THE FREEMAN
IDEAS ON LIBERTY

The Case Against Managed "Fair" Trade and Strategic Trade

by Shyam J. Kamath

The administration of President William Jefferson Clinton was voted into power in 1992 by a minority of the American electorate on the basis of its promise of "change." As a centerpiece of its platform of change, the new administration promised a "new economic paradigm," a major tenet of which was to create a liberal trading environment through strategic intervention in the process of international trade. Such strategic trade policy involved government intervention to open "closed" foreign markets (the example that was offered was Japan), government activism to serve the national interest in supporting "strategic" industries (e.g., commercial aircraft and semiconductors) and selective targeting of trading partners who were trading "unfairly" by subsidizing their exports or dumping them in the U.S. market.

In spite of the victories in Congress on the North American Free Trade Agreement (NAFTA) and the Uruguay Round of Negotiations of the General Agreement on Trade and Tariffs (GATT), neither of which was initiated by them, the Clinton administration remains wedded to a philosophy of managed and strategic "fair" trade as witnessed by recent confrontations with Japan, China, India, and a host of other nations on issues ranging from the opening of "closed" markets to human rights.

The slogan of "fair" trade has regularly inflamed the passions of the American people since the founding of the republic. Yet successive presidential administrations and the majority of the American people, have on balance been champions of free trade and have thereby made the U.S. the richest country in the world. As the champion of multilateral free trade through the active encouragement and sustained support of the GATT, the U.S. has also been instrumental in supporting world development and making people in other free-trading nations prosperous.

Yet, America in the eighties and early nineties has witnessed the rise of protectionism in the form of retaliatory tariffs and other forms of administered non-tariff barriers. Its "Japan problem" has given rise to a groundswell of popular support for "managed" trade and for punishing its partners for alleged "unfairness," even under the ostensibly free-trade administrations of Ronald Reagan and George Bush. The Clinton administration evidences an activist strain of the protectionist virus that has plagued the nation's movement toward freer trade, in spite of appearances to the contrary.

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Free Trade vs. "Fair" Trade

It is a commonplace of elementary economics that voluntary exchange creates benefits/wealth for all parties to the exchange. When it comes to trade between nations, the same principle applies since it is once again individuals who are involved in these exchanges. In fact, the classical theory of comparative advantage underlying the case for free trade argues that such trade is good for a country even if other countries do not return the favor.

Yet, the case for managed "fair" trade continues to be made on the grounds that free trade results in the loss of jobs, the deindustrialization of America, the loss of "strategic" industries to "unfair" foreign competitors, the loss of American economic leadership and, most recently, is alleged to be the cause of global environmental pollution and needs to be made contingent on the achievement of a common standard of human rights. Both the logic and experience of free trade convincingly refute each one of these claims.

The "They Took Our Jobs" Myth

Trade creates jobs as economic activity expands. The experience of the most free-trading nation on earth, Hong Kong, clearly illustrates this point. With no natural resources, except its people and one of the world's finest natural harbors, but with complete free trade, Hong Kong has witnessed an increase in its per capita income over twenty-five fold and an increase in employment of over twenty times within a short span of forty years. Today, its per capita income is greater than that of the United Kingdom, of which it is still a colony. This stellar economic performance has been achieved while the population of this largely barren island-peninsula colony increased from around 300,000 to six million over this period. The experience of the other "tigers," Singapore, Taiwan and South Korea, is similar. Lest these examples be considered atypical, the cases of western Europe, North America, and Japan have been similar both before and especially after the two World Wars.

The common argument that is advanced in favor of "fair" trade is that trade deficits (i.e., excesses of imports over exports) cause job losses. While this argument reveals a lack of understanding of what trade deficits imply in the standard system of balance of payments accounting, it is pertinent to note that over 21 million new jobs were added between 1980 and 1990 even as the U.S. ran up huge trade deficits with the rest of the world. And the majority of these jobs paid rather well, contrary to the "McJobs" myth. Job growth was mainly in those sectors that were largely unprotected against foreign competition such as computers and data-processing, telecommunications, petroleum and chemicals, pharmaceuticals and health-related products, scientific and photographic equipment, banking and finance, entertainment, leisure and recreation, hospitality and tourism, and the service professions.

Meanwhile, protectionist measures designed to "save" jobs in such industries as automobiles have not kept employment in them from shrinking drastically and, in fact, may have added to their troubles. The quotas (euphemistically called "voluntary" export restraints—VERs) against Japanese autos imposed by the Reagan administration in the early eighties did not prevent the net loss of over 200,000 jobs in the U.S. auto industry.

Robert Crandall of the Brookings Institution has estimated that the 27,000 direct jobs that were saved in the U.S. auto-manufacturing sector cost around $160,000 per job saved (in 1984 dollars) in terms of economic welfare losses in production and consumption. The VERs added about $2,000 to the price paid by consumers, reduced consumer choice, reduced the competitiveness and efficiency of American producers, and resulted in windfall profits for American and Japanese (and other foreign) automobile manufacturers, leading to the shift of Japanese auto production to luxury cars and further exacerbating Detroit's woes in this high-margin segment of the industry. Japanese transplant factories that were set up in the U.S. in order to avoid protectionist sentiment and restraints, reduced the magnitude of the job losses in the auto industry and the other pernicious effects of VERs.

The experience in steel, textiles, and a host of other industries such as dairy products, shipping, and meat-packing was similar. These industries continued to shrink while protective tariffs and subsidies were lavished on them to "save" jobs. For example, in the late eighties, consumers spent $27 billion on textile and apparel subsidies alone, and the cost per direct job saved was $42,000 in an industry with an average wage of $12,000. In the protected dairy products and shipping industries the cost per job saved was estimated as $220,000 and $270,000 respectively in 1987. In the carbon-steel industry for the 9,000 direct jobs saved, the cost was a phenomenal $750,000 per job. The impact of these high-cost "saved" jobs is the diversion of scarce resources from other, more market-oriented industries with perhaps a much larger number of jobs that never came into existence.

Restricting steel imports destroyed jobs. It is estimated that in the 1980s, steel restraints protected 17,000 jobs in the whole industry, while they cost 54,400 jobs in steel-related industries, for a net loss of over 35,000 jobs. Higher steel costs added to the burden of steel-using industries that were trying to compete against foreign manufacturers. Thus, for example, expensive steel raised the cost of building cars in Detroit and promoted Japanese auto imports.

The Deindustrialization Myth

The widespread belief that the U.S. has lost its manufacturing base in the face of foreign competition is simply wrong. Deindustrialization never happened. In terms of absolute output, America's manufacturing lead continues to increase, not fall. The U.S. share of total output of OECD countries (the 24-nation Organization for Economic Cooperation and Development, comprising the bulk of the market-oriented industrial economies of the world) increased from 36 percent in 1973 to 39 percent in 1986, and its share of the industrialized world's manufactured exports was estimated to be 18 percent, the same as in 1980, and ahead of Japan's current 17 percent share. Moreover, the absolute productivity level of U.S. labor in general, and manufacturing labor in particular, continues to be the highest in the world. American manufacturing productivity increased at the fastest pace among the OECD nations in the eighties. The U.S. share of OECD manufacturing employment also increased from 24 percent in 1962 to 28 percent in 1985, while the share of countries like France, Germany, and the United Kingdom fell.

If rising incomes and technological innovation raise the demand for services instead of manufactured goods, economic and social survival require that such services be supplied. The decline in the U.S. of the share of manufacturing in total output and employment has been the result of relatively fast productivity growth in manufacturing and an increase in the demand for services as compared to manufactured goods. The result has been very similar to what happened to the American agricultural sector in the early part of the century—unprecedented gains in agricultural productivity and a rising demand for manufactured goods led to a decline in the share of output and employment in agriculture. This "deagriculturalization" was not only desirable, given the shifts in demand and productivity, it also occurred amidst a period of rising trade surpluses in agricultural products. In any case, many of the countries with some of the highest standards of living in the world today specialize in the provision of services.

The Industrial Policy Myth

Another common complaint against free trade and argument for "fair" trade is that other countries, most especially Japan, are targeting and subsidizing "strategic" industries for takeover and ultimate market domination. The argument is that the U.S. government should create a "level playing field" with countervailing tariffs, or subsidies and industrial policy. Once again, the logic and evidence of actual trade belies this view.

The logic of "strategic" targeting and industrial policy requires that government officials possess vast amounts of information about the future and be able to outguess private entrepreneurs with money at stake. This is, as F.A. Hayek taught us, impossible because of the knowledge problem involved in collecting vast amounts of dispersed knowledge in order to predict successfully an unknowable future. Communist nations suffered from the fatal conceit that government planners could perform such impossible feats before their ill-constructed policies eventually collapsed.

Secondly, strategic targeting, even if possible, would lead to a cycle of retaliation and counter-retaliation which would ultimately make everyone worse off. The results of the infamous Smoot-Hawley tariff in the early thirties illustrate the point. Escalating subsidies and industrial policies will distort the price signals essential for the functioning of a dynamic economy, leading to unintended consequences that are worse than the original alleged disease.

The United Kingdom suffered from the disastrous consequences of its post-war protectionist and interventionist industrial and labor policies. It was the "sick man" of Europe until free-market policies in the eighties restored some of its economic dynamism.

Japan is presented as an example of successful strategic targeting and industrial policy. Yet the actual evidence seriously questions this alleged success. If Japanese strategic targeting had been successful, the original company that later became Sony would have never mass-produced the transistor radio and, in fact, the present-day Sony Corporation may have never come into existence. Similarly, Mr. Shoichiro Honda would have never manufactured Hondas if he had taken the Japanese government's advice.

While some Japanese industries clearly capitalized on the opportunities provided by government subsidies, low-interest loans, and import protection, a large number of targeted industries simply did not do well, or actually became inefficient and/or failed. These include the highly protected and inefficient agricultural industry; the heavily subsidized and low-interest loan-financed coal mining, petroleum refining, and petrochemical industries; the protected and politically mollycoddled wholesale and retail distribution industries; the largely unsuccessful and government-assisted aerospace and large commercial aircraft companies; and the government-supported shipbuilding industry which, after an initially successful period in the late sixties and early seventies, ran into heavy weather and had to downsize massively in the late seventies and early eighties. Japan's most successful and internationally competitive industries such as the automobile and consumer electronics industries have enjoyed practically no special government favors. The industrially targeted steel industry actually yielded below-market returns and has been judged by sophisticated analysts as an example of unsuccessful targeting.

What industrial policies and protection did do was to keep the Japanese standard of living lower than what it otherwise would have been. In 1988, the Japanese standard of living, adjusted by purchasing power exchange rates, was estimated to be around 72 percent of the American standard of living. Most of the improvement of its standard of living has occurred in the last fifteen years as it has dropped its tariff and non-tariff barriers.

The Japanese "Unfair" Trade Myth

Another common myth about "fair" trade is that Japan severely restricts imports. In fact, Japan's formal and informal trade barriers are lower than those in the U.S. and other industrial countries. For example, Japan's average tariff on industrial products was 2.9 percent in 1981 as compared to 4.3 percent in the U.S and 5.8 percent in the EC. Non-tariff barriers such as quotas, licenses, and VERs in Japan were found by a World Bank study to be no different than those in the United States, with the Japanese using more non-tariff barriers to protect agriculture, while the U.S. protects more of its manufactures in this fashion.

Japan was the world's third largest importer in 1990, taking in $235 billion worth of goods and services, imports that were almost as large as the GNP of India and larger than the GNP of Sweden. Japanese imports grew by almost 85 percent since 1985. In terms of imports per person, Japan imported $1,900 compared with $2,050 for the U.S. Yet, the typical Japanese person spent more on American products than vice versa—$372 in 1990 as against $357 for the United States. Over the 1986–91 period U.S. exports increased by 91 percent, while Japan's exports grew by around 17 percent and the average OECD growth was around 25 percent. U.S. exports to Japan during this period were especially strong, doubling to $46.1 billion by the end of 1990. The growth of U.S. exports was strongest in the manufacturing sector.

Sophisticated econometric analyses by a number of serious and scholarly analysts such as Gary Saxonhouse of the University of Michigan, Ed Leamer of UCLA, and T.N. Srinivasan of Yale and Koichi Hamada have shown that Japan does not "under-import" (as unmeasurable and illogical as that concept may seem) as a number of trade "revisionists" such as Clyde Prestowitz and James Fallows have contended. In fact, they have shown that Japan's total imports and imports of manufactures are well within the margins of what would be expected for a country with its natural resource endowments and demographic characteristics.

In fact, it can equally well be argued that it is the U.S. which is the unfair trader. In his book, *The Fair Trade Fraud*, James Bovard has documented that the U.S. has over 8,000 tariffs, 3,000 clothing and textile import quotas, and a variety of quotas and other non-tariff barriers for steel, autos, sugar, dairy, peanut, cotton, beef, machine tools, and other industrial products. Bovard estimates that these trade barriers cost U.S. consumers $80 billion on an annual basis, or more than $1,200 per family per year.

The Cleaner Environment Myth

A more recent argument for managing trade has been raised by environmentalists. According to them, free trade will lead to greater pollution as production expands in the trading countries. Therefore, only environmentally "safe" industries should be allowed in the newly industrializing countries, or trade policy should be linked to tough environmental pollution control laws in the developing countries.

The greatest cause of human misery in the underdeveloped nations is poverty. Free trade and free markets are the only viable way to achieve sustained growth and alleviation of this poverty. Restricting trade or slowing growth for environmental reasons will continue and perpetuate human misery in these nations. The existence of the knowledge problem implies planners cannot know enough to achieve "environmentally responsible" managed trade and economic growth.

In fact, if the economic development of the industrialized countries is any guide, free trade and free market policies will most likely lead to a cleaner environment. Julian Simon and others have shown how economic development in the context of a free market, private property rights economy has inevitably led to a cleaner environment while simultaneously alleviating poverty.

A recent report published by GATT shows that since the richer countries pollute less, and trade makes countries richer, protection or managed trade is likely to cause more, not less, pollution. For example, Princeton economists Gene Grossman and Alan Krueger have shown that air pollution in cities rises with national per capita income to around $5,000, but then falls as income increases further. Trade also helps cleaner technologies to spread.

The Strategic Trade Policy Myth

A major influence on the thrust toward managed trade is the presence of "strategic traders" in its ranks. Recent research in the field of international economics has given rise to what is called strategic trade theory where some of the world's leading trade theorists have shown that under certain stylized circumstances (for example, where a single national firm is in combat with a single other-country rival say, like Boeing and Airbus in the commercial aircraft industry), strategic support (for example, with a subsidy) of a domestic industry against its foreign competitor can be in the national interest and provide it with a "strategic advantage." Such arguments have been seized upon by the strategic traders, a group of public policy entrepreneurs and journalists, as evidence of a fatal weakness in the theory of comparative advantage and the case for free trade. Nothing could be further from the truth.

There are many good reasons for rejecting the temptation to implement strategic trade theory. The most important reason is that the knowledge problem makes it impossible to identify which industries to encourage. In any case, targeting one industry with a subsidy will draw away scarce resources from others so that strategic trade policy on behalf of one industry is simultaneously strategic trade policy against other industries. With the likelihood of government policy failure being very high due to the knowledge problem and a host of other problems (called problems of "public choice" by economists), strategic trade intervention is likely to prove most detrimental to the economy.

Secondly, real-life competition in most industries is unlike that depicted in stylized strategic trade models. Seldom is one national industry "champion" pitted against another solitary rival (even in the Boeing-Airbus case the analogy is seriously flawed), and when there are more than two rivals the outcomes are likely to be more varied and run counter to the desires of the strategic policy maker.

Thirdly, the basic premise of the strategic traders and the competitiveness advocates is patently false. Strategic traders portray nations as being like giant corporations with monopoly power pitted in mortal combat with each other. President Clinton himself has characterized nations as "big corporations competing in the global marketplace." This leads to ill-founded fretting about the "competitiveness" of a nation.

Not only is the concept of the competitiveness of a nation difficult to define, there is no equivalent counterpart to the one indicator of the competitiveness of a corporation—its bottom line in terms of profit or loss. When we say that a corporation is uncompetitive, we mean that it is making a loss and that, if it does not improve its market position in terms of profit (or cash flow), it will cease to exist. No such statement can be made about a nation's competitiveness since it does not have a definable bottom line and does not go out of business (the trade balance is clearly inadequate and inappropriate since countries running trade deficits often are attracting huge sums of foreign investment as did the U.S. in the last decades of the nineteenth and early decades of the twentieth century and as Mexico has done in recent years).

Countries also do not compete with each other like corporations since international trade is not a zero-sum game. While IBM and Hitachi tend to be successful at each other's expense in the same market as they wrestle for market share, countries normally comprise each others' export and import markets. This means that if China is successful in exporting a large amount of goods to the U.S., it simultaneously becomes a large market for U.S. goods. The gains from international trade and specialization accrue to both nations unlike the case of IBM and Hitachi competing for market share.

Human Rights

The most recent argument for managed "fair" trade has focused on the issue of human rights and workers' rights in developing countries. The Clinton Administration has threatened countries like China with the loss of most favored nation (MFN) status for its human rights record, and a host of other countries such as India, Indonesia, Brazil, and Thailand have been placed under "super 301" (named for Section 301 of the

U.S. Trade Act of 1974) sanctions for these and other reasons.

Free trade has been a powerful force for the establishment of human rights and workers' rights the world over. It is no accident that human rights and workers' rights have been and continue to be violated routinely in countries which do not participate in a major way in international trade. Even if international trade has not always resulted in the quick establishment of human rights, it is nevertheless a bad idea to use international trade as a political lever.

The argument for using trade as a weapon to enforce a uniform human rights standard can very quickly become the thin edge of a wedge to demand "fairness" in trade for favored domestic industries and pressure groups by the imposition of sanctions, embargoes and protectionist measures. This could very well degenerate into a name-calling "beggar-thy-partner" trade dispute. Looking for policy, institutional, and moral differences as sources of unfair trade is contrary to rule-based trade regimes such as GATT. It results in challenging every policy in the name of "fair" trade, making managed trade inevitable and putting bureaucrats and politicians in charge of a highly politicized trade regime.

It is very easy to see disputes about workers' rights degenerating into the prevention of trade on the basis of genuine comparative advantage such as lower wage labor. There are many who regard it as "unfair" for Mexican or Chinese workers to be paid a fraction of the wages of American workers and call for tariffs or trade barriers to redress the balance. Such arguments are very easily extended to "working conditions" and other labor costs. They are destructive to the aspirations of developing nations since they deny the basis for comparative advantage for these nations. Moreover, the call for workers' rights is often only a thinly disguised call for universal unionization of labor.

Globalization

The strongest argument against managed "fair" trade is the reality of the existence of globally integrated multinational corporations like IBM, AT&T, and Procter & Gamble, and the interdependence of the inhabitants of our "global village." It is estimated that over forty percent of world trade is carried out by over 2,000 multinational corporations that do not have a national identity and that produce and distribute through a globally-integrated operational network. Any attempt to impose "fair" trade on ostensibly "foreign" competitors through countervailing measures such as anti-dumping duties is more than likely to end up hurting ostensibly "domestic" corporations. This has been the experience with U.S. Section 301 sanctions against foreign countries and trade agreements such as the semiconductor agreement, which resulted in injury to "domestic" corporations like IBM, DEC, Apple, and so on.

The comedy of the recent "buy American" campaigns that preceded and followed the 1992 presidential election illustrates the futility of national policies and efforts to protect "us" from "them" in the face of this globally interlinked trade. Today, anyone wishing to "buy American" may have to purchase a car with a nameplate like Honda or Mazda rather than Chevrolet, Dodge, Ford, or Pontiac. Some of Lee Iacocca's much touted new line of American-built cars such as the Intrepid are not even built in the U.S.—they are built in Canada.

In Conclusion

Logic and hard evidence dictate that we resist the siren song of "fair" trade if we wish to maintain and enhance our standard of living in an interdependent world. Free trade is still the best option for promoting American prosperity in spite of our current problems and the exhortations of our politicians. Managed "fair" trade can only lead to costly mistakes and policy errors and an ever-escalating cycle of retaliation and counter-retaliation putting our world trading system and our futures at risk. Our economic and social future depends on keeping our borders open and the goods and services flowing! □

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Get a Grip, Garth!

by Reid Schlager

Garth Brooks has received considerable publicity in recent years, and deservedly so. The country music star has been one of the most popular celebrities in any field. His income over the last two years placed him ninth on *Forbes*' 1993 survey of the highest paid athletes and entertainers. However, he also made news for attempting to prohibit the sale of his latest compact disc recording at stores that sell both used compact discs and new ones. The reason, of course, is that selling used CDs would cheat him out of royalty income.

His position seems to be somewhat paradoxical for someone who:

- earned $47 million the last two years,
- has already retired once, and
- stated in previous interviews that he already had more money than his grandchildren's grandchildren could spend.

NBC's *Dateline* recently noted Mr. Brooks' business savvy, attributing it to his having received a college degree in marketing. However, judging by his stance on used CDs, he falls short in his knowledge of free markets. Basic economic laws explain why selling used CDs will not reduce his precious royalties. Economic principles tell us that the value of a capital good equals the present value of all future benefits the good provides. Future benefits are discounted by an interest rate, whose components are the pure rate of interest, the inflation premium, the tax premium, and the risk premium.

The pure rate of interest is the market price of credit in a world without risk, inflation, and taxes. It indicates the market's preference for spending today versus spending a year from now. Stated differently, it's the market-clearing price of credit that causes the supply of savings to equal the demand for borrowing.

Added to the pure rate are inflation, tax, and risk premiums. The market sets the inflation and tax premiums based primarily on government policies. The risk premium is the market's perception of uncertainty of future benefits.

Of these four components, only the risk premium is a function of the good itself. Thus, in discounting future benefits to establish current market values, the discount rate varies only as a result of uncertainty of the future benefits, not the nature of the asset. (The item itself is significant when there are different tax rates on capital gains and ordinary income. However, the tax rates and definitions of capital assets are arbitrarily set by government policy rather than the nature of the good in question.)

To illustrate, consider a bottle of wine, which will not be ready to drink for ten years. Assume that its value as a consumable good will be $100 a decade hence. Anyone purchasing the wine today will not pay $100, but will discount the value at the

Mr. Schlager is a financial and investment consultant in Norcross, Georgia. The inspiration for this article comes from Armen A. Alchian and William R. Allen, whose economics textbook, Exchange and Production, *he purchased used for $14.20.*