Reality since the Nineteenth Century

The classical economists wrote in the eighteenth and nineteenth centuries. The world has changed in significant ways since then. Governments have become a larger and more powerful part of modern economies. Corporations have proliferated since incorporation became a right rather than a special privilege. New and often mysterious non-physical "products" have appeared, including "financial products" like "collateralized debt obligations." Giant international oligopolies have become more powerful.

Rise of Modern Big Government

In 1900, US government spending was less than 7 percent of GDP, and most of that was local government. Today, government spending is around 40 percent of GDP, and half of that is federal.

Modern Corporations

Corporate charters were once a privilege. They were granted by governments one at a time for specific purposes, such as founding a monastery, a trade guild, a colony, a town, or a college. Charters also went to "joint stock companies" like the British East India Company, with its monopoly on trade with India. Typically, such charters granted limited liability, meaning that members or investors were not personally liable for losses. In the case of trading monopolies, limited liability made it easier to raise money. As mentioned, Adam Smith took a dim view of trading monopolies, which functioned on "other peoples' money."[3]

In the US, only in the nineteenth century did state governments begin to grant private owners a *right* to incorporate—setting off a race to the bottom in lax requirements—a race won by Delaware. By the end of the century, monopolistic and monopsonistic abuses by the "robber barons'" trusts, such as Standard Oil and AT&T, led to demands for federal action. Eventually, first during the "trust-busting" era of the early 20th century, and again during the 1930's, large corporations were broken up or otherwise restricted. Thus government came to rein in privileges once too freely granted.

Starting in the Reagan Administration during the 1980s, policy shifted towards deregulation, and serious anti-trust activity petered out. National and international mergers accelerated. The Glass-Steagall Act of 1933, prohibiting commercial banks from engaging in investment banking, was repealed in 1999, facilitating bank mergers and leading to the crash of 2008.

New Kinds of "Products"

The classical economists thought in terms of exchange of standardized physical commodities—wheat, sugar, cloth, coal, steel, gold and silver. Even in markets like these, there arise at least questions of quality control. Today's markets, domestic and international, have expanded beyond physical products. We have large international markets in contracts, such as stocks, bonds, futures, patents, broadcast licenses, fishing rights, and even in "derivatives" like collateralized debt obligations, or credit default swaps. Along with markets in contracts comes a vast thicket of international treaties to make those contracts enforceable. Many of these contracts, such as patents, in fact convey monopolies—so now we have international markets in monopoly rights—the antithesis of the original concept of free trade.

International Oligopolies, Resource Stripping and Risk

In *Cornered: The New Monopoly Capitalism and the Economics of Destruction*, Barry Lynn reports the growing power of international oligopolies. A handful of giant corporations—sometimes only one—now dominate almost every field of production or service. For example, two giant distributors, InBev of Belgium and SAB of South Africa, control the world beer market—including famous brands like Budweiser, Michelob, Stella Artois, Kirin, Tsingtao and Corona. Almost the entire worldwide optical business, from manufacturing to sales outlets, belongs to a single giant Italian firm, Luxottica. The giant multinationals of course do as monopolists traditionally do: They restrict output to raise prices, reduce variety, and cut back research on new and better products.

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[3] (Smith, : V.1.107)

The multinationals also act as monopsonists—sole buyers. In this role, they squeeze suppliers, eliminating many altogether and forcing the survivors to take shortcuts. The US auto companies, GM, Ford and Chrysler are no longer vertically integrated as they were a generation ago, each with their own independent supply chains. Today they all rely on the same handful of parts suppliers. The squeeze on suppliers by Walmart or Apple helps account for the appalling working conditions in Bangladesh or China. More ominously, according to Lynn, the reliance on very few stressed-out suppliers creates a serious risk of global disruptions. For example, there have been recurrent shortages of vaccines and cancer drugs due to technical problems at the plants of the few remaining manufacturers.

Ironically at the same time that the classical economists were promoting free trade, England led the pack of Europeans in conquering and exploiting overseas colonies. They forced these colonies to deliver cheap raw materials to the mother countries, as well as slaves to the Americas, and to accept unwanted goods in exchange—notably opium in China. Today, the colonial empires are gone in name but not in reality, as multinational corporations fill the Swiss bank accounts of local strongmen in exchange for minerals and agricultural commodities.

In this way, the international oligopolies also create a serious risk to world food and other agricultural staples like cotton and oils. By continually forcing down prices, the oligopolies have put many “inefficient” third world producers out of business. For example, Haiti stopped growing rice twenty years ago. Consequently, when bad weather, pests, war, or other crises damage crops, prices skyrocket and food riots break out due to the lack of alternative sources.

Missing Pieces of Classical Trade Theory from a Modern Perspective

The classical economists offered a clear rule: neither government nor private monopolies should impede productive exchange—from which it followed that government should not support monopolies. In a modern perspective, there are exceptions to this rule, which call for positive actions by modern, powerful governments.

Externalities

As first emphasized by Arthur Pigou (1877-1959), economic activities often have side effects on third parties. He gave the example of an (old-fashioned) coal-burning train throwing off sparks which set fire to a wheat field next to the tracks. Conventional examples of externalities include air and water pollution. Although Pigou and later economists usually call for taxes to reduce the production of externalities, in practice governments usually impose regulations on quantities of emissions. Regulation of domestic externalities is controversial enough. What about international externalities, notable global carbon dioxide emissions?

Consumer and Worker Protection

Classical free trade arguments implicitly assume that parties to exchange are fully informed, competent adults, making un-coerced “arm’s-length” transactions. While the classical economists surely recognized that this assumption fails in many instances, they did not see a role for the small and weak governments of their day.

As noted above, the early twentieth century Progressive Era brought “anti-trust” laws to restrict the size of corporations and combat “combinations in restraint of trade”, that is, monopolistic practices which raised consumer prices and squeezed small businesses.

Protection of consumers from dangerous products also began in the Progressive Era with exposés of horrendous sanitation in the meat packing industry. In 1906, President Theodore Roosevelt signed the Pure Food and Drug Act, and the Federal Meat Inspection Act. These laws prohibited "misbranding" and adulteration of foods and drugs, and set up regulatory agencies to enforce the laws, notably the Food and Drug Administration. Following Ralph Nader's 1965 book, *Unsafe at Any Speed*, the US began regulating the safety of autos and other consumer products.

Worker protection also became an issue in the early twentieth century. Child labor was greatly restricted, labor unions gained government protection, and workplace health and safety laws were introduced.

Public Pensions and Other "Safety Nets"

German Chancellor Otto Von Bismarck established disability and old-age pensions in 1889. The US didn't catch up until President Franklin Roosevelt signed the Social Security Act of 1935, establishing pensions and unemployment insurance by a tax on wages. While Social Security was a very limited program at first, it has since expanded to cover most elderly and disabled. Later safety net programs include medical care for the elderly (Medicare), medical care for some of the very poor (depending on states), and "food stamps."

Implications for International Trade

The proliferation of protective regulations in modern nations raises major questions for international trade, especially trade between developed and less developed nations: Whose rules should prevail, and how should rules be enforced and by whom? For example, should developed nations limit imports from third world nations that pay low wages and don't enforce worker safety laws? What about shrimp from Southeast Asia, where shrimp farms are destroying mangrove swamps. What about palm oil soap, when palm oil plantations are destroying Indonesian rain forests? Finally how should nations deal with the international oligopolists, who have the implicit or even explicit support—including military support—of the US and other powerful nations?

Neoclassical Economists and Changes in Language

Textbook and Conventional Trade Theory

At the end of the nineteenth century, neoclassical economists, led by John Bates Clark, merged land (natural resources) into capital. This effectively obliterated the classical economists' case for taxing economic rent. The neoclassical economists however picked up the classical case for free domestic exchange and free international trade, without Ricardo or George's caveats. In fact, they carried it further, showing that under perfect competition and "complete information", everyone benefits from free trade. And even in the worst case, those who gained could theoretically compensate the losers. Now perfect competition is to economics as absence of gravity or friction is to physics. But modern textbook writers and politicians assume it's a good enough approximation to make a basis for both domestic and international trade policy.

There's an unintentional hypocrisy here: many supporters of "free markets" and international "free trade" turn a blind eye to policies that obstruct domestic markets, or worsen inequality.

They may support monopolies on the grounds that these are more "efficient." If they are "liberal," they may ignore regressive taxes like sales and payroll taxes because they support desirable government programs. If they are "conservative," they may oppose all taxes, but especially taxes like property and income taxes that fall disproportionately on wealthier individuals and larger corporations.

Redefinition of "Free Market" and "Free Trade"

In the transition from classical to neoclassical economics, the meaning of the terms "free market" and "free trade" subtly changed. The term "free" came to mean "free of government interference." This is sheer ahistorical nonsense. From the earliest times that people have regularly met for exchange, government has necessarily provided at least a safe physical space. That government might have been no more than the local chief, who protected the traders for a cut of their profits. The early Sumerian, Chinese and Egyptian governments not only provided market places; they also built roads to those markets. They established and enforced systems of weights and measures, as well as standardized forms of money. They also drew up sets of rules, such as the Code of Hammurabi, and provided courts to resolve disputes. In the time of Christ, under the Roman Empire, it's no surprise to find money-changers in the temple courts, along with all sorts of other merchants—because that was a nice, safe, central location for a market.

Genuine free markets require governments that actively prevent coercion, fraud or monopoly. Good modern governments also help participants find the information necessary to make good decisions, such as requiring accurate labels. And they restrict transactions that could do damage outside the market, for example, barring trade in skins of endangered cats, or requiring background checks on gun purchasers. Even further, genuine free markets require governments that provide some sort of social safety net, including bankruptcy protection, to enable participants to risk innovation, and to protect losers when tastes and technology change. Yet conventional economics textbooks assume genuine free markets just pop up spontaneously like mushrooms after a rain. [4]

Internal Contradictions of International Free Trade Policies

While "free markets" implicitly assume a single government, "free trade" necessarily implies the involvement of multiple governments. That's where problems really begin. Different governments have different rules for labor, property rights, environment, health, consumers, patents, finance and many other areas. They also incline to protect "their" citizens and corporations against the others, regardless of merits. So whose rules should prevail? We have treaties, which even ideally can't spell out all the contingencies as trade patterns and technology change. As for "safety nets", yes, we can and do have procedures allowing one nation to make claims against another for unfair practices such as "dumping." Such procedures don't stop subsidized US rice and cotton from wiping out third world farmers. As for establishing some form of global government to resolve trade conflicts, the current Eurozone disaster makes any such notion preposterous. That leaves truly free international trade as more of a mirage than the classical economists perhaps hoped. In their defense, they couldn't possibly have imagined the complexity of modern markets or the power of multi-national corporations.

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[4] See Cleveland, It Takes Government to Create Markets and From Public Meat Markets to Derivatives Markets: A Lesson from Old New York

Dani Rodrick puts it well: “We cannot simultaneously pursue democracy, national self-determination, and economic globalization. When the social arrangements of democracies inevitably clash with the international demands of globalization, national priorities should take precedence.”[5]

International Trade Agreements

International trade agreements originally—and to some extent still—serve a reasonable purpose. “I’ll reduce tariffs on steel imports if you’ll reduce tariffs on wheat imports.” That’s always a tough deal to make given pressure from domestic producers of steel and wheat, as well as possible job losses for workers producing steel and wheat. But such a deal increases competition and lowers costs overall, while domestic safety nets should compensate losers.

The new style of trade agreements, GATT-WTO, especially bilateral agreements like NAFTA, Columbian and Korean free trade agreements, and the proposed new Trans-Atlantic Free Trade Agreement (TAFTA) and the Trans Pacific Partnership (TPP)—these are different animals altogether. In essence they say, “I’ll enforce your monopoly if you’ll enforce mine,” and “I’ll wipe out my regulations if you’ll wipe out yours.” They are the ultimate gift to multinational monopolists, granting them worldwide protection from competition and regulation. They are royal charters on a global scale, constraining the domestic policies of subordinate nations just as the old British East India Company controlled Indian trade and taxes.

Conclusions

Free domestic trade remains vital to economic functioning, subject to reasonable restrictions for protection of consumers, workers and the environment. Free domestic trade should also include protection from monopolists and monopsonists—a central idea of the classical economists, but now almost forgotten.

Genuine free international trade remains vital too, especially for smaller nations. However international “free trade” has often come to mean in practice freedom of multinational monopolists to strip natural resources from third world countries, to gouge consumers and squeeze suppliers. This is quite the opposite of what the classical economists meant.

[5] *The Globalization Paradox* (2011)