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J. Patrick Raines
University of Richmond

Lewis A. Litteral
University of Richmond, llittera@richmond.edu

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ISSUES AND IMPLICATIONS OF
IMPLEMENTING SURCHARGES TO IMPROVE
THE U. S. BALANCE OF TRADE

J. Patrick Raines

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**ISSUES AND IMPLICATIONS OF
IMPLEMENTING SURCHARGES TO IMPROVE
THE U. S. BALANCE OF TRADE**

By

**J. Patrick Raines, Ph.D.
Assistant Professor of Economics
University of Richmond**

and

**Lewis A. Litteral, Ph.D.
Assistant Professor of Management Systems
University of Richmond**

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Introduction

Throughout the 1970s and early 1980s, increasing positive balances on the services account provided a substantial offset to negative balances in merchandise trade, and, consequently, the cumulative current account balance was a positive \$3.8 billion for the period 1970-80. Since 1981, the progressively smaller balances in services have been insufficient to offset the increasingly negative merchandise trade balances [15]. Table 1-1 shows the deterioration in U. S. international accounts during this period.

Table 1-1

U. S. World Trade Balance and
Current Account Balances
1981-1985

[Billions of U. S. Dollars]

	1981	1982	1983	1984	1985	1986
U. S.	-39.6	-42.6	-69.4	-123.3	-143.8	-150

Source: Economic Report of the President: 1986

This apparent shift from U. S.-produced goods to foreign-produced goods has inflicted economic hardships on workers and producers in key sectors of the U. S. economy. For example, largely because of the 60 percent appreciation of the U. S. dollar on a trade-weighted basis, U. S. imports of capital goods rose from \$29.6 billion in 1980 to an annual rate of almost \$65 billion in the first half of 1985. Additionally, problems in the U. S. agricultural sector worsened as exports of agricultural products declined from \$43.3 billion in 1981 to \$30.1 billion in 1985.

The loss of competitiveness of U. S. producers inferred by their severely squeezed profits and the displacement of many industrial workers and farmers

has produced a sharp rise in protectionist sentiment in the United States. The result has been a deluge of legislation introduced in Congress over the past year seeking surcharges, quotas, or other protectionist measures on a wide array of foreign imports. The thesis of this study is that the effects of protectionism, particularly a surcharge, are so wide-ranging, complex and potentially detrimental that they must be clearly stated before their impacts can be estimated individually or in the aggregate. Thus, after a brief review of recent protectionist legislation introduced in Congress, a theoretical analysis of contemporary effects of a surcharge on U. S. imports is presented.

Review of Surcharge Legislation in the United States Congress

The amount of legislation introduced in Congress in the last 18 months can be construed as indicative of a tilt in United States trade policy toward protectionism. The recent trend began in February 1985 when the House of Representatives introduced H.R. 1139. The bill called for an immediate 20 percent surcharge on all U. S. imports. To force trade partners to open their markets to U. S. goods, provisions were included whereby surcharges could be removed as bilateral free-trade areas were negotiated. Three additional surcharge bills were introduced in the House during the spring of 1985. H.R. 1944 was the first and proposed to levy a 10 percent surcharge on Japanese imports to encourage Japan to eliminate a variety of non-tariff barriers on U. S. exports. The sentiment to expand protectionist measures to other trading partners surfaced in H.R. 2015. This time, proponents argued that surcharges on imports from Japan and other NATO allies should be imposed in amounts sufficient to pay for U. S. troops stationed in respective NATO countries. Recognizing surcharge revenues could go toward the ever-widening gap between federal government

expenditures and revenues, the House introduced H.R. 2120 in April 1985. Surcharges would be imposed on all imports for a two year period and would decline from 20 percent to 10 percent over the period if federal budget deficits were reduced from projected levels. H.R. 3035 introduced in July established criteria to impose a 25 percent surcharge on imports from countries with a large trade surplus with the United States. At the time the bill was introduced, only Japan, Taiwan, Korea and Brazil met the criteria established in the legislation.

The U. S. Senate has also been considering legislation which would impose import surcharges. The Senate introduced S. 761 in March 1985. The bill called for variable surcharge rates on imports from countries with large current account trade surpluses with the United States. Once again, Japan would have been the only country affected under the provisions of the bill in 1985. Senate bill S. 770 targeted imports exclusively from Japan and proposed a 20 percent surcharge on all Japanese imports. S. 906 introduced in April proposed the highest surcharge to date - a maximum 43 percent surcharge on imports from any country that had a substantial surplus in merchandise trade with the United States and that engaged in unfair trade practices.

Although Congress has not passed a bill which would specifically impose a surcharge on imports, both the Senate and House have passed resolutions by overwhelming majorities which could result in import surcharges. Both Senate Concurrent Resolution 15 and House Concurrent Resolution 107 call for the President to take retaliatory measures against Japan unless it opens its markets to U. S. goods. It should also be noted that in May the House of Representatives passed the Trade and International Reform Act of 1986 (commonly known as the omnibus trade bill). Specifically, the bill would tighten countervailing duty and antidumping rules, require countries who run large trade surpluses with the

United States to reduce those surpluses or face retaliation, and impose trade restrictions against countries who do not meet "internationally recognized workers' rights." When the new Congress convenes next year, factors such as another record U. S. trade deficit and persistent unemployment may increase the likelihood that Congress will pass some type of surcharge on imports.

A Theoretical Analysis of Import Surcharges

A growing number of rationales are being offered to justify trade restrictions and surcharges. Proponents of a surcharge argue it will reduce United States deficits in both foreign trade and the federal government budget, aid U. S. industries adversely affected by competition from imports, and induce trading partners to open their domestic markets to U. S. exports. Protectionist measures are advocated as a means to achieving two broad objectives. First, they are intended to provide visible and immediate relief to industries experiencing severe difficulties and especially to their workforce. And, secondly, they are intended to allow ongoing adjustments to changed economic or technological circumstances. Such admirable objectives correspond to a concern for (and political pressure for) employment and social equity on the one hand and to the goal of promoting greater economic efficiency and industrial restructuring on the other. Compared to the complexity of the objectives, protection is a fairly simple and blunt policy instrument.

Trade protection has complex and pervasive effects throughout the economy. The lack of transparency of the many different types of measures being considered makes it difficult to quantitatively assess their impact on macroeconomic performance indicators and any such assessment should be treated cautiously [3]. Nevertheless, recent empirical studies have estimated the aggregate effects on

the U. S. trade balance of a 20 percent surcharge on all imports. In 1985, the Congressional Research Service estimated that the improvement of the trade balance would be \$19.6 billion if a 20 percent surcharge were implemented [8]. Wharton Econometrics and Data Resources, Inc. also presented the results of large-scale studies in 1985 [22] [11]. In testimony before the Senate Finance Committee in April of last year, Professor Lawrence Klein presented the results of the Wharton study and Robert Gavin, CEO of Motorola, presented the results of the DRI investigation. The Wharton study estimated an improvement in the U. S. trade balance in the range of \$11.7 billion to \$21.4 billion, while Data Resources, Inc. estimated a \$54.3 billion improvement.

The effects estimated in these studies are based primarily on economic theory which holds that the price mechanism is the main channel through which countries' international accounts are adjusted. However, in "real world" market economies, the actual adjustment process involves a myriad of individual, freely arrived at decisions by millions of consumers, producers and distributors in countries around the world, responding to gradually evolving market incentives. The analysis which follows identifies a broader set of factors which, at least in part, determine the demand for exports and imports, and should be considered in estimating the cumulative costs and benefits of protectionist measures.

Surcharge Pass-Throughs

The nominal purpose of a surcharge would be to reduce imports by increasing their prices to residents and, thereby, encouraging consumers to switch their purchases from imported goods to relatively less expensive domestically produced substitutes. Empirical estimates of the aggregate effect of a surcharge (usually 20 percent) on the U. S. trade balance generally assume the "tax" is completely passed through by the sellers of imported goods to the final consumers. In

fact, the effectiveness of a surcharge in reducing exports depends to a large degree on the proportionality between the tax and the price increase, i.e., the extent to which the charge is actually passed on to ultimate buyers. Recent evidence suggests that foreign suppliers have the ability to absorb a surcharge and maintain their market shares.

The U. S. dollar appreciated nearly 60 percent against OECD currencies between 1980 and 1985. Obviously, foreign sellers in U. S. markets faced a pricing policy dilemma. They could maintain prices of their goods (and thus their profits) fixed in terms of their domestic currency and permit prices of their products to decline in terms of dollars in the U. S. market in an amount directly proportional to the appreciation of the dollar relative to their domestic currency. This strategy would have led to substantially lower U. S. prices for final consumers of imported goods. Alternatively, foreign sellers could maintain U. S. dollar prices in U. S. markets and increase their profits in their own currency in proportion to the depreciation of their currencies relative to the dollar. The pricing strategy chosen by most major industrial countries tended toward the latter option. A study by the Federal Reserve Bank of New York indicated that the 59 percent appreciation in the U. S. dollar between 1980 and 1985 led to a mere 2 percent reduction in prices of U. S. imports [18]. This suggests that the remainder, some 57 percent, accrued to foreign producers as higher profits. Certainly, the sharp increase in profits accumulated by foreign sellers during the dollar's recent appreciation affords them the ability to moderate - if not absorb - increases in the prices of their products which might result from a surcharge. Such "excess" profits may partially explain why the dollar depreciation in recent months has not led to a rapid adjustment in the U. S. trade balance.

Exchange Rates

A surcharge would initially give manufacturers in the U. S. a relative price advantage over imports. However, the initial advantage would tend to be negated by a round of secondary adjustments. Policymakers should anticipate the exchange rate response described by the economic theory of tariffs. Such adjustments would arise directly from the free market forces unleashed by a surcharge [13].

If U. S. consumers shift their expenditures away from foreign produced goods and toward competing domestic products, the supply of dollars flowing to the foreign exchange markets would be reduced. To the extent that the exchange rate of the dollar relative to other currencies is determined continuously by the supply-demand relationship in the foreign exchange market, a reduction in supply would cause the dollar to appreciate. It follows that the larger the reduction in imports attributable to a surcharge, the smaller the supply of dollars will be to foreign exchange markets - and the greater the appreciation of the dollar. In addition to reducing the initial price advantage of U. S. import-competing producers, the dollar appreciation would adversely affect the price competitiveness of U. S. exporters. As exports are discouraged, hard pressed U. S. export oriented industries, e.g., agriculture, would receive no direct benefits from the surcharge while most likely incurring further reductions in export-related revenues and foreign markets. In the final analysis, the response of exchange rates to a surcharge would tend to remove entirely the positive trade-balance effect of a surcharge [21].

The complexity of current U. S. trade problems belies the simplistic logic of the foregoing analysis. The dramatic increase in the annual trade deficit from \$25 billion to \$144 billion between 1980 and 1985 is related to the sharp

rise in the value of the dollar over that period. However, the decline in the U. S. dollar since March 1985, which was accelerated by the U. S. government and four foreign governments, has not resulted in the reduction in the U. S. trade deficit suggested by conventional wisdom. In fact, the U. S. trade deficit has continued to increase and by mid-year 1986 rose to an annual rate of \$150 billion [10].

The rising U. S. trade deficit recorded in recent months has, assuredly, been influenced by a phenomenon known as the "J curve" effect. Although the "J curve" literature is primarily concerned with the trade balance impact of currency devaluations, the theory has relevant implications for a surcharge trade policy. It should also be noted that the predicted effect has political ramifications as the mettle of politically accountable policymakers may be seriously tested if protectionist measures do not produce immediate, visible benefits for constituents [4].

The evidence on devaluation and trade balances suggests that a worsening of the trade balance is usually observed over the period of time immediately following a devaluation. However, over a longer period of time a swing toward a positive improvement in the trade balance is expected. A surcharge would not have the exact impact of a devaluation on the trade balance because a surcharge would not automatically increase the flow of dollars to foreign producers as a result of higher import prices. However, the time necessary to improve the trade balance with a surcharge would be analogous to the adjustment period hypothesized by the "J curve." Consumers and producers generally would adjust slowly to either a devaluation or a surcharge. It is only after an imported commodity is placed on the shelves that consumers can reject it due to its higher price. Since it takes purchasers time to recognize a changed competitive

condition and make adjustments, a consumer-response lag is inevitable. Also, there is a production-response lag as pre-existing contracts might not permit adjustments in new shipments. Until orders can be canceled or reduced, shipments may continue to arrive, thus raising the value of imports and frustrating policy-makers. Further, additional time is required to phase out production and reduce manufacturing capacity.

That the adjustment of exports and imports to relative price changes occurs only slowly over time has been found in many studies. A study by Junz and Rhomberg found in a sample of 13 industrial countries that the trade response to relative price changes took up to five years, with only 50 percent of the full effect occurring in the first three years [16]. In societies that pursue instant gratification, lengthy adjustment periods would be perceived as policy failures which would necessitate further legislative efforts and could further exacerbate trade problems.

Surcharges, Employment Protection and Modernization

The worldwide slowdown in economic growth and consequent persistent high level of unemployment has increased the pressure on governments to attenuate the speed of structural adjustment and the rate of job losses. It appears that surcharges would have only a limited positive impact on U. S. employment in the protected sectors. To begin with, in the sectors most directly in competition with foreign suppliers, trade flows are usually a fairly minor determinant of employment levels. Also, unless surcharges are applied to all imports, trade diversion may result in a very limited impact on import volumes.

Table 10-1 conveys a noted misconception, namely manufacturing employment declined over the decade 1974-1984 as a result of an increase in import penetration

in the manufacturing sector. Further analysis suggests this outcome is not the result of a trade deficit and that a surcharge would be unlikely to provide much additional employment in the sector. Column 5, denoting changes in labor productivity, provides a compelling answer to the question of why employment has declined in manufacturing between 1974-1984 - productivity has increased 27.9 percent over the period.

Table 10-1
 Manufacturing Sector Indicators
 1974-84

Year	Import Penetration (percent) ¹	Industrial Production (1977=100)	Employment (thousands) ²	Productivity (1977=100) ³	Average Hourly Earnings (dollars) ⁴	Real Net Capital Stock (billions 1982 dollars) ⁵
1974	7.2	92.6	20,077	90.6	4.42	581.1
1975	6.5	83.4	18,323	92.9	4.83	597.2
1976	6.7	91.9	18,997	97.1	5.22	612.5
1977	6.9	100.0	19,682	100.0	5.68	630.5
1978	7.8	107.1	20,505	101.5	6.17	655.1
1979	7.9	111.5	21,040	101.4	6.70	681.4
1980	8.2	108.2	20,285	101.4	7.27	707.2
1981	8.5	110.5	20,170	103.6	7.99	729.7
1982	8.9	102.2	18,781	105.9	8.49	741.3
1983	9.3	110.2	18,434	112.9	8.83	741.1
1984	10.9	123.9	19,412	118.5	9.18	752.9

¹Imports as percent of manufacturers' shipments plus imports minus exports; based on value data.

²All employees; establishment data.

³Output per hour of all persons.

⁴For production workers.

⁵End of year. Based on data to be published in Survey of Current Business.

Sources: Department of Commerce (Bureau of Economic Analysis and Bureau of the Census), Department of Labor (Bureau of Labor Statistics), and Board of Governors of the Federal Reserve System.

Manufacturing employment may well continue to decline as productivity grows and average hourly earnings rise. (Average hourly earnings for production

workers increased nearly 108 percent over the period). This decline in sectoral employment should not be construed as an inability of U. S. producers to compete internationally and a mandate for surcharges or other restrictive measures. Rather it is indicative of a process whereby U. S. producers can become more efficient, economically profitable, and gain a competitive advantage over foreign producers.

If import surcharges increase domestic producers' share of the home market, resources available for industrial adjustment will increase. The improved cash flow provides the opportunity for domestic firms to modernize plants and equipment, to underwrite the costs of involvement in adjusting capacity to demand, and/or to diversify into more promising areas of activity. The increased profitability resulting from protection may even encourage foreign producers to engage in joint ventures with domestic firms. However, protection normally reduces competitive pressures and, given the substantial costs adjustment entails, perpetuates technical and economic inefficiency. Furthermore, the most execrable effect may be that the economic rents created by protectionist measures in industries with low entry barriers simply attract new labor and capital resources as well as additional entrepreneurial talent.

The widely sought after protection of a surcharge stands to delay, not hasten, the much needed structural adjustment in several industries. The non-rubber footwear industry is an excellent case in point. The industry received temporary protection under Section 201 of the Trade Act of 1974 for the purpose of promoting adjustment to a loss of competitiveness internationally. Orderly marketing agreements were negotiated with Taiwan and Korea to limit their shipments to allow for a revitalization of the U. S. industry [10]. Despite the reduction in imports, no increase in real investment to retool the industry occurred

and labor productivity declined. Not surprisingly the import relief did not allow most segments of the industry to become competitive with foreign producers, particularly the leading developing country exporters, who have cost differentials on the order of 5 or 6 to 1.

As Table 12-1 indicates, employment generally decreased in the last decade but not monotonically.

Table 12-1
Manufacturing Sector Indicators: Textiles and Apparel
1974-84

Year	Import Penetration (percent) ¹		Real Output (billions of 1982 dollars) ²	Employment (thousands) ³	Productivity (1977 = 100) ⁴		Real Net Capital Stock (billions of 1982 dollars) ⁵
	Textiles	Apparel			Textiles	Apparel	
1974	4.3	7.6	28.2	2,328	80.7	88.5	26.8
1975	3.6	8.3	27.3	2,111	89.6	94.5	26.6
1976	3.8	10.3	31.0	2,237	91.8	94.5	26.5
1977	3.7	10.0	34.4	2,227	100.0	100.0	26.7
1978	4.3	12.1	35.1	2,231	102.3	104.2	26.9
1979	4.1	12.4	35.7	2,189	104.8	98.1	26.8
1980	4.3	12.9	36.2	2,111	104.7	97.3	26.7
1981	4.9	13.8	36.1	2,067	106.6	103.6	26.3
1982	4.6	13.9	33.7	1,911	113.7	111.0	25.6
1983	4.7	15.4	37.3	1,905			24.6
1984	6.1	20.2	38.5	1,943			24.3

¹Imports as percent of manufacturers' shipments plus imports minus exports; based on value data; 1984 estimated.

²Real gross domestic product.

³All employees; establishment data.

⁴Output per hour of all employees; based on unpublished data from Bureau of Labor Statistics.

⁵End of year. Based on data to be published in Survey of Current Business.

The advanced technology which is being introduced is being implemented in the ancillary operations, such as cutting and grading. However, the stitching operations which account for 80 percent of value added are most likely to remain at least in the medium term - highly labor intensive. Thus, in fragmented,

labor-intensive industries, like clothing and footwear, there is a limited scope for profit-enhancing substitution of capital for labor, and protection appears unlikely to be able to reduce cost differentials between the industrialized nations and the major developing nation exporters [17].

Proponents of surcharges and other protectionist measures suggest that the scope for improving or regaining competitive advantage is greatest in oligopolistic industries [21]. The logic is that since competition in such industries depends on economies of scale, technology and product differentiation, protection will encourage firms to use resources for adjustment and restructuring programs. The United States automobile industry and various segments of the EEC steel industry are offered as prominent examples of such a process. Once again, however, it must be noted that a variety of factors may impede adjustment. Specifically, import surcharges distort market price and quantity signals, and make it difficult for domestic producers to accurately determine long-term costs and establish capital investment plans. Even if protection was successful over the long-term in creating persistent rents, domestic producers are likely to benefit less than expected as profits encourage new entrants, including foreign companies, to seek a share of the protected market. In summary, protectionism is unlikely to provide the type of permanent restoration of competitive advantage envisioned by advocates in either large or small scale industries.

Selective Surcharges and Trade Diversion

Both the U. S. House of Representatives and the Senate considered legislation in 1985 which would impose a 20 percent surcharge on imports from Japan. Such a measure could be expected to generate pervasive trade diversion as imports from Japan are replaced by imports from other suppliers. Consequently,

while the U. S. bilateral trade balance with Japan would improve, the overall improvement in the U. S. trade balance would probably be modest.

Table 14-1 shows the increase in imports by OECD countries and the United States from five major east Asian developing countries from 1979-1984. Both the total value imported by the U. S. and percentage change in real terms increased significantly over the period.

Table 14-1
Total OECD Imports From
Five Major East-Asian NICs 1979-84
\$ US billion

	1979	1980	1981	1982	1983	1984
Singapore	5.1	7.0	6.6	6.6	6.9	8.6
Korea	10.8	11.1	12.5	12.7	14.6	18.1
Taiwan	11.9	13.8	15.2	15.6	18.4	23.7
Hong Kong	10.2	12.3	12.6	12.2	13.3	15.5
Malaysia	8.3	9.2	7.7	7.2	7.7	10.1
Total	46.2	53.4	54.6	54.2	60.8	76.0
of which imported by U. S.	17.6	20.4	23.0	24.1	29.7	39.8

Percentage						
Annual rate of change in real terms ²						
Total		6.3	2.2	11.6	17.5	29.4
U. S.		6.4	14.0	14.3	28.8	42.1

1. For 1984, based on data for the first three quarters.
2. Volume of imports: values deflated by the export price index of manufactures.

Source: OECD Foreign Trade Statistics

It should be pointed out that trade diversion occurs most often in industries where a multiplicity of potential sources exist and in industries such as clothing and footwear where trade is highly responsive to price and quantity signals. However, in recent years as multinational enterprises have taken advantage of opportunities to shift production sites, trade diversion has resulted in previously less mobile industries, such as steel and consumer electronics. The 1977 Orderly Market Agreement (OMA) for color television receivers between Japan and the U. S. is an example of this phenomenon. At the time of the agreement, the OECD reports the U. S. imported 90 percent of completed TV receivers from Japan. Two years after the OMA, Japan's share of the U. S. market had declined to 50 percent. However, during this period the East-Asian countries, shown in the table above, increased their share of the market from 15 to 50 percent. Currently it is anticipated that the Voluntary Export Agreement for automobiles with Japan is affecting a similar result. Imports by the U. S. from Korea and Yugoslavia are increasing as Japan's import penetration remains relatively constant resulting in a negative impact on the trade deficit [6].

Reaction Abroad

No analysis of the impact of an import surcharge would be complete without taking into consideration the reaction in the rest of the world. As the largest trading nation, the United States exerts a strong influence on economic developments in virtually every nation in the world. These nations' exports to the United States represent, in many instances, a significant portion of their total economic activity. For that reason, a real or a perceived threat to their capacity to continue to export would no doubt draw a quick reaction. Viewed from abroad, such measures represent restrictions on foreign countries' exports.

Since the measures are expected to reduce employment and profits in foreign industries, the governments of our trading partners will be pressured to impose restrictions on imports from the U. S. A sample of what such a reaction might be was provided by the governing supranational body of the European Economic Community, the European Parliament, which passed a resolution in March 1985 calling for immediate retaliatory action against U. S. exports in an equivalent amount if the U. S. government were to institute a surcharge on the exports [5].

Even modest increases in protectionist measures elicit foreign responses. In 1984 when the U. S. tightened its rules for determining the country of origin of imports, the Chinese reduced their purchase of U. S. agricultural exports in retaliation. Other nations would, no doubt, respond similarly; their collective action would deal a further blow to already hard-pressed U. S. exporters of both industrial and agricultural products. Given the questionable capacity of the surcharge to significantly reduce U. S. imports, the likely export-reducing retaliation abroad could result in an actual worsening of the U. S. trade balance from what it would have been without a surcharge.

For others, particularly the developing nations whose "retaliatory leverage" against the United States might be rather small because they import little from us but who nevertheless rely heavily on exports to the United States for badly needed earnings of foreign exchange, the surcharge could pose grave difficulties. This could be particularly true of the group of developing nations in Latin America and elsewhere that in recent years have had difficulty in meeting their international debt obligations to the U. S. and other industrial nations' banks. A further impairment of their capacity to earn the dollars needed to service

their debt could, in some instances, lead to their default--with possibly disastrous consequences for some of the industrial world's banks.

Conclusion

The indirect nature of the link between the instrument of a surcharge and the policy target of improving the U. S. trade deficit, along with employment and profits, has been emphasized in this paper. A theoretical economic analysis of contemporary scenarios pointed out the probable ineffectiveness of surcharges on U. S. imports. After examining the failure of the pass-through, the offsetting effects of exchange rates, the impact of trade diversion, and the possibility of retaliation, it is reasonable to expect a much smaller potential impact on the U. S. trade deficit than is hoped for by advocates of surcharges. Future estimates of the impact of protectionist measures on the U. S. trade balance and other macroeconomic variables should consider such important factors in their measurements.

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