

"A powerful and refreshing critique of some cherished assumptions held by mainstream economists. It is uniformly insightful, often brilliant, and remarkably readable. Obama's team should read it – and soon."

—George C. Lodge, Professor Emeritus, Harvard Business School and author of *Managing Globalization in the Age of Interdependence*.

Free Trade *Doesn't Work*



What Should Replace It and Why

Ian Fletcher

Foreword by Edward Luttwak

Free Trade Doesn't Work

What Should Replace It and Why

by Ian Fletcher

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In Bangalore...I [was] standing at the gate observing this river of educated young people flowing in and out...They all looked like they had scored 1,600 on their SATs and I felt a real mind-eye split overtaking me. My mind just kept telling me, 'Ricardo is right, Ricardo is right...' But my eye kept looking at these Indian zippies and telling me something else.*

— *New York Times* columnist Thomas L. Friedman, *The World is Flat*, p. 264

*David Ricardo (1772-1823), British economist who formulated the theory of comparative advantage, cornerstone of free trade economics to this day. See Chapter Five below for why Ricardo was wrong.

CONTENTS

[Foreword](#)

[Introduction: Why We Can't Trust the Economists](#)

PART I: THE PROBLEM

[Chapter 1: The Bad Arguments for Free Trade](#)

[Chapter 2: Deficits, Time Horizons, and Perverse Efficiency](#)

[Chapter 3: Trade Solutions That Won't Work](#)

[Chapter 4: Critiques of Free Trade to Avoid](#)

PART II: THE REAL ECONOMICS OF TRADE

[Chapter 5: Ye Olde Theory of Comparative Advantage](#)

[Chapter 6: The Deliberately Forgotten History of Trade](#)

[Chapter 7: The Negligible Benefits of Free Trade](#)

[Chapter 8: The Disingenuous Law and Diplomacy of Free Trade](#)

PART III: THE SOLUTION

[Chapter 9: Where Does Growth Really Come From?](#)

[Chapter 10: The Multiple Equilibrium Revolution](#)

[Chapter 11: The Natural Strategic Tariff](#)

[Chapter 12: The End of the Free Trade Coalition](#)

[*Bibliography*](#)

[*Praise*](#)

[*About the Author*](#)

Foreword

by Edward Luttwak

Until the economic debacle of 2008, the power and moral authority of the United States were sustained not only by its political values, cultural magnetism, and military strength, but also by its wealth. From its investment capacity as home of the world's most sophisticated financial system to its purchasing power as the world's largest importer, the U.S. had an undoubted primacy. When the latter finally ruined the former—for huge trade deficits tolerated for decades must decapitalize as well as deindustrialize—American diplomacy suddenly had to function without much of its accustomed leverage.

Some Americans have always been displeased by the magnitude of American power, probably because they project onto the nation at large their own moral discomfort with its exercise. For them, as for assorted dictators, Islamic fanatics, and the few serious communists still breathing, the present weakening of the United States is welcome. But for others, including this writer, this weakening provokes an unwelcome question: how much power can the United States retain without this leverage? And what kind of Hobbesian world order will we face in its absence? Whatever complaints of competence or intent one may lodge against this power, the world contains alternative hegemonies with far fewer scruples. A weakened American economy will embolden the enemies

not only of the United States, but of a stable world generally—especially in Latin America, the Middle East, and East Asia.

One early sign of America's weakening economic leverage was the refusal of allies like France, Germany, Italy, and the Netherlands to cooperate with the expansionary measures of the newly arrived Obama Administration in early 2009. With global economic activity sinking as declining demand dragged down production, further reducing demand, only a Keynesian jolt of public spending or tax cuts could break the downward spiral. This much was agreed by all serious players, but every major European government save Britain refused to join with the United States in implementing such measures. Instead, they tacitly proposed to let others carry the burdens of reflation—mainly increased public debt and inflation risk—knowing full well that their own exporters would nonetheless benefit from the resulting increase in global demand.

Above all, these allies could not be brought to heel with the threat of tariffs, quotas, capital controls, or other protectionist measures. This was America's natural card to play, but ruled out by an elite consensus rigidly opposed to any form of protectionism. This consensus—unshared with ordinary voters—prohibits even the milder forms of protectionism *permitted* under international agreements. Instead, it has a puritanical horror of the very concept which refuses to view protectionism as just another form of economic *realpolitik*, to be coldly evaluated according to its merits and costs. Instead,

it is seen as a repudiation of the twin cardinal virtues of competition and openness.

This is a fact of which both America's friends and enemies are well aware, and upon which America's commercial rivals base their own neomercantilist trade policies. The result has been a prolonged failure to safeguard the American economy, especially manufacturing, from foreign predation. The most obvious tactic here has been currency manipulation, but this is only the tip of an iceberg whose size America's rulers still do not appear fully to comprehend. This currency manipulation, involving as it does a tidal wave of cheap foreign capital propping up the dollar by soaking up American debt and assets, has in recent years helped keep interest rates in the U.S. abnormally low. It thus helped enable the speculative property and mortgage bubbles which led to the financial collapse of 2008. Thus many of America's recent economic problems, both visibly trade-related and otherwise, are ultimately linked with an underlying trade problem.

This book, unlike many previous critiques of free trade, is no mere sulk about the harsh realities of capitalism or an extended analytical misunderstanding of what those realities are. Ian Fletcher, in fact, unequivocally favors capitalism—if perhaps more broadly shared in its prosperity, more Fordist (as in the \$5 day), less dogmatic about free markets, better supported by industrial policy, and less decadently plutarchic than today. He favors free markets wherever the evidence

vindicates them. These remain the sovereign cure for mediocrity and sloth, whose dynamism creates wealth and compels improvements in management, production, and distribution. Free markets stimulate innovation, the ultimate root of economic growth. All these facts this book comprehends, which should slow its dismissal by the usual suspects.

Devotees of free trade celebrate its advantages for American consumers. These are real enough. And even industry-destroying free trade can sometimes do good, by shutting down inefficient domestic production that misuses labor and capital, freeing up resources for the industries of tomorrow. But free traders celebrate these advantages and then just stop, as if Americans could be consumers and nothing but, and as if destroying obsolete industries did not beg the question of what is to replace them. The vitality of America's underlying industrial base is either ignored or papered over with questionable economic theory—if not sheer ideological hectoring.

This is where Fletcher comes into his own, for he pries open the dogmatic black box of received trade economics. Despite the myth that serious economics vindicates free trade *simpliciter*, he shows in meticulous detail how the mechanisms which supposedly vindicate unlimited free trade under all circumstances are in fact dubious intellectual contraptions predicated upon unrealistic assumptions. The presumption of

free and unmanipulated currency markets is only the most obvious example; there are many others. Fletcher also elucidates recent theoretical breakthroughs in economics that are finally bringing realism into the doctrinaire mathematical world of academic trade economics, advances that are undermining the intellectual respectability of conventional free trade theory as now commonly understood.

These days, some of the leading practitioners of free trade, the chief executives of the largest U.S. corporations, are also quietly starting to reverse course. They, too, now proclaim that the United States must manufacture more and export more manufactured goods. Certain well-known firms are bellwethers of this change. For example, over the past 15 years, Boeing executives made many a speech celebrating the globalization of their company's manufacturing operations. They tirelessly invoked free trade's logic of comparative advantage to explain why they dismissed American engineers and production workers while Boeing's risk-sharing partners were increasing employment overseas. They strove to impress Wall Street analysts with their periodic downsizings of thousands of workers at a time. These efforts to transfer manufacturing and design overseas were crowned in the 787 Dreamliner, whose wing box and wings were made in Japan and whose composite fuselage was mostly made in Italy—leaving little for the United States but final assembly. That overseas production might be cheaper merely because of subsidies by foreign governments seeking a foothold in this

lucrative and strategic industry was irrelevant to Boeing, which is not responsible for the economy at large, but merely a business run for profit.

But Boeing's self-congratulation came to a sudden halt when the entire 787 program was crippled by devastating development delays, most caused by gross manufacturing errors overseas. The company had to change course drastically to survive, promising Wall Street analysts to bring much design and production back to the United States. With less public drama, General Electric has also changed course: after investing vast amounts in overseas manufacturing plants, America's single greatest industrial corporation is now strengthening its domestic manufacturing base and its chief executive, Jeffrey Immelt, has been publicly explaining why the country as a whole must do the same.

The reality is that manufacturing is inescapable. Few Americans can work in elite fields like corporate management or investment banking, no matter how large these loom in the consciousness of the governing class. Most service employment, such as restaurant work, pays low wages. Agriculture is a miniscule employer in all developed nations. And for all the glories of high tech, it remains a modest employer: during the auto industry wreck of 2009, Americans discovered that Ford, General Motors and Chrysler, despite of decades of decline, still employed more people than all the famous names of Silicon Valley—from Adobe to Yahoo—

combined. As a result, the incomes and living standards of nonpoor Americans must largely rise and fall with manufacturing employment. Even if they do not personally work in manufacturing, a strong manufacturing sector is needed to support the labor market and the value of the dollar on which an import-dependent America now relies for its standard of living from garments to gasoline.

A new American economy is emerging, in which Americans will consume less and save more to rebuild America's capital base, and import less and export more to start retiring America's now-vast foreign indebtedness. (Indeed, America *must* do these things unless it intends to confiscate foreign dollar holdings by devaluation.) And it is hard to imagine how America can rebuild its manufacturing and rebalance its trade without repudiating free trade—to some carefully chosen extent. If nothing else, the need to neutralize foreign mercantilism demands this.

This is not just a matter of concern for Americans, because unless foreign demand increases, the global economy must shrink in proportion to falling American demand. So increased American exports are, in fact, the only way to maintain current American imports and thus global demand. It is thus that a dose of American protectionism may soon be precisely what the whole world needs.

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November 2009

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Introduction

Why We Can't Trust the Economists

Oh yes, I know, we have recently been told by no less than 364 academic economists that such a thing cannot be...Their confidence in the accuracy of their own predictions leaves me breathless. But having been brought up over the shop, I sometimes wonder whether they pay back their forecasts with their money.

—Margaret Thatcher, 1981¹

America's trade deficit. \$696 billion in 2008. \$701 billion in 2007. And a world-record seven hundred and sixty billion dollars in 2006.² Even if it did fall by half in 2009—a temporary plunge seen in past recessions that probably doesn't signify underlying improvement—a \$370 billion deficit is still astronomical by any reasonable historical standard.³

To be fair, the trade deficit is not a perfect indicator of free trade's cost. A nation can always balance its trade by crude measures like forcing down wages by political fiat. So, hypothetically, we could have a small deficit and a large trade problem. Plenty of impoverished Third World nations have

balanced trade, and a single year's deficit means nothing. But with numbers this high, the deficit is obviously a big problem if it's a problem at all.

And yet Americans remain afraid to do anything about it. The dangers of protectionism are notorious, and questioning free trade in an intellectually serious way runs into deep waters of economics very fast. So we remain paralyzed in the face of crisis.

This book aims to loosen that paralysis a little.

Over the last 20 years, Americans have bought over \$6 trillion (that's trillion with a "t," six thousand billion, six million million) more from the world than we have sold back to it.⁴ That's over \$20,000 per American. Ironically, if the U.S. were a developing country, our deficits would have reached the five percent level that the International Monetary Fund takes as a benchmark of financial crisis.⁵

The U.S. economy has ceased generating *any* net new jobs in internationally traded sectors, in either manufacturing or services.⁶ The comforting myth persists that America is shifting from low-tech to high-tech employment, but we are not. We are losing jobs in both and shifting to nontradable services—which are mostly low value-added, and thus ill-paid, jobs. According to the Commerce Department, *all* our

net new jobs are in categories such as security guards, waitresses, and the like.

The vaunted New Economy has not contributed a single net new job to America in this century. Not one.⁷

The mysteries of international finance that let America run a seemingly infinite overdraft against the rest of the world looks suspicious, too—because that’s what it *means* to endlessly import more than we export. But where does the money come from, at the end of the day? Can we *really* get something for nothing forever? Or are we in for another crisis like the 2008 financial crisis? Subprime mortgages looked too good to be true, and then they blew up. The aftershocks are still hitting us. Is trade going to be the next shoe to drop?

Common sense seems to say that American workers are going to have problems when we trade with nations, such as China and India, where the average wage is a dollar an hour or less (57¢ an hour for Chinese manufacturing workers, to be exact).⁸ Corporate America even admits, with barely concealed glee, that competition from foreign labor has American workers pinned. As one Goodyear vice-president put it, “Until we get real wage levels down much closer to those of the Brazils and Koreas, we cannot pass along productivity gains to wages and still be competitive.”⁹

Brazils? Koreas? Our wages?

These nations and others are booming as exporters to the United States. But they remain far too poor to take back enough of *our* exports to balance our trade. Their combination of dreadful wages and regulatory standards on the one hand, and winning economic strategies on the other, has so far produced nothing like the living standards needed to make them significant importers of American goods. Despite recent decades of economic growth, there are still over a billion people in Asia earning less than \$2 a day.¹⁰

Working conditions are the flip side of low pay in developing countries. Production methods long ago abandoned in the developed world—many of them dangerous and environmentally unsound—are still widely in use. In India, for example, foundry workers often don't wear socks, shoes, protective headgear, ear plugs, or even eye protection. Often wearing no more than boxer shorts, they squat on the floor next to the roaring furnaces.¹¹ Charles Dickens has moved to Asia.

The environment is threatened. Thousands of foundries in China run on industrial-grade coke with no pollution control devices on their smokestacks, creating a plume of smoke that stretches across the Pacific on satellite photos. Chlorofluorocarbons (CFCs) are banned in the United States but still used in China as a blowing agent for the production of polyurethane foam cushions and the like, providing a

significant cost advantage for Chinese manufacturers.¹²

None of this happens by accident. Foreign governments treat trade as war and use every trick in the book—legal and illegal under international agreements—to grab their industries a competitive advantage. And even when they don't cheat, they are often more skilled in cultivating their industries than we are. Toyota, despite its troubles, somehow didn't go bankrupt when GM did.

All these facts impinge upon America because of free trade. But economists keep telling us everything will be fine. According to them, free trade is good for us and they can prove it. Ninety-three percent of American economists surveyed support free trade.¹³ This inescapably raises the question of whether they have been doing their jobs—and whether America should stick with the policy they recommend.

WHY ECONOMIC THEORY MATTERS

This is a book about real-world economic problems. Brutally real problems. But it is also a book about economic *theory* because in economics, raw facts don't mean much without a theory to interpret them. This is especially true for parts of economics that are as controversial and theoretically unsettled as trade. Wrong theories helped get America into its current

trade mess, so we will need the right theories to get us out of it. Not *only* theories, of course, but we won't be able to do it without them.

Can't we just find a practical solution? That's the instinct of many Americans, who find economic theory abstruse and often baffling. (To be fair, sometimes it is.) Unfortunately not. To just "do what works" is only an option when what works is obvious, and in trade it isn't. Common sense tells us that airplanes shouldn't crash, but it doesn't tell us how to design a plane that will actually fly. It takes a *theory*, called aerodynamics, to do that. Luckily, the right economic theories are not all that hard to understand, if one makes the effort. And, as we shall see, all this theory has a payoff in the form of an implied solution.

At an absolute minimum, ordinary citizens need to know enough about the economics that *supposedly* justifies free trade to hold their ground in confrontations with the experts and not get ruled out of public debate on grounds of ignorance. America can't be a democracy if one side is intimidated into silence on a question this important. So ordinary citizens need to learn how to criticize the economics of free trade in language that economists (and those who look to them for policy advice) accept as legitimate—and will have to take seriously.

But first, we're going to look at why we shouldn't just defer to what economists tell us. Because if we can, then we should

just leave our trade problems to these experts, and books like this one have no place. So understanding what's wrong with economists is our first step.

FREE TRADE ISN'T JUST BOUGHT

Some people believe economists are irrelevant, and that free trade is American policy simply because big corporations and other vested interests have the political muscle to impose it. This is false. For a start, without economics, vested interests can't tell whether free trade benefits them or not, just as a company can't know whether or not it is profitable without resort to accounting principles. Vested interests can indeed see money piling up in their bank accounts under free trade. But is this more or less money than what they would have gotten *without* free trade? Without economics, they can't tell. When a policy has complex effects, it is not obvious who wins and loses from it—even to the winners and losers themselves, and especially in the long run. They have to *analyze* trade policy to know this, and one can't analyze any economic policy without theories about how the economy works. This is why the British economist John Maynard Keynes (1883-1946), arguably the greatest economist of the 20th century, wrote that:

The ideas of economists and philosophers, both when

they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist...I am sure the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas...But, soon or late, it is ideas, not vested interests, which are dangerous for good or evil. ¹⁴

Furthermore, vested interests are not infinitely powerful. They have to persuade the rest of the country, especially Congress, to go along with the policies they want. Despite political corruption, all the money in the world couldn't bribe Congress to pass a law requiring people to roller-skate to work; legislation always requires some non-laughable justification. Therefore, lobbying successfully for free trade requires credible economic ideas that support it. This is why the famous liberal economist and *New York Times* columnist, Paul Krugman, winner of the 2008 Nobel Prize for his work on trade and a thinker we will draw upon extensively in this book, wrote of his stint in government:

What was more surprising was the way that even strong political considerations could sometimes be

held at bay when a proposal seemed clearly without a good analytical foundation. I know of one corporation that had a demand widely supported by other businesses and highly placed friends in the government, yet got nowhere for more than a year, largely because the company's arguments were so easily torn apart by government economists. In the end the corporation hired some high-quality economists to help produce a well-argued report, and for that or other reasons finally got some action. ¹⁵

So even if free trade economics *is* largely a bundle of rationalizations, these are still rationalizations the system needs in order to function. It follows that if opponents of free trade can debunk these rationalizations, these opponents can deprive free traders of camouflage, credibility, and self-confidence they can ill afford to lose. (That is one purpose of this book.)

ECONOMISTS KNOW MORE THAN THEY LET ON

To be completely fair, to some extent economists haven't been wrong about free trade at all. But the aforementioned seven percent who know better have allowed a mistaken impression of the disciplinary consensus to be foisted upon the public. And when the other 93 percent say they support free trade, this doesn't necessarily mean they support it *without*

reservation.¹⁶ It often just means that they know it has problems, but support it over any likely alternative—which they fear would be worse.

Above all, economists fear that admitting the known problems with free trade might provoke politicians into doing something stupid. As the 19th-century American radical economist Henry George put it, “introducing a tariff bill into a congress or parliament is like throwing a banana into a cage of monkeys.”¹⁷ The great fear is that if protectionism is conceded any legitimacy, special interests will seize control and economic logic will fall by the wayside. For example, Congress might enact a 30 percent tariff on imported steel to save Rust Belt jobs that would be disappearing soon due to technological change anyway. This could cost \$300,000 per job per year, including the cost of making American manufacturers pay more for steel than their foreign competitors.¹⁸ Then every other industry would want in and before we knew it, we would have a crazy-quilt industrial policy set by Congressional logrolling and lobbyist bidding wars. It would be a mess: based on political pull, embodying no rational economic strategy, and costing our economy hundreds of billions of dollars per year.

Fear of such a debacle gets most (not all) economists off the hook for outright incompetence or dishonesty. But it reveals a deeper problem: this fear is not actually a part of economic

science. It is just a somewhat cynical intuition about the American political system. Economists are certainly entitled to their political intuitions (which may even be true) but these intuitions are not part of their actual *knowledge* as economists. They are not something that they have PhD-level expertise in and the rest of us don't. ¹⁹ They are thus not privileged over the intuitions of ordinary informed citizens. The electorate has a right to hear both sides of the debate and make its own decision. That's democracy.

Economists' fears may also be false. Our government is sometimes corrupt and stupid, but it is also sometimes effective. The country wouldn't still be here if it wasn't. Some foreign governments certainly *seem* to have had effective protectionist policies in recent decades, using tariffs and nontariff barriers to boost their economies. Japan clearly did not become the second-richest nation in the world practicing free trade. China is conceded from one end of the political spectrum to the other to thumb its nose at free trade, but it is booming.

Even Europe seems to handle these matters better than we do: Germanic and Scandinavian Europe (Germany, Switzerland, Austria, Holland, Belgium, Luxembourg, Denmark, Sweden, Norway, and Finland) usually run healthy surpluses, and the Eurozone as a whole has had its trade within pocket change of balance since the euro was created in 1999. ²⁰ Thirteen European countries now pay their factory

workers better than we do,²¹ and Germany (not China!) was the world's largest exporter as late as 2008.²² *Do all these countries know something we don't?*

CORRUPT POLITICIANS, VOTERS AND ECONOMISTS

Cynical comments about politicians are also an evasion. In America, we elected them, so what they do ultimately reflects what we want. If we voters are corrupt, and vote for short-term gratification, something for nothing, and sweet deals for our special interests, then the politicians we elect will be corrupt, too. But if we wise up and a sense of national crisis engenders a sense of national purpose, then we may demand (and get) a trade policy sufficiently honest and rational to work. This has happened on other issues before.

Economists can be corrupt, too. Some are simply paid shills of special interests. Economics consulting firms like Global Insight, MiCRA, and Strategic Policy Research basically retail the service of providing whatever conclusions are required, albeit with sufficient sophistication that nobody has to tell any literal lies.²³ Sometimes the corruption is more subtle, cumulative, and unconscious; indeed, it is rarely a matter of, "Say X and we'll pay you \$Y." In order to win clients, economists in private practice (the author used to be one) must cultivate a reputation for saying the kinds of things clients

want to hear. Certain ideas, like rising inequality or the problems of free trade, are just best avoided. They are not “economically correct.” So they drop out of circulation and don’t get the attention they deserve. A few years of that is all it takes to skew the consensus, as ignoring facts is just as effective as denying them. (Indeed, it is more so, as it avoids starting a fight that might attract unwanted attention.) As a result, the age-old question of whether bad policy comes from corruption or bad thinking doesn’t really have an answer, as these two phenomena are intimately entwined. *Corruption inexorably debases the quality of thinking over time*, and a nation that insists on being told what it wants to hear will eventually lose the ability to figure out what the actual truth is.

And, of course, sometimes financial bullying and other outright coercion does occur. Economist Paul Craig Roberts, an Assistant Treasury Secretary under Reagan and today one of the most distinguished critics of free trade, reports seeing, when he was a fellow at the Center for Strategic and International Studies in Washington, memos analyzing what grants that think tank could obtain from the administration of George Bush, Sr. in exchange for firing him.²⁴ (He had displeased the administration by criticizing its economic policies.) Bush’s science advisor, Alan Bromley, was forbidden to talk to the media for six months in 1991 after he told *The Wall Street Journal* that America needed an industrial policy.²⁵ In 2003, the Defense Department temporarily shut

down its own Advisory Group on Electron Devices after this group released a report detailing the destruction of U.S. innovation capabilities in electronics by imports.²⁶ And Bruce Bartlett, one of the early figures of Reagan's supply side economics, was fired by the conservative National Center for Policy Analysis in 2005 for denouncing George Bush, Jr. as a conservative "impostor," later publishing a book by that title.²⁷ Who pays the piper will certainly *try* to call the tune, no government likes to hear bad news, and shooting the messenger remains one of the favored ways of making bad news go away.

Conversely, sometimes The Powers That Be simply avoid the topic of trade problems entirely. For example, in the four presidential and vice-presidential debates of the 2008 campaign, imports were never mentioned, the trade deficit was never mentioned, and exports were mentioned only once.²⁸ China, by contrast, was mentioned 15 times, geopolitical rivalry being much more exciting than economics.

This all raises an important question: do America's rulers secretly *know* that they're making a mess with free trade—but go on doing it for profit's sake—or do they sincerely believe in the policy? The author cannot pretend to be privy to anyone's private thoughts, but it seems to vary by individual. Most such people, especially those whose professional expertise isn't in economics, genuinely believe in the free

trade consensus. They instinctively defer to the officially anointed experts, and these all tell them free trade is correct. And establishmentarians who *are* economists by training are usually among the 93 percent who believe in free trade. Even those who are among the seven percent who don't, usually keep their mouths shut for career reasons.

Change is also resisted simply because it is change; in the words of Gregory Tasse, a senior economist at the National Institute of Standards who has criticized free trade economics: [29](#)

Those with a stake in the status quo and their defenders in government argue for old models of competitive strategy and economic growth. Specifically, factions with vested interests in economic assets such as physical and intellectual capital, existing labor skills, or simply a fear of the trauma and the cost of change, resist adaptation. This is the installed-base effect and it is widespread. [30](#)

But just as the best minds in the Kremlin never really believed in Marxism, some members of America's establishment are well aware of the harm free trade is doing. They are not stupid people, after all (especially when it comes

to money), and, as we shall see, the analyses that reveal that free trade isn't working aren't that hard to do. One can sometimes see glimpses of their awareness if one pays attention. This book is littered with quotes from prominent people who have obviously grasped one aspect or another of the defects of free trade, even if they shy away from publicly conceding any recognition of the whole. Eccentric billionaires, who can afford not to care what other members of the establishment think of them, are another highly visible dissident group. Warren Buffet and Ross Perot in the U.S., and the late Sir James Goldsmith in the UK, are the best known. (We will look at some of Buffet's ideas in Chapter 11.)

ACADEMIC ECONOMISTS VS. THE REAL WORLD

Some academic economists are enervated by sheer ivory tower indifference to the real world. They are trapped in a circular system of publication and promotion procedures that tends to reinforce groupthink: they get published by impressing more-senior economists, and they get promoted based on how much they publish. Their careers are determined by their ability to impress other academics, so it is risky for them to wade into the murky waters of public debate. Nobody gets tenure for picking fights with *The Wall Street Journal*.

Academic economists often say things that people who

actually deal with the realities of trade for a living—executives, diplomats, trade union officials—find they cannot take seriously without risking their own unemployment. Even economists employed by business schools are notorious for being out of sync with other economists on trade. This is no accident, as they have to peddle theories that actually work in practice, which economics department economists generally do not. Among other things, business school economists are much more inclined to see international trade as a *rivalry* between nations, with winners and losers, than are economics department economists, who tend to see the jungle of commerce as a beautiful rainforest (where everybody wins). If engineers and physicists did not see eye to eye, might we not start questioning physics?

For example, it has been obvious for 35 years now that America's economy needs to be internationally competitive. But many academic economists disparage the very concept of competitiveness, mainly because it has no accepted definition.³¹ And indeed it hasn't, for the simple reason that all competition is defined by winning and losing, and there's no obvious standard for what it would mean for America to "win" in international economic competition.³² But this doesn't mean America doesn't have to be competitive. Happiness doesn't have a clear definition either.

SOPHISTICATED MATH DOESN'T EQUAL SOPHISTICATED THINKING

When one scratches the editorial-page surface of economics and comes face to face with its intellectual core, one finds a mass of equations. This gives it the appearance of hard fact. How could anything so mathematical be a matter of opinion? (It also looks distinctly like something which people who don't understand it should keep their mouths shut about.) But in fact, sophisticated math is actually overrated as an economic tool, as hinted by the fact that hedge funds employing it fared no better than others in the financial meltdown of 2008.³³

The overreliance of contemporary economics upon sophisticated mathematics creates a number of problems.³⁴ The fundamental one is that because it is easier to mathematize some ideas than others, some ideas appear truer than they really are. But the presumption physics enjoys, that mathematically “elegant” theories are more likely to be true, simply doesn't hold in economics, however much many economists may want it to.³⁵ The aggressive use of simplifying assumptions can deliver elegant math on demand, but only at the price of misrepresenting reality.

Theories which favor free trade tend to be mathematically neat—mainly because they assume markets are perfectly efficient, which makes their outcomes predictable. Theories

which favor protectionism, on the other hand, tend to be mathematically messy, mainly because they assume markets are *not* perfectly efficient and thus not predictable. So economists have often favored free trade simply because the math is neater. As Paul Krugman once put it, “the theory of international trade followed the perceived line of least mathematical resistance.”³⁶

There is actually a serious paradox here, because intellectual rigor (which math provides in spades) certainly *sounds* like a self-evidently good thing.³⁷ Unfortunately, intellectual rigor can only guarantee that reasoning is internally consistent: its conclusions follow from its premises. It cannot guarantee that those premises were right in the first place, and with bad premises, even the most rigorous reasoning will produce nonsense. Premises don’t even have to be *wrong* to generate false conclusions, they only have to be incomplete, and no set of premises can prove its own completeness. The more mathematically abstruse economics gets, the more basic truths get obscured behind a blizzard of symbols, making it easy to wander into falsehoods unawares for lack of an obvious sanity check.

Formal mathematical modeling of the economy, where these distortions reside, should be viewed as a tool, not as identical with economics as such, an error common in the profession since WWII.³⁸ Sometimes modeling can be very revealing,

but sometimes it conceals realities that are hard to wrap math around.³⁹ Sometimes, it can even *destroy* knowledge, when it prevents important facts from being recognized simply because they are hard to mathematize. Some of the most insightful recent work in economics—by thinkers like 2009 Nobelist Oliver Williamson, Harvard Business School’s Michael Porter, Tokyo-based financial journalist Eamonn Fingleton, and Norwegian economist Erik Reinert—barely uses it.⁴⁰ The economic technocrats of Beijing, Tokyo, and Seoul, who have produced amazing economic achievements in recent decades, have shown almost no interest in it at all, beyond basic statistics.⁴¹

VALUE JUDGEMENTS VS. ECONOMICS

Economics has some problems understanding the effects of free trade simply because it is a social science and therefore value-free. Many people are surprised to learn this, but there is actually *nothing* in economics that holds that prosperity is better than poverty, any more than neuroanatomy holds that pleasure is better than pain.⁴² And yet economics uses terms, such as “efficient,” which certainly *sound* like value judgments. So when economists say that free trade is efficient, this actually has a narrowly technical meaning, with limited connection to national economic well-being as most people

would understand it.

Conversely, economics also has its true believers, for whom the infallibility of free markets, of which free trade is a part, is a “beautiful idea,” a secular religion like Marxism once was. The libertarian Cato Institute in Washington is their Vatican and the old Ayn Rand cult of “objectivism” their fundamentalist sect. But these people are trying to pass off political ideology as if it were economics. It is simply not the same thing.

A discipline dealing in observable facts, like economics, is not an appropriate object of faith, which rightly pertains to religious subjects and other nonempirical matters. If economic facts are observable, then observation should determine what we think about them. Nobody should have “faith” in free markets (or their opposites); they should have evidence (either way) or not hold an opinion. The Cold War gave Americans a terrible habit of turning economics into a quasi-theological clash of absolute values.

ECONOMICS TAKES DECADES TO GET THINGS RIGHT

Economists have been criticizing free trade on and off since it was first advocated near the dawn of modern capitalism 400 years ago. ⁴³ However, the current wave of academic critique

is relatively young. New trade theory, the blandly named but pathbreaking critique that is the academic foundation of Part III of this book, emerged in the late 1970s. But it only achieved its breakthrough synthesis in 2000, with Ralph Gomory and William Baumol's brilliant little book *Global Trade and Conflicting National Interests* (whose ideas we will explore in Chapter 10). Because it takes time to gather data and think through objections, decades may pass before a new insight becomes the general consensus of the discipline. So it may still be a while before the economics profession as a whole digests these innovations and changes its mind about free trade.

Right now, the (slowly crumbling) consensus in economics mainly derives from work that reached acceptance in the 1980s. This was the heyday of free-market economists, Milton Friedman and others, who did brilliant work debunking the liberal Keynesian consensus under which they grew up. That consensus, which was gospel from the 1940s to the 1960s, broke down under the stagflation of the 1970s and was a product of the Great Depression. It had itself overturned an even older consensus derived from the laissez faire gold-standard world of the late nineteenth century. In the 1960s, when the political consensus was Keynesian, the profession was Keynesian. In the 1980s, when free markets resurged in political popularity under Reagan and Thatcher, economics was in eager support with so-called "efficient markets" theory. Neither of these ideas, in its orthodox form, is taken seriously

by many economists today.⁴⁴ This suggests that economists are suspiciously reliable sock puppets of the political status quo, and that their reasoning is not as different from the thinking of ordinary concerned citizens as their intimidating academic facade might suggest.

A NONIDEOLOGICAL ECONOMIC NATIONALISM

Some economists give unhelpful answers about free trade simply because they don't think the *national* economic interest matters. Technically, they are of course correct that choosing America as the entity whose economic well-being one cares about is arbitrary, from the point of view of pure economics. There is nothing in economic science that privileges whatever nation lies between the 49th parallel and the Rio Grande.

But this is an attitude of little practical use to a nation in serious economic trouble. As economist Herman Daly of the University of Maryland, best known for his work on ecological economics, puts it, “Free trade makes it very hard to deal with these root causes at a national level, which is the only level at which effective social controls over the economy exist.”⁴⁵ Because we *have* a national government, because Americans care about what happens to *their* economy, and because it is the *national* debate on the question that will bring changes (or fail to), our trade problems will be fixed in

Washington or not at all.

Globally, for good or ill, the nation-state is still where the buck of political legitimacy stops. (Higher and lower political entities, from Kansas to the United Nations, enjoy legitimacy only because nation-states have given it to them.) So even if other instruments for controlling the world economy can be developed over time, the nation-state will be the bottleneck for developing them. A blanket rejection of even the mildest economic nationalism—an attitude common at both extremes of the political spectrum—simply hands a blank check to multinational corporations, foreign powers, and distorted market forces to do as they please.

At an absolute minimum, economics should not be abused to “prove” the inappropriateness of caring about national economic well-being—something it does not do. From the point of view of pure economics, internationalist assumptions are as arbitrary as nationalist ones. People who reject the national economic interest should do so openly, not hide behind theoretical constructs that do this on the sly.

The ultimate value of nationalism vs. internationalism is a value judgment beyond the scope of this book. A nonpartisan “soft economic nationalism” is postulated herein simply to make the critique tractable, as the problems with free trade become clearest when one asks how a given nation may be helped or harmed by it. The only thing this kind of nationalism insists upon is that a nation’s economy should

basically be run for the benefit of its people.⁴⁶ It has no ideological commitments with regard to other usages of the term “nationalism,” and leaves open to partisan debate the best way to realize its objectives. As we shall see, the trade solutions America needs could be implemented by either party and painted in a wide variety of ideological colors.

Some of the analysis in this book is more relevant to other nations than to the U.S., simply because it applies to economic circumstances that obtain there more than here. We will, for example, take a long hard look at why free trade is bad for developing countries. Whether the policy implications of these analyses are also good for America depends on the analysis in question. This is *not* a univocally America First book, simply because not every valid critique of free trade implies policies that would be in America’s interests. Other nations have the right to play the game for their own benefit and seek the well-being of their own people, too. Free trade is so problematic that easily half the world has something to gain by ending it. There is no point foreclosing the scope of our analysis just to avoid discovering holes in free trade that will help Costa Rica more than ourselves. But don’t worry: *America is going to get plenty out of ending free trade.*

PART I

THE PROBLEM

Chapter 1

The Bad Arguments for Free Trade

Before we delve into the defective economics of free trade, we must clear away a considerable mass of accumulated intellectual debris. The issue is bound up in the public mind with a lot of extraneous questions, so we must disentangle it from these if we are ever to think straight about it.

For a start, we are not debating whether cosmopolitanism is a good thing. In many ways it is, but it is a cultural question with little to do with the actual hard economics of international trade. Neither are we debating the choice between, in the words of *New York Times* columnist Thomas Friedman, “the Lexus and the olive tree,”⁴⁷ that is between the efficient but soulless rationalism of the global marketplace and the rooted particularism of nations and communities. The economics *itself* of free trade is legitimately controversial, so there is no justification for bracketing it as a settled question and turning to imponderables like the relative value of prosperity vs. heritage.

We are also not debating globalization as such (an historical process) or globalism (the ideology that favors globalization).⁴⁸ Though it has ramifications that affect almost everything, free trade is, strictly speaking, a purely economic question, and globalization involves a lot more than

economics. It includes cultural exchanges, population movements, global governance, the global environment, and many other things. So one can certainly oppose free trade and support globalization with respect to its noneconomic aspects (or vice-versa, for that matter).

Even a certain amount of *economic* globalization is perfectly compatible with ending free trade. If every nation on earth imposed a 10 percent tariff, this would end free trade by definition, but the world would still be globalizing economically—albeit in a slower and more controlled fashion than today. It has been estimated that the spread of air freight had the same effect as a tariff cut from 32 to 9 percent in the U.S. from 1950 to 1998.⁴⁹ But no ideological energy is expended on the problem of air freight pricing.

ECONOMIC GLOBALIZATION IS A CHOICE

Economic globalization is often debated as something that is either “good” or “bad” and will either “succeed” or “fail.” But framing the alternatives as binary is too crude, and tends to force uncritical approval on both counts. It encourages the assumption that we “must” make economic globalization succeed, and as a unitary package, with no choice about its different aspects possible. The better questions to ask are how far will it go, what shape will it take, and what measures (if any) should we take to influence either?

If economic globalization is a good thing, then it should be able to survive our getting a choice about how far it is allowed to go. Attempts to foreclose that choice betray a distinct nervousness about what people might choose on the part of those who would foreordain the outcome—usually in favor of a radically laissez faire result. The tragedy of free trade is that it gives up some of the best tools humanity has to shape what *kind* of economic globalization we get: tariffs and non-tariff trade barriers. There simply are not that many levers over the world economy that are both feasible to pull and have a large impact. If we rule out some of the best, we haven't got many left.

The fundamental message of this book is that nations, including the U.S., should seek *strategic, not unconditional* integration with the rest of the world economy.⁵⁰ Economic openness, like most things in life, is valuable up to a point—but not beyond it. Fairly open trade, most of the time, is justified. Absolutely free trade, 100 percent of the time, is an extremist position and is not. (The difference between the two is rational protectionism.) Valid economics simply doesn't support the extravagant notion that, in the words of technoutopian *Wired* magazine:

Open, good. Closed, bad. Tattoo it on your forehead. Apply it to technology standards, to business strategies, to philosophies of life. It's the winning

concept for individuals, for nations, for the global community in the years ahead.⁵¹

Nations need instead a well-chosen *balance* between openness and closure towards the larger world economy.

One giveaway sign that laissez faire in foreign trade (what free trade is) is wrong is that laissez faire hasn't been taken seriously in America's domestic economy for well over 100 years—since before the era of Teddy Roosevelt's trustbusters around the turn of the 20th century. Despite perennial posturing to the contrary by free-market ideologues, we have, in fact, found reasonable levels of regulation in most parts of our economy to be best: neither outright state control nor absolute economic freedom. It is no accident that regulating international trade was well within the intention of the Founding Fathers: Article I, Section 8, of the Constitution *explicitly* authorizes Congress “to regulate commerce with foreign nations.”

FREE TRADE IS NOT INEVITABLE

It is often said (or tacitly assumed) that in today's world, free trade is somehow inevitable. But if so, why do its supporters bother arguing for it so aggressively? The inevitability of free trade certainly does not follow from the apparent inevitability of some form of capitalism, given the long history of protectionist capitalist economies. (The U.S. itself used to be

one, as we will see in Chapter Six below.)

Contrary to myth, modern history has simply not been a one-way escalator to ever increasing global economic interconnectedness. Instead, this interconnectedness has ebbed and flowed upon larger political currents. It was pushed up by colonialism, but pushed down when former colonies, like the U.S. and India, adopted protectionist policies of their own after independence. It was pushed down by fascism on the right and socialism on the left. But it was pushed up by the Cold War. Prior to the 1970s, the peak of world trade as a percentage of world economic output was in 1914—a peak to which it did not return for two generations. [52](#)

This flux is not an idle curiosity of unrepeatable history: anyone who assumes world trade can only go up in the long run should consider what Peak Oil or tightening environmental constraints may do to transport costs. Neither has increased trade always correlated with increased prosperity and its decline with the reverse: the world economy was actually *less* globalized in 1960 than in 1910, but more prosperous. [53](#)

Modern technology does not mandate free trade either. While technology indeed favors the expansion of trade, by reducing shipping and transaction costs, it does not mandate that this trade be *free*, rather than subject to tariffs. Indeed, if technology erodes natural trade barriers like distance, and

trade barriers are sometimes beneficial (as we will shall see), then modern technology can, paradoxically, *increase* the justification for tariffs.

All inevitability arguments are moral evasions, anyhow, because offloading responsibility to the free market ignores the fact that we *choose* whether, and how much, to regulate markets. This is probably what the great protectionist President Teddy Roosevelt was driving at when he wrote that “pernicious indulgence in the doctrine of free trade seems inevitably to produce fatty degeneration of the moral fiber.”⁵⁴

THE NATION-STATE IS NOT IRRELEVANT

It is sometimes suggested that free trade is a moot question because globalization has made the nation-state irrelevant. As Doug Oliver of the Cessna aircraft company recently said, in response to complaints about his company outsourcing its entry-level Skycatcher plane to a firm that supplies China’s air force:

Nothing is American any more. Nothing is German any more. Nothing is Japanese any more. Harley-Davidson sources parts from all around the world.
Let’s face it, we’re in a global economy.⁵⁵

This is all technically true (with respect to the sourcing of parts at least), but it misses the point. Even if the internationality of modern supply chains means that America's trade balance adds up at the component, rather than finished product, level, we still run a deficit or a surplus. And even if who builds which finished products isn't the key to prosperity anymore, who builds which components increasingly is.

In any case, the nation-state is a long way from being economically irrelevant. Most fundamentally, it remains relevant to *people* because most people still live in the nation where they were born, which means that their economic fortunes depend upon wage and consumption levels within that one society.

Capital is a similar story. Even in the early 21st century, it hasn't been globalized nearly as much as often imagined. And it also cares very much about where it lives, frequently for the same reasons people do. (Few people wish to live *or* invest in Malawi; many people wish to live *and* invest in California.) For a start, because 70 percent of America's capital is human capital,⁵⁶ a lot of capital behaves exactly as people do, simply because it *is* people. Another 12 percent is estimated to be social capital, the value of institutions and knowledge not assignable to individuals.⁵⁷

So although *liquid financial capital* can indeed flash around the world in the blink of an electronic eye, this is only a

fraction (under 10 percent) of any developed nation's capital stock. Even most nonhuman capital resides in things like real estate, infrastructure, physical plant, and types of financial capital that don't flow overseas—or don't flow very much. (Economists call this “don't flow very much” phenomenon “home bias,” and it is well documented.)⁵⁸ As a result, the output produced by all this capital is still largely tied to particular nations. So although, for reasons we will examine in detail later, capital mobility certainly causes big problems of its own, it is nowhere near big enough to literally abolish the nation-state as an economic unit.

Will it do so one day? Even this is unlikely. Even where famously dematerializing and globalizing assets like fiber optic telecom lines are added—assets that supposedly make physical location irrelevant—they are still largely being added where existing agglomerations of capital are. For example, although fiber optic backbones have gone into places like Bangalore, India, which were not global economic centers a generation ago, big increments of capacity have also gone into places like Manhattan, Tokyo, Silicon Valley, and Hong Kong, which were already important.⁵⁹ As a result, existing geographic agglomerations of capital are largely self-reinforcing and here to stay, even if new ones come into being in unexpected places. And these agglomerations have national shape because of past history; legacy effects can be *extremely* durable.⁶⁰ Previous technological revolutions, such as the

worldwide spread of railroads, were at least as big as current innovations like the Internet, and they didn't abolish the nation-state.

Ironically, the enduring relevance of the national economy is clearest in some of the “poster child” countries of globalization, like Japan, Taiwan, South Korea, Singapore, and Ireland. In each of these nations, economic success was the product of policies enacted by governments that were in some sense *nationalist*. Japan industrialized after the Meiji Restoration of 1868 to avoid being colonized by some Western power. Taiwan did it out of fear of mainland China. South Korea did it out of fear of North Korea. Ireland did it to escape economic domination by England. In each case, the driving force was not simply desire for profit. This exists in every society (including resource-rich basket cases like Nigeria, where it merely produces gangsterism), but does not reliably crystallize into the policies needed for economic growth. The driving force was national *political* needs which found a solution in economic development.

There is no getting around politics. Politics is still mostly practiced at the national level, and practiced with sovereignty only at that level. And the reality for almost all people and corporations is that national policies still matter. It matters whether one has good physical infrastructure and basic security. It matters whether one must constantly pay bribes to get things done. It matters whether one gets cut out of the best

opportunities in favor of political cronies. It matters whether the local education system produces quality employees. It matters whether one has a sound currency to work with. It matters whether the local population reveres things like science, efficiency, and entrepreneurship. And it matters whether the politicians in charge of all these things are wise enough to keep them that way, and whether the voters (if the country is a democracy) are wise enough to elect the right politicians.

Globalization doesn't make all these things less important—let alone “irrelevant.” They are arguably even *more* important in a more globalized world because the rewards for getting them right (and the punishments for getting them wrong) are larger. Without globalization, mediocre industries can just sputter along for decades. But with globalization, these industries can get wiped out. But they can also conquer the world if they're *not* mediocre. So national policies are arguably more important than ever.

There is an important related factor: as Michael Porter, one of the most distinguished faculty members of Harvard Business School, has observed:

Competitive advantage is created and sustained through a highly localized process. Differences in national economic structures, values, cultures, institutions, and histories contribute profoundly to

competitive success. The role of the home nation seems to be as strong as or stronger than ever. While globalization of competition might appear to make the nation less important, instead it seems to make it more so.⁶¹

So what we can call *economic national character* matters. One sign of this is that even multinational companies are almost always strongly tied to particular nations. Despite the myth of the stateless corporation, only a few dozen firms worldwide maintain over half their production facilities abroad.⁶² According to one study, multinational companies “typically have about two-thirds of their assets in their home region/country, and sell about the same proportion in their home region/country.”⁶³ Another meticulous 2008 study bluntly concluded that:

Globalization as popularly understood does not exist. For example, there is no evidence that U.S. firms operate globally. Instead, they both produce and sell on a home region basis, as do MNEs [multi-national enterprises] from Europe and Asia.⁶⁴

So whatever else multinational corporations may be guilty of,

vanishing into denationalized thin air isn't it.

Economic nationalism is usually held up by free traders as a dumb and reactionary force. Sometimes, of course, it is. Boneheaded economic nationalism belongs in the junkyard of history with the other ideologies rusting there. Nothing in this book is intended to defend it. But economic nationalism can also be a smart, technocratic, forward-looking force—indeed one of the key things that makes economic globalization *work*—when implemented correctly. Nations with weak or fragmented national cohesion, such as Nigeria, Afghanistan, or Iraq, haven't exactly seized the opportunities of the global economy lately. Neither, in the U.S., have we.

THE MYTH OF THE BORDERLESS ECONOMY

The cliché that we live in a borderless global economy does not survive serious examination.

Because the U.S. is roughly 25 percent of the world economy, a truly borderless world would imply that imports and exports would each make up 75 percent of our economy, since our purchase and sale transactions would be distributed around the world.⁶⁵ This would entail a total trade level (imports plus exports) of 150 percent of GDP. Instead, our total trade level is 29 percent: imports are 17 percent and exports 12 percent.⁶⁶ So our economy is nowhere near borderless. And as our trade is almost certainly destined to be

balanced by import contraction, rather than an export boom, in the next few years, our trade level is almost certainly poised to go down, not up.

A truly unified world economy would also mean that rates of interest and profit would have to be equal everywhere (or the differences would be arbitrated away by the financial markets). But this is nowhere near being the case. Even between adjacent and similar nations like the U.S. and Canada, national borders still count: Canadian economist John McCallum has documented that trade between Canadian provinces is on average *20 times* as large as the corresponding trade between Canadian provinces and American states.⁶⁷ It has been estimated that the average cost of international trade (ignoring tariffs) is the equivalent of a 170 percent tariff, of which 55 percent is local distribution costs and 74 percent is international trade costs.⁶⁸ Much of international trade is interregional anyway, not global, being centered on European, North American, and East Asian blocs; this is true for just under 50 percent of both agriculture and manufactured goods.⁶⁹

In reality, the world economy remains what it has been for a very long time: a thin crust of genuinely *global* economy (more visible than its true size due to its concentration in media, finance, technology, and luxury goods) over a network of regionally linked national economies, over vast sectors of

every economy that are not internationally traded at all (70 percent of the U.S. economy, for example).⁷⁰ On present trends, it will remain roughly this way for the rest of our lives.⁷¹ The world economy in the early 21st century is not even remotely borderless.

FREE TRADE AS FOREIGN POLICY

Free traders since 19th-century classical liberals like the English Richard Cobden and the French Frederic Bastiat have promised that free trade would bring world peace. Even the World Trade Organization (WTO) has been known to make this sunny claim,⁷² which does not survive historical scrutiny. Britain, the most freely trading major nation of the 19th century, fought more wars than any other power, sometimes openly with the aim of imposing free trade on reluctant nations. (That's how Hong Kong became British.) Post-WWII Japan has been blatantly protectionist, but has had a more peaceful foreign policy than free-trading America. In reality, free trade sometimes dampens international conflict and sometimes exacerbates it. It enriches belligerent autocrats and helps them dodge democratic reforms. Today, it strengthens the Chinese military by building up China's economy and expanding its access to military technology through both trade and through purchases of American technology companies with the money earned thereby.

Attempts to link free trade to counterterrorism don't stand up, either.⁷³ The U.S. is the world's leading free trader, but somehow the world's biggest terrorist target anyway. Free trade's widespread global unpopularity combines with the perception that America is behind it to antagonize peoples and governments around the world as often as it rallies them to our side. Occasionally, free trade may bribe foreign governments to cooperate with the United States, but it also enriches nations, like Saudi Arabia and Venezuela, whose elites are knee-deep in funding terrorism and other international mischief. Hard-coding free trade as a legal obligation, as the WTO does, frustrates our ability to use trade concessions as leverage to win foreign cooperation against our enemies.⁷⁴

Ironically, the Central Intelligence Agency seems to grasp many of these problems better than the supposedly economics-oriented agencies of the U.S. government. In its *Global Trends 2015* report, the agency warns that:

The process of globalization...will be rocky, marked by chronic financial volatility and a widening economic divide...Regions, countries, and groups feeling left behind will face deepening economic stagnation, political instability, and cultural alienation. They will foster political, ethnic, ideological, and religious extremism, along with the

violence that often accompanies it...Within countries, the gap in the standard of living also will increase....Increased trade links and the integration of global financial markets will quickly transmit turmoil in one economy regionally and internationally.⁷⁵

Neither does free trade promote human rights. If China had to rely upon domestic demand to drive its economy, locking up its population as factory slaves would not be such a viable strategy. The same goes in other nations, and free trade agreements then frustrate attempts to impose sanctions on human rights violators. The sanctions imposed on South Africa in 1986 would be illegal today under WTO rules.⁷⁶

FLASHY, EMPTY ARGUMENTS

Some arguments for free trade are sheer intellectual fluff—like the idea we should engage in it because it embodies the spirit of the age, the tide of history, or some other contemporary repackaging of these shopworn ideas.⁷⁷ Magazines like the libertarian *Reason*, techno-utopian *Wired*, and entrepreneurship-oriented *Fast Company* reveled in such themes all through the dot-com boom years of the late 1990s.⁷⁸ The hallmark here is loose, breathless prose whose

actual analytical content dissolves among vague terms and hyperbolic assertions. (Cf. the quote from *Wired* magazine in Chapter 1.) The aim, above all, is to make free trade *hip*: the wave of the future. But free trade's hard economics is just 19th-century *laissez faire*, the economics of the iron law of wages.⁷⁹ Its intellectual kernel is David Ricardo's 1817 theory of comparative advantage. Its rival, so-called new trade theory, is, by contrast, a genuinely modern—indeed 21st century—school of thought. Free trade is far too old to parade itself as the latest thing.

Skepticism about free trade is often stigmatized with *ad hominem* attacks. These mostly come down to variations on the following:

“Protectionists are dummies, losers, incompetents, hippies, rednecks, dinosaurs, closet socialists, or crypto-fascists.”⁸⁰

Here's free trader Barack Obama's version, delivered to an audience of campaign donors in the exclusive Pacific Heights neighborhood of San Francisco while seeking the Democratic nomination in April 2008:

You go into these small towns in Pennsylvania and,

like a lot of small towns in the Midwest, the jobs have been gone now for 25 years and nothing's replaced them. And it's not surprising, then, they get bitter, they cling to guns or religion or antipathy to people who aren't like them or anti-immigrant sentiment or *anti-trade sentiment* as a way to explain their frustrations. ⁸¹ (Emphasis added.)

God forbid the unemployed of an old-line industrial state should think *trade* has anything to do with their problems!

But economic logic isn't even really the issue here, as these arguments are really aimed at people who don't even *try* to understand economics, but do care immensely about their social status. ⁸² The media are saturated with this attitude. Thus magazine articles on trade problems focus on the unemployed, implying that only life's losers oppose free trade (and that their unemployment is probably their own fault, anyway). The careers of people whose jobs are being lost to offshoring? Mere "drudgery." Their lives are obviously nothing worth worrying about. *They're not like us here in Pacific Heights.*

This is largely just a chic veil thrown over class bias. Despite the documented center-left preferences of most journalists on social and cultural issues, on economic issues, including trade, they lean right. ⁸³ A late-1990s survey by the watchdog group Fairness and Accuracy in Reporting found,

for example, that only on environment-related economic issues were they to the left of the public. But on trade, they were well to the right. For example, 71 percent of editors and reporters supported Fast Track negotiating authority for the North American Free Trade Agreement, while 56 percent of the public opposed it.⁸⁴ As 95 percent of these editors and reporters had incomes over \$50,000, and more than half over \$100,000, this comes as no surprise.⁸⁵

ARROGANCE AND INCOHERENCE

The media sometimes tell us that America's labor force is so much more skilled than other nations that free trade will cause us to cream off the best jobs in the global economy. The next minute, they tell us that our poor math skills and work ethic are the root of our economic problems and that we should only blame ourselves. These obviously can't both be true.

Sometimes, we are told to stop being arrogant and face up to the fact that the world isn't our oyster anymore and that Americans aren't entitled to be richer than foreigners. Fair enough: we're not *entitled* to any particular living standard. But we certainly are entitled to a government that seeks to defend our prosperity, if that's what we elected it to do.

Signs that America's trade policies are dangerously wrong are often reinterpreted as evidence that our economy is so strong that it can survive even these problems. For example,

because we have survived a trade deficit which would have produced a currency collapse in any other nation, trade deficits must not matter. But that is like saying that because the strong constitution of a patient has enabled her to survive cancer, cancer isn't a disease. If free trade *is* a cancer slowly eating at our economy, we need to know *now*—especially if it is a problem whose solutions have long lead times.

Our present complacent attitude is the same one taken by past economic powers, such as the British, Spanish, and Chinese Empires, which postponed economic reform until it was too late. Consider the following piece of triumphalist free-trade rhetoric:

Our capital far exceeds that which they can command. In ingenuity, in skill, in energy, we are inferior to none. Our national character, the free institutions under which we live, the liberty of thought and action, an unshackled press spreading the knowledge of every discovery and of every advance in science, combine with our natural and physical advantages to place us at the head of those nations which profit by the free interchange of their products. Is this the country to shrink from competition? Is this the country which can only flourish in the sickly atmosphere of prohibition? Is this the country to stand shivering on the brink of

exposure to the healthful breezes of competition?⁸⁶

These words could have been spoken yesterday by an American politician on either side of the aisle. In fact, they are from a speech by British Prime Minister Sir Robert Peel—in 1846! (His soaring confidence turned out to be misplaced, and Britain’s economic decline began shortly thereafter.)

America succeeded under free trade (albeit at mounting cost) during the Cold War. But that was a world that was half communist or socialist, and many other nations, as in Latin America, practiced an inward-looking economics that took them out of the game as serious competitors to us. So we didn’t have to face true global free trade. Now we do. (Like many ideals, free trade is more attractive when you don’t really have to live by it.)

NUMBERS THAT DON’T PAN OUT

Many popular arguments for free trade sound persuasive until real numbers intrude. For example:

“Free trade is good for America because it means a billion Chinese are now hungry consumers of American products.”

But America is running a huge deficit, not a surplus, with China. (\$227 billion in 2009, about 61 percent of our total, up from 39 percent the previous year).⁸⁷ China deliberately blocks imports, mainly with non-tariff barriers, in order to decrease consumption, increase savings, and boost investment. (This high investment rate is the main reason its economy is growing so fast.) As a result, even the limited purchasing power China's mostly poor population does have rarely gets spent on American goods. The dream of selling to the Chinese functions primarily as bait to lure in American companies, which are then forced by the government to hand over their key technological know-how as the price of entry.⁸⁸ They then build facilities which they discover they can only pay off by producing for export. The China market remains the mythical wonderland it has been since the 19th-century era of clipper ships and opium wars (when it was hyped as aggressively as today, by the way).

A related myth is this:

“Other nations are rapidly catching up to American wage levels. India, for example, has a middle class of 250 million people.”

But middle class in India means the middle of India's class system, not ours: a family income about a *tenth* of what it

would take here. India's per capita income is only about \$1,000 a year; an Indian family with \$2,500 a year can afford servants.⁸⁹ For \$5,000 a year, American corporations offshoring work there can hire fresh computer-science graduates.⁹⁰

This myth is calculated to soothe American anxieties:

“Offshoring is a tiny phenomenon.”

Offshoring, of course, is just trade in services. But it's just getting started and will be big soon enough, thanks to 15 percent per year compound growth.⁹¹ Alan Blinder, former Vice-Chairman of the Federal Reserve and now an economist at Princeton, has estimated that it will ultimately affect up to 40 million American jobs.⁹²

Here is a hopeful dream some people console themselves with:

“Cheap foreign labor is not a threat to American wages because increasing prosperity will drive up wages overseas.”

While this *may* be true in the long run, at currently observed rates of income growth, it will take decades at best. And it may not happen at all, as the past experience of nations like Japan, which rose from poverty to wages similar to the U.S., may not be replicated. Sub-Saharan Africa has a lower per capita income today than 40 years ago,⁹³ and worldwide, the UN reported in 2003 that 54 nations were poorer than they had been in 1990.⁹⁴

This common claim has no real quantitative basis:

“Free trade brings us enormous benefits.”

But one of the dirty little secrets of free trade is that the benefits of expanding it even further—as we are endlessly told we must do—are actually quite small, *even according to the calculations of free traders themselves.*⁹⁵ (More on this later.)

This next claim appeals to the American sense of superiority:

“We can sustain our huge trade deficit indefinitely because foreigners are so eager to invest in our wonderful business climate.”

Unfortunately for this idea, most foreign investment in the U.S. goes for existing assets. For example, of the \$276.9 billion invested in 2007, 92 percent went to buying up existing companies.⁹⁶ Even worse, much goes into mere government debt—which gets converted, by way of deficit spending, into consumption, not investment.

Here is a sophisticated-sounding analysis that seems to take the drawbacks of free trade seriously:

“Free trade costs America low-quality jobs but brings high-quality jobs in their place.”

That would obviously be a kind of free trade we could live with. But the hard data actually show America losing *both* kinds of jobs. For example, according to the Bureau of Labor Statistics, the U.S. lost over 54,000 engineer and architect jobs between 2000 and 2008.⁹⁷

This myth is particularly slippery:

“Savings to consumers from buying cheaper imports outweigh the wages lost by not producing these goods domestically.”

But there is no data that actually proves this, particularly since the crucial data concerns the long term, which we have not yet had the opportunity to observe. And there is no principle of economics that guarantees that this will be true, *even in theory*.⁹⁸ But we do know that during George W. Bush's term in office, America lost over three million manufacturing jobs.⁹⁹

Here is a seductive and, frankly, rather dangerous argument:

“America is still the world's richest country, and we're free traders, so free trade must be right.”

But any case for free trade that turns on the present general prosperity of the United States ignores the fact that short-term prosperity is a lagging indicator of the fundamental soundness of a nation's economy. Immediate prosperity largely consists in the enjoyment of wealth, such as housing stock, produced in years past, so a nation that has been rich for a long time has considerable momentum to ride on. Declining industries may even reap record profits during the years in which they liquidate their competitive positions by outsourcing production, cutting investment, and milking accumulated brand equity.

Many of the indicators used to show America economically outperforming the rest of the world are questionable, anyway. Our low unemployment rate looks less impressive once prison inmates and other forms of nonemployment are factored in.¹⁰⁰ Our high per capita income is largely a result of Americans working longer hours than in other developed nations and of our having a higher percentage of our population in the workforce. As a result, our output per man-hour is much less impressive,¹⁰¹ even less so if one assumes that our currency is unsustainably inflated (as it is). And due to American income inequality being the highest in the developed world, less of our GDP reaches the bottom 90 percent of our population than in any other developed country.¹⁰²

THE FREE TRADE SQUEEZE

The economic forces that cause free trade to squeeze the wages of ordinary Americans today are relentless. As Paul Krugman puts it:

It's hard to avoid the conclusion that growing U.S. trade with Third-World countries reduces the real wages of many and perhaps most workers in this country. And that reality makes the politics of trade

very difficult. [103](#)

Free trade squeezes the wages of ordinary Americans largely because it expands the world's supply of labor, which can move from rice paddy to factory overnight, faster than its supply of capital, which takes decades to accumulate at prevailing savings rates. As a result, free trade strengthens the bargaining position of capital relative to labor. This is especially true when combined with growing global capital mobility and the entry into capitalism of large formerly socialist nations such as India and China. As a result, people who draw most of their income from returns on capital (the rich) gain, while people who get most of their income from labor (the rest of us) lose.

This analysis is not some cranky Marxist canard: its underlying mechanism has long been part of mainstream economics in the form of the so-called Stolper-Samuelson theorem. [104](#) This theorem says that freer trade raises returns to the abundant input to production (in America, capital) and lowers returns to the scarce one (in America, labor). Because America has more capital per person, and fewer workers per dollar of capital, than the rest of the world, free trade tends to hurt American workers.

Free trade also affects different kinds of labor income differently. The impact of free trade on a worker in the U.S. is

basically a function of how easy it is to substitute a cheaper foreign worker by importing the product the American produces.¹⁰⁵ For extremely skilled jobs, like investment banking, it may be easy to substitute a foreigner, but foreign labor (some yuppie in London) is just as expensive as American labor, so there is no impact on American wages. For jobs that cannot be performed remotely, such as waiting tables, it is impossible to substitute a foreign worker, so again there is no direct impact. (We will look at indirect impacts later.) The occupations that suffer most are those whose products are easily tradable *and* can be produced by cheap labor abroad. This is why unskilled manufacturing jobs were the first to get hurt in the US: there is a huge pool of labor abroad capable of doing this work, and manufactured goods can be packed up and shipped around the globe. Because low-paid workers are concentrated in these occupations, free trade hurts them more.¹⁰⁶

It follows from the above that free trade, even if it performs as free traders say in other respects (it doesn't), could still leave most Americans with lower incomes. And even if it expands our economy overall, it could still increase poverty. In a word: *Brazil*, where an advanced First World economy exists side-by-side with Third World squalor, the rich live behind barbed wire, and shopkeepers hire off-duty policemen to kill street children.

Latin America generally is not an encouraging precedent

with respect to free trade: in the words of former World Bank chief economist Joseph Stiglitz, “In Latin America, from 1981 to 1993, while GDP went up by 25 percent, the portion of the population living on under \$2.15 a day increased from 26.9 percent to 29.5 percent.”¹⁰⁷ Growth happened, but much of the population got nothing out of it. Another cautionary tale from the region is Argentina, whose per capita income was 77 percent of ours in 1910, but which underwent economic decline and whose per capita income is now only 31 percent.¹⁰⁸ This is what radical economic decline might look like.

In recent decades, trade-induced wage decay has been relentless on the bottom half of America’s economic ladder (and is now starting to spread upwards). According to one summary of the data:

For full-time U.S. workers, between 1979 and 1995 the real wages of those with 12 years of education fell by 13.4 percent and the real wages of those with less than 12 years of education fell by 20.2 percent. During the same period, the real wages of workers with 16 or more years of education rose by 3.4 percent, so that the wage gap between less-skilled and more-skilled workers increased dramatically.¹⁰⁹

Taking an approximate mean of available estimates, we can attribute perhaps 25 percent of America's recent rise in income inequality to freer trade.¹¹⁰ It was thus estimated in 2006 that the increase in inequality due to freer trade cost the average household earning the median income more than \$2,000.¹¹¹ For many households, this was more than their entire federal tax bill—something for Republicans to bear in mind when trying to rile up such people against big government as the source of their financial woes.

The increasing availability of foreign labor to American corporations has encouraged them to view American workers not as assets, but as expensive millstones around their necks. Wages and benefits once considered perfectly acceptable pillars of First World middle-class living are now viewed by corporate America as obscenely excessive. One sign of this was the two-tier wage structure (with lower wages for new hires) agreed to by the United Auto Workers with General Motors in 2007 even *before* GM's slide into bankruptcy.¹¹² Under this agreement, within four years roughly a third of GM's employees would be making the new scale—about half what prior employees made. This undid America's historic achievement of an auto industry with middle class factory workers.

The U.S. government has actively abetted this process: the

Big Three automakers were forced to cut wages to the levels of foreign automakers' U.S. plants as a condition for their 2008 bailout.^{[113](#)} And, as shown by export superstar Caterpillar using the threat of offshoring to extract concessions from its labor force,^{[114](#)} it is unlikely we can export our way out of these problems as long as free trade remains in place.

Chapter 2

Deficits, Time Horizons, and Perverse Efficiency

The trade deficit is the single most important statistic of America's trade problems. But because free traders are so adept at explaining why it supposedly doesn't matter, it is essential to understand, once and for all, why they are wrong. ¹¹⁵ Luckily, this doesn't require any particularly sophisticated economics, only a solid grasp of some elementary definitions and basic chains of reasoning. Time horizons work the same way. (Although not a common part of public discussion, they are a crucial part of the conceptual framework we will need to reason our way out of our trade problems.) And by putting trade deficits and time horizons together, we can make sense of exchange rates and their manipulation.

To understand trade deficits, just think through the logic below step-by-step:

Step 1) *Nations engage in trade.* So Americans sell people in other nations goods and buy goods in return. ("Goods" in this context means not just physical objects

but also services.)

Step 2) *One cannot get goods for free.* So when Americans buy goods from foreigners, we have to give them something in return.

Step 3) *There are only three things we can give in return:*

3a) Goods we produce today.

3b) Goods we produced yesterday.

3c) Goods we will produce tomorrow.

This list is exhaustive. If a fourth alternative exists, then we must be trading with Santa Claus, because we are getting goods for nothing. Here's what 3a) –3c) above mean concretely:

3a) is when we sell foreigners jet airplanes.

3b) is when we sell foreigners American office buildings.

3c) is when we go into debt to foreigners.

3b) and 3c) happen when America runs a trade deficit. Because we are not covering the value of our imports with 3a) the value of our exports, we must make up the difference by either 3b) selling assets or 3c) assuming debt. If either is happening, America is either gradually being sold off to foreigners or gradually sinking into debt to them.

Xenophobia is not necessary for this to be a bad thing, only bookkeeping Americans are poorer simply because we own less and owe more. Our net worth is lower.

This situation is also unsustainable. We have only so many existing assets we can sell off, and we can afford to service only so much debt.¹¹⁶ By contrast, we can produce goods indefinitely. So deficit trade, if it goes on year after year, must eventually be curtailed—which will mean reducing our consumption one day.¹¹⁷

Deficit trade also destroys jobs *right now*.¹¹⁸ In 3a), when we export jets, this means we must employ people to produce them, and we can afford to because selling jets brings in money to pay their salaries. But in 3b), those office buildings have already been built (possibly decades ago), so no jobs today are created by selling them.¹¹⁹ And in 3c), no jobs are

created today because the goods are promised for the future. While jobs will be created *then* to produce these goods, the wages of these future jobs will be paid by us, not by foreigners. Because the foreigners already gave us their goods, back when we bought from them on credit, they won't owe us anything later. So we will be required, in effect, to work without being paid.

This situation isn't only a problem for America. This sort of debt burden is something heavily indebted Third World countries, laboring under debts piled up by past (frequently dubious) regimes, often complain about. They sometimes see international debt as a new form of colonialism, designed to extract labor and natural resources without the inconvenience of running an old fashioned pith-helmet empire. This is why they hate the International Monetary Fund (IMF), which administers many of these debts after they have been junked from the private sector through bailouts.

FINANCIAL SOPHISTICATION CHANGES NOTHING

The above facts are all precisely what we should expect, simply on the basis of common sense, as there is no something-for-nothing in this world. And that is what the idea that trade deficits don't matter ultimately amounts to. There do

exist, however, ways of shifting consumption forwards and backwards in time, which can certainly create the *illusion* of something for nothing for a while. This illusion is dangerous precisely because the complexities of modern finance, and the profitability of playing along with the illusion while it lasts, both tend to disguise the reality.

Most of these complexities amount to ways of claiming that the wonders of modern finance enable us either to borrow or sell assets indefinitely. But as long as one bears the above reasoning firmly in mind, it should be obvious why none of these schemes can possibly work, even without unraveling their often baroque details. These financial fairy tales usually boil down to the fact that a financial bubble, by inflating asset prices seemingly without limit, can for a period of time make it *seem* as if a nation has an infinite supply of assets appearing magically out of thin air. (Or a finite supply of assets whose value keeps going up and up.) These assets can then be sold to foreigners. And because debt can be secured against these assets, debt works much the same way.

Thus a succession of financial bubbles in America since the mid-1990s (in New Economy stocks, real estate, derivatives, commodities, and the broader stock market) have helped us keep running huge trade deficits. To a significant extent, we have bought imports with bubble-inflated stock, junk mortgages, bonds doomed to melt with the dollar, and other financial tinsel. Even assets that were not themselves dubious

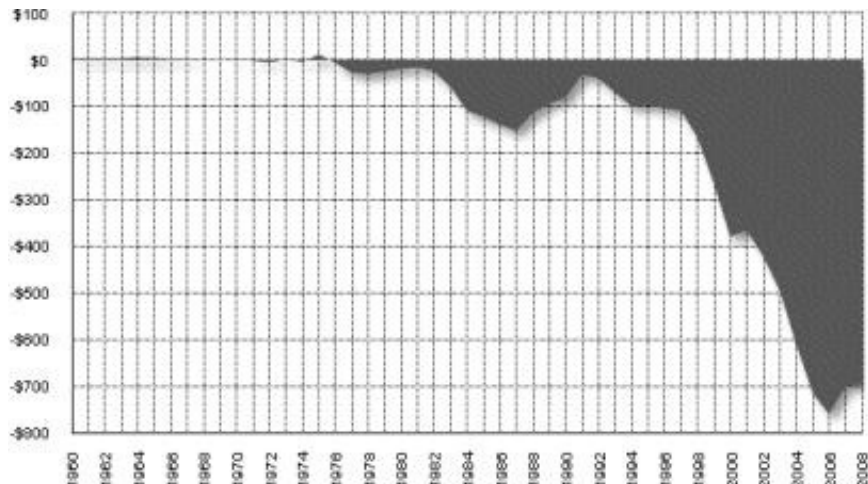
had their value propped up by a general buoyancy in the financial markets that was of dubious origin.

OUR TRADE DEFICIT, OUR CREDIT LINE

In recent years, Americans have been consuming more than they produce to the tune of up to five percent of GDP, making up the difference by borrowing and selling assets abroad. As a result of over 30 years of this, foreigners now own just under 50 percent of all publicly traded Treasury securities, 25 percent of American corporate bonds, and roughly 12 percent of American corporate stock.¹²⁰ Net foreign ownership of American assets (what they own here minus what we own there) is now \$3.5 trillion—over a quarter of U.S. GDP.¹²¹ (GDP is an annual figure and investments are a standing stock of wealth, so these numbers are not directly comparable, but the comparison still gives some sense of the sheer scale.)

It has been estimated that, in the past decade, the U.S. has been absorbing up to 80 percent of the world's internationally exported savings.¹²² Until 1985, the U.S. was a net creditor against the rest of the world, but since then, we have slipped further into debt every year.¹²³ The chart below tells the story:

U.S. Trade Balance in Billions¹²⁴



It has been estimated that every billion dollars of trade deficit costs America about 9,000 jobs.¹²⁵ So it has been estimated that our deficit has cost us approximately one-fifth of all the manufacturing jobs that would otherwise exist.¹²⁶ Another way to look at it is that we lose GDP. The Economic Strategy Institute, a Washington think tank, estimated in 2001 that the trade deficit was shaving at least one percent per year off our economic growth.¹²⁷ This may not sound like much, but because GDP growth is cumulative, it compounds over time. Economist William Bahr has thus estimated that America's trade deficits since 1991 alone—they stretch back unbroken to 1976—have caused our economy to be 13 percent smaller than it otherwise would be.¹²⁸ That's an economic hole larger than the entire Canadian economy.

America's accumulated financial obligations to foreigners mean that an increasing percentage of our future output will go to their consumption, not our own. This applies to both the

public and private sectors: as of 2009, 5.5 percent of the federal budget goes to interest on debt,¹²⁹ and about half the federal debt is foreign-owned.¹³⁰ In 2006, for the first time since we paid off our own 19th-century debts to Europe due to British borrowing here to pay for WWI, America paid more in interest to foreigners than it received from them.¹³¹ Luckily for us, the average interest rate on what we own abroad (largely high-yielding corporate assets) exceeds the average interest rate on what foreigners own here (largely low-yielding government bonds), so we crossed this line long after becoming a net debtor.¹³²

But we can't keep borrowing forever. Both the private sector and the government are threatened by the surging interest rates that would result from our international credit drying up. This surge could easily knock America back into recession.¹³³ And tens of millions of ordinary families are so indebted that they could be pushed into bankruptcy by a sustained rise in the interest rates on their credit cards and other floating-rate debt.¹³⁴

Because wage increases have been barely outpacing inflation for 35 years,¹³⁵ consumer spending has only kept pace thanks to the ability of consumers to tap into the equity of their homes at low interest rates. Without this, the spending

surge of recent years—consumer spending has gone from 63 percent of the economy in 1980 to 70 percent in 2008—would have been unsustainable. ¹³⁶ Americans have, in effect, papered over their economic difficulties in recent decades by massive borrowing from abroad. Because this borrowing helped enable the deficit, and because the deficit itself has been responsible for a large part of our economic difficulties, we have been caught in a slow-motion self-reinforcing doom loop.

THE SELL-OFF OF AMERICA

America's global overdraft is not only financed by debt, of course. It is also financed by selling off existing assets. This tends to make the news only when foreigners buy some huge thing people have actually heard of, as when Japanese investors bought Rockefeller Center in 1989 or a firm controlled by the United Arab Emirates tried to buy six of our major seaports in 2006 (and withdrew upon national-security scrutiny), but it is quietly going on all the time. Sometimes the purchasers are private entities abroad, but they are sometimes actual foreign governments, by way of so-called sovereign wealth funds.

By definition, accumulated trade surpluses can only be invested abroad. Asian sovereign funds investing such monies are expected to have \$12.2 trillion by 2013, with the funds of

petroleum exporting nations reaching a similar level.¹³⁷ Tiny Singapore has \$330 billion.¹³⁸ Little Norway, flush with North Sea oil wealth, has \$380 billion.¹³⁹ Kuwait has \$200 billion¹⁴⁰ and Abu Dhabi \$875 billion.¹⁴¹ South Korea, Brunei, Malaysia, Taiwan, and Chile also have such funds.¹⁴² Even Canada has a huge state pension fund—which denies that it is technically a sovereign fund or would ever politicize its investment decisions, but is still a huge block of capital under foreign government control.¹⁴³

These funds are getting more sophisticated all the time and have the ambition to become even more so. This is why China's State Investment Fund recently bought a 10 percent stake in the elite New York investment firm The Blackstone Group, which specializes in taking large private stakes in corporations and other sophisticated investment strategies. China's government not only wishes to manage its American investments more profitably, but in the long run probably also wishes to learn from this firm the fine art of corporate takeovers and other more active investing strategies.

As a result of this massive shift in wealth, the world's center of financial power is moving away from the Western nations that have held it for centuries. The Central Bank of China (Taiwan), the Bank of Japan, and the Abu Dhabi Investment Authority (ADIA) have, in fact, been bailing out the crippled

powerhouses of Wall Street.¹⁴⁴ The ADIA invested \$7.5 billion in Citigroup's rebuilding of its balance sheet;¹⁴⁵ all told, Citigroup received \$17.4 billion in sovereign money.¹⁴⁶ The sovereign wealth funds of Kuwait and South Korea helped bail out Merrill Lynch.¹⁴⁷ In all, from March 2007 to June 2008, Asian sovereign wealth funds contributed \$36 billion to the recapitalization of Western financial institutions, with oil-based funds kicking in another \$23 billion.¹⁴⁸ Without this money, Wall Street's bailout demands upon American taxpayers might well have been too much to stomach.

This all raises profound issues of economic security, especially as some of these governments are not reliably friendly to the U.S., especially in the long run. Unfortunately, America's mechanisms to prevent problems in this area, principally the interagency Committee on Foreign Investment in the United States (CFIUS), deliberately limit themselves to conventional national security concerns and ignore economic security. CFIUS rarely blocks transactions. Of the 404 foreign investments evaluated in the most recent reporting period (2006-2008), not one was actually blocked, although a number were withdrawn in response to scrutiny.¹⁴⁹ An attempt was made in 2007 to expand CFIUS's brief to include economic security, but it failed. In the words of deputy U.S.

Trade Representative John Veroneau:

Doing so would have unhinged CFIUS from its core function of assessing national security and would have left a wide and ambiguous definition of what constitutes ‘economic security’...Blocking an inward investment is an extraordinarily serious exercise of governmental power and should be done in only the rarest circumstances, namely when national security interests require it. [150](#)

So the U.S. government, like the Soviet Politburo, remains stuck in a narrowly military definition of national security. It has no institution explicitly dedicated to protecting America’s *economic* security, and is uncertain how even to define the concept. (We can perhaps best define it on a straight analogy to conventional military security: it is the ability to prevent foreign nations from doing us harm by economic means.)

WHEN THE WELL RUNS DRY

America’s massive asset sell-off must come to a halt when we run out of assets to sell. More precisely, it must end when our remaining assets promise foreign investors less return on their money than they can get elsewhere. It may taper off gradually as our government’s credit rating and the attractiveness of our

private assets gradually decline. Or it may grind to an abrupt halt in a financial panic due to a sudden collapse of confidence in the U.S. economy. Or it may be choked off by a political decision on the part of major buyers. They are well aware of what is going on. As Zhou Jiangong, editor of the online publication Chinastakes.com, recently asked, “Why should China help the U.S. to issue debt without end in the belief that the national credit of the U.S. can expand without limit?”¹⁵¹

Short answer: because the U.S. is importing about eight percent of China’s GDP.¹⁵² China’s productive capacity is mismatched with its own consumer demand, so it cannot switch overnight to supplying domestic markets. Its own population is still far too poor to buy the fax machines and other goods its factories produce for export, so China risks mass unemployment—potentially 100 million people—if it ceases to run huge trade surpluses. This pretty much requires it to keep devouring American debt and assets in return. China is in a terrible bind, and one can speculate endlessly on what sort of endgame its rulers may have in mind. Their ideal move obviously would be to segue smoothly from foreign to domestic demand, and they are clearly trying to do so, but there does not appear to be enough time to make this switch before America’s capacity to absorb their trade surpluses is exhausted.¹⁵³

In the developing world, which is not rich enough (does not

have enough accumulated assets) to engage in massive asset sales, the upshot of the above problems is a bit different than for the U.S. Free trade, combined with corresponding free debt and asset flows, makes it easier for such countries to pile up huge debts. These are often worsened by the fact that these countries cannot borrow internationally in their own currency, so both their public and private sector borrowers end up owing money in a foreign currency whose local price soars when the exchange rate drops. (This is a big part of what went wrong in Thailand and nearby nations in the 1997 Asian Financial Crisis.)

Both the International Monetary Fund and the World Trade Organization actually understand all the above problems perfectly well, at least on paper. For example, Article XII of the General Agreement on Tariffs and Trade (annexed to the founding agreement of its World Trade Organization successor in 1994) *explicitly* permits nations to restrict the quantity or value of imports in order to avoid trade deficits.¹⁵⁴ Similarly, the IMF's frequent attempts to package free capital flows with free trade are a violation of Article VI of its own Articles of Agreement, which recognizes the right of nations to maintain capital controls (which limit foreign debt and asset sales).¹⁵⁵ Neither of these wise concessions, products of a generation of policymakers more realistic about the pitfalls of free trade than those working today, are honored in practice anymore.

THE FREE MARKET WON'T SAVE US

Readers with a free-market bent may wonder how all the above unpleasant outcomes are possible in a capitalist economy. They may suspect that there is some free-market comeback which proves that the above problems are not really problems after all. After all, doesn't the free market guarantee rational economic decisions? Isn't that a basic axiom of capitalism?

Well, no. Not absolutely.

The root problem is simple: when free-market economics says free trade is best for our economy, it takes no position on whether this is best in the long or the short term. In fact, free-market economics takes no position on whether *any* policy it recommends is best in the long or the short term. It treats short- vs. long-term well-being as an arbitrary consumer-driven preference, like whether the economy should produce pork or beef. Some policies deliver the best short-term results, others the best long-term results, but it's an arbitrary choice which we care about more. Free-market economics certainly does *not* say that we "ought" to prefer long-term well-being, and it has no invisible hand that will push our economy toward an optimal time horizon the way it will set optimal prices as those that match supply with demand.

The technical way of saying all this is that free-market economics “treats the time discount on consumption as an exogenous preference.” An exogenous preference is one brought to economic life from outside, like the fact that Frenchmen prefer wine and Germans prefer beer. Time discount on consumption is a reflection of the fact that economics doesn’t literally deal in time *horizons*. Time horizons are the idea that outcomes matter up to some point in the future (the “horizon”) and then don’t matter after that. Instead, economics deals in time *discount*, which is the idea that the further into the future an economic event is, the less it means today. This is the basis of interest rates, among other things: if you lend me money today and I promise to pay you back later, the longer you have to wait, the more interest you’ll demand in return. So “treating the time discount on consumption as exogenous” means that while economics can give us lots of advice about the most efficient way to produce *whatever it is* we want, it cannot tell us what we ought to want (or when we ought to want it!) in the first place.

There is no way to evade this problem with minor technical adjustments, as the entire logic of free market economics is explicitly set up this way, baked into its mathematical structures from the very lowest levels. As a result, we’re going to need to change that economics a bit to find a solution to our trade problems.

THE ART OF EFFICIENT SELF-DESTRUCTION

How does all this apply to trade? Try this small thought experiment. Imagine two neighboring nations between whom trade is forbidden. Make one a “decadent” nation which prefers short-term consumption. Make the other a “diligent” nation which prefers the long-term variety. The difference between them, of course, is time discount on consumption. In economic equations, this is conventionally designated with the Greek letter *rho* (ρ). A higher value of ρ means one is more short-termist, because one discounts the future more aggressively. Think of ρ as impatience.

Now lift their protectionist barriers so the two nations can trade. And let them lend each other money and sell each other assets so they can run deficits and surpluses. Then see what happens. Standard mathematical models of trade, accepted even by free traders, can then be used to run out various scenarios of what happens next. [156](#)

One scenario in particular is very interesting. In this scenario, the decadent nation maximizes its short-term consumption by buying all the imports it can get. So it buys all it can afford with both its exports and by assuming debt and selling off assets.

In the short run, both nations are happy. The decadent nation is delighted to be able to consume more *right now*. And the diligent nation is delighted that its neighbor has expanded

its range of investment opportunities, which will enable it better to accumulate wealth and consume more later.

In economic language, both nations have “maximized their utility,” the odd word economists use for happiness. So according to free-market economics, both are now better off. This outcome is also “efficient,” as free-market economics understands efficiency, and it agrees with the core libertarian intuition underlying that economics: *more freedom makes people more able to better themselves.*

So is free trade vindicated?

No, because then come the consequences. The increased well-being of both nations (as they define it, remember, decadently or diligently) depends on the ability of the decadent nation to borrow and sell assets. And it cannot do this forever. ¹⁵⁷ Eventually, when it exhausts its ability to sell assets and assume debt, it ends up *poorer* than it would have been if it had not had free trade with its neighbor. Because it depleted its assets and saddled itself with debt, it must now divert money from its own consumption to give to its trading partner.

This outcome should make clear the answer to the question that haunts all criticism of free trade:

How can reducing people’s freedom possibly make them better off?

The answer is:

When they would use short-term freedom to hurt themselves in the long term.

The citizens of the decadent nation would have been better off if restrictions on their ability to trade had prevented them from being *quite* so decadent. Trade restraints for them would be like restrictions on an heir's squandering his inheritance. The citizens' "inheritance" is the entire accumulated wealth of their country that can be sold off to pay for imports, plus its entire debt-servicing capacity upon which debt can be floated.

Mathematical modeling actually reveals that under these conditions, outright Las Vegas decadence is not necessary for there to be a problem. It reveals that under free trade between nations with merely *different* time discounts on consumption, the nation with the higher discount (more impatient) will tend to maximize present consumption by having past generations (who produced the assets that can be sold off) or future generations (who will service the debt) pay for present consumption. ¹⁵⁸ Various factors can interfere, but that's the underlying dynamic.

The fact that two separate societies are involved is key. If

the “decadents” in a society can borrow only from “diligents” in the same society, then every borrower creates a lender in the same society, keeping society as a whole in balance. So no amount of decadence (whatever other problems it may cause) can reduce that society’s *total* net worth or future consumption possibilities. But if members of a society can borrow from outside that society, then it can. Worse, things can spiral out of control, given the self-reinforcing way in which social and cultural validation of behavior creates more behavior, then more validation, and so on. So it *matters* whether people engage in economic relations with compatriots, with whom they share a social and cultural system, or with foreigners, with whom they share only arms-length economic relations. (As noted in Chapter One, nations are far from being economically irrelevant.)¹⁵⁹

THE DANGERS OF PERVERSE EFFICIENCY

The profoundest fact here is actually that this entire mess is efficient, as free-market economics understands efficiency. This explains why free trade’s dangers in this regard have mostly been ignored by economists.¹⁶⁰ Within the rigorously logical (albeit perverse) assumptions of mainstream economics, it is merely a mathematical curiosity that free trade can make a nation worse off by seducing it into decadent consumption. It wanted a short-term consumption binge; it got

what it wanted; what's not to like? The problem has been defined out of existence at the level of basic premises.

Once one realizes how treacherous efficiency can be, and how important preferences are, it becomes clear that economics needs to focus less on the former and more on the latter. One surprising result of all this is a renewed respect for traditional bourgeois culture, or at least that aspect of it which inculcated people to save and not consume. It seems those silly old Protestant misers had a point after all!¹⁶¹ (Given that they created modern capitalism, it is no surprise they were onto *something*.) Crudely put, they reinvested their money in industry, rather than spending it all on palaces as the aristocrats who came before them had done.

The signs of debt addiction in the U.S. economy are not hard to see. The thrift-oriented generation that remembered the Great Depression has mostly died off, and households have become accustomed to endless consumer credit. As the interest rate on consumer debt has exceeded income growth since 1982—the classic formula for a debt trap—consumers have only remained afloat by relying on serial asset bubbles, especially in housing, to prop up their net worth.¹⁶² The combined debt of America's households and government is now 243 percent of GDP—more than our (understandably) high debt level at the end of borrowing to pay for WWII.¹⁶³

Our smartest competitors, meanwhile, use every trick in the

book to keep their citizens from going into debt. It is no accident that 500 million Chinese have cell phones, but only one million have credit cards. [164](#)

Perverse time discount has implications far beyond free trade and raises doubts about many other areas of economic policy over the last 30 years. For example, financial systems have been deregulated in many nations, especially the U.S. and UK, on the assumption that this is “efficient.” Efficient it may be, within a narrow definition of efficiency, but what if this just enables people to *sink into debt* more efficiently? Efficiency at the wrong things can be counterproductive. It is likely that many of the quaint old restraints on finance that have been deregulated away since about 1980 served, in theoretically unrigorous ways, to restrain the self-destructive potentials of perverse efficiency.

Perverse time discount can potentially ruin absolutely anything in the economy, given that every bad thing looks good at first (or else nobody would do it). For example, companies with short time horizons won't invest for the long term. So they will be poorly equipped to handle technological innovation, which requires costly investments that only pay off years later. (We tend to think of innovation as being about quickness and rapid response to change, but it is also about delayed financial gratification.) So this seemingly abstract problem helps explain some very concrete facts, like America's inexorably slipping lead in high technology.

Does all this mean that America must zero out its trade deficit as soon as possible? Unfortunately, the above analysis should make clear that the deficit is a chronic problem, not an acute one. It exerts a steady drag on our economic well-being, undermines our future, and we would be better off without it. But every Chicken Little who has screamed that the sky was about to fall has been embarrassed. (This has led a cynical public to conclude that no problem exists, which also is wrong.) And although failure to fix the deficit inexorably increases the ultimate risk of a financial debacle, there is no clear point predictable in advance when this will happen. We do not know exactly how much of our debt, or how many of our assets, foreign investors are prepared to hold. (They may not know either.) We only know that the one reliable way to avoid crossing that invisible line is to stop running deficits and adding to the total every year. And in the meantime, the deficit inexorably depletes our future.

THE SAVINGS-GLUT EXCUSE

Based on the above realities, in which America consumes too much and saves too little, it is sometimes claimed that our trade deficit is really a savings problem in disguise. Sometimes it is admitted that America saves too little; sometimes it is claimed that the real problem is a savings glut abroad, mainly in East Asia. Either way, this implies that trade policy is irrelevant (and futile to try to change), as only changes in

savings rates can alter anything. For example, the China Business Forum, an American group, claimed in a 2006 report, “The China Effect,” that:

The United States as a whole wants to borrow at a time when the rest of the world...wants to save. The result is a current account deficit in the United States with all countries, including China. [165](#)

This analysis is dubious on its face, as it implies that whether American cars and computers are junk or works of genius has no impact on our trade balance. Neither, apparently, does it matter whether foreign nations erect barriers against our exports. Nevertheless, it is stubbornly asserted in some very high places, largely because it excuses inaction.

But this analysis depends upon misunderstanding the *arithmetic* relationship between trade deficits and savings rates as a *causal* relationship. In national income accounting, our savings are simply the excess of our production over our consumption—because if we don’t consume what we produce, saving it is the only other thing we can do with it. (If we export it, we’ll get something of equivalent value in return, which we must then also consume or save, so exporting doesn’t change this equation.) And a trade deficit is simply the opposite, as if we wish to consume more than we produce,

there are only two ways to get the goods: either import them, or draw down supplies saved up in the past. As a result, trade deficits do not “cause” a low savings rate or vice-versa; they are simply the same numbers showing up on the other side of the ledger. (The decision to eat one’s cake does not cause the decision not to save one’s cake; it *is* that decision.) So neither our trade deficit nor our savings rate is intrinsically a lever that moves the other—or a valid excuse for the other.

Sometimes, it is even argued that foreign borrowing is *good* for the U.S., on the grounds that it enables us to have lower interest rates and more investment than we would otherwise have. But this argument is a baseline trick. It is indeed true that if we take our low savings rate as a given, and ask whether we would be better off with foreign-financed investment or no investment at all, then foreign-financed investment is better. But our savings rate isn’t a given, it’s a *choice*, which means that the real choice is between foreign- and domestically-financed investment. Once one frames the problem this way, domestically-financed investment is obviously better because then Americans, rather than foreigners, will own the investments and receive the returns they generate.

A related false analysis holds that our trade deficit is due to our trading partners’ failure to run sufficiently expansive monetary policies. (This basically means their central banks haven’t been printing money as fast as the Fed.) Some American officials have even verged on suggesting this is a

form of unfair trade.¹⁶⁶ Now it is indeed true that our major trading partners have not been expanding their money supplies as fast as we have. But as we have been doing so largely in order to blow up asset bubbles in order to have more assets to sell abroad to keep financing our deficit, it is not a policy sane rivals would imitate. We can hardly ask the diligents of the world to join us in a race of competitive decadence. (If they did, the result would almost certainly just be global inflation anyway.)

Another dubious theory holds that America's deficit is nothing to be ashamed of because it is due to the failure of foreign nations to grow their economies as fast as ours. Thus George W. Bush's Treasury Secretary, Henry Paulson, Jr., said in 2007 that:

We run a trade deficit because our vibrant and growing economy creates a strong demand for imports, including imports of manufacturing inputs and capital goods as well as consumer goods—while our major trading partners do not have the same growth and/or have economies with relatively low levels of consumption.¹⁶⁷

This analysis appeals to American pride because it carries the implication that we are merely victims of our own success and

that our trade deficit is caused by the failure of foreign nations to be as vibrant as we are. It implies that somebody *else* ought to get his house in order. Unfortunately, it is obviously false that our deficit is caused by slow growth abroad when some of our worst deficits are with fast-growing nations such as China. As for “relatively low levels of consumption” abroad causing our deficits, this is true enough, but it also implies that balancing our trade will remain impossible as long as we have major trading partners with low consumption levels, as we indeed do.

ARE FIXED EXCHANGE RATES THE SOLUTION?

The foregoing analysis gives a big clue as to why the 1945-1971 Bretton Woods system of fixed exchange rates worked so well, despite being a centrally planned system flouting the basic principle that prices (for currency, in its case) can only be efficiently set by a free market. This system generated trade deficits that were tiny by present standards, and the world economy grew faster while it was in operation, with less inequality between and within nations, than ever before or since. [168](#)

The key virtue of Bretton Woods, as we can now see, is that while floating exchange rates may be efficient, they are efficient at the wrong thing. They are driven by the *total* demand for a currency, that is, demand to buy not only a

nation's exports but also its debt and assets. As a result, demand for a nation's currency is determined not only by its export prowess, but also by its willingness to sell off assets and assume debt. But this entails treating unsustainable demand (for assets and debt) the same as sustainable demand (for exports). So floating exchange rates will *not* necessarily find the level optimal for that part of the economy devoted to present production. But this is the only part of the economy that actually *creates* wealth, as opposed to shifting it forwards and backwards in time. It is no accident that we live in an age when the financial tail often seems to be wagging the dog of the real economy! (From 1945 to 1985, the financial sector never made more than 16 percent of U.S. corporate profits, but since then, its share has steadily climbed, peaking at 41 percent in 2005.)¹⁶⁹

Floating exchange rates famously give an economy flexibility. But this flexibility includes the ability to do the wrong things. (Nobody wants to drive over a "flexible" bridge.) Under a Bretton Woods-type system, bad economic policies that affect trade quickly run aground and produce balance-of-payments crises. Britain, for example, had such crises repeatedly during its long pre-Thatcher economic slide, in 1947, 1949, 1951, 1955, 1957, 1964, 1965, 1966, and 1967.¹⁷⁰ These crises force corrective action on the trade front long before serious damage in the form of debt accumulation and asset sales can be done. But with floating exchange rates

and correspondingly free capital flows, pressure is postponed by the cushioning effect of asset sales and debt accumulation, allowing bad policy to go on much longer. So a nation can, in effect, sell the family silver and mortgage the house to pay the gas bill, rather than be forced to ask why it is using too much gas.

Formerly, this was all well understood. As John Maynard Keynes, one of the architects of Bretton Woods, explained it, the economies of the world:

Need a system possessed of an internal stabilizing mechanism, by which pressure is exercised on any country whose balance of payments with the rest of the world is departing from equilibrium in either direction, so as to prevent movements which must create for its neighbors an equal but opposite want of balance. [171](#)

The architects of Bretton Woods, traumatized by the economic chaos of the 1930s and worried about the Soviet threat, wanted a system that avoided outright socialist central planning but would still prevent financial crises. They understood that eliminating such crises entirely was utopian, so they settled for the next best thing: *to keep crises small*. Keynes himself actually wanted something even more radical:

a system of fixed exchange rates mediated by an international reserve currency called the “bancor” and managed by an institution called the Clearing Union. The IMF is a vestige of this idea, but the world got the dollar as its reserve currency instead.

Unfortunately, the dollar, like all national currencies, is a sovereign political artifact, exposed to all the problems of American politics. The Bretton Woods system eventually broke down when Lyndon Johnson inflated the dollar to pay for the Great Society and the Vietnam War at the same time without raising taxes.¹⁷² Initially, this “exported inflation,” in the words of France’s annoyed president Charles De Gaulle, as other currencies were dragged along with the dollar by their fixed parities. It eventually collapsed the system entirely as nations tried to swap their shriveling dollars for gold, by which the dollar was backed and of which we had a finite supply. The whole system ended in 1971, when President Nixon was more or less forced to abandon it.¹⁷³ Exchange rates have floated ever since.

The results have not been happy. In essence, the present system *gives nations enough rope to hang themselves with*: it lets them get into worse trouble, and then has no choice but to be more intrusive in getting them out. This doesn’t produce greater economic stability (let alone more growth), but it does produce some handy opportunities for coercively imposing aggressively free-market economic policies on otherwise

unwilling nations, especially in the Third World. Institutions such as the World Bank have opportunistically taken advantage of such crises to impose free market “reforms” they could not otherwise achieve.¹⁷⁴ For example, according to Dani Rodrik, an economist at Harvard, “no significant cases of trade reform in a developing country in the 1980s took place outside the context of a serious economic crisis.”¹⁷⁵ Translation: *now that you’re broke, privatize all those state-owned assets and stop subsidizing food for the poor, or you don’t get your emergency loans.*

So perhaps the greatest advantage of fixed exchange rates is that, of all the policies available to rebalance the world’s trade imbalances, they are actually among the *least* intrusive. Changing a society’s time discount on consumption is very hard to do: there is no lever directly attached to this variable, and most peacetime attempts to change it in the Western world have failed. Only the authoritarian technocrats of East Asia have pulled it off, by heavy-handed measures ranging from forced savings plans (Singapore) to tight limits on consumer credit (China) to zoning that makes it hard to build large houses (Japan).¹⁷⁶ These are policies no Western electorate would tolerate and that most Third World governments simply don’t have the administrative competence to pull off.

A fixed exchange rate system, on the other hand, operates at the perimeter of an economy, leaving most of its internal

mechanisms untouched. It violates few economic liberties. But even though it leaves flows of goods untouched, regulating the countervailing financial flows that must take place when goods are paid for imposes a balance just as effectively. If the pure free market won't produce the best results on its own in trade and therefore must be regulated *somewhere*, it might as well be here. And if the market is so distorted by taxes and subsidies that these distortions need to be rectified for it to produce rational outcomes, this would be a good way to do it. Fixed exchange rates are a complex issue, but they ought at least to be on the table as part of a solution to the United States' (and the world's) trade problems.

Chapter 3

Trade Solutions That Won't Work

Americans in recent decades have not, of course, been entirely unaware that they have a trade problem. This has drawn into public debate a long list of proposed solutions. Unfortunately, many will not work, some are based on analytical confusions, and a few are outright nonsense. If we are to understand the true scope of our problems and frame solutions that *will* work, these false hopes must be debunked forthwith.

For example, since the early 1990s it has been repeatedly suggested that the U.S. is on the verge of an export boom that will erase our trade deficit and produce a surge of high-paying jobs. (Bill Clinton was fond of this idea.)¹⁷⁷ The possibility looks tantalizing when we observe that America's exports have indeed been growing rapidly—just not as rapidly as our imports. (Between 1992 and 2008, our exports more than doubled, from \$806 billion to \$1,827 billion.)¹⁷⁸ This seems to imply that we are not uncompetitive in world markets after all, and that if only our export growth would climb just a few points higher, the whole problem would go away.

Unfortunately, our deficit is now so large that our exports would have to outgrow our imports by two percent a year *for over a decade* just to eliminate the deficit—let alone run the surplus we need to start digging ourselves out from under our

now-massive foreign liabilities.¹⁷⁹ This doesn't sound like much, but it is, in fact, a very strong export performance for a developed country, and unlikely in the present international economic environment, where every other nation is *also* trying to expand its exports. Much of our recent export growth has been hollow anyway, consisting largely in raw materials and intermediate goods destined to be manufactured into articles imported back into the U.S. For example, our gross (i.e., not net of imports) exports to Mexico have been booming, to feed the *maquiladora* plants of American companies along the border.¹⁸⁰ But this is obviously a losing race, as the value of a product's inputs can never exceed the value of a finished product sold at a profit.

Not only is America's trade deficit the world's largest, but our *ratio* between imports and exports (1.24 to 1 in 2009) is one of the world's most unbalanced.¹⁸¹ Given that our imports are now 17 percent of GDP and our *entire* manufacturing sector only 11.5 percent,¹⁸² we could quite literally export our entire manufacturing output and *still* not balance our trade. Import-driven deindustrialization has so badly warped the structure of our economy that we no longer have the productive capacity to balance our trade by exporting more goods, even if foreign nations wanted and allowed this (they don't).¹⁸³ So the solution will have to come from import contraction one way or another.

Exporting services won't balance our trade either, as our surplus in services isn't remotely big enough, compared to our deficit in goods (in 2009, \$136 billion vs. \$507 billion).¹⁸⁴

Neither will agricultural exports balance our trade (a *prima facie* bizarre idea for a developed nation). Our 2009 surplus in agriculture was only \$25 billion—about *one fourteenth* the size of our overall deficit. 2009 was also an exceptionally good year for agricultural exports; our average annual agricultural surplus from 2000 to 2008 was a mere \$13 billion.¹⁸⁵

PRODUCTIVITY GROWTH WON'T SAVE US

It is sometimes suggested that America merely needs to regain export competitiveness through productivity growth. Comforting statistics, showing our productivity still comfortably above the nations we compete with, are often paraded in support of this idea. Unfortunately, those figures on the productivity of Chinese, Mexican, and Indian workers concern *average* productivity in these nations. They do not concern productivity in their export industries, the only industries which compete with our own. These nations are held to low overall productivity by the fact that hundreds of millions of their workers are still peasant farmers. But American electronics workers compete with Chinese electronics workers, not Chinese peasants.

It is narrowly true that if foreign productivity is as low as foreign wages—an easy claim to make with aggressively free-market theory and cherry-picked statistics—then low foreign wages won't threaten American workers. But a problem emerges when low foreign wages are *not* balanced by low productivity. It is the combination of Third World wages with First World productivity, thanks largely to the ability of multinational corporations to spread their technology around, that has considerably weakened the traditional correlation of low wages with low productivity.¹⁸⁶ For example, it takes an average of 3.3 man-hours to produce a ton of steel in the U.S. and 11.8 man-hours in China—a ratio of nearly four to one.¹⁸⁷ But the wage gap between the U.S. and China is considerably more than that.¹⁸⁸

In any case, industrial productivity is not in itself a guarantee of high wages. U.S. manufacturing productivity actually doubled in the two decades from 1987 to 2008,¹⁸⁹ but inflation-adjusted manufacturing wages rose only 11 percent.¹⁹⁰ From roughly 1947 to 1973, productivity and wage growth were fairly closely coupled in the U.S., but since then, American workers have been running ever faster simply to stay in place.¹⁹¹ Wage-productivity decoupling has been even starker in some foreign countries: in Mexico, for example, productivity rose 40 percent from 1980 to 1994, but

following the peso devaluation of 1994, real wages were [192](#) down 40 percent.

WE CAN'T JUST COMPENSATE THE LOSERS

It is sometimes argued that although free trade has some victims, its benefits exceed its costs, so it is possible for its winners to compensate its losers out of their gains, everyone thereby coming out ahead in the end. (This is the usual fallback position of mainstream economists once they admit that free trade has drawbacks.) It is sometimes even mischievously argued that if such compensation *doesn't* happen, any problems are due to society's failure to arrange it, and are therefore not the fault of free trade *per se*. In theory, this might be true (if the rest of free trade economics is valid), but it also means that a bureaucratic *deus ex machina* is required to make free trade work as even its supporters admit that it should. So free trade turns out to be *laissez faire* on life support from big government. In any case, such compensation rarely occurs, because free trade's winners don't have to pay off its losers. They pay off their congressmen instead—to vote for more trade agreements.

Compensating free trade's victims is the rationale for the U.S. Government's Trade Adjustment Assistance (TAA) program, which has provided supplemental unemployment benefits, training subsidies, and relocation assistance since

1974. But this program is small, compared to the damage wrought by free trade: under a billion dollars a year. Few workers have actually used it, and the concept suffers from intrinsic problems. For a start, it is often impossible to identify who has lost a job due to free trade, as changing technology and consumer tastes also cost jobs (and legitimately). Furthermore, free trade does not necessarily work its harm by reducing the *quantity* of jobs: it can reduce their quality, their wages and benefits, instead. And when free trade drives down wages, it can do so industry-wide, region-wide, or even nationwide, so its actual victims are impossible to pinpoint. TAA has tended to function simply as supplemental unemployment insurance while people wait to get their old jobs back, not as a means of helping people transition to new jobs. ¹⁹³ This is its official purpose, based on the mistaken idea that the harm done by free trade consists entirely in transition costs.

EDUCATION WON'T SAVE US

One commonly suggested solution to America's trade problems is better education. While this would obviously make America *more* competitive, that it would be enough is unlikely, if by "enough" we mean able to maintain wage levels in the face of foreign competition. For a start, our rivals are well aware of the value of education, so it can't be a unique source of advantage for us. And unfortunately, the U.S. is

simply no longer formidable from an educational point-of-view. Roughly the top third of our population enjoys the benefits of a world-class college and university system, plus other forms of training such as the military and the more serious trade schools. But the rest of our population is actually worse educated, on average, than their opposite numbers in major competing nations.

Thanks mainly to the high school movement of the early 20th century, the U.S. once led the world in high school completion, the most readily comparable international measure of education. But we have been slipping behind for decades. This is clear from the fact that while we still lead among 55-to-64-year-olds (who were schooled over 40 years ago) we rank only 11th among 25-to-34-year-olds.¹⁹⁴ (South Korea is first.) Not only is our college graduation rate of 34 percent behind 15 other nations, but it does not even reach the *average* for developed countries.¹⁹⁵ Studies designed to measure specific skill sets tell an even direr story. According to the 2006 Program for International Student Assessment, American 15-year-olds were outmatched in math and science by students from 22 other nations.¹⁹⁶ The very bottom of our population is more alarming still: one 2003 study reported that a third of the adults in Los Angeles County were functionally illiterate.¹⁹⁷

Furthermore, it is a testable hypothesis whether education on

its own can protect wages, and the evidence is to the contrary. For one thing, a college degree is no longer the ticket it once was: workers between 25 and 34 with only a BA actually saw their real earnings *drop* 11 percent between 2000 and 2008.¹⁹⁸ And, as David Howell of the New School for Social Research has written after looking at this problem on an industry basis, “Higher skills have simply not led to higher wages. In industry after industry, average educational attainment rose while wages fell.”¹⁹⁹ This should be no surprise, as merely shoveling education into workers’ heads obviously will not save them, or the industries they work in, if these industries are bleeding market share and revenue due to imports. Neither can people be expected to devote time and money to acquiring more education (or be able to afford it) if there are no jobs for them at the end. Who feels like pursuing advanced training in automotive engineering today? The weak education of American workers is thus a self-reinforcing problem: educated workers not only support, but require strong industries.

Looking to education as a magic bullet can also easily slide into a *de facto* plan to write off the uneducated and uneducable; some remarks by Rep. Marcy Kaptur (D-OH) make this point well:

Putting money into research is this Holy Grail for

people here who are all college educated when the majority of the country is not, and who put themselves on this elevated plane thinking they know. I remember [Clinton Labor Secretary] Robert Reich saying, ‘Here’s what America has to do, Marcy: see this salt shaker?’ ‘Yeah?’ ‘America’s going to do the design,’ he said. ‘It’ll be made elsewhere, but we’ll do the design.’ I thought, ‘Wouldn’t that be an answer from a professor?’ I want both! I want engineering and production because I know the people in my district who used to make goods but don’t anymore, and they have a right to make what they end up buying. [200](#)

Not everyone is going to be able to get a master’s degree in nanotechnology.

Superior technological prowess is unlikely to save America, anyway, for the simple reason that we increasingly no longer possess it. Despite our image of ourselves as a technology leader, we no longer rank all that high by a lot of key metrics. For example, the U.S. today is *15th* among nations in per capita broadband Internet penetration—which will be a serious limitation on our developing the next generation of Internet applications. [201](#) Our share of world patents is dropping fast, [202](#) and federal funding for basic science is not keeping

pace with rising costs, so it is declining in real terms.²⁰³ The entire annual budget of the National Science Foundation equals less than four days of our military spending.²⁰⁴

Meanwhile, our competitors are very deliberately catching up. According to the Organization for Economic Cooperation and Development (OECD), the umbrella group for developed economies, China, with an economy less than a third the size of the U.S.,²⁰⁵ was number three in the world for spending on research and development by 2005.²⁰⁶ It is no accident that, according to the respected Georgia Tech Technology Index, China has now surpassed the U.S. in high tech competitiveness, and if the 27 nations of the European Union are counted as one, the EU has, too.²⁰⁷

CREATIVITY AND FREEDOM WON'T SAVE US

Another frequently suggested solution to our trade problems is superior creativity, based on the idea that the U.S. is an exceptionally creative society. America is often contrasted with China, and we are told that China's political system prevents it from allowing its people sufficient freedom to be creative. This is a seductive idea because it flatters American values, everybody loves creativity, and creativity is a sufficiently vague concept that one can ascribe to it economic effects of any size one likes.

Unfortunately, many of America's serious competitors are simply not authoritarian societies in the first place. China, yes, but India? India is a democracy. So is Japan. So are our European competitors. So are many of the others.

And while it might be *nice* to believe that freedom is a requirement for economic success, it is simply not observably true that authoritarian societies such as China are economically foundering.²⁰⁸ However disappointing to deeply held American values this fact may be, China's authoritarianism has almost certainly *helped* its growth, by enabling factors like the suppressed consumption policy that gives it a 50 percent savings rate and correspondingly high investment levels.²⁰⁹ Censorship of the Internet isn't strangling e-commerce there, even if it is hard to Google the Tiananmen massacre from a Chinese engineering school. Foreign businesses often like the crisp decision-making, obedient labor, and absence of democratic interference; computer chip maker Intel recently decided to build its new Asian plant in China, rather than India, for the latter reason. In the words of Intel's chairman, Craig Barrett:

India has the same issues as the United States. It is a democratic government. The decisions are slower to be made. You have to listen to all the constituencies. In China, they are much more direct... In China, it is

a central planning form of capitalism...We were in serious discussion for chip manufacturing in India, but the government was a bit slow on semiconductor manufacturing proposals. ²¹⁰ (Emphasis added.)

The results speak for themselves: India had a higher per capita GDP than China as recently as 1987, but today, China's is over three times as high, and its lead is still growing. ²¹¹

Free trade isn't going to democratize China either, a myth that has been promoted for decades to justify American trade concessions to that country. Beijing is well aware of the threat it faces and has a sophisticated and ruthless strategy combining ancient Confucian cynicism about human nature with the "global best practices" of modern authoritarianism. ²¹² The commercial advantages of this regime are now filling the pockets of everyone in China with the wits to turn a profit, so this authoritarianism now has a huge constituency outside the government itself.

Another version of the "freedom will save us" argument attacks cultural, rather than political, authoritarianism, usually taking Japan as its foil. Now compared to the U.S., Japan's culture is indeed rather closed and insular. It may fairly be described as an ethnocentric, patriarchal, and conformist society, sometimes reminding observers of America in the 1950s. Yet its record of economic innovation has been strong.

The Walkman was not created by some free spirit in a garage in Silicon Valley, but by Kozo Ohson, manager of the tape recorder division at Sony.²¹³ And innovations, such as commercially viable hybrid cars and flat panel TV, have continued to flow in the decades since then. Japan's corporate conformists are today generating more high-tech initial public offerings than the U.S.²¹⁴ So whatever perfectly valid reasons one might have for objecting to that kind of culture, lack of economic creativity is not one.²¹⁵

And if anyone wants to imagine an American advantage due to cultural *diversity*, Europe, with its 23 national languages and 2,500 years of high culture, has us beat hands down. (So does India, by that standard.)

Even if we forget all the above and assume that America does have a fundamental advantage in creativity, most companies, most jobs, and most people are not creative. It's easy to be dazzled by fascinating stories about entrepreneurs into forgetting that *most people are not entrepreneurs*. And most people won't ever be, simply because one can't have entrepreneurs without having a far larger number of people working for them. Even most jobs at genuinely creative companies like Apple Computer are not creative in any serious sense.

POSTINDUSTRIALISM WON'T SAVE US

Postindustrialism is sometimes suggested as a solution to our trade problems (or as a reason to believe they are not problems in the first place). Its most succinct formulation is this:

Manufacturing is old hat and America is moving on to better things.

The postindustrial economy is considerably less attractive today than it was only a few years ago, thanks largely to India's success in computer software and business process offshoring. This discredited the rather odd idea that our competitors were only going to compete in manufacturing. But one still hears about postindustrialism now and then, and the idea played a large role during the 1980s and 1990s in getting Americans to accept deindustrialization. It has been promoted by writers as varied as futurist Alvin Toffler, capitalist romantic George Gilder, techno-libertarian Virginia Postrel, and futurist John Naisbitt.²¹⁶ Newt Gingrich seized upon it as the supposed economic basis of his Republican Revolution of 1994.²¹⁷

Unfortunately, the core ideas of postindustrialism don't stand up well to empirical evidence. Above all, a declining share of manufacturing in GDP is *not* an automatic correlate

of economic progress. Between 1947 and 1966—a period of rapidly advancing technology and rising prosperity—manufacturing actually went *up* slightly as a share of our GDP.²¹⁸ Manufacturing’s share of GDP has indeed fallen in recent years, with services expanding to fill the gap. But this merely reflects the fact that inflation has been lower in manufacturing than in services, due to higher productivity growth in manufacturing. (This is itself a clue that manufacturing might have its advantages!) If one adjusts for the inflation differential, manufacturing’s share has actually been quite stable for the last 30 years or so, and only began to decline around 2000.²¹⁹ This is far too late for transition to a postindustrial economy to explain it, but entirely in line with our burgeoning trade deficit in manufactured goods. And if one looks at the trend not in America’s *production* of manufactured goods, but in our *consumption*, there is no decline at all.²²⁰ The gap between production and consumption is (as explained in the previous chapter) just our trade deficit. So using postindustrialism to justify our trade deficit in manufactures simply presupposes what it is trying to prove.

Nevertheless, postindustrialism remains popular in some very important circles. In the 2006 words of the prestigious and quasi-official Council on Competitiveness, a group of American business, labor, academic and government leaders:

Services are where the high value is today, not in manufacturing. Manufacturing stuff *per se* is relatively low value. That is why it is being done in China or Thailand. It's the service functions of manufacturing that are where the high value is today, and that is what America can excel in. [221](#)

Unfortunately, the above paragraph is simply not true, and manufacturing is not an obsolescent sector of the economy. Low grade “screwdriver plant” final assembly manufacturing is indeed primitive, and can increasingly be done anywhere in the world, making it an intrinsically low-wage activity. But the manufacturing of sophisticated high-tech products is a different matter and remains concentrated in advanced industrial nations. That “Made in China” stamped on the outer casing of fax machines, cellular phones, and other high-tech products often just means that final “kit” assembly took place there. [222](#) The key internal components, which make up a large percentage of the finished product's cost, are frequently still made in high-wage nations like Japan. In the case of fax machines, this is the electro-optical read-write head. In the case of printers, it is the print engine. In the case of watches, it is the movement. Apple's iPod, for example, is assembled in China, but its display module is made in Japan, its video processor chip in Taiwan or Singapore, its memory chip in

South Korea, and its central processing unit in the U.S. or Taiwan—all nations whose average incomes are multiples of China's. [223](#)

Even more important than the value of these components is their value per man-hour of labor required to make them, as this is the ultimate basis of high wages. For example, of the 28,556 jobs created by the iPod outside retailing and distribution, 19,190 were production jobs, of which China captured the most (11,715). But 9,366 were professional jobs, of which high-wage Japan (with 1,140) and the U.S. (with 6,101) captured the lion's share. [224](#) For products whose production cost mainly consists of technology and capital, not low-skilled labor, low-wage nations have no advantage, as technology and capital are not cheaper there. The table below gives a breakdown of the cost structure of the average U.S. manufacturer: [225](#)

Cost Structure

Raw Materials	45.98 %
Labor	21.00 %
Advertising & Marketing	9.00 %
Research & Development	8.50 %

Interest	3.44 %
Transportation	2.90 %
Health & Safety	1.60 %
Energy	1.53 %
Environmental Protection	1.48 %
Land & Rent	1.46 %
Utilities	1.16 %
Software	0.80 %

It has been estimated that direct labor is under 20 percent of production cost for half of U.S. manufacturers.²²⁶ The average cost disadvantage of U.S. manufacturers versus their opposite numbers in low-wage nations is, in fact, estimated to be only 17 percent, a difference obviously often within the reach of smart strategies.²²⁷ This is why manufacturing still exists in high-wage nations in the first place.²²⁸ It is why America *could* be successfully defending blue-collar wages when we are failing and why some other developed nations are succeeding at this better than we are.

About the only thing postindustrialism gets right is that selling a product with a high value per embodied man-hour

almost always means selling embodied know-how. But know-how must usually be embodied in some physical package before reaching the consumer, and manufactured goods are actually a rather good package for embodying it in. Exporting disembodied know-how like design services is definitely an inferior proposition, as indicated by the fact that since 2004, America's deficit in high technology goods has exceeded our surplus in intellectual property, royalties, licenses, and fees. [229](#)

That some individual companies like Apple make a success out of keeping design functions at home and offshoring the manufacturing does not make this a viable strategy for the economy as a whole. Apple is a unique company; that is why it succeeds. And even fabled Apple is not *quite* the success story one might hope for from a trade point-of-view. Due to its foreign components and assembly, every \$300 iPod sold in the U.S. adds, in fact, another \$140 to our deficit with China. [230](#) If sophisticated American design must be embodied in imported goods in order to be sold, it will not help our trade situation.

Meanwhile, other companies are shutting their U.S. design centers and moving them closer to actual production and the know-how that accumulates where it takes place. As Douglas Bartlett, chairman of the printed circuit board manufacturer Bartlett manufacturing in Cary, Illinois, puts it:

Anyone who knows anything about real-world manufacturing knows that the factory floor and the lab form a continuous feedback loop. Unfortunately, virtually none of our trade and economic policymakers know anything about real-world manufacturing.²³¹

So the erosion continues, industry by industry. For example, in March 2007, Chrysler closed its Pacifica Advanced Product Design Center in Southern California, following the closure of nearby centers owned by Italdesign, American Specialty Cars, Porsche, Nissan, and Volvo.²³² Of GM's 11 design centers, only three are still in the U.S.²³³ In the words of Eric Noble of The Car Lab, an automotive consulting company, "Advanced studios want to be where the new frontier is. So in China, studios are popping up like rabbits."²³⁴ This trend bodes extremely ill for the future; as Stephen Cohen and John Zysman explain in their book *Manufacturing Matters*:

America must control the production of those high-tech products it invents and designs—and it must do so in a direct and hands-on way...First, production is where the lion's share of the value added is realized...This is where the returns needed to finance

the next round of research and development are generated. Second and most important, unless [research and development] is tightly tied to manufacturing of the product...R&D will fall behind the cutting edge of incremental innovation...High tech gravitates to the state-of-the-art producers. [235](#)

Neither are individual technological or entrepreneurial genius going to save America, no matter how impressive they look on the cover of glossy magazines. Richard Florida and Martin Kenny have documented the limited (albeit real) value of stand-alone inventive genius in their book *The Breakthrough Illusion*. [236](#) Despite the impressive U.S. record in pure innovation, innovations actually fail to translate into mass production (and thus high employment) industries here as well as they do in Japan and elsewhere. The fragmentation of America's high-tech research into thousands of small companies in Silicon Valley and elsewhere may be optimal for innovation itself, but it is *not* optimal for mass commercialization. [237](#) Indeed, it has the unfortunate side effect of making it exceptionally easy for foreign companies to buy up American innovations *à la carte*. Among other things, this has helped make Japanese, rather than American, companies the ultimate commercial beneficiaries of much recent Pentagon-funded research.

A small American company named Ampex in Redwood City, California, encapsulates everything that is wrong with postindustrialism. This leading audio tape firm invented the video cassette recorder in 1970 but bungled the transition to mass production and ended up licensing the technology to the Japanese.²³⁸ It collected millions in royalties all through the 1980s and 1990s and employed a few hundred people. Its licensee companies collected *tens of billions* in sales and employed *hundreds of thousands* of people.

So when someone like self-described “radical free trader” Thomas Friedman writes that “there may be a limit to the number of good factory jobs in the world, *but there is no limit to the number of good idea-generated jobs in the world,*”²³⁹ (emphasis in the original) this is simply false.²⁴⁰ There is nothing about the fact that ideas are abstract and the products of factories concrete that causes there to be an infinite demand for ideas. The limit on the number of idea-generated jobs is set by the amount of money people are willing to *pay for* ideas (either in their pure form or embodied in goods) because this ultimately pays the salaries of idea-generated jobs.

The final killer of the postindustrial dream, of course, is offshoring, as this means that even if capturing primarily service industry jobs *were* a desirable strategy, America can’t reliably capture and hold these jobs anyway. The caliber of jobs being offshored—which started with fairly mundane jobs

such as call centers—is relentlessly rising. According to a 2007 study by Duke University’s Fuqua School of Business and the consulting firm Booz Allen Hamilton:

Relocating core business functions such as product design, engineering and R&D represents a new and growing trend. Although labor arbitrage strategies continue to be key drivers of offshoring, sourcing and accessing talent is the primary driver of next-generation offshoring...Until recently, offshoring was almost entirely associated with locating and setting up IT services, call centers and other business processes in lower-cost countries. But IT outsourcing is reaching maturity and now the growth is centered around product and process innovation. [241](#)

Among sophisticated business functions, product development, including software development, is now the second-largest corporate function being offshored. Offshoring of sophisticated white-collar tasks such as finance, accounting, sales, and personnel management is growing at 35 percent per year. [242](#) Meanwhile, despite a few individual companies bringing offshored call centers back home, offshoring of call centers and help desks continues to grow at a double-digit [243](#) pace.

It is no accident that, as noted in the Foreword, some of America's corporate elite are now starting to question postindustrialism, about which they were utterly gung-ho only a few years ago. In the February 2009 words of General Electric's chairman, Jeffrey Immelt:

I believe that a popular, 30-year notion that the U.S. can evolve from being a technology and manufacturing leader to a service leader is just wrong. In the end, this philosophy transformed the financial services industry from one that supported commerce to a complex trading market that operated outside the economy. Real engineering was traded for financial engineering. [244](#)

Immelt has since argued that the U.S. should aim for manufacturing jobs to comprise at least 20 percent of all jobs—roughly double their current percentage. [245](#) Only a few years ago, this idea would have been dismissed as an ignorant and reactionary piece of central planning, especially if it had not been proposed by a respected Fortune 500 CEO.

MANUFACTURING AMERICA'S DECLINE

The claims of an American manufacturing revival that surface

now and again are false. They are based on anecdotes, massaged figures, and airbrushing out the dependence of revived companies upon imported components. For example, the much-heralded revival of the American TV industry based on digital high-definition television (HDTV) never actually happened, and Japanese manufacturers still dominate the industry today.²⁴⁶

Even the vaunted Boeing aircraft company, the single largest U.S. manufacturing exporter, has been relentlessly hollowing itself out of real manufacturing for decades.²⁴⁷ Boeing and similar companies call this “systems integration.” This sounds sophisticated, but doesn’t change the reality that Boeing has been morphing into a “Lego brick” assembler of European, Japanese, and increasingly Chinese components.²⁴⁸ For example, the entire composite wing—master key to aircraft design because the wing determines the weight the rest of the plane can carry—for the Boeing 787 is built in Japan.²⁴⁹ (By contrast, Boeing’s European Airbus competitor by deliberate policy outsources no more than 35 percent of its work.)²⁵⁰

As also noted in the Foreword, Boeing has realized it got burned by this strategy²⁵¹ and is trying to bring more manufacturing back inside the company and back to the U.S. So much for inevitable globalization. But it remains to be seen

whether this emerging countertrend can reach fruition on its own, or whether it is a cry of help from a corporate America that has so badly damaged its competitive position with its hollow-corporation strategy that it will need the help of tariff walls to recover. (This is especially likely outside industries, like aircraft, in which America is still relatively strong.)

Every few years there emerges an entire new industry, like hybrid cars, which has no strong American players—“strong” meaning not dependent on repackaging imported key components or licensing foreign technology.²⁵² And because America’s share of world production in “sunrise” industries continues to drop, this problem is on track to get worse, not better. For example, the U.S. invented photovoltaic cells, and was number one in their production as recently as 1998, but has now dropped to fifth behind Japan, China, Germany, and Taiwan.²⁵³ Of the world’s 10 largest wind turbine makers, only one (General Electric) is American.²⁵⁴ Over time, the industries of the future inexorably become the industries of the present, so this is a formula for automatic economic decline.

The U.S. has been running a deficit in high technology since 2002.²⁵⁵ We even run a deficit in high technology with China,²⁵⁶ a nation that is supposedly specializing in low-end manufacturing so we can specialize in the high end. But China

is rapidly climbing the industrial food chain. In 2009, it exported \$301 billion worth of electrical machinery and equipment, but only \$100 billion of apparel²⁵⁷ and a mere \$7.8 billion of that stereotypical item of “Chinese junk,” toys.²⁵⁸ As a result, whereas in 1989 only 30 percent of America’s imports from China competed with high-wage industries in the U.S., by 1999 that percentage had reached 50 percent, and it has risen further since then.²⁵⁹ Chinese imports now constitute 83 percent of our non-oil trade deficit²⁶⁰ and over 100 percent of our deficit in technology (i.e., we run a surplus against the rest of the world).²⁶¹

America’s areas of industrial advantage, measured by what we are a net exporter of, are few and shrinking: only aircraft, aircraft parts, weapons, and specialized machine tools.²⁶² In 2007, the nation that put a man on the moon was a *net importer of spacecraft*.²⁶³ Given that many of these weapons and machine tools are aviation-related, this means that essentially *all* our net manufacturing exports are a legacy effect of 60 years of Pentagon industrial policy. (We are nonetheless told by free-market ideologues that industrial policy can never work; more on that in Chapter Nine.)

Even our economic rivals are beginning to worry about our health. Akio Morita, the late chairman of Sony, once accused

the U.S. of “abandoning its status as an industrial power.”²⁶⁴
Our rivals have problems of their own, of course, but suffer far less from deindustrialization than we do. Both Japan and Germany have booming manufacturing exports. (Germany was the world’s number one exporter as late as 2008.)²⁶⁵
Both employ a larger percentage of their workforce in manufacturing. Both are high-wage nations, not sweatshop dictatorships. What is their secret? To some extent, simply more manufacturing-oriented business cultures. Also financial systems more oriented to the long term by greater use of bank debt rather than stock market equity, combined with devices like cross-shareholdings to repel speculators seeking short-term gains.²⁶⁶ And more state investment in worker training.²⁶⁷ But also fundamental are Japan’s and the EU’s non-tariff trade barriers, which have helped preserve their economies against being hollowed out of manufacturing.

Many of these barriers are not actual laws, and thus lurk below the surface to casual examination. For example, in the words of William Greider of the liberal magazine *The Nation*:

In the European Union, supposedly liberalized by unifying fifteen national markets, the countries had more than seven hundred national restrictions on import quantities, many of which were converted to so-called voluntary restraints. The UK’s Society of

Motor Manufacturers and Traders maintained a long-standing ‘gentlemen’s agreement’ with the Japanese Automobile Manufacturers Association that effectively limited Japanese cars to 11 percent of the British market. France and Italy had tougher restrictions. The EU periodically proclaimed its intention to eliminate such informal barriers but, meanwhile, it was tightening them. During the recessionary conditions in late 1993, Japanese auto imports to Europe were arbitrarily reduced by 18 percent. [268](#)

Europe has other tricks up its sleeve, such as using discretionary enforcement of antidumping laws to pressure foreign companies into locating technology-intensive functions in Europe. [269](#) And the EU has an institutional bias towards reciprocal market-opening agreements with foreign nations. [270](#) This all suggests that overt or covert protectionism is a necessary part of any solution.

CURRENCY REVALUATION WON’T SAVE US

It is sometimes suggested that our trade problems will go away on their own once currency values adjust. Bottom line? *A declining dollar will eventually solve everything.* But even if

we assume currencies will eventually adjust, there are still serious problems with just letting the dollar slide until our trade balances.

For one thing, our trade might balance only after the dollar has declined so much that America's per capita GDP is lower, at prevailing exchange rates, than Portugal's.²⁷¹ A 50 percent decline in the dollar from 2009 levels would bring us to this level.²⁷² How big a decline would be needed to balance our trade nobody really knows, especially as we cannot predict how aggressively our trading partners will try to employ subsidies, tariffs, and non-tariff barriers to protect their trade surpluses.

Dollar decline will write down the value of wealth that Americans have toiled for decades to acquire. Ordinary Americans do not care about the internationally denominated value of their money *per se*; they will experience dollar decline as a wave of inflation in the price of imported goods. Everything from blue jeans to home heating oil will go up, with a ripple effect on the prices of domestically produced goods.²⁷³

A declining dollar may even *worsen* our trade deficit in the short run, as it will increase the dollar price of many articles we no longer have any choice but to import, foreign competition having wiped out all domestic suppliers of items as prosaic as fabric suitcases and as sophisticated as the epoxy

cresol novolac resins used in computer chips.²⁷⁴ (Of the billion or so cellular phones made worldwide in 2008, not one was made in the U.S.) Ominously, the specialized skills base in the U.S. has been so depleted in some industries that even when corporations do want to move production back, they cannot do so at feasible cost.

Another problem with relying upon dollar decline to square our books is that this won't only make American exports more attractive. It will also make foreign purchases of American assets—everything from Miami apartments to corporate takeovers—more attractive, too. As a result, it may just stimulate asset purchases, if not combined with policies designed to promote the export of actual goods.

A spate of corporate acquisitions by Japanese companies was, in fact, one of the major unintended consequences of a previous currency-rebalancing effort: the 1985 Plaza Accord to increase the value of the Japanese Yen, which carries important lessons for today. Combined with some stimulation of Japan's then-recessionary economy, it was supposed to produce a surge in Japanese demand for American exports and rectify our deficit with Japan, then the crux of our trade problems. For a few years, it appeared to work: the dollar fell by half against the yen by 1988 and after a lag, our deficit with Japan fell by roughly half, too, bottoming out in the recession year of 1991.²⁷⁵ This was enough for political agitation against Japan to go off the boil, and Congress and

the public seemed to lose interest in the Japanese threat. But only a few years later, things returned to business as usual, and Japan's trade surpluses reattained their former size. Japan's surplus against the U.S. in 1985 was \$46.2 billion, but by 1993 it had reached \$59.4 billion.²⁷⁶ (It was \$74.1 billion in 2008 before dipping with the recession.)²⁷⁷

Relying on currency revaluation to rebalance our trade also assumes that the economies of foreign nations are not rigged to reject our exports *regardless* of their price in foreign currency.²⁷⁸ Many nations play this game to some extent: the most sophisticated player is probably still Japan, about which former trade diplomat Clyde Prestowitz has written:

If the administration listed the structural barriers of Japan—such as *keiretsu* [conglomerates], tied distribution, relationship-based business dealings, and industrial policy—it had described in its earlier report, it would, in effect, be taking on the essence of Japanese economic organization.²⁷⁹

We cannot expect foreign nations to redesign their entire economies just to pull in more imports from the U.S.²⁸⁰

In any case, the killer argument against balancing our trade

by just letting the dollar fall comes down to a single word: *oil*. If the dollar has to fall by half to do this, this means that the price of oil must double in dollar terms. Even if oil remains denominated in dollars (it is already *de facto* partly priced in euros) a declining dollar will drive its price up. The U.S., with its entrenched suburban land use patterns and two generations of underinvestment in mass transit, is exceptionally ill-equipped to adapt.

THERE IS NO FREE MARKET IN CURRENCIES

There is an even more fundamental problem with just waiting for the free market to fix currency values: in reality, *there is no free market in currencies*. The advantages to be gained by manipulating a nation's currency are simply too large for governments to resist the temptation. For example, according to the Automotive Trade Policy Council, Japan's currency manipulation gives its exporters a per-car advantage averaging \$4,000 and reaching up to \$10,000 on high-end vehicles like the Infiniti.^{[281](#)}

China, currently the most notorious offender, manipulates the exchange rate between its yuan and the dollar mainly by preventing its exporters from using the dollars they earn as they wish.^{[282](#)} Instead, they are required to swap them for domestic currency at China's central bank, which then "sterilizes" them by spending them on U.S. Treasury securities

(and increasingly other, higher-yielding, investments) rather than U.S. goods. As a result, the price of dollars is propped up by a demand for dollars which does not involve buying any actual American exports. The amounts involved are astronomical: as of 2008, China's accumulated dollar-denominated holdings amounted to \$1.7 trillion, an astonishing 40 percent of China's GDP.²⁸³ The China Currency Coalition, a Washington lobby group, estimated in 2005 that the yuan was undervalued by 40 percent;²⁸⁴ past scholarly estimates have ranged from 10 to 75 percent.²⁸⁵

Forcing China to stop manipulating its currency is sometimes suggested as a solution.²⁸⁶ The most recent effort in this direction is the Currency Reform for Fair Trade Act of 2009.²⁸⁷ This bill would make it official American policy to deem China's currency manipulation an illegal subsidy under WTO rules, thereby claiming the right to apply countervailing duties if China does not stop.

But this effort, though well-intentioned, is misguided. Above all, China's currency is manipulated relative to our own only *because we permit it*, as there is no law requiring us to sell China our bonds and other assets. We can, in fact, end this manipulation at will. All we would need to do is bar China's purchases or tax them to death. This is roughly what the Swiss did in 1972, when economic troubles elsewhere in

the world generated an excessive flow of money seeking refuge in Swiss franc-denominated assets. This drove up the value of the franc and threatened to make Swiss manufacturing internationally uncompetitive. To prevent this, the Swiss government imposed a number of measures to dampen foreign investment demand for francs, including a ban on the sale of franc-denominated bonds, securities, and real estate to foreigners. ²⁸⁸ Problem solved.

If China's currency manipulation is so harmful and easy to stop, why haven't we done something about it long ago? Mainly because if China ever did stop bingeing on American debt and assets, this would entail it ceasing to ship hundreds of billions of dollars per year of (quite cheap, as it mostly gets the low interest rate paid on government bonds) capital to the U.S. If we didn't then raise our abysmal savings rate to take up the slack, this would sharply raise our interest rates, simply by the operation of supply and demand for capital. So it is *our own inability to raise our savings rate* that is the binding constraint here, not anything China does or does not do. We should indeed end China's currency manipulation, but this is something we must do for ourselves, not twist China's arm to do. Ironically, China is probably doing us a favor by not giving in to our pressure until we are ready to handle the consequences.

There is an even more fundamental question here. Why treat floating exchange rates as an ideal in the first place? The tacit

presumption is built into the debate over exchange-rate manipulation that the alternative is floating rates. (The idea that the underlying problem is interference with the free market appeals mightily to people ideologically committed to free markets.) But, to be quite honest, what we really want isn't floating rates at all: it's just manipulated rates more advantageous to the U.S. There's nothing wrong with this—we have as much right to play the international economic game for our own benefit as any other nation—but we shouldn't delude ourselves into thinking it's a free-market solution.

The reality? Our choice isn't fixed vs. floating rates, it's fixed vs. manipulated. And if exchange rates are destined to be manipulated no matter what, then going back to an explicit fixed-rate system, like the Bretton Woods agreement discussed in the previous chapter, might well be the best solution. Fixed exchange rates are, in fact, precisely the outcome when *everybody* manipulates their exchange rate, reaches a stand-off, and codifies the result.

China must eventually stop manipulating its currency at some point because the further the manipulated rate departs from the rate that would otherwise prevail, the more expensive this gets. The longer China keeps at it, the greater China's future loss because the size of China's dollar-denominated holdings, and their likely future drop in value, both grow. Pegging the yuan to a declining dollar also raises inflation in

China by raising the price of imports, especially oil, and encourages financial speculation. [289](#)

Yuan-dollar unpegging is already happening, albeit in very small steps. China first started diversifying its reserve holdings away from the dollar (which has this effect) in July 2005, and from then until July 2008 allowed the yuan to rise from 8.28 to the dollar to 6.83, where it has since been held nearly steady. Does this mean the problem will solve itself automatically? No. For a start, the aforementioned appreciation, while showcased by Beijing, is nominal appreciation; after adjusting for inflation, the change was far smaller: about two percent. [290](#) In any case, as Bush Treasury Under Secretary for International Affairs David McCormick put it in 2007, a more expensive yuan:

Will not provide a magic bullet for solving the problems of American industries facing overseas competition...We have already seen the resilience of China's exporters to currency appreciation. [291](#)

This is so because Chinese currency manipulation is, of course, only one facet of China's low-cost strategy. The China Price Project at the University of California at Irvine has estimated its various components thus: [292](#)

Chinese Cost Advantages

Wages	39.4%
Subsidies	16.7%
Network Clustering ²⁹³	16.0%
Undervalued Currency	11.4%
Counterfeiting & Piracy	8.6%
Foreign Direct Investment	3.1%
Health & Safety Neglect	2.4%
Environmental Neglect	2.3%

Even if China did revalue its currency, it has enough other tricks up its sleeve, in the form of non-tariff barriers, that it could go on its merry way and still leave America with trade almost as unbalanced as before. Protectionism doesn't only mean obvious policies like tariffs and quotas; it also includes local content laws, import licensing requirements, and subtler measures (some of them covert, hard to detect, or infinitely disputable) such as deliberately quirky national technical standards and discriminatory tax practices. And it includes outright skullduggery such as deliberate port delays, inflated customs valuations, selective enforcement of safety standards,

and systematic demands for bribes.²⁹⁴ One study by the Congressional Research Service identified 751 different types of barriers to American exports worldwide.²⁹⁵

Critics who go the next logical step and demand that China eliminate these covert trade barriers are unrealistic. Getting foreign nations to change domestic policies for the benefit of foreigners is a tricky matter even with polite liberal democracies such as Canada. Expecting this to happen with the authoritarian nationalists of Beijing is laughable. Even if China's protectionist policies actually hurt it—a repeated claim of free traders—China's government obviously doesn't think so, as it chooses to define its own national interest. And China is a grandmaster of evading foreign economic pressure. It has thwarted, for example, the market opening agreements it made upon joining the World Trade Organization in 2001, often honoring their letter while evading their spirit.²⁹⁶

The ongoing decline of the dollar, combined with recession, has already produced a dip in our trade deficit in 2009, so we may be fooled into thinking the problem is correcting itself. But our trade balance also temporarily improved due to recession in 1970, 1973, 1981, and 1991.²⁹⁷ So we may yet again decide to let our underlying problems continue to fester. This is a false salvation to watch out for very carefully.

Chapter 4

Critiques of Free Trade to Avoid

Because free trade has so many flaws and causes so many problems, it is tempting to throw at it every criticism we can think of. After all, if it is wrong, why not? But this would be a mistake. It would lead down time-wasting blind alleys, undermine attempts to ignite fruitful debate on the issue, hand free traders spurious arguments they can win, and ultimately mislead the public about the right alternatives. Because, like it or not, some of the most popular critiques of free trade in circulation are mistaken.

Some such criticism has alienated itself from the political mainstream that runs America by its openly anticapitalist, socialist, or even anarchist character. This invites automatic rejection by anyone who does not share its radical premises, as few voters or people in power do. Such criticism can even be counterproductive when it gives the public the impression that only its premises constitute good grounds to reject free trade, implying that anyone who does not share them should accept it. That is when the sheer *antics* of radical critics don't give opposition to free trade a freakish image that forecloses discussion with a snigger and a video clip of some teenager with green hair smashing a Starbucks window. That kind of radicalism certainly has its place in America (Boston Tea Party, anyone?) but street theatre is only effective as part of an overall strategy. The battle over free trade will be won or lost

in Middle America, not Greenwich Village.

Only an appeal to *the self-interest of the average American voter* will shift policy. So it is best to avoid mushy complaints like the idea that free trade is bad because it endorses a materialistic way of life or an obsession with economic efficiency. To some extent, of course, it may, and this is easy to bundle into a feel-good package that connects to a lot of other important issues.²⁹⁸ But this is really a critique of consumer society as a whole, which is not something Congress can legislate out of existence. Free trade is.

Another idea to avoid is that imports as such are bad—an easy attitude to slip into tacitly even if one does not literally believe this. Imports constitute consumption, which we *must* define as good if we embrace broadly shared prosperity and thus a consumer society. We must, in fact, assume imports are good to enable some of the most potent arguments *against* free trade. For example, free trade can cause trade deficits, run down a nation's currency, make imports more expensive, and thus reduce living standards. So the anti-free trade position can actually be the pro-imports position in the long run! (This especially should be pointed out when free traders act as if they were defending the very concept of trade, as they often do.) Nobody serious wants to turn the United States into North Korea, which seals itself off from imports entirely.²⁹⁹

GO FOR THE JUGULAR: THE HARD ECONOMICS

Only destroying the credibility of the actual hard economics of free trade will destroy the power of free traders, by destroying their reputation for technocratic competence and the moral high ground that flows from this in a technocratic society. Therefore criticism of free trade must focus on the jugular vein of its economics, not side issues like culture. These issues are profoundly important in their own right, and naturally emotionally vivid, but this doesn't make them effective tools for ending free trade. In public debate, what people tend to take away from side-issue critiques is that if criticism of free trade is about side issues, then the economics itself must make sense. This is fatal, as most people naturally assume that the *economics* of free trade should determine whether we continue it. Side-issue critiques are also too easy for free traders to respond to by offering non-trade-related interventions to fix any given problem, combined with continued free trade (which has been elevated to a formal ideal by economists like arch-free trader Jagdish Bhagwati of Columbia University). [300](#)

For example, protection of movies and magazines is a legitimate issue, but it is a cultural question that cannot be settled on economic grounds either way. It is, however, certainly illogical to demand that the world accept cultural homogenization because the protection of local cultures against Disneyfication interferes with free trade. Indeed it does, but we don't export weapons to our military enemies

(even when this might be profitable) because we recognize that arms are not essentially economic in nature and therefore ought not be governed by economic logic.³⁰¹ No economic calculation can determine, for example, whether protecting a separate Canadian film industry is a boon to Canadian culture or just a subsidy for mediocre movies. That question, which is a live issue under NAFTA, can only be settled by film critics and audiences.

NO NEED FOR VILLAINS

If free trade is wrong, then it is coldly, factually wrong on its merits, and turning it into a drama of innocents and villains is unnecessary.

Sometimes the Third World is presented as an innocent victim of a First World trying to use free trade to keep it down. This view was expressed by the former Prime Minister of Malaysia, the bigoted but not unintelligent Mahathir bin Mohamad, thus:

Japan was developing at a time when the Western countries did not believe that Eastern countries could actually catch up with the West, so Japan was allowed. And then, of course, later on, when Japan appeared to be doing too well all the time, the yen was revalued upwards in order to make Japan less

competitive. You can see that these are deliberate attempts to slow down the growth in Japan... and after that, of course, Southeast Asian countries, even Malaysia, began to develop fast, and there seemed to be a fear that Eastern countries might actually pose a threat to Western domination, and so something had to be done to stop them. [302](#)

Mahathir basically accuses the developed world of seeking to lock in its present industrial advantage, leaving the rest of the world supplying it raw materials and low-value industrial scraps. Third World nations often (understandably) perceive this as a rerun of colonialism.

But it is implausible that the First World is doing this. For a start, if it has the control over the world economy Mahathir imagines, then it should have succeeded by now. Yet Third World giants like China and India surge ahead. It is also unlikely that the First World corporations which actually *conduct* international trade serve the interests of the nations in which they are headquartered, as opposed to their own profits. Economic, political, and technological power are just too widely distributed in the world today for the literal fulfillment of Mahathir's scenario, even if anyone seriously wanted it (which is doubtful).

Sometimes the Third World is cast as the villain. But

whatever harm Third World nations like China have done to America through trade, most has been due to our own foolishness in embracing free trade. The protectionist America of 1925 would have been barely scratched. Only a limited amount consists of things, such as industrial espionage and brand piracy, which really are inexcusable outright theft. (These are a genuine problem: two-thirds of the American computer software used in China is stolen, according to one estimate, ³⁰³ and copyright theft there is estimated to cost the U.S. \$2.6 billion a year.) ³⁰⁴

Another villain theory is that big corporations are evil—an accusation heard at both extremes of the political spectrum, though the Right tends to use words like “treasonous.” But corporations don’t behave as they do because they are evil (or disloyal). They behave as they do because the rules they operate under make certain behavior profitable. If free trade is legal, we should not get morally indignant when corporations fire their high-cost American workforces and move production overseas. We should change the rules that allow this. ³⁰⁵ Competitive pressures force even corporations that would rather not act this way—they certainly exist—to go along.

FAIR TRADE IS NOT ENOUGH

The idea of fair trade is very appealing. Unfortunately, it will

be only a small part of any trade solution. Fair trade in goods like coffee is a fine thing because there exists a clear idea of unfair practices in how coffee importers treat coffee farmers and how to avoid them. That sort of fair trade basically consists in First World consumers voluntarily not using the full strength of their bargaining position with Third World producers. This is admirable. But fair trade embraces less than one percent of trade in cocoa, tea and coffee, so it will have a small impact for the foreseeable future. [306](#)

Can the idea scale? Perhaps. But there is currently a huge sandbag blocking it from further acceptance: mainstream economics holds that it is largely futile or counterproductive. For example, it holds that the price supports implied by fair trade encourage overproduction and drive down the price for other growers. So this economics must carefully be picked apart, using its own conceptual vocabulary, before fair trade can even get a decent hearing outside those already committed to it.

The more important meaning of fair trade concerns issues like what is the fair share for U.S. firms in the Chinese airliner market? Because the greater share of America's trade problems concerns products like airliners, not coffee. These high-tech, high-value products are decisive for U.S. trade performance and will be the main objects of any future American industrial policy. These products are what American jobs will depend on.

Unfortunately, the concept of fairness is a political minefield. A political coalition strong enough to abolish free trade will need support on both sides of the aisle, and these sides disagree about what is fair every day. This problem is even worse when foreign societies are involved (as they must be in trade) because different societies define fairness differently. The Japanese, for example, consider it unfair to lay off workers in a recession. [307](#) Many European countries consider America's antiunion "right to work" laws unfair. As former trade diplomat Clyde Prestowitz has pointed out:

Because the law assumes that American-style capitalism and laissez-faire international trade are not only good but morally right, it implicitly defines deviations from such a system as 'unfair.' There is no provision for the possibility of a different system or for dealing with problems that arise not out of unfairness but from the grinding together of systems that simply do not mesh well. [308](#)

As a result, appealing to fairness to resolve trade disputes, or judging foreign actions by a standard of fairness, is unlikely to solve anything. For example, there is no particularly good reason why currency manipulation should be considered "unfair." Currency manipulation is a *tactic*, and while the U.S.

should certainly fight back to restore advantageous currency values, this is about protecting the national economic interest, not ethical justice *per se*.

Fairness isn't even a particularly meaningful concept in much of trade economics, which turns on technicalities like capital flows and economies of scale. And fairness isn't the objective of trade policy for the most part, anyhow. Prosperity (of ourselves or others) is. Decent people naturally hope these will coincide, but one can't just *a priori* assume this. China's authoritarianism, for example, is morally objectionable in a dozen different ways, but it has raised the living standards of the Chinese. If prosperity is what we want, then we need to admit that prosperity is what we're after (subject to whatever ethical constraints we believe in).

It is similarly pointless to argue whether America's trade mess is the "fault" of foreign nations or ourselves. Realism demands that we assume foreign nations will take advantage of any opportunities we put before them. And even if foreigners really are to blame sometimes, we don't have control over their actions; we have control over our own.

FORGET A LEVEL PLAYING FIELD

The common complaint that "all we want is a level playing field" is just another way of asking for fair trade. A true level playing field would require not just equal rules for

international trade, but also that nations have the same *domestic* economic policies, as these can also confer an export advantage. There are literally thousands of places in an economy where export subsidies can be hidden, from the depreciation schedules of the tax code to state ownership of supplier industries, land use planning, credit card laws, non-performing loans, cheap infrastructure, and tax rebates. So a true level playing field would require America to supervise the domestic policies of foreign nations, which is obviously not feasible. Even if we reach agreements on paper to end these subsidies, we still have to enforce these agreements on the ground.

Foreign governments often face strong domestic political pressures to keep such subsidies in place even when they want to strike a deal with the U.S. to eliminate them. China, for example, is full of effectively bankrupt state-owned companies that can't be allowed to collapse for fear of unleashing a tidal wave of unemployment. In other nations, subsidies are products of the day-to-day political bargaining that goes on in every country as governments buy political support and buy off opposition, so eliminating subsidies just to keep America happy would risk unraveling the balance of power. Our own difficulties abolishing unjustified agricultural subsidies illustrate just how hard it is to repeal entrenched subsidies.

Level playing fields tilt the other way, too: Americans tend

not to realize how many subsidies our *own* economy contains. But judging by the same standards the Commerce Department applies to foreign nations, they are legion. ³⁰⁹ Agricultural subsidies are just the beginning, and already a flashpoint of international trade disputes. (They basically scuttled the Doha round of WTO talks in 2008.) But there are thousands of others, ranging from the Import-Export Bank (cheap loans for exporters) to the Hoover dam (cheap electricity). And that is just on the federal level; states and localities constantly bid subsidies against each other to attract businesses. Every tax credit, from R&D and worker training on down, subsidizes *something*, and if that something is exported, then it constitutes an export subsidy. So unless we are prepared to have foreign bureaucrats pass judgment on all these policies, subsidies both here and abroad are unavoidable and a true level playing field is impossible. And if a level playing field is impossible, then no free-market solution will ever balance trade, and balanced trade will have to be some kind of managed trade.

LABOR STANDARDS ARE NOT ENOUGH

Trying to solve the problems of free trade by going after low foreign labor standards is understandable. The AFL-CIO not unreasonably asserted in 2004 that China's repression of labor rights gives its exporters a 43 percent cost advantage. ³¹⁰

Chinese workers are denied the right to form unions, are often paid less than China's own very low minimum wage, and are denied overtime pay. And if they really get out of line, there is always China's network of *laogai* ("reform through labor") prison camps—which conveniently supply slave labor for the manufacturing of goods for export. [311](#)

But if free trade is bad for labor, then we should end it, not patch it up, as its fundamental economic defects are too profound for a few labor agreements to fix. These agreements are worth having, as they will (if actually enforced) improve matters somewhat, but they are not the fundamental solution. As United Steelworkers president Leo Gerard puts it:

The fact of the matter is you can't fix NAFTA by putting in environmental rights and labor rights and pretending that will fix it. In fact, Canada's environmental and labor standards are higher than America's. Mexico's are also higher, but they're not enforced. [312](#)

Another problem with using trade as leverage to raise foreign labor standards is that some nations with lower labor standards than the U.S. are democracies, so this amounts to telling foreign nations that they don't have the right to set their own labor laws. Imagine if nations like Germany and

Sweden, where unions enjoy rights undreamed of in the U.S., such as guaranteed board representation, were to demand that Alabama, Texas, and similar states rescind their right-to-work laws as a prerequisite for being allowed to export to the EU! And what about poor countries where unions are legal, like India? Reasonable labor rights there haven't changed the fact that wages are still desperately low.

A RACE TO THE BOTTOM?

The notorious “race to the bottom,” in which free trade causes the lowest standard in the entire world for wages, working conditions, or environmental protection to become the global norm, is a half-truth that needs to be carefully untangled.

The good news is that it is highly unlikely that free trade will ever literally cause the world's lowest standard for wages, worker rights, or environmental protection to become the world standard. While there are indeed pressures in that direction, there are also considerable countervailing pressures. If there weren't, South Korea would still be poorer than Zambia, as it was as recently as 1970.³¹³ And if a small and relatively powerless nation like South Korea can buck this tide, then America certainly can—if we play our cards correctly, which we have not been doing.³¹⁴ This is the real scandal: not that we have been caught in a hopeless situation, but that we have failed to cope with a situation we should have

been able to manage reasonably well.

Free trade certainly generates downward pressure on wages for most Americans, but it is vanishingly unlikely ever to reduce American wages to present Chinese levels. Among other things, 70 percent of America's economy is in industries (from restaurants to government) that are not internationally traded.³¹⁵ So the vast majority of our economy has no direct exposure to international trade. Since average wages are determined by average productivity³¹⁶ and nothing low-wage foreigners do can reduce productivity in the nontraded parts of our economy,³¹⁷ there is no plausible way the entire American economy can be dragged down through trade alone.

The economic mechanism implied by the idea of a race to the bottom is real, but not infinitely powerful. Standards don't automatically hit bottom simply because one country has lower standards. That country also has to be a sufficiently successful competitor to push countries with higher standards out of the industry in question. So if countries with higher standards have a productivity advantage, a quality advantage, or some other factor balancing the cost of their higher standards, the lower standard won't win out.³¹⁸ It is success or failure in bringing these countervailing factors together that determines the fate of advanced economies like the U.S.; industrial policy (which we will look at in Chapter Nine) is about doing precisely that.

The industrial sectors in which a race to the bottom really does occur are generally low-value sectors where most of the cost of production is un-skilled or semiskilled labor. These are intrinsically low-wage industries that are of little value to American workers, simply because they don't pay the kind of wages it takes to live in a developed country. The far bigger problem is America's eroding global position in high skill, high-wage industries—a race we are losing largely to other *developed* nations.

It is definitely a mistake to reduce all of America's trade problems to cheap foreign labor. Cheap labor would indeed explain our problems with China, India, and the rest of the developing world, but it cannot explain our huge deficits with other high-wage countries such as Japan (\$74.1 billion in 2008)³¹⁹ and the EU (\$95.8 billion).³²⁰ If trade were merely about cheap labor, Bangladesh and Burundi would dominate the world economy.

Note, as a corollary to the above, that because most of our economy is nontradable, weak *domestic* productivity growth has actually done America more harm in recent decades than free trade. Turning free trade into a catch-all explanation for all our economic problems will draw attention away from needed solutions to our other economic defects. Foreign competition must not become an excuse for all of our economic failures from short-termist finance to bad secondary education and crumbling infrastructure.

FREE TRADE DOESN'T GUT GOVERNMENT

Another popular half-truth is that free trade guts government by destroying its ability to tax. But the hard fact is that over the 1965-2006 period of increasingly free trade, government revenue has simply not fallen in any of the advanced economies. The table below tells the story.

Tax Revenue as a Percentage of GDP ³²¹

Country	1965	1980	1990	2000	2006	Change 1965-2006
US	24.7%	27.0%	26.7%	29.6%	28.0%	+3.3%
Japan	18.3%	25.1%	30.1%	27.1%	27.9%	+9.6%
Germany	31.6%	37.5%	35.7%	37.9%	35.6%	+4.0%
France	34.5%	40.6%	43.0%	45.3%	44.2%	+9.7%
Italy	25.5%	30.4%	38.9%	42.0%	42.1%	+16.6%
UK	30.4%	35.2%	36.8%	37.4%	37.1%	+6.7%
Canada	25.6%	30.7%	35.9%	35.8%	33.3%	+7.7%
Denmark	29.9%	43.9%	47.1%	48.8%	49.1%	+19.2%
Sweden	35.0%	47.5%	53.6%	54.2%	49.1%	+14.1%

Australia	21.9%	27.4%	29.3%	31.5%	30.6%	+8.7%
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So whatever else increasingly free trade has been doing, withering away the state has not been it. Neither has the tax burden shifted from corporations: developed nations' average taxation of corporate income *rose* from 2.2 percent of GDP to 3.5 percent over the 1965-2004 period.³²²

But isn't it axiomatic that higher taxes render nations less competitive, something they cannot afford now that free trade enables their economic bases to pack up and flee elsewhere? Doesn't the state wear a "golden straitjacket," as they say, these days?³²³ Yes and no. Above all, taxes are not *in themselves* an economic drag, as the people and corporations that pay them get something back: public services. It is the cost-benefit relationship that determines the competitiveness of a nation's tax regime, not the cost alone. Incompetent public services, misguided social programs, and military adventures unrelated to real national security needs indeed impose an economic burden. But taxes well spent do not. A weak welfare state certainly does not confer an export advantage, as comparison between the United States and the European Union makes clear: the relatively spartan U.S. is running the huge trade deficit, not the relatively generous EU

Unwise government spending indeed makes a population poorer by wasting its money. It undermines incentives for

work and investment. High-tax countries where taxes are badly spent, such as Britain, have indeed damaged their quality of life. But they remain roughly as internationally competitive as they otherwise would be. This logic breaks down at the extremes, but is valid within the range of taxation present in most major countries. It is simply not the case that high-tax countries where taxes are well spent, like Sweden, are internationally uncompetitive, according to the standard rankings.³²⁴

Even when taxes *are* misspent, the cost appears to come mostly out of the hide of the taxpayer and the vitality of the domestic economy, not out of the economy's international competitive position. It is easy enough to see why. If taxes get too high in Britain and London banks try to charge more in order to compensate, their foreign customers can take their business elsewhere far more easily than London bankers can pack up and move. So bankers will have to shave their own salaries, rather than raise their fees, to pay the tax; the cost of excessive taxation tends to get shifted to the least-mobile party.

Among advanced industrial nations, the more open economies, where trade is a higher percentage of GDP, actually have *more* welfare spending, not less.³²⁵ This suggests that the welfare state is a needed buffer for people coping with an open economy and, conversely, that the welfare state may actually advance rather than retard trade

openness. (This also makes free trade, contrary to the ideological predilections of many of its promoters, an enlarger rather than reducer of big government.)³²⁶

FREE TRADE WON'T AMERICANIZE THE WORLD

It has often been suggested—if less frequently as America has economically declined in recent years—that free trade will Americanize the rest of the world's economies. But it won't. Free trade can only cause diverse economies to converge on a single model, American or otherwise, if its underlying economics implies that one economic model is always best. But as we shall see, the same insights that enable us to grasp why free trade isn't always best also imply that no single *domestic* economic model is always best, either.³²⁷ The world will not converge on the American variety of capitalism simply because it is unlikely to converge on any single variety. The only caveat is the basic fact that all developed nations, whatever their ideological rhetoric, are mixed capitalist-socialist economies with public sectors between a quarter and a half of GDP.³²⁸

This doesn't mean that all the different national varieties of capitalism are destined to be equally successful. They aren't now, and won't be in future. But it does mean that a great many of them will be sufficiently successful that foreign competitive pressures will not be strong enough to force them

to change. American, Chinese, Japanese, Russian, German, Brazilian, and United Arab Emirates capitalism are meaningfully different. They will remain so. It is emphatically not the case that, in the words of one celebrated commentator, “today there is only free-market vanilla and North Korea.”³²⁹ Economic diversity will remain a fact of life.

In fact, given the mess the U.S. is sliding into, the American version of capitalism will probably increasingly be viewed abroad as a cautionary tale and as a paradigm of what *not* to do. The global economy will probably de-Americanize somewhat as our closer imitators, such as Canada, Australia and the UK, drift away from us and towards more successful models visible in Continental Europe and East Asia.

HOW NOT TO END FREE TRADE

Any future protectionist policies must work well in practice if they are to endure. So they must avoid the mistakes of past protectionist measures, many of which have been counterproductive.

For example, the Voluntary Restraint Agreement (VRA) between the U.S. and Japan on automobiles (official from 1981 to 1994 and since continued unilaterally by Japan) is a case study in how *not* to end free trade. Despite its popularity—it cost consumers billions, ultimately failed to save the American auto industry, but attracted little opposition—this

agreement was a mess.

The VRA's most obvious mistake was to limit the number of cars imported, but not their value. The result was that Japan indeed limited their number, but moved upmarket and started exporting more expensive cars. As the ability of the American auto industry to provide jobs is not a function of the number of cars it makes, but of the amount of money they bring in, this was counterproductive.

A quota is also the worst kind of protectionism from the taxpayer's point of view. Any barrier to imports—quotas, tariffs, voluntary restraints, closed distribution networks—raises the price of the imported product and its domestic substitutes. But a tariff puts much of the price increase into the taxpayer's pocket. On the other hand, a quota puts it into the hands of the foreign producer. So in effect, the VRA was legalized price-fixing for the Japanese auto industry! This price-fixing then raised that industry's profitability, enabling it to plow even *more* money into R&D aimed at surpassing American producers. (This effect was intensified by the fact that the VRA raised the price of Japanese cars, which were *de facto* rationed, more than the price of American cars, which were not.)^{[330](#)}

The VRA also did nothing to ensure wise use of the increased revenues it handed to the U.S. auto industry by increasing its market share and enabling it to raise prices (by

an average of \$659 in 1984).³³¹ All possible uses of revenue are not equal in their value to an industry's long-term health. It can go to increased profits, increased capital investment, increased wages, or some combination of these. As it happened, most went to immediate profits and wages, not investment, the key to the industry's long-term future.³³² Twenty-five years later, the industry is paying the price, with Chrysler and General Motors having passed through bankruptcy and Ford having avoided it only by using the threat thereof to extract concessions from its unions and suppliers. In 2008, Toyota broke GM's 77-year reign as the world's largest automaker.

The intent (and effect) of the VRA was to relocate automobile production, be it by the Big Three or foreign producers, to the United States. Unfortunately, so-called transplants, the U.S. factories of German, Japanese, and Korean companies, are a problematic solution. (There are now 17 in the U.S.)³³³ While they do move production jobs to the U.S., they leave most design jobs at home. Transplant-made cars also have a much heavier dependence on imported parts: the average domestic content of the Big Three is 79 percent, but transplants average only 63 percent.³³⁴ Transplants also undermine the ability of any future tariff to revive an autonomous American auto industry, as foreign producers are now entrenched inside any future tariff wall.

POSITIVE STRATEGY VS. BAND-AIDS

It is important to avoid calling for protectionism merely to save dying industries. In recent decades, protectionists have reliably fretted about these industries, rarely about the harm free trade does to still healthy ones, and almost never about industries that free trade prevented America from developing in the first place. But trying to keep a primitive labor-intensive industry in the U.S. by protecting it (and perhaps stuffing it with subsidized investment) will just squander money that would have been better spent defending an industry in which America has a fighting chance. Or breaking into an entirely new “sunrise” industry. All over America, there are people stocking shelves at Walmart for \$8 per hour who could have been HDTV manufacturing technicians at perhaps double that.³³⁵ (This industry doesn’t exist in the U.S., so we don’t know what their wages would be, but we can guess by looking at other industries that require comparable skill sets.)³³⁶ These people don’t know who they are, so they don’t complain about it, but they are just as big a part of our trade problem as the outright unemployed.

Most of the benefits of protectionism center on winning tomorrow’s industries and keeping today’s from falling into trouble, not on rescuing industries already dying. Centering protectionism on dying industries is like lecturing a heart

attack victim lying in an ambulance on diet and exercise. Better than nothing, but still suboptimal. Industries in trouble are often (not always, as free traders claim) industries in which high-wage nations like the U.S. are becoming intrinsically uncompetitive, and which we quite rightly *should* be shedding.

Protectionism cannot protect every job in America, even if this is the natural promise that tends to get made in the political arena. Even if we could, this would not be a rational objective, as keeping every existing job would mean that the workers in them could not be upgraded to better jobs over time—which is what we should want. And even if everyone can't upgrade to a better job, the natural progression of industry life cycles means that no job will last forever. There is no future for VCR factories, even if this was a sunrise industry in 1978. As a result, an effective defense of the U.S. industrial base will be a rolling defense, not a static one.

PART II

THE REAL

ECONOMICS

OF TRADE

Chapter 5

Ye Olde Theory of Comparative Advantage

The theory explained in this chapter is false. It is the 192-year-old theory of comparative advantage, invented by David Ricardo in 1817. Ricardo was a London stockbroker, self-made millionaire, and Member of Parliament who turned economist after reading Adam Smith's famous *The Wealth of Nations* on holiday. It dates from a time when most of America was wilderness, railroads were an experimental technology, doctors still used leeches, and veterans of the American Revolution walked the streets of Philadelphia. The quickest route between the United States and China was by clipper ship, which took well over two months. Trade with Japan, however, was impossible, as the country had been sealed off from the outside world by the Shogun in 1635 and would wait another 37 years for Commodore Perry to open it up. Great Britain was the world's largest manufacturer and trading nation. World economic output was about one half of one percent of what it is today.³³⁷ International trade was approximately three percent of that output,³³⁸ in comparison with today's 26 percent.³³⁹

It is, however, absolutely necessary that we understand this quaint and unreliable theory because to this day it remains the

core of the case for free trade. All the myriad things we are told about why free trade is good for us are boiled down to hard economics and weighed against the costs by this single theory and its modern ramifications. The rest is details and politics. If this theory is true, then no matter how high the costs of free trade, we can rely upon the fact that somewhere else in our economy, we are reaping benefits that exceed them. If it is false, we cannot. Free traders admit this, for although other theories of trade exist, their normative content is Ricardian.³⁴⁰ The battle over Ricardo is therefore decisive.

ABSOLUTE VS. COMPARATIVE ADVANTAGE

To understand comparative advantage, it is best to start with its simpler cousin absolute advantage. The concept of absolute advantage simply says that if some foreign nation is a more efficient producer of some product than we are, then free trade will cause us to import that product from them, and that this is good for both nations. It is good for us because we get the product for less money than it would have cost us to make it ourselves. It is good for the foreign nation because it gets a market for its goods. And it is good for the world economy as a whole because it causes production to come from the most efficient producer, maximizing world output.

Absolute advantage is thus a set of fairly obvious ideas. It is, in fact, the theory of international trade most people

instinctively hold, without recourse to formal economics, and thus it explains a large part of public opinion on the subject. It sounds like a reassuringly direct application of basic capitalist principles. It is the theory of trade Adam Smith himself believed in.³⁴¹

It is also false. Under free trade, America observably imports products of which we are the most efficient producer—which makes absolutely no sense by the standard of absolute advantage. This causes complaints like conservative commentator Patrick Buchanan’s below:

Ricardo’s theory...demands that more efficient producers in advanced countries give up industries to less efficient producers in less advanced nations...Are Chinese factories more efficient than U.S. factories? Of course not.³⁴²

Buchanan is correct: this is *precisely* what Ricardo’s theory demands. It not only predicts that less efficient producers will sometimes win (observably true) but argues that this is good for us (the controversy). This is why we must analyze trade in terms of not absolute but *comparative* advantage. If we don’t, we will never obtain a theory that accurately describes what *does* happen in international trade, which is a prerequisite for our arguing about what *should* happen—or how to make it

happen.

The theory of comparative advantage has an unfortunate reputation for being hard to understand,³⁴³ but at bottom it simply says this:

Nations trade for the same reasons people do.

And the whole theory can be cracked open with one simple question:

Why don't pro football players mow their own lawns?

Why should this even be a question? Because the average footballer can almost certainly mow his lawn more efficiently than the average professional lawn mower. The average footballer is, after all, presumably stronger and more agile than the mediocre workforce attracted to a badly paid job like mowing lawns. If we wanted to quantify his efficiency, we could measure it in acres per hour. Efficiency (also known as productivity) is always a matter of *how much output we get* from a given quantity of inputs, be these inputs hours of labor, pounds of flour, kilowatts of electricity, or whatever.

Because the footballer is more efficient, in economic language he has absolute advantage at mowing lawns. Yet

nobody finds it strange that he would “import” lawn-mowing services from a less efficient “producer.” Why? Obviously, because he has *better things to do with his time*. This is the key to the whole thing. The theory of comparative advantage says that it is advantageous for America to import some goods simply in order to free up our workforce to produce more-valuable goods instead. We, as a nation, have better things to do with our time than produce these less valuable goods. And, just as with the football player and the lawn mower, it doesn’t matter whether we are more efficient at producing them, or the country we import them from is. As a result, it is sometimes advantageous for us to import goods from less efficient nations.

This logic doesn’t only apply to our time, that is our man-hours of labor. It *also* applies to our land, capital, technology, and every other finite resource used to produce goods. So the theory of comparative advantage says that if we could produce something more valuable with the resources we currently use to produce some product, then we should import that product, free up those resources, and produce that more valuable thing instead.

Economists call the resources we use to produce products “factors of production.” They call whatever we *give up* producing, in order to produce something else, our “opportunity cost.” The opposite of opportunity cost is direct cost, so while the direct cost of mowing a lawn is the hours of

labor it takes, plus the gasoline, wear-and-tear on the machine, et cetera, the opportunity cost is the value of whatever else these things could have been doing instead.

Direct cost is a simple matter of efficiency, and is the same regardless of whatever else is going on in the world. Opportunity cost is a lot more complicated, because it depends on what other opportunities exist for using factors of production. Other things being equal, direct cost and opportunity cost go up and down together, because if the time required to mow a lawn doubles, then twice as much time cannot then be spent doing something else. As a result, high efficiency tends to generate both low direct cost and low opportunity cost. If someone is such a skilled mower that they can mow the whole lawn in 15 minutes, then their opportunity cost of doing so will be low because there's not much else they can do in 15 minutes.

But other things are very often *not* equal, because alternative opportunities vary. The opportunity cost of producing something is always the *next most valuable thing* we could have produced instead. If either bread or rolls can be made from dough, and we choose to make bread, then rolls are our opportunity cost. If we choose to make rolls, then bread is. And if rolls are worth more than bread, then we will incur a larger opportunity cost by making bread. It follows that the smaller the opportunity cost we incur, the less opportunity we are wasting, so the better we are exploiting the opportunities

we have. Therefore our best move is always to *minimize our opportunity cost*.

This is where trade comes in. Trade enables us to “import” bread (buy it in a store) so we can stop baking our own and bake rolls instead. In fact, trade enables us to do this for all the things we would otherwise have to make for ourselves. So if we have complete freedom to trade, we can systematically shrug off all our least valuable tasks and reallocate our time to our most valuable ones. Similarly, *nations* can systematically shrink their least valuable industries and expand their most valuable ones. This benefits these nations and under global free trade, with every nation doing this, it benefits the entire world. The world economy and every nation in it become as productive as they can possibly be.

Here’s a real-world example: if America devoted millions of workers to making cheap plastic toys (we don’t; China does) then these workers could not produce anything else. In America, we (hopefully) have more-productive jobs for them to do, even if American industry *could* hypothetically grind out more plastic toys per man-hour of labor and ton of plastic than the Chinese. So we’re better off leaving this work to China and having our own workers do more-productive work instead.

This all implies that under free trade, production of every product will automatically migrate to the nation that can produce it at the lowest opportunity cost—the nation that

wastes the least opportunity by being in that line of business. The theory of comparative advantage thus sees international trade as a vast interlocking system of tradeoffs, in which nations use the ability to import and export to shed opportunity costs and reshuffle their factors of production to their most valuable uses. And (supposedly) this all happens automatically, because if the owners of some factor of production find a more valuable use for it, they will find it profitable to move it to that use. The natural drive for profit will steer all factors of production to their most valuable uses, and opportunities will never be wasted.

It follows that any policy *other* than free trade (supposedly) just traps economies producing less-valuable output than they could have produced. It saddles them with higher opportunity costs—more opportunities thrown away—than they would otherwise incur. In fact, when imports drive a nation out of an industry, this must actually be good for that nation, as it means the nation *must* be allocating its factors of production to producing something more valuable instead. (If it weren't doing this, the logic of profit would never have driven its factors out of their former uses.) In the language of the theory, the nation's "revealed comparative advantage" must lie elsewhere, and it will now be better off producing according to this newly revealed comparative advantage.

QUANTIFYING COMPARATIVE ADVANTAGE

Let's quantify comparative advantage with an imaginary example. Suppose an acre of land in Canada can produce either 1 unit of wheat or 2 units of corn.³⁴⁴ And suppose an acre in the U.S. can produce either 3 units of wheat or 4 units of corn. The U.S. then has absolute advantage in both wheat (3 units vs. 1) and corn (4 units vs. 2). But we are twice as productive in corn and thrice as productive in wheat, so we have *comparative* advantage in wheat.³⁴⁵

Importing Canadian corn would obviously enable us to switch some of our corn-producing land to wheat production and grow more wheat, while importing Canadian wheat would enable us to switch some of our wheat-producing land to corn production and grow more corn. Would either of these be winning moves? Let's do some arithmetic.

Every 3 units of wheat we import will free up 1 acre of our land because we will no longer need to grow those 3 units ourselves. We can then grow 4 units of corn on that acre. But selling us that wheat will force Canada to take 3 acres out of corn production to grow it, so it will cost Canada $3 \times 2 = 6$ units of corn. Canadians obviously won't want to do this unless we *pay* them at least 6 units of corn. But this means we'd have to pay 6 units to get 4. So no deal.

What about importing Canadian corn? Every 4 units of corn we import will free up 1 acre of our land, on which we can then grow 3 units of wheat. Selling us those 4 units will force

Canada to take $4 \div 2 = 2$ acres out of wheat production, costing Canada $2 \times 1 = 2$ units of wheat. So we can pay the Canadians what it costs them to give us the corn (2 units of wheat) and still come out ahead, by $3 - 2 = 1$ unit of wheat. So importing Canadian corn makes economic sense. And not only do we come out ahead, but because the world now contains one more unit of wheat, it's a good move for the world economy as a whole, too.

The fundamental question here is whether America is better off producing corn, or wheat we can exchange for corn. Every nation faces this choice for every product, just as every individual must decide whether to bake his own bread or earn money at a job so he can buy bread in a store (and whether to mow his own lawn or earn money playing football so he can hire someone else to mow it). The entire theory of comparative advantage is just endless ramifications of this basic logic. ³⁴⁶

The above scenario all works in reverse on the Canadian side, so it benefits Canada, too. Free traders generalize this into the proposition that free trade benefits *every* trading partner and applies to every product and factor of production. ³⁴⁷ As the late Paul Samuelson of MIT explains it, using China as the trading partner:

Yes, good jobs may be lost here in the short run. But

still total U.S. net national product *must, by the economic laws of comparative advantage, be raised in the long run (and in China, too).* The gains of the winners from free trade, properly measured, work out to exceed the losses of the losers. ³⁴⁸ (Emphasis in original.)

LOW OPPORTUNITY COSTS EQUALS POOR NATION

Note that the opportunity cost of producing a product can vary from one nation to another even if the two nations' *direct* costs for producing the product are the same. This is because they can face different alternative uses for the factors of production involved. So having a low opportunity cost for producing a product can just as easily be a matter of having poor alternative uses for factors of production as having great efficiency at producing the product itself.

This is where underdeveloped nations come in: their opportunity costs are low because they don't have a lot of other things they can do with their workers. The visible form this takes is cheap labor, because their economies offer workers few alternatives to dollar-an-hour factory work. As Jorge Castañeda, Mexico's former Secretary of Foreign Affairs and a NAFTA critic, explains it:

The case of the auto industry, especially the Ford-Mazda plant in Hermosillo, Mexico, illustrates a well-known paradox. The plant manufactures vehicles at a productivity rate and quality comparable or higher than the Ford plants in Dearborn or Rouge, and slightly below those of Mazda in Hiroshima. Nevertheless, the wage of the Mexican worker with equal productivity is between 20 and 25 times less than that of the U.S. worker. [349](#)

The plants in the U.S. and Japan are surrounded by advanced economies containing many other industries able to pay high wages. So these plants must match these wages or find no takers. The plant in Mexico, on the other hand, is surrounded by a primitive developing economy, so it only needs to compete with low-paid jobs, many of them in peasant agriculture. As a result, the productivity of any one job does not determine its wage. Economy-wide productivity does. This is why it is good to work in a developed country even if the job you yourself do, such as sweeping floors, is no more productive than the jobs people do in developing countries.

If wages, which are paid in domestic currency, don't accurately reflect differences in opportunity costs between nations, then exchange rates will (in theory) adjust until they do. So if a nation has high productivity in most of its

internationally traded industries, this will push up the value of its currency, pricing it out of its lowest-productivity industries. But this is a good thing, because it can then export goods from higher-productivity industries instead. This will mean less work for the same amount of exports, which is why advanced nations rarely compete in primitive industries, or want to. In 1960, when Taiwan had a per capita income of \$154, 67 percent of its exports were raw or processed agricultural goods. By 1993, when Taiwan had a per capita income of \$11,000, 96 percent of its exports were manufactured goods.³⁵⁰ Taiwan today is hopelessly uncompetitive in products it used to export such as tea, sugar and rice. Foreign competition drove it out of these industries and destroyed hundreds of thousands of jobs. *Taiwan doesn't mind one bit.*

WHAT THE THEORY DOES NOT SAY

The theory of comparative advantage is sometimes misunderstood as implying that a nation's best move is to have as much comparative advantage as it can get—ideally, comparative advantage in every industry. This is actually impossible by definition. If America had superior productivity, therefore lower direct costs, and therefore absolute advantage, in every industry, we would still have a greater margin of superiority in some industries and a lesser margin in others. So we would have *comparative* advantage where our margin was greatest and comparative disadvantage

where it was smallest. This pattern of comparative advantage and disadvantage would determine our imports and exports, and we would still be losing jobs to foreign nations in our *relatively* worse industries and gaining them in our *relatively* better ones, despite having absolute advantage in them all.

So what's the significance of absolute advantage, if it doesn't determine who makes what? It *does* determine relative wages. If the U.S. were exactly 10 percent more productive than Canada in all industries, then Americans would have real wages exactly 10 percent higher. But because there would be no *relative* differences in productivity between industries, there would be no differences in opportunity costs, neither country would have comparative advantage or disadvantage in anything, and there would be no reason for trade between them. There would be no corn-for-wheat swaps that were winning moves. All potential swaps would cost *exactly* as much as they were worth, so there would be no point. (And under free trade, none would take place, as the free market isn't stupid and won't push goods back and forth across national borders without reason.)

Conversely, the theory of comparative advantage says that whenever nations do have different relative productivities, mutual gains from trade *must* occur. This is why free traders believe that their theory proves free trade is always good for every nation, no matter how poor or how rich. Rich nations won't be bled dry by the cheap labor of poor nations, and

poor nations won't be crushed by the industrial sophistication of rich ones. These things simply can't happen, because the fundamental logic of comparative advantage guarantees that only mutually beneficial exchanges will ever take place.³⁵¹ Everyone will always be better off.

It follows (supposedly) that trade conflicts between nations are always misguided and due solely to their failure to understand why free trade is always good for them. In the words of libertarian scholar James Bovard:

Our great-grandchildren may look back at the trade wars of the twentieth century with the same contempt that many people today look at the religious wars of the seventeenth century—as a senseless conflict over issues that grown men should not fight about.³⁵²

Comparative advantage is thus a wonderfully optimistic construct, and one can certainly see why it would be so appealing. Not only does it appear to explain the complex web of international trade at a single stroke, but it also tells us what to do and guarantees that the result will be the best outcome we could possibly have obtained. It enables a lone economist with a blackboard to prove that free trade is best, always and everywhere, without ever getting her shoes dirty inspecting

any actual factories, dockyards, or shops. She does not even need to consult any statistics on prices, production, or wages. The magnificent abstract logic alone is enough.

It is actually rather a pity the theory isn't true.

THE SEVEN DUBIOUS ASSUMPTIONS

The theory of comparative advantage tends to provoke blanket dismissal by opponents of free trade. This is unfortunate, as its flaws are easy enough to identify and it can be picked apart on its own terms quite readily. These flaws consist of a number of dubious assumptions the theory makes. To wit: [353](#)

Dubious Assumption #1: Trade is sustainable.

We looked at this problem at considerable length before, in Chapter Two, when we analyzed why trade, if paid for by assuming debt and selling assets, is not advantageous to the importing nation in the long run. But there is a flip side to this problem that affects exporting nations as well. What if a nation's *exports* are unsustainable? What if an exporting nation, like the “decadent” importing nation we previously examined, [354](#) is running down an accumulated inheritance?

This usually means a nation that is exporting nonrenewable natural resources. The same long vs. short term dynamics we looked at before will apply, only in reverse. A nation that *exports* too much will maximize its short term living standard at the expense of its long-term prosperity. But free market economics—which means free trade—will perversely report that this is efficient.

The classic example of this problem, almost a caricature, is the tiny Pacific Island nation of Nauru, located roughly halfway between Hawaii and Australia. Thanks to millions of years of accumulated seabird droppings, the island 100 years ago was covered by a thick layer of guano, a phosphate-rich substance used for manufacturing fertilizer. From 1908 to 2002, about 100 million tons of this material was mined and exported, turning four-fifths of Nauru's land into an

uninhabitable moonscape in the process. But for a few years in the late 1960s and early 1970s, Nauru had the world's highest per capita income (and tellingly acquired one of the world's worst obesity problems). But after the deposits ran out, the economy collapsed, the nation was reduced to reliance upon foreign aid, and unemployment neared 90 percent.

Nauru is obviously an extreme case, but it is hardly the only nation making its way in international trade by exporting nonrenewable resources. The oil-rich nations of the Persian Gulf are the most obvious example, and it is no accident that OPEC was the single most formidable disruptor of free trade in the entire post-WWII era. But other nations with large land masses relative to population, such as Canada, Australia, Russia, and Brazil, also depend upon natural resource exports to a degree that is unhealthy in the long run. Even the United States, whose Midwestern agricultural exports rely upon the giant Ogallala Aquifer, a depleting accumulation of water from glacial times, is not exempt from this problem.

The implied solution is to tax or otherwise restrict nonrenewable exports. And that is not free trade.

Dubious Assumption #2: There are no externalities.

An externality is a missing price tag. More precisely, it is the economists' term for when the price of a product does not reflect its true economic value. The classic *negative* externality is environmental damage, which reduces the economic value of natural resources without raising the price of the product that harmed them. The classic *positive* externality is technological spillover, where one company's inventing a product enables others to copy or build upon it, generating wealth that the original company doesn't capture. The theory of comparative advantage, like all theories of free market economics, is driven by prices, so if prices are wrong due to positive or negative externalities, it will recommend bad policies.

For example, goods from a nation with lax pollution standards will be too cheap. As a result, its trading partners will import too much of them. And the exporting nation will export too much of them, overconcentrating its economy in industries that are not really as profitable as they seem, due to ignoring pollution damage. For example, according to *The New York Times*:

Pollution has made cancer China's leading cause of death...Ambient air pollution alone is blamed for

hundreds of thousands of deaths each year. Nearly 500 million people lack access to safe drinking water...Only 1% of the country's 560 million city dwellers breathe air considered safe by the European Union. [355](#)

It has even been argued, by economists such as Sir Partha Dasgupta of Cambridge, that China's economy may not be growing *at all* if one takes into account the massive destruction of its soil and air. [356](#) Free trade not only permits problems such as these, but positively encourages them, as skimping on pollution control is an easy way to grab a cost advantage. [357](#)

Positive externalities are also a problem. For example, if an industry generates technological spillovers for the rest of the economy, then free trade can let that industry be wiped out by foreign competition because the economy ignored its hidden value. Some industries spawn new technologies, fertilize improvements in other industries, and drive economy-wide technological advance; losing these industries means losing all the industries that will flow from them in the future (more on this in Chapter Nine).

These problems are the tip of an even larger iceberg known as GDP-GPI divergence. Negative externalities and related problems mean that increases in GDP can easily coincide with

decreases in the so-called Genuine Progress Indicator or GPI.³⁵⁸ GPI includes things like resource depletion, environmental pollution, unpaid labor like housework, and unpaid goods like leisure time, thus providing a better metric of material well-being than raw GDP.³⁵⁹ This implies that even if free trade *were* optimal from a GDP point of view (which it isn't), it could still be a bad idea economically.

The problem of positive and negative externalities is quite well known, even to honest free traders, because externalities are, by definition, a loophole in *all* free-market economic policies. Free traders just deny that these externalities are big enough to matter. Or they propose various schemes to internalize them and make prices accurate.

Dubious Assumption #3: Factors of production move easily between industries.

As noted earlier, the theory of comparative advantage is about switching factors of production from less-valuable to more-valuable uses. But this assumes that the factors of production used to produce one product can switch to producing another. Because if they can't, then imports won't push a nation's economy into industries better suited to its comparative advantage. Imports will just kill off its existing industries and leave nothing in their place.

Although this problem actually applies to all factors of production, we usually hear of it with regard to labor and real estate because people and buildings are the least *mobile* factors of production. (This is why the unemployment line and the shuttered factory are the classic visual images of trade problems.) When workers can't move between industries—usually because they don't have the right skills or don't live in the right place—shifts in an economy's comparative advantage won't move them into an industry with lower opportunity costs, but into unemployment. This is why we hear of older workers being victims of free trade: they are too old to easily acquire the skills needed to move into new industries. And it explains why the big enthusiasts for free trade tend to be bright-eyed yuppies well equipped for career mobility.

Sometimes the difficulty of reallocating workers shows up as outright unemployment. This happens in nations with rigid employment laws and high *de facto* minimum wages due to employer-paid taxes, as in Western Europe. But in the United States, because of our relatively low minimum wage and hire-and-fire labor laws, this problem tends to take the form of *underemployment*. This is a decline in the quality rather than quantity of jobs. So \$28 an hour ex-autoworkers go work at the video rental store for eight dollars an hour.³⁶⁰ Or they are forced into part-time employment: it is no accident that, as of September 2009, the average private-sector U.S. work week had fallen to 33 hours, the lowest since records began in 1964.³⁶¹

In the Third World, decline in the quality of jobs often takes the form of workers pushed out of the formal sector of the economy entirely and into casual labor of one kind or another, where they have few rights, pensions, or other benefits. Mexico, for example, has over 40 percent of its workers in the informal sector.³⁶²

This all implies that low unemployment, on its own, doesn't prove free trade has been a success. This is recognized even by the more intellectually rigorous free traders, such as former Federal Reserve Chairman Alan Greenspan, who has admitted that, "We often try to promote free trade on the mistaken ground, in my judgment, that it will create jobs."³⁶³

Greenspan is correct: even if free trade worked completely as promised, it would not increase the *number* of jobs, only their quality.³⁶⁴ And when we speak of job gains and losses from trade, these are gross, not net, numbers, as people who lose their jobs due to trade will usually end up working *somewhere*, however dismal.³⁶⁵

A recent study by the North Carolina Employment Security Commission explored the problem of workers displaced by trade. In 2005, North Carolina experienced the largest mass layoff in its history, at the bedding firm Pillowtex, costing 4,820 jobs. By the end of 2006, the workers' average wage in their new jobs was \$24,488—a drop of over 10 percent from before.³⁶⁶ A large number had been sidelined into temporary employment, often as health care aides. Nationally, two-thirds of workers are working again two years after a layoff, but only 40 percent earn as much as they did previously.³⁶⁷ The human cost is obvious, but what is less obvious is the purely economic cost of writing off investments in human capital when skills that cost money to acquire are never used again. This kind of cost is most visible in places such as Moscow in the 1990s, when one saw physics PhDs driving taxis and the like, but America is not exempt.

There is also a risk for the economy as a whole when free trade puts factors of production out of action. As Nobel Laureate James Tobin of Yale puts it, “It takes a heap of

Harberger triangles to fill an Okun gap.”³⁶⁸ Harberger triangles represent the benefits of free trade on the standard graphs used to quantify them.³⁶⁹ The Okun gap is the difference between the GDP our economy *would* have, if it were running at full output, and the GDP it does have, due to some of its factors of production lying idle.³⁷⁰ Tobin’s point is simply that the benefits of free trade are quantitatively small, compared to the cost of not running our economy at full capacity due to imports.

Dubious Assumption #4: Trade does not raise income inequality.

When the theory of comparative advantage promises gains from free trade, these gains are only promised to the economy as a whole, not to any particular individuals or groups thereof. So it is entirely possible that even if the economy as a whole gets bigger thanks to freer trade, many (or even most) of the people in it may lose income.

We looked at this problem a bit before, at the end of Chapter One. Let's take a slightly different analytical tack and look again. Suppose that opening up a nation to freer trade means that it starts exporting more airplanes and importing more clothes than before. (This is roughly the situation the U.S. has been in.) Because the nation gets to expand an industry better suited to its comparative advantage and contract one less suited, it becomes more productive and its GDP goes up, just like Ricardo says. So far, so good.

Here's the rub: suppose that a million dollars' worth of clothes production requires one white-collar worker and nine blue-collar workers, while a million dollars of airplane production requires three white-collar workers and seven blue-collar workers. (Industries often differ in this way.) This means that for every million dollars' change in what gets produced, there is a demand for two more white-collar

workers and two fewer blue-collar workers. Because demand for white-collar workers goes up and demand for blue-collar workers goes down, the wages of white-collar workers will go up and those of blue-collar workers will go down. But *most* workers are blue-collar workers—so free trade has lowered wages for most workers in the economy!

This is not a trivial problem: Dani Rodrik of Harvard estimates that freeing up trade reshuffles five dollars of income between different groups of people domestically for every one dollar of net gain it brings to the economy as a whole.^{[371](#)} And on top of this, we still have all the related problems associated with the Stolper-Samuelson theorem we looked at in Chapter One.^{[372](#)}

Dubious Assumption #5: Capital is not internationally mobile.

Despite the wide scope of its implications, the theory of comparative advantage is at bottom a very narrow theory. It is *only* about the best uses to which nations can put their factors of production. We have certain cards in hand, so to speak, the other players have certain cards, and the theory tells us the best way to play the hand we've been dealt. Or more precisely, it tells us to let the free market play our hand *for us*, so market forces can drive all our factors to their best uses in our economy.

Unfortunately, this all relies upon the impossibility of these same market forces driving these factors right *out* of our economy. If that happens, all bets are off about driving these factors to their most productive use *in* our economy. Their most productive use may well be in another country, and if they are internationally mobile, then free trade will cause them to migrate there. This will benefit the world economy as a whole, and the nation they migrate to, but it will *not* necessarily benefit us.

This problem actually applies to all factors of production. But because land and other fixed resources can't migrate, labor is legally constrained in migrating, and people usually don't try to stop technology or raw materials from migrating,

the crux of the problem is capital. Capital mobility replaces comparative advantage, which applies when capital is forced to choose between alternative uses within a single national economy, with our old friend absolute advantage. And absolute advantage contains no guarantees whatsoever about the results being good for *both* trading partners. The win-win guarantee is purely an effect of the world economy being yoked to comparative advantage, and dies with it.

Absolute advantage is really the natural order of things in capitalism and comparative advantage is a special case caused by the existence of national borders that factors of production can't cross. Indeed, that is basically what a nation *is*, from the point of view of economics: a part of the world with political barriers to the entry and exit of factors of production. ³⁷³ This forces national economies to interact indirectly, by exchanging goods and services *made from* those factors, which places comparative advantage in control. Without these barriers, nations would simply be regions of a single economy, which is why absolute advantage governs economic relations *within* nations. In 1950, Michigan had absolute advantage in automobiles and Alabama in cotton. But by 2000, automobile plants were closing in Michigan and opening in Alabama. This benefited Alabama, but it did not necessarily benefit Michigan. (It only would have if Michigan had been transitioning to a higher-value industry than automobiles. Helicopters?) The same scenario is possible for entire nations if capital is

internationally mobile.

Capital immobility doesn't have to be absolute to put comparative advantage in control, but it has to be significant and as it melts away, trade shifts from a guarantee of win-win relations to a possibility of win-lose relations. David Ricardo, who was wiser than many of his own modern-day followers, knew this perfectly well. As he puts it:

The difference in this respect, between a single country and many, is easily accounted for, by considering the difficulty with which capital moves from one country to another, to seek a more profitable employment, and the activity with which it invariably passes from one province to another of [374](#) the same country.

Ricardo then elaborates, using his favorite example of the trade in English cloth for Portuguese wine and cutting right to the heart of present-day concerns:

It would undoubtedly be advantageous to the capitalists of England, and to the consumers in both countries, that under such circumstances the wine and the cloth should both be made in Portugal, and therefore that the capital and labor of England

employed in making cloth should be removed to Portugal for that purpose. [375](#)

But he does not say it would be advantageous to the workers of England! This is precisely the problem Americans experience today: when imports replace goods produced here, capitalists like the higher profits and consumers like the lower prices—but workers *don't* like the lost jobs. Given that consumers and workers are ultimately the same people, this means they may lose more as workers than they gain as consumers. And there is no theorem in economics which guarantees that their gains will exceed their losses. [376](#) Things can go either way, which means that free trade is sometimes a losing move for them.

Having observed that capital mobility would undo his theory, Ricardo then argues why capital will not, in fact, be mobile—as he knew he had to prove for his theory to hold water:

Experience, however, shows that the fancied or real insecurity of capital, when not under the immediate control of its owner, together with the natural disinclination which every man has to quit the country of his birth and connections, and entrust himself, with all his habits fixed, to a strange

government and new laws, check the emigration of capital. These feelings, which I should be sorry to see weakened, induce most men of property to be satisfied with a low rate of profits in their own country, rather than seek a more advantageous employment for their wealth in foreign nations. [377](#)

So in the end, the inventor of the theoretical keystone of free trade had to rely upon an instinctive economic localism in order to make his theory hold. *Something* has to anchor capital for it all to work.

Interestingly, the above paragraph hasn't just become untrue in the modern globalized era. It was *already* untrue a few years after Ricardo wrote it, when billions of pounds began flowing out of Britain to finance railways and other investments around the world. As a result, at its peak in 1914, an astounding 35 percent of Britain's net national wealth was held abroad—a figure not even remotely approached by any major nation before or since. [378](#) British investors' preference for building up other nations' industries, rather than their own, exacted a heavy toll on the once-dominant British economy, a story we will explore more in the next chapter.

Dubious Assumption #6: Short-term efficiency causes long-term growth.

The theory of comparative advantage is a case of what economists call static analysis. That is, it looks at the facts of a single instant in time and determines the best response to those facts at that instant. This is not an intrinsically invalid way of doing economics—balancing one’s checkbook is an exercise in static analysis—but it is vulnerable to a key problem: *it says nothing about dynamic facts*. That is, it says nothing about how today’s facts may change tomorrow. More importantly, it says nothing about how one might cause them to change in one’s favor.

Imagine a photograph of a rock thrown up in the air. It is an accurate representation of the position of the rock at the instant it was taken. But one can’t tell, from the photograph alone, whether the rock is rising or falling. The only way to know *that* is either to have a series of photographs, or add the information contained in the laws of physics to the information contained in the photograph.

The problem here is that even if the theory of comparative advantage tells us our best move today, given our productivities and opportunity costs in various industries, it *doesn’t* tell us the best way to raise those productivities tomorrow. That, however, is the essence of economic growth,

and in the long run much more important than squeezing every last drop of advantage from the productivities we have today. Economic growth, that is, is ultimately less about *using* one's factors of production than about *transforming* them—
into more productive factors tomorrow. ³⁷⁹ The difference between poor nations and rich ones mainly consists in the problem of turning from Burkina Faso into South Korea; it does not consist in being the most efficient possible Burkina Faso forever. The theory of comparative advantage is not so much wrong about long-term growth as simply silent.

Analogously, it is a valid application of personal comparative advantage for someone with secretarial skills to work as a secretary and someone with banking skills to work as a banker. In the short run, it is efficient for them both, as it results in both being better paid than if they tried to swap roles. (They would both be fired for inability to do their jobs and earn zero.) But the path to personal success doesn't consist in being the best possible secretary forever; it consists in upgrading one's skills to better-paid occupations, like banker. And there is very little about being the best possible secretary that tells one how to do this.

Ricardo's own favorite example, the trade in English textiles for Portuguese wine, is very revealing here, though not in a way he would have liked. In Ricardo's day, textiles were produced in England with then-state-of-the-art technology like steam engines. The textile industry thus nurtured a

sophisticated machine tool industry to make the parts for these engines, which drove forward the *general* technological capabilities of the British economy and helped it break into related industries like locomotives and steamships.³⁸⁰ Wine, on the other hand, was made by methods that had not changed in centuries (and have only begun to change since about 1960, by the way). So for hundreds of years, wine production contributed no technological advances to the Portuguese economy, no drivers of growth, no opportunities to raise economy-wide productivity. And its own productivity remained static: it did the same thing over and over again, year after year, decade after decade, century after century, because this was where Portugal's immediate comparative advantage lay. It may have been Portugal's best move in the short run, but it was a dead end in the long run.

What happened to Portugal? It had actually been happening for over a century by the time Ricardo wrote, largely in rationalization of existing conditions. In 1703, in the Treaty of Methuen, Portugal exempted England from its prohibition on the importation of woolen cloth, while England agreed to admit Portuguese wines at a tariff one-third less than that applied to competitors. This treaty merely switched suppliers for the English, who did not produce wine, but it admitted a deluge of cheap English cloth into Portugal—which wiped out its previously promising textile industry. English capital eventually took control of Portugal's vineyards as their

owners went into debt to London banks, and English influence sabotaged attempts at industrial policy that might have pushed Portugal back into textiles or other manufacturing industry. As textiles were (as they remain today) the first stepping stone to more-sophisticated industries, this all but prevented Portugal's further industrialization. Not until the 1960s, under the Salazar dictatorship, did any Portuguese government make a serious attempt to dig itself out of this trap and to this day, Portugal has not recovered its 17th-century position relative to other European economies, and remains the poorest country in Western Europe.

Today, the theory of comparative advantage is similarly dangerous to poor and undeveloped nations because they tend, like Portugal, to have comparative advantage in industries that are economic dead ends. So despite being nominally free, free trade tends to lock them in place.

Dubious Assumption #7: Trade does not induce adverse productivity growth abroad.

As previously noted, our gains from free trade derive from the difference between *our* opportunity costs for producing products and the opportunity costs of our trading partners. This opens up a paradoxical but very real way for free trade to backfire. When we trade with a foreign nation, this will generally build up that nation's industries, i.e., raise its productivity in them. Now it would be nice to assume that this productivity growth in our trading partners can only reduce their direct costs, therefore reduce their opportunity costs, and therefore increase our gains from trading with them. Our foreign suppliers will just become ever more efficient at supplying the things we want, and we will just get ever cheaper foreign goods in exchange for our own exports, right?

Wrong. As we saw in our initial discussion of absolute vs. comparative advantage, while productivity (output per unit of input) does determine direct costs, it *doesn't* on its own determine opportunity costs. The alternative uses of factors of production do. As a result, productivity growth in some industries can actually *raise* our trading partners' opportunity costs in other industries, by increasing what they give up producing in one industry in order to produce in another. If the number of rolls they can make from a pound of dough

somehow goes up (rolls get fluffier?), this will make it more expensive for them to bake bread instead. So they may cease to supply us with such cheap bread! It sounds odd, but the logic is inescapable.

Consider our present trade with China. Despite all the problems this trade causes us, we do get compensation in the form of some very cheap goods, thanks mainly to China's very cheap labor. The same goes for other poor countries we import from. But labor is cheap in poor countries because it has poor alternative employment opportunities. What if these opportunities improve? Then this labor may cease to be so cheap, and our supply of cheap goods may dry up.

This is actually what happened in Japan from the 1960s to the 1980s, as Japan's economy transitioned from primitive to sophisticated manufacturing and the cheap merchandise readers over 40 will remember (the same things stamped "Made in China" today, only less ubiquitous) disappeared from America's stores. Did this reduce the pressure of cheap Japanese labor on American workers? Indeed. But it also deprived us of some very cheap goods we used to get. (And it's not like Japan stopped pressing us, either, as it moved upmarket and started competing in more sophisticated industries.)

The same thing had happened with Western Europe as its economy recovered from WWII from 1945 to about 1960 and cheap European goods disappeared from our stores.

Remember when BMWs were cheap little cars and Italian shoes were affordable?

It's as if our football player woke up one morning and found that his lawn man had quietly saved his pennies from mowing lawns and opened a garden shop. No more cheap lawn mowings for him! (Maybe it was a bad idea to hire him so often.)

Now this is where things get slippery and non-economists tend to get lost. Because, as we saw earlier, gains from trade don't derive from absolute but comparative advantage, these gains can be killed off *without* our trading partners getting anywhere near our own productivity levels. So the above problem doesn't merely consist in our trading partners catching up to us in industrial sophistication. But if their *relative* tradeoffs for producing different goods cease to differ from ours, then our gains from trading with them will vanish. If Canada's wheat vs. corn tradeoff is two units per acre vs. three and ours is four vs. six, all bets are off. Because both nations now face the same tradeoff ratio between producing one grain and the other, [381](#) all possible trades will cost Canada *exactly* as much they benefit the US—leaving no profit, no motivation to trade, and no gain from doing so. And if free trade helped raise Canada's productivity to this point, then *free trade deprived us of benefits we used to get*.

It's worth retracing the logic here until it makes sense, as this really is the way the economics works. When Paul

Samuelson—Nobel Laureate, dean of the profession, inventor of the mathematical foundations of modern economics while still a graduate student, and author of the best-selling economics textbook in history—reminded economists of this problem in a (quite accessible) 2004 article, he drew scandalized gasps from one end of the discipline to the other. ³⁸² How could anyone so distinguished criticize the sacred truth of free trade? Then he politely reminded his critics that he was merely restating a conclusion he had first published in his Nobel Lecture of 1972! ³⁸³ As Samuelson noted, Ricardo himself was well aware of the problem: ³⁸⁴

In Chapter 31 [of *The Principles of Political Economy and Taxation*] Ricardo discovers what he has elsewhere denied: that an improvement abroad can hurt Britain under free trade (or, as needs to be said today, that an improvement in Japan can hurt the American living standard). ³⁸⁵

Most of the time, this problem has low visibility because it consists in the silent change of invisible ratios between the productivities of industries here and abroad. Few people worry about it because it has no easily understood face like cheap foreign labor. But it definitely does mean that free trade

can “foul its own nest” and kill off the benefits of trade over time. Even within the most strictly orthodox Ricardian view, only the *existence* of gains from free trade is guaranteed. ³⁸⁶ It is not guaranteed that changes *induced by* free trade will make these gains grow, rather than shrink. So free trade can do billions of dollars worth of damage *even if Ricardo was right about everything else* (which he wasn't).

There are two standard rejoinders to this problem. The first is that while it proves that gains from free trade can go down as well as up, it doesn't actually prove that they can ever go below zero—which is what would have to happen for free trade to be literally bad for us. This is true. But this doesn't change the fact that if free trade *caused* our gains from trade to go down, then it reduced our economic well-being. We would have been better off under some protectionist policy that avoided stimulating quite so much productivity growth abroad. The second rejoinder is that productivity abroad can rise even without free trade on our part. This is also true. But if free trade sometimes causes productivity abroad to rise in a way that has the effects just described, then free trade is sometimes bad for us.

This problem is actually even more significant than explained here because it is also the foundation of an even more radical critique of free trade we will look at later, after we have developed some needed conceptual tools. This concerns the nightmare scenario that *really* haunts Americans:

the idea that free trade can help other nations catch up with us in industrial sophistication, driving us out of our own most important industries.³⁸⁷

HOW MUCH OF THE THEORY STILL STANDS?

Given that the theory of comparative advantage has all of the above-described flaws, how much validity does it really have? Answer: some. It is a useful tool for analyzing trade in individual industries. Asking what industries a nation has comparative advantage in helps illuminate what kind of economy it has. And insofar as the theory's assumptions do hold—to some extent, some of the time—it can give us some valid policy recommendations. *Fairly open trade, most of the time, is a good thing.* But the theory was never intended to be by its own inventor, and its innate logic will not support its being, a blank check that justifies 100 percent free trade with 100 percent of the world 100 percent of the time. It only justifies free trade when its assumptions hold true,³⁸⁸ and in present-day America, they quite clearly often do not.

One of the biggest insights remaining from the theory is that under free trade, a nation's wages will be determined, other things being equal, by its productivity in those sectors of its economy that possess comparative advantage. That is to say, wages in America aren't high because the productivity of barbers is higher here than in Ukraine. Wages are higher

because the productivity of aircraft manufacturing workers is higher. This is true because a nation's best industries tend to be those in which it has comparative advantage, and are thus the industries from which it exports. So under free trade, these industries will expand and suck in labor, bidding up labor's price in other industries. This doesn't mean export industries will pay more. They will pay the same as other industries requiring the same skill level, as they draw labor from the same pool. But these industries, not other industries, will be pushing the labor market up. [389](#)

The converse is that it's a bad idea for a nation to lose its leading internationally traded industries. So all Americans, not just those working in these industries, have a stake in their health. Many Americans, especially those working in the 70 percent of our GDP that is in nontraded industries, [390](#) are indifferent to the problems of our tradable sector because they think these problems will never affect them. *Directly*, as previously noted, indeed they won't. But indirectly, they eventually will, as our wages are propped up, at the end of the day, by our ability to go work elsewhere if better money is offered. And this basically requires a strong export sector if we have free trade. [391](#)

MODERN DAY ELABORATIONS OF RICARDO

Of course, free trade is not considered justified by economists

today simply on the strength of Ricardo's original 1817 theory alone. His ideas have been considerably elaborated since then, and economists generally use sophisticated computable general equilibrium (CGE) computer models, built upon his work as the foundation, to assign actual dollar amounts to the purported benefits of free trade. These models are called "computable" because, unlike economic models that exist purely to prove theoretical points, it is possible to feed actual numbers into them and get numbers out the other end. They are called "general equilibrium" because they are based on the fundamental idea of free market economics: that the economy consists of a huge number of separate equilibria between supply and demand, and that all these markets clear, or match supply with demand, at once. So it's worth looking at problems with these models a bit.

For a start, these models tend to make some rather implausible assumptions. For example, they often assume that government budget deficits and surpluses will not change due to the impact of trade, but will remain fixed at whatever they were in the starting year of the model. Worse, they assume that trade deficits or surpluses will be similarly stable, with exchange rates fluctuating to keep them constant. And they assume that a nation's investment rate will equal its savings rate: every dollar saved will flow neatly into some productive investment. These assumptions are understandable, as devices to simplify the models enough to make them workable. They are, however, both clearly untrue and serious objects of

controversy in their own right.³⁹²

That investment will equal savings is basically a form of Say's Law, "supply creates its own demand," named after the French economist Jean-Baptiste Say (1767-1832).³⁹³ This basically makes both underinvestment and unemployment theoretically impossible. Furthermore, these models often assume that nations enjoy magical macroeconomic stability: the business cycle has been mysteriously abolished. And their financial systems enjoy unruffled tranquility, without booms, busts, or bubbles. These assumptions are pre-Keynesian,³⁹⁴ and thus at least 70 years behind mainstream domestic economics. (This is a recurring problem in free trade economics: ideas long discarded in other areas of economics recur with alarming regularity.)

These models also generally leave out transition costs. These sound temporary, but such transitions can take decades: consider the pain experienced by the Midwestern manufacturing areas of the U.S. as their industries have gradually lost comparative advantage since the mid-sixties! Given that the world economy is not static, but constantly moving into new industries, there are always new transitions being generated, which means that transition costs go on forever, as an intrinsic cost of having a global economy based on shifting patterns of comparative advantage. *Somebody* will always be the rustbelt. (This does not of itself mean that

economic change is a bad thing, but it does mean that these costs must be factored in to get an accurate accounting.)

Trade in services (AKA offshoring) is another sticking point. The root problem here is that this trade usually isn't regulated the same way as trade in goods. Due to the fact that, prior to cheap long-distance telephony and the Internet, many services were rarely internationally traded, there are actually few outright tariffs or quotas on them. Instead, there is a crazy-quilt of hard-to-quantify barriers, ranging from licensing requirements to tacit local cartels and linguistic differences. As a result, when these barriers come down, they rarely come down in a neatly quantifiable way like reducing a tariff on cloth from 28 to 22 percent. So economists must basically *guess* how to quantify nonquantitative changes in order to model them. (The term for this is "tariff equivalent" numbers.) As a result, the conclusions generated by many models of trade in services are so dependent upon arbitrary guesses as to border on arbitrary themselves.

Another caveat: because all these models are predictions about the future, they are of necessity somewhat speculative under the best of circumstances and notoriously susceptible to deliberate manipulation. It is easy, for example, to generate inflated predictions of gains from trade by extrapolating calculations intended to apply only within certain limits with back-of-the-envelope calculations that go far beyond these limits. (These are known in the trade as "hockey stick"

projections due to their shape when graphed.) So as Frank Ackerman of the Global Development and Environment Institute at Tufts University puts it:

The larger estimates still being reported from some studies reflect speculative extensions of standard models, and/or very simple, separate estimates of additional benefit categories, not the core results of established modeling methodologies. [395](#)

Similarly, the standard way for free traders to play down the damage done to the victims of free trade is to count only workers *directly* displaced from jobs as its losers. [396](#) But, as Josh Bivens of the Economic Policy Institute, a think tank funded by organized labor, reminds us:

The largest cost from trade is the permanent and steady drag on the wages of all American workers whose education and skills resemble those displaced by trade. Waitresses, for example, do not generally lose their jobs due to trade, but their pay suffers as workers displaced from tradable goods industries crowd into their labor market and bid down wages. Not acknowledging these wage costs is a very good way to minimize the total debit column in the

balance sheet of globalization's impact on American workers.

[397](#)

Even if all statistical gamesmanship is removed and other reforms made, there is a deeper problem with CGE models: no such model can predict what *choices of trade strategy* a nation will make. For example, none of the models used in the 1950s predicted Japan's ascent to economic superpower status. Quite probably, no model could have. Indeed, no model based upon purely free-market assumptions will *ever* readily predict the outcomes from such strategic choices, as free-market economics, with its insistence that it is always best to just do what the free market says, rules out *a priori* the possibility that most such deliberate economic strategies can even work.

IS BIG BUSINESS IN ON THE JOKE?

As we have seen, the theory of comparative advantage is considerably out of alignment with the real world. So we should, logically, expect this fact to affect the conduct of actual international businesses at some point. If the theory is wrong, that is, then surely they must deviate from it at some point simply in order to function profitably? A little investigation suffices to reveal that indeed they do: the business community is well aware of how problematic the theory is and generally avoids using it in practice. As Michael

Porter of Harvard Business School puts it:

Comparative advantage based on factors of production is not sufficient to explain patterns of trade. Evidence hard to reconcile with factor comparative advantage is not difficult to find...More important, however, is that there has been a growing awareness that the assumptions underlying factor comparative advantage theories of trade are unrealistic in many industries...The theory also assumes that factors, such as skilled labor and capital, do not move among nations. All these assumptions bear little relation, in most industries, to actual competition. [398](#)

Nevertheless, the business community and its lobbyists in Washington use comparative advantage all the time in politics to lobby for more free trade. So to a huge extent, the American business community has been using, and broadcasting to the public through the media, economic ideas in which it does not itself believe and refuses to live by.

Chapter 6

The Deliberately Forgotten History of Trade

We saw in the previous chapter why the theory of comparative advantage, the key justification economics offers for free trade, is false most of the time. But if this is so, then economic history should reflect this fact. That is, successful economic powers should have prospered by defying this theory's recommendations, not by following them. This indeed turns out to be the case. But while it is widely known that economically successful nations like China and Japan have little use for free trade even today, what is less well understood is that even the nations that have historically championed free trade—the most important being Britain and the United States—have not actually practiced it for most of their history. Instead, they have long, successful, but *deliberately forgotten* records as protectionists.

Standard economic history taught in the United States is distorted by ideology and has key facts airbrushed out. That history, largely a product of Cold War myth-mongering about the virtues of absolutely free markets, attributes world economic growth to the spread of free markets to one nation after another, aided by free trade between them. Not only do free traders believe in this history, but it pretty much *has to be* true if the economics of free trade is valid. But economic history actually reveals that no major developed nation got

that way by practicing free trade. Every single one did it by way of protectionism and industrial policy.

Industrial policy? That's the deliberate manipulation of the domestic economy to help industries grow. Although this is a book about protectionism, from this point on we will not be able to ignore industrial policy entirely. Industrial policy is inextricably bound up with protectionism because these two policies are just the domestic and foreign expressions of the same underlying fact: *100 percent pure free markets are not best*. So it is almost impossible for protectionism to be right without some kind of industrial policy being right, too. And because the mechanisms of effective protectionism are important largely for what they make happen *inside* the industries that make up an economy, understanding industrial policy helps illuminate what makes protectionism work.

One can, of course, always dismiss history as a guide to economic reality. In fact, this is precisely what contemporary economics, which is highly ahistorical, generally does. ³⁹⁹ It is impossible to run real controlled experiments in economics, as one can in the physical sciences, because this would require re-running history with alternative policies. Therefore, one can always claim that nations which succeeded under protectionism would have succeeded without it. One can even claim that they succeeded in spite of, not because of, their protectionism, and that protectionism held them back. ⁴⁰⁰ But such criticism is empty, as it makes *any* economic claim

logically immune to historical evidence. One can only let the history below speak for itself, and see what looks like the least tendentious and most plausible interpretation of the generally agreed facts.

THE GREAT BRITISH FREE-TRADE MYTH

According to the creation myth of free trade, Great Britain is the original motherland of free markets, home of Adam Smith and David Ricardo both, the first nation to break free of the misguided gold-hoarding mercantilism that came before and consequently the industrial superpower of the 19th century, erector of a global empire upon free-trade principles. As Britain was indeed a free-trading state for most of this period, this myth has surface plausibility. Among other things, the British themselves believed in it during their mid-19th-century economic zenith, and some of them still do: the British newsmagazine *The Economist* was founded in 1843 specifically to agitate for free trade, and does so today from [401](#) airport newsstands on six continents.

Unfortunately, this whole story depends upon tricks of historical timing and starts to fall apart once one gets a few dates right. Adam Smith published his epoch-making free-trade tract, *The Wealth of Nations*, in 1776. But Britain in 1776 was not a blank slate upon which free markets and free trade could work their magic. It was the beneficiary of several

prior *centuries* of protectionism and industrial policy.⁴⁰² In the words of British economist William Cunningham:

For a period of two hundred years [c. 1600-1800], the English nation knew very clearly what it wanted. Under all changes of dynasty and circumstances the object of building up national power was kept in view; and economics, though not yet admitted to the circle of the sciences, proved an excellent servant, and gave admirable suggestions as to the manner in which this aim might be accomplished.⁴⁰³

England in this era was, in fact, a classic authoritarian (this is long before English democracy)⁴⁰⁴ developmentalist state: a *Renaissance South Korea*, with kings rather than the military dictators who ruled South Korea for most of the Cold War period. English industrialization must actually be traced 300 years prior to Adam Smith, to events like Henry VII's imposition of a tariff on woolen goods in 1489.⁴⁰⁵ King Henry's aim was to wrest the wool weaving trade, then the most technologically advanced major industry in Europe, away from Flanders (the Dutch half of present-day Belgium), where it had been thriving upon exports of English wool. Flemish producers were entrenched behind huge capital

investments, which gave them economies of scale sufficient to outcompete fledgling entrants into the industry. So only government action could get England a toehold.

Even in the 15th century, there was an awareness that being an exporter of agricultural raw materials was a dead end—a problem African and Latin American nations wrestle with to this day. Henry VII created, in fact, the first *national industrial policy* of the modern era, long before the Industrial Revolution introduced artificial energy sources like steam power.⁴⁰⁶ A whole interlocking series of now-forgotten policy moves underlay the rise of English industry; what all these measures had in common was that protectionism was essential to making them work. In the words of economist John Culbertson of the University of Wisconsin and the Federal Reserve Board of Governors:

Step after step in the cumulative economic rise of England was directly caused by government action or depended upon supportive government action: the prohibition of importation of Spanish wool by Henry I, the revision of land-tenure arrangements to permit the development of large-scale sheep raising, Edward III's attracting of Flemish weavers to England and then prohibiting of the wearing of foreign cloth, the termination of the privileges in London of the Hanseatic League under Edward VI, the near-war

between England under Elizabeth I and the Hanseatic League, which supported the rise of English shipping. And then there was the prohibition of export of English wool (which damaged the Flemish textile industry and stimulated that of England), the encouragement of production of dyed and finished cloth in England, the use of England's dominance in textile manufacture to push the Hanseatic League out of foreign markets for other products, the encouragement of fishing... [407](#)

The aim of English policy was what would today be called “climbing the value chain”: deliberately leveraging existing economic activity to break into more-sophisticated related activities. Fifteenth-century England was considerably more primitive than Bangladesh is today, so, among other things, it had not yet developed sophisticated financial markets capable of systematically identifying and exploiting business opportunities. Therefore it could not count on the free market to drive its industry into ever-more-advanced activities, but required the active intervention of the state to do so. (The free market does not spring into existence fully formed and functional automatically or overnight, a lesson most recently demonstrated in the chaos of post-Communist Russia.)

Henry VII's advisors got their economic ideas ultimately from the city-states of Renaissance Italy, where economics had

been born as a component of Civic Humanism, their now-forgotten governing ideology.⁴⁰⁸ The name for this forgotten developmentalist wisdom of early modern Europe that has stuck is *mercantilism*. One of the great myths of contemporary economics is that mercantilism was an analytically vacuous bundle of gold-hoarding prejudices.⁴⁰⁹ It was, in fact, a remarkably sophisticated attempt, given the limited conceptual apparatus of the time, to advance national economic development by means that would be familiar and congenial to the technocrats of 21st-century Tokyo, Beijing, or Seoul.⁴¹⁰

Mercantilists invented many economic concepts still in use today, such as the balance of payments, value added, and the embodied labor content of imports and exports. They championed the economic interests of the nation as a whole at a time when special interests (notably royal monopolies) were an even bigger problem than today. They began with obvious ideas like taxing foreign luxury goods. They progressed to the idea that exporting raw materials for foreigners to process was bad if the nation could process them itself.⁴¹¹ They understood that nations rose economically by imitating the industries of already rich nations (first the more primitive industries, then the more sophisticated) and that low relative wages were the key advantage of underdeveloped nations in this game.

Even mercantilists' much-mocked obsession with the accumulation of bullion was not as irrational as it is usually depicted as being, given that under a monetary system based on gold, accumulating it is the only way to expand the money supply and drive down interest rates, a boon to investment then as now.⁴¹² Mercantilism, in fact, created the modern European economy and thus made possible the colonial power that economically shaped much of the rest of the world. It is thus the foundation of modern capitalism itself.

Anyhow: Britain functioned on a mercantilist basis for *centuries* before its much misunderstood experiment with free trade began. Even as late as the beginning of the 19th century, Britain's average tariff on manufactured goods was roughly 50 percent—the highest of any major nation in Europe.⁴¹³ And even after Britain embraced free trade in most goods, it continued to tightly regulate trade in strategic capital goods, such as the machinery for the mass production of textiles, in order to forestall its rivals. As we saw in the previous chapter, this was rational, as the win-win logic of free trade can break down if factors of production are mobile between nations (dubious assumption #4) or if free trade induces adverse productivity growth abroad (dubious assumption #6).⁴¹⁴ Even Adam Smith himself was only in favor of free trade *after* Britain had consolidated its industrial power through protectionism.⁴¹⁵

BRITAIN'S FREE TRADE GAMBLE

Free trade in Britain began in earnest with the repeal of the Corn Laws in 1846, which amounted to free trade in food, Britain's major import at the time. ("Corn," in the usage of the day, meant all grains.) The general election of 1852 was taken for a plebiscite on the question,⁴¹⁶ and free trade began inexorably to restructure the British economy from without.⁴¹⁷ Repealing the Corn Laws was a momentous step because this removed the last major constraint on Britain's transformation, along the lines of its then- comparative advantage in manufacturing, into the world's first industrial society, where most workers would be factory workers, not farmers: how to feed so many factory workers?

To some extent, the objective of the Corn Laws was simply to feed a bulge in population (almost a tripling in the previous 100 years) on a small island with limited agricultural potential.⁴¹⁸ Competition with the prairies of North America eventually devastated Britain's old rural economy and the aristocracy that had lived off its agricultural rents,⁴¹⁹ but so committed was Britain to free trade that this price was accepted as in no other nation. Britain's rulers expected that free trade would result in their country dominating the emerging global industrial economy due to its head start, sidelining its trading partners into agriculture and raw

materials. They expected their lead in shipping, technology, scale economies, and financial infrastructure to be self-reinforcing and thus last indefinitely.⁴²⁰

If the rest of the world had been content to be played for fools, this strategy might have worked. Instead, it enjoyed a brief window of plausibility in the 1850s and 1860s, which were the zenith of classical liberalism (of which free trade was a part) in Europe generally. Then things started to sour. For one thing, this zenith of free trade coincided with a prolonged Europe-wide depression, which started to lift as protectionism began to take hold.⁴²¹ More fundamentally, the British plan for universal free trade stumbled as the U.S. and the rest of Europe declined to accept their inferior allotted roles in the global trading system. In Germany and the United States especially, people accused Britain of favoring free trade for *other* countries and only *after* having secured its own position through protectionism. The influential German economist Friedrich List (1789-1846) called this “kicking away the ladder.” As one British Lord said in Parliament:

Other nations knew, as well the noble lord opposite, and those who acted with him, that what we meant by free trade, was nothing more nor less than, by means of the great advantages we enjoyed, to get the monopoly of all their markets for our manufactures,

and to prevent them, one and all, from ever becoming manufacturing nations. [422](#)

So despite British preaching, free trade was falling apart. Britain practiced it unilaterally in the vain hope of imitation, but the United States emerged from the Civil War even more explicitly protectionist than before, Germany under Bismarck turned in this direction in 1879, and the rest of Europe followed. During the 1880s and 1890s, tariffs went up in Sweden, Italy, France, Austria-Hungary, and Spain. [423](#) There was good reason for this: they worked. A study by the Irish economist Kevin O'Rourke shows a clear correlation between protection and economic growth rates in Europe in the 1875-1914 period. [424](#)

FOREIGN PROTECTIONISM, BRITISH DECLINE

The United States brought to global competition continental economies of scale and a more aggressively commercial culture than Britain. Germany brought industrial paternalism that delivered an efficient workforce and a prescient understanding that science-based industry was the wave of the future—quintessentially in optics, chemical engineering, and the electrical industries. Both nations forged ahead under protectionism. Britain's economy still grew, but inexorably

lagged: from 1870 to 1913, industrial production rose an average of 4.7 percent per year in the U.S., 4.1 percent in Germany, but only 2.1 percent in Britain.⁴²⁵ In the melancholy words of one commentator:

The industries that formed the core of the British economy in the 19th century, textiles and steel, were developed during the period 1750-1840—before England abandoned mercantilism. Britain’s lead in these fields held for roughly two decades after adopting free trade but eroded as other nations caught up. Britain then fell behind as new industries, using more advanced technology, emerged after 1870. These new industries were fostered by states that still practiced mercantilism, including protectionism.⁴²⁶

But despite the mounting failure of its great strategic gamble, Britain stuck to free trade abroad and a laissez-faire absence of industrial policy at home. Fundamentally, the country was lulled by the Indian summer of its industrial supremacy—it was surpassed economically by the U.S. only around 1880—into thinking that free trade was optimal as a permanent policy. The clarity of British thinking was not helped by the fact that certain vested interests had fattened

upon free trade and established a grip upon the levers of power that was hard to break.

Britain's decline did not go unnoticed at the time, either at home or abroad. Neither did the underlying problem: in the 1906 words of Member of Parliament F.E. Smith, later famous as a friend of Winston Churchill:

We give to our rivals a free market of 43,000,000 persons in the United Kingdom to add to their own free market. Thus the United States possess an open market of 82,000,000 persons in the United States, plus an open market of 43,000,000 persons in Great Britain, making, altogether, 125,000,000. Similarly, Germany possesses an open market of 43,000,000 in Great Britain. As against this, we possess only such residual of our open market of 43,000,000 as the unrestricted competition of foreign nations leaves unimpaired....*We call ourselves free traders, but we have never secured free trade for ourselves; we have merely succeeded in enlarging the area within which our protectionist competitors enjoy free trade.* ⁴²⁷
(Emphasis added.)

Some British politicians set out to do something about the problem. The great crusader to abolish free trade was the

Conservative Parliamentarian Joseph Chamberlain (1836-1914), father of the more famous Neville. ⁴²⁸ As he put it in a major speech in 1903:

I believe that all this is part of the old fallacy about the transfer of employment...It is your fault if you do not leave the industry which is failing and join the industry which is rising. Well—sir, it is an admirable theory; it satisfies everything but an empty stomach. Look how easy it is. Your once great trade in sugar refining is gone; all right, try jam. Your iron trade is going; never mind, you can make mouse traps. The cotton trade is threatened; well, what does that matter to you? Suppose you tried dolls' eyes...But how long is this to go on? Why on earth are you to suppose that the same process which ruined sugar refining will not in the course of time be applied to jam? And when jam is gone? Then you have to find something else. And believe me, that although the industries of this country are very various, you cannot go on forever. You cannot go on watching with indifference the disappearance of your principal industries. ⁴²⁹

The British turn-of-the-last-century debate eerily echoes the

free trade debate in America today. It was an era like our own, with new technologies like the steamship and the telegraph ushering in fears of what a borderless global economy might bring. The political fate of a weakening superpower with global responsibilities was bound up in fears of its economic decline. Consider these familiar-sounding agenda items from a conference of Britain's Trades Union Congress: "the need to deal with competition from the Asian colonies" and "the need to match the educational and training standards of the United States and Germany."⁴³⁰

The same accusations made in the U.S. today flew back and forth. Free traders were accused of viewing economics solely from the consumer's point of view and of favoring short-term consumption over long-term producer vitality. Protectionist concern for producer vitality was tarred as mere cover for special interests. It was debated whether protectionism stifled competition by excluding foreigners or preserved it by saving domestic competitors (new trade theory now understands it can do either).⁴³¹ It was debated whether the country was living off its past capital. It clearly was: by the late 19th century, Britain ran a chronic deficit in goods and only managed to balance its trade by exporting services as shipper and banker to the world and by collecting returns on past overseas investments. Free traders were accused of abstractionism; in the words of one book at the time:

The free trader hardly professes to base his opinions on experience; he is content to adduce illustrations from actual life of what he believes *must* happen. [432](#)

Those words could have been written yesterday! The trustworthiness of British economists, ideologically mortgaged to the free-trade tradition of classical political economy, was questioned. Free traders denied the existence of a crisis on the grounds that the nation's sunrise industries were doing well (some were, but not enough to replace the sunset industries being lost). The two sides preened themselves on their cosmopolitanism and their patriotism, respectively.

In hindsight, the protectionists had the stronger case, but were outfought by the superior rhetorical and political skill of their rivals. The vested interests and experienced political tacticians were mostly on the free-trade side—which included half of Chamberlain's own Conservative party, which split on the question. Free traders were defending a status quo bound up in concepts of economic liberty believed essential to British national identity, concepts that struck at the heart of what made Britons different from statist Continental Europeans. And free trade's opponents made no attack upon the economic theory *behind* free trade, beyond simply denying its effectiveness. This made it impossible for them to construct a case against free trade strong enough to pull it up by its roots.

Chamberlain struggled to enact a tariff from 1903 to 1906, when his party fought a general election, largely on this very issue. The divided Conservatives lost to the free-trade Liberal party. Their next chance came in 1923 and they lost again, this time to the free-trade Labour party. Thanks to the Great Depression, Britain finally abandoned free trade in 1931—but by then it was too little, too late. Although protectionism buffered Britain against the Depression somewhat, it was far too late to redeem the nation’s position as a leading economic power. Today, outside the City of London’s financial center, the one-time Workshop of the World, which generated a third of global industrial production in 1870,⁴³³ is an economic asterisk.

AMERICA, SWEET LAND OF PROTECTIONISM

The idea that America’s economic tradition has been economic liberty, laissez faire, and wide-open cowboy capitalism—which would naturally include free trade—resonates well with our national mythology. It fits the image of this country held by both the Right (which celebrates this tradition) and the Left (which bemoans it). It is believed both here and abroad. But when it comes to trade at least, it is simply not real history. The reality is that all four presidents on Mount Rushmore were protectionists. (Even Jefferson came around after the War of 1812.)⁴³⁴ Protectionism is, in fact, the *real* American

Way.

Americans were alert to the dangers inherent in trade economics even before Independence. During the colonial period, the British government tried to force its American colonies to become suppliers of raw materials to the nascent British industrial machine while denying them any manufacturing industry of their own. The colonies were, in fact, one of the major *victims* of Britain's previously-noted mercantilist policy, being under Britain's direct political control, unlike its other trading partners. As former Prime Minister William Pitt, otherwise a famous conciliator of American grievances and the namesake of Pittsburgh, once said in Parliament, "If the Americans should manufacture a lock of wool or a horse shoe, I would fill their ports with ships and their towns with troops."⁴³⁵

To some extent, the American Revolution was, in fact, a *war over industrial policy*, in which the commercial elite of the Colonies revolted against being forced into an inferior role in the emerging Atlantic economy. This is one of the things that gave the American Revolution its exceptionally bourgeois character as revolutions go, with bewigged Founding Fathers rather than the usual unshaven revolutionary mobs. It is no accident that upon Independence, a tariff was the very second bill signed by President Washington.⁴³⁶

Protectionism's first American theorist was Alexander

Hamilton—the man on the \$10 bill, the first Treasury Secretary, and America’s first *technocrat*. As aide-de-camp to General Washington during the Revolution, he had seen the U.S. nearly lose due to lack of capacity to manufacture weapons (France rescued us with 80,000 muskets and other war materiel.) He worried that Britain’s lead in manufacturing would remain entrenched, condemning the United States to being a producer of agricultural products and raw materials. In modern terms, a banana republic. As he put it in 1791:

The superiority antecedently enjoyed by nations who have preoccupied and perfected a branch of industry, constitutes a more formidable obstacle than either of those which have been mentioned, to the introduction of the same branch into a country in which it did not before exist. To maintain, between the recent establishments of one country, and the long-matured establishments of another country, a competition upon equal terms, both as to quality and price, is, in most cases, impracticable. The disparity, in the one, or in the other, or in both, must necessarily be so considerable, as to forbid a successful rivalship, without the extraordinary aid and protection of government. [437](#)

Hamilton’s policies came down to about a dozen key

measures. In his own words: [438](#)

1. **“Protecting duties.”** (Tariffs.)
2. **“Prohibition of rival articles or duties equivalent to prohibitions.”** (Outright import bans.)
3. **“Prohibition of the exportation of the materials of manufactures.”** (Export bans on industrial inputs, like King Henry VII’s ban on exporting raw wool.)
4. **“Pecuniary bounties.”** (Export subsidies, like those provided today by the Export-Import Bank and other programs.)
5. **“Premiums.”** (Subsidies for key innovations. Today, we would call them research and development tax credits.)
6. **“The exemption of the materials of manufactures from duty.”** (Import liberalization for industrial inputs, so some *other* country can be the raw materials exporter.)

7. **“Drawbacks of the duties which are imposed on the materials of manufactures.”** (Same idea, by means of tax rebates.)

8. **“The encouragement of new inventions and discoveries at home, and of the introduction into the United States of such as may have been made in other countries; particularly those, which relate to machinery.”** (Prizes for inventions and, more importantly, patents.)

9. **“Judicious regulations for the inspection of manufactured commodities.”** (Regulation of product standards, as the USDA and FDA do today.)

10. **“The facilitating of pecuniary remittances from place to place.”** (A sophisticated financial system.)

11. **“The facilitating of the transportation of commodities.”** (Good infrastructure.)

Hamilton set forth his case in his *Report on Manufactures*, submitted to Congress in 1791. ⁴³⁹ Due in large part to the domination of Congress by Southern planters, who favored

free trade, Hamilton's policies were not adopted *in toto* right away. It took the War of 1812, which created a surge of anti-British feeling, disrupted normal trade, and drastically increased the government's need for revenue, to push America firmly into the protectionist camp. But when war broke out, Congress immediately doubled the tariff to an average of 25 percent.⁴⁴⁰

After the war, British manufacturers undertook one of the world's first well-documented cases of predatory dumping, whose purpose was, in the words of one Member of Parliament, to "stifle in the cradle, those rising manufactures in the United States, which the war had forced into existence."⁴⁴¹ In reaction, the American industrial interests that had blossomed because of the tariff lobbied to keep it, and had it raised to 35 percent in 1816. The public approved, and by 1820, America's average tariff was up to 40 percent.⁴⁴²

Fast-forward a few years. Gloss over a number of important tariff-related political struggles, such as the South Carolina Nullification Crisis of 1832, one of the precursors of the Civil War, in which South Carolina tried to reject a federal tariff. There was a brief free trade episode starting in 1846, coinciding with the aforementioned zenith of classical liberalism in Europe, during which America's tariffs were lowered. But this was followed by a series of recessions, ending in the Panic of 1857, which brought demands for a

higher tariff so intense that President James Buchanan—the last free-trade president for two generations—gave in and signed one two days before Abraham Lincoln took office in 1861.⁴⁴³

SLAVERY VS. THE TARIFF

The next big protectionist event in American history is the rise of the Republican party, spurred into being by the conflict over slavery but inheriting from its Whig party antecedent an agenda of aggressive government support for economic development. The new party favored a number of policies to this end, including hard money (deflation, the preference of creditors), subsidies for railroads, free land for homesteaders, and higher tariffs. In office from 1861, the Republicans lost no time raising tariffs, using the excuse of funding the Civil War and conveniently not having free-trade Southern Democrats in office. President Lincoln's economic guru was a Philadelphia economist named Henry Carey—forgotten in our day but world-famous in his own.⁴⁴⁴

It would be an exaggeration to say that the Civil War was “about” the tariff, as some Southern partisans claim, eager to shed the opprobrium of the South's having fought for slavery. But slavery and free trade are intimately connected as economic policies because free trade is, in fact, the ideal policy for a nation which actually *wants* to be an agricultural slave

state. Because slaves are unsuitable for industrial work, slave states from Rome onward have failed to industrialize.⁴⁴⁵ Because they have no hope of developing comparative advantage in manufacturing, their best move is to optimize the comparative advantage in slave-based agriculture they are stuck with and import most everything else. Classic Ricardian free trade fits this strategy to a “t.” The antebellum South, having little manufacturing industry to protect, derived little benefit from the tariff. Economically, it was still a part of the British Empire that bought its cotton, America’s leading export before 1870.⁴⁴⁶ As the tariff was the main source of federal revenue in those pre-income tax days, the South also bore a disproportionate share of the nation’s tax burden. No wonder it was in favor of free trade (which the Confederate constitution eventually mandated).⁴⁴⁷

There is a larger lesson here, reaching beyond American history. Almost all nations that have failed to break into modern industry have a common characteristic: in terms of U.S. history, *their equivalents of the South won their civil wars*. These were not all actual wars, of course, some being merely struggles of interest group politics, but the pattern is consistent: agricultural or raw-materials interests won a battle with rising manufacturing interests and biased the economic policy of the state to favor themselves. Sometimes this outcome was imposed by a colonial overlord, but it was often self-inflicted. This pattern goes far back, predating the

industrial revolution by centuries. In Spain, for example, the key moment was arguably the *Guerra do los Comuneros* of 1520-21, in which aristocratic agricultural interests, embodied in such groups as the sheep owners' organization *La Mesta*, won control of economic policy after a failed insurrection against the Habsburg monarchy.⁴⁴⁸ So instead of protecting its manufacturing, Spain protected agricultural products like olive oil and wine. As a result, Spanish industrialization actually went backwards and Spain gradually *deindustrialized* for the remainder of the century. Then came the easy pickings of New World empire, and a flood of silver and gold caused Spain to lose interest in industrialization completely. Its economy has only converged with the level of its European peers in the last 20 years.

THE GOLDEN AGE OF AMERICAN INDUSTRY

After the Civil War, tariffs stayed high during the long Republican hegemony from 1865 to 1932. Reading the speeches of 19th-century Republican politicians today, with their expressions of concern for the wages of the American working man, one finds oneself wondering how the party slipped to its present day let-them-eat-cake position. (One can dismiss these sentiments as fraud, but the tariff was real enough.) Republicans of the robber-baron era were no angels, but they did believe that American capitalism depended upon class harmony—in contrast, as they saw it, to unstable

revolutionary Europe. ⁴⁴⁹ Without a significant welfare state, America had to do *something* to smooth the rougher edges of capitalism, and the tariff was a way to unite the interests of American workers and American capitalists.

The country at large generally supported this policy, though the left- and right-wing extremists of the day naturally dissented. Extreme right wing Social Darwinists like William Graham Sumner—who published a fuming book in 1885 entitled *Protectionism, the Ism That Teaches That Waste Makes Wealth*—saw protectionism as a subsidy for the incompetent and an interference with the divine justice of the free market and the survival of the fittest. ⁴⁵⁰ Karl Marx, on the other hand, wanted to see American capitalism break down and therefore favored free trade for its destructive potential. He wrote that:

The protective system of our day is conservative, while the free trade system is destructive. It breaks up old nationalities and pushes the antagonism of the proletariat and bourgeoisie to the extreme point. In a word, the free trade system hastens the social revolution. It is in this revolutionary sense alone, gentlemen, that I vote in favor of free trade. ⁴⁵¹

The Democrats of this era, who generally supported free trade, were not Marxists, of course. But they saw the tariff as either a tax on the non-industrial regions of the country (like the South, solidly agrarian and solidly Democratic during this period) or as a racket for the benefit of big business. In the 1913 words of Democratic Congressman (later the famous House Speaker) Sam Rayburn of Texas:

The system of protective tariffs built up under the Republican misrule has worked to make the rich richer and the poor poorer. The protective tariff has been justly called the mother of trusts [monopolies]. It takes from the pockets of those least able to pay and puts into the pockets of those most able to pay. The two great parties in the long past took distinct positions upon the tariff question—the Democratic party of the masses on the one side and the Republican party of the classes on the other side. [452](#)

America's tariff regime in this era was not especially sophisticated. One searches the historical record in vain for complex theories about what the tariff should be or for the elaborate technocratic institutions that managed it. There were neither. Tariff policy was mostly set by not-entirely-uncorrupt Congressional logrolling. Corruption was moderated by the fact that the dealmaking was fairly public (as tariffs were

considered nothing to be ashamed of), and the tariffs themselves were moderated by the fact that one industry's output was often another's input, so lobbyists seeking higher tariffs were counterbalanced by lobbyists seeking lower ones. But that's about as subtle as things got. In Sumner's annoyed words:

They have never had any plan or purpose in their tariff legislation. Congress has simply laid itself open to be acted upon by the interested parties, and the product of its tariff legislation has been simply the resultant of the struggles of the interested cliques with each other, and of the logrolling combinations which they have been forced to make among themselves. [453](#)

But it worked. This was the golden age of American industry, when America's economic performance surpassed the rest of the world by the greatest margin. It was the era in which the U.S. transformed itself from a promising mostly agricultural backwater, pupil at the knee of European industry, into the greatest economic power in the history of the world.

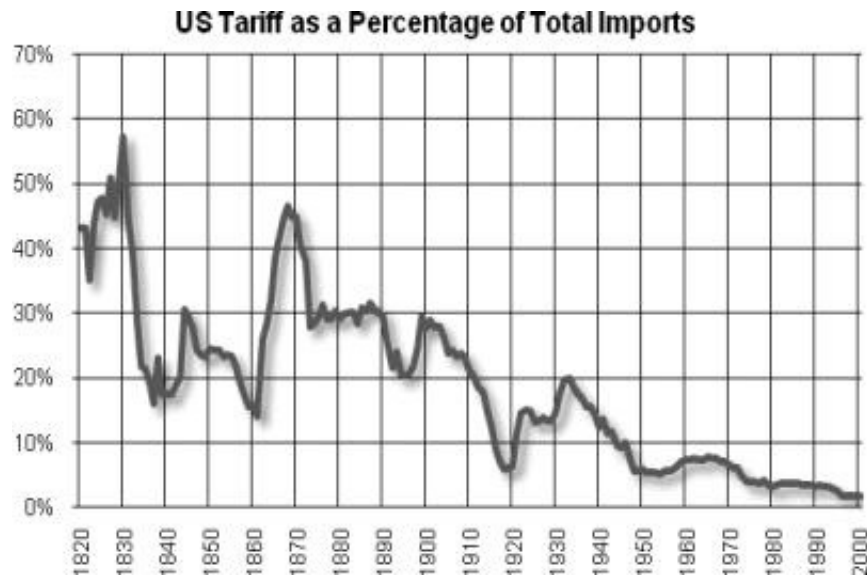
About the only technocratic sophistication American tariffs had was some drift towards taxing manufactured goods more than raw materials. In part, this simply reflected the fact that

raw material imports were less likely to face a competing American industry lobbying for its own protection. In 1872, keeping pace with American industrialization, Congress modified the tariff from a broad-based levy on a wide range of imports to a narrower one targeted at protecting industrial wages and manufacturing industry.⁴⁵⁴ The U.S. went from importing five percent of its imports untaxed to nearly 50 percent; tea and coffee now came in duty-free.⁴⁵⁵

Protectionism was the overwhelming consensus of the era. Grover Cleveland, the sole Democratic president of the 1870-1913 period, survived politically largely by keeping quiet about the tariff. Then, after his first term in office, he ran in 1888 on a platform of cutting the tariff in favor of an income tax, devoting his entire 1887 State of the Union address to this idea. He was tarred in the press as a dupe of British interests and lost to Republican Benjamin Harrison.⁴⁵⁶ He learned his lesson and recanted. He returned to office in 1893, the only split-term president in American history.

The chart below gives the big picture.⁴⁵⁷ Note that this chart does not show the average tariff on *dutiable* goods (not all goods have been dutiable), and that it masks variations by product. Note also that changes in tariffs collected as a percentage of total imports can be caused not only by changes in tariff *rates*, but also by shifting proportions of what is imported. And remember that part of the significance of a

tariff is that it eliminates some imports entirely, a fact that does not show up on this chart at all.



AMERICA'S RETREAT FROM THE TARIFF

Contrary to what one might expect, the United States' retreat from the tariff was not caused by changes in policymakers' opinions about economics. That is, there was no point at which they decided that the economics of protectionism was false and the economics of free trade was true. Rather, this retreat was driven by essentially *political* motives, operating in a space of economic carelessness carved out by our mid-20th-century economic zenith. Fundamentally, we believed that the foundations of our economic strength were so secure that we didn't have to worry very much anymore about what they were. And for decades after we started dismantling protectionism, the legacy effects of 150 years of it shielded us

from the consequences of increasingly free trade and distorted our understanding of what those consequences really were.

Woodrow Wilson was the first modern president to believe in free trade. (It was number three of his famous Fourteen Points for Peace after WWI.) He succeeded in reducing tariffs in 1913, in the course of introducing income tax for the first time since the Civil War, but Congress pushed them back up in 1921. The Roaring Twenties were a tariff era.

The “notorious” Smoot-Hawley tariff of 1930 is sometimes blamed for all or part of the Great Depression—most recently by presidential candidate John McCain, who said during the 2008 presidential campaign:

Every time the United States has practiced protectionism we've paid a very heavy price for it. Some even claim, with some authenticity, that the Smoot-Hawley tariff act was a major contributor to the outbreak of World War II, not to mention the [458](#) Great Depression.

This accusation is obviously implausible, given that the Depression was already taking hold, due to the 1929 stock market crash, before Smoot-Hawley even passed Congress. And it was proved by economist Milton Friedman (at least to the satisfaction of the Nobel Prize committee) that the

Depression's cause was monetary.⁴⁵⁹ The Fed had allowed the money supply to balloon during the late 1920s, piling up in the stock market as a bubble. It then panicked, miscalculated, and let it collapse by a third by 1933, depriving the economy of the liquidity it needed to breathe. Trade policy was not involved.

As for the charge that Smoot-Hawley caused the Depression to spread worldwide: it did not affect enough trade, or raise the tariff by enough, to have plausibly so large an effect.⁴⁶⁰ For a start, it only applied to about one-third of America's trade: about 1.3 percent of our GDP. Our average duty on dutiable goods went from 44.6 to 53.2 percent—hardly a radical change.⁴⁶¹ Tariffs as a percentage of total imports were higher in almost every year from 1821 to 1914.⁴⁶² America's tariffs went up in 1861, 1864, 1890, and 1922 without producing global depressions, and the recessions of 1873 and 1893 managed to spread worldwide without tariff increases.⁴⁶³ Neither does the myth of a death spiral of retaliation by foreign nations hold water.⁴⁶⁴ According to the official State Department report on this question in 1931:

With the exception of discriminations in France, the extent of discrimination against American commerce is very slight...By far the largest number of countries

do not discriminate against the commerce of the United States in any way. [465](#)

World trade declined, but almost entirely due to the Depression itself, not tariffs. “Notorious” Smoot-Hawley is a deliberately fabricated myth, plain and simple. [466](#) *Smoot* was a moderate and routine adjustment to America’s trade regime, not a major shock to the world trading system. [467](#)

THE TURNING POINT ON TARIFFS

America’s tariffs first started to come down for good in 1934, at the instigation of FDR’s Secretary of State Cordell Hull. Hull’s faith in free trade had more to do with his belief it would promote world peace than any particular economic analysis. In his own words:

I reasoned that, if we could get a freer flow of trade—freer in the sense of fewer discriminations and obstructions—so that one country would not be deadly jealous of another and the living standards of all countries might rise, thereby eliminating the economic dissatisfaction that breeds war, we might have a reasonable chance for lasting peace. [468](#)

This strange quasi-Marxist view that the underlying cause of war is “economic dissatisfaction” finds little support in history. But because of it, by 1937, the U.S. had reciprocally cut tariffs with Cuba, Belgium, Haiti, Sweden, Brazil, Colombia, Honduras, Canada, Switzerland, Nicaragua, Guatemala, France, Finland, Costa Rica, El Salvador, Czechoslovakia, and Ecuador.⁴⁶⁹ This first turn towards tariff cuts was greased through Congress by being presented as “an emergency measure to deal with emergency panic conditions,” and was mostly not spotted for the historic turning point it was. Because the Great Depression and World War II interfered with normal trade, it had little immediate practical effect, and the idea of tariff cutting was quietly assimilated to the New Deal consensus without much public ado, despite some fierce battles inside the administration.⁴⁷⁰

But a trend had taken root. As part of this change, Congress unconstitutionally (*contra* Article I, Section 8, which reads, “Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises [and] to regulate Commerce with foreign Nations”) ceded control over tariffs to the President. FDR turned the task over to mid-level officials from the State Department and other government departments—men not even sufficiently highly placed to require Congressional confirmation.⁴⁷¹ Free traders have ever since preferred to

keep tariffs out of the hands of Congress and in the hands of “experts” insulated from democratic accountability. Congress had previously managed the tariff with moderately corrupt favor trading and had had few ideological or geopolitical axes to grind. The Executive was also subject to interest-group politics, but it operated behind closed doors and had a far stronger tendency to make tariff policy the handmaiden of extraneous foreign policy agendas.⁴⁷²

FREE TRADE TO BEAT COMMUNISM

In the aftermath of World War II and in the face of British decline, the U.S. assumed Britain’s mantle of global underwriter of free trade. In the 1947 negotiations that established the General Agreement on Tariffs and Trade, the world’s main trading framework until establishment of the World Trade Organization in 1995, we cut our average tariff 35 percent.⁴⁷³ It was easy to do at the time, with the U.S. running a substantial (4.2 percent of GDP) trade surplus from 1946 to 1947.⁴⁷⁴ This was a deliberate Cold War strategy aimed at strengthening the economies of the noncommunist world and binding them to the U.S.⁴⁷⁵ It was obviously geopolitically wise, even if we know now that Communism was a less formidable economic challenger than it then seemed. “All problems of local industry pale into insignificance in relation to the world crisis,” President

Eisenhower told Congress in 1953.⁴⁷⁶ Thus America became the only major market open to trade; all the others were small, poor, protected, socialist or communist.

At this stage of the game, American policymakers still had some residual awareness of the value of tariffs. (The delusion that free trade actually made economic sense only set in later.) Thus the Marshall Plan to deliberately reindustrialize Europe, and industrialize for the first time agricultural nations like Italy and semi-industrialized nations like France, employed high tariff walls and tight controls on capital mobility.⁴⁷⁷ At the time, we believed not that free trade made economic sense for us, but that our superior productivity had bought us enough breathing room to engage in it for political reasons regardless.⁴⁷⁸ As President Truman put it:

Our industry dominates world markets...American labor can now produce so much more than low-priced foreign labor in a given day's work that our workingmen need no longer fear, as they were justified in fearing in the past, the competition of foreign workers.⁴⁷⁹

For 15 years or so, this was probably true. But our allies' economies had recovered from WWII by 1960. And by the

end of the 1960s, world Communism's "We will bury you" threat to surpass us economically (which had genuinely worried rational people watching the USSR grow faster than the U.S. in the 1950s) had ceased to be credible.⁴⁸⁰ So the original rationales for America's turn towards free trade had expired.

In retrospect, the early 1960s were the time America should have turned back from free trade. We certainly could have. Unfortunately, we instead made the exact same mistake Britain had made a century before and mistook the short-term advantages of free trade, when viewed from the perspective of the leading economy of the day, for permanent benefits. In the early 1960s, it certainly *seemed* as if imports were only penetrating low-end industries, giving us foreign goods on the cheap while leaving our high-value industrial sectors unharmed. This appeared to vindicate the Ricardian notion that free trade would always operate in our favor. So we let a policy with a temporary and political origin harden into a permanent economic dogma. We started to indulge the delusion that the underlying economics really *did* work.

FREE TRADE SOURS FOR AMERICA

In retrospect, John F. Kennedy's Trade Expansion Act of 1962 was America's decisive wrong turn on trade.⁴⁸¹ Quantitatively, the so-called Kennedy Round of tariff cuts was

large enough to be noticed, but not earth-shaking: as this legislation was phased in, our average duty on dutiable imports fell from 14.3 percent in 1967 to 9.9 percent in 1972.⁴⁸² But this was one of history's small yet decisive turning points, occurring as it did at the same moment that America's trading partners were getting into high gear economically and the 1944-71 Bretton Woods system of fixed exchange rates was beginning to falter. And tariff cuts were exceptionally steep on high technology goods, increasing their impact.⁴⁸³ Furthermore, the Trade Expansion Act should be evaluated not simply in terms of its before and after tariff levels, but contrasted with the alternative of turning back from free trade—which is what we should have done.

There were certainly warnings at the time. The famous liberal economist John Kenneth Galbraith bluntly told President Johnson in 1964 that “If we are screwed on tariffs, this will have an enduringly adverse effect on the balance of payments. It will be a serious problem for years to come.”⁴⁸⁴ And, lo and behold, the first serious trade-related cracks in the American economy began to appear in the late 1960s. Black-and-white television production left for Japan. So did cameras, transistor radios, and toys. Our trade went into deficit in 1971. We have not run a surplus since 1975.⁴⁸⁵

There has, of course, been a simmering revolt against free trade ever since. Organized labor, which had actually

supported the Kennedy tariff cuts when proposed in 1962, turned against free trade by the end of the decade. In 1968, Senators Ernest Hollings (D-SC) and Norris Cotton (R-NH) managed to pass a protectionist trade bill in the Senate with 68 votes. President Johnson had it killed by House Ways and Means Committee chairman Wilbur Mills.⁴⁸⁶ 1969 saw the first consideration, by Commerce Secretary Maurice Stans, of creating an American agency to coordinate industrial policy. Nixon abandoned the effort for lack of Congressional support.⁴⁸⁷ In 1971, a trade deficit of one-half of one percent of GDP (about a tenth of today's level) was enough to frighten Nixon into imposing a temporary 10 percent surcharge tariff on all dutiable goods.⁴⁸⁸ In 1972, the AFL-CIO endorsed the Burke-Hartke bill, which would have imposed quotas on imports in threatened industries and restricted the export of capital by multinational corporations.⁴⁸⁹

But free trade survived all these challenges. Fundamentally, protectionist forces in Congress fumbled the ball. In the words of one scholar describing the failure of the big protectionist push in the last days of the Nixon administration:

Even in Congress, protectionist industries failed to utilize their potential resources. During negotiations over general trade bills in Congress, protectionists

exerted weak influence because they lacked an umbrella association to represent them. Instead, protectionists were divided along industrial lines, each promoting its own distinct objectives....The logic of selective protectionism did not encourage industries to cooperate with each other, since the chances for congressional support increased if protectionist bills were narrowly constructed. In addition, protectionist industries did not cooperate with organized labor. [490](#)

The failure of this protectionist effort carries important lessons for tactical thinking about free trade today. Sen. Hollings tried again under President Carter, but Carter preferred the Cold War priority of free trade. Ronald Reagan vetoed two protectionist trade bills, in 1985 and 1988. George H.W. Bush vetoed one, in 1990.

Ronald Reagan viewed free trade as basically a good thing, but with exceptions, so he was willing to deviate from it occasionally for the sake of threatened industries and to protect the technology base needed to win the Cold War. He enacted the “voluntary” automobile agreement with Japan that Carter had negotiated and imposed a tariff on motorcycles to save American icon Harley Davidson. [491](#) He protected steel, lumber, computer memory chips, and sundry other

products.⁴⁹² Unfortunately, his trade pragmatism, while preferable to the extremism of Bill Clinton and the two Bushes, was not guided by any thoroughgoing critique of the underlying economics of free trade—beyond the idea that it sometimes didn't work in America's favor. As a result, Reagan did not go beyond relatively narrow tactical interventions.

America's last major attempt to create a full-blown industrial policy took place from 1983 to 1985 under Reagan's Commerce Secretary Malcolm Baldrige, who proposed turning the Commerce Department into a Department of Trade and Industry analogous to Japan's famed Ministry of International Trade and Industry (MITI). The proposal was killed by the ideological qualms of free-marketeers and by the efforts of the Office of the United States Trade Representative to defend its turf.⁴⁹³

JAPAN'S PROTECTIONIST HISTORY

In the 1980s, Japanese industrial policy was the object of intense American interest, which has since waned due to the misapprehension that Japan is in major economic decline.⁴⁹⁴ There was a flurry of books on the subject and for a while it seemed that America might acquire a serious industrial policy of its own (which never happened). But Japan remains much more relevant to America's situation than China—which

everyone is now obsessing about—simply because Japan has wages comparable to the U.S., while China competes largely on the basis of a low-wage policy that is impossible for any developed nation to emulate. So it is worth examining Japan's trade history.

The Japanese themselves certainly believe their economic success has been due to protectionism. No one in Japan of any standing in business, government, or academe believes that Japan's success has been due to free trade. In the words of economic historian Kozo Yamamura:

Protection from foreign competition was probably the most important incentive to domestic development that the Japanese government provided. The stronger the home market cushion...the smaller the risk and the more likely the Japanese competitor was to increase capacity boldly in anticipation of demand growth. This can give the firm a strategic as well as a cost advantage over a foreign competitor operating in a different environment who must be more cautious. [495](#)

The cultural roots of Japan's repudiation of free trade are extraordinarily deep—as deep, say, as the roots that make America a capitalist society. This was, after all, a nation which

literally sealed itself off from the outside world for two centuries (1635-1853). This act is regarded by most Westerners as merely odd, but it was, in fact, profoundly consistent with the enduring character of Japanese civilization.

Japan's forcible opening to the modern world in 1853, when U.S. Commodore Matthew Perry sailed his famous "black ships" into Tokyo Bay demanding trading rights, added a new element to Japan's existing authoritarian social order: the need for economic and technological sophistication sufficient to defend its existence as an independent nation. Japan promptly set about engaging the modern world on terms congenial to its own political priorities—not those of outsiders. The key slogan of the day was *fukoku kyohei*, "rich country equals strong army." Thus private economic interests have never, except perhaps for a brief liberal moment in the 1920s, been allowed to be the primary drivers of its national economy. Instead, private interests have been subordinated to the national economic interest under a system most succinctly describable as state capitalism. And protectionism is an innate part of that system.

Japan in 1945 was economically crushed, its cities smoking ruins, its empire gone. It was poorer even than some *African* nations untouched by the B-29. It seemed so far behind the United States that there was no plausible way ever to catch up. It was widely expected that Japan would end up an economic also-ran like that neighboring island chain, the Philippines.

And within the economic ideology America was promoting to Japan at the time, free trade according to comparative advantage, there seemed to be no way out, as Japan had comparative advantage only in low-value industries.

History records a fascinating exchange on this topic, which encapsulates the entire postwar free trade debate. In 1955, when the U.S. and Japan were negotiating their first post-occupation trade agreement, the head of the American delegation, C. Thayer White, told the Japanese to cut their tariff on imported cars because, in his words: [496](#)

- 1. The United States industry is the largest and most efficient in the world.**
- 2. The industry is strongly in favor of expanding the opportunities for world trade.**
- 3. Its access to foreign markets in recent years has been limited by import controls.**
- 4 . Although the United States Government appreciates that it is necessary for some countries to impose import restrictions for balance of payments reasons...it would be in Japan's interest to import**

automobiles from the United States and export items in which Japan could excel.

Upon Ricardian principles, White was, of course, 100 percent correct. But the Japanese trade negotiator, Kenichi Otabe, replied that:

1. If the theory of international trade were pursued to its ultimate conclusion, the United States would specialize in the production of automobiles and Japan in the production of tuna.

2 . Such a division of labor does not take place...because each government encourages and protects those industries which it believes important for reasons of national policy.

Needless to say, Japan did not choose to become a nation of fishing villages! Instead, its rulers drew the same conclusion that Alexander Hamilton had drawn 150 years earlier and Henry VII 300 years before that, opting for protectionism and industrial policy. They closed Japan's markets to foreigners in industries they wished to enter, only welcoming foreign goods insofar as they helped build up Japan's own industries. They applied administrative guidance to key industries and rigged

Japan's banking system and stock market to provide cheap capital to industry.⁴⁹⁷ Tokyo instead *protected* its then-fledgling automobile industry in the 1950s, limiting imports to \$500,000 per year. (In the 1960s, prohibitive tariffs replaced this quota.) Japan only allowed foreign investment insofar as this transferred technology to its own manufacturers. Today, it produces over two-and-a-half times as many cars as the U.S., mostly for export.⁴⁹⁸

As Japan has historically been the economic leader for the whole of Confucian Asia⁴⁹⁹ (Japan, Korea, China, Taiwan, Vietnam, Hong Kong, and Singapore), its protectionist policies have been shared with nearby nations to a huge extent. The ultimate basis of these policies is an attitude towards economics that sees the economy not as an end in itself, but as an instrument of national power. (See the William Cunningham quote in Chapter 6 for a reminder of how this attitude used to be the norm even in the Western world.) As Harvard Asia specialists Roy Hofheinz and Kent Calder have written, "For more than a century, nationalist sentiments... have been a basic driving force underlying East Asian economic growth."⁵⁰⁰ Even today, Chinese industry is 30 percent owned by the state.⁵⁰¹ Over a dozen strategic industries have been slated to remain under outright government ownership and control, including information technology, telecommunications, shipping, civil aviation and

steel.⁵⁰² Laissez faire this is not.

In relation to its neighbors, Japan has employed something called the “flying geese” strategy, christened thus by the Japanese economist Akamatsu Kaname in the 1930s.⁵⁰³ Japan breaks into an industry, wipes out existing Western competitors, then successively hands the industry down to less sophisticated neighboring economies such as Korea, Taiwan, Thailand, Malaysia, and Vietnam as they mature. This pattern has held for goods from garments to televisions for five decades. Japan’s withdrawal from labor-intensive goods in the 1970s opened up space for Taiwan, South Korea, Singapore, and Hong Kong, and *their* ongoing withdrawal from these goods is opening up space for China. Among other things, this nicely illustrates how rational protectionism is a dynamic, not a static, strategy, and does not consist in defending every job and every industry.

Chapter 7

The Negligible Benefits of Free Trade

Having looked at the profound theoretical and historical reasons to doubt that free trade is the best policy, let's try some quantification of what benefits America and other nations are *really* likely to get from the current agenda to relentlessly expand it. Because the surprising news here is that even the calculations of free traders *themselves* indicate that the benefits of expanding free trade (if they even are net benefits, which is precisely what is in dispute) are very small. Indeed, this is what Paul Krugman, a self-professed free trader despite his trenchant criticisms, has referred to as the “dirty little secret” of free trade.⁵⁰⁴ So even if we assume that the entire dubious edifice of free trade economics is true, there's just not that much on the table for America—or anyone else.

That the benefits of free trade are relatively modest should be intuitively comprehensible to anyone who thinks back to the economy America had in 1970.⁵⁰⁵ Then, imports were just over five percent of GDP, rather than the 17 percent they are now.⁵⁰⁶ Yet we somehow didn't seem to need very many imports to have the world's highest standard of living.⁵⁰⁷ Imports were mainly a matter of oil, natural products that don't grow here like bananas, luxury goods like Swiss watches, and a few odds and ends like Volkswagens. This rather suggests that the benefits of free trade are *at best* a layer

of icing on our economic cake, not a fundamental basis (let alone *the* fundamental basis, a ridiculous claim that gets made all the time) of our standard of living.

The benefits of free trade are especially dubious in the long run because although we have become dependent upon many imported products and could not switch back to domestic production overnight, we could certainly do so over time. This is not some countercultural vision of the simple life or of voluntarily accepting a lower living standard: it just means going back to lower import levels. It does not mean the end of consumer society or anything like it. It does not even mean going back to the living standards of earlier decades, as our living standards without free trade (not without *trade*) would be much higher, due to economic and technological growth in the intervening years.

Above all, the U.S. has virtually nothing to gain from pushing even further in the direction of free trade. Our government actually knows this perfectly well. The U.S. International Trade Commission periodically releases an official report, *The Economic Effects of Significant U.S. Import Restraints*, which recently put the gain from eliminating *all* remaining American trade barriers at \$3.7 billion dollars.⁵⁰⁸ This is just over two one-hundredths of one percent of GDP—about what Americans spend on Halloween and Easter candy every year.⁵⁰⁹ That in itself is an irony, as about a quarter of these gains consist in cheaper sugar if the

U.S. ends its (admittedly pointless) sugar import quota. [510](#)

SMALL GAINS FOR THE REST OF THE WORLD

Expanding free trade doesn't do much for the rest of the world, either. Generally accepted estimates of the likely benefits of further trade liberalization have, in fact, been going down for years as various criticisms of free-trade economics have started to tell. [511](#) For example, in the run-up to the 2003 World Trade Organization negotiations in Cancun, Mexico, the most widely quoted figure for gains from further trade liberalization was \$500 billion. [512](#) And that was for the developing world alone, with more as gravy for the industrialized nations. But only two years later, at the next round of talks in Hong Kong, with revised economic models, there were few estimates over \$100 billion: a drop of 75 percent! [513](#) Many estimates were even lower. And 85 percent of the expected benefits to developed nations were slated to go to Europe, Japan, Korea, Taiwan, Hong Kong, and Singapore. [514](#) The U.S. and Canada were destined for very small shares because their economies were *already* so open.

The two most important models for generating these estimates are the Global Trade Analysis Project (GTAP) model, maintained at Purdue University in Indiana, and the LINKAGE model, maintained by the World Bank in

Washington. ⁵¹⁵ The declining estimates generated by these models can be clearly seen in the table below:

Projected Benefits of Trade Liberalization ⁵¹⁶

Model	Year	Benefits (in billions)	
		Developing Nations	Entire World
GTAP	2002	\$108	\$254
GTAP	2005	\$22	\$84
LINKAGE	2003	\$539	\$832
LINKAGE	2005	\$90	\$287

The 2005 (most recent) GTAP model estimates that the total benefit, to *all* the nations in the world, of abolishing *all* remaining restrictions on trade is only 84 billion dollars. ⁵¹⁷ This is less than the annual sales of the CVS drugstore chain. ⁵¹⁸ It works out to less than four cents per day per person on the planet, or less than one-half of one percent of world economic output. So for all the disruption and problems trade liberalization causes worldwide, that's the meager

payoff.

This \$84 billion estimate also applies to eliminating *all* the world's remaining trade barriers, which is not realistically on the table. If one dials back liberalization to more plausible levels, the numbers go down even more. For example, for a plausible package of tariff cuts ranging from 33 to 75 percent on various goods, LINKAGE predicts gains only about a third the size 100 percent liberalization would produce. ⁵¹⁹ This would cut them down to just over a penny a day per person in the developing world.

These gains are also a one-time event, not an annual increment. They do not open any new long-term pathways to growth and once they've been exhausted, that's it. Furthermore, they will not be evenly distributed. Some people will get more than a penny a day, some will get less, and some will get nothing at all. Some people will even get less than zero: that is, they will be net losers from trade liberalization.

GTAP also gives a surprising answer regarding which industries the benefits of liberalization would occur in: mainly just agriculture. Free traders love to paint free trade as the master key to a global high-tech boom, but, in fact, *all* the projected net benefits of liberalization are in mundane areas. This shouldn't actually be a surprise, given that agriculture is the most (overtly) protected sector remaining in the developed world, where the big GDPs are and thus the opportunities for percentage gains to translate into large dollar amounts. Most

of these gains simply consist in slightly lower consumer prices if remaining agricultural protections, from sugar in the U.S. to cheese in Europe, are eliminated. The second-largest field of prospective gains, after agriculture, is textiles—which is also the only major industry in which most of the benefits go to developing countries. [520](#)

FREE TRADE DOES NOT REDUCE GLOBAL POVERTY

The First World is at least rich enough to afford mistakes about trade. The Third World is not, so it matters enormously that the potential for free trade to reduce global poverty is minimal, especially compared to the hype on the subject. [521](#)
GTAP calculates that complete global trade liberalization would be worth \$57 per person per year in the developed world—but less than \$5 in the developing world. [522](#)

Many optimistic figures on poverty reduction as a result of trade liberalization do not survive even casual scrutiny. For a start, the World Bank standard for poverty is \$2 a day, so “moving a million people out of poverty” can merely consist in moving a million people from incomes of \$1.99 a day to \$2.01 a day. In one widely-cited study, there were only two nations in which the average beneficiary jumped from less than \$1.88 to more than \$2.13: Pakistan and Thailand. [523](#)

Every other nation was making minor jumps in between. This is better than nothing, but still small stuff to set against the costs of trade liberalization. It is definitely not the qualitative jump from material misery to a decent standard of living that people imagine from the phrase “lift out of poverty.”

The developing world’s projected gains from trade liberalization are also concentrated in a relatively small group of nations, due to the fact that only a few developing nations have economies that are actually capable of *taking advantage* of freer trade to any meaningful extent.⁵²⁴ Although it depends a bit on the model, China, India, Brazil, Mexico, Argentina, Vietnam, and Turkey generally take the lion’s share.⁵²⁵ This list sounds impressive, but it actually leaves out most Third World nations. Dirt-poor nations like Haiti aren’t even on the radar. Even nations one notch up the scale, like Bolivia, barely figure.

Like it or not, this is perfectly logical, as increased access to the ruthlessly competitive global marketplace (which is all free trade provides) benefits only nations whose industries have something to sell *which foreign trade barriers are currently keeping out*. Their industries must both be strong enough to be globally competitive *and* have pent-up potential due to trade barriers abroad, a fairly rare combination. So the most desperately impoverished nations, which have few or no internationally competitive industries, have little to gain.

Might there perhaps be some way to share the gains from free trade more equally among nations at different levels of development? Unfortunately not, because free trade is, by definition, *not* regulated, which means that any such scheme would not be free trade at all. It would be some sort of managed trade. Any number of such share-the-wealth schemes have been proposed, but they are outside free trade entirely. This also leaves open the question of whether these redistributive schemes would actually work and whether the developed nations, which have *de facto* veto power over all proposals to reorder the global economy, would agree to them.

FREE TRADE INCREASES GLOBAL INEQUALITY

Despite careless talk about the “global” economy, only about a third of humanity is actually integrated into modern flows of goods and capital. ⁵²⁶ This third consists of basically the entire population of the developed world plus varying percentages of the populations of poorer nations. But two-thirds of humanity is only peripherally involved at best. The spreading Third World affluence one sees in TV commercials only means that the thin upper crust of Western-style consumers is now more widespread than ever before. There are indeed Indians driving BMWs around Bangalore in a way that there weren't in 1970. But having more affluent people in the Third World is not the same as the Third World as a whole nearing

the living standards of the First. Think of the developed world as a formerly all-white country club that has started admitting rich Asians and a few others, while the economic gap between the club and the surrounding town has actually grown, and you will not be far wrong.

It is no accident that, according to the World Bank, the *entire* net global decline in the number of people living in poverty since 1981 has been in mercantilist China, where free trade is not practiced. Elsewhere, their numbers have grown.⁵²⁷ The story on global poverty in the last 30 years is roughly as follows:

1. China (one fifth of humanity) braked its population growth, made a quantum leap from agrarian Marxism to industrial neo-mercantilism, and thrived—largely because the U.S. was so open to being the “designated driver” of its export-centered growth strategy during this period.

2. India (another fifth) sharply increased the capitalist share of its mixture of capitalism and Gandhian-Fabian socialism after 1991. It did reasonably well, but not as well as China and not well enough to reduce the absolute number of its people living in poverty, given

unbraked population growth. [528](#)

3. Latin America lost its way after the twin oil shocks of the 1970s, experienced the 1980s as an economic “lost decade,” and tried to implement the free market Washington Consensus in the 1990s. It didn’t get the promised results, so many nations have since lurched left.

4 . The collapse of Communism left some nations (Cuba, North Korea) marooned in Marxist poverty, [529](#) while others (Uzbekistan, Mongolia) discovered that the only thing worse than an intact communist economy is the wreckage of one. Much of Eastern Europe and the ex-USSR got burned by an overly abrupt transition to capitalism, then recovered at various speeds.

5 . Sub-Saharan Africa spent much of this period in political chaos, with predictable economic results (except for South Africa and Botswana). Washington Consensus policies in the 1990s did not deliver, and the few bright spots recently noted have yet to prove enduring.

6. Other poor countries followed patterns one through five to varying degrees, with corresponding outcomes.

China is unquestionably the star here. But even China, for all its brutally efficient achievements in forcing up the living standards of its people from an extremely low base, has serious problems on this score. Most fundamentally, its growth miracle has been largely confined to the metropolitan areas of the country's coastal provinces.⁵³⁰ Of the 800 million peasants left behind in agriculture, perhaps 400 million have seen their incomes stagnate or even decline.⁵³¹ China has something like 200 million migrant workers—more than the entire workforce of the US—who have left their villages looking for a place to work.⁵³² In the words of Joshua Muldavin, a professor of Asian studies at Sarah Lawrence College who has lived in the Chinese countryside for years:

China's rural hinterlands are in essence the engine as well as the dumping ground of China's unprecedented economic growth. These rural areas provide the country's booming cities with cheap unorganized labor principally drawn from extremely poor peasant communities in the midst of their own social and environmental crises. It's also here that

the most toxic industries are located, out of sight of the world's media. Rural peasants labor in some of the world's dirtiest, most dangerous conditions in these far-flung townships and village enterprises spread across the whole country. These are industrial subcontractors not only to Chinese companies but also international companies that spew pollution into the air and water and onto the land. And when the health of rural workers is destroyed, they return to tilling decimated lands around their villages, which have become toxic waste dumps for this unregulated production...Rural China, its environment, and its people are on the bottom of a global commodity chain tied to China's emergence as global companies' industrial platform of choice. [533](#)

And even in urban, coastal China, most Chinese are still poor workers, who often sleep 100 to a room in cinderblock factory dormitories.

In the last 30 years of greatly expanding free trade, most of the world's poor nations have actually seen the gap between themselves and the rest of the world increase. [534](#) As Dani Rodrik reports:

The income gap between these regions of the

developing world and the industrial countries has been steadily rising. In 1980, 32 Sub-Saharan countries had an income per capita at purchasing power parity equal to 9.3 percent of the U.S. level, while 25 Latin American and Caribbean countries had an income equal to 26.3 percent of the U.S. average. By 2004, the numbers had dropped to 6.1 percent and 16.5 percent respectively for these two regions. This represents a drop of over 35 percent in relative per capita income.⁵³⁵

This situation is not going to improve any time soon: the United Nations Development Programme reports that if high-income countries were “to stop growing today and Latin America and Sub-Saharan Africa were to continue on their current growth trajectories, it would take Latin America until 2177 and Africa until 2236 to catch up.”⁵³⁶ 2236 is as far into the future as 1782 is into the past. And, of course, developed nations are unlikely to stop growing.

An even profounder problem is that this assumes it is ecologically possible for the entire world to consume at North American levels. This is impossible with current technology and therefore depends upon technological breakthroughs that may not materialize. So mitigating global inequality through growth may be environmentally unsustainable, quite aside

from whether it is economically likely.

THE DISAPPEARANCE OF MIDDLE-INCOME NATIONS

Today, because a few formerly poor nations are succeeding economically while most have been hit with economic decline, the world is splitting into a “twin peaks” income distribution, with a hollowing out of middle-income countries.⁵³⁷ (Most poor nations have high fertility, so population growth drags down their per capita income by a percentage point or two every year if economic growth does not outpace it.) And, contrary to impressions cultivated in the media, economic success is actually becoming *more* concentrated in the Western world, not less.⁵³⁸ According to one summary of the data by Syed Mansoob Murshed of Erasmus University in Rotterdam, Holland:

Between 1960 and 2000 the Western share of rich countries has been increasing; to be affluent has almost become an exclusive Western prerogative—16 out of 19 non-Western nations who were rich in 1960 traversed into less affluent categories by 2000 (for example, Algeria, Angola, and Argentina.) Against that, four Asian non-rich countries moved into the first group. Most non-Western rich nations in 1960

joined the second income group by 2000, and most non-Western upper-middle-income countries in 1960 had fallen into the second and third categories by 2000. Of 22 upper-middle-income nations in 1960, 20 had declined into the third and fourth income categories, among them the Democratic Republic of the Congo, also known recently as Zaire, and Ghana. Most nations in the third group in 1960 descended into the lowest income category by 2000. Only Botswana moved to the third group from the fourth category, while Egypt remains in the third category. *We seem to inhabit a downwardly mobile world with a vanishing middle class; by 2000 most countries were either rich or poor, in contrast to 1960 when most nations were in the middle-income groups.* [539](#) (Emphasis added.)

This is all no accident. Free trade tends to mean that the industrial sectors of developing nations either “make it to the big time” and become globally competitive, or else get killed off entirely by imports, leaving nothing but agriculture and raw materials extraction, dead-end sectors which tend not to grow very fast. Free trade eliminates the protected middle ground for economies, like Mongolia or Peru, which don’t have globally competitive industrial sectors but were still better off *having* such sectors, albeit inefficient ones, than not

having them at all. [540](#)

The productivity of modern industry is so much higher than peasant agriculture that it raises average income even if it is not globally competitive. This is why Mongolia, Peru, and similar nations actually had higher average incomes *before* free trade was introduced during the “reforms” of the 1990s. [541](#) Even their inefficient and protected industrial sectors set national wage floors that discouraged, among other things, overcultivation, the environmental degradation consequent upon driving the entire population into agriculture for lack of alternative job opportunities. [542](#)

The sudden imposition of free trade upon such nations is even worse than its gradual imposition, as sudden drops in output are especially prone to kill off industries dependent upon scale economies, which (for reasons we will explore in Chapter Nine) are the only really good industries to have. Nations which open up their economies to (somewhat) free trade relatively late in their development, and continue to support domestic firms with industrial policy, are far more likely to retain medium and high technology industry, the key to their futures, than nations which embrace full-blown free trade and a *laissez faire* absence of industrial policy too early in their development. [543](#)

There are numerous documented cases in which trade

liberalization simply killed off indigenous industries without supplying anything to replace them. To take some typical examples from the International Forum on Globalization:

Senegal experienced large job losses following liberalization in the late 1980s; by the early 1990s, employment cuts had eliminated one-third of all manufacturing jobs. The chemical, textile, shoe, and automobile assembly industries virtually collapsed in the Ivory Coast after tariffs were abruptly lowered by 40 percent in 1986. Similar problems have plagued liberalization attempts in Nigeria. In Sierra Leone, Zambia, Zaire, Uganda, Tanzania, and the Sudan, liberalization in the 1980s brought a tremendous surge in consumer imports and sharp cutbacks in foreign exchange available for purchases of intermediate inputs and capital goods, with devastating effects on industrial output and employment. In Ghana, liberalization caused industrial sector employment to plunge from 78,700 in 1987 to 28,000 in 1993. [544](#)

One unhappy corollary of this is the so-called Vanek-Reinert effect, in which the most advanced sectors of a primitive economy are the ones destroyed by a sudden transition to free

trade. ⁵⁴⁵ Once these sectors are gone, a nation can be locked in poverty indefinitely.

NAFTA, CASE STUDY IN FAILURE

The North American Free Trade Agreement, America's biggest free trade controversy of the last 20 years, is a veritable case study in failure. This is all the more damning because this treaty was created, and is administered, by the very Washington elite that is loudest in proclaiming free trade's virtues. So there is no room for excuses about incompetent implementation, the standard alibi for free trade's failures in the developing world. This is all the more true given that, with the heavy penetration of American industry into Mexico, the American elite hasn't just been running the American side, but much of the Mexican side as well. And when it hasn't been, the Mexican economy has been under the control of American-trained technocrats such as President Ernesto Zedillo (PhD, economics, Yale) and President Carlos Salinas (PhD, economics, Harvard). So if free trade was going to work anywhere, it should have been here.

Instead, what happened? NAFTA was sold as a policy that would reduce America's trade deficit. But our trade balance worsened against both Canada and Mexico. For the four years prior to NAFTA's implementation in 1994, America's annual deficit with Canada averaged a modest \$8.1 billion. ⁵⁴⁶ Twelve

years later, it was up to \$71 billion.⁵⁴⁷ Our trade with Mexico showed a \$1.6 billion *surplus* in 1993,⁵⁴⁸ but by 2007, our deficit had reached \$74.8 billion.⁵⁴⁹

Eccentric billionaire and 1992 presidential candidate H. Ross Perot was roundly mocked for predicting a “giant sucking sound” of jobs going to Mexico if NAFTA passed. But he has been vindicated. The Department of Labor has estimated that NAFTA cost America 525,000 jobs between 1994 and 2002.⁵⁵⁰ According to the more aggressive Economic Policy Institute:

NAFTA has eliminated some 766,000 job opportunities—primarily for non-college-educated workers in manufacturing. Contrary to what the American promoters of NAFTA promised U.S. workers, the agreement did not result in an increased trade surplus with Mexico, but the reverse. As manufacturing jobs disappeared, workers were down-scaled to lower-paying, less-secure services jobs. Within manufacturing, the threat of employers to move production to Mexico proved a powerful weapon for undercutting workers’ bargaining power.⁵⁵¹

The idea of Mexico as a vast export market for American products is a sad joke; Mexicans are simply too poor. In the 1997 words of *Business Mexico*, a *pro*-NAFTA publication of the American Chamber of Commerce of Mexico:

The reality is that only between 10 and 20 percent of the population are really considered consumers. The extreme unequal distribution of wealth has created a distorted market, the economy is hamstrung by a work force with a poor level of education, and a sizable chunk of the gross domestic product is devoted to exports rather than production for home consumption. Furthermore, workers' purchasing power, already low, was devastated by the December 1994 peso crash and the severe recession that followed. Even optimists do not expect wages in real terms to recover until the next century. [552](#)

According to official figures at the time, fewer than 18 million Mexicans made more than 5,000 pesos a month. [553](#) That was only about \$625: roughly half the U.S. *poverty line* for a family of four. This has not improved much since, so, as Paul Krugman has pointed out, “Mexico’s economy is so small—its GDP is less than four percent that of the United States—

that for the foreseeable future it will be neither a major supplier nor a major market.”⁵⁵⁴

But if NAFTA wasn't a plausible economic bonanza for the U.S. and America's establishment knew it, then what was going on? Krugman again supplies an answer, writing in *Foreign Affairs* that, “For the United States, NAFTA is essentially a foreign policy rather than an economic issue.”⁵⁵⁵

The real agenda was to keep people like President Carlos Salinas, friendly with powerful interests in the U.S., in power in Mexico City. Free trade was pushed not because of any sincerely anticipated economic benefits, but to serve an extraneous foreign policy agenda. To his credit, Krugman later admitted the utter chicanery of it all, writing in *The New Democrat* in 1996 that:

The agreement was sold under false pretences. Over the protests of most economists, the Clinton Administration chose to promote NAFTA as a job-creation program. Based on little more than guesswork, a few economists argued that NAFTA would boost our trade surplus with Mexico, and thus produce a net gain in jobs. With utterly spurious precision, the administration settled on a figure of 200,000 jobs created—and this became the core of the NAFTA sales pitch.⁵⁵⁶

NAFTA was sold in Mexico as Mexico's ticket to the big time. Mexicans were told they were choosing between gradually converging with America's advanced economy and regressing to the status of a backwater like neighboring Guatemala. But the income gap between the United States and Mexico actually *grew* (by over 10 percent) in the first decade of the agreement.⁵⁵⁷ (This doesn't mean America boomed; we didn't. But Mexico slumped terribly.) In NAFTA's first decade, the Mexican economy averaged 1.8 percent real growth per capita.⁵⁵⁸ By contrast, under the protectionist economic policies of 1948-73, Mexico had averaged 3.2 percent growth.⁵⁵⁹

Because Mexico's labor force grows by a million people a year, job creation must get ahead of this curve in order to raise wages; this is simply not happening. Mexican workers can often be hired for less than the *taxes* on American workers; the average *maquiladora* wage is \$1.82/hr.⁵⁶⁰ The *maquiladora* sector is deliberately isolated from the rest of the Mexican economy and contributes little to it. Workers' rights, wages, and benefits are deliberately suppressed. Environmental laws are frequently just ignored.

Mexican agriculture hasn't benefitted either: NAFTA turned Mexico from a food exporter to a food importer overnight and over a million farm jobs were wiped out by cheap American

food exports,⁵⁶¹ massively subsidized by our various farm programs.⁵⁶²

Promoters of NAFTA have tried to cover up its problems by using inappropriate yardsticks of success. For example, they have claimed that the expansion of total trade among the three nations vindicates the pact. But this expansion has just been due to a growing American deficit.⁵⁶³ Because a growing deficit means, by definition, that our imports have been growing faster than our exports, there is no way that economic growth *per se* will ever solve the problem. Congress was right to reject NAFTA initially, which never enjoyed sincere majority support in either the House or the Senate and was bought with sheer patronage by Bill Clinton.⁵⁶⁴

To be fair, NAFTA is not the only thing that has been wrong with the Mexican economy in recent decades. But NAFTA was the capstone to a *series* of dubious free-market economic experiments carried out there since the early 1980s. Between 1990 and 1999, Mexican manufacturing wages fell 21 percent.⁵⁶⁵ Nevertheless, Mexico is now losing manufacturing jobs to China in such areas as computer parts, electrical components, toys, textiles, sporting goods, and shoes: 200,000 in the first two years of the millennium alone.⁵⁶⁶ Mexico's trade deficit against the rest of the world has actually worsened since NAFTA was signed. In the words

of commentator William Greider, “The Mexican *maquiladora* cities thought they were going to become the next South Korea, but instead they may be the next Detroit.”⁵⁶⁷

NAFTA is not America’s only free trade agreement, of course. But our other agreements tell similar tales. We have signed 11 since 2000: with Australia, Bahrain, Chile, Colombia, Jordan, Korea, Oman, Morocco, Singapore, Panama, and Peru. (El Salvador, Nicaragua, Honduras, Guatemala, and the Dominican Republic were lumped together in the Central American Free Trade Agreement or CAFTA.) Every agreement but one has coincided with greater American deficits. The only exception is Singapore, where our existing surplus increased somewhat. But Singapore is tiny, a mere city-state.⁵⁶⁸ Nevertheless, our government pushes for more. As of 2010, country agreements with Colombia, South Korea, Oman and Panama were pending ratification, and the U.S. was in stalled negotiations with Malaysia, Thailand and the United Arab Emirates.⁵⁶⁹ Next on the list are reportedly Algeria, Egypt, Tunisia, Saudi Arabia and Qatar.⁵⁷⁰ In December 2009, the Obama administration announced its intention to eventually join the existing Trans-Pacific Partnership and elevate it into a full-blown free trade area comprising the U.S. plus Singapore, Chile, New Zealand, Brunei, Australia, Peru, and Vietnam.

THE PHONY SUCCESSES OF FREE TRADE

It is possible to explain away these problems with NAFTA and our other trade agreements by using cherry-picked data and other forms of statistical opportunism. Conversely, it is also possible to unjustly *credit* free trade for economic successes in foreign countries that it did not really cause. This is usually done by interpreting paper trade liberalizations (the legal forms of which were not reflected in facts on the ground) as substantive in order to claim that these liberalizations triggered economic takeoffs in nations that actually took off under earlier protectionist policies.

China and India, for example, both opened up their economies to the world about a decade *after* their growth rates took off, so free trade cannot be the cause of their growth. Trade liberalization is, in fact, far more likely to be an effect than a cause of economic growth: once an economy is primed by protectionism and industrial policy and starts growing, it starts to have something to gain from somewhat freer trade (not free trade *per se*) and its political masters act upon this fact—with moderation and selectivity if they are wise.

For example, from its first post-communist reforms in 1978 to 2001—a period of over two decades—China did not allow unconstrained imports. (It does not really do so even today.) If it had, it could easily have ended up like Mongolia or the African nations which unwisely opened up their markets too soon: its (meager at the time) domestic industries could have

been wiped out by imports and it might never have become the economic powerhouse it is now. Instead, it only joined the WTO (and opened up its markets on paper) in 2001, *after* mastering the fine art of non-tariff barriers, largely with Japanese help. Thereafter, it has only opened its markets very selectively and under tight, often covert, controls. It has defied the spirit of WTO rules, and sometimes their letter, ever since.

Case in point: China did not open its financial markets to foreign players until very recently (this is an incremental process, so no single date can be given) and even then has kept them on a tight leash of regulations. This is wise, as an uncontrolled financial system is intrinsically liable to profound mischief (as Americans presumably realize by now). Interestingly, China was unscathed by either the 1997 Asian Crisis or the 2008 financial meltdown. Neither has China allowed true convertibility of its currency. It has not even allowed foreign investors genuine property rights: it allows them plenty of profits by producing for export, but no real ownership of corporations, land, or real estate.⁵⁷¹ India has been similarly sluggish and cagey about opening completely to foreign goods and capital, albeit in different ways corresponding to its socialist rather than communist past, democratic government, and British-derived legal system.⁵⁷²

Advocates of free trade trumpet a supposed correlation between a nation's openness to the world economy and its observed growth rate. But a more careful review of the data

reveals that it is actually *growth in exports* that correlates with economic growth, not openness as such.⁵⁷³ And even high exports do not in themselves bring growth: Sub-Saharan Africa has a higher ratio of exports to GDP than Latin America, but is still poorer and slower growing.⁵⁷⁴ *Economic openness per se simply does not produce growth.*⁵⁷⁵ (Cf. the quote from *Wired* magazine in Chapter 1 for contrast.) Empirically, a rational amount of closure, combined with good domestic industrial policies, does far better.

Many nations trumpeted as evidence of the wonders of free trade have, in fact, succeeded for other reasons. Many of the star performers with respect to tariff reduction, such as Ukraine, Moldova, and Mongolia, have done badly, and some of the most tariff-protected nations, such as Lebanon and Lesotho, have actually done quite well.⁵⁷⁶ In fact, for the decade of the 1990s, one major study found that there was no clear statistical relationship *at all* between tariffs and growth rates; if anything, the data had an inconclusive drift towards the conclusion that higher tariffs actually correlate with more growth, not less.⁵⁷⁷ So a simplistic take on the data (to be fair, insufficient to settle the question) actually favors protectionism.⁵⁷⁸

Some commentators argue that free trade isn't what is hurting the Third World, but the lack of it. Ironically, this

view tends to find its support among both right-wing free market types and left-wing antipoverty activists like the British-based charity Oxfam International.⁵⁷⁹ They point out that developed nations impose much higher tariffs on developing nations (by a factor of four, on average) than they do on other developed nations. Thus Angola pays as much in tariffs to the U.S. as Belgium, Guatemala as much as New Zealand,⁵⁸⁰ Bangladesh as much as France, and Cambodia more than Singapore.⁵⁸¹ (This is not due to intentional discrimination, but to the fact that developed nations protect their agriculture.) Unfortunately, the implied gains of abolishing these discrepancies are very small: between three-tenths and six-tenths of one percent of the GDPs of the exporting nations.⁵⁸² Furthermore, free trade in food and the end of First World agricultural subsidies could easily raise global food prices by 10 percent. (That's what eliminating a subsidy *does*.)⁵⁸³ So Third World nations could easily slip down the path of the old Ireland: exporting food while their own people starve.

Free trade would, however, give them somewhat more-efficient poverty.

Chapter 8

The Disingenuous Law and Diplomacy of Free Trade

Free trade and free trade *agreements* are not the same thing. Nations certainly do not need free trade agreements to have free trade. They just need to drop their tariffs, quotas, and other overt and covert barriers to the flows of goods and services. So (contrary to what one might imagine from the media) NAFTA, our other country trade agreements, and the WTO treaties are not really free trade agreements at all. Although they *contain* free trade agreements, and their sponsors would certainly like the public to debate them as if they were nothing else, 90 percent of their legal substance concerns other things.

Foremost among these is protection for foreign investors. The American oil industry, for example, is haunted by the memory of Mexico's president Lázaro Cárdenas nationalizing its holdings there in 1938.⁵⁸⁴ So these agreements seek to tie governments into legal straitjackets that will prevent such expropriations in future. Unfortunately, these agreements go beyond securing honest foreign investors against theft by opportunistic politicians (which is perfectly reasonable) and embrace the dangerously elastic principle that any action which reduces the future *profitability* of foreign investments

constitutes expropriation.

Taken to its logical conclusion, this ultimately amounts to the idea that the profitability of investments must be the supreme priority of state policy—overriding health, safety, human rights, labor law, fiscal policy, macroeconomic stability, industrial policy, national security, cultural autonomy, the environment, and everything else. While there is no justification for going to the opposite extreme and allowing governments to ride roughshod over legitimate property rights, these agreements thus mandate rigidly property-first solutions to questions where societies must strike a reasonable balance between public and private interests.

A similar ideological bias is evident in other aspects of these agreements, like their attempts to force the privatization of public services. Supposedly, this is to create a level playing field between foreign and domestic producers of these services. Reserving the provision of these services to the state, the reasoning goes, is a form of protectionism because the state is a domestic producer. But this reaches beyond free trade to the far more radical proposition that *everything should be traded*, which not even the strictest Ricardianism implies. So, in the words of the International Forum on Globalization, a left-leaning group:

Those negotiations involve changes in many services that were until recently reserved for governments, like public broadcasting, public education, public health, water delivery and treatment, sewage and sanitation services, hospitals, welfare systems, police, fire, social security, railroads and prisons....We could end up with Mitsubishi running Social Security, Bechtel controlling the world's water, Deutschebank running the jails (and maybe the parks), Disney running the British Broadcasting Corporation, Merck running the Canadian health care system. [586](#)

But the privatization of natural monopolies just substitutes private monopolies for public ones, frequently shrugging off layers of democratic accountability in the process. And in the resulting absence of competition, profit seeking finds its natural outlet in higher prices, not higher efficiency. Private producers can often skim off the profitable parts of the market and saddle the taxpayer with the dregs. Privatization is frequently no more than a one-time sell-off of future profits by the current government—with a cut of the proceeds going, of course, to its friends. In fact, privatization of physical and social infrastructure usually lacks justification, unlike the privatization of industrial operating companies, which have often been successfully privatized around the world over the

last 30 years.

OVERRULING DEMOCRACY

All these free trade agreements are profoundly antidemocratic. For a start, they take precedence over national, state, and local laws whenever a trade angle can be found. What kind of laws have been struck down? *A laundry list*. In the 1993 words of Lori Wallach of Global Trade Watch (referring to the WTO's predecessor, the General Agreement on Tariffs and Trade or GATT):

Successfully challenged under GATT as trade barriers have been the U.S. Marine Mammal Protection Act of 1972, several laws conserving fish resources, and Thai cigarette limitations. Currently under challenge at GATT are the U.S. fuel economy standards, the U.S. gas guzzler tax, and the EU ban on the use of growth hormones in beef. Challenges have been threatened under GATT against restrictions on drift net fishing by the U.S., export bans on raw logs in Indonesia, the Philippines and the U.S., the U.S. 1990 Consumer Education and Nutrition Food Labeling Act, California's Proposition 65, which requires labeling of carcinogens, German packaging recycling laws, and the recycling laws of several U.S. states, the Pelly

Amendment, which enforces a ban on commercial whaling, state procurement laws requiring a certain content of recycled paper, and more. As a result of past pressure of such challenge threats, meat inspection along the U.S.-Canadian border was all but eliminated for a period of years and now remains very limited, a bill banning import of wild-caught birds into the U.S. was delayed and then watered down in Congress as contrary to GATT, Danish bottle recycling requirements were weakened, Canada is now required to accept U.S. food imports that contain 30 percent more pesticide residues than were allowed under their national laws before the 1988 U.S.-Canada Free Trade Agreement, a Canadian plan for provincial auto insurance was scrapped when attacked by U.S. insurers as a subsidy, as was a British Columbia reforestation program challenged as an unfair subsidy to the timber industry. [587](#)

The U.S. was forced in 1996 to weaken Clean Air Act rules on gasoline contaminants in response to a challenge by Venezuela and Brazil. In 1998, we were forced to weaken Endangered Species Act protections for sea turtles thanks to a challenge by India, Malaysia, Pakistan and Thailand concerning the shrimp industry. The EU today endures trade

sanctions by the U.S. for not relaxing its ban on hormone-treated beef.⁵⁸⁸ In 1996, the WTO ruled against the EU's Lome Convention, a preferential trading scheme for 71 former European colonies in the Third World.⁵⁸⁹ In 2003, the Bush administration sued the EU over its moratorium on genetically modified foods.

The WTO not only strikes down laws, but prevents good laws from being made in the first place. For example, the State of Maryland was intimidated against passing sanctions on the Nigerian dictatorship for fear of WTO complications.⁵⁹⁰

RIGGED NEGOTIATIONS

In adopting these agreements, democratic debate is sabotaged at every turn. Because their details are ill-equipped to stand the light of day, most contain both public and secret (so-called side letter) provisions, to which only the governments signing them are privy. American trade negotiators have even been known to withhold details of these treaties from other U.S. government *departments* whose laws they would overturn.⁵⁹¹

When George H.W. Bush announced finalization of the NAFTA text in 1992, he trumpeted this "achievement," but was so afraid of public reaction to the details that he would not release the text until after he had left office. The House of Representatives has exacerbated this erosion of democracy by

agreeing to so-called Fast Track provisions (effective 1974-1994 and 2002-2007), which forfeit its right to debate details, restrict it to a mere 20 hours of debate, and require a straight yes-or-no vote with no amendments. The Senate has given up its right to filibuster.⁵⁹²

These agreements are administered by distant (in the WTO's case, Geneva, Switzerland) and unaccountable bureaucrats. They are susceptible to deliberate manipulation by corporations whose interests, by their own blithe admission, do not align with those of the United States—or any other country, for that matter.⁵⁹³ These bureaucrats operate largely in secret and even when they do not, they employ a deliberate technical abstruseness calculated to frustrate review of their actions by outsiders. Corporate lobbyists are welcomed and have the funding to intervene seriously. Corporations “rent” their own governments, which then cloak their agendas in the name of their respective nations. Most developing nations simply cannot afford the hordes of expensive staffers needed to negotiate effectively, even assuming they had leverage to negotiate with in the first place. Only a token presence from citizen groups is allowed.

When WTO agreements are negotiated, the organization's one-nation, one-vote principle goes by the board and the real deals are struck in so-called Green Rooms by the big players, who then present the results to the others on a take-it-or-leave-

it basis. ⁵⁹⁴ (The term of art for this tacit abrogation of one-nation, one-vote is “invisible weighting.”) William Greider has thus described the WTO as:

A private club for deal-making among the most powerful interests, portrayed as a public institution searching for international “consensus”...The WTO aspires, in effect, to create a Bill of Rights for capital...The system defends property rights but dismisses human rights and common social concerns as irrelevant to trade. ⁵⁹⁵

The *de facto* internal politics of the WTO usually consists in aggressive U.S. pushes for freer trade, restrained somewhat by the EU, with the larger developing nations like Brazil and India representing the interests of the developing world.

REVERSING EXISTING PROGRESS

These trade agreements threaten legislative progress already made. For ex-ample, only three major environmental treaties enjoy protection from potentially being overruled by NAFTA as trade restrictions: the *Convention on International Trade in Endangered Species*, the Montreal Protocol on Substances that Deplete the Ozone Layer, and the Basel Convention on the

Control of Transboundary Movements of Hazardous Wastes.⁵⁹⁶ All the rest are fair game. And the world has 200 or so other environmental agreements vulnerable to being overruled as trade restrictions by the WTO.⁵⁹⁷ In the words of Carl Pope, head of the Sierra Club environmental group:

The treaties that we have negotiated do not permit the enforcement of international environmental obligations. These are basically get-out-of-jail-free cards for the governments of these countries that say they don't have to abide by these international treaty obligations. These are not treaties to enforce environmental laws. These are treaties designed to shield all of the countries, including the United States, from our international environmental obligations under treaty law.⁵⁹⁸

While (as its supporters endlessly point out) the WTO cannot *literally* strike down American laws as the Supreme Court can, it can still demand that the U.S. change its laws or suffer a penalty. This has the same effect, especially when our government is already looking for an excuse to ditch an existing law. WTO tribunals do not observe elementary principles of justice, such as requiring the burden of proof to

be on the challenger to existing laws,⁵⁹⁹ and require unduly stringent standards of proof before allowing trade restrictions to prevent harm to human health or the environment.⁶⁰⁰ Nevertheless, their rulings are deemed to be treaty law, which American courts are required to enforce (and place above domestic laws) under Article VI, Clause 2 of the U.S. Constitution.⁶⁰¹ Nations can theoretically leave the WTO, but in practice this is difficult after their economies have adjusted to the trade concessions involved in joining.

Even when the WTO does not overturn laws, it still refuses to place its enforcement powers, like authorizing trade sanctions, at the service of anything except free trade. Not environmental violations, not labor standards, not human rights, not even invading one's neighbors.⁶⁰² Except it does have a nasty little device called cross-conditionality, which means trade sanctions *can* be used to enforce the dictates of the IMF and the World Bank.⁶⁰³ (Conversely, refusal of loans by these institutions has been used to enforce trade openings, as has withdrawal of foreign aid.)⁶⁰⁴ So although free trade advocates would prefer to separate discussion of free trade from the rest of the free-market Washington Consensus, these policies are tied together in practice.

Like many clubs, the WTO has a tendency to impose higher standards on those who want to get in than it asks of existing

members. Even desperately poor nations have been subjected to this: Cambodia was forced to comply with intellectual property standards on a schedule even faster than that required of other developing nations like India.⁶⁰⁵ And thanks to the WTO's so-called "single undertaking," nations must agree to its entire package of requirements in order to join. No consideration of the diverse needs of economies at different stages of development, or with different strengths and weaknesses, is allowed.

The WTO also implements a number of problematic ancillary legal structures, like its so-called Trade-Related Intellectual Property Measures (TRIPs). These basically require foreign nations to adopt American-style patent law. This has encouraged, even if it has not literally caused, chicanery such as patenting medicines and seed varieties "discovered" by commercializing the botanical knowledge found in the traditional cultures of nations like India. Genetically modified seeds, 99 percent of whose design is the work of millennia of breeding by ordinary farmers, have received one percent modifications and then been denominated entirely new creations, protected by patent.⁶⁰⁶ Even more brazenly, specific *properties* of plants already known to traditional medicine have been patented.⁶⁰⁷

Trade agreements between the U.S. and individual countries are rife with all sorts of mischief, tucked away in various

clauses. For example, strict requirements on the protection of intellectual property have been incorporated into trade agreements with nations such as Jordan and Chile. Within reason, this is a good thing, but these agreements have thereby narrowly restricted poor nations' use of compulsory licensing of patented drugs to force prices down.⁶⁰⁸ These agreements have also imposed the same restrictions back upon the U.S.—which may permanently block use of this policy to control drug prices and the taxpayer's costs for medical programs. The WTO reached an agreement on paper in 2001 to allow public health to take priority over patent rights, but the U.S. has used individual trade agreements to evade it. The EU, while not actively pursuing this strategy itself, has nonetheless benefited from foreign nations tailoring their patent laws to this American pressure; such “piggybacking” is a common strategy of this sly bloc.⁶⁰⁹

THE GATT: LESS RIGIDITY, BETTER RESULTS

The WTO promotes itself as a universal, consistent, and objective “rules-based” system, fairer than its 1947-1994 predecessor the GATT, which was a loose framework of country-by-country agreements. The WTO's universal rules supposedly let even the weakest players in the global economy, with insufficient leverage to force open foreign markets on their own, enjoy the same benefits of free trade

that the strongest enjoy. But the price of this universality is twofold: first, it makes no sense *at all* unless its underlying premise (free trade is always best) is correct, and second, it entails rigidity and authoritarianism.

The resulting lack of room for compromise has actually made the WTO *more* unstable, crisis-prone, and contentious than the GATT ever was. ⁶¹⁰ The GATT was a free-trade system, too, so it was far from innocent, but it did allow, for example, for “special and differential treatment” exceptions to free trade for such purposes as controlling trade deficits and promoting infant industries. ⁶¹¹ As a result, developing nations could carve out solutions to their own particular circumstances and levels of development. And the GATT was more counterbalanced by regional trading blocs, such as the Southern Common Market (in Latin America), the South Asian Association for Regional Cooperation, the Southern African Development Community, and the Association of Southeast Asian Nations, which often sided with the interests of developing countries. ⁶¹²

The WTO’s Trade-Related Investment Measures (TRIMs) also ban many policies developing nations can use to obtain a modicum of leverage over multinational corporations, such as local employment requirements and export quotas. ⁶¹³ TRIMs also rule out help for local corporations like subsidized loans and export subsidies. And the WTO has tried to prohibit

limiting foreign ownership of corporations to under 50 percent—an understandable way for developing nations to bring in foreign capital and expertise without completely surrendering control of their economies.

The WTO now prohibits many of the trade and industrial policies with the best records of success in the developing world. For example, it bans domestic content requirements, export performance requirements, import quotas, and foreign exchange rationing. While it still *technically* allows some of these policies, they are only permitted as exceptional and temporary provisions, or require agreement between the two trading partners. The latter, especially, tends to make them mere bargaining chips to induce developing nations to submit to demands in other areas, not fundamental commitments of the system, built into it because the policies are understood to work.

THE POWER POLITICS OF TRADE

It was only after about 1980, as the GATT's ideological arteries began to harden prior to its morphing into the WTO in 1995, that its former flexibility began to disappear. Cynically, one might blame the decline of the Soviet Union and world socialism generally. The GATT's 1950-1980 heyday seems to have coincided with global capitalism's Cold War need to coax the rest of the world out of the Communist camp. ⁶¹⁴ It is

quite possibly no accident that the Third World made its greatest economic strides from about 1950 to 1980: more Third World nations experienced periods of solid growth and fewer went through economic crises. According to one group of scholars at the UN's Department of Economic and Social Affairs:

In the 1960s and 1970s, nearly 50 out of a sample of 106 developing countries experienced one or more prolonged episodes of sustained and high per capita income growth of more than 2 percent per year. Since 1980, however, only 20 developing countries have enjoyed periods of sustained growth. In contrast, no less than 40 developing countries have suffered growth collapses, or periods of five years or longer during which there was no growth, or a decline, in per capita income. [615](#)

The WTO has not been particularly kind to the United States, either—which should give pause to those who regard the whole thing as a vast American plot. Under the GATT, the U.S. lost only 61 percent of the disputes it submitted for adjudication. But under the WTO, it has lost 74 percent of the time. [616](#) The WTO has also engaged in judicial activism aimed at systematically rewriting American trade law to American

disadvantage. As Robert Lighthizer, a former Deputy U.S. Trade Representative, told a hearing of the House Trade Subcommittee in 2007:

Rogue WTO panel and Appellate Body decisions have consistently undermined U.S. interests by inventing new legal requirements that were never agreed to by the United States....Our trading partners have been able to obtain through litigation what they could never achieve through negotiation. The result has been a loss of sovereignty for the United States in its ability to enact and enforce laws for the benefit of the American people and American businesses. The WTO has increasingly seen fit to sit in judgment of almost every kind of sovereign act, including U.S. tax policy, foreign policy, environmental measures, and public morals, to name a few. [617](#)

For example, the WTO ruled in 2007 that the Unlawful Internet Gambling Enforcement Act interfered with free trade in “recreational services.” More importantly, it has made a string of rulings too technically abstruse to inflame public sentiment but nonetheless important for their behind-the-scenes effects. [618](#) Perhaps the most flagrant was forcing repeal

of the Byrd Amendment, a 2000-2006 American law that caused penalty tariffs in dumping cases to be paid to the victimized industries themselves, rather than to the U.S. Treasury. In response to protests by the EU and seven other nations, the WTO ruled the amendment illegal in 2002 despite the fact that there is nothing in any WTO treaty even *mentioning* what governments may do with penalty money. In 2005, backed by WTO permission, the EU thus imposed a 15 percent retaliatory tariff on American paper, farm goods, textiles, and machinery.⁶¹⁹ (This is standard procedure: the WTO has no enforcement powers of its own, but works by authorizing retaliation by the injured party against goods chosen to maximize political pressure.) In 2006, Congress folded and repealed the amendment.

POWER-HUNGRY BUT BIDDING ITS TIME

All these problems with the WTO are no secret. They are the major reason its drive for ever tighter global economic integration has stalled in recent years. The 1990s were, in retrospect, the gung-ho era for free trade, but a visible turning point occurred in 1999, when the famous Battle in Seattle protestors disrupted the WTO's meeting there. Unfortunately, the main lesson the WTO seems to have learned was, "Don't hold meetings where protests are legal," so in 2001, the next round of talks was held in Doha, capital of authoritarian Qatar.

Protests were simply banned.⁶²⁰ This did nothing, of course, to restore the rapidly eroding credibility of free trade or the WTO's authoritarian implementation of it, so the talks collapsed after only four days. The next round of meetings in 2005, in similarly well-policed Hong Kong, was held in an atmosphere of deliberately lowered expectations. These were fulfilled, and the WTO's agenda has slowed to a crawl in the years since.

Despite its currently slow progress, the WTO retains an inexorable bureaucratic will to power. It is clearly waiting out a tide that it expects will eventually turn. The desires of the multinational corporations and relentlessly power-accreting bureaucrats that are its driving force have not changed, even if both are pragmatic enough to draw back occasionally. The WTO's tendency is to expand over time on two separate tracks. Track one, for those powerless to resist its dictates (or foolish enough to actually believe in them), consists in ever-more-rigid rules, of ever greater scope, designed to usher in a borderless world economy, at least on paper. Its ultimate ambition has been described as "writing the constitution of a single global economy."⁶²¹ Track two, for nations shrewd enough to practice mercantilism while preaching free trade, is a puppet show designed to square these nations' policies with the legal framework that props open their foreign markets. Since this puppet show furthers both the power of the bureaucrats and the profits of the corporations, neither has any

reason to announce publicly what both know perfectly well: *free trade is largely a charade*, the real meaning of which is well understood by those in the know but differs markedly from the literal meaning of the phrase.

Thanks to the many ways in which trade is manipulated, it is, in fact, estimated that only about 15 percent of world trade is genuinely free. ⁶²² So perhaps the saddest defect of the WTO is that despite its undemocratic and authoritarian implementation of an economic ideal that makes no sense even in theory, it actually has *failed* to deliver where free trade might do some good. Rational protectionism is the best policy, followed by a genuinely level playing field; the WTO has delivered neither.

The WTO is rife with posturing of all kinds. The big news at Hong Kong, for example, was the U.S. government's announcement that it would lower its tariff on imported cotton. But the U.S. is a cotton *exporter*. Such empty stunts are not confined to the U.S.: in 2001, the EU's "Everything But Arms" initiative unilaterally opened its markets duty-free to the 49 poorest nations in the world—*which have almost no commercially viable exports* (or they wouldn't be the 49 poorest nations in the first place). The EU also imposes very restrictive rules of product origin, so only about half the products eligible for this program in principle are eligible in practice; tricks like this riddle the system. ⁶²³ Japan long ago perfected the art of combining nominally open borders with a

closed distribution system inside the country, and its pupils China, Korea, and Taiwan have followed right behind. Offset requirements—buy \$X of our exports and we'll buy \$Y of yours—are illegal but common. ⁶²⁴ The Articles of Agreement of the IMF prohibit members from manipulating their exchange rates. ⁶²⁵

Is this situation likely to improve? Unfortunately, it is almost certainly on track to get even *worse* in the next few years because the U.S., the great global underwriter of free trade, is now being forced by economic crisis into the same sorts of illegal subsidies that other nations have long employed. The 2008-2009 bailout of the U.S. auto industry, for example, was full of subsidies brazenly illegal under WTO rules. ⁶²⁶ As a result, America is losing whatever standing it ever had to complain about such practices abroad. (Ironically, foreign subsidies were, of course, one of the things that got the U.S. auto industry into trouble in the first place.)

The WTO-endorsed free trade loophole most harmful to the U.S. is probably Value-Added Tax or VAT. Every other major nation levies VAT, which resembles a state sales tax except that it is levied *every* time goods change hands on their journey from raw materials to consumer, not only when they are sold by the retailer. Because governments let businesses deduct VAT paid earlier in the supply chain, its cost is ultimately borne by the consumer. Governments rebate VAT

on exported goods because their consumers are abroad and thus not the intended objects of taxation. Conversely, they levy VAT on imports because these goods have not already paid their share of the nation's tax burden by passing through a domestic supply chain. This all makes sense, according to the logic of VAT, but it also means that when a country with VAT trades with a country without it, exports enjoy a subsidy and imports suffer a tariff. The average VAT worldwide is 15.7 percent (in the EU it averages 19.4 percent), ⁶²⁷ so American goods face a net competitive disadvantage averaging over 30 percent. U.S. negotiators agreed to this system in 1955, when VAT was fairly rare and in the two to four percent range anyway.

UNCLE SAM, GLOBAL SUCKER?

If the trade agreements our government signs are so disadvantageous, why does it sign them in the first place? In large part, because it simply does not take their dangers seriously. Given its underlying assumptions about the universal benevolence of free trade, there is, of course, no reason for it to. Surprisingly, these assumptions rarely consist in outright intellectual fanaticism about the economics of free trade. That is easy enough to find in academia and the editorial pages, but quite rare in our trade negotiators and diplomatic service generally. Instead, there is a hazy sense that “economics says free trade is best” which renders our trade

negotiators helpless in the face of corporate pressures for more trade agreements. This helplessness is worsened by inexperience and a lack of institutional memory about past negotiations.⁶²⁸ Indeed, our diplomats often have remarkably shallow knowledge of trade subjects: as Jeffrey Garten, Undersecretary of Commerce under Bill Clinton, noted in 1997, “The executive branch depends almost entirely on business for technical information regarding trade negotiations.”⁶²⁹

Can business handle this role? No, because its interests do not align well with the interests of the U.S. economy as a whole. The interests of individual powerful corporations do not even align well with the interests of the U.S. *business community* as a whole, a fact exacerbated by the “every man for himself” mentality of American businesses abroad. (Contrast this with the notorious solidarity of, say, Japan, Inc., which plays as a team due to government pressure and financial ties between corporations.) American companies frequently bid against each other overseas, even over sensitive long-term issues such as technology transfer. Among other things, this makes them exceptionally easy for foreigners to manipulate. When, for example, Japanese companies form alliances with them, this tends to neutralize them as opponents of Japanese trade practices. In the words of distinguished former trade diplomat Clyde Prestowitz, “Once a company has got a deal with Hitachi, they become silent on those issues.

Why attack your partner?”⁶³⁰ Similarly, American aircraft producers have been silenced about Airbus by complaints from their European customers.⁶³¹

Many of the largest American companies are now so dependent on their overseas operations, and thus so vulnerable to pressures by foreign governments, that they have become outright Trojan horses with respect to American trade policy. As former congressman Duncan Hunter (R-CA), for years one of the outstanding critics of trade giveaways in Congress, has put it, “For practical purposes, many of the multinational corporations have become Chinese corporations.”⁶³²

When our trade negotiators work to open foreign markets, they usually do so willy-nilly, with no sense that some industries are more strategic than others. This assumption, too, is profoundly wrong, for reasons we will explore in the next chapter. Superficial attempts at hard bargaining occasionally reflect some well-organized industry that has managed to flag the attention of Congress, but are mainly just posturing. America’s trade bureaucrats have little sense of loyalty to American industry or understanding that their efforts must ultimately be judged by quantifiable success in America’s trade balances.⁶³³ One metric of our government’s sheer unseriousness about trade diplomacy is that between 1972 and 1990, fully half the American trade diplomats who left

government service went to work for foreign nations. ⁶³⁴
Imagine if this were happening with our military officers!

America's trade diplomacy thus leaves America naked in a world where other nations pursue the most sophisticated neomercantilist policies their bureaucrats can devise, backed up by disciplined diplomacy that puts economic objectives first. Our nakedness has, ironically, made us even more desperate in pushing for free trade: having disarmed ourselves by throwing open our markets, we desperately need to disarm everyone else by forcing their markets open, too. But we try to do this *after* having thrown away our principal leverage: *access to our own market*. We rationalize this implausible approach with the fantasy that the rest of the world "must" inevitably embrace our own laissez faire economic ideals, including free trade, due to their innate superiority, one day soon.

Our main method of getting the rest of the world to fold its cards has, of course, been bribing foreign nations to join our vision of a rules-based global trading system under the WTO (which enjoys fanatical American support despite its anti-American actions). Unfortunately, this bribe has mainly consisted in letting foreign nations run surpluses against us. We have thus become the global buyer of last resort and the subsidizer of a system that in theory needs no subsidy because it *supposedly* benefits everyone. ⁶³⁵ One irony of this is that the U.S. has been diligently working to pry open foreign

markets for Japan, China, and the other neomercantilist states. (As noted in Chapter Six, Britain had precisely this problem 100 years ago.)⁶³⁶

We have not even applied the above misguided strategy with systematic discipline, as we have usually treated trade as a political issue first and an economic one second. (This is the reverse of most foreign nations.) China, for example, uses the prospect of large import orders as a wedge to break up solidarity between the U.S. and Europe regarding its human rights record, which might bring trade sanctions.⁶³⁷ By contrast, the first Bush administration bought, to take only one example, Turkey's support in the Gulf War with, among other things, increases in that nation's import quotas for apparel, fabric and yarn.⁶³⁸ Even in peacetime, American military bases abroad have given foreign nations leverage over U.S. trade policy. This has been quintessentially true of Japan, but has also been true of Spain, Portugal, and several other nations.⁶³⁹ As a report by the Senate Finance Committee once put it:

Throughout most of the postwar era, U.S. trade policy has been the orphan of U.S. foreign policy. Too often the Executive has granted trade concessions to accomplish political objectives. Rather than conducting U.S. international economic

relations on sound economic and commercial principles, the executive has set trade and monetary policy in a foreign aid context. An example has been the Executive's unwillingness to enforce U.S. trade statutes in response to foreign unfair trade practices. [640](#)

Today, the U.S. government spends billions trying to help *other* nations improve their trade performance. In 2008, the Office of the United States Trade Representative spent \$2.3 billion on its Aid for Trade program, and it remains official U.S. policy to be “the largest single-country provider of trade-related assistance, including development of trade-related physical infrastructure.” [641](#) The 9/11 attacks intensified this effort; apparently what Osama *really* wants is to export.

American efforts to negotiate reasonable trade agreements are handicapped by the fact that some American politicians have an unrealistic idea of international law. International law is not like ordinary civil law because there exists no sovereign to compel the obedience of nations. Instead, it is analogous to the rules of a game of stickball being played by children on a vacant lot: its rules only mean anything insofar as they are enforced *by the players upon themselves*. Obviously, as in the case of stickball, the players will enforce certain rules, because that is the only way they can have a game at all. So

international law is not a completely vacuous concept, as some cynics suggest. But the players also *won't* enforce any rule grossly to the disadvantage of any particularly powerful player. This means that the Anglo-American legal framework Americans tend to take for granted simply does not exist internationally, and therefore that a trading model based upon neutral and consistent enforcement of legal obligations is not feasible. There is no way to take power politics out of trade, which means that there is no way to leave everything in the hands of a neutral and rational free market once we construct the right international legal machinery.

Foreign nations sometimes seem genuinely puzzled why the U.S. does not grasp the game being played. So they occasionally make the U.S. offers which we logically would accept if we did understand, offers they expect would quiet down Uncle Sam and make his politicians stop uttering bizarre complaints about “unfair” trade.⁶⁴² For example, Japan in 1990 offered a deal to limit its trade surpluses to two percent of its GDP if we would stop trying to reorder Japan’s economy to solve our trade difficulties.⁶⁴³ We showed no interest. Japan’s 1990 surplus with the U.S. of \$41 billion almost doubled over the next 10 years. It has remained at comparable levels ever since, dipping only with recession in 2009.⁶⁴⁴

PART III

THE SOLUTION

Chapter 9

Where Does Growth Really Come From?

If we are serious about finding and justifying an alternative to free trade, we are ultimately going to need more than the long list of negative criticisms examined so far in this book. We are ultimately going to need an alternative *positive* explanation of economic growth, one that doesn't turn on 100 percent pure free markets and thus free trade. We need an explanation not just of how free trade does economies harm, but of how protectionism does them good.

In the free trade view, growth comes from nations integrating themselves ever more tightly with the wider world economy through unconstrained imports, exports, and capital flows, enabling them to ever-better exploit their comparative advantage. But even free traders admit, in unguarded moments, that they actually have little idea *where* growth really comes from. This is a fatal flaw. As the aggressively pro-free-trade magazine *The Economist* has written:

Economists are interested in growth. The trouble is that, even by their standards, they have been terribly ignorant about it. The depth of the ignorance has long been their best-kept secret.

But if free market economics is bad at explaining growth and knows it, then we really shouldn't be taking its recommendations on how to *get* growth so seriously—starting with free trade.

Economic history contradicts free-trade economics at a number of points. For example, the all-important theory of comparative advantage promotes specialization as the path to growth. Supposedly, a nation's best move is to concentrate its factors of production on the products in which it has comparative advantage and import most everything else. (Hewing to this, the World Bank has repeatedly advised heavily indebted Third World nations to specialize in one or two crops or raw materials for export.)

But if this theory is true, it would imply that economies should concentrate on fewer industries as they become richer. Instead, the reverse is observed. In reality, economies starting out from a primitive state tend to *expand* the range of products they produce as they grow.⁶⁴⁶ They only start reconcentrating when they are well past the middle-income stage and start building entrenched positions in a few sophisticated high value-added industries.⁶⁴⁷ Narrow specialization is actually a hallmark of impoverished one-crop states, colonies managed for the benefit of distant rulers, and accidental raw materials-based economies like the Gulf oil producers.

Successful nations diversify. This is an important clue that

economic growth may actually be less about comparative advantage and more about something else. Economic history, in fact, suggests that development doesn't come from increasing specialization, that is, from focusing ever more on what one already produces well, but from learning to produce entirely *new* things. But something new that a nation learns to produce is, by definition, not something in which it already *had* comparative advantage. So Ricardian thinking is not useful here. Even if comparative advantage applies after the fact, when a nation has mastered a new industry, it cannot tell a nation today what new industries it should try to break into tomorrow or how. Ireland didn't have any comparative advantage in IT in 1970, but this industry has been a big driver of its later growth. Same for India. There is no way this industry made sense for either nation in advance based on Ricardo.

There is an even larger lesson here: economic growth is, by definition, a *disequilibrium* event, in which an old equilibrium level of output is replaced by a new and higher level. ⁶⁴⁸ So the economics of equilibria, which means most of free-market economics (whose supply and demand curves intersect *in equilibrium*), is of little use for understanding it. That is why the quote at the beginning of this chapter cuts so extremely deep. Among other things, equilibrium economics cannot explain entrepreneurship, whose profits represent the value of creatively *upsetting* the existing equilibrium in an industry.

Equilibrium is a useful concept for examining how things stand once the dust has settled and the economy has reached a new stable state, but it is intrinsically weak at analyzing change. This is why, when confronted with entrepreneurship and innovation, mainstream economics tends to quietly give up and reach for concepts, such as the Austrian economist Joseph Schumpeter's (1883-1950) idea of creative destruction, that are genuinely illuminating but lie outside the formal mathematical structures of mainstream economics. And as the logic of classic equilibrium-based economics still inescapably leads to Ricardo, this *ad hoc* patching doesn't lead mainstream economics to the right conclusions about trade.

COMPARATIVE ADVANTAGE VS. LADDER EXTERNALITIES

But if specialization according to comparative advantage isn't the key to growth, what is? What is that "something else" mentioned above?

Let's start with the common observation that real-world economic growth often seems to involve a virtuous cycle, in which the upgrading of one industry causes others to upgrade and so on. This has been seen time and again in nation after nation, industry after industry. ⁶⁴⁹ For example, as one industry becomes a more sophisticated consumer of inputs, it may demand that its supplier industries become more

sophisticated.⁶⁵⁰ Conversely, it may enable its downstream industries to increase the sophistication of their outputs. This process then ripples through the economy and repeats.

Crucially, some industries are better at starting this process (or keeping it going if it has already started) than others. And the free market, *and thus free trade*, won't optimize this process automatically. Why? Because the value of an industry for the *next* step in industrial growth is often an externality, from the point-of-view of today.

We met externalities before, in dubious assumption #2 (there are no externalities) of Chapter Five. They occur when the profits of an industry do not reflect its full economic value. In this case, this means that the industry's present owners will not see profits that reflect its long-term ability to help the economy upgrade or break into other industries. As a result, the industry will remain underdeveloped, relative to its long-term value to the national economy, and the free market will *not* give the optimal answer for how much of this industry the economy should contain.

When focusing on the technological aspects of this problem, economists have called these effects "location-specific technological externalities."⁶⁵¹ More generically and colloquially, they have been called "ladder" externalities.

That such externalities exist is taken as obvious by governments from Utah to Uttar Pradesh. That is why they

compete to attract industries—mainly high technology—which they believe will further their economic development in a way that they *don't* get excited about somebody opening a chain of convenience stores employing just as many people.

The existence of these externalities is also taken as a given by businesses in newly industrializing nations, which is why conglomerate-like structures like the Japanese *keiretsus*, the Korean *chaebols*, and the family networks of Taiwan and Italy have played such large roles there. These structures *capture* ladder externalities by taking positions in related and newly emerging industries, so their profits don't just end up in the hands of someone else. [652](#)

Even American managers are well aware of how one industry catalyzes another, though the short-termism imposed on them by the American financial system undermines their ability to exploit this fact strategically. [653](#) In the words of former tech CEO Richard Elkus, who has been on the boards of over a dozen companies:

Some markets are considered more strategic than others. By targeting strategic markets, an infrastructure can be built that ensures a solid basis for economic expansion. However, the leverage is not based simply on the importance of one market over another, but rather on the assumption that, as they

develop, strategic markets will become interrelated and interdependent, with the whole becoming substantially larger than the sum of its parts...Every product becomes the basis for another, and every technology becomes the stepping-stone for the next.

[654](#)

One consequence of this is that *economic growth is path-dependent*. To grow, an economy must continually break into new industries. But to do this, it needs strong *existing* positions in the right industries. So a national economy that doesn't get onto the right path (and stay on it) risks being sidelined into industries which lead nowhere in the long run. We noted this problem before in Chapter Five: 18th-century Portugal derived no other industries from winemaking, while Britain derived many from textiles because the construction of textile machinery spawned a machine-tool industry that could produce innovative machinery for other industries. Similarly, electric cars may be the wave of the future today, but without a strong position in conventional cars, a nation is unlikely to have the know-how or supplier industries to build them.

Path dependence applies to economies at all levels of development, not just those starting to industrialize. Infant-industry protection is, of course, one of the best-known cases for protectionism and industrial policy. (It is often the one case grudgingly conceded even by free traders.) But it is, in

fact, only the most obvious case of the more general phenomenon of the path dependence of economic growth. Infant industries are merely the first rungs of the ladder.

A key concept here is the driver technology, which enables progress in multiple other technologies. As Clyde Prestowitz of the Economic Strategy Institute writes of Japan's makers of industrial policy:

They knew that the RAM [random-access memory chip] is the lynchpin of the semiconductor industry because, as the best-selling device, it generates not only revenue but also the long production runs plant managers use to test, stabilize, and refine the production and quality-control processes. Compared with many other chips, it is a relatively simple product, which makes it a more attractive vehicle for developing new techniques. The latest technology has always been incorporated first in RAMs, which have always been the first product to appear as a new generation. Once RAMs are refined, new generations of other products follow...The Japanese knew that if they could grow faster than the Americans in the RAM segment of the market, they could become the low-cost producer of RAMs. And if they controlled RAMs, they would have taken a long step toward dominance in other semiconductors. And if they had

semiconductors, semiconductor equipment, materials, and everything that semiconductors went into, such as computers, would be next. [655](#)

Free market, free-trade economics systematically maintains the opposite of all this. It maintains that *any* industry can drive an economy upwards, just so long as it enjoys comparative advantage *right now*. And because free trade economics holds that free trade automatically steers an economy into those industries where it enjoys comparative advantage, it holds that free trade will therefore maximize economic growth. [656](#) For free-trade economics, there is, in fact, no important distinction between the long and the short term: comparative advantage is always right, period. Free-trade economics holds that it is profoundly impossible for one industry to be “better” than another. This is the cause of an infamous (subsequently denied) comment by Michael J. Boskin, George H.W. Bush’s chairman of the Council of Economic Advisers:

It doesn’t matter whether America exports computer chips, potato chips, or poker chips! They’re all just chips! [657](#)

Why would Boskin make a statement so brazenly contrary

to common sense with such confidence? Because free-trade economics holds that markets are so efficient that no industry *can* be special. In its view, there can be no ladder externalities because there can be no industry externalities at all—certainly none that are big enough and evident enough to understand and manipulate. Every industry’s profits today *must* accurately reflect its value in both the short and the long term. Why? Because if any industry did have superior value for future growth, its expected profitability today would reflect this, that superior profitability would draw new firms into the industry, and the superior profits would be competed away.

If every industry’s short-term profitability were indeed a correct measure of its long-term value, this would indeed be the case. But when long-term returns may well accrue to another company, even another industry, and someone else may capture them, short-term profitability is not a reliable metric of long-term value. So any strategy that relies on short-term profitability alone to steer an economy will necessarily underperform. (As noted in Chapter Two, short-termism is a crucial hidden part of America’s trade and industrial problems.)

“Just chips” economics is wrong because industries are very much *not* alike in their long term consequences. In the words of Laura D’Andrea Tyson, Bill Clinton’s chairperson of the Council of Economic Advisors (who never got to apply her valuable theoretical insights in office):

The composition of our production and trade does influence our economic well-being. Technology-intensive industries, in particular, make special contributions to the long-term health of the American economy. A dollar's worth of shoes may have the same effect on the trade balance as a dollar's worth of computers. But...the two do not have the same effect on employment, wages, labor skills, productivity, and research—all major determinants of our economic health. [658](#)

NOT ALL COMPARATIVE ADVANTAGE IS CREATED EQUAL

Free market, free-trade thinking can't comprehend the above realities. But it still has a contribution to make to our understanding here. In light of these realities, comparative advantage doesn't disappear from the picture entirely. But a crucial insight is added: *not all comparative advantage is created equal.* [659](#) It is better to have comparative advantage in some industries than in others, and what a nation has comparative advantage in determines its standing in the global economic pecking order. In the words of Paul Krugman:

Each country has a “niche” in the scale of goods; the higher a country is on the technological ladder, the further upscale is the range of goods in which it has comparative advantage. [660](#)

This may sound obvious, but this reality is relentlessly obscured by free-trade thinking, which defines away the possibility of some kinds of comparative advantage being better than others by its insistence that it is always best to act according to the comparative advantage that one has *today*. [661](#)
As the Norwegian economist Eric Reinert puts it:

The very idea of a nation lifting itself to higher levels of living standards through competitiveness—being engaged in activities that raise the national living standard more than other activities—goes directly against the assumptions and beliefs which form the foundations of the neoclassical economic edifice. This is not the way economic growth is supposed to take place in the neoclassical model. [662](#)

One implication of all this is that national economies tend to rise (or decline! Read “Argentina”) over time to the level of income embodied in their exports. Dani Rodrik has

summarized this fact as “you become what you export.”⁶⁶³
This is a fact with vast significance for industrial policy—especially for developing countries, which are desperately trying to *become* something other than what they already are. And this fact profoundly contradicts Ricardian economics. As Rodrik observes:

Under received theory, a country with an export package that is significantly more sophisticated than that indicated by its current income level is one that has misallocated resources (by pushing them into areas where the country does not have a comparative advantage). Such a country should perform badly relative to countries whose export packages are more in line with current capabilities.⁶⁶⁴

That climbing a ladder of industry externalities can lift an economy upward shows up in the data in the fact that economies with more-sophisticated exports are not only richer today (which one would expect) but also grow faster over time.⁶⁶⁵ The latter fact, although not terribly shocking to common sense, is not obvious at all to free-trade economics. But in reality, having a foothold in industries which *intrinsically* lead somewhere is a big part of what makes

economies grow.

All of the above was, of course, well known to mercantilist governments for centuries. In the words of economist John Culbertson:

This view...had been well understood by governments and writers on economic subjects centuries before Adam Smith, that industries are not homogenous. Some lead to cumulative advances in knowledge and technology, some bring new skills and capabilities to people and firms, some permit high incomes to be earned in foreign markets because of the absence of competing producers—especially of competing low-wage producers. Other lines of production have none of these favorable characteristics, and are dead ends. The nation that specializes in them will be economically second rate, at best.

[666](#)

WHAT ARE GOOD INDUSTRIES?

If the industries a nation needs in order to grow economically are those whose intrinsic nature it is to lead onward and upward, and free trade won't automatically nourish them, which lucky industries might these be?

Let's start with the fact that sustained economic growth only really occurs in industries which exhibit increasing returns. This means that for a given increase in inputs, output goes up by more than the size of that increase. For example, because the cost of baking bread consists in a one-time investment in an oven plus a per-loaf cost for ingredients, the cost per loaf will go down with each additional loaf baked, as the cost of the oven is spread out over more loaves. So 10 percent more money will deliver 11 percent more bread and so on. The opposite of increasing returns is diminishing returns: after a certain point, 10 percent more money delivers nine percent more output, then eight percent and so on.

Increasing returns is a simple concept, but it ramifies endlessly, forming the ultimate basis of a long list of the opposite characteristics of “good” (increasing returns) and “bad” (diminishing returns) industries. ⁶⁶⁷ Historically, manufacturing is the quintessential increasing-returns industry and agriculture the quintessential diminishing-returns one. But some types of each behave like the other, and since the mid-1970s the line between manufacturing and services has blurred, with a *small* segment of high-end services acquiring some of the desirable characteristics traditionally associated with manufacturing. And low-end manufacturing has increasingly come to resemble agriculture. But the underlying characteristics of increasing and diminishing returns industries have remained stable, even as which industries exhibit these

characteristics has changed.

Having a lot of increasing returns industries is really the only way to be a developed economy. This is, in fact, the fundamental purely economic difference between the First and Third Worlds: the former is full of such industries, the latter is not. As a result, examining why some industries exhibit increasing returns and some do not can tell us a lot about why some economies grow and some do not. And how free trade can easily lead an economy astray.

WHY DO SOME INDUSTRIES HAVE INCREASING RETURNS?

Industries which exhibit increasing returns do so mainly because they can absorb endlessly rising capital investment. Not all industries can: buying another \$1,000,000 worth of tractors for a coffee plantation that already has them won't increase the plantation's productivity very much. ⁶⁶⁸ Neither will buying every lawyer at a law firm another desk. But putting another \$1,000,000 into production machinery in an automobile or semiconductor plant will do a lot. And capital doesn't just mean factory floor hardware. It also means human capital or skills accumulation, and research and development.

Why are some industries so good at absorbing capital? One big reason is that they are susceptible to innovation, and R&D is a big capital absorber. This activates a virtuous cycle in

which innovation absorbs capital then repays it by raising profitability, generating more capital and repeating the cycle. It is no accident that manufacturing and related fields generate over 70 percent of research & development in the U.S. [669](#) And within manufacturing, high technology accounts for roughly 20 percent of output, but 60 percent of R&D. [670](#)

This susceptibility to innovation derives largely from the fact that good industries tend to produce goods capable of infinite improvement, like laptops or airplanes, while bad industries produce goods whose character is fixed, like fruit or t-shirts. The products of good industries are also susceptible to meaningful variety, so firms don't end up selling the exact same product in pure head-to-head competition. This spares firms the raw price competition that drives down profits, wages, and funds available for further investment. Instead, firms compete on quality, reliability, reputation, marketing, service, product differentiation, special understanding of buyer needs, rapid innovation, and managerial sophistication. This enables them to accumulate strongly entrenched competitive positions where vulnerability to competition—crucially by cheap foreign labor—is not a big issue.

This lack of perfect competition in good industries activates something free-market economics despises: market power, also known as monopoly or quasi-monopoly power. From the point of view of free markets, this is inefficient on first principles, because industries with monopoly power earn

higher profits than the free market would allow. They are parasitic. The confusing term economists use for this excess profit is “rent” (which has nothing to do with rent in the normal sense),^{[671](#)} so in the words of Eric Reinert:

In the static system of neoclassical economics, rent-seeking is seen as a negative term. In a world where increasing returns to scale, imperfect information, and huge barriers to entry dominate all industries of any importance, dynamic rent-seeking seems to be a key factor for economic growth and competitiveness.
^{[672](#)}

This dynamic rent-seeking generates a number of virtuous spirals. One is that rising worker incomes provide the purchasing power to sustain industrial growth. And as incomes rise, what economists call “quality of demand” also rises: people demand not just more but *better* products, driving the industries of their home nation to upgrade and reinforcing the ladder externalities discussed earlier.^{[673](#)}

Good industries also readily absorb rising human capital or skill. The fact that capital accumulates in the workers themselves tends to encourage well-cared-for labor for the same reason factory owners do not let valuable machinery rust away. It generates corporate and state paternalism and the

“countervailing powers,” like bargaining leverage by workers, that spread the profits of industry beyond its owners.⁶⁷⁴ This is reinforced by the fact that good industries tend to produce products for which income elasticity is high, i.e., people buy more as their incomes go up. As a result, productivity gains don’t just drive down the price of the product, and output can rise along with productivity, enabling wages to stay steady despite productivity gains which require fewer and fewer workers per unit of output.

BAD INDUSTRIES AND DEAD-END ECONOMIES

The opposite of good industries is, of course, bad ones. These are *dead-end jobs writ large*. For centuries, this has meant agriculture and raw materials extraction, but since the mid-1970s, unskilled manufacturing has been inexorably joining this category. In these industries, diminishing rather than increasing returns apply, so all the previously discussed benevolent dynamics are absent—or run in reverse.

These industries are hobbled by their very nature. For a start, demand for agricultural products is intrinsically less elastic than demand for manufactured goods simply because of the finite size of the human stomach.⁶⁷⁵ As a result, productivity growth in agriculture tends to translate into lower prices for consumers, not higher wages for farmers. Because productivity growth in agriculture tends to go into lower

prices, while productivity growth in manufacturing does not, agricultural prices generally decline over time relative to the price of manufactured goods.⁶⁷⁶ This problem has been around for a very long time: according to one British estimate of 1938, the same quantity of primary products bought only 63 percent as many manufactured goods as it had in 1860.⁶⁷⁷ Thus nations whose main exports are agricultural or raw material products have slipped further behind the industrial nations, decade by decade.

Agriculture and raw materials also tend to be bad industries because they are too easy for competitors to break into and thus attract too many rivals. When Vietnam, on the advice of the World Bank, started exporting coffee and rapidly became the number two producer after Brazil, this flooded the market and drove the price down from 70 cents a pound to around 40 cents.⁶⁷⁸ Economies dominated by bad industries are subject to volatile income swings due to distant commodities markets, swings exacerbated by undiversified exports and impossible to hedge against. The dependence of agriculture on the weather only makes this worse.

Most agriculture simply can't absorb technological innovations that upgrade productivity and wages on anything like the scale manufacturing can. For example, as Eric Reinert notes:

Mexico specializes in unmechanizable production (harvesting strawberries, citrus fruit, cucumbers and tomatoes), which reduces Mexico's opportunities for innovation, locking the country into technological dead-ends and/or activities that retain labor-intensive processes. [679](#)

Because agriculture can't absorb technology, it can't absorb capital, either, as there's nothing to spend the money on that will pay back a return. In any case, without a strong manufacturing sector, it's hard to raise even *agricultural* productivity because increased productivity means fewer workers are needed, and there's nowhere for the workers released from agriculture to go. So fear of mass unemployment tends to lock society in place. [680](#) For most of the people they employ, agriculture and other bad industries also tend to hit a fairly low ceiling in the amount of skill they can usefully absorb, so human capital doesn't accumulate any more than capital invested in technology. As a result, these industries remain undercapitalized and the societies that host them do not accumulate wealth in these industries. Whatever money is made is siphoned off elsewhere: into castles in Medieval Europe, into Europe in colonial Africa.

Agriculture and other bad industries occasionally do exhibit

innovation. But this is generally only in the production process, not the product itself. And innovations, when they come, tend to come from *outside* bad industries. Agriculture, for example, has benefited from genetic engineering and improved tractors, but created neither of these innovations itself. As a result, innovations do not establish virtuous cycles of innovation → more profit → more innovation inside bad industries. One telltale sign that a formerly good industry is turning bad is that product innovation exhausts itself and the industry turns to process innovation. And when a bad industry turns downright terrible, even process innovation exhausts itself and the industry just seeks cheaper labor. One can trace this process in individual industries over time. The shoe business, for example, began as a First World handicrafts industry, was mechanized over the second half of the 19th century, and began moving to the Third World in the 1950s—just as its productivity growth flattened out.

Which industries are good and bad changes over time as the technological frontier of the world economy evolves. The textile industry was good for a rising economy like Britain in the early 19th century, but is not good for developed nations today. These “has been” industries either migrate to developing nations or gently stagnate in place. As an economy accumulates more and more of them (as Britain’s did in the early 20th century) this is a clear sign that economic decline is around the corner.

No nation can plausibly hope to have its entire economy consist only of good industries, as some bad industries are sectors one can't live without. One cannot go without haircuts, even if the productivity of barbers is no greater than 200 years ago. And even stagnant sectors contribute some output and employ some people. But the more of a nation's economy is in good industries, the stronger its economy will be today and the better its growth prospects tomorrow.

ENTIRE ECONOMIES STUCK IN BAD INDUSTRIES

The poor and slow-growing economies of the Third World are that way because they are predominantly composed of bad industries and the path-dependence of industry entry traps them there. They are stuck in industries that have no increasing returns, no technological advances, and no ladder externalities. These problems mutually reinforce each other, ramify over time, and are the ultimate basis in hard economics for the well-known phenomenon that the rich get richer. (Karl Marx correctly observed that this happens, but he mistakenly thought that it was because the rich were *exploiting* the poor. Sometimes they do, but that's not the fundamental problem.) The United Nations Development Programme has thus estimated that the income gap between the top fifth of the world's nations and the bottom fifth was 3:1 in 1820, 7:1 in 1870, 11:1 in 1913, 30:1 in 1960, and 74:1 in 1997. [681](#)

Ironically, the gap between poor nations and rich ones was actually much smaller in the 19th-century heyday of colonialism than it is today. But this makes perfect sense: 150 years ago, there was *relatively* more to grab in colonies; there's no point in an advanced nation conquering Rwanda today, when its own per capita output is 75 times greater. Insofar as colonialism, traditional or modern, overt or covert, is a deliberate economic strategy, it is about *locking subject nations into bad industries*.⁶⁸² For example, the English government stifled Ireland's nascent industrialization in 1699 by banning its exportation of woolen cloth outside the British Isles.⁶⁸³ Ireland obediently specialized in agriculture and even became a successful exporter. But it continued to export food even when its own people were starving. It had the capacity to produce nothing else.

Colonialism *per se* isn't the problem here, as the economic mechanisms that do the damage are perfectly capable of operating in nations that are politically independent. (We noted Spain as an example of this in Chapter Six.) And not all colonies have been subjected to this treatment. The danger of being trapped in bad industries was, in fact, well understood by a number of small, raw materials-rich colonial nations which managed to avoid this fate. Australia, Canada, New Zealand, and (oddly enough) South Africa are the classic examples. All these nations were beneficiaries of the British Empire getting burned trying to make the U.S. a banana

republic, as the imperial authorities allowed these colonies to raise tariffs against British goods in order to pursue their own industrialization. [684](#)

THE PATHOLOGIES OF BAD INDUSTRIES

Free trade does not automatically assign nations good industries. This is the fundamental problem. Acting according to their immediate comparative advantage, it can just as easily assign them bad ones. This may be optimal in the short term, but if a nation's comparative advantage today is in producing bananas, then it will be stuck with roughly the same productivity 30 years from now. [685](#) That isn't true in industries like computers or automobiles. And in the presence of a large wage gap between nations, low-wage nations will *automatically* tend to attract bad industries under free trade, as here will lie their immediate comparative advantage.

The interaction of free trade with bad industries is toxic in a wide variety of ways, not all of them obviously trade-related. For example, free trade tends to exacerbate all the "bad habits" of modern agriculture, as the attempt to extract more returns from a diminishing-returns industry to keep up with declining terms of trade generates a relentless squeeze. This tends to increase the amount of land under cultivation and undermine conservation programs. It tends to force intensive use of pesticides and fertilizers. It tends to replace diversified

operations with large-scale feed lots and monocrop agriculture. It tends to reduce specialty crops to commodities. And it tends to place absentee owners in control, undermining family farming and rural communities.

The First World palliates (not the same thing as solving) these problems with agricultural subsidies because it can afford to. This has the unfortunate spillover effect in the Third World of generating a tidal wave of cheap exported food that destroys farm jobs the same way manufactured imports destroy factory jobs in industrial countries. Given that the combined agricultural subsidies (including hidden ones such as cheap water) of the U.S., EU, and Japan equal almost 75 percent of the *entire income* of Sub-Saharan Africa, it is no accident that African farmers, for example, cannot compete. [686](#) Once they can no longer support themselves on the land, they have no choice but to seek urban, mainly slum, life. When a Third World nation converts its food production to export and becomes dependent on imported food, it becomes vulnerable to volatility in its export markets. Bubbles in commodities such as biofuels make this worse, as when the bubble ends, it is impossible to convert back to food production in time to avoid food riots.

Raw materials extraction is the other sector notorious for bad industries. It tends to harbor many of the same pathologies as agriculture, plus a few nasty quirks of its own. Raw materials like oil notoriously breed parasitic elites

composed of whomever manages to establish political control of the spot where the oil comes out of the ground. Unlike the elites of manufacturing-oriented economies, they contribute little in managerial or technical skill to the economies they dominate. They can get away with misgoverning their countries in ways that would ruin the productivity of a manufacturing-oriented economy. They have no need to share widely the wealth derived from the raw materials they extract (except with local warlords, security forces, and the police), and little incentive to reinvest more than a fraction of that wealth in the industry itself.

During the Cold War, much opposition to capitalism was motivated not so much by literal hatred of private property (let alone actual love of communism) as by the deep-seated fear that advanced industrial modernity was a closed club of the United States and Western Europe.⁶⁸⁷ Other nations, it was feared, could never break in, but would remain eternally trapped in bad industries—which would then guarantee their poverty and political subordination. So socialism was the only way out, with the USSR as its ultimate geopolitical anchor, even if obviously extreme as a literal economic model to imitate. But once a nation understands the above *mechanisms* of underdevelopment—better yet, how to manipulate them through protectionism and industrial policy—abandoning capitalism entirely shows itself to be an unnecessarily radical solution. Japan and its followers in East Asia understood this,

which is a big part of why they were so staunchly anticommunist during this period. Other parts of the world did not, and thus found socialism considerably more interesting.

GOOD AND BAD INDUSTRIAL POLICY

If free markets and free trade aren't always best, this necessarily opens up the possibility that some other policy might be better, if properly designed and implemented. This, at bottom, is what makes successful protectionism and industrial policy possible.

It is no accident that when reviewing purported free-trade success stories around the world, one often finds protectionism and industrial policy right under the surface. In Brazil, for example, the steel and aircraft industries are legacies of past import-substitution policies;⁶⁸⁸ in Mexico, motor vehicles are; in Chile, grapes, forest products, and salmon. In fact, of the top 20 exporting corporations in Chile in 1993, at least 13 were creations of a single government agency, the *Corporación de Fomento de la Producción* (CORFO).⁶⁸⁹

Over the last 40 years, there have been two key laboratories of protectionism and industrial policy: East Asia and Latin America. As recently as the early 1970s, both regions were at similar levels economically, and Latin America was actually

much richer at the end of WWII.⁶⁹⁰ And yet East Asia has succeeded economically, while Latin America has stagnated since about 1975. (The above examples are happy exceptions.) Protectionism and industrial policy clearly come in both effective and ineffective varieties, and neither concept deserves an uncritical endorsement.

We are now in a position to understand why some kinds of each work and some don't.⁶⁹¹ In the words of Dani Rodrik, both regions employed the “carrot,” that is, tariffs, industrial subsidies, et cetera, to help their industries. But only East Asian governments were politically disciplined enough to employ some needed “stick” as well, i.e., measures to prevent their industries from merely converting this help into immediate profits, not long-term upgrading of their capabilities.

An export requirement is one example of a “stick.” This improves the nation's balance of payments and forces domestic producers to meet global standards for quality and cost. This policy can be implemented in a wide variety of ways, some not immediately obvious as such, like giving companies import quotas for raw materials based on their export performance. Another method is a so-called “rolling” local content requirement, where a company importing goods is required to produce a gradually increasing percentage of the final value of the product domestically. This creates a pressure to produce locally *without* getting so far ahead of market

outcomes as to be hopelessly inefficient.

Other patterns of successful industrial policy emerge. It has tended to maintain domestic rivalry within industries, rather than concentrating resources on a single superficially-strong national champion.⁶⁹² It has tended to involve local ownership *and* understanding of core technologies, rather than the “Lego brick” manipulation of sophisticated inputs in an unsophisticated way. It has tended to combine investment in education with investment in industries that can actually absorb educated workers. It has tended to use access to the national market as leverage to get foreign corporations to locate a share of production there, not merely as a shield for domestic producers or as a source of tariff revenue to be wasted on political pork. (Pulling in state-of-the-art foreign producers also keeps domestic producers on their competitive toes *without* subjecting the economy to an uncontrolled flood of imports.)

What did Latin America do wrong? It allowed domestic competition to wane. It permanently protected mature industries that should have been able to survive on their own by that point. It lacked an interest in exporting, so its industries were not disciplined to reach world standards. Lack of exports then caused a lack of the foreign currency needed to import state-of-the-art production technology. Its industrial know-how therefore lagged behind the rest of the world, as it never developed comparable domestic sources of technology

either. And Latin American nations either failed to emphasize education, or failed to create industries that could absorb educated workers, the latter causing investments in education to dissipate in brain drain abroad rather than accumulate as human capital at home.

THE WORST AND BEST INDUSTRIAL POLICY

In the developing world, the very worst industrial policy has tried to break into new industries merely on the basis of having cheaper factors of production, which mostly comes down to cheap labor. (Number two is probably cheap raw materials, followed by cheap land.) Unfortunately, industries based on cheap labor continually attract new entrants because cheap labor is an undifferentiated commodity, available all over the world. But incumbents are blocked from exit by costs they have already incurred, trapping them in these industries. Today's cheapest labor source is always vulnerable to being undercut by an even cheaper one tomorrow, and rival governments will subsidize even where there is no preexisting cost advantage. [693](#)

A nearby example of this misguided strategy is Mexico's string of *maquiladora* plants along the U.S. border. These 3,000 American-owned factories employ over a million workers. Though they often contain the latest production technology and have the highest productivity of any industry

in Mexico, they have spawned no industrial revolution there. Although these plants often *consume* fairly sophisticated technology, in the form of imported capital equipment, what they *do with* this technology is not especially sophisticated. So the Mexican economy accumulates neither human nor any other kind of capital; the products produced there have no scale economies *at the assembly stage*.⁶⁹⁴ For example, according to Rick Goings, CEO of Tupperware, which has a major plant in Toluca, Mexico failed to grasp the opportunity handed to it by NAFTA:

When all of a sudden the borders opened and all these [jobs] were created for assembly and sending [products] back to the United States, they didn't invest what they needed to in building the skill base of Mexican workers. So you go down there now and what are they complaining about? Losing their jobs to China. All you have to do is follow Nike's pattern over the last 25 years: Korea, China, Vietnam. You just keep following that low labor cost—you just keep following that dragon. Unless you build in these countries an infrastructure and a skill base, they may have a short-term advantage, but it won't last.⁶⁹⁵

Such industry is a technological and economic dead end. For all that anybody will ever learn or develop by working in it or even owning it, they might as well be picking coffee beans by hand—or owning a plantation. The question a nation should always be asking about its industries is, “Is there anything left to learn here?” If there isn’t, it’s time to let another nation further down the ladder of industrial development take over that industry and move on. And if it isn’t feasible to move on, then something is wrong with the nation’s industrial strategy, because it has gotten stuck, and growth requires that it continually be able to upgrade.

What does the most successful industrial policy look like? As economies try to make the jump from the Third World to Newly Industrialized Country status and finally to the First World, the real key to growth turns out to be proactively *anti-Ricardian*, namely getting *away from* their immediate comparative advantage. This key is therefore profoundly contrary to free trade. Above all, this means getting away from advantage based merely on *given* factors of production and transitioning towards advantage based on *created* factors of production. Ultimately, it means transitioning from so-called lower-order sources of advantage to higher-order sources. As Michael Porter explains it:

Lower-order advantages, such as low-cost labor or cheap raw materials, are relatively easy to imitate.

Competitors can often readily duplicate such advantages by finding another low-cost location or source of supply, or nullify them by producing or sourcing in the same place...Also at the lower end of the hierarchy of advantage are cost advantages due solely to economies of scale using technology, equipment, or methods sourced from or also available to competitors....

Higher-order advantages, such as proprietary process technology, product differentiation based on cumulative marketing efforts, and customer relationships protected by high customer costs of switching vendors, are more durable. Higher-order advantages are marked by a number of characteristics. The first is that achieving them requires more advanced skills and capabilities such as specialized and highly trained personnel, internal technical capability, and, often, close relationships with leading customers. Second, higher-order advantages usually depend on a history of *sustained and cumulative investment* in physical facilities and specialized and often risky learning, research and development, or marketing. ⁶⁹⁶ (Emphasis in the original.)

INDUSTRIAL POLICY, AMERICAN-STYLE

For contemporary Americans, one common roadblock to understanding industrial policy and protectionism is the myth that our most successful industries have made it on their own, without government help. We tend to see industrial policy (if we accept it at all) as perhaps suitable for up-and-coming nations, but not for nations like ourselves that have already arrived. But in reality, the fingerprints of industrial policy are easy to find in our own economy, even in the post-WWII era of increasingly free trade (and increasingly strident *laissez faire* rhetoric after about 1980).⁶⁹⁷ Let's look at two of America's most touted industries, semiconductors and aircraft, to see how they *really* became so strong—and thus why the purely free market model of economic growth is so wrong.

Silicon Valley is a famous success story of free enterprise, and to a large extent it deserves this reputation. Nevertheless, its rise was shot through with government support, without which it would probably never have existed. In fact, every place in the world where a semiconductor industry has developed, it has been the explicit target of state industrial policy.⁶⁹⁸

The entire semiconductor industry is based upon the transistor, which was invented by Bell Laboratories in 1947. Bell Labs, however, was no product of free-market capitalism,

but was the research wing of the old American Telephone and Telegraph (AT&T), a government-sanctioned monopoly. This company could only afford to support an expensive laboratory full of Nobel-caliber scientists precisely *because* it was a monopoly: protected from competitive pricing pressures, assured that no competitor would capture the commercial value of what it invented, and dedicated to the long term. It is Exhibit “A” against the canard that large, bureaucratic, government-subsidized companies protected from foreign competition can’t innovate. (This is not to say that these characteristics are positive goods in their own right, but it does rather suggest that the true determinants of industrial dynamism often lie outside laissez faire clichés.)⁶⁹⁹

The semiconductor industry was a massive beneficiary of infant-industry subsidies from the start. As it hatched and grew in the late 1950s and early 1960s, close to 100 percent of its output was bought by the military,⁷⁰⁰ which needed expensive high-performance semiconductors for uses like missile guidance systems at a time when most consumer electronics still ran on vacuum tubes. Even as late as 1968, the Pentagon bought nearly 40 percent of the semiconductors produced in the U.S.⁷⁰¹ Military demand enabled companies to stake their risky investments at a time when nobody else would buy their expensive cutting-edge technology.⁷⁰² It enabled them to build the expertise that was later applied to

civilian markets and achieve the scale economies needed to bring costs down into the range affordable for mass consumption.

Aviation is another example of the dependence of America's most successful industries on industrial policy. The entire 7x7 series of Boeing planes derives from the 707 launched in the late 1950s, which was the civilian twin of the KC-135 aerial-refueling plane built for the Air Force. Boeing actually *lost* money on its commercial aircraft operations for the first 20 years.⁷⁰³ To give further examples of the military lineage that made U.S. civil aviation possible:

Lockheed sold commercial versions of its C-130, C-141, and C-5A. [The Lockheed L-1011, McDonnell-Douglas DC-10] and Boeing 747 were all spawned by technical advances on the engines used for the C5-A. In short, every generation of the new civilian air transport has relied heavily on technology developed for the military.⁷⁰⁴

Other industries have been born from U.S. government industrial policy. The latest, of course, is the Internet, which derives from the military ARPANET built to enable communications between computers used for defense research. Even Google, the ultimate better-mousetrap free-

market success story, was based on research done by founders Larry Page and Sergey Brin at Stanford while supported by National Science Foundation grant IRI-9411306-4 to research digital libraries.⁷⁰⁵ And the biotech industry has been incubated by, and has depended upon basic research funded by, the National Science Foundation and the National Institutes of Health.

Unfortunately, if present trends continue, America's harvest from federally funded industrial policy will inexorably diminish. Even the military itself is now lagging. According to John Young, former head of the Pentagon's Advanced Technology and Logistics division:

The [Defense] Department is coasting on the basic science investments of the last century and is losing the force multiplier advantage conferred by harvesting those investments. The last 15 years (since the demise of the Soviet Union) have seen the Department pull back substantially from many science areas. Yet, scientific knowledge is the underpinning of the current U.S. capability overmatch in most areas.⁷⁰⁶

It seems Sputnik did us a bigger favor than we knew! The need to beat the Soviet Union appears to have been *the*

decisive factor in disciplining the U.S. government to pursue an effective industrial policy, and when the Cold War ended, serious industrial policy seems to have ended with it.

During the final push of the Cold War under President Reagan, the Defense Intelligence Agency and CIA created Project Socrates, whose purpose was to understand America's declining economic and technological competitiveness and develop industrial policies in response. But just as this project was nearing fruition, the Berlin Wall came tumbling down. President Bush was ideologically hostile to industrial policy and systematically destroyed the project.⁷⁰⁷ He had Defense Advanced Research Projects Agency (DARPA) director Craig Fields reassigned and ordered all records of the project destroyed to frustrate Freedom of Information Act requests.⁷⁰⁸ Thus died what should have been the crowning achievement of Cold War industrial policy: a systematic codification of its economic insights. Ironically, some of the key staff of this project have since worked on economic strategy for foreign nations like Poland and Malaysia, which have diligently used this knowledge to compete with the U.S.

With the end of the Cold War, even the most basic elements of purely military industrial policy began to get short shrift. For one thing, the Pentagon ceased to care very much about buying American. In the words of then-Secretary of Defense Dick Cheney, a key figure in this shift, policies favoring American defense producers "raise questions about my

spending money on things I could get cheaper elsewhere, and it raises the specter of having to rely upon less than first-rate technology in certain areas.”⁷⁰⁹ Thanks to nearly two decades of such policies, the U.S. is now unable to put a single military aircraft into the sky without using components made by potential adversaries. As a 2005 Defense Department report put it:

The potential effects of this restructuring are so perverse and far reaching and have such opportunities for mischief that, had the United States not significantly contributed to this migration, it would have been considered a major triumph of an adversary nation’s strategy to undermine U.S. military capabilities.⁷¹⁰

The Pentagon is now facing a rash of counterfeit electronic components in military systems, which lays the U.S. open to the kind of deliberate sabotage we have ourselves employed against adversaries such as Saddam Hussein.⁷¹¹ We also now face politically motivated refusal of foreign suppliers to provide needed components. The best known case is a Swiss company, Micro Crystal AG, which refused to supply piezoelectric timing crystals for the guidance system of the Joint Direct Attack Munition (JDAM) smart bomb at the time

of the Iraq war. ⁷¹² (One surviving American company was found.) The military is not unaware of this problem, but is hamstrung by the political power of defense contractors, who find outsourcing parts very profitable. ⁷¹³

INDUSTRIAL POLICY IN REVERSE: DEINDUSTRIALIZATION

Deindustrialization thanks to bad trade policy is a more complex process than is usually realized. It is not just layoffs and crumbling buildings. It is, in fact, *industrial policy in reverse*. As a result, understanding industrial policy helps illuminate how industries die.

When American producers are pushed out of foreign and domestic markets, it is not just immediate profits that are lost. Declining sales undermine their scale economies, driving up their costs and making them even less competitive. Less profit means less money to plow into future technology development. Less access to sophisticated foreign markets means less exposure to sophisticated foreign technology and diverse foreign buyer needs. ⁷¹⁴ When an industry shrinks, it ceases to support the complex web of skills, many of them outside the industry itself, upon which it depends. These skills often take years to master, so they only survive if the industry (and its supporting industries, several tiers deep into the supply chain) remain in continuous operation. The same goes

for specialized suppliers. Thus, for example, in the words of the *Financial Times*'s James Kynge:

The more Boeing outsourced, the quicker the machine-tool companies that supplied it went bust, providing opportunities for Chinese competitors to buy the technology they needed, better to supply companies like Boeing. [715](#)

Similarly, America starts being invisibly shut out of future industries which struggling or dying industries would have spawned. For example, in the words of Richard Elkus:

Just as the loss of the VCR wiped out America's ability to participate in the design and manufacture of broadcast video-recording equipment, the loss of the design and manufacturing of consumer electronic cameras in the United States virtually guaranteed the demise of its professional camera market....Thus, as the United States lost its position in consumer electronics, it began to lose its competitive base in commercial electronics as well. The losses in these related infrastructures would begin to negatively affect other downstream industries, not the least of which was the automobile....*Like an ecosystem, a*

*competitive economy is a holistic entity, far greater than the sum of its parts.*⁷¹⁶ (Emphasis added.)

Free market economics systematically denies this greater-than-the-sum-of-its-parts aspect of the economy, as it assumes on principle that every *part* of the economy is always correctly priced by the market, rendering impossible any holistic effects in which the whole is worth more than their sum.

The fruits of this reductionist way of thinking are visible all over the U.S. economy today. For example, the U.S. is today inexorably losing the position in semiconductors it built up with past industrial policy. This is visible in declining plant investment relative to the rest of the world. In 2009, the whole of North America received only 21 percent of the world's investment in semiconductor capital equipment, compared to 64 percent going to China, Japan, South Korea, and Taiwan.⁷¹⁷ The U.S. now has virtually no position in photolithographic steppers, the ultra-expensive machines, among the most sophisticated technological devices in existence, that "print" the microscopic circuits of computer chips on silicon wafers. America's lack of a position in steppers means that close collaboration between the makers of these machines and the companies that use them is no longer easy in the U.S. This collaboration traditionally drove both the chip and the stepper industries to new heights of performance.

American companies had 90 percent of the world market in 1980, but have less than 10 percent today. [718](#)

The decay of the related printed circuit board (PCB) industry tells a similar tale. An extended 2008 excerpt from *Manufacturing & Technology News* is worth reading on this score:

The state of this industry has gone further downhill from what seems to be eons ago in 2005. The bare printed circuit industry is extremely sick in North America. Many equipment manufacturers have disappeared or are a shallow shell of their former selves. Many have opted to follow their customers to Asia, building machines there. Many raw material vendors have also gone.

What is basically left in the United States are very fragile manufacturers, weak in capital, struggling to supply [Original Equipment Manufacturers] at prices that do not contribute to profit. The majority of the remaining manufacturers should be called 'shops.' They are owner operated and employ themselves. They are small. They barely survive. They cannot invest. Most offer only small lot, quick-turn delivery. There is very little R&D, if any at all. They can't afford equipment. They are stale. The

larger companies simply get into deeper debt loads. The profits aren't there to reinvest. Talent is no longer attracted to a dying industry and the remaining manufacturers have cut all incentives.

PCB manufacturers need raw materials with which to produce their wares. There is hardly a copper clad lamination industry. Drill bits are coming from offshore. Imaging materials, specialty chemicals, metal finishing chemistry, film and capital equipment have disappeared from the United States. Saving a PCB shop isn't saving anything if its raw materials must come from offshore. As the mass exodus of PCB manufacturers heads east, so is their supply chain.

It's the *big* picture that needs to be looked into. There isn't one single vertically integrated North American shop that could independently supply a circuit board. Almost every shop stays in business supported solely by revenues from 'brokering' Asian boards. ⁷¹⁹ (Emphasis in original.)

All over America, other industries are quietly falling apart in similar ways.

Losing positions in key technologies means that whatever brilliant innovations Americans may dream up in small start-up companies in future, large-scale commercialization of those innovations will increasingly take place abroad. A similar fate befell Great Britain, which invented such staples of the postwar era as radar, the jet passenger plane, and the CAT scanner, only to see huge industries based on each end up in the U.S.

America's increasingly patchy technological base also renders it vulnerable to foreign suppliers of "key" or "chokepoint" technologies. In the words of Laura D'Andrea Tyson:

Because semiconductors are an indispensable input throughout the electronics complex, strategic control over their supply by a concentrated Japanese oligopoly poses a threat to downstream producers throughout the world.⁷²⁰

One form this takes is the refusal of oligopoly suppliers to sell their best technology to American companies as quickly as they make it available to their own corporate partners.⁷²¹ It doesn't take much imagination to see how foreign industrial policy could turn this into a potent competitive weapon against American industry. For example, Japan now supplies over 70

percent of the world's nickel-metal hydride batteries⁷²² and 60-70 percent of the world's lithium-ion batteries.⁷²³ This will give Japan a key advantage in electric cars.

IMPOSSIBLE NOT TO HAVE AN INDUSTRIAL POLICY

Because of the myriad impacts that government decisions have upon industries, there is no option of “not having” an industrial policy. There is only good and bad industrial policy. In the words of James C. Miller III, chairman of the Federal Trade Commission under Reagan, “Any discussion of industrial policy should begin with recognition that we have one. The issue is what type.”⁷²⁴ A nation that refuses to have a conscious industrial policy will still have a *de facto* industrial policy because the sum of its short-term tactical choices will amount to a long-term strategic choice whether intended or not.

If nothing else, the brute fact of foreign mercantilism means that the option of genuinely free trade has long since been taken away from us. Again, D'Andrea Tyson:

We must not be hoodwinked by the soothing notion that, in the absence of U.S. intervention, the fate of America's high-technology industries will be

determined by market forces. Instead, they will be manipulated by the trade, regulatory, and industrial policies of our trading partners. [725](#)

Free trade and the absence of deliberate industrial policy are not neutral choices, free of government interference; they are *positive strategic bets in their own right*, which will only pay off if their key underlying economic assumption is true: pure free markets, at home and abroad, are always best. Taking an ideological stand against “central planning” misses the point, because the central planning that has rightly disgraced itself is *socialist* central planning, something entirely different. Similarly, ideological fulmination against “government picking winners” misunderstands the role that federal support plays. As Michael Borrus, founding general partner of the Silicon Valley venture capital firm X/Seed Capital, explains, referring to the National Institute of Science and Technology’s Advanced Technology Program:

ATP is sometimes labeled with the profoundly misleading and profoundly misinformed characterization of ‘picking winners and losers.’ That is, frankly, flat wrong. No investor, private or public, picks winners and losers in technology innovation. Rather, it is the market (customers) that does the picking. By contrast, with ATP and other

federal technology programs, the government is really helping to plant long-term technology seeds in areas of private market failure or acute public need. Some of those technology seeds will sprout, others will not. But the planting, the activity as a whole, must go forward if long-term economic gains are to be effectively harvested. [726](#)

Opponents of industrial policy claim to oppose all industrial policy, but actually only oppose varieties they disapprove of. Despite the laissez faire myth that industrial policy was discredited with the end of the Cold War, worldwide, as Dani Rodrik explains:

The reality is that industrial policies have run rampant during the last two decades—and nowhere more than in those economies that have steadfastly adopted the agenda of orthodox [free market] reform. If this fact has escaped attention, it is only because the preferential policies in question have privileged exports and foreign investment—the two fetishes of the Washington Consensus era—and because their advocates have called them strategies of ‘outward orientation’ and other similar sounding names instead of industrial policies. [727](#)

Export processing zones are one example of this industrial-policy-by-an-other-name. These receive duty-free access to raw material and component inputs, tax holidays on corporate, personal, and property taxes, exemption from usual regulations (including labor laws), and subsidized infrastructure. Another example is the wide array of subsidies, ranging from tax advantages to one-stop-shop help navigating local bureaucracy, given to encourage foreign direct investment (FDI).

One of the clearest signs in the U.S. of the inevitability of industrial policy is that while Washington has fiddled, the states have rushed in to fill the gap. Research parks—most famously Research Triangle Park in North Carolina—based upon links with state universities are the most obvious case, followed by the huge financial incentives states are awarding to lure foreign corporations. Alabama, for example, in order to win a Mercedes-Benz plant in 1993, agreed to provide tax abatements, train the workers, clear the site, upgrade utilities, install infrastructure, and buy 2,500 of the cars produced. This cost \$153 million—between \$150,000 and \$200,000 per job created. ⁷²⁸ The problem is that state-level policy like this can easily spend public money merely to shift investments from one state to another, with no net gain to America as a whole.

Meanwhile, the federal government continues to stick its head in the sand. For example, it allowed the SEMATECH

semiconductor research consortium to be effectively dismantled in 1996 by opening it up to foreign manufacturers.⁷²⁹ The competitive difficulties of the American semiconductor industry in the late 1980s were treated as a one-off anomaly requiring merely tactical intervention, rather than as a symptom, destined to be repeated, of the difficulties experienced by an American industry trying to compete on its own against foreign industries backed by effective state industrial policy. America's tax credit for research and development, once the world's most generous, is now surpassed by 17 other nations.⁷³⁰ This is despite the fact that, according to one rigorous 1988 study:

A substantial gap exists between the private and social returns [to R&D] despite the availability of patents. The social rate of return is between 50 and 100 percent, so to be conservative we will say that the excess return to R&D is 35 to 60 percent above the return to ordinary capital.⁷³¹

The George W. Bush administration abolished the only program specifically designed to increase the competitiveness of American industry by funding development of technologies that the private sector would not fund on its own: the

aforementioned Advanced Technology Program. Free market ideologues repeatedly tarred this program as corporate welfare despite the fact that an audit by the respected National Academy of Sciences vindicated its claim to generate economic benefits far exceeding its cost.⁷³² One single \$5.5 million grant, for example, seeded development of the small disk drive industry, which enabled creation of the iPod, the iPhone, TiVo and the Xbox.⁷³³ It was replaced by an alternative carefully trimmed to avoid such accusations: the Technology Innovation Program. This program is well run, but pitifully underfunded at a mere \$65 million per year.⁷³⁴

The Obama administration has proved only slightly better than the Bush administration. Although not blinded by an ideological fetish for free markets, its priorities for allocating serious money are decidedly elsewhere. Thus the giant stimulus package it passed in 2009 included money for every Congressional pork barrel under the sun, but nothing for one of the industrial-policy programs with the best track record of saving and creating jobs, the Manufacturing Extension Partnership,⁷³⁵ despite a campaign promise to double the program's funding.⁷³⁶ This program maintains a network of centers in every state designed to help American manufacturers adopt innovative technologies. One evaluation found that it generated \$1.3 billion a year in cost savings for manufacturers and \$6.25 billion in increased or retained sales,

all for an annual federal outlay of only \$89 million. [737](#)

As a result of America's neglect of industrial policy, there is a starvation of basic and applied research in areas such as biocomputing, computer architecture, software, optoelectronics, aeronautics, advanced materials, factory automation, sensors, energy conversion and storage, nanomanufacturing, and robotics. The U.S. will pay a serious price for this in the decades ahead.

Chapter 10

The Multiple Equilibrium Revolution

We saw in the previous chapter how profoundly the real origins of economic growth contradict free-market, free-trade economics. Real-world growth is path dependent, reliant upon scale economies and “good” industries, and inefficient by the standards of pure free markets. This last point is the most important, because it means that a purely free-market approach to economic policy, which rejects protectionism abroad and industrial policy at home, will *necessarily* underperform a competent embrace of these policies. But although this has been known and successfully applied by governments (including our own) for centuries, its underlying economics has never been properly mathematized. This has been the Achilles’ heel of this knowledge in post-WWII America, because academic economists have therefore not taken it seriously. Until now. Finally, someone has found a way to translate this eminently practical wisdom into the abstruse mathematics economists are prepared to consider “serious” economics. This is, in fact, the intellectual innovation that will eventually end economists’ faith in free trade for good. [738](#)

The theoretical breakthrough in question was made by economists Ralph Gomory and William Baumol, starting around 1991 and reaching its crowning synthesis in their 2000

book *Global Trade and Conflicting National Interests*.

Ralph Gomory, currently Research Professor at the Stern School of Business at New York University in New York City, holds a PhD in mathematics from Princeton, spent 30 years with IBM, managed its world-famous Research Division, and was its senior vice-president for science and technology. (Two Nobels were won under his direction.) William Baumol, currently Professor of Entrepreneurship at the Stern School, is Professor Emeritus of economics at Princeton and a former president of the American Economic Association. Prior to his work in trade economics, he was best known for having carved out a place in economic theory for entrepreneurs.

So this is serious economics, albeit cutting-edge and thus highly controversial. It is not a crank theory, an ideological shibboleth, special-interest pleading, or an academic fad. It is, above all, not going to go away any time soon, but will almost certainly challenge the existing free trade consensus until one or the other gives way or a new synthesis emerges.

MATHEMATIZING SCALE ECONOMIES

The easiest way to understand Gomory and Baumol's work is to add another assumption to the list in Chapter Five of the dubious assumptions of the theory of comparative advantage:

Dubious Assumption #8: There are no scale economies.

Gomory and Baumol assume instead that there are. This is both true and, as we saw in the previous chapter, a fact with vast implications. Scale-economy industries are where the action is when it comes to economic growth, and they are the key trade battlegrounds for advanced economies. And because they are the highly capitalized and knowledge intensive industries that most strongly defy Ricardian economics, Gomory and Baumol's analysis is thus highly appropriate for understanding those industries where free trade *isn't* America's best move. This makes theirs an excellent analysis for anyone who wants to criticize free trade—and figure out what the rational alternative might be.

WHAT ARE RETAINABLE INDUSTRIES?

Gomory and Baumol's analysis is founded on the implications they draw from a key fact about scale-economy industries. Because, by definition, their cost per unit goes down as their output goes up, which nation is the world's low-cost producer is, other things being equal, a function of which nation is producing *more*. So whichever nation reaches large production volume *first* in a scale-economy industry thereby

becomes the world's low-cost producer in that industry. The winner's cost advantage then locks other nations out.

Under these circumstances, the only way a challenger can succeed is to start on day one at a production volume equal to the incumbent's. This is rarely feasible. Not only would the challenger have to match the investments that incumbent had already made to reach high-volume production, but the payoff would be a Pyrrhic victory: head-to-head competition with an entrenched incumbent. As this sort of competition tends to drive profits toward zero, it is rarely financially viable to challenge an incumbent under these circumstances. Gomory and Baumol call industries that behave this way "retainable" industries and if a nation can acquire them, it can generally hang onto them.

The important thing here is the lockout phenomenon. Even if another nation hypothetically *might* have been an even lower-cost producer, the first arrival is so entrenched that the latecomer never gets a chance. This is the opposite of what happens in Ricardo's model. In his model, historical accidents of which nation reaches high-volume production first certainly happen, but they don't *matter* because they get washed away afterwards by competitive forces. Potentially superior latecomers realize their potential superiority and win, so if one nation reaches high-volume production before another, this has no particular significance. Ricardo didn't allow for the effects of scale economies, and in their absence, a head start

doesn't permanently lower a nation's costs below its rivals. So without entrenched scale economies, there can be no lockouts.

This is, of course, how the world ended up with half its large passenger aircraft being built in Seattle and two-thirds of its fine watches being made in Switzerland. Ricardian comparative advantage is useless for explaining why Bangladesh exports many t-shirts and few soccer balls, while Pakistan exports the reverse. Why does South Korea export so many microwave ovens, and almost no bicycles, while Taiwan is the other way around? There is nothing intrinsic about South Korea that makes it a good place to build microwave ovens. Entrenched scale economies are the reason.

GOOD-BYE PERFECT COMPETITION

As noted in the previous chapter, scale economies are incompatible with perfect competition. Instead, firms that possess them will be (at least partly) sheltered from competition and will therefore realize quasi-monopoly profits. When two or three firms in an industry all have scale economies, this will tend to make that industry an oligopoly. Imperfect competition is generally a happy thing for those who own and work in such industries, as these industries can reap and pay higher-than-normal profits and wages. Of particular interest to residents of advanced industrial nations,

these industries are sheltered against cheap foreign labor if their scale economies are large enough.

From the general public's point of view, the best thing about these industries is that they pay higher wages to their employees. Hypothetically, they could just return greater profits to their owners, but the empirical data actually suggests that workers receive a greater benefit. The most authoritative study on this question is by Harvard economists Lawrence Katz and Lawrence Summers (former president of Harvard and Secretary of the Treasury, then chief economic advisor to President Obama). They found that "variations in labor rents [extra wages] across industries are at least two to three times as important as variations in the rents accruing to shareholders [extra profits]." ⁷⁴¹ Among other things, their analysis changes the evaluation of industrial policy; as they note with respect to the European aircraft industry:

Once labor rent considerations are recognized, the overall assessment of the Airbus program for European welfare turns from marginally negative to strongly positive. Even in the less favorable case, the subsidy generates a welfare gain representing about half its cost....Policies promoting domestic production that appear undesirable without taking account of labor market imperfections yield large gains once the existence of these imperfections is

acknowledged.⁷⁴²

Imperfect competition has other benefits. As previously noted, it supports innovation, as the only way innovation can be profitable is if firms which finance it get at least *quasi-exclusive* rights to sell its application. And because knowledge *itself* leads to scale economies as the cost of an innovation is amortized over a rising number of units of product sold, this is a self-reinforcing process. More innovation leads to more scale economies, which lead to more profits and more money to finance innovation. Therefore scale economies, in the presence of a healthy financial system with long time horizons, tend to drive an economy to endlessly seek out innovation.

So, despite myths about high technology being the ultimate arena of pure competition and free markets being the master key to innovation, high technology actually tends to be an area in which pure free market principles do *not* operate. In the words of one OECD study:

Oligopolistic competition and strategic interaction among firms and governments rather than the invisible hand of market forces condition today's competitive advantage and international division of labor in high-technology industries.⁷⁴³

Ralph Gomory got a good look at this fact during his time at IBM, which once held 70 percent of the market for mainframe computers and faced a Department of Justice antitrust investigation.⁷⁴⁴

GOOD-BYE RICARDO'S EFFICIENCIES

In a Ricardian world, as noted when we first examined the theory of comparative advantage in Chapter Five, every industry automatically migrates to the lowest-possible-cost producer.⁷⁴⁵ But in a Gomory-Baumol world, it may or it may not—because historical accidents can interfere. In fact, in a Gomory-Baumol world there isn't even *just one* answer to the question of which nation *is* the lowest-possible-cost producer. Instead, there are an infinite number of possible answers, depending on which nation reaches large production volume first.

This has profound implications. For one thing, it means that some possible outcomes are “bad” outcomes, in which the winning nation locks out potentially more-efficient rivals. Would the world enjoy cheaper fine watches if Japan had captured this industry, rather than Switzerland? We'll never know, because the accidental equilibrium that placed this industry in Switzerland is now entrenched. Would the world have better small cars if Brazil had captured this industry,

rather than Japan? Same problem. If the “wrong” nations win the race in various industries, the world economy may get stuck incurring opportunity costs it could have avoided if other nations had won.⁷⁴⁶ Thus it will waste opportunities and be less productive than it could have been. So all bets are off about free trade necessarily producing the best possible outcome for the world economy as a whole.⁷⁴⁷

The same goes for individual nations. Would Germany be a richer country if it had a commanding position in airplanes, rather than cars? Maybe, but maybe not. The fact that the free market steered Germany’s factors of production into the car industry does *not* guarantee that this was the best possible use for them.⁷⁴⁸ Because lockout can interfere, free trade won’t necessarily allocate every nation its most appropriate industries, and mere bad luck can deprive a nation of the industries that would actually have been best for it. And the Ricardian assumption that departing industries will automatically be replaced by better ones becomes even more problematic than already noted with Chapter Five’s dubious assumption #2 (factors of production move easily between industries) because lockout can interfere with breaking into the right replacement industries. Michigan is not going to neatly segue into the helicopter industry.

WEIGHING THE POSSIBLE OUTCOMES

If the Ricardian contention that free trade outcomes are always the best possible is no longer tenable, the obvious next question is just how good *are* the various outcomes that can occur, and for which nations? Is there an intelligible pattern to the quasi-arbitrary outcomes Gomory and Baumol seem to imply, with historical accidents tripping up predictable efficiency as often as not? We need some kind of *map* of the possible distributions of retainable industries among nations, showing who gets which industries when—and how big are the economic benefits when they do.

These possible distributions of retainable industries among nations are the subject of a computer model constructed by Gomory and Baumol on the basis of their theory. This model runs out different possible scenarios of industry assignment between two imaginary nations A and B. In some scenarios, A wins the automobile, aircraft, and semiconductor industries, plus two others, while B wins the rest. In other scenarios, B wins those industries, three others, and A wins the rest. With a model containing just two nations (the UN recognizes 194) and 10 industries (the Commerce Department recognizes about 1,800), ⁷⁴⁹ there are over 1,000 possible distributions of industries between nations. So this model is highly simplified, compared to the real world. But it still suffices to draw out the key implications of Gomory and Baumol's ideas.

Whenever a nation captures an industry, that industry's

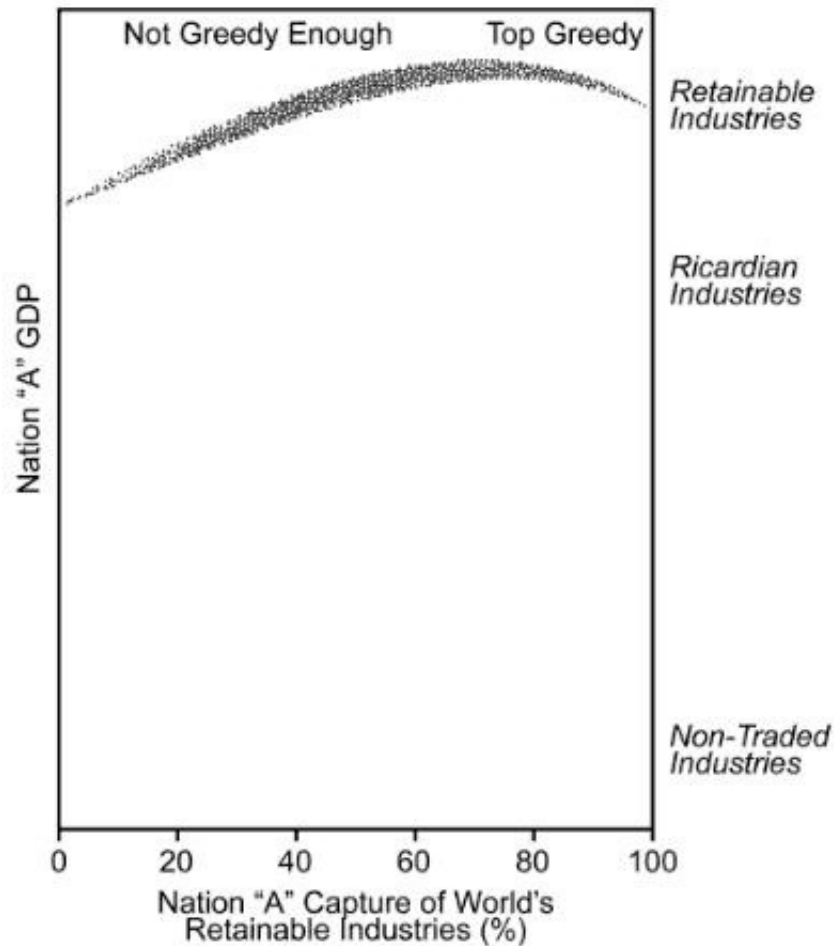
output will become part of its GDP, so the nation will be richer for it. Thus one might, at first sight, conclude that a nation's best move is simply to capture as many retainable industries as it can, by winning the race to high-volume production in each. But if one looks closely at the graph on the next page generated by the computer model, there is clearly more to the story. [750](#)

Each dot on the graph on the next page represents one *scenario*, that is one possible distribution of retainable industries between A and B. Non-retainable industries will be distributed Ricardo-fashion, and nontraded industries will not be (directly) affected by trade at all, but will form a base of unchanging economic activity at the bottom of the graph. The horizontal axis shows what percentage of the world's retainable industries A has captured (B gets the rest); the vertical axis shows A's GDP. So the further to the right a dot is, the more retainable industries A has captured, and the higher a dot is, the richer A is in that scenario.

GREEDY, BUT NOT TOO GREEDY

The graph on the next page shows that, in general, the more retainable industries A captures, the higher its GDP. No surprise there. But there's also a surprise: it is *not* nation A's best move to capture all the retainable industries in the world! If it does, it actually ends up poorer than if it captures, say, 70

percent. Thus the cluster of dots is actually lower at the far right side of the graph than if we move a little to the left. So A's best move is apparently to *be greedy, but not too greedy*.



There are a number of reasons for this. For a start, A taking 100 percent of the world's retainable industries would mean it taking industries for which it is fundamentally ill-suited, despite its luck in winning them. (As noted, a nation can sometimes be a "bad" winner.) When an industry would have been significantly more efficient in B, A would be better off allocating its factors of production to other industries and

importing those goods from B instead. Why? Because A has to balance the monopoly profits from winning a retainable industry against the Ricardian cost of producing for itself goods that B could have produced more cheaply.

We already know about Ricardian costs: these are the costs a nation incurs when it defies free trade and makes for itself things it should import. Nothing in Gomory and Baumol's theory makes these costs go away. But their theory introduces monopoly profits that sometimes outweigh them. Would America be better off if we produced for ourselves the fine watches we currently import from Switzerland? Maybe, because this would mean hosting a sophisticated high-paying industry. But maybe not, if we turned out to be a grossly inferior producer and the extra wages and profits were outweighed by the cost of ending up with inferior and more expensive watches. Ricardo understood the Ricardian cost side of this perfectly, but not the monopoly profits side. In his world, there *are* no monopoly profits because all industries operate under perfect competition all the time—and without scale economies and lockout, it is impossible to have an international monopoly or quasi-monopoly.

There is another problem with A capturing every retainable industry: this would mean dividing up A's finite labor force and capital among them. This would spread A's labor and capital too thin to realize the maximum possible scale economies in each. America has such a large economy that we

tend not to take this issue seriously, but for most nations this is a serious issue. Finland, for example, has a world-class position in cellular phones (Nokia). But Finland is probably too small to support both that *and* world-class positions in avionics, nanotechnology, fiber optics, and genetic engineering. So nation A has to balance its monopoly profits against a scale-economies loss, too.

The final problem is that capturing every retainable industry would mean depriving B of retainable industries of its own. As a result, B wouldn't have enough high-value exports to afford very many imports from A, which would have enabled A to increase its exports from its own best industries even more. So A has to balance its monopoly profits against a trading loss as well.

A good analogy to A's bundle of tradeoffs would be to an exceptionally lucky jack-of-all-trades who manages to monopolize all the most lucrative jobs in a small town. He is the town's lawyer, its doctor, its banker, et cetera. Obviously, up to a point, this might be very lucrative. But if he takes it too far, he will make less profit than if he relinquished a few jobs to other people. His best move? Pick some desirable occupation, whether or not someone else would be better at it, but a) he shouldn't grab any job he's terrible at, b) he shouldn't spread himself too thin, and c) he shouldn't lock everyone else out of good careers entirely. Point a) means there's no point imposing meritocracy on yourself if this just

means somebody else taking your dream job. But equally, you shouldn't try to be your own doctor if you're no good at medicine. Point b) means that working several jobs means several paychecks, but you probably can't make a success out of a profession you practice for only a few hours a day. Point c) means that it's nice to have the best job in town, but unless other people have good jobs too, you won't have many customers.

Clearly, the old Ricardian logic has its place in a Gomory-Baumol world. It just isn't the whole story anymore. The successful pursuit of economic self-interest, for both nations and people, is a *tradeoff* between simply grabbing what one wants and submitting to various demands of efficiency. Nations, like people, benefit from importing and exporting in order to allocate their finite productive abilities to their most productive activities. But nations, like people, *also* benefit by capturing monopoly positions (nations capture good industries, people hold good jobs) *whether or not* this is efficient *per se*. (As noted in Chapter Five, nations trade for the same reasons people do.)

Gomory and Baumol's analysis also warns us that when someone *else* holds a lucrative job, they will use it to extract monopoly profits from us. And they may not be the best person for the job, anyway, merely someone who managed to entrench themselves in it. This reasoning extends to nations: not only is it advantageous to win good industries, but it is

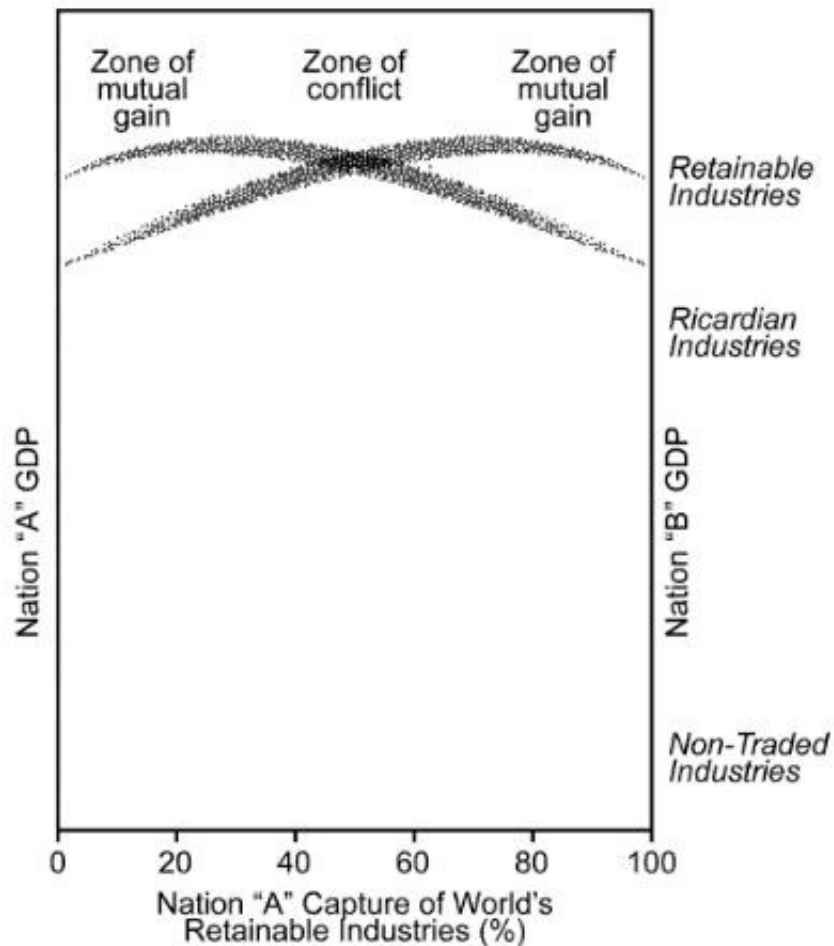
disadvantageous to end up at the mercy of other nations that have—because this will entail paying them tribute in the form of their monopoly profit margins. (And they may not be the best possible suppliers, anyhow.) Americans are only really conscious of this problem in the case of OPEC, which is a natural oligopoly. But if we end up 30 years from now with a solar-powered economy dependent on Japanese-made solar cells, we will be in the exact same position, especially because American-made solar cells might have been cheaper and better, if we had gotten our act together and developed this industry.

WIN-WIN VS. WIN-LOSE TRADE

There is a twin to nation A in the above analysis: its trading partner nation B. When A has 100 percent of the world's retainable industries, B has 0 percent; when A has 90 percent, B has 10 percent, and so on. What does B's experience of the above scenarios look like? Let's plot both nations on the same graph and see (on the next page). [751](#)

The interesting thing about this graph is that in the two side regions (labeled Zone of Mutual Gain), any change in A's industry capture that benefits A, benefits B also. Whenever A captures more industries and its GDP goes up, B's GDP goes up, too. And whenever A captures fewer industries and its GDP goes down, B's GDP goes down, too. So anything either

nation does to benefit itself *also* benefits its trading partner. This means a world in which economic rivalry does not exist because all outcomes are win-win. (This is how Ricardians believe the world works all the time.) However, as one can also see, in the region at the center, things work very differently. There, gain for one nation coincides with loss for the other. In this region, economic rivalry is a fact of life.



Gomory and Baumol are definitely onto something here because they have managed to bridge the gap between the Pollyannaish “international trade is always win-win” Ricardian

view and the overly pessimistic “international trade is war” view. The former view is naïve and, due to dubious assumptions #5 (capital is not internationally mobile) and #7 (trade does not induce adverse productivity growth abroad), untenable even *without* their insights. The latter view ignores the fact that economics precisely *isn't* war because it is a positive-sum game in which goods are produced, not just divided, making mutual gains possible.

So here, at long last, we have a theoretical framework that can accommodate economic reality as we actually experience it, not just lecture us on what “must” happen as Ricardianism does. It's both a dog-eat-dog *and* a scratch-my-back-and-I'll-scratch-yours world. *Economics has finally given common sense permission to be true.*

Gomory and Baumol's analysis is obviously just the beginning of a whole new way of looking at international trade, which will require decades of elaboration before it becomes a complete new theory of the world economy. But the importance of their work should be obvious already. It will have enormous repercussions for economics (and the real-world policy decisions that depend on it) in the years to come.

COMPARATIVE ADVANTAGE IN THE RIGHT INDUSTRIES

What are the policy implications of Gomory and Baumol's work? Basically that a wise nation will willingly let other nations have their share of the world's industrial base, but will try to grab the *best* industries for itself. Then it will sit back (here's where *laissez faire* plays its legitimate role) and let the rest of the world compete—head to head, driving the price down through the perfect competition in free markets it seeks to avoid for itself—to produce for it the things it doesn't want to produce at home.

Here Ricardo's ghost rears its head yet again: comparative advantage remains a valid principle, but a nation's best move is not simply to trade according to the comparative advantage it already has. It is to *seek comparative advantage in the best industries*. Ricardianism is about finding the best use for the comparative advantage one already has (mistaking this for the entire question); Gomory and Baumol are about what kind of comparative advantage it is best *to have*.

The top retainable industries will be the best ones to have comparative advantage in, followed by the lesser retainable industries. What makes one retainable industry better than another? It ideally should be large, strongly retainable, and with a long future potential for innovation, and many spinoff industries, ahead of it. As Michael Porter explains, referring to such industries as “structurally attractive” ones:

Structurally attractive industries, with sustainable

entry barriers in such areas as technology, specialized skills, channel access, and brand reputation, often involve high labor productivity and will earn more attractive returns to capital. Standard of living will depend importantly on the capacity of a nation's firms to successfully penetrate structurally attractive industries. The attractiveness of an industry is not reliably indicated by size, rapid growth, or newness of technology, attributes often stressed by executives and by government planners...By targeting entry into structurally unattractive industries, developing nations have often made poor use of scarce national resources. [752](#)

The industries it is *worst* to have are the nonretainable, no-scale-economies industries. These behave according to the old Ricardian model: head-to-head free-market competition that drives down prices, profits, and wages. Cynically speaking, these are what a shrewd nation wants *its trading partners* to specialize in.

But this doesn't mean a shrewd nation wants its trading partners to be destitute. Then they would have few tradable industries of any kind and low productivity in those they did have. This would make it impossible to realize significant gains by trading with them. Nobody gets rich trading with Kalahari Bushmen, no matter how shrewd, efficient, or even

downright exploitive they are, because Bushmen just don't have that much *stuff* in the first place. ⁷⁵³ Instead, the ideal trading partner is one that perfectly *complements* a nation's own more sophisticated economy. The ideal trading partner is less like a slave (the colonial exploitation model) than like the perfect employee. He skillfully performs all the tasks his employer *doesn't* want to perform, freeing that employer to perform more-valuable tasks. But he *isn't* so skillful that he threatens his employer's entrenched position doing the tasks he wishes to reserve to himself. Every lawyer wants an efficient paralegal; no lawyer wants one so skilled that she sets up a competing legal practice!

The ideal trading partner thus has the highest possible productivity in the industries that a nation *doesn't* want to compete in, but low productivity in those it does want to compete in. ⁷⁵⁴ For example, because Japan is a net importer of oil, Japan should want all oil exporting nations to be the most efficient possible oil producers, as this will provide Japan the cheapest possible oil. But Japan should not want Kuwait to become an efficient producer of cars!

There is a fundamental asymmetry here: a productivity increase in Japan's car industry will always benefit Kuwait, by enabling Kuwait to buy cheaper cars. But a productivity increase in Kuwait's car industry (from zero, as it does not currently have one) will *not* necessarily benefit Japan. (The only time it might is if Kuwait started building car parts that

enabled Japan to build better cars, or if Kuwait started building cheap cars, enabling Japan to stop producing these for itself and produce more-expensive ones instead.) Productivity gains by the leader (Japan) are always win-win, but gains by followers (Kuwait) can sometimes be win-lose. ⁷⁵⁵ This is why the most visible pressures for protectionism appear in threatened leading nations, while the most successful protectionism and industrial policy are visible in catching-up nations. Once one views these phenomena under Gomory-Baumol assumptions, they make perfect sense, while Ricardian thinking sees only misguided complaining driven by special-interest politics and unnecessary protectionism of industries that would have succeeded anyway.

DEFENDING RETAINABLE INDUSTRIES

We have just scratched at a serious issue. Retainability is real, but it is not absolute and it does have to be defended over time as old industries decay into obsolescence and new ones emerge, rendering yesterday's entrenched positions irrelevant. As noted earlier, retainability exists because scale economies entrench productivity differences, which entrench industry assignments among nations. But what if productivity differences are not due to entrenched scale economies, but are just *there*, for whatever reason? Then, as long as they last, the same implications will flow from them that flow from

entrenched productivity differences—only *these* implications will be unstable. So the same Gomory-Baumol analyses will apply. Unfortunately, this also means that the win-lose implications of the Gomory-Baumol analysis will apply, too. So there will be a Zone of Conflict and a Zone of Mutual Gain. There will be harmony and rivalry. There will be winners and losers. Productivity gains by one nation will either help or hurt the other, depending on where on the graph they both are.

This is extremely important. Because it finally gives us a sound theoretical basis for saying what ordinary Americans (and extremely sophisticated international businesspeople) tend to regard as obvious, even if most American economists do not:

Foreign productivity growth can take entire industries away from us without conferring any compensating benefits. [756](#)

This is neither an illusion promoted by special interests nor a myth invented by demagogic politicians. Here, Ricardianism is completely out of touch with reality and catastrophically wrong.

The illusion of permanent advantage that transient productivity differences create explains a fact noted in Chapter

⁷⁵⁷ Six: nations at the peak of their economic power, like Britain in 1860 or the U.S. in 1960, can garner the mistaken impression that free trade is universally beneficial to them. But this illusion depends upon productivity differences between them and their rivals that will not endure forever. This situation also resembles a problem we encountered before, in milder form, with dubious assumption #7 (free trade does not induce adverse productivity growth abroad). By previously analyzing the problem without using multiple-equilibrium ideas, we merely noted that foreign productivity growth can roll back *existing* gains from trade. This is much worse.

ARE INDUSTRIES NATIONAL?

There is one final, and very important, caveat to the whole Gomory-Baumol analysis. When we noted that half the world's large passenger aircraft are built in Seattle and two-thirds of its fine watches in Switzerland, the reason this is true is that the American aircraft and Swiss watch industries are relatively *localized*. That is, the companies that make up these industries, though they do have international operations, are still significantly tied to their national home bases. (As noted in Chapter One, this is still largely true even for most multinational corporations.)⁷⁵⁸ As a result, it is meaningful to talk about the national location of these corporations and thus about national industries.

This is critical, because scale economies mostly reside in companies, not industries as such. As a result, if companies are truly internationalized, the Gomory-Baumol analysis will get no traction on them, and the more internationalized they are, the less traction it will get. As a result, the less any solution based on this analysis will succeed. Luckily, it is, of course, free trade *itself* that tends to denationalize companies, so protectionism can push back at denationalization. Successful protectionism based on Gomory and Baumol's ideas will therefore be a two-pronged policy: first, to maintain in corporations a sufficiently national character for policies imposed at the national level to work, and second, to impose the right national policies.

Strictly speaking, matters are even more complicated than this. What really matters actually isn't how national a company's production is, but how national the *scale-economy stages* of its production are. The supply chain of a product from raw materials to the consumer can have widely differing scale economies at different stages. The classic example is consumer electronics, where the manufacture of silicon chips, liquid crystal displays, and other key components enjoys huge scale economies, but the final assembly of these components into a finished device enjoys comparatively few. The former activities depend upon massive R&D, require expensive and sophisticated machinery for physical fabrication, and employ highly trained engineers and scientists. The latter activities often require almost no R&D and are done by hand (perhaps

on a 1920s-style assembly line) by semiskilled labor, often in developing countries. One possible strategy this implies is to be fairly agnostic about where companies locate overall, but seek to capture the segments of their production that enjoy scale economies. This is, in fact, roughly the strategy pursued by Singapore, which (unlike Japan) has no internationally recognizable brand-name companies but has managed, through aggressive industrial policy, to systematically capture the high-value segments of foreign corporations' supply chains in electronics and other industries.

Chapter 11

The Natural Strategic Tariff

As we have seen, free trade depends upon a long list of assumptions that are always dubious and often false. So there is no justification for assuming that it will be the best policy. But while this necessarily opens up the possibility that some kind of protectionism could be better, it doesn't give an obvious formula for what form that protectionism should take. Which imports, that is, should we tax, how much, and when? We have only scraps of insight here and there, based on the various flaws in free trade we have examined, with no synthesis uniting them into a coherent policy implication. Even Gomory and Baumol's breakthrough insights, while they do tell us what a better outcome than free trade would *look like* (more good, i.e. scale economy or retainable industries), do not tell us how to attain that outcome. Merely stapling together the tariff wish lists of every complaining industry in America will do no good, as this embodies no particular rational economic strategy.

We do, however, have one obvious starting point for reasoning out a tariff policy. If free trade is wrong because of the list of its flaws we have compiled, might the right policy consist in systematically *fixing* these flaws? There is, in fact, an entire school of thought that aims to "restore the lost

innocence” of free trade in this way. ⁷⁵⁹ Because many (not all) of these flaws consist in failures of the free market to work properly, the great attraction of this approach is that it satisfies people who are ideologically attached to free trade as a broken ideal that can be achieved after all, once it is repaired.

Can this approach work? Let’s look at the list of dubious assumptions underlying free trade to see if we can fix free trade by imposing policies that will make these assumptions hold true after all. To wit:

Dubious Assumption #1: Trade is sustainable.

Environmental sustainability is a problem intrinsic to the entire modern industrial economy. In the context of trade, the obvious solution is to tax trade that depletes nonrenewable resources or emits pollution.

Financial sustainability is, as analyzed at length in Chapter Two, achievable by controlling either trade or the countervailing financial flows that take place when trade is paid for. ⁷⁶⁰

Problem fixable? Yes.

Problem fixable without ending free trade? No.

Dubious Assumption #2: There are no externalities.

For negative externalities like environmental damage, the obvious solution is to tax imports produced in harmful ways.

Positive externalities like technological spillovers can be addressed by tax credits for research and development. This is already U.S. policy to some extent, though without protectionism, this can just end up subsidizing research whose value is harvested by production abroad. [761](#)

Problem fixable? Yes.

Problem fixable without ending free trade? No.

Dubious Assumption #3: Factors of production move easily between industries.

This problem mostly comes down to labor. We can do little about it because the U.S. already has one of the most flexible labor markets in the developed world. We

could expand palliative adjustment programs and worker retraining, but they have limited ability to solve this problem, for reasons analyzed in Chapter Three. [762](#)

Problem fixable? No.

Problem fixable without ending free trade? No.

Dubious Assumption #4: Free Trade does not raise income inequality.

Free trade raises income inequality in the U.S. because it lowers returns to the scarce factor of production (labor) and raises returns to the abundant factor (capital). [763](#) It also impacts low-skill workers harder than high-skill workers. [764](#) Although other nations have mitigated these problems somewhat with various nontrade policies, such egalitarian interventions are unlikely in the U.S.

Problem fixable? Yes.

Problem fixable without ending free trade? No.

Dubious Assumption #5: Capital is not internationally mobile.

The controls on international capital flows associated with a new Bretton Woods-style system of fixed exchange rates would help here, [765](#) but this is not a free-trade solution unless we consider it free trade when we lack freedom in the financial flows that pay for that trade. [766](#)

Problem fixable? Yes.

Problem fixable without ending free trade? No.

Dubious Assumption #6: Short-term efficiency causes long-term growth.

As analyzed in Chapter Two, [767](#) short-term efficiency can be downright destructive if people have short time horizons, something only authoritarian governments have been able to correct.

As analyzed in Chapter Nine, [768](#) even with long time horizons, economic growth is largely about ladder

externalities and related dynamics; most effective strategies for exploiting these are contrary to free trade because Ricardianism (and thus free trade) is about best exploiting *immediate* comparative advantage. [769](#)

Problem fixable? Yes.

Problem fixable without ending free trade? No.

Dubious Assumption #7: Trade does not induce adverse productivity growth abroad.

This problem is almost impossible to solve without abandoning free trade, as it concerns events in foreign nations not under our control. Ceasing to import so many goods, especially at the frontier of our trading partners' technological capabilities, would obviously slow them down, but only somewhat.

Problem fixable? No.

Problem fixable without ending free trade? No.

Dubious Assumption #8: There are no scale

economies.

The existence of scale economies is a fundamental fact of modern industry. They are not the product of any particular policy decision, so nothing can be done to make them go away, short of a return to premodern technological levels.

Problem fixable? No.

Problem fixable without ending free trade? No.

So it appears that we can't plausibly hope to fix these eight problems without giving up free trade to some meaningful extent. The above list implies some policies to mitigate free trade's harmful effects, but no fundamental solution that will redeem free trade as such.

IS THERE A NATURAL STRATEGIC TARIFF?

Here's the nightmare that haunts all criticisms of free trade in this country: what if these criticisms imply that America needs a complicated technocratic tariff policy? This seems to be suggested by the complexity of the defects in free trade and by the fact that the nations which have most successfully

repudiated free trade actually *have* complicated technocratic tariff policies. That would spell trouble, as the political difficulties of achieving such a solution in America are no secret. In the words of Alan Blinder, a member of Bill Clinton's Council of Economic Advisors and former Vice Chairman of the Federal Reserve Board,

In Japan, industrial policy was and is run by a cadre of intelligent, respected, and powerful technocrats largely insulated from political interference and acting in the national interest. The United States, I am afraid, is too democratic for that. Political considerations would quickly overwhelm economic merits; industrial policy would more closely resemble life support for dying industries than incubation of emerging ones. [770](#)

It is, in fact, sorely tempting to take these political difficulties as an excuse to do nothing at all. The dangers of a special-interest takeover are not imaginary. But we can't afford to quail at the challenge of making the politics work, as we are competing with rivals who have already done so. Like it or not, they have raised the bar for us. For the U.S. to concede that there exists an area of national policy this important that our rivals can master and we can't is a decision in favor of voluntary national decline.

Billionaire investor Warren Buffett says that one of his criteria for investing in a company is that it must have a business that even a fool can run—because sooner or later a fool will. A similar philosophy should guide our construction of a tariff policy. We need a broad-based policy that can survive imperfect implementation and political meddling, a certain amount of which will be inevitable. We do *not* need an intricate, brittle, difficult policy that will only create work for bureaucrats, lawyers, and lobbyists. Among other things, any policy too complex for the public to understand will be beyond the reach of democratic accountability, the only ultimate guarantee that any tariff policy will remain aimed at the public good.

As noted in Chapter Six, [771](#) one of the great puzzles of American economic history is how the U.S. once succeeded so well under tariff regimes that were not particularly sophisticated. This is where the idea of a so-called “natural strategic tariff” comes in. This idea says that there may be some simple *rule* for imposing a tariff which will produce the complex *policy* we need. The simple rule will produce a complex policy by interacting with the existing complexity of the economy. All the complexity will be on the “economy” side, not the “policy” side, so all specific decisions about which industries get protection, how much, and when will be made by the market. No intricate theory, difficult technocratic expertise, or corruptible political decision-making will be

required.

There are obviously any number of possible natural strategic tariffs. The one we will look at here (which is probably the best) is actually the simplest:

A flat tax on all imported goods and services.

Prima facie, this is strategically meaningless because it protects, and thus promotes, domestic production in all industries equally. And if a tariff is going to win the U.S. better jobs, it will do so by winning us more positions in good industries (as defined in Chapters Nine and Ten). While a flat tariff would help with the deficit, which is good, it would provide the same incentive for domestic production of computer and potato chips alike, so it would not push our economy towards any industry in particular.

Or would it? The natural strategic tariff is a bet that it would. The key reason is this:

Industries differ in their sensitivity and response to import competition.

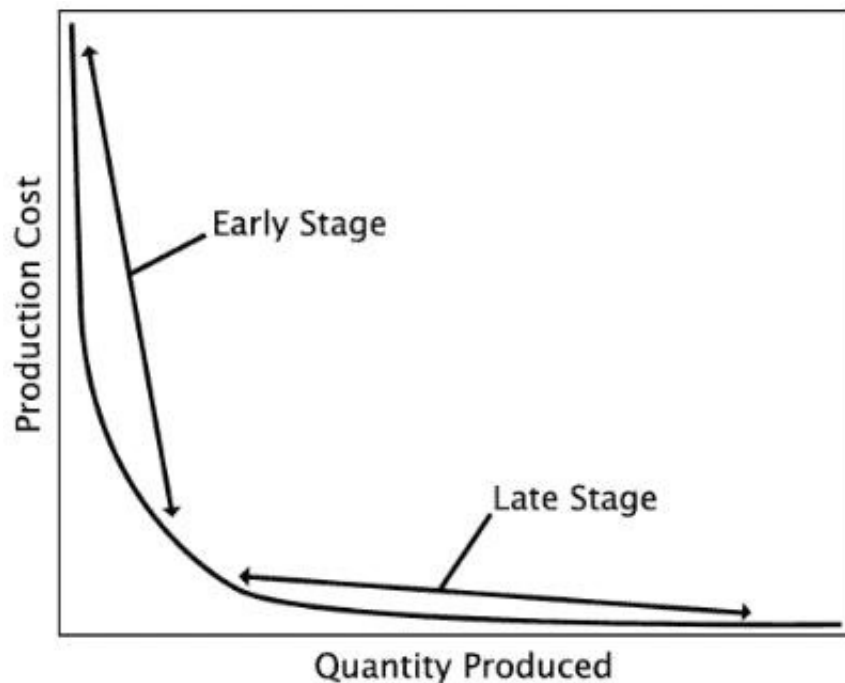
Although this is a complex issue, the fundamental dynamic is clear from the obvious fact that a flat tariff would trigger the

relocation back to the U.S. of some industries but not others. For example, a flat 30 percent tariff (to pluck a not-unreasonable number out of thin air) would not cause the relocation of the apparel industry back to the U.S. from abroad. The difference between domestic and foreign labor costs is simply too large for a 30 percent premium to tip the balance in America's favor in an industry based on semi-skilled labor. But a 30 percent tariff quite likely *would* cause the relocation of high-tech manufacturing like semiconductors. This is the key, as these industries are precisely the ones we should want to relocate. They have the scale economies that cause retainability, high returns, high wages, and all the other effects of good industries. *Therefore a flat tariff would, in fact, be strategic.*

TARIFF EFFECTS ON SCALE-ECONOMY INDUSTRIES

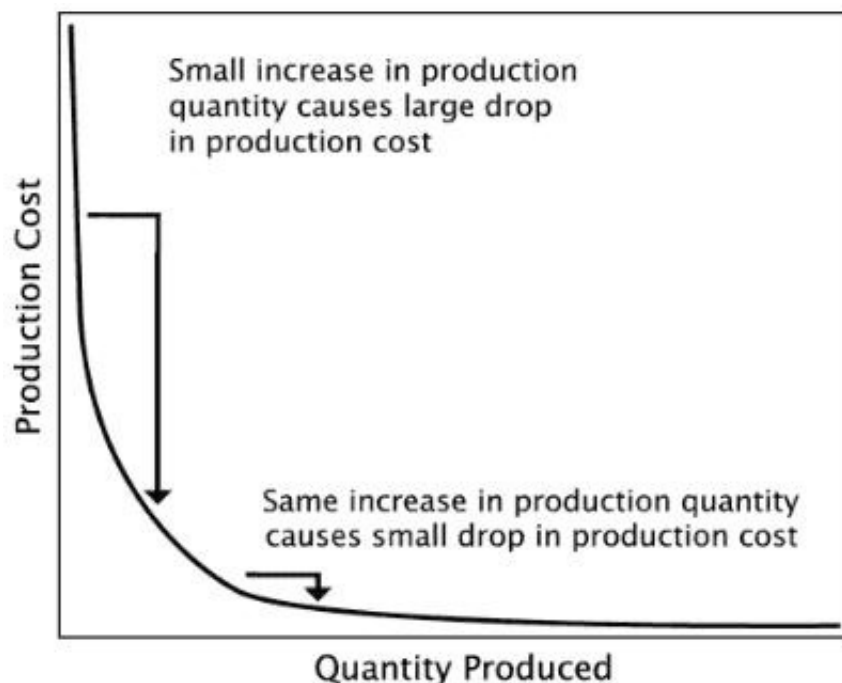
A natural strategic tariff would interact with different industries in surprisingly sophisticated ways. There is not the space here to discuss all of them, but the prime example is the fact that it would have different effects on industries that were at different points on their cost curves. The key here is that the cost curves of scale-economy industries tend to be concave. That is, they go down like this \curvearrowright , not like this \searrow . This is not the place to go into the details, but a concave cost curve is actually *guaranteed* whenever production cost consists of an

investment in capital (physical, human, or intellectual) plus an incremental cost for each additional unit of output. ⁷⁷² As a result, these curves have steeper slopes in their earlier than later stages. That is, they look something like the graph below, though their exact shape will vary:



The difference in slope between the early and late stages is the key. When a tariff is imposed upon an industry that is in the early stages of its cost curve, costs will fall rapidly with relatively small increases in output. So if we start at the far left on the graph above and move to the right a little, the curve goes down a long way. (See the graph on the next page.) Therefore, when a scale-economy industry in its early stages is given tariff protection and its sales increase as a result, it will

enjoy a large cost decline. This *induced* cost decline will then improve its cost advantage over its foreign competitors by even more than the size of the tariff itself. This will result in further sales increases, further cost declines, and so on until its cost curve bottoms out. Therefore a flat tariff will, under these circumstances, trigger a virtuous cycle, and a fairly small tariff will produce a much larger ultimate cost advantage for the domestic producer. This advantage will outlast tariff protection and lock in retainability. (In the extreme case, this virtuous cycle will end only when the domestic industry has wiped out all its foreign competitors and become globally dominant.)



On the other hand, when a tariff is imposed on a mature industry (which, by definition, will be in the *late* stage of its

cost curve), the slope of its cost curve will be relatively flat, so even fairly large increases in sales will not shift its costs very much. Therefore tariff protection will not trigger a virtuous cycle, and the domestic industry's cost advantage will not greatly exceed the tariff itself. The net effect of strong impacts on some industries and weak impacts on others will be a bias towards stimulating industries that a) have concave cost curves and b) are on the early part of those curves. These will necessarily be *nascent scale-economy industries*: nascent because of b) and having scale economies because of a). In other words, the tariff will be *self-targeting on precisely those industries we should want to target*.

This mechanism is not perfect, and in the real world it would suffer a thousand quibbles, complications, and exceptions. Sometimes it would even backfire. But it is real enough to be worthwhile, as it is the effect on average that will matter.

This all resembles, of course, a classic infant industries tariff, but without the contentious problem of deciding which industries should be targeted or for how long. Strictly speaking, a true infant industries tariff would have the same effect as the natural strategic tariff, only more efficiently, as it would not waste any tariff incentive on mature industries, or on industries without concave cost curves. But as noted earlier, ⁷⁷³ infant industries are only the first rungs of the larger phenomenon of the path-dependence of economic

growth, so even a perfect infant-industries tariff would not be ideal.

TOO GOOD TO BE TRUE?

One is justifiably suspicious of cure-alls. So it is worth understanding why the natural strategic tariff is neither a gimmick nor too good to be true. It is neither a magic trick to make economic vitality appear out of nowhere nor a hammock to enable lazy and uncompetitive American industries to survive. Anyone supporting it for these reasons will be disappointed.

Fundamentally, the natural strategic tariff only works because it interacts with the *existing* competitive strengths of the U.S. economy. Specifically, it works because:

1. The U.S. is closer to being cost-competitive in good industries than in bad ones.
2. The U.S. domestic market is big enough to support scale economy industries.
3. A tariff has different effects on industries at different points on their cost curves.

It follows that if we do not cultivate the existing strengths of our economy, a natural strategic tariff will not do us much good. If implemented, such a tariff would be the cornerstone of trade reform, without which other measures will not work very well. But we would still need to fix our substandard education system, our crumbling infrastructure, and our short-termist financial system. We would still need to return to America's Hamilton-to-Reagan tradition of industrial policy to some extent.⁷⁷⁴

THE REST OF THE WORLD

What about other nations? What should they do? The solution for most of them will not be the natural strategic tariff described above. If a Third World nation like Costa Rica, for example, imposed it, it would not push the Costa Rican economy towards good industries. The reason is that Costa Rica, unlike the U.S., is not closer to being cost competitive in good industries than in bad ones, as it is not richer than other nations in skilled labor, capital, or technological know-how. And because Costa Rica's domestic market (smaller than Jacksonville, Florida)⁷⁷⁵ is too small to support, say, a full-scale aircraft industry, its domestic market is not a viable launch pad for significant scale-economy industries.

The right policy for a nation in Costa Rica's position will be one centered on:

- 1 . Avoiding trade deficits, asset sell-offs, and foreign debt, as discussed in Chapter Two. [776](#)

2. Avoiding free trade's tendency to wipe out the most advanced sectors of developing nations, as discussed in Chapter Seven. [777](#)

- 3 . Avoiding the authoritarianism associated with the WTO and related institutions discussed in Chapter Eight. [778](#)

- 4 . Implementing the good newly-industrializing-country industrial policies discussed in Chapter Nine. [779](#)

The biggest choice developing nations must make is whether they are aiming to build up globally competitive industries and ultimately make the jump to the First World, or merely aiming to achieve comfortable (and by no means impoverished) mediocrity. Erik Reinert refers to the latter as the lost art of creating middle-income countries; [780](#) it is a concept basically nonexistent in mainstream economics. Such nations are inefficient by the standards of the global free

market, but they are better off succeeding at the lower standard that they aim for as protected economies than tacitly aiming at world standards through free trade and failing. As noted in Chapter Seven, these nations aim to build up industrial sectors that, while inefficient, are still higher value-added sectors than the peasant agriculture to which their populations would otherwise be confined. [781](#)

This all raises an important question: is there a fundamental us vs. them dynamic in America's trade with the developing world? Is a sound trade policy for ourselves ultimately about nothing better than grabbing an economic advantage at the expense of other nations, especially poorer ones? No. America's serious economic rivals are "big boys" whom nobody needs to cry over. We need not have ethical qualms about taking industries away from Japan. This is true even of the advanced sectors of nations that are still poor overall, such as India and China, as it is not the Third World peasant sectors of these nations that meaningfully compete with us; it is the developed sectors of these nations, which are like islands of First World industry in the Third World. The yuppies of Bangalore are legitimate objects of our rivalry.

What Third World nations really need is things like, in the words of the International Forum on Globalization:

The right to control financial flows across their

borders, set the terms of foreign investment, give preference to domestic finance and ownership, place limits on resource extraction, and favor local value-added processing of export commodities. [782](#)

None of this is a particularly meaningful threat to American prosperity, so there is no reason for us to object. These policies would bring significant benefits to poorer nations, but impose trivial or zero costs on us. Individual corporate interests in the U.S. will certainly complain—and doubtless dress up their complaints as the interests of the U.S. economy as a whole—but there is no reason to expect these policies to impose meaningful harm on America at large. In fact, any U.S. strategy based on exploiting poor nations will be a waste of time for us. Like colonialism as analyzed in Chapters Nine and Ten, [783](#) it is a low-quality economic strategy that will be outperformed by better strategies. We should be battling it out with Japan, Europe and the emerging technological powers in high technology, not fighting to keep cocoa processing from migrating to Ghana.

A POLITICS-PROOF SOLUTION

The natural strategic tariff is imperfect, but infinitely better than free trade and relatively politics-proof. Above all, it is a policy people are unlikely to support for the wrong reasons

(like producer special interests) because it does not single out any specific industries for protection. It thus maximizes the incentive for voters and Congress to evaluate protectionism in terms of whether it would benefit the country as a whole—which is precisely the question they *should* be asking. It would also create the right balance of special-interest pressures: some interests would favor a higher tariff, others a lower one. This is a prerequisite for fruitful debate, as it means both views will find institutional homes and political patrons.

The exact level at which to set the tariff remains an open question. Thirty percent was given as an example because it is in the historic range of U.S. tariffs⁷⁸⁴ and is close to the net disadvantage American goods currently face due to America's lack of a VAT.⁷⁸⁵ The right level will not be something trivial, like two percent, or prohibitive, like 150 percent. But there is absolutely no reason it shouldn't be 25 or 35 percent, and this flexibility will provide wiggle room for the compromises needed to get the tariff through Congress.

A natural strategic tariff has other benefits. For one thing, it avoids the danger of getting stuck with a tariff policy that made sense when it was adopted but gradually became an outdated captive of special interests over time, always a risk with tariffs. Although it is a fixed policy, it would not be fixed in its effects, but would automatically adapt to the evolution of industries over time. In 1900, for example, it would have protected the American garment industry from foreign (then

mostly European) competition. It wouldn't do that today. As which industries are good industries changes over time, which industries it protects will change accordingly.

The tariff's uniformity across industries also avoids the problems that occur when upstream but not downstream industries get tariff protection. For example, if steel-consuming industries do not get a tariff when steel gets one, they will become disadvantaged relative to their foreign competitors by the higher cost of American-made steel. And why should steelworkers be protected from foreign competition at the price of forcing everyone else to pay more for goods containing steel? The only reasonable solution is that steelworkers should pay a tariff-protected price for the goods *they* buy, too. This logic ultimately means that all goods should be subject to the same tariff.

The political bickering that a tariff varying by industry would cause also militates in favor of a flat tariff: as we saw in Chapter Six, the inability of different industries to coalesce around a common tariff proposal sabotaged efforts to achieve a tariff in 1972-74. ⁷⁸⁶ But this is a policy around which the greatest possible number of industries can unite.

The natural strategic tariff is also more ideologically palatable than most other tariff solutions. Above all, it respects the free market by leaving all *specific* decisions about which industries a tariff will favor up to the marketplace. It will thus be considerably easier for ideological devotees of free markets

to swallow than some scheme in which tariffs are set by a federal agency, leading to that nightmare of free-marketeers: *government picking winners*. In the real world, zero government intervention in the economy is impossible, so the issue for believers in economic freedom and small government is to design policies that work through the *smallest possible, carefully chosen* interventions. This is precisely what the natural strategic tariff offers because it operates at the periphery of our economy, leaving most of its internal mechanisms untouched. In fact, the more wisely we control our economic border, the less we will probably need to control the inside of our economy. [787](#)

REASONABLE OBJECTIONS TO A TARIFF PART I: DOMESTIC

One obvious objection is simply that a tariff is a tax increase. So it is. But it does not have to be a *net* tax increase if the revenue it generates is used to fund cuts in other taxes. In order to obtain a “clean” policy debate, in which the tariff is debated purely on its merits as a trade policy, unmuddied by differing opinions about the total level of taxation, any tariff proposal should be packaged with precisely compensating cuts in other taxes.

A related concern is that a tariff is a tax on consumption. This is generally better than a tax on income because it

rewards saving and avoids penalizing work. Unfortunately, consumption taxes also reduce the progressivity of the tax system because the poor consume, rather than save, a higher percentage of their incomes. So any tax rebate financed by the tariff should also be designed to leave the overall *progressivity* of the tax system unchanged. [788](#)

Another objection to a tariff is that if American industry is granted tariff protection, it will just slumber behind it. Many industries indeed long to shut out foreign competition, reach a lazy detente with domestic rivals, then coast along with high profitability and low innovation. But the natural strategic tariff resists this danger because it does not hand out a blank check of protection: it gives a certain percentage and no more. Any industry that cannot get its costs within striking distance of its foreign competitors will not be saved by it. This discipline, although unpleasant for the losers, is the price we must pay for having a tariff that actually *works*, rather than one which eliminates the discipline of foreign competition entirely and protects all industries, whether or not their protection is useful to the economy as a whole.

It is sometimes objected that protectionism stifles competition. This, too, is a real threat. As a result, antitrust policy will become even more important than it already is. Luckily, there is a compensating benefit: rivalry between domestic firms actually appears to be a *more* potent competitive force than rivalry with foreign ones. As Michael

Porter observes:

Domestic rivals fight not only for market share but for people, technical breakthroughs, and, more generally, ‘bragging rights.’ Foreign rivals, in contrast, tend to be viewed more analytically. Their role in signaling or prodding domestic firms is less effective, because their success is more distant and is often attributed to ‘unfair’ advantages. With domestic rivals, there are no excuses.

Domestic rivalry not only creates pressures to innovate but to innovate in ways that *upgrade* the competitive advantages of a nation’s firms. The presence of domestic rivals nullifies the types of advantage that come simply from being in the nation, such as factor costs, access to or preference in the home market, a local supplier base, and costs of importing that must be borne by foreign firms...This forces a nation’s firms to seek *higher-order* and ultimately more sustainable sources of competitive advantage. ⁷⁸⁹ (Emphasis in the original.)

So replacing foreign rivalry with strong domestic rivalry is probably a net plus. Japan’s ferociously competitive (and protected) automobile and consumer electronics industries

illustrate this well.⁷⁹⁰

If a tariff gives companies back market share and lets them raise prices, they may just harvest profits, rather than reinvesting them in long-term growth. As noted previously, this was a problem with one of America's largest recent protectionist undertakings: the Voluntary Restraint Agreement with Japan on automobiles.⁷⁹¹ As also noted, one major difference between effective and ineffective industrial policy is that effective industrial policy involves not only the "carrot" of tariffs and subsidies, but also the "stick" of measures to prevent companies from merely taking out added revenues as profit, rather than investing them in long-term upgrading of their capabilities.⁷⁹² Does this mean that a tariff should be accompanied by agreements on investment levels? No; the needed investment may be in another industry anyway. The solution probably lies in creating *generalized* incentives for investment. Since increased investment is a good thing even if we leave trade out of the picture, and already the object of tax incentives supported across the ideological spectrum, this should not be too hard to swallow politically.

REASONABLE OBJECTIONS TO A TARIFF PART II: FOREIGN

Another common objection to a tariff is that our trading partners would just shrug it off by increasing subsidies to their

exporters.⁷⁹³ This would force us into an endless game of matching these moves on a country-by-country, industry-by-industry, and even product-by-product basis. However, such subsidies by our trading partners would be restrained by the fact that they would be very expensive *in the face of an American tariff*. Right now, these subsidies are relatively affordable only because they don't have to climb an American tariff wall. But if they did, their cost would increase dramatically. Currency manipulation is probably the only subsidy that is affordable over prolonged periods of time (and even then problematic in the end), as it involves buying foreign assets and debt, thus accumulating wealth rather than just expenditures. But other subsidies amount to a giveaway from the exporting to the importing nation. While this doesn't prevent them absolutely, it does tend to set a limit. This is all we need, especially as we have no hope of eliminating or countervailing *all* foreign subsidies no matter what we do, tariff or no tariff.

The same goes for the objection that our trading partners would just devalue their currencies. As previously noted, we can end foreign currency manipulation at any time simply by restricting or taxing foreigners' ability to lend us debt and buy our assets.⁷⁹⁴ We would need to raise our own savings rate if we did this (or face rising interest rates), but we need to do this anyway.

Another objection is that any tariff large enough to mean

anything would impose a sudden shock on the U.S. and world economies, which would tip them into recession as other shocks, notably the 1973-4 oil shock, have done. This is a legitimate concern, as economies do not adapt well when the rules governing them change faster than the economy itself can keep up with. If a 25 percent tariff suddenly makes it economically rational to manufacture disk drives in Colorado rather than Kyushu, this doesn't make plants sprout in Colorado overnight. So until the U.S. and Japanese economies adapt to the newly implied distribution of industries between them, they will be out of balance and thus underperform. Phasing in a tariff over five years or so would mitigate this.

Another objection is that a tariff would trigger a downward spiral of retaliation and counter-retaliation with our trading partners, resulting in an uncontrolled collapse of global trade. But this oft-banded doomsday scenario is unlikely. Above all, our trading partners know that *they* are the ones with the huge trade surpluses to lose, not us. Foreign nations would probably raise their tariffs somewhat, but there is no reason to expect the process to get out of control. After all, the world has survived their trade barriers long enough.

Indeed, there is an opposite possibility. Suppose we tell foreign nations that our tariff increase is in retaliation for their own various trade barriers. (This is, of course, largely true.) And suppose we then threaten to raise our tariff even higher if they don't open up, but offer to drop it back down somewhat

if they do. Then our trading partners may even *reduce* their barriers in response to our imposing a tariff. So our imposing a tariff could, paradoxically, further the cause of global trade openness, not retard it.

We can call this alternative managed open trade. It is not the same thing as free trade. Fully elaborated, it would be based on the internationally shared twin goals of zero tariffs and zero deficits. These goals would be shared, despite the reality of international rivalry and the absence of a sovereign to enforce them, because every nation would know that a) other nations would retaliate in response to excessive surpluses inflicted upon them, and b) the alternative is the system breaking down for everyone, including themselves. ⁷⁹⁵ This substitute for free trade would spare a lot of ideological sacred cows, as it would come fairly close to free trade if it worked. (Many people who think they are defending free trade are actually defending covertly managed trade with zero tariffs, anyway.) But it would depend upon our ability to credibly threaten a tariff if our bluff were called. It would therefore depend upon our having viable contingency plans to function with a tariff. This is one reason why even free traders thinking through how to save as much of free trade as they can should take the option of a natural strategic tariff seriously.

ALTERNATIVES TO A NATURAL STRATEGIC TARIFF

There are a number of alternative proposals on the table for solving America's trade problems. Perhaps the most famous is billionaire investor Warren Buffet's proposal for import certificates. He proposes that exporters be given a \$1 certificate for every dollar of their exports, and that importers would then have to buy a certificate from them for every dollar of goods they imported. This would, of course, force America's trade into balance automatically.

It is not a bad idea, but contains less than meets the eye. If the certificates traded on the open market (as proposed) then an equilibrium price would be set, which price would then be the de facto tariff on imports. Since the revenue from selling the certificates would go to exporters, the scheme would thus amount to an import tariff plus an export subsidy. Because the tariff would be flat, it would have the same natural strategic effects as a natural strategic tariff.

The main differences between Buffet's idea and the natural strategic tariff are that Buffet's proposal would operate on both imports and exports, and it would not raise money for the government. Because it would not raise money, it could not finance progressivity-neutralizing cuts in other taxes, and would therefore make the tax code more regressive. (It would also be a giant transfer of wealth to our export industries.) The main advantage of Buffett's scheme is automatic tariff setting at a level that would zero out the deficit. But a flat tariff (or a

U.S. VAT) could be calibrated over time to do this, too.

Another possibility is simply to institute a VAT in the U.S.⁷⁹⁶ Although this is a well tried system of taxation, used in every other developed country, it is generally regarded in this country as a strange European affectation, which probably dooms its rational consideration. Although mentioned recently as a possibility by Senate Budget Committee chairman Kent Conrad (D-ND) and others, it has attracted vehement opposition.⁷⁹⁷ As with a natural strategic tariff, it would not have to be a *net* tax increase, and would not have to change the overall progressivity of the tax code. The great advantage of a VAT is that, while a natural strategic tariff and import certificates would abrogate America's NAFTA, WTO, and other treaty obligations, a VAT would not. This is an attractive option for legalistic minds in the State Department, for those who fear the consequences of unraveling the international legal infrastructure, and for those who wish to withdraw America from free trade while obfuscating this fact for ideological reasons. (Perversely, the obvious alternative of a so-called Border Adjustable Tax or BAT, which resembles a VAT but without its domestic aspects, would be illegal.) Another big advantage of a VAT is that, like a tariff, it is a consumption tax. Its biggest disadvantage is simply that it would mean having a domestic VAT, a giant change in domestic tax policy simply to address a foreign trade issue.

Another alternative to the natural strategic tariff is a tariff on

manufactured goods that exempts raw materials and agricultural products. This is roughly what traditional mercantilism has done for 400 years, is what Alexander Hamilton proposed in 1791, and is commensurate with U.S. policy in our tariff era after 1872.⁷⁹⁸ It is based on the idea that we are not trying to capture raw material or agricultural industries. The main problems are that if unprocessed goods are admitted duty-free and processed goods are subject to a tariff, then a) we lose the apolitical simplicity of a flat tariff, b) we have to deal with borderline cases and successive stages of processing, and c) we avoid dealing with America's dependence on foreign raw materials. Furthermore, our only really big raw material import is oil, and there are energy-conservation and national-security reasons to tax imported oil anyway. And members of Congress from agricultural and raw materials-producing states will object if the industries of other states are protected and theirs are left to fend for themselves.

One final point: a natural strategic tariff would need to include a rebate on reexported goods in order to avoid handicapping American exporters. This would include both goods that are transshipped without modification and goods that are exported after value-added processing. The latter includes everything from chocolate made from imported cocoa to computers made from imported chips. This is not an add-on to the policy, but implied by its intrinsic logic as a tax on domestic consumption. As noted earlier,⁷⁹⁹ other nations

follow the same logic in rebating VAT to their exporters.

Chapter 12

The End of the Free Trade Coalition

Does America have a serious chance of getting the trade policy it needs? The best way to hazard a guess at the issue's political future is to look at its underlying social dynamic. [800](#) The key is to grasp the way free trade is experienced by ordinary voters:

Free trade is cheap labor embodied in goods.

Although, as we have seen, our trade problems cannot all *literally* be reduced to cheap foreign labor, this is still the aspect that dominates public consciousness and thus mass political opinion. The first rift it implies is between people who obtain most of their income from work and those who obtain most of their income from returns on capital. People in the latter category obviously want all labor to be as cheap as possible. People in the former category want the labor they consume (directly or embodied in goods) to be as cheap as possible, but the labor that they produce and sell, namely their own wages, to be expensive.

This implies the possibility of an electoral coalition in which one part of society treats itself to cheap foreign labor at the expense of another. As long as the self-perceived enjoyers of

cheap labor exceed the self-perceived victims in number, this coalition is politically viable. For example, there can be a coalition of everyone who is *not* a manufacturing worker (91 percent of the labor force today, up from 66 percent in 1950)⁸⁰¹ against everyone who is. While manufacturing workers suffer competition from cheap foreign labor, everyone else enjoys cheap foreign manufactured goods, so a majority is happy. The indirect effects of a decline in manufacturing are either not noticed—partly because they are not understood—or they are postponed for years by America’s ability to accumulate debt and sell assets.

This doesn’t mean, however, that these indirect effects aren’t real. As we have seen, they are inexorable.⁸⁰² So what if we go from 10 percent of the population harmed and 90 percent benefited to 20/80? Or 30/70? Or 50/50? Or 70/30 the other way? Our coalition will start to fall apart. Where are we now on this scale? It is impossible to quantify precisely, but commentator Kevin Phillips estimated in 1995 that free trade was “obviously beneficial to perhaps 10 to 15 percent of the population, detrimental to some 30 to 50 percent,” and things have clearly shifted considerably since then.⁸⁰³

Free traders will respond by claiming that even if we reach 90 or even 100 percent of the population being harmed by competition with cheap foreign labor, Americans will still be better off because goods will be cheaper. The problem, as is

obvious to any laid-off worker who has ever contemplated the cheap goods on sale at Walmart, is that a drop in the cost of merchandise never means as much as a lost job. How many people have voted against incumbents because they were unemployed or underemployed? Compare this to how many have done so because they couldn't buy a pair of scissors for \$.99. Has there ever been a demonstration in the streets about the latter? And (as noted several times in this book) there is no law of economics that guarantees that free trade's benefits in the form of lower prices will exceed its cost in job loss and lower wages for most people. [804](#)

There is not much left of the American economy that is invulnerable to pressures from trade. Even large parts of the 70 percent of our economy that is in nontraded sectors are inexorably becoming tradable due to offshoring, and workers displaced from tradable sectors are driving down wages in nontradable sectors. The remaining sheltered occupations are these:

- 1 . Jobs that must be performed in person, such as policing, cooking, bagging groceries, teaching school, being a criminal, etc.

- 2 . Jobs, like construction, performed on physical objects too large or heavy to be shipped from abroad.

3. Jobs performed on or relative to objects fixed in place: agriculture, mining, and transportation.
4. Jobs where America enjoys significant technological superiority tied to oligopoly industries or specialized local labor pools, a shrinking category.
- 5 . Jobs, like law or advertising, which depend on uniquely American knowledge. But even this is breaking down as law firms, for example, start to offshore work.
6. Jobs dependent upon sovereign power, such as the military. But given our use of “civilian security contractors” in our wars, this can be nibbled away at in surprising ways. And, as noted in Chapter Eight, ⁸⁰⁵ the WTO would like to privatize even more public services, opening them up to offshoring.

The trouble is, these categories are not enough. In particular, they don't add up to enough *high-wage* jobs because most (not all) of these jobs are relatively low paid. So our beggar-my-neighbor coalition starts to fall apart. What happens next?

LEFT AND RIGHT, WRONG ON TRADE

The bad news for Republicans is that what we can call the *psychological bourgeoisie* starts to shrink. This term refers to everyone who identifies emotionally and politically with the ownership of capital, whether or not a majority of their income is investment income. Wall Street financial analysts whose jobs may get offshored are the clearest example, but there are people in this category all over the U.S. The key psychological bargain such people have had with the system until now is that economic forces are things that happen to *other* people. (One can take an amazingly dispassionate view of economic efficiency when this is the case.)

The bad news for Democrats is that, at the level of the presidency and party leadership, they sold out so completely to free trade under Bill Clinton (and never came back) that they threw away their natural position, earned over 70 years, as the party that protects Americans from the rougher edges of capitalism. They should be capitalizing on the economic mess following eight years of Republican rule right now, but they've largely squandered their ability to do so.

Both Right and Left are playing a double game on trade in America today.

Right-of-center Americans generally want to hear that America's trade problems are caused by unfair distortions of

free markets by our trading partners. To some extent, they are, but, as we have also seen, even genuine 100 percent free trade would not solve America's problems. And our trading partners are mostly just ruthless players of the game, as we used to be. The corporate Right (other factions exist, but have no power over Republican economic policy) claims, on ultimately Ricardian grounds, that free trade is in the national interest. But when pressed by contrary evidence, its corporate chieftains fall back on the position that their companies owe no loyalty to the U.S. Indeed, they often say they aren't even *capable* of having such a loyalty, so internationalized are their operations and diverse the nationalities of their shareholders and employees.

Left-of-center Americans generally want to hear that America's trade problems are caused by greedy corporations and exploitative capitalism. But the problem is not that corporations are greedy (which people have always been), it is that the rules they currently operate under make that greed unnecessarily destructive. And although economics certainly shows that exploitation in trade is possible, it doesn't show that exploitation must occur for free trade to do harm. The American Left is also as conflicted as the Right: at some point, it must choose between opposing free trade in the interests of ordinary Americans, and opposing it in the interests of the world as a whole. Intellectually and emotionally, the latter is its obvious choice, but this is unlikely to play in Peoria. The ideal political position from which to oppose free trade would

be a kind of nationalist liberalism, but this Trumanesque or Jacksonian position does not exist in American politics today. [806](#)

It is often disputed whether protectionism is a left- or a right-wing policy. It puzzles people in this regard because it has deep ideological and historical roots on both sides. The truth is that while protectionism obviously contradicts the *free-market* Right, the dominant strand in the U.S. since the collapse of the old protectionist Taft wing of the Republican party in 1952, it is perfectly in tune with old-school “paleo” conservatism, the nationalist Right, and bourgeois paternalism. And while protectionism contradicts the modern, Clintonite, Blairite (as in Tony) globalist Left, it is perfectly in tune with any Left that cares about American workers, the global environment, democratic control over the economy, or the depredations of free trade upon poor nations abroad. If one accepts the basic contention of this book that correctly implemented protectionism is beneficial, then it is probably most accurate to think of protectionism as leftist if its benefits are captured primarily by labor, rightist if they are captured primarily by capital, and centrist if they are divided.

The fact that wildly different partisan figures ranging from Patrick Buchanan on the right to Ralph Nader on the left oppose free trade is a strength for protectionism, not a sign of ideological incoherence, as it means that protectionism can be credibly sold to voters from one end of the political spectrum

to the other. The policy can plausibly be packaged as anything from a right-wing tub-thumping America First appeal to a left-wing tie-dyed hippie sob story. Even better, it can be packaged as a moderate and reasonable “commitment to a middle class society” that will appeal to voters in the center. Believe it or not, the following quote is from the *Republican* platform of 1972:

We deplore the practice of locating plants in foreign countries solely to take advantage of low wage rates in order to produce goods primarily for sale in the United States. We will take action to discourage such unfair and disruptive practices that result in the loss of American jobs. [807](#)

How far we have fallen! If Barack Obama had said this in 2008, he’d have been accused of being an economic ignoramus, if not a closet socialist. (If John McCain had said it, he’d have been considered a candidate for the psychiatric ward.) However, what is reasonable can be redefined overnight—mainly by the media—when the underlying constellations of perceived self-interest shift among the elite. A single cover story in *Time* magazine or *The New York Times Magazine* could make protectionism a respectable conversation topic again. A single speech by a cabinet-level official, if openly supported by the President, could do it.

HOW FREE TRADE WILL FALL APART

Support for free trade will probably fall apart over the next few years. As of mid 2010, there are four missing prerequisites for free trade to explode as an issue:

1. Everyone is still preoccupied with the financial crisis and recovery from recession.

2. There remains a residual sense in the minds of the public and the lawmakers that somehow free trade, despite all its problems, is still sound economics, and that perhaps we should just keep on eating our spinach because it will be good for us in the end.

3. There is no obvious alternative policy on the table. There is instead a grab bag of issues, ranging from Chinese currency manipulation to proposed labor and environmental side agreements of NAFTA. This paucity of credible alternatives feeds the attitude that nothing fundamental can be done.

4. A specific crisis has not happened to *force* the system out of its old way of doing things as the debacle in subprime mortgages upended our financial system in

2008 and made continuation of prior policy impossible whether anyone wanted it or not.

For the first prerequisite above to be supplied, all it will take is time, as recessions do always eventually end, and the financial crisis of 2008 does appear to have been successfully patched, albeit at astronomical cost.

For the second prerequisite to be supplied, all it will take is sufficient public debate, between persons perceived as credible, for free trade to become established in the public mind as an issue with *two* legitimate sides to it. As the reader has hopefully gathered by now, once one seriously scrutinizes the underlying economics of free trade, even if one is not disabused of the policy outright it becomes hard to deny that it is a legitimately controversial issue. The pure “100 percent free trade with 100 percent of the world 100 percent of the time” position is simply not intellectually serious.⁸⁰⁸ So when public debate finally cracks open, free trade will lose its innocence very fast.

Once protectionism is perceived as a *legitimate* choice, it will become the *actual* choice of large numbers of people whose protectionist instincts have been held back by the belief that it is somehow an ignorant position to take. They will not need to master the details of *why* it is legitimate; they will only need to know that it *is* legitimate. Sen. Sherrod Brown (D-

OH), one of the leading opponents of free trade in the Senate, records that ever since he came to Congress in 1993, every free trade vote has been accompanied by predictions by the White House of economic disaster if it was not passed. [809](#) Trade wars, stock market decline, and recession were predicted every time. The power of this rhetoric to intimidate is going to end. Protectionism will cease to be a canard and become just another policy option.

The third prerequisite above (no obvious alternative) can emerge overnight if some major political figure launches a tariff proposal that captures the public's imagination. Or the myriad individual issues that currently comprise the opposition to free trade could force the soldering together of an omnibus proposal on the floor of Congress.

The fourth prerequisite (a sudden crisis) is difficult to predict as to time, but we can rely securely upon the fact that unsustainable trends are always, in the end, not sustained. At some point, America's giant overdraft against the rest of the world must come to an end. Although our government is trying to postpone the day of reckoning as long as possible, this day will come. Secretary of State Hillary Clinton flying to China to beg its government to keep buying our bonds (as she did in February 2009) won't make much difference in the end.

Once protectionism is conceded to be a valid political position, it will eventually win the public debate, if free trade's

unpopularity continues to mount at the pace it has been mounting over the last 10 years. (This pace is, if anything, likely to accelerate.) When this happens, the status quo will be sustained only by the tacit bargain of the American political duopoly, in which the two parties agree not to make trade a serious issue, whatever tactical feints they may deploy. This bargain will hold as long as the benefits of keeping it, which mainly consist in keeping the corporate backers of both parties happy, exceed the benefits of defecting from it, which consist in winning votes. Once one party defects, protectionism will, if rationally designed and competently implemented, almost certainly be sufficiently successful in practice (and therefore popular) that the other party will have no choice but to follow. The alternative, if one party insists on handicapping itself by clinging to an unpopular position on such a major issue, is an era of one-party political dominance like 1860-1932 or 1932-80.

FREE TRADE'S POPULARITY IS WANING

Free trade's popularity has been declining for years. Polls show that even affluent voters have been inexorably losing their dotcom-era enthusiasm for it for some time. For example, a 2004 poll by the University of Maryland revealed nearly three-fourths of Americans earning over \$100,000 per year opposing additional free trade agreements. ⁸¹⁰ (As late as 1999, a similar percentage had been in support.) These people

are disproportionately influential and they, if anyone, should be beneficiaries and thus supporters of free trade. In a September 2007 NBC-*Wall Street Journal* poll of likely Republican primary voters, respondents favored the proposition “foreign trade has been bad for the U.S. economy because imports from abroad have reduced demand for American-made goods, cost jobs here at home, and produced potentially unsafe products” over a free-trade alternative by 59 to 32 percent.⁸¹¹ So free trade’s natural constituency is falling into doubts. And if it can’t hold these people, it won’t be able to hold anyone.

Nevertheless, the public remains quite conflicted on trade.⁸¹² Another 2007 survey revealed a plurality of Democrats, Republicans, and independents saying free trade is good for the country even though they *also* said that it costs jobs and lowers American wages.⁸¹³ But this incoherent position is obviously not particularly stable, is going to have to break one way or the other eventually, and is highly unlikely to break in favor of free trade. For now, the public mainly just has a profound sense that *something* is deeply wrong with U.S. trade policy, to the extent that one 2006 poll found that protecting American jobs against foreign competition was the single foreign policy issue on which the public was most dissatisfied with government performance.⁸¹⁴ But the public doesn’t really know what to think or do about

it. According to the same poll:

The public also seems frustrated about where to place responsibility. Close to eight in 10 (78 percent) say the government could do something about protecting American jobs. But a majority (52 percent) do not think it's realistic for the government to control corporate outsourcing. However, those surveyed don't hold American companies responsible either. Close to three-quarters (74 percent) think it's unrealistic to expect that companies will keep jobs in the United States when labor is cheaper elsewhere. [815](#)

So voters register their protests when given the chance, but otherwise remain stymied in their attempts to crystallize an opinion of what solution they want. A lot of voters, egged on by the rhetoric of certain well-intentioned politicians, favor solutions like “trade that is free *and* fair”—a bromide that neatly reconciles both sides of the debate, is completely contradictory, and impossible as policy.

The most puzzling thing about recent public opinion polls is that while the economy consistently ranks high on voters' priority lists, trade *per se* does not, suggesting that voters have yet to connect all the dots about why trade is the root cause of

so many of America's economic ills. But if trade *is* the cause, then presumably this will eventually tell upon public opinion and trade will move up voters' priority lists.

Let us now take a look at the last three election cycles for signs of how the above dynamics are slowly starting to play out in the voting booth. Because although the trade issue has yet to solidify enough to start proactively driving politics on its own, electoral evidence shows an issue bubbling right under the surface of American politics, waiting to explode.

2004: BUSH VS. KERRY

Offshoring first flared as a political controversy in 2004. The thing about it that differed from previous trade-induced job losses was, of course, that it threatened the white-collar middle class. But in the end, the controversy didn't really go anywhere, in the sense of producing serious political realignments or policy changes. Offshoring was adjudged by the two parties to be a political flashpoint but fundamentally just another political issue, which changed nothing important and should be handled the way most political issues usually are: by jockeying for advantage within the established policy consensus.

So politicians set out to win votes on the issue *without* taking the risks inherent in doing anything substantial. The Democrats, quintessentially Sen. John Kerry in his 2004

presidential campaign, sought to make the smallest policy proposals sufficient to position themselves as “the good guys” on the issue for voters who cared about it, while signaling to everyone else that they weren’t about to go too far. The Republicans, meanwhile, defended a status quo that they were no more or less responsible for than the Democrats using the same old (basically Ricardian) arguments that have always been used on free trade. Both responses were standard procedure for day-to-day Washington politics—which is precisely why they occurred.

Kerry, handicapped by his vote for NAFTA in 1993, did tack left a bit in the 2004 primaries. Facing vocal NAFTA opponents in the sincere Rep. Dick Gephardt (D-MO) and the opportunistic Sen. John Edwards (D-NC), he began railing against what he called “Benedict Arnold” corporations which were moving jobs overseas. This rhetoric effectively blunted Edwards’ and Gephardt’s attacks on his NAFTA vote, enabling his wins in Ohio, Wisconsin, Michigan, and other industrial states especially hurt by free trade. Then, in May, with his nomination secure, Kerry tacked right again. In an interview with *The Wall Street Journal*, he claimed his Benedict Arnold reference had been misconstrued:

‘Benedict Arnold’ does not refer to somebody who in the normal course of business is going to go overseas and take jobs overseas. That happens. I support

that. I understand that. I was referring to the people who take advantage of noneconomic transactions purely for tax purposes—sham transactions—and give up American citizenship. [816](#)

Offshore tax domiciling is, of course, an entirely different issue than offshoring. Kerry had folded his cards.

From that point on, the issue virtually disappeared from the campaign. Kerry’s refusal to engage George W. Bush on trade reached its nadir during the third presidential debate, when moderator Bob Schieffer of CBS asked Bush what he would say to “someone in this country who has lost his job to someone overseas who’s being paid a fraction of what that job paid here in the United States.” [817](#) Bush offered the stock Republican responses: he talked about creating the new jobs of the 21st century, improving primary and secondary education, expanding Trade Adjustment Assistance, increasing Pell Grants to college students, and helping displaced workers attend community college. (We examined in Chapter Three why these solutions are insufficient.)

Bush’s position gave Kerry a clear opportunity to define himself politically with his response at a critical juncture in the campaign. But instead of taking on Bush over trade, Kerry accepted Bush’s basic premise that free trade is best and that his proposed solutions could work, and attacked him for

cutting job training funds, Pell Grants and Perkins loans. ⁸¹⁸
Bunt. Amazingly, Schieffer gave Kerry another chance to exploit the issue minutes later. Kerry squandered it again, with a self-consciously defeatist answer dressed up as political courage:

Outsourcing is going to happen. I've acknowledged that in union halls across the country. I've had shop stewards stand up and say, 'Will you promise me you're going to stop all this outsourcing?' And I've looked them in the eye and I've said, 'No, I can't do that.' ⁸¹⁹

In other words, trade *isn't really a political issue at all*, because there's nothing politics can do about it. Not only is there no meaningful difference between Republicans and Democrats on the issue, there cannot be one. Kerry went on to talk about tangential issues—corporate tax loopholes, violations of international trade rules, subsidies by Airbus, Chinese currency manipulation, and fiscal discipline. ⁸²⁰ Bush had won by forfeit.

In retrospect, it is entirely plausible that Kerry's decision to bunt on trade cost him Ohio and thus the entire 2004 election. ⁸²¹ This problem extended far beyond the narrow

confines of trade as such. By refusing to separate himself from Bush on economics on the single best issue for doing so—where Bush was furthest away from the opinions of swing voters—Kerry allowed social issues summed up as God, guns and gays to determine the election for the lower-middle and working-class voters who were his natural constituency. This problem continues to fester: a 2008 study of the electorate in Ohio by the Center for Working-Class Studies at Youngstown State University suggests that thanks to Bill Clinton’s support for NAFTA in 1993, working-class voters “still do not trust Democrats and they haven’t come back to the Democrats.”⁸²² As a result, these voters have tended to view Republicans and Democrats as equally unlikely to protect their economic interests and have therefore voted on noneconomic issues. (At the national level, this trend has been analyzed by Thomas Frank, who took Kansas as his case study in his book *What’s The Matter With Kansas?*)⁸²³

2002-2006: FREE TRADE OPPONENTS START WINNING

No Republican has ever won the presidency without carrying national bellwether Ohio. The trade issue’s ability to tip Congressional races was first noticed in a 2002 race for the 17th District (around Youngstown) of that state. In the Democratic primary, Tom Sawyer, an eight-term incumbent who had voted for NAFTA in 1993, faced Tim Ryan, a 28-

year-old former high school quarterback and first-term state senator. Writing in *The Nation*, John Nichols described the dynamics of this race:

Sawyer and his Democratic challengers agreed on most issues. But trade was the dividing line. And trade mattered—especially in Youngstown and other hard-hit steel-mill communities up and down the Mahoning Valley. Though Sawyer had voted with labor on some trade issues—including the December Fast Track test—he is known in Ohio as the Democrat who backed NAFTA, and for unemployed steelworkers and their families NAFTA invokes the bitterest of memories. [824](#)

Sawyer lost by *13 points*. In the wry post-mortem words of Howard Wolfson, executive director of the Democratic Congressional Campaign Committee (DCCC) in Washington, “[In] some districts in this country, a free trade position is not helpful.” [825](#)

The 2006 midterm elections proved Wolfson prescient. In these contests, a number of Republicans were taught the same lesson Rep. Sawyer had learned: opposition to free trade could push challengers over the top in competitive races. According to a post-election analysis by the left-leaning Naderite group

Global Trade Watch, no fewer than seven Senate and 30 House seats flipped from pro- to anti-free trade in this election.⁸²⁶ Seventy-three percent of *winning* Democratic candidates emphasized trade as an issue in their campaigns, while 72 percent of losing Democratic candidates did not.⁸²⁷ Not a single candidate of either party ran on free trade as a positive agenda, and not a single opponent of free trade was ousted by a free trader in either the House or the Senate.⁸²⁸

Certain individual races epitomized the trade aspects of this election. In Pennsylvania's 8th District, north of Philadelphia, Democrat Patrick Murphy challenged Republican incumbent (and CAFTA supporter) Mike Fitzpatrick. Because Murphy was not expected to win, he did not receive significant support from the DCCC and was therefore unaffected by its decision not to use free trade as an issue. Murphy attacked Fitzpatrick for "crippling" the local economy by supplying the deciding vote for CAFTA.⁸²⁹ This assault, plus a trade oriented get-out-the-vote program, enabled him to upset Fitzpatrick by 1,521 votes. In central Florida's 16th district, Tim Mahoney also made CAFTA a centerpiece of *his* successful campaign to capture the seat vacated by scandal-disgraced Republican Mark Foley.⁸³⁰ And in southeast Iowa's 2nd District, Democrat Dave Loebsack exploited trade themes to dislodge 30-year GOP incumbent—and staunch free trader—Jim

Leach.⁸³¹

The trade wave crashed over the Senate as well in 2006. Six anti-free-trade Democrats—Sherrod Brown of Ohio, Claire McCaskill of Missouri, Jon Tester of Montana, Bob Casey of Pennsylvania, Sheldon Whitehouse of Rhode Island, and Jim Webb of Virginia, plus Independent Bernie Sanders of Vermont—captured seats formerly held by free traders.

In addition to the above victories, it has been estimated that another 10 to 20 failed Democratic challengers *could* have won, had they attacked free trade.⁸³² Unfortunately, the DCCC was headed by Rahm Emanuel, a former suburban Chicago congressman who is now President Obama's chief of staff. Emanuel, who had played a leading role in securing Democratic votes to pass NAFTA while serving as a White House staffer under Bill Clinton in 1993, decided not to use the issue.⁸³³ But for this decision, Democrat Lois Murphy, for example, might have beaten Republican Jim Gerlach, rated by nonpartisan observers as one of the most vulnerable GOP incumbents in the nation, in Pennsylvania's 6th district northwest of Philadelphia.⁸³⁴ Instead, Gerlach squeaked back in with 1.2 percent of the vote after the DCCC effectively vetoed a trade-oriented get-out-the-vote program.⁸³⁵

2008: OBAMA, HILLARY AND MCCAIN

Like John Kerry four years earlier, Barack Obama was a vocal critic of free trade during the Democratic primaries. In debates with Hillary Clinton and responses to questionnaires from groups like the Pennsylvania Fair Trade Coalition, he denounced Chinese currency manipulation, promised to take a tough stance against dumping, opposed extension of Fast Track negotiating authority, and criticized NAFTA. ⁸³⁶ His denunciations of free trade sharpened as he approached the crucial March 4 Ohio primary. Trailing badly in the state after winning 11 primaries and caucuses in a row, he unleashed a direct mail piece which charged that “Hillary Clinton thought NAFTA was a ‘boon’ to the economy,” asserted that she “was not with Ohio when our jobs were on the line,” and claimed that “only Barack Obama consistently opposed NAFTA.” ⁸³⁷ Clinton fired back with a mailer of her own documenting Obama’s own past support for free trade and had phone bank calls made in which she claimed Obama had distorted her record. ⁸³⁸

The rhetorical battle between the two candidates reached its climax in their debate at Cleveland State University on February 26, 2008. Responding to a question from moderator Tim Russert, both said they would pull out of NAFTA if Canada and Mexico refused to renegotiate:

Clinton: I have said that I will renegotiate NAFTA, so obviously, you'd have to say to Canada and Mexico that that's exactly what we're going to do...Yes, I am serious...I will say we will opt out of NAFTA unless we renegotiate it, and we renegotiate on terms that are favorable to all of America.

Obama: I will make sure that we renegotiate, in the same way that Senator Clinton talked about. And I actually think Senator Clinton's answer on this one is right. I think we should use the hammer of a potential opt-out as leverage to ensure that we actually get labor and environmental standards that are enforced. [839](#)

Broadly speaking, it was a draw between the two candidates on trade. Both were making loud gestures of opposition, though neither was especially convincing to anyone familiar with the candidates' records.

Voters' suspicions were quickly confirmed. Four years earlier, Sen. Kerry had at least waited until securing his party's nomination before backtracking on trade. Obama, on the other hand, began sending signals that his opposition to free trade was mere posturing even before he stopped bashing NAFTA on the campaign trail. He sent one of his top economic advisers, Prof. Austan Goolsbee of the University of Chicago,

to meet with Canadian diplomats in Chicago on February 8, 2008 to allay that nation's concerns about his stand on free trade. Joseph De Mora, a Canadian official, later summarized the meeting in an official memorandum that was leaked to the Associated Press:

He was frank in saying that the primary campaign has been necessarily domestically focused, particularly in the Midwest, and that much of the rhetoric that may be perceived as protectionist is more reflective of political maneuvering than policy. He cautioned that this messaging should not be taken out of context and should be viewed as more about political positioning than a clear articulation of policy plans. [840](#)

After some denials by the Obama camp, news of this meeting leaked on February 27, six days before the Ohio primary. [841](#) This all but doomed Obama's chances in that contest, which he lost 45 to 53 percent. He nevertheless won seven of the eight primaries over the next six weeks, his single and telling defeat occurring in Pennsylvania. This was a state that had lost 208,000 manufacturing jobs, and suffered a two percent decline in real median wages, between 2001 and 2007. [842](#) Clinton scored a nine-point victory there, fueled in large part

by white male blue-collar workers—whom she won by 30 points.⁸⁴³

After securing the nomination, Obama went into full retreat on trade. He retracted the pledge he had made in Cleveland to opt out of NAFTA unilaterally if Canada and Mexico refused to renegotiate and attributed his remarks to “overheated” campaign rhetoric, modestly explaining that, “Politicians are always guilty of that, and I don’t exempt myself.”⁸⁴⁴ His capitulation on free trade, combined with John McCain’s lifelong support for it, meant that the 2008 general election was the *fourth* consecutive presidential contest devoid of any real national debate on the issue, the last being Ross Perot’s third-party candidacy in 1992.

John McCain, of course, took a classic triumphalist line on trade. Speaking to the National Association of Latino Appointed and Elected Officials on June 28, 2008, he said:

The global economy is here to stay. We cannot build walls to foreign competition, and why should we want to? When have Americans ever been afraid of competition? America is the biggest exporter, importer, producer, saver, investor, manufacturer, and innovator in the world. Americans don’t run from the challenge of a global economy. We are the world’s leaders, and leaders don’t fear change, hide

from challenges, pine for the past and dread the future. That's why I reject the false virtues of economic isolationism. Any confident, competent government should embrace competition—it makes us stronger—not hide from our competitors and cheat our consumers and workers. We can compete and win, as we always have, or we can be left behind. Lowering barriers to trade creates more and better jobs, and higher wages. [845](#)

For a glimpse of how old this rhetoric is (and what record of predicting economic success it has), take a look at the 1846 British speech in Chapter 6.

Such thinking is, of course, no surprise from a Republican. But Barack Obama, who had more of a choice, took a very similar line in a speech to workers in brutally depressed Flint, Michigan, subject of Michael Moore's withering 1989 comic documentary on deindustrialization, *Roger and Me*:

There are some who believe that we must try to turn back the clock on this new world; that the only chance to maintain our living standards is to build a fortress around America; to stop trading with other countries, shut down immigration, and rely on old industries. I disagree. Not only is it impossible to

turn back the tide of globalization, but efforts to do so can make us worse off. Rather than fear the future, we must embrace it. I have no doubt that America can compete and succeed in the 21st century. And I know as well that more than anything else, success will depend not on our government, but on the dynamism, determination, [846](#) and innovation of the American people.

We looked at why economic globalization is *not* an uncontrollable force in Chapter One. [847](#) We looked at why dynamism, determination, and innovation won't save America in Chapter Three. [848](#)

THE 2008 CONGRESSIONAL ELECTIONS

Despite the lack of motion on the trade front in the 2008 presidential race, progress continued in the House and Senate. After declining to run ads attacking free trade in 2006, the DCCC, startled by the issue's potency in 2006 even when neglected, relented and aired spots on the topic in 2008. In the words of the nonpartisan *Congress Daily*, which detected this shift in strategy one week before the election:

References to “job-killing trade deals,” outsourcing

and anti-China sentiment abound, with more than 100 trade-related advertisements and counting... Aiding the effort are the Senate and House Democratic Campaign Committees, which have spent heavily on ads criticizing Republicans on trade. [849](#)

By the end of the election cycle, the DCCC, the Democratic Senatorial Campaign Committee, and individual candidates had run more than 160 different anti-free-trade ads across the country. [850](#)

When the dust had settled, 36 new free-trade opponents had been elected to the House: 13 in contests against incumbents, 20 in battles for open seats, and three in special elections. [851](#) (Eight free-trade opponents lost, so the net gain was 28.) And seven new free-trade opponents were elected to the Senate: Mark Begich of Alaska, Mark Udall of Colorado, Jeanne Shaheen of New Hampshire, Tom Udall of New Mexico, Kay Hagan of North Carolina, Jeff Merkley of Oregon, and Al Franken of Minnesota. [852](#) The hallmark trade race of this cycle was in northwest Pennsylvania's 3rd District, where Democrat Kathy Dahlkemper ousted GOP incumbent Phil English, who had provided one of the final two votes needed to pass CAFTA. [853](#) Winners also included

10 *Republican* opponents of free trade who either held or won seats while campaigning against free trade. [854](#)

THE OBAMA PRESIDENCY

In office, President Obama's free trade convictions have not changed. Ironically, this is probably the correct position for him to take for the time being, as he appears to know nothing about trade beyond the received Ricardian wisdom and therefore has no rational alternative. This was demonstrated by his appointment of free trader Ron Kirk, the former mayor of Dallas, to be United States Trade Representative. In his first policy address, at Georgetown University, Kirk assured the audience of Obama's allegiance to conventional analyses of the problems of free trade and his consequent determination to push forward with existing policy:

While the pain of trade can be concentrated at times, its benefits are lasting and widespread. One in six American manufacturing jobs is already supported by trade. Agricultural exports support nearly a million more...And jobs supported by exports of goods pay 13 to 18 percent more than the national average...So we will seek ways to sharpen U.S. trade policy, and to shore up the foundations of global trade today...by rejecting protectionism and

supporting the global rules-based trading system. [855](#)

While it is not surprising that Obama would appoint a free trader to this position, what is perhaps more shocking is that his first nominee, Los Angeles Congressman Xavier Becerra, had turned down the position because, as he put it:

My concern was how much weight this position would have and I came to the conclusion that it would not be priority No. 1, and perhaps, not even priority No. 2 or 3. [856](#)

Given the scale of America's trade problems, Obama's priorities may soon change. In the meantime, his appointees to the important Economic Recovery Advisory Board have been, with the sole exception of Richard Trumпка of the AFL-CIO (since elected head of that organization), free traders. [857](#)

Obama has shown his hand in other ways. He announced in April of 2009 that he would not, contrary to his campaign promise, be renegotiating NAFTA. [858](#) He continues to press for passage of more free trade agreements, with the proposed Trans-Pacific Partnership (Singapore, Chile, New Zealand, Brunei, Australia, Peru, and Vietnam) at the top of his list. He

fought the Buy American provisions included by Congress in the giant stimulus package of 2009 as that old bogeyman Protectionism.⁸⁵⁹ In March 2009, reversing his earlier position, he agreed to allow Mexican trucks on U.S. highways despite safety concerns, exposing American truckers to foreign competition.⁸⁶⁰ Perhaps most importantly, he spoke out against the carbon tariff included in the Cap and Trade legislation passed by the House of Representatives in June 2009,⁸⁶¹ only consenting in the end to extremely watered-down provisions. These provisions would require tariffs on goods produced in nations with inadequate greenhouse gas emission standards but:⁸⁶²

- a) They would only take effect in 2020.
- b) They are preempted by any international agreement reached by 2018.
- c) They could be waived by the president with the consent of Congress.
- d) They exempt industries for which the president determines that 85 percent of global production is in compliance.

- e) They exempt industries of countries that have met emissions standards overall.

All this is despite the fact that Energy Secretary Stephen Chu has publicly backed the idea of *serious* carbon tariffs,⁸⁶³ and the WTO has recently announced its cautious acquiescence.⁸⁶⁴

Like his predecessors, President Obama has tactically bunted and talked out of both sides of his mouth to keep minor trade flashpoints from blowing up into something bigger. For example, he imposed a tariff on Chinese tire imports in September 2009 in retaliation for dumping. While this brought forth howls of ideological anguish from the usual suspects, it was actually a very small move. He did not even impose the full 55 percent tariff permitted by the rules China agreed to when it joined the WTO and recommended by the U.S. International Trade Commission. Instead, he only imposed 35 percent, a clear piece of “I’m not serious” signaling to nervous free traders.⁸⁶⁵

THE END GAME ON TRADE

Obama is not going to be able to support free trade forever. Crisis will eventually come, probably when the dollar finally melts, which will force the public to ask why this happened

and thus force the question of whether America's trade policy has been wise. A sharp decline in the dollar will generate an inflationary shock—and a shock in interest rates—that will capture public attention and quite likely knock the economy back into recession. [866](#)

Ironically, an outright crisis will probably benefit Obama politically, as it will give him room to maneuver out of his earlier free-trade position without looking foolish. It will also help break up the logjam of special interests that currently locks free trade in place. These interests seem impregnable even today in 2010, but the ground is shifting under their feet for two reasons: first, the present trading order depends financially upon America's inexorably doomed international credit and second, it depends politically upon the public continuing to believe that free trade is sound economics.

Other events could trigger the final collapse of free trade. For example, the U.S. government has slipped into a tacit commitment to bail out key industries, starting with banking and automobiles. It has thus far been able to do this by means of the bankruptcy code plus massive infusions of public money. But in the case of automobiles, it resisted doing the one thing that would have done the most to help this industry: giving it back the market share it had lost to imports. A tariff was half-heartedly considered in the early stages of the crisis, but vetoed by "Toyota Republicans" led by Alabama Senator Richard Shelby, whose state is the site of auto plants owned

by Hyundai, Honda, Mercedes, and Toyota. ⁸⁶⁷ If the cost of providing further industry bailouts without tariff protection becomes intolerable, tariffs may eventually prove irresistible, especially if the U.S. government's ability to pay for bailouts with borrowed cash instead declines.

Another possible trigger for the final breakdown of free trade is global warming. ⁸⁶⁸ Even free trader economists such as Paul Krugman have recently conceded that the economic rationale for imposing tariffs on nations which fail to control pollution adequately is impeccable, even within the most utterly conventional economic assumptions. ⁸⁶⁹ In terms of this book, it does not require any of the controversial analyses of Chapters Nine or Ten, only dubious assumption #2 (there are no externalities) of Chapter Five. Americans usually imagine this would involve the U.S. imposing a tariff on polluting nations like China. ⁸⁷⁰ However, it could quite easily involve nations with higher environmental standards than our own, like the Europeans together with Japan, imposing a tariff on the U.S! As French president Nicholas Sarkozy said in September 2009:

I will not accept a system...that imports products from countries that don't respect the rules [on carbon emission reductions]. We need to impose a carbon tax at [Europe's] borders. I will lead that

battle.

And this is managed trade, not free trade.

DEEPER POLITICAL REALITIES OF THE TRADE ISSUE

There is a deeper political reality underlying the whole trade issue: both parties are feeling the heat of an intensifying global economic challenge to the U.S. and are looking for ways to take the pressure off their voters.

Withdrawing from free trade (to an as yet undefined extent) is emerging as the consensus Democratic response, even if the party's leadership doesn't yet realize how deep are the forces driving this or how far it is likely to go. The emerging Republican response seems to be keeping free trade while opposing immigration—which does not enlarge America's shrinking economic pie, but does cut it into fewer slices per voter and is therefore politically salable. [871](#)

The clearest sign of this emerging twin consensus was a pair of Congressional votes: on CAFTA on July 27, 2005 and on immigration amnesty on June 28, 2007. Prior to these votes, American politics was aligned on roughly nationalist vs. internationalist lines, with pro-free-trade and pro-immigration views tending to coincide on one side and anti-free-trade and

anti-immigration views on the other. Because the pro side dominated both parties, the anti side was effectively deprived of influence over public policy despite representing a majority or near-majority of public opinion.⁸⁷² But these two votes revealed a majority of Congressional Democrats embracing a pro-immigration, anti-free-trade position that may fairly be described as leftist, while a majority of Congressional Republicans embraced an anti-immigration, pro-free-trade position that may fairly be described as rightist.⁸⁷³ The nationalist and internationalist positions now have few remaining supporters in either party.⁸⁷⁴

Both parties are thus inexorably reverting to their natural partisan positions of offering competing left- and right-wing solutions to the same underlying problem. (As previously noted, protectionism is *intrinsically* neither rightist nor leftist, but as long as Republicans remain free market-oriented, it is a left-of-center position in contemporary American politics.) This firming of the ideological battle lines suggests that the trade issue may ultimately be resolved in a classic Left vs. Right firefight. This kind of transparent and accountable partisan choice is, of course, precisely the way democracy is supposed to work.

However, the trade issue has not yet fully crystallized in this way, so this process may well be aborted—most likely by the veto power of interest groups in each party—depriving the

democratic process of a firm grip on the question. Or the debate could crystallize neatly along partisan lines but get bogged down in secondary issues, making other issues decisive for the electoral fortunes of the two parties. This could easily place a party in power whose trade position opposes what a majority of voters want.

Luckily, even a broken and incoherent debate could produce an acceptable policy outcome. For example, the U.S. could adopt emergency measures under the pressure of immediate crisis without any fundamental ideological shift—and these measures could prove effective and be followed up later by ideological rationalizations. The clearest precedent for such an emergency move is the 10 percent tariff adopted (and [875](#) unfortunately abandoned) by President Nixon in 1971. This kind of ad hoc solution is also roughly what happened during the Great Depression, when de facto welfare-state Keynesianism was adopted with the ideological infrastructure solidifying later. It may not be the cleanest or most intellectually satisfying way to produce policy, but it does have a history of working.

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Critical Praise

Ian Fletcher has written a powerful and refreshing critique of some cherished assumptions held by mainstream economists. It is uniformly insightful, often brilliant, and remarkably readable. Obama's team should read it—and soon.

—**George C. Lodge, Professor Emeritus, Harvard Business School; author, *Managing Globalization in the Age of Interdependence***

Old-fashioned comparative advantage in international trade has been swamped by foreign industrial policy. The only way to save our economy is for the U. S. to counter with trade and industrial policies designed to correct the defects of free trade. Ian Fletcher's *Free Trade Doesn't Work* is the best guide to develop such policies.

—**Ernest “Fritz” Hollings, Democratic senator from South Carolina, 1966-2005**

Fletcher has laid out a powerful critique of so-called free trade while also making the case for rethinking and reforming our current trade policies. Given the economic challenges we face in an increasingly treacherous global economy, this book provides essential tools and analysis for policy-makers and

activists.

—**John J. Sweeney, former President, AFL-CIO; author, *America Needs a Raise: Fighting for Economic Security and Social Justice***

Like the Holy Grail, free trade is a concept that works in the classroom and in the minds of academics and others insulated from the harsh realities of global trade in the real world. In the real world, we have managed trade. This ranges from the blind free trade faith of economists, editorial boards, and politicians to the mercantilist, protectionist, predatory trade practiced by some of our major global trading “partners” like China. This book is an excellent introduction to these realities and what can be done about them.

—**Dan DiMicco, Chairman and CEO, Nucor Steel Corporation; author, *Steeling America’s Future: A CEO’s Call to Arms***

Most Americans live under the myth that sound economics says so-called free trade benefits all nations. Fletcher shows, in very readable prose, how the discipline is finally catching up with reality and common sense and is changing its mind on that matter. This book will be an essential guide to the emerging debate over the wisdom of “free” trade as a sound policy for our nation.

—Patrick A. Mulloy, Commissioner, U.S.-China Economic and Security Review Commission; former Assistant Secretary of Commerce

Ian Fletcher makes a powerful case for abandoning the simplistic mantra that markets generally maximize welfare, and tariffs or regulations reduce economic prosperity. He points to more-nuanced policies that avoid the extremes of blanket protectionism and unregulated trade.

—Geoffrey Hodgson, Editor-in-Chief, *Journal of Institutional Economics*, Cambridge University Press

Ian Fletcher bravely takes on the free-trade theorists who lead cheers for the slow-motion disintegration of American prosperity and trumps them with facts and clear-eyed logic. If people will listen, Fletcher's informed voice will help turn the country toward a more promising future.

—William Greider, author, *One World, Ready or Not: The Manic Logic of Global Capitalism*

In this sophisticated, well-informed, and comprehensive study, Ian Fletcher provides a very powerful, passionate, and convincing critique of free trade in an accessible and engaging manner. Read it.

—**Ha-Joon Chang, University of Cambridge; author, *Bad Samaritans: The Myth of Free Trade and the Secret History of Capitalism***

Drawing on the insights of a broad array of political persuasions, Ian Fletcher delivers a devastating and powerful indictment of free trade economics—one that should be widely read, not the least by economists themselves, whose work generally remains confined to their own narrow discipline. I agree with Fletcher: “We can’t trust the economists.” *Free Trade Doesn’t Work* will spark some much-needed debate on what sort of political and economic policies we *can* trust.

—**Gavin Fridell, Assistant Professor of Politics, Trent University; author, *Fair Trade Coffee: The Prospects and Pitfalls of Market-Driven Social Justice***

A trenchant and comprehensive analysis of the gap between the theory of free trade and reality, together with a revealing description of the weaknesses of the theory itself.

—**Ralph Gomory, Research Professor, Stern School of Business, New York University; author, *Global Trade and Conflicting National Interests***

Free Trade Doesn't Work is an excellent guide to the economic realities obscured by the intellectually hollow promotion of “free trade.” It is up-to-date, comprehensive, and very readable.

—**Jeff Faux, Distinguished Fellow, Economic Policy Institute; author, *The Global Class War: How America's Bipartisan Elite Lost Our Future—And What it Will Take to Win it Back***

In *Free Trade Doesn't Work*, Ian Fletcher makes clear that America's nearly \$6 trillion trade deficit accumulated since NAFTA took effect in 1994 benefits neither workers nor the nation. The book debunks the myth of free trade and proposes a responsible alternative that would restore a measure of sanity to America's international trade policy.

—**Leo W. Gerard, President, United Steelworkers**

If it strikes you that most of the arguments put forth for “free” trade are really just so much globaloney, you're right! Fletcher rips the mask from free trade myths, pointing out that economists increasingly reject the idea that our nation (or others) should base economic policy on such a dubious proposition. This book is a powerful tool for anyone who wants to help raise common sense to high places.

—**Jim Hightower, bestselling author; national radio and newspaper commentator; editor, *The Hightower Lowdown***

Free Trade Doesn't Work offers a satisfying critique of the flaws of free trade economics and the damage that related policies have caused to the U.S. economy and beyond. Its arguments are tools with which to break the hold of the current free-trade consensus over our politicians and to work towards truly fair trade and economic policies.

—**Stephanie Celt, Director, Washington Fair Trade Coalition**

A superb debunking of the arguments for free trade and a thoughtful examination of the alternatives. Fletcher's book is required reading for policymakers and for the general public trying to understand how the United States has fallen into a debt trap and what has to be done to escape it.

— **Richard H. Robbins, Distinguished Professor, Plattsburgh State University; author, *Global Problems and the Culture of Capitalism***

Ian Fletcher's *Free Trade Doesn't Work* injects some urgently needed common sense and rigorous thinking into what may be the most important economic policy debate of our time.

—**Alan Tonelson, author, *The Race to the Bottom***

Ian Fletcher's book is of immense value in defining the parameters of the idolatry of free trade. Politicians and the general populace continue to be afraid to abandon this false god because of the kind of superstitions and inaccuracies that this book exposes very well. I would highly recommend it.

—**Manuel F. Montes, Chief, Development Strategy and Policy Analysis, United Nations Development Policy and Analysis Division.**

In *Free Trade Doesn't Work*, Ian Fletcher points to the ideal of "free" trade and proclaims it isn't wearing any clothes! Instead of following along with the crowd, Fletcher systematically presents the failures of an unrestrained trade system and offers up a balanced discussion of what a managed trade system could accomplish in its place.

—**Thomas S. Mullikin, author, *Truck Stop Politics: Understanding the Emerging Force of Working Class America.***

Ian Fletcher has convincingly dismantled the facade that for decades enticed U.S. cattle ranchers and their trade associations to support a free trade policy that was

systematically destroying the economic integrity of their industry. A superb analysis of our nation's misdirection.

—**Bill Bullard, CEO, R-CALF USA (Ranchers-Cattlemen Action Legal Fund, United Stockgrowers of America)**

Ian Fletcher's argument against free trade and in favor of tariffs is not only a courageous assault on our so-called conventional wisdom, it makes a brilliant and wildly compelling case for regulation. The book is an impressive piece of scholarship, one that could and should provide the blueprint for government intervention in commerce. Economists will stand up and take notice. Wall Street will hate it.

—**David Macaray, author, *It's Never Been Easy: Essays on Modern Labor***

This readable book dramatizes our lost history of global trade and punctures the mythology surrounding the benefits of unbridled free trade. A vital primer for anyone trying to understand the current trade debate.

—**Chuck Collins, Institute for Policy Studies; co-author, *The Moral Measure of the Economy***

After reading *Free Trade Doesn't Work*, I now understand

why so many of the trade agreements that we negotiated never delivered the promises that were made and, if continued, never will.

—Robert B. Cassidy, former Assistant U.S. Trade Representative for China and for Asia and the Pacific

It is standard for people in policy debates to be reflexive supporters of “free” trade. This book should help people to better understand what this means, so it may change some attitudes.

—Dean Baker, Co-Director, Center for Economic and Policy Research; author, *False Profits: Recovering from the Bubble Economy*.

This book is an instant classic that will be of use for many years, for it makes a major contribution to thinking on trade policy.

— Pat Choate, running mate of Ross Perot in 1996; Director, Manufacturing Policy Project; author, *Dangerous Business: The Risks of Globalization for America*

The world needs to localize, and fast. Instead of throwing out supply lines, we need to reel them in. This book helps show

why.

—**Bill McKibben, author *Deep Economy: The Wealth of Communities and the Durable Future***

Fletcher's book opens up the arcane mysteries of free trade economics for the ordinary reader and makes clear that the most up-to-date economics confirms that free trade has no justification in either history or present-day facts. It is a threat to the incomes of working people, to our environment, and to democratic sovereignty. Luckily, as he also points out, viable alternatives are available if the politicians would only wake up and take notice.

—**Maude Barlow, Council of Canadians, co-author, *Alternatives to Economic Globalization***

You have written a bible for us. It is brilliant! You even cover issues I have been concerned about but never had time to discuss with anyone else. I started by reading it and ended by studying it. Am now going through it for the second time underlining and highlighting.

—**Brian O'Shaughnessy, Co-Chair, Coalition for a Prosperous America; Chairman, Revere Copper Products**



Ian Fletcher is an Adjunct Fellow at the San Francisco office of the U.S. Business and Industry Council, a Washington think tank founded in 1933. He was formerly an economist in private practice, serving mainly hedge funds and private equity firms. Educated at Columbia University and the University of Chicago, he lives in San Francisco with his wife and daughter.

More information about this book can be found at FreeTradeDoesntWork.com; more information about the U.S. Business and Industry Council can be found at usbic.net

1 Margaret Thatcher, speech to Scottish Conservative Conference, Perth, Scotland, May 8, 1981.

2 “U.S. Trade in Goods and Services - Balance of Payments (BOP) Basis,” U.S. Census Bureau, June 10, 2009, <http://www.census.gov/foreign-trade/statistics/historical/gands.pdf>.

3 Author’s calculation based on “U.S. International Trade in Goods and Services: November 2009,” U.S. Census Bureau, January 12, 2010. America’s trade deficit may even be 10-15% larger than this, due to a 1988 lawsuit that forces the U.S. government to calculate the value of imports based on their value when they left their foreign factory, as opposed to their value when they enter the U.S. See Richard McCormack, “The Plight of American Manufacturing” in Richard McCormack, ed., *Manufacturing a Better Future for America* (Washington: Alliance for American Manufacturing, 2009), p. 61.

4 Author’s calculation from “U.S. International Transactions Accounts Data,” Bureau of Economic Analysis, <http://www.bea.gov/international/xls/table1.xls>, accessed November 28, 2009.

5 Five percent.

6 “Employees on nonfarm payrolls by industry sector and selected industry detail,” Bureau of Labor Statistics, <http://www.bls.gov/webapps/legacy/cesbtab1.htm>.

7 Paul Craig Roberts, “The New Face of Class Warfare,” *Counterpunch*, July 2006.

8 Judith Banister, “Manufacturing Employment and Compensation in China,” Beijing Javelin Investment Consulting Company, November 2005, p. vi.

9 Louis Uchitelle, “As Output Gains, Wages Lag,” *The New York Times*, June 4, 1987.

10 “ADB’s Poverty Reduction Strategy,” Asian Development Bank, April 18, 2008, p. 1.

11 “Bush Decision on Chinese Imports Leads to Loss of 500 Very Good Jobs,” *Manufacturing & Technology News*, March 29, 2007, p. 6.

[12](#) Polyurethane Foam Association, written testimony submitted to hearing on “Aiding American Businesses Abroad: Government Action to Help Beleaguered American Firms and Investors,” Committee on Foreign Affairs, U.S. House of Representatives, July 17, 2008.

[13](#) Dan Fuller and Doris Geide-Stevenson, “Consensus Among Economists: Revisited,” *Journal of Economic Education*, Fall 2003, p. 372.

[14](#) John Maynard Keynes, *The General Theory of Employment, Interest and Money* (Hamburg: Management Laboratory Press, 2009), p. 395.

[15](#) Paul Krugman, *Strategic Trade Policy and the New International Economics* (Cambridge, MA: MIT Press, 1986), p. 3.

[16](#) About 20% of economists surveyed support free trade “with provisos,” according to Dan Fuller and Doris Geide-Stevenson, “Consensus Among Economists: Revisited,” *Journal of Economic Education*, Fall 2003, p. 372.

[17](#) Henry George, *Free Trade or Protectionism: An Examination of the Tariff Question With Especial Regard to the*

Interests of Labor (New York: Doubleday, 1905), p. 169.

18 One exact figure, for example, is \$326,000 for the steel industry, reported by Pete DuPont in “Bush’s Steel Crucible: Will He Help Big Industry at Consumers’ Expense?” *The Wall Street Journal*, January 2, 2002.

19 There is a branch of economics, public choice theory, which attempts to model these problems, but it has not vindicated its aspiration to objective expertise, tending to generate conclusions that are merely cynical and right wing.

20 “Balance of Payments (MEI): Current Account Balance,” Organization for Economic Cooperation and Development, 2009, <http://stats.oecd.org>.

21 “International Comparisons of Hourly Compensation Costs in Manufacturing, 2007,” Bureau of Labor Statistics, March 26, 2009, Table 1, <http://www.bls.gov/news.release/pdf/ichcc.pdf>.

22 “International Trade (MEI): International Trade Exports,” Organization for Economic Cooperation and Development, 2009, <http://stats.oecd.org>.

23 These firms are named simply as examples of the industry;

they are neither exceptionally bad nor good in this regard.

[24](#) Paul Craig Roberts, “How the Economic News is Spun,” *Manufacturing & Technology News*, March 17, 2006, p. 10.

[25](#) Richard McCormack, “U.S. Military Fails to Learn An Ancient Military Lesson: No Industrial Economy Equals No Army,” *Manufacturing & Technology News*, October 17, 2008, p. 1.

[26](#) Joseph I. Lieberman, White Paper, “National Security Aspects of the Global Migration of the U.S. Semiconductor Industry,” Office of Senator Lieberman, June 2003.

[27](#) Among other things. See Bruce Bartlett, *Impostor: How George W. Bush Bankrupted America and Betrayed the Reagan Legacy* (New York: Doubleday, 2006).

[28](#) “Presidential Debates: Not Much Stuff Amidst the Fluff,” *Manufacturing & Technology News*, October 17, 2008, p. 4. There were also a few comments that could be interpreted as obliquely touching on the trade deficit. The debate transcripts are at <http://www.debates.org/pages/debtrans.html>.

[29](#) Gregory Tasse, *The Technology Imperative* (Northampton,

MA: Edward Elgar, 2009), p. 36.

[30](#) Ibid., p. 303.

[31](#) Both of Paul Krugman's books *Pop Internationalism* (Cambridge, MA: MIT Press, 1996) and *Peddling Prosperity* (New York: W.W. Norton & Co., 1994) contain extended attacks on the concept of competitiveness. Also see the Cato Institute's Daniel T. Griswold, "The U.S. Trade Deficit: A Sign of Good Times," testimony before U.S. Trade Deficit Review Commission, August 19, 1999.

[32](#) There are, of course, any number of formal definitions available, even if economists do not accept them.

[33](#) Matthew Craft, "Crash of the Rocket Scientists," *Forbes*, 11 May 2009.

[34](#) This is not to say mathematics has no place in economics, only that it is fraught with opportunities for bias masked by its objectivity. As long as production, consumption, and wealth are quantifiable, mathematics will have a place.

[35](#) In technical terms, there is an excessive premium on closed-form solutions. Obviously, such solutions are desirable

if they can be obtained, due to their great explanatory power, but their value does not justify ignoring other solutions or twisting facts to achieve closed form.

[36](#) He was primarily referring to trade models ignoring scale economies. See Paul Krugman, *Rethinking International Trade* (Cambridge, MA: MIT Press, 1994), p. 5.

[37](#) The desirability of reducing the *conceptual foundations* of economics to a mathematical system, as Paul Samuelson did in his era-defining 1947 book, *Foundations of Economic Analysis*, does not logically entail the desirability of mathematizing economics as a whole.

[38](#) Warnings about the dangers of over-mathematizing economics go way back: in 1752 the Italian mathematician, Ignazio Radicati, wrote to some economists headed in this direction that, “You will do with political economy what the scholastics did with philosophy. In making things more and more subtle, you do not know where to stop.” Quoted in Erik S. Reinert, *How Rich Countries Got Rich and Why Poor Countries Stay Poor* (New York: Carroll and Graf, 2007), p. 45

[39](#) The main problem is that some mathematical models of the economy produce equations with closed-form solutions and some don't. Economists strongly prefer the former, and will sacrifice the accuracy of models by making simplifying

assumptions in order to get them. For example, in trade models, they ignore the effects of scale economies. As discussed in Chapter 10, these are crucial.

[40](#) For example, neither Michael Porter's *The Competitive Advantage of Nations* (New York: The Free Press, 1990), nor Eamonn Fingleton's *Blindside* (New York: Simon & Schuster, 1995), nor Eric Reinert's *How Rich Countries Got Rich and Why Poor Countries Stay Poor* (New York: Carroll & Graf, 2007) use any math beyond basic statistics. This is not a new phenomenon: going back a few decades, some extremely important economists, like John Kenneth Galbraith and Joseph Schumpeter, were notoriously unmathematical.

[41](#) Their views of economics do not lend themselves well to mathematical formalism. See Eamonn Fingleton, *Blindside: Why Japan is Still on Track to Overtake the U.S. by the Year 2000* (New York: Houghton Mifflin, 1995) for details.

[42](#) If this idea has any place in the discipline today, it is as a premise brought to it from outside, not as something that economics actually proves. Furthermore, the idea of prosperity tends to be reduced to satisfaction of "preferences," which can lead, as we shall see in Chapter 2, to vindicating short-term preferences with negative long-term economic consequences.

[43](#) Consider, for example, free traders Hugo Grotius (1612),

Francisco Suarez (1612), and Alberico Gentili (1612), or protectionists Antonio Serra (1613), Edward Misselden (1623), and Charles King (1721).

[44](#) Though Keynes has enjoyed something of a revival in real world policy decisions dealing with the financial crisis of 2008, and many of his ideas have been absorbed into the disciplinary consensus.

[45](#) Herman E. Daly and John B. Cobb, Jr., *For the Common Good* (Boston: Beacon Press, 1989) p. 235.

[46](#) A good discussion of what this means, and what issues it raises in regard to corporate America especially, appears in the first five chapters of Clinton Labor Secretary Robert Reich's book *The Work of Nations* (New York: Alfred A. Knopf, 1991).

[47](#) This phrase is the title of a book by self-described "radical free trader" Thomas Friedman, *The Lexus and the Olive Tree: Understanding Globalization* (New York: Farrar, Straus & Giroux, 1999).

[48](#) Vincent Cable, a British Liberal Democrat MP, lists five kinds of antiglobalizers: nationalists (in the full sense), mercantilists (economic nationalists), regionalists (as in the EU or other blocs), dependency theorists (updated Leninism),

and deep greens. See Vincent Cable, *Globalization and Global Governance* (London: Royal Institute of International Affairs, 1999), pp. 121-3.

[49](#) David Hummels, “Time as a Trade Barrier,” Center for Global Trade Analysis, Purdue University, July 2001, p. 25.

[50](#) This phrase is from Dr. Ha-Joon Chang of Cambridge University.

[51](#) Peter Schwartz and Peter Leyden, “The Long Boom: A History of the Future, 1980—2020,” *Wired*, July 1997.

[52](#) Michael Bordo, “Globalization in Historical Perspective,” *Business Economics*, January 2002, p. 22.

[53](#) Prosperity measured by per capita economic output. For measures of relative globalization over time, see Michael Bordo, “Globalization in Historical Perspective,” *Business Economics*, January 2002.

[54](#) Letter to Henry Cabot Lodge, 1895, quoted in Jacob Viner and Douglas A. Irwin, ed., *Essays on the Intellectual History of Economics* (Princeton, NJ: Princeton University Press, 1991), p. 246.

[55](#) “Why Cessna Outsourced Manufacture of Its Skycatcher to Chinese Fighter Jet Company,” *Manufacturing & Technology News*, December 21, 2007, p. 2.

[56](#) Estimate of Nobelist Gary Becker of the University of Chicago. See Gary S. Becker, “The Age of Human Capital,” in Hugh Lauder, ed., *Education, Globalization & Social Change* (Oxford, UK: Oxford University Press, 2006), p. 292.

[57](#) Based on Gary Becker’s estimate above subtracted from intangible capital estimate in Kirk Hamilton et al., “Where is the Wealth of Nations? Measuring Capital for the 21st Century,” World Bank, 2006, p. 20.

[58](#) This was first rigorously documented in Kenneth French and James Poterba, “Investor Diversification and International Equity Markets,” *American Economic Review*, January 1991. Although it has declined since then, it remains substantial, as reported in Amir A. Amadi, “Equity Home Bias: A Disappearing Phenomenon?” Department of Economics, University of California at Davis, 2004.

[59](#) Mitchell L. Moss, “Why Cities Will Thrive in The Information Age,” *Urban Land*, October 2000, p. 2.

[60](#) See, for example, Richard Florida, “The World is Spiky,” *The Atlantic Monthly*, October 2005, p. 48.

[61](#) Michael Porter, *The Competitive Advantage of Nations* (New York: Free Press, 1990), p.19.

[62](#) Winfried Ruigrok and Rob van Tulder, *The Logic of International Restructuring: The Management of Dependencies in Rival Industrial Complexes* (New York: Routledge, 1996) p. 159. Although this study and the one cited immediately below are from the mid-1990s, matters do not appear to have shifted significantly since then. According to one 2003 study, “Therefore, in the overall set of 20 highly inter-nationalized MNEs, the case of a global strategy and structure can be made for only six firms, with the additional observation that even these firms exhibit regional elements. The others are either strongly home triad-based or are from small countries peripheral to the triad and are focused in one of the other triad markets. Most of the other 80 of the top 100 MNEs are even less global and are either domestic or home-based MNEs. Location and region matter even to MNEs.” Alan M. Rugman and Alain Verbeke, “Regional Multinationals and Triad Strategy,” *Research in Global Strategic Management*, vol. 8 (Greenwich, CT: JAI Press, 2003). According to a 2008 study, “There is no evidence of a trend towards the globalization of international business activity.” Alan Rugman and Chang H. Oh, “Friedman’s Follies: Insights on the

Globalization/Regionalization Debate,” *Business and Politics*, August 2008, p. 12.

[63](#) Paul Hirst and Grahame Thompson, “Globalization,” *Soundings*, Autumn 1996, p. 56.

[64](#) Alan Rugman and Chang H. Oh, “Friedman’s Follies: Insights on the Globalization/Regionalization De-bate,” *Business and Politics*, August 2008, p. 13.

[65](#) Remember distance counts as an incremental barrier to trade, even if it is not a discrete one.

[66](#) 2008 figure, from “U.S. International Trade in Goods and Services: Exports, Imports, and Balances,” Bureau of Economic Analysis, 2009, http://www.bea.gov/newsreleases/international/trade/trad_time_

[67](#) John McCallum, “National Borders Matter: Canada–U.S. Regional Trade Patterns,” *The American Economic Review*, June 1995, p. 616.

[68](#) James E. Anderson & Eric van Wincoop, “Trade Costs,” *Journal of Economic Literature*, September 2004, p. 694.

[69](#) Graham Dunkley, *Free Trade: Myth, Reality, and Alternatives* (New York: Zed Books, 2004), p. 88. With respect to multinationals, see Alan M. Rugman and Alain Verbeke, “Regional Multinationals and Triad Strategy,” in *Research in Global Strategic Management* (Stamford, CT: JAI Press, 2003), p.1.

[70](#) Stephen Tokarick, “Quantifying the Impact of Trade on Wages: The Role of Nontraded Goods,” International Monetary Fund, 2002, p. 14.

[71](#) Paul Krugman, “A Global Economy is not the Wave of the Future,” *Financial Executive*, March 1, 1992.

[72](#) *World Trade Organization Annual Report, 1998* (Geneva: WTO Publications, 1998), pp. 37-38.

[73](#) Just over a week after 9/11, U.S. Trade Representative Robert Zoellick used counter-terrorism as an argument for expanding presidential fast-track authority to negotiate trade agreements, in an editorial in the *Washington Post*: “Countering Terror With Trade,” September 20, 2001. See also, for example, Brink Lindsey, “The Trade Front: Combating Terrorism with Open Markets,” Cato Institute, August 5, 2003.

[74](#) Not that trade policy should always be used as a political tool (a problem discussed in Chapter 8), but the WTO is giving us the worst of both worlds: trade concessions without political good behavior in exchange for them.

[75](#) “Global Trends 2015: A Dialogue About the Future With Nongovernment Experts,” Central Intelligence Agency, December 2000, pp. 10, 38.

[76](#) John Cavanagh, Jerry Mander et al, *Alternatives to Economic Globalization: A Better World is Possible* (San Francisco: Berrett-Koehler, 2002), p. 118. To be fair, the WTO has not yet formally ruled on this question, though the language of its agreements appears to prohibit treating different nations differently in trade for political reasons. Brussels certainly thinks so: in 1998, the European Union brought a case before the WTO against the U.S. over a Massachusetts law prohibiting that state from doing business with companies that operated in Burma due to Burma’s human rights record. The U.S. Supreme Court struck down the Massachusetts law before the WTO heard the case, so no WTO ruling was made. It can, of course, be argued that such sanctions are WTO-compliant, but the best arguments turn on such weak reeds as the WTO’s “protecting public morals” clause. See “Are EU Trade Sanctions on Burma Compatible With WTO Law?” Robert L. Howse and Jared M. Genser, *Michigan Journal of International Law*, Winter 2008, pp. 184-188.

[77](#) Free traders have employed this sort of fuzzy logic for centuries. Free trader economist Arthur Latham Perry wrote around 1883 that ,“to relax commercial systems and not to restrict them is alone in accord with the spirit of the age and the leading commercial nations, the United States alone excepted, have been relaxing their commercial systems.” Giles Badger Stebbins, *The American Protectionist’s Manual* (Detroit: Thorndike Nourse, 1883), p. 19.

[78](#) See, for example, Peter Schwartz and Peter Leyden, “The Long Boom: A History of the Future, 1980 - 2020,” *Wired*, July 1997, or John Nye, “No Pain, No Gain: Opposing Free Trade Means Opposing Innovation,” *Reason*, May 1996.

[79](#) This law claims that the masses will always be paid subsistence wages because whenever they are paid more, they simply have more children until they are living at the subsistence level again.

[80](#) Thomas Friedman’s version runs thus: “Let’s face it: Republican cultural conservatives have much more in common with the steelworkers of Youngstown, Ohio, the farmers of rural China, and the mullahs of central Saudi Arabia, who would also like more walls, than they do with investment bankers on Wall Street or service workers linked to the global economy in Palo Alto, who have been enriched by the

flattening of the world.” Thomas Friedman, *The World is Flat* (New York: Picador, 2005), p. 258. Friedman also wrote in his column: “These anti-WTO protesters... are a Noah’s ark of flat-earth advocates, protectionist trade unions and yuppies looking for their 1960s fix.” Thomas Friedman, “Senseless in Seattle,” *The New York Times*, December 1, 1999.

[81](#) Tim Reid, “Barack Obama’s ‘Guns and Religion’ Blunder Gives Hillary Clinton a Chance,” *The Times*, April 8, 2008.

[82](#) Free traders have been playing this game for a very long time. One protectionist complained in 1883: “It is the fashion in many of our colleges to assume that free trade is the ideal of the noblest persons and the best minds in the Old World, while protection is a vulgar and selfish matter advocated by those of lesser note and narrower culture.” Giles Badger Stebbins, *The American Protectionist’s Manual* (Detroit: Thorndike Nourse, 1883), p.19.

[83](#) Whether free trade and protectionism are leftist or rightist positions is genuinely controversial, and is addressed in the last chapter of this book. Here, the conventional acceptation of these issues in contemporary American politics is taken as a given.

[84](#) David Croteau, “Challenging the ‘Liberal Media’ Claim: On Economics, Journalists’ Private Views Are to Right of

Public,” *Extra!*, July/August 1998, p. 8.

[85](#) Ibid., p. 5.

[86](#) Speech of January 27, 1846, quoted in Augustus Mongredien, *History of the Free Trade Movement in England* (New York: G.P. Putnam’s Sons, 1881), p.155.

[87](#) Author’s calculations based on first 11 months of 2009. “U.S. International Trade in Goods and Services,” Exhibit 1, U.S. Census Bureau, January 12, 2010, “Annual 2008 Trade Highlights,” U.S. Census Bureau, <http://www.census.gov/foreign-trade/statistics/highlights/annual.html> and “Trade in Goods (Imports, Exports, and Trade Balance) with China,” <http://www.census.gov/foreign-trade/balance/c5700.html#2009>.

html#2009.

[88](#) Eamonn Fingleton, *In the Jaws of the Dragon: America’s Fate Under Chinese Hegemony* (New York: St. Martin’s Press, 2008), p. 66.

[89](#) Income: “Gross national income per capita 2008, Atlas method and PPP,” World Bank, 2008.

Servants: Aakar Patel, “The Servant in the Indian Family,” *The International News*, May 31, 2009.

[90](#) Ron Hira, “The Globalization of Research, Development and Innovation” in Richard McCormack, ed., *Manufacturing a Better Future for America* (Washington: Alliance for American Manufacturing, 2009), p. 171.

[91](#) “Worldwide and U.S. Business Process Outsourcing 2006-2010,” IDC, November 14, 2006.

[92](#) Alan S. Blinder, “Free Trade’s Great, but Offshoring Rattles Me,” *The Washington Post*, May 6, 2007, p. B4.

[93](#) Benno Ndulu, “Challenges of African Growth: Opportunities, Constraints, and Strategic Directions,” World Bank, 2007, p. 33.

[94](#) United Nations Development Programme, “Human Development Report 2003,” UNDP, 2003, p. 34.

[95](#) See p. 151 for details.

96 Author's calculation based on Y. Louise Ku-Graf, "Foreign Direct Investment in the United States: New Investment in 2007," Bureau of Economic Analysis, 2008, p. 34. It can be argued that investment in existing companies enables American capital to be invested in creating new ones, and the situation is considerably more complex than this one statistic can measure, but this fact is strongly suggestive of problems in this area.

97 Most recent data available; author's calculation from "2000 National Occupational Employment and Wage Estimates," Bureau of Labor Statistics, <http://bls.gov/oes/2000/oes170000.htm> and "Occupational Employment and Wages, May 2008," Bureau of Labor Statistics, <http://bls.gov/oes/current/oes170000>.

htm.

98 As phrased by Dani Rodrik of Harvard, "There is no theorem that guarantees that the partial-equilibrium losses to import-competing producers are more than offset by gains to consumers from lower prices." Blog entry of April 28, 2007, http://rodrik.typepad.com/dani_rodriks_weblog/2007/04/can_th accessed November 29, 2009.

99 "Employment, Hours, and Earnings From the Current Employment Statistics Survey (National): Manufacturing Employment - CES3000000001," Bureau of Labor Statistics,

<http://data.bls.gov/cgi-bin/surveymost>.

[100](#) Counting prison inmates as unemployed would raise the male unemployment rate by well over a percentage point, and more for certain ethnic groups. America also has a higher proportion of “McJobs” than many other developed nations.

[101](#) “While per capita income in the United States [in 2006] was 25% higher than the peer average, only 12 of those percentage points can be attributed to higher productivity, whereas 10 percentage points are due to the fact that U.S. workers work more annual hours on average, and 3 percentage points are due to the fact that the United States employs a larger portion of its population.” Lawrence Mishel, Jared Bernstein, and Heidi Shierholz. *The State of Working America 2008-2009* (Ithaca, NY: Cornell University Press, 2009), p. 366.

[102](#) Ibid. p. 380.

[103](#) Paul Krugman, “Trouble With Trade,” *The New York Times*, December 30, 2007.

[104](#) Wolfgang Stolper and Paul Samuelson, “Protection and Real Wages,” *Review of Economic Studies*, November 1941, p. 58.

105 This is not, of course, the entire story, but close enough for purposes of the present analysis.

106 Dani Rodrik, *Has Globalization Gone Too Far?* (Washington: Institute for International Economics, 1997), p. 12. Increased inequality is also the result predicted by Edward Leamer in a three-factor model (unskilled labor, skilled labor, and capital), as reported in “Wage Effects of a U.S.-Mexican Free Trade Agreement,” in *The Mexico-U.S. Free Trade Agreement*, P.M. Garber, ed. (Cambridge, MA: MIT Press, 1993), pp. 57-125.

107 Joseph Stiglitz, *Making Globalization Work* (New York: W.W. Norton & Co, 2006), p.45.

108 Angus Maddison, “Historical Statistics of the World Economy: 1-2006 AD,” University of Groningen, March 2009, http://www.ggdnc.net/maddison/Historical_Statistics/horizontal-file_03-2009.xls.

109 Robert C. Feenstra, *Advanced International Trade: Theory and Evidence* (Princeton, NJ: Princeton University Press, 2004), p. 101.

[110](#) See Peter H. Lindert and Jeffrey G. Williamson, “Does Globalization Make the World More Unequal?” National Bureau of Economic Research, April 2001, p. 33. This is also the upper end of the estimate in “The U.S. Trade Deficit: Causes, Consequences and Recommendations for Action,” U.S. Trade Deficit Review Commission, 2000, pp.110-18. According to William Cline in *Trade and Income Distribution* (Washington: Institute for International Economics, 1997), 37 percent of the recent increase in inequality is due to trade. Also see Thomas Palley, “Accounting for income inequality in the U.S.,” AFL-CIO Technical Papers, 1999, in which 34 percent of increased inequality is attributed to increased trade, taking into account trade’s negative impact on unionization rates.

[111](#) Josh Bivens, “Globalization and American Wages: Today and Tomorrow,” Economic Policy Institute, October 10, 2007, p. 2. Technically, this paper quantifies the impact of larger trade flows as such, not free trade *per se*.

[112](#) “New Wage and Benefit Structure for Entry-Level Employees,” United Auto Workers, <http://www.uaw.org/contracts/07/gm/gm03.php>.

[113](#) Peter Whoriskey, “UAW’s Sacrifices Look to Some Like Surrender,” *The Washington Post*, December 20, 2008.

[114](#) Louis Uchitelle, “Two Tiers, Slipping Into One,” *The New York Times*, February 26, 2006.

[115](#) For an example of free traders depicting trade deficits as a positive good, see the Cato Institute’s Daniel T. Griswold, “The U.S. Trade Deficit: A Sign of Good Times,” testimony before U.S. Trade Deficit Re-view Commission, August 19, 1999.

[116](#) Obviously, this limit can change over time, but that is not the same as its being infinitely elastic at any given time. Bond rating agencies exist for a reason.

[117](#) There is an exception to this fact if we are running a deficit to import capital goods rather than consumption goods. But this just means we are importing goods that make more goods, so we are back to 3a.

[118](#) Gross, not net.

[119](#) These are gross, not net, jobs. The workers who would have been employed building aircraft will presumably (*pace* cyclical and frictional unemployment) find jobs doing *something*.

120 James K. Jackson, “Foreign Ownership of U.S. Financial Assets: Implications of a Withdrawal,” Congressional Research Service, January 14, 2008, p. 1.

121 “U.S. Net International Investment Position at Yearend 2008,” Bureau of Economic Analysis, June 26, 2009, <http://www.bea.gov/newsreleases/international/intinv/2009/inti>

122 Greg Jensen and Jason Rotenberg, “Bridgewater Daily Observations,” Bridgewater Associates, March 25, 2003, p. 1.

123 “International Investment Position of the United States at Yearend, 1976-2008,” Bureau of Economic Analysis, 2009, http://www.bea.gov/international/xls/intinv08_t2.xls.

124 Source: Author’s chart from “U.S. Trade in Goods and Services - Balance of Payments Basis,” U.S. Census Bureau, <http://www.census.gov/foreign-trade/statistics/historical/gands.txt>.

125 2004 data; author’s calculation from David Ratner’s appendix to Robert Scott’s paper, “Revisiting NAFTA,” Economic Policy Institute, 2006, Tables 1-1a, 1-1b. Note that these are *gross* jobs, not net jobs (jobs gained minus jobs lost),

as workers who lose their jobs due to imports will presumably eventually find *some* other jobs, however ill paid. The unemployment rate is primarily a function of the economic cycle and the *de facto* minimum wage, not gains and losses due to trade.

[126](#) Raymond L. Richman et al., *Trading Away Our Future: How to Fix Our Government-Driven Trade Deficits and Faulty Tax System Before It's Too Late* (Pittsburgh: Ideal Taxes Association, 2008), p. 2.

[127](#) “China’s Financial System and Monetary Policies: The Impact on U.S. Exchange Rates, Capital Markets, and Interest Rates,” hearing of U.S.-China Economic and Security Review Commission, August 22, 2006, p. 93.

[128](#) William Bahr, *The Economic Consequences of Blind Faith in Free Trade* (Draft), Ch. 5. William A. Lovett in 2004 estimated that, “With stronger, reciprocity-based trade policy, U.S. GDP could have been 10 to 20 percent higher,” in William Anthony Lovett, Alfred E. Eckes & Richard L. Brinkman, *U.S. Trade Policy: History, Theory and the WTO* (Armonk, NY: M.E. Sharpe & Co., 1999), p. 130. Another estimate of the size of the problem, by economist Charles McMillion of MBG Information Services, notes that in the 25 years up to 1980, our real GDP grew at an average of 3.8 per year. But in the 25 years afterwards, as our trade deficit ballooned, it grew at only 3.1 percent. Charles McMillion, “Guest Editorial: Forever in

Their Debt,” *Manufacturing & Technology News*, October 25, 2006, p. 5.

[129](#) “The Budget and Economic Outlook: Fiscal Years 2009-2019,” Congressional Budget Office, January 2009, Table 5, <http://www.cbo.gov/ftpdocs/99xx/doc9957/01-07-Outlook.pdf>. Includes off-budget spending.

[130](#) James K. Jackson, “Foreign Ownership of U.S. Financial Assets: Implications of a Withdrawal,” Congressional Research Service, January 14, 2008, p. 1.

[131](#) Net international obligations, per Mark Whitehouse, “U.S. Foreign Debt Shows Its Teeth As Rates Climb: Net Payments Remain Small But Pose Long-Term Threat to Nation’s Living Standards,” *The Wall Street Journal*, September 25, 2006, p. A1.

[132](#) Matthew Higgins, Thomas Klitgaard, and Cédric Tille, “Borrowing Without Debt? Understanding the U.S. International Investment Position,” Federal Reserve Bank of New York, 2006, p. 7.

[133](#) As stated in a recent report by BRUEGEL, a think tank in Brussels, the Korea Institute for International Economic Policy in Seoul and the Peterson Institute for International Economics

in Washington: “A market-led adjustment might involve global recession, abrupt and excessive changes in key exchange rates and assets prices, and, as a consequence, aggravated trade friction. The recent volatility in global financial markets is a reminder of the dangers of failing to act promptly.” Alan Ahearne, William R. Cline, Kyung Tae Lee, Yung Chul Park, Jean Pisani-Ferry, and John Williamson, “Global Imbalances: Time for Action,” Peterson Institute for International Economics, March 2007, p. 3.

134 Robert A. Blecker, “The Ticking Debt Bomb: Why the U.S. International Financial Position is Not Sustainable,” Economic Policy Institute, June 1, 1999, p. 11.

135 Lawrence Mishel and Jared Bernstein, “Economy’s Gains Fail to Reach Most Workers’ Paychecks,” Economic Policy Institute, August 30, 2007, Figure A.

136 Most recent data available; strictly speaking, this personal consumption spending. “National Economic Accounts,” Bureau of Economic Analysis, <http://bea.gov/national/nipaweb/TableView.asp?SelectedTable=5&FirstYear=2008&LastYear=2008&Freq=Qtr> and <http://bea.gov/national/nipaweb/TableView.asp?SelectedTable=5&FirstYear=1980&LastYear=1980&Freq=Qtr>.

137 Diana Farrell, Susan Lund, Eva Gerlemann, and Peter Seeburger, “The New Power Brokers: Gaining Clout in

Turbulent Markets,” McKinsey Global Institute, June 2008, p. 20.

[138](#) Ibid., p. 8.

[139](#) Ibid., p. 7.

[140](#) Testimony of David Marchick before U.S.-China Economic & Security Review Commission on “The Extent of the Government’s Control of China's Economy, and its Impact on the United States,” May 24, 2007.

[141](#) Diana Farrell, Susan Lund, Eva Gerlemann, and Peter Seeburger, “The New Power Brokers: Gaining Clout in Turbulent Markets,” McKinsey Global Institute, June 2008, p.7.

[142](#) Testimony of David Marchick Before U.S.-China Economic & Security Review Commission on “The Extent of the Government’s Control of China’s Economy, and its Impact on the United States,” May 24, 2007.

[143](#) “The CPP Fund and CPP Investment Board are not Sovereign Wealth Funds,” Canada Pension Plan Investment Board, December 10, 2007,

http://www.cppib.ca/files/PDF/SWFBkgr_Dec10_2007.pdf.

[144](#) Diana Farrell, Susan Lund, Eva Gerlemann, and Peter Seeburger, “The New Power Brokers: Gaining Clout in Turbulent Markets,” McKinsey Global Institute, June 2008, p. 6.

[145](#) Ibid., p. 6.

[146](#) Ibid., Exhibit 2.

[147](#) Ibid., p. 6.

[148](#) Ibid., p. 9.

[149](#) “CFIUS Annual Report to Congress: November 2009: Public/Unclassified Version,” U.S. Treasury, November 2009, p. 3. 15 transactions were withdrawn during investigation, a fact open to interpretation.

[150](#) Ambassador John Veroneau, “The Challenges of Foreign Investment,” speech to United States Council for International Business, February 26, 2008.

[151](#) Zhou Jiangong, “China on Wall Street: Buy? Yes. Lend? No,” ChinaStakes.com, October 2, 2008.

[152](#) China GDP: “China,” *CIA World Factbook*, Central Intelligence Agency, <https://www.cia.gov/library/publications/the-world-factbook/geos/ch.html>.

U.S. imports from China: “Trade With China: 2008,” U.S. Census Bureau, <http://www.census.gov/foreign-trade/balance/c5700.html#2008>.

[153](#) “China Says Domestic Demand Can’t Fill Export Hole,” Reuters, May 14, 2009.

[154](#) “General Agreement on Tariffs and Trade,” World Trade Organization, 1947, http://www.wto.org/english/docs_e/legal_e/gatt47_01_e.htm.

[155](#) “Articles of Agreement,” International Monetary Fund, 1945, <http://www.imf.org/external/pubs/ft/aa/aa06.htm#3>.

[156](#) One good example for the present analysis is Joseph Stiglitz, “Factor Price Equalization in a Dynamic Economy,” *Journal of Political Economy*, May-June 1970, especially p.

466.

[157](#) Assuming, as *ex hypothesi* in this thought experiment, that the decadent nation is importing consumption goods. If it is importing capital goods, that is, goods which increase its future capacity to produce goods, it may do fine. America has not been doing this.

[158](#) For a detailed working-out of reasoning similar to this, see Joseph E. Stiglitz, “Factor Price Equalization in a Dynamic Economy,” *Journal of Political Economy*, May/June 1970, especially p. 466.

[159](#) See p. 22.

[160](#) Though not by billionaire Warren Buffett who calls the two nations Thriftville and Squanderville and does not examine how deep the theoretical problem goes.

[161](#) Max Weber’s famous point in his 1905 book, *The Protestant Ethic and the Spirit of Capitalism*.

[162](#) Robert W. Parenteau, “U.S. Household Deficit Spending,” Levy Economics Institute, November 2006, p. 8.

163 Author's calculation based on: Debt (\$34.6 trillion): "Flow of Funds Accounts of the United States: Flows and Outstandings Third Quarter 2009," Federal Reserve Bank, December 10, 2009, p. 2. GDP (\$14.24 trillion): "Gross Domestic Product," news release, Bureau of Economic Analysis, December 22, 2009.

164 Don Evans, Hearing before Committee on Financial Services, "U.S. Interests in the Reform of China's Financial Sector," U.S. House of Representatives, June 6, 2007, <http://ftp.resource.org/gpo.gov/hearings/110h/37551.txt>.

165 "The China Effect: Assessing the Impact on the U.S. Economy of Trade and Investment with China," China Business Forum, 2008.

166 During the Clinton administration, U.S. Trade Representative Charlene Barshefsky and Commerce Secretary William M. Daley made this argument.

167 Henry M. Paulson, Jr., Speech before the Economic Club of Washington, March 1, 2007.

168 Gavin Cameron and Christopher Wallace,

“Macroeconomic Performance in the Bretton Woods Era, And After,” University of Oxford, October 2002, pp. 4-5.

[169](#) Former IMF chief economist Simon Johnson, “The Quiet Coup,” *The Atlantic*, May 2009.

[170](#) Kathleen Burke and Alec Cairncross. *Goodbye, Great Britain: The 1976 IMF Crisis* (New Haven, CT: Yale University Press, 1992), p. 5. Whatever economic problems Britain had in this period, excessive debt accumulation and asset sales were not among them.

[171](#) John Maynard Keynes, “Proposal for an International Clearing Union,” in John Maynard Keynes, *The Collected Writings of John Maynard Keynes*, vol. 25 (Cambridge, UK: Cambridge University Press, 1980) p. 170.

[172](#) Jeffrey W. Helsing, *Johnson’s War/Johnson’s Great Society: The Guns and Butter Trap* (Westport, CT: Praeger Publishers, 2000), p. 230.

[173](#) Nixon tried to defend it in 1970 by raising interest rates, but the domestic political fallout proved too great in the face of the 1972 election and he asked the Fed to reverse course.

174 Naomi Klein, *The Shock Doctrine: The Rise of Disaster Capitalism*. (New York: Metropolitan Press, 2007).

175 Dani Rodrik, “The Rush to Free Trade in the Developing World: Why So Late? Why Now? Will It Last?” in Stephan Haggard and Steven B. Webb, eds., *Voting for Reform: Democracy, Political Liberalization and Economic Adjustment* (New York: Oxford University Press, 1994) p. 81.

176 Eamonn Fingleton, *In the Jaws of the Dragon: America’s Fate Under Chinese Hegemony* (New York: St. Martin’s Press, 2008), p. 128.

177 For example, he said upon concluding a round of GATT negotiations in 1993, “This new agreement will foster more jobs and more incomes in America by fostering an export boom.” President Bill Clinton speech, December 15, 1993, quoted in U.S. Department of State Dispatch, December 20, 1993.

178 “U.S. International Trade in Goods and Services, 1992 - Present,” U.S. Census Bureau, http://www.census.gov/foreign-trade/statistics/historical/exhibit_history.xls, 1992 figure adjusted to 2008 dollars using “Gross Domestic Product: Implicit Price Deflator,” Bureau of Economic Analysis, <http://research.stlouisfed.org/fred2/data/GDPDEF.txt>. 2009

figure: author's calculation based on first 11 months of 2009 from "U.S. International Trade in Goods and Services," Exhibit 1, U.S. Census Bureau, January 12, 2010.

179 Author's calculation based on 2008 imports and exports.

180 In 1992, exports to Mexico were \$40.6 billion; in 2008, they were \$151.2 billion. "Trade With Mexico," U.S. Census Bureau, <http://www.census.gov/foreign-trade/balance/c2010.html#2009>. Mexico supplies only 3% of primary materials and packaging, according to, "How Much Maquiladora Output is Made in Mexico," *Cross-Border Economic Bulletin*, June 2001.

181 Author's calculation based on first 11 months of 2009. "U.S. International Trade in Goods and Services," Exhibit 1, U.S. Census Bureau, January 12, 2010.

182 Manufacturing: "Value Added by Industry as a Percentage of Gross Domestic Product," Bureau of Economic Analysis, 2009, http://www.bea.gov/industry/gpotables/gpo_action.cfm?anon=108681&table_id=24753&format_type=0.

Imports: "U.S. International Trade in Goods and Services: Exports, Imports, and Balances," Bureau of Economic Analysis, 2009,

http://www.bea.gov/newsreleases/international/trade/trad_time_

[183](#) See also David Hale, “Don’t Rely on the Dollar to Reduce the Deficit,” *Financial Times*, January 25, 2005.

[184](#) Author’s full-year estimate based on first 11 months of 2009. “U.S. International Trade in Goods and Services,” Exhibit 1, U.S. Census Bureau, January 12, 2010.

[185](#) Author’s calculation based on “Total Value of U.S. Agricultural Trade and Trade Balance, Monthly: updated 1/12/2010,” U.S. Dept. of Agriculture, <http://www.ers.usda.gov/Data/Fatus/DATA/moUStrade.xls>.

[186](#) In any case, this correlation is only true, even in theory, in equilibrium. Given gigantic exogenous shocks like the sudden entry of billions of new workers into the global trading system due to the decline of socialism, the world can potentially be out of equilibrium for decades.

[187](#) Data from “World Cost Curve for Steel Sheet Plants,” World Steel Dynamics, quoted in “Steel Industry Trends,” International Steel Group, 2004, p. 37.

[188](#) This is not to imply, of course, that direct labor is the

only production cost. If it were, American steel makers could obviously never be competitive with these numbers.

189 “Major Sector Productivity and Costs Index,” Bureau of Labor Statistics, <http://data.bls.gov/PDQ/outside.jsp?survey=pr>.

190 10.7%, to be precise. Author’s calculation from “Major Sector Productivity and Costs Index,” Bureau of Labor Statistics, <http://data.bls.gov/cgi-bin/surveymost>.

191 Madeline Zavodny, “Unions and the Wage-Productivity Gap,” *Federal Reserve Bank of Atlanta Economic Review*, Q2 1999, Chart 2. See also Lawrence Mishel, Jared Bernstein, and Heidi Shierholz, *The State of Working America 2008/2009* (Ithaca, NY: Cornell University Press, 2009), Chapter 3, Figure 30.

192 William Greider, *One World, Ready or Not* (New York: Touchstone Press, 1997), p. 75.

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342 Patrick J. Buchanan, *The Great Betrayal: How American Sovereignty and Social Justice Are Being Sacrificed to the Gods of the Global Economy* (New York: Little, Brown and Co., 1998), p. 67.

343 Paul Krugman wrote an entire essay in 1994, “Ricardo’s Difficult Idea,” complaining about how hard it is for people to understand it: <http://web.mit.edu/krugman/www/ricardo.htm>.

344 These are not necessarily the same size units, and prices are left out to keep things simple. The example would work the same way with these complexities added.

345 Absolute advantage is the *difference* in cost for the same product; comparative advantage is the *ratio* of costs for different products.

346 Comparative advantage is so fundamental an economic principle that it applies even outside capitalism; it applied to trade between communist Poland and communist Bulgaria in 1970. The difference is that under communism, there is no free market to make it work automatically thanks to the price system. So central planners must (somehow!) *calculate* the comparative advantages of the trading partners.

347 Ricardo's own example is this: "Two men can both make shoes and hats, and one is superior to the other in both employments; but in making hats he can only exceed his competitor by one-fifth or 20 per cent; and in making shoes he can excel him by one-third or 33 per cent: will it not be in the interest of both that the superior man should employ himself exclusively in making shoes, and the inferior man in making hats?" David Ricardo, *The Principles of Political Economy and Taxation* (Mineola, NY: Dover Publications, 2004), p. 136.

[348](#) Paul A. Samuelson, “Where Ricardo and Mill Rebut and Confirm Arguments of Mainstream Economists Supporting Globalization,” *Journal of Economic Perspectives*, Summer 2004, p. 135.

[349](#) Jorge G. Castañeda and Carlos Heredia et al., *The Case Against Free Trade: GATT, NAFTA, and the Globalization of Corporate Power* (San Francisco: Earth Island Press, 1993), p. 87.

[350](#) Danny M. Leipziger, *Lessons From East Asia* (Ann Arbor, MI: University of Michigan Press, 2001), p. 85.

[351](#) The idea that all voluntary exchanges must be mutually beneficial is misleading anyway, because it says nothing about the context of relative bargaining power in which exchanges take place. It may be mutually beneficial for a starving man to sell his shoes!

[352](#) James Bovard, *The Fair Trade Fraud: How Congress Pillages the Consumer and Decimates American Competitiveness*. (New York: Palgrave Macmillan, 1992), p. 5.

[353](#) *Pace*, for now, other criticisms we will examine later.

[354](#) See pp. 46-48.

[355](#) Joseph Kahn & Jim Yardley, “As China Roars, Pollution Reaches Deadly Extremes,” *The New York Times*, August 25, 2007, p. A1.

[356](#) Partha Dasgupta, “World Poverty: Causes and Pathways,” University of Cambridge, June 2003, p. 16.

[357](#) There are, of course, countervailing pressures due to pollution costs that cannot be externalized, especially at the level of the national economy as a whole, as opposed to the individual firm. This is why China, for example, appears to be now making some efforts to control pollution. And there are also empirical questions on how strong the pro-pollution incentive is. Nevertheless, the underlying dynamic described here is obviously real, regardless of its size.

[358](#) “Genuine Progress Indicator,” Redefining Progress, http://www.rprogress.org/sustainability_indicators/genuine_prc

[359](#) John Cavanagh, Jerry Mander et al, *Alternatives to Economic Globalization: A Better World is Possible* (San Francisco: Berrett-Koehler, 2002), p. 204.

360 The commonly quoted figure of \$70-\$73 per hour for autoworkers includes health benefits and legacy costs. Their cash wages were about \$28/hr, plus \$2.25 for payroll taxes and \$7 for a health insurance package. Source: United Auto Workers.

361 “Average Weekly Hours of Production and Nonsupervisory Workers on Private Nonfarm Payrolls by Industry Sector and Selected Industry Detail,” Bureau of Labor Statistics, July 2, 2009, <http://www.bls.gov/news.release/empsit.t15.htm>. This does not contradict the fact, noted earlier, that Americans generally work longer hours than workers in other Western developed nations because these other nations have workweeks that are even *shorter* than ours. See “Annual Hours Worked: Per Capita and Per Worker, 2008,” Organization for Economic Cooperation and Development, 2009, <http://stats.oecd.org/Index.aspx?DataSetCode=ANHRS>.

362 World Bank figure, quoted in John MacArthur, *The Selling of Free Trade: NAFTA, Washington, and the Subversion of American Democracy* (New York: Hill & Wang, 2000) p. 81.

363 Sherrod Brown, *Myths of Free Trade: Why America's Trade Policies Have Failed* (New York: The New Press, 2004),

p. 137.

[364](#) Lower consumer prices are equivalent to a higher real (inflation-adjusted) wage.

[365](#) When we noted in Chapter 2 that deficit trade costs jobs in the present, these are gross, not net, jobs.

[366](#) Betty McGrath, Employment Security Commission of North Carolina, statement before U.S.-China Economic and Security Review Commission, September 6, 2007, p. 3.

[367](#) Bureau of Labor Statistics, quoted in Louis Uchitelle, “Retraining Laid-Off Workers, But for What?” *The New York Times*, March 26, 2006.

[368](#) Quoted in Robert Kuttner, *Everything for Sale: the Virtues and Limits of Markets* (New York: Knopf, 1997), p. 25.

[369](#) See <http://upload.wikimedia.org/wikipedia/en/4/4d/EffectOfTariff.s>

[370](#) See http://upload.wikimedia.org/wikipedia/commons/0/0a/Actual_p

[371](#) Dani Rodrik, *Has Globalization Gone Too Far?* (Washington: Institute for International Economics, 1997), p. 30.

[372](#) See p. 34.

[373](#) It is also the reason why economics recognizes such a subject as international trade, with facts and principles different from domestic economics.

[374](#) David Ricardo, *The Principles of Political Economy and Taxation* (Mineola, NY: Dover Publications, 2004), p. 83.

[375](#) Ibid.

[376](#) In technical terms, there is no theorem guaranteeing that partial-equilibrium losses to import-competing producers are more than offset by gains to consumers due to reduced prices. This problem has been formally modeled in Masao Oda and Robert Stapp, “Factor Mobility, Trade, and Wage Inequality,” in Takashi Kamihigashi and Laixun Zhao, eds., *International Trade and Economic Dynamics* (Berlin: Springer, 2008).

[377](#) David Ricardo, *The Principles of Political Economy and Taxation* (Mineola, NY: Dover Publications, 2004), p. 83.

[378](#) Lance E. Davis, Robert E. Gallman, *Evolving Financial Markets and International Capital Flows: Britain, the Americas, and Australia, 1865-1914* (Cambridge, UK: Cambridge University Press, 2001), p. 58.

[379](#) Michael Porter, *The Competitive Advantage of Nations* (New York: The Free Press, 1990), p. 21.

[380](#) Nathan Rosenberg, *Inside the Black Box: Technology and Economics*. (New York: Cambridge University Press, 1982), p. 73.

[381](#) Remember that this toy example only works if all trade between Canada and the U.S. is barter of corn and wheat. For a fully computed analysis of this whole problem, see Paul A. Samuelson, “Where Ricardo and Mill Rebut and Confirm Arguments of Mainstream Economists Supporting Globalization,” *Journal of Economic Perspectives*, Summer 2004, p. 141.

[382](#) Paul A. Samuelson, “Where Ricardo and Mill Rebut and Confirm Arguments of Mainstream Economists Supporting

Globalization,” *Journal of Economic Perspectives*, Summer 2004.

[383](#) “International Trade for a Rich Country,” lecture before the Swedish-American Chamber of Commerce, New York City, May 10, 1972 (Stockholm: Federation of Swedish Industries pamphlet, 1972). Samuelson won the Nobel Prize in 1970.

[384](#) Ricardo also noted this problem in Chapter 7 of the *Principles* (the main chapter on foreign trade): “England exported cloth in exchange for wine because, by so doing, her industry was rendered more productive to her; she had more cloth and wine than if she had manufactured both for herself; and Portugal imported cloth and exported wine because the industry of Portugal could be more beneficially employed for both countries in producing wine. But let there be more difficulty in England in producing cloth, or in Portugal in producing wine, or let there be more facility in England in producing wine, or in Portugal in producing cloth, and the trade must immediately cease.” David Ricardo, *The Principles of Political Economy and Taxation* (Mineola, NY: Dover Publications, 2004), p. 86.

[385](#) Paul Samuelson, “Mathematical Vindication of Ricardo on Machinery,” *Journal of Political Economy*, April 1988, p. 21. The actual passages to which Samuelson refers are not quoted here because they are drawn out and abstruse, but may

be found in David Ricardo, *The Principles of Political Economy and Taxation* (Mineola, NY: Dover Publications, 2004), pp. 263-271.

[386](#) Assuming nations have different opportunity cost ratios.

[387](#) See p. 230.

[388](#) *Pace*, for now, other problems we will look at later.

[389](#) This is not true *by definition*; it is empirically true most of the time, other things being equal.

[390](#) Stephen Tokarick, “Quantifying the Impact of Trade on Wages: the Role of Nontraded Goods,” International Monetary Fund, 2002, p. 14.

[391](#) This phenomenon is familiar domestically, too. The high wage auto industry famously propped up wages in the industrial Midwest for decades during its heyday.

[392](#) See Frank Ackerman, “The Shrinking Gains From Trade: A Critical Assessment of Doha Round Projections,” Global Development and Environment Institute, Tufts University,

2005.

[393](#) Ibid., p. 19.

[394](#) That is, prior to the thinking of John Maynard Keynes (1883-1946), the British economist who revolutionized economic theory and practice by understanding how economies do *not* naturally reach an equilibrium of full employment, and how deficit spending can help economies climb out of recessions.

[395](#) Frank Ackerman, “The Shrinking Gains From Trade: A Critical Assessment of Doha Round Projections,” Global Development and Environment Institute, Tufts University, 2005.

[396](#) See, for example, Scott Bradford, Paul Grieco, and Gary Clyde Hufbauer, “The Payoff to America from Global Integration,” in C. Fred Bergsten, ed., *The United States and the World Economy: Foreign Economic Policy for the Next Decade* (Washington: Institute for International Economics, 2005).

[397](#) Josh Bivens, “Marketing the Gains from Trade,” Economic Policy Institute, June 19, 2007.

[398](#) Michael Porter, *The Competitive Advantage of Nations* (New York: The Free Press, 1990), p. 12.

[399](#) Most economics PhD programs no longer even require economic history.

[400](#) See Douglas Irwin's review of Ha Joon Chang, *Kicking Away the Ladder—Development Strategy in Historical Perspective* (London: Anthem Press, 2002) , <http://eh.net/bookreviews/library/0777>.

[401](#) “About Us,” *The Economist*, http://www.economist.com/about/about_economist.cfm.

[402](#) Ha-Joon Chang, *Kicking Away the Ladder: Development Strategy in Historical Perspective* (London: Anthem Press, 2003), pp. 20-22.

[403](#) William Cunningham, *The Rise and Decline of the Free Trade Movement* (London: Cambridge University Press, 1914), p. 133.

[404](#) The term England is used to refer to England prior to

union with Scotland in 1707.

[405](#) Erik S. Reinert and Arno M. Daastøl, “The Other Canon: The History of Renaissance Economics,” p. 34, in Erik S. Reinert, ed., *Globalization, Economic Development and Inequality: An Alternative Perspective* (Cheltenham, UK: Edward Elgar, 2004).

[406](#) Eric Reinert, *How Rich Countries Got Rich and Why Poor Countries Stay Poor* (New York: Carroll & Graf, 2007), p. 79.

[407](#) John M. Culbertson, *The Trade Threat and U.S. Trade Policy* (Madison, WI: 21st Century Press, 1989) p. 52.

[408](#) Modern economics, that is, as distinct from the *oikonomia* (literally, household management) of the ancient world and the economic theology of the Middle Ages with its just-price theory, etc.

[409](#) See, for example, the pro-free trade but otherwise fairly wise William Bernstein, *A Splendid Exchange: How Trade Shaped the World* (New York: Atlantic Monthly Press, 2008), p. 257.

[410](#) A good analytical summary of its policies appears in Eric

Reinert, *How Rich Countries Got Rich and Why Poor Countries Stay Poor* (New York: Carroll & Graf, 2007), p. 82.

[411](#) Eric Reinert, *How Rich Countries Got Rich and Why Poor Countries Stay Poor* (New York: Carroll & Graf, 2007), p. 87.

[412](#) John Maynard Keynes, *The General Theory of Employment, Interest and Money* (Cambridge, UK: Cambridge University Press, 1936), Chapter 23.

[413](#) Mehdi Shafaeddin, “How Did Developed Countries Industrialize? The History of Trade and Industrial Policy: The Cases of Great Britain and the U.S.A,” United Nations Conference on Trade and Development, December 1998, Table 2.

[414](#) This is not to say that this is the only way of dealing with the problem. Export of capital goods can be a good thing if a nation is successfully following a strategy of exporting capital goods.

[415](#) Peter Schweitzer, “On the Other Invisible Hand...Was Adam Smith, Fabled Free Trader, A Crypto-Protectionist?” *The Washington Post*, July 22, 1990. See also Eric Reinert, *How Rich Countries Got Rich and Why Poor Countries Stay Poor* (New York: Carroll & Graf, 2007), p. 133.

[416](#) Donald Grove Barnes, *A History of the English Corn Laws: From 1660-1846* (Abingdon, UK: Routledge, 2006), p. 291.

[417](#) Imposing free trade in Britain was a progressive process, with true free trade arguably being attained not before 1860.

[418](#) Ronald Findlay and Kevin O'Rourke, *Power and Plenty: Trade, War, and the World Economy in the Second Millennium* (Princeton, NJ: Princeton University Press, 2007), p. 330.

[419](#) See David Cannadine's *The Decline and Fall of the British Aristocracy* (New Haven, CT: Yale University Press, 1990).

[420](#) William Anthony Lovett, Alfred E. Eckes & Richard L. Brinkman, *U.S. Trade Policy: History, Theory and the WTO* (Armonk, NY: M.E. Sharpe & Co., 1999), p. 3.

[421](#) Paul Bairoch, *Economics and World History: Myths and Paradoxes* (Chicago: University of Chicago Press, 1993), p. 46.

[422](#) Lord Goderich during a debate on abrogation of the

Treaty of Methuen, as quoted in Giles Badger Stebbins, *The American Protectionist's Manual* (Detroit: Thorndike Nourse, 1883), p. 26.

[423](#) Peter Matthias et al, *Cambridge Economic History of Europe* (Cambridge, UK: Cambridge University Press, 1989), p. 62.

[424](#) Kevin O'Rourke, "Tariffs and Growth in the Late 19th Century," *The Economic Journal*, April 2000. O'Rourke calculates that a 10% increase in average tariffs was associated with increased growth of nearly 0.2% a year.

[425](#) B.R. Mitchell and Phyllis Deane, *Abstract of British Historical Statistics* (Cambridge, UK: Cambridge University Press, 1971), pp. 520-21.

[426](#) John P. Creegan, *America Asleep: The Free Trade Syndrome and the Global Economic Challenge* (Washington: U.S. Industrial Council Educational Foundation, 1992), p. 59.

[427](#) John Campbell, *F.E. Smith, First Earl of Birkenhead* (London: J. Cape, 1983), p. 192.

[428](#) Technically, Chamberlain was a Liberal Unionist, a

breakaway faction of the Liberal party that functioned as Conservatives, ultimately merging with them in 1912.

[429](#) C.W. Boyd, ed., *Mr. Chamberlain's Speeches*, vol. 2 (London: Houghton Mifflin, 1914), p. 428.

[430](#) Thomas Friedman, *The Lexus and the Olive Tree: Understanding Globalization* (New York: Anchor Books, 1999), p. xvii.

[431](#) Sonali Deraniyagala and Ben Fine, "New Trade Theory Versus Old Trade Policy: A Continuing Enigma," *Cambridge Journal of Economics*, November 2001, p. 3.

[432](#) William Cunningham, *The Case Against Free Trade* (London: John Murray, 1911), p. 142.

[433](#) Walt Whitman Rostow, *The World Economy: History & Prospect* (Austin, TX: University of Texas Press, 1978), Table II-2.

[434](#) Merrill D. Peterson, *The Jefferson Image in the American Mind* (Charlottesville, VA: University Press of Virginia, 1998), p. 24.

[435](#) Claude Halstead Van Tyne, *The Causes of the War of Independence* (New York: Houghton Mifflin, 1922), p. 65.

[436](#) The Tariff Act of 1789 (1 Stat. 24), July 4, 1789.

[437](#) Alexander Hamilton, *Report on the Subject of Manufactures: Made in His Capacity of Secretary of the Treasury* (Philadelphia: William Brown, 1827), p. 29.

[438](#) *Ibid.*, pp. 50-61. Explanations adapted from Ha-Joon Chang, *Bad Samaritans: the Myth of Free Trade and the Secret History of Capitalism* (New York: Bloomsbury Press, 2008), p. 232.

[439](#) Alexander Hamilton, *Report on the Subject of Manufactures: Made in His Capacity of Secretary of the Treasury* (Philadelphia: William Brown, 1827).

[440](#) Cynthia Clark Northrup, *The American Economy: A Historical Encyclopedia* (Santa Barbara, CA: ABC-CLIO, 2003), p. 233.

[441](#) Emory R. Johnson et al., *History of the Domestic and Foreign Commerce of the United States* (Washington: Carnegie Institute, 1915), vol. 2, p. 35.

[442](#) Ha-Joon Chang, *Bad Samaritans: the Myth of Free Trade and the Secret History of Capitalism* (New York: Bloomsbury Press, 2008), p. 51.

[443](#) President James Buchanan supported tariffs for revenue-raising purposes only, not as a spur to industrial development, which put him on the low-tariff or anti-tariff side of the issue as framed in his day.

[444](#) Alfred E. Eckes, Jr., *Opening America's Market: U.S. Foreign Trade Since 1776* (Chapel Hill, NC: University of North Carolina Press, 1995), p. 57. Carey was described by Karl Marx as the only important American economist; Marx

understood perfectly how tariff-based paternalism threatened his communist alternative.

[445](#) For a discussion of why a slave-based society has difficulty industrializing in the American context, see Fred Bateman and Thomas Weiss, *A Deplorable Scarcity: The Failure of Industrialization in the Slave Economy* (Chapel Hill, NC: University of North Carolina Press, 2002), p. 29 and following. Not only do slaves adapt poorly to jobs requiring technical skill and self-supervision, but slave-holding elites see new industries (which they cannot themselves enter) as threats to their power and as requiring undesirable social policies such as mass literacy.

[446](#) Alfred E. Eckes, Jr., *Opening America's Market: U.S. Foreign Trade Since 1776* (Chapel Hill, NC: University of North Carolina Press, 1995), p. 59.

[447](#) Article I, Section 8, Clause 1.

[448](#) Eric Reinert, *How Rich Countries Got Rich and Why Poor Countries Stay Poor* (New York: Carroll & Graf, 2007), p. 85.

[449](#) William Anthony Lovett, Alfred E. Eckes & Richard L. Brinkman, *U.S. Trade Policy: History, Theory and the WTO* (Armonk, NY: M.E. Sharpe & Co., 1999), p. 48.

[450](#) William Graham Sumner, *Protectionism, the Ism That Teaches That Waste Makes Wealth* (New York: Henry Holt and Co., 1885).

[451](#) Karl Marx, “Speech to the Democratic Association of Brussels at its Public Meeting of January 9, 1848” in *Marx & Engels Collected Works, Volume 6* (London: International Publishers, 1975), p. 450.

[452](#) *Congressional Record*, May 6, 1913.

[453](#) William Graham Sumner, *Protectionism, the Ism That Teaches That Waste Makes Wealth* (New York: Henry Holt and Co., 1885), p. 28.

[454](#) Alfred E. Eckes, Jr., *Opening America’s Market: U.S. Foreign Trade Since 1776* (Chapel Hill, NC: University of North Carolina Press, 1995), p. 46.

[455](#) Ibid.

[456](#) William Anthony Lovett, Alfred E. Eckes & Richard L. Brinkman, *U.S. Trade Policy: History, Theory and the WTO*

(Armonk, NY: M.E. Sharpe & Co., 1999), p. 49.

[457](#) Source: author's chart from "Merchandise imports and duties, 1790-2000," Table Ee424 -430 in *Historical Statistics of the United States, Earliest Times to the Present*, edited by Susan B. Carter et al. New York: Cambridge University Press, 2006.

[458](#) Ramesh Ponnuru, "The Full McCain: an Interview," *National Review*, March 5, 2007.

[459](#) See Chapter 7 of his book with Anna Jacobson Schwartz, *A Monetary History of the United States, 1867-1960*, which was cited in the Nobel presentation speech as part of the reason for his award.

[460](#) William J. Bernstein, *A Splendid Exchange: How Trade Shaped the World* (New York: Atlantic Monthly Press, 2008), p. 354.

[461](#) Comparison between trade under the Fordney-McCumber tariff in 1930 and to trade under the Smoot-Hawley tariff in 1931. From Alfred E. Eckes, Jr., *Opening America's Market: U.S. Foreign Trade Since 1776* (Chapel Hill, NC: University of North Carolina Press, 1995), p. 107. The effects of Smoot-Hawley were also blunted by currency depreciation in

America's major trading partners.

[462](#) Alfred Eckes, Jr., *Opening America's Market: U.S. Foreign Trade Policy Since 1776* (Chapel Hill, NC: University of North Carolina Press, 1995), p. 106.

[463](#) In fact, America *cut* its tariff just before the recessions of 1857 and 1872. Alfred E. Eckes, Jr., *Opening America's Market: U.S. Foreign Trade Since 1776* (Chapel Hill, NC: University of North Carolina Press, 1995), p. 112.

[464](#) Peter Temin, *Lessons From the Great Depression* (Cambridge, MA: MIT Press, 1989), p. 46.

[465](#) Alfred Eckes Jr., quoted in Sherrod Brown, *Myths of Free Trade: Why America's Trade Policies Have Failed* (New York: New Press, 2004), p. 180.

[466](#) This myth has its origin in the need of supply-side crank economists for an alternative explanation of the Great Depression. Paul Krugman, *Peddling Prosperity: Economic Sense and Nonsense in an Age of Diminished Expectations* (New York: W.W. Norton & Co., 1994), p. 93.

[467](#) Gertrud Fremling, "Did the United States Transmit the

Great Depression to the Rest of the World?” *American Economic Review*, December 1985.

[468](#) Cordell Hull, *The Memoirs of Cordell Hull* (New York: Macmillan Company, 1948), p. 81.

[469](#) Cynthia Clark Northrup and Elaine C. Prange Turney, *Encyclopedia of Tariffs and Trade in U.S. History* (Westport, CT: Greenwood Press, 2003) p. 172.

[470](#) Michael A. Butler, *Cautious Visionary: Cordell Hull and Trade Reform, 1933-1937* (Kent, OH: Kent State University Press, 1998), Chapters 2, 3, 4.

[471](#) Alfred E. Eckes, Jr., *Opening America’s Market: U.S. Foreign Trade Since 1776* (Chapel Hill, NC: University of North Carolina Press, 1995), p. 143.

[472](#) Nitsan Chorev, *Remaking U.S. Trade Policy: From Protection to Globalization* (Ithaca, NY: Cornell University Press, 2007), p. 57.

[473](#) Douglas A. Irwin, “The GATT’s Contribution to Economic Recovery in Post-War Western Europe,” Board of Governors of the Federal Reserve System, March 1993, p. 10.

[474](#) Trade surplus: E.A. Brett, *The World Economy Since the War*, (Santa Barbara, CA: Praeger Publishers, 1985), p. 106.
GDP: “Gross Domestic Product,” Bureau of Economic Analysis,
<http://www.bea.gov/national/nipaweb/TableView.asp?SelectedTable=5>.

[475](#) Alfred E. Eckes, Jr., *Opening America’s Market: U.S. Foreign Trade Since 1776* (Chapel Hill, NC: University of North Carolina Press, 1995), p. xix.

[476](#) Stephen D. Cohen, Robert A. Blecker, and Peter D. Whitney, *Fundamentals of U.S. Foreign Trade Policy: Economics, Politics, Laws, and Issues* (Boulder, CO: Westview Press, 2003), p. 36.

[477](#) Eric Reinert, *How Rich Countries Got Rich and Why Poor Countries Stay Poor* (New York: Carroll & Graf, 2007), p. 180.

[478](#) Alfred Eckes, Jr., *Opening America’s Market: U.S. Foreign Trade Policy Since 1776* (Chapel Hill, NC: University of North Carolina Press, 1995), p. 158

[479](#) Unpublished pages from “memoirs,” Truman Library,

Independence, Missouri, quoted in Alfred E. Eckes, Jr., *U.S. Trade Policy: History, Theory, and the WTO* (Armonk, NY: M.E. Sharpe, 2004), p. 62.

[480](#) The phrase is from a famous speech by Soviet Premier Nikita Khrushchev in 1956.

[481](#) In the words of historian and former chairman of the U.S. International Trade Commission Alfred Eckes, “Viewed from a historical perspective, the Kennedy Round was a watershed. In each of the seventy-four years from 1893 to 1967 the United States ran a merchandise trade surplus (exports of goods exceeded imports). During the 1967-72 implementation period for Kennedy Round concessions, the U.S. trade surplus vanished and a sizable deficit emerged.” From Alfred E. Eckes, Jr., *Opening America’s Market: U.S. Foreign Trade Policy Since 1776*. (Chapel Hill, NC: University of North Carolina Press, 1995), p.202.

[482](#) Alfred E. Eckes, Jr., *U.S. Trade Policy: History, Theory, and the WTO* (Armonk, NY: M.E. Sharpe, 2004), p. 204.

[483](#) *Ibid.*, p. 197.

[484](#) Galbraith to Johnson, March 11, 1964, White House Central File, Lyndon B. Johnson Library, Austin, TX, quoted in

Alfred E. Eckes, Jr., *Opening America's Market: U.S. Foreign Trade Policy Since 1776*. (Chapel Hill, NC: University of North Carolina Press, 1995), p. 202.

[485](#) “U.S. International Transactions Accounts Data,” Bureau of Economic Analysis, <http://www.bea.gov/international/xls/table1.xls>.

[486](#) Interview, “Fritz Hollings on How to Make Government Work for American Manufacturers,” *Manufacturing & Technology News*, August 29, 2008, p. 8.

[487](#) Lewis Branscomb, ed., *Empowering Technology: Implementing a U.S. Strategy* (Cambridge, MA: MIT Press, 1993), p. 64.

[488](#) The aim was to force other nations to revalue their currencies to save the Bretton Woods system of fixed exchange rates. This happened, resulting in the Smithsonian Agreement of 1971—which collapsed shortly thereafter due to domestic economic problems in the U.S. Cynthia Northrup, *The American Economy: A Historical Encyclopedia*, (Santa Barbara, CA: ABC-CLIO, 2003), p. 260.

[489](#) John B. Judis, *The Paradox of American Democracy* (New York: Routledge, 2001), p. 114.

[490](#) Nitsan Chorev, *Remaking U.S. Trade Policy: From Protection to Globalization*. (Ithaca, NY: Cornell University Press, 2007), p. 89.

[491](#) The VRA was instigated at the end of the Carter administration, but Reagan chose to go through with it.

[492](#) For a list of Reagan's protectionist acts, see Sheldon L. Richman, "Ronald Reagan: Protectionist," *The Free Market*, May 1988.

[493](#) William Anthony Lovett, Alfred E. Eckes and Richard L. Brinkman, *U.S. Trade Policy: History, Theory and the WTO* (Armonk, NY: M.E. Sharpe & Co., 1999), p. 149.

[494](#) See Eamonn Fingleton, *Blindside: Why Japan is Still on Track to Overtake the U.S. by the Year 2000* (New York: Houghton Mifflin, 1995) or Robert Locke, "Japan, Refutation of Neoliberalism," *Post-Autistic Economics Review*, January 2004.

[495](#) Kozo Yamamura, "Caveat Emptor: the Industrial Policy of Japan" in Paul Krugman, ed., *Strategic Trade Policy and the New International Economics* (Cambridge, MA: MIT Press,

1987), p. 177.

[496](#) Transcription from Meeting, March 26, 1955, International Trade Files, RG 43, National Archives; quoted in William A. Lovett, Alfred E. Eckes, Jr. and Richard L. Brinkman, *U.S. Trade Policy: History, Theory, and the WTO* (Armonk, NY: M.E. Sharpe, 2004), p. 64.

[497](#) UBS and Goldman Sachs' internal estimates are that the average cost of capital in Japan is about 4%, vs. 8% in the U.S. See Robertson Morrow, "The Bull Market in Politics," Clarium Capital Management, February 2008, p. 10.

[498](#) "2008 Production Statistics," International Organization of Motor Vehicle Manufacturers, <http://oica.net/2008-production-statistics>.

[499](#) This is used as a not-unjustified term of convenience, not as a detailed cultural analysis.

[500](#) Roy Hofheinz, Jr. and Kent E. Calder, *The Eastasia Edge* (New York: Basic Books, 1982) p. 46.

[501](#) 2007 figure, excluding enterprises with annual sales below 5 million renminbi. Ligang Song and Wing Thye Woo,

eds., *China's Dilemma: Economic Growth, the Environment and Climate Change* (Washington: Brookings Institution Press, 2008), p. 164. For an analysis of the enduring significance of state-owned enterprises in China, see Xiao Geng, Xiuke Yang, and Anna Janus, "State-owned Enterprises in China: Reform Dynamics and Impacts," in *China's New Place in a World in Crisis: Economic, Geopolitical and Environmental Dimensions* (Canberra: Australian National University Press, 2009).

[502](#) Mikael Mattlin, "Chinese Strategic State-owned Enterprises and Ownership Control," Brussels Institute of Contemporary China Studies, p. 13.

[503](#) Kaname Akamatsu, "A Historical Pattern of Economic Growth in Developing Countries," *Journal of Developing Economies*, March-August 1962. Also see http://www.bookrags.com/wiki/Flying_Geese_Paradigm for a summary of different forms of this concept.

[504](#) The exact quote is: "Yet there is a dirty little secret in international trade analysis. The measurable costs of protectionist policies—the reductions in real income that can be attributed to tariffs and import quotas—are not all that large." Paul Krugman, "Dutch Tulips and Emerging Markets: Another Bubble Bursts," *Foreign Affairs*, July/August 1995. Krugman has identified some exceptions to free trade that he accepts, such as environmental externalities; see his blog entry of June 26, 2009,

<http://krugman.blogs.nytimes.com/2009/06/26/the-wto-is-making-sense/>. See also arch-free trader Jagdish Bhagwati: “Ever since the Harberger-Johnson estimates of the cost of protection, measured as the deadweight losses (the so-called Harberger triangles) that typically ran at 2-3 percent of GDP, there has been a sense that, even if free trade is the best policy, protection is not anything you need to worry about too much since the cost of it is rather small,” in Jagdish Bhagwati, *Free Trade Today* (Princeton, NJ: Princeton University Press, 2002), p. 33.

[505](#) This is not intended to be a literal demonstrative economic argument, only an illustration to establish intuitive plausibility.

[506](#) “Gross Domestic Product,” Bureau of Economic Analysis, <http://www.bea.gov/newsreleases/>

[international/trade/trad_time_series.xls](http://www.bea.gov/newsreleases/international/trade/trad_time_series.xls).

[507](#) Excepting microstates Aruba, Bermuda, and Monaco. “GDP, Per Capita GDP - US Dollars,” National Accounts Main Aggregates Database, United Nations Statistics Division, <http://unstats.un.org/unsd/snaama/selbasicFast.asp>, accessed January 15, 2010.

[508](#) “The Economic Effects of Significant U.S Import Restraints: Fifth Update 2007,” United States International Trade Commission, February 2007, p. xvii.

[509](#) “2008 Industry Review,” National Confectioners Association, p. 23, <http://www.candyusa.com/files/>

2008_Annual_%20Review.ppt.

[510](#) \$811 million, from “The Economic Effects of Significant U.S Import Restraints: Fifth Update 2007,” United States International Trade Commission, February 2007, p. xxiii.

[511](#) See, for example, Kym Anderson, Will Martin, and Dominique van der Mensbrughe, “Doha Policies: Where are the Pay-offs?” in Richard Newfarmer, ed., *Trade, Doha, and Development: A Window into the Issues* (Washington: World Bank Publications, 2005).

[512](#) Frank Ackerman, “The Shrinking Gains From Trade: A Critical Assessment of Doha Round Projections,” Global Development and Environment Institute, Tufts University, 2005, p. 2.

[513](#) Ibid.

[514](#) Ibid., p. 8.

[515](#) Both models use the same raw data from GTAP.

[516](#) Source: Frank Ackerman, “The Shrinking Gains From Trade: A Critical Assessment of Doha Round Projections,” Global Development and Environment Institute, Tufts University, 2005, p. 3.

[517](#) Frank Ackerman, “The Shrinking Gains From Trade: A Critical Assessment of Doha Round Projections,” Global Development and Environment Institute, Tufts University, 2005, p. 3. There is a 2008 GTAP database, but no model has yet been generated from it.

[518](#) “Fortune 500 2009,” *Fortune*, May 4, 2009.

[519](#) Frank Ackerman, “The Shrinking Gains From Trade: A Critical Assessment of Doha Round Projections,” Global Development and Environment Institute, Tufts University, 2005, p. 8.

[520](#) Ibid., p. 5.

[521](#) Ibid., p. 9.

[522](#) Ibid., p. 5.

[523](#) Mark Weisbrot, David Rosnick and Dean Baker, “Poor Numbers: The Impact of Trade Liberalization on World Poverty,” Center for Economic and Policy Research, 2004, p. 6.

[524](#) The logic we examined in Chapter 5, according to which any nation, no matter how rich or poor, can realize gains from trade runs afoul of the various flaws in the theory of comparative advantage noted in that chapter. This logic also does not guarantee that gains from trade will clear the hurdle imposed by transaction costs, which include everything from transportation to political corruption. Therefore it is entirely possible for some nations to derive no benefit from trade in practice.

[525](#) Frank Ackerman, “The Shrinking Gains From Trade: A Critical Assessment of Doha Round Projections,” Global Development and Environment Institute, Tufts University, 2005, p. 7.

[526](#) Robin Broad and John Cavanagh, “Global Economic

Apartheid,” in John Cavanagh, Jerry Mander et al., *Alternatives to Economic Globalization: A Better World is Possible* (San Francisco: Berrett-Koehler, 2002), p. 34.

[527](#) “2008 World Development Indicators: Poverty Data Supplement,” The World Bank, 2008, p. 10.

[528](#) Ibid., p. 11.

[529](#) There is some evidence that Cuba, though not North Korea, has actually performed better than conventional GDP measures suggest.

[530](#) “The human poverty index is just under 20% in coastal provinces, but more than 50% in inland Guizhou,” per “Human Development Report 1999,” United Nations Development Programme, p. 3.

[531](#) Statement of Joshua Muldavin, Hearing on “Major Internal Challenges Facing the Chinese Leadership” before the U.S.–China Economic and Security Review Commission, U.S. House of Representatives, February 2-3, 2006, p. 95.

[532](#) Theo Sommer, “Is the 21st Century Going to be the Asian Century,” *Asien*, July 2006, p. 74.

[533](#) Statement of Joshua Muldavin, Hearing on “Major Internal Challenges Facing the Chinese Leadership” before the U.S.–China Economic and Security Review Commission, U.S. House of Representatives, February 2-3, 2006, p. 95.

[534](#) Branko Milanovic, *Worlds Apart: Measuring International and Global Inequality* (Princeton, NJ: Princeton University Press, 2005), p. 78.

[535](#) Ricardo Hausmann and Dani Rodrik, “Doomed to Choose: Industrial Policy as Predicament,” John F. Kennedy School of Government, Harvard University, 2006, p. 3.

[536](#) Kevin Watkins, ed., “Human Development Report 2005,” United Nations Development Programme, 2005, p. 37.

[537](#) Branko Milanovic, *Worlds Apart: Measuring International and Global Inequality* (Princeton, NJ: Princeton University Press, 2007), p. 47.

[538](#) *Ibid.*, p. 61.

[539](#) Syed Mansoob Murshed, “The Conflict–Growth Nexus

and the Poverty of Nations,” Institute of Social Studies, 2007, p. 2.

[540](#) Eric S. Reinert, *How Rich Countries Got Rich and Why Poor Countries Stay Poor* (New York: Carroll & Graf, 2007), pp. 161-4.

[541](#) Ibid.

[542](#) Ibid., pp. 161-4, 183.

[543](#) Jose Antonio Ocampo, Jomo K.S. and Rob Vos, *Explaining Growth Divergences* (New York: Zed Books, 2007), p. 161.

[544](#) John Cavanagh, Jerry Mander et al., *Alternatives to Economic Globalization: A Better World is Possible* (San Francisco: Berrett-Koehler, 2002), p. 214.

[545](#) Eric Reinert, “International Trade and the Economic Mechanisms of Underdevelopment,” PhD diss., Cornell University, 1980.

[546](#) Years 1990-3. “Trade with Canada: 1990, 1991, 1992,

1993,” U.S. Census Bureau, <http://www.census.gov/foreign-trade/balance/c1220.html#1990>.

[547](#) “Trade with Canada: 2006,” Census Bureau, <http://www.census.gov/foreign-trade/balance/c1220.html#2006>.

[548](#) “Trade with Mexico: 1993,” Census Bureau, <http://www.census.gov/foreign-trade/balance/c2010.html#1993>.

[549](#) “Trade with Mexico: 2007,” Census Bureau, <http://www.census.gov/foreign-trade/balance/c2010.html#2007>.

[550](#) Based on the number of workers certified as displaced by imports by the NAFTA Transitional Adjustment Assistance (NAFTA-TAA) program. See Gary Clyde Hufbauer and Jeffrey Schott, *NAFTA Revisited: Achievements and Challenges* (Washington: Institute for International Economics, 2005) p. 41.

[551](#) Bruce Campbell, Carlos Salas, and Robert E. Scott, Economic Policy Institute, “NAFTA at Seven: Its Impact on the Workers in all Three Nations,” Economic Policy Institute, April 2001.

[552](#) *Business Mexico*, April 1997.

[553](#) John R. MacArthur, *The Selling of “Free Trade”:
NAFTA, Washington, and the Subversion of American
Democracy* (New York: Hill and Wang, 2000), p. 81.

[554](#) Paul Krugman, “The Uncomfortable Truth about NAFTA:
It’s Foreign Policy, Stupid,” *Foreign Affairs*, November 1993.

[555](#) Ibid.

[556](#) Paul Krugman, “How is NAFTA Doing? It’s Been Hugely
Successful—As a Foreign Policy,” *The New Democrat*,
May/June 1996.

[557](#) Joseph Stiglitz, *Making Globalization Work* (New York:
W.W. Norton & Co., 2006), p. 64.

[558](#) Ibid.

[559](#) Stiglitz, Joseph, “The Broken Promise of NAFTA,” *The
New York Times*, Jan 6, 2004.

[560](#) John H. Christman, “Mexico’s Maquiladora Industry Outlook: 2004-2009 And Its Future Impact on the Border Economy,” Global Insight, Inc., December 3, 2004, p. 5.

[561](#) Demetrios Papademetriou, John Audley, Sandra Polaski, and Scott Vaughan, “NAFTA’s Promise and Reality: Lessons from Mexico for the Hemisphere,” Carnegie Endowment for International Peace, November 2003, p. 20.

[562](#) Mexican farmers produce maize at 4 cents/lb, vs. 6 cents/lb for American farmers. But American maize is subsidized down to 3 cents/lb. Craig Sams, “Subsidized Theft,” *Resurgence*, May/June 2006, p. 14.

[563](#) Examples include Richard Mills of the U.S. Trade Representative’s office (*Washington Post*, Letters, July 28, 2001) and Robert Zoellick, currently president of the World Bank and then U.S. Trade Representative in “Countering Terror With Trade,” *Washington Post*, September 20, 2001, p. A35.

[564](#) John MacArthur, *The Selling of Free Trade: NAFTA, Washington, and the Subversion of American Democracy* (New York: Hill & Wang, 2000), pp. 257, 264, 275.

[565](#) Bruce Campbell, Carlos Salas, Robert E. Scott, “NAFTA at Seven,” Economic Policy Institute, p. 19.

[566](#) Joseph Stiglitz, *Making Globalization Work* (New York: W.W. Norton & Co., 2006), p. 65.

[567](#) Ralph Nader, William Greider et al., *The Case Against Free Trade: GATT, NAFTA and the Globalization of Corporate Power* (San Francisco: Earth Island Press, 1993), p. 211.

[568](#) “Trade in Goods (Imports, Exports and Trade Balance) with Singapore,” Census Bureau, 2009, <http://www.census.gov/foreign-trade/balance/c5590.html>.

[569](#) “U.S. FTAs,” [Bilaterals.org](http://www.bilaterals.org), http://www.bilaterals.org/rubrique.php3?id_rubrique=55.

[570](#) Ibid.

[571](#) Peter Ping Li and Steven Tung-Lung Chang, “The Effect of Property Rights on International Joint Ventures in China,” in Ilan Alon, ed., *Chinese Culture, Organizational Behavior, and International Business Management* (Westport, CT: Praeger, 2003).

[572](#) India's global trade is still disproportionately small relative to India's size, and it still maintains relatively high tariffs. For its tariffs, see *2009 National Trade Estimate Report on Foreign Trade Barriers* (Washington: Office of the United States Trade Representative, 2009), p. 235.

[573](#) Dani Rodrik & Francisco Rodriguez and Dani Rodrik, "Trade Policy and Economic Growth: A Skeptic's Guide to the Cross-National Evidence," in Ben Bernanke and Kenneth S. Rogoff, eds., *Macroeconomics Annual 2000* (Cambridge, MA: MIT Press, 2001), pp. 261-325.

[574](#) "World Development Indicators Database," World Bank, April 2009, http://ddp-ext.worldbank.org/ext/ddpreports/ViewSharedReport?REPORT_ID=9147&REQUEST_TYPE=VIEWADVANCED.

[575](#) Edsel Beja, "Things are Different When You Open Up: Economic Openness, Domestic Economy, and Income," Manila University, January 2009.

[576](#) Jose Antonio Ocampo, Jomo K.S. and Rob Vos, *Explaining Growth Divergences* (New York: Zed Books, 2007) p. 174.

[577](#) Dani Rodrik, *One Economics, Many Recipes* (Princeton, NJ: Princeton University Press, 2008) p. 217, based on Dollar and Kraay 2000 dataset.

[578](#) David N. DeJong and Marl Ripoli also report that “we find no evidence globally of a negative relationship between growth and the trade barrier we measure directly,” in “Tariffs and Growth: An Empirical Exploration of Contingent Relationships,” *The Review of Economics and Statistics*, October 2006.

[579](#) Kevin Watkins and Penny Fowler, *Rigged Rules and Double Standards* (Oxford, UK: Oxfam International, 2002) p.5.

[580](#) Joseph Stiglitz, *Making Globalization Work* (New York: W.W. Norton & Co., 2006), p. 78.

[581](#) Martin Wolf, *Why Globalization Works* (New Haven, CT: Yale University Press, 2004), p. 213.

[582](#) Calculated on a purchasing-power parity basis to remove distortions due to exchange rates, figures from Graham Dunkley, *Free Trade: Myth, Reality, and Alternatives*. (New

York: Zed Books, 2004), p. 195.

[583](#) Ibid.

[584](#) John MacArthur, *The Selling of Free Trade: NAFTA, Washington, and the Subversion of American Democracy* (New York: Hill & Wang, 2000), p. 135.

[585](#) See Chapter 11 of NAFTA, for example.

[586](#) John Cavanagh, Jerry Mander et al., *Alternatives to Economic Globalization: A Better World is Possible* (San Francisco: Berrett-Koehler, 2002), p. 23.

[587](#) Jorge G. Castaneda and Carlos Heredia et al., *The Case Against Free Trade: GATT, NAFTA, and the Globalization of Corporate Power* (San Francisco: Earth Island Press, 1993), p. 25.

[588](#) The U.S. maintains retaliatory tariffs on Dijon mustard, Roquefort cheese, and truffles worth more than \$125 million per year.

[589](#) The Lome Convention was replaced by the Cononou

Agreement in 2000. This imposed more conditions on recipient nations and was organized as a set of trade and cooperation pacts with individual countries.

[590](#) “The WTO Erodes Human Rights Protections: Three Case Studies,” Global Exchange, November 15, 1999.

[591](#) Ross Perot and Pat Choate, *Save Your Job, Save Our Country* (New York: Hyperion, 1993), p. 20.

[592](#) Despite the fact that since 1960 it has ratified over 25 treaties on subjects as sensitive as nuclear arms without doing so.

[593](#) As Cyrill Siewert, CFO of Colgate-Palmolive, put it, “The United States does not have an automatic call on our resources. There is no mindset that puts this country first.” Louis Uchitelle, “U.S. Businesses Loosen Link to Mother Country,” *The New York Times*, May 21, 1989.

[594](#) Ha-Joon Chang, *Bad Samaritans: the Myth of Free Trade and the Secret History of Capitalism* (New York: Bloomsbury Press, 2008), p. 36.

[595](#) William Greider, “The Battle Beyond Seattle,” *The*

Nation, December 9, 1999.

[596](#) U.S. Department of State, “North American Free Trade Agreement,” December 17, 1992, Article 104, Section 1. Two less important American agreements, one with Mexico and one with Canada, also enjoy protection.

[597](#) Peter Dauvergne and Jennifer Clapp, *Paths to a Green World: The Political Economy of the Global Environment* (Cambridge, MA: MIT Press, 2005), p. 146.

[598](#) “Ardent Foes of Trade Promotion Authority Begin to Make Their Case With Congress,” *Manufacturing & Technology News*, February 23, 2007, p.1.

[599](#) Gary Clyde Hufbauer and Diana Orejas, “NAFTA and the Environment: Lessons for Trade Policy,” Speech delivered at The Bildner Center, New York, February 28, 2001.

[600](#) John Cavanagh, Jerry Mander et al., *Alternatives to Economic Globalization: A Better World is Possible* (San Francisco: Berrett-Koehler, 2002), p. 76.

[601](#) Which reads, “This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and

all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.” State laws are overruled no matter when they were made; Federal laws are only overruled if made before the treaty.

[602](#) Tibet.

[603](#) Ennio Rodriguez and Stephany Griffith-Jones, *Cross-Conditionality, Banking Regulation and Third World Debt* (Basingstoke, UK: Palgrave MacMillan, 1992).

[604](#) Refusal of loans: Ennio Rodriguez and Stephany Griffith-Jones, *Cross-Conditionality, Banking Regulation and Third World Debt* (Basingstoke, UK: Palgrave MacMillan, 1992).

Withdrawal of aid: Kanaga Raja, “North Tactics to Split Developing Country Alliances Exposed,” *Third World Network*, July 26, 2004.

[605](#) Joseph Stiglitz, *Making Globalization Work* (New York: W.W. Norton & Co., 2006), p. 321.

[606](#) Vandana Shiva, *Stolen Harvest* (New York: Zed Books, 2001), pp. 85, 89.

[607](#) Randeep Ramesh, “India Moves to Protect Traditional Medicines From Foreign Patents,” *The Guardian*, February 22, 2009.

[608](#) Robert Weissman and James Love, “U.S.-Chile Free Trade Agreement,” Press Release, Health Gap Global Access Project, January 29, 2001, http://www.healthgap.org/press_releases/01/012901_EA_CPT_

[609](#) Rohit Malpani and Mohga Kamal-Yanni, “Patents Versus Patients: Five Years After the Doha Declaration,” Oxfam International, November 14, 2006.

[610](#) William Anthony Lovett, Alfred E. Eckes & Richard L. Brinkman, *U.S. Trade Policy: History, Theory and the WTO* (Armonk, NY: M.E. Sharpe & Co., 1999), p. 178.

[611](#) *Ibid.*, p. 141.

[612](#) This includes not only the groups named, but various institutional predecessors. John Cavanagh, Jerry Mander et al.,

Alternatives to Economic Globalization: A Better World is Possible (San Francisco: Berrett-Koehler, 2002), p. 226.

[613](#) Edward F. Buffie, *Trade Policy in Developing Countries* (Cambridge, UK: Cambridge University Press, 2001), Ch. 9.

[614](#) William Greider, *One World, Ready or Not* (New York: Touchstone Press, 1997) p. 362.

[615](#) Jose Antonio Ocampo, Jomo K.S. and Rob Vos, *Explaining Growth Divergences* (New York: Zed Books, 2007), p. 3.

[616](#) Nitsan Chorev, *Remaking U.S. Trade Policy: From Protection to Globalization* (Ithaca, NY: Cornell University Press, 2007), p. 163.

[617](#) Testimony of Robert E. Lighthizer, hearing on “Trade Enforcement for a 21st Century Economy,” Finance Committee, U.S Senate, June 12, 2007.

[618](#) For example, it ruled against zeroing in antidumping cases; deemed America’s “foreign sales corporation” provision an export subsidy; and repudiated the Uruguay Round understanding that it would generally defer to national

authorities in dumping cases.

[619](#) “EU Commission Puts Forward Proposal for Sanctions Against U.S. Byrd Amendment,” Delegation of the European Commission to the U.S.A, March 31, 2005.

[620](#) A few token protests were allowed.

[621](#) Though these words are actually a misquotation when attributed to former WTO Director General Renato Ruggerio. Bernard M. Hoekman, *The Political Economy of the World Trading System*, 2nd ed. (New York: Oxford University Press, 2001), p. 3.

[622](#) Estimate of Lawrence B. Krause, University of California at San Diego, quoted in William Greider, *One World, Ready or Not* (New York: Touchstone Press, 1997), p. 137.

[623](#) Jan Orbie, *Europe’s Global Role* (London: Ashgate Publishing, 2008), p. 58.

[624](#) Offset deals can also include coproduction, licensed production, subcontracting deals, technology transfers, directed investment, and export promotion.

[625](#) Article IV, revised, which went into effect in 1978.

[626](#) “Auto bailouts in the United States and elsewhere largely fall within the purview of the WTO definition of actionable subsidies.” This is the conclusion, with much obfuscation, of Claire Brunel and Gary Clyde Hufbauer, “Money for the Auto Industry: Consistent With WTO Rules?” Peterson Institute for International Economics, February 2009, p. 10.

[627](#) Worldwide average: “Border Tax Equity Act: Legislative Overview,” Coalition for VAT Fairness, <http://www.bordertaxequity.org/>. EU average: “The Border Tax Equity Act: VAT - The Problem,” National Textile Association, <http://www.nationaltextile.org/VAT/problem.htm>.

[628](#) Alfred E. Eckes, Jr., *Opening America’s Market: U.S. Foreign Trade Since 1776* (Chapel Hill, NC: University of North Carolina Press, 1995), p. xvi.

[629](#) Jeff Garten, “Business and Foreign Policy,” *Foreign Affairs*, May/June 1997, pp. 70-71.

[630](#) William Greider, *One World, Ready or Not* (New York: Touchstone Press, 1997), p. 188.

[631](#) Ibid. p. 139.

[632](#) Interview “Behind the Sound Bites of Republican Presidential Hopeful Rep. Duncan Hunter: U.S. Multinationals Have Become Chinese Corporations,” *Manufacturing & Technology News*, March 13, 2007, p. 1.

[633](#) William Anthony Lovett, Alfred E. Eckes and Richard L. Brinkman, *U.S. Trade Policy: History, Theory and the WTO* (Armonk, NY: M.E. Sharpe and Co., 1999), p. 139.

[634](#) Sherrod Brown, *Myths of Free Trade: Why America’s Trade Policies Have Failed* (New York: The New Press, 2004), p. 19.

[635](#) William Greider, *One World, Ready or Not* (New York: Touchstone Press, 1997), p. 192.

[636](#) See p. 131.

[637](#) William Greider, *One World, Ready or Not* (New York: Touchstone Press, 1997), p. 132.

[638](#) Ross Perot and Pat Choate, *Save Your Job, Save Our Country* (New York: Hyperion, 1993), p. 19.

[639](#) Nitsan Chorev, *Remaking U.S. Trade Policy: From Protection to Globalization* (Ithaca, NY: Cornell University Press, 2007), pp. 112, 137.

[640](#) U.S. Senate, Committee on Finance, *Trade Reform Act of 1974*, pp.94-95; Public Law 93-618.

[641](#) “United States Promotes Development Through Aid for Trade,” Press Release, United States Trade Representative, December 16, 2008.

[642](#) William Greider, *One World, Ready or Not* (New York: Touchstone Press, 1997), p. 189.

[643](#) Eamonn Fingleton, *Blindside: Why Japan is Still on Track to Overtake the U.S. by the Year 2000* (New York: Houghton Mifflin, 1995), p. 47.

[644](#) “Trade with Japan: 2000,” U.S. Census Bureau, <http://www.census.gov/foreign-trade/balance/c5880.html#2000>

and “Trade with Japan: 2009,” U.S. Census Bureau, <http://www.census.gov/foreign-trade/balance/c5880.html#2009>.

[645](#) “Explaining the Mystery,” *The Economist*, January 4, 1992.

[646](#) Jean Imbs & Romain Wacziarg, “Stages of Diversification,” *American Economic Review*, March 2003. Also see Bailey Klinger & Daniel Lederman, “Diversification, Innovation, and Imitation Inside the Global Technological Frontier,” World Bank, 2006.

[647](#) Dani Rodrik, *One Economics, Many Recipes* (Princeton, NJ: Princeton University Press, 2008), p. 103.

[648](#) “Precisely because economic theory is concerned with static equilibrium, not with the dynamics of development, it is hard to find within traditional theory a basis on which a systematic and positive policy for competitiveness or development can be built.” Stephen S. Cohen and John Zysman, *Manufacturing Matters: The Myth of the Post-Industrial Economy* (New York: Basic Books, 1988), p. 214.

[649](#) Michael Porter, *The Competitive Advantage of Nations* (New York: The Free Press, 1990), p. 103.

[650](#) Ibid., p. 139.

[651](#) These externalities extend far beyond technology *per se*. See Porter, *The Competitive Advantage of Nations* (New York: The Free Press, 1990), p. 144. Further evidence that location-specific externalities exist is the fact that industries often cluster in specific cities or regions, a strategy deliberately employed by China today in the form of the “network clustering” mentioned in the table on p. 76.

[652](#) See Michael Porter, *The Competitive Advantage of Nations* (New York: The Free Press, 1990) p. 153 concerning *keiretsus*, p. 446 concerning Italy, and p. 472 concerning *chaebols*. Conglomerates have suffered a poor reputation in the U.S. in recent years. This is mainly due to the fact that the U.S. conglomerates such as ITT and Gulf+Western were not deliberately run to exploit these externalities. Those that have been, such as GE and 3M, have actually been very successful: note as one case GE’s use of digital imaging technology from one of its military divisions, to take the CAT scanner market from EMI.

[653](#) American venture capital firms have an extremely hard time functioning beyond a five-year time horizon.

[654](#) Richard J. Elkus, *Winner Take All: How Competitiveness Shapes the Fate of Nations* (New York: Basic Books, 2008), p. 67.

[655](#) Clyde Prestowitz, *Trading Places: How We Are Giving Our Future to Japan and How to Reclaim It* (New York: Basic Books, 1993), pp. 139-141.

[656](#) Technically, of course, Ricardian comparative advantage is not a growth model at all like, say, the So-low growth model. But if it doesn't advise on how to obtain growth, it lacks policy relevance.

[657](#) Lester Thurow, "Microchips, Not Potato Chips," *Foreign Affairs*, July/August 1994.

[658](#) Laura D'Andrea Tyson, *Who's Bashing Whom? Trade Conflict in High-Technology Industries* (Washington: Institute for International Economics, 1993), p. 12.

[659](#) Stephen S. Cohen and John Zysman, *Manufacturing Matters: The Myth of the Post-Industrial Economy* (New York: Basic Books, 1988), p. 216.

[660](#) Paul Krugman, *Rethinking International Trade* (Cambridge, MA: MIT Press, 1994), p. 157.

[661](#) Strictly speaking, the theory of comparative advantage finesses this problem by treating comparative advantage as exogenous, i.e., as a given. This is logically coherent but renders the theory useless for determining how to *obtain* the best comparative advantage.

[662](#) Eric S. Reinert, *How Rich Countries Got Rich and Why Poor Countries Stay Poor* (New York: Carroll & Graf, 2007).

[663](#) Ricardo Hausmann, Jason Hwang, and Dani Rodrik, “What You Export Matters” Center for International Development, Harvard University, March 2006. The caveat, of course, is that the exporting industries have to be genuine viable industries, not hothouse flowers permanently dependent upon subsidies.

[664](#) Ricardo Hausmann and Dani Rodrik, “Doomed to Choose: Industrial Policy as Predicament,” John F. Kennedy School of Government, Harvard University, p. 6.

[665](#) Hausmann, Ricardo, Jason Hwang, and Dani Rodrik, “What You Export Matters,” *Journal of Economic Growth*,

March 2007.

[666](#) John M. Culbertson, *The Trade Threat and U.S. Trade Policy* (Madison, WI: 21st Century Press, 1989), p. 72.

[667](#) Eric S. Reinert, *How Rich Countries Got Rich and Why Poor Countries Stay Poor* (New York: Carroll & Graf, 2007), p. 262.

[668](#) For details, see William Easterly, *The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics* (Cambridge, MA: MIT Press, 2002), p. 49.

[669](#) “The Facts About Modern Manufacturing,” 2002 data, per National Association of Manufacturers, 7th ed., October 2, 2006, Section 2, p. 24.

[670](#) Laura D’Andrea Tyson, *Who’s Bashing Whom? Trade Conflict in High-Technology Industries*, (Washington: Institute for International Economics, 1992), p. 32.

[671](#) Strictly speaking, rent is any return to a factor of production above the amount required to cause that factor to participate in that production. As returns in a pure free market will be competed down to that minimum, anything above that

is rent.

[672](#) Erik S. Reinert, “Competitiveness and its Predecessors— a 500-year Cross-National Perspective,” STEP Centre for Innovation Research, p. 5.

[673](#) Michael Porter, *The Competitive Advantage of Nations* (New York: The Free Press, 1990), p. 89.

[674](#) This now unfashionable term derives from economist John Kenneth Galbraith in his 1952 book, *American Capitalism: the Concept of Countervailing Power* (Boston: Houghton Mifflin, 1952).

[675](#) The importance of this fact was noted by Adam Smith (and quoted by Ricardo): “The desire for food is limited in every man by the narrow capacity of the human stomach, but the desire of the conveniences and ornaments of building, dress, equipage, and household furniture, seems to have no limit or boundary.” Adam Smith, *The Wealth of Nations*, Book. I, Chapter XI, Part II, quoted in David Ricardo, *On the Principles of Political Economy and Taxation*, Chapter 21.

[676](#) See Hans Singer, “The Distribution of Gains Between Investing and Borrowing Countries,” *American Economic Review*, May 1950; Raúl Prebisch, *The Economic Development*

of Latin America and its Principal Problems (Lake Success, NY: United Nations Department of Economic Affairs, 1950).

[677](#) *Board of Trade Journal*, August 4, 1951, reprinted in B.R. Mitchell and Phyllis Deane, *Abstract of British Historical Statistics* (Cambridge, UK: Cambridge University Press, 1962), p. 332. This fact had actually been known for a very long time; it is discussed at length in Alexander Hamilton's 1791 *Report on the Subject of Manufactures* (Philadelphia: William Brown, 1827), pp. 44-45.

[678](#) The World Bank disputes this, pointing out that it only directly financed a small part of the Vietnamese coffee industry.

[679](#) Eric Reinert, *How Rich Countries Got Rich and Why Poor Countries Stay Poor* (New York: Carroll & Graf, 2007), p. 112.

[680](#) It has been estimated that modernizing Indian agriculture would put 600 million people in need of new employment. Colin Tudge, "Time for a Peasant Revolution," *Resurgence*, May-June 2005, p.14.

[681](#) "Human Development Report 1999," United Nations Development Programme, p. 3. Note that economic growth in India and China mean that on a population-weighted basis,

global inequality peaked in 1992, and has dropped slightly since then.

[682](#) Of course, some colonial powers lack the understanding of economic mechanisms to do this, and some colonies, such as Canada, weren't true colonies in the economic sense or, as in the case of Manchukuo, were operated according to entirely different economic strategies. And some colonialism doesn't even get this far, but operates by mere plunder or mere territorial conquest without economic content.

[683](#) Lawrence A. Peskin, *Manufacturing Revolution: The Intellectual Origins of Early American Industry* (Baltimore: Johns Hopkins University Press, 2003), p. 20.

[684](#) Paul Bairoch, *Economics and World History: Myths and Paradoxes* (Chicago: University of Chicago Press, 1993), p. 38.

[685](#) For a precise Ricardian analysis of this problem, framed in terms of changing productivity over time, see Frank D. Graham, "Some Aspects of Protection Further Considered," *The Quarterly Journal of Economics*, February 1923.

[686](#) Joseph Stiglitz, *Making Globalization Work* (New York: W.W. Norton & Co, 2006), p. 85. Total OECD subsidies from OECD, *Agricultural Policies in OECD Countries: Monitoring*

and Evaluation (Paris: OECD, 2005), p. 7.

[687](#) The success of Japan was a hidden factor in persuading the Soviet elite to abandon Marxism. The success of China left them no choice, as the U.S.S.R would have declined to irrelevancy within a visible time frame. Because it was America's need to keep Japan anticommunist that allowed Japan the breathing space to rebuild its economic machine after catastrophic losses in 1945, it is arguable that the Cold War was won in Tokyo.

[688](#) Marcelo de P. Abreu, Afonso S. Bevilaqua, and Demosthenes M. Pinho, "Import Substitution and Growth in Brazil, 1890s-1970s," Department of Economics, Pontifical Catholic University of Rio de Janeiro, p. 21.

[689](#) Betsy Rakocy, Alejandro Reuss, Chris Sturr et al., *Real World Globalization* (Boston: Economic Affairs Bureau, 2007), p. 210. One of the hidden stories of Chile is the conflict within the Pinochet regime between the notorious free market "Chicago boys" and their *right*-wing opponents in the military government who leaned, like militarist regimes from General Park's Korea to General Franco's Spain, towards authoritarian developmentalism and disliked free markets.

[690](#) Anthony Elson, "What Happened? Why East Asia Surged Ahead of Latin America and Some Lessons for Economic

Policy,” *Finance & Development*, June 1, 2006.

[691](#) This section largely based on Eric Reinert, *How Rich Countries Got Rich and Why Poor Countries Stay Poor* (New York: Carroll & Graf, 2007), pp. 311-2.

[692](#) Michael Porter, *The Competitive Advantage of Nations* (New York: The Free Press, 1990) p. 117.

[693](#) This paragraph: see Michael Porter, *The Competitive Advantage of Nations* (New York: The Free Press, 1990), p. 15.

[694](#) Eric Reinert, *How Rich Countries Got Rich and Why Poor Countries Stay Poor* (New York: Carroll & Graf, 2007), p. 182.

[695](#) “Americans Are Misinformed: Caterpillar, Deere and NAM Say Multinationals Are Saving the U.S. Economy,” *Manufacturing & Technology News*, June 30, 2008, p. 6.

[696](#) Michael Porter, *The Competitive Advantage of Nations* (New York: The Free Press, 1990), p. 50. Porter is actually referring to competitive, not comparative, advantage in this passage, but the import of the two concepts is the same in this context.

[697](#) Martha Caldwell Harris and Gordon E. Moore, eds., *Linking Trade and Technology Policies: An International Comparison of the Policies of Industrialized Nations* (Washington: National Academies Press, 1992), p. 125.

[698](#) Laura D'Andrea Tyson, *Who's Bashing Whom? Trade Conflict in High-Technology Industries* (Washington: Institute for International Economics, 1993), p. 85.

[699](#) Alert readers will have noticed that the case of ATT (and IBM and other quasi-monopoly companies) contradicts earlier assertions about the value of rivalry. It does: the truth here is complicated, different in different industries, and beyond the scope of this book.

[700](#) *Ibid.*, p. 88.

[701](#) Michael Borrus, "Responses to the Japanese Challenge in High Technology: Innovation, Maturity, and U.S.–Japanese Competition in Microelectronics," Berkeley Roundtable on the International Economy, University of California at Berkeley, 1983.

[702](#) Dieter Ernst and David O'Connor, *Competing in the Electronics Industry: The Experience of Newly Industrialising Economies* (Paris: Development Centre Studies, OECD, 1992).

[703](#) Office of Technology Assessment, *Competing Economies: America, Europe, and the Pacific Rim*, (Washington: U.S. Government Printing Office, 1991), p. 346.

[704](#) Sydney Carroll, “The Market for Commercial Airlines,” in R. Caves and M. Roberts, eds., *Regulating the Product: Quality and Variety*, (Cambridge, MA: Ballinger Publishing Co., 1975), p. 148.

[705](#) “Method for Scoring Documents in a Linked Database,” U.S. Patent Office, Patent ID U.S.6799176, [http://www.patents.com/Method-scoring-documents-a-linked-database/U.S.6799176/en-U.S./](http://www.patents.com/Method-scoring-documents-a-linked-database/U.S.6799176/en-U.S/)

[706](#) John Young, “Department of Defense Science and Technology (S&T) Program,” Memorandum to Robert Gates, Secretary of Defense, August 24, 2007, p. 5.

[707](#) Author’s telephone conversation with Project Socrates Director, Michael C. Sekora, May 22, 2009.

[708](#) *Ibid.*, July 2, 2009.

[709](#) “Cheney: Don’t Expect Pentagon to Bail Out Industrial Base,” *Aerospace Daily*, January 23, 1992, p. 115.

[710](#) “Report of the Defense Science Board Task Force on High Performance Microchip Supply,” Office of the Under Secretary of Defense For Acquisition, Technology, and Logistics, February 2005, p. 15.

[711](#) “Defense Industrial Base Assessment: U.S. Integrated Circuit Design and Fabrication Capability,” Bureau of Industry and Security, March 2009, p. 96.

[712](#) “Swiss Delay of Military Parts Sparks ‘Buy American’ Push,” *The Washington Times*, July 24, 2003.

[713](#) In the (unheeded) words of a 2003 memo by then Deputy Defense Secretary Paul Wolfowitz, “The health of the defense IC supplier community depends on the health of the larger commercial IC base...There-fore the DOD will support policies that provide a level playing field internationally for the procurement of commercial products.” See Richard McCormack, “DOD Broadens Trusted Foundry Program to Include Microelectronics Supply Chain,” *Manufacturing & Technology News*, February 28, 2008, p.1.

[714](#) A good discussion of the complexities of how industries fall apart on the inside and lose the dynamics that push them to excel is in Michael Porter, *The Competitive Advantage of Nations* (New York: The Free Press, 1990), p. 166.

[715](#) James Kynge, *China Shakes the World* (New York: Houghton Mifflin, 2006), p. 112.

[716](#) Richard J. Elkus, *Winner Take All: How Competitiveness Shapes the Fate of Nations* (New York: Basic Books, 2008), p. 75.

[717](#) “SEMI Reports 2009 Global Semiconductor Equipment Sales of \$15.92 Billion,” Semiconductor Equipment and Materials International, March 10, 2010.

[718](#) Richard J. Elkus, *Winner Take All: How Competitiveness Shapes the Fate of Nations* (New York: Basic Books, 2008), p. 149.

[719](#) “Commentary: Manufacturers Know All About Economic Collapse,” *Manufacturing & Technology News*, September 30, 2008, p. 4.

[720](#) Laura D'Andrea Tyson, *Who's Bashing Whom?* (Washington: Institute for International Economics, 1993), p. 146.

[721](#) See, for example, Christine Tierney, "Ford Slams Toyota on Hybrids," *Detroit News*, August 8, 2005.

[722](#) "U.S. Trades Dependence on Foreign Oil for Dependence on Foreign Batteries," *Manufacturing & Technology News*, February 28, 2008, p. 8.

[723](#) "Overview of Global Li-ion Battery Industry," Market Avenue, Inc., March 14, 2008.

[724](#) Anthony H. Harrigan et al., *Putting America First: A Conservative Alternative* (Washington: United States Industrial Council Educational Foundation, 1987), p. 21.

[725](#) Laura D'Andrea Tyson, *Who's Bashing Whom?* (Washington: Institute for International Economics, 1993), p. 14.

[726](#) Testimony of Michael Borrus before the Committee on Science and Technology, Subcommittee on Technology and

Innovation, U.S. House of Representatives, February 15, 2007.

[727](#) Dani Rodrik, *One Economics, Many Recipes* (Princeton, NJ: Princeton University Press, 2008), p. 119.

[728](#) David Bucholz, “Business Incentives Reform: Case Study: Mercedes Benz: the Deal of the Century,” Corporation For Enterprise Development, 2002.

[729](#) “Sematech History,” SEMATECH, 2009, <http://www.sematech.org/corporate/history.htm>.

[730](#) “The Research & Development Credit: Creating Jobs, Growing America's Economy,” R&D Credit Coalition, October 21, 2009, p. 1, <http://www.investinamericasfuture.org/PDFs/TalkingPoints102>

[731](#) Martin Neil Baily and Alok K. Chakrabarti, *Innovation and the Productivity Crisis* (Washington: Brookings Institution Press, 1988), p. 39.

[732](#) Charles W. Wessner, *The Advanced Technology Program: Assessing Outcomes* (Washington: National Academies Press, 2001), p. 5.

[733](#) Richard McCormack, “The Plight of American Manufacturing” in Richard McCormack, ed., *Manufacturing a Better Future for America* (Washington: Alliance for American Manufacturing, 2009), p. 45.

[734](#) Wendy H. Schacht, “The Technology Innovation Program,” Congressional Research Service, August 20, 2008.

[735](#) “A Stimulus for Everyone Save Domestic Manufacturers,” *Manufacturing & Technology News*, February 20, 2009, p. 1.

[736](#) “Barack Obama Campaign Promise No. 7: Double Funding for the Manufacturing Extension Partnership, A Program That Encourages Manufacturing Efficiency,” St. Petersburg Times, <http://www.politifact.com/truth-o-meter/promises/promise/7/double-funding-for-the-manufacturing-extension-par/>. The program did get a 13.4% increase in the regular 2010 budget.

[737](#) “What the Data Show,” Manufacturing Extension Partnership, <http://www.mep.nist.gov/manufacturers/>

[services/business-operations/results.htm](#), accessed December 31, 2009.

[738](#) Gomory and Baumol themselves largely disavow the protectionist policy implications of their work, for various reasons.

[739](#) Their first published work of multiple-equilibrium trade theory was Ralph E. Gomory, “A Ricardo Model With Economies of Scale,” *Proceedings of the National Academy of Sciences*, September 1991. Their book is Ralph Gomory and William Baumol, *Global Trade and Conflicting National Interests*. (Cambridge, MA: MIT Press, 2000).

[740](#) Gomory and Baumol were not the first economists to identify the value of winning retainable industries or establish firm theoretical grounds for the possibility that government intervention might help a nation win them. Credit for rediscovering this ancient truth and putting it into the theoretical framework of modern economics must go to James Brander and Barbara Spencer of the University of British Columbia, who developed a theory of so-called strategic trade around 1983. Their point, elaborated without Gomory and Baumol’s multiple-equilibrium approach, was that in monopoly industries a well-timed government subsidy could potentially hand a “winner take all” industry to one nation or another by getting a national industry to high volume production first.

[741](#) Lawrence F. Katz and Lawrence H. Summers, “Can Interindustry Wage Differentials Justify Strategic Trade Policy?” in Robert C. Feenstra, ed., *Trade Policies for International Competitiveness* (Chicago: University of Chicago Press, 1989), p. 86.

[742](#) Ibid., p. 103.

[743](#) Dieter Ernst and David O’Connor, *Competing in the Electronics Industry: The Experience of Newly Industrialising Economies* (Paris: Development Centre Studies, Organization for Economic Cooperation and Development, 1992) p. 27.

[744](#) Paul E. Ceruzzi, *A History of Modern Computing* (Cambridge, MA: MIT Press, 1998), p. 248.

[745](#) See p. 100.

[746](#) See p. 99 for the original explanation of opportunity costs.

[747](#) Technically speaking, each such distribution will be “locally” optimal (more efficient than any *similar* distribution) but may or may not be “globally” optimal (more efficient than

any *possible* distribution). Therefore, any actually existing distribution may be suboptimal both for maximizing world output and for maximizing the output of any given nation.

[748](#) *Pace*, of course, the fact that the German auto industry is in significant part a product of deliberate non-free-market industrial-policy decisions, starting with the Marshall Plan.

[749](#) Based on the number of North American Industry Classification System (NAICS) codes.

[750](#) Chart adapted from Ralph Gomory and William Baumol, *Global Trade and Conflicting National Interests* (Cambridge, MA: MIT Press, 2000), p. 31.

[751](#) *Ibid*, p. 37.

[752](#) Michael Porter, *The Competitive Advantage of Nations* (New York: The Free Press, 1990), p. 36.

[753](#) Of course, if they *do* have something valuable, such as knowledge of medicinal plants, this changes.

[754](#) Among other things, this means that old-fashioned

colonialism, in which colonies are pushed into bad industries, is not the most profitable international economic strategy. If it had been, England would not have been outperformed economically by Germany in the late 19th century heyday of the colonial era.

[755](#) This result is actually true independently of Gomory & Baumol's insights and is known to economics as the Hicks Theorem. See Hicks, John, "An Inaugural Lecture," *Oxford Economic Papers*, June 1953.

[756](#) A similar result has also been confirmed, using a comparison between hypothetical technologically advanced and undeveloped nations, in Paul R. Krugman & Anthony Venables, "Globalization and the Inequality of Nations," *The Quarterly Journal of Economics*, November 1995.

[757](#) UK: see p. 130; U.S.: see p. 142.

[758](#) See p. 25.

[759](#) See Jagdish Bhagwati, *Free Trade Today* (Princeton, NJ: Princeton University Press, 2002), p. 27.

[760](#) See p. 54.

[761](#) There do exist, of course, circumstances when this is exactly what we *want* to happen, as when overseas production effectively complements domestic research and development, but generally, the point is to capture jobs based on R&D, not shed them.

[762](#) See p. 59.

[763](#) See p. 34.

[764](#) See p. 109.

[765](#) See pp. 52-55.

[766](#) One can, of course, argue that free trade in goods and free movement of capital are different issues, as does Jagdish Bhagwati in *Free Trade Today* (Princeton, NJ: Princeton University Press, 2002), p. 10. But free movement of goods, without free movement of the money to pay for them, is only “free” trade in a pedantic sense: it is like freedom to shop without freedom to pay.

[767](#) See pp. 45-49, 54.

[768](#) See p. 187.

[769](#) See p. 113.

[770](#) Quoted in Ralph E. Gomory and William J. Baumol, “Toward a Theory of Industrial Policy–Retainable Industries,” C.V. Starr Center for Applied Economics, New York University, December 1992, p. 25.

[771](#) See p. 138.

[772](#) We are talking about *average* cost, not marginal cost. The reader can try this out in Excel or another spreadsheet program without difficulty.

[773](#) See p. 189.

[774](#) As noted in Chapter 9, Reagan’s industrial policy was purely military, but was as such very serious, and subsequent presidents have not even employed military industrial policy.

[775](#) Costa Rica: *CIA World Fact Book 2008*,

<https://www.cia.gov/library/publications/the-world-factbook/geos/cs.html>. Jacksonville: Bureau of Economic Analysis, “Gross Domestic Product by Metropolitan Area,” <http://www.bea.gov/regional/gdpmetro/action.cfm>.

[776](#) See pp. 46-48.

[777](#) See pp. 156-158.

[778](#) See pp. 171-172.

[779](#) See pp. 198-201.

[780](#) Eric S. Reinert, *How Rich Countries Got Rich and Why Poor Countries Stay Poor* (New York: Carroll & Graf, 2007), p. 271.

[781](#) See p. 158.

[782](#) John Cavanagh, Jerry Mander et al., *Alternatives to Economic Globalization: A Better World is Possible* (San Francisco: Berrett-Koehler, 2002), p. 230.

[783](#) Ch. 9: see p. 198; Ch. 10: see p. 227.

[784](#) See p. 139.

[785](#) See p. 176 for the original discussion of VAT.

[786](#) See p. 144.

[787](#) For example, there is something of an inverse relationship between protectionism and industrial policy, as is visible in nations such as Singapore which have fairly free trade but very aggressive industrial policy.

[788](#) It is no accident that most nations with VAT have larger welfare states than the U.S., as this is an obvious way to mitigate the progressivity issues of a VAT.

[789](#) Michael Porter, *The Competitive Advantage of Nations* (New York: The Free Press, 1990), p. 119.

[790](#) This holds in many other Japanese industries as well. See Michael Porter, *The Competitive Advantage of Nations* (New York: The Free Press, 1990), p. 118.

[791](#) See p. 90.

[792](#) See p. 201.

[793](#) They are constantly alert to threats against their trading position: China, for example, was recently reported in *China Daily* as increasing export rebates on 3,800 items “to maintain growth.” See “China Raises Export Rebate to Spur Growth,” *China Daily*, March 28, 2009.

[794](#) See p. 74.

[795](#) In other words, it is plausible to expect an approximate Nash Equilibrium to emerge, though of course some turbulence would occur.

[796](#) See p. 177 for the original discussion of VAT.

[797](#) Lori Montgomery, “Value-Added Tax, Once Taboo, is Getting Attention in Washington,” *Los Angeles Times*, May 28, 2009.

[798](#) Victor Selden Clark, *History of Manufactures in the*

United States: 1607-1860 (Washington: Carnegie Institution, 1916), p. 288.

[799](#) See p. 176.

[800](#) This analysis was originally published in modified form in as, “Things Fall Apart: the Coming End of the Free Trade Coalition,” *The American Conservative*, September 2004.

[801](#) 2009: 91%, to be exact. “Employment Situation Summary,” Bureau of Labor Statistics, August 7, 2009. 1950: Ronald E. Kutscher, “The American Work Force, 1992-2005: Historical Trends, 1950-92, and Current Uncertainties,” *Monthly Labor Review*, November 1993, p. 6.

[802](#) This section is adapted from the article, “Things Fall Apart,” originally published in *The American Conservative*, September 27, 2004.

[803](#) Kevin Phillips, *Arrogant Capital* (New York: Little, Brown & Co, 1995), p. 89.

[804](#) In technical terms, there is no theorem guaranteeing that partial-equilibrium losses to import-competing producers are more than offset by their gains as consumers due to reduced

prices. See Chapters 1 and 5.

[805](#) See p. 166.

[806](#) Michael Lind gave an interesting description of what such a position might look like in *The Next American Nation* (New York: Free Press, 1995).

[807](#) “Republican party Platform of 1972,” The American Presidency Project, University of California at Santa Barbara, <http://www.presidency.ucsb.edu/ws/index.php?pid=25842>.

[808](#) Free traders will, of course, respond that none of them actually believe in literal 100% free trade. The reader may judge whether the various kinds of 99% free trade they believe in are significantly different.

[809](#) Sherrod Brown, *Myths of Free Trade: Why American Trade Policy Has Failed* (New York: The New Press, 2004), p. 11.

[810](#) Peronet Despeignes, “Poll: Enthusiasm for Free Trade Fades Dip Sharpest for \$100K Set; Loss of Jobs Cited,” *U.S.A Today*, February 24, 2004.

[811](#) “NBC/Wall Street Journal GOP Primary Voters Survey,” Hart/Newhouse, September 2007, p. 5.

[812](#) “Support for Free Trade Recovers Despite Recession,” Pew Center for the People and the Press, April 28, 2009, <http://people-press.org/reports/pdf/511.pdf>.

[813](#) Scott Keeter and Richard Morin, “The Complicated Politics of Free Trade,” Pew Center for the People and the Press, January 4, 2007.

[814](#) Ana Maria Arumi and Scott Bittle, “Confidence in U.S. Foreign Policy Index,” *Public Agenda*, Winter 2006, p. 17.

[815](#) *Ibid.*, p. 11.

[816](#) “Excerpts From An Interview With John Kerry,” *The Wall Street Journal*, May 3, 2004.

[817](#) “Debate Transcript: The Third Bush–Kerry Presidential Debate,” Commission on Presidential Debates, 13 October 2004.

[818](#) Ibid.

[819](#) Ibid.

[820](#) Ibid.

[821](#) Bush won by 286 electoral votes to 251; Kerry lost Ohio, which has 20.

[822](#) “Ohio Voters Don’t Trust Democrats on Economic Issues,” *Manufacturing & Technology News*, March 14, 2008, p. 1.

[823](#) Thomas Frank, *What’s The Matter With Kansas?* (New York: Metropolitan Books, 2004).

[824](#) John Nichols, “A Congressman’s Defeat Spells Trouble for Business Democrats,” *The Nation*, May 10, 2002.

[825](#) Ibid.

[826](#) Todd Tucker, “Election 2006: No to Staying the Course on Trade,” Public Citizen, November 8, 2006, p. 4., <http://www.citizen.org/documents/Election2006.pdf>.

[827](#) Chris Slevin and Todd Tucker, “The Fair Trade Sweep,” *The Democratic Strategist*, January 7, 2007.

[828](#) Ibid.

[829](#) Greta Wodele, “Fitzpatrick Touts Record, Murphy National Issues In Debate,” *Congress Daily PM*, October 26, 2006.

[830](#) Jeremy Wallace, “Democrats Say Venus Man Can Beat Foley,” *Sarasota Herald-Tribune*, December 12, 2005.

[831](#) Todd Tucker, “Election 2006: No to Staying the Course on Trade,” Public Citizen, November 8, 2006, p. 18, <http://www.citizen.org/documents/Election2006.pdf>.

[832](#) Chris Slevin and Todd Tucker, “The Fair Trade Sweep,” *The Democratic Strategist*, January 7, 2007, p. 6.

[833](#) Ibid., p. 5.

[834](#) Ibid., p. 5.

[835](#) Stuart Rothenberg, “Rothenberg’s Ten Most Endangered House Incumbents,” *The Rothenberg Report*, February 21, 2006.

[836](#) “2008 Presidential Candidate Questionnaire,” Ohio Conference on Fair Trade, <http://www.citizen.org/>

[documents/OhioCFTQuestionnaireObama.pdf](#).

[837](#) “NAFTA Takes Center Stage in Ohio Primary Battle,” *The Wall Street Journal*, February 25, 2008.

[838](#) Susan Davis and Nick Timiraos, “Washington Wire,” *The Wall Street Journal*, February 25, 2008.

[839](#) “*The Democratic Debate in Cleveland*,” *The New York Times*, February 26, 2008.

[840](#) “Report on U.S. Elections–CHCGO Meeting with Obama

Advisor Austan Goolsbee,” memorandum, Consulate General of Canada, Chicago, February 2008, <http://www.nytimes.com/images/promos/politics/blog/2007030>

[841](#) “Obama Staffer Gave Warning of NAFTA Rhetoric,” CTV, February 27, 2008, <http://www.ctv.ca/servlet/ArticleNews/story/CTVNews/200802>

[842](#) Robert Scott, “Pennsylvania Stagnation: Is NAFTA the Culprit?” *The New York Times*, April 15, 2008.

[843](#) Real Clear Politics, “Pennsylvania Democratic Primary,” <http://www.realclearpolitics.com/epolls/2008/president/pa/penn/240.html>.

[844](#) Nina Easton, “Obama: NAFTA Not So Bad After All,” *Fortune*, June 18, 2008.

[845](#) John McCain, speech to National Association of Latino Appointed and Elected Officials, June 28, 2008.

[846](#) Barack Obama, “Renewing American Competitiveness,” speech in Flint, MI, June 16, 2008.

[847](#) See pp. 20-26.

[848](#) See pp. 59-63.

[849](#) Paul Cohn, “Dems Ads In Tight Races Tap Into Anti-Trade Sentiment,” *Congress Daily*, Wednesday, October 29, 2008.

[850](#) Figure derived by combining the number of trade ads run by individual candidates and those run by the Democratic Congressional Campaign Committee and Democratic Senatorial Campaign Committee in the general election cycle. “Election 2008: Fair Trade Gets an Upgrade,” Global Trade Watch, November 5, 2008, pp. 4-5.

[851](#) “Election 2008: Fair Trade Gets an Upgrade,” Global Trade Watch, November 5, 2008, p. 2.

[852](#) Ibid.

[853](#) Ibid., p. 3.

[854](#) Ibid., p. 5.

[855](#) Ron Kirk, “Trade and the Economic Agenda: Serving America’s Families and the Global Recovery,” speech at Georgetown University Law Center, April 23, 2009.

[856](#) “Becerra Says He’s Not Interested in U.S. Trade Rep Job,” *Time*, December 17, 2008.

[857](#) Prof. Laura D’Andrea Tyson, University of California at Berkeley, has done great work as a theorist of protectionism, but has retreated from this position in her public statements in recent years.

[858](#) Doug Palmer, “No Need to Renegotiate NAFTA to Improve It–U.S.TR,” Reuters, April 20, 2009.

[859](#) David Sanger, “Senate Agrees to Dilute ‘Buy American’ Provisions,” *The New York Times*, February 4, 2009.

[860](#) “Mexican Truck Program Revival Clears First Hurdles,” *Today’s Trucking*, July 28, 2009.

[861](#) John M. Broder, “Obama Opposes Trade Sanctions in Climate Bill,” *The New York Times*, June 28, 2009.

[862](#) Bernd Janzen, “Waxman-Markey Bill Border Adjustment Measures Face Revision as Senate Takes Up Climate Bill Deliberations,” *ClimateIntel*, July 31, 2009.

[863](#) Ian Talley and Tom Barkley, “Energy Chief Says U.S. Is Open to Carbon Tariff,” *The Wall Street Journal*, March 18, 2009.

[864](#) Fiona Harvey, “WTO Signals Backing for Border Taxes,” *Financial Times*, June 26, 2009.

[865](#) Alan Tonelson, “Obama’s Tire Tariff Decision: False Promise From a Free-Trade Administration,” *American Economic Alert*, September 18, 2009.

[866](#) Peter Morici, “Trade Deficit Threatens a Double-Dip Recession, Economic Armageddon,” *Online Journal*, November 13, 2009, http://onlinejournal.com/artman/publish/article_5260.shtml.

[867](#) Senator Richard Shelby, *NBC Meet the Press*, Nov 16, 2008.

[868](#) As of this writing, the ultimate outcome of the global warming controversy remains to be seen.

[869](#) Paul Krugman, blog entry of June 26, 2009, <http://krugman.blogs.nytimes.com/2009/06/26/the-wto-is-making-sense/>.

[870](#) This could have significant protectionist effects given that China's carbon emissions per unit of GDP are roughly eight times those of the U.S. According to Jeff Rubin of CIBC, "With OECD's carbon tolerance diminishing with every tonne of CO₂ spread into the atmosphere by non-OECD countries, environmentalism will soon become a significant barrier to trade. A carbon tariff imposed by the U.S. on emissions embodied in Chinese exports would not only abolish the implicit subsidies on the carbon content currently enjoyed by Chinese exports, but it would be large enough to start reversing current trade and off-shoring patterns." See http://research.cibcwm.com/economic_public/download/smar0t

[871](#) This section is based on Robertson Morrow, "The Bull Market in Politics," Clarium Capital Management, February 2008, p. 14.

[872](#) Trade polls 1992-2008: "Polls on NAFTA and Free Trade," American Enterprise Institute, June 26, 2008, p. 3,

http://www.aei.org/docLib/20031203_nafta2.pdf. Immigration Polls: Tim Bolin, "Public Opinion on Immigration in America," Mirage Foundation for the American Dream, p. 8, <http://www.miragefoundations.com/MFAD%20Occasional%20>

[873](#) The final CAFTA vote in the House had almost every Democrat against and almost every Republican in favor. In the Senate, 78 percent of Republicans were in favor while 76 percent of Democrats were op-posed. On amnesty, the Senate vote was 12 Republicans and 34 Democrats in favor, 37 Republicans and 15 Democrats against. (There was no House vote on this bill or an equivalent.) See Robertson Morrow, "The Bull Market in Politics," Clarium Capital Management, February 2008, p. 15.

[874](#) Robertson Morrow, "The Bull Market in Politics," Clarium Capital Management, February 2008, p. 16.

[875](#) See p. 144.