# The Classical Economists' Case for Free Exchange and Free Trade

### What was the original case for free exchange and free trade?

The classical economists made a powerful case for free domestic exchange and free foreign trade.

Adam Smith writes that humans have always had a "general disposition to truck, barter, and exchange." The original case for not inhibiting this disposition rests on several important propositions.

First of all, as Smith describes in the opening chapters of the *Wealth of Nations*, there are enormous benefits to cooperation, specialization of labor and resulting innovation. These made possible the Industrial Revolution whose beginnings he was observing. Second, free exchange and trade brought the benefits of competition, improving quality and quantity of goods. Third, free exchange and trade were consistent with the new ideal of individual freedom, provided that freedom did not interfere with the freedom of others. Finally, as Henry George emphasized, free trade gave nations an incentive to maintain peace.

### The classical economists expounded the principles of absolute advantage and comparative advantage. What are these? What are limitations?

Adam Smith argued that nations or regions should specialize in producing goods for which they are particularly well-suited. For example, warm, dry sunny regions have an advantage in producing olive oil. David Ricardo made a more sophisticated argument that mutually beneficial trade can depend only on relative advantage not absolute advantage. In his famous example, Portugal can produce both wine and cloth more cheaply than England. However England can produce cloth relatively more cheaply than Portugal. Therefore the two countries gain if Portugal specializes in producing wine for England and England in producing cloth for Portugal. In a conventional modern example, an attorney is a faster typist than her secretary. However, both gain if the attorney spends her time negotiating, paying her secretary to type the briefs. (In other words, the secretary is relatively better at typing.)

The theory of comparative advantage does not consider economies of scale and agglomeration. (Physically large plants can generate economies of scale; economies of agglomeration happen when many related businesses cluster together, sharing technologies and employees.) Often the first region to develop a new technology—possibly because that's where the inventor lived—gains a large advantage over other regions, even though those regions may have equal or better resources. The Detroit region in Michigan became the center of the US automotive industry, because that's where Henry Ford built his first factory.

Another important limitation applies to foreign trade as opposed to domestic exchange. A common argument for tariffs and other import barriers is that "infant industries" need protection from foreign competition while they develop their own economies of scale. That can be a valid argument, especially when that foreign competition behaves like a monopolist—as was the case when the US faced Britain in the 19$^{th}$ century.

### What was the context in which the classical economists made the case for free exchange and free trade?

The European classical economists lived in monarchies governed by the nobility, for the nobility and at the expense of the people. These governments typically gave trading monopolies and other favors to insiders. Worse, they engaged in wars over trading monopolies. Though they put it discreetly, the classical economists held a fairly dim view of government. Given the obvious failings of the new democracy in which he lived, Henry George tended to reflect the negative classical view of government.

**What are some limitations to the case for free exchange and free trade?**

**Arms-length**. The case for free exchange and free trade assumes the parties operate at "arm's-length". That means first of all, no coercion. And no coercion in turn means the parties must be relatively equal. That rules out slavery and child labor in domestic exchange, and "gunboat diplomacy" in international trade. “Arm’s-length” also means there’s no fraud, bribery or inside dealing—as when a corporation pays off a local official to get a contract.

**Full information**. Parties must be reasonably well-informed about the deal they’re entering. It may be easy for parties to obtain good information about repeated ordinary consumer transactions such as grocery purchases. But it’s another story when transactions have long-term consequences. Here are some examples: Employees at a chemical factory may not know long-term health risks. Cars may turn out to be lemons. We’ve just witnessed an epidemic of mortgage fraud. Insurance companies may balk at paying claims. Some medications may cause devastating long term side effects in some patients.

**No monopoly**. The case for free exchange and free trade assumes the absence of monopoly. In fact, the classical economists advocated free exchange and trade precisely as an *antidote* to monopoly, replacing monopoly with competition. The anti-monopoly assumption has been progressively forgotten in the modern rush to globalized trade.

**Risk.** When one source has an overwhelming advantage, free exchange and trade may eliminate competition. Exports of cotton and rice from the United States have wiped out small farmers in third world countries. On the other hand, third world countries rich in oil, such as Venezuela, are liable to “Dutch disease.” That’s what happens when discovery of valuable natural resources, like North Sea gas in the Netherlands, makes a country’s currency so expensive it can no longer sell its exports.

**Third-party injury**. Free domestic exchange and free international trade inevitably hurt some third parties. A friend of mine and his brother, while still teenagers, developed a computerized system for controlling theater lighting. Pretty soon, their laptop software put old-fashioned switch-controlled theater lighting companies out of business. Now this is precisely the kind of entrepreneurial capitalism we celebrate; the gains to society surely outweigh the losses. Nonetheless the new technology forced a large number of people to look for new jobs. In international trade, third-party injury drives the demand for trade barriers to protect existing businesses and jobs from “unfair competition.” International trade agreements often contain provisions to compensate those who can credibly claim losses due to increased competition.

**In an era when democratic government supposedly looks out for the public, what sorts of policies can enhance the benefits and mitigate the limitations of free exchange and free trade?**

**Modern court systems**. The case for free exchange and free trade assumes there exist reasonable mechanisms for enforcing contracts. It may seem too obvious, but if buyers can't make sure they get the goods and sellers can't make sure they get paid, there can be no exchange. Within developed countries, the primary function of civil courts is to resolve contract disputes and enforce the decision. The courts also determine what sorts of contracts are enforceable—for example, ruling out racial discrimination in housing. The U.S. Constitution prohibits states from hindering interstate commerce, ensuring that the entire country remains a (relatively) free trade zone. When it comes to international free trade, however, enforcement mechanisms are often limited and ineffectual. There’s no cure for this problem short of nations giving up sovereignty to some international government. Given the difficulties facing the European Union and the Eurozone, a global government is clearly out of the question.

**Information**. Modern governments require businesses to provide information about their products in the form of labeling and guarantees. They also often collect information themselves, notably product safety information on drug side effects, accident rates for different brands of cars. When it comes to international trade, governments may find it much harder to impose information requirements, or to collect information. There have been many cases of tainted drugs and other products imported to the US from China; the US has limited ability to monitor their quality.

**Social Safety Nets**. In the classical era, people relied on their families for protection against adversity. Now we expect government to help by providing protection against both natural adversity like illness or old age, or catastrophic floods, --but also against economic adversity notably loss of jobs. This "social safety net" should mean we can enjoy the benefits of cooperation, specialization and innovation, while mitigating harm to the people inevitably put out of work by exchange and trade.

**Antitrust Enforcement**. Modern governments can forbid mergers and require break-ups of companies that get big enough to become monopolistic. Since the 1980's, anti-trust enforcement has been much reduced in the US, allowing corporations to grow to sizes that would have once been unthinkable.

**Government Management or Regulation of Natural Monopolies**. Some industries, notably utilities like water and power, are "natural monopolies." They have high fixed costs—such as laying the pipes, low variable costs—such as delivering the water. They also offer large economies of scale within a given geographic area. Owners of natural monopolies are in a powerful position to extract rent from their customers, both by charging high prices and providing poor service. Consequently, government either provides the services itself, or regulates the industries that provide the services.

**Government Regulation of Financial and Insurance Industries**. Financial and insurance industries both deal with projections into the future, often the distant future. That makes them both risky and subject to fraud. As we have seen recently, failures of large financial and insurance companies—such as Lehman Brothers and AIG—can freeze up global financial markets. Following the Great Depression in the 1930's, the US instituted strict regulations, only to let them lapse in recent years.