RECONSIDERATION OF GLOBALIZATION and FREE TRADE:
Imperatives for changes in Economics, Business, Political Science, and International Relations

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ABSTRACT

The article presents theoretical and empirical considerations on the topic of international trade and policy. The authors point out that the standard textbooks and typical instruction have drawn seriously misleading implications. In fact, the customary illustrations and explanations can be powerfully deceiving expositions. Unfortunately, it appears that the authors of standard textbooks and most likely college instructors are unaware of serious errors and the untrustworthy conclusions drawn from the popular justifications for globalization and free trade.

GLOBALIZATION AND CROSS-COUNTRY TRADE

Adam Smith, in his classic book *The Wealth of Nations,* first published in 1776, stated, "*If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry employed in a way in which we have some advantage*." This is the idea that underpins the concept of international commerce between the national economies of the world. Economists today still cite Smith as foundational support for explaining trade between the people of different national economies. However, globalization is not simply international trade; it is very different from the simple cross-national exchange of products as envisioned in Smith's 18th century. In 2003, the Managing Director of the IMF defined Globalization as "the process of increasing international division of labor and the accompanying integration of national economies through trade in goods and services, cross-border corporate investments and financial flows" (Köhler 2003).

Over the past couple of decades, globalization policies have transformed the world beyond recognition. Instructors of political economics, international relations and business courses most often refer to the "theory of Comparative Advantage" as explained in 1817 by David Ricardo as well as subsequent theoretical extrapolations of this trade theory to defend their conclusions regarding what is usually called "free-trade and globalization." The theory of Comparative Advantage claims that a nation open to trade will achieve a higher standard of living for its people through international commerce by specializing in the products and services for which the nation has a relative advantage (lower opportunity cost).

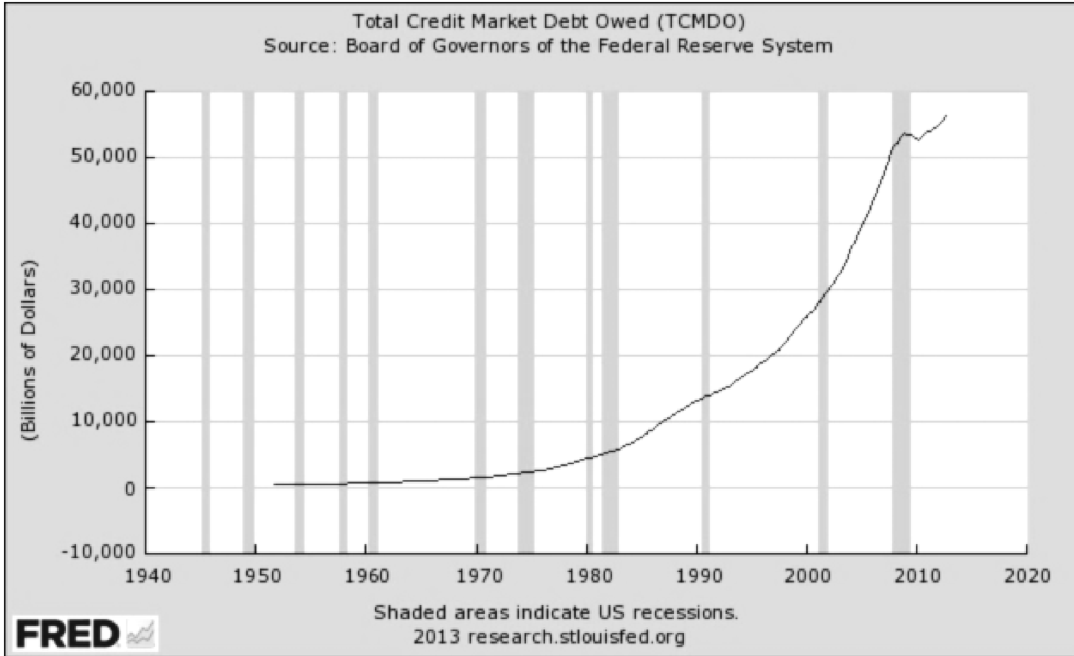
For many years the textbooks used in business courses, political science, international relations, and economic principle courses are often misleading when illustrating the effects of so-called “free trade and globalization.” Unfortunately, many college instructors are unaware of the serious errors of logic and the untrustworthy conclusions that students draw from the popular textbooks. One of the most powerfully deceiving expositions is the explanation and conclusions drawn from the Comparative Advantage theory as it is illustrated and summarize in leading textbooks. Due to a conceptual belief in the textbook presentations of Comparative Advantage theory, there is overwhelming academic support for free trade (Alston et al. 1992; Fuller and Geide-Stevenson 2003).

For many decades, the best-selling introductory economics textbook was by economists Paul Samuelson and William Nordhaus, now in its 19th edition the textbook is still widely adopted (Samuelson and Nordhaus 2012). Two other textbooks, outsell all others combined, representing about 40 percent of the entire market (McConnell, Brue and Flynn 2012; Mankiw, 2012). Nevertheless, the old standard illustrations and explanations are the primary foundation for the students’ conclusions about the effects on economies of the concepts labeled as free trade and globalization. In fact, the impressions conveyed unequivocally promote free-trade and globalization policies as being exceptionally beneficial to most everyone. Specifically, it is the Comparative Advantage theory that is used to explain mutual benefits from international trade and cited as support for the contemporary free-trade policies, and by implication globalization (corporate cross-border business without restriction). The illustrations always conclude that these activities are beneficial for all countries. The examples given are both tabular and graphical depictions of two countries producing the same two products (e.g. wheat and coffee). These conjectural illustrations begin by showing the two nations operating as closed domestic-only economies, and subsequently as open trade economies after the countries adopt specialization and trade, the results show that combined product in this two-country-world has increased.

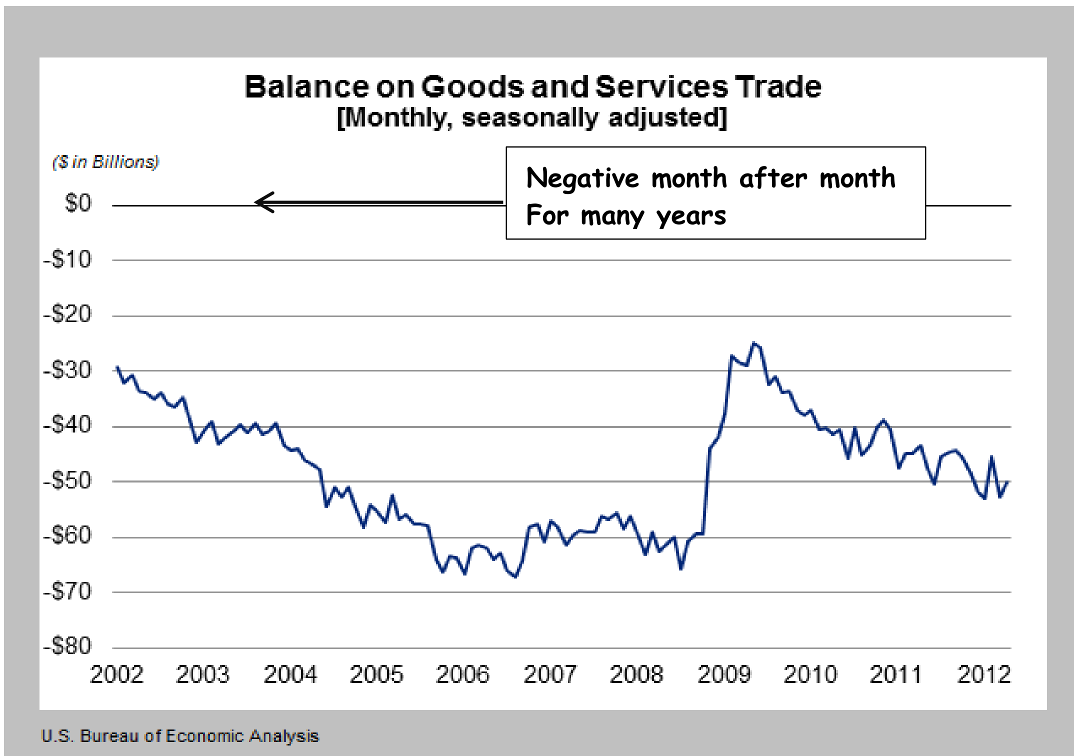
Observers conclude that following the precepts of Comparative Advantage in the real world will result in the people of all countries enjoying a higher standard of living. However, these illustrations do not present or explain why there appears to be contrary empirical evidence where many citizens, even perhaps a very large percentage of those in a developed national economy, will *not* enjoy a higher standard of living. For example, within the empirical data, there is unequivocal contrary evidence. It is common knowledge that a large number of the original U.S. manufacturing companies have now moved production to locations in foreign lands. Many of the products for which the USA was once famous are no longer made in the USA. Over time, the skills required to make these products have disappeared from the labor force of United States.

At the same time, the activities of U.S. businesses in the creation of credit transactions, derivative paper, and financing has more than doubled in as a percentage of GDP, while U.S. manufacturing has declined to less than half its size (Bureau of Economic Analysis). From 1971 to 2012, the U.S. increased financial services by 54%, and there was a commensurate decrease of manufacturing by 54%. This structural change in the U.S. economy might appear to be the result of specialization in “comparative advantage” with benefits accruing to the wellbeing of most Americans. Is this true or is there a hidden problem?

Drilling deeper into evidence, a serious problem is disclosed: U.S. citizens have not been able to afford all the purchases of these seemingly lower priced imported products without going into debt.



During increasing activities of globalization, private debts have been increasing rapidly. In addition, the US government has also been purchasing large amounts of foreign products and services by using borrowed money, a large portion from foreign creditors. Consequently, the trade data in shows the USA no longer makes enough products and services that foreigners want to purchase in order to equalize the trade balance between the USA and the rest of the world. In fact, since 2002 the total credit expansion has been an astonishing six-times the growth rate of the GDP.



Particularly, there exist chronic US trade deficits with countries such as China, Japan and other Asian economies, year after year. The answer to the question of why the peoples of these other countries do not purchase enough US made products to balance trade is reasonable and understandable; the nations of the major trade surplus economies have the physical capital, financing and factories that can increasingly provide many of the same products and services domestically in their homeland. Every year since 1995, the USA runs Trade-Account **deficits** of hundreds-of-Billions of dollars. Thereby accumulating huge debts owed to foreign entities and the private foreign banking system. In just the last ten-year period alone, 2002-2012, the chronic deficits amounted to an accumulated trade debt of over $6.2 trillion. In fact, the USA has not had even a tiny trade surplus since 1992.

COUNTER ARGUMENT CONSIDERED

Nevertheless, as the USA deindustrializes, the political defenders of free-trade globalization argue that there is no long-term problem arising from the U.S. losing production capability because the economic loss will be replaced by gains in "innovation" in America. This is an appealing sounding argument, let foreigner's cheaply manufacture the products that creative Americans invent. At least that is the ideological expectations of the people who were raised on the simplistic interpretation and illustrations of Comparative Advantage theory. However, one of the arguments supporting a contrary position is *"Most innovation does not come from some disembodied laboratory. In order to innovate you have to be pretty good at making it — and we are losing that ability," says* Stephen Cohen, co-director of the Berkeley Roundtable on the International Economy (Uchitelle, 2006)**.** In addition, the textbook illustrations of Comparative Advantage for free-trade theory underpinning the argument for globalization are extremely misleading because of several fundamental errors in presentation and application.

TRUTH VERSUS FICTION

One of the globalization arguments must be true and the other false. The basis of the argument of proponents for globalization and free-trade is Comparative Advantage theory. Is the Comparative Advantage theory false? The scientific answer is that the theory is true under impractical assumptions, but for applied policy in the 21st century, it is false. In fact, the implications drawn from the textbook presentations have been very misleading since at least the later quarter of the last century. There are things not usually addressed in the illustrations of the Comparative Advantage theory of trade: 1) the "**Fallacy of Composition**" and 2) **Very unrealistic assumptions**.

Economist Lester Thurow acknowledged that "the theory of comparative advantage is taught as if everyone benefits from trade. That is not true." Thurow pointed out that total income derived from specialization under comparative advantage increases, but there will be individuals who lose. What the theory actually says is that those who gain from international trade will receive enough profits from these activities that they could compensate those who lose. However, "If that compensation is not actually paid (and it almost never is), then those who lose are quite rational to oppose international trade (Thurow 1996). When students of commerce, international relations and political science read about the Comparative Advantage theory of international trade, do they notice this fallacy-of-composition? Furthermore, do they understand all the other things wrong with the usual explanations of this theory? They will not, if the instructor does not identify the simple but errant impressions given in the textbooks.

As with any theory, assumptions are made and it is extremely important to know the implications of all assumptions. Therefore, the instructors must ask and answer the question: What are the assumptions that are not thoroughly discussed in the typical textbook illustrations?

First, full employment is simply assumed to exist in these illustrations, and therefore it logically follows that cross-country free-trade would not force people into unemployment, because the workers are simply assumed to be always employed, either producing one thing or another. No loss exists from unemployment. This convenient assumption is certainly not empirically supported.

Second, transition costs for factor movement are assumed zero. Under the assumptions, there are no specific human capital losses arising from workers being forced to shift between industries or between employers or regional locations. Therefore, there are no losses between regions, and no industry losses and no capital losses. These assumptions underlying the exposition simply assume problems do not and will not exist. This is not reality; empirically invalid to impose this condition (Autor, Dorn, Hanson, Song, 2013).

Third, the returns to factors of production are assumed equal. Each industry has the same rate of return on human or physical capital. Therefore, there is no cost or consequence to workers. No costs to those people forced to shift employment, because such costs and losses have simply been assumed away in the first place. Under this restricted logic, thus everyone is a winner!

Forth, during the times of Smith or Ricardo, monetary units were anchored to physical metals such as gold and silver, and therefore a nation's ability to pay for imports was limited to its income plus stock of wealth defined in absolute physical units. A nation could not run chronic trade deficits decade after decade. Whereas, today the monetary units are physically unanchored fiat units of account based upon presumption of expected future production, and therefore imports can often be obtained by accumulation of debt, year after year, and far into an ill-defined future.

Fifth, the theory originally stated that there were "gains from trade" as each country specialized in what it could do best and then traded for products from other countries. However, the idea that there are comparative advantages in production is based on countries having different endowments of immobile factors for production. When the theory was originally created in the early 1800s by David Ricardo, agricultural products were the most important component of gross domestic product, and therefore advantages resided in a country's climate and natural fertility and these were immobile factors (Ruffin, 2002). Indeed, climate and geographic location cannot migrate, but capital and technology can. Today, in fact, the digital accounting of financial capital and technological knowhow transfer instantaneously to most anywhere in the world.

Today, there is not merely comparative advantage but sometimes an absolute advantage wherever an extremely abundant supply of low-cost labor exists because capital and technology easily migrates there. Ricardo recognized that the principle behind his theory would not hold if factors of production could migrate from one country to another, internationally. He knew that if permitted by law, the factors of production of capital and technology would migrate to countries that had the greatest advantage, and some people in countries would **gain** while other people would **lose**. A strangely tangled web is woven when jobs and manufacturing are sent overseas.That is the real conclusion, not everyone gains, not even necessarily each trading nation overall. In reality, a third party may be the one who benefits most while others lose, but in the simplistic two-dimensional world of the textbook presentations, there are no third parties. In such exposition, there is no room for a third party, who may even possess multiple-citizenship. Therefore, when you see or hear someone using the Comparative Advantage argument in support

of free-trade policy and globalization**,** be sure to identify and correct the mistaken assumptions underlying their usually fallacious conclusions drawn from simplistic impressions.

POLICY IMPLICATIONS

Many defenders of so-called "globalization and free trade" have been making mistakes because they have confused free movement and owners of factors of production with the conceptual model called Comparative Advantage in Trade. Moreover, because graduates of higher education have been reared and nurtured on the theory of Comparative advantage, they believe they know that free trade is always desirable and mutually beneficial. The argument for free trade seems unassailable to them (as it is presented), and therefore most everyone responds positively to all free trade policies. They advise government officials, but they are making grievous mistakes because they have not peered deeply and have not seen that reality does not comply with the customary assumptions behind the logical illustrations of this trade theory.

Unfortunately, many of the Western economies, previously developed, are losing because of Pollyannaish policies of globalization. The cores of the Western nations' human resources are losing (i.e. over time, large numbers of people living in these countries are actually losing). Admittedly, executive managements of transnational corporations have simultaneously been benefiting greatly while the real net incomes and wealth of the former middle class and lower classes has stagnated or decreased as their responsibility for debts incurred from purchasing seemingly less-expensive imports have increased.

The interconnectivity of communications through the Internet and ease of shipping by containerization means that it is less expensive for an originally U.S. based company to now produce abroad, and then distribute product to U.S. and other national markets at a higher profit margin. That is the globalization paradigm. What has happened is that capital and technology have become highly mobile and free to roam the world. The originally American-based companies have grown large and multinational in composition, and the executive management now has little or no reason to locate production-technology in the USA when they can easily locate it in Asia with abundantly available low cost labor, less regulation and little or no taxes. In addition, many of these large corporations relocate their designated "official headquarters" to a tax haven location (i.e. their global profits are not repatriated to the USA and therefore are not taxed). Therefore, the "compensation" to losers, implied in the assumptions of the standard presentation of trade theory, is not forthcoming.

For example, by locating production in China these companies substitute the U.S. workforce with a Chinese workforce, where the Chinese labor is often paid only a fraction of the previous U.S. wage rate. By locating production in China, the company also avoids other costs such as various high employment taxes, discrimination lawsuits, environmental regulations, etc. The mobility of financial capital, knowledge and technology causes American labor to be in direct competition with all other labor markets in the world, and particularly in countries with the largest surplus labor supplies. The effective supply of labor to a "free trade" company is global in size and in composition, and not limited to a national supply of workers. This creates long-term structural unemployment in the USA (the same is true for many other Western nations in this process). This outcome is very different from the Comparative Advantage theory of international trade. This is very different from early historic examples centuries ago. The situation of today is simply **not** depicted in the textbook examples that illustrate this theory from centuries past.

Chinese employees working with the same business knowledge, the same modern technology and financed by US capital are unlikely to be less productive than are American

employees. In other words, *there is no comparative advantage and shared benefits in the USA*, only an absolute cost advantage found in these regions with very large workforce surpluses. The huge surplus of labor in countries such as China, India and other nations means that wages will not rise very rapidly in these countries, only gradually over decades.

Most of the large U.S. companies became multinational and have garnered lower labor-costs for past few decades. Equally important is that these large corporations significantly avoid paying taxes to the U.S. by declaring tax havens as their headquarters and/or using subsidiaries to amass tax-free profits. Meanwhile, in the USA, as the American workers continue to lose manufacturing and high-tech industrial employment, they seek jobs that are necessarily the next best alternative. Most of these jobs unavoidably pay much lower wages (lower value dictates lower wages in the market). When US manufacturing jobs are lost, so also are jobs in the domestic supply chain on which they depended. The financial capital of the large companies is increasingly invested in foreign entities and not used to increase production in the USA. Over time, this reduces the overall productivity of the U.S. labor force.

The potential of upward mobility for most people in the US (and many other Western developed nations) is lowered because of the outflow of capital investment, and the general real standard of living shrinks over time. That is not a good thing, not a benefit accruing to the public well-being. Retraining is not really a great answer, because for all practical purposes most of these “knowledge-jobs” can also be outsourced to foreign workers at lower labor-costs. The US employers now hire people in Asia to work over the Internet, and these foreign workers preform as accountants, legal researchers, stock analysts, engineers, designers, telecommunications operators, medical consultants and technicians, analysts and producers in most every discipline imaginable.

Only jobs that absolutely require physical presence in the USA need be retained by the multinational companies. Again, this is not what has been envisioned in the presentations of the Comparative Advantage theory of international trade, because it has been presumed absent in the underlying assumptions. As a result, the distribution of income within the USA has become increasingly skewed toward the top 1 percent of the population. Even more astounding is the increase in the share going to the top $1/10^{th}$ of 1 percent. Over the past couple of decades, ownership of a great deal of the wealth of the nation has been transferred to the top tier (an understandable consequence of policies containing the fallacy-of-composition).

Furthermore, the public and private debt owed to foreign entities ballooned and continues to grow. Can this imbalance of debt obligation under globalization continue forever? The trade and capital accounts show serious imbalances, year after year. What about the constant building of this debt owed to the foreign entities? Now, half of the Federal debt is owed to foreign entities. It is no longer a simple matter of Americans borrowing from other Americans. The same is now the case in many other Western countries. It appears that most of the political “leaders” in the USA have unwavering faith in the idea that all Americans will eventually be better off under globalization. This is a dangerous faith. There is currently evidence of serious problems. What will happen over the next couple of decades? What policies are at fault? The answers determine the future of society in which our families will live.

CONCLUSIONS

If you are among the many college professors and instructors teaching economics, business, political science or international relations, it is necessary to challenge students to think critically and not simply memorize conclusions of popular positions. The literature is filled with

arguments that appear to prove everyone benefits, but in reality, the conclusion is not true. The proffered conclusions can be extremely harmful to a nation's well-being because they are deceptively misleading. Too often, people fail to recognize the important qualifier in Adam Smith's advice, "*If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry employed in a way in which we have some advantage*." He lived during the times when monetary units were physically anchored and credit units were ultimately payable in gold and/or silver. Therefore, no nation could manage chronic trade deficits without obviously losing its wealth. Even today with physically unanchored monetary units of account, chronic trade deficits eventually must result in a nation's citizenry losing claim on its own resources as foreign creditors steadily cash-in.

The process is the same, only the result transpires gradually over a longer period and the citizens are not aware of the long-term result — the people of an increasingly indebted nation lose their ownership of national resources, and foreign entities take ultimate ownership and control. In presentations of national accounting, the transaction appears as foreign investment. The usual argument is foreign investment is good, and therefore there is no problem. However, this is not a simple matter, not everyone gains. The reality is only understood when tracking who ultimately gains and who loses. The two-country-world of the principle textbooks does not address the ultimate question of individuals benefiting, it does not really identify specifically who gains and by how much. Instead, the explanations refer to the aggregate output not distribution to people. Unfortunately, in the USA, students studying business, political science and international relations have the impression that free-trade and globalization guarantees substantial profits will accrue to them, while perhaps only few have or will suffer a relative decrease in their standard of living. The textbooks treat globalization as a pure market occurrence. However, markets are rooted in institutional policies and regulations that determine who receives the profits from globalization.

The finding of recent research shows that the practices of offshoring reduce domestic employment and raise income inequality in nations that have weakened institutions for supporting its citizen labor force (Autor et al 2013; Milberg and Winkler 2013). Over time, offshoring reduces domestic investment while emphasizing financial-leverage, lowing corporate taxes paid, and extracting short-term gains in the shares of company securities. Unlike the impression gleaned from contemporary courses in business, political economics, and international relations, not everyone wins in this practice of globalization, and the winners have not volunteered to compensate those who lose. Therefore, the fallacy of composition and unrealistic assumptions embedded in the theories remain unaddressed, while the policies supporting transnational profiteering continue.

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