Gains from Trade

4.1 Introduction

Being a jack-of-all-trades sounds like a good thing, doesn't it? It seems as if having a wide range of knowledge and skills, as well as the ability to perform many kinds of tasks, would lead to a more productive life. Yet it is not necessarily so. It might be true if you lived alone on a desert island. But for the rest of us, being able to do everything for ourselves might not be an advantage.

To illustrate this fact, economists Robert Frank and Ben Bernanke give us the example of Birkhaman, a man from a poor village in rural Bhutan, a south Asian country that lies north of India and east of Nepal. Birkhaman worked as a cook for a Peace Corps worker stationed in Nepal. Not only was Birkhaman an excellent cook, he could also do many other things. He could butcher a goat, make furniture, thatch a roof, and build a house. He could also sew clothing, fix appliances, craft objects from tin, and even prepare home remedies. In short, Birkhaman was a jack-of-all-trades who had a much wider range of skills and abilities than most Americans.

Frank and Bernanke pointed out that although Birkhaman was very talented, he was by no means unique in Nepal. Many Nepalese can perform a variety of tasks that we, as Americans, would hire others to do. What accounts for this difference?

It might seem that the Nepalese do more things for themselves because Nepal is a poor country where many people cannot afford to pay others for their services. But the economists offered another explanation. They argued that poverty is the result—and not the cause—of the jack-of-all-trades phenomenon

In rural Nepal, people produce most of what they need themselves.

Speaking of Economics

specialization
The development of skills or knowledge in one aspect of a job or field of interest. People who specialize become expert in a particular activity.

division of labor
The allocation of separate tasks to different people. Division of labor in the production of a good or service is based on the principle of specialization.

voluntary exchange
The act of willingly trading one item or service for another. Both parties in a voluntary exchange expect to gain from it.

barter
The direct exchange of goods or services without the use of money. Barter is typical in traditional economies.

money
A generally accepted medium of exchange that can be traded for goods and services or used to pay debts. Money is critical in a market economy.

economic interdependence
The characteristic of a society in which people rely on others for most of the goods and services they want. This interdependence results from specialization and trade.

absolute advantage
The condition that exists when someone can produce a good or service using fewer resources than someone else.

comparative advantage
The condition that exists when someone can produce a good or service at a lower opportunity cost than someone else.

In mountainous areas of Nepal, many members of the Sherpa ethnic group work as porters and guides for mountaineering expeditions. Specializing in this way allows Sherpas to earn a better living than most Nepalese.

in Nepal. "The Nepalese do not perform their own services because they are poor," Frank and Bernanke wrote. "Rather, they are poor largely *because* they perform their own services."

Instead of doing almost everything themselves, Frank and Bernanke argued, poor Nepalese would be better off specializing in the production of particular goods and services. They could then trade among themselves to obtain any goods and services they do not produce. The result, as the trade-makes-people-better-off principle tells us, would be more wealth and a better standard of living.

It may be nice to know how to do many things, but that does not mean it is in your economic interest to do them. In this chapter, we will examine how specialization and trade can make people better off than they would otherwise be.

4.2 How Does Specialization Lead to Economic Interdependence?

If you had lived in the United States 200 years ago, there is a good chance you and your family, like Birkhaman, would have been much more self-sufficient. You might have grown your own food, built your own house, made your own tools, and performed many other tasks for yourself rather than relying on others.

Although self-sufficiency may be an appealing idea, it is not necessarily economically productive. In fact, societies that emphasize self-sufficiency are less productive and have a lower standard of living than those that rely on specialization and trade. Why should this be the case?

Specialization Improves Productivity

In *The Wealth of Nations,* Adam Smith wrote about the advantages of **specialization,** an approach to production in which individual workers become highly skilled at a specific task. Smith illustrated this principle by describing a pin factory.

> *One man draws out the wire, another straight[en]s it, a third cuts it, a fourth points it, a fifth grinds it at the top for receiving the head; to make the head requires two or three distinct operations . . . I have seen a small manufactory of this kind where ten men only were employed . . . [who] could, when they exerted themselves, make among them . . . upwards of forty-eight thousand pins in a day . . . But if they had all wrought [worked] separately and independently, and without any of them having been educated to this peculiar business, they certainly could not each of them have made twenty, perhaps not one pin in a day.*
> —Adam Smith, *The Wealth of Nations,* 1776

Smith's description illustrates the **division of labor** that arises from specialization. It also underscores the great efficiency and productivity that result when workers divide the individual tasks that make up a job and become expert at those specific tasks. Smith's pin workers were far more productive when each worker specialized in one step of the manufacturing process.

What was true for Smith's pin factory in the late 1700s is also true for an entire economy today. An economy can produce more with the same inputs of land, labor, and capital when each person or business specializes in a skill or task. As productivity increases, more products and services become available to more people, and living standards rise for society as a whole.

If specialization is so great, shouldn't all societies specialize? The answer, said Smith, has to do with population density and isolation from large markets. He observed, for example, that specialization in the late 1700s was more developed in large British cities than in less-populated rural areas, such as the Scottish Highlands.

> *In the lone houses and very small villages which are scattered about in so desert a country as the Highlands of Scotland, every farmer must be butcher, baker and brewer for his own family . . . A country carpenter . . . is not only a carpenter, but a joiner, a cabinet maker, and even a carver in wood, as well as a wheelwright, a ploughwright, a cart and waggon maker.*

In big cities, however, where the market for each of these jobs was large, different specialists would have performed these tasks. These workers could specialize because they knew that there were enough customers to sustain them. But markets in rural Scotland were too small, and the region too isolated, to support a range of specialists. Therefore, people had to perform a variety of tasks to earn a living and to satisfy their wants.

A similar scenario exists in Nepal, one of the most remote and isolated countries in the world. Nepal actually has a higher population density than many countries, including the United States. But the country's rugged, mountainous terrain and relatively undeveloped transportation system limit contact among different regions and with neighboring nations. These factors make trade difficult and help keep Nepal's markets small, thus discouraging specialization.

The United States presents a very different picture. Even the most remote parts of this country are linked to other regions and the rest of the world through an advanced system of transportation and communications. This system promotes trade and the growth of markets and encourages the development of a highly specialized economy.

This specialization is evident in the variety of jobs performed by American workers. The U.S. Department of Labor's *Occupational Outlook Handbook* lists thousands of types of jobs. These jobs range from familiar occupations like carpenter, engineer, and teacher to more specialized jobs like budget analyst, recreational therapist, and violin repairer. The people

At the start of the Industrial Revolution, factories using specialized machines began to replace hand spinners and weavers in the production of cloth. These old mechanical looms can still be seen in operation at the Boott Cotton Mills Museum in Lowell, Massachusetts.

who work in these jobs are specialists, each pursuing a particular career.

Specialization Encourages Trade

When people specialize, they no longer produce everything for themselves. As a result, they must trade with others to obtain those things they do not produce. They trade not only to satisfy their own wants but also so they can focus on what they do best. As economist and author Charles Wheelan pointed out, "We trade with others because it frees up time and resources to do things that we are better at."

Wheelan noted that we could, in theory, do many more things for ourselves. We could raise our own livestock, for example, and not have to pay others for meat, milk, and cheese. But that would require an enormous amount of time and energy, and the opportunity cost—as measured by all the other things we could be doing—would be very high. After all, what do most of us know about meat and dairy production? In the end, we are better off when we specialize in activities suited to our skills and trade for everything else.

Trade is a **voluntary exchange** in which both parties give up something in order to get something else they want. People trade because it is in their mutual interests. As economists James Gwartney, Richard Stroup, and Dwight Lee pointed out in their book *Common Sense Economics,* "The foundation of trade is mutual gain. People agree to an exchange because they expect it to improve their well-being."

In traditional economies, trade often takes the form of **barter,** the direct exchange of one good or service for another. For example, a farmer and a shepherd might agree to barter by exchanging a basket of potatoes for a bag of wool. Barter works well when there is a **coincidence of wants**—that is, when "you have something I want and I have something you want."

In market economies, barter is replaced by the use of money. **Money** is a medium of exchange that can be traded for goods or services or used to pay debts. Money is useful only when its value is generally accepted throughout society. It facilitates trade because it is easy to carry and convenient to use for commercial transactions.

Trade Creates Economic Interdependence

Whether carried out through barter or with money, trade leads to **economic interdependence**. When we specialize and trade, we depend on other people or countries to produce many of the goods and services we want. A modern economy consists of a complex web of economic links that connect producers and consumers throughout society and across borders.

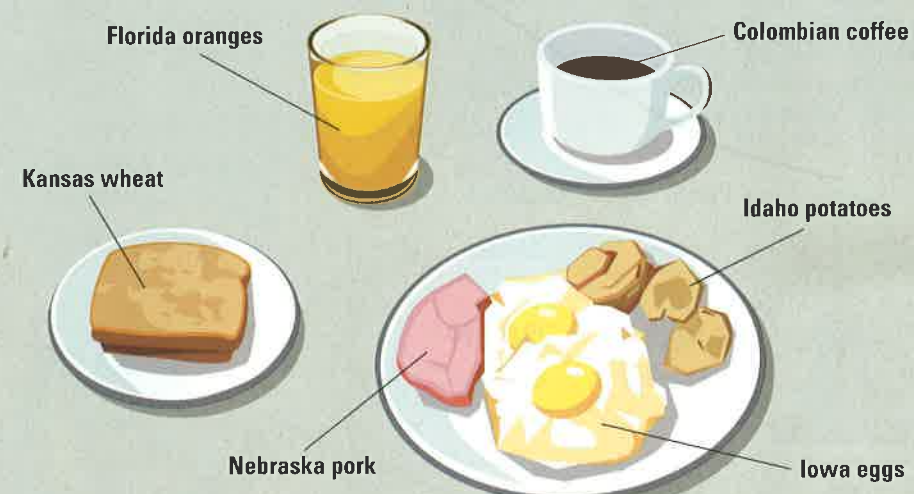
Key Concept

Specialization

When people specialize, they become expert in one activity or field of interest. Specialization gives rise to the division of labor, which, in turn, leads to greater economic efficiency. Specialization is everywhere in a modern economy—even, as this cartoon implies, in places it does not belong.

"Everybody is specializing these days."

Figure 4.2



Origins of the American Breakfast
A typical American breakfast consists of food products from many different places. In that sense, it reflects the specialization, trade, and interdependence that characterize the U.S. economy.

This economic interdependence is apparent in a typical American breakfast. We might begin with a glass of juice made from Florida oranges. We might follow that with toast made from Kansas wheat, eggs from Iowa, or hash browns made from Idaho potatoes. We might also have coffee made from Colombian coffee beans. In other words, our breakfast depends on food produced by people in many different places.

Like Adam Smith, our country's founders believed that trade and economic interdependence are essential to the nation's economic growth. In the years just after independence, they had experienced the problems created when states erected trade barriers against each other. These **trade barriers,** which included tariffs and other measures to limit interstate trade, were designed to protect local industry and promote self-sufficiency. But they prompted conflicts between states and made it difficult for the country to develop a unified national economy.

The framers of the Constitution encouraged the growth of a national market by giving Congress alone the power to regulate interstate commerce. Article I, Section 8, also known as the **Commerce Clause,** states, "Congress shall have Power . . . To regulate Commerce with foreign Nations, and among the several States." This clause empowers the national government to promote trade and economic interdependence among the states. To that end, the federal government maintains an interstate highway system and regulates navigation on interstate rivers and lakes. These government actions contribute to a large and prosperous national economy.

4.3 How Do People and Nations Gain from Specialization and Trade?

Remember Alexander Selkirk? He was the castaway you read about in Chapter 2 who was stranded on a desert island in the early 1700s. Because Selkirk was alone and had no contact with the outside world, he had no chance to improve his standard of living through trade.

Suppose, however, that a second castaway, Pirate Jack, washed up on the island one day. Now Selkirk would not only have someone to talk to; he would also have a potential trading partner. But would trade make life better for either Selkirk or Pirate Jack? To find out, consider the following scenario.

The Castaways' Dilemma: Self-Sufficiency or Interdependence

Shortly after Pirate Jack's arrival, Selkirk tells him about the island's two main economic activities: gathering wild turnips and digging clams. Right away, the castaways face a critical question: would they be better off working separately and fending for themselves or joining forces and working together?