

THE MARKET AND THE DIVISION OF LABOR

Smith, Ricardo, Hechscher-Ohlin-
Samuelson, Krugman

Did we show all of this clearly?

- Competition is an essential feature of markets
 - Good because markets coordinate without cooperation
- Why it's rational not to cooperate.
- Why it's rational not to cooperate in large groups
- Why cooperation is sometimes better than competition
- How can you get cooperation?
 - Government Authority (political liberals)
 - Coase Theorem (economic liberals)

Where we are...?

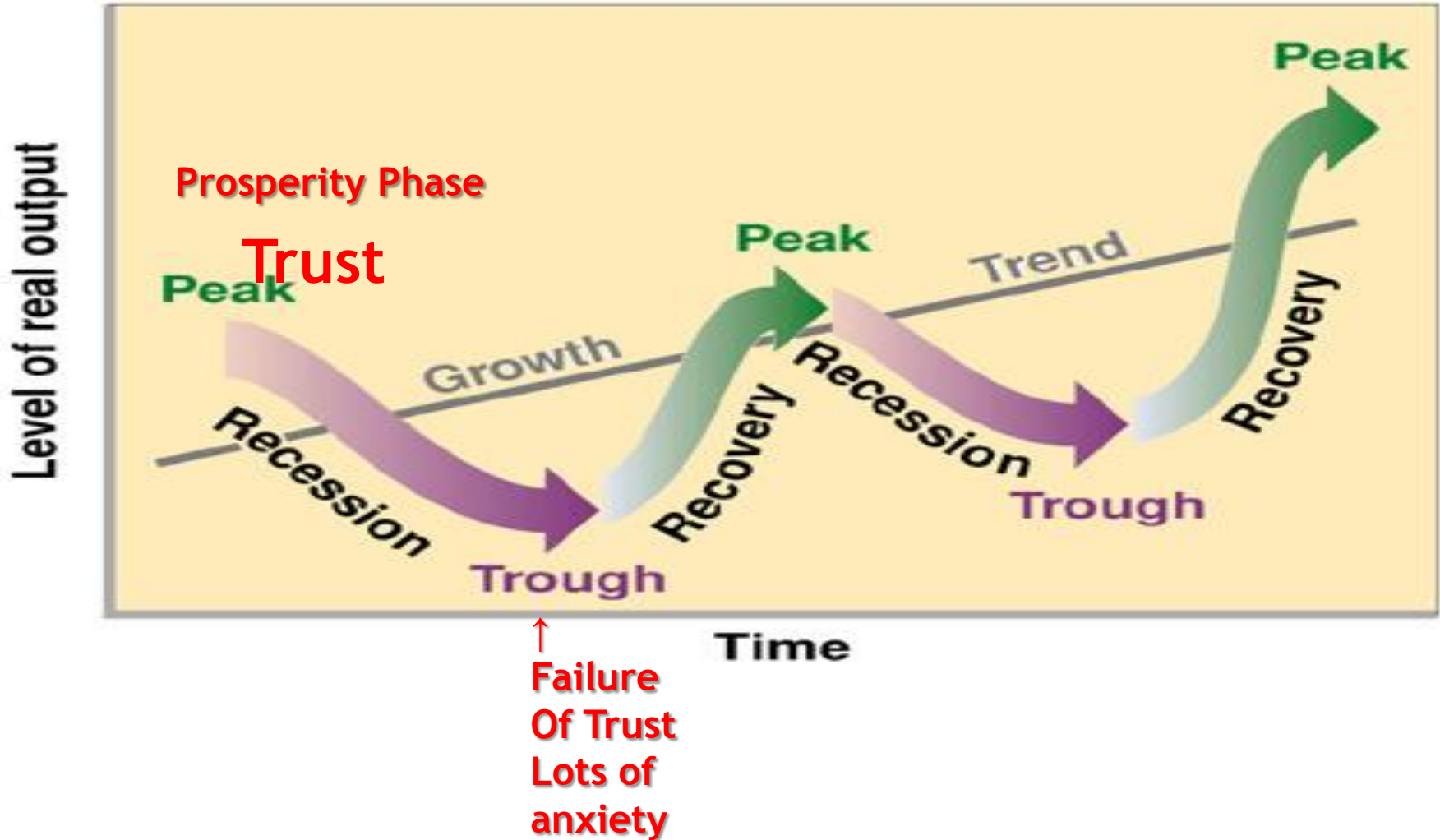
Lindblom helps us

- Market system is only established through certain rules
- We have been talking about the market system (which is a group of institutions) as one form of resource allocation (the economy part of political economy)
- Resources allocated on a free, quid pro quo basis—voluntary transactions
- Efficiency is achieved through the mechanism of human rationality and self-interest---we want the most for the least cost and effort ...achieved also by reducing transaction costs in exchange (how? Money, intermediaries, impartiality=blindness)

You gotta have trust - but it's hard to get

- it is very hard to move from the low-trust situation, in which both prisoners confess, each hunter chases his own rabbits, --or everyone drives their car as much as they want, and arms races spiral out of control---
- to the more trusting situation, in which both team up to get a light sentence, to bring down the stag—or everyone together stops climate change—or countries destroy their weapons.
- Everyone wants to get to “5” but it's hard in large groups

Breakdown of Trust causes market failure



So if cooperation is needed, even in a market system, how do you get it?

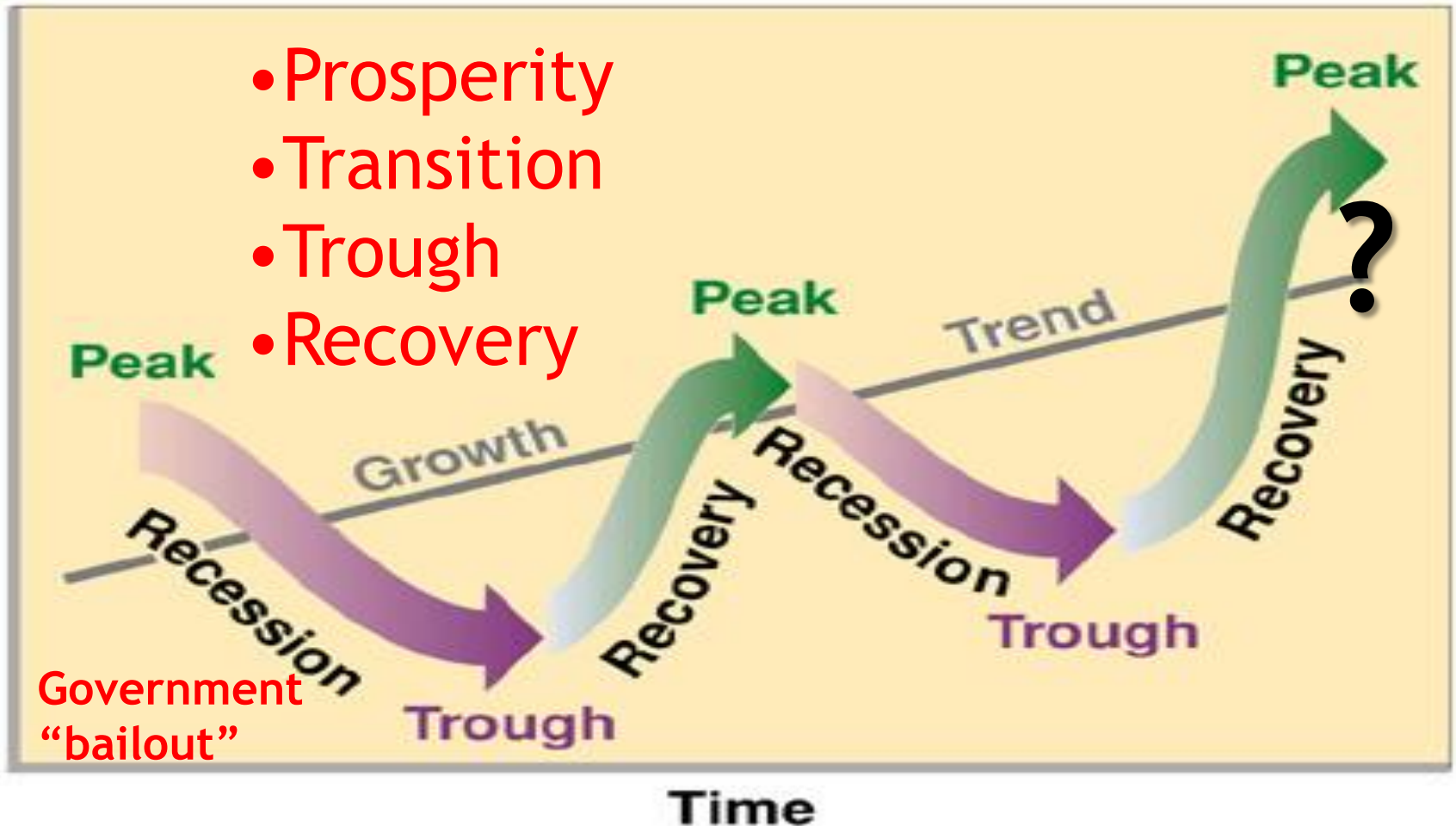


Any move to the high-trust environment is going to require its own, possibly costly, attempt at coordination.

Governments coordinate economic activity when uncoordinated markets “fail”

- Prosperity
- Transition
- Trough
- Recovery

Level of real output



Theory of Comparative Advantage



Specialization + Trade

David Ricardo (1772-1823)



FREE TRADE VS PROTECTIONISM



Production without specialization and division of labor

	Wine	Cloth	Total
England	3	5	8
Portugal	9	6	15
Total goods produced			23

Production with specialization before trade

	Wine	Cloth	Total
England	1	10	11
Portugal	16	0	16
Total goods produced			27

*Before trade: Resources put where they are most **efficient** (specialization)
Note: **Efficiency** increases total number of goods available, from 23 to 27*

Production with specialization and trade

*England trades Portugal 4 units of cloth for 4 units of wine
Exchange rate is 1 to 1.*

	Wine	Cloth	Total
England	5 (1+4)	6 (10-4)	11
Portugal	12 (16-4)	4 (0+4)	16
Total goods produced			27

Total goods produced is still 27 but each country is better off than before trade and both are better off than before “efficiency”

**Without
specialization
and trade:**

	Wine	Cloth	Total
England	3	5	8
Portugal	9	6	15
Total goods produced			23

**With
specialization
and trade:**

	Wine	Cloth	Total
England	5	6	11
Portugal	12	4	16
Total goods produced			27

Opportunity costs

The opportunity cost of doing A is the value of any benefit given up by not doing B



A certain good should always be produced in the country which has the lowest opportunity cost



If a country can choose between producing two goods it should choose the one where it is most **EFFICIENT**

The remote island example

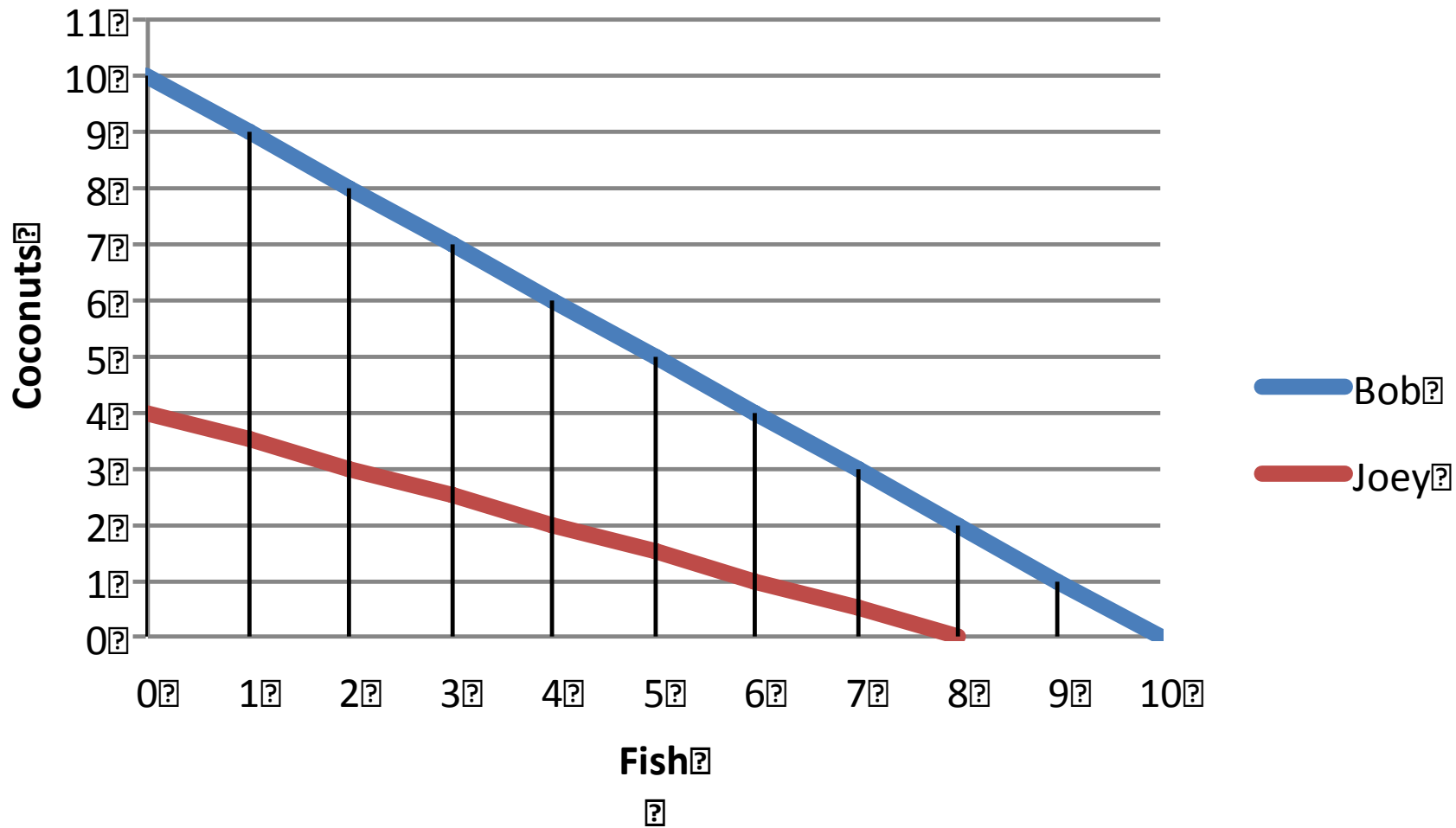
Joey

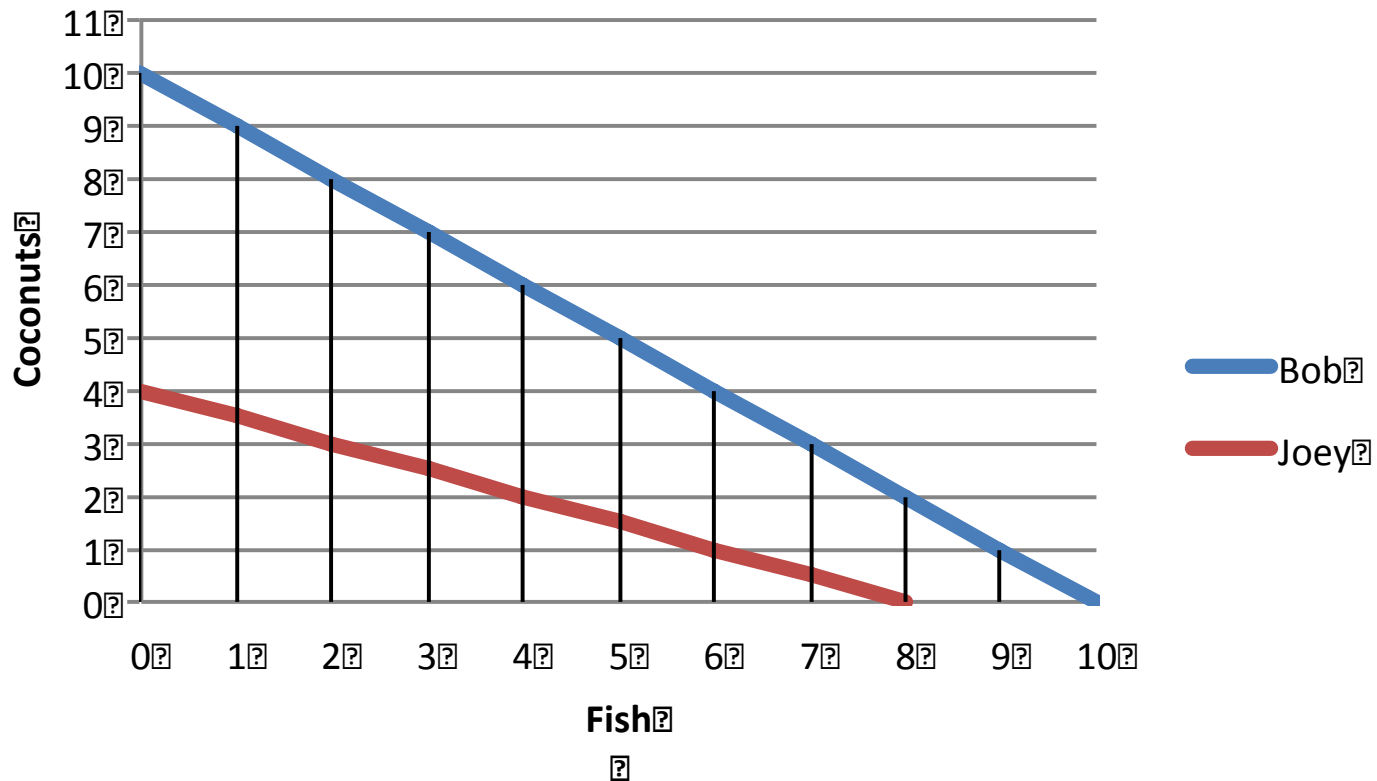


Bob

	Coconuts		Fish
Bob	10	OR	10
Joey	4		8

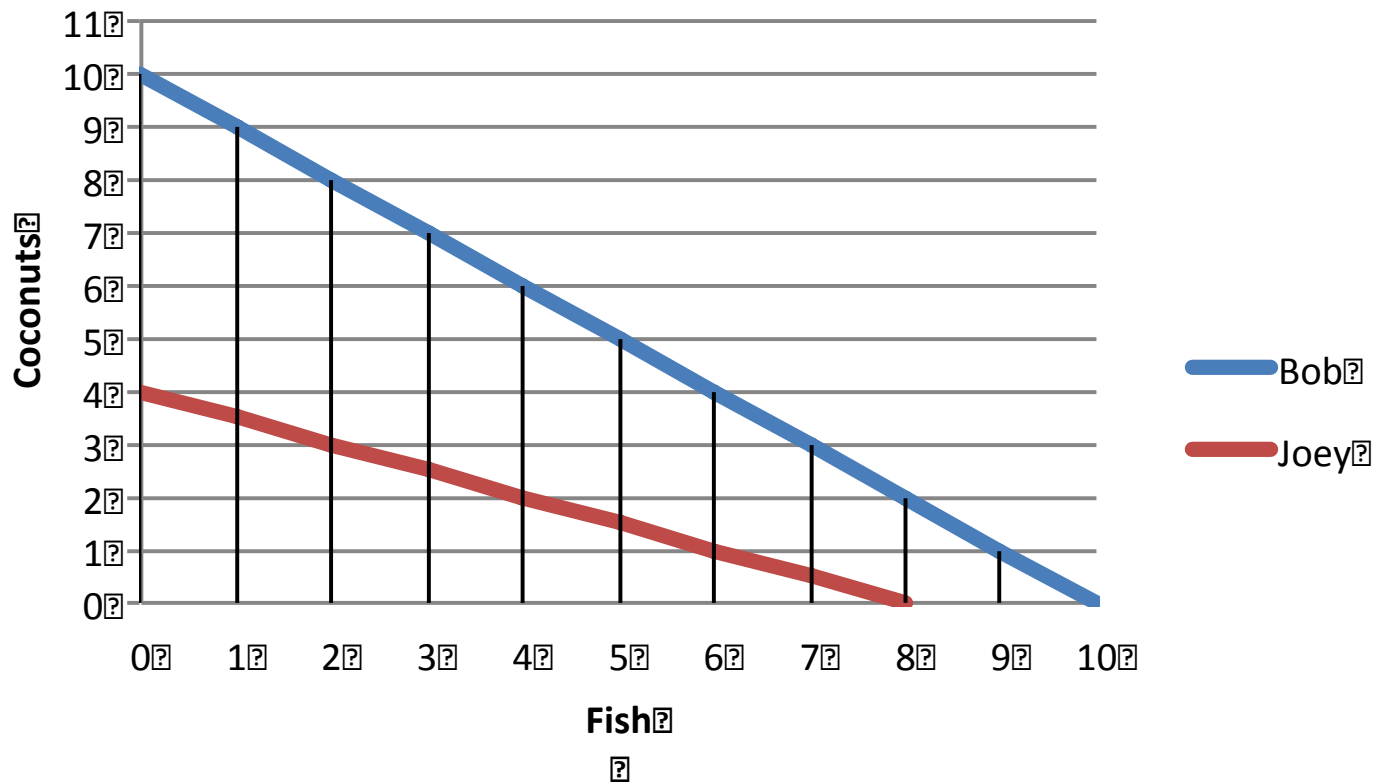
Premise: they *either* find coconuts or fish





If both work on their own:

	Coconuts	Fish	TOTAL
Bob	5	5	10
Joey	2	4	6
TOTAL	7	9	16



WHO SHOULD DO WHAT??

Opportunity cost for coconuts:

Bob: 1 fish per coconut

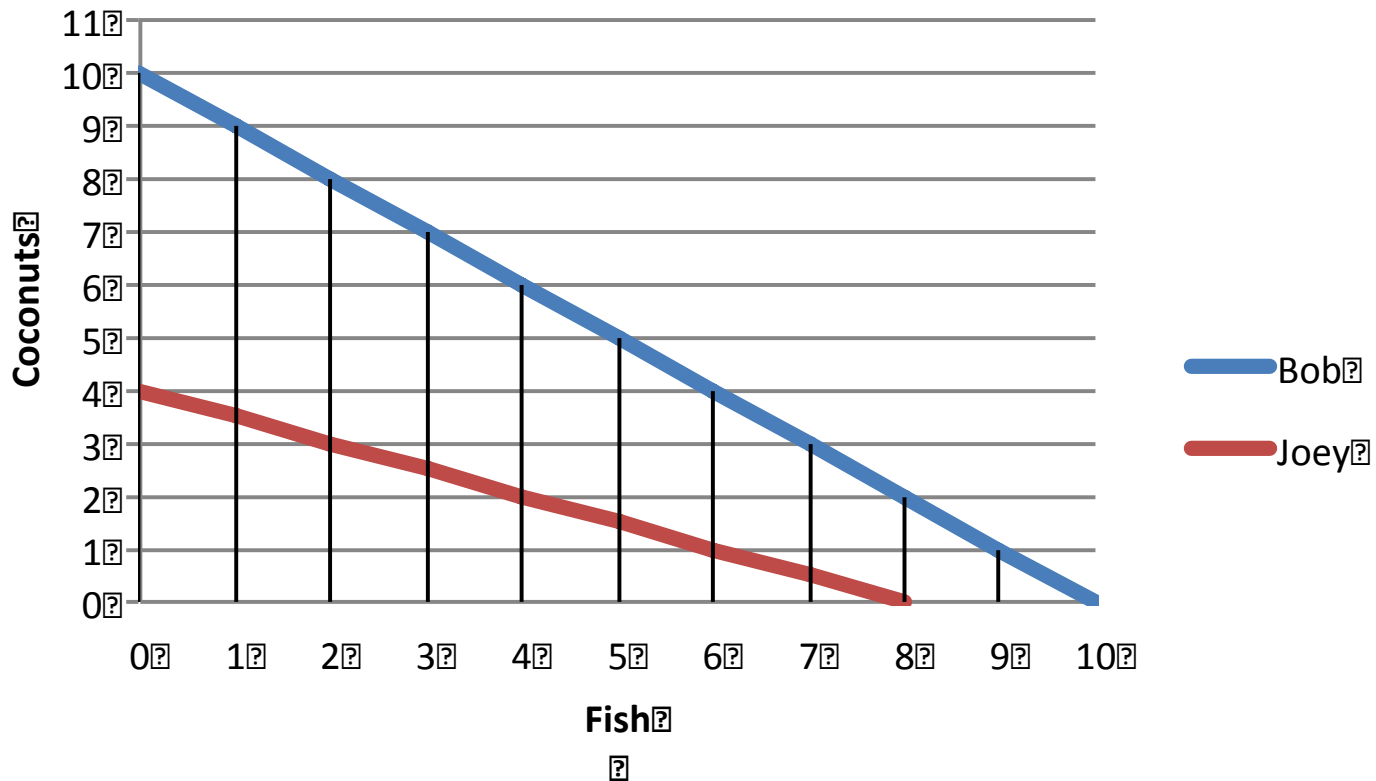
Joey: 2 fish per coconut

Opportunity cost for fish:

Bob: 1 coconut per fish

Joey: 0.5 coconut per fish

BOB → go nuts / Joey → go fish



If they use their comparative advantage

	Coconuts	Fish	TOTAL
Bob	10	0	10
Joey	0	8	8
TOTAL	10	8	18

We had 9 fish in total before we started this...

If they use their comparative advantage

	Coconuts	Fish	TOTAL
Bob	10	0	10
Joey	0	8	8
TOTAL	10	8	18

If they use their comparative advantage - and want as much fish as before

	Coconuts	Fish	TOTAL
Bob	9	1	10
Joey	0	8	8
TOTAL	9	9	18

Two important principles

- 1) Efficiency produces wealth
- 2) Trade is necessary to be efficient, because all countries grow = there is an absolute gain

Why we all should drive Toyota!



Assumptions of Ricardo's Theory

- Assumes static givens in a country's economy ...
- ... and doesn't discuss technology as a factor of production.
- Labor theory of value
- What?



Labor Theory of Value (Smith)



Hechscher-Ohlin-Samuelson modernizes Ricardo

- This model maintains that a nation's comparative advantage is determined by the relative abundance and most profitable combination of its several factors of production, such as capital, labor, resources, management, and technology.

Krugman expands on Heckscher-Olin and wins Nobel Prize



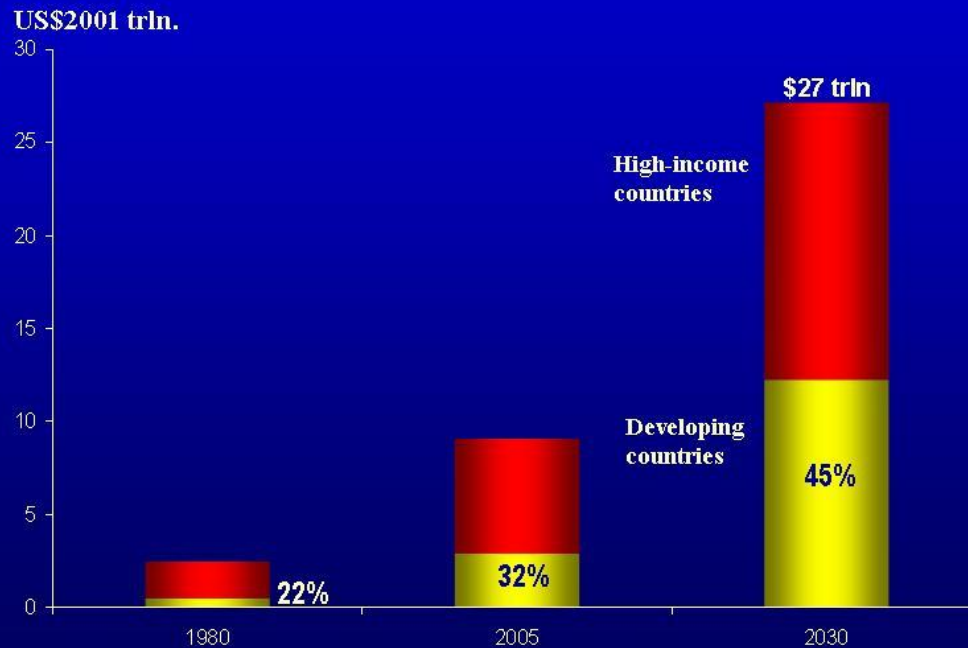
Paul Krugman Defends Free Trade

- "Ricardo's Difficult Idea,"
- People will specialize in producing the goods and services in which they have a comparative advantage.
- The result is that we never need to worry about low-wage countries competing us out of jobs;
- the most they can do is change those goods and services in which we have a comparative advantage.

Free Trade leads to growth in Exports

Globalization increases developing countries share in world trade

Exports from developing and developed countries, 2005-2030



Source: World Bank simulations with Linkage model.

Krugman: Free Trade is the cause of economic development in poor countries

- “The raw fact is that every successful example of economic development this past century--every case of a poor nation that worked its way up to a more or less decent, or at least dramatically better, standard of living--has taken place via globalization; that is, by producing for the world market rather than trying for self-sufficiency.”
(Krugman in Slate 1999)

**Free trade = absolute gain
... but relative loss?**

Comparative Advantage is Dynamic



EU's Single Market or "Fortress Europe"?

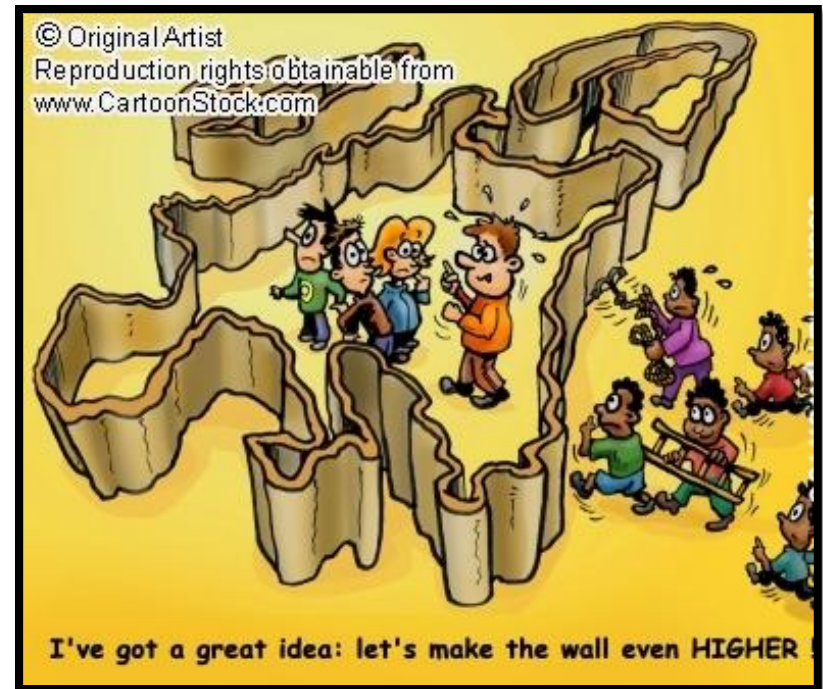


EU single market

- ➔ 10 years
- ➔ 2 500 000 extra jobs
- ➔ € 877 000 000 000 in extra prosperity

<http://europa.eu.int/comm/10years>

The poster features the European Union flag in the background. At the bottom, four diverse people are shown jumping over a hurdle, symbolizing progress and unity.



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I've got a great idea: let's make the wall even HIGHER

The cartoon depicts a map of Europe constructed from cardboard boxes, forming a maze-like barrier. Several cartoon characters are shown interacting with the wall: one is climbing a ladder, another is using a hammer, and others are looking on with various expressions of concern and skepticism.

Sum: Effects of Free Trade

- Efficiency → Growth → Good life for everyone
- Harmonious International Relations
- Role of the State: To let producers produce most efficiently—to separate politics and economics:
- the key actors for liberals are firms and consumers, not states.
- Commerce → Peace Why?
- Efficiency should be the basis of all political relations
- Does Free Trade make the state obsolete?