Ricardo and Unilateral Liberalisation

To re-read Ricardo after decades as a practising international trade economist has been an immense pleasure. Ricardo's powers of abstract reasoning, pursued without any of the tools (props, perhaps) that we have become used to, are breath-taking. Here is truly one of the great exponents of our profession. And the fact that it was all in aid of practical policy-making only doubles the pleasure which I take in it.

Ricardo brought us the theory of comparative advantage which is among the most subtle and powerful ideas in economics and it is arguably more central to our world view today than it was in 1817. That voluntary and undistorted trade benefits both parties is a lesson which we should never forget.

Ricardo also writes about trade policy and argues strongly against the Corn Laws and subsidies ('bounties') to exports, although interestingly he explicitly accepts the case for temporary protection to ease adjustment to trade shocks (p. 272).[1] He does not, so far as I can see, say a great deal about other countries' trade policy, the essential difference between unilateral and bi- or multi-lateral liberalisation. All his argumentation is about British policy and hence, by omission, was implicitly unilateral, but it is not clear that we can jump from this to a view that unilateral liberalisation was his preferred approach under all circumstances. I see three reasons to be cautious about such a leap.

First, Ricardo was trying to influence British policy and that policy was, in the 1810s, pretty restrictive, so his focus was perfectly understandable. Second, he does, at least once, recognise the harm caused by one country's polices to another's welfare: "Bounties on exportation or importation, new taxes on commodities, …..disturb the natural trade of barter ….. in a greater or lesser degree, in every country …" (p.160). It is true that this is in a section where he writing about macro-economic consequences, which he thinks are mostly neutralised by the inter-sectoral movement of factors, but it is, nonetheless, not indicative of an indifference to what happens elsewhere.

The third and main reason to be cautious about drawing an ineluctable link from comparative advantage to unilateral liberalisation is that in Ricardo's model it barely matters what other countries do because each country's relative costs of production of the two goods are constant. Thus in the long run trade policy affects only consumers' welfare: producers can avoid its effects by shifting between sectors. All three caveats suggest that Ricardo did not seriously address the question of unilateral vs bi-lateral liberalisation, and hence that unless we willing to assert that the world is actually like Ricardo's model we cannot safely conclude what he would have thought about that question. (I cast the discussion in terms of Ricardo's model because he undoubtedly had one even if it was expressed in 'mere' words. He understood perfectly well the distinction between his examples and the hurley-burley of the 'real' world.)

[1] All my references are to David Ricardo *Principles of Political Economy and Taxation*, Penguin Edition, edited by R M Hartwell, 1971.

Where does this leave the question of unilateral liberalisation in the twenty-first century, particularly twenty-first century Britain? The basic insight into the gains from trade remains as formidable as ever: international trade has been fundamental to both the high levels of welfare in developed countries and the huge strides made in many developing countries. China could not possibly have grown so fast if it had faced the constraint of consuming what it produced; its growth depended almost entirely on producing a subset of goods very efficiently and selling them abroad, the domestic market being quite unable to absorb such volumes without the price (and the incentive to produce) collapsing. Thus the case for trade liberalisation is also formidable.

The argument for unilateral trade liberalisation is also strong. Over the last two hundred years several arguments have been advanced against liberalisation – such as infant industry arguments, fostering innovation and redistributing income internally – but these apply to any liberalisation and I will not deal with them here. The critical question for unilateral liberalisation is whether to make one's own liberalisation dependent on others also liberalising. Whether to do so depends on two factors and the balance between them: (a) the extent to which partners' trade restrictions harm our welfare and (b) the extent to which withholding our own liberalisation will induce them to change their behaviour (which mostly amounts to whether our restrictions harm them).

In the case of small economies, condition (b) is generally binding – they are too small to constitute any serious threat to larger (or much more numerous) trading partners and so holding out for reciprocity seems pointless. This advice is re-inforced if you believe, as, Gladstone and Cobden did in nineteenth century Britain, that the benefits of free trade will be so obvious that others will follow a unilateralist's lead of abolishing tariffs and hence achieve global free trade. In fact, however, Gladstone and Cobden were proved wrong and the world did not follow the UK push towards free trade, and worse, the policy left the UK with little to negotiate with in the bilateral agreements that grew up during the 1860s (Cain, 1999).

For larger countries, reciprocity is potentially a more attractive policy, but policy makers still have to assess whether the long-run gains of freer trade outweigh the immediate costs of continuing to restrict trade in the short run. Textbook discussions of optimal tariffs – the argument that by restricting imports you drive down their price and so improve your terms of trade – and of strategic trade policy - in which governments intervene in markets to bolster the natural market power of their firms - are typically timeless, but the real world is not. If negotiating success is distant or uncertain, it may not be worth maintaining 'negotiating tariffs' even if they are in principle effective.

There is, however, evidence that trade agreements do satisfy a broad terms of trade reciprocity, e.g. Bagwell and Staiger (2010), although this is consistent with two explanations: viz. that A fears B's barriers and so reduces its own in order to get B to reduce its, and that B's liberalisation is necessary before A can overcome the domestic political barriers to its liberalisation.

Unilateral trade liberalisation has figured in the ongoing controversy about UK trade policy following Brexit. Some researchers – e.g. Miller and Minford (2017) - see the UK as a small open economy with no influence over world prices and nothing to gain from negotiations; hence they advocate immediate unilateral liberalisation. Most, on the other hand, believe that after leaving the European Union, the UK will need improved access to other countries' markets if it is to maintain its current level of openness without a significant terms of trade decline and that being able to offer improved access to its own market in return will improve its chances of achieving this, see, for example, Winters (2017).

The contemporary debate also raises two elements not foreseen by Ricardo or any economist until the last few decades – value chains and standards. In many goods and nearly all services markets are regulated to try to assure quality and safety standards, and this often raises costs for domestic producers and importers alike. Unilateral liberalisation cannot imply eliminating these standards and so there is a trade-off between relaxing the standards and maximising the number of suppliers you can buy from. Once we recognise value chains, however, this trade-off becomes much more complex. If country A uses inputs from country B to produce a good sold in country C, A will want to know that B's input meets C's requirements in order to know that the trade goes through. If C refuses to accept any chlorine-washed chicken A will not want to include B's chlorine-washed chicken in its chicken pies. A cannot, in effect, determine its own standard unilaterally if it wants to keep its value chains going.

Ricardo was undoubtedly a great economist. It is no detraction from his greatness that he did not solve a problem that arose two hundred years after his death. Equally, however, two hundred years later we cannot infer from Ricardo's greatness that unilateral liberalisation is the correct policy prescription.

Bagwell, K., & Staiger, R. W. (2010). The world trade organization: Theory and practice. *Annu. Rev. Econ.*, *2*(1), 223-256.

Cain P (1999). British Free Trade, 1850-1914: economics and policy. *Refresh*, (29), 2.

Minford, P., & Miller, E. (2017). What shall we do if the EU will not play ball?. *Economists for Free Trade*.

Winters L A (2017) The economic benefits of Brexit – revisited and rectified, weblog UK Trade Policy Observatory, 21st August, https://blogs.sussex.ac.uk/uktpo/2017/08/21/the-economic-benefits-of-brexit-revisited-and-rectified/#more-1031