The Free Trade Debate: The Illusion of Security Versus Growth

Robert L. Hetzel

The debate over Nafta, the North American Free Trade Agreement, exposed deep divisions within American society. *The New York Times* (11/16/93) commented on the results of a poll over Nafta:

> Support for the accord has broken down along lines of social class rather than on the traditional party divisions that typically define policy debates. College graduates, people with annual household incomes above $75,000 . . . supported the agreement. But those with a high school degree or less . . . blue-collar workers and those with union members in their households . . . opposed Nafta. (P. B12)

A picture on the same page as this article showed a worker demonstrating against Nafta with a sign reading, "Don't send my job to Mexico." The Nafta debate was so emotional because it crystallized underlying concerns about job insecurity and about the erosion of real wages of unskilled labor. Nafta became a symbol for these concerns. Critics of Nafta assume that the government can provide economic security by restricting competition.

I make the case for free trade. After Section 1, which provides some economic background to the current debate, I make the classical economic arguments for free trade. Free trade allocates resources to their most efficient use. As part of this process, it redistributes jobs to the most productive industries, without affecting the total number of available jobs. I also make the newer argument that free trade increases the growth rate of per-capita income. The world needs U.S. leadership to maintain an open trading system so that poor countries can grow their way out of poverty through integration into the world economy.

The views expressed are those of the author and do not necessarily reflect those of the Federal Reserve Bank of Richmond or the Federal Reserve System.

In addition to discussing arguments about economic efficiency, I discuss protectionism as a fiscal policy of taxes and transfers. Viewed from this perspective, protectionism is a fraud. It cannot achieve the avowed aim of its proponents to help the poor. The cost of using protectionism to preserve jobs in obsolescent industries is too high, and the income transfers more often go to the well-off than to the poor. Finally, protectionism exercises a deleterious effect on the nature of democratic government. By removing fiscal transfers from a recorded budget, it subverts the constitutional mechanisms in place that give content to the idea that sovereignty resides with the people. Protectionism encourages government dominated by special interests.

1. RESTRUCTURING OF THE U.S. ECONOMY

Political pressure for protectionism will always arise from producers desirous of limiting foreign competition. The current political pressure for protectionism, however, is more widespread. Much of the current impetus toward protectionism represents a belief that limiting foreign competition can stop a restructuring of the U.S. economy that is working to the disadvantage of the unskilled. What are the forces that are producing this restructuring and is protectionism a desirable response to them?

Three great forces are causing a profound restructuring of the U.S. economy. First, the telecommunications revolution, aided by the computer, is reducing the need for production to be organized by people in the same physical location (Jensen 1993). As a result, firms are becoming smaller and more specialized. Often, part of a production process that formerly was completely domestic is performed abroad.

Second, many less-developed countries (LDCs) and formerly communist countries are ending their isolation from the world economy. To obtain technologically sophisticated capital goods from Western countries, these countries will have to offer in trade the kinds of goods they have an advantage in producing, namely, goods whose production requires large amounts of relatively unskilled labor. As a consequence of this change in the composition of the supply of goods to the U.S. and the demand for goods from it, production in the U.S. will increasingly emphasize the high-technology goods that require an educated labor force.[1]

Finally, the technology that made possible mass production is no longer the special province of the Western world. The spread of knowledge has eliminated

[1] Indirect evidence for this statement can be found in the increasing return to education. In 1988, earnings of male college graduates exceeded those of male high school graduates by about 60 percent, up from 30 percent in 1980 (Kosters 1992). It is difficult, however, to separate the effects on the return to education of an increasingly open world economy from general technological progress.

the formerly high returns to use of this technology. As a consequence, manufacturing can no longer provide middle-class incomes for unskilled laborers. Toward the end of the 19th century, the United States became the world's preeminent industrial power because of its ability to produce huge quantities of standardized products. Especially after World War II, the United States had no rivals in manufacturing. U.S. workers profited because of the U.S.'s near monopoly on the technology of mass production and because of the escape of the U.S. capital stock from wartime destruction. The spread of technological knowledge, however, has ended the days when U.S. workers could make high wages for performing repetitive tasks. Protectionism cannot restore America's unique position in the post-World War II period. It can only retard an inevitable adjustment to fundamental economic forces.

These three forces are remaking the U.S. economy into a collection of service industries that require a highly educated labor force. Today, anything as complicated as a bicycle is made from a combination of components from numerous countries around the world. The highly skilled jobs are in organizing production rather than in making the components. Robert Reich (1991) surely had the U.S. in mind when he argued the following:

> What's traded between nations is less often finished goods than specialized research, design, fabrication, management, marketing, advertising, consulting, financial and legal services, as well as components and materials. . . . [W]hich nation's workers are responsible for the high value-added activities—such as research, design, manufacturing engineering, complex fabrication and strategy? . . . A nation whose work force is largely in [this] camp will achieve a high standard of living overall. (P. 6)

2. THE BASIC ISSUES

The core argument of Nafta critics was simple. Because U.S. workers earn more than Mexican workers, U.S. companies will move production to Mexico. The United States, Nafta critics reasoned, will lose jobs. This argument is appealing because it seems to encapsulate recent experience. In the 1950s, for example, most televisions sold in the U.S. were produced in the U.S. Now they are produced abroad in low-wage countries. If the U.S. had prohibited the importation of televisions, there would at present be more workers in the U.S. producing televisions. Left unsaid, however, is the fact that there would also be fewer workers in U.S. export industries. In addition, as the English economists David Ricardo and John Stuart Mill demonstrated almost two centuries ago, U.S. workers overall would be producing less valuable goods than they are producing now.

In order to think about the effect of free trade on jobs, it is useful to imagine two countries, East and West, initially prevented from trading with each other. What happens if they begin to trade? Can East lose jobs to West?

To be more precise, assume that each country produces the same two goods, widgets and creakles. Given the different natural resources of each country, East will be better suited for production of one good, say widgets, than the other. That good will be plentiful and will sell for a relatively low price. West will probably be in the opposite situation. It will be good at making creakles, which will be plentiful and sell for a relatively low price.

All that is required for trade to be mutually beneficial is that the goods sell for different prices in the absence of trade. With the advent of trade, both countries become better off by exporting their relatively abundant good in return for the other good. As a result, each country produces relatively more of the good in which it possesses a comparative advantage in production. East neither gains nor loses jobs, although free trade distributes some workers to more productive occupations. After all, the only reason West exports goods to East is that it wants goods produced by workers in East. (For a brief history of how economists have developed these ideas formally, see Humphrey [1988].)

Adam Smith (1937) pointed out that the wealth of a nation increases as its economy becomes large enough for individuals to specialize in production. He extended this common sense argument to free trade:

> It is the maxim of every prudent master of a family never to attempt to make at home what it will cost him more to make than to buy. . . . What is prudence in the conduct of every private family can scarce be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage. (Pp. 424–26)

Rephrasing Smith, the U.S. should welcome cheap foreign goods and devote the resources those imports liberate to more productive uses.

3. PROTECTIONIST ARGUMENTS AND FALSE ANALOGIES

Fallacies about free trade arise because of incorrect generalization from individual experience. Consider an individual who works for a firm losing out to foreign competition. When the firm closes, the worker will have to find a new job. He will receive no income, apart from unemployment insurance, while job hunting. Because the worker will have learned skills that are particular to his old company, he will probably start a new job at a lower wage. Anthony P. Carnivale, chief economist of the American Society for Training and Development, reports that studies show that the wages of laid-off workers are lower initially, “by 10 percent on average for service workers, 20 percent for manufacturing workers, and 30 percent for automobile and steel workers” (*New York Times,* 10/3/93b, p. 28). (See also Jacobson, LaLonde, and Sullivan [1993].)

The laid-off worker is likely to generalize from his experience and conclude that protectionism would make workers better off. He is not likely to understand the consequences of protectionism for the workings of the economy, however. Workers who complain about foreign competition take for granted that they can walk into a Wal-Mart and have before them a huge variety of inexpensive goods. Many of those goods are produced abroad. Just as important, the goods produced domestically are of a higher quality and are cheaper when they face foreign competition. If the government prevents the marketplace from distributing resources to their most productive use, the Wal-Mart of today would look like the five and ten of the 1950s.

Fallacies are especially easy to propagate when they concern international rather than domestic trade. With free enterprise, groups of individuals compete to furnish goods and services for particular markets. Some groups win and others lose in this competition. A country's citizens gain collectively, however, because free entry and its concomitant free exit allocate resources to their most productive use. Free trade is an international extension of the free entry and exit that makes a market economy work domestically. With international trade, however, it is easy to spread the fallacy that one group's loss in a particular market is a loss for the country when, in fact, markets are working to distribute resources to their most productive use.

Countries' enthusiasm for exports and antipathy toward imports is an example of generalizing incorrectly. Countries frequently promote exports while discouraging imports. Exports and imports, however, are opposite sides of a single transaction. Collectively, the citizens of a country export goods and assets only because they want to import. They do not export as a matter of charity. The fallacy that a country can discourage one side of a transaction (imports) without discouraging the other side (exports) arises because particular exports are not associated with particular imports.

Protectionists use the analogy to national power and prestige to argue that there are winners and losers in international trade. It is true that military power is relative. One country becomes stronger than another country. The analogy does not hold for trade, however. Countries trade because it is mutually advantageous.

The intellectual ancestor of protectionism is mercantilism (Sowell 1978). Under mercantilism, governments intervened in the economy to prevent imports of final goods with the intention of running a trade surplus and accumulating gold. Today, protectionists argue that government should prevent imports to increase the job security of workers. The analogue to the mercantilist idea that the world possesses a fixed stock of wealth (gold), which governments should try to gain at the expense of their neighbors, is the idea that the world possesses a fixed stock of jobs, which governments should try to gain at the expense of their neighbors. This point of view is reflected in a reference to the U.S. merchandise trade deficit by an anti-Nafta critic: "If we just stopped trading with the rest of the world, we'd be $100 billion ahead" (*Wall Street Journal*, 10/20/93, p. A9). Like mercantilists, who did not see the contradiction between their measures to accumulate gold and individual well-being, modern-day protectionists see no contradiction between their measures to limit competition and individual well-being.

Adam Smith (1937) commented incisively on the fallacy that international trade produces winners and losers:

> By such maxims as these, however, nations have been taught that their interest consisted in beggaring all their neighbors. Each nation has been made to look with an invidious eye upon the prosperity of all the nations with which it trades, and to consider their gain as its own loss. Commerce, which ought naturally to be, among nations, as among individuals, a bond of union and friendship, has become the most fertile source of discord and animosity. (P. 460)

4. INNOVATION AND FREE TRADE

Growth is integrally linked with the open competition of free markets. It is the competition among different groups wanting to bring goods to a market that furnishes the incentive to innovate and reduce costs. The competition produced by free entry yields a quest for the profits that come from being the first to market a new and attractive good or the first to reduce costs of producing an existing good. This search for high profits yields only brief success. Yesterday's winner in the competition to build the best personal computer is hardly likely to be today's winner. The search for evanescent profits, however, drives the innovation that spurs growth.

Free trade is a major source of the competition that drives innovation. This insight has been documented recently by the McKinsey Global Institute in Washington, D.C. The Institute compared productivity for the United States, Germany, and Japan in selected sectors: car assembly, motor parts, metalworking, steel, consumer electronics, food manufacturing, and brewing. For each country, the Institute found that sectors facing foreign competition were highly productive, while protected sectors were unproductive. For example, in Japan, food manufacturing and brewing are protected from foreign competition. In these sectors, output per man hour is only a third of that in the U.S. The director of the Institute summarized the results of the study as follows: "[T]he more open you are, the more productive you become" (*New York Times,* 10/22/93, p. D1).

Consider also the explanation offered in *The New York Times* (11/21/93) for why Japan lags the U.S. in the technology of wireless communication. "The Ministry of Posts and Telecommunications has ruled over the industry with a heavy hand and has been slow to authorize new services. Such tight regulation might have helped protect Japan's market from foreign competition, but it has also stifled the innovation spurred by the more open market in the United States" (p. D1). By limiting competition, protectionism reduces incentives to increase productivity. In practice, protectionism also limits productivity growth by preserving industries that fail to remain competitive. Examples in Western countries are shipbuilding, steel, mining, and coal (Ford and Suyker 1990, p. 49).

One at times hears the comment that arguments for free trade are "academic" or "theoretical." That comment reflects a failure to understand the forces shaping international events. The most momentous event of the last part of the 20th century was the collapse of societies that attempted to isolate themselves from the world economy. Communist countries, with their ponderously inefficient command economies, were perpetually frozen into yesterday's technology. The LDCs, with their pervasive system of state controls and governmental monopolies, watched the rest of the world leave them in a time warp. The economies of these countries stagnated because the protectionism required to preserve their internal monopolies isolated them from the world economy and deprived them of the competition that spurs technological innovation and growth.

In the last several years, economists have expended considerable effort investigating the sources of economic growth. The importance of trade for growth has been documented by studies showing why some non-Western countries, but not others, grew rapidly in the last several decades. (See, for example, Moreno [1993]; Roubini and Sala-i-Martin [1991]; and Gould, Ruffin, and Woodbridge [1993].) Free trade and its counterpart, the free flow of capital, spread the knowledge that powers technological advance. Brazil, which until recently has been highly protectionist, is a negative example. For instance, for many years Brazil prohibited the import of computers or foreign software. As a result, Brazilian computers were both outmoded and more expensive than foreign computers. The inability of Brazil to make use of modern computer technology dampened innovation throughout its economy.

America, which has maintained a fairly open economy since World War II, is a positive example. At the same time that American firms are investing abroad, foreign firms are investing in the U.S. For example, the German automotive firms BMW and Daimler-Benz are now building plants in the U.S. Many of the new production techniques that are enhancing the productivity of American workers came from Japan. Toyota originated "lean production," which emphasizes just-in-time inventory control, quality control, and multitasking among workers who work and solve problems in small groups. The international organization of economic activity provides the practical way in which innovation from one part of the world is made available to another. As *Business Week* (11/8/93) wrote of a multinational corporation:

> GE is telegraphing the message that for the company to remain competitive and profitable, it has to establish deep manufacturing, technological, and financial roots elsewhere. . . . "The modern company has to spread its brains, its centers of excellence," says Fresco [GE vice-chairman]. It really is a citizen of many countries rather than a citizen of one. (P. 70)

5. U.S. WORLD LEADERSHIP

After World War II, the U.S. provided the leadership for the creation of an open world trading system. Much of the motivation came from a desire to provide a healthy economic environment in which free countries could flourish. Free trade was the economic counterpart to the Kennan-Truman doctrine of containing the expansion of Communism. The American policy of free trade deserves as much credit as containment for the collapse of Communism.

Today, free trade remains just as important. It is essential to elimination of poverty in the LDCs.[2] The specialization that free trade makes possible raises living standards, especially for small countries, which lack a large internal market. Also, if a poor country does integrate into the world economy, it can grow rapidly by drawing on the stock of technological and organizational knowledge that developed countries have acquired. Korea, for example, doubled its output per capita in an 11-year period, 1966 to 1977. Specialization, however, creates an interdependence among the countries of the world. That interdependence in turn creates the possibility of a trade war that could cause a world depression. U.S. leadership has been an important reason why the world has been able to avoid trade wars in the post-World War II period.

The United States can contribute to an increase in LDC living standards, especially in Latin America, by allowing its entrepreneurs to use their management skills to organize the labor force in these countries. It can play there the same role as Hong Kong and Taiwan are playing in Guandong province in China. If the U.S. does not exercise world leadership by promoting an open trading system, that leadership will pass to other countries. Technological leadership could go to countries like the Asian Little Dragons, such as Taiwan, Korea, Hong Kong, and Singapore. The LDCs of the world want technologically sophisticated capital goods. To get those goods, they will supply developed countries with goods whose production favors large amounts of semiskilled labor. If the U.S. closes its markets to such goods, it will also close down much of its own high-tech industry.

---

[2] Ironically, in the U.S., some of the same organizations that seek to alleviate poverty overseas also opposed Nafta. "The United Methodist Church, for instance, is opposed because it believes Nafta would throw people out of work and wreck the environment" (*Wall Street Journal,* 12/23/92, p. 1). The author's own Methodist church has supported a clinic in Matamoros, Mexico. The higher incomes of Mexican workers that would be produced by Nafta would allow them to purchase better health care.

An article in *The Washington Post* (11/7/93) explains where the jobs in U.S. high-tech industries will go if the U.S. closes its borders to imports from low-wage countries:

> The South Korean and Taiwanese economies are being transformed to more advanced industrial bases, spurred in part by a surge in exports to China. . . . The industries losing investment and jobs to China require large numbers of workers sweating over routine tasks. . . . But the explosive growth of China's economy is stoking demand for Korean and Taiwanese products that involve higher technology. (P. H1)

6. THE COST OF PROTECTIONISM

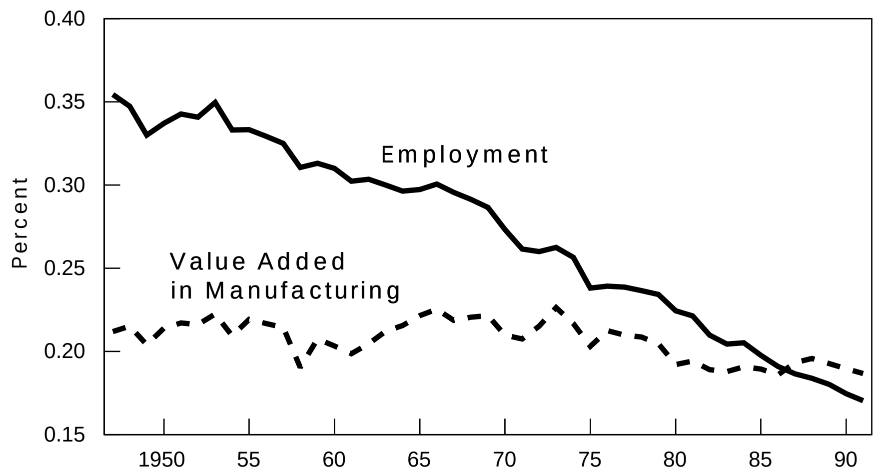
Some idea of the cost of using protectionism in an attempt to preserve jobs can be gained by observing government intervention in agriculture. In agriculture, gains in productivity outstrip gains in product demand. That is, productivity gains shift the supply schedule of agricultural goods outward faster than rising income shifts the demand schedule. Only the sustained exodus of farmers keeps the price of agricultural products from falling.

Most Western governments have intervened heavily in agricultural markets to preserve agricultural employment. What do the results from this intervention suggest for government intervention to limit job loss in manufacturing? First, no government has been able to reduce the secular decline in agricultural employment. In 1900, more than a third of the U.S. labor force was employed in agriculture. Today, only about 3 percent of the population depends upon agriculture for its livelihood. Second, government intervention is extremely expensive. For example, the Organisation for Economic Co-operation and Development puts the per-capita cost of government support for agriculture in 1992 at $360 in the U.S., at $450 in the European Community, and at $600 in Japan (*Financial Times,* 8/16/93).

Similarly, in manufacturing, the rate of growth of productivity is so high that employment in manufacturing falls over time, while the share of manufacturing in U.S. output remains steady. Figure 1 shows the shares of manufacturing employment and output in total employment and output from 1947 through 1991. Over the entire period, the share of manufacturing output has remained fairly steady at around 20 percent. The share of manufacturing employment in total payroll employment, however, has fallen steadily from 35 percent to about 17 percent. In the second quarter of 1993, manufacturing employment was somewhat less than 18 million, only moderately higher than average employment in the 1950s. Manufacturing output, however, has almost quadrupled.

The steel industry, which has been one of the most highly protected industries in the U.S., furnishes another example of ineffective but expensive government policies for protecting jobs. Employment in the steel industry fell

Figure 1 Manufacturing Employment and Output as a Share of Total Employment and Output



Notes: Employment is wage and salary workers in manufacturing divided by the total of non-agricultural wage and salary workers as measured by the Bureau of Labor Statistics payroll employment survey. Value added in manufacturing is real GDP originating in manufacturing (deflated using the manufacturing value-added price deflator) divided by real GDP (*National Income and Product Accounts of the United States, 1929–1982,* 1986; Yuskavage 1990).

by 30 percent between 1982 and 1990 even though steel production rose by 45 percent. Although import quotas and tariffs prevented any increase in imports over this period, the growth of mini-mills, which use fewer workers, increased competition, raised productivity, and reduced employment (*Washington Post*, 10/8/93). In a recent study, Gary Hufbauer and Kim Elliott found that the net cost per year to the U.S. for each job saved in 21 protected industries was $54,000. The cost per job saved ranged from a high of $115,000 per year in luggage to $4,000 in corn brooms (*New York Times*, 11/12/93).

The changing character of world trade renders modern-day protectionism especially costly. Much of the growth in international trade is in services. Computers and new communications technology make it possible to perform data processing and other kinds of back-office record keeping abroad.

> Barbados, Jamaica, the Philippines, Singapore and Ireland have emerged as the most popular "back office" locations. The jobs range from simple data entry to accounting, medical transcription, telemarketing, and technical support for high technology products. . . . In the years ahead, some analysts say, tens of thousands of clerical and technical jobs could migrate abroad.
>
> (*Wall Street Journal*, 8/14/91, p. 1)

The importation of labor services made possible by advances in telecommunications, however, cannot be prevented without isolating the U.S. from the free flow of information.

7. KEEPING GOVERNMENT TRANSPARENT

Keeping Government Accountable

U.S. constitutional democracy is based on the concept of limited government, which reduces the ability of officials to exercise power arbitrarily. A significant means of limiting the power of government is to organize economic activity through the voluntary exchange of a free enterprise economy with its separation of competition for control over resources from competition for control over political power. That separation limits the incentives to compete for power because gaining political power does not confer unlimited power to control. Talented, aggressive individuals thus have incentives to organize economic activity as well as to compete for political power. The resulting distribution of competitive individuals between the private and government sectors is part of limiting the power of government.

Because protectionism results in an organization of economic activity through government control rather than markets, it contributes to a system of incentives that promotes the social importance of political power. One result is to reduce the ability of government to function by encouraging the formation of lobbies to influence government. These lobbies become single-issue blocs. For example, congressmen in districts where economic activity is devoted significantly to textile or sugar production, which benefit from quotas on foreign imports, often require support for these quotas as a condition for joining coalitions for passage of legislation unrelated to trade. The separation of powers that characterizes U.S. government, however, creates the need for coalitions to pass legislation. Achieving political consensus then becomes harder because of the difficulty in forming coalitions out of many single-issue voting blocs. Forming the coalitions necessary to conduct the business of government requires perpetual promises of special favors. By giving government control over the distribution of income, protectionism encourages the formation of the single voter blocs that produce legislative gridlock.

Economic progress inevitably produces winning and losing producers. (Everyone gains as a consumer.) With free enterprise, the winners do not compensate the losers. When the government organizes economic activity, the necessity of governing through coalitions means that often for change to occur the winners must provide some compensation to the losers. The difficulty of arranging such compensation limits the pace of economic progress. An example is the difficulty governments in some countries are having closing their inefficient steel mills. These governments fear the political repercussions from job losses that would come with ending government subsidies. The political difficulty of compensating the steel workers who would lose their jobs induces governments to resist economic change.

The politically corrosive effects of protectionism can be seen most clearly in countries where it has been pursued vigorously. Argentina, for example, is currently dismantling the legacy of Peronism. Peronism only differed in degree from the protectionist program of Nafta critics. It carried to the logical limit the protectionist idea that government can provide job security by limiting competition. Juan Peron promised job security to urban factory workers by protecting Argentine firms from competition. Tariffs and quotas prevented foreign competition, and cartelization and price fixing prevented internal competition. Jobs at firms threatened with bankruptcy were protected through nationalization. As of 1990, more than a third of urban workers worked for the government (*New York Times,* 5/14/90).

Wealth was not gained through entrepreneurial effort, but rather through acquiring government sanction to operate a monopoly. By making government the arbiter of the distribution of income, Argentina encouraged the organization of economic activity into large blocs powerful enough to lobby government or to threaten the government with disruptive strikes. Those who could not organize went into the underground economy. When the prices of Argentina's agricultural exports stopped rising in the post-World War II period and when industrial productivity stagnated, the only forces capable of holding Argentina together were militarism or strident nationalism.

In the absence of competition, Argentina's monopolies became notoriously inefficient. The state oil company drilled wells just to keep its employees busy (*Wall Street Journal,* 7/9/91). Customers had to wait several years to get a telephone from the state phone company (*New York Times,* 4/23/90). State-owned enterprises ran deficits, and the government financed those deficits by printing money. In 1989, inflation was close to 3,000 percent. In that year, rioters looted supermarkets.

To borrow the vocabulary of Nafta critics, there was nothing academic or theoretical about the consequences of protectionism. For the first part of the 20th century, Argentines possessed a standard of living roughly the same as the United States. Argentina purchased a short-lived job security for some workers, but at the price of poverty for many of those excluded from the government's system of worker welfare. In an article aptly entitled, "Argentines Count the Cost of Politics," the *Financial Times* (4/20/89) reported:

> Government figures estimate that 30 percent of households are now classifiable as poor, lacking sufficient income to cover basic necessities of clothing, diet, and education. In 1988, the United Nations Children's Fund estimated that 20,000 Argentine children annually died prematurely from diseases directly related to malnutrition. Some 2m live in slums around Buenos Aires in conditions familiar to countries lacking a tenth of the country's natural resources. (P. 6)

Fortunately, Argentina has now undertaken a vast program of free market reforms including privatization and drastic reduction in trade protection. By the end of 1994, it plans to be part of a tariff-free common market, known as Mercosur, which includes Brazil, Paraguay, and Uruguay.

Monitoring Government

Limited government makes it feasible for citizens to monitor the state's activities. That monitoring gives content to the premise of American constitutional democracy that sovereignty resides with the people. A key way in which the Constitution provided for the monitoring of government was the assignment of fiscal policy to Congress. Congress, in turn, with its two houses and large number of members, was designed to ensure open debate. It was no accident that fiscal policy was assigned to the "world's greatest deliberative body."

Protectionism constitutes a shadow fiscal system of taxes and subsidies. Tariffs and quotas allow Congress to impose taxes and grant subsidies that would not be feasible if they had to be openly debated. When government imposes a tariff or quota, it imposes a hidden tax. That tax is paid by consumers in the form of higher prices. Nowhere does the tax paid by consumers appear on any recorded budget.

Consider comments in *The New York Times* (10/3/93a) about the Canadian experience under its recent free trade policies:

> Old manufacturing industries have been clobbered, but new high technology industries like precision instruments, telecommunications, computer parts and specialized machinery are starting to flourish. . . . The losers—old line businesses like food processing and makers of furniture, appliances and clothing—tended to be labor intensive. The winners are high-technology companies that pay more because of higher skills that add greater value to the end product.
> (P. 1)

If Canada had resisted change by raising tariffs to protect its threatened "old line businesses," those businesses would have been the recipients of the expenditures of the resulting shadow fiscal system. Consumers and the individuals who would have gone into the new high-technology industries would have paid the taxes. The appeal of protectionism is that these fiscal transfers are off budget. While the recipients of the benefits are aware of the benefits they receive, those who pay the tax are usually unaware of the burden imposed on them.

8. DISTRIBUTIONAL ISSUES

Tariffs Are Regressive

Protectionism is driven by the easy identifiability of its benefits and the diffuse, hidden nature of its costs. The incentives it creates to organize politically virtually ensure that wealth is in practice redistributed to politically influential groups and away from the politically powerless. Because the wealth transfers created by protectionism go unrecorded on the government's regular budget, open debate cannot offer protection against perverse wealth transfers. Opponents of Nafta asserted that free trade hurts the disadvantaged. While it is true that the changing U.S. comparative advantage in world trade favors those with an education, it is wrong to conclude that free trade hurts other groups. The taxes that tariffs and quotas impose are often regressive. Consider the case of textiles. The U.S. imposes quotas on more than 3,000 kinds of textile products (Bovard 1991). These quotas impose a tax in the form of higher prices. The U.S. International Trade Commission has estimated that without tariffs and quotas on textiles, the price of clothing would drop by 11.4 percent (*New York Times,* 11/29/93). According to a study by William Cline of the International Institute of Economics, that tax amounted to $260 per household in 1991 (Jones 1991). The tax is a small fraction of the income of a wealthy family, but a large fraction of the income of a poor family. Import quotas on automobiles, shoes, beef, and sugar impose the same kind of regressive tax. For example, U.S. import quotas on beef raise the price of hamburgers, a common part of the diet of lower-income Americans (Sheehan 1993). In general, quotas hurt the poor disproportionately because they cause foreign producers to alter the mix of their exports in favor of high-priced goods.

Similarly, the benefits from trade restrictions often affect the distribution of income perversely. New tariffs and quotas produce a windfall for the existing stockholders of corporations while offering no increase in wages to low-wage workers who, unlike the favored stockholders, continue to offer their labor services in a competitive market. Sugar offers an example. The government keeps the domestic price of sugar at about twice the world level through import quotas. The Commerce Department estimated that for 1988 import quotas added around $3 billion a year to the grocery bills of consumers (Gatt 1993, p. 6). *The Wall Street Journal* (6/26/90) reported:

> The General Agreement on Tariffs and Trade has decreed U.S. sugar import quotas illegal. . . . Opposing change is Big Sugar's lobby and its phalanx of political action committees, long fabled on Capitol Hill for their generosity. From 1983 through mid-1989, sugar and corn sweetener lobbyists supported their pitches to Congress with $3.3 million in campaign contributions. . . . That's a lot of money from about 10,000 beet growers in the Midwest and the West; 1,000 cane producers, dominated by a few big sugar planters and corporations. . . . But they can afford it. Two of the biggest beneficiaries of the sugar program . . . collected what the sweetener users group calls a "windfall" of $180 million in sugar benefits last year. (P. 1)

Needless to say, none of that windfall goes to the workers in the fields cutting the sugar cane.

Unskilled Workers

The deterioration in the economic well-being of less well educated workers since the early 1970s has made the issue of free trade with low-wage countries highly emotional. Economic reasoning (formalized in the Stolper-Samuelson theorem) suggests a tendency toward the equalization of wage rates across countries. The importance of this influence on wages, however, is easily exaggerated. Wage rates should tend to equalize for particular skill levels. On average, U.S. workers have considerable education and training, so very few are in direct competition with the uneducated, manual laborers of the LDCs. Also, trade with low-wage countries cannot be the major reason for the deterioration in relative wages of low-wage workers in the United States because U.S. foreign trade with low-wage countries is relatively unimportant. As Krugman and Lawrence (1993) point out, the average U.S. trading partner in 1990 had a manufacturing wage rate 88 percent of the U.S. level. Imports from countries with wage rates less than half the U.S. level amounted to only 2.8 percent of GDP, a fraction unchanged since 1960.

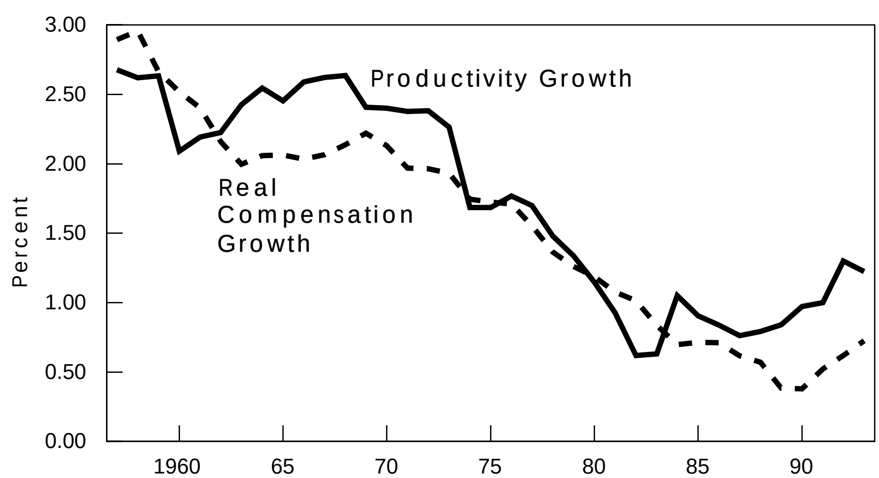
Nevertheless, changes in the world economy will make the U.S. labor market more inhospitable in the future to unskilled workers. The integration into the world economy of the formerly Communist countries and the LDCs in Latin America and Asia will add to the world labor market a huge number of unskilled workers. China and India each have populations near one billion. The increased competition from those workers will reinforce the erosion in the real wages of unskilled and blue-collar workers in the U.S.

What can the U.S. do to help its disadvantaged workers? In considering the effects of changes in world comparative advantage on the distribution of income, one should keep in mind two characteristics of income distribution—the *inequality* among income groups and the *mobility* among income groups. The integration of the world economy may increase income inequality, but it can also offer increased mobility by increasing returns to investing in education. The income ladder in the U.S. may start with a low rung, but access to education makes the higher rungs widely accessible. Such education includes on-the-job training. In a study of job-related education, Alan Eck (1993) found that high school graduates who had taken jobs requiring both qualifying training and subsequent on-the-job training earned slightly more than college graduates with neither kind of training.

It is important to avoid policies that reduce wage inequality by limiting income mobility. Most European countries, for example, established high minimum wages in an effort to prevent the erosion in wages at the bottom of the pay skill that occurred in the U.S. in the 1980s. One consequence was to price many workers out of the market and to raise the unemployment rate. Moreover, those who become unemployed remain unemployed for long periods. Almost half of Europe's unemployed workers have been unemployed for more than a year (*The Economist*, 10/9/93). Those workers lose some of the job skills they already possess, thereby limiting the possibility of a good job in the future. In November 1993, only 22 percent of unemployed workers in the U.S. had been unemployed for more than half a year. The mean duration of unemployment was 19.3 weeks and the median was 8.7 weeks (Bureau of Labor Statistics and Employment and Training Administration).

Finally, it is important to avoid all kinds of government interference in markets such as protectionism that reduce productivity. Productivity growth is the engine that pulls up all real wages, low and high, over time. Figure 2 (suggested by Prudential Insurance *Economic Review,* October 1993) plots the growth rate of labor productivity and of real worker compensation per hour. The series are plotted as ten-year moving averages to eliminate cyclical variation. As shown in Figure 2, productivity growth is the key determinant of real wage growth.

Figure 2 Growth Rates of Labor Productivity and Real Compensation per Hour



Notes: Observations are ten-year moving averages of annual growth rates. Productivity is labor output per hour. Real compensation is compensation per hour converted to constant dollars using the GDP deflator. Both series are published by the Bureau of Labor Statistics.

9. HELPING THE DISADVANTAGED

Protectionism imposes a tax on consumers and on the workers who otherwise would have worked in an expanded export sector. As a tax, protectionism is grossly inefficient in transferring income. Its income transfers often hurt the economically disadvantaged. The economically disadvantaged can be helped with greater assurance of success through the fiscal system consisting of on-budget congressional appropriations and taxes rather than through protectionism. There are ample opportunities to use the existing fiscal system to redistribute income toward the disadvantaged in legitimate on-budget ways. A redesign of the current fiscal system to help the disadvantaged would be much more likely to achieve a desirable distribution of income than the capricious intervention in particular markets recommended by protectionists.

One step the U.S. government could take to soften the economic hardships of the less fortunate would be to tilt the income transfers it controls in their favor. Between 1965 and 1980, the government increased dramatically its control over the distribution of income. In 1965, transfer payments to individuals made by local, state, and federal government were 5.5 percent of GDP. By 1993, this figure had risen to 14 percent.[3] Also, tax expenditures are a significant factor in the U.S. fiscal system. (Tax expenditures measure the revenue loss due to tax breaks for special groups.) As a percent of gross national product, they are about 7 percent (Table 3-16 in Peterson [1991], p. 90).

It is not hard to imagine ways to redesign the current fiscal system to lessen the inequality of income and to help those who are hurting because of an increasingly competitive marketplace. The immediate response to specific suggestions, however, is likely to be that they are politically painful. But does not that response explain much of the political appeal of protectionism? Protectionism, by allowing its proponents to argue that they are addressing the problems of the disadvantaged, makes it possible to avoid discussion of genuine, but politically difficult, responses to the problems of the disadvantaged.

World economic integration and technological innovation will all make the labor market increasingly inhospitable for the unskilled and uneducated. Government cannot protect this group through protectionism and other kinds of direct intervention that reduce economic efficiency. Government could, however, alter the taxes and transfers of the modern welfare state in ways that promote the economic well-being of the least fortunate.

10. CONCLUDING COMMMENTS

The costs imposed by tariffs, quotas, and other forms of trade discrimination appear on no budget. For this reason, the public loses an important protection against wealth transfers from the less fortunate to the politically well organized. At least in the case of protectionism, direct government intervention in markets

[3] Figures on transfers are from "Transfer Payments to Persons" in tables of Federal Government Receipts and Expenditures and State and Local Government Receipts and Expenditures in *Economic Report of the President.*

to redistribute income in practice has often redistributed income perversely. The appropriate way to help disadvantaged workers is to make certain that the overall effect of the fiscal system is to redistribute income to low-income individuals.

The 20th century began as an optimistic era of free trade, free movement of capital and peoples, and the free flow of ideas across national boundaries. The internationalism of that era ended with World War I. The totalitarianism and nationalism of the ensuing period and the murderous wars they spawned came close to extinguishing the human freedom valued by Western civilization. Fortunately, after World War II, the U.S. became a leader in recreating a liberal world order characterized by the free international movement of goods and ideas. Free trade means open borders and the free flow of ideas across national boundaries. The free flow of ideas is the essential condition for the creation of a democratic and prosperous world. U.S. leadership will determine the kind of world the 21st century will be. The weather vane of that leadership is the commitment to free trade.

REFERENCES

Bovard, James. "High Cost of Textile Protection," *The Journal of Commerce*, December 10, 1991, p. 12A.

Business Week. "GE's Brave New World," November 8, 1993, pp. 64–70.

Eck, Alan. "Job-Related Education and Training: Their Impact on Earnings," *Monthly Labor Review*, vol. 116 (October 1993), pp. 21–48.

The Economist. "Doleful," October 9, 1993, p. 17.

Financial Times. "Counting the Cost of Trade Impasse," August 16, 1993, p. 3.

__________. "Argentines Count the Cost of Politics," April 20, 1989, p. 6.

Ford, Robert, and Wim Suyker. "Industrial Subsidies in the OECD Countries," *OECD Economic Studies*, Autumn 1990, pp. 37–81.

Gatt Secretariat. "Trade, the Uruguay Round and the Consumer." Information and Media Relations Division of Gatt, August 11, 1993.

Gould, David M., Roy J. Ruffin, and Graeme L. Woodbridge. "The Theory and Practice of Free Trade," Federal Reserve Bank of Dallas *Economic Review*, Fourth Quarter 1993, pp. 1–16.

Humphrey, Thomas M. "The Trade Theorist's Sacred Diagram: Its Origin and Early Development," Federal Reserve Bank of Richmond *Economic Review*, vol. 74 (January/February 1988), pp. 3–15.

Jacobson, Louis S., Robert J. LaLonde, and Daniel G. Sullivan. "Long-Term Earnings Losses of High-Seniority Displaced Workers," *Economic Perspective*, November/December 1993, pp. 2–20.

Jensen, Michael C. "The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems," *The Journal of Finance*, vol. 48 (July 1993), pp. 831–80.

Jones, Kent. "Real Victims of Textile Quotas," *The Journal of Commerce*, June 26, 1991, p. 12A.

Kosters, Marvin H. "The Rise in Income Inequality," *The American Enterprise*, November/December 1992, pp. 29–37.

Krugman, Paul, and Robert Lawrence. "Trade, Jobs, and Wages," Working Paper 4478. Cambridge, Mass.: National Bureau of Economic Research, September 1993.

Moreno, Ramon. "Are World Incomes Converging?" Federal Reserve Bank of San Francisco *Weekly Letter,* November 26, 1993.

The New York Times. "Government Says Federal Tariffs Cost Shoppers $19 Billion Yearly," November 29, 1993, p. A14.

__________. "Now It's Japan's Turn to Play Catch-Up," November 21, 1993, p. D1.

__________. "Americans Are Closely Split on Trade Pact, Poll Shows," November 16, 1993, p. B12.

__________. "The High Costs of Protectionism," November 12, 1993, p. D1.

__________. "Why U.S. Is Indeed Productive," October 22, 1993, p. D1.

__________. "Canada's U.S. Trade Experience Fuels Opposition to the New Pact," October 3, 1993a, p. 1.

__________. "Policy on Jobs Holds Trade Pact's Fate," October 3, 1993b, p. 28.

__________. "Argentina's Painful Path to Efficiency," May 14, 1990, p. D1.

__________. "Argentina Tries to Sell Its Shaky Phone System," April 23, 1990, p. D8.

Peterson, Wallace C. *Transfer Spending, Taxes, and the American Welfare State.* Boston: Kluwer Academic Publishers, 1991.

Reich, Robert. "The Myth of 'Made in the U.S.A.,' " *The Wall Street Journal*, July 5, 1991, p. 6.

Roubini, Nouriel, and Xavier Sala-i-Martin. "Financial Development, the Trade Regime, and Economic Growth," Working Paper 3876. Cambridge, Mass.: National Bureau of Economic Research, October 1991.

Sheehan, James M. "Sacred Cows of Protectionism," *The Journal of Commerce*, November 19, 1993, p. 6A.

Smith, Adam. *The Wealth of Nations*, Edwin Cannan, ed. New York: The Modern Library, 1937.

Sowell, Thomas. "Adam Smith in Theory and Practice," in Fred. R. Glahe, ed., *Adam Smith and the Wealth of Nations: Bicentennial Essays*. Boulder, Colo.: Colorado Associated University Press, 1978, pp. 149–72.

The Wall Street Journal. "In Debate over Nafta, Many See Global Trade as Symbol of Hardship," October 20, 1993, pp. 1 and A9.

__________. "Free-Trade Pact Spurs a Diverse Coalition of Grass-Root Foes," December 23, 1992, p. 1.

__________. "American Firms Send Office Work Abroad to Use Cheaper Labor," August 14, 1991, p. 1.

__________. "South Americans Push Sales of State Assets in Swing to Capitalism," July 9, 1991, p. 1.

__________. "Small Minnesota Town Is Divided by Rancor over Sugar Policies," June 26, 1990, p. 1.

The Washington Post. "Asia's 'Dragons' Accept Trade's Pains and Gains," November 7, 1993, p. H1.

__________. "NAFTA and Trade Are Tiny Parts of a Job Revolution," October 8, 1993, p. G1.

Yuskavage, Robert E. "Gross Product by Industry, 1988–91," *Survey of Current Business*, November 1993.