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Trade, Trade Barriers, and Trade Deficits: Implications for U.S. Economic Welfare

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Craig Elwell
Specialist in Macroeconomics
Government and Finance Division

Trade, Trade Barriers, and Trade Deficits: Implications for U.S. Economic Welfare

Summary

International trade is a means to a higher standard of living for all trading nations. The post-war era has seen a rapid expansion of trade and the U.S. has been a major participant in this process both as a trading nation and as a leader in the steady lowering of barriers to trade worldwide. The significant benefit of trade does not come without disruption and cost, however. Gaining the benefit of trade and also treating those hurt by trade equitably is often a difficult public policy issue. There is recurring congressional concern about the effect of trade on U.S. economic welfare. Current issues include: "fast-track", steel dumping, export controls, and the rapidly growing trade deficit. This report provides a brief overview of the economic case for free trade, the economic perspective on common arguments for trade barriers, and the cause and economic significance of persistent large trade deficits. The economic benefit of specialization and trade is a fundamental aspect of economic life whether for the individual, region, or nation. Arguments for trade barriers come in many forms but none is on economic grounds greatly compelling. The trade deficit is not a necessary aspect of trade, nor is it caused by foreign trade barriers. The deficit is a means for the nation to spend beyond current production. It can confer significant benefits but at some level of cost. This report will be updated if developments warrant.

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The Growing Importance of Trade to the U.S. Economy

In the post World-War II era the American economy has experienced steady and substantial growth of international trade. Total trade (the combined value of exports and imports) as a share of output (GDP) has risen from 9% in 1950 to 27% in 1999, with sizable gains in the last decade. Even this large increase may understate the rising impact of trade on the economy because of the large share of services output, much of which is *non-tradable*, in U.S. GDP. For example, looking at merchandise exports as a share of total *tradeable* output for the U.S. we see growth from near 4% in 1950 to over 40% in 1999.

The rising integration of the American economy with the world economy has been facilitated by technical advances that have reduced the natural barriers of time and space that separate national economies, as well as policy actions that have steadily lowered various man-made barriers to international exchange. As natural and man-made barriers have fallen, the considerable economic advantages of trade have induced large increases in the international exchange of goods.

Why Do Countries Trade?[1]

Trade occurs because it is *mutually enriching*, with a positive economic effect like that caused by technological change, whereby economic efficiency is increased, allowing greater output and consumption from the same endowment of productive resources. But, like technological change and other market forces, international trade creates wealth by inducing a reallocation of the economy's scarce resources (capital and labor) into relatively more efficient activities and away from less efficient activities. Such reallocation while beneficial to the overall economy can be disruptive and costly to some workers and industries in the relatively less efficient activities. They will likely bear significant adjustment costs and find a diminished market value for their economic services. The economy- wide gains exceed the costs; however the perennially tough policy issue is how to secure the gains from trade for the wider community while dealing equitably with those who are hurt by the process.

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[1] For a fuller discussion see: Mankiw, N. Gregory. *Principles of Economics*. Dryden Press. New York. 1997. Pp 45-57.

The importance of the *gains from trade* is clearly evident in our individual economic behavior. Rather than build our own automobile, provide our own medical services, or produce our own food, we find it far more efficient to specialize in the production of some good or service we are good at and trade these (indirectly with the use of money) for most other goods or services that we want. Such specialization and trade clearly allow each of us to consume far more than we could if we tried to be completely self-sufficient. The same is true for a country, albeit to a less extensive degree in most cases (i.e., U.S. imports amount to only about 12% of GDP).

What is also important to understand about the gains from specialization and trade is that they are mutual, occurring even if the trading parties have an absolute advantage or disadvantage in the efficiency with which they produce all tradable goods. All that is required is a difference in relative efficiency, that is, a difference among countries in the rate at which the output of one good must be curtailed to expand production of another good. If these rates are different, then a comparative advantage exists creating the potential for gains from trade. This principle would explain, for example, why Michael Jordan, the basketball star, despite being able to mow his lawn faster then anyone else, would still find it more efficient to employ a lawn service for that job. The income gained from other uses of the time he would spend lawn mowing will likely more than compensate for the cost of the lawn service. Similarly, the hired lawn mower gains by spending more time cutting grass and less time playing basketball.

Differences in comparative advantage will arise between countries because of differences in the relative abundance or scarcity of the factors of production. Comparative advantage will be found in those activities that make intensive use of the abundant factor. For example, compared to other countries the U.S. with a relative abundance of high-skilled labor and a relative scarcity of low-skilled labor will find that specialization in the production of goods that use high-skilled labor intensively will, with trade, raise national income. In contrast, China which has a relative abundance of low-skilled labor and relative scarcity of high-skilled labor would find that specialization in the production of goods that use low-skilled workers intensively would, with trade, raise that country's real income. (Differences in productive technology among countries could also create differences in relative efficiency and form a basis for trade.) In addition to specialization the gains from trade can also emerge due to fuller realization of economies of scale, increased competitive pressures, and a raised incentive for innovation.

The Economic Effect of Trade Barriers[2]

If international trade is economically enriching, imposing barriers to such exchanges will prevent the nation from fully realizing the economic gains from trade and must reduce real income. Protection of import-competing industries with tariffs, quotas, and non-tariff barriers will lead to an over-allocation of the nation's scarce resources in the protected sectors and an under-allocation of resources in the unprotected tradeable goods industries. This distortion reduces trade, national income, and overall economic welfare.

The U.S. and other nations have made great progress in the post-war era in reducing trade barriers. The average tariff among trading nations has been reduced from near 40% after WWII to near 5% today. These remaining impediments to trade, nevertheless, have significant economic costs. A 1994 estimate of the economic cost of existing U.S. barriers was $70 billion per year with an average cost per protected job of about $170,000.[3] The issue, however, is not just whether to continue removing barriers but whether to resist the erection of new barriers. It is important to remember that during most of the first half of this century trade barriers grew sharply, reversing the substantial trade liberalization achieved in the previous century. Therefore, much of the effort towards free trade in the post-war era has involved reversing protectionist structures erected in the first half of the century.

Arguments for trade barriers come in several forms, but none is greatly compelling on economic grounds alone.

- Jobs are destroyed by trade. The reality is that trade creates and destroys jobs just as other market forces do. Trade creates jobs in industries that have comparative advantage and destroys jobs in industries that have a comparative disadvantage. The economy has had no net loss of jobs. There is short-run hardship for some, but the whole economy's living standard is raised. These effects are qualitatively the same as those induced by purely domestic disruptions such as shifting consumer demand or technological change. In that context, easing adjustment of those harmed is economically more fruitful than protection given the net economic benefit of trade to the total economy.

- Worker wages are hurt by trade. There is no doubt that international trade can have strong effects, good and bad, on the wages of American workers. The

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[2] Man-made trade barriers come in several forms. Two common manifestations are tariffs and quotas. Tariffs are a tax on imported goods. Quotas are a limit on the quantity of a good that can be imported. A variant of the quota is the voluntary export restraint (VER), where the exporting country imposes the restriction. Other forms of barriers (often called non-tariff barriers) include: local content requirements, national procurement policies, and unduly protracted health, safety, and customs procedures. The magnitude of the negative effect on economic welfare will likely vary with the type of barrier used. In general, for a given level of protection quota-like restrictions carry a greater potential for reducing welfare than do tariffs.

[3] See Hufbauer, Gary Clyde, and Kimberly Ann Eliott. *Measuring the Costs of Protection in the United States.* Washington, Institute for International Economics, 1994.

plight of the worker adversely affected by imports comes quickly to mind. But it is also true that workers in export industries will benefit from trade. Moreover, all workers are consumers and benefit from the expanded market choices and lower prices that trade brings. It is true that real wages of American workers have grown slower over the last 25 years than in the earlier post-war period, and it is also true that there has occurred a sharply rising inequality of wages between the skilled and less skilled. But, economic analyses indicate it is very unlikely that growing international trade has had much to do with the slowdown in real wage growth and very unlikely that trade has caused more than a minor share of rising wage inequality. Slow productivity growth and the bias toward high skill in recent technological change have likely played a much larger role than trade in explaining poor wage performance.[4]

- National security is threatened by trade. It is true that some industries, or at least components of some industries, are vital to national security and possibly may need to be insulated from the vicissitudes of international market forces. In practice, however, the industries that actually meet this criterion are most often a very small sub-set of the number that claim to be in this category. It is also true that national security could be compromised by the export of certain *dual-use* products that while commercial in nature could also be used to produce products that might confer a military advantage to our adversaries. Controlling such exports is clearly justified from a national security standpoint; but, it does come at the cost of lost export sales and an economic loss to the nation. Minimizing the economic welfare loss from such export controls will hinge on a well- focused identification and regular re-evaluation of the sub-set of goods with significant national security potential that should be subject to control.

- Infant-industries that are so important to our future economic welfare that they need temporary protection to assure their eventual maturity. This is another argument for protection that could, in concept, be valid. But, it is also a policy that would be very hard to implement in practice. The difficulty is that it would require the government to evaluate future profitability, to in effect pick economic "winners." This is not a task that government is likely to be very good at and therefore invites significant inefficiency. One might ask, if the case for long-run profitability of an emergent industry is so compelling, why is the private market overlooking this prospect. Recent manifestations of this argument for trade barriers have been called *industrial policy* and *strategic industries policy*.

- Unfair competition undermines the benefits of trade. Can trade be beneficial if all parties don't abide by the same rules and regulations? Yes it can. If another country chooses to give a subsidy to an exporting industry, buying those now cheaper exports will hurt domestic industries that compete with

[4] For further discussion see: U.S. Library of Congress. Congressional Research Service. *Is Globalization the Force Behind Recent Poor U.S. Wage Performance?: An Analysis. By Craig Elwell.*

> those foreign goods, but it will benefit the domestic consumers who purchase them. The gain to consumers will typically exceed the loss to producers and workers. Therefore, from the standpoint of overall economic welfare, a prudent economic response may be to accept the gain in real income offered by the subsidized foreign goods and facilitate the adjustment of the adversely affected home workers to more efficient endeavors. Similarly, many economists see a possible economic advantage of buying foreign goods produced under different labor and environmental standards. They view differences in such standards as a basis for creating comparative advantage and realizing mutual gains from trade. In addition to the economic benefit to the U.S. economy, for many poor nations the ability to use such small advantages to produce a tradeable good today, may offer the best vehicle to increased productivity and a steadily rising living standard in the future. Despite the economic gain to the U.S., trade on this basis can undermine long held domestic norms of "fair" market conduct. If deviation from these norms is unacceptable in domestic transactions it may be hard to justify them in international exchanges. Another common activity widely seen as an unfair trade practice is foreign dumping of exports. Dumping can hurt particular workers and firms. But, for total economic welfare to be reduced by dumping one has to accept the premise that there can be a price that is too low. Price cutting is a basic element of competition, widely practiced in the domestic economy, that leads to greater efficiency and economic gain to consumers. Actions to prevent dumping curtail the benefit of such competition in international commerce. A possible exception would be instances of dumping that are "predatory" and part of a plan to establish monopoly power. Such predatory practices reduce economic welfare and preventing them is in our economic interest. Because predatory pricing is rare economists place little merit in the claimed unfairness of most instances of dumping. In general, most concerns with unfair trade reflect a conflict between the goal of increasing economic welfare and some other public policy goals such as distributional equity, environmental quality, or human rights. The tough policy question is finding the most efficient reconciliation of these conflicting goals without necessarily resorting to protection from trade. Policies to compensate for loss and to provide temporary adjustment assistance can be helpful in this regard.[5]

Despite their lack of economic merit trade barriers persist. This most likely occurs because they have very focused benefits accruing to a well defined and politically influential group, while the barriers costs are often widely dispersed over the population among people with less natural cohesion and a more diluted political voice. The protected groups gain, however, is at the greater expense of the wider community.

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[5] For a discussion of striking a balance between fairness and free trade see: Rodrik, Dani. *Has Globalization Gone too Far?* Institute For International Economics. Washington. 1997.

The Trade Deficit[6]

The U.S. trade deficit has risen steadily since 1992. It exceeded $331.4 billion in 1999, an increase of $118.4 over 1998, and a cumulative rise of about $286 billion since 1992. The trade imbalance has grown despite good export sales in recent years, as a strong economic expansion has brought a tremendous increase in the demand for imports. But, it is not necessary that an economic expansion generate a large trade deficit.

A trade deficit does not occur because U.S. exports may face high foreign trade barriers or because foreign exports are being "dumped" in the U.S. market. Nor does the trade deficit exist because American industry and workers are unable to produce world class goods. The global trade deficit is largely reflective of underlying macroeconomic conditions at home requiring more imports than exports to meet current domestic demand. In effect, the economy spends more than it produces, and the excess of demand is sated by a net inflow of goods and services--a trade deficit. Of course, for this to occur there must be at least one other economy that produces more than it spends at home, and that excess supply becomes a net outflow of goods and services--a trade surplus. For the U.S. this phenomenon has its roots in changes over recent decades in both private and government spending / saving behavior. In this recent period, strong rates of domestic investment spending have far exceeded the flow of domestic saving available to finance it.[7] A net inflow of foreign savings, relatively abundant due to wide spread economic weakness abroad, has filled this gap. But, the necessary counterpart of that net inflow of financial capital is a net inflow of foreign goods--the trade deficit.

So long as domestic saving in the U.S. falls short of domestic investment and an inflow of foreign saving is available to fill all or part of the gap, the United States will run a trade deficit. The saving-investment balance suggests two ways the trade gap can be closed. One, the supply of foreign savings dwindles, forcing domestic investment down toward the level of domestic savings. Or two, the level of domestic savings rises and curtails the attraction for foreign saving and shrinks the associated trade deficit. A lower rate of domestic investment is not desirable, but would follow if foreign investors become less willing to invest in the United States. The alternative of raising domestic savings has more economic merit; but, is problematic. Large budget surpluses have raised public saving inflows but are unlikely to continue to push higher. The private saving rate is low, not easy to influence by policy levers, and not a highly probable source of accelerated domestic saving flows.

A trade deficit is not necessarily undesirable. Increasing current spending beyond current means need not be imprudent behavior. Borrowing is widely and usefully done by individuals and businesses and so too by countries. Trade deficits in the 1990s have

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[6] For a fuller discussion see: U.S. Library of Congress. Congressional Research Service. *U.S. Trade Deficit in 1999: Recent Trends and Policy Options.* By Craig K. Elwell. CRS Report RL30561. Washington, 2000.

[7] See U.S. Library of Congress. Congressional Research Service. *Saving in the United States: Why Is It Important and How Has It Changed?* By Brian Cashell and Gail Makinen. Report No. 98-580.

been a means to help finance an elevated level of domestic investment. Investment augments the nations future productive possibilities and is a boon to long-term economic welfare. Of course borrowing carries a cost as the lender at least demands that interest be paid on the borrowings. This "debt service cost" is a burden the borrower must carry tomorrow for living beyond his means today. One's judgement about the desirability or undesirability of the trade deficit will hinge on the benefits gained from that added spending relative to the debt service burden that is also incurred. The current debt service burden of Americas stock of foreign debt can be roughly judged from the net investment income component of the current account balance. From a surplus of near $33 billion in 1981, U.S. net foreign investment income has fallen steadily to a deficit in 1999 of $18.4 billion.[8] A payment of this magnitude certainly does not suggest insolvency, but it is a significant decrement to the annual rate of advance of the nation's living standard and a decrement that can get larger. Some might argue that it is a burden that needs to be curtailed.

Reducing the trade deficit by policy actions is very problematic, however. It is clear that standard trade policy tools such as tariffs, quotas, and subsidies will not change saving or investment behavior and, therefore, will not reduce the trade deficit, but in most cases will create distortions that reduce national economic welfare. Macroeconomic policy can affect the saving-investment balance and can change the trade deficit, but how to do so without harming domestic investment remains unclear. Generating a sustained increase in the economy's rate of saving by reversing the steadily sagging rate of household saving would reduce the trade deficit, but how to raise that rate is uncertain.

There is also the very likely prospect that the trade deficit may correct itself without any inducement by economic policy. There are good reasons to expect that economic forces will work to sate the demand for foreign borrowing as well as reduce the supply of foreign funds being offered. The combination of a moderate slowing of the pace of economic growth in the U.S.(reducing domestic investment relative to domestic saving at home) and a significant acceleration of the rate of growth abroad (raising domestic investment relative to domestic saving abroad) would likely initiate such a process. A change in relative growth rates away from the current extreme differential would most likely alter rates of return between the U.S. and the rest of the world, redirect a larger share of international investment flows towards destinations other than the U.S., and shrink the U.S. trade deficit. A smaller trade deficit will, lacking an increase in the rate of domestic saving, likely lead to a reduction in the rate of domestic investment.

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[8] Two common indictments of the trade deficit— deindustrialization and net job loss— are not macroeconomic issues. The first largely did not happen and the second could not happen. For a discussion of deindustrialization see: U.S. Library of Congress. Congressional Research Service. *Is Globalization De-Industrializing the U.S. Economy?: An Analysis. CRS Report 98-440 E by Craig Elwell.*

Conclusion

For economists the case for free trade is strong and compelling. A reduction of impediments to the flow of goods among nations will raise each trading nation's economic welfare. This conclusion has been repeatedly validated by studies of trade liberalization policies such as the Uruguay Round Agreement and NAFTA.[9] However, public debate over such initiatives makes very clear that many Americans do not share economists optimism about the virtues of free trade. Some of this antipathy might arise from economic concerns that U.S. workers and industries hurt by trade do not receive equitable compensation and other adjustment assistance. Allaying this concern, economists argue, is best achieved by efforts to augment and refine the various U.S. trade adjustment assistance programs.[10] Others, may simply doubt that trade is beneficial. If unconvinced by the numerous technical studies, they might consider that the United States *itself* gives clear evidence of the virtue of free trade. This country is comprised of fifty separate political entities that under the Constitution are required to allow unfettered trade among themselves. Specialization has occurred, interstate trade has grown, and national economic welfare has benefitted. Certainly U.S. economic welfare would be reduced if barriers to interstate trade were erected. The benefit of interstate trade are of the same nature as the benefit of international trade. In policy deliberations, of course, national economic welfare, will be considered in conjunction with political, social, and national defense issues that will also influence trade policy.

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[9] For example see: U.S. Library or Congress. Congressional Research Service. *The Uruguay Round: A Macroeconomic Assessment.* CRS Report 95-529 E, by Craig Elwell and Alfred Reifman. Washington, 1995; and Lustig, Nora, Barry Bosworth and Robert Lawrence. *Assessing the Impact of North American Free Trade. Washington, Brookings Institution, 1992*.

[10] See: Lawrence, Robert Z. and Robert Litan. Globaphobia: The Wrong Debate over Trade Policy. The Brookings Institution. Washington DC. 1998.