CHAPTER 4

Expanding Trade and Avoiding Protectionism

TWICE IN THIS CENTURY the United States has taken the lead in setting a new course for the world's trading system. The first time was in 1930 with the passage of the Smoot-Hawley Act, which led to global protectionism and contributed to the Great Depression. The second time was after World War II with the process of trade liberalization brought about through the General Agreement on Tariffs and Trade (GATT). The result was more rapid recovery from the destruction of war, the unprecedented expansion of world commerce, and increased prosperity in the industrialized and developing countries.

The Smoot-Hawley Act and GATT both taught that the United States has a large influence on the world economy, for better or worse. Likewise, the actions taken in the coming months regarding American trade policy have the potential to influence the course of international trade for years to come.

Recognition of the immense benefits of trade is a fundamental principle of American economic policy. The framers of the U.S. Constitution saw the wisdom of prohibiting all tariffs and duties on the trade between the States. Today those trading States, together with the States that were added later, are among the most prosperous in the world. The same principles of trade apply to commerce between countries.

Although recent negotiations are improving U.S. access to a substantial portion of world markets, current domestic legislative proposals threaten to close U.S. markets and reverse many of the market-opening gains made over the past 40 years. On the positive side are the Canada-United States Free-Trade Agreement entered into on January 2, 1988, the United States-Mexico Framework Understanding signed on November 6, 1987, and other initiatives proposed by the United States in the ongoing Uruguay Round negotiations of GATT. On the negative side are proposed changes to domestic trade law contained in the Omnibus Trade and Competitiveness Act of 1987, the effects of which are potentially dangerous.

EXPANDING TRADE OPPORTUNITIES ABROAD

Both bilateral and multilateral initiatives are vital for expanding trade opportunities. In the past year bilateral agreements were successfully completed, and substantial progress was made at the multilateral GATT negotiations. During the coming year the multilateral GATT negotiations will become increasingly important.

CANADA-UNITED STATES FREE-TRADE AGREEMENT

In many respects a free-trade agreement between the United States and Canada is a natural consequence of longstanding friendship, common economic interests, and geographic proximity. Nevertheless, there is a history of numerous unsuccessful attempts over more than a century to reach a free-trade agreement. That an agreement was reached in 1987 stands as a major achievement. The two nations had to overcome special interests, internal pressures for the status quo, fears about loss of identity, and protectionism in order to craft a final document.

The outcome represents a victory for both countries. For the first time, the agreement firmly anchors free trade as the fundamental principle governing commerce between the two countries. It now remains for the U.S. Congress and the Canadian government to approve the understanding.

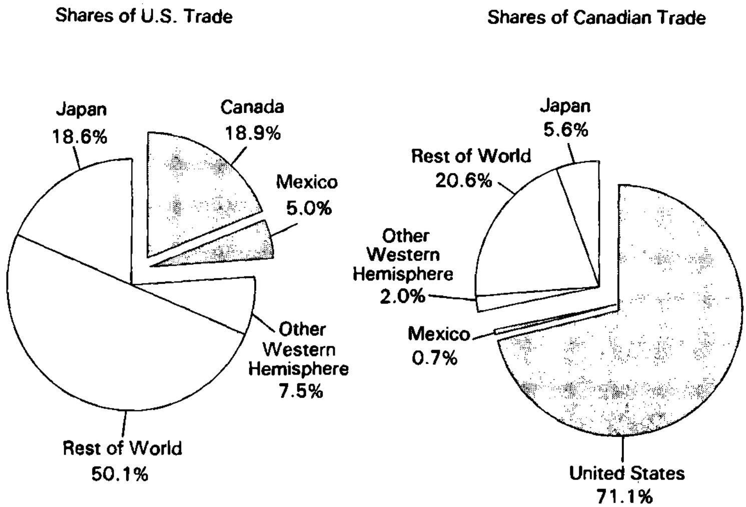
Canada and the United States are each other's largest trading partner. Measured in terms of national product, they will make up the largest free-trade area in the world. Chart 4-1 shows the relative importance of Canadian trade to the United States. In terms of bilateral trade, Canada represents 19 percent of all U.S. trade. As the chart shows, trade with Mexico represents 5 percent of U.S. trade, and trade with all other countries in the Western Hemisphere amounts to 7.5 percent.

History

The United States and Canada share common origins as former British colonies. In spite of different political histories, the natural economic proclivities of the two nations have led them to greater cooperation and economic interdependence as the years have passed.

The earliest attempt at a free-trade agreement dates back over 140 years. Canada initiated discussions with the United States for bilateral free trade in the middle and late 1840s, in response to growing separation from the British market brought about by Britain's unilateral movement toward free trade and the repeal of the Corn Laws. In 1854, under the impetus of the U.S. desire for fishing rights on the east coast, a reciprocity treaty was signed covering free trade in natural products. The treaty was abrogated in 1866 by the United States,

Chart 4-1
Shares of U.S. and Canadian Merchandise Trade in 1986



Note.—Shares are based on the sum of bilateral exports and imports in dollars.
Source: Council of Economic Advisers, based on International Monetary Fund data.

due in some measure to British support for the South in the American Civil War and the ties between Britain and Canada.

In 1867 the Canadian provinces joined together in confederation. Seven years later the United States and Canada negotiated a new reciprocity treaty which failed to be confirmed by the U.S. Senate. Since that time sentiment in both countries has alternated on the notion of bilateral free trade, and the free-trade issue has been revisited frequently, including a half dozen times in this century.

Over the years the tariffs of both countries have been used to provide differing amounts of protection. In 1850 the average U.S. tariff level was 27 percent, and Canadian tariffs were 16 percent. U.S. tariffs rose to a high of 59 percent in 1932 following passage of the Smoot-Hawley Act, while average Canadian tariffs reached 24 percent in 1929. After World War II both countries' tariffs were reduced. The post-Tokyo Round average U.S. tariff was 4 percent, and the average Canadian rate was 7 percent, although tariffs on selected products were substantially higher.

Recognizing the natural economic benefits to both countries, the Canadian Royal Commission on the Economic Union and Development Prospects for Canada concluded in August 1985 that it was in Canada's interest "to engage the United States more directly in bilateral free-trade negotiations." In the United States the Trade Agreements Act of 1979 already had instructed the President to study "the desirability of entering into trade agreements with countries in the northern portion of the western hemisphere" for the mutual expansion of market opportunities. On September 26, 1985, the Canadian Prime Minister requested that the United States and Canada consider the potential for negotiating a comprehensive free-trade agreement. The request was accepted, and the President notified the Congress on December 10, 1985, of his intent to enter into bilateral negotiations, which began formally on June 17, 1986.

Benefits of a Free-Trade Area

Three-fourths of the trade between the United States and Canada is already duty free. Moving to a free-trade area expands the range of duty-free trade to cover all goods.

The reasons for creating a free-trade area are essentially the same as the reasons for encouraging free trade generally. Moving to an open trading regime brings gains associated with the freer flow of goods and better allocation of resources to productive uses. Allowing the Nation's households and firms to trade freely with foreigners means that domestic sellers can add the net demand of foreigners to domestic demand, thus expanding their market. Similarly, buyers can add the net foreign supply to domestic supply, expanding the total supply and lowering the prices of goods they purchase. Because, on average, prices fall for the products for which the country is a net purchaser and rise for the products for which the country is a net seller (a terms-of-trade improvement), the cumulative effect of freer trade is to increase welfare in both countries. Gains by one do not imply losses to the other.

Another benefit from enlargement of the market is greater opportunity for economies of scale in production, marketing, and distribution. Many products can be produced and sold at lower cost per unit if a larger volume is manufactured. A larger volume generally means lower prices to the consumer and a greater variety of products which can be profitably offered for sale in the marketplace. In addition, the incentives to invest in research and development in order to enhance technical knowledge and create new products are greater in a larger market. Again, these benefits can accrue to both countries at the same time.

Many of the effects of the Free-Trade Agreement, such as enhanced growth and the momentum given to ongoing negotiations to open markets worldwide, are difficult to quantify. Benefits in the form of lower prices to consumers (reduced cost of living) and increased profits to firms, however, can be modeled and quantified. Studies of the effects of the Free-Trade Agreement estimate that these economic gains to the United States are on the order of $1.1 billion to $2.9 billion annually. Most studies show that gains to Canada are of a similar absolute size. This stream of benefits is like an annuity that will grow over time with economic growth in the two countries. The present value of these gains ranges between $30 billion and $90 billion.

Because Canada is the smaller country, however, the effect of the free-trade area on returns-to-scale gains is more important for Canada. Studies show that these harder-to-quantify effects have the potential to increase Canadian gains severalfold.

If there are such obvious benefits to freer trade, then why is there opposition to it? One reason is the claim that removing trade barriers eliminates jobs or sends them abroad. But this argument is misleading because overall employment in an economy is determined by internal conditions and macroeconomic policy, not by the existence of trade barriers or the level of trade flows. The United States created nearly 15 million payroll jobs over the course of the current economic expansion, a period of U.S. trade deficits and relatively open U.S. markets. During the same period the European Community (EC) created virtually no net new jobs, even though they experienced trade surpluses. The same level of employment can be obtained in the total absence of foreign trade as when trade is completely free. But without foreign trade a nation will be worse off economically because, in effect, it will throw away part of its productive capability—the ability to convert surplus goods into other goods through foreign trade.

Free trade leads to industrial expansion in those industries in which a country has a comparative advantage. To expand in one sector, however, productive resources, including labor, must shift from other sectors. Thus employment may decline in some sectors, and there may be temporary unemployment during the transition. To halt such economic adjustments in order to prevent the loss of jobs in a particular sector, however, is to lose the benefits of international trade. (For a discussion of the Administration's proposal to aid the transition of workers to new employment, see the summary of the Worker Readjustment Program in Chapter 5.)

Elements of the Agreement

Visible Barriers. If both countries approve the agreement, beginning on January 1, 1989, all bilateral tariffs will be eliminated either immediately or in five or ten equal annual stages, depending on the product. Table 4–1 displays the average tariff rates by sector for each country as they apply to the other. In the clothing and footwear sectors, for example, Canadian tariffs on U.S. products are over 20 percent. Other sectors in both countries are protected by tariffs ranging from 12 percent down to nearly zero. Because each country retains its own tariffs on third-country trade, the agreement provides for rules of origin that require articles imported into one country to be sufficiently processed in the importing country before they can be exported duty free to the other. Thus goods cannot be imported into the country with the lower tariff and then exported duty free to the other country.

TABLE 4-1.—*Canadian and U.S. Bilateral Tariffs by Sector*

[Percent]

Sector	Canada		United States	
	Share subject to tariffs	Average tariff[1]	Share subject to tariffs	Average tariff[1]
Agricultural products	40	9.0	56	4.1
Forest products	33	10.6	9	3.7
Textiles, apparel, and footwear	74	20.9	92	10.4
Energy and chemicals	44	11.7	57	1.8
Minerals and metals	46	9.2	46	3.2
Machinery and equipment	18	9.2	16	4.5
Miscellaneous manufactures	36	11.8	51	6.1
ALL SECTORS	27	10.4	30	3.3

[1] Canadian averages are weighted by imports from the United States and vice versa. Average tariffs are calculated using only those products subject to tariffs.

Source: U.S. International Trade Commission estimates based on 1985 trade data.

The agreement also eliminates almost all quantitative restrictions on trade between the United States and Canada. In energy, quantitative restrictions on imports or exports are prohibited, with exceptions for national security considerations, prevention of the exhaustion of a finite energy resource, and a special exception placing an upper bound on the sales of Alaskan oil to Canada. If restrictions are imposed to prevent resource exhaustion, access must be granted to the other party sufficient to maintain a prescribed proportion of their purchases relative to total supply.

Canada is the largest supplier of energy to the United States, and it is also the largest importer of U.S. coal. Two-way energy trade has amounted to about $10 billion annually and is likely to increase as a result of the Free-Trade Agreement.

Canadians sometimes have argued that it is harmful for Canada to sell its energy resources to foreign countries. It is hard to support such a position when the move to free trade in energy implies higher prices for Canadian sellers, and when contracts to sell are freely entered into by both buyer and seller. From the Canadian point of view, the Free-Trade Agreement represents an assured market in the

United States. From the U.S. perspective, a unified market reduces uncertainties about future energy supply.

In agriculture, several significant quantitative restrictions will be liberalized, in addition to the elimination of tariffs and export subsidies. The United States has a comparative advantage in most fruit and vegetable trade. Seasonal quantitative restrictions remain in place, but they are relaxed under the agreement. Import restrictions on poultry products also will be lessened. Of general significance to agriculture, trade in fertilizers and other agricultural inputs will be liberalized.

Invisible Barriers. The past two decades have seen growth in the less visible, but economically damaging, nontariff and rule-based trade barriers. Invisible barriers to trade can take virtually an unlimited number of forms. Examples include discriminatory access to distribution systems for foreign goods relative to domestic goods, the application of standards and codes that restrict foreign goods, rules about government purchases (e.g., the "Buy American" provisions of U.S. law), failure to provide intellectual property protection for foreign processes and goods, and various procedural restrictions on foreign investment.

The Canada-United States Free-Trade Agreement makes progress in reducing a number of these barriers. For example, both countries now have agreed to provide national treatment to the investors of the other, subject to grandfathering existing regulations. Direct U.S. and Canadian investment in each other's economy currently totals over $68 billion. The free movement of capital across geographic boundaries allows resources to move to the location of their greatest usefulness and profitability, making the opportunities of the combined market available to the resources of both regions. After 3 years Canada will screen direct acquisitions by U.S. investors only when the Canadian company being sold has assets of $150 million or more in constant Canadian dollars. Canadian screening of indirect acquisitions (where a firm's ownership changes when ownership of its parent firm outside the country changes) by U.S. investors will be phased out completely. Other provisions eliminate certain performance requirements imposed by one party on investors of the other. Another section of the agreement ensures ease of border crossing by individuals traveling for business purposes.

The Canada-United States Free-Trade Agreement breaks new ground as the first bilateral agreement involving the United States which governs the entire financial sector. The agreement frees the capital, market share, and growth restrictions placed on U.S. banks in Canada (currently at least 15 U.S. institutions are affected), and it makes it possible for U.S. insurance firms to establish or acquire closely held commercial banks and federally regulated insurance and trust companies. Canadian financial institutions will continue to enjoy the open access already received in the United States. In addition, they are granted certain guarantees giving security of access to the U.S. financial sector.

The General Agreement on Tariffs and Trade is supplemented by an agreement on government procurement describing rules for foreign participation in domestic government procurement. After February 14, 1988, provisions of the code will apply to purchases by covered agencies of signatory governments of 130,000 special drawing rights (in 1987 $167,000) or greater in value. The previous cutoff was 150,000 special drawing rights. Under the Free-Trade Agreement that threshold is reduced for U.S.-Canadian procurement to $25,000. Previously, approximately three-fifths of Canadian government procurement was not covered by the code due to the high threshold. The procurement market affected by this agreement is estimated to be on the order of $500 million in Canada and almost $3 billion in the United States. Measures which strengthen current code disciplines and negotiations to improve the openness of the government procurement process are provided for in the agreement.

Both countries have agreed to refrain from using domestic technical standards as a barrier to trade. For example, they have agreed not to use in-country requirements for accreditation of testing facilities and certification bodies, and to recognize each other's systems for laboratory accreditation. Moreover, both countries will work to harmonize Federal standards when appropriate and to consult about potential problems before new standards are implemented.

Both Canada and the United States already have similar and effective laws for protecting intellectual property. However, the agreement resolves a number of problems in this area. In particular, Canada will extend copyright protection to the retransmission of copyrighted programming. Both countries have agreed to work in the Uruguay Round negotiations to enhance intellectual property rights protection worldwide.

The Canada-United States Free-Trade Agreement is the first major agreement to apply binding rules to trade in the services sector. Scores of service categories are covered, including telecommunications network-based enhanced services, computer services, professional services (accountants, architects, engineers, scientists, management consultants), tourism, insurance, construction engineering, and retail and wholesale trade. The basic principles underlying the agreement for services are national treatment (equivalent treatment of foreign and domestic nationals), access to domestic distribution systems, establishment of a commercial presence, transparency of rules and procedures, and dispute settlement arrangements.

Currently there are relatively few barriers to U.S.-Canadian trade in services, and bilateral trade is already open in most areas. The Free-Trade Agreement insures that the environment will remain open, governed by the principles enunciated in the agreement.

Other Provisions. The machinery and transport equipment sector, which includes road vehicles, accounted for $55 billion of bilateral trade in 1986, over 45 percent of bilateral trade between Canada and the United States. Under the Automotive Products Agreement of 1965 between Canada and the United States, a large part of trade in automotive products is already duty free. Under the Free-Trade Agreement, tariffs on all original equipment, tires, and parts will be eliminated; the Canadian embargo on used-car trade will be phased out in 5 years; and duty waivers on imports of automobile products linked to exports of automobiles to the other party will be stopped. At least one-half of the assembly costs and production materials in automobiles freely traded across the border must originate in the exporting country. To meet this requirement, averaging over a 12-month period on the relevant vehicle class is permitted. Recognizing the fast-changing nature of the automobile industry, the agreement mandates the establishment of a select panel to assess the state of the industry and make further recommendations for later consideration.

The concern over cultural identity, primarily by the Canadians, led the negotiators to exempt cultural industries from the provisions of the Free-Trade Agreement. Cultural industries include the publication of books, magazines, periodicals, or newspapers; the production and sale of films and video and audio recordings; the sale of music; and communication media for the general public (radio, television, and cable television). However, if one party takes actions which normally would have been prohibited, the other party is permitted to take measures of an equivalent commercial effect. Actions inconsistent with free trade, therefore, should be taken only rarely and for strongly held reasons.

The Institutional Features. As with any agreement between two sovereign parties, arrangements must be made to resolve misunderstandings and disputes that arise after implementation. Devising a dispute resolution mechanism suitable to both countries was a major difficulty in reaching a final agreement. The solution chosen to resolve disputes successfully and ingeniously blends the binational settlement process with the separate laws of each nation.

The agreement establishes the Canadian-United States Trade Commission to supervise implementation of the agreement and resolve disputes. The Commission, composed of members from both countries and led by Cabinet-level representatives, will meet at least once a year in regular sessions. Either country may request ad hoc consultations; if consultations are unsuccessful in resolving a dispute, either country may request a meeting of the Commission. If the Commission is unsuccessful in resolving a dispute promptly, it may establish a panel consisting of two members chosen by each country and a fifth member chosen by both countries from a predetermined roster. The recommendation of the panel would form the basis for the Commission's final determination, normally resulting in the non-implementation or removal of a measure. If a country fails to implement the findings of a panel, then the other country has the right to suspend equivalent benefits.

The safeguards provisions, which address problems faced by industries harmed by increased fair trade, are separated into two parts. One part regulates safeguards for third-country trade. The United States and Canada are excluded from any actions taken by the other under Article XIX (the safeguards article) of GATT, unless goods of the other party contribute importantly to and are a substantial cause of the injury. If the other party is included in the action, the remedy cannot cut back imports from the other party to less than the level of imports over the base period specified by the agreement, with allowance for growth.

The other part addresses agreement-related injuries where it can be established that duty reductions resulting from the agreement caused the injury. In this case, the remedy cannot exceed the lesser of the most-favored-nation rate of duty in effect at that time, or preagreement rates of duty. Furthermore, the remedy can remain in effect for only 3 years.

In cases involving antidumping and countervailing duty law, the agreement sets up a separate binational dispute settlement mechanism. A panel is made up of two members chosen by each country and a fifth member chosen by both countries from a predetermined roster. The panel would replace judicial review by both the United States and Canada. Each country would continue to apply its own domestic antidumping and countervailing duty laws, but, upon request, the binational panel would review the administrative record of a disputed decision. After reviewing the antidumping or countervailing duty order for its consistency with the relevant law (statutes and judicial precedent) of the country applying the order, the panel has binding authority to sustain or remand the decision back to the relevant investigating authority.

No future changes to antidumping or countervailing duty law would apply to the other party, unless it is specifically stated to apply to the other country in the legislation, the changes are fully consistent with the GATT antidumping code and subsidies code, the other party is notified, and prior negotiations are entered into upon request. If a panel requires modification of the changes to the statutes because they are inconsistent with GATT, or because they overturn a prior decision of a binational dispute settlement panel, compulsory negotiations are mandated for 90 days. If a solution is not found, the other party may enact comparable legislation, take equivalent executive action, or terminate the agreement with 60 days' notice.

Viewed from the perspectives of economics, history, and international relations, the Canada-United States Free-Trade Agreement represents a remarkable achievement. In its implications for the future of U.S.-Canadian trade, the benefits which it secures for both countries, and the example which it sets for trade liberalization worldwide, it is truly an historic document.

THE UNITED STATES-MEXICO FRAMEWORK UNDERSTANDING

On November 6, 1987, the United States and Mexico signed an understanding concerning a framework of principles and procedures for consultations regarding trade and investment relations between the two countries. A bilateral consultative mechanism was set up to review trade and investment issues, resolve disputes, and negotiate the removal of trade barriers. The agreed upon principles and procedures supplement those in GATT.

Mexico is the third largest purchaser of U.S. goods, behind Canada and Japan. In 1986 U.S. exports to Mexico were $12.4 billion, while U.S. imports from Mexico were $17.6 billion, of which some $3.4 billion was crude petroleum. In trade terms the United States is more than 10 times as large as Mexico's second most important trading partner (Japan). The United States accounts for a full two-thirds of Mexico's total trade with the world.

In spite of the importance of trade between the United States and Mexico, the two countries have been without a formal mechanism to govern their commercial relations. Although the United States and Mexico generally grant one another most-favored-nation treatment and other benefits similar to those found in GATT, there was no formal channel to pursue the complaints that inevitably arise with such a large volume of trade. Agreeing to overcome this deficiency, the Presidents of the United States and Mexico decided in August 1986 to pursue the idea of a bilateral framework understanding. Formal discussions began in February 1987.

Under the bilateral mechanism, either party may request consultations at any time, to be held within 30 days of the request. Annual consultations will be held to review the status of the two countries' trade and investment relationship. The United States and Mexico also agreed to initiate discussions promptly in such areas as investment, intellectual property, electronics, textiles, agriculture, steel, and services sector information exchange.

The United States-Mexico Framework Understanding reflects the size and importance of the two countries' bilateral economic relationship. This step adds further stability to the relationship and signals the mutual commitment to resolve trade and investment problems expeditiously.

GENERAL AGREEMENT ON TARIFFS AND TRADE

In the past 35 years both world production and international trade have grown rapidly. Real global output rose at an average annual rate of 4.5 percent, while the real volume of international trade expanded by 6.5 percent per year. Through more efficient use of global resources, increased international trade leads to higher global living standards. GATT is partly responsible for the flowering of world trade.

GATT is a multilateral agreement that defines the responsibilities and operating rules of international trade that have been agreed upon by 95 signatory governments (contracting parties). As its preamble states, GATT's goal is to raise living standards through "reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international commerce." Four basic principles underlie GATT: (1) Member countries should work to lower trade barriers in general, and to eliminate the use of quotas in particular; (2) any barrier to trade should be applied on a nondiscriminatory basis to all member countries (the principle of most-favored-nation treatment); (3) once a tariff concession is made, it cannot later be rescinded without extending compensation to affected trade partners; and (4) trade conflicts should be settled by consultation.

The Uruguay Round of multilateral trade negotiations, officially launched at a Ministerial Meeting of GATT contracting parties in Punta del Este, Uruguay, in September 1986 is the eighth GATT-sponsored negotiating round since World War II and the first since the 1973–79 Tokyo Round. While an attempt was made to address nontariff barriers in earlier rounds, real progress was not made until the Tokyo Round, which resulted in nine agreements or codes pertaining to issues such as customs valuation, import licensing, technical standards for products, subsidies and countervailing duties, government procurement, antidumping duties, and rules governing trade in civilian aircraft.

This Administration played the principal role in developing a broad consensus among GATT members to launch the Uruguay Round. The centerpiece of the U.S. approach to the Uruguay Round is a bold effort to bring GATT discipline to agricultural subsidies and agricultural trade barriers. Also, due in large part to the efforts of U.S. negotiators, barriers to trade in services, restrictions on foreign investment, and the protection of intellectual property rights (beyond the limited area of counterfeiting) are on the negotiating table for the first time. In pressing for the launching of GATT's most ambitious multilateral trade negotiation ever, the United States is seeking to revitalize and strengthen an institution which has served it and the rest of the world well.

Functioning of the GATT System

The Punta del Este Ministerial Declaration endorsed a three-pronged approach to improve the functioning of the GATT system: enhanced surveillance (on a country basis as well as on a subject basis) of the contracting parties' trade policies; greater ministerial involvement; and closer links between GATT, the International Monetary Fund (IMF), and the World Bank. The Administration believes that these are among the most important reforms to GATT contemplated in the Uruguay Round. Besides fostering transparency and predictability, periodic individual country reviews under the surveillance mechanism would encourage trade policies that benefit the functioning of the international trading system in conformity with GATT intents and precedents. Increased ministerial involvement is expected to raise countries' political accountability within the GATT system and reinforce the free-trade principles on which it was founded. Improving GATT's policy management by linking its activities more closely to those of the IMF and the World Bank would ensure that their activities are complementary in improving the outlook for continued trade liberalization among GATT member states.

Dispute Settlement

Another institutional issue aimed at improving the effectiveness of the GATT system is reform of the dispute settlement mechanism of the General Agreement. There is widespread recognition that the existing consensual dispute settlement procedures do not always foster expeditious resolution of trade disputes. The United States has suggested possible improvements which might include an enhanced GATT mediation role, process timetables, improved panel procedures, avenues for recourse should panel reports be blocked, and the possibility of binding arbitration in certain instances.

Intellectual Property Rights

Reward for creativity and innovation are the principal driving forces for technological change which, in turn, is a great source of dynamism for world trade. But because of inadequate laws, or laws inadequately enforced, patent, trademark, and copyright infringement has grown worldwide. Legitimate firms have reduced incentives to invest in research and development when some of the returns will be pirated. Intellectual property thieves do not devote the large sums of capital needed to develop a new product. Hence, they are able to undersell legitimate competitors. And since the pirates only copy proven successes, they need never absorb the cost of failures. The U.S. International Trade Commission has estimated that lost sales due to infringement of intellectual property are up to $20 billion annually.

Under the auspices of GATT, the Administration seeks a comprehensive intellectual property agreement to establish and enforce intellectual property rights. The U.S. negotiating team has proposed a consultation and dispute settlement mechanism combined with strong rules governing domestic and border enforcement. Such an agreement covering inter- and intracountry measures would increase legitimate trade by raising standards of protection and the obligation to enforce them.

Services

Despite their large and growing role in world trade, now accounting for approximately 20 percent of the total, services have never been a significant area of negotiation in GATT before the Uruguay Round. Difficult new issues arise in services trade that do not arise in goods trade. For example, trade in services often requires local production of the service and, therefore, involves sensitive right-of-establishment and investment issues. The GATT concept of national treatment is based on the notion that a good receives the same treatment as domestic products once it has crossed the border into the importing country. The concept does not immediately carry over to services trade, because it must be applied to service providers as well as to the service itself. The issue of defining the proper "border," and when it is crossed, is different.

This Administration seeks a GATT services agreement which will provide a framework for future negotiations. The United States has proposed an umbrella agreement stating general trade liberalizing principles and second-level agreements or protocols for individual sectors. U.S. goals for services trade include greater transparency of domestic laws; nondiscrimination and national treatment for foreign-provided services; discipline on state-sanctioned monopolies; antisubsidy provisions; and consultation and dispute settlement mechanisms for trade in services. Since liberalization of trade in services is expected to continue for many years, the framework developed in the Uruguay Round must incorporate the flexibility needed to allow for growth and consideration of new issues.

Investment

Direct investment encourages trade in goods and services, boosts development, and contributes to the efficient allocation of resources throughout the world. With a free market in foreign investment, capital is allocated to those projects with the highest rates of return.

The United States is an example of the benefits of foreign direct investment, both as a host country and as an investor. In the 19th century the United States became a leading economic power with the help of foreign capital. After World War II, the United States became a leading provider of foreign direct investment in the world. More recently, the United States again has been attracting increased capital flows from abroad.

Unfortunately, many countries have attempted to stifle or distort the free flow of foreign investment, an action that also affects trade flows. Distortions include domestic content requirements, exchange controls, licensing requirements, technology transfer requirements, and requirements for a minimum level of exports by the foreign corporation operating in the host country. The U.S. goal in these negotiations is to identify and systematically address investment restrictions which have a trade-distorting effect and then to bring those practices within the framework of GATT.

Agriculture in the Uruguay Round

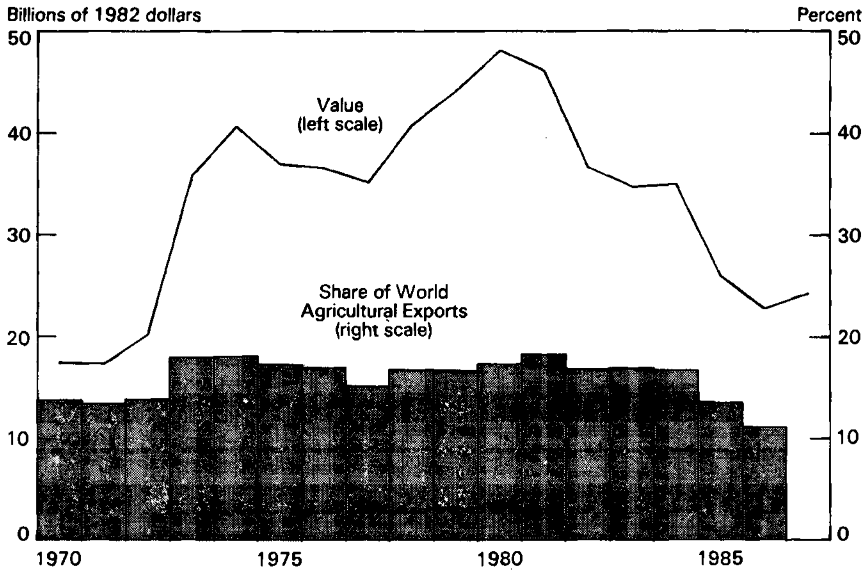
The United States has proposed the elimination of all policies that distort world agricultural production, prices, and trade. Since domestic farm programs and trade policy are fundamentally bound together, free trade in agriculture requires reform of domestic agricultural policies as well as border measures such as tariffs and quotas.

World Agriculture in Disarray. The current round of multinational trade negotiations has begun at a time of stress in world agriculture. Recently, both world market prices and trade volumes have been low, and farm programs worldwide have become more costly and distortionary.

Chart 4–2 shows the changes in the real value of U.S. agricultural exports and the U.S. share of world exports. World and U.S. agricultural exports both expanded rapidly in the 1970s, reached a peak in 1980, and have fallen since then. The U.S. share of world agricultural trade rose from 14 percent in 1972 to over 18 percent in 1981. Agricultural prices rose dramatically during the 1970s, increasing nominal exports sixfold while the real value of exports doubled. Then in the 1980s U.S. agricultural export prices and quantities fell for most commodities. In 1987 the quantities, values, and market shares for U.S. agricultural exports rose and prospects are good for the rest of the decade.

Chart 4-2

U.S. Agricultural Exports



Note.—U.S. value for 1987 estimated; world value not available.
Sources: Department of Agriculture, Food and Agricultural Organization, and Council of Economic Advisers.

World farm production, prices, and trade have been governed by numerous distortionary agricultural programs that frequently work at cross purposes. Many countries use a variety of policy measures that subsidize production or raise prices to consumers. These measures include tariffs, import quotas, variable import levies, export subsidies, price supports, direct government payments based on output levels, paid land diversions, production or input quotas, and subsidies for storage and inputs such as fertilizer, credit, insurance, fuel, and transportation.

One summary indicator of farm program effects, the producer subsidy equivalent (PSE), measures the loss of farm income that would result from the removal of a given set of policies (often reported as a percent of farm revenues). An analogous measure, the consumer subsidy equivalent (CSE), measures the total policy contribution to costs of farm output, often reported as a percent of expenditures. Table 4-2 shows average PSE and CSE measures for a variety of countries.

TABLE 4-2.—*Agricultural Subsidies for Producers and Consumers, Selected Countries, 1979-86*

[Percent of value[1]]

Country	Producers			Consumers		
	1979	1982	1986	1979	1982	1986
Australia[2]	7	13	11	([3])	([3])	([3])
European Community (EC-10)[4]	38	33	41	−22	−30	−32
Japan	68	67	79	−43	−43	−47
United States[5]	11	15	34	−10	−10	−17
Taiwan	([3])	15	23	([3])	−25	−29
South Korea	([3])	60	58	([3])	−52	−65
Nigeria[6]	−89	−34	−27	([3])	63	40
India	([3])	−27	−11	([3])	12	3

[1] Producer figures are subsidy equivalents as percent of farm sales value (PSEs); consumer figures are percents of value at first sale after the farm gate (CSEs). For dairy subsidies, sales value of primary dairy products is used. For Taiwan, Korea, Nigeria, and India, consumer subsidies are percents of consumer values at wholesale or retail levels. Positive figures indicate net subsidy; negative figures indicate that policies provide a net tax relative to no such policies. Commodity coverage varies, but for each country major grains, oilseeds, sugar, and livestock products are included, except as noted for Nigeria.
[2] Estimates do not include state policies, which would raise PSEs.
[3] Not available.
[4] Estimates do not include individual country policies, which would raise PSEs and lower CSEs. For 1979, data are for EC-9.
[5] State policies are minor and are not included, but general Federal subsidies such as for farm credit are included.
[6] Commodity coverage is limited to wheat, corn, rice, sugar, cotton, and cocoa.

Sources: Department of Agriculture (Economic Research Service), Organization for Economic Cooperation and Development, and Council of Economic Advisers.

In many developing countries, where farmers are a large but not particularly influential segment of the economy, producers are taxed and consumers subsidized for many agricultural goods. Thus PSEs are negative and CSEs are positive for most developing countries over a wide range of commodities. (See, for example, the average PSE and CSE for Nigeria and India.)

During the last decade policy distortions have been slowly reduced in developing countries, especially in Asia and Latin America. At the urging of the United States, the International Monetary Fund, and the World Bank, farm prices in developing countries have been allowed to rise so that they more nearly reflect world market levels.

In most wealthy nations, where agriculture is a small part of the economy and generally has been heavily subsidized, farm programs have become increasingly distortionary, leading to higher farm prices relative to world prices, more restrictive import barriers, and increased government subsidies. Crops such as sugar or wheat are grown at high cost in nations using price supports and import barriers, and then surpluses are exported to the world market with the aid of large subsidies. World prices of many commodities have been depressed by these policies, imposing a severe economic burden on export-dependent countries that would have a comparative advantage in the absence of these distortions.

In the United States, farm programs have become particularly costly and complex. Table 4-2 shows that overall PSEs in the United States doubled in the 4 years from 1982 to 1986. The 1981 Agriculture and Food Act mandated high price supports at a time when world market prices were falling. In 1983 farmers were paid to cut back output; surpluses were reduced temporarily, but U.S. participation in world markets also declined. The Food Security Act of 1985 reduced price supports, increased the removal of land and other resources from production, expanded the use of Federal Government programs to aid exports, and maintained target prices at up to twice the market price or more. In 1985 the United States also began the Export Enhancement Program, to counter the subsidies of other exporters (mainly the EC). As a result of these policies, Federal outlays for commodity programs reached $26 billion in 1986, and net farm incomes have been high, despite low market prices.

Agricultural production and consumption also is distorted throughout Europe. The Nordic countries, Switzerland, Austria, and the EC all maintain high producer and consumer prices and restrict imports. During the 1980s EC surpluses have been sold on world markets with the help of export subsidies. Table 4-2 shows that the average PSE for the EC is above 40 percent, and EC buyers pay over 30 percent more because of these farm programs. The Common Agricultural Policy cost taxpayers and consumers of the EC about $60 billion in 1986.

Japan has long been a net agricultural importer, but it distorts world agricultural trade by holding its domestic prices high and limiting access to its markets. For wheat and rice, Japan now has a support price greater than five times the world market price. Japanese producer and consumer prices for many agricultural goods are often twice the world market price. Japanese consumers spend about 20 percent of their income for food, compared to less than 15 percent spent by consumers in the United States.

Many countries continued to pursue policies that increased agricultural trade distortions during a period of slowly liberalizing world trade partly because, at the urging of the United States over 30 years ago, GATT prohibitions on import quotas and export subsidies were not applied to agriculture. During the GATT negotiations held over the past 30 years, few important agreements have been reached for liberalizing trade in agricultural commodities.

The most serious distortions and barriers related to international agricultural trade are caused by domestic programs in the industrialized countries that transfer income from consumers and taxpayers to owners of agricultural resources. Because these programs have been considered part of domestic policy, rather than international trade policy, it has been particularly difficult to include them in international negotiations.

The U.S. GATT Proposal in Agriculture. In July 1987 the United States put forward a GATT proposal on agriculture consisting of three major parts: (1) an elimination, gradually over 10 years, of all subsidies that distort agricultural trade either directly or indirectly; (2) an elimination, gradually over 10 years, of all barriers to agricultural imports; and (3) international harmonizing of health and sanitation regulations so that differences cannot be used as indirect trade barriers.

The U.S. proposal would not prohibit GATT contracting parties from transferring income to agricultural groups. Nor would it restrict bona fide foreign aid or domestic food assistance. Only those programs that have a direct or indirect effect on international trade, including output subsidies, would be restricted.

Reactions to the U.S. proposal have been encouraging. The October and December meetings in Geneva of the negotiating group on agriculture included additional formal proposals. The proposals by both Canada and the Cairns Group (an informal organization of self-proclaimed "nonsubsidizing" nations that includes major exporters from developed and developing nations) were consistent with the U.S. initiative. These proposals sent a clear signal that Canada and other Cairns Group members would be working together with the United States in this GATT round.

The EC and Japan have been expected to resist efforts to liberalize agricultural trade. However, at the October GATT meeting the EC endorsed multilateral reductions of subsidies and the separation of income support from production. As was expected, the EC also suggested a number of short-term measures involving supply controls and market sharing that would run counter to a move to freer trade. Their proposal as a whole, however, leaves the negotiations on track.

Formal GATT proposals from the Nordic countries, Japan, and some other importers were made available in December. The Japanese agreed that subsidies generally should be reduced, but they have emphasized the maintenance of some of the current array of import barriers. Japan and some other countries have argued that, since they are already major importers of farm goods, their production subsidies and import barriers are not a significant problem. However, they undoubtedly would import much more in the absence of barriers. The Japanese recognize that they have much to gain from the Uruguay Round because of Japan's position as a major exporter of manufactured goods. Domestic political pressures in Japan in support of agriculture are strong, but international and domestic pressures to join in the move toward free trade are also considerable.

Consequences of Liberalization. Because liberalization offers very significant potential benefits, organizations such as the World Bank, the Organization for Economic Cooperation and Development (OECD), and the U.S. Department of Agriculture have studied the likely pattern of prices, production, and trade flows that would follow as a consequence of world policy reform. A variety of studies have used different methodologies, different underlying assumptions, different base periods for comparison, and somewhat different policy scenarios. Given these differences, the conclusions are remarkably robust.

Removing agricultural barriers and ending subsidies is projected to foster a major expansion in international trade. Compared to what agricultural trade would likely be in the mid-1990s without reforms, world wheat exports are projected to rise somewhat, and coarse grain and rice exports are projected to expand substantially. In red meats and dairy products, international trade is projected to more than double. East Asia, Europe, and other restricted markets are expected to experience major growth in imports. The United States is expected to profit from a major expansion in exports of several commodities such as tobacco, coarse grain, and meats. U.S. coarse grain sales also would expand in the domestic market because of the expansion of the U.S. livestock industry, which in turn would be free to sell meat directly to currently restricted import markets.

Export prices under free trade are projected to be slightly higher for coarse grains and poultry, in the range of 10 to 30 percent higher for wheat, rice, and sugar, and up to 50 percent higher, or more, for beef and dairy products. Prices paid to U.S. producers of program crops are projected to be higher under free trade than current world prices, but lower than current target prices (or support prices in the case of sugar and dairy products).

Removing trade barriers also would reduce substantially the instability of world commodity prices, a factor now used as a rationale for many farm programs. Because consumers and producers in many countries now are insulated from world markets, weather and yield shocks are not dampened and absorbed through supply and demand responses in the full world market. Free trade is projected to reduce world price variability by 20 to 80 percent for major farm commodities. Large reductions in price variability are projected for beef, wheat, and dairy products, and smaller changes are expected for coarse grains and sugar.

Potential world welfare gains from free trade are substantial. A variety of estimates for large but limited groups of countries and commodities range from $40 billion to $70 billion per year. Trade liberalization that included all industrialized and developing countries and all major crop and livestock markets probably would increase world well-being by significantly more. One careful study has found that, compared to projections without reform, U.S. farmers would gain from multilateral liberalization, and, compared to a potential unilateral reduction in subsidies, their gains would be substantial. Farmers in the developing countries clearly would gain, although their urban consumers would lose. Consumers in Europe, East Asia, and other restricted markets also would benefit. They would enjoy lower food and fiber costs, because they would be allowed to import without restriction from the United States and other efficient producers. Their income gains would be spent on increased imports of nonfarm goods as well, thus improving trade balances.

Under the GATT proposal, the United States would end its distortionary and costly farm production subsidies and the output restrictions that accompany them. However, the United States and other nations would be free to provide transition support and income transfers as long as such aid did not subsidize production or otherwise interfere with trade. The removal of barriers would expand the use of the more efficient agricultural resources in the United States and could increase the demand for farm inputs and marketing services as well.

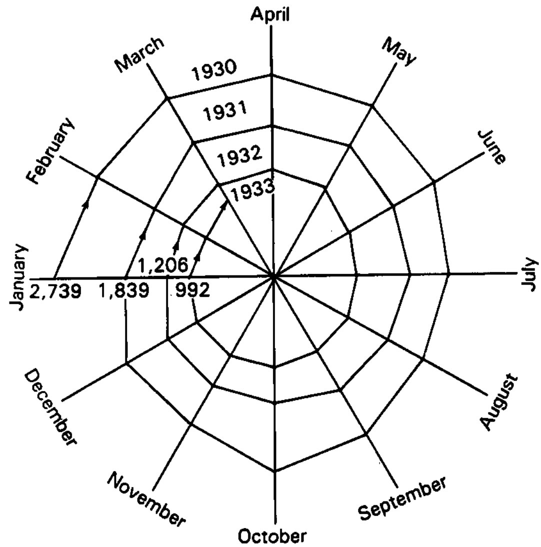
Potential now exists to achieve the first substantial reform since the series of ever-increasing agricultural distortions began. Major international agreement requires patience and persistence, but success in the Uruguay Round would improve well-being throughout the world.

THE PROTECTIONIST THREAT AT HOME

The United States has gone through numerous periods in its history when the sentiments for protectionism gained ascendancy. These episodes typically were associated with times of economic downturn or regionalist sentiment, the early counterpart of special interest politics today. The most recent period of this nature occurred more than 50 years ago with the passage of the Smoot-Hawley Act of 1930, probably one of the most damaging pieces of legislation ever signed in the United States. Passed after the stock market crash of 1929, Smoot-Hawley attempted to benefit U.S. agriculture and manufacturing by raising tariff rates. But it had the opposite effect and caused retaliatory tariffs to be put in place by foreign trade partners. More than 60 nations responded within 2 years with tariffs of their own. World trade fell dramatically. Chart 4-3 shows the spiraling decline in world trade between the beginning of 1930 and the first part of 1933. Far from being beneficial, Smoot-Hawley helped turn the 1930s into a depression.

Chart 4-3

Contracting Spiral of World Trade



Millions of dollars

Note.—Data are total imports of 75 countries.
Sources: Charles P. Kindleberger, *The World in Depression, 1929-39* (Berkeley, California: University of California Press, 1973); data from League of Nations, *Monthly Bulletin of Statistics,* February 1934.

The concerns and frustrations over trade felt today by the Congress, the President, and the American public stem from the large trade deficits which the United States has been running since 1982. As discussed in Chapter 3, the macroeconomic cause of the trade deficit is related to the tremendous growth in Federal spending (22.8 percent of gross national product (GNP) in 1987 versus 20.6 percent in 1979) relative to the also substantial growth in taxes (19.4 percent of GNP in 1987 versus 18.9 in 1979) and the harmful effect of the resulting Federal deficit on the savings-investment balance in the United States. Yet the Congress has responded by seeking to eliminate various foreign trade practices. Many provisions of the trade bill (H.R. 3) passed by the House of Representatives, and the version passed by the Senate, both of which embody these frustrations, are distinctly protectionist. Protectionism is also the motive of recent legislative proposals such as the Textile and Apparel Trade Act (H.R. 1154) passed by the House of Representatives. Ironically, since the macroeconomic causes of the trade deficit are not addressed by these actions, they are likely to have little or no influence on reducing the trade deficit, although their protectionist influence could be harmful and long lasting.

The lesson from Smoot-Hawley is that passage of protectionist trade legislation by the United States will increase protectionist activity in the rest of the world, poison the international climate for trade diplomacy in general, and slow the process of trade liberalization for years to come. Since the United States is a major trading nation, it could suffer major economic losses in the event of increased global protectionism.

PROTECTIONIST TEXTILE LEGISLATION

Two of the most protected industries in the United States today are textiles and apparel. The costs which this protection places on the American family and consumer are enormous, running in the range of $200 to $400 per year per household.

In a major protectionist effort, the House of Representatives passed in 1987 the Textile and Apparel Trade Act which would raise the wall of protection even higher, adding another $280 to $420 in costs per household over the first 5 years. Similar textile legislation was passed by the Congress in 1986 and vetoed by the President. The current bill would set a 1 percent annual growth limit on U.S. global imports of textiles and apparel, freeze shoe imports at 1986 levels, and, for the first time, restrict imports from Canada and the European Community.

The textile and apparel industries do not need greater protection. In 1986 textile industry profits rose 67 percent. Capacity utilization for textile mills was 94.2 percent in the third quarter of 1987, compared with an average capacity utilization rate of 81.2 percent for all U.S. industries. U.S. textile and apparel exports rose 15 percent in 1986 and are estimated to rise another 18 percent in 1987. Average hourly earnings and employment in both sectors continued to rise through the third quarter of 1987. And while the Congress would seek to limit textile import growth to 1 percent a year, U.S. consumption of textiles rose 8.7 percent in 1986.

Regrettably, the Congress frequently considers the larger economic interests of American consumers to be less important than the interests of particular industries. As with other protectionist measures, consumers would have to pay for the special interest legislation, losing more in increased costs than the gains to those who benefit from the legislation. In the United States, the equivalent rate of tariff protection on textiles and apparel already amounts to roughly 50 percent—ten times higher than average U.S. tariffs. H.R. 1154 would cost consumers between $25 billion and $37 billion in the first 5 years, above and beyond the $20 billion to $40 billion annually they already pay because of existing tariffs and quotas.

In addition to generating net economic losses for the country as a whole, the textile bill would act like a regressive tax, hurting those most who can afford it least. Because of the large share of income they are forced to devote to clothing, low-income families—especially those with children—would be burdened disproportionately by this legislation.

EMBRACING PROTECTIONISM—THE OMNIBUS TRADE BILL

The most threatening proposal being considered by the Congress is the Omnibus Trade and Competitiveness Act of 1987, the House and Senate versions of which amount to about 1,000 pages. The bill, which now must be considered in conference committee, includes many features which have only a tangential relationship to trade policy or which are inconsistent with U.S. policy in GATT. Among these are sections dealing with education grants, plant closing restrictions (Chapter 5), subsidies to agricultural programs, changes to domestic tax laws, and investment screening regulations. With so many provisions grouped together in one bill, the President is given little opportunity to consider them on their separate merits. Furthermore, the Administration is on record stating that many of the provisions are unwise and damaging to U.S. interests.

Although the trade bill would include tariffs and trade barriers, as Smoot-Hawley did, it represents a fundamentally different kind of protectionism. In the area of trade policy, the legislation would change the rules for administering U.S. trade law and for granting protection to U.S. producers.

Helpful Features

Every President since 1934 has had authority to enter into international trade agreements involving the reduction of tariffs, and to reduce U.S. tariffs by Presidential proclamation to carry out the country's trade objectives. This authority originally was employed to extricate the country from the economic disorder created by high tariffs after passage of the Smoot-Hawley Act. Tariff proclamation authority was renewed for every President thereafter until January 3, 1980. Reinstatement of this authority is a desirable feature of the trade bill.

A second desirable feature is the so-called "fast track" trade agreement authority which was used in the Canadian free-trade agreement negotiations and in the last round of GATT. Under a modification of the operating rules of the House of Representatives and Senate, the President is allowed to negotiate a trade agreement and present it with necessary implementing legislation to the Congress for acceptance or rejection without amendment within a specified period of time. This authority is important for U.S. credibility in international negotiations, because foreign countries are assured that agreements made at the bargaining table will not be undone later, apart from overall acceptance or rejection. However, the Senate version of the trade bill contains harmful "reverse fast track" provisions allowing the Congress to remove fast track authority at any time.

A third desirable feature of the trade bill is the authority to implement the Harmonized System of tariff schedules. Common tariff schedules greatly facilitate international interaction in trade issues. It is regrettable, and a keen source of disappointment to the Administration, that the Congress chose not to grant this authority in earlier legislation in time for the United States to join in implementing the new system on January 1, 1988. The United States, which was one of the original and principal supporters of the development of the Harmonized System, is now the only major trading country not to have implemented it.

Harmful Features

Unfortunately, the protectionist features of the trade bill outweigh the helpful features in number and in potential for harm. Legislation whose result is protectionist (increasing the number of trade cases filed and the amount of protection offered in response to them) would hamper the attainment of U.S. trade objectives in the rest of the world, damage global perceptions of the United States, and invite retaliation on U.S. products.

Many other countries perceive international trade agreements such as GATT as mechanisms to restrain U.S. antidumping and countervailing duties, whereas the United States views them as a way to control foreign subsidies and alleged unfair trade. In recent years the United States has filed more antidumping and countervailing duty cases than any other nation. The extensive use of U.S. antidumping and countervailing duty law as applied to Canada, for example, was the major difficulty in reaching agreement in the Canada-United States Free-Trade Agreement. The Canadians insisted on establishing a binational panel to review issues related to these laws before an agreement could be reached.

With passage of the omnibus trade bill, damaging protectionism would become embedded in U.S. trade law. Among the dangers are changes to the law designed to: (1) increase the number of cases brought against foreign competitors; (2) rearrange legal definitions and structures to increase the likelihood of finding injury or "unfairness" once a case is brought; and (3) increase the likelihood and magnitude of protection once a case is concluded.

The omnibus trade bill would remove Presidential judgment and discretion from the protection-granting process. Converting important portions of U.S. trade law to mechanical rules for bringing trade cases against foreign trade partners and eliminating case-by-case evaluation by the President would be a serious change in current practice.

Table 4-3 summarizes the four main sections of current U.S. trade law. The origins of present provisions date back many years, and their forms often represent decades of experience. Adjustments to the statutes, the most recent in 1984, frequently have been made to enhance industry access to protection under the various sections. The changes recently suggested, however, represent a sharp break from the past; they would throw out the wisdom that has been crafted into the statutes over time and replace it with untried and potentially dangerous alternatives.

TABLE 4-3.—*Principal U.S. Trade Law Provisions*

Statute	Focus	Criteria for action	Response	Responsibility
Section 201: Fair Trade (Escape Clause)	Increasing imports	Increasing imports are substantial cause of injury	Duties, quotas, tariff-rate quotas, orderly marketing arrangements, adjustment assistance	President (ITC recommendation)
Section 301: Unfair Trade	Foreign practices violating a trade agreement or injurious to U.S. trade	Unjustifiable, unreasonable, or discriminatory practices, burdensome to U.S. commerce	All appropriate and feasible action	President (Interagency recommendation)
Section 701: Subsidized Imports	Manufacturing, production, or export subsidies	Material injury or threat of material injury	Duties	ITC—Injury determination Commerce—Subsidy determination
Section 731: Dumped Imports	Imports sold below cost of production or below foreign market price	Material injury or threat of material injury	Duties	ITC—Injury determination Commerce—Dumping determination

Note.—Origin of current provisions: Tariff Act of 1930 (Smoot-Hawley), as amended; Trade Act of 1974, as amended; Trade Agreements Act of 1979, as amended; Trade and Tariff Act of 1984.

Source: Council of Economic Advisers.

Section 201. The escape clause provisions of current U.S. trade law provide assistance to industries injured as a result of an increase in fairly traded imports. The law is not designed to provide permanent protection, but to aid workers and firms temporarily as they adjust to increased imports. The petitioner submits its case to the U.S. International Trade Commission, which then undertakes an investigation, including public hearings, to determine if the growth in imports is a substantial cause of serious injury. If the U.S. International Trade Commission finds affirmatively and recommends that import relief be granted, the President must decide what method and amount of relief he will provide, including possible adjustment assistance.

Granting relief inevitably burdens other parts of the U.S. economy. Therefore, in his decision, the President is required to consider whether such relief is in the overall national economic interest. Relevant considerations include the impact of relief on industries and firms facing higher prices for their inputs, the effect of the relief on other U.S. international interests, the probability that the relief will be effective in promoting adjustment, and the costs imposed on taxpayers, consumers, workers, communities, and other "innocent" parties. In other words, a favorable recommendation by the U.S. International Trade Commission does not and should not lead automatically to protection being granted.

Changes proposed in the trade bill would narrow the definition of domestic industry used in Section 201 cases to cover only the domestic portion of production, only that subset of the industry which produces the like or competitive article causing the damage, and/or only the geographic area where the imports are concentrated. Narrowing the definition of domestic industry, of course, means that an injury finding would be easier, since non-injured parts of the industry would be removed from consideration.

Another change would alter the procedures for recommending protection once injury is found. The proposal would change the law to say that only those commission members who voted affirmatively (found injury) in the review would be eligible to vote on recommendations about relief. Without the moderating voice of the minority dissenters who failed to find that the foreign fairly traded goods injured the domestic industry, more protection is likely to be granted.

When a Section 201 case reaches the President, proposed changes in the Senate version would effectively require the President to accept the recommendation for protection, or else, in the House version, he would be removed from the process altogether. In the House version the President's authority would be given to the United States Trade Representative (USTR).

In the Senate bill the exceptions to granting protection would be rigidly curtailed. The President would be required to impose protection unless he certifies that protection endangers national security, disproportionately burdens agriculture, results in a net U.S. job loss, causes serious injury to a downstream industry, or burdens the poor disproportionately. The burden of proof would be changed, too. Protection would be imposed unless the President takes action to prevent it. With fewer reasons why protection could be rejected, and with overall national economic interest not among them, the probability of protection would be increased substantially.

Antidumping and Countervailing Duty Law. In the United States, as in GATT, dumping is considered unlawful when it injures domestic, import-competing industries. Dumping is deemed to occur when a product is sold in the United States at less than "fair value," that is, at a price lower than it is sold in the selling country's home market, or below its cost of production. Companies might engage in dumping because they maintain high prices in their less competitive home market, or because they lower export prices in hopes of capturing foreign market share. Furthermore, because exchange rates vary over time, firms may choose to hold dollar prices constant to retain export market shares and let profit margins in their domestic currency change.

Section 731 of the Tariff Act of 1930, as amended, directs the Department of Commerce to examine claims of dumping to determine whether imports are being sold at less than fair value. If the Department rules in the affirmative, the U.S. International Trade Commission then determines whether a U.S. industry has suffered material injury or the threat of material injury as a result of the specified imports.

Countervailing duty law is intended to offset any unfair advantages foreign producers might enjoy as a result of government production or export subsidies. In Section 701 of the Tariff Act of 1930, as amended, the Department of Commerce determines whether the specified imports have received foreign government subsidies. If the Department finds in the affirmative, the U.S. International Trade Commission determines whether a domestic import-competing industry has suffered material injury or the threat of material injury as a result of the subsidized imports. If the International Trade Commission rules in the affirmative, countervailing duties are assessed on the offending products.

There are legitimate reasons for opposing dumping and subsidies. However, improper use of antidumping and countervailing duty law also can be damaging to the country imposing it. Dumping and subsidies are, in and of themselves, beneficial to the importing country (and are costly to the exporting country), because the buyers of the product obtain their goods more cheaply (at the expense of the selling company or country). Subsidies and dumping are harmful to the importing country as a whole if the lower prices drive competitors out of existence (as in predatory pricing) or cause unnecessary adjustment costs to the domestic industry and labor (as in foreign business cycle dumping), and prices of products sold by foreign suppliers subsequently are raised above what they would have been.

The threat of ultimately higher prices, burdensome and unnecessary adjustment costs, and reduced competition is the fundamental reason for opposing dumping and subsidies. But the remedy for dumping also raises domestic prices by imposing duties. If abused, duties have the effect of reducing competition from foreigners in the domestic market as well as harming domestic buyers of the product through higher prices.

Thus care must be taken to ensure that misuse of antidumping and countervailing duty law does not make the cure worse than the disease. The interests of competition and the benefits to consumers and domestic producers, as well as the interests of the import-competing industry, all must be considered.

Because current law already offers adequate protection from harmful dumping and subsidies, changes to expand the use of antidumping duties would be protectionist. For example, in some cases dumping margins are extremely difficult to establish clearly, since the foreign country may not be selling the exported good in its home market, legitimate related costs of selling may be higher in the foreign market, and the costs of foreign production may be difficult to ascertain. Under current law, when a product's fair value is calculated, it is assumed that exporters must sell at a price high enough to provide an 8 percent profit margin, even though the before-tax average rate of profit on sales reported in 1986 for manufacturing, wholesale, and retail trade in the United States was less than 5 percent.

Trade bill proposals for antidumping and countervailing duties would move the law closer to a mechanism for granting protection independent of a legitimate threat to the domestic economy. One proposed change to U.S. antidumping and countervailing duty law would require antidumping cases against products which are not dumped themselves, but which incorporate inputs alleged to have been purchased by the manufacturer at a price below fair value. The amendment proposed in reaction to this newly defined "input dumping" is protectionist and GATT-illegal, and it makes the law less administrable because the foreign producer may not know if he is purchasing dumped inputs or what their fair value is supposed to be. The effect of the proposal is to expand the range of activities against which protection can be offered and encourage the initiation of cases.

Proposals to increase the likelihood of protection once a case is brought would alter the way dumping margins and subsidies are computed. One which would harm American subsidiaries of foreign firms would change the way indirect selling expenses are treated in determining foreign market value for transactions between related parties. The proposal would require that the administering authority not deduct "indirect selling expenses from the foreign market value in order to offset expenses deducted from an exporter's sale price." For example, firm XYZ-Europe produces a product at a cost of $100.

Its selling expenses in Europe are $20 and its profit margin is $5. The product, therefore, sells for $125 per unit. Firm XYZ-America, the subsidiary, sells the same product in the United States for $125 per unit. According to the new proposal, the product would have a dumping margin of 25 percent. The Department of Commerce would be required to deduct U.S. selling expenses and profit on sales as not part of the product cost. In America, the product cost would be $100, while in Europe the product cost would be $125. Thus would come a charge of dumping, whereas a proper calculation would find none.

Historically, the definition of subsidies has been based on quantifiables such as government provision of capital, loans or loan guarantees on better than commercial terms, provision of goods or services at preferential rates, forgiveness of debts, and contributions toward manufacturing expenses. In subsidy cases the Department of Commerce has uniformly held that generally available benefits, applicable to all companies and industries within an economy, are not countervailable subsidies. This position conforms with GATT interpretations.

The trade bill would define a subsidy to include actually conferred benefits which bestow a "competitive advantage" on a class of beneficiaries, regardless of the number of firms or industries receiving the advantage. Expanding the definition, of course, widens the class of actions which could be found countervailable. Applying such a definition to the United States, for example, one might ask whether national weather forecasts would be considered subsidies to agriculture, since the forecasts create greater competitive advantage for U.S. agricultural beneficiaries. The subjectivity of such a definition is dangerous in its possibilities for protectionist abuse and creates unfair uncertainty for trading partners about its application.

Section 301. Section 301 of the Trade Act of 1974, as amended, provides the President with extremely wide discretionary authority to act against the unfair trade practices of U.S. trade partners. This authority can be used to enforce the rights of the United States under a trade agreement, to respond to a foreign practice that has the effect of denying benefits to the United States under a trade agreement, or to eliminate any foreign practice that is unjustifiable, unreasonable, or discriminatory and which burdens or restricts U.S. commerce. "Unjustifiable" is usually taken to mean any act, policy, or practice in violation of, or inconsistent with, the international legal rights of the United States. "Unreasonable" is taken to mean unfair and inequitable, while "discriminatory" typically means acts, policies, or practices which deny national or most-favored-nation treatment to U.S. goods, services, or investments.

Under Section 301 the President can take all appropriate and feasible actions within his power to enforce U.S. rights to obtain the elimination of the objectionable act, policy, or practice. The response can be on a nondiscriminatory basis or solely against the guilty trade partner or party. It can be taken without regard to whether the goods or sector employed were involved in the act, policy, or practice identified as the original cause of the action. Among the responses, the President may suspend or withdraw benefits of trade agreement concessions or impose duties on goods or services as he deems appropriate. The President can act in response to petitions filed by private parties or on his own initiative. Investigations are administered by the Office of the U.S. Trade Representative in cooperation with other U.S. Government agencies. USTR negotiates with the foreign government, resolves the dispute if possible, and recommends actions to the President after interagency consultation.

The Section 301 statute has shown itself to be effective when used in a judicious and discerning manner. This Administration has been more vigorous in its active use of Section 301 than any other, increasing the yearly caseload by more than 50 percent and, for the first time, initiating at the President's request a number of cases such as the Japanese tobacco products case. But the mere act of instigating a Section 301 case does not magically ensure a solution to the problem at hand. While many Section 301 cases have been successful, others resulted in long and inconclusive negotiations, or only modest gains relative to the effort expended. In a sense, cases that end in retaliation or counterretaliation, as some have, represent failures of policy and diplomacy.

Because the Senate trade bill mandates mechanical retaliation against unjustifiable foreign trade practices without regard to whether retaliation is in the national economic interest, or without exercise of Presidential discretion, long-run gains to the United States could be sacrificed. More cases would be brought, but this would be less desirable than if the cases were brought on the basis of discretion.

The trade bill also requires retaliation against countries deemed deficient in their provision of intellectual property rights, and against countries which do not give reciprocal treatment in the telecommunications area. Since the United States has the most open telecommunications market in the world, virtually every country could be covered, even countries which in segments of the market are as free as the United States was only some 10 or 15 years ago before the breakup of the national telephone system.

Schemes for Deficit Reduction by Threats of Trade Sanctions. The trade bill would require retaliation against countries which are found to have "excessive and unwarranted" trade surpluses with the United

States. The term "excessive" is defined according to a formula, and "unwarranted" means that USTR has found the country to have a pattern of unfair trade practices that have an adverse effect on U.S. commerce and contribute to the trade surplus of the country. The provision would allow 6 months to reach an agreement to improve the bilateral trade balance by 10 percent annually, or retaliation is mandated. It does not specify what would be done to reinstate free trade and reduce international tension after the United States has branded one of its trading partners as an "unfair trader" and imposed a retaliatory set of tariffs.

Apart from a misplaced faith in negotiations as the method for reducing the U.S. trade imbalance, belief that bilateral trade balances should be required to stay within some fixed range exhibits a certain amount of confusion over the nature of international trade. Consider the simplest possible example of three countries A, B, and C, each of which produces a single good a, b, and c. Each country can make use of only two of the goods: country A trades some of its a to B, using the revenues to buy c from C; B trades some of its b to C, using the revenues to buy a from A; and similarly for country C. Each country has balanced trade, although no pair of countries has bilaterally balanced trade. Forcing bilateral balance not only would severely restrict trade, but in this case it also would shut down trade altogether.

Situations similar to this example are not difficult to find. For example, in 1986 the United States had a trade surplus with respect to Australia (primarily selling machinery and transport equipment), Australia had a trade surplus with Japan (selling primarily food and raw materials), and Japan had a trade surplus with the United States (selling primarily motor vehicles and sound and image reproduction equipment). Although the stylized example is simplistic, it shows how simplistic it is to believe that trade sanctions should be used to keep bilateral trade balances within a mathematical norm. Retaliations also would damage U.S. international relations. Finally, limitations on bilateral trade balances may not be in U.S. interests in the 1990s when America may need trade surpluses to pay back some of its borrowing of the 1980s.

The Climate for Protection and Removal of Presidential Discretion. The House bill would transfer the President's authority under Sections 201 and 301 (as well as under other sections not discussed here, such as Sections 337 and 406) to USTR, and both the House and Senate bills would transfer to USTR the President's authority to determine whether foreign government practices are unfair under Section 301. In combination with the mandating of Section 301 cases, these transfers of authority would represent a major change in the operation of U.S. law.

Since protection benefits the few at the expense of the many, the President, who speaks for the Nation, usually has been less willing to institute protection than those who speak for selected interests. By design, the executive branch as a whole is also broader in its perspective than its component agencies. The Departments of Agriculture, Commerce, and Labor, for example, have missions to speak for important components of the population, just as members of the Congress represent different regions. The President, however, can take the entire country and economy into consideration, as well as foreign policy objectives, through the interagency process which advises the President from many sources.

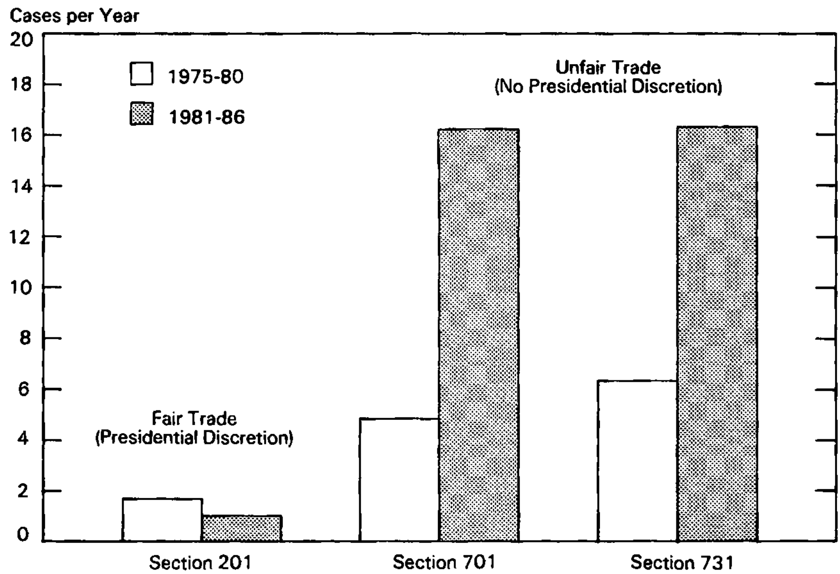
The need for advocating and balancing different interests within the American economic structure was recognized by the founding fathers. U.S. trade law similarly should seek to preserve necessary checks and balances. Thus Presidential discretion should not be removed in Section 201 and 301 cases, as has been suggested, since no single agency has as broad a perspective as the President.

The proposed procedural changes in U.S. trade law and removal of the President from his traditional role in the process are a sad, but perhaps expected, consequence of the growing demand for protection in the United States. Chart 4–4 compares the amount of protection granted in the United States under Section 201, dealing with fair trade where the President has discretion, and interventions under Sections 701 and 731, dealing with unfair trade where he does not, in the periods 1975 to 1980 and 1981 to 1986. As shown, protection granted under Section 201 changed little, but the number of petitions resulting in interventions under Section 701 increased 335 percent, and the number resulting in interventions under Section 731 increased 258 percent. It is difficult to believe that the frequency of foreign subsidies during this Administration are more than three and one-third times what they were previously, or that dumping has risen to more than two and one-half times its previous level (especially since the strong dollar during the latter period made selling to the United States easier for foreigners rather than harder). More likely, the higher intervention rate derives from changes made in U.S. trade law in 1979, the large trade deficit, and the consequent increased demand for protection inside this country.

The net effect of the definitional changes, the procedural changes, the loss of checks and balances, and the removal of Presidential discretion would be to further increase the amount of protection afforded domestic import-competing producers. Since passage of the Trade Act of 1974, the President has found that it was in the national economic interest to grant protection in response to 46 percent of the Section 201 U.S. International Trade Commission recommendations.

Chart 4-4

Trade Interventions



Source: Council of Economic Advisers, based on data from Office of U.S. Trade Representative.

Thus, in the absence of Presidential participation, protection under Section 201 could more than double if trade bill proposals became law. The figure would be substantially higher if curtailing the President's role also created an incentive for industries to file more cases. Mandating the initiation of cases under Section 301 would increase their number while reducing the success ratio. Enlargements of the definition of actionable practices and altered procedures for deciding cases would make Sections 701 and 731 affirmative findings and the subsequent market interventions easier.

The Pork Barrel. In addition to the procedural issues, there are many "pork barrel" amendments in the two trade bills. The Senate version of the trade bill contains a provision establishing a lamb import quota fashioned after the protectionist U.S. meat import law. This provision would place an upper bound on the amount of lamb that could enter the United States each year. Such a restriction is contrary to U.S. obligations under GATT. This trade barrier, like its sister meat import quota, would raise the cost of meat in the United States. Protection on meat is equivalent to voting a new tax on product users, and handing part of it over to domestic sellers. Part of the users' losses (in the form of higher prices paid) would go to domestic producers, but another part (resulting from the cessation of consumer purchases because of higher prices) would end up in no one's hands and thus be wasted.

The legislation also contains protectionist provisions for steel, adding additional products to those currently being protected by voluntary restraint agreements with foreign sellers, a form of quota. Users of wire fence panels, wire fabric, and reinforcing mesh would have to pay higher prices because of these imposed barriers to trade. Since another provision would include downstream steel products (those products incorporating steel components) in the quota of the country where the basic steel input was melted and poured, these products also would cost more to Americans. The bill also calls for the amount of U.S. coal purchased by Japan to be "taken into consideration" in any agreement with Japan regarding imports of steel. That is, U.S. willingness to buy Japanese steel would be linked to Japanese willingness to buy U.S. coal, thus distorting the market.

In addition to the above examples, the trade bills also contain provisions that would provide payments to special interest groups. One such provision is the proposed exception to the requirement that the tobacco program be operated at no net cost to the U.S. taxpayer for government-assisted exports. Pressure to use the public treasury to subsidize tobacco exports could increase Commodity Credit Corporation outlays by many millions of dollars.

Another handout is the sugar duty drawback provision. It is a usual practice in international trade for a firm that imports a product for domestic processing and then exports the good again to receive a refund or "drawback" of the duty paid upon reexport. The drawback normally is applied within a reasonably short period of time after actual import and reexport. The trade bill would extend the drawback period for sugar retroactively to allow drawbacks for exports as late as October 2, 1991, claimed against imports as early as October 30, 1977. This means that future exports (which need not have been imported themselves, and which may have nothing to do with earlier sugar which was not reexported because it was more profitable to sell domestically) would receive duty drawbacks. In effect, the law arranges to give money from the public treasury to refiners of sugar in the United States. Estimates place the transfer at more than $265 million, and possibly higher than $700 million. Because the U.S. Customs Service has not been able to verify potential claims, the loss to the treasury could be even higher.

CONCLUSION

In the area of trade policy, the United States today faces a choice. It can continue its commitment to foster an environment of trade liberalization, or it can turn to protectionism. The choice will be determined by how the Nation shapes domestic law and how it deals with its trade partners in the international forum, rather than by public statements of intentions.

U.S. negotiators have made substantial and historic progress this past year in forging agreements with other countries which free major international markets from trade restrictions. Pacts with Canada and Mexico, and U.S. participation in the ongoing Uruguay Round of GATT negotiations, offer real hope for the future of American trade relations. The U.S. GATT proposal for major reform of agricultural policies that distort international trade offers the prospect for progress in that important sector.

At the same time, spurred by its unwillingness to reduce Federal Government spending and the desire, nevertheless, to appear responsive to the large American trade deficit, many in the Congress appear ready to reconfigure U.S. trade law. Due regard for the macroeconomic and Federal deficit-related causes of the trade deficit suggests, however, that the proposed legislation is unlikely to have any substantive effect on the trade balance. A reasoned review of the various proposed trade provisions suggests that they are protectionist in nature, violate our international obligations under GATT, increase costs to consumers and business purchasers of imported inputs, and distort existing U.S. trade law. The recent textile and apparel legislation also would be damaging and costly.

Because protection favors some groups at the expense of the rest of the country, there always will be pressures from within the United States to provide greater protection. The same pressures exist abroad. But now, as bilateral and multilateral negotiations show signs of success, it is time to resist pressures for protection and international confrontation. The choice is between contraction or further liberalization. Contraction points down the road of economic stagnation, while liberalization will result in continued growth, strengthening the groundwork for international trade well into the 21st century.