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# From Adjustment to Sustainable Development: The Obstacle of Free Trade

HERMAN E. DALY\*

## I. INTRODUCTION

One coming to the development literature for the first time in the early or mid-eighties would encounter the word “adjustment” with a frequency several standard deviations above its average in normal English prose. Syntactically the word cries out for two prepositions, with two objects — adjustment *of* what *to* what? These prepositions are usually suppressed for economy of expression, and sometimes for economy of thought as well. But what serious writers generally have in mind is adjustment of the real economy of a country to the theoretical model of an efficient economy as developed by mainstream neo-classical economics. Concretely this involves three main policies:

(1) Adjustment of prices to make them better measures of full social marginal opportunity costs (internalization of social and environmental costs into prices) which frequently requires politically unpopular removal of subsidies and addition of taxes.

(2) Adjustment of macroeconomic conditions to achieve monetary stability so that correct prices can be properly expressed in reliable monetary units of constant value over time. This means controlling inflation by eliminating fiscal deficits and restraining the money supply. Both inflation and prices that do not measure full social marginal opportunity costs induce “distortions” — that is, situations in which private gain works against public welfare. The object of “adjustment” is then to remove “distortions.”

(3) Adjustment of national markets and prices to world markets and prices so as to integrate the nation into the world trading system in order to increase productivity by specialization according to com-

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parative advantage, and to reap the further advantages of specialization made possible by expanding the extent of the market beyond national boundaries. Tariffs and quotas and any other restriction on international trade are considered "distortions."

There may be other criteria of adjustment but certainly these three seem to cover most instances of so called "adjustment lending," which invariably are for the purpose of financing a policy change aimed at rationalizing prices, dealing with macroeconomic problems of debt and deficit, and liberalizing international trade. Why a country should find it either necessary or desirable to borrow money at interest in order to adopt more reasonable national policies is not always obvious. Some tend to think of adjustment lending as bribery, although for a good cause. In any case the faith is that the policy change, like any other investment, will add more to national welfare than the payment of interest on the loan will subtract from it.

## II. WHAT THE NEOCLASSICAL MODEL OMITTS

The first two goals of adjustment have a great deal of merit, and, with modifications to be discussed below, should remain as key parts of sustainable development policy. The third (free trade) is highly problematic in that it partially undercuts the first two, and has other serious problems as well. Elaborating this point is the main task of what follows. The problems with adjustment, and the consequent need for a transition to sustainable development as the guiding paradigm stem from the inadequacies of the object of the implicit preposition "to" — that is, the mainstream model to which the real economy is being adjusted. What has been left out of adjustment is what has been left out of the mainstream neoclassical model — namely, any serious concern for distribution, and any recognition whatsoever of biophysical constraints on economic growth, either from the side of finite environmental sources of raw material and energy, or from the side of finite environmental sinks for waste matter and energy. The neoclassical view does recognize externalities, but these are considered to be correctable by substitution or technology, and do not constitute a limit to the growth of the economic subsystem.

To put the matter in other terms, we have three economic problems to consider: allocation, distribution and scale. *Allocation* refers to the apportioning of resources among alternative product uses — food, bicycles, cars, medical care. An allocation is efficient if it corresponds to effective demand, that is, the relative preferences of the

citizens as weighted by their relative incomes, both taken as given. An inefficient allocation will use resources to produce a number of things that people will not buy, and will fail to produce other things that people would buy if only they could find them. It would be characterized by shortages of the latter and surpluses of the former. *Distribution* refers to the apportioning of the goods produced (and the resources they embody) among different people (as opposed to different commodities). Distributions are just or unjust; allocations are efficient or inefficient. There is an efficient allocation for each distribution of income. *Scale* refers to the physical size of the economy relative to the ecosystem. The economy is viewed, in its physical dimensions, as a subsystem of the larger ecosystem. Scale is measured as population times per capita resource use — in other words total resource use — the volume of the matter-energy throughput (metabolic flow) by which the ecosystem sustains the economic subsystem. Scale may be sustainable or unsustainable. An efficient allocation does not imply a just distribution. Neither an efficient allocation nor a just distribution, nor both, implies a sustainable scale. The three concepts are quite distinct, although relations among them exist, as noted above.

Adjustment has been seen overwhelmingly in the context of allocation — adjustment to an allocatively efficient economy. Distribution has not been totally ignored, but has certainly been a poor second in adjustment policy. Scale has been completely outside the field of vision of adjustment. Common sense sometimes compels many economists at least to recognize the importance of population limits (one factor of scale). But within the mainstream model economists become quite agnostic on population since it falls outside the domain of allocative efficiency. In any case neither population control, nor land reform, nor any other form of wealth or income distribution, are customary objectives of adjustment lending.

Transition to a sustainable development vision will put scale and distribution on center stage along with allocation. The first two features of adjustment (getting relative prices right and controlling inflation) are key to solving the allocation problem and remain fundamental in the sustainable development vision. As mentioned earlier, the third common feature of adjustment, free trade, must be rejected as a policy for sustainable development. It is time to consider the reasons why this is so, and the intense controversy surrounding this issue.

### III. WHY FREE TRADE CONFLICTS WITH SUSTAINABLE DEVELOPMENT

International free trade conflicts sharply with the national policies of:

- (a) getting prices right,
- (b) moving toward a more just distribution,
- (c) fostering community,
- (d) controlling the macroeconomy, and
- (e) keeping scale within ecological limits.

Each conflict will be discussed in turn.

(a) If one nation internalizes environmental and social costs to a high degree, following the dictates of adjustment, and then enters into free trade with a country that does not force its producers to internalize those costs, then the result will be that the firms in the second country will have lower prices and will drive the competing firms in the first country out of business.

If the trading entities were nations rather than individual firms trading across national boundaries, then the cost-internalizing nation could limit its volume and composition of trade to an amount that did not ruin its domestic producers, and thereby actually take advantage of the opportunity to acquire goods at prices that were below full cost. The country that sells at less than full-cost prices only hurts itself as long as other countries restrict their trade with that country to a volume that does not ruin their own producers. That of course would not be free trade. There is clearly a conflict between free trade and a national policy of internalization of external costs. External costs are now so important that the latter goal should take precedence. In this case there is a clear argument for tariffs to protect, not an inefficient industry, but an efficient national policy of internalizing external costs into prices.

Of course, if all trading nations agreed to common rules for defining, evaluating, and internalizing external costs, then this objection would disappear and the standard arguments for free trade could again be made in the new context. But how likely is such agreement? Even the small expert technical fraternity of national income accountants cannot agree on how to measure environmental costs in the system of national accounts, let alone on rules for internalizing these costs into prices at the firm level. Politicians are not likely to do better. Some economists will argue against uniform cost internalization on the grounds that different countries have different tastes for envi-

ronmental services and amenities, and that these differences should be reflected in prices as legitimate reasons for profitable trade. Certainly agreement on uniform principles, and the proper extent of departure from uniformity in their application, will not be easy. Nevertheless, suppose that this difficulty is overcome so that all countries internalize external costs by the same rules applied in each case to the appropriate degree in the light of differing tastes and levels of income. There are two further problems arising from capital mobility and wage differentials.

(b) Wage levels vary enormously between countries and are largely determined by the supply of labor, which in turn depends on population size and growth rates. Overpopulated countries are naturally low-wage countries, and if population growth is rapid they will remain low-wage countries. This is especially so because the demographic rate of increase of the lower class (labor) is frequently twice or more that of the upper class (capital). For most traded goods labor is still the largest item of cost and consequently the major determinant of price. Cheap labor means low prices and a competitive advantage in trade. (The theoretical possibility that low wages reflect a taste for poverty and therefore a legitimate reason for cost differences is not taken seriously here.) But adjustment economists do not worry about that because economists have proved that free trade between high-wage and low-wage countries can be mutually advantageous thanks to comparative advantage.

The doctrine of comparative advantage is quite correct given the assumptions on which it rests, but unfortunately one of these assumptions is that capital is immobile internationally. The theory is supposed to work as follows. When in international competition the relatively inefficient activities lose out and jobs are eliminated, at the same time the relatively efficient activities (those with the comparative advantage) expand, absorbing both the labor and capital that were disemployed in activities with a comparative disadvantage. Capital and labor are reallocated within the country, specializing according to that country's comparative advantage. However, when both capital and goods are internationally mobile, then capital will follow absolute advantage to the low-wage country rather than reallocate itself according to comparative advantage within its home country. It will follow the highest absolute profit, which is usually determined by the lowest absolute wage.

Of course, further inducements to absolute profits such as low

social insurance charges or a low degree of internalization of environmental costs also attract capital, usually toward the very same low-wage countries. But we have assumed that all countries have internalized costs to the same degree, in order to focus on the wage issue. Once capital is mobile then the entire doctrine of comparative advantage and all its comforting demonstrations become irrelevant. The consequence of capital mobility would be similar to that of international labor mobility — a strong tendency to equalize wages throughout the world. Given the existing overpopulation and high demographic growth of the Third World it is clear that the equalization will be downward, as it has indeed been during the last decade in the United States. Of course, returns to capital will also be equalized by free trade and capital mobility, but the level at which equalization will occur will be higher than at present. United States capital will benefit from cheap labor abroad followed by cheap labor at home, at least until checked by a crisis of insufficient demand due to a lack of worker purchasing power resulting from low wages. But that can be forestalled by efficient reallocation to serve the new pattern of effective demand resulting from the greater concentration of income. More luxury goods will be produced and fewer basic wage goods. Efficiency is attained, but distributive equity is sacrificed.

The standard neoclassical adjustment view argues that wages will eventually be equalized worldwide at high levels, thanks to the enormous increase in production made possible by free trade. This increase in production presumably will trigger the automatic demographic transition to lower birth rates — a doctrine that might be considered a part of the adjustment package in so far as any attention at all is paid to population. Such a thought can only be entertained by those who ignore the issue of scale, as of course neoclassicals traditionally do. For all 5.4 billion people presently alive to consume resources and absorptive capacities at the same per capita rate as Americans or Europeans is ecologically impossible. Much less is it possible to extend that level of consumption to future generations. Development as it currently is understood on the United States model, is only possible for a minority of the world's population over a few generations — i.e., it is neither just nor sustainable. The goal of sustainable development is, by changes in allocation, distribution and scale, to move the world toward a state in which "development," whatever it concretely comes to mean, will be for all people in all generations. This is certainly not achievable by a more finely

tuned adjustment to the standard growth model which is largely responsible for having created the present impasse in the first place.

Of course if somehow all countries decided to control their populations and adopt distributive and scale limiting measures such that wages could be equalized world wide at an acceptably high level, then this problem would disappear and the standard arguments for free trade could again be evoked in the new context. Although the likelihood of that context seems infinitesimal, we might for purposes of *a fortiori* argument consider a major problem with free trade that would still remain.

(c) Even with uniformly high wages made possible by universal population control and redistribution, and with uniform internalization of external costs, free trade and free capital mobility still increase the separation of ownership and control and the forced mobility of labor which are so inimical to community. Community economic life can be disrupted not only by your fellow citizen who, though living in another part of your country, might at least share some tenuous bonds of community with you, but by someone on the other side of the world with whom you have no community of language, history, culture, law, etc. These foreigners may be wonderful people — that is not the point. The point is that they are very far removed from the life of the community that is affected significantly by their decisions. Your life and your community can be disrupted by decisions and events over which you have no control, no vote, no voice.

Specialization and integration of a local community into the world economy does offer a quick fix to problems of local unemployment, and one must admit that carrying community self sufficiency to extremes can certainly be impoverishing. But short supply lines and relatively local control over the livelihood of the community remain obvious prudential measures which require some restraint on free trade if they are to be effective. Libertarian economists look at *Homo economicus* as a self-contained individual who is infinitely mobile and equally at home anywhere. But real people live in communities, and in communities of communities. Their very individual identity is constituted by their relations in community. To regard community as a disposable aggregate of individuals in temporary proximity only for as long as it serves the interests of mobile capital is bad enough when capital stays within the nation. But when capital moves internationally it becomes much worse.

When the capitalist class in the United States in effect tells the



laboring class, "sorry, you have to compete with the poor of the world for jobs and wages — the fact that we are fellow citizens of the same country creates no obligations on our part" then admittedly not much community remains, and it is not hard to understand why a United States worker would be indifferent to the nationality of his or her employer. Indeed, if local community is more respected by the foreign company than by the displaced American counterpart, then the interests of community could conceivably be furthered by foreign ownership in some specific cases. But this could not be counted as the rule, and serves only to show that the extent of pathological disregard for community in our own country has not yet been equalled by others. In any event the further undercutting of local and national communities (which are real) in the name of a cosmopolitan world community which does not exist, is a poor trade, even if we call it free trade. The true road to international community is that of a federation of communities and communities of communities — not the destruction of local and national communities in the service of a single cosmopolitan world of footloose money managers who constitute, not a community, but merely an interdependent, mutually vulnerable, unstable coalition of short-term interests.

(d) Free trade and free capital mobility have interfered with macroeconomic stability by permitting huge international payment imbalances and capital transfers resulting in debts that are unrepayable in many cases and excessive in others. Efforts to service these debts can lead to unsustainable rates of exploitation of exportable resources; and to an eagerness to make new loans to get the foreign exchange with which to pay old loans, with a consequent disincentive to take a hard look at the real productivity of the project for which the new loan is being made. Efforts to pay back loans and still meet domestic obligations lead to government budget deficits and monetary creation with resulting inflation. Inflation, plus the need to export to pay off loans, leads to currency devaluations, giving rise to foreign exchange speculation, capital flight, and hot money movements, disrupting the macroeconomic stability that adjustment was supposed to foster.

To summarize so far: Free trade sins against allocative efficiency by making it difficult for nations to internalize external costs; it sins against distributive justice by widening the disparity between labor and capital in high wage countries; it sins against community by demanding more mobility and by further separating ownership and con-

trol; it sins against macroeconomic stability. Finally, it sins against the criterion of sustainable scale in a more subtle manner that will now be considered.

(e) As previously mentioned, part of the free trade dogma of adjustment thinking is based on the assumption that the whole world, and all future generations, can consume resources at the levels current in today's high-wage countries without inducing ecological collapse. So, in this way, free trade sins against the criterion of sustainable scale. But, in its physical dimensions the economy really is an open subsystem of a materially closed, non-growing, and finite ecosystem with a limited throughput of solar energy. The proper scale of the economic subsystem relative to the finite total system is a very important question. Free trade has obscured the scale limit in the following way.

Sustainable development means living within environmental constraints of absorptive and regenerative capacities. These constraints are both global (greenhouse effect, ozone shield), and local (soil erosion, deforestation). Trade between nations or regions offers a way to loosen local constraints by importing environmental services (including waste absorption (from elsewhere)). Within limits this can be quite reasonable and justifiable. But carried to extremes in the name of free trade it becomes destructive. It leads to a situation in which each country is trying to live beyond its own absorptive and regenerative capacities by importing these capacities from elsewhere. Of course they pay for these capacities and all is well as long as other countries have made the complementary decision — namely to keep their own scale well below their own national carrying capacity in order to export some of its services. In other words, the apparent escape from scale constraints enjoyed by some countries via trade depends on other countries' willingness and ability to adopt the very discipline of limiting scale that the importing country is seeking to avoid.

What nations have actually made this complementary choice? All countries now aim to grow in scale, and it is merely the fact that some have not yet reached their limits that allows other nations to import carrying capacity. Free trade does not remove carrying capacity constraints — it just guarantees that nations will hit that constraint more or less simultaneously rather than sequentially. It converts differing local constraints into an aggregated global constraint. It converts a set of problems, some of which are manageable, into one big unmanageable problem. Evidence that this is not under-

stood is provided by the countless occasions when someone who really should know better points to The Netherlands or Hong Kong as both an example to be emulated, and as evidence that all countries could become as densely populated as these two. How it would be possible for all countries to be net exporters of goods and net importers of carrying capacity is not explained.

Of course the drive to grow beyond carrying capacity has roots other and deeper than the free trade dogma. The point is that free trade makes it very hard to deal with these root causes at a national level, which is the only level at which effective social controls over the economy exist. The adjustment theorist will argue that free trade is just a natural extension of price adjustment across international boundaries, and that right prices must reflect *global* scarcities and preferences. But if the unit of community is the nation — the unit in which there are institutions and traditions of collective action, responsibility, and mutual help — the unit in which government tries to carry out policy for the good of its citizens, then right prices should *not* reflect the preferences and scarcities of other nations. Right prices *should* differ between national communities. Such differences traditionally have provided the whole reason for international trade in goods.

#### IV. DEVELOPMENT, NOT GROWTH

To summarize, it has been argued that the first two goals of adjustment (right prices and price level stability) are necessary to the sustainable development era. It has been shown that the third element of adjustment, free trade, must be abandoned because it is in conflict with: (1) the first two goals of adjustment that have been retained; (2) goals that were downplayed by adjustment (just distribution) but critical for sustainable development; and (3) the goal that was totally ignored by adjustment, but is the principal goal of sustainable development, namely a scale of the economic subsystem that is within the carrying capacity of the ecosystem. It remains to try to spell out a bit more the positive vision of sustainable development.

As already indicated, the basic vision underlying sustainable development is that of the economy as a physical subsystem of the ecosystem. A subsystem cannot grow beyond the scale of the total system of which it is a part. If the total system provides services that the subsystem cannot provide for itself, then the subsystem must avoid impinging on the parent system to an extent and in ways that

impair its ability to provide those services. The scale of the economy must remain below the capacity of the ecosystem sustainably to supply services such as photosynthesis, pollination, purification of air and water, maintenance of climate, filtering of excessive ultraviolet radiation, recycling of wastes, etc. Adjustment in the service of growth has pushed us beyond a sustainable scale.

To maintain the present scale of population and per capita consumption we are consuming natural capital and counting it as income. The effort to overcome poverty by further growth in scale of throughput is self-defeating once we have reached the point where growth in scale increases environmental costs faster than it increases production benefits. Beyond this point, which we have, in all likelihood, already passed, further growth makes us poorer, not richer. The alternative is to stop growth in scale, and seek to overcome poverty by redistribution and qualitative improvement in efficiency of resource use, rather than further quantitative increase in the resource throughput. A policy of limiting throughput will automatically redirect energies toward increasing the efficiency with which it is used. If technology can easily and greatly increase efficiency then the transition could be relatively painless. If not, it will be more difficult. In either case it remains necessary. The basic policy is the same whether one is a technological optimist or pessimist.

In an effort to avoid facing these realities those wedded to the adjustment paradigm have come up with one more adjustment which they contradictorily call "sustainable *growth*."

Much confusion is generated by using the term sustainable growth as a synonym for sustainable development. Respect for the dictionary would lead us to reserve the word growth for quantitative increase in physical size by assimilation or accretion of materials. Development refers to qualitative change, realization of potentialities, transition to a fuller or better state. The two processes are distinct, sometimes linked, sometimes not. For example, a child grows and develops simultaneously; a snowball or cancer grows without developing; the planet Earth develops without growing. Economies frequently grow and develop at the same time but can do either separately. But since the economy is a subsystem of a finite and non-growing ecosystem, then as growth leads it to incorporate an ever larger fraction of the total system into itself, its behavior must more and more approximate the behavior of the total system, which is development without growth. It is precisely the recognition that growth

in scale ultimately becomes impossible, and already costs more than it is worth, that gives rise to the urgency of the concept of sustainable development. Sustainable development is development without growth in the scale of the economy beyond some point that is within biospheric carrying capacity.

Many believe that the present scale is beyond long term carrying capacity and that sustainable growth in its initial phase will require a period of negative growth. Even if one is a technological optimist and believes that development in the productivity of the resource throughput can increase faster than the volume of the throughput needs to diminish, this is still very radical. The term sustainable growth aims to deny this radical transformation, and to suggest that growth is still the number one goal. Growth just needs to be a bit more environmentally friendly. Sustainable *growth* is just one more adjustment to the standard view. Sustainable *development* is an alternative to the standard growth ideology and is incompatible with it. Sustainable development, development without growth, does not imply the end of economics — if anything economics becomes even more important. But it is a subtle and complex economics of maintenance, qualitative improvement, sharing, frugality, and adaptation to natural limits. It is an economics of better, not bigger.