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# Economic Impacts of Trade: Perceptions and Perspectives

**Timothy G. Taylor, Professor, University of Florida;**  
**Gary F. Fairchild, Professor, University of Florida;**  
**Harold M. Harris, Jr., Extension Agricultural Economist, Clemson University**

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## Introduction

World trade has increased steadily, and somewhat invisibly, over the past fifty years, spurred by global policy actions, such as the Bretton Woods Accord (1944) and the General Agreement on Trade and Tariffs (GATT). The U.S. has been, and continues to be, a major factor in international trade. With a 1994 Gross Domestic Product (GDP) of \$6.378 trillion and a per capita GDP of \$25,800, the largest among major industrial nations, the U.S. represents a major market for both domestic and foreign producers of goods and services. In spite of its importance in international commerce, trade is still dwarfed by the size of the domestic economy. In 1994, U.S. exports totaled \$482.2 billion (7.2% of GDP) while U.S. imports totaled \$657.9 billion (9.8% of GDP).

Major export commodities include: capital goods, automobiles, industrial supplies and raw materials, consumer goods, and agricultural products. While agriculture accounts for 2% of U.S. GDP and 2.8% of the labor force, it represents 9.5% of total exports (\$45.7 billion), 4.1% of total imports (\$26.8 billion), and generated a \$18.9 billion trade surplus in 1993 (U.S. Department of Agriculture).

International trade in general, and agricultural trade in particular, contributes to the economy in a number of ways, including employment and economic activity. Estimated trade-impact multipliers indicate that, in 1992, one million dollars of agricultural exports required 21 workers, and each dollar of agricultural export sales generated an additional \$1.44 of economic activity in the U.S. economy. Thus, in 1992 agricultural exports required the employment of 902,000 workers and generated \$104.6 billion in business activity in the U.S. economy (Schluter and Edmondson). Although exports are generally credited with contributions to the economy, imports also generate jobs and create economic activity. Leading imports include: crude oil and refined petroleum products, machinery, automobiles, consumer goods, industrial raw materials, and food and beverages (U.S. Department of Commerce).

In spite of the contributions of international trade to economic activity and employment, some still believe that the U.S. should not participate in an open international trading system. Calls for increased economic isolationism can still be heard in some quarters. But, reverting to a closed economy is not economically rational in today's global marketplace. The notion of "made in America" has become a myth, with "assembled in" becoming a more appropriate term (Reich). However, awareness of international trade has increased significantly with the recent negotiation

and subsequent ratification of the North American Free Trade Agreement (NAFTA) and the Uruguay Round of the GATT (GATT-UR). Questions about the economic impacts of liberalized trade on the U.S. economy have caused debate among Americans, concerning America's ability to compete in international markets and the apparent loss of U.S. jobs to developing countries in Asia and Latin America.

The strength of these concerns has been somewhat surprising. Both NAFTA and GATT-UR liberalize international trade and further level the international playing field. Economic theory supports the notion of gains from trade and is generally consistent with the post-war policies pursued by Western industrialized nations, newly industrialized Asian countries, and more recently, many Latin American countries. However, significant public opposition to these agreements has materialized among the general public. Indeed, ratification of both NAFTA and GATT-UR by the U.S. was in doubt until the last moment.

If trade liberalization is so desirable, why do so many groups and individuals oppose agreements such as NAFTA and GATT? There are, of course, many possible explanations. Trade policies are a mix of economics and politics, and much of the public information about the potential impacts of these policies comes through news media, which tends to focus on the negative side of issues. Therefore, the complexities surrounding the economic impacts of trade are often improperly perceived, or viewed from a rather narrow perspective.

The purpose of this leaflet is to examine the economic impacts of trade by focusing on three issues that have formed the basis for much of the public concern. First, is the question of "Why is there international trade?" The standard response to this question has long been "Because of comparative advantage." But the concept of comparative advantage is difficult to understand, even for students of economics. The second issue is jobs. Income is an economic concept, jobs are political. So jobs have been the single most visible issue concerning the impacts of liberalized trade. However, much opposition to liberalized trade on the basis of saving jobs has been viewed from an individual perspective rather than from the whole economy. The final issue is the belief that the U.S. is losing its industrial base to foreign competitors. This, perhaps more than any of the issues considered here, is a misperception, as discussed later.

## **Why There is International Trade**

By its very name, international trade is perceived as something different than merely doing business with firms in other countries. Discussions in the media about trade policies, or attempts to settle trade disputes, cause international trade to be perceived as us versus them, where one country gains only if another country loses. In fact, even though some of the rules for business conduct are more complex, international trade is not fundamentally different from the inter-regional trade among states in the U.S. Perceptions about international trade persist, partly because the losses from trade are concentrated and often highly publicized, while the gains from trade are less visible and are spread broadly, going virtually unnoticed. Such perceptions also persist because economists have not done a particularly good job of explaining why international trade exists, and what benefits it conveys.

Virtually any textbook on international trade contains a chapter entitled "Why Nations Trade." There is a discussion of comparative advantage using a two-country, two-commodity example, showing that both countries would be better off with free trade, even if one of the countries could produce both commodities at lower cost. This forms the basic foundation of the traditional theory of trade and the free trade philosophy shared by many in the economics profession. However, from the perspective of the individual consumer or business person, the concept of comparative advantage and general statements concerning "gains from trade" lack an experiential basis. As such, endorsing liberalized trade requires a leap of faith, which many individual consumers or business managers seem unwilling to take.

There is an alternative way to understand why there is international trade and what benefits it brings. With the exception of country-level commodity trade boards, nations do not engage in international trade, but rather the individual consumers and businesses within nations trade. When an individual in the U.S. buys a Japanese-manufactured stereo component, he or she has engaged in international trade. This participation occurs indirectly through the power of consumer preferences and the competitive pressure faced by the retailers to satisfy them. When a manufacturing firm buys some of its inputs from foreign sources, it also engages in international trade. So understanding the benefits of trade actually requires understanding why individual consumers or firms choose to purchase foreign, rather than domestically-produced, products.

Over two hundred years ago, Adam Smith in **An Inquiry Into the Nature and Causes of the Wealth of Nations**, argued that competition in combination with individuals freely pursuing their own self interest (i.e. the profit motive for businesses and the pursuit of satisfaction by consumers) would result in the efficient use of economic resources, allowing society as a whole to achieve its highest standard of living "as if guided by an Invisible Hand." Of course, unfettered competition has its drawbacks. There are activities for which markets do not or cannot easily exist, and for which the true costs to society cannot be properly accounted. Moreover, the resulting distribution of income may be judged as being unfair and requiring some redistribution. However, despite these shortcomings, the power of competition and individual choice are the core of American economic philosophy and the primary forces that have enabled U.S. citizens to achieve a high standard of living. Competition and individual choice are also why there is international trade.

To understand why this is so, first, consider choice from the perspective of the individual consumer. With rare exceptions (e.g. the very wealthy), all individuals are faced with incomes that constrain the amount of material goods and services they are able to purchase. To satisfy their individual preferences and wants, consumers attempt to obtain the products they want most, at the best price. When purchasing a television, or some other consumer durable, attention is primarily given to product quality, reliability, and price, not where the product was made. When purchasing clothing, characteristics, such as fit, style, perhaps the designer's or manufacturer's name, and of course price, are much more important than where the product was made. And if consumers want cantaloupe in December, they are more interested in its taste and price than in where it was grown.

Evidence supporting the minor role that country of origin plays in purchase decisions abounds. While brand names and prices are prominently displayed in any retail store, one is not likely to

see information on country of origin prominently displayed. The reason for this is simply that retailers provide consumers with the information they want in making purchase decisions, and this information does not generally include country of origin. Yet when decisions based on such information are made, and the goods or services purchased are foreign-made, consumers have participated in international trade.

Even if consumers wished to buy American, it would be difficult to accomplish. An RCA television is likely to have been manufactured in an Asian country. A Levi's Dockers shirt is probably manufactured in China or the Dominican Republic. Even purchasing something as American as a Pontiac Le Mans is not what it seems.

"Of the \$10,000 paid to GM, about \$3,000 goes to South Korea for routine labor and assembly operations, \$1,850 to Japan for advanced components, \$700 to Germany for styling and design engineering, \$400 to Taiwan, Singapore and Japan for small components, \$250 to Britain for advertising and marketing, and about \$50 to Ireland and Barbados for data processing. The rest - - less that \$4,000 - - goes to strategists in Detroit, lawyers and bankers in New York, lobbyists in Washington, insurance and health care workers all over the country and to General Motors stockholders all over the world." (Reich).

This example also explains why there is trade from the perspective of producers. Faced with the realities of the market place, and the consumer's demand for quality at the lowest price, the competitive pressures of rival firms force businesses to pursue cost-efficient business strategies. While such strategies entail many facets of production engineering and management organization, they also entail obtaining factors of production and other business-and marketing-related services at the lowest possible cost. When assembly by, or materials from, foreign firms or subsidiaries are cheaper, businesses have no choice but to pursue these lower-cost opportunities. Competition from rival firms, domestic and foreign, make such decisions mandatory for businesses if they are to satisfy the demands of the market place and survive.

## **The Fallacy of Lost Jobs**

Few issues have commanded more media attention, or created more debate, than the impact of international trade on American jobs. At the heart of this debate is the perception that liberalizing trade with developing countries, such as Mexico, Central America, or Asia leads to the loss of American jobs, particularly in labor-intensive industries, such as clothing, manufacturing assembly, and labor-intensive agricultural products such as fresh fruits and vegetables. To a certain extent, the perceptions that jobs in certain industries are likely to be eliminated because of trade liberalization are true. However, these perceptions fail to distinguish between the general level of employment in the economy and employment in specific industries. Growing out of these incomplete perceptions is the "lost jobs fallacy" of international trade.

Protective trade measures, such as tariffs, quotas, or voluntary export restraints (VERs), designed to protect domestic jobs, are not without cost. Kreinin estimated that the VER placed on Japanese automobiles in 1982 saved approximately 22,000 jobs in the U.S. with an average salary of \$30,000. However, the cost to U.S. taxpayers for each job saved was estimated to be

\$180,000. Thus, there was an actual social cost (net or deadweight loss) to the U.S. economy of roughly \$150,000 per job saved.

Two important points need to be made. First, because there is an additional transfer of resources from the rest of the U.S. economy to a particular industry in order to save specific jobs, there will be fewer jobs created in other sectors, and perhaps even some jobs eliminated. Second, from a government policy perspective, even if the automobile industry was not protected, up to \$150,000 per worker could be spent on job search and retraining before reaching the cost of job protection. If such retraining and relocation could be done for less, a net economic gain would be realized relative to the cost of protection.

Protection also implies less trade, therefore less exports and fewer jobs in the export sector. Expanded exports create jobs. As noted, considerable emphasis is given to the apparent negative employment effects resulting from increased foreign competition under trade liberalization. However, though trade liberalization leads to increases in imports in certain sectors of the economy, it leads to increases in exports in other areas. Again, these increases in exports create jobs.

U.S. employment in export-related activities is significant. There were 7.2 million export-related jobs in the U.S., accounting for about 7% of the total work force in 1990. Within the manufacturing sector, 17% of total employment is related to export activities and these jobs earn approximately 17% more than similar nonexport-related activities (Aguilar). Comparable figures are available for the agricultural sector, indicating that every \$1 million of agricultural exports (in raw and processed form) generates 21 jobs (Schluter and Edmondson).

There are two key elements of the "lost jobs fallacy." The first suggests that liberalized trade leads to a loss of domestic jobs. In fact, the exact opposite can be true. Trade liberalization can lead to increased domestic employment. It is important to distinguish between the loss of specific jobs and the general level of employment. Trade liberalization can result in the elimination of jobs in specific sectors of the economy, as those who are potentially affected will quickly point out. In the short run, it is possible that job losses in labor-intensive sectors may not be offset by gains in capital-intensive sectors, thus creating increased structural unemployment. However, those who lose their jobs will find employment elsewhere; if they so desire, and if they are willing to re-train.

The second element is the belief that jobs can be saved through government protection. Governments can save specific jobs, however, the cost of doing so can be substantial. As the previous example demonstrated, the cost of a job saved may be many times the income it earns. This net loss to the economy may prevent the creation of employment and possibly lead to the elimination of other jobs.

## **The Perception of America's Lost Industrial Competitiveness**

The U.S. has long viewed itself as the world's leading industrial nation. The cultural and historical roots of this perception stem from the captains of industry with names, such as Carnegie, Ford, and Rockefeller, and the war machine created by the outbreak of World War II.

However, as issues involving international trade and competitiveness have moved to the forefront of public debate, concerns over America's ability to compete in the international market place and fears of a decline in the country's industrial base have surfaced. Indeed, some leaders have warned of a future of hamburger flipping and sweeping floors in foreign-owned manufacturing plants, and President Clinton's administration has advocated the need for an industrial policy to ensure key U.S. industries remain competitive.

As a trip to any shopping mall demonstrates, a vast number of consumer products carry foreign names, such as Mitsubishi, Sony, or Panasonic, or microscopic print notes that it was made in some Asian or Latin American country. And even when a product carries an American brand name, such as RCA or Levi's, it is still often manufactured in a foreign county. So the apparent loss of America's industrial base takes on considerable credibility. However, as is the case with the fallacy of lost jobs, the issue of America's lost industrial base is a matter of perception rather than reality.

Recent data clearly demonstrate that the perception of America losing its industrial base is incorrect (Lindsey). During the 1960s, the U.S. was considered by most to be the industrial giant of the world. At this time, manufacturing accounted for about 22% of real gross domestic product (GDP), with the majority of this output in defense and consumer related products. Capital goods -- items used to produce other goods and services, such as airplanes and industrial machinery -- accounted for roughly 28% of GDP. Moreover, only 20% of capital goods were exported, amounting to 1.4% of GDP.

Currently, and amid concerns about America losing its industrial base, manufacturing output has increased to 23% of real GDP. More importantly, capital goods now account for 38% of manufacturing output, and the proportion of capital goods exported has increased to 45%, amounting to about 4% of GDP.

Clearly, the U.S. is not losing its industrial base to foreign competition through liberalized trade. The converse is true. America is strengthening its industrial base as a result of liberalized trade. What has changed is the composition of the manufacturing sector's output. The manufacturing share of U.S. consumer goods has declined, being supplanted by capital goods.

Commensurate with this change in manufacturing output, the industrial base of the U.S. has become less visible. People tend to believe what they see. That people perceive a decline in the industrial base of the U.S., based on the goods they buy, is understandable, but in this case is more than meets the eye. The BASF Corporation slogan is: "We don't make the products you buy, we make the products you buy better." A similar slogan for the U.S. manufacturing sector might be: "We don't make the products you buy, we manufacture the parts and machines that make and assemble the products you buy." In terms of comparative advantage, the U.S. appears to have an advantage in the production of intermediate goods and capital goods relative to some labor-intensive consumer goods.

## **Conclusion**

The U.S. is fortunate in that its climate, natural resource endowments, and technological knowledge potentially enable it to produce all of the products needed without trade. However, without trade, it is doubtful the U.S. would enjoy the standard of living it does. From a regional perspective, maple trees could be grown to produce maple syrup in Florida, and orange trees could be grown in Vermont to produce orange juice. Floridians would pay a lot more for maple syrup and the citizens of Vermont for orange juice. However, the fact is that Florida is better at producing orange juice and Vermont is better at producing maple syrup, and by doing what each does best, the producer, the consumer, and the economy benefits from more efficient utilization of resources and lower prices.

International trade enables countries to specialize in what they do best and acquire the things they have difficulty in producing. By so doing, resources are more efficiently used on a global, as well as a domestic basis, and these efficiencies are passed on in the form of lower prices and economic growth.

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