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

- Trust reduces our "transaction costs" in groups.
- That's why we have institutions to help create cooperation.
- Institutions formalize trust and thus dramatically expand our ability to interact with those beyond our immediate neighbors.
- That's why we have laws and law enforcement.
- The U.S. government (an institution) decided to "bail out" the financial system when the market broke down.
- It is a way to bring back trust.
- Markets sometimes "fail" at coordinating economic activity.

![Diagram: Trust and Market Cycle]

- **Prosperity Phase**
- **Failure Of Trust**
- **Lots of anxiety**

![Diagram: Level of real output vs. Time]

- **Peak**
- **Trough**
- **Growth**
- **Recession**
- **Recovery**
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

Government "bailout"
Theory of Comparative Advantage

Specialization + Trade
David Ricardo (1772-1823)
Production *without* specialization and division of labor

<table>
<thead>
<tr>
<th></th>
<th>Wine</th>
<th>Cloth</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>England</strong></td>
<td>3</td>
<td>5</td>
<td>8</td>
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<tr>
<td><strong>Portugal</strong></td>
<td>9</td>
<td>6</td>
<td>15</td>
</tr>
<tr>
<td><strong>Total goods produced</strong></td>
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<td><strong>23</strong></td>
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Production with specialization before trade

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<tr>
<td>England</td>
<td>1</td>
<td>10</td>
<td>11</td>
</tr>
<tr>
<td>Portugal</td>
<td>16</td>
<td>0</td>
<td>16</td>
</tr>
<tr>
<td>Total goods produced</td>
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<td></td>
<td>27</td>
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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.*

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<tr>
<td>England</td>
<td>5 (1+4)</td>
<td>6 (10-4)</td>
<td>11</td>
</tr>
<tr>
<td>Portugal</td>
<td>12 (16-4)</td>
<td>4 (0+4)</td>
<td>16</td>
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</table>

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”
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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

FORGET IT. I'M SICK OF PLAYING HIDE-AND-SEEK.
<table>
<thead>
<tr>
<th></th>
<th>Coconuts</th>
<th>OR</th>
<th>Fish</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bob</td>
<td>10</td>
<td></td>
<td>10</td>
</tr>
<tr>
<td>Joey</td>
<td>4</td>
<td></td>
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Premise: they *either* find coconuts or fish
If both work on their own:

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<th>Fish</th>
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<tbody>
<tr>
<td>Bob</td>
<td>5</td>
<td>5</td>
<td>10</td>
</tr>
<tr>
<td>Joey</td>
<td>2</td>
<td>4</td>
<td>6</td>
</tr>
<tr>
<td>TOTAL</td>
<td>7</td>
<td>9</td>
<td>16</td>
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</table>
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

WHO SHOULD DO WHAT??

BOB ➔ go nuts / Joey ➔ go fish
If they use their comparative advantages...

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<td>10</td>
<td>0</td>
<td>10</td>
</tr>
<tr>
<td>Joey</td>
<td>0</td>
<td>8</td>
<td>8</td>
</tr>
<tr>
<td>TOTAL</td>
<td>10</td>
<td>8</td>
<td>18</td>
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We had 9 fish in total before we started this...
If they use their comparative advantage

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<tr>
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<td>8</td>
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If they use their comparative advantage - and want as much fish as before

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<tr>
<td>Bob</td>
<td>9</td>
<td>1</td>
<td>10</td>
</tr>
<tr>
<td>Joey</td>
<td>0</td>
<td>8</td>
<td>8</td>
</tr>
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<td>TOTAL</td>
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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)

• The real price of every thing, what every thing really costs to the man who wants to acquire it, is the toil and trouble of acquiring it. What every thing is really worth to the man who has acquired it, and who wants to dispose of it or exchange it for something else, is the toil and trouble which it can save to himself, and which it can impose upon other people. (Wealth of Nations Book 1, chapter V)
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 Hechscher-Olin and wins Nobel Prize

Mr. Krugman noticed that most international trade takes place between countries with roughly the same ratio of capital to labor. – The auto industry in capital-intensive Sweden, for example, exports cars to capital-intensive America, while Swedish consumers also import cars from America.
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

- While the United States has long imported oil and other raw materials from the third world, we used to import manufactured goods mainly from other rich countries like Canada, European nations and Japan.
- But recently we crossed an important watershed: we now import more manufactured goods from the third world than from other advanced economies. That is, a majority of our industrial trade is now with countries that are much poorer than we are and that pay their workers much lower wages (Krugman 2007).
EU’s Single Market or “Fortress Europe”?
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?