Shattering the Myths About U.S. Trade Policy

Forget the doomsayers, and stop blaming trade. An active trade policy can lead to a stronger U.S. economy. by Robert Z. Lawrence and Lawrence Edwards

As they say on my own Cape Cod, a rising tide lifts all the boats,” declared U.S. President John F. Kennedy several times during the 1960s. That picturesque metaphor encapsulates the assumptions underlying America’s trade policy since the Marshall Plan in 1948, and it has served as the linchpin of U.S. competitiveness strategy ever since.

Kennedy had it right: A free and fair global trading system can result in economic win-wins. Open borders allow companies to grow in foreign markets and, simultaneously, ensure that businesses remain competitive at home. That’s why U.S. policy makers have traditionally urged developing countries to reduce tariff and nontariff barriers, often arousing their ire.

Few could dispute that logic when, from 1980 to 2000, the world’s biggest economy grew just as rapidly as that of all other nations on average.

However, the skeptics about free trade have been gaining influence over the past decade. The longest post-War expansion in America, from 1991 to 2000, ended when the dot-com bust led to a recession in which the U.S. manufacturing sector shed almost 3 million jobs. A sluggish economy (GDP growth averaged 2.3% from 2000 to 2007) and the rapid development of emerging markets shrank America’s share of global GDP by about 10%. The United States experienced large trade deficits and rapid increases in imports from developing countries, particularly China.
Not surprisingly, many Americans blame free trade for their nation’s slide. The Wall Street Journal reported that although 24% of Americans earning over $75,000 a year had supported new trade agreements in 1999, over 50% believed by 2010 that such deals were hurting the United States. The growth in the offshoring of business services over the internet added to the tension. If developing countries’ growth is hurting the U.S., the logic went, that would justify the use of a protectionist trade policy that would preserve American incomes by keeping the rest of the world poor.

The rising opposition to America’s trade policy has two dimensions. The first pertains to jobs. In a 2008 poll, only 30% of respondents indicated that the statement “international trade is good for the U.S. because it leads to lower prices for consumers” came closest to their views; 63% agreed that “international trade is bad for the U.S. because it results in the loss of jobs and lower wages.”

Second, some economists argue that trade is damaging America’s welfare, with global competition hurting U.S. exporters, reducing wages, and increasing wage differentials. That’s vexing, because those experts suggest that the effects are not temporary and will persist even if the U.S. economy grows quickly and returns to full employment.

Emblematic of this view was an article, written in April 2008, by former U.S. Treasury Secretary Lawrence Summers, who invoked the authority of economist Paul Samuelson to argue that developing countries’ growth wouldn’t necessarily improve welfare in the U.S. Summers wasn’t the only one to sound the alarm: Hillary Clinton, during her 2008 presidential campaign, used Samuelson’s theory to support her position that the U.S. should call a time-out on negotiating free-trade agreements.

Summers also noted that in addition to greater competition in export markets, the growth of developing countries like China would increase oil prices, raising America’s energy-import bill. In addition, he observed that although global growth might benefit Americans whose intellectual creations earn rich rewards (filmmakers, for example), such growth could exert downward pressure on U.S. wages in high-tech industries such as computer manufacturing. Like Summers, Nobel Prize–winning economist Paul Krugman argued in 2007 that rising trade with developing countries could reduce the real wages of most U.S. workers and increase income inequality.

Just how valid are these concerns? To find out, we conducted a series of in-depth analyses of U.S. trade data by using regression analysis, other statistical techniques, and input-output analysis. Our findings contradict several popular theories about the impact of U.S. trade with developing countries and demonstrate that trade has been assigned a villainous role that far exceeds its actual impact on America’s economic difficulties.

To be sure, some imports have caused harm, as trade-related job losses hurt specific communities and prove to be costly for displaced workers. However, trade actually accounts for only a small part of America’s economic problems, and many myths surround its role in causing them.

**MYTH 1**

**America’s trade policy is the main cause of job losses, especially in manufacturing.** Manufacturing’s contribution to employment in the U.S. has fallen steadily for over half a century, long before America started running trade deficits. The rate of decline from 2000 to 2010—about 0.4 percentage points a year—was the same per year as during the previous 40 years. Moreover, the United States isn’t unique: Data going back to 1973 show that all industrial countries, even those with large trade surpluses such as Germany and the Netherlands, have reported a similar trend. (See the exhibit “Manufacturing Employment Has Fallen Steadily and Globally.”) Many people blame trade for the decline in America’s employment in manufacturing, but our research shows that the long-run drivers of the trend in the U.S. are primarily a combination of two other factors: increasing productivity growth in American manufacturing, and a shift in demand away from goods toward services.

America’s deindustrialization is “made in America,” so to speak, and it results primarily from Americans’ spending decisions. While productivity growth has led to lower prices, demand has not grown sufficiently rapidly to prevent a declining trend in employment, the data suggest. The reason is similar to that which reduced employment in agriculture: Faster productivity growth has allowed the U.S. to meet its needs for goods and to redeploy workers to other parts of the economy.

Trade deficits in manufactures have played only a partial role in reducing employment—and almost no role over the past decade. Using input-output tables that list the job content of production, we found that in 1998 and 2010, replacing imports with domestically produced goods would have increased manufacturing employment by 2.6 million and 2.9 million in each of those years, respectively. Over that decade, however, the fall in manufacturing employment, to the tune of 6 million jobs, would have been the same with balanced trade as it was with the deficits that the United States actually experienced. (See the exhibit “Balanced Trade Won’t Offset Job Losses Permanently.”)

The main cause, again, is the increasing growth in labor productivity. In current dollars, the manufacturing trade deficit
Manufacturing Employment Has Fallen Steadily and Globally

In the U.S., manufacturing’s share of employment fell by about 0.4 percentage points a year from 2000 to 2010—almost the same as during the previous 40 years. The U.S. isn’t unique: All industrialized countries, even those with trade surpluses such as Germany and the Netherlands, have reported a similar trend.

![Chart showing percentage contribution of manufacturing to employment for Germany, Sweden, Japan, U.S., and Netherlands from 1973 to 2010.](chart.png)

Source: U.S. Bureau of Labor Statistics

was twice as large in 2010 as it was in 1998, but the output per worker was higher, so the job content of each dollar of deficit has been falling rapidly. Even if the U.S. had enjoyed balanced trade in the past two decades, the share of manufacturing in employment would still have tumbled.

Free-trade critics claim that imports have been an important contributor to unemployment, especially during the recent recession. However, we found that the association between employment growth and import growth has been positive. This suggests that, whatever their questionability. Although trade has resulted in higher wages for some workers and occupations over the past decade, studies of recent data don’t show that it created economywide increases in inequality. The reasons why trade has improved welfare and why it hasn’t increased inequality are the same: The U.S. and developing countries have specialized in very different products and processes, making the latter complementary to America’s growth.

The models used by Samuelson and Krugman to predict welfare losses and wage inequality are elegant but simplistic, as they assume that products, factors, and industries are homogeneous; that factors of production are mobile within countries; and that the U.S. and developing countries make similar products. In reality, most products differ in terms of price and quality, factors of production are often used for specific tasks, and many products exported by developing countries are no longer produced in the U.S. That also explains why the economy-wide pressures of trade on wage inequality in America are muted. When the U.S. no longer makes certain products, the declining prices of imports benefit all consumers and do not affect relative wages.

Consequently, distinctive patterns of international specialization have emerged. Developed and developing countries export fundamentally different products, especially those classified as high-tech. Even when exports from both types of countries are in the same product category, prices differ greatly, suggesting that the products made by developed and developing nations are not substitutes for each other.

Higher-tech products have greater scope for product differentiation, enabling U.S. producers to better insulate themselves from foreign competition. Furthermore, the price and quality of developing countries’ exports are, on average, low, while the average price gap between developing countries’ exports and those of the U.S. hasn’t narrowed. These findings shed light on the perplexing trend, exemplified by computers and electronics, that U.S.-manufactured imports from developing countries are concentrated in industries that employ relatively high numbers of skilled American workers.

**MYTH 2**

**U.S. living standards are falling and wage inequality is rising because developing countries compete with the U.S. in its export markets on cost.** The claim that trade with developing countries has reduced Americans’ living standards is questionable. Although trade has resulted in lower wages for some workers and occupations over the past decade, studies of recent data don’t show that it created economywide increases in inequality. The reasons why trade has improved welfare and why it hasn’t increased inequality are the same: The U.S. and developing countries have specialized in very different products and processes, making the latter complementary to America’s growth.

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They sell cement, televisions or coffee. They drive up prices and cost consumers billions. Cartels act illegally, and yet seemingly having nothing to fear. In Europe, it turns out, price-fixing by cartels is a mere misdemeanour, like a traffic violation. Excerpts.

Harald Schumann

The upstanding businessmen usually get together at meetings of the Zentralverband Elektrotechnik in Frankfurt. There they talk about new markets and technologies and whatever else is new in the business of power transformers, those huge devices made of magnets and wire coils without which there would be no electricity supply. But the really exciting stuff always comes at the end of the official programme, in the evenings or on joint excursions.

Then, as the investigators describe it, managing directors and heads of sales meet in “small groups” for “project-related discussions” that can work out to be highly lucratively. What comes up in the conversations are arrangements that secure for the supposed competitors additional hassle-free profits in double-digit millions. Agreements are made in detail on who should get which contract and, above all, at what price.

For at least five years, as established by officials of the Federal Cartel Office in Bonn, the Siemens Group, the Regensburg Starkstrom-Gerätebaupower (high-voltage current equipment manufacturing company), France's Alsthom and the Swiss electrical giant ABB have carved up the German market for transformers, wholly without competition, to rip off their customers, who have had to pay much more, had the providers been forced to compete.

The antitrust watchdog's investigation went on for four long years, and in September last year resulted in a package of fines. Overall, €24.3m in penalties were levied against the four
companies and managers involved, and were paid into the national treasury.

**Name and shame?**

But there it ended. No one had to show up in court. None of those involved had their name published. In the media, not even a brief mention was made about the entire procedure.

That's the way it almost always is when cartels are broken up in Europe. Year after year, the competition authorities investigate hundreds of companies that violate the ban on cartels. Coffee and detergents, cement and chemicals, flat screen televisions and DVD players, glass and wire harnesses for cars, even fire engines and North Sea prawns – the list of industries creating cartels is almost unlimited.

Indeed, the cost of cartels to society are far higher than generally assumed. As the authorities have discovered, the cartels succeed in driving the prices of their products up by an average of 25 per cent and within four years are able to book a whole year's turnover as a windfall profit. Precise data, though, are by their nature, impossible to come by.

Cartels are the “children of darkness”, says Franz Jürgen Säcker, himself formerly an anti-trust judge and one of the leading experts in competition law at the Free University of Berlin. However, a nine-member team of economists from three European research institutes, in a study for the European Commission in 2007, calculated that the economic losses caused by cartels in Europe cost more than €260bn a year. That's 2.3 per cent of Europe's annual economic output, or double the annual budget of the European Union.

**Toothless laws**

This insight into the disastrous effects of the cartel business are nothing new. Walter Eucken, one of the pioneers of the West German economic system, considered the concentration of economic power by syndicates and cartels the fundamental problem of the pre-war economy. He therefore called for the state to enforce competition with an iron hand to keep prices down. In real life, however, little of that notion survived. Indeed, by 1957 the Bundestag had passed the first law against restraint of trade, and a European antitrust law was later included in the the EC Treaties. In practice, the laws against cartels remained toothless for decades, and whether the legislation actually works even now, remains a subject of controversy.

Doubt about the legislation nurtures the already high number of repeat offenders. American economists who analysed 283 cases of international cartels came up with some astonishing results. Between 1990 and 2005 the German chemical company BASF, for example, took part in 26 cartels. The French oil company Total was involved in 18 and Germany's Degussa in 13.

The official cartelbusters cannot be accused in any way of any lack of zeal. Since the start of 2010 the European Commission has dealt with 15 major cases and imposed fines totalling almost €4bn on 112 companies. That amount, levied in just three years, was four times higher than the penalties paid throughout the entire 1990s.

The steep increase, however, is in no way due to greater powers having been given to the antitrust authorities, but to the introduction of a generous arrangement for giving state's evidence. Since 2004 companies and their managers that voluntarily reveal the existence of a cartel to the
European Commission and give the necessary evidence escape without penalties, even if that company itself was the biggest beneficiary of the cartel.

**Risk versus reward**

What's more, the fines are limited to a maximum of 10 per cent of sales. How little that is, was made clear in 2002 by the exposure of a nationwide cement cartel. According to calculations of the cartel office, this brought its clients profits of around €2bn. All the same, the companies ended up paying only €400 million in fines.

Although cartels do enormous harm, the punishment meted out is at the level of fines for traffic violations. Their collusions are merely misdemeanours. In consequence, none of the perpetrators must appear personally before a court. The public usually does not even learn their names.

Things are rather different in the US. There, cartel members face long prison sentences, and in 2004 the maximum imprisonment was even extended to 10 years. Ireland and Britain have followed America's lead. The German federal government, though, does not want to hear of this. Speaking for Minister of the Economy Philipp Roesler, the Secretary of State declared that he considered the sanctions regime as “appropriate” and was “reluctant to turn EU antitrust legislation into criminal law”.

As many lawyers see it, that Germany of all countries continues to regard cartel offences as mere peccadillos is also rather questionable, as this generosity does not apply equally to everyone. Collusion in public tenders, or “bidding cartels”, is indeed indictable. “In that case, the State protects itself vigorously,” remarks Professor Säcker. German lawmakers must now ask themselves whether “collusion between local artisans truly deserves greater punishment than a global price-fixing agreement between multinational companies that causes billions in damage.”