In Defense Of Protectionism

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It has often been said that if all economists were laid end to end, they wouldn't reach a conclusion. On the other hand, sometimes it seems that all the economists in the world are lined up in support of some conclusion, and it's the wrong conclusion. "Protectionism" is arguably such a case.

The reason there is a demand for "protectionism" at all, is self-evident. In the last few years we have seen one factory after another shut down and relocate to a foreign country. We lost 11% of our manufacturing jobs between 1995 and 2002. At latest count employment had declined by 2.7 million jobs since January 2001, the majority of them in manufacturing.

On the other hand economists and other pundits say that while protectionism may be the immediate reaction, it is the wrong one. The majority view of "protectionism" is that it is futile, economically illiterate, and contrary to the principles of free trade as laid down by Adam Smith, David Ricardo, and others.

N. Gregory Mankiw, head of President Bush's Council of Economic Advisers, had this to say on the matter:

> … I think outsourcing is a growing phenomenon, but it's something that we should realize is probably a plus for the economy in the long run. Economists have talked for years about trade, free international trade, being a positive for economies around the world, both at home and abroad. This is something that is universally believed by economists. …
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> Outsourcing is sort of the latest manifestation of the gains from trade that economists have talked about at least since Adam Smith… [1]

Jagdish Bhagwati expressed the issue starkly:

> Only Neanderthals among the economists now militate against free trade… [2]

From these and many other comments, it appears that "respectable" economic opinion is heavily against protectionism. But if we look at primary sources like *Wealth of Nations* and go beyond a *Cliffs Notes* mentality, we may see things economists and magazine pundits have overlooked.

The Classical Case For Free Trade

"Comparative advantage," quoted by most anti-protectionists as the basis of their reasoning, is basically an extension or corollary to "absolute advantage," the principle expounded in defense of free trade by Adam Smith. The problem is that Smith wrote about situations that were unlike the one we face today in the form of off-shoring or foreign outsourcing. The circumstances he envisioned were completely different from ours, and thus the conclusions he arrived at cannot be extended to cover current conditions. We need to return to first principles before we can say how his analysis might be applied to today's circumstances.

Let us look at what Smith wrote in criticism of the mercantile system. While he defended free trade, it is obvious that what he envisioned as trade did not include outsourcing. He wrote

about goods produced in various countries *by* those countries, i.e., at their own expense and effort, then traded between countries. In his explicit statements and in his examples, it is trade in this simple, "normal" sense, not off-shoring, that he considers.

He mainly addresses himself to three types of trade, and all the examples and arguments in his work concern themselves with those three. He categorizes them in *Wealth of Nations* (hereafter *WN*) as follows:

> All wholesale trade, all buying in order to sell again by wholesale, may be reduced to three different sorts. The home trade, the foreign trade of consumption, and the carrying trade. The home trade is employed in purchasing in one part of the same country, and selling in another, the produce of the industry of that country. It comprehends both the inland and the coasting trade. [I.e., it is wholesale trade self-contained within the country.] The foreign trade of consumption is employed in purchasing foreign goods for home consumption [i.e., the import trade]. The carrying trade is employed in transacting the commerce of foreign countries, or in carrying the surplus produce of one to another [i.e., import-export between two foreign countries]. [3]

Those three categories may be said to comprise what Smith considers as trade, and if we say Smith argued for "free trade," those are the activities he included under the heading. None of them involve outsourcing, the use of one country's capital to produce goods in another country, for sale in the first country. He spoke of trading "foreign goods" – not goods produced by ourselves on foreign shores. None of the examples he uses in his book, and no direct statements, refer to outsourcing. It remains to be seen whether the conclusions he drew about "free trade" as he construed it can also apply to production of goods via outsourcing.

One issue that Smith does take up is the relative degree of benefit brought to an economy by various types of economic activity, i.e., by various uses of capital:

> [T]he same capital will in any country put into motion a greater or smaller quantity of productive labour, and add a greater or smaller value to the annual produce of its land and labour, according to the different proportions in which it is employed in agriculture, manufactures, and wholesale trade. The difference too is very great, according to the different sorts of wholesale trade in which any part of it is employed. (*WN*, Book II, Chapter V.)

The things that determine how much a use of capital benefits a country are, how much productive labor it employs or "puts into motion," and how much it adds to the "annual produce" or gross national product of a country. The more economic activity a certain amount of capital sponsors or causes, the more beneficial that use of capital is to the economy.

We see that Smith categorizes various types of trade in light of these criteria:

> The capital which is employed in purchasing in one part of the country in order to sell in another the produce of the industry of that country, generally replaces [i.e., recompenses] by every such operation two distinct capitals that had both been employed in the agriculture or manufactures of that country, and thereby enables them to continue that employment. When it sends out from the residence of the merchant a certain value of commodities, it generally brings back in return at least an equal value of other commodities. When both are the produce of domestick industry, it necessarily replaces by every such operation two distinct capitals, which had both been employed in supporting productive labour, and thereby enables them to continue that support. The capital which sends Scotch manufactures to London, and brings back English corn and manufactures to Edinburgh, necessarily replaces, by every such operation, two British capitals which had both been employed in the agriculture or manufactures of Great Britain. (*WN*, Book II, Chapter V)

The wholesale dealer who trades completely within his own country "replaces" two capitals; that is, he recompenses capital previously laid out by two different parties, the producers of the

"Scotch manufactures" and those of "English corn and manufactures." This keeps those two parties in business, and helps them continue employing labor and adding to the gross national product. To put it another way, it helps keep the total amount of productive capital in use in the country at a high level. This is the beneficial effect of the wholesaler's use of his capital.

By the same token,

> The capital employed in purchasing foreign goods for home-consumption, when this purchase is made with the produce of domestick industry, replaces too, by every such operation, two distinct capitals; but one of them only is employed in supporting domestick industry. The capital which sends British goods to Portugal, and brings back Portuguese goods to Great Britain, replaces by every such operation only one British capital. The other is a Portuguese one. Though the returns, therefore, of the foreign trade of consumption should be as quick as those of the home-trade, the capital employed in it will give but one-half the encouragement to the industry or productive labour of the country. (*WN*, Book II, Chapter V)

Thus import is only half as beneficial a use of capital as trade within a country. It replaces or recompenses only half as much domestic capital, contributing only that much to the total amount of capital in circulation or at work in the country. It puts only half as much productive labor to work. That is not to say it is not beneficial; only that it is half as beneficial, for a given amount of capital, as capital used for wholesale trade completely in domestic goods.

Smith also comments on the carrying trade, which he describes as "purchasing goods in one foreign country in order to supply the consumption of another" – that is, import and export between two countries, neither of which is the trader's home country. Of this trade Smiths says,

> That part of the capital of any country which is employed in the carrying trade, is altogether withdrawn from supporting the productive labour of that particular country, to

> support that of some foreign countries. Though it may replace by every operation two distinct capitals, yet neither of them belongs to that particular country. The capital of the Dutch merchant, which carries the corn of Poland to Portugal, and brings back the fruits and wines of Portugal to Poland, replaces by every such operation two capitals, neither of which had been employed in supporting the productive labour of Holland; but one of them in supporting that of Poland, and the other that of Portugal. (*WN*, Book II, Chapter V)

Thus the carrying trade does not add to the level of productive capital at work in the trader's home country, nor employ labor in his country. For that reason it is less beneficial to the economy of the home country than the other types of trade Smith discusses. In fact, its only benefit is that:

> The profits only return regularly to [the home country], and constitute the whole addition which this trade necessarily makes to the annual produce of the land and labour of that country. (*WN*, Book II, Chapter V)

Keeping in mind the relative advantageousness of the different types of trade, Smith makes this general observation:

> The capital, therefore, employed in the home-trade of any country will generally give encouragement and support to a greater quantity of productive labour in that country, and increase the value of its annual produce more than an equal capital employed in the foreign trade of consumption: and the capital employed in this latter trade has in both these respects a still greater advantage over an equal capital employed in the carrying trade. The riches, and so far as power depends upon riches, the power of every country must always be in proportion to the value of its annual produce, the fund from which all taxes must ultimately be paid. But the great object of the political œconomy of every country, is to increase the riches and power of that country. It ought, therefore, to give no preference nor superior encouragement to the foreign trade of consumption above the home trade. . . (*WN*, Book II, Chapter V)

Anti-Mercantilist Arguments

These then are the types of wholesale trade Smith considers, and the relative degree of advantage he attributes to each. There is no explicit mention of outsourcing or off-shoring – of setting up production facilities in foreign countries to produce the goods that will be sold in one's own country. (He does discuss the situation of the American colonies at that time, which could be considered analogous in some ways.)

But suffice it to say, he does not explicitly mention off-shoring, and none of his examples in the book consider it. If we want to know whether Smith's defense of "free trade" can also be applied to off-shoring, we will have to look at the specifics of his arguments:

> The two principles being established, however, that wealth consisted in gold and silver, and that those metals could be brought into a country which had no mines only by the balance of trade, or by exporting to a greater value than it imported; it necessarily became the great object of political œconomy to diminish as much as possible the importation of foreign goods for home consumption, and to increase as much as possible the exportation of the produce of domestick industry. Its two great engines for enriching the country, therefore, were restraints upon importation, and encouragements to exportation. (*WN*, Book IV, Chapter I)

It is those premises of mercantilism Smith would argue against. Smith's arguments against mercantilism are varied, and he often illustrates grand economic principles by invoking small details of everyday economic life, an effective technique. In regard to restraints on imports – whether in the form of high duties or outright prohibition of imports – aimed at protecting particular domestic industries or encouraging the balance of trade generally, Smith says:

> It is the maxim of every prudent master of a family, never to attempt to make at home what it will cost him more to make than to buy. The taylor does not attempt to make his

> own shoes, but buys them of the shoemaker. The shoemaker does not attempt to make his own clothes, but employs a taylor. The farmer attempts to make neither the one nor the other, but employs those different artificers. All of them find it for their interest to employ their whole industry in a way in which they have some advantage over their neighbours, and to purchase with a part of its produce, or what is the same thing, with the price of a part of it, whatever else they have occasion for.
>
> What is prudence in the conduct of every private family, can scarce be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage. (*WN*, Book IV, Chapter II)

Thus a country concentrates on what it produces most efficiently, that is, where it has an advantage. This is called the principle of absolute advantage.

But we should note how Smith's example involves simple trade, not outsourcing. He says, if "a foreign country" can supply us – not, "if we can go to a foreign country to invest our capital in order to supply ourselves." In his household example he says, "The taylor does not attempt to make his own shoes, but buys them of the shoemaker"; he doesn't say, "The taylor buys his neighbor a cobbler's bench, tools, and materials to start a shoemaking business, in order to provide himself with shoes." It is true he might eventually be able to get shoes cheaper in that way. But meanwhile he has alienated that much of his productive capital; he has tied it up and it can't be used at home. Rather than paying a certain amount for each pair of shoes as it was needed, he has bought a whole factory elsewhere, a benefit not to him but to the neighbor who is now in the shoemaking business. It is doubtful that that would be considered prudent economics for a household.

While Smith's example shows the economic prudence of concentrating on what one produces best, it does not show the prudence of exporting one's productive capital. It makes a

convincing economic case for making the best use of one's capital, time, and energy, but it doesn't extend itself to showing that the best use of that capital is to send it abroad. It is a defense of free trade as such, but not of outsourced production.

Smith continues his comments on the wisdom of buying commodities abroad when foreign countries can supply them cheaper, with these comments:

> The general industry of the country, being always in proportion to the capital which employs it, will not thereby [i.e., by trade] be diminished, no more than that of the above-mentioned artificers [i.e., the taylor, shoemaker, etc.]; but only left to find out the way in which it can be employed with the greatest advantage. (*WN*, Book IV, Chapter II)

On the other hand, in a case of outsourcing, when capital is alienated and sent abroad, "the capital which employs" general industry *is* diminished thereby, and so is the "general industry of the country" as well as the "quantity of productive labour" put into motion and "the annual produce of the land and labour of the society." Since all those factors are the basis of increasing prosperity or "the wealth of nations," an alienation of productive capital would seem to be a source of economic decline; and certainly it cannot be considered as falling into the category of things Smith defends as "free trade." In cases that are not simple trade, but capital flight, the terms of discussion must be different, as must the conclusions arrived at.

"The industry of the society can augment only in proportion as its capital augments," Smith points out; and it may be added that when capital is sent abroad, the capital of the society diminishes, rather than augmenting, and therefore the industry, the annual produce, and the prosperity of the society diminish. The conclusion in such a case must be the opposite from that drawn in regard to simple trade.

Balance of trade

Addressing more generally the whole mercantilist theory of the balance of trade, Smith has this to say:

> Nothing, however, can be more absurd than this whole doctrine of the balance of trade, upon which, not only these restraints, but almost all the other regulations of commerce are founded. When two places trade with one another, this doctrine supposes that, if the balance be even, neither of them either loses or gains; but if it leans in any degree to one side, that one of them loses, and the other gains in proportion to its declension from the exact equilibrium. Both suppositions are false. A trade which is forced by means of bounties and monopolies, may be, and commonly is disadvantageous to the country in whose favour it is meant to be established, as I shall endeavour to show hereafter. But that trade which, without force or constraint, is naturally and regularly carried on between any two places is always advantageous, though not always equally so, to both.
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> By advantage or gain, I understand not the increase of the quantity of gold and silver, but that of the exchangeable value of the annual produce of the land and labour of the country, or the increase of the annual revenue of its inhabitants. (*WN*, Book IV, Chapter III, Part II)

The mercantilist objective was to maximize the amount of gold and silver held by a country, a goal Smith rejected. For him, the standard of advantage or gain was the gross national product, the total amount of goods and services produced by a country. By that standard, trade, even if not on a parity between two nations, is beneficial to both. We will look at his reasoning later, but we should note now: whereas trade may have the effect of increasing the value of the gross national product, or "annual produce of the land and labour" – because a certain percentage of goods, over and above those produced for domestic consumption, are produced for export – capital flight has the opposite effect. The capital invested offshore, in another country, increases the national product of that foreign country, but it decreases the amount of productive capital which

could be at work in the home country, and so decreases the gross national product of that country. Thus again, we cannot apply Smith's arguments for free trade to the different issue of capital flight. On the contrary, the effects of the two are opposite.

Let us return to Smith's argument about the mercantile doctrine of the balance of trade. We have seen that he says natural, unforced trade "regularly carried on between any two places, is always advantageous, though not always equally so, to both." His reason is:

> If the balance be even, and if the trade between the two places consist altogether in the exchange of their native commodities, they will, upon most occasions, not only both gain, but they will gain equally, or very near equally: each will in this case afford a market for a part of the surplus produce of the other: each will replace a capital which had been employed in raising and preparing for the market this part of the surplus produce of the other, and which had been distributed among, and given revenue and maintenance to a certain number of its inhabitants. Some part of the inhabitants of each, therefore, will indirectly derive their revenue and maintenance from the other. As the commodities exchanged too are supposed to be of equal value, so the two capitals employed in the trade will, upon most occasions, be equal, or very nearly equal; and both being employed in raising the native commodities of the two countries, the revenue and maintenance which their distribution will afford to the inhabitants of each will be equal, or very nearly equal. This revenue and maintenance, thus mutually afforded, will be greater or smaller in proportion to the extent of their dealings. If these should annually amount to an hundred thousand pounds, for example, or to a million on each side, each of them would afford an annual revenue in the one case of an hundred thousand pounds, in the other, of a million, to the inhabitants of the other. (*WN*, Book IV, Chapter III, Part II)

The key point again is that in carrying on trade, the two countries "each will replace a capital which had been employed," or invested, in producing the goods traded to the other. That is, trade helps maintain the level of productive capital circulating or working in each country, by

reimbursing that capital for one cycle of production of goods. The key element in the prosperity of a country is a high, and increasing, level of productive capital at work. Thus trade, even a trade of unequal size between two countries, by keeping some amount of productive capital at work in each, is beneficial to both.

This argument cannot be applied to capital flight, for therein some of the capital that could and "should" have naturally been invested in the home country, is invested abroad. Such "trade," or to use a more accurate term, such capital flight, is beneficial only to the foreign country where the productive capital is set to work. (Except, that is, as Smith says, "the profits only" of the enterprise return to the home country – unless they too are reinvested in productive capital in the foreign country.)

Smith sums up the issue of balance of trade this way:

> There is no commercial country in Europe of which the approaching ruin has not frequently been foretold by the pretended doctors of this system, from an unfavourable balance of trade. After all the anxiety, however, which they have excited about this, after all the vain attempts of almost all trading nations to turn that balance in their own favour and against their neighbours, it does not appear that any one nation in Europe has been in any respect impoverished by this cause. Every town and country, on the contrary, in proportion as they have opened their ports to all nations, instead of being ruined by this free trade, as the principles of the commercial system would lead us to expect, have been enriched by it. (*WN*, Book IV, Chapter III, Part II)

Thus Smith sums up his case against "protectionism" where that term means limitations on imports, and subsidies and other encouragements to home industries. Notice his language: towns and countries "in proportion as they have opened their ports" have benefited. We may observe that there is a difference between opening your ports to imports, and sending your capital abroad

to build businesses in foreign countries. The first, which can properly be called an issue of free trade, is conducive to increased prosperity, Smith shows. The latter, capital flight, is quite the reverse, being rather a cause of decline.

The Real Issue

Having thoroughly discredited balance of trade as a significant factor in economic policy, Smith identifies the genuine issue:

> There is another balance, indeed, … very different from the balance of trade, and which, according as it happens to be either favourable or unfavourable, necessarily occasions the prosperity or decay of every nation. This is the balance of the annual produce and consumption. If the exchangeable value of the annual produce … exceeds that of the annual consumption, the capital of the society must annually increase in proportion to this excess. The society in this case lives within its revenue, and what is annually saved out of its revenue, is naturally added to its capital, and employed so as to increase still further the annual produce. If the exchangeable value of the annual produce, on the contrary, fall short of the annual consumption, the capital of the society must annually decay in proportion to this deficiency. The expence of the society in this case exceeds its revenue, and necessarily encroaches upon its capital. Its capital, therefore, must necessarily decay, and together with it, the exchangeable value of the annual produce of its industry. (*WN*, Book IV, Chapter III, Part II)

Or as Micawber would say (at least in the movie version of *David Copperfield*, with W.C. Fields as Micawber): "Young friend, I counsel you: Annual income twenty pounds, annual expenditure nineteen pounds – result, happiness. Annual income twenty pounds, annual expenditure twenty-one pounds – result, misery!" It is thus with the "balance of the annual produce and consumption" of a country: annual income greater than annual expenditure – result,

capital formation and increasing prosperity. Annual income less than annual expenditure – result, capital loss and impoverishment. For as Smith says,

> The capital of all the individuals of a nation is increased in the same manner as that of a single individual, by their continually accumulating and adding to it whatever they save out of their income. (*WN*, Book II, Chapter V)

In short, the key to increasing prosperity is not a favorable balance of trade, but capital formation. It is not building up gold and silver reserves, but increasing the amount of productive capital at work in the country, as it hires labor, contributes to the gross national product, and generally increases the amount of economic activity being carried on within the country.

Capital for more-efficient machinery and for more laborers is essential:

> The annual produce of the land and labour of any nation can be increased in its value by no other means but by increasing either the number of its productive labourers, or the productive powers of those labourers who had before been employed. The number of its productive labourers, it is evident, can never be much increased, but in consequence of an increase of capital, or of the funds destined for maintaining them. The productive powers of the same number of labourers cannot be increased, but in consequence either of some addition and improvement to those machines and instruments which facilitate and abridge labour; or of a more proper division and distribution of employment. In either case an additional capital is almost always required. (*WN*, Book II, Chapter III)

Thus Smith identifies both what is *not* the key to increasing prosperity (mercantilist policies) and what g the productive labor of the foreign country, and as such it is a benefit to their economy. "Annual produce" is added to in the foreign country, and "consumption" is increased at home. Thus the GNP of the foreign country is increased, as laborers are paid, production facilities are bought and rented, and so on; but the finished goods are consumed, meaning

expenditures are made, in this country. So the balance of "annual produce vs. consumption" of this country is not improved by outsourcing, but is impaired.

Smith makes some further explicit comments about a declining "annual produce" of a country:

> The same quantity of money . . . cannot long remain in any country in which the value of the annual produce diminishes. The sole use of money is to circulate consumable goods. By means of it, provisions, materials, and finished work, are bought and sold, and distributed to their proper consumers. The quantity of money, therefore, which can be annually employed in any country must be determined by the value of the consumable goods annually circulated within it. These must consist either in the immediate produce of the land and labour of the country itself, or in something which had been purchased with some part of that produce. Their value, therefore, must diminish as the value of that produce diminishes, and along with it the quantity of money which can be employed in circulating them. (*WN*, Book II, Chapter III)

I.e., a declining "annual produce" has the opposite effect from capital formation. Capital accumulation is the essential element for increasing wealth – not accumulation of gold or a favorable balance of trade. That is the whole message of Smith's anti-mercantilist, free-trade arguments.

> The proportion between capital and revenue, therefore, seems everywhere to regulate the proportion between industry and idleness. Wherever capital predominates, industry prevails: wherever revenue, idleness. Every increase or diminution of capital, therefore, naturally tends to increase or diminish the real quantity of industry, the number of productive hands, and consequently the exchangeable value of the annual produce of the land and labour of the country, the real wealth and revenue of all its inhabitants. (*WN*, Book II, Chapter III)

Thus Smith's arguments do apply to the case of outsourcing, but in a different manner from the way anti-protectionists portray it. Smith wrote in defense of "free trade"; specifically, he wrote that it is not the accumulation of precious metals or a favorable balance of trade that promotes wealth, but capital formation. Anti-protectionists completely ignore the second half of this dichotomy. They give a version of what the answer is *not* (and apply it inappropriately), but stand mute on what the answer *is*. To use a phrase of Abraham Lincoln's, they make an "open attempt to prove, by telling the truth, what [they] could not prove by telling the whole truth…." [4]

Distinguishing Free Trade From Off-shoring

The above remarks are not meant to imply that the arguments for free trade don't apply in those situations where it *is* just a matter of free trade – a matter of one country producing goods at its own expense, for trade with other countries doing likewise. The important thing is to be able to distinguish between the two cases.

This has been pointed out by various commentators; but some of those commentators are not members in good standing of the economists' guild, and so their views have been discounted. For instance there is this, by Paul Craig Roberts:

> Before we spout mantras and mount our high horse to defend free trade, let's be sure that what we are defending is, in fact, free trade. As Ricardo recognized, the free flow of factors of production can be something different. Nothing will more certainly destroy the case for free trade than to defend an impostor in its name. [5]

And we have this, by Lou Dobbs:

> But as American multinationals shifted operations to low-wage nation such as China, they also shipped American technology, production capability and expertise abroad. . . .
>
> We have given away not only our manufacturing base, but also our advantage in technology and services as well. And we have left ourselves dangerously dependent on foreign capital to fund our out-of-control trade deficit. America is, quite simply, losing its advantage. Comparative or not. [6]

Absolute vs. Comparative Advantage

So far we have mostly looked at Smith's analysis, meaning we have concentrated on cases of absolute advantage, which is what he envisioned. But most criticisms of protectionism invoke the principle of comparative advantage. Some discussion should be made of that concept.

Paul A. Samuelson gives perhaps the clearest and simplest explanation of comparative advantage, in his text, *Economics*. He says:

> Even if by chance two countries can both produce the same commodities, they generally find that it pays for each to concentrate its production especially on some goods and trade them for other goods. . . .
>
> If we consider trade between, say, the northern temperate zones and the southern tropics, the foregoing proposition will seem true and trite. Of course, resources near the equator are more productive in the growing of bananas, and northern resources are better designed for wheat growing. Everyone can readily see that in this case specialization and trade will increase the amount of world production of both goods, and also each country's ability to consume both goods. . . [That is case of *absolute advantage*, where each country can produce one commodity cheaper and better than the other.]
>
> It is not so immediately obvious, but it is no less true, that international trade is mutually profitable even when one of the two countries can produce *every commodity* more cheaply (in terms of labor hours or resources) than the other country. One country may be *absolutely more efficient* in the production of *every* good than is the other country; the other country has an absolute disadvantage in the production of every good. But so

> long as there are differences in the *relative* efficiencies of producing the different goods in the two countries, we can always be sure that even the poor country has a *comparative advantage* in the production of those commodities in which it is relatively most efficient; this same poor country will have a *comparative disadvantage* in those other commodities in which its inefficiency is more than average. Similarly, the rich, efficient country will find that it should specialize in those fields of production where it has a comparative advantage, planning to import those commodities in which it has a comparative disadvantage. [7]

That is, even if one country can produce every commodity more efficiently or "better" than another, it is able to produce some commodities "more better," and others "less better." If one country is twice as efficient as the other in bicycles, but three times as efficient in wheat, then it pays both countries if the first grows wheat and trades for bicycles, while the second country produces bicycles and trades for wheat. Such a trade is mutually advantageous, in that both countries thereby enjoy more of all commodities than if each produced everything for itself. Thus the rule is, Trade is mutually advantageous even in the absence of absolute advantage, if there is at least a comparative advantage.

We can observe that this is an extension of Smith's case for free trade; it is based on his arguments, and like them it does not envision off-shoring. It involves production of commodities by different countries, at their own expense, to be traded between them; and it does not envision the investment of one country's capital in the production of goods in another, for sale in the first country. Whether the particular case being discussed is a matter of absolute advantage or comparative advantage, Smith's arguments apply to free trade in an environment of straightforward production of goods, *by* each country *in* each respective country. In this context his criticism of mercantile theories and his defense of free trade are undoubtedly valid, but they cannot be extended to a defense of capital flight.

Dueling Statistics

The reader should pay attention to what is being said here, and what is *not* being said. First of all, it is not clear that we can see any ill effects of outsourcing in the economy at present, whether due to NAFTA or to other causes. That is, I am not choosing sides as to whose statistics are valid. Some reports say we have lost approximately 2.7 million jobs since NAFTA passed; others say more jobs have been created than lost. I have no idea whose statistics are more reliable. All I am doing is attempting to show that Smith's theory does not justify capital flight and can't be applied to off-shoring in the same way it is to free trade. As for the particulars of present conditions, those are open to debate.

How is it possible?

Another issue I have not addressed is, How is such a situation possible? We all have a general sense that an economy should be a self-correcting, steady-state system. In the absence of "outside influence" in the form of governmental action, but where economic agents act on their own in response to economic forces, increasing prosperity should be the result, and every problem or dislocation should eventually be corrected by counteracting forces. The common conception is that it is much like ecology, or the natural environment in the absence of man's influence – a balance is naturally maintained.

But on the contrary, now we apparently have a situation where all economic agents, acting on their own initiative in the absence of any governmental assertion of power, produce an

economic result which is detrimental to the prosperity of their home country. How can such a thing be possible?

Some explanations have been advanced:

Mobility: For one thing, some people assert that the great mobility of goods and people today was not envisioned in formulating the original classic economic theory; and that the theory depends on the relative immobility of these factors of production. If that assumption doesn't hold, it is said, the theory doesn't hold.

For example, Paul Craig Roberts said:

> Free trade is based on the principle of comparative advantage. For comparative advantage to operate, two conditions are required: (1) a country's factors of production must seek comparative advantage within the country and not move to absolute advantage abroad, and (2) countries must have different relative costs of producing different goods. [8]

Other commentators disagree, however. The issue cannot be debated here, but it offers one possible explanation of how the seemingly self-contradictory situation can arise.

Externalities: Another approach is to point out that there is a disconnect in this instance between the costs and the benefits of off-shoring – that is, between the party that bears the cost and the one that reaps the benefits. Rory L. Terry, associate professor of finance at Fort Hays State University, says:

> Our trading problem is an externality.
>
> An externality exists in economics any time there is a separation of cost and benefits, and the decision maker does not have to incur the full cost but receives the full benefits of

> the decision. The fact is, there is no economic force, no supply and demand equilibrium, no rational decision process of either business or consumer, that will make an externality go away. Classic examples of externalities are when a business dumps toxic waste into a nearby river and the downstream residents incur the cost of cancer. The business is able to lower its costs and pass those lower costs on to its customers, and never pay for the treatment of the cancer patients. We have laws in this country against dumping and pollution because they are externalities – they require a legislative solution. . .
>
> The costs of the decision to outsource are not borne by the decision maker. As a society and as a country, we experience many costs from outsourcing, including the loss of jobs, social costs, higher costs of raw materials and loss of natural national sovereignty. Loss of jobs reduces the tax base, creates high unemployment benefit costs, and raises the cost of government retraining programs. . . This is a classic externality. [9]

Taxes and bureaucratic obstacles: Perhaps an artificial situation can arise because there are artificial pressures on our own capital-investment environment. Some commentators say it's not so much the wage differential as a difference in taxes and bureaucratic obstacles, that makes offshore production so much cheaper. Radley Balko says in his article, "Outsourcing Debate Tainted by Myths, Misconceptions":

> In short, companies typically pack up and move overseas only when the tax and regulatory environment at home gets overly burdensome. Indeed, a cursory look at the data shows that the states with the most aggressive tax and regulatory policies tend to be the states that are losing the most jobs to other countries. [10]

Another comment appeared in an *Indianapolis Star* article by Thomas Friedman:

> Several executives explained to me that they were opening new plants in Asia – not because of cheaper labor. Labor is a small component in an automated high-tech

> manufacturing plant. It was because governments in these countries are so eager for employment and the transfer of technology to their young populations that they are offering huge tax holidays for U.S. manufacturers. [11]

In such an atmosphere, a seemingly self-contradictory result could obtain. Other artificial pressures might include union agitation for wage increases, divorced from any gains in productivity; and "brute force" actions by Congress bearing on economic conditions, such as minimum-wage laws and various mandates and dictates imposing their will on the economy.

Solutions Another thing I'm not saying, in pointing out that capital flight is detrimental to prosperity, is what the remedy is. Different alternatives have been suggested, but they're not part of the main point of this piece.

The most obvious approach to a remedy is probably tariffs on imports. Taxes or duties on the export of capital equipment wouldn't work; other countries could take the advantage of the same low-wage/low-tax conditions available in developing countries, to produce goods and market them here below our costs.

In fact, competition is a big part of the reason many companies produce offshore. It's not necessarily because they want to, or because of "greed" for increased profits. More often it's a matter of having to do it to maintain *any* profit, because of competition – meaning, "If we don't do it, other companies will and have." They have to meet the price of any other company competing in the same environment; and that means they have to produce at the same price level as other companies (assuming other factors are equal, including an acceptable quality of the product). Businessmen have to respond to economic forces, and they do so, in the aggregate, in

rational, predictable ways. They are acting in response to economic forces, not (we will assume) from ill will.

Yet we see comments like the following ones (from "GE's plan to lay off workers prompts questions about economic justice," by Bruce Blaustein, in Bloomington, Indiana *Herald-Times*, Aug. 18, 2004):

> What a horror!
>
> This is what I felt after reading…about GE's plans to lay off 525 workers at its Bloomington plant, cutting its work force there by nearly one-third, and replacing them with workers in Celaya, Mexico. General Electric's callous decision is representative of what has been occurring more and more throughout America as "cheap labor" is intensely sought after by owners and CEOs of companies who are literally throwing the jobs of hundreds of thousands of hard-working Americans out of work.[12]

It is a horror, and it's a problem we'd all like to see solved. But calling CEO's "callous" is no explanation or solution. In reality, businessmen respond to economic forces, including the need to produce goods at a competitive selling price. If those forces produce results undesirable for the country, our economic task is to change conditions so as to cause businesses to respond in a different way – a task not aided by excoriating or demonizing businessmen.

A general tax on all imports, to bring the final cost more in line with that of goods produced here at home, might be one means of making offshore production less attractive. Yet this might produce trade wars — generalized responses by other nations in the same vein. Whether this would be detrimental to our economy, or only to third-world economies now benefiting from investment by off-shoring companies, is open to question. To return to the status quo ante – before NAFTA – might be the best policy.

On the other hand, if taxes and bureaucratic obstacles or other artificial influences on the economy like minimum-wage laws and union pressure are partly to blame, then a removal of such artificial pressures might be a partial remedy. But realistically, that won't happen – not because it's not economically sound, but because a lot of other non-economic considerations govern the debate on such issues.

In the last resort, perhaps the disequilibrium between wages received and goods purchased in this country will eventually lead to its own corrective counter-action. With production taking place more and more offshore, and sales taking place here, eventually it seems we should reach a point where consumers can no longer afford to buy all the products produced by paying foreign workers to do the work.

As Paul Krugman says in his article, "Ricardo's Difficult Idea" (a paper for the Manchester conference on free trade, March 1996):

> In Ricardo's case, the essential ingredient was the argument by David Hume that trade imbalances are self-correcting: a surplus country will acquire specie, leading to rising prices that price its goods out of world markets, while a deficit country will correspondingly find its goods increasingly competitively priced. [13]

Some such corrective mechanism should eventually take effect. But "eventually" may be a long time, and we have yet to see if there is a self-correction capable of reversing the process. "There is a deal of ruin in a nation," and it may yet take a long time before the negative effects of capital flight become glaringly obvious; yet the ill effects are thoroughly documented by Adam Smith et al. We can't become (to use an analogy originated, I believe, by Walter Lippmann) a nation whose inhabitants make a living by taking in one another's laundry. Something has to give, but let us hope it doesn't give too late.

Examples of Simple Trade and Capital Flight

It goes without saying that Smith's analysis applies with undiminished force to cases of trade between nations where there is no capital flight – simple free trade, in other words. A perfect example of both types of situation is given by Blake Hurst, in *The American Enterprise*:

> Montana State University estimates that sugar subsidies increase the price of land in Montana's sugar-beet growing areas by more than 30 percent. The same is true in each of the dozen or so states where sugar beets and sugar cane are grown. In the Dakotas, sugar offers revenues three times that of competing crops. No wonder sugar producers fight so hard for their protection from the world market. . .
>
> Critics of sugar tariffs point out that they hurt both consumers and industries that use sugar, with an estimated 10,000 U.S. jobs lost in the last six years due simply to high sugar prices. But protectionism also takes its toll on producers. Farmers elsewhere in the world are now growing other crops because world sugar prices are artificially low. With rising sugar prices, they could cut their acreage devoted to other commodities, providing U.S. farmers with new markets. . .
>
> Recently, I listened to a presentation from an Indiana farmer who also farms in Brazil. He had expanded in Brazil rather than at home because soybeans are cheaper to produce in South America. He shared his crop budgets with us, and, sure enough, the soybeans he raised in Brazil were more competitive than ours. Critics of free trade always emphasize that labor is cheaper elsewhere, or that lax environmental rules cut expenses. But this man was farming with the exact same technology in Brazil that he uses in Indiana, and although South American labor was less expensive, labor was a very small part of his costs.
>
> The biggest difference in his production costs was the cost of land. And guess what the main reason is for higher land costs in Indiana? The capitalized value of farm subsidies. Farm subsidies in the U.S., you see, are linked to acres farmed, and the promise of a continuing income stream from all those future subsidies raises the price of our farmland.

> So the very programs designed to help farmers are driving up our costs, and forcing production overseas. This is another illustration that protection and subsidies are not only a tax on consumers, but in the long run also harmful to producers. It really is true that economic freedom and competition make everybody better at what they do, and ultimately richer. Our best trade policy would therefore be the simplest: Cut subsidies here in the U.S., and challenge our trading partners to do the same. [14]

In this case classical theory is abundantly verified, for we can see protectionist measures taken against a matter of simple trade, backfiring and bringing as an unwelcome result capital disinvestment. The bad policies with regard to a harmless trade led to genuinely unfortunate economic conditions in the form of capital flight.

The Anti-Protectionist Ethos

One problem facing protectionists is that they lack a handy epithet for disparaging their opponents. Somehow anti-protectionists have managed to imbue the word "protectionist" with negative connotations beyond the simple descriptive meaning, adding a tinge of moral disrepute to the term (the usual method of political argumentation today).

We need an epithet for the anti-protectionist side; and I propose "sacrificialist." That seems to be an apt description of the viewpoint of anti-protectionists. In fact, there seems to be a segment of the political spectrum whose approach to our country's interests is sacrificialist on a broad range of issues. They tend to oppose *all* measures aimed at protecting our own country's interests, whether economically, militarily, or by whatever means. They apparently consider themselves too big-hearted, too large-minded to concern themselves merely with our own country's welfare. Mark Steyn described the attitude well:

> [T]he US has no vital national interest in [Liberia]; its tinpot tyrant is no threat to anybody beyond his backyard; the three warring parties are all disgusting and none has the makings of even a halfway civilised government. For many on the Right, these are reasons for steering clear of the place. For the Left, they're why we need to send the Marines in right now.
>
> Why would the Left, currently berating Bush for "putting our brave men and women in harm's way" in Iraq, be so anxious to put them in harm's way in Liberia? It's precisely the lack of any national interest that makes it appealing to the progressive mind. By intervening in Liberia, you're demonstrating your moral purity. That's why all the folks most vehemently opposed to American intervention in Iraq – from Kofi Annan to the Congressional Black Caucus – are suddenly demanding American intervention in Liberia. *The New York Times* is itching to get in. [15]

The same attitude applies economically. They identify virtue with sacrificialist policies; their view is that it is our duty to cut our own throats economically, so all the other nations can drink the blood. We must educate our competitors, subsidizing their tuition at our own universities, even in sensitive fields like nuclear physics and computer technology. We must build up the economies of other countries. That's the sacrificialist approach, and that's the attitude that underlies their opposition to "protectionism."

Internal Protectionism

Internally however, within this country, it tends to be a different story. The same people who insist on following what they consider pure economic theory in the area of foreign trade and outsourcing, often take a protectionist stance toward companies like Wal-Mart, and appeal to non-economic considerations in expressing opposition to new Wal-Mart locations. They become internal protectionists, or "domestic protectionists," as George Will calls them:

> Zoning and other laws used to block Wal-Marts from opening are, in effect, tariffs serving domestic protectionism. Talk about protecting "a sense of community" often is avarice masquerading as altruism. It is rent-seeking – the use of government to confer economic advantages – tarted up as political philosophy. [16]

With internal protectionism, sacrificialists cease to be zealots in their application of pure economics; manner of life, tradition, support for small-scale businesses, all these things suddenly become significant. It just shows, a lot depends on whose ox is gored.

Summation

In sum, protectionism seems at least as economically respectable as sacrificialism, and when applied to capital flight, it is not condemned by Smith's work. Off-shoring is not simple trade; it is a case of capital flight, and as such, by the terms of Smith's own analysis, it tends to diminish prosperity, not enhance it. Commentators should quit extenuating job losses by chanting in unison, "Everything is for the best in this best of all possible worlds." That's the only point I'm really making.

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