THE SIMPLE LOGIC OF FREE TRADE

James M. Buchanan, George Mason University

When I saw the subject matter for this conference, and when I was invited to talk here, I suggested the title, "The Simple Logic of Free Trade." I did so because I thought that, by precommitting myself to such a title in advance, I would then prepare a lecture that would be helpful to me in getting ready for two lecture commitments later this year, one in Taiwan and one in Japan. As sometimes happens, however, my plans did not quite work out as intended. It turned out that I was able to complete drafts for the two later lectures, under the title "The Welfare Politics of Free Trade," by using straightforward application of public choice analysis. But this is not the same as working out the simple logic of free trade, and I did not want to abandon my Radford commitment so readily. So let me try to stick to my initial topic.

Why did I find writing out a lecture on the simple logic of free trade so difficult? My answer to this question is, now, straightforward. The logic is not simple. Free trade is a complex idea, and economists' proclivity to think of the idea as simple causes them to neglect and to obscure the problems involved in generating public understanding and support for free trade itself. Free trade seems a simple idea to economists because they adopt, almost exclusively, the normative objective of economic efficiency, and implicitly assume that this objective also motivates the behavior of political agents.

It is never in the direct interest of an individual, or an agent, to engage in what we would define as free trade or exchange. It is always in the direct interest of an individual, or agent, to seek to place restrictions on the side of the prospective trade or exchange that he initially represents, as either buyer or seller. Free trade, by its very nature, requires that persons behave, toward each other, as holders of reciprocally respected rights. And it is precisely the absence of mutually recognized reciprocity that makes trade impossible for nonhuman animals, and that makes free trade among humans and human groups, both within and beyond national political limits, so difficult to attain and to sustain once achieved.

Let me commence with the simplest possible setting, or model as we economists call it. And let me apologize for returning to the elementary economics primer. There are only two persons and only two goods. I ask you to bear with me in this lapse into the simplified language of economics, which is deliberately stylized to make it remote from the reality of the world we observe. There are two persons, Smith and Jones. There are two goods, apples and oranges. Initially, Smith holds an endowment or stock of apples; Jones holds an endowment or stock of oranges. Suppose, further,
that each person acknowledges that the other has "rights" to the initial endowment that he possesses, at least to the extent that neither person will try to take what he wants directly from the other by stealing. Suppose that both persons desire to consume both goods, and that there is not enough to satisfy all consumption desires.

In this very simple setting, there is some prospect for mutual gains for the two persons if they will engage in exchange or trade. Both Smith and Jones can improve their own well-being, can increase their utility, by trading some of the good they initially possess for some of the other good initially in the possession of the other person. Smith can, by giving up some of his initial stock of apples for oranges, secure a more highly desired bundle. Jones can, by giving up some of his initial stock of oranges for apples, also secure a bundle that he values more highly than the initial stock. In this setting, with only the two traders and two goods, the precise terms of trade may range widely over many possible outcomes. There may be many outcomes that will insure mutuality of gain; the bilateral trading process is indeterminate over many possible solutions.

Let me now make the model a bit more complicated, but only a bit more. Suppose that there now appears on the horizon two other persons, whom we shall call Brown and Green. Brown holds, like Smith, an initial stock of apples; whereas Green, like Jones, holds an initial stock of oranges. Brown is, therefore, a prospective seller of apples and a prospective buyer of oranges. Green is, conversely, a prospective seller of oranges and a prospective buyer of apples.

Let us now examine the behavior of the two initial traders, Smith and Jones, upon the sudden appearance of these two additional persons in the community. Smith, the person who holds the initial stock of apples, and, hence, is the net seller of apples to Jones in the first model, will be motivated to try to prevent Brown from entering the market as an apple seller. Smith will be potentially damaged by Brown's attempts to sell apples to Jones; he will seek to "protect" his market from Brown's entry; he will try, if possible, to deny Brown's entry or access to Jones, who is the apple buyer. Jones, the initial net seller of oranges, will act similarly with respect to the market for oranges. Jones will see the potential damage to his interests that may be caused by Green, the new holder of oranges. He will try to prevent Green from offering his wares to Smith, the initial orange buyer.

I do not want to get you bogged down with names here, but one more step in my stylized argument is needed. Look to Smith and Jones again, but this time look at their roles as net buyers rather than as net sellers of one of the two goods. Smith, whose initial holdings are in apples, is a net buyer of oranges; Jones, who initially holds oranges, is a net buyer of apples. And, as buyers now, each person is interested in opening up his own
purchase prospects to as many sellers as is possible. As a buyer of oranges, Smith will, therefore, welcome with open arms the potential entry to Green, who becomes a potential competitor of Jones, and, hence, can insure that Smith buys oranges on more favorable terms of trade. Similarly, Jones, who is the initial buyer of apples, will welcome Brown's entry as a seller, who then becomes a direct competitor of Smith.

The direct interests of Smith and Jones would seem to be mutually offsetting in this highly stylized example. Smith will want to keep Brown, the new seller of apples, out; but he will want to allow Green, the new seller of oranges, in. Jones, by contrast, will want to keep Green, the new seller of oranges, out; but will want to allow Brown, the new seller of apples, in.

Free trade, which we may define as that regime which allows free entry of all potential buyers and sellers, both in terms of the demand for and supply of all goods, and the access to trade with all participants, free trade will emerge only if the members of the initial trading network or community agree reciprocally to open up the markets.

Perhaps such an agreement might emerge in the two-person, two-good model; perhaps not. I am not directly concerned here with predictions as to whether or not free trade would emerge in the stylized fully symmetrical example. I now want to make the model a bit more descriptive of real world economies by shifting the number of goods from two to many. Suppose, then, that there are now, in addition to apples and oranges, such goods as shoes, potatoes, houses, cars, playing cards, and coffee. Also suppose that there are now many persons in the community, but that each one either has an initial endowment or specializes in the production of only one of the many goods. We have, then, a setting in which each person produces or has in stock a single good, but who, at the same time, desires to consume a bundle that contains some of all of the goods produced in the economy. Each person's most desired consumption bundle contains a bit of all the goods available. But the initial production bundle is made up of only one good. Trade will then allow each person to achieve a more desired state of well-being, but trade will involve giving up a major share of the initial endowment or production stock of one good for small shares in the production stock of all other persons in the community.

The important difference between the many-person, many-good model for trade and the simple two-person, two-good model described earlier is that there no longer exists the same symmetrical offsetting of interests as concerns the potential entry of new traders into the process. Recall that, in the first model, Smith, as our seller of apples, did not want to allow Brown, the second seller, into the market. But recall that, in this stance, Smith was specifically countered by Jones, the buyer of apples, who did indeed want to allow Brown in to compete with
Smith. That is to say, in the first model, selling pressures to close up or prohibit entry into markets were precisely countered by buying pressures to open up entry and access, into each market.

But now let us examine the situation in the many-person, many-good setting, with specialization in production and no specialization in consumption. The single initial seller of apples, as before, will seek to keep all new and potential sellers-producers out of the market. He will try to prohibit entry; he will want to "protect" his market. There will be direct and highly concentrated pressures to restrict entry on the producers-sellers’ side of every market.

But let us look also at the consumer-buyer side of any of the markets. By our specifications of the model, all persons in the economy consume a small share in the total production-supply of each good, while this total production issues from only one specialized producer-seller. Any one consumer of a good, say, apples, will, therefore, have a very limited and minor interest in the market for apples, considered alone and in isolation.

This dispersal of interest among many persons, in their roles as buyers-consumers, guarantees that there will emerge no direct and concentrated pressures to keep particular markets open to entry by potential new producers-sellers. There will exist a clear bias of pressures toward restrictions of markets to the direct and apparent interest of established producers-sellers, despite the generalized harm to the interests of consumers-buyers.

We need now only to add the influence of the state, the political unit, as the ultimate enforcer of contract and a guarantor of individual claims to property rights. If the state is described as an agency or set of agencies that directly responds to pressures placed upon it by individual members rather than as some disembodied benevolence that omnisciently furthers the "general interest," we can readily derive the political basis for a regime of generalized restrictions on trade and markets in the apparent interests of individuals as producers-sellers in separate markets, with the consequences that all individuals are damaged in their roles as consumers-buyers throughout the community, and over all markets. That is to say, the mercantilist-protectionist regime does indeed contain a simple logic. This regime represents little more than the working out of the logic of individualized self-interest through the political structure that reflects direct response to constituency pressures.

It was precisely this regime, the mercantilist network of restrictionist-protectionist regulations and controls over many if not all markets, that Adam Smith attacked in his great book, The Wealth of Nations in 1776, the book from which economics emerged as a separate and independent discipline or science. Smith's argument, so simple to the economists now, counters the simple logic of mercantilism. Smith demonstrated that the producer-
induced restrictions on entry into markets served, finally, to reduce substantially the well-being of all members of the polity-economy, and that a regime of free trade could be mutually beneficial for all members of the potential trading network.

How can we reconcile Smith's central argument with the simple logic of mercantilism? Reconciliation here requires that we generalize the effects of restrictions on individual or particular markets, that we extend these effects over the whole network of markets as we adopt what I call a constitutional approach to the issue of choice among regimes.

Consider, then, a single producer, or more generally, a single producing interest, an industry, in the context of a modern complex economy. As suggested it will always be to the direct and apparent interest of members of this industry, whether these are input-suppliers or owners, or representatives thereof (e.g., labor unions or investors), to restrict or prohibit entry into the industry by potential new suppliers. It will also be to the interest of these producers-suppliers to secure, if possible, enforceable restrictions on output sufficient to reach profit or rent maximizing levels. And, because the consumers-buyers of this industry are widely dispersed, we should not expect offsetting pressures to emerge to prevent the political effectuation of the restrictions sought by the producing interests.

These results emerge, however, only if and when we look at each producing group, each industry, one at a time and in isolation. If we look instead at the whole economy, which includes many separate producing groups, many industries, each of which produces a single good or a small number of goods, we can readily see that the analysis cannot be generalized, even if we leave the interests of nonorganized consumers out of account. The self-interest of producing groups need not be served by generalized restrictions on all markets. Each person, who is specialized as a producer, must also recognize that he remains a nonspecialized consumer, in all of the markets in the economy other than his own. And his interest in all other markets, as in the simple two-person case first examined, lies in allowing freedom of entry to all potential new producers-suppliers, thereby insuring the most favorable terms of trade. Restrictions on trade, or protection for markets, remains in the self-interest or producing interests only if these restrictions are not generalized, only if particular industries are singled out for differentially favored treatment by the political agent. Free trade can emerge, as a preferred regime, when and if persons recognize that the advantages that they might seek, as members of specialized producer groups, remain net advantages only if they somehow succeed in securing differential or discriminatory treatment in their favor. If persons come to acknowledge that others who are also members of producing interests have rights reciprocal with their own, they may be led to support a regime of free trade, in furtherance of their own interests.
Note that no producer group, no industry, will ever find it to its own self interest to support free trade unilaterally. Quite independently of whether other industries succeed or fail with regard to securing political restrictions on their own, they may be led to support a regime of free trade, in furtherance of their own interests.

But this intransigence in favor of particularized restriction and protection is not to be equated with possible support for a shift in the whole trade regime, from one of generalized restriction to one of free trade. In this sort of constitutional choice, the individual member of a single industry is not choosing whether or not his industry is to be free or restricted independently of other industries. He is, instead, choosing between generalized protection and generalized free trade, extended over all industries. There is a constitutional logic of free trade that is fully consistent with the expressions of producer-dominated economic interest in the working of democratic politics. That is to say, we need not depend on political leaders who seek to further the "true public interest," as defined for them by economists who measure efficiency, and we need not rely on direct expressions of consumers' dispersed interests. Industry groups, themselves, because they remain consumers in other markets than their own, may recognize that generalized protection is negative sum game and for all the players.

If we look at the logic of free trade in the perspective taken here, the attempts by particular industry groups to secure discriminatory treatment in their favor should be judged immoral and unjust on precisely the same terms as are other attempts to secure differentially favored treatment. We know, from the logic of economic theory (which I have not developed here), that the gains to the winners in such a political game, the differentially favored groups that do secure cartelized restrictions on output or protection from access to their markets, are less than the damages or losses imposed on all persons in their buyer or consumer roles. To secure a dollar's worth of extra rent by protection, even if by a single industry, may cost consumers two dollars. The national income is reduced over and apart from the income transfer from consumers to producers that is effected here.

Why should attempts to secure differentially favored treatment by an industry be judged more favorable than any other attempt to get values at the expense of others? Why is the seeking for protection different from ordinary theft via politics? As I have argued for many years, Adam Smith's whole argument might have been more effectively put in terms of ethics and morals than in terms of economic efficiency. It is, and remains, immoral to try to close up markets, to deny entry of potential suppliers. And it works, even for those who succeed, only if the results are not generalized over the whole economy, only if some are allowed net gains while others lose. The logic of mercantilism can only be successful differentially; it cannot emerge when all groups are allowed equal protection for their producing interests.
My central argument here may be summarized in terms of the familiar prisoners' dilemma analogy, one that has now become familiar to all students of social interaction. Consider the position of a person who is an input supplier-owner to an industry that produces a good, X. Call this person Individual A. Let Individual B represent all other industries in the economy, or rather, persons who supply inputs to all other industries. The first person, A, will rank the four possible regimes as follows:

First preference (I) Restrictions on entry into the supply of X, his own industry, but open entry into all other markets.

Second preference (II) No restrictions on entry of suppliers in any industry.

Third preference (III) Restrictions on all markets, both on new suppliers to industry producing X and all other industries.

Fourth preference (IV) No restrictions on entry into the production of X, but with restrictions on entry into all other industries.

The first and the fourth of these regimes require nonuniform treatment for different producing groups in the economy; these regimes are, therefore, inconsistent with the basic principle of equality of legal and political treatment. This ordinal ranking of the regimes could readily be represented in a simple two-by-two prisoners' dilemma matrix. I shall not do this blackboard exercise here.

You will note that, to this point, I have not made any distinction at all between trade and exchange between producers and consumers within a single political unit and trade and exchange between members of differing political units, that between internal and external trade, or between domestic and foreign markets. I have deliberately left out this distinction because I wanted to emphasize the commonality of the logic over both areas of economic policy. There is no basic difference between the two cases; attempts to cartelize, monopolize, interfere with, regulate, or control a domestic market in the interest of the producing interests is not one whit different from attempts to limit access to exchanges between potential domestic buyers and foreign suppliers. The efforts by the airline pilots and machinists with Eastern Airlines to re-regulate the airline industry by again imposing entry restrictions is on all fours with the attempts by the Hawaiian sugar interests to maintain the scandalous differential between the supported subsidized domestic price and the world price of sugar. Lee Iacocca's efforts to impose quotas on Japanese cars, along with Gephart's efforts to make us all pay $48,000 for any car, are all grounded on the self
same mercantilist logic. Each and every one of us, if we act in our interest as a specialized producer, will seek to secure the maximal rents from restrictions on our markets. But we will succeed only if we can successfully manipulate the political system in our differential and discriminatory advantage. It is time that we insist, in economic policy structure as elsewhere, that the time for discriminatory treatment is over. Perhaps it is time that an economic rights revolution match the civil rights revolution. Once we take this step, once we require that the restrictions-protections politically guaranteed to any producing interest must be extended to any and all interests, we will then have the grounds from which, on self interest logic itself, we can secure constitutional choice in favor of a shift to a free trade regime. Is it too much to hope that we are near to this shift?