CBO TESTIMONY

Statement of
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on the
Domestic Costs of Sanctions
on Foreign Commerce

before the
Subcommittee on Trade
Committee on Ways and Means
U.S. House of Representatives

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NOTICE

This statement is not available for public release until it is delivered at 11:00 a.m. (EDT), Thursday, May 27, 1999.

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Mr. Chairman and Members of the Subcommittee, I am pleased to appear here today to report on a study that the Congressional Budget Office (CBO) recently released titled *The Domestic Costs of Sanctions on Foreign Commerce*. The focus of CBO's research was the total cost to the U.S. economy of imposing sanctions on other countries. That total cost nets out losses and gains for different groups.

The cost to the United States, large or small, of imposing sanctions says nothing about the cost to the target country, the effectiveness of sanctions in deterring objectionable behavior, or other benefits of such action. CBO's research—and this testimony—do not address questions of effectiveness. However, such information, along with details about the relative costs and benefits of all policy options open to the United States (economic, diplomatic, and military), would be relevant to any decision to impose sanctions.

Not all actions by the U.S. government that call for restricting foreign commerce actually add new restrictions. For actions that do, CBO concludes, the sanctions may have costs for the overall U.S. economy—but those costs are likely to be very small. One reason is that the common targets of U.S. sanctions are developing economies that individually account for very little U.S. trade.

Several other factors play a role in determining the national costs of individual sanctions.

- o Unilateral sanctions (imposed by the United States alone) generally result in a smaller cost to the U.S. economy than multilateral sanctions (in which other nations join the United States), because unilateral actions are less effective in restricting economic activity.

- o Sanctions that narrowly apply to imported goods for which substitute sources of supply exist or to exported goods for which substitute outlets exist, generally create a smaller cost than sanctions on goods without substitution opportunities.

- o Sanctions that restrict foreign aid or export-promotion programs generally result in a smaller cost than sanctions that restrict open commerce. Because those types of government support can distort trade, sanctions that restrict them may even produce small economic gains.

CONCERNS ABOUT SANCTIONS

Broadly, the term "sanctions" refers to actions that the government takes to restrict the flow of goods, services, or capital between the United States and another country in order to promote particular foreign policies or enhance national security. The ultimate goal of sanctions is to deter objectionable actions by raising the costs of

those actions to other countries. But government restrictions on foreign commerce can also impose costs on U.S. businesses and consumers.

Political interest in the domestic costs of sanctions appears to be growing, fueled by at least two concerns. First, the individual groups of consumers, workers, and business owners who bear the direct costs of U.S. sanctions often do not receive direct compensation for their losses. Other sectors of the economy may gain from changes in trade patterns produced by sanctions, but that fact is of little consolation to the losers. Second, although sanctions have only a small economic impact today, they could become more costly for the United States over time if their use expanded or if they kept U.S. businesses out of fast-growing markets—especially markets in which U.S. businesses would otherwise have a competitive advantage. In addition, they might harm the United States' relationships with important trading partners that were not the direct targets of sanctions.

Last year, the Congressional Research Service identified more than 190 provisions of U.S. law that potentially restrict some aspect of foreign commerce for foreign policy reasons. Of those provisions, 102 pertain to restrictions on government foreign aid and trade-promotion programs, including 26 on defense-related aid. Another 49 pertain to restrictions on commercial exports, including 26 on defense-related sales. Those statutes place the most restrictions on commerce with seven countries: Cuba, Iran, Iraq, Libya, North Korea, Sudan, and Yugoslavia.

Assessing the amount of trade that federal statutes affect is difficult for a number of reasons. First, considerable redundancies, such as multiple laws that call for the same restrictions, exist in sanctions policies. Second, limits on U.S. aid to one country may simply make more funds available for other countries. Third, many statutes provide for Presidential delays in enforcement. And fourth, sanctions may be coupled with other government actions that soften their domestic impact. Analyzing the effect of sanctions is further complicated by the fact that the domestic policies of the target countries play a large role in limiting their ability to trade competitively.

COSTS TO THE OVERALL U.S. ECONOMY

To date, sanctions on foreign commerce have had only a small combined impact on the overall U.S. economy. A 1997 study by Gary Hufbauer and others at the Institute for International Economics looked at the effects of all current sanctions. It estimated that sanctions cost the United States about $1 billion in national income and as much as $19 billion in merchandise exports each year. Those figures may seem large, but they are quite small compared with total national income of nearly $7 trillion in 1998 and total merchandise exports of nearly $700 billion—figures that indicate the high potential for replacing currently sanctioned trade.

Those estimates, however, do not preclude the possibility that sanctions will pose a greater threat to the U.S. economy in the future. To estimate the domestic cost of future sanctions, CBO used the results of the Hufbauer study as well as several studies of the benefits produced by lowering barriers to trade. (In general, the benefits from opening trade would be symmetrical with the costs of closing it.) On the basis of those studies' findings, CBO calculated a set of ratios that relate a loss in economic welfare to each $1 reduction in U.S. trade, depending on the size of the economy targeted by sanctions, the participation of other nations, and the time horizon. Those ratios could be used to estimate the total cost of a particular sanction by multiplying the appropriate ratio by the direct loss of trade attributable to that sanction.

Those ratios support the idea—derived from economic theory—that the cost of unilateral U.S. sanctions on a particular economy is likely to be smaller than the cost of multilateral sanctions. And although the cost of both types of sanctions grows over time, that growth tends to be smaller for unilateral sanctions because opportunities for substitution (which are the key reason that unilateral actions are less effective) also grow over time. In terms of the size of the economy targeted, the cost will generally be:

- Small for small developing economies, which account for little U.S. trade now;

- o Somewhat larger for big emerging economies, such as China, which are likely to account for an important share of U.S. trade in the future; and

- o Largest for industrialized economies, which are highly integrated with the U.S. economy and already account for significant U.S. trade.

The lowest cost to the overall economy would come from a unilateral sanction imposed on a small developing economy. Countries in that category—mainly ones in Latin America, Africa, Asia, and Eastern Europe—buy about 15 percent of U.S. exports in all. Current sanctions disproportionately target developing economies that individually account for a very small share of U.S. trade and that supply commodities that are widely available from other sources. Many of those sanctions represent unilateral actions by the United States. Thus, Hufbauer's 1997 study, which examined the effect of current sanctions, provides an indication of the costs of unilateral sanctions on small developing economies. His results suggest a loss in U.S. national income of 5 cents for each $1 of decrease in exports because of sanctions.

That figure may represent a ceiling on the actual cost of such sanctions. Hufbauer's results probably overstate the disruption of exports caused by current sanctions because they do not count the economic gains from increased exports to unsanctioned countries or account for other important factors that could explain the

low volume of trade with sanctioned countries. For example, the domestic policies of nations such as Cuba contribute to their poor economic performance and limited export potential. Moreover, many U.S. actions against small economies limit only foreign assistance or trade in commodities (such as petroleum) for which substitutes are readily available. Those actions should cost the United States little if anything.

The highest cost to the economy would come from sanctions imposed on a large industrialized economy. Countries in that category—including Western European nations, Canada, Japan, and Australia—account for about 60 percent of U.S. exports. To determine what sanctions on those countries might cost, CBO looked at studies of the gains from liberalizing trade by Mun Ho and Dale Jorgenson, Warwick McKibbin, Drusilla Brown and colleagues, and Gary Hufbauer and Kimberly Elliot, among others. Several of those studies modeled the effect of unilateral U.S. action to reduce trade barriers. Viewed from the opposite perspective, their results indicate that multilateral sanctions on trade with an industrialized country could lower U.S. income by 10 cents for each $1 loss of exports in the long term. (The same would be true for imports: a 10 cent loss of income for each $1 loss of imports. The reason those numbers would be the same is that imports tend to move with exports, because the nation's current-account deficit depends on total investment and savings, which are not affected by minor changes in trade policy.)

Other studies of large industrialized economies considered the effect of comprehensive worldwide initiatives to remove trade barriers. Their findings, when

reversed, describe the consequences of the global contraction that could result from a unilateral action to raise trade barriers against a large industrialized economy and a reciprocal, retaliatory action by that country. That type of trade war could have an extreme cost, lowering national income by between 15 cents and 35 cents for each $1 decrease in U.S. exports (or imports) in the short term and between 45 cents and 85 cents in the long term.

The income loss from cutting off trade with a big emerging economy, such as China, is likely to fall somewhere within that broad range (from 5 cents to 35 cents for each $1 of lost exports in the short term), depending on the nature of the sanction and the trade that is disrupted. For example, unilateral action restricting a few widely available imports to the United States would have a small cost at most; multilateral action affecting many specialized imports could have a large cost.

COSTS TO PARTICULAR INDUSTRIES

The direct costs of sanctions for individual U.S. industries would generally be much larger than the net cost to the overall economy. Whatever the size of those losses, they can be significant to the businesses, workers, and communities directly affected by them. Moreover, because the companies and employees who gain from redirected business as a result of sanctions do not compensate the companies and employers who lose, sanctions may seem unfair.

Although they are largely offset at the national level, the direct losses to an industry can provide a useful indicator of the social costs of adjusting to trade sanctions. Besides the dollar amount of trade disrupted, those social costs would include the costs to workers of finding new employment or relocating and costs arising from the uncertainty that such changes bring.