CHAPTER 7

The History and Future of International Trade

For many decades, the United States has worked to break down trade barriers across the globe through a wide range of institutions and agreements. Both the United States and our trading partners have derived substantial benefits from greater global economic integration. Many American consumers, firms, and workers are better off because of these efforts.

While the economic research and performance of this time period show the benefits of trade outweigh the costs, trade liberalization has always brought anxieties. This has been the case both here in the United States and throughout the world. Temptations to retreat to economic isolationism often occur when trade agreements are negotiated and current negotiations are little different in this regard. Therefore, this chapter provides a retrospective on U.S. trade policy and an evaluation of the payoff from greater trade and investment liberalization that has been at the forefront of this country's international economic policy for the last 70 years.

The key points in this chapter are:

- Over the past 70 years, policymakers across political parties have consistently recognized the importance of unfettered international commerce to America's standard of living and economic growth, and have achieved major trade liberalization both here and abroad.
- The net payoff to America from these achievements has been substantial. Many American consumers, firms, and workers have benefited from increased trade.
- A number of barriers to trade, especially in services, remain, and the potential gains to the United States and other countries from further liberalization are still significant. To move beyond trade liberalization in goods, the United States is pursuing greater economic cooperation and more-open markets with our trading partners in order to stimulate economic growth.

A Retrospective on Trade

The country's historical influence in promoting global trade liberalization can be traced back to the early part of the twentieth century, and it spans both political parties. The early 1930s proved to be a critical turning point in the evolution of modern American trade policy and heralded the first major

American trade liberalization effort. In the decades following, the United States has spearheaded multinational, regional, and bilateral negotiations in the interest of advancing trade liberalization. This retrospective illustrates the undeniable progress toward trade liberalization in the United States. Revenues from tariffs (a tariff is a tax levied on imports coming into the United States) in the early 1900s accounted for about half of Federal revenues compared to less than 2 percent today. From the inception of this country until the Civil War, tariff revenues were a major source of government revenue. The addition of the sixteenth amendment to the U.S. Constitution in 1913 broadened the tax base by introducing the personal and corporate income tax. This change began the shift away from indirect taxation (import duties and excise taxes) toward direct taxation on personal and corporate incomes, thereby reducing this country's dependence on import duties as a form of revenue.

Before the 1930s, U.S. trade practices fluctuated between trade-promoting and trade-restricting policies. Prior to World War I, President Woodrow Wilson pursued an internationalist foreign policy that resulted in import tariff reductions through the Underwood Tariff Act of 1913. The economic depression and subsequent reversion to isolationism that followed the 1929 stock market crash led to a rejection of Wilsonian policies in favor of greater protectionism. The Tariff Act of 1930 (otherwise known as the Smoot-Hawley Tariff) significantly raised average duties on selected imports to an all-time high of 59 percent. Such protectionism was designed to reduce unemployment and increase domestic output. By reducing export markets, however, the heightened tariff and nontariff trade barriers (such as quotas or quantitative import restrictions) exacerbated the Great Depression. The collapse of world trade from 1929 to 1933—a decline of more than two-thirds in just four years—followed in the wake of protectionist policies as countries depreciated their currencies, raised tariffs, and imposed quotas. These isolationist policies contributed to a spiraling contraction of world trade and a collapse of domestic demand.

The historic Reciprocal Trade Agreements Act of 1934 marked a turning point in modern trade legislation. The 1934 Act departed significantly from previous protectionist policies, and it began the historic shift toward lower U.S. and foreign trade barriers and greater global economic engagement. Signed into law by President Franklin D. Roosevelt, the Act passed Congress with overwhelming support. The 1934 Act was the first of many steps over the twentieth century leading to America's relatively liberal trade stance today. Table 7-1 shows that key milestones in American trade history have been consistently achieved by a number of administrations.

The Trade Act of 1934 changed U.S. trade policy. The 1934 Act made trade a shared Congressional and Executive Branch responsibility, and instituted a so-called bargaining tariff. Up to that point, trade policy had been primarily

TABLE 7-1.—*Important Milestones in American Trade History*

Milestone (years of negotiation)	Year Signed into U.S. Law	Administrations involved
Reciprocal Trade Agreements Act of 1934	1934	Roosevelt
Kennedy Round (1962–1967)	1962	Kennedy, Johnson
Tokyo Round (1973–1979)	1979	Nixon, Ford, Carter
Uruguay Round Agreements Act (1986–1994)	1994	Reagan, G.H.W. Bush, Clinton
North American Free Trade Agreement (1990–1993)	1994	G.H.W. Bush, Clinton
Trade Act of 2002 and Renewal of Trade Promotion Authority (2001–2002)	2002	G.W. Bush

a product of the legislative exercise of its Constitutional authority over foreign commerce. This Constitutional authority left Congress open to the protectionist demands of specific industries and special interests. President Roosevelt and Secretary of State Cordell Hull recognized this vulnerability and worked with Congress to enact this reciprocal trade program to make lower tariffs more politically durable. With the enactment of the Trade Act of 1934, Congress suspended passage of product-specific trade laws and delegated specific tariff-setting to the Executive Branch. Doing so formally changed the way Congress handled trade issues by insulating elected representatives from the pressures that had led to protectionism in the past.

The 1934 law also instituted the so-called bargaining tariff. This concept linked tariff setting to international negotiations, whereby U.S. tariff cuts were extended in bilateral negotiations to countries that offered reciprocal tariff reductions benefiting U.S. exporters. In this way, the bargaining tariff helped to shift the balance of trade politics by engaging the interests of U.S. exporters. The system effectively allowed the United States to reduce its own trade barriers and to persuade the rest of the world to reciprocate. In the aftermath of World War II, policymakers correctly predicted that postwar trade expansion would help to usher in a remarkable era of world prosperity and contribute to conditions for a stable peace.

A commitment to the Wilsonian notion that prosperity and peace go hand in hand is at the core of postwar trade liberalization for both political parties in the United States. An extension of the reciprocal trade agreement, which Presidents Roosevelt and Truman both had recommended as a keystone of the country's postwar international economic policy, passed Congress with strong support in 1945. The enabling legislation put the Administration in a position to begin in earnest the process of dismantling global trade barriers. President Harry S. Truman signed the General Agreement on Tariffs and Trade (GATT) in 1947, bringing the United States into the multilateral trade regime by executive agreement. The GATT took effect in 1948 and served as a forum for trade negotiations whereby every signatory country could enjoy the concessions of every other signatory (otherwise known as most-favored-nation status). Membership in the GATT not only brought the United States into the multilateral trade regime but also provided a vehicle to rebuild the postwar economies of Europe and Japan. The lessons of Smoot-Hawley contributed to broad support for freer trade that was to become a critical component of U.S. international economic policy. This political consensus marked a shift toward a broadly accepted liberal market and free-trade philosophy that set the stage for the various multilateral negotiating rounds that were to follow.

The next major acknowledgment of the necessity of liberalizing trade came in the 1960s. President John F. Kennedy led the Trade Expansion Act of 1962, which was approved with substantial support in Congress. The Act authorized the U.S. government to negotiate tariff cuts of up to 50 percent, which persuaded other countries to actively participate in the Kennedy Round (1962–1967) of multilateral trade negotiations. Congressional support was partly due to the inclusion of legislation to assist workers affected by trade, also known as Trade Adjustment Assistance. At the time, the Kennedy Round signified the most ambitious series of trade negotiations ever attempted under the auspices of the GATT. The Round included negotiations on agriculture for the first time, and reduced barriers to exporters for developing countries.

The Tokyo Round (1973–1979) led to further tariff reductions and provided new disciplines on nontariff barriers. The Tokyo Round included "codes of conduct" that were designed to curtail the use of such barriers as instruments of protection. Launched under President Richard M. Nixon, continued by President Gerald R. Ford, and signed into law by President Jimmy Carter with the Trade Agreements Act of 1979, the Round demonstrated a strong, consistent bipartisan commitment toward freer trade.

As trade liberalization negotiations moved increasingly beyond tariff reductions in nonagricultural products, progress toward greater liberalization became more difficult for many countries. The Uruguay Round (1986–1994) launched under President Ronald Reagan nearly collapsed in 1990 over disagreements about lowering barriers on agricultural products. Following a redrafting of the agreement by GATT Director-General Arthur Dunkel, President George H.W. Bush spearheaded efforts to complete negotiations of the Uruguay Round, and in 1994 President Bill Clinton signed legislation implementing the final agreement. The Uruguay Round achieved the most fundamental reform of global trade rules since the creation of the GATT. The Round established the World Trade Organization (WTO), extended international trade rules beyond goods to include intellectual property rights and trade in services, and greatly improved procedures for countries to resolve disputes over international trade.

At present, the United States is actively engaged in the current Doha Development Round of multilateral trade negotiations that began in 2001. This round aims to liberalize agricultural trade, lower remaining barriers in nonagricultural goods trade, and reduce trade barriers in services. The Round focuses on increasing market access for developing countries as a means to encourage economic development. Progress has been slower than anticipated, but the eventual success of the previous Uruguay Round suggests that a favorable outcome from Doha will emerge.

In addition to multilateral trade liberalization, over the past two decades the United States has signed a number of bilateral and regional trade agreements. The protracted nature of multilateral negotiations has been one factor that has led the United States to aggressively pursue other avenues toward free trade outside of the major negotiating rounds. Under President Reagan, the United States signed its first bilateral free trade agreement (FTA) with Israel in 1985. The United States and Canada signed a bilateral FTA in 1988 after three years of negotiations. The Bush Administration initiated negotiations for the North American Free Trade Agreement (NAFTA) in 1991, which President Clinton signed into law in 1993 and went into effect the following year. In addition to trade, NAFTA explicitly recognized the benefits of investment liberalization and included provisions designed to extend national (i.e., nondiscriminatory) treatment, among other protections to investors.

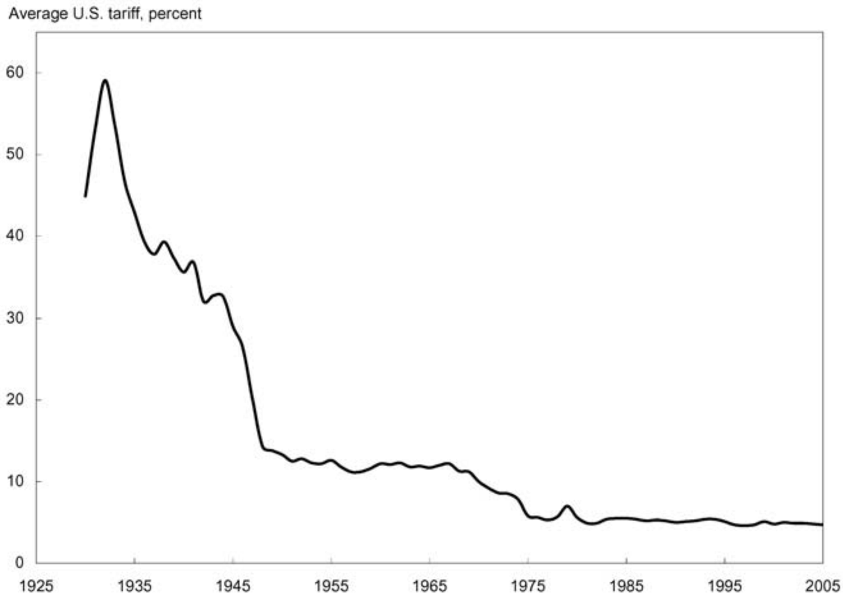
The United States has recently embarked on a renewed series of bilateral and regional free trade agreements. The ability of the United States to negotiate trade-liberalizing agreements was strengthened significantly when the President signed the Trade Act of 2002 into law. That legislation provides the Executive Branch with the ability to negotiate international agreements that are subject to an up or down vote, but not amendment, by Congress. The President's leadership was vital in securing this important authority to pursue a full trade agenda including multilateral, regional, and bilateral trade agreements. The President has implemented bilateral FTAs with Jordan, Chile, Singapore, and Australia. The Administration also has concluded FTAs with an additional ten countries: Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, the Dominican Republic (the Central American-Dominican Republic FTA, or CAFTA-DR), Morocco, Bahrain, Oman, and Peru. The United States is currently engaged in negotiations with the United Arab Emirates, the five nations of the Southern African Customs Union (Botswana, Lesotho, Namibia, South Africa, and Swaziland), Thailand, Panama, Colombia, and Ecuador. The adoption of CAFTA-DR is the latest chapter in America's trade book, which demonstrates the country's ongoing commitment toward trade liberalization and economic development.

Decades of U.S. trade liberalization achieved on a number of fronts have had a dramatic impact on U.S. openness to trade. Chart 7-1 shows how average U.S. tariffs have fallen since 1930. The average tariff on dutiable goods approached 60 percent at the height of the Great Depression and has dropped to 4.6 percent. The current average U.S. tariff on all goods (both dutiable and nondutiable) is just 1.4 percent.

Trade expansion has reached an important juncture, and resistance both here and abroad to further trade and investment expansion could jeopardize increased domestic and international economic growth. The retrospective presented above illustrates America's historic achievements in trade liberalization, and, as the next section demonstrates, Americans, on average, have accrued immense gains along with our trading partners from this liberalization. The United States has a large stake in the current multilateral negotiations of the Doha Round. The gains from prior trade agreements provide grounds to stay the course on trade liberalization.

Chart 7-1 **Average U.S. Tariff on Dutiable Goods, 1930-2005**

Since 1934 the United States has moved consistently towards freer trade.



Source: United States International Trade Commission.

The Payoff to America from Global Economic Integration

Trade liberalization remains a controversial subject because competition invariably raises both anxieties and opportunities. Reducing obstacles to trade can help economies grow more rapidly and efficiently in the long run and create better, higher-paying jobs, while global competition can lead to hardships for others in the short run. (Impacts of international trade on labor markets are discussed in Box 7-2 later in the chapter.) The appropriate social and political response to these hardships is a critical issue. For instance, at the macro level, pro-growth government policies can help set the environment for economic growth and job creation. Constructive policies that help displaced workers train for and find new work and increase the portability of pension and health benefits can also ease adjustment.

The gains from trade liberalization are more widely dispersed than the losses and often not readily apparent. These gains are evident in lower consumer prices and the greater variety of products available to consumers. International commerce helps countries focus resources on strengths and forces firms to innovate and to set prices more competitively. Studies show that firms that are engaged in the international marketplace tend to exhibit higher rates of productivity growth and pay higher wages and benefits to their workers. An economy with higher overall productivity growth can support faster GDP growth without generating inflation. And higher productivity growth means higher sustainable living standards. Taken together, the net benefits from increased economic integration (greater trade and investment liberalization) historically have been positive for the United States.

Benefits to Consumers

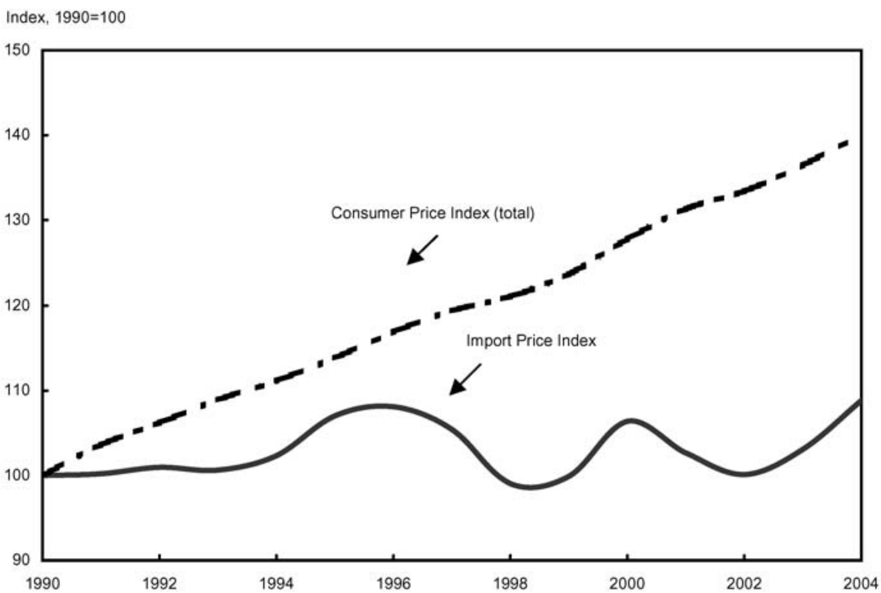
Lower Prices

International trade fosters competition, which in turn restrains cost. There is now ample evidence across many countries that greater trade openness and the resulting exposure to foreign competition reduces the ability of a country's firms to charge high markups above production costs. Pressures for lower prices arise from the direct impact of cuts in trade barriers being passed through to cuts in prices. They also arise from the broader impact of raising market contestability.

At the detailed product level, many studies have linked lower prices and/or price-cost markups to measures of trade openness such as tariff rates. Chart 7-2 presents broader evidence of how trade helps lower prices. It presents indices of U.S. consumer prices and U.S. import prices since 1990. There is a clear difference between the two indices: Overall consumer prices, which include not just imported goods and services but largely nontraded goods and services, have risen much more than have import prices. The average annual growth in U.S. import prices for the period 1990–2004 was just 0.6 percent, compared to a 2.2-percent rise in overall consumer prices. In real terms, total U.S. imports grew threefold during this same period, from $553 billion to $1.5 trillion (in 2004 dollars).

In addition to the pro-competitive effects of trade, other important contributors to price restraint are technology advances and innovation. This has been especially true for consumer electronics and information technology (IT) products. For instance, in just the past eight years, consumer prices of color televisions are down 50 percent, and Americans today pay 60 percent less for camcorders and mobile phones. It can be difficult to empirically separate observed price declines into the relative contributions of trade, technological change, and other forces. But a simple approach to assessing the role of international trade in price changes is to compare price changes between more- and less-traded products. Consistent with the aggregate evidence in Chart 7-2, a clear divergence in price trends emerges when products are split in this way. Internationally traded products tend to experience lower inflation rates—even real price declines—while nontraded goods tend to exhibit price increases. Between 1997 and 2004, real prices fell for an array of highly traded goods, such as audio equipment (-26%), TV sets (-51%), toys (-34%), and clothing (-9%). In contrast, real prices rose for

Chart 7-2 **Consumer and Import Price Growth, 1990-2004**
Consumer price growth has outpaced import prices.



Source: Department of Labor (Bureau of Labor Statistics).

largely nontraded products, such as whole milk (+28%), butter (+23%), ice cream (+18%), peanut butter (+9%), and sugar and sweeteners (+9%).

Exactly which Americans most enjoy the benefits of lower prices depends on which products enjoy the largest cuts in trade barriers. Box 7-1 discusses the regressive nature of the current U.S. tariff schedule.

Box 7-1: The Regressive Nature of U.S. Tariffs

While the average tariff applied to U.S. imports is relatively low at 1.4 percent, there are peaks within the U.S. tariff schedule that fall most heavily on lower-income consumers. Studies have shown that, on balance, U.S. trade barriers are regressive because they disproportionately raise the relative price of goods consumed by lower-income Americans. Some of the most restrictive trade barriers persist on everyday consumer products such as textiles, apparel items, and footwear.

Tariffs disproportionately affect the poor in two ways. First, many tariffs are highest on products that represent higher shares of income expenditures for lower-income households. Staple consumer products such as shoes and clothing face import taxes over 30 percent, some of the highest tariffs in the U.S. tariff schedule. Footwear represents 1.3 percent of income expenditures for lower-income households (1.5 percent for single- parent households) compared to just 0.5 percent for higher-income households. Similarly, lower-income households (and single-parent households) spend roughly 6 percent of their disposable income on apparel, while upper-income households spend just 4 percent.

Second, within these high-tariff product categories, tariffs are often most pronounced on the cheapest products. That is, products that are more commonly purchased by lower-income consumers are subject to higher import taxes than are those commonly purchased by upper-income consumers. For example, lower-priced sneakers ($3–$6 per pair) are marked up with a 32-percent tariff, while higher-priced sneakers, such as $100 track shoes, are subject to a 20-percent tariff.

How did the structure of the U.S. tariff schedule become so regressive? The cause was not a concerted effort to maintain relatively high import taxes on cheaper products. Movement toward increased trade liberalization tends to occur more slowly in labor-intensive industries where greater liberalization may be viewed negatively. The situation may reflect a classic political-economy challenge to liberalizing trade. The beneficiaries of trade protection are often a much more concentrated, well-organized group of individuals or firms than the millions of households across the country that bear the costs. However, the current Doha Round of multilateral trade negotiations offers an opportunity to eliminate these tariffs and other trade barriers, provided other WTO members reciprocate.

Greater Product Variety

International trade also allows consumers to choose from a broader variety of goods and services. One study shows that that the number of imported product varieties has increased by a factor of four over the last three decades, reflecting an important source of gains from trade. Welfare gains from variety growth alone have been estimated to be a remarkable 2.8 percent of GDP, which translates into gains of over $4,000 for the average American family of four.

International trade allows year-round availability of seasonal and perishable food items such as fruits and vegetables. For example, U.S. consumers today enjoy grapes and peaches from Chile, limes and avocados from Mexico, mandarin oranges from China, and cashews from India, many during the off-season for U.S. production. Trade also provides U.S. consumers with greater variety and choice for agricultural products that the U.S. does not produce in large quantity. For example, Americans enjoy coffees from all over the world, including from Colombia, Costa Rica, Indonesia, Ethiopia, and Kenya.

Benefits to Firms and Their Workers

Firms can be linked to the global marketplace through many channels: exporting, importing, investing abroad, or receiving investment from foreign firms (foreign direct investment, or FDI). Stronger linkages to the global economy provide export opportunities for U.S. firms, allow firms to realize economies of scale, and provide the ability to establish and expand global production networks to lower prices and boost productivity. These opportunities can raise U.S. living standards by allocating national resources toward areas in which we have a comparative advantage and by raising firm productivity.

Firms exposed to global competition are exposed to the world's best practices in areas such as supply management, production processes, technology, and finance. Studies show that firms exposed to the world's best practices demonstrate higher productivity through many channels, such as learning from these best practices, and also creating new products and processes in response to this exposure. A number of U.S. industries have been compelled to adjust and innovate as a result of foreign competition via trade and FDI in the United States.

For instance, by the late 1970s, many Japanese carmakers were outperforming U.S. companies in overall assembly productivity, and U.S. imports of Japanese cars were rising sharply. America's leading automakers initially focused their response on trade protection. But competitive pressures from Japanese firms continued, in particular through foreign investment in the United States in the 1980s. This foreign investment established and expanded "transplant" production facilities in the United States that soon achieved productivity levels on par with Japanese plants. These transplants proved to be a major spur to stepped-up innovation and performance among American firms. In the steel industry, a combination of foreign competition and the growth of the highly productive mini-mill sector has compelled U.S. integrated-steel producers to improve their performance.

Various studies show that globally engaged firms have higher productivity growth and tend to innovate more than their purely domestic counterparts. For instance, evidence from the United Kingdom shows that from 1998 to 2000, just 18 percent of domestic firms reported either product or process innovations compared to 45 percent of globally engaged firms. In recent years in the United States, over 80 percent of total private-sector R&D spending has been accounted for by multinational companies (i.e., by the combination of U.S. parents of U.S.-headquartered multinationals and U.S. affiliates of foreign-headquartered multinationals). Sales per employee, one simple measure of productivity, is up to one-and-a-half times larger in exporting plants than in others. Value-added per employee, another measure of productivity, is up to one-and-a-third times larger in exporting plants than in others. Exporting plants adopt new technologies more frequently and intensively than nonexporting plants; they also report more significant benefits from doing so.

The different channels through which international trade and investment contribute to productivity growth are very important for long-run U.S. living standards. Since 1995, the United States has enjoyed an acceleration in labor-productivity growth. From 1973 to 1995, output per worker hour in the nonfarm business sector grew at 1.4 percent per year. From 1995 to 2004, this rate accelerated to 2.9 percent per year—with rates averaging over 3 percent since 2000. Productivity growth of just 1.4 percent per year means average living standards take 50 years to double. At the faster rate of 2.9 percent per year, living standards take just 24 years to double.

Many researchers have concluded that IT hardware has been at the core of this productivity acceleration, citing both faster productivity growth among IT-hardware firms and greater investment in IT hardware throughout the economy. It is important to note that these highly successful IT-producing U.S. firms are among the most globally engaged firms in the U.S. economy. Exports and imports in the IT sector represent over 70 percent of sector output, compared to an economy-wide average of 10 percent. In recent years, IT firms have grown stronger by expanding their global production networks through increased international investment and trade, with output that entails multiple production stages across multiple countries. Indeed, today the United States runs large trade *deficits* in core IT sectors such as computers and office products (see Chapter 10).

American workers, like firms, also benefit from stronger linkages to the global economy. Studies show that workers in U.S. multinationals receive wages and benefits up to 18 percent higher on average than their peers in purely domestic firms. International investment plays an important role, too. Evidence suggests that wage premiums are 19 percent and 13 percent for blue- and white-collar manufacturing workers, respectively, in foreign-owned multinational firms. For American workers in multinationals with foreign investment backing the wage premiums are 7 percent and 2.5 percent, respectively. The productivity advantages of globally engaged firms benefit American workers, insofar as high and rising labor productivity is the foundation for gains in real wages economy-wide.

Taking Stock of the Benefits of Trade to America

The decades of American efforts to advance trade liberalization described above have generated substantial gains for the country overall. On the consumption side, households have enjoyed lower product prices and greater product variety. On the production side, firms have more efficiently allocated resources by focusing on areas in which they have a comparative advantage. Those firms directly engaged in international commerce tend to be more innovative, more productive, and pay higher wages and benefits to their workers. Overall, there is substantial evidence that trade has contributed to high and rising living standards for the average American.

Having discussed the different ways through which freer trade benefits America, the bottom-line question is how much has America benefited in total from decades of trade liberalization? Studies have estimated that the annual payoff from U.S. trade and investment liberalization to date, including from the Tokyo Round, Kennedy Round, and Uruguay Round, NAFTA, and other FTAs, is over $5,000 per capita or $20,000 for an average American family of four. These gains arise through many channels: higher long-term levels of trade exposure in goods and services that come from trade and investment liberalization; increased product variety; more efficient allocation of resources; and better transportation and communication technology. Some economists have conjectured that trade liberalization alone has accounted for about half of these gains, which implies that the annual income gain from trade liberalization to date is over $10,000 for an average American family of four.

Box 7-2 includes a discussion of the impacts of international trade on labor markets. The effects of trade on the environment are discussed in Box 7-3.

Box 7-2: Trade and Labor

Job growth in America is driven largely by demographics—population growth and choices about labor-force participation—and by macroeconomic policies that affect, in particular, the business cycle. As the chart below shows, total employment has closely tracked the number of people in the labor force (employable people) since 1960, which in turn has closely tracked the overall U.S. population. Import competition has the potential to generate job losses where firms fail to adjust their operations to meet new competitors. International trade can also create better, higher-paying jobs in other industries. As discussed in the chapter, American jobs in globally-engaged firms (firms that are engaged in international trade or investment) are on average better and higher-paying than are jobs in purely domestic firms.

The dynamic U.S. economy creates and eliminates millions of jobs each year. The enormous turnover in the U.S. labor market is a reflection of the continuous stream of entry, exit, and resizing of firms in our ever-changing economy. On average over the past decade, the economy has had a net creation of nearly 2 million jobs each year. This net increase has been the result of approximately 17 million jobs created and 15 million jobs eliminated each year. International trade is one of the factors behind job turnover, along with changes in consumer tastes, domestic competition, productivity growth, and technological innovation. Survey data from the Bureau of Labor Statistics show in layoffs of 50 or more people between 1996 and 2004 less than 3 percent were attributable to import competition or overseas relocation. Moreover, studies have shown that the rate of job creation in globally engaged companies is faster than the overall private-sector rate, and that trade-related dislocations on average do not involve longer unemployment duration or lower re-employment earnings than do dislocations from other causes.

Any job loss involves hardship, and any job change can involve challenge. The President has outlined ways to help people gain new skills in fields where jobs are being created.

It is often asserted that international competition pressures American earnings. In today's economy, education is valued more than ever and is a key determinant of worker earnings. Since the late 1970s, the returns to education have been rising in the United States, despite the fact that the supply of educated workers has also grown rapidly,

Box 7-2 — *continued*

Labor Force and Employment, 1950-2004
Employment closely tracks the number of people in the labor force.

Source: Department of Labor (Bureau of Labor Statistics).

suggesting that the demand for skills and education has grown even faster than supply. There is now a large body of empirical research exploring the causes of rising wage inequality across skills. There is broad consensus that trade has marginally contributed to rising wage inequality by placing a higher premium on skills and education. This contribution has been small compared to other factors such as the advent of new technologies that demand higher levels of skill.

It is important that the United States help our workers thrive in a competitive world. The President has said he will not be satisfied until everyone who wants to work can find a job. At the macroeconomic level, monetary policy can aim to achieve maximum sustainable employment with low inflation—irrespective of the trade situation. At the microeconomic level, constructive policies can help students and workers, including displaced workers—regardless of the cause of displacement—train for and find good work in the 21st century. The President has proposed a number of measures to improve job training, including Community-based Job Training Grants and Career Advancement Accounts (for further discussion, see Chapter 2).

Box 7-3: Trade and the Environment

A nation's environmental policies are largely determined by domestic factors. The most direct mechanism through which trade liberalization could affect environmental quality is through changes in the composition of industries or the scale of industrial or agricultural output. Trade means greater specialization, potentially increasing the concentration of polluting industries in some countries (so-called pollution havens) and decreasing it in others. On the other hand, multinational corporations from industrialized countries that set up operations in lesser-developed countries often bring a higher level of environmental performance with them. There is little or no empirical evidence directly linking trade liberalization to environmental changes.

Trade can affect the environment indirectly as well, both positively and negatively. Increased trade can lead to higher incomes, and as incomes rise, the demand for improved environmental quality rises. Another indirect effect is the influence of trade on the rate of economic growth, which could either decrease pollution (due to the use of cleaner technologies through capital stock turnover fueled by economic growth) or increase pollution (due to increased consumption).

While it is widely recognized that international trade policy measures are usually not the best method for achieving environmental objectives, recognition of the importance of the issue has resulted in a number of significant policy and institutional responses, both nationally and multilaterally. For instance, the environmental side agreements of NAFTA established the North American Commission for Environmental Cooperation to undertake capacity-building projects and to put procedures in place that help to monitor each country's effective enforcement of environmental laws. Active participation by governments and institutions is a necessary component of the success of such efforts.

FTAs can provide a basis for enhanced bilateral cooperation on environmental issues. Environmental provisions in NAFTA and U.S. free trade agreements require each country to effectively enforce its own environmental laws, and strive to ensure that failure to enforce these laws does not affect trade or investment. These agreements are accompanied by separate environmental cooperation agreements or arrangements intended to take advantage of the closer economic ties and broadened environmental cooperation that goes beyond the trade sphere. Although some criticize trade agreements for a failure to do even more to advance environmental policy objectives, others acknowledge the significant benefits associated with the core obligations and cooperation mechanisms.

The Policy Scene Today: Avenues to Further Liberalization

Trade liberalization to date has had substantial benefits. Still, barriers to international trade and investment remain and limit growth opportunities for many countries. With the United States accounting for just 5 percent of the world's population, 95 percent of the potential consumers of U.S. goods and services live outside our borders. The prospective gains from further liberalization, particularly in services (e.g., finance, insurance, information technology, and professional and business services), are substantial for the United States and our trading partners through greater efficiency of production and higher national incomes. The extent to which different countries experience gains depends on both the range of sectors that are liberalized and the extent of liberalization within each sector. The United States is pressing for freer trade, especially in services, through bilateral, regional, and multilateral agreements.

Prospective Gains from Further Liberalization

Prospective Gains for the United States

The prospective gains for the United States from further trade reform are substantial. One study suggests that global free trade in manufacturing and agriculture would generate annual economic gains of over $16 billion for the United States, or roughly $220 for the typical family of four. The gains from removing all remaining barriers to trade in services are substantially larger, amounting to about an additional $520 billion for the United States, or over $7,000 for the average American family of four. This is additional income each year that will not be available in the absence of trade reform. These income gains would be fully realized in about a decade from the date of liberalization. These large gains reflect the United States having a comparative advantage in services sectors and the high barriers to services trade in other countries, which are often investment restrictions that effectively block the main conduit for trade in services. These restrictions include limits on the number of service providers, minimum local-content requirements that limit the participation of foreign firms, nontransparent and burdensome standards and licensing procedures, and discriminatory access to distribution networks.

Prospective Gains for the Rest of the World

Further liberalization in trade would bring significant global economic gains, particularly for developing countries. One study reports that the reduction of all remaining barriers to trade in services would generate over

$1.5 trillion in income for the world. For full trade liberalization in agriculture and manufactured goods, the World Bank reports that reducing trade barriers would generate about $290 billion of additional income to the world economy each year once the full effects of liberalization are realized, about a decade out. The income gains are even higher at $460 billion with more generous assumptions of trade's effect on economic growth. Nearly half of those income gains would go to developing countries. Various studies find that at least half of the developing-country gains would be obtained from agriculture trade reform by industrialized countries (including the United States), including tariff reductions and the elimination of subsidies and domestic support programs. (Agricultural trade reform is discussed in detail in Chapter 8.)

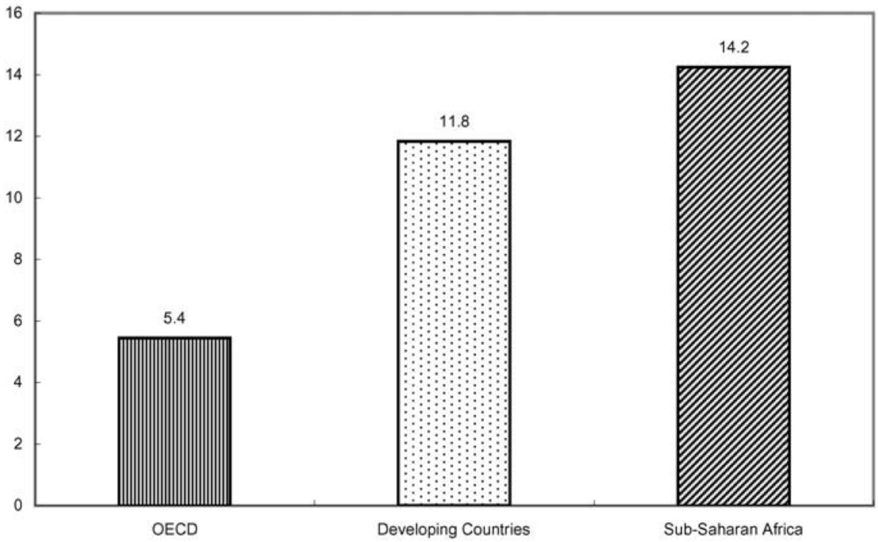
Debt relief and foreign aid can help to reduce poverty, but trade is a more powerful tool. For instance, in 2004, industrialized countries spent over $78 billion on development assistance to poor countries and industrialized countries are currently considering debt relief of $56 billion. Even the conservative estimate of the $140 billion effect of trade liberalization to developing countries exceeds both assistance and debt relief combined. Studies show that reducing barriers to global trade has the potential to lift hundreds of millions out of poverty. Agriculture liberalization is particularly important since roughly 75 percent of the world's poor live in rural areas and farmers constitute the majority of the poor in developing countries.

The gains from integrating developing countries into the global economy are not one-sided. As developing countries increasingly participate in the global economy, industrialized countries benefit from increased export and investment opportunities in those markets. Over the past decade, U.S. export growth to developing countries exceeded the rate to industrialized countries. Yet tariffs and other trade barriers in developing countries remain high (Chart 7-3). Realizing these market opportunities and encouraging development in these countries requires further trade liberalization efforts while promoting transparency, good governance, and sound institutions, all necessary building blocks for economic growth.

Persuading developing countries to reduce trade barriers continues to be an important objective for the United States. As developing countries become more active participants in the global economy, they experience higher rates of economic growth and are better able to reduce poverty. Studies show that over the past two decades, developing countries that have been more open to free trade have experienced higher rates of economic growth. During the 1990s, per capita GDP in developing countries that liberalized more increased 5 percent compared to 1.4 percent growth in other developing countries. China's integration into the world economy is discussed in Box 7-4.

Chart 7-3 **Average Tariffs Across Countries**

Developed countries, on average, have lower tariffs than developing countries.



Note: Tariffs are applied average rates.

Source: World Trade Organization, *World Trade Report 2005* .

Box 7-4: U.S.-Asia Trade Relationship

The robust postwar economic performance of many Asian countries has driven the strong U.S.-Asia trade and economic relationship. In recent years Asian economies have experienced some of the world's highest growth rates and will continue to be key export markets for U.S. firms. Outside of South Asia, trade with the Pacific Rim region represents about 30 percent of U.S. trade with the world. The United States imports different items from the Asian region than it exports. The top imports from the Pacific Rim include electrical machinery, automobiles, toys, furniture, clothing, and footwear. The top U.S. exports to that region include aircraft, chemicals, plastics, agricultural products, automobiles, and pharmaceutical products.

U.S.-China Trade

Since 1995, U.S. trade with China has represented an increasing share of U.S. total trade, reflecting some substitution away from other Pacific Rim trading partners toward China. The United States imports different items from China than it exports to China. In 2004, top import items from China included a wide range of consumer goods, such as toys, sporting goods, apparel, and footwear. Top U.S. export items to China included a number of intermediate components and machinery,

Box 7-4 — *continued*

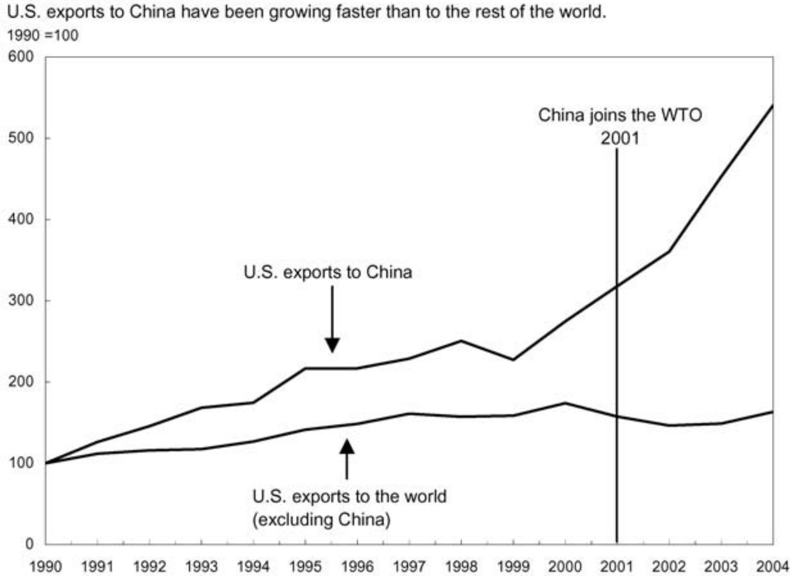
aircraft, soybeans, and cotton. Many imports from China now take the place of goods previously imported from other countries. China increasingly is a large and growing market for U.S. goods and services. As the chart below shows, since China's accession to the WTO, U.S. exports to China have risen faster than exports to the rest of the world.

Engaging China

The U.S.-Asia trade and economic relationship offers vast opportunities for citizens in all of these countries to prosper, however, China's integration into the global economy will not come without challenges. For instance, WTO membership has offered China new benefits, such as Permanent Normal Trade Relations with the United States and access to the WTO's rules-based dispute-settlement mechanism. China's WTO membership also brings new responsibilities, such as improving the protection of intellectual property, full compliance with trade agreements, and continued progress toward a flexible, market-based exchange-rate regime. China has made strides toward economic reform at all levels of government, but there are areas that require further progress. The United States will continue to work with China to assist its integration as a responsible stakeholder in the international economy and to ensure that bilateral economic relations are mutually beneficial.

U.S. Exports to China and the World

U.S. exports to China have been growing faster than to the rest of the world.



Note: Index of exports in 2000 U.S. dollars.
Source: Department of Commerce (Bureau of the Census).

Avenues for Further Liberalization

Countries are increasingly employing negotiations at the bilateral, regional, and multilateral levels to achieve further liberalization. These avenues are not mutually exclusive. The United States employs a multi-faceted approach, and in recent years has signed a number of bilateral and regional free trade agreements. These agreements set rules for trade, increase market access for firms, and strengthen the effective enforcement of intellectual property rights and environmental and labor laws. Other trading partners such as the European Union (EU) have pursued an even greater number of bilateral and regional agreements. The WTO nevertheless remains the most important forum for trade liberalization due to its global reach and the interdependence of the world economy.

The general consensus on the WTO among academics and practitioners is that the organization has facilitated increased trade and openness. By establishing a rules-based system, the organization provides a forum for all members to resolve trade disputes and offers a greater voice to developing countries in the establishment of global trade rules. These rules help to foster better business climates, particularly among developing countries, which can help to reduce corruption and attract more foreign direct investment. The United States fully supports the role of the WTO in promoting a rules-based global trading system, opening markets, and encouraging economic growth.

The 149 WTO members are currently engaged in the Doha Development Round of negotiations, which recognizes that global trade expansion can make a significant contribution to spurring economic growth and reducing global poverty. The Doha Round focuses on better integrating developing countries into the international trading system and enabling them to benefit from increased trade.

Moving Beyond Goods Trade Liberalization

To date, most trade liberalization has been in the form of reduction in barriers to goods trade. Using existing trade agreements and partnerships, trade and investment ties can be strengthened to include services and other nontariff measures that limit international commerce. This section discusses how the United States is pursuing deeper economic cooperation across North America and with the European Union.

Services Liberalization

From telecommunications and finance to health and education, services are the single largest sector in most industrialized and many developing countries. Not only do services provide the bulk of employment and income in many countries, but services provide critical input for the production of other goods and services. An in-depth look at financial services illustrates many of the key issues involved in liberalizing trade in services.

The unprecedented growth of global financial markets in recent years has given prominence to the issues associated with financial services liberalization. Liberalizing international trade in financial services can be a market-based means to strengthen financial systems. It is often an important catalyst in improving the quality of capital flows through exposure to foreign competition and in strengthening financial systems—particularly in developing and transitioning economies. Enhanced financial services trade can improve technology transfer and encourage better risk management across borders. Foreign competition challenges domestic firms to improve the quality of their financial services through broader opportunities for trade and portfolio diversification. This results in more consumer choice and competitive pricing.

Financial services liberalization for developing countries offers many possibilities for strengthening weak domestic financial systems through trade openness, competition, and sound regulation. Countries with fully open financial service sectors grow on average one percentage point faster than other countries. Foreign-backed financial institutions in developing countries often possess a greater ability to lend to those countries during economic downturns and thereby stabilize capital flows in times of crisis. Foreign banks that can extend credit to local businesses can be critical for stabilizing developing-country economies in the absence of more limited capacity of domestic financial intermediaries.

The General Agreement on Trade in Services (GATS) of the WTO is the most comprehensive framework to date that supports national programs of financial services liberalization within an international context. Insurance, banking, and financial services trade exists primarily in two forms: cross-border trade and commercial presence. In cross-border trade, domestic consumers purchase services from a foreign supplier abroad. In the case of commercial presence, a foreign supplier establishes itself in a country through direct investment.

U.S.-EU Economic Initiative

Trade and investment ties between Europe and the United States have been crucial in each region's economic growth for several decades. Trans-Atlantic trade is mostly free in terms of border taxes, with the exception of the agricultural sector. However, there remain a host of nontariff measures and regulatory divergences that hinder U.S.-EU trade and investment. In 2005, the United States and the European Union launched a trans-Atlantic economic initiative, which aims to promote regulatory cooperation and mutual recognition of standards, enhance trade in services, stimulate open and competitive capital markets, and promote innovation, among other economic-cooperation goals.

In order to enhance trade in services, the initiative calls for U.S. and European authorities to work with regulators and professional associations to identify sectors where the potential exists to achieve mutual recognition of professional qualifications. For instance, an agreement in architectural services might allow American architects to provide their services to European developers without having to navigate a complex and often nontransparent regulatory and licensing process. Underlying these goals to promote trans-Atlantic commerce is a commitment to greater cooperation beyond the reduction of traditional trade barriers.

Strengthening Economic Cooperation Across North America

NAFTA achieved important trade liberalization across the United States, Canada, and Mexico, and has laid the foundation for further economic cooperation in trade, investment, and other mutual interests such as immigration and security. Through the North American Security and Prosperity Partnership, the United States is working with the governments of Canada and Mexico to promote such economic cooperation. This "NAFTA-plus" initiative aims to eliminate nontariff barriers, streamline regulatory processes, expand duty-free treatment by liberalizing the rules of origin, and promote free and secure electronic commerce. Heightened security concerns since September 11, 2001, have resulted in greater port inspections, longer shipment times, and more-frequent delays. The imposition of security fees and increased inspections on NAFTA commerce can increase trade costs, adversely affecting businesses that have integrated their operations on a regional basis (such as the auto industry). This initiative also aims to harmonize safety standards for trade, streamline checkpoint operations, and make the movement of legitimate and low-risk traffic across North American borders more secure and efficient.

Conclusion

The expansion of international trade and investment over the past two decades has created an increasingly interdependent global economy. Achievements in trade liberalization have had substantial payoffs for the United States and our trading partners. With just 23 members (or "contracting parties") in 1948, the purview and membership of the GATT have grown dramatically. Today the WTO (the formal international organization of the GATT) has 149 members with many countries eager to join. While this increased engagement by countries in international commerce presents immense opportunities for U.S. consumers, workers, and firms, reaching consensus among all these countries on further reductions in trade barriers can be difficult. Like many other countries, the United States has pursued multilateral, regional, and bilateral agreements to achieve its goals. These avenues all lead to the same destination of more-open markets and greater economic growth. Existing trade partnerships and formal agreements can be platforms for further economic cooperation in areas such as services and investment. Recognizing the payoff to date and the prospective gains from further liberalization, the United States is committed to working with all countries to open markets and create favorable conditions for economic growth both here and abroad.