The Narrow and Broad Arguments for Free Trade

By PAUL R. KRUGMAN*

Economists have a notorious, only partly deserved reputation for disagreeing about everything. One thing that almost all economists have almost always agreed about, however, is the desirability of free trade.

Why are economists free-traders? It is hard not to suspect that our professional commitment to free trade is a sociological phenomenon as well as an intellectual conviction, that is, that there is more to it than our altruistic desire to persuade society to avoid deadweight losses. After all, if social welfare were all that were at stake, we should as a profession be equally committed to, say, the use of the price mechanism to limit pollution and congestion. However, support for free trade is a badge of professional integrity in a way that support for other, equally worthy causes is not. By emphasizing the virtues of free trade, we also emphasize our intellectual superiority over the unenlightened who do not understand comparative advantage. In other words, the idea of free trade takes on special meaning precisely because it is someplace where the ideas of economists clash particularly strongly with popular perceptions.

On the other hand, the contrast between what economists know and everyone else believes about trade creates special incentives for economists to turn apostate. In 1986 John Culbertson was given prime space in *The New York Times*, not once but three times, to propound exactly the same confusion between comparative and absolute advantage that Ricardo had exploded 170 years earlier. (On the strength of that performance he was then invited to publish an article in the *Harvard Business Review*). Lester Thurow's (1992) latest book is a best-seller because it seems to agree with the popular view of international trade as a struggle over market shares, even if some appreciation of general equilibrium is hidden in the footnotes. And despite her considerable qualifications, does anyone think that Laura Tyson would have attracted the attention that has now made her the president's chief economic adviser if she had criticized conventional wisdom on health care or social security instead of trade policy?

Let me be clear from the outset that economists are basically right and the general public basically wrong about international trade. Those who criticize the professional conventional wisdom rarely do so because they have a serious alternative. Usually what their objections amount to is simply a failure to understand the idea of opportunity cost. And it is certainly disturbing when rewards are lavished on economists or self-described political economists who seem to pander to popular misconceptions.

Yet there is still the question of what really is known about trade policy. Is the case for a free-trade policy really as overwhelming as the professional consensus might suggest? The answer, I will argue, is no: there is a case for free trade, but it is a more subtle and above all a more *political* case than we are used to making.

I. What We Know about International Trade

Since the late 1970's there has been a fundamental rethinking of the theory of international trade. This rethinking has not thrown out the grand tradition of trade the-

†*Discussants:* Drusilla K. Brown, Tufts University; Dani Rodrik, Columbia University; J. David Richardson, Syracuse University.

*Department of Economics, Massachusetts Institute of Technology, 50 Memorial Drive, Cambridge, MA 02139.

ory, but it has modified that tradition enough to create a new climate of doubt about what we actually know about trade and trade policy. What is the current state of play?

The first thing that seems pretty clear is that international specialization and trade cannot be explained simply by an appeal to comparative advantage, that is, speaking loosely, by countries trading in order to take advantage of their differences. While comparative advantage due to differences in resources and exogenous differences in technology is clearly important, so is specialization driven by economies of scale and external economies. The importance of noncomparative-advantage sources of specialization is not, or at any rate should not be, news: the importance of increasing returns has repeatedly been emphasized by acute observers of trade, including Bertil Ohlin himself. What has happened since the late 1970's, however, is that the role of increasing returns has been codified in nice models; since economists prefer to emphasize those aspects of the world they think they understand, this codification has made increasing-returns stories about trade and specialization much more compelling to our ears than they used to be.

Once one has abandoned the assumptions of constant returns and perfect competition, one has also abandoned the Arrow-Debreu world in which markets necessarily produce a Pareto optimum; so the "new trade theory" that legitimized imperfect competition in positive discussion of trade also opened the door to possible arguments for government intervention. Also, in the mid-1980's there was a flurry of excitement over the idea, first enunciated by James Brander and Barbara Spencer (1985), that governments could successfully engage in "strategic" trade policies that would help domestic firms snatch excess returns away from foreign rivals.

After several years of theoretical and empirical investigation, however, it has become clear that the strategic trade argument, while ingenious, is probably of minor real importance. Theoretical work has shown that the appropriate strategic policy is highly sensitive to details of market structure that governments are unlikely to get right, while efforts to quantify the gains from rent-snatching suggest small payoffs. (For surveys of this literature, see Elhanan Helpman and Krugman [1989] and Krugman and Alasdair Smith [1993]). Free trade is not the optimal policy, these studies suggest, but clever interventionist policies will do only a little better.

These results apply, however, only to efforts to capture excess returns in oligopolistic industries. What about external economies? International economists have long known that external economies could provide an argument against free trade. Since we have little empirical evidence on the actual importance of external economies, however, it is difficult to know how important this arguments really is. My personal guess, based in part on looking at semi-plausible numerical examples, is that external economies will turn out to be a more important argument against free trade than excess returns, but that we will still be talking about relatively small stakes. I propose the following question: suppose that the United States were to carry out a clever, completely antisocial attempt to corner the world market in high-externality industries, and that the rest of the world were to remain entirely passive as it did so. How much would this raise real income in the United States? I would guess less than 1 percent.

If this guess is right, then the widespread popular view that the economic future of the United States rests on its success in a "head-to-head" international competition over who gets the good industries is basically if not totally wrong. However, to say that trade is not a zero-sum game is not the same as saying that free trade is the best policy. I have just argued that the new trade theory, while it refutes the position that free trade is optimal, does not suggest that any alternative will achieve great results. Still, why should free trade be the null hypothesis? There are, I think, two arguments for free trade that survive the revolution in international trade theory: a narrow economic argument and a more compelling argument that is as much political as economic.

II. The Narrow Economic Argument for Free Trade

If markets were perfect, then laissez-faire in general, and free trade in particular, would be Pareto optimal. This is the simplest case for free trade, but it has a problem: since markets are imperfect, it is clearly an untrue case in fact.

There is, however, a much more sophisticated economic case for free trade. It is that, while markets are without question imperfect, the appropriate fix for their imperfections rarely involves trade policy per se. What is wrong with markets is usually a *domestic* distortion, best fixed by a surgical policy aimed directly at the source of the market failure.

The theory of domestic distortions was developed during the 1960's (see Jagdish Bhagwati [1971] for a classic exposition). The canonical example is a perfectly competitive economy distorted by an exogenous wage differential, say, between unionized and nonunionized industries. The first-best policy to deal with this distortion is a wage subsidy. A production subsidy is second-best. Trade policy, if it is the only tool, can raise welfare, but it is only a third-best policy.

In the imperfectly competitive world of the new trade theory, it is not so easy to produce strong policy rankings. Nonetheless, efforts to quantify strategic trade models suggest that the presumption against trade policy as a preferred tool remains. For example, Avinash Dixit (1988), in a path-breaking if somewhat tongue-in-cheek analysis of policies for the automobile industry, found modest gains to the United States from a small tariff. A subsidy to domestic production, however, was nearly as effective, and when both tariff and subsidy were allowed, both the tariff rate and the incremental gains from the tariff were trivial. In other words, the real reason for intervention was almost entirely to correct a domestic distortion, rather than to exploit market power in trade.

In practice, the theory of domestic distortion is rarely used to prescribe actual policies. Instead, it is used as a debating point against interventionist trade policies. Suppose, for example, that someone argues for import restrictions to save jobs in some industry. The economist can then make an argument something like this: "Well, if it's jobs that are the objective, then let's subsidize employment in that industry—the cost to the taxpayers will be about $xxx,000 per job saved. Oh, you're not willing to pay that price? But you know an import quota is even more expensive when you consider its true costs. So you must really not want one."

However, while the theory of domestic distortions is an effective argument *against* particular protectionist proposals, it seems somewhat lacking as a positive argument *for* free trade. Is it possible to offer something stronger? Only if one goes beyond narrow economic justifications and discusses political economy.

III. The Broad (Political-Economy) Argument for Free Trade

The broad argument for free trade, to which many economists implicitly subscribe, is essentially political: free trade is a pretty good if not perfect policy, while an effort to deviate from it in a sophisticated way will probably end up doing more harm than good.

Let me offer two examples of how this might work. First, imagine trade between two countries that both have considerable market power. It is a familiar point that even in a world of perfect markets, each country has an incentive to try to exploit its market power with an optimal tariff. Yet if both countries impose unilaterally optimal tariffs, the resulting trade war will move them off their contract curve and (if they are not too asymmetric) leave both countries worse off than if they had adopted free-trade policies. In this situation it would be in their mutual interest to commit themselves to free trade. They could, of course, commit to some other efficient set of policies. One may plausibly argue, however, that among the set of efficient policies free trade would be uniquely easy to define and monitor and would thus stand out as a focal point for negotiation.

Now suppose that a new trade theorist comes along and informs the countries that markets are imperfect, and free trade is not really an efficient policy after all. There is, however, no simple and easily defined policy that can take its place, and the gains from optimal deviations from free trade will be small. What should the countries do?

It seems quite reasonable to argue that the countries should stick with free trade rather than try something complicated that could easily lead to a breakdown in cooperation. The perfect may be the enemy of the good: free trade may be a reasonable, rule-of-thumb way of avoiding what could otherwise degenerate into a prisoner's dilemma, in which a seemingly more sophisticated strategy might fail.

This first example may be somewhat lacking in force, since countries do not often seem to set tariffs in order to realize market power in trade. Instead, they seem to protect in order to redistribute income to selected producer groups. Although there have been some attempts to model this political process, notably the clever recent effort by Gene Grossman and Helpman (1992), it is not yet possible to offer as neat a story as that of optimal tariff warfare. Nonetheless, it is not too hard to imagine that setting trade policy also amounts to a kind of prisoner's dilemma: in a country in which each interest group gets the protection it wants, the net effect may be to make even the interest groups themselves worse off than if there had been a prior commitment to free trade. (This is more likely to be true if one thinks of policy as a Rawlsian process in which rules of the game are set before the players are sure whether or not their interest group will be one of the favored ones). As in the first example, free trade may not be optimal, in the sense that it is on the interest groups' contract curve, but it may be the best solution that is simple enough to be negotiable and enforceable.

These examples suggest how one can be both a new trade theorist and a free-trader. That is, one can believe quite strongly that the international economy bears little resemblance to the perfectly competitive, constant-returns world of pre-1980 theory and yet at the same time continue to support free trade as the best policy we are likely to get. That is indeed the position that I personally hold.

IV. The Political Economy of Trade Theory

I think that I have just offered a coherent story of how one can combine a new-fangled view of the world economy with a traditional view about trade policy. This then raises two questions.

First is whether new thinking about trade may not itself do harm. In both of my examples, one finds that it is a bad thing to try to be too clever. It follows that an economist who points out the weaknesses of the traditional argument for free trade may end up reducing everyone's welfare. Does this mean, then, that it would have been better not to think these thoughts—or at least that challenges to free trade should have been treated like recombinant DNA, handled carefully so as not to contaminate the real world? On the other hand, if after all the rethinking of international trade all we end up with is a sadder but wiser endorsement of free trade, does the theory do anyone any good?

The answer to the first question is, one hopes, that trying to understand how the world works is a terribly difficult exercise; it will be an impossible one if the economist is burdened with the additional responsibility of trying to avoid saying anything that may be misused. One might also add that in the long run even the cause of free trade is probably best served by having as sophisticated a model of trade as possible. For example, a few years ago it was common for advocates for aggressive trade policy like Bruce Scott (1985) to dismiss economists on the grounds that their theories neglected "dynamic" aspects. We can now answer, truthfully, that we have looked pretty thoroughly into those dynamic aspects and found their policy implications to be limited.

It is, to be honest, somewhat disappointing that a fundamental rethinking of theory can have such modest implications for policy; but this does not mean that nothing has been accomplished. Even if the ultimate aim of economic theory is better policy, one does not best serve that aim by trying to make every journal article into a policy proposal. The immediate policy implications of a new idea are in the end less important than its intellectual contribution. There are plenty of people out there trying to change the world in various ways; the point of economic research is to understand it.

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