FREE TRADE FACTS

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The Case for Free Trade

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Introduction

One of the simplest and most powerful principles in economics is that both sides gain from trade. When we observe people trading, we know that each of them expects to get more than what he gives up. Otherwise, they would not trade. Of course, people can be disappointed if they find out they did not get what they wanted, but the fact that people make numerous exchanges daily means that, even if they sometimes experience disappointment, they see themselves as gaining from trade overall. This principle applies whether trading is within a city or state, across state lines, or across national borders.

The Main Driver of Trade: Relative Costs

People benefit when they specialize in producing goods or services for which they are the lowest cost producers, sell these outputs, and then use the proceeds from these sales to buy goods and services from others who have a cost advantage at producing other desirable outputs.

Two obvious examples are coffee and bananas. Except for a small amount of coffee produced in Hawaii, there is no US coffee production, as our climate is unsuited for it. We could import the right kind of soil and then grow coffee in expensive hot houses, but that would not be very economical. Banana production faces a similar climate constraint that could similarly be overcome with the use of hot houses. To say that we should not produce coffee or bananas is to state the obvious.

The principle does not change when we consider production of other items that we could produce at less obvious cost disadvantages. For example, we import softwood lumber

from Canada because it is somewhat cheaper than producing it in the United States. For small differences in cost, our gains from trade are less substantial than when the cost differences are large, but the gains are nevertheless positive.

The more we specialize in producing goods and services for which we have a cost advantage and in buying items for which we have a cost disadvantage, the better off we will be. While we buy products like strollers, car seats, and clothing from people in other countries, US manufacturers sell sophisticated airplane parts to people in various countries around the world.

As is often true, Adam Smith, in his 1776 classic *An Inquiry into the Nature and Causes of the Wealth of Nations*, says it best:

> What is prudence in the conduct of every private family can scarce be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry employed in a way in which we have some advantage.[1]

Two Other Important Drivers of Trade: Quality and Variety

Although cost differences are the main factor affecting trade patterns, two other important drivers of trade are quality differences and variety.

One of the best examples of quality differences is from the automobile industry. Japanese producers started shipping substantial numbers of cars to the United States in the early 1970s. However, those cars were not clearly more durable or better performing than US-built cars. That began to change in a major way in the early to mid-1980s. Japanese cars started to last longer and became more reliable, so Americans had the choice of higher-quality cars. That competition from Japan helped create a cycle of improvement: US producers raised their quality, Japanese producers raised theirs, US producers responded, and so on. So now, the worst US car is substantially better than the best mid-1980s Japanese car.

Variety is also an important driver of trade. For example, although I am not a wine or brandy connoisseur, many people are, and the varieties of wine, brandy, and other alcohols produced in other countries enhance the drinking pleasure of millions of Americans.

Why It Matters: A Key to US Prosperity

Specialization, as Adam Smith pointed out, is the key to making people more productive and raising standards of living. Americans start with a huge advantage over almost all other countries: We are large, not just in land but—more important—in population. We have a huge free-trade area that rivals the European Union. That area is called the United States. For that reason, even if our government literally banned trade with other countries, the extensive specialization we have would still give us a fairly high standard of living. We would be without coffee, bananas, and many other low-cost goods, but we would still manage fairly well.

However, why settle? We can do (and have done) better through more extensive specialization. That comes about due to low or zero trade barriers. This matters particularly for lower- and middle-income workers and especially for essential items like clothing. One way to see this is to go to a Goodwill store. You will often find clothing that is

1 Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, eds. R. H. Campbell et al., vol. 1, bk. 4, *Lectures on Rhetoric and Belles Lettres* (London, 1776; repr., Liberty Fund, 1981), 457.

much higher quality than a Goodwill store had 30 years ago. Why? Because opening the clothing market to freer trade brought down clothing prices considerably so that people who buy the new clothing can also unload their old clothing to charity. Every clothing buyer—and we are all buyers—gains from those lower prices.

Access to global supply chains has lowered costs, spurred innovation, and increased quality. Due to the North American Free Trade Agreement and its successor, the United States–Mexico–Canada Agreement, for example, our auto industry has been beautifully integrated within North America,[2] with parts and semi-finished cars and light trucks moving across the borders of the three countries. One benefit has been a large increase in US auto workers' wages.

As a bonus, specializing has created a dynamic export sector that employs millions of highly productive people who are paid handsomely for that productivity.

Debunking the Myth: Real Wages and Middle-Class Decline

We often hear that American families are worse off today than they were—pick a number—10, 20, or 40 years ago. *That is false*. Relatedly, we hear that the middle class is disappearing. This claim is misleading to the point of being effectively false.

The Federal Reserve Bank of St. Louis tracks median household income, and its data goes back to 1984. In 1984, median household income was $58,930. It peaked in 2019, due in part to the growth-enhancing 2017 tax cut, at $81,210. It then fell and then rose. In 2023, the latest year for which we have good data, median family income was $80,610.[3] (All these incomes are measured in 2023 dollars.) That means that the median household income in 2023 was 37 percent higher than it was in 1984. Moreover, that increase understates the real increase, for two reasons. First, the St. Louis Federal Reserve Bank uses the Consumer Price Index[4] to adjust for inflation. The index systematically overstates inflation. A better measure is the Personal Consumption Expenditures Price Index.[5] Using this index leads to the conclusion that between 1984 and 2023, median household income rose by a whopping 61.1 percent, which is more than 1.2 percent annually, compounded.

The second factor that biases the estimated growth of income downward is the size of the household. In 1984, the average US household had 2.71 people. This number decreased to 2.51 in 2013, a drop of 7.3 percent.[6] That might sound small, but it means that the median household income per person actually rose by 74 percent.

That brings us to the middle class. It is disappearing—but *upward*. Economist Mark Perry of the American Enterprise Institute noted that in 1967, 54.6 percent of US households were middle income. The "middle" was defined as households with income between $35,000 and $100,000 in 2022 dollars. In 1967, only 13.1 percent of households were high income, where "high" meant more than $100,000 in 2022 dollars. By 2022, only 39.1 percent of households were middle income, but the percentage in the high-income category had risen to 37.5 percent, almost three times the percentage in 1967.[7] Simply put, households moved from the middle-income bracket to the high-income bracket.

2 Jeffrey J. Schott, "NAFTA and Autos," Peterson Institute for International Economics, February 17, 2006, https://www.piie.com/commentary/testimonies/nafta-and-autos.
3 "Real Median Household Income in the United States," Federal Reserve Bank of St. Louis, updated September 11, 2024, https://fred.stlouisfed.org/series/MEHOINUSA672N.
4 "Consumer Price Index," US Bureau of Labor Statistics, accessed June 5, 2025, https://www.bls.gov/cpi/.
5 "Personal Consumption Expenditures: Chain-Type Price Index," Federal Reserve Bank of St. Louis, updated June 27, 2025, https://fred.stlouisfed.org/series/PCEPI.
6 Veera Korhonen, "Average Number of People per Household in the United States from 1960 to 2023," Statista, July 5, 2024, https://www.statista.com/statistics/183648/average-size-of-households-in-the-us/.
7 Mark J. Perry (@Mark_J_Perry), "Today's Census Bureau report confirms that America's middle class is 'disappearing,' but it's because they have been moving up into higher-income groups. The share of US households making $100K+ (real $$$) has increased ~3X since 1967," X, September 12, 2023, https://x.com/Mark_J_Perry/status/1701763841342800248?s=20.

Additionally, the quality of almost everything has improved, from medical care to cars to electronics. Although most of the increase is due to better technology, a substantial amount is due to relatively free trade. The main areas in which things have stagnated or gotten worse are services run by the government, with government schools as exhibit A.

Protectionism Hurts

What economists have been saying for centuries about the effect of protectionism on consumers has become apparent to almost everyone. Taxes on imports raise the cost to consumers.

Two other negative effects of tariffs are more subtle but still important, nevertheless. One is that tariffs on inputs to production raise production costs and function as a tax on capital investment. This is particularly important for the United States and disproportionately hurts American manufacturers. As Dartmouth College trade economist Douglas Irwin has noted,

> Over half of all US imports are either intermediate components or raw materials. These imports are sold as inputs to domestic businesses rather than as goods consumed directly by households.[8]

One striking example is the auto industry, which is subject to tariffs on two key inputs: steel and aluminum. The average car contains 362 pounds of aluminum; the average light truck contains 523 pounds.

Note the irony. Many advocates of tariffs want them so that the United States will increase manufacturing. *But many inputs into manufacturing are subject to large tariffs*. The other subtle effect of tariffs is on exporters. To the extent that tariffs reduce imports, people in other countries have fewer dollars with which to buy US exports. That one factor explains much of farmers' support for free trade. Agriculture is one of our most successful export industries.

What About Trade Deficits?

I spend more on Safeway grocery products than Safeway spends on hiring people to write economics articles. Similarly, Americans spend more on goods from Canada than Canadians spend on US exports. In a world of specialization, it would be an incredible coincidence if we spent the same amount.

It is true that Americans also spend more on goods and services from other countries than people from other countries spend on our goods and services. We have a trade surplus in services that is more than offset by a trade deficit in goods. Does this matter? No. When people in other countries get those dollars, they do not just hold on to them. It would be good if they did, by the way. The cost of printing a $100 bill is just under 10 cents. What a deal for us!

The vast majority of the money comes back in investments. Foreigners' purchases of federal government bonds allow the US Treasury to pay slightly lower interest rates than it would otherwise. Additionally, foreigners invest in US companies and land and sometimes build capital projects from scratch. Americans gain from all of this. For example, data from the US Bureau of Economic Analysis show that the value of foreign direct investment (FDI) in American manufacturing reached a record $2.2 trillion in 2023,[9] while 22 percent of new manufacturing jobs are facilitated by FDI.[10] As I wrote in April 2025,

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8 Douglas Irwin, quoted in Mark J. Perry, "Nearly All Imports, Even Consumer Goods, Are Inputs for US Firms, Retailers and Factories," American Enterprise Institute, August 19, 2016, https://www.aei.org/carpe-diem/nearly-all-imports-even-consumer-goods-are-inputs-for-us-firms-and-factories/.

9 US Bureau of Economic Analysis, "Direct Investment by Country and Industry, 2023," news release, July 23, 2024, https://www.bea.gov/news/2024/direct-investment-country-and-industry-2023.

10 "States Leading America's FDI Manufacturing Workforce," Global Business Alliance, January 27, 2025, https://globalbusiness.org/states-leading-americas-fdi-manufacturing-workforce-2/?utm_source=chatgpt.com.

We have had annual trade deficits every year since 1976. That's almost half a century. Yet over that time, the average net worth of a US household rose from $364,893 in 1975 to $1,212,974 in the fourth quarter of 2024, all in 2024 dollars.[11]

Conclusion

Since World War II, the whole world has moved in fits and starts toward freer trade. In 1934, the average world tariff rate hit a peak of 22 percent. With various trade negotiations, that average had fallen to 4 percent by 1999.[12] That is incredible progress. Let us not throw it away.

11 David R. Henderson, "Clearing the Air on Tariffs and Trade Deficits," Hoover Institution, April 24, 2025, https://www.hoover.org/research/clearing-air-tariffs-and-trade-deficits.
12 David R. Henderson, "The Benefits of Free Trade Are at Risk," Hoover Institution, February 20, 2025, https://www.hoover.org/research/benefits-free-trade-are-risk.