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Remarks upon receiving the 2005 Adam Smith Award from the Association of Private Enterprise Education

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First, let me tell you how honored and pleased I am to be recognized by this distinguished freedom loving Association. Especially, because when I look around, I see so many of my mentors. So, thank you very much for bestowing your Adam Smith Award on me.

Since I am talking to many in the profession of teaching economics, I must disclose that I became a professor of economics only because I happened to be in the privileged position where I could appoint myself. So, I would like to relate part of my experience in the process of discovering that discipline called economics:

When I was learning engineering in college, I took a required course in economics. I found it so nonsensical that I made the resolution never again to open a book on that dismal science. Recently, I leafed through the textbook we were assigned and confirmed my bad opinion. I don't know how I passed the course because I didn't understand a thing. Fortunately years later, and thanks to the Foundation for Economic Education, I found economics and was fascinated by it. Immediately I realized it was a necessary tool to understand the world we live in.

It seems to me unfortunate that in most widely used college textbooks on economics, "The General Theory of Exchange," as Prof. Pascal Salin properly refers to the law of comparative advantage or, better, comparative costs, is relegated to the latter part of the texts when dealing with international trade. It is then that the theory of comparative advantage is dwelled upon, even though international trade is just one particular case of the phenomena of exchange. I am particularly conscious of this disorder because I began to return to economics in Ludwig Von Mises' *Human Action* in which he deals with exchange in society at the beginning,[1] before getting into demand and supply and other basic concepts that explain exchange.

The Wealth of Nations begins, precisely, with the division of labor but Adam Smith relies on the benefits of the increased individual productivity, resulting from specialization made possible by the division of labor. I did not find him clear on the principle of comparative costs, expounded later by David Ricardo, albeit applied exclusively, I believe, to international trade.

Being an engineer, I thought that trade just shuffled ownership of the same things among participants according to their preferences, and had a hard time realizing that trade itself increased the size of the pie by freeing time; that is, by increasing the productivity of the parties involved, and thus both parties could share in the increase in wealth.

The lack of emphasis on this basic principle at the beginning of textbooks on economics strikes me as particularly regrettable, since the rest of the textbooks deals with the mechanisms that coordinate exchange, such as Price Theory, Monetary Theory, etc. I grant that those getting a degree in economics are well aware of the basic principle of exchange, because they have been through the law of supply, indifference curves, including production frontiers, Edgeworth Boxes and other matters pertaining to the economic allocation of resources. But I consider that the Law of Exchange should be part of the core curriculum of any social studies be it history, anthropology, sociology, or politics, because it explains the very existence of society. As von Mises points out, "In a hypothetical world in which the division of labor

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[1] *Human Action,* 4th Ed., Part II, Chapter VIII: Human Society, Action Within the Framework of Society (143).

would not increase productivity there would be no society."[2]

As is frequently remarked when it comes to international trade, the economists win the academic arguments and lose the policy wars. Many people, successful in other affairs, think that understanding economics is intuitive, and because they are smart, as proved by their success in their careers, they have no qualms about giving economic advice. They have much influence in social, fiscal and economic policies, or spread fallacies in the media (Lou Dobbs comes to mind). Successful businessmen are especially prone to this, and precisely because they are successful in the economic world of business, governments automatically qualify them to dispense economic advice to the nation. Not only do they give bad advice but they are frequently oblivious to the fact that they are trampling fundamental property rights of their own people. I am reminded of George Soros, and the Davos group, who think that they can manage the world as they do a firm, a factory or their business organization. They would, I think, be horrified by their own proposals if they understood the economic implications. They are quick to understand such things as intellectual property rights, but not the right of individuals to trade what is their own.

Businessmen present an unfortunate case similar to the comedy of "Who's on First." Being primarily a businessman I was surprised to learn that the words used in the business world mean something different in economics. To illustrate: many bankers think the price of money (and not of credit) is the interest rate, and I'm sure they would be at a total loss if one asked them what the price of money is. They would be surprised to learn that they are not in the money business, but in the business of intermediation in the credit market, that capital means something different to an economist than to a businessman, that

[2]Ibid., p. 143.

depreciation exists only for tax reasons, and so on. This use of the same words with different meaning in business and in economics is confusing, and unfortunately the last thing many businessmen will do is study some basic economics.

As I acquired an appreciation of the implications of the Law of Exchange (the meaning of comparative costs), the insight that impressed me first was that even in the case when one person is better than another in every task, both could gain by dividing the tasks and subsequently trading the resulting output without even considering the benefits of increased individual productivity. Secondly, that the division of labor comes about due to the perceived prospect of mutual gain, without recourse to value theory, because it relates to productivity and costs and not to preferences. Preferences are determined subjectively, but once they have been determined, the problem becomes either producing them for oneself or reducing the cost of acquiring them at lesser expenditure of labor and resources through division of labor and subsequent trade; i.e., if I need computers I can easily predict that I will have more of them if I plant cotton and leave the manufacture of the computers to Dell.

Especially in this audience, most of the arguments used to justify restrictions on trade are well known but, again, how property rights are compromised is not brought out frequently enough. I regret that whoever started with national accounts somehow missed that the object of exporting is to import, that unfortunately those darn foreigners refuse to send us things if we don't pay for them, and so we are forced to produce for them what they want if we want their products. Wouldn't it be nicer if we didn't have to spend our work and resources to import what we want, if we could import without exporting? If whoever started with national accounts would have assigned a negative sign to exports and a positive sign for imports, the current grave concern with the negative trade deficit would be, instead, a delight with the positive trade surplus.

Another astonishing realization for me was that one could prove arithmetically that the division of labor is a win-win game. I actually had to call a neighbor, who was also an engineer, to go through the exercise because, intuitively, trade just appeared to be a mere reshuffling of the same products. At first blush it seemed impossible that the size of the pie would increase unless their individual productivities increased.

But here was proof positive that in a free—not in a mercantilist–economy, one person's gain is not someone else's loss, that even the more productive benefit when trading with those less productive. This realization kicked the moral high ground right out from under the pedestal of redistributionists since ultimately those who make fortunes are the ones who enrich the others most. Unfortunately, it is easy to underestimate the consequences of these insights for they would afford a much different and enlightened perspective to fiscal policies aimed at redistribution of wealth and income.

Some opponents of free trade attempt to invalidate the simple two parties' model, arguing that trade is among many people and many products, but that forgets that trade is always of one item at a time and, whether direct or indirect, is always necessarily between two parties at a time. I also fail to understand objections related to the mobility of resources, such as those by Paul Craig Roberts,[3] for trade will always provide an opportunity to increase mutual gain so long as people have different opportunity costs. (Incidentally, that is why I prefer to use the term comparative costs.) In other words, the only exception to mutual benefit from trade is when one person is better than the other person equally in all tasks, without exception, the probability of which is as great as, borrowing an example from Don Boudreaux, giving a monkey a typewriter and he proceeds to compose Hamlet. This exception is interesting because, as you know, applied to international trade it means that, not considering transaction costs, trade will always produce mutual

[3] *Washington Times*, April 24, 2005.

gains so long as the relative price structure prevailing in one locality is different from the other locality.

The most important implication that hit me like a ton of bricks generally goes unremarked perhaps because it is too obvious: We exercise our property rights basically in two ways; by enjoying property ourselves or by trading what we own. Admittedly, neither the enjoyment nor the trading of property can be absolute, for they are subject to the limitations necessary for the existence of society, that is, respecting other people's equal rights of enjoyment or of trading their property. But how many people realize that, for instance, being in favor of import duties or other restrictions to the peaceful disposal of one's property through trade violates the property rights of the two parties involved: the exporter's and the importer's. I fail to understand why the right to property depends on the political jurisdiction of place of residence of the parties involved; or how my right to dispose of my property right is lost if the person I'm giving it to lives in another country, and therefore the transaction can be taxed or otherwise restricted. I am reminded of Vaclav and Vladimir, who lived in Prague and Bratislava, respectively: before the Czechoslovakia split, they could trade their rights without the concern of others. When the country split into two countries, their trades became international commerce and the enjoyment of their rights could be legally–if not legitimately–interfered with!

One argument with which violators of our property rights like to justify such intervention is that we don't produce in isolation but with the cooperation and contribution of other members of society. True enough, but in the market society, everyone's freely contracted cooperation is a settled account, precisely by the myriad exchanges of private property, where each exchange is perceived as the best available opportunity for mutual gain, for otherwise it would not occur.

I owe to Giancarlo Ibargüen the quote from you know who, who back in 1849 said:

> Every citizen who has produced or acquired a product should

> have the option of applying it immediately for his own use or of transferring it to whoever on the face of the earth agrees to give him in exchange the object of his desires. To deprive him of this option when he has committed no act contrary to the public order and good morals, and solely to satisfy the convenience of another citizen, is to legitimize an act of plunder and to violate the law of justice. —Frederic Bastiat.[4]

Again, thank you very much for the award.

[4]Bastiat, Frederic. "Protectionism and Communism." In *Selected Essays on Political Economy.* The Foundation for Economic Education, Inc. 1995. Trans. Seymour Cain. Ed. George B. de Huszar. Library of Economics and Liberty. 1 April 2005.