Executive Memorandum

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Undervaluing the Damage of a Tariff

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Some Members of Congress have recently found a scapegoat for lost manufacturing jobs: the yuan, the currency of the People's Republic of China. Their proposed bill (S. 1586) would allow the U.S. government to impose a tariff on imports from China if China fails to revalue the yuan. This bill is an example of flawed economic analysis leading to bad policy. Higher tariffs on Chinese products will hurt millions of U.S. consumers and, even worse, will not address the real issue—China's strict controls on capital flows.

Instead of supporting higher tariffs, the Bush Administration should pressure China to relax controls on capital flows, allowing reserves now accruing to leave the country in search of better returns abroad. The Administration should also work with China to eliminate remaining Chinese tariffs and non-tariff barriers so that the Chinese can import more. A move toward greater economic freedom in China, not less economic freedom in the United States, will bring sustained benefits for both China and the U.S.

- U.S. manufacturing jobs have been declining for almost two decades because of increased productivity—an indication of economic health.
- More tariffs will both compromise the health of the U.S. economy and hurt millions of consumers, workers, and producers who rely on imports.

A Short-Sighted Tactic. While the argument for raising tariffs on Chinese products to safeguard the U.S. manufacturing sector may appeal to workers' fears, it makes no economic sense. In a recent letter to the editor in *The Wall Street Journal*, Senator Joseph Lieberman (D–CT) blamed China's manipulation of the yuan for "American manufacturing hemorrhaging jobs." That faulty statement could get votes, but a policy based on it would harm millions of American consumers and the overall health of the U.S. economy for at least three reasons:

- **China is not the cause of lost manufacturing jobs.** According to the U.S. Department of Labor, manufacturing jobs have been declining for almost two decades, but not because of increased trade with China. China is not the only country with cheaper jobs and lower manufacturing costs. Mexico, several Central American countries, and some other Asian countries also have cheaper labor and production costs than the U.S., and few would argue that this is due to an undervalued currency. The U.S. decline in manufacturing jobs is the result of increased productivity. In plain English, with new technologies the U.S. is producing more with less labor—an indication of economic health, not economic sickness.

  The loss of manufacturing jobs also reflects a shift from a manufacturing-based economy to a service economy based on human capital, akin to the 19th century shift from an agricultural to a manufacturing economy. Those losing jobs in

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manufacturing can be trained for work in the service sector. Job creation in the services sector has increased by almost 70 percent since 1991.

In addition, the loss of manufacturing jobs reflects choices made by Americans. For the past century, manufacturers in the Northern states have complained about job migration to the South. To encourage economic development and raise living standards, Southern states generally adopted less stringent labor, pro-union, and pro-environmental regulations than their Northern neighbors, resulting in lower wages for employees and greater flexibility and potential profits for employers. Today, when developing countries are faced with a similar choice between stricter regulations or feeding people, regulations lose their attractiveness and wages remain lower. Forcing unwanted regulation on these countries may stem job migration, but only at the cost of reduced economic freedom and more hunger in developing countries.

- **Trade barriers hurt the economy**. Trade barriers raise the price of imports for U.S. consumers while protecting uncompetitive economic sectors. The artificially high wages in these less productive industries discourage workers from moving into more competitive sectors, such as financial services or information technology, thereby reducing the overall efficiency of the U.S. economy.
- **China's exchange rate is not the problem**. While many economists argue that the yuan is currently undervalued—perhaps by as much as 40 percent relative to the dollar—there is simply no clear way to know whether this is true. However, even if the yuan is undervalued, raising tariffs is certainly not the solution. This would raise the price of Chinese imports, effectively playing favorites among Americans—making certain U.S. manufacturers "winners" at the expense of millions of U.S. consumers while harming workers in industries that depend on Chinese imports. Such a policy would distort, rather than help, the U.S. economy.

What the Bush Administration Should Do. The Bush Administration should actively oppose calls by Members of Congress to raise tariffs on Chinese products. More tariffs will both compromise the health of the U.S. economy and hurt millions of consumers, workers, and producers who rely on imports. If Congress passes a law raising tariffs, President Bush should veto it.

The Administration should also work with China to remove trade and outbound investment barriers in China. Once Chinese investors have more choices, they can be encouraged to invest in the United States—at a potentially higher return—which would stimulate U.S. job creation.

Conclusion. The U.S. is trending toward a more services-oriented economy and increased productivity in the manufacturing sector. This shift will encourage U.S. workers to train for opportunities in the rising services sector. The loss in manufacturing jobs, therefore, reflects a long-term trend, not the effects of China's current exchange rate.

Imposing tariffs on Chinese products is a short-sighted policy that will not create more U.S. jobs overall but will hurt millions of U.S. consumers. To improve the economy, the Administration should instead negotiate a rapid reduction of Chinese trade tariffs. If China balks, the Administration and Congress should reassess policies on technology transfer to China.

A move toward greater economic freedom in China, not less economic freedom in the United States, will bring sustained benefits for both China and the U.S.

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