

Why Free Trade in the Americas?

This April Quebec City will host the third summit of the ongoing Free Trade Area of the Americas (FTAA) initiative. But even though President Bush will attend and has made trade liberalization in the Americas a high priority for his administration, many Americans' attitude toward FTAA—if they are aware of it at all—is likely to be “So what?” Compared with the time and space the media devote to other topics, the attention FTAA has received in recent years suggests that a free trade agreement spanning the Western Hemisphere carries far less news value than the average four-car pileup.

But FTAA is much more important to the economies of the Americas than this lack of interest would indicate. FTAA would mean lower trade barriers in Latin American countries, where average tariffs are two to three times those in industrialized countries.¹ Some Latin Americans oppose FTAA because they believe their countries would bear the brunt of virtually all the agreement's trade liberalization. Where is the benefit, they ask, when the United States already has such low tariffs that an FTAA agreement will not lower them much more? What they fail to consider is that even though average U.S. tariffs are markedly lower than those of Latin American countries, some types of U.S. protectionism are very high. Some of the products on which U.S. trade barriers are highest—and most damaging to U.S. consumers—are those for which Latin America has a marked cost advantage.

A second reason for FTAA is that trade agreements typically induce participants to trade more.² Rivera-Batiz and Romer (1991), among others, demonstrate that economic integration—and that is what FTAA would be—accelerates economic growth. As a corollary, Frankel and Romer (1999) find a correlation between the importance of trade in a country and the country's income level. Moreover, the direction of causality runs from trade to income, not the other way around.

Coe, Helpman and Hoffmaister (1997) show that productivity growth in developing countries increases with the openness of their trade with developed countries and with the research and development efforts of their industrialized trading partners.

And yet most Western Hemisphere developing countries, the targets of the FTAA, are not very open to trade and also do not generally trade very much.³ For the average lower or middle-income country—a broad category that includes all Western Hemisphere nations except the United States and Canada—exports as a percentage of GDP run about 21 percent. Exports of Latin American and Caribbean countries average about 14 percent of GDP; South American countries separately average about 11 percent. Chart 1 compares Latin American and Caribbean export-to-GDP percentages with those of selected countries and regions of the world, and the differences are striking.

A partial explanation for these low trade ratios is the distance of the more remote Latin American nations from potential industrialized trading partners. Another is that the high tariff barriers of Latin American countries compared with developed countries affect not only

imports but also exports. High tariff barriers, after all, make imports more costly. When these imports are used as inputs to products that are exported—or when they embody new technologies that make production of potential export products cheaper and more efficient—then high import barriers also mean low export-to-GDP ratios. Moreover, as previously noted, lower trade generally means lower GDP.

Why Liberalize Trade?

To answer the question “So what?” about trade agreements, politicians who advocate trade liberalization generally respond that it provides more jobs. Jobs are a red herring. While trade liberalization typically results in increased output by each participating country, the real benefit is increased efficiency in the form of higher output per worker even if no more workers are employed. The reason is that protectionism not only discourages imports but also creates artificially high profits in protected industries, diverting resources away from more productive and efficient but less protected industries.

In addition to artificially high profits, protectionism promotes inefficiency. Using data from a 1981 survey of more than 3,000 Brazilian firms, Braga and Willmore (1991) find that the firms' likelihood of purchasing foreign technology or of developing their own technology through research and development was negatively related to the degree to which their industries were protected from foreign competition. If you don't have to compete, why mess with success?

Opponents of trade liberalization look at it another way. They remind us that if these protected industries had to compete on world markets, many would close and their employees would lose their jobs. A closer look shows that the factors of production (labor and capital) devoted to these industries would be reallocated to business endeavors that could be profitable without charging the

Chart 1

Exports as a Percentage of Gross Domestic Product



SOURCE: World Bank.

consumer-gouging prices that government protectionism allows. This does mean, however, that during the transition from protectionism to trade liberalization, some types of labor and capital would be out of work.

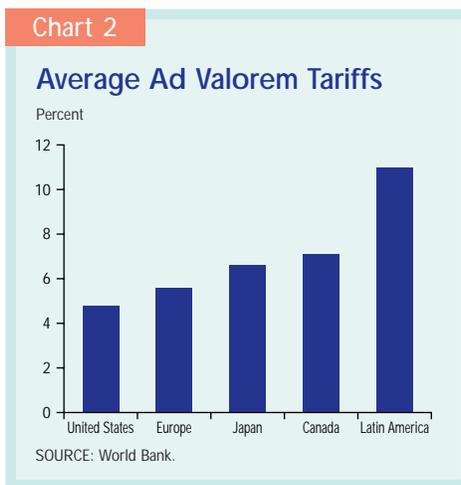
It is instructive, though, to consider the cost of preserving their employment in protected industries. In a 1990 study of 21 trade-protected U.S. economic sectors, Hufbauer and Elliott (1994) report that the average annual cost to Americans per job saved as a result of trade barriers was \$54,348. In contrast, average earnings per year per worker in these industries was \$15,649. In one sector—sugar production—the cost per year per job saved was \$256,966, even though the average worker earned only \$21,810 per year. In peanut production—another highly protected endeavor—the average cost per job saved was \$55,416, but the average annual salary was just \$17,104. Eleven years after this study, many of the same products are still highly protected.

The Price of Protectionism

Indeed, while many Americans believe that the United States and other developed countries have lowered trade barriers across a broad front, the overall picture is more complicated. It is true that the average tariff on industrial goods imported into industrialized countries dropped from roughly 40 percent in 1947 to 1.5 percent by the late 1990s (Hertel 2000).⁴ However, agricultural protection has risen from about 30 percent in the late 1960s to 60 percent in 1998 (Roberts et al. 1999).

There is a reason for the conventional wisdom, though. On average, trade barriers in developed countries are lower than those of developing countries. Chart 2 shows that average tariffs in Latin America are in the 11 percent range, compared with 4.8 percent for the United States, 5.6 percent for the European Union, 6.6 percent for Japan and 7.1 percent for Canada. But these are just averages. In fact, U.S. tariffs exceed 12 percent for approximately one-tenth of the types of products imported, and the closer you look, the worse it gets.

For example, under the putatively trade-liberalizing Uruguay Round, the United States imposes import quotas on



many products. Import quantities above these quotas then incur so-called tariff peaks, one-fifth of which exceed 30 percent ad valorem. Such peak tariffs apply to cow's milk (66 percent), yogurt (63 percent), butter (80 percent), cheese (42 percent), raw cane sugar (90 percent), peanuts and peanut butter (132 percent), chilled/frozen beef (26 percent) and sports footwear with fabric uppers (58 percent) (United Nations Conference on Trade and Development 2000). Under the Generalized System of Preferences, developing countries can export a limited number of the products at half these rates before the peak tariffs go into effect. But even at one-half off, these tariff rates hurt consumers. Also, as noted previously, only a small portion of the total income the protected companies make as a result of protectionism goes to reimburse workers.

To put these rates in perspective, it should be noted that Japanese peak rates for many products are far higher than those of the United States. In fact, based on peak rates, Japan is far more protectionist than any other developed country. Nevertheless, the fact remains that despite the ho-hum attitude of American consumers, they—and their counterparts in other Western Hemisphere countries—continue to feel the effects of punishing trade barriers.

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Notes

- ¹ Latin American tariffs are higher than those in industrialized countries even though Latin American countries have generally lowered their tariffs significantly in recent decades.
- ² Some Americans do not want more trade in any event, on the grounds that it leads to environmental damage. For a related article, see Gruben (2000).
- ³ Mexico is an obvious exception.
- ⁴ Industrialized countries here are members of the Organization of Economic Cooperation and Development, which includes the United States, Canada, Japan, the European countries and, as a recent inductee, Mexico.

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