



# U.S. Trade Policy and International Institutions

ECON 462



## U.S. Trade Policy

### Pre-Civil War:

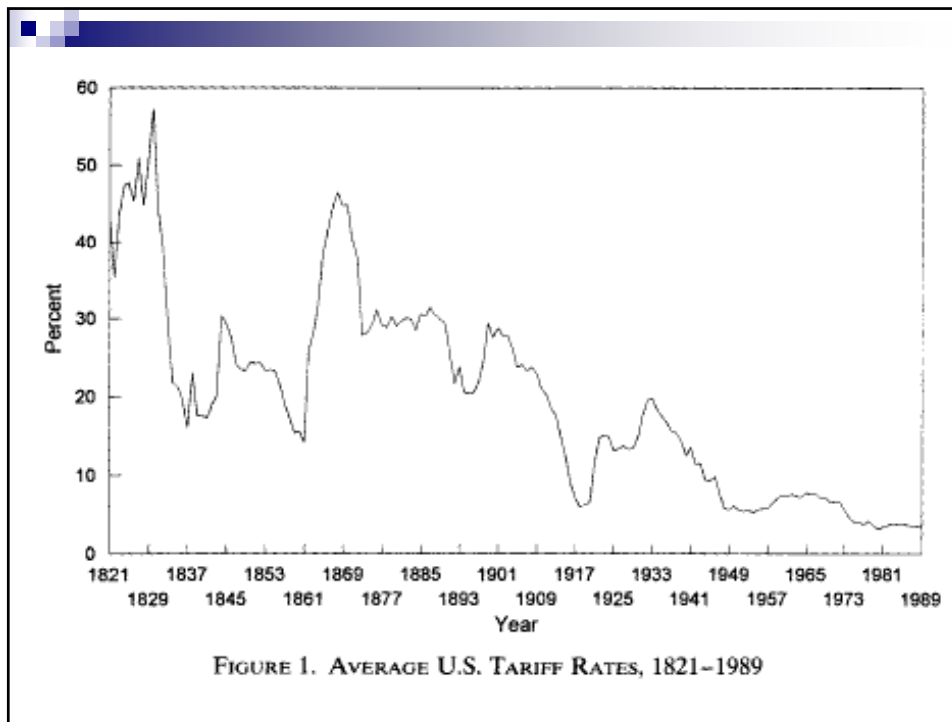
- Tariff Act of 1789: replaced state systems, ad valorem rates varied from 5-15%.
- Import tariffs largest source of federal revenue through WWI.
- Export taxes prohibited by U.S. Constitution.
- Alexander Hamilton's *Report on Manufactures* advocated protection for infant industries.
- After War of 1812, nationalism and manufacturing growth led to rising tariffs.
- Tariff increases of 1824 and 1828 (Tariff of Abominations), led to average tariff over 50%. Started nullification and secession movement in South.
- Compromise of 1832-1842 reduced tariff rates to uniform 20%.
- Tariff of 1842, Walker tariff of 1846, Tariff of 1857 reduced tariffs to "revenue only" purpose, 18% average.

## Trade Policy from the Civil War to WWII

- Morrill Tariff of 1861, tariff rates tripled and stayed high.
- Morrill Act of 1862 created land grant universities to subsidize agricultural research, which helped U.S. develop trade advantage.
- Democratic President Cleveland attacked tariff system as inherently corrupt in 1887, but lost re-election to Republican Harrison. Tariffs raised in 1890, Cleveland re-elected in 1892.
- McKinley elected in 1896, Dingley Tariffs raised rates in 1897.
- Under Taft (1909), argument for tariff reform led to Payne-Aldrich Tariff Act, which made it worse.
- Wilson attempted cuts with 1913 Underwood Tariffs, but war made it hard to expand trade.
- Smoot-Hawley Tariffs of 1930 led to retaliation, declining world trade, contributed to making Great Depression much worse.
- FDR and Cordell Hull: 1934 Reciprocal Trade Agreements Act – but bilateral negotiations slow and results were disappointing.
- During Great Depression, Roosevelt administration increased subsidization agriculture.

## Postwar Trade Policy

- From 1934-48, tariffs gradually reduced in allied countries by 33%.
- Bretton Woods Treaty, 1944. Included 44 allied nations, negotiated new pegged exchange rate system with IMF, IBRD, and (eventually) Dollar reserve standard.
- U.S. signed on to General Agreement on Tariffs and Trade (GATT) in 1947.
- Trade Expansion Act, 1962, gave President authority to negotiate lower tariffs and Multi-Fibre Agreement, set up Trade Adjustment Assistance (TAA).
- Trade Act of 1974 created fast track authority until 1994.
  - Section 301 requires U.S. Trade Representative to take action against countries using unfair trade practices, with very broad authority.
  - Special 301 authorizes USTR to monitor property rights enforcement.
- Trade Act of 2002 gave President authority new fast track authority to 2007.



## Political Economy of Trade

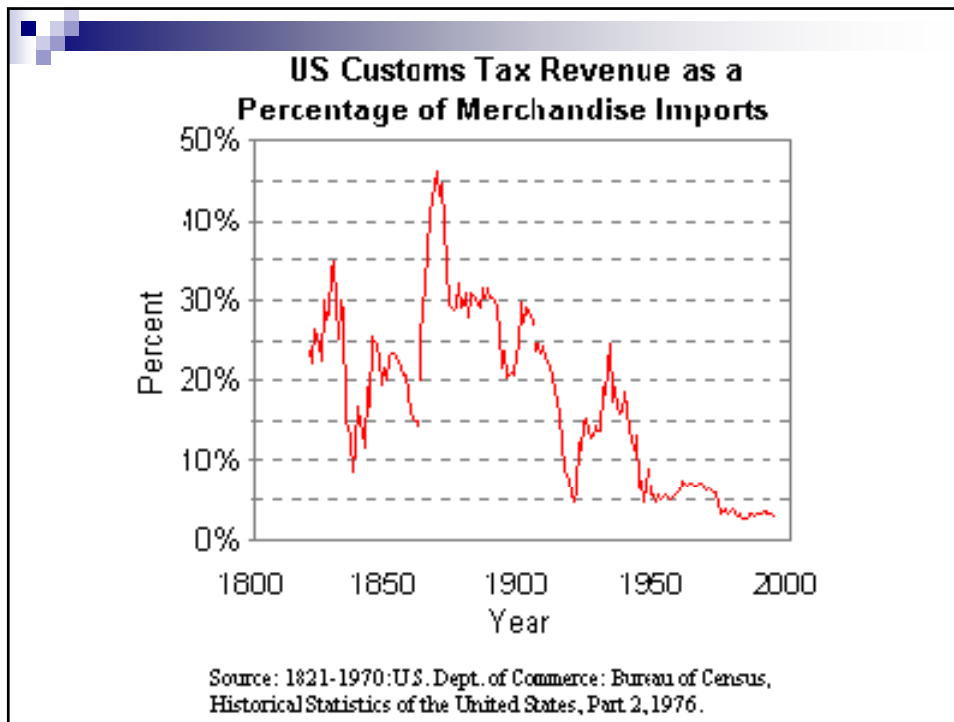
- Theory says trade may be welfare-enhancing, but not for everybody.
- Down's median voter rule predicted that the optimal policy would be the position of the median voter.
- Olson's coalition theory suggests that free trade is an encompassing issue that creates a free rider problem, especially since being informed, voting, and participating is costly. More successful political action comes from those likely to benefit directly and significantly (i.e., distributional coalitions) from protection.
- Presidents are more likely to be pro-trade than congressional representatives, regardless of political party, since the President represents a larger constituency and representatives often have districts dominated by single industries.
- Political entrepreneurship can cause changes in policy even when preferences of voters are stable, and sometimes this leads outside of the Pareto area.
- Madisonian Liberalism argues that voting has the ability to prevent the worst outcomes, and bring you back to the Pareto area.
- International agreements can act as a solution to the prisoner's dilemma of protectionism.

## The GATT

- Havana Charter – negotiations by 54 countries in 1948 to allow international cooperation and rules promoting competition. Attempted to create ITO, international clearing union, and bancor currency. U.S. Congress rejected it.
- GATT was a clause of the charter, negotiated in parallel by 15 countries.
- A treaty, not an organization.
- Principles of multilateralism, reciprocity, and nondiscrimination through MFN status.
- Binding average tariff rates, countervailing duties for export subsidies.
- Framework for negotiating tariff reductions included Geneva (1947), Ancey (1949), Torquay (1950-51), Geneva II (1956), Dillon (1960-61), Kennedy (1964-67), Tokyo (1973-79), and Uruguay (1986-93) Rounds. First three rounds resulted in average 25% tariff reduction, Kennedy Round resulted in further 36% drop, and Tokyo Round another 30%. Net decline of 70% in average rate since 1947 – though this is trade-weighted, and thus biased downwards.
- Exceptions: NTBs, escape clause for temporary tariffs, trigger price mechanism, dumping rules, free trade areas, GSP for LDCs, agriculture, multifibres, services, intellectual property.

## A caution about Average Tariffs

- Tariffs can be averaged simply or weighted by trade.
- Simple averages give equal weight to the tariffs for automobiles and the tariffs for bubble gum. This is rarely used.
- Trade-weighted tariffs are more commonly reported, but are biased downwards because higher tariffs reduce imports.
  - For example, a prohibitive tariff does not raise the average tariff.
- Tariffs are not usually uniform:
  - Tariffs on clothes and shoes are often 10-20 times higher.
  - Developed country tariffs are highest for imports from less-developed countries. Agricultural subsidies have similar effects.
- When a country imports inputs to production and the final good itself, the effective rate of protection (ERP) can be much higher:
  - $EPR = (t_f - a t_i) / (1 - a)$ , where  $t_f$  is the tariff on the final good,  $t_i$  is the tariff on the imported inputs, and  $(1 - a)$  is the share of domestic value-added.
  - Tariffs tend to be lower for raw materials, higher for final goods.



## Economic Integration

- Preferential Trading Arrangements – banned by GATT.
- Free Trade Areas – easy to create, hard to administer due to transshipment problem.
- Customs Union – FTA + Common External Tariff (CET).
- Common Market – Includes free movement of labor, capital. Sometimes includes fixed exchange rates.
- Economic Union – Common Market + harmonized economic policies + monetary union.

The fewer participants, the easier negotiation will be, but the easier it will also be for special interests to get special breaks (i.e., Trojan horse agreements).

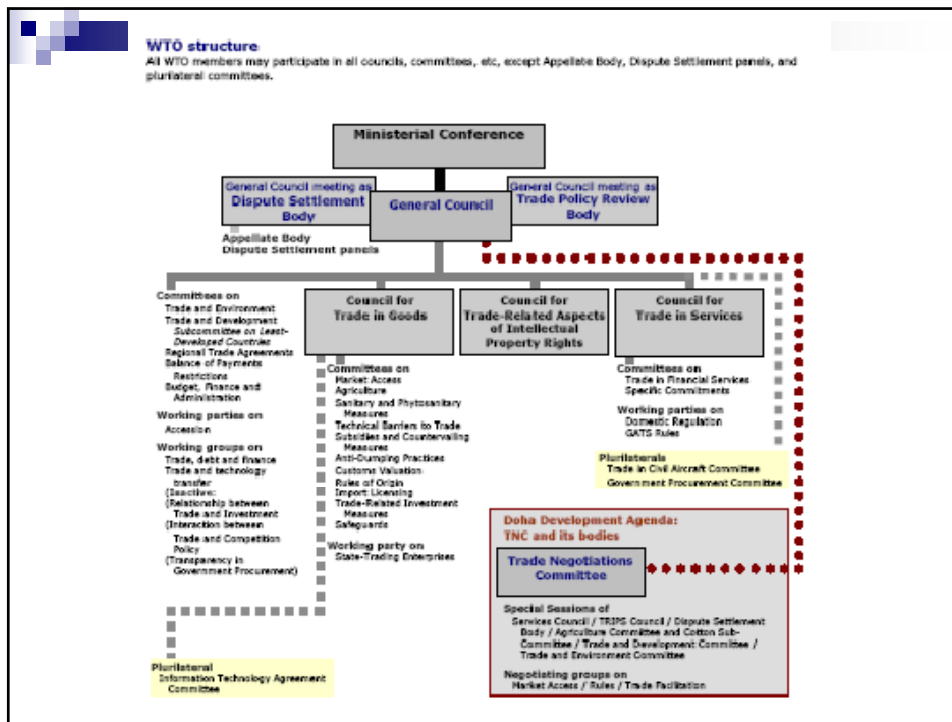
## Trade Diversion and Creation

FTA's can improve efficiency, but can also worsen it.

- Imagine Ricardian models for country A, B, and C producing x and y, with slopes of  $-2/3$ ,  $-1$ , and  $-3/2$ .
- Under free trade, A exports x and imports y, C exports y and imports x, and B will trade but direction is uncertain.
- If countries have 100% tariffs, then A and C will trade with each other, but B will not trade with either.
- If A and B create an FTA, then A will export x to B and import y from B, but will no longer trade with C. This is trade diversion.
- If A and C create an FTA, then A will export more x to C and import more y from C. This is trade creation.
- If all three create an FTA, then A and C will trade more, and B will also trade. This is also trade creation.

## The WTO

- Created by the Uruguay Round as successor to GATT, starting in 1995 (U.S. Senate ratified in 1994).
- Paid staff of 550, budget of \$100 million.
- Most work is done by 151 (current) members.
- Ministerial Conference directs General Council, which acts as Dispute Settlement Body and Trade Policy Review Body.
- Continued of principles of reciprocity, multilateralism, safety valves, and nondiscrimination.
- New principles of transparency and enforceability.
- New agreements: GATS, TRIPS.
- Ten-year expiration of MFA.



## The Doha Round

- A new round of WTO negotiations was supposed to begin with a Ministerial conference in Seattle, 1999 – but was disrupted by protests.
- Round began in Doha, Qatar, in Nov. 2001. Continued in Cancun, Hong Kong, et cetera.
- Intellectual property, esp. patented medicines
- Agricultural subsidies:
  - In 2000, U.S. spent \$49 billion on subsidies (0.5% of GDP), E.U. spent \$93 billion (1.2%), Japan \$47 billion (1.1%).
- Doha Round collapsed in 2008 due to subsidy dispute between developed countries (above) and LDCs (chiefly Brazil, China, India, and South Africa).

## U.S. Trade Institutions

- Harmonized Tariff Schedule of the United States (HTSUS) created in 1989. 2950 pages,
- U.S. Customs and Border Protection (CBP) – focus on security, enforcement of HTSUS, reliance on 11,000 licensed customs brokers.
- U.S. Trade Representative (USTR) – Ambassador Susan Schwab, staff of 200. President’s negotiator for Free Trade Agreements (FTAs), Trade Promotion Agreements (TPAs), Trade and Investment Framework Agreements (TIFAs), Bilateral Investment Treaties (BITs), etc.
  - WTO, NAFTA, CAFTA-PR, bilateral FTAs with 13 countries + southern Africa.
  - Initiatives for Middle East (MEFTA), ASEAN, APEC.
- International Trade Administration (ITA), under DOC – trade promotion, Foreign Commercial Service, Import Administration for trade complaints.
- International Trade Commission (ITC) – independent federal regulator for import injury, unfair trade practices, violation of HTSUS.

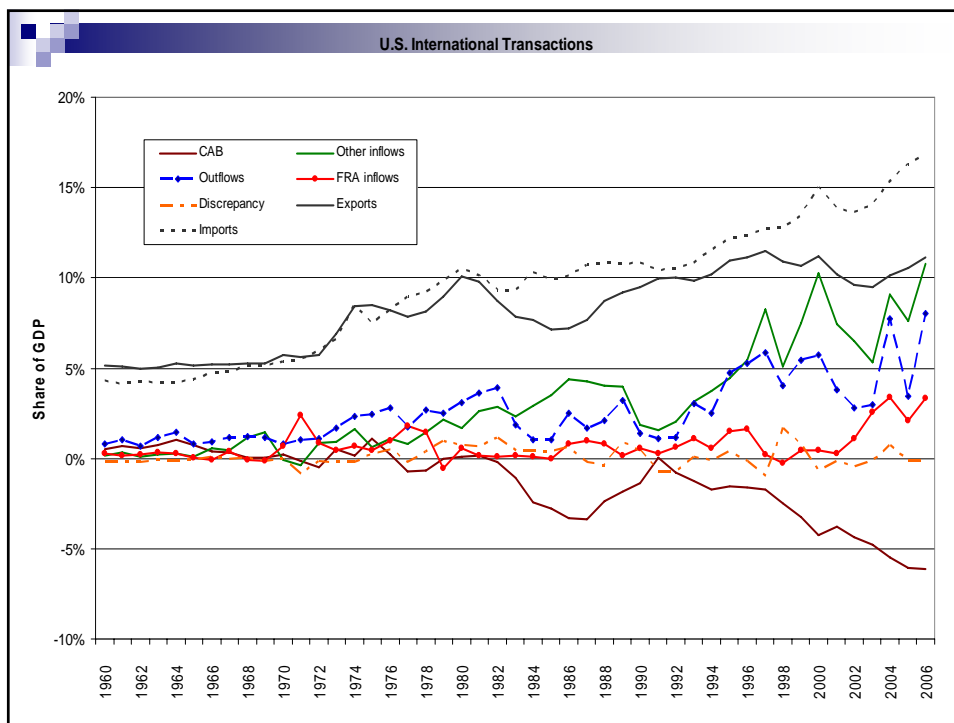
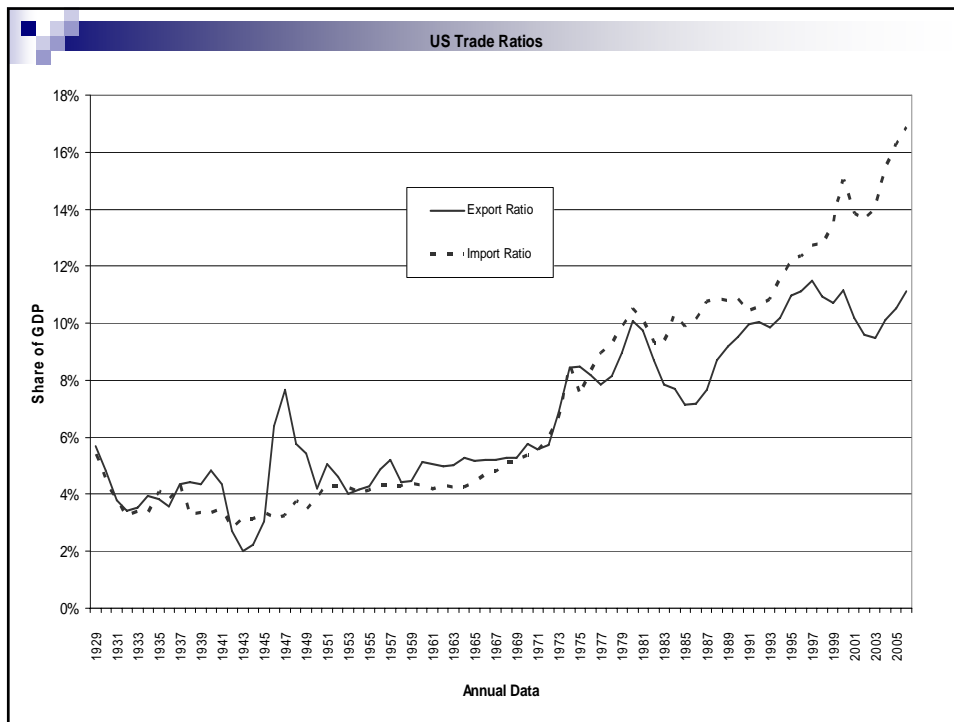
## Effects of Reduced Tariffs?

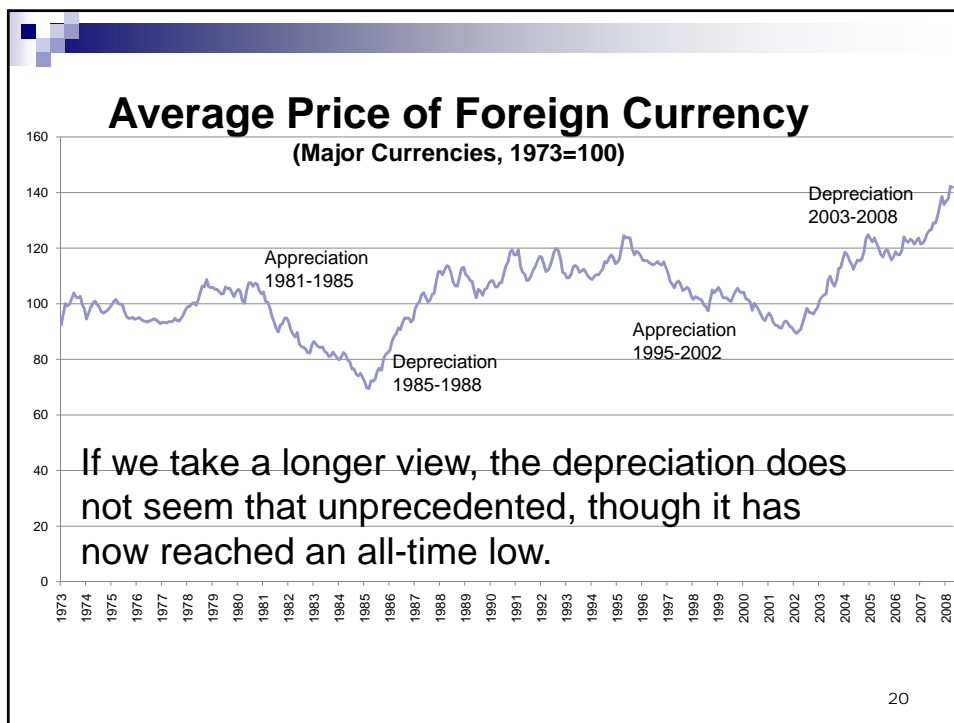
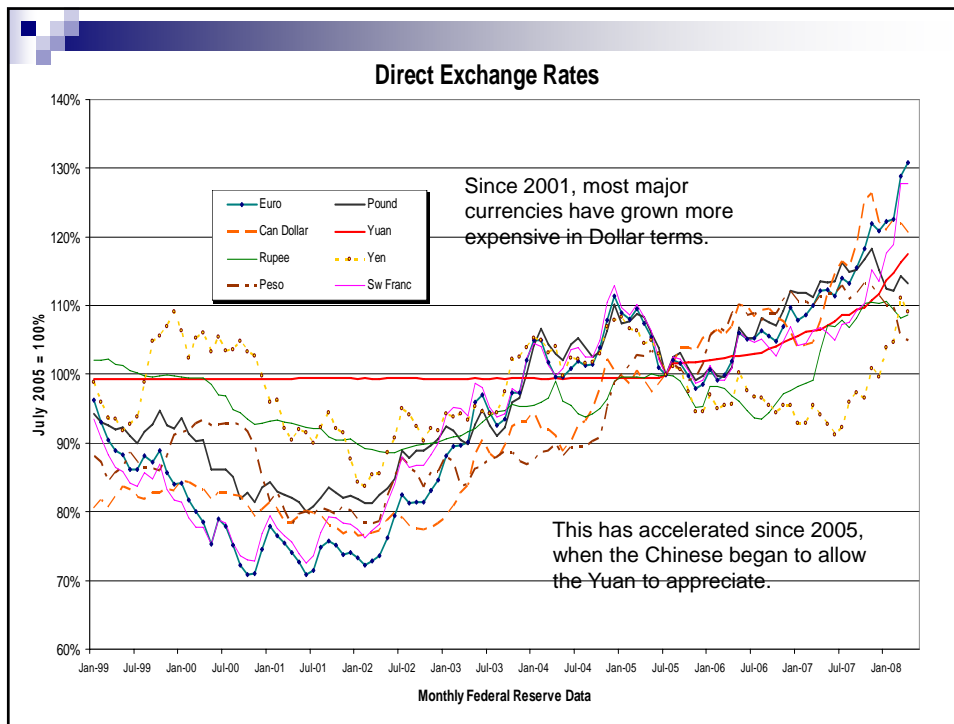
For the United States:

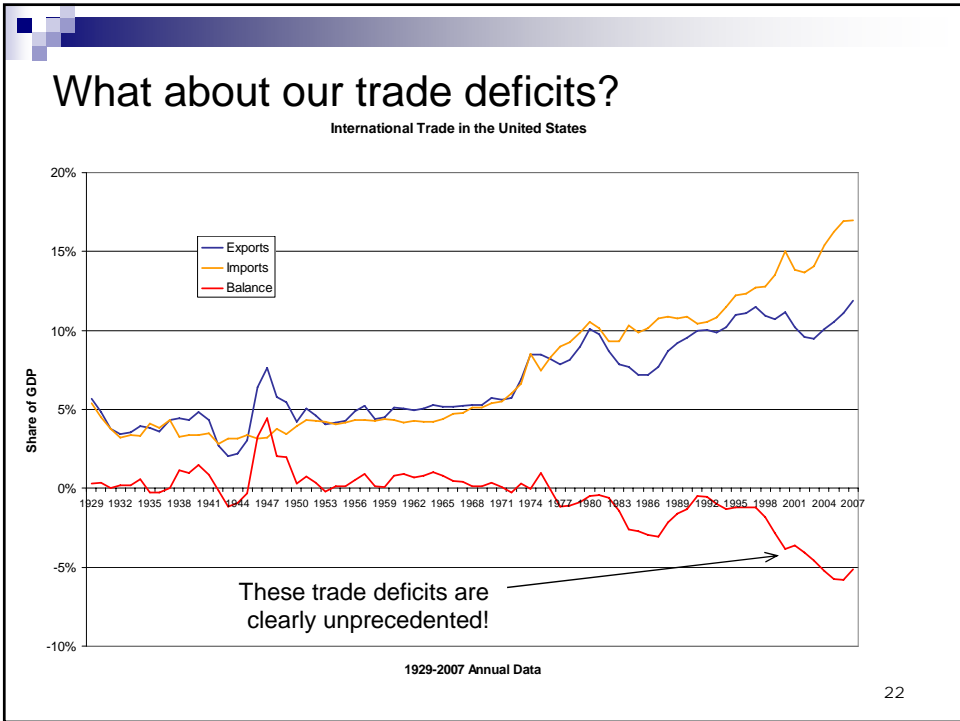
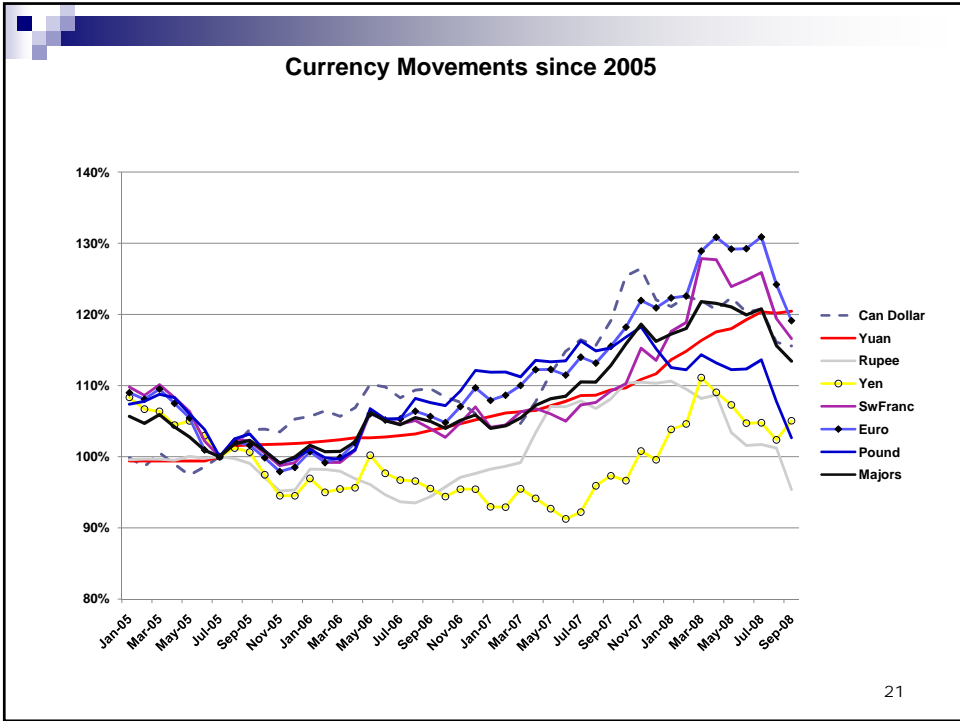
- Average GDP per-capita growth rate rose in postwar:
  - 1.2% from 1820-1850, 1.6% from 1850-1900, 1.7% from 1900-1950, and 2.2% from 1950-2000.
  - However, average growth was the same in 1950-75 as it was 1975-2000, even though tariffs were lower in second half.
- U.S. trade grew substantially:
  - 1929-1970, exports & imports averaged 4.6% & 4.0% of GDP - surpluses.
  - 1971-2000, these averaged 8.9% & 10.2% - deficits.
  - 2001-2006, these averaged 10.2% & 15.0% - unsustainable deficits.

For the World:

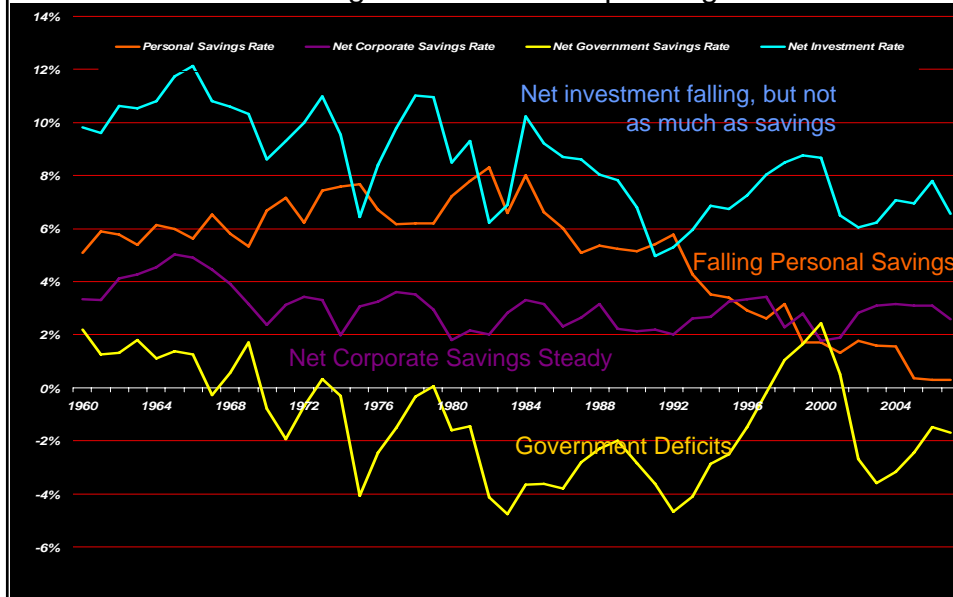
- GDP per-capita growth averaged 1.3% from 1870-1913, 0.9% 1913-50, 2.9% 1950-73, and 1.3% 1973-2000.
- Real per-capita income was 10 times higher in 2000 than in 1870. For Japan, 20 times higher; 5x for the rest of Asia; only 3x for Africa.
- Exports fell from 1913-50, then doubled by 1973, doubled again by 2000.





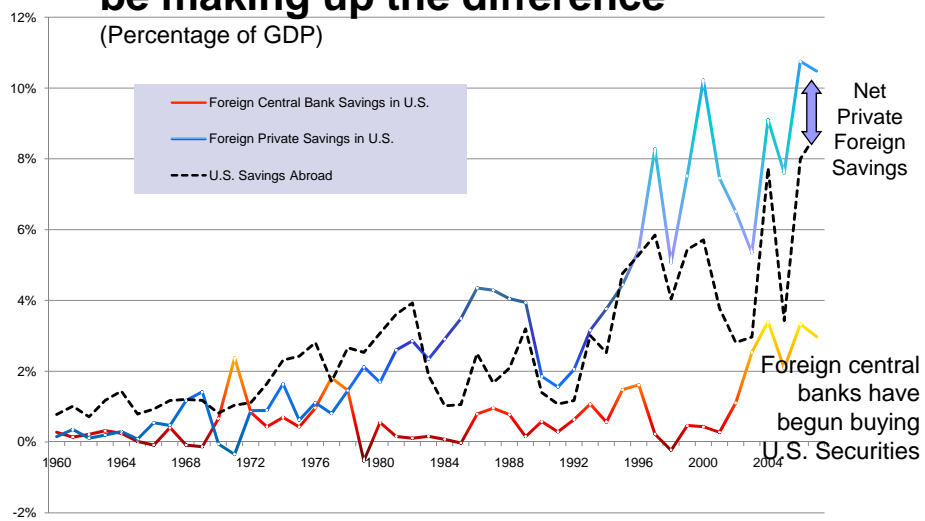


Spending more on new goods than we produced implies that Domestic Savings < Investment Spending



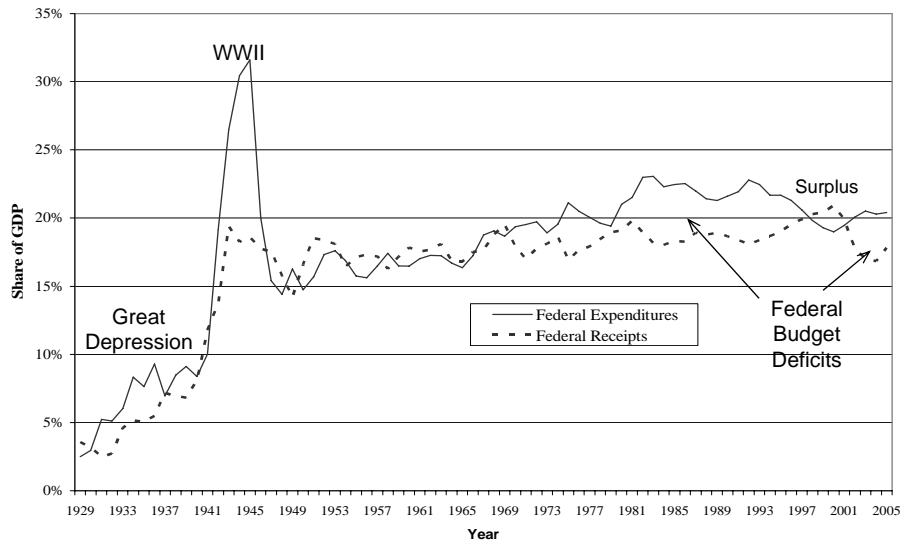
Net foreign savings must therefore be making up the difference

(Percentage of GDP)



## Growth of the federal government

Figure 1: Federal Government's Share of the Economy



## Positive consequences?

The falling Dollar makes imports dearer and exports cheaper. How would this affect the trade deficit?

- Since 2005 alone, the Dollar has depreciated by 20%.
- In the short-run, we spend more on imports. Deficit may rise. Assuming a short-run price elasticity of 0.4 for both exports and imports, the deficit could rise back from 5% to 6% of GDP.
- In the long-run, we export more and buy fewer imports. The trade deficit should fall. Assuming a long-run price elasticity of 1.0 for both exports and imports, the same 20% appreciation would cause the 5% deficit to fall to 2.5%.
- With a 1.5 elasticity, this become a trade surplus of 1% of GDP. This would enable us to start repaying our foreign debt.
- A recession is also likely to reduce our imports. Estimates of the income elasticity of imports are generally greater than one, so the effect could be relatively large.
- If these things happen, however, it will require households to substantially increase their savings rates, unless investment falls dramatically and/or the government stops running budget deficits.

