

Background

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Why America Needs to Support Free Trade

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Free trade is again under attack, despite having been, for over a century, the basis of America's wealth. Some groups in the United States blame free trade for the loss of manufacturing jobs, while others blame it for exposing some U.S. producers to foreign competition.

Free trade, however, is good for America, and for a very simple reason: It allows American workers to specialize in goods and services that they produce more efficiently than the rest of the world and then to exchange them for goods and services that other countries produce at higher quality and lower cost.

Specialization and free trade allow the U.S. to become more competitive and innovative. Innovation constantly provides new technologies that allow Americans to produce more, cure more diseases, pollute less, improve education, and choose from a greater range of investment opportunities. The resulting economic growth generates better-paying jobs, higher standards of living, and a greater appreciation of the benefits of living in a peaceful society.

New technologies bring about change, which, as U.S. economic history shows, benefits society as a whole. In the process, however, some sectors suffer until they can adapt to the new changes and begin to benefit from them. Today, Americans are experiencing some of that "suffering" because new technologies are challenging old methods of production.

This change is especially visible in the manufacturing sector, just as it was in the agricultural sector

Talking Points

- Free trade allows the U.S. to specialize in goods and services that American workers produce more efficiently than the rest of the world and then to exchange them for goods and services that other countries produce at higher quality and lower cost.
- Economic growth is particularly important because eliminating the large federal budget deficit requires either growth to generate revenues or something even harder to come by—the political will to cut spending.
- The Administration should advance more free trade agreements and lead negotiations at the World Trade Organization to eliminate agricultural subsidies, antidumping measures, and other protectionist policies that benefit a very small group of Americans at the expense of most other citizens.
- Instead of threatening to impose barriers against inexpensive imports, the Administration should lower the tax and regulatory burden on U.S. companies so that they can be more competitive.

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100 years ago. But in the same way that it adapted then to a new, more industry-based society, America will adapt again to a new, more knowledge-based society.

The Bush Administration should support free trade by all means at its disposal. Keeping America free of protectionism and special favors helps to generate opportunities and fosters economic growth. Economic growth is of particular importance today because eliminating the large federal budget deficit requires either growth to generate tax revenues or something even harder to come by—the political will to cut spending.

To promote economic growth, the Administration should advance more free trade agreements and lead negotiations at the World Trade Organization to eliminate agricultural subsidies, anti-dumping measures, and other protectionist policies that benefit a very small group of Americans at the expense of most other citizens. In addition, instead of threatening to impose barriers against inexpensive imports, the Administration should lower the tax and regulatory burden on U.S. companies so that they can be more competitive. Moving toward greater, not less, economic freedom benefits all Americans.

Five Reasons to Support Free Trade

For over a century, free trade has been one of the most important determinants of America's wealth and strength. There are at least five important reasons for continuing to support free trade.

REASON #1: Higher Standard of Living

The most compelling reason to support free trade is that society as a whole benefits from it. Free trade improves people's living standards because it allows them to consume higher quality goods at less expensive prices. In the 19th century, British economist David Ricardo showed that any nation that focuses on producing goods in which it has a comparative advantage will be able to get cheaper and better goods from other countries in return. As a result of the exchange, both trading parties gain from producing more efficiently and consuming higher quality goods and services at lower prices.

Trade between nations is the same as trade between people. Consider what the quality of life would be if each person had to produce absolutely everything that he or she consumed, such as food, clothing, cars, or home repairs. Compare that picture with life as it is now as individuals dedicate themselves to working on just one thing—for example, insurance sales—to earn a salary with which they can freely purchase food, a car, a home, clothing, and anything else they wish at higher quality and lower prices than if they had done it themselves.

It simply makes sense for each person to work at what he or she does best and to buy the rest. As a nation, the United States exports in order to purchase imports that other nations produce more skillfully and cheaply. Therefore, the fewer barriers erected against trade with other nations, the more access people will have to the best, least expensive goods and services in the world “supermarket.”

Producers benefit as well. In the absence of trade barriers, producers face greater competition from foreign producers, and this increased competition gives them an incentive to improve the quality of their production while keeping prices low in order to compete. At the same time, free trade allows domestic producers to shop around the world for the least expensive inputs they can use for their production, which in turn allows them to keep their cost of production down without sacrificing quality.

In the end, the results benefit both producers—who remain competitive and profitable—and consumers—who pay less for a good or a service than they would if trade barriers existed.

America as a whole is better off with free trade; but with new technologies evolving continuously at home and abroad, open economies are constantly challenged to change the way they do business. In the process of adapting to change, some sectors suffer until they can adapt to the new changes and begin to benefit from them. For example, during the Industrial Revolution, workers in the agricultural sector had to adapt to the “new industrial economy,” competing with machines that could do the same work more effi-

ciently. Eventually, the agricultural workers trained themselves to use machinery and seized the opportunity to be part of the new industrial economy.

Today, America again faces major economic changes. The U.S. economy is moving from an industry-based to a knowledge-based model. For example, the U.S. textile industry gradually disappeared during the past two decades because it became increasingly less competitive vis-à-vis the lower cost of labor in foreign countries. As a result, many U.S. textile factories shut down their operations.

South Carolina was one of the states most affected by the shutdown of textile factories. South Carolinians, however, did not become permanently unemployed, because other industries moved to the state to take advantage of a trained labor force.

In 2000, BMW leased a research facility at Clemson University's automotive research campus to train engineers to sustain BMW's growth. IBM and Microsoft each contributed to this project with the idea of creating high-paying jobs tied to knowledge. Through this project, BMW "invested \$2.5 billion at the plant, and now employs 4,700 people, with most production workers making \$24 per hour."¹

BMW's investment illustrates the process of adjustment in an economically open society. In order to remain competitive and benefit from the economic evolution brought about by the new knowledge-based technological change, South Carolina's workers trained themselves to seize the higher-paid job opportunities. The adjustment brought better-paying jobs and, with them, the possibility of raising the living standard of all those involved in the process of change.

REASON #2: Competition and Innovation

Innovation is the basis of progress, and competition is the best incentive to innovate. The chal-

lenge of having others producing similar products or offering similar services motivates businesses to find new technologies and better ways to provide what they produce. The need to remain competitive forces businesses to strive constantly to innovate. As a result, new technologies are born.

America is perhaps the world's best example of how competition fosters innovation. Although at times the United States has become somewhat protectionist, its economy has been built primarily on the principles of a free market, private enterprise, and competition.

In such a competitive environment, new technologies, from computers to medicines to machinery, have helped the economy to become increasingly more productive per unit of labor and machinery employed in the production process. Since 1948, according to the Bureau of Labor Statistics, multifactor productivity—a ratio of output to combined inputs—in the U.S. private business sector has more than doubled.² (See Chart 1.) Productivity has fostered economic growth and, by lowering production costs, has given ordinary Americans the opportunity to raise their standard of living.

The U.S. economy is replete with illustrations of how competition fosters innovation. For example:

- In the 1980s, personal computers were very expensive, few people owned them, and those they did own handled only word texts and a few calculations. Due to increased competition, by 2002, 65.9 percent of people living in the United States owned a personal computer that handled text, calculations, graphics, media, Internet access, and many other functions.³
- In 1975, the airline industry carried about 200 million passengers; now, due to competition and lower costs, it carries almost 600 million passengers a year.

1. Jim DuPlessis, *TheState.com*, as quoted by National Association of Seed and Venture Funds (NASVF), at www.nasvf.org/web/allpress.nsf/pages/7945.
2. In multifactor productivity measures, output is related to combined inputs of labor, capital, and intermediate purchases. Labor is measured by the number of hours of labor expended in the production of output. Capital includes equipment, structures, land, and inventories. Intermediate purchases are composed of materials, fuels, electricity, and purchased services.
3. World Bank, *World Development Indicators*, 2003, on CD-ROM.

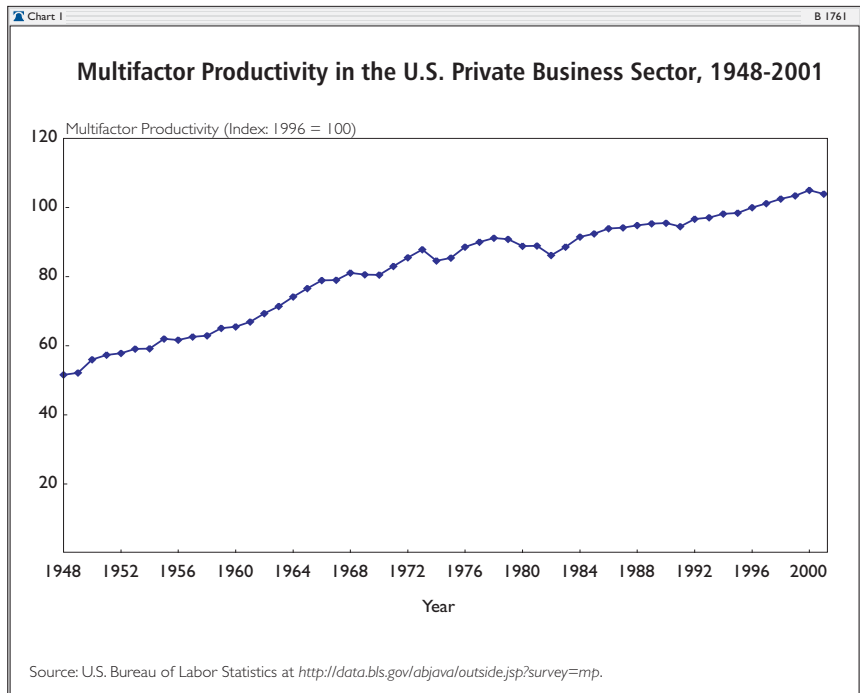
- In 1987, only 0.3 percent of Americans owned mobile phones. By 2002, 50 percent owned one. Similarly, in 1975, only 37.3 percent of people had a telephone mainline; now 64.6 percent have one.
- The percentage of people who own a television set soared from 48.6 percent in 1975 to 93.8 percent in 2001.

These are just a few examples of the millions of products and services made available to increasing numbers of people, thanks to the opening of trade and to the freedom of the U.S. economy.

America's ability to compete and innovate derives from its open markets and from the continual search for new markets through the expansion of free trade. Goods and services flowing across borders foster new ideas and allow U.S. producers to learn about the market through the failure and success of traded products. As they learn more, they are able to innovate to remain competitive.

Scottish moral philosopher Adam Smith had observed this simple truth already in 1776, when he wrote in *The Wealth of Nations*:

When the market is very small, no person can have any encouragement to dedicate himself entirely to one employment, for want of the power to exchange all that surplus part of the produce of his own labour...for such parts of the produce of other men's labour as he has occasion for.... As by means of water-carriage [at the time, a means to expand trade] a more extensive market is opened to every sort of industry than what the land-carriage alone can afford.... [As a result,] industry of every kind naturally begins to subdivide and improve itself....⁴



Smith was even more of a visionary than Ricardo, for he understood that labor specialization is something that constantly changes and that gaining a comparative advantage requires open borders and the ability to adapt to continuous change. It was free trade that continuously challenged local merchants to improve their products and therefore fostered innovation. Consumers benefited as well because, in an attempt to capture a greater share of the market, producers offered consumers the best possible products in the world at the lowest possible prices.

Protectionist policies have the opposite effect. They give advantages to a very small group of producers that do not want to compete. Tens of millions of consumers, as well as smaller producers buying goods and services from the protected few, bear the cost of such protection by paying higher prices for lower-quality products.

For example, U.S. citizens currently pay higher prices for SUVs, textiles, sugar, agricultural products, lumber, peanuts, orange juice, and many other products than they would if there were no trade protections in place. Removing those protec-

4. Adam Smith, *The Wealth of Nations* (New York: Prometheus Books, 1991), pp. 24–25.

tions would allow the market to keep prices low and would encourage protected businesses either to find new technologies in order to compete or to shift operations to a more competitive industry. The result would be greater growth for the economy.

REASON #3: Economic Growth

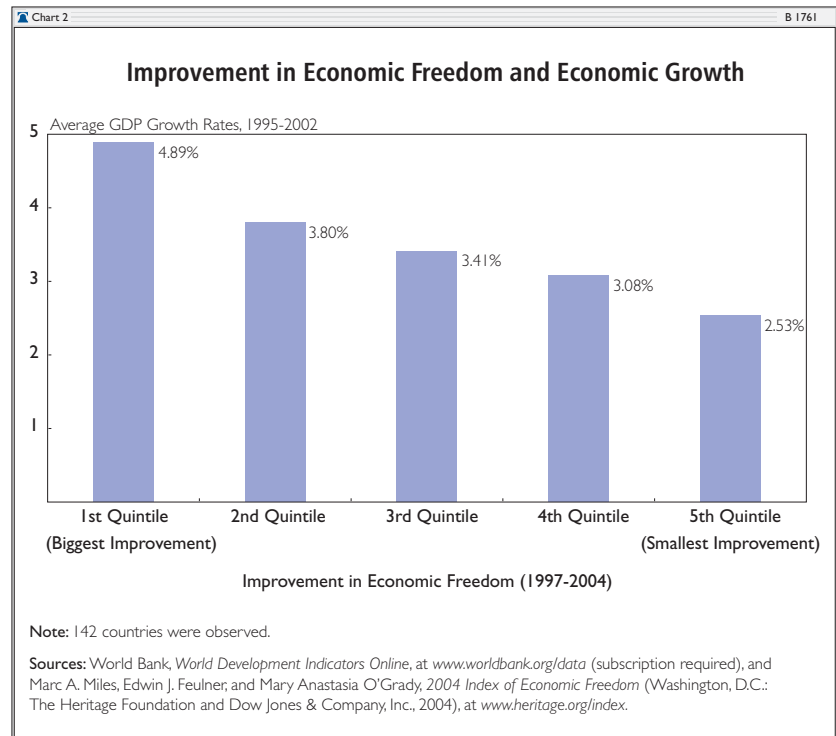
Economic freedom is essential to economic growth, and the true measure of economic freedom involves more than just the question of whether tariff and non-tariff trade barriers are present. It involves other barriers to commerce such as inflationary pressures, regulations that make it more difficult to do business, restrictive banking systems, whether or not property rights are protected, and the fiscal burden of government.

The data presented over the past seven years in the annual Heritage Foundation/Wall Street Journal *Index of Economic Freedom* show clearly that the economies of countries that open their markets grow at a faster pace than the economies of countries that open their markets less or not at all. (See Chart 2.) Of the 142 nations whose economies have been observed during this seven-year period, those that opened their markets the most grew twice as fast as those that opened them the least.

A growing economy increases the demand for goods and services, and as demand increases, more businesses start and expand their operations. Such expansion leads to the creation of more, better-paid jobs. The same is true when the market expands beyond borders. Gaining free access to other markets opens up new business opportunities, encouraging investment and fostering job creation.

REASON #4: Stronger Institutions and Infrastructure

Free trade also fosters the strengthening and development of institutions that safeguard eco-



conomic freedom and development. Facing new opportunities to sell and purchase goods and to open all sorts of trade-related businesses, individuals have a strong incentive to create mechanisms and institutions to seize those opportunities. Adam Smith observed this phenomenon in the 1770s, especially in Italy and Switzerland:

Commerce and manufacturers gradually introduced order and good government, and with them, the liberty and security of individuals, among the inhabitants of the country, who had before lived almost in a continual state of war with their superiors. This, though it has been least observed, is by far the most important of all their effects.⁵

The *rule of law* is the first and most important institution fostered by free trade. In order to enforce contracts, prevent merchandise robbery and damage, and protect ships and their crews, trading countries need to establish a framework of objective rules under which free trade will be conducted. At

5. As quoted in Nikolaus Piper, "Trade, Globalization and Integration: Some Lessons from Hamburg's History," paper presented at the Mont Pelerin Society meeting, Hamburg, Germany, April 3-6, 2004.

the same time, those countries need to have a *law enforcement* mechanism to apply those rules, such as a police force and an independent judicial system. The proper functioning of these two institutions encourages individuals to initiate businesses and to sell, buy, and seize to the maximum extent the economic opportunities of free trade.

A third institution fostered by free trade is the *banking and financial system*, which gives individuals access to credit and a place to save and keep their earnings. At the same time, financial instruments, like checks and money wiring, lower the transaction costs associated with trade. Today, the Internet and other telecommunication technologies have significantly reduced the cost of trading worldwide. The result is that more and more people are able to reap the benefits of trading with any nation around the world.

Equally important is the function of *insurance companies*, through which individuals can reduce the cost of damage and robbery to their merchandise. This enables parties to a contract to preserve what is established in that contract at a lower cost than if the insurance did not exist.

Free trade also promotes the *improvement and expansion of infrastructure*. The construction of ports, where ships and airplanes can arrive and safely unload and load merchandise, must expand to accommodate free trade. Hangars and other types of barns located at ports offer the opportunity to store merchandise temporarily. At the same time, free trade fosters the construction and preservation of roads for trucks and automobiles to transport merchandise safely to its final destination.

Likewise important is the *development of all sort of new businesses* to support free trade, including hotels, restaurants, law firms, packaging and delivery services, software development companies, automobile factories, construction businesses, among many others.

REASON #5: Peace

Free trade fosters an enormous chain of economic activity, the benefits of which culminate in a social desire to be at peace with neighboring and even faraway nations with which trade is conducted or might be conducted in the future. When

individuals see how beneficial it is to live in an economically free society; when they see how freedom allows them to improve their lives and those of their families; when they can create new businesses, engage in commerce, or work for a decent salary or wage, adding dignity to their lives, they want peace to preserve all these good things.

By contrast, when people live under economic oppression and are at the mercy of a small ruling authority that dictates every aspect of their lives and limits their ability to realize their potential, they resent the life they have and learn to hate better lives elsewhere. If they cannot enjoy the fruits of their efforts and cannot realize their potential; if they cannot feel free to do business, work freely, and trade freely; if they do not have anything to gain or to lose, they begin to feel that any change—even war—might be better. They have no incentive to desire peace with their neighbors.

For this reason, the areas of greatest conflict in the world also happen to be those that are economically repressed. (See Map.) The Economic Freedom Map, drawn annually from the *Index*, shows, for example, that countries that are the most economically repressed have also suffered civil wars and unrest.

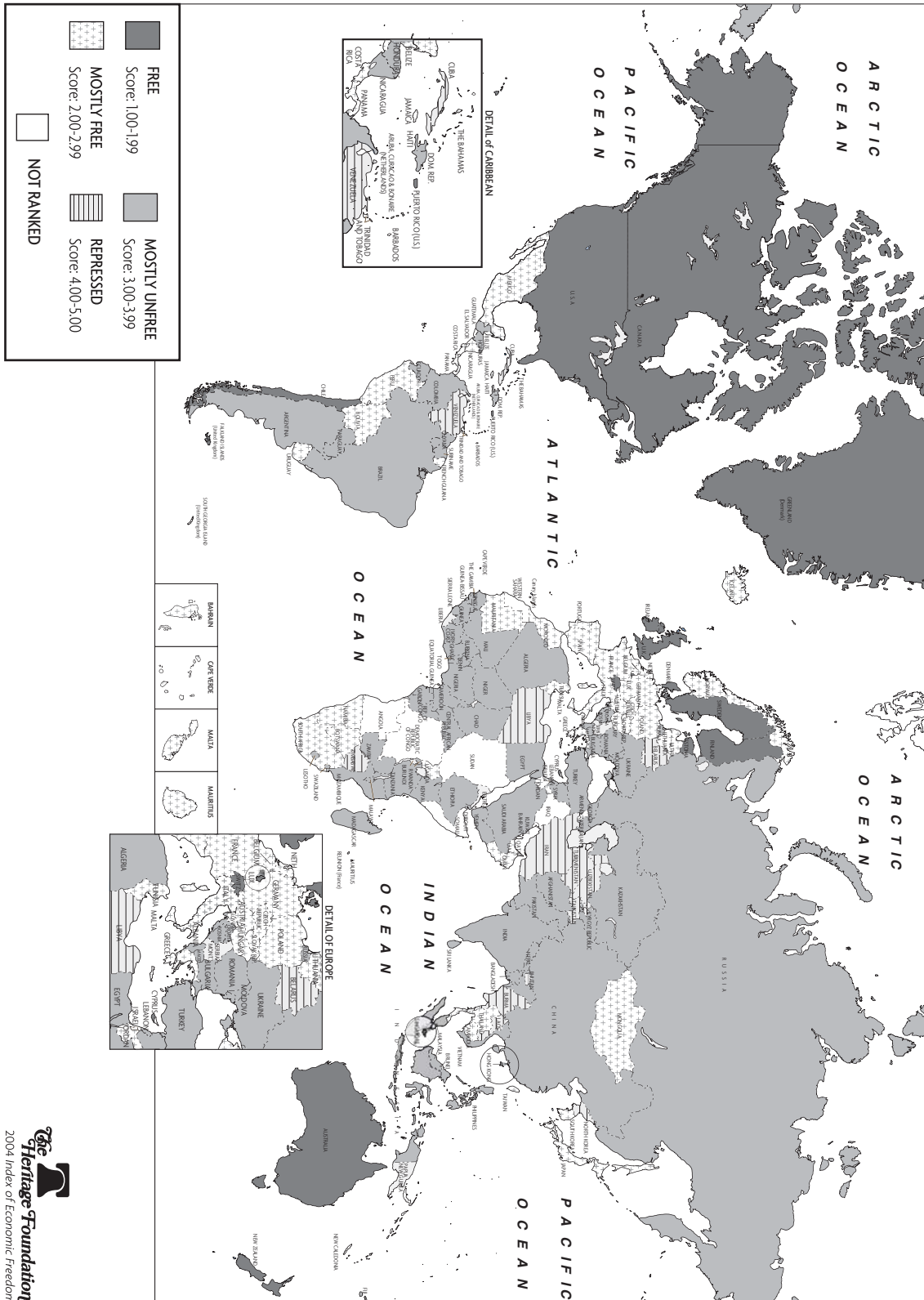
- The areas of the Middle East in which civil wars and terrorist havens abound are both economically repressed and mostly unfree.
- North Korea, a country plagued by starvation and poverty, is repressed.
- Brazil, Argentina, parts of Africa, and some former Soviet republics—all mostly unfree—have high levels of poverty and periodically suffer political and economic crises.

Free trade and economic freedom set the process of growth, innovation, and prosperity in motion. In that process, individuals support the creation of institutions that are conducive to growth and that preserve peace and prosperity. The greater the level of prosperity, the greater the likelihood of peace.

The Question of “Fair Trade”

Politicians, opinion makers, journalists, and businessmen commonly talk about the need to

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support “fair trade.” Seldom, however, does anyone explain either what fair trade is or—even more to the point—to whom trade should be fair. In the name of fairness, different groups advocate different protections for their specific industries and call the comparative advantage of other countries “unfair.”

For example, U.S. manufacturers think it is unfair that labor in China is cheaper than labor in the United States, and therefore ask for tariffs against Chinese products. But those tariffs would, in reality, be unfair to millions of U.S. consumers and producers who would be forced to pay higher prices for locally manufactured goods. “Fairness” assumes a dubious character in policies that pick and choose whom to treat “fairly.”

Others argue that America needs to enact barriers to free trade in order to strengthen national defense. For example, a tariff to protect steel would be justified because we need our own steel to support the construction of tanks, missiles, and arms. This argument is built on the faulty assumption that America’s wealth is at least constant. But a constant level may imply that the U.S. is falling behind other nations in relative terms. The strongest national defense depends on a relatively strong economy, and a strong economy is possible only with economic freedom.

As the *Index* demonstrates, once economic barriers begin to emerge, a nation’s wealth begins to decline. America’s relative economic freedom and wealth have already begun to decline. In fact, according to the *Index*, the United States has lost considerable ground in economic freedom (declining from 4th freest economy to 10th freest in 2004), which means it has also lost more and more opportunities to increase wealth.

The only form of fair trade—if such thing exists—is free trade. When facing competition from Chinese manufacturing, U.S. manufacturers have two options: either adopt new technologies to cut costs and become more competitive or shift the focus of their operations to different areas in which they can be more competitive. Neither of these two options harms consumers, since they will continue to have access to the least expensive,

best-quality products.

Most workers benefit as well. For some people, free trade requires change, but they also now have opportunities to use their skills in more efficient, advantageous, and productive ways that are created by the innovation and prosperity that competition promotes. Likewise, for a strong national defense, America needs the resources, innovation, and income that are derived from the absence of barriers to trade and investment.

What the Bush Administration Should Do

The Bush Administration should support free trade by all means at its disposal. Keeping America free of protectionism and special favors will foster economic growth. To that end, the Administration should:

- **Advance as many free trade agreements as possible.** So far, the Administration has advanced free trade agreements with Chile and Singapore and has completed negotiations with Central America, Australia, and Morocco. It should continue to negotiate free trade agreements with other countries around the world.
- **Eliminate agricultural subsidies, antidumping measures, and other protectionist policies.** Subsidies and special protections benefit small economic interests or sectors at the expense of millions of consumers and producers. They translate into higher prices, the impact of which is felt primarily by poor Americans.

The Bush Administration should advance an agenda to eliminate agricultural subsidies at the World Trade Organization. It should take advantage of Europe’s recent proposal to put the Doha round back on track by ending agricultural export subsidies, and it should encourage Japan to eliminate agricultural export subsidies as well. It is equally important to engage developing nations so that they eliminate convoluted business regulations, corruption, and weak rule of law. By encouraging these steps, the Administration will help these countries to provide a more busi-

ness-friendly environment that attracts both foreign and domestic investment.

Conclusion

Free trade is an essential pillar of U.S. economic power and prosperity. It encourages labor force specialization and the exchange of goods and services that other countries do better and at lower cost. Specialization leads to competition and innovation, providing new technologies that allow Americans to produce more goods and services, cure more diseases, pollute less, get better education, and choose from a wider range of investment options. As the economy grows, people enjoy higher standards of living and gain a greater appreciation of the benefits of living in a peaceful society.

Competition, innovation, and new technologies also bring about changes that challenge some sectors to adapt themselves to those new trends and reap their benefits. Changes currently taking place in the U.S. manufacturing sector illustrate the process by which a growing society changes from a more industry-based to a more knowledge-based society. Those businesses and entrepreneurs who

seize the opportunity to profit from this change will survive and, in surviving, will provide more and more Americans with the opportunity to increase their standard of living.

The Bush Administration should keep America free of protectionism and special favors. To that end, it should advance more free trade agreements and lead negotiations at the World Trade Organization to eliminate agricultural subsidies, antidumping measures, and other policies that benefit selected groups at the expense of millions of Americans and undermine the nation's ability to grow.

Instead of threatening to impose barriers to inexpensive imports, the Administration should lower the tax and regulatory burden on U.S. companies so that they can be more competitive. The more America moves toward economic freedom, the more it will foster its own prosperity, the prosperity of other nations, and ultimately the cause of liberty around the world.

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