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Economic Scene: Wealth Depends on How Open Nations Are to Trade

By VIRGINIA POSTREL

Stumping last week for expanding free trade, President Bush added a fresh argument to the usual promises of new markets for American goods and services. He called free trade a "moral imperative" essential to economic and political progress. "When we negotiate for open markets," he said, "we are providing new hope for the world's poor."

That's true both directly and indirectly. Economists have been explaining the direct advantages of trade since "The Wealth of Nations," by Adam Smith, was published in 1776. By allowing nations, organizations and individuals to specialize in what they do best, trade makes more goods and services available to everyone, raising living standards for all.

Open international trade has indirect advantages as well. By increasing competition, it spurs producers to find ways to reduce costs and, hence, prices to consumers — again, increasing living standards. And it spreads knowledge and skill. People all over the world gain access to the best technologies and most productive business practices.

Unless they're forbidden to adopt them.

Such prohibitions explain why poor countries stay poor, two economists, Stephen L. Parente of the University of Illinois and Edward C. Prescott of the University of Minnesota, argue in "Barriers to Riches," published last year by MIT Press. "Although countries have access to the same stock of knowledge," they write, "they do not all make equally efficient use of this knowledge because policies in some countries lead to barriers that effectively prevent firms

from adopting more productive technologies and from changing to more efficient work practices."

In other words, says Professor Parente, "poor countries are poor because some groups are benefiting by the status quo," and those groups use the law to block change. India has a long history of this. In the early 20th century, strikes kept Indian textile mills from increasing the number of looms each worker operated, and the government protected the old ways through steep tariffs on foreign textiles. As a result, from 1920 to 1938 textile productivity rose by only a third as much in India as it did in Japan, which was beginning its climb to prosperity.

Such policies, the authors note, continue in India, where "regulations require certain firms to award workers with lifetime employment and require firms with more than 25 workers to use official labor exchanges to fill any vacancy."

They add, "The state can and often does discourage entry by firms that use more productive work practices through the subsidization of existing firms."

To protect favored workers, India forces its economy to be less productive than it could be, making the country poorer.

Professors Parente and Prescott came to their bold conclusion after examining alternative explanations, like savings rates or educational levels. The difference, they argue, can't be explained by what countries put into their economies. It must lie in what comes out.

If savings and education were enough, says Professor Prescott, "Khrushchev would have been right."

"The former Soviet Union would have buried the West. They were well educated. They had high savings rates. The efficiency with which you use resources matters."

Take savings as an example. From 1966 to 1993, the savings rates in rich and poor countries were about the same, roughly a fifth of gross domestic product, according to the International Monetary Fund. Africa, for example, lags only a few percentage points behind the industrialized regions and has occasionally surpassed them. The economists acknowledge that these statistics are open to question, since countries have been known to fudge their data and collecting accurate information is a difficult task. But these are the same data used by people who claim that high savings rates are the key to economic growth.

Besides, the savings hypothesis doesn't pass the smell test. The gap between rich and poor countries is simply too big. For savings and investment to account for the difference in output, the authors calculate that "savings rates in the rich countries would have to be 8,000 times higher than in the poor countries."

Education is another common explanation for growth. Basic literacy is necessary, but it isn't sufficient, the economists argue. Education spending can't explain "economic miracles." As Professor Parente notes, "Japan didn't double its schooling capital when it doubled its income."

One by one, the book explores the standard explanations for economic differences and concludes that while inputs matter, they can't account for the huge differences between rich and poor countries or explain why some countries catch up with the economic leaders.

Something must be going on that makes some countries more productive. That's a puzzle, since everyone has access to the same technologies and capital markets. Indeed, multinational companies make information flows between countries increasingly fluid. When Ford builds an auto plant in Mexico, it draws on the best practices developed all over the world. Mexicans don't have to reinvent auto manufacturing from scratch. "Technological transfer is so much easier than it's ever been," Professor Parente says.

The economists argue that the puzzle is explained by local interest groups' blocking efficient techniques. Free trade's indirect benefit is that it forces local monopolies to compete, opening countries to the most productive technologies and practices. Governments that commit themselves to free trade agreements are binding themselves not to protect the status quo, even in the face of interest group pressure. "Trade," Professor Parente says, "is great for getting rid of these vested interests."

This research turns the activist attack on free trade on its head. Multinational companies become the carriers of the state-of-the-art production techniques that poor countries need to climb out of poverty. And political power and influence, which antitrade protesters praise as democratic, becomes the biggest barrier to riches — and the greatest source of poverty.

Not surprisingly, Professor Prescott expresses great hope for a Free Trade Area of the Americas. He recently spent time in Brazil and is distressed to see such a resource-rich country with a dynamic people remain so poor. "If they formed this free trade within the Americas, you'd see growth miracles throughout," he says. "We'd benefit a little bit. These other countries would benefit a huge amount."