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POLICY BRIEF

New Protectionism: Still Protectionism and Bad Economics

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For several years now, news headlines have reflected anxieties about the effects of globalization and freeing trade: Will jobs evaporate? Does China have an "unfair" advantage? Is the middle class disappearing? These fears need to be addressed, because they have resulted in the implementation of misguided policy prescriptions. All too often, these policies have hurt the very Americans they were supposed to help.

Among these prescriptions has been the use of tariffs and quotas, which restrict trade. Proponents offer various justifications for such protectionist policies. Some of the most common include "they do it" (i.e., other governments subsidize their exporters or impose high tariffs on imports from the United States), the notion that the United States and other developed countries owe their prosperity to high tariffs during the time of industrialization, and the belief that a value-added tax (VAT) provides an unfair advantage to exporters in countries that have one.

Most of these arguments rest on a misunderstanding of history, of economics, or of both. Protectionism might benefit favored interest groups, but it hurts American consumers and workers.[1]

THE LESSON OF HISTORY AND ECONOMIC GROWTH

Historically, tariffs have not helped economic growth. Whether one considers the United States before World War I, the countries of the "East Asian miracle" in the middle of the 20th century, or China after that, freer markets and lower barriers to trade were key in promoting economic growth and reducing poverty.

The United States Grew Despite, Not Because of, Tariffs before 1913

For much of its history, the US government relied on tariffs as its main source of revenue. It did so until it adopted the personal income tax in 1913 and gradually increased this tax's rates and base. During the time that the government relied on tariffs, the American economy grew rapidly—faster, in fact, than that of the United Kingdom, which then had far fewer tariffs.

Policy analyst James Pethokoukis provides some figures:

> The U.S. economy grew rapidly in the late 19th century. (Real GDP grew by nearly 4 percent annually from 1870 to 1913, while GDP per capita grew by nearly 2 percent annually. Both figures are roughly twice Great Britain's performance over the period.) . . . (Between 1860 and 1900, the average tariff on durable imports averaged 40–45 percent, never falling below 38 percent or rising above 52 percent.)[2]

This chronological correlation between tariffs and economic growth in the United States has led some, including President Trump,[3] to argue that tariffs caused growth. However, as economists know, correlation is not causation. In fact, there is evidence that the United States became rich *in spite of* these tariffs.

First, until the New Deal the federal government was small—the federal budget consumed on average less than 3 percent of the economy's output. Contrast this with the current situation, in which the government consumes about 22 percent of GDP. Also, save for a few years, there was no personal income tax in the 19th century. There were also no payroll taxes, no capital gains taxes, no death taxes, and no corporate taxes—all of which have been shown to reduce growth because of their distortive effects.

Second, economist and trade historian Douglas Irwin points out that "rather than higher tariffs causing higher growth, the relationship could be spurious: land-abundant countries relied on customs duties to raise government revenue and also enjoyed favorable growth prospects, with little link between the two."[4] The United States is one of the land-abundant countries, which suggests that this correlation between growth and tariffs is likely just that: a correlation.

Also, as Irwin notes, the sectors of the 19th-century American economy that grew the most—services and agriculture—were not much affected by the tariffs. "It appears that trade-related factors were not critical to the overall growth and expansion of the American economy."[5]

The distortions caused by the tariff rates were also relatively small in spite of the rates' magnitude. As Irwin explains, "The reallocation of labor brought about by the tariff was relatively modest, and the productivity consequences were small as well."[6] In addition, 19th-century national economies weren't anywhere near as integrated with each other as such economies are today—another factor that reduced the effect of high tariffs during that period.[7]

In addition, while the 19th-century US government imposed steep tariffs on dutiable imports, the United States imposed zero duties on another very common foreign import: labor. Between 1865 and 1910, immigration to the United States increased from about 200,000 individuals a year to more than 1,000,000, with almost no restrictions whatsoever.[8]

In a paper analyzing tariffs, immigration, and economic insulation after the Civil War, economists Cecil Bohanon and T. Norman Van Cott argue persuasively that attempts to assess the impact of protectionist tariffs on economic growth lead to questionable conclusions if these attempts ignore the massive in-migration that occurred because of the open-immigration policy of the 19th-century United States:

> The thrust of our analysis is that substantial immigration makes the protectionist label for the United States and by extension for Argentina and Canada not so much wrong as *irrelevant*. The impact of high tariffs, clearly an insulating policy, was swamped by free immigration, a quintessential policy of economic openness.[9]

Finally, Irwin notes that the United States was wide open to foreign capital investment during the high-tariff period. This investment resulted in the trade deficit but also contributed to a burst of new technology and ideas. In other words, except for tariffs on a limited array of goods, the US economy was extremely open.

It is misguided to hope that high tariffs today will generate strong economic growth. First, academic research has revealed that the high growth rates of the past existed in spite of the high tariffs, not because of them. Second, the current array of government interventions and the state of the US economy are quite different from those of the late 19th century. Globally integrated supply chains, the present restrictive immigration policy in the United States, the current US tax system with its income and payroll taxes, and the sheer size of trade in the US economy today mean that imposing 1800s-level tariffs would more likely be catastrophic than growth-enhancing.

The East Asian Miracle Happened Despite Protectionism and Industrial Policy

One very common argument made in favor of raising trade barriers is that growth in China, Japan, South Korea, and other Asian countries that are rich today was enhanced by protectionist policies these countries pursued in the past. For instance, South Korea's industrial takeoff in the 1960s happened behind high tariff barriers. Japan protected its nascent domestic car industry from foreign competition for 40 years after World War II. A similar protectionist story can be told about Taiwan and about China, whose regulated and manipulated state-capitalist economy featured some protection of its markets from imports yet grew by nearly 10 percent per year for decades.

The existence of protectionist barriers does not mean that they helped fuel economic growth, however. In fact, the data fail to support the hypothesis that protection helped these economies grow.

The Asian Tigers grew for many reasons. A 1993 World Bank report describes the East Asian miracle, when the economies in the region grew faster than in all other regions of the world and managed to sustain that growth over a long period.[10] Most of this achievement was due to unusually high growth rates in Japan, the four Asian Tigers (Hong Kong, South Korea, Singapore, and Taiwan), China, and the newly industrialized Southeast Asian economies (Indonesia, Malaysia, and Thailand).

It is true that Asian countries have grown very fast. It is also correct that some of them have, or have had, some protectionist barriers in place. But it doesn't follow that this protectionism led to the growth. Again, correlation isn't causation.

The World Bank analysis of the East Asian miracle concludes that

> private domestic investment and rapidly growing human capital were the principal engines of growth. . . . And some of these economies also got a head start because they had a better-educated labor force and a more effective system of public administration. In this sense there is little that is "miraculous" about the [high-performing Asian economies'] superior record of growth; it is largely due to superior accumulation of physical and human capital.[11]

While the report notes that "in most of these economies, in one form or another, the government intervened—systematically and through multiple channels," the authors also conclude that "it is very difficult to establish statistical links between growth and a specific intervention and even more difficult to establish causality."[12]

Economist Arvind Panagariya points out that in Taiwan, "sectors that showed the best performance on the export front were invariably labor intensive and were not subject to selective targeting. In Taiwan, the share of public sector in industrial and manufacturing outputs also fell over time."[13]

The story of South Korea until the early 1970s is very similar to that of Taiwan. Panagariya notes that when all trade interventions are aggregated, there remains only a small net bias in favor of exports relative to a free-trade regime. After careful examination and response to free-trade skeptics, he concludes that "once we look at the evidence carefully, Korea supports the case for outward orientation, rather than protection, interventionism, and infant industry protection."[14]

China grew once it opened its markets. Nobel Prize–winning economist Ronald Coase and his coauthor Ning Wang demonstrate that China's impressive growth, similarly, was the product of free-market reforms and happened in spite of the protectionist measures in place.[15] Trade economist Nicholas Lardy shows that China's growth since 1978 has actually been the product of market-oriented reforms, not state-owned programs, with about 70 percent of China's GDP produced by private firms in 2012.[16] Detailing the toll on the Chinese economy of the recent increase in ambitious industrial policies and the growth of the state-owned sector, Lardy concludes that unless China reverses course, the growing weight of state-owned enterprises, government debt, and malinvestments will result in China's growth withering away.

As Panagariya points out,

> A common argument made by critics is that if we take a snapshot of a rapidly growing economy such as Taiwan in the 1960s or China in the 1980s, we would observe continuing high levels of protection. . . . If protection was indeed the source of rapid growth in these cases, its reduction during the following years should have led to a decline in the growth rate. But the opposite was observed when Taiwan in the 1970s and China in the 1990s and 2000s opened their economies further.[17]

Open economies grew faster than closed ones. A recurring finding of economic research is that open economies have historically exhibited better economic performance in countries at all levels of development; increased the standards of living of consumers, producers, and workers alike; and lifted millions out of poverty. In a report titled "Why Open Markets Matter," the Organisation for Economic Co-operation and Development explains that "relatively open economies grow faster than relatively closed ones, and salaries and working conditions are generally better in companies that trade than in those that do not. More prosperity and opportunity around the world also helps promote greater stability and security for everyone."[18]

Hong Kong never had and still doesn't have protectionist policies in place.[19] Singapore, apart from an experiment with low-grade import protection, has embraced free trade. Yet both Hong Kong and Singapore grew rapidly and are today among the most prosperous economies in the world. Hong Kong is a case worth highlighting.[20] Thanks to its history of free trade under British rule and its current special status in China, Hong Kong is widely regarded as one of the least restrictive economies in the world. Among the policies that have fueled its growth is unilateral free trade.

In 1950 Hong Kong's average per capita income was about one-third the average per capita income in the United States, but by 2017 Hong Kong's was slightly higher. In 1960 life expectancy in Hong Kong was three years shorter than in the United States, whereas by 2017 it was five years *longer*. While free-market policies in addition to free trade contributed to Hong Kong's economic success, at the very least unilateral free trade hasn't prevented Hong Kong's transformation into one of the richest economies in the world.

Prosperity Is Linked with Free Trade

Ultimately, Panagariya marshals considerable evidence and sound theory, and concludes that

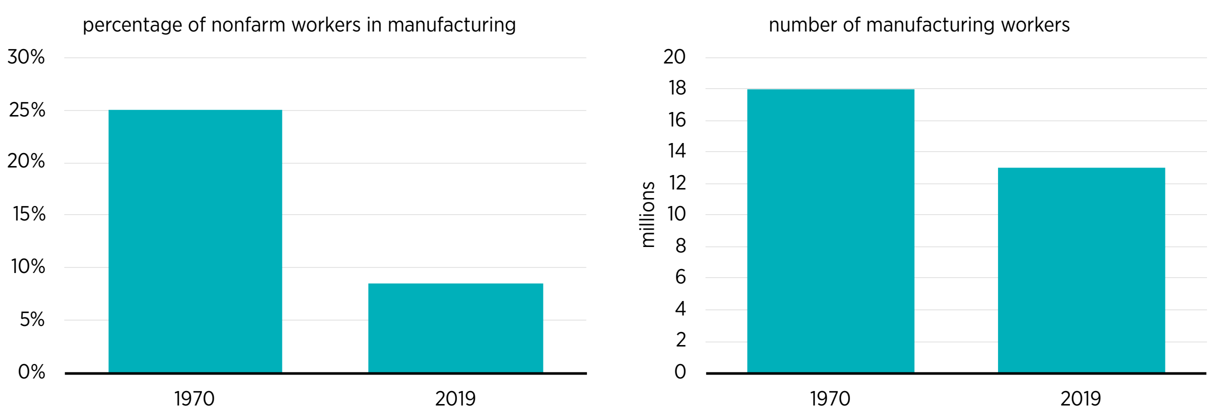
> at the aggregate level, [there is] very substantial evidence connecting growth and trade openness. Even econometric studies have come a long way toward establishing causation between trade and per capita GDP. Free trade critics, on the other hand, have provided nothing that comes even close to this evidence in support of their case. Their argument that the experience during the 1960s and 1970s demonstrates the superiority of import substitution over outward orientation fails miserably: it is in fact the post-trade-liberalization era of the 1990s and 2000s that exhibits the highest growth rates in the developing countries taken together.[21]

CHANGES IN EMPLOYMENT AND EQUALITY: WHAT HAPPENED TO AMERICAN MANUFACTURING AND THE MIDDLE CLASS?

It is undeniable that over the past 50 years the number of US manufacturing jobs has decreased, both in absolute terms and as a share of nonfarm jobs. In 1970 about 18 million Americans—or 25 percent of all nonfarm employees in the country—worked in manufacturing. This number peaked in 1979, at 20 million. But just 13 million Americans work in manufacturing today, and manufacturing workers represent only 8.5 percent of nonfarm workers (see figure 1).

A desire to reverse this trend and "bring manufacturing jobs back to America" is behind recent demand for protectionism to help American workers and firms, particularly those in the manufacturing sector. Historically, union manufacturing jobs were viewed as a way into the middle class, and the trend of shrinking numbers of such jobs stokes fears about a "hollowing out" of the middle class. The reality is far more complicated, and the policy ideas being offered are no solution to the perceived problem.

Figure 1. Proportion and Number of Workers in Manufacturing, 1970 vs. 2019



Source: Federal Reserve Bank of St. Louis, "All Employees, Manufacturing/All Employees, Total Nonfarm," accessed August 13, 2019, https://fred.stlouisfed.org/graph/?g=1Gor. Federal Reserve Bank of St. Louis, "All Employees, Manufacturing," October 4, 2019, https://fred.stlouisfed.org/series/MANEMP.

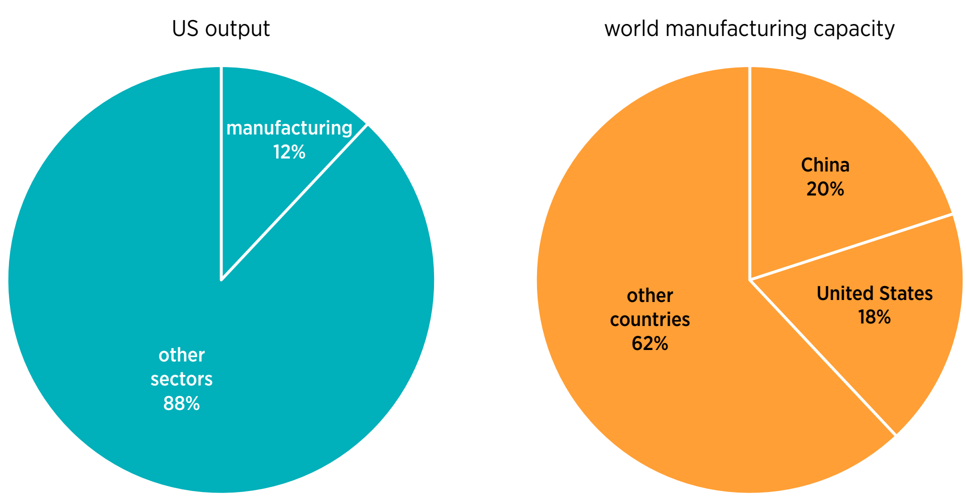
Declining US Manufacturing Employment Accompanies Increasing Manufacturing Output

The data do not support a deindustrialization narrative. While employment in manufacturing has decreased significantly, US manufacturing output is near an all-time high (with $2.17 trillion in value added in 2017) thanks to a spectacular increase in productivity.[22] US manufacturing represents 12 percent of the nation's output and 18 percent of the world's manufacturing capacity (second only to China's portion; see figure 2).[23] In addition, industrial capacity—the existing ability of American factories and workplaces to produce industrial output—is higher now than at any time in the past.[24]

The vast majority of manufacturing job losses are the result of productivity growth brought about by labor-saving innovation, not the result of trade. In fact, research consistently shows that international trade has accounted for at most 20 percent of the reduction in US manufacturing employment.[25] Technological progress has been far more disruptive to manufacturing employment than has trade, and it has resulted in much higher wages for those still employed in manufacturing.[26]

Resorting to protectionist measures will not bring back manufacturing jobs because technological innovation, not trade, is the main driver of the change in the manufacturing sector. Furthermore, higher productivity means higher wages for manufacturing workers. It is doubtful that those who are calling for a return to the labor-intensive manufacturing era are also willing to accept the reduction in wages that would necessarily follow as people replace machines.

Figure 2. Proportion and Number of Workers in Manufacturing, 2019



Source: Darrell M. West and Christian Lansang, *Global Manufacturing Scorecard: How the US Compares to 18 Other Nations* (Washington, DC: Brookings Institution, 2018).

Is the Middle Class Shrinking?

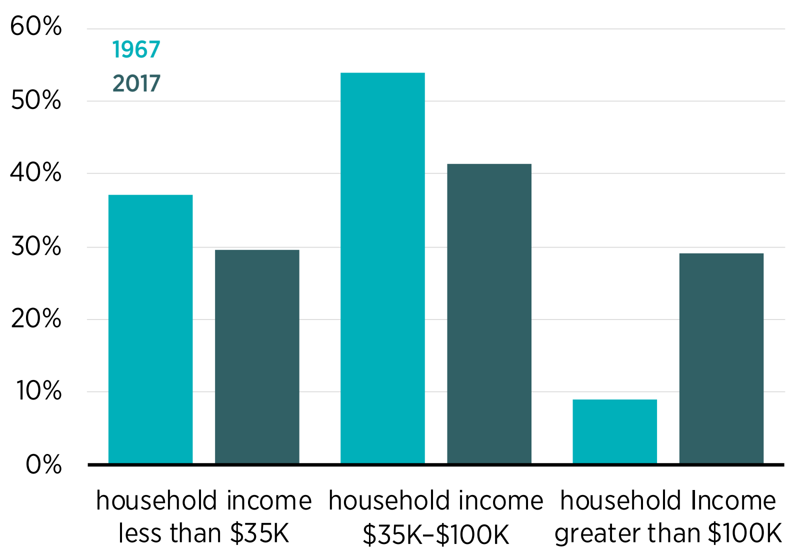
The US middle class has been gradually shrinking. A look at the Census data reveals that the share of US households making between $35,000 and $100,000 (in inflation-adjusted dollars) went down from 53.8 percent to 41.3 percent between 1967 and 2017. The data also show that the share of households making more than $100,000 has increased during the same period, from 9 percent to 29 percent. Finally, the share of households making less than $35,000 has shrunk from 37.2 percent to 29.5 percent. (See figure 3.) In other words, the middle class may be shrinking (and so is the lowest-income class), but that's because more households have moved to the higher income levels.[27]

There are Reasons to Care about the Reduction in Manufacturing Employment

Some sectors of the economy have indubitably struggled in recent years to adapt to significant disruptions. Workers have lost their jobs and never recovered, and some areas in the United States have experienced economic decline. Yet change is part of life and an inescapable element of economic growth.

Slower-than-usual economic adjustments after a shock, whether because of trade, automation, or innovation, have a real cost to those on the receiving end of the failure to adjust. This slowing-down of Americans' ability to adjust to economic change is worth discussing and studying. But that's quite different from saying that government intervention is required. In fact, a closer look will likely reveal that government policies at the federal, state, and local levels have played a significant role in impeding economic adjustments.

Figure 3. American Household Income by Income Category, 1967 vs. 2017



Sources: Mark J. Perry, "Yes, the US Middle Class Is Shrinking, but It's Because Americans Are Moving Up. And No, Americans Are Not Struggling to Afford a Home," *AEIdeas*, January 31, 2018.

Minimum-wage and occupational licensing regulations have a disproportionate effect on lower-income and lower-skilled workers, making it more difficult for them to enter the labor market. Welfare policy may have a similar impact by reducing the willingness of beneficiaries to look for work once they are unemployed. For instance, economist Scott Winship has shown how Social Security Disability Insurance has created incentives for some potential workers to exit the labor market.[28]

It would be a mistake to use these adjustment issues as a pretext for implementing protectionist policies. Such policies would not help solve these adjustment problems because innovation, not trade, is driving the bulk of the change.

CHINESE SUBSIDIES, RECIPROCAL TARIFFS, AND THE EUROPEAN VAT: THE FALLACY OF "FAIR TRADE"

It is common knowledge that China heavily subsidizes some of its favored industries. As the conventional wisdom goes, government support allows the state firms to produce goods at artificially low costs, which translate to artificially low prices. These subsidized foreign producers gain substantial market share in the US market, destroying US jobs. Americans are told that retaliatory measures are necessary to correct this imbalance.

There are two fundamental errors with this argument. First, the benefits from trade come in the form of imports, and exports are the means of obtaining these benefits. Second, most of the cost of these subsidies is borne by the people of China.

As Paul Krugman has written, "All that matters for the gains from trade are the prices at which you trade—it makes absolutely no difference what forces lie behind those prices."[29]

The people on whom the burden of government subsidies fall are the citizens of the government that does the subsidizing. The Chinese subsidies, for instance, are a tragedy for the people of China because they inevitably divert resources away from nonsubsidized areas of the Chinese economy.[30] This means that there are many industries in which China *isn't* producing—or isn't producing as much—because its government arbitrarily subsidizes other areas of the economy.

The lower prices of Chinese imports made possible by Chinese government subsidies work mainly to the benefit of China's trading partners, including the United States. Contrary to common belief, the real benefits of trade are measured by the value of imports that can be bought per unit of exports—in other words, the exports' purchasing power. The lower the price of imports, the better it is for the importer, even if the price is low only because of a foreign government's subsidies. Furthermore, 63 percent of US imports from China are intermediate goods used for the production of other goods and services. The Chinese government is, in effect, subsidizing a large number of *American* producers.[31]

It is true that these subsidies artificially lower the prices of imported goods and, thus, hurt some American firms and workers. However, empirically, the fear that this competition will take out a large number of efficient American companies is overblown. In spite of Chinese subsidies for many of its industries, the share of US consumer expenditure that goes to China is around 2 percent and has been constant at that level since 2010.[32] Furthermore, subsidies often make their recipients noninnovative and inefficient.[33]

Subsidies Do Distort Economies and Fuel Protectionist Sentiment

Despite the fact that foreign subsidies have no net negative impact on the domestic economy, there are reasons to be concerned about them. They distort economies and trade flows. They fuel the resurgence of protectionism, when import competition in the form of subsidized goods, like all other forms of competition, results in some workers losing their jobs in the short term. Understandably, these workers care about their losses, and the politicians who represent them do too. People will focus on these short-term losses even though, in the longer term, foreign subsidies result in cheaper inputs for US manufacturing firms, industries that are more productive, a net increase in aggregate jobs, and higher incomes.

As tempting as protectionism may be to politicians, it does not address the problem they are trying to solve with higher duties. Moreover, the United States has policies already in place that are meant to correct for the problem, such as the antidumping and countervailing duties administered by the International Trade Commission. Unfortunately, domestic and foreign producers operating in the United States that seek government-provided protection against foreign competition have abused the system, but the system is in place. Realistically, the only sustainable solution to this issue of foreign subsidies is the intermediation of multinational organizations such as the World Trade Organization (WTO) and the adoption of multilateral free trade agreements where all parties agree to drop their subsidies. Many countries have successfully used these global rules to address injurious subsidies.[34]

Unilateral Free Trade Benefits Americans More Than Reciprocal Tariffs

The United States has lower duties than most other countries in the world. For instance, the European Union imposes a 10 percent duty on US cars exported to Europe, while the US duty on foreign cars entering America is 2.5 percent. The perceived unfairness of this differential is at the heart of many arguments in favor of increasing US tariffs to match other nations' duties.

As French economist Frédéric Bastiat noted some 170 years ago, however, increasing domestic tariffs in response to foreign tariffs would be akin to blocking up our harbors because other countries have rocky coasts.

Americans Bear the Cost of Tariffs Imposed by the United States

The economic case for free trade is fundamentally unilateral. Americans benefit from lower US tariff rates, independently of what other countries do. That is because tariffs are taxes that raise the cost of living for the residents of the country imposing the tariffs. When the US government imposes trade barriers, Americans bear the cost. Tariffs on imports reduce the amount of goods and services imported into the home country—they are meant to do so. This necessarily reduces the dollars available to foreigners to buy American goods (exports) and services and to invest in the United States (including as purchasers of US government bonds). Consequently, a reduction of imports induced by tariffs means foreigners will reduce the amount of exports they buy from United States, as well as their investments in the US economy.[35]

The recent bout of protectionism in America has provided an opportunity to measure how much Americans have shouldered the costs of the new duties.[36] For instance, economist Pablo D. Fajgelbaum and his coauthors find that American consumers are shouldering the entirety of the $69 billion in added costs imposed by the last year's tariffs on imports from China.[37] This is one of many such academic studies.

This result should not be a surprise. Tariffs are import taxes, the sole purpose of which is to raise the prices of foreign goods to make them so unappealing to US consumers that US consumers instead buy more domestically made goods. Some of the foreign producers of the goods could, in theory, shoulder the full cost of the tariffs if they simply accepted a reduction in their profit margins. However, in reality, importers pass a large portion of the costs of tariffs on to customers—manufacturers and households in the United States—by raising their prices. Data show, for example, that tariffs imposed on global washing-machine imports increased prices by as much as 12 percent between January 2018 (before tariffs took effect) and June 2018.[38] The reduction in demand that followed put downward pressure on the prices, which still remain higher than before the tariffs.

Implementation of a truly reciprocal system of duties would violate the nondiscrimination principle that is at the heart of the global trading system, threatening the system's stability. It would require adjusting individual tariffs upward, product by product, to match the tariffs imposed by other countries, resulting in a substantial tax increase for American consumers.[39]

The global trading system that emerged following World War II was based on successive rounds of the General Agreement on Tariffs and Trade (GATT), ultimately resulting in the establishment of the World Trade Organization. A direct result was a worldwide reduction of trade barriers. A bedrock principle of GATT is nondiscriminatory application of duties—or an unconditional "most-favored nation" (MFN) status—among the 164 members of the WTO. As my colleague at the Mercatus Center Daniel Griswold writes,

> Under unconditional MFN, if a nation imposes a 10 percent duty on imported widgets, it must apply the same 10 percent rate to an imported widget regardless of where it is

> imported from. Under this principle, nations are free to enact different duty rates than other countries on similar products, but each must apply that same rate to all like imports.[40]

Leaving aside countries with which the United States has free trade agreements (meaning that duties are likely close to zero), Griswold looks at the United States' 10 largest trading partners. He finds that under the administration's reciprocity plan, the United States would need to implement more than 25,800 upward duty adjustments.[41] The average weighted duty on imports from those countries would more than double, from 2.1 percent to 5.4 percent, with the higher duties affecting "$583 billion in imports to the United States, raising the duties on 45 percent of imports from the affected trading partners."[42]

Nor can retaliatory tariffs be ruled out. If that happens, the result would be a world with more and higher tariffs across the board, increasing burdens on consumers as well as on workers and firms in industries downstream from these tariffs.

Free trade is extremely easy to implement because all that the home government has to do is eliminate all tariffs, quotas, and subsidies. It doesn't need to wait for foreign governments to stop using trade barriers that impoverish their citizens before it provides relief to its own citizens by lifting all trade barriers.

That's what countries such as Singapore and New Zealand have done, to the benefit of their residents. New Zealand is a better model than China when it comes to trade.

A VAT Is Not a Trade Barrier

There is a belief increasingly encountered among politicians and pundits that a value-added tax acts as a subsidy for exports and as a barrier, or tax, upon imports. This argument was made regularly in 2017, when the House Ways and Means Committee proposed to replace the corporate income tax with a destination-based cash flow tax (also known as a border adjustment tax, or BAT).[43] It continues to be made by the current administration, this time in the context of alleging that other countries engage in unfair trade by using VATs to give their products a competitive advantage over US goods sold in their markets.

The argument goes like this: Most industrial countries have a VAT. The United States doesn't. When a German exporter sends a good to the United States, the German government removes the VAT, and when that German good arrives in the United States it is not subject to a VAT. By contrast (the argument proceeds), when an American exporter exports a good to Germany, the American good is subject to the German VAT upon its sale in Germany. This arrangement is said to be unfair because the foreign country taxes US exports while the United States doesn't tax the foreign country's exports.

This sounds unfair, but it is not. There is some truth to the explanation of how the VAT operates with regard to exports and imports. VATs are destination-based taxes. For instance, it is true that German products exported to the United States are exempt from the German VAT—but so is the US-made car sold in America. This means that the German export is treated exactly the same as US goods sold in the United States. In other words, its treatment is fundamentally fair.

How about US exports in Germany? Well, they get hit by the German VAT in Germany and by the German corporate tax on the manufacturer's German profits, but so too are German goods sold in Germany. In other words, all goods sold in Germany, whether domestic or foreign, are taxed the same way—just as all goods sold in the United States are taxed the same way. What about this arrangement is unfair?

Nearly all economists, from Paul Krugman to Martin Feldstein, have examined the protectionist claim that foreign VATs give an advantage to foreign products sold in export markets without VATs—and, therefore, that foreign VATS artificially boost foreign exports. They have all found that a VAT does not promote exports.[44]

VATs do not give a competitive advantage to exporters from VAT countries. In addition, adopting a VAT in the United States will not boost US exports.

THERE IS STILL A FREE TRADE CONSENSUS

While removing trade barriers creates some local disruptions and short-term job losses, it always ends up being a net positive for the country that engages in it. Opening a nation to international trade raises wages and increases standards of living by raising the general productivity of workers and increasing both the availability and the quality of consumer goods and services as it reduces their prices.

In recent years, however, a few academics and many political commentators have challenged this "free trade consensus" by arguing that free trade's proponents underestimate the disruptions to the US economy caused by increased import competition. The so-called China shock, the argument goes, starting with China's 2001 admission into the WTO, created a competitive shock of such a scale that jobs weren't just reallocated, they were on net destroyed. Furthermore, it is argued, the increase in capital mobility means that the model of comparative advantage that is the basis of claims of gains from trade falls apart. Both arguments are based on fallacies.

A Challenge to Free Trade Orthodoxy Fails

The "China shock" argument became more potent—and the fears of its proponents were apparently confirmed—after the publication of a series of studies by MIT economist David Autor and his coauthors, David Dorn and Gordon Hanson (collectively known as ADH).[45] In their 2016 paper, ADH examined local labor markets that faced direct competition from Chinese imports over the 1999–2011 period (which includes the Great Recession). They found that 2.4 million net jobs were destroyed.[46]

This is an important contribution to the academic literature because it shows some new difficulties that some workers have had adjusting to big shocks—in this case the depressive effect of import competition from China in certain local labor markets. It is not a remarkable finding because it has long been known that all competition (domestic and international) destroys some jobs in particular sectors or localities, and even a net number of jobs in the short term. What is important, however, for assessing trade—either in general or with China specifically—is import competition's full, long-run effects.

The ADH paper is about the effects of imports on import-competing industries; the results shed no light on the long-term effects of Chinese imports on US exporters, on American consumers, or even on wages in non-import-competing industries. All of these effects matter (as do, of course, the unquestionably large gains millions of Chinese citizens obtain from international trade). A local, short-term analysis tells little about economy-wide (even global) trade shocks. To measure such shocks requires a broader, dynamic analysis over a longer period—which the ADH paper doesn't provide.[47]

A vast literature exists exploring whether trade with China is a source of permanent distress for working-class Americans.[48] It confirms the standard trade story of "discrete, but more concentrated, pains versus larger, but more diffuse (and harder to see), benefits."[49] Moreover, it shows that trade doesn't only benefit the elite—a majority of the benefits of trade flow to workers at the lower end of the income spectrum.[50]

Studies such as ADH's are interesting because they detail the China shock's disproportionate local labor-market effects and Americans' problems adjusting, but they do nothing to call into question the long-standing case for a policy of free trade. Contrary to the way the findings of the ADH papers are typically reported, the authors themselves conclude that imports from China are not the problem. In fact, they admit (when asked) that obstacles to local labor adjustments are the problem.[51] A return to large-scale protectionism will do nothing to address these adjustment issues.[52]

Even When Capital Is Mobile, Comparative Advantage Holds

In 1817, economist David Ricardo demonstrated that, even if a country could produce each unit of all goods and services by using less labor and other resources than are used to produce the same goods and services in other countries, it would still be to that country's advantage to specialize in the production of a handful of outputs—the ones that require comparatively the fewest inputs—and to trade for the rest.[53]

The logical conclusion is that every country that specializes according to its comparative advantage will benefit from trade, because total world output will increase.

While Ricardo's insight is an important component in the case for free trade, it is not the only one. Adam Smith showed that trade generates net economic gains even when specialization is not initiated by comparative advantage.[54] Even if all workers start off with identical productive abilities, they can all gain by specializing. Each specialized worker becomes more skilled at his or her task, and the total output of a group of specialized workers is higher than the total output of the same number of unspecialized workers.

Unfortunately, while Ricardo's theory inflicted much damage on the case for protectionism, it didn't kill the sentiment. Support for protectionism resurfaces on a regular basis, each time proving yet again that, outside the economics profession, very few people fundamentally understand the law of comparative advantage. This realization prompted Paul Krugman to compose a great essay called "Ricardo's Difficult Idea":

> The idea of comparative advantage—with its implication that trade between two nations normally raises the real incomes of both—is, like evolution via natural selection, a concept that seems simple and compelling to those who understand it. Yet anyone who becomes involved in discussions of international trade beyond the narrow circle of academic economists quickly realizes that it must be, in some sense, a very difficult concept indeed.[55]

Among the many misunderstandings about comparative advantage was the one on display in a 2004 *New York Times* op-ed by Senator Chuck Schumer and economist Paul Craig Roberts. The authors argued that "comparative advantage is undermined if the factors of production can relocate to wherever they are most productive: in today's case, to a relatively few countries with abundant cheap labor. In this situation, there are no longer shared gains—some countries win and others lose."[56] Roberts and Schumer added, "To call America's economic recovery 'jobless' is inaccurate. Lots of new jobs are being created, just not in the United States."[57] Their proclamation was speedily adopted by a coalition of free trade skeptics.

In a more recent defense of protectionism, the comparative advantage model is said to fall apart because "the theory depends upon a number of key assumptions and fails if they are relaxed."[58] Among these allegedly key assumptions is the immobility of capital.[59]

Unfortunately, this is yet another misunderstanding of the law of comparative advantage. Donald Boudreaux wrote in 2004 that Ricardian comparative advantage absolutely holds even with completely mobile factors of production.[60] While mobile capital will change the pattern of comparative advantage, it doesn't eliminate it. In fact, as Boudreaux wrote more recently in an exchange with the protectionist Ian Fletcher, "Unless and until the opportunity cost of producing *every* good and service in the world is identical for *every* producer in the world, comparative advantage will exist and provide occasions for mutually productive specialization and trade."[61]

In its latest iteration, the defense of protectionism rests on the idea that comparative advantage does exist when capital is mobile, but that the theory no longer *proves free trade is optimal* when this is the case. This argument, once again, misconstrues the role that comparative advantage plays in supporting the case for a policy of free trade. That role is, and has always been, to demonstrate the counterintuitive point that a country's ability to produce good steel using fewer resources than are required to produce lumber abroad does not imply that the people of that country should produce steel. The people of said country might still benefit by specializing in the production of lumber and exchanging lumber for imports of steel.

Stated precisely, the case that an understanding of comparative advantage makes for free trade is this: protectionism in the home country will reduce the aggregate economic well-being of the residents of the home country, *given* the prevailing pattern of comparative advantages across the globe. This case says nothing about the forces that determine comparative advantage or about what is, from the perspective of citizens of the home country, an "ideal" pattern of production and trade.

No serious economist has ever denied that in reality the pattern of comparative advantages can change over time for a multitude of reasons, including innovation and trade. Nor has any serious economist denied the theoretical possibility that an omniscient and apolitical government could use tariffs and subsidies to arrange for the home country's comparative advantages to change in ways that, over time, yield higher real incomes for the people of the home country.

The validity or invalidity of using this theoretical possibility to justify protectionism in the real world has nothing to do with the principle of comparative advantage as such. Even if real-world governments could be trusted to use protectionist interventions in these ways, the resulting case for protectionism would not arise from any failure of comparative advantage to apply in, or to describe, reality.[62]

The theoretical benefits of sophisticated intervention have long been recognized, and so have its real-world problems. Krugman has pointed out that "the gains from intervention are limited by uncertainty about appropriate policies, by entry that dissipates the gains, and by the general equilibrium effects that insure that promoting one sector diverts resources from others." He concludes, "To abandon the free trade principle in pursuit of the gains from sophisticated intervention could therefore open the door to adverse political consequences that would outweigh the potential gains."[63]

FREE TRADE, ITS BENEFITS, AND ITS DEFENSE

Trade agreements have unquestionably made the United States and the rest of the world more economically free than they would have been otherwise. This is true even though uncomfortable compromises included in the agreements—likely as a way to render them politically acceptable—make them less than fully free trade.[64]

Imperfect as they are, free trade agreements have been agents of change for the better. They have led most countries to lower their tariffs. Since the end of World War II, the average world tariff rate for major industrial nations dropped from nearly 22 percent to just 2.59 percent today for all countries, an 88 percent reduction. In 1994, before the creation of the World Trade Organization, the average world tariff rate was 8.57 percent. Just since 1994, the average world tariff rate has fallen by 70 percent, from 8.57 percent to 2.59 percent.

As effective as free trade agreements have unquestionably been at lowering trade barriers, the practical support for free trade since the end of World War II, while unquestionably beneficial, suffered from the weakness of being still rooted to some extent in a mercantilist misunderstanding.

That support took for granted the validity of the wrongheaded belief that the ultimate benefit of trade is exports, whereas imports are the unfortunate but necessary price that must be paid in order to export more. The multilateral and bilateral trade treaties "worked" to make trade freer in practice because each government was willing to allow its citizens to import more as the necessary condition for persuading other governments to allow their citizens to do the same. Each government, in short, agreed to lower import barriers only as a means of increasing its country's exports.

While trade negotiations under this misapprehension worked to make trade freer, ultimately a danger lurks because this underlying belief is false. Trade negotiators and all stakeholders (not just economists) need to understand a key reality: the economic benefit of trade is found in the *imports* the home country receives. Therefore, because other countries' protectionist policies always aim to minimize their imports relative to their exports, the home country is always best served by following a policy of free trade regardless of the policies in place abroad.

The resurgence of protectionist thinking requires a consensus that is more durable—a consensus built on the correct understanding that the ultimate goal of trade is to raise consumers' standard of living, and not to expand the sales of favored domestic producers.

This task is daunting. There are many aspects of free trade that are poorly understood both by the general public and by policymakers. Here are some of the mistaken ideas and faulty concepts that should be challenged in a renewed push for a more durable regime of free trade:

- Trade is exchange. Gains from international trade are no different from gains from domestic trade—and, hence, restrictions on international trade are no different from restrictions on domestic commerce.
- No nation—be it rich, poor, growing, or stagnant—with whom the United States trades is an economic threat to it. *All* trade increases US prosperity. While many Americans do feel threatened by China's desire to dominate, this feeling is unwarranted. Americans should welcome China's growth, as it will make them richer. Genuine national security concerns

should be met using diplomatic, military, and other tools, not by restricting the freedom of Americans to trade for mutual gain.

- The ultimate goal should be a policy of unilateral free trade. While an end to Chinese protectionism is desirable, there is no logic to the United States taxing its citizens in order to try to convince the Chinese to change course and stop taxing themselves.
- Protectionism put in place in the name of "fairness" is inherently unfair, not least because proponents of such protectionism always ignore the harm suffered by their fellow citizens who are buyers of higher-priced imports.
- Trade is voluntary exchange that enriches both parties (especially the global poor). Protectionism benefits a few government-handpicked winners at the expense of millions of consumers (especially poor ones).[65]

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NOTES

1. It is worth noting that there is a long-standing professional consensus among economists about the benefits of free trade. There is also wide divergence between the opinions of economists and those of the public at large.
2. James Pethokoukis, "How Did America Get Rich to Begin With? It Sure Wasn't Because of Tariffs and Protectionism," *AEIdeas*, August 30, 2018.
3. The president tweeted, "Our Country was built on Tariffs, and Tariffs are now leading us to great new Trade Deals—as opposed to the horrible and unfair Trade Deals that I inherited as your President. Other Countries should not be allowed to come in and steal the wealth of our great U.S.A. No longer!" Donald J. Trump (@realDonaldTrump), Twitter, August 15, 2018, 8:04 a.m., https://twitter.com/realDonaldTrump/status/1029745594540150784.
4. Douglas A. Irwin, "Interpreting the Tariff-Growth Correlation of the Late 19th Century," *American Economic Review* 92, no. 2 (May 2002): 165–69.
5. Douglas A. Irwin, *Clashing over Commerce: A History of US Trade Policy* (Chicago: University of Chicago Press, 2017), 284.
6. Irwin, *Clashing over Commerce*, 284.
7. Irwin, "Interpreting the Tariff-Growth Correlation." For a review of the studies on this issue, see also Scott Lincicome, "Doomed to Repeat It: The Long History of America's Protectionism Failures" (Policy Analysis No. 819, Cato Institute, Washington, DC, August 22, 2017).
8. Cecil E. Bohanon and T. Norman Van Cott, "Tariffs, Immigration, and Economic Insulation: A New View of the U.S. Post–Civil War Era," *Independent Review* 9, no. 4 (Spring 2005): 529–42.
9. Bohanon and Van Cott, "Tariffs, Immigration, and Economic Insulation."

10. World Bank, *The East Asian Miracle: Economic Growth and Public Policy* (Oxford: Oxford University Press, 1993).

11. World Bank, *East Asian Miracle*, 5.

12. World Bank, 5, 6.

13. Arvind Panagariya, *Free Trade & Prosperity: How Openness Helps Developing Countries Grow Richer and Combat Poverty* (New York: Oxford University Press, 2019), 204.

14. Panagariya, *Free Trade & Prosperity*, 223.

15. Ronald Coase and Ning Wang, *How China Became Capitalist* (New York: Palgrave Macmillan, 2012).

16. Nicholas R. Lardy, *The State Strikes Back: The End of Economic Reform in China?* (Washington, DC: Peterson Institute for International Economics, 2019).

17. Panagariya, *Free Trade & Prosperity*, 325.

18. Organisation for Economic Co-operation and Development, "Why Open Markets Matter," accessed October 3, 2019, http://www.oecd.org/trade/understanding-the-global-trading-system/why-open-markets-matter/.

19. Panagariya, *Free Trade & Prosperity*, 161–71.

20. Arvind Panagariya, "Why Did Singapore and Hong Kong Escape Protection?," *Economic Times*, June 20, 2001; Panagariya, *Free Trade & Prosperity*, 161–64.

21. Panagariya, *Free Trade & Prosperity*, 123.

22. Federal Reserve Bank of St. Louis, "Manufacturing Sector: Real Output," September 5, 2019, https://fred.stlouisfed.org/series/OUTMS.

23. Darrell M. West and Christian Lansang, *Global Manufacturing Scorecard: How the US Compares to 18 Other Nations* (Washington, DC: Brookings Institution, 2018).

24. Federal Reserve Bank of St. Louis, "Industrial Capacity: Total Index," July 16, 2019, https://fred.stlouisfed.org/series/CAPB50001SQ.

25. Michael J. Hicks and Srikant Devaraj, *The Myth and the Reality of Manufacturing in America* (Muncie, IN: Ball State University, June 2015). Hicks and Devaraj find that "almost 88 percent of job losses in manufacturing in recent years can be attributable to productivity growth, and the long-term changes to manufacturing employment are mostly linked to the productivity of American factories."

26. Hicks and Devaraj, *Myth and the Reality of Manufacturing*.

27. Mark J. Perry, "Yes, the US Middle Class Is Shrinking, but It's Because Americans Are Moving Up. And No, Americans Are Not Struggling to Afford a Home," *AEIdeas*, January 31, 2018.

28. Scott Winship, "What's behind Declining Male Labor Force Participation: Fewer Good Jobs or Fewer Men Seeking Them?" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, 2017).

29. Paul Krugman, "What Should Trade Negotiators Negotiate About?," *Journal of Economic Literature* 35 (March 1997): 113–20.

30. Nicholas Lardy explains how the second-most-important contributor to China's slowing economy is the resurgence of the role of the state in resource allocation. The increase in investment in poorly performing and deteriorating state-owned businesses is crowding out investment in far more productive private firms. The state firms are dragging China's growth down. Lardy, *State Strikes Back*.

31. Galina Hale et al., "How Much Do We Spend on Imports?" (FRBSF Economic Letter 2019-01, Federal Reserve Bank of San Francisco, San Francisco, CA, January 7, 2019).

32. Hale et al., "How Much Do We Spend on Imports?"

33. Lardy, *State Strikes Back*.

34. Scott Lincicome, "Countervailing Calamity: How to Stop the Global Subsidies Race" (Policy Analysis No. 710, Cato Institute, Washington, DC, October 9, 2012); Dan Mitchell, "Bad Mix: China, Trump, and Trade," *International Liberty*, July 27, 2019; James Bacchus, Simon Lester, and Huan Zhu, "Disciplining China's Trade Practices at the WTO: How WTO Complaints Can Help Make China More Market-Oriented" (Policy Analysis No. 856, Cato Institute, Washington, DC, November 15, 2018).

35. This phenomenon is known as Lerner symmetry. For an explanation, see Iowa State University Department of Economics, "Lerner Symmetry Theorem," accessed October 4, 2019, http://www2.econ.iastate.edu/classes/econ355/choi/lerner1.htm.

36. Alessandro Barattieri, Matteo Cacciatore, and Fabio Ghironi, "Protectionism and the Business Cycle" (NBER Working Paper No. 24353, National Bureau of Economic Analysis, Cambridge, MA, February 2018); Aaron Flaaen, Ali Hortaçsu, and Felix Tintelnot, "The Production, Relocation, and Price Effects of US Trade Policy: The Case of Washing Machines" (Working Paper No. 2019-61, Becker Friedman Institute, Chicago, April 2019); Pablo D. Fajgelbaum et al., "The Return to Protectionism" (NBER Working Paper No. 25638, National Bureau of Economic Research, Cambridge, MA, March 2019).

37. Fajgelbaum et al., "Return to Protectionism."

38. Congressional Research Service, *Trump Administration Tariff Actions: Frequently Asked Questions*, February 22, 2019, 24, figure 9.

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40. Daniel Griswold, "Mirror, Mirror, on the Wall: The Danger of Imposing 'Reciprocal' Tariff Rates" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, January 2019), 5.

41. Griswold, "Mirror, Mirror, on the Wall," 4.

42. Griswold, 4.

43. Veronique de Rugy, "Speaker Ryan's Use of Reporters' Recorders to Explain His Border Tax Was Cute—but Misleading," *National Review*, February 20, 2017.

44. Joel Slemrod, "Does a VAT Promote Exports?," in *The VAT Reader: What a Federal Consumption Tax Would Mean for America* (Falls Church, VA: Tax Analysts, 2011); Paul Krugman, "Border Tax Two-Step (Wonkish)," *New York Times*, January 27, 2017; Paul Krugman and Martin Feldstein, "International Tax Effects of Value Added Taxation" (NBER Working Paper No. 3163, National Bureau of Economic Research, Cambridge, MA, November 1989); Caroline Freund and Joseph E. Gagnon, "Effects of Consumption Taxes on Real Exchange Rates and Trade Balances" (Working Paper, Peterson Institute for International Economics, Washington, DC, April 2017).

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47. Lorenzo Caliendo, Maximiliano Dvorkin, and Fernando Parro, "Trade and Labor Market Dynamics: General Equilibrium Analysis of the China Trade Shock," *Econometrica* 87, no. 3 (May 2019): 741–835.

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49. Lincicome, "Failure to Adjust."

50. Mary Amiti et al., "China's WTO Entry Benefits US Consumers," *Vox* (Center for Economic and Policy Research), June 28, 2017.

51. Scott Lincicome, “The Truth about Trade,” *National Review*, April 11, 2016.

52. Research by Douglas Irwin is a must-read on this issue: Federal Reserve Bank of Richmond, “Interview: Douglas Irwin” *Econ Focus*, Third Quarter 2017; Phil Levy, “Did China Trade Cost the United States 2.4 Million Jobs?,” *Foreign Policy*, May 8, 2016.

53. David Ricardo, *On the Principles of Political Economy and Taxation* (London: John Murray, 1817).

54. Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (London: Methuen & Co., 1776).

55. Paul Krugman, “Ricardo’s Difficult Idea,” accessed October 4, 2019, https://web.mit.edu/krugman/www/ricardo.htm.

56. Charles Schumer and Paul Craig Roberts, “Second Thoughts on Free Trade,” *New York Times*, January 6, 2004.

57. Schumer and Roberts, “Second Thoughts on Free Trade.”

58. Ian Fletcher, “Why the Theory of Comparative Advantage Is Wrong,” *International Journal of Pluralism and Economics Education* 2, no. 4 (2011).

59. Ian Fletcher, “Free Trade Theory Known to Be Wrong—since 1817!,” *Activist Post*, March 11, 2011.

60. Donald J. Boudreaux, “Does Increased International Mobility of Factors of Production Weaken the Case for Free Trade?,” *Cato Journal* 23, no. 3 (Winter 2004): 373–79. Boudreaux also noted that Schumer and Roberts erred in writing as though both the supply of capital is fixed and the pauper-labor fallacy is valid.

61. Donald J. Boudreaux, “Fletcher’s Comparative Advantage Is Not Economics,” *Café Hayek*, March 12, 2011.

62. As mentioned earlier, comparative advantage is not the only basis for trade. Economies of scale are also important. And product differentiation means that the United States, the European Union, and Japan can all have a similar comparative advantage in making cars, yet do a lot of trade with each other because of differing consumer tastes.

63. Paul Krugman, “Is Free Trade Passé?,” *Journal of Economic Perspectives* 1, no. 2 (1987): 131–44.

64. Tariffs in free trade agreements, however, are expected to go to zero, with a few exceptions for political sensitivities. GATT Article 24 requires free trade agreements to cover substantially all trade between the parties.

65. Dan Ikenson and Scott Lincicome, “Audaciously Hopeful: How President Obama Can Help Restore the Pro-trade Consensus” (Policy Analysis No. 39, Cato Institute, Washington, DC, April 28, 2009).