# Traders of the Lost Ark

*Rediscovering a Moral and Economic Case for Free Trade*


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*With contributions by* FRED L. SMITH JR., MARC SCRIBNER, DANIEL PRESS, AND RYAN KHURANA

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COMPETITIVE ENTERPRISE INSTITUTE

PROFILES IN CAPITALISM
AUGUST 2018 | NO. 4

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Competitive Enterprise Institute
2018

## FOREWORD

By Daniel Hannan, MEP

“Free trade, one of the greatest blessings which a government can confer on a people, is in almost every country unpopular.” So wrote Lord Macaulay, the British poet, historian, and Member of Parliament, in 1824. His words were true then and are, if anything, even more true today. Which is bizarre when we consider the improvements that free trade has brought to the human condition during the intervening two centuries.

The economic historian Deirdre McCloskey has chronicled, at vast length, how the past 200 years have seen a rise in living standards on a different scale from anything Homo sapiens had experienced up to that point. In Macaulay’s time, almost everyone subsisted on around $3.00 a day. The life of a peasant farmer in Poland or Ethiopia or India or Japan would have been recognizable, in its essentials, to his Iron Age ancestors. Since then, our species has increased its wealth by, at a conservative estimate, 3,000 percent.

Yet clever people campaign against the system that enabled that secular miracle. In industrialized countries, they protest that free trade will shift jobs to places with lower wage levels; in developing countries, they fret that wealthy corporations will take over.

What lies behind these fears? There are, I think, three explanations, one psychological, one aesthetic, and one political.

First, the psychological objection. Free trade is counterintuitive. Our hunter-gatherer instinct is to provide against famine, to hoard. Relying on invisible strangers for basic necessities *feels* wrong. Never mind that Singapore, which imports even its drinking water, transformed itself from a mosquito-ridden swamp into a gleaming city state simply by dropping barriers to trade. Such facts run up against millions of years of evolution.

Second, the aesthetic objection. My children's homework is full of stories about nasty corporations exploiting textile workers in, say, Vietnam. Those stories lack any sense of context or perspective. Now, you and I wouldn't want to work in a Vietnamese sweatshop. But we have not spent our lives bending our backs in rice paddies. We have not fled villages that lacked electricity, clean water, and schools. Employees of foreign companies in Vietnam earn 210 percent of the national average income, and their wages are rising. If we want their wages to rise faster, and their working conditions to improve commensurately, what do you suppose would help—campaigning against free trade or buying their stuff?

It's the third, objection, though, the political one, that seems to animate American protectionists. Free trade brings dispersed gains but concentrated losses. Importing cheap Chinese steel would make almost every American a bit better off, as prices fell, productivity rose, new jobs were created, and money was freed up for other things. But voters, being human, would attribute that rise in living standards to themselves, not to free trade. The losers, by contrast—the small number of workers in industries that were undercut—would blame the government and vote accordingly.

I say "small numbers" advisedly. There are, depending on how we do the counting, between 80,000 and 150,000 people working in the American steel industry. But there are 17 million people employed in sectors that use steel, notably construction, manufacturing, and cars. As costs rise, these downstream industries will lose many more jobs than are preserved in steel. George W. Bush's 2002 tariff postponed a few job losses in the mills, but did so at the cost of 20,000 jobs elsewhere in the economy. It would have been far, far, cheaper to write every steelworker a check for not turning up to work.

Likewise with aluminum. Anheuser Busch, the St. Louis-based brewery conglomerate that is, on some measures, the world's biggest beer producer, says that, "the proposed 10 percent tax on aluminum threatens 20,000 U.S. manufacturing jobs that depend on the beer industry and raises taxes on American beer drinkers by $347 million per year. This tax hurts, not helps, American manufacturing." The combined effect of the two tariffs, says a study, will be to preserve 33,000 jobs in steel and aluminum while destroying 179,000 elsewhere.

And that's before we get to the international consequences: alienation of allies, retaliatory tariffs, loss of global influence—and, not least, the appalling precedent set by defining Canadian steel imports as a threat to U.S. national security.

Donald Trump assures us that "trade wars are good, and easy to win," but his military metaphor is 180-degrees wrong. In a war, you blockade enemy combatants to make them poorer. A tariff, by contrast, is a blockade against yourself. As the 19th-century economist Henry George put it, "What protection teaches us is to do to ourselves in time of peace what enemies seek to do to us in time of war."

Sure enough, others are "retaliating" by hurting their own consumers. Jean-Claude Juncker, president of the European Commission, boasts that, "we, too, can do stupid," and slaps duties on American vehicles, jeans, and bourbon. ("Hit the Chevy with a levy, tax your whiskey and rye," was how a chortling headline-writer in London's normally staid City AM summarized his announcement.) In other words, the EU is effectively saying: "You wanna drop rocks in your harbors, Trump? Fine, we'll drop bigger rocks in ours! How'd ya like that?"

I gave the first word to Lord Macaulay, the greatest Whig politician of the 19th century. Let me give the last to Ronald Reagan, the greatest Republican politician of the 20th.

> Our peaceful trading partners are not our enemies; they are our allies. We should beware of the demagogues who are ready to declare a trade war against our friends—weakening our economy, our national security, and the entire free world—all while cynically waving the American flag. The expansion of the international economy is not a foreign invasion; it is an American triumph, one we worked hard to achieve, and something central to our vision of a peaceful and prosperous world of freedom.

Daniel Hannan is a writer, journalist, and president of the Initiative for Free Trade. He has spent 18 years as a Member of the European Parliament, representing South East England. He is the author of nine books, including *New York Times* bestseller, *Inventing Freedom: How the English-Speaking Peoples Made the Modern World*, and the *Sunday Times* bestseller, *Vote Leave*. His latest book is *What Next: How to Get the Best from Brexit.*

## EXECUTIVE SUMMARY

The basic principles of a free society are timeless, but they need to be relearned every generation. One of those principles is the freedom for people to trade freely with one another—both within nations and across borders. The case in favor of free trade has been uncontroversial among economists since the time of Adam Smith, but support among policy makers and the public has ebbed and flowed with the political winds. Now, with the Trump administration raising tariffs and other trade barriers against Canada, Mexico, the European Union, and China, the ongoing liberalization process that began in the aftermath of World War II is experiencing the greatest threat it has yet faced.

As of this writing, it is too early to tell if the administration's actions are a blip in a longer trend or mark the start of a full-on reversal. Either way, the time has come to restate the economic and moral case for free trade for the current generation of policy makers and the interested public. With that as its aim, this paper provides a comprehensive case for the free exchange of goods and services without government restraint. It makes the case that people should be free to trade with whomever they want, whenever they want, and however they want, without government interference. In addition, it offers a general explanation of how global trading works, places that discussion in historical context, provides a taxonomy of the different types of trade barriers, and outlines the arguments for and against particular trade policies. Most importantly, it makes the case for free trade as a policy that is inherently moral, in addition to being economically sound.

This executive summary contains a brief list of actions policy makers should take to open markets and improve economic growth both here and abroad.

- Ideally, policy makers should lower tariffs and other trade barriers regardless of what other countries do. Even acting alone, the U.S. can reap economic benefits and provide a positive leadership example for the rest of the world to follow.

- Short of that, Congress should repeal Section 232 of the Trade Expansion Act of 1962 and Sections 201 and 301 of the Trade Act of 1974. These legislative provisions give the president the power to raise tariffs unilaterally by citing national security concerns or unfair trade practices. Power of the purse, including raising revenue through tariffs, properly belongs with Congress, not the executive branch.
- Work to remove non-trade provisions from existing trade agreements. These usually concern issues relating to intellectual property and labor, environmental, and regulatory policy. Thus, they often have the effect of imposing regulatory standards on participating countries, without requisite legislation. These are separate issues and should be treated separately, in a way that respects participating countries' sovereignty and lawmaking processes.
- Keep non-trade provisions out of future trade agreements for the reasons noted above.
- Eliminate, or at least reduce anti-dumping duties, the most costly non-tariff trade barrier. In addition to raising prices for consumers and reducing competition, they invite retaliation, which makes them doubly harmful.
- End subsidies and favorable financing deals for exporters. In addition to inviting foreign retaliation, they make American companies less competitive by encouraging them to redirect resources away from value creation and toward political maneuvering.
- Respect the World Trade Organization's (WTO) dispute resolution process. The U.S. can use the process to its advantage to get other countries to lower their trade barriers. America

leading by example is crucial in this area. The WTO lacks binding authority, so its liberalizing efforts rely on its members' playing honestly by the rules.

In making the case for free trade, we seek to dispel some common fallacies surrounding trade.

- Trade must be win-win, or else it would not occur in the first place. Trade is a positive sum proposition. People only agree to trade with each other when both expect to benefit. For one person to gain, it is not necessary for another to lose.
- Countries do not trade with one another; people do. Trade is not a collective phenomenon; it is an individual one. When people in China trade with people in America, one country is not "beating" the other on trade. It means people in both countries are making mutually beneficial deals with one another. In that sense, all trade is balanced.
- Trade deficits are worse than useless as a guide to policy. To illustrate, most of us run a persistent trade deficit with our local grocery store—we buy more from it than it buys from us—yet we all benefit from that trading relationship. Many Americans are happy to trade cash for goods, while many of our trading partners seek cash payments—so they trade with one another. Overseas dollars eventually return in the form of direct foreign investment. Foreign investors with dollars also buy up large amounts of government debt, which helps to keep the government's interest rates low. In the case of government debt, the policy problem is government overspending, not trade.
- Free trade does not mean fewer jobs—or more jobs—but the *right* jobs. Trade affects the *types* of jobs, not their number. The size of the labor force depends on the size of the population;

*Exports are the price we pay for imports.*

85 percent of America's job churn is due to technological change, not trade. However, free trade helps improve labor productivity—and thus raise wages—by incentivizing investment and employment in the sectors and industries in which a country's workers are the most productive. Protectionist policies create deadweight losses by diverting investment and resources to less globally competitive industries.

- When a country raises its trade barriers, it does not prompt other countries to lower theirs. On the contrary, that can lead to retaliatory tariffs and possibly even destructive trade wars. We are finding this out the hard way now.
- Exports are not preferable to imports. Governments usually conduct trade negotiations in a tit-for-tat fashion—lower your trade barriers and we will lower ours. That approach is premised on the misconception that a country benefits more from exports than from imports. Exports are the price we pay for imports. Would anyone turn down the opportunity to get all the imports they want at no cost? Of course not, but the world does not work that way, so we have to pay for those imports by exporting goods, money, or services in return.
- Trade barriers do not increase national security. It is nearly impossible to cut off a country from any commodity in a global market. Moreover, protected industries tend to be less efficient and less competitive, so their products will tend to cost more or be of lower quality—and thus deliver less security bang for the buck. And by weakening the overall economy, high trade barriers mean fewer resources are available for legitimate security needs, including the military.

- Trade barriers are not necessary to protect infant industries. Rather, such protection entails picking winners and losers. Politicians and regulators are no more adept than anybody else at foreseeing which companies or industries will dominate tomorrow's economy. And given that such decisions are subject to political maneuvering, they are unlikely to be made on the basis of economic merit—even to the small extent it could be discerned via the political process.

For more than 75 years, countries around the world, including the United States, have been slowly but surely lowering their trade barriers. In the United States, tariffs on dutiable goods were once as high as 60 percent. Today that figure is under 5 percent. Since most goods are duty-free, the average tariff against total imports is around 1 percent. Most of the rest of the world has moved in the same direction. It is important for America's, and the world's, long-term prosperity for policy makers to continue down the path of trade liberalization. In the short term, that means opposing any raising of trade barriers and making the broader case for freer global trade.

Following the policy suggestions listed above would help ensure that today's skirmishes do not turn into an all-out trade war. The more widely known the case for free trade becomes, the more likely policy makers are to loosen trade restraints. This paper is dedicated to that cause.

## INTRODUCTION

Imagine yourself on a tropical island. Plenty of sunshine, trees for shade, and beautiful white sand beaches all around. You have the whole place to yourself. This idyllic paradise would be one of the poorest places on Earth. Why? Because you would have no one to trade with.

In the wider world, everyone is good at something, but nobody is good at everything. That is why people specialize and trade with one another. You might be good at catching fish, but lack the woodworking skills to build a sturdy shelter. If you had another person with you on the island, she might be handy with construction, but not much good at fishing. Instead of toiling separately at both tasks to middling results, you could specialize—you catch fish; she builds a shelter. Both of you can have full stomachs and a roof overhead, and are both better off.

That seems like a commonsensical lesson. Yet it is often ignored by policy makers and pundits. While trading with your neighbor—or fellow castaway—seems natural, as soon as people on other islands are included, some of your other neighbors are bound to feel jealous. When trade is between people in different countries, those neighbors might lobby the government to protect them from what they decry as "unfair" competition from abroad.

The arguments for protection from foreign competition often follow a similar faulty line of reasoning. Foreign competitors, the argument goes, enjoy unfair advantages thanks to a variety of reasons—from lower labor costs to a laxer regulatory environment to subsidies from their governments. Those advantages help foreign competitors undercut domestic producers, who are then forced to lay off employees and shut down plants. Governments also come under stress, as they lose revenue, have to increase spending to aid displaced workers, or both.

Another common argument for protectionist trade policies involves national security. According to this argument, the ability to produce certain "strategic" products or materials—such as aircraft or some metals—within the nation's borders is vital to secure access to those goods, even when they are produced in allied nations. Yet in a global market, it is impossible to cut off a country's access to a given commodity.

We see both of these types of arguments in current debates about trade, especially with China. China, it is alleged, unfairly manipulates its currency to encourage exports and discourage imports. Its workers are paid low wages and work long hours and its factories produce appalling levels of pollution. And it is suggested that China is doing all of this to gain a national security advantage over its competitors.

Some of these arguments are stronger than others. There is no doubt that China uses an array of protectionist measures in an effort to win competitive advantage. Its forced technology transfer and state-sponsored "national champion" corporations are as protectionist as trade policies get. However, lower wage levels for the skill provided and less strict environmental controls are commonplace in rapidly developing countries and form part of their comparative advantage; China is no exception.

Moreover, as China's per capita income rises and more people can satisfy their basic needs, they will turn their attention to environmental protection, workplace safety, and other social goals. Economists call this phenomenon the environmental Kuznets curve. It is already beginning to take place in China—which is why labor-intensive, low-skill sectors such as textiles are no longer a Chinese comparative advantage, and are moving to countries with lower labor costs than China, such as Bangladesh and Indonesia.[1]

*In a society based on trade, you have to offer a person something in return that they value even more.*

The right response to protectionist policies is not to retaliate in kind. In fact, protectionist arguments getting aired today are nothing new. From the supposedly unstoppable rise of Japan in the 1980s or the effects of increased trade with Mexico and Canada when the North American Free Trade Agreement (NAFTA) was being debated in the early 1990s, we have heard them all before. The protectionist arguments were wrong then, and they are wrong now. Today, they need to be refuted just as strongly.

This paper makes the case that people should be free to trade with whomever they want, whenever they want, and however they want, without government interference. For a few rare exceptions, such as the slave trade, "the problem isn't the *market* in those things; it's those things themselves," as Georgetown University philosophers Jason Brennan and Peter Jaworski point out.[2] [Emphasis in original] In an ethical world, this criterion would be one of the few ethical restraints on trade.

Trade is an inherently social act. In a society based on trade, you have to offer a person something in return that they value even more. Trade makes the modern world possible. As Leonard Read, the founder of the Foundation for Economic Education, pointed out years ago, nobody on Earth knows how to make something as simple as a common pencil.[3] You have to know how to chop wood, mix paint, mine graphite and aluminum, and make all the tools needed for those tasks. But when people specialize and trade with one other, an impossibility becomes a common item sold everywhere for less than a dollar. In the pencil's case, the size of the team is thousands, if not millions of people. While most of them may never come in contact with one another, they are each cooperating, however unwittingly, in a vast network of interactions that yield benefits to more people in more places than any one person could conceive on his or her own.

History bears out the benefits of liberalized trade. In the aftermath of the Great Depression and the Second World War, countries around the world sought to avoid a repeat of the autarkic policies, such as the disastrous Smoot-Hawley tariff, that prolonged the Depression, which in turn helped fuel the political discontent that led to the rise of fascism in Europe.

The postwar effort toward ongoing global trade liberalization was tasked to the General Agreement on Tariffs and Trade (GATT), which established a multilateral framework for ongoing tariff reduction. Coming into force on January 1, 1948 after being signed by 23 countries, GATT held a series of negotiation rounds that resulted in widespread tariff reduction and more countries joining the agreement. The 1973 Tokyo Round, which lasted from 1973 to 1979, involved 102 countries, brought the average tariff on industrial products in major industrial markets down to 4.7 percent,[4] achieving $300 billion in tariff reductions.[5] GATT laid the foundation for the creation of the World Trade Organization (WTO), which superceded and replaced GATT on January 1, 1995.[6]

The multilateral trade negotiation system established under GATT and the WTO has yielded benefits that consumers in America and around the world have come to take for granted. Today, the average tariff rate for total imports is 1.6 percent.[7] Most rich nations have near-zero tariffs on their trade with each other. Many developing countries still have higher tariffs, but the trend, including among poorer countries, is decisively toward lower barriers over time. The process continues today, but not without challenges.

*Nations do not trade; individual people and businesses do.*

The Trump administration appears willing to reverse 75 years of progress toward global freer trade. As of this writing, the administration has imposed tariffs of 25 percent on steel and 10 percent on aluminum from the European Union, Canada, and Mexico;[8] imposed a 25 percent tariff on $50 billion of Chinese imports; announced intentions of a 10 percent tariff on an additional $200 billion of Chinese goods; and has stated intentions to renegotiate the North American Free Trade Agreement.[9] This tide of nationalist populism will likely pass, but not before it does significant damage to the world economy. For now, it presents a real threat to global prosperity were it to derail or even reverse ongoing trade liberalization around the world. That protectionist trend needs to be countered.

## PEOPLE, NOT COUNTRIES, TRADE WITH ONE ANOTHER

As the renowned economist John Kenneth Galbraith quipped, protectionists' greatest misfortune has been for their theories to have been applied so widely and thoroughly.[10] Nowhere is this more evident than in the common misconception that countries "trade" with each other. Nations do not trade; individual people and businesses do.[11] It was individuals trading with one another that enabled the rise of complex human societies, and eventually states. In fact, trade long predates the nation state. As science writer Matt Ridley points out: "In Africa, obsidian, shells and ochre were being traded long-distance by 100,000 years ago. Trade is prehistoric and ubiquitous."[12] Harvard cognitive scientist Richard Wrangham estimates the emergence of long-distance trade as far back as 200,000 years—around the very birth of Homo sapiens as a species.[13]

Centuries later, trade between humans became extensive enough to make the first cities possible. Over time, people found they could achieve a more stable lifestyle by tending to domesticated crops and animals—at least compared to nomadic hunting and gathering—but this required specialization and trade. For example, some people specialized in farming and traded their surplus crops to others in exchange for tools or shelter. Others specialized in skills, such as milling grain into flour or brewing it into beer. Without trade, such specialization would have been impossible. The late University of Maryland economist Mancur Olson theorized that the first governments were "stationary bandits," who traded protection from other bandits—or themselves—for a fee in the form of taxation.[14]

When governments get involved in trade, it is usually to erect barriers to it. While special interests have always benefited from the reduced competition trade restraints bring, historically, most traders have objected to such interventions. Important clauses of Magna Carta enjoin the King of England from stopping traders from entering the country.[15]

The American Declaration of Independence, in its litany of offenses blamed on King George III, chides him for "cutting off our Trade with all parts of the world."

*Exports are the price we pay to get useful imports.*

This is why the first "international" trade system was actually a mechanism for restricting and redirecting trade to fit some government prerogative. The mercantilist system that governed trade during the colonial era was based on the "rights" of monarchs to maintain a "balance of trade" that would allegedly enrich them and their favored commercial partners. It accomplished this by imposing a series of tariffs, import quotas, and prohibitions to affect the balance of trade in favor of these interests. In effect, the mercantilist system was the first example of crony capitalism writ large.

The central problem with the mercantilist system was that it was premised on a false notion— that the prime benefit of trade was the importation of gold and silver in return for exports. In fact, it is the exchange of goods that creates wealth. Exports are the price we pay to get useful imports. Traders export goods in order to import goods they value more in return. Most people would rather have goods they can eat, drive, or otherwise use than a few more coins jingling in their pockets. As economist David R. Henderson notes:

> The only way to create wealth is to move resources from a lower-valued to a higher-valued use. Corollary: Both sides gain from exchange.[16]

Late mercantilists began to realize this. One such thinker, the 17th century English economist, physician, and financier Nicholas Barbon, wrote in 1690 that, "in trade and commerce there is no difference in commodities when their values are equal."[17]

In 1776, Adam Smith picked up this and many other arguments in *The Wealth of Nations*. He wedded the understanding that both parties to an exchange gain from it—along with insights regarding the division of labor and specialization and a robust criticism of the cozy relationship between government and industry—to form a comprehensive argument for the benefits of free trade.[18] Smith's thesis began to turn the political tide in his native Britain toward widespread public recognition of the universal benefits of freer trade.

In 1817 another British economist, David Ricardo, in his treatise *On the Principles of Political Economy and Taxation*, outlined the principle of comparative advantage, which helps boost productivity and lower prices. He hypothesized that if two countries each produce two goods, both countries benefit from freer trade, even if one country has an absolute advantage in producing both goods. In Ricardo's example, the two countries are England and Portugal and the products are cloth and wine. If in England it took 100 hours to produce a yard of cloth and 120 hours to produce a liter of wine, while in Portugal it took 90 hours to produce a yard of cloth and 80 hours to produce a liter of wine, England would benefit by specializing in cloth, Portugal in wine, and trading their increased production. Even though Portugal has an *absolute advantage*, because it can produce both goods more efficiently, England has a *comparative advantage* in cloth, since it takes producers less time to manufacture cloth relative to wine produced in Portugal (100/120 vs 90/80). By specializing in the goods in which they have comparative advantage, the two countries can produce more of the goods at which they are most productive, increasing those goods' overall supply. This increased supply allows everyone to consume more at lower cost.

Ricardo's arguments had a profound effect on British trade policy. The United Kingdom had already been moving toward a policy of freer trade since Adam Smith and the attempted closure of European markets by Napoleon during the Napoleonic Wars. The theory of comparative advantage prompted a change in British trade policy, allowing the country to specialize without protecting domestic manufacturers.[19]

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The repeal of the Corn Laws in 1846 was made possible thanks to the educational and mobilizing efforts of a popular movement for free trade. The leaders of the Anti-Corn Law League, Richard Cobden and John Bright, repeatedly emphasized the benefits that would accrue to the poor through freer trade, specifically in lowering the price of bread. As a result, the UK's labor movement became a strong proponent of free trade throughout the 19th and early 20th centuries. Crucially, with

Cobden's successful conversion of Prime Minister Robert Peel from protectionism to the cause of free trade, Britain began a shift toward a policy of unilateral free trade. The United Kingdom would keep its trade barriers low regardless of other nations' trade policies. Britain's move to unilateralism accelerated when William Gladstone, who was hugely influenced by Ricardo, became Chancellor of the Exchequer in 1852.[20]

Unilateral free trade remains the preferred policy of many free trade advocates. Practical politics make pursuing a unilateralist free trade policy difficult, given that entrenched interests, in all countries, will always lobby for protection from foreign competition, but it remains an aspirational goal worth pursuing, in however piecemeal fashion.

Trade also acts as a form of automatic diversification that helps avoid the risks of putting all your eggs in one basket in terms of food supply and other resources—a strategy that any financial advisor will agree is a good thing when planning for the future. As the late development economist Peter Bauer put it:

> [T]he absence of trading links with the outside world and lack of reserve stocks turn misfortune, such as bad weather, into disaster; belt-tightening becomes starvation.[21]

## TARIFFS

Open trade promotes peace as well as economic growth; tariffs undermine both of those goals. A tariff is a tax on foreign goods entering the country. Tariffs make domestically produced goods artificially attractive to consumers, which benefits domestic manufacturers of those goods at the expense of consumers and other manufacturers. Historically, tariffs have been the most common type of trade barrier, although they have fallen out of favor in recent decades. How do they work, and why do only 6 percent of economists think they are beneficial on net?[22]

*Tariffs cause misallocation of resources via price distortions, retaliatory tariffs, deadweight losses, and rent-seeking.*

Tariffs cause misallocation of resources via price distortions, retaliatory tariffs, deadweight losses, and rent-seeking. While a tariff may result in more jobs in a protected industry, those jobs tend to create less value than the mix of jobs that would emerge without trade barriers. As Texas Tech economics professor Benjamin Powell points out:

> [T]ariffs won't change the total number of American jobs; they will change the mix of jobs in a way that will make us poorer and less productive.[23]

While obviously popular with domestic producers and the politicians they support, tariffs harm everybody else in the economy. The most visible effect of a tariff is to raise the price of a good artificially. Higher consumer prices put individuals' and families' budgets under stress, as they erode purchasing power. Quality can also suffer, because producers have less competition to worry about, and the pace of innovation can

*As producers seek more affordable alternatives to the inputs made more expensive by tariffs, they may still end up paying more, as they settle for second-best substitutes.*

slow down. Ultimately, tariffs make it more difficult for domestic producers to export, as other countries retaliate with tariffs of their own, which costs domestic exporters access to legions of potential customers.

Tariffs also impose deadweight losses on the economy, by introducing inefficiencies into the market, such as raising the prices for some goods to a level too high for some people who would otherwise purchase those goods. That reduces demand, which in turn reduces the quantity supplied. While difficult to quantify with any precision, deadweight losses caused by tariffs and other trade barriers amount to billions of dollars a year. For example, reducing trade barriers by half between the United States and the European Union (EU) would increase U.S. GDP by $53 billion.[24] Ultimately, the costs include inefficient resource usage, reduced access to resources for new or politically disfavored industries, unfulfilled consumer wants, and opportunity costs such as products and jobs never created, factories never opened, and services never provided.

Deadweight losses impose further costs known as downstream effects. As producers seek more affordable alternatives to the inputs made more expensive by tariffs, they may still end up paying more, as they settle for second-best substitutes, while also raising the price of the substitutes. For instance, in March 2018, the Trump administration imposed aluminum tariffs that could cost brewers tens of thousands of jobs and nearly $350 million.[25] Powell gives the similar example of the soda industry, which might switch from aluminum cans to plastic bottles for packaging because of aluminum tariffs:

> That will shift labor and capital into the plastics industry at the expense of other sectors. These tariffs will cause literally hundreds of millions of such adjustments.[26]

Each such adjustment makes the economy less efficient. Even if each one is relatively small, in total they add up to a considerable economic loss—and an avoidable one at that.

One major inefficiency involves the diversion of resources toward beseeching the government for protection from foreign competition. As the economist Gordon Tullock noted, the problem of deadweight loss is actually worse than it first appears, thanks to politics.[27] Producers protected by tariffs stand to gain greater than normal profits—"rents" in economics parlance—and will have an incentive to expend resources to secure those rents. Time and money that could have been invested in customer service, research and development, capital investment, and hiring and training new workers is spent on lobbying instead, as the latter option promises a greater immediate payoff. It is a minor miracle that special-interest lobbying, a multi-billion dollar industry, is not even larger than it is.[28]

Some advocates for protectionism justify tariffs on national security grounds. For instance, the argument goes, the military's need for massive amounts of steel for planes, tanks, and ships makes a viable domestic

*In a world market, it is nearly impossible to cut off a country.*

steel industry a matter of national security. If foreign producers crowd out U.S. producers, they can cut off supply, leaving the military in a difficult position if war breaks out. But in a world market, it is nearly impossible to cut off a country. As noted, trade helps industries diversify their supply chains. China might refuse to sell steel to the U.S., but some steel buyers would happily turn around and resell Chinese steel to American buyers for a profit. The OPEC oil cartel learned this lesson the hard way, when its own member countries undercut its attempts to fix the global price via restricted supply.[29]

In fact, tariffs make war *more* likely. As the saying goes, "When goods don't cross borders, armies will."[30] Countries with strong trading relationships rarely go to war with each other—killing the customer is bad for business, after all.[31] When a country goes to war, one of its first actions is to blockade the opposing country's trade. If protectionist logic held, this would stimulate the blockaded country's domestic industry to new heights.

## NON-TARIFF BARRIERS

Tariffs are not the only ways in which governments stop individuals from trading with one another. Governments have an array of other means at their disposal for throwing up roadblocks to trade. Collectively called non-tariff barriers, they include:

- Regulations such as product standards that stop the import of certain goods. This includes sanitary or health and safety-based regulations. While some safety regulations may be justifiable, they can be easily weaponized into protectionist measures, as was the case with the European Union's reluctance to allow imports of hormone-treated beef from the United States. According to Dartmouth Economics professor Douglas Irwin, a member of the European Parliament even publicly admitted the ban was scientifically unjustified and "was made for political and commercial reasons and not, as the public was led to believe, for consumer protection."[32]

*Anti-dumping actions invite retaliation, enable rent-seeking, reduce imports, cost millions in legal fees, and add uncertainty to trade relations.*

- Anti-dumping laws, which purport to stop a country from purposely exporting at below-market prices to gain a competitive advantage. These are perhaps the costliest type of non-tariff barrier, with a net cost of $4 billion to the U.S. in 1993—which, sadly, is the most recent reliable estimate available.[33] Even updating this figure to account for inflation and GDP growth still likely shows an undercount, since it ignores the costs of downstream producers that face artificially high prices for their inputs, and charge higher consumer prices to make up the difference. Anti-dumping actions invite retaliation, enable rent-seeking, reduce imports, cost millions in legal fees, and add uncertainty to trade relations, which deters long-term investment.[34] Developing countries increasingly use these to get around tariff restrictions, because they are technically temporary.[35]
- State aid such as subsidies, loan guarantees, and other forms of special financial assistance that artificially lower the price of domestic products to make them more attractive to potential

buyers. This is the business model of the U.S. Export-Import Bank and Overseas Private Investment Corporation, which offer below-market financing rates to overseas buyers of American goods.[36]

- Countervailing duties, which retaliate against foreign subsidies seen as giving unfair advantages to foreign producers.
- Government procurement policies that forbid the purchase of non-domestic goods or services or provide incentives for the use of domestic suppliers.
- Rules-of-origin and domestic content requirements.[37] The recent saga of the fishing vessel America's Finest is a notable example. While built in the U.S., it contains 10 percent foreign content by weight, which makes it illegal for the ship to carry cargo between two U.S. ports under the Jones Act of 1920.[38]
- Currency manipulation to discourage imports. This can come in several forms. Many critics of Chinese trade policy highlight China's purposeful devaluation of the yuan to increase the relative attractiveness of China's exports on the world market. Of course, the tradeoff is that imports become more expensive for Chinese consumers. The U.S. engages in similar, though less obvious practices.[39]

Each of these policies has a similar effect to the imposition of a tariff. They change the price and quantity supplied of a good or service in a way that harms the residents of the country imposing the barrier on net. Often, these barriers are erected to benefit a politically connected industry or lobby group, such as a labor union that argues it is facing "unfair competition" from trade.

*Every consumer is a producer, and vice versa.*

This kind of special pleading was ably satirized by the French economist Frédéric Bastiat in 1845, when he wrote a petition to protect candle makers from "the sun [that] is waging war on us so mercilessly." Bastiat recommended that the government "pass a law requiring the closing of all windows, dormers, skylights, inside and outside shutters, curtains, casements, bull's-eyes, deadlights, and blinds—in short, all openings, holes, chinks, and fissures through which the light of the sun is wont to enter houses, to the detriment of the fair industries with which, we are proud to say, we have endowed the country."[40]

## WHAT ABOUT JOBS?

Critics of free trade often blame international trade for jobs "lost" in the U.S. Protectionist measures, they argue, preserve jobs, and may even create them. In reality, the number of available jobs has very little to do with either free trade or protectionism. Rather, it is limited only by the size of the workforce. Every consumer is a producer, and vice versa. This is how the U.S. labor force was able to grow from about 62 million people in 1950 to 162 million in 2018.[41] Those additional 100 million people are more than just stomachs that need to be fed. They are also 100 million more brains and pairs of hands that can create the value they need to feed those stomachs, and benefit others in the process.

Every month, millions of jobs in America are destroyed—5.2 million in February 2018 alone, according to the Bureau of Labor Statistics.

But 5.5 million people were also hired during the same time period.[42] The numbers will vary depending on whether the economy is in a period of boom or bust, but the overall trend is clear—the size of the labor force very closely tracks the size of the population.

Job churn is a natural part of the economy. Some people quit jobs they dislike; others are fired or laid off. Changing tastes will put honest, hardworking people out of a job. Fewer workers today make bellbottom jeans or disco balls than in the 1970s, for example. But the biggest factor in the ongoing churn has little to with international trade, which is responsible for only 13.4 percent of job churn.[43] Where does the rest come from? Mostly technological change.

Decades ago, most people worked on farms. As tractors and other technologies made farmers more efficient, it took fewer and fewer of them to feed the country. Today, only 1.5 percent of America's labor force works in agriculture.[44] Yet, technology has made those workers so much more productive that the U.S. is now a net exporter of many agricultural products, to the tune of $19.5 billion in 2015.[45] Early in this process, many displaced workers found jobs in the growing manufacturing sector—those tractors had to come from somewhere, after all.

However, after a couple of generations, manufacturing jobs also began to disappear, for the same reason. Automation made it easier and cheaper for robots to make cars and other products than a human assembly line. U.S. manufacturing output is still the world's largest, at just over $6 trillion and near its 2014 record high, but it creates all that value with far fewer workers.[46] Total manufacturing employment was less than 13 million in 2018, down from 17 million as recently as 2000.[47]

*Few people would say that preserving horse-and-buggy driver jobs is worth giving up the automobile.*

Of course, critics will argue that manufacturing today is less than 12 percent of GDP; that figure was once as high as 28 percent in the 1950s.[48] And in terms of value added, China's manufacturing sector surpassed America's in 2010.[49] Since China has more than four times America's population, U.S. value-added manufacturing is still the world's largest in per-capita terms. Total value added in United States manufacturing increased from $110 billion in 1953 to $2.1 trillion in 2015.[50] Even after adjusting for inflation, this is more than a six-fold increase. That the rest of the economy has grown even faster speaks to both the strength and diversity of the American economy, manufacturing included. Not only does it have more and larger economic eggs, they are no longer all in one basket.

Fortunately, most former manufacturing workers are finding service sector jobs everywhere from insurance to information technology to health care. Contrary to trade critics' assertions, these jobs tend to pay better than factory jobs, and they are much safer. The average manufacturing job paid $17.72 per hour in 2008. The average office job paid $21.15 that same year, while the two largest service sectors, health care and education, averaged $18.78 per hour.[51]

The economist Joseph Schumpeter coined the term "creative destruction" to describe how the market process works over time. For new innovations to take full flower, older jobs and technologies that do not create as much value must wither away. It is a messy process and it has genuine casualties, but few people would say that preserving horse-and-buggy driver jobs is worth giving up the automobile.

In response to arguments for "saving" jobs via government intervention, Bastiat answers with another parable. On the railroad connecting Paris and Spain, the thinking goes, there should be a break in the tracks at Bordeaux: "[I]f goods and passengers are forced to stop at that city, this will be profitable for boatmen, porters, owners of hotels, etc."[53] But why stop there? If Bordeaux creates jobs from a break in the tracks, why not put one at every city on the way from Paris to Spain? And what about adding in more breaks between cities? Full employment would be guaranteed!

A real-life example akin to Bastiat's railroad is a speed trap on a stretch of Highway 301 that runs through Hampton, Florida. It produced so much revenue from speeding tickets issued to people driving through that it led to massive abuse, including a bloated police force with one officer for every 25 people and $1 million of missing funds.[54] Other such barriers exist, costing untold millions in economic harm and lost opportunities. Getting rid of them would free up both labor and capital for other uses that would create more value, even if some city employees lose their jobs.

## HARM FROM PROTECTIONISM THROUGHOUT U.S. HISTORY

In the United States—despite the denunciation of colonial mercantilism in the Declaration of Independence—free trade has always had to push back against strong protectionist tendencies. Alexander Hamilton's 1791 *Report on Manufactures* was massively influential in generating support for using tariffs for industrial development, in addition to raising revenue. Thomas Jefferson and other founders pushed back, favoring more or less free trade, with non-discriminatory tariffs for revenue purposes only. It was one of the young nation's first major political debates, and one that continues today. However, the Hamilton-Jefferson dispute was not entirely cut-and-dry. During his presidency, Jefferson would enact an embargo on trade with Britain for largely Hamiltonian and supposedly national security reasons.[55]

The first law passed by Congress after the ratification of the Constitution was the Tariff Act of 1789. Its direct purpose was Jeffersonian—not to protect domestic industry, but to raise revenue:

> Whereas it is necessary for that support of government, for the discharge of the debts of the United States, and the encouragement and protection of manufactures, that duties be laid on goods, wares and merchandise.[56]

The federal government lacked an income or sales tax and had massive amounts of debt from the Revolutionary War. Meanwhile, the states were mostly unwilling to contribute meaningfully to federal coffers—a major reason the Constitution replaced the Articles of Confederation in the first place.

The hope was that the new near-universal tariff, by discriminating as little as politically possible among different countries or different types of goods, would create as few economic distortions as possible. Tensions between Northern states, which wanted high tariffs to protect industry, and Southern states, which wanted low tariffs to encourage agricultural exports, were already evident, but not yet strong enough to divert tariffs from their main revenue-raising purpose.

Soon after, Hamilton's *Report on Manufactures* argued that America needed to protect its "infant industries" from competition in order for them to develop.[57] He proposed using proceeds from the tariffs to subsidize manufacturers and to finance government operations. Despite opposition from James Madison and Thomas Jefferson, many of the specific tariffs were adopted, though the subsidies were not.

George Mason University economist Donald Boudreaux points out some key problems with this infant industry approach:

> How does government know which industries will enjoy such genuine comparative advantages in the future that they should be protected today? Will politicians exhibit the political will power to remove protection from protected industries once those industries have matured? Might protection of an industry weaken it—causing it to depend for its survival on political favors—rather than strengthen it? Will the certain costs incurred today to protect an infant industry be exceeded by the (necessarily) uncertain benefits that only come in the future when the domestic industry has matured?[58]

Protectionists have yet to provide compelling answers to these questions, though they stubbornly hew to the same discredited Hamiltonian policies even today.

Hamilton's views on trade were the founding principles of the American School of Economics, which favored protecting national industry over lower cost goods. This culminated in a policy platform known as the "American System," which was advanced by the Whig Party during the early 19th century. It consisted of three parts: 1) a protective tariff, 2) a national bank to promote commerce, and 3) federal subsidies for transportation infrastructure to help develop agricultural markets. Its most notable proponents, Kentucky Sen. Henry Clay and President John Quincy Adams, supported rapid industrialization and large public spending projects using the revenue raised by tariffs and the sale of public lands.[59]

Defenders of protectionist policies argue that the American System era coincided with a period of high economic growth relative to Europe, where freer trade was more prevalent at the time. Therefore, they claim, protectionism could help foster similar growth today.[60] However, that alleged correlation is confounded by other factors, especially the fact that 19th century America was a young country experiencing a population boom and expanding the amount of land being used in agriculture. If one controls for population growth and capital accumulation, there was no evidence that tariffs contributed to any productivity boost, which is essential for economic growth.[61] Were it not for America's westward expansion mostly canceling out the market-shrinking effects of these high tariffs, the U.S. economy would have suffered greatly. Even so, the opportunity costs of the move to protectionism were enormous.

Adam Smith himself noted that the division of labor is limited by the extent of the market.[62] During the frontier era, the extent of America's domestic market grew rapidly, despite its being largely closed to imports. In short, *Internal growth outpaced protectionism's economic drag.*

internal growth outpaced protectionism's economic drag. Had markets been truly open and free in the 19th century, growth may well have been even faster than it was. Economic historian Douglas Irwin notes that the economic growth of the United States at the time can be better attributed to the openness "in terms of ideas, capital and the movement of people" that persisted until the early 20th century.[63]

American System tariffs peaked with the Tariff of Abominations, which John Quincy Adams signed into law in 1828.[64] This legislation raised tariffs on more than 90 percent of imports to an average of 38 percent, a record high at the time. The tariff's impact on the economy of the export-dependent South was so severe that it directly led to the Nullification Crisis four years later, when South Carolina threatened to secede unless tariffs were lowered. Meanwhile, America's trading partners abroad threatened retaliation.

While Congress reduced tariffs in 1833, protectionist policies remained popular, especially in the industrialized North. Abraham Lincoln stated in 1844: "Give us a protective tariff and we will have the greatest nation on [E]arth." Congress raised tariffs throughout the Civil War, alongside luxury taxes and taxes on high-income earners, to fund the Northern war effort. Many of the tariffs remained in effect during Reconstruction. The slight reduction in tariffs following the Civil War was reversed in 1897, when President William McKinley signed the Dingley Tariff. Named for its sponsor, Maine Republican Rep. William Dingley, the Dingley tariff reversed controversial tariff cuts from a few years earlier. Notably, McKinley criticized free trade for what most economists would recognize as some of its key virtues—valuing the consumer over the producer and lower prices over keeping certain work within the nation's borders.[65]

*Henry Ford argued for a reduction in tariffs on his foreign competitors, saying: "We need competition the world over to keep us on our toes and sharpen our wits."*

The introduction of a permanent income tax reduced Congress' reliance on revenue tariffs, which were lowered before the First World War. Protectionism returned in the 1920s, with the Fordney-McCumber Tariff of 1922, which was a precursor to the Smoot-Hawley tariff, and was a larger tariff increase in percentage terms.[66] However, the political consensus in favor of protectionism was weakening at the time. Henry Ford argued for a reduction in tariffs on his foreign competitors, saying: "We need competition the world over to keep us on our toes and sharpen our wits. The keener the competition, the better it will be for us."[67] Farmers, who believed that the 1922 tariff would benefit them, were disappointed at the increasing cost of farm equipment, while manufacturers complained that the higher cost of inputs harmed their enterprises.[68]

At the start of the Great Depression, Congress passed the Smoot-Hawley Tariff of 1930. Named for its two Republican sponsors, Utah Sen. Reed Smoot and Oregon Rep. Willis C. Hawley, it was intended to increase work opportunities and halt the downward pressure on wages that was blamed on foreign trade. There is now a near-universal consensus among economists that the tariff was a major contributor in prolonging the Great Depression.[69] By 1933, international trade plummeted by two thirds and the average tariff rate approached 60 percent.

The economic damage and the public outrage it generated were immediate, and the memory of it was long lasting. After the war, the realization of the true effects of the Smoot-Hawley tariff led the United States to take the lead in creating a framework for long-term global trade negotiations aimed at reducing global tariffs. In practice, this meant taking the lead in crafting the General Agreement on Tariffs and Trade in the late 1940s.[70]

## THE POSTWAR TRADE APPARATUS WAS FOUNDED TO AVOID PAST MISTAKES

After the one-two-three punch of World War I, the Great Depression, and World War II, a new era of peace had arrived. National leaders, determined to make the new peace last, created a number of new treaties and organizations devoted to that goal, including the General Agreement on Tariffs and Trade. GATT helped lead to tariff reductions that enabled a massive increase in global trade, with total world exports rising from $59 billion in 1948 to $15.46 trillion in 2016—more than a 250-fold increase.[71]

The General Agreement on Tariffs and Trade was a multilateral treaty on trade that first came into effect on January 1, 1948. Eight rounds of GATT negotiations led to the establishment of the World Trade Organization on January 1, 1995. GATT's mission—to establish the "substantial reduction of tariffs and other trade barriers and the elimination of preferences, on a reciprocal and mutually advantageous basis"—has been largely successful. At the time of the first round of GATT negotiations, the global average tariff was 22 percent. By the end of the century, this had fallen to 5 percent, with the most significant reduction occurring among the agreement's core participants—Australia, Canada, the United Kingdom, and the United States.[72]

To facilitate trade negotiations, the United States supported a policy of "unconditional most-favored-nation" (MFN) treatment, which meant that the most favorable trade deal afforded to one country would be given to all other countries participating in GATT. This led to the first round of GATT negotiations in Geneva, which led to roughly 45,000 tariff reductions by the 23 signing parties.[73]

The final GATT round, which established the World Trade Organization, began in Uruguay in 1986. It involved 87 months of negotiation and covered politically difficult but increasingly important issues, such as trade in textiles and agricultural goods, imports from developing countries, services, investment policy, and intellectual property. The Uruguay round participants came to a consensus that globalization was proceeding at a faster pace than GATT could adapt.[74] In order to facilitate this adaptation, they set up the WTO. The new world trade body was to derive its principles from GATT, but unlike GATT, it could enforce agreements and resolve disputes as an independent arbiter. The organization was founded through the signing of the Marrakesh Agreement by 123 nations on April 15, 1994.[75]

## THE WTO AND ITS POWERS

The World Trade Organization oversees the implementation, administration, and operation of trade agreements involving member states and provides a forum for negotiations and settling disputes.[76] When the WTO came into being on January 1, 1995, the United States agreed to join an independent trade body regulating trade, something Congress had refused to countenance in 1948. Efforts to create a proposed International Trade Organization (ITO) to enforce GATT went nowhere. GATT continued as an agreement without an enforcing body until the WTO's creation nearly 50 years later.[77]

This means that international trade disputes now have a venue for resolution designed to provide swift and binding settlement. To date, it has operated successfully, providing for a more stable global trade environment and observance of rules. Sanctions are a final option in this system, not a starting point for negotiation.

The principles of international trade facilitated by the WTO as follows:

- **Non-discrimination.** This includes maintaining the most favored nation principle, which means that once a foreign good enters a domestic market, non-tariff barriers may not be used to discriminate against it.
- **Reciprocity.** No nation may benefit from a liberal trade policy under MFN status without liberalizing its own trade policy.
- **Binding and enforcing commitments.** These ensure that changes to national trade policy that are seen as violating WTO rules can be resolved through the WTO's Dispute Settlement Body (DSB).[78]

- **Transparency.** National trade policies are reviewed by the WTO and made available to other countries' governments upon request.
- **Safety.** This allows for exceptions to trade liberalization in cases involving the environment, public health, or wildlife, though restrictions must be demonstrated not to be for economic reasons.[79]

One of the major reasons for establishing the WTO was GATT's lack of an adequate dispute settlement mechanism. The WTO has a fixed dispute resolution timeline of 15 months, including appeals. This fixed timeline and independent ruling ability make the WTO's rules-based trading system more stable than that under GATT. While the WTO does have punitive powers, the vast majority of disputes brought before it are settled through consultation without punitive measure. When a dispute is not resolved through consultation, then the WTO's Dispute Settlement Body will adopt measures to be implemented by the losing party within a reasonable period of time agreed to by the parties involved and the DSB, or by an arbitrator if agreement is not reached.

If implementation is not completed by the party found at fault within a reasonable period of time, the harmed party may request after 20 days to implement "equivalent" sanctions on the losing party, effectively suspending the WTO duties owed by the losing party. The WTO says this is intended "to rebalance reciprocal trade benefits."[80] Out of the 544 disputes brought to the WTO since 1995, seven have had retaliatory sanctions approved.[81] For example, in 2015, the WTO authorized

*Every country in the world would benefit from unilaterally lowering its trade barriers, regardless of what other countries do.*

Canada and Mexico to charge the United States $1 billion in tariffs because the U.S. had instituted country-of-origin labeling for meat products to favor domestic producers.[82]

Every country in the world would benefit from unilaterally lowering its trade barriers, regardless of what other countries do. But as long as that remains not politically possible, the WTO dispute mechanism is the best option currently available. It is important to follow the WTO system, even when it rules against one's own country. Bypassing this system would set a terrible precedent and threaten the integrity of the entire WTO system. If major players such as the United States or the European Union were to disregard the WTO system, other countries would feel free to follow suit, and decades of liberalization could be undone practically overnight.

The WTO is not without its problems, however. It is often perceived as lacking teeth. Countries that choose to ignore its findings have a tendency to get away with it if they are powerful enough. Unfortunately, the United States has been a leader in this regard. For example, in 2013 the WTO found that America's various anti-gambling laws had harmed the Caribbean nation of Antigua, and has now authorized Antigua to revoke up to $200 million worth of intellectual property protections on American movies, books, pharmaceuticals, and other goods as compensation. [83] Antigua has yet to take advantage of this ruling and is seeking to resolve the matter through negotiation. As Antigua's complaint was first lodged in 2003, it is clear that the WTO's hopes of swift dispute resolution are not always realized when one party flouts the rules.

## HOW NAFTA AND THE EU ALTERED TRADE POLICY

The GATT/WTO system has nevertheless yielded substantial benefits, especially compared to previous arrangements, but it still faces other significant problems. It pursues trade liberalization via government-to-government negotiations based on a principle of reciprocity of trade barrier reductions. Such an arrangement ignores the fact that trade is a voluntary exchange between individual parties, not governments. At the national level, the policy that best recognizes this reality is unilateral reduction of tariff and non-tariff barriers. However, the political difficulty of advancing a unilateral free trade policy makes multilateral arrangements a next best solution.

There have been a number of these multilateral agreements in recent years, from the North American Free Trade Agreement and other regional agreements, such as the Dominican Republic-Central American Free Trade Agreement, down to smaller bilateral deals, such as U.S. trade agreements with South Korea, Colombia, and other countries. These are useful to the extent that they lower tariffs and other trade barriers, but they have two significant problems.

First, they give preferential treatment to member countries; true free trade does not treat one country differently from another.

Second, activist advocacy groups—with help from their allies in various governments and transnational organizations—have successfully lobbied for attaching non-trade provisions, mainly concerning labor and environmental standards, into trade agreements. Such provisions undermine countries' sovereignty and export stricter regulatory regimes that can stall growth in developing countries, by having the effect of raising non-tariff trade barriers.

The North American Free Trade Agreement, negotiated in the early 1990s, was the first multilateral agreement to contain significant trade-unrelated provisions. NAFTA contained two side agreements that had the effect of exporting U.S. domestic policies in the areas of labor and environmental standards. As then-CEI scholar James Sheehan wrote in 1995:

> NAFTA … promotes the export of U.S.-style environmental regulations south of the border. NAFTA created a North American Commission on Environmental Cooperation (CEC), headquartered in Montreal, which is now in the process of harmonizing regional environmental standards related to pollution prevention, energy efficiency, climate change, habitat protection, and environmental law enforcement. A variety of new Mexican laws are being patterned after U.S. laws in the areas of hazardous waste, transportation, forestry, fisheries, soil, and water standards. Bureaucratic regulations punish consumers, stifle competition and create trade barriers. The potential long term consequences of NAFTA's environmental provisions were demonstrated by the filing of several petitions with the NAFTA environmental commission seeking to tighten enforcement of environmental laws. NAFTA threatens to undermine national sovereignty by internationalizing domestic environmental policies.[84]

*Trade-unrelated provisions have distorted prices and economic decision making in ways that have held back growth.*

As time passed and NAFTA's effects became more fully apparent, Columbia University economist Jagdish Bhagwati, who coined the term "trade-unrelated provisions," echoed Sheehan's concerns.[85] These provisions consistently work their way into free trade agreements—or "preferential trade agreements" in Bhagwati's terminology, since they exclude all countries not party to the agreement.[86] Canada, Mexico, and the United States have benefited from the trade liberalization NAFTA helped facilitate. All have grown more prosperous and have larger labor forces now than before NAFTA. But the trade-unrelated provisions and discriminatory treatment against non-member nations have distorted prices and economic decision making in ways that have held back growth in all three countries. All three are growing, but they could be growing much faster.

A similar process happened with the harmonization efforts of the European Union in the 1990s. This is well illustrated by the shift in the United Kingdom's trade flows over time, with a genuinely global trade changing over the decades into one predominantly dominated by Europe. The ramifications of this change are one reason why the Brexit process is proving so difficult.[87]

Labor and environmental standards agreements will likely continue to win places in America's future bilateral trade deals. Such provisions erode national sovereignty by delegating elected representatives'

*A trade agreement's labor provisions could make industries in a nation with lower labor costs less globally competitive.*

lawmaking power to treaty negotiators. They also undermine some countries' competitive advantages. For example, a trade agreement's labor provisions could make industries in a nation with lower labor costs less globally competitive. For the nation that exports its regulatory apparatus via provisions in trade agreements, the effect is functionally the same as a protective tariff—misallocation of resources and higher prices for consumers.

Jagdish Bhagwati has stressed for decades that free traders should oppose trade policies that force developing countries into adopting U.S.-style regulations. As he noted in a 2004 *New York Times* interview:

> I think that U.S. protectionism is taking the form of seeming to try to raise labor and environmental standards around the world. One type of protectionism is "import protection": you see competition is growing from abroad, and you put up your barriers. But an alternative, if you did not want to appear to be protectionist, is to say foreign competitors don't have "adequate standards" of all kinds. Or, as in the debate about the North American Free Trade Agreement [NAFTA] in 1994, critics used to say, "Mexico's democracy was not good enough." All these are ways of saying, "This is all unfair trade, and therefore they have to raise their standards or we won't trade with them." The expectation of people who argue that way is that if we raise the standards, it will increase the cost of production, and accomplish the same result as high tariffs.[88]

Thus, we now face more sophisticated forms of protectionism than mere tariffs. Today, trade liberalization is especially challenging because the impact of non-tariff barriers on consumers and business is often not as readily evident as that of tariffs, which carry a clear price tag.

*Today, trade liberalization is especially challenging because the impact of non-tariff barriers is not as readily evident as that of tariffs.*

The inclusion, or even the threat of inclusion, of these provisions into trade agreements has been harmful. For example, the European Union has imposed an agricultural biotechnology ban on Africa, denying countries on that continent access to technological innovations that could help feed their people.[89] Colombia had to significantly change its domestic labor laws to meet requirements imposed by American negotiators.[90]

Even when countries share the same values and goals, they do not necessarily adopt the same approaches to reach those goals. Individual countries are in the best position to make those decisions. For the U.S. to insist that Colombia or any other country ensure compliance and enforcement of its domestic laws through detailed procedures specified by the U.S. violates the sovereignty of that nation.

## MANAGED TRADE IS NOT FREE TRADE

The latest prominent iteration of this trend is the Trans-Pacific Partnership (TPP), a trade deal encompassing countries located around the Pacific Rim. While it includes beneficial reductions for some 18,000 tariffs, most notably in auto manufacturing and agriculture (which have always been strongholds of protectionism), tariff reductions did not make up the majority of the text of the agreement.

Former U.S. Trade Representative Michael Froman, who helped negotiate the deal, highlighted several other aspects of the deal as equally important.[91] The agreement (as drafted when the United States was a party):

- Required signatories to institute enforceable labor standards matching those in the International Labor Organization's Declaration on Fundamental Principles and Rights at Work—which Froman called "the highest labor standards of any trade agreement in history."[92] The agreement would also renegotiate NAFTA to elevate the side agreement on labor standards to having equal weight with the actual trade chapters.
- Elevated NAFTA's environmental side agreement into the core of the agreement, making it fully enforceable. The environmental standards would be expansive:
    - "TPP requires all members to combat wildlife trafficking, illegal logging, and illegal fishing, as well as prohibit some of the most harmful fishery subsidies and promote sustainable fisheries management practices. TPP also requires that the 12 countries promote long-term conservation of whales, dolphins, sharks, sea turtles, and other marine species, as well as to protect and conserve iconic species like rhinos and elephants. And TPP cracks down on ozone-

depleting substances as well as ship pollution of the oceans, all while promoting cooperative efforts to address energy efficiency."[93]

- Included rules on transparency and corruption. While corruption imposes costs on trade, so do overly bureaucratic rules aimed at preventing it. The TPP also "requires regulatory transparency policies based on standard U.S. practice," again exporting U.S. regulation to countries that might have chosen a different approach.[94]
- Included "commitments to promote sustainable development and inclusive economic growth, reduce poverty, promote food security, and combat child and forced labor."[95] These requirements are not strictly related to trade. In fact, gains from trade can help acheive these goals. Rules against "sweatshops" can actually harm the poor in the developing world by reducing opportunities for employment.[96]
- Exempted tobacco companies from the Investor-State Dispute Settlement (ISDS) procedures. ISDS arrangements allow a company investing in a country that is party to the trade deal to redress grievances when its investments are harmed by following a quasi-judicial process. They are sometimes necessary in trade deals where one party has significantly fewer protections for property rights than the other in order to attract foreign investment. Exempting a legal industry based purely on government distaste for its products sets a precedent that would discourage trade in industries that are likely to incur government disfavor.

The Trans-Pacific Partnership might have been beneficial to the United States on net, but it would have been even more so—and more likely to

*True free trade does not require regulatory imperialism. Instead, it would foster regulatory competition.*

have survived politically—had it not become a Christmas tree for myriad trade-unrelated causes. In fact, the remaining TPP countries dropped 22 provisions that had been included at the insistence of the U.S. from the revised agreement after the U.S. dropped out.[97] True free trade does not require such regulatory imperialism. Instead, it would foster regulatory competition.

## REGULATORY COMPETITION IS NOT A RACE TO THE BOTTOM

Regulatory competition is based on the principle of mutual respect. It can be formalized in Mutual Recognition Agreements (MRAs), which recognize that each participating nation's regulatory system achieves the same basic goals of safety and consumer protection. This means that any good that is available for sale in a participating country should be available for sale in the others.

MRAs are often derided as encouraging a "race to the bottom" in regulatory oversight, based on the claim that they will benefit exporters operating in countries with less stringent rules. This has not been the case. MRAs encourage regulatory competition, which helps improve regulation the way competition improves everything else. Jurisdictions with overly strict or prescriptive rules will be exposed to competition for businesses and residents from others with less prescriptive and more effective regulatory regimes. The result is not a race to the bottom but a race to better regulation.

An example of a successful MRA is the German beer market. Domestically produced German beer must conform to the medieval beer purity law, the *Reinheitsgebot*, which severely restricts what ingredients can be used in beer. However, thanks to a MRA with the rest of the European Union, any beer that is sold elsewhere in the EU can be sold in Germany. This means that Germans can buy imported beer without regulatory restriction and foreign brewers do not have to brew special versions of their beer for sale in Germany. The domestic industry has not suffered unduly, as most Germans quite like their traditional local beers, but importers have not been penalized for catering to those German consumers with different tastes.

*The Australia-New Zealand Closer Economic Relations Trade Agreement is broad, simple, and works by recognizing regulatory outcomes from different standards.*

A more expansive example is the Australia-New Zealand Closer Economic Relations Trade Agreement.[98] This MRA is broad, simple, and works by recognizing regulatory outcomes from different standards, rather than trying to align different country standards. Over 80 percent of goods legally sold in one country may be sold in the other without additional regulatory scrutiny. For example, agricultural markets have become so integrated that they closely resemble a common market. Further, most licensed occupations—including in health care, construction, transportation, and legal services—are covered by some form of mutual recognition arrangement.[99] Such a close trading relationship has underpinned spectacular and persistent economic growth between the two nations, while strengthening important cultural and national security relationships.

Businesses that operate internationally often have to deal with duplicative testing and licensing requirements in various countries. Take the Swedish mobile phone producer Ericsson, which complained that, "The life-cycle of a mobile phone is 18 months or less, and yet it currently takes around three months to get the product approved for the U.S. market," when it had already met similar standards within the European Union.[100] (Such government-imposed barriers may be one reason for Ericsson's decline.) The slightly different safety regulations between the U.S. and EU markets (such as different rules mandating the color of indicator lights) cost automakers between $1.68 billion and $2.26 billion in 2014. This is greater than the $1.6 billion in tariffs applied to auto trade across the region for the same year.[101]

Regulatory competition can also help counter the effects of non-tariff barriers. As former CEI scholar Fran Smith commented during the early stages of discussion about a possible trade agreement between the United States and the European Union:

> This "discovery process" is a better way to reduce transaction costs and thus increase voluntary wealth creation. Providing companies with a choice of regulatory regimes often works better than a single uniform regulatory structure or a harmonized system. Centralized regulators can suffer from limited information and pressures from special interest groups. Dispersed regulatory structures can satisfy different preferences, try varied approaches to

> regulating, gain information about what works and what doesn't, and provide feedback to learn more about the cost effectiveness of specific rules. Regulatory competition provides these benefits.[102]

*Without trade, there would be no specialization or division of labor, no way to pursue comparative advantage, and no win-win deals.*

For the United States to take proper advantage of regulatory competition, it could institute a review process to identify areas ripe for regulatory reform by allowing consumers or industry to choose between recognized foreign regulatory systems and the American one. An institution such as a regulatory review commission, as proposed by CEI scholar Wayne Crews, would be appropriate for this process.[103]

## FREE TRADE IS VITAL FOR ECONOMIC DEVELOPMENT

For most of history, poverty has been humanity's default condition. Rising out of poverty takes considerable effort. Trade allows us to escape the state of nature that Thomas Hobbes famously described as "solitary, poor, nasty, brutish, and short."[104] Trade, with its roots in consent, respect, peace, and dignity, is a much more fruitful way for people to enrich themselves than the Hobbesian war of all against all. War and theft are zero-sum at best and negative-sum at worst; wealth is never created and often destroyed. Without trade, there would be no specialization or division of labor, no way to pursue comparative advantage, and no win-win deals.

*How many products were never invented or factories never built because trade barriers kept new inventions and willing workers out of the market?*

The data are crystal clear. Today, the countries most closed to trade are also among the world's poorest, while countries that allow their people to trade freely grow richer.

Economists James Gwartney of Florida State University and Robert Lawson of Southern Methodist University, along with a host of international contributors, have been compiling data on economic freedom since the mid-1990s. The 2017 edition of their *Economic Freedom of the World* report, coauthored with West Virginia University economist Joshua Hall, ranks nearly every country in the world on more than 40 measures, from openness to trade to regulatory climate to levels of judicial corruption. Countries are scored from one to 10, with 10 being the most economically free.[105] The best performers in most years include Hong Kong, Singapore, and Switzerland, while the least economically free countries are an assortment of basket cases such as Zimbabwe, Iraq, and Afghanistan. No country has ever gotten a perfect 10, but the closer a country gets to it, the wealthier it tends to be—and the faster it tends to grow, which matters a great deal for reducing poverty. Countries in the freest quartile have seven times the per capita income of countries in the lowest. While the world's least economically free countries have an average per capita GDP of $6,036, the freest quartile of countries average $42,463 per person. That is a huge difference in standard of living.

New York University economist William Easterly describes trade restrictions and other economic barriers as causing “lost growth.”[106] How many products were never invented or factories never built because trade barriers kept new inventions and willing workers out of the market? Every tenth of a percentage point in a country’s growth rate matters, especially in the developing world. As we noted in a previous paper, thanks to the power of compound interest, a country that grows at 2.5 percent per year for a century will be 63 percent wealthier than an otherwise similar country that grows at 2 percent per year over the same time period.[107]

Developing nations shoot themselves in the foot when they erect trade barriers, but developed nations also share a large part of the blame. For example, one of the most substantial barriers to trading in wealthy Western markets is farm subsidies. Besides costing consumers more at the grocery checkout line, rich-country farm subsidies allow rich-country farmers to outcompete their counterparts in developing countries. They benefit large U.S. agribusinesses at the expense of farmers in the developing world. Price controls, coupled with direct subsidies, guarantee higher domestic prices for domestic producers. American producers can sell their crops artificially cheaply abroad, pricing many developing-world farmers out of business. As a result, in 2002 U.S. companies exported subsidized grain at 43 percent below its cost of production.[108] A similar dynamic applies to the European Union’s Common Agricultural Policy.[109]

The effect is slower growth and less poverty elimination in developing countries. According to a 2007 study by Oxfam, some 10 million people in Central and Western Africa who rely on the production and sale of cotton lose up to $250 million a year because of Western subsidies.[110] Western government trade barriers have held steady over the past decade, according to the Organisation for Economic Co-operation and Development.[111] Yet, this is the tip of the iceberg when it comes to domestic subsidies, which notoriously flow to other cash crops such as sugar[112] and corn-based ethanol.[113] Farm subsidies are a particularly destructive example of rich-world crony protectionism in action. Eliminating them would end the subsidy recipients' unearned gravy train, while benefiting everyone else—from consumers and taxpayers in developed countries to industries and farmers in developing countries.

## CONCLUSION

In an ideal world, governments would impose no trade barriers of any kind. Willing buyers and willing sellers would be free to produce and exchange as they see fit, on terms they mutually agree upon. But as legendary football coach Vince Lombardi said: "Complete victory can never be won," though "it must be pursued, it must be wooed with all of one's might. Each week there is a new encounter, each year there is a new challenge."[114] So while the world may never know perfect free trade, it is worth fighting for every possible victory toward that end.

Protectionism is a persistent problem with persistent appeal. Two centuries of economic theory and empirical fact are apparently not enough to persuade advocates of protectionist policies that tariffs and other trade barriers pave the road to poverty, not plenty. The current administration's seeming predilection for such policies poses a serious threat to decades of ongoing trade liberalization. But it is important to fight back, regardless of the current political situation. Enlightenment values such as openness, growth, dynamism, and progress are eternal. They have already enabled billions of people to rise out of poverty. Billions more can be empowered to join them if free trade and its associated values continue to spread.

*Enlightenment values such as openness, growth, dynamism, and progress are eternal.*

Beginning back in prehistory, trade made civilization possible, and it is just as vital today. Economists are nearly unanimous in favor of free trade, with only 6 percent of them generally disagreeing with the statement "tariffs and import quotas usually reduce the general welfare of society," according to a 2000 survey.[115] A March 2018 Chicago Booth School survey of prominent economists found not a single respondent agreeing with the statement "Imposing new U.S. tariffs on steel and aluminum will improve Americans' welfare."[116]

The general public is less enthusiastic. According to numerous polls cited by Douglas Irwin, mostly from Gallup from the 1940s to the present day, the majority of the public is unfamiliar with trade issues, with only 10 percent of the public declaring themselves familiar with GATT in the 1940s and 13 percent expressing familiarity with the details of President John F. Kennedy's trade plan in 1962. People were more familiar with the highly contentious NAFTA debate, and as recently as 2017 a majority of the public viewed trade as an opportunity rather than a threat.[117]

With public support for free trade tepid at best, it is a minor miracle the world has spent the better part of 75 years slowly but steadily unshackling

*Cultures that are open to trade are both more trusting and trustworthy than their protectionist peers.*

itself from tariffs, quotas, anti-dumping laws, and other government policies that keep willing buyers and sellers apart. Increasing support for free trade is an urgent public policy goal. A bevy of economists from Northwestern University's Joel Mokyr to the University of Illinois at Chicago's Deirdre McCloskey have argued for years for the importance of culture to driving economic growth.

Exchange requires trust on both sides. Cultures that are open to trade are both more trusting and trustworthy than their protectionist peers. As Mokyr writes:

> Commerce, the division of labor, effective markets in labor, credit and land, and similar institutions associated with [Adam] Smithian growth were all outcomes of games between people. They depended on what values people adhered to and what they believed about others' values and behavior.[118]

The results of this trust are expounded upon in great detail in McCloskey's *Bourgeois* trilogy. A small slice from the second volume is enough to make our point:

> You, oh average participant in the British economy, go through at least sixteen times more food and clothing and housing and education in a day than an ancestor of yours did two or three centuries ago. Not sixteen percent more, but sixteen *multiplied*

> by the old standard of living. … And if such novelties as jet travel and vitamin pills and instant messaging are accounted at their proper value, the factor of material improvement climbs even higher than sixteen—to eighteen, or thirty, or far beyond.[119]

This paper's primary goal is to keep that improvement going. Our modest contribution is to make the case for continuing to free the world's markets. Enlightenment values, including free trade, make modern life possible.[120] No person is an island. Humanity is now more than 7 billion strong, and we live on every continent. The freer people are to find new ways to create value for each other, the better off even the poorest of the poor will be.

*The freer people are to find new ways to create value for each other, the better off even the poorest of the poor will be.*

As McCloskey notes:

> We have moved to more or less an era of free trade, which has been very good for the poor of the world, because what you can get with your wage is the key point, and what you can get has steadily increased.[121]

Ideally, trade policy would recognize that these demonstrable gains from trade are enough to justify unilateral free trade. As long as opposition remains strong, however, a next best trade policy would seek to defend and preserve the low-tariff system the world has been building since the

Second World War and avoid loading trade deals with extraneous side agreements. Instead, trade policy should be developed and carried out based on the principle of mutual recognition.

An ideal opportunity to reach such an agreement may soon present itself. After the United Kingdom leaves the European Union—and potentially the European Union's trade restrictions, though there are lobbies pushing to have the UK remain within the EU's Customs Union—it will be in a position to negotiate trade deals on its own. The United Kingdom and United States will be free to reach a trade deal that recognizes each other's regulatory systems as functionally equivalent—an ideal test for future low-tariff trade deals based around mutual recognition. It should be a simple task to add other developed common-law nations, mainly Canada, Australia, and New Zealand, to such a deal. Moreover, as these countries form the "Five Eyes" intelligence alliance, there would be few, if any national security concerns surrounding such a trade alliance. This free trade network could even form the basis of a new Global Free Trade Alliance.[122]

While the economic benefits from free trade are important to recognize, at heart trade is a moral issue. Should people be free to interact with other people on mutually agreeable terms or not? We believe they are, as a matter of human dignity.

## NOTES

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