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## Surely, We Could Trade This for Something Else...

Myths about Trade in Economic Theory

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*Mainstream trade theory suppresses the variations and complexities of real life to produce an unsustainable myth of 'Trade is Good'. Such theories have produced global inequalities and tensions, apart from ecological damage.*

Mainstream economics deploys many intuitively appealing concepts. The market itself is one such concept. The concept of exchange, of which trade is a higher-level manifestation, is another. Most of these concepts are introduced in economics textbooks using simplified models of two people exchanging two commodities, or two countries producing and exchanging two commodities, or production requiring only labour and capital. These simplified models are easy to grasp, intuitively quite appealing and appear problem-free in the manner and at the scale at which they are explained in the textbooks. They are also often backed by some impeccable mathematics.

These concepts, however, manifest very differently once the complexities and interconnections of real life come into play: a multitude of products and countries, ecological limits, supply chains and inter-sectoral dependencies, different classes of people in societies, or different levels of development in different countries. Unfortunately, most mainstream economists and policymakers choose to suppress the variations and complexities of real life, and doctrinally apply the conclusions drawn from the simplified models, much to the peril of common people and the environment.

Trade theory might have temporarily given us 'cheaper goods', but it is the terms of this trade which are also clearly the reason for the US-China conflict today, which is fast sucking other countries into a potentially dangerous global conflagration.

'Trade is good' is thus a belief that forms in the minds of most people who study economics, either as a discipline or as part of the curricula in MBAs, public policy, or similar administrative programmes. But competitive-advantage based production and trade does not guarantee that all nations involved in this kind of a regime would necessarily gain from it. For many nations, the costs could far outweigh the benefits. This, however, is not a well-known or appropriately discussed aspect in the teaching of economics.

In this light, the case of trade in economic theory is particularly contextual today. Trade theory tells us that everybody gains by trading more. The reality on the ground, however, is very different. A liberalized regime of lower import tariffs and of easy mobility of capital over the last four decades has led to manufacturing being concentrated in lower wage countries. The rich countries have lost jobs by the millions, especially of less skilled workers. The dream of working hard and moving into the middle class of society has consequently sputtered and died in these countries. It is the corresponding frustrations and misery of large sections of people in these countries that has led to the rise of Donald Trump and other such politicians. These politicians have tapped on to the real frustrations and misery of people, and touted 'others', often immigrants or vulnerable minorities, as the cause of the problem. Riding on this emotional frenzy, they have come to power. Trade theory might have temporarily given us 'cheaper goods', but it is the terms of this trade which are also clearly the reason for the US-China conflict today, which is fast sucking other countries into a potentially dangerous global conflagration.

Let us look at trade in economic theory in some detail.

### Trade: What the textbooks tell us

The textbooks tell us that if person A has extra wheat and needs apples; and if person B has extra apples and needs wheat, they are both better off if they exchange their surpluses voluntarily. This logic of mutual gain resulting from voluntary exchange is extrapolated, with trade seen as a case of exchange between countries. The mathematical 'proof' for trade rests on the ability to get goods at a lower cost. The textbooks tell us that if England and Portugal both produce wine and cloth, they could mutually benefit by exchanging these goods. The most obvious case of mutual benefit via trade is known as the case of 'absolute advantage' in the cost of production. If England produces cloth cheaper than Portugal, and Portugal produces wine cheaper than England, then England is better off specializing in producing cloth and Portugal is better off specializing in the production of wine. England can then exchange its cloth for the wine

from Portugal.

The textbooks go a step further. They tell us that there is a rationale to trade even when absolute cost advantages do not exist. Even if England produces both wine and cloth cheaper than Portugal, if the ratio of *per unit cost of production* of these two products in each country is different, there is room for each country to specialize in the production of that good which it produces *comparatively cheaper*. It can then trade that good for the other. The theory tells us that as a result of this specialization, the same resources would end up cumulatively producing more wine and cloth in the two countries. In other words, the total production of the two countries would go up. This is the famous ‘comparative advantage’ theory of David Ricardo, which the Nobel laureate Paul Samuelson, the author of the well-known and ubiquitous economics textbook, once claimed as the most elegant and non-intuitive result in economic theory. The textbooks also tell us that while additional output would be produced, how it would be shared amongst the two countries depends on the bargaining power of the two countries, but that both would be better off after trade. Understandably so: if either country were to be worse off than before, it could just go back to its original (autarkic) production pattern.

|| [This] story of comparative advantage, specialization, and mutually beneficial trade hides the impact and unaccounted costs to nature.

The above proposition of ‘comparative advantage’ makes the case for trade almost omnipresent. Note however that a change in the composition of production becomes a corollary to trade. The theory also states clearly that this kind of specialization and trade is mutually beneficial, making trade even more appealing. But is this really so? Let us look at the above propositions a little more carefully.

### What the textbooks duck

#### (i) Are we looking at ecological impact in all this?

The first glitch is that this story of comparative advantage, specialization, and mutually beneficial trade hides the impact and unaccounted costs to nature.

Mainstream economic theory considers only two factors of production: capital and labour. When it says that “the same resources would end up producing more output cumulatively,” it means that *the same amount of labour and capital would be required*. But clearly, in any kind of production, natural resources are a necessary third constituent. Producing more goods requires extra natural resources.

These extra physical goods would also need to be transported, deploying additional fuel resources. A clever economist would be quick to point that the “final lower price to consumers includes the cost of transportation. That is, the benefit from trade is calculated after deducting the additional cost of transportation.” What is omitted here is the fact that fossil fuels externalize a significant portion of their true costs to nature.

This omission might not have mattered in Ricardo’s time when ecological limits were a distant possibility, but in the ‘full’ world that we live in today this is nothing short of a fatal omission.

#### (ii) Do humans only seek more and cheaper goods?

We do not just need cheap goods, we also need secure and dignified livelihoods.

In the above example of wine and cloth between England and Portugal, the theory states that both countries gain by cumulatively producing larger quantities of cloth and wine. But what about the cloth makers of Portugal who lost their jobs because Portugal specialized in wine making? Or of the lost jobs of the wine makers in England? The theory treats these people as ‘resources’, which will soon get ‘optimally allocated’.

|| The theory says that capital would be optimally redeployed. Whosoever tried converting a powerloom into a wine storing tank would know that this ‘optimal redeployment of capital’ is largely in an accounting sense.

In real life, it rarely works like that. Rarely do polities have effective political processes and mechanisms to ensure that displaced workers resume a life of viability and dignity. Even if some political leaders were to try, it is not easy to come up with feasible job options in today’s ‘free trade’ world.

Much of the unrest in the world today, including in the United States, is due to this very phenomenon — better known in economic circles as the China Shock — where regions have lost large numbers of jobs and continue to stay that way, sometimes for decades.

Similarly, what about the manufacturing equipment rendered useless? The theory says that capital would be optimally redeployed. Whosoever tried converting a powerloom into a wine storing tank would know that this ‘optimal redeployment of capital’ is largely in an accounting sense. Actual physical equipment is rendered waste, and the impact on ecology undervalued.

**(iii) Who gets the extra wine and cloth that got produced?**

Nowhere does the theory say that the cumulative gains in production would be equally shared by all the people in the two countries. The increased output would be shared depending on the bargaining power of the two countries, which, in turn, depends both on the internal conditions of each country, the relationship between them, and the production patterns in other countries. But more importantly, within each country, the additional output is invariably shared unequally. Some people bear the costs by losing their jobs, sense of security, and self-esteem; while others corner the gains from the additional output.

The theory just assumes or says that there is a need for political processes to ensure redistribution such that the ‘additional output’ is shared by all, and the losses of those who suffered are compensated. Few real-world polities have such an intent or any redistributive mechanisms. Empirical studies have shown that increased trade and liberalisation have actually increased poverty and inequality in many countries.

**(iv) Which country specializes in what goods, and does it matter? And who decides what a country should specialize in?**

Specialization and trade decisions create clear winners and losers, both within and across countries.

Cloth and wine sound like innocuous goods, but countries actually end up specializing based on their geographical, demographic, and technological conditions. Some countries are pushed to specialize in essentials, while others might specialize in non-essentials. The number of countries specializing in different products is often very different. All of these impact bargaining power, terms of trade, the sovereignty and security of nations, and even the kind of occupations that would be available to citizens in different countries.

The clever economist would again point out: “No one is pushing a country to specialize. This is all voluntary and done by a country only if it sees the benefits. Trade, after all, is voluntary — and why would a country engage in it, unless it sees clear benefits?” In reality, though, the people of a country are not a homogenous group with perfectly aligned worldviews and interests. There exist large economic and social disparities, aspirational and occupational differences, and most importantly, power differences between the various sub-groups in any society.

The foundational source of the power of privileged classes is the ownership of productive resources in any economy. Ownership of resources of production is the most critical factor in both understanding and shaping any society or economy. However, this aspect, and the consequent power differential in society, finds no mention in neoclassical economics textbooks, courses, and discourses. There could not be a bigger lie we could be foisting on our students and our people. It is the evasion by neoclassical economics of these foundational factors that continue to keep us at tinkering with the symptoms, while the systemic problem festers and assumes insolvable proportions.

It would suffice to say that the specialization and trade decisions that get taken create clear winners and losers, both within and across countries. The real picture is far from the fairy tale of the economics textbooks.

**The textbooks don't matter anyway**

One of the key assumptions of the case for comparative advantage is that capital is immobile between the two countries. This implies the producers in the two countries cannot move their productive capacity (as equipment, or via moving money) to the other country just because it is cheaper to produce a good in the other country. This condition is a prerequisite for the results of increased output and mutual gain to hold.

|| The real source of *competitive advantage* of nations, especially for developing countries like India vying for foreign capital, is now based on lower labour costs, poor environmental legislation — the ability to externalize more costs on to nature — or lower taxation and other such subsidies.

However, anyone in touch with the reality of today’s economic world knows that capital can now easily move across countries. This has become increasingly easier in the last four decades as ‘globalisation’ backed by neoliberal economic theory took over the world. Capital (productive capacity) moves to the country which provides the lowest cost of production. We are thus no more living in the era of trade based on ‘absolute’ or ‘comparative’ advantage in cost of production of the Ricardian theory, but in an era of *competitive advantage* in cost of production.

The real source of competitive advantage, especially for developing countries like India vying for foreign capital, is now based on lower labour costs, poor environmental legislation — the ability to externalize more costs on to nature — or lower taxation and other such subsidies. Countries are compelled to sharpen these sources of competitive advantage by what has rightly come to be known in economic literature as the race to the bottom. Each country is pushed to outdo the other by keeping labour costs low, enacting less humane labour legislation, weakening environment laws and enforcement, and increasing government subsidies to private capital.

Production based on competitive advantage is even more potent in its ability to increase overall output than that based on comparative advantage. This regime promises an even bigger cornucopia. If you ask, “For whom?,” the answer would be, “For the people of the world.”

There is a deception here. In the case of production based on comparative advantage and trade, more goods get produced for the same amount of capital and labour used. After trading, both nations gain. This much is assured by the theory. The theory does concede that within the countries there could be winners and losers, and that there ought to be some mechanism for redistribution to ensure the gains are shared by all and the losers taken care of in some manner.

|| [With] the ease of international capital mobility and the dominance of neoliberal economics framework, [nations] and national governments have lost economic power over their geographical domains, thereby being less able to care for their citizens even if they wanted to.

Likewise, in the case of competitive-advantage based production and trade, the total output in the world does go up. However, there is a clear likelihood of having both winner nations and loser nations. The theory meekly suggests that there ought to be some redistribution mechanism to share the gains and compensate the losers. This is known as the ‘potential Pareto’ optimisation condition. That is, we can still *potentially* split the gains and losses more fairly. In the case of comparative advantage, the nation state has some powers to carry out some redistribution and compensatory measures between the winners and losers of trade, if it so desires. In the case of competitive-advantage based production and trade, there is no institution at the global level which has the jurisdiction or power to carry out redistribution across nations.

The other equally fallacious belief facilitated by textbook theory is that it projects the *nation* to be taking production and trading decisions, for the benefit of *all its citizens*. In reality however, it is the capitalist producers who influence public policy and take decisions primarily keeping their private gains in mind. This condition has become far more acute with the ease of international capital mobility and the dominance of the neoliberal economics framework. Nations and national governments have lost economic power over their geographical domains, thereby being less able to care for their citizens even if they wanted to. Prior to the neoliberal period, in theory and even to a fair extent in practice, national governments planned for the nation with the interest of their own populations as key. In the neoliberal regime of today, it is private financial capital (often international), or in other words, the interests of corporations that shape government policy and decisions, and often even hold governments to ransom.

### What ought to be done?

The problems lie deep: they have their roots in the way we have conceived the human project. The belief that more material production and consumption will bring about more human wellbeing is inherently flawed. First, it stems from an incomplete understanding of human nature and needs. The experience of material wellbeing is far more a socio-cultural-economic construct than some pre-determined absolute. Consequently, the belief that ‘more is always better’, which shapes so much of our economics — and consequently our society, politics, and psyches — deserves serious questioning. Beyond material prosperity, humans also need respect, equity, fairness, love, esteem, justice, a sense of contribution, and fulfilment.

|| The more fundamental human ask is a life and society that offers each one of us dignity, equity, justice, love, true and fair opportunity to actualize one’s potential and to make a meaningful contribution to the world around us.

Second, the ‘more is better’ axiom could be pardoned in the 18th and 19th centuries when crossing ecological limits of the planet was nowhere on the horizon. Today, a continued belief in it is suicidal. Unless we are able to differentiate between our psychological and material needs, we would never be able to answer the question: ‘How much is enough?’

Bringing about a humane society is an ethical project. It is not a project of impeccable mathematics that takes as its central character a caricature of a human being as a self-interested, utility maximizing, individual. The more fundamental human ask is life and a society that offers each one of us dignity, equity, justice, love, true and fair opportunity to actualize one’s potential and to make a meaningful contribution to the world around us. Societal design has to necessarily be about manifesting these in society. Terming these as human values is perhaps inadequate. They ought to be termed *societal imperatives*. If these do not manifest in any society, we would only see alienation and pathological behaviour in humans, and ecocide as its corollary.

|| We have got to get the difference between the means and the end right. The true end is a fulfilling, equitable and just, and ecologically sustainable life for all humans.

Flawed theories can work to the advantage of some parts of the world, at least for some period of time. That is the essence of all zero-sum games. China may have moved large numbers of its people out of poverty by specializing in export-oriented manufacturing. This so-called ‘Rise of the Dragon’ deserves a more critical scrutiny. One, this model was feasible only because a free-trade based regime concomitantly gained ground over the world in the same time period. There are many other important facts that cannot be ignored regarding this ‘success’ story. If China effectively stole the jobs of people in other countries, leading to job losses, psychological problems, social unrest, and the rise of demagogues in those polities, does such a ‘success’ deserve applause? Two, this ‘success’ is also under risk, as other Asian (and perhaps later, African) economies offer cheaper labour and other legal and infrastructural advantages. Three, while the full reality of China always remains unknown, there are far too many reports that tell us that this ‘success’ has come at huge environmental costs. Four, China has not managed this ‘economic miracle’ without a corresponding price paid on the civil and political liberties front. All this just shows how myopic our theories and our measures of wellbeing are.

Economics needs fundamental overhauling. Economics and economies are merely means to an end. So are constructs like trade, GDP, productivity, or efficiency. We have got to get right the difference between the means and the end. The true end is a fulfilling, equitable and just, and ecologically sustainable life for all humans. Yes, this can sound very philosophical and distant compared to the immediate fires of today. It can also be argued that many such ‘truths’ have been around for 50, 500, or 5,000 years. And yet nothing short of placing these as our starting point, our constant litmus, and our unchanging compass will help shape the course correction that is urgently required now. It might sound clichéd, but *this time, it really is different*.

The questions that will come up will be difficult to answer. They will rankle many of our deeply cherished ‘truisms’. Is more trade always good? Is innovation always a virtue? Is faster, cheaper technology always beneficial? Will a more equal society not lead to stagnation? Is our notion of progress or development even halfway sound? But perhaps it is the shying away from the difficult questions, and the challenge of finding practical levers to initiate paradigm shifts that has kept us sleepwalking for long.

A loud and clear wakeup call is upon us once again. Will we rise to it?