CENTER FOR ECONOMIC AND POLICY RESEARCH

Issues in Trade and Protectionism

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About the Author

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Introduction

There is widespread concern that the United States and the rest of the world are descending into a round of protectionism and a trade war reminiscent of what the world experienced in the Great Depression. Such concerns are both overblown and misplaced. In the short term, the main concern in the United States and rest of the world should be to promote an increase in demand through whatever means necessary. For the longer term, there has been an excessive fixation on protection for merchandise trade. Other areas, most notably alternative intellectual property regimes and freer trade in highly paid professional services, offer much larger potential gains than further reductions in barriers to trade in goods.

The Short Term Picture

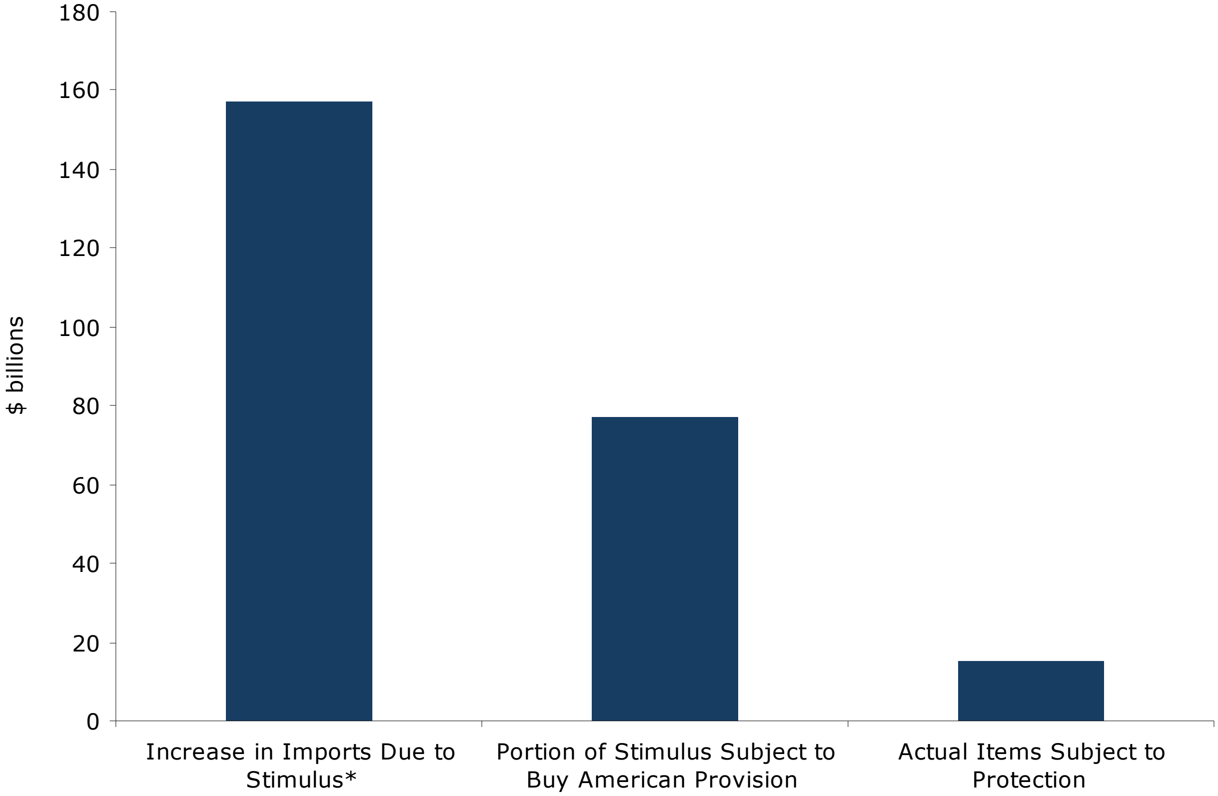
Last February, the United States Congress passed a $787 billion stimulus package designed to help boost the economy out of recession. This package contained a "Buy American" provision that applied to steel and some other manufactured goods that might be purchased as part of this stimulus package. This Buy American provision raised concerns about a new wave of protectionism around the world. In fact, judging by the reaction of some in the media, we are already in the midst of a full-fledged trade war as a result of this provision of the stimulus bill. However, it is easy to show that the reaction to this Buy American provision was hugely disproportionate to its economic impact. Realistically, U.S. trading partners should have been very happy to have the stimulus package, even with its Buy American provision.

The size of the stimulus package was $787 billion, the bulk of which involves tax cuts or spending that will take place in 2009 and 2010. If, for simplicity, we assign a multiplier of 1 to this package (the spending would mostly come with a higher multiplier, while the tax cuts a somewhat lower multiplier), then it will increase GDP by $787 billion over the period in which the stimulus is in place. If we assume a marginal propensity to import in the United States of 0.2, then an increase in GDP of $787 billion implies an increase in imports of just under $160 billion.

The Buy American provision applied to a relatively small portion of the stimulus package. The largest components were tax cuts and aid to state and local governments so that they would not have to make budget cutbacks in response to a loss of tax revenues. The infrastructure portion of the program – together with the other items covered by the Buy American provision – accounts for less than $80 billion of the stimulus.

However, even this figure hugely overstates the impact of the provision. Much of the spending in these categories is for labor. Certainly this is true in the case of infrastructure spending. And much of the materials used for infrastructure are items like asphalt and concrete, which have high weight per unit of value, and therefore are unlikely to have been imported even without the Buy American provision. The amount of goods that could plausibly be excluded as a result of this provision is probably in the neighborhood of 10 percent of the categories of the stimulus subject to the provision. In other words, the Buy American provision may exclude somewhere around $7-$8 billion of imports, as shown in **Figure 1**.

FIGURE 1
Imports from the Stimulus and the Impact of the Buy American Provision



Source: Author's calculations. *Marginal propensity to import = 0.2.

It is understandable that U.S. trading partners would still be unhappy losing even this relatively limited market. However, it is important to recognize that this exclusion only came about because the United States passed a $787 billion stimulus package. President Obama had a serious fight in Congress over the passage of the stimulus and was able to get the package through with very few votes to spare. If he did not include the Buy American provision, it is likely that the stimulus bill would not have passed.

Would U.S. trading partners be happier if the stimulus bill had not gone through at all? In that scenario, they would have a considerably smaller export market to the United States, but there would be no protectionist measures to raise concerns. It is difficult to imagine that U.S. trading partners would view this as a more desirable outcome. If a stimulus package *without* a Buy American provision was not politically feasible, then from the standpoint of U.S. trading partners, a stimulus package *with* the provision is almost certainly the second best outcome (although it is understandable that they would complain about it).

This raises the larger question of what the short-term prospects are for U.S. trade. It is worth focusing on the simple accounting identity, that net foreign savings (X-M) is equal to the sum of public and private savings. The basic point is that if a country has a trade deficit, then the sum of public and private savings must be negative.

Before the recession began at the end of 2007, the United States had a trade deficit that was close to 6 percent of GDP. The accounting identity implies that this must correspond to either a very large budget deficit (low public saving) or very low private savings. (There could also be an investment boom, which would mean in effect that foreign capital flows are financing a domestic investment boom, but that does not seem a plausible scenario for the near-term future.) At present, the trade deficit is at more moderate levels, but this is primarily the result of imports falling off during the downturn. When the U.S. economy starts to recover, it is likely that the trade deficit will again expand to a size that is close to its pre-recession level.

If the trade deficit is taken as given, it raises a question as to what policy U.S. trading partners would like to see the government pursue to complete the accounting identity. On the one hand, the United States could run very large budget deficits, as it is projected to do in 2010. This can sustain demand in the U.S. economy, pushing up the U.S. trade deficit by raising imports, but it will also increase the U.S. government's debt burden. Of course, several major trading partners of the United States have expressed unhappiness with the projected growth in the U.S. debt, supposedly out of concern for the future value of their dollar holdings.

Suppose that the government does not directly boost demand with deficit spending. The alternative would be to have very low levels of private savings. This would bring us back to the situation that the United States had prior to the bursting of the housing bubble in the years 2005-2006. In those years, the government deficit was relatively modest; however, private saving was very low, with household saving being negative by some measures. This was the result of the consumption boom spurred by the housing bubble.

So, we can get back to a situation of high trade deficits without large budget deficits if we can get another round of bubble-driven consumption. Would the U.S. trading partners consider this a good path? Would they be willing to make the loans to support the new asset bubble that would sustain another burst of consumption?

Presumably the answer to these questions is "no." It is difficult to believe that anyone would want to see the United States economy again driven by an asset bubble. However, in the absence of a large federal budget deficit or an asset-bubble-driven consumption boom, there is no way that the U.S. economy can get back to normal levels of output with the current trade imbalance.

There really is just one way out of this story and that is with a lower-valued dollar bringing about a decline in the trade deficit. An over-valued dollar has been at the heart of the imbalances in the U.S. economy and the world economy over the last decade. Unless the dollar drops to a level consistent with more balanced trade, the U.S. and world economies will continue to be subject to large imbalances. It is pointless to complain about large U.S. budget deficits and/or low households savings rates: these are the symptoms of this imbalance. Those who do not want to see the dollar decline in value are in effect endorsing the perpetuation of these symptoms of this imbalance, regardless of whether or not they understand this fact.

The Longer Term Trade Picture

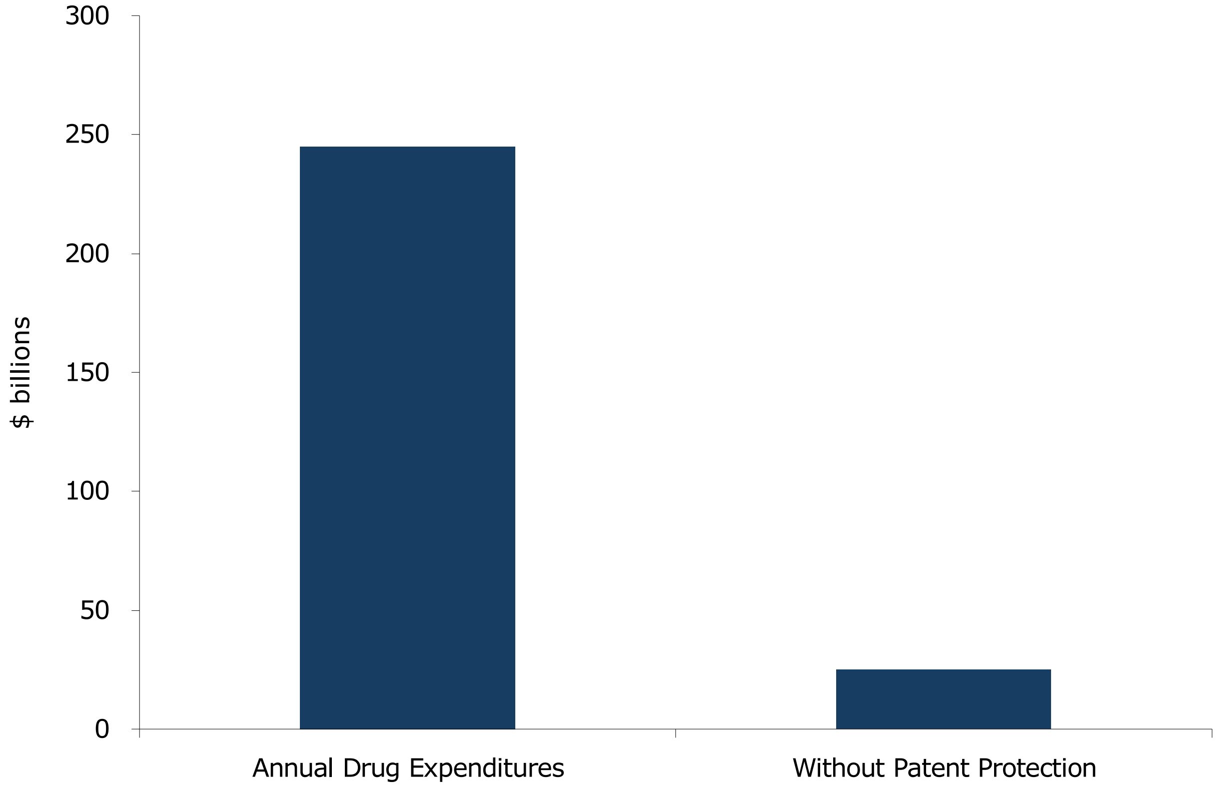
Most public debate on trade policy centers on tariffs and quotas on merchandise trade, the traditional topics of trade negotiations. However, as the world develops into an economy that is increasingly service-oriented, the potential impact of trade restrictions on merchandise trade will be less consequential through time. There are other areas of the economy where trade restrictions can potentially impose much greater damage.

Intellectual Property

At the top of this list is intellectual property restrictions, such as patent and copyright protection. The potential cost of these restrictions is clearest in the case of prescription drugs in the United States. The U.S. has by far the strongest protection for drug patents of any country in the world, allowing firms to enjoy their patent monopoly with no offsetting effort by the government to regulate prices for any substantial segment of the market.

In 2009, the United States is projected to spend almost $250 billion, approximately 1.8 percent of GDP, on prescription drugs. It would likely spend about one-tenth this amount – $25 billion a year – if all drugs were sold as generics, without patent protection (see **Figure 2**). Spending on drugs in the United States is rising rapidly; it is projected to be close to $450 billion a year by the end of the next decade. The vast majority of this increase will be associated with higher mark-ups over production costs, not increased sales of prescription drugs.

FIGURE 2
The Cost of Patent Protection for Prescription Drugs, 2009



Source: Centers for Medicare and Medicaid Services, National Association of Chain Drug Stores, and author's calculations

The huge mark-ups on prescription drugs lead to a wide variety of economic distortions. The most obvious is simply the deadweight loss associated with a product that can sell for several hundred times its marginal cost. Many patients who can't afford drugs at their patent-protected price would have no difficulty paying for the drugs if they were sold as generics. However, since most people in the United States do have insurance that will cover most of the cost of prescription drugs, the bigger waste is probably attributable to the efforts of insurers to limit their spending on drugs. Insurers put considerable effort into restricting their beneficiaries' use of prescription drugs, for example by imposing strict quantity limits or by refusing to pay for drugs prescribed for certain conditions. The latter restriction sometimes creates a round of game playing in which doctors prescribe a drug for a condition that the patient may not have, in order to get around the restriction.

This is just the beginning of the distortions created by patent-protected drug prices. As a result of the substantial mark-up on prescriptions, drug companies have enormous incentive to market their products aggressively. This marketing effort takes a variety of forms in the United States. The industry focuses extensively on promoting their drugs to doctors, since they usually make the decision as to which drug to prescribe to patients. The industry hires tens of thousands of "detailers" who go from doctor's office to doctor's office promoting their company's drugs. The New York Times recently reported that the industry has begun hiring former cheerleaders to do these sales pitches to doctors, apparently since they can effectively convey information about the merits of various drugs.

In addition to pitches to doctors, drug companies in the United States have increasingly focused on direct advertising to consumers through television commercial or other media. These ads often take the form of a former athlete or movie star commenting on how a drug has been very helpful for them. Such ads may be a successful way to boost drug sales, but it is unlikely that they are conveying much information about the drug in question.

Perhaps the biggest economic distortion associated with the extraordinary rents from patent protection for prescription drugs is the misinformation about the effectiveness of the drugs in question. Drug companies have control over the testing process for their drugs. They are required to turn over information about their test results to the Food and Drug Administration (FDA) in order to prove that the drug is safe and effective and therefore can be sold on the market. However, the FDA is strictly prohibited from sharing this information with the public.

This means that information that may be useful to doctors in determining which demographic groups may stand to most benefit from a drug, or be harmed by its side effects, will not generally be available. Of course, drug companies may not share all relevant information with the FDA. There have been many instances in which drug companies withheld test results that reflected poorly on their drugs, either concealing evidence that the drug was ineffective or in some cases that it could even be harmful.

This discussion may appear to be a digression from a discussion of trade policy, however for the last two decades U.S. trade policy has made strengthening rules on patent and copyright protection in our trading partners a major priority. The United States insisted on including the TRIPS rules in the last WTO round and has made intellectual property issues a central concern in almost every bilateral trade agreement it has negotiated.

This drive to increase intellectual property protection is certainly a top priority of the U.S. pharmaceutical industry, as well as the entertainment and software industry. Certainly the goal of the pharmaceutical industry, if not necessarily of U.S. trade negotiators, is to have consumers in other countries pay the same prices for prescription drugs as people in the United States. They would very much like a scenario is which other countries have the same sort of gap between the price and cost for pharmaceuticals that is only seen now in the United States. (Intellectual property does provide an important incentive for innovation, but there are almost certainly more efficient mechanisms that could be developed, especially in the case of prescription drugs.[1])

In this context, the potential harm to consumers and to economic growth from strengthened intellectual property rules is likely to dwarf the barriers on merchandise trade flows that are now featured prominently in discussions of trade conflict. In the case of the pharmaceutical industry in the United States, the excess cost of prescription drugs attributable to patent protection is likely to exceed 2 percent of GDP before the end of the next decade. There is no plausible set of tariffs and quotas that could be imposed by the United States on merchandise trade that would impose any remotely comparable burden on its trading partners. In short, U.S. trading partners stand to lose

[1] See Baker, Dean, "The Benefits and Savings of Publicly-Funded Clinical Trials of Prescription Drugs," CEPR Briefing Paper, March 2008 (http://www.cepr.net/documents/publications/clinicaltrials_2008_03.pdf) and Baker, Dean, "Stagnation in the Drug Development Process: Are Patents the Problem?" CEPR Briefing Paper, March 2007 (http://www.cepr.net/documents/publications/healthcare_stagnation_2007_03.pdf).

much more from accepting conditions on intellectual property as part of trade agreements than they do from increased protectionist barriers on merchandise trade.

Professional Barriers

The other major area in which barriers impose often-overlooked economic costs is in trade in professional services, specifically the highly-paid services of doctors, lawyers, and other highly-educated professionals. The United States has a wide variety of barriers that make it difficult for even highly-qualified professions from working in the United States.

At the most basic level, there is limited opportunity for competing by price. Employers of foreign professionals in the United States must certify that they had attempted to hire a U.S. citizen at the prevailing wage, and had been unable to do so, before they can obtain a visa for a foreign professional for a specific position. In other words, a hospital, a university, or a law firm is legally prohibited from hiring dozens of qualified foreign professionals because they are prepared to work at a lower wage than their U.S. counterparts.

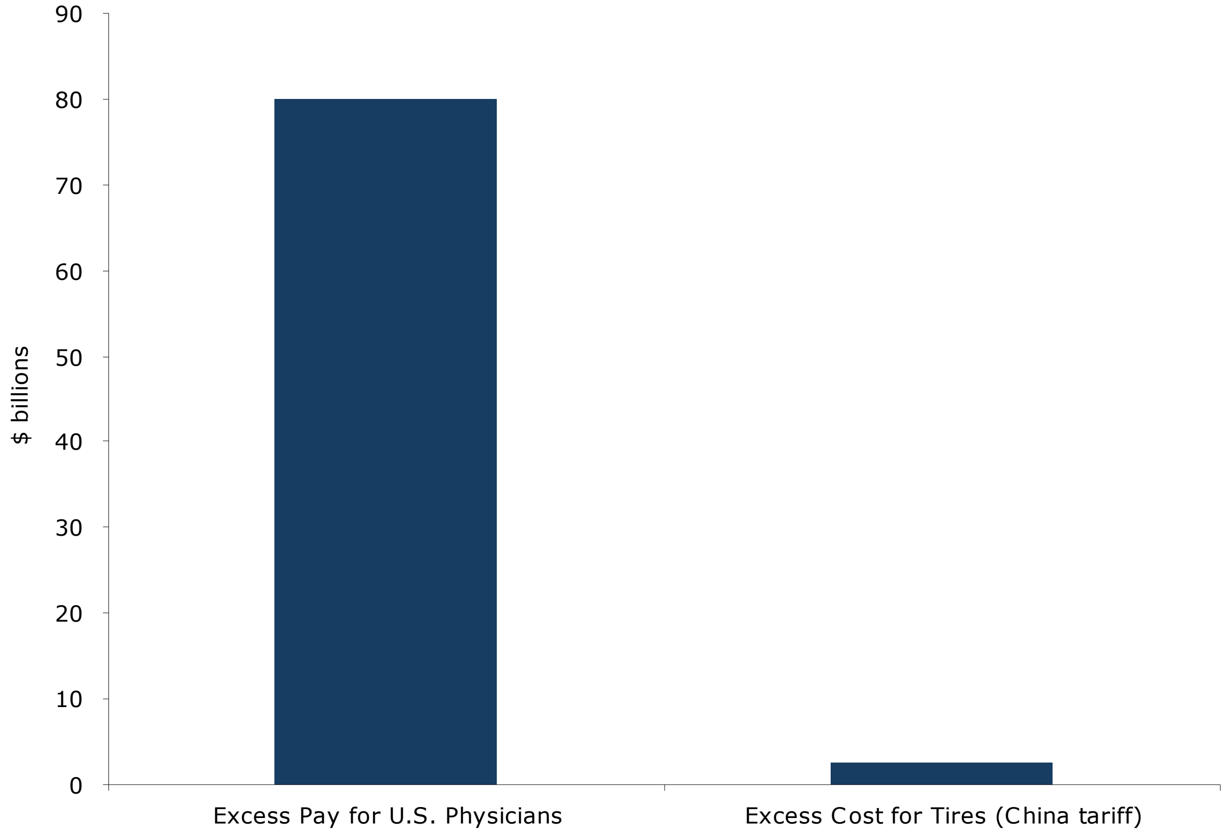
The restrictions on hiring foreign professionals would be comparable to requiring that Wal-Mart first attempt to buy clothing or other merchandise in the United States. Only after failing to find the desired merchandize would Wal-Mart be allowed to import goods, and even then, it would have to pay a price comparable to what is charged by U.S. manufacturers. Of course, such a regime would be immediately (and appropriately) attacked as protectionist. However, the restrictions on professional services rarely get raised in public debates in trade.

This should be disturbing to those who are concerned about the economic cost of protectionist barriers. The United States pays roughly twice as much for its doctors as the average for other wealthy countries. This costs the United States approximately $80 billion a year in extra payments. (Not all of this gap is due to higher pay for the same positions. A much greater share of physicians in the United States are specialists than in other wealthy countries. However, the over-use of specialists is a predictable outcome of rent seeking in the context of a protected industry.)

By comparison, the peak cost of the tariffs that the United States is imposing on Chinese tires should be in the range of $3 billion a year (see **Figure 3**). The economic costs and the risks of a trade war from the tire tariffs has been a major topic of debate in the United States, though the costs imposed by barriers on trade in highly-paid professional services almost never get mentioned in public debates.

The comparison in this figure is an over-simplification, but it is almost certainly the case the United States would stand to have substantial gains if it actively sought to reduce the barriers to the free flow of highly educated professionals across national borders. There would be corresponding potential gains for the sending countries. Professionals trained in these countries would stand to earn much higher wages during their working years, especially those from developing countries.

FIGURE 3
The Cost of Protecting Doctors versus the Cost of Protecting Tires



Source: AMA and Tire Industry Association.

In many cases, if the barriers were removed, professionals may opt to move back and forth over the course of their working career. However, in order to ensure that the sending countries as a whole benefited from this sort of migration, and not just the professionals, it would be a relatively simple matter to have a tax attached to the earning of foreign-trained professionals, which would be remitted back to their country of origin to compensate for the cost of their education and training. This would ensure that all parties gain from this particular form of trade.

For whatever reason, obstacles to trade in highly-paid professional services rarely get mentioned in discussions of protectionism even though the economic losses may be one or even two orders of magnitude greater than the losses associated with most of the polices that do get singled out as protectionist. As goods production continues its long decline as a share of world output, the relative importance of protectionist measures in trade in services will almost certainly increase. In this case, as with the case of strengthened protection for intellectual property, it seems that concerns over protectionism have been seriously misplaced.