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Is Free Trade Out of Date?

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During the recent presidential campaign, some prominent politicians called for a "time out" in negotiating new agreements to expand international trade, and others wanted to reduce it by canceling existing trade agreements. The stated concern is that trade with countries with low labor costs forces American workers to either accept lower salaries and wages or lose their jobs to low-paid foreign workers. This concern raises the question—is the goal of free international trade out of date? My answer to this question is an emphatic "No!" As long as creating higher paying jobs, both here and in other countries by making the best use of scarce resources, is a desirable goal, free trade is not out of date. We may never achieve perfectly free international trade, but the struggle to reduce existing trade restrictions is a noble one. Achieving freer trade would not only improve our prosperity, but it is also the most effective way to help people in other countries improve theirs.

Critical to making the case for free trade is examining the argument that high-paid American workers cannot compete against low-paid foreign workers. This argument sounds plausible, but it cannot stand up to straightforward economic analysis. The high pay received by American workers does not mean that they are more costly than foreign workers who earn less. In fact, the reason freer trade would increase the pay of American workers is because it would direct them into jobs where they are less costly than foreign workers. This statement may sound surprising, but it follows directly from the implications of scarcity—the basis of all economic analysis, and a fact of life with which everyone is familiar. Scarcity results from our limited ability to produce and our unlimited ability to want.

There are two implications of scarcity directly relevant to the benefits from international trade. The first is opportunity cost. Because of scarcity, doing more of one thing always requires doing less of something else. The opportunity cost of everything we do is the value foregone from having less time and resources to do other things. All costs are opportunity costs, whether involving money or not. The cost of spending money on something is the value of what we would otherwise have bought with the money. On the other hand, we can take a walk along a beach and admire the sunset without spending a dime, but the cost is the value of what we could have realized doing something else during that time (like visiting a sick friend). The concept of opportunity cost seems obvious once stated. But it is commonly ignored when people discuss international trade.

A second implication of scarcity is that we should take advantage of opportunities to produce things with fewer workers. This pushes back the limits of scarcity by producing more things we want with the same number of workers. This may seem obvious, yet many people resist technological progress by arguing that it eliminates jobs. Of course it does. Technological progress eliminated jobs making slide rules—which used to be used for calculating. But it created more productive jobs making transistors and electronic calculators, which provided consumers with more value. More than 40 percent of our labor force was required to produce our food in 1900. Technological progress eliminated most of those jobs, with about 3 percent of our workers now producing more food per capita than over 40 percent did earlier. But the tens of millions of workers who used to work on farms aren't unemployed. Instead, they are working in safer and higher paying jobs producing a host of wonderful goods and services that we now have only because technological progress eliminated those agricultural jobs.

With the concept of opportunity cost, we can see that international trade has the same effect as technological progress. International trade makes it possible for workers in all countries to produce more goods, and earn higher wages, by specializing in jobs where they are most productive (which, as we will see, is where their opportunity cost is the lowest), and exchanging some portion of their output for goods produced more productively (at lower opportunity cost) in other countries. This leads to the surprising result that no matter how much more productive a country is than other countries, it still benefits from trading with other countries.

This result is easily illustrated with an example of two countries, the United States and China, and two goods, cars and computers. To keep the discussion as simple as possible, assume the number of workers required is the only difference in production costs. And to highlight the power of international trade, assume further the United States is more productive than China at producing both goods—the same number of workers produces more of both cars and computers in the United States than in China. In other words, the United States has an absolute advantage in producing both goods.

It might seem that in this situation the United States would have nothing to gain by trading with China, but this is not true as we will be able to understand from the following table. The table shows that 100 workers can produce 1,000 computers per week in the United States, but only 500 per week in China. The table also shows that 100 workers can produce 100 cars per week in the United States, but only 25 computers per week in China.

Weekly Output of 100 Workers

	Computers	Cars
United States	1,000	100
China	500	25

Clearly, the United States has an absolute advantage over China at producing both computers and cars, but the only good it can produce cheaper than China is cars. As the table shows, 1,000 computers can be produced in the U.S. at a sacrifice—opportunity cost—of 100 cars, while 1,000 computers can be produced in China at an opportunity cost of only 50 cars. Economists refer to this as China having a comparative advantage in computer production. On the other hand, producing 100 cars in the United States cost 1,000 computers, but producing 100 cars cost 2,000 computers in China. The comparative advantage in car production goes to the United States.

Both the United States and China can do better specializing in producing the product in which it has a comparative advantage (in which it is most productive) and trading with the other country, than by producing everything domestically. If the United States offers China cars at the "price" of 1,500 computers for 100 cars, the United States would get 1,500 computers by giving up 100 cars, instead of getting only 1,000 computers for 100 cars without trade. And China will benefit from accepting the offer since it could then get 100 cars for 1,500 computers instead of getting only 75 cars for 1,500 computers without trade.

We have seen that both countries benefit from trade, but we have not said anything about how much workers are being paid. American workers are cheaper in the production of cars than Chinese workers, because the opportunity cost of labor is less in terms of computers sacrificed per car produced. And this is true regardless of what American and Chinese workers are paid. Similarly, Chinese workers are cheaper in the production of computers than American workers in terms of cars sacrificed—again, regardless of pay in the two countries. This doesn't mean that the amount workers are paid is unimportant. With free trade, wages provide information on how productive workers are in different jobs, and motivate workers to seek employment where their productivity is highest because that is where wages are highest. Pay is higher in America than China because American workers have an absolute advantage in productivity over workers in China. But workers in each country receive higher pay when their wages are determined by international competition, because those wages direct workers into the jobs where they have a comparative advantage in productivity, which is the same as where they have the lowest opportunity cost.

Though our example here is hypothetical, real situations similar to this example always prompt complaints along the lines that, since Americans are more productive at making computers than the Chinese, the only way China can be out competing America in computer production is by "dumping" computers in America—selling them below the cost of production. One cannot rule out governments doing silly things, but subsidizing domestic producers to sell their products for less than it cost to make them is a path to poverty, not prosperity. A more likely explanation, when applied to our example, is that Chinese computer producers are not out competing American computer producers. Instead, American car companies are out competing American computer companies for labor and other inputs because those resources are more productive making cars than computers in America. American computer manufacturers could not pay the wages that American car manufacturers are willing to pay for workers and compete successfully against Chinese computer manufacturers.

So despite widespread fears, imports don't reduce employment opportunities in a country. Rather, they eliminate some jobs by creating more productive ones. When a country's comparative advantages change in response to changing economic conditions, wages and prices also change in ways that direct workers and resources out of employments where they have become relatively less valuable and into those where they have become relatively more valuable. These changes don't happen instantly, and typically result in some transitional unemployment. Because there are many goods in the real world, as opposed to our simple example, these shifts in employment, though taking place constantly, seldom affect more than a small percentage of the work force at any time. While some workers experience temporary unemployment as they make the transition into new, and more productive, jobs, the increased productivity that results increases the general level of real salaries and wages.

True, not everyone who loses his job because of international trade gets a new one that pays better. But even those

Chinese workers prepare boxes of desktop computers at the computer factory of Tsinghua Tongfang Co., Ltd. in Beijing, May 29, 2005.

(Imaginechina via AP Images)

who earn less in their new jobs still earn more than they would in their old jobs after economic conditions change. For example, once electronic calculators became available (whether imported or produced domestically), workers who had previously made slide rules earned more in their new jobs than they could make producing slide rules that no one wanted. Furthermore, every dollar workers earn in new jobs buys more and better goods because they live in an economy where other workers also shift into more productive jobs when changing conditions make their old jobs less productive. Of course, each worker would like her job protected against both foreign and domestic competition, while she continued to benefit from other workers remaining responsive to her desires even when that required moving into different jobs. But would she favor trade restrictions protecting her job if it meant that everyone else received trade restrictions protecting their jobs?

The simple economic logic of opportunity cost and comparative advantage makes it clear that Americans would benefit from freer trade. But it also makes it clear that people in smaller, and generally poorer, countries would benefit far more. The United States is a large free-trade zone that allows us to benefit more from domestic trade alone than can small countries. There are many small, poor countries whose citizens could benefit enormously by specializing in a few productive activities in which they have a comparative advantage and trading for other goods that can be imported more cheaply than produced domestically. But because of restrictions that larger and wealthier countries impose on their exports, many small countries are forced to produce many things for themselves, in which they lack a comparative advantage. The best way we could help poor people in other countries, while helping ourselves at the same time, would be by increasing our freedom to trade with them. By doing so we would benefit from their comparative advantage while letting them benefit from ours.

Attempts to reduce trade restrictions and move toward freer trade will never be out of date as long as people around the world want better opportunities and greater prosperity for themselves and their children.

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