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# The Free Trade Debate: A Left Keynesian Gaze

BY THOMAS I. PALLEY

FOLLOWING the intense debate and ultimate passage of the North American Free Trade Agreement (NAFTA), it has now emerged that the question of globalized free trade has become one of the principal issues on the economic policy agenda. Rather than the closing shot in the trade debate, NAFTA represents an opening shot in the establishment of an international trading structure for the twenty-first century. For this reason, debate over the consequences of free trade is more important than ever.

Yet even as the need for such a debate becomes evident, the monolithic character of the trade establishment within orthodox economics has largely prevented it from developing. In part, this can be attributed to the professionalization of economics which operates to exclude the voices of lay-persons, and it is noteworthy that the political debate over NAFTA was much more contested than the debate amongst economists. If the economist's principle of rational self-interest is to be believed, the extent of public opposition to NAFTA should itself be sufficient to cast doubt on the benefit to the public weal of the agreement. In addition, the narrowness of the free trade debate can also be interpreted as a reflection of the ideological character of orthodox trade theory, the basis of which is derived from *laissez-faire* microeconomic theory.

The monopolization of the free trade debate by orthodox

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trade theorists has major ramifications for both public understanding of the economic consequences of global free trade and for the construction of policy recommendations. This is because the models that underlie free trade prescriptions assume full employment and characterize workers as being paid what they deserve. Such a construction contrasts with a "left Keynesian" view of the economy, in which unemployment is the rule, and in which wages depend on the outcome of wage bargaining. If the left Keynesian position is correct, reliance on orthodox analysis for guidance in the trade debate is likely to produce misguided and damaging policy. It is this concern that motivates the current paper.[1]

### *Characterizing the Economy*

A left Keynesian characterization of the economy involves three axiomatic principles. These are:

(i) The level of employment and output depends on the level of demand for goods and services. Slack demand will tend to lower output and employment; brisk demand will tend to produce inflationary pressures on prices and wages.

(ii) The level of demand depends importantly on the distribution of income between wages and profits. High wages tend to stimulate demand because of their positive effect on the level of consumption.[2]

(iii) The distribution of income between wages and profits depends on bargaining between workers and firms. Conflict is an essential part of this bargain. Moreover, the relative bargaining positions of workers and firms depends importantly on the state of the economy and on labor laws protecting against employer sanctions and layoffs.

### *A Taxonomic Framework for Analyzing Free Trade*

An immediate difficulty in assessing the welfare effects of free trade reforms concerns the questions of, first, whose

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welfare and, second, trade reform with whom? Real world economies are constituted by heterogeneous agents, and economies also differ in their typologies. Together, these features compel a recognition of heterogeneity in any legitimate analysis of trade reform. The taxonomic structure suggested by a left Keynesian gaze distinguishes (a) wage income versus profit income, and (b) high wage/high employment economies versus low wage/surplus labor economies.

Recognizing the tension between wages and profits deconstructs the myth of an automatic single national interest. It makes us see that the economy consists of a multitude of agents, the vast majority of whom rely exclusively on wages for their income. Contrastingly, profit income largely accrues to a small minority who are the wealthiest segment of society. Introducing this distinction means that any welfare assessment of free trade must explicitly confront the issue of income distribution, and any welfare conclusions are contingent on the interpretation placed on free trade's distributional effects. For left Keynesians, given that wage income represents the only source of income for the vast majority of people, the welfare effects of free trade reforms can largely be analysed by reference to their impact on employment and wages.

This contrasts forcefully with orthodox trade analysis which places little weight on the distinction between wage and profit income and uses the device of a "representative consumer" to pretend that all persons are the same. Orthodox theory then argues that if total national income is increased, the representative consumer must be better off, and, consequently, trade reform is beneficial. This difference is central to understanding the distinction between the left Keynesian gaze and the conventional gaze.

Just as there is heterogeneity *within* economies, so too there is heterogeneity *across* economies. This latter form of heterogeneity is also critical for assessing the impact of free trade reforms. From a left Keynesian gaze, free trade is often best when conducted between countries that share common

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characteristics. This contrasts with orthodox analysis, where the greatest gains to trade arise when countries have the greatest dissimilarities. Thus, from a left Keynesian perspective, Americans stand to gain the most from trade with groups such as the EEC countries; for orthodox trade theorists, Americans stand to gain the most from trade with such countries as India, Mexico, and the Philipines. This difference follows from differences in the criteria for assessing the welfare effects of trade reform and from differences in interpretation of how the economy works and how it is impacted by free trade.

For left Keynesians, a minimalist taxonomy involves distinguishing between "high wage/high employment (rich)" economies and "low wage/labor surplus economies (poor)." The former are typified by the industrialized economies such as the United States economy; the latter can be identified with the less developed countries. This distinction not only encompasses the distinction bewteen capital-abundant and capital-scarce economies, but it also captures the notion that economies are social systems, and that multiple facets of these systems are relevant for understanding the impact of trade liberalization. Thus, whereas othodox analysis focuses exclusively on relative endowments of capital and labor as the factor determining the pattern and impact of trade, the above rich/poor taxonomy incorporates the effects of a range of socio-economic characterisuics including firms' social security and health cost obligations, their rights to pollute and obligations to prevent pollution, and employee protection and worker safety laws. In general, richer countries tend to impose heavier obligations on firms, have stronger anti-pollution laws, and have stonger employee protection laws than do poorer countries, reflecting the stronger position that workers in these countries have secured for themselves. The critical import of these socio-economic characteristics is that they significantly alter costs of production, thereby changing the international structure of both absolute and comparative advantage. As we

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shall see, these costs can deeply influence the pattern of international production and trade.

## *The Impact of Free Trade*

The previous section outlined the difficulties associated with making welfare assessments of free trade and the necessity of analyzing free trade reforms within a context recognizing structural difference across countries. This section uses the suggested framework to analyze the potential impact of free trade reforms on rich economies such as the Unites States. The assessment of free trade, therefore, is predicated on the vantage of a rich country: the welfare effects of free trade on poor countries is another chapter. However, it is worth noting that poor countries may win or lose, and the change in their economic welfare depends on the specifics of their situation and the manner in which their welfare interest is defined.

From a United States perspective, there are two types of trade reform. The first involves northern countries; the second involves southern countries.

*North-North reforms.* This type concerns countries with broadly similar socio-economic characteristics (that is, employment conditions, social security laws, pollution rights, and so on). This similarity is important because it means that their impact on costs is broadly equal across countries so that free trade confers no competitive advantage or disadvantage on either party.

At the level of individual goods markets, the abolition of tariffs and quotas lowers the price of imports: this is a source of increased well-being for all consumers. The liberalization of domestic markets also serves to strengthen product market competition, which promotes lower prices and improved quality on domestically produced goods.[3] This is another source of benefit. Finally, by creating a larger unified market,

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this allows for economies of scale which can support lower prices and greater product variety.

From a macroeconomic standpoint, the removal of foreign tariffs and protections increases the demand for exports. Since export demand is part of total demand, this stimulates employment and output. However, balancing this is the fact that the elimination of tariffs and quotas increases imports. Since imports represent a diminuition of demand for domestically produced output, this reduces employment. The net effect on total demand, therefore, depends on the relative size of demand diversion into imports, compared to the creation of new export demand.

The extent of export demand creation depends importantly on the availability of international liquidity to finance expanded international trade. Without this liquidity, realizing the putative gains from free trade reform is problematic. However, northern countries have good access to international liquidity because of their high standing in international credit markets, so that this does not appear to be an obstacle impeding trade.

In sum, from a left Keynesian vantage, free trade liberalizations involving northern countries appear to carry significant benefits. Inevitably, there is some sectoral dislocation since enhanced product market competition leads to elimination of inefficient domestic producers. This dislocation adversely impacts specific groups of workers, but for workers as a whole the liberalization appears beneficial.[4] The net result is likely to be an expansion of demand, employment, and output in the participating countries. It is this reasoning that leads one to conclude that had the acronym NAFTA stood for North Atlantic Free Trade Agreement, its passage would have been largely unopposed. Far from being protectionist, the left Keynesian gaze strongly advocates free trade between northern economies.

*North-South reforms.* Whereas north-north liberalizations are largely unproblematic, the left Keynesian perspective suggests

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the opposite for north-south liberalizations. Now the economies have radically different wage levels and socio-economic structures, which means that these factors no longer cancel out and instead have significant effects on absolute and comparative costs.

Once again, trade opens the possibility for both increased exports and imports, and the demand effects of this are potentially the same as in the north-north case. However, now access to international liquidity to finance trade is problematic. This is because southern economies have lower standing in international financial markets owing to their lower levels of wealth. Southern countries are bound, therefore, by a "finance" constraint that limits their ability to purchase northern exports, thereby reducing the putative benefits of free trade.

Differences in capital:labor ratios between northern and southern economies also set up incentives to re-allocate production. These effects are well recognized in orthodox theory, which predicts that production of labor intensive goods will be transferred to southern countries where wages are low, while production of capital intensive goods will be transferred to northern countries where costs of capital are low. Of course, orthodox theory also assumes full employment so that there can be no unemployment as a result of the trade liberalization. However, even orthodox analysis predicts that the share of output paid to labor will fall in the northern country, and the share of output paid to capital will rise. Consequently, from a distributional standpoint, labor suffers in the northern country while capital gains.

Within orthodox theory, wages are established by reference to the productivity of workers, and competition protects workers against exploitation. However, for left Keynesians, wage determination represents the complex outcome of bargaining between workers and firms. This bargain is framed by reference to firms' abilities to hire replacement workers at lower wages, balanced by the costs of firing existing workers,

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hiring and training new workers, and living with the consequences of a demoralized work force. It is in this dimension that the effects of north-south trade liberalizations may have their greatest impact, and it is this dimension that is completely absent in orthodox readings of trade reform.

These bargaining effects work by raising the threat of employment termination. Costs of production are lower in southern countries owing to lower wages and lower social overhead costs.[5] Though southern workers also tend to be less productive owing to differences in human capital and differences in the extent of public "infrastructure" capital, these productivity differences are often more than offset by the extent of the wage and social overhead cost advantages. The net result is that the replacement threat of firms in northern economies is credibly enhanced by north-south trade liberalizations. This worsening of labor's relative bargainning position then places downward pressure on wages. In a full employment world, this has distributional consequences but no employment consequences; in a left Keynesian world it has both, since worsened income distribution is bad for demand for output.

How real is this bargaining threat? There is certainly evidence that regional cost disparities have mattered within the United States. Thus, one of the principal consequences of the 1970's oil shocks was to set up labor competition within the United States between the "sun" belt and the "rust" belt. This competition weakened labor's position, and it is no accident that the lion's share of subsequent productivity growth has accrued to capital. Another recent example of such bargainning effects was in Connecticut in 1993, when United Technologies used the threat of moving production to Maine or Georgia as a means of getting both tax concessions from the state and wage concessions from the union. If such effects can operate within national economies, there is no reason to believe they will not operate across economies, since interna-

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tional trade is just trade with the added feature of goods being transported across national boundaries.

From a welfare standpoint, not only do north-south liberalizations potentially disadvantage labor, they may also have adverse consequences for the socio-economic structure. This may be termed the "lowest common denominator" effect of free trade. Thus, to the extent that high costs of environmental protection, worker safety standards, health care, or social security are seen as the cause of lost jobs or reduced wages, this will unleash political pressure to lower these politically determined costs. In this fashion, free trade can become a force for remodelling the socio-economic structure.

*NAFTA.*[6] NAFTA represents a special case of north-south liberalization, and the above analysis therefore applies to NAFTA.[7] Thus, the import-export effects, the issue of a finance constraint on Mexico, the threat of job replacement and a deterioration in labor's bargaining position, and the problem of differential social overhead costs are all present. However, there are some additional issues raised by Mexico's geographic contiguity to the United States. This is likely to strengthen the threat of job replacement since transportation costs from Mexican plants to the United States market will be smaller. Such costs represent an important source of protection to labor in northern countries, and the fact that these costs have been declining in recent years may partially help explain the deterioration in labor's position.

The contiguity of Mexico also raises issues related to the nature of Mexico's demand for United States exports. Since Mexican incomes are so low, it is unlikely that there will be significant export of consumption goods. Instead, exports are likely to be made up of capital goods and semi-finished goods shipped for finishing and re-export to the United States. Semi-finished goods first show up as a United States export, and then show up as a United States import, so that they increase the volume of both United States exports and imports.

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However, to the extent that value is added in Mexico, they must ultimately give rise to a worsening of the trade balance since the value of the final import exceeds that of the initial export. More importantly, such semi-finished exports represent stripping out a stage of production (the finishing stage) from the United States economy and a transfer of that stage to Mexico.

The export of capital goods also raises a number of issues. First, there is the question of Mexico's finance constraint, and whether Mexico will be able to secure the liquidity needed to finance such purchases. Second, there is the issue of investment diversion.[8] Such diversion arises if exports of capital goods to Mexico are the result of substitution of investment in Mexico for investment in the United States. Thus, United States and foreign corporations may decide to build plants in Mexico to take advantage of the lower production costs and correspondingly reduce investment in the United States. To the extent that this occurs, the gain in United States exports is offset by a decline in investment in the United States. Moreover, the United States loses the lasting benefits of job creation and permanently enhanced production capabilities that would have occurred in the absence of such diversion.

## *Conclusion: A Left Keynesian Trade Policy for the United States*

The above analysis indicates how the welfare effects of trade liberalizations depends on whether they are between northern countries, or whether they are between northern and southern countries. This contrasts with orthodox trade theory which makes makes no such distinctions and treats all liberalizations as unambiguously beneficial. Indeed, orthodox theory deems the greatest benefits come from liberalizations between northern and southern countries where the differences in capital:labor ratios are greatest.

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Given this left Keynesian analytic framework, what policy conclusions can be drawn for United States trade policy? The analysis would suggest the following:

(1) Free trade between countries which have similar wage levels and socio-economic structures is desirable.

(2) Free trade between countries which have fundamentally different wage levels and socio-economic structures is problematic. Such trade requires case by case evaluation, according to the principles enumerated in (3)–(5) below.

(3) Where there are differences in technical ability to produce goods, trade should be free on the grounds of "technical efficiency." Thus, it makes no sense for the United States to produce coffee when climatic differences confer naturally a technical advantage in the production of coffee on Latin America. This is the traditional Ricardian theory of comparative advantage, which emphasizes differences in technology as the basis for trade.

(4) Where there are conditions of domestic monopoly, there should be free trade as a means of enforcing competitive behavior. In this case, free trade serves to prevent domestic monopolists from earning monopoly profits at the expense of domestic consumers. The application of this principle is readily understood in terms of the history of the "Big Three" United States auto producers. Here, the introduction of free trade in autos has conferred billions of dollars of benefits for consumers by producing lower prices and improved quality.

(5) Where the only reason for trade is the low wage structure and absence of social overhead costs, then trade should be managed through imposition of a "social tariff." The purpose of this tariff is to compensate for low wages and lack of committment to social goals regarding the environment and worker health and safety. Where countries meet these minimum standards, there should be no tariff; where they do not, the social tariff should be imposed.[9] The revenues from this social tariff could be paid to the United States treasury or paid into a fund to benefit the developing countries. There are many ways in which this fund could work: revenues could be paid to the World Bank or some like organization; alternatively, revenues could be used to provide free export credits, thereby actually stimulating United States exports while furthering southern development. Most importantly, the social tariff system provides a self-interest incentive for southern countries to improve wages and socio-economic structures by offering the prospect of

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> unrestricted market access if they do. Efficiently correcting the inequities of development has long been an intransigent policy problem; the social tariff offers a plausible and efficient means of doing so.

Underlying these principles of trade is the fundamental notion that it is unacceptable for trade to be based exclusively on wage competition and competition over social welfare standards. Thus, trade should not serve as a means of undermining the bargaining position of American labor in its wage bargain with capital, nor should trade serve as a force for rolling back laws and regulations regarding the environment, worker safety, and social security. The goal of international trade should be to export American prosperity, rather than import developing country poverty. This is the core moral principle guiding a left Keynesian gaze. It contrasts with the orthodox position, in which competition that sets foreign workers against domestic workers as a means of lowering domestic wages is deemed a good. This is because orthodox anlaysis assumes full employment and assumes that workers get paid back by sharing in the higher profits. When the economy is equally owned by all, it does not matter whether one is paid in wages or through profits; however, when ownership is as radically skewed as it is, shifting income from wages to profits has enormous implications. Likewise, when there is full employment, shifting jobs overseas does not matter since workers just find new and better jobs; however, when there is unemployment, this is not the case.

The deception in orthodox trade theory is that it begins with the persuasive Ricardian theory of trade based on differences in technical efficiency attributable to differences in climatic and natural resource endowments but then ends up justifying trade on the basis of relative wage costs. Free trade between the developed and under-developed worlds, therefore, implicitly becomes a means of indirectly pitting workers in developing countries, who have no protections or bargaining power, against workers in developed countries, who have had

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the historical good fortune to establish a relatively strong bargaining position.

Economics is a contested social science, and there are few areas of widespread agreement. However, one such area is "the law of one price," which states that where commodities and services are traded in an open market, there will be a tendency for similar commodities and sevices to trade at a single uniform price. Applied to free trade between the developed and under-developed world, it is labor that is implicitly being traded through its embodiment in imports, and the pressure for price equalization will be felt on wages, conditions of employment, and attitudes toward pollution in production.

Making the left Keynesian case for a sensible trade policy requires care. This is because left Keynesians recognize that not all free trade is the same, and there is a need to distinguish trade between developed economies and trade between developed and under-developed economies. This introduces an element of complexity which places left Keynesians at a rhetorical disadvantage vis-à-vis orthodox free trade theory, which just asserts that all trade is the same and trade benefits all. Moreover, implementing a left Keynesian trade regime calls for administrative interventions in the setting of standards. This opens the danger of rent-seeking, but it would be a tragedy if such arguments were used to prevent the development of intelligent economic policy; rather, they should serve to make policy analysts aware of the sources of policy failure so that they can be guarded against.

How important is trade policy? For European economies with their larger economic involvement in trade, it is likely to be extremely important. What about the United States? Here trade is a much smaller part of total economic activity, and trade with southern countries only a small part of that. Despite this, trade policy is still important. Though trade may be small compared to the economy, leverage exerted at the margin can have significant effects on distributional outcomes: it is the

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credible threat of movement rather than actual movement by companies that matters. The general worsening of income distribution in the United States is attributable to both domestic market forces and unbridled international wage competition; the former are difficult to counter, which makes it all the more important to embrace other opportunities.

## Notes

[1] Gordon (1994) points out that there is often considerable slippage between economic theorizing and the formation of economic policy. Incorporating increasing returns to size within orthodox trade theory means that there is no longer a theoretical presumption in favor of free trade. A similar observation is made by Eatwell (1994). This objection to free trade is different from that associated with a left Keynesian gaze. However, what is interesting is that orthodox economists continue to unquestioningly promote free trade policy despite doubts about its benefits even within their own theoretical paradigm.

[2] If higher wages significantly reduce the profit rate, they can adversely affect investment spending which then reduces aggregate demand. This tension prevents increases in wages from always being a sure means of expanding economic activity.

[3] Workers in industries with domestic monopoly power may suffer from such liberalizations to the extent that they have been able to capture some of the monopoly rents earned by firms. However, since these high wages are derived from product market monopoly, they effectively come at the expense of all workers in the rest of the economy. This situation is illustrated by the United States auto and steel industries, where unions were able to extract high wages in the period to 1970 when international competition in these in industries was weak.

[4] The normative criterion used to assess the welfare effects of trade reforms has been that of the well-being of workers. In some countries, it is harder to talk about a representative worker. This is particularly true of countries with large agricultural sectors (such as France), in which case there may be a divide between the well-being of rural and urban workers. However, in the United States,

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agricultural employment now represents a small fraction of total employment, so that this problem is not salient.

[5] Per orthodox trade theory, these differences can also matter. Thus, production of goods that are pollution or safety intensive will be shifted to southern countries where the cost of pollution or safety is lower. Since there is also full employment, northern countries benefit additionally to the extent that the "bads" associated with pollution and personal injury are shifted to the southern countries.

[6] The December 1993 issue of the *Review of Radical Political Economics* contains a symposium on the problems posed by NAFTA. Koechlin (1993a) also provides an overview of the left Keynesian position on NAFTA.

[7] The welfare effects of north-south liberalizations for southern countries are not the clear-cut symmetric opposite of those for northern countries. In the case of NAFTA and Mexico, there is a division between urban and rural workers, so that the device of a representative worker will not suffice for analyzing NAFTA's welfare effects on Mexico. Urban workers potentially gain from NAFTA, while rural workers lose owing to the liberalization of trade in agricultural products. Moreover, even if there is an increase in urban sector jobs, this does not mean that urban sector wages will increase. Mexico is a labor surplus country with a rapidly growing workforce, and the loss of jobs in the agricultural sector will compound the problem of urban unemployment. The one clear group that wins is the oligarchy which owns Mexican industry. This illustrates the need to analyze trade liberalizations on a country by country basis.

[8] This issue is emphasized by Koechlin (1993b).

[9] Obviously, this raises questions of what these minimum standards should be. A suggestion for the wage standard might be 40 percent of the United States minimum wage, but this is obviously open to negotiation.

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