ECONOMIC AND BUDGET ISSUE BRIEF

CBO

A series of issue summaries from the Congressional Budget Office

JULY 31, 2003

The Pros and Cons of Pursuing Free-Trade Agreements

Since the end of World War II, U.S. policy has generally supported the liberalization of international trade —that is, the elimination of artificial barriers to trade and other distortions, such as tariffs, quotas, and subsidies, that countries use to protect their domestic industries from foreign competition. The United States has pursued the objective of trade liberalization primarily by seeking agreements among large numbers of countries in successive rounds of multilateral negotiations under the General Agreement on Tariffs and Trade (GATT) and later the World Trade Organization (WTO). In recent years, however, the United States and other countries have also begun to negotiate free-trade agreements (FTAs), which eliminate almost all trade restrictions and subsidies, with various individual countries and groups of countries. A number of such agreements are on the policy agendas of the Administration and the Congress.

Like the North American Free Trade Agreement —which was examined in a recent Congressional Budget Office (CBO) paper, *The Effects of NAFTA on U.S.-Mexican Trade and GDP*—the new FTAs should have a net beneficial effect on the U.S. economy. In most cases, all of their effects—good and bad—should be extremely small. However, the arguments for and against FTAs extend beyond their net economic effects on the United States to considerations of foreign policy and tactics for achieving multilateral free trade.

The net effects of the new FTAs on the other countries involved should also be beneficial but much more significant than the effects on the United States because of the much smaller size of those countries' economies. FTAs thus provide a way for the United States to help various countries for foreign policy reasons while having little effect on the United States. They also offer a way to continue making headway toward the goal of free trade in the face of difficulties that have slowed progress in the Doha Round of WTO negotiations. In fact, they may help stimulate progress in that round because countries not party to the FTAs may fear being left behind while countries that are party to such agreements expand trade with the United States.

Critics worry, however, that the pursuit of free-trade agreements could divert the world from multilateral negotiations and lead to the development of rival trading blocs centered on the United States, the European Union (EU), and Japan. Indeed, the EU has negotiated a number of FTAs in recent years. Critics also argue that because of differences in negotiating dynamics, FTAs between small developing countries and such large entities as the United States or the EU are likely to leave in place some trade barriers that multilateral negotiations in the absence of FTAs would eliminate. Foreign-policy and tactical considerations must be weighed alongside the economic arguments in determining whether the pursuit of FTAs is an advisable path to the goal of multilateral free trade.

The Recent Increased Emphasis on Free-Trade Agreements

The first U.S. free-trade agreement, which was with Israel, went into effect on September 1, 1985; the second, with Canada, took effect on January 1, 1989. Exactly five years later, NAFTA went into effect, creating a free-trade area encompassing the United States, Canada, and Mexico.

More recently, the United States' pursuit of FTAs has intensified. A free-trade agreement with Jordan went into effect on December 17, 2001. Negotiations for free-trade areas with Singapore and Chile, begun in December 2000, have been completed, and the resulting agreements are awaiting final approval and implementation by the respective governments. Negotiations were recently launched for

a free-trade area encompassing the United States and five Central American countries—Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua—with the goal of completing the talks by December 2003. Negotiations for a Free Trade Area of the Americas—comprising 34 countries of the Western Hemisphere (including Chile and the Central American countries listed above)—are also ongoing, with the aim of completion in 2005.

On October 26, 2002, the Administration announced the Enterprise for ASEAN Initiative, the goal of which is to negotiate a number of bilateral FTAs with other members of the Association of Southeast Asian Nations (ASEAN) patterned after the agreement with Singapore. No negotiations have been announced, but likely initial candidates for agreements include the Philippines, Thailand, Indonesia, and Malaysia.

On November 5, 2002, the Office of the U.S. Trade Representative notified the Congress of the Administration's intent to negotiate a free-trade agreement with the members of the Southern African Customs Union: Botswana, Lesotho, Namibia, South Africa, and Swaziland. Eight days later, the office notified the Congress of its intent to negotiate an agreement with Australia. On January 21, 2003, the United States and Morocco announced their intention to negotiate a free-trade agreement, and on May 21, 2003, the United States and Bahrain announced such an intention. U.S. Trade Representative Robert Zoellick said: "A U.S.-Bahrain FTA could serve as a regional anchor for the Gulf, facilitating economic integration and reforms, and leading toward the eventual goal of a Middle East Free Trade Area."[1]

In 2002, the countries with which the United States had free-trade agreements—Israel, Canada, Mexico, and Jordan—received 37.2 percent of U.S. exports and provided 31.0 percent of U.S. imports. Adding in all of the countries covered by FTAs that have been negotiated but not yet approved, for which negotiations are under way, or for which the intent to negotiate has been formally announced would raise those numbers to almost 50 percent of U.S. exports and nearly 40 percent of U.S. imports in 2002 *(see Table 1 on pages 4 and 5)*.

The Benefits of Multilateral Trade Liberalization

The long-standing U.S. policy of supporting multilateral trade liberalization is consistent with well-established conclusions from economic reasoning and empirical evidence about the benefits of trade to all participating countries.

Benefits from Increased Exports and Imports

The most-direct economic benefits from international trade arise from the fact that countries are not all the same in their production capabilities. They vary from one another because of differences in natural resources, levels of education of their workforces, relative amounts and qualities of physical capital, technical knowledge, and so on. Without trade, each country must make everything it needs, including things it is not very efficient at producing. When trade is allowed, by contrast, each country can concentrate its efforts on what it does best relative to other countries and export some of its output in exchange for imports of products it is less good at producing. As countries do that, total world output increases. World output may also grow because of greater use of economies of scale, as a factory in one country can serve a market the size of two or more countries rather than one. Trade can benefit countries' economies in a number of other ways as well, such as by expanding the variety of goods available to businesses and consumers, by increasing competition and thereby reducing the extent of monopolistic pricing and the inefficiency that results from it, and possibly by pushing up the rate of productivity growth. Market forces generally ensure that all countries involved in the trade share in the benefits from the increased output.

Irrelevance of the Balance of Trade

The growth in trade that results from lowered trade barriers is generally beneficial regardless of its effects on the balance of trade (the difference between the values of exports and imports). Some people believe that trade agreements are beneficial to the extent that they increase exports and harmful to the extent that they increase imports and thus that the benefit or harm of an agreement can be determined from its effect on the trade balance. However, it is the growth in both exports *and imports* of each country that allows production to shift to the most efficient producers

1. Office of the U.S. Trade Representative, "U.S. and Bahrain Announce Intention to Seek to Negotiate a Free Trade Agreement: First Step in Implementing President Bush's Vision of a Middle East Free Trade Area" (press release, May 21, 2003).

and thereby expands output. No country would export if it could not import. Exports constitute the giving away of valuable economic commodities in exchange for pieces of paper (currency) or additions to bank accounts that would be worthless if they could not be used at some point to purchase imports.[2]

Whatever concern that trade balances merit (which normally is very little) relates to a country's balance with the world as a whole—not its balance with any one country—and trade agreements usually do not have much effect on the U.S. balance of trade with the world. By an accounting identity, the trade balance with the world as a whole (specifically, the current-account balance) is equal to the difference between aggregate saving and gross domestic investment. Hence, for a trade agreement to have much effect on the trade balance, it would have to significantly alter either aggregate saving or gross domestic investment. Only substantial changes to barriers that affect large amounts of U.S. trade and investment (relative to the size of the U.S. economy) might do that.

Even if an agreement were to significantly worsen the U.S. balance of trade with the world, that would not undermine the benefits of the agreement. Trade deficits with the world are not generally harmful, and trade surpluses are not generally beneficial. CBO examined the U.S. trade deficit with the world in a March 2000 report and concluded that such deficits normally have a small positive effect on gross domestic product (GDP) and little if any effect on aggregate employment (although some redistribution of employment among industries may occur, and some individual workers may be made better or worse off).[3]

The Benefits of Free-Trade Agreements

The analysis of FTAs is a little more complicated than that of multilateral trade liberalization. The rules of the WTO (and before that of the GATT) stipulate that, except in relation to free-trade areas, countries may not impose a higher tariff against one member country than against another, and any reduction in a country's trade barriers must apply equally to imports from all other member countries.[4] Accordingly, any reduction in a country's trade barriers will benefit the competitiveness of all imports equally, and any resulting growth in imports from a given foreign country will displace domestic production and not displace imports from other countries.

In the case of an FTA, however, the reductions in trade barriers increase the competitiveness of imports from the other parties to the agreement not only relative to domestic production but also relative to imports from other countries. Consequently, any resulting rise in imports from parties to the agreement may displace either domestic production or imports from other countries. Economists refer to the displacement of domestic production as *trade creation* because it results in a net increase in trade. They call the displacement of imports from other countries *trade diversion* since it does not increase trade overall but rather amounts to a diversion of existing trade.

2. That statement is true notwithstanding the fact that a U.S. exporter might actually use the currency (or addition to its bank account) to buy foreign assets or currencies of other countries. Those foreign assets or currencies are of value to it only insofar as they (or income from them) can be used ultimately to purchase foreign goods and services, which would constitute imports. Similarly, the sellers of those assets or currencies would accept the currency in question only because at some point someone could use the currency to buy goods or services from the country issuing the currency. A final possibility is that the exporter might use the foreign currency received for its exports to purchase dollars that it then uses to buy foreign-owned assets in the United States. Ultimately, that would mean reduced U.S. exports in the future, which would offset the current increase in exports.

3. Congressional Budget Office, *Causes and Consequences of the Trade Deficit: An Overview* (March 2000).

4. The WTO agreement (and, previously, the GATT) allows free-trade agreements as an exception to the general requirement of equal treatment for imports from all countries. Such agreements are required to eliminate almost all artificial barriers to trade, but in practice some distortions remain. For example, the United States has not eliminated antidumping enforcement against the countries with which it has FTAs. In addition, some domestic programs to aid farmers have the effect of encouraging them to increase their production, which in turn leads to increased exports or reduced imports. Moreover, different tax structures and regulatory standards between countries can, often unintentionally, hinder trade. FTAs usually attempt to reduce the effects of some of those differences, but eliminating all of them is virtually impossible.

Table 1.

U.S. Trade in 2002 with Countries of Current and Proposed Free-Trade Agreements

	U.S. Exports to Country in Billions of Dollars	U.S. Imports from Country in Billions of Dollars	U.S. Exports to Country as a Percentage of Total U.S. Exports	U.S. Imports from Country as a Percentage of Total U.S. Imports
Agreements Already Implemented				
U.S.-Israeli Free Trade Agreement	5.3	12.4	0.8	1.1
U.S.-Canadian Free Trade Agreement	142.5	210.5	22.6	18.2
North American Free Trade Agreement (Mexico only, excluding Canada)	86.1	134.1	13.7	11.6
U.S.-Jordanian Free Trade Agreement	0.4	0.4	*	*
Agreements Negotiated but Not Yet Ratified				
U.S.-Singaporean Free Trade Agreement	14.7	14.1	2.3	1.2
U.S.-Chilean Free Trade Agreement	2.3	3.6	0.4	0.3
Agreements Under Negotiation or for Which Intention to Negotiate Has Been Announced				
U.S.-Central American Free Trade Agreement				
Costa Rica	2.9	3.1	0.5	0.3
El Salvador	1.6	2.0	0.3	0.2
Guatemala	2.0	2.8	0.3	0.2
Honduras	2.5	3.3	0.4	0.3
Nicaragua	0.4	0.7	*	*
Subtotal	9.4	11.8	1.5	1.0
Free Trade Area of the Americas (Excluding Canada, Mexico, Chile, and Central America)				
Antigua and Barbuda	*	*	*	*
Argentina	1.5	3.2	0.2	0.3
Bahamas	0.9	0.5	0.1	*
Barbados	0.2	*	*	*
Belize	0.1	*	*	*
Bolivia	0.2	0.2	*	*
Brazil	11.2	15.6	1.8	1.4
Colombia	3.3	5.4	0.5	0.5
Dominica	*	*	*	*
Dominican Republic	4.1	4.2	0.7	0.4
Ecuador	1.5	2.1	0.2	0.2
Grenada	*	*	*	*
Guyana	0.1	0.1	*	*
Haiti	0.6	0.3	*	*
Jamaica	1.4	0.4	0.2	*
Panama	1.3	0.3	0.2	*
Paraguay	0.4	*	*	*
Peru	1.4	2.0	0.2	0.2
St Kitts-Nevis	*	*	*	*
St Lucia	*	*	*	*
St Vincent and Grenadines	*	*	*	*

(Continued)

Table 1.

Continued

	U.S. Exports to Country in Billions of Dollars	U.S. Imports from Country in Billions of Dollars	U.S. Exports to Country as a Percentage of Total U.S. Exports	U.S. Imports from Country as a Percentage of Total U.S. Imports
Free Trade Area of the Americas Continued (Excluding Canada, Mexico, Chile, and Central America)				
Suriname	0.1	0.1	*	*
Trinidad and Tobago	1.0	2.4	0.2	0.2
Uruguay	0.2	0.2	*	*
Venezuela	4.1	14.4	0.7	1.2
Subtotal	34.1	51.4	5.4	4.5
U.S.-Southern African Customs Union Free Trade Agreement				
Botswana	*	*	*	*
Lesotho	*	0.3	*	*
Namibia	*	*	*	*
South Africa	2.4	4.2	0.4	0.4
Swaziland	*	0.1	*	*
Subtotal	2.5	4.8	0.4	0.4
U.S.-Australian Free Trade Agreement	12.3	6.4	2.0	0.6
U.S.-Moroccan Free Trade Agreement	0.6	0.4	*	*
U.S.-Bahraini Free Trade Agreement	0.4	0.4	*	*
All Current and Proposed Free-Trade Agreements				
Total Trade for All of the Above	**310.7**	**450.4**	**49.4**	**39.0**

Source: Congressional Budget Office based on trade data from the U.S. Bureau of the Census.

Notes: The numbers for exports are free-alongside-ship values, and the numbers for imports are customs values. Numbers may not add up to totals because of rounding.

* = less than $0.1 billion or 0.1 percent.

The distinction between trade creation and trade diversion is important because the former is more likely than the latter to produce a net economic benefit. Although trade creation may hurt some sectors, it is almost always economically beneficial overall because it occurs only when the price of the import in question is lower than the domestic cost of producing the same good. Trade creation therefore allows the domestic economy to obtain the good at a lower cost than would be possible without trade.

Trade diversion is less likely to be beneficial to the importing country (in this case, the United States) in the aggregate, although some sectors are still likely to gain from it, because it results in the import's being obtained at a higher cost to the economy. The reason is that an import's cost to the economy is different from its cost to a domestic purchaser: the cost to the domestic purchaser equals the foreign country's selling price plus any tariff imposed on the import, whereas the cost to the economy equals the foreign country's selling price only. The tariff paid by the purchaser constitutes U.S. government revenue and therefore remains with the U.S. economy rather than going to the foreign economy.

As an illustration, suppose that before NAFTA went into effect, a particular product was imported from Chile and not Mexico, but that after NAFTA, because of the elimination of tariffs on Mexican goods, the same product was

imported from Mexico and not Chile. The fact that the good was imported from Chile before NAFTA means that the price to U.S. purchasers was lower for the Chilean good than for the Mexican good. Since U.S. tariffs on the product were the same for both countries, the foreign country's selling price—the cost to the U.S. economy—must have been lower for the Chilean good than for the Mexican good. The implementation of NAFTA did not change that fact; the cost of the Chilean good to the U.S. economy remained lower than the cost of the Mexican good. However, the elimination of the tariff on the Mexican good meant that U.S. purchasers faced a lower price for that product than for the Chilean one, which was still subject to the tariff, so they bought the Mexican good even though its cost to the economy was higher.

In general, one would expect an FTA to result in some amount of both trade creation and trade diversion. If the trade diversion was sufficiently large relative to the trade creation, the agreement could conceivably end up being slightly harmful to the United States rather than beneficial (although, interestingly enough, the harm would come from imports that did not cause the pain of dislocating production by domestic industries). However, as more and more FTAs are negotiated, the later agreements become less and less likely to divert trade and more and more likely to reverse the trade diversion that resulted from earlier agreements. Returning to the example above, if NAFTA caused a rise in imports from Mexico at the expense of imports from Chile, the subsequent free-trade agreement with Chile would reverse that diversion of trade and eliminate the resulting harm. Ultimately, negotiating individual FTAs with all countries would eliminate all trade diversion and leave only trade creation—just as would happen if free trade with all countries was negotiated multilaterally in the WTO—and the United States and all other countries would benefit.[5]

5. If the United States negotiated FTAs with every other country, the result would not actually be precisely identical to multilateral free trade among all countries unless all other countries also negotiated FTAs with every country. If other countries did not, then U.S. exports to those countries might divert exports from other countries, but that would not be detrimental to the United States.

Likely Effects of Future Agreements

The effects of current FTAs shed some light on the likely effects of the proposed new agreements. The Congressional Budget Office recently analyzed the effects of NAFTA over its first eight years using a statistical model of U.S.-Mexican trade.[6] That model indicated that by 2001 (eight years into the agreement), NAFTA had increased U.S. exports to Mexico by only 11.3 percent ($10.3 billion, or 0.12 percent of U.S. GDP) and had increased U.S. imports from Mexico by only 7.7 percent ($9.4 billion, or 0.11 percent of U.S. GDP). According to the model, the agreement had almost no effect on the U.S. trade balance with Mexico, and what little effect it did have was positive in most years—a $0.9 billion increase (or 0.01 percent of GDP) in 2001. On the basis of those estimates and the results of other studies in the economics literature, CBO estimated that the expanded U.S.-Mexican trade resulting from NAFTA increased annual U.S. GDP by a small amount—probably a few billion dollars or less.

The countries with which the United States is negotiating or considering FTAs have much smaller trade with the United States than Mexico does *(see Table 1)*. Further, unlike Mexico, those countries do not share a border with the United States. Consequently, transportation costs for trade with those countries are higher, and it is unlikely that production-sharing arrangements with those countries will develop to the extent that they have across the U.S.-Mexican border. Therefore, given the results of NAFTA, one would expect the net effects on the United States of the proposed free-trade agreements to be positive but extremely small. Even the temporary disruptions to employment that would result from increases in imports that compete with domestic production should be very small.

The effects of the FTAs on the economies of the partner countries are likely to be much larger, however, because those countries have much smaller economies than the United States does. The NAFTA-induced increase in U.S. exports to Mexico by 2001 indicated by the CBO model, although trivial in comparison to the U.S. economy, equaled 1.9 percent of Mexican GDP. Likewise, the NAFTA-induced increase in U.S. imports from Mexico by that year equaled 1.7 percent of Mexican GDP. The dispar-

6. Congressional Budget Office, *The Effects of NAFTA on U.S.-Mexican Trade and GDP* (May 2003).

ity in size between the U.S. economy and the economies of many of the countries for which free-trade agreements have been proposed is even larger than that between the U.S. and Mexican economies. Thus, the benefits to those economies relative to the benefits to the U.S. economy are likely to be even larger than was the case for Mexico with NAFTA. Moreover, the economies of many small developing countries are less diversified than the U.S. economy, producing one or two main products for export. An agreement allowing those products into the United States would be of tremendous benefit to such a country's economy.[7]

Reasons for and Against the Pursuit of Free-Trade Agreements

One reason for the recent U.S. pursuit of FTAs is that progress in multilateral trade negotiations has become more difficult. The increasingly large membership of the GATT/WTO over time means that more countries must reach agreement in each subsequent round of negotiations. The newer members are generally developing countries that see their interests as being different from those of the United States and other industrialized countries that were more dominant in the earlier rounds. In addition, one might expect countries to agree first (that is, in early negotiating rounds) to eliminate their least politically sensitive trade barriers, leaving the more sensitive ones for later rounds and consequently making those later rounds more difficult. The current Doha Round of WTO negotiations had an original goal of completion by January 1, 2005. However, the EU's resistance to compromise on the politically difficult issue of its agricultural policy and the United States' resistance to compromise on its antidumping policy have dimmed prospects for timely completion of those talks. Free-trade agreements allow progress in trade liberalization to continue with countries for which those issues are not important stumbling blocks.

The negotiation of FTAs by the United States could also help to stimulate progress in the WTO talks. Over the years, the U.S. economy has grown substantially faster than the Japanese and European economies have, and countries resisting compromise in the Doha Round will not want to have their exports to the United States diverted by exports from countries with which the United States negotiates free-trade agreements. The prospect of such diversion could put pressure on countries to make concessions to achieve an agreement in the Doha Round or to negotiate their own FTAs with the United States.

Foreign policy constitutes a second reason for the United States to seek FTAs. Because the proposed free-trade agreements would be of substantial benefit to the economies of small developing countries while having little effect on the U.S. economy (and a beneficial effect at that), they provide a relatively easy way for the United States to help such countries.

The 1985 free-trade agreement with Israel was of value to the United States almost entirely for reasons of foreign policy. FTAs (or the prospect of them) with other Middle Eastern countries also have value for the United States as a tool for stabilization and development and as a carrot in foreign-policy negotiations. An FTA with the members of the Southern African Customs Union would aid the development and stability of a number of extremely poor countries.

Foreign policy was also part of the motivation for NAFTA. Although Mexico was a relatively large U.S. trading partner, a number of people argued that the agreement would have only a small effect on the U.S. economy but would help secure the large amount of trade and other economic liberalization that Mexico had enacted over the previous decade.

Opinion in favor of pursuing free-trade agreements is by no means unanimous. Some critics worry that FTAs might divert the world away from multilateral trade liberalization and lead to the development of large, competing trading blocs—the United States and the Western Hemisphere, the EU and nearby countries, and Japan and its trading partners in Asia and the Pacific Rim—a result that would be inferior to multilateral free trade. Critics also note that the large size of the U.S. economy and its consequent desirability as a market give the United States a great advantage in negotiations with individual countries, especially small developing ones. The same is true for FTAs negotiated by the EU or Japan. The result of such unequal bargaining power can be that significant trade restrictions by the large

7. For similar reasons, the adjustment costs to small developing countries as their less competitive sectors lose out to imports from the United States are also likely to be larger relative to the size of their economies.

countries remain in place that would more likely be eliminated under circumstances of more-equal negotiating power.

Further, if small countries individually negotiate disproportionate concessions in FTAs, it may be difficult to rectify the situation multilaterally in WTO talks because the small countries will no longer have anything of substantial interest to trade away to the large countries in exchange for the latter eliminating their remaining significant barriers. Critics argue that if negotiations were instead to remain in the WTO with no free-trade agreements, the small countries could band together to increase their bargaining power. The result would be a more equal—and quite likely closer to total—elimination of trade barriers, which would benefit all countries. That argument assumes that progress in multilateral trade talks will eventually occur.

Supporters of pursuing FTAs could argue that the EU has already negotiated a number of such agreements with various trading partners and that, consequently, refusal by the United States to negotiate such agreements would not stop any tendency that might exist toward the development of trading blocs. Instead, it only leaves the United States out of the opportunity to have more trade in its own bloc.

In summary, economic reasoning alone cannot determine whether FTAs are an advisable path to take to an eventual goal of multilateral free trade. Foreign policy and tactical considerations are also important. Multilateral free trade is the most desirable trade policy from the standpoint of overall U.S. economic productivity and efficiency. FTAs are similarly beneficial, but to a lesser degree, provided that they do not result in too much trade diversion (and, as noted earlier, trade diversion disappears as more countries are covered by such agreements).

Related CBO Publications: *The Effects of NAFTA on U.S.-Mexican Trade and GDP* (May 2003) and *Causes and Consequences of the Trade Deficit: An Overview* (March 2000).

This policy brief was prepared by Bruce Arnold of CBO's Microeconomic and Financial Studies Division. It and other publications by CBO are available at the agency's Web site (www.cbo.gov).

CONGRESSIONAL BUDGET OFFICE
U.S. Congress
Washington, DC 20515

INSIDE MAIL