Canadian student review

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Fall 2009

Economic Freedom and Global Prosperity

What's good for business is good for the poor
by Nikhil Joseph

Property rights and credit as keys to growth
by Michal Grzadkowski

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The Fraser Institute's vision is a free and prosperous world where individuals benefit from greater choice, competitive markets, and personal responsibility. Our mission is to measure, study, and communicate the impact of competitive markets and government interventions on the welfare of individuals. Founded in 1974, we are an independent research and educational organization with locations throughout North America, and international partners in over 70 countries. Our work is financed by tax-deductible contributions from thousands of individuals, organizations, and foundations. In order to protect its independence, the Institute does not accept grants from government or contracts for research.

Welcome!

In the face of all the recent talk about bailouts and stimulus packages, this issue of *Canadian Student Review* takes a timely look at the real, data-backed recipe for economic prosperity. Economic health is not about increasing consumption or calculating marketplace interventions. It's all about freedom—economic freedom.

This issue showcases the winning essays of our 2009 Student Essay Contest! Students from India, Canada, and Singapore won cash prizes for their exposés on "Economic Freedom and Global Prosperity," covering topics such as labour laws, property rights and credit, and poverty reduction. We've also included details on the five areas of the Economic Freedom of the World Index, which are used to rate levels of economic freedom in 141 different countries, and a recent excerpt from a very enlightening ***Ask the Professor*** live chat about globalization and trade.

We always welcome articles on economics and public policy from new student authors. See our back cover to find out how you can get published in *CSR*.

Best wishes,

Courtenay Vermeulen
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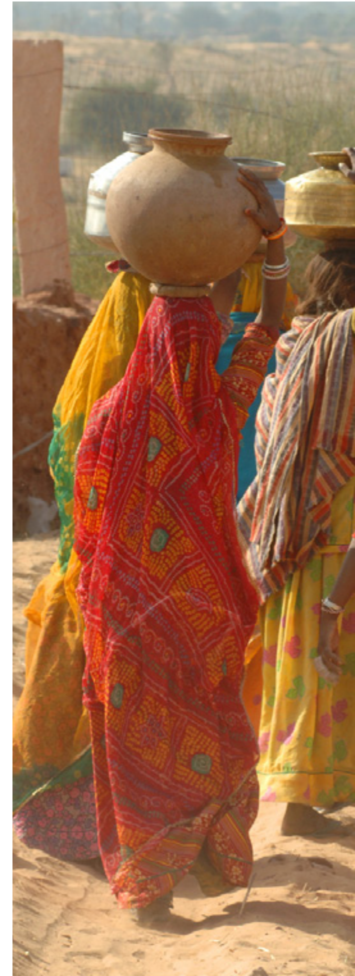
What's good for business is good for the poor

The case of India's labour laws

by **Nikhil Joseph**
Indian Institute of Technology Madras, Chennai, India

On May 16, 2009, after almost two decades of fractured verdicts and fractious coalition politics, when even fringe players could hold a ruling government's policies hostage, participants in the world's single largest democratic exercise bucked the predictions of political pundits everywhere and granted Manmohan Singh's ruling United Progressive Alliance (UPA) coalition a decisive mandate for the next five years. In the editorial pages of *The Economist* following the election, the magazine asked the Indian prime minister, quite simply, not to waste it—and with good reason.

In the hands of Dr. Singh, the architect of the liberalization reforms that have yielded almost 19 years of hitherto unseen economic growth, is a unique opportunity. For the past five years, critics have pardoned the sluggishness of the government over reforms towards greater economic freedom, citing the need for pragmatism in an era of coalition *realpolitik*. The most notable roadblock has been the fact that the Communist Party of India has been the UPA's most important ally. Today, though, there is no such excuse.



Despite consistently being one of the two fastest growing economies in the world, almost 42% of the Indian population lives below the global poverty line of $1.25 per day (Mozumder and Tuck, 2008). In India, that translates into a staggering number: 456 million people. In China and in many of the East Asian Tigers, the economic growth that has raised millions from poverty has been led by growth in the manufacturing sector, but this has not happened in India (Besley and Burgess, 2004). Many economists point to this failure as being primarily responsible for so many people being unable to reap the fruits of the last two decades of economic growth (see, for example, Bhagawati, 1998, and Stern, 2001).

One of the main conclusions of the 2008 *Economic Freedom of the World* report (Gwartney et al., 2008)—one that hundreds of other studies have validated—is that greater economic freedom means greater prosperity and less poverty. In India, economic freedom is severely restricted by labour laws. For example, Indians are notoriously difficult to fire (legally, at least). Such restrictions of economic freedom, this essay seeks to argue, lies at the heart of why millions of Indians are so desperately poor.

"The law is an ass"

Although the Dickensian character who first used the above phrase was talking of the laws concerning marriage, it quite easily applies to India's labour laws as well. In India, labour and all matters concerning it fall under the Concurrent List. This means that both federal and state governments can pass labour-related legislation. The most important piece

of legislation concerning labour in India is the Industrial Disputes Act (IDA) of 1947. Although numerous state-level amendments may act as riders to parts of this legislation, in essence, it still contains provisions that make it impossible for any law-abiding firm employing more than a 100 employees to lay off any one of them without government permission (Section 25M); or even reassign a particular employee without first giving 21 days notice (as per Section 9A). Laws like this one (and others, such as the Contract Labour Act of 1970 and the Factories Act of 1948) have "reduced the productivity of both labour and capital and hence the viability of the enterprise" (Tendulkar, 2003).

Private sector employers, however, have not taken this lying down. As would be expected of any business interested in its own survival, businesses in India have found ways to adapt to these cumbersome restrictions or even bypass them completely. Such measures include adopting capital intensive technology to minimize the employment of permanent workers; outsourcing activities to unregulated and unregistered units; moving units to areas with lax enforcement; and even splitting an establishment into multiple smaller units to avoid coming under the purview of legislation.

This propensity of employers to seek labour outside the bounds of regular contractual employment, in particular, has resulted in the exacerbation of what Suresh D. Tendulkar of the Delhi School of Economics calls the "organized-unorganized duality" of the Indian labour force (2003). The "organized" sector constitutes a tiny minority of India's working class who fully enjoy the privileges that India's labour laws guarantee, while the vast majority of Indians, who work in the "unorganized" sector, are unable to experience even the benefits that regular contract-based employment can provide.

Evidence from other parts of the world also substantiates this point—that greater regulation results in an increase in the size of the unofficial economy and a less impressive performance on economic, political, and social indicators. This finding is borne out by an 85-country study conducted by Djankov et al. (2002) that looked at regulations governing the start of businesses. It is not for nothing that, in India, the 1980s are referred to as the "decade of jobless growth," when manufacturing output grew 7.1% per annum while manufacturing employment stagnated (Bhalotra, 1998). Unsurprisingly, evidence shows that the 1976 and 1982 central amendments to the IDA that further strengthened job security regulations resulted in less demand for labour in firms covered by the regulations, but not in small firms that were not covered by the regulations (Fallon, 1987).

How a lack of economic freedom hurts the poor

The problem with economic truths, as Bastiat prize-winning journalist Amit Varma (2008) puts it, is that they often seem counterintuitive. This is, in a way, also the problem with labour laws. Laws that are enacted with the intention of keeping jobs secure and setting centralized minimum wages end up having completely unintended effects, chief among them the reduction of employment altogether. If, for example, the owner of a café decided that she needed extra help for the summer in order to better service the seasonal increase in demand, she would ideally hire an employee for this very short period of about three months and let him go afterward. But if the entrepreneur in question decided that the extra help would not be worth the trouble of dealing with the bureaucratic red tape involved in laying off an employee, then the

"Allowing the invisible hand to work often produces the most desirable results"

labour law in question would reduce welfare all around—that of the employer, who might have benefitted from the extra help in the summer months, and of the employee, who might have found the extra income useful.

The above example is, admittedly, a simplistic one, yet it highlights an important point: that allowing the invisible hand to work often produces the most desirable results. In 2002, Timothy Besley and Robin Burgess of the London School of Economics authored a remarkable study that highlighted this same point. They looked at state-level amendments to the Industrial Disputes Act between 1958 and 1992 and classified these into three categories: pro-worker, pro-employer, and neutral. They then coded each of these with the values of plus one, minus one, and zero, respectively. Upon regressing the labour regulation variable with indicators of economic development and poverty levels, they found that "regulating in a pro-worker direction was associated with lower levels of investment, employment, productivity, and output in registered [organized sector] manufacturing."

Their most striking conclusion concerns poverty levels. They found that "regulating in a pro-worker direction was associated with increases in urban poverty," and that if Andra Pradesh (a state considered pro-employer) had not implemented pro-employer reforms, then urban poverty levels would have been 110% of actual 1990 levels. On the other hand, if West Bengal, a state considered pro-worker, had implemented pro-employer reforms, then poverty levels would have been 10% lower in 1990.

The sad irony here is that it is those who claim to be acting in the interests of the poor who seem to do them the greatest disservice. The claim that economic freedom does not benefit the poor is, therefore, not only a false one, but also a harmful one.

Nikhil Joseph is the 1st Prize winner in the 2009 Fraser Institute Student Essay Contest. He is a Master's student in Development Studies at the Indian Institute of Technology Madras, Chennai, India.

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The Economic Freedom of the World Project

Economic freedom means that people are free to trade with others, compete in markets, buy what they want, earn a living in a job that they choose, keep what they earn, and own things privately.

It has been over 20 years since the Economic Freedom of the World (EFW) project was initiated by the Fraser Institute. From the very beginning, the objective was to develop a comprehensive measure of economic freedom for a large number of countries. The first Economic Freedom of the World report was released in 1996, following a series of conferences beginning in 1986, which involved 60 of the world's top scholars, including Nobel Laureates Milton Friedman, Douglass North, and Gary Becker.

Today, the Institute collaborates on this project with various institutes in 76 nations and territories. The annual EFW report uses 42 different measures to create an index that ranks 141 countries, representing 95% of the world's population, based on policies that encourage economic freedom. The EFW index, which is based on objective data and independent surveys, measures five areas of economic freedom:

1 Size of government: expenditures, taxes, and enterprises

Taken together, the four components of Area 1 measure the degree to which a country relies on personal choice and markets rather than government budgets and political decision-making. Therefore, countries with low levels of government spending as a share of the total, a smaller government enterprise sector, and lower marginal tax rates earn the highest ratings in this area.

2 Legal structure and security of property rights

The key ingredients of a legal system consistent with economic freedom are rule of law, security of property rights, an independent judiciary, and an impartial court system. Countries with major deficiencies in this area are unlikely to prosper regardless of their policies in the other four areas.

3 Access to sound money

Money oils the wheels of exchange. An absence of sound money undermines gains from trade. Sound money is essential to protect property rights and, thus, economic freedom. In order to earn a high rating in this area, a country must follow policies and adopt institutions that lead to low (and stable) rates of inflation and avoid regulations that limit the ability to use alternative currencies.

4 Freedom to trade internationally

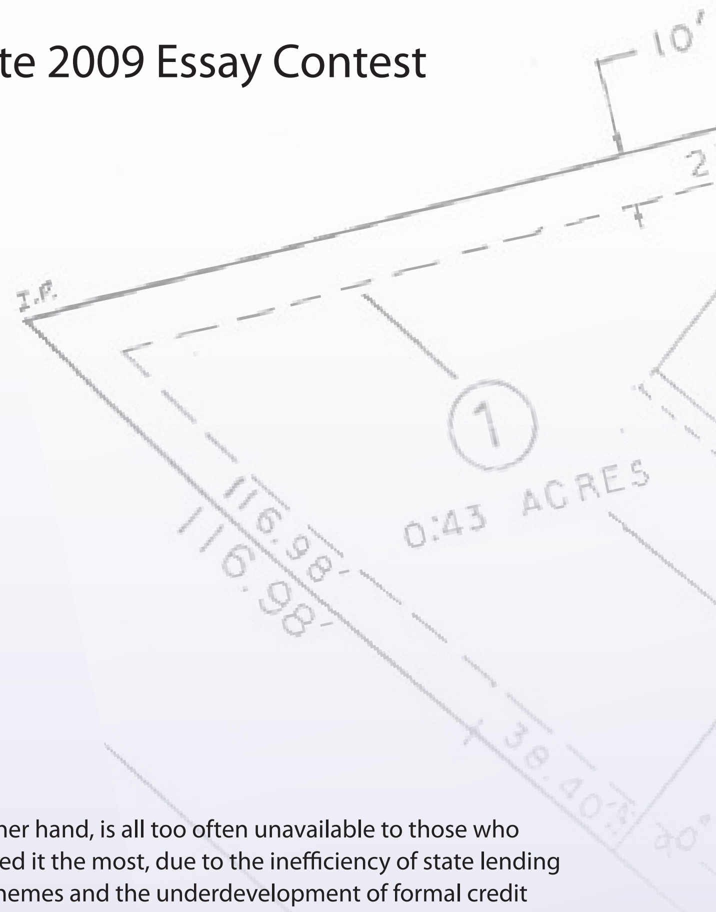
The components in this area are designed to measure a wide variety of restraints that affect international exchange: tariffs, quotas, hidden administrative restraints, and exchange rate and capital controls. In order to get a high rating in this area, a country must have low tariffs, a trade sector larger than expected, easy clearance and efficient administration of customs, a freely convertible currency, and few controls on the movement of capital.

5 Regulation of credit, labour, and business

The fifth area of the index focuses on regulatory restraints that limit the freedom of exchange in credit, labour, and product markets. In order to score high in this portion of the index, countries must allow markets to determine prices and refrain from regulatory activities that retard entry into business and increase the cost of producing products. They also must refrain from "playing favourites," that is, from using their power to extract financial payments and reward some businesses at the expense of others.

To read the complete 2008 report, visit **www.freetheworld.com.**

2nd Place Winner Fraser Institute 2009 Essay Contest



Property Rights and Credit as Keys to Growth

by **Michal Grzadkowski**
University of Waterloo, Waterloo, ON

The storm clouds of recession hanging over the economies of the developed world have done much to divert attention from the plight of the nations that are still struggling to find ways to escape deep-rooted poverty. Notwithstanding the recent surge in government intervention, in the last two decades there has been a noticeable current against the ideology of planned economies, as shown by the gradually increasing world average of the Fraser Institute's Index of Economic Freedom (Gwartney et al., 2008). However, significant controversy exists over which of the elements of economic freedom are most influential in pulling a nation out of poverty, with recent studies suggesting that policies such as increased exposure to international trade and diminished government spending can actually retard development (Carlsson and Lundstrom, 2002). The case must, therefore, be made that secure property rights and unfettered access to credit are the keys to consistent economic growth.

Property is rarely effectively protected by the weak institutions in developing countries, which discourage investment among owners who are troubled by the prospect of the arbitrary appropriation of their land by the government or extralegal parties. Credit, on the other hand, is all too often unavailable to those who need it the most, due to the inefficiency of state lending schemes and the underdevelopment of formal credit markets. Land titling programs and the optimization of credit markets are also strongly dependent on one another, as the two have a symbiotic relationship in providing capital to entrepreneurs using their assets as collateral. The first step to achieving reliable economic growth in developing countries is to simultaneously secure citizens' access to property rights and reliable sources of financing.

A country cannot rise out of poverty if its legal institutions are unable to protect the property of its citizens. In theory and in practice, property rights encourage economic activity as they assure owners that they will be able to reap future rewards from their present efforts to improve the revenue-generating capabilities of their own assets. Recent evidence shows that nations with governments that focus on strengthening the rule of law see considerably higher economic growth than those that concentrate on other areas of reform policy (Bjørnskov, 2005).

A key element of any well-developed legal system is the ability to protect property owners from those who would seek to unfairly appropriate their possessions. This motivates owners to be less reluctant to invest in

the short term to make their property more capable of providing consistent profits in the long term. Surveys from two separate agricultural regions of Ghana demonstrate that with the introduction of land titling, efforts to improve farm land grew in frequency as farmers grew confident that their newfound rights would enable them to profit from their investment in the future (Besley, 1995). Increased investment in turn stimulates national economic growth, as improvements on land increase output while enhancing the ability of proprietors to spend more on goods and services provided, at least in part, by their countrymen.

Furthermore, a study by Knack and Keefer (1995) found that "the security of property rights affects not just the magnitude of investment, but also the efficiency with which inputs are allocated." This can be attributed to the fact that land titles allow for simpler delineation of an owner's rightful property, making it much less costly and time-consuming to transfer land to those wishing to acquire it. By securing the link between increased investment and future gains, and simplifying the process of buying and selling assets, property rights facilitate economic growth through the enhanced freedom given to owners to realize the full potential of their property.

"A country cannot rise out of poverty if its legal institutions are unable to protect the property of its citizens."

In addition to secure property rights, there is another component that is critical to pulling a nation out of extreme poverty: unencumbered access to credit. In countries where the ability of budding entrepreneurs to borrow funds is either restrained by small informal markets or wasted through inefficient legislation, the economy is doomed to stagnate as large portions of society find themselves unable to pursue viable business opportunities. In developing nations, credit is often only available to a small minority of borrowers in the middle and upper classes who already have privileged access to the banking sector through their existing wealth. The rest—especially those in rural areas—are left out of the formal economic system as their isolation from financial institutions blocks any chance they might have to pull themselves out of poverty. This leads to credit being allocated chiefly through circumstance and not merit, which is inefficient and stifles growth in the poorest regions of the world (Ali, 2007). As such, it is no wonder

“Property rights allow owners to use their assets as collateral.”

that informal credit markets are so prevalent in developing countries where formal sources of credit are established but ineffective at serving potential customers in rural and underdeveloped areas (Nisbet, 1969).

Worse still for disadvantaged entrepreneurs are governments that seek to ameliorate perceived deficiencies in credit markets through intervention, which typically includes subsidized lending programs. The experience of Cameroon’s Green Belt Operation in the 1970s suggests that borrowers question the validity of such programs because they are accurately perceived to be losing money on artificially low interest rates (Kamajou and Baker, 1980). This induces high default rates, pushing lending operations deeper and deeper into red ink until they do not have the funds to meet the demand for credit from those who need it most. What is urgently necessary, therefore, are either governments that are not afraid to strengthen financial institutions without interfering in credit markets, or the entry of outside sources of capital into the markets of developing nations.

The amount of foreign capital invested in a particular country has been shown to be closely linked to the degree with which its legal institutions are able to defend property rights (Co et al., 2004). This brings to light the vital relationship between how policies instituting availability of credit and the protection of property rights work together to secure economic growth in developing countries. Land titling programs and increased efforts to provide sustainable financing have been shown to work much more effectively when used in combination with one another; credit markets and property rights often fail to achieve the desired result of helping the poorest of the poor when used in separation.

A key reason why property rights are so effective at sparking investment and development is that they allow owners to use their assets as collateral when seeking a loan, allowing for a greater amount of money to be borrowed at a smaller risk to the lender (de Soto, 2001). If the institutions that are providing credit are either too incompetent or too tightly regulated to effectively supply the demand for capital, then the property that was unable to generate additional capital as collateral before the arrival of land titling will remain in its inert state. Research conducted in rural Paraguay by Carter and Olinto (2003) demonstrates that without a well-developed credit market already in place, property rights reforms tend to aid only wealthy farmers who are first in line to receive capital from financial institutions that are too weak to broaden the outreach of their lending.

“Governments intervene to correct the perceived imperfection of the market, often leading to arbitrary and politicized decisions.”

This result is equally strong in the opposite direction. Without an effective system of property rights, credit markets in the developing world have a habit of encouraging undesirable outcomes such as excessive default rates, which occur as a result of the high cost of enforcing repayment when lenders have limited access to the potential collateral of borrowers because of scantily codified land titles (Besley, 1994).

When banks are losing money on frequent credit delinquencies, especially in rural markets, another adverse outcome takes place: governments intervene to correct

the perceived imperfection of the market, often leading to arbitrary and politicized decisions about who can receive subsidized financing (Besley, 1994). Since the political clout of poorer farmers usually pales in comparison to the lobbying power of more prosperous farmers, lending programs created to give more opportunities for self-improvement to struggling land-owners often end up reinforcing the status quo of economic stagnation. Clearly, introducing secure property rights and access to financing separately leaves the majority of those with assets without the means to use them as an avenue towards greater investment. If legal and financial institutions are to be reformed so as to increase the overall economic freedom of citizens of developing nations, then they must be reformed in unison.

Considered independently, consolidated property rights and pervasive, minimally regulated credit markets are both closely linked to economic growth. Both work to advance the cause of economic freedom: the former makes earned assets impervious to arbitrary appropriation, while the latter allows for greater liberty to invest in profitable ventures. Most important, however, is the way strong legal institutions and well-developed financial institutions work together to achieve sustainable economic development. The most effective way to pull a nation out of poverty is to ensure that its citizens have both secure property rights and unfettered access to credit. ■

Michal Grzadkowski is the 2nd Prize winner in the 2009 Fraser Institute Student Essay Contest. He is currently completing an Honours Bachelor of Mathematics at the University of Waterloo in Ontario.

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High School Winner | Fraser Institute 2009 Essay Contest

Economic Freedom & Poverty

by **Mohamed Ilham B. Mohamed Salleh**
Raffles Institution (Junior College), Singapore

When William Easterly published his research comparing the impact of foreign aid and increased economic freedom on the long-term economic circumstances of countries, critics condemned his finding that aid mechanisms were largely failures in their present form and derided his call for more market capitalism (Lawson, 2002). Yet, further analysis of the relationship between economic freedom and poverty rates did reveal much empirical evidence indicating that the poorer agents in freer market systems enjoyed substantially higher living conditions than those in centrally planned economies (Gwartney et al., 2008).

Part of the reason, it seems, lies in the increase in the overall welfare of a country's residents due to freedom in the economy. Therefore, reforms that seek to liberalize markets in the less developed countries should lead to a decline in poverty levels. While government intervention may still contribute to poverty reduction through the establishment of basic economic security and a meritocratic environment, the need for a free economy should form the more crucial aim of such stratagem.

The reason for poverty, a term associated with the lowest income bracket and a deficiency of many basic needs (Gwartney et al., 2008), stems from the basic problem of scarcity. Since there are limited factors of production and unlimited wants, the poor are those who get the least of the national output from economic activity. The role of any economic system is to allocate these scarce resources between their alternative uses and to do it well. The free economy, with its markets, uses the price mechanism to do this, emphasizing pursuit of self-interest as the main driving force behind decisions. Economic agents may also own private properties and have freedom of choice as well as enterprise. When working properly, these markets are also characterized by their low barriers to entry due to high competition and the absence of externalities. Here, the effectiveness of market liberalization in easing poverty levels is assessed from a macroeconomic viewpoint, looking mainly at areas of fiscal, monetary, and supply-side policy, albeit with welfare economics when needed.

The most prominent way in which a free market economy may moderate poverty levels is through sustained economic growth throughout a country. Such growth entails an increase in the productive capacity in an economy. A general explanation for observed trends of rapid growth after the opening up of an economy, such as that of Singapore or Hong Kong, is that a free market economy eliminates the costly bureaucracy that is needed to allocate resources otherwise. When the price mechanism is in place, prices reflect the types of goods in demand and amount of resources required for their production. Markets tend to a dynamic equilibrium where quantity demanded is equal to that supplied. Hence, manual methods of addressing resource allocation issues, including price controls and output quotas, and their administrative costs are not necessary in the free economy. Hence, a free market economy leads to less wasteful use of resources which may then be redirected to useful output.

With free trade there is more exchange between buyers and sellers in free economies. They swap products they make for those they have less comparative advantage in, and thus the terms of their trade must be mutually beneficial. In a free market, this stops only when people become worse off when they trade. Thus, the skills of the

poorest segments of society are more transferrable in a free economy, as more people may need their services, and this increases their income levels.

Another reason for economic expansions in free market economies is the resulting growth that is due to the high efficiency of the price mechanism in allocating resources. As there is much competition in the free market, firms have an incentive to lower prices and to maintain their profit-maximizing goals. Because their total costs must be kept low, firms will necessarily lower costs until they are productively efficient. Firms will also lower prices to be competitive until the price for the last unit is equal to the marginal cost of that unit. Thus, firms will reduce their unemployment or underemployment of resources in an economy, because the more efficient the firms are, the more profits they will get. This leads to actual growth in the economy, with aggregate demand rising as more factors of production can be employed. A growing economy will provide for more people and poverty may be alleviated.

Evidence of the positive relationship between economic growth and poverty reduction is abundant. For example, Botswana, with increased government investment, enterprise, and spending, had a reduced GDP growth rate from 2005 to 2008 (Grube, 2008, Oct. 8). Governments, too, have their own objective of maximizing electorate wishes and may be influenced by political lobbies. Likewise, they do not have full information about consumer demand and may have time lags in implementing policies. As such, countries that have done away with excessive government interference, such as Ghana, have reaped the benefits of higher economic growth, and through it, increased standards of living. Mauritius has also had a poverty rate of less than 10% since diversifying and privatizing important industries.

Economic growth tends to decrease destitution among a nation's population by allowing more people access to higher material living standards and qualities of life. The problem of scarcity becomes less acute as, on average, more people can afford essential health care services and education, thus reducing the deficiencies of the poor. A rapidly growing economy can also afford to be more generous to the disadvantaged, as the poor can be made better off without the rich being worse off due to increases in overall income levels. Since 1981, 500 million people have been lifted out of poverty in China due to rapid economic growth (Lardy, 2002). Although this redistribution may require government intervention in the form of a tax structure, the cause of the growth was primarily a free economy, as explained above.

Therefore, reforms may enable governments to decrease the poverty rate. A critical example of why reforms are needed can be seen in Zimbabwe which, among other things, raised its money supply, leading to hyperinflation and an unstable currency. Uncertainty resulted in the withdrawal of foreign direct investment, an economic recession, and eventually widespread famine and disease due to poverty. Since other currencies are being used (a small step to reform), investment may re-enter as the economic climate becomes more stable, although this will be affected heavily by a lack of business confidence in the tattered country.

Zambia's privatization of copper mines (Grube, 2008, Oct. 8) since 2006 has also lead to surges in economic growth patterns as private firms seek to increase their revenue. The

loosening of business regulations has also contributed to the increase in productivity, leading to lower prices for the copper-refining industry there and more output for trade, especially with China. Since there is a wider share of ownership, more people have greater stakes in the economy, and thus there is economic growth and decreased poverty. A new floating exchange rate also allows for the devaluation of Zambia's currency in order to correct the deficit incurred by heavy debt. This allows capital reinvestment to return (Fundanga, 2007).

Detractors might argue that economic growth spurred on by free markets will be unevenly distributed. However, data from Adams (2003) shows that economic growth does not affect inequality much, and that the results of growth are often spread to even the poorest sectors. Yet, larger businesses and unions may gain more at the expense of the others and thus relative poverty may still remain while absolute poverty decreases. Other strategies that are cited often fail to recognize this, calling instead for increased regulation. But the poor have more income in free and rich nations than in unfree ones (Lawson, 2002).

Economic activities should be based primarily on a free market framework

Time lags are also an important concern here. It can take a long time for a nation to realize benefits of growth and lowered poverty. There may be hope in some countries that once economic growth sets in, a high multiplier and accelerator may increase the potential of these economies to offset implementation time costs.

There is also the evident need for intervention where there are monopolies or oligopolies in poverty-stricken countries. Supernormal profits may not be used efficiently for research and development purposes, and it is often the more established firms that tend to increase in size and power, which can lead to increases in inequality after deregulation. Governments need to correct for inefficiencies that limit the extent of macroeconomic growth through lump sum taxes on goods, as well as inefficiencies that are associated with negative externalities, such as pollution, which disproportionately affect the more defenseless poor.

As Easterly (2001) has mentioned, poor nations do grow faster than rich ones once economic freedom has been established. Although there is a need for some form of a mixed economy, depending on the unique circumstances of a nation, economic activities should be based primarily on a free market framework to reap the benefits listed here. Opening up an economy is definitely an effective way to increase living standards and reduce hardship. ■

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Ask the Professor

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*Here's an excerpt from a recent Ask the Professor discussion on **globalization and trade** with Dr. Donald J. Boudreaux, Chair of the Department of Economics at George Mason University in Fairfax, Virginia.*

How is it that a typical worker today can easily afford a wide variety of goods and services, the production of which requires the coordinated efforts of millions of workers? The answer is that each of these workers is part of a market so vast that it is worthwhile for many entrepreneurs and investors to organize highly specialized production operations that are profitable only because the market for their outputs is large. This specialization of labour and production across different industries around the world is the phenomenon of globalization.

Alia asked:
In your discussion of free trade, you note that one of the benefits is that it gives consumers the opportunity to buy goods and services from the best producers in the world. However, is it not consumers in developed countries that benefit the most? Many argue that globalization and free trade also cause great disparities, making the rich richer and the poor poorer. What role can free trade play in ameliorating these disparities? When and how do you think developing countries should restrict free trade, if ever?

Dr. Boudreaux wrote:
In fact, though, those who benefit most are consumers in developing countries. Americans, Canadians, and Brits, for example, would suffer if their governments blocked foreign trade. But because industry and market institutions in those countries are so well-developed, a sufficient amount of production would go on internally so that people there would hardly become destitute. But if, say, Guatemala or Mauritius each more severely restricted trade with the rest of the world, the industrial, agricultural, commercial, and financial capacity of those countries is so small that severe reductions in consumer well-being would become manifest in short order.

Now about inequality: the data show that increased trade is NOT associated with increasing inequality within countries. The data DO show that countries that restrict trade grow less than countries that are more open to trade.

George MacArthur asked:
You wrote in your article that, with trade, "cooperation spreads naturally and without much attention to political boundaries." Does this mean that governments are gouging the consumer surplus that would have been there without trade barriers?

Dr. Boudreaux wrote:
If I understand your question correctly, the answer is yes. Trade restrictions protect domestic sellers from competition—from foreign competition, to be precise. That's the political reason why such restrictions exist; it's the monopoly power that such restrictions bestow on domestic sellers that prompts domestic sellers to lobby for such restrictions. And whenever monopoly power exists, consumer surplus is reduced. That is, the gains from trade that consumers get from purchasing the good or service in question shrinks.

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