SENATE FOREIGN AFFAIRS, DEFENCE AND TRADE REFERENCES COMMITTEE

INQUIRY INTO GENERAL AGREEMENT ON TRADE IN SERVICES AND AUSTRALIA/US FREE TRADE AGREEMENT

SUBMISSION

Submission No: 166

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No. of Pages: 6

Attachments: No

Submission for Senate Inquiry into the free trade agreement between Australia and the US July 22, 2003

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Comparative advantage and free trade

Summary

It is often asserted that trade liberalisation, that is the removal of all tariffs and subsidies, is economically desirable, or rational, and able to benefit both, or multiple, arties to free trade agreements. Therefore, it is argued, economic gains from free trade can be used to more than offset any foreseeable loss, such as to Australia's pharmaceutical benefits scheme. This short paper aims to demonstrate that zero sum gains are not necessarily avoided, that is free trade can produce losers as well as winners. Therefore, economic compensation for losses may not always be possible.

Comparative advantage

The view that free trade is mutually advantageous is credited to the work of the 19th century English economist, David Ricardo. Using simple data and assumptions, Ricardo showed that specialisation in a county's "comparative advantage" can increase total production, and thus escape "zero sum game limits"[1]. This is illustrated by the following example.

Ricardo's work used the example of England and Portugal. Assume an equally skilled, equally healthy and equally remunerated workforce, each of 10 people. Assume that in each country, half of this workforce is engaged in producing cloth, and the other half in producing wine. Assume that in England the productivity of the cloth-workers is twice that of the wine-growers, but that in Portugal the situation is exactly reversed. Using these assumptions, table 1 shows that each country produces 45 units of commodity over an arbitrary 30 day period.

[1] In a game with zero sum gain, one party's benefit is always at the expense of another.

	commodity	man-days/unit	workforce	man-days worked	production (30 days)	total
England	cloth	5	5	150	30	
	wine	10	5	150	15	45
Portugal	cloth	10	5	150	15	
	wine	5	5	150	30	45

Table 1: Pre-specialisation. Both countries produce each commodity. Total production is 90 units.

Ricardo showed that that if each country specialised in producing the commodity it was better at then the total output could be increased. This is shown in table 2.

	commodity	man-days/unit	workforce	man-days worked	production (30 days)	Total
England	cloth	5	10	300	60	
	wine	10	0	0	0	60
Portugal	cloth	5	0	0	0	
	wine	10	1	300	60	60

Table 2: Post-specialisation. Each country produces a single commodity. Total production increases to 120 units.

If we assume no transport costs, no diminishing returns of labour productivity, no costs of retraining the specialised workforce, no other unforeseen adverse effects, **and** a perfectly equitable distribution of the increased production to the labour force, wages will increase, in both countries, from 4.5 units per month to 6 units per month. Thus, both parties benefit, and zero sum limits are avoided, at least in theory. Although the assumptions listed at the start of this paragraph are clearly unlikely to be true, their cost (often known as externalities) may still be exceeded by the economic benefits.

However, if we the countries and their labour forces do **not** enjoy equal bargaining positions, **and** that the price for wine and cloth is set by supply and demand - both of which are very plausible - then the finding that both workforces will increase their income does **not** necessarily hold.

For example, assume a third country (Spain) also produces wine, in which it has the same comparative advantage as Portugal. The total production of cloth and wine is therefore 90 units. However, even assuming that the quality of the wine is identical in each country, and that tastes do not change, there is likely to be an over-supply of wine, leading to a reduction in its price (see table 3). Wages in the wine producing countries may fall, even if total wine demand increases.

Furthermore, England, as the monopoly producer of cloth now has the option to increase the price of cloth, further increasing the disparity between the wages paid in the three countries.

These examples are highly simplified, but demonstrate that free trade and comparative advantage do **not** necessarily result in gains for all parties. Free trade, even if genuinely applied can actually increase both absolute and relative inequality between and within nations. Real wages in countries that produce an oversupply of goods may fall, even if total productivity increases. Specialisation may make a country vulnerable to reduced demand for its export, because of substitution or fashion. It also means that a country cannot reduce its comparative disadvantage in a commodity that it does not attempt to produce (Mehmet, 1999: 47). Finally, it leaves it vulnerable to the actions of monopoly producers.

These principles are an important reason for the continuing economic impoverisation of many Third World countries dependent on a limited number of commodities, such as coffee, cocoa and bananas. While Australia is not as vulnerable as many countries, my submission is that the committee should not critically accept assertions that the principle of comparative advantage, even if applied uncritically, inevitably results in mutual gain.

Because Australia has manifestly less economic and political power than the US we should be very careful that any treaty entered is in Australia's long term social, health, environmental and economic interest.

	Cloth			Wine			
	Production	demand	Price	production	demand	price	wages
England	30	20		15	25		4.5
Portugal	15	20		30	25		4.5
Spain	15	20		30	25		4.5
Total	60	60	1	75	75	1	
	pre-specialisation						
England	60	20			25		6
Portugal		20		60	25		3.75
Spain		20		60	25		3.75
Total	60	60	1	120	75	0.625	
	post-specialisation, unchanged wine demand						
England	60	20			28		6
Portugal		20		60	28		4.2
Spain		20		60	28		4.2
Total	60	60	1	120	84	0.7	
	post-specialisation, increased wine demand						

Table 3: Before specialisation, wages in each country are equal at 4.5 per person. After specialisation, the price of wine falls, because of its over-supply. Even though the wine-specialising countries have increased their productivity, wages decline relatively, and may even decline absolutely, depending on the elasticity of demand for wine.

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BMJ 2002;324:1276 (25 May) Letters

Globalisation and health

Those concerned with health must continue to challenge power

EDITOR—Rao argues that trade between unequal partners is better for everyone than no trade at all.[1] Although specialisation and free trade lead to increased total production, however, the benefits between unequal partners are rarely shared equally. Despite increased production it is not even certain that the population of the weaker economy will benefit; an oversupply of goods produced may lead to lower wages because the price of such goods is set not by benign agreement but by supply and demand.

The doctrine of comparative advantage being of mutual benefit holds only for a static position.[2] Uganda may have a comparative disadvantage in software design, but if it produces only coffee then its software industry can never develop. Furthermore, overspecialisation in coffee will always leave it vulnerable, including to oversupply.

While oversupply of goods produced by the stronger economy is possible, that economy's strengths generally cushion it better from adversity. These cushions include the flow of interest from poor to wealthy populations, the leverage afforded to creditor populations over the economic and social policies of indebted populations, and the selective and self serving use of tariffs and subsidies by more powerful economies. For these reasons relative inequality remains important.

Feachem admits that current global economic policies have many failings but laments the health community's naivete for going further than he does in its criticism.[3] He claims that the health community uses no, or only circular, citations to support its critique, but he again claims that globalisation has reduced poverty and inequity. In absolute terms, the number of energy deficient people in the world has declined marginally in recent decades, but there are several plausible explanations: "globalisation" is only one.

In terms of hard, tradeable currency, such as US dollars, the evidence that global inequality has become more extreme recently is unequivocal. No authority disputes this, though some hide it by referring to income adjusted for "purchasing power parity." [4] [5] In fact, the global Gini coefficient (using foreign exchange-adjusted currency) increased from an already high 71% in 1964 to peak at 80% in 1995 and was 79% in 1999.[5] In comparison, Brazil, a country normally considered to be extremely unfair, has a Gini coefficient of little more than 60%.

It is the widening of the gap between rich and poor that so many of the medical profession find unsettling and so many activists find outrageous. The "mainstream" view on globalisation and development that Feacham identifies profits from and supports this inequality.[3] To paraphrase Virchow, those concerned with health have to find the courage to continue to challenge power.

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