Refuting the New Protectionism

EDITED BY EDWARD L. HUDGINS

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1. The Fundamental Freedom to Trade

by Edward L. Hudgins

The case for the right of citizens of all countries to trade freely with one another has never been stronger. The theoretical insights of Adam Smith, David Ricardo, and Frederic Bastiat go back over two centuries. And the record of economic successes resulting from trade liberalization is unambiguous: freedom to trade brings prosperity. Yet that freedom is challenged from many parts of the political spectrum, with few voices calling for the U.S. government to get completely out of the business of regulating trade and to leave individuals free to engage in voluntary transactions as they see fit.

For about three decades after World War II there was a consensus among American economists and policymakers in favor of freer world trade. The General Agreement on Tariffs and Trade (GATT), through numerous negotiating rounds, brought the average worldwide tariff rates down from around 40 percent to about 4 percent today. Annual world trade has grown from around $100 billion in 1960 to some $3 trillion today.

Protectionists in decades past tended to be traditional rent-seekers, for example, textile, apparel, and steel manufacturers. Although such manufacturers might use rhetoric suggesting that the country's economy would be stronger behind trade barriers, most policymakers understood that they simply sought protection from competition at the expense of consumers.

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New Protectionists

Since the mid-1980s, the understanding of and thus support for true free trade has seriously eroded. Populist leaders such as Pat Buchanan and Ross Perot defend protectionist policies out of a deep confusion about or indifference to economic reality. They find their views merging with those of left-wing nationalists such as House Democratic Party leader Richard Gephardt. As America's economy changes to reflect the growing value of information and knowledge-based services, sectors of the population employed in more traditional industries feel threatened and are susceptible to protectionist rhetoric.

Some policymakers profess to favor what they call "free but fair trade." In fact, many would allow bureaucrats to manage international exchanges. And some, in the name of a "level playing field," would export America's failed regulatory policies to other countries under the guise of labor, environmental, and other standards.

What is needed today is a refutation of new protectionism. Americans should understand that, as the world economy becomes more integrated, only free trade internationally and free markets domestically hold the promise of increasing living standards and productive job opportunities in the future. American policymakers should make a commitment to true free trade and to the elimination of all of America's trade barriers.

Rhetoric and Myths

It is often difficult to engage in an intelli-

gent public dialogue about trade policy. Many outright myths about trade are taken as fact without critical analysis by the public, the press, and policymakers. Furthermore, the very words used in discussions often convey misconceptions. It is thus useful to clear up some of the most common fallacies.

• First, free trade is not a "myth" that can be refuted by reality or a "theory" that can be disproved by facts; it is a policy that recognizes the right of individuals to engage in voluntary exchange with one another.

Nearly all governments limit, to some extent, the freedom of their citizens to dispose freely of their own property and to enter into voluntary contracts of exchange with others. With a few very special exceptions, for example, selling weapons to an enemy in times of war, such restrictions violate the basic rights of the individual. (See Hudgins, Chapter 3.)

In one sense the statement "complete free trade is a myth" is the same as "a crime-free society is a myth." Both statements reflect the current situation. Both also identify desirable goals. But the very attempt to eliminate all crime would see governments eliminating many civil liberties; complete free trade simply requires government to restore liberty to citizens.

Many protectionists suggest that because other governments restrict imports, the U.S. government should do the same. Said another way that means the U.S. government should limit the liberty of Americans because other governments limit the freedom of their citizens.

One can speak of a theoretical aspect of free trade policy. For example, one might ask what the particular economic effects of a given proposed trade policy might be. But freedom to trade is first and foremost a policy that places individual freedom ahead of power exercised by government to aid specific interest groups at the expense of others.

• Second, countries do not trade, individuals do.

Too often people speak of free trade as occurring, for example, between the United States and Japan or Mexico. But what do they mean by the "United States," or the name of some other country? Do they mean the governments of these countries or the physical territory?

In fact, "America" does not trade with "Japan" or "Mexico." Individual Americans, Japanese, and Mexicans are the actual merchants and customers. Of course, for the most part, businesses are the principal marketing agents. But businesses are voluntary joint ventures by individuals seeking to better their lot. If individuals have freedom, certainly groups of individuals retain those liberties as well.

Critics, curiously including some conservatives, have argued that America should not mix its economy with the economies of other countries. But the economy does not belong to "America." It belongs to millions of individual private property owners who should be free to use and dispose of their property as they see fit. That freedom includes the right to buy from and sell to the citizens of foreign countries.

• Third, trade deficits as such do not matter.

Whenever trade figures are released, grave TV news anchors often inform us—in tones usually reserved for airline crashes—that the American trade deficit rose.

But nearly all individuals run trade deficits with their grocery stores. The stores purchase nothing from their customers. The customers receive the products and the store receives the money. The customers do not view that "deficit" as a problem. It is no more of a problem in international transactions.

From an economic perspective, a trade deficit in and of itself is neither good nor bad. It simply means that in a given year the citizens of one country purchased more goods and services than they sold overseas. A deficit might result because the economy and purchasing power of consumers in one country grew faster than in others. That would be a sign of economic strength. Or a deficit might result, for a short period, because a country inflated its currency. That would be a sign of unsound policies.

The United States does have an advantage over other countries that allows it to run large trade deficits for long periods of time without its currency dropping low enough to produce trade surpluses: the dollar is a reserve currency for the rest of the world. Foreigners who earn dollars for their exports may use some to purchase American products and some to invest in America; but some of the dollars may be used to purchase goods from suppliers in third countries, and some may be exchanged for local currency from the exporter's government. That government might then use the dollars as reserves—the way governments used gold to back their paper currency in the past.

A trade deficit is not a problem per se and trying to eliminate one could seriously damage an economy and lower the living standards of consumers. Attention should more properly be

paid to the causes of deficits or surpluses.

Bilateral trade deficits in and of themselves are of even less economic significance than overall trade deficits. The U.S. deficit with Japan, for example, simply means that, in a given year, individual Americans end up with more goods and services—more VCRs, more CD players, and more camcorders—and individual Japanese have more dollars. "America" the country does not owe "Japan" the country anything. All goods have been paid for by individuals and enterprises engaging in the transactions.

• Fourth, the fact that exports help create jobs in the United States does not imply that imports destroy jobs; imports create jobs as well.

It is often observed that the export of goods and services creates jobs for Americans. The often-used rule of thumb is that every $1 billion in exports produces 20,000 jobs. But the reverse cannot be said: imports do not cost jobs. Rather, they create more jobs on net, better jobs, and higher living standards.

The goal of economic actions by individuals and enterprises is not production but profit and consumption. Individuals want to make more money so they can purchase the necessities of life such as food and shelter, time-saving goods such as microwave ovens and washing machines, or leisure goods such as televisions and compact disc players. Individuals seek money to pursue hobbies and sports, to attend plays and movies, to go on vacations, to raise children, to help family or friends in need, and to give to charities and causes in which they believe.

Imports, by lowering the prices and increasing the availability of products, improve the lot of Americans in their role as consumers. If individuals could not exchange their labor for the goods and services that are the ultimate goal of labor, there would be no incentive to work.

The myth that imports cost jobs results in part from the mistaken belief that there are a fixed number of jobs. But consider an example. Some might contend that if Americans purchase more steel from Brazilians, there will be more Brazilians working and more Americans out of work. Unemployment in the United States would rise. Actually, it is true that there might be fewer Americans working to produce steel. But the costs for manufacturers using steel would go down or at least not rise. Thus Caterpillar Tractor would be more competitive, in both American and foreign markets. American retail farm equipment merchants would sell more products. And American farmers would be more competitive because they could secure less costly or higher-quality equipment. In other words, free trade in steel might "cost" some jobs but would create others.

Conversely, protectionism costs jobs. Higher steel prices and supply problems resulting from import restrictions did harm American manufacturers using steel in the 1980s. During that same decade, U.S. restrictions on textile and apparel imports cost jobs in the retail and other sectors. Each textile or apparel job—with an annual wage of around $15,000-$20,000—was "saved" at a cost of about $50,000.[1]

It is true that with free trade, workers in one profession might have to change jobs. But that is true when one domestic producer is more efficient than another. Job turnover in the United States is the highest in the industrialized world, but so is job creation. Competition, both domestic and foreign, gives Americans the incentive to redistribute the factors of production quickly, from the production of lower-valued goods and services to higher-valued ones.

There is never a shortage of jobs for workers to do. Rather, government employment policies that interfere with the market, minimum wage hikes, and regulations hamper the ability of entrepreneurs to employ willing laborers. In a free economy, the question is at what level of wages and benefits will a worker be employed? The answer depends on how well the skills of the workers match the demands for labor and the productivity of the economy.

• Fifth, in trade negotiations, when the U.S. government agrees to remove a trade barrier, that is not a "concession" to another country; it is a restoration of freedom for individual Americans.

The fact that individuals, not countries, trade with one another points to an error in language. Political officials might say "The United States has granted a trade concession to Mexico or Japan," meaning that the United States agreed to open its market to more imports from those countries. In fact, the "concession" consists of allowing individual Americans more freedom to dispose of their property, that is, to buy from foreigners.[2] The "concession" is not just to overseas merchants but to American consumers.

Some critics might complain that "Japan won the latest round of trade negotiations because it was able to retain trade barriers,

A trade deficit is not a problem per se and trying to eliminate one could seriously damage an economy and lower the living standards of consumers.

while the United States lost because it was forced to remove some of its barriers." But that would be no victory for the Japanese people: it simply means that the Japanese government continues to restrict the freedom of its citizens, keeping prices high and choices limited. In the best situation, both countries would drop their trade barriers. American exporters along with consumers in both countries might then benefit. In the next best scenario, the United States would remove its barriers rather than continue to impose burdens on its consumers.

• Sixth, tariffs and other forms of protectionism are not paid for by foreign businesses; they are paid for by American consumers.

Tariffs and other forms of protectionism are not paid for by foreign businesses; they are paid for by American consumers.

A tariff is simply another name for a tax. Domestically, when the government raises taxes on businesses, the business can take one or more actions. In a few cases, a business with a high profit margin might reduce its profits and keep prices and supplies for customers the same. But competition generally prevents businesses from operating for long on huge profit margins. For the most part, a tax hike on businesses is passed along to consumers in the form of higher prices.

If many products sustain such price hikes, fewer consumers purchase the goods. A business might therefore cease to hire new workers or might lay many off. Thus, tax hikes can cost jobs.

The same principle operates when imported goods face tariffs, but with an additional consumer-harming twist. Some foreign firms with high profit margins might not pass along to consumers higher costs from tariffs or quantitative import restrictions. But most firms do pass on the higher costs. That is the point of protectionism: to raise the price of products competing with domestic goods. But when those higher costs are passed along to consumers by foreign producers, domestic producers can raise their prices as well.

Thus, in the 1980s, when the U.S. government forced the Japanese government to limit sales of its automobiles in the United States, the price of each Japanese car rose between $500 and $2,000—and the price of each American-made vehicle went up a similar amount. Auto manufacturers in both countries profited at the expense of consumers.

Basic Principles of Economics

The economic case for freedom to trade internationally is the same as for free exchange within a country. The insights of Adam Smith, David Ricardo, and others still hold true: property rights and free exchange result in specialization. As a result, the quantity of goods and services produced closely matches the demands of consumers. The demands of consumers ultimately determine what is produced, in what quantities, and for what prices. The least costly producer of goods or services of a quality that meets consumer demands will find specialization in such production to be most profitable.

Free exchange, domestically and internationally, determines the number and wage levels of Americans employed assembling computers, writing software, developing new medicines, weaving textile material, harvesting sugar, and manufacturing umbrellas. Competition between producers, both domestically and internationally, reduces the costs of most goods and services. Lower costs, in turn, lead to the introduction of new goods and services in the markets: everything from video cassette recorders to personal computers to low-cost package vacations to heart transplants.

Baptists and Bootleggers

Austrian School economist Ludwig von Mises observed that all individuals are both producer and consumer, both worker and entrepreneur. Thus workers, to reap the benefits of an ever more productive and prosperous society, must tailor their skills to market demands. Workers as well as entrepreneurs seek to avoid that necessity through trade protectionism.

Government intervention also introduces economic distortions as when the U.S. or other governments intervene in their economies, favoring one enterprise or sector over another with special handouts, tax breaks, or regulations that harm their competitors.

Trade protection and government favors for particular enterprises or sectors in one country usually give rise to calls from producers in other countries for help from their own governments. Thus arises what is often called the Baptist and bootlegger situation. In some counties in the United States, liquor is banned, usually because of political pressure from religious groups that believe drinking seriously erodes the moral underpinnings of family and society. Those who sell liquor illegally in such counties actually can find the ban to their

advantage because it allows them to charge high prices for their products. Thus, it is said, Baptists and bootleggers work together to keep alcohol illegal.

Similarly, although American enterprises complain of trade barriers and government support for enterprises in other countries, many use the existence of such market-distorting practices to get what they really want: protection for themselves from foreign competition or special government favors. That protection allows them to charge higher prices for their products. Such is the dilemma that protectionism creates.

Destroying Jobs to Save Them

Today the new protectionists ignore basic economic truths. They fail to think through the actual results of their policies. Consider an example of how attempts to "protect" American jobs could destroy American industries. The majority of parts in an American-made personal computer (PC) is imported. If the U.S. government tried to ensure the computer was 100 percent American-made, so as to create jobs making computer parts, the following might ensue:

- Parts would be much more expensive.
- Without competition, there would be little incentive for American parts manufacturers to cut costs and improve quality.
- Market prices for PCs would begin to rise.
- PC sales would drop; PCs would become luxury items.
- Fewer workers would be needed to make PCs and write software.
- Fewer workers would be making PC parts.
- Efficiencies now being realized from the growing use of PCs—including more efficient record storage, communications, scientific research, and design engineering (for example, the Boeing 777)—would not have occurred.

Attempting to create jobs making computer parts in the United States thus would mean that America today would have fewer jobs in other higher-valued sectors.

The Santa Claus Factor

Another way to understand the basic principles of free trade is to imagine a tiny, primitive economy with 1,000 citizens. Some 250 citizens work in farming and raising animals to provide the society's food; 250 make clothing, rugs, curtains, and the like; 250 build tables and chairs and huts; and 250 transport and market products and maintain the mud roads that connect homes and shops and enterprises.

Then a new element is added to the mix. An outsider offers to trade with the society. Or, to make the most extreme case possible, an outsider offers to dump ("unfairly," by the lights of the protectionist) free goods into the market. That altruist from a country to the north, calling himself Santa Claus, will give the citizens of this society all the free clothing, rugs, curtains and other textile products they might need.

Is the society better off with these free goods? The unequivocal answer is "yes!" First, the society with trade will have exactly the same material goods as before. There is no net loss of wealth. Second, it will have 250 individuals who are no longer needed to make textile products. They will be free to pave roads, write songs or books or plays, search for medicines to cure illnesses, make toys for children, or invent indoor plumbing. The society will be richer.

In real trading situations, for example, an Indonesian textile mill that offers cheap though not free shirts and pants, the principle is the same.

It is true that some questions arise: What will idle workers do? And at what rate of exchange will they trade their labor? No doubt some individuals would make better carpenters than poets. No doubt some farmers would jump at the chance to write books or act in a newly built theater constructed by former textile workers, leaving others to grow potatoes. But the distribution of labor is best worked out through free competition and exchange. If textile workers attempt to protect their jobs by barring Santa Claus, the result will be a poorer society, for themselves as well as others.

In an 1845 satirical piece, "The Petition," the great French free market thinker Frederic Bastiat pointed out the absurdity of candlestick makers who claimed that the sun constituted unfair competition.[3] If only all windows could be boarded up during the day, claimed Bastiat's comic protectionists, more jobs could be created making candles. Unfortunately, a principle that Bastiat mocked more than a century ago still receives respectful attention today.

Cutting Up the United States

As a way of understanding the error of protectionism, consider the consequences of such policies if practiced by American states today. California, for example, has had unemployment rates above the national average in recent years. Defense downsizing explains the problem in part. But the state's harsh regulatory regime explains the remainder.

What if California were able to set up trade restrictions against other states? It might use such policies to try to achieve trade surpluses with the other 49 states. For example, it might attempt to "save" jobs in the food processing sector by placing a high tariff on imported canned or packaged food products coming from other states. To protect jobs for low-paid, unskilled workers assembling parts into finished products, a "wage equalization tax" might be charged on finished products coming from lower wage states. And to help agricultural workers, the Golden State might place quota restrictions on imports of beef from Texas, Wyoming, and Montana and on Kansas wheat.

Would such a policy result in higher employment and better pay in California? Hardly! California's productivity would sink, and prices for goods and services would rise. Consumers would cut back on consumption, thus depressing sales and driving many enterprises out of business. Land that is better used for producing wine grapes might be used for raising cattle. The prices for both wine and beef would rise.

In other words, California, or any state or country practicing such policies, would fall into poverty rather than grow prosperous. Full employment would be purchased at the price of poverty.

Market Discovery

Many new protectionists claim to favor free trade but also to favor government aid to domestic industries and managed trade internationally to guide the American economy into the production of higher-value-added goods and services. But it is never obvious which goods and services, at what prices, and in what quantities will best serve the needs of consumers. Nor is it obvious which individuals and enterprises will best be able to meet those demands at any given time. In the buying and selling in a free market, with entrepreneurs competing to meet consumer demands, the best use of resources becomes clear. The market "discovers" who does what best.

No set of bureaucrats, government task forces, congressional committees, or economic security councils can make those determinations. If they could, the individuals with such powers of prognostication could go into business, make investments based on their insights, and become rich. But the record of such efforts, by the U.S. as well as other governments, is poor indeed. (See Barfield, Chapter 5, and Powell, Chapter 7.)

The Solution: Unilateral Free Trade

The answer to the new protectionists is not a watered-down version of the same policies. Indeed, many of the current protectionist proposals, especially the proposals of those who claim to favor "free but fair trade," are more subtle than—though just as dangerous as—the original versions after which they take.

In the 21st century the United States could ensure its own prosperity, set an example for the rest of the world, and create overwhelming pressure for other countries to follow suit by unilaterally eliminating the trade restrictions that currently burden American citizens.

Hong Kong is a good example of how complete free trade can lead to prosperity. That British colony was just as poor as the rest of China, and was still suffering the effects of war and the Japanese occupation, when communists took over the mainland in 1949. The city, with no natural resources, had complete free trade. And today, while China still is poor, Hong Kong has the living standard of an industrialized country.

America should view free trade as an opportunity to grow even more prosperous in an expanding world economy—an economy inspired by America's example, not confused by America's contradictions. Free trade areas in which the United States drops its trade barriers to countries that do likewise are a step in the right direction. But ideally America should follow the policy that best ensures the greatest freedom and prosperity for Americans: It should establish complete free trade, on a unilateral basis if necessary.

America, the world's largest exporter, has a strong merchant tradition. It should strive always to be the once and future Yankee trader.

Notes

[1] Gary Clyde Hufbauer and Kimberly Ann Elliott, *Measuring the Costs of Protectionism in the United States* (Washington: Institute for International Economics, 1994), p. 5 and p. 13.

[2] For discussions of how to think about trade in terms of individuals' rights and the mutual benefits of market openings, see Edward L. Hudgins, "Regional and Multilateral Trade Agreements: Complementary Means to Open Markets," *Cato Journal* 15, nos. 2-3 (Fall/Winter, 1995-96), and Edward L. Hudgins, "Mercosur Gets a 'Not Guilty' on Trade Diversion," *Wall Street Journal*, March 21, 1997, A19.

[3] Frederic Bastiat "The Petition," in *Economic Sophisms*. Arthur Goddard, translator. (Irvington-on-Hudson: Foundation for Economic Education, 1964).

2. The Truth about Trade in History

by Bruce Bartlett

The current debate over "free" versus "fair" trade and the effects of open markets on America's economy often takes place on a theoretical level or from biased parochial circumstances and concerns. Yet a serious examination of 500 years offers one unambiguous lesson for the debate. Countries that pursue freer trade policies prosper while those that close markets face privation and decline. The experiences of the Netherlands, Great Britain, the United States, Japan, and Germany all support that conclusion. This chapter examines those experiences.

Prelude to Trade

The economy of the Roman Empire was characterized by trade over roads and on ships throughout the Mediterranean region. The collapse of Rome meant a collapse of trade. In Medieval Europe agricultural production on self-sufficient feudal estates was primarily for local consumption, which prevented the efficient exploitation of natural resources and the division of labor.[1] Living standards for most peasants were barely above subsistence. A bad crop often meant mass starvation. Life was truly nasty, brutish, and short. When small towns did develop, guilds in the various crafts set limits on market entry as well as on the quantity and kinds of goods produced; the purpose was to keep prices high and to corner markets.

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The Netherlands

The Netherlands was one of the first countries that, from necessity, again took up trade as a route to prosperity. The Dutch inhabited a small land that possessed few natural resources. To survive, the citizens imported wool, tin, and copper from Germany and England, and developed export industries to pay for imports. The Dutch turned to artisanship and industry at a time when the rest of Europe was still constrained by ancient guild regulations.[2] The situation led to clearly defined and protected private property rights, a necessary foundation for the country's future economic growth.[3]

Transition to Freedom

The transition from medieval regulation to renaissance freedom in the Netherlands was not without problems and painful episodes. The historian Henri Pirenne described the process in which artisans resisted but ultimately accepted the opening of markets at the end of the 12th century:

> They made every effort to crush outside competition as completely as possible. Ghent, Bruges and Ypres laid their surrounding neighborhoods under an extraordinary régime of industrial exclusiveness. Military expeditions were organized to search the villages and destroy any tools for the manufacture of cloth. The industry of the small towns was strictly controlled by the large ones, who in the name of pretended "privileges," which were only an abuse of force, prevented them from imitating their own species of woolen goods.

> This protectionism gone mad did not, however, prevent the industry of the towns from falling into decay. . . . Towards the end of the fourteenth century it was obvious that this short-sighted policy was condemned.[4]

Subsequently, the Netherlands developed into the commercial center of Europe. Shipping and ship building grew, giving Amsterdam, the capital, control of the Baltic grain trade, as well as naval supplies and other heavy goods. That led to Amsterdam's becoming the central commodity market of Europe, a development that required expertise in finance, insurance, and related businesses. Scarcity in any part of Europe was quickly and accurately reflected in higher prices on the Amsterdam bourse and higher freight charges, factors that added to the city's prosperity.[5]

Religious tolerance also helped the country.[6] Religious refugees from all over Europe, such as French Huguenots, made Amsterdam their home, adding enormously to the vitality of the city and its prosperity.[7] The demands of trade also promoted pacifism and restricted the growth of government. As Cambridge professor Charles Wilson put it, "The welfare of a merchant republic was not compatible with the caprice inseparable from monarchy which would subordinate trade to politics, diplomacy, fiscalism, war."[8]

Holland as Hong Kong

The demands of trade also restricted the growth of mercantilism.[9] Unlike other countries in Europe at that time, the Netherlands did not prohibit the export of coin and bullion, did not protect domestic industries, and essentially maintained a pure free-trade policy. According to Wilson, "Balance-of-trade doctrine . . . which was strongly attached to the idea of retaining local raw materials for profitable manufacture and export, protecting local manufactures, encouraging industrial techniques and the like, found little response from a people for whom such considerations were, in the nature of things, largely irrelevant."[10] By the 17th century, the Dutch were the richest people on earth.[11] Their country served as a model for advocates of free markets and religious tolerance in England and the United States.

Fall from the Pinnacle

However, the Dutch position at the pinnacle was soon eroded by expanding government and protectionism. By the late 1600s, taxes and tariffs began to creep upward. That had the two-fold effect of diminishing trade and raising wages, as workers demanded more money to compensate them for the increased cost of living.[12] Skilled workers and commerce gradually moved to new locations, such as Hamburg, where taxes and tariffs were lower. By the end of the 1700s, the Netherlands even abandoned its traditional neutrality, quickly suffering major defeats in war with England. It was then finished as a world power.[13]

The rise of the Netherlands was based on free trade. The Dutch were the first to throw off the regulations and restrictions that were the hallmarks of medieval economies. Furthermore, the country's decline came from a reversal of that policy, the adoption of protectionism, and the growth of government that ultimately stifled the creativity and industry of the Dutch people.

Great Britain

As the Dutch were removing medieval restrictions on trade in the 16th century, England was beginning to open its market as well. In the early part of the century, usury laws were no longer enforced, restrictions on the export of unfinished cloth were relaxed, and certain differential duties were abolished. Enforcement of remaining trade restrictions was also generally reduced. The result, according to historian F. J. Fischer, was "one of the great free trade periods in modern English history."[14]

Unfortunately, the initial era of free trade was short-lived. By the latter half of the 16th century trade restrictions were reimposed to protect domestic industry from the effects of a depression caused by government currency policy. However, by 1604 the House of Commons again moved toward free trade as the impact of the depression faded.[15]

17th-Century Market Closings

The end of the 17th century saw another revival of protectionism. Between 1690 and 1704 the general level of duties on imports quadrupled. That level was generated primarily by the need for revenue; nevertheless, the effect was to transform the tariff system into one that was, in practice, protectionist.[16] Furthermore, in France at that time, Jean

Baptiste Colbert, minister to King Louis XIV, was attempting to raise government revenue and make the country self-sufficient through restrictions on imports, including those from England, and through industrial policy. That encouraged English retaliation.

Also contributing to the growth of protectionism was the spread of mercantilist ideas from writers in England such as Thomas Mun. Those mistaken doctrines have an all-too-modern characteristic. For example, one maintained that prosperity came from accumulating gold and silver bullion, and a country could best do that by exporting more than it imported.[17] Many policymakers even today tout the supposed virtues of a positive balance of trade.

Adam Smith's Revolution

In the decades after the 1776 publication of Adam Smith's *The Wealth of Nations*, free trade wholly won the intellectual battle.[18] Smith demonstrated how freedom to trade and the resulting division of labor benefited all parties involved. However, the remnants of mercantilism were extensive, as were restrictions on domestic trade dating back to the Middle Ages. Thus, hard battles would still be necessary to establish free trade.

Among the most important trade restrictions still operating at the beginning of the 19th century were the Navigation Acts and the Corn Laws. The principal Navigation Act, dating back to 1660, required English ships, manned by English sailors, to be used for most trade with England or its colonies. The Corn Laws, dating from 1670, imposed protectionist duties on the import of corn, to keep domestic corn prices high and encourage domestic production.

The free-trade campaign began in 1820 and concluded with the repeal of the Corn Laws in 1846 and of the Navigation Acts in 1849.[19] The principle of freedom to trade was cemented by the Anglo-French Commercial Treaty of 1860.[20] From then until World War I, Great Britain practiced a largely free-trade policy.

The Economic Giant

Free trade was a logical outcome of the free-market policies. As Great Britain's economy grew, it needed more imports, especially as materials for manufacturing and food for the tables of a growing population; the country also needed markets for its products. During this period Great Britain was the world's wealthiest and most powerful nation. Historian Paul Kennedy described the situation:

> Between 1760 and 1830, the United Kingdom was responsible for around two-thirds of Europe's industrial growth of output, and its share of world manufacturing production leaped from 1.9 to 9.5 percent; in the next thirty years, British industrial expansion pushed that figure to 19.9 percent, despite the spread of new technology to other countries in the West. Around 1860, which was probably when the country reached its zenith in relative terms, the United Kingdom produced 53 percent of the world's iron and 50 percent of its coal and lignite, and consumed just under half of the raw cotton output of the globe. With 2 percent of the world's population and 10 percent of Europe's, the United Kingdom would seem to have had a capacity in modern industries equal to 40-45 percent of the world's potential and 55-60 percent of that in Europe. . . . It alone was responsible for one-fifth of the world's commerce, but for two-thirds of the trade in manufactured goods. Over one-third of the world's merchant marine flew under the British flag, and that share was steadily increasing. It was no surprise that the mid-Victorians exulted at their unique state, being now . . . the trading center of the universe.[21]

Free trade was a logical outcome of the free-market policies.

The reversal of Great Britain's free-trade policy began as a reaction to Germany, which imposed a protectionist tariff in 1879 under pressure from its big businesses.[22] The situation soon led to adoption of protectionist measures throughout Europe.[23] Although Great Britain initially resisted the protectionist trend, by the turn of the century it, too, began to adopt such measures. Joseph Chamberlain was the leading advocate of the policy of limiting free trade to the nations within the British Empire, while imposing protection against those outside.[24] Lillian Knowles described the change in policy:

> The period from 1886 to 1914 witnessed a great change in English policy. It is the period of abandonment of laissez-faire in colonization, commerce, industry and agriculture. Great Britain began to modify her cosmopolitan ideas of free trade and laissez-faire, and to concentrate on developing trade within the British Empire.[25]

In 1897, Great Britain renounced its treaties with Germany and Belgium that had prevented the country from giving preferences to its colonies. However, the major break with free trade came in 1915 when the government

imposed tariffs of $33^1/_3$ percent on motor cars and parts, musical instruments, clocks, wristwatches, and movie film. Subsequent legislation broadened the list of items subject to protectionist tariffs.[26]

The abandonment of free trade during World War I coincided with the beginning of Great Britain's economic decline. Freedom to trade had been the strongest pillar of Britain's general free-market policy. When that pillar fell, the doorway opened to socialist measures of all kinds. British history in the 20th century is essentially one of almost continually expanding government control of the economy, and an equal decline in Great Britain's power and influence in world affairs.[27]

The United States

Some protectionists contend that the United States grew economically strong and prosperous because of trade barriers. But America has experienced several phases in its trade history. It is more accurate to say that the country grew in spite of import restrictions.

From Colony to Republic

British trade policy toward the American colonies was mercantilistic. The mother country expected to gain materially from all colonial trade. The Navigation Acts, as noted earlier, generally required that all colonial trade be conducted on British ships manned by British sailors. Also, certain goods had to be shipped to Great Britain first before they could be sent to their final destination. The country's mercantilist policies were a major burden on the colonies.[28] In that way, British protectionism was a significant cause of the Revolution.

Having achieved independence, however, many Americans advocated protectionist policies similar to those they had earlier condemned.[29] Alexander Hamilton, the principal advocate of import restrictions, based his proposals on the alleged needs of infant industries. As he wrote in his "Report on Manufactures" (1791):

> The superiority antecedently enjoyed by nations who have preoccupied and perfected a branch of industry, constitutes a more formidable obstacle . . . to the introduction of the same branch into a country in which it did not before exist. To maintain, between the recent establishments of one country, and the long-matured establishments of another country, a competition upon equal terms, both as to quality and price, is, in most cases, impracticable. The disparity . . . must necessarily be so considerable, as to forbid a successful rivalship, without the extraordinary aid and protection of government.[30]

The First Wave of Protectionism

Although Congress adopted the first tariff in 1789, its principal purpose was to raise revenue. Rates went from 5 percent to 15 percent, with an average of about 8.5 percent. However, in 1816 Congress adopted an explicitly protectionist tariff, with a 25 percent rate on most textiles and rates as high as 30 percent on various manufactured goods. In 1824, protection was extended to goods manufactured from wool, iron, hemp, lead, and glass. Tariff rates on other products were raised as well.

That first wave of protectionism peaked in 1828 with the so-called Tariff of Abominations. Average tariff rates rose to nearly 49 percent. As early as 1832 Congress began to scale back tariffs with further reductions enacted the following year. In 1842, tariffs were again raised; but by 1846 they were moving downward, and further lowered in 1857. Following the 1857 act, tariffs averaged 20 percent.[31]

Failed Tariff Policies

Economist Frank Taussig, in a thorough examination of those tariffs, found that they did nothing to promote domestic industry. "Little, if anything, was gained by the protection which the United States maintained" in the first part of the 19th century, he concluded. That finding considerably questioned the validity of the infant industry argument. "The intrinsic soundness of the argument for protection to young industries therefore may not be touched by the conclusions drawn from the history of its trial in the United States, which shows only that the intentional protection of the tariffs of 1816, 1824, and 1828 had little effect," Taussig said.[32]

Thus, the early experience of the United States confirms the weakness of the idea that protection can aid infant industries. In practice, so-called infant industries never grow competitive behind trade barriers, but, instead, remain perpetually underdeveloped, thus requiring protection to be extended indefinitely. As

Gottfried von Haberler put it:

> Nearly every industrial tariff was first imposed as an infant-industry tariff under the promise that in a few years, when the industry had grown sufficiently to face foreign competition, it would be removed. But, in fact, this moment never arrives. The interested parties are never willing to have the duty removed. Thus temporary infant-industry duties are transformed into permanent duties to preserve the industries they protect.[33]

It is also important to note that the adverse effects of tariffs in 19th century America were more than offset by the economic activity that constituted the western expansion across the continent. Some 20 million immigrants came to the United States in that century. Also, much economic growth came from transportation, farming, mining, and construction of infrastructure. In effect, the United States was a giant, continental-size free-trade zone, from the Atlantic to the Pacific—the equivalent of the distance from Madrid to Moscow.

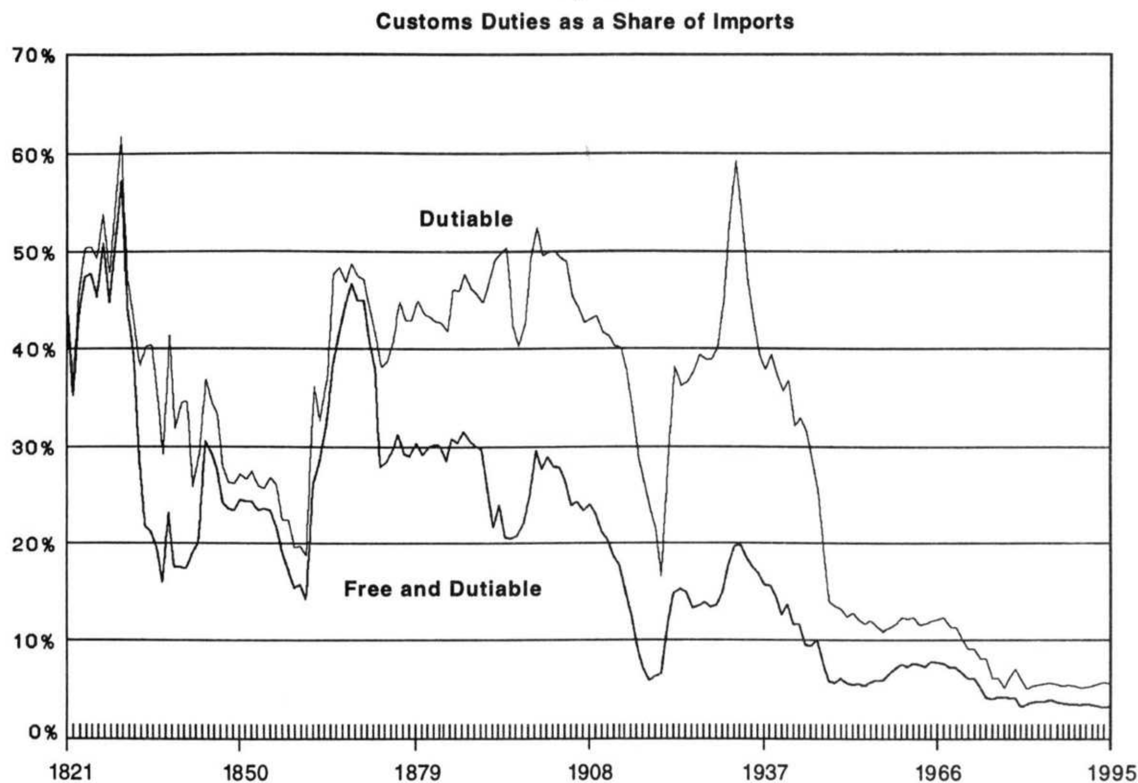
Following the Civil War, some tariff liberalization occurred, mainly assuming the form of exempting items from duties, rather than reducing tariff rates. As Figure 1 illustrates, until that time, duties had covered a large percentage of imports, as shown by the close relationship between the tariff rate on all imports and that on dutiable imports only. But after the Civil War, those rates began to diverge sharply.

Turn-of-the-Century Tariffs

In the election of 1888, Republicans called for tariffs to protect American manufacturing. Benjamin Harrison's defeat of Democrat free trader Grover Cleveland led to passage of the McKinley tariff in 1890. An interesting aspect of the 1890 debate over the tariff is that protectionists abandoned any pretense that high tariffs were needed to protect infant industries. Even mature industries, they argued, needed protection. They further argued that high tariffs were needed to *reduce* the Treasury's surplus. They understood that sufficiently high rates would so discourage imports that tariff revenues would fall.[34]

Figure 1

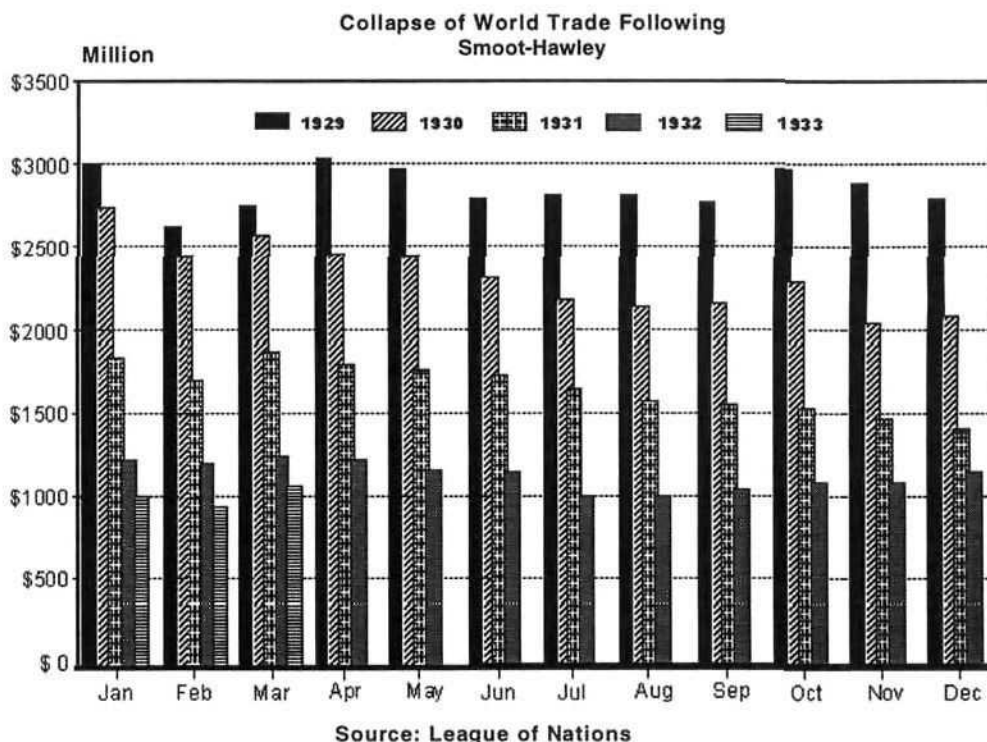
Customs Duties as a Share of Imports



Source: Department of Commerce

Protectionist tariffs remained the bedrock of economic policy of the Republican Party for the next 20 years. Indeed, Republicans were so intent on passing the Payne-Aldrich tariff in 1909 that President William Howard Taft

Figure 2



supported the 16th Amendment to the U.S. Constitution creating a federal income tax as the political price for Democratic support of the tariff.[35] That has to have been one of the worst deals in history—a lose-lose situation if ever there was one.

The Underwood tariff of 1913, passed early in the administration of President Woodrow Wilson, liberalized trade somewhat. But as soon as the Republicans reassumed power after World War I, they raised tariffs again. The Fordney-McCumber tariff of 1922 generally increased tariff rates across the board. However, it also gave the President power to raise or lower existing tariffs by 50 percent.

Table 1

Tariff Rates on Selected Articles, 1921 and 1930

Article	1921	1930
Raw sugar	1.26¢/lb.	2.5¢/lb.
Cattle	Free	3¢/lb.
Milk	Free	6.5¢/gal.
Cream	Free	56.6¢/gal.
Butter	2½¢/lb.	14¢/lb.
Wheat	Free	42¢/bu.
Oats	6¢/bu.	16¢/bu.
Lemons	½¢/lb.	2.5¢/lb.
Pig iron	Free	$1.125/ton
Manganese ore	Free	1¢/lb.
Tungsten ore	Free	50¢/lb.
Cotton	Free	7¢/lb.
Wool	Free	34¢/lb.

Source: Abraham Berglund, "The Tariff Act of 1930," *American Economic Review* 20 (September 1930): 472.

Deepening Depression

The infamous Smoot-Hawley tariff of 1930 was the last outrage inflicted by the Republican protectionists. Rates on dutiable imports rose to their highest levels in over 100 years. Increases of 50 percent were common and some rates went up 100 percent. Table 1 indicates how much tariffs increased during the 1920s as a result of both the Fordney-McCumber and Smoot-Hawley tariffs. A recent analysis estimates that the Smoot-Hawley tariff, on average, doubled the tariffs over those in the Underwood Act.[36]

Economists and historians continue to debate how important the Smoot-Hawley tariff was in causing the Great Depression.[37] Whatever the degree, the effect certainly was adverse and the tariff was certainly bad policy. As Figure 2 indicates, world trade virtually collapsed following passage of the Smoot-Hawley tariff. Thus, if that tariff was not the single cause of the Great Depression, it certainly made a bad situation worse.

The Free-Trade Path

Politically, at least, in the long term the memory of the Smoot-Hawley tariff has kept Americans committed to a free-trade policy. For more than 60 years, a guiding principle of U.S. international economic policy has been that tariffs and other trade barriers should be reduced, that trade wars must be avoided at all costs, and that the best way to achieve those goals is through multilateral negotiations. Thus, the United States took the lead in establishing the General Agreement on Tariffs and Trade that reduced global tariffs in the decades following World War II, and spearheaded major GATT rounds of multilateral trade liberalization, including the Kennedy Round, Tokyo Round, and Uruguay Round.

In recent years, the free-trade consensus has begun to weaken. One must look back to 1929 to find protectionist rhetoric as heated as that commonly heard today. Throughout most of the postwar era, protectionists were embarrassed to call themselves protectionists. Today, however, prominent politicians such as Republican presidential candidate Pat Buchanan and Senator Ernest Hollings (D-S.C.) wear the label proudly.[38] Yet protectionist policies have not been the source of America's economic strength. And American policy, fortunately, remains largely directed toward free trade.

Japan

One reason for the weakening of the free-trade consensus in the United States is the perception that Japan has prospered by using protectionism and government support of industry. But good economic policy, not protectionism, deserves the credit. Protectionism held back Japan's development for centuries, whereas free trade is what has made that country a world economic power.

Weakness from Protectionism

During the Tokugawa period, from the 17th through the 19th centuries, the era of shogun rule, Japan was almost totally isolated from the outside world. Although they had some limited contact with the Dutch and Portuguese, the Japanese were forbidden to travel abroad or even build oceangoing ships. Thus, Japanese feudalism lasted hundreds of years after its collapse in Europe, and industrialization there was nascent long after the Industrial Revolution in the West.[39]

In 1853, the U.S. government dispatched Commodore Matthew Perry to force open a trading port for resupplying American ships traveling to and from China. The spectacle of officers of an American warship in Tokyo Bay, dictating policy to a weak Japan, clarified for many of that country's leaders that isolation was no longer an option. To become an economic and political power, able to defend its interests, Japan had to become more economically integrated with the rest of the world. The result was a gradual opening, culminating in the Meiji Restoration in 1868, which overthrew the shogunate and restored power to the Japanese emperor.

Strength through Trade

Trade played an important role in Japanese economic development after the restoration. Although foreigners initially dominated trade, the Japanese quickly learned how to compete; they imported technology and methods and rapidly incorporated them into Japanese industry.[40] It is important to remember that by the late 1800s, Japan practiced almost totally free trade. That was because treaties with foreign powers generally prohibited any restraint on trade and because the government was not heavily involved in the economy.[41]

Even as Japan turned more protectionist and became increasingly militarized after World War I, growth was still primarily based on private initiative. Looking at the Japanese economy between 1868 and 1938, William Lockwood concluded:

> A study of the whole process of economic development in modern Japan leads to the conviction that the real drive and momentum lay in large measure outside the realm of national political ambition and State activity. At most the latter only accelerated a process of industrialization which was latent in the whole conjuncture of forces at work. . . . Aside from routine government services, indeed, State undertakings provided only a negligible share of the national product. Furthermore, the real economic growth of Japan took place chiefly in those areas of private activity which owed least to political subsidy and support.[42]

Protectionist Wars

With the Depression in the 1930s, Japan witnessed world markets closing and the imperial giants, Great Britain and France, attempting to confine trade within their empires. In reaction, Japan recognized the need to conquer its own empire to ensure access to markets and sources of raw material. It invaded Manchuria in 1931 and China in 1937. In response to the American embargo on oil sales to protest such imperial policies, Japan recognized the need to invade Indonesia and other parts of Asia. That led to its attack on Pearl Harbor and America's consequent entry into World War II.

MITI's Failures

After the war, Japan retained many controls on trade and investment. The Ministry of International Trade and Industry (MITI) was given broad power to use those controls to benefit domestic industry. Japan's great economic success after the war prompted many observers to conclude that MITI and its strategy of targeting industries through industrial policy was the key to Japan's success.[43] Closer examination, however, casts doubt on that conclusion. In a 1976 study, Philip H. Trezise, for example, found that:

> MITI did, of course, engage in an extraordinary amount of legal and extra-legal guidance, assistance, and intervention in the Japanese private sector during a period in which the economy's growth performance was exceptionally strong. The policies espoused by the MITI—import protection, controls on foreign investment and on purchases of foreign technology, financial aid to selected industries through government lending institutions, selective tax incentives, and administrative leadership to prevent excesses in investment and production—did not in any case prevent the economy from going forward at a rapid pace. It is a good deal less clear that these policies provided the consistent and positive—to say nothing of overwhelming—contribution to economic growth that has been attributed to them.[44]

Since the time of that study, doubts about the role of MITI in Japan's prosperity have grown. Among MITI's failures are the following:

- In the early 1950s, MITI sought to eliminate all auto companies other than Toyota and Nissan; it believed that having more than two was inefficient. Fortunately for the Japanese economy, MITI's effort failed.[45]
- Also in the early 1950s, MITI refused to allow Sony to import transistor technology. Although Sony was eventually able to reverse MITI's policy, it was forced to wait two years before being able to do so—all because a single MITI bureaucrat thought Sony lacked the skill to develop the technology.[46] Instead, MITI gave aid to two other firms making soon-to-be-obsolete vacuum tubes.[47]
- A 30-year effort to develop a nuclear breeder reactor ended in failure after at least $5 billion was poured into the project.[48]
- A widely touted effort launched in 1982 to develop a "fifth generation" computer ended in 1992 after it became clear that the computer industry had moved in a completely different direction than the one MITI had envisioned.[49]
- A major effort to develop high-definition television failed when the system that MITI targeted with $1.2 billion in handouts turned out to be obsolete.[50]

Other failures include plans to develop a nuclear-powered merchant ship, suppression of the cable television industry in Japan in favor of a satellite system, a remote-controlled oil-drilling rig, and a nuclear-power blast furnace for steel-making.[51] A thorough empirical analysis, for the Harvard Institute of Economic Research, of all major Japanese industrial policy projects concluded that government subsidies had no effect on the success or failure of the projects.[52] MITI is now viewed as a declining institution that must thoroughly reinvent itself or cease to exist.[53]

To be sure, Japan retains a large trade surplus with the United States, but economists now generally attribute that to macroeconomic forces rather than Japanese trade barriers or industrial policy. In a nutshell, Japan saves "too much" and the United States saves "too little." Thus, Japan's excess saving is "exported" to the United States, leading to a surplus in Japan's trade account.

Japan may never become a complete free trader, but even at its worst it was never as protectionist as many American trade hawks believed.[54] In reality, Japan's economic success is largely attributable to good economic policy. Historically taxes have been low, especially on capital. Savings rates were high and budget deficits were low. Although Japanese businesses have, to a certain extent, been protected from foreign competition, domestic competition is fierce. Inflation has remained low and property rights are secure.[55] Those are sufficient reasons for Japan's economic success.

Germany

American protectionists also look to Germany for a model. Pat Buchanan, for example, cited the work of German protectionist Friedrich List in support of his views.[56] However, an examination of German history, as well as a deeper reading of List, does not confirm the efficacy of protectionism as a path to prosperity.

Protectionism's Toll

First, it is important to remember that as of the early 19th century, Germany was at best little more than a loose confederation of independent principalities. Prussia and Austria were the largest of them. From an economic viewpoint, the major problem was the existence of numerous trade barriers, erected by the German states, that prevented the development of large-scale industry and inhibited the growth of German political influence. The extraordinarily high tolls on the rivers of Germany were important barriers. Until the development of railroads, river traffic was virtually the sole means of transporting large quantities of goods. A British traveler to Germany in 1820 described the toll system in the following way:

> There are no less than twenty-two tolls on the Weser [river] betwixt Münden and Bremen, seven of which belong to the sovereign of Hannover. . . . At every toll every vessel is stopped and her whole cargo examined. On an average, more than one hour is employed at each toll to examine each vessel; so that every one loses one whole day in passing between these two towns. This is mere waste, a loss of time to all the parties, more injurious probably than the duties which the merchants have also to pay. . . . It is said that the expense of collecting the tolls equals the receipts.[57]

Freer Flow of Goods

It is in the context of extreme disunity and its hindrance of trade that one must interpret List's views. Although he favored protection against imports from outside Germany, he was adamant about abolishing all trade barriers, including tolls, within Germany itself.[58] Eventually, List's view prevailed with the establishment of the German customs union, the *Zollverein*, in 1833. By 1854, virtually every German state had joined the union. In other words, the economic enterprise among the Germanic states for most of the 19th century was the creation of a huge free-trade area in the center of Europe. This effort was capped by the unification of Germany under Prussian leader Otto von Bismarck in 1871. For that result, List is revered in Germany as one of the fathers of unification.

List favored protection primarily for political reasons—to further the cause of German unification. Insofar as he had an economic rationale for restricting imports, it was based on the now-discredited infant industry argument. But protection, in List's view, was never to be permanent, only temporary. In every other respect, List was generally in favor of a free market.[59]

The economic enterprise among the Germanic states for most of the 19th century was the creation of a huge free-trade area in the center of Europe.

Restored Restrictions

Until 1879, Germany's tariffs were generally quite low. However, in that year Germany adopted a protective tariff policy for the first time. Although protectionism was promoted by the usual special interests, such as the iron and steel industry, it was held in check by the large agricultural sector which held generally free-trade views and which required open world markets to sell its products. What tipped the political balance toward protection was the central government's need for revenue. At least that was Bismarck's stated reason for supporting higher tariffs.[60]

Ironically, the spread of protectionism elsewhere ultimately forced Germany to moderate its tariffs. Beginning in 1891, Germany negotiated reciprocal trade agreements that substantially lowered tariffs on many imports, in return for reductions in tariffs on German exports. However, the new tariff of 1902 set limits on the government's ability to mitigate tariffs through bilateral agreements, by setting nonnegotiable tariff floors for many goods.

World War I brought a breakdown in trade between Germany and its European enemies. The Depression led to a breakdown in the world trading system. Furthermore, Hitler's rise to power in 1933 brought the explicit fascist principle of economic self-sufficiency and a belief that international trade was controlled by capitalists and Jews who profited at Germany's expense. Thus, Germany remained a high tariff country, to the end of World War II.

At the end of the war, the allied occupation simply maintained all the Nazi economic controls. Trade was virtually prohibited except

under control of the occupation forces. Thus, trade was primarily inhibited by direct controls, rather than tariffs.

Opened Again

In 1948 Ludwig Erhard, then Economics Minister for West Germany, engineered a major reform of the entire German economy virtually overnight. Although its best-known feature was currency stabilization, other key elements were tax reform, trade liberalization, and regulatory reform. Later, Erhard explained that he had no choice but to be radical, for whereas allied permission was required to change any regulation, none was required simply to remove them.[61] The results were astonishing. Henry Wallich described what happened the day after the currency reform and the lifting of price controls took effect:

> On June 21, 1948, goods reappeared in the stores, money resumed its normal function, black and gray markets reverted to a minor role, foraging trips to the country ceased, labor productivity increased, and output took off on its great upward surge. The spirit of the country changed overnight. The gray, hungry, dead-looking figures wandering about the streets in their everlasting search for food came to life.[62]

Although the Marshall Plan continues to get much of the credit for the German revival, the surge in growth in fact predated the arrival of any Marshall Plan aid. When that plan did become operational, moreover, one of its most important aspects was the little-known fact that aid was contingent on the opening of trade. It is important to remember that 16 different countries in Europe received Marshall Plan aid. That aid was primarily used to finance imports and exports among those countries that formed the Organization for European Economic Cooperation (forerunner to the present Organization for Economic Cooperation and Development). Thus, the Marshall Plan's primary impact on stimulating European prosperity after the war was in breaking down barriers to trade.[63]

Subsequently, Erhard continued to liberalize German trade. He believed that trade was an important engine of growth. He also believed that opening the German economy to external competition was critical in making German industry more competitive.[64]

Germany has never adhered to a pure free-trade policy, but it has maintained a more open trade policy than any other country in Europe in the postwar era. For example, in the early 1980s Germany restricted the import of a significantly smaller number of items than any other country did. Whereas Germany restricted the import of 47 items, France and Italy each restricted more than 500.[65] Germany also spearheaded the breakdown of trade barriers and the institution of free trade within the European Union in 1992.

Conclusion

This chapter has aimed to show that, generally, nations rise to power and wealth through free trade and decline when protectionism takes over. Although none of the nations reviewed has ever practiced pure free trade, all had relatively open economies during the periods that coincided with their golden ages. Furthermore, those nations often deemed to exemplify successful growth through protectionism, Germany and Japan, do not in fact fit the model.

Notes

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[6] Jan deVries, "On the Modernity of the Dutch Republic," *Journal of Economic History* 33, no. 1 (March 1973): 191-202.

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[8] Charles Wilson, "Trade, Society and the State," *Cambridge Economic History of Europe*, vol. 4 (New York: Cambridge University Press, 1967), p. 531.

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[12] Adam Smith, *The Wealth of Nations* (New York: Random House, 1937), pp. 826-27, 857.

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[15] Ibid., p. 117.

[16] Ralph Davis, "The Rise of Protection in England, 1689-1786," *Economic History Review* 19, no. 2 (August 1966): 306-307.

[17] Wilson, "Trade, Society and the State," pp. 498-518; Laurence Bradford Packard, "International Rivalry and Free Trade Origins, 1660-78," *Quarterly Journal of Economics* 37, no. 3 (May 1923): 412-35. See also W. J. Ashley, "The Tory Origins of Free Trade Policy," *Quarterly Journal of Economics* 11 (July 1897): 335-71; R. W. K Hinton, "The Mercantile System in the Time of Thomas Mun," *Economic History Review* 7, no. 3 (1955): 277-90.

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3. The Myth of the Race to the Bottom

by Edward L. Hudgins

A frequently heard objection to increased freedom to trade is that Americans will lose jobs to other countries and see real wages decline as workers in Latin America, Asia, and elsewhere grow rich. The one objection actually raises three questions: First, is the United States experiencing a general economic decline? Second, are certain groups faring better while others fare worse? And third, if problems exist, is trade liberalization primarily responsible for them?

Theory explains and empirical evidence demonstrates that:

- Americans on average still have the highest standard of living in the world. As America's economy has increasingly integrated with the global economy, average living standards have continued to rise. There has been no general decline in earnings.
- Since the oil shocks of the early 1970s, economic growth has been less rapid than in the early post-war decades. But this situation does not seem to stem from imports or trade deficits.
- Much of the real growth in earnings has gone to higher skilled and better-educated workers.
- Lower skilled and less educated workers have not fared well in recent decades.
- Although imports have affected certain less efficient American industries and enterprises, imports and trade deficits are not a significant cause of wage disparities.

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Logical Problems

Many Americans fear their wages may decline because of trade. That fear of a "race to the bottom" is based on the erroneous premise that, with free trade, higher paid American workers will be forced to compete with lower paid workers in poorer countries, pulling down American wages in general. Jobs will always go to where costs are lower.

That negative view of free trade ignores the wealth-creating nature of free trade. With freedom to trade, all workers in all countries are able to use their labor to create the most valuable output possible in their situation. Less efficient workers might have to change jobs, possibly accepting lower earnings. And those individuals might have to upgrade their labor skills to raise their earnings. But the need to improve holds true for businesses as well as individuals facing competition. They must offer better products and services at prices acceptable to consumers if they are to continue in business. That is the natural course of market change whether the competition comes from domestic or foreign sources.

Best Use of Labor

Free trade and the division of labor might mean that in the United States more workers are employed writing computer software, creating new pharmaceuticals in research laboratories, running wheat farms with giant planting and harvesting equipment, or operating advanced machines in a highly auto-

mated textile mill. It might mean that in less developed countries more workers are employed assembling computer keyboards, plowing fields with small tractors, or using low-tech sewing machines to stitch collars onto shirts.

Low-wage workers in less developed countries generally do not have the educational background or practical experience to discover new medicines or write new software. They usually do not have access to the capital equipment necessary to farm thousands of acres in a season. And Americans would be foolish to replace a dozen individuals working a handful of huge combines with hundreds of individuals using hand plows to produce the same amount of crops. In either case of misallocated labor, the total amount of wealth created would be less than that created with division of labor and free trade. Hundreds of men hoeing a field would mean hundreds of men not producing other goods and services.

The Value of Labor

Another way to understand this situation is to recall that the value of any individual's labor—that is, the price or wage it commands in the market—depends on the value of the goods and services that the labor can produce. The labor of workers in industrialized countries produces more than that of workers in poorer, less developed countries. Thus American workers can trade their labor for higher wages.

As poorer countries develop, American market restrictions will not make American labor more productive or valuable. Restrictions will simply shield enterprises and workers from competition and thus from incentives to become more productive. The only way for workers to trade their labor for higher wages is to increase productivity.

Protectionists assume that wealth is a zero-sum game, that increased production in one part of the world necessarily means less wealth produced elsewhere. That is never the case when free trade is permitted.

A variation of the race-to-the-bottom argument maintains that the wages in low-wage and high-wage countries will converge if free trade is allowed. That argument will be considered in greater detail later. But in principle it, too, ignores the wealth-creating nature of free trade.

The Case of Puerto Rico

Some people maintain that industries flee the United States for lower wage countries with which America establishes free trade; they have a difficult time, however, explaining the situation in Puerto Rico. That Caribbean island is a commonwealth of the United States and thus can trade with the 50 American states with virtually no restrictions. In 1993 disposable per capita income was about $6,260 in Puerto Rico, compared with $18,552 in the 50 states. Given protectionist theories, one would expect full employment in Puerto Rico. In fact, unemployment is around 17 percent and has been in the double digits for decades. That compares with around 5.5 percent for the rest of the United States.

In truth, many factors in addition to low wages attract enterprises. These include levels of worker skills; the cost and reliability of water, electricity, and other utilities; transportation infrastructure; access to input resources; and proximity to markets. More important is the freedom of individuals and enterprises to earn and retain profits, and freedom from confiscatory levels of taxation and from heavy-handed government regulations that hamper business creation. Further, if a state or country maintains a welfare system that removes incentives to work, the economy will suffer.

Puerto Rico is not a free market paradise; and this is the best explanation for its continuing poor economic performance. For many American industries, it would make little economic sense to locate in Puerto Rico or in other countries.

America's Economic Place in the World

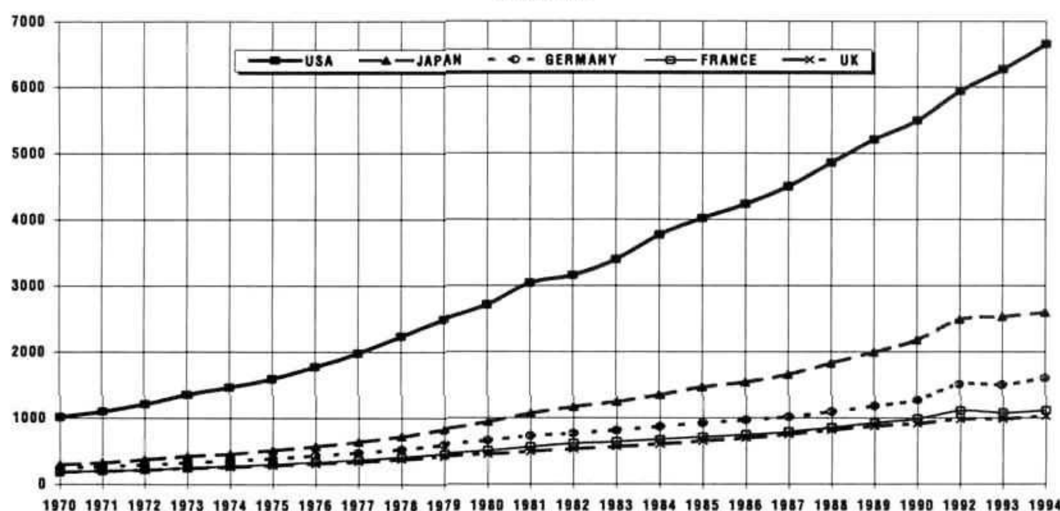
There are those who believe that other countries are overtaking the United States economically or that America is a country of shrinking wealth. They need only compare this country with others to be disabused of those notions.

Still the Largest Economy

America still has the world's largest economy. Calculations by the Organization for Economic Cooperation and Development (OECD) place America's gross domestic product (GDP) in 1994 at $6,649.8 billion. The

Figure 1

Gross Domestic Products
In Purchasing Power Parity
In $-Billions



Source: OECD National Accounts.

next largest economy, Japan, has a GDP of $2,593 billion, not quite half the size of America's. The reunited Germany comes in third at $1,601.7 billion. (See Figure 1.)

America's Purchasing Power

As mentioned earlier, Americans on average have the highest standard of living. Such comparisons are never completely accurate or exact, but some measures are better than others.

World Bank's misleading numbers. There are several ways to compare average earnings in different countries. The World Bank comparisons sometimes quoted by doomsayers are misleading. When comparing per capita GDP in various countries, the World Bank takes a country's average per capita income in local currency and multiplies it by the exchange rate to show the equivalent in dollars. By that measure Americans in 1995 appeared have lower wages than the Japanese, Norwegians, and Danes and to tie with the Swedes. But exchange rates do not accurately reflect differences in living standards. Rather, they reflect factors such as the international demand for a currency to be used for trade or investments.

Workers are paid in local currencies and make purchases in local currencies. A Japanese worker is paid in yen and must purchase food, housing, and all other goods and services in yen. Thus, a closer look finds that the average Japanese spends 25 percent of income on food compared with 15 percent or less for the average American, and as much as double the portion of income for housing than does an American. Two joint U.S.-Japanese government studies showed, respectively, consumer prices in Japan to be on average 41 percent higher than in the United States in October 1989 and 37 percent higher in April 1991.

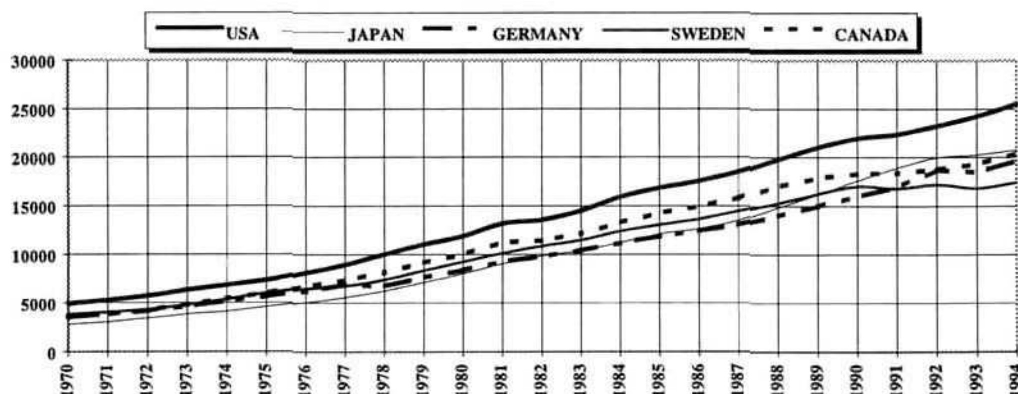
OECD figures. A better overall measure for comparing living standards is purchasing power parity (PPP) as calculated by the OECD. PPP adjusts to a certain extent for exchange rate and trade flow effects, although imperfections remain. For example, some countries keep their national accounts in ways different from the majority of developed countries, creating anomalies in the statistics. Still, PPP better reflects real living standards than does the World Bank measure.

Using PPP, Americans are found to have higher average purchasing power than citizens of other industrialized countries. (See Figure 2.) In 1994 the average American earned $25,515, the Japanese $20,756, the German $19,675, and the Swede $17,442.

These numbers also show that there has been no decline in America's per capita GDP over the past decades as America's economy has become more integrated into the world economy.

Figure 2

Purchasing Power Parity Per Capita
In Dollars



Source: OECD, International Labor Organization, 1992 figures, March 1994.

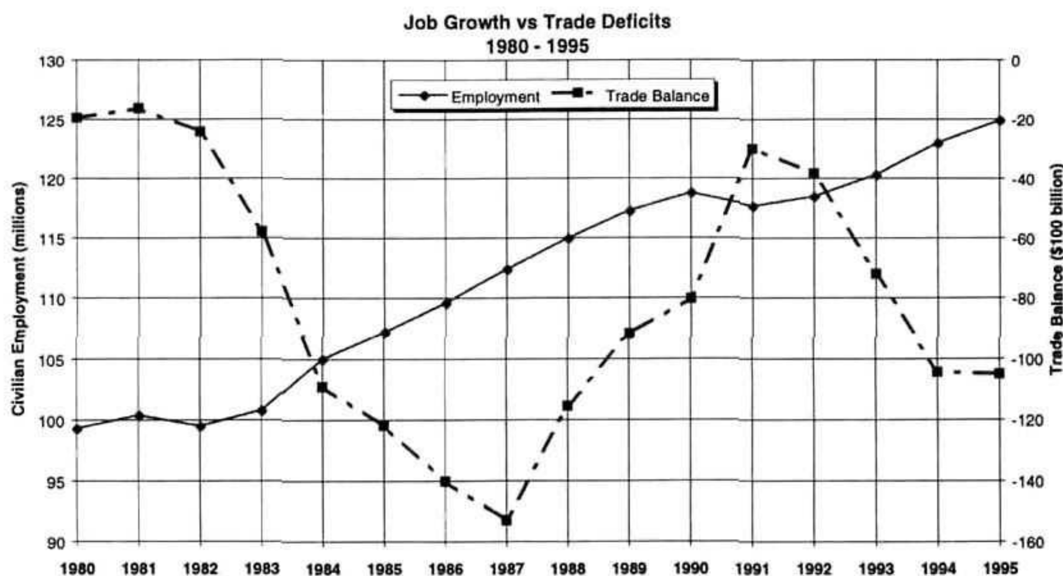
Jobs in America

Strong job creation. The American employment situation is also better than in other industrial countries. Over the past decade more jobs have been created in the United States than in all the other major industrial countries combined. Between 1982 and 1990 America added 17.8 million workers to payrolls, an 18 percent increase. That rapid job creation occurred even though America's trade deficit was reaching record levels. (See Figure 3.)

The rate of job creation in the United States compares favorably with the 6.1 million jobs or 10 percent growth for Japan during the same period and 1.8 million jobs or 6.6 percent growth for West Germany. The average job growth rate in the European Community countries during that period was 8 percent, and in the industrialized OECD countries it was 8.8 percent. Furthermore, most of the jobs created in the United States were in the private sector, whereas a high proportion of the net employment gains in Europe was in the public sector.

Figure 3

Job Growth vs Trade Deficits
1980 - 1995



Employment Source: Economic Report of the President 1991 (Washington: Government Printing Office, February, 1997), Table B-33, p. 338.

Trade Source: Balance on goods and services. Economic Report of the President 1997 (Washington: Government Printing Office, February, 1997) Table B-101, p. 414.

Lower unemployment. Unemployment in Western Europe now averages over 10 percent, or twice as high as America's rate of around 5 percent. The rate for western Germany rose from 6.3 percent in 1991 to around 10 percent in 1995. Unified Germany's unemployment rate has hovered between 10 percent and 12 percent, with a post-war record of more than 4 million out of work.

Sweden, once considered the socialist country that could guarantee full employment, saw unemployment jump from 1.6 percent in 1990 to around 12 percent in 1994. Swedish employment figures have always been deceptive because that country's method of keeping national accounts differs from those in other countries. The Swedish government regularly places the unemployed in government-sponsored public works or job training programs and lists these individuals as "employed." Now, even by their own measure, the Swedes have had to abandon any pretense of government-created full employment.

Not only is Europe suffering from high unemployment levels, European unemployment tends to be longer term than in the United States. In 1989, 90 percent of unemployed Americans were out of work for less than six months. Only 6 percent were out of work for more than a year, compared with 44 percent of the French and 49 percent of Germans.

Unemployment in Japan rose from around 2.2 percent in 1990 to 3.3 percent in late 1996. Although 3.3 percent is low compared with the U.S. rate, it is high by Japanese standards. The wages of many Japanese workers, unlike those of most Americans, are flexible. As much as one-third of the average worker's income is paid in the form of a bonus based on how well a company performed that year. As a result, during short-term economic slowdowns, Japanese firms effectively cut workers' pay, thus avoiding the need to lay off workers. Nonetheless, most large Japanese firms are reevaluating their "employment for life" policies in the face of current economic problems.

Offsetting layoffs. In the United States in recent years, well-publicized layoffs by large companies have fueled calls for government action to protect American jobs. What generally gets little attention is the job creation that might not have occurred had some industries been protected.

For example, much consternation accompanied AT&T's 1996 announcement of planned layoffs of 40,000 workers. But job creation in other telecommunications enterprises and sectors has been strong. Since 1985 MCI employment has grown from 12,000 to 48,000. Jobs with Sprint rose from 27,000 in 1985 to 52,000 today. The number of cable operators and programmers grew during that period from 24,000 to 112,000. No one announces 40,000 new hires at once, so job growth rarely makes the headlines.

Unmeasured Progress

The wage situation in the United States bears closer examination. First, however, consider that such measures of economic well-being do not fully reflect a form of progress that is important to most Americans: the availability of new goods and services. Although the dollar value of such goods and services is generally reflected in economic statistics, their contribution to quality of life usually is not.

Deregulation or freer trade generates some benefits. For example, beginning in the late 1970s, airline deregulation cut the real, inflation-adjusted cost per passenger-mile flown—that is, the cost of tickets—by perhaps one-third. Families that might not have been able to afford a vacation can now visit friends, relatives, or places of interest in faraway parts of the country or world. Other families that might have had to drive to their destinations, wasting vacation days on the road and substantially increasing the risks of an accident, now gain more leisure time and safety by flying.

Other benefits come from technological advances. Medical techniques for heart surgery have advanced over the past decades, saving thousands of lives. More than 2,000 heart transplants now take place annually in the United States. The consumer electronics revolution has brought video cassette recorders and microwaves into most homes. The personal computer revolution can now link anyone to vast stores of information and a worldwide web of communications and knowledge.

Furthermore, in many cases, goods and services that were costly and thus luxuries for the well-to-do have become affordable, as prices dropped, for average Americans.

A Closer Look at Income

Although one can say, simply, that Americans on average are doing well compared with cit-

izens of other countries, a more refined picture of U.S. economic conditions is useful.

Income Per Capita

America fares well compared with other countries in average per capita GDP. But what has been the trend over recent decades? Per capita GDP shows growth in recent decades except during the 1982 and 1990 recessions. Between the end of the Korean War in 1954 and the first oil shock in 1973, per capita GDP grew just over 2 percent annually. From 1974 through 1989 the average annual growth rate was only 1.6 percent. Was this slowdown due to the effects of trade?

W. Michael Cox and Beverly J. Fox of the Federal Reserve Bank in Dallas have observed that in the 84-year period between 1869 and 1953, the country's average per capita GDP grew at a rate of around 1.6 percent, the same as during the post-1973 period. Cox and Fox believe the country could have done better during the post-1973 period, but they do not suggest that more open world markets hampered growth. Nor are they alone in suggesting that the 1950s and 1960s were decades of extraordinary growth resulting from the huge amounts of resources and manpower shifted from the war effort into domestic production.

Furthermore, during the period between the end of the 1982 recession and 1989, when the U.S. trade deficit reached record levels, annual growth in per capita income averaged around 3 percent, well over 1.6 percent annually.

Consumption Per Capita

Average per capita GDP is not synonymous with earnings; GDP includes more than just income—for example, investments. And GDP does *not* include other kinds of economic activity—for example, part of the value of sales of used cars and other used goods.

Another measure of economic progress is consumption, which is the ultimate goal of economic production. The trend in the growth of consumption, Cox and Fox find, runs slightly below but parallel to the growth in per capita GDP. These consumption figures confirm the upward economic trend found in per capita GDP.

Average Earnings or Wages

One measure of economic well-being is hourly wages in the form of cash or money income. That measure shows actual deterioration since 1973, with a loss of about one-half percent per year through 1993. Critics of free trade use that statistic to justify their claim that Americans on average are growing poorer. But wages alone do not tell the whole economic story.

Average Total Compensation

Total compensation for work includes more than cash wages. Of great importance over past decades has been the rise in the value of nonwage and nontaxed income, principally health care and retirement contributions from employers as well as increased paid vacation.

Cox and Fox found that total per capita compensation rose by about one-half percent per year between 1973 and 1993. They observed that from 1953 to 1993 the portion of payrolls devoted to health benefits rose from 3 percent to 14 percent, and the portion going to retirement jumped from 5 percent to 13 percent.

Gary Burtless, a scholar at the Brookings Institution, found that employers' contributions to workers' health and welfare plans grew from 4.5 percent of personal income in 1973 to 6.6 percent in 1993. The government contribution in the form of Medicaid payments grew from 1.8 percent to 5.2 percent on average during that period.

Real Personal Income

A more inclusive gauge of economic well-being is real personal income per capita, which includes wages; benefits, such as employer contributions to health care; and other factors such as rents, interest, dividends, and government transfers. Cox and Fox found an average annual growth rate in real personal income of 1.65 percent between 1973 and 1989. That rate virtually matches their finding of 1.64 percent average annual per capita GDP growth during the same period. They further point out that paid vacation and holiday time have increased by about seven days over the past two decades. Such income gains are impressive.

Median Family Income

Another indicator of economic well-being is

median family income. That measure differs from average per capita income in two ways. First, the unit of analysis is a group of individuals. Second, the median (as opposed to average) family income means the same number of families make more than the median as make less. Cox and Fox find that median family income has virtually stagnated, increasing only one-tenth of one percent per year between 1974 and 1993.

Critics of free trade also point to that statistic as evidence of the adverse effects of open markets. But international trade does not explain the situation. Burtless cites Census Bureau statistics showing that average family size decreased over the past two decades, from 3.44 in 1973 to 3.2 in 1993. Thus, a seemingly stagnant median family income is divided among fewer individuals, leaving more income per individual family member. Looking at income per person within the average now-smaller family, income is seen to go up. According to Burtless, per capita income per median family member increased 7.4 percent over the 20-year period.

Burtless also notes that average rather than median family income increased 13.2 percent between 1973 and 1993. Taking into account smaller family size, that means average real income per family member increased by 21.6 percent during that period.

Consumer Price Index Adjustments

A recent finding with regard to the consumer price index (CPI) may lead to calculations of economic progress. The special Advisory Commission to Study the Consumer Price Index, headed by former Bush administration Council of Economic Advisers chairman Michael J. Boskin, reported to the Senate Finance Committee in December 1996 that the rate of price increases in government statistics has been overstated by about 1.1 percent per annum. Such a CPI overstatement means that real purchasing power has been understated in the past. Thus, estimates by Burtless, Cox, Fox, and others probably understate the level of economic progress for poorer Americans.

Implications of the CPI revision must still be worked out for measurements of living standards. But they initially indicate that consumers, and thus workers in lower paying positions, are better off than previously thought.

Problems for Unskilled Workers

So far the evidence shows that there has been no general decline or even stagnation in the average American's purchasing power since 1973, and certainly not during the 1980s when trade deficits hit record highs. That does not mean there are no problems in some sectors of the economy or segments of the workforce. To round out the earnings picture, it is necessary to examine these problems and determine how trade contributed to the situation.

Critics of the Reagan administration in the 1980s argued that many of the 18 million net new jobs created during that decade were low-paying service positions, often labeled "burger flipper" jobs. Now it is clear that many of those jobs were higher paying and required higher levels of skill and education. So what is the actual situation for low-skilled positions?

The evidence shows that there has been no general decline or even stagnation in the average American's purchasing power since 1973, and certainly not during the 1980s when trade deficits hit record highs.

The Education Factor

Earnings for those in the lowest income brackets have stagnated or declined, a fact apparently linked to levels of education. Cox and Fox found that the premium for better educated workers rose significantly between 1972 and 1992. In 1972 a high school dropout made only about 62 percent of the income of a high school graduate, whereas a worker with an advanced college degree made 172 percent of the income of the high school graduate. By 1992 the dropout was making only 58 percent of the high school graduate's income, whereas the worker with an advanced degree was making 254 percent. Income for all groups with some college education rose after 1972. Thus, there has been a growing premium for better educated and higher skilled workers over the past two decades.

Anecdotal evidence also suggests that the educational factor is responsible for poor earning power. A CEO reports that his factories now hire more college graduates to work the shop floor, whereas 20 years ago high school graduates were adequate. The change stemmed in part from a need for higher skilled workers. But it also reflected a problem with the quality of workers coming out of high school. That quality has declined in recent decades, with such basic characteristics as punctuality and the maturity to hold down a job lacking.

American Enterprise Institute scholar Jagdish Bhagwati and Vivek H. Dehejia seem

to confirm the pattern. They observe that the adjustment difficulties of lower skilled workers and the resulting lower earnings could have been caused by the rise of lucrative alternatives such as drug-dealing, the fall in the quality of schools, and the collapse of the family and hence the fall in the motivation and aptitude for getting educated among those affected.

The Technology Factor

The role that education plays in explaining stagnant earnings for part of the workforce suggests that advances in technology also play a role. Bhagwati and Dehejia note that "the happy experience of the 1950s and 1960s may have been due to technical change that was substantial, was more uniformly spread among exportables and importables, and was more neutral than biased whereas, in the 1980s, it has probably been slower . . . has been more focused on skills-intensive exportables, and has been more skills-biased."

One secret to the success of American textile manufacturers was their use of better technology, much of it imported.

That is, when technological advances can be easily applied in manufacturing facilities employing semi-skilled workers, the differential effects on wages will be minimal. But the information revolution associated with personal computers, advanced software, and the Internet gives a clear advantage to workers with "knowledge." Indeed, knowledge itself is often the product being produced and sold. Furthermore, technological advances in recent decades have helped certain goods and services compete well with imports and indeed become major exports.

Bhagwati and Dehejia also suggest that the earnings gap is due in part to "the greater transferability of workplace-acquired skills by the skilled. An accountant handling IBM, for example, can shift his acquired knowhow readily to a new job at Caterpillar or Chrysler, but working better on the assembly line for autos at Ford may not transfer to working at a blast furnace in Pittsburgh, or for that matter to flipping hamburgers at MacDonalds [sic]."

Transferability of certain high-tech skills would seem to be high. For example, someone who develops one kind of computer software would probably be able to retool easily to develop another kind.

The Trade Factor

Explanations other than trade seem best to explain wage differences. Does trade have any effect?

No doubt imports and international competition help determine which sectors and workers realize higher profits and incomes and which ones find their goods, services, and skills of less value. If the American market were flooded with a cheap, foreign-made product of reasonable quality, American firms would have to respond with changes. That is the point of competition, to allow for specialization.

Competing with technology. In a competitive situation such as that an industry could face several options. It might shut down its operation; it might move all or part of its operation overseas; it might specialize in the lines of products and services in which it remained competitive; or it might become more efficient, for example, through the introduction of new, less labor intensive technologies.

For example, during the recession in the early 1980s, the textile and apparel industries in America laid off hundreds of thousands of workers. That downsizing was no doubt due in part to foreign competition. Since the late 1950s, however, U.S. trade barriers had restricted textile and apparel imports. Those barriers had delayed the industry's adjustment to competition and the introduction of new technology.

By the mid- and late 1980s, those industries, especially the textile segment, recovered and became very profitable. For example, in 1987 textile mills ran at about 94 percent of capacity, compared with 81 percent for American manufacturing as a whole. Total textile and apparel production rose by 6.5 percent between 1985 and 1986, with record consumption of inputs such as cotton, wool, and other fabrics. Profits rose by 46 percent in 1986. Yet in 1985 the U.S. merchandise trade deficit was $122.2 billion and in 1986 it was $145 billion.

One secret to the success of American textile manufacturers was their use of better technology, much of it imported. Anecdotal evidence also suggests another surprising factor. While touring several textile factories in North Carolina during the period of expansion, this author was told that the mills were experiencing problems with a lack of manpower. Apparently the demand for workers in newer, high-tech industries in the region forced some of the textile mills to increase wages to attract workers.

Competing with low-wage foreigners. Some critics of free trade might concede that higher skilled American workers have little to fear from foreign competition. But they would still maintain that lower skilled American workers will always find their wages falling as

low-skilled jobs move overseas, raising wages for foreigners.

Burtless notes several objections to the assumptions behind that scenario. First, it is not clear whether technologies that make use of low-skilled labor are identical in developed and less developed countries. Thus, lower-skilled labor might be more useful in certain industries or aspects of production in developed countries.

Second, returns to scales of production in developed and less developed countries will not necessarily be constant. And finally, the wage-convergence scenario often assumes that trading partners will not specialize in separate export items. In fact, complete specialization does occur.

Low wages with no import competition. Imports may indeed be the principal cause of stagnant or declining wages in import-sensitive industries, so these industries might understandably turn to less labor intensive, higher technologies to remain competitive. But, as Burtless points out, one would not expect that reaction in industries not subject to competition from low-priced imports. In fact, one might expect the opposite. With abundant unemployed workers, industries not subject to import competition might well become more labor intensive.

Burtless examined industries that were highly affected, moderately affected, and not affected at all by trade. Within the highly affected industries he found relatively small wage disparities between higher and lower earners and thus, presumably, between higher and lower skilled workers. In industries not highly affected by trade he found greater disparities.

The trend toward divergence between high and low earners in industries least affected by trade and in those most affected by trade has been the same since 1969. Low-wage, and presumably lower skilled, workers in the heavily trade-affected industries saw their wages slip in comparison with higher skilled workers in those industries. But low-wage workers in the *least* trade-affected industries saw their wages slip as well in comparison with their higher skilled colleagues in the same industries. In other words, import pressures are not the primary cause of wage stagnation in certain segments of the workforce.

The Government Factor

Finally, the greatest change in the American political and economic regime over the past three decades has been the explosive growth in the size of the federal government, with massive redistribution of wealth, regulation of the economy, and welfare state policies. These, more than anything else, have robbed businesses of capital and flexibility, robbed workers and families of income, and created incentives that punish the productive.

The United States has not gone as far as Western Europe in socializing its economy and undermining private property and contract rights. Thus America has a better employment situation than does Europe. But the kind of government policies that have so harmed Europe have harmed America as well, with lower skilled workers as civilian casualties.

A recent example of the effect of the government factor is found in America's business productivity. Between 1982 and 1990 productivity rose by 17.4 percent. But since 1992 it has grown by only 0.3 percent. The effects of the record tax hikes in 1990 (which took effect in 1991) and in 1993 (which took effect in part retroactively) must be prime suspects for productivity's battered condition.

Productivity is crucial to increasing real purchasing power. Put simply, if Americans do not continue to increase the value of goods and services, they cannot increase their earnings. The problem lies not in imports. It lies in federal tax and regulatory policies.

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4. The Myth of Surrendered Sovereignty

by Edward L. Hudgins

Some opponents of the freedom of Americans to trade believe that international agreements, particularly the General Agreements on Tariffs and Trade (GATT), the new World Trade Organization (WTO) that it created, and the North American Free Trade Agreement (NAFTA), sacrifice the sovereignty of the United States. There is legitimate concern about the terms and likely effects of any international agreement or organization to which the United States belongs. But it is also important to distinguish between a trade agreement that might be unsound and one that involves the sacrifice of a country's sovereignty. Fortunately, recent free-trade agreements, in addition to being mostly good economic policy, have preserved America's policymaking autonomy. Indeed, they have restored, in part, the sovereign right of individuals to use their property as they see fit.

Sovereignty: Federal versus State Governments

The term "sovereignty" means having the final say in a particular decision. In its political usage a country's sovereign is the individual, group, or body that makes and administers the laws governing the people in a given geographical area.

In the United States, American citizens, through the country's political institutions and elected officials, federal, state and local, are sovereign. Federal laws must be passed by members of Congress elected by the people and signed by the President.

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The United States has 50 state governments and numerous local authorities as well as a federal government. There has been much well-founded criticism of federal usurpation of the powers reserved for the states by the 10th Amendment of the U.S. Constitution. But Article I, Section 8 of the Constitution clearly gives the federal government the power "To regulate Commerce with foreign Nations." Because the federal government has the exclusive authority to make the rules of international trade, neither NAFTA, GATT, nor other trade agreements infringe on the sovereign power of the 50 states. Those agreements have no such trade-regulating power.

If Congress and the President foolishly place a high tariff on certain goods entering the United States, the government of a particular state cannot grant foreigners an exemption from that tariff. And if the federal government allows the citizens of another country, for example, Mexico, freedom to sell their goods to individual Americans without first paying a tariff, a state government cannot impose a special tariff on such sales. There are, however, instances in which trade issues might infringe on state concerns, such as local health or licensing regulations. Those instances must be examined as special cases.

Sovereignty: Individuals versus Governments

The question "Who should be sovereign over particular decisions?" does not usually require a choice among federal, state, and local governments or some international orga-

nization. Most decisions in a free society should be left to the sole, sovereign discretion of individuals. An owner's use of his or her property belongs solely to the owner as long as the use does not materially harm someone else or another's property. The decision over whether two parties should exchange goods or services should require only the mutual consent of the parties involved, not of government officials or bureaucrats.

Some protectionists such as Pat Buchanan argue that America should not mix its economy with that of Mexico or other countries. But that is a collectivist premise, which one would expect to be rejected by supporters of free markets. The economy is not owned by some entity named "America" nor by the U.S. government. It is owned by millions of Americans, in the form of private property. Trade restrictions limit the sovereign right of individual Americans to use their property as they see fit.

Most decisions in a free society should be left to the sole, sovereign discretion of individuals.

Protectionists argue that Mexicans, Chinese, and other foreigners should not be allowed to sell their products freely in America. But that is simply another way of saying that willing, individual Americans should not be free to purchase products from a willing merchant. Trade restrictions limit the sovereign right of individual Americans to enter into voluntary contracts with others.

The Object of Treaties

Many international treaties and agreements concern relations between governments as they perform their proper roles. For example, neutrality, mutual defense, or extradition treaties concern the functions of national defense and criminal prosecution that generally are exclusive government functions.

Trade agreements, however, regulate commercial exchanges between private individuals and enterprises. Such commercial transactions should be at the sole discretion of individuals. The only exception might be cases of a clear and present danger to national security. Supplying weapons to a military enemy thus could be ruled out.

Unfortunately, governments historically have restricted international trade. The exercise of that power by national governments does not sacrifice a country's sovereignty. Rather, it restricts the sovereign rights of individuals. Thus, any agreement that frees up trade should be considered, *prima facie*, a valid restoration of freedom.

Indeed, the best trade course for the United States would be to remove unilaterally all of its trade barriers, whether other countries do so or not. Unfortunately, that is unlikely to happen soon. Still, any move short of total trade liberalization should be welcomed as a step in the right direction, not a sacrifice of national sovereignty.

The Federal Treaty Authority

Some critics of free trade argue that any kind of trade agreement that binds the United States to conduct its relations with other countries in a certain manner is an infringement on American sovereignty. Trade agreements that define what import and export policies the U.S. government is or is not permitted to pursue, and that establish international bodies to judge whether a country has violated a trade agreement, seem to take decisionmaking power out of the hands of Americans.

But all treaties are pledges by a country to conduct its affairs in a certain manner—that is, to limit its actions. Those pledges are not surrenders of sovereignty but, rather, acts of sovereign governments. When the American people, through the President and Congress, for example, enter into a treaty with Canada, guaranteeing not to invade its neighbor to the North, there is no surrender of sovereignty. America judges the agreement to be in the country's interest. Such a treaty with Canada frees the United States from stationing troops on a 3,000-mile border, at a huge expense to the taxpayers.

Trade agreements mostly limit governments and restore freedom to individuals. When the U.S. government agrees to refrain from some actions, for example, giving subsidies to American businesses, those restrictions usually are to be welcomed.

The sovereignty issue involves the question of whether the United States can exit an agreement that ceases to serve its interest. The answer in the case of all the U.S. agreements is "yes." A vote of Congress and signature of the President will do it. With such an action the United States might well incur the wrath and distrust of other countries—particularly regarding a treaty of a certain duration that America left before it expired. Other countries might act in response, and they certainly would be reluctant to enter future treaties if the United States sought to make them. There

would be a cost to pay. But America's sovereignty would not be violated.

What Constitutes Surrendering Sovereignty?

In the European Union (EU), actual surrender of sovereignty is exemplified. The member governments have ceded certain decisions to the ultimate judgment of a commission composed of representatives of those governments, with weighted votes based partly on the population of the countries. Some powers also have gone to an EU legislature, with members elected directly by the citizens of the member countries. But America's trade agreements do not operate that way.

NAFTA Environmental Agreements

Critics of free trade have focused on the NAFTA environmental and labor side agreements as limits on American sovereignty. The side agreements established a North American Commission on the Environment. (This section details environmental agreements, followed by a section on labor agreements.) At the top is a council made up of high-level representatives from the three member governments. The council is assisted by a Commission for Environmental Cooperation (CEC), with a Secretariat and Executive Director having some independence from the NAFTA governments, to hear complaints that a country is not enforcing its own environmental laws.

Critics are correct that the foregoing mechanism was an unnecessary attachment to NAFTA. If it had worked the way some supporters had hoped, it could have been a threat to American sovereignty. Fortunately, the mechanism of the side agreements has not met the hopes of its supporters nor the fears of its critics.

The question of whether an American law is being correctly enforced should be determined by the U.S. Congress, courts, executive branch, and, ultimately, the American people. It can be validly argued that much of America's regulatory regime violates the letter of the Constitution: that legislators have abrogated their authority to unelected bureaucrats and to judges who have made themselves into legislators rather than interpreters of the laws.

But if at any time, for better or for worse, the U.S. Congress, the courts, and the executive branch enforce a certain policy as law, then that policy *is* the law of the land. A foreign government should have no role in determining whether the law is being correctly enforced. Thus, if the CEC established by NAFTA had the final say on whether the U.S. government was properly enforcing its own law, and if it could force the U.S. government to adopt its position, that indeed would be a breach of sovereignty. But a review of the powers and operation of NAFTA shows that U.S. sovereignty is not endangered.

There are two processes concerning the environment that can be undertaken through NAFTA: (1) fact-finding and (2) dispute settlement.

Fact-finding Process

The complaint. Private parties from the NAFTA countries can inform the CEC Secretariat about enforcement problems with a NAFTA country's own environmental laws. The Secretariat need not act on every complaint. But to proceed, the complaint must meet certain mandatory criteria.

Seeking explanation from governments. If the Secretariat finds merit in a complaint, it asks the accused government for information. If that government indicates that there is an ongoing domestic case or legal proceeding concerning the alleged nonenforcement, the Secretariat must drop its inquiry. If the plaintiff has not sought remedy through the country's own legal system, the Secretariat could drop the inquiry. Other reasons that might cause the complaint to be dropped include enforcement that is inadequate due to lack of governmental resources. There are numerous reasons for a government to legitimately refuse to provide information to the Secretariat. The Secretariat has no subpoena powers.

Whether to fact find. If the Secretariat finds the government's explanation inadequate, then it asks the council of representatives of the three governments whether a fact-finding study should be undertaken. There must be an agreement of two of the three governments.

The study. The study is supposed to be nonjudgmental, focusing on the physical facts of the situation, presenting the critics' allegations and the government's explanation.

Issuing the report. Council members are given a draft report. Two of the three must

agree to make the report public. If two deem the report inadequate for any reason or if the governments involved are satisfied that the problem is being dealt with, the report is voided and never issued.

After the report. When the report is released, the process ends. The report is meant to call attention to a country's failure to enforce its own laws. Operating is the belief that public exposure will pressure governments to abide by their own environmental laws. There is no power to force a country to change its policies and thus there is no breach of sovereignty.

The mechanism established by the NAFTA environmental side agreements is truly a waste of money. Yet at least on paper it does seem to violate American sovereignty.

Dispute Resolution Process

The consultation. If one of the member governments believes that another is engaging in (1) a "persistent pattern of failure to effectively enforce" its own environmental laws; and (2) that the pattern involves "workplaces, firms, companies, or sectors that produce goods or provide services traded between the parties or that compete with goods produced or services provided by another party," it can request consultations with that government. Patterns can only be judged beginning with NAFTA implementation—that is, January 1, 1994. There is a time limit to the consultations. If the accused government convinces the other NAFTA government that the complaint is ill founded or that it is taking steps to reverse the pattern, the case ends.

Decision to investigate. If a plaintiff government is not satisfied in the consultative stage, it must secure the agreement of the other NAFTA government to convene an investigative panel.

The panel study. Panel members are selected from a prechosen roster of experts, some chosen by each of the three NAFTA governments. The expert panel prepares the report on the complaint.

Findings of violation. If a government is found to be engaging in a pattern of failure to enforce its own laws where tradable goods and services are involved, that government has 60 days to offer a remedy to the practice. The panel must certify the remedy.

The fine. If no remedy is agreed to, the plaintiff country can ask the panel to fine the accused government up to $20 million and again request a plan to remedy the offense. The funds from the fine would go into an enforcement trust fund, not to the plaintiff government.

Trade sanctions. Only if a country fails to pay its fine or carry out its remedy can another NAFTA country resort to tariffs to collect the value of the fine. If possible, the tariffs are to be levied on goods or services that were subjects of the case.

Sanction appeal. If a country believes that the tariffs levied against it exceed the value of the fine, it can appeal the fines to the panel.

The mechanism to resolve disputes resembles the one that has operated for decades under the GATT. Neither forces a country to change its policies, but only threatens sanctions if proscribed policies continue. (See discussion on the GATT later.) U.S. sovereignty is not violated. But there are two disturbing aspects of the NAFTA arrangement.

First, as discussed earlier, a country's domestic enforcement of its own laws is none of another government's business. It would be a legitimate issue for resolution if, for example, a country violated the GATT by erecting tariffs not sanctioned by the treaty against American products. But a country's policies that do not directly affect the movement of goods and services are not an appropriate issue for a trade agreement.

A second problem with the NAFTA approach to dispute resolution is the fine that could be levied against a country. Government power to levy fines is a dangerous tool. It should not be put in the hands of foreign governments with the U.S. government as its object. But currently there seems to be no danger of a true violation of American sovereignty, one that would have international bodies levying fines on individual Americans.

Nevertheless, the dispute settlement mechanism is so convoluted that there is little chance that it will ever reach the point of there being a fine levied or a trade sanction authorized.

Environmental Cases to Date

The mechanism established by the NAFTA environmental side agreements is truly a waste of money. Yet at least on paper it does seem to violate American sovereignty. How, then, has the mechanism operated in practice? So far, four complaints have been filed by private parties with the CEC. Two are still pending. None gives any indication of surrendered sovereignty. Explanations of the cases follow.

- The first complaint (SEM-95-001) was

filed on June 30, 1995, against the U.S. government by groups led by the Biodiversity Legal Foundation. The complaint alleged that a Rescissions Act of 1995 resulted in a failure to enforce the Endangered Species Act. Specifically, the act prohibited the U.S. Fish and Wildlife Service from making final determinations concerning species or critical habitats for the rest of that year. The Secretariat did not request a response from the U.S. government, nor that a factual record be prepared. In essence, the complaint was summarily dismissed.

• The second complaint (SEM-95-002) was filed on August 30, 1995, against the U.S. government by groups led by the Sierra Club. The complaint alleged that the Fiscal Year 1995 Supplemental Appropriations Act eliminated private remedies for sales of salvage timber. That complaint met the same fate as the first.

• The third complaint (SEM-96-001) was filed on January 18, 1996, against the Mexican government by private Mexican groups. The complaint alleged that the Mexican government failed to make proper environmental impact evaluations on a development project in Cozumel. The Secretariat requested information from the Mexican government on its response to the charges, which that government provided, and requested creation of a factual record. The case is still being considered.

• The final complaint (SEM-96-002) was filed on March 20, 1996, against the Canadian government by an individual alleging that his government had failed to enforce wetlands laws. The investigation was suspended in June 1996 because a case on the matter was pending before Canadian courts.

NAFTA Labor Agreements

The North American Agreement on Labor Cooperation, NAFTA's other side agreement, established a Commission for Labor Cooperation that consists of a ministerial-level council of representatives of the three governments as well as a Secretariat. The Commission's task is to air complaints about member governments that do not enforce their own labor laws. Commission supporters maintain that it is not meant to replace domestic decisionmaking but only to facilitate education and understanding about policies, and to expose inadequate enforcement to public opinion.

Labor Complaint Mechanism

Although much of this mechanism is similar to that of the CEC, some notable differences render the labor mechanism weaker than the environmental one.

• Private plaintiffs cannot go to the labor Secretariat with a complaint, but must go to an office established by each member government, according to its own laws. In the United States, that is the National Administrative Office (NAO) in the Department of Labor. The NAO experts must judge whether a complaint warrants a fact-finding study.

• A dispute settlement process cannot be initiated by two of the three council members without the experts panel finding a failure to enforce its own labor laws where a trade issue is involved.

• It is also important to emphasize that the labor side agreement does not preclude changes in labor laws. For example, a U.S. Enterprise Zone law allowing a subminimum wage could not warrant NAFTA labor action.

Labor Cases to Date

As in the environmental side agreement, with the labor accord there is little danger to sovereignty, at least in theory, but what about in practice? So far there have been six labor complaints. Although critics might argue that the NAO process is a waste of money, it does not endanger sovereignty.

• The first complaint (No. 940001) was accepted for review by the NAO on April 15, 1994. The Teamsters Union and AFL-CIO alleged that an employer in Chihuahua, Mexico, was denying workers the right to organize a union.

• A second complaint (No. 940002) by the United Electric, Radio and Machine Workers of America, accepted for review on the same day, made a similar allegation against an employer in Ciudad Juarez, Mexico.

The NAO ruled that neither of the two complaints established that Mexico had failed to comply with or enforce its own labor laws. NAO did not recommend ministerial consultations but did suggest that the three governments develop programs to call attention to the right to organize.

• A third complaint (No. 940003), submitted by several international labor groups on August 16, 1994, and accepted for review by the NAO on October 16, 1994, alleged that work-

ers for the Sony Corporation operations in Mexico were not allowed to register as an independent union. The NAO forwarded that complaint for ministerial consultations. As a result, three joint working programs were held on issues regarding union registration in Mexico, and an independent study group was tasked to look into the matter. Reports were issued from the programs and the study group.

- A fourth complaint (No. 940004), which the NAO accepted for review on November 4, 1994, was withdrawn on January 19, 1995, by the plaintiff.
- A fifth complaint (No. 9601) was submitted to the NAO on June 13, 1996, and accepted for review by the NAO on July 29. Human Rights Watch/Americas, the International Labor Rights Fund, and Mexico's National Association of Democratic Lawyers charged that the Mexican government itself was failing to allow employees of its Ministry of Environment, Natural Resources and Fishing to organize and associate with unions.
- One complaint (No. 9602) was forwarded to the Mexican NAO by the Telephone Workers Union of Mexico. It accused the United States of not enforcing its labor laws. The case concerned workers in San Francisco. One week before a scheduled election to establish a union, the company ceased operations, claiming financial difficulties. An American administrative law judge ruled that the company had interfered with the employees' right to organize, but also that it had legitimate reasons for closing its operations.

The Mexican NAO suggested ministerial consultations. As a result, the U.S. Department of Labor agreed to hold a public forum in San Francisco for interested parties to discuss the issue.

That last case came closest to infringing on American sovereignty, but it still was not very close at all. American employers and employees, courts, legislators, and government agencies—not the Mexican government—should deal with American labor policy. But in that case, and others, the worst result from a complaint is a meeting, forum, or report. Critics might correctly say that even these activities are not legitimate functions to be undertaken under NAFTA. But the bottom line is that they do not replace American sovereignty with dictates from foreign governments or agencies.

If the U.S. Congress determines that the WTO proposal is not in the country's best interest and does not pass it into law, it is not law.

The World Trade Organization

Critics have maintained that the new WTO violates America's sovereignty in two ways: (1) through its mechanism for establishing new trade rules, and (2) through its dispute settlement mechanism. Nevertheless, in both situations, ultimate authority remains in the hands of the U.S. government.

Changing Trade Rules

Since the founding of the GATT in 1948, average world tariffs have been reduced from 40 percent to around 3 percent, and other trade barriers have been removed through a series of negotiating rounds. Under the new WTO, instead of the periodic rounds of negotiations, member countries will meet regularly to decide on changes to the GATT. But it is important to understand what the arrangement can and cannot do.

First, each country has one vote on proposed reforms, but a two-thirds majority is needed to pass a proposal. Second, each government still has the option of accepting or rejecting the change. In other words, if the U.S. Congress determines that the WTO proposal is not in the country's best interest and does not pass it into law, it is not law. The U.S. government still is sovereign.

The political dynamics within the new WTO also suggest that the United States has little to fear—owing to its status as having the world's largest economy and as being the world's largest trading country. Other countries would have a strong incentive not to push reforms that the United States would ignore, but, instead, push those reforms that the United States is likely to agree with.

GATT Dispute Panels, Old and New

A GATT mechanism for dispute settlement has existed for decades. If one country accuses another of violating GATT trading principles, it can request a dispute resolution panel. But under the old system, an accused country could delay, indefinitely, a decision. If a ruling by the arbitrator was made against the accused, and if the party at fault refused to change its trade practices, the ultimate result was a trade sanction. That is, the accuser could retaliate by placing a punitive tariff on goods from the country at fault. Such

a sanction, of course, would harm the complainant country's own people and industries by limiting their access to foreign goods and services.

Under the WTO, trade disputes must be heard in a timely manner and a decision must be rendered. But the ultimate sanction, as under the old GATT, remains the same. That is, if a country is found to be acting contrary to GATT principles and refuses to change its policies, the plaintiff can place a trade restriction on the other country's goods. The WTO cannot override an American law now and will not be able to do so in the future.

Under the old GATT there were findings against the United States that the government refused to act on. For example, a GATT panel found that restricting imports of Mexican tuna because the fish were not caught in dolphin-friendly nets violated GATT principles. The United States kept its ban and, in that case, Mexico decided not to retaliate, probably because it was seeking passage of NAFTA. No violation of American sovereignty was involved.

In a recent case under the new dispute resolution mechanism, the United States was found in violation of the GATT because it levied a special tax, for environmental reasons, on certain petroleum imports from Venezuela and Brazil, but not on the same products from American producers. Under the GATT the United States must treat all similar products in a similar manner. In the foregoing case, it should have levied a special tax on all the products or on none. The United States has not decided whether or not to change the policy. Because such a tax is a bad idea, it would be good policy simply to repeal it. If the United States keeps it, Venezuela and Brazil will be allowed to place trade sanctions against American goods. In any case, the ultimate choice is up to the United States. Its sovereignty remains intact.

Regulations Robbing Sovereignty

Some critics of freedom to trade worry that international bodies rather than the federal, state, and local governments of the United States will make regulations for America. Ironically, some fear that foreign bodies will override health and safety laws, whereas others fear that those bodies will impose harsh laws that will destroy jobs and businesses while producing little good for the public.

Regulations do indeed pose a danger. But the potential for problems is not with NAFTA, WTO, or other international agencies or arrangements. Rather, it stems from the American regulatory regime itself. Sovereignty, it can be argued, is not being taken from the American people by a foreign power. It is being taken by the federal bureaucracy.

Article I, Section 1 of the U.S. Constitution states that "All legislative Powers herein granted shall be vested in a Congress of the United States." Thus, the executive branch and its officers, whether career bureaucrats or political appointees, outside the duties specifically assigned to it by the Constitution, can act only pursuant to authority granted specifically by Congress. The executive branch is not supposed to make the law. But Congress for decades has delegated broad, unspecific powers to unelected bureaucrats who essentially make the laws of the land. Those laws are never voted on by Congress. The sovereign grant of powers to Congress has been abrogated by Congress itself.

How does that situation influence the issue of sovereignty and trade agreements? If executive branch officials claim to be acting pursuant to some policy prescription made by an international body, the first question should be "Do they have the authority or discretion, granted by Congress, to act in such a manner?" If Congress has granted them this discretion, then, presumably, they can judge the proposed policy on its merits, and accept or reject it. If the officials seem to act either without the consent of Congress or on abrogated authority, the problem is not with international agreements; it is with the regulatory system that allows for abuses no matter what justification executive branch officials may give.

Conclusion

The danger to America's sovereignty from the NAFTA, GATT, and WTO has been overrated. So far there have been no instances in which the United States was forced to change a policy because of the ruling of an international body. Still, the NAFTA environmental and labor agreements do set a bad precedent. Judgments concerning a country's enforcement of its own laws should rest solely with the government of that country.

The real limits on sovereignty come from other quarters. First, trade barriers limit the freedom of Americans to trade and to dispose

of their property as they see fit. Second, America's out-of-control regulatory regime stems from Congress's delegation of its lawmaking power to the executive branch. Critics who are concerned about sovereignty would do well to address those problems, to restore the sovereign right of individuals to trade.

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5. (Mis)managed Trade

by Claude E. Barfield

During the 1996 primaries and general election campaigns, openly protectionist trade proposals advanced by Patrick Buchanan from the right, by Ross Perot, and by Rep. Richard Gephardt (D. Mo.) from the left did not fare well with voters. The issue of free trade versus protectionism, however, continues to divide Americans; and since the election, neither Buchanan nor Gephardt has given up the fight. Indeed, both have mounted spirited challenges to the expansion of free trade areas in South America and the inclusion of the People's Republic of China in the World Trade Organization.

Buchanan in particular represents a striking throwback to earlier, more nakedly protectionist policies. But his position, though misguided, is refreshingly honest—almost wholly devoid of the deceptive cant forthcoming from many policymakers and opinion leaders who are often heard to say, "I am for free but fair trade," or "I am for free trade with a level playing field."

Despite the recent failures of explicitly protectionist rhetoric to garner voter support, proposals for government intervention to manage trade in the name of opening foreign markets represent the flip side of the government interventionist coin. Managed trade can involve the government of a country limiting the exports of its enterprises to the United States or even to third countries under pressure from U.S. officials. It can involve a country's government "guaranteeing" a percentage of its market to American exporters. Or managed trade can take the form of a government agreeing to change its regulatory regime in a way that harms its own enterprises, to give American firms a competitive advantage.

The Reagan and Bush administrations, although publicly espousing free trade, undertook "temporary" managed trade policies for automobiles, steel, and semiconductors. But the effort was left to the Clinton administration to transform supposedly temporary expedients into a formal policy of "results-oriented" trade.

Certainly it is advantageous for a country to remove its barriers to imports from the United States and other countries. Such restrictions simply punish a country's consumers and its industries that rely on imports.

Managed trade and old-style protection share many characteristics. In both situations, bureaucrats rather than private individuals and enterprises make decisions concerning what is bought and sold. In both situations, special interest groups profit by enlisting the government not to open markets but to manage trade flows. Furthermore, in both situations, government controls limit the freedom of individuals and enterprises to trade. And even further, in both situations, the policies are inconsistent with free markets and limited government. Managed trade is distinct from old-style protectionism, more in operation than in outcome or even intent. This chapter points out the similarities between the two styles and the flaws of managed trade.

That Old-Time Protectionism

The classical form of trade protectionism is found today in the views of Pat Buchanan,

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> **The notion that restricting the freedom of individuals to trade with one another will somehow create wealth is valid neither in economic theory nor in fact.**

Ross Perot, and Rep. Richard Gephardt among others. They believe imports rob Americans of jobs and render the country less competitive. They maintain that trade deficits are problems needing some solution. Yet, the notion that restricting the freedom of individuals to trade with one another will somehow create wealth is valid neither in economic theory nor in fact. The advantages of free trade are acknowledged by libertarian, conservative, and liberal economists alike.

An interesting yet ironic aspect is that the baldly protectionist prescriptions of advocates such as Buchanan, who claim to favor limited government, would have consequences perhaps contrary to the ones they hope for. For example, Buchanan calls for "social tariffs" to compensate for differential wage rates in individual countries. Thus, low-wage Mexico would face higher American tariffs to "equalize" wages. But if adopted universally, such a policy would have unintended and surprising consequences for the United States.

A social tariff policy would be aimed principally at the less developed countries, even though 60 percent of U.S. trade remains with developed countries, not low-wage ones. With such a policy, given the higher total labor compensation among many of America's most important trade partners, this country could face social tariffs against its exports. Germany and France would have to place a 25 percent tariff on American goods to "equalize" wages. Japan would have to place the tariff at 15 percent, up from its current overall tariff rate of less than 3 percent.

Such an outcome is certainly not what Buchanan and other protectionists intend—nor could support. Consequently, the more unapologetic kind of protectionism has not caught on.

Unfair Trade: Foundations of a Flawed Policy

But even though classical protectionism has been slow to revive, an economic danger still exists. Over the past few decades, but particularly in the 1980s, the U.S. government greatly expanded its definition of what constitutes "unfair" trade as well as the remedies for overcoming alleged unfairness. Two major instruments were vital to such expansion: antidumping laws, and Section 301 of the Trade Act of 1974. Both have become the instruments of choice to coerce other countries into accepting the recent favored forms of protection: voluntary export restraints (VERs) and voluntary import expansion (VIE). A typical and ominous pattern has emerged, in which the U.S. government first threatens to invoke antidumping duties or Section 301 but then settles for "voluntary" solutions by the allegedly offending country. Each is examined as follows.

Antidumping as Antitrust

Early in the 20th century when they were first introduced, dumping laws were tied directly to antitrust policy. The theory behind antitrust laws held that firms offering goods or services for prices that were "too low" (below the costs of production) were actually engaging in predatory pricing to drive competitors out of business and allow a firm to establish a monopoly.

As with antitrust laws, laws against dumping initially placed the burden of proof on the accuser who had to show that a foreign competitor had used "predatory" pricing to monopolize markets. Because the tough standard produced few triumphs for domestic producers, the definition gradually was broadened. "Unfair" was applied to differential pricing between the home country and importing country; alleged pricing below the costs of production plus reasonable profit was also deemed unfair.

"Not in Violation But . . ."

Section 301 gives American firms the right to petition the U.S. Trade Representative (USTR) for remedial action against any "act, policy or practice of a foreign country that is unreasonable or discriminatory and burdens or restricts U.S. commerce." Such acts usually include differential regulatory, tax, or performance standards treatment.

If the USTR grants that a complaint is valid, then it must negotiate a settlement within 18 months or devise some form of retaliation—through raising tariffs or other means.

Early interpretations of Section 301 limited its applications to redress for violations of negotiated trade agreements. Subsequent revisions of U.S. trade law in 1979, 1984, and 1988, however, greatly expanded the scope of Section 301 to include any other "unreasonable" act, policy, or practice that is "not neces-

sarily in violation of or inconsistent with the international legal rights of the United States, but is otherwise deemed to be unfair or inequitable." One act that the 1988 law specifically declared unreasonable was denial of the right of establishment, which means that a foreign company is not allowed to create a local corporate presence. Another was denial of workers' rights—for example, the right of workers to organize and strike. Yet another was tolerance by a foreign government of anti-competitive activities by private firms; such activities might, for example, deny distributors selling a firm's products the right to sell competing products.

It should be noted that the recent Uruguay Round negotiations of the General Agreement on Tariffs and Trade (GATT) do not absolutely prohibit unilateral sanctions; but the agreement does stipulate that nations must first use the new World Trade Organization (WTO) dispute settlement procedures before resorting to such sanctions. The United States maintains that, ultimately, it still retains the authority to retaliate against allegedly unfair traders.

Although both antidumping suits and direct retaliation under Section 301 have become important tools in the arsenal of American protectionists, the United States has often settled trade disputes through the more informal, though equally protectionist, negotiation of VERs and VIEs. Especially in the cases of the politically powerful automobile and electronics industries, successive U.S. administrations have preferred those approaches to the more legalistic and time-consuming antidumping and Section 301 procedures.

VERs: The Case of Automobiles

The oil shocks of the 1970s dramatically shifted American consumer demands toward smaller, more fuel-efficient cars. As a result, between 1978 and 1981 the share of Japanese imports, mostly smaller cars, into the American market increased by almost 50 percent, from a share of 17 percent to 26 percent. Meanwhile, more than 200,000 American auto workers found themselves unemployed.

The first VER, which pertained to automobiles, was negotiated with a wink and a nod by the Reagan administration in 1981. Fearing that Congress might pass legislation directly aimed at curbing those imports, and with the threat of a wave of antidumping suits, the Reagan administration and the Japanese government agreed to a "voluntary" annual ceiling on Japanese auto imports. Although granting relief to a purportedly beleaguered U.S. automobile industry, the results were hugely expensive for the American economy, particularly for consumers. The genuine beneficiaries were Japanese and European auto makers, who reaped high profits on the automobiles they did sell in the United States—an estimated $2 billion for Japanese and $1.5 billion for European auto makers in 1982 alone. With fewer autos available to American consumers, and with less competition, all manufacturers—Japanese, European, and American—were able to charge higher prices.

Robert Crandall of the Brookings Institution has calculated that the informal quota added about $2,000 to the price of a midsize American car. Other economic studies have revealed that the cost per American auto worker job supposedly "saved" was $180,000.

The Myth of Mighty MITI

The restrictions on Japanese auto imports had another unintended consequence. In the early 1980s, many American politicians and industrial interest groups were raising the specter of an all-powerful Japanese Ministry of International Trade and Industry (MITI), a body assumed to be busily manipulating world markets and trade flows. In fact, much of MITI's advice and many of its policies did not help the Japanese economy. For example, in the early 1960s, MITI advised Japanese auto manufacturers to produce only a few vehicle models rather than produce the diverse line of cars that they were later to sell successfully in the American market. But critics correctly maintained that MITI tended to act in ways that restricted imports into Japan's market.

Ironically, the restrictions on Japanese auto exports to the United States further empowered MITI bureaucrats: It was MITI that parceled out the quotas to individual Japanese auto companies and made the key decisions concerning who received the largest shares of the $2 billion in windfall profits from higher prices charged in the American market. In retrospect, students of Japanese government have noted that during the 1970s, as Japanese corporations became more global, MITI was gradually losing power but U.S. policy gave that body a temporary new lease on life.

It was the Clinton administration that embraced managed trade as the centerpiece of the U.S. trade agenda.

Another example of the adverse effects of managed trade is the fact that, while the U.S. auto import quota system has lapsed, MITI retains a strong guiding hand in an even more tightly binding quota system for Japanese exports to the European Union. That supposedly voluntary system was also negotiated with Europe in the mid-1980s; its stated aim has been to allow European car producers time to adjust to Japanese competition. Although that system is slated to end in 1999, the president of Peugot, the French auto maker, recently called for an indefinite extension. With the European economies facing high unemployment numbers and slow (or no) economic growth, pressure for such an extension will be a true test for the European Commission. Rather than enjoying freedom to trade, European and Japanese citizens and enterprises have their transactions managed by bureaucrats.

VIEs: The Shift to Export Protectionism

Although forced to impose import restrictions on automobiles, the Reagan administration was aware that VERs were a clumsy and costly political expedient. Driven by the high U.S. dollar and a rapidly expanding economy, a trade deficit burgeoned in the mid-1980s. Such deficits are not an economic problem per se. They simply demonstrate that citizens of one country purchase more products than citizens of another do. In the 1980s, the deficit was an indication of America's prosperity.

Still, the Reagan administration felt it had to deal with the deficit, by instituting more export-oriented trade policies. Beginning in 1985, the administration made selective use of Section 301 to open up foreign markets to American exports. Between 1985 and 1989, 33 Section 301 cases and 217 antidumping actions were initiated.

The Reagan and Bush administrations were also responsible for moving toward VIEs, at least on an ad hoc basis. In 1986, the Reagan administration negotiated a semiconductor agreement with Japan, an agreement that combined some of the worst and most costly features of earlier automobile quotas along with a new demand for special privileges in the Japanese semiconductor market. For example, the import restrictions set such a high floor price on basic semiconductor chips that later economic analyses calculated that they had resulted in a transfer of more than $5 billion of profits to Japanese semiconductor producers—a sum promptly plowed back into semiconductor research and development.

Of equal significance, the United States forced the Japanese government to help ensure that foreign suppliers would gain 20 percent of the Japanese market. That market share target was set out in the supposedly secret sideletter accompanying the agreement in which the Japanese government acknowledged the American expectation that foreign semiconductor suppliers would achieve 20 percent of the Japanese market within five years. The Japanese government stated its belief that "this (percentage) can be realized and welcomes its realization."

During the Bush administration, the semiconductor VIE was extended, and that administration negotiated a second VIE for automobile parts. The latter was notable for two reasons. First, unlike with the semiconductor agreement, the Japanese government did not officially undertake the achievement; that effort was left to Japanese private companies. Second, the agreement favored American companies specifically, stating that "special consideration will be given to the U.S. parts industry, which is currently under a difficult situation."

Clinton's "Results-Oriented" Policy

Although both the Reagan and Bush administrations have much accountability for their abetting the drift toward managed trade, it was the Clinton administration that embraced managed trade as the centerpiece of the U.S. trade agenda. From the outset, U.S. Trade Representative Mickey Kantor and the late Commerce Secretary Ron Brown stated that "measurable results" and "objective criteria" would form the basis for future U.S. trade agreements. As Kantor put it, "if you don't get real numbers in an agreement, you'll effectively have nothing." He likened the demands on the Japanese government to "affirmative action" programs in the United States.

Laura Tyson, then chairwoman of the Council of Economic Advisors, also defended VIEs, but with a nuance. Pointing specifically to so-called strategic industries, she argued that a results-oriented approach "may be

essential if barriers to critical foreign markets are causing serious harm to domestic producers in important high-technology industries."

Organizations representing U.S. domestic producers quickly rallied behind the Clinton administration's new *dirigiste* tilt. Both the Advisory Committee on Trade Policy and Negotiations (ACTPN), a business advisory group to the USTR, and the Council on Competitiveness, another trade-related business group, issued a report strongly backing numerical trade targets, particularly regarding the Japanese market. Also, the ACTPN report stated that "failure to achieve the indicator (target) within a pre-agreed time frame would call for internal review in the United States, and/or bilateral discussions to determine what additional measures are necessary to achieve the result, possibly leading to retaliation."

From the outset, as a part of new "framework negotiations," the Clinton administration demanded that the Japanese government agree to guaranteeing quantitative benchmarks in four sectors: (1) automobiles and automobile parts, (2) medical equipment, (3) telecommunications equipment, and (4) insurance.

In the 1996 negotiations to renew the pact, the United States demanded continued government-to-government oversight of the semiconductor industry in Japan and its trade with America. To their credit, the Japanese adamantly refused to continue oversight. Unfortunately, industry associations in both countries, at the urging of their governments, will create the World Semiconductor Council to collect data and make suggestions to the governments. More ominously, the United States and Japan will create the Global Government Forum to receive reports and recommendations from the council. Those actions seem to set the stage for a more formal version of the ad hoc managed trade in semiconductors that began a decade ago.

Automobiles, Unilateralism, and the WTO

The major battle over targeted import quotas, concerning American auto and auto parts exports, was fought in the first half of 1995. Despite claiming victory, the Clinton administration backed away from retaliation when the Japanese government firmly refused to guarantee a share of the auto and auto parts market to American companies.

Events leading to that confrontation had a bizarre, even random, quality. Although the Clinton administration had given priority to the automobile sector during the initial talks in 1993, regarding the U.S.-Japan framework, it reacted calmly in July 1994 when Ryutaro Hashimoto, then trade minister in Japan, resisted U.S. demands for quantifiable import targets. During the fall of 1994, Commerce Undersecretary Jeffrey Garten and others indicated that the administration was seeking "other methods" for dealing with the Japan problem. Understandably, then, the Japanese government was quite surprised when suddenly, at the end of March 1995, Clinton spokesmen reversed course—and rhetoric—and moved toward a confrontation.

Undermining GATT

One other important event occurred during that period: The new multilateral trade rules adopted by the Uruguay Round of the GATT came into force on January 1, 1995. The newly created WTO had a much stronger dispute settlement process than that under the old GATT. Establishing that process had been a top U.S. priority. Although the new rules did not preclude a country from taking unilateral action, they did demand that grievances first be taken to the WTO. Furthermore, the rules forbade a country from unilaterally changing bound tariffs unless a WTO panel found the alleged offending nation guilty.

U.S. demands on Japan essentially involved three issues: (1) increased purchases of U.S. automobile parts by Japanese manufacturers, both in the United States and in Japan; (2) a fixed number of new dealerships in Japan offering American-made autos by the end of 1996 and the year 2000; and (3) easing of some of Japan's restrictive inspection rules for critical auto parts. One problem Japanese negotiators experienced (as did the media reporting on the negotiations) was the clearly duplicitous public and private stance of U.S. negotiators. As the deadline for a settlement, June 30, 1995, neared, American negotiators reiterated that they were "not after numerical targets," in the words of Jeffrey Garten. Yet it was clear that the United States, at the negotiating table, did push for both specific numbers and for some kind of endorsement by the Japanese government for validity of the numbers.

Section 301 Bullying

In early May 1995, with Hashimoto and his cohorts refusing to accept targets, Kantor invoked Section 301 and threatened to impose 100 percent tariffs, at a total cost of $5.9 billion, on 13 luxury Japanese car models exported to the United States, unless Japan changed its position by June 28, 1995. At the same time, the United States announced its intention to take the case before the WTO. Japan responded to the U.S. threat by steadfastly refusing to agree, by fixed dates, to numerical targets. Japan also announced its own intention to appeal to the WTO if the United States indeed invoked sanctions unilaterally.

The result of the U.S.-Japan clash serves as an object lesson in Washington public relations spin. President Clinton hailed the achievement of "real concrete results" that were "specific" and "measurable." Kantor, straddling the boundary between obfuscation and outright misstatement, later claimed that the "increased commitment by Japan can be enforced by U.S. trade laws." Both the President and Kantor wanted the public to believe that, once again, the Japanese government had itself signed off on a government-to-government guarantee for additional market share for U.S. (and foreign) automobile companies.

Such an interpretation was flatly belied by the documents actually signed by the two governments—and by statements from Japanese officials at the signing and later. An alleged $6.75 billion increase in sales of American automobile parts to Japanese manufacturers, hailed by the Clinton administration, was merely a compilation of business plans announced independently by a group of Japanese automobile companies. The official communiqué from the two governments, which was widely publicized by the Japanese government, explicitly acknowledged that the plans "are not commitments . . . . Rather, they are business forecasts and intentions of the companies based on their study of market conditions . . . . Both ministers recognize and understand that changes in market conditions may affect the fulfillment of those plans." More surprising, the United States agreed to the explicit concession that the plans "are not subject to the trade remedy laws of either country," seeming to foreclose—despite Kantor's disclaimer later—the use of Section 301 for automobile parts.

Regarding increased foreign dealerships, the Japanese government merely agreed to send letters affirming the freedom of companies to establish multiple-brand dealerships. Furthermore, Japanese companies agreed to appoint a contact person to facilitate joint dealerships.

Finally, the Japanese government agreed to ease regulations for independent auto repair shops that compete with dealer shops and to expand the list of parts that did not require strict certification.

WTO Rules

In the Uruguay Round, the United States had insisted on the new dispute settlement procedures. As mentioned earlier, the rules did not prevent a nation from retaliating unilaterally against an alleged unfair trade practice but they did circumscribe unilateral action in two ways. First, they required WTO nations to use the procedures of the multilateral dispute system before retaliating. Second, they forbade retaliation by increasing WTO-bound tariffs with the offending nation, action which would have violated the multilateral unconditional most-favored-nation rule.

One of the most damaging actions the United States took during the confrontation on Japanese automobiles was announcing that it was prepared to flout the new rules by imposing punitive tariffs against Japanese automobiles before undergoing the WTO dispute settlement process. Although the matter was settled before the threat could be carried out, the United States had, in effect, announced to the world its willingness to destroy the new system that it had itself demanded as an accompaniment to the new substantive rules of the Uruguay Round. There could be no worse example for other nations that might enter trade disputes in the future.

Arguments for VIEs: The Flaws

Over the past three years, administration officials have advanced a variety of arguments defending the use of VIEs. Five of those claims are (1) that VIEs are a means of reducing America's trade deficit with Japan, (2) that the disparity of import penetration in targeted sectors proves that the Japanese market is closed to foreign companies, (3) that in key sectors the tightly organized Japanese *keiretsu* system of exclusive supplier agreements and business ties precludes foreign competition, (4) that U.S. demands for import targets benefit all

nations in the international system, and (5) that temporary VIEs for U.S. companies will not undermine the multilateral trading system. But all of those arguments are questionable.

1) *Trade Deficits.* Clinton administration trade officials have repeatedly argued that targeted import quotas constitute an indispensable tool in reducing the U.S. trade deficit. As the late Commerce Secretary Ron Brown put it, "The only logical way . . . to address the trade deficit is to have some measurable results, some targets."

As is often the case, however, one part of an administration does not know what another part is arguing; thus the party line gets muddied. Indeed, President Clinton's chief economic adviser, Joseph Stieglitz, in the 1996 *Economic Report of the President*, flatly—and correctly—rejected the economic fallacy that targeted import quotas will change the overall size of the U.S. trade deficit. As the report stated, the trade balance "represents the bottom line on the income statement of the United States. If it is positive, the United States is spending less than its total income and accumulating assets. . . . If it is negative, as it has been in most recent years, our expenditures exceed our income, and we are borrowing from the rest of the world." The report concluded: "The continuing external deficit remains a cause for concern, but it must be kept in mind that the deficit is caused by macroeconomic factors, not trade policy. It should not be used as a test of whether our trade policy is beneficial."

A consensus among economists holds that if all trade barriers between the United States and its trading partners were to be removed, the U.S. trade balance would change by no more than 10 to 15 percent. That consensus is the chief reason the President's own *Economic Report* pointed out that "the most effective policy option for reducing the trade deficit is the reduction or elimination of the Federal budget deficit." One lesson, then, certainly must be "Mickey Kantor, call home!"

2) *Disparity in Import Penetration.* Another often cited argument for mandated import targets is that Japan or other countries might be importing less than the average amount of market share that American goods hold in other countries or regions. For instance, to support renewal of the semiconductor pact, the USTR argued that because American firms had 50 percent of the European market and 40 percent of the Asian market, excluding Japan, their control of only 20 to 25 percent of the Japanese market was proof of trade barriers.

That claim truly is economic and statistical nonsense. It completely ignores the fact that Japanese companies are the only worldwide competitors with U.S. semiconductor producers and naturally, as with U.S. companies in the U.S. market, they will have a strong position in their own home market. Indeed, the Japanese could well turn the tables on the U.S. government, using the same flawed logic. Japan's worldwide semiconductor market share is about 40 percent; yet it has attained only about 20 percent of the European market and 23 percent of the U.S. market. Why should it not then file an unfair trade practices suit against the United States and Europe if the U.S. position is to hold for all that wish to stand by it?

Concerning automobiles, the U.S. assertion that low market share is only the result of unfair Japanese trade practices will not endure any analysis of the history of American automobile companies' involvement in the Japanese market. Those companies, by their own admission, have rarely exerted much effort to penetrate the Japanese market. As Chrysler chairman Robert Eaton stated in 1994, "We expect to be only a niche player. . . . We don't have any volume or penetration goal [for foreign markets]."

Until 1993, no American automobile company produced a right-hand-drive vehicle for the Japanese market. Even today, none of the Big Three firms, General Motors, Ford, and Chrysler, market models in the small two-liter-and-under class, which is the dominant class in the Japanese automobile market. In contrast, the Europeans, whose market penetration is growing rapidly, offer more than 100 right-hand-drive models and 124 models in the two-liter-and-under category. In 1993, European automobiles, mostly German, captured over one-third of the Japanese luxury auto market.

Such reality recently led one trade policy analyst to conclude that, like other American industries, the automobile industry "has been trying to gain a competitive advantage that would not be attainable in the absence of U.S. government pressure or threats."

3) *Keiretsu.* Even relatively moderate critics of Japan, such as Tyson, and trade economists C. Fred Bergsten and Marcus Noland, both of the Institute for International Economics, have identified the *keiretsu* as an important barrier to competition in the Japanese market. There are several types of *keiretsu*. Most critics have focused on the so-called vertical *keiretsu*, which

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are characterized by long-standing contractual or interfirm relationships and exclusive contracts between upstream and downstream suppliers and manufacturers. In some instances, according to Bergsten and Noland, the existence of "discriminatory networks of affiliated firms" justifies the institution of VIEs.

On closer examination, however, the arguments against the *keiretsu* are fraught with difficulties and contradictions. One should recall that the *keiretsu* are merely a form of industrial practice and organization. It is true that in the United States, at least until recently, a form of vertical integration much tighter than the *keiretsu* was the norm in most sectors. Thus, in the automobile industry, rather than outsourcing the production of many of their parts and components, the Big Three kept production within their own corporate confines. The situation changed in the 1980s when Chrysler and Ford began to outsource a good deal of parts manufacturing and developed a *keiretsu*-like relationship with many of their new suppliers. Today, Chrysler makes only about 30 percent of its parts in-house, and Ford only about 50 percent. General Motors has lagged far behind in that regard, but as a recent strike demonstrated, the company now is determined to increase its efficiency by outsourcing a larger percentage of production in the future.

Managed trade is contrary to the freedom to trade goals that American policymakers have appropriately sought in the nearly 50-year history of the GATT.

In contrast, in the semiconductor industry—the subject of much trade conflict between the United States and Japan—IBM is not only a major computer manufacturer but also a semiconductor manufacturer. Indeed, it produces in-house most of the semiconductors that it supplies to its computers.

Can one imagine the reaction of the Big Three, IBM, or the USTR if Japanese companies demanded that those companies be broken up because Japanese companies could not compete against in-house parts manufacturing?

As economist Paul Sheard of the University of Melbourne recently wrote after an exhaustive analysis of the *keiretsu* practices, "popular discussion associating *keiretsu* with anticompetitive behavior lacks a solid foundation in economic analysis." Similarly, economist Gary Saxonhouse of the University of Michigan queried, "Why is formal vertical integration in the United States better or fairer than informal integration in Japan?"

4) ***Open for All.*** Although successive U.S. trade representatives have avowed that the goal of VIEs and other unilateral demands is to open markets for all nations, the results belie those virtuous claims. Thus, South Korea initially opened up its insurance markets only to U.S. insurance companies. The powerful European Union later also forced its way into the Korean market, but for small countries Korea said, "Forget it." Canada, when threatened with a Section 301 suit against egg and dairy producers, merely doubled the U.S. quota without changing total imports. In other instances, such as for automobile parts and beef, the EU and Australia have complained bitterly that even though no official discrimination exists, Japanese companies have routinely favored U.S. companies, to relieve pressure from the U.S. government. Finally, there has been the spectacle of cash-rich Taiwan and South Korea organizing shopping tours by their companies. One such trip by Korean companies netted over $2 billion of largely trade-diverting purchases in 1987.

Thus, managed trade is contrary to the freedom to trade goals that American policymakers have appropriately sought in the nearly 50-year history of the GATT. The goal of trade policy under the GATT has been to remove governments and bureaucrats from economic transactions between individuals and firms in different countries. Because elimination of all government involvement has, unfortunately, not been possible, governments have pledged themselves at least to abide by basic rules. Most notable is the most-favored-nation principle, by which countries agree to have nondiscriminating tariffs and other barriers to other countries. The record of managed trade is a record of greater government involvement in trade and explicit discrimination for or against certain countries.

5) ***Temporary Arrangements.*** Finally, supporters of VIEs have argued that they are containable and will be used only in special situations. If the history of the U.S.-Japanese automobile and semiconductor negotiations is any indication, however, the demand for VIEs is likely to spread and extend far into the future, vitiating multilateral rules in the process.

As many critics of the original U.S.-Japan semiconductor agreement predicted, the United States was not satisfied when foreign semiconductor imports into the Japanese market reached 20 percent. It had demanded, without disclosing what it considered a reasonable percentage of the Japanese market, that the agreement be extended indefinitely. Further complicating matters, the EU, which has severely criticized the current agreement

as discriminatory against European companies, has recently demanded that it be included in any new agreement signed by the United States and Japan. Should that occur, it would be difficult to exclude the Koreans, for they now, with the Europeans, account for about 10 percent of the world's semiconductor market. Such an arrangement, should it come about, would have all the makings of a four-nation cartel.

A similar scenario could unfold in automobile and automobile parts, a sector in which again the Europeans and Koreans have an even stronger presence in world markets. Any future Japanese cave-in, however unlikely at the moment, would certainly be followed by an EU demand to be included. Likewise, Korea, with a small but growing share of the world automobile market, would have a strong case as a fourth participant.

Conclusion

In charting its future course with regard to voluntary export and import restrictions, American policymakers would benefit if they were to heed the counsel and advice of President Clinton's own Council of Economic Advisers. In the 1996 *Economic Report of the President*, the council stated,

> Every protectionist action invites retaliatory reaction. The costs of a tit-for-tat escalation are so high that in the long run all countries are likely to lose from the adoption of restrictive policies. . . . Even when trade restrictions are used to curtail unfair foreign competition, they can still impose costs to consumers.

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6. Unclean Hands: America's Protectionist Policies

by Stuart Anderson

American policymakers often justify trade barriers against other countries on the premise that the United States practices free trade while other countries erect trade barriers and engage in unfair trade practices. Claiming to favor "free but fair trade," they propose that America keep its markets open only to countries that dismantle their trade barriers. But in fact American policymakers often erect barriers and indulge in the kind of unfair practices that they are fond of denouncing.

Russia's Ambassador to the United States, Yuri Vorontsov, at least was honest when his government increased its tariffs on American poultry. He delivered a forthright defense of protectionism, noting that "the cost is on the shoulders of the Russian consumer, as usual."[1] He did not claim to be reacting to American protectionism. But if he follows the example of U.S. policymakers, he might well use this excuse in the future.

American policymakers use a variety of practices, such as antidumping laws, to restrict imports—often in the name of "fair trade." Such restrictions usually are at the behest of American special interests seeking to restrict their competition.

The first and foremost result of these practices is to harm American consumers. If the United States simply eliminated all tariffs and quantitative restrictions on imports, the net welfare gain to consumers would be $15.49 billion a year, according to a 1995 U.S. International Trade Commission report.[2] (See Table 1.)

The author formerly was director of trade and immigration studies at the Cato Institute.

That is probably a conservative estimate. Economists Gary Clyde Hufbauer and Kimberly Ann Elliot placed the total costs of protectionism in 1990 at $70 billion.[3] American consumers, families, and particularly businesses that rely on imports as raw materials or components for production would benefit significantly if the United States unilaterally removed all import restrictions.

America's protectionist policies also make it more difficult to maintain and expand freedom to trade worldwide. Policymakers in other countries understand that America's holier-than-thou trade rhetoric rings hollow.

If America wishes freer trade, it would do well to start by dismantling its own barriers to trade and ceasing its own unfair trade practices.

It Starts with Consumers

American government officials often complain about trade restrictions imposed by other countries. One reason is that, generally speaking, America is among the world's least protectionist nations. In some ways that distinction is akin to being among the most righteous men at the local brothel.

Despite America's less protectionist track record, its policies remain far from pure. The U.S. government continues to make numerous interventions in international trade that have no economic basis. Protectionist policies in the late 20th century take forms different from the tariffs that traditionally were the restriction of choice. And politicians gain political support by favoring a particular industry while the

nation's consumers lose out. But while other nations may harm the welfare of their own people through protectionist trade policies, that is no argument for inflicting damage on the well-being of Americans by limiting foreign companies' access to the American market.

The list of products with U.S. import restrictions includes meat, footwear, frozen fruit juices, and many other items, most of which have well-funded lobbies. The literature on textile and apparel import restraints alone is voluminous.

Table 1 shows how the economic welfare of U.S. citizens would change if all import restrictions on foreign-made products were removed. The calculations take into account the fact that some workers in particular industries would have to change jobs. But that should not be viewed any differently than a restaurant laying off workers because another, more popular, restaurant moves in around the corner. Competition raises the quality of goods and services and thereby raises the standard of living for consumers and society at large. The nationality of the producer is not relevant to the equation.

Table 1

Economic Welfare Change from Liberalization of All Restraints, by Sector, 1993

(Million dollars)

Economic Sector	Welfare change
Simultaneous liberalization of all significant restraints[1]	15,490
Individual liberalization:	
Textiles and apparel[2]	10,037
Maritime transport (Jones Act)	2,790
Dairy	1,013
Motor vehicles	710
Sugar	661
Meat	185
Blast furnaces and steel mills	162
Non-rubber footwear	147
Home audio and video equipment	98
Industrial inorganic and organic chemicals	62
Rubber and plastic footwear	48
Ball and roller bearings, and parts	47
Ceramic wall and floor tile	41
Frozen fruit, fruit juices, and vegetables	24
Costume jewelry and costume novelties	11
China tableware	11
Personal leather goods	11
Leather gloves and mittens	6
Cotton	0.3

[1] Does not include the effects of liberalization of peanut quotas.

[2] Upper bound of estimates. See chapter 3.

Source: Estimated by the staff of the USITC.

Textiles

Perhaps America's most costly form of protectionism is the restrictions placed on imports of textile and apparel products. Unlike most products, until a few years ago textiles and apparel were explicitly exempted from the decades of trade liberalization that took place under the General Agreement on Tariffs and Trade (GATT). Starting with the ironically named Short-Term Arrangement in 1958, textile and apparel imports were subject to quota restrictions. In the 1980s, when the Multifiber Arrangement was up for renewal, President Reagan's Council of Economic Advisers placed the annual cost to consumers of restrictions on textile and apparel imports at that time between $20 billion and $40 billion annually.[4] The U.S. International Trade Commission (ITC) put the cost in 1991 at approximately $10 billion. In any case, under the new GATT agreement, quantitative import restrictions will be phased out over the next decade.

Peanuts

Children's TV star Barney the Dinosaur sings a happy tune about peanut butter: "First you get the peanuts and you crunch 'em you crunch 'em up—for your peanut, peanut butter and jelly." American parents who listen to that song are likely unaware that the U.S. government makes their children's peanut butter more expensive than it ought to be.

The price of peanuts was approximately 4 cents a pound higher in the United States than on the world market from 1993 to 1994.[5] The import quotas on peanuts are, in part, due to a strange economic goal of the U.S. government—keep domestic peanut prices from falling. Since 1934, taxpayers have paid peanut farmers either not to grow their product or to ensure the farmers high prices without great regard to output in a particular year. Through a quota support pricing system, the federal government sets a national quota for total poundage, and peanut farmers become "domestic quota holders." It is a federal crime to grow peanuts for sale without a peanut growing license; and a license is almost impossible to get for those who have not grown peanuts in the past. Those with licenses have strict quota limits on what they can produce.

If large amounts of peanut imports enter-

ed the American market, then prices of course would drop. That would be great for American consumers but bad for the U.S. Treasury because the government would have to make up the difference in price by paying peanut farmers. According to an ITC report, "The import quota is designed so as to limit the cost of domestic price support programs to the U.S. treasury."[6] From 1953, the import quota on peanuts remained at 1.7 million pounds a year—covering only *one-tenth of 1 percent* of all domestic edible peanut consumption in the United States.[7] Presidential proclamations in 1955, 1956, 1980, and 1991 were needed to temporarily increase the quotas. American peanut butter producers in particular have been vocal critics of the import quotas. American consumers would gain $92 million a year if the peanut import quotas were lifted. Trade barriers raise the price per 16 oz. jar of peanut butter an estimated 40 cents.[8] Yet it is difficult to eliminate such quotas because the peanut farmers who currently benefit from them fight hard to keep the quotas.

The Uruguay Round of the GATT, completed in 1994, made some headway for American consumers. The quotas on imports of peanuts and certain peanut products rose from 775.18 metric tons to 30,393 metric tons and will rise to 53,406 metric tons by the year 2000. This means imports will account for about 7 percent of America's annual peanut product consumption. A tariff-rate quota replaces the previous quotas that amounted to a virtual prohibition on importing products above the quota. A tariff-rate quota sets different tariff rates for items above and below the quota. For example, on shelled peanuts below the quota the tariff will be 6.6 cents per kilogram but for those imported above the quota the tariff rate will be a whopping 151 percent ad valorem. It is important to remember that such restrictions increase prices on goods not only above the quota but below it as well by reducing the available quantity that can be imported.

Sugar

Sugar is another striking example of special interests winning out over the broader interests of consumers. A 1993 General Accounting Office report concluded that the U.S. sugar program, including its tariff-rate import quotas, costs consumers $1.4 billion a year.[9] Sugar imports over quota pay a duty of approximately 16 cents per pound. Removing the quotas would reduce prices on sugar-related imports by 44 percent. Candy producers have fought an unsuccessful battle to remove key elements of the sugar program.

Milk

Since the Agricultural Adjustment Act of 1933, the U.S. government has for the most part banned the import of products derived from cow's milk. Quotas have limited such dairy imports to approximately 2 percent of total U.S. milk production. Similar in operation to the peanut program, the milk program limits imports to prevent consumer prices from falling because that would disrupt the federal government's program to support high prices for milk.

According to the U.S. International Trade Commission, Americans would gain at least $1 billion in net benefits from removing America's import quotas on milk. By changing the quota structure, new GATT requirements will help consumers by allowing more imports of butter, cheese, and nonfat dry milk to reach the stomachs of Americans.

As in the case of sugar and peanuts, only politics prevents Americans from buying as many foreign-produced dairy products as they would like. No economic rationale exists for these restrictions.

The Jones Act

Even though "buy American" measures find their way into various pieces of legislation on Capitol Hill, that does not prevent the Office of the U.S. Trade Representative (USTR) from complaining, for example, that government officials in Brazil maintain their own "Buy National" policy.[10] The elaborate quota system on agricultural imports into the United States also does not prevent the USTR from protesting Honduras' policies that mix tariffs and quotas. "The U.S. government has strongly opposed this policy, which limits access of U.S. agricultural products," complains the USTR.[11]

Few inconsistencies in the official 1996 *Trade Estimate Report on Foreign Trade Barriers*, produced by the office of the U.S. Trade Representative, are more brazen than the U.S. government's protests over Spain's shipping restrictions. The USTR's report states:

In 1992, the European Union established a calendar for liberalizing cabotage practice. While cabotage within peninsular Spain has been liberalized, the EU has allowed Spain to restrict merchant navigation to and within the Balearic Islands, the Canary Islands, and Ceuta and Mililla to Spanish flag merchant vessels until January 1, 1999.[12]

The irony of that complaint is that U.S. law requires all goods shipped within the United States and most exports of products produced or shipped with U.S. government assistance, such as food aid, to be transported on merchant vessels registered in the United States. The Jones Act, passed in 1920, prohibits merchandise traveling by water between American ports to be transported "in any other vessel than a vessel built in and documented under the laws of the United States and owned by persons who are citizens of the United States."[13]

In recent years, for example, hog farmers in North Carolina have found that the Jones Act has hindered their ability to secure feed grain. Barring foreign shippers has served to limit competition, kept shipping prices high, and forced American companies to find other means to ship or send their products domestically. It also may encourage companies to import feed grain rather than buying domestically.

For those reasons Sen. Jesse Helms (R-N.C.), never known as a free trader, introduced legislation that would open up domestic shipping to foreign-flag vessels.[14] On the floor of the U.S. Senate, Helms called the Jones Act "a harmful anachronism that enables a few waterborne carriers to cling to a monopoly on shipping." He noted that the Jones Act prevents some of his constituents, North Carolina pork and poultry farmers, from buying sufficient feed grain from the Midwest. They could not find the necessary certified vessels for shipping. Rail shipments have proved to be an insufficient alternative because of an insufficient number of cars for carrying grain. Instead, the farmers must import their grain, generally from Canada.[15]

Grain producers and their customers are not the only ones hurt by the Jones Act. The steel, petroleum, and chemicals industries, to name a few, also oppose the current restrictions on shipping because the restrictions raise prices on their products. Oil shipments from Alaska to the lower 48 states account for a large amount of the Jones Act shipping and keep gasoline prices higher than they otherwise would be.

In some cases, the act reduces exports by raising the cost of conveying products, such as coal and clay, to coastal ports for export. Residents of Alaska and Hawaii suffer disproportionately from the Jones Act. Overall, by eliminating the Act the United States would reap benefits of $3.1 billion a year, according to the U.S. International Trade Commission.[16] That is the net benefit, taking account of the adverse impact on privileged shipping interests that now benefit from the Jones Act. The direct savings to consumers would be far higher. The price of shipping services now restricted by the law would decline by an estimated one-quarter.[17] But because the Jones Act requires that American sailors be employed for domestic maritime shipping, the law has significant support from organized labor.

Even American yacht owners are affected by related cabotage laws. Yachts cannot be chartered in the United States unless they are American-made and manned by American crews. And while the Jones Act does not cover cruise ships, its sister law, the Passenger Vessel Act, does. That law prevents nearly all of the world's major cruise lines from setting sail from an American port. In 1993, Vancouver, British Columbia, had close to 260,000 embarkations, compared with nearby Seattle, which—because of the restrictions—had only 8,700.[18]

Antidumping Laws

"Antidumping laws as they are written and implemented are protectionist and anti-consumer," notes Consumers for World Trade, a Washington, D.C.-based public interest group.[19] Antidumping laws are meant to exclude from the American market foreign products priced below the cost of production. That practice is labeled by American policy as "unfair."

The rationale behind antidumping laws is that they protect domestic producers. Theoretically, in the long run, they protect consumers by preventing a foreign company from driving American firms out of the market and establishing a monopoly. In fact, those laws protect domestic producers from competition, and consumers face higher prices and fewer choices of products.

It is difficult to construct a scenario whereby a producer could drive out all competition

through low pricing, especially in today's integrated global economy. Meanwhile, consumers would benefit from the lower prices of "dumped" goods.

In any case, antidumping laws are not based on sound economic assumptions. First, pricing below the cost of production often is necessary for an enterprise to limit losses when the price of a product falls. For example, in the 1980s American trade officials accused Japan of dumping computer memory chips on American and other markets. But falling prices and competition from Korean and other producers meant that Japanese manufacturers in many cases could only sell their chips below their costs of production. Second, the formulae by which prices are calculated to make international comparisons intentionally distort prices to make it easier for American companies to gain protection against imports.

One recent antidumping case seems intended to make Italian dinners more expensive for Americans. American companies control approximately 80 percent of the domestic pasta market. Yet their concern that Italian pasta was cutting into their sales brought not better marketing or upgraded quality but, rather, an antidumping complaint. At up to $2.35 a pound, De Cecco pasta, imported from Italy, already costs twice as much as most American pasta. Nonetheless, the ITC ruled that Italian pasta was being dumped on the American market and assessed on it a 47 percent additional tariff, significantly increasing its price and allowing American producers to raise their prices as well.[20]

America's antidumping code proceedings have garnered a Star Chamber reputation. The U.S. Department of Commerce makes an initial judgment and helps set the penalties should dumping be found by the ITC. Filippo Antonia De Cecco, president of De Cecco Pasta, described the process his company endured:

> They gave us 12,000 questions. We answered all of them. We produced 60 kilograms of documents. They gave more importance to the form, to the fact that maybe one or two questions were not answered right. But the substance of what we submitted was right.[21]

Between 1992 and 1994, the time period for which the ITC ruled the American pasta industry was "materially harmed," sales for American pasta makers were virtually unchanged. Even though the American companies' share of the domestic market dropped from 86.2 percent to 80.7 percent, overall pasta consumption rose.[22] That meant no actual sales losses for domestic firms. Even if American pasta makers did lose sales, the federal government's response contradicts its free trade rhetoric—a clear case of "Do what I say, not what I do."

In the end, American consumers lose. The ITC, however, gave this helpful advice to shoppers who prefer eating imported pasta: "[M]ost dry pasta sold in the United States is of acceptable quality to most consumers. . . . Most people probably cannot distinguish between different cooked dry pastas."[23]

The case of Mexican tomatoes is another good example of politics over principle. Given the amount of time some high-level Clinton administration officials have devoted to the issue, one would think Mexican tomatoes are the greatest threat to American security in Latin America since the Cuban missile crisis.

It is difficult to construct a scenario whereby a producer could drive out all competition through low pricing, especially in today's integrated global economy.

In order to please Florida tomato growers, who have for years sought to limit competition from their Mexican counterparts, the U.S. Commerce Department tried first to assist in an antidumping case against Mexico and to help enact legislation against the Mexican tomatoes. The ITC rejected the Florida growers antidumping case, but the Commerce Department tried again. The second time, in a novel approach to demonstrating unfair pricing by Mexican tomato growers, the Commerce Department included only January and February of 1996 and March and April of 1995 in its price calculations.

Greg Rushford wrote in the *Wall Street Journal* that "the sneakiest attack is a legislative ploy designed to require that Mexican tomatoes be packed the same way that American tomatoes are packed." Since Mexican tomatoes come off the vine plump and juicy they must be packed cautiously in cartons, as opposed to Florida tomatoes, which come off the vine hard. Rushford continued:

> When most Americans think of official meetings in the White House, they imagine serious discussions of vital national issues in a dignified setting. How dignified is it for the National Economic Council to schedule a special meeting to hear Mickey Kantor argue that Section 8e of the Agricultural Marketing Agreement Act of 1937 should be amended to squish Mexican tomatoes and please Sen. Robert Graham, a Florida Democrat and the amendment's chief advocate?[24]

Fear of losing the highly politicized antidumping case spurred Mexican tomato growers to reach a compromise whereby a

minimum price is set for their exports to the United States. The compromise was a better resolution from the American consumer's standpoint than a loss for the Mexican growers would have been. The antidumping duties that might have been imposed could have been quite steep. Still, the settlement leaves consumers worse off than had there been no antidumping statutes in the first place.

Recognition that antidumping laws benefit a few industries at the expense of consumers can be found in the appendix to a recent ITC report. ITC Vice Chair Janet Nuzum and Commissioner David Rohr, who support antidumping laws, expressed their displeasure with the report's explicit statement of the cost to Americans of such laws. They wrote:

> Finally, when viewing the conclusions of this report, it must be remembered that the purpose of the antidumping and countervailing duty laws is not to protect consumers, but rather to protect producers. Inevitably, some cost is associated with this purpose. However, unlike the antitrust laws, which are designed to protect consumer interests, the function of the AD/CVD laws is, indeed, to protect firms and workers engaged in the production activities in the United States. So it should not come as a surprise that the economic benefits of the remedies accrue to producers, and the economic costs accrue to consumers.[25]

Although many American policymakers denounce protectionism in other countries while working to maintain it in the United States, a slow evolution of politics and policy is creating pressure for more unilateral American liberalization.

The ITC's study of antidumping laws conservatively estimated that the outstanding antidumping and countervailing duty orders in 1991 exacted costs on consumers, downstream industries, and the overall American economy amounting to at least $1.59 billion. That figure represents a net value, after subtracting the benefits gained by the petitioning industries and their employees. The study does not attempt to evaluate the additional costs of the various antidumping and countervailing duty orders that were not in effect in 1991, because they were either suspended, withdrawn, or terminated. Since those orders also had an impact on prices, the "net costs likely would have been far greater."[26]

Antidumping laws are badly misused against foreign-made products, in part, because the formulae employed to calculate predatory pricing are often biased in favor of the American company filing the grievance. Ronald A. Cass and Richard D. Boltuck write in *Fair Trade and Harmonization: Prerequisites for Free Trade*: "We have examined the fairness claims on behalf of the antidumping and countervailing-duty laws, finding little in those claims that can sustain the legal regimes now in place."[27]

One major reform would be to make any case for antidumping duties pass a simple test: Will assessing the duties benefit American consumers? The answer is likely to be no. Moreover, when evaluating claims of predatory pricing, the federal government should not treat foreign companies differently from domestic companies.

Conclusion

Although many American policymakers denounce protectionism in other countries while working to maintain it in the United States, a slow evolution of politics and policy is creating pressure for more unilateral American liberalization. In recent years industry groups have emerged to oppose specific protectionist acts. While American steel makers favor the use of antidumping orders and other means to limit foreign competition, American companies that *use* steel have banded together to lobby against such restrictions. Something similar has occurred in the high technology arena with the competing interests of semiconductor manufacturers and companies that produce products that need semiconductors.

A bill introduced by Rep. Phil Crane (R-Ill.) would have temporarily suspended antidumping duties in situations where the American domestic user could not obtain the product from an American source. Among the major backers of that bill were companies that import steel and semiconductors. Companies with competing interests in trade laws should continue to "level" the lobbying playing field, to use the fair trader lexicon.

On the international front, the creation of the World Trade Organization (WTO), a kind of super-GATT, and its dispute resolution panels should also provide more protection for American consumers. When the United States or another nation alleges an unfair trading practice, the case is heard at the WTO by a three-judge panel, drawn from international trade experts from different nations. The WTO dispute resolution mechanism is intended to work as a type of binding arbitration although the WTO does not possess a coercive power to enforce its rulings. The United States could decide not to abide by a WTO ruling, in which case the other party's only recourse would be to place a trade sanction on American products. But the WTO will

raise the costs to America of its protectionist policies.

The latest GATT agreement has set the stage for future reductions in tariff and nontariff barriers both in the United States and elsewhere. The GATT changed U.S. policy on items such as sugar and peanut butter from one of strict quotas, with bans on items above the quotas, to one of tariffs placed on imports over quota. In the future, it should be far easier to drive down prices by eliminating or reducing those tariffs on items over quota. Such action will take political will and international cooperation but at least is a clear pathway for the future.

The case for unilateral free trade remains strong. By eliminating tariffs and quotas on all imports, abolishing the Jones Act, and repealing the antidumping statutes, Congress and the President can improve consumer welfare far more than will any new initiative that emerges from a federal agency

International trade is not a war or even a contest between nations, which is why the "level playing field" argument for maintaining U.S. trade restrictions is inappropriate. Trade is a series of mutually beneficial exchanges between companies and individuals. Every distortion introduced into these voluntary exchanges will likely lower the standard of living of Americans. While American companies compete with their foreign competitors in the same industry, there is no case for government action to ensure that a particular company prevail or increase its U.S. sales—particularly at the expense of American consumers.

The goal of trade policy should be to remove governments—the American government as well as foreign ones—from transactions between citizens of different countries. In other words, the goal is to take power away from politicians, thus benefiting American consumers and de-politicizing trade. The U.S. government would do well to stop criticizing other countries until it removes its own trade restrictions. As the saying goes, people who live in glass houses should not throw stones.

Notes

[1] Lorraine Woellert, "Russia Raises Tariff on U.S. Poultry, Says Boost is Small," *The Washington Times*, April 2, 1996.

[2] *The Economic Effects of Significant U.S. Import Restraints: First Biannual Update*, Publication 2935 (Washington, D.C.: U.S. International Trade Commission, December 1995), p. xi.

[3] Gary Clyde Hufbauer and Kimberly Ann Elliot, *Measuring the Costs of Protection in the United States* (Washington: Institute for International Economics, January, 1994).

[4] *Economic Report of the President* (Washington: U.S. Government Printing Office, February, 1988), pp. 149-150.

[5] *Economic Effects*, p. 4-15. The price for shelled peanuts in the United States was 3.6 cents per pound higher and the price for in-shell was 4.4 cents per pound higher.

[6] Ibid., p. 4-14.

[7] Ibid.

[8] Calculations by James Mach for the Peanuts and Tree Processors Association.

[9] *Economic Effects*, p. 4-3.

[10] 1996 Trade Estimate Report on Foreign Trade Barriers, Office of the U.S. Trade Representative, Washington, D.C., 1996, p. 25.

[11] Ibid., p. 135.

[12] Ibid., p. 109.

[13] *The Economic Effects of Significant U.S. Import Restraints*, Publication 2699, U.S. International Trade Commission, November 1993, p. 41.

[14] Stephanie Nall and Tim Sansbury, "Helms Bill Shifts Jones Act Debate," *Journal of Commerce*, May 28, 1996, p. A1.

[15] Ben Wildavsky, "Jones Act Overdue for an Overhaul," *National Journal*, June 8, 1996, p. 1262.

[16] *The Economic Effects of Significant U.S. Import Restraints: First Biannual Update*, December 1995, p. 5-3.

[17] Ibid., p. 5-4.

[18] *Journal of Commerce*, April 26, 1995.

[19] "Pasta Case Brought Home to Consumers," *Window on Washington*, Consumers for World Trade, August 1996, p. 1.

[20] Paul Blustein, "Italy Loses the Pasta Wars," *The Washington Post*, July 31, 1996, p. E1.

[21] Ibid.

[22] Investigations Nos. 701-TA-365-366 (Preliminary) and 731-TA-734-735 (Preliminary), Publication 2905, *Certain Pasta from Italy and Turkey*, U.S. International Trade Commission, July, 1995, p. I-29.

[23] Ibid.

[24] Greg Rushford, "You Say 'Tomato,' Mickey Kantor Says 'Political Opportunity,'" *Wall Street Journal*, September 6, 1996, p. A15.

[25] Views of Vice Chair Janet Nuzum and Commissioner David Rohr in Publication 2900, *Economic Effects of Antidumping and Countervailing Duty Orders and Suspension Agreements*, U.S. International Trade Commission, June, 1995, p. 14.

[26] Publication 2900, U.S. International Trade Commission, p. 10.

[27] Quoted in *ibid.*, p. 401.

7. *Protectionist Paradise?*

by Jim Powell

Proponents of trade restrictions usually believe that their policies somehow will create more and better paying jobs for Americans. They believe that if American consumers are forced to buy goods and services produced by other Americans, the economy will be stronger.

But protectionists in other countries have held similar beliefs and put similar policies into effect. The results have been disastrous. Restrictions on imports prevent customers from protecting their interests by turning to suppliers abroad when domestic suppliers fail to fill their needs. Suppliers that depend on imports for components or raw materials for their products become less competitive. Put simply, without competition there is little incentive for suppliers to become competitive.

Protectionism prevents people from minimizing or escaping the consequences of the unsound policies of their own government. High taxes and heavy-handed government regulations, for instance, might undermine domestic suppliers. If customers can still satisfy their needs by purchasing from abroad, they can reduce those effects. But protectionism cuts off the escape route, and removes an incentive for governments to repeal failed policies.

The experiences of Argentina, India, Europe, and Japan give Americans a preview of what they can expect if American protectionist forces continue to restrict freedom to trade.

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Argentina

Argentina stands out as one of the few 20th-century instances of a country going from riches to rags. Between about 1880 and World War I, Argentina ranked among the world's most prosperous nations. Only Australia, Canada, and the United States were believed to be more prosperous.

Wealthy Land

Earlier in this century a common phrase to denote wealth was "rich as an Argentine." Lavish buildings in Buenos Aires date from the late 19th and early 20th centuries. They include towering, ornately embellished monuments in the classical style, such as Banco de la Nación (1888), Palacio Municipal (1891), Casa Rosada (1894), and the National Congress (1906). The Colon Opera House (1907) rivals La Scala in Milan. Avenida 9 de Julio is wider than the Champs Élysées in Paris.

British author James Bryce offered the following enthusiastic account in 1916:

> All is modern and new; all belongs to the prosperous present and betokens a still more prosperous future. Argentina is like western North America. The swift and steady increase in its agricultural production, with an increase correspondingly large in means of internal transportation, is what gives its importance to the country and shows that it will have a great part to play in the world. It is the United States of the Southern Hemisphere.

Argentina boomed for several reasons. It had a vast plain (*la Pampa*) with some of the

world's most fertile agricultural land. After 1880, the country was at peace. Taxes were low, and the peso was convertible into gold. There were no major restrictions on the movement of people, goods, or capital. As a destination for immigrants, Argentina was second only to the United States. More than 9 million Europeans, principally Spanish, Italian, and German, started new lives in Argentina, accelerating the country's economic expansion. In 1895, almost 85 percent of individual companies were owned by foreign-born Argentines.

Foreign investment financed railroads, industry, and agriculture. During the early 20th century, it was estimated that Argentina accounted for half the railroad mileage in South America. Argentines proved to be among the most efficient cattlemen anywhere, and with the advent of refrigeration, they grew rich serving distant markets. Argentines became world-class exporters of wheat, beef, and wool. The country reported the highest literacy rate on the South American continent.

Perón's Protectionist Path

After World War I, the Argentine government increasingly interfered with business, a trend that accelerated with the Great Depression. Colonel Juan Perón, who came to power during the mid-1940s, copied the economic policies of his hero, Italian dictator Benito Mussolini. The government nationalized companies, raised taxes, enforced price controls, inflated the currency, and promoted compulsory unionism. And chief among his statist policies was trade protectionism as well as seizure of foreign-owned assets and restrictions or outright prohibitions on foreign ownership.

The result, of course, was higher prices and chronic shortages. Most humiliating, during the late 1940s, was that Argentines endured shortages of two products that best symbolized the productiveness of their country: wheat and beef.

By 1990, protectionism had isolated Argentina from world markets. Tariffs averaged 29 percent, compared with about 3 percent for the United States. Much higher rates applied to imports such as automobiles, automobile parts, steel, petrochemicals, plastics, and textile fibers. A licensing system restricted imports in some 3,000 product categories, including automobiles, sugar, alcoholic beverages, medicine, pharmaceutical inputs, leather, footwear, wristwatches, clothing, and synthetic and natural fibers. Argentina retained a "buy national" policy that favored local suppliers, even when their goods were as much as 60 percent more expensive than those of alternative suppliers overseas. Argentina banned competition in many industries, such as insurance and airlines.

Such restrictions made it difficult for Argentines to cooperate with their neighbors. Argentine companies long paid about 25 percent more for tin than did rival U.S. companies, although nearby Bolivia could supply that commodity at quite a low cost. Similarly, Argentine companies paid 40 percent more for copper wire than U.S. companies, although Argentina shared a 2,500-mile-long border with copper-rich Chile.

In the name of protecting "strategically important" domestic industries, the Argentine government prevented its citizens from gaining access to state-of-the-art electronics available from suppliers abroad. Manuel J. Tanoira, Secretary of Growth Promotion during the 1980s, reported:

> The local electronics industry is protected by surcharges on all imported equipment. As a result of this regulation, local users must pay 3 to 4 times the international price for foreign-made computers, video cassette recorders, and other modern electronic equipment. The alleged purpose of these surcharges is to protect a $100 million industry (built mostly with tax money), which manufactures obsolete equipment in limited production runs. Only the very rich could buy a $1,200 video cassette recorder or pay $400 for a computer which sold for less than $100 in New York City.

The lack of computers limited the capabilities of Argentina's financial companies. The brokerage firm Pardo Rabello Y Cia, S.A., for example, in 1991 occupied two floors of a downtown Buenos Aires office building. It had dozens of trading desks, each equipped with a telephone switchboard. On a visit this author observed only one computer screen for the entire organization. In contrast, at sophisticated financial firms in the United States, Western Europe, and Japan, each trader typically has half a dozen screens that display prices for different markets.

Evading Restrictions

As Argentine import restrictions and other regulations became increasingly complex, people had to waste tremendous resources on com-

pliance or evasion. Hector Massuh, a paper company manager, reported: "To export is complicated. To import is complicated. If you want to pay your light bill, that is complicated." Some resourceful people known as *gestores* made money helping others deal with the regulations. As Tanoira noted:

> No Argentine would think of processing his own retirement application, or attempting to register a new car. A gestor, the expert who knows all the forms and procedures, is hired to do it. Importing, exporting, and manufacturing require lengthy bureaucratic approval procedures. The delays are so long that the original product may be obsolete by the time approvals are granted.

Many Argentines as a matter of course would overstate the value of imports on their invoices. This would allow them to evade foreign exchange restrictions under the guise of paying for imports, so they could transfer funds to safe havens abroad. In the late 1980s, the national government relaxed import restrictions as one way of promoting industrialization in remote regions like Tierra del Fuego. The effect, however, was to create a huge loophole for those wishing to get their money out of the country. Imports were overinvoiced more than 500-fold. The financial daily *Ambito Financiero* reported that if invoices were to be believed, enough building materials had been imported to put a roof over all Tierra del Fuego, and the inhabitants could eat 10 steaks and smoke 45 packs of cigarettes daily. A single screw was invoiced at more than $1,000.

Because Argentine regulations allowed handicapped people to import cars tariff-free, many of them did it on a large scale, although that was not the intent of the regulations. Handicapped people without outside income or a driver's license turned out to be the legal owners of expensive cars. For instance, Rosa Galasi, a Buenos Aires squatter who was paralyzed by polio and sold socks for a living, owned a gray BMW 520I; her brother-in-law drove it. Buenos Aires publishing executive Constancio Vigil bought a Mercedes from Juan Carlos Albarracin, the one-legged elevator operator in his office building; Albarracin himself got about with a horse-drawn cart. One handicapped person was believed to have imported 2,000 cars, saving $60 million in import duties.

Such deals inspired jokes such as this: A Buenos Aires police officer stopped a driver and asked the driver why he was in a car that belonged to somebody else. The driver answered, "The owner is blind." There is another: A wife told her husband that the bad news was his leg would be amputated. The good news, she said, was, "Now you can make thousands of dollars as a front man for Mercedes."

Protectionism's Legacy

Businessman Lanus de la Serna summed up well the results of his country's policies:

> Non-communications, low production of petroleum, production of coal that nobody uses or buys, pensions that are insufficient to live on, air transport policy and the routes that nobody can exploit, petrochemicals projects that never get done, violence, bungling and muddle, misinformation from state TV and radio, welfare systems that serve badly after interminable waiting, high sulphur iron that nobody buys or uses, the shipyards that cost more than they produce, the water supply that never comes, the untreated effluents, the ancient, inefficient and expensive ports, transport—slow, irregular and antiquated, insecure and expensive re-insurance, sea freights that cannot be obtained.

In recent years the Argentine government has begun to reverse half a century of policies that took the country from riches to rags. Ironically, those changes have been instigated by President Carlos Menem, of the Peronist party, whose founder led the country to its sorry state.

As Argentine import restrictions and other regulations became increasingly complex, people had to waste tremendous resources on compliance or evasion.

India

When India gained independence in 1947, its future seemed promising. The world's largest democracy, India had an extensive rail network, a reasonably well-trained civil service, and a vast, low-cost labor force. Yet for most of the decades since independence, India's economy has been mired in socialistic and protectionist policies that have brought suffering rather than prosperity to the country's hundreds of millions of people.

Stagnant Statism

In 1950, India's per capita annual income was about $150, and life expectancy was 40 years. This compared with about $350 and 50 years in South Korea. India had a substantially greater portion of savings—12 percent of the gross national product, compared with 8

percent for South Korea. All bets for prosperity were on the Indian Subcontinent, not on peninsular Korea.

After three decades, Indian per capita income was just $230 and life expectancy was 55 years. Meanwhile, South Korea's per capita income had soared to $2,900, and its life expectancy increased to 69 years. Not only had South Korea not received foreign aid in more than two decades, but it was able to pay down its foreign debt. India, in contrast, still depended on foreign aid, and its foreign debt soared to over $60 billion, the fourth largest in the world.

India's suffocating stagnation is the legacy of its most influential political leaders, Mohandas Gandhi and his follower Jawaharlal Nehru, the country's first Prime Minister, who embraced Soviet-style socialism after World War II. India devised five-year plans and nationalized industries, protecting them behind the toughest import restrictions in the non-Communist world. "If not an article of commerce had been brought from outside India, she would be today, a land flowing with milk and honey," Gandhi promised. "Foreign goods and goods made by means of complicated machinery are, therefore, taboo."

Although the Indian government controls 75 percent of the country's industrial assets, those assets contribute only about a third of industrial production or a quarter of the gross national product.

Paralyzing Production

Government-owned enterprises always become inefficient, creating incentives for governments to restrict competition from imports. India is such an example. Before independence, under British rule, the Indian public sector was generally limited to railroads, telegraph, mail service, and ports. After independence, the government sector burgeoned as bureaucracies multiplied. Created were the State Electricity Board, India Oil Corporation, All India Handicrafts Board, Central Silk Board, Coir Board, Village Industries Commission, Village Industries Board, Cashew Corporation of India, Projects and Equipment Corporation of India, State Trading Corporation, Minerals and Metals Trading Corporation, Industrial Finance Corporation of India, Industrial Development Bank of India, and Indian Reconstruction Corporation, among others.

Although the Indian government controls 75 percent of the country's industrial assets, those assets contribute only about a third of industrial production or a quarter of the gross national product. During the past four decades, bureaucrats have wasted more than $120 billion in subsidies on grossly inefficient suppliers.

A World Bank survey of 133 government enterprises that were operating in India by 1987 found that, on average, cost overruns were 82 percent, and the projects took 71 percent longer than planned. In one case, the government took 12 years to expand production capacity at the Bokharo steel mill by only 4 million tons.

In 1989, the Indian Ministry of Programme Implementation reported that in 303 government-funded programs involving more than $12 billion—for steel, railroads, petroleum, power generation, and other industries—total delays added up to 515 years. Costs ran 53 percent over budget.

Protecting Failure

Indian protectionism spread the country's self-imposed economic problems throughout the economy by preventing customers from turning to overseas suppliers. The government banned more than 300 categories of imports, mostly consumer goods desired by millions of Indians. Other goods were severely restricted by import quotas and the world's highest tariffs, which averaged over 130 percent.

Importers who were not stopped by tariffs encountered India's byzantine import licensing system. All imports required the appropriate licenses. That could entail an Advance License, Capital Goods License, Import Passbook License, Special Imprest Import Passbook License, Imprest License, Supplementary License, or Import Replenishment License. Such licenses were issued only if the proposed import was deemed "essential" and could not be obtained from domestic sources. Indian producers were quick to protest any proposed license that might expose them to competition. In hundreds, perhaps thousands, of cases, officials took more than five years to process a license application.

B. P. Adarkar, adviser to the Labour, Finance and External Affairs ministries, conveyed a vivid sense of how protectionism spreads problems throughout an economy:

> The wild growth of rules and regulations can be seen, for example, in the 'Red Books' for Imports and Exports—not Mao's 'red books,' but of the Chief Controller of Imports and Exports! These are clogging the avenues of trade—like the water hyacinth overwhelming and destroying vegetation. The corridors of Secretariats and of other subordinate offices have become like dharamsalas for mendicant businessmen loitering for beggarly bits of

> license worth a few thousand rupees, while a new class of touts and agents has arisen living like parasites on the blood of applicants for licenses! Here is indeed a paradise for the little bureaucrats who simply thrive on the Red Books and their endless addenda and corrigenda, with corruption, delays, increasing costs of industry, and inefficiency, frustration and bad blood all round.

Tata Truck Company executives, for example, spent four years negotiating a license to import a computer. The executives had applied for a much bigger computer than they then needed, figuring they could sell time on it if the license came through earlier than expected. But bureaucrats ruled that Tata could not sell time without another license. Excess computer capacity remained idle, while computers in India remained scarce.

Exchange controls did even more to cut off Indians from the outside world, especially since the mid-1950s. Indian citizens were subject to a 15 percent tax on foreign exchange they took out of the country. Only bureaucrats were legally empowered to trade rupees for other currencies. Also, they decreed that foreign exchange could be spent only on imports which they, not individual citizens, considered "essential." All other transactions were banned. In addition, bureaucrats maintained the rupee at artificially high rates that priced legal exports out of world markets, further turning Indian producers inward. Prospective foreign investors were excluded by the burdens of India's exchange controls.

Shackles on Businesses

Just as the New Delhi government closed borders to the outside world, it created barriers within the country. No one was permitted to start a new industrial enterprise—or expand an existing operation—without explicit government approval. Officials determined who could start a business, where it would locate, how much financial support it would get, what its labor policies would be, and much more.

T. Thomas, Chairman of Hindustan Lever Ltd., reported:

> Trying to set up a new industrial unit in India is like running an obstacle race, except that in this case, as you go along the obstacles are increased both in number and complexity. We have estimated that it takes about 7 years from the conceptual stage to the production stage for any significant investment to take place in India. Out of this, at least 50 percent of the time is spent in procedures to satisfy Government regulations. In any 3-year period of such delay, the cost escalation will be almost 50 percent. In our protected economy, the Indian consumer ultimately pays the price for this cost escalation.

Small businesses suffer as well. Observed Bombay entrepreneur Murarji J. Vaidya:

> There is nothing that a businessman can do without asking for some permit, undergoing some control or requesting some Government officer for something or the other. If a shopkeeper has to deal in a commodity, he must have a permit, he must have it entered in his sales tax permit stating that he is entitled to have such and such a commodity. He cannot deal in more commodities without entering it in his license.

Protectionism ravaged the textile and apparel industries, in which low-cost labor was giving India significant competitive advantages. Inspired no doubt by Gandhi's contempt for modern industry, officials began promoting traditional handlooms in the 1950s. Although handloom textiles were expensive, even with low-cost labor, handlooms proliferated behind India's closed borders. Meanwhile, textile entrepreneurs in Hong Kong, Taiwan, and South Korea were exposed to market forces, so they had to install more efficient power looms—or go out of business.

Results were dramatic. In the early 1960s, India accounted for more than half the textiles shipped from developing countries to industrialized countries; by the 1980s, India's share was only 9 percent, an 80 percent plunge. Taiwan, with less than 3 percent of India's population, did more international textile business. Out of touch behind its closed borders, India missed the global boom in synthetic fabrics.

A substantial number of banned or restricted imports were industrial inputs, such as cast-iron valves, stainless steel wire meshing, electrical conductor sections, textile machinery, and machine tools. By making these items harder to get and more costly for their own manufacturers, officials undermined efforts to promote industrialization.

Punishing People

Indian protectionism meant lower living standards for millions of ordinary people. Too poor to pay income taxes, they were hit hard by indirect taxes passed along in the form of

Just as the New Delhi government closed borders to the outside world, it created barriers within the country.

high prices charged by domestic suppliers. During the 1960s, Gujarat University's B. R. Shenoy compared the prices of domestically produced goods with banned imports. He found that border restrictions added substantially to prices of consumer goods—for instance, 250 percent more for refrigerators and 328 percent more for sugar. Import barriers made life more difficult for peasants, who had to pay 153 percent more for fertilizer, 204 percent more for pumps, and 222 percent more for pesticides. Furthermore, restrictions were a threat to public health. Domestically produced penicillin, for instance, cost 1,250 percent more than what could be obtained easily on the world market.

Thanks to protectionism, Indians in need of a car were stuck with two domestically produced models: a Padmini, which was a knockoff of a 1960s Fiat, or an Ambassador, a knockoff of a 1950s Morris Oxford. With a captive market, producers had little reason to invest in research and development that could improve those unreliable, uncomfortable, gas-guzzling cars. Consumers could wait as long as seven years for delivery of a car they ordered. And adding insult to injury, taxes accounted for half of the high sticker price.

Corrupt at the Core

Trade restrictions and regulations of virtually every kind multiplied opportunities for bureaucrats to demand bribes. The *Economist Intelligence Unit* reported that "businessmen commonly estimate that between 5 percent and 7.5 percent of a project's capital cost goes to officials before it is approved. Then additional inducements are required for connecting electricity, bank loans and other services."

Entrepreneurs had to make increased efforts to coddle bureaucrats, rather than improving their business. One cynical banker remarked, "There are 200 guys in positions of power. One guy wants money, one wants women, one wants to get drunk everyday, one wants his son to go to school in the United States." Black money changed hands to provide desired favors and grease the levers of power.

By the 1980s, there was widespread recognition that India's policies were responsible for the chronic misery of the people. Liberalization has since proceeded slowly, because politically connected special interests have aggressively defended their protectionist privileges.

Europe

In the industrialized world as well as in poor nations, protectionism spreads problems from domestic suppliers to producers, workers, and consumers. Protectionism was a major reason that Western Europe stagnated during the 1970s and grew much slower than the United States in the 1980s. The affliction came to be called "Eurosclerosis." Even when business expanded, companies often failed to create new jobs. The adverse effects of protectionism also forced the European Community to remove most of its trade barriers to other member countries in the 1990s.

Euro-inefficiency

Regulations in each country have served as trade barriers. Each European country has had its own product standards, largely to frustrate competitors. That was entailing higher costs, because manufacturers were losing the economies of scale that would have been possible if the same standards applied throughout Europe. Dow Chemical estimated that the maze of product standards added about $50 million a year to its cost of doing business in Europe.

Each country had distinct professional licensing regulations, which effectively excluded outsiders. "We once calculated that to qualify to work as an accountant in all 12 nations you'd have to go to school for more than 50 years," reported European Commission staffer Matthew Cocks.

Trucks were not free to carry goods across borders unless they had an official license issued by each country. Because few such licenses were issued, they were expensive—so much so that licenses were estimated to constitute 20 percent of total costs for European trucking companies.

Even when trucks had appropriate licenses, they were required to stop at each national border and waste hours as bureaucrats plodded through official forms. Typically, a trucker crossing European borders had to present about 75 forms, weighing several pounds.

Airlines were similarly restricted. National governments blocked airline competition. Consequently, the privileged carriers charged premium rates. It cost about 50 percent more per ton to ship something via air freight in Europe than in the United States.

Telecommunications was long among the

most heavily protected industries in the individual European countries. In West Germany, telephones cost twice as much as in other European countries. Italtel, the Italian government-owned telecommunications monopoly, was notorious for its poor service; few calls could be placed without repeated dialing.

Government monopolies left little incentive to innovate. Consequently, the monopoly France-Telecom, for example, lagged far behind deregulated British Telecom in providing businesses with new services such as cellular telephones. Because the telecommunications monopolies were backward looking, they did little to upgrade their jointly owned international Telex service, a technology dating from the 1920s. Big, ugly, and noisy Telex machines printed messages in only one typeface on rolls of narrow paper.

When private Asian electronics companies, not government telecommunications monopolies, offered inexpensive, convenient, and high-quality fax machines, customers scuttled their clunky Telexes. In the United States, the number of Telex subscribers declined from 118,000 in 1986 to 78,000 in 1988. International fax machine sales have doubled almost every year, and fax producers have continued to introduce faster, cheaper, smarter machines.

Costs to Consumers

The biggest losers from the trade restrictions and subsidies of the various European countries were the hundreds of millions of European consumers, denied the freedom to seek the best value for their money.

Each country had laws that enabled banks to avoid paying interest to small depositors. Other laws prevented foreign banks from opening branches to offer citizens a better deal. Similarly, some laws prevented citizens from opening bank accounts in other countries. In Britain, France, and West Germany, the spread between consumer loan rates and money market rates was three times greater than in less-regulated Belgium. In West Germany, there was one credit card for every 23 people; in the United States, it was a credit card for every 10. Consumer loans and other services were also much harder to get than in the United States.

Millions of European consumers paid outrageous fees for financial services because consumers were not free to shop for better terms. According to a study by the European Commission, consumers in restricted Belgium had to pay 31 percent more for life insurance than in a more open market like Great Britain's. Spanish consumers had to pay 32 percent more and Italian consumers, 51 percent more. Overall, government regulations enabled insurance companies to overcharge consumers by $2.9 billion annually.

Myriad European regulations forced people to pay higher prices for food. For example, in Italy, a law required that pasta be made of expensive durum wheat rather than varieties that are about 15 percent cheaper. Italy enforced an outright ban against imported pizza and many other products.

Comprehending, in the 1980s, that they were falling behind the booming economies of the United States and East Asia, European Community leaders developed an ambitious agenda to liberalize the continental economy by 1992. They swept away hundreds of costly restrictions. But the advantages of trade liberalization could be short lived as high taxes and other regulations still hold back those economies.

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Japan

Some Americans view Japan as a country that has grown and prospered because of trade protection and subsidies to industries. But in fact, the Japanese government's mixed economic policies have produced mixed results. The industries that have done well are those most free of government protection, direction, or interference. The most heavily subsidized and protected industries have fared the worst. Their market shares and employment declined. They became a chronic burden to Japanese customers and taxpayers.

Crippled Crops

Early in the 20th century, Japan was a substantially open market for agriculture; about 90 percent of rice was imported. But the country adopted import quotas and high tariffs in the 1930s that remain to this day. Furthermore, the government guarantees that farmers receive a minimum price for rice that is well above world market levels.

Moreover, the 1952 Agricultural Land Law limited the size of residential farm landholdings and banned nonresidential ownership as a means to prevent the reappearance of a landlord class. As a consequence, the average Japanese farm is only 2.7 acres, compared with

34.5 acres in West Germany, 59.2 acres in France, 158 acres in Britain, and 387.7 acres in the United States. Although the average Japanese farmer has come to depend on rice for only about 6 percent of total income, rice protectionism has become politically untouchable. Agriculture remains Japan's most protected sector.

Agricultural protectionism lowers the living standards for 85 percent of the Japanese people who earn their full-time livelihood off the farm. Farm privileges transfer tax burdens from farmers to all other workers and slow the flow of available workers to industry. They limit the supply of land for industrial development and contribute to higher land costs. Despite enormous protection, the Japanese farm population dropped from 30 million in 1965 to under 20 million in recent years.

Agricultural protectionism lowers the living standards for 85 percent of the Japanese people who earn their full-time livelihood off the farm.

Retail Regulations

Japanese consumers suffer from restrictions on the country's distribution system and from retail outlets that drive up prices. Unfortunately, protectionist policies mean that Americans and other foreigners cannot freely establish competing outlets offering lower prices.

Small stores, experiencing competitive pressure from large retailers during the late 1960s, were protected by the Large Scale Retail Store Law in 1973. That law established licensing requirements for any proposed store with more than 1,500 meters of floor space in most localities, and 3,000 square meters in large cities. The effect was to slow significantly the spread of large stores. Retail companies began expanding mid-size stores, and in 1978, the law was revised: Stores with as little as 500 square meters needed official permission before they could open. The law required retail companies to notify officials in writing seven months before a proposed store opening. That measure gave neighboring mom-and-pop store owners ample opportunity to besiege officials to squelch most competitors. During the 1980s, the government further restricted large retailers, and applications for new stores dragged on for years. Those national restrictions were compounded by local restrictions on large stores, as well as regulations making it difficult to build warehouses suitable for large stores. The Japanese distribution system has thus remained inefficient.

Whereas half of U.S. wholesalers reported more than $1 million in annual revenues, very few Japanese wholesalers have done that much business. In Japan, most goods have been handled by more than one wholesaler, with each adding a markup, whereas in the United States, one wholesaler has been the rule. The magnitude of added costs is indicated by the ratio of wholesale to retail sales; the higher the ratio, the more firms are involved in the distribution process. Japan's wholesale-retail ratio has been 3.9 to 1, whereas America's has been 1.7 to 1. Chain stores have served only about 8 percent of the Japanese market, versus about 50 percent of the U.S. market. Despite protectionism, many small retailers have concluded that their backward operations would continue to decline, and they have sought franchises with chains such as 7-Eleven stores.

The Japanese government combined trade restrictions, special access to foreign currency, and subsidies in attempts to help privileged sectors of the economy. In all cases such efforts simply supported inefficiency and rarely prevented decline in these sectors. Examples include the following:

Steel. The Japanese government has promoted the steel industry since World War II. Exchange control bureaucrats gave producers privileged access to foreign currency with which they could buy needed machinery. The government provided priority supplies of coal and low-cost investment capital. Those policies led to an overcapacity of high-cost steel manufacturing by the 1970s. Investment returns plunged. Soaring oil prices and interest rates triggered horrendous losses. In the 1980s, companies like Nippon Steel, Kobe Steel, Sumitomo Metal, and Kawasaki Steel shut down blast furnaces and cut payrolls by some 47,000 workers. Higher financing costs brought additional turmoil in the 1990s.

Coal. After World War II, the Japanese government began subsidizing the coal mining industry with low-cost loans and priority access to foreign exchange and electrical power. Yet Japanese coal output has dropped more than 50 percent during the past two decades. Employment plunged over the past 20 years from 260,000 to about 26,000. The industry is still declining.

Rail. The long-nationalized Japanese National Railway was notoriously overstaffed and inefficient, with several times more employees per revenue mile than railroads in other industrialized countries. According to Keio University economist Hiroshi Kato, President of the Japan Economic Policy Association, overstaffing amounted to about 93,000

workers, a third of the total payroll. Yet Japan National Railway's share of passenger and freight traffic declined. In contrast, most of Japan's private railways were quite profitable. The situation at Japan National Railway began improving only after it was broken up and privatized as six separate companies in 1987.

Shipbuilding. To help it compete in world markets, the Japanese government provided the shipbuilding industry with tax breaks, low-interest and deferred loans, plus financing through the Export-Import Bank and the Japan Development Bank. The result is high-cost, excess capacity. During the past decade, major shipbuilders like Mitsubishi Heavy Industries, Ishikawajimi-Harima Heavy Industries, Hitashi Zosen, Kurushima Dockyard, Kawasaki Heavy Industries, and Sumitomo Heavy Industries closed shipyards and cut their payrolls by more than 45,000 people. More than a dozen companies failed. Japan has less shipbuilding capacity now than in 1970. The Japanese lost a big share of the ship market to South Korea.

Aluminum. During the late 1960s and early 1970s, the Ministry of International Trade and Industry (MITI) decided that aluminum was a "key" industry and showered six producers with special breaks. But the subsequent escalation of oil prices turned those visionary plans into horrendous losses. One producer ceased operations, seven smelters were shuttered, and overall capacity contracted 60 percent, with the remaining smelters operating at less than half capacity.

Petrochemicals. Japanese officials nurtured the petrochemical industry with subsidies, import restrictions, low-cost land, extra foreign exchange allotments, and favorable tax treatment for licensing foreign technologies. Naturally, that encouraged companies to enter the business. The result was costly overcapacity, triggering profound price declines. Petrochemical companies were further squeezed by MITI's policy of protecting Japanese petroleum producers, especially with import restrictions on naphtha, a principal feedstock for petrochemicals. MITI tried to help petrochemical companies by further protecting their markets and organizing a cartel in the 1980s, but the scheme did not work.

Finance. Japan's financial markets have been among the most heavily regulated in the industrialized world. In many ways, that country's regulations in that arena parallel those of the United States, although American policymakers, in recent years, have moved further toward reform.

Until 1980, Japan had exchange controls, which meant no one could take currency into or out of the country without official permission. Japanese laws prevented commercial banks from selling securities and securities firms from taking deposits. Japanese regulators delayed the introduction of valuable risk-management techniques, such as interest rate futures contracts and options. Investment management was limited to trust banks and insurance companies. A government-enforced cartel of several dozen companies controlled life insurance. Officials determined the kind of securities in which insurers could invest. Securities brokerage commissions were fixed. The result was high brokerage commissions, poor investment returns, and fewer consumer financial services compared with the United States.

Japan's financial system did not prepare Japanese financial companies for the doubling of interest rates in 1989 and 1990. Nor did the regulatory wall prevent the Japanese stock market from falling about 50 percent in 1990. The Japanese equity market remained volatile and thin. Japanese money managers made their share of costly mistakes venturing into U.S. real estate. Required by law to pay policyholders only out of current income, and not capital gains, Japanese life insurance companies loaded their portfolios with securities that yielded high current returns and depreciated sharply. Japanese insurance companies lost billions in such straightforward instruments as U.S. Treasury bonds. Most of Japan's giant commercial banks had their credit ratings downgraded.

Those are just some of the failures of Japanese protectionism. Others include health services, food processing, sugar refining, confectionery, tobacco, and lumber.

By providing subsidies and promoting import restrictions, the Japanese government delayed the transition from declining industries to new industries. Precious people, goods, and capital remained tied up in declining industries longer than they would have been in a wide open market. Consequently, fewer new jobs were created. Japan boomed during the 1980s, but the United States created far more jobs—18 million altogether.

Japanese companies most dramatically expanded their market shares in the United States, Europe, and Asia during the 1980s, when trade and investment liberalization gathered momentum. Tariffs were cut to levels lower than in the United States. Dozens of quotas were scaled back or eliminated. Japanese companies gained easier access to capital, with

more flexible terms and often lower costs. Certification and standards procedures were simplified. Japan has come far, but the process is painfully slow.

Conclusion

As the failures of Argentina, India, Europe, and Japan make clear, protectionism spreads problems from suppliers to customers. Protectionism undermines the competitiveness of companies whose needs are not satisfied by domestic suppliers. And, of course, protectionism makes millions of people poorer.

The way to prevent supplier problems from spreading throughout an economy is to open up markets, setting customers free to satisfy their needs abroad. Free trade means that when taxes, regulations, inflation, and other unfavorable government policies undermine the ability of domestic suppliers to provide what customers need, customers can still protect their vital interests. How can they be legitimately denied?

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8. *Trade and Human Rights: The Case of China*

by James A. Dorn

> Vigorous economic development leads to independent thinking. People hope to be able to fully satisfy their free will and see their rights fully protected. And then demand ensues for political reform. . . . The model of our quiet revolution will eventually take hold on the Chinese mainland.
>
> **—Lee Teng-hui**
> **President, Republic of China**[1]

Some American policymakers would erect trade barriers against countries that are not democratic or that violate the human rights of their citizens. But as well-meaning as those restrictions might be, they in fact would have effects adverse to the cause of human rights.

China provides a good case study. That country rightly is criticized as a violator of human rights, especially in light of the bloody 1989 crackdown on democratic activists in Tiananmen Square. Unlike most countries, China's trade status with the United States is reviewed annually by Congress. Periodically some of China's critics attempt to suspend the standard trade arrangement (called "most-favored-nation" status) that most countries enjoy with the United States.

There are good reasons to maintain free trade with China, in spite of its record on democracy and human rights:

- The right to trade is a basic human right. Depriving Chinese as well as Americans of this right because of Beijing's repressive policies only makes matters worse.
- American trade barriers are unlikely to change the policies of China's communist leaders.
- Trade liberalization itself is a powerful weapon to push a country toward respect for life, liberty, and property, and ultimately toward a democratic regime.

The Path toward Freedom

Over the past two decades China has taken monumental steps away from failed policies of central planning and toward a market economy. Allowing farmers after 1978 to sell much of their produce on the open market, rather than turn it over to the government, has allowed China to feed its 1.2 billion people. Since that year China's economy has grown at an average annual rate of more than 9 percent, and has the potential to become the world's largest economy over the next three decades.

In terms of political power, although the Chinese Communist Party (CCP) has held onto its monopoly, China is a more open society today than a decade ago. More Chinese students now study abroad; and the more they experience freedom, the more they will understand that liberty offers a prosperous and humane society. Faxes, e-mail, and other forms of communication keep freedom-loving Chinese in touch with the outside world. And a population growing more prosperous, thanks to market reforms, is less tolerant of repression.

There are still serious violations of human rights in China. But a case can be made that the country is creeping toward freedom and

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that current development and expansion of free-market institutions will maintain pressure for further liberalization. Denying China most-favored-nation status or imposing sanctions would only politicize trade, strengthen the communists, and harm many innocent consumers and businesses in both China and the United States.

Free Trade as a Human Right

Critics of China's human rights record are justified in pointing out the abuses that are occurring in that country. Yet, many of the critics forget that freedom to trade is just one of the liberties that many Chinese individuals and enterprises have gained in past decades. For America to restrict access to its market first and foremost deprives the Chinese, as well as Americans, of an important liberty.

Without private property and freedom of contract, other rights—such as free speech and religious freedom—would have little meaning.

The proper function of government is to protect life, liberty, and property—including freedom of contract, which encompasses free international trade. Government should not undermine one freedom in an attempt to secure others. The right to trade is an inherent part of property rights and a civil right that should be protected as a fundamental human right.

The supposed dichotomy between the right to trade and human rights is a false one. The rights to own property and to trade with others are natural rights. The freedom to act without interference, provided one respects the equal rights of others, is the core principle of a market economy and the essence of human rights.

Without private property and freedom of contract, other rights—such as free speech and religious freedom—would have little meaning, because individuals would be at the mercy of the state for their survival and prosperity. The human rights fabric is not strengthened by unraveling economic liberties in the hope of enhancing other liberties.

Protectionism violates human rights. It is an act of plunder that deprives individuals of their autonomy—an autonomy that precedes any government and is the primary function of just governments to protect.[2] As Rep. David Dreier (R-Calif.) stated during the July 1994 congressional debate, "Denying trade is a violation of human rights and a reprehensible one."[3]

Americans already find their economic liberty diminished by trade restrictions. Import restrictions presently cost the United States some $70 billion a year.[4] Further trade restrictions on China will simply increase that costly burden.

Economic Sanctions: A Blunt Instrument

Critics of China often fail to appreciate that trade sanctions usually are not effective and have little prospect of fundamentally changing a country's human rights policy. Moreover, trade sanctions could confirm to China that America is not a trustworthy trade partner and push that country more to diversify both its import and export markets.

Two questions need to be addressed when considering the use of economic sanctions: First, are sanctions legitimate? Second, are they effective—that is, will sanctions promote a market economy and will the economic effects of sanctions promote freedom and democracy?

The Question of Legitimacy

Although the general rule for governments should be non-interference with free trade, governments often cite several cases to justify economic sanctions. The following five "exceptions," however, are narrowly focused, not blanket bans, and remain open to practical problems.

(1) Sanctions would be legitimate in preventing trade that would directly enhance an enemy's military capability. The U.S. government, for example, would be justified in preventing the sale of military technology and weaponry that could be used by an enemy to harm U.S. citizens.

(2) Sanctions would be legitimate in preventing a country from profiting from the use of slave labor. Goods made with slave labor should not be allowed into the United States. Because individuals have property in their lives and labor, selling goods made by slave labor is akin to selling stolen property. However, it would not be legitimate for the United States to ban *all* trade with a country if only a small part of its exports were made with slave labor. Private parties should have the right to trade. To ban all trade or to use sanctions to ban many products not directly connected with slave labor would harm many innocent people.

(3) Sanctions would be legitimate in preventing the exporting and importing of goods produced by political prisoners who have not violated anyone's rights to life, liberty, or

property. This case is analogous to the case of slave labor, except the slaves are behind bars. Part of the problem with such sanctions is determining what goods are made by such prisoners and in what quantities.

(4) Sanctions would be legitimate in protecting the rights of minors. But the use of child labor is complicated: in a poor country it may make sense for children to go to work at a much earlier age than in a rich country. There is no clear-cut answer as to when economic sanctions should be used to cut off trade in goods made by child labor. Only a short time ago in the United States, it was not uncommon for 12-year-olds to work long hours on a farm or in a factory to help their families survive. Should the United States now prevent such children from working in poor countries to improve living standards? Economic sanctions would do just that.

(5) Sanctions would be legitimate in safeguarding intellectual property rights. The U.S. government has a legitimate right to ban the importation of pirated computer software or compact discs, and is justified in penalizing foreign producers for violating U.S. copyright laws. Intellectual property rights are no less important than other forms of private property. Allowing thieves to sell CDs at very low prices would only create greater incentives to steal.

The tactic of using sanctions to enforce compliance with U.S. copyright laws should be supplemented with multilateral agreements to protect intellectual property rights. Admitting China into the World Trade Organization would require China to take better care to protect these rights and thus should be a top priority for the United States and other developed countries.

The Question of Effectiveness

Whether sanctions are legitimate or illegitimate, they may not be effective. Sanctions are likely to be effective only when all the following conditions are met:

- They have the near-unanimous support of the target country's major trading partners;
- The government of the target country is responsive to the concerns of its citizens; and
- The benefits of the sanctions to the governments of the sanctioning countries exceed the costs. Few sanctions meet all three conditions.

Institute for International Economics scholars Gary Hufbauer, Jeffrey Schott, and Kimberly Elliott found that economic sanctions "are of limited utility in achieving foreign policy goals that depend on compelling the target country to take actions it stoutly resists."[5] Instead of liberalizing a repressive regime, sanctions may in fact make the regime more repressive by banning exchanges that would extend markets and weaken the power of government.

Seven potential problems make it difficult to use sanctions successfully to further human rights. In the case of China, each of these factors would pose problems that could make sanctions ineffective.

(1) Target countries may circumvent sanctions by substituting new sources of supply if exports to it are cut. Historically, sanctions have not been very effective because the targeted countries have been able to find suitable substitutes. When the U.S. government blocked the sale of grain to the Soviet Union in 1980, the Soviets simply purchased more from Argentina, Australia, France, and other countries.

Even if the U.S. government could block flows of goods and capital to China, other countries likely would step in to fill the gap. Instead of buying aircraft from Boeing or looking to American investors, the Chinese would shift to Airbus Industries and look to European and Asian trading partners for additional capital—and U.S. investors would try to reroute their funds through other countries into China rather than abandon their invested capital.

(2) A country can close its markets in retaliation for trade sanctions. If America simply restricted imports from China but did not try to restrict American exports to that country (which amount to $11.7 billion), China likely would retaliate against American exports, making American firms civilian casualties of the ensuing trade war. China's state-owned enterprises certainly would support such retaliation since protectionism always benefits inefficient firms. Strengthening those enterprises would be bad for China and bad for the United States.[6]

(3) If trade sanctions against a country are minimal, that country will have little motive to change its policies and might find other markets or suppliers. If sanctions are tough enough to hit hard, American consumers and exporters, as well as America's allies in the region, certainly will be victims.

In the case of China, economic sanctions have little chance of success. Although the

Political leaders in Taiwan and Hong Kong oppose sanctions against China even though they strongly favor democracy and human rights.

United States accounts for more than 30 percent of China's export market, the threat of placing prohibitively high tariffs on a range of Chinese products is not politically feasible. American consumers would immediately see the higher prices and protest. It is estimated that revoking China's most-favored-nation status would cost American consumers from $16 billion to $29 billion in higher prices and lead to the loss of up to 200,000 American jobs.[7]

Even if such a policy were politically feasible, it would be difficult to implement: China could transship products through Hong Kong or other countries, and U.S. customs officials would find it hard to identify the point of origin. In the end, tougher action would harm Hong Kong, which has the world's freest trade policy, operates under the rule of law, and respects individual liberty.

Political leaders in Taiwan and Hong Kong oppose sanctions against China even though they strongly favor democracy and human rights. They favor delinking trade agreements and human rights, because they recognize the importance of open markets for the stability and prosperity of the entire Asian-Pacific region. They also understand that trade liberalization is a prudent long-run strategy for promoting human rights in China.

According to an editorial in the *South China Sunday Morning Post*, President Clinton's 1994 decision to delink trade and human rights "was welcomed with a collective sigh of relief."[8] If the United States were to deny China most-favored-nation status, the resulting punitive tariffs would destroy "the Hong Kong-Guangdong partnership, which has been the engine of China's economic growth." Moreover, "the political and economic focus would have shifted back towards the Centre." Human rights in China then would be nipped in the bud as the state sector gained ground and the nascent market sector diminished. Yet, as the *Post* notes, "For all the economic progress trade with the West has encouraged, China remains a harsh political dictatorship."

(4) The costs of monitoring the target country for violating human rights, or for violating intellectual property rights, rise with the size and complexity of transactions and with the extent of the market. Sanctions, therefore, may be very difficult to enforce in large countries such as China.

Monitoring the use of prison labor and tracing goods made by political prisoners in China would be very difficult.[9] But even if the West were able to effectively monitor such activities, there is no guarantee that other countries would do the same. In fact, many countries have supported China against the United States when it comes to human rights. At the 52nd session of the U.N. Commission on Human Rights in April 1996, an attempt to pass a U.S.-sponsored resolution critical of China's record on human rights—especially with regard to Tibet, the criminal justice system, and religious freedom—did not even get off the ground. China proposed a "no action" motion, meaning no discussion of the resolution and no vote on it. That motion passed by a vote of 27 to 20, with 6 countries abstaining.[10]

(5) In many cases, systemic change is needed to deal with some of the deeper economic problems. The piracy of intellectual property, for example, is a significant problem for Western firms. Chinese producers have been major violators of copyright laws. China's membership in the World Trade Organization should be conditioned on China's adherence to international law. If China cannot play by the rules, it should not be allowed to play with those who do.

But the problem is not limited to China. Producers in most less developed countries, and even some developed countries, violate intellectual property rights. (More than 84 percent of Chile's software, for example, is pirated.)[11] Using economic sanctions to punish pirates sounds good in theory, but in practice sanctions are seldom effective. The real solution to piracy may have to wait for technological changes that make it very costly to steal intellectual property and for the rule of law to evolve in China and other less developed countries.

As China develops its own intellectual property, there will be a demand for new laws to protect private entrepreneurs in China. The uncertainty created by China's failure to protect intellectual property rights can only harm China in the long run. Investors will not enter a market if they cannot reap the full benefits of their investment. Fan Gang, an economist at the Chinese Academy of Social Sciences, notes that:

> [People] are bound to find that all this cheating and protecting yourself from being cheated consume too much time and energy, and that the best way to do business is playing by a set of mutually respected rules. New rules and laws will be passed, and people will be ready to abide by them.[12]

Meanwhile, the United States should contin-

ue to criticize China and other countries for their violations of copyright laws and put as much pressure on countries to protect intellectual property as possible short of sparking a trade war.

(6) Economic sanctions may lead to political backlash in the targeted country and fail to have a positive impact. That problem may be especially acute in regimes with an entrenched political class, no freedom of the press, and a strong anti-West bias.

The biggest obstacle to successfully using economic sanctions to promote human rights in China is the CCP. Hard-liners in the party will not tolerate any invasion of their stronghold of power, as the world witnessed in Tiananmen Square. They see sanctions as a capitalist tool designed to undermine China's rapid growth and weaken the CCP's hold on political power. Even if sanctions disrupted economic life, they would have no lasting effect on China's political system—and might even serve to strengthen the ruling elite's resolve to promote communism at any cost. Closing China off to the outside world by means of sanctions would be more apt to play into the hands of the hard-liners than to overthrow them.

(7) Sanctions are apt to politicize trade further in the sanctioning country, because politicians seek to win votes by using the rhetoric of protectionism to retain jobs for special interests in their districts. The danger is that once sanctions were imposed, there would be strong pressure from special interest groups to retain them even if a target country changed its offending policies.

During the July 1994 congressional debate over using trade policy to promote human rights, for example, Rep. Gerald Solomon (R-N.Y.) revealed this motive clearly. He stated that Americans "must apply leverage where we can in order to defend freedom, deter aggression, and, yes, protect American jobs."[13] And during a May 1995 congressional hearing on trade, Rep. Bill Thomas (R-Calif.) observed:

> What I have seen as arguments on workers' rights tend not to be so much for underscoring the international agreements that I think all of us would agree with in terms of fundamentals—the slave labor, prison labor, and the rest—but appear to me to be more and more actually the reverse of what their proponents would hope people would think they were. Frankly, I think a number of them have been protectionist.[14]

Incubating Freedom and Democracy

In contrast to the "feel good" approach of sanctions, developing free markets and the rule of law more effectively secures human rights and helps establish democracy. Unlike sanctions, trade liberalization weakens the power of government.[15]

Even though free markets are neither necessary nor sufficient for democracy, much evidence supports the argument that economic liberalization breeds political liberalization. As markets spread, people acquire greater wealth and have a stronger interest in participating in the political process and protecting their property through the rule of law and an objective, nonpoliticized judicial system.

Traditions of liberty

The rule of law is a by-product of commercial society. Traders who were discriminated against by rulers found ways to circumvent the sovereign and increase their wealth.

Montesquieu, in his 1748 work *The Spirit of the Laws*, explained how Jewish merchants invented the bill of exchange to prevent having their property subject to the whim of rulers,[16] and how foreign exchange markets provided constraints on the ability of rulers to debase the currency.[17] Today international capital markets put pressure on government policymakers to protect private property rights and to pursue prudent monetary, fiscal, and regulatory policies or face massive capital outflows. Global market competition helps good government crowd out bad government.

In *The Wealth of Nations*, Adam Smith in 1776 described how the development of commercial life in Europe "gradually introduced order and good government, and with them, the liberty and security of individuals."[18] And in the 1835 classic, *Democracy in America*, Alexis de Tocqueville observed that "trade makes men independent of one another and gives them a high idea of their personal importance; it leads them to want to manage their own affairs and teaches them how to succeed therein."[19]

Harvard economist Robert Barro, in empirical work summarized in his book *Getting It Right*, found "that improvements in the standard of living . . . substantially raise the probability that political institutions will become more democratic over time." He concluded,

> The advanced Western countries would contribute more to the welfare of poor nations by exporting their economic systems, notably property rights and free markets, rather than their political systems, which typically developed after reasonable standards of living had been attained. If economic freedom can be established in a poor country, then growth would be encouraged, and the country would tend eventually to become more democratic on its own.[20]

Markets and Democratization

A strong case can be made that the gradual introduction of markets in China and the opening of China to the outside world have made the Chinese people freer and reduced the power of government.

The end of collectivized agriculture in 1978 and the return of farming to families under the household responsibility system (*baochan daohu*) changed the whole dynamic of economic, social, and political life in China. The state was no longer the master for 80 percent of China's population who lived in rural areas. Farmers became risk takers, created new markets, developed rural industries, and migrated to urban areas.[21]

Commenting on China's cultural transformation, Jianying Zha writes in her book *China Pop*:

> The economic reforms have created new opportunities, new dreams, and to some extent, a new atmosphere and new mindsets. The old control system has weakened in many areas, especially in the spheres of economy and lifestyle. There is a growing sense of increased space for personal freedom.[22]

The new urban centers, such as Shishi in the province of Fujian, are characterized by the market, not the plan. Their model of development, writes Kathy Chen of the *Wall Street Journal*, is "*xiao zhenfu, da shehui*—small government, big society—which advocates less involvement by cash-strapped governments and more by society."[23] Ambitious young people want to become capitalists, not communists.[24] A recent survey found that young people ranked being an entrepreneur first among 16 job choices and employment with the national government eighth.[25]

New rules will evolve as individuals grope for ways to lower the costs of exchange and expand markets. Liu Ge, a lawyer trained in both China and the United States, says about the dynamics of the move toward markets:

> Gradually, there will be more laws and rules; the market will be more mature, more compatible with international standards, the competition more fair and open. Then, China will have been structurally transformed! Political change will come after that.[26]

According to Zha, "A lot of the educated urban Chinese . . . echo this way of thinking." There is reason to believe, therefore, that institutional change in China will bring about what Princeton University professor Minxin Pei has called "creeping democratization."[27]

Pei believes that Western liberal traditions, such as the rule of law, "have set implicit limits on the state's use of power" and have promoted the democratization of the legal system. People are starting to use the court system to contest government actions that affect their lives, liberty, and property. There has been a sharp rise in the number of civil lawsuits against the state, and individuals are beginning to win—perhaps as many as 20 percent of their cases, according to official sources.[28]

The opening of the legal system is important because it paves the way for the transition from "rule *by* law" to "rule *of* law." Marcus Brauchli of the *Wall Street Journal* writes,

> The state's steel-clad monopoly on the legal process, which makes the courts just another arm of government, is corroding. China's economic liberalization . . . has spawned a parallel legal reform that raises the prospect of rule of, not merely by, law.[29]

Unfortunately, as Brauchli recognizes, "legal ambiguity" remains "a ruthless weapon" for harassing the population. Until that facet of China's institutional structure changes, no one's rights will be secure.

Foreign firms now have more than 120,000 projects operating in China with a total investment of over $135 billion.[30] That amount of investment already is reinforcing incentives for regional and local leaders to protect the market, and is making the rulers in Beijing reluctant to reverse economic liberalization. Pressure may eventually mount for political liberalization.

Western companies have already had an impact on China's civil society. They have raised business standards and demanded a legal infrastructure.[31] Continued economic liberalization is sure to raise business standards further and help cultivate an institutional infrastructure based on the rule of law. The changes

will occur first in the nonstate sector (especially in the southern coastal provinces) and then spread throughout China as competition and openness become the norm.

Democracy is multi-dimensional; the right to vote is only one dimension, albeit an important one.[32] A free society requires constitutional constraints to limit the power of government so that the right to vote does not infringe on the right to property.[33] China's future prosperity will depend increasingly on the development of a legal system that safeguards persons and property against the arbitrary force of the state and on the nation's commitment to comply with international commercial codes and customs.

The surest route to China's freedom and prosperity is to keep trade open and develop China's civil society. Greater economic freedom will spill over into greater political freedom, as it has in other parts of Asia. Imposing economic sanctions, on the other hand, will destroy China's nascent market system and block the surest path toward freedom and democracy.

Real stability will come to China only when its leaders abandon their fatal conceit and realize that it is impossible to plan the market or society.[34] Although the leadership is willing to tolerate gradual reform to keep the economy strong, it is unwilling to tolerate political reform and has vowed to prevent Hong Kong from following Taiwan's path to democracy. But economic reform takes on a political dynamic of its own. In the long run, the Chinese communists probably will not be able to withstand the tide that will sweep away not only socialism but also political repression.

Creating a Market-Liberal Order

To depoliticize economic life, China needs constitutional change and new thinking (*xin si wei*). Chinese scholar Jixuan Hu writes, "By setting up a minimum group of constraints and letting human creativity work freely, we can create a better society without having to design it in detail. That is not a new idea, it is the idea of law, the idea of a constitution."[35]

As the world's leading constitutional democracy, the United States should spread its ethos of liberty by keeping its markets open and extolling the principles that made it great. America should not play the dangerous game of pitting human rights activists against free traders. American prosperity and global prosperity are better served by open markets than by well-intended economic sanctions. History has shown that the best route to freedom and prosperity is market liberalism not market socialism. China should be admitted to the World Trade Organization as soon as possible and be given most-favored-nation status (which should be called "normal trade relations") unconditionally.

Governments everywhere need to get out of the business of trade and leave markets alone. Western democratic governments, in particular, need to practice the principles of freedom they preach and recognize that free trade is not a privilege but a right. They need to understand that

> it is neither possible nor desirable to stop individual European and American companies from doing business in China. What can and should be stopped are the efforts by western politicians to promote trade with China on a government-to-government basis. Such state-sponsored trade promotion is dubious at the best of times. With China it is particularly damaging. It merely reinforces the Chinese government's notion that access to the Chinese market is a political gift to be handed out as a reward to countries China favors.[36]

Using the threat of sanctions to promote human rights in China is illogical and risky. Freedom is better advanced by expanding international trade and by improving our own market-liberal system so it can act as a beacon of liberty for all the world to see. America should not let the dark hand of protectionism prevent that beacon of light from reaching China's shores.

Greater economic freedom will spill over into greater political freedom, as it has in other parts of Asia.

Notes

[1] Teng-hui Lee, "Taiwan's Quiet Revolution." Interview in the *Wall Street Journal*, March 27, 1996, A22.

[2] For a discussion of this issue, see the 1849 essay by Frederic Bastiat, "Protectionism and Communism," in *Selected Essays on Political Economy*, G. B. de Huszar, ed. (Irvington-on-Hudson, N.Y.: The Foundation for Economic Education, 1964), pp. 194-228.

[3] U.S. Congress, "Oxford-Style Debates: Resolved that the United States Should Use Trade Policy to Implement Human Rights Policy," 103rd Cong., 2nd sess., July 20, 1994. *Congressional Record*—House, H5937-49.

[4] J. R. Junkins, "Statement of Jerry R. Junkins, Chairman, President, and Chief Operating Officer, Texas Instruments, Inc., on Behalf of Business Roundtable," in U.S. Congress, *Fast Track Issues*, Joint

Hearing before the Subcommittee on Trade, House Ways and Means Committee, and the Subcommittee on Rules and Organization, House Committee on Rules, 104th Cong., 1st sess., May 11 and 17, 1995, pp. 66-74.

[5] Gary C. Hufbauer, Jeffrey J. Schott, and Kimberly A. Elliott, *Economic Sanctions Reconsidered: History and Current Policy.* 2nd ed. (Washington, D.C.: Institute for International Economics, 1990), p. 92. Also see Bruce Bartlett, "What's Wrong with Trade Sanctions?" *Policy Analysis*, No. 64 (Washington, D.C.: Cato Institute, 1985).

[6] State-owned enterprises accounted for only 20 percent of China's export growth in 1991-92 compared with over 80 percent in 1986-87. See Nicholas R. Lardy, "Economic Engine? Foreign Trade and Investment in China," *Brookings Review* 14, No. 1 (1996): 10-15.

[7] Y. Donghui, "If China's Most-Favored Nation Status Is Revoked, the United States' Long-Term Interests Will Be Hurt Even More Deeply," *Zhongguo Xinwen She* (Beijing), May 3, 1996, p. 3. (In Foreign Broadcast Information Service, *Daily Report: China*, "PRC: Trade 'Expert' Warns U.S. Not to Revoke MFN Status," May 6, 1996, pp. 3-4 [FBIS-CHI-96-088]). C.S. Duffy and M. Harrold, "Don't Break the China: Why Continued MFN Status Helps Americans and Chinese," *Issues Analysis* No. 33 (Washington, D.C.: Citizens for a Sound Economy, 1996), pp. 4-5.

[8] *South China Sunday Morning Post*, "Trade Goes on But Human Rights Falter," June 4, 1995, p. 10. (In Foreign Broadcast Information Service, *Daily Report: China*, "U.S. Shows 'Loss of Interest' in Human Rights," June 5, 1995, pp. 97-98 [FBIS-CHI-95-107]).

[9] Harry Wu notes that there are "more than 1,100 labor reform camps called the *laogai*" in China. As he puts it, "The laogai is not simply a prison system. It is a political tool for maintaining the Communist Party's totalitarian rule. Many of the laogai's 6 million to 8 million inmates are political prisoners." According to Wu, "forced labor from the laogai produces about one-third of China's tea and a significant amount of its cotton. About 60 percent of China's rubber vulcanizing chemicals are produced in a single laogai camp in Shanyang." See Harry Wu, "A Chinese Word to Remember: 'Laogai'," *Washington Post,* May 26, 1996, C7.

[10] C. Weibin and B. Wei, "PRC: West Criticized for Politicizing Human Rights," *Xinhua* (Beijing), April 23, 1996, p. 3. (In Foreign Broadcast Information Service, *Daily Report: China*, April 24, 1996, pp. 3-4 [FBIS-CHI-96-080]).

[11] R. W. Holleyman II, "Statement of Robert W. Holleyman II, President, Business Software Alliance," in U.S. Congress, *Fast Track Issues*, pp. 113-14.

[12] Quoted in Jianying Zha, *China Pop* (New York: The New Press, 1995), p. 203.

[13] U.S. Congress, "Oxford-Style Debates," *Congressional Record*—House, H5938.

[14] U.S. Congress, *Fast Track Issues*, p. 155.

[15] Bartlett, in "What's Wrong with Trade Sanctions?" (p. 10), concluded that economic sanctions "are a way of making ourselves feel that we are doing something substantive about a serious problem without really doing anything at all. The problem is that we are paying a heavy price for invoking this 'feel good' policy over and over again."

[16] Baron de la Brède et de Montesquieu, *The Spirit of the Laws*, A. Cohler, B. Miller, and H. Stone, eds. (New York: Cambridge University Press, 1989), Bk XXI, Ch. 20.

[17] Ibid, Bk. XXII, Ch. 13.

[18] Adam Smith, *The Wealth of Nations*, Edwin Cannan, ed. (New York: The Modern Library, Random House, 1937), p. 385.

[19] Alexis de Tocqueville, *Democracy in America*, J.P. Mayer, ed. (Garden City, N.Y.: Anchor Books, Doubleday, 1969), p. 637.

[20] Robert J. Barro, *Getting It Right: Markets and Choices in a Free Society* (Cambridge, Mass.: The MIT Press, 1996), p. 11. For studies of the degree and scope of economic freedom, see James Gwartney, Robert Lawson, and Walter Block, *Economic Freedom of the World: 1975-1995* (Vancouver, B.C.: The Fraser Institute, 1996); Bryan T. Johnson and Thomas P. Sheehy, *1996 Index of Economic Freedom*, (Washington, D.C.: The Heritage Foundation, 1996); and Rick Messick, *World Survey of Economic Freedom: 1995-1996* (New Brunswick, N.J.: Transaction Publishers, for Freedom House, 1996).

[21] See Kate Zhou, *How the Farmers Changed China* (Boulder, Colo.: Westview Press, 1996).

[22] Zha, *China Pop*, p. 202.

[23] Kathy Chen, "Chinese Are Going to Town as Growth of Cities Takes Off," *Wall Street Journal*, January 4, 1996, A1, A12.

[24] Joseph Kahn and Marcus Brauchli report, "Top university graduates used to consider party membership a career-gilding rite of passage, required for advancement through the ranks. Now, they scorn party recruiters." See Kahn and Brauchli, "China's Communists Face Serious Threat: Creeping Irrelevance," *Wall Street Journal*, December 19, 1994, A1 and A9.

[25] N. D. Kristof, "China Applauds as Its Officials Plunge into Profit," *New York Times*, April 6, 1993, A6.

[26] Quoted in Zha, *China Pop*, p. 204.

[27] Minxin Pei, "'Creeping Democratization' in China," *Journal of Democracy* 6, No. 4 (1995): 65-79.

[28] Minxin Pei, "Economic Reform and Civic Freedom in China," *Economic Reform Today,* No. 4, 1994, pp. 10-15.

[29] Marcus Brauchli, "China's New Economy Spurs Legal Reforms, Hopes for Democracy," *Wall Street Journal*, June 20, 1995, A1, A8.

[30] G. Melloan, "China's Growth Model Has Problems Too," *Wall Street Journal,* May 13, 1996, A21.

[31] See Rep. Philip Crane's discussion of how American firms raise standards in less developed coun-

tries in U.S. Congress, *Fast Track Issues*, p. 153.

[32] James A. Dorn, "Economic Liberty and Democracy in East Asia," *Orbis* 37, No. 4 (1993): 599-619.

[33] See Friedrich A. Hayek, *The Constitution of Liberty* (Chicago: University of Chicago Press, 1960); and Roger Pilon, "On the First Principles of Constitutionalism: Liberty, then Democracy," *American University Journal of International Law and Policy*, 8 Nos. 2-3 (1992-93): 531-49.

[34] James A. Dorn, "China's Fatal Conceit," *Cato Policy Report*, 18, No. 3 (1996): 6-9.

[35] Jixuan Hu, "The Nondesignability of Living Systems: A Lesson from the Failed Experiments in Socialist Countries," *Cato Journal*, 11, No. 1 (1991): 44.

[36] *The Economist*, "China's Wedge," May 11, 1996, p. 18.

9. Free Trade: Salvation for Cities

by Joel Kotkin

Introduction

Even proponents of free trade often think that open markets generate no particular benefits to America's big cities. And critics of free trade often maintain that imports harm cities by destroying jobs for lower-wage workers. But trade, in fact, has been a principal factor in the revival of many of America's great metropolises in the past few decades.

For the most part, America's cities have rarely been held in such low regard as today. The American city of the 1950s, with its rock-and-roll fantasies of corner candy stores, summers on the front stoop of the house, lunch-pail union workers, and the relentless drive toward assimilation, has evaporated as assuredly as artist Norman Rockwell's portrayals of idyllic small towns. Now the chaotic, undefined character of urban life in America, replete with quickly changing neighborhoods, legions of unconventional lifestyles, and diverse ethnic groups, places cities in the American imagination equivalent to the lowest rungs of Dante's *Inferno*.

Conservative technophile George Gilder has maintained that the telecommunications revolution, which makes available all manner of information to the suburban and rural hinterlands, will deliver the coup de grace to the city's long-drawn-out decline.[1] Marxist thinker Mike Davis recently described contemporary Los Angeles as "Chiapas with Freeways."

Nevertheless, there is evidence that cities not only are holding their own but are even making comebacks, rediscovering their historical niches as centers for international trade. From the vast port of Los Angeles to the high-rise towers of Miami and New York, international trade is remaking many of America's leading cities, laying the groundwork for their 21st century renaissance. And immigrants, especially, are helping to make those cities world-class commercial centers. Thus, preserving and expanding world trade will be a top issue for this country in general and for urban centers in particular in the 1990s and beyond.

The Importance of Trade

International trade is a growing sector of America's economy. Only 6 percent of the economy in 1970, exports constituted 8.5 percent by 1980; today they are up to roughly 12 percent.[2] Exports, which rose 90 percent between 1987 and 1993, are expected to rise another 9 percent in 1996, according to the economic forecasting firm DRI McGraw-Hill. Exports are responsible for about 20 percent of 1995 economic growth.[3] International trade in 1994 accounted for about four-fifths of the economic growth in heavily urbanized California and nearly 40 percent in industrial Michigan.[4]

For cities, which have been losing jobs to suburbs for the past few decades, trade already is one of the leading sources of new, well-paying jobs. Since 1986, according to the U.S. Department of Commerce, the percentage of jobs supported by exports has grown from 7.6 percent to 10.9 percent.[5] Equally important,

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jobs tied to exports pay an average of 13 percent higher in salaries than those aimed at domestic customers. Jobs in wholesale trade in California, for example, in a field dominated by international commerce, pay on average $36,000 annually—far above the state average of $29,000.[6]

The urban concentration in exports is beyond question. Over half of *World Trade* magazine's hundred fastest growing exporters, mostly in technology-related fields, are located in either metropolitan Los Angeles or San Francisco, with an additional 15 firms in metropolitan Boston. Those firms support the notion that urban areas, rather than catching up to the national economy, are emerging as leaders of the probable next stage of American economic development. That development is based largely on globally oriented networks of smaller, growing firms in highly specialized market niches. Many of the firms involved concentrate primarily on high-end business services, providing legal, accounting, financial, and communications assistance to overseas clients.

Urban Plight

The connection to world markets is particularly critical for cities because most in past decades have lost many of their traditional economic functions. For example, the urban industrial infrastructure has shrunk. Auto plants have closed or downsized in cities from Los Angeles to Detroit; Pittsburgh barely produces any steel while New York, which boasted over a million factory jobs in 1950, now has barely one-fourth that number.[7]

Many cities, once magnets of opportunity, now are incubators of large, dysfunctional populations. In 1960 only 26 percent of America's poor lived in central cities; by 1990, that percentage rose to more than 42 percent.[8]

The decline in the quality of life—associated with urban deindustrialization, the rise of urban crime, and the transformation of traditional neighborhoods into impoverished war zones—has also helped spur a mass exodus of white-collar managerial jobs from the center cities. In 1970, downtowns accounted for about 80 percent of all office space; today they account for roughly half that amount.[9] At the same time, the overall growth in demand for office space nationwide is only 1 percent annually, less than half the rate over the past two decades. In the past decade, *Fortune 500* firms, the conventional anchors of downtown business districts, have deserted a remarkable 250 million square feet of office space, the equivalent of 250 of New York City's Chrysler building.[10]

Even worse for traditional downtowns, virtually all high-growth companies, particularly in high technology, in past decades have chosen to occupy lower-rise, flexible space along the periphery of metropolitan regions. And major service firms show a marked preference for lower-rise, campuslike complexes located closer to their predominately suburban middle-class workforce.

Today, virtually all the fastest growing metropolitan regions of the country—Atlanta, Dallas, Denver, Phoenix, Orlando, Houston, and Charlotte—find most of their economic activity scattered throughout various urban minicenters. Booming Dallas has a downtown with a 35 percent office vacancy rate, highest among the nation's largest regions, but its suburbs have only a 13 percent vacancy rate.[11]

In contrast, job growth nationwide has been slowest in traditional, highly centralized regions. Manhattan, for example, has discovered during the past five years that it cannot afford two massive office districts. So although midtown remains marginally successful, the old Wall Street downtown district has become, as *Barron's* recently put it, a ghost town of boarded-up Art Deco towers.[12]

Trade and Cities in History

Amid an otherwise bleak picture, the growth of international trade has emerged as one of the central elements reshaping the economy of our urban areas. In many ways, that reflects a "back to the future" scenario in which cities return to the very role that was at the core of their development from the beginning of civilization.

From the ancient riverfronts of Ur in Mesopotamia to Thebes in Egypt, to Alexandria, where the Nile meets the Mediterranean Sea, ancient cities found their sustenance by buying and selling from other lands.[13] Virtually all the great cities of the Atlantic era—from Antwerp and Amsterdam to London and New York—were located on the ocean or with easy access to the open sea.

Urban trading centers long have been hotbeds for the creative as well as the commercial, merging cultures, technologies, and industrial concepts. Seafarers from the multiethnic coastal cities of early Renaissance Iberia

first learned of Indian and Chinese systems of navigation. The earliest progenitors of Asian capitalism were in cosmopolitan coastal cities such as Bombay, Shanghai, Singapore, and Nagasaki.[14]

The sociological aspect of urbanity has worked hand in hand with commerce. Trade connections have tended to follow patterns of ethnic migration. Jewish migration, for example, first to the Netherlands and later to the Americas, linked a vast network of traders across international boundaries in cities from San Francisco and Singapore to New York, Paris, and London. The French historian Fernand Braudel noted that the great economic boom in the Low Countries in early European history benefited by welcoming outcast groups such as Jews and Huguenots. Braudel wrote: ". . . the miracle of toleration was to be found wherever the community of trade convened."[15] Not surprisingly the Netherlands also was among that epoch's freest trade and commercial systems.[16]

Also the migration of British-descended peoples to the New World, Oceania, and South Africa helped form the first truly transnational trading regime.[17]

In contrast, trade often evaporates when cities have moved away from tolerance. Witness the rapid decline of Iberian trade following the expulsion of the Jews in 1492, the Inquisition, and the removal of the *Moriscos*, or former Muslims, in 1609.[18]

Los Angeles Crossroads

Nowhere is the efficacy of the free-trade regime more powerful than in contemporary Los Angeles, now the nation's largest and most important trading city. Even when the region's traditional manufacturing power, aerospace, has been severely cut back, the flourishing trade-oriented economy has played a central role in the region's recent recovery, which resulted in the creation of more than 90,000 new jobs between January 1995 and January 1996.[19]

Much of that increase occurred in sectors, such as wholesale trade, entertainment, tourism, and business services, closely tied to international trade activity. Statewide, 25 percent of California's economy is now tied to international trade: a full quarter above the national average. Furthermore, those trade-generating sectors, according to economist Steve Levy of the Center for the Continuing Study of the California Economy, are now growing twice as fast as the rest of the state economy.[20] In 1995 exports of California electronics rose by more than 30 percent and shipments of industrial machinery rose by 22 percent.[21]

Much of that boost came from the region's premier location as the center for trade with the burgeoning Pacific Rim, where the market for exports is growing at the approximate rate of 12 percent annually.[22] Since 1990, exports to Taiwan from California have risen by more than 65 percent, while those to South Korea have risen nearly 45 percent, and those to Hong Kong have surged by a remarkable 88 percent.[23]

Largely because of its Asian connections, Los Angeles, once a trade backwater, has virtually doubled its share of the nation's trade activity. Today California ranks as the nation's largest port and customs district. The two ports of Los Angeles and Long Beach—where tonnage has tripled since 1981—together constitute the world's third largest container port, following only Hong Kong and Singapore. The next closest American container port, New York, ranks 11th in the world.[24]

Largely because of its Asian connections, Los Angeles, once a trade backwater, has virtually doubled its share of the nation's trade activity.

The economic impact of such trade has been enormous. According to a study by the Long Beach-based World Trade Center Association, total trade has produced nearly 300,000 jobs in the region since 1990,[25] helping to make up for many of the approximately 400,000 jobs lost during the aerospace-induced recession. That growth has accelerated in recent years, rising 17.7 percent in the first half of 1995, as Asian trade continued to surge.[26]

Immigrants Helping Exports

Like the earlier evolution of trading cities, much of the recent growth in the United States has a profoundly human cause. In the past two decades, Southern California has emerged as the leading destination for new immigrants, particularly those from East Asia, Latin America, and the Middle East. Many of the immigrants, observed Los Angeles-based futurist Alvin Toffler, bring with them financial, market, and other business connections critical to success in the global economy.

Nowhere is the ethno-trade connection more obvious than in the rapid growth of Los Angeles-based servicing, warehousing, and distribution of items imported from or export-

ed to Asia or Latin America. Once a series of deserted warehouses and dying factories east of downtown Los Angeles, for example, Toytown, as it is known, has developed into a hothouse of international trade. Founded by an immigrant from Hong Kong, Charlie Woo, the district now consists of more than 500 toy importers, warehouses, and distributors, employing approximately 6,000 people. Revenues are estimated as high as $1 billion. Most of the owners and workers of those businesses are immigrants—Chinese, Vietnamese, Latino, and Middle Eastern people.

"The customers are immigrants, the merchants are immigrants, that's the beauty of international trade," Woo explained. "It's not one language, one culture but people of different backgrounds. LA is becoming the ultimate middle man, not only for Asia, but for Mexico, the Midwest, the South." On weekdays, and particularly on weekends, Toytown is crammed with shoppers, including representatives of toy buyers from as far away as the Carolinas and Argentina. "LA is the best place to trade globally," Woo said. "It's the new Hong Kong."

Today the United States is the undisputed leader in services, exporting nearly $300 billion in such "invisible trade"—including income from overseas assets—in 1994.

But the success of Toytown is not singular. Other trade-related businesses—in textiles, flowers, vegetables, fish, and other food processing as well as large trucking operations—cluster in the downtown district. As a result, although vacancy rates in the high-rise office towers hover at more than 20 percent, industrial and warehouse space downtown has vacancy rates at half that level. Indeed, according to Coldwell Banker, in terms of post-1930s buildings, the real vacancy rate may be only 3 percent or less.

As a result, blocks away from office buildings that are now totally run down, local developers are planning to build new trade-oriented structures. "The people who own the high-rises are going to face the music, but we are developing new properties for where the future is," observed Doug Hinchliffe of Lowe Development Corp., a major builder of industrial and warehouse space now developing a 23-acre import-export center in downtown Alameda. "It's the importers, the garment people, the immigrants, the Asian entrepreneurs who are driving things," he added.

Selling Smart

But such transactions reflect only part of Los Angeles's trade-based resurgence. Increasingly, much of the growth can be ascribed to another urban strength—its predominant role in what the Japanese economist Taichi Sakaiya has called "knowledge value industries."

Such industries include tourism, publishing, fashion, and multimedia, all of which remain heavily clustered in a handful of cities, predominately in California and New York. In contrast to traditional industries such as petrochemicals or textiles, knowledge value involves less engineering skill, which is susceptible to easy duplication, but more of the intangible power of originality. Highly advanced economies, such as those of the United States, Western Europe, and Japan, increasingly must find their niches, Sakaiya has argued, in fields relatively resistant to competition from lower-cost producers in the Third World.[27]

Since 1980, the services share of American exports has grown from less than 20 percent to more than 30 percent. Today the United States is the undisputed leader in services, exporting nearly $300 billion in such "invisible trade"—including income from overseas assets—in 1994.[28]

Entertainment Exports

Artists and entertainers mostly tend to congregate in major cities; New York and Los Angeles alone account for about 14 percent of the nation's artists as well as a large percentage of the design communities.[29] Los Angeles leads the nation in the number of mathematicians, engineers, and skilled technologists. The city ranks third, behind only San Francisco and Boston, as a center for scientific research.[30]

In Southern California and other urban regions, those knowledge professions can be applied to a vast array of products, from aircraft to satellites to medical equipment—all fields where California leads the nation in terms of jobs—that have long been the cornerstones of its export economy.[31]

Entertainment, an industry whose employment in Los Angeles County alone has more than doubled since the late 1980s, is increasingly crucial among "knowledge value" exports.[32] Although costs are high, entertainment-related companies in Hollywood have developed products that remain the top supplier for the world market. Barely accounting for 30 percent of Hollywood's sales in 1980, international markets now account for more

than half of all $4 billion in annual movie revenues. By the year 2000, helped by expanding markets in Eastern Europe, Latin America, and East Asia, overseas markets are expected to be responsible for 70 percent of all American film revenues.[33]

The demand for entertainment-related products encompasses many goods and services, such as designs for theme parks (including the new Universal Studios development in Osaka), "theatrical lighting" for shopping centers, as well as music, film, and television productions. The percentage of revenues from foreign sources for the Walt Disney Company has tripled to almost 25 percent since 1984 and has been growing at almost twice the rate of domestic business.

The continued dominance of Los Angeles over the world mass-culture market grows directly from its highly concentrated urban economy. Charles Como, founder of the Underground Network, a Hollywood-based music consultant specializing in putting music over the Internet, has observed that developing artistic projects requires intensive face-to-face contacts among producers, artists, and marketing professionals. "A group of people in the country simply can't determine where music is going," said Como. "You have to be here in a place like Hollywood to be with the artists who drive the whole process."

The intense concentration of creative people allows for what Jonathan Katz, founder of one of Hollywood's top prop makers, calls "face-time." In an entertainment project, collaboration can mean that the best ideas come over lunch or in casual conversations during the day. With brief lead times, creators' ability to marshal known assets from numerous quarters often determines success or failure.

The density of skill sets, the existence of vast arrays of freelancers, specialists, and service providers allows American producers to create a greater number of unique products than anywhere else in the world. "The world is buying what we produce," observed Phil Romer, the producer of *The Simpsons* and *Garfield* cartoons for a global market. "There's something unique here that comes from nowhere else."

New York International

Similar trade-led urban growth can be seen in New York, which suffered grievously from economic setbacks over the past few decades. Like Los Angeles, for example, New York suffered severely from the 1990 recession; the region lost more value in more industries and more jobs than any other in the nation.[34] With the highest cost of living in the nation, it also sustained the largest net outmigration of any American region.[35]

In such hard times, international trade and the global economy increasingly are aspects to which New York business, academic, and political leaders could look for their economic salvation. With New York's decreasing importance in the national economy, observed Mitchell Moss of New York University's Wagner Graduate School of Public Service, "the scope and character of New York's economy will be largely shaped by its interaction with the global economy."

Even more so than Los Angeles, which still boasts a powerful industrial base, New York's future economic growth probably will be tied to service fields such as advertising, media, and finance. That situation was the case even in the 1980s when foreign banks accounted for more than half the total growth in banking employment in the region.[36] Indeed, despite its relative decline as a merchandise trade exporter, New York City continues to dominate in the world of high-end business services—aided by a local population drawn increasingly from overseas. By the year 2000, for example, New York's nearly 2 million Latino and half million Asian populations will add another half million to their ranks.[37]

Typical of New York's new breed of service exporters is Audits and Surveys, a market research firm located in Manhattan's fashionable Chelsea section. Founded 30 years ago, the company has been expanding rapidly in recent years into global markets, with offices in Canada, Latin America, Asia, and Europe. Foreign-based clients include Bell Canada, the Citizen Watch Company, Minolta, Nestlé, Polygram, and Scandinavian Airline Systems.

To Audits and Surveys founder Sol Dutka, the New York locale is critical to his overseas marketing because most major global companies already have a strong presence there. In New York is a cosmopolitan cultural climate that, he pointed out, he is unlikely to find in less costly but more out-of-the-way locales such as Charlotte, North Carolina. "When I go international," Dutka noted, "I can access all the potential clients right here."

Similarly, like Woo in Los Angeles, Dutka credits New York's diversity with boosting his

firm in the field of global business. Upwards of three-quarters of America's 10 million immigrants during the 1980s settled in a handful of urban states, with New York and California as destinations for about half that total. As a result, 8 of the nation's 10 most diverse counties are located in either the San Francisco Bay, New York, or Los Angeles areas.

For Dutka, the son of Czech Jewish immigrants, those immigrants provide yet another critical creative spark for his company. In recent years, Dutka's employees increasingly reflect the changing population base in the New York area, with more Russian Jews, Koreans, and other Asians than in the past. Employing immigrants, Dutka has suggested, gives his firm a critical understanding of both foreign markets and America's own changing demographics.

"How many people in Greenville or Charlotte know about East Indians or Koreans—both big markets?" Dutka asked. "How would you know there are five different kinds of Hispanics—and each one is a different market?"

Miami's Sunny Prospects

Another city turning immigration and cultural diversity into a trade advantage lies to the south in Miami. High crime rates and massive outmigration of long-time residents in the 1970s and 1980s suggested to many that the old vacation mecca was in a serious, long-term decline. But once again, the surge in cross-border trade with Latin America and the growing economic clout of the city's Latino residents—including 650,000 Cubans, 75,000 Nicaraguans, and 65,000 Colombians—have helped forge a new role for the supposedly dying city.[38]

In 1994, for example, the Miami area accounted for nearly one-quarter of all American trade with South America, including nearly two-fifths of all exports. Miami also accounts for two-fifths of all American trade with the Caribbean and almost 60 percent of all American trade with Central America.[39] With the keenness of the *doges* or *podestas* of Italian city-states, south Florida's political and economic elites are aware of the critical nature of their trade connection.

"We're the only state in America with a foreign policy," observed Buddy MacKay, the state's Lieutenant Governor. "And our foreign policy is that we want to increase the hemispheric free trade and we want Miami to be the capital of that area."[40]

Through the 1990s Miami's trade has been growing, usually by double-digit rates annually, with Latin American countries such as Brazil, Colombia, Argentina, Venezuela, and the Dominican Republic as the top five export destinations. In the first half of 1995, for example, Miami's "Latin strategy" boosted the area's trade volume by an outstanding 19.4 percent.[41] Leading export items included such high-value products as automatic data processing equipment, telecommunications gear, and car parts as well as garments.[42]

But those connections, noted Modesto Maidique, President of Florida International University (FIU), transcend merchandise trade. In the past three decades, Miami has also become a major player in both business and financial services for the entire Latin American region. Since 1984, for example, Miami International Airport has nearly doubled the number of foreign passengers, many of whom come to the city from Latin America for vacation, business, and shopping.[43] Similarly, Miami's airport alone accounts for a remarkable 70 percent of all air cargo transport to and from Latin America and the Caribbean.[44]

Multinational Mecca

Much of the trade expansion has been driven by the rapid expansion of multinational firms in the Miami area, now numbering more than 300. Nearly half of them have set up shop only during the past decade. Eighty percent of those firms are engaged in business and other financial services as well as in construction.[45]

Proximity to markets, particularly Latin America, is a critical element in keeping companies in the Miami area. "If I have an emergency deal in Caracas, I can go there and be home in time for dinner tonight," observed Jay Malinia, president of Manufacturer's Export and Equity Group, a Miami-based firm that helps American manufacturers enter Latin American markets.[46]

The Latin connection has also helped transform Miami into a powerful center for a U.S.-based Spanish-language medium. Both Univision and Telemundo broadcast from Miami to Latinos in the United States as well as in Spanish-speaking nations to the South. "If you take away international trade and cultural ties from Miami, we go back to being just a seasonal tourist destination," observed FIU's Maidique. "It's the imports, the exports, and the service trade that has catapulted us into the first ranks of cities in the world."

Valued Immigrants

As in Los Angeles and New York, immigrants have been critical to the transformation of Miami. The movement of Cuban exiles into south Florida brought an entire professional class accustomed to commerce in Latin America and other points south. Those advantages are part of the reason why competing Southern cities have been unable to wrest the trade business from Miami. But it is instructive to note that up-and-coming Florida cities, such as Orlando and Jacksonville, are also focusing on international trade as a way to develop their economies—for example, by expanding their port or airport facilities.[47]

Beyond Houston's Oil

Like Miami, Houston has been largely saved from permanent economic decline by a trade economy that, according to University of Houston economist Barton Smith, now accounts for approximately 10 percent of the region's employment. Since 1986, tonnage through the 25-mile-long Port of Houston has grown by a full one-third, helping the city recover the jobs lost during the "oil bust" of the early 1980s.[48]

"The energy industry totally dominated Houston by the 1970s—after all oil has been at the core of our economy since 1901," explains Smith. "Every boom leads people to forget other parts of the economy. After the bust, people saw the importance of the ports and trade."

Like most trading cities, Houston's trade commitment is increasingly dominated by services. No longer the prevailing center in oil production or equipment, Houston, noted Smith, has developed into a key service sector for energy and other industries. Business in hotels and traffic at the airport—up 50 percent since 1990—are as good indicators of Houston's economic future as oil rigs or ships loaded with petroleum.

"Cities like Houston are natural places for making deals—for raising money, arranging shipping, doing meetings and getting all kinds of business services," Smith suggested. "Houston's connections to the world economy are underestimated because you don't get a handle on all the accountants, financial services and design services that we offer to international clients."

Ethnic Diversity

One critical factor, Smith said, is Houston's highly diverse population base. Like Los Angeles, the Texas city is a sprawling, sometimes seething melting pot of contrasting ethnic groups; nearly one-quarter of the population is Hispanic and as much as another 8 percent Asian.[49]

That polyglot mixture plays an important role in developing clients and contacts for exporters such as Anaheim Industries, a firm that specializes in van conversions. Ralph Maldonado, president of Anaheim, sells a large portion of his company's hottest product—ballistic resistant vehicles—to South American and Caribbean customers. Such conversions now account for roughly 40 percent of Anaheim's sales, up from 10 percent three years ago. "There's a huge percentage of Hispanics here," said Maldonado, himself a Puerto Rican from New York City. "This makes it a very comfortable environment for them."

In addition, Maldonado credited Houston's location near the Gulf of Mexico as bringing additional benefits for his business. "It's a good place because Houston is perfectly located," said the entrepreneur, who employs 115 workers. "You can ship to anywhere from here—particularly in Latin America or Mexico."

Magnet for Manufacturers

Houston's specialty—concentrated largely in the shipment of raw materials and commodities such as oil and organic chemicals—also provides an ideal environment for companies, like Woodland Millworks, which uses lumber imported from South America to make moldings. The cargo ships that leave their goods on Houston wharves provide an ideal incentive for manufacturers who use such raw materials.

"We're just three miles from the port of Houston and that makes things very convenient," observed Charles Vignal, who moved his company from the Texas Panhandle to Houston a decade ago. "That's why we're here. Being in Houston makes us profitable."

In his business, Vignal explained, transportation costs could consume as much as 40 percent of his total revenues. Proximity to his source of Latin American lumber also provides easy access to leading markets such as Canada, which accounts for about one-third of the sales by his 100-person company.

Detroit's Destiny

It is not just coastal cities that benefit from

As in Los Angeles and New York, immigrants have been critical to the transformation of Miami.

Washington State, with only 2 percent of the nation's population, has 7 percent of all American trade.

world trade. Surprisingly, Detroit has experienced benefits. For years seen as a center of arch-protectionist sentiment, the Detroit area has witnessed its international sales rise dramatically during the past decade. With annual increases in exports of more than 10 percent since 1990, the area now boasts the nation's third largest customs district, behind just Los Angeles and New York.

Unlike Miami and Houston, Detroit's focus is largely northward to Canada—just a hop across the bridge to Windsor—which accounts for two-thirds of its exports. The city also looks to the European Union. Indeed, Canada accounts for the vast majority of all exports derived from Michigan, with the European Union in second place. Exports are responsible for nearly a half million jobs in the state.[50]

In many ways the core of Detroit's trade strength is connected to the very industry—automobiles—most associated with its longtime economic problems. After battling foreign competitors, usually unsuccessfully, the area's automotive complex staged a remarkable comeback in the 1990s. Much of the growth, noted economist David Littman of Comerica Bank in Detroit, has occurred among small, high-tech firms that have become critical suppliers to automotive and other industrial firms.

"The advantage you have here," Littman explained, "is the concentration of state-of-the-art technologies in value-added industries. From Ann Arbor to Auburn Hills, you have any kind of engineer you want. These people have been working on the productivity issues that industrialized countries around the world are concerned with."

Typical of the firms Littman spoke of is Menlo Tool Company, which has been producing precision cutting tools for the auto industry since the mid-1960s. Today the firm exports nearly 55 percent of its products overseas through its dealer network. Although automotive markets are still key, Menlo also sells to industrial and aerospace firms across the world.

John Falk, the company's executive vice president, said the Detroit area provides critical advantages to any firm seeking to produce state-of-the art industrial equipment for the world market. "We have an exceptional workforce here that's well educated," said Falk, whose firm enjoyed $10 million in sales last year. "Michigan has an enormous concentration of skills. There are people and skills that are available right here. It would be a logistical problem if you tried to do this, say, out of Montana."

Seattle Sells

But perhaps no group of cities has gained more from burgeoning global trade than those located along the West Coast. Like Los Angeles and New York, cities such as Portland, San Francisco, and Seattle have excelled in creating "knowledge value" products, from airplanes to software to semiconductors. Those areas of product excellence, plus a prodigious location on the Pacific Rim, have turned that region into the most trade-dependent in the nation.

One might consider Seattle and its setting in Washington State, which now ranks as the nation's fifth largest trade district. Trade there, targeted heavily toward the Pacific Rim, accounts for 10 of the state's 11 largest trading partners. That trade has expanded quickly in recent years. Between 1987 and 1993, for example, the state's exports surged 165 percent, more than 80 percent above the national average, an increase that was the largest for any of the major trading states.[51]

As a result of that surge, Washington State, with only 2 percent of the nation's population, has 7 percent of all American trade. One of every five jobs in the Puget Sound region is tied to international trade.[52] "There's a huge interest in trade activity here," observed Paul Sommers, executive director of the Northwest Policy Center. "There's over forty trade organizations in Seattle alone. Being in the extreme left-hand corner of the country, you have to look around for your markets."

Sommers added that Seattle is beginning to expand the range of its trade economy. Although traditionally as much as two-thirds of the dollar volume of the region's exports is tied to Boeing, the giant airline manufacturer, more and more of the area's exports are in products and services tied to high-tech products, including biotechnology and software. The latter sectors boasted $3 billion a year in exports.[53]

"The dynamic forces are here," said Sommers. "They can be seen in high tech and software. Increasingly it's not just manufacturing airplanes—it's becoming more and more complex. It's like the whole Silicon Valley phenomena."

San Francisco Shipments

Indeed, in terms of high-tech exports from

urban America, few places have outperformed the Bay Area. The Silicon Valley area alone accounts for approximately *one-third* of all the nation's high-technology exports,[54] helping establish San Francisco as the nation's fourth largest port. In 1995 alone, shipments of semiconductors from the region's airports and ports jumped a remarkable 50 percent, helping spur the region to a strong 15 percent growth in trade volume and helping boost employment in the region by 46,000 jobs.[55]

The Bay Area's leading exporters include a virtual "who's who" of the high-tech elite, led by Hewlett-Packard, Oracle Systems, and Varian Associates. Although founded by native-born Americans, many of those companies rely heavily on immigrant engineers, who account for as much as one-third of their engineering workforce.[56]

Yet increasingly much of Silicon Valley's trade—like that of such diverse cities as Houston, Miami, and New York—revolves around more service-related fields such as software. In the past decade, entrepreneur David Lam has made that transition. In 1980 the Vietnam-born Lam founded Lam Research, a semiconductor equipment company, which now has $1.5 billion in sales and more than 4,000 employees.

But by the late 1980s, Lam, like other valley entrepreneurs, saw that the real competitive advantage resided in software. So in 1989 he founded Expert Edge, a company that specializes in programming the sophisticated machinery used in the semiconductor business. "This is where the valley is now going," he stated, pointing to such successful software-based firms as Netscape, Yahoo, and Oracle. "It's where we are best and most competitive."

Another big change, according to Lam, is the quickness of Silicon Valley firms to sell overseas. Traditionally, those technology firms established themselves first in the domestic market and then looked into foreign markets. "Today everything's global," Lam said. "By the time you get your concept, you have to be ready to go overseas."

At Expert Edge, for example, nearly 30 percent of all sales are overseas, mostly to Europe and Asia. That growth, Lam said, has been aided by the multiracial character of the Valley, where Asians now own at least 660 high-tech firms and account for one of every three engineers. At Expert Edge, for example, Lam has key personnel from such varied locales as the Philippines, China, Taiwan, Malaysia, and Singapore.

"We use every personal and cultural connection we have," he explained, "to get in all the key Asian markets. We see our diversity as a huge asset."

Conclusion

Clearly, if global trade were to be squeezed by protectionist pressures, the first and most obvious losers would be the nation's great cities. If America's overall economy has become ever more dependent on global markets, that situation is doubly true of large cities that are struggling, often against great odds, to find a new economic role in the highly dispersed economy of the 1990s.

Fast-growing East Asian countries increasingly produce and trade among themselves the kinds of generic industrial goods created and exported by America's heartland. Nearly half of Asia's total commerce is already self-contained within the region, up from barely 40 percent just five years ago.[57] That will put a premium in the future on "knowledge value" products that originate more from America's urban areas. If America turns away from global trade, others no doubt will gleefully pick up the slack.

Trade is the lifeblood of cities, and global trade is the elixir of urban regions. Any attempt to cut off that vital source of nourishment would plunge America's greatest cities—from Los Angeles to New York—into a deepening pit of decline and despair. In the end, anything that kills trade would not only create havoc in the marketplace but would shatter what has become the last, best hope to revive our great cities.

The Silicon Valley area alone accounts for approximately one-third of all the nation's high-technology exports.

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