The Heritage Foundation

ISSUE BRIEF

No. 4695 | APRIL 28, 2017

Free Trade Agreements that Benefit Americans: Eight Guidelines for Policymakers

Ambassador Terry Miller, Bryan Riley, and Tori K. Whiting

The Trump Administration recently issued an executive order (EO) directing the Office of the U.S. Trade Representative and the Commerce Department to identify foreign trading partners with which the U.S. had a significant trade deficit in goods in 2016 and to assess the major causes of the trade deficit. According to the EO, "For many years, the United States has not obtained the full scope of benefits anticipated under a number of international trade agreements or from participating in the World Trade Organization."[1]

How Trade Agreements Work

How trade agreements actually work is widely misunderstood. The primary function of all modern free trade agreements is the removal of pre-existing government restrictions on trade. All governments restrict trade to some degree through measures such as taxes, quotas, or health and safety regulations. Free trade agreements are the vehicle through which partnering governments agree to mutually remove some or all such restrictions. The end goal of the U.S. free trade movement is the removal of all existing government restrictions on Americans' freedom to trade except those that may be required by health, safety, or national security. Such a goal is essentially identical to and fully consistent with the Trump Administration's deregulatory and tax reform agenda.

Trade Agreements Encourage Competition

Of course, some Americans do not want existing trade restrictions removed. Some firms enjoy monopoly power in the U.S. market because the U.S. government has restricted their competitors through taxes or quotas. Such firms are not going to want to lose their privileged position. However, the removal of trade restrictions will benefit their customers, as they are able to take advantage of increased supply and lower prices.

In the most extreme cases, where a U.S. firm cannot compete at all without government intervention on its behalf (through tariffs, subsidies, or quotas), it may go out of business, requiring its workers to find new jobs. While the U.S. economy is a great job-creating machine (adding 200,000–300,000 new jobs in a typical month), the personal dislocation and hardship suffered by the newly unemployed is an important consideration. However, guaranteeing these individuals a job through government support of an uncompetitive firm—the essence of protectionism—is not a suitable answer. Countries that have gone that route find themselves trapped by slow growth, technological stagnation, and declining productivity.

Thousands of American companies are competing successfully on the level playing fields of international markets free (or at least freer than in the past) from government intervention. America's high level of prosperity is in no small part due to the efficiencies

This paper, in its entirety, can be found at
http://report.heritage.org/ib4695

The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

of a globalized market and firms whose production processes involve workers in more than one country.

Trade: The Pursuit of Mutual Advantage

These days, most U.S. imports are either intermediate goods or capital goods used by American manufacturers. U.S. tariffs make it harder for those companies to compete globally. According to the Arizona company that makes Ping golf clubs:

> Most every other golf equipment manufacturer has sent their production of golf clubs abroad, and you might wonder why that is. And one of the reasons is the tariffs and the way they incentivize that. Unbelievably, the U.S. golf equipment manufacturers are faced with a higher tariff rate to bring in a component part than we are to bring in the whole golf club. And so the industry has responded accordingly. Why does our Federal Government penalize us in this way? We do not know.[2]

That the government should maintain trade agreements only when they benefit Americans is obvious; however, in a complex economy like that of the U.S., the benefits of such agreements are unlikely to be evenly distributed and some may carry costs as well. In fact, any change to the economic policy status quo is likely to create both winners and losers. Signing a new trade agreement will create dislocations that benefit some Americans and hurt others. Abandoning or renegotiating an existing trade agreement will cause dislocations, too. None of this is to imply that existing trade agreements cannot or should not be improved. Where benefits from change outweigh costs, a government policy change may be justified. Where costs outweigh benefits, or where the two are evenly balanced, opting for the status quo is a less disruptive and thus better policy.

If a renegotiation is undertaken, care must be taken to avoid the trap of holding the benefits of an existing arrangement hostage to possible improvements as a negotiating gambit. The U.S. should not use the threat of abandoning an existing trade agreement (as long as it is judged on balance to benefit Americans) in seeking another country's agreement to renegotiate a current deal. Such a tactic is as likely to injure the U.S. economy as it is the foreign party.

Trade is based on the concept of mutual advantage. In seeking renegotiation or improvements in existing trade agreements, it is the identification and recognition of mutual benefits, not unilateral threats, that will carry the day. Free trades take place only when they benefit both parties to the exchange. Critics of free trade seem to think that the global economy is like a pie that can be cut up in different ways, but never grows. They believe it is a zero-sum game where when one country or industry wins, another loses. Contrary to that belief, free trade is about making the pie grow so that everyone can get a bigger slice. It is no coincidence that countries with the lowest trade barriers are much wealthier than those that restrict trade, as reported in The Heritage Foundation's annual *Index of Economic Freedom*.[3]

Trade Deficits

Finally, a word about trade deficits. The concept of a trade deficit is an artifact from the way in which gross domestic product is measured. When we consume more goods and services than we produce, we register a so-called trade deficit. Implicit in the definition, however, is that when we are experiencing a "trade deficit" we are also experiencing a "consumption surplus." Philosophers and economists may disagree about whether our welfare is determined more by what we produce or what we consume, but at the very least it should be clear that considering one without the other tells only half the story. Historically, trade deficits correlate with periods of high economic growth in the U.S. In fact, policies aimed at reducing trade deficits might actually degrade societal well-being.

1. The White House, Office of the Press Secretary, *Presidential Executive Order Regarding the Omnibus Report on Significant Trade Deficits,* March 31, 2017, https://www.whitehouse.gov/the-press-office/2017/03/31/presidential-executive-order-regarding-omnibus-report-significant-trade (accessed April 18, 2017).
2. Hearing, *The Miscellaneous Tariff Bill: Helping U.S. Manufacturers through Tax Cuts*, Subcommittee on Trade, Committee on Ways and Means, U.S. House of Representatives, April 14, 2016, https://waysandmeans.house.gov/wp-content/uploads/2016/10/20160414TR-Transcript.pdf (accessed April 18, 2017).
3. Terry Miller and Anthony B. Kim, *2017 Index of Economic Freedom* (Washington, DC: The Heritage Foundation, 2017), http://www.heritage.org/index/.

The Trump Administration's exclusive focus in the executive order on deficits in goods trade is especially problematic. The U.S.'s economic engagement with other countries involves trade in goods *and* trade in services, as well as U.S. investments in other countries and foreign investments in the U.S. There are massive financial flows into and out of the U.S., including significant foreign purchases of the U.S. government securities that help finance the national debt. All of these flows are inter-connected, and any attempt to influence one part (like the deficit in goods trade) is sure to have unintended consequences on the rest. The entirety of economic interactions between Americans and foreigners must be taken into account if we are to avoid policy mistakes.

With the above in mind, policymakers should consider these eight general guidelines when reviewing current U.S. trade deals and negotiating future agreements:

1. What is the economic impact of existing and proposed agreements on a cost-benefit basis? If the costs outweigh the benefits, the agreement should be re-worked or the U.S. should withdraw.

2. Are the benefits of international supply chains among the partners accruing to people in the U.S.?

3. Does the agreement increase freedom for Americans, or does it primarily create or codify regulatory barriers to trade? Recent trade deals have increasingly included sections dealing with labor, environmental, and other regulatory standards, which may interfere with trade if improperly drafted or implemented.

4. Are America's trading partners complying with the agreement? For trade agreements to have credibility with Americans, our trading partners must play by the rules.

5. Does the agreement need to be modernized? Many current agreements may not address the realities of a 21st-century economy.

6. What gaps exist in the agreement? Although trade agreements are based on joint elimination of barriers to trade and investment, all deals have areas where free trade was not fully implemented due to domestic and foreign political pressures. Identifying gaps on trade deals would provide a basis for improving them and help when negotiating new deals with other countries.

7. How does the agreement compare to others to which U.S. trading partners belong? For example, Canada and Mexico have agreements with the U.S. and with the EU. Are their deals with the EU better in any way than their agreements with the U.S., and could aspects of the Canada–EU and Mexico–EU agreements be usefully incorporated into the North American Free Trade Agreement?

8. Do our agreements align with current U.S. negotiating objectives? Trade Promotion Authority includes several guidelines for new agreements, including "the reduction or elimination of barriers and distortions that are directly related to trade and investment and that decrease market opportunities for United States exports or otherwise distort United States trade." How well do existing agreements meet current U.S. negotiating objectives?

*—**Ambassador Terry Miller** is Director of the Center for Free Markets and Regulatory Reform, of the Institute for Economic Freedom, as well as Mark A. Kolokotrones Fellow in Economic Freedom, at The Heritage Foundation. **Bryan Riley** is Jay Van Andel Senior Analyst in Trade Policy in the Center for Free Markets and Regulatory Reform. **Tori K. Whiting** is a Research Associate in the Center for Free Markets and Regulatory Reform.*