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## **The Debate about Trade: Some small steps towards one**

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This paper addresses the discussion about the desirability of international trade. It starts out from the stylized observation that trade economists and ‘anti-globalists’ not only reject each others conclusions, but also the validity of the reference frame in which the other side makes its arguments. We mend for this problem, constructing a rational dialogue between the various parties by making differences in criteria and modes of analysis explicit. Instead of seeking to develop a comprehensive common framework, we adopt a ‘pluralist’ position, in which we only create a common structure in so far as necessary for meaningful dialogue. We judge the effects of trade as they follow from both the analytical models used by proponents and opponents and from the perspectives of both the criteria used by proponents and opponents. Applying different criteria to both standard and poverty-sensitive trade models, we find that both camps have valid cases, but also that diagonally opposite positions do not necessarily lead to different judgements regarding the desirability of trade. Once differences in preconceptions and criteria are cleared, a fruitful debate is therefore possible. We conclude that the debate about free trade cannot be settled by economics and should in the end take place in the moral and political arena.

## Introduction

Ever since Adam Smith wrote his groundbreaking *The Wealth of Nations*, economists have debated the desirability of international trade. In this discussion, opponents have continuously brought in numerous specific cases in which free trade might not be desirable. Many of these convincing cases notwithstanding, the idea that free trade is beneficial in general has been increasingly accepted among economists, even to the extent that one prominent economist in 1998 could claim that the case for free trade has been settled (Bhagwati et al., 1998). Outside the habitat of trade economists, however, the case for free trade is far from being settled. For decades, development economists and sociologists have pointed at structural weaknesses specific to poor countries that would render protection desirable (ECLA, 1950; Frank, 1969). In addition, in recent years, the debate has increasingly been taken to the streets, with highly visible ‘anti-globalists’ protesting against the ‘neoliberal’ ideology of market economy and free trade, endorsed by organizations like the WTO and IMF. Free trade thus continues to be a controversial issue.

Upon a closer look, it seems that the differences of opinion run deeper than just the verdict on international trade. The old and especially the new breed of opponents to free trade generally do not use the sophisticated mathematical analyses of neo-classical economists, but tend to use more intuitive arguments claiming that free trade is not fair given the weaker bargaining position of people in poorer countries. Moreover, different parties in the debate about trade not only tend to cling to different analytical approaches, but to different evaluative criteria as well. Economists and ‘anti-globalists’ seem to appreciate the same consequences differently when passing their verdicts on international trade. Finally, as we will argue, various parties in the debate about trade at times seem to be talking at cross-purposes, simply because are not asking the same questions.

Lack of sophisticated technical analysis and a failure to make other differences explicit might induce economists to dismiss the opposition as being simply misguided; if these protesters only understood what we, economists, understand they would not oppose free trade anymore. A similar lack of tolerance and understanding is often exhibited by the other side. The consequence is that there seems to be hardly any meaningful debate between the various camps.

A more fruitful angle to enter the discussion, we believe, is neither to start out from the idea that one side must be right and the other side wrong, nor from a priori privileging one set of arguments above the other for settling the case. The main aim of this paper is to enable dialogue between the various positions on trade by specifying underlying assumptions and ideas, and translating the arguments of both parties into the framework of the other. Subsequently, by assessing trade from within these various frameworks, we can establish to what extent differences in opinion between various parties are due to underlying differences in perspective rather than analytical flaws or misconceptions by one party. Thus, we hope to facilitate meaningful discussion.

The remainder of this paper is as follows. In Section 2, we discuss our strategy of translating arguments, and try to reveal the differences perspective behind the various positions in the debate about trade. Sections 3 to 5 deal with the assessment of trade from various perspectives. In Section 3, we stick to standard models of trade, but apply various criteria to assess its effects. Section 4 translates the analytical arguments against free trade into a trade model that explicitly takes into account the consequences of poverty. We analyze the effects

of trade on basis of this model, and judge them on basis of the same set of criteria as we applied to the standard models. Section 5 moves on from the question about the desirability of trade towards the question how trade ought to be conducted. Section 6, finally, concludes.

### **The Debate about Free Trade: Bridging the Gap**

If we acknowledge underlying differences in perspectives, there are two possible directions we can take to foster meaningful discussion. First, we could seek a comprehensive common framework on basis of which we can evaluate trade, examining both positions under the same lens and holding them up to some common standard. A problem with this solution is that it is hard to see what sets apart the moral, methodological and analytical position taken by such a common framework from others; in other words, we would be wanting an argument why this common framework is in fact the right one. Establishing what the 'right' criteria and analytical angles are for a comprehensive framework would take us far into the highly complex and contentious fields of moral philosophy and epistemology, which might be argued not to be preferred within the scope of this discussion.<sup>1</sup> Alternatively, we might adopt a more 'pluralist' position, in which we only create a common structure in so far as this is necessary for meaningful dialogue. Instead of privileging one position, we then look upon the issue from all possible positions that can be distinguished. In other words, we judge the effects of trade as they follow from both the analytical models used by proponents and opponents, from the perspectives of both the criteria used by proponents and opponents and ask the questions asked by various parties. Table 1 delineates this range of perspectives. By discussing trade from each of these perspectives rather than privileging one or two of them, meaningful communication and discussion between the various parties in the debate about international trade becomes possible. Only thus, we can come to a balanced verdict on the desirability of trade.

#### **(Insert Table 1 about here)**

To cool down any overheated expectations, it is perhaps useful to begin with pointing out some of the limitations of our approach. Although we have explicitly taken a pluralist stance that seeks an open, meaningful discussion rather than final verdicts on basis of a common unifying framework, it should be noted that the difference between the two approaches is one of degree rather than kind. For any meaningful discussion about various positions to arise, some kind of common framework is needed. However, here it is stated that this common framework is only necessary on the level of structuring the dialogue rather than on the level of common analytical models or criteria. It is possible to allow a plurality of arguments, verdicts, criteria, questions and analytical models in our discussion, as long as they are formulated into some kind of common language so as to make communication possible. We use the first part of this section to elaborate on this, after which we will delineate the stylized positions we allow to enter our discussion.

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<sup>1</sup>Although ongoing discussions about the right way to analyze and judge economic processes are to be welcomed, they are unlikely to result in such a level of consensus that a meaningful discussion about the desirability of free trade becomes possible (certainly in the short run). For this reason, this paper seeks to separate the discussion about criteria and analyses with which to answer questions of trade from the discussion about free trade itself.

*Common language*

As noted, when looking at the debate about free trade, one is confronted with the discrepancy between the qualified consensus about the desirability of free trade within the economic community on the one hand, and the widespread resistance to opening up trade in public debates on the other. The arguments that have convincingly 'settled the case' within the economic discipline seem to have failed to equally convince the world outside it, which turns out to be less susceptible to economic argumentation. In the same way that economists are often less easily swayed by the reasoning of many critics of free trade, economic analytical arguments are not always recognized and accepted as valid by non-economists. The underlying problem here is that, although Bhagwati (1998) can perhaps convincingly claim that economic analysis shows free trade to be welfare-enhancing, economic analysis cannot make the case for economic analysis to be able to provide valid arguments in a discussion about trade. This is simply assumed on beforehand. In their rejection of free trade and current globalization in general, however, most critics of free trade do not share this assumption. Rather than entering dialogue on basis of economic analytical arguments, they often challenge the economic way of thinking itself, denying its ability to provide valid arguments in this discussion. Similarly, whereas some of the arguments made by critics of free trade might suffice to convince anyone who is ready to be convinced by interpretive, context-conscious reasoning, they do not convince those economists who reject this type of analysis as valid. In short, the problem of the current discussion about free trade is that people seem to be speaking different languages.

This implies that, in order to take the discussion about free trade forward, what is needed is a translation of argumentation of proponents and opponents into some sort of common language on basis of which debate can emerge. Only thus, genuine dialogue can come about. Inevitably, something goes lost in this translation. In our case, for example, we translate the position of opponents of free trade into the language of economic models, which is not the language in which the position has originally been formulated. This might cause a bias in the discussion in favor of the pro-trade cause, for their position is more readily associated with analytical economic models (although such models are not the exclusive domain of free trade advocates)<sup>2</sup>. The need for a common structure along which dialogue is possible also requires us to translate the respective positions of proponents and opponents of free trade into consistent, 'stylized' positions, whereas reality is far more complex and heterogeneous on this matter. Although this puts our endeavor at risk of being dismissed as creating caricatures, the advantage of stylization is that if we are able to overcome the gaps between such extreme 'caricaturized' positions, this renders our insights useful in reality where things are less extreme as well.

*Filling in the cross-table*

We can now turn to the task of filling in the cross-table, by establishing the stylized positions which we will allow to enter our discussion. First, with regard to differences in analysis, the issue we focus on is the stress laid by many free trade-critics on the consequences of poverty, leading to unequal starting positions. The argument here is that being poor and less industrialized puts one at a disadvantage in the competition of free trade, so that initial inequalities are reproduced, if not worsened. By contrast, neoclassical models generally tend

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<sup>2</sup> In order to find out whether such a bias is present, it would be an interesting project to take up the same project as we undertake here coming from another side---translating neoclassical trade models into interpretive, contextual analytical terms, for example.

to predict convergence, because unequal starting positions are looked upon as ‘opportunities for arbitrage’, so to speak, rather than as structural weaknesses. Although this is by no means the only analytical disagreement between proponents and opponents of free trade, we limit ourselves to this stylized opposition since it serves to structure the dialogue and makes our analysis manageable.

With respect to criteria, the main difference we focus on is the point that economic analysis tends to evaluate actions in first instance on basis of their effects regarding efficiency, whereas other criteria such as fairness are also possible. If efficiency is the criterion, any action will be assessed on basis of the welfare it brings about; if total welfare increases by opening up trade, it is positive. Efficiency does not take distribution issues into account. In the case of free trade, the appropriate example is the assessment of situations in which everyone gains, but the rich gain disproportionately more than the poor. From the point of efficiency, this would be considered an improvement. To many people, however, the increase in inequality in this situation seems unfair. On the other hand, also few people would prefer a situation in which everyone enjoys equal, very low incomes above a situation in which some inequality exists but all incomes are higher. Thus, notions of fairness in the discussion about trade seem to be formed to a large extent by a concern with what happens to the incomes of the poor.<sup>3</sup> We translate this observation into the stylized position that if trade implies that those that were worst off prior to trade gain, it is considered fair; if they lose because of trade, it is not. We label this criterion poverty alleviation fairness.<sup>4</sup>

A third issue is about the question to be asked about trade. As Bhagwati (1993, 32) has noted “it is only a mild caricature to say that, ever since Adam Smith invented the case for the Invisible Hand (and hence also for free trade), economists have made their reputation by inventing reasons why the Invisible Hand fails.” However, although this debate among economists might have been settled more or less in favor of trade, it could be said to be an example of the general principle that “everything ‘anti’ thinks in the spirit of that against which it is anti” (Heidegger 1928, 52-3). To economists, the question has almost exclusively been ‘to trade or not to trade’. When dealing with this question, both proponents and opponents of trade have generally conceived trade in a similar way, as a process in which parties try to maximize their own utility by exchanging goods and adapting production. The question how to trade has rarely been addressed. This is all the more interesting since it is the manner in which trade is conducted rather than the existence of international trade itself that is questioned by many of globalization’s critics. Many critics of international trade do not so much want it to be abolished as conducted differently. Advocates of fair trade, for example,

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<sup>3</sup> Fairness, of course, can be interpreted in many alternative ways. The reduction of the whole range of possible criteria to two different positions as has been done here is far from exhaustive or doing right to the literature. Moreover, in the following discussion we limit ourselves to poverty in terms of income exclusively; since this is the one thing the models applied here can say something about. To discuss poverty outside the limited reality of our models, a myriad of more complex, inclusive poverty measures is available in the literature (see Sen 1976; Foster et al 1984; Seidl 1988; Zheng 1997; Kakwani 1995 among others). However, here we are not concerned with developing or discussing different criteria and measures of fairness, but by identifying potential differences in terms of references between the pro-trade and anti-trade camps, as sources of their being at cross-purposes. It is by no means implied that economists are only concerned with efficiency, and anti-globalists only with poverty alleviation; for one thing, both are far from homogenous groups. However, by specifying and recognising these two different criteria, this paper takes a small first step towards clearing the room for meaningful dialogue. The authors would welcome any further attempt to expand upon this approach, by identifying other positions and criteria and constructing a more exhaustive cross-table.

<sup>4</sup>This criterion shows some resemblance to the principle formulated by Rawls (1971) in a Theory of Justice. An important difference, however, is that we are considering income distribution only, whereas Rawls’ principle applies to freedoms.

allege that international trade should be handled in a more just manner—abstaining from the use of child labor, paying decent prices, fostering personal relations between producer and consumer—rather than not at all. All this results in the filled-in table of perspectives that are to be discussed (Table 2). The next step to take is to discuss the desirability of trade from each of these positions, one by one.

**Table 2: Perspectives used**

		HOW TO TRADE?	<i>Criterion applied</i>	
		Analytical focus	<i>Efficiency</i>	<i>Poverty Alleviation</i>
TRADE OR NO TRADE?	<b>Criterion applied</b>		<i>E</i>	<i>F</i>
Analytical focus	<b>Efficiency</b>	<b>Poverty Alleviation</b>	<i>G</i>	<i>H</i>
<b>Standard Trade Models</b>	A	B		
<b>Poverty-Sensitive Framework</b>	C	D		

**Assessing Standard Trade Models**

Now that we have explicitly established the evaluation criteria that we will use in this paper, we can start discussing the desirability of trade in standard trade models (perspectives A and B in Table 2). We will focus on the two analytical angles that are central to international trade theory, comparative cost differences and economies of scale. This choice is also appropriate because of the different implications they have regarding the consequences of liberalizing trade. In comparative cost based models, trade is typically superior to no-trade at a country level of analysis, but there are strong income distribution effects within countries. In models where economies of scale prevail, the income distribution effects are absent or less pervasive, but then the gains from trade are uncertain. To get a complete view on how trade models perform on our evaluation criteria therefore warrants a discussion of both types of models. As we also did this in Maseland and de Vaal (2002), be it for a different purpose, we will use the remainder of this section to briefly reiterate the main results we obtained there.<sup>5</sup> We used the Heckscher-Ohlin factor abundance model of trade to investigate the desirability of trade in comparative advantage based models, while to analyze the desirability of trade when

<sup>5</sup>In Maseland and de Vaal (2002) we investigated the claim made by fair trade organizations like Oxfam that their way of organizing international trade is fair compared to the normal practice of trade. To that purpose we used trade models to compare their trade regime with free trade and protectionist trade regimes on its compliance with the criteria set by the fair trade movement itself.

economies of scale prevail we used the static, trade-only version of the new economic geography model of Fujita, Krugman and Venables (1999, FKV from now on).<sup>6</sup>

It is well-known that comparative cost differences between countries lead to mutually beneficial trade.<sup>7</sup> Trade makes it possible to achieve a more efficient division of labor across countries and both countries will gain. This is irrespective of the reason for comparative cost differences between countries and thus also applies to Heckscher-Ohlin based trade. By the efficiency criterion, therefore, trade based on comparative advantages is desirable. Alternatively, in trade models that are based on economies of scale it is not necessarily true that countries gain from trade. In the trade literature this has been shown to be primarily true when the economies of scale are external to the firm; that is, when the average costs of production depend on sectoral output levels instead of output at the level of the firm.<sup>8</sup> This could imply that the country which is the high cost producer for each conceivable scale of production may in fact be the low cost producer in autarky because of a higher scale of sectoral operations compared to its low-cost counterpart. Upon trade, the high cost country may therefore actually export the good, which reinforces its scale advantage over the other country and leads it to completely specialize in it. Such an outcome is not efficient, as the optimal allocation of resources would have called for specialization in the low cost country. In the presence of (external) economies of scale, trade may thus not be desirable by the efficiency criterion and temporary protection can be optimal. This judgement, however, implicitly applies the efficiency criterion to long-run outcomes. That is, we compare the outcome where the production related externalities overturn the given comparative advantage of a country to an outcome where production externalities reinforce a country's given advantage.<sup>9</sup> But trade is obviously efficient at a given moment in time, as it is always the actual low-cost producer that exports the good. This implies that when differences in starting positions start playing a role, we should make a difference between short-run efficiency and long run efficiency. Whereas the former notion takes all differences between countries as given, the latter allows these differences to change over time. For now, this distinction is not so relevant as the trade models we discuss typically do not model the reason behind externalities. In the framework we develop later, it will have a central place in the analysis though.<sup>10</sup>

When dealing with the criterion of poverty alleviation fairness, the verdict on the desirability of trade is diverse. For the Heckscher-Ohlin model it follows that under reasonable conditions trade is fair because it helps alleviate poverty. Where trade is solely based on differences in factor endowments --- as in the Heckscher-Ohlin model --- a country's abundant factor will

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<sup>6</sup>This particular model was chosen since it not only incorporates scale economies at the firm level and intra-industry trade, but also economies of scale that are external to the firm. As such, the model is a good representation of new trade theory.

<sup>7</sup>See any standard text book on international trade theory for the basic argument. An advanced treatment can be found in Bhagwati et al. (1998) and Bowen et al. (1998).

<sup>8</sup>External economies of scale are either directly modeled (e.g. Ethier, 1979), or come about as a result of pecuniary externalities that are generated by the interaction of returns to scale at the firm level and the existence of transportation costs (e.g. Krugman, 1991, Krugman & Venables, 1995). For the outcome on efficiency the way the externalities are modeled is irrelevant though.

<sup>9</sup>In the literature this has become known as the difference between 'first nature' and 'second nature', see Krugman (1993).

<sup>10</sup>Of course this is a drawback of our choice to restrict our discussion to the part of the trade theory literature that focuses on the comparative static analysis of trade, where in the literature the concept of endogenous comparative advantage has also received considerable attention. We would argue however that most proponents of free trade still base their opinions on comparative static approaches, so that for the purpose of this paper not much is lost by not taking into account these models.

gain from trade, whereas the scarce factor will lose. Since a factor is always less rewarded in the country in which it is relatively abundant than in the country in which it is relatively scarce, the group that is worst off before trade must be the abundant factor in either of the two countries.<sup>11</sup> Since abundant factors gain from trade, it follows that trade in a Heckscher-Ohlin setting is always poverty alleviation fair. For the trade-only version of the FKV model we employed in Maseland and de Vaal (2002), the verdict is less clear and becomes highly case dependent. This is a feature that is inherent to the presence of several nonlinearities in such models, which precludes analytical outcomes and requires computer simulations to get results. Doing so for a standard exposition of the FKV model<sup>12</sup>, it appears that which group is worst-off before trade depends highly on the exact parameter configuration that is chosen.<sup>13</sup> Consequently, also the verdict on the desirability of trade becomes highly case specific. For instance, for the case where the parameter setting is such that before trade agricultural labor has the lowest real income, opening up to trade is poverty alleviation fair as it raises the real reward of agricultural labor. When, in contrast, the parameter setting is such that manufacturing labor has the lower income before trade, opening up to trade may be unfair, depending on the extent to which trade is freed.<sup>14</sup> Only when the opening up to trade reduces trade barriers by enough, manufacturing labor will gain from trade and trade is poverty alleviation fair.

### **Fairness and Poverty**

The standard models of international trade that were discussed in the previous section do not address a main point of critique that opponents of free trade bring in, namely that free trade might be unfair because of the disadvantaged starting position that poverty leads to. Although specifically comparative advantage models do acknowledge differences between countries that engage in international trade --- indeed, in such models these differences are the prime source of trade and welfare gains --- these differences only apply to differences in endowments or technology that are given and are not seen as consequences of the level of development at a particular point in time. The trade literature that sees comparative advantage as a dynamic phenomenon obviously departs from this static perception of differences

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<sup>11</sup>This reasoning holds when factor ownership is distributed such that the poorest group also represents the poorest individuals. If this were not the case, a production factor could be worst off before trade when rewards are measured in per unit terms, while its owners of the production factors are not worst off. It is in the spirit of the perfect competitive nature of goods and factor markets in the Heckscher-Ohlin model to assume that ownership structures do not differ between factors of production.

<sup>12</sup>The standard FKV model involves a world that consists of two countries, each producing homogeneous agricultural goods and heterogeneous manufactured goods. Agricultural goods are produced under constant returns to scale, while manufactured goods incur increasing returns to scale. Labor is sector-specific and in the static version also immobile between countries. Trade in agricultural products is costless, while trade in manufactured goods carries a transportation cost. Both countries are equally large in terms of agricultural labor, but not in manufacturing labor.

<sup>13</sup>These results are based on an extensive sensitivity analysis of the benchmark parameter setting of the FKV model. The benchmark parameter setting is such that the large country has 60% of world manufacturing labor and that consumers world-wide spend 60% of their income on manufactured goods. With a substitution elasticity of five, the economies of scale in manufacturing are intermediate. See Maseland and de Vaal (2002) for all details.

<sup>14</sup>The model used features a parameter that represents the transportation costs of goods and services across borders. The value of this parameter can take any value between 0 (prohibitive transportation costs) and 1 (no transportation costs). The particular value of the transportation cost parameter has been shown to be crucial for explaining relative wage differences between countries in models where scale economies prevail, see e.g. Fujita et al. (1999). In models where economies of scale are absent, as in the Heckscher-Ohlin model of trade, the importance of distance to explain international trade and income patterns is null and void and can be ignored.

between countries, but fails to include poverty-related aspects.<sup>15</sup> These approaches therefore share the implicit assumption that the way economic mechanisms work out is independent of development level or context. In line with many contributions in the sub-discipline of development economics, we would argue that this might not be the case and that economic mechanisms might work out differently under poverty than under relative affluence. If decision making under poverty leads to different outcomes than decision making under affluence, economic actions will be dependent upon outcomes of previous actions, and thus to some extent endogenous.<sup>16</sup> Note that the argument is not that the economic reasoning people apply is different --- we do not contest the economic rationale of decision making --- but rather that the same way of reasoning might lead to completely different outcomes under different circumstances.

In this section we integrate these insights from development economics in trade theory. We develop a framework that explicitly incorporates the consequences of low levels of income and development for economic decision making, thus creating the possibility of self-reinforcing poverty. We will then use this framework to judge free trade from the perspectives C and D in Table 2.

### *How Poverty Matters*

The starting point for our undertaking is two empirical observations, one at the micro-level, and one at the macro-level. First, it is observed that especially people with low incomes often tend to set their labor force participation so as to achieve the income necessary for survival (Kochar, 1995; Moser, 1998; Jacoby and Skoufias, 1997; rather similar 'target earning' behavior has been observed among New York cab drivers (Camerer, Babcock, Loewenstein and Thaler 1997). These observations are at odds with neo-classical theory, which would predict labor force participation to decrease if rewards for labor fall.<sup>17</sup> The second observation is the wide price-swings and periodic bouts of overproduction that characterize many of the products produced by developing economies (coffee being a prime example).

These observations can be brought together in a framework in which the effects of poverty on labor supply decisions are taken into account. To do so, we first concentrate on the micro-level. We assume an untrained laborer who faces the choice between working in the agricultural sector and alternative activities; we can think of schooling, unpaid household labor, community services or simply rest. Laborers face two constraints in this decision. First, they are constrained by the limited number of hours in a day. Secondly, they are constrained by the fact that a laborer needs to gain an income equal or exceeding a minimum subsistence level of consumption in order to survive.

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<sup>15</sup>The literature on endogenous comparative advantage for instance tries to explain how comparative advantages evolve when there are no inherent differences between agents, see Yang and Ng (1998) for an early overview. Also the relation between exogenous and endogenous comparative advantage has received due attention, of which an early and seminal contribution is Yang (1994). The new economic geography literature that was initiated by Krugman's (1991) seminal paper also lends itself to deliberations on endogenous and exogenous comparative advantages, see e.g. Ricci (1999) and Fujita et al. (1999). Neither of these approaches however relate the endogeneity of comparative advantage to poverty-specific issues.

<sup>16</sup>See for example efficiency wage theory (Dasgupta, 1997), which shows that self-reinforcing income differences may occur between initially identical individuals. A similar idea is endorsed by Sen who regards development as an increase in freedoms or entitlements (Sen, 1999). The corollary of this idea is that lack of development means a lack of freedoms and capabilities, which will make decision making qualitatively different.

<sup>17</sup>Except possibly for very high levels of income, when income effects might start overtaking substitution effects; this is called the backward-bending supply curve of labor.

This implies that agricultural incomes influence the decision whether or not to supply labor to paid work in two ways. First, the decision to work is dependent upon the desirability of work, determined by the ratio of the utility gained by wage income relative to the utility gained by alternative activities. Secondly, the decision to work is dependent upon a laborer's possibilities for alternative activities given the necessities for survival. More specifically, a laborer cannot spend such amounts of time on alternative activities that income falls below the minimum subsistence level.

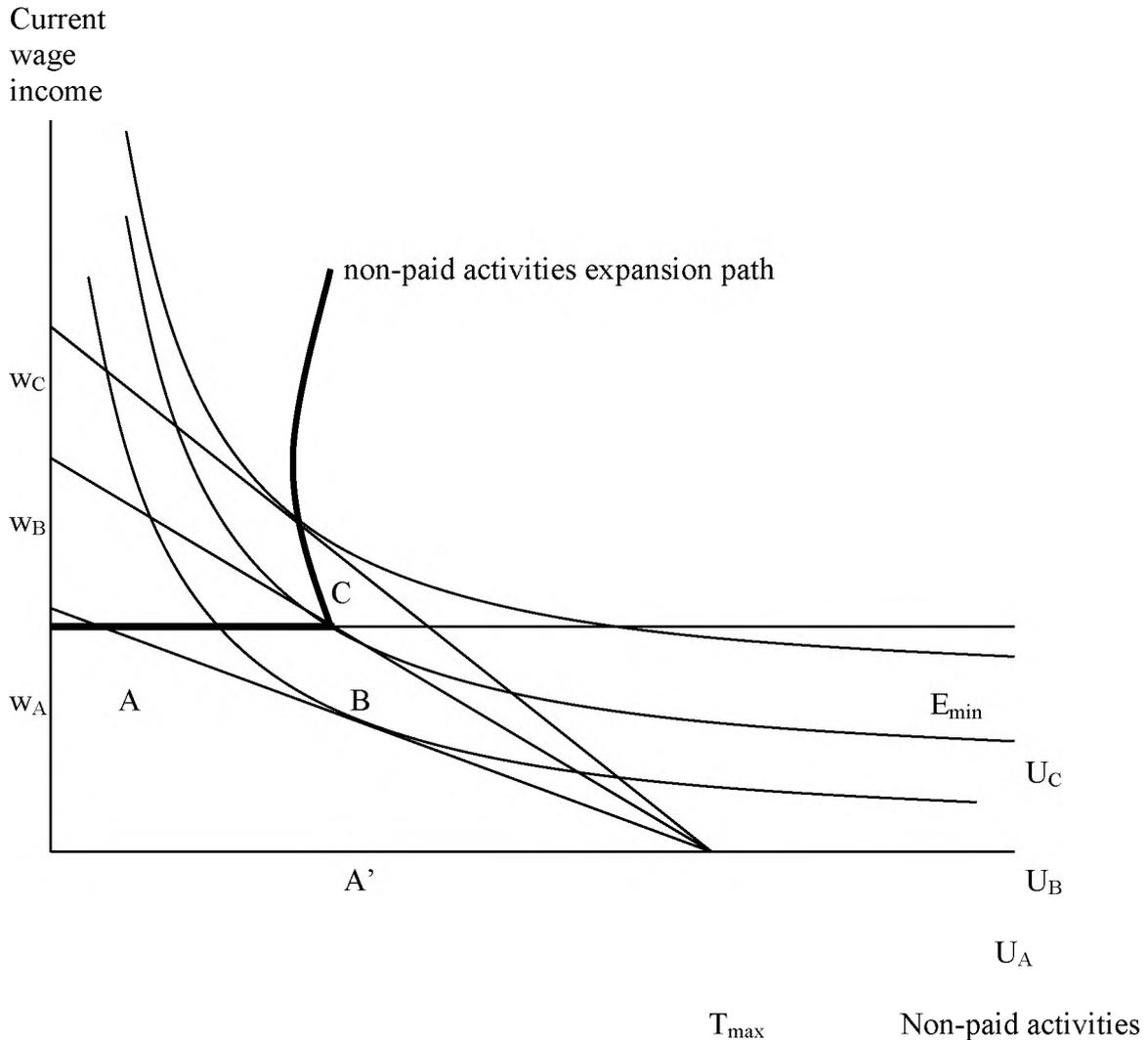
The consequences for the individual labor supply decisions are illustrated in Figure 1. The U-curves represent iso-utility curves depicting all possible combinations of current wage income and alternative activities that yield the laborer the same level of utility. The slope of the curve in each point gives the marginal rate of substitution of current wage income and alternative activities in utility; the steeper the slope, the more the laborer values additional time spent on alternative activities. She weighs this against the opportunity cost of alternative activities, which is here the (expected) wage to be earned on the labor market. In the figure, this is represented by the slope of the budget lines  $w_z T_{\max}$  for  $z = A, B, C$  ( $w$  stands for wage income, whereas  $T$  stands for Time spent on non-paid activities). These budget lines give, for each level of alternative activities that is physically possible ( $T \leq T_{\max}$ ), the income level attainable at the prevailing wage rate. Normally, the optimizing laborer will choose a 'consumption' basket of income and alternative activities such that the marginal costs of alternative activities equal the marginal benefits, that is: where the budget line is tangent to the highest indifference curve possible. Point B and C indicate such points. Below the wage associated with point B, however, optimization means to work until income reaches the level of consumption minimally required to sustain the household (the horizontal line  $E_{\min}$ ), while spending the rest of the time on alternative activities. The low wage prevents the laborer from choosing the desired combination of work and other activities, resulting in a higher than desired labor supply. For instance, for the wage corresponding to budget line  $w_a T_{\max}$ , the optimum choice would be  $A^*$ , yet the laborer must choose A to stay at a subsistence level of income.

In the presence of poverty, therefore, the non-work expansion path is depicted by the bold solid line in the figure. Up until point B, any rise in the wage rate will increase the possibilities for alternative activities, and, thereby the level of it. It is the room for alternative activities that determines the amount of time spent outside paid labor activities, not their preferences. At wages above the wage corresponding to budget line  $w_b T_{\max}$ , however, a laborer is no longer constrained by the need to survive and the level of alternative activities is determined by the normal marginal cost-benefit analysis. Under such conditions, the optimal level of paid labor will be higher than upon subsistence, though if wage levels become high enough non-paid labor activities may increase again. This leads to the 'bend' in the non-paid labor expansion path.<sup>18</sup>

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<sup>18</sup>That is, we implicitly assume that the wages just above subsistence are not high enough to lead to a situation in which higher wages lead to a lowering of the number of hours worked. The latter phenomenon is a well-known possibility in the literature on labor markets, where it leads to the backward bending part of the individual labor supply curve. It seems a reasonable assumption as backward bending supply curves are usually considered to occur in situations of relative affluence.

**Figure 1: The working time decision**



What consequences does this have on a macro-level? In order to link decision-making at the micro-level to wage determination at the macro-level, we need to make some extra assumptions. First of all, we assume decreasing returns to wage labor. You might think of this as in a context of peasantry, in which labor inputs are added to a fixed stock of fertile land. With each extra unit of labor spent on paid work, wages fall. Secondly, we assume that laborers do not have access to credit markets and there are no options available to them for bringing forward future income. Thirdly, we assume only one kind of paid activity. Workers cannot move to another sector or profession, no matter how badly paid their wage labor is—the only alternative exists of non-paid activities.

These assumptions are not very implausible in the context of developing economies. Especially in the countryside, many poor people do indeed not have sufficient access to credit markets. Moreover, for many peasants, moving to another sector or profession means also leaving one's region, moving to the city or even beyond. This implies giving up one's land, which is often the main capital one owns and not seldom an important constitutive part of one's identity. To assume that laborers are 'tied to the land', or more generally 'stuck in their sector', is therefore not an unreasonable assumption.

To make our point, we focus on the case in which income levels are at subsistence levels but in which the room for non-wage activities is positive. In other words, we assume that laborers are able to survive, although they are not capable of working as little as they would prefer to. Under such circumstances, any equilibrium in the labor market is unstable.

What happens if wages rise marginally? Laborers react to a wage rise by withdrawing labor and increasing their alternative activities. Given the higher wage they get, they need to spend less time working to reach the minimum income needed for survival. Since all laborers react in this way, total labor supply falls and, due to decreasing returns to scale, wages rise further, spurring further decreases in labor supply. This spiral goes on until incomes are high enough for laborers to set their ratio of labor and alternative activities according to their preferences rather than on basis of the room for alternative activities. Beyond this point, markets function normally.

Similarly, consider the effects of a marginal fall in wages. Laborers are forced by necessity to compensate for this fall in wages by working more hours. Only thus they can still achieve the same minimum income level needed for survival. However, if all laborers react in this way, the consequence is that total labor supply increases and, due to decreasing returns to scale, wages fall further. This sets off a spiral of ever-further falling wages and increasing labor supply.

This analysis shows that poverty, defined as a situation in which people make decisions on basis of necessity rather than on weighing preferences, indeed alters the way markets function. But does it also affect our verdict on international trade?

#### *Trade in a Poverty-Sensitive Framework*

We are now in the position to make a judgement about trade in the presence of poverty (perspectives C and D in Table 2). We employ our framework to analyze trade on basis of efficiency and poverty alleviation fairness.

First, we discuss efficiency. In standard models of trade, free trade has been shown to be efficient always (in comparative advantage based models), or in most cases (in economies of scale ridden models). These models did however not take into account poverty-induced differences between countries, nor the fact that economic mechanisms may work out differently when income levels are at subsistence. Our 'trade under poverty' framework explicitly models these issues, which has major implications for the functioning of markets. What does this imply for efficiency? If the question is whether to trade or not to trade, all this does not really affect our verdict. Although poverty certainly has consequences for the way markets function, none of this stands in the way of the efficiency gains of international trade. Rather to the contrary: if we assume the laborers of our analysis to work in the sector that enjoys a comparative advantage, trade might set-off a positive spiral of wage gains and reduced labor supply, until laborers are lifted out of poverty and are able to make decisions based on their preferences rather than by force of necessity. From the point of view of efficiency, therefore, trade is beneficial.<sup>19</sup>

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<sup>19</sup>Using trade policy will typically also not be the most optimal way of stimulating working time decisions, as it also distorts production and consumption decisions. A better alternative seems to tax agricultural production, and to use these tax revenues to lower the costs of non-labor activities. In a development context, however, also the

With regard to poverty alleviation fairness of trade, the same conclusion holds. Strictly speaking, our analysis is not capable of providing any verdicts on this account. After all, poverty alleviation fairness—as we have formulated it—is a distributive criterion, whereas a partial equilibrium analysis such as the one above is incapable of providing any insights about distributive effects. However, it should be noted that the poor in our model are living on an absolute minimum income. Since they earn the lowest possible income still compatible with survival, there can be no groups outside the focus of our partial equilibrium analysis that are poorer. It is therefore fair to state that since trade is likely to be beneficial to the poor in our analysis, it can be classified fair on basis of poverty alleviation fairness.

### **How to Trade?**

Until now, we have focused on the question ‘to trade or not to trade’. To many critics of the current globalization, however, that is not the question. Rather than no trade, they seek a kind of ethical trade. In order to assess such ethical trade, we have to acknowledge that there are many proposals and ideas about what constitutes fair trade. However, whether dealing with prohibitions of child labor, minimal working conditions, or paying ‘decent’ prices, the main effect of any such ethical trade vis-à-vis ‘standard’ trade conduct is that it is trade limiting. Paying a higher price for goods, for example, has an effect similar to imposing a quota (Maseland and de Vaal 2002). Imposing conditions about the way goods are produced does the same. Since the effects of ethical trade are thus similar to those of limiting trade, for standard trade models and efficiency the conclusions of the comparison between trade and no trade can be translated to the comparison between standard trade and ethical trade. Standard trade is generally superior when it comes to efficiency, although in economies of scale-setting, a case might be made for applying ethical trade to manufacturing goods. For poverty alleviation, a case might be made for ethical trade in the form of paying above-market prices for goods produced by the poor. The question there is whether the negative welfare effects of limiting trade are offset by the subsidy to the poor in the form of higher prices. As we have argued in Maseland and de Vaal (2002), this depends on the price elasticity of the good in question; how much limitation of trade does the imposition of ethical trade result in?

When it comes to the poverty-sensitive framework, the case for ethical trade becomes stronger. In the previous section, we have shown that poverty on the one hand has very important consequences for producers’ decisions about labor inputs. On the other hand, however, we have argued that this does not invalidate our verdicts about the desirability of trade. The real question, then, is not so much whether to trade or not to trade, but how to trade. Although there is nothing in our analysis of trade under poverty that disqualifies the potentially positive effects of international trade, the fact that poverty results in unstable equilibria implies that it might not be optimal for the economy as a whole if parties engaged in trade do so always exploiting opportunities to increase their own utility to the fullest. As long as producers are poor and buyers always seek to pay the lowest price possible, the specter of getting into a spiral of falling prices, increased production, further falling prices and ever further increasing production is always looming. A ‘fair’ trading rule like paying producers a minimum price for their goods (translating in a minimum wage) can prevent such destructive spirals. Ethical trading, in which buyers take the interest of sellers into account by paying a higher price than would strictly be possible given the market circumstances, can even trigger positive spirals, lifting producers out of poverty and normalizing markets.

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implementation costs carry a heavy weight in the ultimate selection of policies, which might shift the balance in favor of using trade policy any ways.

## Conclusion

This paper has sought to disentangle the debate about the desirability of international trade, which has become rather entrenched over the years. It has argued that unspoken differences in criteria and analytical approaches have caused proponents and opponents of free trade to be at cross purposes. Worse still, at times they even seem to be asking different questions. Arguments from each of the camps therefore fail to make an impact on the position of the other, because they seem to be formulated in different languages. This paper has sought to solve this problem and clear the ground for a meaningful discussion by translating the arguments of trade advocates and antagonists into each other's language.

In order to do so, we have constructed a stylized pro-trade argument and a stylized anti-trade argument, on basis of differences in criteria and analytical angles. We have argued that advocates of free trade are often implicitly concerned with efficiency as a criterion, whereas many of free trade's opponents focus on poverty alleviation. In addition, many antagonists of free trade are focusing on the impact of being the poorer and less industrialized party in a trade relationship, arguing that this puts one in a disadvantaged position, so that initial inequalities are reproduced or worsened. Advocates basing themselves on neoclassical models, by contrast, tend to argue that trade leads to convergence because they view initial inequalities as 'opportunities for arbitrage' rather than as structural weaknesses. Finally, we have noted that there seems to be a deviation in the questions asked. Whereas economists generally seem to assume the debate is about the question whether to trade or not, many opponents want the debate to be about the question how to trade. Although these stylized positions are by no means meant to represent the plurality of positions that can be found in the actual debate, as we have argued they serve to structure the debate and make meaningful comparison possible.

Subsequently, we have assessed the desirability of trade from the various perspectives that arise from this confrontation of positions. The results of our discussion are summarized in Table 3.

### **(Insert Table 3 about here)**

As can be seen in this table, differences in perspective indeed matter significantly for the verdict on trade. Unsurprisingly, when we look at the stylized free trade position, which combines a focus on efficiency with standard trade models (the upper left corner of the first leaf of the table), trade is for the most part beneficial. The only exception is that when taking economies of scale into account, trade might in the long run cause locked-in specialization patterns that are sub-optimal, so that temporary protection could be preferable. Shifting in criterion does not alter these verdicts significantly. Trade is alleviating poverty according to comparative advantage based models, under certain reasonable conditions (most importantly, factor ownership must be distributed so that the poorest group also represents the poorest individuals). In economies of scale-based models, it is impossible to draw general conclusions about poverty alleviation fairness, because who is the poorest group in the world economy is highly dependent upon specific cases and time.

If we make a concession to the position of trade opponents and move to a model that takes the impact of poverty-related unequal starting positions into account, the verdict remains that trade is both efficient and (likely to be) fair from the point of view of poverty alleviation. It is only by moving completely to the critic's point of view—that is, both in framework, criteria

and question asked—that critics of current international trade have a strong case. For poverty does have an impact. We have shown that poverty can affect the functioning of markets in such a way that although trade by itself might be beneficial, gains can be made by addressing the way in which we conduct trade. Exploiting all opportunities for improvement of the own position can result in destructive cycles of overproduction and falling wages, whereas ‘ethical’ trading principles might help markets function properly by lifting people out of poverty.

To conclude, what these results show is that the differences in opinion between advocates and opponents of free trade indeed seem to be related to differences in perspectives. These differences in perspectives have various dimensions; focusing on only one is not enough to fully understand the point of view of an opponent in the debate. The trade advocates case is strongest when applying standard trade models, the efficiency criterion and focusing solely on the question to trade or not to trade. Conversely, the trade critics’ case is strongest when applying a poverty sensitive framework, a poverty alleviation criterion and when the choice is between standard trade and ethical trade.

All in all, the paper suggests that Bhagwati’s claim that the case for free trade is settled has been rather premature, at least when trade between advanced and poor countries is concerned. In fact, the findings indicate that the case for free trade is likely to never be settled. Arguments, perspectives, and criteria will always differ and therefore verdicts are always subject to debate. Rather than closing off this debate by privileging one type of analysis and set of criteria, we should work to make differences explicit in order to foster rational discussion between various positions. After all, it is not the job of economics to settle cases. It is to provide analyses and insights that can bring about and inform meaningful political debate.

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**Table 1: Potential perspectives**

		HOW TO TRADE?	<i>Criterion applied</i>	
		Analytical focus	<i>Trade advocates</i>	<i>Trade opponents</i>
TRADE OR NO TRADE?	<b>Criterion applied</b>		<i>E</i>	<i>F</i>
Analytical focus	<b>Trade advocates</b>	<b>Trade opponents</b>	<i>G</i>	<i>H</i>
<b>Trade advocates</b>	A	B		
<b>Trade opponents</b>	C	D		

**Table 3: Desirability of Trade from Various Perspectives**

		HOW TO TRADE?		<i>Criterion applied</i>		
		Analytical focus		<i>Efficiency</i>	<i>Poverty Alleviation</i>	
TRADE OR NO TRADE?		<b>Criterion Applied</b>				<i>Context-dependent</i>
<b>Analytical Focus</b>		Efficiency		Poverty Alleviation		
		Fairness		Fairness		
		Short-Run	Long-Run	Short-Run	Long-Run	<i>Ethical</i>
Standard Trade Models	Comparative Advantage-based models	<b>Yes*</b>		<b>Mostly yes*</b>		
	Economies of Scale-based models	<b>Yes</b>	<b>Case-specific</b>	<b>Case-specific</b>	<b>Case-Specific</b>	
Poverty-Sensitive Framework		<b>Yes</b>		<b>Yes</b>		

\* Since the comparative advantage models discussed here only deal with comparative static analysis, distinguishing between a short and long run perspective is irrelevant in these cases.