

U.S. TRADE POLICY: HISTORY AND EVIDENCE

Victor A. Canto

Introduction

For the past 13 years, U.S. trade policy has been on a steady course toward increased protectionism. A policy to reduce tariffs across the board among all trading nations has been paralleled by efforts to protect selected industries from foreign competition. In the vernacular, the call for "free" trade has been joined by the admonition to seek "fair" trade. An increasing number of people have advocated protectionist policies in an effort to create a favorable balance of trade. Foreign competition increasingly is blamed for the decline in the health of the U.S. economy while problems of several of the economy's weakest sectors, including steel and autos, are attributed to an uncontrolled surge of imports.

The debate now is much the same as it was 200 years ago. Arguments today that favor increased protectionism incorporate several of the mercantilist concepts, including the importance of a positive trade balance to a nation's prosperity. By contrast, the economic principles invoked by those advocating free trade can be found in the writing of Adam Smith and his predecessors. The trade account is viewed as a means to provide consumers and producers with the widest possible access to foreign goods and markets. Though restrictions placed on trade by foreign nations can be harmful to the domestic economy, imposing additional restrictions on trade at the domestic level serves only to compound the loss of economic efficiency, limiting further the opportunities to realize the benefits of trade.

The historical account of the U.S. trade policy presented in this paper suggests that the rise of protectionist policies can be linked to

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The author is Associate Professor of Finance and Business Economics at the University of Southern California, Los Angeles, Calif. 90089. He wishes to thank A. B. Laffer, R. V. Eastin, and C. W. Kadlec for their comments and suggestions.

the concern for the international competitiveness of U.S. products. The enthusiasm for restricting trade as a means to improve the domestic economy and protect selected industries, however, is tempered by the realization that trade restrictions can become counterproductive, impoverishing domestic and foreign producers and consumers alike.

Historical Survey of U.S. Trade Policies

The Trade Agreements Act of 1934

The roots of current U.S. trade policies can be traced back to the Trade Agreements Act of 1934. The purpose of this act, passed by the U.S. Congress, was to increase United States exports to foreign countries. There was a need for such an act for two reasons. First, the Smoot-Hawley Tariff Act of 1930 raised duties on imports to 53 percent in 1931 and 59 percent in 1932. This action provoked other countries to retaliate against the U.S., shrinking world trade. Second, the ensuing worldwide contraction in economic activity in the early 1930s caused world trade to decline even further. Between 1929 and 1933, world trade shrank 25 percent.

The Trade Agreements Act of 1934 delegated to the president the authority to negotiate U.S. trade agreements. It also allowed the president to participate in negotiations for the purpose of lowering tariffs to a level as low as 50 percent of the rates established by the Smoot-Hawley Act.

Extensions of the Trade Agreements Act, particularly after World War II, permitted the imposition of restrictions when harmful domestic effects could be shown to result from tariff cuts. Nevertheless, under the act, the United States signed bilateral trade agreements with 20 foreign nations. And, by 1947, tariff rates had been reduced to one-half their 1934 levels.

The General Agreement on Tariffs and Trade

In spite of this progress, it was apparent that, in the years preceding World War II, an alarming number of nations had adopted a neo-mercantilist, "beggar-thy-neighbor" approach to trade policy. Many politicians and commentators specifically attributed the outbreak of war to that trade environment.

This feeling served as the underpinning for the major international efforts following the war in which open communication, free trade and international economic interdependence were basic goals. Thus, the United Nations, the Bretton Woods agreement, and the General Agreement on Tariffs and Trade (GATT) were formed—all through the leadership of the United States.

GATT is particularly noteworthy for purposes of this study. It institutionalized the following basic goals:

1. Trade without discrimination (general, most-favored-nation treatment);
2. Protection of domestic industries only through tariffs;
3. Establishment of a predictable and stable basis for trade;
4. Consultation when trade problems arise;
5. Waivers and emergency actions that serve as exceptions to the general rules (e.g., escape clauses); and
6. Acceptance of regional trading arrangements.

Under the provisions of GATT, seven rounds of trade negotiations occurred: in 1947 (Geneva), 1949 (Annecy, France), 1951 (Torquay, England), 1956 (Geneva), 1961 (Dillon Round, Geneva), 1964 (Kennedy Round, Geneva), and 1975 (Tokyo Round, Geneva).

The Trade Expansion Act of 1962

During the span between 1947 and the mid-1950s, trade barriers were reduced on a commodity-by-commodity basis. After the mid-1950s, however, this method was considered ineffective for large-scale reductions. Participants in GATT therefore requested a "linear," or across-the-board, approach to tariff cuts. Such an approach was authorized when Congress passed the Trade Expansion Act of 1962.

The Trade Expansion Act was the most significant piece of trade legislation since the adoption of the Reciprocal Trade Agreements Act in 1934. This legislation was the statutory mandate for the president to negotiate tariff cuts at the next GATT-sponsored multilateral trade negotiations, later to be called the Kennedy Round. This act was significant for another reason: It established the office of the special trade representative (now the U.S. trade representative) to conduct the negotiations, replacing the State Department in this role. The purpose behind this shift was to meet congressional concerns that the State Department was too prone to negotiate trade agreements based on nebulous foreign policy grounds. Thus, trade policy was made less a stepchild of foreign policy and more subject to commercial realities and special-interest pressures.

The Kennedy Round. The Kennedy Round had three major objectives: (1) Overall reduction in tariffs, (2) reduction of nontariff barriers, and (3) participation of less-developed countries. Of these three objectives, reduction of tariffs was the most successful. The reduction of nontariff barriers was not as successful as had been hoped.

Import duties were cut an average of 35 percent on manufactured goods and 20 percent on agricultural products (excluding cereals, meat and dairy products). In all, about 70 percent of imported items were included in the cuts. By the end of the Kennedy Round, tariffs in the United States, the European Community, and Japan averaged only about 10 percent.

The Kennedy Round was also the first set of negotiations that addressed the problem of nontariff barriers, including:

1. Technical Barriers—mainly product standards, labeling and packaging restrictions, statements of origin, etc.;
2. Anti-dumping Policies—selling a product in a foreign market below the price charged by manufacturers in its home market or below cost;
3. The Government Procurement Code—regularizing and opening up procedures for government so that international sellers have better access to government contracts; and
4. The Customs Valuation Code—the evaluation of products for tariff purposes, nomenclature, and related customs procedures.

The inability of the participants to reach agreement in the reduction of nontariff barriers, however, anticipated many of the trade-related problems of the 1970s.

The Kennedy Round was concluded on June 30, 1967, when 53 nations signed agreements to put four years of negotiations into effect. The agreements were implemented over a five-year period ending in 1972. During the late 1960s, however, the steel and textile industries became primary advocates of restricting import competition. The Nixon administration responded to this pressure by endorsing textile and steel quotas. Also, the lack of international negotiations and the failure of GATT as an institution to resolve trade problems caused protectionist legislation to be introduced in Congress. While such legislation, epitomized by the Mills bill and the Burke-Hartke bill, never became law, it emphasized the growing pressure by special domestic interests to cope with the increasing pains of free trade and open-market policies.

New Forms of Trade Restraints

“Voluntary” Restraints. On January 1, 1969, the United States entered into voluntary restraint agreements with countries exporting all types of steel into the United States. Domestic manufacturers of steel called for these restraints because they feared injury from

the tremendous increase of imported steel.¹ These restrictions were in effect until December 31, 1971. A second set of "voluntary" restraints was imposed January 1, 1972, which extended the restrictions until December 31, 1974.

President Nixon, in an effort to adhere to a 1968 campaign pledge, asked Japan and other countries to apply "voluntary" quotas on their exports of woolens and synthetic textiles to the United States. Because Japan was reluctant to abide by the "voluntary" quotas, the chairman of the House Ways and Means Committee, Wilbur Mills, with encouragement from the administration, introduced a bill in May 1969 to limit textile imports to their average annual level recorded in 1967 and 1968.

The Trade Bill of 1970. This action was a sharp departure from more than 30 years of U.S. leadership toward liberalizing trade. In the closed sessions that followed, the committee converted the president's bill into the most protectionist legislation since the Smoot-Hawley Act of 1930. It permitted any industry, when threatened by imports, to seek and obtain protection.

The bill was opposed by the European Economic Community. European governments threatened to retaliate if the bill became law. In spite of heavy opposition to the bill within the United States, especially among major exporters and multinationals, the House of Representatives passed it in November 1970. The Senate also appeared ready to pass the bill. But it adjourned before the vote could be taken, leaving the trade issue to be taken up anew by the next Congress as it convened in January 1971.²

The Burke-Hartke Bill. The near passage of the Trade Act of 1970 encouraged protectionist groups to seek even greater limits to free trade. Representative Burke and Senator Hartke placed a bill before Congress called the Foreign Trade and Investment Act of 1972, the Burke-Hartke bill. The objective of this bill was to provide for significant increases in government intrusion and regulation of the international flow of goods and capital. This bill was never passed, but it set the terms of the trade debate for the first half of the decade.

The Burke-Hartke bill combined traditional protectionism (import restrictions) with new forms of protectionism, including restrictions

¹See "The Attractions of Quotas," *Wall Street Journal*, 15 January 1969, p. 18.

²For a discussion of the debate on the 1970 trade bill, see "Economists Warn Peril of SST if Trade Bill Passes," and "Trade Bill Foes Lose Hard Fight on Amendment," *Wall Street Journal*, 19 November 1970, p. 3; "House Approves Controversial Trade Measure," *Wall Street Journal*, 20 November 1970, p. 4.

on direct foreign investment. In addition, a foreign trade and investment commission, composed of three persons appointed by the president and confirmed by the Senate, would have been established. The commission would have been required to restrict imports to the average quantity for the period 1965–69. The commission's other responsibilities would have included estimating production schedules for various categories of goods from the previous year and fixing import quotas for each category and its supplying country. In order to grant an exception to these limits, the commission was supposed to act, in effect, as a central planning agency for the major sectors of the U.S. economy. The protectionist movement of Burke-Hartke would have frozen the 1967–69 ratio of imported goods to the production of "similar" domestic goods for an undetermined amount of time. It also attempted to freeze the geographic patterns of goods in each category.

The Demise of Bretton Woods. During this same period, the Bretton Woods agreement on international monetary policy collapsed. In August 1971, President Nixon, in violation of the Bretton Woods agreement, refused to convert dollars into gold for foreign central banks. The dollar was devalued 8.6 percent relative to gold, making the official price of an ounce of gold \$38. Tariffs were increased across the board by 10 percent, and wage and price controls were imposed on the domestic economy. In December of that year, the tariff increase was rescinded and, under the Smithsonian agreement, the devaluation of the dollar against gold was "approved." A general realignment of currency values relative to the dollar also was established. The value of the dollar, however, remained under pressure. Gold convertibility was not restored. And, in February 1973, the United States devalued the dollar by another 10 percent relative to gold and, implicitly, relative to most foreign currencies as well.³ In the months that followed, one country after another halted efforts to maintain a fixed exchange rate with the dollar, ushering in the present system of floating exchange rates. Efforts to restore dollar/gold convertibility ceased.

The fracturing of the international monetary system and the shift in the trade debate toward extreme protectionism represented by the Burke-Hartke bill paved the way for advocates of selective limits on foreign competition to appear moderate and constructive.

³For a discussion of the major trade issues at the time, see "U.S. Devalues Dollar 10% by Raising Price of Gold; Japan Agrees to Let Yen Float," *Wall Street Journal*, 13 February 1973, p. 3.

The Trade Act of 1974

The Trade Act of 1974 provided the broadest congressional mandate in history for the conduct of trade negotiations regarding the reduction of both tariff and nontariff barriers. The president was authorized to reduce tariffs as much as 60 percent below the levels that prevailed at the close of the Kennedy Round. It also called upon the president to begin negotiations for the purpose of strengthening the GATT system so that it could serve the purpose that the multilateral negotiations had served: diffusing and resolving trade conflicts.

However, in response to industry and congressional pressure, the cost of this broad mandate was the adoption of several provisions that eased the criteria necessary for imposing trade restraints. These included more flexible criteria for relief from increasing (but "fair") import competition, as well as substantive and procedural revisions of unfair trade practice laws (such as the antidumping and countervailing duty statutes). Thus, in addressing problems created by import competition that is considered to be "fair," the Trade Act of 1974 provided that an industry no longer need demonstrate that its injury was caused by imports resulting from an earlier tariff concession or that imports are the "major" cause—i.e., a cause no less important than any other cause—of its injury. Under the 1974 Trade Act, an industry need only show that imports are a "substantial" cause. If the International Trade Commission (ITC) finds injury, the president then must consider what impact trade restrictions would have on the domestic economy, consumers, and the overall national interests. The final determination of what action, if any, should be taken is, essentially, at his discretion. The ITC may, however, recommend *adjustment assistance* instead of trade restrictions. If the president does not proclaim the relief recommended by the ITC, Congress may override the president and institute the relief recommended by the commission.

The authority of the president to impose quantity restrictions was increased: For the first time, the president was authorized to negotiate orderly marketing agreements as a form of relief under the escape clause. The act also required the fulfillment of reciprocity in trade concessions before a trade agreement could be binding between the United States and another major industrial country. The Trade Act of 1974 triggered a rash of demands by U.S. industries for relief from import competition. These included requests for antidumping and countervailing duties, as well as escape clause restrictions on such items as chemical products, steel products, consumer electronics, industrial fasteners, canned hams, and vinyl shoes.

Changes in tariff policies were specifically circumscribed by GATT.⁴ The GATT agreements also sought to prohibit the use of quantitative restrictions, which were viewed as more harmful than tariffs. However, these prohibitions were not specific enough to prevent circumvention through quantitative restrictions that were quotas in all but name. Moreover, various kinds of nontariff barriers were introduced on a plethora of products. Among the most complex of these arrangements were the multifiber arrangements, establishing the parameters for restricting textile imports by the industrialized countries (effective January 1, 1974).

The use of "voluntary export restraints" also expanded during the 1970s. Under this arrangement, the importing country negotiates an agreement with the exporting country for that country to limit "voluntarily" the amounts of certain exports. In the United States, such negotiated trade restrictions, in the form of orderly marketing agreements, have been imposed on specialty steels, color TV receivers, nonrubber footwear, certain meats, mushrooms, textiles and automobiles. In 1976 the president obtained an orderly marketing agreement to limit specialty steel exports with Japan, and unilateral quotas were imposed on imports from the EEC and various countries.

The Tokyo Round. Under the Trade Act of 1974, the president entered into the Tokyo Round of Multilateral Trade Negotiations. Once again, tariff reductions were high on the agenda. But reduction of nontariff barriers also were considered an integral part of the negotiations. The agreements reached were signed in December 1978, and represented potential progress in both tariff and nontariff reductions.

Tariff reductions averaged about 30 percent for the United States, 22 percent for Japan, and 27 percent for the European Economic Community. Nontariff reductions centered on the codes discussed earlier but generally were attempts to make trade-barrier activities transparent and explicit rather than hidden. The tariff reductions centered on "harmonization," wherein higher tariffs are reduced by a higher percentage than lower tariffs. Agreement was achieved on the "Swiss formula" with exceptions made for particularly sensitive commodities.⁵ Had the Swiss formula been applied in its strictest

⁴The views of GATT's director general on bilateral trade are detailed in B. Bahree, "Bilateral Trade Accords are Blasted by Head of GATT in Appeal for Unity," *Wall Street Journal*, 20 August 1981, p. 34.

⁵Specifically, the Swiss formula called for a tariff rate x to be reduced to a lower rate z , according to the formula, $z = 4x/(x + 14)$. This formula would result in larger percentage cuts for higher rates. There was no historical or intellectual reason for the choice of this particular formula. It was chosen principally because it was simple and implied an acceptable cut in the average tariff levels.

sense, tariff reductions on average would have been 41 percent for the United States, 43 percent for the EEC, 68 percent (in applied rates) for Japan, and 39 percent (in applied rates) for Canada.

Failure of the United States and other countries to meet the tariff reductions dictated by the Swiss formula created a general environment of tariff reduction avoidance. When concessions were made for one country, other countries felt it in their best interest to protect themselves by maintaining higher tariffs on items of particular sensitivity in their countries. Agreements affecting nontariff barriers were reached in three major areas: codes for conduct of international trade, reform of the GATT framework, and the reductions of nontariff barriers in specific products.

Six codes were agreed upon in Geneva. They addressed such trade problems as government procurement, the use of export subsidies, the imposition of countervailing duties, "dumping" of goods in foreign markets, customs valuation, the setting of standards for imports, and the issuance of import licenses. In addition, two other codes were discussed but no agreement was reached. GATT allowed countries to protect themselves against import surges in order to safeguard domestic industries. But increasingly, major industrial nations ignored the GATT mechanisms and used bilateral negotiations that allowed countries to "voluntarily" limit their exports of industry-threatening products.

Recent Developments

In March 1979, the U.S. International Trade Commission determined that Korean bicycle tires and tube imports were injuring domestic producers.⁶ In October, the ITC recommended that President Carter impose three years of quotas on Russian anhydrous ammonia. In November, the commission proposed a sharp increase in U.S. import duties on low-priced porcelain and on steel cookware. By late spring of 1980, pressure was building to impose significantly higher import duties on small trucks imported from Japan. In August 1980, that pressure resulted in a 25 percent duty on lightweight truck chassis originating in Japan.⁷

A significant increase in the use of trade restrictions as a foreign policy weapon was witnessed in 1980.⁸ In response to the Soviet

⁶See "U.S. Ruling Faults Imports of Korean Bicycle Tires," *Wall Street Journal*, 23 March 1979, p. 36.

⁷See A. Pasztos, "Sharp Boost in Duties on Foreign Trucks is not Expected to Aid Sales of U.S. Models," *Wall Street Journal*, 20 August 1982, p. 9.

⁸Support for these actions can be found in F. Allen, "Executives Say Imports Pose Serious Threat," *Wall Street Journal*, 27 August 1980, p. 11.

invasion of Afghanistan, the United States forbade domestic exporters to sell corn, wheat, and certain fertilizer products to the Soviet Union. Severe restrictions also were placed on the export of high technology products.

In the summer of 1980, Ford Motor Company joined with the United Auto Workers to petition the ITC to grant protection from import competition from Japan. The U.S. International Trade Commission determined that imports were not a substantial cause of the domestic auto industry's sales problem. But Congress and the executive branch responded to political pressure and "voluntary" export restraints were discussed with the Japanese government. In effect, the Japanese automakers agreed—under pressure from the Japanese government—to restrict exports to the United States to 1.68 million units in the year following April 1981, and not to increase their exports unless the U.S. sales of all autos expand. Currently, Japanese auto company spokesmen are indicating reluctance to abide by the voluntary restraints. Thus the stage is set for yet another round of calls for tighter protection from U.S. automakers and labor organizations.

Although the Reagan administration endorses free trade, it is considering a new trade policy based on "reciprocity." The goal is to force other industrial nations to reduce their trade barriers to American-made goods and to reduce subsidies to their export industries. If a nation fails to meet these conditions, special restrictions and/or tariffs conceivably would be imposed on its exports to the United States.

The approach represents a radical change in U.S. trade policy. In essence, it is a bilateral framework that requires negotiations with all countries that trade with the United States before extension of the U.S. most-favored-nation (minimum) tariff structure. This policy would represent an abandonment of the unconditional most-favored-nation principle that has been the foundation of trade policy among the industrial nations since 1923. As such, it invites increased protectionism among the industrial countries, and threatens a return to the "beggar-thy-neighbor" policies of the early 1930s.

The move toward protectionism got another push when the domestic steel industry on January 11, 1982, filed forms with the Commerce Department and the International Trade Commission charging nine European countries, Brazil, and South Africa with unfair trade practices. In its preliminary rulings, the Commerce Department found that nine foreign governments had been unfairly subsidizing steel exports. The International Trade Commission agreed that 90 percent of the unfair trade complaints represented reasonable injury to

domestic steel products. The Commerce Department's final ruling reduced most of the subsidy margins cited in its preliminary determination and narrowed the list of offenders to six Western European countries.

On October 21, just hours before the Commerce Department would have been required to impose countervailing and penalty duties—selective increases in U.S. tariffs and duties—quota negotiations were finalized limiting European steel imports to about 85 percent of 1981 levels. In addition, the quotas were extended to pipe and tube products. The accord has two parts:

1. Carbon and alloy steel shipments will be limited to an average 5.44 percent of the projected U.S. market. The pact also sets individual ceilings for specific categories. The Europeans will set up a new export licensing system to enforce this part of the accord.
2. Pipe and tube exports will be restricted to 5.9 percent of expected U.S. demand. If it seems likely that the limit will be breached, the two sides will have 60 days to find a settlement. Otherwise, either may impose new restrictions.

The United States will help enforce the agreement by invoking a newly enacted law that allows the customs service to block specified steel imports that have not received foreign export licenses. Such actions could undercut U.S. efforts to persuade the Western Europeans and Japanese to move toward freer trade by dropping some nontariff barriers.

Restrictions on U.S. exports to the Soviet Union and U.S. efforts to curtail East-West trade in the aftermath of martial law in Poland also threaten to disrupt trading patterns that have been established during the past 10 years. That, too, will detract from economic growth both in Western Europe and Japan, increasing economic tensions among the industrial countries.

With record trade deficits persisting, implementation of the new GATT codes of conduct only beginning, and unemployment rates in the United States near their postwar high, pressure will be intense to protect American industries, from autos and steel to textiles and footwear. The influence of the protectionist groups is fairly apparent in the various trade legislation currently on Congress' agenda. The influence of protectionist groups is felt both in the formulation of protectionist legislation and free trade policies. An example of the push for protectionism on Capitol Hill is the local content legislation that is aimed at largely eliminating Japanese auto imports. Protectionist influence is also evident in the supposedly "free trade" type

of legislation such as the Caribbean Basin Initiative. This legislation would reduce trade barriers for numerous commodities but retain protection for textiles and sugarcane—commodities in which the Caribbean region has a clear comparative advantage.⁹

The November 1982 GATT Meeting. In November 1982, for the first time since 1973, a GATT ministerial meeting was held. The following major issues appeared on the GATT agenda:¹⁰

1. A moratorium on protectionism, designed to stem the proliferation of new trade barriers;
2. A new safeguards system that would limit the import restraints a country may impose to protect industries threatened by foreign competition;
3. Extension of the GATT rules to cover trade in services, investments, and high-technology products;
4. Common Market subsidies on agricultural exports;
5. A proposed round of negotiations between rich and poor countries aimed at opening the developing countries; and
6. The development of a dispute-settling mechanism.

One of the objectives of the meetings was to reassure the world that the major trading countries would resist the kind of protectionism that could result in a worsened worldwide recession. However, due to the disagreement among member countries, the meetings were doomed to failure.¹¹ Even the GATT director doubted that much agreement could be reached on the major issues, such as import safeguards.¹²

At best, the results of the ministerial meeting can be considered a symbolic victory for free trade. The member countries committed themselves in principle to avoid further violations of GATT rules and to correct existing ones. The document, however, lacks any new measures to reinforce that pledge.¹³

⁹See C. Sieb, "Reagan Sends Caribbean Plan to Congress," *Wall Street Journal*, 18 March 1982.

¹⁰For a more detailed account of the basic issues, see A. Pine, "Ministers Mull World Trade," *Wall Street Journal*, 11 November 1982, p. 6.

¹¹See A. Pine, "U.S. Worries that . . . GATT Parley Will Increase Protectionism not Trade," *Wall Street Journal*, 5 November 1982, p. 36; and idem, "GATT Talks Face Problems as Negotiators Fail to Agree on any Big Issue on Agenda," *Wall Street Journal*, 10 November 1982, p. 25.

¹²See World Briefs column in the *Wall Street Journal*, 8 October 1982.

¹³See A. Pine, "GATT Meeting Communique Isn't Likely to Have Much Influence on World Trade," *Wall Street Journal*, 30 November 1982, p. 2.

The lack of agreement on the major policy issues discussed at the GATT ministerial session should not be surprising to an economist. The dismantling, as well as the imposition, of trade restrictions alters the incentive structure of different interest groups in the member countries. The restrictions clearly increase the well-being of some the poor member countries. However, to the extent that the restrictions do not benefit the world as a whole, countries negatively affected will either try to circumvent the regulations¹⁴ or lobby for more favorable restrictions.¹⁵

Trade restrictions give rise to economic rents. This in turn gives rise to rent-seeking behavior. To the extent that those countries that benefit from the actions can organize effectively, the political process may result in protectionist policies.¹⁶ Thus one of the problems for advocates of free trade is to keep protectionist pressures within bounds and to avoid repeating the experience of the Smoot-Hawley Act of 1930.¹⁷

The Williamsburg Summit. Recent developments are not encouraging to those who advocate free trade. At first glance, the trade restrictions of high tariffs and new quotas on specialty steel and an effective increase in tariffs on frozen concentrated orange juice from Brazil seem too superficial to be concerned about. But a close look reveals that the threat posed by these restrictions is potentially far more than a mere blemish on the economic recovery of the world economy. The actions suggest a retaliatory behavior on the part of the United States. The view becomes more credible as one takes into consideration the fact that the countries affected were the

¹⁴For an analysis of individual behavior and smuggling activity in the presence of trade restrictions, see J. N. Bhagwati and B. Hansen, "A Theoretical Analysis of Smuggling," *Quarterly Journal of Economics* 87 (May 1973): 172-87; J. N. Bhagwati and T. N. Srinivasan, "Smuggling and Trade Policy," *Journal of Public Economics* 2 (November 1973): 377-89; and R.E. Falvey, "A Note on Preferential and Illegal Trade under Quantitative Restrictions," *Quarterly Journal of Economics* 92 (February 1978): 175-78.

¹⁵For a discussion of the politics of special interest groups, see W. A. Brock and S. P. Magee, "The Economics of Special Interest Politics: The Case of the Tariff," *American Economic Review* 68 (May 1978): 246-50.

¹⁶Analysis of rent-seeking behavior can be traced to A.O. Krueger's seminal paper, "The Political Economy of the Rent-Seeking Society," *American Economic Review* 64 (June 1974): 291-303. Krueger's analysis has been further refined and generalized by J. N. Bhagwati and T. N. Srinivasan, "Revenue Seeking: A Generalization of the Theory of Tariffs," *Journal of Political Economy* 88 (December 1980): 1069-87.

¹⁷On this issue, see R. Straus, "The Mercantilist Threat to World Trade," *Wall Street Journal*, 24 November 1982.

ones opposed to the major issues discussed at the November 1982 GATT meeting.

The decision by the president to provide protection to the specialty steel industry, little more than a month after the May 1983 Williamsburg economic summit, undercuts the U.S. efforts to ease trade barriers among the industrialized countries. To add insult to injury, the new restrictions on steel—ranging from higher tariffs on stainless steel sheet strips and plates to quotas on stainless steel bar and plates, and alloy tool steel products, which reduce imports by as much as 44 percent below their 1982 levels—fall largely on six industrial nations: Canada, France, West Germany, Italy, Japan, and the United Kingdom.

Administration arguments that the new trade restrictions are designed to foster the goals of the Williamsburg summit by pressuring other nations to get rid of practices injuring U.S. producers are fatuous. The European response was to threaten to retaliate with higher tariffs on U.S. exports to the Common Market. Furthermore, the U.S. actions ignore recent European moves reducing "unfair" trade practices. Prior to the economic summit, the Common Market countries had agreed to phase out, over the next 18 months, the steel subsidies that are so offensive to U.S. producers and the administration. Yet, the higher tariffs and quotas will prevail for four years.

Effect of Trade Policies on the U.S. Economy

Sectoral Impact of Trade Policies

This section presents two case studies analyzing the effectiveness of trade policies used to aid a domestic industry. First, the apparently successful case of temporary import restraints on color televisions is explored. Next, the more complex, and apparently unsuccessful, attempt to assist the domestic steel industry adjust to foreign competition is presented.

Color Televisions. In the spring of 1977, the United States negotiated an orderly marketing agreement with Japan that reduced the number of Japanese color television imports into the United States to 1.56 million units from their high of 2.5 million units reached in 1976.¹⁸ The Japanese producers more than complied with these restrictions, reducing exports to the United States to 1.4 million units in 1978.

¹⁸A more detailed analysis of the effects of the orderly marketing agreement can be found in V. A. Canto and A. B. Laffer, "The Effectiveness of Orderly Marketing Agreements: The Color TV Case," *Business Economics* 18 (January 1983): 38-45.

U.S. producers, however, did not benefit from this restriction. Instead, foreign producers (especially in South Korea, Taiwan and Canada) increased dramatically their exports to the United States. As a result, color television imports in 1978 were above their 1977 level and nearly as high as their record 1976 level. The sudden success of these foreign producers led to new or extended import quotas for Taiwan and South Korea. As a result, total color television imports in 1980 were 1.3 million units, less than half of their 1976 peak.

The apparent success of the effort to protect the domestic color television manufacturers is misleading. Domestic producers (both U.S. and foreign-owned) circumvented these restrictions by beginning the production of their televisions in the United States, exporting the incomplete sets for the bulk of the manufacturing and assembly, and then "reimporting" the televisions for final assembly in the United States. The tariff imposed on the "reimported" TVs is only 5 percent of the foreign value added.

During the 1977-80 period, incomplete color TV imports rose to nearly three million units from virtually zero in 1976. Subtracting these from total "U.S.-produced" TVs indicates that the domestic production of color TVs has increased only slightly since the imposition of the trade restrictions. Moreover, since 1977, the number of persons employed and the average number of man-hours worked in the domestic industry have declined.

*Steel.*¹⁹ In response to the steadily growing market share of Japanese steel imports, the United States in 1968 negotiated a three-year voluntary restraint agreement with Japanese and European exporters. Exports of steel to the United States were limited to a target of 14 million tons in 1969—22 percent below their 1968 level. The target was allowed to increase gradually during the subsequent years. And the agreement was extended in 1971 for three additional years.

In the face of the quantity restriction, the Japanese and European exporters shifted their product mix from lower-valued steels—where they had made the largest inroads—to higher-valued products. During the six years of the import restrictions, domestic prices of higher-valued steel products, such as cold- and hot-rolled steel, remained fairly close to those of the Japanese. The price of lower-valued steel products, such as structurals, however, increased well above the

¹⁹The analysis in this section is based on V. A. Canto, R. V. Eastin, and A. B. Laffer, "Failure of Protectionism: A Study of the Steel Industry," *Columbia Journal of World Business* 17 (Winter 1982): 43-57.

world price. As a result of this shift, even though the tonnage of steel imports was reduced, the overall value of imports remained approximately the same.

The net effect of increased competition in higher-valued steels and less competition in lower-valued steels was, if anything, to hurt the U.S. steel industry. The rate of return of the industry during the period of import restrictions (1969–74) was lower than during the three years prior to the period of import protection and the two years subsequent to import protection. During the protected period, capital expenditures in constant dollars declined relative to 1967 as well as to the years subsequent to the expiration of the voluntary restraint agreements. Moreover, the voluntary import restraints did not stop the decline in the steel industry's employment levels.

Trigger prices, too, have been unsuccessful in fostering a healthy, domestic steel industry. The trigger prices have been successful in reducing the market share of steel imports from Japan and the European Economic Community. But the bulk of this gap has been filled by imports from other foreign producers. Moreover, the trigger price mechanism acts to increase the profit margin of foreign producers as soon as it becomes effective. As such, it provides them with an incentive to increase their production, even if sold at prices below the trigger and prevailing market prices. This distortion of incentives can be expected to lead directly to an increase in the incidence of dumping charges by U.S. producers.

The 1950-to-1983 experience of the U.S. steel industry can be explained largely in terms of the standard trade theory without any reference to government interference in world steel markets. Following World War II, as Japan rebuilt its steel industry, resulting in larger and more efficient plants, the cost advantage of producing steel shifted from U.S. producers to Japanese producers. The steady loss of market share by U.S. producers is, to a large extent, due this shift in cost effectiveness.

In January 1982, major U.S. steel companies sought relief from government-subsidized competitors. As a result of these legal actions, the U.S. government dropped enforcement of the trigger price mechanism. Preliminarily in June and finally in late August, the Commerce Department upheld charges of government-subsidized steel prices against six Western European nations. Under the law, high tariffs in the form of countervailing and penalty duties would have been levied to offset the advantages of foreign subsidies and dumping. In their stead, the Commerce Department negotiated quotas on European steelmakers. Individual ceilings for specific categories also were set.

The Impact of Trade Policies on the National Economy

Import tariffs and export subsidies represent another set of policies attempting to improve the balance of trade. Advocates of these policies observe that tariffs raise the domestic prices of imported goods and subsidies reduce the prices of exported products to foreigners. This reduction in imports and the stimulus to exports are believed to improve the balance of trade and, consequently, domestic economic conditions.

An analysis of the effects of changes in average tariff rates on the trade balance, however, indicates that the real-world effects of tariffs on the balance of trade are more complex. Not only do tariffs reduce imports but they are associated with a decline in exports as well. Thus, the impact of tariffs on the trade balance is ambiguous (with the exception of the extreme case in which a country is running a trade balance deficit and then bans all imports). The decline in exports and imports indicates that the overall volume of trade is reduced by tariffs. Moreover, since both exports and imports are reduced by import tariffs, the trade balance (exports less imports) would be little changed. This result can be understood by realizing that exports and imports are two sides of the same transaction: The object of producing goods for export is to be able to import and consume goods produced by foreigners.

Suppose that a tariff successfully reduces the volume of imports by one-half. There are now only half as many foreign goods available to exchange for domestically produced goods, given the world terms of trade. So, the volume of exports must be reduced symmetrically by one-half. The net effect on the trade balance is zero. In other words, a tax on imports is equivalent in effect to a tax on exports. This principle is referred to as Lerner's symmetry theorem, a well-known principle of trade theory.²⁰

Quantitative restrictions in the form of import quotas and self-imposed foreign export quotas also are on the menu of protectionist policies. In principle, there is a precise correspondence between quotas and tariffs: For any quota (or quantitative restriction) imposed, there exists a tariff that will produce exactly the same price and quantity effects on the volume of imports and exports. The Lerner symmetry theorem is equally applicable to quotas. A restriction on imports is equivalent to a restriction on exports and can be expected to have little or no effect on the balance of trade. Thus, the efficacy

²⁰A.P. Lerner, "The Symmetry between Import and Export Taxes," *Economica* 3 (August 1936): 306-13.

of protectionist measures to improve the trade balance is dubious on both theoretical and empirical grounds.

Trade restrictions reduce the efficiency of the world economy and reduce the standard of living of all trading partners.²¹ To the extent that trade restrictions are effective, the gains from trade in both production and consumption are lost. Production incentives shift away from those goods that are produced more efficiently domestically. And consumers are no longer able to choose goods produced more efficiently abroad. Trade restrictions devised to protect a particular industry may well accomplish that task for a period of time. But the cost of protecting that industry is borne by the rest of the economy.

Further, tariffs and quotas on imports constitute tax wedges for the world economy. With fewer goods available in each domestic economy, at higher prices, the rewards for work effort are reduced. The Smoot-Hawley Act tariffs offer grim evidence of the tax wedge imposed by tariffs.

Conclusion

The increase in protectionist legislation and the Reagan administration's new trade policy based on "reciprocity" represent a departure from the postwar trade liberalization movement. The administration hopes to convince other nations to lower their trade barriers and to reduce subsidies to their export industries. In order to achieve these objectives, the United States stands ready to increase its trade barriers on a bilateral basis and increase subsidies to its import-competing industries. This policy is supposed to be sufficient to further the goal of freer world trade.

The policy issue therefore centers on whether judiciously applied protectionist measures can contribute to domestic economic stability and growth. In particular, can instruments of trade policy be used to improve a country's balance of trade and its overall economic performance? Furthermore, can specific industries suffering from import competition be assisted through protectionist measures, thereby reducing unemployment and increasing total output and income?

The grim experience of the early 1930s amply demonstrates that the movement toward protectionism carries with it major implications for the U.S. economy. Virtually all economists and policy makers agree that, in the extreme, trade restrictions are self-defeating, impoverishing foreign countries and U.S. citizens alike.

²¹See V. A. Canto, A. B. Laffer, and J. C. Turney, "Trade Policy and the U.S. Economy," *Financial Analyst Journal* (September/October 1982): 237-46.

PROTECTIONISM AND THE U.S. ECONOMY

Sidney L. Jones

Introduction

It is obvious that the world economy has become highly integrated in terms of international monetary, trade, and investment relations. The integration continues to increase despite the disruptive effects of economic nationalism, supply-side oil and crop shocks, military destruction and cold war tensions, and extensive geopolitical manipulation. Most nations, including the United States, have benefited from this integration, fulfilling the positive expectations of economists that the overall wealth of nations is enhanced by pursuing specific areas of comparative advantage (or minimal disadvantage) and then liberally exchanging goods and services. U.S. merchandise exports and imports have grown rapidly during the last decade: 1971 exports of \$43 billion rose to \$236 billion by 1981, before an unexpected decline in the volume of world trade in 1982, and imports jumped from \$46 billion to \$264 billion during the same ten-year period. These trade totals are relatively small compared to a total gross national product of approximately \$3 trillion, but the rapid growth is impressive and it should be emphasized that foreign trade is very important to American farmers and manufacturers, and of increasing significance to our service industries. The revival of international trade is now a crucial element in reversing the extended economic recession that has seriously disrupted the world economy.

Despite the important benefits created by expanding international trade and investment, our current policy dilemma is the most serious since the 1930s, when widespread restrictions disrupted political, social, and economic stability and contributed to the devastating

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The author is a Resident Scholar at the American Enterprise Institute, Washington, D.C. 20036.

world war. Trade policy problems are now comparable to the deteriorating monetary conditions that developed during the late 1960s, when fundamental economic distortions and repeated government interventions eventually caused the Bretton Woods system of fixed exchange rates, based on the role of the U.S. dollar, to collapse during the summer of 1971. Current trade policy issues appear to be at a similar turning point: (1) The international rules of conduct established in the early postwar era during extended GATT negotiations are increasingly swamped by the realities of competition and an ominous shift toward protectionism and excessive economic nationalism; (2) the escalation of abrasive trade problems is seriously disrupting fundamental international political and security relationships; and (3) the current distortions will likely become worse before they are corrected.

The paper by Professor Canto properly emphasizes the movement toward trade distortions caused by the proliferation of nontariff barriers, even though tariffs have been significantly reduced by occasional multinational GATT procedural negotiations.¹ The political responsiveness to special interest groups demanding short-term assistance in the form of protective tariffs, import quotas, export subsidies, nontariff barriers, investment restrictions, capital exchange controls, cartels, and geopolitical economic sanctions is recognized as a threat to the long-term benefits of an open and competitive international trade and investment system. The fundamental problem continues to be the difficulty of comparing the benefits of expanding foreign trade and investment, which are diffused throughout the entire economy, against the specific costs of competition from foreign sources.

The immediate challenge is to sustain support for the somewhat abstract principle of an open and competitive system despite specific distortions. The degree of actual public support for this principle typically falls well below the level assumed by most economists and tends to fluctuate in direct response to changing conditions of domestic economic growth and unemployment. While the world has avoided an all-out trade war, which would return us to the unfortunate conditions of the 1930s, it is naive to assume that the familiar arguments in favor of increasing foreign trade and investment are universally accepted, particularly during periods of unusual domestic unemployment and geopolitical tensions.

¹Victor A. Canto, "U.S. Trade Policy: History and Evidence," *Cato Journal* 3 (Winter 1983/84): 679-96.

Even when the general principle is accepted there is considerable disagreement about what strategic and tactical policies to use. Part of the growing skepticism about the effectiveness of traditional American policies represents normal political responses to specific constituencies and near-term election schedules. But another factor involves the historical failure of economists to convince politicians and the general public that significant *net advantages* justify continued reliance on an open and competitive economic system, and that the explicit costs and potential risks require specific policy and operating adjustments rather than generalized protectionism.

The large gap between the theories of international trade and investment and the realities of our domestic political economy is typical of the market system. Most Americans, particularly our business and government leaders, are not particularly impressed by theories. Policies and institutions that work well are perpetuated; those that do not perform as expected are quickly discarded. This attitude is prevalent in foreign trade activities where American companies have traditionally concentrated on the domestic market and only sporadically turned to external markets to utilize unused capacity or exploit technological and marketing comparative advantages. As the world has evolved into an integrated economy, this casual approach has failed to develop and sustain a comprehensive trade policy that adequately responds to our diverse political, social, economic, and security goals. America has not created a definitive set of guidelines that adequately respond to our diverse interests and responsibilities. Individual executive departments and congressional committees have been left to work out ad hoc responses to domestic special interest groups and external pressures from other industrial and developing nations. The confusing and contradictory results have created serious problems requiring attention at three different levels of analysis: (1) identification of the current and potential sources of difficulty; (2) agreement on a philosophy for trade policies; and (3) selection of specific strategies.

The Diversity and Changing Mix of Trade Problems

As various trade problems have converged, it is useful to consider the diversity and timing of issues rather than concentrating on current controversies, such as steel, agricultural products, high-technology goods, and pipeline equipment. A comprehensive approach is needed to avoid an uncoordinated series of responses to specific interest groups as priorities and conditions change. Recognizing the diversity of cyclical and structural problems, supply-side shocks, and

geopolitical trade distortions is the beginning point for trying to identify coherent national policies.

Cyclical Problems

The extended international economic recession has created historically high unemployment in most industrial and developing nations, triggering intense pressures for trade protectionism to preserve domestic industries and jobs based on questionable "beggar-thy-neighbor" assumptions that actually increase stagnation problems. Some of these distortions will be alleviated as the anticipated cyclical recovery accelerates.

Structural Problems

The impressive postwar recovery of Western Europe and Japan and the rapid emergence of many new industrial nations has increased competition for world export markets. The U.S. share of world trade will continue to be eroded, even though the absolute amount of foreign sales will rise if the international economy revives, and many specific industries will experience a difficult transition. Structural problems have developed as nontariff barriers have increased and discriminating trading blocs have been created to promote regional political and economic interests.

Supply-Side Shocks

The oil shocks (1973–74, 1979), the large appreciation of the U.S. dollar since mid-1980, occasional world crop disasters, and many other real and contrived raw material shortages have seriously disrupted international economic relations, particularly trade patterns. The recent economic recession, and its continued impact in many foreign countries, apparently eroded the power of OPEC and other cartels, but there is still an unfortunate trend toward arbitrary trade restrictions.

Geopolitical Distortions

Despite many persuasive theoretical arguments, and abundant empirical evidence concerning the ineffectiveness of economic sanctions as a tool for directly changing the political and military behavior of other governments, the United States continues to frequently use trade and financial sanctions to punish adversaries as part of its geopolitical policies. The disjointed nature of the sanctions used has confused foreign governments and domestic manufacturers and farmers. When such sanctions have been used, other sources have typically supplied the goods and services, resulting in the loss of

important markets for American exports. The sanctions have usually been reversed after a relatively brief period of time, but the domestic economic injury has persisted and foreign sales have been lost. The use of sanctions has demonstrated U.S. antagonism and symbolized important national principles, but there is considerable evidence that the economic injuries inflicted have not changed the geopolitical behavior of the target nations.

Ambiguous Trade Policies

U.S. trade policies historically have not been based on any clear and firm commitment to the role that trade is supposed to play on a sustained basis. Most economists favor "free trade" principles and individual businessmen and government officials have attempted to promote trade, but the necessary clarity of national goals and supportive policies and procedures has not been developed. To become more comprehensive, beyond the familiar concepts of commercial profits and balance-of-payments benefits, future trade policies must consider broader national goals—political, social, economic, and military security. Until our overall national interests are better defined, we will continue to muddle along relying on the rhetoric of free markets as a general guideline, but sporadically turning to restrictive trade practices whenever such actions seem to serve the immediate interests of the government and powerful special interests.

Identifying National Trade Philosophy

The United States has traditionally followed a policy of benign neglect with regard to trade policy issues because of the dominant influence of domestic markets on the plans of domestic companies, a philosophical aversion to government intervention in economic activities, and a general absence of organizational skills in developing consistent and sustained procedures. Most government and business leaders continue to advocate an idealized version of a competitive market economy (even though their actual behavior too often calls for government financial assistance and special protection). When American exporters and importers attempt to enter the world markets, however, they usually must deal with state-controlled buying and selling organizations or competitor firms that receive advantageous government aid and protection. Most nations have not adopted our economic model and are unlikely to do so during the foreseeable future despite the demonstrated advantages of an open and competitive economic system.

In preparing to compete in this type of world economy, an explicit decision is required concerning the proper role of government. There

are several possibilities, each with its own implications for U.S. trade policy:

- An aggressive role, with government encouragement, subsidies, and adjustment of regulations, controls, taxes, and research activities to promote exports and discourage imports.
- A passive role, with private American companies and farmers responsible for solving their own problems.
- A defensive role, with government responding to discrimination against U.S. interests; one example would be support for current legislation calling for trade reciprocity to promote “fair” trade as distinguished from “free” trade.

The difficulty of identifying a distinct U.S. trade philosophy is that attitudes shift all the way along the spectrum in response to special interests, external trade pressures, and cyclical conditions. The framework of policies in other nations appears to be more formalized and stable. It must also be recognized that businessmen must have a consistent attitude with regard to government intervention; that is, if the government is expected to play an aggressive role, there may be additional regulation and public planning even though most businessmen would object to this type of intervention as distinguished from the helpful forms of preferential treatment.

Policy Strategies

After identifying the diversity of trade problems that must be responded to and selecting a consistent philosophy to clarify goals, the next step is to develop a strategic approach. Five different approaches could be taken, ranging from completely free trade to comprehensive government planning of U.S. trade policy:

1. Hands-Off Approach—absolutely no government interference or assistance in the sale and purchase of goods and services in foreign trade.
2. Modified Market Approach—same philosophy, except for limited controls over “strategic” goods and services and in cases involving health and safety issues; grant national treatment to foreign goods and services and expect all U.S. laws and taxes to be honored.
3. Case-By-Case Approach—continue the present practice of allowing the Executive Branch and Congress to change the rules for specific countries and different goods and services whenever it seems to serve a current political, social, economic, or security interest.

4. Geopolitical Approach—explicitly admit that trade and investment rules will be manipulated to reward and punish other nations for their political and military support or antagonism.
5. Economic Warfare Approach—use trade and investment rules to mount an organized attack on political and military enemies.

Throughout the postwar era the policy strategies have shifted over the entire spectrum. At this time the United States appears to be using the case-by-case approach involving a basic free trade orientation mixed with specific marketing orders and voluntary agreements with other nations to limit their exports. This approach clearly reflects a responsiveness to special interests during a period of considerable economic difficulty. Those who favor a more open and competitive system criticize this strategy, but its advocates argue that such compromises are necessary to avoid a more widespread rejection of trade and investment exchanges favored by protectionist interests.

Conclusion

Trade policy issues will continue to become more important in the future world economy. Professor Canto's paper describes some disturbing trends that deserve attention. In the political environment it will always be difficult to achieve the level of free trade and investment principles that most economists favor, but such studies should help focus attention on the risks of allowing protectionism to expand. The current cyclical recovery in the United States may alleviate some of the protectionist pressures while the rest of the world waits for an improvement in global economic performance. In the interest of promoting economic growth, however, special emphasis should be placed on studying the range of trade problems, the proper philosophy to be followed, and the specific strategies to be followed.