Cato Handbook *for* Policymakers

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8. International Trade and Investment Policy

Congress should

- recognize and publicly acknowledge that the purpose of trade is to increase the size of the economic pie;
- recognize and publicly acknowledge that trade barriers are regressive taxes that reduce real incomes and raise living costs;
- recognize and publicly acknowledge that trade barriers increase the cost of production for businesses in the United States and make them less competitive with producers in other locations;
- recognize and publicly acknowledge that greater access to imports—not greater access to export markets—is the primary conveyor of trade's benefits;
- recognize and publicly acknowledge that production and export subsidies distort markets and benefit the few at a cost to the many;
- recognize and publicly acknowledge that investment in domestic value-added activities is more important to U.S. growth and employment than is reducing foreign market barriers to U.S. exports;
- recognize and publicly acknowledge that "Buy American" provisions in various federal procurement laws and regulations that preclude use of foreign-made products and prohibit bidding from foreign companies result in the waste of tens of billions of dollars of taxpayer resources every year and contribute to budget deficits and the continuous demand for more taxes;

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- eliminate tariffs on imports of intermediate goods—if not on all imported products—to reduce production costs and remove impediments to investment in downstream, import-using, domestic industries;
- reform—if not repeal—the U.S. antidumping law to mitigate the effects of import duties on downstream, import-using, domestic industries;
- pass legislation requiring a comprehensive audit of the U.S. regulatory, tax, and policy environments to identify redundancies, inefficiencies, and systemic problems that artificially raise the cost of doing business and deter investment in U.S. value-added activity;
- reform—if not repeal—the Jones Act to reduce excessively high U.S. transportation costs; and
- ratify the Trans-Pacific Partnership and pursue other forms of trade liberalization.

Why We Trade

Imagine how impoverished we would be if we each lived in isolation, making our own clothes, building our own shelters, hunting and harvesting our own food. Forget leisure or luxuries; all of our time would be consumed trying to produce bare necessities just to subsist. The purpose of exchange is to enable each of us to focus our productive efforts on what we do best. Thus, instead of allocating small portions of our time to the impossible task of producing each of the necessities and luxuries we wish to consume, we each specialize in an occupation and exchange the monetized output we produce most efficiently for the goods and services we produce less efficiently. That way we are able to produce and consume more output than we could in the absence of specialization and trade. The larger the size of the market, the greater is the scope for specialization, exchange, and economic growth.

Free trade is the extension of free markets across political borders. Enlarging markets in this manner—to integrate more buyers, sellers, investors, and workers—enables more refined specialization and economies of scale. Those, in turn, lead to greater wealth and higher living standards. When goods, services, capital, and labor flow freely across borders, Ameri-

cans can take full advantage of the opportunities of the international marketplace.

The benefits of trade come from imports, which deliver more competition, greater variety, lower prices, better quality, and continuing innovation. Opening foreign markets is a valuable part of trade policy because larger markets allow for greater specialization and economies of scale, but real free trade requires liberalization at home. The real benefits of trade are measured by the value of imports that can be purchased with a unit of exports—the so-called "terms of trade." When we transact at the local supermarket, we seek to maximize the value we obtain by getting the most for our dollars. In other words, we want to import more value from the local merchant than we wish to export. In our daily transactions, we seek to run personal trade deficits.

But when it comes to trading across borders or when our individual transactions are aggregated at the national level, we seem to forget these basic principles and assume that the goal of exchange is to achieve a trade surplus. We forget that trade barriers at home raise the costs and reduce the amount of imports that can be purchased with a unit of exports. But, as Adam Smith famously observed, "What is prudence in the conduct of every private family can scarce be folly in that of a great kingdom."

U.S. trade barriers hurt U.S. citizens, as consumers, taxpayers, workers, producers, and investors. Americans would be better off if we simply undertook our own reforms—on tariffs, regulations, and other artificial impediments to commerce—without regard for what other governments do. Congress has the authority to remove U.S. trade barriers, so the fact that many barriers remain implies that policymakers think U.S. citizens are unworthy of the freedom to make their own economic choices. Free trade is about the freedom of people to transact as they wish, when they wish, with whom they wish, and without politicians and bureaucrats as gatekeepers.

Although tariffs and other trade barriers have been reduced considerably since the end of World War II, U.S. policy continues to accommodate egregious amounts of protectionism. We have "Buy American" rules that restrict most government procurement spending to U.S. suppliers, ensuring that taxpayers get the smallest bang for their buck. We have heavily protected services industries, such as air transportation and shipping, that drive up the cost of everything. We have apparently interminable farm subsidies; quotas and high tariffs on imported sugar; and high tariffs on basic consumer products, such as clothing and footwear. We have energy

export restrictions, the market-distorting cronyism of the Export-Import bank, and antidumping duties that strangle downstream industries and tax consumers. We have regulatory protectionism masquerading as public health and safety precautions, protectionist rules of origin and local content requirements that limit trade's benefits, and restrictions on foreign investment. The list goes on.

Interdependence

In our globalized economy, expanding the size of the market not only means more customers, it means more competition for U.S. consumers' dollars, more providers of intermediate goods, more opportunities for supply chain collaboration, greater variety, innovation, and so on. When trade barriers come down, the factory floor can span borders and oceans, and production can be organized in new and more efficient formats. The result is more value creation and greater wealth.

Globalization means that companies have growing options with respect to where and how they produce. So governments must compete for investment and talent, which both tend to flow to jurisdictions where the rule of law is clear; where there is greater certainty to the business and political climate; where the specter of asset expropriation is negligible; where physical and administrative infrastructure is in good shape; where the local workforce is productive; where there are limited physical, political, and administrative frictions; and so on.

In most tradable industries, global production sharing has become the norm. In 2015, about half of the value of U.S. imports was industrial supplies, other intermediate goods, and capital equipment—the purchases of U.S. businesses, not end-user consumers. According to estimates from the World Trade Organization and the Organization for Economic Cooperation and Development, over two-thirds of the value of global trade flows in 2015 was intermediate goods trade.

Increasing global interdependence is reflected in a variety of other statistics, as well. For example, only about 50 percent of the value of U.S. imports from China reflects Chinese labor, materials, and overhead. The other half consists of value added in other countries. When it comes to high-technology products, Chinese value added is much lower—less than 5 percent for the "Assembled in China" Apple iPhone.

Meanwhile, more than 30 percent of the content value of a Boeing Dreamliner is imported or produced by foreign-owned companies in the United States. The largest steel producer in America is Arcelor-Mittal,

a majority Indian-owned company with headquarters in Luxembourg. American icon General Motors produces and sells more automobiles in China than in the United States; Ford Motor Company has more production and assembly operations outside the United States than within it; Chrysler is an Italian company; and more than half of U.S. auto production occurs in foreign nameplate factories across the United States. In fact, there is over $1 trillion of foreign direct investment in U.S. manufacturing operations—the most foreign investment in any country's manufacturing sector—and more than 6 million Americans work for foreign-headquartered companies in the United States.

Exposing and Refuting the Myths Surrounding Trade

Electoral campaigns are often rife with misinformation about trade, free trade, free trade agreements, and U.S. trade policy. Members of Congress should feel a responsibility to distill fact from fiction and to set the record straight for the American public. A rejection of trade and international cooperation in favor of protectionism and retrenchment would be a costly mistake—as history reminds us. Members of Congress should be aware of the most common trade fallacies and be able to refute them.

Trade Is Not a Zero-Sum Game

Too often trade is portrayed as a competition between Team USA and the foreign team. According to that narrative, exports are Team USA's points; imports are the foreign team's points; the trade account is the scoreboard; the deficit appearing on that scoreboard means the United States is losing at trade; and it's losing because the foreign team cheats.

But trade does not lend itself to sports metaphors. It is not a zero-sum game with a winning and losing team. Trade is a mutually beneficial endeavor that occurs between people—not countries—seeking to obtain value. Aggregated trade statistics are just the culmination of billions of daily transactions between people cooperatively pursuing the satisfaction of their needs and wants.

The Trade Deficit Does Not Reflect Trade Policy Failure

The objective of trade policy is not to secure a trade surplus, but to create the conditions that enable individuals to specialize in the most refined capacities, create greater value, exchange larger surpluses, and

achieve stronger economic growth. Those are the mechanisms through which the wealth of nations expands.

The United States has run trade deficits for 41 straight years and, as the issuer of the world's preferred reserve currency, may always run trade deficits. Those deficits reflect favorable global perceptions of the quality of U.S. investments. There is no leakage of economic activity associated with running trade deficits because the excess dollars that go abroad to purchase more from foreigners than foreigners purchase from Americans comes back to the United States in the form of investment. That investment undergirds U.S. economic activity, which supports jobs.

The data strongly suggest that there are positive correlations between the magnitude and direction of the trade deficit and the magnitude and direction of economic output. The same goes for the relationship between the trade deficit and U.S. employment. Looked at another way, if the goal of trade policy is to achieve a trade surplus, then by extension the goal of trade policy is slower economic growth, even contraction.

U.S. Manufacturing Is Thriving in the Global Economy

One of the most persistent fallacies is that international trade killed U.S. manufacturing. The problem with the assertion is that U.S. manufacturing is thriving—as it always has. By any relevant measure—output, value added, revenues, exports, imports, investment, research and development expenditures—U.S. manufacturing remains a global "powerhouse." With respect to most of those metrics, year after year (except during recessions), the sector sets new records.

Manufacturing's share of the U.S. economy peaked in 1953 at 28.1 percent; today, manufacturing accounts for only 12.1 percent of gross domestic product (GDP). But in 1953, U.S. manufacturing value added amounted to $110 billion, compared with a record $2.1 trillion in 2015. A sector that produces, today, more than six times the value in real terms what it produced when it was the engine of the U.S. economy, can hardly be described as declining.

Of course, employment in the manufacturing sector peaked at 19.4 million workers in 1979 and has been on a downward trajectory ever since. But that is something to celebrate, not lament. Producing more output with fewer inputs is the objective of economic activity. These so-called "productivity gains" are the wellspring of wealth creation and higher living standards. It is a sign of manufacturing strength, not weakness, that fewer workers are required on the production line today. If 10 workers

were needed to produce 1,000 widgets per day last year, but use of a new machine enabled 5 workers to produce the same number of widgets per day this year, then that productivity improvement amounted to a doubling of output per worker. Still, to reap the full benefits of that productivity gain, the talents of the 5 displaced workers must be redeployed elsewhere in the economy. Thus, it is incumbent upon policymakers to remove the impediments to labor market adjustment that slow or prevent displaced workers from finding new jobs in new firms in new industries.

U.S. manufacturing attracts more foreign direct investment than any other country's manufacturing sector. After 12 straight years of net growth, the stock of foreign direct investment in U.S. manufacturing surpassed $1 trillion in 2014. By comparison, the stock of foreign direct investment in China's manufacturing sector—the world's second largest manufacturing investment destination, which is now famously rife with overcapacity—is less than half that of the U.S. stock.

Outsourcing Is Good for the U.S. Economy

People tend to think of outsourcing, or outward foreign direct investment, as a substitute to domestic value-added activity. The quintessential example is that of a factory closing somewhere in the Rust Belt and being rebuilt in Mexico or China, rafter by rafter, bolt by bolt to produce for export back to the United States. U.S. companies invest abroad for a variety of important reasons, but serving U.S. demand from those foreign locations is not prominent among them. Over 90 percent of the value of output from foreign affiliates of U.S.-based companies is sold in foreign markets.

Most outward investment is made to serve purposes that cannot be fulfilled practicably or cost-effectively in the United States. Reaching potential foreign customers without having any physical presence in their countries, for example, would be a difficult task. There are several reasons to invest abroad that are highly unlikely to be successfully replicated from within the United States. They include marketing to foreign customers, getting better acquainted with foreign product preferences, having retail locations to serve demand abroad, performing postsale and other customer-service activities, tapping into local expertise, and diversifying market-specific risks.

Outward investment is essential for U.S.-based companies to compete effectively in the global economy. In reality, outsourcing is overwhelmingly complementary to U.S. value-added activity, not a substitute for it.

Small and Medium-Sized Businesses and Lower-Income Americans Are the Primary Beneficiaries of Trade.

The myth that trade disproportionately benefits big multinational corporations and high-income individuals is another assertion that fails to hold up to the evidence. Trade barriers increase the costs of goods and services to businesses and the cost of living for consumers. Trade barriers are costs. A tariff or other barrier to trade is much more likely to deter a small or medium-sized firm than a large sophisticated firm from engaging in international trade. Likewise, the cost of a tariff constitutes a much higher percentage of a lower-income family's budget than a higher-income family's budget. It is a regressive tax.

The Gilded Age adage that "the tariff is the mother of the trust" is still quite apt today. Protectionism always has and always will serve to protect incumbent business interests from competition.

Recommendations for Congressional Action

Eliminate Tariffs on All Intermediate Goods

At great expense to producers, consumers, and taxpayers, the U.S. government maintains "protective" tariffs on thousands of imported products, including many items not even produced domestically. To mitigate those costs, Congress has, on occasion, suspended the duties on some of these products through the passage of so-called "miscellaneous tariff bills." These bills temporarily suspend duties on certain, noncontroversial products—usually intermediate goods, such as chemicals, electronic components, and mechanical parts—that are not manufactured domestically but that U.S. producers need to generate their own output. The impact of these bills is limited by their temporary nature, by the requirement that there be "no domestic production," and by the caveat that the suspended duty must not reduce tariff revenues by more than $500,000.

The last miscellaneous tariff bill provided an estimated $748 million of import tax relief. However, in 2014, U.S. Customs collected nearly $45 billion in duties, taxes, and fees levied on imports, with approximately $27 billion collected on imported intermediate goods. That amounts to nothing more than a tax on U.S. value creators.

Recognizing that downstream import-consuming industries account for a greater share of U.S. GDP, employ more workers, pay more taxes, and are more innovative than the protected firms in upstream industries that produce raw materials, Congress should permanently eliminate import

duties on all intermediate goods, regardless of the existence of domestic production. Otherwise, Congress should expect duties on products like sugar, steel, magnesium, polyvinyl chloride, and other crucial manufacturing inputs to continue to chase companies to foreign shores—where those inputs are less expensive—and deter foreign companies from setting up shop stateside.

Reform the Antidumping Law to Mitigate Collateral Damage on U.S. Import-Consuming Firms

Antidumping proceedings involve more than a dispute between a domestic industry and its foreign competition. They also involve a conflict of interests between the relief-seeking U.S. industry and its U.S. customers. Those U.S. customers—usually other producers—are given no quarter under the law. If the petitioning industry can demonstrate that it has suffered "material injury" on account of less than fair value imports, duties are imposed—regardless of the impact on the downstream-consuming industries and the economy at large.

That is hardly a recipe for rational policymaking. Antidumping duties on products such as magnesium, saccharine, polyvinyl chloride, and hot-rolled steel may please their domestic producers, who are freed to raise prices and reap larger profits. But those same duties are costly to U.S. producers of auto parts, food products, paint, and appliances, who consume those products as inputs in their own manufacturing processes.

Since 2000, close to 90 percent of all U.S. antidumping measures involved imposing duties on imported intermediate goods. Yet the statute forbids the administering authority from considering the economic impact of antidumping restrictions on those downstream, import-consuming firms or on the economy at large. The antidumping law should be changed to give producers in consuming industries legal standing to participate meaningfully in antidumping proceedings; to require the administering authorities to conduct an analysis of the economic impact of prospective antidumping duties on downstream industries and the economy at large; and to deny imposition of duties if the estimated costs exceed a certain threshold.

Require an Audit of U.S. Regulatory, Tax, and Policy Environments

In the global competition to attract investment from the world's best companies, the United States has some enormous advantages. For many decades, the United States has been the world's premier destination for

foreign direct investment. But in recent years, the United States has been slipping in a number of important investment-location decision criteria. Accordingly, its share of global foreign direct investment declined from 39 percent in 1999 to 21 percent in 2015.

Congress should formally recognize that the United States is competing with the rest of the world to attract investment in domestic value-added economic activities, and that success in that regard requires maintenance of smart domestic policies. Accordingly, Congress should pass legislation requiring a comprehensive audit of the U.S. regulatory, tax, and policy environments to identify redundancies, inefficiencies, and systemic problems that artificially raise the cost of doing business and deter investment in U.S. value-added activity.

Foreign direct investment is a verdict about the efficacy of a country's institutions, policies, and potential. Given the importance of foreign direct investment to economic growth, understanding its determinants and crafting policy accordingly are matters of good governance and common sense. As Sen. Bob Corker (R-TN) put it, "If we want the U.S. to be the very best place in the world to do business, we need to take a close look at what we're doing right, what we're doing wrong, and how we can eliminate barriers that diminish investment in the U.S."

Repeal the Jones Act

Congress should finally repeal the nearly 100-year-old Jones Act, which has been a spectacular failure. It has resulted in the near total decimation of the U.S. shipbuilding industry and increases in the costs of shipping, infrastructure projects, and other forms of transportation—all of which have raised the costs of production and retail prices in the United States for the benefit of a few protected interests. Among the act's unjustifiable provisions is a ban on foreign shipping between U.S. ports, which is estimated to raise the costs of shipping by $2.8 billion (1996 dollars) annually, according to an International Trade Commission report. However, the indirect costs of using less-efficient transportation modes and routes (highway and rail)—including traffic delays, infrastructure erosion, environmental degradation, and higher costs of federal and state procurement projects—adversely affect U.S. GDP as well. Removing Jones Act restrictions to permit greater competition in maritime shipping (as well as air and rail transport) would reduce costs and prices, increase efficiencies, and help the United States remain competitive as a destination for investment.

Ratify the Trans-Pacific Partnership

The Trans-Pacific Partnership (TPP) is a comprehensive trade and investment agreement between the United States and 11 other Pacific-Rim nations, which reduces tariffs and other impediments to trade and investment. Its value as an agreement to create greater wealth and higher living standards by more closely integrating 12 economies accounting for 40 percent of global GDP is indisputable. But there is an even bigger picture to consider.

The TPP is the first step in the process of reestablishing the primacy of nondiscrimination and other tenets of the U.S.-led, post-WWII liberal economic order. It is a blueprint for securing U.S. geoeconomic and geopolitical interests now and into the future by refreshing the rules of international trade law and accommodating those institutions to a multipolar, 21st-century global economy.

Work with the President to Ensure that Other Trade-Liberalizing Initiatives Are Pursued

Other trade initiatives worthy of continued pursuit include the Transatlantic Trade and Investment Partnership, the World Trade Organization's Trade in Services Agreement, and the U.S.-China Bilateral Investment Treaty.

Although progress in the Transatlantic Trade and Investment Partnership negotiations has been slowed by a variety of factors (including the United Kingdom's likely departure from the European Union), the objective of removing trade barriers between the United States and Europe, as envisaged by the negotiations thus far, would likely yield large dividends for the U.S. economy. Likewise, the negotiations in the World Trade Organization to reach an agreement on services liberalization, if successful, would reduce impediments to competition from foreign service providers in the U.S. market, while creating greater opportunities for U.S. services firms to compete abroad. Finally, the ongoing negotiations with China over a bilateral investment treaty could very well reach a conclusion in the coming year, opening new sectors of the Chinese economy to U.S. investment and vice versa. However, the process could take longer. Either way, congressional support for an eventual investment treaty with China would demonstrate commitment to broadening economic opportunities for Americans, as well as interest in keeping the bilateral relationship on solid ground.

Suggested Readings

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