

cally the actions of divorce courts and child-support bureaucracies. The Uniform Child Custody Jurisdiction and Enforcement Act, designed to prevent parental kidnappings, could also be modified to protect service personnel whose children are snatched away. Finally, Congress should repeal the infamous Bradley Amendment, so that judges can exercise reasonable discretion to modify child-support debts downward as well as upward in cases in patent injustice.

It is ironic that, as we defend a questionable military policy with patriotic appeals to support the troops who must execute it, we allow the breakdown of traditional morality and the erosion of ancient legal protections for the family to ruin those same troops once they return home. This undermines not only the military, of course, but also the patriotic appeals. But even more, in the long run it also undermines our national defense. It would be difficult to find a single policy that so simultaneously weakens the nation within and without.

What we are seeing here is only one vindication of now forgotten prophecies from critics like G.K. Chesterton that easy divorce would destroy not only the family but civilization itself. Yet as the prediction is fulfilled before our eyes, our leaders obfuscate it with clichés and psychobabble.

The much-belabored parallel with Rome is irresistible. External threats are successfully withstood until the internal moral decay that accompanies the breakdown of republican freedom and virtue. For Islamists who regard the West as a morally and sexually decadent culture, the prospect must be encouraging. ■

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# Trading Up

A new school of economic thought better fits the facts.

By Ian Fletcher

AFTER DECADES of providing academic legitimacy to the free-trade consensus, the economics profession is finally starting to make public something it has actually known for some time: free trade is a far more dicey proposition than commonly supposed. The most famous recent apostasy came from MIT's Paul Samuelson—Nobel laureate, author of the best-selling economics textbook in history, and general Grand Old Man of the discipline—but he is only the tip of a very large iceberg.

That iceberg is called New Trade Theory, and it is destined to become prominent in public debate over the next few years as America tries to think its way out of the \$500 billion a year deficit free trade has drawn us into.

New Trade Theory began to develop in the early 1980s, partly in response to America's trade problems with Japan. It is now a well-developed critique, operating within accepted standards for economic thinking and thus immune to that favorite canard of free trade ideologues, "You don't understand economics."

But before economic patriots break out the champagne, they should understand exactly what New Trade Theory does and does not prove. It does not prove that any type of protectionism is *eo ipso* better than free trade. It proves something more oblique and thus more unsatisfying if they are unfamiliar with theoretical economics. It proves that it is mathematically possible for protectionism to be sometimes best because it is mathematically possible for free trade to be sometimes less than best.

This is an important change as conventional trade theory purports to prove that free trade is always (with minor and grudging exceptions) best. But New Trade Theory shows that its mathematical models, seemingly so airtight, do not accurately reflect the complexities of the real economy. Economists, for better or worse, take these more seriously than the non-quantitative arguments with which we are more familiar. These models move the profession and the advice it gives to policymakers in a way Ralph Nader does not.

So how is conventional trade theory wrong? Start with how little it actually promises, even if true. The way some free traders talk, you'd think America would be in the Stone Age without it. They often lump in all benefits of trade under the heading of free trade, which is not the same thing.

Conventional trade theory, while unequivocally endorsing free trade, does not actually predict it to be all that much better, quantitatively, for a large and diversified economy like the United States. There is not the space here to explain the standard analysis, but the question of what free trade is worth turns on the size of what are called Harberger Triangles after the graph in which they appear. These triangles are estimated to be maybe 2-3 percent of GNP. That's all we get for all the trouble free trade causes!

This is intuitively plausible if one remembers how well the U.S. did in the '50s and '60s, when our imports, other than oil, were mostly odds and ends like

bananas and Volkswagens. Or how the U.S. became the world's leading industrial power during our protectionist period, which lasted from Alexander Hamilton until the Cold War made us open our markets to the world as a bribe not to go communist. The globalist myth that free trade is essential to our prosperity, as opposed to a (questionable) layer of icing on our economic cake, is ludicrous.

The gains from free trade are not only small, they are swamped by free trade's income-distribution effects. If free trade causes a 3 percent increase in GNP but a 5 percent redistribution of income from employees to employers, most of the population loses. Distribution-agnostic models of trade, which count gains from trade without analyzing who receives them, are meaningless.

Those readers who know their economics will rightly object at this point that the above only considers so-called "static" gains from free trade, that is, the immediate benefits of abolishing a tariff or not having one in the first place, not

conventional trade theory must rely upon general ideas of how economies function, New Trade Theory has exposed the dubious assumptions that it makes in this area. It relies on primitive, simplistic, and outdated economic ideas that are no longer taken seriously in other parts of the discipline. And second, because anything that conventional trade theory says happens must happen by means of a specific mechanism, it has investigated what these mechanisms must be and has discovered that many do not pan out in detail, no matter how plausible they seem when described casually or in the abstract.

For example, free trade is touted as increasing the entrepreneurial vigor of an economy. New Trade theorists have discovered that for this to be true, certain strict conditions must be met. Without them, it is just as easy for foreign imports to destroy the incentives for entrepreneurship in the affected industry. There hasn't exactly been a flurry of start-up activity in the American VCR industry lately.

Conventional trade theory also claims that free trade benefits economies by increasing economies of scale as it opens up wider markets. New Trade Theory has probed this claim and found that it, too, only pans out if certain strict conditions are met. For example, it requires that industries in which there are increasing returns to scale expand after trade liberalization. If these industries merely lose sales to foreign competition, then returns to scale go into reverse. As expected, some empirical data indeed show that high import penetration correlates with productivity stagnation.

Similarly, conventional trade theory claims that free trade enhances technological dynamism. Unfortunately, this is based on the casual assumption that increased competition necessarily increases dynamism. But it is well established that the relationship between competition and innovation is much more complex than that. AT&T certainly didn't lead innovation for 100 years because of free competition.

This naïveté about technology is symptomatic of a deeper flaw in conventional trade theory: its claims are not embedded in a state-of-the-art theory of industrial performance, of what drives productivity at the firm and industry level. It is now well-understood that, *pace* techno-libertarianism, technological growth is the product of a complex interaction of supply-side and demand-side factors that produce different results under different circumstances. Opening an economy to free trade may be beneficial to the right nation in the right stage of economic development, but for a different nation, it can cut the other way.

This is a recurring theme of New Trade Theory: free trade has ambivalent effects depending on circumstances. Ideology-driven notions about it being univocally good or bad just don't square with real economics. Irony of ironies, the ski-masked protestors of Seattle belong

**OPENING AN ECONOMY TO FREE TRADE MAY BE BENEFICIAL TO THE RIGHT NATION IN THE RIGHT STAGE OF ECONOMIC DEVELOPMENT, BUT FOR A DIFFERENT NATION, IT CAN CUT THE OTHER WAY.**

the long-term benefits that supposedly accrue from free trade making the whole economy more efficient. Free traders rely upon these "dynamic" gains to push free trade's benefits above a few percentage points. They constitute the hard economics that underlies all the puffery about the glory of the globalized world economy. Unfortunately for free traders, it is in the analysis of dynamic gains from free trade that New Trade Theory really comes into its own.

New Trade Theory has damaged old theories concerning dynamic gains from free trade in two ways. First, because

This problem is worse in many Third World and newly industrializing countries, where the ready availability of imports may kill off whole sectors of the economy before they can mature to the point where they could handle competition. The Third World was promised a lot in the neoliberal '90s that hasn't materialized, and New Trade Theory has some answers as to why. For example, many supposed benefits of free trade—like technological innovation—are lost to Third World nations because they lack the indigenous ability to digest these supposed gifts.

# **LOOK AT THE FACTS: IT SHOULD BE OBVIOUS TO ANYONE THAT OUR ECONOMIC OPERATING SYSTEM NO LONGER ALLOWS US TO COMPETE**

**We have been predatorily rendered uncompetitive with much of the rest of the world and we can no longer support ourselves.** We can't compete with Chinese wage rates; we can't compete with Japan's capital and knowledge intensive superior manufacturing industries. Our present standard of living can now only be supported by imports and debt which we can pay off only if we sell ownership of our wealth producing industries. We have sold 8600 of some of our best companies in the last 10 years to foreign countries. In fact, a big percentage of whole industries like 69% of the movie industry, 81% of the cement industry, 100% of the TV manufacturing industry and a host of others are now owned by foreign companies. The profit that we formerly counted on to propel our economy is now lost as a result. We have fewer companies to produce for ourselves so we must import more and more from foreign companies which is now propelling us into a major state of dependency and choking debt.

**Last year, our balance of trade deficit escalated to \$617 billion - that is \$1.25 million dollars per minute exiting our country.** The accumulation of this money to foreign countries has allowed countries like Japan to accumulate 1 trillion American dollars to buy anything or any company in America that they want and our companies are for sale to anyone on the open stock market. China has \$600 billion, Korea has \$200 billion. We are being economically subjugated in an economic war and losing ownership and control of our country almost as if we lost a military war.

**GM has a for sale value based on present stock price of less than \$20 billion. Japan could theoretically buy GM for only 2% of its available American currency reserves.** They have not yet bought GM but they have been buying many of our other strategic companies that generate wealth, which we need to protect ourselves and support our living standards.

**A few simple facts will show the glaring difference between the US and Japan, which shows clearly that they are extremely more efficient and have a much better economic operating system than we do.** Japan with only 4% of our land area and 40% of our population and with no resources had an \$80 Billion dollar balance of trade surplus with us last year and the all time highest current account surplus with the world of \$181 billion. We had a current account deficit of \$665 billion with the rest of the world.

**We are now extremely vulnerable as we don't own enough of our own companies to earn enough money to pay our bills or support ourselves.** However, our problems are not beyond fixing. We must first recognize we can't continue like this, allowing our industrial base to collapse and outsourcing our manufacturing to foreign countries; living on imports and debt and selling productive companies to cover our debts.

**Our children will pay a terrible price for these mistakes. Major changes must quickly take place or we will soon see an America we won't recognize.**

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on the same intellectual scrap heap as the *Wall Street Journal* editorial page.

The practical implication of this is that free trade is just one economic-development strategy among many. A powerful strategy sometimes, to be sure, but needful of discretion and choice in its application. That nations therefore need governments with the expertise and civic virtue to make these choices correctly is a sobering implication but not a refutation. There is no way to avoid choosing some policy and there is no neutral or default choice, only the

that make them self-reinforcing, intelligible, and susceptible to advantageous manipulation by companies and nations that understand them.

Much of New Trade Theory is simply the application of the well-established economic principle the Theory of the Second-Best. This holds that even if perfectly free markets are best in an ideal world, the minute you introduce one market imperfection, subsequent imperfections may in fact be better than pure free-market policies, as they may just cancel out previous imperfections and

England swapping wool for Portuguese wine. But today, most trade is in manufactured goods, so comparative advantages are mainly artificial. Most are accidents of industrial history, sometimes decades old, whose effects became entrenched as economies of scale and accumulated know-how made established industries difficult to dislodge. As a result, the distribution of comparative advantage is largely arbitrary, from the point-of-view of today, and assigns winners and losers in ways that are not necessarily efficient in Ricardo's sense.

Why, for example, should Switzerland, endowed by nature only with scenery, have dominated the world watch industry, to its immense profit? Why should Finland have such a strong position in cellular phones today? It simply isn't true, as free-trade theory claims, that free trade automatically shunts nations into those industries for which they are best suited. There isn't one right answer for who is the naturally most efficient producer. And if free trade doesn't always produce the best possible outcome, something else might sometimes produce better.

This insight has been mathematized by Ralph Gomory and William Baumol in their *Global Trade And Conflicting National Interests*. National rivalry, not harmony, is the condition predicted by their model, as nations tussle over comparative advantages rather than meekly submitting to their natural places in the world economy. Free traders' eternal claim that trade rivalries are merely the product of nations' failure to see where their true self-interest lies is finally refuted not just empirically but in theory as well.

Another criticism of Comparative Advantage is most closely associated with economist Paul Craig Roberts. He points out that the theory presupposes that capital used to produce traded goods is immobile between nations. (One cannot pack up the vineyards of

## FREE TRADERS' ETERNAL CLAIM THAT TRADE RIVALRIES ARE MERELY THE PRODUCT OF NATIONS' FAILURE TO SEE WHERE THEIR SELF-INTEREST LIES IS FINALLY REFUTED.

search for beneficial over harmful policies. It is impossible to abdicate responsibility to the free market, as this merely brings all the pluses and minuses of free trade with no intrinsic guarantee the former will outweigh the latter.

New Trade Theory is based, ultimately, on four innovations that have in recent years modified reigning neoclassical economics: an appreciation of market imperfections; the new industrial economics of strategic behavior; New Growth Theory, a fresh approach to the question of economic growth; and a changing appreciation of political context.

The neoclassical orthodoxy is no longer what it was in its '80s and '90s heyday—not that think-tank hacks, neo-conservative magazines, or hired-gun consulting firms have taken note.

This orthodoxy was aware of market imperfections but did not take them very seriously on the assumption that they are relatively small, tend to cancel each other out, and there's no good theory for analyzing them. New Trade Theory has challenged all this by showing that in trade, they are bigger than has been thought and tend to have patterns

push the market back towards efficiency, not away from it. So if we don't have perfectly free domestic markets, due to government regulation and other factors, perfectly free markets in foreign trade are not necessarily optimal. For example, if trade is subsidized by the global U.S. security apparatus, it should be taxed to balance this subsidy or the market will produce too much of it.

Criticism of free trade must eventually reckon with its theoretical heart, the venerable theory of comparative advantage. This classic argument holds that nations are best off when they produce what they are better at and trade it for what they are worse at. The problem, of course, is that it is not a matter of indifference what a nation is better at, just as a janitor is not indifferent to the fact that he is better at something different from a surgeon. That Taiwan is better at producing laptops and Togo at producing cocoa gives the Taiwanese a vastly higher quality of life.

This might imply nothing if comparative advantages were determined by things nobody can do anything about, as in David Ricardo's ancient example of



Portugal and move them to England.) But if that capital is mobile, as is the case in a post-Cold War world where most nations are open for business, then corporations are no longer constrained to settle for comparative advantage but can pursue absolute advantage based on the cheapest adequate labor. This leads to international labor-cost arbitrage, which does not necessarily benefit a high-cost labor force.

This all begs the question whether a nation is better off taking the best deal it can get under the existing distribution of comparative advantage or whether it should sacrifice a bit of short-term efficiency to shift long-term comparative advantage in its favor. Japan might have been better off in 1950 if it had allowed its people to buy Chevrolets, but it chose to force them to buy Toyotas, enabling a world-beating industry to be built up by 1980.

This “infant industries” argument was familiar to Hamilton, father of America’s protectionist tradition. New Trade Theory shows that it doesn’t only apply to infant industries but also, under certain circumstances, to mature ones. Perhaps America should have sacrificed consumer welfare for a few years in the ’70s and ’80s to stop Japan from destroying its TV industry? Perhaps buying cheap goods from China today is helping China build up her competitive industrial skills in a way that will cost us more in the long term than the value of those goods?

Or perhaps not. Many nations have tried to play these neo-mercantilist industrial policy games and failed. In trade, the free market may not always be right, but outsmarting it is not a game for amateurs. For 20 years after World War II, Latin America seemed to be winning with a strategy of tariff-based import-substituting industrialization. Then it stumbled. Conversely, post-1989 Russia embraced free trade too soon and wiped out whole industries. It is all

a matter of when and how, and there is no perfect one-size-fits-all policy. Different economies are subject to the same general laws, but these laws operate upon particular facts that differ from economy to economy. New Trade Theory makes clear globalism is wrong and the national economy still matters, if only because different nations will thrive best under different policies.

New Trade Theory makes other criticisms too technical to recount here. It has discovered many purely methodological flaws in the case for free trade. Causality is one: successful nations and industries may have high exports, but did they become successful because they exported, or did they export because they were successful? It is also hard to draw clean statistical conclusions about one country when its international trade results are inescapably complicated by the trade policies of 200-odd other nation-states. And it is difficult to distinguish the effects of trade policy from the

The last resort of free traders is to abandon economics altogether and make the political argument that no government is wise enough to apply protectionism correctly. They argue the attempt will just enable parasitism by industrial and labor interests at public expense. This is not wholly wrong, but the empirical evidence for its quantitative scale is in fact soft, perhaps because other players in the economy are aware of merely corrupt protectionism and tend to fight it.

More fundamentally, one cannot charge these costs against protectionism without charging against free trade the costs of the parasitism that occurs under it, despite its blithe pretensions of political innocence. Having lived through a decade of corporations using free trade as an excuse to rewrite of America’s laws for their profit under NAFTA and the WTO, we have no excuse for naïveté. This is true both as a purely economic question of companies wheedling hidden subsidies and as a

## **A GOVERNMENT FOR SALE TO THE HIGHEST CORPORATE BIDDER IS SCANDALOUS; ONE FOR SALE TO THE HIGHEST FOREIGN BIDDER IS A FORMULA FOR NATIONAL SUICIDE.**

effects of other national policies, like macroeconomic stability, which free trade can impair by exposing the national economy to the fluctuations of the world economy and fickle “hot money” investment capital.

Conventional trade theory systematically overestimates the importance of factors that are easy to mathematize. This is ultimately due to economists’ mistaken elevation of physics, as opposed to biology or other less numerical sciences, as the model for social science. But there is no good reason to think neat factors that are easy to wrap an equation around are more important in the economy than messy ones. Businesses don’t run on math alone.

more profound political question about the health of our democracy. A government for sale to the highest corporate bidder is scandalous; one for sale to the highest foreign corporate bidder is a formula for national suicide.

The cost of free trade has gotten too high for us to treat the cost of protectionism as a dispositive objection; we must properly weigh the relative costs of the two policies. New Trade Theory will be the key intellectual tool that lets us do this with real economic analysis, not competitive sloganeering. It comes not a moment too soon. ■

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## Iraq 1920

The U.S isn't the first to try remodeling Mesopotamia.

*In their introduction to an August 22, 1920 piece entitled "A Report on Mesopotamia," London's Sunday Times explained that Lt. Col. T.E. Lawrence—better known as the legendary Lawrence of Arabia—"has written this article at our request in order that the public may be fully informed of our Mesopotamian commitments."*

*Lawrence first traveled to Mesopotamia—now Iraq—as an archeologist, but joined British military intelligence when World War I broke out. He went on to serve as the British liaison officer to the Arabs, organizing the tribes to defeat the Turks and extend Arab-British control. He argued for Arab independence at the Versailles Peace Conference, where Syria, Palestine, and Iraq were mandated to France and Britain against his objection.*

*By 1920, with British attempts to build an Iraqi colony growing as unpopular on the home front as they were in Baghdad, the Colonial Office appointed Winston Churchill to find a solution. He recruited Lawrence, whose gloomy assessment of British prospects then does not bode well for the current American project.*

THE PEOPLE OF ENGLAND have been led in Mesopotamia into a trap from which it will be hard to escape with dignity and honour. They have been tricked into it by a steady withholding of information. The Baghdad communiques are belated, insincere, incomplete. Things have been far worse than we have been told, our administration more bloody and inefficient than the public knows. It is a disgrace to our imperial record, and may

soon be too inflamed for any ordinary cure. We are today not far from a disaster.

The sins of commission are those of the British civil authorities in Mesopotamia (especially of three "colonels") who were given a free hand by London. They are controlled from no Department of State, but from the empty space which divides the Foreign Office from the India Office. They availed themselves of the necessary discretion of wartime to carry over their dangerous independence into times of peace. They contest every suggestion of real self-government sent them from home. A recent proclamation about autonomy circulated with unction from Baghdad was drafted and published out there in a hurry, to forestall a more liberal statement in preparation in London, "Self-determination papers" favourable to England were extorted in Mesopotamia in 1919 by official pressure, by aeroplane demonstrations, by deportations to India.

The Cabinet cannot disclaim all responsibility. They receive little more news than the public: they should have insisted on more, and better. They have sent draft after draft of reinforcements, without enquiry. When conditions became too bad to endure longer, they decided to send out as High Commissioner the original author of the present system, with a conciliatory message to the Arabs that his heart and policy have completely changed.

Yet our published policy has not changed, and does not need changing. It is that there has been a deplorable contrast between our profession and our practice. We said we went to Mesopotamia to defeat Turkey. We said we stayed to

deliver the Arabs from the oppression of the Turkish Government, and to make available for the world its resources of corn and oil. We spent nearly a million men and nearly a thousand million of money to these ends. This year we are spending ninety-two thousand men and fifty millions of money on the same objects.

Our government is worse than the old Turkish system. They kept fourteen thousand local conscripts embodied, and killed a yearly average of two hundred Arabs in maintaining peace. We keep ninety thousand men, with aeroplanes, armoured cars, gunboats, and armoured trains. We have killed about ten thousand Arabs in this rising this summer. We cannot hope to maintain such an average: it is a poor country, sparsely peopled; but Abd el Hamid would applaud his masters, if he saw us working. We are told the object of the rising was political, we are not told what the local people want. It may be what the Cabinet has promised them. A Minister in the House of Lords said that we must have so many troops because the local people will not enlist. On Friday the Government announce the death of some local levies defending their British officers, and say that the services of these men have not yet been sufficiently recognized because they are too few (adding the characteristic Baghdad touch that they are men of bad character). There are seven thousand of them, just half the old Turkish force of occupation. Properly officered and distributed, they would relieve half our army there. Cromer controlled Egypt's six million people with five thousand British