SPECIAL REPORT

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U.S. PROTECTIONISM TALK: TRYING TO PUT THE TOOTHPASTE BACK IN THE TUBE

Highlights

- In the current presidential campaign, both leading candidates have taken somewhat protectionist positions on trade and have lobbied criticisms at NAFTA.
- New import tariffs on key trading partners would likely do more harm than good. They raise prices for American consumers and have knock-on effects for U.S. businesses through globalized supply chains, with little evidence that they save American jobs.
- Protectionist rhetoric is a common occurrence on the campaign trail. Once in office, leaders don't typically implement the full extent of their campaign rhetoric.
- Non-tariff barriers have been enacted in recent years, but are often contested by counterparties.

Uncertainty is always heightened during an election campaign, but in the current presidential campaign, change is a certainty. One theme that is coming across is an increase in protectionist rhetoric from both Republican and Democratic candidates. Presumptive Republican nominee, Donald Trump, has commented on enacting punitive tariffs on both Chinese and Mexican imports. Likewise, presumptive Democratic nominee, Hillary Clinton, has been critical of NAFTA and does not support the Trans Pacific Partnership. Understandably, protectionist sentiments capture the reality that trade activity has disproportionate impacts on regions within the U.S., where traditional industries have declined as a result of globalization. The main challenge of promoting freer trade is that the costs are highly concentrated (damaging job losses in certain industries in specific regions, which can devastate a region), while the welfare benefits of lower import prices are diffused, making them less directly observable or easy to explain in a soundbite.

However, there are a few reasons why it is unlikely the protectionist posturing will come to pass in its existing form under the next administration. First, trade policies like tariffs need to be enacted by Congress. It is not at all clear that Congress would go along with a protectionist agenda. Second, punitive tariffs on Chinese or Mexican imports tend to be bad for American businesses. U.S. companies have built up intricate cross-border supply chains over the years, which would be adversely impacted by an increase in tariffs or by scrapping NAFTA. That is in addition to the fact that recent analysis shows that the additional costs passed on to U.S. consumers from higher tariffs frequently does not translate into many benefits for U.S. producers. And, more often than not, another U.S. industry will be hurt by retaliatory tariffs. Finally, there are precedents for candidates talking tough on trade, and putting "America first" during election campaigns. But, once in office, don't implement the full extent of their protectionist campaign rhetoric.

However, U.S. governments can enact other non-tariff barriers that can have many of the same negative consequences as tariffs, and there a few examples in recent years, such as country of origin labelling for meat or "Buy American" provisions in government procurement. The business of America is business,

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and any trade response should bear in mind that 95% of the world population – who are potential customers – or 80% of global economic activity lie outside of its borders. Protectionist policies are like trying to put the toothpaste back in the tube – it's difficult to do, messy, and can be wasteful.

The art of the possible

It is often said that politics is the art of the possible. Perhaps nowhere is this more true than in the U.S. system of checks and balances, where the division of powers between the executive (the President) and legislative (Congress) branches make it difficult for a President to act unilaterally.

The U.S. can withdraw from NAFTA with six-months' notice. However, it is unclear whether abrogating NAFTA requires congressional approval. Previous trade agreements (CUSFTA, NAFTA and WTO agreements) have been treated as congressional-executive agreements and have been approved by a majority vote of both the Senate and the House of Representatives, and implemented into public law. This would suggest that Congress would be needed to repeal this agreement, as presumptive Republican nominee, Donald Trump, has suggested he would do. However, the law on withdrawal from congressional-executive agreements seems unsettled[1]. In part this is because there is no precedent for abrogating a trade agreement like this; they are typically superseded by a new trade agreement (like NAFTA and the CUSFTA). Since Republican members of Congress voted in favor of NAFTA (to a greater degree than Democrats), it would be out-of-step for a Republican dominated Congress to support extreme protectionist policies. Donald Trump has also threatened to impose 35% tariffs on Mexican imports, which would run afoul of NAFTA, and would certainly trigger a challenge by Mexico and retaliatory measures.

In the case of tariffs on China, under existing laws, the U.S. could (and has) impose tariffs or countervailing duties on specific categories of goods by demonstrating violations of trade rules, such as export subsidies, dumping or to temporarily "safeguard a domestic industry". The President does have the authority to apply "safeguard" measures and to withdraw them, after the International Trade Commission (a bipartisan six member independent agency) recommends that safeguards be imposed. Implementing broader tariffs requires congressional approval and unilateral tariffs on Chinese imports would be in violation of World Trade Organization (WTO) rules. So while the next President does have some authority to implement more protectionist measures, the more extreme policies suggested by the presumptive Republican nominee would be far more difficult, and likely require the cooperation of Congress.

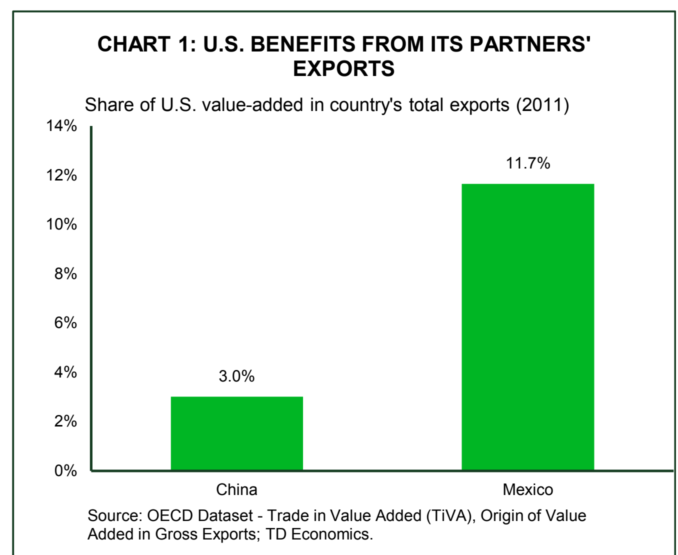
The business of America is business

In an increasingly globalized world, the supply chains of U.S. companies stretch across borders, blurring the definition of what is "Made in Mexico" or "Made in China". Many of those products contain a high degree of content that was "Made in the USA". For example, nearly 12 cents of every dollar Mexico exports is value-added by the United States (see Chart 1). Therefore, American businesses suffer as well when the flow of goods within its trading partners is hampered by tariffs.

Due to the complexities of global value chains, referring to trade deficits with certain countries as some kind of failure on the part of the U.S. economy, misses the fact that an import from China, for example, contains content from many countries. Reported trade balances are simplistic and do not adequately capture the complexity of global value chains in today's globalised economy[2].

Value-added trade data reveals these more complex economic relationships, showing for example that close to a third of exports from both China and Mexico are actually value added by other countries (see Chart 2). The implication for trade policy of all of this interconnectedness is that when U.S. trade barriers reduce demand for Mexican imports, they also hurt demand for U.S. goods and services incorporated into these products.

In fact, one study[3] estimates that due to highly shared production processes between the U.S. and Mexico, imports from Mexico actually have 40% U.S. content. That is ten times greater than the linkages to China. Tariffs on Mexican imports would heavily impact demand from U.S.



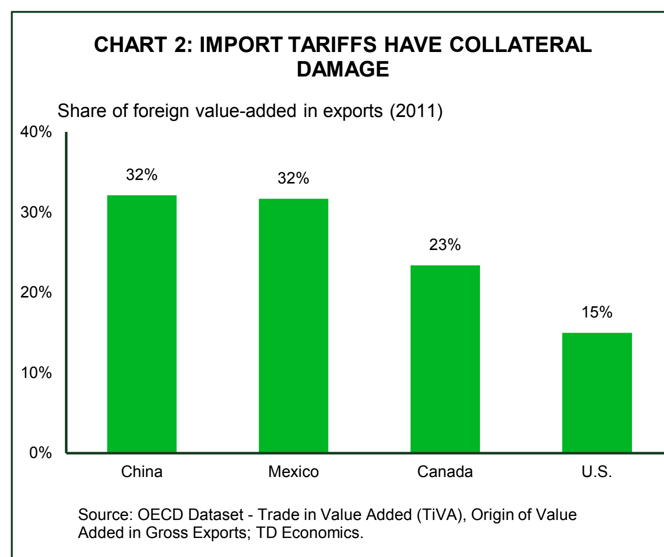
suppliers, in addition to raising prices for consumers. The biggest imports from Mexico are transportation equipment (which includes motor vehicles and parts), computers and electronic products and electrical equipment, appliances and components. Therefore, prices for many big-ticket items would increase for American consumers. Research from the National Bureau of Economic Research (Caliendo and Parro, 2012) shows that when estimating the welfare benefits of tariff reductions that occur in trade agreements like NAFTA, including estimates of supply chain linkages (or trade in intermediate goods across borders) amplifies the affects[4].

At the same time, the implementation of a tariff wall to keep out Mexican imports is unlikely to result in a substantial boon for U.S. manufacturing employment. Aside for the significant amount of U.S. value-added in these products, which would in and of itself hurt U.S. industry and jobs, the repatriation of the work currently done in Mexico would result in only a limited number of jobs returning to the U.S. Given the higher productivity of U.S. workers, it would take comparatively fewer additional U.S. jobs to compensate for the reduced Mexican imports, as firms substituted capital for labor – with the latter being more expensive in the U.S. In fact, a back-of-the-envelope calculation suggests that U.S. auto workers are about 3.5 times as productive as their Mexican counterparts, implying that reshoring of 10,000 Mexican auto sector jobs would result in a more subdued increase in U.S manufacturing payrolls – to the tune of 3,000. Moreover, any gains would have to be netted out by job losses resulting from reduced exports to Mexico, partly related to the significant U.S. value-added content in these products. Lastly, reshoring of some lower value-added production processes, currently performed in Mexico, would likely lower U.S. labor productivity and could put downward pressure on U.S. manufacturing wages in the longer run.

In the case of China, the United States is the second most important source of value added after Japan. These interconnections show that implementing tariffs have negative blowbacks to U.S. businesses apart from any retaliatory tariffs that might be levied. As will be discussed in an example in the next section, countries frequently retaliate against import tariffs. In the case of China, the U.S.'s biggest export categories to China are transportation equipment, computers and electronic products, agricultural products and chemicals – industries that would see significant impacts if they are targeted by retaliatory tariffs levied by China.

How tariffs rob Peter to pay Paul

A couple of recent examples of import tariffs on Chinese goods show how tariffs can raise prices for consumers, have consequences for American businesses in unrelated industries, and produce little benefits for U.S. producers. One such example was in 2009, when President Obama imposed tariffs on Chinese-made tires in response to accusations of dumping (tariffs were for 3 years, 35%, 30%, 25%, in consecutive years). Analysis by The Peterson Institute[5] showed that these tariffs came at a high cost to the pocket book of American consumers.



Source: OECD Dataset - Trade in Value Added (TiVA), Origin of Value Added in Gross Exports; TD Economics.

They estimated that the total cost to consumers for higher tire prices was around $1.1 billion in 2011. From September 2009 to September 2011, tire manufacturing employment rose by 1,200 jobs. Under the generous assumption that all of the increase was due to the tariff – which is highly unlikely given the U.S. economy was in the midst of a cyclical upswing – these jobs came at a cost of at least $900,000 per worker in 2011. The cost of protection generally exceeds by a wide margin a reasonable estimate of what a jobs program for displaced workers might cost.

As a result of the tariff, Chinese tire imports fell, but imports from other countries rose. In other words, overall tire imports did not fall. Substitution towards higher-cost suppliers occurred to exporters in Thailand, Indonesia, and Mexico. This means that the bulk of higher prices accrued to foreign tire manufacturers, rather than U.S. producers. And, higher prices for tires meant American consumers had less money to spend on other goods, at an estimate of a net loss of 2,531 jobs in other sectors. Furthermore, China retaliated with tariffs of 50.3% to 105.4% on American poultry imports, which reduced U.S. exports to China by $1 billion.

Another study attempted to control for the cyclical upswing in the economy over the time the special safeguard on

Chinese tires was imposed. It found that total employment in the sector and average wages in the U.S. tire industry showed no different trend from a modelled counterfactual scenario without import tariffs. This result is primarily due to the result that the drop in Chinese tire imports were completely offset by imports from other countries – import diversion – leaving scant gains for domestic producers[6].

In another more anecdotal example, in 2012, the U.S. imposed anti-dumping duties of up to 78% on Chinese solar panels after German-owned SolarWorld AG complained that below-cost Chinese imports were hurting its U.S. production. China responded with 57% duties against U.S. producers of polycrystalline silicon, the raw material for photovoltaic cells. This hurt an industry that was expanding fast to meet demand from Chinese solar panel makers. A $1.5 billion investment in a new polysilicon plant was abandoned in 2014 by Dow Corning.

All of these factors, supply chain linkages, potentially higher costs to American consumers with little net benefit to domestic producers, and knock-on impacts to other U.S. sectors from retaliatory tariffs are all reasons why it is not a clear cut case that punitive tariffs against key trading partners would benefit Americans. At the very least, it can be said that any benefits that accrue to one segment of the economy carry costs to another, and this trade-off needs to be understood in advance on any action.

Risk of protectionism via non-tariff barriers

Even though the presumptive Democratic nominee, Hillary Clinton, has not supported the more extreme protectionist measures of Donald Trump, she has been critical of NAFTA and does not support the TPP. Therefore, both leading candidates have a protectionist bent in the campaign, and could still enact anti-trade policies even if they are not as extreme as 35% or 45% tariffs.

Despite the economic arguments against tariffs, countries frequently enact rules or non-tariff barriers that hurt a country's trading partners. Even in a free trade zone like NAFTA. Recent examples include "Buy American" legislation in government procurement and country of origin labelling (COOL) in the meat industry. Canada and Mexico ultimately won a challenge against the COOL requirements, but the WTO ruled that the damage to Canada's meat industry amounted to $1 billion annually, while the rules were in place from 2009 to 2015. The risk and economic damage to other countries via non-tariff measures cannot be dismissed or underestimated. However, this is also why any unlawful action on the part of the U.S. would lead to lengthy and costly periods of litigation through counterparty challenges, and potentially risk retaliatory responses.

Posturing, not policy

Finally, there is precedent for Presidential candidates to talk about "putting America first" during election campaigns, but once elected govern from a more even-handed stance. One recent precedent is under President Obama, who also made many anti-NAFTA statements during the 2008 election. Once elected, the President became a supporter of the Trans-Pacific Partnership agreement. This is because U.S. exports of services have been growing at an average of about 8% over the last ten years, and the greater market access enabled by the TPP is to the U.S.'s advantage (see TD's report on the TPP). As American business leaders have pointed out, 95% of the world's population and 80% of its economic activity is outside of the United States, and American business have more opportunities to grow in a world where trade deals try to level the playing field and safeguard market access for American firms.

The Bottom line

The U.S. is less exposed to international trade than other countries, but it is still a globalized economy that would experience many undesirable consequences from increases in the types of import tariffs proposed by the presumptive Republican nominee. They would lead to higher prices for many consumer goods, while import substitution to suppliers in other countries often leaves few benefits for U.S. producers. Furthermore, interconnected global supply chains mean that demand for many U.S. suppliers would be directly affected. Last but not least, countries are likely to initiate retaliatory tariffs, which would impact many U.S. exporters. That, combined with the likelihood of needing congressional approval to abrogate NAFTA or imposing new tariffs, makes implementing these extreme policies much more complex than a simple strike of the pen. That said, there are many non-tariff barriers the U.S. can put in place outside of large tariffs or scrapping existing trade agreements that can have damaging consequences for its trading partners. However, here too, anything deemed unlawful by the targeted country would surely elicit a legal or retaliatory response.

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ENDNOTES

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