MAD ABOUT TRADE

Why Main Street America Should Embrace Globalization

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Foreword

This is a book that ought to be read by all Americans. As its author, Dan Griswold, points out, international trade seems often to provoke more anxiety than gratitude. That is unfortunate, for without the encouragement of foreign investment and a concomitant expansion of trade, we'd likely still be a Third World country today. "Globalization," a concept that has provoked more fear than comfort throughout the world, also has far more positive attributes than negative ones. It is ironic that those who loudly protest against free trade and a global economy are often among its beneficiaries. (In fact, one can almost guarantee that protesters will be wearing clothes that are produced in a country other than their own.)

In this tome, Dan Griswold confronts protectionism and methodically demolishes its supportive arguments. Protectionists have always relied on emotion and xenophobia, rather than facts, to carry their agenda. Remember the "sucking sound" of disappearing jobs that was to accompany NAFTA? In the 15 years since NAFTA was passed, our trade deficit with Mexico and Canada has grown (as its critics relentlessly point out), but compared to the 15 years before NAFTA, just about every imaginable economic indicator shows that all three countries—Mexico, Canada, and the United States—have benefited from the agreement. Not all of those benefits are attributable to NAFTA, of course, but there is no denying that NAFTA helped push those indicators in the right direction.

Griswold wears on his sleeve genuine compassion for the poor and empathy for the often forgotten consumer. Throughout his book, he emphasizes that protectionists have little or no concern for the downtrodden of the world, or even for the middle class. Their concerns are for the select producer groups who have the political clout to fend off international competition. When governments kowtow to such groups, they inevitably impose inefficiencies on our society, and that hurts the poor more than anyone else. Competition motivates entrepreneurship and productivity. Protection from competition, in contrast, produces only lethargy and complacency. The result: more costly products and services.

As Griswold so effectively emphasizes, protectionism is really just another tax on working families, often paid unknowingly. The benefits of more-open trade are diffuse, but they're often difficult to quantify, and they may not even be visible. In contrast, the benefits of protectionism are concentrated on a definitive class of producers; they are quantifiable and visible to that group, and the beneficiaries are highly motivated to defend them. So guess who typically gets the most attention from policymakers?

Griswold provides an especially useful discussion of the impact of trade on job creation and job turnover. He points out that the entire discussion of job losses or job gains from trade has been vastly overblown in recent years. Free-trade advocates have oversold anticipated job gains from trade agreements; their critics, in turn, have oversold anticipated job losses. In reality, trade agreements have had little impact on the number of Americans who are employed.

Job churn, or turnover, is another matter. Few of us realize just how much job turnover there is in our dynamic, capitalistic economy. Millions of American jobs disappear every year. But if that is a "sucking sound," it is drowned out by the clatter of even more millions of new jobs being created. Fortunately, the average income level of those new jobs has typically exceeded the level of those that are lost, and they're often more desirable from a quality of life standpoint. That is why our vibrant economy is the envy of the world.

Griswold estimates that no more than 3 percent of our job churn is in any way related to international trade. Most of the other 97 percent represents technological change. Whatever the cause, job churn is not a painless process, and the United States has had a mixed record of success in helping people adjust to it. Where trade is involved, trade adjustment assistance has helped a bit, and we've been trying to improve those programs. But where technology is the agent of change, our public policy response has been unimpressive. Griswold properly notes that if we, as a nation, wish to ease the pain of job transitions, the rationale for doing so is as persuasive when technology is the culprit as it is when job change is trade related.

U.S. manufacturers have taken a big hit in the present recession, so devoting a chapter to that subject may seem incongruous. But it is not. The present recession was in no way caused by global trade, so it is entirely appropriate to analyze what has happened to U.S. manufacturing in the preceding years. Protectionists fret over the loss of manufacturing jobs, but they conveniently forget that the vast majority of those losses are attributable to technology, not trade. And they also conveniently forget that manufacturing continues to be an American success story. Our manufacturing output has been remarkably steady in recent years, so we are not de-industrializing America. We are producing the same level of output with far fewer employees than we did in the past. Our productivity in manufacturing has skyrocketed. As Griswold points out, that is a mark of strength, not weakness. Furthermore, we've "moved up the food chain" in manufacturing. We're now producing more capital-intensive, technologically advanced, higher-quality products, where the operating margins are higher. That, of course, enhances our international competitiveness.

I am especially appreciative of Griswold's comprehensive discussion of the trade deficit and its counterpart, our capital account. Many Americans are worried about both. They wonder whether the trade deficit is ever going to peak and begin to decline, and whether we can forever depend on the rest of the world to finance that deficit. These are provocative, but relevant, questions. Griswold answers by noting that for much of our history, capital flows may have been the drivers of trade flows, rather than vice versa. The United States has been "the global frontier" for more than 200 years. Investors from throughout the world have sought to march across that economic frontier, and they've needed dollars to do that. The only way to get those dollars is by selling merchandise or services to us. In addition, the U.S. dollar has long been the world's leading currency, reflecting the strength and stability of our economy. So it is not surprising that the dollar is strong, which makes the rest of the world's goods and services attractive to U.S. consumers. The bottom line: So long as we welcome and encourage foreign investment—and use it wisely—our trade deficit will be manageable.

Griswold also makes the salient point that we have only ourselves to blame for our low savings rate: that is, the situation where our domestic investment consistently exceeds our domestic saving. To make the two balance, we must attract savings from abroad. If we really wish to do something about that, we could start by reducing government "dissaving," which is reflected in our federal budget deficit. That'll be a little difficult in the near term, of course, in light of recent stimulus packages! We could also generate greater private-sector savings through changes in tax policy, but that will not likely be on the Congressional agenda anytime soon.

This book has a superb chapter on the importance of investment flows. U.S. politicians have had a field day recently with their demagogic comments on outsourcing. But we insource as well as outsource. To encourage one and condemn the other would be utterly foolish! Foreign investors have created huge numbers of jobs in the United States throughout the years and have brought new technology, new business management techniques, and a myriad of auxiliary benefits to our shores. Without that input, our economy would not be nearly so vibrant and productive, and our personal incomes would all be a lot lower. At the same time, we need to recognize that U.S. investment abroad is also in our self-interest. Without it, we would not sell nearly as much in the way of either products or services. Griswold notes that for every $1 billion worth of goods that we export from the United States, we sell $6 billion from the overseas base that foreign investment has provided. That, in turn, creates jobs in the support structure here in the United States. So, outsourcing typically turns out to be a benefit, rather than a drag, on the U.S. economy.

Finally, this book does more to articulate the intangible benefits of trade and globalization than any I have ever read. Griswold draws attention to the interactions of people, business firms, and governments—all of which help to develop understanding, tolerance, fidelity, prudence, respect for cultural differences, and a whole host of other positive attributes. Over time, this contributes to peace, freedom, and civility, thereby also reinforcing democratic trends. Beyond that, more-open trade helps to pull people out of poverty and boosts them to middle-class incomes, where they can see a better life ahead for their children. That, too, is a "peace dividend" of major importance to the entire world.

Dan Griswold discovers a lot of good in globalization and international trade, and he lays it out for the reader in understandable language. We should all be grateful for his contribution.

—Clayton Yeutter
Former U.S. Trade Representative and Secretary of Agriculture

Preface

Until I left home for college at age 18, I had spent my entire young life in two small midwestern towns of no more than 4,000 souls each. My family life was quintessentially small-town, middle-class America. In the 1870s, my great-grandfather, Henry Daniel Griswold, migrated from Connecticut to become a successful dairy farmer in La Crosse County, Wisconsin, establishing his farm on the edge of the town of West Salem. My grandfather, Harry W. Griswold, bought and sold dairy cows throughout western Wisconsin. The connections he made servicing the dairy farms enabled him to win a seat in the state legislature in 1932 and then in Congress in 1938. He died of a heart attack the following year at age 53 after only six months in office.

My dad, Donald W. Griswold, left the farm for good after serving in the Aleutian Islands in Alaska as a captain in the Army during World War II. He saved enough during the war to buy the local weekly newspaper, the *West Salem Journal.* When I was 13, he sold the newspaper, and he, my mother, and I moved to Sauk Centre, Minnesota, a small town with a more vibrant business district, where he bought another weekly newspaper. The *Sauk Centre Herald* office was downtown, two blocks east of the boyhood home of Sinclair Lewis, the Nobel Prize–winning author of the 1920 novel *Main Street*, and a block west of the town's only stoplight, at the intersection of Sinclair Lewis Avenue and the Original Main Street.

Hanging around the newspaper office as a kid, I caught the bug and spent more than a decade in the business—one year as assistant editor of the *Sauk Centre Herald* and a dozen years as editorial page editor of the daily *Gazette Telegraph* in Colorado Springs, Colorado. I wrote editorials that landed on 100,000 doorsteps every morning and spoke around town to schools, Rotary Clubs, the Breakfast Optimists, and other civic groups. In 1995, I left newspapering to earn a diploma in economics and a master's degree in the Politics of the World Economy at the London School of Economics. Since

1997, I've supported my family by researching and writing about trade, globalization, and immigration at a think tank in Washington, D.C.

My family story is worth recalling not because it is unusual, but because it is so typical. In four generations, my line of Griswolds moved from the farm to manufacturing (newspapers and publishing, Standard Industrial Classification no. 3371) to a research job in a nonprofit educational institution in a metropolitan area of 5 million. I don't know where my three children will find their vocations, but it will probably not be on a farm or in a factory.

During the past century, our country has made a similar journey. A hundred years ago, my great-grandpa Henry Daniel was among the 40 percent of Americans still earning their living in agriculture. As more Americans left the farm, along with my father, those working in factories and the service sector grew. Then, as the 20th century matured—during a time of rapidly expanding trade and foreign investment—the number of factory jobs peaked and began to decline, while my brothers and I and millions of other baby boomers found our calling in the service sector. This book will try to explain the largely positive role that trade and globalization are playing in this economic transition that continues to shape our country and our daily lives.

Allow me one more personal story. A few years back, a counterpart at another Washington nonprofit, Stephen Canner of the United States Council for International Business, invited me to lunch to talk about U.S. trade policy. Stephen told me he wanted "the clean view from ten thousand feet," which stuck with me as a neat description of what I may have to offer in the current debate about America's place in the global economy. Journalists write their stories from ground level about particular workers and businesses, whereas academic economists write their research papers from a "cruising altitude" of 35,000 feet (or sometimes deep space). But if you press your nose against the window as the plane is descending, you know that some of the most revealing views of your destination occur at 10,000 feet. From there, you can drink in the whole landscape and yet also see the individual parts—the backyard pools, the lay of the subdivisions, the fields and farmhouses, the traffic snaking along the highways, and what lies over the ridge—and how they all fit together.

This book offers a clean view from a vantage point that strives to make sense of America's changing place in the world economy and the effect this change is having on families and workers across America. This book is also unapologetically American centered. It examines every aspect of the globalization debate from the perspective of what it means for millions of typical American families. This book is written for my fellow Americans living in small towns, farmhouses, cities, and suburbs who wonder where we are all heading in this more open world of ours.

—May 18, 2009
Washington, D.C.

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1. Introduction: Main Street Meets the Global Economy

Welcome to my closet—my multinational, middle-class closet. If you had cared to look inside on a Saturday afternoon in early 2009, you would have found:

- Ten business suits and blazers: two of them made in China, two in Canada, two in the United Kingdom (my tweed jackets from the 1990s), and one each in Mexico, Guatemala, India, and parts unknown (the label fell off).
- Fourteen dress shirts: four made in Bangladesh, two in Honduras, and one each in China, Mexico, Nicaragua, Vietnam, Peru, Costa Rica, Korea, and Egypt.
- Seventeen neckties: nine made in the U.S.A. (several of those from imported fabric, including "finest Italian silk"), three in China, and one each in Costa Rica, South Korea, the United Kingdom, Italy, and parts unknown.
- Sixteen casual button shirts: five from India, three from Canada, two from Malaysia, and one each from the U.S.A., South Korea, the Philippines, Thailand, China, Bulgaria, and parts unknown.
- Thirteen knit shirts with collars: three each from India and Egypt, and one each from Thailand, the Philippines, Honduras, Bulgaria, Vietnam, Brunei/Darussalam (time to get out the atlas), and China—the last with Lou Dobbs' worst nightmare on the label: "Hecho en China."
- Twenty-seven colored and printed T-shirts: nine from Honduras, six from Mexico, three from El Salvador, two from Thailand, one each from China, Singapore, Australia, and four from parts unknown.
- Six sweaters: two from China, one from Mexico, one from Italy, one knit by my dear wife, and one from parts unknown.
- Twelve pairs of jeans and other pants: seven from the Dominican Republic, four from Mexico, and one from Guatemala.

- Six pairs of shorts: two each from Sri Lanka and Nicaragua and one each from El Salvador and Egypt.
- As for shoes, if you include my spouse's to increase the sample size, almost all come from China and the rest from India, the Dominican Republic, and that export powerhouse, parts unknown.

If you were to snoop in my dresser drawers, you would find various undergarments and furnishings from Costa Rica, the Dominican Republic, Honduras, and Thailand. On the coat rack inside our front door hangs outerwear from Israel, Jordan, Macedonia (with fabric woven in Italy), the Philippines, Portugal, Sri Lanka, Ukraine, and Vietnam.

In the kitchen, you would find a drip coffee machine from Mexico, a quarter-century-old coffee grinder from Germany, and from China, an electric tea kettle, a toaster, an electric griddle, an electric sandwich grill, a food processor, a bread machine, and a hand vacuum. As you move through the rest of the house, items made—or at least assembled—in China are everywhere: two laptop computers and accessories, a label maker, a table lamp, a DVD player, a steam iron, folding chairs, an indoor/outdoor thermometer, a plastic electronic barking guard dog, three basketballs, and a football. A year-old desktop computer and a decade-old TV are from Mexico, and the 4-in-1 printer is from Malaysia.

Peek over my shoulder as I check the balance of our 401(k) online—alas, not what it was in the fall of 2007—and you will see 10 percent of our retirement assets parked in an international index fund. According to the fund portfolio, our modest savings are providing capital to Japan, the United Kingdom, France, Switzerland, Germany, Spain, Australia, the Netherlands, Italy, and Hong Kong. In the upper left corner of the web page is the logo for the Dutch insurance conglomerate that administers the plan. Inside my health insurance file nearby is paperwork from a South African company that used to administer our health savings account. My wife's home page on her laptop is set to the BBC website.

And sitting outside our townhouse in our two parking spots on a late winter day are a Dodge minivan and an Oldsmobile sedan. Both were made by Detroit-based automakers, but if they are typical of even "American-made" cars, they contain plenty of parts from

Mexico, Canada, and even a few from outside North America. And before it went out of business, a Venezuelan-owned CITGO down the road is where we would occasionally gas them up.

An inventory of your own closet, home, and life would probably tell a similar tale. Whether you live in Manhattan, a small town in the Midwest, or anywhere other than a primitive mountain cabin, you are plugged into the global economy and it is plugged into you.

America's Growing Globalization . . .

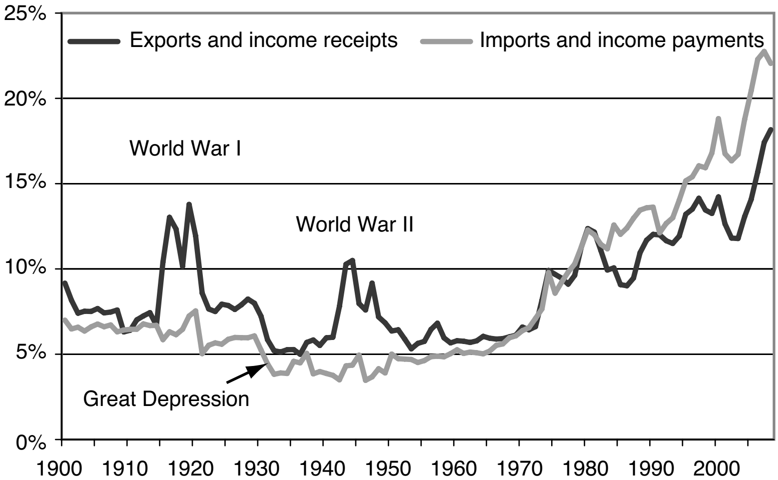
Growing trade and globalization have come to Main Street, and not just in how we spend or earn our money. Through our TVs, newspapers, and Web browsers, the global economy has become a major subject of coverage and controversy. TV personalities such as Lou Dobbs and Pat Buchanan and a growing chorus of politicians and interest groups blame trade and globalization for a long list of real and imagined ills afflicting our nation. They blame the trade deficit and our growing inventory of foreign products for the loss of millions of well-paying jobs, declining real wages and household incomes, a shrinking middle class, deindustrialization, and the exploitation of poor workers in distant countries. They tell us that multinational companies are "shipping our jobs overseas," and now millions of white-collar service jobs are at risk of being "outsourced." Polls show that their message resonates with a majority of the public.

Much of this book will be spent examining the merit of those claims as we shine a light on just what trade and globalization mean for the typical middle-class American family.

We can all agree that America is a more globalized place today than it was in the past. The trend is true whether we look at the narrower measure of international trade—the movement of goods and services across our borders—or the broader measure of globalization, which includes not only trade but also the movement of capital and the growing integration of production across borders. In 2007, 18.7 million standard shipping containers arrived at U.S. ports carrying many of the shirts, shoes, toys, and consumer electronics that fill our closets and family rooms. That figure is an average of 2,133 containers arriving every hour of the year, 24/7. Almost half arrived from one country.[1]

Figure 1.1 shows total annual U.S. imports and exports as a percentage of our gross domestic product going back to 1900. The share

Figure 1.1
AMERICA'S GROWING GLOBALIZATION
(imports and exports as a percentage of GDP)



includes not only trade in goods but also services and income earned on investments, such as profits, dividends, and interest. U.S. exports spiked during both World Wars as Americans exported arms and other war supplies to our allies, whereas both imports and exports plunged during the Great Depression of the 1930s as output fell and trade barriers rose. As recently as the 1960s, both imports and exports were only about 6 percent of our GDP. In 2007, after four decades of historic growth, exports reached 17.4 percent of GDP and imports 22.8 percent.[2] Not since colonial days have Americans earned or spent a higher share of our income in the global economy than we do now.

On foreign investment, the story is the same. Cross-border ownership of assets has soared since the United States and most other developed nations lifted controls on foreign investment in the 1970s. In 1976, the sum of U.S.–owned assets abroad and foreign-owned assets in the United States was less than $1 trillion, equivalent to about 40 percent of our GDP. The current sum total of cross-border assets is $38 trillion, nearly three times our GDP.[3] To grease the global exchange of goods, services, and assets, about $3 trillion change hands *daily* on foreign exchange markets.[4]

America's growing globalization has been driven by three fundamental changes—growth of the global economy, reduced government barriers to international trade and investment, and the spread of new technologies. The first cause may be the least obvious, but one reason why we do more business with the rest of the world today is because there are so many more people in other countries who are able to do business with us. The recovery of Japan and Europe after World War II, the explosive growth of the "Little Tiger" economies in East Asia and the formerly sleeping giants of China and India, and the emergence of former Communist countries from their self-imposed isolation have multiplied the opportunities for Americans to buy, sell, and invest abroad.

Meanwhile, trade and investment barriers have been coming down in the United States and most other countries in the world. Trade agreements have played a part. Eight rounds of negotiations through the General Agreement on Tariffs and Trade since it was established in 1947 have helped to bring global tariffs on manufactured goods down sharply. Those agreements now limit tariffs and other barriers to trade for more than 150 members of the successor World Trade Organization. The United States has signed and implemented free trade agreements with 16 other countries, cutting tariffs to zero on most goods we trade with those countries and opening markets even more widely to foreign investment. Many developing countries cut their barriers to trade and investment unilaterally in the 1980s and 1990s, most spectacularly China and India, but also Chile, Vietnam, and Mexico before the North American Free Trade Agreement.

Powering America's globalization have been advances in transportation, telecommunications, and computing technology. International shipping costs have declined sharply since the 1950s for both air and ocean freight. On the high seas, the introduction of container shipping in the 1960s has allowed manufactured goods to be transported more quickly and cheaply. Containerization enables goods to be packed once in a standard container and then shipped by a variety of modes—usually by truck, rail, ocean liner, rail, and finally truck again to the final destination. This process speeds loading and unloading at the docks, so ships spend less time in port and more time plying the oceans from one port to another. Gains in efficiency continue to accumulate as more ports in developing countries modernize to accommodate container shipping. The open registry of ships to countries such as Panama and Liberia has allowed shippers to circumvent high regulatory and manning costs imposed by rich nations. And higher trade volumes have allowed ships to grow bigger, moving goods with greater economies of scale and enabling the creation of a global hub-and-spoke system for moving goods.

In the air, the development of jet aircraft engines after World War II dramatically raised the speed at which goods can be delivered, at a cost that continues to fall. Because jet engines are faster, more fuel efficient, and more reliable and require less maintenance than piston props, the actual cost per ton-kilometer to transport goods has fallen by more than 90 percent in the past half century, from $3.87 in 1955 to $0.30 in 2004, according to a comprehensive study by David Hummels of Purdue University.[5] Air transport still represents less than 1 percent of the weight and ton-kilometers shipped, but it is grabbing a larger and larger share of the market to ship smaller but more valuable manufactured goods and other high-value items. As a result, the value of U.S. exports going outside of North America via air has jumped from 12 percent of total exports in 1965, to 28 percent in 1980, to a majority of 53 percent by 2004. Almost a third of the value of U.S. imports from outside North America now arrives by air.[6]

The spread of the Internet and the plunge in the cost of international communication has allowed companies to coordinate operations around the globe. This coordination has led to a dividing up of the "supply chain" so that the various parts of a final product, from an iPod to a jumbo jetliner, can be made in dozens of countries to take advantage of differences in costs and capabilities. Services such as writing software, entering medical data, and providing technical support can now be "shipped" electronically across the globe at almost zero cost.

Falling transportation costs have stimulated trade at least as much as falling tariffs. Technological progress in the air and seas has cut the aggregate expenditures on freight for U.S. imports from 8 percent of their total value in 1974 to 4 percent in 2004. Even after those gains, importers in 2004 were still paying three times as much for shipping costs as for tariffs, leaving even more potential gains for the future.[7] As Professor Hummels concluded in his study, "[T]echnological change in air shipping and the declining cost of rapid transportation has been a critical input into a second era of globalization during the latter half of the twentieth century."[8]

. . . and Growing Opposition

The growth of trade and other measures of globalization has stirred more anxiety than gratitude among Americans. Polling data on trade paints a mixed and sometimes contradictory picture. Most polls show a majority of Americans expressing some degree of skepticism that free trade and globalization benefit most Americans, and yet other polls show a majority holding a favorable if qualified opinion. Some polls show the skepticism growing, yet polls from the early 1990s revealed widespread fear about imports and foreign investment from Japan. From the Civil War to the 1920s, Republicans won election after election running on protectionist platforms, which were popular not only with the public but also with much of the business community. Skepticism toward trade and the global economy is an American tradition dating back to our founding as a nation.

One reason why skepticism remains is the difference between "what is seen and what is unseen." The transition costs of moving to free trade are visible and lend themselves to images and anecdotes: a factory closing in North Carolina, the anxiety on the face of a laid-off steel worker, and the sweatshop conditions in factories making shirts in Honduras and soccer balls in Bangladesh. Yet the benefits that flow from free trade and globalization, while real and substantial, are diffused and often hidden from view: a dozen jobs created at a small business serving an American exporter or foreign-owned plant, lower interest rates on a loan, and $20 saved on a Saturday-afternoon shopping trip because of import competition.

Another related reason for the skepticism is the emotional appeal of arguments against trade. In a November 2007 essay, "Why Lou Dobbs Is Winning," the generally pro-trade Third Way Foundation tried to explain why the skeptics have been winning the rhetorical debate. Advocates for open trade "have lost the debate on values," the authors concluded. "While neopopulists and 'fair' traders speak compellingly of 'justice' and 'fairness,' we speak of dollars per household in economic gains, job growth, and economic efficiency. . . .'Fair' traders fight with values; free traders fight with data."[9]

That depiction is not quite right. "Fair" traders also fight with data, much of it wrong or misleading, as we shall see. But it is certainly true that those of us who advocate the embrace of free trade and globalization as the best policy for America too often confine ourselves to data. We fail to close the deal by drawing a connection from the facts to our deepest American values of fairness, compassion, competition, freedom, progress, peace, and the rule of law. The mission of this book is to make that connection.

As we build that connection, this book will challenge much of what we hear and read about trade in the American media. Here are some facts and themes from *Mad about Trade* that you will not hear on cable TV, talk radio, or the most popular blog sites.

Free trade is the working family's best friend. Import competition delivers lower prices and more variety, empowering consumers to get the most from their paychecks. Greater product variety from imports boosts our incomes by $400 billion a year. Those Americans who benefit the most from being able to buy imports from China through big-box retailers are the poor (chapter 2).

Trade has delivered better jobs for American workers. Most of the net new jobs created in the past decade pay more than the average manufacturing job. The American middle class today is built on millions of well-paying service-sector jobs. Despite the most recent recession, Americans today enjoy significantly higher real hourly compensation, household incomes, and family net worth than 15 years ago (chapter 3).

Most American manufacturers have managed to thrive in a global economy. Trade has helped American factories move up the value chain. We're producing more planes, pills, appliances, chemicals, semiconductors, and sophisticated equipment than in decades past. The volume of U.S. manufacturing output was 50 percent higher in 2008 than when Congress passed NAFTA in 1993 (chapter 4).

America's big trade deficit is not a scorecard for U.S. trade policy. It reflects a steady inflow of foreign investment and continued domestic demand for goods and services, whether made at home or abroad. Since 1982, America's unemployment rate invariably rises when the trade deficit shrinks and falls when the trade deficit grows. Despite what Warren Buffett says, raising trade barriers cannot "fix" the trade deficit (chapter 5).

American companies that invest abroad are not "shipping jobs overseas"; they are reaching new customers for U.S.–branded goods and services. For every $1 billion in goods that U.S. companies export, they sell $6.2 billion through their foreign affiliates—and 90 percent of those sales go to foreign buyers. Foreign capital flowing into the United States cuts almost a full point off long-term interest rates, saving a typical homeowner $1,000 a year and federal taxpayers $40 billion (chapter 6).

High U.S. trade barriers in the 19th century were a drag on growth and bred anticompetitive domestic monopolies. The Great Depression occurred on the protectionists' watch. America's economic performance has been superior during the era of lower tariffs since World War II, including the past 15 years since NAFTA was enacted. Nearly a quarter of a million small and medium-sized U.S. companies are now exporting to global markets, including China (chapter 7).

Membership in the WTO has not compromised U.S. sovereignty. It has served our national interest by opening markets abroad to U.S. exports and restraining the U.S. government's abuses of our economic liberty. A global "rule of law" in place today has prevented a repeat of the disastrous trade wars of the 1930s (chapter 7).

The spread of trade and globalization has helped to cut world poverty in half since 1981. Fewer children are dying, fewer are heading for work on the farm and in factories, and more are in school, especially girls, than in decades past. Once the world shakes off the current recession, a growing middle class in developing countries will be hungry to buy U.S.–provided goods and services (chapter 8).

Thanks in part to expanding trade, our world is more democratized and peaceful. More people enjoy full political and civil rights under democratic governments around the world than in any previous era. Trade has promoted peace among nations, making it less likely that America's sons and daughters will fight in future wars (chapter 8).

America is not yet a "free trade" nation. American citizens remain fettered by anticompetitive regulations and thousands of restrictive tariffs on everyday products that protect politically connected domestic producers. Existing tariffs fall especially hard on low-income families struggling to buy the necessities of life (chapter 9).

Many Americans these days are "mad about trade"—mad as in angry. They perceive that trade is reducing our welfare by eliminating good jobs in a global race to the bottom. By the end of this book, I hope that readers open to persuasion will see that we really should be "mad about trade" in quite a different way—mad as in crazy in love with the opportunities that our new and more open world is creating before our eyes, not only for ourselves but, more importantly, for our children. We should have the same positive feelings toward free trade and globalization as we do toward digital cameras, iPods, email, online shopping, a well-fed child going off to school, and peace on earth.

2. America's Consuming Interest in Trade

Free trade is the American consumer's best friend. Whereas trade barriers limit competition, free trade keeps producers honest by forcing them to work hard to offer consumers more and better products at lower prices.

Millions of American families benefit from free trade every day. We benefit whenever we buy a cart of groceries, a new shirt, a TV, or a car. The receipt doesn't say, "You have saved $30 (or $300 or $3,000) because of import competition," but the savings add up to hundreds of billions of dollars every year for American households.

Most Americans believe in competition. We are better off when a dozen restaurants and half a dozen auto repair shops compete for our business instead of only one or two. By expanding the number of producers selling goods and services in the domestic market, trade safeguards and intensifies competition. The result is lower prices, more variety, and better quality for tradable products. We should think of trade as the market's trust buster. In a recent annual report for the Dallas Federal Reserve Bank, Michael Cox and Richard Alm wrote, "Globalization erodes market power. Natural monopolies that might rise in national economies—airlines, electricity, or telephone service, for example—don't exist on a global scale."[1]

Consumer benefits are the most important and yet least appreciated payoff of trade. One reason is that the benefits are largely invisible. They are diffused throughout the economy in millions of daily transactions that are small and often hidden but collectively deliver a huge boost to our standard of living. Producers pinched by trade often join together, hire lobbyists, and buy advertisements to get the attention of Congress. Consumers are simply too numerous to organize and generally unaware of the stake they have in defending an open and competitive market.

The other reason why the consumer benefits of trade are too often dismissed is that "consumption" has a bad reputation. There is something ignoble, even grubby, about wanting more and wanting it "cheap." We liken consumption to acquisitiveness and greed. Consumption in the minds of many means four cars in the driveway, a triple-decker cheeseburger, and a 52-inch flat screen TV bought with a credit card at 18 percent annual interest.

Consumption can be abused, but it is also life itself. Without consumption, we would all be starving, naked, homeless, and quickly dead. Consumption is the proper end of all economic activity. We do not start a business or show up at work every day just to be there but because we seek to be rewarded in a tangible way. And the paychecks or profits we earn do us no good unless we can translate them into goods and services with real value—a place to live, a car, clothes, food, that big-screen TV, tuition for the kids, a donation to church or charity. Production divorced from consumption is akin to slavery.

The founder of modern economics, Adam Smith, understood clearly that the argument for free trade begins with the consumer. As he wrote in his 1776 book, *An Inquiry into the Nature and Causes of the Wealth of Nations*:

> Consumption is the sole end and purpose of all production; and the interest of the producer ought to be attended to, only so far as it may be necessary for promotion of the consumer. The maxim is so perfectly self-evident, that it would be absurd to attempt to prove it. But in the mercantile system, the interest of the consumer is almost constantly sacrificed to that of the producer; and it seems to consider production, and not consumption, as the ultimate end and object of all industry and commerce.[2]

By the "mercantile system," Smith meant one based on protecting domestic producers against their foreign competitors regardless of the impact on consumers. The multiple trade barriers that still exist are holdovers from the mercantilist thinking of the 17th and 18th centuries that Smith intellectually demolished in his great work. We can't begin to understand the benefits of free trade without shedding the old, producer-focused way of thinking and instead consider the well-being of American families as consumers. Here is where trade delivers the greatest benefits to the widest possible number of Americans.

Benefits of Import Competition

Politicians and critics of trade tend to belittle the consumer benefits. Their sympathies lie with producers, or more accurately, certain noisy producers, and so they are quick to dismiss any argument that trade broadly benefits consumers. For example, in his 2004 book, *Exporting America*, CNN host Lou Dobbs dismissed any concerns for consumers. "I don't think helping consumers save a few cents on trinkets and T-shirts is worth the loss of American jobs," he wrote.[3]

When he was running for president in 2007, then-Sen. Barack Obama was equally dismissive of consumer worries about higher prices. At a Democratic primary debate in Chicago, moderator Keith Olbermann of MSNBC asked the reasonable question, "If buying American costs more, and in many cases it does, how do you convince a working family that's struggling to get by on a tight budget and in part makes ends meet using $10 T-shirts for their kids, that buying American is still best for them no matter what the price is?"[4]

Before a stadium full of cheering union members, Senator Obama basically said, "let them pay more": "Well, look, people don't want a cheaper T-shirt if they're losing a job in the process. [Applause.] They would rather have the job and pay a little bit more for a T-shirt. And I think that's something that all Americans could agree to."[5] Like most politicians, he chose to favor the noisy producer interests over the silent, suffering consumer.

When it comes to T-shirts, most Americans have a consuming and not a producing interest. Virtually all of America's 114 million households (most of them "working families") buy shirts every year. In fact, Americans buy 4.5 billion T-shirts and other apparel tops each year, 94 percent of them imported.[6] That's an average of almost 40 shirts per household. But very few American workers, less than half a million, make their living producing T-shirts, other apparel, and textiles.[7]

Yet Senator Obama and the union audience clearly sided with the one-third of one percent of American workers (many of them still unionized) who make shirts and other clothing rather than the 99.7 percent who unambiguously gain from being able to buy their clothing at more affordable prices. Democrats and their union allies were not representing "working families" against big corporations but a small and declining share of U.S. producers and their employees at the expense of the vast majority of American households.

Lou Dobbs and Barack Obama are both guilty of exaggerating the impact of imports on American workers and of minimizing the benefits of imports for American consumers. A well-paid television personality in New York City or a politician in Washington need not care about the price of a T-shirt or other everyday consumer items, but millions of American families, especially those living on low and middle incomes, do care. Our freedom to buy in the global marketplace benefits American families in three major ways.

Lower prices

Open markets keep a lid on prices. A domestic producer who tries to raise prices runs the risk of being undercut by a foreign competitor. An open market makes it more difficult for domestic producers to "conspire" with one another to raise prices at the public's expense. As a result, the prices we pay for goods and services exposed to global competition tend to rise more slowly or even fall compared to prices paid for goods and services where competition is limited to the domestic or local market.

Table 2.1 shows the change in prices between 2000 and 2007 for an assortment of products and services. Price changes cover a wide spectrum, from an 81 percent fall in the (quality-adjusted) prices paid for personal computers and accessories to the 71 percent jump in what we pay for college tuition and fees. By comparison, the overall price index for all urban consumers during that same period rose 24 percent.[8]

With a few exceptions, the unmistakable pattern is this: The prices we pay for goods most exposed to international competition rise more slowly than overall prices, and for many categories, the prices actually fall. Meanwhile, the prices we pay for goods and services that are insulated from global competition tend to rise faster than inflation.

Among the goods globally traded are consumer electronics, toys, clothing, shoes, household goods, and new cars. Those are the same sorts of goods that have gone up the least or even fallen in price. This trend is no coincidence. Among the goods and services least likely to be traded across borders are college tuition, medical care, electric utilities, cable TV, admission to sporting events, and auto repair. Again, it is no coincidence that those services also lead the

Table 2.1
COMPETITION AND PRICE CHANGES
PERCENTAGE CHANGE, JANUARY 2000 TO DECEMBER 2007

Price Changes below Inflation	% Change	Price Changes above Inflation	% Change
Personal computers and peripheral equip,	−80.7	Laundry and dry cleaning services	24.6
Televisions	−70.8	Haircuts and other personal care services	25.6
Toys	−36.0	Full-service meals and snacks	25.6
Dishes and flatware	−25.3	Fruits and vegetables	30.8
Wireless telephone services	−20.6	Motor vehicle repair	31.5
Infants' and toddlers' apparel	−14.6	Rent of primary residence	32.0
Men's and boys' apparel	−13.3	Garbage and trash collection	32.2
Sports equipment	−12.2	Admission to movies, theaters, and concerts	32.5
Men's footwear	−5.7	Prescription drugs	33.3
Women's and girls' apparel	−5.7	Cable and satellite television and radio service	35.8
New cars and trucks	−4.7	Household electricity	40.9
Music instruments and accessories	−3.5	Bread	41.0
Women's footwear	3.8	Admission to sporting events	44.7
Breakfast cereal	7.4	Dental services	44.7
Roasted coffee	9.9	Veterinarian services	58.8
Peanut butter	12.0	Inpatient hospital services	65.9
Sugar and artificial sweeteners	16.8	College tuition and fees	71.5
Eyeglasses and eye care	16.9		
Consumer Price Index	**24.4**		

SOURCE: Bureau of Labor Statistics, U.S. Department of Labor.

list of steepest price increases. Many of those services are not "protected" by government-imposed trade barriers but rather by the nature of the service, yet the result is the same: less domestic competition and a greater ability on the part of producers to saddle consumers with higher prices.

Higher prices mean that we can buy less with our paychecks and other earnings. A higher consumer price index translates into lower real wages, compensation, and household incomes. Erecting barriers to trade may "protect" certain industries and their workers, but they rob workers in every other sector by diminishing the value of what they earn.

Some of the tradable items in the table do face trade barriers, but the tariffs our government imposes on shoes, clothing, tableware, and musical instruments have not stifled trade completely but only slowed its growth. Without tariffs, prices would have fallen even further, to the benefit of American consumers. And prices have also gone up, sometimes sharply, for such freely tradable commodities as fruits and vegetables and crude oil. But commodities are more prone to natural price swings than manufactured goods, and we can be certain that prices would have been even higher if import competition had been curbed by artificial trade barriers.

Another seeming anomaly on the list is prescription drugs. In 2007, Americans imported $71 billion worth of medicinal, dental, and pharmaceutical preparations, making it one of the more heavily traded product categories. Yet the average price level for prescription drugs since 2000 has risen faster than inflation. One plausible explanation is a trade restriction of sorts—the U.S. government's granting of patents for brand-name drugs. Patents are in essence temporary monopolies granted by the government to the creators of an innovative product such as a new medical drug.

The purpose behind patents is to encourage investment in breakthrough products by allowing the people and companies that develop the new products to benefit the most. Otherwise, one company would invest heavily in researching and developing a new drug, only to have other producers immediately co-opt the formula, driving down prices. Companies would then lose the incentive to innovate, depriving the public of potential medical advances. To make drug patents effective, the U.S. government has also imposed restrictions on the "re-importation" of U.S.–made drugs that have been sold abroad at prices lower than what they are sold for here in the United States.

Without taking sides on the re-importation issue, it's worth noting that some of the same members of Congress who complain the loudest about free trade and "unfair" import competition are also leading the charge to lift restrictions on drug re-importation so that American consumers can enjoy the benefits of lower prices. If only they cared as much about lowering prices for food, clothing, and shoes as they do for lowering prices for Viagra.

Import competition might be one reason that inflation rates are lower than in past decades. As the late Nobel Prize–winning economist Milton Friedman explained, inflation is ultimately caused by the creation of too much money by the central bank, but lower trade barriers can help to moderate price increases by breaking the power of domestic monopolies and oligopolies to charge higher prices. As the United States and other major economies have become more globalized in the past two decades, global inflation fell from 30 percent in the early 1990s to 4 percent by 2003. Inflation ticked up recently during the spike in oil and food prices, but it is nowhere near where it was 15 or 30 years ago. By making workers more productive and prices more flexible, open markets have reduced pressure on central banks to inflate the money supply. Our expanding freedom to trade assets and currencies has given Americans more options to shield themselves from the impacts of inflation.[9]

More Choice and Variety

Free trade delivers real benefits for American families not only through lower prices but also by enriching the variety of products and brand names we can buy. More choices among similar products increase our satisfaction as consumers. Instead of one-size- or one-taste-fits-all, we can choose the brand or flavor that gives us the greatest satisfaction. Consider imported beer. Even if imports did not cause the price of a six-pack to drop, consumers are still better off if they can choose among not only Miller High Life, Old Milwaukee, and Coors but also Heineken, St. Pauli Girl, and Newcastle Brown Ale. Increased variety can have the same effect on our well-being as a drop in prices.

Free trade means we can buy fresh-cut flowers from Colombia in the middle of winter along with fresh fruit from Chile and fresh vegetables from Mexico. Free trade means we are more likely to find the style and size of shirt we want on the shelves at the department store. A more sophisticated global supply chain has allowed such retailers as J.C. Penney to cut the time it takes for a junior fashion design to go from concept to the store from 70 weeks a decade ago to 17 weeks today.[10]

The consumer benefits of variety can be harder to quantify than a simple drop in price, but they are just as real. Two economists for the National Bureau of Economic Research calculated the consumer benefits of increased variety in a 2004 study, and the benefits add up to hundreds of billions of dollars. Authors Christian Broda and David E. Weinstein built their study on the pioneering insight of the liberal Nobel Prize–winning economist and *New York Times* columnist Paul Krugman that consumers do not care just about the price of imports but also even subtle differences in similar products. As the NBER authors succinctly put it, "Consumers value variety," which free trade delivers in abundance.[11]

If trade delivers more brands while keeping prices in check, we are better off. In fact Broda and Weinstein calculate that the global varieties available to Americans multiplied four-fold between 1972 and 2001. "Roughly half of this increase appears to have been driven by a doubling in the number of goods and half by a doubling in the number of countries supplying each good," the authors found.[12] Adjusting for the benefits of increased variety, they calculate that import prices actually fell 1.2 percent faster than official statistics showed. As a result, the real incomes of American families are about 3 percent higher because of the greater variety that imports bring.[13] That's not "a few cents"; it's nearly $400 billion in our current economy. That figure translates into a real gain of $1,300 per person or more than $5,000 for a family of four just from the expanding varieties that trade has brought to the marketplace. Trade with China has done more to expand the variety of imports we enjoy than trade with any other country, but more on that in a moment.

Better Quality

A third benefit of free trade for American consumers is higher quality. Nowhere have Americans witnessed the improved quality from trade more noticeably than in the automobile market. When I first began to drive in the mid-1970s, the American market was dominated by the Big Three. American automakers and their unions had grown fat and happy with their exclusive franchise of making big and powerful cars for the world's largest domestic car market. Imported Volkswagens and Toyotas were seen back then as rather exotic. Now it is the boxy, unreliable, and gas-guzzling American cars of that day that seem exotic, like four-wheeled dinosaurs destined for extinction.

Three decades of oil spikes and vigorous foreign competition have transformed the U.S. auto market. Today foreign-brand vehicles account for more than half the cars and light trucks sold in the United States. Along with the increased competition have come more moderate price increases, greater variety, and, yes, better quality. Today's cars are safer, better designed, more loaded with extra features, and more fuel efficient for their class. It was Japanese automakers who introduced crossover utility vehicles, hybrid vehicles, and small light trucks to the American market. According to an October 2008 poll commissioned by the Japanese Automobile Manufacturers Association, 79 percent of Americans agreed that competition from

Japanese automakers has spurred the Big Three to offer hybrid technologies and more fuel-efficient vehicles.[14]

Trade skeptics have been quick to jump on safety concerns about toys and pet food imported from China. Those concerns are real, but they spring from breakdowns in quality control, not from trade itself. U.S. regulators have every right under international law to impose exactly the same safety and health standards on imported products as they do on products made domestically. Poisoned pet food or toys with lead paint are just as much a safety concern whether they come from abroad or another state. In the past three years, Americans have been sickened and even killed by baby spinach from California and ground beef from Nebraska tainted by E. coli bacteria, chicken from Pennsylvania tainted with listeria, and peanut butter and peanut products from Georgia tainted with salmonella. The regulatory challenges are no different. Importing goods from less-developed countries need not lead to any lowering of health and quality standards.

How Imports from China Improve Our Daily Lives

It seems an American cannot go shopping today without buying something "made in China." Our store shelves brim with products made, or at least assembled, by workers in the world's most populous nation. Factories in China specialize in goods that are especially attractive to consumers in the United States, so it only makes sense that the world's richest consumer nation would buy lots of stuff every year from one of the world's leading makers and exporters of consumer goods. Of those 2,133 containers that arrived every hour in 2007, slightly more than 1,000 came from China.[15]

Most of what we import from China are everyday consumer goods that make our lives better at home and work. As Table 2.2 shows, more than 80 percent of the goods imported from China in 2007 were consumer products: laptop computers, iPods and MP3 players, furniture, shirts, shoes, sporting goods, TVs and DVD players, and office products.[16] China was the source of 80 percent of America's imported toys, sporting goods, and bicycles; 73 percent of imported footwear; 68 percent of imported radios, CD players, and other audio equipment; and more than half of imported computers, furniture, and household items.[17]

Table 2.2
WHAT WE BUY FROM CHINA
(2007 imports in billions of U.S. dollars)

Consumer Products	
Computers and telecommunication equipment	72.4
Furniture, appliances, household goods	56.4
Apparel and footwear	51.6
Toys and sporting goods	27.6
TVs, radios, dvds, cameras	23.5
Vehicles and parts	9.5
Printed matter, writing supplies	7.1
Food, paper and energy	5.7
Jewelry, artwork, and miscellaneous	4.8
Miscellaneous	3.9
Total	262.3
Industrial Goods	
Industrial machinery	30.9
Steel and other metal products	11.0
Building materials	5.2
Packing materials	4.7
Chemicals	4.4
Textiles	2.9
Total	59.2
Total Goods Imported	321.5

Although China is now the number one source of imported goods for the U.S. economy, 85 percent of what we import still comes from countries other than China. And Chinese imports must be seen in the context of the U.S. economy that in 2008 produced $14 trillion worth of goods and services. There is nothing wrong with the fact that Americans spend the equivalent of 2 percent of our national income on things put together by the one-fifth of mankind that lives in China.

Imports from China have delivered lower prices on goods that matter most to the poor, helping to offset other forces in our economy that tend to widen income inequality. In a 2008 study, two economists from the University of Chicago confirmed the pro-poor bias of imports from China. Christian Broda and John Romalis calculated that between 1994 and 2005, the inflation rate for goods bought by U.S. households in the lowest tenth percentile of income was 6 percentage points lower than inflation for goods bought by families in the top tenth percentile. Lower-priced imports from China were a big reason why. "Since Chinese exports are concentrated in low-quality non-durable products that are heavily purchased by poorer Americans, we find that about one-third of the relative price drops faced by the poor are associated with rising Chinese imports," they concluded.[18] Broda and Romalis found that trade with China has helped to offset nearly a third of the official rise in income inequality during this period. Lower prices on goods imported from China have more than compensated for any downward pressure on low-skilled wages because of U.S.–China trade.

Imposing punitive tariffs on imports from China would be a direct tax on tens of millions of working families in America. Some members of Congress have proposed that the U.S. government drastically raise tariffs on Chinese goods. Sens. Charles Schumer, a New York Democrat, and Lindsey Graham, a South Carolina Republican, offered a bill in 2005 that would have imposed a 27.5 percent tariff on Chinese goods unless Chinese authorities allowed their currency to rise in value compared to the dollar. Sen. Byron Dorgan, a North Dakota Democrat, has proposed revoking "normal trade relations" with China, which would expose Chinese imports to prohibitively high tariff rates.

Imposing steep tariffs on imports from China would, of course, hurt producers and workers in China, but it would also punish millions of American consumers through higher prices for shoes, clothing, toys, sporting goods, bicycles, TVs, radios, stereos, and personal and laptop computers. It would disrupt supply chains throughout East Asia, invite retaliation, and jeopardize sales and profits for thousands of U.S. companies now doing business with the people of China. Sanctions of the kind contemplated in Congress would also violate the same set of international trade rules that members of Congress accuse China of violating.

Exchange-rate policies can also bite into family budgets. Certain U.S. producers tend to favor a weak dollar vs. China's yuan because it makes U.S. exports more competitive abroad and Chinese imports less competitive in our domestic market. But the exchange rate is a double-edged sword. A weak dollar also drives up import prices for American families and import-using producers. It is no coincidence that the upward spike in global food and energy prices in 2007 and 2008 followed a major decline in the value of the U.S. dollar. When the dollar is worth less compared to other currencies, foreign producers will demand more dollars before they sell us a barrel of oil or a ton of rice. American families lose when the dollars in their pockets and checking accounts buy less in global markets.

Imports from China are just the kind of consumer goods that millions of low- and middle-income families buy at discount stores throughout the year, but especially during the Christmas shopping season. Imports from China tend to spike upward in August through November compared to the rest of the year as importers rush to fill store shelves in anticipation of the holiday shopping rush. Whereas imports from our other major trading partners also typically rise 10 to 15 percent on a seasonal basis, peaking in October, imports from China surge an average of 20 to 30 percent from August through October each year compared to average monthly imports throughout the year.[19] If the Grinch who tried to steal Christmas were in the U.S. Senate, he would gladly co-sponsor higher tariffs on imports from China!

How Big-Box Retailers Deliver the World

The principal channel through which American families enjoy the benefits of imports is American retailers, especially the "big box" stores such as Wal-Mart, Home Depot, and Best Buy. Access to global markets has allowed retailers to expand the range and variety of products we can buy and keep prices significantly lower than they would be if they were not able to source abroad.

Wal-Mart, for example, buys its products wholesale from a network of 60,000 suppliers worldwide. It now imports more than $20 billion a year from China alone. But sourcing from abroad is not just a Wal-Mart phenomenon; Target, Home Depot, Sears, Lowes, Kmart, Best Buy, Office Depot, Staples, and Costco are also major importers. IKEA furniture stores import a large share of their furniture from China.[20] In fact, imports bound for Wal-Mart stores accounted for less than 4 percent of those 18 million containers entering U.S. ports in 2006.[21]

Imports have allowed big box retailers to multiply the variety of goods on their shelves, especially compared to the corner hardware and grocery stores that were the only option when I was growing up in a small town in the Midwest. A typical Wal-Mart store today will stock 60,000 different items, a supercenter 120,000.[22] As we saw earlier, more choice means more customer satisfaction per dollar spent. In his sometimes critical but fair-minded book, *The Wal-Mart Effect*, author Charles Fishman accurately captured the phenomenon: "Step inside a Wal-Mart, pause briefly at the threshold—with two, or three, or four acres of brand-new goods before you piled to the ceiling—and at that moment you command a cornucopia from every corner of the globe that wasn't available, not even to the richest and most powerful, one hundred years ago."[23]

The price savings from the big-box retailers are just as striking, especially when it comes to groceries. Food prices at a Wal-Mart supercenter are typically 15 to 25 percent lower than at traditional grocery stores and supermarket chains. Even families that do not shop at a Wal-Mart benefit because the competition keeps prices lower than they would be otherwise at the traditional stores. Savings are greatest for lettuce, ham, butter/margarine, apples, yogurt, coffee, ice cream, potatoes, tomatoes, and bottled water.[24] Fishman estimates a family of four with an income of $52,000—middle class by any definition—saves about $900 a year by shopping at a Wal-Mart.

Those cost savings enabled in part by global sourcing are even more important for low-income families. In a 2005 study for the U.S. Department of Agriculture, authors Jerry Hausman and Ephraim Leibtag found that buying groceries at a supercenter allowed upper-income families to save the equivalent of 20 percent of their food expenditures, but for low-income families, the savings approached 30 percent. As the authors concluded, "The spread of supercenters has the greatest impact on poorer households and minority households. Thus, the spread of supercenters has favorable distribution effects across the population."[25] The pro-poor impact of the big-box retailers is one reason why spending at Wal-Marts continued to increase in the depths of the 2008-09 recession as sales plunged at other, more expensive retailers. As one major newspaper noted in a headline, "Wal-Mart Flourishes as Economy Turns Sour."[26] Affordable, imported staples have extended a more immediate and effective lifeline to families struggling to stay afloat during tough economic times than any lumbering government stimulus package.

Others in the political arena understand the consumer and distributional benefits of big-box retailers plugged into a global market.

Jason Furman, who now serves as a top economic adviser to President Obama, remarked at a public debate in 2005: "The lower prices at Wal-Mart are staggering. They are eight to 40 percent lower than what people would pay elsewhere. The total annual savings in one recent study . . . for consumers are $263 billion. That's $2,300 for every household in America. There are very few public policies that I've advocated in my life that would make as big a difference as that."[27]

Political opposition to big-box retailers has been spearheaded by organized labor. Workers at Wal-Mart and other mass retailers tend to be nonunion, while workers at many grocery-store chains belong to the United Food and Commercial Workers International Union. The union sees double competition in the supercenters, both from their nonunion workers as well as the goods they sell that are produced by foreign workers and farmers. Domestic unions have caught the ear of politicians who tend to ignore the consumer benefits of competition while responding to the noisy producer interests who want to stifle competition at the expense of most working families.

Trade Policy As If Consumers Mattered

After he dismissed concerns about the cost of clothing during the 2007 primary debate, then-candidate Obama asked rhetorically, "[O]n whose behalf is the president negotiating [trade agreements]? Is he or she negotiating on behalf of the people in this stadium, or are you only negotiating on behalf of corporate profits? And that is an important issue and it's an important distinction that we've got to make."

Good question. Should we design our policies toward imported T-shirts and other "sensitive" products in order to pad the profits of the few domestic companies that still make those products and thus benefit the small slice of the U.S. workforce they still employ? Or should our policies be designed for the benefit of the tens of millions of Americans, including poor families living on the edge, who buy those T-shirts, shoes, and socks to clothe themselves and their children? Barack Obama won the cheers that day of union members, but who in that stadium was representing the single mother who must struggle to pay the duties our government imposes on imported goods that loom large in her budget?

Unfortunately, for all his talk about change, Sen. Obama that day sounded like most politicians who typically ignore the interest of Americans as consumers. They pander to the squeaky wheels, and in the trade debate, that almost always means a few producers rather than consumers. As we've seen, the benefits of free trade are diffused widely among more than 100 million households. Although the cumulative savings are huge, they are realized in small doses—just the right product available when you want it, increased satisfaction with that new car or laptop, or a $20 dollar savings from a Saturday trip to the shopping center. But many consumers are not even aware of those benefits or the threat posed to them by protectionist legislation. And even if awareness did grow among consumers, it is daunting to organize millions of diverse people into an effective political coalition.

Adopting a pro-consumer, pro-middle-class position on trade would transform the debate in Washington. Lowering our own trade barriers to imports would not be seen as a "concession" we make to other countries in order to coax them to lower their barriers to our exports. Free trade is a policy we can adopt right now to make our lives better. When other countries keep their trade barriers higher than we keep ours, that is not evidence of "unfair trade" but of misguided trade policies on the part of the other governments, policies that hurt our exporters, to be sure, but that are just as damaging to the other countries' consumers and overall economies.

Just because other countries pursue trade policies that hurt the large majority of their own citizens is not an argument for our own government to do the same to us. To insist on a "level playing field" is to demand that our government adopt or maintain trade policies that are as misguided and self-damaging as those of other countries. We should insist that our government adopt trade policies that are best for most Americans, regardless of what other countries do. And that means pursuing trade policies that spread benefits to the widest possible number of Americans, especially the poor and middle class who have the most to gain from removing the final remaining barriers that separate us from the global marketplace.

3. How American Workers and Families Have Traded Up

Even when Americans can see the consumer benefits of a more open market, fears remain that more vigorous competition may cost us our jobs. What good do lower prices do me if I don't have a paycheck? Those anxieties multiply during times of economic distress such as those that Americans are facing now.

Critics of trade and globalization hammer away that the real wages earned by most American workers have been stagnant or in decline for decades. They claim that higher-paying manufacturing and white-collar jobs are being destroyed by imports and outsourcing, whereas the jobs left behind are lower-paying service jobs such as flipping hamburgers or cashiering at a big-box retailer. In the verdict of public opinion, trade and globalization are held partly, if not primarily, responsible for the perceived loss of jobs, downward pressure on wages, and a middle class under siege.

Before we reach for trade barriers as an elixir for what ails our economy, we need to ask ourselves: What is the real story of jobs, living standards, and the middle class in the United States today, and what role has expanding international trade played in the changing number, composition, and compensation of American workers? By any reasonable and objective measure, American workers and families are better off than during comparable periods in the past, and expanding engagement in the global economy has played an important role in the upward trend in American employment and living standards.

Trade and Jobs: Why Both Sides Are Wrong

Trade is not about more jobs or fewer jobs, but about better jobs. Advocates of trade liberalization who claim that lower barriers boost the total number of jobs in our economy are as wrong as skeptics who argue that lower barriers mean fewer jobs. During the debate over NAFTA in 1993, people on both sides were guilty of this fundamental mistake. Independent presidential candidate H. Ross Perot famously predicted that passage of the agreement would create "a giant sucking sound" of jobs and investment heading south across the border. Advocates of the agreement, including the Clinton White House, countered that NAFTA would create hundreds of thousands of net new jobs. Both sides were wrong to the extent they predicted the agreement would cause a net change in jobs either way.

Trade a Net Wash on Total Employment

Trade does cause certain jobs to disappear, certain companies to go out of business, and certain sectors of the economy to shrink. That's to be expected from increased competition, domestic as well as international. But trade as a rule does not affect the total number of jobs or the overall rate of employment or unemployment. Studies that claim that trade expansion, trade deficits, or trade agreements have caused the loss of a specific number of jobs during a certain period are misleading if they leave the impression that the economy today has that many fewer jobs than it would have otherwise. Trade does not affect the total number of jobs in an economy for three reasons.

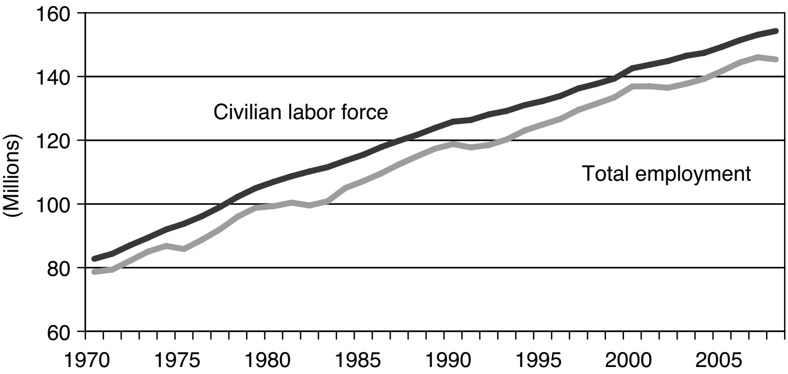
First, if workers, capital, and resources can shift within the domestic economy, jobs eliminated by import competition will quickly be replaced by jobs created elsewhere. Focusing merely on jobs lost because of imports ignores the offsetting jobs that trade and globalization create through other channels. One channel is expanding exports as U.S. producers ramp up production to meet demand abroad as well as at home. Trade competition also reduces costs for U.S. producers by allowing them to buy raw materials, intermediate inputs, and capital machinery at lower, more competitive global prices. Lower producer costs translate into higher profits, attracting more investment and creating more employment in those sectors that benefit from open markets. Trade also delivers lower prices on imported and import-competing consumer goods, giving households more money to spend on domestic goods and services, stimulating further employment gains. Globalization also means more international investment flowing into the United States. Inward foreign direct investment creates jobs by establishing foreign-owned production facilities in the United States, whereas inflows of financial capital create jobs by reducing long-term interest rates, thus promoting greater investment and job creation by domestic companies.

Second, the much misunderstood reality of "comparative advantage" means that our economy will always be globally competitive in a range of sectors. If we lose our competitive edge in one sector or industry because of shifting technology and factor prices or the emergence of new global competitors, the competitive edge of other sectors will be enhanced. The insight of comparative advantage, first expounded by David Ricardo in 1817, is that a country will tend to export what it can make more efficiently relative to what else it could produce domestically given its own endowment of land, labor, capital, and institutions. If the United States loses its shoe industry to lower-cost global competition, we will likely gain competitiveness and export share in pharmaceuticals, civil aircraft, financial services, and other sectors where we are relatively more efficient than making shoes.

Third, trade does not tend to affect the overall number of jobs because of other more powerful and counterbalancing factors in the broader economy such as monetary policy and foreign exchange rates. If a surge in imports did cause widespread layoffs in certain sectors, the resulting increase in unemployment would push the Federal Reserve to tilt toward a looser monetary policy and lower interest rates to stimulate the overall economy. Increased imports would also have the effect of pumping more dollars into international markets, causing the dollar to depreciate in foreign currency markets. A weaker dollar, in turn, would make U.S. exports more attractive, stimulating employment in export sectors while dampening demand for imports, offsetting initial job losses. For all those reasons, changes in trade flows have not determined the overall level of employment in the U.S. economy.

Even the most cursory glance at the employment numbers during recent decades should dispel any fear that trade and globalization threaten overall employment. Across the decades, against a backdrop of rising levels of trade and repeated business cycles, a central truth has stood out: In the long run, job growth in the United States tends to keep pace with growth in the labor force. As new workers have entered the labor market, U.S. producers have found profitable ways of employing them. Job growth invariably reverses during

Figure 3.1
U.S. EMPLOYMENT GROWS WITH LABOR FORCE



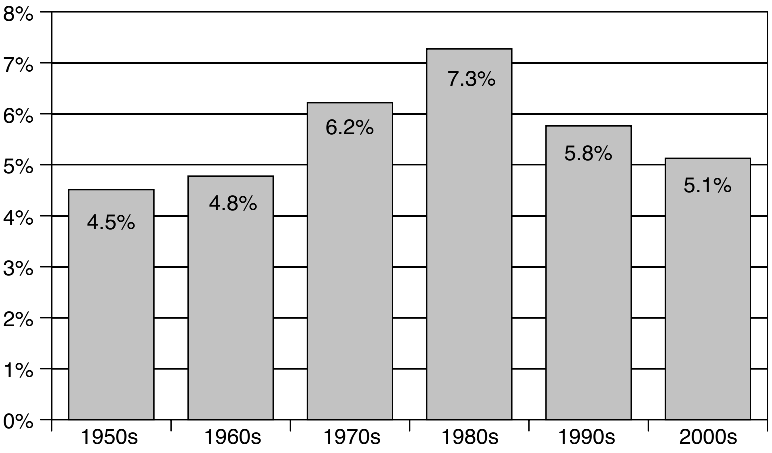
SOURCE: Bureau of Labor Statistics.

recessions, as we have painfully witnessed during the current downturn, but then catches back up with labor-force growth during expansions, driving the unemployment rate back down to a level consistent with "full employment."

In the past four decades, during a time of expanding trade and globalization, the U.S. workforce and total employment have each roughly doubled. As Figure 3.1 shows, total employment has closely followed labor-force growth. Since 1970, the number of people employed in the U.S. economy has increased at an average annual rate of 2.22 percent, virtually the same as the 2.25 percent average annual growth in the labor force.[1] Despite fears of lost jobs from trade, total employment in the U.S. economy during the recession year of 2008 was still 8.4 million workers higher than during the 2001 recession, 27.6 million more than during the 1991 recession, and 45.8 million more than the 1981–82 downturn.[2]

Nor is there any long-term, upward trend in the unemployment rate. In fact, even counting the recession year of 2008, the average unemployment rate during the decade of the 2000s has been 5.1 percent. That rate compares to an average jobless rate of 5.8 percent in the go-go 1990s and 7.3 percent in the 1980s (see Figure 3.2). After decades of demographic upheaval, technological transformations, rising levels of trade, and recessions and recoveries, the U.S. economy has continued to add jobs, and the unemployment rate shows

Figure 3.2
AVERAGE UNEMPLOYMENT RATES BY DECADE



no long-term trend upward.[3] Obviously, an increasingly globalized U.S. economy is perfectly compatible with a growing number of jobs and full employment.

Trade's Small Role in "Job Churn"

Expanding international trade does eliminate a certain number of jobs each year. We can see that reality often in the news media and sometimes in our own communities: An auto parts supplier downsizes its workforce, an apparel factory closes its doors, a marketing firm outsources a call center to India. Affected workers are real people with bills to pay and dependents to support. But the number of people dislocated from their jobs each year because of shifting trade patterns is relatively small in America's dynamic market economy where "job churn" is a fact of life even in the best economic times.

The number of workers who lose their jobs each year because of expanding trade, offshoring, and outsourcing probably falls in the range of 300,000 to 500,000 a year. The Economic Policy Institute, a left-of-center research organization in Washington, claimed in a 2001 paper that rising imports had eliminated 3 million "actual and potential jobs" from 1994 to 2000—an average of 500,000 per year.[4] In a more recent study, EPI claims that our economy lost 200,000 jobs a year just from trade with China in the past decade.[5] Lori Kletzer, in a 2001 study for the Institute for International Economics, estimated that trade accounted for 320,000 job losses annually from 1979 to 1999.[6] Even if we accept the highest of those figures, jobs lost because of expanding trade are a relatively small component of the underlying churn in the U.S. labor market.

Every year, the U.S. economy creates and destroys millions of jobs. According to the U.S. Department of Labor, an average of 32.1 million jobs were created and 30.4 million were eliminated annually between 1992 and 2006, creating an average annual net job gain of 1.7 million.[7] About half the churn is seasonal, but the other half is permanent, meaning that each year about 15 million jobs disappear, never to be seen again.[8] If changing flows of trade account for the loss of 500,000 jobs a year, trade would be responsible for about 3 percent of the overall churn in the labor market.

Job displacement because of expanding trade also appears small when compared to weekly filings for unemployment compensation. If the estimates of job losses from trade expansion are correct, about 10,000 workers lose their jobs in a typical week from trade-related causes. Those job losses provide plenty of sound bites and TV images for the critics of trade. And yet in a typical week, even when the economy is humming, more than 300,000 people file claims for unemployment insurance. By that yardstick as well, workers displaced by expanding trade account for only 3 percent of total displaced workers in good times and an even smaller share during recessions. For every American standing in the unemployment line because of trade, 30 are standing directly ahead who have lost their jobs for reasons that have nothing to do with imports or the global economy.

Technology, not trade, accounts for most of the job turnover each year in the United States. The introduction of the personal computer 30 years ago eliminated hundreds of thousands of jobs for typists, secretaries, and telephone operators. Kodak, the camera company headquartered in Rochester, N.Y., has laid off 30,000 workers since 2004—not because of unfair trade by foreign competitors but because of the proliferation of digital cameras and plunging sales of film. Brick and mortar record and book stores have closed their doors, not because of imports but because online retailers such as Amazon.com and iTunes have captured an expanding share of the market. The daily newspaper business that once supported my family has seen venerable papers declare bankruptcy or shut down entirely as readers and advertising migrate to the Internet. The Pew Project on Excellence in Journalism predicted in a recent report that "by the end of 2009, a quarter of all newsroom jobs that existed in 2001 will be gone."[9]

Workers also lose their jobs because of changing consumer tastes and domestic market competition as one American company cuts into the market share of another. Trade plays only a bit part in the ongoing upheaval in the American workplace.

Trade, like technology, affects the types of jobs in our economy but not the total number. If workers and capital can move freely between states and between sectors, jobs lost in one area will tend to be replaced by jobs created in another. The overall number of jobs depends on the growth rate of the economy and the labor force, business investment, flexibility of employers to hire or lay off workers, and other broader factors. A nation open to the global economy can enjoy low unemployment, just as a nation with a relatively closed economy can suffer high unemployment (like America during the Great Depression). It is simply wrong to blame trade for causing a net loss of jobs or anything other than a small fraction of job displacement.

Higher Pay, Better Jobs

Critics of trade respond that our economy may have been creating jobs in our more globalized era, but the new jobs pay less than the jobs being destroyed. The result is stagnant or falling real wages and living standards and a shrinking middle class. The belief that most American workers are earning less than in years past rests on a faulty understanding of how trade affects the economy and living standards and a misinterpretation of recent wage and income data. Greater freedom to trade, in practice as well as in theory, has helped to lift the wages and incomes of most Americans to levels above what they would be had markets remained less open. Contrary to the common tale, expanding levels of trade in recent decades have been accompanied by rising real hourly compensation for American workers and a higher median income for households.

How Trade Raises Incomes

Trade raises the general wage level by expanding the opportunity for Americans to work in sectors where productivity and pay exceed the average. Because of comparative advantage, American workers tend to be most productive in those sectors that are the most capital intensive—those that require large investments in physical and human capital and intellectual property. Examples of such industries are pharmaceuticals, chemicals, civilian aircraft, sophisticated machinery, microprocessors, and professional services in finance, insurance, accounting, and other sectors. Those industries also tend to pay higher than average wages. As the more competitive industries expand output and employment, the overall wage level tends to rise as they compete in the labor market to hire new workers.

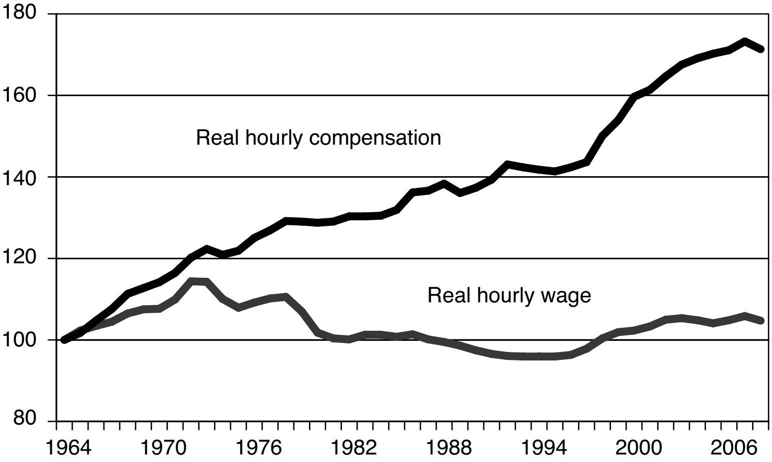
Where Americans find it hardest to compete internationally is in sectors that are relatively labor intensive, such as toys, sporting goods, shoes, and apparel. Those industries tend to pay wages that are lower than average. As the American economy opens itself to global competition, we tend to import more of the labor-intensive goods, reducing relative employment in lower-paying sectors, while we export more of the capital-intensive goods, promoting greater employment in higher-paying sectors. Thus expanding trade tends to raise overall wage and income levels. Even for the majority who work in nontrade sectors, global competition delivers lower prices for everyday consumer goods, allowing workers to stretch their paychecks further.

Yet official statistics show that the average real hourly wage paid to American workers—wage earnings adjusted for inflation—is lower today than in the 1970s. From a peak of $8.99 an hour in 1972, the average real wage (in 1982 dollars) declined steadily to a low of $7.52 in 1993 before rising again to $8.32 in 2007.[10] The statistic that the average real wage remains below its peak of more than 30 years ago has become a rhetorical battering ram against trade liberalization. It is a prime example of where the critics of trade readily seize upon a piece of data to make their case no matter how flawed it may be.

The Unreality of the Real Wage Data

The average real wage is a fundamentally flawed measure of the well-being and progress of American workers, for three reasons: First, the real wage does not include benefits. Second, it relies on cost-of-living estimates that have tended to systematically overstate inflation in recent decades and thus understate gains in real earnings.

Figure 3.3
RISING COMPENSATION FOR AMERICAN WORKERS



Third, today's real wage is often compared to past peaks that were deceptively high.

By excluding benefits, the real wage data underplay the real gains made by American workers. Although money wages remain a majority of total compensation, benefits have grown as a share of the average worker's compensation package. Those benefits help Americans pay for medical care and retirement. More companies than in decades past are also offering dental and eye care benefits and more generous paid leave and matching 401(k) contributions. The average real wage numbers fail to capture those real benefits.

A more accurate measure of earnings is "real hourly compensation," which includes not only wages but benefits. The BLS data on wages and benefits combined tell a more accurate and encouraging story about the well-being of the average American worker. Since 1973, average real hourly compensation for American workers has increased by 41 percent, and by 23 percent since 1991.[11] Figure 3.3 shows that real hourly compensation has not only climbed since 1973, but its rise began to accelerate in the 1990s along with America's growing economic openness. The average American worker has not suffered from "stagnant" earnings in the past three decades but in fact has enjoyed real gains.

Even the more comprehensive compensation numbers tend to understate the real gains American workers have enjoyed in recent decades. Economists have long realized that the consumer price index (CPI) tends to overstate the cost of living compared to past years because it often fails to accurately capture the increased quality of new and improved products. As Michael Cox and Richard Alm explain in their 1999 book, *Myths of Rich & Poor*, new products do not show up in the CPI shopping cart until several years after they have become popular with consumers. For example, pocket calculators were not added until 1978, VCRs until 1987, and cell phones until 1998 (by which time nearly 40 percent of households already owned one).[12] That means the CPI fails to capture the steep price declines that often mark new electronic consumer goods as they become ubiquitous.

Thanks in no small part to international trade, American workers today benefit from an ever-expanding and improving array of products on which they can spend their paychecks. In the mythical golden era of 1973, the average American worker earning a supposedly higher real wage could not buy a microwave oven, personal computer, cell phone, laser printer, CD, DVD, or MP3 player, iPod, digital camera, camcorder, a car with air bags and antilock brakes, or a cheap cross-country ticket on a discount airline.[13] When we fully account for benefits as well as wages and the wider and more useful array of products we can buy today, the average American worker is much better compensated than his counterpart in decades past.

A third way the real wage data are misused is by the constant comparison to the peak of 1972–73. If more recent real wage data have been distorted by an overstating of inflation, the data of the early 1970s were distorted in the opposite direction. The year 1973 marked the final sprint of a Nixon-era, election-cycle expansion fueled by easy monetary policies and wage and price controls that kept inflation temporarily bottled up (only to see it explode into double digits in 1974). The price controls caused real wages to appear deceptively high that year, making it a misleading benchmark to judge subsequent years.

The Growth of Middle-Class Service Jobs

Behind the rise in average real compensation is a changing mix and growing number of middle-class service jobs. The common story

Table 3.1
MORE JOBS, BETTER-PAYING JOBS

Employment Sector	Number of Jobs (thousands) 1991	2008	Change	Average Hourly Wage (2008)
Information	2,677	2,987	310	$24.74
Natural resources and mining	739	774	35	$22.42
Construction	4,780	7,175	2,395	$21.86
Professional and business services	10,714	17,863	7,149	$21.15
Financial activities	6,558	8,192	1,634	$20.28
Education and health services	11,506	18,878	7,372	$18.78
Subtotal	36,974	55,869	18,895	$20.52
Manufacturing	17,068	13,455	−3,613	$17.72
Trade, transportation, utilities	22,281	26,332	4,051	$16.19
Other services	4,249	5,520	1,271	$15.86
Leisure and hospitality	9,256	13,615	4,359	$10.83
Subtotal	35,786	45,467	9,681	$14.54
Government	18,545	22,457	3,912	

SOURCE: U.S. Bureau of Labor Statistics.

is that trade has caused the loss of well-paying, mostly unionized, middle-class manufacturing jobs, whereas the service economy creates mostly lower-paying, nonunion jobs in food service or retail. That is one of the big lies of the current trade debate. Although some better-paying manufacturing jobs have indeed disappeared, the trend in recent decades has been for lower-paying factory jobs to be replaced by better-paying service jobs.

Since the beginning of the 1990s, the U.S. labor market has in fact shed a net 3.6 million manufacturing jobs. But that loss has been overwhelmed by the creation of 18.9 million net new jobs in mostly service sectors where the average wage is higher than in manufacturing (see Table 3.1). Education and health services alone added 7.4 million jobs between 1991 and 2008. Another net 7.1 million new jobs were created in the professional and business services sector, 2.4 million in construction, and 1.6 million in financial activities—

all sectors where average wages are significantly higher than in manufacturing.[14]

Two-thirds of the net new jobs created in the past two decades of rapid globalization are in sectors where the average wage is higher than in manufacturing. For every one job lost in manufacturing since 1991, our economy has created five in better-paying service sectors, three in less well-paying sectors, and one in government. That pattern was not just a phenomenon of the 1990s. During the Bush years of 2001–2008, two-thirds of the net new jobs were also created in sectors that paid more than manufacturing.

In recent years, economists and politicians have raised the specter that millions of those better-paying white-collar service jobs are now "at risk" because of outsourcing. It is true that the Internet and the falling cost of international telecommunications have made it possible to trade services that were not tradable before. This development has allowed U.S. companies to outsource call center work to the Philippines and computer programming to India. But only a small share of American service jobs could be easily outsourced, and Americans are more likely to sell outsourcing services to the rest of the world than to buy them. Because of our continuing comparative advantage in knowledge-based sectors, we continue to run a large trade surplus with the rest of the world in higher-end services. In 2008, Americans exported $85 billion more in "other private services" than we imported, including big margins in financial, business, professional, and technical services.[15]

In contrast to the nostalgia about manufacturing, the American middle class today earns its keep from better-paying service sector jobs. Knock on doors in a typical middle-class American neighborhood, and you will meet people who work not in factories but in the service sector: teachers, managers, carpenters, architects, engineers, computer specialists, truck drivers, loan officers, vocational counselors, public relations specialists, automotive service technicians, accountants and auditors, police officers and fire fighters, insurance and real estate agents, registered nurses, physical therapists, dental hygienists and other health care professionals, and self-employed business owners.[16] Those are the occupations that now form the backbone of the American middle class. Those are the jobs our children aspire to fill.

Middle Class and Moving Up

A related theme repeated by critics of trade is that global competition has "squeezed" the American middle class. Large sections of Lou Dobbs' book, *The War on the Middle Class*, and many of his nightly homilies are devoted to criticizing trade expansion as a major battle front. As trade and globalization destroy higher-paying manufacturing jobs, the story goes, the great American middle class finds itself shrinking and in threat of disappearing altogether.

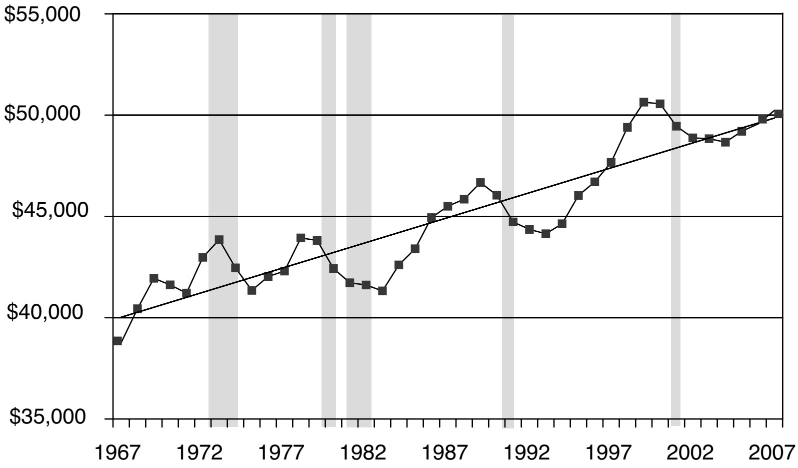
As with the employment and wage data, truth about the size and state of the American middle class has become another casualty of anti-trade propaganda. America remains a solidly middle-class country, with a large and growing number of middle-class households earning their living in the service sector. To the extent that trade has affected the middle-class job market, it has tended to create better-paying jobs while eliminating lower-paying jobs. Real household income in America, like real hourly compensation, has continued to trend upward through the ups and downs of recurring business cycles.

The Upward Trend in Household Incomes

Opponents of trade expansion frequently compare the latest median household income figures with those of the year 2000, a peak year at the end of a decade-long expansion. But when compared with previous years at similar stages in the business cycle, the latest household income numbers fail to provide any support for dire warnings about a shrinking middle class or declining household income.

According to the most recent numbers from the U.S. Census Bureau, the median income of America's 117 million households was $50,233 in 2007. That figure was indeed slightly below the median of $50,557 in 2000 (expressed in real, 2007 dollars).[17] That fact has allowed ideological opponents of trade to say, "The median household income has been dropping for eight years!" But that isn't quite right. Median household income did decline in the wake of the 2001 recession, as it does during every downturn, but it had been rising again since 2004 as the economy gained steam. In fact, median household income in 2005, 2006, and 2007 rose almost exactly in line with the long-term trend stretching back 40 years, as we can see in Figure 3.4.

Figure 3.4
Median Household Income, 1967–2007

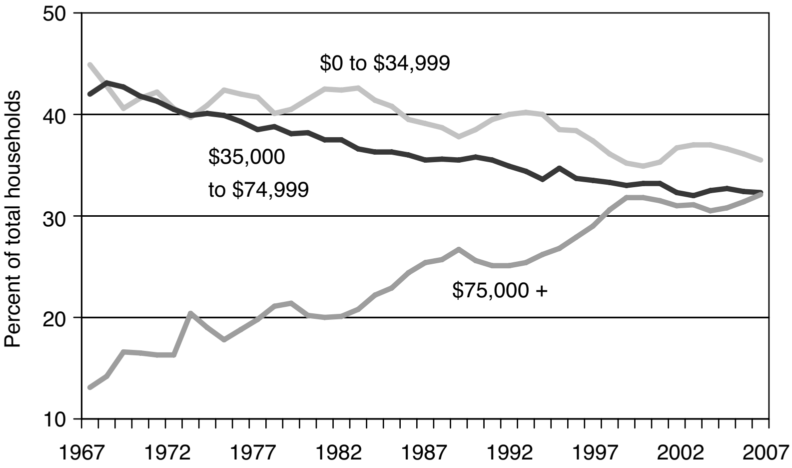


Note: Shaded areas mark recessions.
Source: U.S. Census Bureau.

As the graph reveals, median household income fluctuates with the business cycle as it trends upward. Like the waves of an incoming tide, household incomes retreat during recessions, then climb back during the recovery and expansion to eventually exceed the previous peak, only to repeat the cycle. During the previous five cycles of recession and expansion, median household income fell an average of 4.5 percent from peak to trough and then expanded 8.7 percent until the next peak and downturn.[18] Two steps forward, one step back, two steps forward—and through it all, American households have reaped an average gain of $246 in real spending power each year.

The positive trend in household income probably understates the standard-of-living gains of individuals within households. The average number of people per U.S. household has been declining for decades because of more single-parent households, more young single people living outside their parents' home before they marry, more elderly widows, and fewer children per family. Between 1970 and 2005, the average number of people per household fell from 3.2 to 2.6. That number means that the higher incomes earned by today's households are supporting fewer members, allowing even more

Figure 3.5
THE REAL STORY OF THE "SHRINKING MIDDLE CLASS"



NOTE: Household incomes in real 2007 dollars.
SOURCE: U.S. Census Bureau.

purchasing power per person. After decades of expanding trade and globalization, American households, like individual workers, are earning more. There is no reason to doubt that trend will resume once we recover from the current recession.

Behind the "shrinking" middle class

The American middle class is not disappearing but moving up. The same government numbers that show an upward trend in median household income also show a rising share of households moving up to the middle class and beyond. According to the Census Bureau, just under one-third of American households earned a middle-class income of between $35,000 and $75,000 in 2007. That share was indeed down slightly from the 35.8 percent of households that fit that definition of middle class in 1990 (all incomes again in real, 2007 dollars) (see Figure 3.5). But if the middle class has been shrinking, it is not because more families have been squeezed by globalization and other pressures into lower income brackets. The share of households earning less than $35,000 also shrank during the period, from 38.5 percent to 35.5 percent. Meanwhile, the share of households earning $75,000 or more jumped from 25.6 percent to 32.1 percent.[19]

If we define the middle class more broadly, say $35,000 to $100,000; or $25,000 to $75,000; or $25,000 to $100,000; the same pattern emerges: The middle class continues to slowly shrink over time, while the share of households earning less also shrinks and the share earning more continues to grow. As we see in Figure 3.5, the "decline" of the middle class has been remarkably gradual and steady. During times of recession, the lower-income brackets grow, whereas during good times, the upper-income brackets swell. Over time, the great American middle class has been shrinking not because more households have slipped down the income ladder but because more have moved up.

Contributing to that upward mobility has been the growth of two-earner households. Some critics decry the trend of women joining the workforce as another negative result of globalization, claiming that the alleged downward pressure on wages has forced wives and mothers to leave home for the workplace to help the family pay its bills. But this argument ignores the ample evidence that real hourly compensation and the number of higher-paying service sector jobs have been rising over time, not falling. Critics also ignore the many positive reasons why so many women have decided since the 1970s to work outside the home for pay. Those reasons include growing levels of education among women, growing career opportunities in the expanding service sector, and the wider availability of labor-saving appliances and prepared foods that have reduced labor demands at home—reasons that have nothing to do with globalization and a "middle-class squeeze."

Most women have always labored, whether in the home, farm, or workplace. The difference today compared to four or five decades ago is that a significantly larger share now get paid in dollars in the labor market, which has expanded the financial opportunities of American families. As Cox and Alm observe in their book *Myths of Rich and Poor*,

> When men went to work outside the home, the family's living standards rose because of the tremendous gains from specialization and exchange. Why do we insist that the same transition for women can only mean a pinch on household's

> possibilities? It makes no sense to suggest that the economic rules flip-flop when a second adult takes a job. Working women are a sign that families are making themselves better off, not slipping toward poverty.[20]

America remains a solidly middle-class country. A majority of Americans see themselves as middle class. They earn middle-class incomes and lead middle-class lives. Through recurring business cycles and the changing composition of employment, median household income has trended upward as a rising number of families move into the middle class and an even larger number move to the upper-income brackets. Expanding trade and globalization have played a positive role in helping Americans make the transition to a middle-class service economy.

Improving Our Household Balance Sheets

Even when the critics acknowledge the longer-term income gains of American households, they claim those gains have come at the expense of the household balance sheet. They charge that Americans have boosted their consumption primarily by borrowing, and as a result, middle-class families "are drowning in debt."[21]

That claim has more than a ring of truth. Too many American households borrowed too much money in recent years based on the mistaken assumption that home values would keep rising at double-digit rates. When housing prices began to fall in 2006, Americans were forced to curtail consumption and even give up their homes to foreclosure.

The resulting economic recession has been brutal on the balance sheets of American households. Over the course of 2008, the double whammy of falling home and stock prices reduced the net worth of American households and nonprofits by more than $11 trillion, or 18 percent.[22] But the recession and loss of wealth cannot plausibly be blamed on trade and globalization, and in fact the global market for assets has helped American families build and keep their wealth.

Globalization has helped to boost the net worth of American households in two main ways: first, by raising household income above what it would be without expanded trade, and second, by enlarging opportunities to tap into global capital markets directly and indirectly. As we will see in more detail in chapter 6, outward foreign investment has boosted returns for U.S. companies that invest abroad as well as individual and institutional U.S. investors who have added foreign holdings to their portfolios. Inward foreign investment has created well-paying jobs for American workers while increasing demand for real estate, business, and financial assets held by American households. The lower interest rates delivered by the inflow of foreign capital have boosted asset prices for Americans while lowering their borrowing costs and debt service payments.

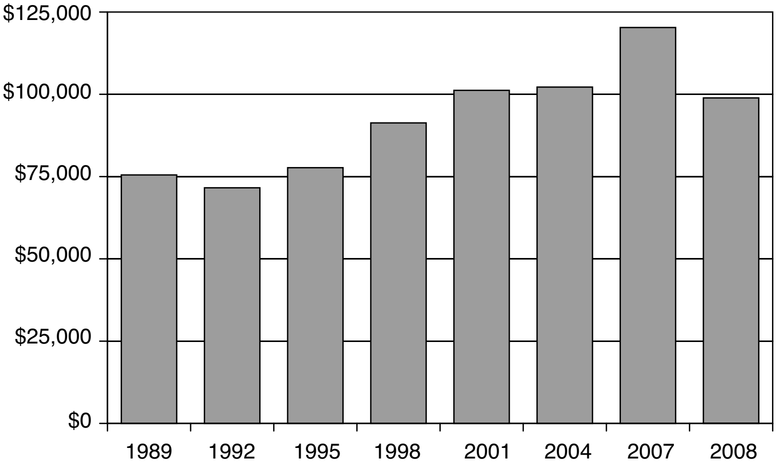
Even when we account for the recent loss in household wealth, the balance sheet of the typical American family is still healthier than it was 10 or 20 years ago. Every three years, the Federal Reserve Board conducts a "Survey of Consumer Finances," a detailed look at the changing incomes and wealth of American households. According to the most recent survey, released in March 2009, the net household wealth of the median U.S. family rose from about $75,000 in the early 1990s, to $100,000 by 2004, to $120,000 in 2007 (all figures in real 2007 dollars). The recent dive in stock and housing values dropped the median net wealth of U.S. households back to just below $100,000 in late 2008, according to the survey's authors. Despite the drop, the median family net worth is still 10 percent above a decade ago and a solid 30 percent above what it was 20 years ago[23] (see Figure 3.6).

A closer look at the typical household balance sheet shows that families have not been "drowning in debt," nor have they been borrowing just to pay for daily necessities. More than 70 percent of debt accumulated by American families has been used to purchase and improve our primary residences, and 11 percent has been used to finance other residential property. Another 6 percent of our debt went to buying vehicles and 4 percent to financing education. Only about 6 percent of family debt in 2007 had been used to buy goods and services.[24]

Credit card debt has been rising in recent years but only at about the same rate as our overall incomes, as one might expect. According to the latest Survey of Consumer Finances, less than 4 percent of family debt is owed to credit card issuers. Less than half of American families owed any balance on their credit cards as of 2007,[25] and the median outstanding credit card balance for families in the middle quintile of income was a manageable $2,400.[26]

The share of family income needed for debt payments, including principal and interest, has held steady during the past decade. The

Figure 3.6
MEDIAN NET WORTH OF AMERICAN HOUSEHOLDS



NOTE: Real 2007 dollars.
SOURCE: 2007 Survey of Consumer Finance, Federal Reserve Board.

ratio of debt payments to family income for all U.S. households was 14.9 percent in 1998 and 14.5 percent 2007. The ratio for families in the middle quintile of income rose slightly during the same period, from 18.7 percent to 19.8 percent. By keeping interest rates lower, our openness to the global economy actually makes it easier for American families to manage their debt.[27]

The opportunities offered by our engagement in the global economy have raised incomes and asset values and lowered the cost of borrowing for middle-class American families. The latest recession has brought hardship to millions of American households, but we would be in even worse condition if our government deprived us of access to global markets.

Those who blame trade for "declining real wages" and a "shrinking middle class" are guilty at the very least of a lack of perspective. They have confused the passing pain of a cyclical downturn with the long-term, ongoing, upward trend in U.S. living standards. Trade cannot be blamed for causing recessions. Even the best economists have not figured out how to repeal the business cycle. Trade does, however, boost the overall productivity of the economy and individual workers, allowing more goods and services to be produced in an average hour of work, leading to higher real compensation per hour and a higher median household income than if our economy were not as open to trade. In part because of expanding trade, American workers and households emerge from each recession and recovery in a better place economically than they would be without trade.

4. U.S. Manufacturing in a Global Economy: More Stuff, Better Stuff, Fewer Workers

"We just don't make things anymore!" That common refrain captures the widespread perception that America is "deindustrializing." We hear repeatedly that our manufacturing base has been shrinking, and as a result our economy, our security, and our identity are all in jeopardy. Exhibit A is the fact that more than 3 million net manufacturing jobs have disappeared in the past decade as we continue to run a huge trade deficit in manufactured goods with the rest of the world.

Super Bowl rocker Bruce Springsteen captured the angst in his 1984 song, "Hometown":

> *Now Main Street's whitewashed windows and vacant stores*
> *seems like there ain't nobody wants to come down here no more*
> *They're closing down the textile mill across the railroad tracks*
> *Foreman says these jobs are going boys and they ain't coming back*
> *to your hometown.*[1]

Two decades later, the critics of trade are still singing the same mournful tune. In a 2003 column titled "The Death of Manufacturing," conservative Pat Buchanan wrote, "Across America, the story is the same: steel and lumber mills going into bankruptcy; textile plants moving to the Caribbean, Mexico, Central America, and the Far East; auto plants closing [here] and opening overseas; American mines being sealed and farms vanishing."[2] On the left, Sen. Byron Dorgan (D-ND) asserts in his 2006 book, *Take This Job and Ship It*, that "America's manufacturing base is being dismantled. . . . Our manufacturing base is shrinking. . . . Our nation is in danger of having the world's strongest manufacturing and industrial base destroyed."[3]

At the center of anxiety about U.S. manufacturing is the trade deficit. In 2008, Americans imported $1,628 billion worth of manufactured goods from abroad and exported $1,000 billion worth, resulting in a trade deficit of $628 billion.[4] Opponents of trade expansion cite the deficit as all the proof they need for the failure of U.S. trade policies. In fact, our trade deficit tells a misleading story about American manufacturing. The aggregate trade numbers disguise the huge domestic market that U.S. manufacturing firms continue to serve and the comparative advantage of U.S. producers in higher-end products. By virtually every measure but employment, the long-term trend for America's manufacturing and industrial base has been one of growth, not decline.

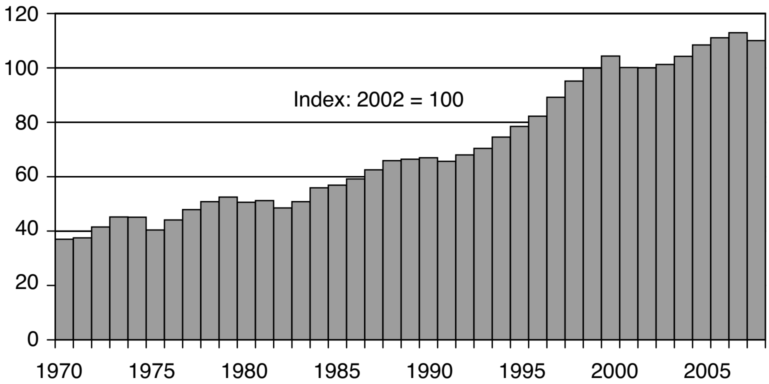
Cars, Planes, Steel, Computers, Refrigerators, Chlorine Gas, and Pills

Contrary to the popular picture, U.S. manufacturing in the past decade has been more than surviving in a global economy. Although the recession that took hold in 2008 has been brutal for many U.S. manufacturers, as recently as 2006, American factories were producing more output, more sales, more profit, and a higher return on investment than ever before. It's true that certain sectors have contracted and factories have closed in the face of global competition, dislocating workers and impacting real lives. But other sectors of U.S. manufacturing, in fact most sectors, have found a profitable place serving global and domestic markets. Stories of the demise of U.S. manufacturing can be found in the popular press, on TV, and in the halls of Congress, but not when we actually count and measure what we make.

As part of its monitoring of the national economy, the Federal Reserve Board each month estimates the volume of manufacturing produced by U.S. factories. Volume means the actual quantity of output after adjusting for quality changes. According to the Fed, the volume of manufacturing output in the United States in the recession year of 2008 was still 10 percent higher than during the previous recession of 2001. Since the earlier downturn of 1991, the total volume of U.S. manufacturing output has expanded by two-thirds, and since 1980, output has more than doubled. Although output rises and falls with the overall economy, as we can see in Figure 4.1, the long-term trend for U.S. manufacturing output in our more globalized world—like the trends for real hourly compensation for workers and median income for households—continues to point upward.

Behind the aggregate index are millions of tangible "made in the U.S.A." goods that we buy and use every day. In 2007, U.S. factories and workers manufactured:[5]

Figure 4.1
U.S. MANUFACTURING OUTPUT, 1970–2008



SOURCE: Federal Reserve Board.

- 5,250 complete civil aircraft valued at $7.83 million each and 15,341 complete civil aircraft engines valued at $589,998 each[6]
- 81 million metric tons of raw steel and 113 million tons of shipped steel products[7]
- 10.7 million motor vehicles[8]
- 25,657,243 computers (digital, analog, hybrid, and other) valued at $1,437 each[9]
- 11,594,319 household refrigerators and refrigerator-freezers; 11,618,088 washing machines; 7,097,709 water heaters (electric and nonelectric); 8,415,134 dishwashing machines; 7,133,988 household gas and electric ranges; and 1,366,231 clothes dryers[10]
- 10,403,942 motor-vehicle air conditioning systems; 3,959,624 split system air-conditioning condensing units; 3,664,663 natural gas, forced-air furnaces; 2,132,547 room air-conditioners; 1,861,941 air source heat pumps (excluding room air-conditioners); 727,598 commercial refrigeration units and mechanical drinking water coolers; and 592,174 year-round, central air-conditioners[11]
- 31,361,195 electric (nonindustrial) fans[12]
- 1.61 billion square yards of carpet and rugs, enough to cover 6.1 million average-sized U.S. homes wall to wall[13]

- 11.9 million short tons of chlorine gas, 8.9 million tons of sodium hydroxide, 4.7 million tons of hydrochloric acid, and another 2.6 million tons of commercial aluminum sulfate, sodium sulfate, finished sodium bicarbonate, and sodium chlorate[14]
- 1.5 billion gallons of paint and allied products at $13.60 a gallon[15]
- $123 billion worth of pharmaceutical preparations (except biologicals)[16]
- And a large share of the 3.13 billion books sold in the United States that year[17]

That's a lot of stuff. Some of those numbers have been falling and others rising in recent years, but nobody can say that Americans don't make anything anymore. American workers produce millions and millions of big and complicated manufactured goods every year in a relatively open U.S. market. We don't appreciate all the manufactured goods our fellow Americans produce because most of it is not the kind of stuff we put in our closets or living rooms. We are much more likely to buy a shirt made in Bangladesh or a DVD player made in China than an American-made jet engine or a ton of steel or chlorine gas. Many of our heavy appliances are made in America, but the labels of origin are not as obvious.

The American companies and sectors producing all those products have (in recent years, up to the current downturn) enjoyed a growing and profitable business. According to a recent study by my Cato colleague Daniel Ikenson, U.S. manufacturing companies in 2006 enjoyed record real output, record real revenues, and record real operating profits.[18] Against a backdrop of record imports of manufactured products that year, America's domestic manufacturers earned a collective $350 billion in after-tax profits.[19] That is not the profile of a dead or even a dying industry.

U.S. factories have even managed to hold their market share of global manufacturing value added as China and other emerging economies rapidly expand their output. According to the United Nations Industrial Development Organization, America's share of the world's manufacturing value added has remained steady at about 21 percent since the early 1990s. Despite all the attention paid to China's rise as a manufacturing power, U.S. factories in 2006 cranked out two and a half times the value added of all the factories in China.[20]

Productivity Up, Employment Down

Critics of trade typically ignore output and instead complain about declining employment. As we saw in the previous chapter, 3.6 million fewer Americans were employed in manufacturing in 2008 than in the early 1990s. But a declining number of workers in a particular sector need not be a problem for the economy or for the nation as a whole, or even for the sector that is losing the jobs.

More output from fewer workers points to one inescapable fact—manufacturing output per worker has been rising, and rising smartly. U.S. factories employ fewer workers than a decade ago, not because the factories are producing less (they are in fact producing more) but because the workers they still employ are producing so much more per hour of work.

In recent decades, productivity in the manufacturing sector has been galloping ahead of productivity in the rest of the economy. Manufacturing productivity grew at about the same pace as productivity overall up until 1973, but from 1973 to 1995, it grew about 1 percentage point faster, and since 1995, it has grown nearly 2 percentage points faster than overall nonfarm business productivity.[21] Behind the surge in productivity has been the interplay of automation, more skilled workers, computer-guided production systems, and just-in-time inventory management, among other production improvements. The result has been a relative as well as absolute decline in manufacturing employment.

Rising productivity is not a mark of weakness in U.S. manufacturing but of strength. In fact, rising productivity is the essence of economic progress and competitiveness. Higher productivity allows U.S. manufacturers to compete effectively in global markets even though workers in other countries are paid less. It allows U.S. companies to pay more to their workers for an hour of work than what factory owners pay in countries where workers are less productive.

The real test of a nation's manufacturing might is not how many workers it employs in the sector but the real value of what it produces. Consider which of these two countries would be more of a manufacturing power: The first employs 20 million workers churning out 1 billion widgets a year, the second 10 million workers producing 2 billion widgets. Unless your job is to collect union dues from as many workers as possible, the answer is obviously the second country—the one that produces twice as many widgets through the effort of workers who are four times more productive (200 widgets per worker per year vs. 50).

If employment is the measure of success, then America would be more of a manufacturing power than it is today if half the American workforce earned its living cobbling shoes, sewing shirts, and finishing tables in our garages. Such a cottage-industry economy would reverse America's progress by a couple of centuries. In contrast, expanding global trade has helped to make America the manufacturing powerhouse that it remains to this day.

The Not-So-Telling Anecdote of the Swingline Stapler Factory

Instead of acknowledging the general progress of U.S. manufacturing, the critics spin anecdotes. A factory closing down and hundreds of workers losing their jobs can create powerful and sympathetic images. But anecdotes can obscure a more accurate picture of the underlying transformation of American manufacturing.

In his 2000 book, *The Selling of "Free Trade": NAFTA, Washington, and the Subversion of American Democracy*, author John R. MacArthur spends the first 50-plus pages recounting in great detail the story of a stapler factory in Queens, New York, forced to shut down a decade ago because of competition with Mexico. With a reporter's eye for detail, MacArthur, the publisher of *Harper's* magazine, recounts how Swingline, Inc., was founded earlier in the 20th century, how the staplers were made for decades at the company's Leemar Building on 33rd Street in the Long Island City section of Queens, and how the famed "Classic 747" Swingline staplers themselves were fabricated and assembled at the main plant and headquarters nearby at 3200 Skillman Avenue. He even describes the huge, 60-foot-high Swingline sign that dominated the neighborhood's skyline for decades. (A photo of the sign, rusted and in disrepair, serves as cover art for the book and a metaphor of the decrepit state of U.S. manufacturing under the ravages of free trade.)[22]

In the summer of 1998, the happy story of the Swingline stapler factory came to an end. In the midst of the chapter titled, "Death of a Factory: Long Island City," MacArthur writes:

> As I walked into the fluorescent-lit habitat of Swingline's Leemar Building on July 30 [1998], the Dow Jones Industrial Average was still giddy from a record high of 9,338 on July

> 17, U.S. unemployment had fallen to 4.5 percent, and the U.S. dollar was the dominant currency of the world. At the same time, Swingline Inc., a division of ACCO USA, in turn a subsidiary of Fortune Brands, was shutting down its two Long Island City plants, laying off 450 people and moving the operation and all its jobs to Nogales, just across the U.S. border, in the Mexican state of Sonora.[23]

Here, supposedly, was the giant sucking sound for all to hear. Just as critics of trade had warned, or so MacArthur explains, the lower tariffs brought about by NAFTA had encouraged U.S. companies to move operations to Mexico in search of the cheapest labor possible, putting downward pressure on wages in the United States. In fact, the demise of the Swingline factory in Queens a decade ago provides a perfect example of comparative advantage at work for the greater good.

Although the factory's closing caused temporary hardship for several hundred workers, it was not indicative of a general decline in U.S. manufacturing. Over the course of 1998, the year in which the Swingline plant closed its doors, the real volume of output at U.S. factories was 7 percent higher than the year before and 36 percent higher than output in the final pre-NAFTA year of 1993. Stapler factories may have been moving to Mexico, but many more U.S. factories were staying put and actually ramping up production and employment.

Manufacturing growth was so strong that the number of total jobs was actually growing along with booming productivity gains. In the first five years after NAFTA took effect on January 1, 1994, the U.S. economy *added* a net 500,000 manufacturing jobs. The "death of a factory" in Long Island City that MacArthur chronicled may have typified a certain subsector of manufacturing, but for manufacturing overall, it was more a sideshow than the main story.

Swingline's departure was certainly not the death of Long Island City. The New York City neighborhood has managed to survive and thrive in the years after the last fluorescent light was turned off at the stapler factory. On an October 2007 visit to New York, I rode the Number 7 subway line from Manhattan just a few short stops to the 33rd Street/Rawson Street Station in Queens, just down the street from both former Swingline plants. At 10:00 a.m. on a normal weekday, I emerged along with a throng of other passengers onto a bustling Queens Boulevard. The neighborhood is an eclectic mix of upscale delis; computer, appliance, and furniture stores; a YMCA; a McDonald's; and LaGuardia Community College.

The former Swingline headquarters building on Skillman Avenue has seen better days, but the three-story industrial plant is no empty hulk, either. Inhabiting the space where staplers were once made are now Ames Tools and Supplies Service, the City View Tennis Club, and shipping and receiving facilities for Mercury Beach-Maid Inc., S&S Industries, and Krysman Inc. In front of the frame at the top of the building that once displayed the Swingline sign is now one for North Fork Bank. The Leemar Building down the street became semifamous in the post-Swingline era as the temporary home of the Museum of Modern Art from 2002 to 2005 while the main museum site in Manhattan was being remodeled. The spruced-up facility continues to serve as a storage site for the museum.

The real lesson of the Swingline stapler factory in Long Island City is not that free trade inevitably closes factories. Moving to free trade will cause some factories to close, but it will allow others to expand production. The factories and sectors that expand will generally be those that enjoy a comparative advantage in the U.S. economy—those that are more technology and capital intensive, that require innovative product development and not just rote assembly, and that locate in regions of the country where land, labor, and transportation costs allow profitable operations.

The Swingline factory was not just crowded out by competition from Mexico. It also faced competition from other producers in New York City competing for the same land, workers, and capital. Manufacturing low-tech staplers a 15-minute subway ride from Manhattan was probably not viable in the long run given the city's prospering service sector. If the Swingline operation had not moved to Nogales, Mexico, or another low-wage country, it probably would have moved to a lower-cost region of the United States the way the textile mills moved from New England to the South a hundred years ago. Swingline's 450 workers would still have lost their jobs, but they would have had the cold comfort of knowing it was not because of international trade.

Moving Up the Value Chain

As the tale of the Swingline factory in Long Island City really illustrates, expanding trade has not reduced manufacturing output, but it has upgraded the mix of what we make. While output has continued to rise decade after decade, growth has been especially robust for high-tech goods such as semiconductors, computers and peripheral equipment, information and audio/visual equipment, medical equipment and supplies, oil drilling equipment, pharmaceuticals, chemicals, and nonautomotive durable goods such as major household appliances.[24] In contrast, a more globalized economy has not been so kind to American makers of clothing, textiles, leather goods, footwear, and pottery ceramics—all products where Americans enjoy no comparative advantage in global markets.

Despite the evidence, the myth still lingers that American manufacturing has lost its high-technology edge. At a congressional hearing in March 2007, the chairman of the House Foreign Affairs Subcommittee on Terrorism, Nonproliferation, and Trade, Rep. Brad Sherman (D-CA), unleashed a broadside against the impact of trade on U.S. manufacturing. Quoting a newspaper column, the chairman said "[T]he United States 'has the export profile of a 19th-century Third World economy.' . . . Our chief exports are not value-added high-tech goods. They are scrap metal, waste paper, cigarettes, rice, cotton, coal, meat, wheat, gold, soybeans, and corn."[25]

Talk about misleading. The only sense in which those commodities could be considered "our chief exports" would be by weight or volume. But that is not how the world measures trade. No country would trade away a ton of semiconductors for a ton of soybeans, or a container of name-brand pharmaceuticals for a container of scrap metal. What matters is value—what others are willing to pay—and by that measure, our chief exports are almost all high-technology manufactured goods. By Chairman Sherman's measure, air freight accounts for only a trivial 2 percent of global trade (by weight), but according to Frederick W. Smith, chairman and CEO of FedEx, air freight now carries 40 percent of the value of international trade, much of it the high-tech, high-value-added components fueling the information economy.[26]

In 2007, America's top ten exports by total value were, in descending order: semiconductors, civilian aircraft, passenger car parts and accessories, passenger cars (new and used), industrial machines, pharmaceutical preparations, telecommunications equipment, organic chemicals, electric apparatus, and computer accessories (see Table 4.1). Every one of those categories, except perhaps organic

Table 4.1
AMERICA'S CHIEF EXPORTS 2007
(in billions of U.S. dollars)

Exports by End-Use	Value
Semiconductors	$50.2
Civilian aircraft	$48.8
Vehicle parts and accessories	$44.2
Passenger cars, new and used	$43.7
Industrial machines, other	$38.3
Pharmaceutical preparations	$35.0
Telecommunications equipment	$31.4
Chemicals-organic	$31.4
Electric apparatus	$31.1
Computer accessories	$29.4

chemicals, would comfortably qualify as high-tech. None of them would typify a commodity-exporting Third World country from the 19th century. Together, they accounted for more than a third of total U.S. exports.[27]

In terms of their actual value, the commodities Representative Sherman cited as "our chief exports" rank far down the list. Nonmonetary gold ranks 26th out of 139 categories of exports, corn 34th, soybeans 35th, meat 38th, wheat 42nd, and raw cotton, coal, tobacco, rice, scrap metal, and waste paper even further back in the pack.[28]

Come to think of it, why should our country be embarrassed about exporting millions of tons of corn, meat, soybeans, cotton, wheat, and coal? America today is blessed not only with cutting-edge, high-tech industries employing millions of well-educated workers but also with rich and ample farmland and abundant natural resources. The fact that those commodities have found a place in our export mix is nothing to apologize for but rather more evidence that comparative advantage works. Perhaps it is the subcommittee chairman who owes an apology to America's farmers, coal miners, and scrap metal and waste paper dealers who have found successful niches in world markets. We should celebrate and not denigrate their global success.

Other members of Congress pine for a past when we manufactured a less sophisticated array of goods. In his 2006 book, Senator Dorgan lamented that America now imports certain name-brand manufactured products that it once made at home. The senator described the demise of domestic production of such icons as Huffy bicycles, Etch-a-Sketch, Fig Newton cookies, Pennsylvania House Furniture, Levi's blue jeans, Fruit of the Loom underwear, and Radio Flyer Classic Red Wagons.[29] All were once made in the United States but are now imported from China and other lower-wage countries.

Of course, moving production of those products offshore has cost certain workers their jobs, bringing hardship to families and to communities where those industries were concentrated. But those job losses were relatively small compared to the overall size and churn of the U.S. labor market. As we saw in chapter 2, a growing reliance on imports for those lower-tech items has kept prices low for millions of consumers on modest incomes. More American kids in small towns in North Dakota can enjoy a bicycle or a wagon or name-brand blue jeans because of imports.

Like the closing of the Swingline stapler factory, the demise of factories producing Huffy bicycles, Etch-a-Sketches, and Fruit of the Loom underwear has freed workers, land, and investment capital to go to work for other, more competitive producers—creating more fulfilling jobs for today and tomorrow rather than preserving the jobs of yesterday. U.S. manufacturing has been moving up the value chain, not down, producing and selling more and better stuff as our nation becomes ever more integrated in the global economy.

Assembled in China, Created and Enjoyed in America

Nothing illustrates America's move up the manufacturing value chain more than our growing trade with China. Despite the fears about the $266 billion bilateral trade deficit with China, U.S. manufacturing has not been under threat from alleged "unfair" Chinese imports. Our growing trade with China has probably accelerated the decline of the more low-tech, labor-intensive sectors of U.S. manufacturing, whereas the growth of the Chinese economy has provided a major export market for higher-end U.S. manufacturers.

Everyone can agree that imports stamped "made in China" have soared in the past decade. In 2007, the total value of goods imported from China surpassed $300 billion, a huge increase from the $60 billion we imported in 1996. During that same period, imports from China as a share of total U.S. imports rose from 6 to 15 percent.

During the past decade, imports from China have grown more than twice as fast as imports from the rest of the world.

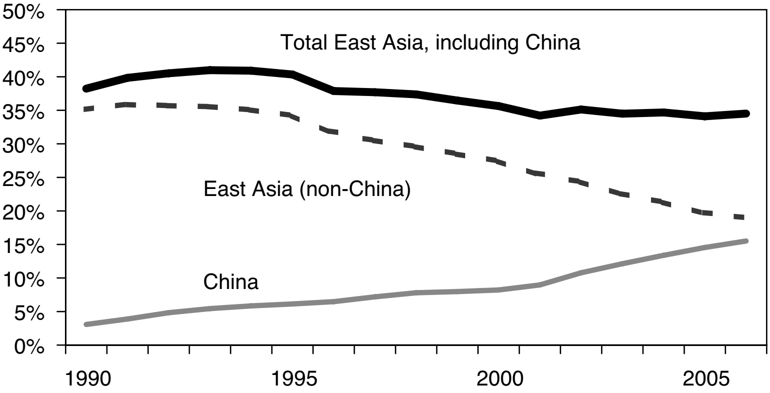
Despite their rapid increase, imports from China have not been a major source of competition for most major sectors of U.S. manufacturing. Chinese factories specialize in lower-tech, labor-intensive goods, in contrast to the higher-tech, capital-intensive goods that are the comparative advantage of U.S. manufactures. Many of the hard-hit industries, such as apparel, footwear, toys, games, and sporting goods, have been in decline for decades, long before China became a major source of imports. Rising imports from China have not so much replaced domestic production in the United States as they have replaced imports that used to come from South Korea, Taiwan, and Hong Kong. The biggest job losses in manufacturing during the 2000–2003 downturn, when many of those 3 million jobs were lost, occurred in export-intensive industries for the United States where imports from China are only a small presence. (Apparel was the one exception.)[30]

Higher up the quality scale, China has become the final assembly and export platform for a vast and deepening East Asian manufacturing supply chain. Even in mid-range products such as personal computers and DVD players, rising imports from China have typically displaced imports from other countries rather than domestic U.S. production. Final products that Americans used to buy from Japan, South Korea, Taiwan, Hong Kong, Singapore, and Malaysia are now being put together in China with components from throughout the region.

China's more economically advanced neighbors typically make the most valuable components at home, ship them to China to be combined with lower-value-added components at a foreign-owned factory, and then export the final product from China to the United States and other destinations. Thus in the trade statistics, the entire value of the product is counted as an import from China, when in fact most of the value of that product originated outside China. As China imports more and more intermediate components from the region for final assembly, its growing bilateral trade surplus with the United States has been accompanied by growing bilateral deficits with its East Asian trading partners.

The sharp rise in imports from China is not driven primarily by China's currency regime but by its emergence as the final link in

Figure 4.2
CHINA AND THE EAST-ASIAN SUPPLY CHAIN
IMPORTS TO THE UNITED STATES AS A SHARE OF TOTAL U.S. IMPORTS



SOURCE: U.S. Department of Commerce. Major East Asian sources of imports include Japan, South Korea, Taiwan, Hong Kong, Malaysia, Indonesia, Thailand, and Singapore.

the supply chain. Although imports from China have been growing rapidly compared to overall imports, the relative size of imports from the rest of East Asia has been in decline. In 1994, the year China fixed its currency to the dollar, imports from East Asia accounted for 41 percent of total U.S. imports. By 2006, imports from that part of the world— including those from China—accounted for 34 percent of total U.S. imports. China's rising share of U.S. imports has been more than offset by an even steeper fall in the share of imports from the rest of Asia, as shown in Figure 4.2.[31]

The "made in China" label we see on so many products today fails to tell the full story. Most of the products we import from China are assembled in non–Chinese-owned factories from components that are typically made outside China. Of China's top 200 exporting companies in 2005, 70 percent were foreign owned or joint ventures.[32] China's own Ministry of Information Industry reports that foreign-owned factories now account for two-thirds of China's exports of electronic products, whereas joint ventures accounted for another 16.5 percent. That means that only one in six factories in China that produce electronic products for export is purely "Chinese" in ownership terms.[33]

Goods made in those foreign-owned factories are typically stuffed with non-Chinese components. Consider a typical laptop computer sold in the United States and stamped "made in China." A look under the hood would reveal processing chips made by Intel, software from Microsoft, an LCD display screen and memory chips from South Korea or Taiwan, and a hard drive from Japan, all assembled in a factory owned by a Taiwanese company.[34] According to the Peterson Institute for International Economics, "On average, about two-thirds of the value of these so-called 'processed exports' originates outside China, mostly in other Asian countries."[35]

Something To Smile About

American companies have managed to claim their share of value-added in the bourgeoning East Asian supply chain. In the lingo of people who do business in the region, Americans have managed to grab the high ends of the "smiley curve," while the Chinese perform the lower value-added tasks in the middle. In a July 2007 cover story for the *Atlantic*, author James Fallows explains the differing roles of American and Chinese producers in the global manufacturing process:

> The [smiley] curve is named for the U-shaped arc of the 1970s-era smiley-faced icon, and it runs from the beginning to the end of a product's creation and sale. At the beginning is the company's brand: HP, Siemens, Dell, Nokia, Apple. Next comes the idea for the product: an iPod, a new computer, a camera phone. After that is high-level industrial design—conceiving of how the product will look and work. Then the detailed engineering design for how it will be made. Then the necessary components. Then the actual manufacture and assembly. Then the shipping and distribution. Then retail sales. And finally, service contracts and sales of parts and accessories.
>
> The significance is that China's activity is in the middle stages—manufacturing, plus some components supply and engineering design—but America's is at the two ends, and those are where the money is. The smiley curve, which shows the profitability or value added at each stage, starts high for branding and product concept, swoops down for manufacturing, and rises again in the retail and servicing stages. The

> simple way to put this—that the real money is in brand name, plus retail—may sound obvious, but its implications are illuminating.[36]

What are the implications of the smiley curve for Chinese and American workers? "In case the point isn't clear," Fallows concludes, "Chinese workers making $1,000 a year have been helping American designers, marketers, engineers, and retailers making $1,000 a week (and up) earn even more. Plus they have helped shareholders of U.S.-based companies."[37] Exactly so.

The lesson of the smiley curve was brought home to me after a recent Christmas when I was admiring my two teenage sons' new iPod Nanos. Inscribed on the back of each was the telling label, "Designed by Apple in California. Assembled in China." To the skeptics of trade, an imported Nano only adds to our disturbingly large bilateral trade deficit with China in "advanced technology products," but here in the palm of a teenager's hand was a perfect symbol of the win-win nature of our trade with China.

Assembling iPods obviously creates jobs for Chinese workers, jobs that probably pay higher-than-average wages in that country even though they labor in the lowest regions of the smiley curve. But Americans benefit even more from the deal. A team of economists from the Paul Merage School of Business at the University of California-Irvine applied the smiley curve to a typical $299 iPod and found just what you might suspect: Americans reap most of the value from its production. Although assembled in China, an American company supplies the processing chips, a Korean company the memory chip, and Japanese companies the hard drive and display screen. According to the authors, "The value added to the product through assembly in China is probably a few dollars at most."[38]

The biggest winner? Apple and its distributors. Standing atop the value chain, Apple reaps $80 in profit for each unit sold—an amount higher than the cost of any single component. Its distributors, on the opposite high end of the smiley curve, make another $75.[39] And of course, American owners of the more than 100 million iPods sold since 2001—my teenage sons included—pocket far more enjoyment from the devices than the Chinese workers who assembled them.[40]

Handling an "assembled in China" iPod also exposes the myth that China has somehow become an "advanced technology superstate." As the chronically alarmist U.S.–China Economic and Security

Review Commission warned in a 2005 report, "U.S. producers of advanced technology products are also subject to the growing pressures posed by China. In 2004, the U.S. trade deficit in advanced technology products with China grew to $36.3 billion."[41] The message sounds ominous, but it misses the fact that most of the "advanced technology products" we import from China are what have become everyday consumer items stocking the shelves of a Best Buy or Wal-Mart. In fact, 91 percent of such products imported from China are in a single sector—information and communication products, with notebook computers the single largest item by value. A distant second in the category are so-called "opto-electronics" items such as CD and DVD players. And even if we include those off-the-shelf items, the high-tech guts are made outside China. More than 90 percent of China's exports of electronics and information technology products are produced in foreign-owned factories that have little interaction with domestic Chinese firms.[42]

Would members of the U.S.–China commission be happier if iPods had been designed by a Chinese company in Shanghai, assembled at a Japanese-owned plant in California with major components from Canada, Mexico, and Europe, and exported by the millions back to China for the enjoyment of their teenagers instead of ours? Under that scenario, our deficit with China in "advanced technology products" would be a bit smaller, but it would be the Chinese who would reap the biggest gains while we would content ourselves with the lower-paid tasks at the bottom of the smiley curve.

China As a Customer

For American manufacturers, China has become more than an assembly and export platform; it has also become a major export market for American-made goods. In the past decade, China has lowered its tariffs on goods of the greatest importance to U.S. industry from a base average of 25 percent in 1997 to 7 percent in 2006.[43] Fueled by more open and liberalized markets and double-digit economic growth, China has become the fastest growing major export market for American goods. Since Congress approved permanent normal trade relations with China in 2000, American exports of goods to China have grown at an annual rate of 23 percent, a rate almost twice as fast as in the 1990s and more than four times faster than the growth of U.S. exports to the rest of the world since 2000.[44]

By the end of 2007, China had surpassed Japan as the fourth largest market for U.S. goods exports, behind only Canada, the European Union, and Mexico.[45]

Of the $55.2 billion worth of goods that American companies exported to China in 2006, a third were industrial machinery and components, with semiconductors the single largest item, composing more than 10 percent of total U.S. exports to China. Another third of U.S. exports to China were industrial supplies, such as plastic materials, chemicals, and steelmaking supplies. Another 10 percent were civilian aircraft and parts (think Boeing). Of the remaining quarter of U.S. goods exported to China, more than half were agricultural products—with soybeans and cotton leading the way—with other transportation equipment and miscellaneous goods composing the rest.[46]

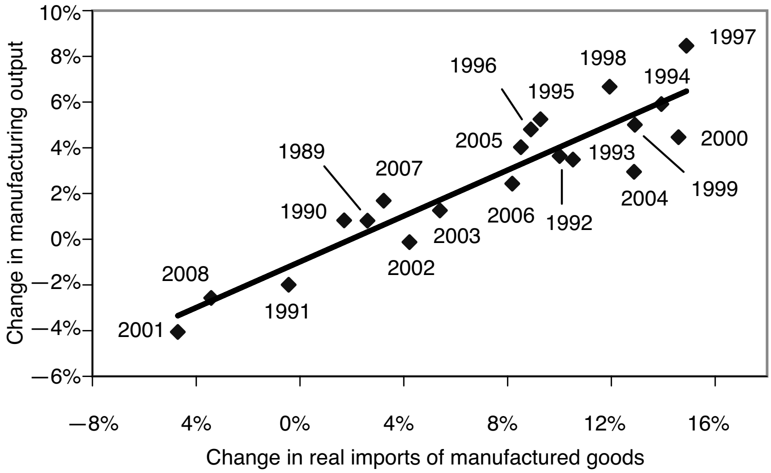
America's trade relationship with China has been good for Americans as consumers and producers. Trade with China has accelerated American industry's climb up the value ladder, opening up new export markets for leading-edge U.S. producers while filling the void left by the decline of lower-value-added industries that have been in retreat for decades.

U.S. Manufacturers Need Imports, Too

U.S. manufacturers not only sell and compete successfully in global markets, they also scour those same markets for huge amounts of raw materials, capital machinery, and parts and components. More than half of what Americans import each year are not final consumer products sold by retailers, but goods used by American companies to produce their final products here in the United States. Of the $2,117 billion in goods we imported in 2008, 21 percent were capital goods (not including automobiles), 21 percent were petroleum and other energy products, and 15 percent were industrial supplies and materials.[47] Less than half were consumer goods, automobiles, and food.

The critics of trade usually glide over the fact that U.S. manufacturers and other producers are also major importers. Instead, we are told that imports are universally bad because every good we import displaces domestic production and leads to the layoff of American workers. A dreaded "flood of imports" should mean slower growth or outright contraction of manufacturing output, whereas a slowdown

Figure 4.3
MANUFACTURING IMPORTS AND OUTPUT RISE AND FALL TOGETHER



SOURCE: Bureau of Economic Analysis; Federal Reserve Board.

of import growth should bring relief to domestic producers and thus faster domestic output. The story sounds plausible, but it is almost 180 degrees wrong.

If the critics of trade were correct, a rise in the growth of manufacturing imports should lead quite directly to a decline in the growth of manufacturing output. By the same reasoning, a decline in imports should stimulate domestic output, as consumers substitute domestic-made goods for foreign-made goods. But an analysis of manufacturing imports and output during the past two decades plainly refutes this pillar of protectionist thinking.

Figure 4.3 compares the annual change in the volume of manufacturing imports to the change in manufacturing output for each year since 1989. Manufacturing imports are defined as industrial supplies and materials, capital goods, automotive vehicles and parts, and consumer goods.[48] Manufacturing output is measured by the annual average of the Federal Reserve Board's monthly index of manufacturing output.[49] The percentage change in real manufacturing imports from the previous year is plotted on the horizontal axis, and the percentage change in manufacturing output from the previous year is plotted on the vertical axis. Each dot represents a specific year, showing its change in imports and output.

If the trade skeptics were right, the trend line would be sloping down—that is, the more rapidly imports grow in a particular year, the more depressed we would expect manufacturing growth to be in that same year. But something funny happened on the way to the anti-trade rally. In the past two decades, years of rapid growth in manufacturing imports are also years of rapid growth in manufacturing output, and years of slower growth in imports are years of sluggish growth, or even declines, in domestic output. The positive slope of the line means that every 2 percent uptick in the growth of manufacturing imports is, on average, associated with a 1 percent increase in manufacturing output.

One reason why manufacturing output and imports grow together is that American producers themselves are major importers. As American-based companies ramp up production to meet rising domestic demand, they must import more capital goods, intermediate inputs, and raw materials to keep the assembly lines humming. And when factories cut their production, they also cut their demand for imports. Another reason that output and imports grow together is that both track the health of the overall economy. As demand rises among American businesses and consumers, they buy more domestically made goods and more imported goods. During a downturn like the one we are suffering now, demand falls for imports as well as domestic output. American and foreign suppliers to the U.S. economy prosper and suffer together.

When it comes to manufacturing, we either enjoy years of high import and output growth, or we suffer years of low import and output growth. For most of the 1990s and again in 2004–06, we enjoyed healthy growth; in 1989–91, 2001–03, and now again during the current recession, we are suffering through low growth or declines in both imports and output. If forced to choose between the two scenarios, and it seems they are the only alternatives, I would choose more imports and output.

The critics of trade are selling an illusion. They suppose that if imports are reduced, through higher tariffs, a depreciated currency, or other policy tools, Americans will instead buy more domestically produced goods and create more and better-paying jobs at home.

But the reality of the American economy is closer to the opposite. The protectionist dream is really a nightmare for U.S. manufacturers. Slower growth of imports typically means slower growth in domestic output and vice versa. Any efforts to restrict the access of Americans to global markets—either through higher tariffs or an artificially depreciated currency—would cripple rather than protect U.S. industry. Indeed, for American manufacturers, imports and output are a package deal: The more we prosper, the more we trade; the more we trade, the more we prosper.

Manufacturing and National Security

Beyond the economic arguments, skeptics of trade warn that America's "deindustrialization" threatens our national security. The U.S. –China Security and Economic Review Commission predictably advocates that:

> Congress should consider imposing an immediate, across-the-board tariff on China's imports at the level determined necessary to gain prompt action by China to strengthen significantly the value of the RMB [its currency]. The United States can justify such an action under WTO Article XXI, which allows members to take necessary actions to protect their national security. China's undervalued currency has contributed to a loss of U.S. manufacturing, which is a national security concern for the United States."[50]

Duncan Hunter, a former Republican congressman from California and presidential candidate in 2008, cited trade as one way he differed from President Bush. "You know, we won World War I, World War II, and the Cold War with a major industrial base. We're losing our industrial base through bad policy right now."[51] When in Congress, Hunter sponsored "Buy American" amendments to defense spending bills that would require that a significantly higher share of Pentagon purchases be of American-made manufactured products rather than imports. Advocates of such a policy argue that America must retain the capacity to produce sufficient amounts of war-related materials should we be cut off from global supplies during a conflict.

One obvious weak spot in the national defense argument against trade is that America's manufacturing and industrial base is not shrinking but in fact has been expanding decade in and decade out.

Our manufacturing output and capacity are greater today than 10, 20, or 30 years ago. As we saw earlier in the chapter, America remains a formidable manufacturing force in the world. American workers produce impressive amounts of steel, chemicals, and plastics and huge numbers of aircraft, motor vehicles, appliances, semiconductors, and computers. With America's flexible internal labor and capital markets, production of items needed in wartime could ramp up quickly.

Advocates of the Buy American approach and other restrictions on trade in the name of national security are fighting an imaginary war detached from today's global realities. America is unlikely to face an embargo of shipping routes between us and our major trading partners. No Iranian, North Korean, or al-Qaeda U-boats are prowling off our shores ready to block access to global markets. Most of our imports come from a stable and diversified list of friendly countries such as Canada, Mexico, Japan, South Korea, Australia, and members of the European Union. The chances are negligible that any of those countries would cut us off commercially in wartime.

Steel provides a perfect case for what is wrong with the Buy American approach. In January 2002, the U.S. government ruled on a so-called Section 232 case that had alleged that foreign imports of steel were jeopardizing U.S. national security. As part of the Trade Expansion Act of 1962, Section 232 allows the president of the United States to "adjust the imports" of an article or good "so that such imports will not threaten to impair the national security."[52] After receiving a petition, the Secretary of Commerce investigates and then makes a recommendation to the president.

In its 2002 report, the Commerce Department weighed the needs of the U.S. military and other agencies for iron ore and semifinished steel products and found no cause for action. The investigation found no evidence that America is dependent on imports or that imports in any way impair the ability of domestic producers to satisfy our national security requirements. The United States draws its steel imports from a diverse and dependable stable of foreign suppliers, the largest being our neighbors in the Western Hemisphere—Canada, Mexico, and Brazil. Even with imports, U.S. production dwarfs our nation's defense needs. According to the Commerce Department report, the U.S. Department of Defense consumes only about 300,000 tons of steel per year, and demand has been flat for several years.

That amounts to an almost trivial 0.3 percent of domestic production of 100 million tons in a typical year. As the report concluded, "There is no probative evidence that imports of iron ore or semifinished steel threaten to impair U.S. national security."[53] And that story is repeated across a wide swath of U.S. industry.

In the name of national security, Congress would cut the U.S. military off from global suppliers of needed goods preemptively in the name of promoting more plentiful supplies during a hypothetical war.

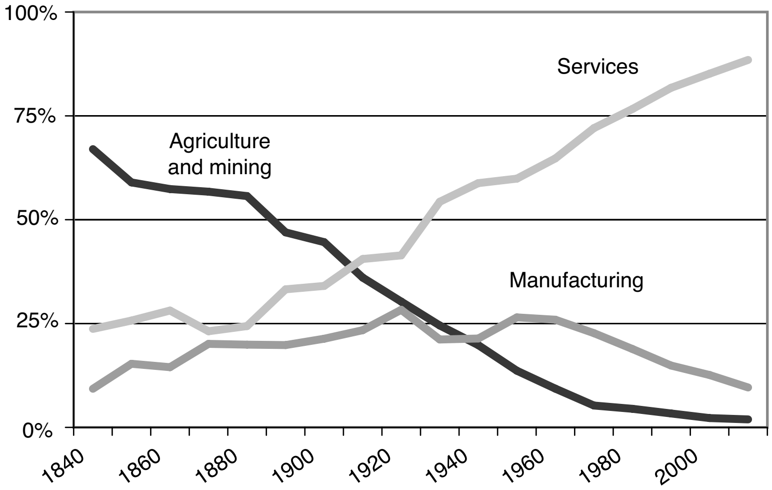
America's Post-Industrial Economy

In his 2006 book, Senator Dorgan laments that "America cannot be great if most of its workers are in the service sector or cashiering at Wal-Mart."[54] That statement is both misleading and, on a deeper level, simply false. It's misleading in the way it equates the typical service job with cashiering at a big-box retailer, when in fact—as we saw in the previous chapter—most of the new jobs being created in the service sector pay higher wages than the manufacturing jobs being lost. The statement is simply false because nearly four out of five American workers earn their living in the service sector today at a time when America remains a great country.

Do the senator and those Americans who agree with him really pine for the days when more than half of Americans worked outside the service sector? That would take us back to about 1930 when our incomes and our standard of living were far lower than they are today. Around the world, the nations with the lowest share of their workforce in services are invariably among the poorest, and those with the highest share of workers in services are among the richest. Most Americans would rather be in the latter group than in the former.

Expanding trade and globalization are helping to speed America toward a brighter post-industrial economy, and that future is nothing to fear. It appears to be a law of human development that, as incomes rise, we spend a smaller share on goods, such as food and manufactured products, and a higher share on services. At the same time, we are turning to foreign producers for a larger share (although still a minority) of the manufactured and agricultural goods we continue to purchase. This one-two effect guarantees that manufacturing will constitute a declining share of our economic output for as long as our

Figure 4.4
THE CHANGING AMERICAN WORKFORCE
(share of workforce by sector)



SOURCES: U.S. Census Bureau; Historical Statistics of the United States, Colonial Times to 1970 Bicentennial Edition; and Council of Economic Advisors, 2008 Economic Report of the President, Tables B-35 and B-46.

economy keeps growing. And the faster-than-average productivity growth in manufacturing means that manufacturing employment as a share of total employment will continue to fall.

None of those trends should worry us. We should embrace the relative rise of the service sector compared to manufacturing as natural and positive in an advancing economy. Virtually every developed economy today has long passed the stage where manufacturing constituted a majority or a growing share of economic output. In the United States, manufacturing peaked at 28.3 percent of the economy in 1953—more than half a century ago. Since then, it has been steadily declining to a level of 12 percent today.[55] Manufacturing employment as a share of the workforce peaked in the late 1940s at more than one-quarter of overall U.S. employment and has also been in steady decline ever since.[56] Meanwhile, employment in the service sector has been rising inexorably as employment in farming has been falling (see Figure 4.4).

The world's most advanced economies are all following the same path. Manufacturing's share of employment peaked for the United Kingdom and France within a decade or two after its peak in the United States, followed by Japan and Germany in the early 1970s and Taiwan and South Korea in the 1980s. Its share is already declining in Brazil and China.[57] On average, the share of workers in manufacturing in the 23 most advanced economies in the world peaked in 1970 at 28 percent.[58] For most countries, the share of the economy accounted for by industry peaks at the equivalent of $10,000 to $15,000 GDP per capita.[59] Just about every country with a standard of living above that range is "deindustrializing." The share peaked earlier in the United States than other countries not because we were somehow a less successful economy or were declining more rapidly but precisely because we were more advanced. A declining share of workers in manufacturing is not a sign of economic failure but of success.

A major reason why manufacturing is relatively less important in what Americans produce is that it is less important in what we consume. The share of personal income spent on durable and nondurable goods has been in steady decline for decades. In 1950, Americans spent two-thirds of their personal consumption income on durable and nondurable goods and one-third on services. Today we spend 60 percent of our personal income on services and 40 percent on goods. The share of personal income Americans spend on food, clothing, and shoes has dropped in half since 1950, from 38 percent to 18 percent, and the share spent on durable goods such as motor vehicles and furniture has dropped from 16 percent to 11 percent. Americans in the past half century have shifted more than a quarter of their spending from stuff grown or manufactured to services delivered.[60]

About half the increase in spending on services has been for increased medical care in the form of doctors, dentists, other medical professionals, hospitals, nursing homes, and health insurance. We have also increased the share of our spending on housing, recreation, education and research, religious and other charitable activities, domestic and foreign air travel, and "personal business"—brokerage charges, investment counseling, and banking, financial, insurance, and legal services.

We've shifted a big chunk of our household budgets from food, clothing, and other basic necessities to nurturing our health, educating our minds, and improving our finances. That sounds like progress. The increased share of spending on services has helped to spur output and employment in the domestic service sector, creating millions of those well-paying service-sector jobs discussed in the previous chapter. Those who mourn the relative decline of U.S. manufacturing shouldn't blame foreign competition but the evolving preferences and resulting spending habits of their fellow Americans.

U.S. manufacturing is going through a transition similar to American agriculture in middle of the past century. From 1940 to 1970, soaring productivity on American farms allowed agricultural output to grow by 60 percent, while actual employment on the farm declined by 6 million. During those three decades, two-thirds of farm-related jobs disappeared, probably never to return barring some sort of economic cataclysm. Agriculture's share of total employment plummeted from 19 percent of workers to 4 percent as America "de-agriculturalized." At the same time, like prices in manufacturing, real prices paid for farm goods also fell as labor productivity quadrupled, allowing consumers to reduce the share of their personal consumption expenditures on food.[61]

Although that transition destroyed millions of agricultural-related jobs, can anybody seriously argue that Americans are not better off because of it? We should view the transition of manufacturing in our more globalized era with the same hopeful expectation.

5. America's Trade Deficit: Accounting Abstraction or Public Enemy No. 1?

No aspect of international trade is so widely discussed by Americans yet so little understood as the trade deficit. Year after year, Americans spend more on imports than we earn from our exports. That's plain enough. But what that means for our economy, our jobs, and our future is open to a wide range of interpretations. Behind only "13" and "666," the U.S. trade deficit has struck more fear into the hearts of Americans than any other number.

The trade deficit has become the trump card of the critics. They present it as proof in itself that U.S. trade policy has failed and that Americans are losing in the global game of trade. When the final trade numbers were released for 2006, showing yet another record deficit, House Democratic leaders wrote to President Bush as though a plague of locusts had descended on the American landscape: "The United States has run record-setting trade deficits for each of the last five years. The consequences of these persistent and massive trade deficits include not only failed businesses, displaced workers, lower real wages, and rising inequality, but also permanent devastation of our communities."[1]

That is quite an indictment to lay at the feet of what is basically an accounting abstraction. Even in the best of economic times, a camera crew does not need to look far in our nation of 300 million to find any one of those signs of economic distress, but it is misleading to blame trade in general and the trade deficit in particular for our nation's economic troubles. The trade deficit is not a primary or even a secondary cause of economic hardship in the United States. It is the result of deeper economic currents that have little connection to trade.

What the Trade Deficit Is—and Isn't

First, let's define what we mean by the trade deficit. Those who keep track of our trade with the world measure three balances:

- The *merchandise trade balance* counts the flow of goods across our borders, including manufactured products but also agricultural goods and commodities such as lumber, minerals, and crude oil.
- The *trade balance* includes goods and services, such as travel, transportation, royalties, banking, finance, education, and technical services.
- The most comprehensive measure of trade, the *current account balance*, includes goods and services along with income earned from investments, such as interest, dividends, and profits, and unilateral transfers, such as worker remittances, foreign aid, and military transfers.

In a typical year, Americans will run a big merchandise deficit with the rest of the world, approaching $800 billion in recent years. The goods deficit typically includes large deficits in manufactured goods and crude oil partially offset by a small surplus in agricultural goods. The trade deficit is always smaller than the merchandise deficit because we typically roll up a surplus in services trade of $100 billion or more. The broader current account deficit usually clocks in close to the trade deficit, with a net outflow of unilateral transfers offset by a small net surplus earned on America's foreign investments abroad compared to what we pay out on foreign investments in the United States. (For this reason, I'll use the terms "current account deficit" and "trade deficit" interchangeably.)

Table 5.1 shows what America's trade accounts looked like in 2008:[2]

An obsession with the trade deficit obscures the important fact that Americans buy and sell in two distinct but interconnected global markets, one for current transactions for goods and services, and a much bigger market for assets, which is reflected in what is called the financial account. The key to understanding America's trade deficit is the counterintuitive fact that it is much more about investment flows than trade.

For every nation, the two markets are bound together in mirror-like fashion. A nation that runs a current account deficit, like the United States, will inevitably run a nearly equal surplus in the financial account, and a nation that runs a current account surplus, like China, will inevitably run a nearly equal deficit in the financial account.

Table 5.1
AMERICA'S TRADE ACCOUNTS FOR 2008

Merchandise balance	−$820.8 billion
+ Services	+$139.7 billion
= Trade balance	−$681.1 billion
+ Investment income	+$127.6 billion
+ Unilateral transfers	−$119.7 billion
= Current account balance	−$673.3 billion

The reason springs from the inherent nature of trade. We acquire things of value by surrendering things of similar value. Trade could not occur otherwise. The Japanese will not send us cars, the Chinese will not send us shoes, and the Canadians will not send us natural gas unless we give them something tangible that is of at least equal value in their eyes. Foreigners who give us things of value ultimately want to be left holding something more than little pieces of green paper.

Let's follow the money. When an American buys a $3,000 big-screen TV from Japan, the producer ultimately wants something of equal or greater value; otherwise, the trade won't happen. If the Japanese buy $3,000 worth of soybeans or engineering services, our current account is balanced and congressional leaders are happy. But if the Japanese invest the $3,000 in GE stock, a U.S. Treasury bill, or a New York City condo, the result is a $3,000 deficit in our current account and a $3,000 surplus in our financial account. Global trade accounts have become "unbalanced."

Of course, the foreign producer who provides us with the big-screen TV may not want or need anything from the United States. Because they probably can't pay their workers or suppliers in the U.S. dollars they earned by selling in our market, they exchange them for local currency on the international foreign currency market with somebody who does want to acquire something in the United States. The party who bought the dollars will then buy an American-made good or service or a U.S. asset. The result is the same: Americans acquire a good, service, or asset in exchange for a good, service, or asset.

The current and financial accounts are inextricably tied together. When we import goods and services from the rest of the world, we ultimately pay for them by either surrendering goods and services or title to assets. Our nation's international accounts are merely the sum total of millions of just those kinds of mutually beneficial transactions. Before he became a newspaper columnist, Nobel Prize–winning economist Paul Krugman wrote sensible books about international economics. As he wrote in his 1994 book *The Age of Diminished Expectations*: "As a matter of straightforward accounting, the United States always buys exactly as much as it sells from the rest of the world. If it sells foreigners more assets than it buys, it must correspondingly buy more goods [and services] than it sells."[3]

Americans practice unbalanced trade every day. Consider two businesses next door on Main Street. Jack, the owner of the USA Appliance Store, spends $1,000 to buy services from his neighbor Joe, the plumber. If Joe spends that $1,000 for a new refrigerator at his neighbor's store, their trade is "balanced" and everybody is happy. But perhaps Joe is in a saving mood and instead buys $1,000 worth of shares in the appliance store. Or he puts his earnings in the local bank, which then lowers its lending rates and extends a line of credit to USA Appliance. Jack then uses the money to install a new sign or upgrade his accounting software. But Jack's wife begins to nag him at the dinner table: "You buy from Joe, but he doesn't buy from you. That's unfair!" She urges him to boycott Joe and take his business to a competitor whose rates are higher and service inferior but who promises to spend money at the appliance store. Our nation's trade deficit debate is the same story but on a global scale.

Investment Flows Drive the Trade Account

As with the two neighbors on Main Street, savings and investment decisions are the hidden hand behind our nation's trade accounts. In 2007, the two-way trade of Americans in goods, services, and investment income totaled $5.6 trillion, but two-way cross-border investment flows—that is, the trading of assets—totaled $58 trillion.[4] In other words, our trade in assets is more than 10 times our trade in current transactions.

The exchange rate acts as a transmission belt between the two markets. When foreign demand for U.S. assets increases, so does demand for the U.S. dollars needed to buy those assets, which bids up the value of the dollar. A stronger dollar tends to make U.S. exports less competitive in global markets and imports more attractive, which together cause the current account deficit to widen. A wider trade deficit accommodates the greater net inflow of foreign investment. In effect, foreigners seeking to invest in the United States outbid foreigners seeking to purchase U.S. goods and services for the limited dollars in global exchange markets.

The reason why more investment flows into the United States each year than flows out is because the pool of domestic U.S. savings falls short of available investment opportunities. Foreign savers fill the gap. In other words, the current account is equal to the difference between domestic savings and domestic investment. If we save more than the level of domestic investment in a year, we will send our extra savings abroad and we will run a current account surplus. If we save less than the level of investment, a net surplus of capital will flow into our economy and we will run a current account deficit.

What that all means is that the trade deficit is not determined by unfair trade barriers, bad trade agreements, currency manipulation, or the alleged declining competitiveness of American industry. We run a trade deficit because our domestic level of savings falls short of domestic investment. Period. If politicians want to shrink or eliminate the trade deficit, they must find a way to either decrease domestic investment or (a better idea) increase domestic savings. But urging Americans to save more does not have the same rhetorical ring on the campaign trail as denouncing a trade agreement with Mexico or imports from China.

Why Is America's Trade Deficit So Large?

U.S. trade deficits have grown so large in recent decades for three reasons: 1) America has retained its appeal as a haven for investment, 2) domestic savings in the United States have persistently lagged behind domestic investment, and 3) the pool of global savings available to fill the gap has been overflowing. Let's briefly look at each phenomenon.

Despite its problems, the U.S. economy remains an attractive place for Americans and foreigners to put their money to work in the form of investment. Gross investment in the U.S. economy averaged $2.5 trillion a year during 2004–08, an amount equal to about 19 percent of GDP.[5] Our economy is not only by far the largest in the world but also (at least for now) one of the most free and dynamic. Businesses can make a profit in the United States serving more than 300 million relatively well-off consumers. Those companies can hire some of the world's best-educated and skilled workers, enjoy strong protections for tangible and intellectual property, and move goods and money in and out of the country more or less freely. Even during the current recession and financial turmoil, foreign capital has continued to flow into the United States in a "flight to quality."

Meanwhile, the amount of savings we set aside each year falls chronically short of investment. During that same period, 2004–08, gross savings in the U.S. economy averaged $1.8 trillion a year, an amount equal to about 14 percent of GDP.[6] The real engine of savings in our economy is the supposedly shortsighted corporate sector, which puts aside hundreds of billions of dollars each year in undistributed profits or "retained earnings." In the private household sector, as we are often reminded, savings have fallen to near zero in recent years, and the federal government runs large and now exploding fiscal deficits, which are a form of "dissavings" only partly offset by modest surpluses that state and local governments accumulate in normal years. The persistent gap between domestic savings and investment—roughly $700 billion a year, or 5 percent of GDP—suspiciously resembles the size of the chronic current account deficit.

Filling the gap so that investment in America can be fully funded are foreign savers. Each year, households, corporations, and governments abroad put aside a staggering pool of savings of $6 trillion or more. Those foreign savers have quite rationally decided to park 10 to 15 percent of their savings in the world's largest economy, the United States.[7] Foreign savings have become even more readily available in recent years because of falling government barriers to capital flows, a greater willingness of global savers to invest outside their home country—a decline in what is called "home bias"—and a "savings glut" in oil-exporting countries and emerging economies such as China. A telling sign that the world has been awash in savings is the recent decline in global real interest rates.[8]

Thus, the "global imbalances" that we are supposed to worry about in large part reflect a positive development in the global economy—the emergence of a vibrant cross-border market for assets. The liberalization of trade that began after World War II has finally been matched by a liberalization of capital flows. When capital flows were restricted, the only way a nation could pay for imported goods and services was by exporting goods and services of equal value. Now people can trade for goods and services by offering assets in return, and vice versa.

Global trade is still balanced in a cosmic sense, but individual nations can now mix and match current transactions and capital flows to match their own internal level of savings and investment. Domestic savers and investors can now search abroad for better returns, whereas domestic borrowers, corporations, and entrepreneurs can seek financing beyond the limited pool of domestic savings.

The good news for Americans is that the U.S. trade deficit reflects a continued willingness of savers around the world to put their money to work in the U.S. economy. Foreigners still like to buy our stuff—we remain the world's top exporter of goods and services combined—but they love to buy our assets. U.S. real estate, U.S. Treasury bills, bank deposits, and corporate bonds and stocks have remained relatively attractive to world savers. In our globalized world, Americans enjoy a comparative advantage not just in a range of high-end services and products but also in offering attractive investment assets. Why is that such a bad thing?

The Trade Deficit and Jobs—The Real Story

For critics of trade, the deficit symbolizes everything that is wrong with free trade and U.S. trade policy. They claim with passionate intensity that the trade deficit is a drag on growth, that it destroys millions of good middle-class jobs, that it is mortgaging our future to foreign lenders, and that it will end in a messy "hard landing" for the economy. None of those charges can be made to stick.

One of the most persistent myths about the trade deficit is that it destroys jobs. Critics of trade rely on a simplistic formula that assumes that imports invariably displace U.S. jobs and that only exports create jobs, and therefore a trade deficit by definition will cause a net loss of employment. A union-backed organization in Washington called the Economic Policy Institute has raised this line of analysis to an art. It routinely publishes studies that supposedly show that our bilateral trade deficits with China, Mexico, and other trading partners have put millions of Americans out of work. Typical was an October 2007 report with the headline-grabbing title, "Costly Trade with China: Millions of U.S. jobs displaced with net job loss in every state."[9]

A major flaw of such studies is that they ignore the other channels through which trade and globalization create economic activity and employment opportunities in the U.S. economy. They focus on one column of our international accounts while ignoring the other. Foreign capital flowing into the United States—the flip side of the trade deficit—creates jobs through direct investment in U.S. companies and indirectly by lowering interest rates, which stimulates more domestic investment. Meanwhile, imports allow U.S. employers to expand production and consumers to shift their cost savings to buy other goods and services. Even when trade does displace workers, in a flexible and growing economy, new jobs will be created elsewhere.

By focusing on bilateral balances, the EPI studies offer a misleading picture of the overall impact of trade. Although the total trade balance is determined by our nation's underlying levels of savings and investment, our various bilateral deficits are allocated by comparative advantage and patterns of savings and investment in individual countries. We run a large bilateral trade deficit with China not because of currency manipulation or unfair trade but because China has a comparative advantage in making the kind of lower-end consumer products that millions of Americans love to buy.

The EPI studies exaggerate the number of American companies and workers who compete directly against those who produce Chinese imports. As we saw in the previous chapter, many of our main imports from China—shoes, clothing, toys, and consumer electronics—were being imported from other countries before China's emergence as a major supplier. In fact, as imports from China have risen since 2001 as a share of total imports, imports from other Asian countries have been in relative decline. So imports from China do not typically displace U.S. production but instead displace imports from other countries.

The actual experience of the U.S. economy provides a powerful rebuttal to the elaborate computer models that supposedly show that trade deficits destroy jobs. If the EPI model were accurate, a worsening trade deficit—imports rising faster than exports— would cause net job creation to slow and the unemployment rate to rise. But in the real U.S. economy, the one where we all live and work,

Table 5.2
AS THE TRADE DEFICIT GROWS, UNEMPLOYMENT FALLS

	Trade Deficit as % of GDP			Unemployment Rate		
Period	Beginning	End	Change	Beginning	End	Change
1982–87	0.5%	3.2%	2.7%	8.5%	5.7%	−2.8%
1988–91	3.2%	0.5%	−2.7%	5.7%	7.3%	1.6%
1992–00	0.5%	3.9%	3.3%	7.3%	3.9%	−3.4%
2001	3.9%	3.6%	−0.3%	3.9%	5.7%	1.8%
2002–06	3.6%	5.8%	2.2%	5.7%	4.4%	−1.3%
2007–08	5.8%	4.5%	−1.3%	4.4%	7.0%	2.6%

a rising trade deficit is typically accompanied by faster job growth, while a shrinking deficit usually accompanies slower job growth.

The reason for the surprising correlation is that imports and jobs typically rise together with expanding domestic demand. Confident consumers will spend more on domestic as well as imported goods. Businesses that are expanding production will not only hire more workers but also import more machinery, inputs, and raw materials. The same rising tide that lifts domestic demand and employment also whets the appetite of American consumers and businesses for imported as well as domestic goods and services.

The EPI computer model may tell us that a trade deficit means fewer jobs, but the real-world experience of the American economy and the American people tell us the opposite. Consider America's recent economic experience, as laid out in Table 5.2. From 1982 to 1987, the trade deficit exploded during the Reagan era of the "twin deficits," while at the same time the unemployment rate fell from 8.5 percent to 5.7 percent. From 1988 to 1991, critics of the trade deficit cheered as a weaker dollar helped shrink the deficit to almost zero, yet during that same time the unemployment rate rose to a recessionary 7.3 percent.[10]

During the Clinton-era expansion of 1992–2000, the trade deficit ballooned while employment surged and the unemployment rate dipped below 4 percent. During the Bush II years, the trade deficit shrank slightly during the recession of 2001 while unemployment jumped, then the deficit rose through 2006 as the recovery gained steam and the unemployment rate fell back below 5 percent. Since 2007 and the onset of recession, the trade deficit has predictably declined while the unemployment rate has climbed. If the EPI model reflected the real economy, its next report should be titled, "Declining Trade Deficit Costly: Millions of U.S. Jobs Lost as Imports Fall."

For all the same reasons, a trade deficit is not a drag on growth. The trade balance is more like a safety valve or ballast for the economy. When the economy is in danger of overheating, imports expand to meet increased domestic demand in a way that does not stoke inflationary pressures. When the domestic economy slows, exports will usually grow faster than imports, or at least decline more slowly as they have during the current recession, providing an external source of demand to keep American factories working more than they would otherwise.

Americans should be wary that the critics of trade might actually get their wish. According to their story line, we could create millions of new middle-class jobs if only we could find a way to reduce the inflow of imports. Yet whenever imports really do decline, the news is bad for American workers. In a 2007 study for the Progressive Policy Institute, author Doug Karmin found that, "Since 1960, imports have decreased in value only five times—in 1961, 1975, 1982, 1991, and 2001. These years happen to mark the last five major U.S. recessions—periods when the economy slowed and unemployment rose."[11] The year 2009 is on course to join that dubious list.

During the economic expansion of the 1990s, the Clinton administration's Council of Economic Advisers explained that "the trade balance is a deceptive indicator of the Nation's economic performance and of the benefit that the United States derives from trade."[12] The state of the economy exerts a strong influence on demand for imports, the council noted, causing the trade deficit to increase when the U.S. economy is growing rapidly and to diminish when the economy is weak. "An increasing trade deficit is therefore usually the result of a strong economy, not the cause of a weak one."[13]

America As a "Debtor Nation"

There is no evidence that the trade deficit hurts the U.S. economy in the short run, but what about the long run? Are we mortgaging our nation's future prosperity and independence by borrowing hundreds of billions of dollars every year from abroad?

By definition, the cumulative effect of chronic trade deficits is that foreign ownership of U.S. assets will grow faster than U.S. ownership of assets abroad. The difference in the stock of cross-border assets is called the Net International Investment Position. During most of the 20th century, Americans owned more assets abroad than the rest of the world owned in the United States. In the mid 1980s, however, as large current account deficits accumulated, our nation's net investment position turned negative. In the eyes of many, America became a "debtor nation."

Like the trade deficit itself, our net investment position means less than what it appears. At the end of 2007, foreign investors owned $20.1 trillion worth of assets in the United States, whereas Americans owned $17.6 trillion in assets abroad. The $2.5 trillion gap is what Americans supposedly "owe" the rest of the world. If direct investment is calculated according to its current market value, rather than its value when acquired, the gap shrinks to $1.7 trillion.[14]

America's net international investment position is large by any measure but not quite so intimidating when compared to the overall size of the U.S. economy and the stock of assets owned by Americans. America's negative investment position represents about 16 percent of GDP. By a more fitting "assets-to-assets" comparison, it represents less than 3 percent of the more than $100 trillion in total assets owned at the end of 2007 by U.S. households, nonprofits, and businesses.[15]

It is misleading to refer to America's negative net investment position entirely as debt. Debt is commonly understood to be a specific amount owed to another party, to be repaid with interest during a specified period. Most of the assets owned by foreigners are indeed debt instruments such as U.S. Treasury bills, corporate bonds, and bank deposits. But more than 40 percent are equity holdings, such as corporate stock, real estate, and direct investment.[16] Those holdings are not debt in any real sense. Americans are not obligated to repay anything. Although foreigners earn dividends and profits from those assets, they are not entitled to any fixed interest or repayment of principal. When foreign holders sell those equity assets, they will receive whatever the market price happens to be at the time of sale.

Yes, But Is the Trade Deficit Sustainable?

Economists have been debating since the 1980s whether large trade deficits are sustainable. Clearly, the United States cannot run ever-expanding trade deficits forever. At some point, foreign savers will have gobbled up all available U.S. assets. But we are far from that point, and if market signals—exchange rates, interest rates, and asset prices—are allowed to adjust, trade balances will also adjust to a sustainable equilibrium.

So far, Americans have invested their money abroad wisely—so wisely, in fact, that we continue to earn a net surplus on investment income. Since 1990, U.S. residents have earned an average return of 1.3 percentage points more on our investments abroad than foreigners have earned in the United States.[17] One reason our returns are higher is that the United States is considered a more secure home for investment than most other locations in the world, which means those who invest in the United States will demand a smaller "risk premium" for investing here.

As a result, even though foreigners own a couple trillion dollars' more of assets in the United States than Americans own abroad, Americans continue to earn more on our international investments than what foreigners earn here. In 2007, American investors earned $818 billion abroad in interest, dividends, and operating profits, while foreign investors earned $736 billion on their holdings in the United States. That means Americans earned a net $82 billion surplus on foreign investment. Far from being a net drain on our national income, foreign investment remains a modest net positive. This is a "burden" that we can sustain for years to come.

Persistently large trade deficits are not unique in the world or in our own history. Great Britain, Spain, and Australia are all developed nations that have recently run trade deficits of comparable magnitude as a share of their economies. Like the United States, all of them have enjoyed relatively good economic performance during the past 20 years compared to other advanced economies.

America's own history shows that persistent trade deficits can be sustainable for long periods of dynamic growth. For most of our first century as a nation, Americans imported more merchandise from the rest of the world than we exported. According to economic historian Robert Lipsey, "The United States began its existence as a net debtor and all through the 19th century and up to World War I it paid out more in interest on its debts then it earned on its foreign assets."[18] The trade deficits of that era made room for a steady inflow of foreign capital that "went to large, lumpy, social overhead capital projects, such as canals, railways, electrical utilities, and telephone and telegraph systems."[19]

Today's inflow of capital is not funding canals and railways, but as we will see in the next chapter, it is funding automobile and chemical plants, research and development (R&D) facilities, and the huge and growing federal budget deficit. The trade deficits of today, like those of the 19th century, allow the world to invest in expanding the productive capacity of the private-sector American economy. The net inflow of investment, then and now, makes American workers more productive than we would be otherwise, leading directly to better jobs and higher living standards.

A Hard or Soft Landing?

Another fear is that trade deficits will erode the confidence of foreign investors in the U.S. economy, spurring them to withdraw their funds and precipitating a "hard landing" for the U.S. economy. The often predicted scenario has become a standard feature of news stories and TV analysis: Big trade deficits spark worries abroad, foreign investors withdraw their funds, the dollar plunges, interest rates soar, and the U.S. economy stumbles into recession.

As much as the critics would try, the economic downturn that accelerated in 2008 cannot be blamed on the trade deficit. It was not precipitated by foreign investor jitters, a slumping dollar, rising interest rates, or any other element of the hard-landing scenario. It was sparked by the bursting of the domestic housing bubble, which was entirely a "made in America" phenomenon. If anything, America's relative attractiveness to foreign investors has been enhanced during the period of global economic uncertainty as global savers seek a "safe haven" for their investments. As a result, the dollar strengthened during 2008 as interest rates fell—just the opposite script from what the trade-deficit doomsayers have been predicting for years. We should be thankful that as our domestic credit markets stumbled, Americans have been able to borrow what we need from the rest of the world.

The most likely scenario for the unwinding of the trade deficit will not be a hard landing but a soft landing. At some point in the future, a critical mass of global investors will decide that the share of their portfolios invested in the U.S. economy has reached an optimum level. As interest in U.S. assets levels off, so too will demand for dollars to buy those assets. As the dollar adjusts downward, so too will the current account deficit, as a weaker dollar makes U.S. exports relatively more attractive in global markets. The key to a soft landing will be flexible and open markets that allow capital flows and exchange rates to adjust to changing fundamentals.

A trade-deficit-induced "hard landing" is unlikely as long as the United States maintains a hospitable climate for investment. If foreign investors lose confidence in the U.S. economy for whatever reason, we will be in for a rough ride. A current account deficit is not necessary for that scenario to happen. Even if the United States were to maintain a perfectly balanced current account and net international investment position, we would still be vulnerable to a loss of confidence and a withdrawal of foreign investment. Indeed, if Americans lose confidence in the economy and begin sending more of their savings abroad, the "hard landing" scenario would be just as plausible. In truth, any nation connected to the global economy is vulnerable to one degree or another to capital flight. Our response should not be to seek a smaller trade deficit or to slap controls on capital flows but to make every effort to maintain our attractiveness as a home for foreign investment.

Why Protectionism Won't Work

Raising trade barriers or devaluing the currency cannot "cure" the trade deficit because neither would do anything to alter our nation's underlying levels of savings and investment. If the central bank devalued the U.S. dollar, the result would be to pump more dollars into the global exchange markets. As those dollars found their way back to the U.S. economy, the overall inflation level would rise. Prices for U.S. exports would soon reflect higher domestic costs, offsetting the depreciation of the dollar and leaving U.S. exports no more competitive than before the depreciation.

If Congress were to impose new barriers on imports in a misguided effort to close the trade gap, the results would be equally self-defeating. In 2003, Omaha, Neb., billionaire Warren Buffett proposed an idea in *Fortune* magazine to eliminate the trade deficit by requiring tradable "import certificates," a kind of "cap and trade" scheme for the current account deficit. Under his plan, if a U.S. company wanted to import $100,000 worth of stuff, the company would need a certificate, which it could obtain only by exporting $100,000 worth—thus guaranteeing "balanced trade." The certificates would be tradable because the companies that export would not necessarily be the same companies wanting to import.[20] Buffett's proposal is really just an old and failed idea wrapped in a new gimmick. Countries such as India tried for decades to manage their balance of payments through import licensing schemes, only to give up after years of corruption, lagging trade, and slow growth.

Famous for his long-term outlook on investing, Mr. Buffett failed to think through even the most obvious and immediate implications of his plan. If Americans were forbidden to spend more on imports than we earn from exports, the world's foreign exchange markets would be deprived of the $700 billion that Americans currently spend annually on imports over and above what we earn for exports. The constricted supply of dollars would cause the price of the dollar to soar. A sharply appreciating dollar, in turn, would make U.S. exports less competitive in the global marketplace. The lethal combination of a soaring dollar and a major new restriction on imports would mean a drastic fall in trade overall, with exports falling and imports tumbling even further.

Meanwhile, an expensive dollar would make U.S. assets less attractive to foreign investors. The $700 billion in net foreign investment flowing into the U.S. economy each year (the flip side of the current account deficit) would dry up. Less demand for U.S. assets would force the federal government to pay a higher interest rate to finance its budget deficit. Homeowners would pay higher rates on their mortgages, aggravating the already high foreclosure rate. American companies would pay more to banks and bondholders to finance investment, and foreign companies would build fewer factories in the United States. The U.S. economy would slow even further.

Increase Savings, Not Trade Barriers

If our politicians are determined to do something about the trade deficit, the most constructive step they could take would be to promote a higher level of national savings. More domestic savings would reduce the need for foreign funds to finance domestic investment. A larger pool of domestic savings would cause domestic interest rates to fall, which would make U.S. interest-bearing assets less attractive to foreign investors, reducing foreign demand for dollars and causing the dollar to depreciate in the foreign exchange markets. A weaker dollar, in turn, would make U.S. exports more competitive and imports less so—shrinking the trade deficit without resorting to an artificially debased U.S. dollar, higher trade barriers, or wacky import licensing schemes.

How to spur greater domestic savings is both straightforward and challenging. The most direct approach would be to reduce or eliminate the federal budget deficit. If the federal government were to borrow a few hundred billion dollars less each year, the pool of domestic savings would rise, and more domestic funds would be available for investment. My Cato colleagues have provided a long list of ideas of where to cut the federal budget in a way that would put a huge dent in the deficit without raising taxes.[21] Politicians should not complain about the trade deficit unless they are willing to drastically reduce the federal government's gargantuan appetite for debt that contributes so much to the size of the trade deficit in the first place. Ironically, many members of Congress who complain loudest about the trade deficit have voted in the name of economic "stimulus" to plunge us ever deeper in debt.

Policies should also be implemented to encourage more savings among households. This encouragement could be done most effectively by eliminating the bias in the federal tax code that currently favors debt and discourages savings and investment. Taxing consumption rather than production and income would give individuals and companies an incentive to save more of their income for the future. The domestic pool of savings would grow, reducing the demand for foreign capital to fund domestic investment.

It would also be helpful if politicians and economic commentators would stop lecturing Americans that it is our patriotic duty to consume as much as we can, even if it means running up credit card debts and borrowing more against our home value than necessary. Rediscovering a "culture of thrift" would put more families on a firm financial footing while providing more domestic savings for the national economy. Our individual bank balances would be larger, and our nation's trade deficit smaller.

The greatest threat posed by the trade deficit is not anything inherent in its nature but the danger that politicians will seek to administer protectionist "cures" that would be far more damaging than the imagined harm caused by a macroeconomic statistic.

6. Foreign Investment: Paying Dividends for American Families

In late 2008, the CEOs of the "Big Three" Detroit-based automakers flew to Washington in their corporate jets to ask Congress for billions of dollars in emergency aid. Caught in a downward spiral of declining sales and stubbornly high costs, the CEOs predicted the virtual end of the American automobile industry if Congress denied them tens of billions in "bridge loans." At a November 19, 2008, hearing before the House Financial Services Committee, now-former General Motors chief Rick Wagoner warned members that "if the domestic industry were allowed fail, the societal cost would be catastrophic." His counterpart at Ford, Alan Mulally, predicted that "the collapse of the U.S. automotive industry would be a calamity for the entire economy."[1]

Both CEOs spoke as though they represented the "U.S. automotive industry," when in fact the Big Three are only a part, and a declining part, of a rapidly changing U.S. motor vehicle market. More than half the new cars now bought by Americans each year are made by car companies headquartered outside the United States, bearing such foreign nameplates as Toyota, Honda, Nissan, Kia, Volkswagen, and BMW. Most of those "foreign" cars are made in the United States by workers who are just as American as employees of the Big Three. And two of the Big Three automakers—Ford and GM—now sell more of their own cars abroad than they do in the United States, with most of those cars made abroad. In short, the U.S. automobile market and industry have become globalized.

As a consequence, we can no longer neatly divide the auto industry into "us" versus "them." Toyota, Subaru, Isuzu, Mazda, Mitsubishi, Nissan, Honda, and Hino are all Japanese companies that produce motor vehicles in the United States. According to the Japanese Automobile Manufacturing Association, its members made 3.4 million vehicles in the United States in 2007 at 17 plants in 11 different states. Most cars now made in the United States are not made in

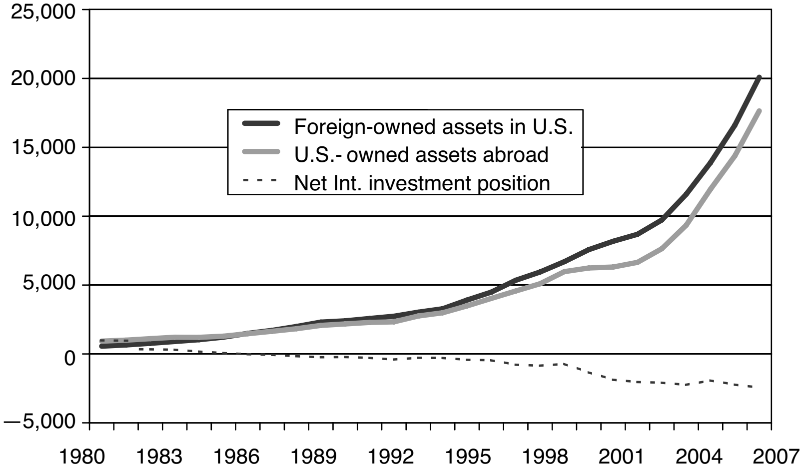
Michigan and Ohio, but in such places as San Antonio, Texas; Vance, Alabama; Georgetown, Kentucky; Smyrna and Decherd, Tennessee; West Point, Georgia; and Greer, South Carolina. Those and other factories owned by foreign producers now employ nearly a third of all automotive industry workers in the United States, and that share continues to grow.

Meanwhile, Ford and GM have gone global themselves. Nearly two-thirds of GM's vehicle sales in the first quarter of 2008 were outside the United States. Through a joint-production venture with Shanghai Automotive Industry Corp., the company supplies 10 percent of the cars sold in China, second only to Volkswagen in market share. GM sells twice as many Buicks in China as it does in the United States.[2] It builds cars and SUVs in South Africa for export to Europe and has become the biggest nondomestic carmaker in Russia, selling more than a quarter of a million vehicles there in 2007.[3] At Ford, international operations in 2007 accounted for 46 percent of its assets, 53 percent of its revenue, and 57 percent of its vehicles sold. Although Ford sales have been dropping in the U.S. market, they were up 19 percent in South America and 26 percent in China in 2007.[4] All three Detroit automakers have deeply integrated their North American operations with our NAFTA partners, Canada and Mexico.

Cross-border investment is not unique to the automobile industry. Across the American economic landscape, foreign investment is raising the productivity of American workers, injecting new competition into the consumer market, and opening opportunities for American companies to reach new customers and earn more profits in the world's fastest-growing markets. Fears about undue foreign influence in the United States or U.S. companies "shipping jobs overseas" or a global "race to the bottom" are overblown or unfounded.

Foreign investment flows are the deep undercurrent of the global economy. Trade in goods and services produces the waves and the froth, but like the mighty Gulf Stream, it is the trade in assets that determines the climate. The United States is by far the largest recipient and supplier of global foreign investment. At the end of 2007, Americans owned \$17.6 trillion in assets abroad, whereas foreign investors owned \$20.1 trillion in assets in the United States.[5] The stock of both inward and outward investment has grown exponentially in recent years, doubling since 2003 (see Figure 6.1).

Figure 6.1
CROSS-BORDER OWNERSHIP OF ASSETS
(in billions of U.S. dollars)



Foreign investment flows through two channels: portfolio investment and direct investment. Portfolio investments are "passive," like buying shares in a mutual fund in which the investor has no influence over how the enterprises are run. Examples are bank deposits, bonds, or stock shares amounting to less than 10 percent of an individual company's value. Direct investments occur when a foreign investor buys 10 percent or more of the controlling shares of a company, or when it owns the foreign affiliate outright. When the foreign investor's share exceeds 50 percent, the company is known as a majority-owned foreign affiliate, or MOFA. Multinational companies are those that own controlling shares in at least one affiliate outside their home country.

Most of the investment flows worldwide are of the portfolio variety. Tens of billions of dollars can move across borders in an instant, with bonds, stocks, and other investment paper changing hands frequently. Direct investment tends to be more stable because it involves ownership and control of hard assets—factories, warehouses, real estate, and companies with office buildings and equipment.

Foreign investment has never been more important to the global economy. According to the U.N. Conference on Trade and Development, foreign-direct investment flows in 2007 reached a record $1.8 trillion. The United States was the largest recipient country, followed in order by the United Kingdom, France, Canada, and the Netherlands. (Notice that China is not on that list.) The global stock of foreign direct investment (FDI) has reached $15 trillion. An amazing 11 percent of global economic output is now produced by the nearly 800,000 foreign-owned affiliates operated by the world's 80,000 multinational companies.[6]

Foreign investment, like trade in goods and services, has brought broad benefits to millions of Americans—in two fundamental ways. When foreigners invest in the United States, the inflow of portfolio capital benefits the large majority of Americans with lower interest rates, whereas FDI injects new competition into the consumer market and creates better-paying jobs by upgrading our factories and machinery and introducing new technology and ways of doing business. And when Americans invest abroad, we earn higher returns on our savings, we diversify our investment portfolio to safeguard the future, and we reach new customers with American-brand goods and services.

The World Invests in America

In 2001, I spoke at a conference in an unusual venue—the auditorium of the sprawling BMW plant in Greer, South Carolina. I was invited there by then-Rep. and now-Sen. Jim DeMint, a South Carolina Republican who has successfully run for re-election in his district and state on a protrade platform. While there, I learned that the German-owned state-of-the art plant employed 4,000 workers, who at the time were making Z-3 Roadster convertibles. (I wasn't paid by BMW or anybody else for the trip, although I was half hoping that I could be compensated in-kind with the title to one of the new cars on the lot.) By 2007, employment at the facility had grown to 5,400 full-time workers producing 157,000 vehicles, two-thirds of them exported mostly through the port of Charleston. BMW announced in 2008 that it would be investing another $750 million to expand capacity to 240,000 vehicles per year.[7] Conveniently, the BMW plant is just down Interstate 85 from a French-owned Michelin tire factory. In fact, upstate South Carolina is home to hundreds of foreign-owned facilities attracted by the state's flexible workforce and friendly business climate. It is a success story that has been replicated in a number of other states.

The United States is a magnet for global savings. Year after year, hundreds of billions of dollars flow into the United States from abroad to invest in our economy. An important share of the inflow is FDI. From 2003 through 2007, inflows of FDI in the U.S. economy averaged $153 billion a year. Major investments flowed into the financial, insurance, and wholesale sectors, but by far the biggest single share flowed into U.S. manufacturing. During that period, foreign manufacturing companies invested an average of $59 billion a year in America's manufacturing base. Sectors that attracted the most foreign investment were chemicals, machinery, computers and electronics, and "other manufacturing."[8] It appears that foreign companies are also skeptical of America's rumored "deindustrialization."

A Foreign Boss, Five Million Good Jobs

Foreign-owned affiliates in the United States employed more than five million American workers in 2006, according to the Commerce Department's latest survey. That is 4.6 percent of the private workforce, up from 3.4 percent 20 years ago. States with the highest share of workers employed by foreign affiliates are Connecticut, South Carolina, Delaware, New Hampshire, and New Jersey. Two million workers are employed by manufacturing affiliates—more than one in eight U.S. factory workers. The highest shares of foreign-affiliate employment are in chemicals, mining, and motor vehicles and parts. In 2006, 325,000 Americans worked for foreign affiliates in the motor vehicle and parts sector alone, 278,000 in chemicals, and 180,000 in nonmetallic mineral products such as cement.[9]

Americans who work for foreign-owned affiliates typically have some of the best jobs available. On average, they earn $63,400 a year compared to the U.S. average of $48,200.[10] And the main reason why those affiliates pay so well is that they are among the most globally connected, productive, and innovative enterprises in America. Foreign-owned affiliates account for 19 percent of total U.S. exports and 26 percent of imports. Together, they spent $34 billion on R&D in 2006. As the Commerce Department noted, "U.S. affiliates accounted for 14 percent of the total R&D performed by all U.S. business, a share notably higher than the affiliate share of U.S. private industry value added or employment."[11] Three-quarters of the foreign-affiliate R&D was concentrated in manufacturing, especially chemicals, motor vehicles, and pharmaceuticals.

Americans should think of FDI in our country as a form of "insourcing." For years and on a large scale, foreign companies have been "shipping jobs overseas" to America. By acquiring affiliates in the United States, foreign multinational companies can deliver their products and services more directly to millions of middle-class and wealthy American consumers. They can more successfully research and develop new products for the American market if they are closer to their customers. They can hire skilled and motivated American workers. And they can enjoy the advantages of operating in a relatively free and open market with a transparent legal system and stable political environment. The continual inflow of foreign investment is, among other things, an expression of confidence in the American system.

A Matter of Interest to U.S. Borrowers

Even when foreign investors are not directly operating affiliates and employing Americans, we still benefit from their passive investment in the U.S. economy. The inflow of portfolio capital into U.S. stocks, bonds, and bank accounts leads to lower borrowing costs for Americans and more investment by Americans in our own economy. Of the $20 trillion in foreign-owned assets in the United States at the end of 2007, by far the biggest share was portfolio investment, including $6 trillion in corporate bonds and stocks, $4 trillion in bank deposits, $3.3 trillion in foreign official assets (mostly U.S. Treasury bills owned by foreign central banks), and $2 trillion in financial derivatives.

Those trillions in passive investment provide working capital for U.S. companies and help our profligate federal government finance its yawning budget deficit without devouring all of the nation's private seed corn. When foreigners buy a $1,000 Treasury bond, that is $1,000 the U.S. government does not need to borrow from the limited pool of domestic U.S. savings. Instead, we can use our savings to fund education, investment in plants and equipment, and research into new products. Foreign investment thus almost entirely eliminates the "crowding out" of domestic private investment by government borrowing.

Foreign investment in the U.S. economy has exerted measurable downward pressure on U.S. interest rates. Because Americans are free to tap into the global pool of savings, the "price" of borrowing—in other words, the rate of interest—is lower than it would be if we were limited to our own supply of domestic savings. In a 2006 study from the National Bureau of Economic Research, economists Francis E. Warnock and Veronica Cacdac Warnock calculated the impact of foreign investment just in U.S. Treasury bonds alone from 1984 to 2005. They found that "foreign inflows into U.S. bonds reduce the 10-year Treasury yield by 90 basis points"[12] That's almost a full percentage point lower than what rates would be without the inflows. Almost two-thirds of the reduction came from the purchase of bonds by East Asian sources, mostly the central banks of China and Japan.

Those lower rates translate into real savings for Americans. A homeowner with a $150,000, 30-year mortgage is saving more than $1,000 a year in interest payments. That can spell the difference between continued homeownership and foreclosure for a large number of American families. The federal government is saving more than $40 billion a year from lower interest payments on its outstanding public debt. Lower interest rates also mean lower costs for American farmers and small businesses who need to borrow for new equipment, buildings, and land. Those savings can be attributed directly to foreign investment in U.S. Treasury bills.

Through portfolio investment in the United States, anonymous foreign investors have done far more over the years to make housing more affordable for Americans than shell games and gimmicks by Fannie Mae and Freddie Mac. And the foreign investors did not distort the market with "subprime" loans misdirected and repackaged in mysterious ways that aggravated the housing bubble and crash. Instead, foreign investment has delivered a transparent and universal cut in long-term interest rates available equally to all Americans.

A Loss of Sovereignty, or a Stake in Our Prosperity?

Despite all the benefits of inward foreign investment, reasonable Americans worry that the cost is too high. One major concern is the loss of American sovereignty. When foreign investors own a $20 trillion share of U.S. assets, it raises the fear that our nation will be vulnerable to outside influence and even blackmail by hostile foreign powers. A foreign holder could threaten to withdraw large amounts of capital, driving up interest rates, driving down the value of the dollar, and disrupting the U.S. economy. Those worries focus on funds controlled by foreign governments, such as central bank reserves and government-directed "sovereign wealth funds" (SWFs). On February 28, 2007, after the stock market had dropped precipitously the day before, then-Sen. Hillary Clinton of New York took to the floor of the Senate to warn her colleagues, "And while our markets were reeling, alarm bells were ringing once again over the irresponsible fiscal and economic policies of this Administration that continue to surrender the economic sovereignty of our country to foreign banks, investors, and governments piece by piece."[13]

The worries expressed by Senator Clinton are possible in theory, but highly unlikely for several reasons.

One, despite the rapid growth of foreign investment in the United States, it remains modest compared to the total value of U.S. assets. At the end of the second quarter of 2008, the combined assets of households, nonprofits, and businesses in the United States was still a whopping $110 trillion.[14] Foreign investment is less than 20 percent of that total, and foreign investment directed by central banks and other foreign government agencies is only 3 percent. Foreign investment is too diversified to give any one investor much leverage. The central bank of China is the single biggest foreign holder of U.S. Treasury bills, with nearly $600 billion in its portfolio in 2008. But even those holdings represent only about 15 percent of the federal government's outstanding public debt and a tiny fraction of total U.S.-based assets. And when one foreign holder of U.S. assets sells, another foreign investor may be ready to buy.

Two, even if an outside investor such as the government of China could disrupt the U.S. economy by dumping U.S. Treasury bills, it would not be in the Chinese government's own interest to do so. An economic downturn in the United States, such as the one that hit the U.S. economy full force in 2008, also exacts a toll on our commercial partners. Countries such as China see their exports to the U.S. market slump along with the dollar value of their remaining U.S. assets. Investment in the United States gives foreigners a stake in America's prosperity.

Three, SWFs are still a small and unremarkable slice of global investment. These funds are often established by countries that have accumulated large foreign currency reserves, such as the oil-exporting countries of the Middle East. The funds seek higher returns by diversifying out of more conservative government bonds and into stock funds and real estate. According to testimony in February 2008 by then-Treasury Undersecretary David McCormick, the 40 SWFs in the world control $3 trillion in assets, compared to the $190 trillion stock of global financial assets and $62 trillion managed by private institutional investors.[15] SWFs do operate under different rules than private funds: They do not typically pay domestic taxes, and they can forgo profits for the sake of national objectives. But SWFs so far have not behaved much differently from other actors in global capital markets. Their managers want solid returns at low risk. At a time when our domestic credit markets are reluctant to lend, we should welcome foreign savers who want to put their money to work in America.

Concerns about sovereignty and foreign investment can sound like self-fulfilling prophesies. Out of fear that foreigners may remove or deny us investment funds, we are urged to take actions that in effect deny us what we fear losing. By this tortured logic, we must deprive ourselves of the immediate benefits of inflowing capital—namely, lower interest rates—to avoid the small risk of being partly deprived of the inflow in the future. We deny ourselves a benefit now at great and continuing expense, out of fear that someone else may remove some of the benefit in the future.

Other worries focus on specific direct investments by foreign companies in certain "strategic" U.S. assets. Those worries are multiplied when the enterprise is controlled by a foreign government. In the 1980s and early 1990s, fears focused on private Japanese investors buying U.S. technology companies and prominent real estate. More recently, firestorms have erupted over the proposed purchase of the American energy company UNOCAL by the China National Offshore Oil Corporation in 2005, and the proposed operation of six U.S. ports by Dubai Ports World in 2006. Public and congressional opposition scuttled both acquisitions. Fears in both cases were exaggerated. The CNOOC acquisition would have given the Chinese no leverage in domestic or global energy markets. The Dubai Ports World company is based in the Persian Gulf state of the United Arab Emirates, which is among the most modern, moderate, and globally connected of the Arab states. It operates port facilities around the world in a number of Western countries. The actual threat to U.S. port security would have been negligible.

Even if truly worrisome acquisitions were to surface, the U.S. government has established a review mechanism to ensure that U.S. security is not compromised. The Committee on Foreign Investment in the United States is an interagency committee that includes the Secretary of the Treasury and other top U.S. officials. The CFIUS has the power to screen and reject any foreign acquisition that in any way compromises U.S. national security. It would be foolish to sacrifice the benefits of foreign investment out of misguided fears that have already been reasonably and adequately addressed in a review process that Congress strengthened in 2006.

The greatest danger is not too much foreign investment in the U.S. economy but unwise policies that send investment elsewhere. Xenophobia, burdensome regulations, high corporate tax rates, an inadequately educated and trained workforce, and trade and immigration restrictions can discourage foreign investors from choosing to put their savings to work in the United States. If foreign investment inflows decline, American workers will be the losers.

Americans Invest in the World

The other side of the foreign investment coin is even more controversial but just as beneficial. Each year Americans spend hundreds of billions of our savings to buy assets in foreign countries. Our freedom to invest abroad allows American companies and businesses to reach new customers for their products and American citizens to earn higher returns on our savings.

Many of our fellow Americans take a darker view of outward foreign investment. Companies that establish and expand operations abroad stand accused of "outsourcing good American jobs." In 2004, Democratic presidential candidate John Kerry branded business executives who made such decisions "Benedict Arnold CEOs." In his nomination acceptance speech in Denver in 2008, Barack Obama pledged that, "Unlike John McCain, I will stop giving tax breaks to corporations that ship jobs overseas, and I will start giving them to companies that create good jobs right here in America."

To demonize U.S. companies that own production facilities abroad is to target virtually every major American company. At latest count, more than 2,500 U.S. corporations own and operate a total of 23,853 affiliates in other countries. In 2006, majority-owned foreign affiliates of U.S. companies posted $4.1 trillion in sales, created just under $1 trillion in value-added, employed 9.5 million foreign workers, and earned $644 billion in net income for their U.S.–based parent companies.[16]

In a global economy, it can make good sense for corporations to actually make and deliver some of their products outside their home country. It certainly makes sense for the foreign-owned companies that employ those five million Americans at their affiliates in the United States. American companies that operate affiliates abroad do so for similar reasons.

For individual Americans, investing in the world has been profitable. In 2007, Americans earned $818 billion on their investments abroad. That works out to a return on investment of 4.6 percent on the $17 trillion in U.S.–owned assets, a rate of return almost a full point higher than what foreign investors earned on average in the U.S. market. The freedom to invest abroad has allowed millions of Americans to earn higher rates at less risk through their 401(k) plans, pension funds, and mutual fund investments.

Reaching Billions of New Customers

The primary reason why U.S. companies acquire affiliates abroad is to sell more products to foreign customers. Certain services can only be delivered on the spot, where the company and the client must be in the same place. McDonald's cannot "export" Big Macs to Russia, nor can Wal-Mart export its retail services to Mexico. The provider must have a physical presence in the foreign market. U.S. companies also establish foreign affiliates because of certain advantages in the host country—lower-cost labor, ready access to raw materials and other inputs, reduced transportation costs, and proximity to their ultimate customers. Operating affiliates abroad allows U.S. companies to maintain control over their brand name and intellectual property such as trademarks, patents, and engineering expertise. Yes, the motivations can include access to "cheap labor," but labor costs are not the principal motivation for most U.S. direct investment abroad—as we will see in a moment.

Politicians focus most of their attention on comparing exports and imports, but the most common way American companies sell their goods and services in the global market today is through their overseas affiliates. In 2006, U.S. multinational companies sold $3,301 billion in goods through their majority-owned affiliates abroad and $677 billion in services. For every $1 billion in goods that U.S. multinational companies exported from the United States in 2006, those same companies sold $6.2 billion worth through their overseas operations.[17] For every $1 billion in service exports, U.S.–owned affiliates abroad sold $1.6 billion.[18]

Contrary to popular myth, U.S. multinational companies do not generally use their foreign operations as an "export platform" back to the United States. Close to 90 percent of the goods and services produced by U.S.–owned affiliates abroad are sold to customers either in the host country or exported to consumers in third countries outside the United States. Even in Mexico and China, where low-wage workers are supposedly too poor to buy American products, more than half of the production of new and existing U.S. affiliates is sold in their domestic markets and another third is exported to other countries, whereas customers in the United States accounted for only 17 percent of sales.[19] Think of General Motors in China or Ford in Europe: the primary focus of their overseas operations is to produce cars custom made for local markets, not to export back to the United States to displace production here.

More Jobs Abroad, More Jobs at Home

Investing abroad is not about "shipping jobs overseas." There is no evidence that expanding employment at U.S.–owned affiliates comes at the expense of overall employment by parent companies back home in the United States. In fact, the evidence and experience of U.S. multinational companies points in the opposite direction: Foreign and domestic operations tend to complement each other and expand together. A successful company operating in a favorable business climate will tend to expand employment at both its domestic and overseas operations. More activity and sales abroad usually require more managers, accountants, lawyers, engineers, and production workers at the parent company.

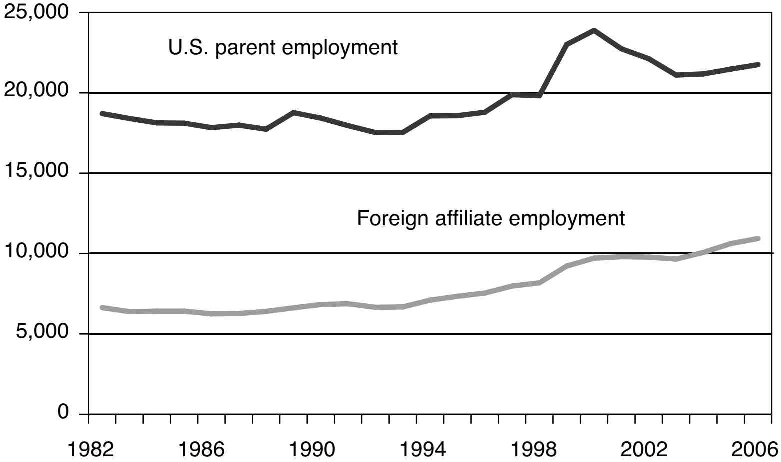
Consider Caterpillar Inc., the Peoria, Ill.–based company known for making giant earthmoving equipment. From 2005 through 2007, the company enjoyed booming global sales because of strong growth in overseas markets, especially those with resources extracted from the ground. According to the company's 2007 annual report, Caterpillar earned 63 percent of its sales revenue abroad, including $1 billion in sales in China alone. In response, Caterpillar ramped up its employment at its overseas affiliates during that time from 41,238 to 50,788, an increase of almost 10,000 workers. During that same three-year period, the company expanded its domestic employment from 43,878 to 50,545, a healthy increase of 6,667. As the current downturn took its toll on the company's sales, it has downsized its workforce abroad as it has downsized at home.

Caterpillar's experience is not unusual for U.S. multinational companies. A 2005 study from the National Bureau of Economic Research found that, during the 1980s and 1990s, there was "a strong positive correlation between domestic and foreign growth rates of multinational firms." After analyzing the operations of U.S. multinational companies at home and abroad, economists Mihir A. Desai, C. Fritz Foley, and James R. Hines Jr. found that a 10 percent increase in capital investment in existing foreign affiliates was associated with a 2.2 percent increase in domestic investment by the same company and a 4 percent increase in compensation for its domestic workforce. They also found a positive connection between foreign and domestic sales, assets, and numbers of employees.[20] "Foreign production requires inputs of tangible or intellectual property produced in the home country," the authors explained. "Greater foreign activity spurs higher exports from American parent companies to foreign affiliates and greater domestic R&D spending."[21]

The positive connection between foreign and domestic employment of U.S. multinational companies has continued into the current decade. As Figure 6.2 shows, parent and affiliate employment have tracked each other since the early 1980s. More recently, employment rose briskly for parents and affiliates alike in the boom of the late 1990s, fell for both during the downturn and slow recovery of 2001–2003, and then rose again for both from 2003 through 2006. Although the numbers have not been reported yet for 2007 and 2008, it's likely that the loss of net jobs in the domestic U.S. economy will be mirrored by much slower growth or outright decline in foreign affiliate employment.

The myth of jobs being shipped overseas endures on the campaign trail. In a primary debate in Texas in February 2008, then-Senator Obama said, "In Youngstown, Ohio, I've talked to workers who have seen their plants shipped overseas as a consequence of bad trade deals like NAFTA, literally seeing equipment unbolted from

Figure 6.2
U.S. Multinational Employment
(thousands)



Source: Raymond J. Mataloni Jr., "U.S. Multinational Companies: Operations in 2006," *Survey of Current Business* 88, no. 11 (November 2008): Table 1, p. 27.

the floors of factories and shipped to China."[22] That makes for a good sound bite in the heat of a campaign, but it does not reflect the broader reality of outward foreign investment by U.S. manufacturers.

Outflows of U.S. manufacturing investment to Mexico and China have been modest by any measure. Between 2003 and 2007, U.S. manufacturing companies sent an average of $2 billion a year in direct investment to China and $1.9 billion to Mexico. That pales in comparison to the $22 billion a year in manufacturing capital "shipped" to Europe, but talking about seeing equipment unbolted from the floors of U.S. factories and shipped to England just doesn't have the same effect. The modest annual outflow in investment to China and Mexico is positively dwarfed by the annual inflow of manufacturing investment to the United States and the average of $165 billion a year that U.S. manufacturers invest domestically in plant and equipment.[23]

The fear of manufacturing jobs being shipped to China and Mexico is not supported by the evidence. While U.S. factories were famously shedding those 3 million net jobs between 2000 and 2006, U.S.–

Table 6.1
EMPLOYMENT AT U.S.–OWNED AFFILIATES, 2000–06
(thousands)

	Total			Manufacturing		
	2000	2006	Change	2000	2006	Change
All countries	8,171	9,498	1,326	4,409	4,536	128
Rich economies	5,296	5,751	455	2,545	2,450	−96
Other economies	2,876	3,747	871	1,864	2,087	223
Mexico	823	890	67	642	545	−97
China	252	589	337	194	365	172
India	71	211	140	48	67	19
U.S. employment	131,785	136,174	4,389	17,263	14,197	−3,066

SOURCE: Mataloni Jr., "U.S. Multinational Companies: Operations in 2006," Bureau of Economic Analysis.

owned manufacturing affiliates abroad increased their employment by a mere 128,000 jobs. An increase in 172,000 jobs at U.S.–owned affiliates in China was offset by an actual decline in employment at affiliates in Mexico and Europe, where the number of manufacturing jobs decline by nearly 200,000 (see Table 6.1). As we saw in chapter 4, the large majority of factory jobs lost in the United States since 2000 were not shipped to China or anywhere else, but were lost to automation and other sources of increased efficiency in U.S. manufacturing.

U.S. investment in China remains modest compared to the huge investment that politicians and pundits have in making it an issue. U.S. direct investment in China remains a relatively small part of China's overall economy and a small part of America's total investments abroad. Of the nearly 10 million workers that U.S. affiliates employ abroad, fewer than 5 percent are Chinese. American-owned affiliates employ just as many manufacturing workers in high-wage Germany as they do in low-wage China.[24]

Politicians are not usually specific about exactly what "tax breaks" they are talking about. The biggest tax exemption for U.S. companies that invest abroad is the deferral of tax payments for "active" income. U.S. corporations are generally liable for tax on their worldwide income, whether it is earned in the United States or abroad. But the relatively high U.S. corporate tax rate is not applied to income earned abroad that is reinvested abroad in productive operations. U.S. multinationals are only taxed on foreign income when they repatriate the earnings to the United States. Not surprisingly, the deferral of active income gives U.S. companies a powerful incentive to reinvest what they earn abroad, but this is not a green light to "ship jobs overseas."

Such deferral may sound like an unjustified tax break to some, but every major industrial country offers at least as favorable treatment of foreign income to their multinational corporations. Indeed, numerous major countries exempt their companies from paying any tax on their foreign business operations. Foreign governments seem to more readily grasp the fact that when corporations have healthy and expanding foreign operations, it is good for the parent company and its workers back home.[25]

If President Obama and other leaders in Washington want to encourage more investment in the United States, they should lower the U.S. corporate tax rate, not seek to extend the high U.S. rate to the overseas activities of U.S. companies. Extending high U.S. tax rates to earnings abroad would put U.S. companies at a competitive disadvantage as they try to compete to sell their goods and services. Their French and German competitors in third-country markets would continue to pay the lower corporate tax rates applied by the host country, while U.S. companies would be burdened with paying the higher U.S. rate. The result would be lost sales, lower profits, and fewer employment opportunities in the parent company back on American soil.

Politicians who disparage investment in foreign operations are wedded to an outdated and misguided economic model that glorifies domestic production for export above all other ways for Americans to engage in the global economy. They would deny Americans access to hundreds of millions of foreign customers and access to lower-cost inputs through global supply chains. In short, they would cripple American companies that are trying to compete in global markets.

The Myth of the "Race to the Bottom"

Another common but unfounded fear of foreign investment is that it stokes a "race to the bottom." This dark theory of globalization contends that if multinational companies can move their capital freely around the world, they will gravitate to countries where wage costs are lowest and labor and environmental standards are the least restrictive. Richer countries such as the United States will then be forced to reduce domestic wages and weaken standards in a “race to the bottom” to keep investment capital from fleeing. The push to insert labor and environmental standards into all trade agreements springs from just such fears. If we don’t explicitly forbid our free-trade partners from trashing their own standards and suppressing their own workers’ wages, so the theory goes, U.S. exporters and workers will face unfair pressure to denigrate our own standards to remain competitive.

The “race to the bottom” is yet another common myth about free trade and globalization that is refuted daily by what is actually happening in the world. If the theory were true—that a major driver of investment decisions for American multinational companies is a remorseless search for cheap labor and low standards abroad—then we should expect that most outward foreign investment from the United States would flow to low-wage, low-standard countries. The reality is quite the opposite. The large majority of U.S. outward investment flows to other rich, developed, high-wage, high-standard countries.

In the half decade from 2003 through 2007, of the $45 billion in manufacturing investment that U.S. companies sent abroad on average each year, 71 percent flowed to the rich, high-standard economies of Europe, Canada, Japan, Australia, and New Zealand. If we include the upper-middle-income economies of Hong Kong, Israel, Singapore, South Korea, and Taiwan, the share approaches 80 percent. The proportion of nonmanufacturing investment flowing to other relatively wealthy countries is even higher.[26] Far from racing to the bottom, U.S. multinational companies are racing to invest in the world’s richest and most expensive places.

In a 2001 study on manufacturing investment, the consulting firm of Deloitte and Touche labeled this phenomenon the “high-wage paradox.” Why would U.S. companies prefer to locate their overseas affiliates in countries where wages and standards are highest when hundreds of millions of workers are available in countries where wages and standards (and presumably business costs) are much lower? There is really no paradox at all. What companies ultimately seek is not lower costs, but higher profits. U.S. companies can operate just as profitably in a rich country as in a poor country, and often more so. After all, it is the rich countries where consumers have the most money to buy what U.S. companies make, where the workers have the education and skills to fill technical and well-paying jobs, where goods, services, and capital move freely across borders, where the utility and infrastructure systems work best, where the laws are transparent and the courts fair, and where the threat of political upheaval is minimal.

For most U.S. companies and industries, labor costs and environmental regulations are only two of many factors that determine where to locate new investment. Complying with environmental regulations typically accounts for less than 1 percent of production costs for industries in Western countries, ranging up to 2 percent for more pollution-intensive industries.[27] U.S. companies will gladly pay higher wages for more productive workers and comply with more stringent environmental regulations if the overall business climate is hospitable.

All that explains why more U.S. FDI flows to Ireland (population 4 million) in a typical year than to the entire continent of Africa (population 700 million). More U.S. manufacturing FDI flows to the tiny but rich European Low Countries of Belgium, the Netherlands, and Luxembourg (population 27.5 million) than to China, Mexico, and India combined (population 2.5 billion). Labor and regulatory costs are obviously higher, much higher, in the smaller European countries (higher even than in the United States), but those higher costs are more than offset by the huge advantages that companies enjoy by operating in a rich, open, and relatively free economy.

The expanding freedom of Americans to invest abroad has not compromised in any way our ability to maintain whatever environmental, safety, and labor regulations we choose. U.S. environmental regulations today are among the strictest in the world, and U.S. air and water standards have improved accordingly. As we saw in chapter 3, U.S. incomes and living standards have been rising decade after decade in the era of globalization—not racing to the bottom as the critics wrongly tell us. In developing countries, the spread of globalization has lifted living standards and reduced poverty and child labor, as we will see in chapter 8.

Foreign investment flowing into and out of the United States has put our economy on a sounder footing, further enriching us as consumers, workers, and investors, while allowing American companies to reach new markets around the world. America would be foolish to forfeit such rewarding dividends.

7. America in the Global Economy: Strong, Free, and Open for Business

American consumers, producers, borrowers, and investors—that is, just about all of us—benefit from our greater freedom to participate in the global marketplace, but so too does the American economy as a whole. Free trade has not just been good for Americans; it has been good for America.

The current recession cannot be blamed on our engagement in the global economy. Recessions have been a fact of life throughout our nation's history, during times when trade barriers were high and, more recently, when barriers have been low. Trade policy cannot repeal the business cycle.

Expanding trade and deeper commercial relations with the rest of the world have equipped our country to face the challenges and embrace the opportunities of a changing world. Free trade and globalization have raised the speed limit of our economy, allowing our domestic output to grow faster and at a more even pace than if we had been a more "self-sufficient" nation. And a healthier economy has come without sacrificing our national sovereignty and independence.

Critics of trade paint a far different picture, one that denigrates the recent performance of the economy and extols, even romanticizes, the virtues of previous eras when the United States was less open to the global economy. But a look back at our economic history during the "golden era" of protectionism reveals that we really are much better off today with America's more open, 21st-century economy, even as we struggle to emerge from a deep recession.

America's Protectionist Past

Opponents of trade have constructed a myth that America's economic and industrial might grew in the 19th century because of high tariffs that protected upstart American companies from European competition. That fable has been embraced by many conservatives and liberals alike, from Pat Buchanan to Sen. Sherrod Brown. The real story of our history is that America grew into a global economic power despite high tariffs, not because of them.

It is a simple historical fact that the U.S. government maintained high tariffs on a range of imports throughout the 19th and into the early 20th century. Alexander Hamilton, Treasury Secretary under George Washington and one of our nation's founders, championed the protective tariff as a way to boost American manufacturing. In his influential 1791 "Report on Manufactures," Hamilton argued that America needed a strong manufacturing base to compete with Europe. He urged subsidies and tariffs to counter European support for their own producers and to speed America's transition from an agricultural to an industrial economy. "In such a position of things," he wrote, "the United States cannot exchange with Europe on equal terms; and the want of reciprocity would render them the victim of the system which should induce them to confine their views to agriculture, and refrain from manufactures."[1]

For the next 140 years or so, with a few brief exceptions, Congress followed Hamilton's advice. From the beginning of our republic, tariffs were an important source of revenue for the federal government as well as a tool for protecting certain industries. Before the Civil War, high duties were imposed in part to help the government pay off its debts from the War of 1812, culminating in the 1828 "Tariff of Abominations." The overall level of tariffs fluctuated, depending on which party was in power in Washington. The cotton-exporting Southern states supported free trade with Great Britain, their best customer, whereas the more industrial northern states saw Britain as their chief competitor and wanted to keep British imports out. Import duties rose during the Civil War and remained high during most of the period of Republican, northern-state political dominance after the war. According to Dartmouth trade economist and historian Douglas Irwin, the average tariff-rate equivalent of trade barriers ranged from 30 percent to 49 percent during the half century between the Civil War and World War I.[2]

Those high tariffs coincided with the epic expansion of American industry, a coincidence that skeptics of trade have pounced on. They compare America's industrial expansion in the late 19th century to free-trade Britain, which lost its leadership in manufacturing to the United States during that period. They also compare the success of high-tariff America back then to the "deindustrializing" low-tariff

America today. But, of course, correlation does not necessarily mean causation. Just because American industry expanded behind high tariffs more than a century ago does not mean that the high tariffs were the key to the expansion. A closer look at that era shows that the tariffs were a drag on the U.S. economy. America in the 19th century grew despite the tariffs, not because of them.

The High-Tariff Fable Exposed

The biggest hole in the high-tariff fable is the fact that it was not the protected industries that led America's economic surge in the late 19th century. According to Douglas Irwin, the sectors with the fastest productivity growth were services such as transportation, distribution, utilities, communications, and construction. Productivity growth in those nontraded sectors was much more rapid after the Civil War than in manufacturing or agriculture. In contrast, protection of textiles, silk, and woolens did nothing to boost the overall output or competitiveness of the U.S. economy. It was not protected steel mills and textile factories that spearheaded America's emergence as a global economic power back then, but the railroads, the telegraph, the residential building trade, and electrical production and distribution.[3]

Although high tariffs on manufactured goods did nothing to promote America's overall growth, they did impose real costs and distortions on the U.S. economy. Tariffs on capital goods—machinery used to produce other goods—reached 40 percent by 1890, forcing American companies to pay artificially high prices for British machine tools, steam engines, steel rails, and precision instruments, reducing investment from what it would have been under free trade.[4] Lower investment in capital goods retarded the growth of knowledge and productivity among American manufacturers. Another economic historian, the University of California–Berkeley's Brad DeLong, writes that the lesson from that period in American history is that "a high tariff economy is a lower-investment economy, a lower capital stock economy, and a lower wage economy."[5]

High tariffs further aggravated the problem of industrial concentration and even monopolies. By shielding domestic producers from foreign competition, the tariff wall allowed them to exercise monopoly pricing power against consumers. In the late 19th century, about the time of the Sherman Act, a current saying was that "the tariff is the mother of the trust." Those who denounce the trusts and the concentration of wealth at the time should aim at least some of the blame at high tariffs.

America's industrial expansion in that era is less impressive in hindsight than the advocates of protection portray. What drove the expansion of U.S. manufacturing was not any great leap in competitiveness but a massive influx of capital and labor. In the language of economists, our industrial growth was "extensive" rather than "intensive." We produced more because inputs of labor and capital grew, not because labor and capital together became remarkably more productive. When we consider the combined productivity growth of capital and labor, or "total factor productivity" (TFP), America's record in the late 19th century was about the same as Great Britain's during the same period. "In the end, productivity growth in the 'protectionist' United States was roughly the same as that in the 'free trade' United Kingdom," concluded Dartmouth's Douglas Irwin.[6]

What allowed the United States to pull ahead of Great Britain in total output was the huge increase in the stock of both capital and labor. The capital came from domestic savings but also from abroad in the form of foreign investment, much of it from Britain itself. The steady inflow of capital from abroad was the main reason why the United States ran almost continuous trade deficits through the second half of the 19th century. Much of the expansion of labor came from the rest of Europe in the form of millions of immigrants, the "huddled masses" who arrived at Ellis Island from Scandinavia, Germany, Italy, Poland, Austria-Hungary, and Russia. In the half century from 1865 through 1914, the United States more or less welcomed 26.4 million legal immigrants.[7] As a share of the U.S. population, the immigration rate during that period was more than double the rate today.

Consider the irony: The same era that Pat Buchanan and other trade skeptics praise for its high tariffs was also an era of persistent trade deficits and mass immigration! And all the evidence shows that it was those trade deficits and the inflow of foreign capital they accommodated combined with large-scale immigration that did the most to transform America into an industrial giant, not self-damaging tariffs.

Smoot-Hawley's Colossal Failure

America's protectionist tradition culminated with passage of the Trade Act of 1930, forever etched in the nation's memory as Smoot-Hawley. It is worth spending a few moments recounting the story of what has become the most infamous piece of trade legislation in American history. Many of the same skeptics of trade who extol the virtues of high tariffs in the late 19th century also downplay the impact of the 1930 tariff law on the American economy. The bill was named after its two chief sponsors, Sen. Reed Smoot of Utah and Rep. Willis Hawley of Oregon, both Republicans. The bill was introduced in June 1929 and began as an attempt to protect American farmers (sound familiar?). During the next year, it devolved into a feeding frenzy of special interests all wanting protection from allegedly unfair foreign competition. In the end, it raised tariffs punitively on hundreds of manufacturing and agricultural products, some of them not even made or grown in the United States. Congress passed the final version of Smoot-Hawley on June 13, 1930, and President Herbert Hoover signed it into law soon thereafter.

It would be an exaggeration to say the Smoot-Hawley tariff bill caused the Great Depression, but it did aggravate the economic downturn and certainly did not deliver the tonic its supporters promised. From 1929 to 1932, imports to the United States plunged. As nominal prices fell, the per-item duties imposed by Smoot-Hawley rose sharply as a percentage of import value. Whether in response to the U.S. action or for other reasons, most foreign nations followed America's example by raising their own tariffs against American exports. Even formerly free-trade Great Britain jumped on the protectionist bandwagon. What followed was a downward spiral of global trade, the disintegration of national economies, and deepening international tensions. By 1938, the volume of trade among industrialized countries had fallen below what it had been in 1913.

Skeptics of trade are curiously quick to downplay what should have been one of their crowning achievements. Trade historian Alfred Eckes Jr., for example, argues that the Smoot-Hawley tariff law affected only a minority of import categories and could not have had the negative impact that critics of the bill claim. Although it is true that most imports continued to enter the United States duty free even after passage of the Trade Act of 1930, the duties that were imposed were so steep and strategically targeted that it was bound to have a major impact on trade flows. After all, reducing import competition was the very purpose of the law. Doug Irwin estimates that Smoot-Hawley raised the effective average tariff rate on all imports from a range of 24 to 27 percent in the 1920s to a peak of 35 percent in 1933.[8] As a consequence of Smoot-Hawley, the height of America's tariff wall rose by a third, and imports fell by more than half. The architects of the tariff bill had accomplished their task all too well.

If the ultimate aim of the Smoot-Hawley tariff bill was to save American jobs and protect American industry, it was a colossal failure. Enactment of the tariff bill was followed by the most sickening economic free fall in our nation's history. From 1930 to 1933, not only did trade collapse, but real output of goods and services fell by one-third, unemployment soared to 25 percent of the workforce, and the stock market lost 89 percent of its value from its peak in 1929. If the Smoot-Hawley tariff bill had such a minimal impact on imports and the economy, as Alfred Eckes and others argue in hindsight, that begs the question of why Congress and their import-competing constituents worked for over a year to enact it. The answer, of course, is that advocates of protection, then as now, really thought they were protecting the U.S. economy when in fact they were compounding its misery.

Out of the Protectionist Wilderness

President Franklin D. Roosevelt and the new Democratic majority in Congress soon began to dismantle the damage of Smoot-Hawley. In 1934, Congress enacted the Reciprocal Trade Agreements Act, which empowered the secretary of state to negotiate agreements with U.S. trading partners to reduce tariffs by as much as 50 percent. FDR's visionary secretary of state, Cordell Hull, used the authority of RTAA to negotiate agreements with Belgium, Switzerland, Great Britain, and more than a dozen other countries covering 60 percent of U.S. trade. By the end of the 1930s, the average effective tariff rate had fallen back to the level of the 1920s, undoing the worst of Smoot-Hawley.[9]

In the aftermath of the 1930s and World War II, the United States joined with its postwar allies to drive a stake into the kind of "beggar thy neighbor" protection that had sown so much misery and discord. A major step was the signing in 1947 of the General Agreement on

Tariffs and Trade. The agreement committed the 23 original member nations to lower tariffs on a range of industrial goods and to apply tariffs in a nondiscriminatory manner, meaning that imports from any other GATT member would face the same tariff rate as that which applied to imports from the "most favored nation." GATT members also agreed to "national treatment" of imports from other members, meaning that domestic regulations would apply equally to all products regardless of origin. Members could not enforce one set of health and safety regulations on domestic products while imposing more stringent regulations on imports as a disguised form of protection.

Membership in the GATT codified America's historic turn away from its protectionist past. By the late 1940s, the average effective tariff rate on imports had fallen to 11 percent, the lowest level of protection for at least a century, perhaps since the days of Alexander Hamilton.[10] America's decisive turn in the direction of free trade and away from its protectionist past did not occur with NAFTA in 1993, the election of Ronald Reagan in 1980, the move to floating exchange rates in 1973, or the Kennedy Round trade agreement of 1967. It occurred in 1947 with America's entry into the GATT. By embracing lower tariffs and a global, rules-based trading system, the U.S. government erected an important pillar of America's postwar prosperity.

The turning point is important because the critics of trade assign the strong growth of the U.S. economy after World War II to the mythical pre-globalization past, when in fact it belongs squarely in the present era of globalization. The true golden era of America's growth, prosperity, and global influence began simultaneously with our nation's embrace of the global economy.

A More Open, Productive U.S. Economy

Through eight rounds of GATT negotiations and other trade agreements, the U.S. government lowered barriers to imports in the decades after World War II. America's openness to trade has not been a steady progression throughout the postwar period. Barriers to trade may have actually climbed somewhat in the 1970s and 1980s because of the U.S. government's trade distorting quotas—including "voluntary" export restraints—that restricted imports of automobiles, textiles and apparel, iron and steel, semiconductors, and other products. Quotas are especially damaging to the "protected" economy because the higher prices charged to consumers, the so-called quota rents, go directly into the pockets of the foreign producers who can still sell into the protected market rather than to the protecting government in the form of tariff revenue. Irwin calculates that the trade restrictiveness index actually rose to the 15 percent range by the early 1990s but has declined to an unprecedented low of 5 percent because of the elimination of the Multifiber Arrangement and other quota-based restrictions after conclusion of the Uruguay Round in 1994.[11]

Turning to free trade has been an important reason why the U.S. economy has grown strongly in postwar decades. Lower barriers at home have spurred innovation and productivity growth for American producers, while expanding markets abroad have opened new opportunities to export. The result has been faster and steadier growth.

Since the signing of the GATT, the U.S. economy has grown by an average of 3 percent per year. The growth record of the U.S. economy in an era of more open trade has been impressive—in two important ways more impressive than the era of protected industrialization that the critics of trade hold up as a superior model. One, growth today is driven more by productivity gains than by increases in labor and capital. Growth of TFP in the past half century has been far higher than TFP during the late 19th century. Because of new technology, human capital, and the invigorating breeze of global trade, Americans are working smarter. We can produce more from each hour worked and each unit of capital. This more intensive growth leads more directly to higher living standards.

Recessions Are Nothing New

The other way that growth in our more open era has outperformed growth in the protectionist path is its consistency. This argument may seem odd in the midst of a serious recession, which may prove to be one of the deepest and longest of the postwar era. But the recession that began in late 2007 came at the end of a quarter of a century in which the U.S. economy enjoyed strong growth, moderating inflation, and two relatively short and shallow recessions. Recessions are not a unique feature of our more globalized era. In fact, economic downturns were more frequent, deeper, and longer during past eras when barriers to trade were much higher.

The high-tariff golden age of the late 19th century so admired by skeptics of trade was also a time of wrenching and frequent boom-and-bust cycles. From 1854 to 1944, the U.S. economy suffered 21 recessions averaging 21 months in length. During that era, despite tremendous growth, the U.S. economy was contracting 41 percent of the time. A depression in the 1870s lasted six years. The "Gay Nineties" and the "Roaring Twenties" each witnessed four recessions. And, of course, let us not forget that the Great Depression of the 1930s occurred on the protectionists' watch.

In welcome contrast, the more globalized era since World War II has seen a moderation of the business cycle. According to the National Bureau of Economic Research, our nation suffered through nine recessions totaling 96 months in length between 1945 and 1985, representing 20 percent of the time. Since then, including the most recent recession that began in December 2007, our economy has been in recession about 12 percent of the time. Like a superior investment, our more globalized economy has delivered growth rates at least as good as past protectionist eras but with less volatility.

Evaluating the "NAFTA Era"

Perhaps no advancement of the trade agenda has been so reviled by the critics as the North American Free Trade Agreement. NAFTA has been blamed by critics of trade for a long list of economic ills, real or imagined, since it went into effect on January 1, 1994. But by virtually every measure, the U.S. economy in the NAFTA era has performed better than in the era leading up to it.

Consider Table 7.1, the "NAFTA Scorecard." It compares the 15 years since its enactment, including the recession year of 2008, to the 15 years that came immediately before NAFTA. The comparison is illuminating. Since NAFTA's passage, the U.S. economy has grown faster, inflation has been cut in half, the average unemployment rate has been lower by almost two full points, and manufacturing output accelerated. Labor productivity has jumped, and the annual growth in real compensation per hour has almost doubled. Median household income has grown by more than $6,000 in real dollars, compared to an almost negligible gain during the preceding period. The average poverty rate has fallen.

The only two measures that have not "improved" are total job creation and manufacturing employment. But a slight decline in

Table 7.1
NAFTA "SCORECARD"

Major Economic Indicators	Before NAFTA 1979–93	"NAFTA era" 1994–08
Real GDP growth (annual)	2.7%	3.0%
Inflation (average annual rate)	5.4%	2.7%
Job growth (millions)	25.6	24.0
Unemployment rate (average annual)	7.0%	5.1%
Manufacturing output (growth)	35%	58%
Manufacturing jobs lost (net, 1,000s)	2,158	3,278
Labor productivity (annual growth)	1.6%	2.3%
Real compensation (annual growth)	0.7%	1.3%
Median household income (change)	$206	$6,090
Poverty rate (average annual)	13.8%	12.8%
Misery Index (average annual)	12.4%	7.8%

SOURCES: Census Bureau, Labor Department, Commerce Department, Federal Reserve Board.

overall job growth occurred because of slower labor force growth. And falling manufacturing employment was entirely because of rising productivity, because actual output increased in the NAFTA era. Of course, NAFTA has not been the primary reason for the superior performance of the U.S. economy since its passage, but it has contributed to a more open and globalized American economy that has helped to propel our modern growth. And it has clearly not brought about the economic Armageddon that prominent opponents of NAFTA predicted.

Tapping into Global Markets

Like a more diversified stock portfolio, trade and globalization have given us a more resilient and flexible economy. Exports can take up slack when domestic demand sags, and imports can satisfy demand when domestic productive capacity is reaching its short-term limits. Access to foreign capital markets can allow domestic producers and consumers alike to more easily borrow to tide themselves over during difficult times.

Three-quarters of the world's buying power and 95 percent of the world's people exist outside the United States. The most rapidly growing major markets in the 21st century are not within our own borders but in Asia and other emerging markets. These countries represent a huge potential market for U.S. producers in general and hundreds of thousands of American small businesses in particular.

Exporting to the world has reached Main Street. A quarter of a million U.S. companies export to foreign markets, the large majority of them small and medium-sized enterprises (SMEs) that employ 500 or fewer workers. According to the U.S. Chamber of Commerce, more than 230,000 SMEs now account for nearly 30 percent of U.S. merchandise exports. The number of such companies exporting has more than doubled since 1992.[12]

This growth has been propelled by not only the expansion of global trade generally but also technological developments especially favorable to smaller exporters. On the cutting edge of this development has been the spread of the Internet and e-commerce. There are now more than 1.3 billion Internet users in the world today, and the number is growing rapidly. Of those, 85 percent shop online. With the assistance of delivery services such as FedEx and UPS, small businesses are able to reach global markets without the daunting expense of establishing sales teams and distribution networks in foreign countries. The Internet has also facilitated the slicing up of global supply chains, creating more opportunities for smaller U.S. companies to find profitable niches as suppliers for larger multinationals.

One of the most important and fastest growing markets for America's small-business exporters is China. In 2008, Americans exported $65 billion worth of goods to China, making it our fourth largest customer for U.S. goods in the world, behind only the European Union and our NAFTA partners, Canada and Mexico. Small and medium-sized U.S. companies are basking in this export success. In 2004 (according to the most recent figures we have), 19,210 SMEs in the United States were exporting to China. That is more than six times the number that were exporting in 1992. The share of U.S. companies exporting to China that are small or medium-sized enterprises has grown during that time from about three-quarters to more than 90 percent. SMEs accounted for 35 percent of U.S. merchandise exports to China in 2004, a higher share than their 29 percent share of exports overall.[13] Board any flight from the United States bound for China, and you will probably be sitting near somebody representing a small U.S. company heading off to buy and sell in the world's fastest growing major market.

Earnings from abroad have helped to keep the U.S. economy afloat during the recent turbulence. As the *Wall Street Journal* summarized in a front-page story in August 2007, "Economies in most other parts of the world—including China, Latin America and Europe—have grown faster than the U.S. over the past 18 months, providing a countercyclical balance for multinational companies. Overseas growth could provide further support for companies and investors if parts of the U.S. economy continue to worsen."[14]

American companies have been earning a larger and larger share of their profits overseas for decades now. According to economist Ed Yardeni, the share of their profits that U.S. companies earn abroad has increased steadily from about 5 percent in the 1960s to about a quarter of all profits today. Even the iconic Harley-Davidson motorcycle company in Milwaukee, Wis., has become a multinational company. The company that once came begging to Washington for protection from foreign competition is enjoying robust sales and profits abroad even as its domestic sales slump. In the second quarter of 2007, the company saw its profits jump by 19 percent, fueled by the double-digit growth in sales in Europe, Japan, and Canada even as its domestic sales fell 5.5 percent.[15]

The more moderate business cycle is no trivial development. Recessions mean real pain to real families—layoffs, extended unemployment, pay cuts, home foreclosures, and business bankruptcies. Although most people keep their jobs during a recession, the number of people suffering dislocation rises sharply. Moderation of the business cycle in recent decades is something to be thankful for, and expanding trade and globalization deserve a slice of the credit.

Exercising American Sovereignty

Critics of trade charge that the various trade-expanding agreements that the U.S. government has signed have compromised our national sovereignty. They claim that we have signed over our ability to determine not only our own trade policies but also our own health, safety, and environmental regulations. Dark warnings about surrendering our sovereignty to "secret tribunals" and shadowy "world government" conspiracies come from such sources as Ralph

Nader, the John Birch Society, and congressman and presidential candidate Ron Paul.

Tariffs are a tool of centralized government economic planning, whereas trade agreements help protect individual Americans from being manipulated by government planners. Agreements are not a transfer of sovereignty from the U.S. government to authorities outside the United States but from governments around the world to citizens. Political power is not transferred abroad but merely curtailed at home.

Signing trade agreements is not a surrender of American sovereignty but a prudent exercise of sovereignty. When the U.S. government enters a trade agreement such as NAFTA or the Uruguay Round, it is making a deal with other governments that it will grant American citizens greater freedom to buy goods and services provided by citizens of the other countries if those other countries will grant their citizens greater freedom to buy the goods and services we provide. The participating governments agree to curtail their own harmful economic policies, first for their own benefit, and also for the benefit of others. As trade economist Robert Lawrence concluded, "Just as individuals do not lose their liberty when they voluntarily sign beneficial contracts, so nations do not abridge their sovereignty when they sign trade agreements that advance their interests."[16]

Of course, trade agreements can be very complex documents that go beyond the reduction and elimination of tariffs. One reason agreements can be so detailed is because of numerous phase-out periods and exceptions demanded by noisy protected industries that do not want to surrender their privileged positions. A related reason is regulations on "rules of origin" to prevent countries outside the agreement from enjoying its benefits.

Why Ron Paul and Ralph Nader Are Both Wrong about the WTO

Some otherwise sensible free traders get confused on this point. Rep. Ron Paul (R-TX) supports free markets and espouses free trade, but he also opposes virtually all free trade agreements as unconstitutional infringements on the sovereignty of the U.S. government. He always votes against trade agreements and routinely sponsors resolutions to withdraw the United States from membership in the

WTO. While the congressman understands the benefits of free markets, he is as mistaken about trade agreements as the Naderites on the left and the John Birchers on the right.

Trade agreements do not limit our freedom as individual Americans. They are written to limit the power of governments to interfere in the peaceful commerce of their citizens. By limiting the scope of government action, trade agreements actually enhance the liberty and prosperity of the people living in the participating countries.

Ron Paul and Ralph Nader both demonize the WTO, but that modest institution poses no threat to American sovereignty. Membership in the WTO encourages the United States to keep its own markets open, for the benefit of U.S. consumers and import-using industries. It also promotes trade liberalization abroad, which opens markets and keeps them open for U.S. exporters. WTO agreements open foreign markets along with our own and put those commitments in writing, so there is less temptation for governments to backslide and re-impose damaging trade barriers under short-term political pressure.

Americans have witnessed the benefit of a global trading system during the recent downturn. A major reason why more governments have not raised barriers to U.S. exports is the existence of agreements they signed along with the U.S. government to reduce barriers and keep them down. Governments know that if they raise tariffs beyond the "bound" rates written in WTO agreements, or if they violate other provisions designed to keep markets open, they will be vulnerable to challenge in the WTO dispute settlement system. This is one of the huge advantages we enjoy today compared to the 1930s, when the race to raise trade barriers was unchecked by either economic sense or international agreements. Representative Paul rightly blames the government for causing the Great Depression but criticizes modern-day trade agreements that make those mistakes of the past less likely to occur again. Trade agreements have provided a rule of law for trade relations rather than the beggar-thy-neighbor rule of the jungle that prevailed so disastrously in the 1930s.

By its nature, the WTO is incapable of infringing on U.S. sovereignty. It lacks any tangible enforcement power other than the respect and credibility that its dispute settlement mechanism has built among its members. It is a contractual organization driven by the consensus of its membership. Unlike the International Monetary

Fund or the World Bank, the WTO dispenses no large amounts of money to foreign governments with strings attached. Unlike the United Nations, it dispatches no troops with "WTO" written on their helmets. Unlike the European Union, it writes no rules that are automatically enforceable in member countries.

The WTO's chief function is to facilitate negotiations among its members and then to render nonbinding opinions as to whether particular laws and regulations of its members are consistent with the WTO rules. Those rules are written by members through protracted negotiating rounds and are only adopted when all members finally agree.

A Firewall of Protection for U.S. Sovereignty

The sovereignty of the U.S. government is protected behind an insurmountable series of firewalls built into the WTO system. First, no trade rules become adopted within the WTO without the consensus agreement of every one of its members. This provision grants the U.S. government effective veto power over any change or expansion of WTO rules.

Second, the WTO's basic charter explicitly allows member countries to impose trade restrictions in the name of national security, public health and safety, and other areas where issues of sovereignty are most sensitive.

Third, any challenge to a U.S. trade–related law must be initiated by another WTO member and will proceed to a dispute settlement panel only after efforts to reach a compromise among the disputing members have failed. The WTO itself does not initiate any challenges to U.S. laws or regulations. It is not a regulatory cop prowling the global trade beat looking for offenders.

Fourth, if the U.S. government actually loses a case in dispute settlement, the WTO has no authority or power to do anything to enforce the decision. If the U.S. government decides to ignore a WTO decision against it, the WTO itself possesses no coercive power of any kind that could be used to enforce any outcome the U.S. government does not want to accept. The ultimate decision to impose retaliatory tariffs can only come from a WTO member government that filed the original complaint.

Finally, if the complaining member ultimately decides to impose sanctions against exports from the United States, the U.S. government retains exactly the same freedom of action it has always possessed in the face of foreign trade threats. Trade sanctions have been used and abused as a tool of commercial and foreign policy for decades, by the United States as well as by other nations. The WTO's "enforcement" mechanism has not conferred any new power on other countries that they would not have if the WTO system did not exist. In fact, by establishing a set procedure for settling trade disputes, WTO rules make it *less* likely that the United States will face the external pressure of sanctions.

Belonging to the WTO enhances the freedom and prosperity of Americans without surrendering an inch of national sovereignty.

Opening Markets Abroad

The U.S. government's membership in the WTO has yielded tangible benefits for American citizens. Successive rounds of negotiations through the GATT have lowered global trade barriers here in the United States and around the world. WTO agreements also restrict the ability of foreign governments to place quotas on imports, impose domestic regulations that unfairly discriminate against U.S. products, and subsidize domestic industries that compete against American firms. Those agreements don't just benefit large U.S. exporters. Small and medium-sized companies benefit from the more predictable rules and dispute settlement procedures. By providing transparency, trade agreements enhance the ability of smaller U.S. companies to cut through what can be the bewildering customs and regulatory red tape in foreign markets.

WTO membership allows the U.S. government to challenge the trade practices of other nations within the rule of law. If other members are violating their commitments, the United States can present its case before an impartial panel of trade experts. In the 14-plus years the WTO has been in operation, its dispute settlement mechanism has arbitrated hundreds of cases in what most observers agree to be a fair and restrained manner.

Of course, belonging to the WTO means U.S. laws can also be challenged by other countries. Between establishment of the WTO in 1995 and mid-2007, the U.S. government has brought 84 cases against other member governments and been the defendant in 94 cases against its own trade practices.[17] During that time, the U.S. government successfully used the WTO dispute settlement system to open foreign markets in 53 of those cases, 28 by winning a final judgment on the core issues of the complaint and 25 by settling favorably before completion of the case. Appealing through the WTO has helped the U.S. government to remove barriers to the sale of U.S. semiconductors in China (2004); beef and rice in Mexico (2003); genetically modified crops in the European Union (2003); apples in Japan (2002); milk in Canada (1997); 2,700 specific product categories in India, including high-technology products, petrochemical, textiles, and agricultural products (1997); and copyrighted sound recordings in Japan (1996).[18]

Even when the U.S. government loses a case brought against it in the WTO, the American people usually win. That's because the questionable trade barriers our own government is trying to defend often benefit the protected industry but at the expense of other U.S. companies and millions of American households (for all the reasons we shall see in chapter 9). WTO cases have resulted in the reduction or removal of U.S. barriers against imported underwear from Costa Rica, wool shirts from India, shrimp from Asia, computer chips from Korea, steel from a host of countries, lamb meat from Australia and New Zealand, and lumber from Canada.[19] Those "losses" in the WTO brought the U.S. government into closer compliance with its international commitments and delivered lower prices to domestic consumers and producers. When it comes to trade policy, the U.S. government is not always on the side of American consumers and families, so when it "loses" as a defendant in the WTO, we often win.

Confidently Embracing the World and the Future

We should think about trade policy not just for what it means for Industry X or Union Y but what it means for the United States of America. By engaging in the global economy, we have made our nation stronger and more influential in the world.

For a nation, free trade is like fresh air and exercise. It can be uncomfortable at first as the body adjusts to the new regime. We breathe hard, we sweat, and our muscles ache. But soon our aerobic capacity expands, and we discover that we can run faster and farther, we can lift more weight, and we can more quickly shake off the ups and downs of life. In contrast, protectionism is like lounging on the couch, watching reruns, and eating Cheetos in a stale room with the windows shuttered. It may feel comforting in the short run, but it leads to flabbiness, fatigue, and decline for the protected parts of the body.

The payoff to the American economy from its postwar trade liberalization has been measurable and immense. Scott C. Bradford, Paul L. E. Grieco, and Gary Clyde Hufbauer calculated the benefits to Americans from the postwar reduction in trade barriers and transportation and communication costs. Using several different models, they estimate that the benefits to Americans from increased consumption, variety gains, and increased productivity amounts to 7.3 percent of our total gross domestic product. That means "roughly $1 trillion of annual U.S. GDP is attributable to global integration,"[20] or $7,100 for a typical household. They also estimate that achieving global free trade would boost the U.S. economy by another $450 billion, potentially adding another $4,000 to a typical American family's income.[21] The only barriers standing between Americans and the final gains from trade liberalization are politicians and interest groups wedded to the status quo.

A vibrant economy connected to the world expands American influence. Other countries are more likely to pay attention to American interests when our economy carries more weight in the world rather than less. Foreign policy expert Joseph Nye referred to this as "soft power." A U.S. economy that is buying and selling more goods, services, and assets in the world will be a nation more able to influence other countries through means other than military force or other threats. We should not hide the light of our free and dynamic society under a bushel basket of trade and investment barriers.

Pursuing free trade offers a "two-fer" for U.S. policymakers: For the same reasons we pursued freer trade after World War II, free trade allows us to promote higher living standards at home while advancing our broader foreign policy interests. As we'll see in the next chapter, trade and globalization are making the world a more hospitable place for us, our nation, and our values.

8. More Like Us: The Growth of the Global Middle Class

A quiet revolution has changed the world for the better in the past three decades. The world is becoming more like us—more middle class, not just in what people wear and eat but in the way they live and think. Across a broad swath of what used to be called the Third World, incomes have been rising and poverty has been falling. Ownership of such middle-class tokens as a car, a refrigerator, and a computer are becoming more widespread. More kids are going to school, even college, leaving the farm for a better life in the city.

The impact of the emerging global middle class goes beyond daily living standards to shape the world in a way that is more hospitable for Americans today and for generations to come. An educated, property-owning middle class has become the backbone of democracy in a majority of the world's nations. Expanding commercial ties, coupled with representative government, have encouraged nations to live at peace with one another. The rising middle class has helped to spread middle-class, "bourgeois" virtues of thrift, industry, trustworthiness, and tolerance.

Trade and globalization have profoundly shaped the world we all live in today. Since 1980, according to the International Monetary Fund, world trade has grown five-fold in real terms. Trade expressed as a share of world GDP has risen from 36 percent to 55 percent, and that growth accelerated in the 1990s and into the new century. Financial globalization has also proceeded at an even more rapid pace. The total value of cross-border financial assets has more than doubled since 1990 relative to global GDP, from 58 percent to 131 percent in 2004.[1] Those trends took a hit as the global downturn deepened in 2009, but even so the world is still much more globalized than it was three decades ago, and the emerging economies that have participated in the latest wave of globalization have arguably benefited the most.

Plugging into globalization allows less developed countries to turbocharge their growth. Study after study has found that nations that are open to the global economy grow faster and achieve higher incomes than nations that remain closed, and this is especially true for poor countries that want to escape their poverty. Development economists call it the “late-comers’ advantage.” Farms and factories in poor countries can now produce for global markets rather than their own limited domestic customer base. They can enjoy the benefits of off-the-shelf technologies developed in rich countries—such as the Internet, computers, software, cell phones, pharmaceuticals, and scientific instruments—without paying the up-front cost of R&D. According to the World Bank, new technologies that took 50 years to spread to most countries in the world now reach less developed markets in one-third the time.[2]

The advanced economies, especially the United States, Canada, and western European countries, blazed a development trail starting with the Industrial Revolution two centuries ago. Now more and more of the world’s people are following our path, taking advantage of the human knowledge, technologies, and prosperous markets that have been developed over decades and at great initial expense. In a recent study for the Copenhagen Consensus Project, international economists Kym Anderson and L. Alan Winters concluded that, “The past experience of successful reformers such as Korea, China, India, and Chile suggest trade opening immediately boosts GDP growth rates by several percentage points per year for many years.”[3] When compounded over two or three decades, those faster growth rates allow dramatic gains during a single generation.

A Rising Middle Class, Falling Poverty

The global economic downturn that reared its head in 2008 should not obscure the unprecedented material progress that globalization has brought to the world in recent years. Beginning in the 1990s, growth began to accelerate in China, India, and other emerging markets. The growth has been broadly based, creating the greatest expansion of the global middle class in human history. For the first time ever, a majority of the world’s people now live in cities, and more people work in the service economy than in agriculture—milestones that the United States passed decades ago.[4]

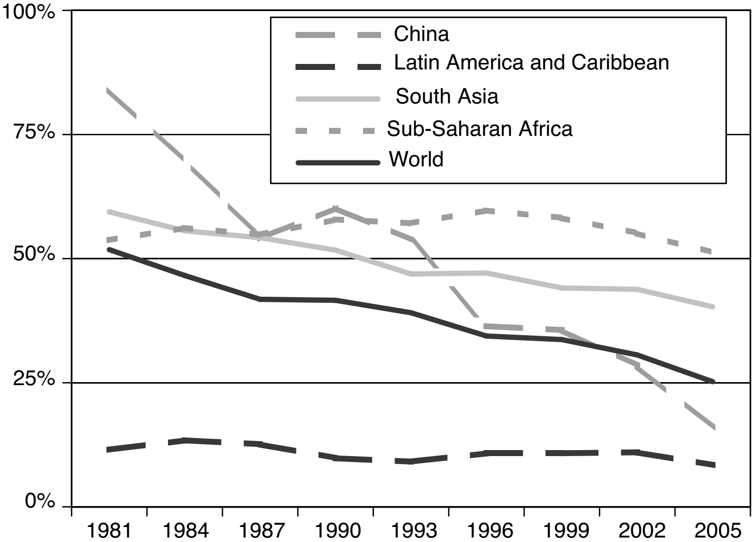
In sheer numbers, the World Bank calculates that 400 million people in less developed countries have already achieved an annual middle-class income of $16,800 to $72,000 per household. That number is on track to triple to 1.2 billion by 2030.[5] By 2030, per capita income in the developing world will reach $11,000 a year in real terms—approximately the living standard in today's Czech Republic in the European Union. In a separate study released in July 2008, Goldman Sachs researchers Dominic Wilson and Raluca Dragusanu defined the middle class somewhat differently but came to the same conclusion: "An astonishing 2 billion people could join the global middle class by 2030!"[6] They estimate the global middle class to be growing by about 70 million people a year, which is close to the annual growth in the world's population of 80 million. In other words, just about all of the world's net population growth is now occurring in the middle class.

The rise in the global middle class has gone hand in hand with a heartening drop in global poverty. The share of the world's population living in absolute poverty has been cut in half in the past 25 years. According to the World Bank, 52 percent of the world's population lived on the equivalent of $1.25 a day or less in 1981. By 2005, that share had dropped to 25 percent. For the first time in centuries, the total number of poor people living in the world has actually begun to decline in absolute numbers in the past two decades.[7] The current global downturn has put that progress on pause temporarily, but we can expect it to resume when global growth returns to its more recent trend.

Progress has been across continents, as we can see in Figure 8.1. Even in Sub-Saharan Africa, the poverty rate finally began to fall after 1996. In China alone, since its market reforms began 30 years ago, the number of people living in absolute poverty has dropped by more than 600 million. The number of people in China living on $2.50 per day or less has also fallen sharply.[8] This is the greatest anti-poverty program the world has ever seen. It has occurred primarily not because of foreign aid, internal redistribution, or threats to impose trade sanctions but because of market reforms and expanding trade.

The real news is not that more than a billion people in this world remain in desperate poverty but that so much rapid progress has been made in our globalized era. The poor have always been among

Figure 8.1
PROGRESS AGAINST GLOBAL POVERTY
(percent living in absolute poverty)



NOTE: % of population living below $1.25 a day.
SOURCE: World Bank.

us. In the early 1800s, an estimated 80 percent of the world's population lived on today's equivalent of $1.50 a day or less.[9] It took more than 150 years of spreading globalization, industrialization, and technology to cut that share in half. The miracle is that mankind has managed to cut the ranks of the poor in half again, this time in a mere 25 years. Simply put, globalization and free trade have done more to lift people out of poverty than all the government foreign aid programs that ever existed.

If that were the sum of the story, it would be good news enough. But all sorts of positive things start to happen when the average per capita income in a developing country surpasses about $5,000 a year. Freed from the specter of starvation, people turn their attention to the relative luxuries of sending their children to school; accessing electrical, water, and sewer utilities for their homes; acquiring a TV, cell phone, household appliances, and a car; buying more health care and travel; and demanding protection for their property, a cleaner environment, and a larger voice in their own government. By spurring faster growth and rising incomes, trade and globalization also promote a rising consumer class and social progress.

For any American who has traveled recently to emerging economies, those are not hollow numbers. In places as diverse as Seoul, South Korea; Beijing, China; Mumbai, India; and Monterrey, Mexico, I have seen with my own eyes how ubiquitous automobiles, cell phones, laptop computers, and other consumer goods have become. More than a billion people in the world continue to live in deep poverty, but the real story of our time is how many of them are escaping to a life that more closely resembles our own.

If we look beneath the headlines, we can find stories of the emerging middle class. In Brazil, the shantytowns around its major cities, known as *favelas*, are being transformed into something resembling middle-class suburbs. In the metropolis of São Paulo, new apartment buildings are going up, and electricity, piped water, and sewer systems are being rapidly extended. A 2005 study of households in four *favelas* in São Paulo found that virtually all owned refrigerators and color TVs (often more than one), nearly half owned cell phones, and almost a third owned DVD players and cars. In the words of the *Economist* magazine, “They are members of a new middle class that is emerging almost overnight across Brazil and much of Latin America. Tens of millions of such people are the main beneficiaries of the region’s hard-won economic stability and recent economic growth. Having left poverty behind, their incipient prosperity is driving the rapid growth of a mass consumer market in the region long notorious for the searing contrast between a small privileged elite and a poor majority.”[10]

More Customers and Business Partners

For Americans, the rise in the global middle class and the decline in global poverty have yielded direct and indirect benefits that will benefit our country and our children and grandchildren for decades to come. In the most direct way, a wealthier world means more potential customers and business partners for American producers and more suppliers competing to satisfy American consumers.

American companies are well positioned to sell their goods and services to a growing global market. American companies will increasingly find their best growth opportunities not in our mature domestic market but in rapidly expanding emerging economies. As hundreds of millions of people abroad join the global middle class, their appetite for and ability to buy the more sophisticated type of products and services offered by American producers will only grow. As the global middle class expands, the World Bank predicts that it "will participate actively in the global marketplace, demand world-class products, and aspire to international standards of higher education. That is, they would have the purchasing power to buy automobiles (perhaps second hand), purchase many consumer durables, and travel abroad."[11]

Increased travel will bring more Chinese, Indians, and Latin Americans to the United States to spend dollars at our restaurants, hotels, and tourist attractions. Demand for airliners, including the new Boeing 787 Dreamliner, will predictably increase. Demand for U.S.–based medical and educational services will climb. By 2017, pharmaceutical sales in the biggest emerging markets are predicted to reach $300 billion a year, equal to today's sales in the top five European markets and the United States combined. America's leading drug companies are well positioned to meet the growing demand for an expanding array of medications and designer drugs.[12] The Goldman Sachs study predicts rising global demand for meat, personal computers, financial services, insurance, and health care—sectors where American producers and brand names predominate.

The rising global middle class offers the best hope for America's automobile manufacturers. As we saw in chapter 6, Ford and General Motors are already selling more cars abroad than in the United States, and that trend will only grow. The Goldman Sachs team that has studied the emerging middle class notes that families in developing countries begin to buy automobiles when per capita income reaches $5,000, with the growth in demand peaking at $10,000 per capita. The number of cars on the road in the world is expected to climb from 600 million today to 2.9 billion by 2050. By 2030, there will be as many cars in China as there will be in the United States. If one out of ten cars is replaced each year, annual global car sales will also jump from just under 60 million in 2008 to nearly 300 million by 2050—a five-fold increase.[13]

In a more globalized world, our children will find more opportunities to work profitably with people around the world.

Rising Global Social Standards

The rise of a global middle class and the decline in poverty has not just been about higher incomes and more consumption. The rising global tide we have seen in the past two decades has allowed families in developing countries to acquire healthier lives.

The amazing progress of mankind during our era of globalization was summarized powerfully by Cato senior fellow Johan Norberg in a recent paper he delivered to the Swedish Globalization Council.[14] Rising living standards enabled by globalization are about more than cars and TVs. You probably won't hear these facts on the nightly news:

Life Expectancy. People in most poor countries are living longer than ever before, and the gap between rich and poor countries is closing. Since 1960, the average life expectancy in developing countries has jumped from 45 years to 65 years. The gap between life expectancy in the developing and advanced economies has been cut in that time from 24 years to 14 years. Most of the credit belongs to the growth of medical knowledge, but globalization has helped to develop and spread that knowledge. It has enabled people in poor countries to better afford the medicines, vaccinations, and public health improvements that put that knowledge into practice.

Infant Mortality. The global infant mortality rate, the share of children born alive who die before their first birthday, fell by 60 percent between 1960 and 2005. Again, the spread of modern medicine played the primary role, but rising levels of trade and income were its handmaidens. The share of children vaccinated against measles, diphtheria, tetanus, and whooping cough has jumped sharply to about three-quarters. Smallpox and polio, which were scourges as recently as the 1950s, have been virtually eliminated from the human race. As a result, the number of children dying each year in the world dropped by 2 million from 1990 to 2005. Only the most hardened critics of globalization can fail to be encouraged by such tangible progress.

Daily Bread. An adult human being needs 2,000 to 2,310 calories a day to perform everyday activities while preserving health and body weight. In 1961, the average daily per capita intake of calories in developing countries was 1,930, or just below the minimum. By 2002, after a "Green Revolution" on the farm, the average intake had risen to 2,666. The share of people living in developing countries who are undernourished was cut by more than half, from 37 percent to 17 percent. Famines caused by natural disasters such as crop failures have become a thing of the past.

Literacy. As recently as 1970, fewer than half of adults in developing countries could read or write. Today the proportion has risen to two thirds. Progress has been even more rapid among youth, especially young girls. Girls still lag boys in years of schooling for a host of cultural reasons, but the amount of schooling for girls compared to boys climbed from 56 percent in 1960 to 73 percent in 2000. The gap in East Asia and Latin America has been abolished entirely.

Child Labor. With more boys and girls in school learning to read and write, the share working has been falling. Worldwide, the proportion of children ages 10 to 14 who are working fell from 25 percent in 1960 to 10 percent in 2003, and it has continued to fall since then.

In February 2007, I was called upon to testify before a Senate subcommittee that was considering an anti-sweatshop bill supposedly designed to improve working conditions and reduce child labor in factories abroad. Presiding over the hearing was Senator Dorgan, a sponsor of the legislation and, as you may have gathered from preceding chapters, a critic of free trade and globalization. One of the witnesses before me told the story of Halima, an 11-year-old girl working long and exhausting hours in a garment export factory in the impoverished South Asian country of Bangladesh.

As heart wrenching as these stories can be, Halima is not a victim of free trade and globalization, but of her own government's failure to promote rapid and sustainable economic growth. Her story does not represent that of the 90 percent of children in the world today who are in school, and it does not even represent the declining minority of those who are working. As I told the committee in my own opening statement later in the hearing:

> By raising incomes in poor countries, free trade and globalization have helped pull millions of kids out of the workforce and helped them enroll in school, where they belong. The International Labor Organization recently reported that the number of children in the world ages 10 to 14 who are working rather than attending school has dropped by 11 percent

> since their previous report in 2002. There are 20 million fewer Halimas today than there were just 4 or 5 years ago. And it's not because of [Congress wielding] a legislative billy-club, it's because of trade and growth in developing countries. . . .
>
> Parents in poor countries love their children just as much as we love our own. When they rise above a subsistence income, the first thing they do is remove their children from the workforce and put them in school. Studies confirm that labor-force participation rates by children decline sharply with rising per capita GNP.
>
> The overwhelming majority of child laborers toiling in poor countries work in sectors far removed from the global economy. More than 80 percent work without pay, usually for their family, and typically on subsistence farming. I notice we don't have any representative [at the hearing today] from a rural farming area, where most poor people live in the world and most child laborers toil. Most others work for small-scale domestic enterprises, typically non-traded services, such as shoe shining, newspaper delivery, and domestic service.[15]

If Congress were to enact anti-sweatshop legislation, it would hinder the very progress that its advocates claim they want to promote. Raising tariffs on goods imported from poor countries would eliminate the best paying jobs in those societies. When parents in poor countries suffer a loss of income, they will be more likely to remove their children from school and send them back to the field or the streets in a desperate attempt to make up for the loss.

How do we expect hundreds of millions of people to pull themselves out of poverty if we do not allow them access to global markets? It is morally and economically incoherent to denounce global poverty and sweatshops one moment and to denounce imports from and foreign investment to the very same countries where the poor people actually live.

Mexico Before and After NAFTA

One way that critics of trade have sought to undermine it is by painting a dark picture of Mexico in the NAFTA era. They claim that since the passage of NAFTA in 1993, real wages in Mexico have declined and poverty has increased. They even blame NAFTA for spurring more illegal immigration, arguing that lower tariffs have flooded the Mexican market with subsidized U.S. corn, displacing

Mexican corn farmers who have then migrated illegally to the United States.

Mexico is a country with its share of problems, and no one would confuse Tijuana with San Diego or Ciudad Juarez with El Paso. But its problems did not begin with the passage of NAFTA, and in fact its deepening commercial ties to the United States before and after enactment of NAFTA have helped Mexicans modernize their economy and political system. Mexico is a far better place than it was 20 or 30 years ago, and NAFTA is one of the reasons.

NAFTA codified a process of economic opening that had actually begun early in the 1980s in the wreckage of Mexico's old model of a closed economy dominated by a single party, the Institutional Revolutionary Party, or PRI. NAFTA reduced and eliminated Mexican trade barriers to U.S. exports during the 15 years after it went into effect.

In December 1994, within a year after enactment of the agreement, Mexico suffered an economic crisis. The government was unable to pay its short-term debts, its currency (the peso) plunged in value, prices and interest rates shot up, and the country suffered a sharp drop in output and employment. Real wages fell, and poverty increased. U.S. exports to Mexico fell, turning a small bilateral trade surplus with Mexico into a deficit.

Despite what the critics of trade claim, NAFTA was not the cause of the peso crisis. In fact, it would be more accurate to see the crisis as the last, dying gasp of the old Mexican order. Since the mid 1970s, Mexico had suffered various forms of economic crises related to its six-year election cycle. The PRI government would spend heavily on the eve of each election to enhance its re-election prospects, and then the bills would come due afterward, fomenting an economic crisis. The deepest and most prolonged was the 1982 banking crisis, which occurred a full decade before NAFTA and required most of the 1980s to undo.

Thanks to NAFTA, Mexico bounced back from the 1994 crisis far more quickly than it had recovered from the 1982 crisis. Although Mexico's economic growth has not been spectacular since NAFTA, it has been strong and steady enough that, despite the peso crisis, real wages are higher today than before NAFTA and the poverty rate is lower. Progress has been especially strong in those regions of the country that have been most closely tied to trade with the United States.[16]

The critics are wrong about corn, too. American farmers produce mostly yellow corn, which Mexicans import as feed for cattle. Mexican farmers grow mostly white corn, which they use domestically to make tortillas and other foods for human consumption. Although U.S. exports of corn to Mexico have indeed increased under NAFTA, Mexico's domestic corn production has also increased. According to a 2007 study by the Woodrow Wilson Center in Washington, D.C., Mexican farmers grew about 15 million metric tons of corn a year before NAFTA, compared to an average of 20 million tons a year from 2001 to 2006.[17] The U.S. government should not be subsidizing the production of corn in the United States, but that is not a fault of NAFTA, and the free trade in agriculture that NAFTA brought about has not devastated or even reduced Mexican corn production.

Those Mexicans who have migrated to the United States in recent years have not typically come from the corn growing regions, anyway, but from certain states in central Mexico with a tradition of sending migrants north. If the United States had spurned NAFTA, Mexican workers would have even fewer opportunities in their own country, and Mexico would be a less cooperative partner with the United States in dealing with illegal immigration and other border issues.

Democracy and Human Rights

Another way that people outside the United States are becoming more like us in our more globalized world is through the spread of civil liberties, human rights, and democracy. Along with the expansion of trade and foreign investment in the past three decades, the world has also become more hospitable to other realms of human freedom, and the two developments are related.

Political scientists since Aristotle have noted that an educated and property-owning middle class provides the most solid foundation for democracy. When citizens own homes, businesses, and financial assets, they are less likely to succumb to revolutionary appeals that have brought so much upheaval and misery to poor countries. When people are better educated, they are more able to exercise independent judgment in choosing their rulers and public policy. Economic independence nurtures the confidence to assert social and political independence from the government. Those traits have been the durable foundation of American freedom since our founding.

Consistent with those theories, our more globalized world has also become a more democratic world. According to the think tank Freedom House based in New York, the past 35 years of expanding global trade have also witnessed the blossoming of political and civil freedom around the world. Freedom House rates nearly 200 countries every year according to freedom of speech, assembly, and worship as well as the freedom to participate in open, competitive elections.

In its annual "Freedom in the World" report, the organization groups countries into three categories: "Free"—those countries in which citizens enjoy full civil and political freedoms of the kind that we Americans take for granted; "Partly Free"—those countries in which some freedom exists but is seriously curtailed; and "Not Free"— those countries in which basic political rights are absent and basic civil liberties are widely and systematically denied.

In the past 30 years, the number of countries that are "Not Free" declined by a third, whereas the number that are "Free" doubled. The share of nations that are democracies has jumped from 42 percent in 1989–90 to a plateau of 61 to 64 percent since 2000. In 1973, when the surveys began, Freedom House found that 35 percent of the world's population lived in countries that were classified as "Free." Today that share has grown to 46 percent. In that same time frame, the share living in countries classified as "Partly Free" has slipped from 18 to 17 percent, and the share living in countries classified as "Not Free" has dropped from 47 percent to 37 percent.[18] If the percentages were the same today as in 1973, there would be roughly 700 million fewer people living in the full sunlight of democracy and civil liberty, and 700 million more living in the darkness of tyranny.

How Free Trade Nurtures a Free Society

Expanding trade and globalization deserve a share of the credit. Economic freedom and development have spread the tools of communication. Hundreds of millions of people in developing countries now have access to cell phones, the Internet, and satellite TV. Increased foreign travel and foreign investment have exposed them to a world of new friendships, ideas, and lifestyles. A more open and less controlled economy fosters the growth of "civil society"—

including new businesses, independent labor unions, professional associations, and clubs, or what the great 18th-century British statesman Edmund Burke called society's "little platoons." People in a free and open market tend to see people outside their ethnic and religious group not as threats but as potential customers and business partners. People learn to practice tolerance and compromise in their everyday lives, essential public traits for a democracy.[19] Growth has also created a rising global middle class that is economically independent and politically aware. Freed from the daily shackles of toiling for subsistence, these middle-class families have turned their attention to such causes as securing property rights, improving the environment, and getting their kids through college. As people embrace the daily freedom of the marketplace and property ownership, they come to expect more freedom in the political sphere.

Nations open to the global economy are significantly more likely to enjoy greater political and civil freedoms than those countries that are relatively closed. Governments that grant their citizens a large measure of freedom to engage in international commerce find it increasingly difficult to deprive them of political and civil liberties, whereas governments that "protect" their citizens behind tariff walls and other barriers to international commerce find it much easier to deny those same liberties. A special panel commissioned by the WTO to survey the state of the world trading system on the WTO's 10th anniversary rightly observed, "Generally, the marks of closed economies are lack of democracy and a free media, political repression, and the absence of opportunity for individuals to improve their lives through education, innovation, honest hard work and commitment."[20]

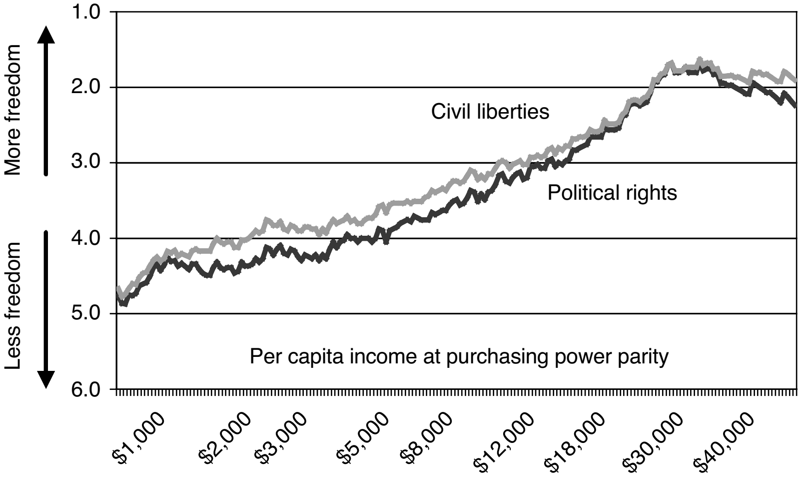
If we compare the economic openness of individual countries to their civil and political freedom, we can see an unmistakable pattern: Citizens of the most economically open countries are far more likely to enjoy political and civil liberty than citizens of less open countries. The annual *Economic Freedom of the World Report*, by James Gwartney and Robert Lawson, measures the level of economic freedom in 140 countries around the world, including the freedom to engage in international transactions. Their study considers tariff rates and foreign exchange and capital controls. Among the 28 countries in the top quintile of openness, 22 are rated "Free" by Freedom House. Among the 28 countries in the bottom quintile of openness, only five are rated "Free." In fact, the number of "Free" countries rises in each quintile along with the freedom of citizens to engage in the global economy.

Globalization provides a double boost for democracy and human rights. Trade itself opens societies directly to more outside influences that promote freedom. And by enabling faster growth, trade and openness raise incomes and expand the middle class, which also reinforce the desire for broader freedoms in society. If we track civil and political freedom by income, we see the same powerful pattern as we did with economic openness. Wealthier countries tend to enjoy more political and civil freedoms than poor countries. Figure 8.2 shows the average political and civil freedom in the world among countries at a given income level. For each income level, the graph shows the average political and civil freedom ratings for countries in that "neighborhood"—the nearest 20 countries on either side of that income. With 193 countries represented, each neighborhood is a kind of floating quintile measuring the gradual changes in freedom as we move up the income ladder.

According to the graph, political and civil freedoms expand slowly from $1,000 to about $5,000 annual per capita income—the same significant threshold we mentioned earlier in the chapter. In this income neighborhood, political rights average 3.9 on the Freedom House scale and civil liberties 3.5, placing these nations squarely in the "Partly Free" category. From then on, the neighborhoods improve more rapidly. By $15,000 per capita, the average scores cross the threshold into the "Free" category, and by $34,000, government oppression of civil liberties and political rights is at a minimum. The ratings suffer slightly at incomes above that because of the presence of a few oil-rich but freedom-poor states such as Qatar, Brunei, Kuwait, and the United Arab Emirates.

The spread of economic freedom, trade, globalization, and middle-class incomes has helped to lay the foundation for the flowering of democracy in such formerly authoritarian countries as South Korea, Taiwan, and Chile. It is not a coincidence that within a decade after the passage of NAFTA, one-party rule in Mexico was broken with the election of Vicente Fox in 2000. NAFTA helped to break the grip of the long-ruling PRI over the economic life of the country. Now Mexico has become a vigorous multiparty democracy. In contrast, countries where political freedom and civil freedoms are in retreat,

Figure 8.2
WELCOME TO THE NEIGHBORHOOD



SOURCES: Freedom House, CIA Factbook.

such as Venezuela and Zimbabwe, are also countries where governments are busy curtailing economic freedom.

Promoting Freedom in China

The connection among economic freedom, growth, and political and civil freedom should encourage Americans who love liberty and strike a note of fear in the hearts of oppressive governments around the world. China's rapid economic rise has moved it into a mixed neighborhood where "Free" countries become more common than "Not Free" countries. If the experience of other countries offers a pattern, the communist rulers in Beijing will find it increasingly difficult to suppress the legitimate desires of their citizens to enjoy political rights and civil liberties commensurate with their citizens' expanding economic freedoms and middle-class incomes. The recent economic downturn and rising unemployment in China may provide a spark.

Another potential catalyst for political change in China could be environmental and land-use concerns. Chinese citizens have become more willing to challenge the government to provide cleaner air and water and to protect their homes from unjust takings by the government. During a visit to Shanghai in 2006, I read in the local English-language press that homeowners had successfully halted development of a second leg of a high-speed magnetic levitation train. In a scenario familiar to American homeowners, Chinese families feared the presence of the train would reduce the value of the homes they can now buy and own. More recently, the *International Herald Tribune* reported in January 2008, "Demonstrations against the maglev in downtown Shanghai over the weekend, the city's largest public protest since thousands took part in sometimes violent anti-Japanese demonstrations in 2005, present authorities with a new challenge: a growing middle class that wants a say in major decisions about development in the city."[21] Call it NIMBY—"Not in My Back Yard"—with Chinese characteristics.

The line connecting globalization to human rights and democracy is not always straight. The world is too complex a place. Culture and history influence the political order along with economic arrangements. The city-state of Singapore has one of the most open economies and highest standards of living in the world, but the civil and political freedoms of its citizens remain partly curtailed. Despite its economic reforms and rapid growth, the Chinese communist government refuses to allow much noneconomic freedom. Many oil-producing states in the Middle East have achieved relatively high incomes and have selectively opened their economies, but most of them remain stubbornly "Not Free." But these outliers do not disprove the dominant positive correlation between economic development and political and civil freedom.

The global advance of freedom has not followed a straight upward slope either. For reasons as varied as the countries, the past three years have witnessed a stall in the rising share of countries and people enjoying political and civil freedom. Arch Puddington, the head of Freedom House, noted in the most recent report that one-fifth of the world's countries have suffered major or incremental reversals of freedom in the past two years. But the world remains a far more hospitable place for basic civil liberties and representative government than it was 30, 20, or even 10 years ago, and expanding trade and globalization are a major part of the story.

Free Trade's "Peace Dividend"

Our more globalized world has also yielded a "peace dividend." It may not be obvious when our daily news cycles are dominated by horrific images from the Gaza Strip, Afghanistan, and Darfur, but our more globalized world has somehow become a more peaceful world. The number of civil and international wars has dropped sharply in the past 15 years along with battle deaths. The reasons behind the retreat of war are complex, but again the spread of trade and globalization have played a key role.

Trade has been seen as a friend of peace for centuries. In the 19th century, British statesman Richard Cobden pursued free trade as a way not only to bring more affordable bread to English workers but also to promote peace with Britain's neighbors. He negotiated the Cobden-Chevalier free trade agreement with France in 1860 that helped to cement an enduring alliance between two countries that had been bitter enemies for centuries. In the 20th century, President Franklin Roosevelt's secretary of state, Cordell Hull, championed lower trade barriers as a way to promote peaceful commerce and reduce international tensions. Hull had witnessed first-hand the economic nationalism and retribution after World War I. He believed that "unhampered trade dovetail[s] with peace; high tariffs, trade barriers and unfair economic competition, with war."[22] Hull was awarded the 1945 Nobel Prize for Peace, in part because of his work to promote global trade.

Free trade and globalization have promoted peace in three main ways. First, trade and globalization have reinforced the trend towards democracy, and democracies tend not to pick fights with each other. A second and even more potent way that trade has promoted peace is by raising the cost of war. As national economies become more intertwined, those nations have more to lose should war break out. War in a globalized world means not only the loss of human lives and tax dollars but also ruptured trade and investment ties that impose lasting damage on the economy. Trade and economic integration have helped to keep the peace in Europe for more than 60 years. More recently, deepening economic ties between China and Taiwan are drawing those two governments closer together and helping to keep the peace. Leaders on both sides of the Taiwan Strait seem to understand that reckless nationalism would jeopardize the dramatic economic progress that the region has enjoyed.

A third reason why free trade promotes peace is because it has reduced the spoils of war. Trade allows nations to acquire wealth through production and exchange rather than conquest of territory and resources. As economies develop, wealth is increasingly measured in terms of intellectual property, financial assets, and human capital. Such assets cannot be easily seized by armies. In contrast, hard assets such as minerals and farmland are becoming relatively less important in high-tech, service economies. If people need resources outside their national borders, say oil or timber or farm products, they can acquire them peacefully by freely trading what they can produce best at home.

The world today is harvesting the peaceful fruit of expanding trade. The first half of the 20th century was marred by two devastating wars among the great powers of Europe. In the ashes of World War II, the United States helped to found the General Agreement on Tariffs and Trade in 1947, the precursor to the WTO that helped to spur trade between the United States and its major trading partners. As a condition to Marshall Plan aid, the U.S. government also insisted that the continental European powers (France, Germany, and Italy) eliminate trade barriers between themselves in what was to become the European Common Market. One purpose of a common market was to spur economic development, of course, but just as importantly, it was meant to tie the Europeans together economically. With six decades of hindsight, the plan must be considered a spectacular success. The notion of another major war between France, Germany, and other Western European powers is unimaginable.

Compared to past eras, our time is one of relative world peace. According to the Stockholm International Peace Research Institute, the number of armed conflicts around the world has dropped sharply in the past two decades. Virtually all the conflicts today are civil and guerrilla wars. The spectacle of two governments sending armies off to fight in the battlefield has become rare. In the past decade, wars have been fought between the governments of Eritrea and Ethiopia in 1998–2000, and the United States and Iraq in 2003, but between 2004 through 2007, no two nations were at war with one another.[23] Civil wars have ended or at least ebbed in Aceh (in Indonesia), Angola, Burundi, Congo, Liberia, Nepal, Timor-Leste, and Sierra Leone.[24]

Coming to the same conclusion is the Human Security Centre at the University of British Colombia in Canada. In a 2005 report, it documented a sharp decline in the number of armed conflicts, genocides, and refugees during the past 20 years. The average number of deaths per conflict has fallen from 38,000 in 1950 to 600 in 2002. Most armed conflicts in the world now take place in Sub-Saharan Africa, and the only form of political violence that has worsened in recent years is international terrorism.[25]

All this helps explain why the world's two most conflict-prone regions—the Arab Middle East and Sub-Saharan Africa—are also the world's two least globally and economically integrated regions. Terrorism does not spring from poverty but from ideological fervor and political and economic frustration. If we want to blunt the appeal of radical Islam to the next generation of Muslim children coming of age, we can help create more economic opportunity in those societies by encouraging more trade and investment ties with the West. Enacting free trade agreements with certain Muslim countries, such as Morocco, Jordan, Bahrain, and Oman, represented small steps in the right direction. An even more effective policy would be to unilaterally open the U.S. market to products made and grown in Muslim countries. A young man or woman with a real job at an export-oriented factory making overcoats in Jordan or shorts in Egypt is less vulnerable to the appeal of an Al-Qaida recruiter.

Of course, free trade and globalization do not guarantee peace or inoculation against terrorism. Hot-blooded nationalism and ideological fervor can overwhelm economic calculations. Any relationship involving human beings will be messy and non-linear. There will always be exceptions and outliers in such complex relationships involving economies and governments. But deeper trade and investment ties among nations have made it less likely than for generations past that America's sons and daughters will be called upon to fight in a war.

The Moral Case for Trade

As if it were not enough to argue that free trade has lifted millions out of poverty, strengthened human rights and democracy, and spread peace, let me make one more bold claim: Free trade and globalization encourage individuals to behave in better ways. The same "invisible hand" that turns our personal drive for betterment to the public's benefit also shapes our characters. The commercial and personal interactions with people from other countries that have come with globalization teach us tolerance, sympathy, humility, prudence, trustworthiness, and a spirit of service to our fellow human beings.

Success in the global marketplace requires winning the trust of strangers, proving reliability, and cooperating with people of differing language, culture, ethnicity, and race. The late Pope John Paul II, in a 1991 encyclical called *Centesimus Annus*, described the global economy as a sphere of activity where "people work with each other, sharing in a 'community of work' which embraces ever widening circles."[26] In this expanding economic community, the pope observed, a market system encourages the virtues of "diligence, industriousness, prudence in undertaking reasonable risks, reliability and fidelity in interpersonal relationships, as well as courage in carrying out decisions which are difficult and painful but necessary, both for the overall working of a business and in meeting possible set-backs."[27] As markets expand across borders and into new regions of the world, those "bourgeois virtues" increase at the expense of such vices as sloth, mistrust, duplicity, prejudice, and xenophobic nationalism.

The expansion of global markets reinforces fair play and the rule of law. Citizens and officials are not exposed to the temptation to game the system and seek special favors. When imports are controlled by arbitrary tariffs, quotas, and licensing regimes, opportunities multiply for graft and bribery. In less developed countries, it is not uncommon that citizens who want a consumer good or need a spare part must seek the favor of someone in authority. Barriers to trade can also promote smuggling, underground supply chains, and criminal cartels. For all those reasons, studies show that nations that are more open economically tend to be less corrupt.[28]

Historically, those cities and countries at the forefront of international trade were also among the most open and tolerant societies of their day. Venice in the 1400s and the Dutch Republic in the 1600s were the leading commercial centers of their eras. They each provided freedom and legal protection to Jews and religious dissenters. Their citizens learned to welcome people of differing religions and races because intolerance was, among its other shortcomings, bad for business. Today, as we have seen, societies open to trade are more likely to be open to freedom of religion and speech and political pluralism.

In the end, the argument in favor of free trade comes down to one of basic justice. If an American wants to trade what he has produced for something a person or group of people in another country have produced, our government should not interfere. To use the power of government to forbid a transaction that is beneficial to the two parties involved is to violate the sovereignty of free individuals. Trade barriers rob people of the rightful fruits of their own labor, distributing the spoils to other people with no moral claim to the confiscated wealth other than political power.

Free trade gives to each person sovereign control over that which is his own. In his 1849 essay, "Protectionism and Communism," the French political economist Frederic Bastiat wrote,

> Every citizen who has produced or acquired a product should have the option of applying it immediately to his own use or of transferring it to whoever on the face of the earth agrees to give him in exchange the object of his desires. To deprive him of this option when he has committed no act contrary to public order and good morals, and solely to satisfy the convenience of another citizen, is to legitimize an act of plunder and to violate the law of justice.[29]

That should be reason enough for Americans to demand that the last fetters on our freedom to trade be removed.

9. The Protectionist Swindle: How Trade Barriers Cheat the Poor and the Middle Class

Our politicians love to say that the United States is "the most open economy in the world," and it's true that America's trade barriers are relatively low compared to most other countries. But we are not the most open economy in the world, not even close. Our generally low average tariff rate disguises high tariff "peaks" on certain goods and other barriers against a range of imports important to millions of American workers and families. Those remaining trade barriers slow our economy and cost American consumers and producers tens of billions of dollars a year.

If an Olympics were held for the most open economy, the United States would be out of medal contention. According to the most recent annual *Economic Freedom of the World Report*, people living in 26 other countries enjoy greater "freedom to trade internationally" than do Americans. The report considers not only tariffs on imports but regulatory barriers, exchange rate and capital controls, and actual levels of trade. Bragging rights for the most open economies belong to, in descending order, Hong Kong, Singapore, the United Arab Emirates, Chile, the Netherlands, Ireland, Hungary, Switzerland, the Slovak Republic, and Estonia. The United States lies back in the pack, in 27th place among the 140 ranked nations.[1]

Despite the claims of openness, our government imposes significant barriers against imported clothing, footwear, leather products, glassware, watches, clocks, table and kitchenware, costume jewelry, pens, mechanical pencils, musical instruments, cutlery, hand tools, ball and roller bearings, ceramic wall and floor tile, railway cars, processed fruits and vegetables, rice, cotton, sugar, milk, cheese, butter, and canned tuna. Through 232 separate antidumping measures, the government imposes tariffs as high as 280 percent on products from 39 different countries, mostly against imported steel and chemicals.[2] Federal law prohibits or restricts foreign competition in domestic airline service, broadcasting, intercoastal shipping, and government contracting. When it is not interfering in our freedom to trade, the government distorts trade with an array of export promotion programs and other subsidies to favored businesses and farm sectors.

Every one of those barriers and programs is backed by domestic special interests that benefit from restricted competition, but every one also extracts money from millions of consumers and taxpayers, leaving our economy weaker and American families poorer than we would be without the intervention.

Harmonized Tariff Nightmare

The first tip off that America is not a free trade country is the tariff code itself. The official Harmonized Tariff Schedule of the United States rivals the U.S. income tax code for random complexity. It fills 2,959 pages, encompasses 99 chapters, and features 10,253 separate tariff lines.[3] Each line is designated by an eight-digit tariff code and accompanied by three separate tariff rates. Column 1 "General" is the rate that applies to most countries, and Column 1 "Special" applies to countries with which we've signed free-trade agreements or to which we've extended unilateral preferences. Column 2 contains the highest tariff rates reserved for a handful of unsavory states that are on the U.S. government's black list, such as North Korea and Cuba.

General tariff rates in Column 1 apply uniformly to more than 90 percent of our trading partners, but there is nothing uniform about the rates. A bit more than a third of the lines are duty free, meaning the tariff is zero, but the rest are all over the map. One out of every twenty lines imposes a duty greater than 15 percent.[4] Rates vary even among products that appear similar. A reasonable person would be stumped to explain why one rate applies to one line of products, and another rate to the line above or below it.

Open the harmonized tariff schedule at random, and you will quickly confront the puzzling complexity of it all. Figure 9.1 displays a typical page. In chapter 10, "Cereals," the tariff for durum wheat is 0.65 cents per kilogram, for Canadian western extra strong hard red spring wheat, 0.35 cents per kilogram. Rye, oats, and yellow corn enter duty free, but importers of yellow dent corn must pay

0.05 cents per kilogram, popcorn 0.25 cents, rice in the husk 1.8 cents, husked brown rice 0.83 cents, grain sorghum 0.22 cents, canary seed 0.32 cents, barley for malting purposes 0.1 cents, and barley for other purposes 0.15 cents.

In chapter 61, "Articles of apparel and clothing accessories, knitted or crocheted," the tariff on men's or boys' overcoats of various kinds is 15.9 percent if made of cotton. If the coat is primarily of man-made fibers but contains 25 percent or more by weight of leather, the tariff is 5.6 percent; if 23 percent or more by weight of wool or fine animal hair, the tariff is 10 percent plus 38.6 cents per kilogram. Overcoats of wool or fine animal hair are assessed a tariff of 16 percent plus 61.7 cents per kilogram. If it contains 70 percent or more by weight of silk or silk waste, the tariff drops to 0.9 percent. Women's or girls' overcoats made of wool or fine animal hair face a slightly higher ad valorum (percentage) duty than their male counterparts, 16.4 percent, but a slightly lower per kilogram duty of 55.9 cents. (Perhaps our government wants women to wear coats that are heavier but less expensive than those worn by men.)

In chapter 72, covering "Iron and Steel," ferronickel enters duty free, but ferromolybdenum is charged 4.5 percent of value, ferrotungsten and ferrosilicon tungsten 5.6 percent, ferrotitanium and ferrosilicon titanium 3.7 percent, ferrovanadium 4.2 percent, and ferroniobium 5 percent. In chapter 92, "Musical instruments; parts and accessories of such articles," upright and grand pianos face a general duty of 4.7 percent; other pianos 3.5 percent; guitars, violins, harps and other stringed musical instruments 3.2 percent; guitars valued under $100 (excluding the value of the case) 4.5 percent; brass-wind instruments 2.9 percent; drums 4.8 percent; while keyboard pipe organs, piano accordions, mouth organs, and cymbals enter duty free.

See the pattern? Me neither. Like the federal tax code, the tariff schedule has devolved into a mishmash of disconnected duties with varying rates that defy any rational explanation. The rates are arbitrary, discriminatory, and distortionary. They appear to be generated randomly by a computer, or by a roomful of protectionist monkeys pressing buttons for fun. Of course, each tariff rate has its own history, probably originating in a meeting years ago between congressional staffers and lobbyists for domestic producers seeking "protection" from foreign competitors, only to be lowered through protracted negotiations with other countries.

Figure 9.1
HARMONIZED TARIFF SCHEDULE OF THE UNITED STATES (2008) - SUPPLEMENT 1
annotated for statistical reporting purposes

Heading/ Subheading	Stat Suffix	Article Description	Unit of Quantity	Rates of Duty 1 General	Rates of Duty 1 Special	Rates of Duty 2
6103		Men's or boys' suits, ensembles, suit-type jackets, blazers, trousers, bib and brace overalls, breeches and shorts (other than swimwear), knitted or crocheted:				
6103.10		Suits:				
6103.10.10	00	Of wool or fine animal hair (443)........................	No. .... kg	38.8¢kg + 10%	Free (BH, CA, CL, IL, JO, MX, P, SG) 12.7¢/kg + 3.3% (MA) 9.9% (AU)	77.2¢kg + 54.5%
		Of synthetic fibers:				
6103.10.20	00	Containing 23 percent or more by weight of wool or fine animal hair (443).........................	No. .... kg	60.3¢kg + 15.6%	Free (BH, CA, CL, IL, JO, MX, P, SG) 18.6¢kg + 4.8% (MA) 15.5% (AU)	77.2¢kg + 54.5%
6103.10.30	00	Other (643)	No. .... kg	28.2%	Free (BH, CA, CL, IL, MX, P, SG) 5.7% (JO) 8.5% (MA) 15.5% (AU)	72%

		Of other textile materials:				
		Of artificial fibers:				
6103.10.40	00	Containing 23 percent or more by weight of wool or fine animal hair (443)	No. kg	Free		77.2¢kg + 54.5% 72%
6103.10.50	00	Other (643)	No. kg	Free		
6103.10.60		Of cotton:		9.4%	Free (BH, CA, CL, IL, JO, MX, P, SG) 3% (MA) 8.4% (AU)	90%
	10	Jackets imported as parts of suits (333)	doz. kg			
	15	Trousers, breeches and shorts imported as parts of suits (347)	doz. kg			
	30	Waistcoats imported as parts of suits (359)	doz. kg			
6103.10.70	00	Containing 70 percent or more by weight of silk or silk waste (743)	No. kg	0.9%	Free (AU, BH, CA, CL, E, IL, J, JO, MX, P, SG) 0.4% (MA)	45%

SOURCE: U.S. International Trade Commission, Harmonized Tariff Schedule of the United States.

And this is the tariff schedule we offer to our "most favored" friends. If a country is not granted the general duty rates in Column 1 "General" or the generally lower or duty-free rates in Column 1 "Special," it must face the prohibitive rates in Column 2. Those rates date back to the trade-killing Smoot-Hawley Tariff Act of 1930 and are punishingly higher than the general rates. The most common Smoot-Hawley tariff rates are 25 percent, 35 percent, 40 percent and higher, with spikes exceeding 100 percent. Per kilogram duties in Column 2 are commonly 5, 10, or 20 times the general Column 1 duties. When certain members of Congress threaten to repeal normal trade relations with China or another targeted country, the effect would be to shove them into Column 2 and impose prohibitive tariffs that would bar most of our trade with that country.

Declaring War on Consumers

American workers and families pay for those tariffs every day in the form of higher prices and fewer choices when we shop. The tariffs are really discriminatory sales taxes imposed on imports. Those taxes drive a wedge between prices received by producers abroad and those paid by consumers in the United States. A 20 percent tariff will typically mean U.S. consumers will be stuck paying a higher price for the good than they would under free trade, while the foreign producer of the good makes fewer sales and earns less revenue than they would under free trade. The U.S. government, of course, collects revenue from the tariff, but at the expense of less trade and a less efficient use of our own productive resources, leading to a "deadweight loss" to our economy.

Among the most damaging trade barriers for American families are those imposed on what we wear and what we eat.

Clothing

When Americans shop to clothe themselves and their children, they pay higher prices, sometimes much higher, than they would otherwise because of government trade barriers. According to the U.S. International Trade Commission (USITC), in its biannual study of significant U.S. import barriers, the trade-weighted average tariff on imported clothing in 2005 was 10.6 percent.[5] (A trade-weighted average takes into account the volume of trade, with more heavily traded items accounting for a proportionally larger share of the average.) That is a lot higher than the overall average trade-weighted applied tariff rate of 1.4 percent.[6] Congress imposes some of its highest tariff rates on items that are most popular with American consumers. For example, certain women's and girls' man-made fiber pants face a 28.2 percent tariff, blouses 32 percent, and man-made fiber sweaters 32 percent.[7] Men's and boys' woven shirts, man-made fiber knit shirts, man-made fiber trousers, and swimwear imported from China and Vietnam face tariffs of more than 20 percent. [8]

Our government artificially jacks up the cost of clothing for American families through tariffs, quotas, and complex "rules of origin" that require foreign apparel makers to use American-made textiles in order for their clothing exports to qualify for the lowest import duty rates. A 2004 "Memorandum of Understanding" with China limited clothing imports from 2005 through 2008 by imposing 21 quotas covering 34 categories of textile and apparel products. The MOU required China to hold shipments to no greater than 7.5 percent above the previous year.[9] The alleged purpose of the MOU was to avoid "market disruption" and promote the "orderly development of trade." The real purpose was to shield domestic producers from the full effects of liberalized trade with China, all at the expense of American consumers. The USITC calculates that restrictions on imported clothing and textiles are the most costly trade barriers of all.[10]

Footwear

When the government is not taxing the shirt on your back, it is taxing the shoes on your feet. Some of the highest rates in the tariff schedule are reserved for imported footwear, especially the less expensive shoes families buy at discount stores. The USITC reckons the average tariff on shoes and other imported leather products was 10.7 percent in 2005.[11] Again the average disguises tariff peaks as high as 67 percent aimed at the more popular, mass market footwear.

The anti-consumer nature of the shoe tariffs prompted a bipartisan group of more than 150 members of Congress to sponsor the Affordable Footwear Act of 2007. The bill would eliminate tariffs on more than half of shoe imports. The bill's preamble notes that the government collected $1.8 billion in duties on imported shoes in 2006, a tax burden that falls disproportionately on low- and moderate-income families because they spend a larger share of their disposable income on shoes and other necessities. Shoe tariffs don't even "save" a significant number of jobs. The American shoe sector is so uncompetitive that even when hiding behind tariff walls, imports now account for 98 percent of domestic shoe sales. There are virtually no jobs left to save.[12]

Not content to tax our shoes, the government also taxes imported socks. In January 2008, the Bush administration imposed a temporary 13.5 percent tariff on the 8.3 percent of imported socks that come from Honduras. The tariff was meant to placate a certain Republican lawmaker in Alabama with several sock factories in his district and a few other, mostly southern, lawmakers whose votes were thought necessary for upcoming trade deals the administration wanted. The trade agreements never came to a vote, but 300 million Americans were socked with higher prices to keep their feet warm and dry. All this for the sake of a domestic sock industry that, by its own count, employs only 20,000 workers in jobs that are not well paid.[13]

Food

Americans who have struggled to pay rising food prices may be surprised to know that it is the explicit policy of the U.S. government to keep the domestic price of certain foods fixed well above prices paid on world markets. Our government conspires with producers to restrict domestic supply by imposing tariffs and tariff-rate quotas on imported sugar, rice, milk, butter, and canned tuna.

Tariff rate quotas, or TRQs, allow a certain amount of a good to enter from a designated country under a low or zero tariff, but any imports above the quota face prohibitively high rates. In all, 195 tariff lines are subject to TRQs, with in-quota rates averaging 9.1 percent and out-of-quota tariffs an intimidating 42 percent.[14] The intended result is to drive a wedge between the lower global prices and a higher domestic price. Domestic producers and our own government reap extra revenue from the higher prices, while American families and food-processing industries are stuck paying the difference.

One of the most protected commodities is sugar. Because of subsidies and tariff-rate quotas in place since 1981, Americans have been paying two to three times the world price for sugar. Higher sugar prices also drive up what we pay for candy, soft drinks, bakery goods, and other sugar-containing products. The federal government guarantees domestic producers a price of at least 22.9 cents per pound for beet sugar and 18 cents for cane sugar. To maintain those prices, it enforces a rigid system of quotas that virtually guarantees domestic producers 85 percent of the nation's sugar market. The government grudgingly allows the importation of specific amounts of sugar and sugar-containing products from certain countries to fill the remaining 15 percent. The Godfather himself could not have devised a more effective protection racket.

The sugar program redistributes money from the many sugar users to the few sugar producers. According to a 2000 study by the General Accounting Office, the higher prices engineered by the sugar program cost American households and sugar-consuming industries $1.9 billion a year. Of that, $1 billion goes into the pockets of a relatively small number of sugar producers—about 5,000 sugar-beet growers and fewer than 1,000 sugar-cane growers. Another $400 million goes to the favored sugar-producers abroad who are allowed to sell into the inflated domestic U.S. market, what economists call "quota rents." With tariffs, at least our own government collects the revenue, but with the quota system, the money goes to foreign exporters and their governments. And the other $500 million? It just disappears in lost efficiency, or "deadweight loss," to the U.S. economy.[15] A more recent study of the sugar program by the USITC found a similar negative impact.[16] The sugar program enriches a few thousand sugar producers by ripping off consumers and by making our nation poorer.

American families also pay more for their milk, butter, and cheese, thanks to federal dairy price supports and trade barriers. The federal government administers a Byzantine system of domestic price supports, marketing orders, tariff-rate quotas, export subsidies, and domestic and international giveaway programs. Federal policy blocks American consumers from buying lower-cost dairy products from more efficient producers in New Zealand and Australia. As the USITC staff concluded, "A consequence of government intervention has been to raise U.S. domestic [dairy] prices substantially above world market prices."[17] According to the USITC, between 2000 and 2002, the average U.S. domestic price of nonfat dry milk was 23 percent higher than the world price, U.S. cheese prices were 37 percent higher, and the price of U.S. butter was more than double the world price.[18]

Hungry for a bowl of rice with your glass of milk? The federal government protects domestic rice producers with an array of tariffs on various kinds of rice imports. According to the Harmonized Tariff Schedule of the United Sates, rice tariffs range from 0.44 cents per kilogram on lower quality, broken rice to 2.1 cents per kilogram on husked, brown rice. Imported white and parboiled rice face an ad valorem (or percentage) rate of 11.2 percent. U.S. tariffs are significantly lower than tariffs imposed by other developed countries, such as Japan and Korea, but existing U.S. tariffs of 3 to 24 percent still keep domestic rice prices higher than they would be otherwise if Americans could buy rice freely from producers abroad.[19]

Thinking of a tuna sandwich for lunch? The U.S. government limits imports of canned and pouch tuna through the familiar tariff-rate quota system. Tariffs average 17.7 percent on tuna packed in oil and 10.8 percent on the more common tuna packed in water. The TRQs take their biggest bite in the Pacific island of American Samoa, where three-quarters of the canned tuna for the U.S. market is processed. TRQs add 4 to 8 percent to the final cost of tuna (with producers paying the rest of the tariff) The amount of tuna that can be imported at the lower, in-quota rate is limited each year to 4.8 percent of domestic consumption during the previous year. This rule requires importers to stockpile large quantities of tuna in customs-bonded warehouses in late December while they wait for the quota to be determined for the New Year. Once the New Year arrives, they rush to import the tuna before the 4.8 percent quota is filled.[20]

On top of all those tariffs, the government imposes unnecessary regulations designed to advantage American producers at the expense of consumers. In the 2002 farm bill, Congress imposed a new "country-of-origin labeling" (COOL) requirement on beef, lamb, pork, fish, shellfish, and other perishable agricultural commodities. After understandable resistance from retailers, the government finally began in March 2009 to require that such food items must have the country of origin stamped on them. This is nothing but a form of regulatory harassment designed to play to antiforeign prejudices. COOL provides zero health or safety information; foreign meat and produce must conform to exactly the same health and safety standards that apply to domestic-made goods. The U.S. Department of Agriculture estimates the COOL regulations will cost $89 million to implement in the first year and $62 million annually even after 10 years of adjustment. Although the costs are significant, the USDA found the public benefits to be negligible. Country-of-origin labeling was not meant to serve the public but instead to provide yet another unfair advantage to domestic producers at the expense of the public.[21]

The cost of all those restrictions on imported food may sound like nickel and dime stuff, but it adds up to real money out of the pockets of American families. The Organisation for Economic Cooperation and Development, in its annual assessment of rich-country farm policies, estimates that U.S. agricultural trade barriers transferred $11.8 billion from American consumers to producers in 2007. That amounted to an annual "food tax" of $39 on every single American, or $155 for a family of four.[22]

Planes, Cars, Cutlery, and Clocks

Government tariffs hit us when we travel and when we stay at home. To make public transportation less economical, the government imposes a 14 percent tariff on imported railway or tramway passenger coaches.[23] Imported motor cars are assessed a 2.5 percent tariff, whereas motor vehicles designed for the transport of goods are socked with a 25 percent tariff. The latter category covers light trucks and at one time even applied to imported minivans.

If you choose to fly instead of drive, you will pay a higher airfare because of government restrictions on airline competition. Foreign-owned carriers are flatly banned from flying paying passengers from one U.S. city to another. Of course, there are legitimate security reasons for not allowing the national air carriers of Syria and Iran to fly across U.S. airspace, but such concerns are silly when applied to British Airways, Qantas, Air Japan, and other established carriers from friendly, developed nations. European Union officials rightly complain that American-owned airlines are free to make money flying paying passengers from London to Berlin or other internal routes in Europe while European carriers are forbidden from serving internal U.S. routes.[24]

Federal law also prohibits foreign investors from controlling more than 25 percent of the voting stock of a domestic airline. Those restrictions preclude entrepreneurs such as Britain's Richard Branson from starting and controlling a low-cost carrier to serve passengers within the United States—making it more expensive for low-income grandparents to visit their grandchildren. The result of those restrictions is less investment in our domestic airline capacity and less competition for service and airfares. On top of airline restrictions, the U.S. government sticks the flying public with high tariffs on imported luggage.

If you decide to stay at home and build your household nest, the U.S. customs service will not leave you alone. The tariff code imposes an average, trade-weighted tariff of 7.9 percent on ceramic tile, a 6.4 percent on costume jewelry, 4.6 percent on cutlery and hand tools, 4.5 percent on glassware, 3.9 percent on musical instruments, 5.1 percent on pens and mechanical pencils, 5.4 percent on tableware, earthenware, and pottery products, and 5.1 percent on watches, clocks, and parts.[25] As with most other categories, average tariffs mask much higher duties on particular products that are often the less glamorous, mass-market items middle- and lower-income Americans buy.

Taxing Imports, Taxing the Poor

Import taxes on food, clothing, and shoes fall especially hard on the poor and middle class. The lower a family's income, the more it will spend proportionately on basic necessities. As the Organisation for Economic Cooperation and Development concluded in its study on rich-country farm programs, tariffs on imported food "can bear heavily on low-income consumer households, for whom food constitutes a larger share of their total expenditures."[26] In this way, U.S. trade barriers against farm products act as a regressive tax. Higher prices at the grocery store negate some or all of the income support the government seeks to deliver to low-income households through such programs as food stamps. What the government gives with one hand, it takes away with the other.

In the same way, U.S. tariffs on clothing and shoes fall disproportionately on the poor. Edward Gresser of the Democratic-leaning Progressive Policy Institute has done more than anyone to expose the anti-poor bias of the U.S. tariff code. Poring over those 3,000 pages and 10,000 lines, Gresser has discovered a disturbing pattern: More expensive, higher-end items enter under the lowest or zero tariffs, while the highest rates fall on the less expensive product lines most likely to land in the shopping cart of a poor, single mother.

For example, synthetic fiber men's shirts prompt a 32.5 percent tariff, cotton shirts 20 percent, and silk shirts 1.9 percent. Ladies' polyester underwear is assessed a 16 percent tariff, silk underwear 1.9 percent. Men's dress leather shoes, the kind worn in Wall Street brokerage houses and Washington think tanks, are charged an 8.5 percent duty, sneakers of more than $20 a pair 20 percent, and sneakers under $3 a pair a whopping 48 percent.[27] As Gresser concludes:

> In general, American tariffs are low or zero on high-technology products and heavy industry goods. They are zero or trivial on natural resources and industry goods, and also low on luxury goods. But they are very high on a narrow but important set of products: the cheap and simple clothes, shoes, and food that poor people buy and poor countries make and grow. . . . Without any particular intention, therefore, the United States has created a system that is open and kind to wealthy countries and rich people, but wildly harsh for the poor.[28]

According to Gresser, a recent welfare system graduate earning $15,000 a year as a maid in a hotel will forfeit about a week's worth of salary in a year to the U.S. tariff system, while the hotel's $100,000-a-year manager will give up only two or three hours' pay. And the defenders of the status quo can't even argue they are saving jobs, since so few American workers are still employed making cheap shoes and clothing.

This is the status quo that so many "progressives" in America, from the Public Citizen Naderites to AFL-CIO labor leaders, are expending millions of dollars to defend. They reflexively oppose any trade agreements that would reduce those regressive tariffs. Their trade policy boils down to keeping barriers high on goods made and grown by poor people abroad and consumed by poor people here at home.

Trade barriers are a costly and regressive form of income redistribution. They take from the many and the disproportionately poor, and give the spoils to the politically connected few. What is fair about that?

Crippling American Producers

Consumers are not the only losers from America's remaining trade barriers. Duties and restrictions on trade impose damaging costs on American companies, hobbling their ability to compete and forcing them to downsize, outsource, or even relocate abroad.

When government intervention raises the domestic price for raw materials and other commodities, it imposes higher costs on "downstream" users in the supply chain. Higher costs can mean higher prices for consumers, reduced competitiveness for U.S. exporters in global markets, lower sales, less investment, and ultimately fewer employment opportunities and lower pay in the affected industries. If domestic prices for a key commodity become too expensive, domestic producers may be forced to go out of business or to move production to other countries where they can buy the commodities at lower prices. Import restrictions can also disrupt deliveries, just-in-time inventory management, and production cycles by forcing domestic users to rely on a smaller number of suppliers.

A Sour Deal for Candy Makers

Consider the poster boy for self-damaging protectionism, the U.S. sugar program. When the program is not raising prices for consumers at the store, it is savaging the bottom line for American companies. Artificially high domestic sugar prices raise the cost of production for refined sugar, candy, and other confectionary products, chocolate and cocoa products, chewing gum, bread and other bakery products, cookies and crackers, and frozen bakery goods. Higher costs cut into profits and competitiveness, putting thousands of jobs in jeopardy.

In a report issued on Valentine's Day 2006, the U.S. Commerce Department found that the sugar program is not such a sweetheart deal for the U.S. food manufacturing industry. When U.S. companies are forced to pay two to three times the world price for wholesale refined sugar, as they have for the past 25 years, it erodes their competitiveness and profitability. For makers of confectionary products and breakfast cereals, for example, sugar accounts for 20 to 30 percent of the total cost of production. As a consequence, "Many U.S. [sugar-containing product] manufacturers have closed or relocated to Canada, where sugar prices average less than half of U.S. prices, and Mexico, where sugar prices average about two-thirds of U.S. prices."[29]

The Commerce report surveys the damage: Ferrara Pan Candy in Forest Park, Ill., closed its domestic facilities and eliminated 500 jobs while opening one plant in Mexico and two in Canada. Hershey Foods closed plants in Pennsylvania, Colorado, and California while moving production to Canada. The Chicago area, long a hub for the confectionary industry, has been especially hard hit. The city lost 4,000 jobs in the industry from 1991 to 2001, including 1,000 jobs at Brachs facilities.[30] In 2002, Kraft Inc. announced that it was closing a Life Savers candy factory in Holland, Mich., in order to relocate production to Canada, where the company could buy sugar at world-market prices.[31] The number of sugar refineries in the United States has dropped from 23 to 8, in large part because of the high costs of domestic raw sugar.[32]

In each of those cases, company representatives cited the high price of domestic sugar as a major reason for the exodus of productive capacity and employment from the United States. In all, 6,400 workers in the sugar-processing industry have lost their jobs because of their own government's deliberate policy to drive up the cost of their major input. According to the USITC, the sugar program "saves" only 2,200 jobs in the sugar growing and harvesting industry. So our sugar policy eliminates three jobs for every one it saves. The Commerce report concluded that "eliminating sugar quotas and tariff rate quotas and allowing sugar to freely enter the United States duty free would result in economic gains in the form of increased domestic food manufacturing production and U.S. exports, gains for consumers, taxpayer savings, and a net positive effect on U.S. employment."[33] Now that would be a nice Valentine present to the country.

I've participated in many a panel discussion where I have heard lobbyists for the sugar growers complain that other countries "dump" sugar on global markets. They claim with a straight face that sugar quotas are a "no-cost" program because they do not typically require direct tax expenditures. They warn against allowing more imports into what is already "a chronically oversupplied U.S. market."[34] But dumping is not the real issue. The American Sugar Alliance also opposes increased imports from Australia, a country that offers minimal support to its farmers. Most tropical countries where cane sugar is grown are too poor to lavish government tax subsidies on their growers. And even if subsidized sugar has worked its way into global markets, our government should not deprive domestic consumers and workers from reaping the benefits of lower prices. It is laughable to claim the sugar program is "no cost" when it forces American families and factories to pay more than a billion dollars a year in higher prices. And if the domestic U.S. market is "chronically oversupplied," that is because the sugar program itself encourages domestic overproduction. A lower, world-market price would curb the most inefficient domestic production while stimulating greater consumption, bringing supply and demand into a sustainable balance.

Steel Tariffs and Quotas

Another way trade barriers damage American producers is by restricting access to steel on global markets. The domestic U.S. steel industry has been among the most protected sectors of the economy for decades. The domestic industry hid behind quotas during most of the 1980s. In 2002, President Bush unwisely imposed restrictions on imported steel to fulfill an implied promise during the 2000 campaign and to win over additional votes for Trade Promotion Authority. The quotas lasted for 20 months, restricting imports from a number of our trading partners. The tariffs were finally lifted after the U.S. government lost a challenge in the WTO brought by a dozen countries that justifiably complained that the restrictions violated our commitments to international trade rules our government had agreed to follow.

In this case, our trading partners did us a favor. Steel tariffs may keep a few aging steel mills running, but they impose costs on U.S. industry. When our own government restricts imports of steel, it results in a higher domestic price for steel, driving up production costs for steel-using industries such as automobile manufacturing, machine tool makers, metal fabrication plants, and construction. During a congressional debate on steel tariffs in 1999, my Cato colleagues and I calculated that for every one American working in the steel industry, there were 40 Americans working in those industries that must buy steel to make their final products.[35] Once again, protectionism favors the few at the expense of the many.

Driving Up Shipping Costs

Congress adds to the cost of doing business in the United States by driving up the cost of moving goods by ship. American producers who want to move goods from one U.S. port to another must pay artificially high rates due to Section 27 of the Merchant Marine Act of 1920. Known more commonly as the Jones Act, it requires that any ship carrying goods between U.S. ports must be U.S. built, U.S.

registered, U.S. owned, and staffed by a crew made up predominantly of U.S. citizens. No foreign-owned shipping companies need apply. This outright ban on any international competition in intercoastal shipping imposes a heavy price on U.S. industry and our entire domestic transportation infrastructure.

Under the Jones Act, a foreign-flagged ship can enter a U.S. port with cargo from just about any port in the world except another U.S. port. A foreign-flagged ship can carry cargo from Miami to the Bahamas, and then from the Bahamas to Charleston, S.C., but not directly from Miami to Charleston. Under similar restrictions in the Passenger Vessel Services Act of 1886, a foreign-owned cruise ship can carry passengers from Seattle, Wash., to Vancouver, Canada, but not from Seattle to Juneau, Ala. The result is the same: American tourists, like American business owners, pay more than they should to travel between U.S. ports.

Building and operating ships is much more costly in the United States than in most other countries. The daily cost of operating a U.S.–flagged container ship is $34,260 compared to $22,190 to operate a foreign-flagged ship. Operating a U.S.-flagged tanker costs $27,900 per day compared to $16,600 to operate a foreign-flagged tanker.[36] By mandating the use of U.S. ships, the Jones Act drives up the cost of moving goods between U.S. ports, forcing more goods to be shipped by rail or truck, which adds to costs and congestion on America's railways and roadways.

Defenders of the Jones Act claim it promotes national security by maintaining a merchant marine fleet in case of war. But Jones Act ships tend to be old and of limited use in times of real emergencies. In fact, during the 1991 Gulf War, only one Jones Act ship actually went to war; President George H. W. Bush suspended the law because it was interfering in the efficient transfer of goods. President George W. Bush again suspended the law in 2005 so that fuel and other needed supplies could more quickly reach New Orleans after Hurricane Katrina.[37] What is an expensive indulgence for domestic shippers during peacetime becomes an intolerable liability for the nation during times of emergency.

More recently, in the name of combating terrorism, the U.S. Congress voted to impose sweeping new costs on ships bound for the United States. A provision in the SAFE Port Act of 2006 requires that, by mid 2012, 100 percent of all containers must be scanned for radioactive material before being loaded on a U.S.-bound vessel. No American wants to leave a door open for terrorists to smuggle a nuclear device into the country, but this provision is overkill. It treats the most secure, supervised, and low-risk containers the same as those that pose a higher risk. The result will be millions of dollars of additional costs with no additional security.

The U.S. Customs and Border Patrol agency estimates the SAFE Ports provision will impose $380 million to $640 million annually in additional filing requirements alone. The head of the CBP warned Congress that the 100 percent screening requirement will have an "enormous" impact on trade, resulting in "lower profits and higher transportation costs for U.S. importers."[38] That fear has been seconded by our trading partners in Europe, who warned in a 2008 EU study that the screening requirement will have a "potentially devastating economic impact." A pilot program in the port of Southampton, Great Britain, revealed the steep costs of full implementation. "This measure is unilateral and would disrupt trade and cost legitimate EU and U.S. businesses a lot of time and money while no real benefit is proved when it comes to improving security," the EU report concluded.[39]

So why was the 100 percent screening requirement approved by Congress? Because it allows members to impose a regulatory tax on imports while sounding tough on national security. Never mind that it will not actually make us any more secure and that the costs of this unfunded mandate will ultimately be imposed on not just foreign producers and shippers but also on American consumers and businesses.

Our Unfair "Unfair Trade" Laws

America's antidumping law is considered holy writ by members of Congress. They express horror at the thought that American companies would be left to the mercy of global competition without being able to use the antidumping law to defend themselves against "unfair" trade. But the antidumping law itself is unfair and has no connection to fairness or sound economics.

American trade law defines dumping as selling imports in the U.S. market at "less than fair value"—at a price below the average total cost of production or below the price in the exporter's home market. If the U.S. Department of Commerce determines that dumping exists, and if the U.S. International Trade Commission determines that dumping has caused "material injury" to the domestic industry, then duties are imposed on the targeted category of imports to offset the alleged dumping.

At first glance, the law sounds reasonable. Why would a foreign producer sell something at a loss or a price lower than they could get in their home market unless they had some devious purpose such as putting their rivals out of business so they can charge monopoly prices? In reality, foreign producers have plenty of legitimate reasons to do both.

U.S. companies sell at below-average total cost every day in the domestic market. In fact, all businesses that are losing money, which is typically half of all businesses in operation (and even more during a recession), are by definition selling at below average total cost. They keep selling because the additional ("marginal") cost of producing each new item is lower than what they receive for the sale of each item, but still not enough to also cover the firm's fixed costs. By the law's definition, the money-losing Big Three U.S. automakers have been "dumping" their cars on the U.S. market for years.

U.S. companies also sell at different prices in different markets in order to meet the local competition or establish a presence in a new market. The company may sell its products at a higher price in Connecticut than in rural Mississippi. It's called "price discrimination," and it is perfectly legal. There is nothing predatory about the practice. Thus the antidumping law unfairly punishes foreign producers for engaging in practices that are normal and perfectly legal among domestic U.S. producers.

By design, the antidumping law is stacked against foreign producers and their American customers. When a domestic company petitions the Commerce Department for relief against alleged unfair trade, the targeted foreign producers must fill out long and complex forms that require teams of specialized lawyers to decipher. The law is written in such a way that "dumping" is almost always found, and the dumping margins tend to be high. One reason is a technique called "zeroing," in which the Commerce Department ignores sales of imported products at prices above "fair value," while counting only those priced below. This technique inflates the dumping margins in cases where dumping would exist without zeroing. Not surprisingly, zeroing has been repeatedly and successfully challenged in the WTO by our major trading partners.

Once the Commerce Department finds dumping, the USITC determines whether the "unfairly traded" goods have caused "material injury" or threaten to cause such injury to the domestic industry. Here, too, the threshold is low and stacked against foreign producers and their U.S. customers. Most existing businesses are better off with less competition, so allowing more price-competitive imports to be sold in the U.S. market will probably inflict some injury on domestic producers. The right question should be whether any injury has been inflicted on the U.S. economy as a whole, including consumers and import-using industries, and there the answer would almost always be "no." Although domestic producers of a product will suffer from lower prices, the more numerous domestic consumers will gain.

The antidumping law has been heavily used by the steel industry to selectively cripple its foreign competition. Of the 232 antidumping measures in force at end of 2007, 51 percent were aimed at steel and iron products. Antidumping duties can range as high as 280 percent and can all but eliminate imports in the targeted category. Once in place, antidumping orders typically remain in place for years. Forty percent of the current measures have been in place for more than a decade, with the oldest dating back to 1973.[40] The United States has agreed to submit its antidumping measures to five-year sunset reviews, but most duties are kept in place even though there is nothing inherently wrong with "dumping" as legally defined. If our government cared about our welfare, it would welcome rather than punish healthy price competition.

"Rip-Off America" Provisions

Along with the many barriers it maintains against imports, the federal government has rigged its own procurement system against foreign providers and the U.S. taxpayer. The Buy American Act and other provisions require the U.S. military and other agencies to buy from American suppliers even if it means paying a lot more for the same or an inferior products and services. The $787 billion American Recovery and Reinvestment Act of 2009, signed in February by President Obama, contained its own "Buy American" provisions.

The Buy American Act of 1933 requires federal agencies to do just that: Buy American. The law steers federal procurement spending to supplies, construction material, and "domestic end-products" manufactured in the United States in which more than half of their components are also made in the United States. The "Buy American" requirement can be waived if it is deemed "inconsistent with the public interest," if the product is not available domestically, or if it is not available at a "reasonable" cost. The requirement can also be waived if an imported alternative can be procured for a price that is 6 percent less, including import duties, than the price of a domestic good. If the domestic provider is a small business or located in an area of high unemployment, the import must be available at a 12 percent discount, and if the purchase is for national defense, the import must be at least 50 percent cheaper.[41]

For the benefit of taxpayers and our military, the Buy American Act has been modified in recent decades. The WTO Agreement on Government Procurement allows U.S. companies to bid on foreign government contracts on a reciprocal basis with major trading partners. Certain information technology hardware and software goods are exempt from the rules. But for most government contracts, the Buy American Act gives domestic producers the license to overcharge the government 6 to 12 percent on routine contracts and up to 50 percent on military contracts.

Cargo preference laws require that U.S.–flagged ships must transport at least half of all government-owned cargo and virtually all military cargo. All exports funded by the Export-Import Bank must be transported on U.S. ships unless a waiver allows shipment by the recipient country. The Fly America Act requires that government-financed transport of passengers or cargo must take place on a U.S.-flag air carrier or on a code-sharing foreign airline. The Food Security Act of 1985 requires that U.S.–flagged ships be used for 75 percent of food shipments by the U.S. Department of Agriculture and U.S. Agency for International Development.[42] Thanks to those requirements, we as taxpayers must pay more to fly officials to their meetings, transport subsidized U.S. exports, and deliver food to hungry people.

State and local governments also discriminate against foreign producers at the expense of their own taxpayers. The European Union cites 10 states that require that local construction projects use only

U.S.–made steel, even if steel can be purchased at a lower price on international markets.[43] As our European friends see it, “In the field of procurement, the main U.S. trade barriers are contained in a wide array of clauses in federal, state and local legislation and regulation giving preference to domestic suppliers or products, or excluding foreign bidders or products altogether.”[44]

When our government is not excluding foreign competitors, it is subsidizing U.S. companies directly. The Export-Import Bank provides loans, loan guarantees, and subsidized insurance rates to some of America’s largest exporters, especially the aircraft sector. (There is good reason why the Ex-Im Bank is known as “Boeing’s Bank.”).[45]

The Market Access Program subsidizes overseas advertising promotion for companies using U.S. farm products to the jingle of $254 million in 2005. The Dairy Export Incentive Program subsidizes the export of milk powder, butterfat, and cheese. Through the Export Enhancement Program, the Department of Agriculture offers cash bonuses to exporters, allowing them to sell abroad at below cost (an act that in other circumstances our government might call “dumping”). In all, 19 federal agencies oversee 100 separate export promotion programs.[46] Hundreds of other direct government subsidies on a state and local level are channeled to companies trying to compete in global markets, with taxpayers footing the bill.

The mandate to “buy American” sounds patriotic, especially on matters of national defense, but the true impact of these laws is to weaken our security. The federal government does not have a bottomless pot of money to spend. Buy American provisions mean we get less bang for the buck. We either pay more for the same amount of national defense, or we buy less defense with the same dollars. In the 2009 “stimulus bill,” the Buy American provisions mean taxpayers will see fewer bridges, roads, and buildings built, whereas more debt will be passed on to our children.

There is nothing patriotic about wasting tax dollars or sending our troops into battle without the best possible equipment our money can buy. If a foreign power tried to deny us the ability to buy the defense-related products we need in global markets, we would consider it an act of war. Yet in the name of a misguided patriotism, we seem ready to inflict a global embargo on ourselves.

How Trade Barriers Weaken America

Every one of the trade barriers and subsidies maintained by the U.S. government imposes a drag on the U.S. economy. For the benefit of a few small, concentrated special interests, millions of Americans pay higher prices, import-using producers and their workers suffer, and our economy grows more slowly than it would if trade were free.

When the government imposes tariffs on a category of imported goods, it starts a damaging chain reaction through the whole economy. Import prices rise for consumers and the volume of imports falls for the targeted products, as intended, which allows domestic producers to raise their own prices. Demand will shift to domestically made products, spurring more output and employment in the protected domestic sector, but overall demand will fall as consumers are put off by the higher prices. Meanwhile, U.S. exports in the liberalized sector fall because our domestic producers become even less price competitive in global markets. Output and employment in nonprotected sectors will decline, the overall economy will shrink slightly, and total employment will remain unchanged.

Shrinking and Re-Slicing the Pie

Trade barriers impose more costs on our economy than any benefits produced. When we import more of a certain category of good than we export, say shoes or shirts, by definition we are buying and consuming more of that type of good than we produce. More Americans have more money at stake as consumers of the good than as producers. So when a tariff raises the domestic price of an item, we have more to lose collectively as consumers than we have to gain as producers.

Trade barriers are portrayed as a way to protect "our" producers against "their" producers, our jobs against their jobs. But in practice as well as theory, trade barriers are really about protecting some American producers at the expense of other American producers, some American workers as the expense of other American workers. Protection is worse than a zero sum game. As we learned from the example of sugar quotas, protection redistributes wealth from one group of citizens to another while destroying wealth in the process by making our overall economy less productive. It re-divides and shrinks the pie at the same time.

Trade barriers are also sold as a way to protect jobs, an especially appealing pitch during times of recession and high unemployment. But again, the real impact of higher barriers is to save some jobs and destroy others, usually in equal numbers. The U.S. International

Trade Commission determined in its study that "about 60,000 workers would move from contracting sectors to expanding sectors as a result of liberalization."[47] In other words, keeping those trade barriers in place suppresses trade and output while protecting a small number of jobs, while preventing the creation of the same number of jobs in other, more productive and sustainable sectors of the economy.

A Tax on Imports Is a Tax on Exports

Trade barriers impose further damage on the economy by making it harder for America's most competitive companies to export to foreign markets. When tariffs, quotas, and regulations make it difficult for foreign producers to sell in the U.S. market, those producers earn fewer dollars. Fewer dollars flowing into global currency markets drives up the price of dollars, making U.S. exports relatively more expensive. How can foreigners buy our exports if we deny them the opportunity to earn dollars by selling in our market? Fewer goods sold in the U.S. market quickly translate into fewer U.S. goods sold on global markets. A tax on imports becomes a tax on exports.

America's trade barriers also impede our exports by complicating efforts to negotiate lower trade barriers abroad. Our remaining barriers to imported agricultural products, for example, make poor countries less likely to open their markets to U.S. goods and services. The Doha Round negotiations in the WTO foundered in part on the reluctance of the United States and other rich nations to open our protected markets to farm goods grown in poor countries. The protected domestic sugar industry opposed the Central American Free Trade Agreement because it contained a modest increase in the amount of sugar Americans can buy from our small neighboring democracies.

In a February 2008 letter, major U.S. business groups complained to the Bush administration that the sugar quotas in the farm bill will hurt their ability to compete in global markets. In the letter, the National Association of Manufacturers, the U.S. Chamber of Commerce, the American Beverage Association, Grocery Manufacturers Association, National Retail Federation, and 11 other key trade groups highlighted the direct cost to the U.S. economy of quotas on imported sugar:

> The sugar industry is the most highly protected U.S. agricultural industry and has already won major additional protection in the pending farm bill, as well as an increase in their

> government-guaranteed price. . . . Our trading partners will be reluctant to enter into agreements if they see the U.S. Congress passing legislation that invalidates key provisions of one of our most important trade agreements. . . . reopening NAFTA's sugar provisions could put in jeopardy the market access achieved not only for U.S. farmers, but for U.S. manufacturers and service providers as well.[48]

Remaining trade barriers make America look hypocritical in the eyes of the rest of the world. Our politicians demand more open markets abroad while clinging to our own politically sacrosanct trade barriers at home. We fail to set a good example for other countries to follow. "Do as I say, not as I do" is as unconvincing on an international level as it is on a personal level.

"Dumbing Down" the U.S. Economy

Protectionism wastes time and energy by encouraging special interests to seek favors from the government. Millions of dollars of industry resources that could be spent on research, product development, investment in new plants and equipment, and employee training are instead diverted to lobbying for or against trade protection. The American Sugar Alliance, USA Rice Federation, the American Iron and Steel Institute, the National Textile Association, as well as certain trade unions all maintain Washington offices staffed with well-paid lobbyists charged with the mission of maintaining and raising barriers against their foreign competition—at the expense of the general American public. Those trade groups, in turn, raise and contribute millions of dollars to political activities to win influence on Capitol Hill.

Hiding behind trade barriers has not even proven to be good for the protected industries in the longer run. Protected sectors tend to grow weaker and less competitive when shielded from competition. High trade barriers have not "saved" the domestic textile, apparel, footwear, and other low-end manufacturing sectors from long-term decline and job losses. Higher domestic prices forced on consumers also dampen demand and promote substitutes, shrinking the domestic market. The protected sugar industry has seen its share of the domestic sweetener market cut in half since 1967,[49] while protected U.S. rice growers have seen their share of global exports steadily decline since the 1970s, when the United States was the world's leading exporter.[50] For protected sectors, trade barriers are a kind of devil's bargain. The industries have sold out their long-term viability for short-term dominance over shrinking markets.

Trade barriers "dumb down" our economy by undoing the good work of our best engineers, scientists, and entrepreneurs. The most creative and best-trained minds in America developed the jet engines, the containerization technology, and the Internet and global telecommunications that have done so much to promote the growth of global trade and output. In contrast, trade barriers are a kind of anti-technology. The mind-numbing columns of arbitrary tariff rates in the Harmonized Tariff Schedule and the tangled regulations that limit trade and investment stand in opposition to decades of technological advancement. We find a way to move goods, services, and capital around the world faster, more efficiently, and at lower cost, only to watch the politicians in Washington throw sand into the gears by erecting artificial barriers to commerce.

Think about it: If one of our children grows up to invent a way to move goods and bits of information even more rapidly around the world, we rightly call that "progress"; if another child grows up to become a populist politician who advocates raising trade barriers to slow the movement of those same goods and data across borders, we perversely call that "progressive."

Even if you are convinced that American companies need protection from foreign competition, how confident can we be that Congress will enact the right policies? Once we open that door, Congress needs to decide which industries deserve protection, which imported products need to be subject to tariffs or TRQs, and how high the tariffs should be. How confident can we be that Congress will impose such tariffs in a way that serves the public interest and not the special parochial interest of a small minority of producers? This is the same Congress, after all, that earlier in 2009 passed an omnibus appropriations bill riddled with 8,000 earmarks for pet spending projects. This is the same Congress that presides over an income tax code stuffed with deductions and credits aimed at social engineering. Predictably, the same institution has given us a tariff code that defies rational explanation.

"A Conspiracy Against the Public"

Americans instinctively understand that competitive and open markets are healthy. When producers must compete openly for the consumer's dollar, prices tend to come down, and quality and choices improve. But that same competition can make life uncomfortable for established producers, who would rather carve up markets among themselves and stifle new competitors. Adam Smith exposed the problem two centuries ago in *The Wealth of Nations* when he warned, "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices."[51]

In 1890, the U.S. Congress enacted the Sherman Act in an effort to prevent just those kinds of conspiracies. As the cornerstone of U.S. antitrust law, the statute prohibits "every contract, combination . . . or conspiracy in restraint of trade."[52] Over the decades, U.S. courts have interpreted the law to forbid such anticompetitive acts as price fixing, division of markets among competitors, and bid rigging. The Supreme Court has embraced a "quick-look" test that defines a violation as when "an observer with even a rudimentary understanding of economics could conclude that the arrangements in question could have an anticompetitive effect on customers and markets."[53]

All the trade barriers described in this chapter fail the "quick-look" test. They trample on the spirit if not the letter of U.S. antitrust law. The overriding purpose of tariffs and price supports is to fix prices for the benefit of a cabal of producers at the expense of "customers and markets." TRQs by definition allocate market share among producers to maximize their profits at the expense of buyers. (We'll let those foreigners have 4.8 percent of the domestic tuna market, not one can more!) Buy American provisions are nothing more than bid rigging wrapped in patriotic clothing.

Free trade is not just a matter of sound economics, although it is certainly that. Free trade is also a matter of justice, fairness, and social equity. In contrast, protectionism is a conspiracy against liberty and the public good, a conspiracy encouraged, enabled and joined by our own government.

10. A Trade Agenda for a Free People

U.S. trade policy should enhance the freedom of individual Americans, promote economic growth and prosperity, and advance our broader national interest in a more hospitable, peaceful world.

In more reflective moments away from the campaign trail, most of our nation's political leaders understand all that well enough. In the middle of a best-selling book, an aspiring American politician wrote a passage that would have fit comfortably in this book (had I been able to write as well):

> There is no doubt that globalization has brought significant benefits to American consumers. It's lowered prices on goods once considered luxuries, from big-screen TVs to peaches in winter, and increased the purchasing power of low-income Americans. It's helped keep inflation in check, boosted returns for the millions of Americans now invested in the stock market, provided new markets for U.S. goods and services, and allowed countries like China and India to dramatically reduce poverty, which over the long term makes for a more stable world.[1]

The author is Barack Obama; the book is *The Audacity of Hope.*

Our new president and members of Congress from both parties should pursue a trade policy that reflects "the better angels of our nature," as President Abraham Lincoln expressed it at the end of his first inaugural address. They should work together to systematically eliminate the last vestiges of an old trade policy rooted in mercantilist thinking of the 17th century and the politics of America's 19th century. Here are eight policy proposals that would bring U.S. trade policy into the 21st century:

1. Eliminate All Tariffs on Products of Special Interest to the Poor at Home and Abroad. Eliminating tariffs on products disproportionately consumed by low-income families would immediately put money in the pockets of Americans who would gain the most from the additional income. It would eliminate the most regressive form of taxation our federal government imposes. For those looking for a way to stimulate consumer spending, eliminating those tariffs would increase the spending power of the segment of society with the highest propensity to spend extra income on consumption. The loss of $25 billion in federal revenue now collected by the customs service represents a mere 1 percent of federal revenue projected for Fiscal Year 2009. It could easily be "paid for" through spending cuts or a small upward adjustment in other revenue sources less biased against the poor. Congress could consider a single bill for an up-or-down vote that would eliminate all trade barriers on food, clothing, shoes, and any other consumer items that millions of American families buy and consume every day.

2. Repeal All Tariffs and Other Trade Restrictions That Raise the Cost of Production for U.S.–Based Companies. The federal government should not impose unnecessary costs on U.S. companies trying to compete in global markets. Congress should repeal all tariffs and other trade restrictions that arbitrarily raise the cost to American companies for raw materials, intermediate inputs, capital machinery, and the transportation of goods. If Congress wants to promote the United States as a base for global manufacturing, it could give special attention to current restrictions that inhibit the competitiveness of U.S.–based manufacturers, such as restrictions on imported sugar and steel and intercoastal shipping. All those reductions could be consolidated into a single bill to be voted on by Congress without the threat of crippling or compromising amendments.

3. Rebase the U.S. Antidumping Law on the Traditional Yardstick of "Predatory Pricing." Selling at below "fair value" should be redefined to mean predatory pricing—selling at a cost intended to drive competitors from the market and thereby gain monopoly pricing power. If markets are kept open, this scenario will virtually never happen. Our "unfair trade laws" should be reformed so that they are no longer unfair to foreign producers but treat foreign producers the same as we do domestic competitors. A reformed law should require the Commerce Department and U.S. International Trade Commission to consider consumer and downstream producer interests alongside the interests of producers seeking protection. Lower import prices by definition will make life more difficult for domestic competitors; the real question is whether lower prices serve the national interest, and the answer is almost always yes. In sum, the antidumping law should be rewritten to serve the nation, not special interests.

4. Direct the U.S. International Trade Commission to Analyze the Income-Transfer Effects of Existing and Proposed U.S. Tariffs. The commission's biannual report on "Significant Import Barriers" provides a useful catalog of the major remaining barriers to trade, but the reports are silent on the deepest impact of those barriers. The real but relatively small net negative impact of those barriers on the overall economy disguises their much larger effect on income redistribution. Barriers on food, clothing, and shoes benefit a small slice of American producers at the expense of tens of millions of American households. The USITC model should be able to tell us who pays the cost of those barriers and how much they pay.

5. Consolidate All Unemployment, Job Retraining, and Wage Insurance Programs to Apply Equally to All American Workers, Not Just Those Displaced By Trade. The federal program of "Trade Adjustment Assistance" fails to help the vast majority of American workers displaced from their jobs and seeking a new line of work for reasons that have nothing to do with trade. A worker displaced by technology, domestic competition, or changing consumer wants is no less deserving of consideration when lawmakers craft public policy. Potential ideas include tax-exempt job retraining accounts that would allow adult workers to deduct payments for technical and professional retraining. A private-sector system of unemployment insurance should be encouraged so all workers can afford the option of insurance against prolonged unemployment. Health care benefits should also be divorced from employment through universal deductibility of insurance premiums and the expansion of health savings accounts so workers do not face losing their health insurance when they lose their jobs. This proposal would benefit all displaced workers, not just the relatively small minority who lose their jobs because of import competition.

6. Improve the Education System to Prepare Americans for the Workplace Opportunities of the Future. As technology and globalization shift our economy up the value chain, skills and education will become even more important for American workers. It is simply a fact of life that the ability of our children to earn a middle-class income in tomorrow's economy will increasingly depend on their human capital—the skills and knowledge they possess. The shortcomings of the American public education system and what to do about them are beyond the scope of this book, but the answer to anxieties about the future lies in preparing our children for the higher-skilled jobs of today and tomorrow, not raising trade barriers further to preserve the lower-skilled jobs of the past.

7. Promote Domestic Savings By Cutting the Federal Budget and Reforming the Tax Code. Both of these policy proposals are far removed from trade, but they would directly address political concerns about the U.S. current account deficit. Reducing, with the goal of eliminating, the federal budget deficit would free capital for other private-sector uses, reducing the demand for foreign savings to pay the current costs of our government. Our national pool of private savings can be increased by reducing the bias in the federal tax code against savings. One approach would be to shift federal taxes from income to consumption. The federal income tax could be repealed and replaced with a national sales or value-added tax. The current income-tax code could be reformed by creating a new individual savings account that would allow taxpayers to defer income taxes indefinitely on all saved income, paying taxes only when it is actually spent on consumption. Expanded 401(k)s and individual retirement accounts would also increase incentives to save for the future, providing more domestic savings for investment. A larger pool of domestically generated savings would reduce demand for foreign capital and incrementally encourage a smaller current account deficit.

8. Talk about the Benefits of Import Competition at the Highest Levels of Our National Trade Discussion. The president of the United States and the president's economic team have a unique responsibility to safeguard the economic interests of the entire nation, not the noisiest producer groups. In speeches, in the annual Economic Report of the President, in veto warnings to Congress, and in trade negotiations with other countries, the president should exercise leadership in guarding the interests of all Americans in an open and competitive American economy. The president has a special obligation to give voice to the single largest economic constituency group in the country—consumers. Members of Congress should do the same, standing up for the large majority of constituents in their states and districts who have much more to gain from free trade than from erecting and maintaining anti-competitive trade barriers. As the face of U.S. foreign policy, the president also has the greatest responsibility to use trade policy as a tool not just to promote economic development and fairness but also to encourage the spread of freedom and peace abroad.

For Main Street America, free trade is the trifecta of trade policy. Simply and effectively, it enhances our liberty, promotes prosperity, and advances peace. It reduces the role of government in our daily lives. It says “No” to the special interests and “Yes” to our national interest. Free trade confidently embraces the future. It affirms that Americans have much to offer the world and much to gain from collaborating with people in other countries as customers, suppliers, business partners, and friends. Free trade unites us with other people in an ever-widening “community of work” that provides a powerful alternative to conflict and war. Free trade embodies a policy of hope rather than fear.

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About the Author

Daniel Griswold directs the Center for Trade Policy Studies at the Cato Institute in Washington, D.C., where he has authored numerous studies on trade and immigration policy. He has written for major newspapers such as the *Wall Street Journal* and the *Los Angeles Times*, appeared on CNN, PBS, C-SPAN, Fox News and other national TV and radio networks, and testified before congressional committees. Earlier in his career, he served as a congressional press secretary and the editorial page editor of the *Colorado Springs Gazette.* After growing up in a small town in the Midwest, he earned a bachelor's degree in journalism from the University of Wisconsin at Madison and a diploma in economics and a master's degree in the Politics of the World Economy from the London School of Economics.

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